NEW PROPOSAL ON VAT CHANGES: POSITIVE FOR BUDGET REVENUE, MODERATELY NEGATIVE FOR CONSUMPTION

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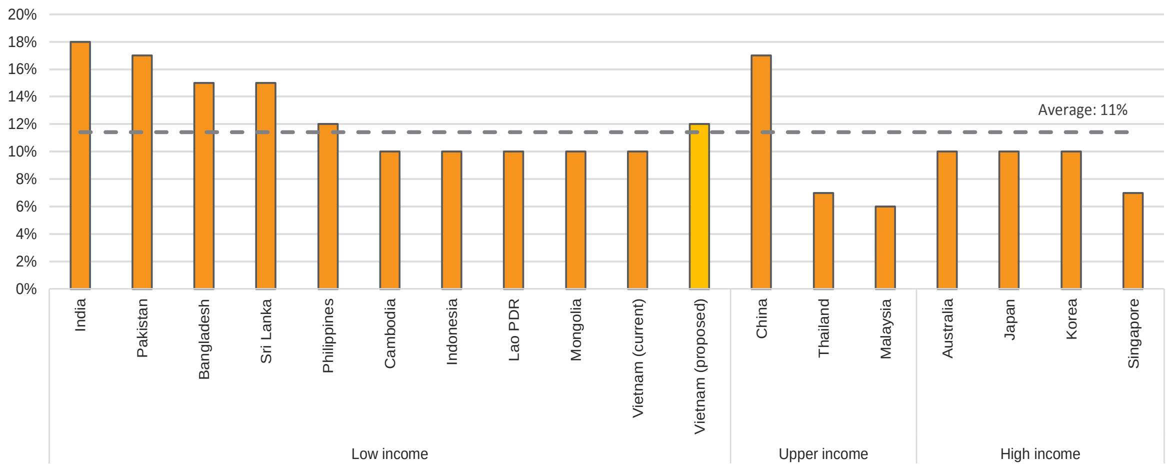
Vietnam will raise its Value Added Tax (VAT) over the next few years to touch 12% in 2020 up from 10% today. At the start of 2018, Vietnam's Ministry of Finance (MoF) sent the second draft of the revised law on value-added taxes (VAT) to the Ministry of Justice, before submitting the final draft to the government. According to the new draft, the country's VAT will be raised from the current 10% to 11% in 2019 and then 12% in 2020.

VAT is the largest source of revenue for the government (~21% of budget revenue in 2010-2016), and the new proposal could lead to a significant impact on budget revenue (1% of GDP). In order to support efforts at fiscal consolidation and to lower the budget deficit to below 3.5% of GDP by 2020, it is important for the government to broaden the VAT collection. However, we think the authorities should not only raise more revenue but also control recurring expenditure to reign in the fiscal deficit and bring public debt on a sustainable path.

The VAT increase could spur higher prices, reduce aggregate demand and increase income inequality. The VAT hike is necessary for the economy to boost the sagging budget revenue, although according to MoF's calculation, this will result in an expected 0.5 percentage point GDP growth cut and a 2.2 percentage point increase in inflation in the next two years. Because of this negative impact, the authorities might provide supplementary policies in order to help this proposal pass through the national assembly in 2018. In addition, if Vietnam's fiscal position improves, we think the government could increase public spending to offset the fall in consumption. Therefore, the net impact on GDP growth might not necessarily turn out to be negative.

Figure 1: VAT rates across APAC countries by income bracket



Source: VNDIRECT

Compared to the first draft, the authorities are now less aggressive in their VAT hike target. In the first draft, the proposed VAT hike was 12% in 2019 followed by 14% in 2021. The current proposed pace of hiking the VAT rate is more gradual and lower than the original proposal. In addition, the transfer of land use rights will continue to be VAT exempt instead of becoming taxable at the standard VAT rate in the first draft. This shows that the authorities do not want to disrupt the current buoyancy being observed in the real estate industry.

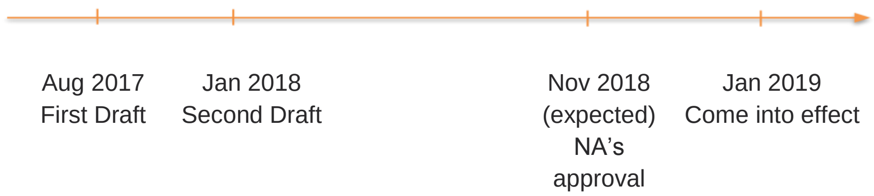
If this proposal is passed, Vietnam will have the highest VAT rate in Southeast Asia, the same rate as Philippines, though the Philippines has also discussed raising its VAT to 15%. In comparison, the VAT rate is 10% for Cambodia, Indonesia and Lao PDR and 7% for Thailand. The country's VAT collection is estimated at around 6-7% of GDP, which is similar to the ratio observed in the Philippines (6.6% in 2015).

Exhibit 1: Main features of the VAT reform

- Standard VAT rate increased from 10% to 11% in January 2019 and then to 12% in January 2020.
- Previously exempt goods and services will have a 5% VAT rate starting 01/01/2019 and then a 6% VAT rate starting 01/01/2020.
  - Fertilizers
  - Machinery and equipment for agricultural production
  - Offshore fishing boats
- Increase in the number of goods and services that will have a standard VAT rate, and no longer have the 5% VAT rate.
  - Water
  - Fishery net and rope
  - Medical equipment used for multiple purposes
  - Educational equipment used for multiple purposes
  - Sporting and entertaining activities
  - Books
- Other changes:
  - A VAT refund is open to taxpayers manufacturing goods or providing services subject to the 5% VAT and having an accumulated input VAT within 12 consecutive months. This change is expected to prevent cheating on tax refunds.
  - The non-cash payment requirement for VAT credit would be tightened and cut down from VND20million to VND5 million for each transaction in order to boost non-cash payments and money laundering.

Implementation progress

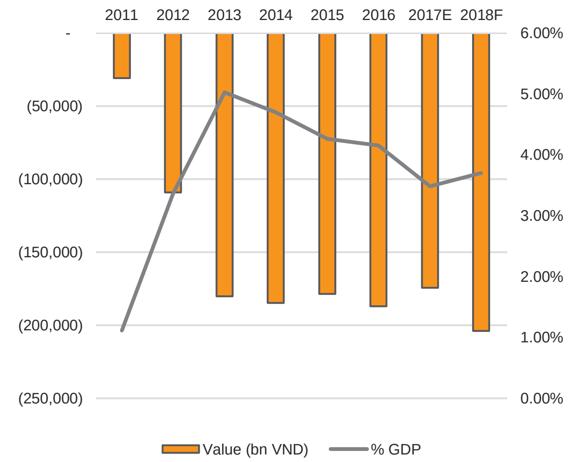
The MOF submitted a proposal for a draft law amending and supplementing the five tax laws (including the Laws on VAT) in August 2017. After many arguments against the VAT increase, the MOF became less aggressive with its plan and proposed a gradual and lower hike in January 2018. The government will consider this and escalate the draft law to the XIV National Assembly for their consideration in the 6th session (expected in November 2018). When ratified, this amendment law will take effect on 01/01/2019.



Vietnam's fiscal position: A thin wallet

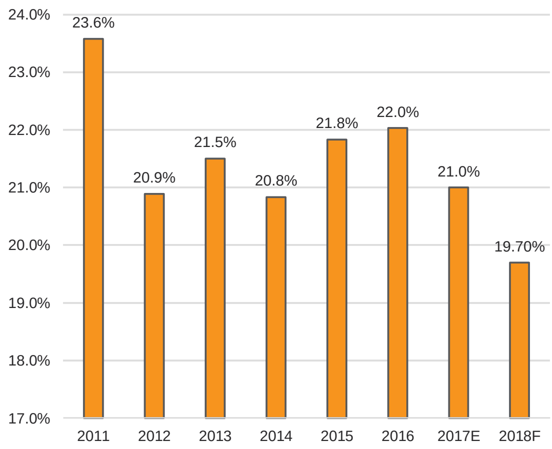
Vietnam has suffered from fiscal imbalances for several years now. The rising budget deficit has led to (i) higher public debt; (ii) constraints on public spending on infrastructure, education and health; (iii) a burden on monetary policy to support economic growth. At 61.3% of GDP (2017E), Vietnam's public debt is high compared to its regional peers. The country's transition towards middle-income status in 2010 has led to a dry-up in ODA funding, requiring Vietnam to borrow on regular commercial terms from the bond markets. Due to the gradual tightening of monetary policy globally, the interest rate risks on foreign currency debt has risen, and foreign debt is equivalent to 45% of GDP. Non-guaranteed SOE debt amounted to about VND1,547,000 billion or 36.9% of GDP and 59.7% of total government debt (2015), presenting additional fiscal risk.

Figure 2: Overall budget balance



Source: MoF, VNDIRECT

Figure 3: Tax-to-GDP ratio



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Since 2015, we acknowledge that the government has signalled a commitment to fiscal consolidation by developing a medium-term fiscal framework supported by submission and passage of a comprehensive new revenue bill, while continuing to pursue expenditure management. The authorities plan to reduce the fiscal deficit to 3.5% of GDP by 2020. Projected tax-to-GDP ratio is only 19.7% in 2018, the government targets increasing this ratio to about 21.0% by 2020. The authorities' goal is to keep government debt under 65% of GDP in 2016-2020.

Figure 4: Fiscal Framework for 2016-2020

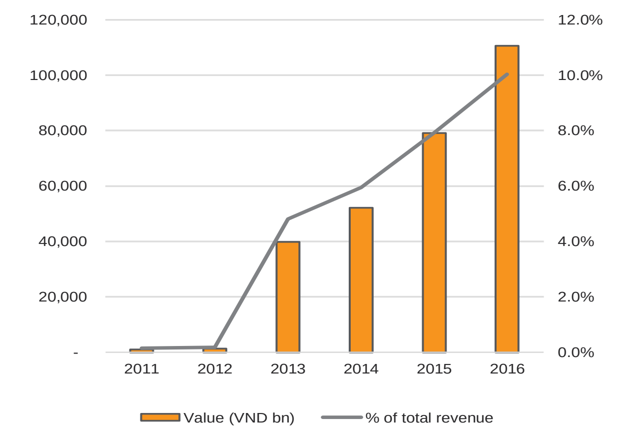
	2016-2020 (Plan)	2016-2017 (Actual)
Total revenue (VND bn)	6,864,000	2,340,877
%GDP	*23.5%*	*24.6%*
Tax-to-GDP	21.0%	22.5%
Domestic revenue/total revenue	84.5%	80.7%
Total expenditure (VND bn)	8,025,000	2,706,809
Development investment (VND bn)	2,000,000	539,258
% of total expenditure		
Development investment	*25.5%*	*20.0%*
Recurring expenditure	*64.0%*	*64.5%*
Education	*20.0%*	*15.2%*
Science and Technology	*2.0%*	*0.8%*
Budget deficit (%GDP)	3.9%	3.8%

Source: VNDIRECT

* Education, science and technology expenditure are included in recurring expenditure

Erosion of budget revenue is another major concern. The revenue from State IPOs and divestments has been positive recently, at around VND120,000 billion (USD5.3 billion) in 2017, and we expect that this will repeat in 2018 given the strong privatization pipeline. However, this type of revenue is not really recurring in nature, and cannot be counted on over the medium-to-long term. Revenue from state IPO/divestments accounted for ~9.0% of the budget revenue in 2017, and dividends from state companies accounted for ~5.1% of the budget revenue in 2013-2016. In addition, the import-export tax collection has decreased to 7.7% of the total budget revenue in 2017 from 9.5% in 2010, and this trend will continue in the next few years due to the import tariff reduction schedule from new FTAs.

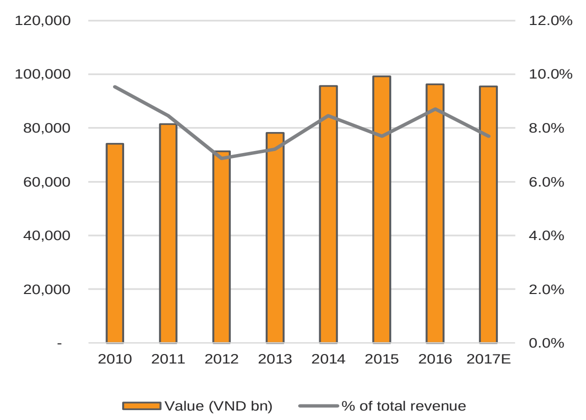
Figure 5: Non-tax revenue from SOEs*



Source: MoF, VNDIRECT

* including dividends from SOEs and IPOs/divestment revenue

Figure 6: Import-Export tax collection



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Budget revenue quality remains low. Since 2015, the recurring budget revenue growth has relied too much on non-tax revenues driven by charges, surcharges and revenue from the assignment of land use rights. The share of charges, surcharges of total budget revenue, increased sharply, with collection rising from 4.6% to 7.1% over the 2011-2017 period. Meanwhile revenue from land user rights was up from 8.4% in 2010 to 9.5% in 2017. Revenue from land user right assignments accounted for 9.5% of total revenue, topped only by VAT (24.5%) and CIT (17.0%). Last year, the revised Law on State Budget took effect, introducing new revenue lines from lottery services, which accounted for 2.4% of total revenue.

Figure 7: Collection from charges, surcharges

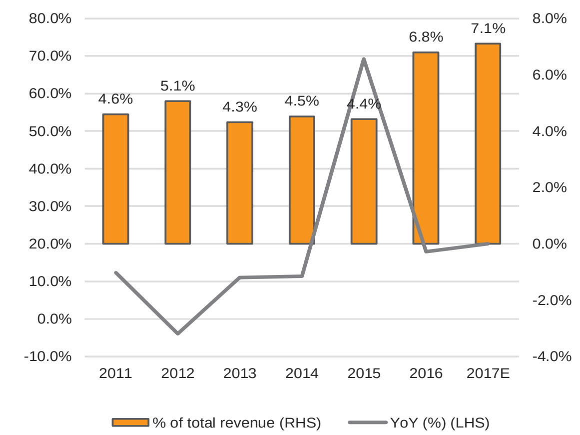

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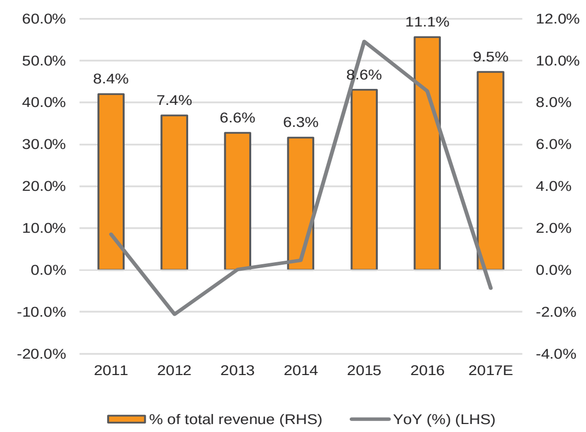
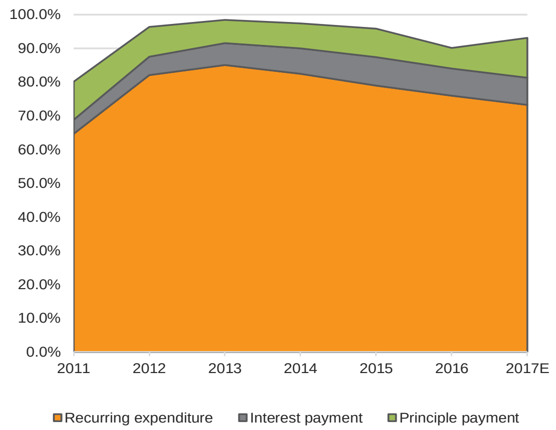
Figure 8: Collection from issuing of land use rights



Source: MoF, VNDIRECT

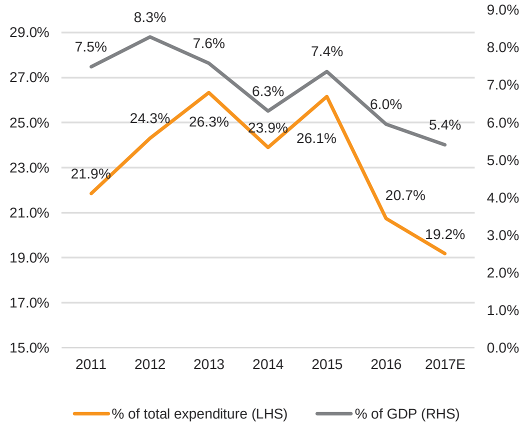
Demand for infrastructure in Vietnam has intensified. In 2016 - 2017, the country's budget revenue was only enough to cover the recurring expenditure and debt burden. As a result, public spending on infrastructure has decreased to 19.2% of total public expenditure in 2017 from 26.1% in 2015. This deterioration is one of the key binding constraints to the country's economic growth in the medium-term. In 2016-2030, ADB estimates that Vietnam needs around US$480 billion in infrastructure investment and the state budget can only provide a third of that amount. This investment includes 11 thermal power plants (13,200 MW) and 1,380 km of expressways.

Figure 9: Recurring expenditure and debt burden as a % of total budget revenue



Source: MoF, VNDIRECT

Figure 10: Public spending on infrastructure



Source: MoF, VNDIRECT

Potential impact of a VAT hike: Positive for budget revenue, moderately negative for consumption

A VAT hike is expected to improve the fiscal balance

The increase of VATs will significantly increase the budget revenue, as VAT is the largest source of revenue (~21% of budget revenue and 6% of GDP in 2010-2017). According to our estimates, the new revenue measures are likely to generate incremental tax revenues equivalent to 1.1% of GDP in 2019 and 1.0% of GDP in 2020. We think the VAT hike could support the government in its efforts to improve the fiscal balance, and allow the government to push the budget deficit to below 3.5% of GDP by 2020. We also project that this will result in increased public investment, assuming there is no major additional recurring expenditure. A reduced fiscal deficit will also limit the country's exposure to global financial markets, which are expected to gradually become tighter in the next 2-3 years. In addition, a reduced debt level will reduce the burden on the central bank to support economic growth.

Figure 11: The impact of the VAT hike on budget revenue as % of GDP

	+1 percentage point VAT	Expansion in tax base	Move some goods and services to a standard rate	Total
2019	0.60%	0.50%	0.10%	1.10%
2020	0.60%	0.40%		1.00%

Source: VNDIRECT

A short term but marginal increase in inflation could result

If the National Assembly passes the new VAT Law, there will be more demand prior to the VAT rate hike at the end of this year. As a result, inflation could inch higher in 2018 prior to enactment of the new VAT. In addition, the VAT hike will raise price levels by a similar amount as the expected tax increase in 2019-2020. However, we think any rise in prices resulting from the imposition of a new VAT increase would be a one-time event that would have a small effect on the general trend of inflation thanks to gradual adjustments and relatively low international commodity prices. The GSO estimates that a 2 percentage point VAT increase would add 2.28% to Vietnam's CPI.

Over the long-term, the VAT hike could lead to weaker consumption and GDP growth

Despite the country's strong economic growth, the majority of Vietnamese consumers still belong to the low-income segment. According to Euromonitor, the lowest-income class remains the most prevalent in the country (32% of total population). Given that this segment consumes a higher percentage of their income than the well-to-do, they are going to pay more VATs as a percentage of their income. Hence, we think that the authorities will pass other tax amendments (ie. reducing taxes for smaller businesses) simultaneously, aimed to benefit the low income segment, which could help mitigate the negative effect on aggregate demand. According to the MoF's estimate, Vietnam's GDP will be 0.54% lower versus the baseline in 2019 and will also be 0.5% lower than baseline levels in the following year as a result of the new VAT.

VAT collection efficiency will decrease

Because the tax authorities' capacity to detect and enforce tax obligations is limited today, we estimate that around 30-50% of VAT collection is wasted from VAT evasion and collection inefficiency. A VAT hike could make this situation more serious as it will increase the incentives to evade taxes. In the new VAT proposal, the authorities reduce the threshold for non-cash payment requirement for VAT credit from VND20 million to VND5 million for each transaction in order to mitigate VAT evasion.

Potential impact by industry: Fertilizer and agriculture will benefit while entertainment, healthcare, and education will be hurt; the impact on consumer goods companies will vary

Fertilizers, machinery and equipment for agricultural production will be removed from VAT exemption to the 5% VAT rate (01/01/2019) and then to the 6% VAT rate (01/01/2020). If this happens, fertilizer and agricultural machinery producers that use input materials with a 10% VAT may benefit due to an input tax refund. Stocks that could potentially be impacted by this include **LAS, DCM, DPM, VAF, NFC and VEAM.**

Because a number of goods and services entitled to the 5% VAT rate will begin to be subjected to the standard VAT rate (+120% tax assuming the standard VAT rate is 11% in 2019), companies which are operating in water supply, education, entertainment and healthcare will be negatively impacted. However, the impacts will be different depending on the price elasticity of demand. We think that the impact on educational and entertainment companies could be much more pronounced than for healthcare and water supply companies. Stocks that could be impacted include **BTW, BWE, CLW, TDW, and PNC**.

The VAT hike could lead to weaker consumption, and the impact on consumer goods companies will be mixed. Consumers will become more selective and consumer goods companies that compete on price or in commoditized categories will face harsher competition. Stocks that could be impacted include **VNM, BHN and SAB.**

Case study of the impacts of a VAT hike in Philippines: no major setbacks when introduced in 2006

During November 2005, the Philippines extended its VAT base to include energy products and select professional services, and then followed with an increase in the VAT rate from 10% to 12% in February 2006. Revenue collection increased by around 1.3 percentage points of GDP in 2006. In order to reduce the impact on poor households the government also announced plans to spend 30% of the incremental revenue from the VAT reform on infrastructure and social services, and also reduced selected petroleum excises. In Philippines' case, the VAT reform of 2006 raised the inflation rate by 1.7 percentage points, before going down by 1 percentage point the year after. According to the IMF, the final impact was an estimated 2.5% gross reduction in household consumption. Furthermore, the mitigating package of tax measures and increases in social spending cushioned the net reduction in household consumption, reducing the decline from 2.5% to 1.9%.

We think that Vietnam's economy and stock market will only face a minor near-term setback from the proposed VAT hikes

1) Risk of accelerating inflation is not high: The VAT hike will not significantly impact inflation in Vietnam as compared to Philippines' case study. We see Vietnam's inflation remaining in the single digits, only mildly impacted by the change in VATs, as the impact will be a one-off event when introduced.

2) The decision to gradually raise VATs should cushion the impact on the real economy: Philippines raised VATs much faster (immediately from 10% to 12%), while Vietnam is proposing only gradual hikes. This should produce less of a negative impact on the economy, and not majorly impact the stock market.

3) Select sectors of the stock market will even benefit. Some companies, such as fertilizer companies, are actually poised to tangibly benefit from this increase in VATs. Listed consumer blue chips are less likely to be negatively impacted than the overall impact on consumption would suggest as they compete more on brand recognition than on price. Smaller, less known players or brands could however face some setbacks but such names tend to have limited representation in the stock market.

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Hold	The stock's total return is expected to be between negative 10% and positive 15% over the next 12 months.
Reduce	The stock's total return is expected to fall below negative 10% over the next 12 months.

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Sector Ratings	Definition:
Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

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Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.

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