The Pacific Review, Vol. 13 No. 2 2000: 257–277

Some alternative scenarios for the role of the state in Vietnam

Ari Kokko and Fredrik Sjöholm

Abstract The Vietnamese economy has by most standards performed very well over the last decade. For instance, economic growth has averaged around 8 per cent per year during the 1990s. The high growth rate has mainly been achieved through large increases in investment, and a large share of the investment has come from foreign sources. However, it is likely that the Asian crisis will lead to a significant reduction in the inflows of foreign capital, which will make it difficult to maintain a growth strategy based on increased capital formation. Continued high growth requires improved economic efficiency. Such efficiency gains have to focus on the state-owned enterprises that account for a large share of the Vietnamese economy, but are known to face serious efficiency and profitability problems. This paper discusses economic consequences of some different choices regarding the role of the state-owned sector. We discuss two scenarios where the state will continue to play a dominant role – centralized or localized state-owned enterprises – and two scenarios with a stronger private sector – supporting the establishment of new private firms and privatizing existing state-owned enterprises.

Keywords Vietnam; SOEs; regulations; liberalization; industrialization; economic development.

Introduction

The Vietnamese economy has exhibited remarkable development and change during the past decade. Thanks to a program of comprehensive reforms that replaced plans and commands with market incentives – known as *doi moi* – Vietnam managed to move from stagnation and macro-economic instability in the mid-1980s to reasonably stable prices and

Ari Kokko is Professor of International Business at Åbo Akademi University in Finland. Fredrik Sjöholm is Assistant Professor at the National University of Singapore. Both are associated with the European Institute of Japanese Studies in Stockholm.

Address: Ari Kokko, Åbo Akademi University, Department of Business Administration, Henriksg. 7, FIN-20500 Åbo, Finland. E-mail: ari.kokko@abo.fi

ISSN 0951–2748 print/ISSN 1470–1332 online
http://www.tandf.co.uk/journals

annual GDP growth rates of around 8 per cent in the mid-1990s. Economic growth has also facilitated an improvement in various social indicators. Poverty has been reduced by about a third during the first ten years of *doi moi*, the provision of various health services has improved, an increasing share of the population has access to safe water and sanitation, and primary school enrollment rates have been rising (UNDP 1996).

However, during the past couple of years, it has become increasingly well understood that it may not be possible to sustain the gains of the *doi moi* program unless further structural reforms are introduced. The strong growth record in Vietnam has to a large extent been facilitated through factor accumulation, or more specifically, through increases in investments (Riedel 1997: 60). Investment as a share of GDP increased from around 12 per cent in 1990 to more than 25 per cent since 1995. Continued growth under the present system requires even larger amounts of investment. For instance, it was calculated in 1996 that continued high growth rates would require investment between 1996 and 2000 of more than US$40 billion (PIP 1996). Such investments cannot be financed through domestic savings alone but require a substantial amount of foreign capital. Foreign capital, mainly in the form of foreign direct investment (FDI), but also significant amounts of foreign aid, has accounted for more than a third of total investment (CIEM 1999) and the Public Investment Program of 1996 estimated the foreign capital requirements for the period 1996–2000 to around US$20 billion.[1] However, the Asian crisis, and the large Vietnamese current account deficits, amounting to over 10 per cent of GDP in 1995–96 and between 5 and 10 per cent in 1997–98, have made foreign lenders very cautious. Accordingly, the amount of FDI has decreased substantially and many foreign firms have actually closed or scaled down their operations in Vietnam in recent years (de Lestrange and Richet 1998; Kokko 1998). The competition for FDI has increased substantially as other countries in the region have devalued their currencies and deregulated large sectors of their economies. It is therefore unrealistic to expect that Vietnam would be able to attract the amounts of FDI that flowed into the country during the mid-1990s. Hence, it is reasonable to expect that realized investment would fall way short of the level required for sustained high growth of the kind seen before the advent of the Asian crisis.

If the rate of capital formation falls, continued high growth will instead require increased efficiency in the use of existing resources. To consider the possibilities for such efficiency gains, it is necessary to pay attention to institutional factors in general and to the role of state-owned enterprises (SOEs) in particular, because of their central role in the Vietnamese economy. The state sector accounts for about 40 per cent of GDP, and it is sometimes reported that SOEs produce over two-thirds of the country's industrial output (Mallon 1997: 5). Although these figures overestimate the strength of the indigenous SOEs – they include the output of joint ventures between SOEs and foreign investors – it is still clear that overall growth will largely be determined by how the resources controlled by SOEs are used.[2]

The purpose of this paper is to contribute a long-run perspective to the debate by outlining some scenarios for Vietnam's future development, with the relationship between the state and the private sector as a point of departure. One reason for this approach is that the leading role of the state appears to be one of the few unyielding ideological foundations of the Vietnamese leadership, although it is not clear how this leading role should be implemented. Should the state be directly responsible for the production of goods and services – and if so, how should state-owned enterprises be organized – or should the state focus its resources on creating a favorable business environment for private firms? The state sector presently accounts for such a large share of the Vietnamese economy that the development in most other policy areas depends on these decisions regarding the role of the state.

The next section points to some of the contradictions and shortcomings in the present policy environment. The third section discusses two alternative scenarios in which the state sector continues to play a dominant role in industry. The first one assumes that development is based on centrally controlled SOEs, while the second scenario focuses on diversified locally controlled SOEs. The fourth section examines two strategies to establish a stronger private sector: supporting the establishment of new private firms and privatizing existing state-owned enterprises. The final section summarizes the findings, and offers some concluding comments.

Status quo: sitting on two chairs

Observing the Vietnamese economy from the sidelines, it is hard not to be confused by an environment where sound incentives and policies are mixed with contradictory and conflicting objectives. Reforms aiming at liberalization and market orientation have improved resource allocation and efficiency in many sectors, but public intervention, discriminatory regulation, and soft budget constraints have allowed inefficiency and waste of scarce resources in other sectors. Although most transition economies have experienced similar contradictions at some stage of their development, the problems appear to be more serious in Vietnam than elsewhere. The reason is arguably that Vietnam is still searching for a balance between plan and market, and between public and private.

Some of the policy contradictions are obvious, and have contributed to Vietnam's current economic problems. For instance, through its membership in the AFTA (and eventually WTO), Vietnam has committed to significant trade liberalization, and it is often stated that export promotion is a major policy objective for the coming years. Yet, recent analyses of the current trade environment have revealed that the Vietnamese trade barriers are substantial (CIE 1997; Kokko 1999; Gates

1998), and the investment decisions of the main economic actors confirm the inward-looking character of the policies: most SOEs and a large share of the foreign investors are active in import-substituting activities.

Another contradiction can be seen in the policies concerning industrial productivity and efficiency. On the one hand, there are strong statements indicating that improved management skills, technology upgrading, and efficiency are priority objectives. The cautious *equitization* of a relatively small number of state-owned enterprises has been a step in this direction. The equitized firms have exhibited significant performance improvements, and the official objective is to extend the process. Another example of 'good governance' was given at the opening session of the tenth parliamentary assembly in 1997, where the new prime minister Phan Van Khai stressed the need to speed up SOE reform.

On the other hand, industrial policy has effectively reduced competition in many industries. The establishment in the mid-1990s of eighteen General Corporations and sixty-four Special Corporations – which are large conglomerates incorporating some 2,000 SOEs operating in various strategic industries or specific geographical areas – is a step in this direction. The restructuring of state enterprises has concentrated decision-making and resources in many key industries, creating monopolies and cartels with significant market power. It is not likely that the Vietnamese government will be able to monitor and control the operations of these conglomerates to guarantee competitive pricing, high efficiency, and hard budget constraints.

Instead, there is a serious risk that these firms will continue to suffer from the incentive problems that render much of Vietnam's state-owned industry inefficient and unprofitable. Most SOEs operate with obsolete machinery and equipment, and surveys of the sector indicate that perhaps one-third of the capital stock is useless (Le Dang Doanh 1996). The financial performance of the SOE sector at large is also remarkably weak. Recent studies indicate that most SOEs are running at a loss and that only 300 enterprises account for 80 per cent of the SOE sector's contributions to the state budget (CIEM 1997). Owing to their low profitability, many SOEs have been forced to borrow capital from other state enterprises, the banking sector, and other capital sources, which has created a complex maze of cross-subsidization and indebtedness.

The attitudes toward the private sector have been marked by the same ambivalence (Ljunggren 1997). Official statements have identified an important role for the private sector in Vietnam's future industrialization, but at the same time it is understood that the state sector will remain dominant. In fact, the Eighth Congress of the Vietnamese Communist Party in 1996 restated the objective that the state sector should hold a central role in the country's development, and SOEs enjoy various privileges before private firms. In addition to the market power created by the establishment of General Corporations and Special Corporations, it is obvious that SOEs still have priority access to investment funds (at favorable terms, e.g. without collateral requirements), foreign exchange, and land-use rights, and it is likely that their formal connections with political decision-makers result in other, less obvious advantages. For instance, to the extent that decisions related to taxation, trade regulations, and other notes can be influenced through lobbying, it is clear that SOEs are better placed than private Vietnamese firms to influence the decision-making process (Kokko and Zejan 1996).

This lack of a level playing field is a serious problem not only for the private sector, but also for the efficient use of resources in state-owned enterprises. If a disadvantaged and weak private sector is established alongside a privileged SOE sector, it is unlikely that it will be able to operate efficiently. At the same time, there is a serious risk that the performance of the weak private sector would set the standard also for SOEs, and result in suboptimal performance.

To ensure continued growth in Vietnam it appears obvious that fundamental changes in economic policies are needed. Neither reasonable short-run objectives – such as macroeconomic stability, high growth rates, and employment generation – nor Vietnam's ambitious long-run objective to become an industrialized country by the year 2020 can be achieved unless the contradictions and conflicting objectives discussed above are resolved. In particular, it is necessary to define what should be the role of the state in the Vietnamese economy, to ensure that state-owned enterprises are operated efficiently, and to determine the relation between state-owned and private industry.

Relying on a strong state sector

The official Vietnamese view, as noted earlier, is that the state should hold a leading role in the country's economic development. Many Vietnamese interpret this to mean that the state should be a major actor in industry and commerce, and that SOEs should account for a significant share of production and trade. Although many outside observers would tend to disagree with the economic and political arguments underlying this view, it is reasonable to consider some possible consequences and policy requirements of such a choice.

It is possible to distinguish at least two different scenarios where the state sector dominates the economy. First, we may picture a situation where the state sector is very concentrated, and centered around a small number of large, centrally controlled enterprises or conglomerates. This scenario is essentially an extrapolation of the decision to concentrate public resources in General Corporations and Special Corporations. Second, it may be useful to consider an alternative where the dominance of the state sector is based on a large number of smaller, locally controlled firms.

Before the scenarios are outlined in closer detail, it is necessary to note that neither of these alternatives would be sustainable in the present environment. The reason is that Vietnamese SOEs do not appear to be subject to hard budget constraints. Financial profit is not the only objective of SOEs nor is the remuneration of SOE managers directly related to the enterprise's economic performance, which means that the managers have limited incentives to maximize their enterprise's profitability. On the contrary, inefficiency losses can be expected and do normally occur, as evidenced by the indebtedness and weak financial position of many SOEs. Hence, a strategy based on SOEs would require significant changes in the economic environment, including harder budget constraints and increased exposure to international competition.

In a remarkable action, the government announced in mid-1997 that SOEs would not need to adhere to the strict collateral requirements introduced by an increasingly cautious banking sector. Consequently, state banks continue to lend large sums of money to loss-making SOEs despite failure to pay back old loans. This type of action has confirmed that the budget constraints of Vietnamese SOEs are still relatively soft, and there is a risk that the SOE sector in general will interpret the support program as a signal that the government will cover future financial losses as well. A situation where budget constraints remain soft and SOEs continue to operate inefficiently is obviously not sustainable, and would rule out any possibility to achieve the ambitious growth targets for the coming decades. Irrespective of what is assumed about the future structure of the Vietnamese SOE sector, harder budget discipline must therefore be imposed on the firms.

For private firms operating in a market economy with perfect competition and full information for shareholders, there are no problems in formulating appropriate incentives for efficiency and hard budget constraints. The objective of the firm is to generate an acceptable profit for its shareholders. Since the prices of inputs as well as outputs are determined in competitive markets, it is only possible to generate acceptable profits if production is efficient. Moreover, since the profit of the individual firm (or the value of the firm) can be compared with those of its competitors, shareholders can easily monitor the performance of the manager, even without knowing all the details about the production process. A manager who is not maximizing profit will be replaced, which provides a strong incentive for managers to work hard. This is a serious threat even if the firm's own shareholders are passive. A manager who is not maximizing profit is not maximizing the value of the firm's stock. This means that the firm's assets will appear relatively cheap, and outside investors may see an opportunity to make a profit by purchasing the shares and replacing the old management with more competent personnel. Private firms that are not able to operate efficiently and generate profits can also be forced into bankruptcy, which typically means that the owners lose the funds they invested in the company. This provides strong incentives for owners and shareholders to actually monitor the performance of the manager. However, it should be stressed that perfect competition and full information is not typically the case in the real world. Instead, imperfect competition and asymmetric information lead to situations where, for instance, the incentives or the possibilities to monitor the management might be restricted. The solution in Western economies has been to either develop a detailed legal framework or to have concentrated ownership of enterprises.

In a regulated economy dominated by SOEs, managers typically have weaker incentives to maximize efficiency and profits, there may be no easily identifiable owner with strong incentives to monitor the performance of managers, and it is harder to find good performance measures. The incentives for efficient management are particularly weak if managers are appointed on the basis of political decisions rather than professional capacity, and if salaries and job security are not related to economic performance. Lacking individual profit-oriented owners, the objectives of SOEs are often defined by politicians, and may include a multitude of specific targets ranging from maximization of employment to regional policy objectives. In these cases, performance is often very difficult to monitor, both because it may be hard to find appropriate performance measures for all objectives and because the weights of the different objectives are seldom specified. Monitoring may be difficult even when profit maximization is the formal objective. With regulation and limited competition, the SOEs are facing input prices that do not reflect underlying demand and supply. Moreover, they may hold enough market power to set their own prices. In these conditions, the nominal profit that is generated is not a good measure of efficiency. For example, an SOE that has a monopoly in its market may be able to generate a financial profit even if management and physical production practices are inefficient. With limited competition and lack of a level playing field for SOEs and their competitors, it is also hard for decision-makers to determine what is a reasonable return on business operations in any specific industry.

Hence, whatever the role of Vietnamese SOEs, it will be necessary to establish harder budget constraints and 'good governance' in the enterprise sector. Some reforms, such as formal profit objectives and management incentives relating pay to performance, are conceptually simple to introduce, and the subsequent discussion assumes that such measures are set up.[3] It is equally obvious that increased transparency, which reduces unnecessary red tape and corruption, are prerequisites for any sustainable strategy. In addition, sustainability requires that some source of competition be established, both in order to put reasonable pressure on SOEs and to facilitate the formulation of appropriate performance objectives. Apart from obvious differences in the character and structure of state-owned industry, the two scenarios discussed below differ mainly in how this competition is achieved. It should be noted that any realistic strategy would probably mix elements from the two scenarios, as well as from the alternatives where development is centered on the private sector. Yet, for reasons of analytical clarity, it is convenient to treat each alternative separately in the present context.

Centralized, large SOEs

One of the recent trends in Vietnamese industry, as noted above, has been in the direction of increasing concentration of public resources. Following a decision by the prime minister in 1994, the SOEs in a number of strategic sectors were merged into eighteen General Corporations during the following year. Table 1 identifies these large industrial conglomerates. Simultaneously, sixty-four Special Corporations were created by merging large numbers of small SOEs operating in the same business or the same geographical area.[4] Together, these General and Special Corporations have absorbed approximately 2,000 of the 6,300 SOEs that existed at the end of 1994, and they are estimated to account for about half of the employment and some 80 per cent of the resources and production capacity of Vietnam's SOE sector.

The motives for the establishment of these conglomerates have largely been ideological, but it is also possible to distinguish some economic arguments. For instance, the conglomerates are sometimes seen as a way to secure the leading role of the public sector by establishing state control over a number of strategic industries with high growth potential, to improve SOEs' ability to procure funds, to achieve economies of scale in production and management, and to make it possible for Vietnamese SOEs to compete on a more equal basis with foreign multinational corporations.[5] It can be questioned whether these objectives will be met through the establishment of large state corporations. For instance, although some of the General Corporations are found in sectors that can be char-

Table 1 List of general corporations

Vietnam Electric Corporation	Vietnam Steel Corporation
Vietnam Coal Corporation	Vietnam Coffee Corporation
Vietnam Petroleum Corporation	Vietnam Tobacco Corporation
Vietnam Cement Corporation	Vietnam Paper Corporation
Vietnam Maritime Corporation	Northern Food Corporation
Vietnam Civil Aviation Corporation	Southern Food Corporation
Vietnam Post and Telecommunications Corporation	Vietnam Chemicals Corporation
Vietnam Gemstones and Gold Corporation	Vietnam Rubber Corporation
Vietnam Textiles and Garments Corporation	Vietnam Railways Union

Source: IMF (1996: 35).

acterized as natural monopolies, such as electricity, railways, post, and telecommunications, most of them are in industries that are not obviously of 'strategic' importance. It is also uncertain whether any significant economies of scale can be achieved in management, given that all of the member companies retain their top management and some degree of independence regarding production decisions. Furthermore, it can be questioned whether there is a strong positive relation between international competitiveness and size. Many Asian economies, such as Taiwan and more recently China, have been able to achieve more impressive export performance through small and medium-sized enterprises than through large state-owned firms. However, we will leave these objections aside, and examine some consequences of continued reliance on a strong, concentrated state sector based on large industrial conglomerates.

As noted earlier, an absolute requirement for sustainability is that the managers of enterprises are accountable to the enterprise owners (in this case, the state), that the owners set up clear performance objectives, and that the owners are able to monitor the performance of their enterprises. Besides imposing strict discipline on SOEs, including willingness to fire managers that do not meet their performance objectives and a credible commitment to let loss-making firms go bankrupt, it is necessary to establish some degree of competition in the industrial sector. In addition to the competitive pressure needed to motivate enterprise managers, competition provides some points of reference that make it easier for the owner to set up reasonable performance objectives for the firm. This is particularly important in a scenario where industry is dominated by a few monopolistic conglomerates. Since the conglomerates will yield significant market power on input as well as output markets, prices are unlikely to reflect demand-and-supply conditions, and the financial results are not likely to be good indicators of economic performance.

Given that it will be impossible per definition to provide a level playing field for private domestic enterprises in industries that are meant to be dominated by General Corporations, the competition must come from abroad. Hence, some degree of import penetration is probably a prerequisite for effective monitoring of SOEs' performance. However, it would be difficult to determine the appropriate degree of import penetration, and it is not likely that substantial trade liberalization would be possible in the short and medium run. Most of the large SOEs operate in import-substituting sectors, where Vietnam does not have strong comparative advantages. A very significant share of these SOEs would not be able to compete if trade restrictions were removed or significantly reduced within the coming five to ten years (Gates 1998). A more limited and notably slower trade liberalization process would therefore be necessary. It would be very hard for Vietnam to combine this strategy with membership in either AFTA or the WTO, which require faster trade liberalization and more comprehensive reforms.

It should be remembered that earlier Vietnamese and international experiences indicate that it may not be possible to fulfill the first condition for sustainable state-led development: upholding a hard budget constraint in SOEs. Apart from the obvious challenges related to incentives and monitoring, the government might also find it difficult to handle the pressure from the concentrated SOE sector, which would make up a very powerful interest group. The lobbying from these interest groups would make it very difficult to reduce trade barriers and to introduce other measures to impose fiscal discipline and hard budget constraints, even if the government had the political will to do so. Hence, to even consider a development strategy based on a strong SOE sector, it is necessary to begin by determining whether it is possible to set the rules for the operations of SOEs – and to implement these rules – independently from the interests of the managers of SOEs. Few, if any countries, have been able to achieve this.

The choice of a strong SOE sector will have implications for the political stability of Vietnam through the effects on regional development and the labor market. Regarding regional development, it appears that the scope for a geographical diversification of industry would be limited in this development alternative. Given the large scale and capital intensity of the SOEs in question, as well as their relatively high demands on industrial infrastructure, it is obvious that the established industrial regions in Vietnam would be the favored investment locations. Demands for a more equitable geographical distribution of industrial investment would probably be made by local authorities in the more disadvantaged regions, but it should be noted that there is a trade-off between regional policy objectives and industrial efficiency. Large, capital-intensive investments in less industrialized regions would face additional costs for infrastructure development, transportation, and communications, and might not be able to meet reasonable performance targets even if costs for land and unskilled labor are lower than in the main industrial areas. Thus, there would be a risk of increasing regional tensions, and it would be necessary to establish more comprehensive programs for the transfer of resources from central to peripheral regions.

Developments in the labor market would probably add to the need for more active regional policies. With focus on large, capital-intensive SOEs, industrial sector employment could not grow enough to absorb more than a limited share of the new entrants to the labor market. However, the skill demands for new jobs in the capital-intensive SOE sector are relatively high, which would put pressure on the educational system, in particular higher technical education. The combination of high capital-intensity and high skill requirements would also result in relatively high physical labor productivity in SOEs, and relatively high wages for those entering the industrial sector. Consequently, the majority of the labor force would face significantly lower earnings, mainly in urban services, the informal industrial sector, or in agriculture. It is possible that this emerging duality in the labor market could cause some social tensions, an evil that Vietnam has largely been able to avoid.

Locally controlled SOEs

An alternative scenario for state-led industrialization could involve the establishment of many relatively independent, locally controlled SOEs in each industry. This alternative, which bears some resemblance to the situation in Vietnam prior to the establishment of General and Special Corporations in 1995 and to the Chinese township and village enterprise (TVE) sector, would make it possible to avoid some of the efficiency problems inherent in the strategy focusing on large monopolistic SOEs. An industrial environment with competition between many smaller SOEs would promote higher allocative and productive efficiency for several interrelated reasons. First, a geographically diversified SOE structure would make economic policy-making less complicated, since the political influence and bargaining power of individual SOEs would be reduced. Consequently, reforms such as trade liberalization would meet less organized resistance. Second, focusing development on local and regional SOEs would facilitate an industrial diversification of the SOE sector. Only a limited number of these enterprises would find it possible to enter into import-competing sectors with high capital and technology requirements, and most would instead operate with technologies that are better suited to Vietnam's factor endowment. The resulting allocation of resources would be more efficient, and would also facilitate an increasing export orientation. Third, competition between SOEs would force the firms to reduce slack and inefficiency, and would simplify the monitoring task of local authorities.

Both regional development and labor markets would look very different in a situation with many competing SOEs instead of a few large General Corporations. With a large number of locally controlled SOEs, industrial development would exhibit a more diversified geographical pattern. The character of industrial development would probably also differ between regions, depending on local conditions. In particular, it could be expected that the more modern and capital-intensive industries would be concentrated in major industrial centers, like Ho Chi Minh City and Hanoi, while other areas would focus on simpler and more labor- and resource-intensive sectors. This might cause some regional tension, but certainly to a lesser extent than in the previous scenario, where most regions would be left almost without any industry. The tensions in the labor market would probably also be less serious than in the previous alternative, since more employment would be created through the promotion of smaller and less capital-intensive firms. These advantages would be important from the point of view of political and social stability.

While the strategy with competing state-owned firms is, in many respects, more attractive than that based on monopolistic General Corporations, it is also important to note that some problems would remain. First, management incentives and monitoring of performance would still be less efficient than in a market economy. The managers of locally owned SOEs would still be accountable to politicians rather than to shareholders, and would probably face multiple performance objectives. In addition to profit maximization, objectives might include maximization of employment or wages, as well as maximization of turnover or local taxes. Second, it is likely that SOE management would have some influence over local policy-making, perhaps to the extent that budget constraints would not be entirely hard. Third, local decision-makers might be tempted to reduce local competition, e.g. by introducing local and regional trade barriers. All of these distortions would reduce efficiency and productivity, but to a lesser extent than comparable distortions at the central level. The reason is that the resources controlled by local authorities, as well as the policy instruments available to local authorities, are more limited in size and scope than those at the command of central authorities. While the central government may influence fundamental variables, such as exchange rates, interest rates, and trade barriers, the range of local decision-making is generally limited to local taxes and regulations. The distortions caused by inappropriate local decision-making would therefore be significantly smaller than those caused by successful lobbying at the central level. At the same time, it is likely that a strategy based on locally controlled SOEs would require the central government to monitor development in the various regions, and to intervene in order to remove any local trade restrictions that may emerge. Moreover, it is conceivable that a decentralized system would allow some beneficial institutional competition. The regions and provinces with the most appropriate local policies would be relatively successful, and attract resources from regions with more restrictive policy environments. This might facilitate a more general diffusion of policies and institutional solutions that are appropriate for the Vietnamese environment.

On a cautious note, it is also useful to remember that there is very limited international experience of economic development under the leadership of locally controlled SOEs. The only reasonably successful example is the Chinese TVE sector, and it is uncertain whether this alternative is a sustainable strategy for long-term development. In particular, problems may occur as industries mature and domestic competition becomes fiercer. This typically requires industrial restructuring, but the necessary changes may be hard to achieve if local politicians and SOE managers are unwilling to relinquish their positions. Hence, although this scenario probably outperforms the alternative with large, centrally controlled SOEs, it is still unlikely to match the performance of an economy based on market-oriented private enterprises.

Supporting private enterprises

Although the state sector has played an important economic role in many countries, it is notable that no economy has been able to achieve stable long-run growth with reliance only on the state sector. Instead, competition and private enterprise have been important in all countries that have succeeded in generating sustainable economic development. The generally superior performance of private firms operating in competitive markets is largely explained by the hard budget constraints facing these firms. As discussed earlier, the objective of a private enterprise is to generate profits for its owners. Only those enterprises that generate acceptable profits survive in the long run, and only those enterprises that operate efficiently manage to generate acceptable profits in a competitive market.

Before turning to two scenarios for creating a strong private sector, it is important to note that neither alternative presumes a weak state. On the contrary, the state sector is expected to hold a central role in several areas. Apart from the provision of public utilities, such as water, gas, electricity, and other infrastructure services, the state will be responsible for setting the rules of the game. The private sector will not be able to generate sustainable growth unless the state establishes appropriate economic institutions and defines the various rights and responsibilities of the actors in the economy. In some cases – such as market failures due to monopolies or externalities – this may involve direct interventions to influence the allocation of resources. In these cases, it is desirable that the state is strong enough to withstand pressure from various lobby groups that may try to influence the decision-making process to further their own interests. Moreover, the state must take responsibility for equity and income distribution. Given an appropriate institutional framework, a market economy with private firms can be expected to yield an efficient allocation of scarce factors of production. If the resulting distribution of income and wealth is not politically or ideologically desirable, the state will have to take on the task of redistributing resources in an efficient manner. Hence, successful development will require a strong state even if the state withdraws from the direct production of goods and services.

Supporting the emergence of new private firms

Although official Vietnamese statistics suggest that the private sector accounts for some 60 per cent of GDP, it would be incorrect to assume that the modern private sector is presently a serious competitor to the SOEs. Private industry of the kind found in market economies, consisting of limited liability and joint-stock companies, is still embryonic and accounts for no more than about 1 per cent of GDP (Riedel and Tran 1997). Altogether, these companies represented some 8 per cent of the registered capital and 12 per cent of the employment in the manufacturing sector in 1995.[6] Meanwhile, family farms, household firms, and sole proprietorships accounted for the bulk of the Vietnamese private sector.[7]

To achieve a stronger and more modern private sector that will contribute to the industrialization of Vietnam, it is obvious that the number and size of private industrial firms must grow. Some of this growth may occur through the privatization of SOEs – we will shortly discuss the possibilities to pursue this alternative – but it is also necessary to support private entrepreneurship and the emergence of entirely new private firms. The most important policy measures to support this objective require neither massive resource investments nor technically complicated interventions in the markets. Instead, the most important requirement is conceptually simple: to establish a level playing field for private enterprise.

Although the need for a private sector has become increasingly accepted during the last few years, it is still clear that SOEs are favored in many ways, and the official signals concerning the future role of private enterprises in the industrialization process have been contradictory (Ljunggren 1997). This uncertainty hampers the growth of private enterprises, not least because industrial investments have long pay-back periods, and few investors are willing to risk their funds in projects that may face unfair competition as well as discrimination from political authorities.

To determine what measures are necessary to achieve a level playing field, it is appropriate to begin by looking at what private investors consider as their main problems. On the basis of interviews with fifty managers of private companies, Riedel and Tran (1997) identify several major problems. First and foremost, private companies in Vietnam are plagued by lack of credit, partly due to alleged discrimination by the banking system. Moreover, virtually all credit extended to the private sector is of short maturity, typically three to six months. Private entrepreneurs are therefore forced to turn to informal markets, where the cost of capital is significantly higher than in the formal banking system, where SOEs are preferred customers. Recently, government directives releasing SOEs from formal collateral requirements and calling for more long-term capital to be allocated to the SOE sector have highlighted the favorable treatment of SOEs.

Second, Vietnamese law does not recognize land ownership – only the right to use land – and imposes limitations on the transfer of land. This benefits old companies, that are almost exclusively state-owned, and constitutes a serious obstacle for the development of new private firms.

Third, trade regulations make up another stumbling-block for private enterprise. To engage directly in international trade, the certification rules applied in the late 1990s call for a minimum working capital of US$200,000, which effectively excludes most private firms. Furthermore, the allocation of import licenses and foreign exchange is discretionary, and discriminates against non-state companies. Similar complaints are heard regarding the tax system. The complex set of rules includes a multiplicity of taxes and tax rates, and a great deal of discretion is reportedly used in the determination of tax liabilities.

Finally, the general bureaucratic environment is a major obstacle for new firms. Although individuals are free to invest their own money in many business fields, permissions from the state are required to establish, dissolve, or change a business. Apart from being costly and time consuming, the process leaves plenty of room for discretion, and local authorities have ample opportunities to erect obstacles for private firms trying to compete with SOEs.

Any serious attempt to create a level playing field for private enterprises must necessarily address all of these grievances. However, it is clear that this is not a short order, and that piecemeal efforts to revise various regulations, in order to give the same formal rights to private firms and SOEs, will not suffice.[8] Instead, it is necessary to introduce comprehensive institutional reforms and to liberalize important sectors of the economy. For instance, to promote private investment, it will not be sufficient to encourage banks to provide long-term credit to private firms, but it is also important to establish an environment where the creditworthiness of private firms is comparable to that of SOEs. A reduction of bureaucratic red tape, liberalization of trade licensing requirements, reforms of the landholding system, a simplification of tax rules, and a market for equity capital are all necessary complements to formal changes in the banking system. A more realistic exchange rate would also be required to facilitate and support the reforms in other areas, such as trade policy. Without these interrelated changes, it is not possible to determine the value or creditworthiness of private firms, and will not be possible to convince prudent bankers to lend to private firms rather than to SOEs, whose debts may be guaranteed by the state.

Some other consequences of – and prerequisites for – a development strategy with a stronger emphasis on the private sector have already been mentioned. A general deregulation of the economy would be necessary to provide a level playing field for the private sector. This would include a more efficient financial sector with a market for equity capital, trade liberalization, and investment liberalization. These reforms would have a notable impact on the structure of new investment. Instead of the present bias in favor of relatively capital-intensive import-substituting industry, deregulation would stimulate growth in export-oriented sectors where Vietnam has comparative advantages. Some geographical diversification of the production structure would probably take place as a result of the improved export opportunities, but the dominance of the main industrial regions would probably remain, although the polarization between center and periphery would be less pronounced than in the scenario with centrally controlled SOEs. The reason is that the centripetal influences from access to infrastructure, inputs, and skilled labor would outweigh the centrifugal influences of rising urban wages, land prices, and congestion for the foreseeable future. Hence, regional policy would remain an important area for the government.

Regarding developments in the labor market, it would be reasonable to expect more rapid employment creation than in any of the scenarios dominated by the SOE sector. In the absence of public policy interventions, the demand for labor would grow particularly fast in the urban centers, with corresponding increases in the demand for urban infrastructure. This would be another priority area for public policy. Although much of the demand would focus on cheap labor, wage differentials would probably increase, perhaps challenging the distribution objectives of the government. Reforms of the tax system, including transfers, might therefore be called for. Tax reform would also be necessary in order to find alternative sources of budget revenue for the public sector. Profit remittances from SOEs are presently among the largest sources of government revenue, but increasing competition from private firms would lead to a severe fall in the financial surplus generated by the SOE sector. This income source would have to be replaced by more broad-based taxes, such as a value-added tax and perhaps also income taxes.

Privatizing SOEs

It is conceivable that a strategy focusing on the development of a strong private sector could be successful without explicit attention to SOEs. Given that the necessary deregulation, liberalization, and institutional reforms were carried out, it might be possible to let market forces account for much of the subsequent SOE reform. Facing tougher competition from domestic private firms and from abroad, SOEs would have to become more efficient or face long-term losses and eventual bankruptcy. In import-substituting joint ventures between SOEs and foreign investors, the foreign partners would gradually withdraw their investment as trade barriers were reduced, or provide assistance to restructure production towards exports. In either case, the surviving SOEs would face a competitive environment, where the problems related to the control and monitoring of performance would be less serious than if SOEs continue to dominate the economy. Only the state enterprises in industries characterized by natural monopolies would remain unaffected by the changes, and require particular monitoring beyond a requirement to generate an acceptable rate of return on capital. However, SOEs could also play a more central role in the establishment of the private sector. Rather than aiming for a natural adjustment of the SOE sector that is driven by deregulation, liberalization, and market forces, many countries have opted for various schemes to privatize SOEs. The advantages of this alternative are that the public funds invested in state-owned industry can be released for other badly needed uses, and that the restructuring and rationalization of industry will be faster, since privatization brings stronger incentives for the necessary upgrading of technology and management practices.

A cautious *equitization* program has been under implementation in Vietnam since 1992. That year, the National Assembly established a pilot scheme for 'diversifying' the ownership of SOEs. The program aimed to facilitate the mobilization of investment capital, to allow employees to own shares in their enterprise, and to increase efficiency through improved incentives for management and workers. The pilot scheme was extended in 1996, with the issuance of a formal decree on equitization. This decree allows the transformation of non-strategic SOEs into joint-stock companies. The shares of the enterprise are divided among the enterprise's employees, the state, and Vietnamese individuals and organizations – at present, foreigners are not permitted to purchase shares.[9] The employees are allocated 10 per cent of the shares free of charge, and are also offered subsidized credit to finance additional share purchases. In most companies that have been equitized so far, the ownership share of employees has been between 35 and 50 per cent. The government has typically retained 20–30 per cent of the equity (although the government share in one of the equitized firms is zero), while external actors have accounted for 20–30 per cent of the ownership (Freeman 1996). Individual allocations are maximized to 5 per cent of the shares, while the initial ceiling for institutions is 10 per cent. These restrictions apply only for the initial allocation of shares: single shareholders will eventually be allowed to own up to 50 per cent of the companies.

The equitization program has proceeded very slowly and only a few dozen enterprises had completed the process by the beginning of 1998. Yet, it seems that the performance record of the first enterprises to go through the process has improved. Most of the firms have reported significant increases in turnover and profits, compulsory redundancies have been avoided, and the average earnings of employees have increased significantly. The improvements are particularly remarkable because there have been no major changes in management or technology. Instead, the improvements appear to be related mainly to more appropriate incentives for managers and employees, which suggests that the potential for efficiency increases through further equitization are tremendous.[10] Nearly 200 SOEs were registered for equitization during 1997 and 1998 and the objective is to speed up the process in the immediate future.

The relatively slow progress of the equitization program has been due to administrative obstacles, particularly related to the valuation of enterprises and because of uncertainty and weak incentives for the present 'owners' and managers of SOEs. Most SOEs that might qualify for equitization are owned and controlled by local People's Committees and line ministries, and some of these SOEs are major sources for revenue to their owners. It is clear that the incentives for giving up ownership and control are weak if there is serious uncertainty about the valuation of the assets of the enterprise. Moreover, although the state retains an ownership share when an SOE is equitized, this share is no longer managed by the local authorities but by the Ministry of Finance. It is possible that more widespread local support for equitization may require that local authorities are compensated for the possible loss of future income and influence.

A major concern for SOE managers is the loss of various privileges associated with managing a state enterprise. For individual managers, it is clear that equitization can be perceived as a serious threat. Since neither the pay nor the job security of SOE managers have been strictly related to economic performance, it is understandable that some managers tend to resist changes that make them accountable to new owners with tougher demands. Yet, since one of the explicit objectives of the program is to provide stronger management incentives, there is little reason to sympathize with these objections. In fact, a recent decision allows the 'owner' of an SOE to register the enterprise for equitization, rather than requiring the SOE to volunteer itself. At a more general level, SOEs have also enjoyed privileged access to foreign trade licenses, credit, and other resources, and equitization may lead to the loss of these advantages. However, recent reforms have addressed some of these problems. Equitized firms are now guaranteed the same access to credits, imports, and exports as SOEs, and they will also enjoy a 50 per cent exemption from profit taxes for the first two years of operations.

How much of the SOE sector should be privatized? Apart from the provision of some public utilities and activities related to national security, most of the industrial enterprises could in principle be included. However, the present equitization process is limited to 'non-strategic' sectors, excluding basic industries like cement, fertilizer, paper, and steel. General exclusions of this kind are difficult to justify. Reasonable limitations on the scope of privatization should instead be based on current and expected future levels of competition. The impact on efficiency from privatization of industries characterized by limited competition is complex, and it is not always certain that private ownership is significantly better than state ownership. More specifically, if competition has been suppressed by the state, privatization may be desirable if it is complemented by liberalization of markets, whereas privatization of natural monopolies is not likely to yield large efficiency gains. Empirical evidence indicates that reforms of the regulatory framework may be more significant determinants of efficiency than the question of ownership when the industry is a natural monopoly (Molyneux and Thompson 1987).

In spite of the uncertainty regarding the amount of capital involved in a privatization, it is likely that the character of industrial investment, as well as the impact on various policy areas and on political stability, would resemble those in the scenario where policies focus on nurturing the emergence of new private firms.

Concluding remarks

Recent economic developments in Vietnam have revealed some deeply rooted structural weaknesses – primarily related to a contradiction between the low competitiveness of the import-substituting SOE sector and the challenges posed by increasingly tough international competition. Structural changes of the Vietnamese economy in general and the SOEs in particular seem to be unavoidable. Essentially, the choice is one between increasing controls and regulation to isolate the economy from changes that are not initiated by Vietnamese decision-makers, or reducing controls and liberalizing markets to allow individual consumers and producers to adjust more flexibly to these changes.

In this paper, we have discussed four scenarios for the role of the state in this era of change. Although we have departed from the relationship between the state and the private sector, we have not only discussed whether the state sector should be small, medium, or large. Determining the role of the state and the SOEs also determines how much central control and individual freedom – or how much regulation and liberalization – are desirable in order to achieve the best possible results in each case. Clearly, our first scenario, with development based on large, centrally controlled SOEs, is also the one that requires the highest degree of central control and central decision-making. It is also the scenario with the bleakest economic prospects. Although Vietnam could undoubtedly achieve some industrialization and modernization focusing on centrally controlled SOEs, the opportunity costs would most certainly be enormous. The other alternatives would generate stronger economic performance. Scenario two, based on locally controlled SOEs, would require significant decentralization of decision-making, while scenarios three and four, where development is based on a strong private sector, also call for comprehensive liberalization and deregulation.

Although it is not reasonable to assume that any of the four scenarios could be fully realized in the medium term, it is important to set priorities. The reason is, of course, that a consistent policy framework is hard to establish unless the desired development path of the economy is known. In practice, it will not be possible to avoid compromises, but it is necessary to know the general direction of policies in order to avoid fundamental contradictions and inconsistencies. The last few years have demonstrated many such inconsistencies, partly because of pressure brought about by the Asian crisis, although the general direction of Vietnamese development has probably still been toward increasing market orientation. It is likely that many of these recent reforms would have been more efficient if consumers and investors, domestic as well as foreign, had been sure that this is also the desired direction of future reforms.

Acknowledgements

This study is inspired by our work for the Swedish International Development Cooperation Agency (SIDA). We would like to thank Björn Larsson, Börje Ljunggren, Ray Mallon, Nguyen Quang Ngoc, and Robert Glofcheski for valuable comments on earlier versions of the paper.

Notes

1 Riedel (1997: 61) estimated the need for foreign capital between 1996 and 2000 to twice this figure.
2 Wholly or partly foreign-owned firms were reported to account for about 13 per cent of GDP and 22 per cent of gross industrial output in 1995 (CIEM 1997). In 1998, foreign investors reportedly accounted for 32.8 per cent of industrial output (CIEM 1999). See Mallon (1996, 1997) for other reasons why Vietnamese SOEs (unlike SOEs in many other transition economies) have been able to maintain a dominant position even after the introduction of economic reforms.
3 Here, it is again relevant to note that Prime Minister Phan Van Khai's opening speech to the tenth assembly of the parliament in 1997 emphasized the need to reform SOE management and to establish hard budget constraint for most state enterprises.
4 The General Corporations are established under Prime Minister's Decision No. 91-TTg, dated 7 March 1994, while the establishment of Special Corporations is based on Decision No. 90-TTg of the same date.
5 See Decision 91-TTg (7/3194), 'Pilot Work to Establish Business Groups'. See also Mallon (1996) and Akiba (1998).
6 More recent figures are, unfortunately, not available.
7 Private firms are of more importance in the service industry where they constitute the bulk of production growth.
8 Failures of previous piecemeal reforms in Vietnam are described in Probert and Young (1995).
9 According to information from the Equitization Committee, rules for foreign participation in the equitization process are still under discussion. One of the central questions concerns the ceiling for foreign ownership – apparently, the maximum limits discussed range between 30 and 49 per cent, depending on the sector.
10 As a caveat (suggested by an anonymous referee) it should be noted that some of the reported improvement may be exaggerated by the authorities, since they may want to secure further extensions of the equitization program by demonstrating good results.

References

Akiba, M. (1998) 'The concentration of state-owned enterprises and the role of internal capital transactions in general corporations: the case of textile and clothing industry in Vietnam', *MOCT-MOST* 8: 97–121.

CIE (1997) 'Vietnam's trade policies 1997', Centre for International Economics, Canberra and Sydney.

CIEM (1997) 'Vietnam's economy in 1996 – a policy analysis', mimeo, Central Institute of Economic Management, Hanoi, January.

—— (1999) 'Vietnam's economy in 1998 – a policy analysis', mimeo, Central Institute of Economic Management, Hanoi, May.

De Lestrange, A. and Richet, X. (1998) 'Economic reform and behaviour of state-owned enterprises in Vietnam', *MOCT-MOST* 8: 77–95.

Freeman, N. J. (1996) 'The role of "equitization" in Vietnam's reform of state-owned enterprises', *Communist Economies and Economic Transformation* 18: 217–35.

Gates, C. L. (1998) 'Vietnam's accession to the ASEAN free trade area: effects on trade and industrial competitiveness', *MOCT-MOST* 8: 45–75.

IMF (1996) 'Vietnam – recent economic developments', mimeo, IMF, Washington, DC.

Kokko, A. (1998) 'Vietnam, ready for doi moi II?', *ASEAN Economic Bulletin* 15: 319–27.

—— (1999) 'Trade and industrial policy reform in Vietnam: the challenge of continuous change', in C. Brundenius and J. Weeks (eds) *Globalisation and the Future of Third World Socialism – Cuba and Vietnam*, Basingstoke: Macmillan.

—— and Zejan, M. (1996) 'Vietnam 1996: approaching the next stage of reforms', Macroeconomic Report 1996: 9, Sida, Stockholm.

Le Dang Doanh (1996) 'State-owned enterprise reform and its implications for industrialization in Vietnam', paper presented at Senior Policy Seminar on Industrialization and Integration: Vietnam and the World Economy, Hanoi.

Ljunggren, B. (1997) 'Vietnam's second decade under doi moi emerging contradictions in the reform process?', in B. Beckman, E. Hansson and L. Roman (eds) *Vietnam: Reform and Transformation*, Stockholm: Center for Pacific Asia Studies.

Mallon, R. (1996) 'State enterprise reform in Vietnam: policy developments, achievements and remaining constraints', paper prepared for the Asian Development Bank, mimeo, Hanoi, May.

—— (1997) 'Mapping the playing field: options for reducing private sector disincentives in Viet Nam', paper prepared for the Swedish Embassy in Hanoi, mimeo, Hanoi, November.

Molyneux, R. and Thompson, D. (1987) 'Nationalised industry performance: still third-rate?', *Fiscal Studies* 8: 48–82.

PIP (1996) Public Investment Program, 1996–2000, Prime Minister's Decision No. 2920/QHQT, 18 June, Hanoi: Socialist Republic of Vietnam.

Probert, J. and Young, D. (1995) 'The Vietnamese road to capitalism: decentralization, de facto privatization and the limits to piecemeal reform', *Communist Economies and Economic Transformation* 7: 499–525.

Riedel, J. (1997) 'The Vietnamese economy in the 1990s', *Asian Pacific Economic Literature* 11: 58–65.

—— and Tran, C. S. (1997) 'The emerging private sector and the industrialization of Viet Nam', report on the project The Emerging Private Sector and the Industrialization of Viet Nam, Hanoi: VCCI.

UNDP (1996) *Catching Up: Capacity Development for Poverty Elimination in Viet Nam*, Hanoi: UNDP and UNICEF.

Vietnam Economic Times, various issues.