

I. INTRODUCTION

12. In March 2000 the Asian Development Bank (ADB) adopted a Private Sector Development Strategy (PSDS), to articulate how private sector development (PSD) will be supported in order to provide the economic and employment growth needed to achieve ADB's overarching objective of poverty reduction in Asia. To implement the PSDS, Private Sector Assessments (PSA) are to be formulated for each developing member country (DMC). This paper presents the PSA for Viet Nam.

13. The PSA begins with a profile of the private sector in Viet Nam: its typology, contribution to the economy, its role in the infrastructure sector and its contribution to poverty reduction. It then analyzes the principal constraints to its development (section III) and reviews current donor activities in support of PSD (section IV). Based on this analysis, it recommends (Section VI) a focus for future ADB operations in Viet Nam during the 2006-2008 period, to be implemented through the new Country Strategy and Program.⁵

II. THE PRIVATE SECTOR IN THE MACROECONOMIC ENVIRONMENT

A. Overview of Macroeconomic Environment

14. Viet Nam is a country of about 80 million people, the majority (approximately 76%) of whom live in rural areas. Although still one of the poorest countries in the region, Viet Nam has made steady progress toward adoption of a market-oriented economy (through Doi Moi or economic renovation since 1986) and has achieved rapid economic growth. Viet Nam's average gross domestic product (GDP) growth rate (7.7%) during the 1990s marked the second fastest growth in the region, after the People's Republic of China (10.1%).⁶ In 2003, Viet Nam posted a GDP growth of 7.1%, which is expected to repeat in 2004. Per capita GDP increased from \$361 in 1997 to an estimated \$455 in 2003 (Table 2). Although the share of foreign direct investment to GDP declined recently, exports have continued to rise. Gross domestic savings and capital formation also increased during the period.

15. The investment to GDP ratio rose to 35.1% in 2003 and 35.8% in 2004, compared with 27% of GDP in 1999. The share of domestic private sector investment - including both investments by individuals and by private companies - within total national investment has increased progressively in recent years from 20 percent in 2000 to an estimated 27 percent in 2003. Investment by domestic private companies registered under the Enterprise Law has now surpassed that of state-owned enterprises (SOEs) and nearly reached the level of SOE investment combined with

Table 1: Investment Trends 2001 - 2010

	2001-2005 estimates (VND trillion)	2006-2010 Plan (VND trillion)
SOE investment	226.0	336.5-356.0
Private investment	328.5	568.0-607.1
Foreign Direct Investment	206.0	252.7-277.5
Source: MPI, Draft Five-Year Socio-Economic Development Plan 2006-2010, June 2005		

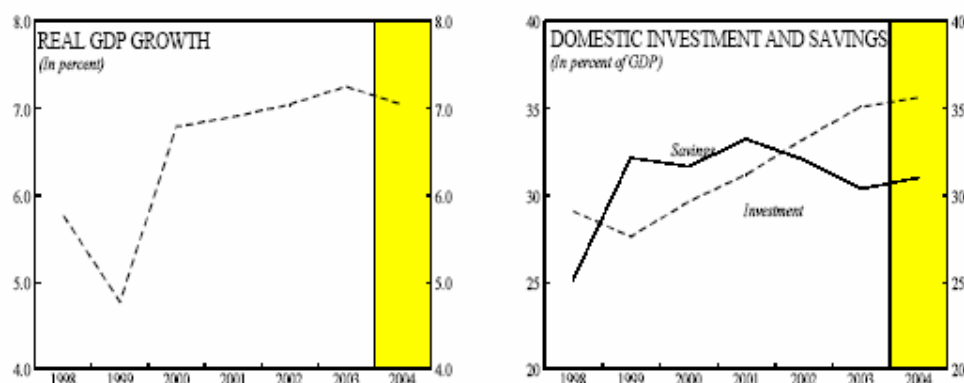
⁵ This PSA was prepared by Laure Darcy and To Dhin Thai, Consultants, with support from Kanokpan Lao-Araya, Head Finance, Trade, Governance, and Private Sector, VRM and Bui Trong Nghia, Financial Sector Officer, VRM. It draws from numerous background papers and field interviews conducted in Hanoi in June/July 2005. The previous PSA, revised in March 2003, was also used as background.

⁶ In comparison, the world average during the period was about 2.7%, while the average for the low-income countries was about 3.3%.

state credit. In some areas, investment by private firms is now the main source of capital for local economic development.⁷

16. Prudent fiscal management has resulted in general macroeconomic stability, an important ingredient for a favorable investment climate. The government has maintained a budget

Figure 1: Real GDP, Savings and Investment Growth 1998 - 2004



Source: IMF Country Report No. 05/148, May 2005

deficit of between 0.1 percent and 2.8 percent over the period 1997-2003, and government debt that is attributable to budgetary expenditures including ODA on-lending stood at 33% of GDP at end 2003. Even if recent bond issues to finance infrastructure and education projects are factored in, as well as recapitalization costs of state-owned commercial banks⁸, the total debt figure to GDP would remain a manageable 36%. Inflation remained in the 3-5% band since 2002, despite volatility in 2004 due to temporary spikes in key food commodity prices.

17. Viet Nam's economic performance has also been remarkable in terms of poverty reduction. According to the 2002 Viet Nam Household Living Standards Survey, 29% of the population had expenditures below the poverty line in 2002, down sharply from 37% in 1998 and 58% in 1993. Geographic disparities persist, with the southern half of the country generating a much larger share of GDP than the northern half, and rural provinces generally poorer than urban ones.

18. Strong export performance has been a major driver of growth. During 1997-2003 exports grew at an average annual rate of 14 % in value terms and now amount to approximately 55% of GDP. Exports grew by 21 percent in 2003, with garments recording the highest increase at 45%

Table 2: Comparative Average Income by Region

Per Household per month	Average income 2001 (VND1,000)	Average growth 1999-2001 (%)
Whole country	331	6
<i>By region</i>		
Red River Delta	337	9.6
Northeast	259	-
Northwest	212	-
Northern central region	239	6.1
Coastal southern central region	331	14.4
Central Highlands	269	-10.4
Southeast	490	-3.9
Mekong Delta	371	4.2

Source: Preliminary results of 2002 Household living standards survey

⁷ In Ho Chi Minh City, for example, private enterprises accounted for 38% of total investment in 2002, higher than the combined total of investment by both SOEs and the state budget (36.5%)

⁸ SOCBs have received a combined capital injection of about VND10.9 trillion as part of their restructuring plans; this recapitalization has largely been in the form of 20-year government bonds carrying a coupon of 3.3 percent

and generating as much foreign exchange revenue as crude oil. Rapid export growth has been aided by bilateral and regional trade agreements that came into effect during this period, most notably the ASEAN Free Trade Area (AFTA) and the US Bilateral Trade Agreement.

Table 3: Basic Economic Indicators

Item	1997	1999	2000	2001	2002	2003
Population	74.3 million	76.6 million	77.6 million	78.7 million	79.7 million	80.9 million
GDP per Capita	\$361	\$369.2	\$395.5	\$403.8	\$426.0	454.8 ^b
GDP Growth ^a	8.2	4.7	6.1	5.8	6.4	7.1
Agriculture (%)	25.8	25.4	24.5	23.2	23.0	21.8
Industry (%)	32.1	34.5	36.7	38.1	38.5	40.0
Service (%)	42.2	40.1	38.7	38.6	38.5	38.2
Exchange Rate (D per \$1)	11,683	13,944	14,168	14,800	15,280	15,732
Export (\$ million)	9,185	11,541	14,448	15,029	16,706	20,176
Import (\$ million)	10,432	11,742	15,637	16,218	19,745	25,227
Labor Force (million)	34.5	36.0	36.7	37.7	40.5	41.2
Agriculture (million)	23.6	24.1	24.3	24.5	23.3	23.1
Industry (million)	2.9	3.1	3.2	3.3	4.2	4.6
Service (million)	7.8	8.6	9.0	9.7	12.7	13.2

GDP = gross domestic product.

^a Refers to annual percentage change.

^b Staff estimate.

Source: ADB. 2004. *Key Economic Indicators – Viet Nam* (www.adb.org/statistics);

IMF. 2003. *Viet Nam: Country Report – Statistical Appendix*. Washington, D.C.

19. One of the most striking features of Viet Nam's rapid growth is the rise in the industry sector, which grew by 8% in terms of share of GDP between 1997 and 2003. Industry represented 40% of GDP in 2004, yet it is important to note that growth in output in the sector has not been accompanied by a commensurate rise in employment. Agriculture, despite its recent decline, remains the top employer of the Viet Namese labor force.

20. Viet Nam's economy is at first sight extremely open, with exports and imports combined equivalent to over 90% of GDP⁹. Quantitative restrictions were adopted in the past when needed to maintain the balance of payments at acceptable levels. They should be largely phased out in line with the PRGF agreement with the IMF. Finally, it must be pointed out that, for its level of per capita income, Viet Nam has a higher cost structure due to high personal income tax rates, high rental cost or valuation of land, and high transaction costs due to red tape and cumbersome regulations. These factors and the high degree of protection granted to certain industries have tended to skew foreign invested activities towards import substitution in more capital-intensive sectors rather than light industrial production for export markets. Ratification of the bilateral trade agreement with the United States should result in significant opening of the Vietnamese economy, particularly in the services sector.

21. Overall, Viet Nam's strong economic growth rate, coupled with its high savings and low public debt rate should allow it to weather future dips in private investment. Public investment in the enterprise sector has historically generated fewer jobs and returns than private investment, however, so despite the government's fiscal headroom to contract additional debt, borrowing should be strictly focused on those investments which have no prospects for private sector participation. This can include selected infrastructure investments as well as modernization of health and education services.

⁹ This high ratio is partly explained by the fact that Viet Nam exports crude oil and imports refined oil products, but even excluding these trade flows the ratio is over 70%. Most of the non-energy exports are still agricultural commodities (rice, coffee, tea), with a growing share of light industry (garments, leather and footwear, electric and electronic goods) while imports are essentially intermediate inputs, machinery and equipment.

B. Critical Trends and Issues

22. A number of critical trends and issues are shaping the direction and pace of Viet Nam's economic reforms. Perhaps the most important of these is the need to create jobs for the estimated 1.5 million new job seekers every year¹⁰. Public investment levels, although rising, are not sufficient to support this expansion, so more rapid PSD will be needed. Moreover, continued reform and downsizing of the public sector will mean that its share of the total workforce (10.4% in 2003) will continue to decline, making the private sector the only viable option for job seekers. The majority of Viet Nam's enterprises are microenterprises producing/selling low value-added goods and services into their local markets.

23. A second significant factor shaping Viet Nam's economic reforms is its planned accession to the WTO. Preparations have been underway over the past 5 years, with direct impact on the revision of tariff levels and regulatory reforms designed to make Viet Nam's markets more open to foreign investment. Free trade agreements have already been signed with ASEAN (AFTA), the European Union and the United States (BTA), so that harmonization of the requirements in each of these agreements (particularly commitments providing market access to US firms ahead of other FIEs) remains a key challenge. Beyond these issues, the requirement to increase market contestability is proving to be one of the most difficult to implement, as SOEs still dominate the economy and receive preferential access to finance, land and information resources.

24. As a result of these agreements, trade has fueled growth over the past 4 years, led by the textile and garment sector. Private sector investment rates have risen, with investment levels by domestic private companies registered under EL now surpassing that of SOEs¹¹. Most new jobs have also come from the private sector (private companies and household businesses) which has created between 1.6-2 million jobs since 2000.

25. Despite notable reforms to simplify the investment environment for business, Ministries and state agencies continue to promulgate legal regulations emphasizing control, pre-checking, and restrictions on business. Biases against the private sector for access to land, credit, allocation of quotas and participation in public investment projects persist. Addressing these constraints so that the private sector can grow in size and value-added remains a key development challenge for Viet Nam.

Progress on World Trade Organization Accession

Viet Nam applied for WTO membership in January 1995 and is among 25 countries seeking accession. Viet Nam's 10th and most recent WTO Working Party meeting was held on 20 May 2005. At this meeting, new Working Party Chairman Eirik Glenne urged Viet Nam to complete bilaterals in the "next couple of months" if it were to hope for accession in December 2005.

Eight new commitments and developments were presented by the Vietnamese side including a proposed revision of excise duties to end discrimination against imported motor vehicles; a similar proposal for excise duty on beer; the elimination of export performance subsidies; a commitment to require supported products made in free zones to be subject to normal customs formalities when entering Viet Nam; the setting up of TBT and SPS enquiry points; the extension of trading rights with exceptions for sensitive products such as petroleum, pharmaceuticals, sugar, tobacco, salt, fertilizers, rice and cultural products; and the streamlining of import licensing procedures. The Secretariat also received a series of draft laws, including the draft Commercial Law, the draft Amendments to the Customs Law, the draft Law On the Conclusion, Accession and Implementation of International Treaties, the draft Law On E-Transactions, the draft Common Investment Law, Part VI of the draft Law On Intellectual Property Rights and Technology Transfer", the draft Intellectual Property Law, and a document comparing the draft Law on Export and Import Duties to the Provisions of the existing Law on Export and Import Duties.

Source: US-Viet Nam Trade Council Education Forum, *Catalog of Legal Updates: Viet Nam Trade Policy Regime*, June 15 2005

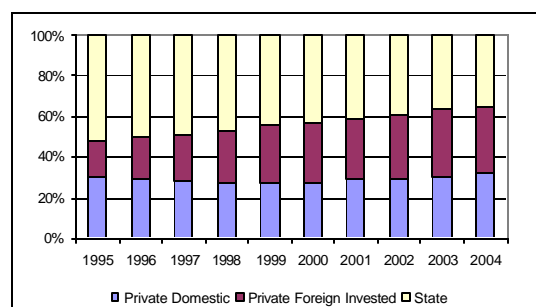
¹⁰ over 50% of Viet Nam's population is under 20 years old

¹¹ In HCM, private enterprises are the main source of investment capital; they accounted for 38% of total investment in 2002, more than the total of SOEs and the state budget (36.5%)

C. Private Sector Profile

26. The growth of Viet Nam's private sector has outpaced the public sector by every measure over the past 10 years (output, investment, employment), buoyed by the expansion of international trade and tangible improvements to the investment climate. While the private sector now accounts for over 50% of GDP, 27% of total invested capital and more than 90% of the total workforce¹², its potential for wealth creation is still largely undeveloped, as Viet Nam remains one of the lowest per capita income countries in SE Asia.¹³ Key reasons for this relative underdevelopment are discussed in section III below. Viet Nam also maintains a large informal/shadow economy, which analysts estimate at between 16-50% of the formal economy¹⁴. If one were to add this informal GDP to the official figure, the percentage of total GDP generated by the private sector would be somewhere between 57-67%. Incentives to remain informal persist, from discriminatory tax rates and regulations to costly licensing and permit regimes in the formal sector. These factors are discussed in more detail in section C.6 below.

Figure 2: Growth in Manufacturing Output 1995 - 2004



Source: World Bank, Vietnam: Investment Climate Assessment. Draft August 2005

27. A profile of the private sector must begin with a definition. This PSA defines the private sector as all individuals or groups of individuals who invest or use private capital to produce or trade goods or services. In Viet Nam, this definition therefore includes both formal and informal enterprises and collectives, domestic and foreign. It does not include state-owned enterprises or joint-stock companies majority-owned by the state. The formal private sector is defined as all enterprises which have a business registration certificate and tax code, including some household non-farm businesses¹⁵. All businesses operating without registration certificates and/or tax codes, including farm-based businesses¹⁶, are considered informal.

Table 4: Shares in total GDP and Employment¹⁷

¹² As cited in the Government Report presented by Standing Deputy Prime Minister Nguyen Tan Dung to the 7th Session of the 8th National Assembly May 5, 2005 (reprinted in the Viet Nam Business Forum Report June 1, 2005, p115); these figures include both registered and a portion of unregistered enterprises as estimated by the GSO, which does not include all informal economic activity and therefore understates actual GDP (estimates of actual GDP vary from 116-150% of official GDP)

¹³ IMF (2005) estimated GDP per capita at USD483 in 2003 and projected USD537 on 2004; ASEAN average was USD1266 in 2003; of the 10 ASEAN member countries, only Cambodia, Laos and Myanmar have lower GDP per capita rates than Viet Nam

¹⁴ According to the World Bank/IFC/MPDF Study "Informality and the Playing Field in Viet Nam's Business Sector", 2003, pg15, the share of the shadow economy in GDP increased from 30 percent in 1997 to 51 percent in 2001; informal GDP includes unreported revenues of both registered and unregistered firms

¹⁵ Household non-farm businesses, almost all of which are microenterprises, are required to hold a business registration certificate which allows them to operate in a particular district, yet in practice few apply for the certificate.

¹⁶ Farm-based businesses are not required by law to register

¹⁷ GDP figures include GDP generated by unregistered/informal microenterprises and farms. Estimates derived from the following sources: CIEM (Source: CIEM. 2005. "Kinh te Viet Nam 2004". The Scientific and technical publisher, Hanoi, 2005) reported size of state sector as 39.2% GDP in 2004. CIEM also estimated that the state administrative service accounted for 10.1% GDP in 2003. This paper estimates that SOEs and the state administrative service accounted for 29.2% and 10% GDP respectively in 2004. CIEM (2004) also indicated the non-state sector comprises 45.6% GDP, of which the agriculture sector (both state and private agricultural farms) accounted for 21.8% GDP (The non-state sector comprises of

28. Official government statistics tracking the private sector have typically focused on the non-farm sector and segmented enterprises into 4 major categories: (1) Household (2) Domestic formal private, (3) Collectives and (4) Foreign Invested Enterprises. Statistics are gathered by several different sources¹⁸ which do not always use the same definitions of formal and informal, making detailed analysis difficult. A second segmentation by employee size is also used, with Large (>300 employees and > VND 10 billion of registered capital) and SMEs (<300 employees < VND 10 billion of registered capital). Recognizing that this SME

	Share in GDP 2004	Share in employment 2003	Informality ratio
Large enterprise	23.9%	4.6%	0.0%
<i>Of which SOE</i>	23.6%	4.4%	
<i>Large private</i>	0.3%	0.2%	
SMEs	19.1%	11.6%	not available
<i>Of which SOE</i>	5.6%	1.1%	
<i>SME private</i>	13.5%	10.5%	
Micro enterprises	11.0%	17.4%	69.0%
FIEs	15.2%	2.1%	0.0%
Subtotal Enterprise Sector	69.2%	35.7%	
Farms*	20.8%	59.0%	100.0%
State Administration*	10.0%	4.9%	0.0%
TOTAL	100.0%	99.6%	

Note: Figures with * are from GSO and CIEM, other figures are estimated; ** Informality is a ratio of number of un-registered units to the total. This ratio was calculated based on GSO data for 2002 published in 2004.

grouping is too general to provide useful data for policy formulation, the Ministry of Planning and Investment's Agency for SME Development introduced a further size segmentation in its SME Development Plan 2006-2010, dated June 10 2005. This new segmentation further breaks out the SME category into Micro enterprises (< 10 persons), Small enterprises (10 to 49 persons) and Medium sized enterprises (50 to 299 persons). This PSA profiles the private sector according to this employee size segmentation, and includes a discussion of the informal sector which exists within the Small, Medium and Microenterprise segments. A separate discussion is provided for Foreign Invested Enterprises (FIEs) whose operating environment is significantly different from that of domestic enterprises.

29. As of January 2005, Viet Nam had an estimated 150,000 private registered enterprises¹⁹ with tax codes, 18,000 cooperatives and approximately 800,000 registered non-farm household firms without tax codes. While SOEs continue to represent the single largest contributors to GDP (29.2%), non-farm private enterprises (micro, small and medium) are gaining ground and now account for 24.8%, as illustrated in table 3 below.

30. Despite the rapid growth in the number of registered businesses operating in the country²⁰, Viet Nam still has one of the lowest formal business density ratios in SouthEast Asia.

non-agricultural and agricultural (including fishing and forestry) components). This paper estimates that non-state (or private) agriculture represents 20.8% of GDP, while state agriculture represents 1% of GDP. The non-state non-agricultural sector therefore contributes 24.8% of GDP. Total GDP figure used for 2004 is VND 713 billion; total employment figure used for 2003 is 41.18 million

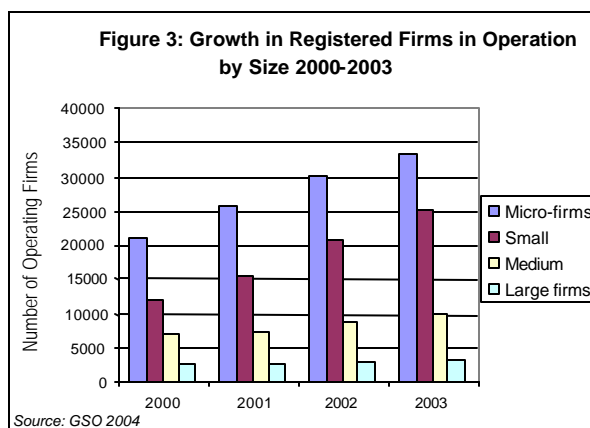
¹⁸ Main sources of data on the enterprise sector is from the General Statistical Office (GSO), the General tax Authority and the Agency for SME Development (ASMED) of the Ministry of Planning and Investment (MPI).

¹⁹ No official Government estimate of the number of registered enterprises as of end 2004 is available; this 150k number is an author estimate based on official figures from the Ministry of Planning and Investment, which recorded 128,878 registered enterprises as of end 2003 and a growth rate of 27,000 registrations per year; it should be noted that the number of 170,000 registered enterprises as of June 2005 cited in MPI's "SME Development Plan 2006-2010", First Draft June 10 2005, pg5 is considered to overstate actual numbers

²⁰ In 2004, as many as 37,230 new businesses were established with total registered capital of

Indeed, Viet Nam's ratio of one registered firm per 470 people is much lower than the average of 1 firm per 20 people in the more developed APEC economies. While this number also reflects the comparatively higher number of unregistered business in Viet Nam vs its APEC neighbors, it underscores the apparent difficulty/unattractiveness of establishing and growing a formal business in the country. An expansion and formalization of the private sector will ultimately result in better resource allocation, as all market participants abide by the same rules and can therefore make more informed investment decisions. Formalization will occur when pro-business regulations are in place, resulting in stronger incentives for compliance, and supported with enhanced Government capacities for enforcement.

31. As is typical in emerging economies, the microenterprise segment has the largest number of formal enterprises and is growing most rapidly²¹. Small and medium enterprises show similar growth trends, while the large enterprise segment has remained flat in terms of numbers of firms. This would suggest difficulty in transitioning from medium to large size, and is also consistent with numerous survey results which illustrate a general reluctance from entrepreneurs to grow their businesses, as larger enterprises are considered to attract more scrutiny from Government officials (tax, inspections, licensing) than those which are smaller.²²



32. The geographic distribution of the private sector is closely aligned with the distribution of wealth in the country, with nearly twice as many private enterprises in the Southern third of the country (27,919 in 2002), where GDP per capita is VND 8,650 million as in the Northern third of the country (15,281 private enterprises in 2002) where GDP per capita is VND 5,180 million²³. Indeed, 11 of Viet Nam's 64 provinces account for over 60% of growth in the private sector and 70% of both revenue and investment. While this geographic disparity can be partly explained by natural economies of agglomeration, where new businesses tend to locate where economic activity is already higher (and physical infrastructure of better quality), several recent studies reveal the importance of provincial government policies and practices in encouraging PSD²⁴. This

VND76,636 billion, a 34% increase in the number of businesses and 32% increase in registered capital compared to 2003. In the first four months of 2005, 10,993 businesses were established, with total registered capital of VND30,201 billion, a decrease of 8.2% in the number of businesses but a 35.2% increase in registered capital compared to the same period the year before

²¹ It should be noted that the introduction of the new Enterprise Law in 2000 greatly simplified the business registration process, reducing its duration from 98 to 7 days on average, and its cost from VND8 million to VND550,000; approximately 136,000 new registrations were recorded over the ensuing 5-year period (2000-2004) with about VND185 trillion (\$12 billion) in investment.

²² A survey conducted in 2003 of 629 private registered businesses in 11 provinces found that tax inspections show a strong and positive correlation to a firm's growth rate (source: World Bank/IFC/MPDF Study "Informality and the Playing Field in Viet Nam's Business Sector", 2003)

²³ GDP figures are for 2003, calculated from: GSO. 2005. "Social-Economic Statistical Data of 64 Provinces and Cities", Statistical Publishing House, Hanoi 2005. Further confirming this point, the UNDP Dec 2003 report "Comparative Provincial Performance in Private Business Development" included a map showing a significant inverse correlation between the number of registered enterprises and the poverty rate in provinces in Viet Nam

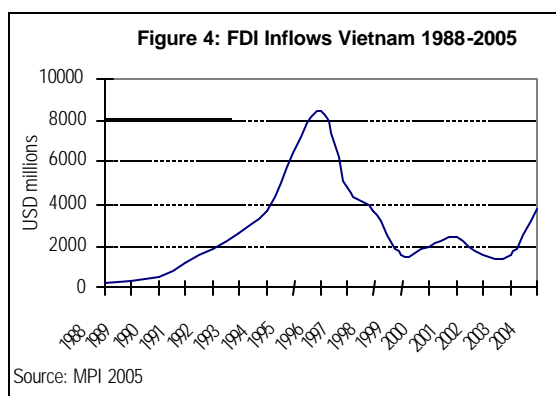
²⁴ These include the USAID-funded Provincial Competitiveness Index (May 2005) and the 2004 "Private Enterprise Formality and the Role of Local Government" Discussion Paper by the ADB-funded Making Markets Work for the Poor project

finding, further discussed in section III below, is supported by the fact that the legal and regulatory framework in Viet Nam is structured to allow a significant level of discretion in implementation. Procedures can be completed slowly or quickly, and complex rules and regulations can be interpreted to facilitate or obstruct private sector activity. In this way the general business climate can be significantly influenced by the provincial authorities who have delegated implementation authority from the center.

33. The following paragraphs profile the main segments of the private enterprise sector: Foreign Invested, Large, Small/Medium and Micro enterprises, describing the general operating parameters of each as well as specific challenges to further development. A short profile of the informal sector (which is composed essentially of microenterprises), is also included to complete the discussion.

1. Foreign Invested Enterprises and FDI

34. The foreign invested sector has grown rapidly during the 1990s, and now accounts for 15.2% of GDP and more than 58% of total exports. Foreign investment enterprises (FIEs) are defined as any firm with foreign capital. Foreign direct investment and FIEs are regulated by the Foreign Investment Law, approved in December 1987, and subsequently amended in June 1990, December 1992, November 1996, and June 2000. Both partners enjoy limited liability. Capital must be contributed by both parties, with the foreign share larger than 30 percent of the actual investment. Since 1986, 100 percent foreign owned enterprises are also allowed, and there have been a number of recent cases of conversion from JV to wholly foreign-owned status. As of 2003, of the 2641 registered FIEs in the country, 71% were wholly-owned foreign firms while 29% were joint-ventures. The number of foreign firms has been growing at a rate of approximately 20% per year over the past 4 years.



35. Although FIEs are more limited in the range of sectors in which they can operate than 100% domestic firms, the Government is making efforts to narrow the gap. For example, Government Decision 260 of May 2002 allowed foreign ownership in non-state enterprises in 35 designated industries, including agriculture, forestry and fisheries, science and technology, education and medicine. Since October 2003, domestic and foreign investors have been allowed to build electricity plants with capacities of less than 100 mw and sell energy directly to local customers, and Law 20 of June 15th 2004 now allows 100%-foreign-owned banks. The proposed new Common Investment Law, currently under preparation, is expected to further open up sectors heretofore closed to foreign investment by giving equal access to foreign and domestic enterprises.

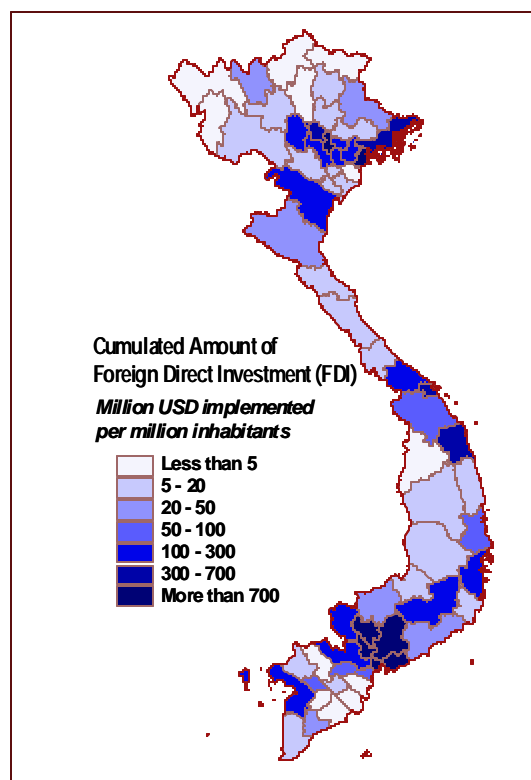
36. Most FIEs are capital intensive and have ten times the labor productivity of the national average. They are predominately active in the petroleum and gas, heavy industry, hotels and tourism and construction sectors. Preliminary surveys²⁵ suggest that their backward linkages to other domestic sectors remain limited. In the coming years, as the Bilateral Trade Agreement with the United States is implemented, FIEs are likely to become a source of competitive pressure to Viet Namese SOEs, forcing them to restructure and become more cost efficient. If this happens,

²⁵ Source: Ari Kokko and Fredrik Sjöholm. 2004. The Internationalization of Viet Namese SMEs. Stockholm School of Economics. April. (see also section 3 below)

the overall efficiency of the Viet Namese economy will improve. Backward linkages to local suppliers should also be strengthened as the manufacturing capabilities of local firms improve.

37. As of July 2005, Viet Nam had attracted a total of US\$ 48.8 billion in investment commitments since the country was opened to foreign investment in 1988, although only 53 % of this has amount has been disbursed to date. After peaking in 1996-1999 at over 4% of GDP, FDI inflows to Viet Nam declined to 2% of GDP in the 2001-2003 aftermath of the Asian Crisis, and recovery has been slow²⁶ (see Figure 4 above). Delays in improving the investment climate, together with intense competition for capital from neighboring China and Thailand have slowed the growth of FDI. Of the total capital commitments made to date, 59% went to the industrial sector (oil and gas, automotive, electronics, construction, garments and foodstuffs), while 33.6% went to the services sector (banking and finance, transportation, telecommunications, hotels & tourism, real estate, EPZ/IPZ development). Most of the foreign investment in the garments and electronics industries have been in labor-intensive and low value-added processing and assembly, providing limited opportunities for transfer of technology or know-how. Indeed now that 100% foreign-owned companies are allowed, more than 70% of new investments are being made in this form rather than through joint-venture with existing local firms (2004 data).

Figure 5: Distribution of Cumulative FDI 1988-2000



Source: World Bank, draft Vietnam Development Report, Nov 2005

38. Most FDI continues to flow to southern Viet Nam, to Ho Chi Minh City and the neighboring provinces of Dong Nai, Binh Duong, Ba Ria-Vung Tau, Binh Phuoc, Tay Ninh and Long An (see Figure 5 above). Based on the most recent breakdowns available from the MPI, the first four of these jurisdictions alone accounted for 74% of FDI in 2003. Five Asian countries (Singapore, Taiwan, Hong Kong, Japan and South Korea) accounted for 63.5% of total cumulative foreign investment projects in Viet Nam and 61.8% of total approved foreign investment capital. US companies, which should be encouraged by the opportunities created by the Bilateral Trade Agreement, seem to be waiting for further improvements to the investment climate, in particular increased legal transparency and the protection of intellectual property rights.

39. While FDI from all sources is expected to increase upon Viet Nam's accession to the WTO, it will be dampened by the unique constraints faced by FIEs in the country. These include:

²⁶ 2005 has seen a material uptick in investment, with 109 new FDI projects registered by March 2005 with a total capital value of \$US 1.3 billion, compared to \$US 420 million in Q1 2004 – a rise of more than 300%. Two mega-projects accounted for \$US 770 million (Hutchison Telecom's \$US 655.9 million Business Cooperation Contract (BCC) with Hanoi Telecom to develop and operate a 3G mobile phone network and service, and a \$US 115 Hanoi real estate project by a Luxembourg consortium), yet even excluding these projects, FDI rose by 28%.

- Inability to mortgage land to secure loans from foreign banks
- Cumbersome procedures requiring all FIEs wishing to import goods for manufacturing to register their import and export plans with an MoT-authorized agency
- Restrictions on FIE activities in selected sectors. For example foreign banks are limited in terms of number of branches and retail operations; foreign insurers are subject to restrictions with respect to products, customer base and compulsory reinsurance ratio; and fixed line telecommunications are the a monopoly of the State. A number of these restrictions will be gradually lifted as the BTA is implemented and Viet Nam prepares for World Trade Organization accession.
- Specific licensing requirements for FIEs which do not apply to domestic enterprises in the same sectors; these licenses add to the cost and risks of doing business as their attribution has in some cases been at the discretion of the licensing authorities²⁷

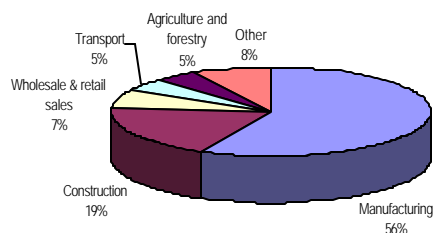
40. In addition to the above constraints applicable only to FIEs, these firms are also particularly affected by the following rules and regulations which apply to all firms in Viet Nam :

- Personal income tax of Viet Namese nationals at very high marginal rates²⁸ (40% for incomes over VND40 million) introduces a barrier to their recruitment, significantly raising skilled labor costs to achieve competitive after-tax incomes. In addition, no firm may employ more than 50 foreign workers or 3% of their total workforce, as per Decree No 105/203/ND-CP
- Comparatively high personal income tax rates of 40% for foreigners earning over VND120 million per month
- Various tax rules which add to the cost of doing business include the application of VAT to exported services²⁹ and the 10% cap on the amount of marketing/advertising expenses can be claimed as a business expense; these all contribute to pushing up the effective tax rate for certain companies to 50-60%, even though the nominal income tax rate is 28%
- Complicated, lengthy and expensive customs processing procedures

2. Domestic Sector: Large Enterprises

41. In 2003, the GSO counted 3,325 large domestic enterprises among the total of 72,012 formal operating firms of the country³⁰, most of which were SOEs. There are very few fully private domestic

Figure 6: Sector Distribution: Domestic Large Enterprises 2003



Source: Based on data of GSO "The real situation of enterprises through the results of surveys conducted in 2002, 2003, 2004", GSO, Hanoi 2005

²⁷ It should be noted that the Government in timeframes for managing the approval process applied, should significantly reduce the time

²⁸ As per Ordinance 14, which became effective

²⁹ While Circular 120/2003/TT-BTC stipulates exported services are defined as only those services difficult to prove by the seller and therefore the 0% rate is rarely applied

³⁰ All numbers of enterprises indicated in this Section taken from GSO's "The Real Situation of Enterprises Through the Results of Surveys Conducted in 2002, 2003, 2004. Statistical Publishing House, Hanoi 2005; MPI reported that by 2005, registered enterprises totaled 170,000

firms in Viet Nam with more than 300 employees. As illustrated in table 3 above, of the 23.9% of GDP generated by large domestic enterprise in 2004, only 0.3% was generated by private companies. The majority of large firms (57.3%) are in the manufacturing sector (see Figure 6 opposite), followed by construction, wholesale and retail sales, transport and agriculture and forestry. As illustrated in Table 5 below, large firms (private and public) made significant contributions to state tax receipts, paying 66.7% of the taxes and fees of the formal enterprise sector.

42. Detailed data on the large private enterprise segment is not readily available, making it difficult to inform policy decisions³¹. What can be inferred from the many private sector surveys conducted over the past several years is that large firms generally appear to face greater scrutiny from tax and licensing officials (generating higher costs), although results vary significantly from district to district. To the extent that land remains in short supply and credit is difficult to obtain without collateral of at least equal value to the loan, large private companies continue to face significant challenges to growth. While insufficient data exists to measure the extent to which competition from state-owned companies (which make up the bulk of the large enterprise sector) represents a serious constraint to large private company growth, the dominance of SOEs in selected sectors of the economy does effectively block the entry of private firms of sufficient size and resources to compete.

Table 5: Selected indicators of the formal enterprise sector 2003

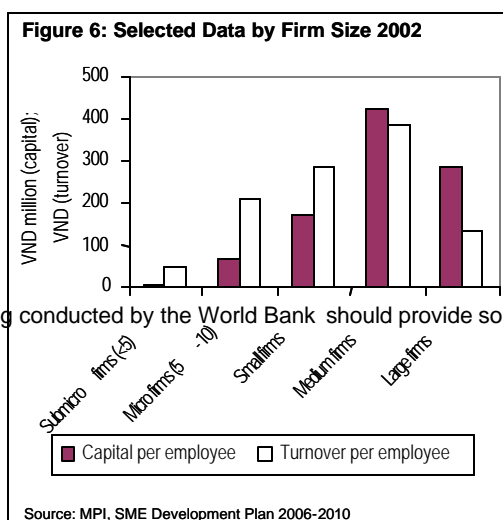
	Unit	Micro firms	Small firms	Medium firms	Large firms
1. Number of enterprises 2003	%	46.6	35	13.8	4.6
2. Employment 2003 (% of total enterprise sector)	%	3.5	10.2	22.6	63.7
3. Average capital per one firm 31 Dec 2003	Bill VND/1 firm	1.41	5.36	34.42	360.91
4. Share in the total capital of the firm sector	%	2.7	7.8	19.8	69.6
5. Average taxes & fees paid by one firm	Bill VND/1 firm	0.095	0.294	2.629	22.097
6. Share in the total taxes & fees paid	%	2.9	6.7	23.7	66.7

Source: "The real situation of enterprises through the results of surveys conducted in 2002, 2003, 2004". Statistics Publishing House, Hanoi 2005; and "The real situation of enterprises through the results of surveys conducted in 2001, 2002, 2003. Statistics Publishing House, Hanoi 2004

3. Domestic Sector: Small and Medium Enterprises

43. The small and medium size firm category (firms with between 10-299 employees) continues to grow in number, from 18,828 units in 2000 to 35,158 units in 2003

³¹ the Investment Climate Assessment currently being conducted by the World Bank should provide some useful data to focus in on this subsegment



and over 45,000 in 2005³². Private SMEs represent the largest segment of the enterprise sector in terms of contribution to GDP (13.5%), while employing 10.5% of the total workforce, compared to 17.4% for microenterprises. On average, small enterprises employ 19 people, while medium enterprises count 112 employees. SMEs have a high potential for growth, as innovation and increasing levels of invested capital make firms more competitive and help them to gain market share. As is true in most countries, the amount of capital invested and sales per employee in Viet Nam generally increases with the size of the firm. Interestingly, however, medium-sized firms had more capital invested and turnover per employee than large firms, indicating that the SOE sector, which dominates the large firm segment, has very low productivity. This finding is further supported by the fact that large companies had on average 4.5 times more capital invested per firm than medium enterprises and 73 times more than small firms.

44. SMEs are predominantly involved in manufacturing (31% of registered SMEs), repairing-wholesale-retail activities (24.6%) and construction (19.8%). They have been the focus of the Government's efforts to facilitate private sector development, yet despite their demonstrated dynamism, most still face a host of administrative complications and resource constraints to their continued expansion, most notably a limited access to capital, credit, land and information on market opportunities. SMEs are particularly vulnerable to these constraints as unlike FIEs, they have more limited financial resources and managerial expertise, and unlike the microenterprise and informal sector, they strive to operate within the parameters of existing regulations. Indeed, the difficulty of accessing key resources formally (particularly land and capital) incites many SMEs to operate at the margin:

- Access to land. Many enterprises do not have land use right certificates, if they acquired land use rights in the past, when issuance of certificates and transfer of proof of ownership were not common. Obtaining a land use right certificate or land rent approval is a cumbersome procedure, requiring visits to as many as 20 offices. In addition, land cost and land transfer taxes can be high, while SOEs receive free land allocations. Available land may not have access to adequate infrastructure, unless it is located in industrial parks. The current 35% vacancy rate in the 71 existing industrial parks in Viet Nam suggests that this property does not fully conform to SME requirements for price, location or configuration.
- Access to credit. State-owned commercial banks (SOCB) prefer to lend to SOEs because of the implicit Government guarantee on such loans or explicit "encouragement" by the authorities to do so. Collateral is often a problem, if land has been acquired without all the official registrations requirements, or if the allowable collateral value of land as set by local governments does not reflect market prices, thereby reducing the value of land as a mortgage asset to raise capital. Access to long-term credit is limited. Informal credit from relatives, acquaintances or money lenders is often used for expansion, but the cost can be higher and there are limitations to the amount that can be mobilized and the maturity of such loans.
- Taxation. The complications and occasional conflicts in the tax system, and high tax rates compared to other Asian countries induce private entrepreneurs to opt for presumptive taxation and side payments rather than paying legal liabilities.
- Licensing and inspections. There is still a large number of requirements for sublicenses or certificates, and enterprises are subject to frequent "inspections" and requested to pay fines or service fees for non-compliance

³² This 45,000 number is based on an extrapolation of the MPI 2004 data indicating that 37,099 new business registrations were recorded in 2004 (data does not indicate size breakdown); since 2001, approximately 24% of new business registrations have been SMEs, with the balance being microenterprises and a very small proportion of large enterprises

45. In addition to the resource and administrative constraints listed above, SMEs also suffer from an acute shortage of managerial expertise as well as functioning business linkages to other SMEs and large firms. Few business training resources (academic or on-the-job) were developed within the predominantly state-run economy, so that the skills and experience needed to run competitive medium and large size firms are in short supply. The absence of strong business linkages is fundamentally due to the lack of reliable information on supply/partnership opportunities. This point is well illustrated in the automobile industry in which domestic suppliers provide no more than 2-3% of car value for the FIE manufacturers.³³ Lack of technical capacity and expertise to supply the needed parts leaves SMEs out of the subcontracting opportunities. At a more fundamental level, firms which do have the necessary production capabilities often do not have access to accurate information regarding supply opportunities. The results of another recent survey³⁴ of SMEs also underscores this point: it was found that 65% of SME customers were individuals, with only 20% other SMEs and 9% SOEs.

4. Domestic Sector: Microenterprises (<5 employees)

46. The microenterprise sector is composed of household non-farm enterprises with 10 employees or less. The GSO estimates that there are as many as 2.6 million such microenterprises, only 800,000 of which have registered with authorities³⁵, and an even smaller number of which have tax codes. The microenterprise sector therefore remains largely informal, and is a major employer of non-farm labor. It is estimated that up to 150,000 new microenterprises are added every year, creating 450,000 new jobs. This is approximately as many new jobs per year as are created by SMEs and Large Enterprises combined.³⁶

47. As in most economies, the microenterprise sector is characterized by low productivity. In Viet Nam the ratio of GDP per worker in the non-farm microenterprise sector is even lower than in the farm sector. According to a 2002 GSO census, 60% of microenterprises had only one employee, 38% had between 2-5 employees, and only 2% had 6-9 employees. Most microenterprise employees combine farm and non-farm jobs to secure more stable incomes. The census showed that firms with 5-9 employees generated on average 4 times more turnover per employee than firms with less than 5 employees. Wages per person were also 16 times higher in the larger microenterprises than in the smaller ones.

48. Microenterprises are typically involved in small retail sales, services (especially transport), food processing, garments and wood products. Products are typically sold into local low-income retail markets. They are required to register with district authorities in order to gain permission to operate in a particular district, and are liable for both VAT and income tax. In practice, however, only an estimated 30% obtained registration certificates and tax codes as noted above.

49. The informal nature of most of these firms necessarily limits their access to formal sources of finance. When credit is required, most microenterprises obtain finance informally from family and friends. Firm surveys indicate that microenterprises do not consider lack of finance as

³³ All 11 joint ventures in the automotive industry committed to increase the local content of their products to 30-40% by 2006. However, only Toyota Viet Nam has now reached 13%, the others are at the level of 2-3% (<http://www.moi.gov.vn/News/detail.asp?Sub=71&id=6067>). Only 11 domestic suppliers are acceptable sub-contactors for these 11 automotive joint ventures (<http://saigon.vnn.vn/read.php?id=3982>).

³⁴ Ari Kokko and Fredrik Sjöholm. 2004. The Internationalization of Viet Nameese SMEs. Stockholm School of Economics. April

³⁵ Source: GSO survey: "Results of Establishment census of Viet Nam 2002" indicates that among 2.619,341 non-farm households in 2002 there were only 809,024 (31%) non-farm households that are registered.

³⁶ Source: Ministry of Planning and Investment, "SME Development Plan 2006-2010", First Draft June 10 2005, pg8

a major resource constraint, but rather complain of difficult access to markets and competition. This would suggest the precarious nature of most of these enterprises, as the lack of market information, crowded competitive field and the generic nature of their products are their primary challenges, leaving access to finance to a later stage of growth. Similarly, availability of land or premises to develop the business is often not a major constraint, as most of these enterprises operate out of the family dwelling or attachments. Regulations also pose no difficulties, since most household businesses operate informally. The main challenge for the sector is therefore how to increase the size of its market, a step which could be facilitated through linkages with larger enterprises or traders able to link local production to broader domestic or international demand.

5. Informal Sector

50. Although reliable estimates of the size of the informal enterprise sector are not available, it is commonly accepted that the sector includes approximately 10 million farm households, 1.7 million non-farm microenterprises and an unknown percentage of SMEs. Official GDP figures released by the Government claim to capture the GDP generated by these firms. If one applies a broader definition of informal economy, one should include all business transactions which are not reported to authorities through tax records, VAT or customs receipts. A number of studies and surveys conducted in Viet Nam over the past 5 years have concluded that this informal/shadow economy is quite large, and could add as much as 50% to official GDP figures³⁷.

51. These and other studies³⁸ have found that entrepreneurs make very rational decisions regarding the formalization of their business transactions, based on the sum of perceived benefits minus the costs. Indeed, formalization seems to occur only when the expected marginal benefits of formalization equal the expected risk-adjusted marginal costs. High levels of informality typically occur in environments with high levels of taxes and complex regulations which the governments themselves have difficulty enforcing. Indeed, in a highly formalized economy, rules, regulations and their application are highly predictable and consistent, and compliance with these rules provides net benefits to firms. In Viet Nam, the rules and regulations for doing business remain complex, many treat SOEs, private and foreign firms unequally³⁹. The application of these rules and regulations, moreover, appears to be largely at the discretion of government officials, underscoring the generally weak enforcement capacity. In this environment it is not surprising that many firms seek to conduct at least a portion of their business transactions informally.

52. Informal business transactions involve the sale/lease of products and services (including land), employment and investment. According to a 1999 study by the Institute of Law Research,⁴⁰ approximately 95% of household land in Hanoi is bought and sold outside state law, while the underground market in land-use rights accounts for about 70% of the total market⁴¹. Complex labor laws incite private companies to hire an estimated 20% of their workforce without

³⁷ These include sample surveys conducted by the General Statistical Office (GSO) in 1989, 1992, 1994, and 1996 which estimated the GDP of the informal sector at more than half the size of the formal sector's; and the World Bank/IFC/MPDF Study "Informality and the Playing Field in Viet Nam's Business Sector", 2003, pg15, the share of the shadow economy in GDP increased from 30 percent in 1997 to 51 percent in 2001

³⁸ Including the 2004 "Private Enterprise Formality and the Role of Local Government" Discussion Paper by the ADB-funded Making Markets Work for the Poor project

³⁹ This is particularly the case with marketing expenses whose tax deductibility is capped at 5% of COGS, or punitive income taxes which are imposed for ROE in excess of 20%

⁴⁰ Institute of Law Research. 1999. "The Social Research on Household and Land-Use Rights in Hanoi City in 1998". Hanoi: Ministry of Justice.

⁴¹ Dinh Duc Sinh. 2002. "Some Matters on Land and the Promotion of the Development of a Multi-sectoral Economy." Paper presented at the Hanoi Association of Industry and Commerce conference, Land for Production and Business: Current Status and Solutions, November.

formal labor contracts⁴². According to the World Bank ‘Doing Business’ database, Viet Nam’s score for employment rigidity was twice as high as its regional average (51 compared to a regional average of 24), indicating much higher restrictions on hiring, firing and changing the number of hours that workers can work. Lastly, the unofficial stock market in Viet Nam is thought to involve more than 1,000 companies with a total market value of about \$1 billion, approximately six times as much as the official exchange, according to local investment banks⁴³. All of these informal activities are facilitated by the use of cash as the principal form of payment in the country. According to the U.S. Department of Commerce⁴⁴, more than 50% of domestic business transactions are conducted outside the banking system.

53. While informal business activity can be seen as a positive response to a poor business climate, it ultimately undermines the ability of the economy to rapidly integrate with regional and international partners. Beyond the short-term costs of informal business transactions (which tend to be associated with informal payments to government officials⁴⁵), businesses operating informally restrict their ability to enter into contracts with foreign firms and access finance through formal banking channels. Resource allocation can therefore not be optimized. The more rapid integration of Viet Nam into the world economy, and indeed the more rapid growth of its private sector will necessarily require increasing levels of formalization.

54. To achieve higher rates of business formality, Viet Nam will need to (1) simplify the legal and regulatory framework for business, (2) harmonize its application to all business types (domestic, foreign, public, private), (3) ensure that regulations encourage rather than sanction investment and (4) strengthen the government’s enforcement capabilities. This is not incompatible with maintaining a large population of informal, farm-based businesses which today absorb the majority of the workforce (59%), but it must be recognized that these businesses will not have the capacity to take in the more than 1.5 million new workers entering the labor force every year. Formalization will be gradual and can be largely voluntary, as farm-based businesses, Microenterprises and SMEs with the potential to grow see formalization as a means to access the resources necessary to fuel that growth.

D. Private Provision of Physical Infrastructure

55. Private provision of physical infrastructure is a vital component of an integrated PSD strategy, contributing to three key goals: (1) increasing business opportunities for private sector companies in the construction and operation of physical infrastructure facilities, (2) providing needed finance to leverage public sector contributions, (3) improving the overall competitiveness of the country by reducing transport and communications costs and increasing utility reliability. The following section describes the current service levels and investment requirements in the two major infrastructure subsectors (utilities and transport), legal and regulatory frameworks, sources of finance, extent of current PSP and key constraints to further PSP. A proposed strategy for increasing PSP in each of these subsectors is presented in the recommendations section VI of this report.

⁴² Results from survey conducted by World Bank/IFC/MPDF Study “Informality and the Playing Field in Viet Nam’s Business Sector”, 2003

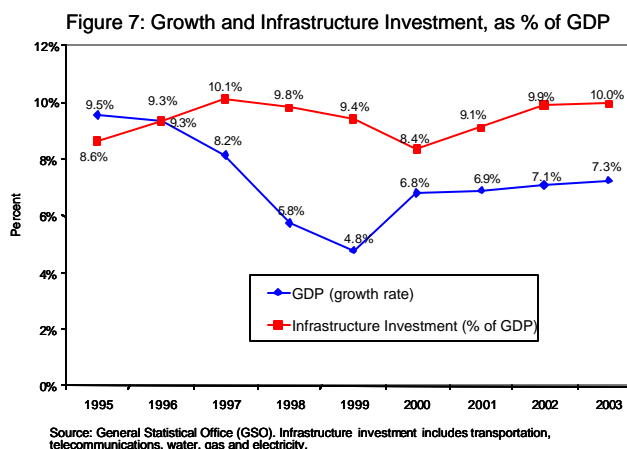
⁴³ Ha, K. Oanh. 2003. “Taking Stocks to the Street: Viet Nam’s Unofficial Stock Market Is Booming.” Mercury News. www.bayarea.com/mld/mercurynews/business/4959959.htm.

⁴⁴ Country Commercial Guide FY2002

⁴⁵ According to the survey conducted by World Bank/IFC/MPDF Study “Informality and the Playing Field in Viet Nam’s Business Sector”, 2003, a 20% reduction in the share of transactions going through banks is associated with a 50% increase in the share of revenues being paid in unofficial payments; moreover, unreported income by public sector officials with households businesses accounts for no less than half of their reported income

1. Current service coverage and investment requirements

56. Viet Nam has made impressive progress in improving its infrastructure over the past decade. Between 1997-2002, the Viet Nameese government directed 44% of total State investment to infrastructure, allowing this investment to consistently outpace GDP growth (see Figure 7 opposite). The result has been comparatively good service coverage levels in all major infrastructure categories: power, water, sanitation and transport. Only in telecommunications does Viet Nam lag significantly behind its neighbors.



57. The rapid pace of economic and population growth continues to put strains on existing infrastructure resources, however, making further investments critical. Power generation is already close to capacity, as are port facilities in Viet Nam's busiest port, HCMC. Transport volumes have been growing at a faster rate than GDP (in terms of tonnes and passengers) on all modes of transport, straining existing infrastructure. Annual investment needs in energy and transport infrastructure alone during 2001-2010 are estimated at \$3.4-3.9 billion⁴⁶ or 6-7 percent of GDP, an amount equivalent to the entire public investment program in recent years. Subsequent Ministerial Decisions⁴⁷ have placed the total even higher, at \$5-7 billion annually, or 15% of GDP at projected +7% annual GDP growth rates. These investment targets represent a 60% increase over average levels since 2000. The scale of these financial requirements is beyond the fiscal capacity of the Government, even with expected contribution of increased user fees, equitization proceeds, new bond issues and ODA loans. The shortfall, which could be as much as \$2.5 billion per year, will need to be mobilized from the private sector in the form of viable public-private partnerships.

58. The following sections detail the service levels and estimated investment requirements in the utilities (power, water/sanitation and telecommunications) and transport (roads, ports, airports and railways) subsectors.

Utilities: Power, Water, Sanitation and Telecommunications⁴⁸

59. **Power:** Although Viet Nam's electrification rate, at 75%, is comparatively high, weak transmission infrastructure leads to losses (13.4%) that are among the highest in the region. Rapid urbanization and industrialization have led to corresponding increases in demand, resulting in peak period outages in 2004 and 2005. According to the Government's Revised Power Development Master Plan V (March 2003), demand for electricity is expected to grow at 15% per year to between 88.5- 93 billion KWh by 2010, almost triple the amount consumed in 2002⁴⁹ and

⁴⁶ \$2.0-2.5 billion annually in the energy sector, and \$1.4 billion annually in the transport sector (World Bank, ADB, UNDP, *Viet Nam 2010 – Entering the 21st Century. Pillars of Development*, Joint Report to the CG Meeting for Viet Nam, December 2000)

⁴⁷ Prime Ministerial Decisions 95 (22 June 2001), 40 (21 March 2003), 158 (11 Oct 2001), 162 (15 Nov 2002) for the power (95 and 40), telecommunications and road/urban transport sectors, respectively. These Decisions and their underlying investment requirements are presented in the individual sector discussions below

⁴⁸ This section largely taken from "Private Sector Participation in Infrastructure" paper presented by Tony Foster at the Viet Nam Business Forum Consultative Group Meeting November 29, 2004

⁴⁹ The state-owned utility (EVN) generated 21.5 billion KWh in the first half of 2005

requiring investments of over \$2.5 bn per year. Total installed generation capacity in 2004 was approximately 9,000 MW. More than 55% of the country's power generation is based on hydro sources, making it particularly vulnerable to periods of drought, as was the case in 2004. The state-owned utility (Electricity of Viet Nam) has 13 projects planned to add generation and transmission capacity, including 9 hydropower plants already under construction. EVN estimates its financing shortfall for these projects at \$3 billion⁵⁰.

60. **Water and Sanitation:** The percentage of the population with improved access to water and sanitation was 77% and 47%, respectively, in 2003⁵¹. As in most countries, access is considerably higher in the major cities than in the rural areas, where current access to clean water supply stands at 48.5%. High levels⁵² of non-revenue water in urban areas point to low efficiencies and poor operating practices. According to Prime Ministerial Decisions, the capital needed for development of the water systems in Hanoi and HCMC alone up to 2010 is around \$2 billion. In order to meet the goal of expanding access to 85% of the rural population by 2010, an estimated \$600 million annually will need to be spent, four times the annual investment over the last 10 years.

61. **Telecoms:** While growing rapidly, the teledensity rate of Viet Nam was still only 14.8% in May 2005. Internet access is even more limited, with only 3.2% of the total population as registered users. The Government is targeting a threefold increase in teledensity to between 32% and 36% by 2010, with mobile phones growing faster than fixed lines⁵³. Decision 158 of the Prime Minister dated 11 October 2001 estimated the capital needed for the telecoms sector between 2001 and 2010 at around \$4 - 6 billion, 60 per cent of which is expected to come from domestic sources, and the other 40% to come from foreign investors.

Transport: Roads, Railway, Ports, Airports

62. Viet Nam's transport infrastructure has developed rapidly over the past decade, with the density of the road network (0.63 km per square km of surface) now similar to that of more developed countries in ASEAN. Many road and rail bridges have been repaired or rebuilt, and port handling capacity has increased to more than 70 million tons per year, almost double the throughput observed five years earlier. Rail traction equipment and rolling stock, however, remain in poor shape. Despite these gains, the current transport infrastructure is inadequate to support the country's high rates of economic growth.

63. The Ministry of Transport estimates the transport sector's investment needs over the 2002-2010 period at VND 790 trillion, 25% of which would go to developing inner city metrorail/trams for Hanoi, Ho Chi Minh City and Danang. The road network would absorb 31%, while the railway would be the remaining big ticket item at 28% of the total.

Table 6. Transport infrastructure Investment Requirements 2002-2020 (Billions VND)

	Mode of Transport Infrastructure	Period 2002-2010	Period 2011-2020	Annual average
1	Roads	245.990	328.530	31.918
	Of which : High ways	56.570	158.530	11.950
	National roads	139.420	125.000	14.690
	Regional roads	50.000	45.000	5.278

⁵⁰ As reported in the Viet Nam News, July 4 2005, pg14

⁵¹ World Bank Development Indicators, 2004

⁵² Estimated at 69% in Hanoi in 1995 and 30% in HCMC in 1998

⁵³ This includes both fixed and mobile phones; if one considers only fixed lines, Viet Nam's current teledensity is only 8%, and is expected to increase by approx one percentage point per year to reach 15% in 2010.

	Mode of Transport Infrastructure	Period 2002-2010	Period 2011-2020	Annual average
2	Railway	218.661	393.576	34.013
	Of which : High railway	204.000	361.500	31.417
	Normal railway	14.661	32.076	2.596
3	Sea transport Infrastructure	20.378	65.000	4.744
4	Internal water transport infrastructure	4.673	4.507	510
5	Air transport infrastructure	17.880	36.330	3.012
6	Urban transport in Hanoi and HCMC	195.886	423.595	34.416
7	Rural roads	86.500	77.850	9.131
	Total	789.977	1.329.388	117.744

Source: <http://www.mt.gov.vn>

64. **Roads:** Viet Nam has an estimated 210,000 km of roads, representing twice the density of the networks of Thailand or Malaysia. Despite this broad coverage, only 13.5% of the network is considered to be in good condition, just 26% has two or more lanes, and only 29% is paved. Over 10% of villages are inaccessible by road for at least one month of the year⁵⁴. Investment requirements in the sector are estimated by the Government at 246 trillion VND during the 2002-2010 period, and another 328 trillion VND through 2020. These investments will go to both maintenance, rehabilitation and modernization of the existing network as well as construction of new road corridors on key trade routes.

65. **Rail:** Viet Nam's rail network consists of approximately 2,600 kilometers of single-track line covering seven routes, and is owned and operated by the vertically integrated government agency Viet Nam Railway. Rail plays a minor role in meeting the transportation needs of the country, carrying only 5% of total cargo and 12% of total passengers in 1995. Indeed Viet Nam's rail utilization rate (measured in tons + passengers per km) is one of the lowest in the ASEAN region, leading to poor financial performance and insufficient revenues to support ongoing maintenance⁵⁵. Government subsidization of coastal and in-land shipping has made it difficult for rail linkages to remain competitive, and tariffs remain at below cost-covering levels. The Ministry of Transport estimates that as much as VND 219 trillion will be needed to rehabilitate the railways between 2002-2010, and another VND 394 trillion from 2011-2020, close to 30% of the total investment requirement for the transport sector.

66. **Ports:** Viet Nam has seven international seaports, and five special ports through which only oil and coal are shipped. The major ports are Haiphong in the north (22% of traffic), Danang in the centre (8% of traffic) and Ho Chi Minh City in the south (70% of traffic). A significant amount of investment has gone into upgrading the ports over the past decade, which can now handle approximately 14m tonnes of freight per year (excluding crude oil), up from 4.5m tonnes in 1993. Container traffic to and from Viet Nam has reached over 1,000,000 TEUs per year. Despite these upgrades, the main HCMC port is considered substandard by comparison to regional and international competitors, and will be insufficient to meet demand by as early as 2006⁵⁶. Most of the other major ports in the country are congested, poorly maintained and managed, and possess inadequate water (channel) and road access. The current state of the ports results in higher unit costs for shipping lines, further depressing the competitiveness of the country as a whole. The Government is considering a proposal to move the HCMC inner city ports to Cai Mep – Thi Vai, to add capacity and improve the competitiveness of the HCMC port network.

⁵⁴ Source: Economist Intelligence Unit, Viet Nam Country Profile 2004. pg20

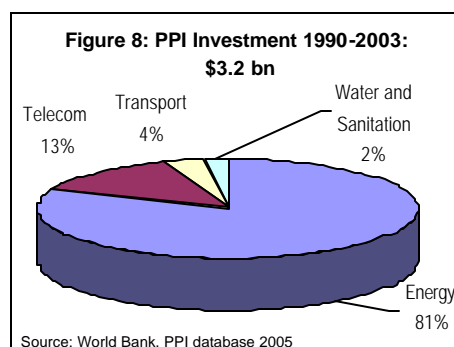
⁵⁵ Source: World Bank, Public-Private Infrastructure Advisory Facility, "Opportunities for Private Provision of Infrastructure: Country Framework Report for Viet Nam", 1999, p53

⁵⁶ Source: Infrastructure SubGroup of Manufacturing and Distribution Working Group, Viet Nam Business Forum, as published in the November 2004 Meeting Notes

67. **Airports:** Viet Nam has three international airports (Ho Chi Minh City, Hanoi and Da Nang) and 13 domestic airports. Air transport remains largely undeveloped in the country, with less than 20% of the aircraft, freight and passenger traffic of countries such as the Philippines and Thailand. Low per capita income makes air transport a luxury to most Viet Nameese. The Ministry of Transport estimates that VND 18 trillion is needed to maintain and expand existing airport infrastructure from 2002-2010, or only 2% of the total investment requirement for the transport sector as a whole.

2. Sector structures, regulatory frameworks and existing PSP

68. State monopolies, low tariff levels and lack of receptivity to PSP have limited opportunities for private investment in infrastructure. Viet Nam has one of the lowest rates of PPI in the ASEAN region, with only \$3.2 billion of realized investments since 1990⁵⁷. Most of this investment (81%) was made in the power sector, particularly with Phu My 2.2 and 3. While 15% of infrastructure investments had some private participation over the 1997-2003 period, if one excludes the US\$ 1.3 billion development of a gas field and pipeline in 2002, this percentage drops to 8.5%, a low number when compared to close to 20% for the Philippines⁵⁸. In absolute terms, the \$3.2 billion PPI number for Viet Nam is less than 10% of the estimated \$30.2 billion of public-private infrastructure investment in the Philippines during the same period, and less than 2% of the \$198 billion of PPI for all of East Asia and the Pacific.



Utilities: Power, Water, Sanitation and Telecommunications

69. **Power:** The electricity sector is dominated by state-owned Electricity of Viet Nam (EVN), which generates 90% of the power, owns and operates all of the transmission infrastructure and most of the distribution networks. The new Electricity Law⁵⁹, which came into effect on July 1 2005, is the first law to govern activity in the sector. It calls for the unbundling of the sector and creation of competitive power supply market. EVN operating units are to be equitized and in some cases privatized.

70. This ambitious plan is to be phased in over a number of years, beginning with a single buyer model and eventually developing into wholesale and finally retail competition. It is expected that transmission assets will remain under state control. In the near term, the transformation of the sector will require the legal and financial unbundling of EVN, so that the corporatized EVN generating units can compete on equal terms with private generators. This will be particularly challenging as the buyer of power will remain EVN in the near term. The GoV will also need to determine how to best structure additional generation capacity with private sector so that it does not create large PPA liabilities in the future when the power pool is put in place.

⁵⁷ This figure presents both private and public contributions to projects in which private investment was involved

⁵⁸ The Philippines is used here as a relevant comparator due to its similar population size of approx 80 million, although Philippine GDP is twice that of Viet Nam

⁵⁹ Law 28-2004-QH11 on Electricity; promulgated on December 3, 2004 and drafted in accordance with Viet Nam's Strategy for Electricity Development

71. A number of issues will need to be addressed in the future implementing texts to the law, including the mechanics of spot trading, the roles and responsibilities of the Electricity Regulator, and the conditions and procedures for licensing each electricity activity. The Ministry of Industry, which maintains broad regulatory authority over the sector, will place these responsibilities with a new Regulator going forward, an entity which will be housed within the Ministry. The electricity retail tariffs will be prepared by the Minister of Industry with the assistance of the Regulator and approved by the Prime Minister. Electricity generation and wholesale tariffs, fees for electricity transmission and distribution, and auxiliary services will be proposed by the entities involved in the relevant electricity activity and will be evaluated by the Electricity Regulator and approved by the Minister of Industry.

72. Tariffs in the sector have historically been sufficient to cover EVN's operating costs, yet not enough to cover the long-run marginal costs of production. At an average of \$0.05/kWh for manufacturing customers in 2004, electricity tariffs remain below the regional average of \$0.088/kWh and are among the lowest in ASEAN.

73. To date, PSP in the sector has been limited to a number of small scale private distributors and approximately 100 private generators who provide close to 1000 MW of power. The largest of these is 375MW Hiep Phuoc plant built by a Taiwanese company to supply an industrial zone south of HCMC. Only two real IPP projects have been completed to date, in 2002/2003: Phu My 2.2 and 3, both of whom are generating power from gas. These two projects, the first to be done under Viet Nam's BOT laws, were funded by foreign consortiums and ODA loans⁶⁰. Both are structured with PPAs guaranteed by the Government, with Phu My 2.2 receiving a World Bank partial credit guarantee⁶¹. A third IPP is under development at Oh Mon 2 with investment from Unocal and Mitsui, among others.

74. **Water and Sanitation:** The water and sanitation sectors are decentralized, with center setting policy and approval of major projects, while provincial People's Committees responsible for water supply services. In urban areas Water Supply companies operate piped water systems. In rural areas they are called Water Resource companies. But in both cases they are SOEs controlled by the provincial People's Committees. Maximum tariffs are set by the State Price Committee, and typically only cover operating expenses, not maintenance or investment. Low tariffs, combined with high rates of non-revenue water, have made formal private sector participation in water distribution unviable. Private sector participation remains limited to small scale water retailers and some waste removal businesses. Private sector investment should be viable in bulk water supply, but only two attempts have been made to negotiate BOTs in this service, both of which ended unsuccessfully⁶².

75. Looking forward, increasing private participation in water and sanitation services will require formalizing the rules of the game. There is no specific law regulating water supply at present. Moreover, the Government's receptivity to private participation in water projects is unclear. Prime Minister's Decision 155 dated August 24, 2004 ("Decision 155 of 2004") confirms that the State will retain at least 50% of capital in large urban water companies, but does not explicitly prohibit private (domestic or foreign) participation in bulk water supply. Given the

⁶⁰ The Phu My 3 power project, a 720MW gas-fired power plant sponsored by BP, SembCorp, Kyushu Electric and Nissho Iwai, was financed by an ADB/Fortis led consortium, which included JBIC, Mizuho, Bank of Tokyo-Mitsubishi, Credit Agricole Indosuez and Credit Lyonnais. Phu My 2-2, another 720MW gas-fired power plant power project, was sponsored by Electricite de France, Sumitomo and TEPCO, and was financed by an ADB/ANZ Bank consortium.

⁶¹ ADB financing for this project was in the form of a PSOD's loan and guarantee.

⁶² The first attempt involved a consortium with Lyonnaise des Eaux and ADB, and the second a Malaysian company Binh An Water Corporation Limited (BAWC), which was to supply 100,000 m3/day of treated water on take-or-pay basis to HCMC (approx 10% of total need), and also provide water to Bien Hoa Industrial Zone. Both deals broke down due to inability to agree take or pay terms.

existing confusion regarding the legality of PSP in the sector, a clear statement of policy and target sector structure is needed to create opportunities for investment. The Government's current work in preparing a new Decree for Urban Water Supply is a good opportunity to make PSP opportunities more explicit.

76. **Telecommunications**⁶³. This sector has been undergoing significant change in line with commitments made under the Bilateral Trade Agreement (BTA) with the US and forthcoming WTO accession. The telecom services monopoly has been broken, allowing new domestic service providers such as Military Communications Co (Vietel), the semi-private Saigon Posts and Telecommunications (Saigon Postel), and the Electricity Telecommunications and Information Company (ETIC) to enter the market. Viet Nam Post and Telecommunications Corporation (VNPT) still holds a 90%+ market share⁶⁴, but increased competition has helped reduce telephone rates and improve efficiencies. Under the BTA, U.S. companies will be allowed to establish 49% U.S. equity JVEs beginning in December 2005 for mobile services and data transmission, and may enter the fixed line services market by the end of 2007. Other companies will have to wait for Viet Nam's accession to the WTO.

77. While the liberalization of the sector⁶⁵ has allowed multiple operators to enter the market, almost all of these are SOEs, leaving virtually no private participation. The sector is further distorted by the dominant role of VNPT, which is both the largest player in the market and exercises significant influence over the sector regulator, the Ministry of Post and Telematics (MoPT)⁶⁶. The MoPT fulfills the dual role of policy maker and sector regulator, as provided for in Government Decree No. 90/2002/ND-CP of November 11, 2002. VNPT's influence over MoPT reaches to key areas such as pricing and licensing. While formally MoPT sets consumer tariffs for telecommunications services and applicable interconnection charges between operators, in practice these prices are proposed by VNPT and validated by the Ministry. In the area of licensing, VNPT is widely considered to influence the process, preventing any business that is a potential rival of firms under VNPT's umbrella from obtaining a license⁶⁷. These practices highlight the importance of creating a truly independent regulatory authority capable of ensuring competition at the network level.

78. The mobile market is controlled by VNPT via two dominant operators, Vinaphone and Mobifone, although 5 competitors are gaining market share: S-Fone⁶⁸, Saigon Postel, Vietel, ETC and Hanoi Telecom. Full Internet services became available in mid-1998 in both Hanoi and Ho Chi Minh City, yet internet usage remains expensive and only 3.2% of the population are regular users, compared with around 7.7% in Thailand and 34% in Malaysia. The dominant Internet service providers remain state-owned, i.e. the Viet Nam Datacommunications Company (VDC), which controls 62% of the market, followed by the Corporation for Financing and Promoting Technology (FPT), which controls 23%. Decree No 55 of 2001 opened up the ISP business to the private sector and foreign investors. Internet exchange provision business is still reserved only for state-owned enterprises or enterprises in which the Viet Nameese state holds absolute majority

⁶³ This section is largely based on data and analysis provided in the June 2005 report "Catalog of Legal Updates: Viet Nam Trade Policy Regime" by the U.S.- Viet Nam Trade Council Education Forum, pp63-64

⁶⁴ VNPT has 94 affiliates and eight foreign joint ventures operating in manufacturing telecom equipment

⁶⁵ Formalized with the Ordinance on Post and Telecommunications of May 25, 2002, abolishing VNPT's monopoly over network infrastructure and services

⁶⁶ Decree 90-2002-ND-CP of the Government dated 11 November 2002 sets out the regulatory role of MoPT

⁶⁷ As reported in European Union's Asia IT&C Programme document, "Status of Telecommunications Development in Viet Nam: Assessment Report" March 2004. According to this report, the recent delaying of SPT's CDMA mobile service is an example of VNPT's monopolistic power

⁶⁸ S-Fone is the first privately invested mobile phone venture, operated by a South Korean joint venture, SLD Telecom (SK Telecom, LG Electronics and Dong A Telecom), and the semi-private Saigon Post and Telecommunications Co (Saigon Postel); invested capital as of end 2003 was \$230 million

shares.

Transport: Roads, Railway, Ports, Airports

79. **Roads:** The road sector is planned, managed and operated by the Viet Nam Road Administration (VRA), a department within the Ministry of Transport. VRA has a substantial degree of autonomy, and manages 55 companies, including 6 freight transport enterprises, 1 passenger transport enterprise, 4 regional road management units (Hanoi, HCM, Danang and Vinh), 40 sub-units, and 4 ferry groups. VRA is responsible for all national roads, highways and bridges. Provincial, district and urban roads are managed by their respective Provincial, District and Urban Departments of Transport.

80. Private participation in the roads sector is very limited, with few instances of private companies obtaining construction and maintenance contracts, and only one private BOT toll road⁶⁹. In Quang Ninh, a private sector company built a segment of road in exchange for land use rights along the road corridor, a model which has been replicated in other locations. Apart from the Tan Thuan EPZ road, all other toll roads currently operational in the country are owned and managed by SOEs, most notably two toll roads in HCMC operated by the Ho Chi Minh City Infrastructure Investment company (CII), an SOE owned by the Ho Chi Minh City Investment Fund for Urban Development (HIFU). The Phu My Bridge linking districts 2 and 7 in HCM City, due to start construction in September 2005, will be developed on a BOT basis by a consortium of state-owned companies⁷⁰. Complex land acquisition procedures and the difficulty of recovering costs with current tariff levels has deterred private consortia from developing new toll roads. The few road segments that have sufficient traffic to generate cost-covering revenues are managed by SOEs. Looking forward, the Government is seeking private participation in 4 highway BOTs: the 176km Hochiminh city – My Thuan – Can Tho highway (\$785 million), the 160km Da Nang – Quang Ngai highway (\$340 million), the 48km Noi Bai – Ha Long highway (\$400 million) and the 106km Ha Noi – Hai Phong highway (\$300 million)⁷¹. A fifth BOT (Hochiminh city – Long Thanh – Dau Day and Long Thanh – Vung Tau highways) is scheduled to be completed by the state-owned Viet Nam Expressway Corporation at a total estimated cost of \$650 million. It is not known if the proposed private BOT deals are financially viable without counterpart funding from Government.

81. Beyond BOT opportunities, the domestic private sector could be much more present in the construction, rehabilitation and maintenance of the road network. State-owned companies provide the majority of these services, as Government procurement practice is in favor of SOEs. In addition, state enterprises often submit very low bids that reflect either a below-cost access to construction equipment or an inability or unwillingness to include all costs that allow adequate fulfillment of the contract. In some cases, these bids lead to very slow mobilization and implementation, or to less or different construction material being used than called for in the specifications, with negative consequences on the durability and operation and maintenance costs of the infrastructure.

82. According to ADB's 2002/03 Private Sector Assessment, only about 10% of private enterprises were able to participate in publicly funded projects in the 2000-2002 period. Companies surveyed by the Chamber of Commerce indicated that obtaining information on bids was expensive, prequalification requirements effectively screened out most private firms, and bid evaluation was not fair. In the construction industry, private firms (excluding household

⁶⁹ The Tan Thuan EPZ - Highway 1 toll road and bridge, financed by the Central Trading and Development Group of Taiwan (70%) and Ho Chi Minh City (30%); operational since 1997

⁷⁰ total cost estimated at over VND1.8 trillion; consortium members are Hanoi Construction, Construction Investment and Development, HCM City Infrastructure Development and Investment, Chau Thoi Concrete 620 and Thanh Danh Construction and Trading

⁷¹ Source: Foreign Investment Agency, Ministry of Planning and Investment, "LIST OF KEY PROJECTS CALLING FOR FOREIGN DIRECT INVESTMENT", June 2005

construction activities) accounted for only 12% of output. Many of these firms were small and had a limited track record and limited access to equipment and engineering expertise, and could not obtain guarantees (bid-bond) from banks. Further consideration should be given to designing procurement to allow domestic private firms to establish a track record without endangering quality or the project timetable. One way would be to allow smaller contracts, possibly resulting from the division of larger ones, to be available for (but not allocated to) smaller and younger firms, and to encourage sub-contracting. If these firms completed their contracts, they would be "graduated" in steps and eventually allowed to bid on larger contracts. Under this approach, intensifying third-party inspections may be necessary to ensure adequate quality. This would help create a more level playing field and overcome the historical lack of private firms of medium and large size in Viet Nam

83. **Railway:** The national railway network is owned and operated by Viet Nam Railway, a wholly-integrated government department within the Ministry of Transport. There has been no significant PSP in the sector to date, although the Ministry of Planning and Investment has issued a list of four corridors in which the Government it seeks PSP via BOT: the 80km Bien Hoa – Vung Tau railway (\$310 million), the 49km Trang Bom – Hoa Hung railway (\$575 million), the 305km Dak Nong – Chon Thanh – Thi Vai railway (\$590 million) and the 105km Ha Noi – Hai phong railway (\$320 million). The city of HCM is also exploring an unsolicited BOT project proposal to build an underground metrorail at a estimated cost of \$800 million. Attracting private sector investment into these projects will require creating a strong economic rationale, and clarifying the Government position regarding private investment into the sector. Decision 155 of 2004 in fact poses explicit restrictions on PSP : (1) Management and maintenance of the national railway network are to remain State owned, as are large airports and seaports, sewage treatment works in big cities and public lighting, (2) Companies that have State capital of at least VND 30 billion and average annual contribution to the State budget of VND 3 billion and that operate in air and rail transportation will continue to be 100% State owned.

84. **Ports:** The ports sector is largely controlled by the Viet Nam National Maritime Group (Vinamarine), a state organization under the auspices of the Ministry of Transportation. Vinamarine is responsible for the planning, construction and management of ports, and directly operates the country's 3 major ports in Haiphong, Danang and HCMC. The remaining 7 large national ports are operated by Vinaline, a General Corporation reporting directly to the Prime Minister. The country's 60 other ports are operated by local SOEs and various other Ministries. Despite the dominance of public operators in the sector, three private ports have been developed under greenfield BOT schemes: a bulk cargo facility at Baria Serese (Joint Venture with 60% foreign equity, 40% SOEs), the VICT container handling terminal in Ho Chi Minh City (Joint Venture with 65% foreign equity, 35% SOE) and a small private terminal serving the industrial zone at Dinh Vu (100% foreign-owned). Two other private port projects are under development at Cai Map and Cailan, and the Government is seeking PSP in two large transshipment ports: Ben Dinh – Sao Mai (\$637 million) and Van Phong (\$500 million).

85. Tariff levels for port services are fixed by the Ministry of Transportation and are the same for all ports in the country. Container charges are set by the individual ports to allow competition. As port service charges are already comparatively high in Viet Nam, allowing each port to set its own port service charges would incite greater competition and efficiencies in the sector. Those ports which are not economically viable but serve a public purpose could then be more effectively targeted for support by the government.

86. The port sector has significant potential for increased private sector participation, both in the form of BOT schemes as well as with private management contracts. The Government has developed the framework for third-party management of ports, with Vinaline signing a formal lease with Vinamarine for the management of Cailan port in 2004. Although this was an example of a public sector entity signing a lease with another public sector company, the leasing framework could be replicated with private sector participation, if sector regulations are modified to allow it. Indeed, a clarification of PSP restrictions in the sector is needed, particularly in view of

Decision 155 of 2004 which prescribes that the management and maintenance of large ports is to remain under state ownership. Until these regulations are clarified, and the Government's plans to develop key supporting road and rail infrastructure surrounding the ports are backed with tangible investments, private investors will remain cautious.

87. **Airports:** Viet Nam's airports are administered by the Civil Aviation Administration which reports directly to the Prime Minister's office. PSP in the sector has been limited to small scale supply and construction contracts, but no significant opportunities for concession / management contract or BOT have been successfully developed⁷². Looking forward, opportunities for PSP in the sector remain limited due to restrictions imposed by Decision 155 of 2004 (see paragraph 86 above).

3. Sources of Finance for Infrastructure

88. The low rate of private participation in infrastructure investment over the past decade has left the burden of finance largely with the Government. While precise figures are not published, it is estimated that on average 70-80% of infrastructure investment costs are borne by the government. A recent analysis by the World Bank⁷³ confirmed this allocation for 2003, as illustrated in the table below.

Table 7: Sources of Infrastructure Finance (c. 2003)

Finance Source	Transport (% GDP)	Electricity (% GDP)	Telecoms (% GDP)	Water (% GDP)	Total (% GDP)	Percentage of Infrastructure Financing
Users		0.9	0.2	0.1	1.2	14
ODA	1.7	1.2		0.3	3.2	37
Budget	0.8	0.1	0.6	0.1	1.6	18
Govt. Bonds	1.2				1.2	14
SOCBs	0.1				0.1	1
Private	0.2	1.2		0.1	1.4	16
Total	3.9	3.4	0.8	0.6	8.7	100

Source: World Bank draft paper "Cross-sectoral aspects of Viet Nam's Infrastructure Strategy", July 2005, pg30

89. With the expected phasing out of concessional ODA funding in the coming years, the cost of infrastructure finance will continue to rise. Government bonds, which were issued for the first time in 2003 to finance infrastructure, will become an increasingly important source of replacement finance, but at considerably higher interest rates of 8-9% and higher. A total of VND 5 trillion of infrastructure bonds were issued in 2003, another VND 5 trillion in 2004, and a further VND 10 trillion is planned for the August 1 to September 30 2005 period. The main purchasers of the bonds have been State-owned Commercial Banks (SOCBs) and insurance companies. Despite the rapid rate of growth of the infrastructure bond issues, they represent only 2-3% of total outstanding public debt, which itself remains at a manageable level of 36% of GDP⁷⁴. Looking forward, the government plans to raise a total of VND63 trillion (US\$4 billion) by 2010 to finance infrastructure and education projects including the north-south Ho Chi Minh Highway, roads in mountainous areas and in the Mekong River Delta, and irrigation projects in the disaster-prone central provinces.

⁷² In the mid-1990s, the Southern Airport Authority solicited qualification statements for a US\$200 million Build-Transfer, turn-key expansion terminal for Tan Son Nhat Airport (Ho Chi Minh City), but that bidding process was eventually suspended.

⁷³ Unpublished draft paper titled "Cross-sectoral aspects of Viet Nam's Infrastructure Strategy", July 2005

⁷⁴ This figure of 36% is the sum of the 33% of GDP officially published debt data and the 3% of government bond issues which the Government maintains as an off-budget item; this figure does not include the estimated VND6.5 trillion of arrears due from the Viet Nam Road Agency to various state-owned road construction companies (source: World Bank Public Expenditure Review 2004, p21)

90. The Government's continued ability to borrow for infrastructure investment has seemingly reduced the incentive to open up infrastructure markets to PSP. Needed reforms to introduce competition, establish regulatory frameworks and allow private management have been delayed in all infrastructure sectors with the notable exception of power. Looking forward, the investment levels required to achieve the Government's target annual GDP growth rate of +7% will put strains on its borrowing margins, making increased PSP essential.

4. Key constraints to expanded PSP in infrastructure

91. As the preceding analysis demonstrates, a number of legal, regulatory, structural and resource constraints⁷⁵ continue to complicate private participation in infrastructure. Large scale private investments, of the kind needed to support Viet Nam's continued 7%+ annual growth rates, have been "one-off" ventures that have not formed part of a concerted Government strategy to increase PSP in the sector. While dialogue with the private sector on this issue has increased notably in recent years⁷⁶, the Government continues to issue infrastructure development masterplans which generally include private financing as an afterthought, to fill shortfalls in government resources. These masterplans, while useful in identifying Government priorities, are largely supply-driven and inflexible by design, with limited room to accommodate private sector proposals not specifically defined in the plan. A more flexible planning process that accommodates unsolicited proposals for infrastructure investments, and is supported by simple, transparent proposal evaluation and award procedures would be an important step in improving the conditions for private investment.

92. Beyond the constraints inherent in the Government's general approach to infrastructure planning, the key remaining legal, regulatory and resource constraints to PSP in infrastructure can be broadly summarized as follows:

- the absence of a clear policy statement from the Government specifying the forms and sectors in which PSP is actively encouraged
- outdated BOT framework, absence of BOO modalities and unequal treatment of domestic and foreign participants in a BOT⁷⁷
- high risks due to poorly regulated markets and financially opaque single buyers⁷⁸;
- complicated tendering and licensing procedures allowing a high level of Government discretion and delays in negotiations for large projects,
- limitations on collateral and guarantee for foreign lenders,
- undeveloped capital market limiting the ability to raise domestic finance⁷⁹ and diversify risk via securitization
- weak dispute resolution framework

93. Additional PSP constraints specific to each subsector also exist. Many of these relate to the uncertain legality of PSP in each sector and/or limitations on forms of investment. They are summarized as follows:

⁷⁵ In particular the difficulty of accessing land for development and the limited availability of long term local currency finance due to underdevelopment of debt and capital markets

⁷⁶ The creation of an Interministerial Team on PPI and bi-annual consultation with the Viet Nam Business Forum is a welcome step in this regard; the more recent formation of a public/private working group to further develop policies for PPI is another positive measure

⁷⁷ A new BOT framework with equal treatment for domestic and foreign firms is to be developed as one of the numerous implementing decrees to the proposed Unified Enterprise Law and Common Investment Law due to be enacted before end 2005

⁷⁸ these conditions create the need for government guarantees which are difficult to obtain

⁷⁹ Particularly in the form of institutional equity investment and project bonds that pay out in the same currency as the revenues collected

Infrastructure Subsector	Key PSP Constraints
Power	<ul style="list-style-type: none"> • Issuance of implementing regulations to new Electricity Law is needed to define the future structure of the subsector and clarify mechanisms for transitioning from single buyer to competitive power pool • Reluctance of the government to issue guarantees for power purchase agreements
Water and Sanitation	<ul style="list-style-type: none"> • Decision 155 of 2004 prohibits private management and maintenance of sewerage treatment works in large cities, and requires State ownership of at least 50% capital in large urban water companies • No track record of successful BOT or management contracts in the sector • End-user price caps do not allow cost recovery, leaving bulk water supply the only viable form of PSP
Telecommunications	<ul style="list-style-type: none"> • Investment by foreigners in constructing and operating international telecommunications networks and local telecommunications networks restricted to Business Cooperation Contracts (BCC) until end 2005 for US companies and WTO accession for non-US firms • Lack of a functioning regulatory framework independent of policy making and influence from VNPT
Ports	<ul style="list-style-type: none"> • Decision 155 of 2004 prohibits private management and maintenance of large seaports • Legal form for PSP in the sector remains unclear; laws could be interpreted to mean that foreign investors can only participate in the form of joint ventures • Continued price controls and dominance of Vinamarine in the sector reduce opportunities for competition between ports
Airports	<ul style="list-style-type: none"> • Decision 155 of 2004 prohibits private management and maintenance of large airports • No track record of successful BOT or management contracts in the sector
Roads	<ul style="list-style-type: none"> • Difficult land access and clearance complicates road development on a BOT basis • Decision 155 of 2004 requires State ownership of at least 50% of the companies operating in the management and maintenance of important roads
Rail	<ul style="list-style-type: none"> • Decision 155 of 2004 prohibits private management and maintenance of national railway • Poor economics of the network make PSP unattractive except in

	cases of specific corridors or urban transport
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94. Expanded participation of the private sector in infrastructure service provision, as part of a larger effort to increase competition, will be essential to improving service quality, sector economics and meeting the significant investment financing gap. The Government is well aware of the need for increased PSP, but has not yet developed a focused strategy to achieve it. In the current legal and regulatory environment, it would appear that the opportunities for PSP may be limited to IPPs in the power sector, upgrading of existing road segments into toll roads and management contracts for selected port services. The absence of functioning regulatory frameworks and continued restrictions on foreign investment will continue to limit PSP in telecommunications services. A significant expansion of private investment in infrastructure provision will therefore require fundamental policy, legal and regulatory reforms as outlined in Appendix IV of this PSA.

5. Expanding PSP in Provincial/Municipal Infrastructure

95. While most large infrastructure decisions and investment are made at the national level (e.g. power, telecommunications and national transport systems), provinces and municipalities retain responsibility for water, sanitation and urban transport systems. Increased PSP in infrastructure service provision must therefore also happen at the local level, in partnership with subnational authorities. The Government's 2001 Public Administration Reform Master Program (for 2001-2010) envisages the establishment of regulations on decentralization of administrative management and fiscal functions to provincial governments by 2005. The two most significant components of this new finance framework will be:

- Establishment of Provincial Infrastructure Development Funds (PIDFs) which would offer an operational and legal structure for the provincial governments to focus on infrastructure, including the ability to enter into contracts with the private sector.
- Permission to provincial governments to borrow up to 30% of their annual budget for development investments; HCMC and Hanoi are allowed to borrow up to 100%. Provincial governments will be allowed to raise the debt through revenue or general obligation bonds.

96. The new finance framework, already largely in place in HCMC, has demonstrated its effectiveness in streamlining decision-making and raising finance for infrastructure investment. The Ho Chi Minh City Investment Fund for Urban Development (HIFU) was the first infrastructure fund established by the Government in 1997⁸⁰. During its 8 years of operation, it has provided VND 2.9 trillion in loans and VND 155 billion in direct investments in transportation, water, health, education, housing and industrial park projects, including investments in companies operating infrastructure assets⁸¹.

97. Funds managed by HIFU are sourced in part through direct contributions from the state budget, proceeds from the sale of state-owned housing, borrowing from State-owned Banks and the Development Assistance Fund, and most recently the issuance of VND 4 trillion in HCMC

⁸⁰ HIFU is a state-owned company reporting to the People's Committee of HCMC, and has served as a model for 12 Provincial Infrastructure Development Funds which have been established throughout the country

⁸¹ The most notable of these is the joint-stock Ho Chi Minh City Infrastructure Investment company (CII) which operates two toll road segments linking HCMC; CII paid a concession fee of VND 1 trillion to HCMC to gain control of the road segments which it manages and collects revenues from users for a 9-year period. The CII "concession" model is one which HIFU seeks to replicate in other urban infrastructure sectors.

municipal bonds⁸². Purchasers of the bonds were large state-owned institutional investors including commercial banks, with a small portion bought up by individual investors (exact proportion not known). While the direct participation of the private sector in HIFU (either as an owner or operator of infrastructure assets) remains minimal, a framework for contracting has been established which could facilitate PSP going forward.

98. While HCMC has now set an important precedent for municipal finance, few other municipalities/provinces possess the capabilities and demonstrated creditworthiness to follow suit in the near term. Those that do still need to (i) upgrade their disclosure standards and practices⁸³, (ii) strengthen financial management capabilities, (iii) establish mechanisms for consistent debt repayment and (iv) issue policies/procedures for public-private partnerships in infrastructure. In short, if the mobilization of subnational finance is designed principally to raise capital for infrastructure, then a coherent infrastructure investment strategy is needed, supported by the capabilities and tools for its implementation.

III. ENABLING ENVIRONMENT FOR PRIVATE SECTOR DEVELOPMENT

99. The enabling environment for private sector development in any economy is characterized by a combination of physical and financial infrastructure, government policies, legal and regulatory frameworks and the institutional capacities for their implementation. The following discussion focuses on those aspects of the enabling environment that continue to inhibit private sector development in Viet Nam, so as to highlight the needed reforms going forward.

A. Policy and Institutional Framework for Private Sector Development

1. Policy Towards Private Sector Development

100. The Government's commitment to developing the private sector can be traced to the adoption of the *doi moi* (renovation) policy in 1986. Necessary changes were made to the Constitution in 1992⁸⁴, and pro-private sector themes were mainstreamed in subsequent planning documents. The *Strategy for Socio-Economic Development 2001-2010*, approved by the 9th Communist Party Congress in April 2001 committed to the vigorous and durable development of all economic sectors, including "the individual and small-owner economic sector, the private capitalistic economic sector, ... and the foreign invested economic sector." [p.6-7]. "The State is to respect the objective principles and operational mechanisms of the market, creating conditions to promote its positive aspects while overcoming and restraining its negative effects.... [and]... radically reducing its direct interference by administrative measures in production and business activities" [p.20]. In addition to this oversight role, however, the *Strategy* also proposed that "the leading role of the State economic sector is to be enhanced, governing key domains of the economy; State enterprises are to be renewed and developed, ensuring production and business efficiency" [p.6]. More specifically, State enterprise development is to take place in a range of domestic and international markets, "such as petroleum, electricity, coal, aviation, railways, high-

⁸² These 2 bond issues by HCMC represent the first such direct revenue-raising initiative by a subnational government. They were allowed to proceed despite the absence of a complete legal framework for municipal debt instruments, and as such were based on central government bond guidelines

⁸³ Current disclosure standards for provincial government operations are inadequate and inconsistent, and as such represent a significant constraint on the emerging decentralized municipal finance system

⁸⁴ Article 15 of the 1992 Constitution states "The State promotes a multi-component commodity economy functioning in accordance with market mechanisms under the management of the State and following a socialist orientation. The multi-component economic structure with various forms of organization of production and trading is based on a system of ownership by the entire people, by collectives, and by private individuals, of which ownership by the entire people and by collectives constitutes the foundation".