Fiscal Decentralization Trends in Vietnam: Developments and Reforms

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Abstract

Over the past few decades, Vietnam has been achieving a number of positive results in fiscal decentralization and improving the efficiency of using national financial resources. This article analyzes the current fiscal decentralization in Vietnam, focusing on four main pillars, namely: (i) expenditure assignments; (ii) revenue sharing; (iii) intergovernmental fiscal transfers; and (iv) local governmental borrowing. The study also presents a number of developments and reforms that may have a great impact on fiscal autonomy. It concludes that decentralization is a continuous process and some further reforms should be done to enhance fiscal decentralization in Vietnam in the future.

Keywords: Fiscal decentralization, fiscal autonomy, expenditure assignments, revenue sharing, intergovernmental fiscal transfers, local government borrowing, Vietnam.

Introduction

Fiscal decentralization is the process through which powers over expenditures and revenues are delegated from the central government to the local governments. The extent of fiscal decentralization depends on the ability of lower tiers of government to make independent revenue and expenditure decisions within their jurisdiction, without interference by the central government (Martinez-Vazquez and McNab, 1997). The main purpose of fiscal decentralization is to ensure the efficiency of spending and providing public services; harmonize the powers over budget management among levels and contribute for the socio-economic development.

Fiscal decentralization is a major concern for developing countries and has been receiving more attention of economists and policy-makers. Like other developing countries, Vietnam has attempted to improve fiscal decentralization in order to make the delivery of social services more efficiently, especially since the adoption of the State Budget Law (SBL) 2002 with effect from fiscal year 2004 towards improving local autonomy and the system of intergovernmental fiscal relations. The SBL 2002 sets key principles for spending assignments, revenue arrangements, intergovernmental fiscal transfers and local government borrowing. It also grants provincial authorities a fair degree of autonomy to determine fiscal relationships with districts and communes within their jurisdiction. The current system allows a reasonable level of differential treatment across provinces to take account of their specific circumstances. Progress has been steady and considerable but some challenges remain in terms of fiscal autonomy, the clarity of spending assignments, the effectiveness of local revenue arrangements and potential for debt increasing for local authorities.

The revised SBL 2015, with effect from fiscal year 2017, is a turning point in state budget management, providing a more comprehensive legal framework in consistent with current economic context as well as the trend of international integration and contributes to the process of public finance reform. It ensures the uniformity of the state budget, increases fiscal decentralization and promotes the autonomy of the local government.

This paper aims to review current fiscal decentralization in Vietnam and provide fiscal decentralization trends through doing research on available data, current laws, regulations and policies on fiscal decentralization at central and local levels. The study focuses on four pillars of fiscal decentralization, namely: (i) expenditure assignments; (ii) revenue sharing; (iii) intergovernmental fiscal transfers; and (iv) local governmental borrowing.

The rest of the paper is organized as follows: The next section briefly covers macroeconomic developments in Vietnam in recent years. Then it describes Vietnam's recent central-local fiscal system. The following section analyses achievements and drawbacks of our current fiscal decentralization that focuses on four main pillars. Next, it mentions a variety of developments and reforms as a result of the issuance of the revised SBL 2015. And the final section concludes.

Macro-economic Developments

Vietnam exhibits a record of high and sustained growth in recent years. Real GDP growth picked up to 6.68 percent as of 2015, driven by strong domestic demand amidst external headwinds. On the production side, the manufacturing sector sustained relatively robust growth on the back of continued foreign direct investment (FDI) inflows, and construction industry also improved together with a recovering real estate market and strengthened investment activities (AMRO, 2016). Inflation, meanwhile, recorded its lowest level of 0.6 percent in 2015 but pace could jump in 2016. Table 1 below summarizes key economic indicators for 2011-2015 and the Government's target for 2016.

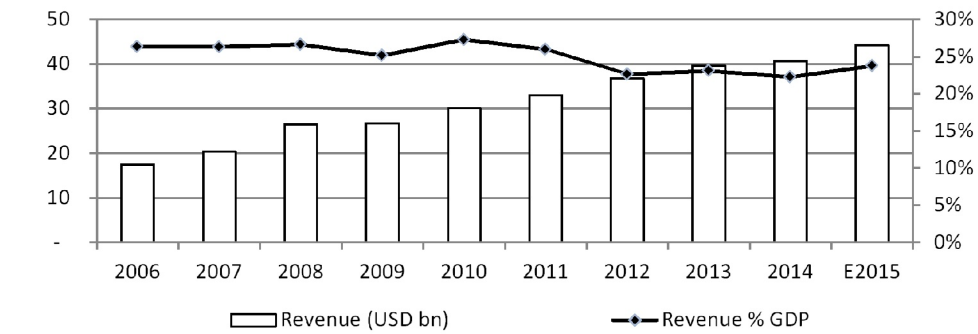
Table 1: Key indicators for 2011-2015 and the Government's target for 2016

	2011	2012	2013	2014	2015	2016 (target)
GDP growth (*at constant 2010 prices - annual growth %)*	6.24	5.25	5.42	5.98	6.68	6.7
GDP per capita (*USD*)	1,532	1,753	1,902	2,049	2,088	2,164
Inflation *(Average CPI; previous year = 100%)*	18.13	6.81	6.04	1.81	0.6	<5

Source: General Statistics Office of Vietnam and International Monetary Fund (2016)

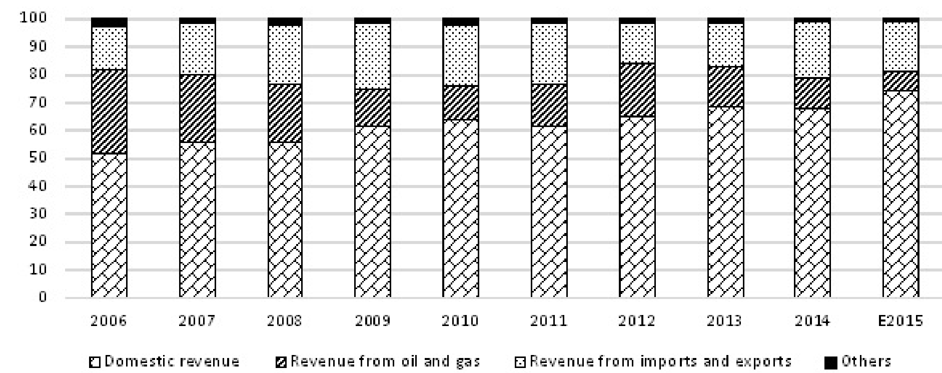
The Government's revenues continued to increase despite the after-effects of the global financial crisis and falling oil prices as a result of the Government's various tax reforms that have been designed to support the business and production sector by lowering the corporate income tax rate. Total State budget revenues for the period of 2011-2015 increased 2 times compared to the previous period of 2006-2010 (Figure 1). Share of domestic revenues increased from 59 percent for 2006-2010 to 68 percent for 2011-2015, meanwhile revenue from imports and exports reduced from 21 to 18 percent and revenue from oil and gas decreased from 18 to 13 percent (Figure 2).

Figure 1: Total revenue and revenue % GDP



Source: Calculated from Ministry of Finance of Vietnam data (2016)

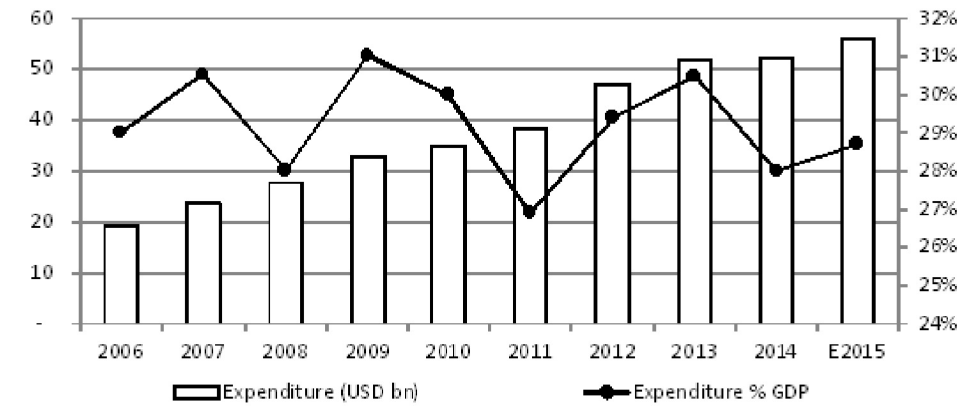
Figure 2: Revenue structure (% total)



Source: Calculated from Ministry of Finance of Vietnam data (2016)

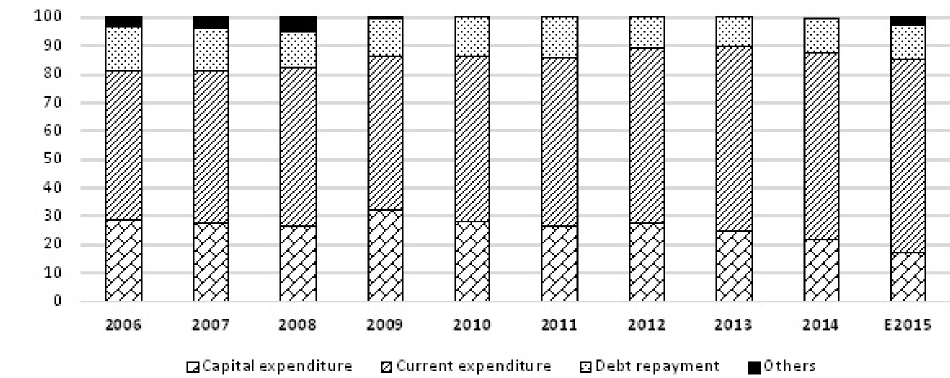
However, State budget expenditure also increased rapidly due to the expansion of current expenditure. Actual budget spending is estimated to increase marginally to 28.7 percent of GDP in 2015, relative high in compared with other countries in the regions[1] (Figure 3). In addition, the current expenditure took the largest share of the total expenditure meanwhile there was a fall in share of capital expenditure in total expenditure[2] (Figure 4).

Figure 3: Total expenditure and % GDP



Source: Calculated from Ministry of Finance of Vietnam data (2016)

Figure 4: Structure of budget expenditure (% total)



Source: Calculated from Ministry of Finance of Vietnam data (2016)

The budget deficit remained persistent as the expansion in budget expenditure outpaced the improvement in revenue collection. The overall budget deficit, which excludes principal repayments, was 4.7 percent of GDP in 2014 and estimated to be about 4.6 percent of GDP in 2015[3]. Public debt has been increasing rapidly. Latest data suggest that public debt, which includes central government debt, government guaranteed debt and local government debt, remained at high level of 62.2 percent of GDP in 2015 (Table 2). Persistently sizeable net government borrowings to finance the budget deficit and public investment have been the key factors contributing to such an increase in public debt.

Table 2: Budget deficit and debt indicators (% of GDP), 2011-2015

	2011	2012	2013	2014	E2015
Budget deficit *(excluding principal repayments)*	1.1	3.4	5.0	4.7	4.6
Public debt	50.0	50.8	54.5	58	62.2
Central government debt	39.3	39.4	42.6	46.4	50.3

Source: Ministry of Finance of Vietnam (2016)

Recent Central-local Fiscal System

The legislative framework for budget is firmly established. The SBL, first enacted in 1996, and revised in 1998, 2002 and 2015, is the key legislation underpinning budget management in Vietnam and covers all levels of government to ensure uniformity of the budget system. Vietnam has 4 tiers of government: central govemment; 63 provinces (cities); 713 districts (cities, towns) and 11,162 communes (wards). Vietnam's budget system consists of central budget and local budget, in which local budget includes provincial budget (including provincial and district budgets); district budget (including district and commune budgets) and commune budget.

Vietnam is one among a few countries that utilize a nested budget system ('Matrioska') that means lower level budgets are components of higher level budgets. Although it ensures the uniformity of the budget, it reduces fiscal autonomy of local governments and complicates budget preparation and monitoring through bottom-up budgeting and top-down decision-making. In addition, it does not facilitate fiscal accountability of the lower levels of government[4].

Current Fiscal Decentralization in Vietnam

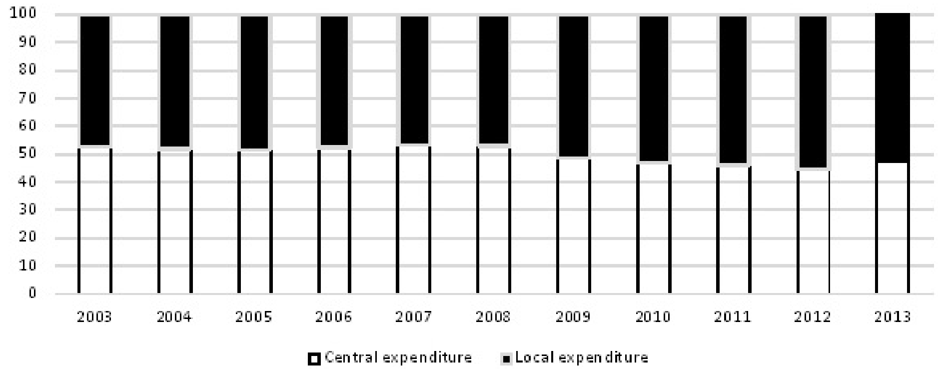
Expenditure assignments

The SBL 2002 lays out the spending tasks that are assigned to the central or local budgets. Spending tasks of central budget comprise: (i) investment spending (investment in construction of socio-economic infrastructure projects managed by the central level; investment and capital support for State enterprises); (ii) current spending (spending on activities in the fields of education, training, health care, social affairs, culture, information, physical training and sports, science and technology managed by the central agencies; spending on national defense and security, excluding the portion allocated to the localities; price subsidies; national programs implemented by the central government); (iii) payment of principles of and interests on Government's borrowings; (iv) aids; (v) other expenditures as stipulated by laws; (vi) additions to the central financial reserve fund and (vii) supplementary revenue to the local budget.

The spending tasks of the local budgets include: (i) spending on development investment (investment in the construction of locally managed socio-economic infrastructure projects); (ii) current spending on locally-managed activities in the fields of economy, education and training, health care, culture, information, science and technology, tasks of national defense and security assigned to the provinces, social policies managed by the provinces; (iii) payment of principals and interest on funds mobilized for investments of provinces; (iv) spending on supplementing the financial reserve fund and (v) spending on supplementing lower-level budgets.

Local spending accounts for a half of total government spending (Figure 5). Both local capital and current expenditures take a large proportion in the total capital and current expenditure respectively. In 2013, 69 percent of overall capital expenditure and 54 percent of current expenditure were devoted to local governments. Local governments play a particularly important role in public service delivery. In practice, more spending is given to local governments in social sectors such as education, health care, social assistance and economic services. During 2011-2015, local authorities account for the average of 80-90 percent of total current spending for education and around 75-80 percent for health care (World Bank, 2015).

Figure 5: Expenditure position (% total expenditure)



Source: Calculated from Ministry of Finance of Vietnam data (2016)

However, most spending assignments are shared or concurrent. The SBL 2002 currently assigns the same expenditure responsibilities to both central and provincial authorities. Sector legislation in health and education for example provides some clarity in terms of assigning exclusive responsibility for regulation to central government. In general, however, having so many shared functions between central and provinces causes ambiguity over spending assignments. In many cases, both province and district authorities are also assigned the same service delivery responsibility and may lead to overlap and complicates planning and budgeting.

Central fiscal rules and norms on minimum allocations impact adversely on local autonomy. Despite increased power over spending, central fiscal rules and norms affect local autonomy over budget decisions in selected areas and allocate financial resources inefficiently. For example, there are minimum allocations set for education and science and technology without due consideration of actual needs, the level of service provision and capacity to absorb that may lead to waste and the inefficient use of resources[5].

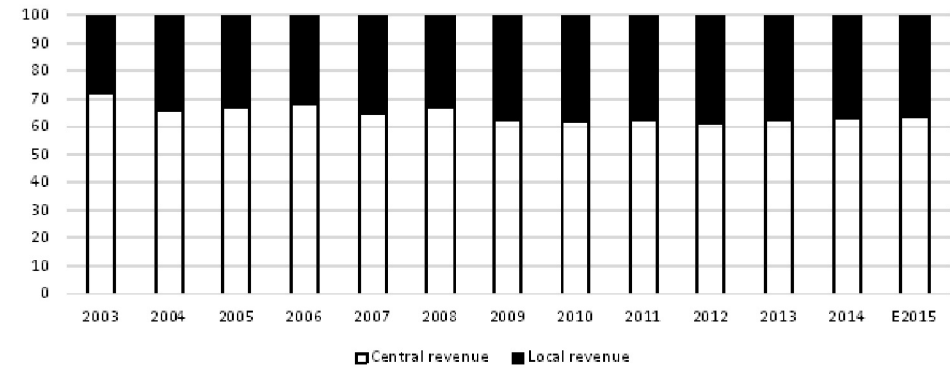
Revenue sharing

According to the SBL 2002, the revenue sources are divided into 3 categories: (i) central revenues includes value added tax (VAT) on imports; excise tax on imports, import and export taxes; corporate income tax (CIT) on enterprises with uniform accounting, taxes and other revenues from petroleum; (ii) revenue retained 100 percent by local authorities includes land tax; natural resource (except petroleum) tax;

registration fees, licensing fees, rental of land and water and sale of state property and (iii) revenue shared between central and local authorities includes VAT (except VAT on imports), excise tax (except excise tax on imports), CIT (except enterprises with uniform accounting), personal income tax, environmental protection tax.

Figure 6 below shows that share of local revenue in total government revenue increased from 28.1 percent in 2003 to 36.4 percent in 2015.

Figure 6: Budget revenue composition (% total revenue)



Source: Calculated from Ministry of Finance of Vietnam data (2016)

Vietnam adopts the "sharing rate" which is kept stable for 5 years (known as the Stability period). In principle, provinces with "sharing rate" less than 100 percent will transfer to the central budget. In the Stability period 2011-2015, among 63 provinces, there were only 13 provinces having revenue transferred to central budget and 50 provinces retaining 100 percent of shared taxes collected in their jurisdictions.

Local authorities have limited powers in setting fees and charges within the ceiling set by the central authority. Local authorities are not allowed to impose local taxes but allowed to impose some local fees and charges that present only 10 percent of total local budget. In practice, revenues retained 100 percent by local authorities are small and unstable taxes and fees with relatively low tax collection efficiency. Increasing revenue autonomy is one of the most significant issues with the current local revenue arrangements in Vietnam. It is important for the efficiency of spending and enables richer provinces to fill their infrastructure financing deficit.

Shared revenues in Vietnam are allocated based on where revenues are actually collected rather than where the tax is incurred, especially for the VAT and CIT. In this case, the major taxes are credited to the local governments where the headquarters of the enterprises are located or the place of business registration which are mainly large cities (e.g. Hanoi, Ho Chi Minh City and industrially developed provinces). It may cause inequality as being likely favour more socio-economic developed local governments.

Intergovernmental transfers

Vietnam has a relatively transparent, rules-based system of intergovernmental fiscal transfers to narrow horizontal and vertical imbalance, including balancing transfer (or unconditional transfer) and targeted transfer (or conditional transfer) [6]**.** Separate formulae are used to determine current and capital spending needs of provinces (and of districts). The formulate use population, geographic location (e.g. mountainous, rural/urban...) and other criteria to take account of the specific circumstances, and therefore funding needs of different provinces.

According to the SBL 2002, the local budgets may utilize revenue retained 100 percent by local authorities, revenue shared between central and local authorities and transfers from the upper-level budget to the lower-level budget to balance budget revenue and expenditure and ensure the implementation of the assigned socio-economic, national defense and security tasks.

The current system has improved equity in resource allocation across and within local governments, but shortcomings still remain. In fact, there is a wide variation in per capita spending across local governments. Provinces with highest spending per capital are 5.6 times higher than provinces with lowest one (Vu Nhu Thang, 2012). Moreover, principles and regulations on allocation have been developed but the 'negotiation mechanism' still exists. Some provinces do not actively attract investments and highly depend on targeted transfers for projects in the areas.

Local government borrowing

According to the SBL 2002 and the Public Debt Management Law 2009, local authorities are allowed to borrow domestically to finance local infrastructure projects but not to meet current expenditures[7]**.** Sources of local borrowing include: (i) the domestic capital market (local bonds, loans from commercial banks); (ii) borrowing from the State Treasury; (iii) borrowing from domestic development banks; and (iv) on-lending from the central government of external funds. All external borrowing is undertaken only through central government on-lending. Currently, share of borrowing by local authorities in Vietnam's total public debt remains small (the average of 3 percent during the period of 2003-2015).

The local borrowing limits help to maintain local debt at prudent levels. For local governments, Vietnam's provinces are required to maintain total outstanding debts below 30 percent of their capital budget (Hanoi and Ho Chi Minh City are exceptions with the ceiling at 100 percent of annual capital budget). In practice, some provinces with higher levels of capital spending needs and strong economic potential have breached their borrowing ceiling.

A ceiling based on annual capital budget is not based on economic rationale. The annual capital budget is unstable and heavily relies on the local revenue. The ceiling of

local government borrowing should monitor both debt service and debt stock that reflect debt sustainability, solvency and repayment capacity.

Aside from direct liabilities, indirect and contingent liabilities need to be closely monitored by local authorities. In fact, explicit contingent liabilities may be the most frequent type of indirect liability but implicit contingent liabilities are often more costly. The latter include bailouts of local SOEs, local governments and natural disasters contingent liabilities, which can significantly add to governments' balance sheet risk and may have a great impact on a country's fiscal position and debt sustainability.

Developments and Reforms

The revised SBL 2015, with effect from fiscal year 2017, ensures the uniformity of the state budget, increases fiscal decentralization and promotes the autonomy of the local governments. It also addresses the shortcomings of the fiscal decentralization in the SBL 2002 through major changes as follows:

Revenue source is classified more accurately and comprehensively and it aims to maximize revenue retained at local budget either through 100 percent local retained or central-local shared revenue, **i.e.** revenue from fines for administrative violations and other fines is not clearly specified in the SBL 2002 but is mentioned in the SBL 2015 as the central revenue; CIT of enterprises with uniform accounting shall be shared between central and local governments instead of the central revenue according to the SBL 2002[8].

Intergovernmental fiscal transfers have some major changes. Firstly, according to the SBL 2002, balancing transfers keep unchanged in absolute values during the Stability period, thus difficulties may arise for provinces with limited fiscal capacity. However, the SBL 2015 prescribes that the competent authorities are able to decide an increase in balancing transfers from the higher level budget to lower level budget compared to the first year of the Stability period. Secondly, targeted transfer is well-defined in the SBL 2015 for specific cases as follows[9]: (i) To implement new policies enacted by higher level authorities those are not allocated in the budget estimate of the beginning year of the Stability period; (ii) To implement National target programs and programs/ projects assigned by the higher level authorities; (iii) To support for recovery from natural disasters, epidemics and disasters beyond the fiscal capacity of the lower level budget; and (iv) To support for several major and particularly important programs/projects that have a tremendous impact on local socio-economic development. The total capital investment of central budget transferring to local budget shall be capped at 30 percent of total capital expenditure of central budget.

Local budgets are allowed in deficit[10]. The state budget deficit includes deficits of both central and local budgets. Local authorities are allowed to borrow domestically but must maintain local outstanding debts under the threshold based on the debt servicing capacity, i.e. (i) The SBL 2015 caps outstanding loans of Hanoi and Ho Chi Minh City at 60 percent of the revenue retained; (ii) Provinces which have their total retained revenue higher than local current expenditure are required to maintain outstanding loans below 30 percent of the revenue retained and (iii) Provinces which have their total retained revenue not exceeding local current expenditure must maintain outstanding loans below 20 percent of the revenue retained.

The Way Forward and Concluding Thoughts

Since the adoption of the SBL 2002, Vietnam has been achieving a number of positive changes regarding fiscal decentralization and improving the efficiency of allocating and using national financial resources. The proportion of local revenue in the total state budget revenue has been significantly increasing in recent years. Local governments play a more important role in public service delivery with over half of total government spending. Yet in spite of achievements, many shortcomings remain and that requires the revision of legal framework on state budget management. The issuance of the SBL 2015 may have a positive impact on fiscal decentralization and promote the autonomy of the local government. However, decentralization is a continuous process and not a stage that once reached remains immutable (Jorge Martinez-Vazquez, 2011). Consequently, further reforms should be done to improve fiscal decentralization in Vietnam and handle the remaining challenges, focusing on aspects as follows: (i) gradually eliminate the unique nested budget system; (ii) enhancing local revenue autonomy is one of the most significant policy issues, it can be considered through allowing local governments to set tax rates and tax bases for some selected taxes or determining fees and charges; (iii) more explicit assignments on service delivery for different tiers of government within a jurisdiction; (iv) improve local autonomy on budget appropriations; (v) complete the mechanism of intergovernmental transfers including both balancing transfer and targeted transfer in order to promote greater equity in resource allocation[11] and (vi) local governments should also closely monitor indirect liability to ensure the debt sustainability.

Fiscal decentralization reform is considered as an important requirement in the process of public finance management reform in Vietnam. However, there is general acknowledgement that decentralization may create a number of benefits but also imply risks. Strengthening fiscal decentralization should be accompanied by improving transparency and accountability of local finance.

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Notes

1. Indonesia: 17.4%; Malaysia: 25.2%; Philippines: 19.4%; Thailand: 22.3%; Singapore: 20.3% (IMF, 2016).
2. The share of current expenditure in the total expenditure increased from 47% on average for 2006-2010 to 63% for 2011-2015 meanwhile the share of capital expenditure in the total expenditure decreased from 29% on average for 2006-2010 to 24% for 2011-2015.
3. Vietnam's state budget reports budget balance, both including principal repayments as well as without it.

The latter is more in line with the Government Financial Statistics (GFS).

4. The higher levels of government have certain "veto rights" over budgets adopted by provincial and sub-provincial authorities (Article 47 of the SBL 2002).
5. Central government sets minimum allocations for specific areas (e.g. not less than 20 percent of total spending has to be allocated to education and at least 2 percent of total spending must be allocated to science and technology).
6. The balancing transfer or unconditional transfer is used to deal with the horizontal balance across local governments. Currently, in Vietnam there have been 50 provinces receiving balancing transfers from the central governments. The targeted transfer is used for specific purposes, i.e. to implement National Target Programs (NTP).
7. Only provinces are allowed to borrow to finance infrastructure projects.
8. According to the SBL 2002, CIT of enterprises with uniform accounting is the central revenue. However, these enterprises use local resources for their manufacturing, production and business activity. Therefore, it is more appropriate if CIT of these enterprises is shared between central and local governments.
9. Article 36 (3) of SBL 2002 only states that *an upper-level budget may provide purposeful supplementary revenue to support the lower-level budget when necessary important tasks emerge, and the latter is not capable of accommodating such tasks even after rearrangement of the budget, and utilization of budget provisions and financial reserve.* However, such tasks are undefined.
10. According to the SBL 2002, local budgets are not allowed in deficits.
11. It needs to complete a set of expenditure norms and criteria as the basis for the budget allocation between central and local governments in order to provide a better ground for strict control over state financial resources utilization. Currently, Decision on promulgating a set of quantitative norms for state budget allocation for investment expenditures in the period of 2016-2020 has been enacted.

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