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Intergovernmental Fiscal Relations in Vietnam

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INTERGOVERNMENTAL FISCAL RELATIONS IN VIETNAM

I. INTRODUCTION

Intergovernmental fiscal relations play a fundamental role in the economic and social development of Vietnam. As in all unitary forms of government, the central government sets national policies and assists with the financing of the activities of subnational administrative units, as well as undertaking certain expenditure responsibilities directly.¹ On the other hand, decentralization facilitates implementation of policies that reflect the preferences of inhabitants of subnational administrative units. An important objective, therefore, is to design a system that reconciles the sometimes conflicting objectives of centralization and decentralization. This report is intended to assist the government of Vietnam in designing its system of intergovernmental fiscal relations (IFR).

The next section describes the political system within which intergovernmental fiscal relations are imbedded. The third section provides an overview of intergovernmental fiscal relations in Vietnam. Section IV describes the assignment of expenditure responsibilities among levels of government, Section V discusses fiscal management and budgeting, and Section VI describes and appraises the revenue side of intergovernmental fiscal relations. These sections contain descriptions of current practice, a brief statement of criteria against which they are to be appraised, an appraisal of current practice, and recommendations for improvements. Section VII describes how the present system of subventions could be replaced by an improved system of intergovernmental transfers. This discussion focuses primarily on relations between the central government and the provinces; relations between provinces and districts and between districts and communes are generally quite similar.

II. THE POLITICAL SYSTEM OF INTERGOVERNMENTAL FISCAL RELATIONS²

Vietnam is divided into 53 provinces; this count includes Hanoi, Hai Phong, and Ho Chi Minh City, which have provincial standing. The provinces are subdivided into 459 districts and 76 towns (which have district status). Districts, in turn, are subdivided into 9,557 communes.

At each level of government there is a legislative authority and an executive authority, which is selected by the legislative authority. In the case of the central government these bodies are the National

¹ For expositional convenience this report sometimes makes reference to subnational levels of government (e.g., provincial governments), even though this terminology may not appropriately and accurately describe the legal status of the various administrative units in Vietnam's unitary form of government.

²

This section is based on material from David Husband, *Public Finance Developments in Vietnam*, a report to the Asian Development Bank, February 1996.

Assembly and the Prime Minister, who is head of the government; at the provincial and district levels they are the People's Councils and the People's Committees. The Communist Party operates in parallel to the government structure at all levels of government.

Article 83 of the Constitution of 1992 defines the following powers of the National Assembly:

The National Assembly is entrusted with the right to decide the main principles governing the organization and functioning of the state apparatus and the social relations and activities of citizens as well as the right of supreme control of all state activities.

Based on Article 4 of the Constitution, the Communist Party provides guidance to the National Assembly and the government (but does not exert explicit control) through the issuance of resolutions.

The Communist Party of the Socialist Republic of Vietnam is the vanguard of the Vietnamese working class, the faithful representative of the rights and interests of the working class, the toiling people, and the whole nation, acting upon Marxist-Leninist doctrine and Ho Chi Minh's thoughts and is the force leading the state and society.

The National Assembly, which consists of 395 members, is elected for a period of five years and meets twice per year in sessions lasting 4 to 8 weeks. Between sessions of the National Assembly a Standing Committee acts as the legislature, issuing ordinances with the power of law.

The central government, which is elected by the National Assembly, is responsible for all aspects of public administration. The Prime Minister, who is the head of the government, must be a member of the National Assembly.

Laws enacted by the National Assembly and ordinances issued by the Standing Committee are often broadly worded, and thus vague. The government thus has the important power to issue decrees, decisions, and circulars interpreting them. These must, of course, be consistent with laws, ordinances, and regulations issued by the higher authorities. The National Assembly has the power to rescind any ruling made by the government that it considers to be inconsistent with the Constitution, laws, or ordinances, but this power has apparently been used only rarely.

The principle of "democratic centralism" dominates intergovernmental fiscal (and non-fiscal) relations in Vietnam. Both the legislative process and the administrative structure are hierarchical. Officials of subnational governments answer to Hanoi, as well as to their local superiors. The budget process (described briefly in Section III and in detail in Section V) is one in which the budgets of each level of government are "nested" in those of the next higher level. Article 53 of the new Budget Law enacted in April 1996 gives the Prime Minister or Chairman of the People's Committee at the next higher level of

government the right to request adjustments in the budget of the lower level of government, if these budgets are deemed to be inconsistent with decisions of the National Assembly or the People's Council at the higher level of government. The result is a highly centralized and complex system of IFR that is characterized by "top-down" decision-making.

The People's Councils operating at the provincial and district levels are elected by universal suffrage. But their powers and those of People's Committees they select to implement their decisions are somewhat circumscribed. While the People's Councils exercise the legislative function regarding matters concerning their territory, including budgetary matters, they do so under the supervision of the Standing Committee of the National Assembly and subject to laws, ordinances, and regulations issued by the National Assembly, the Standing Committee, and the central government. The Standing Committee can rescind decisions of the People's Councils and even dissolve the Councils in extreme cases.

The Chairman of the People's Committee has considerable power over subnational administrative operations. Yet this power is exercised subject to the supervision of the Prime Minister, who has the right to dismiss the Chairman and Vice Chairman of People's Committees and to suspend or annul decisions of the provincial Committees if they are contrary to the Constitution or laws of the central government.

Like the People's Councils and the People's Committees, government officials at the provincial and district levels are subject to dual subordination, both to the People's Committee at their level and vertically to the corresponding ministries of the central government. Of particular importance for IFR is the fact that tax administrators in the provinces and districts are subordinate to both the General Tax Department in Hanoi and to their respective subnational governments. Section VI describes the disadvantages of dual subordination of the tax administration.

III. AN OVERVIEW OF IFR

The basic structure of intergovernmental fiscal relations in Vietnam resembles that in other planned economies, including those in the former Soviet Union. Yet there are important variations. Box III-1 contrasts various features of IFR in Vietnam and Kazakhstan.

Expenditure assignment. Responsibilities for public expenditures are divided among the central, provincial, district, and commune levels roughly in accordance with the dictates of the economic theory of decentralization: Activities reflecting national objectives, those with benefits that reach beyond provincial boundaries, and certain very large projects fall within the domain of the central government. By comparison, activities with more localized benefits are assigned to the province, district, or commune level. An important difference from systems found in the former Soviet Union is that subnational governments are responsible for some expenditures for capital investment, as well as for current expenses. The budgetary requirements of each level of

government are determined by application of standards or “norms” provided by the central government. An important item of expenditure at each level of government above the commune level are subventions paid to governmental units at the next lowest level.

Box III-1: Comparison of Intergovernmental Fiscal Relations in Kazakhstan and Vietnam

<u>Expenditures</u>	<u>Kazakhstan</u>	<u>Vietnam</u>
Norms	Detailed/Specific Uniform	General/Per capita Differentiated regionally
Responsible for capital spending	Central	All levels
Discretion to reallocate budget	Yes	Unclear
Subnational borrowing	No	Yes
Hard budget constraint	No	Yes
Subnational revenue targets	No	Yes
Taxation:		
Subnational control of:		
Tax base	No	No
Tax rate	No	No
Dual subordination of tax administration	No	Yes
Tax sharing rates:		
Uniform across jurisdictions	Before 1996: No After 1995: Essentially	No
Uniform across taxes	No	Yes
Choice of regulating (shared) taxes	VAT; excises; individual and enterprise income taxes	Turnover tax; profits tax
Stable sharing rate	No	Before 96: No After 95: Yes
Excess central revenue shared?	No	Yes

Revenue assignment. Revenue sources fall into two categories: those assigned entirely to one level of government (hereafter “own” revenues) and those that are shared by two or more levels (hereafter “shared” or “regulating” taxes). In general, revenue sources assigned entirely to a province are inadequate to meet provincial budgetary requirements. As a result, a portion of shared taxes collected within the province are assigned to the province. This fraction is equal to the budgetary requirements that cannot be financed by own provincial revenue sources divided by estimated revenues from shared taxes. Own

revenues of the central government in 1996 include taxes on international trade, excises, and profits taxes on certain enterprises operating throughout the country (e.g., the electricity and the post and telecommunications enterprises). Profits taxes on other enterprises and turnover taxes are shared between the central and provisional governments. Own revenues of subnational governments include taxes collected for the granting and transfer of land use. (Before enactment of the new Organic Budget Law these were simply own revenues of subnational governments. Now they are to be shared between the provinces and communes).

Subventions. Where a 100 percent sharing ratio is not adequate to meet the provincial revenue shortfall, the central government provides a subvention to cover the residual shortfall. In recent years, only 14 of the 53 provinces of Vietnam (hereafter called non-subvention provinces) have been able to cover their budgetary requirements from provincial taxes and provincial shares of shared taxes; the remaining provinces (hereafter called subvention provinces) have received subventions from the central government.

Stability of tax sharing and subventions. One common feature of budgetary systems based on application of expenditure norms, revenues estimates, variable sharing rates, and subventions is lack of certainty in subnational budgeting from one year to the next; sharing rates commonly vary from year-to-year. In Vietnam there has also been instability in the assignment of taxes between categories (own revenues of the central or subnational governments or shared revenues); see Section VI A. The new Organic Budget Law enacted in April 1996 reflects an attempt to provide greater certainty for subnational governments. It assigns taxes to major categories and provides that sharing rates will remain fixed for a period of three to five years. (In addition, the interim decree under which the budgets for 1996 and 1997 are to be formulated provides for similar stability). In the case of provinces receiving subventions, subventions will be adjusted for (only part of) year-to-year inflation. This method of introducing “stability” will cause the deterioration of the budgetary position of subvention oblasts; see Box VII-1.

Dual subordination. Taxes other than those on imports and exports are administered by the General Tax Department (GTD). Although the GTD operates throughout the country on a the basis of vertical authority, officials of the GTD are also subject to dual subordination to the finance departments of subnational governments (provinces and districts). In principal, vertical subordination within the General Tax Department is intended to guarantee uniform application of tax laws and regulations throughout the country, while subnational finance departments exercise operational control of GTD offices under their jurisdiction. In fact, it creates anomalous results; see Section VI.

Revenue targets. Tax officials in each province (and each district) are given revenue targets. While both budgetary requirements and revenue goals are ostensibly set by application of objective formulas, in fact there is substantial room for negotiation, especially on the tax side, where estimation of revenues is inherently difficult.

Hard budget constraint. It appears that, once budgets and revenue targets are set, subnational governments in Vietnam face hard budget constraints. That is, if revenues fall short of expectations,

subnational governments must reduce expenditures. On the other hand, if revenues are higher than expected, the excess is generally available for investment spending by the jurisdiction experiencing the surplus.

Latitude for fiscal effort. The central government determines the base and rate of all taxes levied in Vietnam. Thus it is impossible for a subnational government to exercise additional fiscal effort by imposing additional taxes or setting higher tax rates on economic activity under its jurisdiction. Because of the dual subordination of local officials of the General Tax Department to the finance department of subnational governments, as well as to their superiors in the vertical chain of command within the GTD, it is possible for subnational governments to exercise some tax effort through the zeal with which taxes are administered in their jurisdictions. This is, however, problematic, for reasons described in Section VI.

IV. EXPENDITURE ASSIGNMENT

A. Existing Practice

Current expenditure assignments. Budgetary expenditures in Vietnam take place at four levels of government: central government, 53 provincial governments (including independent city administrations), 509 district governments (including dependent city governments), and approximately 10,000 communes.³ The assignment of expenditure responsibilities at these four levels as of May 1996 is summarized in Table IV-1.

The division of expenditure responsibilities is similar to that found in the FSU and Eastern Europe, as well as those in many decentralized market economies. The central government is in charge of nationwide services including defense, the justice system, the security system, and foreign relations. In the social sectors, as is common in other countries, responsibilities are shared. Thus universities and referral hospitals are the responsibility of central government, but primary and secondary education and smaller hospitals and clinics are the responsibility of subnational governments. Subnational governments have exclusive responsibility for traditionally local services such as water and sewage, but the large unmet need in some of these areas has led the central government to assume some of the responsibilities.

Some differences in expenditure assignments are noticeable in Vietnam vis-a-vis other transition countries in the FSU and in Eastern Europe. In Vietnam subnational governments are assigned some capital expenditure responsibilities while in the planned economy systems of the FSU and Eastern Europe, capital expenditures often remain the exclusive domain of the central governments. Also different is the fact that for the most part housing has not been a government responsibility at any level in Vietnam. Last, Vietnam has not faced the significant problems created during the transition by the divestiture of social responsibilities

³ The budgets of communes have not been integrated in the overall budget process. However, the new Budget Law makes provision for this integration.

by state enterprises in the FSU and Eastern Europe. The more agrarian nature of the Vietnam economy no doubt helped in this respect.

In theory the assignment of expenditure responsibilities among provinces, districts, and communes should apply uniformly throughout the national territory reflecting the unitary system of government. There is no information on whether this is the case, but in reality provincial governments would appear to have exercised their discretion in dividing responsibilities between themselves and their districts. In fact there are some provinces that have not introduced territorial divisions into districts.

Evolution of expenditure assignments over time. The assignment of expenditure responsibilities has changed from year to year. But, on the whole, expenditure assignments have been quite stable over time, especially by comparison to the experience of Russia and other FSU countries over the past 5 years, and also compared to tax assignments in Vietnam, discussed in Section VI. The history of recent changes in expenditure assignments in Vietnam is summarized in Box IV-1.

Expenditure assignments in the 1996 Budget Law. One of the important issues addressed by the new Budget Law is the assignment of responsibilities at all four levels of government. However, with few exceptions, the assignments in the Law are too general and vague to be a practical guide for implementation. This is an area of the Budget Law that awaits implementation by regulation.

The assignments in the Budget Law are summarized in Table IV-2. Almost every possible category of expenditure, including national defense, overlaps the central and subnational governments. There are very few concrete assignments in the Budget Law. In particular, cities are assigned capital investment responsibilities for water supply, sanitation, transport and electricity. Communes and precincts are assigned capital investment responsibilities for schools, health centers and water supply systems.

Table IV-1
Expenditure Assignments, as of May 1996

Category	Central Government	Provinces	Districts ¹	Communes (and Precincts)
Defense	-Largely central responsibility	-Local Militia -Conscription	-Local Militia	---
Justice/Internal Security	-Largely central responsibility	-Maintaining local law and order	-Maintaining local law and order	---
Foreign Economic Relations	-Entire responsibility	---	---	---
Eduation ²	-Post-secondary education	-Secondary	-Primary	-Pre-primary
	-National Programs	-Technical and Vocational	-Teacher Salaries	
	-School buildings in poor provinces	-School Buildings -Teacher Training	-Maintenance and some school building	
Health ³	-Specialty and referral hospital and training and research institutions	-Hospital and Clinics -Training of medical assistants	-Small Hospitals and Polyclinics	-Primary Health Centers
	-National Programs	-Prevention Programs		
	-National health insurance compulsory for state workers			

Table IV-1 continues on next page...

Table IV-1 (continued)

Category	Central Government	Provinces	Districts ¹	Communes (and Precincts)
Roads (and Inland Waterways)	-National Roads	-Building Facilities -Provincial Roads -Some maintenance of national roads	-O & M of facilities -Local Roads	-O & M of facilities -Local Roads
Public Transportation	-Rail and Air Transportation	-Limited Bus Transportation	-Limited Bus Transportation	---
Fire Protection	---	---	-Local Responsibility	-Local Responsibility
Police	-Mostly, a central responsibility	-Local Militia	-Local Militia	---
Libraries	-National Institutions	-Provincial Libraries	-Local Libraries	---
Sanitation	-Financing of some projects	-----Subnational Responsibility (serious shortages exist)-----		
Water/Sewage	-Financing of some projects	-----Subnational Responsibility (serious shortages exist)-----		
Housing	-----Most housing is privately constructed (serious shortages exists)-----			
Price Subsidies	-Mostly central responsibility	-Responsibility for implementing central mandates	---	---
Welfare	-Social Security System	-Relief for the elderly, orphans, and handicapped	-Shared Relief Functions	-Shared Relief Functions

Table IV-1 continues on next page...

Table IV-1 (continued)

Category	Central	Provinces	Districts ¹	Communes (and Precincts)
Environment	-National Programs	-Provincial Programs	-Local Environment Protection	---
Economic Activity Enterprises	-Mostly central responsibility -Major irrigation flood control and embankment projects	-Regional Development -Land Management -Irrigation Maintenance	-Local Development -Land Management -Irrigation	-Local Development -Irrigation
Other Capital Investment	---	-Most capital investment activities are controlled by central government	-Formally no capital investment responsibilities	-Formally no capital investment responsibilities

¹Some provinces have failed to introduce district jurisdictions.

²Fees are tentatively used for vocational and secondary education, and for textbooks, uniform and transportation at all levels.

³Many health services and most drug sales are carried in the private sector. Public health services often are subject to category recovery fees.

Table IV-2
Assignment of Expenditure Responsibilities in the New Budget Law, 1996

	Central Government	Provinces	Districts and Cities	Communes (and Precincts)
Health	-Central Facilities -Research -National Health Programs	-Provincial Services	-District Services	-Commune health activities
Education	-Post-secondary -National Programs	-Provincial Services	-District Services	-Evening Schools -Pre-primary
Economic Activities	-Economic services, managed centrally	-Provincial Services	-District Activities	-Maintenance of facilities, managed by communes
Culture and Sports	-National Programs	-Provincial activities, supporting individuals	-District Activities	-Commune Activities
Social	-National Programs -Social Security	-Provincial Activities	-District Activities	-Commune Activities
Defense	-National Defense	-Military Conscription -Other Defense Activities	-District Activities	-Commune Activities
Police and Security	-National Police	-Local security and social order	-Local security and order	-Security and defense at the commune level
Political Organs	-Central organs of CP and other central organizations	-Provincial organs of CP and other organizations	-District organs of FP and other organizations	-Support for political and social organizations
Price Subsidies	-Central Programs	-Subsidies conforming to national policies	-As conforming to national policies	---

Table IV-2 continues on next page...

Table IV-2 (continued)

	Central Government	Provinces	Districts and Cities	Communes (and Precincts)
Interest	-National Debt Service	-Service of provincial debt	---	---
Other Expenditures	-As stipulated by law	-As stipulated by provincial budgets	-As stipulated in district budget	---
Capital Investments	-Programs in infrastructure -Support of state enterprises and joint companies -National investment and development programs	-Construction of basic economic infrastructure -Support of state enterprises according to the law	-Cities only: -Power -Water supply -Sanitation -Transport	-Infrastructure such as health enters, primary schools, local roads, water supply systems
Transfers	-Transfers to subnational governments	-Transfers to lower budget	-Transfers to lower budget	---

Relative importance of subnational government expenditures. Because expenditure responsibilities are shared by the central and subnational governments in many different areas, it is helpful to quantify how much each level of government spends. The mission was unable to collect updated budget data for provincial governments. The information in this section on consolidated provincial expenditures comes from previously published reports.⁴ At present there appears to be no information on province-district expenditure division. There is no information either on the relative importance of communal budgets.

Provincial consolidated expenditures (provinces and districts) accounted for approximately a third of total consolidated expenditures in 1994. The provincial share in particular expenditures varied significantly. In 1994 the provinces accounted for about 50 percent of administrative expenditures, 72 percent of education and training, and 60 percent of public expenditures on health. Judging from the changes in expenditure shares, there appears to have been a slight trend toward recentralization.⁵ In 1992 consolidated provincial expenditures represented 35.5 percent of total expenditures, while in education and health these shares were over 80 percent in both cases.

Public expenditures at the subnational level are quite low. The low level of public expenditures per capita reflects both low income levels and a relatively low share of public expenditures in GDP. In 1995 public expenditure on social services represented about 8 percent of GDP and less than 50 percent of all private and public expenditures in health and education. There are also significant disparities across provinces in expenditure per capita. See Box IV-2.

Box IV-2: Disparities in Per Capita Expenditures

Provincial expenditure per capita for 1993 varied significantly. For high income provinces (per capita GDP over 450 th Dongs) total expenditures per capita were D 178.6 (in education D 26.5 and in health D 14.7); for middle income provinces (per capita GDP 300-450 th Dongs) total expenditures per capita were D 95.7 (in education 21.8 and in health D 9.3); for low income provinces (per capita GDP less than 300 th Dongs) total expenditures per capita were D 104.7 (in education D 23.3 and in health D 4.4).

Source: Table 7, page 13 in Bird, Litvack, and Rao, 1995.

⁴ In particular, Richard M. Bird, Jennie I. Litvack, and M. Govinda Rao, "Intergovernmental Relations and Poverty alleviation in Vietnam" Policy Research Working Paper 1430, The World Bank, March 1995; Husband, 1966; and Ngyen C. Nghiep, "Public Finance Developments in Vietnam" Financial Scientific Institute, Vietnam, November 1995; UNDP "Viet Nam: Public Expenditure Review" April 1996; UNDP Viet Nam: Public Investment Programme", (revised draft) April 1996; World Bank "Viet Nam: Public Sector Management and Private Sector Incentives, An Economic Report" September 1994; World Bank "Viet Nam: Poverty Assessment and Strategy", January 1995; World Bank "Viet Nam: Restructuring Public Finance and Public Enterprises, An Economic Report" April 1992.

⁵ Husband, (1996).

B. Criteria for Evaluation

In general, there are no clear-cut criteria for assigning expenditure responsibilities to different levels of government. Adequate assignments are reached typically as a compromise among often conflicting objectives pursued by the government's decentralization policy.

An *efficient* provision of government services requires that government satisfy the needs and preferences of taxpayers in the least-cost way. Because local governments are closer to taxpayers, efficiency can typically be increased by keeping the provision of services at the lowest level of government. Higher levels of government should be assigned expenditure responsibilities for those services with significant spillover benefits across smaller jurisdictions. It is likely that smaller governments will fail to adequately internalize those spillover benefits. Higher levels of government should be assigned expenditure responsibilities for those services with significant economies of scale and scope. However, these production efficiencies may still be captured by smaller governments by contracting for services with either non-government enterprises or larger government units. The realization of efficiency gains in the allocation of expenditure responsibilities requires effective democratic representation and proper budgetary institutions, including local discretion to vary the composition of the budgets and the ability to link costs of provision via fees, service charges, or local taxes.

Expenditures undertaken by government for *equity* or income equalization and for *macroeconomic stabilization and growth* should generally be the responsibility of the central government. Attempts by subnational jurisdictions to redistribute income can easily backfire if there is taxpayer mobility. More importantly, the incidence of the poor is likely to be higher in relatively poorer jurisdictions, which will thus have more difficulty alleviating the poverty of their poor.

These general principles for assignment of expenditure responsibilities can help identify wrong assignments but they do not lead to a unique or best assignment blueprint. Balancing the objectives of efficiency and equity can lead to quite different, but equally admissible, assignments. For example, governments that emphasize the equity objective may give the central government a more direct responsibility for primary and secondary education, while those governments that give higher priority to economic efficiency may assign primary and secondary education entirely at the subnational level. Actually, clarity and stability in the assignment of responsibilities may be as important for the efficient provision of public services as getting the assignment of responsibilities exactly right. The damage from getting the “wrong” assignment typically will be less than the damage caused by the under provision of services arising from an unstable or murky assignment of expenditure responsibilities.

C. Appraisal

The new Budget Law still does not provide a formal assignment of expenditure responsibilities. It is somewhat uncertain what the government regulations developing the provisions in the Budget Law will bring. The preparation and discussion of the Budget Law took four years, allegedly due to the controversial

nature of many issues, and some of the drafts did contain quite radical changes in the assignment of expenditure responsibilities; for example, the recentralization of most education leaving provinces with responsibility only for pre-primary education. Such massive recentralization would help little to increase the efficiency of public expenditures.

There remain critical shortages in basic services. Water supply remains the single most important problem in urban areas.⁶ Because of the rapid increase in urban population, the percent of the population in urban area with access to safe drinking water has decreased from over two-thirds to roughly one-half in recent years. Similarly, it is estimated that less than half of the rural population has access to safe water. The needs for capital infrastructure in sanitation, roads, and transportation are also enormous. The government policy is to allow a bigger role to the private sector in the provision of some of these services, but there does not appear to be a national policy defining the role subnational governments should play. Even in those areas where services are more adequate, such as health and education, there are significant needs. For example there are very significant needs for school building in secondary education, now the responsibility of provincial governments.⁷

Some confusion on expenditure assignment remains. Even though there appears to be a specific assignment of expenditure responsibilities, as summarized in Table IV-1, in practice there often appears to be confusion concerning actual division of responsibilities. There is confusion in particular in the assignment of capital investment responsibilities for infrastructure. This is in part a result of the lack of transparency in the capital budgeting process (see Section V). One such area is irrigation services. While some districts appear to assume responsibility for these investments, smaller commune irrigation systems appear to go largely underfunded.⁸ The introduction of the PIP in 1996 should help clarify some of these issues. The PIP will cover all central and local projects to be financed from the central government budget or by Official Development Assistance (ODA). Capital expenditures financed by subnational governments directly will not be included in the PIP. Limiting the scope of the PIP to projects financed with central government funds is the proper thing to do. However, provincial governments should develop their own PIPs. This would not only increase the efficiency of capital investments at the subnational level, but it would also allow for better coordination and identification of underserved areas.

Confusion in the assignment of responsibilities is enhanced in many cases by the fragmentation of service responsibilities and the lack of coordination or integration of many different agencies. Dual subordination of central government and subnational government authorities often helps aggravate this problem. For example, in the case of public education, responsibilities are shared by the Ministry of Education, which is in charge of educational policies, curriculum, and teacher training; by the Ministry of

⁶ UNDP "Viet Nam: Public Investment Programme" (revised draft), April 1996.

⁷ Only one third of children between the ages of 11 and 14 attend secondary school and attendance drops to 10 percent for those in the 15 to 17 years of age group.

⁸ World Bank "Viet Nam: Public Sector Management and Private Sector Incentives, An Economic Report", September 1994.

Finance, which is responsible for budgeting; by the Ministry of Planning and Investment, which is responsible for investments in capital infrastructure; and by the Government Committee for Personnel and Organization within the Ministry of Labor, which is responsible for wage and salary and staffing policies. All the agencies just listed are at the central government level. At the subnational level, the Provincial Department of Education reports to the provincial authorities, the People's Committee and the People's Council, and also directly or indirectly to the central authorities and performs a number of functions such as textbook distribution and teacher training; district and commune governments manage most primary schools; and district governments are responsible for paying most teacher salaries.

The fragmentation in policy decisions gives little incentive to low level officials to manage operations efficiently. For example the reduction in the number of teachers would simply lower assigned budgets without the possibility of using discretionary funds for other purposes. (Budget management issues are discussed further in Section V).

Lack of adequate maintenance expenditures. The lack of adequate maintenance of infrastructure facilities is among the most important problems related to the assignment of expenditure responsibilities. Infrastructure facilities, including clinics, schools, roads and irrigation schemes, are reported to be in severe disrepair across the country. It is not possible to establish how much of this problem arises from the separation between investment responsibilities (at the central level) and maintenance and operations (at the subnational level) and how much is due to the lack of resources. Budgetary constraints in the past significantly reduced the funding for maintenance operations.⁹

Lack of financing ability for capital expenditure responsibilities. Perhaps the most important issue is that local governments have been assigned the responsibility for capital investment (rehabilitation, replacement and new construction) in many service areas, but most local governments lack the capital funds or the financial ability and sophistication to borrow for these purposes. The critical question is how to mobilize the resources needed to start filling the gap for these infrastructure needs. At least part of the solution will have to be that subnational governments borrow for capital investment purposes. The new Budget Law allows subnational governments to do just that. There is minimal experience with borrowing at the subnational level in Vietnam. In 1994 the Government allowed Ho Chi Minh City to issue bonds to finance a road and the operation received favorable reviews from central government authorities.

Cost recovery practices. Cost recovery practices for general social services are more common in Vietnam than in most other countries in transition. However, the record in Vietnam is worse for other local services. Subnational governments have discretion to set fees for water, sewerage, and solid disposal services.¹⁰ Fees are also charged for irrigation and transport. Apparently at the commune level local contributions in cash and in kind accounted for half of the cost of rural road improvement between 1991

⁹ It is reported that budgetary spending on operation and maintenance fell from 3.2 percent of GDP in 1986 to 0.4 percent in 1993.

¹⁰ Electricity tariffs are set by the central government.

and 1995. However, the norm is that fees are insufficient to cover the cost of service delivery. Wastage due to lack of maintenance has made full cost recovery measures more difficult.¹¹ Lack of metering makes cost recovery more difficult. It also preempts the selective disconnection of services as a credible threat to enforce payment by individual users.

For education, parents now contribute to the costs of schooling by paying for textbooks and since 1988-89 by paying a school fee which increases with the education cycle. However, there are no compulsory fees, only voluntary contributions for the first three years of primary school.¹² Students also have to cover the cost of vocational training or get an enterprise to pay for it. In secondary education there is a small but increasing number of “semi-public schools”. For these schools the government provides the facilities and equipment but salaries and other operation funds are covered by fees.¹³ At the college level, a group of best students have free tuition but the rest of the students have to pay full tuition. In 1993 it is estimated that families spent D 2,000 billion in education costs of which fees were 400 billion. By comparison, public expenditures in education for the same year were D 2,700 billion. Cost recovery fees are also common in health services and most patients have to pay for their medicines.

Revenues collected by fees are typically retained by the facilities concerned such as hospitals and schools; reporting is deficient. In the case of health services, retained fees are kept by the health centers except for the remission of 5 percent to the provincial health office. In the case of education, they apparently are used for different purposes at the local level and not always for the maintenance and operation of the schools. There are reports that government plans to change the current policy on revenue from fees. Some agencies will still be allowed to keep these revenues, but many others will have to transfer the funds to the central government budget. This would be a sensible approach if the cost of those services were covered by the central budget. When the costs of the services are covered by the subnational government budgets the revenues from fees should accrue to the subnational government budgets or be allocated to their discretion to the implementation of spending units.

Overall, the use of cost recovery fees is desirable because it helps reduce reliance of tax financing. It also increases efficiency and reduces wastage. However, there is also a down side to this policy, especially for social services when user charges are not based on ability to pay. The otherwise desirable use of user charges requires that government policies pay more attention to service coverage of the poor.

The lower involvement of the public sector in the economy. The size and composition of public

¹¹ It is estimated that, for example in Hanoi, about 40 percent of the water is lost due to leakages.

¹² From the 4th to 6th grade the fee is the equivalent of 1.5 to 2 kilos of rice per month and for secondary schools the fee is the equivalent of 2 to 2.5 kilos of rice per month.

¹³ The government has plans to increase the enrollment in these schools to 15 percent of total enrollments by the year 2000.

services in Vietnam differ from those in Eastern Europe and the FSU. The most important difference is in housing, which in Vietnam is mainly constructed privately. The government plans to keep most housing construction in the private sector and to concentrate public expenditures on the provision of water and sanitation services and the development of sites and other basic services such as roads and electricity, required for housing development. However, these policies have been far from successful and housing shortages in Vietnam remain critical.

D. Options and Recommendations for Change

On the regulation for implementing expenditure assignments. The regulations should obey the general criteria for expenditure assignment reviewed in this report. However, as mentioned, these criteria do not provide an exact assignment for many public services. Regardless of which decisions are made on final reassignment, it would be important that the regulations provide a concrete and detailed assignment of responsibilities, especially for capital investment responsibilities and in those areas in which services are shared by different levels of government. This will represent a very labor-intensive and difficult task.

On increasing maintenance expenditures. Poorly maintained infrastructure is costly, not only because it leads to inferior service provision, but also because it is almost always much more expensive to replace worn out infrastructure than to maintain it. Before the government embarks on massive local infrastructure investments there is a need to consider how to make these investments sustainable. This will require rethinking the role of subnational governments in the process. There is a need to set the incentives right for the proper maintenance of capital infrastructure at the subnational level. Infrastructure built by the central government for local governments without local government involvement in the decisions and in the financing of the projects has in many other countries typically led to inadequate maintenance. Subnational governments should have at least partial ownership of the projects in terms of technical specifications and financing.

Another option is for the central government to require minimum expenditure standards for maintenance. This will require changing the budget classification in order to identify expenditures on maintenance and to ensure that general funding of subnational governments allows enough funds for this activity. The identification in the central government PIP of the recurrent maintenance expenditures associated with projects should facilitate the quantification of the necessary funding. When provincial PIPs are introduced, they should also identify the necessary maintenance expenditures for all subnational projects. This should allow better monitoring of adequate maintenance expenditures and adequate identification of such expenditures and the funds allocated in the budget.

Sustainability of public infrastructure projects will also critically depend on the ability to generate revenues from these projects on a cost recovery basis. This will require in turn the ability to charge service users on a consumption basis. In the long term this will require the metering of services, where feasible.

Facilitating borrowing by subnational governments for capital infrastructure projects. It is

a generally accepted principle of public finance that borrowing is the proper way to finance long-lived public infrastructure. Borrowing solves the problem of lack of liquidity to undertake major investments and it is fairer for different generations of taxpayers. Borrowing also satisfies the budgeting principle that capital investment responsibilities for any service should lie with the level of government in charge of current expenditures (including maintenance for that service).

Although large cities such as HCM City, Hanoi and Haiphon, and some provincial governments should be able to issue bonds, most other subnational governments will lack the size and sophistication to do that. In addition, the financial markets for bond issues are likely to remain thin in the future. One option would be to create a financial intermediary that specializes in lending to local governments on a strict business basis. Such a financial intermediary would be able to on-lend loans and grants from international lenders and could offer technical assistance to subnational governments on project development.

On the use of cost recovery fees. Metering of services and charging full cost recovery fees will be necessary for the sustainable development of urban services such as water, sewerage, sanitation, and transportation. The capacity of subnational governments to borrow for this kind of capital investment project will depend on their proven ability to repay loans. This latter can be ensured by setting aside in escrow accounts sufficient fee revenues from the operation of these services.

User charges for general government services such as education, health and roads are also generally desirable. However, adequate safeguards need to be used to protect the poor. Also transparent records need to be kept to ensure the proper use of these funds. Revenues from user charges should accrue to the government level responsible for the service. However, that government may encourage successful implementation by sharing the proceeds with the particular agency or spending unit providing the service and also in charge of collection.

On the involvement of the public sector in economic activities. Within the framework provided by its economic system, the government should continue its policy of disengaging the budget at all levels of government from those activities that should and can be carried out in the private sector. This applies not only to general manufacturing and service activities but also to housing. Where there is pronounced market failure, as may be the case with low-income housing, more direct government intervention is justified.

V. FISCAL MANAGEMENT AND BUDGETING

Budgeting is a key component of a decentralized system of subnational finances. Without adequate budgetary autonomy there is no real possibility of attaining the efficiency gains associated with fiscal decentralization. Budgetary autonomy means that subnational governments have (some) discretion regarding the level of services they deliver as well as their mix. Budgetary autonomy also means that subnational authorities are able to decide how to produce public services, in particular what inputs to hire and how much to pay for them.

Budget institutions and budget process are important for a decentralized system of intergovernmental finances because they provide the mechanism to translate taxpayer preferences into spending decisions and because they help maintain subnational government officials accountable to taxpayers.

This section of the report examines the degree of budgetary autonomy, the vertical structure of budget relations, and the three stages of the budget process (preparation, execution, audit and evaluation) at the subnational level in Vietnam.

A. Existing Budget Institutions and Process

The current extent of budgetary autonomy. Subnational governments appear to have little budgetary autonomy. However, as with many other aspects of subnational finance in Vietnam, there is considerable confusion about this point. The central government's formal control of subnational budgets takes many different forms:

- all wages and salaries of subnational government employees are set at the central government level;
- the Ministry of Finance issues strict guidelines for budget implementation to subnational governments;
- the central government has the authority to modify and even revoke any decision made by subnational governments;
- all capital expenditures made the provinces with their own funds, it would appear, must be approved by the central government.¹⁴

Vertical budget relations. Up to the enactment of the 1996 Budget Law, vertical budget relations, involving the central and provincial governments as well as districts and communes, loosely followed the Soviet model.¹⁵ Only provincial governments dealt directly with the Ministry of Finance and other agencies at the central government level. Revenues and expenditure assignments in the district budgets were determined by the provincial governments.¹⁶ However, the discretion of provincial governments vis-a-vis

¹⁴ Previous studies of intergovernmental finances in Vietnam disagree on this point. The mission also got conflicting views from field visits to subnational governments.

¹⁵ For a more complete description of this model, see, for example, Christine Wallich, "Intergovernmental Fiscal Relations: Setting the Stage," in Christine Wallich, editor, *Russia and the Challenge of Federalism* (Washington, World Bank, 1994), pp. 19-63, or Jorge Martinez-Vasquez, Charles E. McLure, Jr., and Sally Wallace, "Subnational Fiscal Decentralization in Ukraine," in Richard M. Bird, Robert D. Ebel, and Christine I. Wallich, editors, *Decentralization of the Socialist State: Intergovernmental Finance in Transition Economies* (Washington, World Bank, 1994), pp. 281-319.

¹⁶ Surprisingly, some provinces do not appear to have a district level of government. The only explanation the mission was given for this was that some provincial governments simply did not comply with the government law on

district governments has been for the most part only nominal. Although provinces have been “free” to establish their own expenditure standards with the districts, in doing so provincial governments had to follow central government norms regarding expenditures per capita and the like. In addition, the system was not entirely hierarchical: districts at the third tier of government have played no role in determining the budgets of communes at the fourth tier of government. Communes have been allowed by their provincial government to retain a share of the land tax. Communes have also received some minor subventions directly from the provincial government. The 1996 Budget Law is likely to change the vertical relationships among subnational governments, but this structure is still to be developed through regulations.

Budget preparation. The budget process at the subnational level officially begins some time between June and August when the Ministry of Finance issues the budget circular and provincial governments start their initial forecast of revenues. Subnational governments are required to follow centrally determined budgeting procedures. The expenditure and revenue budget proposals submitted by the provincial governments to the Ministry of Finance comprise the consolidated budget for the provincial governments and all district governments within the province.¹⁷ Expenditure projections are based on a centrally determined set of norms (discussed below). The expenditure requirements minus forecasted own revenues set the amount of the consolidated provincial budgets that have to be covered by revenue sharing and, if needed, a general subvention. A general subvention is granted to the province when the forecasted revenues from tax sharing, set at the maximum sharing rates of 100 percent, are not sufficient to cover the expenditure requirements net of (forecasted) own revenues.

The current budgeting process requires subnational governments to forecast their own revenues and the revenues from taxes shared with the central government. Both sets of forecasts determine the sharing rates granted to the provincial government and the level of the subvention, if any. The provincial government revenue forecasts are based on initial national forecasts and targets prepared by the Ministry of Planning and Investment. The main task of the provincial governments is to adjust the initial forecasts to local economic conditions, often taking into account expected performance of individual enterprises.

The final budget proposal approved by the Ministry of Finance is the result of several rounds of negotiations often involving trips by the provincial authorities to Hanoi to negotiate with the Ministry of Finance. After the Prime Minister submits the state consolidated budget to the National Assembly and this body approves it, the provincial governments proceed to vote their own budgets, which include the financial resources that are passed along to the districts and communes. The People’s Council of the province approves the budget allocations for the provincial government and for the districts. The People’s Council at the district level approves the district budgets. The budget approval process at the subnational level has limited significance because subnational governments have, at present, little autonomy to reallocate funds from one budget category to another after they are approved by the National Assembly. However, subnational governments do have discretion to spend “surplus collection” funds in any way they want to

the creation of districts.

¹⁷ Up to now, these consolidated provincial budgets have excluded the budgets of the communes. The 1996 Budget Law explicitly incorporates commune budgets into the regular budget process.

other than on wages and salaries.

All subnational governments must operate with balanced budgets. However, expenditures typically exceed budgeted amounts because the “surplus collections” are not included in the budget approved by the National Assembly. For all effective purposes there appear to be no extra-budgetary funds at the subnational level in Vietnam. Extra-budgetary funds are still used widely in many countries in transition as a way to grant subnational governments some budgetary autonomy. Flexibility in the use of “surplus collections” appears to be the substitute for extra-budgetary funds in Vietnam. Although the Vietnamese practice has the advantage of encouraging tax collections at the subnational level, the use of “surplus funds” seems to be subject to the same lack of scrutiny as extra-budgetary funds are in other countries in transition.

Subnational governments can have financial reserve funds but draw on them only for unforeseen emergency expenditures and with prior approval of the National Assembly at the central government level. The reserve funds are supposed to be replenished in the following fiscal period. Subnational governments are allowed to borrow only for capital investment purposes. So far very few subnational governments have actually borrowed.

The use of norms. The formulation of budgets at the subnational level is based on expenditure norms. The norms are developed by the Ministry of Finance in consultation with the Ministry of Planning and Investment and the relevant line ministries.¹⁸ These norms have been used to provide an expenditure ceiling in budget requests and to distribute available resources among subnational jurisdictions. Rather than the massive detailed norms used in the Soviet budgeting system, Vietnam has used a simpler set of norms. These norms come in two types: financial norms, which specify the amounts of funds for a particular activity most often on a per capita basis; and physical norms, such as pupil/teacher ratios or class size. The financial norms in some cases try to capture differences in needs by providing different levels of funding according to the population in five different geographical zones (cities, plains, midland and coastal areas, low mountains and remote areas, high mountains and islands.) This differentiation for needs is used for some types of expenditures, for example basic education, but not for others, for example, vocational, technical, and higher education. In the latter types of expenditures, the same expenditure norm is used throughout the national territory. In the case of maintenance expenditures for infrastructure and equipment, specific norms are used based on the nature of the physical asset and they are the same throughout the country.

The actual budgets are not the result of the direct application of the norms. The budget proposals submitted to the Ministry of Finance by the provincial governments based on these norms are routinely modified by the central authorities according to available budgetary resources. These latter have been specified in a previous step by the Ministry of Finance to fit into the consolidated public sector spending and the macroeconomic envelope of the government.

The final budget allocations to the provincial governments, those approved by the National Assembly

¹⁸ The norms are not specified in the budget circular sent out by the Ministry of Finance at the start of the budget cycle. They are contained in separate decrees and inter-ministerial circulars, which are updated from time to time.

after submittal of the consolidated budget by the central government, bear a variable relationship to the norms used at the beginning of the process.

Capital budgeting. The budget process in Vietnam separates recurrent and capital expenditures and these two budgets are contained in independent documents. Capital budgeting is the responsibility of the Ministry of Planning and Investment. The capital budget is based on the requests from line ministries and subnational governments. The capital projects submitted by the provinces to the Ministry of Planning and Investment are prepared and appraised by the provincial or city committee for capital investment projects. The practice has been for the provincial governments to submit a long list of investment proposals to the Ministry of Planning and Investment from which only a few are eventually selected.

A major reform in the capital budget process is that, beginning fiscal year 1997, the Ministry of Planning and Investment will base the annual capital budget on a three-year rolling Public Investment Programme (PIP).¹⁹

The vast majority of capital investment projects at the provincial level, approximately 90 percent, is financed with central government funds. Other sources of capital funding at the subnational level include local government own revenues, budgetary savings, surpluses from collections, and a small amount of borrowing. For those projects financed with central government funds, subnational governments have zero discretion.

For the most part, districts and communes have no capital expenditure responsibilities.²⁰ Even though most of the capital expenditures are carried out by the central government, the provincial governments play a major role in maintaining public infrastructure.

Budget execution. The budgets approved by the National Assembly are forwarded not only to the provincial governments but also to the local offices of the State Treasury.²¹ Funds are credited periodically to each spending agency's Treasury account. Up to now the role of the State Treasury has been simply to transfer funds and make payments within the limited amounts determined by the budget allocations. The Treasury has not examined the purpose of the expenditures nor monitored these expenditures against the

¹⁹ The first PIP, in draft form, has been put together with the technical assistance of the UNDP.

²⁰ Here, as in any other area of intergovernmental finance in Vietnam, there is considerable confusion as to actual practices. For example, it is commonly stated in previous reports that the responsibility for school construction is with the districts and communes. In reality, it appears that most of the capital investment is realized through the provincial budgets. The answer also seems to depend on how these investments are measured. Apparently at the commune level local contributions in cash and in kind accounted for half of the costs of rural road improvements between 1991 and 1995.

²¹ The State Treasury was established in 1990 with responsibility for managing the distribution, cash management, control, accounting, debt management, and reporting of government finances at all government levels including local governments and state enterprises. However, in its relative short existence the new Treasury has not been able to implement effective programs in all these areas especially at the local level.

budget subcategory allocations. Such monitoring has been the responsibility of the Division for Administrative Services in the provincial administrations. There is ample awareness that the monitoring provided by this agency has had limited effectiveness. This has contributed to the generalized perception in Vietnam that spending agencies at all levels de facto have been able to use funds for purposes not strictly in line with their budget appropriations.

Beginning in 1997, plans are for the Treasury to introduce a warrant system which will serve to check the legitimacy of all expenditures at the commitment stage. These ongoing reforms will give the Treasury a more preeminent role in the internal control and audit of public expenditures.

Budget audit and evaluation. Until 1995 the Ministry of Finance was in charge of all ex-post audits. In theory, these audits were carried out by inspection teams based on the reported financial statements from all spending units, including subnational governments. Since 1995 ex-post audits have been carried out by a new agency called the State Audit Office. This agency still depends on the central government executive and it does not respond directly to the National Assembly. At present, there is no institution charged with carrying out evaluations of government programs or projects at any level of government in Vietnam.

B. Criteria for Evaluation

The realization of the efficiency gains associated with decentralization requires a significant amount of discretion at the subnational level, regarding both the level and composition of services assigned at the local level and the mode of delivery for these services whether directly produced in the public sector or contracted out with the private sector. This discretion allows local officials to be responsive and accountable to the needs and preferences of local residents and to deliver services at least possible cost.

In order for a decentralized system of subnational finance to work properly, that is to allow for the realization of efficiency gains, there needs to be substantial separation among the budgets of the different levels of government. Lower-level governments can depend on the transfer of funds from upper-level governments, but these transfers should be predictable and stable over time. Without these attributes, lower-level governments would not be able to plan ahead or manage their affairs in an orderly and efficient way.

Regardless of the degree of decentralization, budgeting at the subnational level should meet adequate and transparent standards and criteria in all phases of budget preparation, execution, and audit and evaluation.

C. Appraisal

On budgetary autonomy. It is hard to determine with any certainty how much freedom current practices leave to subnational governments. On the surface it appears to be very little. However, in practice there may be more. Because there is no consistent follow-up and control, subnational governments may actually have considerable discretion on what they do. The different practices among provincial governments in organization and process reinforce this presumption.

The issue of budgetary autonomy at the subnational level was discussed intensely in recent years. The 1996 Budget Law does address the issue of subnational governments' autonomy to formulate their own budgets. However, as in other areas, the Budget Law is non-committal here. Article 25 of the Budget Law, which specifically deals with how much power to give to the subnational People's Councils to develop their own budgets, awaits yet another regulation for its full development.

On subnational fiscal relations. The 1996 Budget Law has reduced the dependency of district and commune governments on provincial governments by means of listing revenue and expenditure assignments for each of these three levels of subnational governments. However, concrete expenditure and revenue assignments still have to be spelled out in government regulations. Provincial governments will still determine the tax sharing rates and the level of transfers to be received by the districts. Both sharing rates and transfers are supposed to be stable for a period of 3 to 5 years. It remains to be seen if provinces will be able to respect this provision. Their ability to do so will depend to a large extent on whether the central government obeys this same provision of 3 to 5 year's stability vis-a-vis provincial governments.

On budget preparation. As in the former FSU, the budget system lacks enough detail for one to study the efficiency of public expenditures and the budget process still involves too much negotiation. There is a strong negotiation element in the forecasts of provincial revenues. Subnational authorities have an incentive to underestimate their revenues because if collections at the end of the year actually exceed budgeted targets, local authorities get to keep all excess collections for local taxes and a share of excess collections for national shared taxes. These surpluses are the only practical avenue to divert additional resources toward local expenditure priorities. Subnational governments are less accountable for the use of these funds since they typically are not included in regular budget appropriations and little information is provided on them in ex-post expenditure reports. On the other hand, the Ministry of Finance has an incentive to bring provincial revenue forecasts up so that tax sharing rates and general subventions can be reduced. However, this adjustment upwards still has to leave enough incentive to the provincial authorities to exert greater effort in collections.

Negotiation is also present in setting up the expenditure budget. The first round of expenditure proposals is based on preset norms. But because available funds are enough to cover the expenditure requirements arising from the application of norms, the Ministry of Finance routinely adjusts budget allocations downward and this process also involves negotiations and bargaining with the subnational governments. The negotiated approach to budget formulation leaves the door open for larger and richer subnational governments to use the budget process in their favor. Despite the declared intentions of the

government, it is not clear that the 1996 Budget Law has offered an alternative to the current negotiated system. The Ministry of Finance has been considering plans to reduce bargaining from the budget determination process. One approach being discussed is to discontinue the practice of having local governments submit their own revenue forecasts. However, the Ministry of Finance may not have all the information needed for forecasting local and shared revenues. More importantly, it would be politically difficult to eliminate bargaining as long as the funding system for local governments continues to be a “gap-filling” system.

The most innovative aspect of the budgetary process in Vietnam is the sharing of “collection surpluses” between the central and subnational governments.²² One of the perceived advantages of this system is that provincial governments will have an incentive to exert a greater effort in tax administration. Even though the tax administration system is a central government institution, tax administration officials are subject to double subordination to the province's authorities. The People’s Committee and the People’s Council at the subnational level are expected to exert pressure on local enterprises to pay taxes in arrears and apparently have had some success at this.²³

The question is whether or not this arrangement to share surpluses will be time-consistent. The new budgeting process outlined in the 1996 Budget Law still allows the MOF at the central level to change the sharing rates for a variety of taxes, and it is likely that negotiations would reflect the ability of provincial governments to exceed budgeted revenue targets in the past. To the extent that this happens, the provincial governments would lose much of the incentive to increase tax collection efforts. The promise in the 1996 Budget Law to keep revenue assignments stable for a period of 3 to 5 years may help with this problem. However, it is quite uncertain that this promise on stable financing arrangements will actually be delivered.

On the use of norms. The use in Vietnam of general capitation norms to formulate budget proposals is a significant improvement over the use of a much more detailed set of norms, often based on capacity, as practiced under the Soviet budgeting system.

However, there are several important problems with the current use of norms for budget formulation purposes in Vietnam. Often there is a lack of consistency between funding or financial norms and what can be called second tier technical norms. Such technical norms specify staffing ratios or mandate expenditure ratios; for example that expenditures on wages and salaries or supplies and materials should be a fixed percent of total expenditures. If the funding norms are followed then the technical norms are not, and vice versa.

Financial norms also appear to be set quite independently of the perceived costs of provision.

²² One hundred percent of the surpluses from provincial revenues stays with the province budget and the surpluses for national taxes are shared with the central government. The sharing arrangements are still to be decided in future regulations.

²³ Reportedly it is not unusual for officials of the Communist Party in the provinces to get involved in persuading enterprises to pay their taxes on time.

Subnational governments often complain about how inadequate this funding is. Past studies of the budget process and intergovernmental relations carried out by international organizations have also unanimously criticized existing norms because they do not appear to be based on realistic estimates of the costs of providing “adequate” standards of service and maintenance of infrastructure.

It is not very clear for what purpose the norms are used at the present time other than imposing a limit to the budget requests from spending units. As already mentioned, the Ministry of Finance, in the first round of budget review, cuts appropriations well below those arising from the strict application of financial norms which are themselves already inadequate. Because the Ministry of Finance scales down the budget proposals submitted by the provincial governments, the current system of norms, it would appear, may only serve to determine the relative share of each province in the total resources planned for subnational governments. However, the relative shares subnational governments end up with are not necessarily proportional to their submitted budgets since the cuts, adjustments, and bargaining can vary by expenditure item and by subnational government. If all that norms are used for is to limit budget requests, as appears to be the case, this can be accomplished more easily by giving subnational governments budget caps or ceilings by major type of expenditure when the budget circular from the Ministry of Finance is sent out. This is the practice followed by most countries.

Other problems exist with the current use of budgetary norms. Some of the financial norms still reflect capacity, such as in the case of number of hospital beds in the health budget. The use of these norms based on physical capacity, however limited, is inefficient since it gives an incentive to preserve excess or obsolete capacity by spending units. It also leads easily to inequities if the existing physical capacity differs significantly across jurisdictions. Vietnam does appear to offer significant disparities in physical infrastructure across provinces, as well as within provinces. A similar problem potentially develops in the norm for administration expenditures which is based on the number of employees. Those subnational governments that have relatively more employees and may be operating less efficiently are the ones that may be receiving more funding.

A problem commonly pointed out is that some of the norms could better reflect need, for example, by using number of school-age children rather than population for the formulation of subnational government education budgets.

The use of norms in the process of budget formulation discourages the setting of explicit program objectives or output requirements for budgetary activities. Instead it converts the budgetary process into an input-oriented activity making it more difficult to establish budget performance criteria and budget evaluation in general.

On capital budgeting. The approval process of capital expenditure requests by the Ministry of Planning and Investment continues to be poorly understood at the subnational level. The selection process of capital investment projects financed with central government funds has been both complicated and non-transparent. According to the MPI (Ministry of Planning and Investment, previously the Planning Committee), projects have been selected by weighting several factors of the proposals submitted by the

provincial governments including the completion of already started projects, the importance of the sector to central government policies, and the level of development of the subnational government.

For capital investment projects at the subnational level, plans are to retain the current centralized system of submissions and approval of projects through the MPI. The approved projects would be incorporated in the Public Investment Programme (PIP). The intention is also to continue the current policy of giving the People's Councils no discretion whatsoever in centrally financed projects. However, the transparency of the selection process, it is hoped, will be increased with the full implementation of the PIP. For the time being the PIP is not yet integrated into the budget process.

The existing level of autonomy of small projects directly financed by the provincial budgets is unclear. The common wisdom in previous reports is that practically all investment projects even down to small projects at the commune level have to be approved by the central authorities. Some subnational governments stated to the mission that a provincial project financed with provincial funds needs to be approved only by the provincial committee unless it is a very large and significant project. Typically projects with values over 15 billion dong have to be central government projects.

On budget execution. Budget execution reports are produced by local governments on a monthly and annual basis. These reports on revenues and expenditures are supposed to go to the People's Committees of the local governments and to the Ministry of Finance. However, the Ministry of Finance does not seem to have complete and updated information on budget execution for subnational governments. The Ministry of Finance is supposed to be able to check budget execution the local level through the Treasury. But it is unclear whether this monitoring capability is already functional. The Treasury prepares a 6-month and an annual report of budget execution, and the final accounts of the consolidated executed budget are presented to the National Assembly 8 to 10 months after the end of the fiscal year. Despite these requirements, there is a general impression in Vietnam that there is not enough control and accountability of spending units, including, and foremost, of subnational governments. The full development of the Treasury with commitment accounting and controls should help improve the current situation.

On budget audit and evaluation. This part of the budget process is acknowledged to be the weakest in Vietnam's budgetary system. Besides the lack of tradition and inadequate institutions for budget audit, it appears that auditing is considered by most spending units as interference in their internal affairs. There is little internal audit other than the (weak) control currently exercised by the Treasury system.

The external audit agency created in 1995, the State Audit Office, has been placed within the executive. The State Audit Office also lacks adequately trained personnel and material inputs to carry out the gigantic task of performing ex-post audits at all levels of government, including local governments and state enterprises. In addition, neither the State Audit Office nor any other government agency performs evaluations of government budget programs. The main problem with the assessment of performance is that there remains in Vietnam a high degree of confidentiality accompanying any type of budget information and a lack of transparency in budget decision-making and accountability in budget performance.

Unfortunately, the problems of audit and budget evaluation are practically ignored in the new Budget Law. The only exception is Article 24 (3), which allows the Ministry of Finance to report on implementation and effectiveness of utilizing budget funds. This article appears to grant the Ministry of Finance powers to conduct budget evaluations, but this issue is not developed any further in the Law.

D. Options for Change

On budgetary autonomy. There exists here a clear tradeoff between the need to maintain budgetary discipline and control and the need to increase the efficiency of public expenditures by allowing spending units more flexibility and freedom to use their resources. The choice of the degree of budgetary autonomy to be granted to subnational governments in Vietnam lies along a continuum between two extreme cases. There may be complete lack of autonomy if subnational budgets are approved by the central authorities and subnational spending units have no discretion to transfers funds from item to item within a budget category. At the other extreme subnational governments may be granted absolute autonomy to formulate their budgets and local spending units granted freedom to spend their budget allocations in any way they see fit.

On balance, Vietnam's current approach gives too much emphasis to control at the expense of efficiency. Expenditure management could be improved by allowing fiscal authorities more discretion over the allocation of funds within their purview. This would require removing most of the financial norms and technical norms on input ratios which dictate how the resources should be allocated within each sector. Local managers would be free to move resources among different items in a category of expenditure. The control emphasis would be shifted from budget allocations based on inputs to allocations based on specified outputs and goals. Local governments could still be subject to minimum expenditure requirements in some key expenditure areas of national importance such as health and education.

One of the possibilities considered by the Ministry of Finance to develop Article 25 of the Budget Law is to give the People's Councils autonomy to change funding for particular budget items, including the total wage bill, as long as there are no violations of the law.²⁴ This would appear to be a reasonable compromise as long as the legal environment does not preempt significant levels of discretion.

On subnational fiscal relations. There are many models to organize the vertical structure of budgets, in particular which powers of decision and control are granted to upper-level governments over lower-level governments. A particular issue relevant to Vietnam is how much discretionary power should be granted to second-tier provincial governments over lower-level governments, the districts and communes.

Given that Vietnam has a unitary system of government, ultimate decision powers and controls should

²⁴ One such violations would be to change wages for individual employees, which still would be set by the central government.

reside within the central government. However, within this unitary structure there is room for granting considerable discretion at each level of government. The 1996 Budget Law is consistent in that it applies the same principles for central-province relations as for province-district relations. The new framework for province-district relations is incomplete or inadequate for the same reasons that the new framework for central-province relations is inadequate. A predictable and stable system of revenue sharing and transfers is as desirable for districts vis-a-vis provinces as it is for provinces vis-a-vis the central government.

All the reasons used to justify a transparent and stable system of finances between the central and provincial governments apply equally to the relationship between the provincial and district governments.

A finer point that should be allowed for in the design of a vertical structure of subnational budgets is that not all local governments have the same management capabilities. In granting more autonomy to subnational governments, it will be desirable to keep the system flexible and to introduce more autonomy in phases.

On budget preparation. There are two basic choices for reform in the process of budget formulation. These two choices depend on the level of autonomy granted to subnational governments to formulate their own budgets, which in turn depends to a great extent on the model chosen to finance subnational governments. At one end of the spectrum, subnational governments could be granted the right to formulate their own budgets autonomously from the central government budget. This would require sources of revenue in own taxes, shared taxes and transfers that are stable and predictable. At the other end stands the current approach requiring central government approval of all subnational budgets. In between the two extremes there may a reasonable compromise giving better balance to the two objectives of control and efficiency. But, even if the current approach is kept, there are measures that can be taken to facilitate budget preparation at the subnational level.

The stability and predictability of funding sources (shared taxes and transfers) as envisioned by the 1996 Budget Law would be a significant step in the right direction. Other aspects of current practices could be improved. For example, provincial governments are now required to produce their initial budget estimates usually within one month after receiving the budget circular from the Ministry of Finance. This is not sufficient lead time and the practice by subnational governments is to start preparation much earlier using as a basis the previous year's circular and instructions plus any interim decrees. It would be helpful for planning at the subnational level to start the budget cycle early in June without delays. (As noted above, the budget cycle sometimes does not start until as late as August).

On the use of norms. If it is known a priori that available funds will not match funding needs arrived at by the application of norms, little is gained by using a norm approach for budget formulation.²⁵ It would be preferable to redefine the level of funding in the norms to reflect the availability of funds or simply to do away with the system of norms and use an incremental budgeting approach which allows budget requests

²⁵ Even in the rare cases that norms are met, provinces often complain that funding would be insufficient anyway. In Hanoi the cost of primary education is said to be twice the norm.

for the current year on the basis of rolling budgets from the previous year.

On capital investment. In the case of capital investments there are good reasons to keep central control of those projects financed with central government funds. However, public expenditure efficiency can be increased by letting local authorities participate in the design and implementation of the project. Subnational governments need to have a more direct involvement in the capital budgeting process. This involvement should not only include the preparation stage but also ownership of the projects through co-financing, which could be arranged with matching grant programs for particular types of infrastructure. The matching rates could be adjusted to the ability to pay of provincial governments. (Transfers are discussed in Section VII of this report).

For those projects financed with subnational funds, there is in general no good reason to keep the current requirement of prior approval by the central authorities, although it might be desirable to require information reporting, to facilitate macroeconomic management. However, at the provincial level the small amount of investment that takes place rarely includes previous analysis or evaluation of the projects. At some point in the future, especially if subnational governments will be undertaking a more significant number of capital investment projects, it will be desirable to require that each provincial government develop its own PIP.

On budget execution. Internal control of budget execution requires that spending units not commit budget resources without a warrant or authorization from the budget authority which matches the appropriations approved in the budget document. But, who should this budget authority be, the Ministry of Finance or the subnational government itself - for example the provincial finance department? Given that the Treasury function in Vietnam has been extended through the subnational level, it is logical to keep this authority within the Treasury at the central level. A compromise rule for the movement of funds may be to permit the subnational budget authority to shift funds within narrow budget categories (budget heads) and to require previous approval from the Ministry of Finance for the transfer of funds across broader budget categories (budget chapters).

On budget audit and evaluation. Again the basic choice is similar in budget audit and evaluation: have them performed by central government authorities or delegate them to subnational governments. Given that Vietnam is a unitary state it may be desirable to keep many of these functions at the central level. For example, internal control and audit of subnational governments should be carried out, as is now the case, by the Ministry of Finance; and external audit would be carried by the State Audit Office. However, placing the external audit agency within the executive branch of government goes against basic budgetary principles. This agency should be made independent or answerable only to the legislative branch of government, the National Assembly. For the case of budget evaluation, it would be desirable that the subnational governments themselves develop practices for the evaluation and assessment of their own expenditure programs so that any lessons learned from past performance can be incorporated directly into the new budgets. Special evaluation programs at the subnational level should be carried out by the State Audit office at the request of the government, the National Assembly or the People's Council.

E. Recommendations

On budgetary autonomy: The increase in efficiency associated with decentralization cannot be attained unless subnational governments are granted considerable discretion in the formulation of their budgets. Limitations to this discretion may be imposed by the central government by using, for example, minimum expenditure requirements for some types of expenditures of national interest such as education and health. Spending units at the local level should also be granted flexibility on spending decisions. To guarantee some control, spending units may be required to get permission from the province budget department before funds are reallocated across budget categories.

Subnational authorities should also have discretion on wages and salaries paid to local employees. Limitations may be needed to avoid local authorities' paying themselves large sums of money. This may be accomplished by requiring that the salaries for members of the People's Committees be approved by the People's Council.

On vertical budget relations. The most immediate step should be to implement the mandate in the 1996 Budget Law for a specific expenditure and revenue assignment between the central and provincial governments and between the provincial governments and their district and commune governments. The medium-term goal should be to allow for relative separation between the budget processes at each level of government based on the fact that subnational governments would be able to plan their own budgets based on the stable and predictable assignments of expenditure responsibilities and revenue sources and transfers from upper-level governments. This goal may be implementable only after some years and after some systems are tried over a stable period of 3 to 5 years.

On budget preparation. Subnational governments should be able to prepare their own budgets in a timely fashion. The budget process should also be objective and not subject to discretion and undue influence of authorities of the next higher level of government. Some of the current budgetary principles such as the non-existence of extra-budgetary funds, the balanced budget principle, the existence of budgetary reserves and the permission to borrow funds for capital expenditure purposes should be retained. The current practice of sharing "surplus collections" with subnational governments should also be retained, but the use of these resources should be subject to the same reporting and control requirements as the rest of the budget.

On the use of norms. The government should not go back to building a detailed set of norms based on costing different services. Although a few countries (e.g., Denmark and Japan) do this sort of exercise, a detailed set of norms can be costly and misleading. The inherent problem with detailed norms is that the cost of provision will differ with the level and quality of the service and it may differ across space and over time. Besides giving a misleading impression of concreteness, detailed sets of norms are costly to develop and update. The reality is that the current system of norms is judged to be grossly inadequate because the government has lacked the information necessary to cost "standard" levels of service. These conditions are not likely to change in the future.

It would be better for Vietnam to adopt a rolling budget approach in which funding for agencies is initially based on the last-year allocation adjusted for changes in policy objectives, inflation, and any other considerations impacting the relative budgetary significance of individual expenditure items. One problem with a rolling budget incremental approach is that it carries a lot of inertia and may be slow to change to rearranged expenditure priorities. For example, provinces and budget categories that have received substantial funding in the past will continue to do so, in the absence of explicit--and perhaps politically difficult--decisions that they should not. However, a budgeting approach based on norms may be even less responsive to changes in budget priorities. Another problem with a rolling incremental approach to budgeting is that it may not be sensitive enough to differences in needs across subnational jurisdictions. This does not have to be the case, however. In addition, a well designed equalization transfer which takes into account differences in needs and capacity across jurisdictions is a better way to approach the problem of fiscal disparities.

On capital budgeting. The process of approval for capital investment projects submitted by subnational governments and their acceptance into the central government PIP should be made transparent and part of well announced central government policies. In particular, matching grant programs developed to stimulate local investments in areas of national interest should be implemented through explicit formulas and be entirely integrated in the PIP. For capital investment projects financed with central government funds, subnational governments should be made whenever feasible participants in both the design and implementation of the project. For those capital investments financed with subnational government funds no prior approval by the central authorities should be required, but provincial governments should be required to develop their own PIPs.

On budget execution. The current system of budget execution that extends the Treasury to the subnational governments should be kept and strengthened. A national or central government treasury system can be quite effective for even highly decentralized systems of government as long as subnational governments and their spending units are allowed to keep their own subaccounts in the system. Besides the accounting and expenditure control systems, there are other functions of the Treasury that will become more important at the local level including cash management and debt monitoring.

On budget audit and evaluation. The Government should pay special attention to strengthening the audit and evaluation element of the budget process at all levels of government, and in particular at the subnational level, where the problems appear to be more acute. In the absence of reporting and of control and audit systems that allow increased accountability of subnational officials in the use of public funds, there may be little point in trying to bring about more autonomy to subnational governments. At both the central and subnational level there is a need to develop an internal audit capacity. This should be performed by the Ministry of Finance or by a separate agency directly attached to the office of the Prime Minister. The Budget Law actually gives the Ministry of Finance internal control and power to audit all organizations receiving funds from the state budget; these would include subnational governments although these latter are not explicitly mentioned in the Budget Law. The external ex-post audit agency, the State Audit Office, should be made dependent on the National Assembly and be provided with adequate resources to carry out ex-post audits at the subnational level also. The government should also commence a program of budget evaluation with units located in the Ministry of Finance, the new State Audit Office, and the subnational governments themselves.

VI. REVENUE ASSIGNMENT

The tax system of Vietnam contains a number of anomalies that the government is committed to eliminating. First, the government plans to replace the turnover tax with a value added tax. Given the manifest disadvantages of turnover taxation, this is an highly important reform. For reasons to be spelled out below, the VAT should not be employed as a regulating tax. Second, excises are applied only to domestic production; import duties are employed to gain revenues from imports, as well as to prevent a competitive advantage for imports or to protect local production. Effective protection may be quite high in some sectors, due to the imposition of higher taxes (either import duties or excises) on finished products than on intermediate goods and capital goods. Vietnam should shift to a more conventional system in which excises apply equally to imports and domestic production and import duties are both much lower and much more nearly uniform. Third, the existing profits tax differentiates between various forms of ownership (state, foreign, etc). It would be more appropriate to have a unified system in which there is only one tax regime for all taxpayers. Fourth, individual income tax is currently levied only on those with very high incomes from labor and at extremely high rates; the tax does not apply to non-labor income.

It would be appropriate to convert the individual income tax to a conventional tax with a much broader base and much lower rates. The discussion that follows assumes that these changes will be made. However, problems with tax assignment under the current regime are also discussed.

A. Existing Revenue Assignment

All of revenues from certain taxes (and other sources) are assigned entirely to a particular unit of government (central, provincial, district, or commune). By comparison, revenues from various other sources (“shared” or “regulating” taxes) are shared between two levels of government. The following lists the assignment of revenues contained in the Law on State Budget adopted in April 1996. An appraisal of revenue assignment is provided below.

Revenue of the central government. The central government receives all revenues from the following taxes and other sources:

- Revenues from exploiting and processing oil (including income tax from workers of oil firms);
- Profit tax from business accounted as a single unit;²⁶

²⁶ These are nation-wide activities in which the profits cannot legitimately be assigned to only one province, such as the post and telecommunications and electricity enterprises. The economic distinction between these enterprises, for which profits must be accounted as a unit, and others operating in more than one province, the profits from which are assigned to the province where the enterprise is registered, is not totally clear.

- Export and import duties;
- Excise tax;
- Revenues from utilization of budget capital;
- Transport fees;
- Dividends from state shares in joint ventures;
- Incomes from selling and renting state properties managed by central government authority;
- State capital returns from state-owned enterprises (depreciation and fees for the use of capital);
- Income from selling goods and services and administrative receipts from organizations under management of central government authority;
- Taxes, fees, and charges paid to the central budget (such as: fees from registration of natural resources exploitation; charges from airport use; charges for using air space of the territory...);
- Returns from state loans (both principal and interest);
- Withdrawals from state reserve fund;
- Grants to the government from foreign governments, non-government organizations and foreign individuals;
- Borrowings of the government;
- Revenues from state economic activities which the government determines shall be paid into the central budget, such as after-tax profits or income of state-owned enterprises; income from selling and renting properties managed and utilized by the State; capital returns from state-owned enterprises, capital returned from development support funds...;
- Other non-tax revenues as stipulated, and
- Revenue from the accrued balance of the central budget.

Revenues shared between central and provincial governments. The following are shared between central and provincial governments:

- Turnover tax;
- Profit tax or income tax of businesses (excluding tax on profits of businesses which must be accounted as a unit);
- Personal income tax (excluding tax on employees of oil firms);
- Natural resource tax;
- Revenues from renting land.

Revenue of provincial government. In addition to revenues from these shared taxes, provincial governments receive all revenues from these sources:

- Revenues from lotteries;
- Housing tax;
- License tax (except for license tax imposed on small businesses in communes);
- Registration tax;
- Other fees and charges determined by the government to be paid to provincial budgets;
- Income from selling and renting state properties given to provinces to be managed and utilized;
- Income from selling goods and services and administrative receipts of units under management of provinces;
- Voluntary contributions for provinces;
- Grants from organizations and foreign individuals sent directly to provinces;
- Other revenues as stipulated, and
- Revenue from accrued balance of provincial budget.

Subventions from the central government. Of course, some provinces also receive subventions from the central government.

Revenue sources of district governments. District governments receive all revenues from these

sources:

- Fees and charges from activities implemented and managed by organizations at district levels;
- Income from selling and renting state properties given to districts to be managed and utilized;
- Income from selling goods and administrative receipts from units managed by districts;
- Voluntary contributions for districts;
- Supplementary allocations from provincial budget;
- Other revenues as stipulated, and
- Revenue from accrued balance of district budget.

Besides the revenue items mentioned above, cities and towns having the status of districts (provincial-dependent cities and towns) are assigned part of tax on issue or transfer of land use rights and supplementary revenue from urban activities, as allowed by the government.

Subventions from provinces. Some districts also receive subventions from provinces.

Revenues of communes:

- License tax from small business;
- Slaughter tax;
- Fees from activities of units under management of communes;
- Revenue from selling and renting state properties that are managed and utilized by communes;
- Money collected from using public assets and land for public benefit;
- Revenue from selling goods and services and administrative receipts under the management of communes;
- Voluntary contributions for communes;
- Aid from organizations and foreign individuals sent directly to communes, and

- Other revenues stipulated.

Revenues shared between province and commune governments: Revenues from the following sources are shared between provincial and commune budgets.²⁷

- Tax on using agricultural land;
- Tax on transfer of land use right;
- Receipts from issue of land use right, and
- Land and housing tax.

Evolution of revenue assignment. Since 1990 there have been a number of changes in policy regarding the assignment of revenues between the central government, subnational governments, and regulating (shared) revenues. The most significant of these are the following. This evolution is summarized in Table VI-1.

²⁷ This list appears twice in the budget law. In the first instance it does not include the third item.

Table VI-1

Evolution of Revenue Assignment, 1990 to Present

	1990	1992	1994	1995	1996	Budget Law
1. Turnover tax	R	R	R	R	R	R: C/P
2. Excises	C	C	C	C	C	C
3. Profits tax	R	S	**	R ¹	R ¹	R:C/P
4. Individual income tax	*	*	*	S ²	R ²	R:C/P ²
5. Foreign trade taxes	S ³	**	**	R	C	C
6. Land use rights:						
Grant	*	*	50S/50C	30S/70C	S	
Transfer	*	*	C	50S/50C	S	R:P/Com
Agriculture tax	R	R				R:P/Com

KEY: C = central; S = subnational; P = provincial; Com = commune; R = regulating

*No information; **No information; presumably as before.

¹ Profits tax on nation-wide enterprises taxed as a unit accrue to the central government.

² Individual income tax of individuals employed in the oil and gas sector accrues to the central government.

³ Only taxes on minor amounts of foreign trade may have accrued to subnational governments.

Assignment to districts and communes. Before enactment of the new Organic Budget Law in April 1996, regulating taxes were shared only between the central government and subnational (translated “local”) governments. The new Budget Law extends assignment of revenues, including tax sharing, to the district and commune levels.

Profits tax. In 1992 the profits tax was converted from a shared source of revenue to a solely subnational source of revenue. This decision was revised in 1995, when the profits tax -- with the exception of tax calculated for nationwide enterprises as a unit, which was made a revenue source of the central government -- once again became a shared source of revenue. In 1996 withholding tax on foreign remittances, except those of joint ventures in the oil and gas industry, was added to the list of shared revenues. The new Budget Law clarifies that the profit tax (with exceptions noted above) is shared between the central and provincial governments.

Individual income tax. In 1995 the tax on high-income individuals, except that on employees working in the oil and gas industry, which goes to the central government, was a subnational source of revenue. However, in 1996 this tax was made a shared tax. The new Budget Law specifies that the individual income tax is shared between the central and provincial governments.

Land use rights. In 1994 all revenues from the transfer of land use rights, but only 50 percent of revenues from granting land use rights, accrued to the central government; the remaining 50 percent of revenues from granting land use rights were revenues of subnational governments. In 1995 these percentages were changed to the following: granting land use rights -- 70 percent subnational and 30 percent central; transfer of land use rights -- 50 percent each to central and subnational governments. In 1996 all revenues from both granting and transfer of land use rights were assigned to subnational governments. The new Budget Law provides that revenues from both these sources be shared between provincial and commune governments.

Agricultural land use tax. In 1990 the tax on the use of agricultural land was a shared revenue source. In 1996 this tax became a source of subnational revenue. The new Budget Law specifies that it is to be shared between provinces and communes.

Sales of housing. In 1994 all revenues from the sale of state-owned housing accrued to the central government. In 1995 these revenues were assigned entirely to subnational governments.

Taxes on foreign trade. In 1992 taxes on imports and exports (of small amount) were revenue sources of subnational governments. In 1995 these taxes were shared between the central and subnational governments. In 1996 revenues from taxes on imports and exports were converted to revenues of the central government.

Other taxes. Several important taxes have not changed categories during this period. Excises have constantly been assigned to the central government, and the turnover tax has been employed as a regulating tax. In the new Budget Law the turnover tax is shared between the central and provincial governments. Whereas the tax on natural resources began as a subnational revenue source in 1992, in 1996 it was made a regulating tax (shared between the central and provincial governments under the new Budget Law).

Tendencies and assessment. One can identify several trends in these assignments of revenues. First, there is the constant -- and appropriate -- assignment of excises to the central government. Second, there is the constant -- and less appropriate, but perhaps inevitable -- use of the turnover tax as a regulating tax. Third is the shift of certain taxes (e.g., taxes on foreign trade) to the central unit, where they belong. Fourth, is the (apparently sensible) shift of certain taxes (e.g., on the grant and transfer of land use rights) to subnational levels of government. Fifth is the designation of the profits tax as a regulating tax, following a period of shifting assignment. Sixth is the appropriate assignment of certain taxes on the oil and gas industry to the central government. Seventh is the sharing of excess revenues from taxes assigned to the central government with subnational governments. This is troubling, for reasons discussed below. Eighth is the extreme instability of some of the rules, which have changed every few years, often only to return the

assignment of a few years earlier.

Interpreting Tax Assignment. Tax assignment must be accompanied by rules interpreting such assignment. Some such interpretive rules are more sensible than others. Indeed, if interpretive rules are not sensible, then particular tax assignments that are potentially reasonable may be inappropriate. For example, in Kazakhstan revenues from excises are assigned to jurisdictions where production or importation occurs. This results in substantial exporting of taxes from one jurisdiction to another²⁸. A conceptually preferable rule would be to assign revenues from excises to jurisdictions where consumption occurs. If this is not possible, excises should be assigned to the national level, as in Vietnam, rather than being a regulating tax (or even worse, a tax assigned entirely to subnational governments). The discussion of current practice that follows comments on the interpretations of various assignments in Vietnam.

B. Criteria of Evaluation

Fiscal autonomy of subnational government. Decentralization of fiscal responsibilities has several advantages. Most obviously, it places responsibility for fiscal decisions closer to those affected by them than under a centralized system. Local officials may be more responsive than a central government to the needs of their constituency. This is especially important where tastes for public services are not uniform across the nation and there is not an overwhelming case for nationally uniform policies. Decentralization may allow local determination of both the level and composition of public spending.

A separate line of reasoning emphasizes the role of mobility of labor and capital in achieving an efficient allocation of resources. First, if labor is sufficiently mobile between jurisdictions, people may “vote with their feet,” moving to the jurisdiction that provides the choice of public expenditures and taxes that best fits their needs. In this sense, government provision of goods and services shares some of the benefits of market allocation of resources.

Second, competition among jurisdictions for the location of business can be quite salutary. Such competition helps assure that government is efficient and that tax payers get what they pay for. For these mechanisms to be effective, local governments must control both tax and spending policy.

Reward for tax effort. One objective of decentralization is to create a link between taxes paid and benefits received. Where that link is strong, there is an incentive for subnational governments to choose the tax rates their constituents are willing to pay, in order to provide the public services the constituents want. Where that link is weak, there is little incentive for tax effort.

²⁸ Note, however, that the concept of tax exporting is essentially meaningless *ex ante* in a system such as that employed in Kazakhstan and Vietnam, to the extent that sharing rates and subventions are adjusted to achieve a given budget target. See also *Fiscal Transition in Kazakhstan*, Asian Development Bank, 1996. For convenience this caveat is ignored in most of what follows. *Ex post*, tax exporting can be important, especially in a system such as that in Vietnam, in which dual subordination gives local officials substantial control over the amount of revenue collected.

Transparency and certainty. Democracy works best when institutional arrangements are transparent and certain. In the field of IFR, this requires that assignment of expenditure responsibilities and revenue sources should be stable and predictable.

Tax exporting. Among the problems that can arise in a decentralized system is the exporting of taxes levied by one jurisdiction to residents living in another. Tax exporting would occur, for example, if (as in Kazakhstan, but not Vietnam) revenues from excises were assigned to the jurisdiction where production or importation occurs. One would expect the burden of such taxes on imports to be borne primarily by consumers of imported goods, most of whom ordinarily live in other jurisdictions.

Tax exporting is not fair. Moreover, in a system in which subnational jurisdictions are given latitude to choose their own tax rates, the ability to export taxes to nonresidents reduces the local cost of public services and may encourage overexpansion of the public sector.²⁹ In a federal system in which there are few restrictions on the taxing power of subnational governments, tax exporting may be relatively common and difficult to prevent. See Box VI-1 on tax exporting in the United States. However, in a unitary system, such as that in Vietnam, where taxing powers are assigned by the central government, there is little reason not to design a system that will minimize undesirable tax exporting.

Box VI-1: Tax Exporting in the United States: Lessons for Vietnam

The constitution of the United States provides the states with virtually unlimited authority to impose any tax they wish, subject only to quite limited and general restrictions, the most important of which involve non-interference with interstate and foreign commerce and compliance with due process. (This broad authority has been circumscribed in only minor ways by federal legislation.) Although taxpayers have recourse to the courts if they believe their constitutional or legal rights have been violated, federal courts have been extremely reluctant to limit the states' taxing authority, absent clear and flagrant violations. One of the many undesirable results of such a system of independent and uncoordinated legislation is the high degree of tax exporting that can occur.

Tax exporting--the shifting of tax burdens to non-residents of the taxing jurisdiction--is generally undesirable. It is unfair, it undermines the accountability of government, and it may induce overexpansion of the public sector. In some cases tax exporting is not problematical, however, as when tourists pay higher taxes imposed to cover the costs they create (for example, for extra police protection).

²⁹ It should be noted that not all tax exporting is bad. For example, if benefits of public services are exported, it is appropriate that taxes levied to pay for them also be exported. The discussion in the text and remainder of this section ignores this qualification.

Box VI-1: Tax Exporting in the United States: Lessons for Vietnam-1 (continued)

Tax exporting can take many forms, reflecting the interplay of market forces in determining the incidence of taxation (who bears the burden of taxation). Under certain conditions (especially state domination of the relevant market for the taxed product), taxes can be exported to non-resident consumers. More commonly they may be exported to non-resident owners of the factors of production (land, labor, and capital).

In the United States tax exporting takes many forms. States that are especially popular with tourists (for example, Florida, Hawaii, and Nevada) do, indeed, impose taxes intended to be paid largely by tourists; these include taxes on hotel occupancy and taxes on gambling.

In the United States much ownership of land and natural resources is in private hands. Taxes on land and natural resources, including property taxes, are exported, to the extent that they borne by non-resident owners.

Delaware imposes extremely high corporate franchise taxes (equal to some 20 percent of state revenues), in order to extract revenues from corporations that take advantage of the state's relatively lax incorporation statutes. (In the United States a corporation incorporated in one state can operate in other states). More generally, state corporate income taxes may be borne by non-resident owners of corporate shares.

Quantitatively the most important form of tax exporting results from the ability to deduct income and property taxes levied by state and local governments in calculating federal taxable income. (Since the deduction reduces federal taxable income, the federal government, in essence, pays a fraction of state and local taxes equal to the marginal tax rate of the taxpayer). The important lesson for Vietnam from this experience is that surcharges levied by provincial governments should not be deductible in calculating liability for the income tax of the central government, unless they constitute a business expense.

In a federal system in which the states retain the authority to impose taxes of their choosing, it is very difficult to prevent tax exporting. In the United States the only remedy is to be found in the courts. (Of course, taxpayers may also attempt to have tax laws changed legislatively.) In the early 1980's the U.S. Supreme Court rejected the view that tax exporting was sufficient grounds to find a tax on coal--argued to be borne by non-resident consumers--to be in violation of the constitutional provision prohibiting interference with interstate commerce. The Court noted, among other things, that it could not be expected to undertake the complex economic analysis needed to determine the incidence of taxation.

It is much easier to address the issue of tax exporting in a unitary system of government. The rules of tax assignment can be designed to minimize the likelihood of tax exporting. For example, excise taxes can be assigned to the province where consumption occurs or to the central government, instead of to the province where production or importation occurs. Similarly, revenues from individual income taxes should go to the province where people work or live, and not to the place where their employer is registered or has its primary place of business. It may also be appropriate not to allow subnational surcharges on the enterprise income tax, because of the possibility of tax exporting.

C. Appraisal

The criteria against which revenue assignment is judged include subnational autonomy in the choice of tax rates, subnational realization of revenues resulting from increased tax effort, transparency and certainty, and inability to export taxes (in excess of the cost of public services financed by such taxes). On these criteria Vietnam's present system of IFR fares rather badly. Governments of subnational jurisdictions have essentially no autonomy over the level of tax rates applied to economic activity occurring within their jurisdiction. They can exercise tax effort only because of the dual subordination of the tax administration to subnational governments, as well to superiors in the vertical chain of command within the GTD. This is problematic, for reasons indicated below. The present system is not transparent and certain. Things are not what they seem. Rather than being clear and objective, the system contains substantial incentives and opportunities for negotiation. To the extent that a subnational government can exceed its revenue target, it may be able to export part of its tax burden; this depends on the jurisdiction's tax base and economic conditions. This section elaborates on these general points and then discusses particular taxes.

General Appraisal

Fiscal autonomy. There appears to be no reason, in principal, why subnational governments should not be given latitude to determine the rates of some taxes levied on economic activity within their jurisdiction. Perhaps the best example is the agriculture tax, which is levied on farm land. There seems to be no good reason that districts and communes should not be allowed to levy higher or lower taxes on land falling within their jurisdiction in order to provide higher or lower levels of public services. This may also be true of the enterprise profits tax and of the individual income tax, once it is reformed to make its coverage more comprehensive. The next part of this section discusses how this might be done.

The same approach would not be appropriate in the case of the value added tax, for administrative reasons to be explained in the next part of this section. Application of differential turnover tax rates chosen by subnational governments is also questionable, as it could create tax exporting; indeed, the turnover tax does not appear to be appropriate for use as a shared source of revenue.

Tax effort. Under the present system of determining sharing rates and subventions, subnational governments would have little incentive to levy tax rates higher than the existing rates. Indeed, they would have an incentive to levy lower rates, if sharing rates and subventions would simply be adjusted upward to offset the reduction in revenues from local taxes. It would be appropriate to base sharing rates and subventions on presumed application of a standard tax rate determined centrally, so that subnational governments would actually be able to increase (or reduce) total revenues by levying taxes above (or below) the presumed standard rate. Section VII describes such a scheme.

Negotiated revenue targets. Any system of IFR of the type found in Vietnam creates incentives for negotiation. Subnational governments can be expected to overstate revenue needs and to understate

revenue potential. The central government can be expected to resist these pressures, with resolution finally depending on the negotiating strength of the two parties, including the political power of particular subnational jurisdictions. This is, of course, not a transparent and certain system. Given the plan to freeze sharing rates for a period of three to five years, there will be intense pressure on the negotiation of budget targets and revenue estimates for the first (base) year of this period.

Tax exporting. As described in greater detail below, there would be an unacceptable level of tax exporting (for example, of the enterprise income tax and excises) if the present system of tax assignment were to be carried over to a system of surcharges.

Dual subordination. The General Tax Department was created in 1990. It is often said that this removed tax collection from the subnational level to the national level. In fact, this appears to be a substantial overstatement of the degree to which the tax administration was centralized. Creation of the general tax department brought together three separate tax administrations, those responsible for the taxation of state-owned enterprises, those responsible for the agricultural tax, and those responsible for the commerce and industry tax paid by cooperatives. It did not, however, create a central tax department as in certain countries of the former Soviet Union (e.g., Kazakhstan). Whereas the central tax inspectorate in Kazakhstan is legally subordinate only to the central government, in Vietnam subnational officials of the GTD remain subordinate to subnational finance departments, as well as vertically within the GTD.³⁰

Subordination of the GTD to the subnational administrations also encourages negotiation of estimates of tax revenues and it may undermine fairness in tax administration. Under current practice revenue targets are not only assigned to provinces. Tax officials may be expected to derive assigned amounts of revenues from particular enterprises. This creates an environment for negotiation with enterprises and potentially arbitrary assessments instead of strict application of law. Revenue estimation ideally should be a technical exercise undertaken by disinterested parties employed by the central office of the General Tax Department. While tax officials in the finance departments of subnational jurisdictions may be called on for data and judgment, they should not make the estimates.

A further potential problem in this area is the failure to rotate tax inspectors from one enterprise to another (and perhaps to another province). Rotation is needed to prevent development of a “cozy” relationship between enterprise managers and tax officials who monitor this compliance with tax law. Because the tax system is relatively new, Vietnam has not yet addressed this potential problem.

³⁰ Contrary to the situation in many parts of the former Soviet Union, this dual subordination is legal and explicit. In the FSU legal lack of dual subordination may mask *de facto* subordination to subnational administrations, which supply housing and other perquisites. In Vietnam officials of the tax administration provide their own housing.

Appraisal of Particular Taxes

Turnover Tax. In Vietnam, receipts from the turnover tax are assigned to the province where turnover originates. To the extent that public services are provided primarily where production occurs and the production-distribution process involves only one stage, this assignment rule is appropriate. If, however, consumption of public goods is more closely related to consumption than to production, it would be more appropriate to assign revenues from the turnover tax to the jurisdiction of destination of sales. Moreover, to the extent the production-distribution process involves more than one stage, neither assignment will be satisfactory. (For the most part, these distinctions are unimportant. They are, however, important to the extent that sales cross jurisdictional borders). Of course, turnover taxes are plagued by well-known problems, and should be replaced by a value added tax or a single stage tax, such as a retail sales tax. These issues are not discussed here. It is assumed, however, that Vietnam will replace its turnover tax with a value added tax. If it were expected that the turnover tax would remain part of the fiscal landscape in Vietnam, it would be important to investigate the feasibility of assigning revenues from the turnover tax to the jurisdiction of destination, rather than the jurisdiction of origin. Given the present administrative structure, in which the General Tax Department of a province monitors the activities of resident enterprises, but not the activities of non-resident enterprises making shipments into the jurisdiction, destination-based assignment of the turnover tax would appear to be highly problematical. In any event, the impending switch to the value added tax will soon render this issue moot. Thus it is assumed here that origin-based assignment will continue until that shift occurs.

Value added tax. It is difficult, for a variety of reasons, to employ the value added tax as a regulating tax. The most obvious problems involve international trade. Virtually all countries employ the destination principal for international trade. (The only important exceptions are the members of the Commonwealth of Independent States or CIS, which employ the destination principal only for non-CIS trade; they use the origin principal for trade within the CIS. This creates problems for all members of the CIS, but cannot be overcome unilaterally by any one member, except Russia, which seems to favor the present arrangement). Under the destination principal, VAT is applied to imports and it is rebated on exports. If the VAT is used as a regulating tax, the provinces through which imports enter the country would receive a portion of the VAT on imports destined for consumption elsewhere. This could involve an unacceptable level of tax exporting. By comparison, the provinces through which exports leave the country would be required to share in the cost of rebates of VAT on exports. This is also generally unfair, and it can lead to manipulation of business transactions intended to shift as much of the cost of rebates to other provinces as possible.³¹

³¹ Whether and how this would occur depends on the details of rules interpreting tax assignment. If, as in Ukraine, importation and exportation is deemed to occur where title changes hands, inland provinces would have an incentive to establish trading companies headquartered in other provinces (presumably where exportation occurs) in order to shift the burden of rebates to other provinces. By comparison, they would attempt to structure transactions in such a way that VAT on imports was shared with the province of residence of an enterprise, rather than the point of importation. While the second of these schemes would seem to give an appropriate result, the first clearly would not.

One potential way to alleviate this problem would be to distinguish between VAT on imports and other VAT revenues, with only the later being shared with the provinces. jurisdictions. All things jurisdictions. All things The central government would take all revenues from the former and provide all credits related to imports and all rebates related to exports. More commonly, it is believed that the value added tax should be assigned entirely to the central government, because it is not reasonably used as a regulating tax.

Use of the value added tax as a regulating tax also encounters difficulties, even in the domestic context. One possible objective of decentralization is to allow subnational governments latitude to choose their own level of public spending and levy the taxes to finance it. In such a context, it is generally agreed that a destination (consumption)-based VAT is preferable to an origin (production)-based tax, because consumption of public goods is more closely related to private consumption than to production. Implementation of the destination principal would, however, be extremely difficult in Vietnam, as it would entail either fiscal borders between jurisdictions or an elaborate “clearinghouse” system, in which each enterprise would report shipments to each province and the revenues due that province on goods and services sold there. The first would destroy the internal market and would create enormous administrative and compliance costs. The second is probably beyond the administrative capability of Vietnam. (It is only now being introduced in the European Union).

The origin principal could be used for internal trade, but only if there is a uniform tax rate throughout the country. Differential tax rates would create incentives to employ artificial transfer prices to place as much value added as possible in the jurisdictions with the lowest VAT rates. To prevent this abuse, it might be necessary to introduce fiscal borders. If so, the interference with trade would probably be even greater than under the destination principal. While currently taken as the norm, a uniform VAT would eliminate the possibility of using differentiated rates to reflect differences in preferences for public goods in different jurisdictions. Removing the VAT from the arsenal of regulating taxes would, of course, substantially reduce the amount of revenues the provinces see as “theirs”. All things considered, if the value added tax is to be employed as a regulating tax, a single rate should be applied throughout the country and revenues should be assigned on an origin basis. In that case, as suggested above, responsibility for border tax adjustments on international trade should be the responsibility of the central government, rather than being shared with the provinces.

Profits tax. Assignment of revenues from the profits tax currently depends on the system of accounting employed by enterprises. First, revenues from those enterprises operating throughout the country, such as the electric utility and the telecommunications and postal enterprise, are assigned entirely to the central government. This is entirely appropriate, since profits are calculated for the entire entity, operating as a unit. It would be difficult to determine the geographic source of profits of these enterprises, (even if an attempt were made to do so).

Profits tax paid by other enterprises are shared between the central government and the provinces. The division of profits between jurisdictions depends on the accounting system of the enterprise. If the enterprise maintains only one set of books, its profits are attributed entirely to the jurisdiction where the

enterprise is headquartered. If, however, the enterprise employs separate accounts to determine the profits of its branches or subsidiaries, the profit tax is attributed to the jurisdiction where the branch or subsidiary is headquartered. This opens the way for manipulation of transfer prices and financial charges on transactions between related entities to place profits in the provinces where tax rates are lowest. Moreover, economic interdependence between related entities often precludes the accurate division of profits among the various entities.

In Vietnam, profits taxes of subcontractors are paid through the contractor. This can be problematic from the point of view of revenue assignment, if subcontracts involve work done in jurisdictions other than the contractor's jurisdiction of residence.

The assignment of revenues from excises entirely to the central government is probably appropriate. In theory, it would be preferable to assign revenues from excises to the subnational jurisdiction in which consumption of goods subject to excise occurs. This is, however, likely to be administratively infeasible for the foreseeable future. (This issue deserves further study. It might, for example, be feasible to implement consumption-based excises in the case of taxes on petroleum products, but not other products). The alternative, found in much of the former Soviet Union, of assigning revenues from excises to the point of production or importation, is quite inappropriate. (Note that excises in such countries generally apply to imports from outside the Commonwealth of Independent States, but not to imports from other members of the CIS. It is assumed that Vietnam will reform its excise tax system to subject imports to tax). Under such a system, subnational jurisdictions where production or importation occurs can export their taxes to residents of other jurisdictions.

Excises. By assigning excises and taxes on imports and exports to the central government, Vietnam has avoided problems that have been encountered by members of the former Soviet Union. Note, however, that sharing revenues in excess of revenue targets with subnational governments creates these same problems, although on a smaller scale. For example, it would be inappropriate to share revenues from export duties with the province where exports occur, as this would assign revenues to the "wrong" jurisdiction. Economic theory suggests that export duties reduce the income of the producer of exports. Thus the jurisdiction where exports occur would be collecting tax that is borne by residents of another jurisdiction.

Dual subordination has both benefits and costs. On the one hand, subordination of the tax administration to governments of subnational jurisdictions provides some capacity for the exercise of tax effort by the administrations of subnational jurisdictions. By comparison, subordination to subnational administrations undermines uniformity of administration throughout the country. (Representatives of the private sector told the mission that interpretations of laws differs substantially across the country. It is unclear whether this reflects administrative problems of a kind found in many countries, even with truly centralized tax administrations, or pressures for additional revenues created by dual subordination. This issue deserves further investigation). It would be far better to allow subnational jurisdictions to exercise tax effort by changing their tax rates, instead of by exerting influence on the diligence of tax administration.

D. Options for Change

It is convenient to think of four alternative methods to of financing a decentralized system of government. These are a) independent legislation and administration, b) tax sharing, c) tax surcharges, and d) revenue sharing. Each of these gives different answers to one or more of the following important questions: 1) Who (which level of government) gets the revenue, 2) Who decides which tax(es) is (are) imposed, 3) Who defines the tax base(s), 4) Who sets the tax rate(s), and 5) Who administers the tax(es)? While it is sometimes thought that the same answer must be given to all five of these questions, this is not the case. Viable systems of fiscal decentralization can and do exist in which not all five questions are answered the same way.

Independent legislation and administration. The 50 states that comprise the United States enjoy almost complete freedom in the area of tax policy. Subject to quite general constitutional limitations (involving primarily non-interference with interstate and international trade) and several quite minor specific statutory restrictions, the states can enact virtually any tax they wish and implement it as they choose. Thus they use an assortment of taxes, including individual income taxes, corporate profits taxes, retail sales taxes, excises, and a variety of other less important taxes, including (in resource-rich states) those on natural resources. Local governments in the United States (which legally are creatures of their respective states) rely primarily on property taxes (especially on real estate), but also receive substantial amounts of revenue from sales taxes and income taxes on individuals and corporations, as well as numerous less important taxes, fees, and charges.³²

Under this system, “the state” is the answer to all five questions posed in the previous paragraph. Thus, this system, which is characterized by independent legislation and administration of taxes, provides maximum fiscal autonomy for the states. But it is characterized by complexity, duplication of compliance burdens and administrative effort, and tax exporting. This is perhaps most obvious and most troublesome in the area of corporate income taxation. Box VI-2 describes the problems in that area in the United States. Such a system would be totally unacceptable for Vietnam.

³² For further discussion, see Harley T. Duncan and Charles E. McLure, Jr., Tax Administration in the United States of America: A Decentralized System,” forthcoming in *Hacienda Pública Española*.

Box VI-2: Formula Apportionment in the United States

In the formula for an apportioned income tax, as commonly applied in the United States, virtually everything is up for grabs. Thus:

$$T_i = t_i \times I [(W_i/W) + (P_i/P) + (S_i/S)]/3,$$

where:

T_i is tax liability in state I,
 t_i is the tax rate in state I,
 I is the company's taxable income,
 W_i , P_i , and S_i are payroll, property, and sales in state I, and
 W , P , and S are total payroll, property, and sales.

The tax rate and the ratio of in-state to out-of-state payroll are the only parts of this formula not subject to considerable controversy. Within quite broad limits, each state can adopt its own definition of taxable income. States need not treat sales consistently. Most measure sales at destination, but others measure them at origin. An increasing number depart from the typical formula, double-weighting sales. Some states that generally measure sales at destination include sales originating within their boundaries if made to a state not taxing corporate income.

Nor is there agreement on the entity to which the formula is applied. Some states adopt a strict legal entity approach. This opens the door for abuse through manipulation of transfer prices. Others combine related companies deemed to be engaged in a "unitary business," but there is no accepted definition of a unitary business. Some states apply unitary combination on a world-wide basis, whereas others restrict combination to "the water's edge," apportioning only profits deemed to be earned in the United States. The treatment of intercorporate dividends is particularly troublesome. Dividends flowing between firms filing combined reports are eliminated from the calculation. Some other dividends are taxed, but still others are exempt; this varies by state.

Apportionment based on payrolls and property attributes corporate income to states where production occurs. Including sales in the apportionment formula gives weight to the consuming jurisdiction, but introduces an element of turnover taxation, since the formula does not distinguish between sales of final products to households and sales of capital goods and intermediate products. Double-weighting sales increases this undesirable tendency.

Tax sharing. Tax sharing avoids the problems inherent in independent legislation and administration by assigning shares in revenues from particular taxes to various levels of government. This is the system employed in Vietnam. In Vietnam subnational governments receive a share of revenues raised in their jurisdictions, but the central government decides which taxes to impose, defines the tax base, sets the rates, and administers the taxes. (In this sense, even taxes assigned entirely to subnational governments are best seen as shared taxes, with a sharing rate of 100 percent, since the governments that receive the revenues have no say in answering the last four questions.) Contrary to the situation in most Western market-oriented nations, where sharing rates are commonly uniform for a given tax, in Vietnam sharing rates for

non-subvention provinces are to provide equality between revenues and revenue needs.

A system based on tax sharing cannot realize the full potential of decentralized government. Although subnational governments have “own” revenues, they do not have the right to set tax rates applicable to economic activity within their jurisdictions. As a result, they cannot exert tax effort -- or can do so only by exerting pressure on the tax administration, as under the system of dual subordination found in Vietnam. Moreover, in the system used in Vietnam, there is really little economic difference between tax sharing and a system in which the central government simply takes

Tax surcharges. A system based on tax surcharges provides subnational autonomy in determination of tax rates, and therefore tax effort, without the unacceptable complexity and duplication of independent legislation and administration. In such a system, the central government would choose the taxes that are subject to surcharge, define the tax base (and its division among jurisdictions, if necessary), and administer the tax. But subnational governments would be allowed to choose (perhaps within limits) the tax rate(s) applied to economic activity within their jurisdictions. This system is used in Canada, where most of the provinces levy surcharges on the individual and corporate income taxes of the federal government, and at the state-local level in the United States, where many states allow local governments to levy surcharges on the state’s retail sales tax and some allow surcharges on the state’s individual income tax. A system based on surcharges is a reasonable long-run goal for Vietnam.

Many taxes are not suitable for the application of surcharges. Unfortunately, this includes many of the most important revenue sources actually or potentially in use in Vietnam, most notably the VAT and perhaps most excises.

Taxes on foreign trade are not suitable for surcharges. Nor are surcharges on a value added tax likely to be administratively feasible in the foreseeable future. Subnational surcharges on the turnover tax would be feasible, but undesirable, if levied on an origin basis. Destination-based surcharges on the turnover tax might be acceptable, but they would probably be administratively infeasible at present. The individual income tax would provide a relatively attractive base for surcharges, provided coverage is sufficiently comprehensive, in the sense of the tax being paid by a substantial portion of the population. (If the tax is paid by a minority of the population, there is a risk that a democratic vote might result in excessive taxation of those few individuals who pay the income tax).

For the foreseeable future the profits (or income) tax on enterprises is likely to be the most appropriate base for subnational surcharges. However, the existing system, in which profits are attributed to the jurisdiction where the enterprise is registered will increasingly become inappropriate. Nor is it possible to determine accurately the geographic origin of profits. It would be better to employ a formula to divide the income of enterprises among the jurisdictions where they operate, as is done in many countries with multiple tiers of government. Among “factors” commonly used to divide such profits among jurisdictions are payroll, property, and sales. Kazakhstan has recently introduced an apportionment formula containing these three “equally weighted” factors for use in the determination of the origin of profits for

purpose of calculating oblast shares of enterprise profits taxes. While sales can most easily be attributed to the jurisdiction where they originate, it is probably more appropriate to attribute them to the jurisdiction of destination of sales. Doing so provides a “market related” counterbalance to the “production-related” factors of payroll and sales. Vietnam might consider such a move, recognizing that there may initially be problems of obtaining the need information, especially on sales at destination. (Kazakhstan currently employs sales at origin in its new three-factor formula).

Revenue sharing. The three alternatives described thus far provide tax revenues primarily to subnational governments when economic activity occurs. Thus rich provinces have greater fiscal resources than poor ones (except where sharing rates differ by province, as in Vietnam). To combat such horizontal fiscal disparities it may be thought useful to provide revenue sharing grants. Rather than simply returning revenues to the subnational government where it originates, revenue sharing funds can be allocated on some other basis, for example, on a per capita basis, perhaps with allowance for average income. In order to further transparency, such allocations are ideally based on formulas that remain stable. Given the difference in abilities of central and subnational governments to raise revenue, vertical fiscal disparities are common in many countries. Revenue sharing grants can also be used to offset these. Section VI discusses revenue sharing in greater detail.

E. Recommendations

If Vietnam wants to provide subnational governments with greater fiscal autonomy, it should allow more latitude in setting tax rates. The present system of dual subordination does not provide adequate or appropriate opportunity for the exercise of fiscal autonomy and tax effort, and it creates problems. Of the techniques described in the previous part of this section, tax surcharge is generally the most appropriate.

Revenue assignment. An ideal long-run target might be to shift to surcharges with an assignment of revenue sources such as the following:

- Taxes on foreign trade -- central only;
- VAT -- central only;
- Individual income tax -- provincial;
- Excises -- province where consumption occurs; and
- Enterprise income tax -- formula apportionment of the tax base, based on payrolls, property, and sales at destination

In addition, subnational governments should be given wide latitude in setting policy for, and

implementation of, taxes when appropriate, such as the agriculture tax.

In the short run this surcharge-based assignment may not be feasible. The following may be appropriate in the interim:

- Taxes on foreign trade -- central only;
- Turnover tax: shared, with uniform sharing rate;
- Individual income tax: provincial;
- Excises: central, except where assignment to province of consumption is feasible; and
- Enterprise income tax -- shared, with uniform sharing rates, with formula apportionment of tax base.

In any event, it will be necessary to have a system of revenue sharing intended to offset both horizontal fiscal disparities and vertical fiscal imbalance. See the next section.

Subordination of GTD. Dual subordination is problematic. It should be replaced with a system based only on vertical subordination within the GTD. This will help ensure uniformity in application of tax laws and reduce the latitude for negotiation on revenues. Interests of subnational governments could be protected by having them participate in an oversight committee charged with assuring that the GTD devoted adequate attention to surcharges imposed by subnational governments.

VII. Intergovernmental Transfers

A. Existing System of Transfers

This section of the report examines the issues and options for reform in the system of intergovernmental transfers. Special emphasis is given to the design issues, especially those related to the equalization mechanism.

The current system of transfers in Vietnam is simple. The cornerstone of the transfer system is a general subvention for those provinces which have not enough revenues from own sources and shared taxes to finance “approved budgeted expenditures.” This form of general transfer replicates the old Soviet gap-filling subvention. The level of the subvention is determined by the implicit formula of “approved budget” minus own sources of revenues minus revenues from shared taxes. The subvention is lump-sum, but implicitly may reflect the relative needs of provinces. This depends on how well the norms used for the

calculation of the approved budget reflect relative needs.³³

There is no explicit mechanism to determine the overall level of transfers. The outcome is the aggregation of negotiations and bargaining between the provincial authorities and the Ministry of Finance plus any posterior adjustments made by the National Assembly. Implicitly the central government rations the overall level of transfers by adjusting the minimum expenditure requirements at budget time. The size of the transfer, of course, is also affected by how much the central government decides to increase the provinces' sharing rates in national taxes and therefore make less use of the subvention.

Vietnam does not have an explicit capital transfer program. However, at the time the provincial budgets are approved funds are occasionally allowed in the general budget for local capital projects such as building local government and commune offices, local roads and schools. Even though the local governments do not have discretion to use these funds for any other purpose, the funds do not appear in the local budgets as earmarked transfers.

In addition, Vietnam does not have a system of categorical transfers earmarked to specific types of expenditures. However, the national special programs introduced by the central government in 1989 to address areas of national priority (as perceived by the central government), de facto work as a system of categorical transfers. These programs are funded and designed by the central government but implemented through the local governments.³⁴

The special programs are relatively small in size. They represented approximately 7 percent of total provincial expenditures in 1994 and are highly fragmented. Approximately one-third of the funds are dedicated to reforestation and the rest of the funds to many other programs such as the elimination of the third shift in schools, increasing literacy, training programs, anti-malaria programs, family planning, job creation, and price supports for specified commodities.³⁵

With the approval of the 1996 Budget Law, the government plans to replace the current system of negotiated annual transfers with a formula-based general transfer for each province.³⁶ As with many other aspects of the new Budget Law, the actual formula will be established by regulation in the future. Although the Budget Law is vague in this respect, it requires the use in the formula of different demographic and

³³ The budget formulation process and the use of norms is discussed in Section V above.

³⁴ Clearly, these national special programs in Vietnam are not unfunded mandates. A common occurrence in the FSU countries and in Western countries, unfunded mandates occur when central governments assign additional expenditure responsibilities to subnational governments without a corresponding increase in their funding.

³⁵ See Bird, Litvack, and Rao, 1995.

³⁶ However, elements of negotiation would appear to remain in the system sketched in the Budget Law. For example, the new Budget Law still contains provisions for solving the conflict between the provinces and the Ministry of Finance regarding revenue forecasts.

regional variables as approximations for needs.³⁷ The Budget Law also requires the new transfer system to be stable for a period of three to five years. Supposedly, this stability refers not only to the formula itself but to the level of funding. For this latter purpose, it appears that the plan of the government is to keep using the adjustment for 1996 which multiplies the subvention in the past year by the inflation rate and by the ratio of the subvention to total expenditures in the local budget. Box VII-1 shows that this mechanism hurts poorer jurisdictions.

Box VII-1: Defects of the Formula for Stabilizing Subventions

The decrees underlying the formulation of the budget for 1996 and 1997 provide a formula for the partial indexation of subventions to provinces unable to meet budgetary requirements from local taxes and shared taxes. The mission was told that regulations interpreting the new Organic Budget Law would contain a similar formula. Rather than increasing subventions by the rate of inflation from year to year, this formula would provide for subventions to be increased only by a fraction of the rate of inflation, where that fraction is the percentage of subnational expenditures covered by the subvention. (The 1996- 97 decree provides the following example: With a rate of inflation of 12 percent and a subvention equal to three fourths of subnational spending, the annual increase in subvention would be only three fourths of the rate of the rate of inflation, or 9 percent.)

This method of “stabilizing” subventions would result in the deterioration of the relative fiscal position of subvention provinces, for two reasons. First, allowance is made only for inflation in calculating subventions. By comparison, own revenues and shared revenues of all provinces will presumably rise by roughly the rate of nominal increase of the value of output; that is, increases in tax revenues will reflect growth in real output, as well as inflation. Second, adjustment for inflation is only partial.

Box Table VII-1 illustrates the growth in the financial capacity of provinces characterized by different ratios of subventions to total expenditures in the base year, for different rates of inflation. The table is based on the assumption of real growth of 9 percent per annum and alternative inflation rates of 0, 10 percent, 20 percent, 30 percent, and 50 percent. The budget of a non-subvention province provides a benchmark. In the absence of inflation, it grows by the rate of growth of real output, from D100 in the first (base) year to D109 in year 2 and D141.2 in year 5. If inflation exists, the budget of the non-subvention province grows by the rate of growth of nominal output, 19.9 percent for an inflation rate of 10 percent, 30.8 percent for an inflation rate of 20 percent, etc.

³⁷ The variables mentioned in the Budget Law such as population, type of region, or socioeconomic development are similar to some of those now used for expenditure norms.

Box VII-1: Defects of the Formula for Stabilizing Subventions (continued)

The table includes calculations for provinces that rely on subventions for 10 percent, 50 percent, and 90 percent of their budgets in the base year, also assumed to be D100. Whereas the tax component is assumed to follow the same growth patterns as the total budget for the non-subvention province, the subvention component is partially indexed for inflation, according to the formula described above. Total revenues available from taxes and subventions in years 2 and 5 are compared with those of the non-subvention province, for alternative rates of inflation. Revenues of subvention provinces lag behind those of non-subvention provinces, in some cases by substantial amounts.

Provinces with only small dependence on subventions (illustrated by the “10 percent subvention province”) do relatively well, especially at low rates of inflation. Subventions are increased by only 10 percent of the amount of inflation, but subventions are a relatively unimportant source of revenues. By year 5 the budget of such provinces are 92 to 97 percent of the level of non-subvention provinces, depending on the rate of inflation. The loss in relative revenues in the zero-inflation case is only 35 percent as great as that in the case of 50 percent inflation.

By comparison, provinces that rely heavily on subventions lose substantial ground. This is true, even though indexation is provided for 90 percent of inflation, because no adjustment is made for growth in real output. The loss in total revenues in year 2 (to 90 percent of revenues of the non-subvention province, rather than 92 percent) is hardly greater if the inflation rate is 50 percent than if it is 0. Similarly, by year 5 the loss in relative revenues -- to 74 percent of the revenues of the non-subvention province -- is substantial, even if there is no inflation. It is only 8 percentage points higher if the inflation rate is 50 percent. Thus the relative loss of revenue in the zero-inflation case is 77 percent of that in the case of 50 percent inflation.

At low rates of inflation the revenue loss of the “50 percent subvention province” lies between those for the other two proto-typical provinces (but nearer that for the low-subvention province). At higher rates of inflation this province loses, relative to the other two, and it actually loses more than the high subvention province in Year 2 for inflation rates of 30 percent or higher.

Perhaps the most troubling figures in this table are the ones for the provinces that rely on subventions for 50 and 90 percent of their budgets in the base year. At an inflation rate of 20 percent, the budget of these provinces will be only 70 to 75 percent as great, in relative terms in year 5, as the budget of the non-subvention province. This would have a dramatic and adverse impact on the ability of these poor provinces to deliver public services.

The pattern of growth of revenues in subvention provinces seems inappropriate, and probably unintended. Consideration should be given to a system that relates the adjustment of subventions to the nominal growth of GDP, rather than only (part of) the rate of inflation.

B. Criteria for Evaluation

A system of transfers should serve several objectives:

- help to provide adequate funding of local governments to correct for vertical imbalances;

- reduce fiscal capacity disparities between relatively rich and poor jurisdictions;
- induce subnational government expenditures in services with significant spillovers across jurisdictions and those deemed of national priority, and
- compensate subnational governments for those services mandated by the central government or implemented on its behalf.

These objectives can be pursued with many different forms of transfers including general-purpose grants and matching and non-matching specific-purpose grants. Regardless of the shape these grants take, the system of transfers should be implemented in a way that helps achieve other general goals of decentralization policy. Efficiency of public expenditures requires that budgetary discretion is preserved at the local government level. Efficiency also requires that funding for local governments should exhibit a high degree of certainty and stability and that local government revenue-raising efforts are not penalized or discouraged.

C. Appraisal

The structure of the current system of transfers is incomplete. It has a general-purpose transfer addressing the problems of vertical imbalances and possibly horizontal disparities (more about this below), but the specific-purpose transfers are insufficient and too fragmented. The current system of transfers also scores poorly against many features of an ideal system. The negotiations and bargaining associated with the current system, at the very least, create the appearance of arbitrariness. Besides being non-transparent, the current system is neither stable nor certain. The gap-filling nature of the system also discourages tax effort.³⁸ See Box VII-2. Most of these problems will be addressed in the ongoing reform of the transfer system.

³⁸ To the extent that the system is based on revenue collections rather than capacity, it also discourages local tax effort. However, the retention and sharing of collection surpluses over budgeted targets helps address the negative impact on tax effort. As discussed in Section V, the benefits of this arrangement may be limited because they are not likely to be time consistent.

Box VII-2: The Consequences of a Gap-Filling Transfer System

The following example illustrates the use of a) the present system, in which tax rates for provincial tax rates are set by the central government; b) a “revenue-offset” system, in which tax rates are set by subnational governments, with higher or lower expected revenues offset by changes in sharing rates and subventions; and c) a system that maintains subnational tax effort, in which subnational governments actually gain increased revenues from the imposition of taxes above a centrally set standard (and lose revenues to the extent that they choose a tax rate below the centrally set standard). Suppose that application of expenditure norms suggests that budgetary requirements are D180. Suppose that the estimated tax base is D1000 and the tax rate is 10 percent. Under the present system, illustrated in Column A, estimated revenues would be D100 and expenditures of D80 would be covered by revenues from shared taxes and subventions. The subnational government in question could exercise tax effort only by demanding greater diligence by officials of the GTD under dual subordination.

Box VII-2: The Consequences of a Gap-Filling Transfer System (continued)

Suppose now that the same subnational government were given discretion to levy a tax rate of its choosing between 8 and 12 percent, and that estimated local revenues used to determine tax sharing rates and subventions would be based on the actual tax rate chosen by the jurisdiction. The choice of a tax rate of 12 percent would result in estimated revenues of D120 and a reduction of estimated shared revenues and subventions from D80 to D60. (See Column B.) Residents of the jurisdiction in question would have little incentive to increase the taxes they pay since estimated increased revenues would be offset by a reduction in shared taxes and subventions. Indeed, they would have an incentive to reduce their tax rate, if they knew the central government would offset the revenue loss.

Suppose, finally, that estimated revenues from subnational taxes would be based on application of a standard rate of 10 percent, even though the subnational government in question chose to impose a rate of 12 percent. In this case, estimated revenue from shared taxes and subventions would be D80, as in Column A, but estimated revenues from own sources would be D120. (See Column C.) Thus, total estimated revenues would be D200; the subnational government would actually receive the additional D20 represented by application of an additional 2 percentage point tax to its tax base of D1000. (By comparison, choice of a subnational taxes rate of 8 percent would result in total revenues of D160, divided evenly between revenues from the 8 percent tax and estimated revenues from shared taxes and subventions of D80).

Table VII-2

Illustration of Present Subvention System and of Systems that Offset or Maintain Subnational Tax Effort

	Present System (A)	System that Offsets Tax Effort (B)	System that Maintains Tax Effort (C)
1. Target budget (from budget norms)	180	180	180
2. Revenue expected from tax rate of:			
8 percent	xx	80	80
10 percent	100	100	100
12 percent	xx	120	120
3. Subvention, with tax rate of			
8 percent	xx	100	80
10 percent	80	80	80
12 percent	xx	10	80
4. Total available subnational revenue with tax rate of:			
8 percent	xx	180	160
10 percent	180	180	180
12 percent	xx	180	200

xx = not relevant

The present system of transfers has some positive features. First, it distributes funds as block grants. However, this feature is neutralized to a large extent by the fact that subnational governments have limited budgetary discretion. (See Section V). More importantly, the current system helps close the significant vertical imbalance for local governments and it appears to help reduce horizontal fiscal disparities across subnational governments.

However, it is hard to establish exactly how effective the current system has been on these two counts. The system of norms used to estimate the “approved” expenditure budgets has been judged by practically all observers of intergovernmental finances in Vietnam as insufficient to provide adequate services. Furthermore, the level of the “approved” budget actually funded tends to be well below that estimated by applying the expenditure norms. However, there is no unambiguous standard for adequacy of provision. Because Vietnam is a poor country, it means that most public services, at both the central and local government level, will be underprovided.

Regional disparities appear to be quite pronounced. The incidence of poverty ranges from 33 percent of the population in the southeast to 71 percent on the north-central coast. In addition, rural areas in the country are much poorer than urban areas. This probably translates into significant intra-province disparities, although no data exist on this.

Within the limited degree of decentralization, the government policy is to strike a balance between fostering the development of some relatively richer provinces and helping those that are poorer. There is a painful awareness of the fact that there are significant disparities in wealth between the provinces and within the provinces. A high priority of the government is to promote economic development outside Hanoi and HCM City by means of developing their infrastructure and human capital.

With respect to the ability of the current system to reduce horizontal fiscal disparities across jurisdictions, the use of budgetary norms based on population should be equalizing. In addition, the greater weight given in some of the norms to geographical areas (e.g., the mountainous regions) should also be equalizing as long as these larger weights at least compensate for the higher costs and needs for provisions in these areas.³⁹ However, the negotiated approach to the final determination of the transfers may be counter-equalizing if richer, more developed provinces have more clout in Hanoi. Also the ability to retain surpluses of actual collections over targets, although in other ways desirable, may also benefit richer provinces more.⁴⁰

³⁹ The differences in expenditure norms for budgeting purposes are not too pronounced. For primary education they range from D 37,500 per capita in the cities to D 42,800 in the high mountains and islands. Also, other norms per capita, such as for sports, go in the opposite direction. Norms for maintenance are based on capacity and norms for administration are based on the number of employees. These two approaches tend to help richer provinces more.

⁴⁰ That seemed to be the case in 1993; the actual per capita expenditures from “surplus funds” in 1993 ranged from D 51,670 in high income provinces to D 26,800 in middle income provinces and D 31,030 in low income provinces. See Bird, Litvack, and Rao, 1995.

Overall, there appears to be a significant redistribution of funds through the central budget from richer to poorer provinces. There is evidence from previous studies that the current transfer (cum sharing) system transfers resources from richer to poorer provinces. Current public expenditures per capita on health and education have been quite even. Nevertheless significant disparities still exist in other areas. Total budgeted expenditures in all categories for 1993 differed by a factor of 6 between the richest and poorest provinces.⁴¹ Because updated data were not available it has not possible here to address this question empirically. Bird, Litvack and Rao, 1995, found with data for 1992 and 1993 that higher per capita provincial domestic product correlated positively with subnational public expenditures per capita.⁴² This was true for both current and capital expenditures per capita. However, this correlation was not statistically significant between expenditures per capita and infant mortality or illiteracy rates.

D. Options for Change

The most challenging element in a system of transfers is the design of an equalization mechanism. In Vietnam the objective of equalization takes particular importance because of what appear to be significant disparities across jurisdictions in fiscal capacity, actual levels of public services, and physical infrastructure. These disparities are in Western countries and in many countries in transition ameliorated by national expenditure programs. Although it is extremely hard to measure the regional incidence of many central government expenditure programs, (and Vietnam is no exception) one can be sure that sizable social welfare programs for unemployment, health, and pensions would help reduce disparities in economic well-being across the country. However, in Vietnam many of these national welfare programs are incipient or do not exist at all.⁴³

Equalization will also become more important if more taxing powers are granted to subnational governments. The following paragraphs address some of the important issues the government would need to consider in designing an equalization mechanism.

Revenue Capacity Equalization. One of the fundamental objectives of an equalization system is to take into account the ability of local governments to raise adequate revenues. The system needs to put emphasis on the equalization of capacity rather than equalization of actual revenue collected. The actual revenues collected depend on the behavior of local governments, including their tax effort and their revenue collection efficiency. By equalizing revenues, the tax effort of jurisdictions gets penalized.

Two conventional approaches are used to measure fiscal capacity. The first employs an overall proxy

⁴¹ See Bird, Litvack and Rao, 1995.

⁴² See Bird, Litvack, and Rao, 1995.

⁴³ General social insurance was introduced in 1995 with the creation of the Social Insurance Fund. Prior to that, only central government workers were covered. Vietnam does not have an effective unemployment compensation system.

for tax capacity such as per capita income. The problem with this approach is that there is always a non-systematic portion of these aggregate measures that is non-taxable. The second approach employs a “representative tax system.” Capacity in this case is proxied by the revenue that would be raised in a jurisdiction by the application to its base of the average taxes and tax rates (or any other standard) of all jurisdictions. This approach is preferable but it presupposes that local governments have autonomy in choosing tax rates.

How important is this issue for Vietnam? At present the main sources of subnational revenues are tax sharing and transfers, which are controlled by the central government. Local taxes raise little revenue. In this sense, there would appear to be little harm in equalizing revenues rather than capacity. However, there is considerable scope for local tax effort in Vietnam, as the current system of shared surplus over revenue targets shows. The direction for long-term reform is clear. The government should abandon the present system of gap-filling in the determination of transfers; it should develop more tax autonomy at the local level, using, for example, the local income tax and surcharges proposed here;⁴⁴ it should develop the necessary data to measure tax bases; and should use tax capacity in the revenue equalization formula.

Expenditure Equalization based on a “representative expenditure system.” Some countries perform equalization on the revenue side concentrating exclusively on tax capacity equalization. Other countries attempt to equalize according to expenditure needs also.

Measuring differences in expenditure needs is harder than measuring differences in tax capacity. One way is to try to measure the costs of providing a standard level of services in each jurisdiction. There are many difficulties with this approach. For example, costs will differ depending on the choice of the quality of the service. In addition, the same standard services may cost more depending on the relative incidence of groups with special needs (such as the young and the elderly), or the concentration of crime, or geography.

Rather than relying on the vague notions of standards packages, the most exact approach is to use a “representative expenditure system” based on regression analysis. This approach uses the actual expenditure experience of all local governments in relation to their characteristics to provide a standard measure of need, which is derived on the basis of regression analysis as follows. First, using all jurisdictions, the variable “actual expenditure per capita” is regressed on a set of variables related to service need, such as relative importance of different population groups or population density, and fiscal capacity variables. Then these regression coefficients are used to predict what would have been the expenditures of the jurisdiction given its actual need factors, such as percent of the population that is elderly, but under the assumption that all jurisdictions have the average fiscal capacity. This approach can be implemented for different expenditure categories. The difference between the predicted need for each jurisdiction and average expenditures is the amount of equalization, if any, to be carried out by the equalization mechanism.

⁴⁴ See Section VI.

But the use of a “representative expenditure system” presupposes that expenditure levels are responsive to higher “needs.” This would be the case if subnational governments, for example, could tax themselves more to cover those higher needs. This latter has not been the case in Vietnam. However, the system of budgetary norms used by the Ministry of Finance to estimate minimum expenditure budgets may impart some degree of responsiveness of subsidies and actual expenditures to the different needs of subnational governments. Until there is much more autonomy in revenue sources and discretion in expenditure decisions it would make more sense not to use a “representative expenditure system” for expenditure need equalization and to use instead a simple formula giving different weights to proxies for expenditure needs. In the shorter term a simple weighted formula would be adequate.

The source of equalization funds. There are two general systems for funding equalization transfers. The first is a horizontal system, also called “fraternal,” in which the funds redistributed to poorer jurisdictions are provided directly by wealthier jurisdictions.⁴⁵ The other is vertical funding in which the funds are provided by the central government and raised from central government revenue sources.

There are both advantages and disadvantages to these two approaches. One advantage of the “fraternal” system is that it offers more flexibility in an intergovernmental finance system. In general, it is not desirable to differentiate among poor and rich communities in the taxes they are assigned or in the sharing rates of some taxes. A “fraternal” approach to funding equalization in fact permits “taking back” or discriminating against richer local governments which may benefit disproportionately from a particular scheme of tax assignments or tax sharing, without singling out any specific jurisdiction. That is, the system would continue to apply if wealthier and poorer local governments were to reverse fortunes. Another advantage of the fraternal system is that it is a more transparent system.

Regardless of the funding mechanism, it is taxpayers from the richer communities who eventually pay to equalize the fiscal opportunities of poorer communities. Among the disadvantages, the fraternal system represents an element of forced solidarity. It is this aspect of imposition that has made this system of funding unpopular and criticized in the Nordic countries and other countries where it is used. Using the system may introduce an element of political dissension. The alternative is to finance the entire equalization fund from the central government with funds retained by lowering revenue sharing with local governments.

Absence of discretion or manipulation of funds distributed. A very important aspect of any system of transfers is its transparency and objectivity guaranteed by the formula application of general principles. The formulas employed would have to take into account that there are significant regional inequalities in income, in the incidence of poverty, and in infrastructure. However, the formula used also has to take into account the fact that data on socioeconomic characteristics and public expenditure patterns for provincial and local governments have yet to be developed in form and continuity that could allow adequate

⁴⁵ A fraternal system of funding does not imply that contributions are voluntary. Contributions are regulated by law approved at the national or subnational level, as the case may be. Countries using this approach for at least part of their transfers are Denmark, Germany, Sweden, and the Swiss canton of Zurich.

economic analysis.

Besides designing the entire system on formulas, some countries have established an Equalization Board or Grants Commission which is charged with implementing some parts of the equalization process mechanism and solving any conflicts that may arise.

Should tax effort enter into the equalization formula? Tax effort is measured by how much a local government uses its capacity by comparison to how other jurisdictions, on the average, would tax the same capacity. The government has officially recognized the need to stimulate tax effort at the local level by sharing any surplus in collections of national taxes over the budgeted targets. The attraction to including tax effort in the equalization formula is that it is a direct way to encourage more revenue mobilization. But there are also disadvantages. In particular it allows local governments to manipulate the equalization formula in their favor.

A strong argument against giving an incentive to tax effort in the formula is that local governments should not pay for the higher expenditure of other local governments. A phrase often used in this context is that “other jurisdictions should not pay the cost if a jurisdiction decides to paint its roads.” On the other hand, there is little question that equalization should not discourage tax effort. The latter is achieved, as discussed above, by performing equalization on tax capacity rather than revenues collected.

The issue for the government to consider is whether it is desirable, at least for a period of time, to offer incentives to local governments to use the surcharges proposed here (see Section VI), use their own sources of revenue already assigned to them, and become more effective in their administration. Rewarding tax effort may be desirable, especially if reforms introducing more autonomy at the local level fail to lead local governments to mobilize revenues.

E. Recommendations

On the structure and types of grants: general-purpose versus specific-purpose grants. The government should use both types of grants. The benefit of general-purpose grants is that local governments have greater flexibility for spending. The gains in efficiency associated with decentralization accrue when local expenditures can reflect the needs and preferences of local residents. The equalization grant should be a general-purpose grant.

The government should also introduce a limited number of specific-purpose grants by reforming the current system of special programs. This limited number of specific grants should be used to encourage infrastructure construction with significant externalities such as water and sewage treatment plants, environment cleaning programs, or school construction. Some of the specific grants could include matching arrangements and the matching rate should be adjusted for the degree of externalities involved in the service and the relative tax capacity of the subnational government.

The third element in the grant system should be transfers that pay subnational governments explicitly and directly for services or programs implemented on behalf of the central government, to avoid unfunded mandates.

On the need to address minimum standards of provision. Budgetary discretion, as provided by general purpose grants, is very desirable. However, in order to guarantee that basic services are not neglected, it may be necessary to impinge on budgetary autonomy and impose minimum standards of provision on local governments. These minimum standards may be admissible in the areas of health, education, welfare and the environment. Minimum expenditure standards may perhaps be less necessary if local governments are encouraged through matching grant programs to voluntarily spend more on these services.

On the use of formulas for transfers. The government should proceed with the mandate in the new Budget Law to introduce a formula-driven system of grants. This should apply not only to the general-purpose equalization grants but also to the specific- purpose grants.

On Revenue Equalization. Given the apparent disparities in revenues and revenue capacity across provinces there is little doubt that there is a need to explore ways to introduce a revenue equalization formula. The simplest approach in revenue equalization would be to raise those local governments currently under the national average up closer to the average, for example by closing the gap by half. If a fraternal funding system is used, provinces over the national average would contribute half of their own (positive) deviations. In the longer run the basis for equalization should be tax capacity. But using tax capacity will require that the expertise and data are in place for performing these estimations, and that tax surcharges or other forms of revenue autonomy have been introduced. Until that time, the basis for equalization should be revenues from tax sharing. The danger of discouraging tax effort would be reduced by excluding local revenues and surpluses over budgeted targets from the equalization basis.

On Expenditure Equalization. To a large extent the expenditure equalization currently carried out through the budgetary norms should be transferred to an apportionment formula which funds needs rather than capacity. Two approaches should be considered. One is based on a simple weighted formula using proxies capturing expenditure needs.⁴⁶ In the longer run a “representative expenditure system” approach, as described above, should be considered.

On Funding of Transfers. There is no clear choice on how to fund the overall level of transfers. To promote certainty and stability, the government could assign a fixed share of its revenues to this end. Stability and certainty can also be achieved with current plans to adjust last year’s transfer for the rate of inflation. This system actually may be more stable and certain than one assigning a certain share of revenues.

⁴⁶ Expenditure equalization could be performed on the basis of a simple formula with the following proxies for needs (and weights): population (with a weight of 0.4), population under 16 years (with a weight of 0.3) and population over 65 (with a weight of 0.3).

However, it may be less elastic, especially if the inflation adjustment index is scaled down by the relative importance of transfers in local budgets, as is the current practice. As shown in this report, this method of adjustment is inimical to poorer jurisdictions and therefore it should be discontinued.

An alternative is for the government to consider funding part of the transfers for equalization on a fraternal system basis. This approach has the added advantage of helping the government address the richer-versus-poorer province issue when granting more revenue autonomy to subnational governments.

What is recommended here is to stop the current gap-filling approach to determination of transfers and not to adopt any other similar approach that relies on costing subnational expenditure responsibilities and then setting transfers to ensure adequate resources. These approaches are unlikely to be helpful because of the difficulty of costing out services. Furthermore, the level of funding required for the “adequate” provision of services may well be a multiple of what the country can afford. The level of funding for transfers has to be decided early in the budget process at the most aggregate level to fit into the government’s macroeconomic fiscal policy.

On the implementation of the system of transfers. The government should consider creating an Equalization Board or Grants Commission for monitoring and helping with conflict resolution in the implementation of the system of transfers. Both central government and subnational government representatives should have an input in the appointment of the Board. The Equalization Board or Grants Commission will guarantee objectivity and impartiality vis-a-vis the particular agendas of the central and subnational governments. Box VII-3 describes the activities and tentative recommendations of the newly created Financial and Fiscal Commission in South Africa.

Box VII-3: Financing Provinces in South Africa

Constitutional foundations. Like Vietnam, South Africa has a unitary government. The post-apartheid constitution of South Africa contains provisions dealing with various aspects of intergovernmental fiscal relations (IFRs), including the assignment of expenditure functions and tax assignment. In addition, it provides that a non-partisan Financial and Fiscal Commission (FFC) should advise the Parliament and provincial governments on a variety of issues in intergovernmental fiscal relations. These include the taxing powers of the provinces, the allocation of revenues collected by the central government between tiers of government, grants from the central government to the provinces, and borrowing by subnational governments. It is hoped that institution of the FFC will help to base decisions on IFR on objective technical grounds, and not purely political considerations.

Taxing powers. The constitution of South Africa allows the provinces to levy taxes (presumably via independent legislation and administration), other than income tax, value added tax, general sales tax, and customs duties. If allowed by enabling national legislation, provinces can levy flat-rate surcharges (presumably implemented by the tax authorities of the central government) on the base of taxes imposed by the national government, except for the company income tax, the value added tax, and customs duties. The above limitations were motivated, in part, by recognition of administrative problems inherent in provincial surcharges on VAT and fear of exporting of provincial taxes on company income. Due to the administrative difficulties of imposing destination-based provincial surcharges on excises, these two provisions imply that surcharges on the individual income tax are likely to be the most important source of provincial revenues from own sources.

Taxation and equalization. The Financial and Fiscal Commission has recommended that the provinces be allowed to exercise their constitutional prerogative to impose surcharges on the individual income tax. In order to make “room” for such surcharges, while holding aggregate tax revenues of the central and provincial governments roughly constant as a percentage of GDP, the FFC proposes that the central government reduce its individual income tax rates by a certain number of percentage points (r , set provisionally at 7 percentage points). A zero-sum system of tax equalization grants (which can be either positive or negative, for a given province) has been proposed to compensate partially for horizontal fiscal disparities, as reflected in differences in the taxable capacity of the provinces, as reflected in revenues from the income tax surcharge. This grant would not, however, be dependent on the provincial tax rate actually chosen (or on other grants it receives). Thus, by levying a tax rate higher or lower than 7 percent, a particular province could have a higher or lower level of public services.

Conditional grants. The FFC has also recommended that the central government provide two important types of grants to the provinces: conditional grants for basic health and education, motivated by the desire to guarantee the capacity to finance minimum services, and an unconditional grant intended to overcome vertical fiscal imbalance and ensure the fiscal capacity of the provinces. (It has also recommended conditional grants for the training of doctors in provincial hospitals, justified by the national interest in such training.) The minimum service grants for health and education, intended in part to help provinces overcome regional disparities in the availability of services, can be spent only for the purposes intended. They are based on the qualifying population in each province (for example, the number of children aged 5-17, in the case of the education grant).

To avoid disrupting provincial budgets, the FFC proposes that these grants be phased in over a period of 7 to 10 years.

Box VII-3: Financing Provinces in South Africa (continued)

Overcoming vertical imbalance. The unconditional grants are based on population, but with each member of the rural population given a weight of 1.25 times that of the urban population, to reflect the relative deprivation of rural areas. Being intended to offset vertical fiscal imbalance, the aggregate amount of these grants would be set to achieve a given split of government spending between the provinces and the central government, taking account of other grants and the reduction of the individual income tax rate of the central government (and the desire to reduce the budget deficit).

Summary of advantages. The system described combines several advantages: tax surcharges to provide fiscal autonomy, tax equalization to compensate for horizontal fiscal disparities, unconditional grants based largely on population to overcome vertical fiscal imbalance and differences in need, and conditional grants to ensure minimum levels of certain services. It is essentially a textbook example of how to structure intergovernmental fiscal relations.

VIII. CONCLUDING REMARKS

The system of intergovernmental fiscal relations in Vietnam is based on the principle of “democratic centralism.” Decision-making processes (exemplified by dependence of subnational People’s Councils on the National Assembly and “nested budgets”) and administrative structures (e.g., dual subordination of officials of subnational governments) both reflect this. The resulting system of “top-down” decision-making and administration is cumbersome and complex. Moreover, it sacrifices self-determination at the subnational level in favor of central control. In short, “democratic centralism” is short on democracy and long on centralism. It is more appropriate to an economic and political system based on central planning than to one that recognizes the value of decentralized decision-making, via markets and other means.

A natural accompaniment of *da moi* in the economic sphere, which has proven so successful in Vietnam, is reform of the system of IFR to give subnational governments greater power of self-determination. One objective of this report (the others being to describe the system of IFR and to explain its effects and weaknesses) is to describe the reforms of IFR that would be needed to create such a system.