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PERSPECTIVE

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Growing Fiscal Deficit Presents a Major Risk for Vietnam

Le Hong Hiep

EXECUTIVE SUMMARY

- Vietnam's fiscal position has deteriorated in recent years due to both cyclical and structural factors. However, the single most important reason is the rapid increase of recurrent expenditures. Other important reasons include falling oil prices, diminishing foreign grants, and the increasing debt service burden.

- Vietnam's public debt will likely continue rising as the government increasingly relies on borrowing to fuel economic growth and to finance its budget deficit.

- In response, the government seeks to increase its revenue from domestic taxes and fees and sell its stakes in equitized companies. It has also pursued public investment reforms and promoted Public Private Partnership models to compensate for the falling public investment in infrastructure projects.

- The government also needs to consider serious political and administrative reforms to curb the fast expanding recurrent expenditure.

- Since Vietnam's spending on security and defence increased more than three times between 2008 and 2013, the fiscal constraint may also trigger efforts to control this outlay

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INTRODUCTION

Vietnam's fiscal position has deteriorated rapidly in recent years. For example, its budget deficit in 2015 increased 14 per cent to reach 256 trillion dongs (US$11.47 billion), equivalent to 6.1 per cent of its GDP (*CafeF*, 2016). The country's increasingly precarious fiscal position has been identified by experts as an urgent matter that can generate potential risks for its long-term macro-economic stability (see, for example, *Financial Times*, 2016; *VnExpress*, 2015b). It also poses a considerable challenge for Vietnam's new government in achieving socio-economic targets set by the recent twelfth congress of the Communist Party of Vietnam (CPV). If the fiscal imbalance persists or worsens, it will generate serious economic, political and strategic implications for Vietnam. Solving or mitigating the problem, however, will require not only sound economic policies but also political determination to embrace challenging reforms on the part of the CPV.

This essay seeks to examine this particular problem and its implications. It provides first an overview of Vietnam's worsening fiscal position and its underlying reasons, and then an analysis of the economic, political and strategic implications that can be expected in the coming years.

VIETNAM'S INCREASINGLY PRECARIOUS FISCAL POSITION

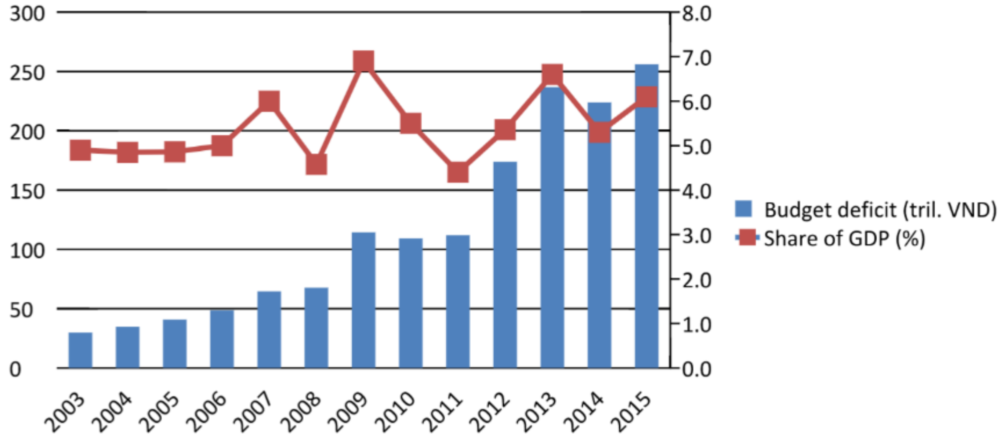
According to data released by Vietnam's Ministry of Finance (MOF), the country consistently ran a budgetary deficit from 2003 to 2013, the latest year for which final accounts have been approved by the National Assembly.[1] For the years 2014-2015, estimates show that the trend remained unchanged, with the budgetary deficit continuing to expand.

As shown in Figure 1, Vietnam's nominal budget deficit increased 8.6 times from 29.9 trillion dongs to 256 trillion dongs between 2003 and 2015. Consequently, although Vietnam's GDP grew at an average rate of 6.4 per cent per annum from 2003 to 2015, the budget deficit as percentage of the GDP has remained high, averaging 5.4 per cent during the period.

Vietnam's budget deficit is due to both cyclical and structural factors. On the one hand, there was a 70-per-cent surge in the deficit in 2009 corresponding with the government's counter-cyclical fiscal measures to deal with the negative impacts of the 2007-2008 Global Financial Crisis. Specifically, the government released a major stimulus package worth 143 trillion dongs (approximately US$8 billion) in 2009, which included components such as tax breaks, interest rate subsidies, and increased public investment. In early 2013, the government announced another stimulus package worth 30 trillion dongs aimed at the real estate sector. These stimulus packages, while helping to sustain economic growth, also undermined Vietnam's fiscal sustainability by eroding fiscal buffers and increasing the debt service burden on the budget.

[1] According to the Law on State Budget, the government is given up to 18 months to prepare and submit the final accounts of a given year's budget to the National Assembly for its review and approval. The final accounts of the 2014 budget are therefore expected to be submitted to the National Assembly in July 2016.

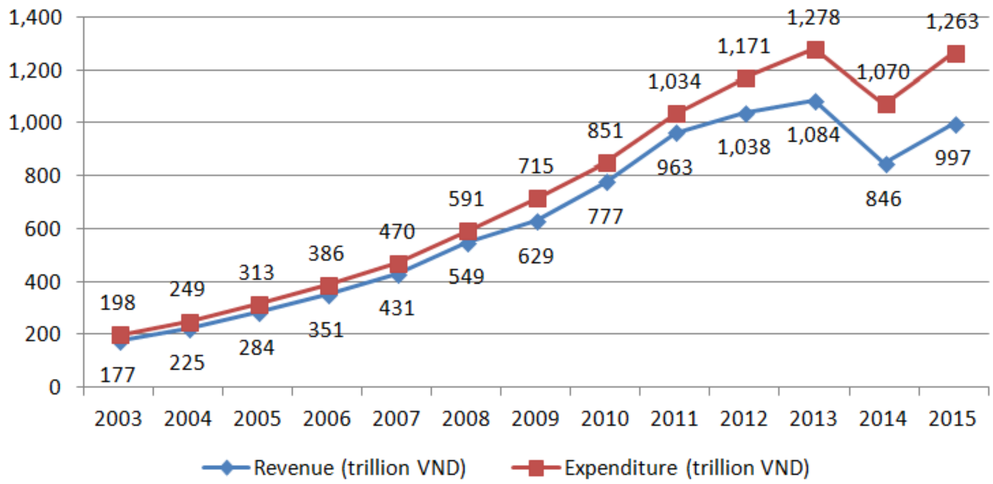
Figure 1 - Vietnam's nominal budget deficit, 2003-15



Note: Data for 2014 and 2015 are estimates.
Source: Author's own compilation based on MOF (2016).

On the other hand, Vietnam's budget deficit also results from structural reasons. Despite the economic slowdown since 2008, the government's revenue has been increasing steadily, except for 2014 and 2015. However, the increase in revenue was not able to match the increase in expenditures, which have expanded remarkably. Consequently, as shown in Figure 2, the gap between government revenues and expenditures has been widening between 2003 and 2015.

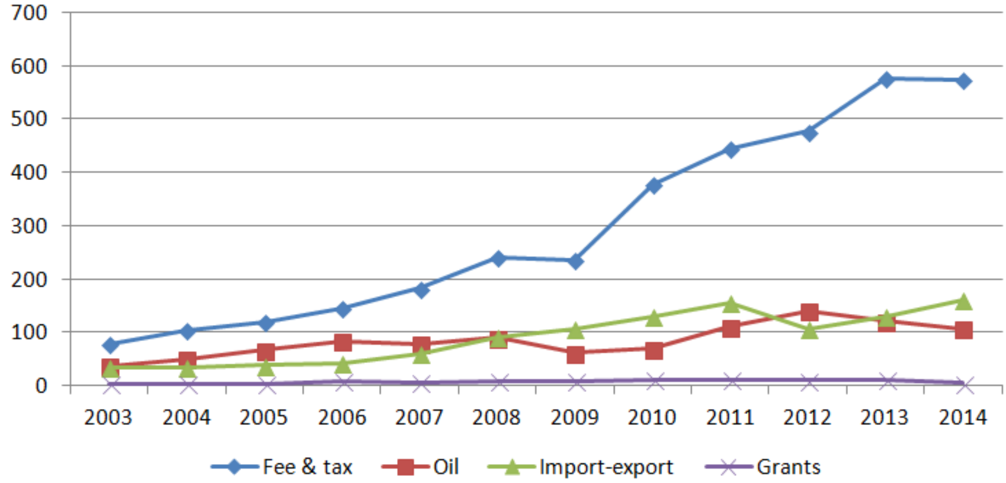
Figure 2 - Vietnam's revenues and expenditures, 2003-15 (in trillion VND)



Note: Data for 2014 and 2015 are estimates.
Source: Author's own compilation based on MOF (2016).

In terms of revenue collection, as shown in Figure 3, that coming from domestic fees and taxes has been increasing throughout the whole period, except for a slight decrease in 2009 due to adverse effects from the Global Financial Crisis. Since 2010, this source of revenue has grown strongly again. Although the increased revenue from domestic fees and taxes has provided a strong buffer for the state budget at a time when revenues from oil and grants have tended to decline, the trend seems to conflict with the government's counter-cyclical measures taken since 2009 to deal with the economic slowdown.

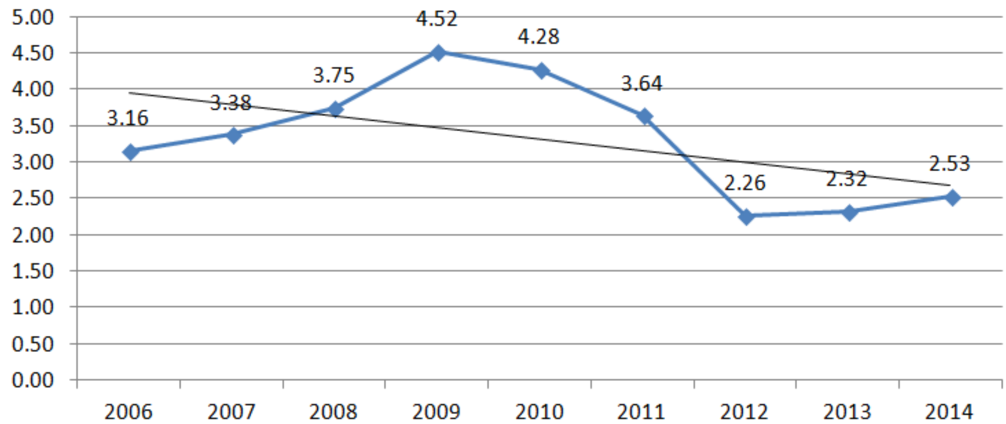
Figure 3 - Vietnam's major sources of revenue, 2003-14 (in trillion VND)



Note: Data for 2014 are estimates.
Source: Author's own compilation based on MOF (2016).

Revenue from import-export duties in absolute terms has also been increasing during the period except for a decrease in 2012. Preliminary data for 2014 also suggest that this source of revenue was in an upward trend, defying the myth that in joining a series of Free Trade Agreements (FTAs), Vietnam's revenue from import and export duties would decline. In relative terms, however, as shown in Figure 4, import-export duties as a percentage of Vietnam's total import and export have generally declined between 2006 and 2014. This is mainly due to the strong growth in Vietnam's total foreign trade turnover, which increased 3.5 times over the same period. This trend is likely to continue in the future if more of Vietnam's FTAs, especially the Trans Pacific Partnership (TPP), come into force.

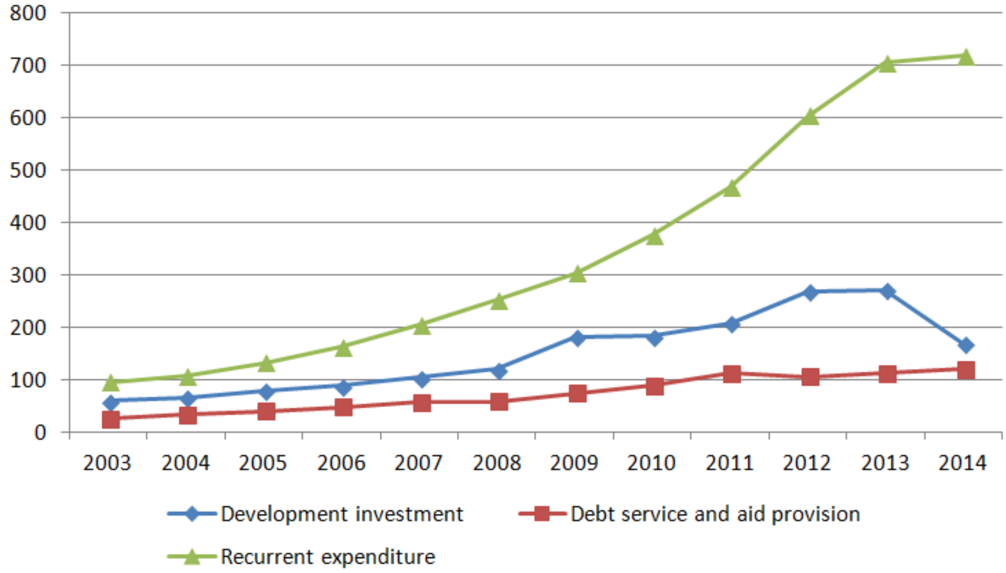
Figure 4 - Import-export duties as a percentage of Vietnam's total import and export (2006-14)



Note: Data for 2014 are estimates.
Source: Author's own compilation based on various annual Statistical Yearbooks of Vietnam and MOF (2016).

On the expenditure side, Figure 5 shows that Vietnam's recurrent expenditures have increased at a striking pace. In 2014, for example, recurrent expenditures account for 67 per cent of the government's spending, while back in 2003, the share was just 53 per cent. The swelling recurrent expenditures result from multiple factors, including the increased spending on administration, social security, pensions, wages and salaries, and especially security and defence.

Figure 5 - Vietnam's major expenditures, 2003-14 (in trillion VND)



Note: Data for 2014 are estimates.
Source: Author's own compilation based on MOF (2016).

However, due to the lack of reliable data on the composition of these expenditures, especially at the provincial level, it is impossible to conclude decisively what factors caused Vietnam's recurrent expenditures to expand so quickly in recent years. Nevertheless, it is obvious that it is the swollen recurrent expenditures that have been the most important reason for Vietnam's burgeoning budget deficit in recent years.

Meanwhile, Vietnam also had had to put aside more money to service its debts. Within 10 years, this outlay more than quadrupled, from 25.4 trillion dongs in 2003 to 112 trillion dongs in 2013. Increased recurrent expenditures and debt servicing have therefore constrained the country's spending on development investment. Specifically, this outlay almost levelled out in 2013 before falling 37 per cent in 2014. Consequently, Vietnam's estimated public expenditure on development projects in 2014 was lower than that in 2009. This is a major setback for the economy at a time when it needs more capital investments to upgrade its infrastructure and to boost economic growth.

MAJOR IMPLICATIONS OF THE GROWING DEFICIT

The growing budget deficit is a risk for Vietnam's macro-economic stability. To defuse this risk, the government has two straightforward options: cut down on its expenditures, and/or increase its revenue. In case these objectives cannot be achieved, Vietnam's debt burden will expand. The long-term impact of this on the country's macro-economic conditions should not be underestimated.

Economic implications

Where revenue collection is concerned, oil revenue faces uncertainty while import-export duties and foreign grants are expected to decline in the future. Vietnam will therefore have to rely on domestic fees and taxes to raise its revenue. Indeed, at a session of the National Assembly Standing Committee in March 2016, Minister of Finance Dinh Tien Dung mentioned that the government planned to revise eight tax policies to gain an additional 450 trillion dongs (approximately US$22 billion) in tax money (*VnExpress*, 2016). However, given the economic difficulties that many domestic enterprises are facing, instead of seeking to increase taxes and fees, the government may consider focusing on stricter and more effective enforcement of its tax laws to prevent tax evasion and avoidance instead. Accordingly, crackdowns on tax evasion as well as illegal tax avoidance practices may be stepped up in the coming years.

In addition, the Ministry of Finance also expects to earn as much as 150 trillion dongs from selling government stakes in equitized enterprises in the near future (*VnExpress*, 2016). This measure was first announced in October 2015 when the government informed the National Assembly that it wanted to sell its stake worth US$3 billion in 10 major listed companies, including profitable ones such as Vinamilk, FPT and Bao Minh Insurance Corporation (*Vnexpress*, 2015a). If the measure is expanded successfully into other listed and unlisted companies, as well as those yet to be equitized, the government's state-owned enterprise (SOE) reform programme may be accelerated in the future.

Further public investment reforms are also needed to enhance the efficiency of public spending. As acknowledged by the government on various occasions, public investment has been inefficient partly because it is spread across too many projects. Consequently, many projects do not receive enough funding in a timely manner, causing delays and cost overruns. Corruption in capital investment projects is also a major reason accounting for the wastefulness and inefficiency in public expenditure. The 2014 Law on Public Investment is expected to solve this problem by tightening the procedure of selecting, appraising, approving and implementing public investment projects. However, as the law was enacted only recently, it will be a while before we see whether it does enhance the efficiency of public investment or not.

Meanwhile, in order to promote capital investment without putting too much pressure on the national budget, the government will need to further encourage the participation of non-state sectors in developing the infrastructure. It has accordingly been promoting Public-Private Partnerships (PPP) in infrastructure projects by enacting Decree no. 15/2015/ND-CP in February 2015 to provide a comprehensive legal framework for this type of investment. Such a policy orientation has also been reaffirmed by the government in a recent conference reviewing BOT investment projects (*Vietnam Government Portal News*, 2016).

However, in order to develop infrastructure and to support economic growth, Vietnam cannot rely exclusively on PPP projects, and capital investments remain primarily a responsibility of the state. The government is however facing a dilemma in this regard: as recurrent expenditures expands at the expense of development investments, the government becomes increasingly reliant on borrowing to fund projects. Vietnam's public debt is likely to continue increasing. According to the IMF (2016), the country's gross public debt in 2015 was 2,486.1 trillion dongs (approximately US$110 billion), equivalent to 59.3 per cent of its GDP. Statistics released by the government in March 2016 showed that Vietnam's public debt was equivalent to 62.2 per cent of the GDP (*Thanhnien News*, 2016), increasing from 56.3 per cent in 2010 (MOF, 2014, p. 11). Accordingly, experts at HSBC (cited in *Dan Tri*, 2016) have projected that Vietnam's public debt-to-GDP ratio will increase to 64.5 per cent in 2016, approaching the limit of 65 per cent set by the National Assembly. As such, the government will face difficulties in balancing between the two conflicting goals of supporting economic growth through capital investments and keeping its national debt level within safe boundaries.[2]

Political and administrative implications

Even when its gross revenue is increased, Vietnam will not be able to balance its budget if the government cannot curb its expenditures. Towards this end, the government's expanding recurrent expenditures need to be reduced.
For example, the government will need to downsize its bureaucracy to reduce the bill for wage and salaries. According to the Ministry of Home Affairs, there were 539,654 civil servants and cadres (at the end of 2013), and 1,995,414 public employees (by June 2014) on the government's payroll (Ministry of Home Affairs, 2014).[3] Between 2008 and 2011, the number of central government civil servants and public employees grew by 2.8 and 3.9 percent per annum, respectively. Meanwhile, the number of provincial civil servants also increased an average of 5.1 per cent annually from 2009 to 2013. At the same time, a total of 11 million people receive regular transfers from the government (including pensioners and recipients of social security benefits), putting greater strain on the government's budget (*Vietnamnet*, 2016). Without reforms to reduce this outlay, Vietnam's fiscal position is unlikely to improve.

Moreover, since the CPV system operates alongside the government system, and gets its funding mainly from the state budget, the country will be able to save considerably if the Party can make its system leaner, or integrate itself into the government system. Indeed, there have been experiments at integrating the two systems (*nhất thể hóa cơ quan Đảng và chính quyền*), most notably in Quang Ninh province. If such an approach is adopted nation-wide, it will not only help the Party and the government to save on expenditures but also make the bureaucracy more efficient and conducive to economic growth.

The government also provides funding for public mass organizations.[4] According to research done by the Vietnam Economic and Policy Research Institute (VEPR), these mass organizations received 12,638 billion dongs in 2012 from the central and local governments (Thanh, Giang, & Cuong, 2015, p. 55), which was twice as large as the

[2] By March 2016, Vietnam's foreign debt was equivalent to 43.1 per cent of its GDP (*Thanhnien News, 2016*).
[3] These data do not include police and military officers.
[4] All these organizations are associated with or guided by the CPV. The five most notable ones include the Vietnam Fatherland Front, Vietnam General Confederation of Labour, Vietnam Women's Union, Vietnam Farmer's Union, Ho Chi Minh Communist Youth Union, and Vietnam Veterans' Union. Although these organizations collect membership fees, most of their funding for staff salary and operational costs comes from state budget.

national expenditure for science and technology for the same year.[5] Therefore, the CPV may also need to reduce the size and scope of these mass organizations or change its budgetary policy. Such a move will be a painful one as these mass organizations have long been essential tools in the maintenance of the Party's rule and in the implementation of its policies.

Reforms in certain key sectors are also needed. For example, a review on public expenditure being prepared by the Government of Vietnam and the World Bank points out that as the average teaching time per Vietnamese teacher is lowest among ASEAN countries (JICA, 2013), teachers' teaching load can actually be increased, especially in lower-secondary education. Such a measure would reduce the number of teachers needed and thus the salary bill in the education sector, and enable the government to pay higher salaries to attract more qualified teachers. Similar reforms can also be applied to the healthcare sector, where a typical Vietnamese doctor is seeing far fewer patients per year than their colleagues in many other countries (OECD, 2012).

Strategic and security implications

Although the consequences of Vietnam's growing fiscal deficit will be felt most clearly in socio-economic domains, the implications for Vietnam's defence and security should not be underestimated, especially given that increasing tensions in the South China Sea are making it necessary for Vietnam to maintain the pace of its military modernization programme.

As pointed out in the previous section, Vietnam's expenditure on security and defence has expanded considerably in recent years, contributing to the worsening fiscal position of the country. Specifically, Vietnam's spending on security and defence increased more than three times between 2008 and 2013, from 49,366 billion dongs to 152,828 billion dongs.[6] Although available data do not reveal how the funding was allocated between national defence and domestic security, or between staff salary and asset investments and operational costs, it can be inferred from Vietnam's recent defence acquisitions that its military modernization programme should have accounted for a rather large share in this outlay. For example, according to the Stockholm International Peace Research Institute (SIRPI), Vietnam's total arms imports during 2011-2015 represented a 699 per cent increase from 2006-2010, turning Vietnam into the eighth largest arms importer in the world during the same period (Reuters, 2016; SIPRI, 2016). Therefore, the shrinking national coffer may put considerable constraints on Vietnam's efforts to modernize its military.

However, given the CPV's traditional "security first" mentality and the intensifying South China Sea dispute, Vietnam can be expected to give priority to its military modernization programme at the expense of other sectors. Even so, the government may become more selective in its military acquisition projects. Such a tendency will encourage Vietnam to continue favouring Russian weapons and military equipment over those produced by the

[5] National expenditure for science and technology tasks in 2012 was 5,918 billion dongs.

[6] The data were extracted from National Assembly resolutions ratifying the final accounts of state budget for 2008 and 2013.

US or Western countries due to the large difference in price.[7] Therefore, despite the recent US full lifting of its lethal arms embargo on Vietnam and Hanoi's efforts to diversify its arms sources away from Russia, Moscow is likely to remain Vietnam's largest source of arms in the short to medium term.

Even if Vietnam is reluctant to slow down its military acquisition programme, it may want to contemplate alternative measures to reduce its overall security and defence expenditure. For example, it may increasingly favour co-production over imports where possible to save costs and to absorb foreign technologies. Leasing arrangements for non-essential military equipment are also an option that Vietnam can consider to ease the immediate pressure on its budget. In the longer term, defence force restructuring and gradual steps to downsize the domestic security apparatus, which has been expanding in recent years, should also be considered to save costs and enhance professionalism and efficiency. Such measures, however, may face strong opposition from vested interests in the two sectors.

CONCLUSION

Among major challenges that the Vietnamese government is facing at the moment is its persistently growing budget deficit, which has resulted from both cyclical and structural factors. However, the single most important reason underlying Vietnam's worsening fiscal position are its rapidly increasing recurrent expenditures, which are now accounting for more than two thirds of the government's annual spending. Failing to addressing this problem will prevent Vietnam from consolidating its finances and maintaining its economic growth.

The government will need to generate more revenue from domestic fees and taxes while curbing expenditures. Given the rather large share of defence and security spending in the national budget, Vietnam will also face the traditional gun-versus-bread dilemma. After all, despite the importance of defence and security issues, the CPV will still need to consider social and economic outcomes since its domestic socio-economic performance decides its political legitimacy. Therefore, in the long run, limiting defence and security expenditures will also be necessary.

The burgeoning budget deficit, if left unchecked, holds wide-ranging and far-reaching economic, political and defence implications. Raising public debt to fund the deficit, for example, will present substantial risks for the country's macro-economic conditions. Likewise, austerity measures to curb the deficit will also hold back economic growth and generate popular resentment against the Party and the government. Wise policy prescriptions and strong political determination are needed for painful but necessary reforms to be taken.

After all, historical precedents around the world show that it is domestic economic problems, not foreign "hostile forces", that are the most common cause behind regime collapses.

[7] For example, while US F-15 or F18 fighter jets cost 100 and 92 million USD each, respectively, Russian Su-27/30/35 fighter jets cost only 22-25 million USD each (The Motley Fool, 2015).

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