actionaid

POLICY BRIEF

Cost of tax incentives and tax avoidance by FDIs to Vietnam

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LIST OF ABBREVIATIONS

AAV	ActionAid Vietnam
CIT	Corporate Income Tax
FDI	Foreign Direct Investment
FIA	Foreign Investment Agency
FIE	Foreign Invested Enterprise
FTA	Free Trade Agreement
UNIDO	United Nations Industrial Development Organization
VTA	Vietnam Tax Consultants' Association

POLICY BRIEF

COST OF TAX INCENTIVES & TAX AVOIDANCE BY FDIs TO VIETNAM

KEY MESSAGE

Every year, Vietnam foregoes US$20 million through tax incentives given to businesses to attract foreign direct investment (FDI), and tax avoidance schemes practised by some companies.

1.0. INTRODUCTION

Vietnam has been quite successful in attracting FDI inflows since implementation of Doi Moi in 1986. By 2013, FDI inflows had reached US$19.2 billion a year, an astounding increase of 65.5% over the previous year's FDI[1]. By the 4th quarter of 2013, the Vietnamese economy had surpassed the government's target of US$ 13-14 billion in annual FDI contributions[2].

The current trend of above-average FDI inflows is expected to continue through 2015, according to the National Financial Supervisory Committee (NFSC), due to improving global economy and increased FTAs with trading partners.

[1] *General Statistics Office of Vietnam 2013*
[2] *General Statistics Office of Vietnam 2014*

In general, FDI has boosted industrial and exports growth, created more jobs, and it has also significantly impacted on Government revenue. However, as a result of decreasing (low) Corporate Income Tax (CIT), tax exemptions and tax avoidance practised by some companies, government losses US$20 million out of its potential revenue annually. The Government's law and policy enforcement and monitoring efforts further aid to this cost[3].

This policy brief highlights the cost of tax incentives and tax avoidance to Vietnam and offers policy options to ensure FDI without necessarily reducing CIT. The policy brief draws from a national tax research carried out in 2014 by Actionaid Vietnam in collaboration with Vietnam Tax Consultants Association titled *"Vietnam's tax policies with objectives of equality, efficiency, economic growth promotion, poverty reduction and elimination".*

The policy brief covers eight crucial aspects associated with the cost of tax incentives & tax avoidance in Vietnam;

- *Fiscal incentives vs. FDI in Vietnam*
- *FDI structure in Vietnam*
- *Low Corporate Income Tax vs. FDI*
- *Tax incentives vs. Tax revenue gap (lost revenue)*
- *Tax revenue gap due to tax avoidance by FIEs in Vietnam*
- *Estimated lost revenue due to tax avoidance schemes by FIEs*
- *Lost revenue as a fraction of State budget expenditure on Education & training*
- *Lost revenue as a fraction of State budget expenditure on Health care*

2.0. FISCAL INCENTIVES VS. FDI IN VIETNAM

Foreign Investment Enterprises (FIEs) have been typically attracted to invest in Vietnam due to the generous fiscal incentives, including tax breaks and land rent reductions offered by the government[4]. Other cheaper input factors such as cheap and hard working labour as well as safe and stable political situation have also made Vietnam a popular destination for FDI.

Vietnam CIT Law which was promulgated in 1997 has since been amended three times (2003, 2008 & 2013), dropping the standard tax rate significantly. The 2008 amendment reduced standard tax rate from 28% to 25% while the 2013 amendment brought the rate further down to 22% and will be reduced to 20% from 2016[5] in what has been termed by some economists as a race to the bottom syndrome.

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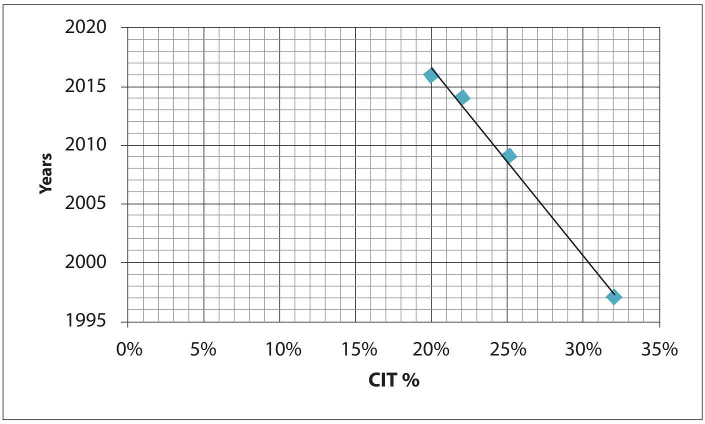
[3] *Vietnam Tax Consultants' Association 2013*

[4] *UNIDO 2011*

[5] *www.kpmg.com/VN/en*

Fig. I. Trajectory of CIT rate since 1997

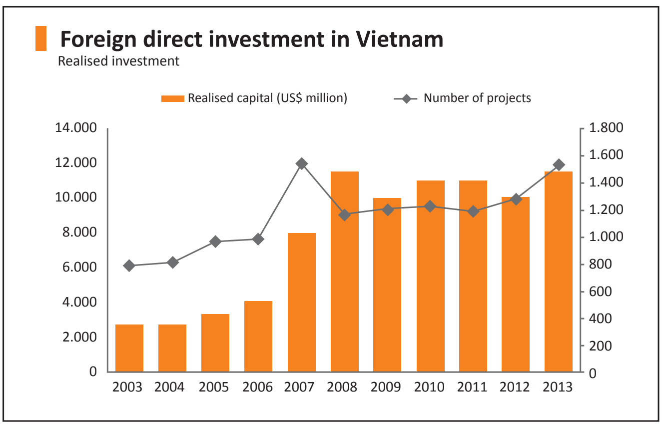


Source: AAV/VTA Tax report - 2014

Statistics in figure I illustrate that the CIT rate has gradually fallen from 32% in 1997, to 25% in 2009, and most recently to 22% (as of January 1st, 2014) and 20% (takes effect on January 1st, 2016).

Lowering of the tax burden for FDIs has since fuelled more investments as illustrated below.

Fig. II. FDI trend 2003- 2013



Source: General Statistics Office of Vietnam

FDI inflows into Vietnam since 2003 have been regarded as a very impressive phenomenon of the economic transition from a centrally planned economy to a market oriented economy. However, there are still inconclusive arguments for the role of FDI inflows in enhancing Vietnam's overall economic growth since FDI promotes growth under only certain policy conditions.

2.1. FDI structure in Vietnam

Manufacturing and construction sectors have absorbed a bigger share of FDI in the recent past.

Table I. FDI structure in Vietnam by 2012

Rank	Industry	No. of projects	Registered capital (US$ b)
1	Manufacturing	7987	93.053
2	Real estate	373	47
3	Construction	839	12.5
4	Accommodation & food services	314	11.9
5	Electricity, gas, steam & water supply	68	7.4

Source: Foreign Investment Agency (FIA)

Manufacturing, construction and real estate captured nearly 30% of the total FDI attracted. Other notable sectors based on statistics from the Ministry of Finance are accommodation & food services, electricity, gas, and information & communication among others.

Table II. Major FDI sources, 2013

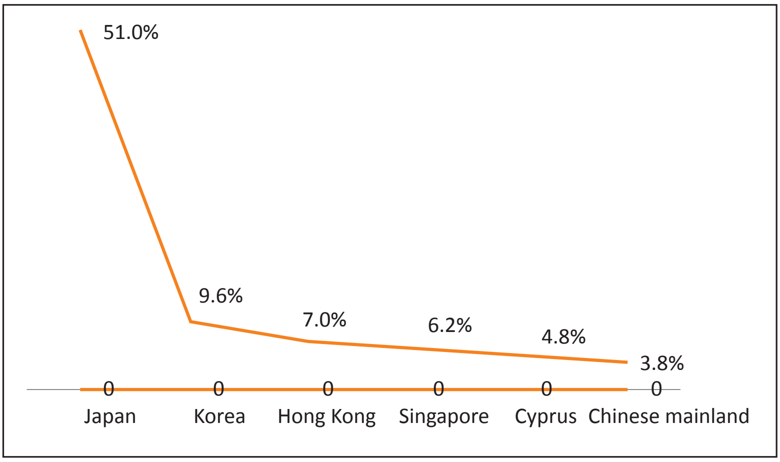
Source	Registered capital (US$ m)	Share of total
Japan	4,007.4	51.0%
Korea	757.1	9.6%
Hong Kong	549.6	7.0%
Singapore	488.4	6.2%
Cyprus	375.6	4.8%
China	302.2	3.8%

Source: General Statistics Office of Vietnam 2013

As can be seen in table II, Japan and Korea have been the largest investor countries in Vietnam with a combined registered capital of US$ 4764.5 million. Majority of FDI into Vietnam come from Asian countries. There has been a 65.5% year on year increase, with the total capital reaching US$ 19,234 million by the second half of 2013[6].

[6] *General Statistics Office of Vietnam*

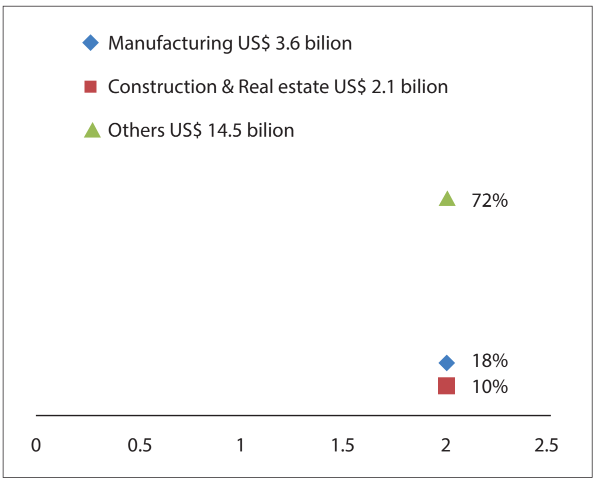
Fig. III 2013 FDI annual average share capital %



Source: General Statistics Office of Vietnam 2013

As illustrated in figure III, the annual average capital share of Japan was about 51.0% of the total FDI in Vietnam in 2013 followed by Korea at 9.6% and Hong Kong at 7.0%.

Fig. IV. Registered capital for FDI by sector 2013 (US$)



Source: Foreign Investment Agency (FIA)

Figure III indicates that manufacturing and construction sectors continued to be the most attractive sectors for FDI, with combined newly registered capital of $5.7 billion, accounting for 28% of the total FDI in the 11-month period.

2.2. Over reliance on tax incentives to attract more FDI

Government has placed high reliance on fiscal incentives including low CIT as a tool of investment policy. However, its use as a policy tool should be determined by its

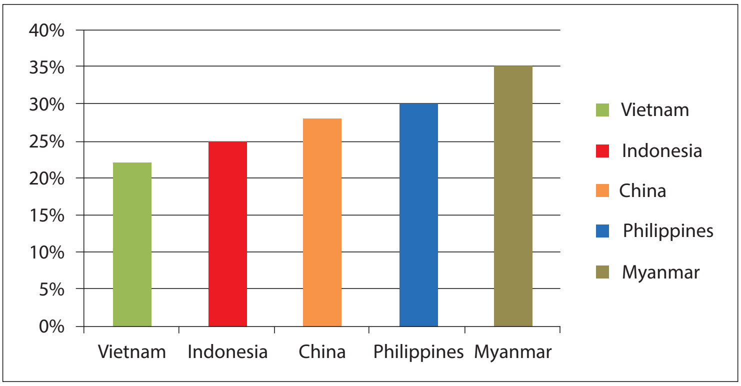
ability to influence investment decisions in the first place and then by its cost effectiveness.

Incentives are secondary to more fundamental determinants, such as availability of skilled labour, effective legal system and good infrastructure. According to a 2011 FIA and UNIDO report on Vietnam Industrial Investment, 32% of foreign investors were unable to run at full capacity due to lack of high-skill workers[7].

2.3. Low Corporate Income Tax vs. FDI

FDI data in 2013 from the World Bank shows that the Philippines which still maintains a 30% CIT rate has experienced increased foreign direct investments with improved credit ratings, better performing stock market and better debt position. This is attributed to better trade liberalization and presence of highly skilled workforce.

Fig. V. CIT rate among some ASEAN countries -2013



Source: KPMG

[7] *Vietnam Industrial Investment report 2011 (UNIDO)*

Statistics above reveal that Vietnam has one of the lowest CIT rates (22%) in the region, paradoxically; this has not necessarily translated into superior attraction of FDI compared to other countries with higher CIT rates.

Table III. FDI Inflows among other regional countries (2012-2013)

FDI inflows (US$)			
	2012	2013	% Increase
China	295,625,587,109	347,848,740,397	17.67%
Philippines	3,215,415,155	3,859,792,447	20.04%
Malaysia	9,733,616,207	11,582,675,744	19.00%
Vietnam	8,368,000,000	8,900,000,000	6.36%

Source: The World Bank 2014

Data in table III which covers 2013 figures shows a 20.4% overall increase in FDI for the Philippines with a less impressive 6.36% for Vietnam despite having a lower (22%) CIT rate.

2.4. Tax incentives vs. Tax revenue gap *(lost revenue)*

The efficacy of incentives as a determinant for attracting FDI and hence leading to economic development has often been challenged in Vietnam due to notable failures which further erode the revenue base. Tax incentives for FIEs not only enable foreign firms to avoid taxation but, in turn give rise to illegal tax evasion activities.

2.5. Tax revenue gap due to tax avoidance by FIEs in Vietnam

A nationwide investigation into tax evasion by the National Tax Office established that 83% of foreign companies used various tricks to substantially minimize their tax liability in 2013[8]. Checking at 2,110 enterprises, Tax Investigators retrieved tax arrears and fines of more than VND 988 billion[9], an equivalent of US$47 million. In some provinces like Bac Giang, Hoa Binh, and Gia Lai, 100% of foreign corporations were found to be tax violators[10].

8 *http://www.thanhniennews.com/business/vietnam-victim-of-corporate-tax-evasion-25350.html*
9 *Vietnam Chamber of Commerce & Industry April 2014*
10 *General Department of Taxation 2014*

Table IV. 2013 FIEs tax violations - VND billions (rounded figures)

No.	Province	No. of businesses inspected	No. of violations	Amount of tax arrears	Loss reduced
1	Hanoi	332	326	498	1,575
2	HCM city	193	164	173	870
3	Quang Tri	27	27	2.3	1.2
4	Thai Nguyen	20	20	3.1	24.3
5	Tay Ninh	18	18	5.3	63
6	Hoa Binh	16	16	3.6	46
7	Ben Tre	17	15	1.5	21
8	Hai Phong	50	12	28.8	169
9	Ninh Binh	10	8	1.2	119
10	Nam Dinh	6	5	1.6	8.2

Source: General Taxation Department 2013

Figures in table IV only reflect a tiny part of the tax evasion picture among FIEs. Though Tax Investigators successfully demanded enterprises to shrink losses of more than VND 4,192 billion[11], the real magnitude of revenue loss to Government over the years cannot easily be established because FIEs use superior resources, legal loopholes and multinational structures to avoid tax.

2.6. Estimated lost revenue due to tax avoidance schemes by FIEs

Vietnam does not publish 'tax expenditure' reports detailing the tax revenue given away through incentives for FIEs and it seems that even government itself is not aware how much revenue is foregone.

However, limited available figures demonstrate the scale of the incentive epidemic. In 2012, the last year for which data is available, FIEs avoided paying taxes amounting to over US$ 20 million through profit shifting[12] (allocation of income and expenses between related corporations or branches of the same legal entity such as using transfer pricing in order to reduce the overall tax liability).

2.7. Lost revenue as a fraction of State budget expenditure on Education & training 2012

[11] *Vietnam Chamber of Commerce & Industry vccinews.com 2014*
[12] *General Department of Taxation 2013*

Table V. State budget expenditure on Education 2008-2012 (VND billion)

Sector	2008	2009	2010	2011	2012	5 years
Expenditure on Education & training	43,414	69,320	78,206	99,369	152,590	442,829
% of total state budget expenditure	10.54%	13.64%	13.34%	14.07%	17.94%	14.46%

Source: State Budget finalization report 2008 - 2012

As reflected in table V, Government had a combined total expenditure of 442,829 VND billion, an equivalent of US$ 21 billion on Education & Training between 2008-2012.

2.8. Lost revenue as a fraction of State budget expenditure on Health care (2012)

The brunt of tax avoidance by FDIs also heavily affects the health sector. If this additional (lost) revenue was realised and well mobilized, it could mean more sustainable financing for health care.

Table VI. State budget expenditure on Health care 2008-2012 (VND billion)

Sector	2008	2009	2010	2011	2012	5 years
Expenditure on health care	14,414	19,354	25,130	30,930	54,500	144,298
% total of public expenditure	3,50%	3,81%	4,29%	4,38%	6,41%	3,98%

Source: State Budget finalization report 2008 -2012

Statistics in table VI indicate that State budget expenditure on Health care for the period 2008-2012 was VND 144,298 billion[14] (US$7 billion). In a nutshell, low CIT and tax avoidance by FIES has cost the Government millions of US$ Dollars which should have been used to improve public services, social welfare and social justice.

2.9. Conclusions

Though fiscal incentives may be a useful tool for stimulating productive investment, they must be carefully designed and well administered so as to avoid side-effects that diminish Government revenue.

Tax incentives by themselves do not shape the economy's competitiveness hence, instead of offering more *open-handed* tax incentives to FIEs, Government should focus on improving its investment environment like perfecting the legal system, improving infrastructure, and the quality of labour force.

In addition, the local supporting industry should be developed to supply inputs for other industries, especially manufacturing. Having an effective and strong supporting industry not only increases the value added created in Vietnam in the value chain and the competitiveness of Vietnam's local industries as a whole but is also a crucial factor in attracting FDI.

A considerable amount of revenue is lost due to unethical and illegal practices of tax dodging. Although, government is taking measures to address it, further strict laws and policies are required to tackle it, together with a robust monitoring and compliance audits.

3.0. POLICY RECOMMENDATIONS

Taxes pay for our public services and social welfare. Therefore, in view of the fact that tax incentives have increasingly created a big tax revenue gap through foregone revenue and illegal tax schemes including tax avoidance, AAV offers the following recommendations to ensure FDIs without reducing the tax burden and to improve tax compliance;

- Government should focus on improving FDI climate by improving transportation and communications infrastructure (which also reduces costs throughout the supply chain).
- Significant resources should be dedicated to improving Vietnam labour force since availability of skilled labour is more fundamental in determining FDI.
- Government should reform the tax system and tax administration to reduce leakage on the usage of tax incentives, ensure full compliance and reduce compliance costs.

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[14] *Synthesized data-State Budget finalization report 2008 to 2012*

- Governments should systematically count the full cost of tax incentives through published tax expenditure reports. Reports should be published annually at the same time as the budget to inform debate on the cost and benefit of its investment policies.
- Government should coordinate statutory tax incentives with neighbouring countries in order to counter tax competition.
- All the companies, FIEs in particular, should practice good corporate governance which must include paying legitimate tax, with zero transfer pricing, while operating in Vietnam.
- The Civil Society Organisations, tax justice campaigners and relevant regulators should combine and increase their efforts in making this happen.

A full report can be downloaded from:

http//www.actionaid.org/Vietnam/publications

Research report by:

Actionaid Vietnam and Vietnam Tax Consultants' Association

Policy Brief prepared by:

Moses Mubiru

Comments contributed by:

Mr. Ramesh Khadka
Ms. Nguyen Phuong Thuy

Reviewed by:

Ms. Hoang Phuong Thao

ACTIONAID VIET NAM

Floor 5, 127 Lo Duc street, Hanoi, Vietnam

Tel: +84 4 3943 9866, Fax: +84 4 3943 9872

Email: mail.aav@actionaid.org

Website: www.actionaid.org/vi/vietnam