Trade Policy, Domestic Reforms & Structural Transformation in Vietnam

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The Impact of Vietnam's FTAs on Domestic Policy Reforms: Changes Arising from the CPTPP, RCEP, and EVFTA (EU-Vietnam FTA)

It is important to recognize, at the outset, that there are inherent difficulties in attributing domestic reforms directly to FTAs. The presence of multiple policy drivers makes the process of identification and attribution a difficult one. In some cases, we can trace the reforms directly to provisions contained in the FTAs, while others may have occurred indirectly and possibly preceded the more recent proliferation of FTAs. In particular, the early reforms associated with accession to the ASEAN Free Trade Area (AFTA) and the WTO were game-changing. They may have enabled Vietnam to sign up for the more ambitious, modern agreements, such as the CPTPP and the EVFTA. Therefore, AFTA and WTO accession may have contributed to reforms that tend to be associated with the subsequent FTAs. Indeed, one interviewee argued that the clear dividends from earlier liberalisation episodes made subsequent reform to some extent "self-fulfilling".

The CPTPP, ratified by Vietnam in November 2018, has had a discernible impact on reforming intellectual property (IP) and labor laws. For instance, the process to register a sound mark follows the requirements of Article 18.18 of the CPTPP, which is incorporated under Article 105.2 of the Vietnam IP Law 2022. Also, enforcement has improved, with reported increases in the seizure of counterfeit goods along the Northern border. But these improvements have been incremental. Although the legal framework for copyright and trademark infringements is comprehensive, the number of investigations and convictions is almost zero. The prevalence of counterfeit goods and online piracy shows lax enforcement of these laws.

As of 2024, six years after ratifying the CPTPP, Vietnam is still on the US watch list in the "Special 301" Report, which tracks progress on IP rights protection and enforcement. The CPTPP was effective in changing legislation but remains limited in improving enforcement.

Although Vietnam has not ratified the collective bargaining convention of the International Labour Organisation, workers representative organisations now exist following CPTPP standards. The New Labor Code took effect in 2021, allowing employees to join or form an employee representative organization that is independent of the Vietnam General Confederation of Labor, which is the sole and unified trade union organisation made up of the 18 National Industrial Unions. This is a significant development that must have involved a rethink within the ruling Party, but the CPTPP appears to have played a role in bringing about such a change. These changes, while significant, are still insufficient for Vietnam to sign up to Pillar 2 of the Indo-Pacific Economic Framework (IPEF), however.

Other than Singapore, Vietnam is the only ASEAN country with an FTA with the EU. Like the CPTPP, the EVFTA addresses WTO-X and WTO+ issues. The EVFTA is also expected to generate significant market access benefits because Vietnam does not have existing FTAs with members of the EU, unlike with the CPTPP or the RCEP. In the difficult area of government procurement, the EVFTA is making progress in selectively opening the education and health sectors, as well as green procurement.

The EVFTA is providing a template for the development of the many rules and standards associated with regulating exchange in these sensitive areas. Once these rules and standards are established, they can be easily implemented, thereby ensuring that the FTA acts as a stepping stone towards non-discriminatory liberalisation. In most cases, it is impossible to regulate access in a preferential manner like with tariff concessions. Even when it is possible, the cost associated with preventing free riding may not justify the benefits of trying to do so.

Despite these achievements, these agreements have had limited impact on reforming state-owned enterprises (SOEs). Although the

CPTPP's separate chapter on SOEs includes advanced and innovative regulations, the carve-outs and extended timeframes that Vietnam negotiated, which themselves indicate limited appetite for reform in this area, have dampened impact.

Although not as ambitious or deep as the CPTPP or EVFTA, the RCEP is the world's largest FTA with a comprehensive reform agenda. One of its key objectives is to promote the growth of global supply chains through its open rules of origin, which has already benefitted Vietnam. Progress on regulatory convergence has been slow but could lead to impactful changes over time, given its reliance on foreign direct investment.

The Vietnam experience demonstrates how modern FTAs like the CPTPP and EVFTA can keep the reform momentum going and fill in gaps in difficult areas of reform. At the same time, it is also evident that the impact of modern FTAs varies across different policy areas, depending on technical and political difficulty. For instance, there has been less progress on the politically sensitive issues of SOE reform and digital openness, while progress with worker rights and government procurement has been selective. The ability of FTAs to safeguard against the rising tide of protectionism is also less clear, as the global shift toward increasing resilience through industrial policy and export controls may lie beyond the purview of FTAs.

While various tangible outcomes indicate the role of FTAs in shaping the reform agenda, membership can also expose countries to indirect and demonstration effects, the benefits of which may be difficult to quantify but are no less real. The big-bang changes came with the decisions to join ASEAN and the WTO, and the preparatory reforms associated with them continue to influence the economy more than any of the FTAs signed subsequently. Similarly, future FTAs currently under negotiation may be less impactful than focusing on implementation of Vietnam's recent high quality FTAs and could even have negative effects if this were to contribute to a "noodle-bowl" effect of messy trade rules.

Structural Transformation in Vietnam: Model & Data

A key economic justification for the FTAs Vietnam has entered into is in supporting domestic reforms that can facilitate the structural transformation of the economy. Structural transformation refers to the process of shifting workers from low-productivity traditional subsistence agriculture to industry and services where productivity is higher and often grows faster. Nobel prize-winning economist Arthur Lewis (1954, *Economic Development with Unlimited Supplies of Labour*, The Manchester School 22, https://doi.org/10.1111/j.1467-9957.1954.tb00021.x) focused on this dynamic to explain the process of economic development. Dani Rodrik (2013, "Unconditional Convergence in Manufacturing", *The Quarterly Journal of Economics* 128, https://doi.org/10.1093/qje/qjs047) argues that manufacturing is "special" given its ability to absorb large numbers of unskilled workers, its tendency to exhibit rapid convergence in worker productivity with the global frontier, and its role as a foothold for achieving beneficial economic agglomerations or clustering effects.

It is acknowledged that Vietnam's accession to ASEAN and the WTO, as well as the modern FTAs that it has implemented subsequently, have had discernable impacts on the domestic reform agenda. These reforms have undoubtedly facilitated the ongoing process of structural reform of the economy. In this section, we build on this to examine Vietnam's economic development from a structural transformation perspective. We do so by applying the structural transformation model developed by Roland Rajah and Ahmed Albayrak (2024, *Pathways to Prosperity: the Future of Manufacturing and Services Led Growth*, Sydney: Lowy Institute, forthcoming) to understand Vietnam's past and future economic development. The model draws on data from the Extended Economic Transformation Database produced by the Groningen Growth and Development Centre at the University of Groningen. This database provides comprehensive, long-term, and internationally comparable data on output and employment for 12 sectors across 51 countries in Africa, Asia, and Latin America covering the period from 1970 to 2018.

We now introduce the formal structural transformation model by Rajah and Albayrak (2024). The model has similarities to those of Min Zhu et al. (2019, *China's Productivity Convergence and Growth Potential – a Stocktaking and Sectoral Approach*, International Monetary Fund) and T. Sasaki, T. Sakata, Y. Mukoyama, K.. Yoshino (2021, *China's Long-Term Growth Potential: Can Productivity Convergence Be Sustained?*, Bank of Japan Working Paper Series), and builds on these by estimating a more complete set of sector level equations utilizing a single consistent cross-country data set. The approach involves estimating a series of individual regressions for the employment share for 11 economic sectors contained in the GGDC database, with agriculture treated as the residual sector of employment reflecting Lewis's idea of surplus traditional agricultural workers, as well as regressions for sectoral productivity growth for all 12 sectors. The sample period is 1970 to 2018. These are then brought together into a single integrated economy-wide model consisting of 12 sectors for output and employment that is capable of being used for historical assessment and projection purposes.

The utility of the overall model lies in capturing within a single integrated model several key stylized facts well established in the literature on structural transformation and economic growth in developing countries. The first is that of conditional convergence, whereby countries and sectors with lower productivity levels exhibit faster growth, thereby catching up over time to richer ones (Robert J. Barro 2012, *Convergence and Modernization Revisited*, Working Paper No. 18295, National Bureau of Economic Research, https://doi.org/10.3386/w18295; Dani Rodrik 2013; Alister Dieppe & Hideaki Matsuoka 2021, *Sectoral Decomposition of Convergence in Labor Productivity: a Re-examination from a New Dataset*, World Bank Papers). Second is the evolving relationship between manufacturing employment and development as documented for instance by Dani Rodrik (2015, *Premature Deindustrialisation*, John F. Kennedy School of Government Harvard University), Jesus Felipe (2018, "Manufacturing matters…but it's the jobs that count", *Cambridge*

Journal of Economics, https://doi.org/10.1093/cje/bex086), and Hagen Kruse et al. (2022, "A Manufacturing (Re)Naissance? Industrialization in the Developing World", *IMF Economic Review* 71, https://doi.org/10.1057/s41308-022-00183-7). Specifically, the share of manufacturing in total employment tends to rise with higher levels of GDP per capita before declining as the economy matures and labor costs rise, following a hump-shaped pattern.

Critically however, there is also evidence of 'premature deindustrialization', whereby employment deindustrialization now sets in at lower levels of development compared to earlier decades, generally thought to reflect technological changes (automation) and China's role in crowding out other countries in manufacturing. The final key stylized fact is of the rising 'servicification' of the economy (Gaurav Nayyar et al. 2021, *At Your Service?: the Promise of Services-Led Development*, The World Bank; M. McMillan, D. Rodrik, and C. Sepulveda 2017, *Structural Change, Fundamentals, and Growth: A Framework and Case Studies*, Washington, DC: International Food Policy Research Institute, https://doi.org/10.2499/9780896292147; Richard Baldwin & Rikard Forslid 2019, *Globotics and Development: When Manufacturing is Jobless and Services are Tradable*, 94th ed., WIDER Working Paper. UNU-WIDER. https://doi.org/10.35188/UNU-WIDER/2019/730-9; and F. J. Buera, & J. P. Kaboski, 2012, 'The Rise of the Service Economy', *American Economic Review*, 102(6), pp. 2540–2569. https://doi.org/10.1257/aer.102.6.2540), reflecting the movement of workers from agriculture into traditional services, the rising value-added role of services as inputs within global value chains, and advances in information communication technology which have made trading services across borders increasingly possible.

The regression equations we estimate for individual sectors closely follow the approaches used in other seminal studies in capturing the above key stylized facts. The model does not attempt to capture causal relationships. Indeed, the individual regression models rely on country and time fixed effects as controls rather than incorporating a battery of policy and other variables, noting the substantial difficulties identified in the literature in credibly identifying the causal determinants of economic growth and their related magnitudes (Growth Commission 2008, *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, World Bank Publications).

We begin by estimating labor productivity growth within each sector using a fixed effects model with robust standard errors, the key aspect in line with the literature being that labor productivity in each sector is expected to exhibit "conditional convergence" – whereby countries with lower sector labor productivity exhibit faster growth after controlling for other relevant factors. The regression is given by the following equation:

$$\hat{y}_{ijt} = \alpha_i + \beta^i ln y_{ijt} + \gamma_j D_{ij} + \varphi_t D_{it} + \varepsilon_{ijt} \quad (1)$$

where $\hat{y}_{ijt}$ is the annual labor productivity growth rate in sector i, country j and year t. lny_{ijt} is the natural log of the labor productivity level in 2015 PPP terms (we used PPP conversion factors from the World Bank). D_{ij} is a set of country fixed effects, D_{it} is a set of time fixed effects, α_i is the constant term and ε_{ijt} is the error term. The coefficient β^i represents the convergence rate in sector i and is expected to have a negative sign, indicating that countries with lower productivity levels will exhibit faster growth. The inclusion of country fixed effects provides a simple and standard method of controlling for all other country specific factors, including geography and institutions.

We also estimate the relationship between sectoral employment shares and GDP per capita whilst controlling for population with the following fixed effects model with robust standard errors using the same methodology as Rodrik (2015). The key aspect is that sector employment shares follow a non-linear (quadratic) relationship with the level of GDP per capita, which can be interpreted as capturing how sectoral employment shares generally evolve in line with the economic development process (Herrendorf et al. 2014, Rodrik 2015, Felipe 2014). The regression is given by the following equation:

$$empshare_{ijt} = \alpha_i + \beta_1 lngdp_{jt} + \beta_2 (lngdp_{jt})^2 + \beta_3 lnpop_{jt} + \beta_4 (lnpop_{jt})^2 + \gamma_{ij} D_{ij} + \varphi_t D_t + \varepsilon_{ijt} \quad (2)$$

where $empshare_{ijt}$ is the employment share of the sector i, in country j and year t. $lngdp_{jt}$ is the natural log of the GDP per capita of country j in year t in 2015 PPP terms, $lnpop_{jt}$ is the population of country j in year t, D_{ij} is a set of country fixed effects, D_{it} is a set of time fixed effects, α_i is the constant term and ε_{ijt} is the error term.

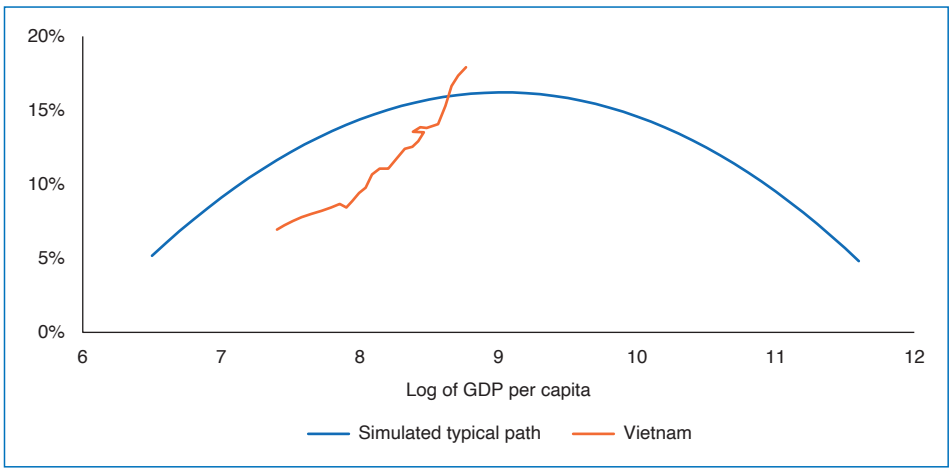
Structural Transformation in Vietnam: Results

Bringing the individual models together and combining this with demographic projections (for total and working age population) from the United Nations Population Division allows us to construct an integrated economy-wide model of 12 sectors capable of projecting employment and output growth. The time effects in Equation 1 follow a consistent linear trend so we extrapolate these for future years. In Equation 2, we found no trends in the time effects, so we do not make any adjustments. For projections, we add recent error terms to each regression to more finely calibrate the scenario results. We assume the employment to population ratio will remain unchanged going forward, with total employment therefore growing in line with growth in the working age population as projected by the UN.

The future path of the manufacturing share of employment is particularly critical, since this has the key driver of growth for Vietnam both through within-sector productivity increases and the productivity gains from the movement of workers out of lower productivity agricultural employment. *Chart 1* compares the evolution of Vietnam's manufacturing share of employment relative to its GDP per capita over time and compares this to the typical development path estimated by our model (i.e. applying the median country fixed effect and the same population size as Vietnam). It shows how remarkable the Vietnamese experience has been, with the manufacturing share of employment

CHART 1

Vietnam manufacturing employment share over time compared to typical development path



Source: Author's calculations based on GGDC and World Bank data

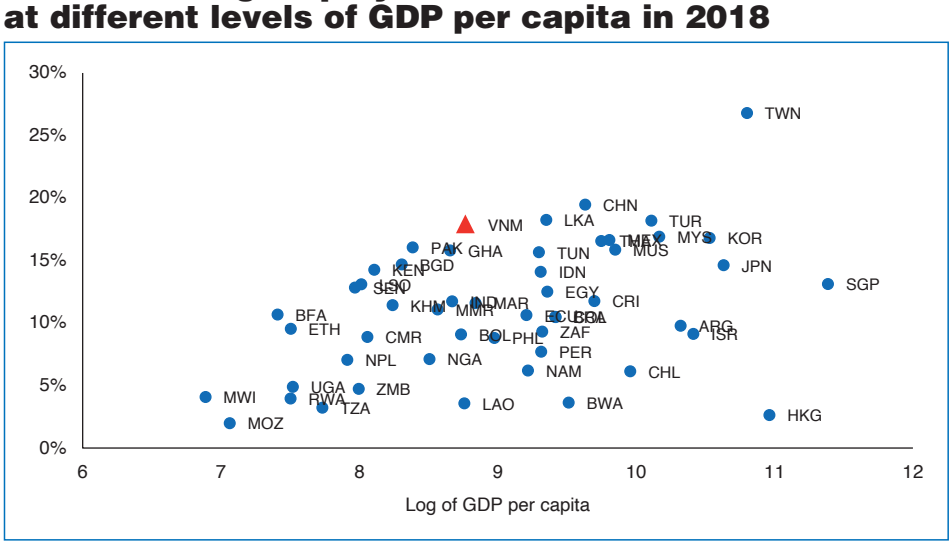
rising rapidly from substantially below the typical development path to one substantially higher and seemingly on a continuous upward trajectory. As the decomposition in *Chart 3* indicates, the productivity benefits of this structural change have been a major driver of economic growth.

A key question is whether Vietnam will be able to sustain the trajectory of manufacturing employment share in future years. On the one hand, there are reasons to think that Vietnam might be able to do so, particularly as the country has been a prime destination for supply chains and FDI diversifying away from China given rising labor costs and escalating geoeconomic tensions between China and the United States. On the other hand, China remains highly competitive even in relatively labor-intensive sectors (who will fill China's shoes?) and ongoing automation has increasingly reduced the ability of the manufacturing sector to absorb labor, as reflected in the evidence on premature deindustrialization and our model. Indeed, as *Chart 2* shows, Taiwan is the only country in our sample to presently have a substantially higher manufacturing share of employment than Vietnam. If Vietnam follows the cross-country experience which is encapsulated in our model, then the manufacturing share of employment can be expected to decline.

We consider three different projection scenarios to examine Vietnam's future growth prospects through structural transformation over the following decade depending on the future path of the manufacturing share of employment. In the first scenario, the manufacturing employment share evolves according to our model. This sees the share of manufacturing in total employment decline slightly from 17.9% in 2018 to 17.5% a decade later, reflecting the cross-country experience of modest employment deindustrialization setting in beyond Vietnam's current level of GDP per capita. In the second scenario, we instead assume Vietnam can continue to outperform to a substantial degree, extrapolating the most recent trend during 2014-2018 of a sharply rising manufacturing employment share. This would see manufacturing reach 28% of total employment by 2028, one percentage point higher than Taiwan presently. In the third scenario we assume a mid-way path between the first and second scenario, with the manufacturing share of employment reaching 23% by 2028. This would be a very similar path to extrapolating Vietnam's long-run trend over 2000-2018. Across the three scenarios, all other sectors and variables are projected according to the structural transformation model.

CHART 2

Manufacturing employment shares across countries at different levels of GDP per capita in 2018

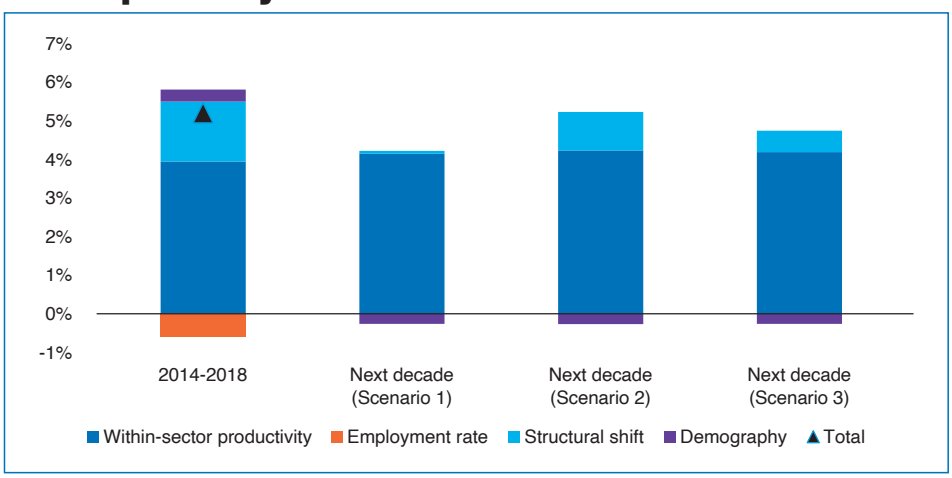


Source: Author's calculations based on GGDC and World Bank data

Chart 3 shows the results, decomposing the sources of projected growth in output per capita into its sources. During 2014-2018, output per capita growth averaged 4.9% per year. Under Scenario 1, economic growth would fall to 4% per year over the next decade as gains from the structural shift of workers from lower to

CHART 3

Output per capita growth projection scenarios decomposed by source



Source: Author's estimates & GGDC

higher productivity sectors almost entirely peters out. However, with a higher share of its workforce engaged in manufacturing and other non-farm activities with stronger productivity growth, the contribution from within sector productivity gains rises slightly, from 3.9% to 4.1%. In Scenario 2, by contrast, Vietnam sustains more rapid growth at an average of 5% per year over the next decade. This is virtually entirely driven by continued large gains from structural change, contributing about one percentage point to total growth and reflecting the continued rapid expansion of manufacturing employment assumed in this scenario. The contribution from within-sector productivity gains is also marginally higher at 4.2% per year. Finally, Scenario 3 represents a mid-way path, with growth in output per capita averaging 4.5% a year, driven by a more moderate productivity contribution from structural change.

These are mechanical projection scenarios intended to shed light on the potential future sources of economic growth in Vietnam through structural transformation of the economy, which is thought to be arguably the key economic benefit of the many FTAs Vietnam has entered. There are several key insights. First, future economic growth will need to be driven primarily by within-sector productivity gains rather than expanding manufacturing employment. This is borne out by both the historical decomposition and the projection exercise. Positively, Vietnam has recently been generating strong within-sector productivity gains and is projected to continue to do so. Second, attempting to maintain the pace of growth seen prior to the pandemic by continuing to expand manufacturing employment seems difficult.

Most countries tend to experience employment deindustrialization around Vietnam's level of GDP per capita and there are few examples of countries managing to achieve and sustain a substantially higher level than Vietnam today. Third, this suggests that delivering on Vietnam's growth ambitions of achieving sustained growth upwards of 6% a year to reach high income status by 2045 will require focusing on within-sector productivity gains (World Bank 2024, *Taking Stock April 2024: Promoting Innovative Entrepreneurship*, World Bank, https://doi.org/10.1596/41463). Even under the most ambitious assumptions for continued manufacturing employment expansion, the productivity gains would only be enough to deliver growth of around 5%. Finally, generating greater within-sector productivity gains will require looking not only at promoting greater productivity and industrial upgrading within the manufacturing sector but across all sectors of the economy, including services.

Conclusion

The key question that this study has strived to answer is whether Vietnam been able to use its trade policy in general, and its FTAs in particular, as a vehicle for pursuing and locking in difficult domestic reforms. And if so, which of the agreements have had the greatest impact on domestic reforms, and in which sectors. To do this, the analysis employed a combination of qualitative and quantitative approaches, as well as desk research of existing studies. On the qualitative side, a mission visited Hanoi in April 2024 to conduct interviews with Vietnam's policy makers, researchers, industry representatives and development partners. JS

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