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Fiscal Decentralization and Local Budget Management in Vietnam: An Overview

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Abstract: *Viet Nam has gradually decentralized more fiscal responsibilities to local authorities. In 1996, the first State Budget Law was promulgated, and fiscal decentralization was formally mandated. This law was then revised in 2002 and put into operation in 2004, giving more autonomy to local governments, especially at the provincial level to promote sustainable development underpinned by local preferences and economic stability, equity across provinces, efficient services delivery, and enhanced transparency and accountability in public finances. Today, local spending accounts for just over one-half of general government spending, while local revenue accounts for over one-third of general government revenue, and just over one-half when extrabudgetary sources are included. These are significant shares when compared to other countries, particularly those at a similar level of development to Viet Nam (World Bank 2014). This study has two objectives: (i) to take stock of the current institutional framework for intergovernmental fiscal relations, and (ii) to empirically assess the deficit sustainability of local governments in Viet Nam.*
Keywords: *Local budget government, Fiscal decentralization, Vietnam*

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I. Introduction

Viet Nam's local government system was established in 1945, at the same time as the Democratic Republic of Viet Nam, operating under the principle of democratic centralism. This principle created a hierarchical top-down administrative system, meaning that subordinates obey superiors, and local governments obey the central government. Today, Viet Nam has four tiers of government: (i) central; (ii) 63 provinces, including 5 major cities; (iii) 710 district-level cities, towns (in urban areas), and districts (in rural areas); and (iv) 11,145 wards and townships (in urban areas) and communes (in rural areas). Each tier of government has both legislative and executive authorities. At the central level, legislative authority rests with the National Assembly, and executive authority rests with line ministries and agencies. At the local level, each tier of government has a people's council to exercise legislative authority and a people's committee and line departments to exercise executive authority.

From 1975 to 1989, Viet Nam remained a centralized fiscal and economic system. Local governments acted as an agency for the central government, and they also were assigned some limited own-source revenue including fees, charges, asset depreciation, some shared revenue including revenue from the profit of state-owned enterprises (SOEs), and taxes on agriculture and industrial activities. In 1983, the government issued a resolution to further clarify local government own-source revenue and revenue shared by local governments with the central government. Sharing rates were still determined by the central government. The central government also designed a subsidy scheme for provinces that were unable to cover their local expenditures with own-source and shared revenues.

During this period, the role played by local governments in the budget-making process grew, and the central government began considering local governments to be an integral component of the state budget. In 1989, the government implemented a resolution that regulated the spending responsibilities of and revenue sources for local governments. Under this resolution, local government revenue came from three different sources: (i) 100% of locally collected revenue (e.g., collections to cover depreciation, taxes on the slaughter of livestock, and various fees and charges); (ii) shared tax revenue with the central government (e.g., revenue from profits of central and local SOEs and industrial activities); and (iii) conditional transfers to balance local governments' budgets. Under this new arrangement, shared revenue could not be retained by local governments; thus, of 44 provinces, 14 returned additional revenue to the central government from shared revenue because their local budgets were balanced.

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In 1996, to further reform the central–local government relationship, the first budget law was promulgated, coming into effect in 1997. This law outlined the spending responsibility and revenue allocations for central and local governments, and regulated the borrowing of local governments and intragovernment fiscal transfers. This law was then revised in 1998, coming into effect in 1999. Under the revised law, the lower tiers of local government (i.e., district and commune levels) were assured greater revenue and expenditure responsibilities. For example, they were to secure at least 70% of their revenue from taxes on the rights of land transfer, land and housing taxes, licensing taxes from small businesses, and agriculture taxes. This law also defined the roles of different agencies engaged in the preparation of the central budget as well as the roles of line ministries and local governments in implementation

To give more fiscal responsibility to local governments, especially at the provincial level, the new budget law was promulgated in 2002, taking effect in 2004.1 This law has several distinguishing features:

(i) The central government has given local governments more autonomy. While the 1997 law established intergovernmental fiscal relationships among all tiers of government, the new law only regulates the fiscal relations between the central and provincial levels. Local governments now have autonomy in deciding the fiscal relationship among government levels within their jurisdictions.

(ii) The fiscal capacity of local governments has been strengthened. The central government now shares some types of revenues that used to be solely central government revenue sources (e.g., special consumption taxes, and gasoline and oil taxes) with local governments.

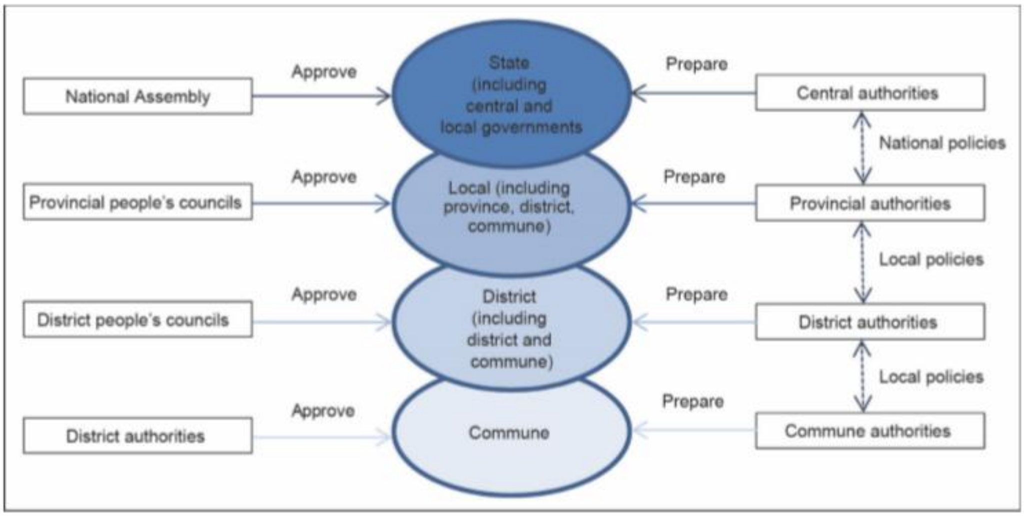
(iii) The central government also has designed some incentives for revenue efforts made by local governments.

(iv) The central government has also established a legal foundation for the adoption of formula-based intergovernmental fiscal transfers.

(v) It established budget stabilization periods of 3–5 years as determined by the National Assembly. Since 2004, there have been three stability periods: 2004–2006, 2007–2010, and 2011–2016.

The new budget law specifies that there is a single, unified public sector budget that must ultimately be ratified by the National Assembly, implying that the National Assembly is given more power in the fiscal decentralization process. The transfer norm decision was also moved from the Ministry of Finance to the National Assembly, and is made public to sector ministries and provinces, thus improving the transparency and budget process. Moreover, the National Assembly approves not only estimates of total revenues and expenditures but also their composition.

Figure 1: Fiscal Process in Viet Nam



Source: World Bank (2014).

Different from other countries, the hierarchical nature of the Viet Nam fiscal system complicates the budget-making process. Although each local government has some autonomy in estimating its budget, budgets of lower-level governments are examined and approved by the higher level of government. Eventually, the outcomes of the entire process must be integrated into the single state budget. This hierarchical nature also undermines the autonomy of the lower level of governments, as their budgets are highly subject to changes and revision requests by higher levels of governments

Fiscal decentralization in Vietnam

Expenditure Decentralization

Since the new budget law, local authorities have been given more power in making decisions relating to resources allocation within their provinces, as the law defines spending functions for the central government and local governments. The central government still has the exclusive esponsibility for external relations, foreign trade and foreign assistance, food safety, and drug regulation. Responsibility for all other public services is shared among the various tiers of overnments.

Expenditure assignments also take into account the special character of provinces and are symmetric across provinces. Fiscally advantaged provinces enjoy greater fiscal and administrative autonomy, while central government agencies have a more expansive role in fiscally disadvantaged provinces.

Table 1: Ratio of Decentralized Revenue to Total Expenditure
(%)

Expenditure	2007	2010	2013
Total expenditure	46.6	53.1	52.6
Development investment expenditures (including capital expenditure)	62.7	73.4	68.9
Debt services and overseas aid	15.2	9.7	6.3
Recurrent expenditure	50.3	53.5	53.7
Education	86.2	89.6	90.9
Health	79.0	80.8	84.4
Social welfare	14.0	17.9	24.5

Source: Authors' calculations using Ministry of Finance data.

Local government spending makes up an important share of total government expenditure in Viet Nam (Table 1). The share of local government spending increased from 47% in 2007 to about 53% in 2013. In 2013, local governments made up about 70% of total capital spending, since the central government's responsibility was limited to large national projects. Their share in recurrent expenditure also increased to about 54% in 2013. Except for social security functions, which still accounts for a large share of central government spending (about 75%), local governments' share of total recurrent spending in other government functions was high. For example, in 2013, local governments were responsible for 91% of total recurrent expenditure in the education sector and 84% in the health sector.

At the lower levels of local government, the degree of decentralization is rather high. In many provinces, district spending constituted more than 45% of total local spending (World Bank 2014). Lower-level local governments were responsible for most of the recurrent expenditure in the education sector (75% in 2012) and health sector (60% in 2012). Uchimura and Kono (2012) and the World Bank (2014) found that the shares of rural population and the level of local capacity in provinces are important factors in explaining the level of district expenditure in local expenditure. However, the degree of capital expenditure decentralization between the provincial level and lower levels is rather limited. Only 30% of provincial total capital expenditure was implemented by the lower levels of government. This could be attributed to some concerns over efficiencies regarding capital spending at the lower levels.

Although Viet Nam has accelerated its fiscal decentralization process, there are some institutional factors that may have negative effects on the effectiveness of such decisions. First, the spending responsibilities for each level of government are still not clearly defined, thus creating unnecessary overlaps. Except for some exclusive responsibilities as previously mentioned, responsibility for all other public services is shared between the central and provincial governments, including national defense and social insurance and protection. While the local contributions for these areas are typically small, they disproportionately affect poorer provinces, and sometimes these expenses cannot be anticipated and therefore require diverting local resources from other services (World Bank 2014).

Moreover, if coordination among tiers of government is not smooth, ambiguous expenditure assignments may cause overlaps and inefficiency. The most visible overlaps are seen in the education and health sectors. For example, in the education sector, the central government and local governments co-share administering, financing, managing, and delivering almost all levels of education, from prekindergarten to university. Such overlaps in expenditure responsibilities create a number of burdens for local government, including time and efforts to clarify respective functions for each level (World Bank 2014).

Second, although the new budget law lists spending functions for both the central and local governments, the lists are both overdetailed and vague, impacting the autonomy and flexibility of local governments. For example, they list some ambiguous functions like investment in SOEs, state economic organizations, and state financial institutions, but spending functions in certain areas may be different among provinces due to socioeconomic development conditions.

Third, the new budget law gives provinces autonomy to assign expenditure responsibilities to lower tiers of governments, which leads to substantial heterogeneity in provinces' expenditure assignments. In the first stability period, all three subnational governments were responsible for health care in 25 provinces, provincial and communal governments shared the responsibility in eight provinces, provincial and district governments shared the service responsibility in 14, and the service was the exclusive responsibility of the provincial government in 17 provinces (Le 2006).

Revenue Decentralization

Revenue collected in Viet Nam can be grouped into three categories: (i) central government revenue, (ii) revenue entirely retained by local governments, and (iii) revenue shared between the central government and local governments. Accordingly, shared taxes include value-added tax (VAT) (except the VAT on imported goods), corporate income tax (except some special cases), personal income taxes, taxes on profits remitted abroad (except for the petroleum industry), special consumption taxes, and gasoline and oil fees. Note that the sharing of these taxes is based on the domicile of the taxpayer, and tax rates and bases are set by the central government and are uniform throughout the country.

The sharing rate has some special features, including a new rate introduced at the beginning of each stabilization period, a uniform rate for all shared taxes, a fixed rate during a stability period, and different rates applied in different provinces. The sharing rates are established at the beginning of each stabilization period and are based upon provincial fiscal capacity. Table 2 presents the sharing rates of provinces that had rates of less than 100%.

Taxes and fees fully dedicated to provinces include taxes on land and housing, natural resources (excluding petroleum), license taxes, taxes on transfer of land-use rights, taxes on the use of agriculture land, fees on land use, land rent, revenue from leasing and sale of houses owned by the state, registration fees, and revenue from state-run lotteries, as well as various fees and charges. Of all of the revenue sources, this type of revenue is the most suitable type of own-source revenue in the standard language of fiscal decentralization. This revenue source, together with shared revenues that can be viewed as fiscal transfers, makes up decentralized revenue. They represent the core of the locally collected revenue.

The new budget law also allows provincial governments to design their own revenue assignments to districts and communes within their jurisdictions, although there are still some general principles and minimum standards that the provinces must follow. However, more autonomy in assigning expenditure responsibilities enable provinces to delineate expenditure responsibilities based upon the fiscal capacity and rural and urban characteristics of local governments.

Table 2: Portion of Shared Provincial and Central Government Revenues Retained by Provinces
(%)

Province	2004–2006	2007–2010	2011–2015
Hanoi	32	31	42
Quang Ninh	98	76	70
Hai Phong	95	90	88
Vinh Phuc	86	67	60
Bac Ninh	100	100	93
Khanh Hoa	52	53	77
Ho Chi Minh City	29	26	23
Dong Nai	49	45	51
Binh Duong	44	40	44
Ba Ria–Vung Tau	42	46	44
Long An	99	100	100
Tien Giang	99	100	100
Vinh Long	90	100	100
Can Tho	95	95	91
Others	100	100	100

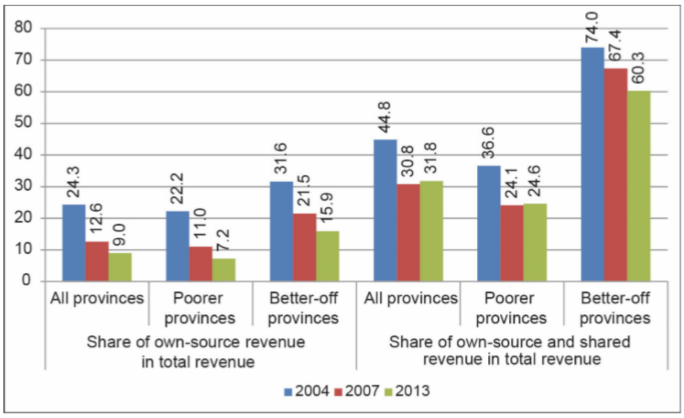
Source: Authors' compilation from Ministry of Finance data.

The law also includes an incentive for revenue collection at the local government level. A local government can retain up to 30% of all shared revenue actually collected in excess of the estimated amount. Further, to avoid the temptation to underestimate future shared tax revenues, the law stipulates that the excess amount retained must not exceed the difference between this year's actual revenue in shared taxes and last year's.

During 2006–2012, decentralized revenue in Viet Nam constituted about 9.6% of gross domestic product (GDP). Decentralized revenue, however, did not account for a large share of local economies in Viet Nam. In most of the provinces, decentralized revenue was equal to about 7.0% of local GDP; these provinces also retained 100% of the shared revenue that they collect. This is because some of the most potential sources of revenue, such as trade-related revenue, petroleum-related revenue, and corporate income taxes from large SOEs, accrue to the central government and not to local governments

Figure 2 presents the contribution of decentralized revenue to total revenue at the local government level. The share of revenue that is fully dedicated to provinces (i.e., own-source revenue) declined from 24.3% in 2004 to 12.6% in 2007 and further to 9.0% in 2013.4 The share of own-source revenue and shared tax revenue also declined from 44.8% in 2004 to 30.8% in 2007, yet the share of these two sources of revenue was stable at about 30.0% of total revenue during 2007–2012. This implies a declining role of decentralized revenue in total local government revenues. Figure 2 also indicates a huge gap in the importance of these two sources between provinces with a sharing rate of 100% and provinces with a sharing rate of less than 100%. In 2013, about 60% of total revenue of better-off provinces was from these two sources, while this figure was about 25% in poorer ones.

Figure 2: Share of Decentralized Revenue in Total Local Government Revenue
(%)



Source: Authors' calculations using Ministry of Finance data.

Despite efforts to give more power to local governments to raise their revenue, several obstacles continue to limit the size of local government own-source revenue. First, there are two concerns about the shared revenues. On one hand, the sharing rate is set to take into account differences in fiscal capacity. However, in reality, sharing rates are determined through negotiations between central and local government authorities, and thus could lead to suboptimal outcomes due to poor revenue forecasts and differing negotiating capacity (World Bank 2014). The other concern relates to the fairness of the system. The shared revenues in Viet Nam are split, based on where revenues are actually collected rather than where the tax is incurred. This raise questions concerning the fairness of the system, especially for the VAT and corporate income tax (e.g., if a firm operates in one province, and its headquarters are in another province).

Second, some regulations hinder the autonomy that the central government gives to provincial authorities. For example, with regard to fees and user charges, provincial authorities can only set the charges and fees for 19 of 63 items, while the Ministry of Finance has the authority to set the fees and user charges of the remaining items. This partly explains why only about 11% of own-source revenues were collected from fees and charges (World Bank 2014). Another regulation is related to the share of resources allocated to the commune level: (i) communes and townships receive at least 70% of revenues from a tax on transfer of land-use rights, land and housing taxes, the license tax on individuals and individual households, and registration fees for land and housing; and (ii) townships and cities receive at least 50% of revenues from registration fees, excluding registration fees for land and housing. Such sources of revenue cannot be reallocated among communes, which has caused vertical imbalances among communes. While many communes and townships cannot absorb the minimum stated shares of resources, other communes cannot raise adequate resources to meet their spending needs. This can lead to inefficient spending or regular carryovers in surplus jurisdictions, and poorer services delivery in deficit jurisdictions (World Bank 2014).

Third, the lack of minimum standard guidelines for services provision leads to heterogeneity in responsibility sharing across provinces. For example, some provincial governments retain all revenue from taxes on natural resources, while subprovincial governments (i.e., districts and communes) in other provinces are fully or partly entitled to this tax, depending on business ownership. Sharing rates of a revenue source may even vary among districts within a province. For example, in 2008, the sharing rates for land and house registration fees ranged from 13% to 38% among 24 districts in Ho Chi Minh City.

II. Conclusion And Implication

Since the new budget law was promulgated in 2002, the fiscal responsibilities of local authorities have significantly increased; thus, local fiscal policies play a large role in Viet Nam's growth and development.To fulfill their growing role, the central government has granted local authorities more financial resources, including sharing parts of its revenue with local governments. Intergovernmental fiscal transfers have also been reformed to play an important role in mitigating vertical and horizontal fiscal imbalances.

However, several issues hinder the effectiveness and efficiency of fiscal decentralization in Viet Nam, including unclear expenditure assignments among tiers of governments, various measures and regulations that limit the autonomy of local governments in carrying out expenditure revenue management, and a lack of minimum standards for expenditure outcomes. Regarding intergovernmental fiscal transfers, although the transfer system is working fairly well, weaknesses in transfer norms, incentive problems in resources mobilization and allocation, and existence of many national and provincial targeted programs with overlapping objectives and targets also limit the efficiency of this system. Local governments are permitted to borrow in capital markets, but it seems that the fundamental foundations for local government borrowing management are weak. Lack of transparency is also observed in all aspects of fiscal decentralization.

To make the fiscal decentralization work better in Viet Nam, it is recommended that:

(i) The central government should make expenditure assignments more explicit. It could also give up some of its responsibilities to lower tiers of governments. The central government also needs to design minimum standards of services delivery, not only to secure acceptable equality in services delivery across jurisdictions but also to provide local governments with more autonomy over resources allocation.

(ii) The central government should review its current sharing arrangements such as using separate formulas for each revenue source instead of using a common formula. The central government could further strengthen local government revenues by allowing provinces to impose surtaxes on some types of taxes such as personal income taxes and local business taxes, or by giving them more autonomy in setting fees and charges. Introducing a property tax could be considered in the longer term.

(iii) Regarding intergovernmental fiscal transfers, some measures could be taken immediately, such as revising transfer norms, adopting a formula-based transfer system, and avoiding negotiations to mitigate incentive problems in resources allocation.

(iv) The central and provincial governments should review the current targeted programs, including objectives and targets, and identify overlapping programs. Resources allocations for each program should be matched with the targets. In addition, financial resources for each program should be linked to outcomes.

(v) To strengthen the current legal foundations for local government borrowing, areas that should be emphasized include having a transparent reporting system for local government debt reporting, developing a creditworthiness evaluation mechanism for local governments, and specifying a threshold on local debt stocks and debt servicing to ensure debt sustainability.

(vi) Measures should be created that ensure fiscal accountability at the local government level.

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