VIET NAM PERSONAL INCOME TAX POLICY DISCUSSION PAPER

JAY K. ROSENGARD,
KENNEDY SCHOOL OF GOVERNMENT,
HARVARD UNIVERSITY

DO NGOC HUYNH,
TAX POLICY DEPARTMENT,
VIET NAM MINISTRY OF FINANCE

10 MAY 2006

Prepared Under Viet Nam Ministry of Finance/United Nations Development Programme Project VIE/03/010 (Strengthening Capacity in Financial Policy Analysis for Human Development), Special Service Agreement #2005/231

Table of Contents

I. Executive Summary

Background

This Personal Income Tax (PIT) Policy Discussion Paper (PDP) has been written to assist the Ministry of Finance in improving taxation of personal income, one component of Viet Nam's comprehensive tax reform program.

As Viet Nam continues to equitize state-owned enterprises and promote private sector development, diversify its economy to reduce dependency on oil-related activities, and reduce trade taxes via bilateral and multilateral trade agreements, it will have to decrease its reliance on state-owned enterprises, petroleum-based activities, and trade tariffs to generate tax revenue. Instead, Viet Nam must increase the contribution of other tax instruments and sources. When compared with the performance of other countries of similar per capita income level and economic structure, the taxation of personal income offers modest potential in the short- to medium-term to help diversify state revenue.

It is hoped that the framework for evaluating taxation of personal income presented in this PDP, together with application of the framework to assess the current PIT and formulate recommendations for PIT reform, will contribute to the promulgation of a conceptually sound PIT law that can be administered as designed in a fair and efficient manner.

Conceptual Framework

The primary objective of the PIT should be to generate a significant amount of revenue in an economically efficient and socially equitable manner. The best way to achieve this policy objective is to meet revenue targets with as large a tax base as possible, as low an effective tax rate as possible, and as simple and transparent a tax design as possible.

However, application of these principles is constrained by: limited administrative capacity and taxpayer sophistication; dominance of the rural and informal sectors in the national economy; generally low levels of income; and political and social considerations. Viet Nam will need a transitional strategy to accommodate these policy constraints.

Assessment of the Current Personal Income Tax

The total revenue generated from all three components of the personal income tax (income tax on high-income earners, corporate income tax on individual and household businesses, and the land use right transfer tax) is quite small: in 2004, it was 7.55 trillion VND, which was only 5.10 percent of total state budget revenue from taxes, fees and charges (including oil-related revenue), and only 1.06 percent of GDP.

Administration is inefficient in that an inordinate amount of effort is spent trying to collect the CIT on individual and household businesses. However, most of the "income tax on high-income earners" portion of the PIT is collected through payroll withholding, for a modest fee of 0.5 to 1.0 percent of total PIT withheld. The government estimates that it spends 0.9 percent of all tax revenue it collects on tax administration. Taxpayer compliance costs are low due to the extensive use of payroll withholding and presumptive taxation.

The "income tax on high-income earners" portion of the PIT is fair in that most of the revenue comes from foreigners and because most Vietnamese fall below the tax threshold, although this number should increase rather than decrease per current trends as the economy grows. It is unfair because although a small percentage of Vietnamese pay this tax, these taxpayers are not necessarily those with the greatest capacity to pay – many much wealthier Vietnamese who are not salaried employees are able to evade the tax with impunity. It is also unfair because those with significant unearned income, again wealthy Vietnamese, do not have to pay tax on this unearned income.

The CIT on individual and household businesses is also both fair and unfair. It is fair in that only a small portion of the nearly two million households granted business licenses and many more unregistered household businesses are paying this tax, given that most of these businesses probably do not generate enough net profits to justify trying to collect the CIT from them. It is unfair because many individual and household businesses that do generate substantial income are not paying the CIT, especially those engaged in professional services. It is also unfair because evasion of the CIT is widespread among larger businesses that clearly have greater capacity to pay.

The most distortionary features of Viet Nam's current taxation of personal income are the high tax rates of the "income tax on high-income earners" portion of the PIT, coupled with the relatively narrow income bands and the low income threshold for the highest marginal tax rate, which all provide strong incentives for tax avoidance and tax evasion.

Recommendations to Improve the Personal Income Tax in Viet Nam

The recommended long-term vision and the transitional strategy for taxation of personal income are both based on the principles of enlarging the tax base, broadening taxable income, and simplifying and enforcing tax design.

Key elements are: inclusion of more potential taxpayers and income sources; reduction of tax rates and widening of tax bands; reduction of income adjustments; and heavy reliance on withholding and presumptive taxation.

When these basic principles are compromised, it reduces revenue potential while increasing inequities and inefficiencies. It is important to recognize the winners and losers, both in theory and in practice, of all income exclusions and adjustments that are being considered in the policy discussion of income tax reform. When potential taxpayers or potential income are excluded from the PIT, either another taxpayer has to make up the difference to generate the same amount of revenue, or these "tax expenditures" crowd out other expenditures to make up the revenue shortfall. Both results are clearly unfair and tend to be anti-poor, as they increase the burden on those already paying the income tax and not able to take advantage of special tax treatment.

The speed at which Viet Nam moves from the transitional strategy to the long-term vision depends on: the government's tax administration capacity, including the quality of taxpayer service and the degree of cooperation between agencies; the skills and awareness of taxpayers; the structure and complexity of the economy; and the social and political environment.

Fiscal analysis indicates that without reform core PIT revenue should increase from 0.99 percent of GDP in 2004 to 1.61 percent of GDP in 2015. However, with the recommended transitional reform strategy, core PIT revenue should rise to 1.85 percent of GDP, a 14.9 percent increase from the base case.

Scenarios that simulate implementation of an OECD-model PIT over the next decade rather than after a transition period indicate that while gross core PIT revenue might rise between 1.2 and 3.7 percent more than the transitional strategy if tax administration and taxpayer awareness improve dramatically, the results could be quite different with less optimistic assumptions: net core PIT revenue could be much less because of increased tax administration and taxpayer compliance costs; there could be a high opportunity cost in diverting scarce administrative resources from incorporating new taxpayers in the tax base to enforcing compliance of existing taxpayers with new tax regulations; and the change in tax incidence could be quite regressive.

All of the tax simulations indicate that the government will still fall 5 percent short of its income tax target of 12 percent of total revenue by the year 2015 if tax reform is limited to broadening the definition of taxable income of existing taxpayers, regardless of the new tax design model selected: income tax revenue rises to only 2 percent of GDP under all three reform scenarios. The difference can only be made up by improved tax effort: reducing tax evasion by wealthy residents who are not paying any taxes, as well as pervasive taxpayer underdeclaration of income and overestimation of expenses.

The conceptual framework, assessment of the current system, and recommendations for near-term and long-term reform are summarized in the following table.

	Current System	Transitional Strategy	Long-Term Vision
Revenue Generation	Total Revenue Low (-) 6.1% of state revenue 1.4% of GDP PIT Portion Low (-) 2.2% of state revenue 0.5% of GDP PIT Not Buoyant (-) ½ FDIE growth rate Declining number of taxpayers Rapidly increasing threshold PIT Administration Efficient (+) Payroll withholding Modest fee CIT Administration Mixed (±) Presumptive but still administratively intensive Compliance Cost Low (+) Mainly payroll withholding and presumptive taxes	Enlarge Tax Base Include all sectors, but with very high exemption Include HH enterprises from CIT Broaden Taxable Income Include all earned income Include interest/dividend income at very low rate Include only cash income Exclude capital gains Defer social/health insurance Include all net business income Exclude land use rights transfer Exclude inheritances Simply and Enforce Tax Design Reduce number of tax rates and widen tax bands Reduce income adjustments Rely heavily on withholding and presumptive taxation	Enlarge Tax Base Include all sectors, with equal treatment Include HH enterprises from CIT Broaden Taxable Income Include all earned income Include all unearned income Include non-cash income Include capital gains Defer social/health insurance Include all net business income Exclude land use rights transfer Exclude inheritances Simplify and Enforce Tax Design Minimize number of tax rates Minimize income adjustments Increase use of self-assessment
Social Equity	PIT Fair (+) 70% of revenue from foreigners Most Vietnamese below threshold PIT Unfair (-) Foreigners/Vietnamese evasion Heavy burden on wages/labor Unequal treatment of foreigners and Vietnamese CIT Mixed (±) Most households exempt but evasion by many services and exclusion of selected sectors	[see "Enlarge Tax Base," "Broaden Taxable Income," and "Simplify and Enforce Tax Design" above] [see "Reduce/Harmonize Tax Rates" below]	[see "Enlarge Tax Base," "Broaden Taxable Income," and "Simplify and Enforce Tax Design" above] [see "Reduce/Harmonize Tax Rates" below]
Economic Efficiency	Inefficient (-) High PIT marginal tax rates Narrow PIT income bands Lack of harmonization with CIT Exclusion of unearned income Exclusion of capital gains Exclusion of economic sectors	Reduce/Harmonize Tax Rates Cap highest MTR at CIT rate Cap unearned and irregular income at 5% [see "Enlarge Tax Base," "Broaden Taxable Income," and "Simplify and Enforce Tax Design" above]	Reduce/Harmonize Tax Rates Cap highest MTR at CIT rate Same rates for all types of income [see "Enlarge Tax Base," "Broaden Taxable Income," and "Simplify and Enforce Tax Design" above]

II. Introduction

This Personal Income Tax (PIT) Policy Discussion Paper (PDP) has been written to assist the Ministry of Finance (MOF) in the formulation of its strategy to improve the taxation of personal income, one component of Viet Nam's comprehensive tax reform program.

The current tax base in Viet Nam is not sustainable, given the heavy reliance on state-owned enterprises, oil-related revenue, and non-oil trade taxes:

- In 2002, state-owned enterprises paid 79.7 percent of the corporate income tax, 73.6 percent of excise taxes, and 59.7 percent of the value-added tax.

- These high figures understate the dominance of state-owned enterprises because they exclude the large number of foreign-invested enterprise joint ventures with state-owned enterprises.

- From 1998 to 2002, oil-related revenue comprised 26.5 percent of all revenue and non-oil trade taxes made up 13.1 percent of all revenue.

As Viet Nam continues to equitize state-owned enterprises and promote private sector development, diversify its economy to reduce dependency on oil-related activities, and reduce trade taxes via bilateral and multilateral trade agreements, it will have to decrease its reliance on state-owned enterprises, petroleum-based activities, and trade tariffs to generate tax revenue.

Instead, Viet Nam must increase the contribution of other tax instruments and sources. When compared with the performance of other countries of similar per capita income level and economic structure, the taxation of personal income offers modest potential in the short- to medium-term to help diversify state revenue.

It is hoped that this PDP will contribute to the current policy dialogue regarding PIT reform, and will assist senior policy makers in making an informed decision as to the most appropriate way to tax personal income in Viet Nam.

The PDP's main text is divided into three sections:

- In Section III, we make our assumptions explicit about what constitutes a good PIT, including what we consider to be appropriate PIT policy objectives, desired PIT design components, and the most common internal and external constraints in achieving the ideal PIT design.

- In Section IV, we evaluate the current system of taxing personal income in Viet Nam, based on the criteria described in Section III and comparisons with the PIT design and implementation in other countries. These comparisons are important not only for examples of PIT successes that might be adapted to Viet Nam, but also for the insights they offer on PIT policies and practices that have failed. Often the most important lessons from international experience are what <u>not</u> to do, especially in respect to the taxation of personal income, as failures greatly outnumber successes.

- In Section V, we recommend ways to improve the PIT in Viet Nam, formulating both a comprehensive long-term vision for the taxation of personal income and more specific suggestions for a transitional strategy given institutional, political, and social constraints in Viet Nam today. The transitional strategy adapts the long-term vision to current realities.

The PDP also has an annex that complements and supplements the main text: Annex I presents a historical assessment of the taxation of personal income in Viet Nam. A fiscal analysis of the PIT has been prepared under separate cover (Andrey Klevchuk and Chun-Yan Kuo, "Fiscal Analysis of the Personal Income Tax in Vietnam," March 2006).

III. Criteria for a Good Personal Income Tax

A. Policy Objectives

The primary objective of the PIT should be to generate a significant amount of revenue in an economically efficient and socially equitable manner:

- "Significant revenue" can be measured in many ways. At a minimum, the total financial cost of generating PIT revenue should be a small fraction of the resources mobilized. The PIT share of total tax revenue and GDP should vary according to the structure of a nation's economy, with the PIT share increasing as the informal economy shrinks and incomes grow.

- "Economically efficient" is determined by the magnitude of distortions in the allocation of resources caused by the PIT ("excess burden" or "deadweight loss"), including the costs of tax compliance, tax avoidance, and tax evasion: the smaller the distortions, the more efficient the tax.

- "Socially equitable" is determined by the degree of horizontal and vertical equity, or the equal treatment of equals and the unequal treatment of unequals: those with the same capacity to pay ("equals") should pay the same amount of taxes, and those with different capacities to pay ("unequals") should pay according to these differences.

The best way to achieve this PIT policy objective is to meet revenue targets with as large a tax base as possible, as low an effective tax rate as possible, and as simple and transparent a tax design as possible:

- "Tax base" is the total value on which the PIT is assessed, comprising taxpayers ("tax subjects") and their personal income ("taxable income"): the PIT tax base is maximized by taxing as much income as possible, regardless of the source or nature of this income, of as many people as possible, regardless of who they are or what they do to generate income.

- "Effective tax rate" is the ratio of actual tax liabilities to total income, and can be quite different from the legislated ("statutory") tax rate due to income adjustments such as exemptions, exclusions, deductions, credits, and special provisions: deadweight loss increases at the square of the tax rate, so the lower the rate, the lower the level of economic inefficiency.

- "Simplicity and transparency" reduce the costs of tax administration and compliance, as well as opportunities for corruption, and assist in the consistent application of the PIT: complexity and obtuseness are administratively and economically inefficient because they are expensive to both tax administrators and taxpayers; they also increase social inequities because they mask corrupt practices and make it difficult for honest tax officials to administer the PIT accurately for all taxpayers.

B. Policy Constraints

The ideal PIT is conceptually relatively simple, but application of the PIT is extraordinarily complex. Thus, the ideal PIT described above should be seen as a long-term policy objective that provides us with criteria both to assess the current system of taxing personal income in Vietnam and to evaluate the benefits and costs of proposed PIT reforms. We do this in Sections IV and V.

Application of the PIT in Viet Nam is constrained by a number of factors:

- Limited administrative capacity and taxpayer sophistication:

  PIT policies and design features that might appear to enhance equity through greater precision could actually reduce equity because their complexity exceeds tax administration capacity and taxpayer capabilities.

- Dominance of the rural and informal sectors in the national economy and generally low income levels:

  PIT policies and design features that are based on successful practices of high-income countries might not be practical in Viet Nam due to lack of data, an easy means of tax collection ("tax handles"), use of formal financial institutions, and revenue potential – in a highly-skewed tax base, most people earn their livelihoods as part of the informal economy of self-employed with relatively low levels of household income.

- Political and social considerations:

  As in most countries, the political and social concerns of key constituencies in Viet Nam necessitate the formulation of many technical compromises to obtain a broad consensus on proposed PIT changes.

C. Reconciliation of Policy Objectives and Policy Constraints

Viet Nam will need a transitional strategy to accommodate these policy constraints in the design and implementation of the PIT to enable transformation of the current system to a more optimal PIT. The pace of change will depend on administrative capacity and service quality, taxpayer awareness and skills, and both the structure of the economy as well as the complexity of economic transactions within this evolving economic structure.

IV. Assessment of the Current Personal Income Tax in Viet Nam

A. Summary Description of the Current PIT[1]

The central government uses three main instruments to tax personal income:

- The Income Tax On High-Income Earners
  - Taxable income
    - Regular income (wages and salaries, bonuses, patents and trademarks, consulting and training services, and broker commissions)
    - Irregular income (technology transfers and lottery winnings)
  - Tax schedule and tax rates
    - Progressive tax schedule for the regular income of resident Vietnamese and foreign taxpayers, as follows:

Tax brackets	Tax rate (%)	Taxable income (VND millions/month)	
		Vietnamese taxpayer	Foreign taxpayer
1	0	0-5	0-8
2	10	5-15	8-20
3	20	15-25	20-50
4	30	25-40	50-80
5	40	Over 40	Over 80

    - For non-resident taxpayers, a final, flat rate of 25 percent of total income
    - For irregular income, a flat tax rate of 5 percent of total income from technological transfers over VND 10 million/time and a flat tax rate of 10 percent of total income from lottery winnings over VND 15 million/time

- The Corporate Income Tax assessed on individual and household businesses
  - Taxable income: net business income (total turnover – expenses)
  - Tax rate: 28 percent
  - Tax exemption: small businesses with net income less than VND 350,000 per month

[1] Please see Annex I for a more detailed description of the current PIT.

- The Land Use Right Transfer Tax
  - Taxable income: total turnover from transferring land use rights and housing ownership
  - Tax rates: 2 percent for agricultural land and 4 percent for other types of land

B. Revenue Generation

The total revenue generated from these three sources is quite small: in 2004, it was 7.55 trillion VND, which was only 5.10 percent of total state budget revenue from taxes, fees and charges (including oil-related revenue), and only 1.06 percent of GDP. The revenue from just the personal income tax portion is even less significant, totaling just 2.50 percent of total state revenue from taxes, fees and charges (including oil), and 0.52 percent of GDP:

Taxes on Personal Income in 2004

Tax Component	Number of Taxpayers	Tax Revenue (VND billions)	Share of GDP (%)	Share of Revenue from Taxes, Fees, & Charges (incl. oil) (%)	Share of Revenue from Taxes, Fees, & Charges (excl. oil) (%)
PIT for High-Income Earners	Total: 205,000 Vietnamese: 160,000 Foreign: 45,000	3,700	0.52	2.50	3.16
CIT for Individual/Household Businesses	Total: 812,000 Individual: 25,000 Household: 787,000 Self-Assessment: 14,000 Presumptive: 773,000	3,350	0.47	2.26	2.86
Land Use Right Transfer Tax	NA	500	0.07	0.34	0.43
Total	1,017,000 (excl. land use transfer)	7,550	1.06	5.10	6.44

2004 Estimates

GDP = VND 715,307 billion; total tax revenue including oil = VND 148,185 billion; and total tax revenue excluding oil = VND 117,163 billion.

Note: Total tax revenues from the individual/household businesses, including VAT, SCT (special consumption tax) and CIT: VND 5.8 trillion

Sources: MOF; www.mof.gov.vn; International Monetary Fund, *IMF Country Report No. 06/22* (IMF: Washington, D.C., January 2006); and authors' calculations.

These figures are extremely low when compared with countries of a similar GDP per capita, all developing countries, and high-income countries:

International Comparison of Taxes on Personal Income				
Country (all figures in U.S. $)	Total Tax Revenue Share of GDP	Income Tax Share of Total Tax Revenue		
		Total	PIT	CIT
1. Low-Income Developing Countries: GDP per capita < $745	14.1%	35.9%	16.6%	19.3%
2. Medium Low-Income Developing Countries: GDP per capita $746 - $2,975	16.7%	31.5%	16.0%	15.5%
3. Medium-Income Developing Countries: GDP per capita $2,976 - $9,205	20.2%	29.4%	20.5%	8.9%
4. All Developing Countries	17.6%	31.2%	18.0%	13.2%
5. High Income Countries: GDP per capita > US$9,206	25.0%	54.3%	44.6%	9.7%
6. Viet Nam (GDP per capita: US$552) (GDP and revenue figures from 2004)	***20.7% (total revenue with oil)***	***33.2%***	***5.1%***	***28.1%***
	16.4% (total revenue w/o oil)	***27.9%***	***6.4%***	***21.4%***
7. China (GDP per capita: US$1,272) (GDP and revenue figures from 2004)	19.3% (total revenue)	21.6%	6.6%	15.0%
8. Thailand (GDP per capita: US$2,620) (GDP figures from 2004) (revenue figures from FY04: 1 Oct-30 Sept)	17.0% (total revenue)	39.8%	12.6%	27.3%
9. United States (GDP per capita: US$43,142) (GDP and revenue figures 2005 estimates)	16.8% (only central gov.; consolidated budget)	54.5%	43.5%	11.0%

Sources: Roger Gordon and We Li, *Tax Structures in Developing Countries: Many Puzzles and a Possible Explanation*, Working Paper 11267 (Cambridge, MA: National Bureau of Economic Research, April 2005); ADB, *Key Indicators of Developing Asian and Pacific Countries* (Manila: ADB, 2006); http://devdata.worldbank.org; www.mof.gov.cn; http://dw.mof.go.th; www.cia.gov; and authors' calculations.

Not only are current Viet Nam PIT figures low, but trends since 1996 are also of concern. While PIT revenue has remained relatively constant as a share of total tax revenue and in relation to GDP, PIT revenue trends do not reflect Viet Nam's tremendous economic growth and dramatic rise in incomes over the past decade from its primary tax base, foreign invested enterprises: industrial output of the foreign invested sector more than quadrupled between 1995 and 2000, and than nearly doubled from 2000 to 2003 at an average annual nominal growth rate of almost 25 percent, but PIT revenue grew at only half this rate (12.5 percent) between 1999 and 2003 (see Annex I for a description of the evolution of the PIT in Viet Nam).[2]

Total revenue generated by the taxation of personal income is small due to both external and internal factors. Principal external factors are a generally poor population, and the dominance of a primarily rural and informal economy in which most people are self-employed. The most important internal factors are: a tax design that excludes many tax subjects and many income sources, and encourages widespread evasion with relatively high marginal tax rates (see Annex I for a more detailed discussion of these issues); limited administrative capacity to realize the full tax potential of the system as designed; and a combination of poor taxpayer service and low taxpayer awareness, which discourages voluntary compliance.

It is difficult to assess the administrative efficiency of the taxation of personal income. With the exception of Hanoi, Ho Chi Minh City, and Baria-Vungtau, the provincial tax offices do not have separate personal income tax divisions. Instead, tax officials divide their work by tax subjects based on employer classification rather than by specific tax or tax administration function, and are responsible for collecting all domestic taxes from their tax subjects.

However, interviews with local tax officials indicate that field officers spend most of their time trying to collect taxes, including the CIT, from individual and household businesses, which is not a cost-effective use of resources. For example, in the Hanoi Tax Department, roughly one-quarter of all employees are based in the main Hanoi office and collect approximately 90 percent of all taxes, while the remaining 75 percent of employees in the 14 district offices collect about 10 percent of the total tax revenue for Hanoi.

In contrast, most of the "income tax on high-income earners" portion of the PIT is collected through payroll withholding. For example, in the Hanoi Tax Department, of the 20,581 PIT taxpayers, only 42 pay directly rather than via withholding, accounting for just 0.5 percent of total PIT revenue.

Employers receive a fee of 0.5 to 1.0 percent of total PIT withheld. This is comparable to the 0.5 percent ratio of administrative costs to taxes collected for the United States Internal Revenue Service. The government estimates that it spends 0.9 percent of all tax revenue it collects on tax administration.

Taxpayer compliance costs for both the PIT and the CIT on individual and household businesses is relatively low, as the former is collected almost entirely via payroll withholding while the latter relies primarily on presumptive taxation.

[2] Vietnam General Statistics Office, *Statistical Yearbook* (Hanoi: Statistical Publishing House, various years); IMF Country Report No. 06/22; www.mof.gov.vn; and authors' calculations.

C. Social Equity

The current system of taxing personal income in Viet Nam is both quite fair and extremely unfair in terms of horizontal and vertical equity.

The "income tax on high-income earners" portion of the PIT is fair in that most of the revenue comes from foreigners, who generally have much higher incomes than Vietnamese, and thus, greater capacity to pay, although equity would be enhanced if there was not such widespread underdeclaration of income by foreigners.

Not only is the share of total income tax generated by resident foreigners large, but it has also gone up significantly over the past few years. The ratio of income tax from resident foreigners to total income tax increased from 48.2 percent in 2000 to 62.4 percent in 2003, while the contribution from Vietnamese fell from 42.4 percent to 30.0 percent during the same period; the remainder of income tax revenue came from non-permanent residents. In 2005, less than 50,000 foreign income taxpayers accounted for roughly 70 percent of revenue from the income tax on high-income earners.

The "income tax on high-income earners" portion of the PIT is also fair because most Vietnamese fall below the tax threshold, although this number should increase rather than decrease per current trends as the economy grows.

Estimates from 2004 highlight the equity of a high tax threshold, even with the likelihood of substantial underdeclaration of income by Vietnamese taxpayers:

- The average per capita income of all Vietnamese was VND 484,000 per month, while the reported average per capita income of Vietnamese income taxpayers was 20.7 times greater at VND 10 million per month.

- The average amount of income tax paid by Vietnamese was VND 500,000 per month, so their reported after-tax income was still 19.6 times greater than the monthly average per capita income of the total population.

While it is appropriate to apply this tax to a small number of citizens in a country where most of the population is poor, it is worrisome that the number of Vietnamese income taxpayers is declining. In 2001, the total number of Vietnamese income taxpayers was 0.5 percent of the population (362,000 people), and in 2003, this number had dropped to 0.3 percent (239,000). This figure is estimated to decline further to 0.2 percent (150,000 people), due to the tax threshold increase from VND 3 million to VND 5 million, effective 1 July 2004.

The current system is unfair because although a small percentage of Vietnamese pay this tax, these taxpayers are not necessarily those with the greatest capacity to pay – many much wealthier Vietnamese who are not salaried employees are able to evade the tax with impunity. It is also unfair because those with significant unearned income, again wealthy Vietnamese, do not have to pay tax on this unearned income. Thus, the tax burden falls primarily on Vietnamese whose main income is from wages paid in the formal sector, including civil servants - it is essentially a tax on labor. Another feature that some consider unfair is lack of taxpayer differentiation by number of dependents. Finally, it is unfair because of differential tax rates between Vietnamese and foreigners, the PIT and the CIT, and economic sectors.

The CIT on individual and household businesses is also both fair and unfair. It is fair in that only a small portion of the nearly 2 million households granted business licenses and many more unregistered household businesses are paying this tax, given that most of these businesses probably do not generate enough net profits to justify trying to collect the CIT from them. However, it is unfair because many individual and household businesses that do generate substantial income are not paying the CIT, especially those engaged in professional services. It is also unfair because evasion of the CIT is widespread among larger businesses that clearly have greater capacity to pay.

D. Economic Efficiency

The most distortionary features of Viet Nam's current taxation of personal income are the high tax rates of the "income tax on high-income earners" portion of the PIT, coupled with the relatively narrow income bands and the low income threshold for the highest marginal tax rate, which all provide strong incentives for tax avoidance and tax evasion. Comparisons with selected ASEAN countries, as well as with other developing and transitional countries, highlight these differences in Viet Nam's PIT rate structure:

International Comparison of Income Tax Rates			
Country	Personal Income Tax (2005)	Threshold for PIT Highest MTR (2003, US$)	Corporate Income Tax (2005)
Selected ASEAN Countries			
Indonesia	5-35%	$22,371	30%
Philippines	5-32%	$9,320	32%
Singapore	3.75-21%	$184,438	20%
Thailand	5-37%	$92,379	30%
Viet Nam (2004)	***0-40%***	***(Vietnamese) $30,486 (Foreigners) $60,972***	***28%***
Other Developing/ Transitional Countries			
China	5-45%	$12,048	33%
India	10-30%	$3,139	35-40%
Mexico	3-29%	$61,689	30%
Poland	19-40%	$18,278	19%
Russia	13%	n.a.	24%
High-Income Countries			
Australia	17-47%	$35,149	30%
Germany	15-42%	$52,659	25%
Japan	10-37%	$148,478	30%
United Kingdom	0-40%	$48,413	30%
U.S.A. (2005)	10-35%	$326,450	35%

Sources: MOF, World Bank, 2004 World Development Indicators (Washington, D.C.: World Bank, 2004); www.worldwide-tax.com/comparison2.asp; U.S. Dept. of the Treasury Internal Revenue Service, *2005 1040 Instructions* (Washington, D.C.: IRS, 2006); and authors' calculations.

The main economic impact in Viet Nam of the current PIT tax structure is not so much creation of a disincentive to work as an incentive either to hide income from tax authorities or to negotiate a reduction in tax liabilities. Inconsistent and unequal treatment of potential taxpayers and taxable income also create economic distortions, for example the exclusion of unearned income, capital gains, and the agriculture, forestry, and fisheries sectors.

V. Recommendations to Improve the Personal Income Tax in Viet Nam

The following recommendations are divided into two parts:

- A long-term vision for the taxation of personal income in Viet Nam, based on the theory of optimal taxation and the most successful international experiences in PIT design and administration.

- A transitional strategy for PIT reform, given the realities of institutional, political, and social constraints in Viet Nam today.

The long-term vision and the transitional strategy are conceptually consistent, but only the transitional strategy presents an operationally feasible means in the short to medium term of generating a reasonable amount of revenue in a relatively equitable and efficient manner. Thus, while the long-term vision is useful in making explicit our tax reform philosophy and ultimate objectives, **the transitional strategy comprises our recommendations for the PIT law**.

A. Enlarge the Tax Base

1. Increase the Number of Taxpayers

<u>Long-Term Vision</u>

- Include all economic sectors:
  No exclusion for agriculture, forestry, and fisheries.

  Rationale

  As productivity in agriculture, forestry, and fisheries increases and income disparities between urban and rural economic activities decrease, it becomes more economically efficient, socially equitable, and administratively justified to tax the income of all sectors equally.

- Include individual and household businesses:
  Move these taxpayers from the CIT to the PIT.

  Rationale

  It is common practice to include taxation of all personal income in one tax, regardless of whether the income comes from salary and wages or individual and household businesses. Moreover, these businesses are already being taxed in Viet Nam, and including this tax base in the PIT would rationalize tax administration while reducing opportunities for tax avoidance from exploiting differences between the CIT and PIT.

<u>Transitional Strategy</u>

- Include all economic sectors, but with a very high exemption level: Effectively exclude small-scale agriculture, forestry, and fisheries; (agribusinesses should be included in the CIT, using a high threshold based on some minimal presumptive production value, i.e. number of hectares x schedular production value/hectare).

  Rationale

  The income of small-scale agriculture, forestry, and fisheries does not warrant the administrative and social cost of trying to collect the PIT.

- Include individual and household businesses: Move these taxpayers from the CIT to the PIT.

  Rationale

  It is common practice to include taxation of all personal income in one tax, regardless of whether the income comes from salary and wages or individual and household businesses. Moreover, these businesses are already being taxed in Viet Nam, and including this tax base in the PIT would rationalize tax administration while reducing opportunities for tax avoidance from exploiting differences between the CIT and PIT.

2. Broaden the Definition of Taxable Income

<u>Long-Term Vision</u>

- Include all personal earned income: No deductions for income earned by singers, circus performers, dancers, football players, and professional athletes.

  Rationale

  It is unfair to treat the income of some professions as more meritorious than the income of other professions, especially in light of both horizontal and vertical equity, and tax on this income could be withheld at source. An alternative to broad exclusion of income for selected professions is itemized deductions of allowable expenditures for all professions (see "Income Adjustments" under "Tax Design" below).

- Include all unearned personal income:
  No exclusion for interest and dividend income.

  Rationale

  It is common practice to include both earned and unearned personal income under the PIT so that the tax code is neutral between consumption and investment. Moreover, exclusion of unearned income favors the wealthy, as they generate more income than they consume, and thus, can invest in financial instruments that generate interest and dividend income. This would be very easy to collect from financial institutions and would introduce the concept of taxing all income regardless of source.

- Include both cash and non-cash personal remuneration:
  No exclusion for cash or in-kind allowances and gifts.

  Rationale

  Although it is extremely difficult to tax non-cash allowances and gifts at the individual level fairly and efficiently, due to problems in valuation (at cost or current market value?), allocation (business or personal use?), documentation (credible receipts?), and declaration (voluntary disclosure?), over time, tax administration capacity should be strong enough to capture the most significant sources of non-cash remuneration.

- Include personal capital gains:
  Tax capital gains when they are realized.

  Rationale

  Although this tax is exceedingly difficult to enforce fairly and efficiently, over time, the tax administration should develop credible and timely information sources, as well as the capacity to utilize information from these sources, to tax realized capital gains. This is a major source of income for the wealthy, and to exclude capital gains in perpetuity would only increase the tax burden of lower income wage earners in order to generate an equivalent amount of tax revenue.

- Defer taxation of employer or self-employed direct mandatory contributions to social insurance or health insurance from salaries and wages, but do not defer taxation of life insurance premiums:
  Tax social and health insurance benefits when they are received, whether in the form of lump sum payments or annuities, but do not tax life insurance benefits.

Rationale

Social and health insurance benefits are treated as deferred income, and can be withheld at source when paid out; life insurance benefits are treated differently because they are difficult to tax in practice for social and political reasons, and thus life insurance premiums are a common tax loophole that life insurance companies tend to exploit to the fullest.

- Include all net business income:
  No exceptions for net income generated by household business activities, whether legal or illegal.

  Rationale

  This is consistent with the policy of treating all earned income the same, whether from wages and salaries or from self-employment. Likewise, breaking the law does not exempt one from meeting tax obligations.

- Exclude transfer of land use rights:
  Do not consolidate this tax with the PIT.

  Rationale

  This tax should be considered in a comprehensive review and rationalization of all land and building related taxes and charges. While this is a well-intentioned attempt to capture part of the windfall gains from the conversion of rural to urban land, this tax is extremely difficult to implement credibly and raises very little revenue. It will become even easier to evade if consolidated with the PIT. This tax also undermines the potential for a viable local property tax because it corrupts property tax roll valuation data. A special land appreciation tax, if enforceable, might be a more effective way for the government to share some of the benefits of private gains due to public sector investments.

- Exclude inheritances:
  Tax the capital gains of assets on death, but do not tax the gross wealth inherited upon the death of the benefactor.

  Rationale:

  If the government decides that it wishes to tax inheritances, it should be done as a separate tax rather than as part of the PIT. However, the inheritance tax is usually imposed for political expediency, and is generally ineffective in both low-income and high-income countries. Thus, many countries have either abolished this tax or instituted very high thresholds. In a developing country this tax would fall primarily on the *middle class and their small businesses, which is both socially inequitable and economically inefficient. A more feasible option is to tax the capital gains of assets on death as any asset transfer would be taxed, rather than to try to tax the total value of an inherited estate.*

<u>Transitional Strategy</u>

- Include all personal earned income:
  No deductions for income earned by singers, circus performers, dancers, football players, and professional athletes.

  Rationale

  It is unfair to treat the income of some professions as more meritorious than the income of other professions, especially in light of both horizontal and vertical equity, and tax on this income could be withheld at source. An alternative to broad exclusion of income for selected professions is itemized deductions of allowable expenditures for all professions (see "Income Adjustments" under "Tax Design" below).

- Include some unearned personal income, treated differently from earned income:
  Subject interest and dividend income paid from financial institutions to a very low final withholding tax.

  Rationale

  This would be very easy to collect from financial institutions and would introduce the concept of taxing all income regardless of source without undermining attempts to develop financial and capital markets.

- Include only cash personal remuneration as part of the PIT and tax non-cash allowances and gifts as part of the CIT:
  Exclude non-cash allowances and gifts from the PIT. Instead, impose an excise tax on fringe benefit expenditures made by businesses to their employees, and collect this tax from the firms and government departments that give these perquisites.

  Rationale

  It is extremely difficult to tax non-cash allowances and gifts at the individual level fairly and efficiently, due to problems in valuation (at cost or current market value?), allocation (business or personal use?), documentation (credible receipts?), and declaration (voluntary disclosure?). Thus, these perquisites constitute some of the most inequitable and distortive elements of the current PIT.

- Exclude personal capital gains:
  Do not try to tax capital gains, realized or unrealized, other than those from land via a special land appreciation tax (see below).

  Rationale

  This tax is exceedingly difficult to enforce fairly and efficiently; including it in the PIT law simply undermines the government's credibility.

- Defer taxation of employer or self-employed direct mandatory contributions to social insurance or health insurance from salaries and wages, but do not defer taxation of life insurance premiums:
  Tax social and health insurance benefits when they are received, whether in the form of lump sum payments or annuities, but do not tax life insurance benefits.

  Rationale

  Social and health insurance benefits are treated as deferred income, and can be withheld at source when paid out; life insurance benefits are treated differently because they are difficult to tax in practice for social and political reasons, and thus life insurance premiums are a common tax loophole that life insurance companies tend to exploit to the fullest.

- Include all net business income:
  No exceptions for net income generated by household business activities, whether legal or illegal.

  Rationale

  This is consistent with the policy of treating all earned income the same, whether from wages and salaries or from self-employment. This includes the application of general (basic) deductions. Likewise, breaking the law does not exempt one from meeting tax obligations.

- Exclude transfer of land use rights:
  Do not consolidate this separate tax with the PIT.

  Rationale

  This tax should be considered in a comprehensive review and rationalization of all land and building related taxes and charges. While this is a well-intentioned attempt to capture part of the windfall gains from the conversion of rural to urban land, this tax is extremely difficult to implement credibly and raises very little revenue. It will become even easier to evade if consolidated with the PIT. This tax also undermines the *potential for a viable local property tax because it corrupts property tax roll valuation data. A special land appreciation tax, if enforceable, might be a more effective way for the government to share some of the benefits of private gains due to public sector investments.*

- Exclude inheritances:
  Tax the capital gains of assets on death, but do not tax the gross wealth inherited upon the death of the benefactor.

  Rationale:

  If the government decides that it wishes to tax inheritances, it should be done as a separate tax rather than as part of the PIT. However, the inheritance tax is usually imposed for political expediency, and is generally ineffective in both low-income and high-income countries. Thus, many countries have either abolished this tax or instituted very high thresholds. In a developing country this tax would fall primarily on the middle class and their small businesses, which is both socially inequitable and economically inefficient. A more feasible option is to tax the capital gains of assets on death as any asset transfer would be taxed, rather than to try to tax the total value of an inherited estate.

B. Reduce the Tax Rate

Long-Term Vision

- Earned Income:
  Cap the highest marginal tax rate near the CIT rate, now 28 percent, and adjust downward as the CIT rate is reduced.

  Rationale

  Harmonization of the highest PIT and CIT marginal tax rates will minimize the incentive to pursue tax avoidance by exploiting differential tax treatment of household income, thus increasing the social equity and economic efficiency of both taxes.

- Unearned and Irregular Income:
  Treat the same as earned income.

  Rationale

  At present, there is a tax bias against earned income, that is, income generated by labor in the form of salaries, wages, and other employment compensation. This is clearly an anti-poor policy, as it does not tax income that the wealthy derive from their savings and investments, such as *interest from bank deposits and dividends from stocks. Irregular income, for example windfalls from lottery winnings, should also be taxed like earned income for social equity.*

- Transfer of Land Use Rights:
  Do not consolidate this tax with the PIT, but rather, replace with a special land appreciation tax and cap at 15 percent of capital gains net of inflation.

  Rationale

  See previous section on the option of instituting a land appreciation tax.

Transitional Strategy

- Earned Income:
  Cap the highest marginal tax rate near the CIT rate, now 28 percent, and adjust downward as the CIT rate is reduced.

  Rationale

  Harmonization of the highest PIT and CIT marginal tax rates will minimize the incentive to pursue tax avoidance by exploiting differential tax treatment of household income, thus increasing the social equity and economic efficiency of both taxes.

- Unearned and Irregular Income:
  Cap at 5 percent of income paid by financial institutions and other institutions that pay out dividends.

  Rationale

  It is not feasible to tax all unearned and irregular income fairly and efficiently, but interest and dividends paid out by financial institutions and other dividend paying institutions can be withheld at source. This unearned income is also a good source of data to cross-check reported earned income. However, too high a tax rate will undermine efforts to develop financial and capital markets.

- Transfer of Land Use Rights:
  Do not consolidate this tax with the PIT, but rather, replace with a special land appreciation tax and cap at 15 percent of capital gains net of inflation.

  Rationale

  See previous section on the option of instituting a land appreciation tax.

C. Simplify and Enforce Tax Design

Long-Term Vision

1. Minimize Number of Tax Rates

- Apply the fewest number of rates possible on all taxable income, preferably from one to three rates:
  Collapse current multiple rates into fewer rates with larger income bands, or into a single revenue neutral rate for all income for all taxpayers (above a large personal deduction and/or selected other deductions – see below).

  Rationale

  It might be politically difficult to move from so many rates to a single rate, but the current system still can be dramatically simplified to improve transparency, facilitate administration, increase horizontal and vertical equity, and reduce economic distortions.

2. Minimize Income Adjustments

- Apply minimal income adjustments for all taxpayers:
  Allow a basic deduction of at least four times per capita income or
  Allow deductions for the taxpayer and dependents that total about the same amount. Either option would use pre-determined amounts and qualifying criteria for standard deductions.

  Rationale

  This complements the strategy of a lower tax rate by widening the tax base to generate the same amount of revenue. The fewer income adjustments allowed, the larger the tax base. In contrast, every income adjustment requires that either someone else must pay more taxes, or the government must reduce its budget to this "tax expenditure" (loss of tax revenue because some item is excluded from the tax base).

3. Adapt PIT Administration to Greater Implementation Capacity, More Sophisticated Taxpayers, and Changes in the Structure of the Economy

- Continue to rely on withholding of taxes wherever possible as a payment and collection mechanism, but complement this with self-assessment in the filing of tax returns to reconcile total income with total tax liabilities for both wage earners and the self-employed. Also, use third-party data to detect tax evasion and tax avoidance.

Rationale

One of the main benefits of a simplified, more transparent tax system that continues to utilize "tax handles" such as withholding for payroll workers and estimates such as presumptive expenses for businesses is that it will free resources to increase "tax effort" (the ratio of tax collections to tax capacity): these practices will allow tax administrators to increase revenue and equity by reducing tax evasion from non-reporting or underdeclaration of income. A simplified system also reduces opportunities for tax avoidance, and a simple system decreases opportunities for corruption.

Transitional Strategy

1. Reduce Number of Tax Rates and Widen Tax Bands

- Reduce the current 7 tax rates and 12 income brackets for earned income (5 rates and 10 brackets for Vietnamese citizens and resident foreigners, 1 rate and bracket for non-resident foreigners, and 1 rate and bracket for individual/household businesses) into 4 rates and 4 brackets:

  1) 3 rates and brackets for all but non-resident foreigners (for example 10, 20, and 30%)
  2) 1 rate and bracket for non-resident foreigners (for example, 10, 20, 25, or 30%)

- Increase the threshold of the PIT's highest marginal tax rate for all taxpayers to the current level for resident foreigners (VND 80 million/month, approximately $60,000/year).

- Apply a low final rate (5% or less) for unearned and irregular income above a threshold (to be determined), withheld at source.

Rationale

It might be politically difficult to move from so many rates to a single rate, but the current system still can be dramatically simplified to improve transparency, facilitate administration, increase horizontal and vertical equity, and reduce economic distortions. The most important tax simplification measures in light of the previous assessment of the current PIT (see Section IV) should be to treat all earned income of all resident taxpayers the same, continue to use the effective single final rate for non-resident foreigners, and introduce a very low rate for interest and dividends paid by financial institutions.

2. Reduce Income Adjustments

Two alternative proposals:

<u>Proposal 1</u>

- Apply a single income adjustment for all taxpayers:
  Allow a personal deduction of at least four times per capita income – the current exemption threshold of VND 5 million would meet this criterion, as it is about ten times the average per capita income of all Vietnamese. It would also capture more income of foreigners, as this would lower the threshold from the current VND 8 million.

- Remove the exemption threshold for irregular income:
  Continue to tax irregular income on a per receipt basis but without a high threshold to reduce the current widespread tax evasion.

- Tax only cash income without any further adjustments:
  No personal or dependent allowances, deductions, credits, exclusions, or exemptions to reduce taxable cash income (see earlier discussions re pension and insurance contributions and payments, and treatment of business in-kind perquisites and gifts).

  Rationale

  The purpose of these simplifications is to remove many of the opportunities discussed in Section IV for tax avoidance and tax evasion, thereby increasing PIT revenue in a fair and efficient manner. The key is to deal with individuals rather than households, effectively exclude most farmers and urban poor, and then try to collect taxes on income that is both easily identified and relatively accessible.

<u>Proposal 2</u>

Apply a system of basic deductions:

- Basic deduction for the taxpayer of at least two times per capita income (for example, VND 1-1.5 million/month).
- Basic deduction for the spouse equal to the deduction for the taxpayer.
- Basic deduction for a limited number of dependents (for example, VND 0.5 million/month/person)
- Basic deduction for the education of children less than 18 years old (for example, VND 0.3 million/month)
- Special basic deduction for foreigners (for example, VND 0.3 million/ month/person)

Rationale

The purpose of providing a system of basic deductions is to increase the equity of the personal income tax by accommodating the different family status of taxpayers. However, current tax administration capacity would have to improve significantly to detect and punish the inevitable tax avoidance and tax evasion opportunities that these basic deductions would create, such as wrongly declaring one's marriage status and number of dependents. The special basic deduction for foreigner taxpayers is necessary to encourage them to work and live in Viet Nam in the context of a very competitive regional and global market.

3. Adapt PIT Administration to Current Implementation Capacity, Taxpayer Awareness and Skills, and Structure of the Economy

- Continue to rely on final withholding for wage earners

- Rely on final withholding for the payment of interest and dividends from financial institutions and other dividend paying institutions

- Continue to rely on presumptive taxes for individual and small household businesses but allow the use of self-assessment, make self-assessment for large household businesses mandatory, and provide an incentive for all household businesses to move to self-assessment over time such as the "Blue Tax Return" system for small businesses in Japan.

Rationale

The current PIT is quite efficient in collecting income tax from wage earners and should be maintained – it minimizes the cost of both tax administration and taxpayer compliance. The same strategy should be applied to interest and dividends paid by financial institutions. The current system of presumptive taxes for individual and household businesses is still quite administrative - intensive and can be simplified. A move to self-assessment, however, would only increase the burden for tax officials and the self-employed.

VI. Fiscal Analysis[3]

Fiscal analysis indicates that without reform core PIT revenue[4] should increase from 0.99 percent of GDP in 2004 to 1.61 percent of GDP in 2015.

With the recommended transitional reform strategy, core PIT revenue should rise to 1.85 percent of GDP, a 14.9 percent increase from the base case.

Scenarios that simulate implementation of an OECD-model PIT over the next decade rather than after a transition period indicate that while gross core PIT revenue might rise between 1.2 and 3.7 percent more than the transitional strategy if tax administration and taxpayer awareness improve dramatically, the results could be quite different with less optimistic assumptions: net core PIT revenue could be much less because of increased tax administration and taxpayer compliance costs; there could be a high opportunity cost in diverting scarce administrative resources from incorporating new taxpayers in the tax base to enforcing compliance of existing taxpayers with new tax regulations; and the change in tax incidence could be quite regressive.

If the current seven tax rates and twelve income brackets for earned income are reduced to a single tax rate for all PIT core revenue, the 2004 revenue neutral single income tax rate is 22 percent.

However, it is clear from the tax simulations that even with extremely optimistic assumptions about tax administration capacity and taxpayer compliance, the government will still fall roughly 5 percent short of its income tax target of 12 percent of total revenue by the year 2015 if tax reform is limited to broadening the definition of taxable income of existing taxpayers, regardless of the new tax design model selected: under all three reform scenarios, income tax revenue rises to only 2 percent of GDP.

The difference can only be made up by improved tax effort: reducing tax evasion by wealthy residents who are not paying any taxes, as well as by the pervasive underdeclaration of income and overestimation of expenses by current taxpayers. This can best be achieved through continued reliance on tax withholding for high-income earners; continued reliance on presumptive taxes for individual and household businesses, but with simplified and more accurate tax estimation tables; and better utilization of third party sources for identification of potential taxpayers and taxable income.

---

[3] This section is a summary of Andrey Klevchuk and Chun-Yan Kuo, “PIT Policy Options: Projections of Tax Revenue and Incidence,” April 2006.
[4] PIT for high-income earners and CIT for individual and household businesses.

VII. Conclusion

The recommendations presented in this PDP suggest a transitional strategy from the current system of personal income taxation to a more optimal system that will generate greater revenue in a manner that is also more socially equitable and economically efficient.

The speed at which Viet Nam moves from the transitional strategy to the long-term vision depends on a variety of factors: the government's tax administration capacity, including the quality of taxpayer service and the degree of cooperation among agencies and between the government and third-party data sources; the skills and awareness of taxpayers; the structure and complexity of the economy; and the social and political environment.

The foundation of both the transitional strategy and long-term vision is enlargement of the tax base, broadening of taxable income, and simplification and enforcement of tax design. Every time these basic principles are compromised, it reduces revenue potential while increasing inequities and inefficiencies. It is important to recognize the winners and losers, both in theory and in practice, of all income exclusions and adjustments that are being considered in the policy discussion of income tax reform.

When potential taxpayers or potential income are excluded from the PIT, either another taxpayer has to make up the difference to generate the same amount of revenue, or these "tax expenditures" crowd out other expenditures to make up the revenue shortfall. Both results are clearly unfair and tend to be anti-poor, as they increase the burden on those already paying the income tax who cannot take advantage of special tax treatment.

We hope that the framework for assessing taxation of personal income presented in this PDP, together with application of the framework to assess the current PIT and formulate recommendations for PIT reform, will contribute to the promulgation of a conceptually sound PIT law that can be administered as designed in a fair and efficient manner.