The Vietnamese Economy

Awakening the dormant dragon

Edited by

Binh Tran-Nam and Chi Do Pham

RoutledgeCurzon
Taylor & Francis Group

The Vietnamese Economy

This book, written by economists of Vietnamese origin, is an extremely comprehensive collection of economic issues facing Vietnam. The chapters cover the full spectrum of economic topics, ranging from macroeconomics, microeconomics and international trade to sectoral and structural issues such as agriculture, education, information technology, institutional reforms as well as income distribution and poverty measurement.

Themes covered in this insightful book include:

- the success of Vietnam's *Doi Moi* in the early 1990s;
- the slowdown of economic growth in recent years;
- the rapidly changing external environment due to globalization;
- the growing environmental degradation and income inequality.

The Vietnamese Economy will greatly interest a wide range of readers, from students of transitional economies and Asian studies, through academics and researchers in these areas to policy makers, advisers and business persons with interest in Asia.

Binh Tran-Nam is senior lecturer at the University of New South Wales.
Chi Do Pham is visiting associate professor at the American University and was previously senior economist with the IMF.

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RoutledgeCurzon
Taylor & Francis Group
LONDON AND NEW YORK

First published 2003
by RoutledgeCurzon
11 New Fetter Lane, London EC4P 4EE

Simultaneously published in the USA and Canada
by RoutledgeCurzon
29 West 35th Street, New York, NY 10001

RoutledgeCurzon is an imprint of the Taylor & Francis Group

This edition published in the Taylor & Francis e-Library, 2005.

"To purchase your own copy of this or any of Taylor & Francis or Routledge's
collection of thousands of eBooks please go to www.eBookstore.tandf.co.uk."

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data
A catalog record for this book has been requested

ISBN 0-203-63909-X Master e-book ISBN

ISBN 0-203-63935-9 (Adobe eReader Format)
ISBN 0-415-29651-X (Print Edition)

This book is dedicated to the young generation of Vietnamese origin, especially the children of the contributors and editors

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Chi Do Pham is visiting associate professor in economics at the Kogod School of Business of the American University. Prior to returning to academia in 2001, he was senior economist for many years at the IMF in Washington DC. Born in Hanoi, he obtained a BSc in economics at Université Laval under the Colombo Plan (Canada) scholarship program, and an MA and PhD in economics at the University of Pennsylvania. He was an instructor at the University of Pennsylvania. He was also the IMF resident representative in Togo (1985–8) and Laos (1990–4). His research interest includes international finance, monetary policy and economic development with focus on Vietnam, ASEAN and Africa. He has edited two books on the Laotian economy and published a number of IMF country studies and research papers.

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Foreword

This book has been dedicated to the young generation of Vietnamese origin. Rightly so, because this book, like those to whom it is dedicated, is a cause for celebration. The book is the first of its kind in Vietnam, written by Vietnamese scholars at home and overseas, for students of Vietnam (of all ages), about Vietnam. Dr. Binh Tran-Nam and Professor Chi Do Pham have edited a labor of love of nineteen contributing authors for their country and people, covering current thinking on all areas of the Vietnamese economy: from the 1986 launch of the *Doi Moi* reform agenda, through Vietnam's efforts to join the global family in trade and financial integration, to the topics of poverty reduction and institutional reforms of today.

The most exciting feature of this book is that current data and independent analysis are presented and written in a clear manner that can appeal to a wide audience. This is the key to generating a global debate about Vietnam's transition and prospects, to attracting foreign investment and tourism to Vietnam, and to helping awaken the dormant dragon therein.

For those of us lucky enough to be working directly with the Vietnamese government and enterprises, it is apparent that Vietnam is and will be one of the most interesting and vibrantly diversifying economies in Asia–and the world. With this book, it is perhaps the first time that outsiders can begin to appreciate the dynamism and potential of Vietnam to the same degree to which insiders have assessed it in recent years. It is a pity that the book did not appear even sooner to share the secret earlier.

For too many years, Vietnam has been overlooked in the published lists of emerging economies. It is even difficult to get weather forecasts for Vietnam on global news services. Yet Vietnam, a country of nearly 80 million people, is one of the fastest growing economies in the world; it is the second biggest exporter of rice and coffee; and half of its population is under 25 years of age, so that its literate and highly industrious labor force will be productive consumers and savers for the next 30–40 years. Hopefully this book will not only awaken the dormant dragon, but also arouse the dragon-watchers around the globe. At the same time, my own hope and expectation is that Vietnam will not only awaken, but become a *Thang Long* or ‘Ascending Dragon’–the ancient name of its capital, Hanoi. Its time is coming!

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Preface

This book was inspired by the youthful dream of the second editor when he first read the Vietnamese translation of Professor Paul Samuelson's *Economics* at the age of fifteen. He then saw economics as the principal tool by which modernity and prosperity could be brought to the underdeveloped and inward-looking economy of Vietnam. Through the ups and downs of life, this ambition had become seemingly unattainable until he met in 1999 the first editor who shares the same dream and ideal. As a result of this chance meeting, the idea of the book became crystallized and with the support of Vietnamese colleagues all over the globe, their life-long dream has finally been fulfilled.

The present book has several notable features. First, the contributors are all Vietnamese economists who live in Vietnam or around the world. Most of them possess considerable experience in teaching and research at universities, research institutes, government ministries, international institutions or private organizations. Many of them have participated in the practical designing and planning of economic development at national level. It should also be emphasized that the book brings together in a single volume, for the first time, the work of Vietnamese economists both in Vietnam and overseas.

Second, unlike previous books on the Vietnamese economy, the present book is very comprehensive in its scope. The various chapters cover the full spectrum of economic issues, ranging from macro economics, microeconomics and international trade to sectoral and structural issues such as agriculture, education, information communication technology, institutional and environmental reforms, and to income distribution, social safety net and poverty measurement. The contributors not only employ current data but also present independent and critical analyses of the many important aspects of the Vietnamese economy.

This book is intended for a very wide readership. While the analysis is rigorous, all chapters are written in a fairly non-technical manner. Potential readers include students (undergraduate and postgraduate), academics and researchers who are interested in Vietnamese studies, Asian studies and transitional economies. The book should appeal to economic experts working in government departments and international organizations as well as business people who wish to conduct business in Vietnam (including both current and potential foreign investors). It should also be of interest to those overseas Vietnamese who wish to find out about recent economic developments in Vietnam.

Two final remarks deserve mention. First, the subtitle of the book is used in a figurative sense. Vietnam has never been a tiger, let alone a dragon, economy. But according to Vietnamese legend, the Vietnamese people are descendants of the Dragon King. Awakening the dragon in this context can be thought of as an attempt to remind and arouse the Vietnamese of their proud historical tradition. This also explains why the book is dedicated to all young people of Vietnamese origin.

Second, all chapters reflect the contributors' own personal views and assessments. These are not necessarily the views endorsed or policies recommended by the institutions with which they are affiliated. The editors and contributors are alone responsible for any errors or shortcomings that may remain in the book.

Acknowledgments

This book is a joint product of many persons from around the world. First of all, we wish to express our gratitude to each and every contributor of this book. Their contributions, fellowship and cooperation helped to bring this book into being within a remarkably short period of time.

In editing this volume we have also received invaluable comments and suggestions from many generous friends and colleagues. It is not possible to acknowledge each of them individually. Nevertheless, special thanks must go to Dr. Le Anh Tu Packard, Dr. Nguyen Duy Chinh and Professor Thai Van Khi for their constant encouragement and constructive advice.

Some of the chapters in this book were presented at a conference in Hanoi in May 2001. The conference was organized by the Central Institute of Economic Management (CIEM) and funded by the United Nations Development Programme (UNDP) in Hanoi. We wish to thank both CIEM and UNDP for providing overseas Vietnamese economists with a first ever forum for sharing ideas and discussing policies with their nationally resident Vietnamese counterparts. We are particularly grateful to Dr. Le Dang Doanh, the then director of CIEM, and Mr. Edouard Wattez, the then Resident Representative of UNDP in Hanoi. Our most sincere thanks must also go to Dr. Youske Horiguchi, Dr. Chanpen Puckatikom, Dr. Susan Adams, Mr. David Cowen and Professor Michel Robe for their friendship and support.

A modern book typically comes into existence with the support of a capable editorial team. We would like to single out for praise the ever cheerful, timely and unconditional assistance of Pham Tieu Muoi, our style editor. We are also greatly indebted to Colin Fong, our proofreader, and the Routledge editors Terry Clague and Robert Langham, the copy-editor Steve Turrington and two anonymous reviewers. Their professional and enthusiastic approach has resulted in vast improvements to the book.

Last, but by no means least, we wish to thank our families for their love, understanding, patience and support throughout all stages of this project.

Binh Tran-Nam, Sydney
Chi Do Pham, Washington DC
25 March 2002

Abbreviations

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
AICO	ASEAN Industrial Cooperation
AIPA	ASEAN Intellectual Property Association
AMA	Asset management corporation
APEC	Asia–Pacific Economic Cooperation
APTA	ASEAN Preferential Trading Agreement
APTO	ASEAN Patent and Trademark Office
ASEAN	Association of South East Asian Nations
BTA	Bilateral trade agreement
CALAVI	Cambodia Laos Vietnam CC Central Committee
CEPT	Common Effective Preferential Tariff
CGE	Computable general equilibrium
CMEA	Council for Mutual Economic Assistance
CPC	Communist Party of China
CPI	Consume price index
CPM	Capability poverty measure
CHC	Commune health center
CPV	Communist Party of Vietnam
CS	Civil service
EU	European Union
EV	Equivalent variation
FDI	Foreign direct investment
FIL	Foreign Investment Law
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariff and Trade
GDP	Gross domestic product
GNP	Gross national product
GCOP	Government Committee for Organization and Personnel
GSO	General Statistical Office
GTAP	Global Trade Analysis Project
GTM	Gravity trade model

HDI	Human Development Index
HPI	Human Poverty Index
HRS	Household responsibility system
IAP	Individual action plan
ICOR	Incremental capital output ratio
ICT	Information and communication technology
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
LSS	Living Standard Survey
MBN	Minimum basic needs
MFA	Multi Fiber Arrangement
MFN	Most favored nation
MFP	Multi-factor productivity
MOET	Ministry of Education and Training
MOF	Ministry of Finance
MPI	Ministry of Planning and Investment
NA	National Assembly
NT	National treatment
NIEs	Newly industrialized economies
NGO	Non-government organization
NPL	Non-performing loan
NTB	Non-tariff barrier
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PAR	Public Administration Reform
PPP	Purchasing power parity
RCA	Revealed comparative advantage
ROW	Rest of the world
SOE	State-owned enterprise
TFP	Total factor productivity
TRIMS	Trade-related investment measures
TRIPS	Trade-related aspects of intellectual property rights
TVEs	Township and villages enterprises
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
WB	World Bank
WTO	World Trade Organization

Part I

Overview

1 Introduction and summary

Binh Tran-Nam and Chi Do Pham

1 Background

The history of Vietnam is one of continuous struggle, whether against its giant northern neighbor, the weaker southern kingdoms, or the colonialists from the West and the East. In modern times, perhaps no other country on earth has paid a higher price than Vietnam in its fight for political independence. After 30 years of full-scale war ending in 1975, Vietnam's economic performance was seriously hampered by the failures of its foreign policy and command economic management, the collapse of the former Soviet Union and the US-led trade and investment embargo.[1] As a result, Vietnam stood among the poorest countries in the world in terms of standard of living.[2]

The failure of Vietnam's first post-war five-year plan (1976–80) forced its leadership to consider alternative approaches to improving Vietnam's economic performance. Even before the collapse of the communist regimes in Eastern Europe, Vietnam had already begun to make a tentative shift towards a market economy. This process, known as *Doi Moi* (meaning renovation, renewal or reform), was officially embraced by the Communist Party of Vietnam (CPV) in its sixth congress in 1986. The Vietnamese leadership finally came to accept that prolonged peace and constructive engagement with the outside world is the first step towards rescuing the country from its disabling isolation and economic backwardness.

Economic liberalization has produced impressive results in Vietnam, especially after the US lifted its embargo on trade with Vietnam in February 1994. The economy seems to have made good progress on many fronts, including macroeconomic stabilization, economic growth and poverty alleviation. For example, during the decade 1986–95, Vietnam's real GDP growth rate was highest among the 40 poorest countries listed in the *World Development Report 1996* (see World Bank 1996:172 and 188). In fact, considering its macroeconomic problems and its dependence on the former Soviet Union in the mid 1980s, Vietnam's economic performance in the early years of *Doi Moi* was comparable to that of China, one of the fastest growing economies in the world.

The gradual transformation of the Vietnamese economy has also given rise to a rapid growth in the quantity and quality of research papers focusing on Vietnam. This literature growth is clearly demonstrated by the long lists of references in a special focus issue of the *ASEAN Economic Bulletin* (1996) devoted to Vietnam. More substantial publications on Vietnam include, for example, Than and Tan (1993), Fforde and de Vylder (1996), IMF (1996), Harvie and Tran Van (1997), Griffin (1998) and Beresford and Dang (2000).

However, these books are subject to a number of drawbacks.

- They focus mainly on the process of transition of the Vietnamese economy at the macro level. Many relevant and important sectoral or microeconomic issues are either neglected or inadequately discussed.
- The data used are dated. More seriously, they cover only the initial years of *Doi Moi* and the resulting analyses tend to be somewhat over-optimistic.
- With the exception of Beresford and Dang (2000), existing books typically describe and examine the Vietnamese economy from the viewpoint of outside (whether Vietnam-born or foreign-born) economists. They do not contain substantial work by nationally resident Vietnamese economists. Thus, the country's own perspective is often ignored in the literature.

2 Motivation, rationale and objectives

This book represents the collective work of nineteen Vietnam-born economists, seven of whom live in Vietnam and twelve overseas. The idea of editing such a book originated from Professor Pham's international experience as an economic adviser to developing countries, especially Togo and Laos. Between 1990 and 1994, he was appointed IMF Resident Representative in Laos. In that capacity, he was able to offer his advice to the highest levels in the Laotian government for 4 years. Due to the implementation of his various policy recommendations, the government of Laos was able to stabilize its economy very successfully. These macroeco nomic successes are documented in Pham (1994). From this experience, both editors strongly believe that it is now time to produce a similar, but more comprehensive, book for Vietnam.

The book is also directly motivated by a host of specific factors. Some of them are:

- the remarkable successes of Vietnam's *Doi Moi* in the early 1990s;
- the slowdown of economic growth in Vietnam in recent years;
- the growing income inequality in Vietnam;
- the rapidly changing external environment due to globalization and

the information communication technology revolution;

- the recently ratified bilateral trade agreement between the US and Vietnam;
- the apparent lack of active policy debate among the academic and professional economists in Vietnam; and
- the unfortunate lack of dialogue between overseas Vietnamese economists on the one hand and domestic Vietnamese economists, administrators and policy makers on the other.

This book seeks to address the above problems. In particular, it aims to:

- promote awareness of Vietnam's recent economic achievements and problems;
- discuss Vietnam's current problems, issues and challenges as the economy enters the twenty-first century;
- propose future directions and policy for Vietnam's sustainable growth; and
- foster an atmosphere of open dialogue between overseas and domestic Vietnamese intellectuals and experts, especially the English-speaking economists at home and abroad, with a view to generate sensible policy recommendations for sustained growth for Vietnam.

Some chapters of this book were presented in a conference entitled *The Vietnamese Economy Entering the 21st Century,* which was held in Hanoi in May 2001. This conference was organized by the Central Institute for Economic Management (CIEM), the leading economic think tank in Vietnam, and sponsored by the United Nations Development Programme (UNDP) in Hanoi. The conference represented the first attempt to bring overseas and domestic Vietnamese economists together in a single forum to exchange ideas and discuss economic policies of national importance.

The conference was very successful from many different perspectives. It attracted many high-ranking government officials, academics, researchers and professional economists working for various ministries in Vietnam. It has been proposed by various high-level officials that the conference be made into an annual event so that its analyses and recommendations can be incorporated into the annual Economic Report by the Prime Minister to Vietnam's National Assembly. It is important to stress that it is the book that led to the conference in May 2001, and not other way round (like many conference proceedings). The enormous success of the conference offers another reason why the book should be made available to a wider audience.

The present book possesses a number of key features:

1 It is very comprehensive in its scope. The various chapters cover the full spectrum of economic topics, ranging from macroeconomics,

microeconomics and international trade to sectoral and structural issues, such as agriculture, education, information technology and communication, institutional and environmental reforms, and to income distribution, social safety net and poverty measurement.

2 The various chapters use up-to-date data and present independent analyses of current issues of critical importance to the Vietnamese economy. Note that the contributors represent a balanced mix of economists working for universities, research institutes, government ministries, international organizations and the private sector. At the same time, the chapters are expressed in a fairly non-technical language that will be comprehensible to a wide readership.

3 All the contributors are Vietnamese economists or experts. Most of them possess considerable experience in teaching or researching at universities, research institutes, government ministries, multilateral institutions or private organizations. Many of them have participated in practical designing and planning of economic development at the national level. They have combined their technical training in the West and their understanding of the Vietnamese culture to analyze issues from a balanced perspective and propose appropriate solutions to Vietnamese economic problems. It should also be reiterated that the book brings together, for the first time, the work of Vietnamese economists both in Vietnam and overseas, in a single volume. Some of the economists residing in Vietnam have had access to unpublished data or internal reports, which are normally unavailable to overseas economists.

It is also important to stress from the outset that different authors use different sources of data, and that these data may exhibit some minor discrepancies. This is a common problem facing all economists working on developing economies in transition such as Vietnam.

3 Summary of the remainder of the book

The book is divided into four main topics:

- a broad evaluation of *Doi Moi* and related issues (Chapters 2 to 6);
- the Vietnamese economy and international economic integration (Chapters 7 to 11);
- sectoral policies and institutional reforms (Chapters 12 to 16); and
- poverty alleviation (Chapters 17 to 19).

Chapters 2 to 6 are concerned with Vietnam's past, present and future developmental issues. Before entering the new century and proposing a long-term growth strategy, Vietnam's economic planners and policy makers need to reflect on the country's path of development in the twentieth century and to determine its position, at least from a regional perspective. This is an extremely difficult task due to the lack of reliable and comparable statistics, as well as the division of the country during the years of the war. However, Professor Tran Van Tho has attempted to collect data on both North and South Vietnam, and sketched the economic picture for the entire nation in Chapter 3, reflecting on the twentieth century and comparing Vietnam with other countries in the Asia-Pacific region. The most striking feature of his study is the widening gap between Vietnam and its neighboring countries in the second half of the twentieth century. The author poses a question about the relative position of Vietnam as it enters a new century, and proposes some most effective strategies for narrowing Vietnam's gap with nearby nations.

In Chapter 3, Professor Chi Do Pham and Dr. Duc Viet Le review a decade of *Doi Moi* 1989–99. This period is an important benchmark of comprehensive and far-reaching reforms after many years of the failure of central economic planning (1975–88). In their analysis, the authors examine distinct phases of the reform process:

1 tentative macroeconomic reform in 1986, particularly with the liberalization of prices in the agricultural sector;
2 the macroeconomic deterioration during 1987–98;
3 the application of serious reform measures over 1989–90;
4 the decisive reform policies during 1989–92;
5 macroeconomic successes from 1992 to 1997; and
6 economic slowdown in the years 1998 and 1999.

In Chapter 4, author Van Nhu Dang studies the familiar macroeconomic relationship between investment and economic development during the years of *Doi Moi,* and forecasts the required rate of accumulation to achieve the growth target of 7 percent per annum set by the Vietnamese authority in its development strategy for the decade 2001–10. This chapter considers the four main sources of investment in Vietnam, including the public sector and state-owned enterprises, private sector, foreign direct investment (FDI) and official development assistance (ODA). A simple macroeconomic model is used to analyze investment demand by industry in the next 10 years. The author evaluates the implications of two alternative strategies: export promotion and import substitution.

Chapter 5, by two public finance economists, Tran Ngoc Anh and Dr. Anh Dinh Vu, focuses on shorter-term macroeconomic stabilization for the period 2001–5. Fiscal policy provides the government with an important macroeconomic tool to intervene in the economy according to its own policy objectives. Since Vietnam is transforming from a centrally planned economy and a market economy with a socialist orientation, it is crucially important for the government to understand and correctly assess the role of fiscal policy in assisting and accelerating growth, while creating a stable macroeconomic environment at the same time. The two authors also examine a number of fiscal actions that could be employed to stimulate the economy's aggregate supply curve in the long run in order to meet the needs of a society that long suffered from the shortage of many goods and services.

In Chapter 6, Dr. Van-Can Thai, considers fundamental issues relating to economic growth, social consensus and effective coordination in a general and systematic manner. In order to alleviate poverty, raise living standards and catch up with more developed nations, at the same time achieving the aim of human development, the optimal strategy involves a high and sustained economic growth which focuses on social justice and environmental protection. The author then proposes some general policies for achieving these goals and discusses the crucially important role of the government in pursuing these policies.

Chapters 7 to 11 examine Vietnam in an international setting. In Chapter 7, Dr. Binh Tran-Nam and Professor Ngo Van Long explain the benefits of economic openness from a theoretical perspective and discuss the relevance of the theory to developing economies such as Vietnam. Their analysis includes both theoretical qualifications such as strategic trade policy, foreign ownership, foreign bargaining power, volatility of portfolio foreign investment and protection for domestic infant industries, as well as specific trade and FDI problems peculiar to Vietnam. Some qualitative policy proposals are also made.

Dr. Quoc-Phuong Le in Chapter 8 seeks to verify empirically that international economic integration is beneficial to Vietnam by the use of computable general equilibrium (CGE) modelling. The benefits to Vietnam in terms of GDP growth are shown to be increasing as trade liberalization is extended from unilateral and ASEAN Free Trade Area (AFTA) to Asia-Pacific Economic Cooperation (APEC) and global. His main proposal is that Vietnam should continue the process of regional and global economic integration, especially under the broad framework of APEC and World Trade Organization (WTO).

In Chapter 9, Professor Trien T.Nguyen examines the similarities and differences of trade policy under the globalization framework of WTO and regionalization framework of AFTA. Focusing on organizational structure, he shows that these two directions of integration tend to be complementary rather than substituting. This is consistent with Vietnam's efforts in implementing AFTA reforms while at the same time negotiating to join WTO. His conclusion is that the success of trade reform requires a flexible economy that can respond to external changes from international markets.

In discussing economic reform, it is impossible not to consider China, widely regarded by many observers as the most successful transitional economy. In Chapter 10 Dr. Thien Pham studies some aspects of the Chinese economic model and attempts to draw some relevant lessons for

Vietnam. Although China achieved remarkable successes in the last two decades, how the Chinese authorities will balance the market economy and political control remains a question for years to come. This is particularly relevant to Vietnam, which will have to face similar problems and policy choices in the near future.

One of the doors to international economic integration and economic development is attracting FDI. Vietnam succeeded in the early years of *Doi Moi* with the attraction of a new and unexplored market. However, the FDI flows to Vietnam have reduced substantially in recent years due primarily to internal weaknesses, although the Asian financial crisis has also played a role. In Chapter 11, author Khai Nguyen reviews the historical level of and all major problems with FDI in Vietnam, and proposes an appropriate FDI policy for Vietnam in the next decade.

Chapters 12 to 16 are concerned with sectoral policies and structural reforms. Professor Xuan Tong Vo in Chapter 12 examines a strategy for developing markets for Vietnamese agricultural products. He analyzes the situations leading to successes and failures of the Vietnamese agricultural sector, the conditions required to respond adequately to markets, and the appropriate macro policy for market building. He proposes an all-sided strategy encompassing identification of products with a tropical comparative advantage, research on production, processing and preserving products, tax policy to encourage investment, finding and retaining new markets, providing market information to producers, and large-scale production through cooperatives.

The role of education in long-run economic development is studied by Dr. Tran-Nam in Chapter 13. He argues that human capital and technical progress will be the two most important factors for the Vietnamese economy in the long run. Although the Vietnamese government has always regarded education policy as its top priority and attempted some reforms, there has not been any clear direction of notable success since 1993. The author proposes a number of reform measures, both general and specific, that may help to overcome the present problems and difficulties facing the education and training sector in Vietnam.

The Vietnamese government has officially declared the information and communication technology (ICT) as a strategic industry. In Chapter 14, author Tran Quoc Hung considers the true potential of and the requirements for ICT in structural reform and raising labor productivity in Vietnam. He concludes that effective impacts of ICT require substantial investment over a long time period, while developing economies need synchronous investment in different areas such as education, health, transport, communication and energy. Treating ICT as a short cut to modernization and industrialization while slowing down other structural reforms is simply an illusion.

In Chapter 15, Dr. Quan Xuan Dinh explores the progress of the National Public Administration Reform (NPAR) program and the updating of the civil service in recent years. Currently institutional constraints hamper the development process. A revision of the constitution and the functioning of the party could untangle the NPAR. Given the challenges Vietnam faces, a successful public administration reform, especially a good and workable institutional framework, will likely take a long time to accomplish. Main ingredients for success are:

1 the existence of a competent civil service, and
2 further institutional reforms, especially clarifying the relationship between the government and the party, and between central and regional agencies.

Although the Vietnamese economy has made good progress since 1989, it is currently facing a number of serious problems, including environmental degradation. Dr. Hanh Van Nguyen considers this urgent problem in Chapter 16. He outlines some observations on the current environmental conditions and suggests a comprehensive approach to incorporating environmental protection measures into the ongoing reform process for sustainable economic development. Key measures suggested include refining regulations and standards, promotion of technology transfer for pollution control, reducing over-exploitation of natural resources, rehabilitation of damaged ecosystems, adoption of sustainable agricultural and aquaculture practices, and expansion of technical training and financial resources.

Chapters 17 to 19 deal with the issue of income distribution and poverty alleviation in Vietnam. Chapter 17 by Professor Nguyen Manh Hung examines the degrees of income inequality between regions and between urban and rural areas, using data relating to the period 1990–4. He studies the distribution of income from both a theoretical and an empirical perspective. In view of recent findings that suggest a negative relationship between income inequality and growth rate, he concludes that a market economy needs a socialist orientation, and provides some concrete proposals for transforming this orientation into realistic policies.

In Chapter 18, Dr. Dinh demonstrates that the economic progress during *Doi Moi* has not resulted in similar improvements in the social sector. His analysis shows that the urban area is more privileged than the rural area in terms of social services (education, health and pension/insurance). Secondary and tertiary education received a higher proportion of public funding at the expense of primary education, and contributions from users increased markedly. In the health sector, a very small fraction of the health budget is allocated to the majority of people under the commune health system. The pension and social relief expenditure concentrate mainly on public servants and war invalids. He concludes that competition in the delivery of social services and a new public–private sector partnership may be the pathway towards a viable social sector.

In Chapter 19, author Thang Tan Nguyen measures and assesses the many different dimensions of poverty, with particular reference to Ben Tre (one of the poorest provinces in the Mekong Delta). He argues that conventional measures of poverty, based on income or expenditure, only reflect some aspects of poverty. Using regression analysis, he is able to establish a statistically significant relationship between income and observable indexes, which measure housing conditions, household content and household size. The poverty line is then established according to this estimated relationship. From the application of this method to Ben Tre, a national strategy for poverty reduction is proposed.

In the concluding chapter, Professor Pham and Dr. Le propose that Vietnam should continue the vigorous reforms of the early 1990s in order to reinforce the recovery in 2000–1 and pursue the roadmap to a market economy in subsequent years. To this end, Vietnam needs to review its economic situation and accelerate the coordinated measures in a number of areas. The suggested measures include the review of all achievements and defects of policies implemented, the analysis of political constraints that slow down structural reforms and the adoption of a long-term plan for sustainable growth and social equity with an emphasis on poverty reduction strategy, especially in the rural areas.

Notes

1 Vietnam's international isolation is best measured by aid statistics. According to The Economist's *Vital World Statistics* (1990:190), Vietnam had the fourth lowest total aid received per capita in 1988 (US$2.3 per head). The countries with lower total aid received per capita were Brazil, China and Mexico. This source of data is consistent with the World Bank's *World Development Report* (1992:256) which stated that in 1990, foreign aid per capita to Vietnam was the second lowest among low-income economies (US$2.9 per head), excluding India and China. In addition, economic aid to Vietnam was often conditional. For example, Japan's aid to Vietnam was tied to the condition that Vietnam would repay, with interest, all the Japanese loans to the former South Vietnamese government.

2 By standard of living is meant GDP per capita in purchasing power parity (PPP) dollar. According to various issues of the United Nations Development Programme (UNDP)'s *Human Development Report,* Vietnam has been ranked among the 30 poorest countries in the world since 1990 when estimates of its GDP per capita in PPP dollar first became available (see UNDP 1990–9).

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Part II

Doi Moi

Past, present and future development issues

2 Economic development in Vietnam during the second half of the twentieth century

How to avoid the danger of lagging behind

Tran Van Tho

1 Introduction

Looking back at the twentieth century and comparing Vietnam with other countries in the Asia-Pacific region, one can see a remarkably widening economic gap between the former and the latter during the second half of the century. Over the last 40 years, the Asia and the Pacific region has grown rapidly, and can be characterized by an extensive industrialization across the region. Due to its historical condition, Vietnam lost several decades of development and lagged behind its neighbors. The *Doi Moi* has integrated Vietnam into the regional industrial surge in Asia. How is Vietnam positioned now and what is the prerequisite for it to shorten the distance between it and neighboring countries?

2 Vietnam's economy in the second half of the twentieth century

The war in Vietnam ended and the country was reunified in 1975, but the complicated political situation in the region made it difficult for the economy of Vietnam to move to a peaceful development stage right after the reunification (not until 1989 did Vietnam withdraw all its troops from Cambodia). The *Doi Moi* officially started in 1986, but bold and thorough steps only began in 1989 and showed effects in 1992 when the economy grew rapidly and the hyperinflation was curbed.

For these reasons, the second half of the twentieth century can be divided into two periods: 1955–91[1] and 1992–2000. The analysis of the first period will focus on the comparison of Vietnam's economic development with that of a number of neighboring Asian countries, the discussion of the second period will mainly assess the achievements of the *Doi Moi* and the positioning of Vietnam in the Asian economic picture. Prior to 1975, Vietnam had a dual economy; therefore the first period is further subdivided into 1955–75 and 1975–91.

2.1 Characteristics of Vietnam's economy from 1955 to 1991: a comparison with Asian countries

To compare the growth rate and the structure of Vietnam's economy with other countries in the region, a recalculation and conversion of Vietnam's economic indicators were needed (prior to 1993, the material product system was at work and has to be converted to the system of national account of the United Nations (UN)). Thanks to the cooperation from the General Statistical Office of Vietnam, we have successfully completed this task in a joint research program on long-term economic statistics of Asian countries.[2] Although there is room for further improving the estimates of the data, this is so far the only source available for examining the long-term economic trends in Vietnam. The analysis on Vietnam below is therefore based on the findings of our study.

As shown in Table 2.1, during 1950–73 (or 1955–75 for Vietnam), Japan experienced an exceptional growth, with per capita gross domestic product (GDP) growth averaging 8 percent annually. As a result the real income of the Japanese doubled every 8–9 years.[3] The next successful group was South Korea and Taiwan (5–6 percent), where per capita income doubled every 12–13 years. Vietnam, China and the Philippines belonged to the slowest growth group, with the per capita GDP growth averaging only 2 percent; thus it took these countries up to 35 years to double their people's income. These three countries had different political experiences, but the common factor was that politics suppressed the development of the production forces. In Vietnam throughout most of this period the economy was characterized by the war and the country was divided into two regions with different economic and political regimes.

During this period, the North Vietnamese economy growth averaged 6 percent (per capita GDP growth averaged 3 percent), and the South Vietnamese economy grew at 3.9 percent (per capita GDP growth averaged 0.8 percent). In particular, the South's growth was negative in the second half of this period (1965–75), mostly due to its widespread and bitter war. In terms of economic structure, a large share in the North's GDP was represented by industry (including mining and manufacturing sectors), while a large share in the South's GDP was taken up by services, which reflected the fact that the population was concentrated in urban areas, where the economy was sustained by American aid and military expenses.

In terms of saving and consumption, the South spent more than what it produced during 1955–75, except for the 2 years 1960 and 1971, therefore the investment to GDP ratio was extremely low (only 7–8 percent during 1955–65 and 10–11 percent during the subsequent period) and totally relied on foreign aid. The North had a higher investment ratio, but during the post 1965 period, consumption also exceeded production, therefore the balance of payment deficit was always high. In general, prior

Table 2.1 Average annual growth rate of GDP (%) of Vietnam and selected Asian countries in the second half of the twentieth century

	1950–73	*1973–96*
Vietnam*	1.9	2.8
China	2.1	5.4
Thailand	3.2	5.6
Malaysia	2.8	4.0
Indonesia	2.5	3.6
Philippines	1.8	0.8
Taiwan	6.2	6.1
South Korea	5.2	6.8
Japan	8.0	2.5

Sources: for Vietnam see Tran (1998; 1999a); for other countries refer to Crafts (1999).

Note

* Statistics for Vietnam based on the two periods: 1955–75 and 1976–95.

to 1975 both the North and the South had little saving, and the economies grew slowly and heavily relied on foreign aid.

During that time Asian countries, with the exception of China and the Philippines, achieved significant outcomes, especially in the newly industrialized economies (NIEs) like South Korea, Taiwan and Singapore. Since the early 1960s, many Asian countries followed the import-substitution industrialization strategy, and during the 1970s the NIEs started shifting to the export-oriented strategy and competed with Japan in labor-intensive industries. The share of the manufacturing sector in GDP (an important indicator that measures the degree of industrialization) of Japan reached a peak at 35 percent around 1960 and maintained that level until the mid 1970s, while South Korea caught up with Japan at high speed. By the mid 1980s, South Korea's share of manufacturing sector in GDP reached the same level as Japan at around 30 percent. ASEAN countries, especially Thailand and Malaysia, developed at a slower pace, but also actively participated in the industrialization process in the region. Since the late 1970s, the Asian industrial wave started spreading to China.

Since the mid 1980s, the Asian industrial wave shifted to a new stage with substantive change characterized by the high speed of industrialization in China and ASEAN countries, and the shift in the industrial structure took place rapidly in various countries. Japan gradually moved to the post-industrial era, but remained competitive in this sector thanks to the shift to such technology and knowledge intensive industries as auto mobile, high-quality electronics and machinery. Many facilities that produced household electrical appliances such as television, refrigerator, washing machine, car parts, and electronics moved to other Asian countries. Such NIEs as South Korea, Taiwan, and Singapore also shifted their industrial structures from labor intensive to more capital and technology intensive industries.

What was the context for the substantive change in the Asian industrial wave since the mid 1980s? Three factors deserve mention here. First, there was a change in the attitude of ASEAN countries and China toward the operation of the multinational corporations. Previously, especially prior to 1975, these countries feared that the multinationals would dominate their economies, and tried to erect barriers to and curtail the activities of these corporations. This view changed since the 1980s; this facilitated the transfer of capital, technology and managerial skills from the more advanced countries, such as Japan. Second, the Japanese yen appreciated sharply within a short period of time (only after 3 years from 1985 to 1988, the US dollar depreciated by half from 254 yen to 127 yen), which made production costs in Japan skyrocket; Japanese companies had to cope with it by expanding their investment abroad. Third, NIEs started shifting from capital and technology importers to exporters of these resources, and undertook substantial direct investment in ASEAN countries. (The second and third factors are analyzed in detail in Tran 1993 and Tran 1999b.) These three factors created strong capital, technology and business skill flows in Asia and the Pacific, and accelerated industrialization in this region.

This industrialization was also observed in the shift in the export structure of these countries. The ratio of manufactured products to total export of China and ASEAN countries increased rapidly since the mid 1980s. For example, this ratio in Thailand rose from 42 percent in 1980 to 77 percent in 1999, Malaysia from 30 percent to 82 percent and China from 48 percent to 90 percent during the same period (calculated from the UN trade statistics). South Korea (and Taiwan) were a few decades ahead of these countries, and this share reached 90 percent in 1990, and kept unchanged since then. Of course, Japan was even more advanced due to its higher stage of development and its poor natural resource endowments. Industrial development spread from Japan to NIEs, China, and more advanced ASEAN countries like Malaysia, Thailand and then Indonesia (Vietnam will be considered later). Asian economists described this phenomenon as a 'flying geese' development pattern (see Tran 1997: ch. 1 and Tran 1999b).

The industrial wave not only spread extensively, but also spread intensively in Asian countries. Within the manufacturing sector, there was also a shift in the structure. Until the 1980s, exporting industries of many Asian countries were mainly labor-intensive, such as textile, footwear, toys and simple household tools. However, at present, technology and capital intensive products such as machinery and electronic parts, have become more important as a share in the exports of these countries. The intra-industry trade became more popular in these countries and, moreover, many countries moved from net importers (meaning they imported more than they exported) to net exporter in many technology and capital intensive industries. Some examples are given below.

In the early 1980s, South Korea moved from a net importer to a net exporter in automobile, machine tools, steel and others. Thailand strongly developed its capital equipment industry over the last 10 years: from net importer to net exporter of machine tools in 1990, as export of electrical and electronic appliances increased rapidly, the trade deficit of this industry shrank very fast and the industry tended to move closely to trade balance. In China, export of machine tools increased rapidly from 1985 and more recently China moved from a net importer to net exporter in this industry; its steel and electrical appliances were also very competitive in the world market since the early 1990s. For Malaysia in 1975, machines and equipment accounted for only 6 percent of its exports, but by mid 1990s this share was more than 50 percent (a more detailed account of this point is given in Tran 1999b).

Thanks to these strong developments, East Asian countries have occupied a growing share in the world market for manufactured products. Shares of these countries grew from 18 percent in 1980 to almost 29 percent in 1996. In particular, the share of ASEAN countries and China increased fourfold during the same period.

Foreign direct investment (FDI) flows from Japan, Taiwan and South Korea further promoted the shift in the industrial structure in Asia. The comparative advantage of an industry shifted from one country to another, and the industrial structure of the more advanced countries also moved in such a way that more share was taken by high value-added industries and technology intensive industries.

The strong shift in economic structure from agriculture to manufacturing and the shift within the manufacturing sector from labor intensive to capital and technology intensive helped Asian countries grow faster in this period. As shown in Table 2.1, during 1973–96, except for Japan, the Philippines (and Vietnam), average per capita GDP of East Asian countries jumped compared to the previous period. Taiwan maintained the high growth of the previous period.

During this time, Vietnam belonged to the slowest growth group in the region (see Table 2.1) with average per capita GDP growth of about 2.8 percent. This figure was higher than that of the previous period thanks to the achievement of *Doi Moi*. As mentioned previously, the impacts of *Doi Moi* became apparent since 1992. Taking 1991 as the dividing point for the 1975–95 period, one can see that during 1976–91, per capita GDP only grew at 1.9 percent (GDP grew at 4.1 percent but the population grew at 2.2 percent). This was equal to the growth rate of the 1955–75 period. But for the 1991–5 period, average per capita GDP growth jumped to 6.6 percent (GDP growth was 8.8 percent and population growth was 2.2 percent). This was equivalent to that of Taiwan and South Korea during 1973–96.

From 1955 to the early 1990s, per capita GDP growth of Vietnam was less than 2 percent. This meant that a Vietnamese person needed 35 years to double income and living standards, while a Taiwanese needed only 11 years, and a Thai 15 years. However, if the *Doi Moi's* achievements, started in 1992, continue for a very long time into the future, Vietnam would expect to catch up with its neighboring countries.

2.2 Vietnam's economy in the late twentieth century

The economy of Vietnam experienced high and stable growth (at 8–9 percent) from 1992 to 1997, which is comparable to the neighboring Asian countries. The Asian financial crisis in 1997 brought many countries to recession in 1998, but they recovered in 1999 and 2000. Vietnam was also affected by the crisis (mainly in the areas of exports and inflows of foreign direct investment), and its economy slowed down to 4–5 percent growth per annum. As this chapter takes a long-term view, the issues of the last 3 years of the twentieth century are temporarily put aside. We will return to this period when discussing how Vietnam can avoid the trap of lagging behind in the future.

Vietnam's remarkable development performance during 1992–7 can be attributed to two groups of factors. The first was related to the bold measures and policies of *Doi Moi* from 1989, which liberalized the market and mobilized resources for development, first of all in agriculture, and then in industry and services, in parallel with the efforts to bring hyperinflation under control. The second group was related to the international context that became more favorable to Vietnam. Japanese aid commenced in 1992 and the donor community, comprising developed countries and international institutions, started to provide official development assistance (ODA) to Vietnam from 1993. This helped to quicken the pace of infrastructure development in accordance with the government's plan.

These two groups of factors allowed Vietnam to participate in the international division of the dynamic Asia-Pacific region. By 1994, more than 70 percent of Vietnam's trade was with this region (prior to 1990 more than 70 percent of Vietnam's trade was with the East European countries). In particular, FDI increased rapidly during this period. These capital inflows were mainly from Japan and NIEs, which attempted to promote a strategy of industrial restructuring in the whole Asia–Pacific region. In total investment of Vietnam during 1991–5 (US$18 billion), FDI accounted for 25 percent (US$4.5 billion) and ODA 11 percent (US$2 billion). Share of FDI in total capital formation increased to over 30 percent in the period of 1995 to 1997 and declined to 25 percent in 1998, and 18 percent in 1999 and 2000. By international comparison, however, that share in Vietnam is still high.[4]

In the mid 1990s, Japanese manufacturing corporations, especially those in household electrical appliances, such as televisions, refrigerators, washing machines, plastics, chemicals and motorcycles, had plans to move their production plants from neighboring countries to the industrial and export processing zones in Vietnam. They invested a significant amount of capital in Vietnam during 1995–7. The FDI flows from Japan for the 3 years totaled 93 billion yen, while the total cumulative investment of these companies in Vietnam in years prior to 1995 was only 24 billion yen. Apart from Japan, NIEs also actively invested in Vietnam, especially in labor-intensive industries, such as footwear and garments.

Thanks to the initial achievements of *Doi Moi* and the favorable international conditions, Vietnam was able to join the industrial wave that was spreading in East Asia. The manufacturing share in Vietnam's export increased steadily from 1992. Garments and footwear accounted for 26 percent of total exports in 1997, which was higher than the combined share of crude oil and rice (25 percent). For comparison, the respective shares of those two groups of export products in 1990 were 1 percent and 38 percent.

A deeper analysis of Vietnam's manufacturing exports suggests that these achievements in export should not be overstated, since the import contents of these products were also high (for export processing). However, one has to admit that the industrial wave from Asian countries has come to Vietnam from the mid 1990s and, if continued, as indicated by the experience of neighboring countries, Vietnam in the future would be able to build for itself a more solid industrial structure.

3 Determining the position of Vietnam's economy in the late twentieth century

Where is Vietnam now in the development stage, compared to the neighboring countries? This section attempts to compare Vietnam and Thailand, the two countries which have similar population sizes (in 1990 the population of Vietnam was 66 million and Thailand was 56 million), with similar natural resource endowments, and especially during the 1950s, the two countries were at a comparable level of development.[5]

In addition, depending on the context, China is another comparable country for Vietnam, although no detailed exploration is made as in the case of Thailand. China is a very large country, but has similar political and economic regimes as Vietnam, and also commenced as a backward agricultural country; comparison may therefore be useful.

The comparison of level of development between countries is not easy, since one can hardly find a general indicator that covers the whole development level of a country. However, an exploration of a group of fundamental indicators in Tables 2.1, 2.2 and 2.3 may yield a fairly clear picture. A commonly used indicator is the per capita gross national product (GNP) or GDP. According to the World Bank, in 1996 per capita GNP of Vietnam was US$290, Thailand US$2,960 and China US$750. In 1998, the respective figures were US$330, US$2,200 and US$750.[6] However, these numbers do not fully reflect living standards, as the US dollar purchasing power varies from country to country. For a more accurate comparison,one should use the GNP or GDP based on purchasing power parity (PPP). Table

Table 2.2 PPP GNP and PPP per capita GNP of selected Asian economies in 1998

	PPP GNP	*PPP per capita GNP*	
	(US$ billion)	*(US$)*	*Compared to Vietnam (%)*
Vietnam	131	1,690	100
China	3,984	3,220	191
Thailand	357	5,840	346
Malaysia	155	6,990	414
Indonesia	569	2,790	165
Philippines	266	3,540	210
South Korea	569	12,270	726
Japan	2,928	23,180	1,372

Source: World Bank (2000).

Table 2.3 Investment and saving to GDP ratio for Vietnam, China and Thailand (%)

	1970	*1980*	*1990*	*1995*	*1997*	*1999*
Vietnam						
I/GDP*	–	–	12.6	27.1	28.3	19.7
S/GDP*	–	–	2.9	16.1	21.8	22.0
China						
I/GDP	–	35.2	34.7	40.8	38.1	37.8
S/GDP	–	34.1	37.8	41.1	41.5	39.0
Thailand						
I/GDP	25.6	26.4	36.8	41.4	32.2	26.8
S/GDP	21.2	20.1	33.6	33.4	32.4	36.4

Source: Economic Planning Agency (2000), *Ajia Keizai 2000* Tokyo: Ministry of Finance (based on the World Bank statistics).

Note
* I denotes gross investment and S gross saving.

2.2 shows that in 1998 the PPP per capita GNP of Vietnam was US$1,700, or half that of China and the Philippines. Table 2.2 also shows that Thailand's living standard is 3.5 times higher than that of Vietnam.

However, two further problems remain. First, if income distribution is too unequal, the significance of increase in per capita income is undermined. Second, environment, living and working conditions matter. People in two countries with the same per capita income (based on PPP) but different in those criteria would certainly have a very different quality of life. In brief, with more equitable development and better environmental condition, it is not necessary to have US$6,000 per capita to reach the same living standard as Thailand today.

Another group of indicators of the development level of a particular country refers to the changing economic structure. Countries with high population density and backward agriculture must follow a path of industrialization in order to develop the economy. Without industrialization, the agricultural sector itself cannot be modernized. According to World Bank statistics, in 1994 the share of industry in GDP of Vietnam was 22 percent, approximately equivalent to that of Thailand in 1980. Vietnam's statistics do not allow us to accurately calculate this share, since it usually includes mining, therefore the 22 percent might be an over-estimate of the true share. According to the calculation by Dr. Vu, a senior statistician of the UN, in 1993 this share of Vietnam was only 15 percent (see Vu 1997:90). In a book published several years ago, we based on this figure and concluded that the share of industry in GDP of Vietnam was comparable to that of Thailand in 1970 (see Tran 1997: chapter. 15). Of course, since 1993, Vietnam's industry has grown fast and its level of industrialization in 2000 might have been equivalent to that of Thailand in the latter half of the 1970s.

Regarding the share of manufactured products in exports, in 1996, Vietnam's figure exceeded 40 percent, which was equivalent to Thailand in 1987. However, as mentioned previously, the import content of Vietnam's manufacturing exports is very high. On the other hand, Thailand followed the import-substitution industrialization strategy for a long period and only started to promote exports during the 1980s, especially after 1985 (therefore the level of industrialization in Thailand's exports only started substantially increasing from 1986).

Another important indicator is the ratio of investment over GDP. GDP is the market value of final goods and services produced in a year. These final products, put simply, will be used either for private consumption or investment to generate new capital for production. As a result, the higher the investment rate, the faster the economy can grow in subsequent years. As shown in Table 2.3, this rate in Thailand was 25 percent during the 1970s and more than 35 percent during the 1990s. The rate for Vietnam has increased significantly in recent years. It was about 28 percent in 1997, which was comparable to Thailand's in the 1970s. Investment comes from both domestic (savings) and foreign sources, but the domestic source is critical, hence the saving ratio relative in GDP should steadily increase. This ratio for Vietnam now is about 22 percent, broadly equivalent to that of Thailand during the 1970s.

Based on indicators of industrialization, saving and investment, together with the additional analysis above, we can conclude that at the end of the twentieth century, Vietnam lagged behind Thailand by about 20 years. In 1997, based on the 1993 and 1994 statistics, the author suggested that Vietnam was about 25 years behind Thailand (Tran 1997, ch. 15). How should the lags of 25 years (in 1997) and 20 years (in 2000) be evaluated? Between 1993 and 2000, Vietnam grew faster than Thailand,

and the gap between Vietnam and Thailand should now be shorter than 25 years. This is an area where accurate estimates are difficult to obtain, so one can regard that the current gap between the two countries is between 20 and 25 years.

4 Strategy for shortening the gap

The analyses in the previous section broadly suggest that Vietnam is about 20 to 25 years behind Thailand. However, this does not mean that Vietnam needs that amount of time to reach the current level of development of Thailand. If proper policies are in place, latecomers can skip some stages, and this is the general trend observed in the case of Japan, South Korea and many other countries. In addition, as mentioned earlier, if Vietnam's development is more equally shared, and people live in better environmental conditions, Vietnam can reach the same level of well-being as Thailand today with a lower PPP per capita income.

Compared to Thailand, Vietnam now has a number of advantages, especially in terms of human development. The United Nation Development Programme (UNDP) combines indicators of education, health and income, and provides a general indicator on human development (Human Development Index) for 174 countries. In 1997, Vietnam ranked 110, Thailand 67 and China 98, with detailed indices shown in Table 2.4. If ranked by PPP-based per capita GDP, Vietnam ranked 133, Thailand 60, and China 104. These figures show that compared to its per capita GDP, Vietnam attained a fairly high level of human development. If measured by some more specific indicators, such as adult literacy rate, Vietnam is not much behind Thailand, and is even higher than China (see Table 2.4).

However, the deteriorating quality of education in Vietnam is a worrying sign (see Chapter 13 for a more detailed discussion). All levels of education, from primary to tertiary and post-graduate, have problems that need to be addressed. This has attracted the attention of the whole society for the past 5 years or so. Nevertheless, viewing from a more optimistic perspective, if all the current major problems in education were solved, the human development of Vietnam would be further enhanced. And, as

Table 2.4 Selected indicators on human development of Vietnam, Thailand and China in 1997

	Vietnam	*Thailand*	*China*
Human Development Index	0.664	0.753	0.701
Average life expectancy	67.4	68.8	69.8
Adult literacy rate	91.9	94.7	82.9

Source: UNDP (1999).

this advantage is harnessed, the possibility for shortening the gap from other countries will become more promising.

Another advantage of Vietnam is its geographical location, with the long coastline which is accessible by more developed countries in the region. This natural endowment, together with political and social stability, and the human capital mentioned above, have all attracted foreign companies to Vietnam since the early 1990s. If the investment conditions are further improved, the country would not be short of capital, technology and business skills necessary for catching up with other countries in the course of its development.

Vietnam's third advantage is that its cities and economic centers are fairly evenly distributed across the country. If an appropriate plan is made now, population and economic activities can be spread evenly across the country, thus avoiding severe environmental pollution and income inequality between different groups of population and between regions.

The advantages mentioned above are largely potential. These potentials should be harnessed to achieve high and sustainable economic growth. With a strong commitment to the country's development and a proper development strategy, Vietnam's GDP would grow at about 8–9 percent on average per year (per capita GDP would grow at 7 percent per year) during the first 20 years of the twenty-first century. If this target can be met, Vietnam's living standards would double every 10 years. To achieve such a high and sustainable growth for a long time, it is necessary to accelerate the capital accumulation process and create conditions for effective economic development. These two points require further elaboration.

First is the issue of capital accumulation. The current problem for Vietnam is how to create a conducive environment for both domestic and foreign capital to be invested. Since the mid 1990s, the investment to GDP ratio has risen rapidly, reaching 27–28 percent, but then dropped substantially (see Table 2.3). This was partly due to the Asian financial crisis, but more importantly to the inefficient bureaucracy, which increased the transactional costs for investment. The policy for the development of a multiple-sector economy was in place, but the non-state sector faced difficulties in accessing capital, information on investment opportunity and market. The orientation in the industrialization strategy was unclear and the frequently changing policies resulted in higher risks for investment projects.

In particular, FDI has steadily declined since 1997. Given that the domestic private sector is still small and the state-owned enterprises are inefficient and in transition, how could Vietnam maintain a high growth rate in the absence of a powerful reversal of the FDI trend? Looking at their neighboring Asian countries, the Vietnamese are fully aware of the importance of FDI in the course of globalization, and are trying to further attract FDI. After decades of development and FDI inflows, neighboring countries were able to build a much stronger industrial base compared to that of Vietnam. The technology and knowledge in business management of these countries were improved a great deal and heavily relied on the accumulated FDI stock. As a latecomer, the FDI stock of Vietnam was too small compared to Thailand, the Philippines and others. To bridge the gap and to avoid the danger of lagging behind, more attention should be paid to the role of FDI.

The second issue is the efficiency of development. Together with capital accumulation, efficient development is the most effective way to bridge the gap with the neighboring countries. Capital accumulation, though strong, cannot exceed certain limits, due to environment issues and the limitation in capital, technology and market. Therefore, at the same rate of capital accumulation, a country that is more efficient in development would grow faster. Table 2.5 indicates that capital accumulation played a very critical role in China, Thailand, Malaysia, Taiwan and South Korea during 1960–94, more than in Japan during 1950–73, which was deemed a miracle. However, Japan was much more efficient in development (measured in terms of total factor productivity (TFP)), therefore economic growth was higher in Japan than in other Asian countries.[7]

Japan's experience has many implications for Vietnam. To be efficient in development, what should Vietnam do? The author in a publication several years ago (see Tran 1997: ch. 2) presented an analysis, summarized here as follows:

1 It is imperative to create a conducive environment for sound competition (among different economic actors) and actively integrate into the world market so the capital and other production factors can be most efficiently utilized.
2 There should be a long-term plan for human resource development, and mechanism should be put in place to reward labor skills appropriately.

Table 2.5 Factors contributing to economic growth of selected Asian countries during 1960–94 (% per year)

	Output growth	*Capital*	*Labor*	*TFP*
China	7.5	3.1	2.7	1.7
Thailand	7.5	3.7	2.0	1.8
Malaysia	6.8	3.4	2.5	0.9
Indonesia	5.6	1.9	2.9	0.8
Philippines	3.8	2.1	2.1	−0.4
Taiwan	8.5	4.1	2.4	2.0
South Korea	8.3	4.3	2.5	1.5
Japan*	9.2	3.1	2.5	3.6

Source: Crafts (1999), based on findings of various previous studies.
Note:
*refers to 1950–73.

3 The environment should be created for science and technology to be widely applied in Vietnam, and business management skills spread throughout the country.
4 The administrative system should be reformed quickly (with clear responsibilities and authorities assigned to different levels of government so that management can be organized in an orderly fashion) and qualified and capable people should be promoted to the executive positions. The existing administrative system can easily increase the transaction costs for companies and is a recipe for corruption. Given that environment, businesses would have incentives to develop under-the-table relations with officials (termed as rent-seeking activities by development economists) instead of making efforts to find market, improve technology in order to reduce costs or improve product quality. A country can grow fast and efficiently when businesses make efforts in genuine profit-seeking, rather than rent-seeking, activities.

5 Concluding remarks

During the second half of the twentieth century, the industrial wave spread extensively and intensively in the Asia–Pacific region, and countries one after another joined the development process. Due to its historical conditions, Vietnam lost most of the second half of the twentieth century in economic development. The reform process has integrated Vietnam into the regional industrial surge since the early 1990s. However, at the end of the last century, there still existed a big gap between Vietnam and the neighboring countries in terms of development (e.g. the gap between Vietnam and Thailand is estimated between 20 and 25 years).

Entering the new century, given its comparative advantages in human resource development and being the latecomer in a dynamic region in terms of technology, capital and business skill development, Vietnam is fully capable of shortening the development gap between itself and its neighboring countries. However, these only represent Vietnam's potential opportunities. The sufficient conditions should be a commitment to avoiding the danger of lagging behind, taking bolder steps in reform, creating a competitive environment among different economic players, and actively attracting FDI. Those are the key factors for fast capital accumulation and efficient economic development; two prerequisites for high and sustainable growth, which will make it possible for Vietnam to catch up with neighboring countries.

Notes

1 The first period started from 1955 (not from 1951) since 1954 was an historically very significant point, and also for statistical and data reasons.
2 For statistics of Vietnam's economy during 1955–75, see Tran (1999a) and for 1975–95, see Tran (1998). The detailed calculations of this research were published in Hanoi in Vietnamese (Tran 2000). The project on long-term economic statistics for Asian countries was conducted by Hitotsubashi University (Tokyo) from 1995 to 2000.
3 There is a vast literature on the economic development of East Asia. The references are therefore skipped here. Among well-known works on this issue published in English in the past decade are World Bank (1993) and Asian Development Bank (ADB 1997). The earlier work by Oshima (1987) and a more recent work by Crafts (1999:139–66) are also useful for understanding the pattern of economic growth in this region.
4 In 1998, FDI share in total capital formation was 12.9 percent in China, 13.9 percent in Malaysia, and 12.8 percent in the Philippines. See United Nations Conference on Trade and Development (UNCTAD 2000).
5 According to Economic Commission for Asia and the Far East (ECAFE), the predecessor of UN Economic and Social Commission of Asia–Pacific (ESCAP), in 1954 the per capita income of Vietnam was US$117, while that of Thailand in 1952 was US$108 (and that of Indonesia was US$88). Quoted from Japan International Cooperation Agency (JICA 1995:13).
6 For 1996 figures, refer to World Bank 1998, and for 1998 figures to World Bank 2000. Per capita GNP of Thailand in US dollars declined between 1996 and 1998 due to the strong baht depreciation during the currency crisis.
7 The well-known argument by Krugman (1994) that Asian growth has been input-driven should be referred here. According to his view, the economic growth of most East Asian countries has been realized mainly by the expansion of inputs, particularly capital, not by technological progress. Therefore, he argues, Asian growth will not be sustained, due to the law of diminishing returns. This argument has been controversial (see, for example, Chen 1997 and Tran 2001) but it has been useful for drawing attention to the importance of the efficiency of development. While recognizing the importance of this issue, our scope in this chapter does not extend as far as such a technical efficiency issue. Instead, we emphasize the allocative efficiency of capital formation.

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3 A decade of *Doi Moi* in retrospect: 1989–99

Chi Do Pham and Duc Viet Le

1 Introduction

Since the late 1980s, most formerly centrally planned economies have undertaken market-based economic reforms. Similar to the experiences of the former Soviet Union, Eastern Europe and China, the case of Vietnam has received wide coverage (see, for example, Beresford and Dang 2000; Griffin 1998; Harvie and Tran Van 1997; Fforde and de Vylder 1996 and IMF 1996). Vietnam had begun some macroeconomic reforms in 1985 after the sixth party congress, especially with price liberalization in the agricultural sector. However, this move was followed by a long period of policy slippage and macroeconomic deterioration until 1989–90, when more serious reforms were resumed.

The focus of this chapter will be on macroeconomic lessons from the transition during the last decade 1989–99 in Vietnam, starting with decisive reform measures in 1989–92 leading to strong macroeconomic performance in 1992–7, then followed by more hesitant reforms and a slowdown in economic growth during 1998–9 with the attendant Asian financial crisis. It will analyze the unfinished policy agenda in the mid 1990s and the underlying factors leading to the country's economic difficulties in recent years.

This chapter will review how the country has managed to achieve considerable macroeconomic progress, being transformed radically from an economy with stagnation, rampant inflation and isolation in the late 1980s to an open one with sustained growth and broad financial stability through the mid 1990s. In particular, it will study how Vietnam was able to dramatically curtail inflation. It will particularly review the nexus of exchange rate policy, monetary policy and the disinflation process. Inextricably linked with this, of course, is the fiscal performance and the reduced need to rely on inflationary financing. In addition, there was an impressive (and quick) supply response that led to relatively high annual growth rates. Although a detailed analysis of the supply response is beyond the scope of this chapter, the key factors that were conducive to output growth will be highlighted.

The chapter is organized as follows. Section 2 provides the background and overview of initial conditions, key outcomes and reform policies. Section 3 focuses on the major economic policies that helped to bring about macro-stabilization within a fairly short period, namely fiscal, monetary and exchange rate policies, and some initial state-owned enterprise (SOE) reform. Section 4 then reviews the difficulties encountered and discusses unfulfilled challenges for the subsequent period (1997–9) when Vietnam experienced a slowdown due to the failure to carry out further reforms, especially in structural areas, and to the impact of the Asian financial crisis in 1997–8.

2 Background and overview

This section attempts to analyze the initial conditions of the Vietnamese economy in order to place its reforms in perspective, both historically and in comparison with other transition countries. It will review how key initial conditions and the adopted reform strategy have affected Vietnam's macroeconomic experiences and performance. In addition, it will also compare briefly some relevant parallels with Eastern Europe's centrally planned economies.

2.1 Initial conditions

2.1.1 Legacy of war and isolation

After three decades of the Indochina war and subsequent internal strife, and a long period of virtual economic and political isolation, Vietnam faced an economy in ruins and a reunification of the country's two halves with distinct economic and political systems. The challenges of reform were thus particularly formidable. The dynamics of economic transformation have been going on in the context of a political system that still emphasizes communist ideology and socialist objectives.

2.1.2 Low incomes and the role of agriculture

In the late 1980s Vietnam had a per capita income of around US$200, and agriculture was the dominant sector representing about half of GDP and generating over 80 percent of employment. The industrial sector was of relatively small size (at about 25 percent of GDP). The large agricultural sector was collectivized into production and distribution cooperatives. Farm gate prices and trade in agricultural products were administratively determined.[1]

2.1.3 Centrally planned system

The country had officially adopted the Soviet-style of central planning under which the economic system is highly regulated. Food coupons, constituting the bulk of public employees' salaries, were usable only in state stores. Trade among provinces was restricted. In addition, the industrial SOEs operated under central directives regarding input allocation and output targets. These enterprises had to transfer annual targeted amounts to the budget, regardless of their financial performance, and often had to borrow from the banking sector to finance current operations.

However, unlike the case of Eastern European transition economies, central planning in practice was not deeply entrenched in Vietnam. Because of the lack of an organized bureaucracy, central planning was introduced only in a hesitant and somewhat *ad hoc* manner, and collectivization and centralization did not fully take hold. There remained a strong market legacy, especially in South Vietnam, that facilitated subsequent market-based reforms.

2.1.4 Macroeconomic conditions

Achievements of the short episode of partial centralized planning were disappointing. Before undertaking reforms, Vietnam experienced stagnant or slow growth and serious financial crises prompted by substantial domestic and external imbalances. Domestic price controls and tight restrictions on both domestic and foreign trade led to the emergence of active parallel markets for goods and foreign exchange. Meanwhile, a distorted incentive structure created supply shortages. Moreover, lax fiscal and credit policies, which accommodated borrowing requirements of loss-making SOEs, fuelled inflation.

When aid from and trade with the Council for Mutual Economic Assistance (CMEA) countries ruptured in 1990–1, Vietnam's exports collapsed and the country was left with virtually no external reserves. Furthermore, given the limited monetization of Vietnam's economy and total lack of confidence in the local banking system, the use of domestic currency was scattered and US dollarization pervasive. In addition, due to highly negative real interest rates, private small-scale enterprises had no access to bank-credit.

As a result, informal markets for credit, goods and foreign exchange boomed, which also explained the existence of widespread smuggling and the virtual absence of domestic taxation. Indeed, one salient feature of the Vietnamese economy during this period was the important role of the informal sector. This sector helped to keep the momentum in the economy. Informal economic activities were sustained by sizable annual capital inflows provided by the large number of overseas Vietnamese, notably those in the US, in support of both consumption and investment expenditures at home. Although accurate information is not available, some rough estimates indicate that Vietnam received about US$6–8 billion during 1975–90 from overseas Vietnamese (see Dodsworth, Chopra *et al.* 1996); the amount rose sharply to US$2–3 billion a year (or about 15–18 percent of Vietnam's total exports) recently. This sizable amount of financial support, in the absence of official external aid during the period, sustained the flourishing parallel markets.

The lively experiences of the informal sector and parallel markets, in contrast to the stagnant public enterprise sector under planning directives, led to an early recognition by the Vietnamese leadership that central planning was not working well. This recognition was reinforced by the demonstration effect of the rapidly growing, market-oriented economies of neighboring East Asia. It explained the promptness with which the national authorities put in place comprehensive reform measures guided by an overall macroeconomic framework, even though macroeconomic management lacked many of the conventional tools used in a typical market economy.

2.2 Key outcomes

Facing the simultaneous challenges of systemic transformation to create a market-based economy and stabilization to restore macroeconomic balances, the reform efforts resulted in considerable progress on both fronts. On the one hand, the basic elements of a market-oriented economic system were now in place, including (i) a free price system; (ii) a small but growing, dynamic private sector; (iii) a limited but opening foreign trade regime; and (iv) the integration of widespread informal economic activities into formal markets. On the other hand, a comprehensive set of macroeconomic policies combined with some key structural measures were promptly undertaken to sharply reduce inflation within a fairly short period. Subsequently, this macro-stabilization effort was sustained by further reform measures, giving rise to a strong supply response and resulting in accelerated economic growth, increased employment and improved standards of living.

One of the most striking features of Vietnam's transition to a market economy was the considerable success in taming inflation while maintaining output. This experience of Vietnam, similar to that of China, contrasts sharply with the collapse of production and accelerated inflation in other transition economies in Eastern Europe and the former Soviet Union (see Bruno 1992). The key distinction in the case of Vietnam was perhaps the deliberate phasing of reform measures to avoid major disruptions to production activities and displacement of labor. These measures sought to develop gradually a 'new' private sector characterized by dynamic profit-oriented enterprises, while improving the operations of most 'old' SOEs left in place in key sectors. In particular, price liberalization measures and the removal of trade restrictions created monetary incentives, notably absent in centrally planned economies, which helped quickly redress the under-utilization of resources, especially in the agricultural sector. In contrast, the sudden collapse of central planning in Eastern Europe with the closing of several SOEs mostly in heavy industries caused, in the early stage of reforms, sharp contraction of production, disruption of the distribution network and serious unemployment. The key distinction lay in the large size of the agricultural sector in Asian transition economies like Vietnam and China.

At the same time, the opening of Vietnam to the world economy led to a reorientation of the bulk of its trade from the CMEA countries to the convertible currency area. The increased trade flows also led to an upsurge in foreign direct investment (FDI) and external assistance. As a result, Vietnam has built up a comfortable level of external reserves, compared with almost nil before the reform. The role of FDI was critical to Vietnam's growth performance and may explain partly some differences with the cases of former Soviet Union and Eastern European countries.

Following the liberalization policies that helped first to correct the distorted price structure and misallocation of resources, Vietnam chose to phase in an appropriate mix of financial policies, accompanied by systemic reforms, for stabilization purposes. In particular, although the exchange rate was not adopted as the nominal anchor in the early stage of macro-stabilization, de facto it served this role in the subsequent stage after the official exchange rate was brought close to the parallel market rate under strong financial policies. Thus, the nominal exchange rate was virtually constant in Vietnam during 1992–5. The relatively stable exchange rates, coupled with increased confidence in the domestic banking system, led to the increased use of domestic currency. This, in turn, helped significantly to integrate various informal markets into official channels. Meanwhile, inflation was reduced sharply from an annual average of some 157 percent during 1988–90 to some 14 percent in 1994–5 and further to about 4 percent during 1996–7, while economic growth rose from 5 percent in 1990 to an annual average of 8–9 percent in 1996–7 (see Table 3.1).

2.3 Sequence of policies

In the first phase, Vietnam began the reform process by liberalizing prices and trade, both domestic and external, so that production, consumption and investment decisions by economic agents could be increasingly based on market signals. The authorities subsequently embarked on systemic reforms to transform economic management to a market-based system. These reforms decollectivized the agricultural sector, which was not mechanized as in Eastern Europe and in which the family farm played the important role of a basic producing unit;

Table 3.1 Vietnam's macroeconomic performance, 1987–99 (% unless otherwise stated)

	1987–90	*1994–5*	*1996*	*1997*	*1998*	*1999*
Real GDP growth	4.2[a]	9.2	9.3	8.2	3.5	4.2
Inflation rate (end of period)	157.0[b]	14.0	4.4	3.6	9.2	−0.2
Overall budget balance (including grants)/GDP	−8.7[c]	−2.2	−0.7	−1.7	−2.3	−2.6
External current account balance (excluding official transfers)/GDP	−7.7[c]	−7.8	−11.0	−6.9	−4.6	4.0
External debt service ratio	42.0[c]	15.0	12.9	12.8	13.9	12.8
Official reserves (in weeks of next year's imports)	–	4.8	6.4	7.2	6.8	8.1
FDI/GDP	1.5[b]	8.2	8.1	8.3	3.5	2.5

Sources: Data are based principally on various IMF's reports on Vietnam, especially the latest report for 2001.

Notes

GDP data used in this table are IMF's estimates, which are sharply lower than those provided by the Vietnamese authorities and somewhat lower than those estimated by the World Bank and Asian Development Bank. Technical assistance is provided by the IMF Statistics Department to fundamentally review the social national account methodology and is expected to provide a commonly accepted set of national accounts statistics to be used by both Vietnam and the international financial institutions. Thus, these GDP data may be different from those used by other authors in the book, who might use GDP figures produced by Vietnam's General Statistical Office,

a average 1987–8.

b average 1988–90.

c 1989.

gave greater autonomy to public enterprises; and encouraged greater integration into the world economy. These measures were also supported by a successful land reform to spur agricultural production and domestic income. This helped consumption and aggregate demand to hold up relatively well. At the same time, the existing small-scale private sector responded strongly to improved investment and trade opportunities and helped offset the output decline associated with disappearing import demand from CMEA member countries.

In the second phase, the strategy emphasized macroeconomic stability and, in particular, inflation curtailment. Thus, tight credit policy and high interest rates were used initially to control an upsurge in inflation. Exchange rate policy was designed to reduce the large spread between official and parallel market exchange rates, the latter having been successfully used to guide relatively small adjustments of the official rate at intervals. These policies were accompanied by a strengthening of fiscal policy, including both revenue-enhancing and expenditure-containing measures, and introducing other structural reforms–notably the reforms of the exchange and trade system, the financial sector and the state enterprise sector.

3 Stabilization and reform during 1989–95

This section outlines the liberalization and decollectivization moves that first helped correct the distorted price structure and misallocation of resources, the ensuing disinflation process with the crucial role of monetary and exchange rate policies accompanied by fiscal tightening, and the role of some systemic and structural reforms that supported the favorable supply response to stabilization policies. There is ample literature discussing this important period of reforms. For example, Ljunggren (1993) and Fforde and de Vylder (1996) provide a good description and analysis of the early important reforms from the mid 1980s until 1995; Beresford and Dang (2000) give an assessment of more recent reform measures; while Dodsworth, Chopra *et al.* (1996), Griffin (1998) and Tran-Nam (1999) describe the sequencing of these policies.

1 Price liberalization and agricultural decollectivization were the key initial reforms introduced in Vietnam. They permitted a long overdue shift in the domestic terms of trade in favor of agriculture in an economy that was largely agricultural. The impact was so strong that it turned Vietnam from a rice importer to the world's third largest rice exporter by the mid 1990s.
2 In the land tenure area, Vietnam introduced contractual and leasing systems. However, it still faces the challenge of adopting full-fledged property rights to give more economic incentives.
3 Tight credit policy and high interest rates were most instrumental in bringing about price stability. This was achieved against the back-

ground of many years of financial mismanagement that included the lack of monetary control, a distorted interest rate structure and a credit allocation system based on plan directives. Despite a weak financial system and lack of many modern instruments of monetary management at the beginning of the stabilization process, monetary authorities were still able to re-establish monetary control rather quickly. Thus, monetary expansion was cut drastically, through the use of tight fiscal policy to reduce bank financing of budget deficits and of direct control instruments to slow credit growth to loss-making public enterprises. In addition, a high interest rate policy was pursued with notable results. Rates on savings deposits were significantly increased, and considerable savings previously held in a variety of asset forms (mainly gold, precious stones and foreign exchange) were shifted to financial savings with the domestic banking system.

4 The movement toward an open economy was led by an exchange system reform under which a flexible market-based exchange rate policy was adopted in two phases. In the initial phase of the disinflation process, the country undertook an early unification of the exchange rates, aligning the overvalued administered rates with the parallel market rates with a view to finding a rate that reflected market conditions better than under the fixed or managed floating system. In the subsequent phase, once the spread between the two rates had been significantly narrowed, the national authorities undertook tight financial policies to stabilize both rates. This policy turned out to be quite successful in Vietnam as it was followed by a period of broad stability of the exchange rate that strengthened the disinflation process and helped restore confidence to the local currency. The Vietnamese dong was hence fluctuating within a small trading range (10,000–11,000 dong/US$l) during 1992–5; this was quite a significant achievement of stabilization policies among transition countries.

5 The tight monetary policy was supported by a strong fiscal adjustment program that reduced significantly the overall fiscal imbalance and hence the need for deficit financing. In particular, the current fiscal balance turned around from a large deficit to a growing surplus to finance increased capital spending. On the revenue side, one of the key reforms was to replace the long-established system of negotiated transfers from SOEs to the government by well-defined tax obligations. This was an early and integral part of various tax reforms aimed at creating a relatively simple but transparent tax system. Vietnam also undertook significant expenditure control, notably a drastic reduction in civil service personnel, sharp cuts in subsidies, wage restraint, and contained capital outlays commensurate with available external financing.

6 A number of important structural reforms were also introduced that helped to strengthen the foundations for economic growth. Vietnam

liberalized its trade system and foreign investment regime during 1989–95, and reaped considerable benefits. Import liberalization was substantial, including in particular the elimination of public sector monopolies on certain goods and the reduction of quantitative restrictions.

7 The strengthening of monetary management was also facilitated considerably by a major financial sector reform whose principal elements were the establishment of a two-tier banking system and the broadening of the central bank's instruments of monetary control. The extension of banking services and improved management of commercial banks increased confidence in the banking system and was instrumental in increasing the demand for money and reducing its velocity. It also enhanced inflation control and stabilized exchange rates, increased financial intermediation, and attracted foreign capital. This was particularly highlighted by the opening of a large number of foreign banks.

8 There was also a partial restructuring of the public enterprise sector accompanied by some progress in creating the legal and institutional framework for private enterprises. While the private sector has been responsive, it continues to be confined to small-scale operations, largely due to continuing preferences given to state-owned enterprises. In Vietnam, such favoritism has been a deliberate policy, the result of an ideological commitment to maintaining a strong SOE sector coupled with concern about the 'undesirable' effects of a large private sector. In particular, as in the case of China, the Vietnamese authorities have been concerned both about the potential loss of tax revenue that SOEs provide (more than half of total tax revenues) and about the destabilizing effect of rapid labor shedding in the public sector.

4 Recent economic problems: 1996–9

Due to the standstill in economic reform after 1996, the economic growth rate of Vietnam started decelerating. In particular, from 1998, the unfavorable trend for the Vietnamese economy became pronounced; this stemmed from internal weaknesses of the economy, and was compounded by the Asian financial crisis. While some other economies in the region had been quicker to recover, Vietnam's economic performance might have still worsened, as the government needed to implement bolder reforms which aimed at mobilizing all economic participants in the development process.

4.1 Major indicators

The analysis of developments over the 3 years 1997–9 indicate that

Vietnam's economy faced a difficult path. Major indicators include the following.

4.1.1 Sharp deceleration in economic growth and steady increase in unemployment

The annual growth rate declined continuously from 1995 to 1999. While real GDP growth was 9.5 percent in 1995, it dropped to 4.2 percent in 1999. Two observations could be made from the pattern of GDP growth. First, part of growth in the first half of the 1990s stemmed from unsold products which were produced largely by SOEs. The value of inventories rose to exceedingly high levels by the mid 1990s. This is summarized in Table 3.2. Second, the deceleration of the growth rate took place in all economic sectors, as shown in Table 3.2. The growth of agriculture was not much higher than the population growth.

In the industrial sector, most industries experienced a sharp drop in their growth rate. Only a few industries such as crude oil, cement, paper, coal mining, and various other mining and consumer good industries could maintain their growth, but they, too, were confronted with difficulties because of fierce competition by imports from Asian countries, especially smuggled goods from Thailand and China. In addition, well-protected SOEs targeted import-substituting products (see below and other chapters in this book for reasons for the concentration in heavy and import substituting industries). Both the widespread smuggling and the poor quality of monopolistic SOEs resulted in high inventories of unsold goods.

According to macroeconomic theory and the experiences of many countries around the world, for an economy like Vietnam with a population

Table 3.2 Annual GDP growth by economic sector (%)

Year	*Agriculture*	*Industry*	*Service*
1986	2.4	10.3	−2.8
1987	−0.5	9.2	5.3
1988	3.9	5.3	9.1
1989	6.8	−2.8	7.6
1990	1.6	2.9	10.8
1991	2.2	9.0	8.3
1992	7.1	14.0	7.0
1993	3.8	13.1	9.2
1994	3.9	14.0	9.6
1995	4.8	13.6	9.8
1996	4.4	14.5	8.8
1997	4.3	12.6	7.1
1998	3.5	8.6	4.9
1999	5.2	7.6	2.3

Sources: General Statistical Office (1995–2000).

growth rate of 2 percent per year, a labor productivity growth of 5–7 percent, a growth of the labor force of more than 3 percent, plus 2–3 million unemployed and 6–7 million under-employed people, a minimum GDP growth rate of 6–7 percent per year is required in order to create jobs for new workers while improving the living standards of existing workers. Based on this criterion, a growth rate below 5 percent experienced by Vietnam in 1998–9 was a worrying sign. Low growth resulted in an increase in the officially reported unemployment rate from 5.9 percent in 1995 to 6.8 percent in 1998, and 7.4 percent in 1999.

4.1.2 Sluggish consumption and general cut in expenditure by households

The recurring problems of the Vietnamese economy since mid 1996, as indicated by the deceleration of growth rates in all economic sectors, made households worry about another looming bad time, similar to the one they had experienced during 1986–90. Concerns arose that future income and living standards might decline. As a result, most households began to save more to be able to better cope with a perceived difficult period ahead (Figure 3.1). The deceleration of economic growth during 1998–9, together with the negative impact of the Asian crisis, have confirmed the rationale of this pessimistic expectation.

In addition, the high-income group that emerged during the process of economic reform had already purchased enough household appliances and durable goods during 1991–5, and no longer had strong demand to buy more in the late 1990s. In this context, when private sector development was not really being fully promoted, wealthy people converted their savings into gold and hard currency. From 1997–8 to the present, as the

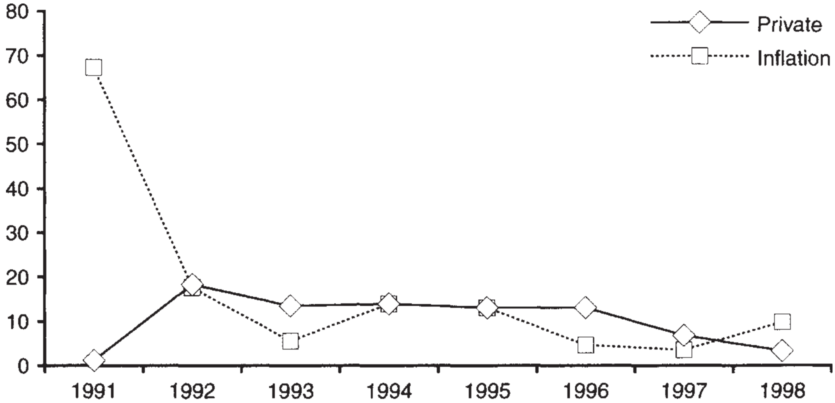

Figure 3.1 Inflation and growth in private consumption (%)

Source: Ministry of Planning and Investment (2001).

potential for devaluation of the Vietnamese dong is perceived to be high, it has further encouraged the increase in foreign currency savings.[2] Many sources of information indicate the significant outflow of funds from Vietnam during the late 1990s, as the private sector tried to send money abroad.

4.1.3 Firms are reluctant to invest

The excess supply in markets for most domestically made products resulted in a substantial decline in investment returns. In many industries, the average selling price was lower than the production cost. As a result, many firms stopped investing. This reflected the basic principle of an emerging market economy: declining profit results in lower investment.

Figure 3.2 shows a sharp drop in the growth of private investment. This drop is further accentuated by increasing competition from imports and from the foreign-invested sector. The disbursed investment of the foreign invested sector also fell dramatically (Figure 3.2). An extremely serious problem is the accelerated fall in FDI commitments, which are important in sustaining high economic growth rates for Vietnam.

In the state sector, those enterprises that enjoyed monopolistic and oligopolistic power continued to make profit even with high operating costs, while non-monopolistic enterprises just tried to survive in order to pay workers. The objective of non-monopolistic enterprises was not profit, but job creation and income generation for their own employees. Despite variations, overall investment growth in the public sector has slowed in recent years. Many SOEs were reluctant to increase capital outlays.

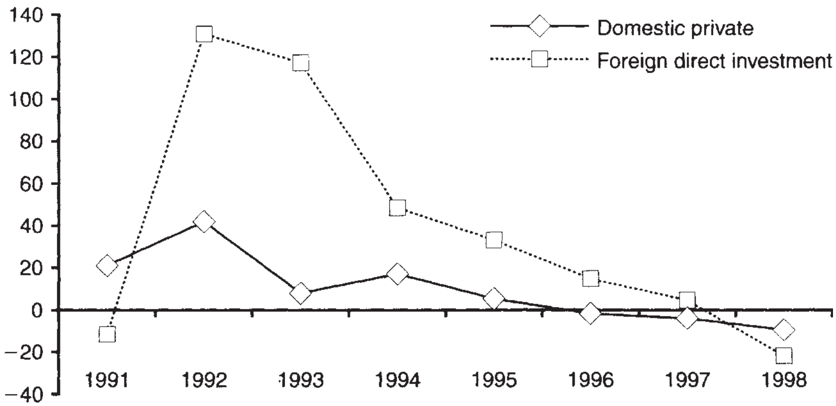

Figure 3.2 Growth of private investment and implemented FDI (%)

Source: Ministry of Planning and Investment (2001).

4.1.4 Low inflation, or even deflation, in the Vietnamese economy

Due to excess supply, inventories of unsold goods rose. Most industries operated below capacity. The rate of under-utilized capacity was very high, especially in the areas of construction, tourism, hotel and capital goods production. The general consequence was more deflationary pressure.

Inflation in Vietnam fell from 12.7 percent in 1995 to 4 percent during 1996–7, rose to 9.2 percent in 1998, and sharply fell again to 0.1 percent in 1999. As indicated in Figure 3.3, from 1992 to 1999, the monthly Consumer Price Index (CPI) increased significantly only during the traditional New Year *(Tet)* holidays, and remained stable or increased slightly during the rest of the year. From 1996, prices fell for many consecutive months. Especially, prices fell continuously after the second quarter of 1999. This was an important sign of deflation.

4.1.5 The problematic banking system

The Vietnamese banking system was under severe stress because of the extremely high rate of non-performing loans. The state of the banking system in the last few years was similar to that prior to the 1990 banking crisis. The banking sector, including joint stock banks and rural credit funds, was still kept afloat by strong government patronage. The situation of Vietnamese banks was not much different from that of East Asian countries before the financial crisis erupted. According to some foreign analysts who assessed the problems of the banking system, the Vietnamese banking system was ranked the weakest among Asian

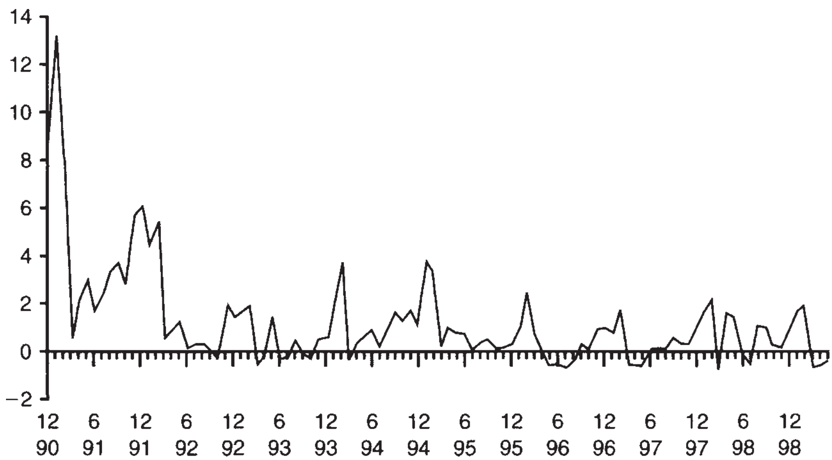

Figure 3.3 Monthly percentage change in CPI during 1991–9 (%)

Source: Ministry of Planning and Investment (2001).

countries, and it out performed only Russia and Ukraine. This made the investment environment in Vietnam unattractive.

In analyzing the causes of this situation, one could see that Vietnamese banks, like those in the crisis Asian countries, continued to lend to already highly leveraged borrowers. Compliance was poor with commercial and prudential criteria that are often used in a modern market economy to determine the credit worthiness of potential borrowers. A strong relationship existed between the political and administrative pressures, coupled with wrong decisions made by top managers in the banking system, and the proliferation of corruption among business practitioners. Consequently, total outstanding debts of banks increased rapidly while production grew slowly or did not grow at all, and production costs continued to increase. The main reason for rising production cost was that *an import-substituting strategy gradually replaced the initial export-oriented strategy, rendering well-protected and highly inefficient SOEs uncompetitive.*

In addition, quite a few enterprises used bank loans to engage in real estate speculation or to produce goods for which demand in both domestic and world markets was saturated; this happened without active monitoring by the lending banks. As a result, many enterprises became financially insolvent or bankrupt and were unable to repay their debt to the banks, which further weakened the banks.

The weaknesses of the banking system exacerbated the difficulties of the economy as a whole, in both financial and real sectors.

- Due to large loan losses, a number of private banks declared bankruptcy and were taken over by the central bank. A number of joint stock banks were also merged with state commercial banks. The third category of state-owned commercial banks survived thanks to the State Bank's financial bail-out.
- In the context of bank restructuring, commercial banks tended to reduce overall growth in lending and focus it on SOEs, which continued to enjoy implicit loan guarantees from the government. Banks also put more pressure on the enterprises in order to recover bad loans. As a result, the growth of credit declined: it fell drastically during 1997–9 and was lower than the growth of deposits.

4.2 Major causes of the current difficulties

There are several reasons for the above economic situation. Here we focus on analyzing the most fundamental causes, both internal and external. The evidence cited below indicates that Vietnam followed a development model that was too capital intensive with scant attention paid to economic efficiency.

4.2.1 The highly capital intensive model

Figure 3.4 shows the rapid economic growth of Vietnam in the early 1990s, driven by the strong growth in domestic investment and saving both in absolute terms and as a share of GDP. Domestic investment and saving was low during 1986–90, averaging 12.6 and 2.4 percent of GDP, respectively; and GDP growth in this period was only 4.3 percent on average. During 1991–5, the investment and saving ratios rose to 22.3 and 14.7 percent of GDP, respectively, and average GDP growth also increased markedly to 8.2 percent. During 1996–8, the domestic investment and saving rates continued to rise to 28.7 and 19.6 percent of GDP, respectively, but GDP growth slowed to 7.8 percent The deceleration in GDP growth during the past few years was a lagging result of a low-efficiency development strategy, and was further aggravated by the impact of the Asian currency crisis in 1997–8.

The relationship in Vietnam between economic growth and investment growth is fairly pronounced, as shown in Figure 3.5. In real terms, investment grew by an average of 30.3 percent per annum during 1991–5, resulting in real GDP growth of 8.2 percent per annum. Furthermore, the data also indicate that there was a lag of 1–2 years in the effect of investment on growth. Since investment was a driving force of economic growth in Vietnam in the 1990s, a slowing in the rate of investment growth would predict a lowering of GDP growth, unless some remedial policies had been put in place to improve investment efficiency.

4.2.2 Inappropriate investment structure

Table 3.3 shows that foreign capital played an important role in investment activities of the country. The domestic saving–investment gap (as a share of GDP) was very high during 1986–90 and 1993–7, but

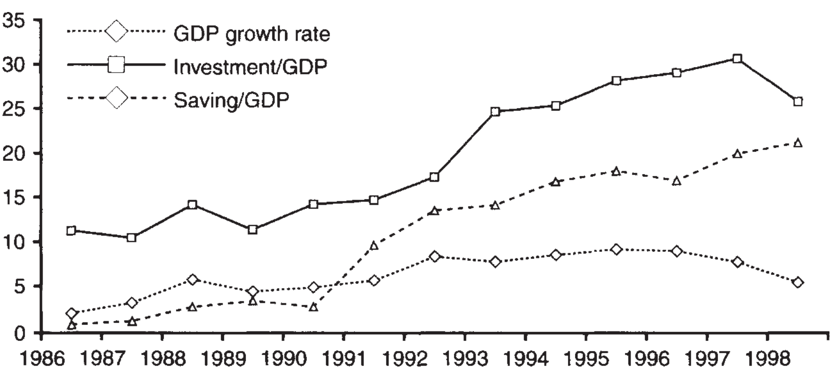

Figure 3.4 GDP growth and domestic investment and saving to GDP ratios (%)
Source: Ministry of Planning and Investment (2001).

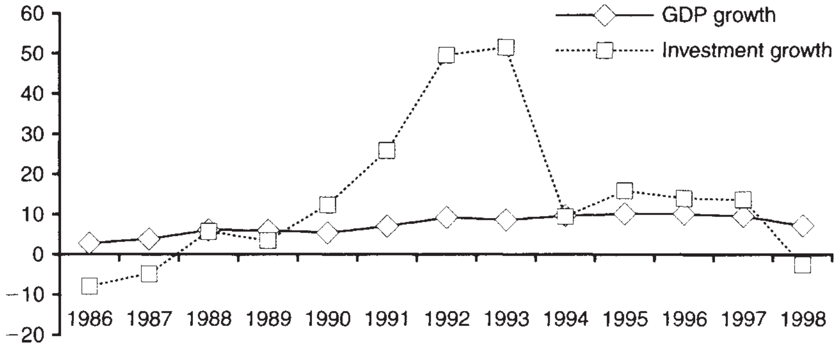

Figure 3.5 Relationship between GDP growth and investment growth (%)
Source: Ministry of Planning and Investment (2001).

fell sharply during 1991–2 when the Soviet bloc collapsed and during 1998–9 after the Asian crisis erupted. This suggested that Vietnam may have over-relied on foreign capital for its economic development. Compared to neighboring countries, it was obvious that the rate of foreign capital mobilization was very high in Vietnam. Despite the differences in political and social conditions among countries, this gap between neighboring countries did not exceed 4–5 percent of GDP. Therefore, Vietnam might wish to reconsider the benefits derived from its FDI-based strategy in the period up to the mid 1990s.

Table 3.4 gives another example of uneven investment mobilization. The share of FDI increased rapidly during 1990–6 and at some point reached one-third of total investment. Domestic investment did not increase proportionally, and the economy grew more dependent on foreign capital. The share of private and household investment fell sharply and steadily during the 1990s, and yet it was the source of investment that generated the most employment and recorded the highest economic returns. In fact, the non-state sector, including agriculture, accounted for only about 20 percent of total investment, but produced more than 30 percent of GDP and employed more than 70 percent of the labor force. This reflected the initial government policy to direct or restrict FDI to joint ventures with ailing SOEs, unlike a more liberal approach adopted in recent years. In addition, the cumbersome legal and administrative system put much burden on foreign investors, which rendered much of FDI inefficient or wasteful.

4.2.3 Inefficient capital utilization

Inefficient capital utilization was apparent not only at the economy-wide level, but also at sectoral and product levels. For the economy as a whole, the incremental capital output ratio (ICOR) of Vietnam rose very fast during the 1990s.[3] While ICOR was 1.8 in 1992, it tripled to 5.3 in 1998,

Table 3.3 Domestic saving–investment gap as percentage of GDP

Country	*1981–90**	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Vietnam	−10.2	−5.0	−3.8	−10.4	−8.4	−10.2	−12.0	−10.8	−4.7
Hong Kong	6.3	6.6	5.3	7.0	1.2	−4.3	−1.4	−3.6	0.3
South Korea	−0.9	−3.2	−2.1	0.3	−1.1	−1.8	−4.7	−1.9	13.3
Singapore	0.6	11.6	11.2	8.6	16.1	17.8	15.9	14.4	18.2
Taiwan	11.4	6.5	3.7	1.8	1.9	1.9	3.9	2.8	2.4
China	1.0	4.6	3.9	−1.6	0.6	0.3	0.9	3.3	2.5
Indonesia	1.4	−3.1	−1.6	−1.9	−2.0	−3.4	−3.4	−1.4	1.1
Malaysia	−3.3	−9.4	−3.0	−0.1	−1.6	−4.0	1.1	1.8	14.8
Philippines	n.a.	−1.7	−1.4	−8.4	−6.5	−4.8	−4.6	−3.5	0.7
Thailand	−4.9	−8.0	−6.3	−5.0	−5.6	−8.0	−8.0	−2.1	11.5
Bangladesh	−11.0	−1.3	0.7	0.1	2.3	0.3	−2.7	−2.5	−1.5
India	−1.4	−0.7	−1.6	−1.3	−2.1	−1.4	−1.1	−1.5	−1.7

Source: Asian Development Bank (1999).

Note
* For Vietnam, the period is 1986–90.

Table 3.4 Investment by source (%)

Year	*State budget*	*SOEs*	*Private firms and households*	*FDI*
1990	26.0	11.3	49.0	13.7
1991	29.8	14.5	47.0	9.7
1992	35.3	5.2	44.6	15.0
1993	38.5	7.5	31.6	21.4
1994	24.1	12.5	34.1	29.4
1995	25.6	9.7	30.8	33.9
1996	28.2	10.7	26.9	34.1
1997	31.7	14.0	22.8	31.5
1998	36.9	16.7	21.3	25.1

Source: Ministry of Planning and Investment (2001).

the fastest rising in Asia (see Table 3.5). The ICOR of Vietnam in 1998 was higher than the average ICOR during 1991–7 of other countries in the sample, while Vietnam was at a much lower level of development. This also indicates that the source of high economic growth in Vietnam in the 1990s was primarily capital-intensive investment.

At the sectoral level, investment funds were improperly allocated and were not used efficiently. According to Table 3.6, the share of investment in agriculture fell sharply during 1991–5, while this was the sector with the lowest ICOR and highest rate of employment creation. Investment in agriculture was also unstable, experiencing large fluctuations since 1995. Meanwhile, the share of investment in industry fell dramatically but that in services and social infrastructure rose significantly.

At the product level, as expected, an attempt to 'plan' investment demand by SOEs resulted in massive capital outlays in the 'wrong' industries, which led to poor economic efficiency as reflected in the build up of large unsold inventories. Typical examples were cement, steel, coal, sugar, rubber, vegetables and pork. In addition, Vietnam also made mistakes in selecting cutting-edge sectors that were not appropriate for its current stage of economic development, for example, high quality mechanical work, electronics and biology. These industries had very low rates of return with high capital requirements. Investment was also concentrated on purchasing some obsolete foreign-assembled production lines, equipment and buildings (e.g. from China for political reasons), which resulted in high production costs and hence required significant protection from competition.

4.3 The Asian economic crisis and its impact

This section will assess the two major channels through which the Asian economic crisis negatively affected Vietnam's growth, namely by leading to a major FDI fallout and shrinking the export market.

Table 3.5 ICOR of Vietnam and selected Asian countries

Country	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Vietnam	2.40	1.76	2.20	2.83	2.68	3.05	3.56	5.30
Hong Kong	5.33	4.32	4.67	5.11	8.18	7.73	6.06	−6.94
South Korea	3.45	7.69	6.34	4.08	4.06	5.21	6.98	−6.36
Singapore	5.73	5.52	3.39	3.59	3.72	4.80	4.53	24.93
Taiwan	3.00	3.35	3.89	3.88	3.98	4.16	3.12	4.58
China	3.58	2.44	2.66	3.43	3.90	4.25	4.55	4.90
Indonesia	3.42	4.65	4.64	3.93	3.79	4.09	6.27	−2.28
Malaysia	3.72	4.91	4.47	4.11	4.30	5.06	5.39	−6.77
Philippines			9.90	5.36	5.00	3.72	4.44	−47.60
Thailand	3.66	5.36	4.86	4.48	4.58	7.56	−104.25	−4.38
Bangladesh	3.85	2.67	2.60	3.36	3.14	3.07	2.88	3.04
India	28.50	4.53	3.49	2.67	3.01	3.31	5.14	4.28

Source: Authors' calculations based on Asian Development Bank (1999).

Table 3.6 Share of capital investment by sector (%)

Sector	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Manufacturing and construction	38.4	44.0	48.9	55.3	39.0	33.0	41.1	31.5
Agriculture, forestry and fishing	17.1	15.7	12.7	8.9	9.4	12.0	8.5	15.4
Services and social infrastructure	44.5	40.3	38.4	35.8	51.6	55.0	50.4	53.1

Source: Ministry of Planning and Investment (2001).

4.3.1 Foreign direct investment

From 1996–7, the incoming FDI (in terms of number of projects and the total value of projects) to Vietnam started to drop and the decline accelerated. In particular, registered FDI fell by 11.3 percent in 1998. As for the committed capital prior to 1998, the total number and value of dissolved projects rose very fast, indicating that foreign investors gave a vote of 'no confidence' and started withdrawing from Vietnam in 1997. As a result, the implemented investment capital fell by 40 percent in 1998, and continued to decline markedly during 1999–2000 (refer to Chapters 4 and 11 for further discussions on this topic).

In the past, the foreign-invested sector was always the most dynamic sector in the Vietnamese economy, with an annual growth rate of 20 percent on average during 1990–7. A sharp reduction in investment of this sector in recent years entailed a reduction in its own growth and overall economic growth. Consequently, economic stagnation deepened. Moreover, a reduction in the capital account surplus also caused the overall balance of payments to deteriorate and foreign exchange reserves to fall.

4.3.2 Foreign trade

The Asian economic crisis exerted strong pressure on the external trade and current account balances of Vietnam. It caused domestic demand in affected countries to shrink, resulting in Vietnam's lower exports. Furthermore, most Asian currencies steeply depreciated relative to the Vietnamese dong, and Vietnam's competitiveness worsened. Moreover, the crisis also caused prices of many Vietnamese agricultural exports to fall. These three factors significantly hampered Vietnam's export growth in 1998–9.

In terms of imports, the Asian crisis caused prices of imports into Vietnam to fall, thus stimulating its import demand. Imported goods vigorously competed with the domestic goods in the home market, further causing difficulties for the already troubled domestic enterprises. To fight against the expansion of imports and improve the balance of payments, the

Vietnamese authorities devalued the currency four times between fall 1997 and late 1999. The government also resorted to many traditional measures in controlling imports, such as raising import tariffs and quotas, even imposing a ban on a number of products that could be made domestically, and requiring enterprises to surrender their foreign exchange earnings to banks. As a result, imports fell by 1.1 percent in 1998 and increased by only 0.9 percent in 1999. Although the current account deficit contracted after early 1997, the overall balance of payments was in deficit for the first time in 3 years.

5 Concluding remarks

Vietnam began reforming its economy in 1986, initially through liberalizing prices in agriculture. However, after these initial steps, a long period of slow policy reforms followed, with the macroeconomic situation worsening until 1989–90, when the reform effort accelerated again. The focus of this chapter was the macroeconomic lessons drawn from the 1989–99 reform in Vietnam, starting with decisive policy measures taken during 1989–92, which led to sharply improved macroeconomic performance during 1992–7, followed by a more hesitant period of reform and a serious economic slowdown during 1998–9.

Problems in the Vietnamese economy during 1998–9 can be traced to the inward-oriented development strategy lasting since earlier years, and especially to the halt in structural reform, compounded by the Asian economic crisis. This crisis magnified the internal weaknesses that served as the main cause of the economic slowdown. Paradoxically, one of the major problems for the economy was now the excess supply of ‘unwanted’ goods produced by SOEs, while living standards were still low. This requires an urgent solution in terms of effective economic policies to bring the country out of this malaise.

Thus, the Vietnamese economy has been in a difficult period after 1997, as evident by lower GDP growth rate, dampened domestic consumption and a higher danger of deflation. Both commodity and labor markets were sluggish. Direct investment from both private and state sectors declined or slowed down, and FDI fell sharply and steadily. The inventories of unsold goods piled up rapidly and reached troubling levels. The SOE sector was the main problem, since it was an important drain on resources. Commercial transactions with foreign partners shrank. The bureaucracy and corruption in the administration became rampant. Unemployment and social unrest rose. In addition, the environment for the development of Vietnam in the next few years will not be as favorable as it was during the early 1990s, as competition for export markets and for FDI and ODA becomes fiercer.

Given the situation, what is the future direction of *Doi Moi,* and will it continue? In the short run, Vietnam should find another engine of growth in the next 1–2 years, which can temporarily replace the weakening export sector. One way is to further liberalize private sector activity in order to increase aggregate demand. Over the longer term, however, an appropriate exchange rate policy and more structural reforms are required to accelerate exports which will be vital for Vietnam to resume fast and sustainable development. Chapters 5 and 20 in this book will analyze those short- and long-term policies in greater details. In particular, Chapter 20 will review developments and further adjustment policies in 2000 and 2001.

In conclusion, the economy of Vietnam after the *Doi Moi* decade of 1989–99 ironically experienced the two most important but undesirable changes:

- the rising weight of the public sector (including the SOEs) in terms of its increased share of GDP in 1999 compared to 1989 (before *Doi Moi* began)[4]; and
- the gradual replacement of the initial export-led development strategy by an import-substituting strategy.

Both developments are fundamentally contrary to the 'growth philosophy' recommended by various important international financial institutions in support of Vietnam's economic reforms such as the Asian Development Bank, the International Monetary Fund, and the World Bank Group. This chapter has sought to demonstrate that the *reform agenda as of mid 1990s was unfinished* and would necessitate a *Doi Moi Mark II* to deal with the current situation. It also suggests that the above international financial institutions would need to take a long view of Vietnam's achievements and problems during the last decade of reforms.

Notes

1 The price system was subject to strict control, with about 70 percent of prices (mostly related to prices of food items and other basic necessities) in Laos and Vietnam being administered by the government. (see Otani and Pham 1996 and Pham 1994).

2 At the end of 1998, dong deposits in Vietnam increased about 19 percent compared to the end of 1997, while dollar deposits increased by 135 percent during the same period.

3 ICOR is computed based on the 1995 constant prices using the following methods:
(a) $ICOR(t) = I(t-1)/\Delta GDP(t)$; and
(b) $ICOR(t) = i(t-1)/g(t)$
where I(t) is the total investment of year t, $\Delta DGP(t)=GDP(t)-GDP(t-1)$, i(t-1) is the investment to GDP ratio in year t–1, and g(t) is the GDP growth rate of year t. Since
$I(t-1)/\Delta GDP(t) = [I(t-1)/GDP(t-1)]/[\Delta GDP(t)/GDP(t-1)] = i(t-1)/g(t)$ both methods above give the same result.

4 Based on an important recent study by Vu (2001), the GDP share of the public sector in Vietnam rose to 40 percent in 2000, compared with an average of 35 percent during 1990–5.

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4 Investment and growth

A simple macroeconomic projection for 2001–10

Van Nhu Dang

1 Investment: a source of growth

1.1 General investment picture

Vietnam achieved an impressive growth in the last decade. But problems are lying ahead with regard to sustaining its high growth. The first round of growth in the early 1990s was fuelled by the unfettered production capacity (especially in agriculture and the private sector). But this source was a one-time shot. It ran out of steam by 1997 and another round of structural reforms was needed to uphold the momentum.

High growth during the early 1990s was helped by the large incoming foreign direct investment (FDI). But even this source of growth was dampened since late 1996 by the poor and confusing regulatory environment and then hard blown by the Asian crisis since mid 1997.

An interesting observation can be made from the picture of investment by sources (see Figure 4.1). In 1990, state budget and private domestic investment as a share of total was very large, accounting for 74 percent of total investment, while state credit, state-owned enterprises (SOEs) equity

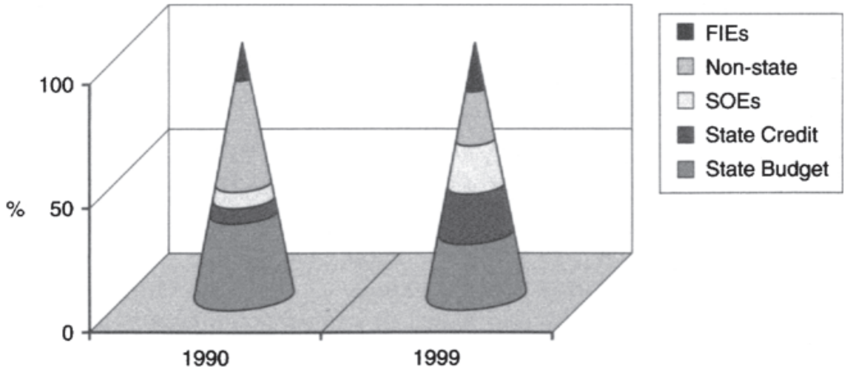

Figure 4.1 Investment by source

Source: Ministry for Planning and Investment (MPI 1999).

and foreign investment were all negligible. The picture looked quite different in 1999. Investment from the state budget was cut, but state credit rose as a substitute (most of which was extended to SOEs). The share of private domestic investment shrunk, while that of SOE equity and foreign investment expanded. The underlying factors behind these figures were that at the early stage of reform in 1990, state subsidies to SOEs were drastically shed, and shortly after that FDI came, as a result of the enactment of the Foreign Investment Law in 1987.

But total investment has increased by 15 times between 1990 and 1999, with some components rising faster than others, thus changing the whole picture. While SOEs were weaned from state budget subsidies in the early 1990s, they were later nurtured again by state credit. In 1998, 46 percent of credit from state commercial banks still went to SOEs. This showed the government commitment to the state-led economy. Concerning the domestic private investment, the untapped non-state potential was released in the early stage of reform, when private business was recognized for the first time after three decades of official policy lines against private proprietorship. This burgeoning private investment, however, was soon forestalled by a proliferation of rules and regulations that favored the SOEs at the expense of private entrepreneurship. The environment became so discouraging that during 1998 and 1999 there was almost no increase in the number of new businesses in the non-state sector. The situation was only improved in 2000 after the enactment of the new Enterprise Law, which required no business license to start a business.

The investment atmosphere was most sluggish in 1998 and 1999. Investment of all sectors became stagnant. It was interesting, or almost a paradox, that bank deposits grew faster than bank credit even though the central bank tried to intervene by lowering the lending interest rate ceiling five times and deposit rate four times in 1999 (see Figure 4.2). This only made things worse for the banks when many borrowers tried to repay their loans long before these came due, then applied for new loans to enjoy the lower interest rate. In 1998, the growth of credit was estimated at 12 percent, while the growth of deposit, or fund mobilization, was 24 percent (see Central Institute for Economic Management 1999). This indicated that investment here was insensitive to interest rate; something else was at work.

Ironically, on the one hand, private firms complained that they were discriminated against by the state banking sector in accessing credit and that shortage of credit put a constraint on their growth. On the other hand, the banks had a problem with their excess deposit money over their lending. The past experience with bad debts from both private and state borrowers made bankers more cautious in their lending. Moreover, due to their weakness in credit and risk analysis, and their unfamiliarity with commercial lending practices, banks failed to pick the best borrowers to lend to, and thus stuck to state borrowers to lend, implicitly expecting state

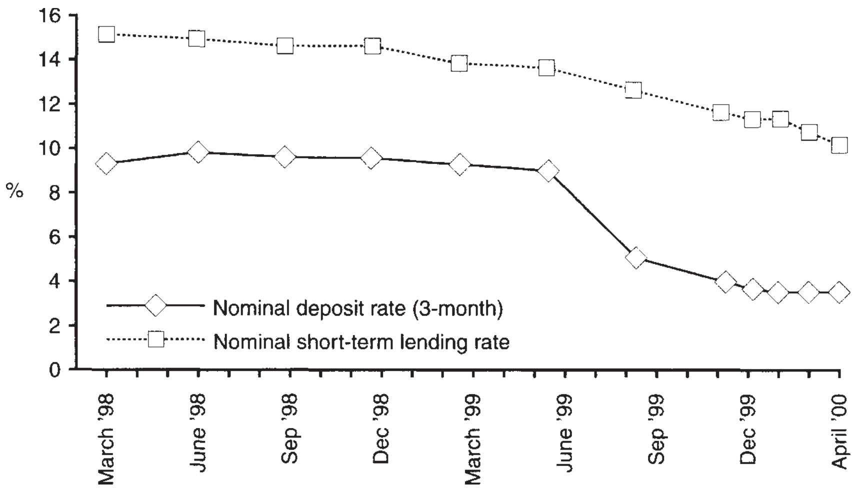

Figure 4.2 Nominal interest rate
Source: IMF (2000).

backup if something went wrong. Banks also persisted with collateral from private borrowers, thus exacerbating the discrimination against the private sector's access to credit. Credit institutions are still not put under hard budget constraints and full market discipline to have enough incentive to pick up the good borrowers. Collateral from private borrowers was taken as the first, instead of the last consideration for lending, as suggested by good lending practices. As they accumulated more deposit than they could lend, the risk-averse banking sector chose to buy government bonds to earn interest instead. Government bonds became the best, and sometimes the only investment choice not only for banks, but also for SOEs and some large private firms as well. It was much safer to buy the risk-free and inflation-indexed government bonds than to invest elsewhere. The same was true for individual savers, who had nowhere to put their money but buying government bonds or depositing in the banks since no better alternative was available.

In brief, what went wrong in the financial sector in Vietnam was that the banks, instead of being an intermediary fund from savers to its best users, only acted as a pawn-shop for private borrowers and as a credit distributor for SOEs. A capital-short economy like Vietnam could not afford this kind of disintermediation.

Another constraint on investment is that Vietnam is still unable to mobilize a higher saving rate to fund its own investment need. Vietnam's saving rate during the 1990s is much lower than that of all other high performing East Asian economies (see Table 4.1). This on the one hand

Table 4.1 Savings as percentage of GDP

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
South Korea	36	36	35	35	35	35	34	33
Indonesia	32	31	33	29	30	28	28	28
Malaysia	29	23	30	28	34	35	38	39
Philippines	18	18	18	17	20	17	19	19
Singapore	45	47	48	46	51	51	51	51
Thailand	32	35	34	34	34	33	33	33
Hong Kong	36	34	34	36	34	32	30	31
China	38	38	37	41	42	40	39	41
Taiwan	31	30	29	29	27	27	26	25
Vietnam	**15**	**10**	**14**	**15**	**17**	**19**	**16**	**20**

Sources: State Bank of Vietnam (1999) and General Statistical Office (2000).

would put a great constraint on its potential growth over the next decade, and on the other hand it implies that Vietnam still has to rely on foreign savings at least in the medium term for investment funding.

1.2 Four sources of investment: potential, constraints and trends

1.2.1 State sector investment

Looking at the components of state investment in 1997 (see Figure 4.3), one can see that the bulk of state funds went to industry, telecommunication and transport; and then agriculture, forestry and fishing. Industry, telecommunication and transport (most of which were state monopolies) accounted for 65 percent of state investment. This again showed a strong government commitment to keep key industries in state hands and use it as a regulatory device for economic intervention.

With regard to state credit, as mentioned earlier, 46 percent of state commercial bank credit in 1998 was extended to SOEs, most of which were heavily indebted and losing money due to falling demand and high cost. The inefficient and unprofitable SOEs were, however, kept afloat by the state-directed and inefficient banking sector (see Appendix 4.1). Over the past years, state banks acted as the credit distributing device in state hands, with an unclear distinction between directed lending and normal commercial lending. The past evidence showed that the increasing role of the SOE sector constitutes a drag on, instead of leading growth (see Appendix 4.1). This situation is clearly unsustainable. Both the SOE and the banking sectors sooner or later need to be reformed. If the government firmly embarks on the 3-year reform program as it plans to do, it can make much better use of state resources to boost growth.

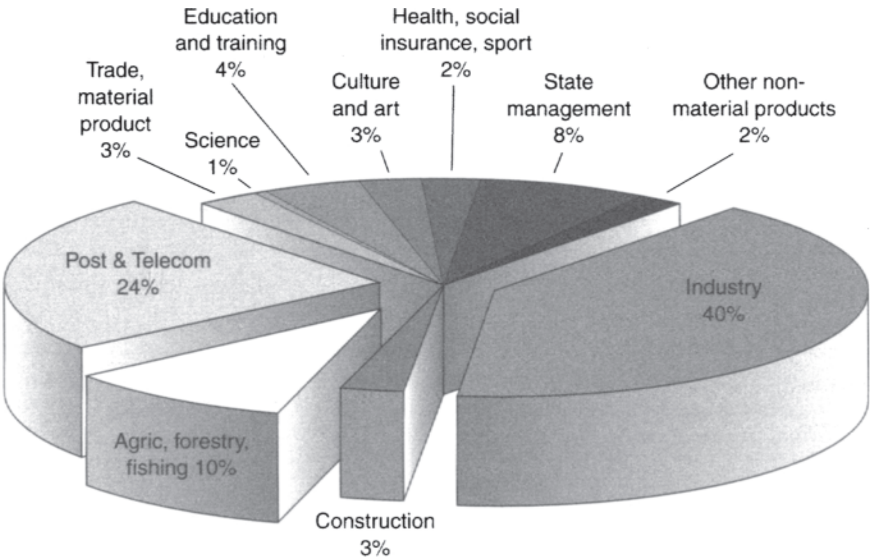

Figure 4.3 State investment by economic activities, 1997

Source: MPI (1999).

Note: The share of the finance, banking and insurance was 0.1 percent and thus omitted from the above graph.

1.2.2 Domestic private sector

The private sector in Vietnam, both the registered corporate and informal household components, accounts for 40 percent of GDP and for 90 percent of employment. However, the registered component is very small–7 percent of GDP and 1 percent of employment–and operates mainly in trading and some manufacturing. Despite its small share in total employment, the registered private companies recorded a steep employment growth in recent years, reaching as high as 16 percent in 1998 versus 2 percent of the state sector (see Table 4.2). Even stronger growth in employment is observed among private manufacturing firms, at 20.8 percent in 1998 (see Mekong Project Development Facilities (MPDF) 1999). While employment growth in the state sector almost stagnates, or even declines at some points, employment growth in the formal private sector is always double-digit. If this sector can expand and become more significant in both GDP share and employment, its overall potential impact on job creation will be great.

The industrial pattern of private firms also shows that they have high potential in promoting an export-led growth path for the economy, if an enabling business environment is available for their investment. Private manufacturing firms concentrate in labor intensive industries (e.g. garment, food processing and leather) that are very export-oriented,

Table 4.2 Composition and growth of employment by ownership form, 1996–8 (%)

	1996		*1997*		*1998*	
	Share	*Growth*	*Share*	*Growth*	*Share*	*Growth*
Total labor force and growth rate	**100**	**3.5**	**100**	**3.4**	**100**	**3.0**
Public	**9.1**	**−2.6**	**9.2**	**4.6**	**9.1**	**2.0**
SOEs	5.1	3.7	5.2	3.8	5.2	3.4
State administration	3.6	−11.6	3.7	4.6	3.6	0.6
Collective sector	0.3	20.1	0.4	16.9	0.3	−3.7
Private	**90.3**	**3.7**	**90.2**	**3.2**	**90.2**	**3.0**
Households and farmers	89.2	3.6	89.0	3.1	88.9	2.9
Formal private sector	1.1	13.7	1.2	12.0	1.3	16.2
Foreign-invested sector	**0.6**	**132.9**	**0.6**	**3.9**	**0.7**	**7.2**

Source: General Statistical Office (1999).

targeting such key markets as Europe and East Asia. At present, investment and growth of this sector are still squeezed by a high-risk environment, government regulations and thwarted by SOE counterparts in unfair competition (see MPDF 1999).

The recently enacted Enterprise Law was a positive step in liberalizing private investment in the sense that it removes any licensing requirements to start a business, thus new entrants now face fewer start-up problems and costs. This has a more obvious impact on newly established firms than on existing ones. But a good start for businesses may facilitate their future prosperity. A recent report indicated that within the first 7 months of 2000, 7,684 new private enterprises were established (on average about 1,100–1,200 new firms came into being every month) with total capital of 7,087 billion dong (equivalent US$505 million); and on average each employed 10–12 workers and about 100–300 indirect jobs were created (see *Vietnam Investment Review* August 2000). This once again reaffirmed the high potential for job creation of the private corporate sector. Unlike the SOE sector, the dynamic private sector, if unthwarted, can grow fast and create jobs without any strong fiscal or quasi-fiscal support. All it needs is an enabling environment with clear signals from the government.

1.2.3 Foreign direct investment

FDI contributed significantly to growth in the past years. The sector always grows faster than the economy as the whole, and peaked at 20.7 percent in 1997. In the weak year of 1999, it still grew at 13 percent versus 4.7 percent of overall GDP growth (see Table 4.3).

Table 4.3 Percentage growth in real GDP by sector, 1995–9

	1995	*1996*	*1997*	*1998*	*1999*
State sector	8.4	9.7	8.3	5.0	4.1
Non-state sector	8.7	7.2	5.7	4.3	3.5
Foreign-invested sector	14.9	19.4	20.7	18.1	13.3
GDP growth	8.9	9.3	8.1	5.8	4.7

Source: General Statistical Office (1999–2000).

Due to the policy orientation that encourages the expansion of capital base and favors import substitution, FDI in Vietnam tends to be inward oriented and concentrated in the non-tradeable sector, this is clearly seen in its industrial structure. Foreign investment in heavy industries, including oil and gas, and in construction and housing always accounted for the largest share of total investment during 1991–9 (see Figure 4.4).

Both Vietnamese policy makers and foreign investors are responsible for the orientation towards import substitution and capital intensive industrialization. From the policy makers' side, they have good reason to attract foreign capital, as the country is hungry for funds and it spent decades developing under the Soviet model with emphasis on heavy industry. For foreign investors, they are rational to seek new and presumably better investment opportunity in a newly opened economy. In the late 1980s international investors searched actively for good investment opportunities in Southeast Asia with high growth rates. Vietnam in the early 1990s joined the region in attracting foreign investment, although not necessarily the same kind of investment.

In terms of job creation, the overall foreign-invested sector's impact on employment was very mild, with merely about 290,000 jobs being created in 1998 and its capital-labor ratio is very high compared to the domestic sector. Based on data from Table 4.4, it costs US$11,488 on average to create a job in the foreign-invested sector, while for heavy industries the figure is US$37,643 per job. These figures mean that the foreign invested sector in general, and foreign investment in heavy industry in particular, are very capital intensive and have little impact on job creation. In terms of exports, only FDI in food and hotel industries are export-oriented, while the whole sector on average exports less than half of its turnover.

The great challenge for Vietnam in the next few years is to reverse the recent FDI collapse. It is not easy in the context of the improved competitiveness of other Asian countries after the Asian crisis. A survey done by Japan External Trade Relations Organization (JETRO 1999) indicated that doing business in Vietnam by most criteria is more expensive than in a number of other countries in East Asia like Indonesia, Thailand and China (JETRO as quoted by Apoteker 2000). Also, another survey by JETRO showed that the profitability of Japanese firms in Vietnam was the worst

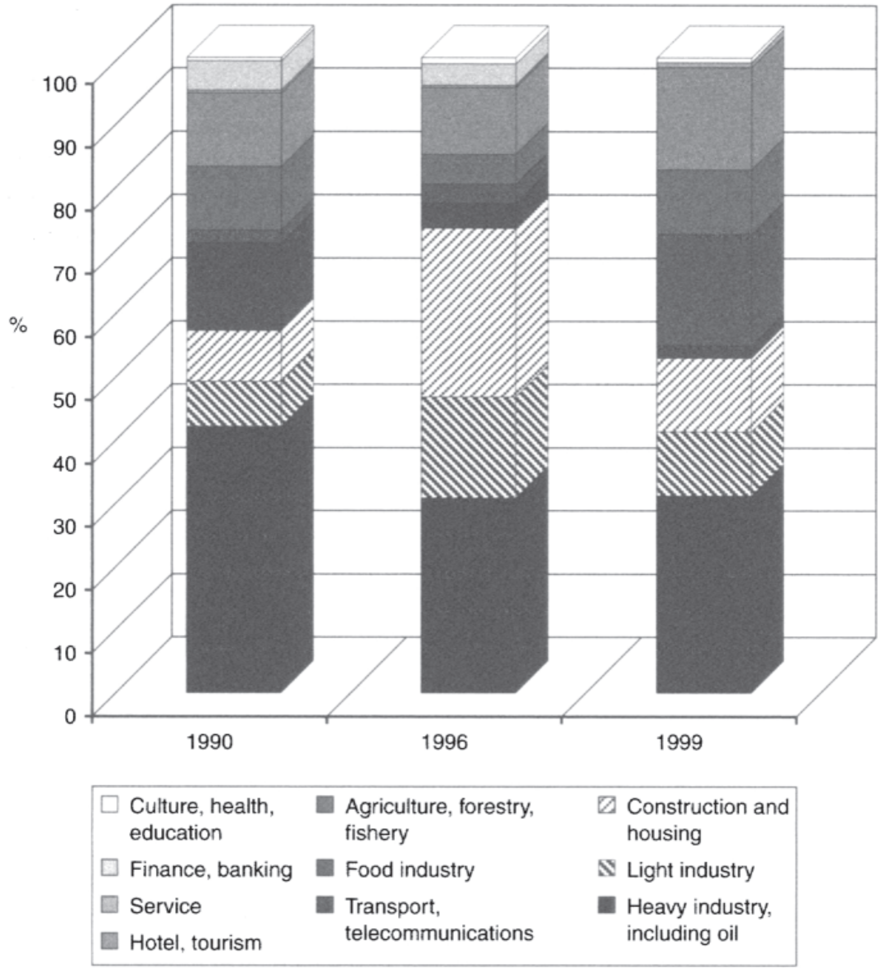

Figure 4.4 Industrial structure of FDI
Source: MPI (1999).

among the eight Asian countries surveyed (JETRO, as quoted by Apoteker, 2000). Since it is impossible to change this situation overnight, one cannot expect FDI inflows to Vietnam to resume their 1996 high soon.

1.2.4 Official Development Assistance (ODA)

Slow disbursement of ODA is a sign of low absorptive capacity. Despite the capital shortage in the country, not all incoming capital is adequately absorbed for productive uses. As a result, the undisbursed fund has been built up over the years (see Figure 4.5). While ODA commitment for

Table 4.4 Contribution of FDI to domestic economy, 1998

	Number of projects	*Number of workers*	*Turnover US$ million*	*Imports*	*Exports*
Heavy industries	519	40,539	1,526	639	n.a.
Petroleum and gas	38	803	n.a.	n.a.	653
Light industries	574	148,755	787	542	11
Food industry	127	12,956	317	194	686
Agriculture and forestry	325	34,366	278	152	60
Fisheries	90	5,952	12	10	5
Construction	237	9,664	181	592	7
Industrial Park/Export Processing Zone infrastructure	14	499	12	51	0
Hotel and tourism	187	17,534	47	175	68
Office properties and apartments	143	3,576	24	114	6
New cities	3	32	0	0	5
Services	108	2,200	15	11	9
Transportation and communication	125	8,799	54	222	0
Banking and finance	32	1,237	43	14	15
Culture, health and education	84	4,083	48	15	6
Total	2,606	290,995	3,343	2,732	1,531

Source: IMF (1999a).

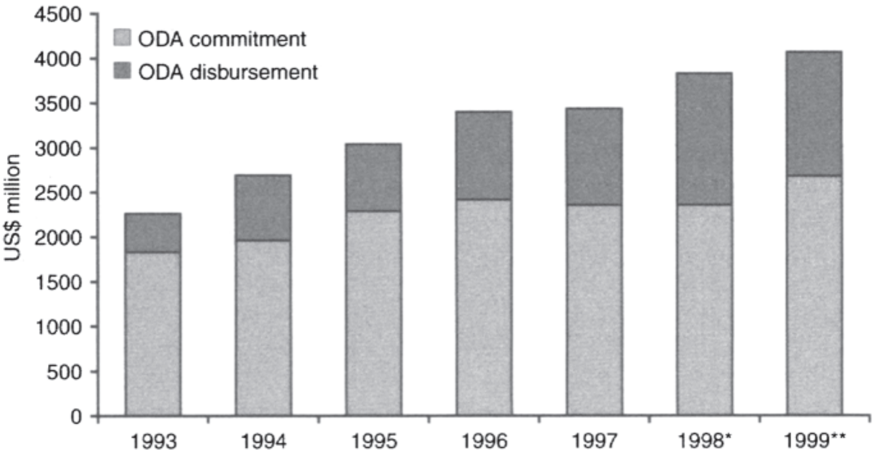

Figure 4.5 ODA commitment and disbursement

Sources: United Nations Development Programme (as quoted in CIEM 2000) for 1993–8 and MPI (1999) for 1999.

Notes
* commitment includes US$500 million for budget support
** commitment includes US$700 million for budget support.

Vietnam kept rising in the last decade, it is unlikely to increase any further–or it might even decline–in the next decade.

Since 1998, Vietnam has received ODA as a substitute for the falling FDI inflows. However, in the medium to long run, it would be unsustainable to rely heavily on ODA as the major source of funding for a number of reasons:

- First, it costs a lot of government resources to provide the counterpart capital (to foreign aid) and to manage foreign aid. Different donors have different policies and procedures, which are not always reconcilable with the government's own procedures; and this requires a lot of negotiations and concessions to clear the policy barriers before the fund can be actually disbursed.
- Second, different donors have different priorities. If the government does not take a strong hold in its development strategy, aid is very likely to be donor-driven, and the country may become aid-dependent in the future while the fund may be channeled in areas that the country and its citizens do not really need, but have to pay for.

Despite the great contribution of ODA, it should be received with caution because these loans eventually have to be repaid some time in the future. Unless the country manages these resources wisely and uses them for productive purposes, it can run into indebtedness, which will harm its future growth.

2 A simple macroeconomic projection for 2001–10

2.1 Growth path-based projection

The Vietnamese government set the targets for doubling real GDP during 10 years to 2010 and a 7 percent annual real GDP growth. A simplistic calculation based on an assumption of rising incremental capital output ratio (ICOR) (see Appendices 4.2 and 4.3 for detailed calculations) shows that an average US$7.4 billion (in 1994 prices) of annual investment or almost 28–29 percent of GDP is needed to attain such growth. We make the projection on capital requirement here based on the assumption of diminishing returns to scale, which is reflected by the rising ICOR over time. Based on this assumption, two following possibilities can happen, depending on the choice that Vietnam makes on its industrialization path.

Capital intensive and import substituting industrialization

In this case, ICOR will rise faster, which means that towards the end of the period concerned, much more capital would be needed to keep the economy growing at the same rate as before. On the one hand, the country would have to rely much more on imported inputs to build its capital base, thus more foreign exchange would be needed to meet the demand for import. On the other hand, the sector that produces import substitutes and non-tradeable goods for the domestic market would expand faster than the sector that produces for export, which means that the country cannot generate foreign exchange as fast as it should to pay for its imports. The country then would run a higher current account deficit, which has to be financed by foreign savings.

Labor intensive and export-oriented industrialization

By contrast, following this second path the ICOR would rise more slowly, implying that less incremental capital is required later in the period to maintain its growth. Along this path, the country would tend to tap more of its comparative advantage, which is labor, to produce for export and to boost growth. According to the Heckscher-Ohlin model of comparative advantages in international trade, nations export goods that use their most abundant factor intensively, and they import goods that use their scarce factor intensively (Brown and Hogendorn 1994:57). As Vietnam intensively uses its abundant resources to produce and trade with the world, it can gain by improving the allocative efficiency of the economy.

At this point, we are speaking strictly of physical capital only, while in fact human and social capital are also at work to determine the speed and quality of growth. Concerning human capital, Vietnam can focus first on the low value-added labor intensive industries, but in the future it may think of moving up the value chain to higher value-added industries, such as software development for exports. It would be useful if this is included in the long-term growth and human development strategies of the country.

Given the scope of this chapter, we cannot deal specifically with these factors and see how they affect growth. It would be interesting to explore incremental human capital output ratio (IHCOR) and incremental social capital output ratio (ISCOR) further in another paper.

2.2 Reform-based projection

Concerning the shares of different sources of investment, for simplicity, Appendix 4.3 gives a rough projection based on the share of each source in 1999, the ICOR, and the growth target, assuming that these shares remain constant throughout the period. However, the funding requirement from the state sector, the non-state sector and the foreign-invested sector would depend to a large extent on the pace of reform undertaken with the SOEs, the banking sector, the business environment and the liberalization process in general. In this regard, two scenarios can be expected.

High scenario

The assumption here is that the reform is fast with accelerated SOE reform, strong private investment liberalization and improvement in the business environment to attract more FDI. In this case, less budget resources are needed and less reliance on ODA as a source of funding is likely. More FDI can be expected to fund the growth target. With a more investment friendly and enabling environment, more of both domestic and foreign private investments can be expected, as the two pull up each other.

Low scenario

If the SOE reform continues to be slow, the private investment suppressed and crowded out, and the business environment stagnant, FDI and non-state investment cannot grow as fast as they should. Therefore, the government has to commit more of its scarce resources and ask for more ODA to fund its investment need. Budget commitment must be at least equal to the level of 1999 to keep up with growth. Less public resources would then be available for such public goods as basic education, primary and preventive health care, and qualified and devoted civil servants.

2.3 Saving-investment gap based projection

With a saving rate estimated at about more than 20 percent of GDP, while the investment need is about 28 percent of GDP, the saving–investment gap would be about 8 percent of GDP. The saving–investment gap by definition should equal the trade gap (see Appendix 4.2). According to calculations based on ICOR and the constant saving rate of 20 percent of GDP (Appendix 4.2), the total saving–investment gap for the next 10 years would be about 283 billion dong or 26 percent of the total investment need, and the annual saving–investment gap would be about 5-8 percent of GDP throughout the period. This means that in order to meet the investment requirement and to achieve the growth target, each year Vietnam needs to attract an amount of foreign savings equal to 5–8 percent of its GDP, if the domestic saving–GDP ratio does not increase.

In the long run, to narrow the gap and reduce the reliance on foreign savings, the country has either to increase its domestic savings or to increase exports to fuel more growth, or at least to prevent the gap from further widening. As saving is a function of income, interest rate, a sound and credible banking system, and inflation rate, long-run macroeconomic policies should address these variables in order to boost domestic savings as a source of funding for growth. On the other side of the equation, exports should be promoted as a means of generating foreign exchange earnings that would pay for the country's imports, thus also funding its growth.

3 Policy implications

In light of all potentials and constraints in the investment environment and the macroeconomic projections analyzed in the previous section, there are three policy areas to be addressed to harness growth and bring the economy right on track of its comparative advantages:

1. objectives of investment strategy,
2. trade regime, and
3. domestic reform.

Concerning the first policy issue, the government must be clear about its *objectives,* whether it wants high growth, efficient and intensive use of its abundant resources, more jobs, faster poverty reduction and international integration, or a strong expansion of the industrial base and the large but inefficient state sector, with heavy reliance on external funding sources.

As far as investment strategy is concerned, as the country is short of capital, it has to rely on foreign resources. The contribution of FDI to economic growth in the past decade has been obvious and thus further efforts are needed to attract more FDI. As discussed earlier, the business environment should be improved in such a way as to become more enabling and predictable, with less or no differential treatments, less cost for doing business, with the right policy signals or incentives, profitability and secured profit repatriation before higher FDI is possible. An unpredictable and risky environment would add more risk premium to the returns that foreign investors require while making investment decisions. However, from now on the government should be more selective in accepting FDI, based on its strategic vision. The import substituting FDI, which comes to take advantage of and lobbying for protection, should be avoided. Incentives instead should be given to the FDI that helps Vietnam develop its comparative advantage and brings in both financial and non-financial contributions (such as technology, access to foreign market, skills and good international practices) to the country.

For the time being, when capital is scarce, state investment should complement, rather than substitute and crowd out private investment. The state should focus its scarce resources on social spending and investment in public utilities, which facilitate private investment, both domestic and foreign.

Concerning the second policy issue, Vietnam should rely on *trade* as an engine of growth, rather than restrict it to favor the few money losing domestic industries, at the expense of domestic consumers and the public at large. According to trade theory, a country can gain from trade by selling what it produces relatively more efficiently and buying what it produces relatively less efficiently. Vietnam at the moment does not really follow this theory. What it does is a reverse of the suggestion by the Heckscher-Ohlin model. High tariffs have attracted foreign investors in such capital intensive and import substituting industries as car, motorcycle, cement, steel and sugar. By protecting the high-cost, inefficient capital intensive industries, it is rewarding foreign investors who bring in capital, which is scarce in the country, and penalizing the labor intensive industries and agriculture, which extensively use the abundant resources of the country.

Finally, to address the third policy issue, *reform of the domestic economy,* it is imperative to break the iron triangle that financially locks the state commercial banks, the SOEs, and the state administration. The banking sector must stop using its mobilized resources as a substitute for fiscal support–mostly to the SOEs–and move to full commercial lending. The SOEs, except a very few in public utilities, should be weaned from fiscal and quasi-fiscal supports, and treated equally with other sectors. State regulatory bodies should stop owning some SOEs and regulating the sector where they operate at the same time, to avoid the conflict of interests and uneven playing field at the expense of other non-state enterprises.

Further delaying these reforms would impose a great cost on the economy.

- First, the ailing banking system would continue to accumulate more deposits than it can lend and its lending is not to the most productive uses, thus failing to intermediate the scarce funds to those who most need them.
- Second, the inefficient SOEs would continue to sink into indebtedness and high inventories of unsold goods, and then cry out for more protection at the expense of the domestic consumers.
- Third, the discriminated private sector cannot release its potential to invest, create jobs and serve as an engine of growth. Last but not least, given this high cost business environment and modest growth, potential investors will take a wait-and-see attitude and further postpone their investment decision, which entails a loss of opportunity for Vietnam and affects its growth potential. Remember that the foreign-invested sector has always grown faster than the domestic sector over the last decade, thus pulling up the overall growth.

A joint study by Japan International Cooperation Agency (JICA) and Vietnam's Ministry of Planning and Investment (MPI) found that between 1990 and 1998, Vietnam has lost its competitiveness versus the four ASEAN countries and all newly industrialized countries by all measures (see JICA/MPI 1998). With the strong recovery and restructuring of the crisis-hit countries in Asia during 1999 and 2000, the gap between Vietnam and these countries will be widened, if Vietnam does not promptly take bold reform measures to correct the situation. This is a warning sign, telling Vietnam to act now and not further delay.

4 Conclusion

Our policy recommendations in this paper are based on pure economic analyses, taking efficiency as the ultimate goal of public policies. However, we all know that every country has to balance its multiple objectives in its socioeconomic reform process and growth is only one of them. Of course, growth and development per se are desirable, since they help the country to lift itself up from poverty. For a country in transition like Vietnam, sound economic performance is influenced by a series of historical, ideological and moral factors. This means that policy and strategy are a complicated and balancing task.

Vietnam has implemented an impressive economic reform and achieved significant results, especially during 1992–7. However, at the beginning of the new century, the country is now faced with decelerated economic growth and stagnant investment due to lost opportunities with foreign investors and a wrong incentive structure. The government must make a difficult choice between efficient and higher growth, on the one hand, and continued heavy state involvement, on the other. The difficult decision it has to make is how much and where to intervene in economic activities. We hope that the analyses in this chapter and elsewhere in this volume will open a dialogue, which aims at clarifying choices that our country is faced with in the coming years.

Appendix 4.1: A paradox under *Doi Moi:* increasing weight of the SOEs

Despite the SOE reform, SOEs' share in GDP rose from 36.5 percent in 1991 to 40.07 percent in 1998. In 1998, profitable SOEs accounted for about 40 percent, the unprofitable and chronic loss-making SOEs accounted for 20 percent, the remaining 40 percent were unprofitable and marginal SOEs, and their profit was negligible.

Among the central SOEs in agriculture, about 17 percent made losses in 1998. The average loss of these unprofitable SOEs was 8.4 billion dong, while the average profit of the profitable SOEs was 1.3 billion dong. Thus the drain on resources through these SOEs more than outweighed the profit they made. And their profitability, if any, owed itself to state protection and favored treatment.

During 3 years 1997–9, the state budget transferred almost 8 trillion dong directly to SOEs, of which 6,482 billion dong were provided as supplementary capital to the SOEs and 1,464.4 billion dong as loss subsidies to relieve SOEs from some financial burden. In addition, since 1996, the government also provided 2,288 billion dong of tax exemption and reduction, 1,088.5 billion dong of debt write-off, 3,392 billion dong of debt freezing, 540 billion dong of rescheduled debt, and further provided 8,685 billion dong of preferred credit to SOEs.

Paradoxically, while efforts are made to reform existing SOEs and make them more efficient, new SOEs are established solely on the ground of infrastructure or import substitution projects. A number of agencies that establish new SOEs, as the owners, do not carry out any market research for their products. Therefore, many SOEs soon after establishment become indebted, with unsold products and over-capacity. In addition, many SOEs that are put in the divestiture list try to embrace a public utilities function to be retained in the state sector.

(Source: Central Committee for Enterprise Reform (2000) and World Bank (2000).)

Appendix 4.2

As gross domestic product (GDP) is made up of total consumption, total investment, government expenditure and net exports (exports minus imports), we can start with the basic national income identity:

$$GDP = C + I + G + X - M$$

where C stands for consumption, I for investment, G for government spending, X for exports and M for imports.

GDP can be allocated to C, tax payments to the government (T) and saving (S). We can thus rewrite the above identity as follows:

$$GDP = C + I + G + X - M = C + T + S$$

Assuming, for simplicity, that the government budget is balanced (i.e. G=T) and eliminating C from both sides of the equation, we have

$$I + X = S + M$$

or

$$I - S \text{ (saving gap)} = M - X \text{ (trade gap)}$$

Each variable in this model is, in turn, a function of other determinants.

In this model, we can assume that the trade balance exactly equals the saving gap, or the shortfall of domestic saving versus investment. This gap is about 26,700 billion dong or US$1.9 billion (6.7 percent of GDP) for Vietnam in 1999 (see Figure 4.6). This means that the need for foreign capital for Vietnam is 6.7 percent of its GDP. This need can be reduced in the future if Vietnam is able to accumulate a higher rate of domestic savings or increase its exports.

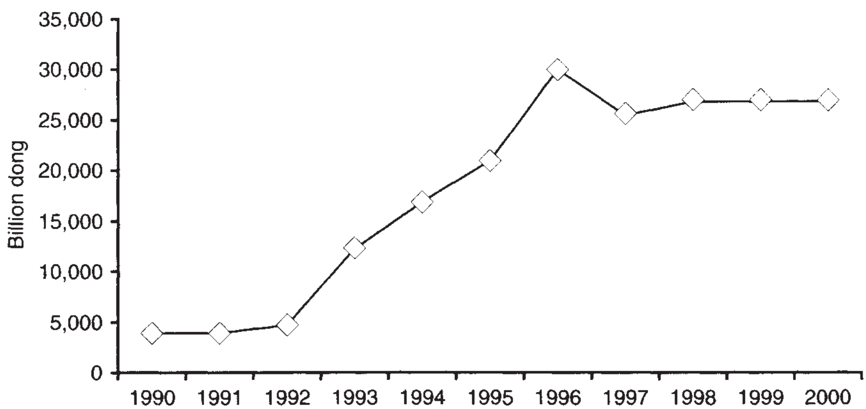

Figure 4.6 Trade gap (imports minus exports) in current prices
Source: General Statistical Office (2000).

Appendix 4.3

The projection of investment requirement is calculated by using the growth target set by the government to be 7 percent annually for the period 2001–10 and the incremental capital output ratio (ICOR), which is the ratio of incremental investment in the year and the absolute increase in GDP. This ICOR tells us how many dollars of new or incremental investment capital is needed to create one dollar of increase in GDP. ICOR is often an indicator of an economy's capital productivity, which is expected to fall as more capital is invested in the economy. The faster ICOR rises, the more capital is needed to maintain the same GDP growth rate.

In this projection, we take the 1999 GDP of 255,269 billion dong in 1994 constant prices, multiply it by the targeted growth rate to derive the values of GDP for the subsequent years up to 2010. We then multiply the projected ICOR (from a JICA/MPI joint study) with the targeted growth rate to derive the required investment ratio (investment as percentage of total GDP). From here we can estimate the absolute amount of investment capital needed to achieve the growth target (see Table 4.5).

From Table 4.5, we can see that:

- annual average investment need for the period 2001–10 is US$7.4 billion; and
- total saving–investment gap for the 2001–10 period would be 283,241.5 billion dong or 26 percent of the total investment requirement.

In Table 4.6, we make a projection on the investment fund required from each source of funding, based on their actual respective share in total investment of 1999. To make it simple, the assumption is that the shares of funding sources will remain constant throughout the period. The respective share of each source is multiplied by the total investment requirement of a particular year to derive at the amount from each source.

Acknowledgment

The author would like to thank Drs. Chi Do Pham, Le Anh Tu Packard, Binh Tran-Nam and Thien Pham for the ideas they contributed to this chapter as well as other valuable supports that they offered.

Table 4.5 Projected total investment need to achieve the growth target

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
GDP in 1994 prices[a] (billion dong)	270,585	289,526	309,792	331,478	354,681	379,509	406,075	434,500	464,915	497,459	532,281
ICOR[b]	3.3	3.45	3.6	3.72	3.82	3.9	3.95	3.97	3.98	3.99	4
GDP growth target (%)	0.06	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
I/GDP[c] (%)	0.19	0.24	0.25	0.26	0.27	0.27	0.28	0.28	0.28	0.28	0.28
S/GDP[d] (%)	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
(S−I)/GDP (%)	0.01	−0.04	−0.05	−0.06	−0.07	−0.07	−0.08	−0.08	−0.08	−0.08	−0.08
S−I gap (billion dong)	−541	12,015	16,109	20,021	23,905	27,704	31,064	33,847	36,542	39,448	42,582
Gap/investment requirement (%)	−1.01	17.1	20.6	23.1	25.2	26.7	27.6	28.0	28.2	28.3	28.5
Gap/GDP (%)	−0.2	4.1	5.2	6.0	6.7	7.3	7.6	7.7	7.8	7.9	8
Investment need (billion dong)	53,575	69,920	78,067	86,316	94,841	103,606	112,279	120,747	129,525	138,940	149,038
Investment need (US$ billion)	3.8	4.9	5.6	6.1	6.8	7.4	7.9	8.6	9.2	9.9	10.6

Sources: General Statistical Office (GSO 2000), JICA/MPI projection (1998) and author's own calculations.

Notes

a GDP in current year=1.07×GDP in previous year; GDP in 1999 is taken from GSO (2000).

b Based on JICA/MPI projection,

c Investment/GDP ratio=ICOR*GDP growth rate,

d Saving rate is assumed to be constant at 20% of GDP throughout the forecast period. Investment need in US$=investment need in dong/nominal exchange rate where nominal exchange rate=number of dong per US$.

Table 4.6 Projected investment need from each source (in US$ billion, unless otherwise stated)

Source of investment	*1999**	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
State budget	25	0.9	1.2	1.4	1.5	1.7	1.8	1.9	2.1	2.3	2.5	2.7
State credit	18	0.7	0.9	1	1.1	1.2	1.3	1.5	1.6	1.7	1.8	1.9
SOEs	18	0.7	0.9	1	1.1	1.2	1.3	1.5	1.6	1.7	1.8	1.9
Non-state	20	0.8	1.0	1.1	1.2	1.4	1.5	1.6	1.7	1.9	1.9	2.1
Foreign-invested sectors	18	0.7	0.9	1	1.1	1.2	1.3	1.4	1.6	1.7	1.8	1.9

Sources: Table 4.5 and author's own calculations.

Note

* Percentage of total (these percentages are provided by Ministry of Planning and Investment).

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5 Fiscal policy options for the period 2001–5

Tran Ngoc Anh and Anh Dinh Vu

1 Introduction

Fiscal policy is an important macroeconomic instrument of the government for intervening in the economy to achieve its objectives. The government budget is the largest fund nationally, and therefore its size and composition strongly influence the whole economy. As Vietnam has been moving from a centrally planned to a market-based economy with a socialist orientation, it is critical to properly address the role of fiscal policy in promoting economic growth and creating a stable macroeconomic environment. This chapter is divided into three sections:

- A brief discussion of the fiscal development process in Vietnam since the *Doi Moi* policy was launched. This was an important shift in Vietnam's fiscal policy from a primitive subsidization system towards a strong and effective macroeconomic management. Uncompleted steps are also discussed.
- A discussion of current trends and viewpoints in fiscal policy as well as their theoretical bases. The key viewpoints are the supply side and Keynesian theories, and the size of the government budget.
- The viewpoints of the authors and related arguments concerning the size of the government budget, the level of deficit, the priority of expenditures and the selection of revenue sources during 2001–5.

2 The evolution of fiscal policy in Vietnam

Since the *Doi Moi* was launched in 1986, fiscal policy in Vietnam and the associated economic growth have undergone three phases: 1986–91 with 4.7 percent annual growth rate, 1992–7 with 8.7 percent annual growth rate and 1998–2000 with lower annual growth rate of 5.7 percent. Previously, during 1976–85, the economic growth rate was only 3.7 percent per annum, and the budget was in large deficit and heavily relied on external resources. Domestic revenue as a share of total revenue accounted for only 60–80 percent (see GSO 1986–2001). Other revenues came from aid and foreign borrowing. The budget expenditure was a subsidization system under central planning, distributed evenly, and thus destroyed incentives for production and business, wasted resources and brought low efficiency. The typical characteristic of this period was that the government budget acted as the planned distributor and a pool of fund for the state sector. All revenues, including companies' profit, if any, were transferred to the budget; and all losses were financed by the budget through direct and indirect measures. Budget revenue relied mainly on receipts from state capital fees and agricultural tax. Budget expenditure mainly focused on state-owned enterprises (SOEs) and building of heavy industrial facilities. The result is that the government had to print money to finance the budget deficit, causing inflation to surge (Bui 2000). Coupled with inefficient production, it deepened the economic crisis. Additionally, during the 1980s the banking system operated as an extended budget (which provided credit to the SOEs as directed under the planned target), played a passive role and had no control over the monetary policy. It was in fact a money printer to finance budget deficit. Between 1986 and 1990, on average 63 percent of the budget deficit was financed through printing money (MOF 2000).

Since 1989, the government of Vietnam tried to minimize printing money to finance the budget deficit. The government also realized that it could no longer run such a large budget deficit and it was time to reshape budget expenditure and radically reform the budget revenue system.

The SOE finance was gradually reformed, with less soft budget constraint, more business autonomy was established, and companies having to be responsible for their own profit and loss account. However, the result of reform during this period was limited: the budget deficit as a share of GDP kept rising, and the deficit as a share of total expenditure rose from 30.8 percent in 1986 to 46 percent in 1989 (MOF 2000). The main reasons were slow economic growth, which affected the budget revenue, and the heavy subsidies in the system. The primary objective of the 1986–91 reform was inflation control, macroeconomic stabilization and bringing Vietnam out of the socioeconomic crisis. The most important contribution to inflation control of the fiscal policy in this period was the restructuring of the deficit financing sources. While in 1986, external funding accounted for 35.5 percent and printing money for 64.45 percent, these figures in 1989 dropped to 41.3 percent and 58.7 percent, respectively (MOF 2000). Table 5.1 summarizes how the economy was brought out of crisis from 1986 to 1991.

The fiscal and monetary policies during 1989–90 were responsible for an important improvement in the macroeconomic situation, but this gain was fragile and vulnerable to instability, especially in the wake of the collapse of the Eastern Europe bloc, causing a sudden stop in external funding. Therefore stabilization remained a critical task. The most essential objective of fiscal policy during this period was a cleaning up of the

Table 5.1 Bringing the economy out of the socio-economic crisis, 1986–91

	1986	*1987*	*1988*	*1989*	*1990*	*1991*
GDP growth (%)	6.5	3.4	4.6	2.7	5.1	6.0
Inflation based on CPI (%)	674.1	273.0	123.0	34.7	67.1	67.5
Budget revenue (% of GDP)	14.0	13.2	11.3	13.9	14.7	13.8
Budget expenditure (% of GDP)	20.2	17.9	18.3	21.4	20.5	15.9
Budget deficit (% of GDP)	−6.2	−4.7	−7.0	−7.5	−5.8	−2.1

Source: Institute of Financial Research (2000).

government budget, reduction in and sustainable level of budget deficit, gradual improvement in the national fiscal position, improvement in management effectiveness, macroeconomic adjustment, and mobilization of resources for investment and development. To balance the budget, Vietnam further reformed expenditure structure and raised more revenue. The government budget expenditure was separated (though not completely) from state corporate finance, and a hard budget constraint was introduced whereby state companies had to be accountable for their business, being responsible for their profits and losses (Vo 1993). The government gradually reduced and eventually eliminated subsidies to SOEs, thus substantially reducing current expenditure and financing from the state budget to cover losses of these enterprises (however, the capital expenditure from the budget increased more slowly than expected). In addition, SOEs were restructured and their number reduced (from 12,500 in 1990 to about 6,000 in late 1995). Table 5.2 summarizes the economy's high-growth period from 1992 to 1997.

Budget revenue was substantially improved, and thus contributed to the reduction in the deficit: budget revenue went up from 13.1 percent of GDP in 1991 to 22.7 percent in 1995, mainly from tax and fees, which rose from 12.8 percent of GDP in 1991 to 22.1 percent in 1995 (GSO 1991–5).

Table 5.2 Period of high economic growth, 1992–7

	1992	*1993*	*1994*	*1995*	*1996*	*1997*
GDP growth (%)	8.6	8.1	8.8	9.5	9.34	8.2
Inflation based on CPI (%)	17.5	5.2	14.4	12.7	4.5	3.6
Budget revenue (% of GDP)	19.0	23.6	23.2	23.3	22.9	20.5
Budget expenditure (% of GDP)	22.0	30.1	27.9	27.4	25.9	24.5
Budget deficit (% of GDP)	−3.0	−6.5	−4.7	−4.1	−3.0	−4.0

Source: Institute of Financial Research (2000).

The first stage of tax reform (starting in 1990) showed its effect. On the one hand, it secured revenue for the government budget and met the expenditure requirement. On the other hand, the tax system was rationalized and became simpler and more appropriate, creating a more equal playing field for enterprises and, to a certain extent, encouraging production and promoting economic growth.

However, the budget deficit during this period was still large, although the nature of deficit had changed (caused by the capital investment for development, not by the recurrent expenditure as previously).

In general, the fiscal policy of Vietnam in past years was adaptive and flexible enough to reflect the macroeconomic changes, and exerted a positive impact on economic growth. The following remarks can be drawn from various studies.

- Under the centrally planned system, the government budget, both its revenue and expenditure, accounted for a small share in GDP, partly due to the loss of revenue in an incomplete tax system and too primitive collection procedure. More importantly, low economic growth has limited revenue potential and capital expenditure had to rely totally on external resources.
- Budget revenue increased substantially during 1992–7, and this could be explained by the faster economic development and the slower increase in budget expenditure. This reflected the tighter fiscal policy, with reduced deficit and no money printed for financing the deficit. These factors brought inflation under control and restored macroeconomic stability. However, the tight fiscal policy during this period was responsible for the economic slowdown in the subsequent period. On the one hand, the high economic growth of Vietnam was unsustainable, and mainly stemmed from the liberalization of petty production factors (in agriculture and small trading) and investment made during the subsidized system period, when the cost was not market determined. Therefore, the high budget revenue dug into the capital accumulation and capital base expansion of enterprises, resulting in a great drag to growth in the subsequent period. On the other hand, budget expenditure increased slowly and could not sufficiently satisfy the capital investment needed for high economic growth, and this caused an incompatibility between the infrastructure and the production capacity (high inventories). In addition, the weaning of SOEs from state budget transfers and the inconsistency in separating the state corporate finance from the public finance have 'threw' this leading sector into the water while 'it never learned how to swim'. To survive, these SOEs had to cling to the state as a 'lifeboat', although the 'lifeboat' may not keep itself afloat.
- Faced with the severe slowdown in economic growth during 1998–2000, Vietnam promptly reduced the state budget revenue

Table 5.3 The period of decelerated growth with signs of stagnancy, 1998–2000

	1998	*1999*	*2000*
GDP growth (%)	5.8	4.8	6.7
Inflation based on CPI (%)	9.2	0.1	−0.6
Budget revenue (% of GDP)	18.8	17.2	17.5
Budget expenditure (% of GDP)	22.7	22.2	22.4
Budget deficit (% of GDP)	−3.9	−5.0	−4.9

Source: Institute of Financial Research (2000).

> through tax cuts and a package of demand stimulus, especially the demand of investment. However, this expansionary fiscal policy actually stimulated supply rather than demand, as budget expenditure declined and capital expenditure was aimed at consuming the stockpile of low quality and high cost products. On top of that, corruption and inefficient investment eroded the effect of the government's policy for investment demand stimulus.

Table 5.3 summarizes the economy's slow-down phase during 1998–2000.

3 Fiscal policy and economic growth

Prior to 1992, Vietnam implemented tight fiscal and monetary policies. From 1993, the monetary policy was relaxed (in interest rate and credit ceiling policy) but the money supply was still tightly controlled and the fiscal policy continued to follow a cautious course (except in 1993 when the state credit was expanded). In other words, after succeeding in stabilization, the policy focus was shifted to high growth.

Vietnam achieved high and steady economic growth to catch up with the world economy and to meet the requirements of the domestic economy. However, it was extremely difficult to choose the growth path. It was actually hard to grow fast for a long time, since economic growth itself contained many destabilizing factors that might lead to crisis. The cyclical effect in the economy did not leave any country immune, even the so-called 'miracle' economies. The international experience showed that many countries followed the high investment model and incurred a heavy and rising foreign debt burden, or in other words, growth at any price. As a result, the economy grew at a double-digit rate, with accelerating inflation, became overheated and gave rise to factors of economic and financial crisis. Eventually, a crisis was inevitable. However, a number of economists supported the path of accepting crisis (high inflation, debt crisis and fiscal deficit) and considered it to be based on factors that more effectively promoted structural change, and thus higher growth. In brief, this was an up-and-down growth model, which eventually brought the economy to a higher growth path.

The second viewpoint that was supported by many countries was the stable growth path. From an economic point of view, macroeconomic stability would build a solid foundation for future development or the 'straight line' economic growth, i.e. without crisis. The market economy by its nature always gives rise to crisis factors, especially in the context of high growth. Therefore, macroeconomic policies should be sensitive and frequently adjusted to the situation. This was not an easy task. Moreover, growth could only be sustained at a moderate rate (the international experience suggested that the sustainable growth rate was 6–8 percent per annum). In fact, many countries with high growth in the medium term have experienced crisis, which resulted in decelerating growth with lower growth in the long run. The Philippines was a typical example. Inappropriate incentives and high investment called for inefficient and uncompetitive capital flows. In addition, domestic saving could not meet the investment demand and the current account deficit was financed with external capital, which resulted in a high debt burden.

4 Demand and supply driven trends

The macroeconomic theory developed by Keynes was typical for the demand driven trend. According to Keynes, to boost production and maintain the supply and demand equilibrium in the market, effective demand stimulus measures are needed. On the one hand, the government should intervene more in the economy to effectively increase demand, stimulate the investment to generate jobs and income. The government should use its budget to stimulate private and public investment. On the other hand, to increase the aggregate demand and employment, it is necessary to diversify investment, and investment in any area is good as long as it creates employment, increases income, combats crisis and unemployment. Keynesian theory especially emphasizes fiscal, monetary and credit instruments. Keynes argued for an increase in the quantity of money in circulation to reduce the lending interest rate, expand investment, supply more currency notes to the budget and implement the 'controlled inflation' in order to stimulate the market. To expand consumption, Keynesian proponents encouraged private consumption of the capitalists, the well-off and the poor.

However, in the late 1970s, Keynesian theory turned out to be inappropriate in reality. The consequence of heavy government intervention in the economy was that the budget was too large, and taxes were increased, which discouraged business and investment, and thwarted the market. The economy of many developed countries fell into stagnation with high inflation.

In the 1980s, the supply driven theory and the monetarist theory became the theoretical base for many schools of economic thought. According to the supply driven theory, production output was the result of costs, and costs stimulate the economy. Therefore, the task of the government was to facilitate the economic stimulating factors to emerge. Such cost-push economic stimulus caused the supply to increase. The new supply will create the new demand. The supply driven theory did not agree with Keynesian theory in considering savings as the source of over-production that cause employment and economic activities to decrease. In this view, it is not necessary to stimulate demand, but to increase productivity. To increase productivity, it is necessary to stimulate employment, investment and savings. High growth requires savings, and only savings can meet the demand of investment and finance the budget deficit. The supply driven theorists argued that high tax rates would reduce the level and size of savings, and discourage entrepreneurship–the engine of investment. Raising income tax would increase the propensity to consume and reduce savings in the public sphere. Savings were future income for individuals. The more one saved the present income, the higher the future income; thus the argument was to cut tax sharply and uniformly in the long run to stimulate production, increase income and the gross national products; fiscal revenue would rise as the result. However, many people doubt that tax cuts could reduce income and increase the fiscal deficit.

Choosing the supply or demand driven theory was an on-going debate among economists. In our view, the choice must start from the context and the development objectives for the economy in each period and for each nation. For Vietnam, given the legacy of a long period of a centrally planned system, the aggregate supply was basically lower than the aggregate demand, therefore the long-term objective was to apply measures that increased the aggregate supply to meet the needs of a society that suffered from the shortage of many goods and services. However, due to the very small scale of the economy, the short-term aggregate demand may be saturated at a low level, and a demand stimulus package was needed to increase the aggregate demand. A simple rule in economics is that the economy is stable when demand and supply are in equilibrium, policy makers could base on the specific situation to stimulate the aggregate demand or supply, bring them to equilibrium and prepare for equilibrium at a higher level due to the economic growth. For this reason, we believe that it is necessary to properly combine the aggregate demand stimulus measures in the short term and the aggregate supply stimulus measures in the long term.

Fast economic growth could be a result of many factors, of which a very important one was the liberalization and maximal use of resources, especially financial resources in tapping sources of capital (state, business, households, domestic and foreign capital), and the efficient allocation of those resources. However, after 1995, the growth rate of Vietnam decelerated. The main reason was that the factors for extensive development (investment in production expansion, job creation, production factor lib-eralization were all suppressed by the old mechanism, harnessing the capacity of the previous investment) were exhausted, while factors for intensive development (technology change, management, quality improvement, cost reduction, capacity building, intensive market penetration, etc.) did not receive adequate attention. Labor productivity increased slowly and technology was slow to be changed; thus investment efficiency was not high, competitiveness was weak, many products stagnated and could not be sold, and domestic products could not compete with imported products and could not be exported due to their low quality, high cost and low value added. Many sectors were import substituting in a highly protected market through tariff and non-tariff barriers (quota, administrative procedures, preferred credit, subsidies, price subsidies, etc.) and no effort was made to explore the exports market and to gain share in the domestic market. The regional crisis had also played a role in slowing down economic growth in Vietnam. However, in our view, the effect of the crisis on growth over the last 2 years was relatively mild. The main reason for the economic slowdown was the internal factors of the economy.

5 Size of the government budget

The two most important instruments of fiscal policy were tax and fiscal expenditure. It is also critical in the economic, political and social life to determine the size of the budget, or in other words, government expenditure as a share of the economy as a whole.

Free market economists do not support government intervention in the economy and advocate a small budget, just sufficient for the government to implement its governing and border protection functions. The ‘traditional’ theory of macroeconomics developed by Keynes advocates the strengthening of government intervention in the economy. With this theory (and other rationales), the size of government budget in capitalist countries tends to expand, up to 50 percent of GDP. A large budget size allows the government to implement large-scale economic and financial strategies. However, the biggest limitation in implementing Keynesian theory is the bureaucracy and corruption in the administration, which leads to inefficient allocation and waste of resources. As a result, more recently, countries have started reducing budget size. The government uses its budget to intervene in key activities of the economy only; others are left to the market.

At present in Vietnam, there are two opposite views on the size of the budget.

- On the first view, in the early stage–the transitional period–of reform, the non-state sector is too small and inexperienced to do business and engage in production, and in order to grow fast, the government should build a strong state sector, which requires a large state budget and higher budget revenue as a share of GDP. This view is in line with the Keynesian theory.

- On the second view, the opposite is the case: the size of budget should not be large, just enough to meet the expenditure on administration, national security, defense and a number of other recurrent expenditures. There might be some expenditure for economic activities, but an insignificant amount. This view is more similar to Adam Smith's theory.

We believe that the size of a government budget should be large enough to make sure that the government can implement all of its functions, including macroeconomic management. At present, this function is critical, especially in building the physical infrastructure and public utilities, creating a conducive environment for doing business in all economic sectors.

Nevertheless, one should not abuse this function of government to justify an unnecessarily larger expenditure, and thus size of budget. In this connection, it is extremely important to review the number of expenditure items in the government budget to determine which ones should be incurred by the budget, and which should not. To have a sound budget, bold steps should be taken to restructure the budget in such a way as to spend sufficiently on the necessary items, and to remove the unnecessary items which do not belong to the government budget function. In addition, the size of budget should not have a negative impact on the accumulation or re-investment of businesses and the private sector, i.e. the interests of the government, the business community and the public at large should be properly addressed (Nguyen *et al.* 1998).

6 Discussion on fiscal policy in Vietnam

Based on the analysis above, we believe that in the near future, Vietnam should continue to promote growth to achieve an annual growth rate of 7–8 percent, to control inflation and stabilize its macro economy while ensuring social equity. The financial policy in general and fiscal policy in particular should focus on these objectives.

In the next 5 years, budget revenue should be maintained at 19–20 percent of GDP through two major steps.

1. A tax cut is necessary to encourage business and production by different economic agents.
2. Budget revenue should be secured through expanding the tax base, improving collection procedures and taking measures to minimize losses.

The positive impact on production and business is derived from lower tax rates, more equality due to a larger tax base, and minimal tax preferences, reduction or exemption; and tax reduction or exemption should be based on performance, rather than on the taxpayer. Currently, oil revenue accounts for more than 10 percent of budget revenue, and is highly vulnerable to changes in the world price for crude oil and the prospects of new exploration–which are all very difficult to predict, but are fairly stable.

In our view, in the short run there should be a reduction in the tax rates of the most important taxes: VAT and corporate income tax. The VAT rate should range between 5–10 percent and the corporate income tax should range between 20–25 percent (Huynh 2000). The role of taxes as a regulating device can be enhanced through new taxes such as anti-trust tax, property tax and excise tax.

In addition, one should notice that with economic integration with the rest of the world, revenue from tariff, which currently accounts for 21–22 percent of total revenue, would drop sharply, thus pulling down the whole budget revenue. In future, Vietnam should maintain the low revenue from the agricultural sector, at 3 percent of agricultural GDP, 18 percent from the industrial sector, and 25 percent from the service sector. In fact, shares of revenue from the industrial and service sector steadily declined from 27–28 percent for industry and 32 percent for services in 1991–5 to 17 percent and 28 percent in 1999, respectively (GSO 1995).

Some have argued that the agriculture tax should be removed, since it was negligible, while requiring a complicated and cumbersome apparatus to administer, and not favoring farmers. However, the maintenance of this revenue in the short run can be beneficial.

- First, currently agriculture shares one quarter of GDP and there is no reason for it not to contribute to the budget.
- Second, agricultural revenues are left to local government to spend on agricultural production, without which many local governments would be in a difficult situation, especially those in purely agricultural regions with fiscal decentralization and no way to change the economic structure overnight.
- Third, the agricultural sector in Vietnam is moving toward larger farms, rather than petty household production, and tax revenue from this sector is both fair and feasible.

Another issue is the share of direct and indirect taxes. Many people have suggested that the share of direct taxes should be increased from the current 30 percent to 50 percent of the total tax revenue, to be appropriate to the structure of developed countries. But in our view, this would be difficult for the following reasons.

- The tracking of income, both personal and corporate, in Vietnam is difficult due to the incomplete accounting system and limitations in auditing, and it is hard to cover all income sources in a transitional economy like Vietnam.
- Vietnam is weak in management and tax collection experience.
- Awareness of tax discipline among taxpayers is low, even for indirect taxes, coupled with ineffective tax authority.
- The custom of recording transactions, disclosure, income statement and receipts is non-existent; cash transactions are too common.
- Information systems in Vietnam are inefficient in many areas, and coordination among the authorities concerned is not smooth, resulting in a lack of capability for valuing the taxable income (Vu 2000).

Fees and charges, though accounting for only 3 percent of the total revenue, are complicated and daunting in Vietnam now due to the discretionary fee collection. Almost every level of the administration can set its own rules and collect fees or charges to spend on uncontrollable activities. Each individual fee or charge may not be significant, but too many fees and charges may negatively affect economic activities, and leave much room for corruption and bribery, with the formation of many off-budget funds. In our view, Vietnam should issue soon a law on fees and charges, stipulating uniform application, with legitimate and specific fees and charges, uniform rates, collecting authority and the purpose of expenditure. The current 'anarchy' in fees and charges should be brought to an end.

Due to the new economic mechanism achieved during the *Doi Moi* period, budget revenue during 1986–2000 rose faster than expenditure and the revenue structure also changed toward a more positive trend, with more revenue from domestic sources. However, the demand for expenditure is rising to meet the requirements of economic growth, infrastructure and social sectors such as health and education. Expenditures for education, training, health, culture and social issues rely mainly on the budget, while the budget can meet only 50–60 percent of the demand (24 trillion dong versus 40 trillion dong each year). The current payroll bill is 22 trillion dong (or 49.7 percent of the total recurrent budget expenditure, double compared to 1991), while real wages are only 75–80 percent compared to the early stage of wage reform. The increase in number of state employees is 50,000 per year. A radical wage reform would require an annual increase of 6–6.5 trillion dong; the wage bill would account for 64 percent of the recurrent expenditure and the consistently low non-wage recurrent expenditure would be further cut in absolute terms (MOF 2000).

In terms of budget expenditure, the government has reduced subsidies to its enterprises, increased their autonomy, and increased capital investment in infrastructure and social welfare, especially spending on human development such as education, training and health care. The expenditure structure has changed in favor of capital expenditure for infrastructure, education, training, social welfare, poverty reduction, employment creation, environment protection and social equity. However, this is far from meeting demand and remains low in efficiency. Recurrent expenditure is obviously spread too thinly and is subsidy-like in nature. While expenditure on state employee salaries increases, the real wage remains low due to the large and fast increasing number of employees, and the salary structure does not encourage people to work hard. Since expenditure on salaries is proportionately high, expenditure on maintenance of equipment is inadequate, resulting in deteriorating capital equipment. (The budget expenditure for education and health is mainly on salaries, therefore, school buildings, hospitals and teaching or health equipment in many places are deteriorating, thus negatively affecting the quality of public education and health care).

There are too many expenditure items with small amounts for each, thus limiting the effect. Some works can only be half completed due to the shortage of funding. Expenditure on human development and social issues tends to be stable and gradually increase, but remains low. Expenditure on economic development accounts for a too small share.

Expenditure on servicing domestic debt, issued through treasury bills during 1986–90 accounted for only 0.5 percent of the total budget expenditure, but rose to 7.6 percent of total expenditure during 1991–5 (GSO 1986–96).

The budget deficit is mainly financed by domestic borrowings and foreign concessionary loans, not by commercial borrowing or printing money. This helps to stabilize the macro economy and control inflation; however, high interest rates on short-term domestic borrowing within a short time has put a burden on the budget. Table 5.4 summarizes the budget deficit situation in the last few years.

Table 5.4 Budget deficit, 1986–2000 (% of GDP)

	1986–90	*1991–5*	*1996*	*1997*	*1998*	*1999*	*2000*
Deficit	6.5	4.4	3.0	4.0	3.9	5.0	4.9
Domestic borrowing	4.3	2.7	1.8	2.7	1.1	2.5	3.3
Foreign borrowing	2.2	1.7	1.2	1.3	2.8	2.5	1.6

Source: Institute of Financial Research (2000).

7 Concluding remarks

Given the current conditions of Vietnam, to achieve high growth, tax rates have to be reduced in order to stimulate production and business in the different economic sectors, to reduce budget revenue as a share of GDP as mentioned earlier. Furthermore, the government should be responsible for developing the infrastructure for the economy, science and technology research, education and training, and a number of other areas, in which the private sector cannot, are not allowed to or are unwilling to invest. For this reason, the size of the government budget can remain at 22–23 percent of GDP, as it is now. To stimulate demand and create an economic and financial breakthrough in the next 5 years, budget expenditure should increase up to 24–25 percent of GDP. In addition, special attention should be paid to the quality of management over expenditure and investment; problems have recently arisen in such inefficient programs as cement or sugar plant imported from China.

Priority should be given to current expenditure, debt servicing and capital expenditure, though most of the budget deficit comes from capital expenditure. Current expenditure represents about 11–12 percent of GDP, mostly salary expenditure, but salaries are still unrealistic and cannot cover the cost of living for state employees. This is one of the main reasons for inefficiency in the state apparatus. In the future, salaries should be adjusted to ensure upper average income level for state employees; this can be done through increasing the payroll bill and reducing the administrative staff. In fact, if staff reduction takes place first, salary increases would be much easier. State employees are critical in determining the success or failure of the reform, since they are directly involved in policy making, implementing and specifying the government policies. Numerous examples can be found in recent years in which the lower level does not follow the upper level, and resolutions cannot be implemented due to interruption or freezing at the intermediate level.

Debt servicing expenditure is currently about 3 percent of GDP or 14 percent of the government budget. Thanks to the debt negotiation with Russia, the biggest creditor of Vietnam, Vietnam's total debt and debt service have been reduced substantially and are no longer such a burden on the budget. However, Vietnam still needs to allocate budget for debt service in due course in order to protect its creditworthiness and secure future borrowings.

Capital expenditure for development is 6 percent of GDP (22–23 percent of total budget expenditure), meeting only a part of the requirement for infrastructure. Capital expenditure could be 9–10 percent of GDP (current expenditure at 13–14 percent of GDP, debt service at 1–2 percent of GDP). Special attention must be paid to the efficiency of public investment.

As mentioned earlier, the SOE sector should be equally treated in terms of taxation with other economic sectors. Partly due to the historical legacy, and partly determined by Vietnam's market economy with a socialist orientation, SOEs constitute a component of the economy with strong physical, financial, and labor resources. The efficiency of this sector will have a great effect on or even determine the efficiency of the economy as a whole. For this reason, one cannot simply divest the loss-making SOEs through equitization or change in ownership; and it is almost impossible to force them to return to the subsidized system. One cannot ignore accountability in doing business or maintain the state monopoly, regardless of economic efficiency, as is the case now. The government of Vietnam instead has to facilitate SOEs to strengthen and compete on an equal footing with the non-state sector in a sound and efficient competitive environment.

Spending on science and technology, education and training is worth considering too, especially with today's trend toward globalization and a knowledge-based economy. Vietnam should separate this item in current expenditure and make it a separate item for budget allocation. This is an investment in the future and in the present when the speed of technology change becomes unprecedented and knowledge is becoming a direct production instrument.

Reducing revenue and increasing expenditure would no doubt result in a widening budget deficit. In our view, at least in the next 5 years Vietnam can sustain a deficit of 5–6 percent of GDP, not below 5 percent as it is now. Given a small budget deficit, the fiscal situation may look safe, but it does not create the impetus needed for high growth as desired. Moreover, as mentioned earlier, the country's foreign debt is now far below the debt safety threshold (at 60 percent of GDP), and it is quite possible that the government of Vietnam could borrow from abroad to finance its deficit. Even domestic borrowing would not be a threat, since the domestic interest is low and it is fairly easy to borrow. In terms of deficit financing structure, we think that both domestic and foreign borrowing should be given the same weight. If domestic borrowing is likely to crowd out private investment, more foreign borrowing should be sought; and if there is a capital surplus in the country, more domestic borrowing is advisable. The government can use this financing source as an effective tool to intervene in the economy. The government should not miss this opportunity.

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6 Economic growth, social consensus and coordination

Van-Can Thai

During 1990–2001, Vietnam recorded impressive economic progress. The rate of real economic growth was high, inflation controlled, international reserves increased and poverty substantially reduced.[1] Fundamental reforms have transformed almost all aspects of the economy life. Legal, regulatory and administrative frameworks have been updated, public institutions modernized (see Chapter 15 for a review and proposals for administrative and civil service reforms). At the same time, the management of the economy has considerably improved; economic policies have been formulated and implemented more rationally, and appropriate economic instruments used more systematically.

Against the backdrop of this performance, it would be opportune to reflect on two basic economic issues that the country would have to face in the period ahead:

- What is the kind of economic growth that might be envisioned for the long term?
- What are the necessary policies that might be adopted to advance rapidly toward achieving that vision?

Those issues seem innocuous and even trivial. But they are fundamental because there is a sense of urgency to move the economy to a faster growth path so as to create more employment and to accelerate the reduction of poverty. For these objectives to materialize, the operating mode of business-as-usual is no longer sufficient. A shift in thinking is necessary to forge a clear and resolute consensus on the following fundamental issues: the determination of the ultimate goal and objectives of economic policy, the role of the state to achieve those objectives, the timetable of implementation, the need for coordination for effective policy implementation, the necessity of reinforcing policy credibility that would have to be based on a strengthening of the rule of law and good governance, and the participation of all in the development effort. This article will briefly deal with each of those issues.

1 Consensus on the ultimate goal of human development

On the goal of human development, not only consensus but also unanimity should be obtained from all decision makers. Implicitly or explicitly, this goal underlines the struggles, reforms and revolutions in human history. It is enshrined in the charter of the United Nations and in the constitution of the country (see Cong Hoa Xa Hoi Chu Nghia Viet Nam 1993, Article 3). It is also a moral imperative.

For each person, the attainment of that goal means to rise out of poverty through increased per capita income and a higher living standard; to be able to live the life of a human being without fear of hunger, lack of shelter or persecution; and to have a place under the sun. This goal is the necessary condition, the surest way, the safest bet and the fastest path for the country to become economically prosperous, strong, harmonious and just. The country would then be able to take care of the poor, the weak and the vulnerable; to catch up with other nations, to have a voice among them; and to exist, without fear of domination and yet in independence, partnership and cooperation with others, especially after the demise of the bipolar ideological adversity toward the end of the 1980s.

2 Consensus on a strategy for economic growth of high quality and with a human face[2]

The best strategy to attain the goal of human development is to obtain a consensus on growth endowed with the following main features.

2.1 Growth should aim at a rate higher than those achieved by richer and stronger neighboring countries if the objective is to catch up with them

It is not enough to grow at the rate of population growth because per capita income will remain unchanged and the objective of a higher living standard will not be attained. Nor is it enough to grow at the average world growth rate, because the country will stay in the same position relative to others and the objective of catching up will not be realized. The country must take the necessary measures to achieve a growth rate that is higher than those achieved by fast growing countries in the region. In this context, one wonders whether the country may afford the luxury of not implementing expeditiously the needed reforms so as to grow as fast as neighboring countries, notably China.[3] Time is of the essence, because any delay may widen the gap–not only have other countries preceded Vietnam on the road to reforms, but they have also pushed forward for deeper reforms–and because the sooner the reform process can be accelerated, the faster the country will achieve the expected results.

2.2 Growth should be sustainable

Sustainability would aim at minimizing fluctuations in the growth rate that might fall below that required to catch up with other countries. Sustainability would also maximize the gains due to the effect of compounding and create a momentum for further reforms, which would lead to further growth.

2.3 Growth should be concerned with equity[4]

There are several reasons. Equity is a worthy objective in itself because it is morally right and socially just. It could lead to a reduction of poverty because with a more equally distributed income, the number of people falling below the poverty line would be reduced. Poverty reduction could, thus, reduce political conflict, foster political cohesion and engender lasting political support for reforms.

Experience shows that economic growth might widen income gaps among various segments of the population.[5] Policies should thus be adopted to ensure that both the fruit and the hardships generated by growth-enhancing policies and reforms be shared equitably among the population. They should also be designed to integrate the poor in the development process because those policies would give them, in addition to increased income, a sense of worthiness and self-esteem derived from the feeling that they, too, could contribute, however little, to the common good.

2.4 Growth should be environmentally friendly[6]

There are three main reasons for growth to be environmentally friendly.

2.4.1 The first reason is that environmental degradation can reduce economic growth

The reduction may be caused by a decline in the quantity and quality of inputs on account of environmental degradation (see Gandhi 1996). Excessive exploitation of natural resources, such as overfishing, deforestation, soil erosion, over-mining, loss of biodiversity or cultural heritage, will soon cause losses in production, cuts in the supply of raw materials and increases in the costs of domestic industries.[7] Water and air contamination will impair health and will thus lower labor productivity.

2.4.2 The second reason is that growth can go hand in hand with environment protection

Judicious policies could be designed to exploit natural resources at a sustainable rate that permits the conservation of the value of rivers, forests, oceans and air. The policies could be implemented by enforcement of property rights, taxation or subsidies (see World Bank 1992).

2.4.3 The third reason is that it is meaningless to have more income if one cannot take advantage of it

Growth would not be needed if one could not breathe air because it is contaminated, not use cars because one has to sit in monstrous traffic jams, not enjoy the fruit of one's hard work because one gets sick from pollution-induced diseases, or not live in one's preferred place because intolerable pollution produced by industrialization forces one to move to another place. Finally, there is the equity issue, because the poor tend to share a heavier burden of environmental degradation due to bad growth.

3 Consensus on the role of the state

There are basically two major participants in the growth process: the state and the private sector. Each has its interests in and responsibilities for the attainment of the agreed growth objective. The interests of the state are the furtherance of the common good. Those interests are also its responsibilities and duties that are entrusted to it by the people and reflected in the constitution (see World Bank 1997 for an ampler discussion of the role of the state).

As the trustee of the people, the state must reflect the long-range vision of the country that is the goal of human development. The state has to play a leading and catalytic role by establishing an environment that is favorable to a smooth and efficient functioning of both the private sector and the state so as to move toward the goal of human development more rapidly.[8]

3.1 This favorable environment would have three constituent blocks

These are the promotion of governance, clear and uncompromising commitment to equity, and fostering of a competitive, open and efficient economy.

3.1.1 Promotion of good governance should move steadily forward

In this regard, vast efforts have been deployed to develop a legal framework and a contract culture where contracts would be strictly enforced, rights protected and property secured to provide a stable, predictable environment for the effective functioning of the economy.[9] In the period ahead, reforms should aim at improving on the clarity, simplicity and fairness of the current framework so as to facilitate the administration of the law. To be effective, the strengthening of institutions should continue and the effective independence of the judicial system should be ensured. Equally important is the full enforcement of court decisions, which would require the complete cooperation and assistance from other institutions. This would help to further the respect for the rule of law.[10]

Governance could be further strengthened by advancing transparency in public institutions. Most important is the provision of more regular, complete and timely information to the public, because without information on how similar cases have been treated, it will be difficult to ensure the adherence to the rule of equality of treatment before the law. However, information openness would need a judicious legal framework that would balance the right to disclosure against the need for confidentiality.

In this regard, codes of good practice of transparency with internationally accepted standards should be adopted, not only by public institutions but also by key private sectors. Such codes have been available in the areas of fiscal, monetary and financial, security, insurance and social policies. Compliance with those codes should be overseen by strong regulatory and supervisory bodies.[11]

Governance would also benefit from a further reinforcement of accountability, which would impose discipline, integrity and soundness on public institutions. In the process, accountability would increase credibility of public institutions and thus enhance the efficiency of policy making.[12]

Transparency and accountability should also be the basis for the relations between the state and the private sector, which would be governed strictly by the rule of law. This means that the state will have to observe the principles of equal treatment and at-arm's-length in its transactions with the private sector. Notwithstanding these principles, both parties should work in the spirit of partnership and cooperation because both would benefit more from cooperative than uncooperative behavior.

The state should promote equal treatment by ensuring that the public and private sectors, on one hand, and nationals and foreigners, on the other, be subject to the same taxation, benefit from the same access to inputs and prompt administrative services.[13] However, if preferential treatment is needed, it has to be justified with clarity, simplicity and transparency. It also has to be accompanied by sunset legislation, which indicates the date by which the preferential treatment will end. For example, infant industries might be temporarily protected, but the end of the protection should be unambiguously stated, otherwise infant industries would never grow up. The state should also guarantee that the rule of law be enforced, propriety rights respected and lawful contracts honored.

The private sector would, in return, have to comply with legitimate demands from the state such as payment of taxes, observance of regulation and bankruptcy. It should adopt internationally accepted standards and code of good practices on accounting, auditing and corporate governance. It should de-link itself from the state and stop spending time in ministries to seek favored treatment, such as tax breaks, subsidies and import protection (these are known as rent-seeking activities). It would thus be able to devote its full energy to run its business: to invest, produce, sell, export and to prosper for itself and for the country.

Transparency and accountability should also be the basis for the state in its relationships with the foreign sector. This sector is highly sensitive to the stability and predictability of the business environment and the respect of the rule of law. To avoid misunderstandings that would be prejudicial to the credibility of the state, it is important to understand that the relationships are based on mutual benefits. The benefits to be received by the country include gains in know-how, and access to technology and foreign markets.[14] The benefits to the foreign sector are predominantly economic, but non-economic benefits might also be the motivation, which varies according to foreign entities. Example motivations include: for non-government organizations (NGOs), the fulfillment of some idealistic desires to help; for foreign bilateral partners, geopolitical presence; for multilateral organizations, the achievement of their main missions as stated in their charters (e.g. the World Bank for economic development, the IMF for economic stability in member countries and the international monetary system, or the World Trade Organization (WTO) for the development of international trade).

Promotion of transparency and accountability in public institutions would also help to reduce the incidence of corruption and supplement the efforts deployed by the state during the last few years to fight corruption. The state has used administrative and legal remedies to deter or limit the discretion of officials.[15] In the long term, the fight against corruption, to be effective, should be supported by fundamental economic reforms. These reforms should aim at removing the conditions which initially give rise to corruption (see Abed 2000); strengthening enforcement mechanisms, and fostering a free press and civil society.

3.1.2 Commitment to social equity should be clear and uncompromising

This commitment is perhaps the most potent element in the strategy for economic development because it would contribute powerfully to the mobilization of support for reforms. This commitment would take the form of equal opportunity of access to education (especially basic education) and health care (especially preventive health care), and the implementation of a social safety net to mitigate the adverse impact of economic adjustment and reforms on the poor, the weak and the vulnerable.[16] Those policies would contribute to narrowing income inequality, reducing disparities in human capital across income groups and raising economic growth in the long term. To carry out this commitment, tax must be paid so that the state has resources to implement the required reforms.

3.1.3 The move toward a more competitive, open and efficient economy should be steadfastly pursued[17]

This move would require an acceleration of economic restructuring which should be guided by the experience that the most efficient way to energize the economy is to replace the state by the private sector as the engine of growth. Accordingly, the state would have to disengage itself, at an appropriate fast pace, from activities that may be taken on by the private sector. Public enterprises should be restructured, including privatization, and the banking sector strengthened, including through restructuring, recapitalization and closure of problem banks. Public enterprises and banks would have to be subject to high standards and good practices of governance, well defined regulation and supervision. In these areas, the country could learn from the experience of others to avoid pitfalls and adopt relevant and good practices (these include Eastern European countries, Russia and the UK).

Furthermore, other structural policies would have to be more rapidly implemented to heighten competitiveness. These would include:

(a) continued elimination of distortions (such as tax, credit and interest advantages); this would ensure that decisions by the private sector are not based on distortions; and
(b) continued integration of the country into the world economy by further opening up trade and financial sectors.[18]

These structural changes would provide the economy with needed competition, know-how and technology.

The structural changes, to be effective, should be accompanied by appropriate institutions and adequate macroeconomic stability. Institutional changes would reflect the new market-friendly environment with the prevalence of the rule of law and good governance discussed above. The macroeconomic stability that the country has reached during the past decade (in terms of adequate growth, low inflation, reduced fiscal and external current account deficits) would have to be pursued with appropriate policies to meet successfully changing conditions.

The design and implementation of structural reforms and macroeconomic policies should pay attention to two issues. First, remedies should, as seen above, be in place to address effectively the temporary negative impact of reforms on the most vulnerable segments of society, including workers who become unemployed due to public enterprise reform. Second, appropriate sequencing would need to be established for various reforms and policies (structural reforms, macroeconomic policies, trade and capital liberalization, and institutional changes). These should be integrated into a consistent overall framework in order to maximize benefits. In particular, the liberalization of the capital account, as the Asian crisis showed, should carefully be sequenced: first reinforcing the domestic financial system, then liberalizing long-term capital inflow and finally decontrolling short-term capital flows.

3.2 A clear timetable, with indication of all steps, should be established for the implementation of the agreed policies

This timetable would concretize commitment for policy changes, facilitate their implementation, avoid the risk of backtracking and allow a clear monitoring of progress.

3.3 Coordination of all actions are essential for effective and timely implementation of agreed policies

3.3.1 Once consensus has been obtained on the goal, objectives and policies, coordination of all actions for implementation is essential to achieve the desired results

Coordination may be defined as a set of integrated actions of all involved entities for the attainment of the goal and objectives on which consensus has been obtained. It can provide a better chance to achieve, at a faster pace, collective (and also individual) goals and objectives by avoiding inefficiency that would result from inconsistent actions of various entities in the implementation process.[19] It can avoid the damaging consequences of uncoordinated actions while bringing clear benefits. These may include:

- minimizing the chance of making a mistake–even the smallest one, during the implementation process–which can wreck havoc on the whole effort of development;[20]
- consolidating the credibility of the state owing to: (i) the reduced risk of stop-and-go or backtracking policies that usually originate from uncoordinated actions; (ii) the perception of the rule of law; and (iii) the progress made in achieving the declared objectives;
- creating a momentum for continued reforms because, since people can enjoy the fruit of reforms sooner, they tend to provide more support to additional reforms; and
- increasing the cohesiveness of the society because people perceive that, together, they can effectively achieve coordination.

In all, these benefits can give a greater chance of success to efforts for high and sustainable growth (see Abramovitz 1986; Knack and Keefer 1997).

3.3.2 Further coordination, both vertical and horizontal, would need to be achieved to reach higher growth rates, although coordination has been improved during the last few years[21]

Vertical coordination ensures that instructions be carried out from the highest to the lowest level of the administration, i.e. from the central to local governments and within the local governments from provinces to districts, cities, towns and communes. Vertical coordination may be facilitated by a clearer rule for the apportionment of the budget between central and local governments and a more elaborated definition of the accountability of the People's Committee vis-à-vis the same level People's Council and the superior State organs (see Cong Hoa Xa Hoi Chu Nghia Viet Nam 1993: Art. 119; 1995:71–106).

Horizontal coordination should receive the highest priority, since it is often the focus of much difficulty for effective implementation. At the systemic level, the relationship between the party and the government should be more clearly defined to eliminate risk of superimposition of responsibilities, especially in day-to-day policy execution. In this regard, efforts to clarify those responsibilities and improve coordination have been pursued. Nevertheless, coordination should be further strengthened among the three branches of the government (the legislative, executive and judiciary), in particular between the last two so that the decisions of the courts can be enforced and the rule of law upheld.

Within the executive branch itself, horizontal coordination among various ministries, departments and services is essential for the successful implementation of government programs. The public entities that are in charge of economic programs (often the Ministry of Finance and the central bank) should receive full and active cooperation from other entities. The reason is that the programs belong to the whole government and not to the ministry of finance and the central bank alone. The latter, by virtue of the delegation from the cabinet, and of their expertise and responsibilities in financial and economic areas, are more equipped to coordinate the implementation of those programs.

To facilitate successful strengthening of coordination, a competent and dedicated professional staff is required. In this regard, the provision of adequate resources is essential to allow a proper and efficient discharge of their responsibilities and duties.

3.4 Credibility should be strengthened to elicit a greater participation of all in the development effort

It is important to strengthen the credibility of the state and to sustain it. Credibility may be best achieved by a successful implementation of reforms in a swift, transparent and fair manner, in accordance with the rule of law and good governance. This success is the concretization of the trust that the people put in the state.

All government employees must sustain credibility, once strengthened, in both space and time. The loss of credibility caused by the action of one person or entity in the government will put in question the credibility of the whole government and may erase any hard-won credibility. It will take a long time and hard work before credibility can be regained.

Only when credibility is solidly established can the full participation of all people in the development of the country be expected.[22] At the grass roots level, all citizens would feel that their participation was worthwhile because it had brought them benefits in a fair and just manner and, at the same time, the feeling of having contributed to the common good. At a higher level, those who were in charge of the economy, would feel that their unequivocal devotion to the furtherance of the common good had also brought them benefits and, at the same time, the satisfaction of having gained the trust of the people. This earned credibility will make people feel secure to invest their efforts and build their future and their children's now, in the country, rather than in some undetermined future, in some other place, or to appropriate what can be appropriated today.

4 Conclusion

During the last decade, Vietnam has made impressive achievements in economic growth, macroeconomic stability with low inflation, reduced fiscal and external current account deficits, and poverty reduction. These accomplishments were reached through a shift in economic thinking toward a market-oriented economy, the updating of a legal, regulatory and administrative framework more transparent and friendly to business, and considerable advance in economic management capacity.

However, the country continues to face the challenge of enhancing the quality of its economic development. In this regard, the objective of higher and sustainable economic growth with concern for equity and environment protection would be highly sensible. This objective would permit not only reduction of poverty, raising living standards, and catching up with other richer and stronger neighboring countries, but also a powerful contribution to the ultimate goal of human development. To achieve this vision, the state would have to consolidate further its leading and catalytic role on three mutually reinforcing points.

First, the establishment of a favorable environment for an efficient functioning of the economy must be accelerated. This environment should be governed by equal treatment of all economic actors, the rule of law and good governance based on transparency and accountability. It would also reflect a clear and uncompromising commitment to equity, and the promotion of a competitive, open and efficient economy.

Second, consensus must be forged, and both vertical and horizontal coordination substantially enhanced on all aspects of economic policies, from their formulation to their implementation. Consensus and coordination are the necessary conditions to ensure effective implementation of announced policies in a timely and efficient manner and maximize the chance to achieve good quality growth.

Third, the credibility of the state would have to be strengthened. For this, nothing is more powerful than the demonstrative effect of the effective implementation of its economic policies and their success. This would also create a potent momentum for support for further reforms and thus could lead to further growth.

How soon could the country catch up with richer and stronger neighboring countries, and build a more civilized and just society? This will depend on how soon and how comprehensive the needed consensus and coordination could be forged to realize the above growth strategy. If there is a will there is a way, and the history of the country has amply shown it.

Acknowledgment

The author is grateful for very helpful discussions and advice from many colleagues and particularly from Bernard Donge and Hinh T.Dinh. Opinions in this article are those of the author and do not necessarily reflect the position of the Executive Board or of the IMF.

Notes

1 Economic growth is estimated to average 7 percent annually; a triple digit inflation rate was brought down to 4 percent in 2001; international reserves reached more than 2 months of imports; and poverty was reduced by 20 percent. For a more detailed discussion of recent economic developments in Vietnam, see Chapters 2 and 3 of this book; Vu (1997) and International Monetary Fund (2001a).

2 See Camdessus 1999:55–65.

3 During the last 10 years, the annual average growth was 10 percent for China compared to 7 percent for Vietnam. To catch up with China is a daunting challenge. For a comparison of economic performance between China and Vietnam, see Chapter 10 of this book.

4 Poverty reduction and equity have become more prominent on the international scene. It was a major issue of the September 2000 Annual Meetings of the IMF and the World Bank in Prague (see IMF 2000 and World Bank 2000).

5 Evidence indicates that growth may be accompanied by an increase or decrease in inequality. Growth was associated with an increase in inequality in China (see Dollar and Kraay 2001a:18). For an ampler discussion on the relationships between trade, growth and income distribution, see also Dollar and Kraay (2001b, 2001c) and Rodriguez and Rodrik (2000).

6 See Chapter 16 of this book for more detail on the current status of and proposed policies for environment protection in Vietnam.

7 Deforestation and its consequences for soil erosion contributed to intensity of floods in the Mekong delta in the southern part of Vietnam in 2000 and 2001.

8 Policies are similar to labor and capital; they are inputs and determinants of growth. For the theoretical foundations of this view, see the literature on endogenous growth, for example, Romer (1990), Barro and Sala-i-Martin (1995) and Aghion and Howitt (1998).

9 The legal framework helps to ensure that (i) business risks can be assessed rationally, (ii) transaction costs are lowered and (iii) government arbitrariness is minimized. This favorable environment, which promotes predictability, should prove conducive to risk-taking, growth and development. Stability and predictability refer to the existence of (i) laws, regulations and policies to regulate society, and their fair and consistent application and (ii) clear procedures for changes in those features if needed.

10 This is particularly needed for the state to ensure compliance with and enforcement of taxation, which is the cornerstone of any well functioning economy.

11 The codes should provide for (i) clear definition of objectives, role and responsibilities of each institution in relevant legislation and regulation, (ii) open and predictable process for formulating and reporting policy decisions, (iii) disclosure to the public in a routine, regular and prompt manner of available, reliable and selected information on policy decisions and other data pertaining to the responsibilities of the institutions and (iv) accountability of the decision makers in the performing of their official duties. Officials at these institutions should be available to appear before the designated public bodies to explain the policy objectives, report on the conduct of policies and describe their performance in achieving their objectives. Audited financial statements of their operations should be publicly disclosed on pre-announced schedule. To avoid conflict of interest, the code of conduct should require officials to publicly disclose their personal financial affairs. For more detail on standards and codes (see IMF 2001b).

12 The elements of good governance are: predictability, transparency, accountability and the participation of all economic actors. These four elements are mutually supportive.

13 The case for favorable tax treatment of foreign capital is not convincing since foreign investment is determined more by a stable, predictable and transparent environment than by tax treatment.

14 The role of information technology in stimulating economic growth is examined in Chapter 14.

15 Capital punishment has been carried out and complicated procedures for economic activities reduced. Decision 19 of 3 February 2000 eliminated 84 permits to simplify procedures for production.

16 Review of and reform proposals for education are discussed in Chapter 13, and for social sectors in Chapter 18.

17 Trade, investment and financial policies for the economy in a global context are discussed in Chapters 7, 8 and 9.
18 The Vietnam-US Bilateral Trade Agreement was promulgated by the US and Vietnam in December 2001 and negotiations for Vietnam accession to WTO is underway as of December 2001.
19 See Gosh and Masson (1993). This and other similar conclusions are established for policy coordination among different countries but are applied in this article to coordination among entities in the same economy.
20 See Kremer (1993). The destruction of the space shuttle Challenger was found to result from a faulty O-ring.
21 The Administrative Reform Program of 1994 streamlined and simplified administrative procedures and established consistencies among different decisions taken by various local governments, and the *1995 Nghi Quyet Trung Uong* of the Party defines the role of the central government. In its report to the National Assembly, the government reaffirmed its commitment to administrative reform; see *Nhan Dan* (9 May 2000).
22 Economic actors would also include NGOs. These members of civil society can be helpful in identifying the people's interests, mobilizing public opinion in support of these interests, and can be a useful ally for the state in enhancing participation at the community level to the economic and social development.

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Part III

The Vietnamese economy in a global context

7 Economic openness and the gains from international trade and investment

The case of Vietnam

Binh Tran-Nam and Ngo Van Long

1 Introduction

After a decade of building its market-based economy, Vietnam has accomplished remarkable achievements in many areas. These economic successes have been well documented and analyzed in various chapters of this book (refer to Chapter 3 in particular). In general, the *Doi Moi* policy has two main components: domestic structural reforms, from macro to micro, and an open policy that promotes international trade and investment. More specifically, economic development in Vietnam has in recent years relied heavily on foreign direct investment (FDI). The substantial decline of FDI inflows to Vietnam in the last few years of the last decade has adversely affected its GDP growth rate.

The issues of FDI, international trade policy and international integration have already been mentioned in Chapters 3 and 4, and will be further discussed in the remainder of Part III of this book, especially Chapter 11. Other authors have put forward many observations, analyses and proposals concerning Vietnam within the globalization context. This kind of research has largely relied on analyses of quantitative data or international trade laws, and is empirically oriented. To complement that line of research, this chapter will emphasize theoretical aspects of the gains from international trade and investment, and attempt to draw some qualitative conclusions from economic theory. The arguments in this chapter will be mainly based on the neoclassical theory of economics.

The conventional approach tends to draw a distinction between international trade and FDI. However, from a theoretical point of view, both are basically the same. Foreign investment can be thought of as a form of intertemporal trade. Thus international trade should, in principle, cover foreign investment as a special case. Nevertheless, to avoid possible confusion that may arise because of this long-standing convention, in this chapter we will continue to maintain the distinction between international trade and foreign investment.

The remainder of this chapter is organized as follows. Section 2 discusses the theory of the gains of trade in general and the case of Vietnam in particular. Section 3 reviews the benefits of foreign investment, particularly FDI. Section 4 analyzes a number of normative issues relating to trade such as foreign ownership, the bargaining power of foreign investors, the volatility of portfolio investment, and the protection of infant industries. Section 5 proposes a number of specific measures in conjunction with trade and FDI policy that may maximize Vietnam's social welfare in the long run. The final section then summarizes main issues and results obtained.

2 The gains from international trade

2.1 Theory of the gains from trade

The majority of people think that international trade is obviously gainful to all trading partners. A sovereign nation like Vietnam is under pressure from no country to engage in cross-border trade. If it does choose to trade with other nations, then international trade must be beneficial to Vietnam. A quick glance at economic data reveals the importance of the rest-of-the-world sector to Vietnam's economic growth.

In fact, this kind of argument is only true in the aggregate. It is well known in trade theory that while trade makes some people better off, it also causes others to be worse off, relative to autarky. If we are not willing to engage in interpersonal utility comparison, in what sense can foreign trade be said to be gainful? This is basically the nature of the problem posed by the French social philosopher Montesquieu over 250 years ago (see Montesquieu 1748). The novelty in Montesquieu's question is that he defined the benefits of trade from the perspective of individual citizens, rather than from that of the king. Montesquieu's questions can be interpreted as having two components: (i) in what sense is trade potentially gainful, and (ii) under what conditions can gainful trade take place when individuals are not homogeneous?

David Ricardo, the best-known and most influential trade theorist, provided the answer to (i) through the principle of comparative advantage. He, however, avoided question (ii) by concentrating on economic models with homogeneous populations. This kind of model is not useful in analyzing the internal distribution of income. People, as a matter of course, differ in terms of preferences, resources, wealth, work effort and access to information. Other leading economists in the nineteenth century, such as John Stuart Mill, Edgeworth and Marshall, all recognized this, but were unable to respond adequately to question (ii) by Montesquieu.

We have to wait until the end of the nineteenth century when Pareto's invention of the concepts of Pareto optimality and compensation principle provided economists with the required tools to solve problem (i). Since Pareto's writings were in Italian, his work was ignored and misinterpreted for almost 50 years. Under a number of standard assumptions, Samuelson

(1939, 1950) proved that free trade policy is gainful to a small open economy[1] in the following sense. If such an economy moves from autarky to free trade, there exists a lump-sum transfer scheme from those who are better off to those who are worse off so that none is worse off, and at least one person is better off than under autarky.

Nowadays, economists are aware that any proposition concerning the gains from trade requires two components:

- the specification of trading nations (preferences, endowments, technology and market structure) including the scheme of lump-sum transfers from those who gain to those who lose from trade; and
- the world economy has a post-trade equilibrium.

The existence of the world economy's autarkic equilibrium needs to be assumed also.

After the publication of Samuelson's path-breaking papers, Arrow and Debreu (1954) and McKenzie (1954) independently proved the existence of a perfectly competitive equilibrium. Soon the Arrow-Debreu-McKenzie model was applied to problems relating to the gains from trade, and Montesquieu's agenda can be considered as being satisfactorily discharged.

However, more general propositions concerning the gains from trade only appeared about 30 years ago (see, for example, Grandmont and McFadden 1972; Kemp and Wan 1972). Thanks to the contributions of many economic theorists, particularly Kemp (see, for example, Kemp 1995, 2001) the gains from trade have been proven under much more relaxed conditions.[2] The fundamental proposition of the gains from trade can be stated as follows:

> However trade is distorted by tariffs, subsidies or quantitative restrictions, any subset of trading nations can establish a customs union such that each member country of the union can potentially benefit from trade.

Note that the proposition that 'free trade is gainful' is simply a special case of the above proposition.[3]

2.2 Strategic trade policy

When markets are perfectly competitive, the benefits of trade can be realized without the government's active intervention. However, if the market competition is not perfect (e.g. in the presence of oligopoly) free trade is not necessarily better than restricted trade. In the early 1980s a number of American economists developed the 'new trade policy' and the concept of 'strategic trade policy' (see, for example, Brander and Spencer 1983; Brander is a Canadian economist and Spencer is an Australian economist working in the US). According to that theory, government's trade policies, such as export subsidies or tariffs, can be used to shift profits from foreign firms to domestic firms, especially if the foreign country does not retaliate. The idea of strategic trade industry is closely related to the infant industry argument that will be further discussed in section 4 of this chapter.

The concept of strategic trade policy sounds very attractive for Vietnam, but is extremely difficult to implement, due to a host of reasons, both theoretical and practical.

- The idea of strategic trade policy is more applicable to large economies with very big firms like the US, Japan and the European Union.
- The theory of strategic trade policy is based on partial equilibrium analysis. It lacks the attractive generality of the traditional theory of trade.
- How are strategic industries to be identified? Since domestic firms will compete for government support, the government may incorrectly identify strategic industries.
- What is the optimal form and amount of government support? A major problem with the new trade theory is that equilibrium and government policy both depend on the choice of the equilibrium concept.
- There must be a transparent and efficient administrative system which can withstand pressures from rent-seeking domestic firms is needed.

2.3 The case of Vietnam

Vietnam is often said to be a market-based economy with a socialist orientation. While the meaning of this frequently quoted statement is by no means clear, it is very apparent that state-owned enterprises (SOEs) enjoy preferential treatments in many important inputs such as land, credit and FDI. In terms of contribution to GDP, Vietnam's state sector has played a significant role, averaging 40 percent in the decade of 1990s (see IMF 2000). A relevant question pertaining to Vietnam is therefore: 'Does a centrally planned economy gain from economic openness?' Kemp (2001) has shown that a command economy (both before and after trade) will benefit from international trade without the requirement of a transfer scheme as in the case of market-based economies.

At this stage we need to recognize that *Doi Moi* has two separate but related components: (a) the building of domestic markets, and (b) international economic integration. The benefits from (a) and (b) are necessarily greater than that from (a) or (b) alone. However, the interaction of (a) and (b) has an ambiguous welfare implication. In some cases, building domestic markets will increase the gains from international

Table 7.1 Vietnam's total trade by region (%)

	1990	*1995*	*1999*
Asia	43.5	72.4	57.7
Europe	50.5	18.0	26.3
East Europe	42.4	2.8	2.0
European Union	7.1	12.3	21.7
Oceania	0.3	1.0	7.3
America	0.7	4.4	5.7
Africa	0.2	0.7	0.4

Source: *Vietnam Economic Times* 1 June 2000.

Note
Total trade=exports+imports.

trade. In other cases, developing domestic markets will reduce the gains from trade. This may happen in principle if after building domestic markets, the autarkic relative price moves closer to the world relative price.

Until now, Vietnam's openness can be characterized as being regional rather than global. This is indicated in Table 7.1. The theory of trade suggests that the benefits of trade are greater the more substantial is the difference between Vietnam and its trading partners. In recent years, Vietnam has traded mainly with similar economies such as China and some countries within ASEAN. In the future, via the trade agreement between the US and Vietnam and similar future bilateral treaties, Vietnam stands to gain more in trading with countries whose economies are more complementary to the Vietnamese economy.

In the 1990s, both Vietnam's exports and imports have increased rapidly as shown in Table 7.2. The figures in Table 7.2 are subject to an important qualification. There are large differences between prices of traded goods and services (in US$) and domestic prices (in Vietnamese dong). Without some appropriate price adjustments, the raw data in Table 7.2 tend to overestimate Vietnam's degree of openness. The aggregate figures also tend to hide various domestic regulations and barriers to international trade.

Examining the data more closely, Vietnam's patterns of trade in the past 5 years exhibit the following remarkable trends:

- the reliance on exports of crude oil (from 13 percent to 20 percent of total exports) and agricultural-marine products;
- exports of light manufactured products such as textile, garments and footwear have increased steadily from 12 percent to 27 percent of total exports;
- exports of other manufactured goods has declined from 33.3 percent in 1995 to 28.9 percent in 1999;

Table 7.2 Vietnam's exports and imports, 1990–9

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Exports										
US$ million	2,404	2,087	2,581	2,985	4,054	5,449	7,256	9,145	9,323	11,500
% of GDP		24.0	26.2	23.3	26.1	26.3	29.5	34.1	34.4	40.1
Imports										
US$ million	2,572	2,338	2,541	3,924	5,826	8,155	11,144	11,622	11,494	11,600
% of GDP		26.9	25.7	30.6	37.5	39.3	45.3	43.3	42.4	40.4

Source: UNDP (2001).

- imports of machinery and tools have declined from 25 percent of total imports in 1995 to 17.3 percent in 1999.

Vietnam's historical trade patterns appear to be consistent with predictions based on the principle of comparative advantage. However, its pattern of imports seems to indicate the government's preference, by means of a variety of measures (tariff, non-tariff barriers, taxation and regulation) for an import-substitution policy for the tool industry. In recent years, the Vietnamese government has also publicly identified a number of strategic industries, such as information communication technology and biological technology. Although the government has begun providing some subsidies to these industries, it is doubtful if Vietnam can succeed in its strategic trade policy.

3 The gains from foreign investment

3.1 What is capital?

In production theory, 'capital' is a factor of production, along with labor and land. Capital is often defined as 'produced means of production'. At the level of the firm, capital includes machines, equipment, and buildings (it may also include inventories). These goods are called 'capital goods'. At a national level, capital includes also public capital, such as roads and bridges. Economists have developed various measures of the stock of all capital goods in a country, and these measures are often expressed in value (i.e. in money terms). The Penn World tables provide estimates of capital stocks for many countries.

Capital can also mean the amount of money (or funds) that a firm must have to finance its purchase of machines, equipment and buildings. For example, when we say 'firm F raises capital in the stock market', we mean that this firm issues shares (pieces of papers which entitle their holders to receive a share of the future profits that the firm may earn), and sells them to the public to obtain money (funds) which is used to buy capital goods, etc. The concept of capital as 'capital goods', and the concept of capital as 'funds for investment' are related: capital goods are bought by firms that have funds for investment.

When we say 'poor countries need capital to develop', we mean that they need capital goods and public capital. Capital goods can be bought from the international market, or can be produced in the countries (as in the case of buildings). In either case, substantial amounts of money (funds) are needed. Where do poor countries get these funds? They can come from (a) domestic savings, (b) loans or gifts from international organizations, such as the World Bank, (c) foreign aid, and (d) foreign investors (which can be firms, such as Toyota or Sony, or individuals, or agencies such as pension funds management). In this paper, we will focus on (d).

3.2 Why do foreign firms invest in poor countries?

The main objective of firms in developed countries is to make profits– the more profits, the better. To fulfill this objective, firms are always looking for opportunities to expand the market for their products, and to reduce production costs. Since in poor countries, labor is abundant and labor cost is low, firms from developed economies have an incentive to bring capital to these countries, creating 'affiliate firms' where the returns are expected to be high, at least after an initial period of settling-in. In some cases, these affiliate firms can reap high profits as soon as they get established in the poor countries. More often, it takes a few years before they begin to make profits.

Neoclassical economics explains international capital movement by using the theory of factor proportion, according to which the marginal product of capital (i.e. the rate of return to capital) is high when the ratio of labor to capital is high. Poor countries have a lot of labor, and little capital. So the marginal product of capital in these countries are high. Richer countries have a higher capital-labor ratio, and therefore marginal product of capital is low. Thus firms and individuals living in rich countries have an incentive to invest in poor countries. On the other hand, wealthy individuals from poor countries often invest part of their wealth in rich countries, because they want to diversify their portfolios (i.e. they do not want to keep all their eggs in the same basket). However, the net flow of capital (funds for investment) from rich countries to poor countries is positive, and substantial.

Foreign investment into a country can take two forms: (a) foreign direct investment and (b) portfolio investment FDI means that a firm from a foreign (normally wealthy) country sets up an affiliate, or forms a joint-venture, in the poor country, and has an active participation in, or direct control of, management decision-making in these affiliates or joint-ventures. On the other hand, those who make portfolio investment do not have an interest in management decision making. For example, pension funds managers in rich countries have no interest in controlling a business in a poor country. Portfolio investment can take the form of purchase of shares, without intention of controlling, or purchase of bonds and debentures (i.e. providing loans to firms or to the government).

In reality, in addition to the rate of return, the decision to invest in a foreign country also depends on other factors such as:

- the social and political stability of the host country;
- the host country's administrative and taxation laws;
- transaction costs of business;
- the ease by which profit can be expatriated; and
- the way in which disputes between the host country and foreign investors are resolved.

3.3 Gains from foreign investment

Foreign firms, on average, gain from investing in poor countries: they achieve a higher average rate of return, because of lower wage costs, and because they have access to a new market.

From the point of view of the 'host country' (here, the poor country), there are also gains from foreign capital inflow. An important gain is that foreign investment results in increases in both employment level and wage level in the poor country. The basic argument was established by MacDougall (1960). Another gain is that foreign firms must pay taxes to the host country. Kemp (1966) has shown that there exists an optimal tax on foreign capital income.

Another source of gains from foreign investment is technology transfer, which is likely to happen if a foreign firm forms a joint-venture with a local firm, or provides local firms with licenses to manufacture the products developed in the advanced country. The multinational enterprises are important agents in the process of international diffusion of knowledge. Industrial knowledge may take the 'narrow form', such as information on products and technical processes, which can be well documented; but quite often, it is the 'broad form' of knowledge, not easily documented, such as organizational know-how, that is more important. In fact, it is practically impossible to write contracts to license these proprietary intangibles. This impossibility serves to explain the relative dominance of direct foreign investment over licensing.

In China, joint ventures between domestic and foreign firms have proved to be very successful. Foreign firms typically provide training to local managers and technicians. There are also indirect technology transfers, in the form of 'learning by watching'. By observing foreign firms' management techniques, domestic firms can improve their organization of production and internal controls. Technology transfers seem to be more successful in countries that adopt export promotion strategies than in countries that choose import substitution strategies.

Foreign capital will continue to flow in, as long as the rate of return in the host country remains higher than the level prevailing in the 'source country'. According to the law of diminishing marginal productivity, when the capital–labor ratio increases, the rate of return to capital will fall, if there is no technological progress or no other favorable changes in the economic environment. However, we may expect that other favorable changes will occur. First, workers (including those occupying administrative and managerial functions) may become more skillful and more knowledgeable as a result of learning-by-doing, training and learning-by-watching, both at the production and at the managerial level. Even if the population is not growing, the increase in labor efficiency may be regarded as an increase in the total supply of labor (measured in efficiency units). This will attract additional inflow of foreign capital. Second, the government of the host country, benefiting from increased tax revenues (from profit taxes and wage taxes), may decide to increase spending. If the increased spending is directed to public capital formation, such as the building of roads, bridges, schools, then this will have beneficial effects on production, and raise the rate of return to private capital.

Another important item of government spending that would encourage further inflow of capital is the use of human resources to develop a fair and effective legal system, and a transparent administrative system. Business cannot be effectively carried out without agreements between various parties to a transaction. Some of these agreements are informal, and are 'enforced' by mutual trust. But many complicated agreements must be written down in the form of a contract, so that each party to an agreement knows exactly their rights and obligations and so that, in the case of breach of contract, the law court can decide on an equitable compensation for damages. Firms from developed countries tend to rely on formal contractual agreements; they often feel uncomfortable if agreements are not formalized by contracts that can be enforced by a fair and effective legal system.

Similarly, by a 'transparent administrative system' we mean that government regulations should be clearly stated, and responsibilities for administering them should be clearly defined and subject to regular and effective auditing. For example, foreign firms should be able to know where to obtain a building permit, and that once a permit is given, it will not be revoked, except under very special and well-defined circumstances. Economies such as Hong Kong and Singapore are reputed for having very good legal and administrative systems. This is one of the main contributing factors to their spectacular growth rates, which have been maintained over several decades. (In terms of income per person, adjusted for purchasing power parity, Hong Kong and Singapore are ranked higher than Japan, according to the World Bank.)

3.4 The case of Vietnam

While there are many factors that account for Vietnam's robust growth, the main driving force has been the tradeable goods sector, especially the foreign-invested industry sector. Thus, Vietnam's economic growth is primarily due to its growing openness and can be characterized as FDI-led. The importance of FDI to Vietnam's growth is illustrated in Table 7.3.

It is important to note that the data used in different chapters may vary somewhat, depending on the sources. This is a common problem faced by applied economists working on Vietnam. The simple correlation coefficient between two variables in Table 7.3 is 65.4 percent, indicating a close association between FDI and economic growth in Vietnam.

From a legal perspective, Vietnam's Foreign Investment Law (FIL), promulgated in 1987 and subsequently amended in 1990 and 1992, goes

Table 7.3 Ratio of disbursed FDI to GDP and GDP growth rate in Vietnam, 1991–9 (%)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Disbursed FDI/GDP	2.4	3.9	8.7	12.5	12.9	10.6	12.1	7.2	5.3
Real GDP growth rate	6	8.6	8.1	8.8	9.5	9.3	8.1	5.8	4.7

Source: UNDP (2001).

further than most other developing countries in protecting FDI, not only against outright expropriation, but also against subsequent changes in laws. However, a number of problems relating to FDI are apparent:

- Low rate of disbursement. Less than 43 percent of the approved FDI was implemented between 1991 and 1999. This low rate of disbursement is attributable to a number of factors which include a weak administrative system (which lacks experience, coordination and efficiency), an inadequate legal system and an unreliable banking sector. However, the disbursement rate has improved in recent years.
- Tax compliance costs are too high. While Vietnam currently provides a very favorable corporate tax regime, foreign investors are confronted with complicated and inconsistently applied tax laws. In terms of dealing with government departments, foreign investors are faced with inexperienced administrators. changing requirements, hidden fees and very costly appeal procedures. Thus, the business costs of tax compliance in Vietnam are very high (see Heij 1995).
- Expatriation of profits tend to be difficult. Although the FIL guarantees foreign investors the right to repatriate capital and profits, Decree No. 18-CP restricts these overseas remittances and subjects them to a withholding tax varying from 5 to 10 percent.
- Dispute resolution is not regarded as satisfactory. In dispute resolution, Vietnam has ignored the current worldwide trend towards international arbitration. Vietnam's dispute resolution provisions, via the Foreign Arbitration Committee, are needlessly restrictive.

The Vietnamese government have been consciously aware of the above problems and introduced various measures to improve its FDI climate. These simplification measures have been met with approval from foreign investors but much improvement is still required.

4 Some issues relating to foreign investment

4.1 The concern about foreign ownership and multinational firms

While host countries no doubt gain from the inflow of foreign capital, many people in poor countries are concerned about the fact that in many important industries, major firms are largely foreign-owned. If we think of capital as an input, just as labor, raw material and fuel (such as zinc, copper, oil, coal) are inputs, and that all inputs 'cooperate' in (i.e. contribute to) the production of goods, then the payments to foreign capital, in the form of profit, is no different from the payment to foreign suppliers of zinc, copper, oil and coal. In the formal language of neo-classical economics, we say that all factors of production earn their marginal products. Payments to factors of production (capital, labor, raw material, etc.) are in accordance to their contributions.

There remains, however, the concern that foreign capital represents substantial power, both in the sense of market power (as in the case of monopoly or oligopoly) and in the sense of bargaining power (with governments, with trade unions, etc.). In fact, a small number of intellectuals in developed economies (among whom is the famous MIT Professor of Linguistics, Noam Chomsky) seem to believe that there is a conspiracy by multinational corporations to exploit poor countries. Their view seems to be not well founded, or much exaggerated.

There is no doubt that multinational corporations are price-setting firms rather than price-taking firms. In this context, host country governments have an important role to play. They can negotiate with foreign firms on matters such as technology transfer, training of workers and working conditions.

When the government of a host country negotiates with a big foreign firm, the latter can threaten that if the government sets conditions that are 'too strict', it will move its factories to a neighboring country, where conditions are less strict. (This happens even in the European Union, where the foreign firms are Japanese-owned or American-owned.) Competition among host countries to attract a big foreign firm can reduce the magnitude of the gains from foreign investment.[4] One way to get out of this sub-optimal outcome is that both host countries form an economic union with a single policy-making agency entrusted with making taxation decisions on foreign capital income. The cost of having such an agency is the loss of autonomy.

4.2 Another qualification: learning by doing by domestic firms

The arguments in favor of the free trade in goods, and of the freedom for foreign firms to set up in the host countries, are subject to an important qualification, which states that, under some very special circumstances, it may be beneficial to protect local firms from foreign competition (either competition from goods produced by firms located in foreign countries, or by foreign firms located in the host countries.) The nineteenth-century English economist John Stuart Mill was the first person to clearly articulate these special circumstances, by putting forward the 'infant industry argument'. A modern evaluation of the infant industry argument was presented by Kemp (1962).

In many real-world situations, domestic firms are unable to compete with foreign firms; because the domestic industry is still in its early infancy, the cost of production is high owing to lack of experience in production. However, according to the infant industry argument, if the domestic industry is given an opportunity to produce in sufficiently great quantities, then with time it will accumulate enough experience in production, and this will result in lower production costs, making the domestic industry eventually viable and profitable. These future profits may well outweigh the loss that the industry must incur in its infancy if it faces foreign competition during its learning phase. In that case, the net social benefit generated by the domestic industry over its life cycle is positive. It would seem that such an industry deserves support by the government, in the form of loan subsidies, or production subsidies, or an outright ban of imports or prohibition of the establishment of foreign firms in the host countries.

Upon reflection, the existence of learning-by-doing, and the potential positive net social benefit mentioned above, are not, by themselves, sufficient reasons for the government to take action to support the infant industry. Many businesses make losses when they are first established, but their owners are willing to incur such losses, with the financial backing of private lenders: they do not need government intervention. Thus, it has often been argued that, for the infant industry argument for protection to be valid, it must be the case that either the domestic market for loans is imperfect, or part of the gains generated by infant firms cannot be captured by them (the impossibility of full appropriation by the firms of the social gains that they create).

Many authors have however questioned the wisdom of government intervention when the loans market is imperfect. In an imperfect loans market, borrowers are rationed. But such rationing may well be a rational response to problems such as moral hazard (that is, borrowers are suspected of adopting opportunistic behavior). And, in the presence of moral hazard, it is not clear whether there is anything the government can do that is better than the contracts developed in the so-called imperfect loan market. It seems, therefore, that the only valid infant industry case for protection must rely on the impossibility of full appropriation. This arises when there are spillovers in the learning process: when one firm gains direct experience, other firms may obtain indirect experience (e.g. learning-by-watching) from this direct experience, and the first firm cannot make the other firms pay for this indirect gain.

While there are respectable reasons to provide protection to an infant industry, the optimal evolution of the degree of protection over time is in general difficult to determine. Clemhout and Wan (1970) showed that if there are two or more infant industries, and firms take prices as given, then the relative protection that an industry should get may alternate over time from being positive to being negative.

Another complication arises when there are just a few individual domestic firms, because they would have market power when there is no foreign competition. This is the case analyzed by Benchekroun and Long (2000). The domestic firms know that their production will generate knowledge for the whole industry, and that this stock of knowledge will evolve over time. Each firm knows that it can partially influence the time path of this stock. Therefore, it tries to solve a dynamic optimization problem, while knowing that its rivals will try to solve a similar problem. The strategic interaction among domestic firms requires an in-depth analysis.

The authors show that if the government wants to maximize social welfare over time, it must find an optimal subsidy rule. They demonstrate that the optimal time path of subsidy rate may well be non-monotonic, for example, the optimal protection may be very high during the early infancy of the industry, and this may be followed by a phase of lower protection, then another phase of high protection again. In one particular case with linear demand and quadratic production cost, they showed that it may be optimal to penalize the industry when its stock of knowledge is still small, with the promise that the penalty will be reduced as the industry accumulates knowledge. This policy prescription for the linear-quadratic case might sound at first surprising, as it seems to go against the conventional wisdom that infant industries need protection in their early infancy, and that such protection ought to be phased out in the long run. Upon reflection, however, this rather unusual policy prescription is not different from the treatment that many talented musicians receive during their childhood. It was reported that Albert Einstein was so moved after listening to a beautiful performance by the talented child violinist Yehudi Menuhin that he exclaimed: ‘Now I believe that God exists; for otherwise how could one explain such genius?’ Someone later pointed out to him: ‘Sir, Yehudi’s genius is easily explained; Yehudi’s mother continuous scolding of her son is the primary cause of his virtuosity.’ It seems, then, that there is a parallel between a theory of infant industries, and a theory of industrious infants.

4.3 Volatility of portfolio foreign investment

We have argued that the gains from foreign direct investment can be substantial and that, subject to minor qualifications, governments of host countries should, in general, provide an economic environment that is favorable to FDI. We now turn to a different category of foreign investment, called portfolio foreign investment.

Generally speaking, the term 'portfolio capital' refers to investment without intention of controlling the running of the enterprises. Portfolio capital consists of portfolio equity and loans by commercial banks and non-bank private creditors. Portfolio investments tend to be short-term, and therefore volatile. For example, in 1996, the flows of portfolio equity and commercial bank loans into five Asian economies (South Korea, Indonesia, Malaysia, and the Philippines) were US$12 billion and US$55 billion respectively; and in 1997, these flows became negative (minus US$11 billion and minus US$21 billion). Foreign direct investment, however, was stable: US$7 billion in 1996, US$7.2 billion in 1997 (see Radelet and Sachs 1999). There was in fact some evidence indicating that the Asian crisis that began in July 1997 was unduly deep because of panic among portfolio investors.

A financial panic happens when short-term lenders suddenly do not renew their loans to a solvent borrower, each lender believing that if he does not withdraw his fund in time, he will lose it. A panic can be self-fulfilling, and therefore the withdrawing action of each lender is, from the individual point of view, 'rational', even though collectively the run may be called irrational, in some sense. Usually a panic follows a triggering event that occurs in an economy where there are already some indications of possible weaknesses in the economic fundamentals. The ratio of short-term debt to foreign exchange reserve is an indicator of exposure to risk of a financial crisis.

Many people believe that the volatility of short-term capital flows can sometimes be excessive and can be a contributing factor to financial crises. They therefore advocate policy measures such as restricting the volume of short-term foreign debts for the whole economy, or for some specific sectors, taxing international financial transactions, or even a temporary freezing of certain categories of capital outflow. In general, capital controls impair economic efficiency, because they prevent capital from flowing to the sectors where they are most needed (i.e. where the rate of returns are relatively high). Most economists think that capital controls should be avoided, except under very exceptional circumstances. The government should however keep a watchful eye on the volume of short-term debts.

5 Some qualitative proposals

Based on the economic theory discussed so far, a number of qualitative proposals may be derived as follows.

5.1 A compensation scheme

The normative theory of international trade states that trade is gainful for all if the government implements a compensation scheme for those who are worse off as a result of trade. This idea can be generalized to economic reforms (including internal structural reforms) in general. It is recognized that the information requirements for full compensation are too prohibitive in practice. Nevertheless, the government should try to build a political context for reforms (including trade liberalization) based on the principle of compensation. Such a scheme can be administered through the tax-transfer system which may reduce income inequality between regions, and between cities and rural areas.

5.2 Accelerating trade liberalization and privatization

The theory of trade, supplemented with empirical evidence, suggests that Vietnam should try to increase trading with complementary, rather than similar, economies such as North America and the European Union. Similarly, it will be necessary to privatize a high proportion of SOEs and create a level playing fields for all enterprises, private or state owned. This has already occurred but can be accelerated further.

5.3 Encouraging FDI but avoiding FDI competition

Vietnam's banking, administrative and legal systems must be quickly improved and simplified in order to encourage foreign investment, especially FDI. With respect to ASEAN countries, FDI competition is not a real problem because they are foreign investors in Vietnam. Further, as member countries of AFTA, they will ultimately have similar tax policies, which will reduce FDI competition. Thus, China will be Vietnam's main competitor for FDI, especially following the trade agreement between Vietnam and the US. In principle, China and Vietnam should conduct negotiations to reduce mutually harmful FDI competition.

5.4 Monitoring short-term debts

In the last few years, Vietnam's short-term debts have grown fairly rapidly. In the context of increasingly international financial integration, the Vietnamese government needs to monitor Vietnam's foreign debts, especially short-term and non-concessional debts. There are some policy measures, including tax policy, that can be employed to discourage foreign borrowing for consumption.

5.5 Concentrating on light manufacturing industries in the short run

Vietnam should move away from its current import-substitution to an export-oriented policy. In accordance with the static principle of comparative advantage, Vietnam should focus, at least in the short run, on relatively labor-intensive industries, such as food processing, or light manufacturing industries, such as textile and garments, and footwear. These industries can help to alleviate partially the unemployment problems arising from the agricultural and state sectors. These export-oriented industries may also help to diffuse technology more rapidly.

5.6 Industrial policy in the long run

Vietnam may have to devise a strategic trade policy in the long run, at least in response to China's industrial policy. It is very difficult for Vietnam to modernize and industrialize in the presence of strong competition from low-price (sometimes below production costs) manufactured products from China. Thus, Vietnam needs to develop a flexible industrial policy that can deal strategically with China's own policy. An alternative direction is to focus on some aspects of knowledge-intensive industries (that do not require too much production experience) such as software development (using the Indian model).

5.7 Human resource policy in the long run

In order to encourage FDI in the long run, the government must implement a well planned human resource program. A skilled workforce not only uses capital more effectively, but also attracts more capital inflows from overseas. Such a policy requires more resources to be allocated to the education sector. This may slow down the growth rate of real GDP in the short run, but will be beneficial in the long run.

6 Conclusion

In this chapter we have discussed the gains from economic openness to Vietnam primarily from a theoretical viewpoint which is based on neoclassical economic analysis. In this sense, this chapter provides the theoretical foundation for Chapters 8 and 9, and is related to Chapter 11. We have explained how international trade typically benefits a nation while making some residents of this nation worse off. This chapter also analyzes the ben efits of foreign investment, especially FDI, to a host country in general and Vietnam in particular. A number of major issues relating to foreign investment such as competition for FDI, protection of infant industries and the volatility of portfolio investment are also discussed.

From the theory of international trade and foreign investment, we arrive at a number of qualitative proposals for Vietnam. These propositions are intuitively obvious and consistent with those made in other related chapters in the book. Some policies suggested here have been attempted and implemented by the government. The purpose of this chapter is thus to provide theoretical arguments to support the ongoing reforms in international trade and foreign investment in Vietnam.

Notes

1 A country is said to be small if it has no influence on world prices.
2 International trade is potentially gainful in the cases of (i) trading nation is small or large, (ii) missing markets, (iii) increasing returns to scale and thus imperfectly competitive markets, (iv) resources are renewable or non-renewable, (v) barter or trade with money, (vi) overlapping generations and (vii) technology and preferences are dependent on the state of information.
3 When the custom unions include all trading nations, and tariffs and subsidies are all zero, then the fundamental proposition becomes 'free trade is gainful.'
4 This can be explained by game theory using simple models such as 'the prisoners' dilemma' or 'the centipede game'. In the prisoners' dilemma game, the foreign investor negotiates with many host countries simultaneously. In the centipede game, the foreign investor negotiates with each host country one at a time. The outcomes of these two models are the same: without a binding agreement between host countries, they will not be able to achieve optimal outcome. See Binmore (1992) for an exposition of game theory with economic applications.

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8 Vietnam's international economic integration

Impacts and implications

Quoc-Phuong Le

1 Introduction

Vietnam began its sweeping economic reform in the late 1980s. As part of the reform program, policy adjustments have been made toward integrating the country with the world economy. The authorities have implemented important policy changes in liberalizing the trade regime and opening up the economy to foreign investment. Vietnam has expanded its trading relationship, moving from trade mainly with the former Soviet bloc to other regions including the European Union (EU), the US, Japan, China, and the newly industrialized economies (NIEs) such as Hong Kong, South Korea, Singapore and Taiwan.

Significant steps also have been made in joining regional and multilateral organizations. Vietnam joined the Association of South East Asian Nations (ASEAN) in 1995, and commenced its commitments to ASEAN Free Trade Area (AFTA) in 1996. The country became a member of the Asia-Pacific Economic Co-operation (APEC) in 1998 and began its commitments under APEC in 1999. The government submitted application for World Trade Organization (WTO) membership in 1995, and has since negotiated on conditions for joining this multilateral body. Vietnam also concluded trade pacts with its important partners, including a framework agreement on economic cooperation with the EU signed in 1995, and a bilateral trade agreement (BTA) with the US signed in 2000.

Economic integration creates enormous opportunities, but at the same time imposes serious challenges. Potential benefits include expansion of export markets and increased competitiveness and efficiency of the local economy, which in turn will result in higher economic growth. But the challenges are enormous, especially for the less developed economies: economic integration means opening up domestic market to intense foreign competition. What impacts, both positive and negative, will this process have on Vietnam, still a poor and backward country? Should Vietnam go ahead with trade liberalization and speed up its international economic integration?

To help shed some light on these important issues, the author has carried out a series of research works using various analytical frameworks, including the gravity trade model (GTM), the revealed comparative advantage approach (RCA), and global trade analysis project model (GTAP). The studies using GTM were published in Le (1997a; 1996) and Le *et al.* (1996). The analysis using RCA indices will be available in Le (2002). This paper, due to its size limit, presents mainly the results of the study using the GTAP model. Separate parts of that study have also been published in Le (2001; 2000; 1999).

2 Vietnam's international economic integration: an overview

Vietnam's international economic integration has been implemented at various levels. First, Vietnam has unilaterally carried out its economic reforms and trade liberalization measures, regardless of other countries' commitments since 1988, well before the country joined regional organisations such as ASEAN and APEC. Major liberalization measures include exchange rate reform, trade-based tax reform (reduction of export taxes and import tariffs, reduction of the number of goods subject to export taxes and import tariffs), and decentralization of foreign trade (relaxation of central government's monopoly and participation of private sector in foreign trade). These measures have played an important part in stimulating the expansion of the Vietnamese economy and its foreign trade in the 1990s.

The second dimension is economic integration at the sub-regional level of South East Asia via ASEAN, which Vietnam joined in 1995. As an ASEAN member, Vietnam was admitted to AFTA in December 1995, and began its commitments in January 1996. The core part of AFTA is the Common Effective Preferential Tariff (CEPT) scheme, whereby the members have agreed to cut tariffs for ASEAN-originated goods to 0–5 percent, and to abolish most other non-tariff barriers (NTBs). Vietnam is allowed to complete its commitments under CEPT by 1 January 2006.

The third dimension is integration at the supra-regional level of the Asia-Pacific via APEC, to which Vietnam was admitted in 1998. APEC's major goal has been to turn the Asia-Pacific region into an area of free trade and investment (by 2010 for developed nations and by 2020 for developing countries). The members' commitments to reach this goal are outlined in their Individual Action Plans (IAP). Vietnam commenced its IAP in 1999 and is committed to reduce tariffs and other NTBs to meet APEC's goal of free trade zone by 2020. The government is also committed to open domestic markets for foreign investment, including sensitive sectors such as legal services, insurance, air travel and telecommunications.

Finally, the broadest dimension is economic integration at the global level. Vietnam submitted its application for WTO membership in 1995, and has since negotiated on conditions for joining this multilateral body. Once becoming a WTO member, Vietnam will benefit from access to a large market of more than 140 members. The country, however, will also need to open its domestic market for foreign competition (see Le 1998 and Chapter 9 of this book for more details of Vietnam's commitments under regional and multilateral agreements).

3 Assessing impacts of Vietnam's international economic integration

3.1 GTAP model: a CGE model of global trade

To assess the impacts of Vietnam's international economic integration, the author has applied a general equilibrium framework, namely the GTAP model. This model has been developed from the Global Trade Analysis Project (Hertel 1997). The GTAP model is used in this study because of its several advantages.

First, GTAP belongs to the class of computable general equilibrium (CGE) models, and as such it has a number of features that make it an especially useful tool for policy analysis, particularly trade policy. Any hypothetical policy change would move the model from existing equilibrium to a new equilibrium. It is therefore possible to quantify direct and indirect effects of policy changes on the economy. In addition, CGE models have a multi-sector framework, and can therefore be used to evaluate the impacts of policy changes on various industries of the economies in concern.

However, unlike single-country CGE models, which can be used mainly for an economy-wide analysis, the GTAP model, with its multi-country structure, is a global model, which can facilitate multi-country analysis. In addition, GTAP is a trade-focused model, and therefore it is especially useful for analysing trade-related issues. Further, GTAP database version 4 (released in 1998) includes Vietnam, along with most other members of ASEAN and APEC. It can therefore be used to analyze Vietnam's trade reform in the context of AFTA and APEC. Moreover, the global database of GTAP makes it virtually a worldwide model. The GTAP model can thus facilitate the analysis of individual economies in a global context, in particular the likely impacts of Vietnam joining WTO.

The full GTAP database version 4 identifies 50 commodity categories and 45 regions (for more details of GTAP data, see McDougall *et al* 1998). For simulations, the model is normally aggregated to a smaller number of regions (region aggregation) and commodities (sector aggregation). The size of each aggregation will depend on the researcher's interest. The GTAP users tend to use aggregation strategies that allow them to focus on key industries and regions of concern.

In this study, the 45 regions are aggregated into 16 regions, including Vietnam, most members of APEC as at 1995, the EU and ROW (the rest of the world). The 50 commodities are grouped into eleven sectors. These are:

raw agriculture, forestry and fishery (RAG); food processing (FPR); textiles (TEX); wearing apparel (CLO); other light manufactures (OLM); chemicals (CHE); metals (MET); transport equipment (TRP); machinery and electronics (MCN); mining (MIN); and services (SER). Detailed explanation of the author's region- and commodity-aggregation is given in Le (2000; 1999).

3.2 Scenarios

International economic integration incorporates many aspects. These include policy adjustments in trade regime in line with international standard, reduction of tariffs and other NTBs, changes in foreign investment regime and so on. In this study, tariff cuts are used as a representative to assess impacts of Vietnam's economic integration.

To capture the impacts of Vietnam's economic integration in various contexts, from unilateral to AFTA to APEC to global, four simulation experiments are designed. For convenience and a comparable assessment, an across-the-board tariff cut of 50 percent is assumed in all experiments (see Table 8.1).

It is worth noting that at the end of this writing, two events of special significance took place: the Vietnam-US BTA (officially in force in December 2001) and China's accession into WTO in November 2001. Given the

Table 8.1 Experiment design

Experiments	*Explanation*	*Exogenous shock*
Experiment 1 (ULTR)	Vietnam's unilateral tariff reduction	Vietnam unilaterally cuts tariffs by 50%, while other countries do not reduce tariffs
Experiment 2 (AFTA)	Tariff reduction within AFTA	All ASEAN members including Vietnam cut tariffs by 50%, while other countries do not reduce tariffs
Experiment 3 (APEC)	Tariff reduction within APEC	All APEC members including Vietnam cut tariffs by 50%, while other countries do not reduce tariffs
Experiment 4 (GLOB)	World-wide tariff reduction	All regions in the world cut tariffs by 50%

Source: Author's simulation design (Le 1999).

major role in world trade of the US and China, and their importance to Vietnam in terms of foreign trade (the US and China have been among Vietnam's top trading partners in the last few years), these events will have substantial impacts on Vietnam. Although these recent developments are not included in the above scenarios, it is the author's intention to use the GTAP model for a future investigation into these important issues.

3.3 Positive effects on the Vietnamese economy

The GTAP simulation results show that trade liberalization under four scenarios will generate overall benefits for Vietnam (see Table 8.2). In all scenarios, both real GDP and welfare value increase. GDP increases by between 1.6 percent and 4.0 percent. The overall welfare gain, measured by variable EV (equivalent variation), also rises by between US$261 million and US$495 million. In all experiments, Vietnam's foreign trade also experiences expansion. Exports increase by between 0.4 percent and 3.3 percent while the rise in imports is between 2.7 percent and 7.8 percent. As the rise in imports exceeds that in exports, the country's trade deficit widens in all scenarios. The increase in trade deficit ranges between US$198 million and US$578 million.

With the exception of experiment 2 (AFTA), the simulation results indicate that broadening the trade liberalization process would increase the extent of gain to Vietnam. As the context of trade liberalization widens from unilateral to regional (APEC) to global, the increase in GDP expands from 2.9 percent in experiment 1 (ULTR) to 3.2 percent in experiment 3 (APEC), and 4.0 percent in experiment 4 (GLOB). The welfare gain increases from US$457 million in experiment 1 to US$462 million in experiment 3, and US$495 million in experiment 4. Similarly, the rise in Vietnam's exports is 1.7, 1.8 and 3.3 percent in the respective scenarios.

While the GTAP model predicts that trade reforms under all experiments would bring overall benefits to Vietnam, the result of experiment 2

Table 8.2 Overall impacts of trade liberalization on Vietnam's economy

Macrovariable	*Change*	*Experiment 1 ULTR*	*Experiment 2 AFTA*	*Experiment 3 APEC*	*Experiment 4 GLOB*
Exports	%	1.7	0.4	1.8	3.3
Imports	%	8.5	2.7	7.8	9.9
Trade balance	US$ million	−578	−198	−518	−577
GDP	%	2.9	1.6	3.2	4.0
Equivalent variation	US$ million	457	261	462	495

Source: GTAP simulation results (Le 1999).

(AFTA) indicate that the effects of trade liberalization under AFTA are very small. Exports increase by only 0.4 percent, while imports rise by just 2.7 percent. GDP grows by only 1.6 percent, whereas overall welfare increases by US$261 million. In comparison to the changes under the other three scenarios, including the unilateral experiment, these increases are minimal.

This may be explained by the fact that Vietnam and some ASEAN countries such as Indonesia, the Philippines and Thailand have a similar comparative advantage, and therefore compete rather than complement one another in a number of industries. Indeed, as indicated by the author's analysis using the RCA approach (Le 2002), these countries have a similar comparative advantage in primary products (such as agriculture, fishery and forestry) and labor-intensive industry (such as textiles, clothing and footwear). It is thus understandable that AFTA trade liberalization will not offer a lot more opportunities for trade creation and economic growth between these countries. Consistent with this explanation, the gains from AFTA trade liberalization seem fairly minor for some ASEAN countries including Vietnam. This result also agrees with the conclusion of another analysis by the author using the gravity trade model (Le *et al.* 1996 and Le 1997a), that AFTA has had little effect on expanding intra-ASEAN trade.

The GTAP model not only shows overall impacts on the economy as a whole, but it also demonstrates effects on separate economic sectors. Changes in sectoral outputs reflect adjustment of both production and trade patterns in accordance with comparative advantage. As a result of trade reforms under various scenarios, some sectors are expected to be expanding, while some other sectors are predicted to be contracting (see Table 8.3). Sectors predicted to be expanding include wearing apparel, textiles, machinery and services.

Table 8.3 Effects of trade liberalization on Vietnam's economic sectors (% change in output)

Sector	*Experiment 1* *ULTR*	*Experiment 2* *AFTA*	*Experiment 3* *APEC*	*Experiment 4* *GLOB*
RAG	−2.8	0.2	−2.6	−3.3
FPR	−17.3	−10.2	−18.6	−23.2
MIN	−0.3	0.1	−0.1	−0.3
TEX	2.6	−2.7	3.6	6.4
CLO	21.7	−1.4	20.0	28.0
OLM	−7.8	−2.6	−6.5	−7.4
CHE	−5.7	−3.3	−5.0	−5.1
MET	−10.2	−1.5	−9.0	−11.0
TRP	−39.9	−9.3	−36.4	−42.1
MCN	0.2	0.1	0.1	−0.5
SER	2.4	1.2	2.4	2.5

Source: GTAP simulation results (Le 1999).

The expansion of wearing apparel sector (CLO) is most significant: its output rises by 21.7 percent in experiment ULTR, 20 percent in experiment APEC, and 28 percent in experiment GLOB. Textile sector (TEX) also expands, though less impressively, with its output increasing by 2.6 percent, 3.6 percent and 6.4 percent in the respective experiments. The model's prediction of the expansion of textiles and wearing apparel is consistent with the fact that these sectors represent labor-intensive industries in which Vietnam enjoys a relatively strong comparative advantage. Already, these labor-intensive industries have grown strongly in the last few years, thanks to the country's large workforce, 36,000,000 out of a population of 78,000,000 (*Nhan Dan* 29 December 2000), and relatively low labor cost. Textile and clothing industries currently employ as many as 1,600,000 workers, who comprise almost a quarter of Vietnam's labor force in all industrial sectors (*Nhan Dan* 30 December 2000).

The rise of these sectors can also be attributed to foreign investment, mainly from some NIEs such as South Korea, Singapore and Taiwan, which have shifted their labor-intensive industries overseas, due to rising labor costs at home. As a result, wearing apparel and footwear have emerged as Vietnam's leading exports in recent years. In 1999, for example, the share of clothes and footwear in Vietnam's total exports was 15 percent and 12 percent, respectively (*Nhan Dan* 10 August 2000).

In experiment 2 (AFTA), however, Vietnam's wearing apparel and textiles decline by 1.4 percent and 2.7 percent, respectively. This reflects the fact that some other ASEAN countries such as Thailand, Indonesia and the Philippines also have a comparative advantage in labor-intensive industries. This is also consistent with the result of another analysis by the author using the RCA framework, which indicates a similarity in the comparative advantage structure of the less developed members of ASEAN (see Le 2002). As a result, after the market opening under AFTA, Vietnam's wearing apparel and textiles is still an infant industry compared to that in other ASEAN countries, and has to compete with more advanced companies in those countries. Commitments under AFTA, therefore, may well have some negative effects on this sector.

The machinery sector (MCN) expands slightly: its output increases by 0.1 percent to 0.2 percent in three of the four experiments. This is rather surprising, as Vietnam is generally regarded as having no comparative advantage in this industry. However, this rise can be explained by an increase in the production of electronic equipment, which is included in the machinery sector in our aggregation. Thanks to strong foreign investment in recent years (mainly from Japan and NIEs such as South Korea, Taiwan and Singapore), electronic manufacturing has grown from year to year. In 1999, electronic goods such as TV sets, radios, hi-fi systems and computer components (hard disk drives, printed-circuit boards, etc.) accounted for 5 percent of Vietnam's total exports. This is equal to the share in exports of such leading agricultural items as coffee, and half of the share of rice (*Nhan*

Dan 10 August 2000). It seems that a strong expansion of the electronic industry may offset the decrease of other sub-sectors, and give rise to the whole machinery industry.

Services sector (SER) also expands slightly in all experiments (by between 1.2 percent and 2.5 percent). There are several explanations for this result. First, this sector appears to benefit from trade liberalization through a relative increase in the terms of trade for non-tradeable commodities, as services can be regarded as non-tradeable. Second, the services sector involves quite intensive use of labor, of which Vietnam enjoys an abundance. Third, the rise in services may be attributed to the growing tourist industry. The latter industry currently employs some 150,000 employees plus another 300,000 people engaged in related activities (such as production and sales of souvenirs), providing services to more than 2,000,000 foreign visitors and generating revenue of US$1.2 billion (*Nhan Dan* 2 January 2001).

Based on the result regarding the expansion of services, a policy suggestion can be made that the government should encourage this sector to develop further, in order to explore the country's comparative advantage in labor force and its large potential in tourism.

3.4 Negative impacts

Sectors of the Vietnamese economy predicted to be declining after the tariff reduction include raw agriculture, food processing, light manufacturing other than textiles and clothing, chemicals, metals and transport equipment.

The most unexpected outcome is the very slight increase in the output of raw agriculture-forestry-fishery (RAG) in experiment 2, and even a contraction in other experiments (by between 2.6 percent and 3.3 percent). Vietnam has been regarded as enjoying strong comparative advantage in agriculture-forestry-fishery, which is based on the country's abundance of natural resources (land, water, sea territories, tropical climate) and labor (large labor force and low wages). Agriculture, forestry and fishery still constitute a large component of the Vietnamese economy, accounting for a quarter of its GDP. Agricultural and aquatic products have been among the country's top export commodities in recent years. In 1999 rice, coffee and seafood accounted for almost a quarter of the country's total exports, with rice accounting for 10 percent, coffee 5 percent and seafood 9 percent (*Nhan Dan* 10 August 2000). Vietnam is currently the world's fifth largest rice producer (more than 30 million tons) and second largest rice exporter (4 million tons) behind only Thailand, and second largest coffee exporter (660 thousand tons) after only Brazil (*Nhan Dan* 25 December 2000). The agricultural sector, therefore, is expected to be expanding, at least in the short term and medium term after liberalization. The simulation result indicating a decline in this sector seems to run counter to this expectation.

This problem may have been caused by poor data quality, particularly data on Vietnam's agriculture (this problem has been addressed in Le 2002). Notwithstanding this data problem, the result showing a contraction of raw agriculture may point to the fact that Vietnam's agriculture sector is far from efficient. In fact, while the rural population makes up almost 80 percent of Vietnam's total population, agriculture accounts for less than 25 percent of GDP. This suggests that labor productivity in this sector is rather low. After the market open-up, Vietnam seems unable to compete with the more efficient agriculture sector in other countries such as the US, Australia, New Zealand, Canada and even Thailand.

In this regard, the following proposition can be made. Vietnam currently possesses certain comparative advantages in agriculture, forestry and fishery, due to the country's abundance of factor endowments (such as cultivation land, forest cover, sea territories, tropical climate and labor). With market open-up following trade liberalization, however, this comparative advantage may not materialize, due to low labor productivity and inefficiency in this sector.

The food processing industry (FPR) is also predicted to be contracting. However, unlike raw agriculture, a decline in food processing is not a surprise, since this industry so far is undeveloped in Vietnam. In fact, while Vietnam has certain factor endowments in the former sector, the country does not have much comparative advantage in the latter sector, which is still in its early stage of development. Vietnam has been a net exporter of raw agricultural products but until recently, a net importer of processed food items such as meat products, dairy products, brewery and tobacco. Faced with market open-up, Vietnam's infant food processing industry may not be able to compete with more advanced foreign producers. However, to take advantage of the abundance of raw agriculture, in the long term Vietnam will need to invest to build up its food processing industry. A strong food processing sector will assist the exports of high value-added processed food in the future, rather than the low value-added raw agricultural products. This, in turn, will help to expand the production of raw agricultural products.

The contraction of other sectors can also be reasonably comprehended. Chemicals (CHE), metals (MET) and transport equipment (TRP) are, undoubtedly, capital-intensive and technology-intensive industries, in which Vietnam currently does not have a comparative advantage. It is therefore logical that these sectors will experience a large contraction as a result of the market opening. However, this does not necessarily imply that Vietnam should abandon these industries. A recommendation can be made that, in the long term, Vietnam will need to gradually shift its economic structure towards developing technology-intensive industries, in order to catch up with more advanced economies in an increasingly competitive environment. It should be noted that this issue has also been of concern to one of the country's chief economic planners:

> Currently, Vietnam's less competitive industries are those requiring large capital investments and high technological level. Their ability to compete depends mainly on technology, not labor and resource factors. However, our inefficient investment, resulted from limited capital resources and purchase of backward technology, has made it difficult to lift the competitiveness of these industries. Therefore, we should now implement proper measures to facilitate the desirable structural shift.
>
> (Tran Xuan Gia, Minister for Planning and Investment, *Nhan Dan* 24 September 1999)

3.5 Impacts on other economies

The simulation results also show the impacts of trade liberalization on other regions and the world as a whole. The limited length and Vietnamese focus of this chapter do not allow a detailed analysis of other economies to be presented here (for more details, see Le 1999; 2000). The following are some major implications of trade liberalization on other economies.

In experiment 1, unilateral tariff reduction has positive effects on Vietnam, but its impacts on the world economy are very limited. This is because of Vietnam's small size in the regional and world economy.

In experiment 2, the overall impact of trade liberalization under AFTA is rather limited not only for the world as a whole, but also for most of ASEAN countries except Singapore. This reflects ASEAN's relatively small share in the world trade: foreign trade of all ASEAN countries combined account for only some 5 percent of the world trade (author's calculation based on IMF). More importantly, this also reflects the fact that most of ASEAN countries still have quite a similar structure of comparative advantage, and therefore tend to compete with one another. The competitive nature of ASEAN economies suggests that AFTA's trade liberalization tends to have not only trade creation effects, but also considerable trade diversion effects. Only Singapore's gains are somewhat significant, reflecting Singapore's high degree of complementarity with other ASEAN members. This issue has been investigated more thoroughly in Le (2002).

In experiment 3, APEC trade liberalization will have major impacts not only on the club's members, but also on the world as a whole. This is consistent with the fact that APEC economies combined constitute more than half of world output, and 60 percent of world trade volume (author's calculations based on IMF and WB). Finally, experiment 4 shows that worldwide tariff reduction will have major impacts on the world economy.

4 Some policy recommendations

Based on the analysis of the GTAP simulations, as well as the results of the author's other studies, a number of suggestions and policy recommendations can be drawn regarding the implications of international economic integration for Vietnam.

First, since Vietnam began its economic renovation program in the late 1980s, significant steps have been made towards integration with the world economy. The economic reforms, particularly in the area of foreign trade and investment, have created favorable conditions, stimulating an expansion of Vietnam's economy and its foreign trade. As a result, Vietnam has turned from being an 'under-performer' in regional and world trade in the 1980s, to being an 'average performer' in the 1990s. Despite these important achievements, Vietnam remains a poor and backward country. The country's comparative advantage is still based on agriculture and other raw materials, although in recent times there has been a shift to some labor-intensive industries.

Second, economic integration at any level, from unilateral to regional and to global, is expected to generate overall benefits for Vietnam. The benefits are greater if the context of liberalization expands from unilateral to APEC to global. The major policy implication is that Vietnam should follow the process of integration, especially in the framework of APEC and WTO. The central concern here is that 'the government should be active preparing necessary conditions for economic integration, and select an appropriate roadmap for this process' (Le Van Chau, former Chairman of State Securities Committee, *Nhan Dan,* 1 August 1999).

Trade liberalization under AFTA, however, has limited impacts on Vietnam and other ASEAN members. This reflects the fact that most ASEAN countries (except Singapore, and Malaysia to some extent) still have similar structures of comparative advantage. These economies thus tend to be competing with each other in a number of industries including the primary sector (agriculture, forestry, fishery and mining) and labor-intensive sector. This suggests that AFTA alone tends to have both trade diversion effects and trade creation effects, and as a result AFTA's impact is rather limited. It is also worth noting that because of a similar structure of comparative advantage of most ASEAN economies, foreign direct investment (FDI) by ASEAN countries in Vietnam is not expected to grow significantly in the foreseeable future. The link between the comparative advantage structure and FDI by ASEAN countries in Vietnam has been addressed in Le (1997b).

But if AFTA's liberalization is combined with commitments under APEC and/or WTO, the positive impacts of trade reforms on ASEAN members including Vietnam will be much greater. The major benefits for Vietnam joining AFTA are that commitments under CEPT/AFTA can be seen as a preparation for joining APEC and WTO.

Third, trade reforms are accompanied with the structural shift. As sectoral analysis suggests, market open-up would result in significant structural changes, particularly a shift away from the resource-based sector (raw agriculture, forestry and fishery) to labor-intensive industries (textiles, wearing apparel and services). Although the prediction about a decline in raw agriculture is subject to some limitations of the GTAP model, particularly the problem of data quality, it also suggests this may be a cost of trade liberalization. Since Vietnam has been regarded as predominantly an agricultural country, a decline in agriculture means that a significant proportion of the rural population will be out of jobs.

To smooth the process of structural changes, the government will need to expand investments in the labor-intensive light industries (such as textiles, clothing, footwear) and some services (such as tourism), so that these sectors can grow and be able to absorb the redundant labor force. The State will also need to implement other necessary measures including retraining the former farmers for work in non-agricultural sectors.

Finally, it seems that capital- and technology-intensive industries such as chemicals, metals and transport equipment may have little chance to expand, at least in the short and medium term. As a result, Vietnam will still need to import a large amount of these goods for its current industrialization. The government, however, should have a long-term strategy to gradually move the economy towards these sectors, to ensure that the country is able to catch up with advanced economies in an increasingly competitive environment.

In conclusion, the above analysis shows that the GTAP model is a very useful analytical framework for assessing impacts of Vietnam's economic integration. This study used only a tariff cut as a representative measure of trade liberalization. The GTAP model can also be applied to analyze effects of other measures such as abolishment of NTBs, or changes to foreign investment policy.

It should be emphasized that GTAP is just a model, and no matter how sophisticated it is, it cannot reflect the complexity of the real world. In addition, since this study uses the GTAP standard static closure for simulations, the results reflect mainly the short-term changes. Further, the GTAP data have some limitations, especially in regard to data on Vietnam (limitations of GTAP model are detailed in Le 2002; 1999). The results of GTAP simulations, therefore, should be used and interpreted with cautions. Nevertheless, this study hopes to make some contribution to the growing literature on Vietnam.

Acknowledgement

The author would like to thank Professor Tom Nguyen, Professor Trien T. Nguyen, Dr. Rod Tyers and Dr. Jay Bandara for their useful comments. Thanks should also go to the GTAP Centre for permission to use GTAP 4 data, and Professor Robert McDougall for his help in overcoming technical problems of the GTAP model

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9 Trade policy under globalization and regionalization

Trien T.Nguyen

1 Introduction

The Association of Southeast Asian Nations (ASEAN) was originally founded in 1967 as a regional political organization of non-communist countries in Southeast Asia with a primary focus on security towards the communist bloc of Cambodia, Laos and Vietnam (CALAVI).[1] Thirty years after its inception, ASEAN officially admitted Vietnam as the seventh, and only communist, member of the organization. The enlargement process continues with the last three countries in Southeast Asia, namely, Cambodia, Laos and Myanmar, despite serious concerns by several countries over human right issues, especially in Myanmar. With all ten member countries in Southeast Asia, ASEAN accounts for an area of 2.3 million square miles (about 4 percent of the world total) occupied by a fast-growing population of nearly half a billion. The per capita income is, however, not evenly distributed within the region (see Table 9.1, last column). For example, at the top of the scale are the tiny oil-rich Brunei and newly-industrialized Singapore, while Malaysia and Thailand are trailing far behind; the three CALAVI countries finish at the bottom of the scale (see <http://www.asean.or.id>; <http://www.wto.org> and <http://www.apecsec.org.sg>).

In 1992, the adopted ASEAN Free Trade Area (AFTA) agreement set out a comprehensive economic cooperation program covering various areas of industries, minerals and energy; finance and banking; food, agriculture and forestry; and transportation. It also introduced new areas of cooperation such as research and development, technology transfer, promotion of tourism and human resources. In terms of trade liberalization, the agreement called for an accelerated removal of all tariffs and non-tariff trade barriers (NTBs)[2] throughout the region within 8 years from 1 January 1995 to 1 January 2003.

Within the same time frame, the world also undergoes several important changes in its multilateral trading system. In particular, the recently concluded Uruguay Round on the General Agreement on Tariffs and Trade (GATT) calls for several far-reaching measures of trade reforms

Table 9.1 ASEAN–10

	ASEAN	*APEC*	*GATT*	*WTO*	*Area 1,000 square miles*	*GNP billion US$*	*Pop. million persons*	*Average income US$*
Brunei	1984	1989	1993	1995	2.2	9	0.3	30,000
Cambodia	1999			?	69.0	2	9	193
Indonesia	1967	1989	1950	1995	735.4	111	191	560
Laos	1997			?	91.4	1	4	270
Malaysia	1967	1989	1957	1995	127.3	55	19	2,925
Myanmar	1997		1948	1995	261.2	38	43	863
Philippines	1967	1989	1979	1995	777.0	46	65	707
Singapore	1967	1989	1973	1995	0.2	40	3	12,310
Thailand	1967	1989	1982	1995	198.1	79	56	1,938
Vietnam	1995	1997		?	127.2	15	68	224
ASEAN–10					2,389.0	396	458	864

Notes
? indicates admission pending;
APEC: Asia Pacific Economic Cooperation;
GNP: Gross National Product;
Pop.: population.

such as extending trade liberalization, exploring new trade issues and resolving trade disputes through the new World Trade Organization (WTO). With the exception of three CALAVI countries, which still have only an observer status pending admission to the organization, the other seven members of ASEAN were already fully-fledged members of the old GATT, and hence, automatically became members of the new WTO in 1995. This gives rise to an interesting intertwined relationship of trade liberalization 'in the large' under WTO and 'in the small' under AFTA for these ASEAN economies. The impacts of trade reforms under these two related regimes then must be carefully compared and contrasted in order to sort out relevant policy options for ASEAN.

Although there is a small but growing body of research, in English as well as Vietnamese, on WTO or AFTA per se, the existing literature on the interrelationship between WTO and AFTA is, to our knowledge, rather thin, if not almost non-existent (see, for example, Anderson (1999) and Do Tuyet Khanh (1999; 2000) on Vietnam's WTO accession; Hoang Vinh Phuc (1997), Nguyen Huu Cat (1997), Nguyen Huu Dat (1997), Pham Ngoc Tan (1997), Truong Duy Hoa (1997) and Vu Tuan Anh (1996) on Vietnam and AFTA). This chapter contributes to this gap in the literature with a review of these two landmark trade agreements in a compare and contrast style. Since the presentation is intended for a general readership, technical details will be relegated to footnotes. The chapter concludes with a general discussion on the importance of structural reforms for the transition economy of Vietnam in the wake of globalization and regionalization.

2 WTO and AFTA in tango

This section provides a review of key provisions of the Uruguay Round agreement which are most relevant to ASEAN countries. More than 100 countries signed the Uruguay Round agreement on 15 April 1994 (effective 1 January 1995) after an arduous process of trade negotiations which dragged on over almost a decade 1986–94. The signed document consists of over 400 pages of final agreements plus 20,000 pages of supplementary schedules and appendices. Four major areas are covered:

(a) trade liberalization including contentious old issues such as agriculture and textiles;
(b) code of conducts on market access, safeguards, anti-dumping;
(c) new issues of trade in services, investment measures, intellectual properties; and
(d) institutional issues.

Since our main focus is on ASEAN, we will refer only to the rules and provisions which are applicable to developing countries, least developed countries and economies in transition.

On the other hand, the ASEAN trade pack evolved from the original ASEAN Preferential Trading Arrangement (APTA)[3] to the newly-created AFTA[4] signed in Singapore on 28 January 1992 (entered into force on 1 January 1993) and continued to be refined, amended and updated. In terms of historical precedence, AFTA was signed more than 2 years ahead of WTO during the low points of Uruguay Round negotiations where the collapse of trade talks was imminent. This precedence allows AFTA to claim exemptions to certain WTO rules on a grandfather clause basis.[5]

It is important to bear in mind that, with the exception of the three CALAVI countries still in the application process, the remaining ASEAN countries are also fully-fledged members of WTO. This 'dual status' means that WTO and AFTA are complementary to, instead of a substitute for, each other.[6] ASEAN members must fulfill their WTO obligations to all WTO members (both inside and outside ASEAN) as well as their AFTA obligations to other ASEAN members.

Both AFTA and WTO adhere to the principle of most-favored-nation (MFN) and national treatment (NT). MFN requires all members to be treated equally so that 'no countries will be treated more favorably than others,'[7] while NT requires all nationals of members to be treated equally so that 'foreigners are treated no less favorably than own nationals.'[8]

While WTO generally does not allow bilateral arrangements, ASEAN does recognize that sub-regional arrangements (either among members only or even between members and non-members) could complement the overall economic cooperation effort.[9]

2.1 Tariff liberalization

WTO has a very complex tariff liberalization[10] scheme where rules change vastly from developed to developing countries and from agricultural to non-agricultural goods (see Table 9.2). The basic tool is a *relative* cut in the *average tariff*. For example, developing countries are required to cut import tariffs on both agricultural and non-agricultural goods according to the following scheme:

1 For agricultural goods, tariffs are cut such that the unweighted average tariff is down from the 1986–8 base level by 24 percent in equal installments[11] over 10 years by 1 January 2005. In addition, each individual tariff must be cut by a minimum of 10 percent over the same period.
2 For non-agricultural goods, tariffs are cut such that the *weighted average*[12] tariff is down by 20 percent in equal installments by 1 January 2000.

This tariff-cutting formula allows some degree of flexibility as countries may freely structure the required cuts to suit their preferences (e.g.

Table 9.2 Trade liberalization

	WTO	*AFTA*
Tariff reduction	• *relative* cut • *differential* coverage • *tariffication* of NTBs (add to existing tariffs)	• *absolute* cut • *uniform* coverage • *removal* of NTBs • *removal* of quotas
Agricultural goods	Cut *average* tariffs • 24% from 1986–8 level • minimum 10% each tariff • in equal installments • in 10 years (1995–2005)	Cut *all* tariffs • down to 0–5% • uniform across all goods • in 10 years (1993–2003) Special for Vietnam: • in 10 years (1996–2006) due to 3 years late entry to CEPT AFTA amendment in 1995: • agricultural goods now in CEPT
Non-agricultural goods	Cut *weighted average* tariffs • 20% from 1986–8 level • in equal installments • in 5 years (1995–2000)	Cut *all* tariffs • down to 0–5% • uniform across all goods • in 10 years (1993–2003) Special for Vietnam: • in 10 years (1996–2006) due to 3 years late entry to CEPT AICO firms: • can have low CEPT tariffs now (no need to wait for 10 years)

above-average cuts for some products of choice and below-average cuts for others). Moreover, WTO permits members to hold on to their own tariff structure even after the required average tariff cut. That is, it is possible for a country to start with a high pre-cut tariff structure and yet continue to have a relatively high post-cut tariff structure afterwards. In terms of global distribution, developed countries must make a deeper cut (36 percent on agricultural goods and 38 percent on non-agricultural goods) than developing countries (24 percent on agricultural goods and 20 percent on non-agricultural goods).

While the global scheme of WTO uses the fairly complex method of differential percentage cuts on average tariffs,[13] the regional ASEAN counterpart follows a much simpler strategy with a uniform target tariff for all members regarding their current level of economic development. That is, the same rule applies to both high-income members (e.g. Brunei, Singapore) and low-income members (e.g. Indonesia, CALAVI).

The key instrument of AFTA is the 1995 Common Effective Preferential

Tariff (CEPT) scheme of 0–5 percent uniform tariff throughout the entire region by 2003 (5 years earlier than the original target date of 2008). In fact, the plan has gone through a few rounds of revision as follows:

1 The original AFTA agreement signed on 28 January 1992 at the Fourth Summit Meeting in Singapore stipulates a time span of 15 years (1993–2008) to achieve CEPT targets on all manufactured goods (excluding agricultural goods) using the following rule:

   a For manufactured goods currently bearing tariffs over 20 percent, members are required to bring tariffs down to the 20 percent mark within 5–8 years (1998–2001) in equal installments; and then, further down to the target level of 0–5 percent within the next 7 years (2001–8) in equal installments.
   b For manufactured goods currently bearing tariffs under 20 percent, the plan is to bring tariffs down to the target level of 0–5 percent. Members are, however, allowed to decide on the details of their tariff reduction schemes.

2 The amendment signed on 15 December 1995 at the Fifth Summit Meeting in Bangkok not only accelerates the CEPT scheme plan by reducing the time span to 10 years (1993-2003) but also widens the product base by including agricultural goods as well. The rule of tariff liberalization was revised as follows:

   a For goods currently bearing tariffs over 20 percent, members are required to bring tariffs down to the 20 percent mark within 5 years (1993–8) in equal installments; and then further down to the target level of 0–5 percent within the next 5 years (1998-2003) in equal installments. The time span was thus shortened from 15 years to 10 years to complete the CEPT scheme.
   b For goods currently with tariffs under 20 percent, the plan is to bring tariffs down to the target level of 0–5 percent. Again, members are allowed to decide on the details of their tariff reduction scheme. Note that the rule now applies to all goods, namely, both manufactured and agricultural goods.

3 Also at this same meeting, Vietnam officially joined ASEAN effective 1 January 1996.[14] Because Vietnam's entry was 3 years behind schedule, the clock was set to start in 1996 (instead of 1993) for its 10-year CEPT plan (1996–2006). Vietnam has finished compiling 6,000 CEPT goods, with 1,900 more goods to be added within the next 3 years (2001–3) to meet the 2006 deadline.
4 In addition, the ASEAN Industrial Cooperation (AICO) scheme[15] speeds up the tariff liberalization process by immediately granting CEPT tariffs to the so-called AICO arrangements of at least two manufacturing firms from two different ASEAN countries. This newly

created class of intra-ASEAN firm structure does not have to wait until 2003 in order to enjoy the benefit of low CEPT tariffs of 0–5 percent.

2.2 Market access

Both WTO and AFTA have their own special provisions on market access. Being fully-fledged members of both organizations, ASEAN countries must, therefore, honor their contractual obligations to both sides (see Table 9.3). At the global level, WTO rules require the following measures to facilitate access to domestic markets.

1 Domestic supports and export subsidies

WTO members are required to reduce their domestic supports and export subsidies[16] on all goods (i.e. both agricultural and manufactured goods). For agricultural goods, developing countries must agree to cut their agricultural domestic supports by 10 percent starting from the 1986–8 base level within 10 years (1995–2005) and export subsidies by 24 percent within 6 years (1995–2001). For non-agricultural goods, GATT disciplines (used to be on developed countries only) are now extended to developing countries as well. In addition, developing countries must phase out export subsidies within 5 years (1995–2000) if they are contingent on use of domestic goods and within 8 years (1995–2003) if they are contingent on export performance.

2 Import quotas

For markets with prohibitive trade barriers, member countries must provide minimum import quotas at 5 percent of the domestic consumption within 6 years (1995–2001). An important new rule is that all bilateral quotas on textiles and apparel under the Multi Fiber Arrangement (MFA) will be phased out by 2004.

3 Safeguard

Safeguards refer to retaliatory measures taken by a country to protect its domestic industries against injurious foreign imports. WTO tightens the rules by only allowing developing countries to apply safeguards for no more than 10 years. Furthermore, safeguards must be applied equally against all countries (i.e. on an MFN basis).

4 Anti-dumping

Dumping is the unfair trade practice of selling goods abroad well below domestic prices. Anti-dumping refers to retaliatory measure by imposing

Table 9.3 Market access

	WTO	*AFTA*
Domestic supports	Agriculture • cut 10% of 1986–8 level • in 10 years (1995–2005) GATT disciplines • now applied to *all* countries	
Export subsidies	Agriculture • cut 24% of 1986–8 level • in 6 years (1995–2001) Non-agriculture • gradual phase-out in 5–8 years	
Import quotas	Provide import quotas • at least 5% of domestic consumption level • in 6 years (1995–2001) Phase-out • all MFA quotas on textiles and apparel by 2004	Eliminate • all quotas on CEPT goods • all NTBs • in 5 years
Safeguards	May use safeguards • applied equally against all countries (MFN principle) • used in 10 years maximum	May use emergency measures • suspend CEPT provisionally • applied equally against all countries (MFN principle)
Anti-dumping	• stricter rules of conduct • used in 10 years maximum ('sunset provisions')	
Other provisions		Foreign exchange restrictions: • make exceptions to facilitate CEPT-related payments Further areas of cooperation: • harmonization of standards • product testing/ certification • foreign investments • macroeconomic consultation • fair competition • venture capital

additional import duties on these 'dumped' goods. Not only does WTO make stricter rules on anti-dumping conducts, but also provides the so called 'sunset provisions' to terminate anti-dumping tariffs within 5 years after their impositions.

At the regional level, AFTA rules require the following additional measures to promote market access and economic cooperation within the region:

1 Quantitative restrictions and NTBs

ASEAN members must eliminate all quantitative restrictions on products under CEPT as well as all NTBs within 5 years.

2 Emergency measures

In some extreme cases, ASEAN members are allowed to use drastic emergency measures to suspend preferences provisionally and without discrimination. These measures, however, must be consistent with GATT principles (i.e. on an MFN basis).

3 Foreign exchange restrictions

If ASEAN members set up foreign exchange restrictions, they must make exceptions in order to facilitate payments for CEPT products as well as repatriation of such payments. These actions, however, must not violate GATT and IMF rules.

4 Further cooperation

ASEAN members must also agree to explore further areas of cooperation such as harmonization of standards,[17] product testing and certification, removal of barriers to foreign investments, macroeconomic consultation, rules for fair competition and promotion of venture capital.

2.3 Trade in services, investments and intellectual properties

In addition to settling old and contentious issues in agriculture and textile, WTO was able to address, for the first time, a whole set of new issues involving service trade, trade-related investments and property rights (see Table 9.4).

1 General Agreement on Trade in Services (GATS)

This agreement provides a general framework for trade in services based on the two principles of non-discriminatory MFN and transparent

Table 9.4 New areas

	WTO	*AFTA*
Trade in services	GATS MFN and NT principles Liberalization: • gradual • sector by sector • existing policies as baseline • further negotiation in 2000 Temporary exemptions: • maximum 10 years • under review every 5 years Specific rules: • entry of service worker • financial services • telecommunications • air transport • maritime services	ASEAN *Framework Agreement on Services* (extending GATS): • Free Trade Area in Services • eliminate discriminatory measures and market limitations within ASEAN
Investment measures	TRIMs NT principle only • prohibit 6 measures: local content export performance local manufacturing trade balancing production mandate foreign exchange restrictions • to be completely removed in 5 years (1995–2000)	• foreign exchange restriction: make exceptions in order to facilitate CEPT payments • AICO scheme to accelerate CEPT • explore further cooperation to remove barriers to foreign investments
Intellectual properties	TRIPs MFN and NT principles Deadlines: • 1996: developed countries • 2000: developing countries (additional 4 years extension) Based on 4 existing international copyright conventions: • Rome Convention • Paris Convention • Berne Convention • Integrated Circuits Convention	ASEAN *Framework Agreement on Intellectual Property Cooperation* (extending TRIPs): • APTO office on patents and trademarks • AIPA office on intellectual properties • common database on intellectual property registration

NT. Trade will be liberalized gradually sector-by-sector starting from the baseline of existing policies. Temporary exemptions are allowed but must be reviewed every 5 years and should not last more than 10 years. Several annexes contain sector-specific rules on movements of service workers, financial services, telecommunications, air transport and maritime services. New negotiations on further liberalization of service trade are to be scheduled within 5 years after WTO enters into force, i.e. by 2000.

2 Trade-Related Investment Measures (TRIMs)

WTO members must abide with the principle of NT in dealing with foreign investors. Specifically, they are not allowed to use six prohibited trade-related measures (i.e. local content, export performance, local manufacturing, trade balancing, production mandate and foreign exchange restrictions). In fact, these prohibited measures must be removed within 5 years (1995–2000).

3 Trade-Related Aspects of Intellectual Property Rights (TRIPs)

WTO members must abide to both principles of MFN and NT in dealing with intellectual property rights (i.e. copyrights, patents, trademarks, industrial designs, integrated circuits). Many provisions of this agreement are based on the following four existing international conventions:

a Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations (1961);
b Paris Convention for the Protection of Industrial Property (1967);
c Berne Convention for the Protection of Literary and Artistic Works (1971);
d Treaty on Intellectual Property in Respect of Integrated Circuits (1989).

In general, WTO members must meet their MFN and NT obligations by 1 January 1996. Developing countries are, however, given a special extension of an additional 4 years (1996–2000) to implement their obligations.

In light of the global development of WTO, ASEAN also has its own version of rules on these new issues.

1 Framework Agreement on Services[18]

This document extends beyond GATS to create a free trade area in services by eliminating all existing discriminatory measures and market access limitations within ASEAN.

2 ASEAN Free Trade Agreement

This original 1992 document requires members to make exceptions to their foreign exchange restriction rules with respect to CEPT-related payments within ASEAN. Members must also agree to explore further various areas of cooperation including the removal of barriers to foreign investments. In addition, the AICO scheme provides immediate CEPT incentives to joint ventures by firms across ASEAN boundaries.

3 Framework agreement on intellectual property cooperation [19]

This document is an ASEAN version of TRIPs spiced with additional intra-ASEAN arrangements:

a further regional cooperation in the areas of copyrights, patents, trademarks, industrial designs, geographical indications and integrated circuits;
b creation of ASEAN Patent and Trademark Office (APTO) in charge of patents and trademarks within the region;
c creation of ASEAN Intellectual Property Association (AIPA) in charge of intellectual properties within the region; and
d development of an ASEAN common database on intellectual property registration within the region.

2.4 Institutional organization

One of the most visible achievements of Uruguay Round negotiations is the creation of WTO as a permanent international body to manage global trade issues (see Table 9.5).

1 Administration

The highest governing body of WTO is the biennial Ministerial Conference consisting of representatives of all member countries. Decisions are based on simple majority voting with 'one country, one vote' rule regardless of country sizes. That is, big traders such as the US, Japan, France, Germany, the UK, Canada and the European Union (as a member itself) still have one vote each despite the fact that these economies account for two-thirds of world merchandise exports. Below the Ministerial Conference, there is a General Council to oversee day-to-day operations including approving annual budgets, settling disputes and reviewing members' trade policies. This General Council has three subcouncils in charge of trade in goods, trade in services and intellectual properties. The administrative function of the organization is the responsibility of the WTO Secretariat headed by a Director General appointed by the Ministerial Conference.

Table 9.5 Institutional organizations

	WTO	*AFTA*
Governing body	Ministerial Conference • biennial (every 2 years) General Council: • approve annual budgets • dispute settlements • trade policy reviews Three subcouncils on: • Trade in Goods • Trade in Services • Intellectual Properties	Meetings of ASEAN Foreign Ministers ASEAN Economic Ministers Other ASEAN Ministers • annual (every year) Standing Committee: • handle interim business • rotation (country to country) • foreign minister of host country (served as chair) + 9 ambassadors of remaining countries
Secretariat	WTO Secretariat WTO Director General • appointed by Ministerial Conference • 4-year term	ASEAN Secretariat ASEAN Secretary General • appointed by ASEAN Foreign Ministers • 2-year term • rotation (country to country) ASEAN Director General • one for each member country
Dispute settlement mechanism	Settlement procedure: • consultations • establishment of panel • panel ruling • appeal and arbitration End after 600 days maximum	Settlement procedure: • consultations • establishment of panel • panel ruling • appeal and arbitration End after 290 days maximum

2 Rules and Procedures on Dispute Settlement[20]

This document contains various provisions in the procedure for resolving trade disputes among members. The entire process must not take more than 20 months (600 days) from start to finish. Generally there are four basic steps as follows:

a consultations;
b request for a panel and establishment of a panel;
c issuance of a panel report and adoption of panel report;
d appeal and final arbitration.

The organizational structure of ASEAN follows roughly the same line of WTO. In terms of size, however, ASEAN has only 10 members compared to 142 full members and 33 observers (as of 26 July 2001) in WTO (see <http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm>). On the other hand, due to its small size, ASEAN is able to run various administrative tasks on a rotational basis including choices for the top post of Secretary General.

1 Administration

The highest governing body is the annual ASEAN Foreign Ministers Meeting in charge of policy formulation and guidelines. This is supplemented by annual meetings of ASEAN Economic Ministers on economic issues and of Other ASEAN Ministers on non-economic issues. Next to the Foreign Ministers Meeting, there is a Standing Committee to take care of business arising in the interim periods between ministerial meetings. This Standing Committee is chaired, on a rotational basis, by a foreign minister of the host country, and consists of nine ambassadors of the remaining countries. Administrative routines are performed by the ASEAN Secretariat headed by an ASEAN Secretary General who is appointed by the ASEAN Foreign Ministers on a rotational basis for a 2-year term. In addition, each member country has its own ASEAN Director General.

2 Protocol on Dispute Settlement Mechanism[21]

This document provides procedural steps in resolving trade disputes among members. The entire process must not exceed 290 days (i.e. less than half of the time under WTO). Similar to WTO, there are also four basic steps as follows:

a consultations;
b request for a panel and establishment of a panel;
c issuance of a panel report and adoption of panel report;
d appeal and final arbitration.

3 Vietnam at the dawn of WTO and AFTA

The previous section presents a side-by-side comparison of two trade organizations which are of most concern to Vietnam. At the regional level, Vietnam has already joined ASEAN, while at the global level it is actively working on its application for WTO admission. This section will provide a general discussion of trade issues for the transition economy of Vietnam in terms of globalization and regionalization.

WTO accession is a time-consuming process which could easily drag on well over a decade. Vietnam certainly cannot take a do-nothing stand during the long wait since it still has contractual obligations to implement trade reforms along the CEPT scheme of AFTA by the 2006 deadline. In terms of tariff liberalization, although WTO rules are very complex: they only require cuts of *average* tariffs by 20–24 percent from the 1986–8 level. On the other hand, AFTA requires cuts of all tariffs down to 0–5 percent for all goods. Vietnam must also adhere to the two basic principles of MFN and NT not only for WTO and AFTA, but also in all future bilateral agreements with key trade partners such as the US (see <http://www.ustr.gov/regions/asia-pacific/text.pdf>), Canada, Japan and European Union.

On the cost side, tariff liberalization means a loss of government revenue on export and import goods. On the benefit side, this loss will, however, be made up indirectly by the increase in consumer welfare as a result of lower prices of import goods. In general, trade reforms benefit consumers since firms (domestic as well foreign investors) will have to compete with each other until only the most efficient ones survive in the market to serve consumers. That is, competition and free trade will force firms to maintain optimal efficiency and profits and, hence, will promote growth.

It is important to realize that successful trade reforms require an economy with a perfectly competitive market structure. Failing that theoretical condition, the economy must then exhibit at least some degree of structural flexibility so that it can adequately adjust to exogenous shocks from the world market. The more flexible the adjustments, the bigger the rewards because all weak or inefficient links in the economy will be eventually eliminated. This is similar to the law of natural selection (i.e. survival of the fittest).

If Vietnam is to catch up with the rest of the world in the current trend in globalization and regionalization, it will have to be serious about structural reforms of the economy. Inefficient firms must be let go in order to make room for newcomers. This draconian rule should apply uniformly to not only state and private sectors, but also domestic and foreign firms. In other words, the government must have the political will to drastically fix their favorite but chronically ailing state-owned enterprises once and for all—by either restructuring, equitization, privatization or even shutdown—because these firms cannot, and should not, be continually kept on life support and drain out scarce resources of the entire economy. A medical metaphor for this tough measure is that cancerous organs must be surgically removed to prevent the disease from spreading to the rest of the body. To put it in the parlance of body building, well-exercised muscles grow while neglected ones are doomed to wither.

Most simulation studies based on the theory of perfect competition[22] and computable general equilibrium (CGE) techniques[23] report fairly small welfare gains from trade reforms, usually ranging from a half to one percent of gross national product (GNP) in both global trade and single small-open economy settings. In a path-breaking study on trade reforms in Canada, Harris (1984) used the framework of imperfect competition and found much larger welfare gains than those normally calculated with the traditional perfect competition theory. These large gains seem to suggest that an economy under imperfect competition probably has more scope for adjustments (i.e. rationalization). In other words, the economy must work harder to make the required adjustments, and hence, the gains must be bigger. Intuitively, the idea is simple: a mediocre student must put in a lot more effort to earn the honor of being a valedictorian (and the reward will mean much more to him) than a student already at the top of the class.

In particular, Fukase and Martin (1999a and b) use a CGE model to analyze two different counter-factual scenarios: the US granting MFN status to Vietnam and Vietnam joining AFTA. Like many works in the traditional CGE trade modeling literature, their calculated welfare gains for Vietnam were very small, about less than one percent of GNP (see also Chapter 8). It is noteworthy that Fukase and Martin model Vietnam exactly in the same manner as a well-developed market economy with perfect competition and highly efficient private enterprises. In other words, in their model, there is no real difference between Vietnam and advanced countries like the US, Canada or Western Europe.

Their conceptual framework is, however, unlikely to fit the realities of Vietnam's transition economy, which has been overloaded with inflexible and inefficient state-owned enterprises. If Vietnam is able to fully mobilize its resources, it will reap the reward of welfare gains not only from trade reforms per se but also from structural adjustments. Compared to trade reforms, structural adjustments are probably more challenging but also more rewarding. In short, there is an urgent need to develop a theoretical model which can truly describe the unique transition economy of Vietnam—rather than a verbatim copy of 'off the shelf' models designed for more advanced market economies. A more faithful model as such might be able to capture much bigger welfare gains from trade reforms than those reported by Fukase and Martin. This task of original economic modeling remains an open research problem for students of Vietnamese economics.

Globalization and regionalization should not be considered a 'cure-all' solution, especially for problems of poor performance in a badly structured economy. Once structural adjustments are made, the benefits of globalization and regionalization will soon follow. An economy laden with rigidities and inefficiencies cannot effectively respond to changes of winds from the outside trading world in order to reap the benefits of globalization and regionalization. Accordingly, failures in regionalization will be most likely to bring failures in globalization as well, and vice versa. The idea is simple and intuitive: a physically fit and well-conditioned athlete will be able to take up any regime of sport training and benefit from it. On the other hand, 'couch potatoes' must first learn to get fit before they can engage in any type of sport activities.

Last but not least, there is a common fear of 'losing sovereignty' upon entry to the WTO. This concern arises from the lack of understanding that sovereign is a non-issue which should not be brought into the deliberation in the first place. Vietnam, like many other countries in the world, is already an independent sovereign state under no pressure to join any international organization against its will–be it WTO, ASEAN, APEC, IMF, World Bank or United Nations. All organizations, big or small, present both benefits and obligations at the same time. As a result, the relevant question is to decide whether the benefits are worth the obligations: if benefits exceed obligations then it makes sense to join the club, otherwise stay outside. For example, when Vietnam, like any of the other nine countries in Southeast Asia, decides to join ASEAN, it agrees to fulfill the contractual obligations of this regional organization in exchange for the admission ticket. Sovereignty has not, and should not, be an issue in this type of decision (i.e. ASEAN in the past and WTO in the future).

Besides, even though WTO, like other international organizations, does have its own shortcomings, the majority of countries in the world–rich and poor, developed and developing, market and transition–have already been its members. If there is a need to reform WTO, Vietnam's interest will be better served by being a full member actively participating in the reform process. Otherwise, with a lowly observer status, standing outside the meeting room, without voting power, without a voice, it will not be able to do anything good for itself as well as for the rest of the world.

4 Concluding remarks

This chapter provides a review of trade policy under the framework of globalization of WTO and regionalization of AFTA in a compare and contrast style. Such a closer look suggests that these two development trends seem to be complementary to each other, rather than substitute. This is consistent with Vietnam's parallel effort to fulfill its contractual obligations to AFTA as well as admission requirements by WTO. To reap the benefits under both frameworks, Vietnam really needs to carry out effective structural reforms so that the economy can make flexible and timely adjustments to exogenous shocks from the outside world.

The pressure to reform will be even greater because of the two landmark events in 2001, namely, the US Congress has finally ratified the long-awaited bilateral trade agreement with Vietnam (see <http://www.ustr.gov/regions/asia-pacific/text.pdf>) and China has successfully completed its quest for WTO accession. From now on, the dimension of trade issues has doubled from two-fold (AFTA and WTO) to four-fold (AFTA, WTO, US and China). Contractual trade obligations with the US now become real and Vietnam will have to start working on them soon. In addition, the pressure to keep up with China in the global economy now becomes more intense. Although Vietnam does share some common features in economic structure and political ideology with China, its transition path is probably different enough (see, for example: Fforde 1999) to warrant a search for a secured niche in the world market It is thus time for our little 'sleeping dragon' to wake up, stretch its wings and join the global and regional flight–especially with the 'big dragon' in the north and the American eagle across the Pacific ocean.

Notes

1 CALAVI is our new acronym for Cambodia, Laos and Vietnam, as a replacement for the old name Indochina from the colonial French. The Vietnamese common phrase 'Vietnam, Cambodia, Laos' (Viet Mien Lao) implies Vietnam as leader of the pack. Our acronym is more neutral since the names are listed in an alphabetical order without suggesting any country as leader or follower.

2 NTBs are measures to restrict imports, not by tariffs, but by indirect methods such as standards, bureaucracy and exchange controls.

3 APTA consists of three key documents: (a) Agreement on ASEAN Preferential Trading Arrangements signed on 24 February 1977 in Manila; (b) Protocol on Improvements on Extensions of Tariff Preferences Under ASEAN Preference Trading Arrangements signed on 15 December 1987 in Manila; and (c) Protocol to Amend the Agreement on ASEAN Preferential Trading Arrangements signed on 15 December 1995 in Bangkok.

4 AFTA has two key documents: (a) Agreement on the Common Effective Preferential Tariff Schedule for the ASEAN Free Trade Area, and (b) Framework Agreement on Enhancing Economic Cooperation signed on 28 January 1992 in Singapore. Subsequent amendments include (a) Protocol to Amend the Agreement on the Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area, and (b) Protocol to Amend the Framework Agreement on Enhancing ASEAN Economic Cooperation signed on 15 December 1995 in Bangkok.

5 The term 'grandfather clause' refers to claims to exemptions to new rules based on previously entered agreements.

6 Complementarity is like salt and pepper (i.e. they always go together in cooking). On the other hand, substitutability is like strike breakers and union labor (i.e. the former are hired to replace the latter during a strike).

7 MFN means that everyone is 'most favored' and hence, there is no 'favorite child' or 'black sheep'. This principle is similar to the economic notion of Pareto optimality (i.e. no one can be better off without someone else being worse off).

8 NT means that foreign investors in Vietnam, including overseas Vietnamese, must be treated in the same manner as local Vietnamese. As a result, the unpopular dual pricing policy (one low price for local Vietnamese and one extremely high price, usually double or triple, for foreigners, including overseas Vietnamese) will not be consistent with this principle.

9 See Article 4 of the Framework Agreement on Enhancing Economic Cooperation signed on 28 January 1992 in Singapore.

10 Tariff liberalization refers to measures to abolish or reduce customs tariffs levied on import goods.
11 Equal installment means that the cut does not have to be all in one shot.
12 The 'weighted average' rule allows member countries to decide which goods are important to them (assigned with higher weights) and which goods are unimportant (assigned with lower weights).
13 Differential cut means that different goods may have different tariff cuts.
14 See the two documents (a) Protocol for the Accession of the Socialist Republic of Vietnam to the Agreement on the Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area, and (b) Protocol for the Accession of the Socialist Republic of Vietnam to the Framework Agreement in Enhancing ASEAN Economic Cooperation, both signed on 15 December 1995 in Bangkok.
15 See the Basic Agreement on the ASEAN Industrial Cooperation Scheme signed on 27 April 1996 in Singapore.
16 Domestic supports are measures to assist domestic producers while export subsidies are measures to promote export goods. Examples of these measures are capital grants, low-interest or interest-free loans.
17 Harmonization of standards requires all standards to be consistent with each other.
18 See the ASEAN Framework Agreement on Services signed on 15 December 1995 in Bangkok.
19 See the ASEAN Framework Agreement on Intellectual Property Cooperation signed on 15 December 1995 in Bangkok.
20 See the Memorandum of Understanding on Rules and Procedures Governing the Settlement of Disputes.
21 See the Protocol on Dispute Settlement Mechanism signed on 20 November 1996 in Manila.
22 Perfect competition is the theoretical cornerstone of market economics. Basically, it rules out monopoly power and any factors that interfere with the notion of *laissez-faire* or free competition.
23 CGE is a computer modeling technique to numerically analyze an economy as the whole. It is often used to evaluate policies of trade or tax reform.

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10 The Chinese economic model

Some tentative conclusions for Vietnam

Thien Pham

1 Introduction

The rise of the Chinese economy during the past two decades has been a striking phenomenon. Of course, China has always been a significant world power with its large population and a vast territory. But in terms of economic strength, it lagged far behind Western nations, or even other countries in the Council for Mutual Economic Assistance (CMEA) community. Things began to change decisively at the eleventh party congress in 1978. Recognizing the poor performance of its collectivist system, and facing a collapsing communist bloc, Chinese leaders under Deng Xiaoping had little choice but to opt for reforms. Their initial aims were modest. They still had faith in the central planning system, but wanted to liberate production incentives in order to propel economic growth.

Their initial focus was on agriculture, the mainstay of China's economy. From these modest beginnings, reform measures steadily gained strength, spreading successively to the industrial sector, the service sector and the whole economy. China now ranks among the top ten economies in the world, alongside the US, Germany, Japan and Great Britain. There is even some speculation in the media about China overtaking the US economy in 2030 or so. China is suddenly taken more seriously, not only economically but strategically as well. Our purpose in this chapter is to review and assess the past 20 years of Chinese economic performance.

The motivation for this exercise is simple to understand. If success factors are determined to be unique to China, then this amounts to a *sui generis* case of economic transformation, and other countries (Vietnam included) need not look here for any guidance. But if those factors (or at least some of them) are not specific to China, and can be replicated in other nations, then some relevant lessons can be drawn. It is not true that China in the last two decades has been an unqualified success story. It achieved a number of remarkable results (high GDP growth, fairly equal income distribution, social and political stability, integration into the world economic system, etc.). But China still faces a host of unresolved problems that will pose a threat to its future economic well-being. We will analyze the most salient of these issues, and point out why they need to be tackled as soon as possible.

It is well known that the Vietnamese leadership followed with keen interest how China has transformed itself into a market economy without suffering the collapse that befell the former Soviet Union. The Communist Party of Vietnam (CPV) adopted the motto of 'building a socialist market economy with Vietnamese orientations', which was eerily similar to the Chinese description of their own guiding principle. We will point out the pitfalls that Vietnam can avoid, while still using China as a valid model for economic transformation.

The chapter will be structured as follows. Section 2 will use empirical data to paint a picture of economic progress in China since 1978. In section 3, by examining the chronology of events, we can discern some distinct periods in which different policy actions were undertaken and underlying reasons behind their adoption. Section 4 investigates the reasons behind China's successful growth strategy. Section 5 analyzes the major unresolved problems facing the Chinese economy. Section 6 concludes with our assessment as to what lessons Vietnam can draw from China's example in strengthening its ongoing economic reform program.

2 The record of achievements

Since the late 1970s, economic reforms in China have resulted in a period of substantial and uninterrupted economic growth. The record has been quite impressive:

- During a 20 year period between 1979 and 1999, real GDP rose at an average annual rate of 9 percent, or 7 to 8 percent in per capita terms, making China one of the world's fastest growing economies (see IMF 2001: Statistical Appendix p. iv). The benefits of growth have improved people's living standards. According to World Bank estimates, China succeeded in raising 200 million people above the poverty level (see World Bank 2000:145).
- China's growth rate was surprisingly rapid right from the start of reforms, in marked contrast to the other transition economies in the former Soviet Union and Eastern Europe. In Russia, for example, real GDP declined by 50 percent between 1989 and 1995. In Eastern Europe, the fall in output was less dramatic, but within 2 years of reform inception, real GDP in the Czech Republic, Bulgaria and Romania had declined by one-fourth.
- China's growth rate has been much higher than transition economies in Europe, especially after the latter had recovered from their initial output contraction and started growing again. Take the case of Poland, which was widely considered a success story and boasted the longest record of positive economic growth: its annual

output expan-sion since 1992 has averaged 6 percent. Other East European economies resumed positive growth only in 1995, and their growth rate since then has stayed in the single digit range.

- The benefits of economic growth have been widely distributed in China, encompassing rural as well as urban populations. Output expansion in agriculture has been of special importance because of its role as a poverty-reducing engine. World Bank statistics showed that in 1978 about one-third of China's population, or 260,000,000 people, lived under the poverty line. After 5 years of continuous economic expansion, that number had dropped by one half, to 123,000,000, in 1983. And it declined further to 80,000,000 by 1994.

3 The phases of economic reforms

Many international observers had commented that the Chinese leadership never had a comprehensive blueprint for change when they launched the reform measures in 1978. It was more a process of 'crossing the river by feeling the stones', variously described by outside observers as gradualism or incrementalism. However, as we cast a look over the two decades of successful economic growth in China, the process can be seen to be evolving through several phases.

Phase one (1978–84)

The focus here was on invigorating production incentives in agriculture, a crucial sector given its large share in national output and employment.

- Under the previous commune system, peasants were organized into collectives, where production incentives were weak because benefits were equally shared by all members regardless of individual efforts. But now, with encouragement from the government, some collectives adopted a new household responsibility system (HRS), whereby peasants were granted long-term leases on their land, and were permitted to sell on the market any output above their assigned production quota. This simple organizational reform unleashed a wave of production incentives, based on the peasants' self interest to produce in excess of stipulated levels. After witnessing its success in raising agricultural output, the government popularized the HRS structure to all communes. By 1984, collectivized agriculture, which was imposed on the population beginning in 1949, had ceased to exist in China (see IMF 1993:30).
- Many provincial businesses organized themselves as township and village enterprises (TVEs) to benefit from local party sponsorship, but were allowed to sell their products at market prices. They

existed alongside, and competed vigorously with, long-established state owned enterprises (SOEs). However, SOEs were permitted to retain as profits any revenues above their stipulated contribution to the central government budget.
- Several coastal provinces were declared special economic zones, enjoying liberal trading privileges and preferential policies, aimed at attracting foreign capital and technology.

Phase two (1984–8)

After witnessing the success of reforms in agriculture, flowing from liberalized incentive and pricing mechanisms, the government now moved to stimulate similar results in the urban industrial sector.

- A two-track pricing system was established, under which products by SOEs above stipulated levels were sold at market prices. This is essentially a version of the HRS, which had worked so well in agriculture, being replicated in industry, and given the name of production responsibility system. It proved to be equally effective in boosting incentives and raising productivity. Workers wages were reformulated to reflect individual productivity, replacing the previous 'iron rice bowl' arrangement, where workers were guaranteed a living wage regardless of contribution to output.
- Joint ventures between local TVEs or SOEs and foreign businesses were promoted, most often involving overseas Chinese partners. The Chinese diaspora in South East Asia represented a potent source of capital, business know-how and cultural affinity with local market conditions. The World Bank estimated that two-thirds of foreign direct investment (FDI) inflows between 1978 and 1995 originated with Chinese entrepreneurs in Hong Kong, Singapore and Macao.
- The revenue sharing system between provincial and central government was reformed to allow for greater revenue-retention at local levels, thus providing additional resources for SOEs to invest in capital equipment and modern technology.

Phase three (1988–91)

This is a phase of macroeconomic instability, which would become a pattern of boom-and-bust cycles that were to plague the economy in later years. Its appearance 9 years after the inception of reforms, and not sooner, was a tribute to monetary and fiscal management by the government.

- Reform measures initiated in 1979 had raised national income, but had also unleashed pent-up demand among the population, whose consumption needs had been constrained by government fiat under

40 years of central planning. By 1989, the overheated economy had produced double-digit inflation, causing widespread discontent among retirees and workers in loss-making SOEs, who saw their earnings eroded by market forces beyond their control.

- Fearing social unrest, the government deferred plans for another round of price liberalization, and in some cases even reversed previous market-based decisions. But these measures to restrain the economy soon showed up in falling output, deflationary pressures and rising inventories. The SOEs were hard hit, suffering a severe decline in revenues as people deferred purchases. They resorted to bank loans and inter-enterprise debt to defray operational expenses, while cutting back on their contribution to central budget revenues. Resulting fiscal imbalances threatened the government's ability to discharge its function.
- Such signs of macro instability forced the government to ease up on controls to avoid further output contraction. By 1991, the economy was well on its way to recovery and resumption of positive growth.

Phase four (1992–6)

In this phase, economic reform resumed full-speed with the famous 1992 southern China tour by supreme leader Deng Xiaoping, in which he reaffirmed the government's commitment to deepening and expanding economic reforms, even at the price of occasional macro instability, as had happened in the previous phase.

- The Chinese constitution was amended in 1993, stating that the government's goal was to establish a socialist market economy, and that the non-state (i.e. private) sector was an essential complement to the economy, side by side with the state sector. The constitutional wording thus made it official: the government no longer views the market system (and its manifestation, private businesses) as incompatible with socialism.
- Major institutional reforms were adopted:

  1. in 1994, the dual-track system in the foreign exchange market was unified;
  2. in 1995, central and commercial banking laws were enacted to strengthen the development of a legal and regulatory framework underpinning the market economy, and
  3. in 1996, China ended capital controls on current account transactions (i.e. adopted IMF Article VIII status).

Phase five (1997–present)

China managed to escape serious damage during the Asian financial crisis of 1997–8, and maintained its GDP growth at 8.8 percent and 7.1 percent in those 2 years, while other countries (most notably the Asian tigers) suffered major output contraction.

- Problems of loss-making SOEs received special government attention during this period, highlighted by Premier Zhu's pledge at the 1998 National People's Congress to turn them around in 3 years.
- The constitution was amended again in 1999 to recognize the private sector's role in China's economic development, declaring that 'the private sector is an important component of China's socialist market economy'. This followed on the heels of, and was designed to strengthen, the 1993 amendment, which accepted for the first time the legitimate existence of private enterprise alongside the long-established state sector. The 1999 amendment was widely interpreted as signalling the 'irreversibility' of China's march toward a completely free and open market economy.
- Reforming the financial and banking sector was given prominence with the implementation of new securities regulation laws, the establishment of four Asset Management Corporations to handle non-performing loans (NPLs) owed by unprofitable SOEs to commercial as well as state banks.
- A bilateral trade agreement was concluded with the US in 1999, opening the way for China's accession to WTO membership in 2001.

4 Reasons for success in China's reform program

The record of achievement was impressive. The question naturally arises as to what conditions led to this favorable outcome. One obvious motivation for this analysis is the potential application of China's lessons to other transition economies. As complex a phenomenon as the Chinese economy is typically driven by a multitude of factors. It is unrealistic to examine them all. We will limit ourselves to several of the most salient issues that may help explain the Chinese record to date.

A stable environment Unlike the former Soviet Union, China started its reform program without the attendant pressures of political and social collapse. The Communist Party of China was firmly in power, in spite of rumblings of unrest in Eastern Europe which culminated in the fall of the Berlin Wall. Such stability in China was decidedly more favorable to an orderly process of economic experimentation and transformation. Up to this time, the Chinese economy had been performing adequately, but not very efficiently. Over nearly two decades from 1960 to 1978, GDP growth had averaged 5.3 percent per year, hardly a scenario of crisis or disintegration. This allowed the leadership to begin a process of 'crossing the river by feeling the stones', a luxury denied to other transition economies in Eastern Europe.

A reservoir of surplus labor China started its economic transformation as a predominantly agricultural country, with 71 percent of its labor force employed in this sector and accounting for 65 percent of output. As pointed out by W.Arthur Lewis, a development theorist, agricultural labor is underemployed due to seasonal factors and productivity is low due to a lack of modern technology (see Dornbusch and Fischer 1998:303). These conditions fully applied to China in 1978 at its inception of reforms. The appearance of non-state businesses (as typified by TVEs) attracted large numbers of workers from the countryside. Workers from the state sector (employed in long-established SOEs) were less interested in moving to private business. They were enjoying the privileges of an iron rice bowl arrangement, with guaranteed wages, lifetime employment and good pension benefits. Their countryside brethren were less well treated by the state and were ready to jump on the reform bandwagon. They had nothing to lose but their underemployment and below-poverty living conditions.

A rapid rise in productivity The above-mentioned migration of the labor force, out of the agricultural sector to industry and manufacture, led to a marked improvement in national productivity, just as development authorities such as W.Arthur Lewis had predicted in their writings. Estimates indicated that this more efficient reallocation of resources (labor in this case, but true for any other factor of production) accounted for 1.2 percent, or about two-thirds, of the 1.8 percent annual growth in TFP (total factor productivity) between 1985 and 1995. Another reason for such improvement in TFP is simply that TVEs, and other forms of private businesses, are organized and operated more efficiently than their SOE counterparts.

Rapid integration into the world trade system Right from the start, China opened its economy to the world, taking full advantage of outside resources to strengthen its reform program. China's access to overseas markets provided ready outlets for its agricultural and manufactured exports which, in the event, proved to be highly competitive due to their high labor content, a source of comparative advantage for China. China then used these export earnings to purchase capital equipment, and the modern technology embodied therein, to further improve its competitiveness. FDI inflows, from overseas Chinese entrepreneurs and other Western businesses, provided further incentives for growth, as TVEs and SOEs were compelled to improve their performance when faced with a more intense competitive environment. Thus, in contrast to the Manchu dynasty of the nineteenth century, who considered all foreigners to be barbarians, Chinese leaders in 1978 were ready to embrace the world market system and turn it to China's advantage.

High savings rate Savings levels in China were high, even after allowing for the high savings observed in Asian countries in general. World Bank estimates showed that Chinese households saved 23 percent of disposable income, as compared to 21 percent in Japan and 18 percent in Taiwan. Most household savings were successfully channeled by the state into formal institutions such as the banking system and rural credit cooperatives. Financial flows from Chinese households to the financial sector grew steadily from 3.4 percent of GDP (1978) to 11.4 percent (1991). The banks recycled these resources as business loans, with the lion's share going to SOEs and the government. Such mobilization of domestic resources lessened the need for money creation by the state and helped damp down inflationary pressures. The anti-inflation impact was also reinforced by a lack of alternative financial instruments other than currency, which still served as the primary vehicle for transactions settlements. As the economy expanded, demand for money expanded more than paripassu, as can be readily observed in the ratio of M2 to GDP, which rose from 38 percent in 1978 to an unprecedented 110 percent in 1995. Such high growth rate in the utilization of currency has shown signs of leveling off, as more and more segments of the economy (mainly agricultural areas and far flung provinces in the hinterland) have become increasingly monetized and integrated into the transaction mainstream of the economy.

Central planning never was entrenched in China Contrary to popular impressions of China as a huge bureaucratic engine run by the state from top to bottom, central planning, *à la* Soviet Union or Eastern Europe, was never rigidly or successfully imposed in China. The Soviet Union became a central planning machine beginning with Lenin's New Economy Policy in the 1920s. China became an independent communist state only in 1949, nearly 30 years after the Bolshevik revolution. Central planning had much less time to do its damage. The Chinese mentality is that of a merchant (the so-called comprador mind-set) and is ingrained in the Chinese people. Thirty years of communist rule (1949–79) were not sufficient to erase this cultural imprint. Given a new liberal atmosphere started by Deng Xiaoping in 1978, it quickly came back to life and, as the saying goes, the rest is history.

5 The remaining challenges

In spite of many policy achievements that resulted in high GDP growth and strong balance of payments (BOP) position, China still faces a host of problems that may threaten its future economic well-being. This section will review several of the most intractable issues that have persisted in spite of repeated attempts at their resolution.

5.1 Macroeconomic instability

Since the start of reforms in 1979, China's economy has been subjected to a series of boom-and-bust cycles that occasionally raised doubts about the viability of market-oriented policies.

Role of interest rate and credit A major source of imbalance is in the credit area. Due to its strategic role, interest rate has not been completely set free to be determined by market supply and demand. In other words, credit rationing remains a policy tool wielded by the central authority (see Mundell 1998:130). When rates are set below market-clearing levels, all enterprises (private businesses, TVEs or SOEs) have incentives to demand more credit than can be supplied. Under strict central planning, such excess demand will be subject to allocation decision from the Plan authority. Inflationary pressures are effectively contained, because conflicting claims on resources (credit in this case) would have been resolved at the Plan level, and not allowed to manifest in the market.

Anatomy of a boom-bust episode After the introduction of reforms in 1979 and enactment of a liberalizing banking law in 1984, with each relaxation of credit control, enterprises of all kinds went on an investment boom. The banking system responded by creating credit. If fully backed up by increased savings, no demand pressures were generated. If not, the banks effectively injected new high-powered money into the system. In due course, the economy would become overheated, resulting in spiraling inflation. Responding to popular discontent and wishing to head off undesirable social consequences, the state began to clamp down on credit creation, causing investment projects to stall, leading to a cooling off in output growth. A slow growth period soon led to declining profits in private enterprises and widening losses in SOEs. Since budget contributions from SOEs were linked to their financial results, government revenues began to contract. Fiscal pressures soon became unbearable, and measures to pump up economic growth had to be implemented. Thus the cycle would begin all over again. Such episodes of credit easing followed by output expansion, monetary tightening and output contraction had occurred repeatedly in the past: in 1984–5, 1988 and 1992–3.

5.2 The corruption problem

After the introduction of reforms, a dual-track pricing system grew up: for each commodity, good or input, a market price is allowed to exist alongside an administered price. The differential between the two can be substantial and represents a form of rent that creates opportunities for corruption.

- Non-state enterprises as well as SOEs are obviously tempted to obtain inputs at official prices, use them in production, then sell them at market prices, thus reaping excess profits. If it is necessary to pay a bribe to obtain those gains, then it will be treated as a part of doing business. Competitive pressures ensure that once the practice started with some enterprises, it will inevitably be imitated by others. Thus corruption becomes built into the system, and any attempt at resolving it will run into systemic opposition.
- SOEs in strategic sectors (mostly heavy industries) are given preferential treatment in getting low-cost credit and buying inputs at plan prices. They are not reluctant to use insider dealing or bribery to obtain their full allocation of such subsidized items. SOEs in less strategic sectors, or with less connection, frequently lost out in getting their share of allocated resources.
- Corruption under its many shapes and forms has been a quasi-constant source of popular discontent and a threat to social stability, and has remained an intractable problem. Periodically, a scandal of major proportions erupted, leading to hand-wringing among senior leaders and some death sentences. But things soon return to normal, and business goes on as usual.

5.3 The poor performance of SOEs

In recent years, SOE operational performance has shown signs of improvement when faced with an increasingly competitive market environment. But their financial performance has not improved, and loss-making SOEs have become a heavy drain on state resources.

High capital expenses Most SOEs are found in strategic sectors (which Lenin called the 'commanding heights' of the economy), which are considered important for national security: transportation, power, mining, heavy machinery, etc. By nature, these SOEs are highly capital-intensive. This runs contrary to China's competitive advantage, which lies in its abundant and low-cost labor force. They are therefore at a comparative disadvantage when competing with private enterprises and foreign businesses.

State mandated responsibilities Outside observers also noted that some SOE losses can be traced to their having to assume policy-induced burdens that a regular private business would not have to contend with. SOEs are not free to dismiss employees even when such a move is economically justified, because they have a double role as an employment agency for the state. Under the iron rice bowl policy, workers in SOEs are guaranteed a job for life, enjoy free health care, and subsidized housing and food. When workers retire, generous pension benefits are provided. All these constitute heavy costs for SOEs and serve to inflate their operational expenses. In fact, it is difficult to arrive at a reliable judgment on the performance of a particular SOE, when its income statement is cluttered by all these extraneous expenditures mandated by the state, a legacy of the central planning period. It may operate efficiently and profitably on its own, but may show a loss after all government-imposed burdens are factored in.

The agency problem In a modern corporation, ownership and management have long been divorced. In fact, the corporate form was designed to achieve exactly this result, in order to limit owners' liability. But in solving one problem, it gave rise to another. The real owners of a company (the shareholders) rarely have any control over its operations. They are too numerous (a major corporation like AT&T may have millions of stock holders) and not organized to have input in the day-to-day running of the business. Thus the professional class of managers come to wield great power and influence. But their interests do not coincide with those of the owners, in spite of the common platitude of 'maximizing shareholder value' widely adopted by all business managers. They have their own agendas, and can engage in activities inimical to shareholder interest: pay themselves high salaries, utilize excessive perks, resort to unwise empire-building, mergers and acquisitions transactions. The list of potential abuses is endless. In corporate finance theory, this is called the agency problem (see Breasley and Myers 1998:991–4).

SOEs poor performance can be impacted by many factors as mentioned earlier, but deep down it reflects an agency problem. The real owners are the state. But local managers have direct control over operations that result in profits or losses. Their agendas rarely coincide with the government's, and may even conflict. They may want to keep a high payroll to help friends and relatives, give themselves and their workers pay raises even when not justified by economic reality, etc. Under reforms, they are allowed to retain a share of profits and the rest reverts to central government budget. Such an arrangement gives rise to all kinds of rent-seeking behavior: for example, giving high wages and excessive bonuses to themselves and coworkers, ending up with low accounting profits or even losses. The amount of wastes and losses associated with this problem has been estimated in many billions of dollars every year.

5.4 Problems in the financial sector

The weakness in China's banking sector is a mirror reflection of problems in loss-making SOEs. Failing or unprofitable SOEs have not been closed down or rationalized (for fear of causing social problems such as unemployment), but were instead kept afloat by bank loans.

- During the period of central planning, losses by SOEs were financed by fiscal subsidies from the state budget, because SOEs produced on directives from the central plan authority. They turned to the state for support when such directives led to financial losses. With reforms enacted in the 1990s, such fiscal subsidies were gradually phased out, only to be replaced by loans from state or commercial banks. Estimates showed that the amount of bank loans outstanding to SOEs rose from (renminbi) RMB185 billion (equivalent to 52 percent of GDP) in 1979 to RMB4,097 billion (74 percent GDP) in 1997.
- Because SOEs were for the most part unprofitable, a large share of loans extended to SOEs are classified as non-performing (overdue in interest payment, in amortization or in both). It is difficult to know with any certainty the quality of bank assets in China. People's Bank of China sources indicated that over one-third of all loan portfolios are considered NPLs. Assuming a recovery rate of 50 percent (i.e. the bank gets back 50 cents on each dollar lent) if debtors are forced into liquidation, the potential loan-loss faced by the banking system was estimated at RMB670 billion. The total capital of all banks amounted to RMB227 billion (end 1997). A write-off in such magnitude would imply technical insolvency for the banking system.
- One solution is privatization. This method had been used to rescue failing banks in the transition economies of Eastern Europe. One obstacle to this approach is the lack of potential buyers due to the poor quality of assets. Given a dearth of accounting information, it is difficult to get a reliable estimate as to how much a bank loan portfolio is really worth.
- Another solution is recapitalizing the banks. This would involve writing off NPLs totally or partially. The loss in bank assets would have to be replaced by government bonds. Assume a potential write-off of RMB800 billion (the estimated amount of bad debt at end 1997) was necessary, and substituted by state bonds. Such recap would effectively triple the amount of internal government debt, and entail an annual debt-servicing burden of RMB120 billion (given that government bonds carried a 15 percent coupon). This budget expense was equivalent to 2.1 percent of GDP, or equivalent to one-fifth of the combined central and provincial government revenues.

6 The lesson for Vietnam

Vietnamese leaders have followed with keen interest the twists and turns of reform programs in China. Of the former Eastern bloc members, China, North Korea, Laos and Vietnam are the only surviving nations. And China led the way in adopting reforms that saved it from the fate that befell the former Soviet Union. A casual comparison reveals many similarities indicating that valuable lessons can be drawn from the Chinese experience. In this section, we will review how China and Vietnam began similar economic reforms in 1979 and 1986, respectively, but went on to achieve different results due to diverging policy choices.

Initial conditions were almost identical at the beginning of reforms in both countries:

1 Political and economic stability was prevalent. There were no signs of crisis as the ruling party was firmly in power, unlike the unrest that culminated in the Berlin Wall collapse in Eastern Europe. However, both economies were operating inefficiently under the previous collectivist policy, thus providing a compelling case for reform to jump start economic growth.
2 Both countries were predominantly agricultural, with all the attendant problems of such economic structures, namely a large pool of surplus labor with low productivity due to mismanagement and backward technology.
3 Central planning had been the organizing principle, but had not been entrenched in either country.

Taking off from such similar initial conditions, China began its reforms in 1979 and has compiled a better record of achievement. Real GDP growth in China averaged 9.7 percent per year during the 20 years from 1979 to 1999. Vietnam's output growth was estimated at 5.8 percent over the same period (see World Bank 2001:220). The share of the Chinese state sector has shrunk to 25 percent of industrial output whereas it is heading in the opposite direction in Vietnam. During the Asian meltdown of 1997–8, the renminbi stood as a pillar of stability while the baht, the ringgit and the rupiah all buckled under speculative market pressures.

Our review of reform achievements in the two countries point out many objective lessons that can be drawn from the Chinese experience. Four of them stand out in importance.

6.1 A clear and firm commitment by the Chinese leadership to a policy of reforms

Chinese reforms started out hesitantly and experimentally in 1979 with the HRS. Trial runs of the new system were carried out in selected communes. They unleashed significant production incentives that led to rapid economic growth. However, inflationary pressures and other macro imbalances soon led to a boom-bust cycle that caused Chinese leaders to wonder if they were on the right track. This stop-and-go syndrome was soon recognized to be a major obstacle to further progress. In 1992, Deng Xiaoping made his famous southern China tour, in which he reaffirmed China's commitment to reforms regardless of macro consequences. China has not looked back since. The country's progress towards a full market economy is now considered 'irreversible' by people inside China as well as by outside observers.

This attitude of full commitment by Chinese policy makers has been effective in many areas but one prominent example is in the SOE problem. China had long been aware that SOEs acted as a drag on national economic growth. Repeated surveys showed that TFP was lower in SOEs than in private businesses or in joint ventures with foreign partners. Due to high capital intensity, the cost of creating one job in the state sector is three times higher than in private business. The Chinese government decided to give high priority to reforming the SOE sector. In 1998, Premier Zhu declared to the National People's Congress that SOEs were the focus of his attention, and pledged to resolve their problems in a 3-year period.

Due to a clear-cut emphasis, China's SOE policy produced encouraging results. The state sector accounted for 78 percent of gross industrial output in 1978, but that share fell to 65 percent in 1985, to 55 percent in 1990 and further to 25 percent in 1997. The non-state sector overtook the state sector in industrial output by 1995, accounting for 57 percent of total output, and that share rose to 75 percent in 1997. The experience with SOEs in Vietnam has been less successful, with the state sector's share of industrial output showing signs of increasing rather than decreasing. As of 1998, SOEs accounted for 70 percent of Vietnam's industrial output.

More than a decade after the start of *Doi Moi* in Vietnam in 1989, Vietnam's commitment to reforms still seemed to be stuck in a stop-and-go process. Unlike China, outside observers noted that the top party echelon in Vietnam is not unanimous in their backing of market reforms. There are still cross currents among the leadership group that can block or delay major reform initiatives. The constitution has not been amended–as had happened in China–to enshrine the private sector's role as the main motor for economic growth. The official party line on this issue is a complicated formula of 'building a socialist market economy bearing Vietnamese characteristics, with the state sector as a guiding component'. This ideological bowl of soup, with so many ingredients floating in it, is a symptom of the shadow boxing among contending factions in the politburo. There is no overriding supreme leader *à la* Deng Xiaoping who can lay down the reform policy and effectively have it carried out.

Vietnam implemented decisive economic reforms in 1989–92, leading to significant achievements during the 'golden period' of 1992–7. Then suddenly the drive for reforms turned cautious in 1998–9 that led to unsatisfactory macroeconomic results in those 2 years. The Asian financial crisis that broke out in 1997 may have been the catalyst for caution. But the result was detrimental to continued economic growth. A quick com-parison of China and Vietnam's recent performance is instructive: China's GDP grew at 8.8 percent, 7.8 percent and 7.1 percent in 1997, 1998 and 1999 respectively, while Vietnam's corresponding growth rate was 8.2 percent, 3.5 percent and 4.2 percent.

The lesson for Vietnam here is to avoid a stop-and-go policy in general, with regard to reforming SOEs in particular. China amended its constitution three times (in 1988, 1993 and 1999) to officially recognize the private sector as an essential component of the national economy and promote its development. Reducing the state sector's size was declared a policy priority by the national leadership. The Prime Minister went before the National People's Congress to pledge a 3-year program to achieve a solution. In contrast, Vietnam still maintains a policy goal of 'building a socialist market economy, with the state sector as a guiding component'. This is hardly a ringing endorsement of market mechanisms. Such language can be interpreted as an ambivalent attitude with regard to SOE reforms. Managers of SOEs, many with their own self-interested agendas, feel they can expand their activities into areas best left to private initiatives. Consequently, the state sector in Vietnam is far from 'withering away' as had been hopefully expected, but has grown to dominate a larger portion of the economy than before.

6.2 An open orientation towards integration into the world economic system

From the inception of reforms in 1979, Chinese leaders showed a determination to open the country to outside markets as well as capital flows. One example is its welcome of investments (both direct and financial) by Chinese entrepreneurs in South East Asia. FDI flows from this source made significant contribution in the early years of reforms, when capital inflows from the West was nonexistent due to lack of confidence in, or unfamiliarity with, Chinese markets and policies. In 1995, FDI amounted to US$40 billion, equivalent to 25 percent of total investment in China. Fully 40 percent of those FDI flows originated with Chinese entrepreneurs in Hong Kong. If capital flows from Taiwan and Singapore were included then up to 65 percent of total FDI came from overseas Chinese sources.

Due to a resolutely open policy, by the early 1990s China's share of world trade had quadrupled compared with the pre-reform period, and it was regularly the recipient of more FDI than any other transitional or developing economy. Indeed in 1993, when those inflows exceeded those into all developed economies as well, China was the recipient of more FDI than any other country in the world. Moreover, it was the first transitional economy to be awarded an investment grade rating for its sovereign debt in international capital markets. Last but not least, China has successfully issued more debt and equity on world markets than any other transitional economy.

In contrast to China, Vietnam's attitude towards overseas Vietnamese *(Viet Kieu)* and their investments has always been ambivalent. Legally, they are considered to be still citizens of Vietnam even though they have become nationals of other states after leaving Vietnam during the 1975 diaspora. To renounce Vietnamese nationality is a painful and complicated process, and involves the application for a special dispensation from the government. *Viet Kieu* can accept being treated as Vietnamese nationals subject to Vietnamese laws and regulations if they can enjoy the corresponding benefits. But they are not given full citizens rights. A dual pricing system had been in place with the higher prices reserved for *Viet Kieu* and this was abolished very recently. After years of hesitation by the government, it was only in July 2001 that they have been allowed to engage in real estates transactions, e.g. buying a house or an apartment and registering it in their own names.

Since 1975, the flow of remittances from overseas Vietnamese to their families inside the country has been estimated at between US$600–800 million per year during 1975–90 and since then at US$2–4 billion per year. Cumulating over the past 25 years (1975–2000), this represents a substantial source of foreign exchange for the state, and investment capital for the economy. The role of such remittances was especially important in the early years right after unification, when Vietnam was effectively cut off from the outside world by a US-led embargo.

Vietnam should create a win-win situation in utilizing the resources of overseas Vietnamese. Many of them complain that the state is only interested in 'taking' their remittances to the home country, but reluctant to 'give' in return, in terms of recognition or assistance with their investment projects. Any cooperation should be a 'give and take' process. Indeed many *Viet Kieu* were invited by the police for 'working sessions' when they go home to visit relatives or to explore business opportunities. Such treatments can be interpreted as a kind of intimidation. We think that this attitude of suspicion and wariness–a legacy of the wartime period–has a chilling effect on the willingness of many *Viet Kieu* to invest in Vietnam.

Actually, overseas Vietnamese's aspirations are fairly simple. They love their country and want to contribute. After all, most still have families or relatives in Vietnam. This is similar to the feeling of the Jewish people still looking to Israel as a beacon of hope, even though they may be scattered in hundreds of countries because of the Jewish diaspora. The *Viet Kieu* ask for no special treatment, just the same treatment that the state offers to local businesses or even foreign investors. To use a *cliché,* what they are looking for is a level playing field. Many of them resent being treated as a 'cash cow' by the state or other local businesses. In spite of popular mythologies, they are not all rich 'capitalists' who deserve to pay a higher price than local residents. They do have some savings and capital resources, resulting from years of frugal living and hard work while doing business in other countries.

Now they want to bring those assets home, along with their business knowledge and technical know-how, to build a better Vietnam.

One area where overseas Vietnamese can potentially make a great contribution is in information technology, including hardware, software, internet services, etc. The government is well aware that globalization and information technology are major forces driving the world economy. It has organized countless conferences and seminars to discuss how Vietnam can become a 'knowledge society', bypassing the industrial phase of economic growth. The *Viet Kieu* community in California has achieved significant results in establishing high-tech companies, and many have become millionaires many times over. They are eager to bring financial resources and technical know-how to invest in the homeland. The government would do well to take advantage of this resource.

In this context of opening to outside economic forces, we want to mention the role of foreign investors other than *Viet Kieu.* The litany of difficulties that the outside investor might encounter in Vietnam has become too familiar, from petty corruption to entangling bureaucracies. In recent years, many American and European enterprises have voted with their feet, and withdrawn from the Vietnam market. The FDI flows have declined precipitously over 1997–9. Official figures from the Ministry of Investment and Planning (MPI) showed FDI commitments falling from US$70 billion (1997) to US$1.56 billion (1999). Corresponding figures for disbursements were US$2.07 billion (1997) and US$0.70 billion (1999).

6.3 Flexibility in macroeconomic policies

China's policy makers have demonstrated a sophisticated understanding of macroeconomic policies, and an ability to use them flexibly. Their policy stance has been pragmatic, consistent with Deng Xiaoping's dictum that all cats, whether black or white, are useful if they catch mice. Other countries in South East Asia, Vietnam included, usually put undue emphasis on maintaining their nominal exchange rates, which are most frequently pegged to the US dollar. During the Asian financial crisis of 1997–8, Thailand expended considerable resources to defend its nominal exchange rate, but finally had to abandon the struggle at a great cost to its economy and financial system.

China's record in this regard is different. In 1993, faced with a deteriorating current account, China readily and flexibly adjusted its nominal exchange rate, and was rewarded with a rapid balance of payments (BOP) improvement. Its foreign exchange reserves were constantly improving and stood at healthy levels, covering more than 12 months of imports. In 1986 and 1989, China also adjusted its exchange rate, not because of any worsening BOP position, but due to a desire to improve its export competitiveness (see People's Bank of the Republic of China

2001:252). Again, the policy measures were effective and resulted in a stronger trade and current account.

In contrast, Vietnam's handling of exchange rate policies left much to be desired. During 1992–7, national investments increased rapidly, reaching 31 percent of GDP, with a large contribution from FDI. Capital inflows of such magnitude naturally exerted upward pressures on the real effective exchange rate of the Vietnamese dong, damaging the competitiveness of Vietnam's exports. The lack of a nimble foreign exchange rate policy allowed this overvaluation to persist. The situation was further aggravated during the Asian crisis of 1997–8 when the currencies of Vietnam's competitors (Thailand, Malaysia, Indonesia, etc.) all suffered significant devaluations. Only recently has some flexibility been introduced in exchange rate management, with a widening of the bands around the central rate. The Vietnamese State Bank should go further in this regard by switching to a crawling peg regime. Under this policy, incremental adjustments are made to the central rate at regular intervals (thus avoiding introducing instability to the foreign exchange market), and without pre-announcements from the State Bank (thus depriving speculators of rent-seeking opportunities). The small adjustments also would not unduly interfere with commercial activities once they have been built into the economy's expectations.

6.4 Measures to prevent social and political instability

The Chinese government is aware of social and political implications flowing from its reform policies. It wants to head off undesirable consequences due to economic changes. Economists call this problem the revolution of rising expectations. Societies tend to fly apart when forces of change are at work in one area, say the economy, then begin to impact on others. The most obvious social problems in China include unemployment in urban areas, corruption among party cadres and income inequalities among different classes in society. Of special concern is the growing gap between urban and rural populations.

The Chinese government has permitted popular elections at village levels. Local administrators are now representatives of the people, voted into office by them, and accountable to them. These rural officials represent a channel of communication, through which popular grievances and discontent can be defused and resolved before they lead to social problems. The government has also reformed the legal system, allowing citizens to bring legal actions against institutions, including government agencies, that abuse their authority. This is also another channel to mitigate social unrest.

The Vietnam government would do well to take a page from this experience. Recent unrests in Thai Binh and Nam Dinh provinces are indications that the government has been slow to address issues of grassroot democracy, allowing them to fester and grow into major sources of social instability. Such incidents can be used by hard-line factions in the party leadership to justify a go-slow approach, causing the same stop-and-go problem that had been discussed earlier in this chapter.

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11 Foreign direct investment and economic development

The Vietnamese experience

Khai Nguyen

1 Introduction

Foreign direct investment (FDI) has been one of the important stimulating factors of the Vietnamese economy in the last 10 years. It grew steadily until the Asian financial crisis began to affect Vietnam in 1998. FDI not only brought into Vietnam foreign capital, technology and management skills that Vietnam needs, but it also helped open up the Vietnamese economy, a tightly closed and highly inefficient economy near the brink of famine in the early 1980s. The FDI demand has put tremendous pressure on the Vietnamese policy makers to adopt substantial economic reforms in order to attract much needed foreign capital.

Private foreign investment comes in various forms: private lending, portfolio investment and FDI. After a series of serious debt crises facing the developing countries in the 1970s, 1980s and early 1990s,[1] private lending lost its popularity for foreign investors. Portfolio investment provides little or no control over the money invested and is fairly risky if it takes place in a developing country with inadequate business experience and management skill. FDI, the focus of this study, has become a dynamic tool for foreign investors. FDI is defined as:

> Investment that involves a long-term relationship reflecting a lasting interest of a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor. The direct investor's purpose is to exert a significant degree of influence on the management of the enterprise resident in the other economy.
>
> (IMF 1993)

In recent years, Vietnam has begun to invest in fishery, sea transport, wood processing and information technology in neighboring countries. The amount of FDI outflows from Vietnam is still insignificant but rose to about US$13 million as of April 2000 (see the Economist Intelligence Unit 2000b). This chapter discusses FDI inflows only and is structured as follows. The first section describes the scope of the study, followed by an analysis of the FDI trend in Vietnam in section 2. Section 3 examines the auto industry in Vietnam. Section 4 debates the FDI climate.

Section 5 presents views on the FDI and the US–Vietnam bilateral trade agreement (BTA). Section 6 addresses the contributions of FDI to the Vietnamese economy. The final section provides some suggestions to improve the FDI environment in Vietnam.

2 FDI trends in Vietnam

Vietnam issued the Foreign Investment Law (FIL) for the first time in 1977, 2 years after the country's reunification. However, this effort to draw in foreign capital failed due to Vietnam's military intervention in Cambodia in December 1978, followed by its border war with China in February 1979. After the severe food shortage began to spread in Vietnam in 1985, following the collapse of the farm collectivization program, Vietnam was forced to transform its centrally planned economy into a market-oriented system in 1986 under the *Doi Moi* (Renewal) Program. In the following year, the new FIL was promulgated in an attempt to bypass an economic boycott imposed by the international community. FDI began to flow into Vietnam gradually after it withdrew its troops from Cambodia in 1989, concurrent with the collapse of the communist regimes in Eastern Europe.

FDI inflows increased from a total of US$168 million during 1988–91 to US$2.1 billion in 1997. The bulk of FDI disbursement took place during the high growth period 1992–6. It peaked at US$2.3 billion, which is equivalent to 11.3 percent of GDP in 1995. FDI inflows declined sharply to US$800 million in 1998 and around US$700 million in 1999 when Vietnam began to feel the effect of the Asian financial crisis (Table 11.1 and Figure 11.1). Total FDI commitment in 1999 was US$1.5 billion, or about 40 percent of the 1998 total of US$3.9 billion. The total FDI committed during the first 8 months of 2000 amounted to US$488 million, a 46 percent decrease from the same period in the previous year. Slow economic reforms in Vietnam and increased competitiveness in other Asian countries in the past few years have partly contributed to the reduction of FDI inflows to Vietnam. The signing of the BTA with the US in July of the year 2000 was too late to reverse this trend, at least in the short term.

The total of FDI commitments during the period 1988–98 was about US$32.5 billion, and the total FDI disbursement during the same period was about US$10.3 billion (Table 11.2). The implementation rate, as measured by the disbursement to commitment ratio, was about 31 percent. This figure is quite low, even though the FIL required that FDI projects start to be implemented within 6 months after they are approved. The analysis of detailed data shows that the FDI project implementation rate has been improved in recent years as the government has gradually simplified the FDI review procedure. The implementation rate is better regarding more active sectors such as oil and gas (80 percent), and services (63 percent). Other sectors do not score well, especially office

Table 11.1 Vietnam: disbursement of FDI by sector, 1988–99a (as % of total unless specified otherwise)

	1988–91	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*[b]
Industry	17.8	15.2	28.8	36.1	32.6	43.0	46.8	41.3	41.6
Heavy industries	10.1	6.3	8.0	18.7	13.1	16.9	20.3	12.8	26.0
Export processing zones	0.0	1.0	0.3	0.6	1.7	6.3	3.6	3.1	3.2
Light industries	5.9	3.2	4.9	9.1	10.3	16.5	17.6	15.4	7.1
Food	1.8	4.8	15.6	7.7	7.6	3.3	5.2	10.0	5.3
Oil and gas	41.3	23.2	40.6	37.7	25.7	15.3	0.0	6.2	12.6
Construction	0.0	1.9	4.8	2.3	5.0	14.0	7.3	31.3	7.8
Transportation and communication	17.4	6.0	2.9	3.0	7.0	4.1	3.7	1.9	6.4
Real estate	16.7	16.8	12.2	17.1	19.2	18.6	20.4	14.1	20.4
Hotels and tourism	11.3	13.7	9.0	12.8	11.2	11.2	14.3	9.1	8.2
Office property and apartments	5.4	3.2	3.3	4.3	8.0	7.4	6.1	5.0	12.2
Agriculture, forestry and fishery	8.6	3.8	3.5	2.3	5.3	3.8	13.7	5.1	6.3
Services	−1.8	33.0	7.2	1.6	5.1	1.2	8.1	0.3	4.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total disbursement (US$ million)	168	315	923	1,636	2,262	1,962	2,074	800	700
As % of GDP	2.0	3.9	7.8	11.2	11.3	7.7	8.1	3.2	2.4
Total commitment (US$ million)	2,381	2,293	3,585	3,664	6,722	7,702	4,456	1,738	1,563

Sources: International Monetary Fund (1999a, 1999b, 2000).

Notes

a includes investment by domestic joint venture partners,

b preliminary.

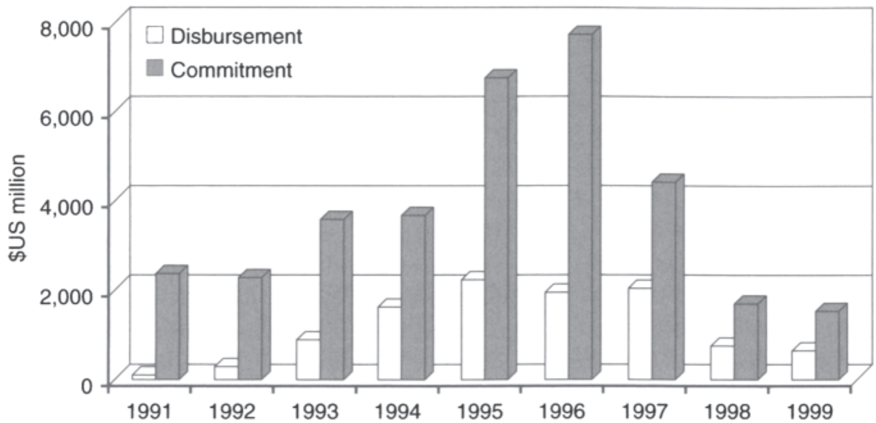

Figure 11.1 FDI in Vietnam 1991–9

Sources: see Table 11.2.

Note: The year 1991 includes 1989–91.

property and apartments (13.5 percent), and transportation and communication (14.7 percent). There were a number of reasons for low implementation rates (see Le 1997). Some projects require land-use permits, construction permits, population removal, site clearance, equipment import permits, etc. Each project has to be approved by different agencies. In addition, about 15 percent of the approved projects were later withdrawn due to various reasons.

In earlier years, between 1988–91, most of FDI was poured into offshore oil and gas projects, which were exposed to minimum political and economic risks, followed by hotels and tourism projects, which were easily carried out and managed. In the second stage, FDI expanded into production areas. During 1988–98, foreign investments concentrated in the following sectors as measured in terms of total FDI disbursements: oil and gas (20 percent), real estate (18 percent), heavy industry (15 percent) and light industry (12 percent). At present, foreign investors have very limited access to the service sector. Their participation in this area is only 5 percent. The BTA with the US approved by the US Congress allows American firms to invest more in a broad array of services. FDI flows to manufacturing and export sectors are also very limited.

Like China, the majority of FDI projects in Vietnam during 1991–8 are joint ventures with state-owned enterprises (SOEs), which accounted for 65 percent in terms of commitments. Joint ventures with private companies (PCs) account for only 2 percent, since PCs were new in Vietnam and were allowed to join a partnership with foreign investors after the FIL was amended in 1992. Fully foreign-owned projects accounted for

Table 11.2 Distribution of FDI by country of origin, 1988–98* (US$ million unless otherwise stated)

	Commitment	*Disbursement*	*Disbursement ratio (%)*	*Equity disbursement*	*Foreign loans*	*Undisbursed commitment*
Singapore	5,857	998	17.0	564	434	4,859
Taiwan	4,028	1,375	34.1	913	462	2,653
Japan	3,266	1,197	36.7	683	514	2,069
Korea	2,903	941	32.4	491	450	1,962
British Virgin Islands	2,772	352	12.7	241	111	2,420
Hong Kong	2,671	982	36.8	583	399	1,689
France	1,489	328	22.0	190	138	1,161
Malaysia	1,182	763	64.6	308	455	419
US	1,059	270	25.5	171	99	789
Thailand	994	334	33.6	164	170	660
Australia	873	398	45.6	286	112	475
UK	693	586	84.6	260	326	107
Switzerland	653	303	46.4	127	176	350
Other	4,102	1,436	35.0	863	573	2,666
Total	**32,542**	**10,263**	**31.5**	**5,844**	**4,419**	**22,279**

Sources: IMF (1999a, 1999b, 2000).

Note
* Includes investment by domestic joint venture partners.

22 percent of total commitments. Two other forms of FDI projects, namely business cooperation contract (BCC) and build, operate, and transfer (BOT) accounted for 12 percent. In terms of FDI disbursement, joint ventures with SOEs accounted for only 52 percent, as compared to its 65 percent share in total commitment. The share of PCs joint ventures remained 2 percent, while BCC and BOT combined accounted for 24 percent. These statistics suggest that for a number of FDI projects, joint ventures were converted to BCC or BOT (see IMF 1999a).

Taiwan, Japan, Singapore, Korea and Hong Kong are major investors in Vietnam. Total FDI from the Asian region, including Malaysia and Thailand, accounted for about two-thirds of FDI inflows. This explains why the total FDI commitment to Vietnam fell sharply from US$7.2 billion in 1996 to US$4.2 billion in 1997 when the financial crisis hit Asia, and FDI disbursement declined substantially from US$2.1 billion in 1997 to only US$800 million in 1998. The delayed effect on FDI disbursement was due to a low implementation rate that is explained above. Other important sources of FDI for Vietnam are the British Virgin Islands, France, Australia, the UK, the US, and Switzerland. The modest participation of American investors was due to the US trade embargo imposed against Vietnam until 1994 and the lack of the US–Vietnam BTA until 13 July 2000, which was not effective until 4 December 2001.

After the US lifted the trade embargo in February 1994, US firms began to invest in Vietnam. As of 10 June 2000, the US was ranked ninth among foreign investors in Vietnam with 90 projects amounting to US$1.2 billion. The US investment increased from US$120 million in 1994 to its peak of US$392 million in 1995. Since 1996, it has been on the decline and reached the lowest point in 1999 with committed capital of only US$96 million. The prospect was worse for 2000: only one project in oil and gas was approved in that year. The US investment projects with 100 percent American-owned capital account for 55 percent of the number of projects and 49.6 percent of total investment capital. The corresponding figures for US joint ventures are 39 percent and 50.1, respectively. The US presence in Vietnam has been relatively new but highly visible due to a number of world renowned firms.[2]

3 FDI and the automobile industry in Vietnam

Mekong Corporation established in 1991 in Vietnam was the first car assembly company and produced Korean 4WD Sangyong vehicles and light trucks and buses in cooperation with the Italian car manufacturer Fiat. Two years later the Vietnam Motor Corporation (VMC) was set up and started assembling Korean Kia and Japanese Mazda, as well as light commercial vehicles, in a joint venture with Kia's Filipino Associate Colombia Motors. In 1995, VMC expanded its operations to assemble German BMW cars. During the next few years, other carmakers entered the Vietnam market, including Mitsubishi, Daewoo, Mercedes-Benz, Toyota, General Motors, Daihatsu, Isuzu, Ford, Suzuki and Chrysler. Together, these international automobile manufacturers formed 14 car assembly joint ventures with Vietnamese counterparts. Their total capacity was 75,000 vehicles a year. Another estimate was 150,000 vehicles as compared to the market demand of about 15,000 new vehicles a year prior to the Asian financial crisis (see The Economist Intelligent Unit 2000a).

What went wrong? Foreign investors overestimated the domestic demand for automobiles. Certainly, Vietnam has a large population and experienced high growth during the period of 1992–7. However, the annual national income per capita is still below the 1 dollar-a-day threshold. A person with that income, assuming they had free shelter and meals daily, would have to save their full salary for 63 years to be able to buy a Mitsubishi Pajero, sold in Vietnam with a price tag of US$22,000 (see *Asia Pulse* 1999). Currently, there is no effective demand for cars in Vietnam. According to some experts on the auto industry, cars and trucks appear in people's wish list only when the annual national income per capita reaches the minimum US$6,000 level.

When the Vietnamese economy was hit by the Asian financial crisis, vehicle sales went down from 15,000 vehicles to only 6,000 in 1997 and 1998, and 5,200 in 1999. The import of 13,500 cars valued at US$100 million in 1998 aggravated the disaster of the vehicle assembly sector in the middle of the Asian crisis. In addition, the Hanoi government decided to limit the use of cars by state-run administrative offices and businesses. Moreover, foreign invested firms cut back their expenditures as a result of the financial crisis and the demand for cars by taxicab companies also diminished (see *Asia Pulse* 1999). VMC, the second largest vehicle assembly company, collapsed. Chrysler withdrew from Vietnam. In 2000, there were eleven operational automobile joint ventures. More carmakers will likely pull out since the cost of staying in Vietnam is too high. Toyota is the only profitable one. Its sales have been the highest in Vietnam. During the first 8 months of 2000, Toyota sold about 2,200 cars, accounting for 37 percent of total cars assembled in Vietnam, while Ford sold only 500 cars. During this period, Vietnam also imported 7,261 cars. According to one estimate, the total demand for cars and trucks slightly increased from 15,000 to 20,000 in 2000, which is equivalent to only 26 percent of the total capacity of the auto industry in Vietnam. Foreign investors failed to look into the issues of consumers' income, distribution and road networks, financing, and the motorcycle market. Most of people in Vietnam move around in cities by motorcycles and bicycles; between cities, they take buses. Old cars and trucks from the former Soviet Union, French and Japanese era are still running and dominate the public transportation market. All fourteen car manufacturers kept their plan secret in the hope of being the first presence in Vietnam, and they all came over during a 5-year period.

4 FDI climate in Vietnam

Uncertain environment

The top priority of the Vietnamese leaders is to maintain political stability rather than radical economic reforms. Despite *Doi Moi,* Vietnam still favors SOEs over the private sector. A small group of liberal and well-educated political leaders inside the government, who favor economic reforms, have recently gained more influence due to economic difficulties during the last 3 years. The recent implementation of a number of economic reform measures has improved the investment climate. More importantly, the approval of the BTA with the US in July 2000 indicates a major change in Vietnam's economic policy, which will likely encourage foreign investment in the country.

Legal system

The legal structure in Vietnam is based on Communist legal theory and the French civil law system. The Constitution is the source of government and legislative authority in Vietnam. The laws passed by the National Assembly constitute the highest form of legislation. The lower legislative levels include ordinances passed by the council of state, followed by decrees enacted by the council of ministers and ministerial circulars. In addition, there are many important decisions made by the People's Committees at city, province and district levels. In reality, an administrative decree can change a substantial law, as in the case of the land-use rights applied to FDI (see Pham 1999).

The legislative branch consisting of the National Assembly and People's Courts in reality is not a separate and independent body of the national government structure as seen in any Western democratic country. This is what foreign investors fear most. Economic courts handle economic and business disputes. Lay assessors, together with professional judges, are permitted by law to rule on both questions of rules and facts. The laws are on the books, but their enforcement is weak and varies depending on the area of law and the parties involved (see Pham 1999). Commercial disputes do happen from time to time. The fairness of the court system is a major concern of foreign investors in Vietnam. As business laws are not always applied or are constantly changing, the volatile and unpredictable legal framework adds more uncertainty to the investment environment.

Purchasing power and customer preference

There are two broad reasons for multinational companies to invest in Vietnam: the cost-push factors and the attraction-pull factors. Vietnam has been viewed by foreign investors as a source of abundant, hard working, loyal, literate but cheap labor. The Vietnamese population is relatively young. The national income per capita is US$350 per annum as compared to US$2,160 for Thailand, US$750 for China and US$440 for India. The minimum wage is currently set at US$50 per month in Vietnam (see Pham 1999). Second, Vietnam is rich in natural resources (off-shore oil and gas deposits, phosphates, coal, manganese, bauxite, chromate and timber). Third, with 78 million people, Vietnam is the second largest country in South East Asia and the thirteenth largest in the world. Vietnam is a potential market for foreign products and services. It is quite noticeable that Vietnamese consumers have discriminating tastes in favor of foreign products made abroad, especially in Japan, France, Germany or the US.

Dual pricing

Vietnam has adopted a dual pricing policy like China. Under this policy, Vietnam charges foreigners double prices for almost everything including water and housing as compared to prices applied to locals. For example, advertising rates are six times higher than those for local competitors (see Pham 1999). A train ticket from Hanoi to Saigon costs US$254 for foreigners but only US$50 for locals (see Truong 1997). An air ticket for the same cities costs a foreigner US$350 as compared to US$135 for a local. For that amount, in the US, one could fly from Washington DC to Los Angeles, a distance five times that from Hanoi to Saigon. The higher the level of foreign investment activities, the more foreigners come to Vietnam and absorb higher prices to subsidize local consumers and industries. Therefore, the dual pricing policy indirectly adds more cost to foreign investment and effectively undermines the low cost factor and chases foreign investors away.

Land-use right

During the last 10 years, land prices have skyrocketed. This is due to the fact that money sent back to Vietnam from overseas Vietnamese and exported workers, estimated at more than US$1.5 billion a year, has been ultimately used to purchase land-use right and housing. In addition, many approved FDI projects have been looking for land to build plants, offices and houses. As mentioned earlier, 65 percent of FDI projects are joint ventures between foreign investors and SOEs. Typically, foreign investors contribute 70 percent of the capital to joint ventures in terms of machinery, equipment and cash. SOEs contribute the remaining 30 percent, in most cases in the form of land, no matter how large a piece of land is. Even though the new Land Law promulgated in 1993 set the rules on land-use right, its inheritance and transfer, and establishes a basic rent schedule for six types of land for different regions, SOEs tend to inflate the price of land to match at least 30 percent of the required capital for the joint venture. Some SOEs try to value their contributed land up to 50 or 51 percent of the assets of the joint venture (see Pham 1999). As a result, the practice of using land-use right as a contributed asset to joint ventures has pushed up the price of land and has created an unproductive land speculation market in Vietnam. This is harmful to the FDI policy and the economy.

To make the land situation worse, the government of Vietnam later issued a circular that set very high fees for land-use rights, which effectively paralyzed the real estate market. In February 1995, the government of Vietnam issued a decree which transformed land-use rights on commercial properties into land leases, effectively terminating the quasi-ownership of land under the long-term land-use rights. This latest decision has created two serious problems. First, under the new law, the rent for using land must be paid by Vietnamese business partners and is much less than the value of the long-term land-use rights. For this reason, foreign investors want to revise downward the equity contribution of local partners to joint ventures, although they have not been successful so far. Second, banks no longer accept land-use rights as collateral for loans. Some banks even want to cancel loans approved earlier (see Pham 1999). These typical examples indicate the volatility and unpredictability of the legal system in Vietnam.

FDI incentive package

Vietnam presents a newly opening market for all types of consumer goods. The current national income per capita of US$350 per annum is quite low. However, it is rising steadily. Vietnam has been an attractive host country for foreign investors since Vietnam started the renewal program in 1986 and issued a new FIL in 1987, which has been amended several times: 1990, 1992, 1996 and, most recently, in June 2000. The attraction-pull factors include tax regime, economic policies, infrastructure, business environment and political stability.

Like many other host countries, Vietnam designed and kept changing its FDI incentive package including tax holidays, import duty exemption and favorable corporate profit tax to lure foreign investors, as shown in Table 11.3. Generally speaking, what Vietnam offers is quite competitive with its neighboring countries. But foreign investors seem more concerned about the high costs of land and utilities, undeveloped infrastructure, primitive banking and legal systems, opaque laws, a murky tax regime, wide-spread corruption, an inequitable playing field among local, especially state-owned, and foreign-invested companies and, most importantly, unresponsive bureaucracy.

> Most of us know from early contact with overseas Vietnamese that the work force–given training–is world class and this has proven true in-country. What creates the problem is the complex matrix of governments intertwined with state-owned enterprises that investors and other foreign-based business people must deal with on a daily basis.

Table 11.3 Foreign investment incentives in selected Asian countries

	Vietnam	*China*	*Thailand*	*Philippines*
Profit tax (%)	15 20 25	15 20	20 25	20 25
Tax holidays	2 years plus 2 years tax exemption at 50%	2 years	3–5 years	5–8 years
Import duty Exemption	machinery raw materials	machinery raw materials	machinery selected raw materials	machinery selected raw materials

Sources: World Bank (1999c, 2000) and ASEAN (2002).

> The time needed to manage these relationships is simply too costly. There are simply too many toll gates, ministries, customs officials, tax collectors, inspectors, People's Committees, quotas, licenses, chops, etc. than many managers can manage and still run a profitable business. Too much control over too few businesses.

This extract is from Jules Carlson (1998), country manager for Cargill Inc, the Minneapolis-based agriculture company, and former chairperson of the American Business Community in Saigon and the American Chamber of Commerce, Saigon division.

Infrastructure

Table 11.4 compares the prices of land and utilities in Vietnam with selected countries. Vietnam has one of the lowest national incomes per capita in the region. However, the prices of land and utilities in Vietnam are unfortunately among the highest. According to an estimate, Vietnam experiences a seasonal electricity shortage of 250–450 MW, about 10 percent of total generating capacity, during the month of May (see The Economist Intelligent Unit 2000b). A telephone call from Hanoi to Washington DC costs about US$3 per minute (or US$4–5 at the hotels), while a call originated from Washington DC costs about 75 US cents per minute. Vietnam Post and Telecommunications, the state monopoly, charges internet service providers one of the world's highest connection fees of UK$1,500 a month for a 64K leased line. Home surfers are charged US$1.24 an hour (see Cohen 2000) while Vietnam's average income per capita is less than one dollar a day. Vietnam has an outdated road system of 105,000 km, only one-fourth of which is paved, but poorly maintained. The railroad system of 2,600 km is also obsolete. About 87

Table 11.4 Prices of land, electricity and water for industrial and export processing zones in selected Asian countries, April 1997

Country	*Land (US$/m²)*	*Electricity (US$/kW)*	*Water (US$/m³)*
China	0.06–3.2 (per year)	0.015–0.037	0.02–0.06
Thailand	39.5–66.7 (for project life)	0.100	0.36
Malaysia	6.3–22.2 (for project life)	0.620	0.35–0.46
	45.0–61.7 (for project life)	0.050	0.42
Philippines	0.20–0.24 (per month)	0.037–0.073	n.a.
Vietnam	65–150 (for 50 years)	0.080	0.45
	1.3–3.0 (per year)		

Source: World Bank (1999c, 2000).

Note

n.a. not available.

percent of the total railroad has a narrow gauge (1 meter). Most locomotives have surpassed their maximum lifetime. There are 17,700 km of navigable waterways of which only 5,149 km are navigable at all times by vessels up to 1.8 m draft (CIA 2000). Vietnam has 36 paved airports of which sixteen are major ones; but only three airports handle international flights. Table 11.5 compares some basic infrastructure indicators of Vietnam with selected Asian countries. Vietnam does not score well in terms of paved highways per capita and falls far behind its neighboring countries in terms of electricity production per capita.

Personal income tax

Vietnam has a progressive personal income tax system. For those foreigners working in Vietnam with annual incomes between 360 million and 600 million dong (about US$25,700–43,000), the personal tax rate is 40 percent. For annual incomes exceeding 600 million dong (about US$43,000) the tax rate of 50 percent is applied (see Vietnamese Embassy 2000). In addition, the full gross income is taxable, since tax deductibility does not exist in Vietnam. As a result, personal income tax is quite high by both regional and world standards. In Thailand for example, the 30 percent and 37 percent tax rates apply to annual personal incomes between 1,000,000 baht and 4,000,000 baht (US$25,000–102,000) and those exceeding 4,000,000 baht (US$102,000), respectively. Moreover, the tax system in Thailand does permit tax deductions with respect to personal allowance, contribution to provident funds, interest payments on mortgage loans and contribution to the social securities fund. There is no distinction between resident or non-resident, local and foreigners. China's personal income tax rates are even lower than those in Thailand (see Ma 1999). Vietnam's income per head is one-sixth of Thailand and half of China. One wonders if the tax authority has ever studied the tax regimes of neighboring countries.

Table 11.5 Estimates of infrastructure indicators in selected Asian countriesa

	Vietnam	*Thailand*	*Philippines*	*India*	*China*
Electricity production (billion kW)	14.9	85.0	39.6	448.6	1,160.0
Electricity production per capita (kW)	193	1,388	528	458	936
Telephone main lines per 1,000 persons[b]	26	84	37	22	70
Paved road (1,000 km)	23	63	40	1,517	271
Total road (1,000 km)	93	65	200	3,320	1,210
Paved road as % of total road	25.1	97.5	19.8	45.7	22.4
Paved road per 1,000 persons (m)	0.00	0.00	0.00	0.00	0.00
Aircraft departure (000)[b]	30.0	94.0	62.0	196.0	511.0
Aircraft departures per 1,000 persons	0.39	1.54	0.83	0.20	0.41
GNP per capita (US$)[b]	350	2,160	1,050	440	750
Population (million)[b]	77.0	61.2	75.0	980.0	1,239.0

Source: Based on data published by CIA (1999).

Notes
a Based on latest data available. They are not necessarily the same year for all countries.
b Based on data published by World Bank (1999a).

Banking system

As a transitional economy, Vietnam's banking system has been facing numerous problems: government intervention, weak supervision, non-performing loans, weak capital base, low profitability, heavy debt overhang and ineffective management. In addition, the local currency (dong) is not convertible, while foreign exchanges are limited. The banking system in Vietnam is still in the infant stage. Almost all business transactions must be carried out in cash since checks and credit cards have not been widely accepted. The government of Vietnam has authorized check writing since 1997. However, the lengthy procedure has made checks unusable. More importantly, the check is valid for only 15 days (see *The Economist* 1997). The over-regulation and the rudimentary status of the banking system in Vietnam discourage people from using checks and banking services as a means to deposit their excess cash. People save by hoarding US dollars and gold. It is estimated that the amount of hoarded gold is worth about US$10 billion. Consequently, the saving rate excluding hoarded gold is about 15 percent of GDP, one of the lowest in East Asian countries, and the share of bank deposits in broad-money supply in Vietnam is among the lowest in the world (see *The Economist* 1995).

5 FDI and US–Vietnam bilateral trade agreement

Vietnam and the US finally concluded the BTA in July 2000. This trade pact went officially into effect when President George W.Bush and President Tran Duc Luong signed it into law in October and December 2001, respectively. This agreement will improve the FDI climate in Vietnam substantially. The implementation of the agreement will lead to long-awaited further economic reforms, which will have strong positive effects on growth and increase in FDI inflows. 'During ten days in July, the Vietnamese government did more to promote economic growth in Vietnam than it has done over the previous ten years', observed Reed Irvine (2000). Among important economic measures that the government of Vietnam is expected to take are the following.

- Privatize many ailing SOEs, promote fair competition among all local private, state-owned, and foreign-invested firms.
- Allow all Vietnamese firms and, in 3 to 7 years, US persons and firms to import and export freely (subject to some exceptions), agree to substantially lower import tariffs on all US agricultural and industrial products, phase out all non-tariff measures, adopt WTO standards with respect to customs, import licensing, state trading, and sanitary measures.
- Adopt WTO standards of intellectual property rights protection within 18 months.
- Allow American investors to have access to a broad array of the service sector. The implementation of the agreement on the service sector will be done within 3 to 5 years.
- Protect US investment from expropriation; eliminate local content and export performance requirements for US investment projects; phase out licensing regime.
- Adopt a fully transparent regime with respect to free trade of agricultural and industrial products, intellectual property rights, market access for services, and investment provisions (see White House 2000).
- Implement a simple registration regime for investment licensing within 2 to 9 years for all types of projects[3] (with some exceptions subject to the evaluation regime[4]). This procedure requires only basic information on the investor and the proposed investments and ensures quick approval.
- Eliminate local content requirement for manufacturing firms and export obligations.
- Remove other trade-related investment measures (TRIM) inconsistent with the World Trade Organization (WTO) standards within 5 years with some exceptions.[5]
- Abolish within 4 years the discriminatory pricing regime against foreigners concerning goods and services provided by the government, including water, electricity, telephone, telecommunication, air transport and tourism.

The key factor is that free competition under the BTA will require Vietnam to restructure non-performing sectors such as banking and public enterprises and to improve business and investment laws. Although this is a bilateral agreement, the European Union and other countries may ask Vietnam for the same 'national treatment' it gives to the US. It is expected that FDI from the US as well as other countries will increase in the future. In addition to the BTA, another important event that took place in Vietnam in July 2001 is the opening of its first stock-trading center after 8 years of planning. The establishment of the stock market was delayed for many years since the government of Vietnam was concerned that the stock market might expose the economy to external crisis. However, the domestic market, small as compared to the world, has been sluggish. The slow down of the economy and drastic decline in FDI had persuaded the government to look for an alternative way to attract more foreign and domestic investment. But again, the action was slow as seen by most observers. Professor Carlyle A.Thayler of the Asia and Pacific Center for Security Studies (2000) commented:

> Many of the clauses of the trade agreement do not come into force immediately but are scheduled to be phased in over several years–matching conservatives' desire for gradual reform.

6 FDI contributions to economic development

An IMF study (see IMF 1999a) pointed out that during the period of 1992–7, robust GDP growth, large FDI inflows and strong exports were highly associated (Figure 11.2). The main driving forces for economic growth during this period were private consumption and FDI. Foreign-invested enterprises raised the GDP growth by 3.4 and 5.3 percentage points in 1992 and 1993, respectively, followed by 7.9 points in 1994. The FDI performance declined afterward and turned negative in 1996 (Table 11.6). Concurrently, FDI disbursements decreased for the first time. The FDI commitments would have also come down, if the government had not approved two projects worth US$3.1 billion on the last day of the Vietnamese fiscal year. During the entire high growth period of 1992–7, FDI increased the GDP growth by 3.4 percentage points per annum on the average. FDI suffered a serious set back in 1998 with drastic declines in both new commitments and disbursements, due to the Asian crisis. Economic growth slowed down to 3.5 percent, losing more than 8 percentage points to a negative performance of FDI alone.

Total turnover by FDI enterprises increased from 2 percent of GDP in 1991 to 14.2 percent in 1997 and declined to 13.3 percent in 1998 or 8 percent on average during 1991–8. Transportation and communication, heavy industry, light industry, and food industry were the largest sectors, which together accounted for an average of 74 percent of the total turnover

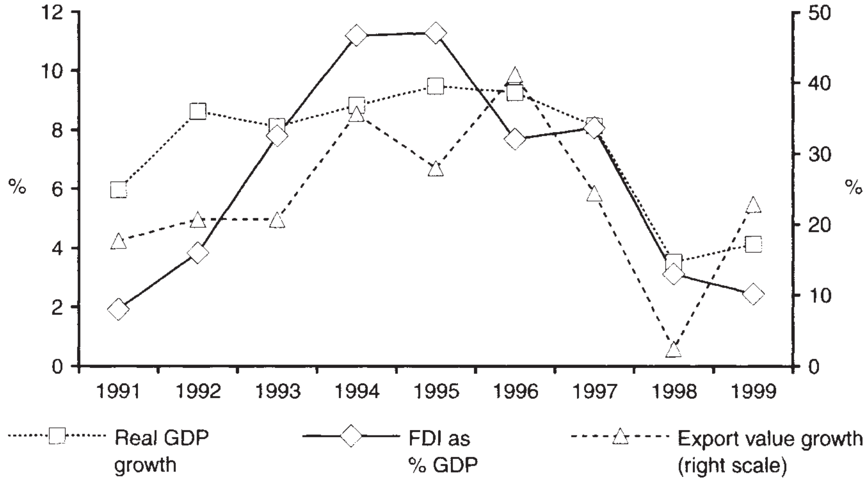

Figure 11.2 Vietnam: GDP, exports growth and FDI, 1991–9

Sources: see Table 11.2.

Table 11.6 Vietnam: contribution to GDP growth (percentage)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*
Consumption	17.6	9.5	8.5	11.0	6.5	5.7
Private	14.8	7.5	7.6	9.9	5.8	5.1
Public	2.8	2.0	0.9	1.2	0.7	0.6
Investment	10.2	6.2	6.1	3.2	6.1	−7.9
Public	1.8	−1.1	0.7	1.6	1.0	0.6
FDI	5.3	7.9	2.9	−2.9	3.9	−8.3
Other private	3.0	−0.5	2.4	4.5	1.2	−0.1
Domestic demand	20.6	15.7	17.5	11.3	1.7	2.3
Net exports	−12.5	−7.4	−7.5	−2.0	6.5	1.2
Exports	4.4	14.0	11.5	17.0	19.8	16.4
Imports	16.9	21.4	19.0	19.0	13.3	15.3
Real GDP growth (%)	8.1	8.3	10.1	9.3	8.2	3.5

Sources: Based on data obtained from IMF (1999a, 1999b, 2000).

during the same period. Agriculture, fisheries, hotels and construction accounted for another 21 percent. These statistics suggest that FDI was concentrated in import-substitution, high cost industries (heavy industry, light industries producing consumer goods) and non-tradeables (hotels, offices, apartments, construction, transportation and communication).

The total exports by foreign invested enterprises amounted to US$1.5 billion in 1998 and accounted for only 8.5 percent of total exports. The good sign is that this share rose from 0.1 percent in 1991 to 16.3 percent in 1998.

Most of these exports came from two sectors: oil and gas and food industry, which accounted for 78 percent of FDI exports, followed by the hotels and tourism industry with a small share of 9 percent.

The imports by FDI enterprises in 1998 amounted to US$2.7 billion and accounted for 26 percent of total imports. This represents a substantial trade deficit of US$1.2 billion, which aggravated Vietnam's current account deficits and raised the import content of FDI products. The heavy industry, light industry, and transportation and communication sector combined caused a trade deficit of US$1.4 billion in 1998, while the food industry brought about a trade surplus of about a half billion dollars. These data indicate that not enough FDI funds have been invested in export-oriented industries. Vietnam has overlooked such low-cost and labor-intensive manufacturing as textiles, garment, shoe, electronics and computer industries, in which Vietnam has great comparative advantage. For the same reason, the impact of FDI on employment is quite small. As of October 1998, there were 2,606 FDI projects operating in Vietnam, employing 290,995 workers, which accounted for 4 percent of total urban work force of 7.1 million (see IMF 1999a). The average number of workers per FDI project was 112 on the average. By the same token, FDI in Vietnam has contributed limited technology transfer to the local economy.

The loan component of FDI increased steadily from US$10 million in 1991 to more than US$1 billion in 1997, then dropped by 48 percent to US$0.6 billion in 1998 as the foreign-invested sector began to be hit by the Asian financial crisis. Its share in total disbursement has grown from 6 percent to 70 percent during the same period (Table 11.7). Loan components of FDI flows to the banking sector, and the food industry account for 100 percent and 80 percent respectively (see IMF 1999a). Joint ventures with SOEs borrowing from FDI sources also increased. Their share of loans in FDI rose from 8 percent in 1991 to 62 percent in 1998. Loan portions from FDI to BCC projects also climbed from 3 percent to 82 percent in 7 years, while the figure for fully foreign-owned projects has been relatively stable in recent years and stood at about 41 percent in 1998. Since FDI loans are costly and mature quickly, Vietnam is expected to service large debt repayments soon. By the end of 1998, the stock of debt accumulated from FDI loans amounted to US$4.5 billion. According to a forecast by the Ministry of Planning and Investment, Vietnam has to repay in hard currencies interest and principal obligations on FDI loans, which amount to US$1.1 billion a year on average during 2000–5. This could be bad timing for Vietnam since the economy is not yet out of trouble. In addition, annual dividends on equity amount to about one half a billion US$ according to a government estimate. These capital outflows will be added to Vietnam's current account deficit and deplete foreign exchange reserves further. The trade balance and net factor income arising from FDI in this early stage are both negative and definitely contribute to current account deficit.

Table 11.7 Vietnam: equity and loan composition of FDI disbursement, 1991–9a (in US$ million)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*[b]
Commitment	2,381	2,293	3,585	3,664	6,722	7,702	4,456	1,738	1,563
Disbursement	168	316	922	1,636	2,260	1,963	2,074	800	700
Disbursement/commitment ratio (%)	7.1	13.8	25.7	44.7	33.6	25.5	46.5	46.0	44.8
Foreign equity	158	294	697	1,033	1,287	891	1,002	240	274
Foreign loan	10	38	238	594	989	921	1,072	560	426
as % of disb.	6.0	12.0	25.8	36.3	43.8	46.9	51.7	70.0	60.8

Sources: Based on data obtained from IMF (1999a, 1999b, 2000).

Notes
a includes investment by domestic joint venture partners,
b preliminary.

7 Recent developments and prospects for FDI

After a slowdown of FDI flows into Vietnam in the first half of the year 2000, FDI began to recover during the second half. Total FDI committed for this year rose to US$1.9 billion as compared to the 1999 figure of US$1.6 billion, while the actual disbursement amounted to US$800 million, a slight increase from the 1999 level of US$700 million. The year 2001 saw a significant increase in the number of approved FDI projects and investment inflows, despite the fact that total FDI flows among all the countries in the world have declined by 40 percent as a result of a global economic downturn. During the first 7 months of 2001, new investment projects in Vietnam increased by 37 percent (see The Economist Intelligent Unit 2000c).

Political Economic Risk Consultancy rated Vietnam as the safest place in Asia to invest in a recent survey. The signing of the BTA with the US also encourages foreign investment since it indicates that Vietnam is fully committed to further economic reforms. In August 2000 Vietnam amended the FIL to attract more foreign investments. A number of positive measures have been taken to lower import tariffs and taxes, relax currency balance regulations, reduce investors' risk concerning land uses, and allow foreign investors to change investment forms, transfer capital and reorganize their companies. Vietnam is expected to take additional steps to enhance the FDI environment further. Improving the legal system, state management of foreign investments, investment promotion, and technical and language training, and minimizing investment costs should be the areas to be seriously tackled. If Vietnam implements this FDI policy effectively, looking for other FDI sources in North America and Europe in addition to East Asia and Australia, it would be able to compete with China and India for foreign investments, which are needed for its ambitious 10-year economic development plan.

8 Conclusion

Vietnam has come a long way since it made a dramatic policy change in 1986 to begin converting a centrally controlled economic system to a free market economy. Within merely a few years, a famine-threatened Vietnam had transformed itself into a food exporter without government intervention. Vietnam enjoyed steady economic growth during 1990–7. FDI played an important role in this process. The national gross national product per capita has increased from US$200 to US$350 per capita in 8 years. The progress is quite obvious. However, the pace of progress is too slow and the magnitude of progress is quite small, due to the government's failure to take further reform measures in later years and lack of appropriate FDI and trade policies.

There has not been any profound reform in Vietnam during the last few years. The economic growth has slowed down. External debt has accumulated. Foreign exchange reserves are limited. During a period of economic downturn, financial aid from the official development assistance source is likely to shrink. The non-performing state-owned enterprise sector continues to put a heavy burden on the economy. The Labor Ministry forecasts that 8 million people–20 percent of the workforce–could be unemployed in 2000 (see Prasso and Magnusson 1999). Each year 1.2 million new job seekers enter the labor market. Vietnam has been facing a real threat of a reoccurrence of the economic disaster in the late 1980s. These problems were not quite visible during the high growth period of 1992–7.

FDI inflows have substantially declined in recent years, ignited by the Asian financial crisis. A number of foreign-invested firms withdrew from Vietnam. Long before the FDI retreat happened, the number of jobs in the foreign-invested firms had been small. The FDI sector has experienced a substantial trade deficit. The disbursement rate is low. The prices of utilities and land-use right are high. The personal income tax rate applied to foreigners is ranked the top in the Asian region. The auto industry is near bankruptcy. These are strong indications that the FDI policy is not right. Academia, business community, international agencies and foreign governments have carried out numerous studies on FDI in Vietnam and a number of host countries in Asia and South America. Long lists of recommendations have been sent to the Vietnamese government for consideration. They point out numerous problems that Vietnam encounters: FDI has been concentrated in import-substitution industries, capital-intensive industries rather than export-oriented and labor-intensive industries; the FDI legislation is vague, restricting and outdated; and market access is rather limited. After a decade, Vietnam is still struggling to determine what FDI policy is right for the country.

What Vietnam needs is a liberal FDI policy with no limits on foreign ownership, and no forced partnerships, particularly with SOEs (see Appendix 11.1 for detailed recommendations to improve FDI environment). FDI is a long-term and continuing process. FDI projects in the long run will make positive contributions to the balance of payments as in the cases of other Southeast Asian countries and Latin American countries. In addition, FDI will bring about positive, indirect and long-term effects on the economy: technology transfer, employment opportunity, rising domestic investment. According to an earlier study, for each job created by foreign-invested firms, another 1.6 jobs are created by other sectors of the economy (see Dupuy and Savary 1993). A research on FDI into South East Asia found that foreign-invested capital raises domestic investment by the same amount for the economy of a host country (see Fry 1993).

In July 2001 after a long delay due to political reasons, Vietnam finally decided to make two major changes in its economic policy, which the international business community welcomed, although some have argued that Vietnam had already passed the 'point of no return' (Dapice 2000):

signing the BTA with the US and establishing the stock market. These decisions will be accompanied by fundamental economic reforms such as SOE equitization, banking sector restructuring and FDI law overhaul. All production sectors of the Vietnamese economy and all kinds of services will be open for foreign investment in the next several months to a few years. These measures will likely spur exports and attract foreign capital and technology, two important elements that Vietnam needs to grow.

Appendix 11.1 Recommended measures for improving FDI in Vietnam under a progressive and competitive FDI policy

Macro measures

1 Concentrate on manufactured export-oriented and labor-intensive projects (garment, shoe, etc.) and high-tech industries (electronics, computers, communication, etc.) where Vietnam clearly has comparative advantage.
2 Develop the private sector, allowing local and foreign private firms to play a larger role in the economy.
3 Reform the debt-ridden banking sector and the legal system.
4 Abolish monopolies of SOEs on import and export trading.
5 Privatize all the SOEs, especially loss-making ones.

Micro measures

1 Streamline the lengthy approval procedure for FDI ventures, thus reducing the maximum number of days to issue a foreign investment license from 60 days to 30 days.
2 Make a real effort to stop smuggling.
3 Ensure transparency and fairness with customs procedures and tax laws.
4 Make a real effort to stop the pervasive corruption.
5 Lower personal income taxes for both Vietnamese and foreigners and stop the dual pricing practice.
6 Lower taxes on profits remitted overseas.
7 Lower value-added-tax on imported materials not locally available.
8 Lower utility cost.
9 Seriously implement decrees and circulars, which have been designed and already issued to ease the investment environment.
10 Remove restrictions on who could be employed by foreign-invested firms.
11 Eliminate:
  a a minimum level of investment,
  b a minimum level of legal capital as a percentage of invested capital,
  c inflated land-use fees.

12 Provide for longer-term leases of real estate and the ability to obtain local mortgages.
13 Provide for tax deductibility of interest paid on business loans.
14 Allow a realistic valuation of the contribution of skills, technology, machinery, plants and land.
15 Allow a realistic valuation of the contribution of brand names, goodwill, distribution systems, and tangibles.
16 Provide equal opportunity for all sectors–state, private, and foreign.
17 Officially allow joint ventures to convert to fully foreign or Vietnamese-owned companies as they wish.

Notes

1 The world debt crisis in 1982 and Mexican debt crisis in 1994.
2 For a list of US firms in Vietnam, visit VIAM Communications' website (see VIAM Communications 2000).
3 Two-year limit for projects with a minimum 50 percent export rate or with a maximum investment capital under US$5 million, and industrial zone and export processing zone projects; 6-year limit for manufacturing projects with a maximum investment capital under US$20 million; 9-year limit for all other projects.
4 Includes broadcasting, publishing, transportation, banking, insurance, construction and power projects.
5 The 80 percent export performance requirement still applies to the following sectors up to 7 years: alcohol, cement, ceramics, clothing, footwear, paper, polyvinyl chloride, tobacco, etc.

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Part iv IV

Sectoral policies and institutional reforms

12 Agriculture

A strategy for market development

Xuan Tong Vo

1 Introduction

The *Doi Moi* has brought Vietnam's agriculture to a steady growth path. Rice production rapidly grows on a year-to-year basis, and most evidently from mid 1988. But when Vietnam opens up to participate in the international market with other rice exporting countries, it will see that every buyer has found a trading partner. That is natural since buyers will not wait for Vietnam to open up to buy its rice. Many other agricultural and aquacultural products were previously exported, but with low value added due to weak bargaining power. We may point at the trade embargo as a source of unfavorable prices for Vietnamese goods, but other factors are at work as well.

Agricultural product exporters, who want to find buyers quickly, either have no freedom or resources to go out to search for buyers, or are willing to sell at low price, once they find a buyer. These buyers are usually onetime buyers or non-returning buyers, as they are discouraged by the contracting practices and the product quality of many Vietnamese exporting companies. Of course, there are companies at the provincial level who operate in good faith, gain the customers' confidence, do not break contracts and are keen on improving product quality. They go out to foreign markets to seek contracts for the local farmers; however, these companies are few.

With 80 percent of its population earning their living from agriculture, Vietnam should be aware that unless the domestic and foreign markets are fully tapped, especially the domestic market, farmers and fishermen cannot become rich and the agricultural sector cannot further develop. The neighboring countries have foreseen this issue for some time, and are continuing to improve product quality and increase their agricultural and aquacultural production. Even countries that have no agriculture, such as Singapore and Hong Kong, import unprocessed agricultural and aquacultural products from other countries, process them to a higher standard and then re-export them. What should the Vietnamese agriculture and aquaculture do then? Any strong strategy should start from the basic principle: knowing others and knowing oneself. Let us take an objective look at our exports, and see what customers want when buying our agricultural products. Based on those findings, we will be able to decide how to attract customers in a professional way and bring the country out of poverty and backwardness.

2 Meeting the customers' needs

In a market economy, customer is the king, who should be respected by all successful sellers. Domestic customers are usually less demanding than foreign customers, but that does not mean that producers can afford to ignore and underestimate domestic demand. Producers should understand that domestic consumers want to trade their hard-earned money for goods of quality at a reasonable price, and not keep afloat bad producers. That is a principle that foreign businesspeople have mastered when looking at the market with 78 million Vietnamese, all of whom want to buy durable goods at competitive prices. Regardless of trade barriers, local consumers see that foreign goods are more attractive than domestic goods in terms of quality and prices.

Foreign customers are usually companies from one country that buy goods from another country to distribute to retailers or for retail sales in their home country or a third country. They are usually very demanding and sophisticated. They are very experienced in the international market and not easily cheated. They have no inclination or reason to buy goods of poorer quality at more unfavorable terms from any country.

Though customers are diverse, both local and foreign, they have common requirements. Below are some of the requirements that exporters have to take account of in their market research in order to design a production program that can win the heart of their customers.

2.1 Product

Each of the agricultural and aquacultural products demanded by each market has to meet specific local requirements. The four product dimensions to be taken into account include category, quality, package and delivery.

2.1.1 Product category

Fresh and unprocessed Some customers buy only fresh goods to supply direct to their market, especially to supermarket processing plants. Products in this category are very diverse, ranging from high quality mustard greens, fruits such as mango, durian and lychee, to aquaculture like gudgeon, crab and lobster. Customers want these fresh products to be ready for supermarket shelves on arrival in their country as planned;

fish, crabs and shrimps are required for live display in aquaria in restaurants. Other customers have a demand for decorative fish, trees and flowers.

Semi-processed Another group of customers prefer semi-processed goods, such as salted mushroom, condensed pineapple juice, frozen meat or shrimp, fish fillet, fermented cocoa nuts, peeled cashew nuts, peanuts, red bean, green bean, soybean, dried coffee nuts, tea, rubber, feather, salted hide, etc. for further processing later. A number of supermarkets in foreign countries also distribute gudgeon, eels and frozen fish.

Processed This product category, like fresh goods, is relatively difficult to export, since it is difficult to meet quality standards. A number of popular products for export, including canned mushroom, sauces, fish sauce, salted duck eggs, canned fruit juice and especially rice, still have to face an unstable market, since problems persist with quality. In the future, the proportion of processed goods in export should be increased in order to gain more profit for the farmers.

2.1.2 Product quality

Product quality is the primary concern of customers. They do not want to be let down a second time if the first purchase shows them that the quality is not as advertised or is lower than what was offered in the sample, or is uneven across the products. Unfortunately, many exporters cannot control product quality in the initial stages, especially immediately after farmers or fishermen harvest or catch the products. As a result, no matter how modern the processing facilities are, the low quality inputs are unable to ensure outputs of desirable quality. The quality standard is usually set by the customer, based on the international rules for each particular product. These rules cover such characteristics as:

Size Each product needs to meet specific requirements for size, depending on the taste of the destination country, e.g. Southeast Asian, Middle Eastern and European customers like long grain rice while Japanese and Korean customers prefer round grain. Size also depends on storage or display conditions, e.g. supermarkets need to buy oranges of the same size so that six oranges can fit a carton box for display on a shelf. If the product fails to meet the size requirement, it will not be accepted. Buon Me Thuot coffee has a different bean size and can be sold at US$900 per tonne, but a Singaporean customer who buys this coffee for further processing can bring its value up to US$1,200 with a very simple step: using a bean selecting machine to dry the beans according to the technical standard, grading them into different sizes;

beans of the same size look very even, since there are no moldy or wrong-size beans.

Color, freshness and flavor usually go hand in hand and are most easily noticed; each product therefore needs appropriate technology for storage and preservation. For example, American fresh grapes are gathered and stored in late September every year. However, with modern technology, grapes are ultra-heat treated within half an hour of being picked from the vine; by April or May of the following year fresh grapes are still available for sale. No significant research has been made on the preservation technology for other fresh fruits such as mango, lychee and star apple.

Chemical and biological ingredients of each product, especially the processed ones, need to be printed on the package. Chemicals in the prohibited list of the importing country (e.g. antibiotics, residuals from insecticides) should not be added.

Food hygiene is the highest concern of the customers. First the product should be approved by the food quarantine and environment authority before the importer can bring it into the country. There are cases in which fresh products (to be urgently exported) are stored in exporters' freezers before the quarantine takes place. If the product fails to meet the hygiene standards (e.g. it contains *Escherichia coli virus,* residuals of insecticides, herbicides), it has to be discarded. In this case, the exporting company has to pay all the costs incurred by the importer. To ensure that the product will not be rejected, exporters often assign some expenditure for inviting representatives of the food quarantine authority from the customer's country to come and have an on-the-spot inspection of the whole production process, from plant design to packaging. The two countries with very strict food quarantine, the US and Japan, also often send experts to check in countries of origin. The European Union also has very strict food quarantine requirements.

2.1.3 Packaging

Depending on the customer's requirement, packaging can be plastic bag, metal box, plastic bottle or glass bottle. Suppliers of a product usually take great care about the packaging of a product, since the color and shape of the package matter in catching customers' eyes when put together with dozens of other products on the shelf. Each manufacturer has to spend a lot of resource on their trade mark design on the packaging, which may need be registered with the relevant authority. When they import Vietnamese products, it is very probable that they will require Vietnamese producers to attach their trade mark to the imported goods.

2.1.4 Time of delivery

Buyers of agricultural and aquacultural products are usually intermediaries who distribute to supermarkets or restaurants in the foreign country. They may well be redistributors in other countries (e.g. mustard-greens trading centers in Singapore import the goods, put them in smaller packages under their own brand, and re-export to Europe). They plan to deliver to their customers just in time. Therefore, when they buy from a particular company, they must be sure that the goods are delivered just in time to avoid both a stockpile and a shortage for sale. If a company fails to deliver as contracted, the buyer's plan is ruined; they have to compensate their customer and there is no chance for them to come back next time. Vietnamese exporters will therefore have to change their production organization for agriculture and aquaculture, if they want to retain customers. At present, most of our companies only gather the product from smaller producers, even for the most important products like rice. Exporting companies rarely actively invest in their own sources, and only go out to buy or subcontract to other intermediaries after the contract is signed. This practice is typically observed amongst our state conglomerates. If we continue this practice without investing in raw materials from the beginning, we simply keep exploiting one another. This reflects the relationship between one party that has power for attracting customers, but no land, no goods and no investment in the production facilities (e.g. companies in Ho Chi Minh City or state conglomerates) and the other party that has land and goods but no customers (provinces in the Mekong river delta or in the Southeast). Such a business practice is unacceptable in a socialist country.

When the plan for purchase is made, the means of transport and export procedures should be ready before the date of delivery.

2.2 Prices

The price of a particular good is usually determined by labor cost, cost of raw material, transportation cost, tariff and demand conditions. Vietnam has a comparative advantage in tropical agricultural products as mentioned earlier. Early on, foreigners thought that our labor cost is low and the raw materials are cheap; later, they discover that that is not the case. Workers have to be paid more so that they can pay income tax, which is extremely high compared to neighboring countries, and the prices of raw materials are also higher due to high production costs. As a result, the price competitiveness of Vietnamese goods has eroded over time. Let us take rice as an example. The production cost is very high since farmers have to pay for fertilizer, insecticide, labor costs and fuel for water pumping, both for early sowing and flood prevention at the end of harvest, and to provide enough water for rice growth. Our fruits are produced in the same way. Therefore, in the Vietnamese market today (2000), Thai rice and fruits are preferred by local consumers due to their low price and good flavor.

2.3 Prestige

In the market as well as in daily life, everybody has to build trust. Long-term customers, not one-time buyers, are needed. Both buyers and sellers have to follow the commitments in the contract. To do this, from our side, sellers have to study and do market research for both domestic and foreign markets, to be able to understand and analyze market information, to combine knowledge of price trends and climatic conditions in regions that are producing the same items in order to make a forecast on what is likely to happen, and decide on the selling price while signing the contract. On the other hand, producers have to bear in mind that it is difficult to find a market, but is even more difficult to keep it. Therefore, in addition to price competition, quality should be always maintained or improved, and not allowed to deteriorate.

3 Macro policies that encourage agricultural exports

The export market is quite diverse. However, if the above conditions can be satisfied, we can expect to win markets. But these conditions cannot be all met unless a conducive and consistent policy environment is in place. While farmers are focusing on production, the government's role is decisive in the success of Vietnam's agriculture, in the sense that it has to forsee the situation facing Vietnamese exports in the market so that appropriate policies can be put in place.

3.1 Taxes

Taxes serve as an effective tool for the government to regulate the country. They are also a double-edge knife. The government can use taxes to encourage or discourage a product, making it more competitive or less attractive. The main concerns for farmers and aquaculture processors include land use tax, tariff on fuel, turnover tax, value added tax and export tariff.

3.2 Private investment mobilization

In all nations, the largest proportion of capital and wealth is held by the private sector. An effective government policy would have that capital make a substantial contribution to the country's development. Our government always encourages people to invest in production, and recognizes the non-state sector. However, the government also maintains that the state sector should play the leading role. Therefore, it is not surprising that the private sector in our country is underdeveloped. The state sector's monopoly in exports of a number of agricultural and aquacultural products which could have been exported by the private sector (e.g. rice, shrimp and fillet fish) put farmers at a disadvantage, since they have to sell at a very low price for a long period. Not until 1998 did the government allow seven companies to export directly without going through the state monopoly, and by mid 2000, all private companies were allowed to export rice directly. Within only a few months, many private companies invested in rice exporting and managed to export at a much higher price compared to the state companies. This is an important lesson for many other sectors. Such a policy has really encouraged private investment in economic development for the country. The government should take bolder step in expanding private entry, and only keep in state hands a few key sectors in which private investors are unwilling to enter.

3.3 Market development

In the fiercely competitive environment of today, market development plays a crucial role. Our farmers can grow almost every crop, but cannot sell most of them due to the lack of a market. An individual farmer can only produce on a subsistence basis, but the above-mentioned conditions should be met before cash crop production is possible. The identification of possible products should be done on the basis of careful and professional market research. For a less developed country like ours, where most farmers are poor, private companies underdeveloped and state companies inactive, the government should have a policy conducive to market development: even the head of state needs to go out to other countries to seek markets. The following example shows how the supportive policy of the Malaysian government helps the palm oil development and export strategy.

> A meeting of 35 years ago still leaves a deep mark in my mind; that was when I participated in the Asian Youth delegation to visit Malaysia in 1968, and was honored to be received by Prime Minister Tungku Abdul Raman. Mr. Tungku told us that in the subsequent 20 years Malaysia would dominate the export market for palm oil. Our group was really struck by such an affirmation, especially since we did not understand what palm trees mean and why they received more attention than rice. After the meeting, we learned about the whole tactic that Commander Tungku had mapped out.

1 Why take palm trees as a strategic crop? Palm oil is the necessary ingredient in the daily diet for those who want to keep the cholesterol level in their body stable; for sure everyone, especially the rich countries would be regular consumers.

Moreover, palm trees grow very well in the all-year humid weather of Malaysia, which is located right at the equator, with evenly distributed rainfall throughout the year, ideal conditions.

2 How to receive support from people for palm tree plantation? The government funded the agronomy to study the most appro priate cultivating techniques for different soil areas in Malaysia. These techniques were then passed on to the agricultural extension service to train farmers. At the same time, the government provided a tax holiday during the first 10 years for those who invested in palm tree crops on the newly reclaimed land, and the first 5 years for the depleted rubber crop area to switch to palm trees. For those who made land reclamation for palm tree crops, the government provided preferred credit to encourage them invest in new palm tree farms. The government also designed a project to borrow from the World Bank to set up palm tree farms (called FELDA by the Malay). The World Bank loan was used for land clearance, allotment, construction of residential facilities for farmers, construction of roads within the farm, market place, health centers, kindergartens, post office and palm oil preliminary processing plants. Those who were accepted in the FELDA had to sign a loan contract and could receive a house, a plot, seedlings, and fertilizer. This loan was to be repaid in 20 years under World Bank conditions, starting from the year the palm trees had fruits and the contractor started to deliver raw palm to the processing plant.

3 How to sell the palm? The government established the Institute of Research on Palm Oil Based Food Processing, and encouraged the construction of palm oil refinery for export. The government also set up the Palm Oil Promotion Board to boost palm oil sales all over the world and to market palm oil based products.

I had many opportunities to visit Malaysia subsequently and visited many palm tree planting areas in the FELDA and private farms, and learned that most of the FELDA contracts have repaid the loans after 15 years, and contractors have fully owned their houses and the contracted plots. And of course, today Malaysia dominates the world market for palm oil.

In brief, it is hard for individual farmers to create a market. The conditions created by the government as mentioned above played a vital role in the success of Malaysia in this sector.

Vietnamese exporters and importers of agricultural and aquacultural products should participate more in international trade fairs held at home and abroad to market their products. They need to publish a catalog of their products and send it to as many customers as possible. More import-antly, they need to advertise their product on the internet through their own websites or those of local information companies.

The government should in the near future review the role of state conglomerates to see whether they can freely earn money from provinces' products as they are now doing, or whether they should act as market finders for local producers in aquaculture and agriculture (as subsidiaries) and help these producers develop so that the conglomerates can earn commission for each deal.

3.4 Market information networking

In general, farmers and producers in our country usually lack market information for many reasons. An obvious reason is that they rarely spend resources on market research and only follow what the neighboring countries are doing (e.g. coconut, coffee, pepper, eucalyptus, fruit plantation, mushroom, shrimp and crab raising). Successful producers usually have to spend resources and make efforts in studying the customer's taste (to decide on the quality and package) and organize production accordingly.

Producers need to have eyes and ears in the centers of consumption and production areas in order to know as accurately as possible about the quantity of the goods to be produced, the harvest timing, price trends, etc., and to decide on their own production. If they cannot get this information, they are very likely to fail.

In the longer run, the government needs to develop a strategy for production in order to have integrated measures from production organization for farmers to market development. The government should not leave production completely to the farmers; this can easily lead to the high inventories of unsold goods as happens now.

3.5 Production organization for farmers and fishermen

Farmers in the rich countries are fully aware that they could never meet the four conditions mentioned above by producing individually. They need to form cooperatives or a farmers union to be able to compete. In the Netherlands, a European country with an area equivalent to the Mekong river delta only, most farmers own shares of the richest agricultural cooperative in Europe, which invests in building up many production plants for export, and even engages in banking services to finance Dutch investment abroad. In Japan, farmers are very rich, they own thousands of large and small enterprises that produce and process goods to be sold throughout the Japanese market and for export. They hire hundreds of thousands of university graduates of many disciplines to work in their transaction offices, credit banks, and processing plants for agricultural products and for export. Graduates from universities or professional schools can find employment, rural society becomes more civilized and catches up with cities. Looking at the situation faced by our farmers, we can come to some conclusions on the factors that put a restriction on their prosperity. Though our economy is shifting toward a more commercial economy, we still live for the most part on a subsistence basis. Farmers do their business on an individual basis, making their own efforts to seek technology; some capital may make their life better, otherwise, they have to live with what they have; the rich become richer and the poor become poorer. We fear cooperatives or production brigades; we have a farmers' association, but we do not own the association or have an institutional means to employ professionals to help the farmers' association in marketing their products. This explains the widespread unemployment among agronomists in our country, which leads fewer and fewer young people to study agronomy.

It is time for farmers to get together and prepare for international competition, and not to continue the backward individual working style inherited from their great-grandparents. What matters here is that the government should have a consistent policy framework to facilitate farmers in owning cooperatives or farmers' associations. In Japan, the unique government policy and mechanism for agriculture from the end of World War II has backed up the exceptional development of Japanese farmers' associations. After Japan lost the war due to the atomic bombs that destroyed two Japanese cities in 1945, Japanese farmers were very poor, and the Japanese government learned from development models applied by other countries in rural development. By 1948 they decided to take the Danish farmers' association model for nationwide application in Japan. After many adjustments for adaptation to Japanese society, the Japanese farmers' association now is the strongest and richest economic organization, thanks to the government's support. The major principle of the farmers' association and cooperatives in developed countries is real ownership by farmers; the government only intervenes through policy measures. Farmers only become association members if they contribute to the association's fund; they can elect the manager and implement credit, technology and business related activities. For example, to encourage every farmer to contribute to the fund so that the association can lend to farmers, the Japanese government provides a guarantee that the interest received is equivalent to the commercial banks' rate. At the same time, the government helps farmers by fixing the lending interest rate from the fund. If the commercial rate increases, the government provides subsidies for the difference to the association. Therefore, all Japanese farmers deposit money to the farmers' association, and not to commercial banks.

However, during the initial stage, farmers were too poor to deposit money in the farmers' association fund, and the government had to advance some money to the fund to lend to farmers for their production under the technical assistance of extension workers. After a few crops, they had some savings to deposit in the association fund. Thanks to the govern-ment's back-up (mainly through interest subsidies), more farmers own shares in the association. The farmers' association in each prefecture takes care of all production aspects for farmers. Today they open shops for supplies and set up agricultural processing companies that ensure the timely delivery of the best quality and quantity of products as required by customers (including a chain of supermarkets across the country and abroad). The association's most important companies operate the country grain elevators. After harvesting, farmers deliver all the output to the company, which transports it to the plant for drying to preserve the quality of the rice, then for threshing and storing. The rice owner can be sure that the rice is put in the farmers' association's bank. The farmers' association buys at US$2.6 per kg; after processing and packing, it sells at US$5–6 per kg. The profit is then distributed to members. The government provides protection to rice farmers. (Here I only wish to describe exactly what Japan has done, but does not recommend a similar subsidy policy for Vietnam, given the budget constraint of the country). Other agricultural products are treated in the same way. In other words, the farmers' association takes care of the production and marketing for farmers as much as possible, and minimizes intermediaries. Can our country do something to make farmers rich? Based on past achievements, I think that if the will is there, it can be done. In recent years, farmers of Song Hau and Co Do farms in Can Tho province have been very happy after harvesting their rice. They no longer had to worry about whether the rice would be sold, since the association takes care of the marketing for the product.

3.6 Fight against smuggling and corruption

To protect domestic goods, the government should stop the rampant smuggling across the country. All corrupt behaviors involving illegal import through unofficial channels should be strictly penalized, smuggled goods should also be checked in shops and fines levied, and counterfeited goods should be identified and made illegal.

3.7 Other policies

Our potential for agriculture and aquaculture export would be even higher if foreign companies invested in local production in Vietnam. Many companies have invested but, given our business practices, between 1998 and 2000 many of them withdrew, and the turnover of the foreign invested sector has steadily declined. The major cause of their withdrawal is the vague contract law, restrictive investment law and the permanent threat from the state sector. These reasons make it too risky to invest in Vietnam, a country with ideal security conditions. Looking at the outside world, Thailand, Malaysia and the Philippines have rapidly recovered after the recent crisis thanks to their ability in regaining the foreign investment inflow. Even a rich country like Japan enjoys increasing foreign investment from abroad. Our policy makers should change their opinions soon.

Trade liberalization policy

Having joined ASEAN/APEC (Asia–Pacific Economic Cooperation) and applied to the World Trade Organization (WTO, preceded by GATT, the General Agreement on Tariff and Trade), the government should be very careful in negotiation to avoid being disadvantaged by the rich countries, thus hampering domestic production, especially agriculture and the natural environment of the country. In negotiation, it is necessary to:

1 maintain the comparative advantage in terms of geography;
2 accelerate the preparation for global economic integration; and
3 most importantly, improve education and training for human resources in key disciplines and strengthen infrastructure.

The Uruguay round of GATT tried to include agriculture in free trade through many provisions, which have environment implications, such as:

- 'internationalization of national environment standards', which means that countries have to adjust their standards according to the international standards set by the superpower in their own favor. For example, the new US policy on the 'green state' was criticized by GATT for its effect in 'triggering a trade war' since this green policy prohibits agricultural insecticides which can cause cancer or deformation to the foetus, prohibits the logging of scarce timber and oil rigs off-shore, reduces carbon dioxide emissions by 40 percent and removes from the market chemicals that can deplete the ozone layer;
- 'improving market access through removal of tariff barriers to all agricultural products', which means that when more agricultural products are sold at a higher price, the farmers will be eager to exploit the natural resources and use more insecticides to provide higher yields. For the importing countries, higher prices encourage them to be self sufficient to reduce the demand for foreign exchange and boost production in marginal areas. In both cases, the environment is affected;
- competition by removing import controls on agriculture;
- removing agriculture subsidies;
- 'freedom in trading wood and wood products' (Indonesia prohibits the export of raw rattan, and is criticized by Japan and Europe as unfair competition against their rattan manufacturing companies).

In the early part of this decade, Vietnam will face strong competition due to global economic integration, mainly through the WTO, APEC and EU rules. Unless our government is sharp in negotiations, the potential for agricultural exports will be threatened.

4 Business management and agricultural business

In this global world of tough competition, we need competent entrepreneurs for export management combined with active businessmen in agriculture. In this context, directors of the existing companies have to be well trained in all aspects of marketing and business skills. Managers of agricultural cooperatives and farms and farmers have to be provided with specialist knowledge in agricultural business in order to acquire the necessary skills to organize production according to the market demands.

5 Conclusion

Vietnam is committed to follow the Asian tigers. But, clearly, the more Vietnam tries to catch up, the further they move ahead. The success of Vietnamese agricultural and aquacultural products in winning the markets from other exporters depends on whether we can produce what customers want, and at the lowest price. Therefore it is vital the Vietnamese agricultural and aquacultural sectors ensure that their products are of high quality and low price. Every farmer and fisherman has to be aware of 'high quality and low price', whether producing on the field, in the farm or on the fishing boats. Companies that produce and process for export have to invest in ensuring product quality right from the time when farmers and fishermen harvest, and organize to produce at the lowest possible cost. On top of that, the government should create a legal framework that encourages farmers and companies to produce enthusiastically and thus guarantee the steady growth of the Vietnamese economy.

13 Education reform and economic development in Vietnam

Binh Tran-Nam

1 Introduction

The *Doi Moi* policy has brought many remarkable economic achievements for Vietnam. During the decade 1986–95, Vietnam's real GDP grew, on average, 6.4 percent per annum. This growth rate was highest among the 40 poorest countries listed in the *World Development Report 1996* (see World Bank 1996:172 and 188).[1] Thanks to this rapid economic growth, income poverty in Vietnam dropped from 75 percent to 40 percent during the same period (see UNDP 1997:38).

In recent years, the Vietnamese economy has faced multiple hurdles, especially the sharp decline in foreign investment and the poor performance of the state and the banking sectors. These difficulties reduced Vietnam's GDP growth over the last few years. In early 2001, the government of Vietnam set a target of 7–7.5 percent GDP growth per year for the 2001–10 period. This seems to be a feasible challenge, provided that further reforms take place in the coming years.

The economic race between Vietnam and its neighboring countries is a long-term issue. For example, based on the PPP GDP per capita, to catch up with the living standards of the Philippines and Indonesia, the annual GDP growth of Vietnam should be 3.5 percentage points higher than that of the Philippines for the next 20 years, and 3 percentage points higher than that of Indonesia for the next 40 years (see Tran-Nam 1999:242 for more details). In addition, based on the experience of China (see World Bank 1996:173), the economic growth of Vietnam in the next decade will be lower than it was in the last decade, unless there are substantial changes in its economic policy or external environment.

The two points mentioned above suggest that the government of Vietnam should seriously consider systematic and long-term economic development programs. Low-income nations tend to be forced to implement economic policies with short-term and tangible benefits, and are thus constrained by the 'vicious circle'. However, to catch up with neighboring countries within the shortest possible period of time, the government of Vietnam should forgo short-term benefits and develop a solid foundation for long-term eco-nomic development. With such a foundation, the GDP may grow more slowly in the early stage, but would then accelerate in the longer term.

Economic development in a low-income country in transition like Vietnam is a multifaceted and complicated issue. In this paper, the author attempts to focus on the relationship between education, human resources and economic development. The primary purpose of this paper is to discuss the importance of education in economic development, review the performance of and problems faced by education in Vietnam and to propose some general as well as specific education policies for Vietnam. The paper will be confined to education at secondary and tertiary levels. The ideas presented in the paper reflect the author's experience as an educator at a number of universities in New Zealand, Australia, Japan and the United States, as well as arguments based on neoclassical economic theory.

The remainder of this paper is organized as follows. Section 2 discusses the role of education in the long-term process of economic development. This discussion highlights the human capital accumulation aspect of education, as well as the external benefits of education. Section 3 reviews the performance and problems in education of Vietnam. Section 4 proposes a number of reform measures for education and human resource development in Vietnam. The concluding section summarizes the main findings of the paper.

2 Education, human resources and economic development

It is generally acknowledged that the aggregate output of a nation and, hence, its economic growth path depend ultimately on how it utilizes its four factors of production: human, physical, natural and social capital. Since this paper focuses on education and human resources, it would be sufficient to briefly describe the other factors of production. The accumulation of physical capital for economic growth was highlighted in the Solow-Swan model (see Solow 1965 and Swan 1965). Although Hotelling (1931) completed the theory of a mining firm about 70 years ago, economic theorists only began constructing general equilibrium models to accommodate resource exhaustibility in the 1970s.

Social capital, alternatively called social capabilities, is a more elusive concept, which does not render itself easily to formal analysis. It includes such factors as openness and competitiveness of the economy, institutional arrangements, secure property rights, honesty, trust and interpersonal networks. In short, social capital represents a set of any intangible things that reduce transaction costs and, thus, help markets operate more smoothly. The role of social capital as an input in the production process has been considered mainly by development economists in connection with developing or transitional economies (see, for example, Hasson and Henrekson 1994).

More recently, many economists have increasingly turned to endogenous growth models, based on the work by Uzawa (1965), Lucas (1988) and Romer (1990). These models explain the accumulation of human capital and emphasize knowledge as an engine of economic growth. Therefore, nowadays, we start to hear such new terminologies as knowledge-intensive industries in addition to more established terms such as labor- or capital-intensive industries.

Human capital can be accumulated through three major ways: education, training and work experience. This paper concentrates on the relationship between education, training and human capital. From an economic perspective, education today is a preparation for labor tomorrow. Therefore, all spending on education is not consumption, and instead should be treated as investment in human resource, similar to investment in physical or natural capital.

At this stage, it is worthwhile to stress that investment in macroeconomics confines itself to the accumulation of physical capital. Only expenditure on durable goods in education (e.g. school building and computers) is treated as investment. Most other education expenditures (e.g. teacher salaries, textbooks, school materials) are all treated as consumption in the national accounting system. To determine the output potential of a country, we should look at not only the increase in physical capital, but also in education expenditures (as a percentage of GDP).

The benefits of investment in education are both internal and external. Thanks to education, an individual can enjoy higher labor productivity when working in the future. In a market economy, such an increase in labor productivity can be estimated by the differences in income of workers who are of the same age group but possess different levels of education attainment. In principle, based on the internal costs and benefits to the individuals, we can estimate the internal rate of returns on education.

In addition to the internal benefits, which are captured by individual students, education also brings many external benefits to society as a whole. These benefits are multifaceted, including economic, cultural and political aspects. Typical examples include the following:

- Educated workers use physical capital better than less educated workers, and are more likely to be capable of improving the technology and devising new and more efficient forms of production.
- Educated workers tend to increase the average productivity of their coworkers.
- Public education is an effective way of reducing income disparities, and thus contributes to economic development in the long run.[2]
- Part of the incremental income for the highly educated workers will become tax revenue for the government and will benefit all citizens.
- Education improves the quality of life.
- Education helps people to understand better their roles in the

process of economic development, and helps them to participate more effectively in social and political debates.

Moreover, education, especially at the university level, is usually associated with research, discovery and invention, which are increasingly considered by economists as the main engine of output growth, especially in developed countries. Research findings can be regarded as investment in aggregate knowledge. Research at universities in advanced countries often results in new products, production or organizational methods. These improvements increase social welfare and accelerate economic growth. In developing or transitional countries, high education institutions also serve as a forum for constructive debates on pluralistic changes and development.

Put simply, the human capital of a country is an increasing function in its labor force (the number of working people) and its aggregate knowledge. However, we have to distinguish between human capital and knowledge. Human capital is short-lived (it disappears when people retire or die), incompatible between different uses (one person cannot do many different jobs at the same time) and costly (workers only work if they are paid). On the other hand, knowledge today is almost immortal, non-rival in production and almost costless to be employed.

There are many reasons why Vietnam needs to try much more in education and human resource development. First, human capital is the most important source of economic development for Vietnam in the long run. Vietnam is often described as being rich in natural resources. In fact, on a per capita basis, the natural resources of Vietnam are insignificant compared to those of its neighboring countries like China, Thailand or Malaysia (see Tran-Nam 1999:246–7). Physical capital accumulation is important, but Vietnam cannot afford to continue to rely on foreign capital indefinitely, and needs a qualified work force to utilize the physical capital and new production technologies in a more efficient way.

Second, as mentioned earlier, human resource development through education is not only a means, but an end in itself. For this reason, UNDP measures the well-being of countries around the world by the Human Development Index (HDI), which is based on life expectancy, knowledge (literacy rate in conjunction with primary, secondary and tertiary enrolment rates) and PPP GDP per capita. In the case of Vietnam, education also helps people better understand such issues as tax obligations, population control and environment protection for sustainable development.

Third, for a low-income and labor-abundant country like Vietnam, growing international trade tends to result in the expansion of relatively labor-intensive production techniques or products. To avoid producing these products for too long, Vietnam needs to continue its strong investment in educating the generation that is going to join the labor force. Otherwise, based on the experience of Thailand from mid 1980s to mid 1990s, individual earnings inequality in Vietnam will worsen.

However, all of the above do not mean that Vietnam has to devote as many resources as possible to education. According to the economic theory of marginalism, to maximize the social utility function, educational expenditure must be set at a level at which marginal social benefit and marginal social cost of education are equal.[3] However, the marginal social benefit of education is difficult (or even impossible) to quantify accurately for two main reasons:

- while the costs of education are short-term in nature, the benefits of education tend to be long-term and spread over a number of periods;
- as mentioned earlier, many benefits of education are external to the recipients.

Another issue is the allocation of total expenditure on education between the public and private sectors. Though the government can control part of the public spending on education, the remainder is determined by private decisions. Similarly, how to divide the total expenditure of education between primary, secondary and tertiary education? Within the secondary level, how to allocate resources between general and vocational schools? Within the tertiary level, how to allocate resources between arts, social sciences, commerce, science and technology? Though economists can apply the standard cost-benefit analysis to partly answer the above questions, economics alone cannot satisfactorily resolve all of those problems. Therefore, these issues must be solved by multidisciplinary studies, which call for inputs from economists, educators, administrators, planners and the business community.

Before ending this section, it may be useful to reiterate that education is only one dimension of the long-term economic development policy. Based on economic data, education attainment in the developing world has improved steadily; yet economic growth varies considerably among countries within this block. Therefore, while education is necessary, it is in itself not sufficient for strong and sustainable growth.

Economists recognize that one of the important factors explaining the differences in growth performance by developing countries is the openness of the economy. It is conceivable that the open-door economic policy helps to transfer technology from more to less developed countries more rapidly. This makes the skills level of the labor force relevant as the absorption and effective application of technologies brought in by foreign trade and investment depend primarily on the domestic supply of skilled workers.

3 Overview of education in Vietnam

3.1 Education system in Vietnam

From 1954 to 1975, Vietnam suffered from division and warfare. In the North, the education program was part of the wider social-political-economic policies, rather than having economic purposes. This policy emphasized mass education, especially illiteracy eradication campaigns as well as vocational and professional training. Following the Soviet and Eastern European models, universities in the North tended to be highly specialized and dispersed, and to focus mainly on science and engineering. A significant contribution of education in the North during this period was teacher training colleges. These colleges trained people in villages, especially young women, to become teachers in rural primary schools.

During the same period, education in the South was influenced by the French and later the American system. The teaching programs here tended to be academic and paid little regard to vocational and technical training. The secondary school curriculum in the South (known as the Hoang Xuan Han curriculum) closely followed the French model until the mid 1960s. From 1965, the American model of comprehensive secondary education was experimented with in a number of Demonstration Schools in the South. In addition to three multidisciplinary public universities, there were also three specialized private universities operated by various religious groups. Following the recommendations for reform by a team of American education and administration specialists, the South Vietnamese Government established a number of community colleges at provincial level in 1971 and a Polytechnic University in Thu Duc in 1973.

The education system in Vietnam today is similar to that in most Asian countries. Children between the age of 3 to 5 go to kindergartens. Basic education starts at the age of 6, with 5 years in primary school and 4 years in lower secondary school. The next level is 3 years of higher secondary or vocational school. In addition, there are various out-of-school education programs such as literacy campaigns, in-service training and social welfare education activities provided by the government and various unions.

Decree 90/CP dated November 1993 divides the post-secondary education into two levels: college (certificate) and university (bachelor degree). The college program lasts for 2 to 3 years (no more than 4 years), while a bachelor degree lasts for 4 to 6 years. Both programs have two parts: general education and specialized education. Above the bachelor degree, there are master and doctorate degrees. In general, the post-secondary education lasts for 2 to 9 years, depending on the subject and degree (see Truong 1996 for more details).

Public education is the responsibility of the Ministry of Education and Training (MOET), except for a number of military and security schools. The central government regulates the post-secondary institutions, local governments regulate secondary schools and district or village administrations regulate primary schools. Financing education is the responsibility of the government at each level. The central government pays for most teacher salaries and student scholarships. Other expenses, e.g. school construction, are usually funded by the provincial, district or village administration. Though education is by and large operated by the government, private education has started emerging in recent years, especially at the secondary and university levels.

In principle, each village in Vietnam should have at least one primary school, and each district should have one secondary school. Based on official statistics, on 30 September 1996, Vietnam had 8,205 kindergartens, 20,242 primary and lower secondary schools, 1,407 general higher secondary schools, 266 vocational secondary schools and 109 colleges and universities (see *Statistics Yearbook 1996* by the General Statistical Office: 258, 260, 273 and 276). Most colleges and universities are concentrated in five cities: Hanoi, Ho Chi Minh City, Hue, Da Nang and Thai Nguyen. At present, there are five multidisciplinary universities, Hanoi National University (established in December 1993), Hue University, Thai Nguyen University and Da Nang University (established in April 1994), and Ho Chi Minh City National University (established in January 1995).

3.2 Achievements and trends of education in Vietnam

As a poor country, Vietnam has recorded many impressive achievements in education. Based on the HDI, 174 countries around the world in 1995 were classified into three categories. Vietnam ranked 122 and thus belonged to the lower end of the middle category. Vietnam was among a group of a few nations, whose ranking in HDI (125) is higher than the ranking in income (152) by at least by 25 points (see UNDP 1998).

For basic education, Vietnam has achieved good outcomes for a long time. Thanks to government policy, the adult illiteracy rate in Vietnam steadily declined from 20 percent in 1985 to 13.4 percent in 1990 and 7.5 percent in 1993 (see UNDP 1990:128; UNDP 1993:136). In 1995, this rate was 6.3 percent, comparing favorably to its richer neighbors like Indonesia (16.2 percent), China (8.5 percent) and the Philippines (5.4 percent) (see UNDP 1998).

Examining more deeply, however, the education achievements of Vietnam are still weak. The UNDP data shows that in 1995, the enrollment rate at all levels in Vietnam was 55 percent, compared to 80 percent in the Philippines, 62 percent in Indonesia, 60 percent in China and 61.6 percent in the world (see UNDP 1998). Achievements at the secondary and higher education remain very low as indicated in Table 13.1 below.

In addition, the enrollment rate at university level in Vietnam did not increase (remaining at 2 percent between 1980 and 1993), while this rate

Table 13.1 Education attainment rate (%)

	Groups of nations			
Level of education	*High growth*	*Moderate growth*	*Low growth*	*Vietnam*
Primary	98	91	74	80–85
Secondary	64	46	34	35.2
Post-secondary	23.4	14.3	5.7	2–3

Source: Truong (1996:28).

increased very fast from 1 percent to 4 percent in China (see World Bank 1997:226).

In recent years, educators noticed a number of worrisome trends (see Truong 1996:28–9):

- the enrollment rate drops at all levels;
- the gender enrollment disparity at university level is fairly high and has widened in recent years; and
- children of high-income families enjoy some advantages over children of low-income families in secondary and university education (this means that the poor do not benefit from the fruits of education after the *Doi Moi*).

3.3 Problems and shortcomings in education in Vietnam

Problems and shortcomings in education in Vietnam are obvious and have been extensively discussed in a comprehensive report on education and human resources by the MOET, UNDP and UNESCO (see MOET-UNDP-UNESCO 1992). Most of the problems in education are the consequence of the 'vicious circle' and result partly from the transition experienced by Vietnam. Some of the main problems are briefly described below.

LACK OF RESOURCES FOR EDUCATION

Although the Vietnamese government has tried to increase the budget allocation for education, the public spending on education in Vietnam is only 2 percent of GDP, while the average for other Asian countries is 3 percent (see MOET-UNDP-UNESCO 1992:53). As the per capita GDP of Vietnam remains low, this means that the per capita public expenditure on education in Vietnam is among the lowest in the world.

LOW EFFICIENCY OF RESOURCE UTILIZATION IN THE EDUCATION SECTOR

The internal efficiency of the education sector in Vietnam is low, mainly due to inappropriate organization and management. The dropout rate is fairly high and the completion rate is low.[4]

WEAKNESS OF, AND CONSTRAINTS ON, TEACHING STAFF

This problem is common to many countries, including the advanced ones. In the case of Vietnam, this is of the highest concern and most daunting to solve.

OUTDATED AND IRRELEVANT SYLLABI AND TEACHING AND ASSESSMENT METHODS

Subject content is obsolete and teaching methods outdated so that graduates do not acquire the necessary skills for a society that is changing swiftly in many fundamental ways. As a result, the external efficiency of education in Vietnam is relatively low.[5]

LACK OF LINKAGE AND COORDINATION BETWEEN EDUCATION, PRODUCTION AND EMPLOYMENT

The linkage between education and research institutions and businesses is almost non-existent or very weak due to the lack of appropriate organizational mechanisms and market institutions.

INAPPROPRIATE MANAGEMENT AND ORGANIZATION IN UNIVERSITIES AND RESEARCH INSTITUTES

Despite a number of reforms (e.g. the establishment of National Universities), the post-secondary education system in general is too fragmented, isolated and inefficient.

In addition, Vietnam has recently suffered from a proliferation of post-graduate programs where teachers are unqualified and teaching or research methods are of poor quality. This has resulted in substandard degrees and graduates. This is a negative phenomenon in the educational system of Vietnam.

4 Some strategies for education and human resource development in Vietnam

4.1 Education policy

Education is a dynamic, not a static investment. Education policy and curriculum should change and adapt to practical needs, especially in the context of a transitional economy which faces rapid changes as a result of global free trade and the information technology revolution. A fixed and unchanged program is a stagnant one, and not appropriate to human training today. Though the primary purpose of education is virtually the same everywhere, the teaching materials and methods should be flexible to be appropriate to the peculiar circumstances and the diverse development needs of each location.

Recently, the National Education Committee was established to examine the most critical issues in education and training. Membership of this Committee should be expanded to include the political leaders, administrators, educators and representatives of business and international organizations, as well as overseas Vietnamese experts. In addition to its regular meetings, the Committee should report to the National Assembly and the government about five times a year to review successes and failures of the recent past, and to recommend direction and specific policies for the coming years.

4.2 Resources for education

The Vietnamese government fully recognizes the role of education and has steadily increased public expenditure on education in the national budget in the last decade. However, as a share of GDP, public expenditure on education from 1993 to present has shown little increase. Table 13.2 illustrates this. A multifaceted policy is needed to increase education expenditure in Vietnam.

INCREASE GOVERNMENT EXPENDITURE RELATIVE TO GDP

This is a big challenge as in recent years tax revenue as the share of GDP has declined (19 percent in 1992, peaked at 24.7 percent in 1994, and down to 17.8 percent in 1999, see General Statistical Office). Unless bold reform takes place in revenue collection, this policy may not be feasible.

CHANNEL MORE FOREIGN AID TO EDUCATION

More overseas aid should be allocated to infrastructure development, especially building more schools in low-income regions.

Table 13.2 Public expenditure on education in Vietnam, 1992–9

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
% of total budget	5.8	7.4	8.2	8.5	8.6	10.0	10.3	9.8
% of total recurrent budget	7.7	9.8	11.1	11.1	11.6	14.2	15.1	15.8
% of GDP	1.4	2.1	2.2	2.0	2.1	2.4	2.3	2.1

Source: IMF (1998:21; 1999:21).

ENCOURAGE PRIVATE EDUCATION AND PARENTS' CONTRIBUTIONS

It is necessary to encourage the private sector (both domestic and foreign) in providing education services. Public schools should be given some autonomy in fund raising. Parents also need to play a more active role in financing schools, especially in buying such expensive facilities as computers.

LINKAGE WITH LARGE COMPANIES AND FOREIGN NON-PROFIT ORGANIZATIONS

These entities may be able to finance specific education plans, for example, improving English or accounting studies at schools.

SET UP PARTNERSHIP OR SISTERHOOD WITH FOREIGN EDUCATION INSTITUTIONS

Through an appropriate search and introduction program, Vietnamese high schools and universities may obtain financial or human capital support by direct linkage with sympathetic institutions in developed countries.

ENCOURAGE OVERSEAS VIETNAMESE TO ASSIST

Currently there are about half a million Vietnamese expatriates with undergraduate and postgraduate qualifications. Many of them are willing and able to contribute to the Vietnamese people. They can contribute in terms of labor (providing advice for reform, teaching, cooperation in research, support in bringing local students to study abroad, etc.) and funding (providing scholarship, building schools and libraries, sending books and research papers, etc.). So far very few Vietnamese expatriates have actively contributed to education in Vietnam. The government should devise an appealing policy and specific programs to take advantage of these enormous resources. Thanks to electronic mail, communication and connection are no longer the problem they were before.

With regard to private education development, the government should address the following issues. First, private schools or universities should focus on subjects relevant for a market economy such as English, computer science and accounting, and should operate mainly at the tertiary level. In such a situation, public expenditure on education can be allocated to other subjects such as natural and social sciences, and to primary and secondary education. Second, the government should regulate private schools (especially at tertiary level) to avoid the proliferation of low quality degrees. Third, the Ministry of Education and Training should support children of poor families so that they are not too disadvantaged versus better-off children who can afford private tuition.

4.3 Organization and management

In general, the education organization and management, especially at the university level, should become more appropriate, efficient and flexible. Public education institutions should have more autonomy, but at the same time become more accountable to the government. With regard to reform, the Vietnamese government should also follow the experience of high-performing economies.

At the secondary level, schools that are located far from large cities should have more autonomy in such areas as fund raising and curriculum. In addition to general policies and guidelines, these schools need the flexibility to be adaptive to local development needs. In contrast, in large cities, the organization and management as well as the curriculum for all schools should be uniform. However, there is still room for some flexibility in fund raising, depending on the income level of each area.

At the university level, there should be a plan to establish multidisciplinary universities in the remaining large cities by merging the existing specialized universities and institutes under the same organization. As a result, the organizational structure would become simpler and the duplication in administrative and training functions would gradually disappear. These multidisciplinary universities should be able to enjoy the same rights and status as National Universities. Universities need to form an advisory board with representatives of large firms and overseas experts who can advise on the modernization of the curriculum and teaching methods.

In the future, specialized universities should only be opened in special areas in rural, mountainous or coastal areas. The curriculum and research plans of these universities should be linked to local development need. For example, a branch of Da Nang University, specializing in chemistry, could be located near Dung Quat refinery.

4.4 Teacher training

Training teachers who are capable and highly committed to the profession is a great (if not the greatest) challenge to education in Vietnam now. This problem is also common to many countries around the world, but it is more severe in Vietnam due to the transition of the economy and its low income. Vietnamese people are keen on learning and respect teachers. In the recent past, however, for some economic and social reasons, the teaching profession has been degraded, resulting in both poorer quality and smaller quantity of teaching staff. To reverse this situation, a number of specific and urgent measures are needed, including:

- increase the number of apprentices in the teaching profession;
- increase the value of scholarships for these apprentice teachers;

- within the budget constraint, increase teachers' salaries at all levels;
- develop private education so that teachers can earn extra income from private tuition;
- select, reward and promote teachers based on their qualifications, teaching performance and professional research;
- allocate aid-funded budget to good teachers so that they can go abroad to attend workshops, conferences or training courses (both short- and long-term) in order to improve their technical expertise and organizational and administrative skills;
- at the university level, invite foreign consultants (including overseas Vietnamese) to work on a short-term basis in strategic courses, using donor assistance or individual goodwill. For local teachers, teaching and research work should be combined in order to improve the effectiveness of education; and
- restore the important role and dignity of the teaching profession and teachers in society.

In Vietnam, there are currently many unemployed educated people, most of whom are graduates from natural and social/human sciences, especially economics, law and foreign languages. If the teaching profession is appreciated, these people can undertake some additional pedagogy training to become qualified teachers at the primary or secondary levels. This can easily happen through the credit and double degree learning system at multidisciplinary universities.

4.5 Objectives of education

The educational philosophy of Vietnam should be directed to three major aims: liberation, collectivism and pragmatism. First, students should be taught about the position of Vietnam in the world. Though we can be proud of the past achievements of our ancestors and the intelligence and industriousness of the Vietnamese people, students should know that Vietnam is a poor and backward country (not only compared to Western countries, but also to other nations in Southeast Asia) and has to rely on foreign resources for its development. Only with such knowledge will Vietnamese students try to learn more to contribute to the future development of the nation. In addition, students should learn to develop an inquiring and critical mind, and the ability to debate in a modest, fair-minded and constructive manner. Teachers and adults are not always right, and students and children are not always wrong.

Second, students should learn to work within a team. Students should be taught that everyone has to fulfil one's own task as assigned to head towards the common goal of the collective. It is necessary to emphasize for students that individual excellence (unconcerted wisdom) is not a sufficient condition for development.

Third, students should be trained to have practical skills through suitable vocational subjects. These subjects should give students opportunities to develop all their aptitude and capability in problem solving, and adaptivity to real life, if they have no chance to study further. Students should also learn how to think in terms of mass production and long-term business, rather than small-scale production and short-sighted business practices.

4.6 Teaching, assessment and research methods

Schools should encourage self-learning and studying by deduction and comprehension rather than learning by memorizing and cramming. At the higher secondary level (grades 10, 11 and 12) and tertiary level, the emphasis should be on recognition, formulation and problem solving skills. To this end, the teaching methods should encourage students to:

- search for necessary materials and make study-aids right from a young age;
- learn by questioning, presenting and discussing in order to help students gain confidence and develop independent, critical and demo-cratic thinking;
- work collectively through a common project or off-class activities; and
- develop practical skills in their daily life.

The formal knowledge acquired at schools should be supplemented by outside study tours of government bodies (National Assembly, People's Committee, the courts, etc.), firms and factories.

In terms of assessment, teachers should:

- focus on the content and ideas, rather than the format or style, while grading;
- reduce the regular examinations and increase research papers or common projects;
- give practical research topics that can be applied in the society or business; and
- use more multiple choice exams to encourage students to study comprehensively and with understanding, rather than memorizing or studying selectively.

At the university level, distance education can also be trialed in a number of disciplines that do not require much experimentation (e.g. economics, accounting, etc.) to encourage enrollment among students outside large cities.

4.7 Subjects

Feedback from large firms is needed in preparing syllabi and textbooks for vocational secondary schools, colleges and universities. Given a rapidly changing world with globalization and information technology revolution, education in Vietnam should further emphasize the following subjects.

FOREIGN LANGUAGE, ESPECIALLY ENGLISH

Though the government has encouraged the study of English, learning English in Vietnam still faces a number of barriers, mainly due to the shortage of good teachers or native English speakers. This problem can be partly overcome by the assistance of non-profit organizations and schools and Vietnamese expatriates (especially overseas-born young people of Vietnamese ancestry) from English-speaking countries. For example, young people of Vietnamese origin from abroad can be facilitated to come and teach English in isolated regions.

Students from secondary levels upward should have the opportunity to write their essays, reports or theses (especially in the field of information technology) and present their results in English. In addition, Vietnamese students should be encouraged to communicate frequently with students from sister institutions abroad through emails or the post office. In addition, the government should consider providing tax incentives for encouraging foreign companies to sponsor regular essay writing or debating contests in English in different locations. Currently, most secondary students in Vietnam can study only one foreign language. If possible, a second foreign language, e.g. French or Japanese, should be added for the last 3 grades of the secondary level.

INFORMATION COMMUNICATION TECHNOLOGY (ICT)

Vietnamese students are gifted in this area, and computer software services would be an important export industry for Vietnam in the future. To this end, Vietnamese students should be familiarized with computers as early as at lower secondary schools (it is best at primary schools, but this may not be feasible at this stage). If schools do not have the budget to purchase computers, external funding can be sought from parent contributions (through cash donation or fund raising activities) and sponsorship from large firms or from the computer industry. In terms of teaching ICT, there needs to be similar assistance as in the case of English.

VOCATIONAL SUBJECTS

At the secondary level, students should be allowed to select from an optional range of vocational subjects such as agronomy, industrial arts, home economics and business studies. These subjects were tested with positive results in some Demonstration Schools in the South three decades ago. Today, due to the budgetary constraints, these subjects can be reintroduced to the secondary education curriculum in a more limited and localized fashion. In rural areas, agronomy should be developed, and in industrial areas, more focus should be on industrial arts.

5 Conclusion

Over the last 10 years, the Vietnamese economy has developed strongly thanks to the open-door policy and the accumulation of factors of production, especially physical and social capital. Although the government has placed education at the top of the national agenda, and attempted to reform it, neither clear direction nor significant achievement has been made since 1993. In order to meet the average, annual growth target of 7–7.5 percent in this decade, education may not yet be the key. But looking further into the future, human capital and technological progress would be the most important factors in the Vietnamese economy in the coming decades.

In general, education is a complicated topic and education reform is difficult, since most of the problems in education typically result from the 'resource constraint'. However, problems in education and training are becoming critical and the government should immediately implement a number of specific reforms to get out of this 'vicious circle'. Those reforms will channel resources to human capital investment. Investment in physical capital such as roads and equipment can easily increase production in the short run. In contrast, education and investment in human capital take a longer time to bring about visible benefits. As a result, investment in human capital may slow down the growth of output in the early stage. But that will certainly be a beneficial sacrifice by Vietnam in the long run.

Education reform, like any other reform, requires clear and appropriate policy. In terms of resources, it is necessary to encourage private-sector contributions, both at home and abroad, especially in courses which are relevant to a market economy and at the university level. The government should also work closely with the business community, voluntary organizations and Vietnamese expatriates, not only to supplement resources for education, but also to listen to their recommendations about organization, management, curriculum and teaching methods. More specific policies are urgently needed in teacher training, since this is the most difficult problem for education in Vietnam right now.

Educational philosophies and methods of teaching and assessment should be improved to help students develop independent and innovative thinking, problem solving skills, practical skills and teamwork. The subject syllabi should be modernized, adding a few vocational subjects (at the secondary level) and emphasizing such subjects as English and information communication technology. At the post-graduate level, there should be a closer connection between teaching and research, improved organization and management systems and stronger link with businesses.

Acknowledgment

The author wishes to thank Associate Professor Nguyen Thien Tong (Head of Department of Aeronautic Engineering, Faculty of Engineering, Ho Chi Minh City National University) for his valuable comments.

Notes

1 Based on purchasing power parity (PPP) GDP per capita.
2 According to the argument of economists like Simon Kuznets (Nobel Prize Laureate in economics in 1971) and Nicholas Kaldor, the widening gap in profit and wealth distribution is inevitable in the early stage of economic development. However, based on more recent and better data, Dieninger and Squire (1997) show that (i) economic growth does not necessarily cause income inequality to increase, (ii) unequitable distribution of wealth may hamper economic growth and (iii) income redistribution policy is beneficial if it does not cause investment to decrease.
3 The social utility function represents the utility of the whole population and depends on the per capita GDP. GDP depends on the quality of labor, and the quality of labor in the present time is determined by the expenditure on education in the past. As a result, education expenditure can be treated as a choice variable for maximizing the social utility function.
4 According to the World Bank data (see World Bank 1995), the rate of completion at primary schools in Vietnam is about 50 percent and the dropout rate is more than 40 percent.
5 The report by MOET-UNDP-UNESCO, based on the 1989 Census, indicates that the unemployment rate among university, college, and vocational secondary school graduates in Vietnam was 12.2 percent. The unemployment rate among university graduates in Thailand in 1988 was 6 percent and Indonesia 12.6 percent (see World Bank 1993:4).

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14 The ICT industry, structural reform and labor productivity

Lessons for the developing countries

Tran Quoc Hung

1 Introduction

In this chapter, the information and communication technology (ICT) is defined to encompass information technology (IT), both hardware (computers and related equipment) and software (operating systems and application programs), and communication technology. However, due to lack of comparable data, the data mentioned in the tables do not include software, which is available only for the US. Consequently, the data presented underestimate to some extent the crucial role of ICT in the globalization process and the formation of the 'new economy' (see Tran 2002).

Representative of this change is the US economy which just ended a 10-year expansion, the longest in post-war history, with low unemployment and inflation rates, and rising productivity. While economists are still debating the permanent effect of ICT on the economy, many developing countries are encouraged by the success of India's software industry and have launched IT development programs as a strategic thrust in the hope of leapfrogging more advanced countries in the industrialization process. This chapter analyzes the role and impact of ICT on the economies of the US, Europe and Japan, and draws on relevant experience for the developing countries, particularly to avoid setting unrealistic expectations.

Generally speaking, ICT has direct and indirect effects on the economy.

1 Direct effect: ICT output (both goods and services) when used for final consumption and investment will boost GDP growth rates.
2 Indirect effects:

   - stimulate fixed capital formation, raising the capital-labor ratio through capital deepening, thus lifting labor productivity;
   - help raise multi-factor productivity (MFP); and
   - impact the employment rate.

Raising labor productivity and the employment rate will lift the trend growth rate, producing strong economic growth over a sustained period of time without causing high inflation (which in the past has led to high interest rates and ultimately causing recessions). This is the most important yardstick by which to evaluate the impact of ICT on the economy.

2 Investment in ICT

In the past two decades, investment in ICT (at fixed prices), particularly IT hardware and communication equipment, has risen significantly, most notably in the US (see Table 14.1). Of special interest is the acceleration of investment in IT hardware in the US during 1990–6, while a deceleration took place in Europe and Japan. As a result, till 1996, the ratio of ICT investment to gross capital formation was highest in the US compared to other countries. The share of ICT capital stock to total capital stock reached 7.4 percent in the US, compared to 5.2 percent in the UK, 3.0 percent in Germany and 2.3 percent in Japan.

The rapid rate of ICT investment was largely due to the sharp fall in the ICT price index, reflecting technological advances which have been embodied in ICT equipment with ever rising efficiency and falling costs. This produced a substitution effect: corporations invested more in ICT because its prices have fallen more relative to those of other kinds of

Table 14.1 Investment in ICT

	USA	*UK*	*Germany*	*France*	*Japan*
Average annual growth rate (%)					
IT					
1985–90	19.6	25.5	18.8	16.2	23.6
1990–6	23.8	17.6	18.6	11.0	14.5
CT					
1985–90	16.7	20.3	18.4	19.0	34.7
1990–6	5.1	2.2	3.4	2.1	15.0
ICT investment/ Total capital investment (%)					
IT					
1990	8.7	7.5	3.5	5.0	3.8
1996	13.4	11.7	6.1	6.0	4.6
CT					
1990	7.0	5.8	3.7	3.8	1.5
1996	6.5	6.6	4.8	4.9	3.5
ICT capital stock/ Total capital stock (%)					
1985	6.2	3.6	2.9	2.4	1.2
1996	7.4	5.2	3.0	3.2	2.3

Source: Schreyer (2000).

machines and equipment, as well as labor costs. As already mentioned in the introduction, if IT software spending was included, the figures for ICT investment would have been higher.

3 The direct effect of ICT

Since it is a part of final use, investment in ICT contributes directly to GDP growth. With the highest share relative to other countries, the contribution of ICT investment to GDP growth is largest for the US. This is an important feature of the evolving new economy in the US. During 1980–5, ICT investment contributed 0.27 percentage points to the average annual GDP growth rate (or accounted for 8.2 percent of GDP growth). This contribution rose to 0.34 percentage points (or 10.6 percent) during 1985–90 and to 0.42 percentage points (or 14.0 percent) during the period 1990–6 (see Table 14.2). In the most recent period, 1996–9, including software spending, the contribution of ICT increased to 1.1 percentage points (or 25.0 percent) per annum (see Elmeskov and Scarpetta 2000). Note that in the US$10 trillion economy, 1 percent equals US$100 billion.

In the future, beyond the current recession, investment in ICT will probably resume growing, raising its contribution to GDP growth. There are two reasons supporting this long-term trend. Competitive pressure in the global economy forces companies to invest more in ICT, especially in B2B (business-to-business) e-commerce, to improve productivity and

Table 14.2 The contribution of ICT to GDP growth rates

	1980–5	*1985–90*	*1990–6*
USA			
Percentage points	0.27	0.34	0.42
% of GDP growth	8.2	10.6	14.0
UK			
Percentage point	0.16	0.26	0.29
% of GDP growth	7.6	6.9	13.8
Germany			
Percentage point	0.12	9.17	0.19
% of GDP growth	8.6	4.7	10.6
France			
Percentage point	0.17	0.23	0.17
% of GDP growth	10.0	7.2	18.9
Japan			
Percentage point	0.11	0.17	0.19
% of GDP growth	3.1	3.5	10.6

Source: Schreyer (2000).

reduce production costs. In addition, rapid technological advances (including broad-band fiber optics and 3G (third-generation) mobile telephony in the near future, and DNA-chips, quantum computing and nano-technology in the longer term) will continue to improve the efficiency and reduce the cost of ICT products and services.

4 The indirect effects of ICT

ICT can influence the GDP trend growth rate in two ways: by improving labor productivity and by contributing to raising the employment rate (if other enabling factors are also present).

Many factors contribute to improving labor productivity, measured as production (i.e. GDP) per worker, or per working hour. The per-working-hour measure is more accurate in comparing labor productivity across countries, which have different total working hours per year. For example, the average annual working hours in the US are 1,833, compared with only 1,620 hours in the EU. The most important factor is capital deepening, or raising the capital-labor ratio: a worker supported by more modern and efficient machinery and equipment can produce more. Capital deepening has happened not only in ICT, but also in other areas of fixed capital. Technical advances in ICT (digitalization, miniaturization, specialized chips, etc.) have pushed companies to upgrade and modernize their capital stock to incorporate the latest advances. Table 14.3 presents the changes in US labor productivity per working hour, and the various contributing factors to these changes.

According to Table 14.3, labor productivity in the US has recovered in 1995–8 after two decades of decline, starting with the energy crisis in 1973. The latest data confirm this recovery: labor productivity rose by 5.6 percent in second quarter of 2000 compared with second quarter of 1999, and increased by 2.4 percent in third quarter of 2001 in the midst of a recession. The contributing share of capital deepening was 1.13 percentage points per annum during 1995–8, higher than the average annual contribution during the four decades 1959–98, but still less than during the 1959–73 period.

Table 14.3 US labor productivity growth and its contributing factors (%)

	1959–98	*1959–73*	*1973–90*	*1990–5*	*1995–8*
Labor productivity	2.04	2.95	1.44	1.37	2.37
Due to capital deepening	1.10	1.49	0.91	0.64	1.13
Due to rises in MFP	0.63	1.01	0.33	0.36	0.99
Due to improvement in labor quality	0.32	0.45	0.20	0.37	0.25

Source: Jorgenson and Stiroh (2000).

More significant has been the impact of ICT on the growth of MFP, defined as the increase in output after accounting for the contribution of higher usage of both capital and labor inputs. MFP represents disembodied technological changes, reflecting the combined effect of new production methods, economy of scale and changes in the organization and work process within and between companies, in both domestic and international market places. In the period 1995–8, MFP increased on average by about 1 percent per annum, almost equal to the rate observed during 1959–73. Including the improvement in the quality of labor (i.e. higher levels of education and specialization required to operate the modern equipment), MFP rose by 1.25 percent per annum during 1995–8 and more than 2 percent per annum in the 1998–9 period.

There are two points worth mentioning from the US experience.

1 Substantial investment in ICT has to persist for a long period of time, at least a decade, before labor productivity starts to improve, first within the ICT itself, then spreading to other industrial sectors. The main reason is that it takes time for the entire economy to absorb and learn to use efficiently the new technology.
2 ICT is only the necessary but not the sufficient condition to spur improvement in MFP. There need to be appropriate institutions and a suitable business environment to encourage competition and to foster changes in organizational structure, work method and management style so that productivity can be improved. Investing in ICT without implementing necessary changes will not lead to productivity improvement. A recent study (see Brynolfsson and Hitt 1998) compares four groups of companies sorted on the basis of the level of investment in ICT and reform of business organization (as measured by the degree of decentralization of management through the use of the intranet). The result shows that those companies able to combine a high level of ICT investment with significant degree of decentralization achieve the largest productivity improvement. Those investing substantially in ICT but not making appropriate organizational changes tend to score the poorest productivity improvement.

5 Raising the employment rate

Once labor productivity has improved, it is important to raise the employment rate (increase in employment) to sustain a higher trend growth rate. This has been the US experience compared with Europe and Japan (see Table 14.4).

The US employment rate reached 2.2 percent per annum during 1995–8. With labor productivity growing by 1.6 percent per annum on average, output has grown by 3.8 percent a year, stronger than in many other industrialized countries. In the case of Germany, companies have

Table 14.4 Growth of business output and its contributing factors (%)

	USA	*UK*	*Germany*	*France*	*Japan*
Output per annum					
1980–90	3.1	3.0	2.3	2.3	4.0
1990–8	3.3	2.1	1.6	1.7	1.4
1995–8	3.8	2.3	1.7	1.8	1.1
Employment					
1980–90	2.0	0.6	0.5	−0.2	1.3
1990–8	1.9	0.6	−0.5	0.0	0.1
1995–8	2.2	0.7	−0.3	0.2	0.0
Labor productivity (per worker)					
1980–90	1.1	2.3	1.8	2.4	2.7
1990–8	1.4	1.5	2.1	1.7	1.3
1995–8	1.6	1.6	2.0	1.6	1.1
Capital deepening					
1980–90	1.1	1.8	3.9	2.3	4.9
1990–8	0.6	1.2	3.7	2.3	4.7
1995–8	1.0	1.0	3.1	2.3	4.4
MFP					
1980–90	0.8	...	1.1	1.6	1.6
1990–8	1.1	1.2	1.0	0.9	0.7
1995–8	1.1	1.3	1.1	0.8	0.8

Source: OECD (2000).

tried to improve labor productivity by increasing capital formation and reducing employment. The result is slower economic growth in the 1990s compared to the 1980s, together with higher unemployment (9 percent compared to 4 percent in the US) leading to social problems. The rate of capital deepening has been quite high in Japan compared with the OECD countries, but labor productivity and employment have grown very feebly, causing economic stagnation in the past decade. This resulted from the lack of efficiency in the investment process, resulting in wastage of capital in Japan. The same phenomenon has been observed in many Asian countries in the 1997–8 crisis.

The above comparison illustrates the complex relationship between ICT and employment. Normally, companies invest in ICT, or in fixed capital in general, in an effort to raise productivity in the face of market competition, with the ultimate aim of improving profit. The result of this process is to reduce employment, since modern machinery and equipment can enable fewer workers to produce the same as, or more than, before. Laws and regulations in the US labor market are more liberal than in Europe and Japan, consequently the process of increasing fixed capital and reducing employment can take place more easily and quickly in the US. However, the openness and flexibility of labor market, as well as other input and output markets in the US, together with the appropriate social environment have encouraged and enabled entrepreneurs to accept risks and launch new businesses. The new enterprises tend to make use of the latest ICT advances, introducing new products and services, and have created more new jobs than those lost in the restructuring process. The result is to raise the employment rate, lifting the trend growth rate–a key feature of the new economy in the US. To put it more concretely, trying to protect existing enterprises and jobs being rendered obsolete by ICT advances is to hinder the formation of new enterprises and jobs more suitable for the global economy. In order to fully utilize the potential of ICT, an economy with its system of laws and regulations has to be flexible, dynamic and open so as to be able to adjust quickly to changing conditions. If not, there is the risk of raising investment at the expense of reducing the employment rate, causing long-term problems for the economy and society.

Another point is worth mentioning in the evaluation and comparison of published data on labor productivity. In the case of Europe and Japan, increasing investment but reducing (or not raising) employment leads to productivity improvement, defined arithmetically. In the case of the US, capital deepening goes hand in hand with rising employment, consequently macroeconomic data on productivity tend to underestimate the true productivity improvement at the enterprise level.

6 The US economy and cyclicality

A capitalist economy has a distinct cyclicality: expansion, recession, recovery and then expansion. Even within the expansion phase, economic developments also exhibit cyclicality. Generally, the longer an expansion lasts the more imbalances between supply and demand are being encountered in markets for inputs and outputs. As a consequence, growth rates decelerate and inflation accelerates, pushing up interest rates, curtailing investment and consumption, eventually leading to a recession. The recessionary period creates the conditions to re-stimulate investment and consumption, starting a new growth phase.

Changes in the structure of the US economy due to high investment in ICT and restructuring have rendered the latest expansion, which started from second quarter of 1991 till March 2001, rather unusual. Concretely, growth rate and labor productivity accelerate in the later years of the expansion, while inflation decelerates (see Table 14.5). Of particular significance is the acceleration of productivity growth at the tail end of a long expansion, which makes such improvement in productivity all the more remarkable.

Concretely, three lessons can be discerned from the formation of the new economy in the US in the past decade.

Table 14.5 The US economy through different expansions (%)

	GDP growth	*Labor productivity*	*Inflation rate*	*Real investment*	*Real R&D expenditure*
1961–9					
Years 1 and 2	5.5	4.7	1.2	10.0	5.7
Years 3 and 4	5.9	3.6	1.6	15.0	7.8
Years 5 and 6	5.8	3.3	2.6	9.5	8.0
Year 7+	2.8	1.3	4.6	6.0	6.0
1982–90					
Years 1 and 2	6.7	3.0	3.0	17.0	8.2
Years 3 and 4	3.0	2.1	2.5	2.2	5.6
Years 5 and 6	4.0	1.0	3.6	5.5	2.5
Year 7+	1.2	0.9	4.2	2.2	6.2
1991–2000					
Years 1 and 2	2.8	2.5	2.3	7.0	0.0
Years 3 and 4	3.4	1.0	2.1	13.0	5.0
Years 5 and 6	3.4	1.8	1.8	9.6	6.1
Year 7+	4.2	3.2	1.4	14.5	13.0

Source: US Department of Commerce (2000).

- High investment in ICT needs to be maintained for a long period of time to produce results (capital deepening, raising labor productivity and trend growth rate) since it takes time to absorb ICT.
- It is imperative to implement structural reforms and to change business organization and processes within and between enterprises so as to be able to raise MFP. Without restructuring, there is the risk of increasing investment but not improving the efficiency of the whole economy (the case of Japan).
- The economy has to have a high degree of flexibility and adjustability to be able to create new enterprises and jobs in sufficient number to offset the employment loss due to restructuring and capital deepening. Without this ability, there is the risk of reducing employment, slowing down the economy and pushing up the unemployment rate (the case of Europe during the 1990s).

The challenge to the developing countries is how to benefit from these lessons.

7 Lessons for the developing countries

The development challenge facing the developing countries is to industrialize and modernize their economies to raise employment and income in the conditions of obsolete technology, low productivity, weak institutions of public and corporate governance, ineffective financial and banking systems, in addition to being plagued by widespread corruption. In a global economy with fierce competition from both the multinational companies headquartered in industrialized countries and other developing countries, the classical development model according to which a country moves progressively through stages in agriculture, light industry, heavy industry and then services is no longer practical. The developing countries have to implement a comprehensive development program to overcome their main weaknesses, especially in institution building, and to develop a few economic sectors where they enjoy comparative advantages in order to participate in the global division of labor. This is the content of the integration process with the global economy.

What is the role of ICT in helping the developing countries cope with this challenge?

Integration

In the global economy, ICT has become a standard means for communication, exchange and integration. Integration can be understood in a broad sense of opening and having transactions with the global economy. It can also be understood in a narrow sense of being able to participate in electronic business networks, for example the B2B e-commerce exchanges which are being quickly formed and rolled out. In other words, if the world communicates via e-mails, one cannot rely only on faxes or the post. Just making good use of ICT infrastructure can help improve the efficiency of information exchange and distribution, thus raising economic productivity. But even effective usage can take time: at many large Western corporations, secretaries still have to print out e-mails everyday for their bosses to read, to take short-hand replies and send them back via e-mail. Therefore, adequate investment in ICT, including sufficient training to enable its proper usage, is necessary.

Investment

To realize the direct effect of ICT, it is important to maintain a high level of investment for a long period of time to attain a share of ICT capital stock of at least 5 percent of total fixed capital, especially since the starting share is usually tiny and ICT capital has a rapid depreciation rate. (Current shares in selected developing countries: Argentina 3.4 percent, Brazil 5.8 percent, China 4.9 percent, India 3.5 percent, South Korea 4.4 percent, Malaysia 5.5 percent and the Philippines 2.7 percent (see IMF 2001).) Once the capital-labor ratio has been raised, improvement in labor productivity can begin to be reflected in macroeconomic data. In many developing countries, this process may take even longer than in the industrialized countries, since most of the ICT capital stock is usually employed in ICT-using industries, not ICT-producing industries. Experience in the US shows that labor productivity increases first and most clearly in ICT-producing industries, before spreading to the ICT-using sectors.

Institutions

The improvement in MFP depends entirely on the ability to restructure and to build appropriate institutions. The potential to improve productivity is great, since the developing countries move from uneconomical and inefficient structures to a more competitive and dynamic market environment. However, resistance to reform is also great, due to reasons ranging from ideological and political, to protecting vested interest in maintaining rent-collecting monopolies, and to natural organizational inertia. It is also important to pay attention to information policy. Through the world wide web (www), ICT can be more useful and potent if information is comprehensive, widespread and timely. Investing in ICT while maintaining a controlled and closed-door information policy is comparable to racing Formula-1 cars on village roads. The ability to reform is essentially social and political, not technological. However, implementing new ICT systems usually highlights the lack of logic and efficiency in the old ways of doing things, thereby creating pressure for change (for example the reform and deregulation process in India). Thus ICT can be a catalyst for restructuring, but it is entirely dependent on other enabling factors for reform to be successful.

Employment

The main challenge to the developing countries is to create jobs for the surplus workers moving from agriculture and the countryside to the cities. But ICT tends to reduce employment because it raises productivity. For countries like China and Vietnam, there is the added problem of reforming the state-owned enterprises (SOEs). The SOEs are inefficient but employ many people. A successful reform of the SOEs leads to huge redundancy. Therefore, it is imperative for these countries to implement all necessary policies to encourage the formation of new private sector enterprises, not only in ICT but also in other sectors, including services, to absorb the released workers. Otherwise, unemployment will rise causing economic stagnation and social problems.

IT industry

Several Asian countries have recently implemented a policy to develop IT in hardware or software, aiming at exporting products and services, including contract work. In addition to India, Malaysia (with its Multimedia Super Corridor program) and the Philippines have had some initial results. For a latecomer like Vietnam, having to deal with the saturation of regional and international markets for manufactured goods, such as automobiles or consumer electronics, which used to serve as catalysts for industrialization, it is quite reasonable to develop a software industry to take advantage of the fact that Vietnamese students have shown an aptitude for sciences, mathematics and computer science in order to diversify its range of exports. Indeed, the Vietnamese government has promulgated a master plan to develop IT into a key economic sector. According to the 10-year plan (2001–10), Vietnam's transmission network will cover the whole of the country and be comprehensive, quick, cheap and of good quality; IT will become a key economic sector; and the number of internet users as a percentage of the population will reach the world's average. The key targets of the more detailed 5-year plan (2001–5) include: an annual growth rate of 20–25 percent (so that IT will account for 4 percent of GDP by 2005); an output value of US$1 billion for the hardware industry, and US$500 million for the software industry, by 2005 (compared with the total output of US$235 million in 2000); an internet penetration rate of 1.5 percent, the training of 50,000 IT experts of different levels including 25,000 professional programmers. The master plan also includes generous tax incentives to domestic as well as foreign IT firms and workers and substantial state investments in infrastructure projects and high-tech parks.

Policy and planning

Vietnam's IT master plan has stirred a debate among economists. The important issues are:

- the proper scale of state investment in the software industry, since there are many other areas in need of government spending which is quite constrained by resource availability;
- the appropriate combination of government actions (constructing the infrastructure, especially efficient telecommunication channels with low tariff, supportive laws and regulations, particularly those protecting property rights) and the ability and initiatives of entrepreneurs to seize opportunities and add value in the international market place.

Early experience in Vietnam seems to be consistent with the main analytical thrust of this chapter that 'soft' constraints are quite important compared with investing in hard assets. For example, after investing several hundred millions of US dollars in the past decade, Vietnam has made some progress in building the physical infrastructure for ICT. Computers and PCs are becoming a common sight in offices and even private homes. According to Vietnam Post and Telecommunication

(VNPT), all 61 provinces and cities are now equipped with digital voice and data exchanges, connected by high capacity fiber optic cables and satellites (see *Vietnam Economic Times* 2001b). The telephone subscription rate has jumped 25-fold since 1991 to 5.7 telephones per 100 inhabitants, and the GSM mobile telephone network has been extended to cover the whole country. Internationally, Vietnam participates actively in commercially exploiting the SEA–ME–WE3 undersea fiber optic network connecting Europe with Asia.

However, IT utilization and development is judged as 'quite poor' according to a recent conference in Vietnam (see *Vietnam Economic Times* 2001b). The reasons include:

- lackluster support by the political leadership and enterprise management to implement appropriate changes in organizational structures and work flows to exploit the benefit of ICT investment;
- the poor quality of the design and implementation of IT projects;
- telephone and internet connection charges are significantly higher than regional averages due to monopolistic power of VNPT in the sector; and
- the severe shortage of adequately trained IT personnel. Several participants were of the view that ICT has been 'the most wasteful sector of the economy,' as computers are being acquired for prestige reasons rather than practical use; and IT purchasing projects have been open to corruption.

In addition, due to lack of properly enforced laws on property rights, Vietnamese software companies are being hurt by massive piracy; and while the government claims that 4,000 IT specialists are graduating each year, NetViet–a local head-hunting firm in Ho Chi Minh City–was able to fill only 5 slots out of 23 vacancies at a Canadian IT company despite hundreds of applications. NetViet said 'most IT graduates need to improve their English and to make sure that their IT skills are up to scratch' (*Vietnam Economic Times* 200la).

In short, it is necessary to invest in ICT to build up infrastructure and attain a sufficient technical standard to integrate with the global economy by producing value-added goods and services. The important issue is to conduct a cost-benefit analysis to determine the appropriate scale of investment in ICT. Experience has shown that it takes a substantial level of investment over a long period of time to reap the positive effects of ICT. Meanwhile a developing country faces urgent demand for government spending in many different areas such as education, health care, transportation, energy, etc. but is subject to severe resource constraint. In addition, to focus on ICT investment and regard it as a shortcut to become industrialized and modernized, while neglecting structural reform and institution building, is to entertain an illusion.

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15 Public administration and civil service reforms in Vietnam

Quan Xuan Dinh

1 Introduction

Doi Moi or economic renovation began in 1986 with an agricultural sector reform followed by wide-ranging economic and institutional reforms. Many economic reforms started from 'below' while the political sector was left untouched (see Fforde and de Vylder 1996). Since 1990 foreign investment has poured into Vietnam and unleashed a mini-wave of prosperity. As a result, the economy has achieved a steady growth of around 7.3 percent per year for the past 10 years (1990–2000), prompting a rapid reduction of poverty,[1] which dropped from 58 percent of the population in 1993 to 37 percent in 1998 (see World Bank 1999).

With *Doi Moi,* Vietnam built the basic legal and regulatory framework and justification for a 'market economy with a socialist orientation'. In addition, the *Doi Moi* program covers both administrative and political changes. A public administration reform (PAR), civil service (CS) strengthening and many other institutional changes, such as the budget system, the retrenchment in the state apparatus, improvement in the pay system, were launched. The aim of the PAR and the CS reform is to give the government a tool to manage more efficiently the transition to the market economy system.

After 14 years of reform, Vietnam is unsure just how many more reforms it should implement and how much more ideology it should shed. The economy has slumped in recent years and Vietnam is experiencing a decline in foreign direct investment (FDI), a drop in economic growth and a rise in unemployment. Foreign investors cite complex regulations, excessive red tape, widespread corruption and a banking system that needs reform as the main factors behind a slowdown in investment. Companies are pulling back, shuttering their factories and abandoning joint ventures.

Vietnam's legal and bureaucratic systems and corruption are choking its economic reform program. The Communist Party of Vietnam (CPV) is reforming its organization, status and functioning (see Vasavakul 1997), while institutional factors such as the functioning of the politburo, and the relationship between the party and the government have not been resolved. Resistance from the CPV has transformed PAR into a limited retrenchment and procedural reform program (see Dinh 2000:360). The anti-corruption campaign launched 2 years ago has resulted only in the dismissal of few high ranking officials and the disciplining of a few thousand members.[2] With strong CPV control and an imperfect institutional system, Vietnam will be constrained in its economic development without an overhaul of its administrative machinery and its CS. This chapter explores the progress of the PAR and the CS reform in recent years. Present institutional settings and human resources are main constraints to development. The chapter argues for the need for a political and institutional reform, especially the building of a professional CS and the revision of the 1992 Constitution. The chapter is divided into two sections: the first gives a brief overview of Vietnam's institutional reform since the *Doi Moi,* the second analyzes constraints and identifies new challenges for Vietnam in the twenty-first century.

2 Institutional *Doi Moi:* context and results

The renovation program introduced broad macroeconomic policy to stabilize the economy and to attract foreign investment. Thus, FDI and official development assistance (ODA) and overseas Vietnamese remittances[3] fueled investment, which increased from 11.6 percent of GDP in 1986 to 23 percent in 2000.

Doi Moi introduced diversified forms of ownership: public and private. State-owned enterprises (SOEs) (around 5,300 in number) are capital intensive, import substituting industries and not competitive on the world market.[4] The present industrialization strategy stresses the leading role of the state (see Fforde 1999) and the playing field is uneven for the private sector[5]

The institutional *Doi Moi* included legal, public administration (PA) and political components. The Foreign Investment Law (FIL) was promulgated in 1987. The Land Law was enacted in 1988 and revised in 1993. Many laws, such as the Banking Law, Commercial Contract Code, Business Law, Companies Law, the Civil Code and lately the Enterprise Law, were passed to support the transition to the market institutional framework.

The political component included a new role for the National Assembly (NA), the redefinition of the role and functions of government in the economy (see D.D.Le 1996) and a new Constitution in 1992. Limited competitive elections and the regeneration of the political leadership have been used to upgrade Vietnam's political environment and the law is seen more and more as a channel to resolve conflicts, redress grievances and a mode for resolving the arbitrariness of the bureaucracy.

2.1 First wave of Public Administration Reform (PAR)

Aspects of the PAR included:

1 the justification of the market economy with socialist orientation and the role of the CPV within the rule of law, i.e. the role and composition of the NA, the use of elections, the regeneration of the Central Committee (CC) of the CPV and the preparation of a national PAR program;
2 the reform of state institutions and administrative procedures; and
3 the building of the CS.

2.2 The CPV and the rule of law

After the collapse of the socialist bloc, Vietnam had to adjust its organization and functioning to reflect the new situation (see Vasavakul 1997). Factors such as the functioning of the state, NA, politburo and standing committee had to be reviewed and improved.

The first reform in the early 1990s aimed at preparing a new justification for a market economy with socialist orientation. The intense debate centers on how to emphasize the role of the party within the rule of law. The move from socialist to rational–legal values was justified by formulas such as 'a state of the people, by the people and for the people', 'a state governed by the rule-of-law', and the definition of market system with socialist orientation as a state in which 'the. people are rich, the country is strong and society is civilized'. Law is seen more and more as a channel to resolve conflicts, redress grievances and a mode for resolving the arbitrariness of the bureaucracy. Vietnam's strategy for legitimacy is based on the premises that the PA (see GCOP 1993):

- exists to serve the people (a state of the people, by the people and for the people);
- functions in a state governed by the rule of law;
- is able, as the executive arm of the government, to implement government policies and priorities effectively, on the basis of division of responsibility and coordination;
- is established on the basis of 'democratic centralism' manifested through such approaches as centralization, decentralization, deconcentration, devolution, delegation and related approaches; and
- is placed within a political system where people exercise their ownership rights.

The new constitution adopted in 1992 was a first step to support the transition to the rule of law. The CPV obtained legitimacy and the monopoly in the political process through article 4 of the 1992 constitution. Article 4 ensures the supremacy of the CPV as the only political party in the country.

In the past, the NA had a limited role and its members worked on a part-time basis. The CPV or the *Mat Tran To Quoc* (Front of the Fatherland) selected candidates to the NA (see Thayer 1992:122). They met twice a year to review and vote for the legislative agenda and programs proposed by the government.

With *Doi Moi,* there was a new role and limited democratization for the NA. Limited competitive elections have been used to incorporate non-party members which allowed 'screened elites' to express their opinions and showed that the party was incorporating a wide range of opinions and interests. It is a channel for some new independent voices to emerge. During the 1992 NA election, 7 percent of non-party members were included. This proportion now stands at 20 percent for the 1997 NA election, which fielded 663 candidates for 450 positions. In the 1997 NA, women and minorities represented over 30 percent of the total and a younger and better-educated generation of representatives (less than 55 years old) has emerged.

The NA was given a greater scope to express critical views, as seen during the tenth NA meeting in November 1996 in which it approved only eight ministers out of twelve presented by the government. In May 2000, the NA was particularly vocal on red tape, corruption and low salaries in the public sector.[6] Vietnam's NA has become more aggressive because the economy is not improving and delegates are asking tough questions instead of being compliant and unquestioning. This is particularly true during the discussions of amendments of the FIL when NA members questioned cabinet members, especially the Minister of Planning and Investment (MPI), the Minister of Finance (MOF) and the Minister of the GCOP (see *Nguoi Viet* 2000). Proceedings of the NA are aired on state television and radio, and the system is now unquestionably more open.

2.3 State institutional reform

Coming out of a long period of war, Vietnam is weak institutionally. It had to initiate PAR reform to restore state administrative controls (see Vasavakul 1996). Vietnam's PA is constrained by the lack of a professional CS, an inadequate understanding of the role of government in a market-based economy, and the training and upgrading of civil servants. After 2 years of discussion, the government published a national program on public administration reform (NPAR) document under the guidance of Prime Minister (PM) Vo Van Kiet and his team (see CGOP 1993). The PAR could be seen as an effort to launch an institutional cum political *Doi Moi* to readjust the country to the new political reality in Asia. According to the NPAR document, the main goals of administrative reforms are the following:

- To establish a unified institutional system for state administrative organization, defining the role and operational mechanism for the three powers: legislative, executive and judiciary within a unitary state model. The machinery of the central public administration will rationally address relationships amongst central-level organizations, and the distribution of authority amongst government agencies;
- To establish the relationship between the political leadership of the CPV and the state machinery;
- Identification of principles and directions for addressing the relationships between the central government and local authorities;
- Identification of the role of the local authorities: People's council, People's committee, and clarification of its responsibilities, functions, and authority.

Resolution No. 38/CP of May 1994 instructed all agencies to simplify and adjust administrative procedures. The government used the PAR to streamline, adjust, standardize and reduce red tape, especially through the introduction of 'one door policy'. This policy had first been launched by the Ho Chi Minh City administration, which still has some institutional memory of the past South Vietnamese administration systems and procedures. The same approach has been used to assess and eliminate taxes contrary to laws, decrees or ordinances imposed by local governments. Overall responsibility relating to PAR was given to the GCOP,[7] which had been created to strengthen and to manage the CS.

With the institutional *Doi Moi,* the number of government ministries and state committees was reduced from 76 to 49 by merging ministries and state agencies. Later, the state apparatus was further reduced,[8] modern PA tools such as the Budget Law, the creation of an administrative tribunal system and the creation of a CS had been introduced. Ministerial functions shifted toward a policy-oriented role instead of direct control over production. Similar reductions were operated at the provincial level. Furthermore, at the local government level, the CPV tested the rejuvenation of leaders in the first multi-candidates election for provincial People's council (provincial assembly) in December 1994. Since the provincial assembly selected the head of People's committee (provincial government), the election boosted the legitimacy of provincial leaders. The 1994 election has been instrumental in the emergence of a younger and more educated generation of communist leaders at local level. This was reaffirmed during the eighth national congress (NC) of the CPV in 1996 where new members had to be younger than 55 years and university graduates.

The first wave of PAR reform adjusted past command economy procedures to the market system. It required changes in the legal and institutional framework, which were carried out with minimum opposition.

2.4 Second wave of PAR: perfecting state institutions and the CS

This second wave of reform aims at improving the functioning of and further reducing state institutions. It is still beset by difficulties and remains unfinished.

In January 1995, the eighth plenum supported the drive for institutional changes and resulted in a resolution on 'continuing to build and perfect the State of the Socialist Republic of Vietnam–taking a Step toward Reforming the State Administrative System'. This document marked the second wave of institutional reform and laid out the most current state strategy in respect of PA reform, for which there are five major thrusts to:

- continue renewal of the organization and work of the NA;
- continue the step-by-step reforms in the state administrative system;
- renew the work and organization of the judiciary bodies;
- promote the people's role as master of the state; and
- strengthen the Party's leadership towards the state.

An action plan dated 20 March 1995 was subsequently prepared to combat structural weaknesses.

First, ministerial functions shifted toward a policy-oriented role instead of direct involvement in economic activities such as the supervision and allocation of money to commercial SOEs. An important aspect of economic restructuring was to redefine the role and functions of government in the economy which included (see D.D.Le 1996):

- managing the macro economy, fiscal and monetary policies;
- coordinating central, regional and local government activities;
- creating the legal, financial, administrative and regulatory infrastructure for the market;
- managing and creating a framework for investment, innovation and structural change; and
- creating a governmental capacity to manage in a market economy including the creation of a capable and honest CS.

SOEs were freed from their parent ministries *(Bo Chu Quan)* and classified as public and commercial ventures. New measures aiming at the institutional reform of the SOE sector included:

- registration of companies;
- equitization of a number of state-owned companies;
- enterprise management reform; and
- abolition of the parent ministry.

With decision 91/TT of March 1994, seventeen chaebol-type enterprise groupings have been created along with 47 other sector SOEs.

Equitization or the legal transformation of SOEs into joint-stock companies has been implemented since 1992. The conservative faction of the CPV wants to retain control over the economy through SOEs, while the progressive faction believes in a higher speed of renovation and the shedding of commercial enterprises for efficient state management. Furthermore, bureaucrats and managers have a vested interest in slowing down reform for their own advantage. Recent corruption scandals[9] showed the connection between SOE managers, local party members and state-owned commercial banks (SOCBs).

SOEs are poor performers but many belong to or are under the party apparatus and therefore protected. The party has been delaying the equitization process since the seventh NC, as only five SOEs had been equitized by May 1996. The process of equitization was painfully slow but is picking up speed because of present economic difficulties; a total of 400 SOEs were equitized by December 2000. Recently the third plenum of the ninth NC in August 2001 adopted a resolution to continue the reorganization of the SOE sector.[10] At present, there are around 5,200 SOEs.[11]

Second, many ministries were eliminated, merged and their functions evolved. Ministries have shed their supervisory functions and are concentrating on policies. Furthermore, in each ministry, each province and each public organisation, a PAR committee was formed to review procedures and streamline organisations. During this period, the number of ministries and state committees was further reduced from 27 to 22 and the number of provinces changed from 57 to 61. The Office of the Government (OG) has been streamlined. The OG, which used to supervise a myriad of autonomous agencies (tax, customs, archives, oil and gas, etc.), has shed many agencies. Agencies such as Taxation, Customs and Treasury have been restructured, strengthened and reverted to the supervision of the MOF and other line ministries.

Third, the government is introducing modern PA tools through the 1994 information technology (IT) program, the 1996 Budget Law, and new management methodologies and systems. Provincial personnel management services were linked to the GCOP by computerized systems and its personnel trained in new technologies. The personnel management systems at GCOP are being upgraded through training and new management tools (as in the GCOP–SIDA project 1997).

The National Institute of PA (NIPA) and its annexes were established and provincial schools consolidated. PA training at provincial level is basic, more political than technical.[12] At national level and contrary to other PA schools in Asia and elsewhere, NIPA provides only short-term courses, workshops and courses at the graduate level. Each province can select and send candidates to the school for training. There is no national entrance exam or competitive selection of candidates. The process of selecting candidates to NIPA is opaque.

The creation of an administrative tribunal system is an additional step toward relying on the rule of law to solve administrative conflicts between citizens and the administration and to redress grievances. The training and upgrading of civil and public servants including administrative judges through a 3-month course, seminars, etc. helped to strengthen the role of the state in establishing the rule of law to support the transition to the market economy.

PA tools for the market economy such as the budget, the public priority investment program, the computerization of the budget, taxation and customs, were introduced while other reforms such as the relationship between the government and the party have been postponed.

Fourth, the CS is being modernized. New approaches in ministerial, provincial, urban and municipal management, personnel retrenchment approaches, district and commune organization, training and entrance exam for civil servants, budgetary systems, management of land certificate, rural–district relations, etc. were tested through the pilot PAR program.[13] A CS statute was prepared and discussed during a 3–year period and finally enacted at the end of 1997. Another priority is the need to train civil servants for new skills and tasks. The curriculum at the NIPA and at provincial schools has been slowly updated. GCOP also revamped its training department to update the CS. A vast program of training has been initiated to update cadres.[14]

Pursuing the seventh plenum in August 1999 focusing on issues relating to the organization and apparatus of the political system, and wages and allowances funded by the state budget,[15] the government initiated further reforms. The 40 hour-week work system has been introduced followed by an increase in salary and a large retrenchment program. Salaries and allocations are being revised and monetarized. Presently, the retrenchment involves the streamlining of 200,000 state workers, or 15 percent of the total.[16]

Fifth, Vietnam continues to revise and add new laws to update its legal framework. Thus, the FIL promulgated in 1987 was revised and supplemented in 1990, 1992, 1996 and in May 2000. The Enterprise Law that came into effect in January 2000 was designed to support the market economy. Recently, the NA has approved amendments on new legislation aimed at creating a favorable legal environment designed to boost foreign investment in the country's key oil and gas sector.

There is more openness in dealing with PAR. Vietnam is willing to seek advice and funding from international organizations. Pilot PAR projects encompassing ministries and provinces and municipalities were prepared (see GCOP 1995). An International Colloquium on PA was organized in Hanoi.[17] Academic and staff exchanges with international institutions, although limited, are creating a more favorable environment for exchange and learning. With the PAR, government structure has been modified and rationalized. It followed an incremental strategy, but the institutional *Doi Moi* is presently stalled (see Ryan and Wandel 1996). What were the problems of the institutional *Doi Moi* during the past 14 years and what are the challenges for the future?

3 Problems and challenges

With *Doi Moi,* the NPAR calls for broader institutional and political reforms. It includes:

1. state administrative organization within a unitary state;
2. establishing the relationship between the CPV and the state machinery;
3. the relationship between the central and local governments.

Vietnam has faced many constraints and challenges in its PAR program. However, the CPV is split into conservative and progressive factions and Vietnam's leaders face a difficult choice. The question is how many more institutional reforms can be carried out without diluting the CPV's power? A fundamental change in attitude is needed to allow wider institutional reforms and the creation of a professional CS to manage the change to meet the challenges of development.

3.1 Constraints

There is a need for a change in attitude and a strong commitment from all levels of the state and party apparatus. A weak CS and the need to update the central-local government relationship are major constraints.

3.2 Weak service

During the war, every district had to live in autarky, and thus had adopted organizational structures appropriate for wartime. With the move to the market economy, Vietnam recentralized selected areas (tax, customs, budget system, etc.) and strengthened local governments to mobilize resources, deliver public services and carry out government policies efficiently.

The GCOP, created in the early 1990s, is in charge of the CS. Its mission is to manage the senior staff executives, CS human resources (estimated at 1.3 million) and government structures. Thus, it handles the promotion, training and payroll for the CS. In addition, GCOP supervises PA reform. GCOP also supervises local governments and the management of elections. Presently, GCOP faces many constraints (see GCOP 1997a):

- lack of adequate facilities, equipment and methods;
- lack of capacity to design, prepare and negotiate projects for the PA; and

- insufficient opportunities for professional development of staff in a market environment.

With fewer than 250 staff at the central level, it is difficult for the GCOP to plan and implement the PAR reform efforts, and manage and train the CS personnel. Although over 40 percent of the professional staff are university graduates, their expertise is in areas that bear no relation to their work (e.g. engineering, agriculture, pharmacy, language). There is a lack of expertise in administration, human resource training or management, and few have knowledge of the functioning of the market system. The GCOP had to upgrade its personnel and to rely on other ministries and lower administrative echelons to implement the reform program. Thus, it had to delegate some PAR responsibilities to other ministries such as the Ministry of Health (MOH), the Ministry of Education and Training (MOET) for their respective share of the CS. Many examples illustrate these constraints on the Vietnamese CS.

Example 1 Prior to the PAR, staff from the health, education or administrative sectors are employed by the state immediately after graduation. They are selected at the provincial level and usually stay in the same province for their whole career. They are placed into a 3–5 year mandatory practice at a site selected by the MOH, the MOET or GCOP or their counterparts at the provincial level.

CS entrance exams started in 1997 but are not yet universal. Civil servants stay at the same job and same province because there is no central human resource plan to provide for an orderly rotation between rural and urban areas or between central or provincial levels. The training and upgrading of civil and public servants, including administrative judges, are basic[18] and focused more on political courses than on necessary knowledge and management tools to carry out their day-to-day duties.

Since there was no open entrance exam for civil servants, the selection of personnel was dependent more on connection and ideology than competency.[19] Moreover, promotion, supervision and evaluation criteria are not clearly defined, which may allow personal ties with leaders, connections and links to the government to take precedence over technical performance. As a result, the CS is excluding 97 percent of its citizens (outside of the CPV) from having the chance to serve in the public sector and/or to attain management levels without being a member of the CPV. In this environment, it is difficult to select and retain human resource with high competency and creativity.

To make things worse, the current budget of a hospital, for example, is a ratio of the number of beds or staff in the hospital. Along the same line, the administrative budget of a provincial CS is a percentage of the number of civil servants in the province. Thus, with present administrative and budgetary procedures, overstaffing[20] is a built-in factor in the CS. Many state structures, practices and procedures under the command economy have not been modified or updated.

In the present retrenchment exercise,[21] GCOP provides indicative targets for the retrenchment (15 percent of the staff by 2002), but it had to rely on ministries and agencies, local governments, provincial authorities and lower echelons in the administrative organization to plan, select and carry out the retrenchment exercise. This exercise could be difficult because local governments have to lay off members of their own family or friends and present administrative and budgetary procedures still encourage overstaffing.

Example 2 Public sector wages have not kept up with inflation.[22] The low salary levels provide little or no incentive for civil servants to improve their work. A physician earns about US$30 per month and a senior physician with 30 years' experience can reach the top salary of US$100 per month. Limited advancement prospects and poor compensation contribute to the prevalent problem of low morale and retention of qualified personnel. As a result, there are significant issues in quality of care, facilities maintenance, record keeping and personnel management. Civil servants (teacher, health workers, etc.) have to hold a second job to survive. This might be a factor behind the widely publicized allegations of bribery, corruption and abuse of power in the rural areas.

The economy suffers from widespread corruption. The main complaint of foreign investors is the complex web of licenses and other documents that are strangling businesses and discouraging investors. Kickbacks from businesses help top up low wages. Many documents are issued and monitored by local administrators instead of a centralized agency. This offers a fertile ground for corruption, especially when many documents are still being prepared manually while there is no centralized file access. The government issued decision No 19, dated 3 February 2000, which canceled 84 business licenses[23] in a bid to simplify procedures and attract investment.

Corruption trials uncover collusion between SOEs, SOCBs and party officials, and above all the lack of clear rules and regulations governing the management of these institutions. A recent MOF's audit of government agencies has found that nearly 30 percent of state assets have been excluded from official records for personal use and gains (see Watkin 2000).

To stem the rise in corruption, the government increased the salary of civil servants in 1999 by 25 percent (Resolution of the seventh plenum of the CC in August 1999) after a 7–year halt on government wage increases during which inflation rose by around 30 percent. The new wage brought minimum monthly salaries to the equivalent of just US$14. However, raising salaries alone cannot be the main tool for fighting corruption. Unless civil servants secure a stake in the success of reforms, the bureaucracy can be expected to position it to delay or distort various policy reform efforts.

Example 3 Vietnam suffered a drop in FDI; in the last 4 years, the registered FDI projects showed a gradual meltdown (see *Vietnam News* 19 May 2000). Compared with 1996, the registered capital of FDI projects in 1997 decreased by 49 percent, in 1998 by 16 percent and 1999 by 60 percent. This was partly due to red tape, bureaucracy and lack of capable human resources in the CS.

There is a poor understanding by middle-level and low-level cadres of the functioning of the market because many civil servants were former military personnel or guerilla fighters with an inherited war mentality. War and ideology have deprived Vietnam of its best and brightest, especially in the area of public management. The American Rice Company (ARC) saga, a multimillion-dollar effort to build a rice business in the Mekong delta, is a vivid example of this mentality.[24] Local partners had become enemies. ARC encountered the same problems that threaten foreign and private companies in Vietnam today: poor legal protection, hostile joint-venture partners, heavy bureaucracy and a deep-seated suspicion of capitalism and foreign interests.

A survey by the MPI found three main complaints by foreign investors: dual pricing, discrimination against the private sector and in favor of SOEs, and difficulties in accessing land (see T.Le 2000). Furthermore, at least twelve ministries may be involved in the licensing process, creating red tape. Foreign investors have complained about the dual pricing system in which foreign companies pay more for services, fees and charges. Another problem is the ‘unanimous principle’ in article 14 of the FIL which calls for the most important issues in enterprises to be unanimously agreed by both parties regardless of their share of the capital. Foreign investors said that this unanimous principle hinders their business.

Vietnam is trying to reverse the tide and create favorable conditions for FDI through decision No. 53. Furthermore, the government has convinced the NA delegates to approve almost all its FDI amendments. The new FIL now contains 21 new additions and 20 amended articles (see Ha 2000). Major changes include changes to investment forms and voting procedures in joint ventures.

Many foreign investors’ complaints have been addressed, such as the certificate of land use right to enterprises in industrial and export processing zones (IZs and EPZs) and the unanimous principle in article 14 of the FIL. The amended FIL was passed in May 2000, but at a time when many FDI enterprises had already closed their doors. The existence of a good CS could minimize obstacles to FDI enterprises until the NA are able to revise and update the FIL.

3.3 Central-local government and party overlap

The 1992 Constitution introduced the 'cloning' of central institutions at provincial level. In addition, party directives intervening in the state chain of command, the legacy of war and the parochial behavior of provincial governments exacerbated the confusion and have become a bottleneck to development.

The present local administrative organization is inefficient because of the unclear vertical and horizontal relationship between the People's council (provincial assembly), the People's committee (provincial government), the local party apparatus and central authorities. The central-provincial administrative relationship is tenuous because of the lack of administrative procedures. Limited knowledge of a modern administrative organization combined with bureaucratic red tape leads to many anarchic situations at local levels. Examples abound.

Example 1 The Vietnamese health system is modeled on the socialist healthcare system (see Dinh 1999). At the provincial level, the provincial health service (PHS) directs health activities in the province. There are around 250 provincial hospitals, 570 district hospitals and around 10,165 commune health centers at the commune level (see Government of Vietnam 1999:15). *Doi Moi* and the pressures of public health expenditures have shortchanged the system (see Kieu and Dinh 1998).

Funds are allocated according to geographical and administrative levels. In the province, maintenance funds are allocated, based on staffing level or the number of beds, and the provincial budget supports staff salaries. However, local governments have to shoulder 90 percent of the operating costs of education and health without a concurrent reallocation of fiscal authority. Thus, provinces tend to overstate their expenditures and underestimate their revenues to claim larger transfers from the national budget. In Quang Binh province, the provincial hospital receives orders directly from the Ministry of Health instead of the PHS. Thus, there are no incentives for this provincial hospital to serve the people and the support of district hospitals since its budget does not depend on the provincial budget. This 'abnormal' situation is not uncommon. Furthermore, provincial health statistics are not trustworthy because of the lack of good procedures for collecting and disseminating information, thus hampering corrective measures.[25]

Example 2 At the provincial level, power belongs to the provincial party apparatus. It is a parallel organization to the administration, from central to provincial and grassroots levels. Any decision has to be reviewed by the provincial party apparatus before being implemented by the local government structure.

This parallel structure is a point of dispute between the government and the party. PM Khai called for the reduction of the overlap between the government and party functions.[26] Those in the government structure resent intrusion and micro management from the party, which it claims rightly is not held responsible for its decision.[27] Those in the party feel neglected because they do not command a high status as in the past and do not control budget resources.

Vietnam has yet to solve the problem of how to reform an overlapping decision-making structure (see Thayer 1998:42) and, therefore, the efficient functioning of the economy until it can define a clear definition of the role of the party and government. Thus, the government has not been able to create a modern administration and CS because of resistance from party conservatives. What are the options for change?

3.4 Options for change

The main challenge for Vietnam is to find jobs for the 1.2 million people who will enter the workforce every year. By postponing the PAR and a further opening of the political system, Vietnam is postponing the emergence of institutional and political capacities that could help attract foreign investment and improve governance.

Institutional weaknesses and governance should be addressed in a sequenced way to create a clear role between the party and the state, and central and local authorities. Furthermore, the urgent need is for the advent of a professional CS to prepare and manage the public sector and institutional changes. A change in attitude within the CPV could accelerate institutional reforms.

3.4.1 Clear role between the government and the party and between central and local governments

Institutional reforms, such as efforts to establish the rule of law, the strengthening of the NA, and the introduction of a CS system, are meaningless without a clear definition of the role of the CPV and its relation to the government. How can the rule of law be established when the CPV can intervene at will in the judiciary system? How can the NA be strengthened when the CPV (or the Fatherland Front) selects candidates for the NA election? How can PAR be effective when local party committees continue to maintain their authorities over the local governments?

The CPV controls the government through key personnel appointments, the propaganda machinery, the army and the security apparatus. The NPAR document focused on the following:

- to establish the relationship between the CPV and the state machinery;
- identification of principles and directions for addressing the relationships between the central Government and local authorities.

This parallel structure in the present state organization is a point of dispute between the government and the party. Former PM Kiet and PM Khai called for the reduction of the overlap between the government and party functions and according to former PM Kiet, party and state functions need to work within a 'state governed by law'.

The current challenge is to define a workable consensus on the relationship between the state and the party. In Vietnam, the secretary general of the CPV is neither the head of the executive nor the head of the state. Policy implementation is given to the PM, head of the government, without the full power of cabinet selection. Thus the problem of overlapping responsibilities, micro management and controls exist at each step. This organizational structure caused the parallel chain of command and an additional burden to the budget. In other countries, the head of the majority party is in charge of the country's affairs, narrowing the gap between policy making and policy implementation. In China, the secretary general of the communist party of China (CPC) is also the head of state. This system reduces the problem of double control and micro management.

Under the principle of democratic centralism, debate is allowed in the CPV before a decision is made. Once a decision is reached, it is final. This principle allowed the politburo to manipulate and restrict discussion under the name of unanimity (see Dinh 2000). A move to a simple or two third majority with a secret ballot system, instead of unanimity in the politburo or the CC could break the impasse, improve the decision-making process and accelerate changes. This change could be possible through the NC process.

A change in the 1992 Constitution (art. 101 to 108) would improve the functioning of the state. The constitution should be amended to facilitate changes to the state apparatus. The main problem is clarifying the functions of the legislative, executive and judiciary bodies. It should allow the SG of the CPV to compete either for the position of head of state or head of government. Vietnam needs to introduce independence between the executive, legislative and judiciary and clear working rules and procedures between them.

Unclear vertical relationships (central-provincial administrative relationship) and horizontal relationships (the provincial assembly and local government) is another hurdle. The relationship could be improved with a change in the 1992 Constitution (art. 118 to 125). The 1992 Constitution introduced the 'cloning' of central institutions at provincial and district levels but it has yet to be supported by clear local administration and fiscal laws on decentralization.

3.4.2 Need for a professional civil service

At this juncture, only a severe crisis or a change in the balance of leadership in the CPV will open the gate for needed changes and allow the separation of the party and the state. This lack of openness in the institutional environment, the economic slowdown, recent corruption trials and growing rural disturbances due to abuse of power point to the urgent need for a professional CS. The government reiterated its willingness to continue the PAR process in its report to the NA in May 2000 (*Nhan Dan* 9 May 2000). A PAR master plan for 2001–10 was approved in September 2001 aimed at raising the effectiveness and efficiency of the state apparatus.[28]

There are signs of the CS not having the necessary competencies to implement government policies as witnessed by the low absorptive capacity and red tape. For example, only 6 percent of the Asian Development Bank (ADB)'s commitment was disbursed in 1996. In 1999, just 30 percent of the development assistance the ADB allocated to Vietnam was actually used and just 16 percent of the loans earmarked by the ADB were used within the year.

Because of the lack of transparent procedures in the administration, corruption extols a high cost and drives away foreign investors, and is the cause for rural riots. A professional CS with high technical competence, responsive to political leaders, and impartial toward all citizens may be the answer. It involves the development of institutions, practices and personnel procedures to reduce inefficiencies and overstaffing: budget procedures–allocation between current expenditures, investments–salary procedures, promotion, retrenchment, etc. which can carry government functions effectively within the rule of law.

There are various steps that could be taken immediately to ensure that governmental function is carried out effectively and successfully. There are two main models of CS:

1. Centralized CS with some degree of decentralization such as in France, Germany, Japan, South Korea and the Netherlands. Usually there are three entities: policy guidance organ, oversight agency that ensures fair and meritocratic practices, and financial control cum monitoring agency. Key organs could be made responsible to political authority, as in the case of the Japanese CS Management Coordination Agency which is under the PM. Centralized systems could delegate selected functions to deconcentrated levels. This system ensures a high level of coordination and relies on staff audits to impose government employment ceilings.
2. Countries such as the UK, Australia, Sweden, etc. are developing a new model of decentralized CS management. Policy guidelines are to be worked out at the center while autonomy is left to line managers. This model requires good personnel management skills all along the line and uses cost control as determinants of optimal staffing levels.

Vietnam can learn, select and use the CS model or a combination of CS models it wishes. To improve its capacity to attract foreign investments, CS reform and institutional reform programs must be designed to improve selected institutions such as MPI, MOF, GCOP and Ministry of Agriculture and Rural Development.

Recruitment in the CS must be based on merit and promotion on competence. National entrance exams to the CS and to NIPA should be open to all and this would be the first step in allowing the government to select talent among a broad base pool of talent. A senior executive CS or its variant could be a second step in the staffing of the senior management level (see Oszlak and Gantman 1993). A large training and upgrading program for middle and low level civil servant is an another step. The main criteria for the CS should be expertise/competency based on a broad, open and nation wide selection.

The current administrative system in Vietnam remains highly authoritarian and the challenge is adjustment to the regional governance standards of public management.

4 Conclusion

With *Doi Moi,* Vietnam built a new legal and regulatory framework for a market economy with socialist orientation. It covers both administrative and political structures including a PAR program and CS reform. The new 1992 Constitution, the new role of the NA and reliance on limited elections were a few political changes. They are signs of the growing emphasis on legal legitimacy.

During the *Doi Moi,* government organizational structures and processes have been rationalized and improved. The PAR follows an incremental and pragmatic reform strategy due to fractured political leadership and competing interests. The on-going wave of PAR aiming at improving the functioning and changes of state institutions' functions, especially, a clear distinction between the government and the party is stalled. Thus, the PAR is reduced to procedural and retrenchment activities with limited scope and impact.

The present wave of PAR has allowed the justification of the market economy with socialist orientation and the role of the CPV within the rule of law. A master plan for PAR for 2001–10 was put into place in September 2001. However, this task is still unfinished since its most important challenge–the role of the state and the party–has not yet found a workable solution and the building of a professional CS is still a long-term goal.

Vietnam is committed to developing a market economy, opening up its economy and integrating into the regional and global economy. However, the government is reluctant to embrace meaningful institutional reform as Vietnam's economy continues to stagnate. Indecision in addressing economic and institutional reforms sends a negative message to foreign investors.

It would be unrealistic to assume that Vietnam could shake its socialist baggage and make the transition to the market in a decade. The consensus is that there should be no backpedaling on reforms. Vietnam is in a position of a cyclist who will fall off if he does not continue to pedal (see Morey 1996). Successful PA reform will likely take a long time to accomplish. It would involve the revision of the 1992 Constitution to clarify the relationship between the role of the government and the CPV and between central and local government. Main ingredients for success are:

- the existence of a competent CS;
- good regulations; and
- a clear relationship between the government and the party.

The party should not fear the creation of a professional CS, which will help implement government policies. A clear division of labor between the party and the government, a clear relationship between central and local governments, and between local government and local assembly should be the next priority of the PAR reform. A quarter of a century after the reunification of the country, the challenge is to further reform the PA system to bring Vietnam to the international standard of governance, transparency and accountability.

Notes

1 The Ministry of Invalids and Social Affairs (MOLISA) defines poverty as a person having a monthly income of 55,000 dong (or US$3.9) for people living in mountainous areas, 70,000 dong (US$5) for rural areas and 90,000 dong (US$6.4) for urban areas. This is lower than the World Bank definition of poverty at US$1 per day per person.

2 The anti-corruption campaign has resulted in the dismissal of a deputy prime minister, two members of the National Assembly, the expulsion of 492 party members and disciplining of about 3,124 others.

3 According to the Central Overseas Vietnamese Committee in Hanoi, *Viet Kieu* (overseas Vietnamese) injected an estimated US$1.1 billion into the Vietnarnese economy in 1999. It is estimated that for each dollar sent through official channels, two dollars were sent through unofficial channels. This is bigger than ODA and FDI combined in 1999.

4 For example, focusing on the cement and sugar sectors, Ohno and Sugiyama (1999) show that SOEs are not competitive.

5 According to Minister of Planning and Investment (MPI) (*Vietnam News* 15 May 2000):

> The discriminatory attitudes of state cadres of all levels towards the non-state sector have long existed and have been ingrained in their minds. Heavily driven by the spirit of a centrally planned economy, SOEs and a number of administrative organs have been looking down on private counterparts and imposed a myriad of obstacles on-their operations.

6 For discussions of the NA on the state of the economy and the budget see *Vietnam News* online, 15 May 2000.

7 The Government Committee for Organization and Personnel (GCOP) is the equivalent of the CS or the equivalent of the Ministry of Interior in French speaking countries. It manages the CS personnel, organization, local government and human resource training. It is in charge of organization, personnel and reorganization of the state structure at national, provincial and local levels. GCOP is a creation of *Doi Moi.* Before *Doi Moi,* it was a small unit depending on the council of ministers (Government Office).
8 In the reorganization of the government apparatus, the number of ministries has been reduced from 49 to 22. Many ministries have been eliminated, reduced or absorbed by others.
9 Illegal land deals were at the heart of the Tamexco and Minh Phung-Epco cases. The Tamexco–Minh Phung–Epco corruption scandals show the collusion between SOE managers, party members and SOCBs to use public money for personal benefit, resulting in a loss of over US$60 million of public funds. Many perpetrators were sentenced to death.
10 The third plenum of the ninth NC held in Hanoi in August 2001 stressed the decisive role played by the state economic sector in maintaining the country's socialist orientation (see *Voice of Vietnam* website, 27 September 2001).
11 Vietnam's strategy for equitizing and reforming its SOEs was recently presented. The plan, which was developed by the Central Enterprises Management's Reform Committee, will be based on debt management, competitiveness and staffing. New SOEs would be largely limited to the fields of security, defense or monopoly situations. Equitization policy will be in accordance with the Enterprise Law. Among the 3,200 enterprises to be restructured in the next 5 years, more than 2,000 will be equitized and the rest will apply other means of ownership transfer such as mergers, dissolution, selling and leasing (see *Vietnam News Agency* 9 August 2001).
12 Personal observations by the author based on a pilot PA project in Ninh Binh (see GCOP 1997b). A typical PA school in Ninh Binh has two sections: political and PA. It has eighteen faculty members with MAs and BAs in five areas: philosophy, political economy, history of the party, organization and state management. The annual budget is 588 million dong (US$45,000) of which 358 million dong are allocated to current expenses and 230 million dong to training. It has four classrooms, a library and facilities for 70–100 students. Commune staff receive a 3-week training program and the province pays US$0.5 day for each staff room and board. The curriculum is outdated and stresses political subjects over PA. It lacks legal, administrative, economics and personnel management subjects.
13 Personal observations by the author. A pilot PAR program was established in 1996 to test various public sector and personnel management tools and systems. Over eleven projects encompassing central agencies, local governments and urban authorities were the focus of the program that introduced CS exam, training and upgrading of PA school staff, computerization of personnel management, reduction of red tape, relation between provincial and district authorities through the implementation of the budget, updating of personnel, etc.
14 Training programs have been provided by various projects and at GCOP.
15 Resolution of the seventh plenum on 'issues relating to the organization and apparatus of the political system, wages and social allowances funded by the

state budget, and preparations for the upcoming ninth NC'. According to *Vietnam News,* five million workers in administrative bodies and SOEs were paid from the state budget, but up to 30 percent were unqualified for their jobs. Vietnam aims to cut back its vast public-sector workforce by 15 percent by the end of 2002 by banning new recruitment, implementing early retirement and outsourcing. The government had adopted new policies on allowances, insurance and retraining to facilitate the reforms and to ensure the rights of those facing retrenchment.

16 According to Vietnamese regulations, each retiree receives 1 month salary for each year of service. The government wants to use the savings from the retrenchment exercise to increase the basic salary scale for state employees from the present US$11 per month to US$14 per month.

17 To organize the colloquium on PA, the GCOP needed the green light from the Office of the Government and party authorities (see GCOP 1996).

18 This is a personal observation by the author. Administrative judges are trained through a 3-month course; civil servants are updated through 1-week to 2-month courses, etc. At NIPA, there is a 2-year MA program. However, civil servants considered for promotion have to go through the Ho Chi Minh Political Institute.

19 During a debate at the NA, a delegate (Nguyen Van Tho) criticized the minister of GCOP on salaries and entrance examinations. According to Mr. Nguyen, CS entrance examinations and retrenchment exercises are excuses for few people with decision-making authority to enrich themselves (see *Lao Dong* 30 May 2000).

20 The tendency for local governments to build oversized health centers, schools, hospitals, etc. is due to the fact that the current budget is a ratio of the number of beds, personnel, etc. Unless administrative procedures are revised and modernized, overstaffing and waste will continue.

21 For a number of years, staff in the CS came from demobilization of the military personnel. The number of personnel in the CS is not high (1.3 million) as such but often staff did not possess the necessary education, training background and skills to stay in the administrative sector. Thus, there is both a need for trained personnel and a surplus in other staff.

22 In Vietnam, there is no salary increase for good performance. Wage increase can be obtained through seniority increases or promotion. It takes two years for C and D civil servants to get a seniority increase and three years for A and B civil servants (see Nguyen 1997).

23 PM Phan Van Khai ordered the elimination of dozens of business licenses for firms which are regulated by the new Enterprise Law (see *Vietnam News* online 16 February 2001).

24 This is the story of a multimillion-dollar rice business joint venture between a US company and an SOE. It recounts problems and difficulties encountered by foreign and private companies in Vietnam (see Frank 2000).

25 These observations are from Project Vietnam–American Academy of Pediatrics, Chapter 4:

> When asked why there are discrepancies between child statistics on malnutrition in Quang Binh, local authorities responded by saying it would show bad results and reflect badly on them. Thus, although Quang Binh

had the highest incidence of malnutrition, it has the lowest concentration of government and international efforts concerning child malnutrition.

26 Unlike China, the secretary general of the CPV is not the head of the state or the head of the government. This system reduces the efficiency of the government decision-making process due to the parallel chain of command.
27 This became apparent during the author's work and discussions with party and government officials at different levels.
28 The master plan for PAR for the period 2001–10 was the result of the PAR pilot program. A PAR review was undertaken in 1999 and a government strat-egy for PAR for 2001–10 was prepared. After many drafts and discussion, the master plan was adopted in 2001. It covers five principal themes and tasks, namely: political orientation for PAR; institutional reform; organizational restructuring; human resource management; and development of public finance management.

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16 Environmental conditions and sustainable economic development in Vietnam in the decade leading to the new millennium

Hanh Van Nguyen

1 Introduction

Since 1989, the economic reforms in the Socialist Republic of Vietnam have brought encouraging results. The lifting of the US trade embargo in February 1994, followed by Vietnam's admission to the Association of Southeast Asian Nations (ASEAN) in July 1995, have expanded the country's opportunities to steady its course of economic growth. Building a better environmental foundation for future sustainable economic development remains a major challenge.

This paper will attempt to outline some serious environmental issues and present an approach to building environmental protection policy and measures for the long-term sustainability of economic development in Vietnam. Observations on recent economic progress have been presented in detail by other contributing authors of this volume. Additional remarks on the early years of economic reform can be found in other papers presented at the Second International Trade Conference, 2 August 1996, sponsored by the Assembly Select Committee on the Americas, California State Legislature (see Nguyen 1996). A preliminary version of this chapter was presented at the Viet-Tech International Conference, held at California State University in San Jose, by the Vietnamese Association for Computing, Engineering Technology and Science (VACEST) in July 1997.

Experiences of other nations, developed and developing alike, suggest that a successful approach to sustainable economic development can be pursued through effective policies and programs integrating environmental protection into economic development efforts. Recent gains in economic growth amidst environmental degradation in Vietnam point to the necessity of addressing the concerns for environmental quality and proper management of the natural resource base.

In a nutshell, the Vietnamese economy was in a deep crisis during 1975–89, experiencing widespread poverty, hunger, high unemployment and hyper-inflation (see Nguyen 1990). The environmental conditions also suffered serious degradation. The economic reforms (renovation or *Doi Moi*) undertaken since 1989 have successfully removed price controls, partially renovated the financial sector and the legal system, improved macroeconomic management and encouraged foreign investment. With a population of 80 million, approximately 80 percent of the people live in the countryside and the rest in growing urban centers. A traditional agrarian society, Vietnam has the potential for rapid industrialization and foreign trade, due mainly to its inexpensive labor supply and relative abundance of natural resources.

Remarkable changes have transformed the agricultural sector, which absorbs over 70 percent of the labor force. The country once again became self sufficient in food production and began exporting rice in 1989. Since then Vietnam has established itself as the third largest rice exporter, after the United States and Thailand. Over 3 million tons of rice have been exported annually during the past several years. Aquaculture (fish and shrimp farming) has also expanded vigorously. Increased coffee and rubber production, along with other agricultural commodities for exports, have become significant foreign exchange earners since the mid 1990s.

Vietnam has attracted more tourists, with over 1 million visitors arriving annually in recent years. Major attractions such as Halong Bay, Nhatrang, Dalat, the Mekong Delta, the Central Highlands have become better known among foreign visitors and the Vietnamese overseas, as the costs of local sightseeing trips have remained very competitive. The tourism and hospitality sector expanded steadily through mid 1997, experienced some temporary slowdown in response to the recent financial difficulties in the Asia–Pacific region, and has resumed its upward trend. Healthy growth in this sector is expected in the coming years, as Vietnam's investment and trade partners in Asia regain their economic strength, and the Vietnamese market becomes stronger. Recent local construction and infrastructure projects have also substantially improved hotel accommodation and the transportation systems.

Geographically, the country has over 2,000 miles of coastline including hundreds of miles of white sand beaches. Recent accounts from many American visitors to Vietnam suggest that any resentment from the war appears to have given way to building business and economic relations.

During 1991–6, the country managed to match the dynamic growth rates in the ASEAN countries, and surpassed the Philippines and Indonesia in economic growth. The passage of the 1987 Foreign Investment Law, with subsequent amendments, has been viewed as one of the cornerstones of the economic reforms. Foreign investment continues to grow, and has further increased after the lifting of the US trade embargo. Most important to the local economy, perhaps, is the fact that expansion of trade activities has encouraged rapid absorption of unemployed labor.

The lifting of the trade embargo in 1994 was a new starting point for the local economy. Since the establishment of full diplomatic relations with the US in August 1995, foreign trade has become an issue of significant interest to both countries, although the US has not been among the top investors. Most significant capital inflow has come from Hong Kong, Japan, Singapore, South Korea, Malaysia, Australia, the US, France and Switzerland. The US invested about US$980 million in 57 projects in 1998, and ranked 10th among key foreign investors. Overall, US businesses seem to enjoy a positive reception in Vietnam.

The US–Vietnam bilateral trade agreement signed on 13 July 2000 is expected to become a milestone for a higher level of economic activities in Vietnam. More American firms are expected to explore trade opportunities in the new market, in competition with other well-established transnational corporations. The drive for trade and economic expansion will benefit Vietnam substantially. However, unless properly planned and managed, expanded export activities can create costly environmental problems.

Although progress has been significant since 1989, the economic turnaround in Vietnam remains tenuous. The country continues to face deep poverty, especially in the countryside. Many other chronic problems persist: high unemployment (see Dodsworth *et al.* 1996:9), widespread malnutrition and diseases among children, a continuous migration to urban areas, outdated legal system, bureaucratic inefficiency and corruption.

In particular, environmental degradation has become a major concern in need of solution (see Nguyen 1997). The long-term effects of Agent Orange on the environment and the local people have not been fully documented and shared in a public forum since the war ended in 1975. The pervasive poverty affecting Vietnam is further exacerbated by the increasing disparity in income distribution. Recent economic progress has benefited mostly urban areas, leaving the much larger rural sector in subsistence living conditions. Income per capita in Ho Chi Minh (HCM) City was estimated at about US$800 per annum in 1995, compared to the average of about US$220 for the entire nation.[1] More recent estimates bring the annual GDP per capita figures closer to the US$300–320 range, reflecting a noticeable progress in the past few years. However, with an average income less than US$1 a day, a typical Vietnamese continues to struggle to meet basic needs, even after a full decade of economic reform.

For Vietnam, the tradeable sector, supported by foreign direct investment (FDI), has effectively served as the engine of economic growth, but also presents a potential source of environmental degradation. Vietnam exports primarily crude oil, rice, coffee, other agricultural and marine products, coal, textiles and garments. With most of the export commodities (crude oil and agricultural products) derived from natural resources and the labor force, environmental conditions play a key role. Currently hazardous industrial discharges, urban decay and over-exploitation of natural resources all present serious health problems and very precarious working conditions for the poor. Sustainable development and long-term growth of the economy calls for a proper response to these widespread environmental problems.

2 General environmental conditions

Economic activities and population growth in the past decades have impacted the environment in large measures. Abject poverty, continuing population pressure, toxic industrial effluents, uncontrolled and excessive use of hazardous pesticides, unsustainable aquaculture and logging practices have eroded the natural resource base and aggravated the environmental problems throughout the country.

Hanoi, Haiphong, Viettri, HCM City and other swelling urban areas are now facing major environmental problems with water contamination, air pollution, industrial discharges, municipal wastes and urban decay. Concentrations of nitrous oxides, sulfurous and chloric acids, benzene and heavy metals have risen steadily in untreated releases from outdated and poorly maintained equipment in hundreds of industrial plants. More carbon monoxide, volatile organic compounds, NO_x, SO_x, particulate matters, mercury and lead have polluted the air in congested urban centers. Leaded gasoline used in transportation has contributed significantly to air pollution. Widespread water-borne diseases, toxic chemicals and air pollutants have become major public health concerns (see World Bank 1993 and O'Rourke 1995).

Widespread damage to natural resources and fragile ecosystems continues unabated due to the constant struggle for survival by the majority of the population. In the absence of adequate public education to encourage environmentally benign agricultural practices, a vicious circle of deep poverty has been perpetuated. Low income in most areas is exacerbated by high population growth, poor health, unemployment and overexploitation of natural resources, leading to increased loss of biodiversity and further environmental degradation of many ecosystems at risk.

Natural resources in the Red River Delta in the North have become generally degraded as a result of domestic wastes, mining, reduced soil fertility and contaminated drinking water. Demand for fuel wood and crop expansion onto the hillsides in the northern provinces and the central highlands have aggravated deforestation and soil erosion. The national forest area has lost some 350,000 ha annually to deforestation in the past 25 years, shrinking from 40 percent to 25 percent of the total area of the nation (see World Bank 1993).

The devastating annual floods during 1994–6 and 2000 in the Mekong Delta, especially in the regions bordering Cambodia, the Tiengiang River, and Dong Thap Muoi came as a result of severe deforestation and sedimentation upstream in Thailand, Laos and Cambodia. More frequent and severe runoffs caused by soil erosion were intensified by uncoordinated diking in the lower catchment areas and the lowland paddy fields.

Uncontrolled use of pesticides and chemical fertilizers has been on the rise as more farmers engage in rice crops for exports. Excessive and frequent use of chemical pesticide sprayings to control insects, especially the brown planthopper in the Mekong Delta, has left high levels of toxic chemical residues harmful to natural predators, other organisms and humans. Integrated pest management techniques have not been efficiently adopted by local farmers. Contamination by chemical residues was blamed for repeated losses in shrimp farming since 1994.

Unsustainable practices in aquaculture have significantly reduced the wetland forest areas in the Mekong Delta. Over half of the mangrove forests in Minhhai Province have been destroyed by uncontrolled shrimp farming since 1982. Leaving behind highly acidic and unproductive ponds, these practices alone have created a severe opportunity cost that the impacted communities can hardly absorb (see World Bank 1995). With much of the wetland ecosystems becoming severely at risk, urgent policy measures need to be put in place to address the critical situation, before the valuable services of the natural wetlands are lost forever.

As agricultural commodities comprise a large portion of exports from Vietnam, proper remediation, maintenance and improvement of the natural resource base should be a high priority in the continuing national economic reform policies. The fundamental difficulties in environmental management in Vietnam have been compounded by:

1 the lack of consistency in environmental parameters and coordination among institutions conducting environmental monitoring;
2 the inadequacy of environmental databases and the unavailability of electronic data storage and retrieval equipment;
3 the fragmentation of environmental laws, regulations, policies, guidelines and enforcement procedures; and
4 insufficient resources and trained personnel (see Weitzel 1994).

Noticeable national efforts, however, have been initiated in recent years to improve the environment. The Law on Environmental Protection, passed in January 1994, institutes the safeguards of the national environment, protects public health and promotes effective management of the environment. This legislation also established the Ministry of Science, Technology, and Environment (MOSTE) as the lead agency for central coordination and provided the direction for related decrees and directives (see United Nations Development Programme (UNDP) 1995). Still in their developmental stage are refined standards for industrial pollution emissions and effluent release, and procedures for Environmental Impact Assessment (EIA). Foreign joint ventures and large-scale projects are now required to submit an EIA report to the government. This requirement, however, remains largely pro forma at the present, due to limited budgetary resources and trained personnel in relation to the overwhelming regulatory and monitoring tasks of environmental safeguards nationwide.

During the past decade, international assistance programs have provided valuable assistance to help address some of the major environmental concerns. Reforestation projects by the UNDP have been noticeable in many areas throughout the country. As a major international agency, UNDP has financed and implemented a comprehensive environmental program in Vietnam. Also, the Master Plan for the Mekong Delta was completed in 1993 by the Netherlands Engineering and Development Consultants (NEDC). This significant effort was undertaken under a World Bank contract, in coordination with the local government, the Mekong Secretariat and UNDP (see NEDC 1993). The World Bank has conducted an environmental assessment nationwide and supported a training program for natural resource planners and decision-makers, in addition to several other major projects in finance and education (see World Bank 1995). In 1995, the Asian Development Bank financed an environmental improvement project for HCM City and the development of a national urban strategy. Some environmental management training for local professional staff was provided by Singapore.[2] Starting 1998, US assistance to Vietnam in environmental protection, through the US–Asia Environmental Partnership (US–AEP) program, has begun to connect the Vietnamese efforts to the Western world.

Remediation efforts and systematic integration of environmental safeguards into economic development activities should be a national priority, if sustainable growth is to be maintained in the years ahead. The agricultural sector, in particular, would benefit substantially from a systematic approach to mitigate environmental problems. Proper natural resources management guidelines should be established to support new endeavors in national economic development.

3 An approach to balanced economic growth and environment protection

As Vietnam embarks on the new millennium with expanded economic activities, the country will need to forge ahead with renewed economic reforms. Selective approaches to ensure environmental safety must be found to control hazardous industrial discharges, reduce air pollution and mitigate municipal waste problems in urban centers. Pollution from agricultural wastewater, deforestation, barren land expansion and shifting cultivation in the central and northern highlands, wetland destruction in the Mekong Delta and over-exploitation of marine resources in coastal regions all require mitigation measures. Additional financial resources and trained personnel need to be developed to undertake these major tasks. Promoting public education on environmental stewardship, increased direct participation in environmental remediation and development of employment opportunities for the local communities in the rural sector and the coastal ecosystems should receive high priority.

Short-term actions can be initiated to deal with pressing issues such as air and water contaminations, and hazardous waste disposal in urban centers, where public health problems remain a major concern. Longer-term solutions will be essential to address many interrelated problems in the integration of environmental protection into the economic decision making process. In the context of economic reforms, the integration efforts should involve industrial and agricultural investment evaluation, natural resource utilization, infrastructure upgrade, personnel training and public education as well as management and organizational reforms. Technology transfer and financing capability will be essential in most of the short- and long-term environmental programs in Vietnam to support the transition of its fledgling market economy towards a stronger foundation for sustainable economic development.

3.1 Policy requirements

The national endeavor to improve environmental quality requires appropriate policy and management reforms. If past experiences of other Asian nations (e.g. People's Republic of China, Taiwan, Thailand and the former USSR) are any guide, timely availability of sufficient resources and proper technologies will be essential for cost-effective environmental protection in Vietnam (see Taiwan 2000 Study 1989). Economic reform can and should go hand-in-hand with environmental protection, as suggested at the 1992 United Nations Conference on Environment and Development in Rio de Janeiro (see United Nations 1992).

The encouraging economic performance by Vietnam in the past decade can only be sustained if a proper balance between economic development and environmental protection is established and maintained. Such a balance begins with a national policy designed to foster environmental technology transfer, adequate investment in education and training and effective implementation. A coherent set of laws (starting with the existing Law on Environmental Protection), regulations and standards should be further refined and implemented. Adequate institutional capacity, enforcement and remediation are essential to uphold the national legislation. The fact that most factory managers throughout the country declined to invest in pollution control equipment, and many rice growers in the Mekong Delta continued to rely on excessive quantities of toxic chemical pesticides, means that new enforcement measures are called for to ensure proper implementation of regulations and standards (see O'Rourke 1995 and World Bank 1995). The tasks of developing and implementing environmental laws and regulations with built-in proper economic incentives require well-trained professionals, a streamlined organizational structure with modern management capability, supported partially by international assistance in institutional capacity building and information management technology.

The delicate balance in policy choices requires both regulatory and market-based measures. A proper mix of mechanisms for financial incentives (such as pollution reduction credit, tax exemption or reduction for pollution control equipment, loans and grants for environmental remediation and research projects) are key elements for policy considerations. Rigid punitive actions against polluters have often proven ineffective, so has the 'command-and-control' approach, as evident during the 1970s and early 1980s in the US. Practical trade-offs between regulatory enforcement and economic incentives, based on existing environmental conditions and economic potential would have a better chance of success in Vietnam at the present stage of economic development.

Efforts should be undertaken to initiate proper cost/effectiveness analysis and risk assessment for environmental programs. Considerations for new technologies, compliance with pollution standards, and market-based incentives for investors should be carefully weighed. These interdependent policy measures should be incorporated into project formulation, evaluation and the decision making process for major investment projects.

3.2 Management and training upgrade

Effective methods of environmental management need to be established. Training in modern technologies, proper natural resource management, costs and benefits of environmental protection activities and environmental impact assessment procedures for investment projects should take place in conjunction with management reform. A pilot international training program should be established in cooperation with some experienced international agencies to promote the development and management of priority environmental activities. Key program components can include assessment of specific environmental problems and needs, conducting short-term and medium-term training, identification of proper technologies and services for remedial actions, development of environmental databases, identifying financial resources for selected projects and promotion of international technology diffusion.

An example of a training program could be an intensive short-term class to upgrade the existing local technical capability for conducting EIA. The Environmental Management Systems (EMS), an effective approach newly developed in the US, and the series of International Organization of Standardization programs, such as ISO 14000, can serve as topics for training and technical assistance programs for improving cross-media pollution control. Research and development methodology for environmental remediation projects, natural resource management and micro enterprise financing (fashioned after the successful Grameen banking model being used in various low-income countries) deserve consideration for formulating an effective technical assistance program in Vietnam.

A well-designed training curriculum should also include public education on existing environmental problems and encouraging public participation in preventing further environmental degradation. For instance, training efforts can involve both men and women in local environmental issues, population control, sanitation and public health safety, community impacts on ecosystems at risk and environment-related small business in the rural sector. This interdisciplinary approach has the potential to break up the vicious circle of poverty by providing alternative income earning opportunities through sustainable economic development programs and promoting environmental stewardship through public education.

Community participation in the training program can be enhanced by financial assistance. A revolving fund for microenterprise lending to local borrowers for environment-related small businesses is recommended. This comprehensive solution to reduce environmental degradation has been successfully demonstrated in a number of developing nations, and supported by the 1994 International Conference on Population in Cairo (see Nebel and Wright 2000).

3.3 Technical programs for environmental quality improvement

In conjunction with the policy, management and training requirements suggested above, special technical programs should be established to address identified pollution problems, improve infrastructure and equipment for toxic waste management and pollution prevention in the growing number of Industrial Development Zones and the Export Processing Zones, as well as the outdated facilities of the state-owned enterprises throughout the country.

The larger rural sector would benefit much in the long run from new efforts to promote sustainable agriculture and shrimp farming practices, adopt integrated pest management techniques, modernize water resource management and mitigate wetland destruction. Over-harvesting of natural resources should be alleviated to avoid ‘the tragedy of the commons’, where uncontrolled access to public resources (such as coastal fisheries) often leads to depletion of natural resources beyond the carrying capacity of the ecosystems. Concurrent with the development and financing of environment-related small businesses, new efforts should be initiated to expand employment opportunities away from exploiting the natural resources base, such as training in new technologies (telecommunications, information management, etc.) to improve the existing foundation for future development of modern technologies. In essence, constant efforts should be made to coordinate and integrate the following activities into the on-going economic reform efforts:

- promoting international transfer of appropriate environmental technologies;
- upgrading institutional capability for planning, monitoring, and assessment of environmental impacts in the agricultural and industrial sectors;
- adopting sustainable agriculture and aquaculture practices;
- establishing an effective and transparent enforcement system with accountability;
- expanding employment opportunities and financial assistance to disadvantaged communities near fragile ecosystems;
- modernizing technical information management, establishing environmental databases, and improving applied research facilities.

3.4 International networking to facilitate technology transfer

More international and US firms are expected to explore new trade and investment opportunities in Vietnam as the bilateral trade agreement between the US and Vietnam took effect in December 2001. Also an increasing number of American universities continue to assess the educational and training needs in the new market. Additional technology transfer opportunities will emerge to benefit both the host country and US environmental corporations. Technical exchange programs, industrial equipment imports and foreign contracting firms in Vietnam will all engage in a higher level of economic activities generated by the comprehensive US–Vietnam trade pact. Timely preparations and adjustments in environmental protection measures will be vital to support new economic growth and long-term sustainable development.

Assistance in technology transfer can be built into the comprehensive training program discussed earlier. Through technology diffusion, both Vietnam and the US will stand to benefit from their improved economic relations. A number of Vietnamese American high-tech companies specializing in environmental engineering may also welcome the opportunities to engage in technology transfer to assist Vietnam in its transition to the free enterprise system in the long run. Through similar initiatives in international collaboration, the existing California Environmental Technology Partnership Program CA–AEP can participate in joint efforts with US–AEP to promote trade overseas and expand domestic employment. In addition to fostering international cooperation in mitigating global environmental difficulties, these collaborative endeavors can also effectively advance US leadership and assistance in Vietnam and Southeast Asia.

Global environmental technologies and trade opportunities can be accessed by the Vietnamese through bilateral and multilateral contacts with many international entities. A success story from South Korea in 1996 offers a good example. South Korea and Oklahoma established a partnership to address air pollution, improve environmental regulations in Korea and organize a network of Korean and Oklahoma businesses. About US$6.3 billion was allocated by the South Korean government for these purposes during 1996–2001. Through international networking efforts jointly sponsored by US–AEP program and the Council of State Governments, South Korea was able to establish this mutually beneficial partnership with the US (see Amstrong 1996). There are indications that the US–AEP program in Vietnam is moving in this direction (see US–AEP International Program 2000).

The California Environmental Protection Agency (CEPA) and the California Trade and Commerce Agency have jointly established the California–ASEAN Initiative in 1996 to assist Californian environmental companies and other corporations to identify business opportunities and to link up with trade and investment partners overseas (see CEPA 1996). This program has the potential to help improve regional environment conditions through technology transfer and capital inflow into many Asian countries, including Vietnam, and at the same time enhance US trade performance.

3.5 Financing environmental protection

Foreign and domestic investors in commercial facility and infrastructure development projects should be required to finance pollution control measures in a fair and equitable fashion. Both economic incentives and disincentives for effective pollution control should be part of the financial equation for consideration by policy makers and corporate managers alike. To improve environmental quality and protect public health, consideration should be given to the requirements of domestic and foreign factory owners and operators to establish and maintain adequate financial assurance mechanisms (enterprise fund, letter of credit, etc.) to pay for future damage from environmental accidents that may be caused by their operations.

Financial resources should be generated to support revolving funds needed for the training, microenterprise loan, ecotourism promotion, and other sustainable environmental and agricultural businesses. A comprehensive program to provide low-interest loans, loan guarantees, and grants should be established to provide financial incentives to larger environmental remediation and development programs. Equipment tax credits, as well as assistance in meeting permit requirements, should also be made available to companies engaging in environmental clean-up and ecosystem restoration.

In addition, financial resources for biodiversity conservation and preservation can be developed through the natural conservancy mechanism, a successful financing approach well known in the US. Public and private international entities can be approached for financial contribution to secure long-term land use rights for special areas or ecosystems in need of protection, with significant in-kind contribution and collaboration by the Vietnamese government.

As President Bill Clinton decided to visit Vietnam in mid November 2000, much attention is being focused on the new US–Vietnam economic relations. One would hope the dire needs for improved environmental protection for the Vietnamese people, who continue to suffer from the long-term effects of the war and now provide the labor for the American and other transnational corporations in the new market, received due attention from the US President during his historic trip. A significant training and assistance program from the US in sustainable economic and environmental development and other key areas will go very far in promoting the relationship between the US and the Vietnamese peoples.

4 Conclusion

While the general trend in economic performance since 1989 has been encouraging, the road to full economic development for Vietnam remains an arduous one. The national commitment to pursue economic reforms will necessitate sound policies and implementation measures to address critical environmental problems.

Long-term economic growth in Vietnam requires a national endeavor to integrate environmental protection activities into a sustainable economic development strategy. As a member of the ASEAN, and a partner in the international trade networks, the continuing expansion of foreign trade and investment in Vietnam presents an excellent opportunity to bring in modern technology essential to long-term economic growth and improvement of environmental quality. Continuing improvement of laws and regulatory requirements, establishing market-based incentives for pollution control, promotion of sustainable development of natural resources and rehabilitation of damaged ecosystems are all essential. Supported by innovative training and financial assistance programs from the international community, including the US, these efforts would be effective in a comprehensive approach to integrate environmental protection into sustainable economic development in Vietnam.

The outcome of these endeavors will depend on the soundness of the policy and program structure, compliance by domestic and foreign corporations being regulated and the willingness of the Vietnamese people to practice and support environmental protection. Public participation through education and training, management efficiency and availability of economic incentives will play a vital role in the effectiveness of the national endeavor in improving environmental conditions.

The challenge to integrate environmental safeguards into sustainable economic development in Vietnam should be of vital interest to the Vietnamese government and the international community. Proper responses to this challenge can bring lasting benefits both to the host country and the foreign assistance agencies. As the transition to a market economy is gaining momentum in Vietnam, timely efforts to balance sustainable economic development and environmental protection, in the long run, will minimize the extremely high costs of remediation in the future. The prospects for a polluted environment, shrinking natural resources, indepth poverty suffered by future generations in Vietnam and their negative impacts on the global environment should be of concern to all of us, as members of the world community.

Notes

1 Personal communication between Dr. Nguyen Xuan Oanh and the author in 1995. Dr. Nguyen Xuan Oanh, a PhD graduate in economics from Harvard University, was a minister in the South Vietnamese Government in 1975.

2 Personal communication between Mr Hoang Anh Tuan (Director of Department of Science, Technology and Environment in HCM City) and the author in January 1995.

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Part V

Poverty alleviation policy

17 Regional and rural-urban income disparities in the Vietnamese economy

Nguyen Manh Hung

1 Introduction

Over the last decade, the Vietnamese economy witnessed positive changes in building a market economy. During this transition, achievements in improving production efficiency, management and export have partly proved the flexible responses of all economic actors along the path of *Doi Moi* policy. That is the visible part of the iceberg. Below, attention should also be paid to the income distribution aspect of the economy, which is one of the major concerns of the economy besides the allocation of resources in production and consumption. This chapter will examine the problem of income disparities:

- among different regions of the country; and
- between urban and rural area for each region.

At the outset, I would like to say that the primary objective of this chapter is to provide a benchmark for comparison between the periods before and after the implementation of *Doi Moi* policy when Vietnam underwent a structural change from a command to a free market economy. Comparison of this sort will be comprehensive provided we select a cross-section of data corresponding to the two types of economic management. *Doi Moi* policy orientation took place in 1986 after the sixth congress of the Communist Party of Vietnam. In 1984 the Vietnamese economy was a centrally planned system operated with quantitative quotas; and certainly, it is still a long way from a market economy. It is a transitory economy, and it is interesting to define a reference date during this period for setting a comparison benchmark. I will thus focus on the 1990–4 period and analyze in some detail the 1993 data. The choice of the 1990–4 period, which is distant enough from 1986, aims at avoiding the temporary shocks usually encountered in the first few years of a new economic policy.

Before proceeding, I wish to make it clear that this analysis in no way implies that income disparities examined here are the outcomes of *Doi Moi* policy. In fact, they were a legacy of the past, determined by geographical and historical factors. Section 2 will recall some useful preliminary remarks on income distribution aspects deemed appropriate for a developing economy which adopts a market-based organization. Section 3 provides a quantitative appraisal of income disparity by region, and then income disparity between the urban and rural areas in each region in Vietnam. Section 4 gives some perspectives capturing the possible evolution of the aforementioned disparities in the present context of globalization of the world economy. Section 5, the conclusion, will summarize the major findings of the chapter, and emphasize that an ideal policy for the economic development of Vietnam should at the same time aim at reducing the rich-poor gap in society.

2 On income disparity problem for a developing economy in transition

Economics over the last three decades has formulated many models addressing various aspects of resource allocation in production and consumption, but paying rather inadequate attention to the problem of income distribution. According to the neoclassical school, the distribution problem is somehow reduced to the determination of the factor prices under perfect competition, namely labor wages and capital rents that equal the respective values of their marginal productivity. Income of the factor-owner depends on these factor prices, thus so is the income distribution, which is entirely determined by the market mechanism.

Does this pricing system potentially cause an unsatisfactory income disparity in society? In a competitive market economy, with all commodities and production factors perfectly mobile, market prices only reflect economic efficiency. This price system does not ensure any social concerns such as fairness, dignity, security or solidarity among members of a society. Therefore, as observed in almost all economies, government policies are often called for complementing the market whenever the latter does not fulfill non-market functions. A policy of redistribution of income may aim at setting up social support for the functioning of the market system by eliminating social unrest, violence and violation of law and order.

Recognizing the following violations of neoclassical theoretical premises in the context at hand might convince readers that the problem of income distribution and income disparity cannot be disentangled by the market mechanism. First, the assumption of perfect competition would not hold for a developing economy. In the transition toward a market-based organization, competition is an imperfect competition with a few emerging groups of capital owners. The market for labor, not yet well organized, is archaically operated with a wage spectrum for the same job and the same qualification. Second, production in this economy, often being agrarian, is still in the phase where basic factors such as soil and climate are quite important. Obviously they are immobile, thus preventing the competitive pricing mechanism to work. Third, the mobility of capital and labor incurs some transaction costs. These costs, including the bribes paid for corruption, can be quite substantial for both individuals and the society as a whole. Finally, labor mobility between regions depends on many factors, not just job search in expectation of higher income. Schools, hospitals, etc. are the public goods that affect these decisions. The sedentary character of traditional societies, a well-known cultural factor that impedes population movement, also prevails.

It is difficult to satisfactorily define an optimal income distribution. Optimality here is not simply a distribution system that is either compatible with, or created from, an efficient production system. The concept of optimality from a social standpoint requires an appropriate combination of economic efficiency and other social norms regarding justice, fairness, fraternity and solidarity. In this respect, economics does not yet help much. For this reason, perhaps the first step is to lay out the factual evidence.

In the following, I will pay special attention to inter-regional income distribution, and to rural-urban income disparity. These issues are crucial from the point of view of stability and national security, without a minimum of which the prospect for an economy to develop and to modernize would be ruined. In many developing countries, the regional income disparity usually reflects geographical distributions of natural resources, the level of development of each region and the economic integration amongst regions. If this disparity is negligible, stability can be sustained. However, once this disparity reaches a 'critical' level, economic interest conflicts between regions are inevitable. These conflicts may lead to clashes, and even to secession when irreconcilable. The recent history of mankind gives many examples of this possibility, especially in Africa over the last 20 years. The explanation of such dramatic events usually refers to ethnicity and cultural factor as reasons for clashes. Nonetheless, income disparity is, I believe, a very important cause. If the latter is compounded by an external push, often from a foreign economic power with an eye on some valuable resources (e.g. diamonds in Sierra Leone or gold in Congo), the likelihood of translating clashes into riots and secession is all in all very considerable.

The rural-urban income disparity is encountered dramatically in a backward economy. Rural areas therein are characterized by widespread agricultural activities. Over the past decades, the world prices for primary commodities (agricultural, forest products, raw materials, etc.) have declined relative to manufactured commodities. And since industries are located in cities or their vicinity, it is urban dwellers who benefit from this change in relative price, therefore the income of the urban population has increased as compared to the income of its rural counterpart. In addition, capital-intensive technological progress in agriculture induces a lower demand for agricultural labor. The resulting labor excess supply would inevitably exert a negative impact on the rural income. Moreover, with the development of the service sector, which is also mainly located in cities, the rural–urban income disparity is further exacerbated.

Even in advanced economies, this trend also takes place. Agricultural production usually benefits from government subsidies in order to survive (see Vu 1997:77–127). The share of agriculture in the gross national products (GNP) of the advanced countries is between 10 to 15 percent, while its share of the labor force is about 8 to 10 percent. In Vietnam, 80 percent of the population is now working in the agricultural sector. The contribution of agriculture to GNP was 38.6 percent in 1990 and 29.4 percent in 1995. With these figures, it is difficult to see how to protect an agricultural sector which consumes considerable resources and is too labor-intensive to produce products whose prices were continuously declining over the past few decades. Given extremely scarce resources in a backward economy, the outlook for the impact such protection would have on reducing rural income disparities does not seem realistic. Yet the relative erosion of rural living standards always results in land disputes. An analysis by Kolko (1997) based on World Bank statistics indicates that between 1988 and 1990, there were about 200,000 complaints on land use and land ownership. Between 1988 and 1992, there were 2,600 land disputes. Among these disputes, 11 percent were qualified very serious (violent), 49 percent were serious (with some violence) and only 40 percent were described as moderate. The state of rural unrest, such as the peasant protests in Thai Binh province, is to some extent an alarming situation.

3 Appraising the income distribution and disparity in Vietnam

The appraisal of income distribution is established for different regions in Vietnam. Figures on income disparity will be reconsidered in view of the regional provision of public goods, such as access to healthcare and education services. Finally, the rural-urban income disparity, which is identified as the rich-poor gap, will be discussed.

3.1 Regional income disparity

Data used in the present analysis are all taken from the important work of Vu (1997) and the 1994 Statistical Yearbook published by the General Statistical Office of Vietnam. Using the average per capita income in Vu (1997:50 and 178) and the 1994 Statistical Yearbook, we can come up with the per capita GDP in 1993 for each of the seven following regions:

Region 1: Northern highlands
Region 2: Red River Delta (including Hanoi, Hai Phong, Nam Dinh, etc.)

Region 3: North Central
Region 4: Central Coastal
Region 5: Central Highlands
Region 6: Southeast (including Ho Chi Minh City, Gia Dinh, Bien Hoa, Vung Tau, etc.)
Region 7: Mekong River Delta

The data compilation is summarized in Table 17.1. From Table 17.1 we can establish the income distribution given in Table 17.2.

From Table 17.2 one can see that:

- Region 6, including the Southeast and especially Ho Chi Minh City, accounts for 12.5 percent of the country's population in 1993 and 30 percent of the total income, thus raises the average per capita income to 1,949,000 dong. This region has the highest per capita income; the second highest is region 7, with per capita income approximately equal to the national average.

Table 17.1 Per capita income distribution by region, 1993

Region	*Per capita income (thousand dong)*	*Urban population (million people)*	*Rural population (million people)*	*Rural/urban income ratio*
1	1,258	1,576.5	10,532.8	0.16
2	1,811	2,385.6	11,429.2	0.15
3	1,215	936.2	8,580.7	0.17
4	1,444	1,704.9	5,669.8	0.32
5	1,364	671.5	2,232.0	0.43
6	4,524	4,008.1	4,684.8	0.18
7	1,818	2,364.5	13,167.1	0.36
Vietnam	**1,949**	**13,647.3**	**56,296.4**	**0.20**

Sources: Vu (1997:50 and 178) and General Statistical Office (1994).

Table 17.2 Income distribution by region, 1993

Region	*Income (% of total)*	*Cumulative income (cumulative %)*	*Population (% of total)*	*Cumulative population (cumulative %)*
3	8.62	8.62	14.5	14.5
1	11.43	20.06	17.2	31.7
5	2.95	23.01	4.3	36.0
4	7.94	30.95	10.4	46.4
2	18.64	49.59	19.5	65.9
7	21.04	70.63	21.9	87.8
6	29.31	100.00	12.3	100.0

Sources: see Table 17.1.

- Between the years 1990 and 1994, regions 1, 3, 4 and 5 are the poorest as compared to other regions. Region 2 is the only one that experienced a slight increase in income compared to the national average, which is nearly equal to the per capita income level of region 7. These two regions 2 and 7 contribute very little to the income disparity pattern of the country. Region 6 is the single rich region, with a per capita income more than twice the national average.
- Regions 4 and 5 collectively account for 14.4 percent of the total population and 11 percent of the country's GDP. Regions 3 and 4 are the poorest, with the lowest per capita income. While they account for 30.47 percent of the total population, their share in the country's GDP is only 20 percent, being lower than the GDP share of the Mekong River Delta, which accounts for less than 22 percent of the total population.

Data on income disparity in 1993 reflects the regional income distribution as a historical legacy of years ago. This historical factor might be a result of the uneven distribution of natural resources in agriculture, which is the major source of income disparity among most regions. The Mekong River Delta (region 7) has always been the fertile area. The Northern Highlands (region 1) and the North Central (region 3), on the other hand, all have much less land and less favorable conditions for current cultivation practices. The rapid urbanization, especially in Ho Chi Minh City, Hanoi, Hai Phong and Da Nang, is a cause for concern. This matter will be elaborated on in the next section.

Income disparity only reflects purchasing power, and not adequately either consumption or living standards. In regions dominated by rural activities, the so-called 'family economy' is fairly common in Vietnam. The government encourages family-scale cultivation, which basically serves for self-provision. This thus helps raising consumption over income. On the other hand, consumption does not fully reflect living standards, which includes consumption of public goods such as healthcare and education that are often publicly provided free of charge. To capture their impact, the disparity in the public provision of healthcare and education services among regions in 1993 is shown in Tables 17.3 and 17.4. Table 17.3 presents data for healthcare drawn from the 1994 Statistical Year-book.

It can be seen in Table 17.3 that the numbers of medical doctors, doctor's assistants, nurses and midwives in regions 2 and 6 are higher than the respective national averages. The number of hospitals is the highest in region 5, followed by region 6. In rural areas, the numbers of healthcare centers and doctor's assistants per thousand inhabitants in regions 4 and 7 are very low. Except for the highly urbanized regions 2 and 6, it should be noted that healthcare services are distributed relatively evenly. But regions 2 and 6 account for a major part of the income disparity. Therefore, the

Table 17.3 Healthcare services by region in 1993 (number per thousand inhabitants)

Region	*Doctor*	*Doctor's assistant*	*Nurse*	*Midwife*	*Hospital*	*Healthcare center*
1	0.33	0.76	0.58	0.13	1.26	1.23
2	0.38	0.60	0.61	0.18	1.33	1.08
3	0.26	0.70	0.51	0.19	1.28	1.65
4	0.29	0.75	0.54	0.16	1.60	0.79
5	0.29	0.70	0.47	0.13	2.10	1.12
6	0.43	0.84	0.75	0.23	1.79	0.35
7	0.23	0.71	0.42	0.17	0.96	0.50
Vietnam	**0.31**	**0.80**	**0.55**	**0.16**	**1.63**	**1.20**

Source: General Statistical Office (1994).

Table 17.4 Education services by region, 1993 (per thousand inhabitants)

Region	*Primary and secondary education*			*Tertiary education*
	No. of classes	*No. of teachers*	*No. of students*	*No. of students*
1	6.31	7.41	0.193	9.72
2	5.40	6.86	0.209	34.10
3	5.96	6.95	0.206	11.00
4	5.45	6.27	0.194	12.00
5	6.55	6.49	0.202	12.14
6	4.58	8.35	0.175	39.40
7	5.24	5.44	0.184	4.48
Vietnam	**5.55**	**6.38**	**0.194**	**17.57**

Source: General Statistical Office (1994).

regional distribution of healthcare services does not help to alleviate the regional disparity.

Table 17.4 presents data for education. According to this table, while college and university students concentrate mainly in regions 6 and 7 (Hanoi and Ho Chi Minh City, respectively), primary and secondary school students are distributed relatively evenly across regions. In regions 1 and 5, the numbers of primary and secondary classes and teachers per thousand inhabitants are the highest, perhaps because of their highland geographical characteristics that scatter their inhabitants. Though education services do not reduce the disparity, they are evenly distributed on the per capita basis and do not have any significantly negative impact on the regional disparity under consideration.

3.2 Urban–rural income disparity

As mentioned earlier, the regional income disparity together with the urbanization that took place over the last two decades have largely contributed to create a serious problem. The urban-rural gap in per capita income is continuously widened, enhancing therefore the movement of population toward urban areas. Based on the data given in Table 17.1, we can compute the average per capita income for each region respectively for urban and rural areas, and present a picture of urban-rural income disparity in Tables 17.5 and 17.6. Here the rich-poor gap between the urban and rural area is obvious.

Based on the data mentioned above, we can draw the Lorenz diagram given in Figure 17.1. From these data, one can see that:

Table 17.5 Urban and rural income by region, 1993

Region	*Total income (million dong)*	*Rural per capita income (thousand dong)*	*Total rural income (million dong)*	*Urban per capita income (thousand dong)*	*Total urban income (million dong)*
1	15,233,533	747.25	7,870,700	4,670.35	7,363,807
2	25,008,100	915.00	10,452,777	6,100.00	14,552,160
3	11,563,155	820.80	7,043,039	4,828.04	4,519,973
4	10,649,066	968.30	5,490,261	3,025.80	5,158,989
5	3,960,374	1,044.00	2,330,208	2,427.80	1,630,268
6	39,327,132	1,459.20	6,836,060	8,106.40	32,491,261
7	28,236,450	1,430.10	18,830,126	3,972.50	9,392,976

Source: General Statistical Office (1994).

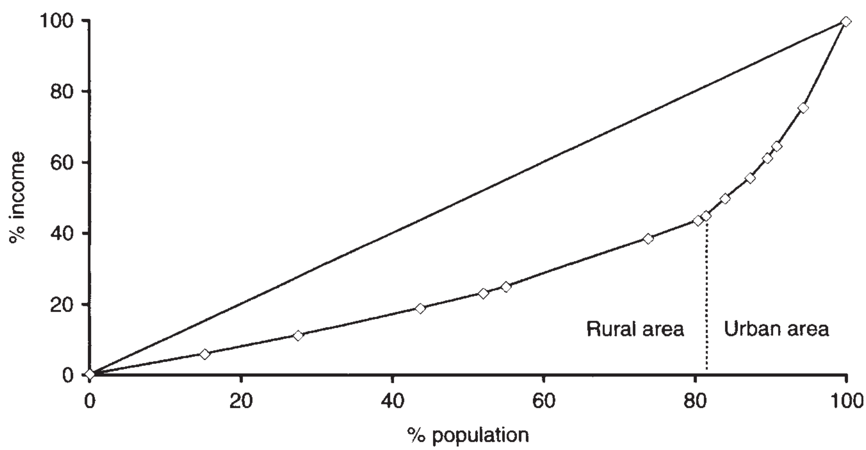

Figure 17.1 Urban–rural income disparity in Vietnam, 1993

Sources: see Tables 17.5 and 17.6.

Table 17.6 Urban and rural per capita income by region, 1993

Per capita income (thousand dong)	*Total income (billion dong)*	*Population* (million)*	*Income (% of total income)*	*Cumulative income (%)*	*Population (% of total population)*	*Cumulative population (%)*
Rural	*58,853.2*					
748.25	7,870.7	10.533	5.88	5.88	15.06	15.06
820.8	7,043.4	8.580	5.25	11.13	12.27	27.33
915.0	10,452.8	11.429	7.80	18.93	16.34	43.67
968.3	5,490.3	5.670	4.10	23.03	8.11	51.78
1,044.0	2,330.2	2.232	1.74	24.77	3.19	54.97
1,430.1	18,830.1	13.167	14.05	38.81	18.83	73.80
1,459.2	6,836.1	4.685	5.10	43.92	6.70	80.50
Urban	*75,109.4*					
2,427.8	1,630.3	0.671	1.21	45.13	0.96	81.96
3,025.8	5,159.0	1.705	3.85	49.98	2.44	83.90
3,972.5	9,393.0	2.365	7.02	56.00	3.38	87.28
4,670.3	7,362.8	1.576	5.50	61.50	2.25	89.53
4,828.0	4,520.0	0.936	3.37	64.87	1.34	90.87
6,100.0	14,552.2	2.386	10.87	75.74	3.41	94.37
8,106.4	32,491.1	4.008	24.25	100.00	5.73	100.00
Vietnam	*133,961.6*	*69.944*				

Source: General Statistical Office (1994).

Note

* The urban and rural populations are the numbers of registered residents based on the *1994 Statistical Yearbook*.

- Rural areas account for 80 percent of the population, but only 44 percent of the total national income. In contrast, urban areas account for 20 percent of the population, but share 56 percent of the total national income.
- On average, the urban population in regions 2 and 6 accounts for 9.14 percent of the country's population, with the income of 47,043.5 trillion dong or 35.12 percent of the country's total income. The rural population in region 1 is the poorest. With the same population, their income is only approximately 4,778 trillion dong, which amounts to 10.15 percent of the urban population income in regions 2 and 6.
- The rich-poor per capita income ratio, based on the official data, is estimated to be around 10. According to Tran (1997:233), this ratio is higher than those of the Philippines, South Korea, Taiwan, Indonesia, and Thailand over the last two decades, and is comparable to that of Malaysia in 1987.
- Taking the poverty line to be 1,470,000 dong per person per year, or about US$0.40 per person per day, we can see that the whole rural population, which represents 80 percent of the total, is below that line. Alternatively, assuming that 51 percent of the population is below the poverty line (based on the Word Bank data quoted by Tran 1997:236), then except for rural population in regions 6 and 7, all the remaining rural population in the country should be classified as poor.

The rich-poor gap in the Vietnamese society can likely be identified as the urban-rural income disparity. This calls for a careful policy consideration with regard to several matters. First, the most important concern is the national security problem. The poorest region is region 1, located right at the border with China, and is the homeland of many ethnic minority groups all living in rural areas. They are the poorest in the income scale of Vietnam and, for historical reasons, they do not always identify themselves as Vietnamese. Second, the problem of social unrest may gain an explosive dimension as pointed out in Kolko (1997). When the income gap reaches a certain critical level, economic conflicts and social disputes (between farmers themselves, and between rural and urban inhabitants) could become inevitable. Third, rural people can migrate to urban areas. This would create new urban problems in terms of housing, unemployment and all kinds of poverty-related evils such as crimes, prostitution, mendacity, etc.

4 Some perspectives on income disparities in Vietnam

To gains some perspective on the evolution of the income disparity problem in Vietnam, there is no other way than to use simplistic projection based on data available for a short period of time, namely the period 1990–4 chosen in this crude analysis. Nevertheless, the trend that is captured in observing data clearly shows how this problem would be aggravated over time if no policy correction is undertaken by the political authority.

4.1 Evolution of income disparity by region

Based on Vu's study (see Vu 1997:45–75), we can come up with data on per capita income and its growth rate in Table 17.7 for the period 1990–4. We can see that during 1990–4:

- Region 6 per capita income is more than double the national average, and its growth rate is the highest. As a result, the income gap between this region and the other regions in the economy tends to increase.
- Regions 1, 3 and 5 have the lowest per capita income in the country, and their rates of growth are also relatively lower than the rest. The

Table 17.7 Per capita income and growth rate by region, 1990–4

Region	*1990*	*1991*	*1992*	*1993*	*1994*
1a	471	740	1,048	1,258	1,498
b		4.5	9.2	4.0	5.8
c		0.736	0.649	0.670	0.645
2a	580	968	1,415	1,811	2,193
b		1.8	10.7	8.0	6.5
c		0.87	0.85	0.9	0.93
3a	436	773	1,007	1,215	1,589
b		1.7	5.5	6.5	9.8
c		0.65	0.68	0.64	0.62
4a	540	899	1,239	1,444	1,788
b		3.2	4.8	4.6	8.0
c		0.8	0.79	0.79	0.74
5a	488	770	992	1,364	1,605
b		5.9	15.8	5.8	2.4
c		0.73	0.67	0.63	0.7
6a	1,480	2,479	3,432	4,524	5,725
b		13.5	8.4	13	11.8
c		2.21	2.17	2.19	2.32
7a	640	1,228	1,541	1,818	2,074
b		7.6	5.6	5.6	8.9
c		0.96	1.13	0.98	0.93
Vietnam a	**669**	**1,140**	**1,563**	**1,949**	**2,379**
b		**6.7**	**7.9**	**8.1**	**8.8**

Source: Computed from data in Vu (1997).

Notes
a per capita income (thousand dong);
b growth rate (%);
c ratio of per capita income in the region and national average.

per capita income by region, as compared to the national average, shows that except for regions 2 and 6, all other regions are relatively worse off during the period 1990–4.

- The rates of growth of per capita income in regions 1, 2, 3, 4, 5 and 7 are lower than that of region 6 (except for region 5 with 15.8 percent growth rate in 1992). As shown by the average per capita income data, region 6 became much richer during 1990–4. Regions 2 and 7 were almost unchanged in income ranking while regions 1, 3 and 5 became relatively poorer.
- The regional income disparity in general tends to be more important. From 1994 to the present time, the Vietnamese economy has adopted basically the free market system, albeit with the curious claim of a market economy with a *socialist orientation.* If the latter implies a large public sector, it would certainly go in the opposite direction of the policy trend in an era of economic privatization. But this claim might just be wishful thinking; whether or not it has anything to do with reality is another matter.

4.2 Evolution of income disparity between the urban and rural areas

Table 17.8 shows that, as compared to the urban, the rural per capita income has declined over the 1991–4 period across the country. The urban-rural income gap has significantly widened in regions 1, 3, 4 and 7 where the major economic activity is agriculture. Table 17.8 shows that the rural per capita income has declined compared to the urban income in every region. That rural poverty in Vietnam increases during 1990–4 is indisputable.

Table 17.8. presents some features worthy of attention.

- Except for 1994 in regions 5 and 7, the urban-rural per capita income ratio has increased for all regions during 1990–4. In other words, the rich–poor gap is widening.
- The urban economic growth rate is higher than its rural counterpart in regions 6 and 7. At the same time, the rate of population growth in the urban area is lower than in the rural area. If this trend continues, the rich-poor gap in the Southeast and in the Mekong River Delta will increase.
- For regions 2 and 3, the urban population growth rate is higher than the rural counterpart during 1990–4 (this is perhaps due to the migration of farmers to cities in the North). Urban impoverishment should be expected, with the rural poor becoming the urban poor through regional migration, especially with respect to region 3.

On the basis of the national average, the urban rich has a per capita income about five times the rural poor. This urban–rural disparity ratio is

Table 17.8 Per capita income growth in urban and rural areas by region, 1991–4

<table>
<tr><th rowspan="2">Region</th><th colspan="2">1991</th><th colspan="2">1992</th><th colspan="2">1993</th><th colspan="2">1994</th><th colspan="2">Population growth rate 90–4</th></tr>
<tr><th>Urban</th><th>Rural</th><th>Urban</th><th>Rural</th><th>Urban</th><th>Rural</th><th>Urban</th><th>Rural</th><th>Urban</th><th>Rural</th></tr>
<tr><td>1a</td><td>−4.3</td><td>−0.8</td><td>23.7</td><td>0.8</td><td>−0.9</td><td>5.1</td><td>5.6</td><td>1.8</td><td>1.9</td><td>2.7</td></tr>
<tr><td>b</td><td colspan="2">0.26</td><td colspan="2">0.18</td><td colspan="2">0.16</td><td colspan="2">0.16</td><td></td><td></td></tr>
<tr><td>2a</td><td>−2.1</td><td>0.8</td><td>13.0</td><td>2.8</td><td>4.7</td><td>5.1</td><td>4.8</td><td>0.3</td><td>3.4</td><td>1.8</td></tr>
<tr><td>b</td><td colspan="2">0.19</td><td colspan="2">0.15</td><td colspan="2">0.15</td><td colspan="2">0.14</td><td></td><td></td></tr>
<tr><td>3a</td><td>5.3</td><td>−2.4</td><td>0.9</td><td>3.7</td><td>13.2</td><td>−0.8</td><td>11.4</td><td>0</td><td>4.0</td><td>2.2</td></tr>
<tr><td>b</td><td colspan="2">0.24</td><td colspan="2">0.21</td><td colspan="2">0.17</td><td colspan="2">0.14</td><td></td><td></td></tr>
<tr><td>4a</td><td>−9.4</td><td>8.2</td><td>15.8</td><td>−3.7</td><td>8.3</td><td>−0.28</td><td>1.0</td><td>8.4</td><td>0.8</td><td>3.0</td></tr>
<tr><td>b</td><td colspan="2">0.55</td><td colspan="2">0.36</td><td colspan="2">0.32</td><td colspan="2">0.29</td><td></td><td></td></tr>
<tr><td>5a</td><td>1.3</td><td>2.0</td><td>26.0</td><td>7.5</td><td>−5.1</td><td>3.8</td><td>5.4</td><td>−2.1</td><td>3.9</td><td>3.8</td></tr>
<tr><td>b</td><td colspan="2">0.71</td><td colspan="2">0.54</td><td colspan="2">0.43</td><td colspan="2">0.61</td><td></td><td></td></tr>
<tr><td>6a</td><td>13.5</td><td>3.4</td><td>13.2</td><td>−3.0</td><td>10.3</td><td>5.5</td><td>10.7</td><td>6.3</td><td>0.8</td><td>4.4</td></tr>
<tr><td>b</td><td colspan="2">0.24</td><td colspan="2">0.20</td><td colspan="2">0.18</td><td colspan="2">0.18</td><td></td><td></td></tr>
<tr><td>7a</td><td>11.6</td><td>3.7</td><td>9.7</td><td>2.4</td><td>4.0</td><td>3.3</td><td>6.1</td><td>6.9</td><td>0</td><td>2.5</td></tr>
<tr><td>b</td><td colspan="2">0.60</td><td colspan="2">0.41</td><td colspan="2">0.36</td><td colspan="2">0.45</td><td></td><td></td></tr>
<tr><td>Vietnam a</td><td>5.1</td><td>2.4</td><td>13.6</td><td>1.5</td><td>7.3</td><td>3.1</td><td>7.6</td><td>4.2</td><td>1.5</td><td>2.6</td></tr>
<tr><td>b</td><td colspan="2">0.28</td><td colspan="2">0.21</td><td colspan="2">0.20</td><td colspan="2">0.19</td><td></td><td></td></tr>
</table>

Source: Computed from data in Vu (1997).

Notes

a growth rate of per capita income;

b rural-urban per capita income ratio.

relatively higher in regions 1, 2 and 3, and relatively lower in regions 5, 6, and 7. For region 6, where the level of urbanization is high, this ratio is approximately equal to the national average. As such, therefore, the rich-poor disparity is generated and exacerbated mainly in the socialist Northern part, and not elsewhere across the country.

The urban per capita income growth across the country is significantly higher than its rural counterpart during 1991–4 for every region. In region 6, the differential growth rate with respect to other regions is quite substantial. This region, which is composed of Ho Chi Minh City and its vicinity, will become an urban oasis surrounded by the poor people from all over the country. To a lesser extent, this remark applies equally to region 2 with Hanoi and Hai Phong as the main urban centers.

The finding extracted from the raw data in this analysis points nevertheless to an issue that also concerns economists working with the World Bank. Glewwe, Gragnolati and Zaman (2000) have used the statistical data from the Vietnam Living Standard Surveys for 1992–3 and 1997–8 to show that the variation in income distribution and living standards is substantial during these periods. They concluded that:

1 Urban white-collar workers were better off and reaped most of the benefit of the *Doi Moi* policy, while farmers benefited the least, and became relatively poorer.
2 The effect of education on living standards is increasing, especially with high education.
3 Geographical location is a determinant: poverty reduction among urban inhabitants is more significant than in rural area; people in more urbanized regions, namely the Red River Delta (region 2) and the Southeast (region 6) have more opportunities to become richer than their compatriots living in other regions.

To sum up, based on the 1990–4 data, inhabitants in rural areas become relatively poorer as compared to urban dwellers. According to Table 17.8, the rural population growth rate is higher than that of the urban; therefore the income disparity tends to increase as time unfolds. Combined with the regional disparity, it is obvious that income in region 6 will become much higher than the national average in future. This is also true for urban areas in region 2, but somehow to a lesser extent.

The urban-rural per capita income disparity, which is in fact the rich–poor gap, tends to be further widened over time for the following reasons.

- The market economy allocates resources for production and consumption on a voluntary basis through the price system. The determination of income would follow as a result. Vietnam is a labor surplus country, both in the urban and rural areas. Excess labor supply exerts a downward pressure on wages. In addition, the declining trend of agricultural products prices in the international market, as mentioned earlier, would not help in improving labor wages in rural areas. Both these features should exert a negative impact on the income for poor farmers.

- Under the pressure of 'privatization' and 'globalization' taking place in the world economy, governments' intervention policies, including the income distribution policy, tend to be much less important than in the past. As a result, the provision of two social services, healthcare and education, will tend to decrease in both quantity and quality.
- Capital investment, especially foreign investment, is usually located in regions with better infrastructure, which means urban areas. Business expansion and foreign investment thus have the negative effect of further widening the urban-rural income disparity. However, the dilemma is that without additional capital, the economy would continue to lag behind in the state of a petty craft economy with discretionary and compartmental distribution of land. In this event, the chance to take-off and stick to a development path is rather slim.

According to Tran (1997:232–3), the rich-poor gap ratio (ratio between the average income of the top quintile and the bottom quintile of the population) during 1965–89 is 4.8 for Japan, 5 for Taiwan, 6.5 for Indonesia, 7 for South Korea, 8 for Thailand in East and Southeast Asia. This ratio for Vietnam in 1993 is within 9.5 to 10.5, based on the data gathered in Tables 17.5 and 17.6, and thus the highest in the region. Also during the same period, the growth rates of per capita income in those countries are 4.1, 6.7, 4.5, 7.1 and 4.4 percent, respectively. Thailand has the highest rich-poor gap ratio and one of the lowest growth rates of per capita income. This is not unusual. A similar pattern is observed with Brazil during 1972–83 and with the Philippines during 1970–85. Therefore, the correlation between economic development as displayed by the growth rate of per capita income and the rich-poor disparity merits further attention.

5 Economic development and income disparity

Reducing the income and living standards gap between the rich and the poor is not always a matter of policy consensus. Income redistribution is, for some economists, not the appropriate policy, especially because of its implications for economic growth. A major question, namely whether disparity and inequality are *de facto* a prerequisite for economic growth, is often asked.

What is the relation between the rich-poor income gap and the income growth rate in a modernized and developing economy? The classical answer to this question is Kuznet's inverted-U shape curve, which indicates that the disparity tends to rise during the initial stage of economic development and then fall in the subsequent stage. Theoretical analysis and empirical evidence for Kuznet's hypothesis put forward 30 years ago are not firmly grounded. Over the last 10 years, a number of economists have reviewed this hypothesis and come up with some important assessments.

Economic science is now enriched with some high-quality research aimed at answering satisfactorily the question mentioned above. Galor and Zeira (1993) proved that, at macroeconomic level, the distribution of income as well as of wealth and asset has a direct effect on short-term and long-term output and investment, and on the pattern of adjustment to exogenous shocks. Investigating further, Persson and Tabellini (1994) and Alesina and Rodrik (1994) have shown with several econometric studies that high disparity in income distribution is always associated with low economic growth. Benabou (1996) confirmed this conclusion through a number of researches on this issue made for different countries. Using a new data set, and replacing income by wealth and asset, Birdsall and Londono (1997) showed without any doubt that high disparity would result in low economic growth. Ask the converse question, namely does economic growth result in widening the rich-poor disparity? Bruno, Ravallion and Squire (1996), using a data set of 20 countries, came to conclude that economic growth does not have any negative impact on the *variation of* the rich-poor disparity degree. The results of their study showed that economic growth reduces poverty across all the income quintiles, but the extent of such reduction depends on the level of income so that economic growth is not completely distribution neutral.

In recent years, a number of economists have linked the rich-poor income gap to social conflicts and explained its impact on investment (Schork 1996, Benhabib and Rustichini 1991, and especially Alesina and Perrotti 1996). Obviously, conflicts would result in social instability and thus high country risk, which in turn increases the opportunity cost of investment. Once again, through its negative effect on investment, a higher level of rich-poor income gap in a country would have a negative impact on macroeconomic development.

6 Conclusion

The regional and rural-urban income disparity was examined from data sets for 1993 and for 1990–4 period. The gap between the rich and poor, which tends to be widening over time, may well exceed in the near future a critical level which ensures a stable society with some social consensus on the matter of a fair income distribution. On the other hand, economic development and modernization are the primary political and social objectives for Vietnam. The first step forward in this direction consists of putting the Vietnamese economy onto the market-oriented path. Economic science clearly shows the allocative efficiency of the price system resulting from the laws of supply and demand.

Yet this market price system is rather neutral with respect to the social distribution of income. No doubt, the free market does not have any regulatory mechanism dealing with income distribution so as to bring the latter to a level compatible with some consensus warranting a stable and secure society. Governmental interventions are therefore always needed to keep income disparity within some socially acceptable limits. On the other hand, income redistribution policy does not necessarily impede economic growth and development process. In recent years, a number of serious studies confirmed that the rich–poor gap has a negative impact on growth, and that economic development would reduce this gap over time. Therefore, among other things, if the so-called socialist orientation is one which ensures a fair income distribution, then the 'market economy with the socialist orientation' in Vietnam is an appropriate policy option.

With its achievement, economics can only study part of the making of a nation. Building a nation requires far more than just economic considerations. A social ethics that links members of a society having the same history and sharing the same future is of the utmost importance. Income redistribution in order to sustain such a society is a concern of this social ethics. It would therefore be wrong to leave the economy at an underdeveloped stage to the mercy of free market dogma. A market economy with a socialist orientation is a proper vision, if the latter is not just confused phrasing. For Vietnam, unless a redistribution policy is in place, the rich-poor income gap in different regions will become larger and larger under the pressure of 'globalization' and 'privatization' in the economy. Increasing income disparity would create complicated problems in terms of national and social security. Especially, the overflow of rural migration to cities would turn the latter into ghettos of unemployment, prostitution, criminality, etc. In rural areas, land disputes would lapse into a daunting problem of a petty agrarian production society.

A common expectation for all Vietnamese is to live in a country with a developed and gradually modernizing economy. This should not undermine a social policy that aims at reducing the rich-poor disparity by region and through the urban-rural strata. In particular, any sound policy should ensure that the degree of disparity is less than a threshold level, beyond which both political and social instability would happen. To this end, it is imperative to permit an economic development that leaves room for the market. But this option by no mean implies that the government has no role to play with respect to redistribution. To conclude, I would echo the concern about regional development and agricultural economy by a number of economists (see Vu 1997:169–83 and Tran 1997:230–49) for the case of Vietnam. This concern is well grounded and should be further considered. From that starting point, we can expect that Vietnam would be put on an economic development path with some sense of social justice.

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18 Social sector reforms and development in Vietnam

Quan Xuan Dinh

1 Introduction

Vietnam has successfully managed its transition from a centrally planned command economy to a 'socialist-based market' economy. The first decade (1987–97) of *Doi Moi* was devoted to building the foundation of main macroeconomic and institutional components. Land reform in the agricultural sector, price liberalization and wide-ranging economic reforms were introduced. As a result, the economy has achieved a steady growth of 7.3 percent per year for the past 10 years (1990–2000), prompting a rapid reduction of poverty. The living standards have improved markedly, but the benefits are distributed unevenly, as shown by Vietnam's 1992–3 Living Standard Survey (LSS) where 90 percent of the 51 percent considered as poor live in the rural area (see GSO 1994). According to preliminary results from the latest 1997–8 LSS, the ratio of absolute poor,[1] has dropped from 51 percent of the population in 1992–3 to around 37 percent in 1998.

While economic progress has been impressive, the picture in the social sectors is less impressive. Under the old central-planning system *(Bao cap),* social services were free and the state was the sole provider of services. At that time, Vietnam received major support and assistance from the socialist bloc.

During the *Doi Moi* and under severe budget constraints, user fees in health and education were introduced in 1989 and health and education were opened to private providers through a policy called *xa hoi hoa* or socialization. From 1989 on, contributions from users and parents increased steadily. The impact of this policy on the social sectors is mixed at best, because the social protection system in the rural area remains largely dependent on family support and informal mechanisms combined with public poverty alleviation programs.

Vietnam managed to achieve a human development index (HDI), an index established by the United Nations Development Program (UNDP), which is quite impressive compared with similar low-income countries. UNDP places Vietnam's HDI in 2000 at 108 among 174 countries. However, these improvements in the social sectors are fragile.

Although insulated from the worst of the Asian crisis, Vietnam felt its ripples. The economic downturn disproportionately affected the poor and uncovered weaknesses in the social sectors (see ADB 1999).

After many years of socialism, Vietnam still believes in the direct involvement of the state in socio-economic activities. Vietnamese authorities feel uneasy about the private sector's involvement in the delivery of social services. There is lack of consensus among the leadership as to the speed, depth and pace of change, and overall a reluctance to discuss the development of the private sector, for it would be a 'deviation from the market economy with socialist direction'. The role and place of the private sector and/or its partnership with the public sector are still under discussion, and the lack of direction effectively hampers the speed of socioeconomic development in Vietnam. The constant internal strife between 'reformers' and 'conservatives' slows down the pace of *Doi Moi* in the area of social sectors.[2]

In health and education, recipients, including the poor, are shouldering a large portion of the costs of social services. This chapter presents the situation of the social sectors during the *Doi Moi* and analyzes problems and challenges for the twenty-first century.

2 Overview of the social sectors during *Doi Moi*

Doi Moi reforms opened Vietnam to the outside world and spurred high economic growth. Vietnam's GDP per person has more than doubled from US$150 in 1990 to US$400 in 2000 (see UNDP 2001). However, a lot still remains to be done, and in 1992, using its own national poverty measurement of 2,100 calories per person per day, 51 percent of the population was still considered poor.

2.1 **Doi Moi** *and the role of the state*

The *Doi Moi* program is characterized by openness to foreign investment and foreign trade and strong basics: stable exchange rate, low inflation and low deficit policies. It sets broad macroeconomic policy to stabilize the economy and to attract foreign investment. It creates a stable environment for foreign firms to invest. In essence it follows the various Asian development models.

The reforms have yielded unprecedented levels of growth, especially for the past years. GDP grew in real terms at an annual compound rate of 7.3 percent between 1990 and 2000 (see Table 18.1). The growth of output was closely associated with the growth of foreign direct investment (FDI) and exports. FDI inflows and imports were fueling consumption and investment. Inflation has been kept in check and the budget deficit has been reduced to an acceptable level of 2 to 3 percent of GDP.

Table 18.1 Macroeconomic data (%)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
GDP growth	5.1	6.0	8.7	8.1	8.8	9.5	9.4	8.8	5.8	4.8	6.7
Budget deficit (% of GDP)				5.2	2.3	1.5	1.3	1.7	1.5	0.1	3.4
Inflation	67	67.5	17.5	5.2	14.4	12.7	4.5	3.7	9.2	0.1	−0.6

Source: UNDP's fact sheet online <http://www.undp.org.vn> (30 December 2001).

The *Doi Moi* also introduced diversified forms of ownership–public and privately owned. However, the industrialization strategy still favors state-owned enterprises (SOEs). The development model followed by Vietnam during the *Doi Moi* period is based on:

- the leading role of the state and support for industrialization through SOEs;
- a dependence on foreign investment and export of primary commodities; and
- strong administrative controls over external trade, bank lending activities and interest rates.

The model stresses the leading role of the state as agent for change in society (see Fforde 1999) and supports the SOEs' dominance through bank credit, tax breaks and state contracts (see Wing 1997). A growing number of non-performing loans from SOEs are endangering the banking sector (see Dinh 2000a). As a result, the Vietnamese development pattern focusing on the leading role of the state is increasingly inward looking (World Bank 1997:25).

During this period Vietnam has preserved the leading role of the state in the industrialization process, but what about the social sectors: education, health and safety net?

2.1.1 Government spending and mobilization of resources

Prior to *Doi Moi,* public expenditure on social sectors depended solely on the state budget. During the Cold War and practically until 1990, public health and education expenditures have been 'subsidized' by foreign aid from various East block countries (Soviet Union, China and Eastern European countries). In 1975, under the *Quan quan* (military management), the population suffered acute shortages of services due to the forced nationalization of all socio-economic activities.

With *Doi Moi,* institutional reforms were introduced. Redefining the role of the government has been one of the major features of institutional reform of Vietnam's transition to the market economy. *Doi Moi* redefined the role and functions of government in the economy which included (see Le 1996):

- managing the macroeconomic environment, fiscal balance and monetary policies;
- coordinating central, regional and local government activities;
- creating the legal, financial, administrative and regulatory infrastructure; and
- creating a governmental capacity to administer a market economy including the creation of a capable and honest civil service.

In the social services, the user fees policy called socialization for the provision of the social services was introduced. The second major change affected the way the government allocated public expenditures. The budget was decentralized to local governments.[3] With those two changes, the funding of social sectors included (i) central budget, (ii) local budget, (iii) off-budget funded mainly by official development aid (ODA) programs and projects, and (iv) contributions from users.

The result of those changes of the trend in government spending reveals a mixed pattern depending on the sub-sector (see Table 18.2). Education spending fell by nearly half from 1986–8 and then rose again after 1989, cumulating at around 2.4 percent GDP in 1997 to level around 2 percent GDP in 2000. Health spending had risen but leveled around 1 percent of GDP in 1997. However, real per capita spending in the health sector was much higher thanks to private contributions. Spending on pension and social relief has more than quadrupled at around 3 percent of GDP.

A small percentage of GDP was spent by the government on social services. The increased level of public spending was the result of *Doi Moi,* which brought growth in the budget complemented by funding from ODA.

Doi Moi reforms have led to a significant rise in pledges of ODA which have averaged US$2.0 billion per year during the past 5 years. The WB, Japan, the European Union and the ADB are the four largest contributors to ODA in Vietnam in 1999. The WB, with disbursements totaling US$187 million, focused mainly on the energy, transportation and agriculture sectors. Japan was the second largest contributor of ODA with US$160 million disbursed in 1997, including the social sectors, particularly education and health investment funding with US$39 million in 1997. The ADB funds on an average US$130 million per year, aiming at infrastructure, energy and education.

The United Nations (UN) agencies disbursed US$57 million in 1997. The health sector was the main beneficiary with US$15 million (child primary healthcare and nutrition programs; child and women immunization; and reproductive healthcare). Other UN agencies supported humanitarian aid and relief and agricultural and rural development assistance. More than 26 percent of UN agencies went to basic social services (mainly primary curative health, basic preventive health and family planning service).

Total basic social services (BSS) disbursements for Vietnam in 1997 remained low.[4] ODA investments in the social sector (human resource development, health, area development, and humanitarian aid and relief) increased from US$77 million in 1990 to US$86 million in 1997. However, BSS is around 5.5 percent of the total ODA disbursements with the bulk of BSS spending aimed at health (primary healthcare, immunization and disease control programs, family planning, etc.) and primary education.

Table 18.2 Allocation of expenditure by sector (billion dong)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Current expenditure on social services	1,998	3,343	6,245	9,639	14,042	18,249	20,317	23,785
as % of GDP	4.8	4.4	5.6	7.1	8.2	8.2	7.9	8.0
Education	439	748	1,495	2,321	3,414	4,722	5,500	7,150
as % of GDP	1.0	1.0	1.4	1.7	2.0	2.1	2.1	2.4
Health	368	636	1,136	1,754	2,214	2,387	2,761	3,050
as % of GDP	0.9	0.8	1.0	1.3	1.3	1.1	1.1	1.0
Pensions, social relief	695	1,278	2,374	3,752	5,861	7,382	8,191	8,989
as % of GDP	1.6	1.6	2.1	2.7	3.4	3.3	3.1	3.0
Other	496	681	1,240	1,812	2,553	3,758	3,865	4,596
as a % GDP	1.3	1.0	1.1	1.4	1.5	1.7	1.6	1.6
Capital expenditure*	425	367	790	763	2,323	3,228	3,820	4,498
as % of GDP	1.0	0.5	0.7	0.6	1.4	1.4	1.3	1.5

Source: GSO (2001).

Note

* Includes education, health, culture, finance and government.

By international standards, Vietnam's public spending for the social sectors is low. The flow of ODA has increasingly compensated and sometimes offset current low spending on the social sectors by the government. How were expenditures spent in the education, health and safety net sectors?

2.2 Social sectors

2.2.1 Education sector

Vietnam has an extensive network of schools (see MOET-UNDP-UNESCO 1992) with over 14,000 primary and lower secondary schools, 1,100 secondary schools, and 230 universities and colleges of which 16 are private or mixed funding colleges in 2000.[5] Vietnam's education system is modeled on the socialist education system. At the central level, the Ministry of Education and Training (MOET) provides overall policy guidance and technical direction. At the provincial level, the Provincial Education and Training Service (PETS) directs education activities in the province. At the district level, the education and training system is administered by the District Education and Training Center (DETC), which manages district primary and lower secondary schools. At the commune level, the primary school is the basic education unit.

During 1997–8, primary and secondary public schools enrolled about 99 percent of all children. Junior secondary schools enrolled 77.7 percent while senior secondary schools enrolled 36.2 percent. At secondary level, public schools served 94 percent of the children. A nationwide system of official tuition fees for public schools was introduced in September 1989. Parents are expected to contribute to teachers' salaries and pay for textbooks, clothing and food. Since 1989 private schools have been tolerated but religious schools are still not authorized. Private colleges have been allowed since 1995.

The increased access has not resulted in better quality. There is deterioration in both quantity and quality as evidenced in school enrollment trends (see Table 18.3).

- From 1985 to 1995, enrollment in primary schools grew by only 2.1 percent, lagging behind the population growth rate.
- There was a high drop-out rate in secondary school: for the 1993 school year, 78 percent of children finished their primary schools but only 11 percent finished upper secondary classes. Secondary school starts on average with a 50 percent enrollment but decreases to 16 percent for senior secondary school classes.
- Enrollment declined by 65 percent in vocational schools.

Only 1.5–2 percent of people between 18–24 joined tertiary level education, broadly defined to include technical and secondary vocational

Table 18.3 Enrollments in education, 1985–95 (million students)

	1985	*1990*	*1995*
Primary	8.16	8.58	10.04
Lower secondary	3.08	2.75	3.67
Upper secondary	0.79	0.69	0.86
Vocational	0.17	0.09	0.06
Technical	0.12	0.13	0.13
University – Tertiary	0.12	0.13	0.34
Population	59.8	66.2	73.9

Source: Ministry of Education and Training (2000), *Education Statistics,* Hanoi: MOET.

schools together with universities and colleges (full-time and continuing education). Enrollment for students attained 354,000 in school year 1995 including 137,000 full-time students. The ratio of students in Vietnam is 50 per 10,000 persons, compared to 270 in the Philippines and 170 in Thailand. This will be a major constraint for Vietnam in the search for a knowledge-based economy.

The central budget for the MOET funds the higher education institutions (universities and colleges) and also a variety of targeted education programs implemented by local governments. Provincial governments are responsible for secondary schools, post-secondary technical and vocational training, and local government supports the lower levels of schooling with subsidies from the district government. A teacher in the rural sector earns between US$20–25 per month (see World Bank 1996:31) and at the upper secondary level, salary rises to US$38–50 per month. It is not unusual to see teachers 'moonlight' or parents to contribute through various fees. Currently Vietnam lacks nearly 84,000 teachers. Lack of space is also a major issue, and school facilities host two or three shifts of students daily.

The central government budget finances only one-quarter of the state budget for education, with the remaining three-quarters spent by the local governments (see Table 18.4). In a recent study of the national education budget (current and capital expenditure), 30 percent was allocated to public primary schooling, 27 percent to secondary education and 13 percent to higher education (see World Bank 1996). The balance mostly provided for lower secondary schools, with 5 percent to upper secondary schools and 10 percent for targeted programs. Off-budget funds come from ODA and this trend is growing slowly.

Contributions from parents have emerged as an important complement to state budget outlays at all levels of education. Estimates based on reported household expenditures from the LSS[6] suggest that total private spending on education amounted to about 50 percent (textbooks, payment of official fees to public schools, public school uniforms and other expenditures such as transport, food and lodging, etc.). However, the aggregate figure masks considerable variation across levels. Contribu-tions

Table 18.4 Allocation of education expenditure by level of government (million dong)

	1991		*1992*		*1993*		*1994*	
Total expenditure	1,481	100%	2,370	100%	3,961	100%	6,035	100%
State budget	**1,256**	**85%**	**2,038**	**86%**	**3,506**	**89%**	**5,011**	**81%**
Central	367	29%	603	30%	873	25%	1,392	28%
Local	889	71%	1,434	70%	2,632	75%	3,618	72%
Off-budget	**225**	**15%**	**332**	**14%**	**454**	**11%**	**1,024**	**17%**
Commune	162	72%	195	59%	253	56%	395	39%
ODA	63	28%	136	41%	201	44%	629	61%

Source: World Bank (1996:40).

from parents are larger than public subsidies for all levels of schooling except for post-secondary education. In addition, the burden of education is higher for the rural sector (see Table 18.5) at all levels.

The state budget finances 48 percent of public primary schooling and around 40 percent in secondary schools. At tertiary level, public funding becomes dominant with 81 percent of total expenditures. These figures show the disparity in public expenditure subsidies.

2.2.2 Health sector

The Vietnamese health system is modeled on the socialist healthcare system. It has a vast infrastructure of health facilities and Vietnam's ratio of commune health centers (CHCs), the basic unit of healthcare delivery, is around 170 compared with 32 in Indonesia, 63 in China and 141 in Thailand. The ratio of hospital beds compares favorably to many neighboring countries (see Table 18.6).

The health system is composed of about 250 provincial hospitals, 570 district hospitals and around 10,165 CHCs (see Government of Vietnam 1999:15). This network is complemented by 3,800 traditional medicine centers.

At the central level, the Ministry of Health (MOH) provides overall

Table 18.5 Burden of education, 1996 (% of per capita income paid by households)

	Urban	*Rural*	*Vietnam*
Primary education	6	11	9
Lower secondary	13	22	18
Upper secondary	28	48	40

Source: World Bank (1996).

Table 18.6 Ratio of hospital beds

Country	*Hospital bed/persons*
Vietnam	1/389
China	1/465
Thailand	1/665
Indonesia	1/1,743

Source: World Bank (1995).

policy guidance and technical direction. It supervises many centrally funded technical departments and various specialized institutes such as the National Institute of Hygiene and Epidemiology, the National Institute of Nutrition, Institute of Pediatrics, Tuberculosis, etc. The MOH manages many national preventive programs such as immunization, maternal and childcare, safe water, anti-malaria, family planning, anti-HIV, etc. The structure is complex and inefficient with overlapping institutional mandates.

At the provincial level, the Provincial Health Service (PHS) directs health activities in the province. It supervises provincial hospitals, mostly general hospitals with facilities for essential specialty care surgery, obstetrics, internal medicine, etc., and several specialized hospitals. The PHS maintains secondary medical schools which train middle-level health workers such as assistant physicians, nurses, midwives and secondary pharmacists.

At the district level, the health system is administered by the District Health Center (DHC), which manages district hospitals staffed by general practitioners, surgeons, obstetricians, pediatricians, dentists and sometimes other specialists such as ophthalmologists.

Inter-communal Polyclinics (IPC) serve as first-referral facilities for every three to six communes, providing back up and training to CHCs. To staff these facilities, Vietnam has one of the highest health worker ratios in the developing world. However, CHC workers represent only 23 percent for 77 percent of the population residing in the rural areas. The liberalization of the agriculture sector with the disbanding of cooperatives and the pressures of public health expenditures have shortchanged the system (see Kieu and Dinh 1998).

During the period 1975–89 the population suffered an acute shortage of medicines and drugs, and overseas Vietnamese had to send medicines to their relatives. After 1989, private providers were allowed to operate. Doctors have been allowed to practice privately, using public facilities after hours, in private clinics or out of their homes. This was adopted as a temporary system to help relieve pressures on public healthcare delivery. However there are no publicized standards of medical care, nor regulations to ensure quality in private practice. In the transition to the market economy, it is expected that the public sector would provide preventive healthcare, immunization and ensuring adequate basic healthcare services for the poor, while the private sector would carry the bulk of the curative services (see UNDP, UNICEF and UNFPA 1995:55).

Healthcare training is carried out in eight medical and pharmaceutical schools and 25 secondary schools (provincial level), and produces around 2,000 graduates annually. The training uses outdated training curriculum and management concepts. It still centers on wartime priorities and does not sufficiently address areas such as community medicine and epidemiology.

Health workers are employed by the state immediately after graduation, and are placed into a 3–5 year mandatory practice at a site selected by the MOH. Most professionals stay at the same job for their entire careers because there is no central plan to provide for an orderly rotation between rural and urban areas. About 3,000 physicians are unable to find positions in public hospitals or accept their provincial assignment. Salaries of health workers are low (a physician earns about US$30 per month, and a senior physician with 30 years' experience can reach the top salary of US$100 per month). Moreover, current promotion, supervision and evaluation criteria may allow ideology to take precedence over technical performance. The limited prospects for advancement and poor compensation both contribute to the prevalent problem of low morale and difficulty for retention of qualified personnel. Healthcare supervision is deficient and, as a result, there are significant issues in quality of care, facilities maintenance, record keeping, and personnel management.

There is a misdistribution of resources and a deep disparity between urban and rural areas. Ho Chi Minh City has 35 hospitals, 38 DHCs and 282 CHCs, staffed by 3,218 physicians (6 per 10,000 persons) and 2,682 doctors in private practice. In the Delta of the Mekong, 70 percent of CHCs do not have assistant doctors and in the north central coast, in Quang Binh province, 91 percent of communes do not have assistant doctors and 51 percent do not have midwives.

Funds are allocated according to the geographical and administrative levels. Maintenance funds are allocated, based on staffing level as a percentage of the total salary expenditure and/or the number of beds, and the province supports staff salaries. Using the government projections for 1995–2000, spending in the health sector including ODA, user fees and health insurance is as given in Table 18.7.

As a whole, real public expenditure on healthcare in Vietnam ranked lowest among all Asian nations with US$0.83 per capita in 1989. By 1993, it had grown to US$1.42 per capita and US$3.20 in 1997 (see Table 18.8) thanks to external funded programs by ODA donors.

In 1990, public spending on health was less than 1 percent of GDP and in 1997 public spending was still 1 percent (Table 18.2). According to a WB study, the public sector finances only 16 percent of all health

Table 18.7 Projections of spending in health sector (constant US$)

Sector	*1996*	*1997*	*1998*	*1999*	*2000*
State budget	205	225	248	273	301
ODA	58.6	64.4	67.7	71	71
User fees	27.3	31.8	30	27.3	25.5
Health insurance	38.2	38.2	38.2	40.9	40.9
Total	329.1	359.7	383.7	412.2	438.4

Source: Government of Vietnam (1999:41).

Table 18.8 Health spending, 1989, 1993 and 1997 (US$ per capita)

Sector	*1989*		*1993*		*1997*
	US$ per capita	*As % of total*	*US$ per capita*	*As % of total*	*US$ per capita*
Public	0.83	33	1.42	16	3.2
Private	1.67	67	7.27	84	
Total	2.50	100	8.69	100	

Sources: World Bank (1995) for 1989 and 1993; Bui (1997) for 1997.

expenditures while beneficiaries have to finance from their own pocket 84 percent (see World Bank 1995). Sick rural residents have a less than 10 percent chance to be treated by a trained doctor. The amount of public expenditure for health places Vietnam at the bottom of Asian countries at around 1 percent of GDP in 1989 (Table 18.9). As a result, hospitals tend to be utilized more by urban and better-off people while the CHCs are used by all income categories except the top income group and those in the urban areas.

Table 18.9 Health spending in Asia, 1989

Country	*Government health expenditure*		
	US$ per capita	*As % of total*	*% of GNP*
Bangladesh	1.26	4.5	0.7
China	2.88	4.2	0.8
India	5.04	6.7	1.6
Indonesia	4.51	3.8	0.9
South Korea	29.74	2.2	0.6
Laos	3.03	4.9	2.0
Malaysia	55.41	6.8	2.7
Thailand	13.64	6.1	1.1
Vietnam	0.83	3.3	0.7

Source: World Bank (1992).

In 1995, a health insurance system (VHI) was established for which the employee pays 5 percent and the employer 15 percent. The VHI is of limited extent and low in effectiveness and highly bureaucratic. It does not operate in rural areas and rural residents have to be either self-sufficient or rely on support from family, relatives or charity organizations.

2.2.3 Safety net

The safety net is funded by the budget and administered by the Ministry of Labor, Invalids and Social Affairs (MOLISA) and the Vietnam Confederation of Labor. Pension and social relief expenditure has doubled–as much as health and education combined–and grew from 1.6 percent of GDP in 1990 to 3.4 percent of GDP in 1994, leveling at 3 percent of GDP in 1997 (see Table 18.2). These outlays are spent on:

1 social security–pension for public sector employees (civil servants and state enterprise employees);
2 disability allowances and war invalid and martyrs' families; and
3 social relief measures for victims of natural disasters, starvation and 'social evils'.

Pensions and disability payments for government workers take the lion share of the budget (80 percent). In addition, the social relief program protects those who are not insured by the formal social security program.

In 1993 the government created the Vietnamese Social Security Organization (VSSO). Originally social security was restricted to public sector employees. It was expanded by Decree 43 CP in 1993 to include private enterprises, joint ventures enterprises and workers in Economic Processing Zones. About two-thirds of social security spending pays for pensions, with the rest allocated to disability payments. The VSSO is funded by a 15 percent payroll tax. Presently, only 12.4 percent of the population is insured (old-age pensions, disability and survivors' benefits), mostly civil servants and urban workers. More than half of the public pension program is subsidized out of general revenues collected from the entire population even though it covers only a proportion of the population.

Presently the social security program funds 1.2 million pensioners. There are various relief programs: disability program (0.5 million recipients), war invalids and martyr families (1.5 million recipients), social relief program for natural calamities and programs for displaced population.

Recent studies by the World Bank (see, for example, World Bank 1995) show few people receive benefits from such social security expenditures. The bulk of the amount (82 percent) is used to subsidize pension and leave payments for Government employees who make up only 4.5 percent of the country's population.

For the poor, the primary source of support continues to be the family. The 1992 LSS found that 15 million people or 21 percent of the population received private income transfers. A recent study by Haughton (1999)[7] reports 4 million families are recipients of overseas transfers annually, estimated at US$1 to 1.2 billion per year, representing around 5 percent of GDP or 11 percent of exports. Most recent estimates put it at US$2 billion. Private transfers (within country and from overseas Vietnamese) provide the ultimate safety net for poor households.

2.3 Impact of the Doi Moi *on the social sectors*

Recent data from the 1997–8 LSS show that the ratio of poor fell to 37 percent in 1998 and 90 percent of the poor reside in the rural areas (see World Bank 1998). According to UNDP (1998a), *Doi Moi* has achieved considerable progress in improving the well-being of the Vietnamese people. Vietnam's accomplishments stand out in the human development index (HDI) above many countries with comparable income, however it still ranks among the poorest Asian nations in the world. The 2000 *Human Development Report* placed Vietnam 108 out of 174 countries surveyed (see UNDP 2001).

The progress is generally impressive: increased life expectancy; reduced infant mortality; improved healthcare; higher literacy rates; higher per capita income; higher per capita grain production; expansion of primary, secondary, and tertiary education; and so on. Some of these achievements are summarized in Table 18.10.

Although Vietnam did not fare badly within its income category, many disturbing trends are evident in social sectors, especially in the rural areas (see, for example, UNDP, UNICEF and UNFPA 1995, De Morey 1996, De Walle 1998 and World Bank 1998). Poor families, especially rural households, bear a disproportionate burden when sending their children to

Table 18.10 Profile of human development in Vietnam

Indicator	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Life expectancy at birth (years)	65.2	65.5	66	66.4	67.4	67.8
Adult literacy rate (%)	91.9	92.5	93	93.7	91.9	92.9
Combined enrollment rate (%)	49	51	55	55	62	63
Education spending (% of GDP)					2.0	
Health spending (% of GDP 1997)				1.3		
Real capita GDP (in PPP$)	1,010	1,040	1,208	1,236	1,630	1,689
HDI ranking	120	121	121	122	110	108

Source: UNDP's fact sheet online <http://www.undp.org.vn> (30 December 2001).

primary school or to CMHs. Major challenges in the social sectors include the following.

Education Vietnam chooses to invest in primary, secondary and tertiary education at the same time. Thus, it spreads its resources across all levels of education and serves fewer people (largely in the urban areas). The basic education–primary, lower secondary but also vocational and technical levels–tends to be under-supplied in the rural areas. The secondary and tertiary educations have received an increasing share of public funding at the expense of primary education. Furthermore, there are urban-rural, regional, provincial and interregional and interprovincial variations in public expenditure. The rural sector tends to be at a disadvantage because of the inability of local governments to raise taxes, the low public expenditure in primary education and parents too poor to pay school fees.[8] When well-off families spend 44 dong for every 100 dong by government in higher education, rural families must spend 80 dong for every 100 spent by the government in primary education (see World Bank 1996). The costs of education are increasingly shouldered by recipients, with growing inequality. Recent studies show enrollment rates among the poor in the rural areas lagging behind the urban areas. The quality of learning is of concern with the school year shorter than international standards (165 days versus 185 days), and shorter school hours because school facilities are used many times within the same day.

Health There is no universal health insurance. In the rural sector, CHCs are underfunded, the personnel is undertrained and cannot meet the needs of the rural residents. Only 5 percent of the health budget is allocated to the CHCs, which serve 77 percent of the population. As a result, 20 percent of the poorest receives 11 percent of health subsidies while the richest 20 percent receive 30 percent (see World Bank 1995: viii). A main deterrent for accessing public services is the collection of user fees, which constitute a significant barrier for the poor. In the rural areas, poor are deprived of medical care often because of cost, isolation and lack of transportation.[9]

Social security There is no real modern safety net in Vietnam. The formal social security system (VSSO) targets only a minority of urban workers and civil servants and will not be sustainable in the long run.[10] The majority of people still rely on family support and transfers for old age.

It is clear from the above discussion that there is a need to improve the management and delivery of social services. The priority should be the improvement in equity, efficiency and quality of social services, as well as their financing.

3 Key challenges in the social sectors

Although the number of absolute poor has been reduced, poverty remains widespread, especially in the rural sector. Vietnam faces many challenges, such as reforming and improving current pension systems, health and unemployment insurance with a view to improving equity and ensuring sustainability, establishing an affordable social safety net for the rural sector, reforming the community based network and above all, taking care of the high number of war invalids and martyr's families.

There is an urgent need:

- to rethink and reform the public-private sector partnership and reduce the disparity between urban and rural sectors;
- to improve the public administration and institutional environment; and
- to target realistic objectives for improving the social sectors service delivery and financing systems in order to serve the majority of people.

3.1 Ruralr–urban income disparity and the role of the state

Although 77 percent of Vietnamese live in rural areas, under the *Doi Moi* industrialization policy, the majority of investment goes to a few cities in three geographical areas of Vietnam: Hanoi and Hai Phong in the northern part of the country, Da Nang and Quang Nam in the center, and Ho Chi Minh City and Vung Tau in the south. The industrialization strategy focuses on foreign investments, concentrated in capital-intensive, import-substitution, and on SOEs protected by tariff barriers and does not create jobs. This development strategy has left out rural areas.

As a result of this policy, a yawning income gap between rural and urban areas, between north and south, between mountainous and delta areas has spawned a disaffected class of rural poor. Government statistics show that the gap between the top and bottom 20 percent of income earners has increased from 6.8 times in 1995 to 7.3 times in 1997. In 1997, Vietnam's official unemployment rate was 6.5 percent in urban areas and 3.9 percent in rural areas (GSO 1997), but underemployment is estimated at over 25 percent in rural areas. These data imply that around 8.6 million persons of working age are either unemployed or under-employed.

In the rural sector, the government regulates all facets of socio-economic activities and is crowding out the private sector. Public investments are lagging as compared to the urban sector. There are myriad administrative regulations. The approval process is long and tedious because of burdensome requirements and multiple steps by 'concerned ministries and agencies'. Approvals can take years for the education sector. A survey carried in 1997 showed the bias against the private sector and various regulatory costs imposed on enterprises (see Kaufman 1997).

The insistence of the leading role of the state (Fforde 1999) and bad policy has become an impediment to socioeconomic development and is a significant contributor to the current difficult situation.

3.2 Institutional reform and changing role of the public sector

The implementation of the 1992 Constitution raises new problems. The responsibilities of the People's Council (provincial assembly), the unclear vertical and horizontal relationship between the People's Council, the People's Committee (provincial government) and central authorities create many administrative hurdles. Furthermore, the public administration in Vietnam does not have the staff and competency to implement government policies and is a bottleneck to development. Many examples can be cited.

Example 1 From 1986 to 1998, Vietnam's industrialization policy left the rural sector shortchanged. In its report to the tenth National Assembly in May 1999, the government promised to put more emphasis on the rural sector. However, there is a wide gap between objectives and realities. For example, newly introduced income tax rates for businesses in the rural sector in 1999 are higher than for the urban or foreign invested corporate sectors.

Cooperation between the private and public sector is necessary. There is a need to reassess the role of the public sector in the education, health and safety net areas. China's partnership between the public and private sector in education could be an interesting example for Vietnam (see Kai 1999). This partnership has been extended from primary to tertiary education, especially in the vocational and technical secondary schools.

Example 2 Social services throughout Vietnam are underfunded. Local governments have to shoulder 90 percent of the operating costs of education and health without a concurrent reallocation of fiscal authority. However, the capacity to raise revenues differs among provinces and, as a result, this situation tends to widen the gap between urban and rural areas. Provinces tend to overstate their expenditures and underestimate their revenues in order to claim larger transfers from the national budget. Emphasis is required on fiscal area and improvements in the intergovernmental finance system that could help ensure that each level of government is adequately funded (see Bird, Litvack and Rao 1995). Provinces must play a greater role both in raising revenues and in allocating expenditures, with incentives built in to ensure responsibility and efficiency.

After years of socialism, the transition to a public-private sector partnership is an imperative necessity and would resolve many difficulties between state policies, state practices and socio-development outcomes.

Redefining the partnership between the public and private sectors in managing the education, health and safety net sectors is an unfinished agenda. What could Vietnam do to improve the social sectors?

3.3 Targeting social service reforms

The precise mix of social service and safety net policy reforms depends on Vietnam's income level and ultimately on economic growth. Social service reforms cannot be established overnight. In the short term, Vietnam could promote targeted realistic reform in the social sectors as follows.

3.3.1 Improving basic education in partnership with the private sector

Much remains to be done to achieve universal primary education, especially in the poorer areas of Vietnam. Through the use of the internet, poorer areas can link to the outside world. The delivery and quality improvement in the basic education could be achieved with the partnership with the private sector, including religious organizations and increased competition. In basic secondary and vocational education, Vietnam should find the right mix between regulatory and direct involvement in the educational activities and allowing the private sector to contribute.[11]

3.3.2 Improving the communal health system

Improving rural health and sanitation is not always costly. The bulk of health and sanitation problems–infectious, respiratory and parasitic diseases, safe water and sanitation–can be solved at the CHC level. Local conditions and needs differ from place to place. Leadership and management at the CHC level are important factors in health service quality, access and delivery, especially the preventive care for children at the commune level.[12]

In order to increase the effectiveness and revitalize the CHC healthcare network, local integration of vertical preventative health programs might be pursued. Commune-level health staff should be able to participate in the determination of priorities for their areas. This pragmatic approach to community health development must go hand-in-hand with public administration reform, fiscal and decision making decentralization.

Reform of the current health insurance system is needed, especially for the rural sector. The Hai Phong model of reformed health insurance could be illuminating for the formulation of an improved healthcare system for the poor and the rural sector.[13] Private individual providers (doctors, pharmacists, healers, etc.) have been allowed to operate but there is a need to publish regulations to ensure quality in private practice and safety for medication and overall standards of medical care and costs.

3.3.3 Strengthening social safety nets

The present VSSO is not sustainable because payments will not be sufficient to cover future payouts. There is much inefficiency in the management of the system. The burdens of providing assistance to war invalids and martyrs' families will constrain Vietnam's safety net for many years to come.

Lately, Vietnam has allowed many international private insurance companies to operate. This is a good start because competition will foster efficiency. Many countries of Asia and former socialist countries have moved from a budget-type social security system toward a multi-pillars social security system. Being a latecomer, Vietnam can benefit from these experiences.

4 Concluding remarks

Under the old central-planning system, social services were free but were restricted to basic services with few choices. With *Doi Moi,* a new policy called *xa hoi hoa* or socialization was introduced. User fees were introduced and private operators were selectively allowed to operate in health and education sectors. Vietnam has achieved considerable progress in improving the basic education and health sectors. Its elderly are living longer than ever and literacy rates high, even if the system is still burdened by the assistance to a large number of war invalids.

Education and health spending together represent 3 percent GDP and social safety net around 3–4 percent. Currently, social sector accomplishments are under threat because poor families bear a disproportionate burden in sending their children to school or to hospitals, even with external ODA commitments in the social sectors. During the 1987–97 period, secondary and tertiary education received an increasing proportion of public funding at the expense of primary education. In the health sector, only a small fraction of the small health budget was allocated to the CHCs, which serve 77 percent of the population. The pension and social relief expenditure in the budget equals education and health combined, although 80 percent of its resources mostly benefits a minority, the public servants, and only 13 percent were served by this safety net.

Private contribution is 7 to 8 times larger than the budget contribution in the health sector. In the education sector, the contribution of the private sector is equal to the budget contribution. Furthermore, these sectors are inefficient because of the monopoly of the state, including the distribution of budget subsidies and the need to improve the safety net's sustainability.

Vietnam does not have a modern safety net system. Social services are under threat because rural areas must contribute more than urban areas. Social sectors are in full transition and it will depend on Vietnam's income level, the extent and nature of its poverty problem and many other factors.

A modern social safety net, and education and health systems cannot be established overnight and must be a long-term objective. Their improvement depends ultimately on the continuing economic growth.

Current difficulties stem from the insistence on the leading role of the state in the delivery of services while it does not have the resources and management skills. To better serve the poor, and especially the rural poor, the introduction of competition in the delivery of services would be an improvement and would enhance the quality of services. There is also the need for a new approach to public-private sector partnership, including the delivery of services by various non-governmental or religious organizations, which would complement and support public funding in the social sectors and reduce poverty.

Vietnam should take a fresh look at alternative development strategies in which the partnership between the public and private sectors are a main force for development. Strong administrative and regulatory reform could provide the needed improvement in the social sectors. Main ingredients for success include:

1 the existence of a competent civil service;
2 good regulations;
3 a good partnership with the private sector; and
4 strong competition in the delivery of social services. This means that the civil society could contribute within the rules and regulations.

Doi Moi was successful because farmers were free to produce. It brought the redefinition of the role and functions of government, but old habits die hard. However, Vietnam has an enormous stake in promoting the same kind of reform in targeted social sectors to ease the impact of this difficult transition period. Within a poor country, this can only be accomplished through a healthy partnership with the private sector and other organizations of civil society. A key development strategy would be to encourage private sector contribution in all areas, with the public sector intervention only in areas where it has an advantage or for social equity reasons. Such an approach would be greeted with enthusiastic approval by the majority of recipients of social services themselves and by the international community which has promoted the changes for years.

Notes

1 The official poverty line takes into account only food consumption. It is defined as 2,100 calories per person per day or the equivalent of 25 kg of rice per person per month in the urban area and 20 kg of rice per person per month in the rural area. A person with food consumption of less than 20 kg of rice per month is considered as poor. According to the Ministry of Veterans and Social Affairs, a poor person in the mountainous area is one with an

income less than 55,000 dong (or US$3.9) per month, 70,000 dong (US$5) for the rural area and 90,000 (US$6.4) dong for the urban area. This definition of poverty is lower than the World Bank definition of US$1 per person per day.

2 The difference between conservatives and reformists is chiefly the speed of change. This problem has been analyzed by many authors including Vasavakul (1996, 1997), Thayer (1998:42) and Dinh (2000b: 360).

3 A province gets income from (i) 'own' taxes assigned by the central government and collected by the province, (ii) 'share' of taxes split in some proportion by the central government and (iii) transfers from the central government. In general, local governments do not have tax powers or discretion in allocating revenues. Revenue and expenditure projections are based on norms set by the Ministry of Finance. The budget process is lengthy and complicated.

4 Under the Copenhagen World Social Summit in 1995, countries have committed to devote 20 percent of their ODA and budget expenditures to BSS. Total BSS disbursements for Vietnam in 1997 remained low (see UNDP 1998b).

5 Vietnam first allowed private colleges in 1995. Currently it has 16 private colleges out of a total of 230 nationwide. Nearly 23 million students at all levels were enrolled in the 2000–1 school year (see also Lam 1995 and World Bank 1996).

6 Data from the 1992–3 LSS and the Vietnam Education Financing Sector Study (VEFSS) show a high contribution from recipients. The VEFSS also discussed the various policy options for the education sector.

7 It is estimated for each US$1 received through official channel, US$2 is sent in cash by informal channels (see Haughton 1999).

8 A key finding for the VEFSS is that public expenditure for primary education is low relative to other levels and relative to private spending.

9 The UN's report on poverty elimination in Vietnam gives a good account of causes and difficulties of the poor (see UNDP, UNICEF and UNFPA 1995).

10 It is known as Pillar 1 as popularized by the World Bank (1994). Under this system, known as pay-as-you-go (PAYGO), pensions are paid out of levies on current payrolls. All over the world, this PAYGO system is under fiscal stress. In Vietnam, declining SOE contributions led to a reduction in the collection of payroll levies.

11 The government has issued a set of regulations for private schools. It requires them to follow the same curricula, textbooks and schedule. Currently 20 percent of students from kindergarten to high schools follow the private schools. However, private schools lack teachers and many schools hire public school teachers to work on a part time basis.

12 Discussion with Dr. Q.Kieu, head of the project Vietnam of the American Academy of Pediatrics. Experiences in Da Nang, Quang Binh, Ninh Binh and Thanh Hoa show that involvement of the health personnel and recipients of healthcare are important factors at the grassroots level. Experiences of NGOs yield similar results.

13 Hai Phong's experience in providing healthcare for the poor is of interest for the development of a health insurance system for the rural sector. In 1993, the Hai Phong's VHI committee decided to help the poor receive healthcare through the purchase of a VHI card. Public authorities determine the status of poor households and buy healthcare cards for the poor. See De Morey (1996:95).

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19 Measuring multidimensional aspects of poverty

A case study of Ben Tre province

Thang Tan Nguyen

1 Introduction

Throughout the world, from rich to poor countries, all agree that reducing poverty is a fundamental objective of long-term economic development. Poverty exists everywhere in the world. The most well known countries to experience severe poverty are located in developing regions such as India, South East Asia, Africa and South America, but poverty also occurs in developed and wealthy countries. Poverty not only results in many people suffering, but in the suffering of a country as a whole. When considered carefully, it can be seen that all the effects of poverty are negative. Poverty results in many tragic outcomes. These include overcrowding, starvation, lack of clothing, malnutrition and disease.

The twentieth century witnessed major improvements in the health and education status of many, reflected in declining infant mortality rates, increasing life expectancy and higher literacy rates. Globally, the proportion of people living in poverty declined from 29 percent in 1987 to 26 percent in 1998 (see IMF 2000). The reduction in the incidence of global poverty is attributed to progress made in East Asia, most notably in the People's Republic of China, although progress was somewhat reversed during the recent Asian economic crisis. The performance in three other regions (Africa, Latin America and South Asia) shows only moderate or no declines in the incidence of poverty, while the number of people living in poverty in these regions has increased. In Sub-Saharan Africa, an additional 74 million people joined the ranks of the poor, reaching a total of 291 million in 1998. In Latin America, the figure increased from 64 to 78 million and in South Asia a total of 522 million people live in poverty. Eastern Europe and Central Asia experienced an increase in both the incidence of poverty and the number of people living below the international poverty line. Here, the incidence rose from 2 percent to 5 percent, translating into 24 million people in poverty (see IMF 2000).

Recently, 1.2 billion people have been estimated to still live on less than US$1 per day, and almost 3 billion on less than US$2 per day. In addition, 110 million primary school age children in developing countries are out of school and 60 percent of them girls. All over the world, there are many more people living without adequate food, shelter, safe water and sanitation (see IMF 2000).

2 An overview of the poverty situation in Vietnam

Poverty has no limit and exists everywhere in the world, especially in developing countries including Vietnam. In 1993, the Living Standard Survey (LSS) in Vietnam indicated that nearly 58 percent of Vietnamese people were living in poverty. As such, with a per capita GDP of US$200 in 1993, Vietnam was still one of the poorest countries in the world. In the 1990s, after achieving a successful process of *Doi Moi* reform, the Vietnamese economy was changed from a centrally-planned to a market-based mechanism and since then, Vietnam has achieved remarkable results of poverty reduction. According to a World Bank report, it is in no doubt that poverty in Vietnam has been quickly reduced from 1993 to 1998 (see World Bank 1999a). The proportion of people with per capita expenditure under the total poverty line has dropped dramatically from 58 percent in 1993 to 37 percent in 1998. The number of people below a ‘food poverty line’, which is lower, has also declined from 25 percent to 15 percent, indicating that even the very poorest segments of the population have experienced improvements in their living standards during 1993–8.

The poverty level has been largely lowered in seven areas of the country. According to the same report, three regions account for almost 70 percent of Vietnam’s poverty: Northern Uplands (28 percent), Mekong Delta (21 percent) and the North Central Coast (18 percent). In general, poverty in Vietnam is largely a rural phenomenon and about 90 percent of the poor live in rural areas. The incidence of poverty is higher in rural areas (45 percent) than in urban ones (10–15 percent depending upon what estimate of unregistered migrants in poverty is used) and so is the depth of poverty.

The dramatic gains in poverty reduction in Vietnam during the last 5 years remain quite fragile. According to another World Bank report in 1998, poverty estimates are very sensitive to the exact positioning of the poverty line (see World Bank 1998) and the incidence of poverty might best be described as lying somewhere in the range between 30–45 percent. It is obvious that this proportion is still very high and therefore Vietnam has to continue its campaign of combating poverty in a quick and radical way in order to achieve the goal of sustainable development in the context of global economic integration.

To do this, the multidimensional and comprehensive pictures of poverty in such poor areas should always be drawn successfully first so as to have appropriate policies of poverty reduction apply in the right places whenever necessary. However, methods of measuring poverty are not simple and disputable over the centuries. Indeed, poverty is a multidimensional phenomenon that results in many tragic outcomes, such as overcrowding, starvation, little clothing, malnutrition, diseases, vulnerability, limited access to fresh water, poor sanitation, no voice in the community and lack of human basic needs (see World Bank 1999b). Therefore, measures that only reflect a partial picture of poverty such as income or expenditure come to be seen as inadequate; the approach of identifying the poor by lack of income will be supplemented by an alternative approach in this chapter.

3 Other methods for measuring poverty

Definitions of poverty and what it means to be poor are generally understood without too much difficulty in normal life. It is easy to see that a rich person is quite different from a poor one from their life style, appearance and possessions. However, it is a quite a different matter when poverty comparisons or making policies for poverty reduction need to be made. These purposes require a theoretical background. A vast literature has accumulated on alternative definitions of poverty, which will be briefly discussed before another method of measuring poverty is presented in this chapter.

3.1 Income or money-metric perspective

The most common way to measure poverty is based on income or consumption level (see, for example, Ravallion 1992 and McKinley 1997). A person is considered poor if his/her consumption or income level falls below some minimum level necessary to meet basic needs. This minimum level is usually called the 'poverty line'. This money-metric approach has proved to be useful when applied for making comparisons over time and across countries.

Although this conventional approach has proved itself to be useful for many purposes it does face some problems which are discussed below. First, data on incomes or consumption are usually collected at the individual level through household income and expenditure surveys. There are no direct estimates of the command over resources or consumption of individuals.

Second, there is a concern regarding economies of scale in household consumption. Obviously, a larger household will require more income than a smaller household to meet the needs of its all members. But the total income that it requires will not be larger in proportion to the number of its members. Third, information obtained through household surveys has a short reference period–usually less than one year. This conventional approach, therefore, is increasingly supplemented by other approaches with non-income indicators so as to give an overall picture of the poverty situation.

3.2 Basic needs perspective

The basic needs approach to poverty can be summarized as follows:

> Poverty is deprivation of material requirements for minimally acceptable fulfillment of human needs, including food. This concept goes well beyond the lack of private income: it includes the need for basic health and education and essential services that have to be provided by the community to prevent people from falling into poverty. It also recognizes the need for employment and participation.
>
> (UNDP 1996–7)

Recently, there has been a trend towards the use of the Minimum Basic Needs (MBN) approach for measuring or monitoring poverty. This approach views poverty as a multidimensional state of deprivation characterized by lack of access to potable water, lack of adequate shelter or lack of nutritional food, among others (see Micro Impacts of Macroeconomic and Adjustment Policies (MIMAP) Project Updates 1997).

The major difference between the basic needs approach and other poverty alleviation strategies is that for its success, it depends on the astute transfer of technology. It does not rely solely on income generation or transfers, but rather on the provision of opportunities for the full physical, mental and social development of individuals, which in today's world, revolve around the gaining and using of knowledge or the transfer and assimilation of information and technology. Further, the basic needs approach differs conceptually from many other poverty-oriented strategies in that for the best results it should be targeted at not only a few groups considered as poor, but the entire population, on the basis that poverty is widespread in underdeveloped countries.

3.2.1 MBN indicators

The MBN indicators are basically grouped into three aspects, namely, survival, security and enabling needs. In this set, income is but one indicator of enabling needs. This approach views poverty as a multidimensional state of deprivation characterized by lack of access to potable water, lack of adequate shelter, lack of nutritional food, etc.

According to the authors of the MIMAP project, the poor are identified through the MBN approach because these indicators are related to, but more easily observable than, income; or they can represent achievements (shortcomings) that are desirable (undesirable) by themselves. In other words, the MBN indicators could be used either as a *proxy for income-based poverty,* or as an *alternative definition of poverty* altogether. But how exactly we use it to define poverty is another matter. One possible approach is to set an apparent benchmark, classification or criterion for determining poor households based on their MBN characteristics. This project made use of six indicators found in the Family Income and Expenditures Survey (FIES). They are:

- access to potable water;
- access to sanitary toilet facility;
- non-makeshift house;
- non-squatting tenure status;
- above-basic educational attainment of the household head; and
- per capita income at least equal to the given poverty threshold.

3.2.2 Limitations of the basic needs approach

Basic needs policies will have to recognize the economic, political, social and cultural, as well as the technological differences among countries and groups. Consequently, there are no objective criteria for defining the contents of a basic needs package. So although basic needs will have to address the minimum physiological conditions necessary to sustain life, there are no detailed prescriptions to include the various geographical areas, cultural nuances and timing of interventions. There are also no fixed levels of basic needs but rather a spectrum of them, specific to each case. Basic needs, therefore, is a dynamic country specific concept that should be placed within a context of overall national economic and social development. Recently, another perspective which has also been widely used in the world is the 'capability approach' (see UNDP 1996–7).

3.3 Capability perspective

'In all countries, poverty can not be eradicated merely by boosting income. It will also take a broad expansion of basic human capabilities and the productive use of those capabilities,' warns the 1996 Human Development Report (UNDP 1996–7).

Human development is more frequently understood in terms of capability perspective by the World Bank, UNDP and other international organizations because practically this concept in poverty analysis has shown its advantage and has been used mainly with simple functioning data. This issue was mentioned again in the Human Development Report in 1997 (see UNDP 1996–7): 'Poverty in the human development approach draws on different perspectives of deprivation but draws particularly on capability perspective.' The report introduces a new, multidimensional measure of human deprivation called the capability poverty measure (CPM). The CPM considers the lack of three basic capabilities:

1 the lack of being well nourished and healthy, represented in this case by the proportion of children under 5 years who are under-weight;

2 the lack of capability for healthy reproduction, shown by the proportion of births unattended by trained health personnel;
3 the lack of capability to be educated and knowledgeable, represented by female illiteracy.

A higher ranking indicates a higher level of capabilities.

In his research, McKinley (1997) has shown some examples of basic capabilities:

> A life free of avoidable morbidity, being adequately nourished, being informed and knowledgeable, being capable of healthy reproduction, enjoying personal security and being free to actively participate in society. Each of these are measured differently, with different indicators, based on capability-specific thresholds.

McKinley also stated that human deprivation should not be defined in terms of all important capabilities, but only essential or 'foundational' capabilities. Examples are malnourishment, illiteracy, ill health from a preventable disease or physical hardship occasioned by inadequate shelter. Being able to function on the basis of these essential capabilities is an objective, observable phenomenon; it is not a matter of subjective perception, nor is it culture-specific.

The difference between the capability and basic needs perspectives is that basic needs tends to concentrate on the means to satisfy human needs (e.g. food, shelter, health care) and not on human capabilities themselves. The capability approach puts the emphasis on people as active agents, with abilities and capacities, whereas basic needs tends to see them in a more passive role, in need of certain goods and services. There are two main types of indicators officially used for measuring capability poverty, one is the capability indicator and the other is the human poverty index.

3.3.1 Capability poverty indicators

The CPM in the 1996 Human Development Report is an example of a simple composite index of human deprivation. The first two indicators (underweight young children and illiterate adult women) are direct measures of human capabilities, namely, the capabilities of being adequately nourished and being informed and knowledgeable. The third (births unattended by trained health personnel) is not a direct measure; it is an access indicator that acts as a proxy for the capability of safe and healthy reproduction. The percentage of low-birth-weight babies would be a desirable indicator for the latter capability, except that the data for it come mainly from births in hospitals whereas many low-birth-weight babies are born outside medical facilities.

Four groups of indicators for capability are presented here: health and nutrition, reproduction, education and housing. For each group only a core set of indicators is offered, with the emphasis on outcome indicators. In practice, this core set should be supplemented by a larger group of output and intermediate output of variables that measure the critical factors that contribute to these outcomes. A number of such indicators are already in common use and are summarized in Table 19.1.

HEALTH AND NUTRITION

Health and nutrition here are combined into one category because in terms of outcomes, i.e. people's quality of life, it is often difficult to distinguish the impacts of the two. In practice, the distinction among inputs may be clearer, such as between the availability of food and immunization against disease.

Life expectancy is chosen as a leading indicator for this cluster because it is a comprehensive outcome variable that is able to reflect the impact of a broad range of factors, health, nutrition, lifestyle, environment and so on. The under-5 mortality rate serves the same general function except that it is focused on children. Neither of these indicators identifies poverty as such. However, among particular groups–geographically or ethnically defined perhaps–where there is a high incidence of capability or income poverty, there will tend to be unusually low life expectancy or high under– 5 mortality rates.

Immunization rates for 1-year olds and for mothers are intermediate output indicators that serve as a test of the effectiveness of the public-health system; considered as input, they affect such health outcomes as

Table 19.1 Capability poverty indicators

Health and nutrition	• Life expectancy • Children under 5 under-weight • Under 5 mortality rates • Stunting (height for age) • Immunization rates for wasting (weight for age)
Reproduction and education	• Low birth weight • Adult literacy rates • Percentage of anemic mothers • Net primary enrollment ratio • Infant mortality rate • Primary completion ratio
Housing	• Floor area per person • Percentage of dwellings with sanitation • Percentage of dwellings with covered floor

Source: McKinley (1996).

life expectancy and under-5 mortality rates. In general, they are related to people's capability to escape medically avoidable cases of morbidity or mortality.

The percentage of children under-5 who are underweight is an important outcome variable because it reflects both the short-run and long-run consequences of under-nutrition. It also reflects the effect of ill health on children's ability to assimilate food. The nutritional condition of children is a good indicator of the condition of the whole population. Stunting shows the long-term effects of under-nutrition while wasting can provide information on its short-term effects. All three of these indicators are excellent for identifying capability-poor households

REPRODUCTION

The percentage of infants who are born with low weight is chosen as the principal outcome variable for reproduction because it registers the health and nutritional condition of the mother as well as of the infant. The percentage of expectant mothers who are anemic gives more direct information on their health condition. The infant mortality rate provides information on more critical lapses in provision of conditions for safe and health reproduction.

The infant mortality rate can be used to identify groups with a high incidence of poverty. The percentage of low-birth-weight babies or of anemic expectant mothers can help to identify households that are capability-poor in this respect.

EDUCATION

The adult literacy rate is an outcome variable that represents a stock of educational attainment and can be used to monitor the effectiveness of a country's basic educational system. Both the net primary enrollment ratio and the primary school completion ratio are immediate output variables that reflect current educational conditions; they are inputs, for example, into future changes in literacy among the population 15 years of age and older. All three of these variables can be used to monitor capability-poverty at the household level–that is, show whether the adults or the children of a household lack basic educational capabilities.

HOUSING

Shelter satisfies a basic human need for physical security and comfort. Measuring characteristics of the dwelling is an indirect way of gauging the well-being of people. The size of housing–namely, the floor area per person–is used as a proxy for housing's overall adequacy. An alternative, much in use, would be the number of rooms per person.

The size of housing is supplemented by information on whether the dwelling has such rudimentary facilities as a toilet and covered floor.

In order to identify poor households in terms of housing conditions, a threshold would have to be determined for the size of the dwelling, below which it would be considered inadequate. This threshold, necessarily arbitrary and set for just one dimension, would have to be combined with other minimally acceptable conditions such as having sanitation facilities or a covered floor. Other indicators that could serve a similar purpose are the household's access to potable water or to sources of energy such as electricity.

Generally, the major drawback of this type of indicator is the difficulty of covering all required information in one household survey, which will be more complicated and difficult to be carried out on a large scale. Therefore, there is a trend to focus only on the major dimensions of poverty in terms of capability perspective which are nutrition, health and education.

3.3.2 Human Poverty Index

The UNDP, in its Human Development Reports beginning in 1990, has chosen a series of indicators that have been varied and adjusted over the years, with a purpose of evaluating the situation of different countries. With that purpose in mind, the UNDP's *Human Development Report* 1997 introduced a human poverty index (HPI) in an attempt to bring together in a composite index the different features of deprivation in the quality of life to arrive at an aggregate judgment on the extent of poverty in the community. The HPI pursues the same approach as the CPM (see UNDP 1996–7) but on a broader and more representative set of variables in a consistent relationship to human development.

As a concept, the HPI includes many aspects that cannot be measured or are not being measured. However, it is difficult to reflect on many aspects in a composite measure of human poverty in reality. In particular, issues of poverty in the developing countries may be different from the developed countries. Poverty in the developing countries involves hunger, illiteracy, epidemics and the lack of health services or safe water, whereas in the developed countries these issues are not so central. Here, the focus is more on so-called *social exclusion.* As a result, there is no real possibility of constructing an index of human poverty that would be equally relevant in the different types of countries (see UNDP 1996–7).

The HPI in the 1997 *Human Development Report* includes deprivation in three essential elements of human life: longevity (measured as life expectancy at birth), knowledge (measured based on a combination of adult literacy and combined primary, secondary and tertiary enrollment) and a decent living standard (measured as purchasing power parity GDP per capita). The HPI is summarized in Table 19.2.

Table 19.2 Human poverty index indicators

Indicators	*Description*
Percentage of people expected to die before the age of 40	Vulnerability to death at a relatively early age
Percentage of adults who are illiterate	Adults being excluded from the world of reading and communication
Composite indicator reflecting a decent standard of living: % of people with access to health services % of people with access to safe water % of malnourished children under age 5	This composite indicator reflects a decent standard of living and overall economic provisioning

Source: UNDP (1996–7).

It is believed that the HPI is useful for policy makers in that it can supplement the deficiency of income in capturing different aspects of human poverty. It can also be used as a tool for identifying poor areas within a country so that policies can be drawn up for targeting the poor in areas of priority. The HPI can play an alternative role of a simple composite for assessing the human development of a country over time instead of using the GDP or other measures.

LIMITATIONS OF THE HPI

Like any indicator in use, the HPI does have its drawbacks. This composite indicator cannot capture income poverty in its many dimensions. However, it can serve as a useful complement to income measures of poverty. Another drawback is that with the HPI the incidence of human poverty in a country can be judged, but this incidence cannot be associated with a specifically targeted group of people. Moreover, a problem also arises in the process of aggregating the three components of the HPI. 'The process of aggregation can be sensitive to the overlaps in the three dimensions of HPI', states the *Human Development Report* 1997. In fact, there may be a number of persons who are identified as poor with this method while it remains unclear whether they are deprived on all three dimensions of the HPI or just two of them.

The criticisms of the HPI also arise from its construction and from what it leaves out. First, by deriving a 'deprivation index' that in effect subtracts a country's actual level of welfare from the maximum observed internationally, the index is clearly sensitive to the maximum and minimum values of the indicator. It is also obviously sensitive to the weights (equal) assigned to its components. Moreover, there is a qualitative assumption problematic for many social scientists in that the HDI is of operational use only to developing countries because developed countries tend to be close to the maximum. Second, the HPI is impervious to changes in income or wealth distribution. Third, by concentrating on only three aspects–health, knowledge and material status–the HPI misses other elements of well-being such as social status, quality of the environment and freedom.

Another problem with this composite indicator, as Lok (1995) argued, is that the HPI has sometimes been erroneously interpreted as a measure of sustainable human development (SHD). For example, many national development reports have disaggregated the HPI by regions, etc., and used the results to illustrate varying degrees of SHD within a country. Although the HPI is certainly an improvement over per capita income as a measure of SHD, it only captures a few of its characteristics. The HPI contains variables for longevity, human capabilities (measured by literacy and schooling) and income, while SHD refers to a much broader range of factors spanning the political, economic (growth and equity), social and environment spheres.

3.4 Methodology for measuring multidimensional aspects of poverty

There are no accurate and undisputed measures of poverty, no consensus as to the starting point or to the conclusions. Every method has its usefulness and drawbacks. The money metric approach appears to be less reliable when being used alone to assess poverty. It should be supplemented with other social indicators to draw a more comprehensive picture of poverty. Nowadays, a more direct way of identifying human needs is preferred by measuring material well-being in its multidimensional aspects, such as nutritional and health status, life expectancy, education and housing conditions. These aspects are well captured in the basic needs and capability approaches as mentioned above. To sum up, no matter what method is utilized, if any can simplify the task of identifying the poor and capture well multidimensional aspects of capability poverty it will be useful. The following section will discuss an alternative method which has been successfully employed by Sosa (1997) and can measure many aspects of poverty.

First, some quantitative regression analyses were carried out to examine the relationship between income and some essential basic functionings. This was done to see how well income reflects levels of poverty. It was found that this relationship is ambiguous. In addition, some tests were conducted to see whether not there is any significant relationship between the income indicator and other social indicators with regard to nutrition, health, the educational level of the household head, etc.

In order to see more clearly the role of income in explaining the shortfalls in the two basic functions such as health and education, four logit regressions were run. The analyses are based on data derived from the LSS of 4,800 households in Ben Tre province conducted jointly in 1997 by UNDP and Institute for Economic Research of Ho Chi Minh City (IER).

The variables used in the various regressions are defined as follows:

YPCH:	Income per capita
SECONDUM:	A binary dummy variable representing the education level of a household member. It takes value 1 if the household member goes to secondary school or higher; and 0 otherwise.
MORBDUM:	A binary dummy variable representing the health condition of a household member. It takes the value 1 if the household member has been seriously sick over the last 12 months; and 0 otherwise.
ZONA:	A binary dummy variable representing the location of the household. It is equal to 1 if the observation is from a rural area; and 0 otherwise.
SEX:	A dummy variable taking value 1 if the person is female and 0 if the person is male.
AGE:	Age of the household member.
CHILDDEP:	Child-dependency ratio (number of children under 12 divided by the total number of people in the household).
PERSONS:	The number of persons who live regularly in the household.

Four logit regressions were run and the regression results are summarized in Table 19.3. The results of the regressions show that the income variable appears to play a less important role in all models used to interpret shortfalls in health and education. However, the aim of this chapter is not to prove the proposition that income does not matter, but to point to the fact that its role is not exclusive but depends on a plurality of personal, household and regional characteristics. Income in itself is not the one conveying all the information of interest if the aim is to provide a comprehensive picture of poverty. As such, if a person is defined as income poor one cannot know for sure whether or not he will be poor in other social aspects as well. So the way to define who the real poor are without using income but capturing income poverty is of main interest and discussed by using this methodology.

It is believed that this method contains some indicators which are good proxies for income and more observable in measuring human deprivation. Therefore, this methodology utilized regression models to consider the relationship between income level and other visual indicators of housing, facilities and over-crowdedness. The results of those regressions are that the visual indicators utilized in this alternative methodology can be good proxies for income since they show strong relationships both with income and with other social indicators as well. With this approach the poverty line will be derived to identify the poor based on the indicators of housings, over-crowdedness and facilities being used in the household.

Table 19.3 Regression results

Variable	*Coefficient*	*Standard Error*	t-*statistic*	*Probability*
SECONDUM = f_1(*YPCH*)				
Constant	−0.63149	0.02103	−30.02779	0.0000
YPCH	0.00062	0.00006	10.44178	0.0000
Sample size = 16,383				
Log likelihood = −10,816.67				
SECONDUM = f_2(*ZONA, YPCH, SEX, AGE, PERSONS, CHILDDEP*)				
Constant	0.88861	0.07472	11.89302	0.0000
SEX	−0.33060	0.03350	−9.86950	0.0000
AGE	−0.01709	0.00093	−18.30993	0.0000
ZONA	−0.34758	0.04068	−8.54482	0.0000
YPCH	0.00049	0.00006	8.40239	0.0000
PERSONS	−0.01620	0.00873	−1.85470	0.0637
CHILDDEP	−2.61842	0.10115	−25.88676	0.0000
Sample size = 16,383				
Log likelihood = −10,272.61				
MORBDUM = f_3(*YPCH*)				
Constant	−0.56555	0.02452	−23.07009	0.0000
YPCH	−0.00028	0.00007	−3.80417	0.0001
Sample size = 12,672				
Log likelihood = −8,182.28				
MORBDUM = f_4(*ZONA, YPCH, SEX, AGE, SECONDUM, PERSONS, CHILDDEP*)				
Constant	−1.26455	0.09183	−13.76988	0.0000
SEX	0.10272	0.03810	2.69594	0.0070
AGE	0.01556	0.00112	13.85830	0.0000
ZONA	0.38531	0.04853	7.93987	0.0000
YPCH	−0.00022	0.00007	−3.00371	0.0027
SECONDUM	−0.24369	0.03992	−6.10446	0.0000
PERSONS	−0.033021	0.01011	−3.26670	0.0011
CHILDDEP	0.91471	0.10912	8.38288	0.0000
Sample size = 12,672				
Log likelihood = −7,979.7				

In order to identify the poverty line, this methodology utilized three major indicators: housing index, facilities index and bed index (reflecting the overcrowdedness in the household). The people who are poor according to the determined poverty line will be examined further to obtain their profile, the causes and probabilities of being poor. The main purpose of setting the poverty line here is to identify the group of poor people in a rural area and their profile so as to focus attention. Once the poor are identified by three indexes representing the housing conditions, the grade of utilities and the overcrowdedness, the poverty profile of the poor in Ben Tre will then be identified for the government to know more clearly about the poor and set policies for targeting them (for a more detailed discussion refer to Nguyen 1998).

4 Case study of Ben Tre province: a poor province in Vietnam

The author has applied the method outlined above to the data obtained from the LSS of Ben Tre province. The aim of the study is to examine the poverty situation in Ben Tre, which is the poorest province in the Mekong Delta. According to his calculations, 43 percent of the population in Ben Tre province are living in poverty. This proportion accounts for 2,064 households in the total of 4,800 households in the observed sample. More specifically, it was found that of the classified poor households, there are:

- 1,892 households whose housing index is less than or equal 0.25, meaning that they are living in a house whose walls, floor and roof are made of the worst materials;
- 108 households who are living, on average, in good houses but do not have adequate basic facilities;
- 64 households who are living, on average, in good houses and have adequate facilities but are overcrowded.

The Institute for Economic Research (IER) in Ho Chi Minh City has also done the assessment of poverty in Ben Tre based on the same kind of data which were derived from the Socio-Economic Household Survey performed by themselves in 1998. To measure poverty, the IER applied the poverty line of 1,675,000 dong for classifying the poor and the non-poor. The people whose monthly consumption is below this poverty line would be considered as poor. This benchmark represents the total consumption expenditure needed for purchasing 2,100 food calories for a person per day, plus other non-food basic goods and services.

The IER study, conducted by Truong and Nguyen (1998), found that 26.5 percent of people in Ben Tre live in poverty, whereas the author's own study suggested that about 43 percent of the Ben Tre's population are poor. The significant difference between the two studies is not surprising because the two methods are fundamentally different. Another possible interpretation is that the difference lies in the purposes of the poverty assessment. The method used by the IER mainly follows the consumption-based approach, which is widespread and easy to use for monitoring poverty over time and comparing poverty among regions. In the alternative method used in this paper, poverty is based on both the capability and basic needs perspectives, rather than on income or consumption, with the aim of measuring relative poverty in many aspects.

As such, the results do not necessarily imply that the poverty situation in Ben Tre has been either underestimated by the IER or overestimated by the author. The only thing that could be concluded here is that each method can yield its own results, which may be different from others. The choice of which approach should be applied depends not only on the purpose of the research but on the context of the region under study as well.

From the above method of analysis, 43 percent of households in Ben Tre province are considered as poor. The most important application of this comprehensive poverty picture is to recommend policies with an aim of allocating resources to poorer areas in Vietnam, especially rural areas with a poverty rate of 46.4 percent. The poverty rate in urban areas is two times less than that of the rural areas. Therefore, governmental policies to reduce poverty must focus primarily on rural areas where the vast majority of the poor live. In addition, this study shows that there are 28.5 percent of poor households whose heads are men. This also means that the proportion of poor households whose heads are women is very high, 71.5 percent. We can see this more clearly in Tables 19.4 and 19.5.

As a result, one of the effective methods for reducing poverty is to enhance the role of women both inside and outside the home. Nowadays, in any society women play an increasingly important role in the development process and therefore more attention should be paid to the role of women, not only in Ben Tre province in particular but also in Vietnam as a whole in the poverty reduction campaign. The results show that the increase in the number of dependent children (under the age of 12) in the household also increases the probability of falling into poverty. So, in order to lower the probability of poverty in Ben Tre, the fertility rate should always be kept under control.

In terms of job opportunities, of 73 percent of households in Ben Tre whose heads have had stable jobs in the last 12 months, 32.3 percent of them are still classified as poor. Therefore, in order to reduce poverty in Ben Tre the government should pursue policies that absorb and make productive use of the rural labor force. Rural development is going to be critical for growth, raising living standards and reducing poverty. Reducing poverty in Ben Tre will require both higher incomes from agricultural production, as well as diversification of incomes from non-farm activities. It is obvious that agricultural growth is the key to the growth of non-farm activities. Rising farm incomes, therefore, will lead to greater demand for consumer goods and services.

The logit regressions also indicate that the higher the income earned, the lower the probability of being poor. Therefore, for the long-term, the government should create more opportunities for those people whose jobs are mainly in cultivation and husbandry. This can be done by giving more credits with reasonable interest rates to the poor households and teach them how to use the credits in the most efficient way rather than doing nothing, because the farmers usually do not have enough experience or knowledge to catch up with new technologies which help increase the productivity in the production process.

A striking point here is that in total the number of household heads who have higher than secondary education is so small for both poor and

Table 19.4 Classification of poor households by location

	Urban			*Rural*			*Total*		
	Number of households	*Row %*	*Col %*	*Number of households*	*Row %*	*Col %*	*Number of households*	*Row %*	*Col %*
Non-poor	625	22.8	72.5	2,111	77.2	53.6	2,736	100	57
Poor	238	11.5	27.5	1,827	88.5	46.4	2,064	100	43
Total	863	18.0	100.0	3,937	82.0	100.0	4,800	100	100

Source: Nguyen (1998).

Table 19.5 Classification of poor households by gender of household head

	Number of households			*As % of grand total*		
	Non-poor	*Poor*	*Total*	*Non-poor*	*Poor*	*Total*
Male	1,769	1,367	3,136	36.9	28.5	65.4
Female	966	697	1,663	20.1	14.5	34.6
Total	2,735	2,064	4,799	57.0	43.0	100.0

Source: Nguyen (1998).

non-poor households. By looking at the results of the logit regression, we see that the most effective tool in eradicating poverty is by educating the poor. After many years of study, economists all over the world have confirmed that education is an essential factor in breaking the cycle of poverty (see, for example, De Morey 1996). Even minimal levels of education, particularly for women, can mean better nutrition, health and education for children; higher use of contraceptives and fewer pregnancies; and higher returns from income generating activities.

However, barriers still remain. One of the greatest barriers to improving children's education in Vietnam is the lack of qualified full-time teachers, which is seriously affecting the quality of primary and secondary education. To temporarily fill empty positions, district educational services should recruit candidates who have completed the ninth or twelfth grades and provide them with an intensive primary school training course. The ultimate objectives are that primary education should be universal, more schools should be built, more teachers with high teaching quality should be encouraged by highly paid jobs. One expense that all Vietnamese families face, whether urban or rural, is the cost of educating their children. Schools now are so crowded and with such a high student-to-teacher ratio, because qualified teachers are very scarce. Another problem is that some rural families doubt the value of an education for their children. They often ask questions like 'why spend so much money to educate a child, when he or she is going remain in the village, still doing farm work?'; as a result, many families lose interest in sending their children to school after a certain age.

Most of the residents in Ben Tre are living in rural or remote areas and they are obviously isolated from the community. Opportunities for non-farm employment are few, and the demand for labor tends to be highly seasonal. Most of the poor are living in the regions where the social services (education and health) and the infrastructure (irrigation, information, technical assistance, transport and market centers) are not good. This is also true not only for Ben Tre Province but for the whole country as well. There are also marked differences in access to infrastructure between urban and rural areas, with urban areas generally favored, as well as considerable regional imbalances. The poor are suffering from a lack of information, communication and facilities used for production. The effects that migration to the towns has on poverty depend crucially on whether urban employment opportunities are better or worse than in rural areas. The evidence suggests that urban areas do offer more opportunities for higher-paid jobs, and this implies that, on balance, urbanization helps to reduce poverty. So modernization and urbanization should be carried out at as high a speed as possible so as to bring them together in a commonly developed community in Ben Tre as well as in Vietnam as a whole.

5 Strategies f or alleviating poverty in Vietnam

Unlike the money metric method, this alternative method (see Appendix 19.1 for a detailed explanation), which is based on the three indicators of housing, facilities and bed indexes, is not complicated by the monetary issue because all the information needed is observable and measurable. Especially, when the poverty situation in any region has to be urgently examined in order to focus attention on alleviating poverty and hunger, this method can be applied immediately for the rapid assessment of poverty even at national level. This work can be done by a person without many skills in poverty assessment, and the results are reliable.

However, we need bear in mind that the three indexes are very sensitive to the values assigned to them. It means that people from different areas may have different cultures and ideas and may then assign different values to the same factors under consideration. This may lead to different results and therefore it is not consistent for practical application throughout the country. Once all the observable information is already at hand, more attention should be paid to the assigned values associated with the three indexes in order to make the results more consistent and feasible in practice, especially when using it for poverty comparisons among regions.

From the results of the study, it is obvious that the choice of an appropriate method to identify poverty is very important. Nevertheless, once the poverty profile has been identified, the next issue that should be solved is how to use this profile to reduce poverty in the quickest, most efficient and radical way. This is a question which has been much debated in every country in the world, including Vietnam. In order to have a comprehensive strategy for alleviating poverty, Vietnam has to focus on five major goals:

1. develop the social and technological infrastructure;
2. human development;
3. manage the economy efficiently;
4. indirectly manage the country via economic tools; and
5. enhance the potential development of economic areas and regions in the country, both in rural and urban areas.

From those leading viewpoints, the government has to clearly identify key programs for poverty reduction. The following are some recommendations of this chapter.

- Because 90 percent of Vietnamese people are living in rural areas, there is an increasing need to improve the rural infrastructure systems, especially those of roads, irrigation networks, schools, post offices and health centers.
- More job opportunities should be created. The fact that the transition to the market economy in Vietnam is still ongoing inevitably leads to the situation of structural unemployment. This is because more and more farm land will be used for constructing new metropolitan areas, which will result in the unemployment of farmers. Therefore, the government should support those unemployed people by different forms of subsidies, credits for unemployment or necessary education appropriate for the needs of the labor market.
- According to many recent studies, education has a decisive influence on the success of a poverty reduction campaign. Therefore, there is an urgent need both to improve the educational and vocational training systems to meet increasing market needs, as well as to increase other unofficial forms of education for children without any schooling and illiterate persons. Raising primary school enrollment in low-income developing countries is also an important policy goal. However, achieving this goal will require more than simply improving access to primary schools. Because access to post-primary education is an important determinant of primary school enrollment, it is equally important to expand and improve access to middle and secondary schools. In regions where enrollment rates are already acceptable, the focus of policy needs to be on improving school quality. The quality of available schooling is the single most important factor determining primary school completion.
- Promote the activities of health services: prevention from malaria, giving anti-polio inoculations, child and maternal health care, etc, as well as other programs of health treatment and free medication for the poor.
- Improve the managerial level of local officers in order to create a healthier economic environment which can provide equal opportunities for all economic sectors, including the poor.
- Promote the availability of various sources of information; increase the exchange of information among regions in order to facilitate the full and equal access of people to all available sources of information.

Appendix 19.1 An alternative method for constructing a poverty line to identify the poor

The choice of indicators

To differentiate the poor from the non-poor one always needs to use a poverty line. Unlike the income-based approach, the proposed method employs the three main dimensions which are more observable than income to set the poverty line. It is argued that a person who is considered as poor with this type of poverty line would also be poor in other aspects as well. Meanwhile, another one who is income-poor is not necessarily poor in other social aspects. These dimensions are as follows:

1 housing conditions;
2 basic facilities (water, light and toilet); and
3 adequate space for sleeping at night.

It is easily recognized that a person who lacks of any of these three dimensions would be considered as capability poor. It is also obvious that a poor person always desires better living conditions, including a better house with sufficient facilities for a comfortable life. Despite the fact that some households may have enough food to eat and be able to struggle for survival, in the longer term they will certainly hope for some positive changes in their lives. Moreover, they cannot live permanently in a house whose walls, roof or floors are made of bad materials, a house without sanitation, toilet, etc. Living in such a house also means that they are quite vulnerable to the environmental influences as well as to fatal diseases, etc. Such deprivations are closely related to other basic capability functions and appear to be so essential that they can cover other aspects of poverty such as education, health and nutrition of children, implying that a person living continuously in a bad house may be deprived in other aspects as well.

As mentioned in the literature review, in both the basic needs and capability perspective to poverty, housing is widely perceived as a basic need of a human life in any context. The conditions of the house in general, i.e. housing conditions, facilities being used in the house and the size of that household, can represent accurately the level of well-being of a household in terms of wealth and social status. Everyone desires a better life and most people share a common feeling that they do not want others to look down on them because of their poverty. So it is evident that indexes generated from housing can be used to define thresholds for identifying the poor.

Housing conditions

The main components of the house are wall, roof and floor which are easily recognized and compared between two houses to see which one is better. Further, information about the characteristics of these components can be precisely obtained by interviewers through household surveys. It is true that the overall appearance of the house can reflect the social status as well as the well-being of the household. The conditions of the house also matter for health and sanitation reasons. The cheapest materials for the construction of walls or other components are acceptable for the poor household because, despite the fact that its members would always want to live in a nice house, they have to spend their extra money, if any, on food and other basic necessities for survival. It would be the case that the poorest households which suffer from poverty for a long time will give priority to the most crucial needs such as food, clothing, medical treatment and education. 'While these persons can be considered income-poor, they are also socially inferior as a result of their housing conditions,' said Nigeli Sosa (1997). Identifying the poor this way is, according to Sosa, not arbitrary and objective.

The variables taken into consideration to reflect the housing conditions are *wall, roof* and *floor*. These three variables should be considered in conjunction. It cannot be the case that a household is considered as non-poor if its walls are made of concrete whereas the roof and floor are made of the worst materials. Each one will be assigned values from 1 to 4 corresponding to the materials used to construct it. The worst material is the cheapest and assigned value 1; the best material is the most expensive and has a value of 4.

Basic facilities (water, light and toilet)

Generally speaking, human beings cannot live long and healthy lives without those basic facilities which can be used to distinguish a poor from a non-poor household. As suggested by Nigeli Sosa, consideration should be given to the source of water, lighting, type of toilet and fuel used in the house. These types of information can be obtained from a living standards survey. However, the source of data from UNDP–Ben Tre survey utilized in this research does not have information on the type of fuel used. As a result, this chapter will consider information on the remaining three basic facilities which are sufficient in themselves to be used in conjunction for classifying the poor. Poverty in this case is reflected in several dimensions such as isolation (e.g. a household has no public piped water into the house or no electricity because they live in a remote area), social inferiority as well as income-poverty. Without those basic facilities, pressure will be put on the social status of the household and it is more likely that they will live an unhealthy life and may remain illiterate for a long time.

The variables reflecting basic facilities are source of water, source of lighting and type of toilet used in the household. Again, these variables will be assigned value 1 to 4 depending on the quality of each facility.

Over-crowdedness

The third criterion used for determining poor households is the degree of over-crowdedness. In Sosa's research, this is measured by the number of persons per bedroom in the house. However, it is believed that this criterion cannot be applied in this study for two reasons: (i) the database used does not have information on bedrooms and (ii) the number of bedrooms is not sensitive to income in Vietnam. More specifically, according to traditional customs in Vietnam, a new house does not necessarily have a bedroom for each member. In Western countries, people develop an independent lifestyle by having to stay alone in their rooms even when they are still young. In Vietnam, it is everywhere evident that members of the household usually share the same room even when their living area is large enough to build several bedrooms. This is especially true in rural Vietnam where some households can afford to build enough rooms with simple materials but choose not to do so as they like to live together. According to the author's own judgment, beds can be used as a good proxy for bedrooms.

As for the above two dimensions, this criterion is also assigned values. It seems reasonable to assign the value 4 to a household which has one or less persons per bed; value 3 in the case of two or three persons per bed; value 2 to four or five persons per one bed and value 1 if the number of persons per bed is six or over.

Indexes created from the chosen indicators

Three indexes created from the above variables are housing index, facilities index and bed index. The following formula is used for the creation of each:

$$\text{Index} = \frac{(\Sigma\text{Actual value} - \Sigma\text{Minimum value})}{(\Sigma\text{Maximum value} - \Sigma\text{Minimum value})}$$

where the maximum and minimum values are 4 and 0, respectively. The proposed index will have values ranging from the minimum of 0.25 to the maximum of 1. For a household that utilizes materials for walls with value of 1, material for floor with value 1 and also 1 for roof material, then its index would be 0.25. This house is clearly made up of the worst materials for all three components of the house (wall, floor and roof). This then enables us to create the benchmark for identifying the poor from the non-poor.

Association between the three indexes

The chi-square test is used to test the associations between these indexes since it is possible that the three indexes are correlated. In addition, the associations between income and these indexes will also be tested to see whether or not these indexes can capture income poverty.

Application of this method for identifying the poor

According to this method, the household is viewed as poor if one of the following three conditions is satisfied.

1 The housing index is less than or equal to 0.25.
   It is unlikely that a non-poor household lives in a house whose wall, floor and roof are made of the worst materials (which are therefore all assigned value 1). Hence, a housing index with values less than or equal to 0.25 can alone be indicative of poverty.
2 The housing index is greater than 0.25 but its facilities index is less than or equal to 0.25.
   Those households whose source of water is mainly from the river, which is not safe for health, who have no electricity and toilet in the house would be classified as poor. There is certainly no way that such households are considered non-poor if their facilities index is less than or equal to 0.25.
3 Both the housing and facilities indexes are greater than 0.25 but its bed index is less than or equal to 0.25.
   Again, households with not enough beds for each member, say, at least 3 or more members share the same bed would be overcrowded. This is also an evidence of poverty.

These three criteria were successfully used by Nigeli Sosa in 1997 for measuring multidimensional aspects of poverty in Belize.

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Part VI

Conclusion

20 Continued roadmap to a market economy

Chi Do Pham and Duc Viet Le

1 Introduction

This chapter will analyze the latest developments of and prospects for the Vietnamese economy, including the difficulties in recent years (as partly analyzed in Chapter 3), assessing policy measures that have been adopted in 2000–1 and finally proposing a long-term strategy at the beginning of the twenty-first century.

In the late 1980s, Vietnam implemented a comprehensive package of market-oriented reforms, including notably adjustment policies to foster economic growth and stabilization. These macroeconomic reforms resulted in impressive annual economic growth rates, broad financial stability and improved living standards in the early 1990s.[1] During 1994–7, the annual growth rate was impressive at 8–9 percent, while annual inflation fell from well above 150 percent during 1987–90 to 14 percent during 1994–5 and below 4 percent since 1996. However, structural reform was brought to a halt and exacerbated by the Asian financial crisis. This indicated that the reform that only aimed at economic stability was not enough, and new challenges in the path of *Doi Moi* for Vietnam have emerged. During 1998–9, Vietnam faced new economic problems: the growth rate fell by about half to 4–5 percent. The problems stemmed from both internal and external sources.

Internally, hesitation in structural reform further weakened the state sector, the bubble real estate market went bust, and the solvency of the banking sector worsened. Weaknesses in domestic policies hampered also important multilateral aid. International financial institutions such as the International Monetary Fund (IMF), the World Bank (WB) and the Asian Development Bank (ADB), postponed the disbursement of structural adjustment loans (the so-called program loans) during 1996–2000, in putting pressure on Vietnam to accelerate state sector reform.

In addition, the attractiveness of the Vietnamese economy was fading away compared to neighboring Southeast Asian countries, which had started to recover from the economic downturn brought on by the financial crisis in 1997–8. In particular, investment from East Asia fell sharply, as the crisis depleted capital flows to Vietnam from these countries, which had been the source of foreign direct investment (FDI) and the engine of growth for Vietnam during the mid 1990s. Another equally important reason was the corruption and red tape, which continued to impede FDI.

Since 1998, growth in Vietnam has slowed and prices stabilized and, of late, fallen. The main cause of this stagnation-deflation is an unbalanced investment strategy, which relied too much on foreign investment with inadequate attention to economic efficiency.

During 1991–7, the share of investment in GDP increased steadily, reaching 31 percent by 1997. And more than 60 percent of that investment came from FDI, which increased rapidly and on average accounted for more than a third of total investment. In contrast, the share of investment by the domestic private sector dropped very fast, from 49 percent in 1990 to 23 percent in 1997.

Foreign capital came in too much and too fast, while Vietnam was unprepared in terms of absorptive capacity. This has resulted in the emergence of an overvalued exchange rate and increasingly inefficient use of capital. Consequently, Vietnam soon lost its comparative advantages of abundant labor and low production costs compared to neighboring countries. Vietnam has shifted its investment structure from agriculture and export oriented light industries to import substituting and capital intensive industries (see Chapter 16 on FDI).

However, the biggest mistake was the policy switch to import substitution, adopted in 1996, which was well publicized as a 'grand policy re-orientation for industrialization and modernization'. Given its low level of development, Vietnam should have focused on developing export oriented and labor intensive industries such as agriculture and consumer goods, and export manufacturing like textiles and garments, footwear, toys, household appliances, household electrical equipment, etc. That is exactly what the 'Asian tigers' did in the 1980s and what China is doing now.

Vietnam has directed sizeable investments by state-owned enterprises (SOEs) into several import substituting industries, which has resulted in a huge excess supply of 'unwanted goods' from a lack of market signals, an all-too-familiar phenomenon in countries where the remnants of centralized planning are still strong. Most of the new factories do not fully utilize their designed capacity, with high costs and low efficiency. Moreover, as the competitiveness of the economy worsened, domestic protection was strengthened in recent years. A number of examples can be cited. Vietnam currently produces one million tonnes of sugar per year, more than its population could consume, but at a cost double that of the world price. This encourages smuggling and the piling up of unsold output. It is a daunting problem, as some 40,000 sugar cane workers now depend on this industry for a living. Cement and domestically produced motorcycles are in the same situation: the price of a motorcycle made in Vietnam is twice that in

Thailand and four times that in China; and Vietnamese producers are crying for more protection from the government.

In many other areas of the domestic economy, serious problems persist. The banking sector is basically insolvent with total non-performing loans becoming alarmingly large. This relates mostly to the collapse in real estate prices between 1997 and late 2000 (when the construction sector began to recover), which was responsible for the bankruptcy of many SOEs that invested heavily in construction projects. Most non-performing loans stemmed from banks' poor lending practices of the recent past, which gave priority to well connected real estate speculators and unprofitable businesses.

Regarding structural reform, the speed has been slow. Few preliminary steps have been taken to address the poor financial state of the banking sector, such as the adoption of the restructuring plan for joint-stock banks, closure or merger of weak banks or placement of a number of insolvent banks under special supervision by the State Bank of Vietnam (SBV) and strengthening of the legal framework for lending practices. With regard to the SOE reform, a new Enterprise Law that aims at creating a better enabling environment for private sector development and a decree that allows the sale of SOEs have been adopted. An encouraging outcome is that 250 SOEs were 'equitized' (the popular word officially used in Vietnam for 'privatized') in 1999. However, the inefficient SOE sector continues to be a major obstacle and the absence of a level playing field between the private and state sectors is impeding private sector development. This is the key factor that hinders growth in Vietnam.

Can the current stop-and-go policies help Vietnam exit from economic slowdown and regain its high growth of the 1994–7 period? We will state in the conclusion that in order to further the path of a market economy, it is imperative to revitalize *Doi Moi* by tackling a number of short- and long-term issues, including most notably accelerating structural reform and further transforming economic institutions.

2 Recovering from the slowdown: demand stimulus measures

From late 1999, Vietnam urgently introduced a number of measures to increase domestic demand. In general, this policy helped to improve the economy in 2000–1 compared with 1998–9, in conjunction with the boom in agricultural production and high growth in export earnings associated mainly with the sharp rise in petroleum prices. However, economic recovery seems to be fragile due to continued low investment and poor economic efficiency.

2.1 From a difficult economic situation in 1999...

The year 1999 was bad for the Vietnamese economy. The growth rate dropped to 4.8 percent, the lowest level since 1989. The negative impact of the Asian financial crisis still lingered in Vietnam, affecting exports and foreign investment. Natural disasters also intensified as rain and floods affected many areas, especially in the crop-producing zones. At the same time, consumption and investment stagnated, domestic purchasing power stayed low, inventories grew and foreign investment continued to decline. Bad debts also mounted. In addition, unemployment and under-employment increased, and social instability arose.

The slowdown in economic activity was accompanied by deflation in the latter part of 1999, which occurred for the first time in many years. This caused further stagnation in production. In the event, many economists predicted that economic conditions in 2000 would be more difficult, and that Vietnam might even fall into the spiral of recession-deflation, as observed in the case of Japan during the 1990s. Huge excess supply of goods, large inventories, increasing non-performing loans accumulated by the banking system–all these were likely to cause large macroeconomic imbalances, especially with regard to saving and investment balance, output and employment, which all weakened with the danger of economic and social crisis looming large.

2.2 ...To more positive outcomes in 2000–1

However, the economic situation in 2000–1 was much brighter than expected, and one can say that Vietnam started to reverse the economic slowdown during 1998–9.

In general, all macroeconomic indicators looked better in 2000–1 than in 1999. GDP growth recovered to an annual rate of about 5 percent in 2000–1 (according to IMF estimates; different estimates by Vietnam and other international financial institutions indicate a range of 6–7 percent for these 2 years), and all economic sectors showed much better performance than in 1999. Industrial production came back strongly by some 15 percent in 2000 and by a somewhat slower pace in 2001, but mainly for the domestic market and partly in support of a strong construction sector. Agricultural output rose by some 3 percent on average in 2000–1 but at a slower pace in 2001; and the service sector, although still staying strong, also registered a lower growth rate in 2001 due to declining rural incomes.

Export growth recovered strongly to some 25 percent in 2000, compared with 23.2 percent in 1999 and only 2.4 percent in 1998, but is expected to decline sharply to some 6 percent in 2001, mainly due to poor manufactured exports, a decline in oil prices in the second half of 2001 and depressed non-oil commodity prices. Meanwhile, import growth, after rising markedly by 34.5 percent in 2000, was contained to an estimated 6 percent in 2001, due partly to a lack of demand as many imported goods are used for exports. Thus, the current account has been maintained at a small surplus of 2 percent of GDP during 2000–1. With continued surpluses of the balance of payments in 2000–1, gross official reserves rose to some estimated US$3.6 billion at the end of 2001, or double the level at the end of 1998, a fairly comfortable level equivalent to about 9–10 weeks of annual imports. There was also a relatively more flexible exchange rate policy. After a long period of stability, the exchange rate of the Vietnamese dong versus the US dollar was allowed to depreciate by about 4 percent in 2001, but no change in real effective terms, reflecting partly the strong appreciation of the US dollar in the world market. Moreover, the authorities reduced again the foreign exchange requirement from 50 to 40 percent in May 2001, reflecting increased confidence in the foreign reserve position.

2.3 ... With reasons for achievement

The major boom for the Vietnamese economy from the recession-deflation spiral is the stimulus package that Vietnam has used to increase aggregate demand, accompanied by some microeconomic measures to solve bottlenecks in all economic sectors. Appendix 20.1 describes the main features of this package, and the detailed policies are discussed below.

Handling difficulties in production

The most critical change in the recent investment policy is the bold step in removing the infamous 'asking–giving' mechanism that is the well-known recipe for corruption and bureaucracy (private businesses used to have to go through the complicated process of asking for the investment license and the government had to approve to give the license). Since February 2000, in many sectors, all that private businesses need to do is to simply register without applying for business licenses as before. Owing to the Enterprise Law, the number of registered enterprises in 2000 jumped markedly: some 12,000 new private enterprises were registered in 2000 and private investment rose substantially by 38 percent over 1999. Available detailed data for the first 6 months indicate that 7,664 enterprises registered with total capital of 7.1 billion dong (or US$500 million), three times the number of registered enterprises and 1.7 times the capital for the same period of 1999 (see Vu 2000). This number is small but significant as the number of registered private enterprises had steadily decreased before the new law. The development of this sector is most important for changing the future economic prospects of Vietnam.

With regard to agricultural production, Vietnam issued in February 2000 a decree on the development of a 'farm economy', and further in June 2000 a decree to change the structure and improve distribution of agricultural products. The most critical problems of agricultural production, notably agricultural pricing, domestic distribution channels and agricultural export incentives, were addressed. In addition, the government allowed state banks to minimize administrative procedures in order to provide more credit to the rural area and to invest in agricultural infrastructure.

For industrial production, apart from the incentives provided for more competitiveness in the form of tariff reduction or exemption, exemption from VAT and interest subsidies, Vietnam sought to accelerate the equitization of SOEs and actively apply the Enterprise Law from early 2000. The removal of 145 types of business licenses (in February and August of 2000) created a more liberal environment for private investment and business, especially for the small and medium enterprises.

Fiscal, monetary and credit measures

A more accommodating fiscal policy stance has been adopted since the second quarter of 1999 and contributed to the economic recovery, thus helping stimulate private investment. A number of factors led to the increase in revenue, such as the rise in oil prices and improvements in tax collection, with the ratio of budget revenue to GDP increasing to 21 percent in 2000 and 22 percent in 2001, compared with 19.8 percent in 1999.

Meanwhile, budget expenditure as a share of GDP rose sharply to 25.5 percent in 2000 and 26.3 percent in 2001, with the main component being investment outlays. In 2000, the government twice added funds to the investment budget. Reflecting this expansionary stance, the budget recorded an estimated overall deficit (including all capital costs of structural reform) of about 4.4 percent of GDP in both years, compared with 2.6 percent in 1999 (see Table 20.1).

Similarly, monetary policy has been further relaxed after 1999, especially in the last two quarters of 2000, with broad money rising by some 39 percent annually in both years. However, it is expected to be contained, under the IMF-supported program, to about 23 percent in 2001. In 2000, the government allowed credit institutions to lend to SOEs without collateral, and relaxed conditions for loan guarantee for credit institutions, especially for mortgages. Commercial banks were also more accommodating, raising the amount of loans without collateral to more than 10 million dong (and up to 50 million dong) for agricultural and farming households. Moreover, the interest rate ceiling has been replaced by the base interest rate, and the foreign exchange control and exchange rate regulating mechanism have been made more flexible, both better reflecting market conditions. In 2000–1, interest rates have gone down slightly compared to 1999, which tended to encourage investment (though real rates remained high).

Table 20.1 Vietnam: macroeconomic performance, 1996–2001 (% unless otherwise stated)

	1996	*1997*	*1998*	*1999*	*2000*[a]	*2001*[a]
Real GDP growth	9.3	8.2	3.5	4.2	5.5	4.7
Inflation rate[b]	4.4	3.6	9.2	−0.2	−0.6	2.0
Overall budget balance[c] as % of GDP	−0.7	−1.7	−2.3	−2.6	−4.4	−4.9
External current account balance[d] as % of GDP	−11.0	−6.9	−4.6	4.0	1.7	1.2
External debt service ratio (debt due as % of exports)	12.9	12.8	13.9	12.8	11.2	10.2
Official reserves[b]						
in US$ million	1,673	1,857	1,765	2,711	3,030	3,601
in weeks of next year's imports	6.4	7.2	6.8	8.1	8.6	9.4
FDI as a percentage of GDP	8.1	8.3	3.5	2.5	2.6	3.3

Sources: Data are based on various IMF reports (see IMF 1989–97) and the updates and estimates for 1998–2001 are drawn from the IMF (2002).

Notes
a estimated.
b end of period.
c including grants, on-lending and capital cost of reforms.
d excluding official transfers.

The above structural, fiscal, monetary and credit policy measures resulted in large increases in investment and consumption expenditures, and hence the increase in aggregate demand. However, the end-year consumer price index (CPI), after declining slightly in both 1999 and 2000, increased by only 2 percent in 2001, owing mainly to depressed food prices, which negatively affected farmers' income in recent years. In brief, Vietnam's economic recovery in 2000–1 reflected both the positive impact of the demand stimulus package by the government and the sharp rise in petroleum export prices.

2.4 Challenges of the roadmap to a market economy

Although the economic situation in 2000–1 is basically improved over 1998–9 in the sense that the trend toward economic slowdown after the Asian crisis has been reversed, and the possibility for faster future growth has become clearer, the path toward a desired market-based economy is full of problems and will require that Vietnamese leaders further accelerate the reform program (see IMF 2002).

Problems persist for the domestic economy

Industrial production has recovered, owing mainly to export growth. However, exports are unlikely to grow significantly in the future, given the near saturation of the world market for the non-diversified exports from Vietnam. Most importantly, prices of crude oil are heading down compared to previous years. The quota for Vietnamese textile and garment exports to the European market is limited. In addition, a number of key export products such as rice, footwear, coffee, rubber and coal, are also slowing down in their growth. The only hope is the expected rise in trade with the US after the recent ratification of the bilateral trade agreement (BTA) in December 2001 (further discussion is provided in section 5).

Investment is growing again, but the investment to GDP ratio remains low, with the attendant low economic efficiency and inappropriate investment structure; these are the major concern now. In particular, many investment projects rely on large amounts of bank credit, especially in the state sector. They tend to be unproductive, which creates difficulties in repaying the loans, thus badly affecting the financial status of the banking system. The concentration of investment in a few import substituting industries, which are mostly inefficient and uncompetitive, is causing macroeconomic imbalance. In the foreign invested sector, both the commitment and disbursement of funds have steadily declined and there is no sign that this trend would be significantly reversed in the near future, as foreign investors are disappointed with the red tape and corruption in Vietnam.

The danger of a potential crisis is also hidden in the enduring ease of fiscal and monetary policies. Although the rise in budget deficit and the growth of money supply in 2001 were deemed to be appropriate, given Vietnam's economic situation, it is time to prioritize the effectiveness of expenditures, rather than to continue expanding capital spending without a bold and rational adjustment in the investment structure. Recently, many investment projects were started for political rather than economic reasons. In the future, should these projects fail, the financial burden on the banking system would be really severe. Therefore, any future easing of fiscal and monetary policies should be accompanied by a substantial change in the investment structure, in order to improve overall economic efficiency in such a way as to give priority to export-oriented industries, small and medium-sized enterprises, private undertakings, and agricultural households. Moreover, in the years ahead, it will be necessary to closely follow changes in output and prices so as not to over-stimulate the economy through an easing of fiscal and monetary policies, which might rekindle inflation.

Currently, structural reform is conducted on a learning-by-doing basis, and in response to the short-term need of the economy, rather than following a long-term overall program. While the enactment of the Enterprise Law has given a boost to private sector development, its actual interpretation and application in real life are proving to be a problem. The process of equitization and restructuring of SOEs continues to be slow, even incurring a halt since mid 2000 due to political and social obstacles. The restructuring of the state and non-state commercial banks is also stalling. These represent big challenges for the path towards a market economy in the future.

3 Short-term measures to further the reform path

In 2000–1, it was necessary to further a number of demand stimulus measures in order to maintain and accelerate economic recovery. However, in the future, priority should be given to stimulating quality investment and aiming at export-led long-term growth. The critical issue that should be re-emphasized is that the import substitution strategy of the past decade led to high production costs and often required heavy domestic protection (see the detailed discussion on this point in Chapter 3).

The analysis in Chapter 3 and in this chapter also shows that it is necessary to establish firm measures for maintaining and accelerating the trend of economic recovery, while preventing a financial crisis from breaking out in the future, which may result from low economic efficiency and continued growth in consumption. In our view, the sooner Vietnam resolves the problems in the private sector and the foreign invested sector, and the sooner it undertakes comprehensive reforms in the state enterprise sector and the banking system, the more likely it can maintain a high and sustainable growth rate.

It is necessary to restructure economic sectors in such a way as to improve the efficiency of business and production. In agriculture, production should be reorganized to meet domestic and foreign demand, credit access should be increased to producers, crop patterns should be diversified and land ownership should also be addressed to help farmers promote the farm economy. For industry and services, there should be a reorientation of industries and products to increase competitiveness, while business regulations should be relaxed to allow private and foreign invested enterprises to enter most industries and services so that they can fully develop their potential. Customs services should be improved to facilitate the flows of exports and tourists.

SOE reform should follow a specific road map. First, there needs to be a detailed timetable for the SOEs that are subject to equitization in the next 2 years. This action should be actively promoted, not just a half-way measure. Especially, the government may think of equitizing a number of key state banks. To this end, it is critical to complete international auditing of all state commercial banks soon. Second, regulation over SOEs should be strengthened, reducing the number of those that directly belong to the government, and dissolving the unprofitable ones and reducing their monopolistic power. Third, legal, credit and other preferential treatments for SOEs should be reduced to create a level playing field for all economic sectors. Last, but not least, it is necessary to review the social safety net (e.g. the severance package for redundant workers and unemployment allowances) to mobilize the support of the whole society for SOE reform.

Fiscal policy can be further relaxed to temporarily run a budget deficit of around 4–5 percent of GDP.[2] In terms of tax policy, as the budget deficit remains high in the coming years due to the spending need for structural adjustment, the government will have to make efforts to raise more revenue. It is necessary to implement a number of tax reforms in order to create equal treatments for both domestic and foreign investments, to remove the excess profit tax and to reduce the high marginal tax rate for personal income. It is also necessary to improve value-added tax regulation by reducing the number of tax rates, the scope of tax exemption, and expanding the voluntary tax declaration. In addition, it is necessary to further reform in such a way as to make the tax system transparent, easy to apply and with the least opportunity for corruption. In terms of budget expenditure, the increase in expenditure should give priority to investment for long-term development. However, in parallel with the increase in public investment, there need to be measures to improve capital productivity. The government should also allocate some budget expenditure for repaying arrears it owes to enterprises and pay off debts owed to the banks by enterprises (with many debts incurred prior to 1989) in order to create a sound environment for banking reform.

Regarding monetary policy, the expansionary policy stance should be applied more cautiously and special attention should be paid to the quality of loans. In the short run, measures are needed to encourage commercial banks to extend more loans, based on market principles, with the highest priority, as mentioned earlier, being given to exporting enterprises, farmer households, small and medium enterprises with special focus on the low-cost consumer goods producers that meet the affordable demand of the working public at large.[3] In addition, modern instruments of controlling the overall money supply need to be introduced. Commercial banks should be restructured, with a strong commitment to merge or divest the weaker and unprofitable ones. Arrears should be settled in order to clean up the domestic financial system. Administrative interventions in credit granting decisions by commercial banks should be stopped.

In terms of trade policy, it is necessary to accelerate the liberalization of foreign exchange transactions, and let the exchange rate be determined by market supply and demand, with regulation by the SBV in order to make the Vietnamese currency convertible. Especially, it is necessary to further liberalize the exchange rate regime in order to strengthen the competitiveness of Vietnam's exports. The most important comparative advantage of Vietnam vis-à-vis other Southeast Asian countries, namely cheap labor, is disappearing while the investment environment in Vietnam improves very slowly. As a result, to promote exports (the major engine of economic growth in Vietnam during 1994–7) in order to create jobs and raise income in the long run, Vietnam may need to adjust its exchange rate further. Meanwhile, Vietnam has also made substantial progress in liberalizing the trade regime, thus helping to improve the efficiency of foreign trade and give a convincing signal to both domestic and foreign investors in this area (see IMF 2002).

4 Toward a comprehensive agenda for poverty reduction, rational trade policy and sustainable growth

According to a WB study quoted earlier (see World Bank 2000), despite its impressive records in growth and improved standard of living in the 1990s, nearly half of Vietnam's rural population still lives below the poverty line and poverty rates among ethnic minorities remain very high. To address the issue of poverty reduction and social balance, some focus on the development of the rural sector has recently been initiated.[4] But there is a need to set a more comprehensive agenda encompassing both anti-poverty actions and more sustainable development than in the recent past. Some highlights of this two-pronged strategy are discussed below.

Sustainable growth strategies

In order to achieve this objective, the strategy would build on the economic and social progress made over the 1990s and maintain the economy on a resumed path to higher growth. To this end, the authorities will need to accelerate structural policies and undertake sectoral reforms in the areas of private sector development (as emphasized above), agriculture, livestock, fisheries, energy, transportation and promotion of good governance at the central and local levels.

Implementation of this strategic choice will involve the transfer to the private sector of more responsibility in order to stimulate broader growth and create jobs. For the state, this implies a government's refocusing of its mission on meeting social demands more effectively. The strategy would need to be centered on the following:

- enhancement of the quality of public expenditure;
- an approach to regional development that involves a more active partnership among the state, social and professional groups and local communities;
- economic growth supported primarily by private investment in a favorable economic, fiscal, legal and social environment; and

- rational management of the environment to reduce the impact of climatic hazards and human behavior induced by deteriorating living conditions, and to restore the equilibrium of natural ecosystems. This is the most urgent policy area in light of recurring devastating floods in different regions of the country.

Macroeconomic and sectoral policies

Fiscal policy plays a key role in this strategy to improve revenue mobilization and ensure efficient management of public spending. In particular, the government would need to allocate additional resources to the social sectors while improving programming and execution of public expenditure in these sectors. On the *monetary front,* the SBV should pursue a prudent policy compatible with growth and inflation objectives. In addition, as the result of the sound fiscal policies implemented and the improved environment for private investment, the banks are expected to increase financing for productive investment, especially in the industry and services sectors, and to support the efforts of businesses to reorganize and adapt themselves to the accelerating pace of foreign trade liberalization.

Appropriate *structural and sectoral policies* are needed in the areas of regulatory and legal framework; transportation, energy and mining policies as well as agriculture, livestock and fishery policies (see IMF 1989–97). In particular, the government's agricultural development policy would need to ensure the competitiveness of agricultural output; it should include an antipoverty dimension that will involve rural people in various economic and social infrastructure projects. The objectives of this policy include:

1 achieving a target annual growth rate to be defined for the sector;
2 enhancing food security through more diversified and competitive local production;
3 creating jobs and generating high enough incomes to mitigate rural poverty significantly; and
4 protecting the natural environment.

Poverty reduction strategy

To ensure that the benefits of growth are more equitably distributed, a specific antipoverty program is being adopted by the government during 2002. The underlying strategy is being developed in consultation with all constituencies (public administration, local communities, civil institutions and development partners).

The anti-poverty program, termed the Comprehensive Poverty Reduction and Growth Strategy Paper (CPRGSP) by the government, should include the following:

- promotion of income-generating micro enterprises supported by an appropriate credit facility (micro credit);
- improved access to essential social services, based on cooperation with local governments and grassroots organizations;
- creation of an effective information and monitoring system for measuring the impact of development programs on the living standards based on defined targets; and
- strengthening of capabilities at the grassroots level.

5 How to maximize the potential benefits from the BTA with the US?

The ratification of the US–Vietnam BTA by Vietnam's National Assembly on 28 November 2001 represented a significant political and economic milestone in the modern history of Vietnam. Politically, the agreement, when it became effective on 10 December 2001, has signaled the end of Vietnam's long, often tortuous, path to full normal relations with its former adversary. Economically, the agreement will pave the way for Vietnam's eventual accession to the World Trade Organization (WTO) and further reinforce its efforts to be integrated into the global economy.[5]

5.1 Potential benefits to Vietnam

In principle, the agreement would benefit both countries when they engage in trade in line with international rules. The significance of the US market to Asian nations, both developing and developed, is undeniable. This is more so in the case of Vietnam, not only because of the size of the US economy, but also because the US and Vietnamese economies are substantially different and therefore highly complementary. Under the BTA, Vietnam will gain access to the huge US market and enjoy the most favored nation (or normal trade relations) status where the tariffs on Vietnamese exports to the US will be reduced to 3–4 percent from an average of 40 percent.

According to a study by the WB done prior to the current economic downturn in the US, the lower tariffs could eventually double Vietnam's exports to the US (which presently stands at about US$820 million). In the short term, the BTA comes at a very opportune time to the Vietnamese government as global economic slowdown has begun to threaten Vietnam's growth plan of an average of 7–7.5 percent per annum. Vietnam's exports turnover to the US will potentially increase further in the following years if Vietnam can diversify its products, improve the competitiveness of its exports to meet the demand of US consumers and further penetrate the US market. Vietnam will not be able to meet these requirements in only 1 or 2 years, but the country should take advantage of this opportunity at the earliest time possible. In addition, and perhaps more importantly, Vietnam can now expect a steady increase in foreign direct investment (FDI) flows from the US, which at present ranks only as the twelfth biggest foreign investor in Vietnam.

To enjoy the above benefits, the BTA requires Vietnam to accelerate the equitization of SOEs, develop the private sector and create a level playing field for the state and private sectors. Vietnam must also permit free trade between Vietnamese and American businesses, reduce tariff and non-tariff barriers, accept regulations of the WTO, protect intellectual property rights and ensure that it will not nationalize American investments. An important point is that American entrepreneurs and companies may invest and operate in the service sector within 3 to 5 years, an opportunity they eagerly expect, as they believe they will have a chance to dominate the Vietnamese market. All of these, if properly implemented, will provide stimulus to a much needed new wave of reforms. However, this *Doi Moi* mark II will be essentially external-driven rather than the internal-driven *Doi Moi* mark I in the 1990s.

5.2 Hope and reality

Most of the Vietnamese public, including trade and diplomatic officials, policy makers and political leaders, place high hopes on the opening of the American market with substantially lower tariffs for Vietnamese goods. They believe it will provide Vietnam with an opportunity for an economic take-off. They expect miracles from the BTA, especially the favorable influence when it began to take effect in December 2001. However, economists, particularly young economists, have a more realistic view. They understand clearly the obstacles in economic restructuring and the poor competitiveness of Vietnamese goods against products from regional countries.

If Vietnam does not implement the necessary institutional and structural reforms, apply a more flexible foreign exchange rate and quickly find new outlets as well as improve its market access and competitiveness, it will hardly be able to reap maximum benefits from the agreement. Without proper preparations, Vietnam can only export more vegetables, fruit and seafood with low value added, while the US will greatly benefit from financial services such as insurance and banking that are in high demand in Vietnam. A number of American goods are popular in Vietnam, thanks partly to their quality but mainly to their 'American trademark'. In addition, Vietnam should not forget the tremendous competitiveness of Chinese goods (garments, textiles, footwear, wood furniture and light industrial goods), especially now that China is a WTO member and enjoys favorable trade conditions.

Some other issues may also reduce the short-term benefits of the BTA to Vietnam. First and obviously, was the US economy in early 2002 in recession and this may adversely affect Vietnam's exports to the US.

Second, while tariffs will fall significantly across the board, more subtle forms of trade restriction will come into play. One long-established form of non-tariff barriers is product standards and the most recent successful move by some southern US states to restrict Vietnamese exports of catfish is a typical example of this approach. Third, Vietnam has not yet convincingly demonstrated its ability to supply much larger quantities of a variety of exported products at uniform quality and on time. This will be a serious challenge facing Vietnamese exporters in the next few years.

5.3 Suggested measures

There are a number of measures that Vietnam can adopt to maximize the potential benefits of the BTA. In particular, Vietnam should take bold, urgent measures to increase its competitiveness. Some of the suggested measures are:

- adjust the foreign exchange policy to enhance the competitiveness of Vietnamese goods and services;
- establish special economic zones at selected economic centers to promote competition among different regions;
- reduce the state corporate sector and promote private initiatives to gain optimum benefits from the trade agreement;
- reduce and restructure large debts of SOEs to minimize nonperforming loans for the banking sector and reform the sector; and
- clear agro-product stockpiles by adjusting the foreign exchange policy, as mentioned above, and allowing greater participation of the private sector in distribution of agro-products, including exports, instead of reserving monopoly rights for large SOEs.

In terms of exchange rate policy, we recommend a devaluation of the Vietnamese dong against the US dollar to encourage exports, particularly in the current stagnant agricultural and aqua sectors. The Vietnamese Government should also issue a special policy to develop Hanoi, Haiphong, Danang, Ho Chi Minh City and Cantho as special economic zones, like the Chinese model. This will serve as a pilot move to fast track administrative reform, minimize corruption and attract foreign investment. This may be the most practical policy to deal with sluggish reform of the state corporate and banking sectors, red tape and loss of attraction to foreign investors. It particularly suits the custom of 'The king must bow to the village practices' in Vietnam. The policy is expected to kick off a hectic race between big cities to reform weak SOEs and inefficient banks under their management. It should also reduce overlapping local regulations to attract local and foreign investment and achieve high growth rates for their localities, as well as to solve severe local unemployment.

In the longer run, Vietnam should seek effective solutions to increase market access and take major restructuring measures. To increase market access, Vietnam should seek the assistance of overseas Vietnamese and invite them to work as trade intermediaries. After China and Israel, no other country has as large human resources and strong marketing forces as Vietnam, with almost 3 million overseas Vietnamese living in more than 150 countries worldwide who know their local trade practices, customs and languages. If Vietnam, like China, creates a national policy offering equal treatment to overseas Vietnamese and deals with them on a win-win basis, it will be able to develop a large force of trade representatives to promote exports, especially to America, as a spearhead for future development.

6 Summary and conclusion

Faced with mounting economic difficulties, Vietnam would need to move decisively to put the economy on a higher growth path. A first generation of reform policies based essentially on economic stabilization have brought encouraging results in increasing Vietnam's growth in the 1990s (see Ljunggren 1993; Dodsworth *et al.* 1996; Le 2000) and generally improving the living standards of most of its population, notably in urban areas (a similar case for Laos can be seen in Pham 1994 and Otani and Pham 1996). To reduce poverty and pursue sustainable and more equitable growth, a second generation of reform policies under *Doi Moi* mark II will be urgently needed. It will have to be based on a major switch in economic strategy from import substitution to export-led growth, better governance, accelerated development of the rural sector, and creation and respect of the rule of law.

The policies would cover essentially these key areas:

- a firm commitment to strengthen the private sector by sharply reducing the role of the public sector;
- prompt implementation of reform of major SOEs by liquidation or equitization;
- quick and bold adjustment of the current exchange rate to provide further flexibility and restore competitiveness;
- reform of the banking sector;
- modernization of the legal framework aimed at promoting domestic investment and attracting foreign capital;
- establishment of social safety nets to cushion the adjustment shock on the population groups suffering from structural reforms; and
- appropriate sectoral policies targeting the rapid promotion of the rural sector.

Some of the above measures are structural and longer-term policies but their effect on restoring investors' confidence can be substantial and immediate. They constitute crucial elements of a comprehensive policy package required not only for sustained renewal of program loans by international financial institutions, but also for the sake of the survival of *Doi Moi* and the full integration of the Vietnamese economy into the global economy under the great challenges of the new century. This policy package needs to be considered seriously and fully backed by the high-level authorities.

These actions are understandably difficult given the ongoing political ideology debate and power struggle in Vietnam, but the stakes are high. They require a new vision, better policy coordination, and more equitable sharing of the burden of adjustment among the different segments of the population. These are necessary to harvest the fruits of continued economic growth in a just and stable society. From a historical perspective, however, it would be challenging to see how such a roadmap toward a market economy could be achieved with a continued 'socialist orientation', as often stated by the senior Vietnamese leadership. The key choice would be a decisive reduction of the state sector as well as of the dominant role of SOEs. This is a policy much emphasized by Western and overseas Vietnamese economists, and also well understood but not yet implemented by the Vietnamese authorities as they continually try to balance out between political and economic objectives. The cost involved would be much slower economic growth for Vietnam for the years–if not the decades–to come. As such, it will be the most important national issue over which current and future generations of Vietnamese will have to ponder.

Notes

1 According to a WB study (see World Bank 2000), based on data collected from two household living standard surveys for Vietnam conducted in 1992–3 and 1997–8, the poverty rate of Vietnam has reduced by half during this period.

2 However, for 2002–3, when the economy returns to the high growth rate of more than 8 percent (the potential growth rate) and private investment is more solid, it will be necessary to gradually reduce the budget deficit to around 2–3 percent of GDP.

3 One of the causes of the high unemployment and under-employment in the country is an over-concentration of investment in the capital intensive, rather than labor intensive, enterprises. This stems from the import substitution orientation of the economic structure. Consequently, the country cannot make use of its biggest comparative advantage, which is the low-cost and abundant labor.

4 In the WB study (see World Bank 2000), it was found that urban, white-collar households have benefited most from the recent economic reforms while agricultural households (especially ethnic minorities and workers living in poorer regions) have progressed the least.

5 This discussion is drawn from Pham and Tran-Nam (2001).

Appendix 20.1 Main features of demand stimulus

Demand can be stimulated by relaxing the fiscal and monetary policies to encourage investment by the private sector. Demand stimulus through fiscal and monetary relaxation may cause the fiscal deficit to expand and the money supply to increase in the short run (for a few years), but in fact this relaxation does not aim at systematically increasing medium- and long-term budget expenditures; its focus is on long-term growth target and increasing the purchasing power for the working public at large. Namely, in terms of income distribution, there was a need to increase the share for wages and salaries compared with that for profits. Prior to August 1999, profit share used to be consistently high and expanding, while that of wages and salaries, typically for farmers and workers, was constant or even reduced. Therefore, income policies began to be used by the Vietnamese government in late 1999. A major salary increase for the public sector in early 2000 was a step in this direction.

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