Vietnam’s Growth and Foreign Aid: An Ideal Recipient?

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Vietnam is one of the better-performing economies in the world, at least by the normal metrics of real GDP and export growth, poverty reduction, and improving social indicators. The economy grew at 8-9% a year from 1991 to 1997, and since then the official GDP growth is 6% a year, though the IMF estimates only 4.5%. Developmental aid on a net basis has generally declined, globally and in Asia over the last decade, but it has risen in Vietnam. Indeed, in 1999, all net official aid from all sources to all nations was only $5.4 billion. Even ignoring the -$12.6 billion in IMF flows, the $18 billion net figure is a tiny fraction of GDP, investment, or private flows in or to developing nations. The 1999 net figure is also only 10-15% of flows in the 1985-94 period, or less than half of earlier levels if the IMF flows are excluded.

There can be no reasonable doubt that Vietnam has done well since it announced its Doi Moi reforms in the later 1980’s. In spite of the collapse of the Soviet Union, its main donor and trading partner, it probably halved poverty from three-quarters to three-eighths from 1987 to 1997. Breaking up collective farms helped spark an explosion in farm output, from rice to coffee to seafood. All are now important exports. Indeed, exports in $ tripled to over $2 billion from 1988 to 1991, and in 2001 exceeded $15 billion. Roughly one-third of exports are manufactured, a quarter is oil or minerals, and the rest are agricultural products. The recently completed Bilateral Trade Agreement will enhance the growth of manufactured products from Vietnam, and attract further FDI. Inflation and foreign debt are low and budget deficits modest. In spite of good health and education levels in the 1980’s, the data show improvements in the last several years after an initial dip. A higher proportion of Vietnamese are in secondary school than are Thais.

Aid to Vietnam has grown steadily from 1993, when it was negligible. By 1997, net loans and grants had just exceeded $700 million, or 2.5% of GDP. By 2000, it had doubled to $1.5 billion and was still rising. Put another way, grants and loans were 15% of government spending in 2000. Other significant sources of dollars in the same year were $800 million in gross FDI and over $1.3 billion in private remittances. Oil exports were $3.5 billion in 2000, and oil-based taxes were nearly one-third of all revenue.

It is possible to evaluate aid in several ways. One is to look at the project portfolio and see what has been financed and the rates of return. Another is to try to link “policy” lending with specific reforms called for in various agreements. A third is simply to take a macroeconomic approach and try to see if more aid has resulted in more growth, other things equal. There are problems with each approach. Since money is fungible, projects that would anyway have been done could be aid-financed, and the liberated funds used

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1 Large loan disbursements to cover financial crises in richer developing nations are excluded from this definition of “developmental.”
2 The FDI figure is a weak one. It includes some “in-house” loans to the local entity set up by the foreign company, and excludes some estimated $600 million in repayments of past loans. The remittance figure is hard to estimate and may be low, as some estimates approach $2 billion.
for other things. So, the entire investment portfolio has to be reviewed, not just the aided portion. Such a review would be uncomplimentary, as there are a huge number of big, bad projects, some not aid financed, that are built as funds become available.

For “policy” lending, it is very difficult to know when (say) banking practices really change. There have been a number of bank recapitalizations, but less change in their practices. Similarly, the progress of diluting the subsidized state-enterprise dominance has been mixed, with “equitization”\(^3\) amounting to only 3% of the capital value of SOE’s since 1995. While certain reforms, such as the Enterprise Law, have undoubtedly made it easier for private firms to register, IMF estimates show a declining share of domestic private investment from 1996 to 2000, from 20% to 16%. The foreign invested sector has increased its share, but much of that output is from import substituting and high-cost operations that face an uncertain future if already negotiated tariff cuts are enacted.

Finally, the macroeconomic approach is a difficult one to execute. There are weak data, only a few years of usable observations, and many exogenous shocks. The period of most rapid growth coincided with $2 billion annual inflows of foreign direct investment from 1995-97. During this period, net aid flows were a quarter as large, and private remittances were larger than aid. And again, much of the FDI was in protected heavy industry or in real estate projects that even now are underutilized. It would appear that at least the boom in the mid-1990’s might have been part of the larger Asian bubble. If the results were less harmful than in the rest of Asia, the private capital flows were relatively smaller (as they started later) and were not mainly short-term debt. Also, the capital account was not open so speculation was impossible.

To understand the role of aid, one must understand aid flows from a political economy perspective. Aid under central planning had been a political process. If a province wanted a particular project, it went to Hanoi and persuaded the Ministry of Planning that its plans were of higher priority than others. The local success of a provincial leader would often rest on his ability to “bring home the bacon.” After a switch to the market system in agriculture, the aid process changed much less. The *vocabulary* changed, and officials talked of “infrastructure.” They also tried to attract expensive cement or sugar plants, both highly protected, and also dams, refineries, and industrial parks. Most of these investments are overpriced and largely unnecessary or uncompetitive.

A few provinces figured out that they could prosper with a low tax on a large volume, and worked to attract both foreign and private domestic investment. These provinces had no harbors, expensive labor, so-so initial infrastructure, and little state industry. They resemble Guangdong province in style and pace if not scale. They have added tens or even hundreds of thousands of workers, many of them internal migrants. They have developed diversified export and efficient import-substituting industry. They mainly want reduced confiscation of their taxes for real infrastructure needs\(^4\), and even more

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\(^3\) Equitization is a Vietnamese word used instead of privatization. It means the state enterprise is set up as a joint-stock company with a board of directors. However, often other SOE’s or the government may remain as the major shareholders. Alternatively, sometimes the existing management gets effective control.

\(^4\) The wealthier provinces have to pay a net 80-90% of their tax revenues to Hanoi for poor provinces.
regulatory freedom. But they are only a handful, compared to the dozens that still focus
mainly on how to get a larger share of the aid budget rather than how to create favorable
conditions for investors. The location decision of a Japanese chip plant in a southern
province rather than in Hai Phong where Nomura had an excellent industrial zone (in
terms of infrastructure) is a good example of why policies trump physical investment.
The Japanese manager of the Nomura zone said he had told the Japanese firm to go to the
south! He said, “It was too hard doing business in Hai Phong.”

Right now the Vietnamese have an immense backlog of low-return political projects that
are funded as resources permit. There is a billion dollar “Ho Chi Minh Highway” that
connects mountain villages in a road parallel to Route 1 along the coast. This is a project
described by a Vietnamese that knew it well as a transfer of income to selected officials –
with no evident economic rationale. There is a $1.5 billion refinery in a typhoon prone
area far from both supplies and markets. No foreign oil company was interested in that
location. There is over $1 billion in urea plants that will raise the cost of fertilizer to
farmers. There are hundreds of millions of dollars more in excess ports, unneeded
bridges, uneconomic sugar plants, and billions more in planned steel, cement, and
petrochemical projects. Taking these projects together, it is little wonder that the capital-
output ratio has risen from 3 to 6. Meanwhile, the banks hold billions of deposited dollars
offshore in 1% annual accounts while private firms are starved for capital. The
“Development Assistance Fund” – a bureaucratic and aid-supported government creation
grew as fast as bank credit in 2000, and all of its credits go to state entities.

What would happen if aid were cut? This is not entirely a hypothetical question. Japan is
a major donor and may be ending its ability to continue lending as it has been. The last
time there was a prospect of aid being cut, the agricultural system was privatized, prices
were allowed to go to market levels, inflation was reduced, and private business activity
was allowed. Compared to those steps, subsequent changes – the Enterprise Law aside –
have been comparatively tame. But if local leaders had to start thinking about how to
generate wealth locally rather than rely on funds from Hanoi, it is likely that more places
would begin to imitate those already successful. While the results would probably not be
of the same magnitude, they would certainly be of a similar direction.

Guangdong province has the same population, literacy, and life expectancy as Vietnam.
But it has $100 billion in manufactured exports, not $5 billion. It gets $12-14 billion in
FDI each year, not $1 billion. Vietnam lacks the connections to Hong Kong, but even
allowing for that, it is likely that a switch of more Vietnamese provinces to policies of
those now growing rapidly would result in many times more FDI, exports, and jobs.
Though the research has yet to be done, the hypothesis is that with less aid, more export-
oriented FDI would result. The outcome for Vietnam would be better growth, more
poverty reduction, and less corruption. This is a sobering conclusion when many wish to
double aid.
What Would Doubling Aid Accomplish?
(A version is to be in the next issue of The Far Eastern Economic Review)

The disappointing economic performance of many poor countries has led to calls for greater debt relief from old aid loans and a doubling of aid to these nations. What would a $50 billion increase in aid likely accomplish? In Assessing Aid, World Bank researchers concluded that aid given to nations with poor policies had little impact, or worse. The question then may boil down to the incentives that both the aid givers and aid recipients have, and if these incentives are likely to produce outcomes very different from what has been happening.

It is useful to recall that Africa has received more aid per capita over the past twenty years than any other region, often on IDA terms – which is to say at negative real interest rates. Yet the productivity of these “investments” has been so poor that wholesale debt forgiveness is now argued as the only moral course. If soft loans with a large grant element over decades fail to create anything more than poverty, stagnation, and debt, is it wise to prescribe even more of the same?

The current system tends to direct more aid (including debt relief) to those nations that do worse. Corruption on public works contracts has been said by Transparency International to be higher than in any other industry – even defense contracts. There is every incentive for a recipient government to use aid to over-invest in infrastructure, pad expenses, and take care of friends that will finance the next election or one’s retirement. Nations that do poorly tend to have more of this behavior than others do that grow well with less aid. If one looks at the percentage of population doing well, the relatively good experiences of India and China with 2.3 billion loom large. Aid at $2 per capita is not a significant factor in the growth of these two poor nations.

The alternative to having a recipient government control corruption is to have the donor do it. Most aid people mean well, but know that it is very hard to change the current system. They get promoted for making loans, not for getting into pitched battles with underpaid officials in "their" countries about the way aid is to be disbursed. If the World Bank were serious about dealing with these problems, it would allocate most aid by function, not by country. But even if it all its loans were clean, the problem of fungibility would arise. The entire scope of spending needs to be addressed, not just the loans of one donor. This is not at all done in the Comprehensive Development Strategy now being touted. Is it likely that any donor will be influential enough to control corruption comprehensively? Is this not akin to a new kind of imperialism?

We now come much closer to the nub of the problem. Development is not primarily a technical problem. It is a political problem. The technical aspects are solved readily if there is a powerful coalition that wants to grow fast and sustainably. If the elites do not
see the rule of law, a “level playing field”, and sensible conditions for wealth creation as being in their interest, simply adding money (e.g., Nigeria, Venezuela) will not influence much more than the foreign bank accounts of those in a position to extract graft. Donors pretend it is a technical problem. The recipients are happy to play along. Both, in their hearts, know better. Heavy investments in both physical and human capital combined with bad policy lead to little growth and an outflow of skilled and energetic people.

I skip over some obvious points. As Ravi Kanbur points out, taking the time to deal with aid, which is a small fraction of total investment in most nations, is often a distraction from serious attention to domestic administration and policy. That bad policies have often been allowed to go on longer with aid than they would have without it. That writers from P.T. Bauer to William Easterly have warned against aid as an elixir for growth.

So what is to be done? Should the poor and poorly governed be left to their own devices, perhaps inviting terrorism and waves of unwanted immigrants? Should the OECD nations try to force and bribe good governance on the unwilling? Should new aid mechanisms be developed that reward good behavior rather than promises of it? Whatever sets of decisions are made, it is best to keep the real goal in mind. Wealth is created when the conditions are favorable for its creation. Local governments have almost complete control over those conditions. Both domestic and foreign savers and investors are happy to direct funds to those places where there is a reasonable chance to profit. (And profits that come from competition and reasonable rules are likely to create wealth, not reallocate it.) Many nations will choose to remain as they are, but some will choose or stumble upon the right coalition and begin to change. Those deserve support and encouragement. The others should probably get humanitarian aid to help with food, health, and education, but perhaps no more than that.

But even for this, is more money needed? It is hard to say, but much of aid is not well spent. For sure, the case for doubling aid is far from being made.