Promoting Business to Business Commercial Contracts in Vietnam

Hanoi, January 2005
Amanda Carlier
Son Thanh Tran

A PSD Policy Note on

Promoting Business to Business Commercial Contracts in Vietnam

Contractual linkages between Vietnam's large and small-scaled firms
Dispute Resolution and Contract Enforcement

Hanoi, January 2005
Abstract. Business-to-business commercial contracts are good for both small and large, private and state owned firms. These commercial contracts provide important market opportunities for small firms and can improve the international competitiveness of larger firms. This Note looks at the current level and nature of commercial contracts (supplier and subcontracting) between firms in Vietnam. It explores how and why these commercial linkages are made, and what are the barriers in the current business environment blocking more extensive level of commercial contracts. Part of the problem, as discussed in this Note, is the lack of an effective mechanism to resolve disputes or enforce contracts amongst firms. In conclusion, a number of actions at the policy, regulatory and institutional level that would help promote increased levels of commercial contracting between firms in Vietnam are suggested.
Acknowledgments

This Policy Note report has been completed thanks to the overall direction of Khalid Mirza, Sector Manager, and Klaus Rohland, Country Director of the World Bank in Vietnam. We are grateful to the following people: Theresa Bradley, Adam Sack and Dalisay Maligalig, who were kind enough to be the peer reviewers; Andrew Stone for his invaluable comments. Special thanks are extended to my colleagues Dung Thi Ngoc Tran and Ha Thanh Hoang for their administrative and publication support.
Executive Summary

Promoting business-to-business commercial contracts would provide renewed impetus to private sector development in Vietnam. The opportunity for small-scaled firms, who usually lack the capacity to export directly, to supply larger firms and the government represents an important market opportunity for these firms. Commercial linkages can also boost state-owned enterprise (SOE) reform and support Vietnam’s global integration.

Even though commercial linkages between firms have existed for several years in Vietnam, the extent of business-to-business contracting is well below its potential. In the current business environment, firms tend to avoid contracting altogether if possible. While, those firms which do contract other firms to supply some of their inputs typically do so because they have no other choice (i.e., lack the capacity to produce all in-house), rather than as a result of a deliberate strategy. And where possible, firms take their business offshore. Many foreign direct investment (FDI) and high-end SOEs/private firms, in particular, bypass domestic suppliers preferring to source from overseas based firms. For example, more than half of the large FDI and SOE firms interviewed as part of the research for this Note considered firms located overseas, rather than domestically based companies, to be their most important group of suppliers.

A combination of factors makes the current business environment in Vietnam unattractive for business-to-business linkages. These factors include the infancy of the domestic "supporting industry" (i.e., limited number and experience of "qualified" suppliers), the lack of an effective business information system to match sellers and buyers, and a dysfunctional legal framework and contract enforcement system. Unlike their international counterparts, most firms in Vietnam with the exception of the FDI firms do not understand the benefits of subcontracting out. Elsewhere it is now standard business practice,
especially for USA or European based multinationals, to shop on the
global market for the most competitive source of inputs. This practice
enables the firm to reduce its cost and free-up in-house capacity to
focus on its core competencies, thereby maximizing its international
competitiveness. As a result of this global trend, firms in diverse
geographical locations have become linked through complex
international supply and product chains.

On the whole, Vietnamese based firms are missing out on the
tremendous opportunities created through business-to-business
linkages. At one end Vietnam's larger firms through maintaining the
"Do-it-yourself" practice rather than contracting out work/inputs are
missing out on the opportunity to increase their competitiveness.
While on the other hand, Vietnam's smaller firms that potentially
could be suppliers or "cogs" in the domestic or even international
supply chains, are missing out on this key market opportunity.

Vietnam's bilateral and multilateral agreements such as US-Vietnam
Bilateral Trade Agreement (USBTA), ASEAN Free Trade Area
(AFTA), and its pending World Trade Organization (WTO) accession
represent a great opportunity, but also a potential threat to Vietnam's
firms. If its firms are to survive and capture the benefits of Vietnam's
global integration, they need to be able to become a link in the regional
and global supply chains or, at minimum, not be replaced in domestic
supply chains by more competitive offshore firms once all the tax and
non-tax protections they are enjoying now ultimately would be lifted.

In order to create a business environment that encourages business-
to-business commercial linkages, policy-makers need to understand
the current contracting and subcontracting practices in Vietnam and
the barriers to an enhanced level of business-to-business linkages.
This knowledge is the first step in adopting a system-wide reform
approach that will enable Vietnam's firms to take advantage of, rather
than be threatened by, its global integration and support private sector
development through business-to-business linkages. It is hoped that
this Policy Note will go some-way towards bridging that information
gap.

Some of the key findings of this research are that:

- because of the weakness in the business environment, firms that
  provide contracts use a number of risk mitigation strategies to
  limit their exposure in case the other firm breaches the contract.
  They take time to get to know and to "test" the potential partner;
they use short-term contracts with the promise of renewal upon successful completion; and some delay payment to ensure future deliveries. This process wastes both sides' time and resources, and can result in missing business opportunities. Whereas suppliers, who are usually smaller firms, have no effective way to protect themselves from contract breach by the other party.

- firms, in general, have no confidence in the ability of Vietnam's legal system to help them resolve a dispute or enforce a contract. Even when a serious contractual dispute arises that could potentially threaten the firms commercial viability, it is very rare for firms to resort to formal procedures such as arbitration or Court. In Hanoi, with a population of more than 10,000 firms, only 70 cases were brought to the Economic Court in 2003, and 20 to the International Arbitration Center under the Vietnam Chamber of Commerce and Industry (VCCI).

- firms tend to regard the option of going to Court as a waste-of-time/money and/or too risky as the outcome is totally unpredictable. Because of the conflicts and overlaps in the three main laws dealing with contracts, and limited capacity of judges (who generally do not have adequate training to handle economic cases), firms cannot even be confident about which law will be applied to their case, or which court it will be heard in. The costs of pursuing formal procedures can be substantial, both in the form of legal and official court costs and unofficial costs, such as "incentive fees" needed to enforce a Decision. A firm that takes his case to Court, also risks damaging his reputation, as this is not regarded as appropriate business practice except in extremely serious cases. All this effort, risk and cost, can be a waste of time as the current laws makes it easy for the other party to block the process. Finally, even if the firm succeeds in getting a Court Decision in their favor they then face the greatest challenge of all - which is to get the Decision enforced.

- a key priority for the Government's action is the revision of the existing body of legal codes pertaining to contracts. The Ordinance of Economic Contract, the Civil Law, and the Trade Law together create a body of law on economic contracts that is, in parts, antiquated, contradictory, overlapping, and leaves many "grey areas". The revision of the Trade Law, scheduled to be discussed by the National Assembly in November 2004, provides a good opportunity to address this legislative tangle, provided
that this review takes into consideration the body of relevant legislation as a whole, rather than just the Trade Law in isolation.

- firms need to have an easy and quick way to identify potential suppliers or contractors. At present, there are large information gaps and no "match-making" mechanism, making it hard work and a largely haphazard and costly process by which contractors and suppliers find each other. In this area, business associations could play an important role in promoting commercial linkages simply by disseminating members product/service information and providing information about contract opportunities.

- Vietnam's firms could make themselves more attractive as potential suppliers by obtaining quality certifications and process/product standards, such as the ISO series. These certifications serve as an independent "quality" stamp and provide confidence to potential contractors.

Fortunately, some of the needed changes are relatively easy to implement. The publication of Court Decisions, for example, can go a long way to build confidence amongst the business community in the legal system and to increase the predictability of the outcome of going to Court. But other actions, such as strengthening the institutional capacity of the Courts and the Enforcement Agency are more complex and will require several years to affect. These legal institutions are critical elements of a market economy based on the rule of law, where the rights of economic parties are effectively protected in legislation and through an independent judicatory. If Vietnam wishes to create a business environment that is conducive to business-to-business linkages and supports its firms' ability to capture the benefits of global integration, the difficult task of strengthening these institutions needs to be started in earnest. The concluding section of this Note suggests a number of actions that are needed and the various parties involved.
Contractual Linkages between Businesses

The opportunity for small-scale firms to supply or sub-contract to large-scale, established firms, either SOEs or foreign invested firms, provides an important impetus for the development of small and medium enterprises (SMEs). Such commercial linkages provide SMEs with significant market opportunities and often facilitate the transfer of technology and management skills to SMEs. On the flipside, the ability of SOE’s to reliably sub-contract to external suppliers for inputs (parts, components, services, etc) supports SOE reform by enabling SOEs to free themselves of non-core activities and focus on their core competencies.

At a broader level if Vietnam wishes to reap the benefits of its efforts to integrate with the global economy, its firms need to be able to effectively become a link in cross-border supply chains. Today most of Vietnam’s firms lack the skill and experience needed to effectively compete with other suppliers in the region and thereby enjoy a larger share of the lucrative major world markets such as Europe and North America.

This study looks at the tangible and intangible costs and benefits of contracting in Vietnam, how these factors affect entrepreneur decisions to produce in-house or to outsource. From the institutional perspective, it looks at the effectiveness of formal institutions dealing with contracts such as laws, court system, enforcement mechanism, as well as informal institutions such as arbitration and intermediaries such as private debt collectors. As a starting point, given that the current extent and the nature of the commercial linkages between small-scale firms and larger firms is largely unknown in Vietnam, in-depth structured interviews were conducted with 42 enterprises. These
enterprises were handpicked on the basis that they were likely to have a reasonable amount of first-hand experience as a supplier, subcontractor or contractor in Vietnam and constituted a cross-section of enterprises according to type, ownership and sub-sector of operation. The 42 Enterprises interviewed included nine large SOEs and 11 foreign-invested enterprises that contracted other firms to provide inputs (i.e., the "contractor") and ten small SOEs and 11 private domestic enterprises that produced inputs under contract for firms (i.e., the "supplier"). The firms interviewed covered a wide spectrum of sub-sectors including electronics, transportation, textile and garment, information technology, construction, manufacturing, legal and consultancy services, marketing/promotion, and agro-processing.

In this Note, the term "supplier" is used in a general sense to refer to a commercial arrangement where one party (firm) enters into a contractual commitment to supply goods (e.g., inputs, spare parts or finished products) and/or services (e.g., IT or accounting support, transport services) to another party on agreed terms and conditions (quantity, quality price and delivery time, etc). The arrangement may be a once-off agreement, but is often a long-term arrangement spanning several years of multiple service/product deliveries. The majority of supplier arrangements reviewed in this research are technically "subcontracting" arrangements, where the product/service is tailor-made to the technical specifications of the buyer; but as this was not always the case we have used the more general term of supplier (instead of subcontractor).


Commercial linkages and supplier/sub-contracting relationships have existed for several years across all categories of enterprises operating in Vietnam-state, foreign and domestically owned, large and small-to-varying degrees. Some large firms are already sourcing a very significant portion of their inputs through these supplier arrangements. As Table 1 illustrates, for 11 of the 19 large contracting firms interviewed inputs sourced through subcontracting/outourcing made-up more than 90 percent of the total inputs. For a third of these contractors the value of the inputs was equivalent to more than half of their total revenue. Typically, these linkages are composed of many sub-contracts with many different parties, rather than just drawn from a small pool of firms. The contractors interviewed in our sample, provided multiple contracts each year (on average 304) ranging from as few as 2 to more than 4500 contracts in the case of one large SOE.
From the perspective of the smaller scaled firms interviewed that are supplying the larger firms, these commercial relationships are even more important. On average these firms generate 65% of their total revenue from these sub-contracts. One third of these small firms are totally dependent on these commercial links: deriving 100% of their revenue from their supply of products and services to large enterprises via sub-contracts.

**Who are the Contractors?** Among the firms interviewed large SOEs were considered to be the most important source of contracts for small suppliers (either private or small scale SOEs). Government agencies were also ranked highly as an important contractor by several firms. In contrast, foreign firms in Vietnam are not yet considered to be an important source of contracting opportunity. This is regrettable from a developmental point of view, as commercial linkages between FDI firms and local firms can be an important conduct for the transfer of technology, modern management techniques and exposure to standard requirements of international markets.

Several large SOE contractors reported that their high reliance on external suppliers was more a result of limited options than preference. They explained that they would prefer to be totally vertically integrated; producing all inputs in-house rather than having to rely on external sources for supplies. The main explanations they gave for this preference was increased profitability and reduced vulnerability. Firms expressed a reluctance to have to rely on other businesses in general and especially in a narrow market where the limited number of suppliers in some sub-sectors means that there are very few alternatives if one supplier fails to perform. This attitude contrasts with the worldwide trend of moving more to sub-contracting as a business strategy to support greater firm specialization and hence competitiveness.

**Who are the suppliers?** Firms located outside Vietnam are considered the most important group of suppliers by Vietnamese firms. More than half of the large FDI and SOE firms interviewed reported that they considered firms located overseas, rather than domestically

---

### Table 1. Percentage of contractors' inputs supplied from subcontracting/outsourcing

<table>
<thead>
<tr>
<th>% Of inputs from subcontracting/outsourcing out of the total output</th>
<th>Number of contractors</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>- 100%</td>
<td>4</td>
<td>21.0</td>
</tr>
<tr>
<td>- 90-99%</td>
<td>7</td>
<td>36.8</td>
</tr>
<tr>
<td>- 50-89%</td>
<td>2</td>
<td>10.5</td>
</tr>
<tr>
<td>- 30-49%</td>
<td>1</td>
<td>5.3</td>
</tr>
<tr>
<td>- Less than 30%</td>
<td>5</td>
<td>26.4</td>
</tr>
<tr>
<td>- 0%</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>19</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: WB/CEM Commercial linkages survey

### Table 2. The most important contractor structure (as viewed by subcontracting enterprises)

<table>
<thead>
<tr>
<th>Contractors</th>
<th>% of responding enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large SOEs</td>
<td>33.33</td>
</tr>
<tr>
<td>Small SOEs</td>
<td>9.52</td>
</tr>
<tr>
<td>Government agencies</td>
<td>19.05</td>
</tr>
<tr>
<td>Foreign companies in Vietnam</td>
<td>1.29</td>
</tr>
<tr>
<td>Overseas-located companies</td>
<td>4.76</td>
</tr>
<tr>
<td>(exporters)</td>
<td></td>
</tr>
<tr>
<td>Private domestic enterprises</td>
<td>1.29</td>
</tr>
<tr>
<td>Individuals</td>
<td>4.76</td>
</tr>
</tbody>
</table>

Source: WB/CEM Commercial linkages survey
Contractors explained that their preference for offshore suppliers reflected the limited availability of good quality locally produced inputs. This may also reflect difficulties of identifying capable suppliers, as it appears easier for firms to identify suitable external suppliers than Vietnam based suppliers. Price also seems to be a factor in firms' decision to use overseas suppliers. Some contractors reported that the local products are more expensive than the imported options.

While commercial linkages cut across all enterprise groups our research suggests that some clear patterns currently exist in Vietnam. Small domestic firms tend to sub-contract or supply to other private domestic firms or low-end SOEs (i.e., low-technology, low-end product quality SOEs), but rarely sub-contract to FDI or high-end SOEs. FDI firms show a strong preference to contract with other foreign firms either with firms based in Vietnam or externally (i.e., through imports) for their inputs. Similarly, imports rather than domestically sourced parts are an important source of inputs for large SOEs.

2. Match-making: How the Commercial Linkages are created.

There is enormous scope to increase the extent of commercial linkages through making it much easier for contracting firms to find potential suppliers and visa-versa. At present it is hard work and a largely haphazard process by which contractors and suppliers find each other. This is an area where there are large information gaps, both for contractors and suppliers. The searching process is typically time-consuming and costly for all firms, especially small firms, with unpredictable outcomes. Most SMEs lack the resources and the know-how to perform effective marketing activities and miss-out on opportunities as a result. Small firms tend to rely on their "direct marketing efforts", which in most cases means the staff/directors personal effort to find partners rather than a structured marketing
approach. Others rely on word-of-mouth to spread their product/service information.

From the demand side, contractors (foreign and domestic alike) report that they find it very difficult to identify qualified suppliers. Contractors complain about the lack of simple items such as product/services and providers catalogues, or other effective channels to help them learn about new suppliers. One FDI firm provided the example of the metal cover for their DVD players which they believed many Vietnamese suppliers are technically capable of producing, however as they were unable to find any information on suppliers, nor had been approached by potential suppliers, they resorted to importing the parts from China. Another FDI firm reported that they employed a dedicated team of searchers whose only job was to cover every corner in Vietnam in search of potential suppliers.

As the following table illustrates, personal contacts and their own firms marketing efforts (such as advertising) are the most important ways for small firms to obtain supply contracts. Larger firms rely heavily on their-own-seeking efforts (i.e., the efforts of their staff to identify suppliers), but also consider the suppliers marketing efforts important (which shows that these are effective). Bidding is seen as a secondary but also useful method to obtain sub-contracts. Notably the commercial linkage between a significant portion of both contracting firms and suppliers is based on "internal/existing linkages". In these cases, the firms concerned are SOE who have either an administrative/ownership or other pre-existing link with the other firm.

Connections made through third parties such as the government or business associations are considered the least important method of establishing commercial linkages. This indicates that Chamber of Commerce and business associations have the opportunity to play a much more active role in promoting commercial linkages between firms. At present, the most relevant publications of associations such as VCCI, are limited to the “yellow-page” type of directory of their members, which provide only very limited information on the company and its products/services. This reflects the current reality that many of Vietnam’s business associations are still weak with limited scope of activities, or focus more on lobbying activities in the interest of some of their large members than general business promotion.

Conversely the finding that government intermediaries or government nominations play a minimal role in establishing commercial linkages
is good news, as the government should not be playing a matchmaking role in a market economy.

### Table 3: Methods Used by Subcontractors to find Contractors and Vice Versa.

<table>
<thead>
<tr>
<th>(A). Methods Used by Small Enterprises to Obtain Subcontracts</th>
<th>Most important</th>
<th>Second most important</th>
<th>Third most important</th>
<th>Forth most important</th>
<th>Least important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Via individual relations</td>
<td>18.18</td>
<td>23.81</td>
<td>20.83</td>
<td>21.43</td>
<td>0.00</td>
</tr>
<tr>
<td>Via enterprises’ marketing efforts</td>
<td>36.36</td>
<td>14.29</td>
<td>16.67</td>
<td>0.00</td>
<td>18.18</td>
</tr>
<tr>
<td>Via governments’ nomination</td>
<td>0.00</td>
<td>4.76</td>
<td>4.17</td>
<td>14.29</td>
<td>27.27</td>
</tr>
<tr>
<td>Via bidding</td>
<td>9.09</td>
<td>19.05</td>
<td>12.50</td>
<td>0.00</td>
<td>9.09</td>
</tr>
<tr>
<td>Via associations, organizations</td>
<td>4.55</td>
<td>9.52</td>
<td>0.00</td>
<td>14.29</td>
<td>9.09</td>
</tr>
<tr>
<td>Via internal or already available linkages</td>
<td>13.64</td>
<td>14.29</td>
<td>12.50</td>
<td>26.57</td>
<td>9.09</td>
</tr>
<tr>
<td>On-their-own seeking</td>
<td>0.00</td>
<td>14.29</td>
<td>25.00</td>
<td>21.43</td>
<td>18.18</td>
</tr>
<tr>
<td>Others</td>
<td>18.18</td>
<td>0.00</td>
<td>8.33</td>
<td>0.00</td>
<td>9.09</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(B). Methods Used by Large Enterprises to Find Subcontractors/Suppliers</th>
<th>Most important</th>
<th>Second most important</th>
<th>Third most important</th>
<th>Forth most important</th>
<th>Least important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual relations</td>
<td>11.76</td>
<td>15.79</td>
<td>18.75</td>
<td>35.71</td>
<td>22.22</td>
</tr>
<tr>
<td>Suppliers’ marketing efforts</td>
<td>23.53</td>
<td>15.79</td>
<td>37.50</td>
<td>14.29</td>
<td>11.11</td>
</tr>
<tr>
<td>Governmental intermediaries</td>
<td>5.88</td>
<td>5.26</td>
<td>6.25</td>
<td>14.29</td>
<td>55.56</td>
</tr>
<tr>
<td>Internal or already available linkages</td>
<td>17.65</td>
<td>31.58</td>
<td>12.50</td>
<td>35.71</td>
<td>0.00</td>
</tr>
<tr>
<td>On-their-own seeking</td>
<td>41.18</td>
<td>31.58</td>
<td>25.00</td>
<td>0.00</td>
<td>11.11</td>
</tr>
</tbody>
</table>

Source: WB/CIEM Commercial linkages survey

### 3. Selection Criteria: What firms look for in each other.

Firms were asked to identify what criteria they considered to be the most important in selecting sub-contractors from the following list: competitive price, payment terms and currency, response time, timeliness, quality, safe delivery, after-sale service, good understanding of suppliers, geographical proximity, nomination by government agencies, trademark/fame, existing relationship, and lack of alternatives. The response from the majority of contractors and sub-contractors alike was that the quality of the product/service was by far the most important criterion used to select a supplier. This is also consistent with the findings that many contractors continue to source offshore to meet their required standard of quality. Several of the subcontractors felt that contractors required suppliers to have Trade-marks, but the responses from the contractors suggest that Trade-marks are just regarded as a symbol of quality, and it was the quality itself (with or without a trade mark) that was important.

Because of the emphasis placed on quality, (i.e., consistent quality, of all the goods/items and in each delivery) Vietnamese firms miss out on considerable domestic market opportunities which would in turn help to develop the private sector. Many large contractors rely on...
foreign suppliers when they need large volume and consistent quality of supply, such as in the case of a milk producer who imports milk powder from Eastern Europe for production, when there is several large milk producing areas in Vietnam. While it is often not cost-effective for individual contracting firms to try and evaluate quality and consistency of potential suppliers in Vietnam, quality standard boards/certification agencies, (and firms undertaking ISO certifications) could play an important role in confirming the quality of domestic producers and thereby increasing their opportunity to penetrate new markets and compete with offshore suppliers.

The competitive price of product/service, while still a criterion for some, was generally much less important than quality, and its importance was rated more-or-less on par with response-time or timeliness as a criteria. Interestingly, suppliers themselves considered price a less important consideration than contractors. Contractors placed much higher importance on safe delivery of the product/service than the sub-contractors did.

While the general response was to rank quality (with/without trademark), competitive price, timeliness and safe delivery in that order, there were some notable exceptions. For one major international trader who establishes almost 100 sub-contracts a year and seeks to create a long-term relationship with its sub-contractors, the attitude of management was the main selection criterion used. This firm believed that if the manager had the “right attitude” they would succeed in developing and maintaining a long-term commercial relationship. The other exception, came from two of the nine large SOEs who reported that they had no choice in their selection of sub-contractor; but were obliged to work with other SOEs that they were “linked to” by ownership and/or administrative arrangements.

4. The Relationship between the Contractor and Sub-Contractor.

4.1 The Contract.

Commercial contracts, either formal or informal, are a fundamental tool to coordinate operations of firms in an economy. Through these business linkages, resources scattered in individual firms are integrated to produce comprehensive products or services with greater accumulated added value. Contracts, however, involve transaction costs to firms, which will significantly influence a firm’s decision to
engage in contracts, or not. Reducing transaction costs involved with contracts is a key role of a country's public institution. An effective legal framework would encourage firms to move from informal commitments to formal and impersonal transactions, a must in a market economy wishing to integrate with the world economy.

All the companies in our sample consistently use some form of written contract to formalize their sub-contracting relationships, albeit with varying degrees of sophistication. Almost ninety percent of the large firms interviewed used written contracts prepared by "experts" (but not necessarily lawyers), reflecting both their greater professional and human resource capabilities compared to the smaller firms. Slightly less than half of the smaller firms used contracts prepared by experts in accordance with the regulations, while eight of the 21 firms used written contracts in a simple format.

Despite the existence of a formal written contract, none of the firms place much faith in the ultimate legal enforcement power of these contacts. Nor do they seriously entertain the possibility of resorting to legal action if the other party violates some of the terms of the contract. Instead, the main purpose of the written contract seems to be to minimize the room for misunderstanding between the parties. And although, very few firms adhere strictly to the terms of these contracts in practice, suppliers generally attempt to fulfill the contract terms. They do so for the sake of building their reputation and goodwill with the contractor, rather than because they are concerned about the possibility of any legal consequences to a breach in the contract.

4.2 The Contractor-Supplier Relationship - Beyond the Written Contract.

Length of the Relationship. A specific contract is only part of a broader relationship between contractors and suppliers. In virtually all cases, contractors and suppliers have known each other for a number of years. Despite the existence of a formal written contract, none of the firms place much faith in the ultimate legal enforcement power of these contacts. Nor do they seriously entertain the possibility of resorting to legal action if the other party violates some of the terms of the contract. Instead, the main purpose of the written contract seems to be to minimize the room for misunderstanding between the parties. And although, very few firms adhere strictly to the terms of these contracts in practice, suppliers generally attempt to fulfill the contract terms. They do so for the sake of building their reputation and goodwill with the contractor, rather than because they are concerned about the possibility of any legal consequences to a breach in the contract.

Transaction cost in business transactions has been extensively studied by the "New Institutional" economists such as Ronald Coase, Oliver Williamson, Benjamin Klein. For more literature reference see Appendix A.
of years, usually several times longer than the specific term the contract. In our firm sample, 98 percent of the contracts were made with suppliers that the contracting firm had known for three or more years, compared to the longest contractual term of 12 months, and the medium only 8.6 months. Keeping the term of the contract relatively short is one of the methods used by contractors to mitigate their risk, as discussed later.

In our sample, only two percent of the contracts were with relatively unknown/"untested" suppliers, suggesting that contractors do not change suppliers easily. A combination of factors, including uncertainty and difficulties to find alternative suppliers, and high up-front costs in establishing a relationship with a new supplier, seem to be the main reasons that contractors "stick" with known suppliers, even when they are only marginally satisfied with the supplier.

Compared to the contractors, the suppliers we interviewed had known their commercial partner for a shorter period, which is unsurprising given the young age of most of Vietnam's small firms. But even among these cases, one third of the suppliers had known the contracting firm for more than three years, and half for between 1-3 years. This compares with an average contract term of 9.3 months and the longest term of 18 months. Thus, for both contractors and suppliers, the term of any specific contract is equivalent to only a small portion of the total time that they have maintained a commercial linkage with the other party.

Other forms of support: In many market economies, contractors provide various forms of assistance to suppliers in an effort to strengthen their long-term capacities, for the mutual benefit of both parties. The types of support provided include:

- Management training and labor training
- Machinery and equipment rent/lease
- Technology transfer or/activities to support product quality improvement
• Working capital / financial support or the provision of materials/fuel etc

But in Vietnam, contractors are not yet thinking in terms of the mutual benefits of helping to build the subcontractors capacities. In our survey, apart from a limited amount of working capital on a few occasions (in the form of a pre-payment or materials), the subcontractors interviewed did not receive any type of support.

5. Risk Mitigation Strategies: How Firms Protect Themselves From The Risk of Default by the Other Party

No firm seems to seriously believe in the enforceability of the legal contract. Therefore the "threat" of legal consequences for contract violation has little value. Given that there are effectively no legal remedies that can ensure, with reasonable probability, that a firm will be compensated for losses that would result from breach of a contract, firms (especially contractors) take a number of measures to minimize the possibility of serious breaches of contract occurring in the first place. The degree to which the contractor uses these strategies to protect himself or herself against non-performance/substandard performance by the sub-contractor depends on how serious or costly the ramifications of the product failure/delay would be to their business. When the ramifications are very significant (e.g. faulty service could lead to a airplane crash) contractors tend to be extremely risk adverse. All the contractors in our sample used the following risk mitigation strategies to some extent to protect themselves.

• Very careful/restrictive selection of suppliers and a long "dating" period (building trust over a long period): Firms select their commercial partners carefully, taking time to learn as much as they can about the other firm before committing to long-term sub-contracting arrangements (most of the firms in our sample have known their partner for at least three years). If not, firms limit themselves to a simple sales/purchase transaction. In one case when quality was critical the contractor chose only sub-contractors with trademarks and even then put them on a pilot arrangement for 3 years, before "accrediting" them as a sub-contractor. Trial/small sub-contracts are a variation on this strategy used by contractors to minimize their exposure to an unproven supplier. One of the contractors interviewed explained that they provide new suppliers with gradually increasing orders, starting at around USD10-30,000 compared to its regular orders of several hundred
thousands of dollars each, which helped suppliers build capacity and learn as they grow. This contractor noted that it took 2-3 years on average in the "building process' before they can officially count on a firm as a supplier for regular orders.

- **Keeping the individual contracts relatively short term, with the option to renew helps contractors to limit their exposure and provides an incentive for the supplier to perform well in order to get another contract.** Contractors prefer to stick with known/tested suppliers as part of long-term relationship.

- **Limiting the size of the individual contract and diversifying the suppliers, where possible.** Where there are multiple qualified suppliers, contractors minimize their dependence on any single supplier and therefore the severity of the consequences in the case of contractual breach by one supplier, by splitting up the contract. On the flipside, this strategy involves higher transaction costs from dealing with more than one supplier.

- **Transferring the financial risk to suppliers is a key risk mitigation strategy used by contractors.** In many developed market economies the contracting firm provides the supplier with an advance/deposit/materials, which they can use as working capital to prepare the order (e.g., the provision of materials is very common in the garment business). However, only about one third of the Vietnamese suppliers interviewed for this Note, reported having ever received some credit or material support from contractors. More typically, contractors withheld the payment until the full delivery of the good/service. In some cases, contractors even withheld the payment of a previous delivery until the next delivery, as a way of guaranteeing quality and delivery! Among the firms we interviewed one large SOE-contractor reported that holding payment until they had received the next delivery was their standard practice. Similarly, a bamboo-product supplier reported that several of the contracting firms he dealt with held payment until a later and separate delivery. This practice while limiting the contractor's exposure, places tremendous financial burden on the suppliers to find the working capital for the production/service delivery period. In Vietnam, because of the significant difficulties firms face in securing commercial working capital , the only option for many firms is to rely on internal resources, which at minimum represents a significant opportunity cost for firms. Frequently, the lack of access to working capital
precludes firms from being able to accept a supply-contract altogether, or is the reason for their poor/late performance. Ironically, in an environment such as Vietnam where it is very difficult for suppliers to secure working capital from banks, providing the supplier with some advance/working capital may increase the likelihood of satisfactory performance. But again in an environment where no one has the confidence to enforce a legal agreement this approach is considered risky.

At present, suppliers have very few ways to protect themselves against default by the contracting firm. With the exception of "getting-to-know" the partner, and trial contracts which can work both for contractors and suppliers, the risk mitigation strategies discussed above are used primarily by contractors. Suppliers hold the view that at present Vietnam is very much a "buyers" market, and feel that if they want the work they can't be too selective and demanding. While many suppliers have late payment penalty clauses in their written contracts, none of the suppliers we met with had ever invoked these clauses for fear of upsetting the contractors, and jeopardizing their access to future subcontracts.

Financial institutions such as banks have not yet played a significant role in reducing risks relating to contract payment in Vietnam, but there are some exceptions. Guaranteed accounts (effectively frozen deposit accounts) are used to ensure that parties abide by their commitments (e.g., bid security of bidders on a tendered contract). On occasion, contractors will set-up a Guarantee account where the funds will be frozen until the sub-contractor fulfills the agreed conditions, after-which the Bank will release the funds as payment to the sub-contractor. More typically, however, it is the contractor who requires the sub-contractor to deposit funds as guarantee that they will complete the job.

6. The Contracting-Sub-Contracting Experience: Successful or Not?

In general, the suppliers we interviewed are either indifferent or satisfied about their experience with the contracting firms they dealt with. As illustrated in Figure 3, the main exception to this general finding was the dissatisfaction felt by some private firms in respect to their supply contracts with SOEs. This finding is not surprising given the frequent occurrence of delayed payments when the SOE is the contractor. Interestingly, none of the SOEs that sub-contracted or
supplied other firms report any dissatisfaction with their experience with contractors. This may be because SOEs are less concerned about suffering from the consequences of default, as they enjoy protection from government. For example, as SOEs in Vietnam still enjoy preferential treatment and government support they do not need to worry particularly about the cash-flow implications of delayed payments, which can jeopardize the commercial viability of private firms.

Another reason that SOEs are more satisfied than other types of subcontractors could be that they have lower expectations in the first place (especially compared to FDI firms) and because some SOE subcontractors may receive better treatment from their contracting "masters", who are frequently other SOEs to which they have administrative links.

On the flipside, contractors in general reported lower levels of satisfaction in dealings with suppliers, especially when the supplier was an SOE. As reflected in Figure 4, in each category of contracting firms (whether they be large SOE themselves, joint venture companies or FDI firms) report some level of dissatisfaction with the performance of SOE suppliers. It is unclear whether SOE suppliers poorer performance in these few cases, results from a lack of profit incentive to perform well, or interference in its operations that frustrates its ability to meet its contractual commitments.
7. When things go wrong: Dispute Resolution and Contract Enforcement.

Of all costs relating to a contract, contract enforcement cost is certainly the key element. Reducing the costs relating to contract enforcement would therefore be the best way to promote better business linkages.

Contract violations in Vietnam are not uncommon, especially in respect to product/service quality, delivery time and price. Some observers claim that that even when enterprises are quite capable of handling contracts as required, problems such as delayed payment and untimely delivery have become habits, even deliberate behaviors of both parties, and is often regarded as the norm, provided that it does not lead to serious consequences.

From the contractors' perspective the most typical case is when suppliers provide low-quality goods. When this happens, contractors usually request suppliers to replace the goods. None of the firms interviewed reported imposing financial penalties for such a breach. Violation of delivery schedule is also reported to be a common occurrence, but in this case the response of contractors varies. Most contractors simply issued a notice to the suppliers, but some contractors regarded this violation as serious enough to cancel/avoid any future agreements with that supplier. From the perspective of the supplier, the most common complaint about the contractual agreement being violated relates to delayed payments, especially by SOEs. (FDI firms have the reputation for paying on time). Although, most contracts allow for a late-payment penalty, suppliers explained that they never try to apply this provision for fear of upsetting the contractor and jeopardizing subsequent contracts.

In the small proportion of cases where the violation is serious (estimated at 5 percent), most cases just linger indefinitely while two parties try to find some compromise. Sometimes, when contractors and suppliers are unable to resolve the dispute between them, they may attempt to use out-of-court and informal measures to settle the dispute. One informal tactic used is to get a third party, such as the economic police or tax authority to "threaten" the other party. In a typical scenario the authority would call in the (violating) firm and tell them if they do not honor the contract with the other party, they will start scrutinizing the firm's operations and/or accounting books, which for most firms is sufficient incentive to quickly try and find a way to settle the dispute. Another "informal" method that is used is to
threaten to involve the media and to broadcast the behavior of the violating company in newspapers.

But even in serious cases, it is very rare for either party to resort to formal procedures such as arbitration or court. This is reflected in the extremely low caseload handled by economic courts and arbitration centers. For example, in Hanoi with over 10,000 firms, there were only 70 cases brought to economic court and 20 brought to the Arbitration Center in 2003.

Figure 5. Contract Dispute Settlement Diagram (NB. most disputes never go further than the first step)
Based on the firms' interviews, there are several reasons why firms avoid/refuse to take legal action:

- **Reputation / Image damage.** It is not considered appropriate [standard] business practice in Vietnam to take another firm to court. There seems to be a general view that it is inappropriate to resort to the Court except in the most extreme cases. The perception is that this action will result in "great damage and severely affect the enterprise status and viability in the market place". Therefore such action is only warranted for major violations. Hence, a firm that has incurred commercial damages as a result of non-performance by the other contracting party, risks to also suffer "reputational" damage if they pursue the case! The concept that the "punishment/consequences" will fit the violation", as is standard in most market economies, does not seem to apply in Vietnam. Some observers argue that this reluctance is more a matter of culture, claiming that pursuing formal proceedings is not the Asian way-of-doing-business. It is doubtful however, that firms would avoid using formal proceedings just for cultural reasons, if these procedures offered a quick and cost-effective option to resolve disputes.

- **The outcome of going to courts is totally unpredictable.** Enterprises cannot even be confident about which law will be applied to their case, due to the tangled legislative framework and the weakness of the courts. As entrepreneurs cannot be confident with any degree of probability about the result of bringing their case to court, there is little incentive to pursue legal action especially as they know that the cost and risks of doing so can be very high. This contrasts with the experience in many economies where, although firms can never be completely confident of the outcome especially in complex or unusual cases, they can usually be very confident about which law will apply. In other countries, through studying precedence (previous courts decisions) which are publicly available, firms can also get a good sense of how courts have decided in similar cases. Thus firms can make a reasonable prediction about the likelihood of a court deciding in their favor, and hence whether it is worthwhile for them to take the case to the courts. In Vietnam, the situation is very different, as illustrated by the following example of one local lawyer: A person has a contract with a construction firm to build his house. After a month the house collapses. The person sues the firm. In court the judge may use one of the three laws: the Civil Law (because the
case can be defined as a civil relationship), the Ordinance of Contract (because there's a contract involved), or the Trade Law (because the case involves a commercial entity). Judgment can be different in each option. There is also uncertainty over which court will deal with the case. There have been many extensive debates over whether a dispute should be heard in the economic court or the civil court (which reportedly is more a issue of "passing-the-buck" that "grabbing territory").

- **Costs.** Costs include the official costs for the court and enforcement agency, the fees for the lawyers and the "unofficial" fees to lobby for a favorable decision and to provide an "incentive" for the enforcement agency to enforce the decision (corruption). The court fees are stipulated in Decree 70/CP (12 June 1997) and depend on the disputed amount involved. If the disputed amount is over 1 billion VDN the court cost is 21 million VND and 0.1% for all amounts above 1 billion. The structure and amount of fees charged by lawyers tends to depend on whether the firm is a domestic or FDI firm. The fee for an international law firm is based on an hourly rate ($100-150/hour), with an average case costing USD3-5000. Vietnamese legal firms are typically paid through success fees, ranging from 1-10% of the settlement. This means that there is considerable financial risk for local lawyers to go to court (i.e., they have to incur expenses without any certainty of being paid as so many factors are beyond their control). Local legal firms are thus often reluctant to advise their client to take a case to court. Nor is there any provision, the current Vietnamese system to require the "losing" party to pay for the legal fees of the "winning" party, or the court costs. The plaintiff has to cover these court costs whether they win or lose. In addition, firms can expect to have considerable costs in terms of management time and expenses if they decide to pursue legal action.

- **Waste of time: the structure of the law makes it easy for the other party to frustrate/block the process.** For example, the other party (defendant) is required to be present in court for a decision to be reached, but there are no punitive sanctions if the "other" party fails to turn up in court. Thus simply by refusing to appear in court, the defending party can often render the legal proceedings futile.

- **Corruption.** While it is impossible to confirm or quantify, there is at least a perception that judicial corruption in Vietnam can
unfairly influence a Court Decision. Corruption is also believed to be an important factor in the enforcement of Decisions.

- **Difficulties getting Decisions Enforced.** If a firm successfully secures a court decision in its favor, they then face the greatest challenge of all, which is to get the decision enforced. Enforcement is the responsibility of an agency under the Ministry of Justice and thus has no connection with the court system. The Enforcement agency currently has a huge backload of cases and is reported to prioritize their cases based on the extent that the involved parties "lobby" them (i.e., provide unofficial payments). Some local legal firms claim that these "unofficial fees" can cost up to 50% of the 'settlement' amount. The catch here is that both the winning and losing party will provide incentives to the enforcement agency for exactly the opposite purpose, and therefore firms cannot be certain of a successful outcome even when it received the court decision in its favor.

The reasons above largely explain why firms in Vietnam are reluctant to take contract disputes to the formal procedures. But if Vietnam wishes to move towards a market economy based on the rule of law, where the rights of economic parties are effectively protected in legislation and through an independent judicatory, each of the issues outlined above must be addressed. This is a particularly challenging agenda as it involves the establishment and/or strengthening of institutions, which in developed market economies evolved over hundreds of years. It also requires a significant change of popular mind-set, something that is much harder to affect than modernizing the legislative framework. Most of these issues are not unique to the area of contract enforcement, but relate more generally to the rule of law underpinnings for an effective market economy.

The WBG Report of Doing Business in 2005, [http://rru.worldbank.org/doingbusiness](http://rru.worldbank.org/doingbusiness) found that by regional standards contract enforcement was particularly complex and time-consuming in Vietnam (see Table 4). The Doing Business study takes a standard type of contract as an example, and looks at the steps and time involved to enforce this contract in 145 economies. With 404 days required to enforce such a contract, Vietnam was ranked 96th out of 145 countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of procedures</th>
<th>Time (days)</th>
<th>Cost (% of debt)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vietnam</td>
<td>37</td>
<td>404</td>
<td>30.1</td>
</tr>
<tr>
<td>China</td>
<td>25</td>
<td>241</td>
<td>25.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>26</td>
<td>390</td>
<td>13.4</td>
</tr>
<tr>
<td>Philippines</td>
<td>25</td>
<td>380</td>
<td>50.7</td>
</tr>
<tr>
<td>Cambodia</td>
<td>31</td>
<td>401</td>
<td>121.3</td>
</tr>
<tr>
<td>Singapore</td>
<td>23</td>
<td>69</td>
<td>9.0</td>
</tr>
</tbody>
</table>

*Source: Doing Business 2005 Database - The World Bank Group*
8. Contract Law: A Legislative Tangle

In order to foster commercial linkages and more broadly to cement the legal underpinnings of Vietnam's transition to a market economy, a key priority for Government action is the revision of the existing package of legal codes pertaining to contracts. This is a legal area that is particularly muddled. As discussed in the Box below, the three most relevant laws are the Trade Law, the Civil Law and the Ordinance on Economic Contracts. When viewed together these laws, in parts, are inconsistent, overlapping and leave many "grey areas". As a result there is uncertainty as to which Law will be applied in any specific case. An example of the inconsistencies relates to the time limit allowed for the submission of a petition. The Ordinance on Economic

---

**Box 2. Legislation Relating to Contract Enforcement and Dispute Resolution in Vietnam.**

There are three major legal codes dealing with contracts, drafted by various ministries at different times. These codes are contradictory, overlapping and leave many "grey areas", and thus create significant uncertainty as to which Law will be applied in a specific case. The most relevant legal codes are:

Ordinance on Economic Contracts (passed September 1989) This Ordinance applies to all kinds of for-profit commercial contracts. The definition of "commercial contracts" here is very vague and certainly cannot clearly distinguish itself from the part of the Civil Law dealing with contracts. This Ordinance was designed in the 1980's, in the very early days on Vietnam journey to a market economy, and is generally regarded as obsolete by the legal community. This Ordinance is primarily oriented to standardize contracts SOEs that make with each other's and other entities, and is very inflexible in defining what must be included in the contents of a contract. It has specific requirements for payment terms and form, dispute settlement (stipulated the Arbitration center must be selected), contract completion procedure, and even the level of fine in case of contract-breaching (between 2-12% the violated value). In sum, this Ordinance attempts to put all kinds of commercial contract into one simple form, which no longer reflects the reality of modern business and the diverse range and types of contracts that have evolved to cater for increasingly complex commercial relationships (such as franchising contract, technology-transfer contract, and the consulting contract). In practice whilst contracts of this traditional form can be still found on occasion amongst SOEs, they are no longer used nor considered suitable by other types of firms, especially FDI firms.

Trade Law (passed May 1997, implemented since 1998). This law covers "merchants" operating in Vietnam. Merchants are defined as individuals, family business, cooperatives and legal entities performing commercial (trading) activities on a regular basis. Commercial activities are defined as one of the 14 activities involving with trading of goods, franchising/representing of other commercial entities, and trade promotion. The law covers both for-profit and not-for-profit activities. The assessment of this law from the legal community is that it is poorly crafted, despite being relatively recent. Lawyers complain for example, that many commercial activities cannot be placed in any of the 14 categories. An amendment of this law is currently being drafted and will be presented to the National Assembly for comments in November 2004.

Civil Law (passed Oct 1995, implemented since 1996). This law applies to all civil relationships, which as a result of being relatively loosely defined means that the civil law covers a surprisingly large area, including contracts, property/copyrights, and rights on land. Unlike other laws written at the same time, the Civil Law focuses more on principles and less on implementation details. The legal community generally regard this Law positively, and consider it a much more sensible law than the Trade Law. Accordingly, lawyers frequently try to present the commercial cases they are representing as a civil relationship so that it will be covered by the Civil Law rather than the Trade Law. The Civil Law has a substantial part dealing with contracts. In addition to the common articles on contracts (26 Articles), it has sections dealing with some specific kinds of contract, including: assets selling contract (which clearly overlapping with the Ordinance of contract); property selling contract (including principles on real estate auction); assets exchange contract; asset leasing contract; house renting contract; service contract; transportation contract; processing contract (i.e., subcontracting contract); insurance contract; authorizing contract; and settlement of damages in contract-breaching cases. In brief, a good lawyer can map any kind of commercial contract into one of types of contracts covered in this law to try and ensure that the dispute is dealt with under the provisions of the Civil Law rather than the Trade Law.
Contracts stipulates a six-month "procedural prescription" but the Trade Law allows petitions to be submitted within two years of the complaint (although it provides no explanation of when a complaint is legal considered to have occurred).

Many of the provisions in these laws are outdated, with a degree of rigidity that is not longer suitable for modern commercial practices. For example, the Ordinance on Economic Contracts stipulates that contracting firms should sign a "contract completion notice" once the final delivery is made. However, as this requirement makes no sense in the context of some modern contractual arrangements such as principle contracts. Most firms do not have a contract completion notice, which causes major complications if a dispute is taken to court.

An amendment of the Trade Law is currently being drafted and will be presented to the National Assembly for comments in November this year. It is hoped that the proposed amendment will be considered in the broader context of other existing legislation dealing with contract enforcement and dispute resolution, as this will be key to addressing the inconsistencies and overlaps and making this revised legislation effective.


9.1 WHY. When firms are familiar with operating in a given business environment in which they have found "ways" to get things done, and when they do not have the experience of other business environments to compare, entrepreneurs and officials alike do not necessarily see the value and the need to change the system. Some would argue that this is the case in respect to the contracting, dispute resolution and contract enforcement system in Vietnam. But a more objective evaluation suggests that the current system, which lacks a cost effective means to resolve disputes and enforce contracts, is costing Vietnam's firms dearly, and in doing so undermining the countries growth potential. This argument is supported by a wealth of academic literature on why contract enforcement is important. It is important because modern market-based economy relies on impersonal transactions, allowing the selection of suppliers/products based primarily on price and quality. It is important because in the absence of a secure transaction environment, firms rely less on market transactions and more on hierarchy, internalizing functions that would otherwise be efficiently
contracted for. It is important because a weak contracting environment may not allow the development of complex, long-term transactions.

The current system is costing Vietnam firms in the form of lost business. We have seen that many firms based in Vietnam look offshore for reliable suppliers to avoid the hassles of finding and contracting to domestic firms with "unproven" ability to perform on a contract where there is no cost-effective recourse if they don't perform. And if firms based in Vietnam - who are already familiar with the business environment and language - are looking elsewhere for suppliers, it is fair to assume that overseas firms are even more reluctant to do business/form commercial linkages with Vietnamese firms, in an environment where protection of their contractual rights can not be assured.

Beyond the opportunity cost of missed business, there are tangible costs to the firms currently forming commercial linkages in Vietnam. These costs include the commercial costs and reputation damage to firms when the other party they are contracting with fails to meet the agreed terms. The costs may be (i) because of the need to temporarily stop a production line, while awaiting spare parts or due to the failure of a sub-standard part/machine; or (ii) from additional financial costs as more working capital is needed to bridge a longer time period than planned; or (iii) in the form of management and staff time in scouting around for reliable suppliers, "testing them out over time" and then following up on contract performance; or (iv) from the "facilitation fees" played to other parties to help enforce a contract. Small-scale businesses tend to be particularly vulnerable in such a business environment as they usually lack the resources, especially the finance, needed to carry them through such commercial shocks (such as protracted no-payment for a contract).

Vietnam needs to build its institutional capacity to efficiently resolve disputes and enforce contracts in order to:

• **Protect property and contractual rights of all parties involved.** Legal institutions that can effectively protect property rights constitute the fundamental underpinnings of a market economy based on the rule of law. Where these institutions are absent, the level of investment will be sub-optimal and the effectiveness of legislation compromised.
• **Support the development of small and medium scaled enterprises and the development of supporting industries.** The growth of Vietnam’s fledgling private sector depends greatly on the growth in access to market opportunities/demand. Commercial linkages, especially subcontracting to larger firms represents a critical market for these small businesses, few of who could compete directly on the international market. But as most of these firms are young and untested, the larger firms shy away. If it was easier for the larger firms to identify potential suppliers in the first place, and if they could be confident, in the worst case of contract default that they would be appropriately compensated, then the large firms could be more forthcoming about providing contracts to Vietnamese SMEs. Similarly, a supportive parts industry can only develop in Vietnam if there is strong commercial demand for the products, which in turn will only happen when Vietnamese larger firms have the confidence to source some of their inputs and parts externally rather than producing them in-house, and from Vietnamese suppliers rather than overseas sources.

• **Strengthen the competitiveness of Vietnam's firms, including its large SOEs with aspirations of becoming international conglomerates.** In today’s global business environment, the international conglomerates rely extensively on outsourcing and sub-contracting in order to reduce costs and maintain a competitive edge needed for a global presence. These firms shop the global market to find the most competitive source for each part, and limit in-house production (i.e., the inputs the firm manufactures itself) and service provision areas to core-competencies, where the firms have a clear competitive edge (probably technology based). Many large Chinese corporations that are emerging as a competitive force in the international arena are also adopting this approach of greater specialization and increased outsourcing/sub-contracting, such as the largest machine tool manufacturer in the northeast that has graduated from a traditional SOE producing A-Z in machine tools, to now focusing on a few key products where it is internationally competitive and using subcontracting to increase its flexibility and specialization. Large Vietnamese firms, most of which are SOEs, have yet to make this transition, but the ability to reliably subcontract out and thereby free themselves to focus on their core competencies will be important to increasing their competitiveness and more generally the success of Vietnam’s SOE reform program.
Building effective dispute resolution and contract enforcement mechanisms require a system-wide approach, involving several actors, because just "fixing" the legislation, for example, without strengthening the courts capacity to make decisions and the enforcement of decisions, will do nothing to improve the impact on the ground. And an effective dispute resolution and contract enforcement system in turn, is just one piece - albeit an important piece - of developing a business environment that encourages and helps forge commercial contracts between businesses. There is no quick fix or single stroke action that will provide the solution. While the private sector has a key role to play in reducing the risks and costs relating to contracts and encouraging contractual linkages among firms, the Government must take the lead in this effort. Only the Government can undertake the systematic enhancement of the information, enabling and contractual enforcement systems, that is required. Some of the suggested actions and the players involved are outlined in Table 5 below.

Table 5: Key Players and Proposed Actions for Effective Dispute Resolution and Contract Enforcement

<table>
<thead>
<tr>
<th>Who</th>
<th>Suggested action</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Government - as a legislator</strong></td>
<td>Detangle the legislative framework. Review the package of legislation and sub-laws (decrees etc.) pertaining to commercial contracts to remove inconsistencies/confusion and antiquated clauses that are no longer appropriate for modern business. The current revision of the Trade Law provides a good opportunity to take a holistic approach. Make recourse to the Economic Courts an effective option for firms. Actions here could include: revise inappropriate/outdated articles in the litigation law that discourage firms going to court; enforce penalties if defendants fail to appear in court; and, enable the winning party to claim reimbursement for litigation fees from the losing party.</td>
</tr>
<tr>
<td><strong>Courts as a decision-maker</strong></td>
<td>Capacity building: Provide specific training/certification program for judges of Economic Court. Procedural streamlining: Simplify filing procedures and shorten the pre-proceeding time. Consider options for simplified quick mechanism to deal with small claim cases, such as a system of &quot;small claims court&quot; (as found in many countries), specifically designed for the resolution of minor economic disputes.</td>
</tr>
<tr>
<td><strong>Government - as a enforcer</strong></td>
<td>In this both a complex area and one where there is substantial opportunity for improvement. Recommended to start with an expert diagnostic review of the current operations of the enforcement agency as a basis to develop a tailor-made institutional strengthening program (possibly donor supported) which would bring about, inter alia, the following results: (i) limit the time a case needs to be enforced (ii) minimize the situations where the enforcement agency can delay the implementation of the court's judgment (iii) hold the enforcement agency responsible for cases not implemented.</td>
</tr>
</tbody>
</table>
| **Government - as a monitor** | • Establish a record system to monitor the enforcement of Economic Court decisions;  
  • Open (economic) court and enforcement files to public access to create a transparent environment where the public (legal professionals, media) can monitor Court decisions. |
<p>| <strong>Government - as a contractor</strong> | Setup an effective mechanism for small private enterprises to participate in purchasing/supply contracts with the Government (central and provincial levels). Where possible, break the contracts down into smaller orders, and provide reasonable payment terms with some upfront payment to facilitate the participation of smaller firms. Make bidding sessions public and publish tender opportunities and results to help ensure transparency and fairness. Establish procurement procedures that reward (SME) suppliers who have performed satisfactorily with bigger contracts, and punish suppliers who do not perform by reducing or even banning them from participating in future contracts, regardless of their ownership and size. Follow good business practices, the Government and SOEs as a contractor should adhere to agreed terms and conditions, such as paying the supplier in the agreed timeframe. If it is unlikely that this will be feasible, then these terms and conditions should not be agreed to in the first place. |</p>
<table>
<thead>
<tr>
<th><strong>Who</strong></th>
<th><strong>Suggested action</strong></th>
</tr>
</thead>
</table>
| **Legal Profession** | Build capacity. Through law schools and legal professional associations improve skills of legal professional in:  
- Contract negotiation and writing, and knowledge of contracts originating from overseas;  
- Specialization in economic cases, and ability to advise clients on the most effective way to solve a commercial dispute. |
| **Business Associations / Chamber of Commerce etc.** |  
- Provide informative product/service catalogues on supplier products etc.;  
- Support members efforts to obtain standards/ certifications;  
- Build awareness among members of the importance of fulfilling contractual terms;  
- Provide legal education and updates to members;  
- Assist members in crafting economic contracts and advise on dispute settlement options;  
- Revamp old-style business associations (BA). Many BA continue to be dominated by, and work mostly in the interest of large members and/or were established for political reasons. Such BA need to be rebuilt to work as an independent associations on a self-sustainable basis, through the provision of value-added services to all members; such as (i) timely market information, (ii) organizing promotional activities, (iii) technical assistance in deal-making and settling contract disputes. |
| **Firms** | Build a culture of honoring contracts as a way of building market credits, especially if they want to expand to international markets. Be more cautious in writing or signing contracts. Ideally, firms should have professional legal advise (i.e., capable law firms) when entering into complicated contractual relationship or contracts with sophisticated partners (i.e., with FDI or firms overseas). Firms should also familiarize themselves with, and be able to use, detailed contracts such as contracts with technical specifications annex, rather than traditional contracts that tend to cover general terms and leave several details open and thus bearing the high risk of dispute during implementation |
| **Donors** |  
- Support institutional strengthening in the Courts system and enforcement agency;  
- Offer technical support for the revision of legal documents relating to contract enforcement and dispute resolution;  
- In their institutional building programs to support business associations, support the activities outlined above. |
| **Media** | Watchdog function on Court decisions, enforcement of decisions and building awareness on good business practices. |

Fortunately some of these initiatives are relatively easy to implement and could go a long-way towards creating a business environment that supports business-to-business commercial linkages. For example, easier access to more comprehensive product and service information of Vietnam’s firms would greatly assist contractors identify potential suppliers. Increasing the awareness and helping firms gain recognized quality certifications and process/product standards, such as the ISO series, which serve as an independent "quality" stamp, makes such firms more attractive commercial partners to potential contractors. Revising the legislation framework is a critical step in developing a coherent and useful body of contract law. And the publication of Court decisions can go a long way to build confidence amongst the business community in the legal systems and increase predictability. Other actions, such as strengthening the institutional capacity of the Courts and Enforcement Agency are more complex and will require several years to affect. If Vietnam wishes to complete it transition to a market economy based on the rule of law over the next years, it is necessary to start the process now of strengthening the legal institutions which are the foundations of such a system.
Box 3. Arbitration: A Feasible Alternative

Given the reluctance of Vietnamese firms to take formal legal proceedings to settle contractual disputes, commentators have suggested that arbitration may be a more appropriate solution for Vietnam. In practice, however, and despite the new Ordinance, arbitration appears to be an even less popular alternative.

Provincial Arbitration centers. After nearly 9 years of implementation of Decree 16/CP, five Centers of Economic Arbitration have been established in Hanoi (2), Hanoi (former), Ho Chi Minh City and Danang. According to legal commentators, however, these arbitration centers provide mainly consultancy rather than arbitration services. This apperently stems from the legal foundation - Decree 116/CP which is unclear about the legal status of economic arbitration centers, overly simplistic and vague in respect to the criteria for arbitrators (i.e., necessary qualifications, professional and objectivity) and the rights and duties of arbitrator, are not clearly defined, resulting in bias in the parties selection of arbitrator.

The International Arbitration Center - Vietnam Chamber of Commerce and Industry (VCCI). In practice, the international Arbitration Center established at VCCI in 1993 is the only center that performs arbitration, but even this facility is little used. The VCCI center is staffed with 6 fulltime employees and about 75 part-time arbitrators (not in payroll, called in when needed). From 1998 to 2003, 99 cases were brought to VCCI, of which 23 rds received a decision (it is unknown as to how many of these decisions were actually implemenated as this is not monitored by VCCI). In 95% of these cases one of the parties involved was a foreign firm. Accordingly to VCCI, the reasons why foreign firms have elected to use the Center are (i) because they tend to respect contracts, (ii) VCCI's Arbitration center was named as dispute settlement agent in the original contract (FDI firms often prefer to use their own country's arbitration center, however in case Vietnam partners are powerful enough they agree to accept to accept to settle the in dispute Vietnam) and (iii) for cost reason - fees for arbitration in Vietnam are much cheaper than overseas. Vietnam has been party to the international treaty on arbitration since 1998 and VCCI's arbitration center staff claim that thier justmaent havebeetl accepted overseas.

In contrast the local business community seem to lack confidence in this form of dispute settlement, for various reasons, and partially because the center itself has not done a good job have persuading businesses to use thier service. Previously, many commenters claimed that the poor legal framework governing arbitration was the main reason why arbitration was used so little in Vietnam. In response, the government elaborate a new Ordinance of arbitration in 2003, which corrected many of weakness of the former code and thus was, expected to lead too much greater use arbitration to settle dispute. However, while it is too early to effectively assess the impact of the new Ordinance, the fact that only 7 case have been brought to the arbitration center nationwide in the first nine months that the new arbitration has been in effectively (i.e., June 2003 - March 2004) compared to an average being generally recognize as a well scatted ordinance. Instead, local lawyer and firm explain that resorting to arbitration for domestic business is considered even less attractive than going to the Courts, because if the platy do not accept the Arbtrator decision the parties canthen petition the economic court - so the parties might as well go straight to the courts.

<p>| Vietnam International Arbitrator's Center on its dispute resolution: |
|---------------------------|-------------------|-------------------|-------------------|-------------------|</p>
<table>
<thead>
<tr>
<th>Year</th>
<th>Handling (# of cases)</th>
<th>Solved (# of cases)</th>
<th>Petition withdrawal (# of cases)</th>
<th>Conciliation (# of cases)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>18</td>
<td>11</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>1999</td>
<td>16</td>
<td>11</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>2000</td>
<td>21</td>
<td>16</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>2001</td>
<td>14</td>
<td>10</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>2002</td>
<td>16</td>
<td>12</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>2003</td>
<td>14</td>
<td>4</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Total</td>
<td>99</td>
<td>64</td>
<td>12</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: International Arbitrator Center - VCCI
End Notes:

i CIEM conducted most of the interviews and related fieldwork for this Policy Note.

ii The sample was not statistically significant, therefore the findings should not be regarded as representative of Vietnam business community as a whole; indeed the firms interviewed were selected precisely because they were expected to have considerably more commercial linkages that the average firm in Vietnam.

iii This research did not look at non-firm sub-contractors, such as individual/farmers who are an important long-term suppliers to contractors in processing industries especially food processing industries (sugar, coffee, tea, pepper).

iv As discussed in Policy Note on "Firm Dynamism: Beyond Registration " June 2004, Private entrepreneurs in Vietnam face considerable difficulties securing commercial credit including working capital as they typically do not have the LUR which banks accept as collateral, and most commercial banks in Vietnam do not yet accept non-collateral backed loans or other forms of collateral such as equipment or contracts.
APPENDIX A:
References in Contractual Relationship Literature

This Policy Note is not intended to be an academic paper. For those interested in reading some of the academic literature in this field following references is provided:


