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## **INSTITUTIONAL CHANGES FOR PRIVATE SECTOR DEVELOPMENT IN VIETNAM: EXPERIENCE AND LESSONS**

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*Institutional Changes for Private Sector Development  
in Vietnam: Experience and Lessons<sup>1</sup>*

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<sup>1</sup> The opinions expressed in this paper rest exclusively with the authors and do not necessarily reflect the views of their organization, the Central Institute for Economic Management (CIEM).

## I. Introduction

To have a deep and thorough understanding of development is always a challenge to economists. It is recognized that while competition and efficiency is essential for development, 'market failure' is not less common than the 'state failure'. That is why economists and other social researchers have had a lot of efforts to find the ways of explaining economic reform and development from the viewpoint of institutional economics.

The centrally-planned economies (CPE) have faced more serious problems in transition. They have to deal with three key sets of reforms: liberalization and stabilization; institutional changes that support market exchange and shape ownership; and the establishment of social programs to ease the pain of transition (World Bank 1996). This general guideline does not, however, reflect all complexity of the transition process, as showed by the experience of a number of transition economies. As Jeffries (1993, p. i) mentions, 'The rejection of central planning by so many countries in 1989 represents one of the truly extraordinary events in the history of economics. But the transition to the market also presents economists with formidable challenges because the path has never been trod before. The issues raised will remain at the top of the economic agenda for many years to come'.

Since *Doi Moi (Renovation)* launched in 1986 and especially since the 1989 reforms, the face of Vietnam's economy and society has changed significantly. Yet, it is now generally recognized that Vietnam is among the best developing countries in terms of achieving relatively high economic growth and reducing poverty incidence. And one of the main factors contributing to Vietnam's success is prudent adjustments in the microeconomic foundations for supporting the private sector.<sup>2</sup> At the same time, some have argued that in international comparisons Vietnam's performance is not so spectacular and moreover, there remain many problems for sustaining economic growth and ensuring quality of development.<sup>3</sup>

In fact, the process of economic reforms and *Doi Moi* in Vietnam has also been complicated and unsmooth. The complication of reform process seems to be continuing as Vietnam aims at 'establishment of synchronous institutions of a market economy by socialism orientation', which is considered a key dimension for successful implementation of the Socio-economic Development Strategy 2001-10.<sup>4</sup>

An examination of Vietnam's experience is, therefore, to help enrich our understanding of the underlying political and economic determinants of transitional and developmental

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<sup>2</sup> See, for example, Arkardie and Mallon (2003) and Joint Donor Report (2005).

<sup>3</sup> See, for example, Dapice (2003). Vietnam also recognizes that economic growth during 2000-05 was under its potential and the competitiveness of the economy was quite low. According to the World Economic Forum, Vietnam's competitiveness is at the positioned 53/59 in 2000, 60/75 in 2001, 65/80 in 2002, 60/102 in 2003, 77/104 in 2004 and 81/117 in 2005.

<sup>4</sup> CPV (2001).

process. It is also helpful for Vietnam to adjust her institutional reform process for getting better policies for development. With that purpose, this paper is about the economic reform process in Vietnam, in which the changes in institutions for supporting private sector development are taken as the focus of consideration.

The remainder of the paper is organized as follows. Section II highlights the process of economic reform in Vietnam and its socio-economic achievements. Section III marks the salient features of changes in the microeconomic foundation to support private sector development. They include the recognition of private ownership, rights of doing business, and competition as well as the relaxation of restrictions related with the administrative procedure for business registration and sectoral-ownership conditions. Section IV emphasizes the problems of private sector's access to production factor markets, its participation in infrastructure development and public services, and the enforcement of Competition Law. The key lessons from the whole reform process, including the microeconomic foundation improvements, are examined in the final section, Section V.

## **II. Process of economic reforms, achievements and the role of private sector**

Since the reunification in 1975, the economic development and policy changes in Vietnam can be characterized by three periods (Figure 1).<sup>5</sup>

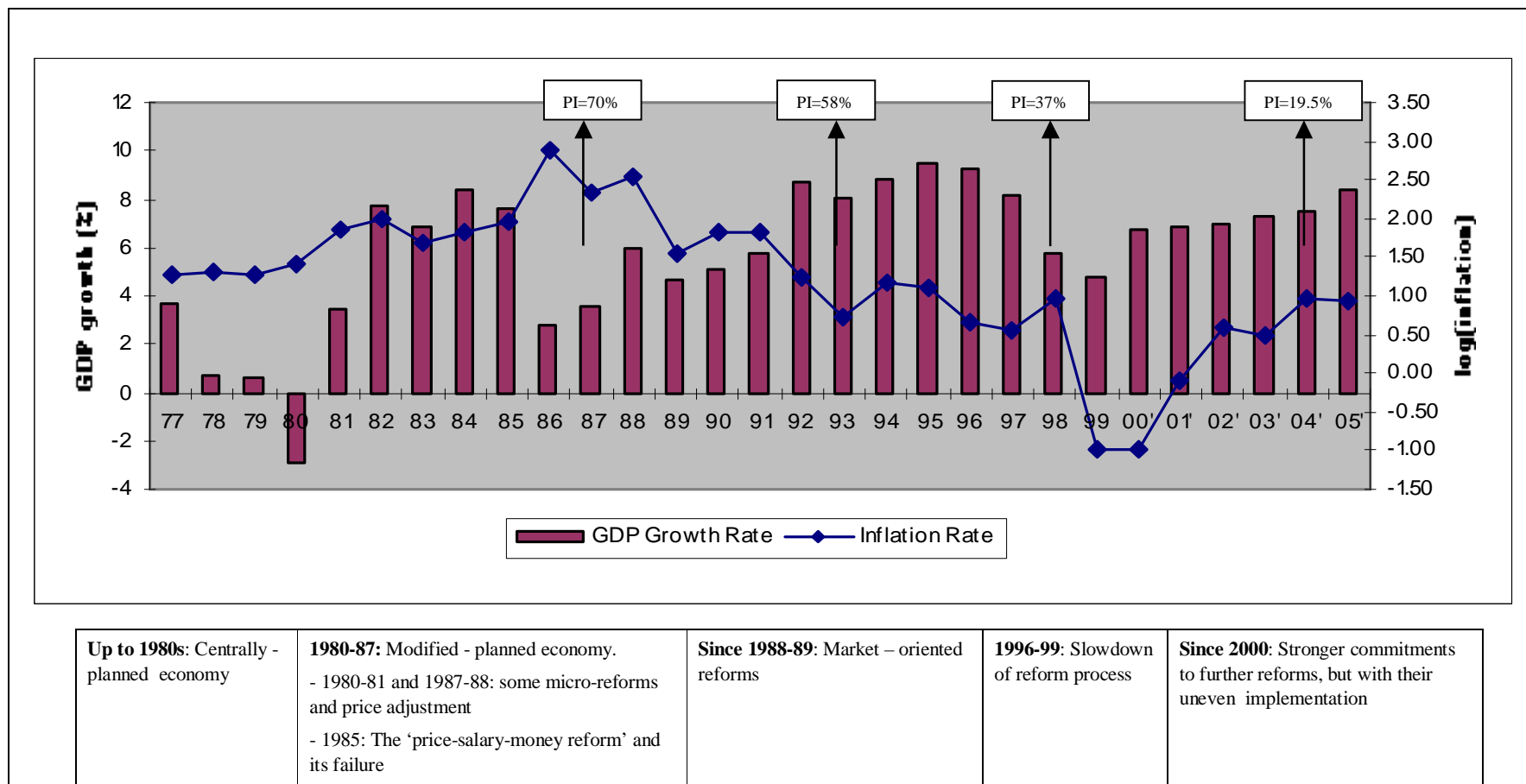
*Before the 1980s*, Vietnam was essentially a CPE, following closely the Soviet model. Major characteristics of the economy included: (i) state or collective ownership of production means; (ii) government administered supply of physical input and output; (iii) lack of business autonomy, absence of factor markets, highly regulated goods and services markets; and (iv) a bias toward heavy industry in investments. Vietnam was also relatively autarkic, trading mostly with the former socialist countries. With the poor incentives and restricted information flows, the resource allocation was heavily distorted. The problems were further compounded by an unfavorable geopolitical context because of the military conflict with Cambodia in late 1978 and China in 1979. By the late 1970s, Vietnam was facing a 'major economic crisis, with acute shortages of food, basic consumer goods, and inputs to agriculture and industry, and a growing external debt' (ADB 1989, p. 6). The failure of the centrally-planned system had become apparent and pressures for economic reforms increased substantially.

*During the period 1980-87*, the economy can be regarded as a modified-planned economy where some micro-reforms were undertaken to respond to depletion of the economy, but without any significant changes in macroeconomic management.

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<sup>5</sup> This Section is adapted from Vo Tri Thanh and Pham Hoang Ha (2004).

**Figure 1: Vietnam: Landmark reform, economic growth, inflation, and poverty reduction 1977-2005**



*Note:* PI = Poverty incidence. Inflation in 2000 (-0.6%) is set to be 0.1 for possible calculation of log function.

*Source:* Data of economic growth, inflation, and poverty are provided by the General Statistics Office (GSO) and our assessment of the reform process

De Vylder and Fforde (1988) have described the reform process as a ‘*bottom up*’ one. It was firstly initiated through partial, unofficial relaxation of constraints on private activity and spontaneous moves towards production and trade outside of official/plan channels (for example ‘illicit contracting’ in agriculture and ‘fence breaking’ in manufacturing sector),<sup>6</sup> leading to eventual Party recognition of the role of the household sector in agriculture, handicrafts, and retail trading. In 1979, the Council of Ministers issued a decree providing scope for local state enterprises to operate outside the central plan once central plan targets had been realized<sup>7</sup>. In January 1981, a contract system was introduced in the agricultural sector<sup>8</sup>, and the government issued a decision providing limited autonomy to state enterprises<sup>9</sup>. These micro-reforms enhanced voluntary and decentralized interactions between individual agents and created new incentives for producers in raising outputs during the period 1982-85. The economy became more dynamic and as a result, Vietnam enjoyed a rather high rate of economic growth in the first half of the 1980s (Figure 1).

Although those micro-reforms in the period 1979-1985 exhibited a trend towards liberalization and an undermining of the state planning system, they were not a transition in real terms. The fifth Party Congress 1982 initiated attempts to recentralize the economy and in 1983, administrative changes were made to control ‘anarchy’ in the market; the freedom of state enterprises to trade outside of official/plan channels was narrowed. These moves reflected considerable internal debate within the Party about future policy directions. Such an uncertain environment checked the growth of non-state economic activity as it discouraged long-term investments.

The improved economic growth was not to be sustainable. In September 1985, in a vain attempt to solve the problem of high free market prices, the authorities increased state prices, introduced a new currency and the so-called ‘price-salary-money reform’. These reforms were implemented without changing in fundamental problems of resource misallocation, trade restrictions and macroeconomic imbalances in the economy. As a result, these reforms failed to cut down inflation. In the mid-1980s, the inflation rate accelerated to several hundred percent.

The year 1986 is recorded as the beginning of the transition because it represented an irreversible change in ideology. The Sixth Party Congress in December 1986 publicly rejected the fiction of trying to implement the central planning model, and instead declared its intention to move toward some form of mixed market economy (a multi-ownership structure). This included agreement on the need for policy reforms aimed at reducing

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<sup>6</sup> One interesting characteristic of the Vietnamese system is its pragmatic flexibility. This characteristic is believed to be built-up over three decades of fierce struggle against powerful enemies. This characteristic explains why such ‘fence breaking’ behaviors were more easily accepted in Vietnam than in other communist countries.

<sup>7</sup> Decree 279-CP (2/8/1979) ‘On Work to Promote the Production and Circulation of Commodities not under State Management and the Supply of Inputs or Raw Materials and Waste and Low Quality Materials at the Provincial Level’

<sup>8</sup> Directive No. 100 of the Party Central Committee, 13 January 1981, ‘On Piece-work Contracts to Employee Groups and Individual Employees Working in Agricultural Cooperatives’

<sup>9</sup> Decision No. 25-CP (21/1/1981) on ‘Several Directions and Measures to Enhance the Rights of Industrial State Enterprises to take Initiative in Production and Business and in Self-Financing.’

macroeconomic instability and accelerating economic growth, and that all ‘economic levers’ (price, wages, fiscal and monetary policies) were to be used to achieve these objectives.

However, significant changes in this direction occurred only sometimes after the approval of the Doi Moi program by the Congress.

*From 1988-89 onwards*, the economy has been an economy in transition, striving for industrialization and international integration. During 1988 and in early 1989, Vietnam adopted a radical and comprehensive reform package aimed at stabilizing and opening the economy, and enhancing freedom of choice for economic units and competition so as to change fundamentally its economic management system. The reforms included:<sup>10</sup>

- almost complete price liberalization;
- large devaluation and unification of the exchange rate;
- increases in interest rates to positive levels in real terms;
- substantial reduction in subsidies to the SOE sector;
- agricultural reforms through replacement of cooperatives by households as the basic decision-making unit in production and security of tenure for farm families;
- encouragement of the domestic private sector and foreign direct investment (FDI); and
- removal of domestic trade barriers and creation of a more open economy.

Macroeconomic stabilization was successful in conjunction with price liberalization, the changes in interest rate and exchange rate policies and at the same time, the relief of the fiscal burden. The improvement of monetary policy and the better use of monetary instruments played a key role in cutting down inflation.

Since 1989, the structural reforms, such as the SOE and banking system reform and private sector promotion, have also been carried out, but not without problems (which shall be discussed in following sections).

In parallel with the domestic reforms, the acceleration of the process of international economic integration has played a key role in enhancing efficiency and promoting economic growth. The trade regime has gradually liberalized (though it did not achieve neutrality in the incentive structure). Up to 2005, Vietnam has entered into 87 bilateral trade arrangements and 48 investment protection agreements, and had trade relations with 224 countries/territories. In 1992, Vietnam signed a trade agreement with the European Union (EU). In 1995, Vietnam joined ASEAN and fulfilled the agreements under the AFTA in 2006. Vietnam applied for WTO membership in 1995 and attained membership status in November 2006. In 1998, Vietnam became a member of the APEC. In 2000, Vietnam signed the Bilateral Trade Agreement with the United States and the agreement became effective in December 2001. Since 2002, Vietnam has also joined regional integration clubs such as ASEAN +1. These moves have created huge market access for Vietnamese

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<sup>10</sup>Note that Land Law of 1988 and ‘Party Resolution 10,’ April 1988, abandoned the collective farming system that had been introduced in the 1960s; Resolution 27/HĐBT of March and Decision 16/NQTU of July 1988 officially encourage private enterprises; Law on foreign Investment 1987 to call for foreign investment. See also the next section.

entrepreneurs and played a key role in booming exports which is the main engine for growth in Vietnam.

With the market-oriented reforms, the socio-economic achievements Vietnam recorded have been impressive. In 1989 inflation was under control and since then it has stood at single digit levels.<sup>11</sup> From 1990 to 1997, the GDP growth rate was maintained at around 8% per annum on average. The GDP growth rate, however, went down between 1997 and 1999, partly because of the Asian financial crisis, and partly because of the dissipation of reform effects. Since 2000, the economy has gradually regained its rather high growth rate. The export growth rate averaged 24% per year during 1990s and continued to be high over the last three years (2003: 19.1%; 2004: 33.2%; 2005: 21.6%). The poverty incidence has significantly reduced, from 70% by in the late of 1980s to 58% in 1993, 37 % in 1998 and further to 19.5% in 2004 (Figure 1 and Table 1).

**Table 1: Some major macroeconomic indicators, 1991-2005**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 <sup>a</sup>
GDP growth (%)	5.81	8.70	8.08	8.83	9.54	9.34	8.15	5.76	4.77	6.79	6.89	7.08	7.34	7.69	8.43
Inflation (%)	67.6	17.5	5.2	14.5	12.7	4.6	3.6	9.2	0.1	-0.6	0.8	4.0	3.0	9.5	8.4
Domestic S/GDP (%)	10.10	13.77	16.78	17.08	18.20	17.21	20.10	21.49	24.57	27.12	28.82	28.67	27.42	28.31	30.0
Investment/GDP (%)	15.00	17.64	24.26	25.48	27.14	28.10	28.30	29.05	27.63	29.61	31.17	33.22	35.44	35.58	38.9
FDI (US\$ bill.) <sup>b</sup>	1.322	2.165	2.900	3.766	6.531	8.497	4.649	3.897	1.568	2.014	2.536	1.379	1.653	2.100	4.100
Export (US\$ bill)	2.087	2.581	2.985	4.054	5.449	7.256	9.185	9.360	11.540	14.308	15.027	16.706	19.900	26.500	32.200
- Change (%)	-13.2	23.7	15.7	35.8	34.4	33.2	26.6	1.9	23.3	24.0	3.8	11.2	19.1	33.16	21.6
Import (US\$ bill)	2.338	2.541	3.924	5.826	8.155	11.144	11.592	11.499	11.622	15.200	16.200	19.730	25.000	31.954	36.980
- Change (%)	-15.1	8.7	54.4	48.5	40.0	36.6	4.0	-0.8	1.1	30.8	3.4	19.73	26.7	27.81	15.5
Total Trade/GDP	52.9	51.9	52.4	60.6	65.4	74.6	73.7	70.5	79.9	94.0	95.00	104.6	109.4	127.3	128.5

Note: a) Estimated figures; b) Total commitments of newly registered projects.

Source: Data provided by General Statistical Office (GSO) and Ministry of Planning and Investment (MPI) and CIEM.

The role of both foreign invested enterprises (FIE) and the (domestic) private sector in the economy has increased significantly. The FIE sector has become an integrated part of Vietnam's economy with an increasing share in (current) GDP from nearly 0% in 1991 to 15.9% in 2005. In 2005, this sector accounted for 34.5% of the total merchandise export value (57.4% if crude oil export is included) and 16.3% of total investment. Meanwhile, the share in GDP of the state sector increased from 31.2% in 1991 to 38.4% in 2005, while that of the non-state sector (dominated by the private sector) decreased from 68.9% in 1991 to 45.7% in 2005. But this is largely explained by a sharp decline of the agricultural sector (from 40.5% GDP to 20.7%), where business units are basically households. Table 2 indicates an increasing significance of the non-state sector in industry, especially in those where Vietnam has comparative advantages (labour-intensive manufacturing). The private sector became a major source of employment, absorbing as much as about 90% of 1.3 – 1.4 million new labor market entrants each year.

<sup>11</sup> In 2004 and 2005, inflation rate (measured by CPI) increased considerably, to 9.5% and 8.4% respectively from the low rates during 2000-03.

**Table 2: Role of the non-state and FIE sectors in industry, 1998 and 2005**

	% of total industrial output	1998			% of total industrial output	2005		
		By sector (% of a specific industry output)				By sector (% of a specific industry output)		
		Total	FDI	SOE		Non-state	FDI	SOE
<b>Total</b>	<b>100.00</b>	<b>34.68</b>	<b>43.38</b>	<b>21.94</b>	<b>100.00</b>	<b>37.16</b>	<b>34.32</b>	<b>28.51</b>
<b>Mining industry</b>	<b>14.57</b>	<b>83.74</b>	<b>12.56</b>	<b>3.69</b>	<b>9.11</b>	<b>71.82</b>	<b>20.42</b>	<b>7.76</b>
<i>Mining of coal</i>	1.21	0.74	97.81	1.45	1.44	1.86	96.47	1.67
<i>Petroleum and natural gas</i>	12.20	99.76	0.24	0.00	6.50	99.88	0.12	0.00
<i>Metal ores</i>	0.11	2.72	73.65	23.63	0.16	3.07	45.94	50.99
<i>Stone and other mining</i>	1.04	1.84	50.82	47.35	1.01	1.40	38.88	59.72
<b>Manufacturing</b>	<b>79.23</b>	<b>25.34</b>	<b>47.61</b>	<b>27.05</b>	<b>84.91</b>	<b>35.87</b>	<b>31.45</b>	<b>32.68</b>
<i>Food products &amp; beverages</i>	22.37	21.73	46.02	32.24	20.95	26.51	31.53	41.96
<i>Tobacco products</i>	2.84	0.50	99.12	0.38	2.57	1.83	97.37	0.80
<i>Textiles</i>	4.97	21.03	54.30	24.67	4.71	30.01	40.94	29.05
<i>Wearing apparel</i>	3.09	23.29	33.26	43.45	3.72	38.11	22.59	39.30
<i>Tanning &amp; dressing of leather, leather products</i>	4.58	45.25	29.63	25.11	4.58	59.26	12.70	28.04
<i>Wood &amp; wood products</i>	1.88	9.36	20.67	69.97	1.87	18.54	11.80	69.66
<i>Paper &amp; paper products</i>	2.06	12.75	52.23	35.02	2.06	17.18	32.79	50.03
<i>Publishing &amp; recorded media</i>	1.19	1.83	89.49	8.68	0.93	3.24	86.82	9.94
<i>Coke, refined petroleum products</i>	0.06	0.00	0.00	100.00	0.12	43.65	0.00	56.35
<i>Chemical &amp; chemical products</i>	5.74	27.35	62.73	9.92	5.32	41.95	40.58	17.47
<i>rubber and plastic products</i>	3.22	22.01	34.15	43.84	4.70	29.51	24.79	45.71
<i>non-metallic mineral products</i>	8.76	19.04	59.73	21.24	9.13	22.83	50.42	26.75
<i>Basic metal</i>	2.96	44.62	44.13	11.25	3.27	30.35	41.38	28.28
<i>Fabricated metal products, except machinery and equipments</i>	2.98	28.45	15.42	56.13	3.75	31.15	11.68	57.17
<i>Machinery and equipments</i>	1.28	23.42	58.72	17.86	1.54	52.23	24.13	23.64
<i>Office, accounting &amp; computing</i>	1.01	98.51	0.00	1.49	0.56	96.15	0.00	3.85
<i>Electrical machinery &amp; apparatus</i>	1.74	33.79	52.10	14.10	2.76	45.69	38.89	15.43
<i>Radio and communication equipments and apparatus</i>	2.37	81.36	17.27	1.37	2.26	78.52	11.80	9.68
<i>Medical, precision, optical instruments, watches, clocks</i>	0.23	71.39	20.72	7.88	0.20	85.20	6.86	7.94
<i>Motor vehicles</i>	1.09	70.57	15.71	13.73	2.56	82.33	12.21	5.46
<i>Other transport equipment</i>	2.71	69.34	18.68	11.98	3.99	66.89	15.18	17.93
<i>Furniture</i>	2.01	26.75	7.90	65.35	3.26	40.66	5.24	54.11
<i>Recycle</i>	0.08	0.00	0.00	100.00	0.07	1.46	0.00	98.54
<b>Electricity, gas and water supply</b>	<b>6.20</b>	<b>0.36</b>	<b>99.53</b>	<b>0.11</b>	<b>5.98</b>	<b>2.79</b>	<b>96.25</b>	<b>0.96</b>
<i>Electricity and gas</i>	5.63	0.17	99.79	0.03	5.59	2.73	96.41	0.86
<i>Water</i>	0.58	2.19	96.97	0.83	0.39	3.75	93.82	2.43

Note: The choice of the year of 1998 is not only due to data availability, but because this is the year before the Enterprise Law was approved.

Source: GSO and our estimates.

However, Vietnam is currently facing great challenges. Vietnam is still a low-income economy in transition, striving to catch up with more advanced economies in the region.

While Vietnam has recorded remarkable achievements in socio-economic development, imbalances in growth have emerged. There are weaknesses and vulnerabilities in several areas such as in the SOE sector, the financial system, public investment, and the education and training system. Another concern is about the growing private sector being not associated with a redistribution of firms by size. This means that thriving firms are either small (in the case of the domestic private sector) or quite large (in the case of the FDI sector). This phenomenon has not only limit the positive spillover effects in the economy, but also suggests that there have been a lot of obstacles for private businesses to grow, and eventually make it to the top.

The problem of poverty and income inequality also adds the risk of socio-economic instability, which may stall economic development. Vietnam can benefit substantially from its trade liberalization and international economic integration. But the existing problems and weaknesses may be exaggerated as the economy integrates deeply into the regional and world economy. The adjustment costs, especially in short run, during integration process could also be significant.

### **III. Microeconomic foundation changes for supporting private sector development**

Since 1979 there have been three main steps of micro-reforms implemented: (i) the private ownership and rights of doing business were officially recognized; (ii) a series of legal frameworks on business/company types have been set up and implemented; and (iii) market entry has gradually been relaxed. These reforms have helped liberalize domestic resources (such as entrepreneurialism,<sup>12</sup> human resources, capital) for economic development.

#### ***Recognition of private ownership, rights of doing business and competition***

Following the Sixth Congress, there was a gradual relaxation of the administrative constraints to private sector activity and to domestic trade. In early 1987, many of the checkpoints that had been established to limit domestic trade were reduced, and private markets for agricultural goods developed rapidly.<sup>13</sup> In March 1988, the Council of Ministers had issued a series of decrees clarifying the rights of the non-state sector to engage in industrial production.<sup>14</sup> These policy guidelines were reinforced by a Politburo Resolution in July 1988.<sup>15</sup> These policy guidelines recognized the important potential contribution of the non-state sector in industrial production, and explicitly stated that the state recognizes and protects the rights of the non-state sector to the ownership and inheritance of property and lawful earnings of non-state enterprises.

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<sup>12</sup> By comparing the statistics on the fraction of rural self-employment accounted for by non-farm activities Vietnam during the 'Doimoi' process, Joint Donor Report (2005) believed that this country is more entrepreneurial than many other countries, even China.

<sup>13</sup> The extent to which administrative constraints were relaxed varied considerably throughout the country depending on the actions of local level administrative authorities.

<sup>14</sup> Council of Ministers Decree 27, 28 and 29-HDBT, 9 March 1988, on 'Rules and Policies on the Private Economic Sector in Industrial Production, Service Industries, Construction and Transport', on 'Rules and Policies on the Collective Economy in Industrial Production, Service Industries, Construction and Transport', and 'Rules and Policies on the Family Economy in Production and Service Activities', respectively.

<sup>15</sup> Politburo Resolution 16/NQTW, 15 July 1988, on 'Renovation of Management Policies and Mechanisms towards Non-state Economic Sectors'.

The Land Law (passed in December 1987 and enacted in 1988), and the Amended Law (passed in 1993) were an important step towards the introduction of property rights, recognizing private land-use rights (the state retains ownership). The Party Resolution No.10, passed in 1988, introduced a critically important reform. It greatly enhanced the rights of rural families, and diminished the legal authority of village cooperatives, providing for a much greater role for individuals and private enterprise in the agriculture sector. Farmers really owned their produce and could sell it in the free market. These moves, in combination with price and trade reforms, have contributed to sustained growth in agriculture since 1988 and been essential to poverty reduction as they provided income to some three-quarters of the population.

It should be noted that until 1995, there was no legal framework (even in the Constitution) to specify and to guarantee and enforce the property rights. Consequently, there was some uncertainty about what actually was permissible and what would be permissible in the future. That uncertainty did not much retard investments by family businesses and farming activities, where investments mostly were small and short-term. Strong growth in the private sector's share of retail trade showed that even before formal institutions were established, changes were gradually occurring in informal institutions that substantially affected the way economic business was conducted. When formal institutions were not in place, economic behavior was mostly governed by informal institutions such as social norms and practices, and behaviors, and pressures to conform.<sup>16</sup> However, when the scope and scale of economic activities increase, those informal institutions can be costly for those unfamiliar with them and therefore, they could impose major obstacles for investment. A small-survey of enterprises conducted by World Bank confirmed that in the absence of formal institutions, firms have to apply a range of mitigation strategies to protect themselves from a contract breach, such as carefully selecting counterparts, keeping their contracts relatively short-term with an option to renew, limiting the size of an individual contract, or diversifying suppliers whenever possible (Joint Donor Report 2005). These practices are costly and not relevant for long-term and large scale investments.

After having achieved remarkable results in the reform process and freed from threat of economic crisis, Vietnam needs long-term and large scale investment to sustain economic growth. This requires informal institutions be legalized to make the business environment more transparent and accountable. Responding to the demands of development, Vietnam's National Assembly approved a newly amended Constitution in 1992, which was recognized

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<sup>16</sup> The small-scale survey of enterprises conducted by the World Bank shows that all the firms in the survey do indeed use some form of written contract to formalize their deals. However, none of them places much faith in the ultimate legal enforcement power of those contracts, nor do they seriously entertain the possibility of resorting to legal action if the other party violates its obligations. The main purpose of the contracts seems to be to minimize the room for misunderstanding between the parties. And although very few firms adhere strictly to their terms, suppliers generally attempt to fulfill them. They do so for the sake of building their reputation and boosting the goodwill of the contractor, rather than because they are concerned about the possibility of any legal consequences of a breach. Reputation, through repeated interaction, is the cornerstone of business-to-business deals in Vietnam. In virtually all cases, contractors and suppliers have known each other for a number of years, usually several times longer than the term of their business deal. In the small-scale survey, 98 percent of the contracts were with suppliers that the contracting firm had known for three or more years, whereas the longest contractual agreement was for 12 months (Joint Donor Report 2005).

as a milestone in laying the foundations for the private sector to compete with the state sector (Government of Vietnam 1992). The Constitution acknowledges private ownership and provides guarantees against nationalization (Article 23), states that foreign investment and trade are to be encouraged (Articles 24 and 25), and specifies that SOEs should be run autonomously and be accountable for their performance (Article 19). Property rights and private ownership were further detailed in the first Civil Code 1995. The Code not only confirms the protection of lawful property right and private ownership, but also covers provisions on the establishment of property rights, and provisions on transactions in and transfers of these rights and property.

However, it was recognized even in 1996 that the reforms were not keeping pace with economic development. The reform process in general slowed down during the period 1996-99, especially after the Asian crisis. Note that the Asian crisis was seen differently in Vietnam. While many have maintained that the crisis has simply reinforced the importance of further reform, others have emphasized the dangers of exposure to global markets in terms of social stability and sovereignty. The slowdown in the reform process discouraged foreign investors who had greatly believed in Doi Moi. FDI inflows decreased sharply. Newly licensed capital declined on average by 24% annually, while implemented capital decreased on average by 14% per year (Le Xuan Ba 2006). As a result, economic growth went down and reached a trough of 4.8% in 1999.

The slowdown in economic growth in late 1990s put more pressure on reform.<sup>17</sup> The reform process was then powered by promulgating Enterprise Law in 1999, which has been recognized as one of the most fundamental reforms in business law of Vietnam.

First, the Law officially acknowledges the right of doing business: 'Citizens are free to do business in all business areas not prohibited by Law'. The Law has helped harness Vietnam's economic potential and removed constraints which hindered innovation and creativity in business. The Law has also revitalized entrepreneurship and strengthened the trust of investors and entrepreneurs in the reforms and policies initiated by the Party and Government.

Second, the Law has brought about a fundamental shift in the approach and tools with which the government manages enterprises. Prior to the Enterprise Law 1999, it was believed that 'the freedom to do business should only be broadened along with and within the expansion in governance and monitoring capacity of authorities'. This view has receded and has been replaced by a more innovative thinking. The Law implicitly set up a new principle that 'management and governance capacity of the Government authorities should be strengthened and developed to the point that it can promote and manage development process'. The old management style which focused on inspection and monitoring is gradually being replaced with one that leans more towards cooperation and facilitation.

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<sup>17</sup> However, in a long war against the most powerful enemies (1945-1975) Vietnamese Communists proved their capacity to adapt to difficult situations. They were resolved in their target but willing to change their strategy to match the requirements of new situations, as long as these strategies served the targets. Capacity to adapt has been acknowledged as one of the important characteristics of Vietnamese leadership in the Doi Moi process (Arkadie and Mallon 2003)

Such reform is the impetus for accelerating administrative reforms and enhancing the capacity of public authorities to be in line with market economy requirements.

Ex-prime Minister Phan Van Khai said in his annual business meeting 13-14 September 2001 in Hanoi that ‘...coupled with the policy ‘Khoan 10’ (Resolution 10 in 1988) which helped to liberalize the freedom and the production potential in rural and agricultural economy, the acknowledgement of the role of rural households in agriculture production has enabled Vietnam to graduate from a rice importer to the second largest rice exporter in the world. Of no less importance than the policy, the Enterprise Law has been a breakthrough in institutional reforms, enabling liberalization of production forces in urban areas through the development of private enterprises’.

**Table 3: Formal Laws on Governing Business entities**

Laws	Dates laws approved, amended or replaced	Categories of business entities or arrangement addressed
Companies	Enacted December 1990 Amended June 1994 Replaced in January 2000 Amended and Unified in Enterprise Law in November 2005	Joint stock companies Private limited liability companies
Private Enterprises	Enacted December 1990 Amended June 1994 Replaced in January 2000 Amended and Unified in Enterprise Law in November 2005	Private Unlimited liability Enterprises
Enterprise Law	Approved April 1999 Enacted January 2000 Amended and Unified in Enterprise Law in November 2005	All private Enterprises Allows State enterprises to be incorporated
Civil Code	Approved October 1995 Amended November 2005	All business entities
State enterprises	Approved April 1995 Amended and Unified in Enterprise Law in November 2005	Entities with state invested capital (State corporations, Public Service Enterprises, and Business Enterprises.)
Cooperatives	March 1996	Cooperatives
Financial Institutions	Approved November 1997	Banks and other financial institutions
Insurance Services	Approved May 2000	Entities providing insurance
Bankruptcy Law	Approved December 1993	All business entities
Commercial Code	Approved May 1997 Amended in November 2005	All business entities
Environmental Protection	Approved December 1993 Amended November 2005	All business entities
Land Law	Approved December 1987 Amended November 1993 Amended December 2001	Applied differently to different entities.
Labor Code	Approved June 1994	Applies differently to different entities.
Promotion of Domestic Investment	Approved June 1994 Amended April 1998 Amended and Unified in Enterprise Law	All domestically owed business entities.
Foreign Investment	Approved December 1987 Amended June 1990 Amended December 1992 Amended April 1997 Amended May 2000 Amended and Unified in Enterprise Law	Joint-venture entities Foreign-owned entities Business cooperation contracts Build-operate-transfer project
Law on competition	Approved December 2004	All business entities

Unified Enterprise Law	Enacted July 2005 Approved November 2005 Enacted July 2006	Joint-stock company Limited liability company Private company Partnership company
Common Law on Investment	Approved November 2005 Enacted July 2006	All business entities regardless their nationalities.
Law on Intellectual Property.	Approved November 2005 Enacted July 2006	All business entities

*Source:* CIEM/UNDP (2001) and CIEM (2006).

In fact, the Enterprise Law has expanded the autonomy and the ability for initiative in regards to an enterprise's operations while at the same time creating a legal basis ensuring a more transparent relationship between the State and enterprises. The business environment has become more predictable and less risky and the investors are more willing to invest. It has resulted in a boom in business activities in all fields and contributed a great deal to Vietnam's economic recovery and growth, to job creation and poverty reduction.

Statistics from the Agency for Small and Medium Enterprise Development reveal that 160,672 private enterprises were registered during the 2000-05 period. This is 3.2 times more than the total number of private enterprises registered during 1991-99. Accumulated capital registered by new enterprises amounts to nearly VND 321,200 billion (around USD 20 billion). This figure does not include the additional capital registered by existing enterprises due to expansion of their business, which is estimated around USD 6.3 billion.

**Box 1: Key Contents of Enterprise Law 2005 (be effective on 1<sup>st</sup> July 2006 )**

The core ideas of the Enterprise Law 2005 is further simplifying the procedures and reducing obstacles to market entry for non-state enterprises. The constraint of ownership (30%) for foreign investment is fundamentally abolished, except for some restricted industries and areas.

According to Enterprise Law 2005, newly established SOEs have to apply the Law immediately, while the existing enterprises have to transform management organization and operation in the forms of limited liability or joint-stock company as stipulated by the Law (the transition deadline is subject to annual schedules, but should be completed within four years from 1<sup>st</sup> July 2006). The existing FIEs are permitted to either re-register within two years, or continue operating with the granted license.

The Law for the first time covers regulations on company groups (including holding–subsidiary company, business group and other forms). In general, the objective of the regulations on company group is to set up legal grounds for the development of large-scale companies, make business operation transparent, and to protect the interest of minority shareholders. A noteworthy point is that the Law clearly stipulates responsibility of the holding company over subsidiaries, such as loss compensation for the subsidiary company in some cases.<sup>18</sup>

The regulations on corporate governance are more in line with international corporate governance

<sup>18</sup> For example, beyond-authority interference of the owner, member or shareholder, as well as forcing subsidiary company to do business in contrary to business practices or to carry out non-profit activity without satisfactory compensation, resulting to the loss of the subsidiary company.

<sup>19</sup> For example, they are required to inform the company accurately and in a timely fashion about the enterprises in which they or their relatives share ownership or equity or controlling equity (Article 119); explain works carried out by the manager in their own name or in other's name within the scope of the company business, which can only be performed if approved.

standards, and are uniformly applied to all domestic and foreign invested enterprises. The regulations on disclosure and transparency are significantly widened, especially the regulations on managers<sup>19</sup> and related parties.

State administration over enterprises is also reformed. In order to strengthen the coordination among state agencies, the Law requires these agencies to provide information for each other.

Based on the widely recognized successes of the Enterprise Law 1999, the (unified) Enterprise Law 2005 was approved by National Assembly in December 2005 and came into effect on 1<sup>st</sup> July 2006. The new Law governs not only private enterprises, but also joint-stock companies, limited liability companies, limited-liability companies with one-person membership, and partnership companies *regardless of the ownership*. In content, the Enterprise Law 2005 inherits and further expands the reforms that were introduced successfully by the Enterprise Law 1999 (Box 1).

In regard to the investment environment for FDI, one year after launching *Doi Moi* Vietnam promulgated the first Law on Foreign Investment in 1987. Since then the Law has undergone four amendments and supplements in 1990, 1992, 1996 and 2000, and finally unified in (common) Law on Investment in December 2005 (Box 2). The evolution of the Law on Foreign Investment shows Vietnam's priority to FDI and her willingness to change to win in international competition for FDI. Undoubtedly, this Law and its amendments and supplements have significantly contributed to an improved investment environment, technological progress and economic development in Vietnam.

**Box 2: Key Contents of Law on Investment 2005 (effective on 1<sup>st</sup> July )**

The ruling position and guidance in development of the Investment Law are to abolish discrimination between investors of all forms of ownership, between domestic and foreign investors, to respect the freedom of business, and the investors' right of self-determination in making management decisions. The law also provides fundamental changes in the state administration of investment and business activities in the direction of minimizing administrative intervention, ensuring favorable conditions for investors and merchants, and adopts the principle of National Treatment (NT) and Most Favored Nation (MFN) as stipulated in international treaties, of which Vietnam is a member.

The law stipulates that investors, regardless of whether domestic or foreign, have the right of self-determination in investment-business; the right of selecting investment sector, investment, capital mobilization form or choosing investment partner; the right of doing simultaneous business in various sectors, including export, import, advertising, processing and re-processing; the right of purchasing foreign currency; the right of transferring capital or investment projects; the right of raising a mortgage with land-use rights and land-attached assets; the right of remittance of capital and assets abroad; the right of accessing and using resources including capital, credit, land and natural resources; and other rights of the investor such as access to economic, legal and policy information and access to services on the principle of non-discrimination.

Investment Law 2005 stipulates that the State shall protect investors in respect to their capital and property; protect intellectual property rights; ensure that fees and charges controlled by the Government are equal for both domestic and foreign-invested enterprises; guarantee lawful interests of the investor in case the State changes its policies and regulations, and ensure that disputes will be settled properly.

The stipulation on investment support and preference is a selective inheritance of provisions of the Law on Domestic Investment Encouragement (1998) and Law on Foreign Investment (1996). Most of the conditions for entitling investment preferences remain unchanged.<sup>20</sup> The new investment law adds *economic zone* into the list of localities with investment preference, which has originated from practical needs.

The investment incentives and support measures under the Law on Domestic Investment Encouragement (1998) and Law on Foreign Investment (1996) are basically ‘transferred’ to the Investment Law 2005 as ‘general reference’.

However, the Law still maintains some reasonable and legitimate discrimination between Vietnamese and foreign investors. This discrimination is subject to the agreed roadmap of implementation of international commitments in international treaties, to which Vietnam is a member. These differentiations are employed widely in many countries and are believed to protect special national interests, ensuring security and sovereignty, legitimately protecting domestic production. These discrimination measures are limited and shall gradually decline in accordance with the roadmap specified in the bilateral and multilateral commitments signed by Vietnam.

However, FDI inflows have significantly declined since 1997 and only started to recover after 2000 (Table 1). Apart from the objective factors and weaknesses of infrastructure, the legal framework on investment and business still had a number of limitations, which have continuously been claimed by foreign investors. This is largely reflected in discrimination between domestic and foreign investors. Before enactment of Law on Investment 2005, there were two investment laws in Vietnam separately governing foreign investors (Law on Foreign Investment 1987) and local investors (Law on Domestic Investment Encouragement), which covered different systems of incentives and supports. In addition, investment laws and policies in general do not ensure transparency, openness and predictability in the long run.<sup>21</sup> Moreover, administrative barriers have also discouraged not a few investors, making Vietnam’s investment environment less attractive than some other countries in the region (Joint Donor Report 2005).

In order to match domestic policies with international commitments, especially with commitments to WTO, which require outlawing all forms of discrimination against foreign products and businesses, a series of 29 laws were approved in 2004-05. The important laws include the Civil Code amended 2005, the Competition Law 2004, the (common) Law on Investment 2005, the (unified) Enterprise Law 2005, the Commercial Code amended 2005, the Law on Export and Import Tax amended 2005, the Law on Intellectual Property 2005, the Law on Electronic Transactions, the Law on Bidding, the Law on Practicing Thrift and Fighting against Waste in Public Expenditures, the Law on Prevention of and Fighting against Corruption, the State Audit Law, and the Intellectual Property Law. By

<sup>20</sup> For example, eight preferential investment groups are clearly listed in Article 27. These sectors are selected in compliance with the industry structure development strategy and reasonable priority in the context of integration. Localities with socio-economic difficulties or special difficulties, industrial zones, export-processing zones, hi-tech zones remain geo-economic zones entitled further preference for development.

<sup>21</sup> According to World Bank (<http://info.worldbank.org/governance/kkz2004/tables.asp>), governance indicators (with five headings: governance effectiveness, regulatory quality, voice and accountability, rule of law and control of corruption) in Vietnam are far lower than that of neighboring countries in ASEAN such as Thailand, Malaysia and Singapore. However these indicators have steadily improved since 1996.

promulgating these laws, Vietnam has been widely acknowledged as having basically established necessary 'legal' institutions for a market economy. The Law on Investment, the Enterprise Law, and the Competition Law are expected to contribute significantly to improvement of business environment in Vietnam and a new boom in foreign and private investments through:

- creating a more level playing field for all investors based on fundamental principles of WTO, such as national treatment, most favored nation, openness and transparency;
- settling and mitigating difficulties and obstacles to market entry, ensuring investors' freedom to invest in areas not prohibited by law; and
- improving transparency and accountability in implementing State's role on management by separating state management and business management. The State is supposed to play the role of supporting enterprises, providing effective legal framework and ensuring strict enforcement of law without directly intervention in business management of the enterprise.

In relation to competition regulation, before promulgation of the Competition Law in 2004, there had been some provisions related to anticompetitive and unfair competitive practices in specific areas and to protection of lawful interests of consumers.<sup>22</sup> In practice, these rules were poorly enforced and had an insignificant effect on competition environment. On 3 December, the National Assembly approved the Competition Law which came into effect on 1 July 2005. This law marks an important milestone in the process of establishing and developing a fair competitive environment in the economy. The Law, in general, regulates anti-competitive and unfair competitive practices, and procedures and remedies applied to complaints on competition. All business activities are subject to the Law, including domestic private enterprises, SOEs, and FIEs operating in sectors/areas of production, distribution, public service, even industry and profession associations. Notably, the Competition Law also applies to State administrative agencies, in case their practices are harmful for competition in doing business.

It should be noted that these improvements in the legal environment for economic activity result in part from good dialogue between the business community and government agencies. Since 2000, the Vietnamese Government has maintained a direct dialogue with business community through three levels. The highest level brings together representatives from a number of business associations and a range of line ministries and government agencies. It is organized twice a year under the name of Vietnam Business Forum (VBF). These regular gatherings have led to the identification of a series of policy priorities for business development. Participation by the highest national authorities allows the business community to convey its views and concerns in an effective manner. The second level of policy dialogue is between specific ministries or agencies and the relevant stakeholders in

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<sup>22</sup> These rules are stipulated in separate legal documents. The Commercial Law (1997) contains several provisions to protect consumers and restrain in unfair competitive practices. Decree 54/2000/CP, dated 3 October 2000 by the Government, sets out regulations on the protection of intellectual property rights regarding trade secrets, geographical indication, trade names and protection against unfair competitive practices relating to intellectual property.

the business community. These exchanges occur mainly in the process of drafting new laws or decrees, and are becoming more regular over time. The third level involves provincial authorities and the corresponding business community. These exchanges are aimed at improving the local investment environment and attracting investors to the province.

Table 4 shows the encouraging investment response by foreign and private business community to Vietnam's reforms since 2000.

**Table 4: GDP and investment growth rate by ownership 1996 - 2005 (%)**

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
<b>GDP</b>		<b>9.34</b>	<b>8.15</b>	<b>5.76</b>	<b>4.77</b>	<b>6.79</b>	<b>6.89</b>	<b>7.08</b>	<b>7.34</b>	<b>7.79</b>	<b>8.43</b>
Investment	State	34.2	20.1	15.3	16	16.2	13.7	7.8	8.2	17.9	5.9
	Non-state	3.8	8.1	7.8	11.2	9.7	11	32.5	28	19.6	15.7
	FDI	-1.7	28.3	-23.8	-8.5	19.9	10.2	13.4	5.6	14.7	16.4

Source: GSO various volumes and CIEM (2005), CIEM (2004).

### ***Relaxation of market entry restrictions***

Resolution 100 in agriculture and then resolution 10 in 1988, Civil Code 1995 and the Enterprise Law are milestones in the process of recognizing the private ownership and right of doing business in Vietnam. The Investment Climate Survey (ICS) conducted by the World Bank shows that only 5.5% of ICS correspondents see the legal system as a severe or major constraint in Vietnam, compared to about a quarter elsewhere in the region or in the world (Joint Donor Report 2005). This reaffirms that institutional reforms in the legal framework related to private ownership and rights of doing business have won credibility with business entrepreneurs. In return, the private sector has increasingly confirmed its role in process of economic development in Vietnam, especially in creating of jobs and improving income.

However recognizing private ownership and rights of doing business is only a necessary condition for business development. Vietnam would not score remarkable achievements in promotion non-state business if they had not removed many market entry restrictions. These restrictions are mainly administrative procedures for business registration, granting favorable conditions for SOEs, and sectoral-ownership conditions.

### ***Administrative procedures for business registration***

In developing countries administrative procedures are key restrictions on making business ideas come true. In Vietnam, simplification of the procedures for business registration and business establishment is considered one of the breakthroughs of the Enterprise Law 1999, reflected in three aspects. First, the procedures and documentation for the establishment of enterprises have been simplified. According to empirical data, the time it takes to establish an enterprise has been reduced from 90 days from the receipt of proper documentation to seven days on average. In addition, the cost of business registration has been significantly reduced, from an average of VND 10 million to about VND 500,000 (GTZ, CIEM and UNDP 2005). Second, the Law clearly defines the rights of the State as well as the rights of State officials *vis a vis* the rights of the investor and the enterprise, having the effect of

gradually reducing the tendency by State bodies to over-administer and create hassles for enterprises. Third, 159 business licenses have been abolished, removing a significant amount of unreasonable administrative barriers on the operations of enterprises.

The ICS conducted by The World Bank shows that only 1% of the ICS respondents in Vietnam see licenses and permits as a 'severe' or a 'major' constraint, compared to an average of about 15 percent elsewhere, both in the region and across all developing countries. This positive perception is a testimony to the dramatic simplifications in business registration introduced by the Law. A survey of enterprises jointly conducted by CIEM and the GTZ also confirms this perception. The Enterprise Law requires business registration process to be completed within 15 days. The CIEM-GTZ study found that this deadline was respected in two thirds of the cases, with only 5 percent of enterprises having to wait for 30 days or more. In many provinces the registration process was actually completed in less than one week. Similarly, 70 percent of the companies surveyed received their tax code within seven days, and only 6 percent of them had to wait for more than 15 days.

According to the ICS for Vietnam, the government agencies are considered by respondents as relatively cordial. Respondents were asked to choose, among a long list of options, the two agencies which had been the most supportive, and the two which had been the least helpful. At one end of the spectrum, District People's Committees were perceived as the friendliest, followed by the Business Registration and Licensing offices under the Department of Planning and Investment. An insignificant number of correspondents claimed these two agencies were unhelpful. The Traffic police came at the other end, followed by the Market controller and land administration agency which received almost no support from entrepreneurs. The Labor and social security, Product quality registration, Fire and building safety agencies on average received more good comments than bad ones, while the Tax authority, Municipal police, Customs department, Department of construction and Environmental agency were perceived as unhelpful rather than helpful but the differences were not very large (Joint Donor Report 2005). These findings prove that administrative procedures do not hinder business development in Vietnam, as has been common wisdom. By contrast, government agencies in Vietnam have gained confidence from the business community and become a real friend for entrepreneurs. Table 5 provides a comparative view of Vietnam's business environment. Here, it is useful to focus on what is perceived as 'severe' or 'major' constraints for the growth of business, out of a list including 18 possibilities.

There are only 3 out of 18 criteria in which Vietnam is claimed to have a more binding constraint than the world and East Asian countries. 'Labor skill and education' and 'cost of finance' criteria are roughly the same as in the world/East Asia (to be precise, the skills constraint is only marginally more important in Vietnam than it is worldwide; and it is not more severe in statistical terms than in other East Asian countries), while for 13 other criteria Vietnam is significantly better than the world and East Asian economies. Interestingly these 13 criteria are related mainly to administrative procedures. Hence, it can be said that reforms in microeconomic foundations have greatly improved the business environment in Vietnam.

**Table 5: Binding constraint in Vietnam and elsewhere**

Constraint	East Asia	Vietnam	The World
Access to finance	17.4**	37.4	30.1**
Access to land	9.9**	26.4	14.5**
Labor skill and education	23.8	22.3	20.4*
Transportation	15.2**	21.6	12.4**
Cost of finance	20.2	21.3	36.1
Macroeconomic instability	34.1**	16.8	40.2**
Electricity	24.4**	15.7	24.4**
Policy uncertainty	32.5**	14.7	40.2**
Tax rates	28.2**	13.8	40.5**
Corruption	28.6**	12.8	36.8**
Customs and trade regulations	20.1**	12.5	21.6**
Anti-competitive behavior	21.6**	12.3	29.7**
Labor relations	17.4**	10.9	17.3**
Tax administration	22.4**	8.7	32.4**
Telecommunications	12.9**	6.5	10.3**
Legal system	27.3**	5.5	21.6**
Crime and theft	19.3**	4.0	25.7**
Licenses and permit	14.4**	1.4	15.9**

Source: Joint Donor Report (2005, Table 4.1). Figures indicate the percentage of firms which consider that constraint is either major or severe. Figures for East Asian are based on observations from Cambodia, China, Indonesia, Malaysia, Philippines and Thailand. Figures for the world include 57 developing countries and transition economies but exclude Vietnam. An asterisk indicates that the figure is statistically different from that for Vietnam at 90 percent confidence level; two asterisks indicate 99 percent confidence level.

Note that trading rights have also gradually been ensured during the process of Vietnam's trade liberalization and integration. Before 1989 trade was essentially characterized by state monopoly. Since 1989, the entry into trading activities has been somewhat relaxed, although up to 1997 the conditions for entry were still very restrictive. The abolition of trade licenses in 1998 was a most significant step forward in trade liberalization. From then on all domestic enterprises have been allowed to trade freely most commodities/items, except for a few items prohibited or under specialized management. The number of enterprises registered for trading activities increased from 2,400 in the early of 1998 to about 30,000 in 2005. Since 2002, the FIEs have been granted the right to export goods other than those they produce.

#### Reform and equitization of the SOEs

Before Doi Moi, the SOEs played a crucial role in Vietnam's economy and the role of the private sector was quite trivial. In transition to a market economy, there is the widely-held belief that public firms have been mismanaged and squandering assets and resources. Consequently, privatization is recommended as the only way to improve the performance of

SOEs. Vietnam recognized the inefficiency of the SOE sector, but she has attempted to ‘restructure and/or equitize SOEs’ rather than ‘privatizing’ them.

In the early 1990s, in order to make the operation of the SOEs viable, Government reduced substantially subsidies, diminished ‘cheap’ credit to these enterprises and gave them greater autonomy. Furthermore, inefficient and money-losing enterprises were liquidated. From 1990 to 1994, the number of SOEs fell from 12000 to 6300, and 1.5 million SOE workers (out of the 4.05 million total SOE employees) retired or were converted to part-time workers. These reforms led to some positive improvements in the growth performance of the SOE sector in the first half of the 1990s. But even then it was recognized that the reforms of SOEs and the financial sector had been limited and have not kept pace with economic development. In the second half of 1990s, these reforms stagnated in line with the slowdown in overall economic reform.

Vietnam has gained some progress in restructuring the SOEs sector. In 2001 there were 5355 SOEs, of which 1997 enterprises are under control of central government. During 2001-05, Vietnam restructured 3572 SOEs, of which 2378 SOEs were equitized (Table 6). However, these equitized SOEs accounted for only less than 10% of total state capital in SOEs<sup>23</sup>. Moreover, in general, during 2001-05 the pace of SOE reform was slower than was planned. Even in 2005, as the SOE reform has accelerated, the number of equitized SOEs represents only 70% of the planned. After 20 year of transition from a centrally-planned economy to a market-oriented economy, the Government of Vietnam retains cumbersome SOEs.

**Table 6: The process of restructuring SOEs 2001-2005**

Types	2001	2002	2003	2004	2005	2001-05
Enterprises equitized	205	164	532	753	724	2378
Enterprises Transferred	18	34	51	24	12	139
Enterprises sold	16	17	24	19	18	94
Enterprises merged	85	83	154	68	40	430
Unified enterprises	34	44	48	7	10	143
Enterprises dissolved	22	27	50	35	30	164
Enterprises bankrupted		2	4	12	12	30
Transformed to one-member limited liabilities companies			14	41	60	115
Newly established		37	18	12	12	79
<b>Total</b>	<b>380</b>	<b>408</b>	<b>895</b>	<b>971</b>	<b>918</b>	<b>3572</b>

Source: Data provided by MPI.

The good news is that according to a survey of the performance of equitized enterprises with sample of 445 enterprises conducted by CIEM (CIEM and World Bank 2005), 87.5% enterprises confirmed their performance in terms of profitability, and their financial state was better or much better than before equitization. Specifically, the turnover and profit after tax of equitized enterprises in the first year after equitization increased by 13% and 48.8%

<sup>23</sup> See *Saigon Times Weekly*, No 48-2005 (780), 24 November 2005.

respectively.<sup>24</sup> Furthermore, 96% of equitized enterprises confirmed that after equitization, the managers were more concerned about profitability and more proactive in seeking profit.

There have also been several new dimensions of SOE reform since 2005. The first is the decision to cement the equitization of SOEs by listing them in the stock market and to equitize the large SOEs and some General Corporations (GCs). So far, some big SOEs have been equitized (e.g. Vietnam Milk Corporation and Song Chinh-Vinh Son Hydropower Plant). The second is to transform big SOEs and GCs into the so-called holding-subsidary companies and there have been 47 entities transformed into companies following this model. The third is to establish and develop Business Groups on the foundation of GCs. On this basis, Vietnam Post and Telecommunication Group, Vietnam Coal Group, and Vietnam Textile and Garment Group were established. The expectation is that the holding-subsidary companies and the business groups can take advantage of internal linkages, large scale and diversity of ownership to be more efficient and more competitive. The fourth is to have a pilot equitization of two state-owned commercial banks (SOCBs), the Bank for Foreign Trade of Vietnam (Vietcombank) and the Housing Bank of Mekong Delta. The preparation process is to be completed and their stocks are expected to be sold in the early of 2007.

The SOE reform is coming into a very decisive moment. Some concerns have been raised about the future efficiency of the new holding-subsidary companies and business groups. There are also difficulties in terms of political economy, which cannot be simplified (Painter 2005). It is, however, believed that the SOE reform will be progressed in a more effective way. The two new laws, the Common Law on Investment and the Unified Enterprise Law, and deep economic integration (e.g. WTO accession) are new grounds for pushing this process forward.

#### **IV. Major issues for further development of the private sector**

The improvements in microeconomic market foundations mentioned in Section III do not mean perfection. A lot of problems remain and Vietnam should continue to think of further improvements. There are other major obstacles for private firms to develop, including difficulty in accessing to resources such as land and credit, and a state-enterprise monopoly in some key sectors. Furthermore, as Vietnam is now integrated more deeply into the world economy, the obstacles for private sector development may not originate from administrative agencies, but from unfair competition in the market due to the weakness of the legal system. Consequently, the sustainable development of the private sector also depends on two important things: the competitiveness of firms and the efficient enforcement of a (good) Competition Law.

##### ***Access to key production factor markets***

One of the critical determinants in the expansion of the private sector in Vietnam is access to appropriate financing resources (Table 5) to fund medium- and long-term investments. It has been estimated that in 2005 around 80% of private companies in Vietnam had access to external sources of finance (Joint Donor Report 2005). However private sources of finance

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<sup>24</sup> Interestingly, according to this survey, among equitized enterprises, proportion of 'better' replies in enterprises where the state held a dominant share was lowest.

from retained earnings, and resources from family and friends remained an important source. According to a JBIC survey, more than 80% of private firms relied on their own funds at the time of founding the company, and 60% of them cited family, relatives and friends as the second source for procuring investment funds (JBIC 2002). Where private companies are able to access bank loans, this is often in the form of short-term credit, primarily for working capital or trading needs, rather than for more long-term fixed capital investment needs.

As numerous studies have pointed out, unfavourable access to bank loans, and particularly long-term credit, relative to the state enterprise sector has been one of the major obstacles faced by the private sector. A number of factors are frequently cited to explain this phenomenon, both in terms of banks' willingness to lend to the private sector and private firms' ability to meet minimum lending requirements, including:

- the high degree of opacity surrounding companies' financial accounts (largely a by-product of the existing tax regime that motivates firms to under-report their activities in a bid to reduce their tax exposure), which makes it difficult for credit officers in banks to make a full credit assessment;
- banking regulations that inadvertently inhibit the expansion of banking business into the private sector;
- the small scale and fairly primitive stage of some private companies;
- when applying for a bank loan, many private companies lack viable business plans, or coherent strategies on how they intend to invest the credit;
- banks are sometimes reluctant to make the kinds of comparatively small loans required by private firms, because of the relatively higher transaction costs involved;
- the collateral requirements can be quite demanding for private firms in Vietnam, and many companies simply lack sufficient assets to provide as security for bank loans;
- banking regulations pertaining to bankruptcy and loan collateral (and taking possession of collateral after a lender defaults) remain undeveloped or difficult to enforce;
- although financial depth in Vietnam in last decade has developed remarkably, it still does not match that of her neighbors (e.g. Thailand, China and Malaysia), and this hinders banks in making loans to the private sector where this is perceived as risky; and
- lack of access to land (see next section), an essential ingredient in mortgage finance, is also a key obstacle for enterprises.

According to ICS, across all institutional types and sizes of enterprises, only 54 percent of respondents to the ICS declared that they had the right to sell or mortgage the piece of land they had acquired recently. And only 10 percent of them were located in what they considered to be their own land. Therefore, solving this problem is a key task for future reforms, thus helping the private sector and the business community to have better access to one of the most important inputs for their development.

As indicated in Table 5, access to land is significantly more difficult than average in the world and in East Asia. The survey of enterprises jointly conducted by CIEM and GTZ

(cited above) suggests that before an enterprise can be in operation, it needs to go through 13 administrative procedures, taking 260 days altogether. Of this, 231 days correspond to the time needed to acquire land, under the assumption that the enterprise wants to purchase it from the government and needs to go through land clearance and compensation for resettled populations. Getting land in an industrial zone would reduce the waiting period, on average, from 231 days to 83. These figures show that access to land is the most time-consuming procedure in setting up a new business in Vietnam.

There are several key problems. First, before 1987, private persons were allocated a parcel of land for their lives and work without any official right of use or ownership. The right of using land was supported by unofficial institutions; local officials knew which piece of land or property ‘belonged’ to whom, and arbitrated in case of conflict. Many transactions of land took place at this time under these institutions in the absence of proper legal documentation.

The land-use right was first established in the Land Law of 1987. While only the State can own land, a private person or entity can also own ‘use rights’ to a parcel of land for a specific period of time. However, due to unofficial rights of using land in the past, it has been very complicated to identify which piece of land should be allocated to whom. The 2004 revision of the Land Law is an important milestone towards completing the land titling process. However, up to 2004, 28% of agricultural land was without land-use right certificates (LUC). The figure for urban land is not available but should be much higher due to urbanization and temporary occupation of land by immigrants. Consequently, despite the Government’s huge efforts, land occupation without legal title is still common and this is the main obstacle for business to gain access to land.

Second, commercial and industrial land in urban areas is mainly in the hands of SOEs, whereas private firms face considerable difficulties in getting land. The ICS sample gives a sense of the magnitude of the problem. Among enterprises with 250 employees or more, SOEs have on average five times more land than private firms. To some extent, limited access to industrial land simply reflects the overwhelming population density and the ensuing shortage of idle space within urban boundaries. Most of the existing industrial land is already occupied by SOEs (they are automatically entitled to all areas they had in pre-*Doimoi* time), whereas the conversion of agricultural land into industrial land at the fringes of the cities is a slow and often controversial process. Thus, the supply of available land coming on to the market is too small to meet the demand. In the period from 1994 to 2002, in Hanoi only 428 new rental contracts covering about 3 million square meters were issued. More than half of these contracts were to SOEs. By now, an overwhelming 95 percent of land under lease to organizations in Hanoi is in the hands of SOEs, leaving less than 5 percent to private firms, cooperatives and other production groups (Joint Donor Report 2005).

Officially, SOEs are not allowed to sub-lease their land to other enterprises, but they do so in practice. In the small-scale enterprise survey conducted by the World Bank, 11 percent of the respondents had rented land from SOEs. Since these leases are not legal and typically short term (less than 10 years), private enterprises are put in a risky position with high

uncertainty. Furthermore, due to illegal leases, the rents that private enterprises pay to SOEs cannot be counted as a tax-deductible expense. This puts enterprises in a vulnerable position. In addition, revenues from sub-leasing land are not recorded in the accounts of SOEs. This is potentially important source for corruption and gives SOEs an incentive not to return to the State land that is not required for the conduct of business operations, as stipulated in Land Law.

Third, rapid economic development and urbanization has raised the demand for converting agricultural land into land for industrial, residential, commercial, and infrastructure purposes. By the end of 2004, there were 192 major industrial zones and clusters in 13 provinces, with a total area close to 30 thousand hectares of land. Originally, some 84 percent of this land was agricultural. It was recovered from over 100 thousand households.

The most common recovery procedure was the compulsory recall of farmers' LUCs by the state with compensation. Due to the gap between the market price and state compensation,<sup>25</sup> land conversion has been resisted by the affected households, leading to social unrest and considerable delays in land clearance. A recent assessment of the implementation of the new Land Law 2004 by MONRE included a review of 17,480 denunciation letters, more than 70 percent of which were related to site clearance and compensation.

Last but not least is corruption involved in land clearance and transactions

Therefore, to solve the problem of land access for private firms, the following steps should be carried out simultaneously:

- hastening the process of allocating land-use rights to households;
- pushing forward the equitization/restructuring of SOEs to make land that they are occupying marketable (so it can be leased or sold);
- the land conversion process should be based on market mechanisms that promote communication between enterprises that need land and land holders, rather than on purely administrative means. Land holders should be willing to transfer their lands voluntarily, rather than under administrative pressure. The model of land holders' contributing land as capital to become stockholders of an enterprise (Box 3) can be a good model in solving the problem of land conversion.

**Box 3: The whole hamlet contributes farming land to establish a company**

In Bac Vong Hamlet, Bac Phu Commune, Soc Soc District in the outskirts of Hanoi is a farming locality with 800 laborers. In early 2003, Mr. Thuc (an agricultural engineer) proposed that farmers consolidate their land and use the value of the land as capital contributions to start a big business, challenging the notion that investments should be made only in small businesses and that farmers are not willing to take large risks. His idea was well received by the municipal authorities, the Party cell and the farmers. Investors, like the Central Seeds Company No. 1 and

<sup>25</sup> In fact, due to the underdeveloped real estate market in Vietnam, it is difficult to estimate a marketable price for a plot of land. The price that LUC holders perceived as reasonable is usually higher than the marketable price. Furthermore, the price of a plot of land is usually much higher after it is converted into commercial or industrial land. These facts are also the main reasons why affected households keep resisting conversion, even after having agreed.

Viet Ha Beer Company, also supported this idea and cooperated in doing business.

In early May 2004, 227 farmer households signed contracts to contribute their small farming land areas to the company and effectively became shareholders of the company; while another 43 households signed contracts for the long-term lease of their lands to the company. A big business plan, using the capital from the land contributed by the farmers, is being carried out. With this method, Bac Vong Shareholding Company had 50 hectares of land at the time of its establishment without incurring any costs for compensation or clearance.

*Source: Law Newspaper of Ho Chi Minh City, 14 July 2004.*

### ***Private sector participation in infrastructure development and public services provision***

Infrastructure and public services in Vietnam are still underdeveloped. Studies in development show that development of infrastructure and public services is essential condition for economic growth.<sup>26</sup> According to the Government's forecast in 2000 (World Bank 2000), Vietnam must commit around 12% GDP annually in order to meet the infrastructure needs of the nation. Of this, the state budget and donor community can only finance at most of 5% of GDP, leaving at least 7% GDP for private and foreign investors.

There are some prominent characteristics of investment in infrastructure and public services that make it difficult for attracting private investment:

- high capital cost and long life of operation imply high risks;
- it may generate highly positive externalities to the economy and society, but may generate low internal benefits for investors;
- it may have a wide consumer base, but this does not guarantee a 'willingness to pay'.

Due to these characteristics, traditionally investments in infrastructure and public services are believed to be state responsibilities. However the increasing gap between the need to improve the quality and availability of infrastructure and public services, on the one hand, and the limited public financial resources, on the other hand, requires the involvement of the private sector. The government can stimulate private infrastructure investment, leading to improvements in the quantity and quality of public services, while lowering their cost. For example, increased competition in infrastructure (e.g. electricity), tariff increases toward cost recovery (e.g. water and transport), hard budget constraints on public utilities, and so on, can stimulate private investment and generate large fiscal savings.

Public-private partnerships (PPPs) are defined as privately financed infrastructure projects in which a private firm either: (i) sells its services to the government; or (ii) sells its services to third parties with significant fiscal support in the form of guarantees. PPPs may generate benefits for the economy such as fiscal savings, enlargement of national assets and their externalities, but they entail risks as well.

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<sup>26</sup> A study in China by Fan and Chan-Kang (2004) finds that \$1 spent on increasing the length of high-quality roads would increase GDP by about \$1.50. However, the study indicates that the marginal benefit-cost ratio for low-quality roads is nearly 4 to 1 for urban GDP and more than 5 to 1 for rural GDP.

In Vietnam so far there are two forms of PPP available. In the first, the Government commits itself to purchase the output of the private partner. In practice, many SOEs, especially in construction sector, have contracted with private companies in this form. However due to unclear procedures in bidding for these contracts, this form of cooperation is usually criticized as a mechanism for corrupting managers of SOEs. The publicized corruption case of PMU 18 is evidence for this criticism, when many managers' relatives in this 'corporation' established enterprises for supplying services and input for projects under the management of PMU 18 with favorable prices.

In the second form, final users purchase the services supplied by the private partner (e.g. Build-Own-Operate), but the Government provides financial support in the form of guarantees. However if the project is unprofitable, the Government has to spend large sums for support and this may cause large budget deficits.<sup>27</sup>

In summary, given the sheer volume of investments needed in Vietnam, the Government should be ambitious in seeking private participation in infrastructure. To support this trend, some institutions should be established to support the development of markets for infrastructure services when some form of competition is possible. The aim here is to develop rules for private providers to access to the market, to settle disputes and, occasionally, to set the price of services in a way that would 'mimic' the outcomes of a competitive market, despite all the network effects, social objectives and the like.

### ***Improvement of Competition Law and its enforcement***

Currently, it is too soon to evaluate the effectiveness and efficiency of the Competition Law. However, there are some initial signs that most enterprises and consumers have had no faith in the enforcement effectiveness of the competition legal framework and the competition authorities. The 'collision' in telecommunication interconnection between Military Telecommunication Company (Viettel) and Vietnam's Post and Telecommunication Corporation (VNPT- a state giant) in 2005 is a typical case. To resolve the dispute, both companies *immediately* lodged a complaint with the Prime Minister rather than to the Competition Commission (Vietnam's Competition Administration Department VCAD, a statutory body directly under Ministry of Trade). Additionally, up to now, there have been very few complaints with VCAD about anti-competitive practices, although in reality violations of the Competition Law have been rampant. For example, many enterprises, especially SOEs, have abused their dominant or monopoly position in large regions by compelling farmers to undersell agricultural products to them.

There are several reasons for the lack of faith in the effectiveness of the law enforcement and competence of the VCAD.

First, the competition authorities up till now are weak. The Vietnam Competition Council (VCC), which is in charge of judging disputes, is not yet operational.<sup>28</sup> Meanwhile, the VCAD, depending purely on the state budget, does not have the necessary resources, staff,

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<sup>27</sup> The guarantee on a single road in Korea, running from Seoul to a new airport at Incheon, may cost the government as much as \$1.5 billion annually (about one-quarter of a percent of GDP) (Irwin 2004).

<sup>28</sup> Only on 9 January 2006, the Prime Ministry signed Decree 05/2006/ND-CP on the establishment and functions, duties, powers and organization of the VCC.

and reputation to deal with violation cases. Competition authorities such as VCAD and VCC do not have independent legal status (VCAD is a unit of Ministry of Trade and its head appointed by Minister of Trade; the VCC is also an executive body).<sup>29</sup> Hence enterprises and consumers do not trust the neutrality or objectivity of these agencies in settling their disputes. This has created a practice of seeking recourse to the Primer Minister for help in dispute resolution and has created a ‘bad’ precedence in law enforcement.

Second, protection of consumer interests is rather new in Vietnam’s legal framework, even to consumers. Therefore, with limited knowledge of the law and lack of faith in the courts, Vietnam’s consumers are hesitant to lodge a complaint/appeal. Dispute resolution has largely been conducted via negotiation. For instance, according to Vietnam’s Office of Consumer Protection in Hanoi, in the first half of 2005, it accepted nearly 100 complaints about violations of the lawful interests of consumers, but 70% of the complaints were settled by negotiation.

Third, it seems that the Government has not been strong in enhancing fair competition and fighting against monopoly, especially that of SOEs. The SOEs obtained their dominant market position or monopoly position via state protection, rather than via competition. Though the Competition Law has laid initial legal grounds for combating monopoly, the state administration bodies have not pushed such action in respect of the state-enterprise giants.

Enhancing the effectiveness of law enforcement is of high importance, but this objective is not easily achieved in the short term and even in medium term. This requires enormous efforts and comprehensive measures of the Government.

The international experience, particularly of Thailand, has shown that having a competition law is necessary but not sufficient condition for creating a competitive environment. Thailand promulgated its competition law in 1995, but its effectiveness has been limited. This fact is usually attributed to lack of the necessary resources, political will, and neutrality of the competition authorities. Some researchers (e.g. Brooks 2005)) argue that in order to have a more effective and fairer competition environment, developing countries should simultaneously build effective institutions to protect property rights in general and intellectual property rights in particular, create a credible and neutral/independent legal system and intensify trade and investment liberalization. Singapore till recently had no competition law, but owing to the existence of these ‘supporting’ institutions, it has had a quite healthy competitive environment and high competitiveness in comparison with other nations in the region and in the world.

These experiences imply that in the long term, along with establishing competition-supporting institutions, Vietnam should make greater efforts in implementation of the law, especially in establishing efficient competition authorities with a higher legal and neutrality status (at least in the perception of businesses and consumers). In the short term, it is necessary to increase the creditability and capability of VCAD by making it more neutral

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<sup>29</sup> Ministry of Trade is a line management body of a number of SOEs. Despite almost all of the SOEs having been equitized, it has been common practice that the State has heavily intervened in their business/production activities. Consequently, decisions made by VCDA can be biased.

and more independent in terms of finance. A mechanism for efficient cooperation between VCAD and industry competition-related regulators in settling breaches of the Competition Law is also needed.<sup>30</sup>

It is worth noting that the implementation of Competition Law or competition policy should go closely with the improvement of institutions dealing with market exit. At present, Vietnam's institutions dealing with bankruptcy are extremely ineffective. Since the Bankruptcy Law was promulgated in 1995, there have been only few bankruptcy cases proceeded by formal procedures. According to the Report on Business Environment 2007 by the World Bank and IFC (2006), it takes about 5 years and the cost of 15% of total assets to resolve a bankruptcy case by formal procedures.

#### **V. Key lessons from reform process and microeconomic foundation improvements**

After the reunification in 1975, Vietnam shifted its focus on reconstruction and socio-economic development. The failure of the economic development that closely followed the centrally planned model forced Vietnam to undertake microeconomic reforms in the early 1980s. However, only the *Doi Moi* in 1986 and especially the radical market-oriented reform of 1989 marked a turning point in the history of Vietnam's economic development. Since the 1989 reforms, the face of Vietnam's economy and society has changed significantly. Vietnam has recorded remarkable achievements in terms of GDP growth, macroeconomic stabilization, export expansion, and poverty reduction.

During 20 years of *Doi moi* Vietnam has changed substantially in its way of thought, in the 'rules of games' (formal and informal rules), in the 'playing of games' (mechanisms/sanctions) and in the 'players of the game' (business entities, government agencies, consumers and their behaviors). Major fundamental institutions for a market economy such as prices for goods and services, a legal framework for property and commercial transactions, private ownership, a two-tier banking system, and a tax system, have gradually been established.

There is now consensus that the achievements in Vietnam can be attributed to four key factors: (1) the acknowledgment of the right of private business and establishment of institutions for market transactions; (2) the market-oriented reforms (especially in terms of price liberalization and structural reforms); (3) the opening (mostly in terms of trade and FDI) and integrating of the economy into the regional and world economy; and (4) the keeping of macroeconomic and social stability. *In nature*, the economic reform process is to grant rights and to enlarge opportunities for people in choosing and deciding the directions and forms of their production and business activities. These factors have motivated economic behavior changes and once they are gradually locked-in, it is very difficult, if not impossible, for Vietnam to return to the previous economic management system.

There are several interrelated lessons, which can be withdrawn from Vietnam's experience.<sup>31</sup>

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<sup>30</sup> For instance, a violation of regulations on pricing is stipulated in both Decree 170 and the Competition Law and accordingly, both the Ministry of Finance and VCAD (the Ministry of Trade) are responsible for dealing with cases. VCAD is a direct competition regulator but has a lower legal status than that of MOF and has no legal recourse to require MOF to cooperate with it.

- First, effective reforms require both political will, changes in the way of thought and policy decisions reflecting the dynamics of real life. The microeconomic reforms introduced in the early of 1980s recognized and legalized the people's spontaneous measures to operate outside the plan, so they can be seen as 'bottom up' reforms. The failure of the efforts to stabilize the economy up until 1989 and of the last attempts to control the free market during the period 1985-88 as well as the drying up of aid from the former Soviet Union had created a strongest pressure on reform. The slogans 'let markets be untied' and 'let rescue by yourself' in fact reflected the nature of the relatively radical reform package in 1989.
- Second, since Vietnam has been an agrarian economy in transition, where economic policies and implementation procedures are still a legacy of a centrally planned economy, the approach to and the way of reform implementation are very essential for ensuring success, while keeping social and political stability. The 'bottom up' reforms first launched in rural areas were relatively easy as they satisfied the people's willingness, and the political situation in rural areas was not as complicated as in urban areas. In general, the economic reform in Vietnam has been a process of 'learning by doing' and characterized by *gradualism*. This approach has several advantages since it can avoid the crisis/collapse of the economy, while gradually gaining the confidence in and the support for reform as the people see the successful outcomes of reforms.
- Third, selection of the reform approach is not only driven by the targets the reforms should achieve, but it is also based on the structure of existing institutions. In a broader view, it can be seen that underlying Vietnam's (and China's) reforms is a series of institutional changes in novel forms of transitional institutions. These institutions could work because they achieved two objectives at the same time — they improved economic efficiency on the one hand, and made the reform a win-win game and interest-compatible for those in power on the other hand. These institutional reforms were not created 'solely for increasing the size of the pie, but also reflecting the distributional concerns of how the enlarged pie is divided and the political concerns of how the interest of those in power are served' (Qian 2001).
- Fourth, pursuing an approach of gradualism does not mean that the focus should be first solely on reforms at the microeconomic level. Vietnam's experience in 1980s has shown that the partial reform measures could be good, but not good enough. They should be undertaken within more comprehensive reforms, especially in conjunction with macroeconomic reforms and the opening of the economy. Macroeconomic stability and 'getting the prices right' are as essential as ensuring ownership and creating business opportunities.
- Fifth, one cannot understand the economic reform in Vietnam without examining carefully the 'turning points' associated with significant institutional changes. An important example is the reforms in 1989. Vietnam's radical reform package launched in 1989 was an exception in the context of gradualism, but its outcome was very different in comparison to the experiences of many transitional economies in Eastern

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<sup>31</sup> They are partly taken from Vo Tri Thanh (2005)

Europe, although the liberalization and stabilization measures used were similar to these economies (Riedel and Comer 1997). The gradual approach did not work well in Vietnam until the 1989-reform was launched. It was forced to happen under the pressures of macroeconomic instability, crisis and the 'drying up' of aid from the former Soviet Union. Surprisingly, the 1989-reform outcomes were very impressive, although it was implemented without the technical and financial assistance from international institutions such as IMF or World Bank. The economic reform package in 1989 is considered most successful since the basic conditions were created for the transformation into a market-oriented economy.

- Last but not least, a firm recognition of private ownership and rights of doing business is a very essential condition for business development. But not less important for the sustainable development of an efficient private sector are administrative reforms, a building of a level playing field, which is closely associated with the structural reforms, and the development of factor markets. Otherwise, the private sector cannot develop 'to the top' and play a significant role in infrastructure development and public service provision. The risk of effective PPPs is also higher when government transparency and accountability is not ensured and corruption is rampant.

Putting all aspects together, it can be said that the enlargement of business choices (created by both domestic market reform and integration), macroeconomic stability, institutional incentives (not 'money' incentives), policy credibility, and easier access to the production factors are the keys for a healthy development of private sector.

As in other transition economies, Vietnam's reform process has also been uneven. It was recognized even in 1996 that the reforms were limited and were not keeping pace with economic development. Moreover, the reform process in general slowed down during the period 1996-99, especially after the Asian crisis. The years 2000-05 witnessed new commitments to reform continuation and some progress were made, especially in the development of private sector and trade liberalization and integration. Meanwhile, the reform of state-owned enterprises (SOEs), the banking system, and public administration were slower than expected and this has limited the effectiveness and efficiency of other reforms. Moreover, the policy measures implemented in some cases have been not comprehensive enough and/or not consistent with market-oriented reforms and process of integration, even when Vietnam recognized the serious weaknesses of its economy. A main reason, of course, is rooted in a legacy of a centrally planned economy, which is reflected in the ways of directing and controlling resources, especially capital allocation, and dealing with the SOE sector.

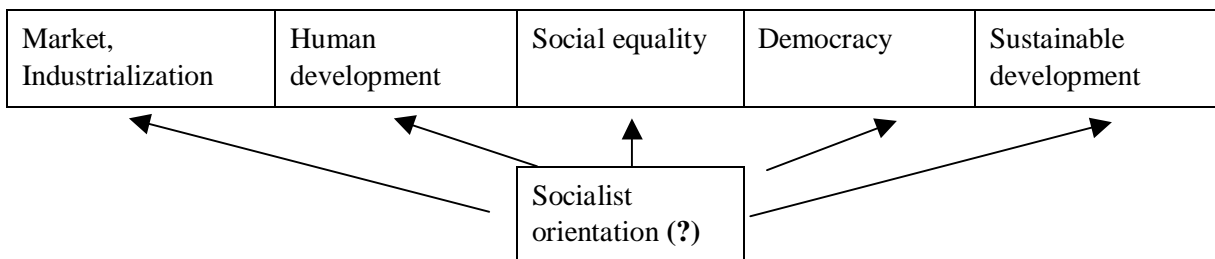
The explanation can be seen also in other ideological, economic and social factors. The Communist Party leadership has been considered a most decisive factor for guiding Doi Moi process and ensuring its success. The Party, on the one hand, has recognized its foundation ideology as being a compass needle for its general guidelines. On other hand, the Party has seen the need to have a new approach to its interpretation and application so that its leadership can effectively adapt to a new environment of a market-oriented and open

economy. For instance, Vietnam has accepted the necessity of a market mechanism, but at the same time it should be ‘under state management’ and /or ‘by socialist orientation’.

This naturally has had a complex impact on the economic reform process. In Vietnam, the concept of ‘socialist orientation’ has three dimensions.

- The first is based on an assessment of the role of the state sector, which is thought to play a leading role in the economy. In fact, the GDP growth has been still heavily dependent on the SOEs’ performance and driven by state investment, and this tendency seems to be continuing in recent years.<sup>32</sup> However, both state investment and the SOE sector have been recognized as inefficient, and moreover, corruption has been widespread in connection with state investment.
- The second is very much associated with the problems of ownership, especially that of factors of production, and income distribution. A concern is that an over-developed private sector would lead to the exploitation of people by people. There is also a concern about the social problems such as the gap between the poor and the rich and social stability in the process of international economic integration and SOE reform. As a result, it is hard to create ‘a level playing field’ in practice for all institutional economic sectors and the reform process has been sometimes characterized by ‘stop-and-go’ policies. When efficiency and economic reforms are emphasized, this is not always easy to reconcile with this concept.
- The third is more or less directly attached to the goals of development, meaning that development is for the people, by the people, and of the people and Vietnam needs to strive for ‘Prosperous people, a forceful country, and an equitable, democratic and civilized society’. This approach, though it sounds beautiful, does not provide much concrete policy guidance.

As a result, there has been some embarrassment in interpreting the concept of ‘socialist orientation’ in connection with the major aspects of development (which are shown in the figure below). An example is the role of the state sector/SOE sector in a market economy or in industrialization. Another is social value in the process of development by socialist orientation.



<sup>32</sup> At present, the SOE sector accounts for about 30% of GDP and the state investment (including state budget investment expenditure, state credit and owned outlays by the SOEs) accounts for more than 50% of total investment.

Moreover, the concept of 'socialist orientation' is sensitive to changes in the region and in the world. For example, the intense arguments for and against globalization could heavily bias approaches to reforms toward the political and social conceptual realities in Vietnam, emphasizing the dangers of global markets. For example, the Asian crisis and the socio-political turbulence in some countries were seen differently in Vietnam.

Finally, there is the problem of asymmetry in incentives for those supporting or opposing reforms, depending on whether they will be winners or losers. For instance, in general, most people will benefit from the reduction of trade barriers, while the inefficient and highly protected enterprises will have difficulties surviving in the new market environment. A complex package of reforms means the involvement of many participants with different motives. Benefits for the many are merely potential gains without certainty and therefore reactions may not be concerted and strong. For those with vested interests, however, the loss of benefits through reduced protection and limited public advantage is real, but they are still in a position to influence the decision. This can be seen in the case of Vietnam, where the administrative way of managing the economy has created close mutually beneficial connections between the line ministries and the SOE sector as a whole and the State General Corporations in particular. The problem of conflict of interests is difficult to attack effectively since vested interest groups can use the same political and social arguments as above to justify the status quo.

All these ideological, economic and social factors have also had significant impacts on the process of policy and decision making and 'rule of law' enforcement in Vietnam. In recent years, both review and consultation involved in the policy development process have been considerably improved.<sup>33</sup> It has taken into account more seriously the consultation with and feedback from all stakeholders, such as various government agencies, the business community, social organizations (including NGOs), and experts or technocrats. But there remain several problems.

- Regulations have in many cases been developed by the public agencies/ministries that are responsible for implementation and enforcement. The role of non-state or non-party organizations has rarely been about developing new ideas and key principles for regulation-making, but limited to comments on the inappropriateness of some articles or the negative impacts of the regulations they can observe. The participation of stakeholders can improve good regulations, but rarely prevents the implementation of bad ones. As a result, the problem of conflict of interests can arise.
- This problem can become more serious due to the complexity of the 'principal-agent' problem in Vietnam. The concern is often about the agents. However, the principal's interests are not always clear cut due to the fact that bureaucrats function in the government hierarchy, but they are often appointed to a post by the Party and also under Party leadership. Together with different interpretations of the concept 'socialist orientation', this limits transparency, accountability, responsibility and thoroughness in regulation and policy implementation. This is also a major cause of weak coordination

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<sup>33</sup> See Dee (2006) for a policy development system working in an ideal fashion.

and information sharing among government agencies. In many cases, the consultations between and feedback from ministries for comments and suggestions have been formalistic. Moreover, this narrows significantly the scope for an independent and effective review and supervision over the policy and regulation implementation.

- Even when the problem is well identified, state intervention is often preferred to the use of other institutions. This is a result of both the legacy of a centrally-planned economy and pressure from vested interest groups. Lack of cost-benefit analysis of alternative measures/instruments also limits the effectiveness and efficiency of the state interventions, when they are necessary.

An attempt to avoid those mentioned problems is to form a so-called Taskforce. A typical example was the Enterprise Law Enforcement Taskforce (Box 4). Note that at the end of 2004, a similar taskforce was suggested for implementation of the Land Law. Regretfully, the suggestion was not undertaken (CIEM and GTZ 2006).

**Box 4: Successes and the lack of sustainability of the Enterprise Law Enforcement Taskforce**

This Taskforce was established in December 1999 when the implementation of the Enterprise Law 1999 was at risk of lagging significantly behind schedule. The Taskforce had played an essential role in enforcing the Enterprise Law and in removing unnecessary business licenses. It has been regarded as a good example in law implementation and highly appreciated by the business community and a number of stakeholders. The operation of the Taskforce, however, was not sustainable.

The success of the Taskforce can be attributed to external and internal factors. The former includes two factors. The first is the strong political commitment of the Party and Government to legal reform and to business environment improvement. In fact, the Taskforce is an advisory body to the Prime Minister and hence, benefited a great deal from the direct support of the Prime Minister. The second is the wide support by many economists, researchers, media and the business community. The latter also includes two factors. First, the Taskforce is a team of members who are market reform minded, fully committed to economic reforms, and professionally independent (though they are still part of the administrative system). Second, it has a reasonable working mode and does not baulk at sensitive issues. The concrete conditions and actual context of all involved stakeholders are always taken into full account in any of its proposals.

The reasons for the lack of sustainability in the operation of the Taskforce are as follows.

- At the beginning it is stated that the Taskforce operation is short-term and ad-hoc in nature.
- As time goes by, the external enabling factors have declined. Many reasonable proposals by the Taskforce were not considered and accepted. Many measures taken were against the Enterprise Law. These factors have dampened and depleted the energy of the Taskforce.
- As most members have to devote only part of their working time to the Taskforce, they tend to spend more and more time on the work at their organization.
- The work 'not included in the Taskforce meeting' was not clarified. There is no mechanism to protect the Taskforce members when they performed the tasks that were not identified or assigned in the Taskforce meetings, despite the fact that such tasks fell into the task list of the Taskforce. This fact gradually decreased the independence of members, particularly of standing members. Since then, the work of the Taskforce has become more 'administrative'.

*Source: CIEM and GTZ (2006).*

## **VI. Concluding remarks**

The dream and expectation of Vietnam to be a civilized society and an industrialized country have always been the focus of her development strategy. In the past, however, Vietnam failed to bring its dream into reality mainly because it pursued a centrally planning system — an institution lacking incentives and efficient resource allocation. With the *Doi Moi* and market-oriented reforms, Vietnam has not only entered a new stage of development, but also had a good opportunity to be successful in industrializing and modernizing its economy.

The development goals of Vietnam over the first two decades of the New Millennium are quite ambitious. They are to sustain high economic growth, to escape the status of a poor country by 2010, and to become ‘a modern-oriented industrialized country’ by 2020.

In order to achieve these development goals, Vietnam has no choice but to continue *Doi Moi* process. The first and foremost factor for overcoming the obstacles on the road to prosperity is to change the still state-led economic institutions into efficiency-enhancing institutions with more people participation and an essential role for the private sector. The reforms should also be consistent with the process of building a market economy and international integration. It is not an exaggeration to say that the reform process in Vietnam has been an international commitment-based reform process. Moreover, the economic, administrative and political reforms need to be implemented in a more synchronous manner.

Overall, institutional reform and human resource development should be priorities. The limitations and constraints in institutions also mean that there is much room for Vietnam to change in order to create an incentive environment for advancing and even leapfrogging the industrialization and modernization of its country. The institutional changes together with skill formation will be a very effective insurance measure. This is because they enlarge both the set of choices by people and their capability to exploit benefits from the newer choices. As a result, people and firms become less vulnerable to the changes in the economy and society.

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