

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".

sea transport, telecommunications, mechanical engineering, metallurgy, chemistry, building materials, import-export, banking, insurance, auditing, etc.” [p.18-19]. Similar themes are echoed in the 2001 *Directions and Tasks for the Five-Year Socio-Economic Development Plan 2001-2005*. In addition, the *Plan* indicated that by 2005 “the process of restructuring, reorganizing and renewing the management system of SOEs will be essentially completed, ...[and] ... those SOEs of which the state does not own 100% of capital will be equitized” [p.40].

101. To support the private sector, the Government issued Decree 90/2001/ND-CP—Support for Development of SMEs (Decree 90)—in November 2001 and officially recognized SMEs for the first time in Viet Nam. Decree 90 provides a framework for the Government to support and encourage private sector development and covers the establishment of (i) an SME Promotion Council with cross-ministry membership to act as an advisory body to the Prime Minister, and (ii) the Agency for SME Development in the Ministry of Planning and Investment (MPI) to coordinate SME-related activities. Further progress in refining the definition of SMEs to isolate micro, small and medium enterprises was done in 2005, with a concurrent commitment to collect relevant data and statistics to allow more targeted policies for each subsegment.

102. While the Government’s formal pronouncements on the importance of private sector development are unambiguous, its approach to opening up markets has proved less so. A culture of control remains pervasive, where private business activity must be pre-checked, licensed and/or inspected, and all allowable activities must be explicitly permitted by law. This approach runs counter to the practices of governments in most vibrant private sector economies, where all activities not explicitly prohibited by law are allowed, and licensing is automatic, allowing no discretionary authority to implementing officials. The culture of control is also evident in the government’s continued operation of over 4,000 SOEs, many of which are non-strategic and compete against private companies. SOEs benefit from implicit government guarantees on lending, generous land allocations and a myriad of other benefits⁸⁵ which make them formidable competitors to private companies. While the government has made efforts to level the playing field for the private sector by equitizing SOEs, strengthening their corporate governance practices and developing a unified enterprise law to place all companies on equal regulatory footing, only a small portion (<10%) of total SOE equity is now in private hands⁸⁶, and the draft Unified Enterprise Law (in its May 2005 draft form) will have limited application to SOEs.

103. Despite these limitations it must be recognized that the Government’s reform agenda is ambitious, and significant progress has been made to date. The passage of the Enterprise Law in 1999 greatly simplified the business registration process, reduced its duration from 98 to 10 days on average and its cost twenty-fold, from VND10 million to VND0.5 million. Annual business registration boomed as a result. The Foreign Investment Law, introduced in December 1987⁸⁷, progressively expanded the markets and business forms open to foreign investors. Viet Nam’s preparations for accession to the WTO, and its signature of the Bilateral Trade Agreement with the US in 2001 signaled its commitment to implementing a host of reforms regarding customs procedures, trade policies, intellectual property protection, competition, commercial dispute resolution, judicial transparency, banking reform and market access for foreign investors. As part of this process towards global market integration, a critical next step will now be to harmonize the legal and regulatory framework for all forms of enterprises (domestic, foreign, public and private), which is the intent of the Unified Enterprise Law and Common Investment Law currently under preparation.

⁸⁵ For example government support in finding foreign partners or markets, information on government procurement opportunities

⁸⁶ The total capital of the roughly two thousand SOEs equitized, sold or liquidated through mid 2004 represents approximately 10 percent of total SOE capital in 2004, according to World Bank calculations (as reported in Viet Nam Development Report 2005, Joint Donor Report to the Viet Nam Consultative Group Meeting, December 2004).

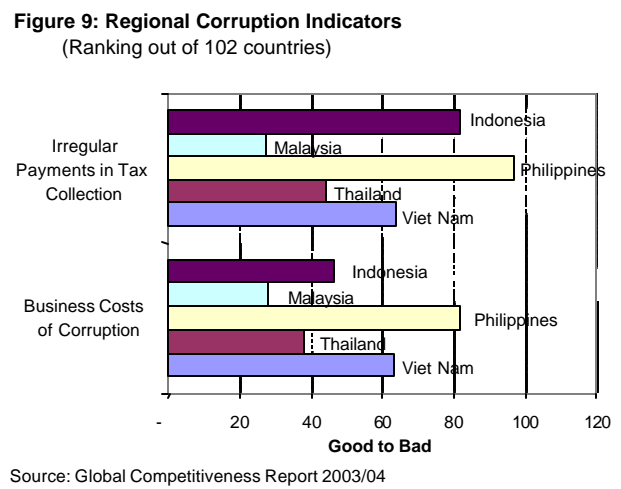
⁸⁷ subsequently amended in June 1990, December 1992, November 1996, and June 2000

2. Interface with Public Administration

104. Viet Nam's administrative structure includes 64 provinces, altogether comprising 611 districts subdivided into 10,602 communes. The ongoing decentralization process means that an increasingly larger number of government decisions are made at lower levels in the administrative structure, and especially at the province level. Businesses interface with the both the central and local authorities at all stages of their lifecycle, from startup and licensing to land acquisition, employee contracting, import/export and operating/income taxes.

105. While the institutional framework in support of private sector development remains highly centralized in policy (with central government promulgating most rules, regulations and incentives for private business activity), it is decentralized in implementation. While many of the rules and regulations issued by the center are very specific in their prescriptions (precisely to limit discretion in their implementation), the result is sometimes the opposite, i.e. the complexity and contradictions generated by the proliferation of detailed regulations often force interpretation. Compounding this problem is the fact that new laws often provide only a framework for action, with the ministerial circulars needed to guide implementation lagging months after the law has taken effect. Without guiding ministerial circulars, local bodies may be reluctant to move on a decree, even though it has already come into effect. But even if the roles of the various government institutions were clarified and the inconsistencies in the legislation addressed, there would still be substantial room for local authorities to apply their own interpretation to central policies. In this environment, local officials have different perceptions of how much administrative flexibility they actually have in order to make expenditure decisions and experiment with local development strategies. Some provinces see themselves as agents of the central government, others as representatives of their localities. Some provincial People's Committees simply accept national dictates; others choose the most generous interpretation of a dictate or actively negotiate with higher administrative levels about expenditure decisions and development policies; and still others openly deviate from central norms and devise their own strategies on development issues or social service delivery⁸⁸.

106. Perhaps the most vivid demonstration of the role of local authorities in creating a pro-business climate is in their application of the New Enterprise Law. While some provinces have applied even shorter business registration time limits than that required by Law, others have yet to meet the Law's requirements. The success of Binh Duong province in attracting 50% more FDI inflow than its neighbor Dong Nai in 2001, and ten times more private domestic investment per capita⁸⁹, illustrates the power of local authorities to create a pro-business climate. Binh Duong created a "one-door" system to allow all administrative formalities associated with creating a business to be processed by one office, and senior officials meet weekly with both domestic and foreign businesspeople to quickly resolve issues such as land compensation, taxes, or disputes. The province also worked to make credit more available by allowing 70 percent of capital goods purchased with a loan to count as



⁸⁸ World Bank/IFC/MPDF Study "Informality and the Playing Field in Viet Nam's Business Sector", 2003, pg19

⁸⁹ First four months of 2001

collateral towards the loan used to purchase the goods.

107. The important role of provincial authorities in attracting investment has led to intensified competition between provinces for that investment⁹⁰. In addition to efforts to facilitate administrative procedures, local governments have also issued a proliferation of investment incentives, some of which seemingly go beyond their authority to offer⁹¹. While this is a very positive development in its underlying motive to promote private sector development, a rationalization of incentives would be in the best interests of the central government so that revenue is not foregone unnecessarily.

108. A second and equally important result of the complex legal and regulatory environment and discretionary authority of government officials (either central or local) is the incentive to seek unofficial payments. The large size of the informal/shadow economy in Viet Nam suggests that some level of complicity is necessary to maintain it, and indeed Viet Nam scored poorly in Transparency International's Corruption Perceptions Index for 2004, ranking 102 out of 145 countries surveyed, behind all regional competitors save Indonesia and the Philippines. The World Economic Forum's Global Competitiveness Report 2003/04 confirmed this result with its findings that the Business Costs of Corruption in Viet Nam are even higher than in Indonesia, although lower than in the Philippines. A 2003 survey by the World Bank⁹² found that on average, private firms reported paying 2.8% of their sales revenues in bribes to government officials. While bribes are paid to procure licenses and permits, pass/avoid inspections and to expedite various administrative procedures, they may be less common in the calculation and payment of income tax than anecdotal evidence suggests. Indeed, the same World Bank survey found that only 8% of surveyed firms indicated that they negotiated with tax authorities over the applicable rate of taxation.

109. Avenues for combating corruption are invariably tied to the issues of improving transparency and accountability. Recently, the Government and the CPV leadership have devoted much attention to the issue of corruption. The need for Government cleansing was a major theme of the Sixth and Seventh CPV Plenum in October 1998 and August 1999, and the 9th National Congress of CPV in April 2001, with criticism by the Party leadership of the heavy bureaucracy of Government, weak supervision and inspection and corruption and wastefulness. Important ordinances and decrees have been passed addressing anti-corruption, such as the ordinance against Corruption (March 1998), and related implementing regulations. The Government's approach to fighting corruption centers on legal reforms, reform of administrative procedures, and reform of the structure and remuneration of the civil service. This approach which looks at corruption as a systemic issue and not as a problem of individual behavior, improves the opportunity for successfully addressing the problem.

3. Mechanism for Dialogue between the Private Sector and the Government

110. Many of the obstacles to private sector development change as a result of evolving regulation and economic circumstances, and many of the services and support which private businesses need to grow can be provided more efficiently for an organized group than for single users. It is therefore important that processes exist, which allow private entrepreneurs to seek solution (among themselves or in cooperation with the Government) to the most binding constraints at any given time. The importance of such dialogue mechanisms for a dynamic

⁹⁰ For more on this topic see the USAID/VCCI/VNCI Provincial Competitiveness Index Summary Report, May 2005

⁹¹ This is true of fiscal incentives offered by Danang and Bac Ninh provinces, for example, although their authority to do so is restricted under Decree 164 of 2004

⁹² As reported in World Bank/IFC/MPDF Study "Informality and the Playing Field in Viet Nam's Business Sector", 2003, pg35; 629 private firms were surveyed

economy cannot be overstated. Associations and forums are important vehicles for this dialogue.

111. Decree 88/2003/ND-CP regulates the establishment and operation of professional associations, including those related to business. This legal framework allows entrepreneurs to be self-organized, although the formation of an association still requires government approval⁹³. As of 2000, 150 associations (business and non-business) had been established at the national level, approximately 600 at the provincial level, and over one thousand (including clubs) at the district level. Most of these do not receive public financial support and should not be confused with the six political associations under the Government/Party umbrella⁹⁴. Some of the most relevant business associations include⁹⁵:

- Viet Nam Chamber of Commerce and Industry (VCCI), sponsored by the Government with about 5,300 members, of which 33% are SOEs. VCCI officials are Government employees. VCCI has 5 branch offices and 3 representative offices. It provides a range of services to its members including patents, arbitration, business software development, consulting, and technology information.
- Viet Nam Cooperative Alliance (VCA), also sponsored by the Government, with staff appointed from government ranks. The Alliance has member-alliances in all 64 provinces and central cities. Any cooperative can be a member. The provincial alliances usually provide a range of services to their members, such as training, information delivery, promotional activity and consultation. These services are provided based on the Government's and donors' resources, as well as self-generated resources from service fees.
- National Council of Young Business Leaders, established by the Ho Chi Minh City Youth Union following earlier Business Clubs. At present there are Young Business Associations and Clubs in 25 provinces. Majority of their members are private companies.
- Hanoi and Ho Chi Minh City Unions of Associations of Industry and Commerce (UAIC), both of which were established before the doi moi reforms (1986), originally for private businesses. They can be considered as the first associations of private businesses in Viet Nam. At present, they have approximately 1,800 members, mostly from private enterprises.
- There are a number of sector associations such as: IT Association, Civil Engineering Association, Footwear Association, etc. Members of these associations are predominantly SOEs.
- In addition, there are 20 nationality-based Chambers of Commerce such as the American, Australian, British and French Chamber of Commerce which meet regularly and try to advance the interests of their constituencies.

112. Only a few of the many business associations registered in the country are actually active representatives of, or a service provider to their members. A 2002 MPDF study⁹⁶ indicated that the majority of surveyed business associations did not consider themselves capable of engaging in a dialogue with the government on behalf of their members, nor were they able to provide any services to these members beyond short-term training and research. Most business associations

⁹³ Preparation committee for establishing an association of entrepreneurs should be approved by Ministry of Planning and Investment

⁹⁴ These include the Viet Nam Fatherland Front, Labor Union, Women's Union, Ho Chi Minh Communist Youth Union, Farmers' Association, and Veteran's Association.

⁹⁵ See Appendix VII for list of registered Associations

⁹⁶ Nguyen Phuong Quynh Trang and Jonathan R. Stromseth. 2002. *Business associations in Viet Nam: Status, roles and performance*. Private sector discussions No13. MPDF. August.

simply do not have the financial resources to conduct their activities, and there appears to be insufficient demand from the business community to commit the funding required to strengthen them.

113. Dialogue between the business community and government agencies occurs on three levels. The first is between the business community and Government/Prime Minister, which usually is organized twice a year as the Viet Nam Business Forum⁹⁷. The second is between the business community and relevant ministries/government agencies to discuss new draft laws or specific policy issues (tax, land...). These are becoming more regular and include the Monthly Business Forums in Hanoi and HCMC organized by VCCI/Asia Foundation. The third level of dialogue occurs between local authorities and the business community at provincial levels. These exchanges are typically focused on improving the investment environment and attracting investors to the provinces. It is worth noting that recently, the authority-business dialogue had become a regular practice in Viet Nam, and an important method of identifying issues, measures and solutions to improve the business environment.

114. The foreign community is active in the Viet Nam Business Forum, and has spearheaded the formation of working groups to focus on specific subsectors, namely banking, manufacturing and distribution and infrastructure. These working groups meet with varying frequency throughout the year and aim at obtaining resolution to specific issues, which are then often announced at the plenary Business Forum meetings and incorporated in legislation and regulations as appropriate. While the Forum has proven to be a highly effective vehicle for identifying key weaknesses in the business climate, it would benefit from a stronger representation from the domestic business community as a means to ensure that the concerns of domestic SMEs are voiced.

115. In addition to policy advocacy, business associations could assist their members by organizing training, marketing, and technical services. This may be done more effectively at the level of industry associations, grouped around the type of business such as shoes, textiles, ceramics, electronics, coffee, as typically done in other nations. These associations could be organized regionally by industry. Supporting the establishment of such groups and using them to provide business services and information more efficiently would be a concrete way to support the private sector. A very modest export or excise tax could partially fund such associations, in addition to membership dues and fees for services.⁹⁸ Allowing such associations to register as non-profit entities without tax liability could be an important step to support their creation and development.

B. Legal and Regulatory Framework

1. Access to Resources

Finance

116. Virtually every survey of Viet Nam's SME sector identifies the lack of access to finance as a key constraint to business growth⁹⁹. Most small businesses finance their operations through retained earnings and non-bank sources of credit and capital, e.g. supplier credit, contributions

⁹⁷ Held to coincide with the midterm or year-end Consultative Group Meetings

⁹⁸ In Taipei, China a very low export tax (about one-tenth of 1%) was introduced on manufactured exports with matching funds from the government. These funds were handed over to the local industry association to use for marketing and technology surveys, and could be used for training.

⁹⁹ These include (1) Webster L and Taussig M, 1999, "Viet Nam's Undersized Engine: A Survey of 95 Private Manufacturers", MPDF, Discussion Paper No 8, (2) Hemlin M, Ramamurthy B and Ronnas P, 1998, "The Anatomy and Dynamics of Small Scale Private Manufacturing in Viet Nam", Stockholm School of Economics, Working Paper Series in Economics and Finance No 236

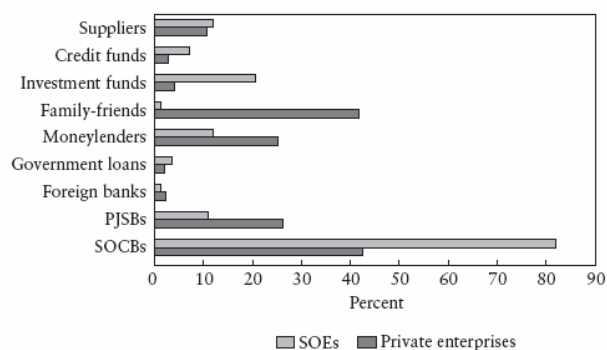
from family and friends, etc, while larger, more formal firms contract bank credit and solicit third-party equity investors. As is typical in the SME sector worldwide, the smaller the firm, the more informal the sources of finance tend to be. A 2003 World Bank survey¹⁰⁰ of 692 private firms of all sizes revealed that 66% of firms had borrowed money over the past 5 years, and 42% of these had received bank loans. In fact as many firms received bank loans as funds from family and friends (see figure 9 below). While this number may appear to signal easy access to bank lending, the high number of firms seeking loans from money lenders (27%) underscores the inability of some entrepreneurs to procure bank finance. By way of comparison, 90% of the SOEs surveyed in the study received bank loans, more than 80% of which was provided by state-owned banks.

117. Viet Nam's financial sector, although expanding, remains largely undeveloped, with many local business transactions occurring outside the banking system. Non-bank financing tools are limited, although the leasing sector is currently under development with support from the ADB¹⁰¹. The banking sector is itself dominated by four State-owned commercial banks (SOCBs) which hold approximately 75% of outstanding bank credit. Private participation in the banking sector includes 34 Private Joint Stock Banks (PJSBs) and 26 foreign bank branches which together supply 17% of the commercial credit market. Other lenders include the Central Credit Fund/People's Credit Fund (CCF/PCF) network, the Viet Nam Social Policy Bank (VSPB) and approximately 60 microfinance initiatives sponsored by various NGOs and channeled mainly through the Viet Nam Women's Union (VWU) and the Viet Nam Farmer's Union (VFU).

118. An organized stock exchange has been established and the insurance sector is growing rapidly, but the development of the nonbanking financial sector is still limited. Only 29 enterprises have been listed on the stock exchange, 27 of which are equitized SOEs. None of these companies have raised additional capital since their listing, and their market capitalization, at \$300 million, is less than 1% of GDP. An estimated 1,000 companies have their stock traded on the unofficial over-the-counter (OTC) market which is estimated to be 6 times the size of the official market. The underdevelopment of the stock market seriously constrains the development of the venture capital industry and thus the opportunity for using this means as an investment vehicle for larger SMEs. Equity flows are further constrained by numerous restrictions in investment, particularly on the use of foreign capital, and by the poor quality of information and disclosure standards, which pose heightened risks for all investors. The debt market is larger than the equity market, at \$1.5bn or 3% of GDP, but is still composed exclusively of sovereign and quasi-sovereign bonds.

119. At the most basic level, credit flows to private enterprises are constrained by four key factors: (1) the propensity of the dominant state financial institutions to lend money to SOEs

Figure 10: SOURCES OF LOANS IN THE PAST FIVE YEARS
(percentage of enterprises having obtained money from these sources)



Source: World Bank/IFC/MPDF Study "Informality and the Playing Field in Vietnam's Business Sector", 2003

¹⁰⁰ World Bank/IFC/MPDF Study "Informality and the Playing Field in Viet Nam's Business Sector", 2003

¹⁰¹ Leasing products are currently limited to financial leases; 5 of the 8 leasing companies currently operating are subsidiaries of the SOCBs; funding is generally sourced from parent banks as collateral-backed instruments that could facilitate participation in the industry by institutional investors and channel institutional funds to SMEs have yet to be developed

(thereby “crowding out” private companies), (2) weak credit evaluation systems making it very costly to assess credit risk, (3) weak creditor rights regime, and (4) onerous collateral requirements .

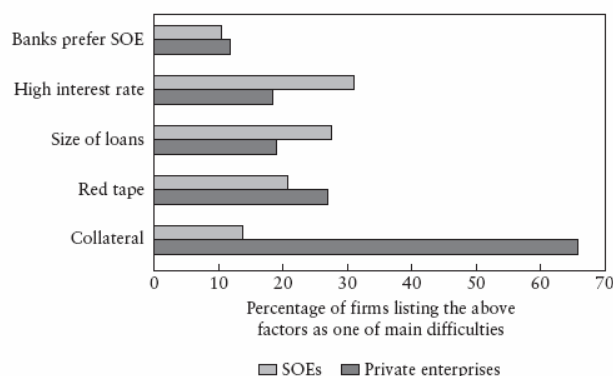
(1) Crowding Out by SOEs. SOEs absorb an estimated 45% of the credit channeled through SOCBs, which themselves provide 75% of all commercial credit in Viet Nam. Thus 33% of all commercial credit in the country is allocated to SOEs. While the share of SOEs in total lending is on the decline, SOCBs continue to favor SOE lending because of the implicit Government guarantee on such loans or explicit “encouragement” by local authorities to do so¹⁰². Although the recent elimination of interest rate caps allows banks to price risk into loan prices, few have the technical resources to do so (see 2 below)

(2) Weak Credit Evaluation Systems Viet Nam lacks a functioning credit scoring system, giving banks few mechanisms by which to evaluate the creditworthiness of borrowers. This leads to an over reliance on collateral-based credit, and very few instances of contract or cash-flow based lending¹⁰³. While the Central Bank does maintain a credit bureau, it only tracks information on large corporate borrowers and SOEs. No information on SME borrowers is collected¹⁰⁴.

(3) Weak Creditor Rights Regime.

Functioning creditor rights regimes are essential to credit flows. With the cumbersome procedure to foreclose on assets pledged against a loan, banks will be reluctant to lend, or will severely discount the value of assets pledged. While the establishment of a Secured Transactions Registry¹⁰⁵ and the revision of the Bankruptcy Law¹⁰⁶ are positive steps in strengthening creditor rights, the absence of a regulatory framework for foreclosure will continue to constrain their use¹⁰⁷.

Figure 11: MAIN DIFFICULTIES IN GETTING BANK LOANS



Source: World Bank/IFC/MPDF Study “Informality and the Playing Field in Vietnam’s Business Sector”, 2003

¹⁰² Years of directed lending and poor credit evaluation systems has led to high levels of nonperforming loans (NPLs) in Viet Nam’s SOCBs; the IMF estimated NPLs at \$8–10 billion in June 2003, which was equivalent to approximately 55–65 percent of total domestic credit. Standard & Poor’s estimated NPLs at between 50 and 75 percent of SOCB loan portfolios in November 2003

¹⁰³ Decree 178/1999 ND/CP legalized non-collateral loans, yet most of these are being allocated to SOEs, not private firms

¹⁰⁴ It should be noted that as part of its 2005-2006 programme, the MPDF proposes to work with the State Bank of Viet Nam to create a new credit bureau to collect information on SMEs and individuals. Work will entail the creation of a legal framework for credit information collection and dissemination as well as the creation of the institution

¹⁰⁵ As of 2004, the STR had approximately 60,000 registered assets, all of which can be assumed to have been pledged as collateral for financing

¹⁰⁶ The 2004 Bankruptcy Law has simplified the concept of bankruptcy and facilitated the initiation and conduct of proceedings, yet key limitations remain, including: (i) business households and individuals are not eligible to declare bankruptcy, (ii) secured creditors are not entitled to file petitions to start bankruptcy proceedings (iii) there are no regulations about the mechanism for debtors to recover when they are in financial difficulties unless bankruptcy proceedings are underway; and (iv) the regulations about the responsibility to continue settling debts indefinitely, even after selling all existing operating and own assets are considered too strict.

¹⁰⁷ A related issue is the complex and inherently weak bankruptcy regime in Viet Nam which discourages enterprise from filing; indeed it is estimated that only about 100 enterprises in Viet Nam have filed bankruptcy applications and the number of bankruptcy announcements is even smaller.

(4) **Onerous collateral requirements.** Most bank lending remains strictly collateral-based, with land use right certificates (LURC) the preferred form of security. Even when borrowers do have LURCs to pledge, the allowable collateral value set by banks is often significantly below market prices, thereby reducing the mortgage value of the asset (see Figure 11 above). Project-based lending remains rare, as does lending against the value of purchased assets.

120. It is important to recognize that constraints to formal credit flows also exist on the demand side, where enterprises consciously prefer to forego bank credit due to the disclosure requirements inherent in such borrowing. This is most evidently the case for companies operating in the informal sector, but affects SMEs of all sizes.

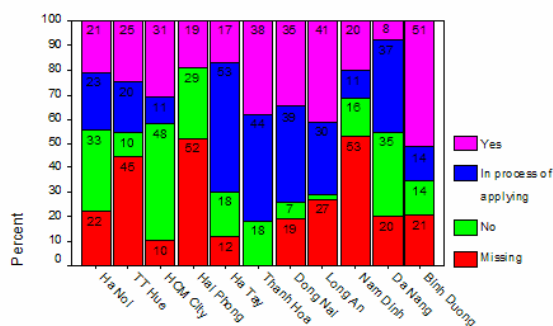
121. Looking forward, increasing the access of private companies to bank credit will require (i) strengthening the corporate governance and imposing harder budget constraints on SOCBs so that lending to SOEs is done on the same terms as to the private sector, (ii) further development of information sources and credit evaluation capabilities of banks, (iii) modernizing the regulatory framework for lending, including bankruptcy and foreclosure, and (iv) establishing a market-based mechanism for valuing LURCs and strengthening the capabilities of banks to provide project-based loans or loans secured with future assets.

122. It is important to note that efforts to improve the regulatory framework and market mechanisms for SME lending should also be supported by reforms to the Government's Development Assistance Fund (DAF), which is one of the largest financial institution in the country. Although the DAF does not operate like a commercial bank, it does provide loans to SOEs on concessional terms. In 2004, its outstanding stock of loans was estimated at close to 12 percent of GDP, approximately 50% of which was onlending from domestic sources. Of the resources mobilized domestically, about 80 percent has been on-lent to SOEs¹⁰⁸. The issuance of Decree 106/2004/ND-CP, which regulates the operation of DAF, is a step towards providing a sound regulatory framework for this policy lending as it limits funding to projects that are capable of direct repayment, have socio-economic efficiency, and have feasible business or production plans.

Land

123. There is no system of private property in Viet Nam, the state owns the land and issues land-use rights (LURs) which can be bought, sold, inherited and mortgaged. The scarcity of land and complex regulatory framework governing its commercial use may be the most significant constraint posed to PSD in the country. Indeed, the World Bank's August 2005 draft Investment Climate Assessment found that access to land was the most important constraint to doing business for private firms in HCMC and the Red River Delta. Although a new Land Law (Law 13/2003/QH11) came into effect

Figure 12: Percentage of firms with land use rights certificates



Source: Malesky, Edmund. "Entrepreneurs on the Periphery", Mekong Project Development Facility (MPDF) July 2003

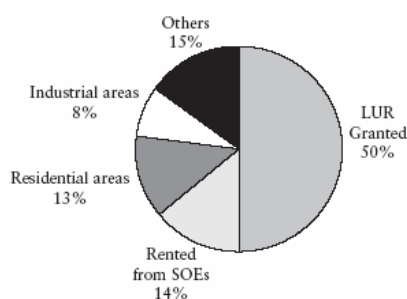
¹⁰⁸ Source: World Bank, 2004. Public Expenditure Review, p22

on January 1, 2004¹⁰⁹, with the intention of simplifying the regulatory framework and formalizing defacto LURs, implementation will be a major undertaking requiring the establishment of functioning land use registries and the mechanisms to allow greater market-based pricing of land.

124. It is estimated that 95% of existing LURs are held by individuals and households, and only 5% by SMEs. There is evidence that SME demand for land far exceeds available supply. In Hanoi, the 8-year period from 1994 to September 2002, only 147 new land leases were awarded to private companies, which is less than the number of applicants for land in the first 10 months of 2002 alone¹¹⁰. There is a shortage of land throughout the country, as existing industrial land is already occupied¹¹¹ and the conversion of agricultural land to industrial use is cumbersome. In most provinces, no more than 50% of private enterprises have formal LURC for the land they occupy, and almost all indicate that they would purchase additional land to expand their businesses if it would be made available¹¹². Thus, despite the complex procedures for valuing land and obtaining LURCs, a more fundamental constraint to land access is an actual physical shortage of commercial and industrial land.

125. While private businesses suffer from this general shortage, SOEs are illegally subleasing the excess land that they control throughout the country. Many of the lessees are SMEs. By law, SOEs are required to return any idle land that is not required for the conduct of their business operations to the State, yet in practice none have done so. Revenue generated from subleasing this land is not recorded in the annual accounts, nor do the lessees have any contract ensuring them any tenure on the land. As a result, SMEs with tenuous land use rights are sometimes reluctant to make long-term investments in machinery and equipment. Moreover, these businesses cannot deduct the rental expenses from their taxes, nor can they use the "lease" as collateral for credit. While no data is available to estimate the total amount of "unused" SOE land, a 2003 survey of 692 private firms found 14% leased land from SOEs¹¹³.

Figure 13: PRIVATE FIRMS' MAIN PREMISES



Source: World Bank/IFC/MPDF Study "Informality and the Playing Field in Vietnam's Business Sector", 2003

126. SOEs occupy a significant portion of the industrial land in the country. In Hanoi, 95% of the 3 million square meters of new rental contracts issued between 1994 and 2002 went to SOEs, with the balance being contracted by private firms and cooperatives. To the extent that SOE hold significant land holdings in reserve, an effective process to formalize these LURs would be an important step in freeing up valuable resources for the private sector. The current land law, while it requires the surrender of this excess land, does not provide a definition of excess land nor define a mechanism by which this formalization can be done. Implementing regulations to this effect are now required.

127. Land can also be made more accessible to the private sector with more transparent planning mechanisms. Viet Nam has an extensive urban planning system, but lacks a clear policy with respect to: the assignment of land for commercial and industrial purposes reflected in the master plans on the development of urban and rural areas; and the rational distribution of

¹⁰⁹ Subsequently amended in July 2004

¹¹⁰ Report from Architect Pham Cao Nguyen, Director of Hanoi Land & Housing Management Dept, Nov 2002 Conference "Land for Production & Business"

¹¹¹ It should be noted that 35% of the land available in the 71 industrial zones operating the country is vacant, but in most cases their location and/or price makes them unattractive to SMEs seeking land

¹¹² Survey of 255 private firms throughout the country; as reported in Malesky, Edmund. "Entrepreneurs on the Periphery", Mekong Project Development Facility (MPDF) July 2003

¹¹³ World Bank/IFC/MPDF Study "Informality and the Playing Field in Viet Nam's Business Sector", 2003

commercial and industrial land between the state sector and the private sector. Peoples' Committees are also meant to publicly announce their land use plans so that enterprises can see where potential for investment exists. In practice, it is rare for SME applicants to be able to access this information because the relevant agencies do not comply with this requirement. The information on land zoning and plans is valuable and is sometimes used as the basis for land speculation. Finally, the system for land acquisition involving compensatory payments to existing users and site clearance is expensive and time consuming and deters investment by SMEs¹¹⁴.

128. While the new legal framework for land management addresses many of the issues inhibiting the development of a formal land market, a number of these remain. Most important is the absence of a market-based mechanism to price land. The new law stipulates that land prices shall be determined either by (i) Provincial PC's (ii) auction of LURs (iii) agreement among land users and concerned parties (with some limitations), and (iv) the price registered by the owner, provided that it is within the price-frame of the State. Open public bidding been successfully piloted in the case of LUR for urban estate development projects in Hanoi and HCMC. Extending this pilot to land for commercial use, such as manufacturing, services, and office-space, would be an important step in creating true market values, but the intention of the government in this regard is not clear. It appears that the price of LURs will continue to be under the control of the State, although the State is expected to calculate the price of LUR "close to market value". How this will be done will be spelled out in the implementing guidelines to the Law. Until a market-based mechanism can be used to price LUR transactions, dual prices will persist, with parties to a transaction agreeing on a price that is likely to be substantially higher than the officially recorded price determined by the provincial authorities. Beyond the lost tax revenue that such a system creates, it also generates incentives for corruption.

Information

129. Information is a vital resource for an entrepreneur, as it helps to inform investment decisions and facilitates the expansion of activities into new markets. Information resources are scarce in Viet Nam, with limited dissemination from public sources and few private providers. The general lack of information is rooted in both the limited supply and general reticence of private firms to pay for specialized research. Thus the market for business services remains undeveloped.

130. On the supply side, few Government Ministries or Provincial authorities publish (in hard or soft copy) market profiles with data on suppliers, buyers and types of products produced. Similarly, information related to planned changes to sector regulations, tariffs and other market-altering issues are not readily available to private firms¹¹⁵. As importantly, very few Ministries and SOEs post procurement opportunities on the web¹¹⁶. Surveys of private firms indicate that even profession Business Associations, which should provide such information, rarely do so on a systematic and current basis. In some cases information is purposefully diverted to SOE recipients, such as when trade associations direct potential buyers exclusively to SOEs. In official delegations, trade shows and commercial offices abroad, SOEs are promoted much more prominently than private companies. In short, private firms must therefore operate with very little visibility regarding their market and potential opportunities/threats.

¹¹⁴ Paragraph take from World Bank. *Viet Nam Development Report 2005: Governance*. Joint Donor Report to the Viet Nam Consultative Group Meeting. Hanoi 2004

¹¹⁵ Even the most business-friendly cities such as HCMC do not include public procurement /investment plans on their website

¹¹⁶ Information on public procurement opportunities is must be made public by law, but wide dissemination is rare; of the government Ministries, only the websites of the Ministry of Transportation and MPI have some information on procurement opportunities for large projects; other Ministries with large procurement budgets such as the Ministries of Education, Health, Agriculture and Rural Development do not provide this basic data.

131. On the demand side, SMEs are reluctant to pay for specialized market research or other professional services, resulting in an underdevelopment of this market. While larger firms and SOEs do contract out these services, their cost is considered prohibitive by most SMEs. While this phenomenon is expected to change as markets mature, firms become larger and BDS providers more established, in the interim most SMEs have to operate with very little information with which to expand their business linkages (suppliers, buyers), improve their products (new technologies, technical standards) and refine their competitive strategies (pricing, product differentiation, etc).

132. The Government and donor community is well aware of the information problem, and is taking measures to publish basic market, regulatory and planning data on a more systematic basis. While this will help, the extent of the problem will likely require grass-roots solutions, where local business groups can be supported with training on how to access market information, can publish their own directories and organize trade fairs. Similarly, Provincial governments could establish free business information centers with internet access, and larger subcontracting firms (including SOEs) should be encouraged to regularly publish contracting opportunities and technical requirements.

Business Registration Under Enterprise Law

Following the enactment of the Enterprise Law in 2000, the business registration process for new private companies has simplified significantly, as widely perceived and evidenced by this survey. This improvement has been widely commended by the business community in Viet Nam. The four principal steps of the business registration process and start-up process are as follows:

- (i) Register for a business certificate from the local DPI;
- (ii) Get a corporate seal made and register it at the local police station;
- (iii) Receive a company tax code from the local tax office; and
- (iv) Purchase a red invoice book from the tax office.

Firms must follow this process, one step after another, according to this strict sequence. It is not possible to pursue multiple steps in tandem. Our survey found that, on average, it took a firm about 50 days to complete the whole registration and start-up process.

Source: MPDF, "Business registration and Startup in Viet Nam", Private Sector Discussions No20, May 2005

2. Regulation

133. The regulatory environment for doing business in Viet Nam is highly complex and evolving. As is to be expected in an economy transitioning from a highly centralized system of economic management to an increasingly market-based framework, a large number of new rules and regulations are issued, often with conflicting provisions¹¹⁷. Between 1992 and 1999, for example, Viet Nam issued 120 new laws and ordinances, and thousands of implementing regulations and guidelines. The Law on Foreign Investment was changed four times between 1987 and 2000. Old laws are not replaced entirely by new laws, but rather are superseded by new laws and amendments only in cases of direct conflict, thereby adding further complexity. Although the business community recognizes the Government's good faith efforts to improve the investment climate through the issuance of these new rules and regulations, the ensuing instability of the framework raises the risks/costs of doing business in the country.

134. At the most basic level, SMEs are affected by legal and regulatory requirements for business establishment, financial reporting, taxation, contract and dispute resolution, bankruptcy, land use rights, technical standards, and banking and finance. The rapid pace of regulatory changes have given rise to several generic problems, specifically; incomplete implementing provisions allow for interpretation in their application and lead to inconsistent implementation; a tendency to overly regulate and supervise rather than create an enabling environment for business; and shortfalls in implementation capacity in terms of adequately skilled and resourced

¹¹⁷ For example, the 1998 Law on Complaints lays out a path for appeals of local administrative decisions. At the same time, it requires complainants to accept the findings of the relevant body without appeal

personnel.¹¹⁸

135. While the Enterprise Law of 2000 has resulted in an increase in business registration and significant reductions in the time, cost and documentation requirements for starting a business, the implementation of the new provisions for simplified business registration has not been consistent nationally. Post registration formalities to obtain seals, tax codes and VAT invoices have remained cumbersome, time consuming and expensive. Finally, the business registration system itself has not been established on a unified national basis, potentially nullifying many of its benefits, and both human and physical resources are inadequate in some locations.

136. The Enterprise law successfully abolished 150 licensing requirements which restricted market entry, leaving a total of 228. Since 2001, however, the government has issued more than 70 legal documents—including 2 laws, 2 ordinances, 13 decrees, and 31 circulars—reintroducing, in disguised form, licenses, capital requirements, and other entry restrictions¹¹⁹. These have served to increase the time and costs associated with starting a business, reversing some of the key gains of the Enterprise Law. Recognizing the propensity of government agencies to want to control business activities through excessive licensing requirements, the Prime Minister is currently exploring options to implement a process of regulatory impact assessments (RIAs). These RIAs would in the first instance be designed to rationalize the current range of 298 licenses, and place more rigorous controls on the issuance of any new regulations.

137. The government has also been working to harmonize the regulatory regimes for all enterprises: domestic, foreign, public and private¹²⁰. A second draft Unified Enterprise Law (UEL)¹²¹ and 8th draft of a proposed Common Investment Law (CIL) have been under preparation for many months, and are intended to be finalized by end 2005¹²². The stated purpose of these new laws is to (i) create a level playing field for all enterprises in Viet Nam, (ii) open up all business activities not specifically proscribed by law to the private sector and (iii) strengthen corporate governance practices. The UEL focuses on business registration and corporate governance, while the CIL focuses on investment incentives, prohibited sectors and licensing requirements. The laws have been prepared with active input from the private sector and donor community.

138. While these new laws will introduce a welcome shift from an investment licensing to an investment registration system, simplify the complex web of over 300 existing investment incentives, and strengthen corporate governance guidelines, the current drafts fall short of creating a level playing field for all enterprises. Key shortcomings include:

- The UEL will only apply to SOEs that are LLCs or have been equitized, which is only 8% of the SOEs (measured in terms of capital)¹²³
- According to the CIL, FIEs will still be excluded from certain sectors that will remain open to domestic private enterprises

¹¹⁸ This paragraph adapted from Enterplan/PwC “Preparing the SME Sector Development Program: SME Roadmap” May 2004, p61

¹¹⁹ Central Institute of Economic Management (CIEM). 2002. The Enterprise Law’s Enforcement: Achievements, Challenges and Solutions. Hanoi.

¹²⁰ Including all forms of private enterprises (sole proprietorships, LLCs, joint-stock, etc)

¹²¹ The UEL will apply to domestic enterprises (currently regulated by the existing Law on Enterprises), FIEs (regulated by the Law on Foreign Investment) and equitized SOEs (regulated by the Law on State Owned Enterprises).

¹²² The laws will be accompanied by 10 implementing decrees, including one intending to harmonize the legal regime for BOT transactions for all enterprises

¹²³ There is an ongoing debate within the Government as to if and how SOEs might be brought under the law; the UEL does not provide any requirements in this regard

- The UEL allows a broad range of licensing/permit requirements proscribed in other laws, decrees and ordinances to persist.
- The corporate governance prescriptions of the UEL are very detailed and overly prescriptive for smaller enterprises

It will be important for the next iterations of these laws to address these shortcomings, as in their current form the laws may not achieve their full intended purpose. Moreover, changes to over 60 related regulations (regarding business establishment, tax, finance, land, corporate governance, etc) will also be required to ensure that the spirit of the new UEL and CIL is consistently applied.

3. Competition

Competitive Landscape

139. Viet Nam's competitive landscape has long been distorted by numerous rules and regulations applying inconsistently to the various types of enterprises: private, public, foreign, domestic, large and small. While changes to this regulatory framework are underway to provide national treatment to foreign enterprises and harmonize rules applying to all enterprise types (see section B above), the SOE sector will remain largely exempt from the new UEL and as such will continue to distort the playing field. With over 4845 SOEs¹²⁴ operating in almost every sector of the economy, competition between private and public enterprises is widespread (see Table 8 above). While SOEs generate a smaller portion of GDP than the private sector (29% for SOEs compared to 40% for the non-farm private sector), they consume 75% of state-owned bank credit and are widely believed to occupy most of the available industrial land. According to the World Bank's August 2005 draft Investment Climate Assessment, SOEs pay close to 5 times less per square meter than private domestic firms to rent land. SOEs are capital intensive, yet produce 2-3 times less revenue per employee than private SMEs. SOEs dominate the large enterprise segment (>299 employees) of the domestic enterprise sector, generating 99% of its GDP. SOEs hold monopolies in a wide range of sectors including electricity, petroleum, aviation, ports, railway, cigarette production and mining, and hold dominant positions in banking, telecommunications, construction, cement, steel, shipping, textiles and a number of other sectors.

Table 8: MAIN COMPETITORS OF SAMPLE FIRMS
(percentage of firms in the sample)

Competitors	Private	SOEs
None	10	10
Domestic SME private firms	55	44
Domestic large private firms	23	8
SOEs	29	50
Foreign companies	16	18
Smuggled goods	13	27

Source: World Bank/IFC/MPDF Study "Informality and the Playing Field in Vietnam's Business Sector", 2003

140. The Government's stated policy is to encourage fair competition in the economy as a whole, in line with Constitutional changes made in 2001 to end official discrimination between the public and private sectors. As part of this policy, the government has pursued a policy of SOE restructuring to increase their competitiveness. Between 2001-2004, the government restructured an estimated 2,657 SOEs, of which 2,242 were equitized¹²⁵. Restructuring efforts created 17 conglomerates and 77 "special corporations" which account for 80% of the state sector's production capacity. While SOE restructuring and equitization has resulted in only a small amount of divestment, the purpose of the program is to improve the financial performance of SOEs¹²⁶. To

¹²⁴ 2947 of these operate at the provincial level, 1898 at the central level

¹²⁵ Equitization is a process by which shares are issued by a company but not necessarily sold to the private sector; shares can remain in state or local government control, or be sold or transferred to the enterprises' workers, or sold to outside parties. Shares of the 2242 state firms equitized represent a total value of \$1.13bn, or about 8.2% of all SOE capital., 46.5% of the shares are still held by the state, 38.1% have gone to employees and 15.4% have been sold to private investors

¹²⁶ It should be noted that this program is ongoing, with the goal of equitising another 1,460 SOEs in

the extent that this has been achieved by introducing hardened budget constraints and reduced subsidies to the restructured SOEs, it has succeeded in placing them on a more equal footing with private firms¹²⁷.

141. Other measures taken to place SOEs on a more level playing field with private enterprises include:

- Decision 155/2004/QD-TTg reducing the number of sectors considered strategic and reserved for SOEs¹²⁸
- Decree 153 of 2003 allowing the creation of holding company structures and facilitating corporate governance reforms to clarify the shareholder/manager relationship
- The adoption of new accounting standards based on international practice harmonizing accounting practices between SOEs and private firms

142. While important, these changes are only the beginning of what should be a much larger program of reform, and which should include the application of UEL and CIL provisions to SOEs, and measures to eliminate fundamental differences in their access to key resources. Specifically, additional measures should include:

- the formalization of land resources held by the SOEs, through the issuance of LURCs for the land and inclusion in balance sheets
- hardened credit evaluation processes by SOCBs and DAF, applying the same collateral and/or profitability standards to SOEs as to private firms
- corporatization of SOEs and strengthened corporate governance reforms, allowing the simplification of the SOE shareholder role within the government and improved transparency in operations
- equal allocation of export quotas to private as well as public firms
- equal access to public procurement contracts¹²⁹
- equal access to foreign partners¹³⁰
- introduction of equal tax treatment for public and private firms

143. The proposed agenda is ambitious, and may prove too sensitive to apply to some of the largest and most powerful SOEs. It is recognized that a close network of relationships exists between bureaucrats, politicians and SOE managers. This, together with unclear lines of command and control between ministries and SOEs, serves to create broad areas of vested interests that are likely to stiffly resist change. It is however imperative that the government pursue the SOE reform process as an essential element in creating a level playing field for private sector development.

Competition Legislation

144. A new Competition Law went into effect on July 1st 2005. The law will apply to business

2006–07, in line with commitments made under the IMF Poverty Reduction and Growth Facility (PRGF) and World Bank Poverty Reduction Support Credit (PRSC).

¹²⁷ It should be noted that the financial performance of SOEs, although difficult to measure, appears to be improving. A 1999 survey by the Ministry of Finance indicated that 40% of SOEs (covering approximately 70% of SOE value added) could be defined as profitable, while 44% were intermittently profitable, and 16% (accounting for 6% of value added) were loss making or insolvent

¹²⁸ Strategic sectors listed in the Decree are national defence, public utilities, power transmission and cigarette production; the Decree also restricts the management and operation of large airports, seaports, roads and railways to SOEs

¹²⁹ This may require a revision of bid qualifications which in some cases are designed to exclude all but SOEs

¹³⁰ Qualifications for partnership with foreign investors should not unduly favor SOEs

enterprises and professional and trade associations in Viet Nam; overseas enterprises and associations with activities in Viet Nam; public utilities and state monopoly enterprises; and state administrative bodies. "Overseas enterprises" include foreign companies with a commercial presence (such as branch or sales offices), foreign-invested businesses such as wholly owned ventures, and foreign contractors having an office or otherwise doing business directly in Viet Nam. The new competition law will prohibit four broad types of anti-competitive activity: (1) agreements that restrain competition; (2) abuse of monopoly or dominant market position¹³¹; (3) economic concentrations (mergers and acquisitions); and (4) acts of unhealthy competition. The last three are considered to be subsets of the first category.

145. Implementation of the law is intended to be done with a 3-pronged institutional structure modeled on international best practices. The first of these has already been established: the Competition Management Department which will exercise the function of State Administration of Competition. While currently under the MoT, the National Assembly acknowledged that, in the long term, it will be necessary to make the State Administrative Body for Competition independent of the MoT. The Competition Law also provides for the establishment of associated advisory and enforcement bodies, the Competition Commission and Competition Council. Four implementing decrees are under preparation to allow implementation of the law:

- A Decree on administrative penalties for offences in the competition sector
- A Decree providing detailed guidelines and regulations for implementation of a number of articles of the Law on Competition (June 2005 Draft) which provides greater detail on the types of market behavior that will constitute practices in restraint of competition and, in particular, on how the market position of entities will be determined
- A Decree on functions and organizational structure of Viet Nam's competition authorities; and
- A Decree on illegal multi-level selling

146. Viet Nam's introduction of this complex legislation is quite important, and regional experience (e.g. Indonesia) demonstrates that although highly complex, the spirit of these laws can be successfully implemented if protected from political interference. In Viet Nam, particular attention will need to be paid to the way that the Competition Bureau handles cases of anti-competitive behavior involving SOEs, as these are the only companies holding dominant market positions today. While the law allows the Bureau or the Prime Minister to provide exemptions, the rationale and frequency of their use will provide an indicator of the independence of the Bureau.

147. For tradable goods, the best insurance against effective monopoly is relatively free trade. The phase-in of lower trade barriers and of competition in banking and telecommunications over the next several years (linked with the BTA and other ASEAN commitments) will reduce the power of several general corporations and improve the welfare of consumers and industrial users of their products. Establishing customers' associations and promoting the development of better market information would also have a pro-competitive effect.

4. Taxation

148. Viet Nam's corporate tax system has been evolving rapidly over the past years, both in terms of regulations and implementation. The new law on Corporate Income tax (CIT) and implementing Decree 164, which took effect in 2004, applies the same standard QT rate of 28 percent and the same preferential rates of 20 percent, 15 percent and 10 percent to both

¹³¹ The law prohibits abuses of dominant market position, but not the existence of dominant positions, except when they are proposed as the result of mergers or acquisitions

domestic and foreign invested enterprises throughout Viet Nam¹³². The number of VAT tax rates has also been cut from 4 to 3, including the abolishing of the highest rate of 20 percent, and the overseas profit remittance tax and surtax on enterprise income have been abolished. Most notably, in 2002, agricultural land use tax has been reduced by 50 percent; and since 2003 nearly all farmers are exempted from such tax, so that approximately 75% of Viet Nam's population no longer pay direct taxes.

149. An increasingly sophisticated and computerized tax inspection system has been developed to reduce the opportunities for tax avoidance, although it is unclear if this system has reduced the level of discretion exercised by tax officials in calculating and collecting payments. Indeed while the level of CIT is comparable to that in other countries in the region, the structure is very complicated, making it difficult for firms to calculate tax liabilities. Overall tax collection receipts continue to grow, however, with the General Department of Taxation (GDT) estimating that total tax receipts in the 2001–05 period would reach VND720trn, or approximately 22.8% of GDP.

150. Private enterprises consistently cite high tax rates and complicated tax rules as a significant constraint to doing business. While the official CIT rate is now capped at 28%, the effective tax rate is higher due to the method of calculating profit. Expenses which in most countries are considered legitimate business expenses are arbitrarily capped¹³³, while others are refused entirely, such as rental/utility costs of land leased from SOEs or the use of private homes for office space. While surveys suggest that the level of discretion exercised by tax officials in calculating taxable income varies from district to district, a further simplification of tax rules and alignment with international best practices would be an important step in reducing the opportunities for discretion.

151. Viet Nam also has a complex system of tax incentives, with over 300 different rules which are defining eligibility and terms of application, many of which are overlapping and/or contradictory. In practice, few newly established enterprises have managed to take advantage of tax reductions and exemptions, due to lack of information on the applicable incentives and the process for procurement. The system is also largely ineffective, with most firms having successfully received fiscal incentives reporting that they would have proceeded with their investments in the same form and location had the incentives not existed. The proposed new Common Investment Law includes a necessary rationalization of the tax incentive regime.

5. Commercial Dispute Resolution

152. A functioning legal framework with implementing judicial institutions is essential for supporting formal private sector investment. Where it does not exist, the risks of doing business are necessarily higher, thereby depressing the competitiveness of the country and discouraging companies from entering into large scale contracts. In Viet Nam, the effective absence of this functioning framework (see relative performance in Table 9 opposite) has meant that most SMEs limit contracting as much as possible, and resolve any disputes that arise with contractors outside of the formal court system¹³⁴. Foreign investors have mitigated risks by including international arbitration clauses in their contracts, or working with SOEs, where they have more confidence

¹³² FIEs licensed from January 1st 2004 are subject to the new tax regime. FIEs licensed prior to this date will remain subject to the tax rates stipulated in their licenses.

¹³³ An often-cited example of this is marketing expenses which are capped at 10% of total business expenses; other examples include caps on employee salaries

¹³⁴ In Hanoi, which has approximately 10,000 firms, only 70 cases were brought to the Economic Court in 2003, and 20 to the International Arbitration Center operated by VCCI; firms generally avoid the courts because the process is lengthy and expensive, decisions are considered arbitrary and the enforcement mechanism is ineffective

Table 9: Costs of Enforcing Contracts

	Number of Procedures	Time (days)	Cost (% of debt)
Vietnam	37	404	30.1%
China	25	241	25.5%
Thailand	26	390	13.4%
Philippines	25	380	50.7%
Cambodia	31	401	121.3%
Singapore	23	69	9.0%

Source: World Bank, *Doing Business 2005 Database*

that commitments made in the absence of contracts will be honored. The Government recognizes the importance of developing of a more formal legal basis for contracts, dispute resolution and enforcement for the growth and global integration of Viet

Nam's economy, and is preparing a Legal Reform Masterplan to guide its implementation.

153. Strengthening the legal basis for business contracting necessarily involves 3 components: (1) reforming the body of legal codes pertaining to contracts, (2) strengthening the capacity of the courts and arbitration bodies to objectively adjudicate disputes, and (3) strengthening the capacity of the Enforcement Agency to enforce decisions. Viet Nam has made notable progress in addressing the needs of all three of these components, specifically:

- A revision of Viet Nam's 1997 Commercial Law was approved by the National Assembly at its May 2005 Session, and will take effect in January 2006. The new Law reconciles differences between Viet Nameese commercial law and international commercial laws in order to accommodate requirements arising from the BTA and other international agreements.
- A revised Civil Code was also approved by the National Assembly in May 2005, for effect in January 2006. Where previously business contracts could be governed by the Commercial Law, the Civil Code or the Ordinance on Economic Contracts, now all contracts will be governed by the revised Civil Code. As a part of this reform the Ordinance on Economic Contracts was repealed, and contracts will now be governed by the civil code and disputes adjudicated by the civil courts¹³⁵.
- A new Commercial Arbitration Ordinance (08-2003-PL-UBTVQH11) became effective on 1 July 2003, making arbitration decisions involving a foreign party legally binding and enforceable. Foreign arbitrators may be appointed and arbitration proceedings may be conducted under foreign laws and/or in a foreign country. The Ordinance represents a vast improvement on previous Viet Nameese arbitration law.
- A revised Ordinance (13-2004-PL-UBTVQH11) on the Execution of Civil Judgments came into effect in July 2004 and provides for enforcement of decisions on bankruptcy and domestic arbitration awards as civil judgments. The time limit within which an enforcement body must issue a decision on enforcement of a judgment was reduced to five days.
- A new Civil Procedure Code (24-2004-QH11) came into effect in January 2005, consolidates and simplifies the procedures for all types of legal proceedings, including economic and commercial matters.

154. The implementation of these new laws and regulations will require significant efforts in capacity building, including improving the overall transparency of the court system. The publication of decisions, a major breakthrough achieved on a pilot basis in 2005, is an important element in this effort. Looking forward, emphasis should now also be placed on strengthening the mechanisms for the enforcement of decisions, one of the weakest components of the dispute resolution framework¹³⁶. While in the past the role of enforcing court decisions fell to the

¹³⁵ The Economic Court, which had jurisdiction over the Ordinance on Economic Contracts, may be refocused on matters of intellectual property and non-contractual commercial disputes.

¹³⁶ Legal observers in Viet Nam estimate that of the 15,000 decisions rendered every year in civil cases, only 5% are enforced

Enforcement Agency within the Ministry of Justice, but was in fact subordinate to the local People's Committees, in the future the Enforcement Agency will only consult the People's Committees as required, and will have more direct control over the Judicial Police. A new Law on the Enforcement of Judgments is expected to be promulgated in May 2006 to elevate Ordinance 13 and provide detailed policies and procedures for enforcement.

155. In summary, Viet Nam has made significant progress in creating a functioning framework for commercial transactions, contracts and dispute resolution. As has been the experience of its SouthEast Asian neighbors, legal reform takes time and requires significant resources, particularly in building the technical capacity of the implementing institutions. The donor community¹³⁷ has and should continue to support this effort as an essential component to private sector development.

6. Summary of Key Constraints to PSD

156. As the preceding analysis demonstrates, the key constraints to private sector development remain centered on the limited access to key resources, the market protections and concessional resources given to SOEs (creating an uneven playing field), the intrusive bureaucracy charged with implementing the legal and regulatory framework for doing business, the complex nature of this legal and regulatory framework, and the absence of reliable mechanisms for the resolution of commercial disputes. Together, these constraints create incentives for the private sector to operate informally, avoiding as many regulations as possible and in the process placing themselves outside the formal credit and business networks. In summary:

- *Limited access to credit and capital.* Private enterprises continue to find it difficult to borrow from the commercial banking sector, and the relative underdevelopment of the financial sector makes few other sources of finance available. Bank credit is restricted by weak credit evaluation systems and creditor rights regimes, onerous collateral requirements and a general crowding out by SOEs who benefit from implicit government guarantees, making them better credit risks.
- *Limited access to suitable land/business premises.* The shortage of suitable industrial land and absence of a formal land market present considerable challenges to private enterprises. Moreover, existing titling systems and regulations make it difficult for enterprises with leased facilities to fully utilize these assets to mobilize additional business investment
- *Limited access to information.* Information regarding market structures, suppliers, customers, public procurement contracts, planned public investment programs and regulatory changes is not readily available in Viet Nam, leaving companies to either expend valuable time researching it or simply operate without. In the absence of this information, businesses find it very difficult to identify new market opportunities or make significant investment decisions.
- *Lack of a level playing field.* SOEs continue to dominate the economy, benefiting from market protections and resources offered at concessional rates by the government (in particular finance and land). This shuts the private sector out of certain commercial sectors, and creates unfair competition in others. Continued subsidization of the SOE sector not only diverts government resources which might be otherwise channeled in support of PSD, but also restricts the competition which could stimulate innovation and value-creation for the Viet Namese consumer

¹³⁷ Major donors in Legal Reform include Danida, Cida, USAID and JICA

- *Intrusive bureaucracy.* While results vary significantly from province to province, businesses often complain of the frequency of inspections, degree of discretion exercised in tax collection, and time spent dealing with the changing requirements of various licensing offices. The sheer success of some provincial governments in facilitating the regulatory compliance of its private sector point to the progress that can be made by their more intrusive peers.
- *Complex legal and regulatory framework for doing business.* The propensity of lawmakers in Viet Nam to want to prescribe all allowable activities in law leads to an extensive set of laws, decrees, ordinances and implementing regulations. At the same time, the efforts of the government to transition to a market economy have generated a host of new rules and regulations, many of which overlap and/or contradict the existing ones. The complexity of the framework at best creates delays in implementation, (as officials seek clarifications on the law), or at worst opportunities for unofficial payments (as officials use discretion in applying the law).
- *Absence of reliable dispute resolution mechanisms.* In Viet Nam, the effective absence of formal and reliable dispute resolution mechanisms raises the risks of doing business and leads most SMEs and foreign investors to limit contracting as much as possible, thereby restricting the development of domestic business networks.

157. While these constraints persist, it should be noted that Viet Nam is making remarkable progress in improving its investment climate and preparing for greater economic integration via the WTO. Indeed the transition to a more, open, market-based economy is a complex undertaking, made more so by the government's desire to maintain a large grouping of SOEs to coexist with the private sector. The momentum created by the issuance of competition-enhancing legislation must be maintained into implementation if tangible benefits are to reach the private sector.

C. Firm-level Operations

1. Comparative Analysis of the Cost of Doing Business

158. The costs of doing business in any country are critical factors in its competitiveness. In an increasingly global market, intense competition for both export markets and scarce investment capital makes cost competitiveness critical to economic growth. This is particularly true for the developing economies of the GMS, which not only compete against each other but also against regional neighbors in SouthEast Asia.

159. To assess the comparative costs of doing business in a country, one must consider both basic manufacturing costs as well as the added costs associated with licensing, permits, dispute resolution and general administrative procedures necessary for operations. Direct manufacturing/production costs would include the following:

- raw materials (including all costs associated with delivering the raw materials to their location of transformation, including customs processing)
- labor (wage rates, social security taxes, severance payment liabilities, other benefit obligations, limitations on working hours, etc)
- productivity
- taxes (corporate income individual income, property, machinery and equipment)
- office / property rents
- utilities
- logistics (cost of delivering goods from the factory to their point of sale)

Indirect costs of doing business also play a role in determining competitiveness. These costs include:

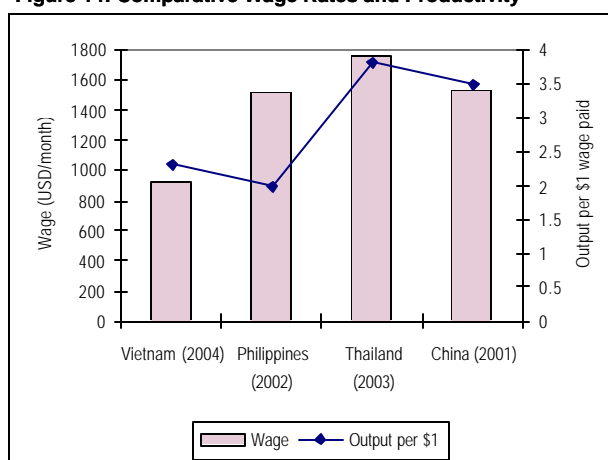
- licensing and permits (time required to obtain and renew permits and licenses)
- dispute resolution (efficiency, reliability and equity of the legal system in resolving business disputes and enforcing judgments)
- efficiency and equity of tax assessment and payment process

While the indirect costs of doing business have been detailed in the preceding analysis, this section focuses on the direct costs – those which can be more easily compared with competing investment destinations. A summary of this direct cost analysis is presented as Viet Nam's Total Factor Productivity (TFP), a measure of the output of the economy relative to the size of all of its primary factor inputs. The higher the TFP, the more efficient and competitive the economy.

160. According to the World Bank's draft Investment Climate Assessment for Viet Nam (August 2005), Viet Nam's TFP compares favorably to Malaysia, Philippines and Thailand in most manufacturing sectors. More specifically, Viet Nam is as efficient as these 3 competitors in the garments, metals and food processing subsectors, is at least 21% more efficient in wood processing and 10% less efficient than Thailand (but on par with Malaysia and Philippines) in textiles.

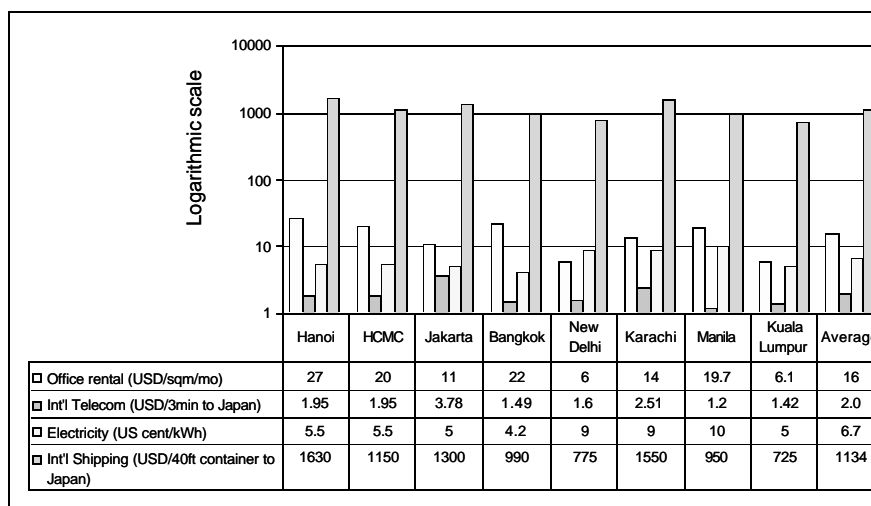
161. Viet Nam's success in attracting FDI in manufacturing over the past decade was largely driven by its low labor cost. This key cost advantage has begun to erode, however, as productivity gains in other countries have outpaced those of Viet Nam (see Figure 13 opposite). To these productivity figures one should add the labor rigidity index, which measures the ease of hiring and firing workers, along with the associated costs. According to the World Bank's Doing Business 2005 survey, Viet Nam had the second highest labor rigidity index in the region, at 55 compared to a regional average of 37 (only Indonesia was higher, at 57; China was 30). During the period 2002-2004, the average wage rates of workers and mid-level managers in Viet Nam increased 11% and 21% respectively.

Figure 14: Comparative Wage Rates and Productivity



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

During the period 2002-2004, the average wage rates of workers and mid-level managers in Viet Nam increased 11% and 21% respectively.

Table 9: Comparison of Investment-Related Costs in Vietnam 2004

Source: JETRO Survey of Investment Related Costs, November 2004

162. Viet Nam's key non-labor input costs are largely on par with regional competitors:

Office rental: Office rental costs in Viet Nam are among the highest in the region, reflecting the general shortage of space. Monthly office rental costs in 2004 in Hanoi was \$US 27/square meter, or 2.5 times that of Bangkok. Office rents increased 12% between 2000 to 2004.

Telecommunication cost: Telecommunications cost have fallen dramatically in Viet Nam, and it is now 72% cheaper to make a 3 minute call to Japan than it was in 2002. International telecoms costs are now roughly on par with regional averages. Internet costs, however, remain among the highest in the region, second only to Indonesia. The ADSL basic charge in Viet Nam was \$US 76.35 per month, 10 times less than Indonesia at \$US 782.12 but 5 times more than Bangkok, at \$US 14.61.

Electricity: Electricity cost, a major component of manufacturing costs, averaged \$0.05/kWh in Viet Nam, 10% higher than Jakarta or Kuala Lumpur and 30% higher than Bangkok, but 39% less than New Dehli or Karachi. From 2002 to 2004 the power cost in Viet Nam decreased 8 percent.

Transportation cost: International shipping costs from Viet Nam are among the highest in the region, due largely to high port handling charges and the relatively limited capacity of Viet Nam's ports. The cost of shipping a 40ft container from Hanoi to Japan was 44% higher than the regional average, while from HCMC the cost was roughly on par with the regional average. From 2002 to 2004 the cost of international shipping increased 9 percent.

163. A number of measures could reverse the trend of Viet Nam's declining input cost competitiveness, including: (1) the development of better domestic supply networks, reducing the amount of inputs that need to be imported, (2) improvement in the quality and capacity of physical infrastructure, (3) simplification of rules and regulations for hiring/firing workers, (4) release of surplus industrial land held by SOEs and simplification of land procurement procedures.

2. Business Support Services

164. Business support services (BSS) include training, consultancy and advisory services, marketing assistance, research, technology development and transfer, and business linkage promotion. BSS are designed to help enterprises reduce costs, improve efficiency, access new markets, increase sales, enhance productivity and grow. As detailed in section B 1 above, the BSS market in Viet Nam is largely underdeveloped, representing an estimated 1-2 percent¹³⁸ of GDP.

165. The underdevelopment of the sector is due to limitations in both supply and demand. On the supply side, there are only a small number of private BSS providers, and the SOEs that dominate the market lack are largely subsidized by the government and have few incentives to develop their market. Even the more active business associations lack the resources to provide value-added services to their members. On the demand side, the general perception among the SME community is that available BSS are expensive and of limited added value. Moreover, SMEs tend to consider BSS services as more tailored to the needs of large enterprises than the specific challenges of SMEs. Purchasers of BSS are predominantly SOEs and FIEs in the manufacturing sectors.

166. The development of the BSS market is also constrained by an incomplete legal and regulatory framework. Firms have difficulty deducting BSS expenses from taxable income, consultants cannot offer services without operating within a consulting firm, and legal contracts are difficult to enforce. As business standards are raised throughout the country (e.g. technology, disclosure), and competition intensifies with accession to the WTO, the demand for BSS is expected to grow. Addressing the legal and regulatory constraints to the development of the market will be essential to providing Viet Namese companies with higher-quality BSS. In tandem with these reforms, the SOEs operating in the sector should be corporatized and placed on more equal competitive footing with private providers, this will facilitate the emergence of more efficient BSS providers thereby lowering costs to the consumer.

IV. OTHER AID AGENCIES' ACTIVITIES IN SUPPORT OF PRIVATE SECTOR

167. A large number of aid agencies and NGOs are active in promoting private sector development in Viet Nam. A recent study conducted by the Mekong Private Sector Development Facility¹³⁹ found that 58 projects are in progress and/or recently completed, with a total funding commitment of nearly US\$840 million over a ten-year period of 2001-2010. Out of these, 26 (45%) were new projects that were launched in 2004 and 2005. In this study, PSD activities are defined as those that fall into three categories:

(i) *Business Enabling Environment (BEE)*: legal/regulatory environment, government capacity, and business culture/entrepreneurship

(ii) *Access to Finance (ATF)*: short/medium/long-term credit, microfinance, equity finance, and other non-banking financial services such as leasing, guarantees, insurance, etc.

(iii) *Business Development Services (BDS)*: business services (legal, accounting, finance, marketing, IT, etc.), consulting, training, business linkages (clusters, associations, incubators, and other types of groupings to achieve economies of scale), information on domestic market, information on foreign markets (trade promotion), and technology transfer.

The following paragraphs summarize the main findings of the report, to which is added a short profile of work being conducted in two critical related areas: (i) Judicial reform and (ii) SOE

¹³⁸ CIEM, Vision and Associates Ltd, and Deacons Viet Nam. 2003.

¹³⁹ Nhu-An Tran, "Private Sector Development in Viet Nam: An Analysis of Potential Gaps and Conflicts in Donor Interventions" MPDF, May 2005