

III. FISCAL SUPPORT FOR THE TRANSITION

Prudent fiscal management is considered as one of Viet Nam's important achievements during its transition period. Rapid economic growth has been accompanied by positive fiscal developments, both in terms of dynamic revenue collections and well managed expenditures, making room for the needed infrastructure investments within overall modest fiscal deficits. Even in difficult times, a certain amount of government savings has also been maintained and used to partly finance and sustain a relatively high level of capital expenditure, which has been critical to long-term economic development. In addition, various efforts have been exerted to improve the quality of fiscal management. On the revenue side, for example, simplification of the tax system, modernization of tax administration, and broadening of the tax base to improve collections from the emerging private sector, have, *inter alia*, helped sustain dynamic revenue growth. Public expenditure management has also been given due attention. The promulgation of a budget law, the implementation of a public expenditure review, and the formulation of a public investment program have contributed to improvements in the allocation and efficiency of public spending. Even the recent setbacks associated with the corruption in PMU 18 transport projects have been addressed aggressively and transparently.

Progress since the Beginning of *Doi Moi*

During the initial phase of reforms in the late 1980s, budgetary management posed a major challenge to Viet Nam's authorities. Following the price reform, transfers from SOEs, which used to be the main source of budget revenues, were falling substantially from 9.2 percent of GDP in 1987 to 2.6 percent in 1991.³⁶ At the same time, demands on the national budget were rising as SOEs had to make severance payments to their laid-off workers. This difficult fiscal situation was partially overcome by the substantial savings in expenditures resulting from the elimination of direct subsidies to SOEs, which in 1987 were equivalent to nearly 5 percent of GDP.³⁷ However, capital expenditure, which was badly needed for infrastructure investments particularly at that time, had to be scaled down by 2-3 percent of GDP.³⁸ Fiscal deficits were then kept at 4-5 percent of GDP.³⁹ Nevertheless, as foreign assistance from the Soviet Union was stopped abruptly, a major proportion of the fiscal deficits, some 80 percent, had to be financed by the State Bank.

Over the subsequent twelve years, Viet Nam's fiscal developments can be classified in three distinct periods. The pre-Asian Crisis period of fiscal consolidation in 1992-1996 was followed by post-Asian Crisis adjustments 1997-2001 and renewed development progress of the 2002-2004 period which we are still experiencing (see Figure 3.1).

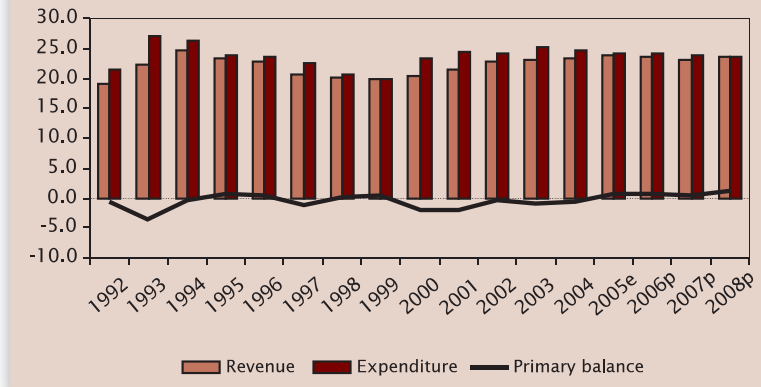
³⁶ Leipziger (1992).

³⁷ To compensate for the explicit subsidies a wide range of implicit subsidies was granted to SOEs, such as cheap credits. However, these implicit subsidies were not registered in the budget (Fforde and de Vylder, 1996).

³⁸ Leipziger (1992).

³⁹ Except in 1988, fiscal deficit rose to 7.5 percent of GDP (Fforde and de Vylder, 1996).

Figure 3.1: Revenue, Expenditure, and Primary Balance, 1992-2008
(in percent of GDP)



Sources: Ministry of Finance, International Monetary Fund (IMF), staff estimates (e) and projections (p)

In the years preceding the Asian Crisis, the primary balance was moving from deficits to surpluses of less than 1 percent of GDP in 1995-1996.⁴⁰ The generally improving trend largely reflected encouraging results of the series of reforms undertaken under *Doi Moi*. Budget revenues strengthened from 19 percent of GDP in 1992 to average of more than 23 percent of GDP in the subsequent four years. This revenue buoyancy mainly came from (i) increases in profit and turnover tax payments from SOEs as they started to benefit from the reforms, and (ii) increases in customs duties collection as international trade was picking up in response to more open trade policies. And these increases in tax collection should be also attributed partly to the tax system reforms, which began in the late 1980s.⁴¹ Public expenditure increased significantly to 26-27 percent of GDP in 1993-1994, partly due to a substantial wage adjustment in 1992-1993. Subsequently, however, overall public expenditure was scaled down with a real wage compression and a contraction in other expenditures by nearly 3 percentage point of GDP, partly contributing to the surpluses in 1995-1996.

Following the onset of the Asian financial crisis, a fiscal adjustment was undertaken that restricted the primary balance from falling below a deficit of 2 percent of GDP in 2000. The most significant change was seen in tax revenue, which plunged to 14-15 percent of GDP in 1997-2001, compared with 18-19 percent of GDP in the previous four years. The decline in tax revenue was mainly due to lower customs duties collection. In 1997, for example, total collection of export and import duties fell by 1.6 percentage points of GDP as export and import growth plummeted, as a result of depressed regional and domestic demand caused by the Asian Crisis. Lower tax revenue was also partly due to the generous tax relief and concessions provided to stimulate investment that had been discouraged by domestic structural weaknesses and constrained by the regional crisis.

Expenditure also had to be adjusted, and was vigorously reduced from 23.2 percent of GDP in 1996, on the eve of the crisis, to 20.3 percent of GDP in 1998. Across-the-board cuts were made in current expenditures, with the expenditure on general administrative services and social subsidies, for example, declining by 0.6 percent of GDP each. However, capital expenditure, which was most needed to spur the economic recovery in that

⁴⁰ The primary balance is the overall fiscal balance of the central government net of interest payments (financing costs) on outstanding government debt. These financing costs tended to average just over one percent of GDP over the 1992-2004 period so that a primary balance of just over one percent of GDP was required for a balanced budget over this period.

⁴¹ A number of laws were enacted in 1989-1991 to replace the previous administrative decrees on taxes. The new tax laws were designed to raise sufficient levels of tax revenues as well as improving tax administration including better tax collection from non-State enterprises (IMF, 1998).

period, was not subject to down-scaling. In fact, capital spending by the central government on average amounted to 6.9 percent of GDP during this period and was a very significant 0.8 percent of GDP higher than in the pre-Crisis period.⁴² This was a truly remarkable fiscal adjustment in the face of the Asian Crisis.

From 2002, the rebound in economic growth augmented these improvements in fiscal developments. The primary deficit was narrowed to less than 1 percent of GDP over the three years ending in 2004 (see Figure 3.1). Tax revenues were restored to an average of 16.7 percent of GDP in 2002-2004, compared to 15.4 percent of the previous adjustment period. The expansion in tax revenue was mainly fuelled by value added tax collection, rising from 4.0 percent of GDP in 2001 to 5.8 percent of GDP in 2004 as economic activities were accelerating.⁴³ Custom duties collection also increased by 0.5 percent of GDP in 2002 as exports and imports were recovering from the stagnant period following the Asian Crisis. Current expenditure continued to be restrained while capital spending was kept above 8 percent of GDP.

However, a more complete fiscal picture can only be portrayed if capital investment is more broadly defined, combining the on-budget capital spending as discussed above and off-budget investment expenditure. Off-budget outlays were increasing significantly in magnitude (see Figure 3.2). Net on-lending through the Development Assistance Fund (DAF)⁴⁴, which is considered as contingent liabilities and kept off-budget, has amounted to more than 2 percent of GDP in recent years. In addition, a substantial amount of bonds issued to fund large multi-year infrastructure projects and recapitalization of SOCBs has also been kept off-budget. In 2003, for example, off-budget investment expenditure, including the issuance of bonds for education and infrastructure projects, for recapitalization of SOCBs, as well as the issuance of municipal bonds, amounted to 5.2 percent of GDP, so that overall capital outlays reached 13.5 percent of GDP. This has created demand pressures in the economy that resulted in an acceleration of inflationary pressures. However the level of such capital outlays was quickly adjusted downwards in 2004 to a more sustainable level of 11.4 percent of GDP.

The overall fiscal deficit, taking into account off-budget expenditure, was thus much more worrisome, averaging at more than 5 percent of GDP (see Figure 3.2). These sizable annual deficits raised the level of public debt from 37 percent of GDP in 2001 to nearly 42 percent of GDP in 2003.

Viewed in a regional context, Viet Nam also appears to have been doing very well. An average annual tax collection of 16.4 percent of GDP during 1995-2003 was slightly higher than 16 percent of Thailand. On the expenditure side, Viet Nam's recent capital spending level of more than 8 percent of GDP, let alone off-budget investment outlays, was far greater than that of Thailand (less than 3 percent of GDP). This seems to reflect a greater importance given to public investment and/or a bigger role of the Government in Viet Nam, compared with Thailand. However, as Viet Nam continues its transition to a market-based economy, public capital expenditure should be expected to decline, in the longer term, to be more in line with fiscal developments in other countries. And the emerging private sector will then be expected to play a greater role in providing investment outlays.

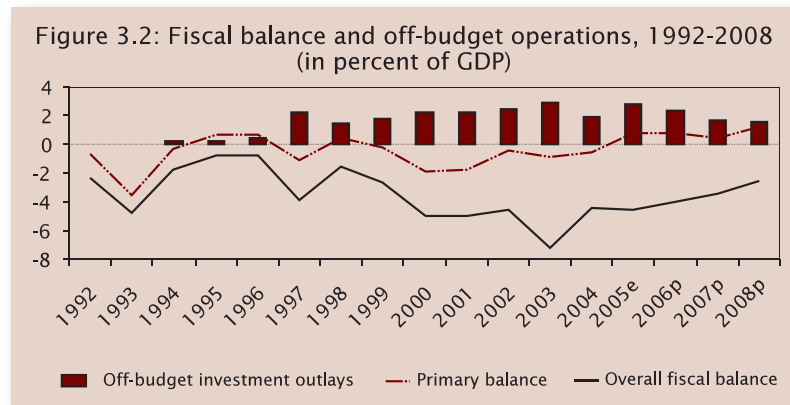
Recent Developments

The overall fiscal outturn in 2005 was generally better than budgeted. The primary balance improved from a deficit of 0.5 percent of GDP in 2004

⁴² If account is taken of off-budget capital outlays, the comparison is even more compelling with the increase in capital outlays rising from 6.3 percent of GDP in the period 1992-1996 to 8.7 percent of GDP in the period 1997-2001, an increase of 2.4 percent of GDP.

⁴³ The equivalent of value-added tax prior to 1999 was the turnover tax.

⁴⁴ The DAF provides soft loans to priority investment projects on the list approved by the Prime Minister. DAF operations are partly funded by ODA loans. In addition, the DAF also raises funds domestically through bond issuances and borrowings from social security funds and postal savings companies. On 30 May 2006, DAF was officially converted into the Viet Nam Development Bank (Viet Nam News, 31 May 2006).



Sources: Ministry of Finance, IMF, staff estimates (e) and projections (p)

to a surplus of 0.8 percent of GDP in 2005. Net on-lending, however, increased significantly to 2.8 percent of GDP in 2005. This was partly due to the very first issuance of international bonds by the Vietnamese Government in October 2005. A total of US\$750 million proceeds from the international bond issuance was then on-lent to Vinashin, a state-owned ship-building enterprise.⁴⁵ In addition to the on-lending, other off-budget domestic bond issuance was estimated at 1.6 percent of GDP. While the primary balance improved, the overall fiscal balance deteriorated slightly with deficit rising from 4.4 percent of GDP to 4.5 percent of GDP (see Figure 3.2). The increasing divergence between primary and overall balance was due to higher off-budget outlays, which appears to have undermined fiscal transparency. Total public debt rose to 42.5 percent of GDP at the end of 2005. Debt service, nevertheless, remained relatively low at 4.0 of GDP as a high proportion of public debt was contracted on concessional terms under Overseas Development Assistance (ODA).

Revenues outperformed budget expectations by about 10 percent, led by strong oil-related revenues on account of higher-than-anticipated oil prices. In nominal terms, total revenue increased by nearly 20 percent from the 2004 level. Oil-related revenue growth was reflected in both direct taxes (higher corporate tax payment of oil exporters) and indirect taxes (higher receipts from taxes on oil exports and petroleum imports). Benefiting from rising oil prices, the oil sector has recently become a major budget contributor. In the first half of the 2000s, the oil sector contributed, on average, 6.7 percent of GDP, making up about 30 percent of total budget revenue. However, there have been concerns about such heavy reliance on oil revenue windfall as it would make Viet Nam's fiscal stance vulnerable to negative oil price shocks.

⁴⁵ The Government had initially planned to raise US\$500 million but later decided to increase this target to US\$750 million given a stronger than expected market interest. The international rating agency Moody's raised the foreign-currency country ceiling for bonds and notes and the foreign-currency rating for government debt from B1 to Ba3 (World Bank, 2005b).

⁴⁶ World Bank (2005a).

Rising oil prices, at the same time, exerted upward pressure on expenditures as well. The Government had to provide increasing subsidies to the importers of oil products to compensate for the lagged domestic price adjustments against world oil price changes. The higher wage bill arising from the 30 percent wage increase in October 2004 placed another drain on public expenditure. The additional current expenditure required for the increase in wages and salaries is estimated at 0.5 percent of GDP in 2005.⁴⁶ Despite these consumption pressures, capital expenditure was sustained at 8.2 percent of GDP.

Outlook

Looking ahead, as economic growth is forecasted remain strong, Viet Nam's fiscal position is expected to gradually improve. The primary balance is projected to sustain moderate surpluses in the 1.5 percent range of GDP. Projected reductions of off-budget capital outlays will lead to a decline of overall fiscal deficits from an estimated 4.5 percent of GDP in 2005 to 2.6 percent of GDP in 2008.

Strong economic growth will be accompanied by increased budget revenue. Revenue expansion is however expected to slow down in the coming years. World oil prices would eventually have to ease, according to a World Bank forecast, no later than 2007, leading to lower revenue contribution from the oil sector.⁴⁷ Receipts from international trade taxes will also decline as Viet Nam implements its commitments under AFTA and WTO in the longer term. Viet Nam is expected to incur an annual tax reduction of US\$60 million, which is about 6-7 percent of the total annual import tax collection, in the first five years after it joins the WTO.⁴⁸ Such revenue shortfalls are expected to be partly covered by higher receipts from the rapidly expanding private sector. However, additional efforts will be needed to ensure sufficient revenue growth. Among necessary tax reforms to be carried out are increasing direct tax receipts to substitute for the decline in indirect tax revenue, and modernization of the tax administration system to improve efficiency of tax collection. Total budget revenue is expected to fluctuate in a range of 23-24 percent of GDP in 2006-2008 (see Figure 3.1).

Current expenditure is expected to decline relative to GDP with the public sector assuming a diminishing role as the economy moves towards market-based approaches. A full range of subsidies, including the oil price subsidies, will have to be phased out gradually to ease pressures on the budget. Total current expenditure is projected to decrease to 15.3 percent of GDP in 2008. Despite increasing investment of the growing private sector, capital expenditure remains vital to Viet Nam's socio-economic development. Capital outlays by the central budget are thus expected to be sustained at above 8 percent of GDP during the projection period.

Off-budget operations are expected to be reduced gradually from the high level of 2005 while remaining significant in light of the continued substantial investment requirements for infrastructure and education, and the ongoing banking reforms. The Government is expected to have to issue a substantial amount of new bonds to finance its 110 trillion dong investment program on education and infrastructure envisaged for 2005-2010. The continued slow progress in SOCB reform may necessitate a significant amount of additional government debt raised to cover their recapitalization costs. At the same time, subsidy cuts have been agreed under the WTO. The overall fiscal deficit is thus projected to narrow significantly to below 3 percent of GDP in 2008.⁴⁹

The sizeable buildup of quasi-fiscal liabilities arising from off-budget operations has significant implications for debt sustainability. Total public debt is thus projected to continue expanding relative to GDP. However, should off-budget operations be contained in line with expectations, the public debt burden would still remain very manageable at about 48 percent of GDP in 2008, given its highly concessional terms.

⁴⁷ World Bank (2006b).

⁴⁸ This projection was made by the Ministry of Finance, based on its recent survey of 87 industries. According to the survey, these industries are expected to see a cut in import taxes from an average of 30.4 percent to 15.3 percent as Vietnam joins WTO. (Viet Nam News, 15 July 2006, "WTO Entry May Lighten State Coffers").

⁴⁹ The overall fiscal balance takes into account off-budget outlays.