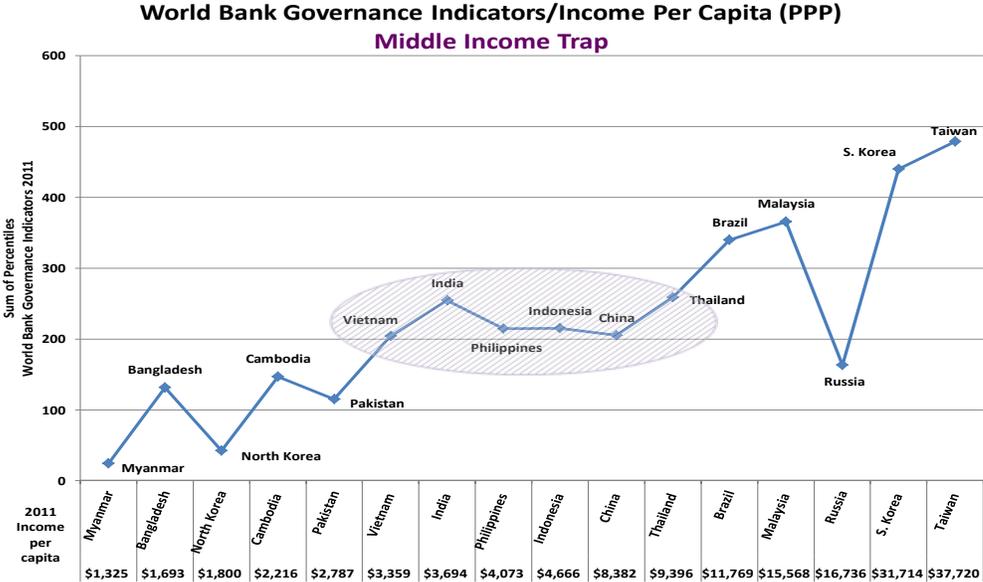


Vietnam: The Political Economy of the Middle Income Trap

Background

There is a phrase used by political economists more than economists – the “middle income trap.” It refers to economies that grew fast for a decade or more and reached middle income status but then slowed down well before they reached high income status. The figure immediately below suggests the problem:



- Middle Income Trap:**
- Where medium income nations slow their growth due to lagging institutions and political development.
 - Crony groups capture government policy and even democracy may not reverse this.
 - Poor nations may face similar challenges but at a lower income level. Elite capture must be avoided.

Notice that the “middle income trap” does NOT say that rapid growth is impossible for middle income nations. China alone has disproved that. It does say, however, that if governance or institutions more broadly fail to grow in line with per capita income, that growth will slow at some point well before EU (even Southern EU) levels of income per capita are reached. Now, up to 1945, no country maintained a growth rate more than 3% per capita for decades. Japan managed to grow at 8-10% from the early 1950’s up to 1973 with 1% or so population growth. It was closely followed by South Korea and Taiwan, who managed to grow fast for three decades or more. In the late 1970’s, China began its reforms and started its decades of rapid growth, only now ending. Vietnam, starting in the later 1980’s managed to grow fast for nearly two decades but then slowed to the 4-6% range for GDP growth (deduct 1% or so for population growth) more typical of richer ASEAN economies such as Thailand or Malaysia.¹

¹ The cases of Singapore and Hong Kong are excluded from this analysis. They are city-states and exempt from many of the issues that larger nations with significant rural areas have to deal with. Outside of Asia, very few nations have sustained rapid growth over decades.

Sources of Growth

The previous paper referred to IMF graphs showing various sources of growth. They included increases in the quantity of labor, the quantity of capital, the quality of labor (usually measured by years of schooling) and TFP or factor productivity. As was argued, a major source of TFP is the transfer of workers from low to high productivity sectors. Even if productivity in farming and manufacturing were constant, if farmers produce only \$1000 a year per worker and factory workers produce \$4000 a year, shifting from farming to factories will give TFP for the overall economy a boost. It is almost impossible to sustain very rapid growth in GDP if there is not a transfer of workers to more productive sectors.

In Vietnam, the productivity of different sectors in 2010 and 2013 were as follows (constant prices of 2010):

	Agriculture		Industry		Services	
	2010	2013	2010	2013	2010	2013
Workers (millions)	24.3	24.4	10.3	11.1	14.5	16.7
Output/Worker (Million Dong)	16.8	18.3	80.3	88.7	63.8	66.8
% Growth in Productivity/year	3%		3.5%		1.6%	
% Growth in Workers	0.0%		2.6%		5.1%	

While the agricultural workforce is about level, its productivity is growing 3% a year, not much lower than industry, where productivity is growing 3.5% a year. The slowest growth in productivity (1.6% a year) is in services, and services are also absorbing two-thirds of all workers. This is not all bad – the *level* of productivity in farming is only a quarter of services and a fifth of industry. But workers are not being transferred out of agriculture - only newer ones are not much going into it. The lack of movement of existing workers into higher productivity sectors (as opposed to new entrants) explains why Vietnam's GDP is only growing 5% or so a year. From 2003 to 2006, the share of workers in agriculture fell 5% and the numbers working in industry rose by 1.8 million – workers leaving agriculture who were used in higher productivity sectors. Service sectors gained 1.2 million jobs. (Each sector also grew in output per worker more than recently.) From 2003 to 2006, the GDP grew at more than 8% a year.

One reason for the growth slowdown is sluggish structural change in the workforce. Something is keeping existing workers much less productive “on the farm” and they are not moving into more productive activities. Of course, some rural workers also work in non-farm jobs, but the 2012 Living Standards Survey finds consumption per capita in cities 74% higher than in rural areas.

Urban Development

One possible hypothesis to explore is if urbanization is inefficient in Vietnam. Why should urban growth be only 3-3.5% a year since 2000, and less than 2.5% in recent years? If workers could earn so much more by moving, why do they stay? Industry and services are growing about twice as fast as farming.

One answer is that older people are less likely to move. If the rural areas are getting grayer, it is likely that the answer lies more in demographics than urban policy. Older workers are slower to pick up new techniques and are probably less well educated. If this is the case, the rural areas are a way of keeping less agile workers employed, even if less productively. Changes in agricultural policy might allow easier consolidation of farms into bigger units if more rapid growth in rural productivity is desired, but that might displace older farm workers. Training programs and support for productivity-raising activities in rural areas would be another approach to helping aging farm workers become more productive.

A second answer is that land and thus housing prices, especially in urban areas, are too high. If this is true, new workers might have to live just outside cities where land prices are cheaper but then many have to travel long distances to work or schools. This creates congestion, pollution and other inefficiencies that slow growth. The lack of serious public transport (even with the buses, which are not widely used) makes it hard to reconcile high land prices, tall buildings, and efficient traffic in major cities. With this analysis, the solution would be to develop public transport, restrict automobile use², and impose property taxes to fund urban services and discourage land or property speculation.

A third possibility – and these are not mutually exclusive – is that there is insufficient job creation in the high productivity (largely urban) sectors. By this reading, the problems may lie more in access to land or loans, a level playing field for private businesses, the inefficiency of state enterprises, or poor efficiency of building cost-reducing infrastructure. Infrastructure here refers to both “hard” infrastructure like roads or drainage, and also to “soft” infrastructure such as customs procedures or water management.

Take the example of flooding. One kind of inefficiency is the continued pumping of groundwater. This results in the ground sinking and makes flooding worse. Filling in wetlands for urban development may give runoff from heavy rains nowhere to go but into the city. Another kind is building the wrong types of dikes or flood control barriers, or drains - or not building them where they are needed. Flooding creates

² Singapore did this by requiring expensive daily permits to drive in central districts during rush hours. There are other examples, such as odd and even day driving depending on the license plate number, but these are prone to abuse.

many problems – in Thailand, the heavy floods actually destroyed dozens of factories and caused disruptions in international supply chains. Getting the policies and the investments right – making sure that important problems are solved in an efficient way, and things that are not needed are not built, can be difficult.

The Politics of Public Spending

In Vietnam, there are only ten or twelve provinces that are net payers into central funding, after deducting central payments to the city or province. The others are net recipients of central funding. These “deficit” provinces know that any extra investment will require negotiation and political activity to succeed in attracting public funds to their province. (This is true for the surplus provinces too but they find it easier to attract private investment, which is why they are surplus. Also, infrastructure in the more active places can often be paid by tolls or development rights.) The structure of the Parliament and Central Committee is such that these negotiations are made and they matter. Many of the proposed investment ideas are meant to satisfy local political priorities but are not necessarily of high economic priority.³ Because at least some of these “have” to get funded, the result is that Vietnam has a low infrastructure score in spite of relatively high levels of infrastructure spending. The Global Competitiveness Index for 2014 puts Vietnam about tied with India and below Indonesia, even though both India and Indonesia spend far less on infrastructure than Vietnam.⁴ This suggests that Vietnam is not getting value for money in its infrastructure investment, especially since its geographic situation is so much better than Indonesia, with its thousands of islands.

If this line of analysis is correct, there has to be a *political* solution to what is, at base, a political problem. The outlines of an approach might be found in looking at clusters of productive activity. These can be found all around Vietnam, not just in major cities. If the “cluster” provinces found productive infrastructure investments and cooperated with the surplus provinces, a political alliance for more efficient investment could push back against the less efficient projects. Combined with improvements in infrastructure policies – think groundwater pumping and traffic management – the cost structure of many Vietnamese businesses would improve. This might allow Vietnam to get a share of growing FDI.

³ Nguyen Xuan Thanh has shown how excessive investment in many major ports is wasteful in Vietnam. These investments often have central ministry support, not just local support. It helps make their budgets and importance bigger.

⁴ Price Waterhouse, an accounting and consultancy firm, has produced a report on infrastructure in Southeast Asia: <http://www.pwc.com/sg/en/capital-projects-infrastructure/assets/cpi-sea-infrastructure-spend-summary-201405.pdf> and shows that as a share of GDP, Vietnam (11.7%) is well above Indonesia (6.9%) in recent years.

Education

It is generally true that on average more educated workers earn more and are, presumably, more productive. However there is nothing automatic about the process. In some countries, educational quantity outruns both quality and the demand for more educated workers. In those cases, the earnings differential between different levels of education shrinks or disappears altogether, and/or educated workers migrate to find better opportunities. The question is if this is the case in Vietnam.

One way to answer this is to observe different earnings levels among workers of different educational levels. In 2013, workers with no educational qualifications beyond basic schooling earned 3.3 million a month, while vocationally trained workers earned 4.6 million. However, workers with a higher (secondary) vocational degree earned .4 million and college-educated workers earned only 4.7 million. University-educated workers saw earnings jump to 6.6 million. (Report on Labor Force Survey 2013, GSO, p. 34) So it appears that important parts of the educational system do not add much value over basic vocational education.

Part of the productivity gap may be due to poor “value added” in education at the middle and upper-middle levels. If this is the case, then reforms to bring needed skills to those students is indicated. But part of the problem may be that few “good” jobs are being created even if skills are adequate. Non-state jobs pay only 3.5 million on average while state jobs pay 5.1 million. Is it true that state workers are really more productive, or are they fortunate enough to have jobs in companies that have some market power or other advantages, and so can be better paid? (This is a question that can be asked in many other countries, and not only with state jobs!) If pay is not indicative of productivity due to market failures, an economist’s solution would be to reduce the distortions so that pay and productivity more nearly matched each other. In Vietnam, it is quite possible that both explanations apply.

State Enterprises

A number of studies have found that state owned enterprises (SOE’s) get more physical and human capital per unit of sales than the private sector or the foreign-invested sector.⁵ Their contribution to GDP (and share of capital and labor) has been falling, but they still get more and give less than the other sectors. Changing the rules under which SOE’s operate would push their management to pay more attention to economic returns and worry less about political constraints. This sounds fine in general but

⁵ See: Unplugging Institutional Bottlenecks to Restore Growth, a VELP discussion paper, August, 2013 at: <http://www.ash.harvard.edu/extension/ash/docs/VELP.pdf>

is very difficult to realize in practice. But so long as SOE's have a "leading role" and are able to crowd out more efficient producers due to special access to land, loans, easier regulation or contracts, productivity growth will be slower. It will also slow the development of market-supporting institutions needed by both the state and private sector – institutions that develop specialized knowledge in particular sectors about marketing, technology, financing or product design. As wages rise, if Vietnam does not find a way to support productivity growth, it will find itself (like Thailand) boxed in and subject to slow growth at rather low levels of GDP per capita.

Political Maximization and Economic Satisficing

Growing at 4-6% is not the end of the world. It is fast by historical (pre-World War II) standards and could double per capita incomes every two decades or so. It may be that part of the middle-income trap is a political calculation that moderate growth is better politically than pushing hard and upsetting institutional roles that constrain growth. If this is so, then the system is doing exactly what it wants to: providing the best political solution while getting an acceptable economic solution.

The trouble with this approach is that China is already twice the per capita income of Vietnam and will be in a powerful economic position to influence Vietnam's economic choices if Vietnam is a slow-growing economy with a growing income gap (per capita) with China. If China indeed slows down, Vietnam has a chance to approach parity, or at least lessen the gap. Considering that Vietnam and China were nearly equal in PPP per capita income in 1990 (at least according to the World Bank, they were only 10% different), remaining at less than half of their GDP per capita with a growing gap amounting to many thousands of dollars would be a failure.

A Vietnam that is fast-growing and approaching China's per capita income is likely to also be a more open country with more economic choices and more friends willing to support it. In the end, it is not mainly about money but about the ability of Vietnam to stand on its own and have more influence over its own affairs. To do better, it needs to reform. Reform is difficult. But falling behind a neighbor can also be hard. To reform, coalitions of reformers have to be created. That is the political question that may produce the much-needed economic answers.