



The Rach Miếu Bridge inaugurated on Jan. 19, 2009. Photo: Hòa Tấn

Applying The Tiebout Model to Fiscal Decentralization in Vietnam

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1. Introduction

How to make local governments get more responsible to the public is discussed a lot by various theories of fiscal decentralization. Different approaches to the fiscal decentralization all originate from the central question: What is the optimal fiscal decentralization? What activities should be left to the central government and what are most appropriate to local ones?

This paper employs the theory of effective

provision of public goods, especially the Tiebout model, as analytical basis for suggestions that aim at perfecting the fiscal decentralization in Vietnam, thereby establishing a framework for improvements in effectiveness and validity of local governments, namely their right actions (supplying public services appropriate to citizens' demand), non-autocracy (acting in the best way with the lowest cost and highest standard), and responsibility (acting according to the approach based on public interests).

2. An outline of the Tiebout model

Limitation of the public choice theory is its failure to deal with difficulties the local government has to face when supplying the public goods to residents. They are: (i) Preference revelation: it's difficult to design a democratic mechanism in which the public express honestly the preference for public goods; and (ii) preference aggregation: It's difficult to synthesize preferences of millions of voters in order to make decisions on public policies. And as a result most levels of governments don't make enough effort to determine optimal volume of public goods they should supply.

Charles M. Tiebout discovered in 1856 that there was no trade and competition in the public sector so that the public goods market couldn't supply the same optimal volume of public goods as the private good market. From this insight Tiebout maintained that the competition would exist when the public goods were supplied by local governments because voters could vote with their feet by moving to other localities. In localities where the public goods are not effectively supplied, residents and organizations tend to move to other localities with better supply of public goods to live and do business. This leads to fiscal principles for local governments and creates an instrument for preference revelation: mobility. Tiebout argued that danger of mobility might lead to effectiveness of the local supply of public goods. In other words, in certain conditions, the supply of public goods may be carried effectively by local governments. They should pay full attention to interactive relations between three parties involved in the local provision of public goods: (i) government; (ii) residents; and (iii) companies (principal factors of the local economy).

The Tiebout model contains many controversial points and is still criticized (Tiebout's mobility is not perfect, Tiebout financing causes inequality, etc.) but normative value of the Tiebout model of fiscal decentralization has an important meaning. It shapes principles of the provision of public goods between different levels of government. To a certain extent, the public goods should be supplied by local governments. Scope of public goods supplied by local

governments, however, is determined by:

- Firstly, there is a link between tax and benefits in public goods, that is, if most residents gain benefits (such as local roads), the public goods should be supplied by local governments. If the public goods have a weak link between tax and benefits (such as paying social benefits), that is, most local residents gain no benefits, they could be supplied by authorities of higher level. If local residents gain direct interests, they will buy public goods by paying property tax, otherwise they can vote with their feet.

- Secondly, externalities or positive impact of the public goods: If the locally-supplied public goods produce positive impact on neighboring localities, these localities tend to supply such goods at a level lower than the demand. In this case, the authorities of higher level had better promote the provision of such goods.

- Thirdly, economies of scale: Public goods with economies of scale, such as national defense, will not be effective if supplied by local governments. Public goods without economies of scale, such as social order, could be supplied effectively by local governments. That is why the Tiebout model maintains that local public expenditures should be put in programs with less externality (spillover effect) and of small scales, such as road repair, garbage collecting and urban sanitation.

3. Fiscal decentralization in Vietnam

The Vietnam's fiscal decentralization is considered as a centralized system. Public goods are supplied by a unified system of the government in which rights of the central government are delegated to local ones at provincial, district or communal levels. In this centralized system, the national budget ensures some unity. The national budget is passed annually by the National Assembly. All policy decisions relating to budget income and expenditure are made by the central government and carried uniformly all over the country by ministries and local governments. After 1997, many reforms in the fiscal decentralization have been carried out in order to improve the situation. The National budget Law establishes the legal framework for fiscal decentralization among

levels of governments. The National Budget Laws 1998 and 2002 establish the fiscal decentralization from the central to local governments that is as follows:

- Allocation of local budget income: The budget income at local level at present is similar to the policy on local budget income. According to the National Budget Law and its bulk of subordinate legislation, revenues by local governments come from: the 100% locally- controlled revenues, revenues shared with the central budget and subordinate budget; and contributions from the public.

- + The 100% locally- controlled revenues: Land and property taxes, severance tax (not including the one on crude oil), license tax, land use right transfer tax, land value tax, fee of land use, land rental, rental on state-owned houses and proceeds of sale of such houses, registration fees, retrieval of state-owned capital from state-owned companies, revenues from local financial reserves, income from equity capital owned by local governments, unrefunded aid from foreign sources; fees and charges for public services, revenues from public land and assets, and voluntary contributions from individuals and organization at home and abroad.

- + Revenues shared with the central and subordinate budget: VAT (not including the one on imports), corporate income tax (not including the one on major corporations that control the whole industry), personal income tax on high-income earners, tax on profit transferred abroad (not including the one on profit from the oil business), excise tax on local goods and services, and fuel fees.

- Allocation of local budget expenditure: Local governments are allowed to cover expenditures on implementation of regular functions of administrative units, undertake and carry out a major part of functions of the central government in locality. The National Budget Law assigns the following expenditure responsibilities to the local government:

- + Development expenditure: This class comprises spending on socioeconomic infrastructure works run by local governments; investment in and support to state-owned companies and financial institutions as set by

laws.

- + Regular expenditure: this class includes expenditures on public services, education, health care, culture, information, arts and literature, sports, sciences and technologies, environment protection and other services run by local governments; national defense, social order and security (part of tasks assigned to local governments); operations of administrative bodies; local VCP units and civic organizations; support to trade associations as allowed by law; support to groups of residents cared by local governments; parts of national programs assigned to local governments; and price support allowed by national policies.

Thus, the fiscal decentralization in Vietnam is based on the structure of administrative units. Basically, the central and local governments have the same expenditure responsibilities and the only difference is in the size and administrative borders. Such fiscal decentralization doesn't discriminate features of each level of the government and between urban and rural governments. And as a result, the local government couldn't take right actions (supplying public services inappropriate to citizens' demand), become autocratic and irresponsible for the provision of public goods.

4. Some suggestions about the fiscal decentralization in Vietnam

Firstly, it's necessary to change the way of public governance of local governments: To shape the market for public goods, the public governance by local governments must be changed according to contents presented in the following table.

Table 1: Basic changes in the model of public governance by local governments

Existing concepts	New concepts
Acting as rulers	Voter-centered public governance
Acting as subordinates of the central government	Representatives of the public carrying out assigned tasks
Responsible to higher authorities	Responsible to voters and launching improvements in local governance

Supplying directly public goods	Buying public goods and selling them to local residents
Provision of public goods run by some public organizations	Acting as catalysts for local governance and cooperation with outside suppliers, settling conflicts of interests and developing sources of capital
Lack of transparency	Transparent governance
Control over inputs	Stress on outputs, results and impact
Concentration on the inside	Concentration on the outside and competition
Dependent on directives from the central government	High autonomy in financial issues and governance decisions
Dealing with market failures	Dealing with market and governmental failures

Each level of government is a supplier of services to the public. This supply can be measured by their quality, trust in such services over time, and degree by which the public are allowed to take part in the decision-making process in order to satisfy their demand. Local politicians will try to maintain well community activities and interact with voters and organizations to offer options of investing in municipal projects and ensure the provision of basic services.

Secondly, the fiscal decentralization must be realized. Regarding the allocation of revenues, local governments have little power to make decisions on sources of revenue. All decisions on tax rates and other taxes collected in the locality are made by the central government. Although the allocation of expenditure to the local budget from 1992 on has increased from 26% to 43% in the total national budget expenditure, the power of local governments affecting decisions on local expenditures is much lower than the said proportion, because shortage of fund and limited revenues, they couldn't change division of expenditures between functions and economic activities. The following are my suggestions.

- Decentralizing power of controlling tax revenues by the central government: Local governments should be assigned right to make decisions on taxes closely linked with interests of local residents and local property, such as

property tax, and personal income tax, etc.

The personal income tax is very appropriate to this effort because the personal income doesn't move easily and it's easy to control sources of personal income of local residents.

Taxes on goods also constitute a source of income for the local budget, except for the excise tax, or special consumption tax, in cases of natural monopoly. Similarly, revenue from the fixed sale tax on small retailers is usually small and difficult to control, therefore it's reasonable to allow local governments to assess and collect this tax.

Tax on means of transport is considered as the best option to assign the right to impose taxes to local government. This tax can be imposed on fuel, driving license, parking lot, and use of roads or bridges, etc. Similarly, the property tax is also a good option that has been chosen by many countries. The logic behind this delegation of tax collecting right is that public goods supplied by local authorities usually add value to local properties, especially real estates.

At present, the revenue from corporate income tax on subsidiaries to major corporation that control a whole industry (or government monopolies) is classified as the 100% locally-controlled revenue for the central government while these subsidiaries operate in localities and benefit from public goods supplied by local governments. It's reasonable to share part of this revenue with local governments.

- As for expenditure responsibility for supplying public goods that produces spillover effects on other localities, such as health care and higher education, the central government had better promote the provision or carry out the fiscal decentralization more actively. Foreign experience shows that the spillover effects are better when these public goods are financed partly by local governments and partly by higher authorities through counterbalance subsidies.

- The next question is whether the higher authorities should redistribute revenues among governments of lower levels to reduce differences in revenues and expenditures. The answer is yes. In the Tiebout perfect model, communities will establish effectiveness of public goods provision and redistribution will hinder this effectiveness

because it reduces the competition. To a certain extent, however, the Tiebout model can't reflect the real world perfectly. In addition, the foot voting is less possible under current conditions in Vietnam because the Vietnamese people don't like migrating for better jobs and many of them are tied to their localities by the household registration system, which almost neutralizes the Tiebout model. In this case, it's necessary to re-distribute revenue in favor of districts with poor provision of public goods in order to support local residents. Another reason is the externality. If the best part of revenues from taxes is spent on public goods with wide spillover effects on neighboring areas, these effects are reasons for subsidies to localities that produce public goods with positive spillover effects.

According to the National Budget Law 2002, the re-distribution is realized through regulatory payables and additional grant-in-aid, but it is nearly not based on the scientific grounds of fiscal decentralization. Shares of the central and provincial governments in revenues are determined by the former and its decisions apply to all shared revenues set separately for each provinces. After being set the proportion will be kept intact for from three to five years. When the percentage is smaller than 100%, the provincial government is allowed to retain the whole revenue to be shared, and the shortage will be covered by additional grant-in-aid. Thus, the grant-in-aid for poor provinces and payables imposed on richer provinces that aim at balancing the national budget are based on evaluation of differences between provincial income and expenditure. In other words, the central government balances the budget on behalf of the provincial government. Statistics of the years 2004 – 2008 show that the policy to promote the decentralization has helped increase the number of provinces with balanced budget to 15. Of 49 provinces that failed to balance their budget in 2004-08, 27 provinces a year on average had to receive grants-in-aid from the central government to cover over 50% of their expenditures. Moreover, the grant-in-aid equaled some 31% of the central budget income. Of the total grant-in-aid, 60% was used for helping balancing the local budgets and 40% was

targeted grant-in-aid. In some provinces, the targeted grant-in-aid accounted for some 70% of grant-in-aid from the central government, as reported by the NA Committee of Finance and Budget. These data are worrying because they mean that the fiscal decentralization hasn't been carried out well, the central government still held most power and provincial government enjoyed only a little autonomy in balancing their budgets.

I think that the central government had better stop balancing the budget on behalf of the provincial governments by delegating more rights and responsibility to provincial governments. Revenues to be shared between the central and local governments must be reduced and turned into 100 locally- controlled revenues in order to encourage them to enhance their managerial ability, responsibility and transparency. In addition, grant-in-aid should be considered as a last resort when the provincial government fails to balance their budget in spite of its effort to cut expenditures to the bone and make the best use of their sources of revenues. In other words, the central government should not supply grant-in-aid to fill the local budget deficit and it had better force the local government to cover part of its deficit in order to improve its sense of responsibility. According to theory of governance and experience from many foreign countries, the grant-in-aid may be equal to 80% of 90% of the local budget deficit. This measure will force local governments to enhance their management and improve the local business climate, and make issues of local bonds and development of local sources of revenues to reduce the budget deficit possible ■

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