THE EMERGING PRIVATE SECTOR AND
THE INDUSTRIALIZATION OF VIETNAM

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of
James Riedel Associates Inc.

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Finally, we wish to thank the many owners and managers of private companies in Vietnam who took time from their busy schedules to tell us of their experiences as new entrepreneurs in Vietnam's emerging private sector.
INTRODUCTION

Vietnam’s comparative advantage lies in labor-intensive, light manufacturing. This comparative advantage has been crucial to the extraordinary successes of numerous East Asian economies that comprise the “East Asian Miracle”. To replicate the success of others in the Region, rapid industrialization in Vietnam will require outward-looking, export orientation. And as has been the case in each of the successful export-oriented economies in East Asia, including ideological opposites China and Taiwan, the crucial enterprise in Vietnam will be private small- and medium-sized companies.

Household firms, which account for the bulk of Vietnam’s private sector, are generally too small to compete in foreign markets. State enterprises are generally too inflexible and inefficient to keep pace with dynamic global demands. Experience has shown that it is private small- and medium-sized companies—large enough to be efficient, small enough to be flexible—that are as the key to rapid export-oriented industrialization.

Today, while Vietnam’s agriculture and services sectors have largely been privatized, the contribution of private manufacturing companies to manufacturing output and to employment remains dwarfed by that of state-owned enterprises. Nonetheless, this report finds that Vietnam’s private manufacturers should be seen as seeds with full potential to blossom and form the core of a vibrant private sector. Despite an infertile business environment, the young firms that have emerged are dynamic and profitable. Of this there is no doubt.

Based on a review of secondary literature and in-depth interviews with some 50 private companies in the summer of 1996, this report was prepared by James Riedel Associates, Inc. on behalf of the Mekong Project Development Facility (MPDF). The Facility is a multi-donor initiative, managed by the International Finance Corporation (IFC) and designed to promote private small- and medium-sized companies in Vietnam, Cambodia and Laos.
Vietnam has made the transition from a centrally planned to a market economy, albeit one in which government plays a heavy role. In this respect it is no different from many so-called market economies, in which the public sector rivals the private sector in importance. It is mainly in Vietnam's industrial sector where the government's role is disproportionately large. The agricultural sector is now almost entirely private, and in the service sector private firms already account for about 53 percent of value-added and their share is rising. In the industrial sector, however, non-state enterprises account for only 27 percent of value-added, and their share appears to be declining according to published statistics (see Figure 1).

The small and apparently declining share of the private sector in industry is a matter of utmost importance to Vietnam's prospects for economic development. In order for Vietnam to achieve rapid economic growth it must industrialize, and to do that efficiently it must follow its comparative advantage in labour-intensive, light manufacturing, which means that its industrialization, if it is to be successful, will inevitably be export-oriented, as was the successful phase of industrialization in other East Asian countries. In each and every one of the East Asian countries that succeeded with export-oriented industrialization, the dominant form of industrial enterprise has been private small- and medium-sized companies, whether that country be communist (as in China, where the equivalent of private companies are the "town and village enterprises") or capitalistic (as in Taiwan).

Vietnam is poised to replicate the success of the other East and Southeast Asian countries via an export-oriented industrialization strategy. Vietnam satisfies the precondition in terms of the required resource endowment, and the government has to a large extent established the policy framework needed to make the strategy work. The only thing that seems to be missing is the private companies that have been an essential ingredient of export-oriented industrialization everywhere else.
There are of course private manufacturing companies in Vietnam, although their number is small and their contribution to manufacturing output and employment is dwarfed by the state-owned enterprises. Nevertheless, it is important to bear in mind that most private manufacturing companies in Vietnam are less than five years old, and so it may only be a matter of time before they assume the role that is required of them. The key issue, therefore, is whether the seeds of a private manufacturing sector have been well planted and whether the economic environment in Vietnam is conducive to the rapid expansion of the private corporate sector in manufacturing. This is the central question addressed in this study, which is based on a review of published statistics and secondary literature, as well as on the results of in-depth interviews conducted by the authors during the summer of 1996 with some fifty private companies in Vietnam. For reasons that are discussed below, it is our view that the published statistics and much of the existing research on the private companies do not accurately reflect the achievements that they have made or the prospects that lie ahead for them in the manufacturing sector.

While Vietnam's private companies are, in our view, stronger than is generally recognized, they nonetheless face serious obstacles mainly arising from government policies and regulations. In concluding this study, therefore, we offer recommendations for policy reforms that are needed to create a more conducive environment for the growth of a private corporate sector in manufacturing.
I. THE IMPORTANCE OF PRIVATE SMALL- AND MEDIUM-SIZED COMPANIES

The argument that private small and medium-sized companies are critically important to Vietnam's economic development is based on three fundamental propositions which, as we shall show, are solidly supported by empirical evidence. The three propositions are:

(a) that export-oriented industrialization is the only viable strategy for rapid economic growth in Vietnam;

(b) that Vietnam satisfies the prerequisites of the strategy in terms of the resource endowment and the policy framework needed to make the strategy work;

(c) that critical to the success of the export-oriented industrialization strategy is the emergence of private small- and medium-sized companies as the dominant (but not exclusive) form of industrial organization in the manufacturing sector.

a. The Imperative of Export-Oriented Industrialization

In the vast literature on economic development over the past 100 years there is no empirical regularity that is more robust and universal across time and across countries than the positive relation between openness to trade and economic growth. This fact was not always known or appreciated, and indeed most developing countries commenced their industrialization by closing their economies to international trade. The import-substitution strategy of industrialization, which virtually every developing country (except Hong Kong) adopted at the outset of industrialization, was based on two false premises. One was the premise that the export-oriented industrialization was bound to fail because developing countries would find no market for their products in the developed countries. The other false premise was that developing countries, by closing their economies and protecting domestic industry, would be able to capture economies of scale and economies of time (learning by doing), which would eventually make them competitive in industries in which they initially lacked comparative advantage.

Both of these premises were proved false by the cumulative experience of developing countries over the past four decades. The experiences of Hong Kong, Singapore, Taiwan and South Korea, which were the first countries to abandon the conventional wisdom of the day and adopt the export-oriented industrialization strategy, were a powerful demonstration of the fallacy of the premise of export pessimism. In spite of the evidence, however, export pessimism persisted in the form of the "fallacy of composition" argument, which
held that the success of the first-comers to export-oriented industrialization (the four "Tigers") could not be replicated by latecomers on grounds that the first-comers had saturated the market for labour-intensive manufactures in developed countries. However, this last stand of export pessimism was thoroughly demolished when, following the success of the Asian Tigers, a succession of other developing countries, including China and most of the Southeast Asian countries, adopted and succeeded with the export-oriented industrialization strategy in the 1980s.

The second premise—that scale economics and learning by doing, would allow developing countries to revoke the law of comparative advantage and instead put their scarce investible resources into capital-intensive, high-technology industry—was proved equally false and disastrously costly for developing countries. Certainly the import-substitution strategy did create large industrial bases in the larger continental developing countries (like China, India, Brazil and Turkey), but in every case it carried an enormous cost in terms of economic inefficiency and often brought with it macroeconomic instability.

The positive experiences of countries following the export-oriented industrialization strategy, combined with the overwhelmingly negative experiences of countries following the inward-oriented, import-substitution strategy, have impelled many countries to undertake broadbased programs of economic reform since 1985. Indeed, outside of Sub-Saharan Africa, there is nothing short of a revolution in policy reform underway in developing countries, as one country after another has undertaken unilaterally to lower its barriers to trade and institute market oriented reforms.

b. The Appropriateness of the Export-Oriented Industrialization Strategy for Vietnam

The export-oriented industrialization strategy is appropriate for Vietnam for two reasons: (1) there is no alternative strategy that will work as well, and (2) the economic conditions in Vietnam are similar to those that existed in other countries that succeeded with the export-oriented strategy, so it is also likely to succeed in Vietnam.

The only countries that have achieved a high level of per capita income without industrializing are those with an extraordinary abundance of natural resources, mainly oil. Unfortunately, Vietnam is not such a country. It has substantial mineral resources (mainly oil and gas), and in recent years they have contributed significantly to exports and to government revenues, but on a per capita basis Vietnam's oil reserves are only a fraction of those of, say, Indonesia or Malaysia.

Vietnam is also blessed with about 70,000 square kilometers of fertile agricultural land, which at present provides employment for about 80 percent of
the population, and in good monsoon years generates a food surplus (mainly of rice) for export. Relative to the population of about 75 million, however, Vietnam's agriculture is already close to the limit of its capacity to feed the country. Agricultural productivity will therefore have to rise in the future. An export-oriented industrialization strategy will not relieve Vietnam from the necessity of having to invest heavily in the agricultural sector to raise productivity. Even with substantial investment in agriculture, however, the sector will not be able to provide productive employment for the millions of people who reside there and the millions more who will be born into the rural sector in the years to come. Indeed, the only way to raise agricultural labor productivity is to transfer a large proportion of agricultural labor force to the industrial sector.

Industrialization is, therefore, the key to raising per capita income in Vietnam over the long-term. Moreover, industrialization must follow Vietnam's comparative advantage and therefore must be, for the most part, labor-intensive and export-oriented. For as shown in Table 1, Vietnam's comparative advantage is first and foremost the abundance of its human resources. Like all the other countries of East Asia that have succeeded with export-oriented industrialization, Vietnam is a highly densely populated country, with meager natural resources and with the majority of its population in the rural sector. Furthermore, as Table I shows, in terms of human resource development, Vietnam has achieved levels comparable to those that existed in the other countries when they successfully launched the export-oriented industrialization strategy.

Table 1: Comparative Economic and Social Indicators

<table>
<thead>
<tr>
<th></th>
<th>Taiwan 30-35 yrs. ago</th>
<th>Thailand 15-20 yrs. ago</th>
<th>China 10-15 yrs. ago</th>
<th>Vietnam most recent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population Density (pop/sq.km)</td>
<td>300</td>
<td>108</td>
<td>96</td>
<td>195</td>
</tr>
<tr>
<td>Ag.Population Density (pop/sq.km)</td>
<td>629</td>
<td>240</td>
<td>219</td>
<td>934</td>
</tr>
<tr>
<td>Ag.Land/Total Area (%)</td>
<td>24</td>
<td>45</td>
<td>44</td>
<td>21</td>
</tr>
<tr>
<td>Life Expectancy (years)</td>
<td>63</td>
<td>60</td>
<td>65</td>
<td>67</td>
</tr>
<tr>
<td>Secondary School Enroll (% school – age children)</td>
<td>30</td>
<td>26</td>
<td>47</td>
<td>42</td>
</tr>
<tr>
<td>Illiteracy Rate (% of pop. over 15 yrs)</td>
<td>30</td>
<td>7</td>
<td>27</td>
<td>16</td>
</tr>
</tbody>
</table>

One area which Vietnam is deficient compared to the other countries that adopted the export-oriented industrialization strategy is in terms of industrial development. Industrial development in Vietnam currently is far below the levels achieved by the other countries when they shifted from the inward-looking, import-substitution strategy to the outward-looking export-oriented strategy. This is illustrated in Table 2, which shows that per capita output of Vietnam's principal industrial products is only about one-tenth to one-twentieth of what it was in Taiwan or China when they launched the export-oriented industrialization strategy.

Table 2: Per Capita Production of Selected Manufactured Goods

<table>
<thead>
<tr>
<th>Product</th>
<th>Vietnam (most recent)</th>
<th>Taiwan 1960</th>
<th>China 1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steel (kg)</td>
<td>1.5</td>
<td>28.3</td>
<td>37.8</td>
</tr>
<tr>
<td>Machine Tools (10^4 units)</td>
<td>11.1</td>
<td>210.8</td>
<td>136.6</td>
</tr>
<tr>
<td>Chemical Fertilizers (kg)</td>
<td>4.9</td>
<td>34.4</td>
<td>125.6</td>
</tr>
<tr>
<td>Electric Motors (10^3 units)</td>
<td>0.1</td>
<td>1.5</td>
<td>na</td>
</tr>
<tr>
<td>Electric Fans (10^3 units)</td>
<td>2.8</td>
<td>18.5</td>
<td>7.4</td>
</tr>
<tr>
<td>Paper (kg)</td>
<td>1.2</td>
<td>7.5</td>
<td>na</td>
</tr>
<tr>
<td>Cotton Fabrics (meters)</td>
<td>4.7</td>
<td>16.0</td>
<td>7.6</td>
</tr>
</tbody>
</table>


Because Vietnam's industrial base is relatively small, some might be led to suggest that like most other countries Vietnam should follow an inward-looking policy to build up its industrial base before undertaking an export-oriented industrialization strategy. This, however, would be a major mistake, for the export-oriented industrialization strategy succeeded in the other countries by being "footloose" and hence able to circumvent the inefficient industrial base built-up during the earlier import substitution phase. The essence of the strategy is, for the most part, combining low-cost labor, drawn mainly from the rural sector, with mainly imported raw materials and capital goods. Seen in this light, the relatively small size of Vietnam's industrial base, which is primarily state-owned, is an advantage rather than a disadvantage, because it largely obviates the necessity (though not the desirability) of attempting to privatize or close down state-owned industries that are not able to compete internationally.

Vietnam not only meets the prerequisites for a successful export-oriented industrialization strategy in terms of resource endowment, but also in terms of the macroeconomic framework that is required. At least three macroeconomic conditions are common to all the successful applications of the export-oriented industrialization strategy: (1) macroeconomic stability, (2) relatively high and rising domestic saving and investment rates, and (3) if not free trade, as in Hong Kong and Singapore, then free access for exporters to imported inputs and capital
goods. As Figure 2 shows, one of Vietnam's most remarkable achievements has been its ability to reduce inflation and keep it down, a tribute to the government's commitment to a prudent fiscal policy.

**Figure 2**

**Macroeconomic Stability and Fiscal Balance**

As Figure 3 shows, the requirement of high (or at least rising) domestic saving and investment rates has also been established in the 1990s. Indeed, the rates shown in Figure 3 may well understate domestic saving and investment, since a growing proportion of both saving and investment is in the private sector which is known to under-report the level of its economic activity. Finally, it should be noted that Vietnam has gone a long way towards lowering trade barriers, especially for exporters, although much more remains to be done to put exporters on an equal footing with their competitors in world markets, an issue to which we shall return later in the report.

Source: General Statistical office; World Bank, 1996.
c. The Role of Private Small and Medium Sized Enterprises

There is a body of opinion in development economics and in some international development institutions that "small is beautiful," and therefore that small and medium-sized companies should be promoted because they are small. That opinion is not shared by the present authors. We advocate efficiency rather than any particular form of industrial organization. If efficiency is served by large, state-owned enterprises, then so be it. Indeed, there are some industrial branches, such as steel and chemicals, in which large enterprises are no doubt more efficient than small ones. There are even some industries in which state ownership might be preferable to private ownership, as for example in the case of utilities (water, gas and electricity), which as natural monopolies must be closely regulated if privately owned.

The importance of private companies in export-oriented industrialization is grounded not on theory or ideology, but on the fact that this form of industrial
organization is the most successful in low-wage, labor-abundant, open economies. By "most successful" what is meant is that, if treated fairly, private companies earn higher returns on investment than larger state-owned enterprises or smaller private household businesses. As a result they are better able to compete for scarce investable resources and emerge as the predominant form of business enterprises in relatively labor-intensive, export-oriented branches of manufacturing.

Evidence of the superior performance of private companies in labor-abundant countries can be found in any of the successful East Asian countries. Here we draw evidence from Taiwan, which is the most successful country among all the East Asian countries and is the one most appropriate for purposes of comparison to Vietnam, since as shown in the above tables Vietnam bears a striking resemblance to Taiwan thirty-five to forty years ago.

One similarity that would come as a surprise to many is that state-owned enterprises dominated the manufacturing sector in Taiwan in the late 1950s, just as they do in Vietnam today. Indeed, the real (US dollar) value-added of state-owned manufacturing firms in Taiwan in the late 1950s was greater than that of state-owned manufacturing, firms in Vietnam currently. However, as shown in Figure 4, the contribution of state-owned manufacturing firms was entirely eclipsed by the growth of private manufacturing after the export-oriented industrialization strategy was launched in the 1960s.

**Figure 4**

Real Manufacturing Value-added by Taiwanese Private and Public Enterprises

(*constant 1985 prices, NT$ billions*)
The economic characteristics of manufacturing enterprises in Taiwan by form of ownership are shown Table 3. By 1986, the year of the industrial census reported in Table 3, private corporations accounted for about 85 percent of manufacturing value-added and employment, a fifty percentage point increase from their share (about 35 percent) in 1960. The average size of private companies in Taiwan is about 40 employees, which is comparable to the average of private manufacturing companies in Vietnam.

Table 3: Characteristics of Manufacturing Enterprises in Taiwan by Form of Ownership: 1986

<table>
<thead>
<tr>
<th></th>
<th>Private Companies</th>
<th>Household Enterprises</th>
<th>State Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of firms</td>
<td>57477</td>
<td>61224</td>
<td>221</td>
</tr>
<tr>
<td>Employment (thousands)</td>
<td>2299</td>
<td>337</td>
<td>93</td>
</tr>
<tr>
<td>Fixed Capital (Millions NT$)</td>
<td>1013</td>
<td>101</td>
<td>294</td>
</tr>
<tr>
<td>Value-added (Millions NT$)</td>
<td>2835</td>
<td>170</td>
<td>325</td>
</tr>
<tr>
<td>Share in total Value-added (%)</td>
<td>85.2</td>
<td>5.1</td>
<td>9.7</td>
</tr>
<tr>
<td>Employees/Firm</td>
<td>40.0</td>
<td>5.5</td>
<td>420.0</td>
</tr>
<tr>
<td>Capital/Employee (thousands NT$)</td>
<td>440.0</td>
<td>300.0</td>
<td>3161.2</td>
</tr>
<tr>
<td>Value-added/Employee (thous.NT$)</td>
<td>1233.0</td>
<td>504.4</td>
<td>3161.3</td>
</tr>
<tr>
<td>Value-added/Capital (ratio)</td>
<td>2.8</td>
<td>1.6</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Riedel, 1997, p.211.

It is quite apparent why the private small and medium sized companies emerged as the dominant form of enterprise in Taiwan. The average return on capital is shown to be almost three times higher than in the much larger and more capital-intensive state-owned enterprises and about two times higher than in the smaller and slightly more labor-intensive family firms. In a labor abundant, low-wage, open economy, the private companies predominate because they are small enough to be flexible and they are large enough to be efficient. Their beauty is not in their size but in their profitability. Because they are profitable they do not need to be promoted by Government, they need only to be given a fair chance to succeed.
II. THE SIZE AND STRUCTURE OF THE PRIVATE CORPORATE SECTOR IN VIETNAM

It is exceedingly difficult to get an accurate measure of either the size or the structure of the private manufacturing sector in Vietnam. The statistics reported to the authorities are notoriously inaccurate, and the presentation of these statistics is confusing and often incomprehensible. Among the complications are: (1) aggregation—quite often the data are given only for the aggregate of industry, the definition of which varies widely, sometimes, but not always, including mining, construction, and utilities; (2) ownership classification "non-state" firms are classified in various ways, sometimes, but not always, including cooperatives, unregistered household firms and sole proprietorship, in addition to limited liability companies and joint-stock companies; (3) coverage—some statistics are intended to represent the universe of firms while others are based on samples of firms, and it is not always clear which is which; (4) stocks and flows—it is often difficult to know whether data refer to the stock as of a given date or the change in the stock over a given time period; and (5) the time period for which the data are measured is inconsistent and sometimes difficult to determine.

In spite of all these difficulties, an overall picture emerges even though its precise details are ambiguous. The overall picture is simply this: private companies of the kind which fueled growth of export-oriented industrialization in Taiwan and other Southeast Asian countries, which in the Vietnamese context are the private limited liability and joint-stock companies, occupy a very small place in the manufacturing sector in Vietnam, but from a small (almost zero) base they are growing rapidly. As Table 4 shows, as of July 1, 1995 there were fewer than two thousand private limited-liability companies and joint-stock companies in manufacturing. Altogether, they accounted for only about 8 percent of the total registered capital in the manufacturing sector. In terms of employment, our estimate is that they currently account for about 12 percent of manufacturing employment. Sole proprietorship which are the most numerous form of enterprise in manufacturing, because of their small size only account for about 3 percent of registered capital and employment. Of course even more numerous are the household firms and cooperatives which number around 800,000 in the industrial sector, reportedly employ about 2.5 million people, and account for as much as 20 percent of industrial output.

Table 4: The Distribution of Industrial Firms by Form of Ownership
As of July 1, 1995

11
In all branches of industry

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietor Enterprises</th>
<th>Limited Liability Companies</th>
<th>Joint Stock Companies</th>
<th>Household Enterprises</th>
<th>State-Owned Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>18243</td>
<td>7346</td>
<td>165</td>
<td>800000</td>
<td>6310</td>
</tr>
<tr>
<td>Capital (VN dong millions)</td>
<td>3071</td>
<td>5693</td>
<td>1704</td>
<td>na</td>
<td>77656</td>
</tr>
</tbody>
</table>

In manufacturing

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietor Enterprises</th>
<th>Limited Liability Companies</th>
<th>Joint Stock Companies</th>
<th>Household Enterprises</th>
<th>State-Owned Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>5030</td>
<td>1735</td>
<td>41</td>
<td>400,000</td>
<td>2777</td>
</tr>
<tr>
<td>Capital (VN dong millions)</td>
<td>758</td>
<td>1628</td>
<td>183</td>
<td>na</td>
<td>21099</td>
</tr>
</tbody>
</table>

Source: General Statistical Office, Hanoi.

The growth of private industrial companies Vietnam in Table 5. Starting from a close to zero base in 1991, they have grown extremely rapidly. The surge in the number of private companies after 1992 is explained by the fact that the legal basis of private companies was only established in 1992 with adoption of the new Constitution.

Table 5: The Number and Registered Capital of Private Industrial Companies: 1991-1996

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Companies:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sole Proprietorships</td>
<td>76</td>
<td>3126</td>
<td>8690</td>
<td>14165</td>
<td>18243</td>
<td>21000</td>
</tr>
<tr>
<td>Limited Liability Co.</td>
<td>43</td>
<td>1170</td>
<td>3389</td>
<td>5310</td>
<td>7346</td>
<td>8900</td>
</tr>
<tr>
<td>Joint – Stock Co.</td>
<td>3</td>
<td>65</td>
<td>106</td>
<td>134</td>
<td>165</td>
<td>190</td>
</tr>
<tr>
<td>Capital VN dong billions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sole Proprietorships</td>
<td>na</td>
<td>930</td>
<td>1351</td>
<td>2090</td>
<td>2500</td>
<td>3000</td>
</tr>
<tr>
<td>Limited Liability Co.</td>
<td>na</td>
<td>1490</td>
<td>2723</td>
<td>3882</td>
<td>4237</td>
<td>7300</td>
</tr>
<tr>
<td>Joint – Stock Co.</td>
<td>na</td>
<td>310</td>
<td>850</td>
<td>1071</td>
<td>1244</td>
<td>2500</td>
</tr>
</tbody>
</table>

Source: General Statistical Office, Hanoi.

The sectoral distribution of output of private companies, household firms and state-owned enterprises in industry is shown in Table 6. Food processing is
the predominant activity of all three types of firms and in total accounts for 44 percent of industrial output (excluding electricity and fuel). The predominance of the food processing sector is a clear indicator of low levels of industrialization in Vietnam. Table 6 also indicates that both the household firms and the private companies are highly concentrated in a few branches. Aside from food processing, construction materials figure importantly for household firms, while textiles and garments (along with food processing) is the main line of activity of private companies in Vietnam.

Table 6: The Composition of Output in Manufacturing by Form of Ownership

<table>
<thead>
<tr>
<th></th>
<th>Share in total of Private Companies</th>
<th>Share in total of Household Enterprises</th>
<th>Share in total of State-owned Enterprises</th>
<th>Share of Private Companies in total output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food and Foodstuffs</td>
<td>31.0</td>
<td>44.5</td>
<td>29.9</td>
<td>3.7</td>
</tr>
<tr>
<td>Textiles and Garments</td>
<td>27.0</td>
<td>7.9</td>
<td>8.1</td>
<td>12.4</td>
</tr>
<tr>
<td>Wood/Wood Products</td>
<td>11.4</td>
<td>7.8</td>
<td>0.9</td>
<td>15.5</td>
</tr>
<tr>
<td>Building Materials</td>
<td>4.7</td>
<td>18.3</td>
<td>7.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Other</td>
<td>25.3</td>
<td>21.5</td>
<td>53.7</td>
<td>2.2</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>4.0</td>
</tr>
</tbody>
</table>

Source: General Statistical Office, Hanoi.

These statistics, while somewhat out of date and imprecise, help to put the role of the private sector in perspective. The number that is most often given to indicate the importance of the private sector is its approximately 60 percent share in GDP. Indeed, at the Eighth Congress of the Communist Party, consideration was given to the question of whether steps should be taken by the state to recoup an additional 20 percent share of GDP from the private sector. However, it is clear in Figure 5 that the debate on this issue was misplaced, since the private sector with which the state vies for resources consists almost entirely of small family farms and household businesses, which are not the kinds of business that any government, even a socialist one, would want to run. The private corporate sector, consisting of the limited liability and joint-stock companies, still occupies but a tiny part of the economy, accounting for no more than about one percent of GDP, and therefore poses no threat to state-owned enterprises or the government's social objectives. On the contrary, those objectives in terms of growth, employment and equity, and even the preservation of existing state-owned enterprises, rest on the success of industrialization and hence on the strength of the private corporate sector.
Figure 5
Measure of the Importance of the Private Sector

- Private Corporate Value-added in GDP
- Family Farms and Household Firms
- Non-State Sector in GDP
III. PROBLEMS OF FACING PRIVATE INDUSTRIAL COMPANIES

a. "Credit, Credit and Credit"

The Communist Party Secretary General, Mr. Do Muoi, has described the problems of economic development in Vietnam as three: "capital, capital and capital." Private small and medium sized companies in Vietnam share this view, identifying the main obstacles to their growth as "credit, credit and credit." In our recent interviews with some 50 private limited liability and joint stock companies, it was acknowledged that ambiguities about property rights, restrictions on international trade, irrationality in the tax system and excessive bureaucracy and red tape complicate business and carry costs, but virtually every one of the companies we interviewed identified these problems as secondary to credit--more precisely the lack of it. A similar finding is reported in every other survey of private firms in Vietnam.

As with the measurement of the size and structure of the private sector in industry, so too in finance the published statistics do not accurately reflect the reality facing private small and medium sized companies. The published statistics (see Table 7) show the "non-state" sector achieving a dramatic increase in its share of domestic credit, up from just 6 percent in 1990 to about 40 percent in 1996. At 40 percent, the private sector's share in domestic credit is of course still well below its share in GDP (about 60 percent); nevertheless the problem of inequity in the credit allocation system appears to be diminishing.

Table 7: The Share of Non-State Firms and Private Companies in Domestic Credit

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Non-state Firms in Domestic Credit</td>
<td>6.2</td>
<td>7.2</td>
<td>16.2</td>
<td>28.4</td>
<td>32.5</td>
<td>38.5</td>
<td>40.7</td>
</tr>
<tr>
<td>Private Companies in Domestic Credit</td>
<td>na</td>
<td>na</td>
<td>0.8</td>
<td>3.8</td>
<td>6.6</td>
<td>na</td>
<td>na</td>
</tr>
</tbody>
</table>


Unfortunately, this positive development has few or no practical consequences for the private corporate sector. The increase in the private sector share of domestic credit is of little importance to private companies for two reasons: (1) private companies have obtained only a small share of the allocation of domestic credit to the private sector (see Table 7), and (2) virtually all the credit that is extended to the private sector is of short maturity, generally no longer than three to six months. Furthermore, the issue of loan maturity is more critical to private companies than for the small farmers and household businesses that have received the majority of loans in the private sector, because private companies are far more capital-intensive and their investment projects have a
much longer gestation period than the investments of household businesses whether in industry, commerce or agriculture.

Although most of the companies we interviewed had at one time or another obtained bank loans of three to six month maturity to finance working capital, only a very few were able to obtain medium to long-term bank financing for fixed investment. Most of the companies interviewed had to rely entirely on cash holdings, retained earnings and by borrowing, from relatives and in informal credit markets to finance fixed investment. Since the opportunity cost of cash to private companies and implicit interest rates in informal credit markets is at least five times higher than interest rates earned on deposits in the banking system, this situation constitutes an enormous inefficiency of financial intermediation and a significant disincentive to private investment in the manufacturing sector.

While private companies have virtually no access to long-term credit in the domestic formal financial system, they have hardly any more access to foreign sources of finance. Vietnamese law precludes foreigners from taking equity in Vietnamese private companies, and interest rate ceilings and financial regulations make it relatively unprofitable and risky for foreigners to lend directly to Vietnamese private companies. As a consequence the dozen or so foreign investment funds operating in Vietnam have few assets in the private corporate sector in Vietnam. Even financial leasing, which potentially could be of great benefit to private companies most of which have a desperate need for imported machinery and equipment, has not yet developed and is not likely to be significant until the government begins to grant additional leasing licenses.

b. Property and Land Use Rights

The fledgling status of the private corporate sector in Vietnam is hardly surprising, given that the legal protection of private property was first established with the adoption of the 1992 Constitution. Furthermore, it was not until 1994 that a basis for resolving disputes over property rights, through civil and economic courts and non-governmental arbitration censers, was established. As matters stand, the legal framework for a free enterprise market economy is still incomplete and in need of reform. In particular, the legal requirements for government intervention in private economic decision making, especially on investment, and the differentiated rules and incentives applying to different forms of business ownership constitute serious obstacles to the establishment and growth of private small and medium sized companies.

Property rights with respect to land are far and away the most problematic. Vietnamese law establishes the right only to use, not to own land, and imposes severe limitations on the transfer of land. As a result, land use rights often are not transacted openly, leading to extreme price volatility, speculation and inefficient use of land. Of course in such an environment the most disadvantaged firms are
those that are just starting to get established, in short Vietnam's private manufacturing companies.

In a measure adopted ostensibly to redress the inordinate advantage of state-owned enterprises over private companies in acquiring land, the government decreed in February 1995 that all businesses, publicly or privately owned, would have to pay rent to the government on non-agricultural land to which they held land-use rights. Furthermore, the decree stipulated that mortgages of non-agricultural land were to be limited to the value of prepaid rent and the value of property on the land. The effect of this decree has been the opposite of what was intended, since it has made the transferability of land use rights even more ambiguous than before and has exacerbated the problem for private companies of using land and real estate as collateral in the banking system. The net effect is to put private companies in an even more disadvantageous position relative to state-owned enterprises with which they compete both for land and for credit.

c. The Tax System

Death and taxes, it is said, are the only things one can count on in life. Taxes are no more popular in Vietnam than they are anywhere else in the world. Nevertheless, the managers of Vietnam's private companies generally do not cite taxation as a major obstacle to business. They expect to pay taxes and for the most part they report that the taxes they pay are reasonable and fair, and in many cases arrived at through negotiation between themselves and the tax authority.

The problem with the tax system in Vietnam and its implications for small and medium sized companies is not the level of taxation per se, which by international standards is quite low. Rather the problem is mainly the irrationality of the tax system and the way in which it is administered. What is irrational about the tax system is multiplicity of kinds of taxes and rates of taxation. Private companies, for example, are subject to three major taxes—a turnover tax, a special sales tax and a profit tax. Furthermore, the rates that apply for each kind of tax vary across types of business and commodity category, with turnover taxes ranging from zero to forty percent and profit taxes from 25 to 45 percent. As a result of the proliferation of taxes and tax rates, a great deal of discretion is introduced into the administration of the system. This in turn encourages businesses to keep multiple sets of books and in general to avoid transparency in their financial records. The consequence of such a system is not only inefficient and inequitable tax collection, but also the undermining of accurate accounting and financial record keeping, which are critical ingredients of a sound financial system.

d. The Trade Regime

Like the tax system, the trade regime is not regarded by small and medium sized companies as a major obstacle to business. The growth of trade at about 30
percent per annum or three times the rate of growth of GDP, testifies to the overall openness of the economy. Nevertheless, a number of trade-inhibiting measures remain and for the most part these measures bear disproportionately on private small and medium sized companies.

Certainly the most discriminatory trade practice is the requirement of a government certification to engage in trade directly. To obtain certification, which is granted by the Prime Minister, firms must have working capital of $200,000, which constitutes an insurmountable barrier for many private companies. In lieu of such a certificate, private companies are obliged to export or import through large state trading companies, which charge fees as high as 2 percent of the value of transactions.

In addition to the transaction fees of state trading companies, importers must pay duties, the rates of which vary widely from commodity to commodity, generally in the range of zero to 50 percent \textit{ad valorem}, and are subject to change on a quarterly basis according to the changing "needs" of the country, as interpreted by the authorities.

Although import duties on raw materials and capital goods are relatively low (under 20 percent), the administration of trade policy in Vietnam demonstrates a rather strong inclination on the part of officials to protect domestic industry from international competition. However, by applying for membership in ASEAN, the AFTA and the WTO, the government is committing itself to the kind of liberal trade regime that is critical for the success of the export-oriented industrialization strategy.

\textbf{e. Bureaucracy and Red Tape}

The logic of a market economy is that the person who invests his own money is the best judge of whether that investment will succeed, since the investor profits if it does and loses if it does not. The Vietnamese authorities have accepted the necessity of a market economy, but still do not completely trust its underlying logic. Individuals are not free to invest their own money in legal business ventures, but must first get the permission of the state to establish, dissolve or change a business. In the case of private small and medium-sized companies this process is especially burdensome.

Under the current regime, to start a business it is necessary to get a license from a Provincial Planning Committee, following approval by a People's Committee. Each provincial or municipal committee establishes its own requirements, consistent with nation-wide regulations. In Ho Chi Minh City, for example, in order to establish a limited liability or joint-stock company an investor must: define the objectives, activities and areas of business; show proof of having the required capital (between $30,000 and $100,000); show proof that the manager/owner is adequately qualified.

In addition, the following documentation is required:
• application to establish a business;
• operating plan for the business;
• certificate of background for shareholders;
• certificate of residential status;
• certificate of good character obtained from the police;
• certificate of health;
• draft of the enterprise by-laws;
• bank certification of the company's liquidity position;
• feasibility study.

In addition to being costly and time consuming (up to nine months), this process gives authorities at various level of government excessive discretionary power, which can easily be abused and reportedly often is.
IV. CONCLUSIONS AND RECOMMENDATIONS

There is a good deal of confusion about the role of the private sector in the ongoing debate about the course of economic development in Vietnam. In just one decade the private sector has grown to account for about 60 percent of GDP, a statistic that is often interpreted, either with alarm or satisfaction depending on one's viewpoint, as evidence of a capitalist reorientation of the economy. In fact, however, no such interpretation is warranted, since all but a very small proportion of the private sector in Vietnam consists of family farms, household firms and sole proprietorships. The private corporate sector, consisting of limited liability and joint stock companies, which is the only part of the economy that could conceivably be considered capitalistic, is still minuscule, accounting for no more than about one percent of GDP.

Although it is still but a tiny part of the economy, it is the private corporate sector that offers the best prospects for rapid long-term growth in Vietnam. This goal can only be achieved by export-oriented industrialization, the success of which depends on the emergence of a dynamic private corporate sector, dominated by small and medium-sized companies. Household firms are generally too small to compete in export markets, and state-owned enterprises are generally too large and inflexible to succeed in the ever changing global marketplace. What works best in densely populated, labor-abundant countries that pursue the export-oriented industrialization strategy are the private small and medium-sized companies, which are large enough to be efficient and small enough to be flexible.

There is not much reliable information about the private corporate sector in Vietnam. The statistics tell us that there are about 5000 companies in the manufacturing sector, but not much else. What additional quantitative information exists is not at all reliable. In order to obtain an understanding of the strengths and weaknesses of Vietnam's emerging private corporate sector one must go to the companies, meet their managers and try to get to know them in a social as well as business context. That was the approach taken in this study, the authors having spent much of the past nine months interviewing and getting to know the managers of some 50 private companies. The information we garnered from these interviews is almost entirely qualitative, but it is in our view no less valuable for that fact.

The seeds of a private corporate sector have been planted and the young firms that are emerging are dynamic and profitable; of this there is no doubt. The strength of the new private companies in Vietnam as one would expect, draws from the strengths of their owners and managers, whom we found to be success-driven entrepreneurs. Most of the new entrepreneurs we met were well educated. Those in the South tended to have more entrepreneurial experience, while those in the North were better educated, in the majority of cases having been trained as engineers in Eastern Europe. As engineers they tended to know the production end of their businesses better than the marketing end, and recognized the latter as
a shortcoming that would become increasingly critical. Having started their business in most cases only four or five years earlier with modest initial investments of, on average, about $20,000, and having achieved rapid growth, with revenues reaching, on average, between one and six million dollars, they were almost all very optimistic about the future. Most of the companies interviewed had specific and well developed investment plans. None, however, expressed any realistic hope of being able to finance their planned long-term investments in formal financial markets any time soon.

Not surprisingly therefore the managers of Vietnam's emerging private companies describe their triad of problems as "credit, credit and credit," recognizing of course that many policy areas, such as the tax system, property rights and the trade regime, impact on the workings of the financial system.

The inefficiency of the financial system is a burden to all forms of business, public and private, large and small. It is, however, especially critical for the emerging private companies, which unlike the state-owned companies cannot rely on the government to guarantee their bank loans, and unlike household firms have to face relatively large capital investment requirements which have relatively long gestation periods. Without access to formal financial markets, the emerging private companies are forced to either borrow at exorbitant rates in the informal market or amass personal savings to meet the capital requirements for investment. As a result, no doubt many potentially able entrepreneurs with profitable projects are discouraged from investing, which means that many fewer jobs are created in the manufacturing sector, that much less foreign exchange is earned from exporting manufactures, and that much less revenue is collected from taxing Vietnam's most profitable companies.

Finding solutions to the problem of financing private corporate investment should be a top policy priority. The establishment of the long-awaited stock market is a step in the right direction, but it will not go far towards solving the financing problems of new private companies. Much more important are measures which would deal directly with the problem of securing bank loans and guaranteeing foreign currency credits on imports of machinery and equipment for private companies. To assist private companies in overcoming the problems they face in formal financial markets, the government should consider establishing a fund to provide credit guarantees to private companies, as many other governments in East Asia have done. In Taiwan, for example, the government established such a fund with initial endowment of only $400 million in 1974, which has guaranteed in excess of $58 billion in credit to small and medium-sized businesses and generated a surplus to the fund of more than $200 million.

In addition to taking steps to remove existing obstacles to financing private investment, the government must also make every effort to avoid creating new obstacles. Caution is especially warranted at the present time, when some in the government are recommending restrictions on imports and on the use of deferred letters of credit to finance imports as a means of dealing with the country's large
trade deficit. If Vietnam's trade deficit is a problem, it is one that was created by state-owned enterprises, not by Vietnam's emerging private companies. Indeed, Vietnam's private small and medium-sized companies, as the essential ingredient of a successful export-oriented industrialization strategy, are the long-term solution to the balance of payments constraint the country faces. It would therefore behoove the government to consider the establishment of special programs in the State Bank to give Vietnam's new export-oriented private companies priority access to foreign exchange.

To conclude, the seeds of a private corporate sector are well planted in Vietnam and dynamic and profitable companies are emerging. All they need now is a conducive environment in which to grow, which only the government can provide. Given a conducive environment, we have no doubt that more and more entrepreneurs will emerge to form companies and mobilize capital to exploit the vast economic opportunities present in Vietnam.