

**Sharing the Load**  
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Taxes are not only the main instruments for raising fiscal revenue, but they are also key policy instruments available to the government to influence resource allocation decisions over time and across different economic sectors and activities. While tax policy will be inevitably influenced by political and social considerations, in a fully market-based economy, tax policy is usually shaped with the objective of minimizing distortions and impediments to the operation of market forces—except of course in cases of market failures. To the extent taxes generate the needed revenue, a simple and transparent tax system tends to better meet such requirement; while also reduce uncertainties and discretion, thereby minimizing rent seeking activities and ensuring fair implementation.

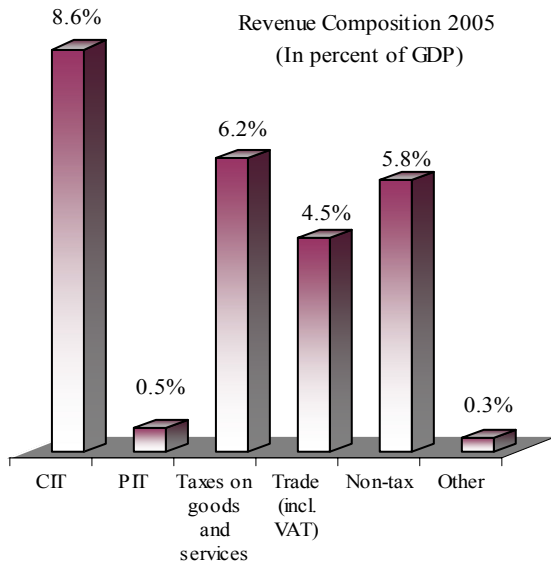
To assess whether Vietnam's tax system is currently appropriate to support economic activities in the period ahead, one would first need to review the current and projected revenue performance against future fiscal needs, and the distribution of the tax burden over different sectors and activities, especially relating to businesses and new investments. At the same time, it is important to note that fair and transparent enforcement of a tax system is equally, if not more, important than the appropriateness of the system itself. In this regard, it is useful to compare revenue performance with other countries. A simple numerical comparison across countries alone, of course, would not be a proper measure of adequacy of a country's fiscal revenue system as it would not take into consideration the differences in economic structure and government policy objectives. Nevertheless, overly dissimilar ratios from international norms could signal potential problems or weaknesses.

**How does Vietnam's tax system compare with other countries?**

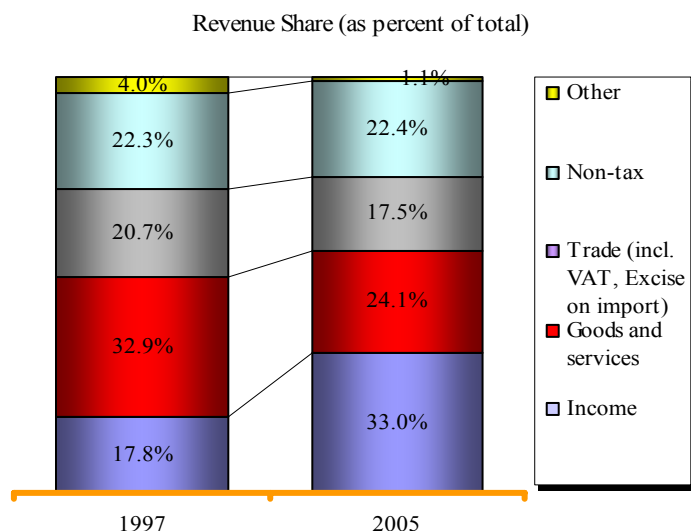
Vietnam's tax system as measured by revenue collection to GDP fares well compared to other countries at similar level of development. Vietnam's total revenue of 26 percent of GDP, or total tax revenue of 20 percent of GDP, is above the average of its neighbors as well as non-OECD country norm of about 18 percent of GDP. This favorable revenue performance reflects both the relatively important role played by the government in the economy as well as the large gains made from natural resources that are shared with the public at large through the budgetary process.

In 2005, Vietnam relied on the corporate income tax (CIT) for about a third of its total revenue, followed closely by taxes on goods and services that accounted for a quarter of total revenue. Trade taxes at just above a tenth of total revenue (or close to a fifth of total revenue if VAT on imports is included) show that Vietnam is not overly dependent on international trade, which is sometimes the case in low income countries. Nevertheless, personal income tax (PIT) at 2 percent of total revenue, which translates to about 6 percent of CIT, is very low

by international standards (A PIT/CIT ratio of 85 percent is the norm for non-OECD countries). This reflects in part the fact that a relatively large proportion of economic activities are still not properly captured in the tax system; it also shows the need to revisit the PIT system. In terms of GDP, CIT accounted for about 8½ percent of GDP, followed by taxes on goods and services at 6.2 percent of GDP.

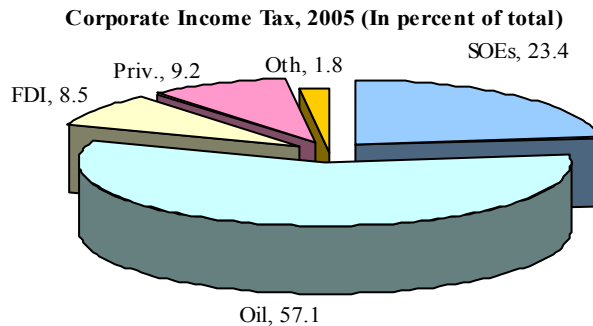
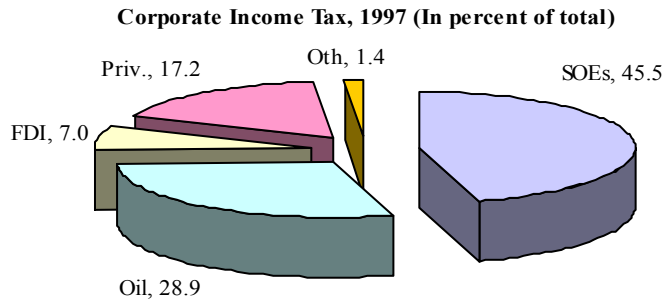


Vietnam's revenue performance as well as its composition are strongly influenced by developments in the international crude oil price. Revenue from crude oil exports are collected through the CIT and charges and fees captured as part of the non-tax revenue. Together oil revenue and charges and fees accounted for close to 30 percent of total revenue in 2005 (excluding taxes/tariffs collected on imported petroleum products). In fact, compared with 1997 data, oil revenue in value terms has increased seven-fold, or 2.6 times as a percentage of GDP. As is explained below, the large increase in taxes on income, from 18 percent to 33 percent of total revenue largely reflects the increase in CIT from crude oil exports.



CIT collection doubled from 3.7 percent of GDP in 1997 to 8.6 percent of GDP in 2005, of which about 4 percent of GDP is accounted for by the increase in oil CIT alone. Excluding foreign-invested enterprises (FIEs), CIT revenue from other entities has remained broadly constant as a percentage of GDP, but has fallen by half as a percentage of total CIT. To the extent that the public sector share of GDP and local non-farm private sector share of GDP have remained broadly unchanged at 40 percent and 25 percent, respectively, their relative contributions to revenue (as percent of GDP) have not changed despite various tax policy and administrative reforms—one should note, however, that the tax policy reforms also entailed reduction of tax rates. CIT from the FIEs as a percentage of GDP doubled during the same period as did their relative share in GDP, indicating no increase in CIT per FIE contribution to revenue.

The limited increase in CIT from FIEs could partly be explained by the tax incentive system. Current tax incentives in Vietnam are broadly in line with neighboring countries. However, Vietnam's incentives are rather complex and rely on particular forms of CIT holidays and reduced rates that could potentially undermine the CIT base. International experiences generally indicate that the tax system is usually one of several factors investors take into consideration. A simple and transparent tax system that is easily understood and fairly administered is often more attractive to investors than a complex system that allows discretion. The latter case will raise the net cost for investors, especially for those with interest in long-term investment.



### **What are the challenges on the fiscal revenue front?**

Vietnam is faced with several challenges regarding revenue performance. The composition of revenue has long been foreseen to undergo changes with the implementation of AFTA, WTO-accession related changes, and internal structural reforms. The tax base is expected to shift further away from international trade and, more importantly, from SOEs. Furthermore, assuming the quantity of crude oil export remains constant, crude oil revenue should fall as percent of GDP since international crude oil prices are unlikely to rise indefinitely.

Vietnam can not afford to reduce fiscal revenue in the period ahead given its commitments already made on civil service wages and the planned investment in infrastructure. Thus, these expected changes call for compensatory tax measures. In fact, the broadening of the tax base would not only help meet the expected shortfall, but it will also facilitate a more even distribution of the tax burden in Vietnam, bringing its tax system closer to the international norm, especially relating to PIT. Moreover, tax incentives will have to be streamlined not only to ensure a level playing field with domestic investors, but also to reduce the cost of uncertainty for investors in general. A modest reduction of the CIT rate combined with a streamlined and transparent incentive system could attract more FDI as long as it is fairly administered.

### **What changes will be required to meet these challenges?**

Vietnam's tax and non-tax system underwent two rounds of rigorous reforms since the early 1990s. These reforms have made concrete advances in both tax policy and administration. A

total of nine tax laws and ordinances were introduced ranging from VAT to corporate income tax on the tax side, and royalty fees and surcharges on the non-tax front. The revenue base was expanded to all economic sectors, while at the same time incentives were provided to attract foreign investment. Tax administration was developed in parallel with these tax policies both at the local and the central level.

Notwithstanding these significant reforms, scope for further improvement in the tax system remains. Accordingly, the government is already in the process of implementing the comprehensive tax reform program (Decision No. 201/2004/QD-TTg dated December 6, 2004) that covers 2004 through 2010. The overall objective of the strategy is to further tailor the tax system to better fit within the market-based system while still maintaining the socialist orientation. The reform will involve changes in tax policy as well as tax administration.

On the tax policy front, most tax rates will be affected. The threshold on the value-added tax will be moved from the minimum level of income to revenue, with rates unified at 10 percent (with some exceptions set at zero). Tax calculation is expected to be based on a single method of calculating tax deductions, and reimbursements will be based on clear criteria. CITs will be expanded to cover all economic sectors without differentiation, while their cost deduction rules will be simplified and tax rate reduced to 25 percent. Tax incentives will be streamlined with clearly defined time limits. Regarding the PIT, as already widely announced, key changes in the PIT draft law include a reduction in the threshold while at the same time an expansion of the coverage to both local and foreign income earners equally.

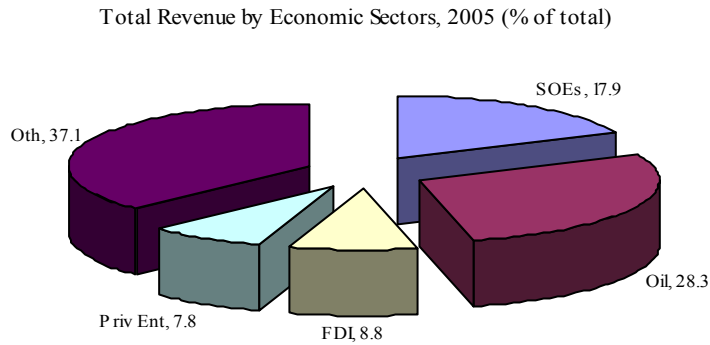
On the administration front, tax administration will be modernized through changes in the organizational structure and adoption of the IT system. As recently announced by the General Department of Taxation, the pilot-based self-assessment will be rolled out nationwide next year. Self assessment is expected to improve taxpayer compliance as well as free up more time for the tax authorities to better supervise, including through random inspection on compliance, and keep an arms-length relationship with tax payers. The self-assessment will cover value added tax, CIT, special consumption and resource taxes.

### **What are the prospects of success?**

These proposed reforms will help expand the tax base and improve compliance. However, the expected gains in revenue will be realized only gradually over the medium and long term. In particular, the PIT will truly expand only when the informal private sector activities are properly captured in the tax base and the CIT will expand if FDI inflows continue at a rapid phase and local private businesses grow from small household-level activities into medium- and large-size enterprises, thereby compensating for the expected shrinking SOE sector.

Thus, these reforms are most likely to pay off in the long term, although maintaining revenue of 26 percent of GDP continuously through the medium term will be a challenge. While rigorously implementing these reforms, one need to be mindful when deciding on expenditures that revenue growth as percent of GDP may not necessarily be smooth. One

plausible and simplest way to smooth the expenditure path would be to save some windfall oil revenue while prices are expected to be high temporarily, especially when this additional revenue is allocated to current expenditure.



As noted earlier, FDI will provide an increasingly important revenue source. Nevertheless, while one should not ignore the scope of tax incentives relative to other countries, greater focus in creating a simple and transparent tax system that is fairly administered will go a long way in not only attracting foreign investors, especially those who have more longer-term investment plans where stability and predictability are more important than short term tax breaks.