# ADJUSTMENT TO FISCAL SPACE FOR A SUSTAINABLE DEVELOPMENT IN VIETNAM

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***Vietnam has changed from a backward country to a middle-income nation. After the recent financial crisis and economic recession, Vietnam should adjust its fiscal space to accelerate economic transformation and prevent economic shocks. This paper discusses the fiscal space as an instrument for expanding the policy options for the government. By assessing elements and challenges presented in each factors of the four pillars of the FSD model (revenue, ODA, deficit financing, reprioritization and efficiency of public expenditure) we can have an overview on the role fiscal policy in realization of macroeconomic objectives of a country. With this model, we can identify endogenous and exogenous nature of various options in the fiscal space in order to draw policy conclusions.***

***Key words: Fiscal space, ODA, revenue, deficit financing, reprioritization, and efficiency of public expenditures.***

## 1. Concept of fiscal space

At present, "fiscal space" is still a controversial term. Peter Heller (2005) defines it as the availability of budgetary room that allows a government to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy.

The Development Committee of the joint World Bank –IMF Board on Fiscal Policy and Growth (2006) defined fiscal space as "the gap between the current level of expenditure and the maximum level of expenditures a government can undertake without impairing its solvency."

Both definitions conceptualize fiscal space in residual terms ('room' or 'gap').

Roy and Heuty (2005) define fiscal space as "concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective." The focus on domestic resource mobilization in this definition underscores the fact that ultimately the sustainability and solvency of an economy depends on (a) mechanisms for financing public expenditure; and (b) mobilization of resources aims at financing long-term economic development requirement in the context of political-economic stability. In other words, while the Heller and joint World Bank –IMF Board (2006) definitions are primarily concerned with the short-term consequences (and mainly the potential adverse effects) of an increase in public expenditure, Roy and Heuty (2005) seek to evaluate how concrete policy actions may support trend-changes in the potential for domestic resource mobilization for pro-poor public investment.

This difference in emphasis thus arises because policy and economic transformation concerns differ. The general idea, however, is that the fiscal space is created if additional resources are used for financing useful public projects. The government can create the fiscal space by seeking for sources of finance and carry out necessary reforms to support effective implementation of policies and

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set of development objectives. In implementing the policies, the government should ensure macro-economic stability and long-term sustainable fiscal development.

## 2. An Analytical Framework for Assessing Fiscal Space

The Development Committee of the joint World Bank –IMF Board on Fiscal Policy and Growth (2006) built a Fiscal Space Diamond (FSD) used as an analytical framework for assessing fiscal space (see Figure 1). The fiscal space diamond has four 'pillars' that collectively constitute the universe of avenues to secure fiscal space. The diamond is created by putting the four pillars together in Cartesian space, with the area of the diamond representing the aggregate fiscal space available in the country. The diamond does not include seignorage which is not commonly considered to be a desirable option.

(1) Official Development Assistance (ODA) through aid and debt relief

(2) Domestic revenue mobilization through improved tax administration or tax policy reforms

(3) Deficit financing through domestic and external borrowing

(4) Reprioritization and raising efficiency of expenditures

can be used as an operational tool, depending on the policy assumptions. In the short run for example, expenditure switching policies and tax policy measures to increase revenue would be of limited value compared to measures that make public expenditures more Pareto-efficient (for example productivity gains) and tax administration reform measures. Conversely in the long-term the latter measures are unlikely to have as great a magnitudinal significance compared with the former. That is why it's necessary to identify policy assumptions that serve as foundations of the FSD and time framework in which various policy solutions come into effect.

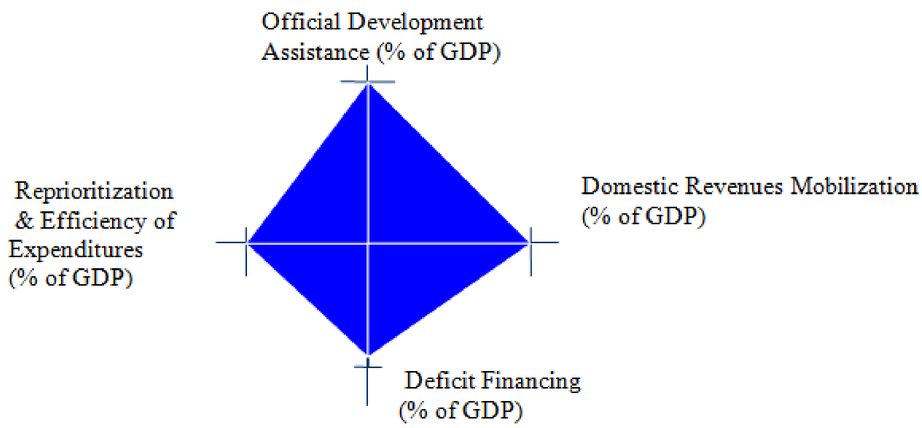
Based on the FSD, WB-IMF Development Committee (2006) introduced two situations, or scenarios, of challenges to economies. The first situation (scenario 1), prevalent in most developed countries, and in many upper middle income countries is one in which the achievement of internationally agreed development goals involves two objectives for fiscal policy:

- Managing the downsides caused by structural shocks; and

- Enhancing economic welfare and increasing access of the relatively poorer sections of the population to key public goods

In this situation, it is the stabilization and al-

**Figure 1: The Fiscal Space Diamond**




The diamond is constructed by (a) mapping the four pillars, one on each axis, with the total resources available under each head representing a point on the axis; (b) joining the points. There are many different situations in which the diamond

location roles of fiscal policy (Musgrave, 1959) that are at the cutting edge of pro-development policy formulation. With respect to the first objective, the focus is on designing appropriate countercyclical fiscal policies to avoid anticipated shocks and to mitigate the impact of unanticipated adverse structural shocks (Dervis and Birdsall, 2006; Vos et al., 2007). The second objective focuses on securing fiscal space for income transfers and/or expanding the availability of public goods at the margin so as to improve the quality and access to public goods for the poor.

When fiscal policy is focused on the stabilization, allocation and redistribution functions of public finance then there is unlikely to be a substantial permanent increase in the size of the government expenditure. Equally, on the revenue side, there is unlikely to be a significant permanent increase in the public sector borrowing requirement. Hence the issue is to find adequate fiscal space to secure the above objectives without typically requiring structural changes in the pattern of resource mobilization or a permanent increase in the size of the public sector.

The second situation, prevalent in most low- income countries is one in which the objective of fiscal policy is to finance a sustained, magnitudinally significant and permanent increase in public investment to support economic growth and deliver the basic necessities to secure a development transformation. The time horizon to achieve this transformation is 10-20 years. In this context the growth and allocation functions of fiscal policy are at the cutting edge of pro-development policy formulation. This typically implies a permanent increase in government spending in the economy (G/GDP ratio) over the long-term. The expansion of government spending is consistent with “Wagner’s law” (Wagner, 1911), which states that government activity increases as economies grow.

In short, countries at different stages of development typically face different policy challenges that require specific fiscal instruments for enhancing fiscal space. It’s development objective set by individual country that serves as a basis for working out instruments for enhancing the fiscal space.

## 3. Fiscal space in Vietnam

In the past 20 years, Vietnam, from a backward and poor country, has transformed its economy and become a middle-income country. In 1990-2010, its personal income made a fivefold increase and its growth rate was about 7%-8%. In this process, a fiscal space has been developed to achieve transformation objectives by various measures including tax reform aiming at increasing the public expenditure; and increasing budget deficit by better mobilization of both internal and external resources (see Table 1).

**Table 1: Indicators in the fiscal space (% of GDP)**

| Indicator | 1993 | 1995 | 2000 | 2005 | 2008 |
|---|---|---|---|---|---|
| National budget income | 13.5 | 23.3 | 21 | 27 | 24.8 |
| Public expenditure (*) | 16.6 | 27.4 | 27 | 32 | 40.1 |
| Budget deficit (**) | 3.1 | 4.08 | 4.2 | 4.1 | 5 |
| ODA (disbursed) | 3.4 | 3.5 | 5.5 | 3 | 3 |

*Source:* Ministry of Finance; (*) MPI (Lê, 2008)

- National budget income comprises tax take, fees, charges and other receivables
- Public expenditure (*) includes budget expenditures and other spending financed by government bonds, state lottery, target programs;
- Budget deficit (**) is anticipated in the Budget Act.

### *a. Tax reform*

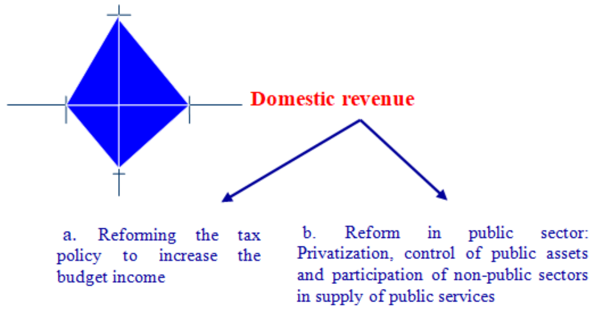
In order to expand the fiscal space to serve the economic development, tax reform could be seen as a breakthrough in the reform in the public finance in Vietnam. After 20 years of economic reform, ratio of tax take and other receipts to GDP has been much improved, from 13% in 1990 to 24% in 2008. And as a result, the fiscal situation is healthier; the budget income is large enough to not only cover regular expenditures but also finance some investment projects. In addition, to facilitate improvements in endogenous resources, the public sector is changed radically by privatization, stricter control over public assets and participation of other sectors in supply of public goods (Figure 2).

In the context of international integration, the Vietnam’s tax system faces various challenges:

- Sources of revenue: Integration into the world economy forces the government to increase the tax take and play well its role as its counterparts in developed countries (scenario 1). The problem is how to increase the revenue without reducing economic dynamics while income from foreign trade is to plunge drastically.

- Taxation management: Tariff barriers should be removed as required by the international integration. Flows of capital will be stronger while capacity to manage the taxation is limited and the best part of budget income comes from duties. Replacement of duties on foreign trade with taxes on domestic market, and transfer pricing practices by foreign-invested concerns are great challenges to tax authority.

**Figure 2: Exploitation of endogenous resources in the fiscal space**




Economic efficiency and tax competition: Tax competition in the process of attracting capital is also a challenge when capital is allowed to flow freely. Vietnam has to offer more tax incentives to attract and compete for foreign capital. This will make the tax policy less fair and neutral.

***b. Reform in public expenditure:***

Report of Ministry of Finance to NA Commission of Finance and Budget shows that, in the past 20 years, the public expenditure has increased quickly, from 20% of GDP in 1990 to some 40% in 2008. And as suggested by UNDP, increasing the efficiency of public expenditure is one of principal solutions to improvement in the fiscal space needed for economic growth (UNDP, 2008). That is why the Vietnamese government, besides increasing the public expenditure, has tried its best to enhance the efficiency of allocation of resources in order to make more room for development (Figure 3):

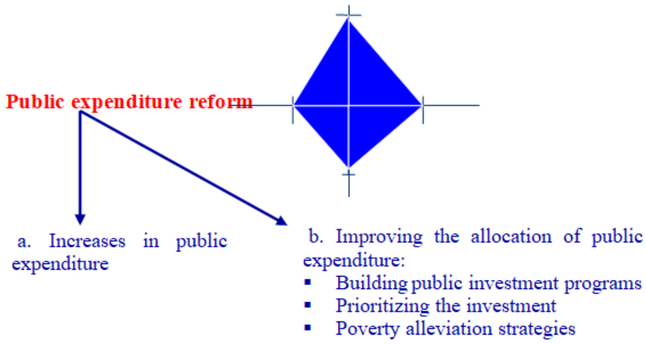
- Program-based budgeting must be taken by planning public investment programs for each stage of development; these programs created a framework for all public spending programs, thus helping the Government control strictly the allocation and use of `financial resources in the long run.

- Public investments must take priority over regular expenditures. In structure of public investments, outlay on non-production or unproductive projects was cut by degrees, along with outlay on state-owned companies.

- Orientation to public expenditures on the poverty objectives should be enhanced.

Fast increases in public investment lead to increases in the regular expenditure, which limits expenditures on social welfare. In addition, separation between public investment and regular expenditure results in a situation in which finished projects have proven ineffective due to lack of fund for maintenance and upgrading (UNDP, 2004). Consequently, supply of goods is both quantitatively and qualitatively poor.

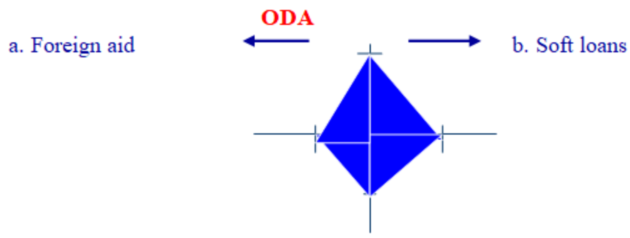
**Figure 3: Reform in public expenditure in the fiscal space**




***c. Budget deficit:***

With increasing the public expenditures as a policy, the Government has accepted a high and increasing budget deficit. In 1991-1995, the budget deficit equaled 2.85% of GDP; and this figure was 3.87% in 1996-2000 and 4.9% - 5% in 2000- 2007. In the years 2008- 2009, when the countercyclical fiscal policy was adopted to stop the recession, the deficit was expected to amount to 8% of GDP. Increased deficit led to much bigger volume of government bonds issued in this period. To reduce the pressure, the Government had to resort to external sources of finance, mainly the ODA (see Figure 4). From 1993 to 2008, some US$22 billion out of committed 42.5 billion has been disbursed. The ODA covered some 30% of the budget deficit, equaling from 1.5% to 1.7% of annual GDP.

**Figure 4: Exploitation of external sources of finance in the fiscal space**

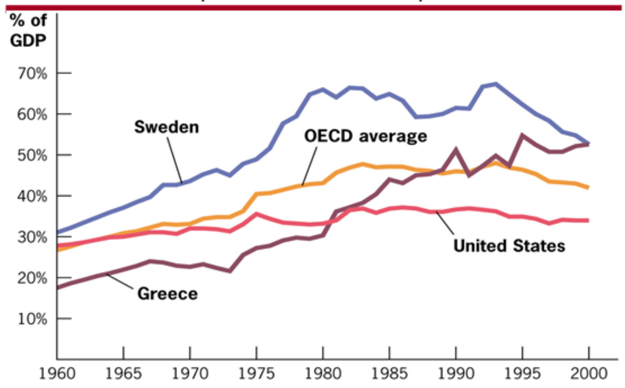



A prolonged and continuous deficit leads to challenges to macroeconomic stability and effort to deal with domestic investments and export that are crowded out as analyzed in the IS-LM model by Kyenes. Mobilization of large sums from the domestic finance market may lead to the shortage of fund and higher interest rate. Consequently, it limits capacity of mobilizing the capital and expanding the investment in the private sector. Using the foreign sources of capital to finance the deficit may increase the supply of foreign exchange and improve the balance of payments for a short term, yet it also entails changes in the exchange rate that may be unfavorable to the export. The bigger the ODA is, the heavier the national debt is. The economy then involves in various potential risks to the exchange rate and balance of payments in the long run. Solving the economic crowding-out depends a lot on policies to improve efficiency and performance of the public investment.

In short, to obtain economic transformation, the Vietnamese government has created a roomy fiscal space in order to secure sources of capital as well as exogenous and endogenous resources for economic transformation, with the result that its spending equals 40% of GDP and national debt by the end of 2009 equaled 44.7% of GDP. If VND146,000 billion and US$1 billion worth of government bonds along with the newly-committed ODA (some US$8 billion for 2010) are taken into account, the national debt will be much bigger, equaling some 50% of GDP. Thus, the Vietnamese fiscal space is facing various challenges:

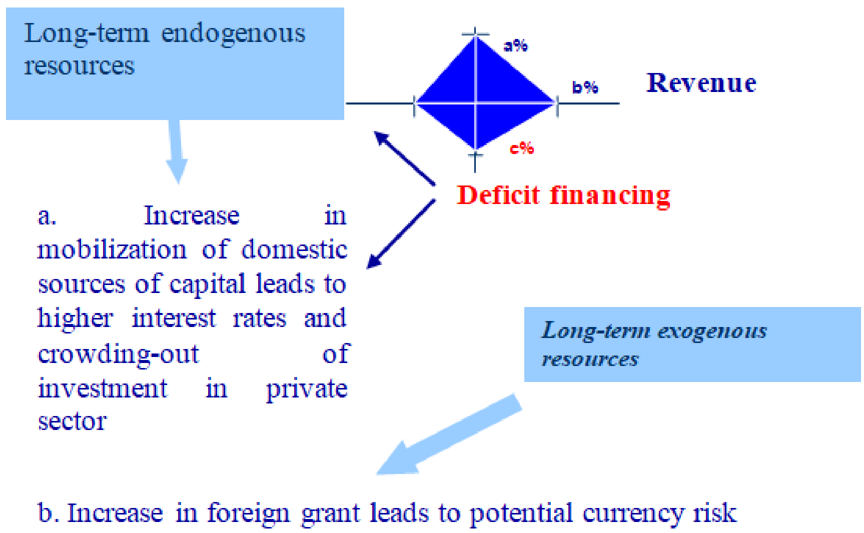
- At present, the public expenditure is much higher than the average figure found in developing countries and equal to the ones of developed countries (Figure 5).
- Fiscal expansion can produce potential risks (Figure 6).

Figure 5: Public expenditure in some developed countries




Source: OECD Historical Statistics

**Figure 6: Potential risks in Vietnam's fiscal space**



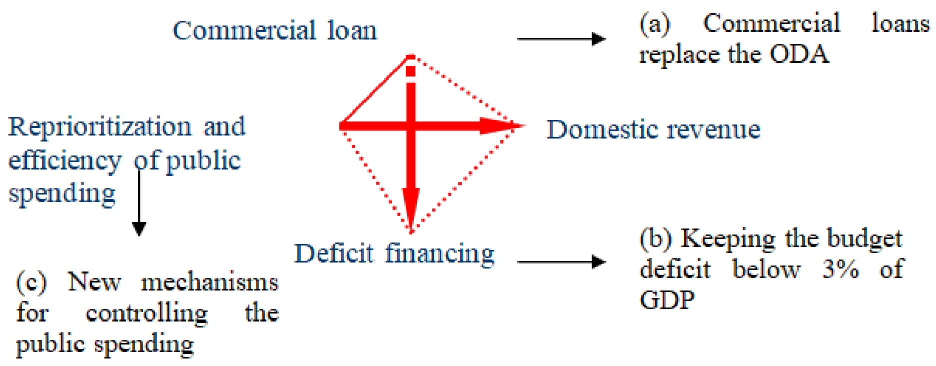

## 4. Adjustment to Vietnam's fiscal space for a stable development in 2011 -2020

*a. Selecting the development objectives*

Global financial crisis and economic recession slowed down the Vietnam's economic growth.

Overcoming the middle-income trap [3] is a great challenge to Vietnam. What lesson can be drawn on the way to development with a view to avoiding the middle-income trap? The key point is the quality of economic growth. Only high growth quality can maintain high and sustainable growth rate; and only good growth quality helps ensure interest of civilians and the healthy economic growth. Thus, sustainable development and maintaining a reasonable growth rate must be inevitable options for Vietnam in the next 10 years.

**Figure 7: Adjustments to the fiscal space**




***b. Challenges to fiscal space adjustments***

To achieve development objectives, a country should mobilize all possible sources of capital and resources, and make the best use of them to gain high growth rates in many successive years. By adjusting the fiscal space for development in the next 10 years, Vietnam may face various challenges:

- At present, sources of tax take are nearing their peaks; and it is extremely difficult to increase the tax take in the context of international competition and economic recession.

- Sources of ODA will fall and come to an end when Vietnam becomes a middle-income country (this will happen in one year or two), and the ODA will be replaced by commercial loans.

- Budget deficit must be well manipulated in order to prevent external shocks when Vietnam integrates more fully into the world market.

With these challenges, the Vietnam's fiscal space in the next 10 years still follows the scenario 2 to realize economic transformation, but it needs appropriate adjustments to changes in factors of the model: (i) replacement of the ODA with commercial loans; (ii) new mechanisms for controlling expansion and improving efficiency and performance of public spending; and (iii) reducing the budget deficit, and keeping it below 3% of GDP to prevent economic shocks (see Figure 7). These adjustments help Vietnam move to the scenario 1.

***c. Necessary adjustments to the fiscal space***

- Adjustment to the ODA: The ODA still plays an important role in the economic transformation, especially in construction of infrastructures. This means that it is to stay at a certain level in the fiscal space. As a middle-income country, however, Vietnam should get access more proactively to commercial loans instead of relying on the ODA.

Challenge and loss of national interest when accessing this source of capital are great. Insolvency and debt burden on future generations seem inevitable in the event that such loans are still treated as financial support for state-owned corporations and groups. When unproductive loans require daily repayment of both principal and interest, expenditures on social welfare, poverty alleviation, health care and education will certainly be reduced. It is about time Vietnam rejected its old thinking way about borrowing with a view to managing to overcome the "middle-income trap." Getting loan at any price is unacceptable. Making the best use of loans will face a lot of challenges and obstacles, especially corruption. Thus, the Government should attend to long-term challenges, such as reform in mechanisms, instead of short-term ones. Such reform requires more transparency and accountability, good supply of information, better mechanism for external supervision and public participation in policy-making process.

- Reform in public administration and expenditure: This is the most important measure to improve resources in the fiscal space for the economic transformation. The centralized management characteristics of the mechanism for controlling expenditures according to input items may lead to ineffective use of public finance and irresponsibility for public goods supplied to society.

Facing the pressure of economic development and international competition in the context of integration and higher demand for public goods, change from mechanism for controlling expenditures according to input items to method of managing the expenditures based on results is necessary. The new method aims at creating an overall fiscal discipline, overcoming carelessness and linking responsibility of officials with output and performance of their organization. In other words, result-based management of public expenditure is an instrument for: (i) concentrating public resources on the most socially productive fields; (ii) Helping improve public policies (through result-based assessment); and (iii) enhancing managerial efficiency (by making all objectives and priorities transparent). However, changing organizational culture into the new managing method is a time-consuming and difficult task that requires continuous improvement and screening. Rational leadership and shared sense of commitment to the reform is very important in an attempt to build a result-based managing culture.

- Controlling the budget deficit: In the process of international integration, Vietnam must be more careful about budget deficit with a view to avoiding shocks. In other words, Vietnam should keep the deficit below 3% of GDP to stabilize the economy with a reasonable rate of inflation and prevent wide fluctuations in the domestic market. Thus, in the fiscal space in the upcoming year, the budget deficit must be controlled more strictly. To cease the economic recession then, the Government should design and make the best use of “automatic stabilizer” of the fiscal policy. Automatic stabilization is a product of long-term objective and should be designed carefully to deal with economic cycles. In designing the automatic stabilizer, full attention must be paid to its reacting power. Such a mechanism can operate automatically without increasing the budget deficit. Improving the reacting power of the automatic stabilizer can be realized by enhancing the progressive tax system and reforming social welfare programs. Personal income tax is an instrument with a high self-stabilizing degree. Social welfare programs that stabilize the income for the poor and wage-earners should be radically reformed by developing schemes of social insurance and unemployment insurance in relation with good manipulation of the income tax■

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