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**Budget Deficit and Economic Growth in
Developing Countries: The Case of Vietnam**

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(The views and opinions presented in this paper are those of the author. They do not necessarily reflect that of affiliated institutions. The author would be very grateful if he could receive any comment and opinion (email: dongochuynh@mof.gov.vn).

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Introduction

□ **Background**

- Controversial arguments on the relation of budget deficit and economic growth in economic theory and practice
- Emerging issues in developing countries, especially Vietnam

□ **Purpose of study**

- Considering the relation of budget deficit and economic growth in developing countries, especially those in Asian in recent period
- Making analytical views and policy analysis on budget deficit and economic growth in Vietnam
- Identifying major policy issues and international experience
- Abstracting policy recommendations

Budget deficit and economic growth in developing countries

- **Economic theories of budget deficit and economic growth**
 - **Aggregate demand management (Keynesian Economics)**
 - ✓ Strong points: positive impacts of government policy, especially fiscal policy in the period of recession (short-term)
 - ✓ Weak points: over-valued and excess-used, timely, level of interventions
 - **Supply-side Economics:**
 - ✓ Strong points: micro-based for long term economic growth
 - ✓ Weak points: difficult to explain in the period of recession; ignore the role of aggregate demand management and government interventions in short-term.

References:

- Wallace (2001), “Fiscal Architecture and Analysis of Public Expenditure Needs and Revenue Capacity”, International Studies Program’s Working Paper
- Serven (2007), “Fiscal Rule, Public Investment, and Growth”, WB Policy Research Working Paper
- Favero and Giavazzi (2000), “[Debt and the Effects of Fiscal Policy](#)”, NBER Working Paper
- Mankiw and Elmendorf (1999), “Government Debt”, Handbook of Macroeconomics, Vol. 1, Taylor, J.B. and M. Woodford

Budget deficit and economic growth in developing countries (cont.)

□ **International experience**

- Industrialized economies (Japan and other OECD countries)
- Developing countries other than transitional economies
- Transitional economies

□ **Experience from developing Asian**

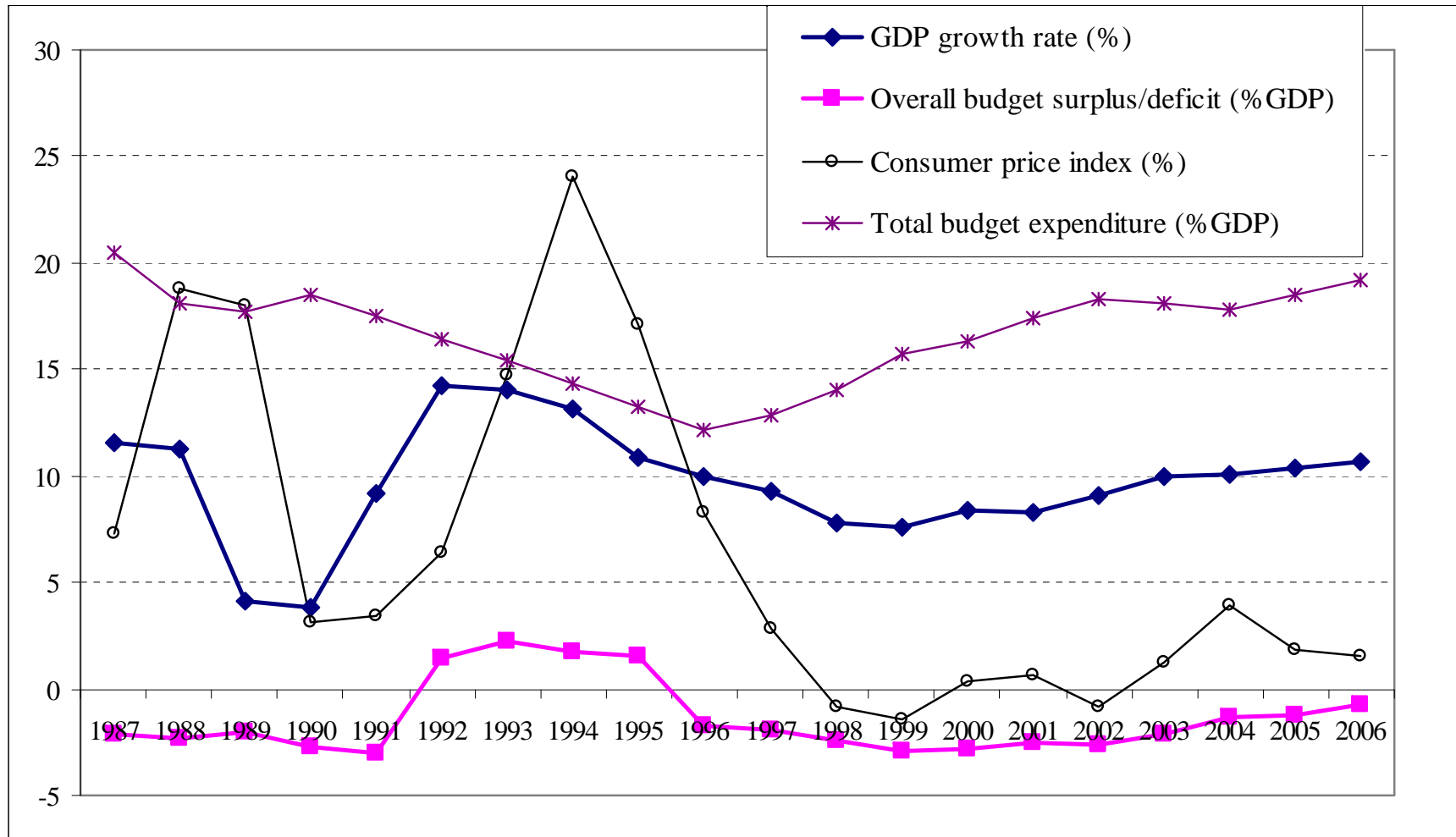
economies: China, India, Thailand, The Philippines, Indonesia, Malaysia, Chinese Taipei, Singapore

Government budget size and fiscal balance in developing Asian countries

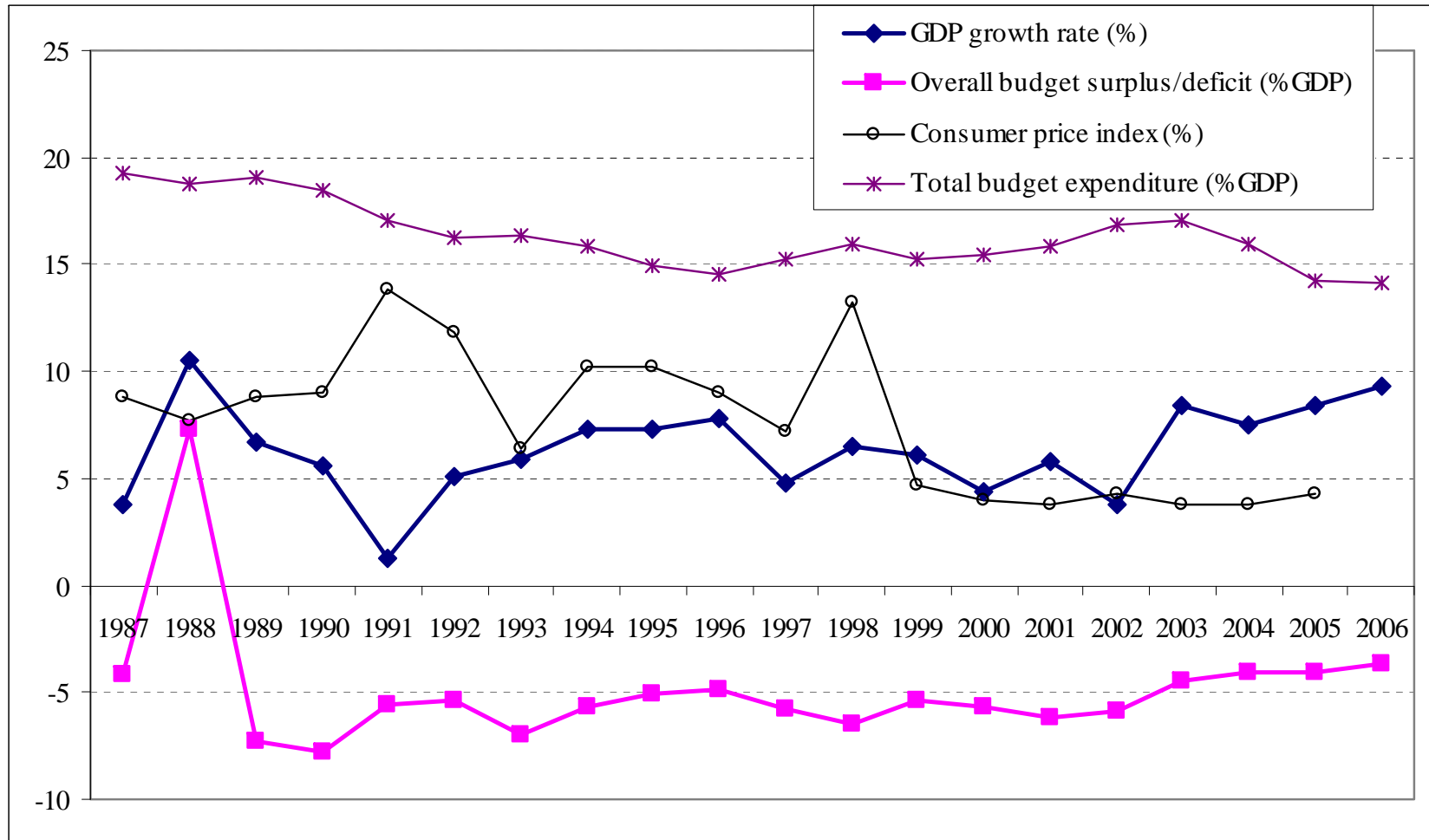
Country	Total Expenditure				Fiscal Balance			
	1990	1995	2000	2006	1990	1995	2000	2006
China, People's Rep. of	18.5	12.2	16.3	19.2	-2.8	-1.8	-2.8	-0.7
Cambodia	8.4	14.8	8.4	14.2	-4.5	-7.2	4.3	-0.9
Indonesia	19.6	14.7	15.8	20.1	-0.9	3.0	-1.1	-1.0
Lao PDR	23.4	26.7	19.6	17.4	-9.7	-12.9	-4.3	-4.3
Malaysia	27.7	22.1	22.9	24.9	-2.9	0.8	-5.5	-3.3
Philippines	20.4	18.2	19.3	17.3	-3.5	0.6	-4.0	-1.1
Thailand	13.9	15.4	17.3	16.4	4.8	3.0	-2.2	1.1
Viet Nam	21.9	23.8	23.4	29.8	-7.2	-1.3	-5.0	-4.1
Bangladesh	12.4	13.7	14.4	13.1	-0.4	1.5	0.8	3.0
India	18.5	15.0	15.5	14.1	-7.8	-5.1	-5.7	-3.7
Pakistan	25.9	23.0	18.9	18.7	-6.5	-5.6	-5.5	-4.3
Kazakhstan	38.2	25.7	22.2	21.2	-6.5	-4.0	-0.1	0.8
Kyrgyz Republic	37.2	27.8	18.0	22.5	-8.2	-11.5	-2.0	-0.2
Turkmenistan	19.3	20.1	23.9	22.2	1.7	0.4	-0.3	0.0
Uzbekistan	...	32.6	28.9	20.8	...	-2.9	-1.0	-1.3
Average above	20.3	20.4	19.0	19.5	-3.6	-2.9	-2.3	-1.3
Singapore	21.3	16.1	18.8	15.8	10.8	14.5	10.0	7.0
Korea, Rep. of	15.5	15.8	18.9	23.6	-0.6	0.3	1.1	0.4
Taipei,China	14.5	14.4	15.4	15.9	1.8	-1.1	-3.1	-0.3

Source: Asian Development Bank (ADB) - Key Indicators 2007 (www.adb.org/statistics)

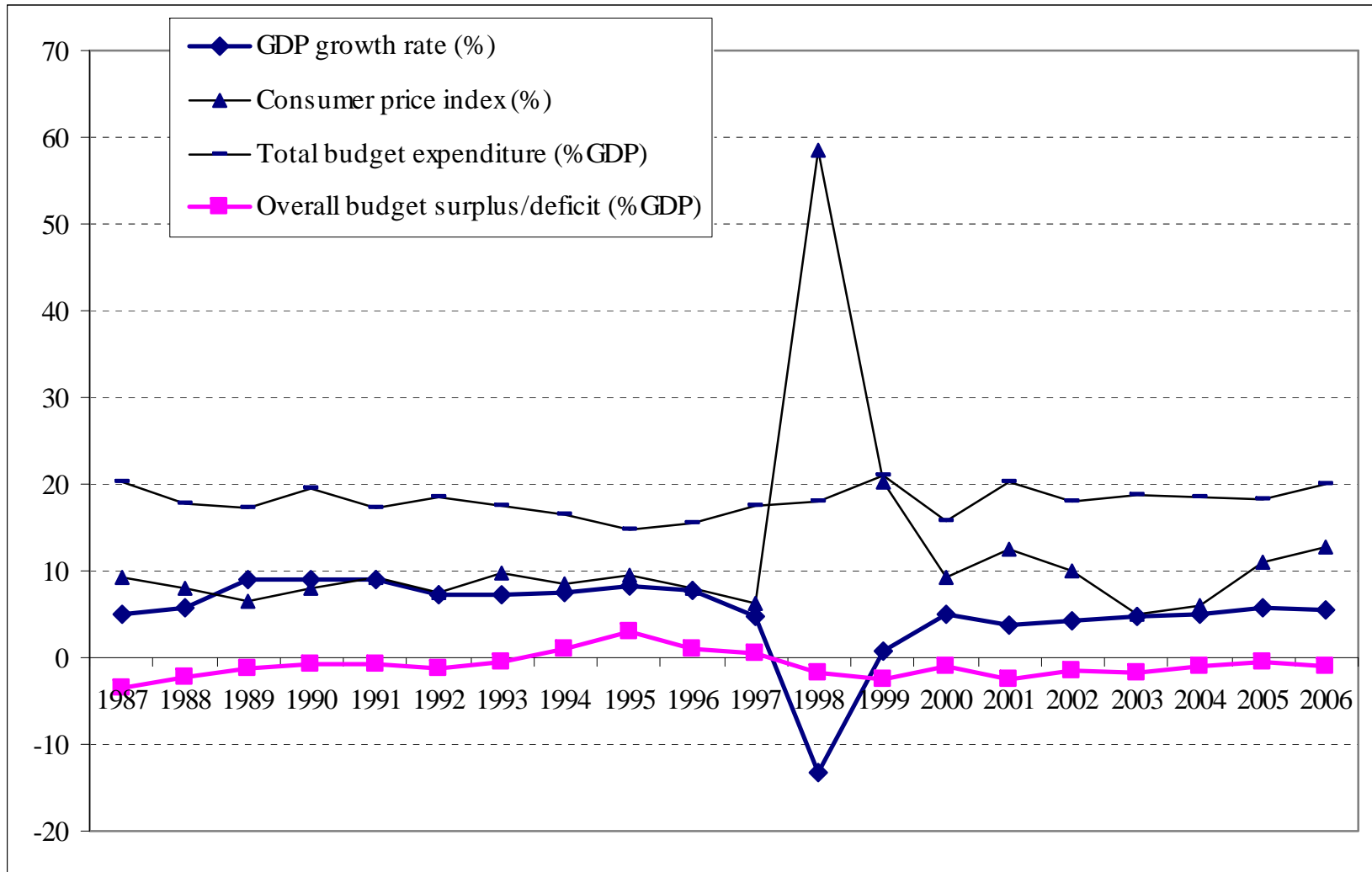
Budget deficit and economic growth: China



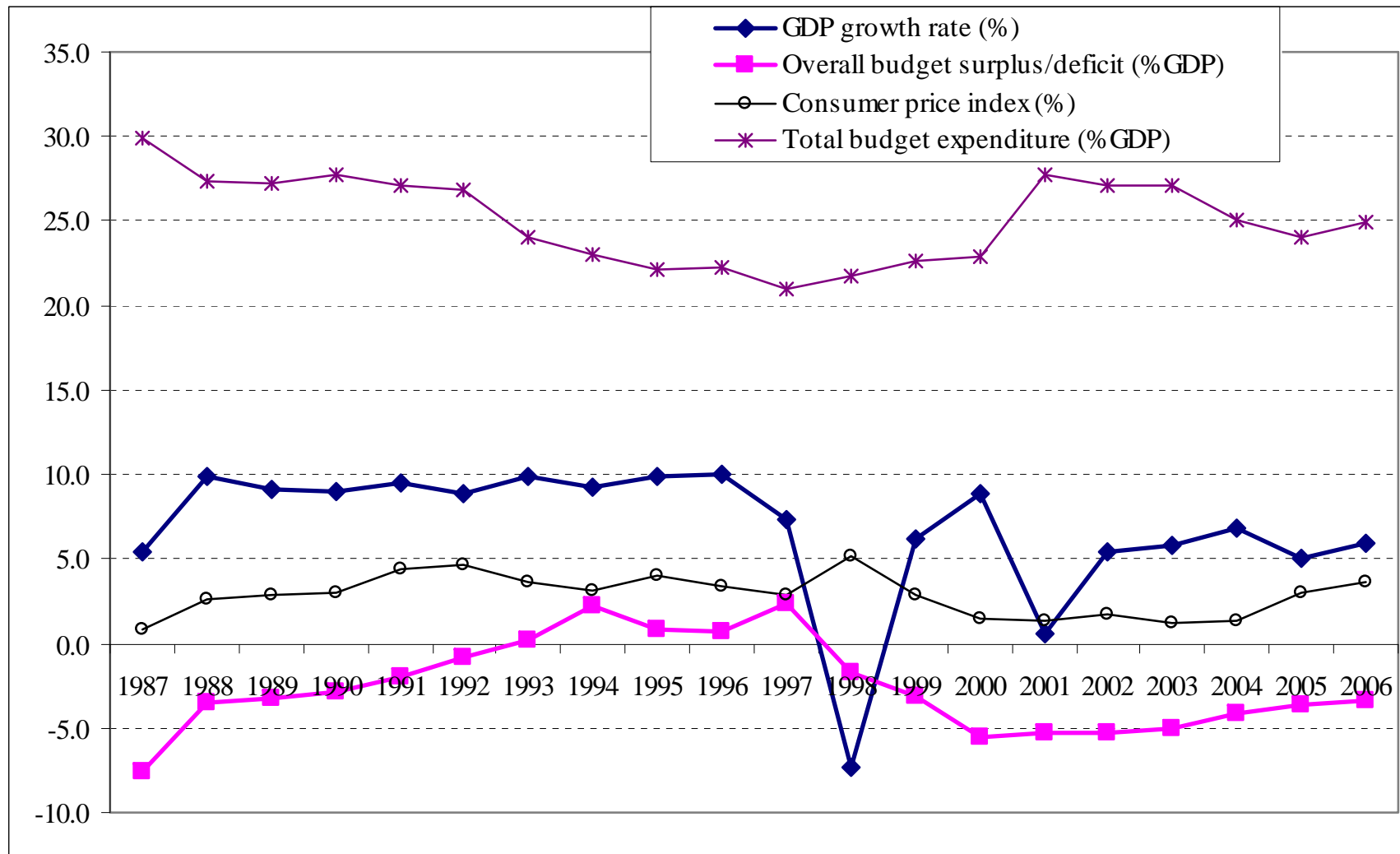
Budget deficit and economic growth: India



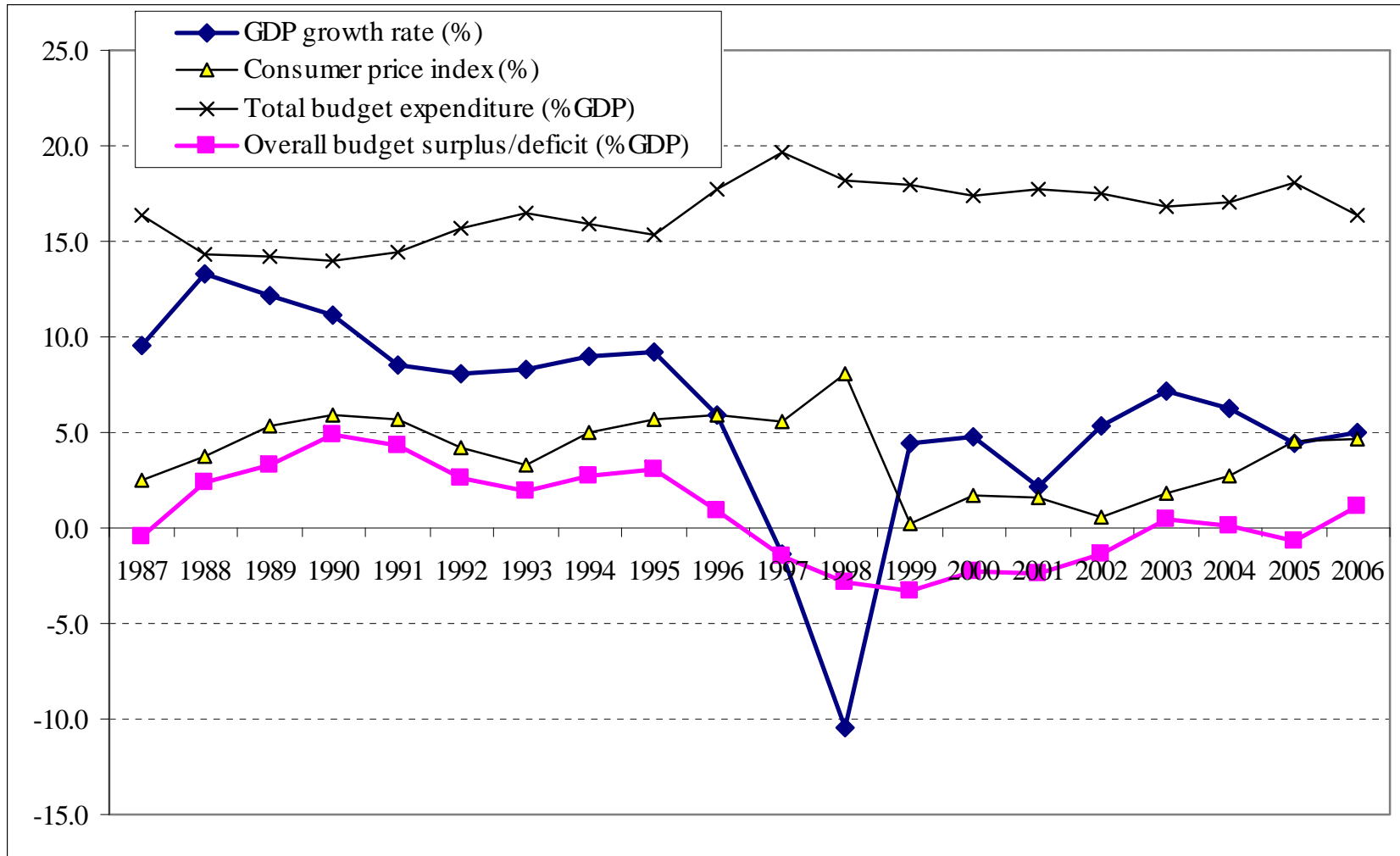
Budget deficit and economic growth: Indonesia



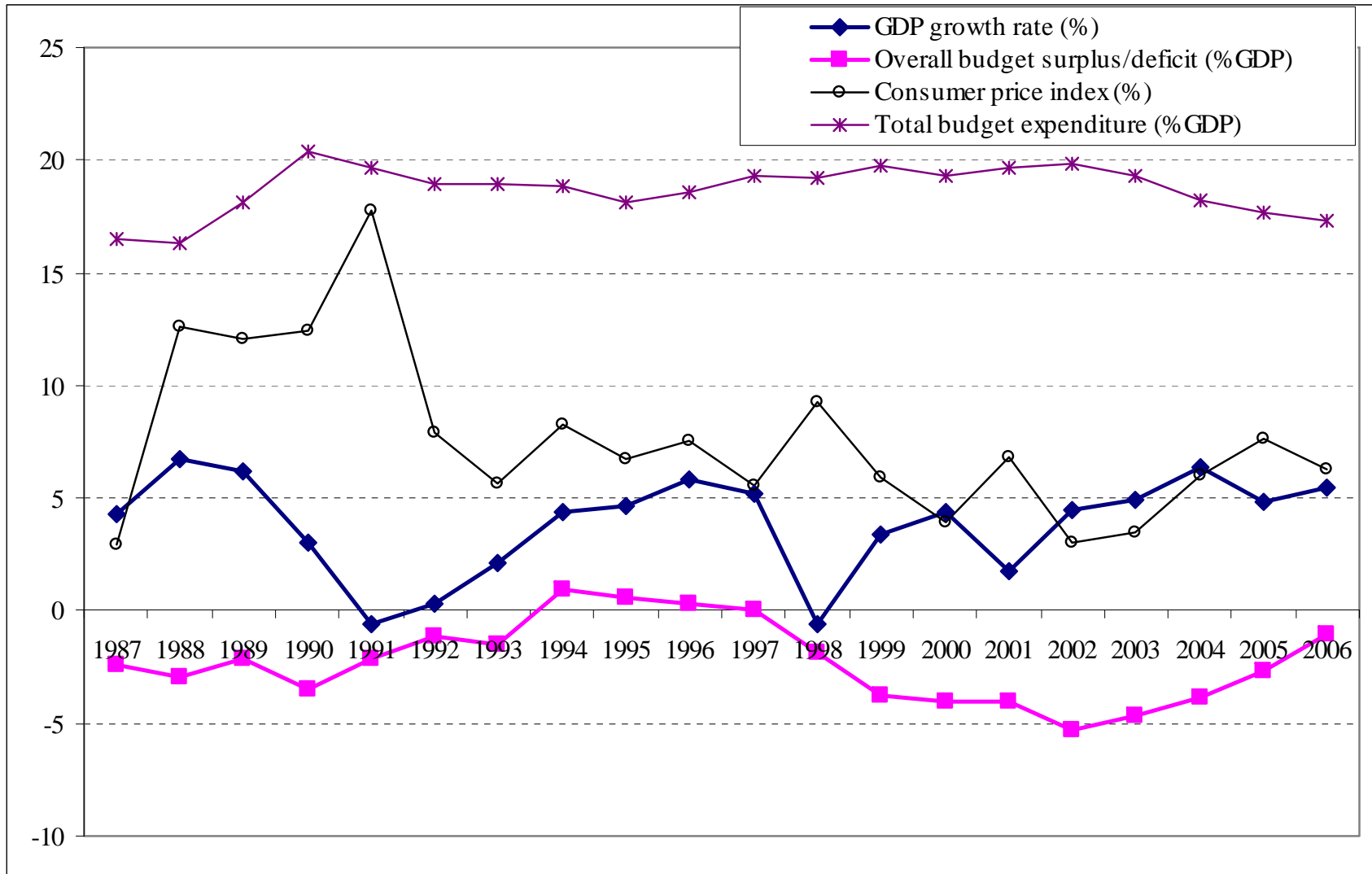
Budget deficit and economic growth: Malaysia



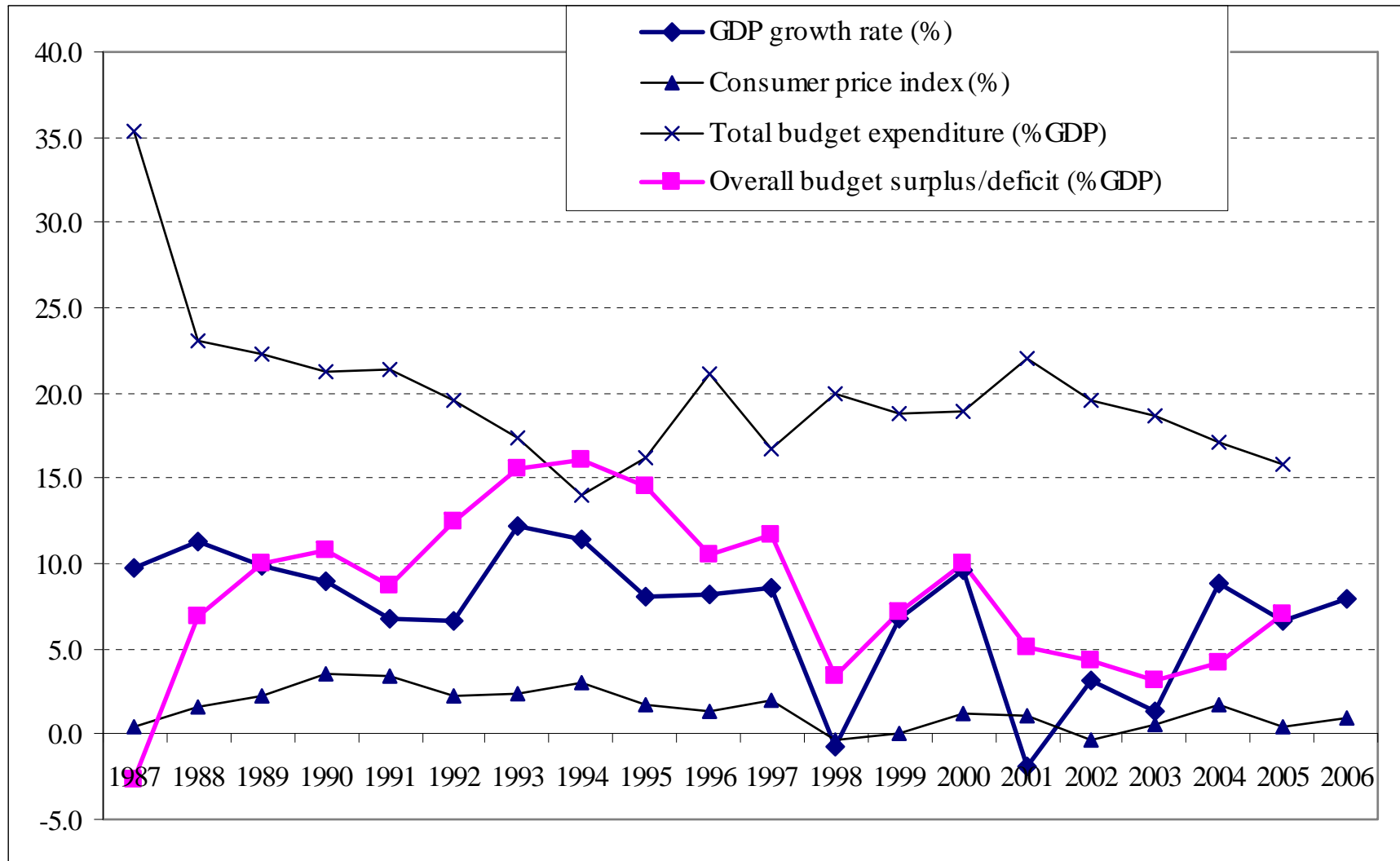
Budget deficit and economic growth: Thailand



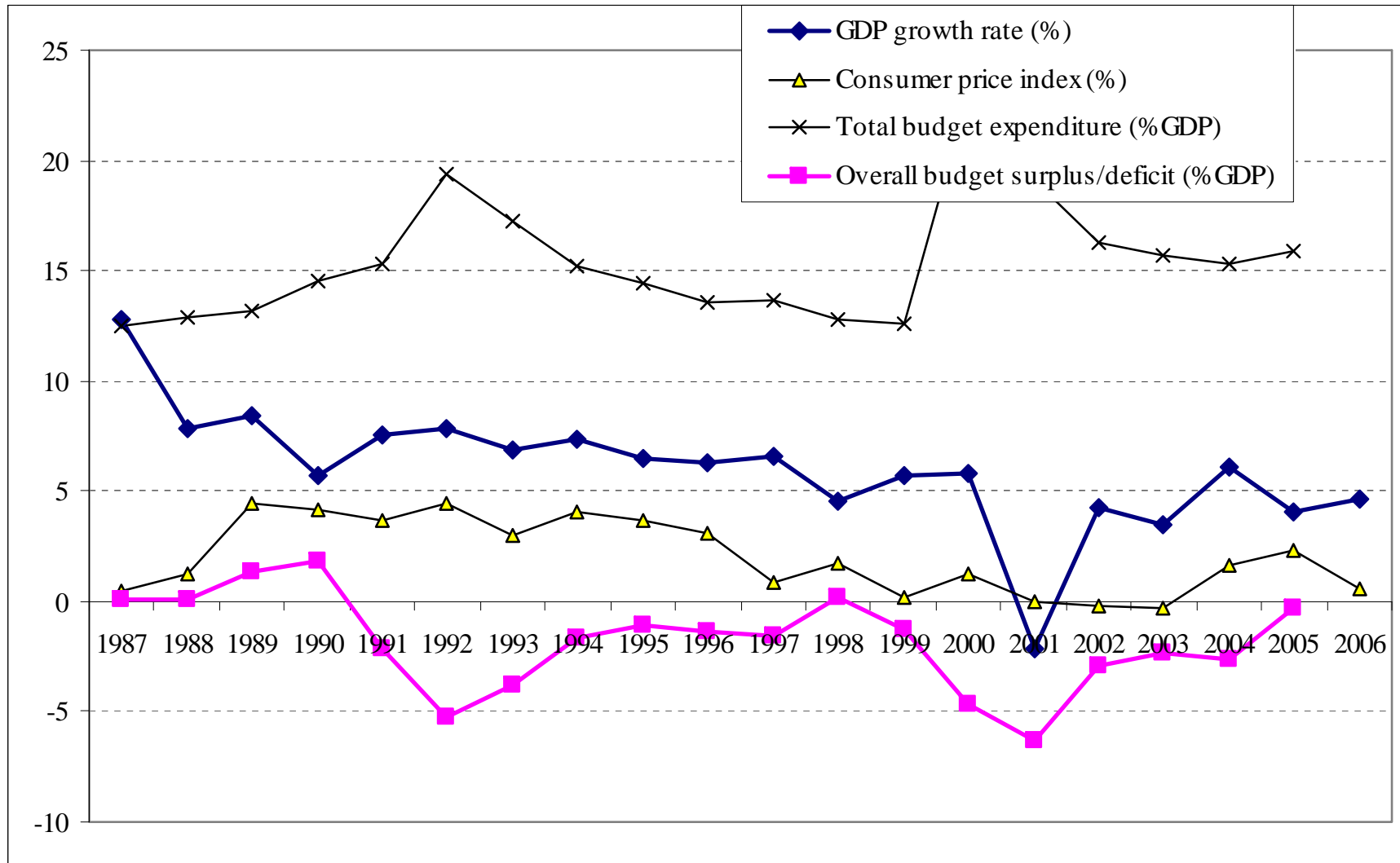
Budget deficit and economic growth: The Philippines



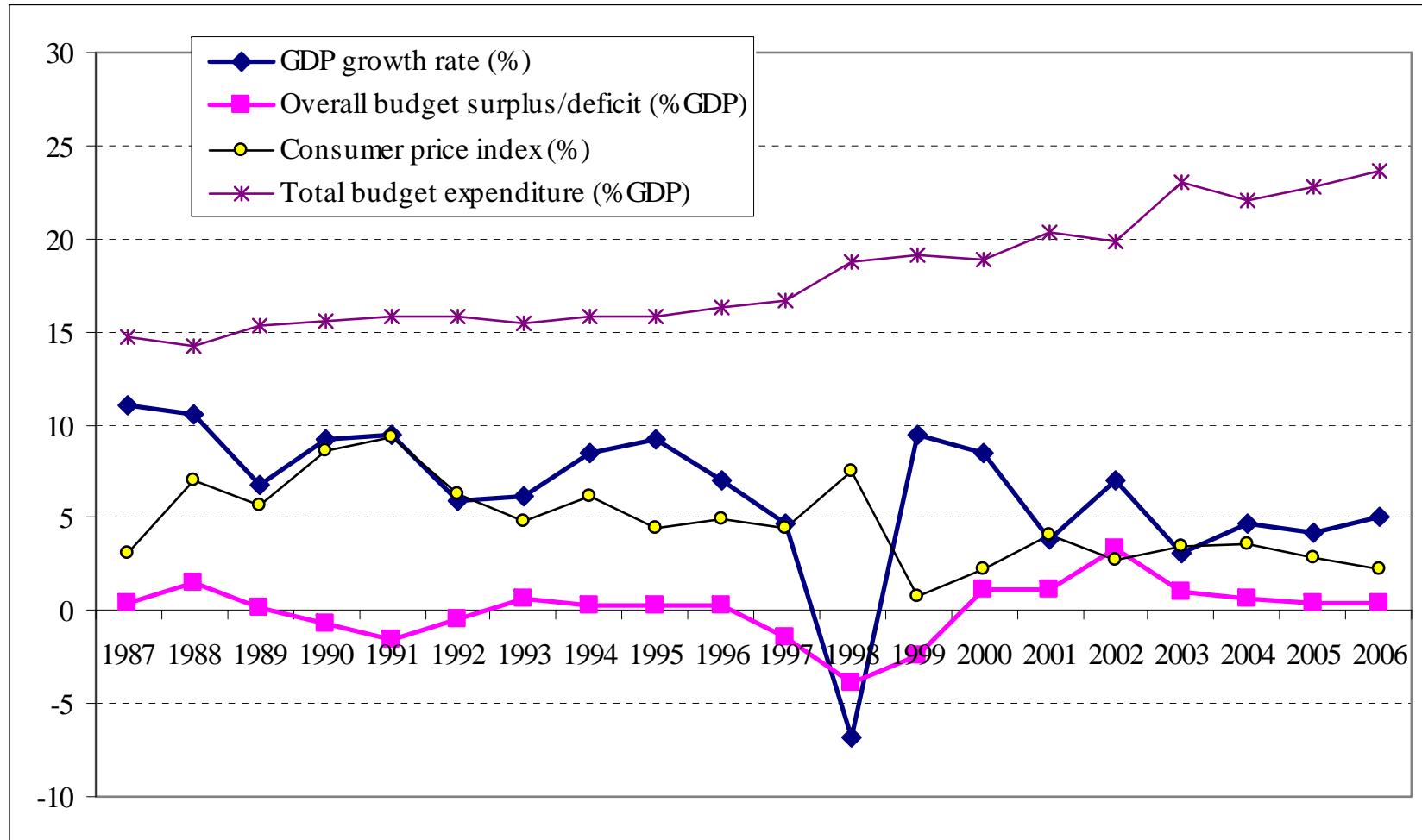
Budget deficit and economic growth: Singapore



Budget deficit and economic growth: Taipei, China



Budget deficit and economic growth: Korea



Main points from Asian experience

- ❑ The lower the budget deficit (precisely, the ratio of budget deficit to GDP), the higher the GDP growth rate
- ❑ The lower the budget deficit, the lower the consumer price index (CPI)
- ❑ The larger the share of government budget expenditure in GDP, the lower the growth rate of GDP

Analytical view of budget deficit and economic growth in Vietnam

□ Policy reform process

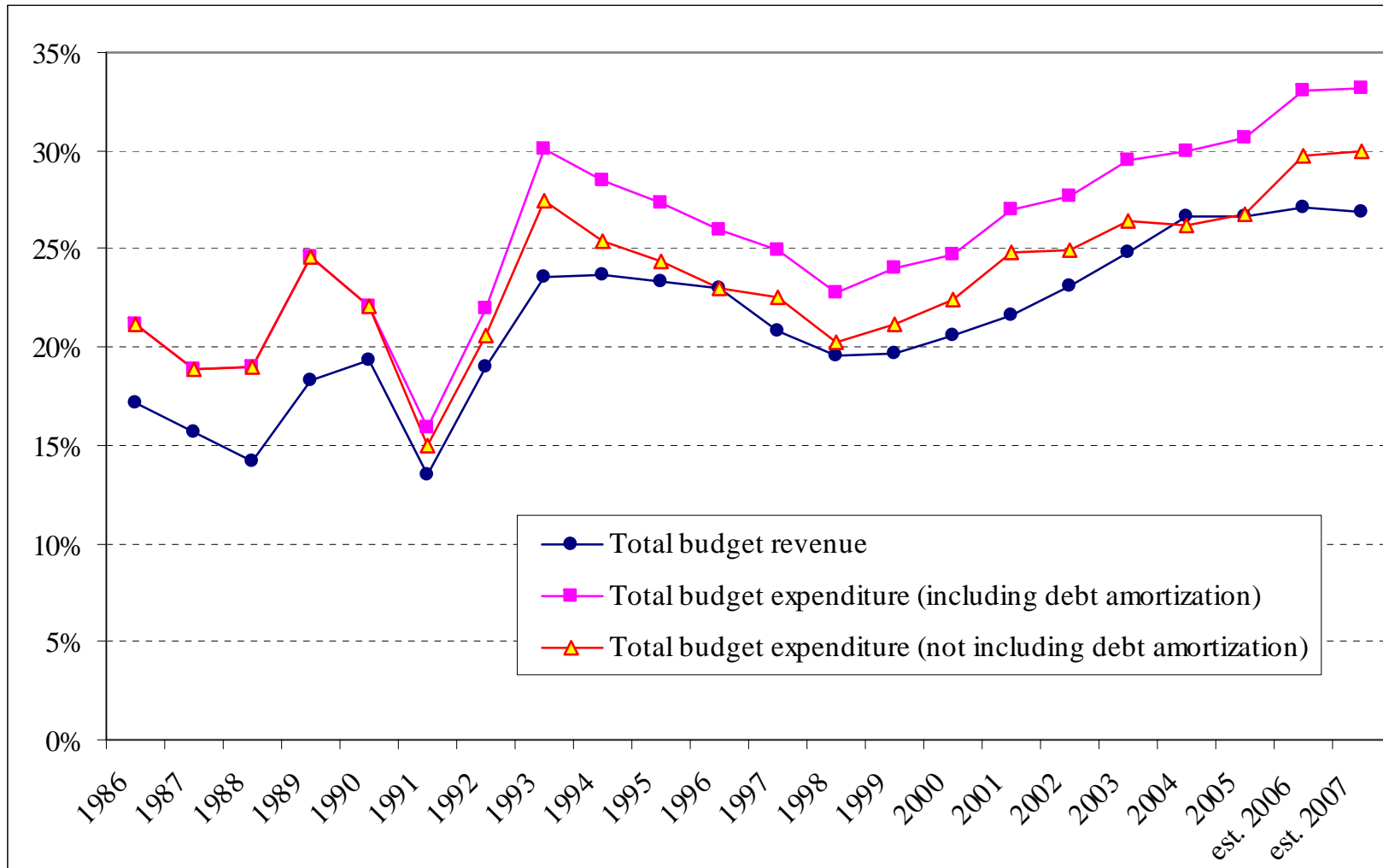
- Macroeconomic reform:
 - Fiscal reform: imposing the hard budget constraint for the government; reforming the tax system; cutting budget subsidies and reducing budget expenditures
 - Monetary reform: Making two-tier banking system; liberalizing the financial markets; reforming the interest rate policy and exchange rate policy
- Microeconomic reform:
 - Commercializing the SOEs system and making them autonomy
 - Liberalization of the market and business activities
 - Encouraging the private sector and FDI sector

Analytical view (cont.)

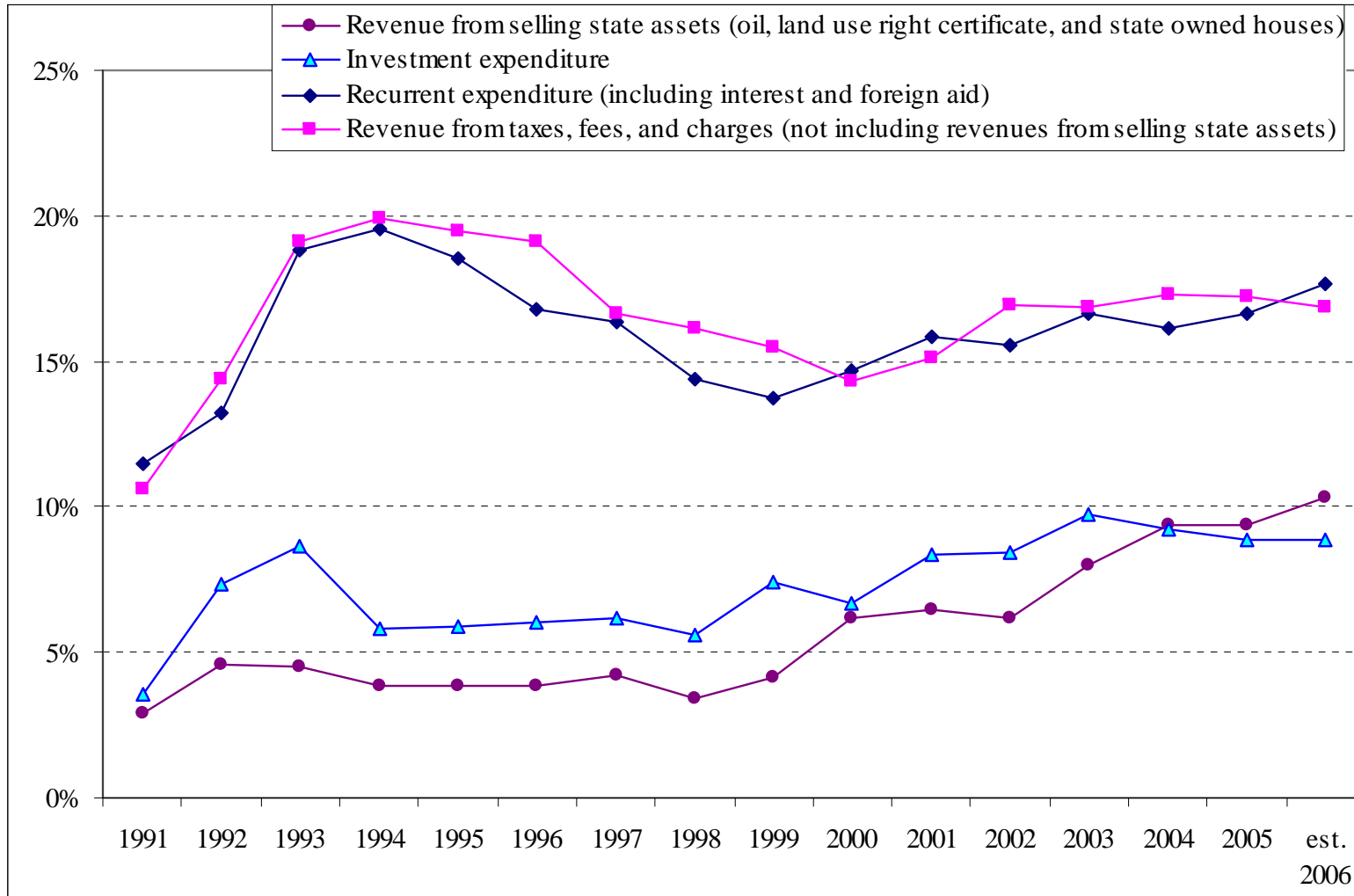
□ Situation of budget deficit and economic growth

- Budget deficit:
 - Reduced in the beginning of the reform process; then maintained stable at around 4-5% GDP since 2000
 - Relatively high compared to other countries in the region
- Inflation:
 - Controlled from hyperinflation in the middle 1980s to one-digit level since the middle 1990s
 - Relatively high and unstable inflation rate compared to other countries in the region
- Economic growth:
 - Speeded up at a relatively high growth rate of around 8% during two decades of economic reform
 - Emerging issues on sustainable long run growth

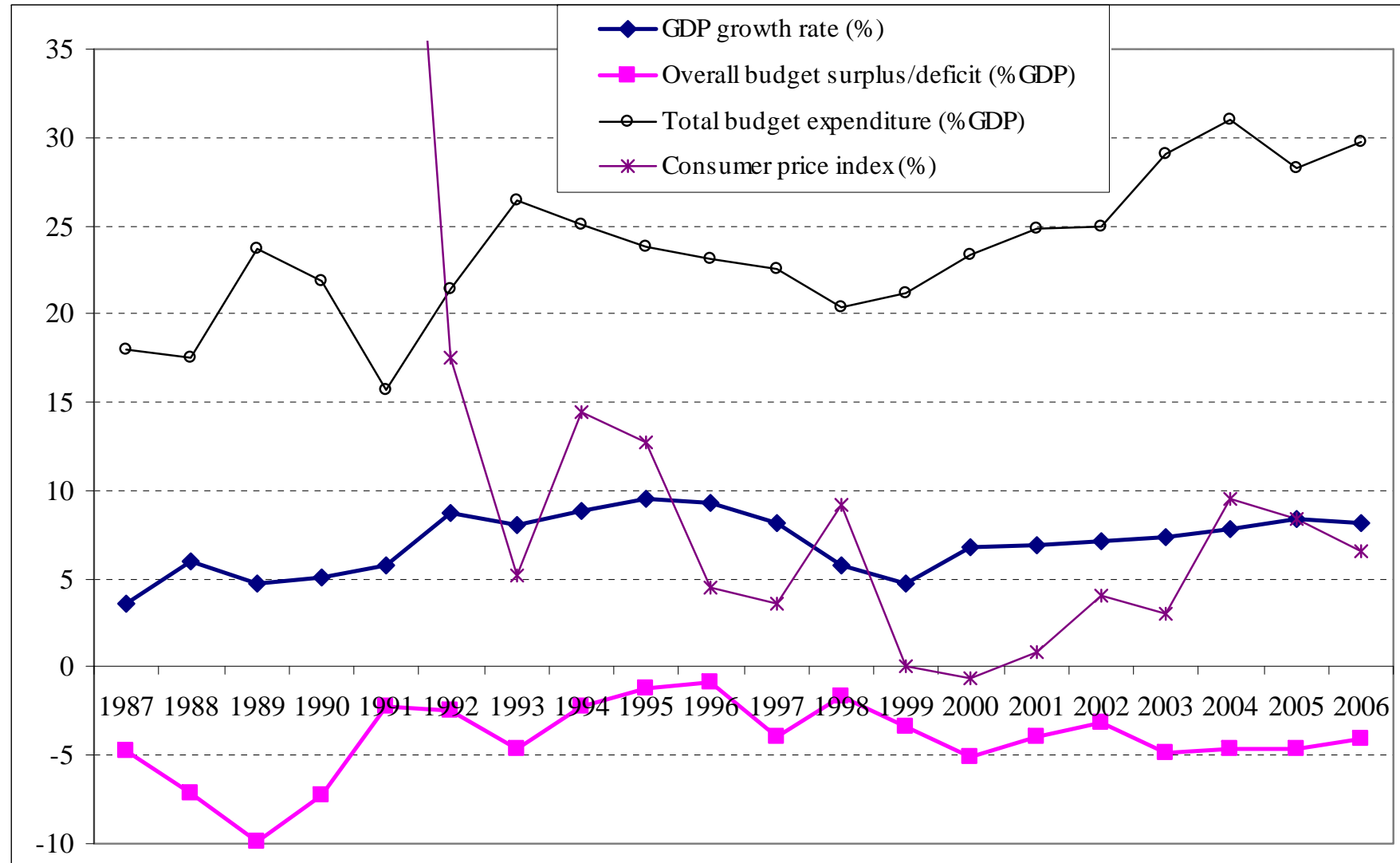
Government budget deficit



A closer look at the budget deficit



Budget deficit and economic growth in Vietnam



Analytical view (cont.)

□ Determinants of budget deficit and economic growth

■ Budget deficit:

- Tax revenues – budget expenditure needs
- Availability and possibility of using borrowing instruments
- Optimal size of the government budget: Role of the government in providing public goods and services...

■ Economic growth:

- Investment (public investment and private investment)
- Human capital
- Distortions of policies, especially tax policies and expenditure policies
- The efficiency and openness of the economy; liberalization of markets
- Institutional reform and legal enforcement system
- Macro and microeconomic environment...

Analytical view (cont.)

□ Possible impacts of budget deficit to economic growth

- Productive/positive factors: public investment and its relation with private investment (both physical and human capital)
- Environment/negative factors:
 - Tax burden; crowding-out effects;
 - Distortion or disincentives of tax policies and expenditure policies in resource allocation and income distribution
 - Macro and micro effects: affecting socio-economic conditions and business environment, including high pressure on inflation and interest rates
 - Necessary conditions for legal system and legal enforcement system

□ Optimal/relevant level of budget deficit

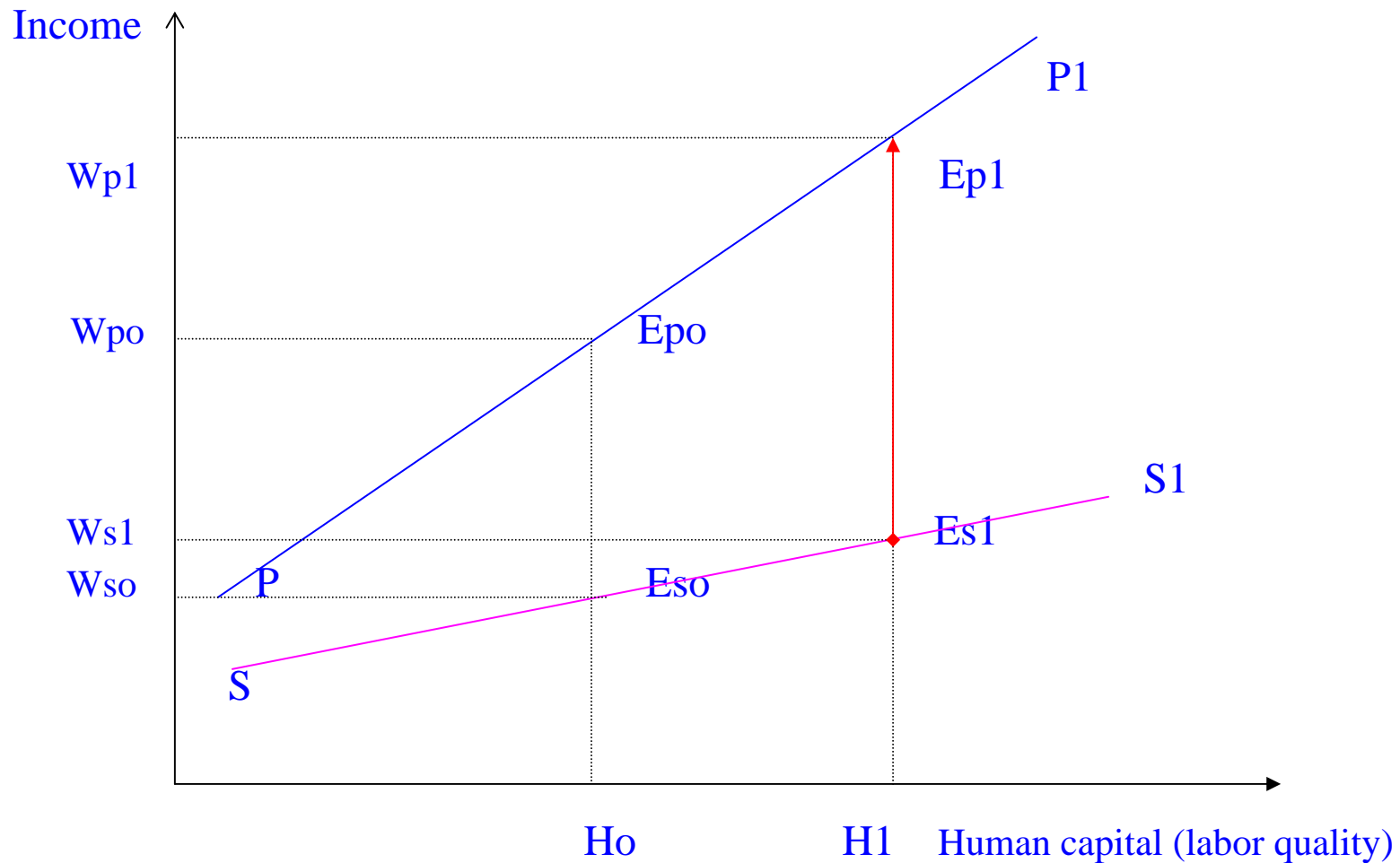
- Balance of positive effects and negative effects
- Consideration of effects on the short term and medium and long term
- Dependent on socio-economic conditions and environment

Analytical view (cont.)

- **Main issues and challenges for Vietnam**
 - Requirement for fiscal expansion policy:
 - Infrastructures (physical and social)
 - Social insurance and security system
 - Public sector' wage reform
 - Off- budget operations
 - Tax reductions
 - Complexity of fiscal and monetary policy instruments and their interactive effects
 - Quality of public policy analysis and formulation
 - Discretion in policy implementation and law enforcement system
 - Strong linkage to and influenced by international economic environment → macro and micro risks on the Vietnamese economy

Public sector's wage reform

□ Movement of labor forces between economic sectors



Tax reduction

- ❑ Reduction in revenues from selling state assets: crude oil, issuing land use right certificate, selling state-owned houses: currently accounted for over 30% of total budget revenues
 - ❑ Reduction in the revenue from import duties due to international commitments: currently accounted for 10% of total budget revenues
 - ❑ High pressure of reduction of tax rates from both domestic and international aspects (international tax competition)
 - ❑ Large tax expenditures: wide and non-focused tax incentives for many types of taxes, especially major taxes: VAT, Import duties, CIT, PIT, land and housing tax
- Very high potential of reducing government budget revenues

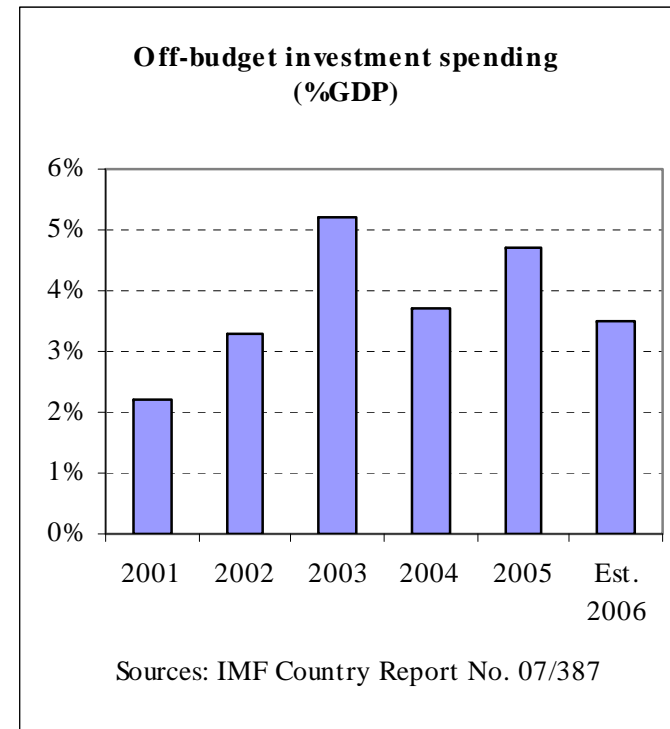
Size and structure of tax revenues in Vietnam comparing with other countries

Group of countries by GDP per capita	Total tax revenue (%GDP)	Tax structure (% Total tax revenue)					
		Total	CIT	PIT	Taxes on goods and services	Export-Import duties	Others
1/ Low income developing countries (GDP per capital of less than \$ 745)	14.10	100	19.28	16.62	43.50	16.40	4.20
2/ Medium income developing countries (GDP per capita of \$746-\$2,975)	16.70	100	15.47	16.03	51.80	9.30	7.40
<u>Vie Nam: - Total revenue of taxes, fees, including oil revenue</u>	<u>25.20</u>	<u>100</u>	<u>31.60</u>	<u>2.00</u>	<u>28.60</u>	<u>12.00</u>	<u>25.80</u>
<u>- Total revenue of taxes, fees, excluding oil revenue</u>	<u>18.40</u>	<u>100</u>	<u>18.70</u>	<u>2.67</u>	<u>39.20</u>	<u>16.40</u>	<u>22.30</u>
3/ High income developing countries (GDP per capita from \$2,976 to \$9,205)	20.2	100	8.91	20.49	53.1	5.4	12.1
4/ Developing countries on average	17.60	100	13.20	18.00	51.20	8.60	9.00
5/ Developed countries (GDP per capita of higher than \$ 9,206)	25.00	100	9.67	44.63	32.90	0.70	12.10

Source: Can Developing Countries Impose an Individual Income Tax?, J. Alm and S. Wallace (2004) and author's estimation

Off-budget operations

- Large scale and long term off-budget operations
 - Variation and complicatedness in procedures in the environment of weak legal enforcement system → Macro- and micro-economic risks of off-budget operations
 - Strong socio-political pressures on the expansion of off-budget operations
- Potentially negative effects on the stability and sustainability of the government budget



International experience

- Keeping low budget deficit and public debt as one of the most decisive and important factors for macroeconomic stability and sustainable economic growth
- Maintaining the systematic and consistent policy stance for fiscal reform
- Budget deficit and public debt do transfer the tax burden to the future generations
- Reducing and eliminating distortions of public finance system:
 - Tax incentives
 - Off-budget operations
 - Wasteful and wrongly-directed public expenditures on social policies
- Importance of policy implementation and legal enforcement system
- Learning how to learn international experience

References:

Hemming (2006), “Fiscal Priorities for Developments”, APEC FMM Process 2006

Hemming and Thornton (2006), “Fiscal Policy, Stability, and Growth”, APEC FMM Process 2006

Taylor (2000), “Reassessing Discretionary Fiscal Policy”, Journal of Economic Perspective

Tanzi and Zee (1997), “Fiscal Policy and Economic Growth”, IMF Staff Paper...

Concluding remarks and policy recommendations

- Importance of imposing the hard budget constraint to the government
- International experience of keeping low budget deficit and public debt to maintain a good macroeconomic environment to foster sustainable economic growth
- Vietnam has been facing serious issues of budget deficit and macroeconomic imbalances: it is time to reconsider the fiscal and monetary expansion policy

Concluding remarks and policy recommendations (cont.)

□ Policy recommendations

- Importance of considering the optimal/sub-optimal size of the government
- Tri-dimension reduction: budget deficit, tax burden, and government expenditure share/GDP (public investment)
- Enhancing public financial management reform to increase the efficiency of the public sector
- Using effectively the revenue from natural resources (oil and gas)
- Reducing fiscal risks, policy distortions, especially off-budget operations and tax expenditures
- Establishing the manageable framework of coordination of fiscal and monetary policies

**Thank you very much
for your attention**