Summary

Objective and Background

This report examines Vietnam's framework for foreign direct investment (FDI), focusing in particular on three industries: food processing, garments and electronics. The background to this survey is the recent sharp decline of FDI inflows to Vietnam a reversal that began even before the Asian crisis. This reversal sharply contrasts with the growing worldwide volume of FDI flows to developing countries, a form of financial flows which is recognised as an important means of external development finance.

Vietnam's framework for FDI encompasses a broad spectrum of issues. This report identifies and focuses on six components:

- the trade regime,
- the financial regime,
- legal regulations,
- taxation and investment incentives,
- institutional capability, and
- physical infrastructure.

While the framework encompasses such a broad spectrum of issues, the investigation focuses mainly on the following three questions:

- What features of Vietnam's framework for FDI reduce the country's attractiveness to foreign investors and limit the scope of FDI to contribute to growth and development?
- What should Vietnam do to improve its framework for FDI in order to overcome these problems?
- How can international development assistance support Vietnam in addressing this challenge?

Methodological Approach and Survey Design

The empirical survey is based on an extensive review of the Vietnam-specific literature, including Vietnamese legal documents and on data the authors collected in Vietnam from mid-February to the end of April 2000.

Interviews were conducted with:

1. more than 60 foreign direct investors in the food-processing, garment and electronics industry;

2. Vietnamese authorities dealing with FDI-related issues and

3. experts from Vietnamese and international institutions and firms with specific knowledge on policies affecting FDI.

Beyond the core part, the questionnaire asked questions on assets transferred by FIEs, i.e. local linkages, employment, and training.

After the first chapter, which is dedicated to the introduction of the report, the second chapter describes the development of FDI flows to Vietnam over the past decade and provides a summary of the forces that have given rise to this development. The third and core chapter of the report describes and analyses Vietnam's framework for FDI on the basis of the empirical survey. The fourth and concluding chapter identifies policy challenges to Vietnamese authorities and implications for development assistance relating to an improvement of the framework for FDI.

FDI in Vietnam: Trend and Contribution to the Economy

After the beginning of *doi moi* in 1986, Vietnam was able to attract large amounts of FDI. However, these inflows have declined dramatically

since the mid-1990s, i.e. even before the Asian countries – where most of the FDI originated – began to be affected by the regional crisis.

The decline in FDI inflows is related to three major internal and external factors:

- While the reform effort moved quickly at the beginning of *doi moi*, it stagnated slightly in the mid-1990s. In particular, the pace of equitisation of SOEs advanced slowly and the private sector in general did not receive the support it expected.
- During the Asian crisis many foreign investors faced liquidity constraints. This was especially true for investors from the Asian region, Vietnam's most important foreign investors.
- As in many other countries in transition, foreign investors had overoptimistic expectations, which were driven by wishful thinking concerning the time horizon needed for such a transition process.

Furthermore, only a few sectors of the Vietnamese economy were able to attract large amounts of FDI. From 1988 to 1998, FDI mainly went to the oil and gas sector, to heavy industry, export processing zones (EPZ) and industrial zones (IZ), and to real estate.

Only recently have the food industry, light industry, and other industries received a larger share. Thus FDI in Vietnam had been channelled primarily to capital- and import-intensive, high-cost industries instead of labour-intensive industries where the country has comparative advantages. As a result, the employment created through FIEs remains modest. Three fourths of all FDI was aimed at the Vietnamese market, while only one fourth was aimed at exports. Accordingly, the impact of FDI on Vietnam's current accounts was negative.

The industries selected play an important though varying role in Vietnam. The garment industry is central to Vietnam's transition process and a critical element in Vietnam's export drive, accounting for one fifth of the total exports in 1997. The food-processing industry is a large and rapidly growing industry in the Vietnamese economy. Electronics in Vietnam is a relatively small industry with significant growth in a few product areas.

The interviews conducted for the survey revealed that FIEs in the garment, food-processing and electronics industries generate varying gross effects on employment, training, and linkages. On average, the garment industry creates most jobs, while the figures for the electronics and the food-processing industry are significantly lower. Training of employees is common in all industries selected; it differs, however, with respect to industry and educational level. The results show that the food-processing industry is especially linked to the local economy.

Vietnam's Framework for FDI

For the six crucial 'components' of Vietnam's framework for FDI, the findings are as follows:

Vietnam's **trade regime** performed badly in the past and, as is reflected in the overall pattern of FDI to Vietnam, has inhibited any more comprehensive development of Vietnam's economy despite existing comparative advantages.

In recent years, Vietnam's trade policy appears to have been driven by two powerful yet contradictory forces. On the one hand, authorities have recognised that export growth and further integration into the world trading system are key engines for economic development. Consequently, there has been a pronounced movement towards trade liberalisation as testified by the signing of the Association of South East Asian Nations (ASEAN) Free Trade Agreement (AFTA) Vietnam joined the ASEAN and the trade agreement with the EU. On the other hand, policy-makers still seem strongly convinced that certain targeted sectors of the economy continue to require high levels of import protection. Certain features of the 'old' trade regime aimed at import-substituting industrialisation are therefore still in effect. Beyond this, trade policy has been explicitly used by the authorities to manage short-term tensions in external balances which have been exacerbated by the collapse of FDI inflows and the impact of the Asian crisis.

Trade liberalisation, if undertaken gradually and yet in a determined manner, would serve Vietnam's vital interest for a number of reasons, key among which are the following three:

- *Improving competitiveness*. Trade liberalisation would correct investment incentives and provide clearer signals to investors to allocate more resources to labour- and resource-intensive industries, thus making Vietnam's economy more competitive. It would also promote Vietnam's distribution sector and improve the profitability of import-intensive industries since imports would become cheaper and more readily available.
- *Expanding export markets*. Trade liberalisation would, already in the short term, allow Vietnam to expand its access to foreign markets, especially non-Asian ones. It would also contribute to attracting more FDI targeted at export markets.
- *Strengthening law-based procedures*. Trade liberalisation would curb incentives inherent in a highly regulated, intransparent trade environment to engage in illegal activities. It would simplify customs clearance procedures and reduce incentives for bribery.

The efficient functioning of the **financial system** is faced with two main problems:

- strong linkages between state-owned commercial banks (SOCB) and state-owned enterprises (SOE),
- weak and non-existent institutions, among others, bank supervision and information systems.

Since the financial sector does too little to collect savings, it cannot fulfil its main function, namely to support the most productive investments especially in the private sector. For this reason, almost all private enterprises in Vietnam have substantial difficulties in obtaining VND loans and rely heavily on equity to finance investments.

This situation also affects FIEs in Vietnam: FIE are directly affected through the weak financial system, as it is almost impossible for them to get long-term VND loans. They are affected indirectly as they have to import their inputs, because potential local suppliers can offer only low quality. One reason for the low quality of local inputs is outdated machinery resulting from insufficient investment, because local suppliers, too, are practically unable to obtain VND loans.

One important bottleneck for investors to obtain VND loans is the fact that loan demand is largely crowded out by the continuous credit expansion from SOCB to SOEs. However, just recently additional efforts were undertaken to tackle this problem. The State Bank of Vietnam has taken major steps towards levelling the playing field between SOEs and the private sector.

The other main problem of Vietnam's financial regime is its weak or non-existent institutions, namely weak bank supervision and lack of information systems and supporting financial intermediates. The establishment of a stock market could enhance the mobilisation of capital and would be an important institution to implement the privatisation process.

While the GoV has started to improve the **legal regulations** for foreign investors, there are still a number of regulations on setting up and operating businesses that reduce Vietnam's attractiveness to foreign investors. These can be found mainly in the following fields:

- business approval;
- choice of the corporate form of an FIE;
- access to land;
- labour recruitment;

- dual pricing of foreign and domestic enterprises;
- unequal treatment of private enterprises and SOEs.

The empirical survey has shown that foreign investors in the industries selected consider dual pricing and unequal treatment between private enterprises and SOEs as the most serious problems, followed by access to land. Less serious are business approval and labour recruitment. Finally, least important is the choice of corporate form. However, most enterprises agree that all these regulations need further improvement. This result demonstrates that investors perceive levelling the playing field between foreign and domestic as well as between SOEs and private enterprises as most important. The investigation has also shown that investors consider regulations to be a harassment which sometimes hinder the expansion of their business, but they do not see them as a reason to leave the country. The perception of these legal regulations does not differ remarkably between Asian and non-Asian enterprises.

Although recent legislation has brought improvements, implementation is still lagging behind and there is a lack of transparency. Since implementing regulations are sometimes lacking, implementation depends heavily on whether local authorities have up-to-date information on legal regulations and are capable of implementing them. The legal environment therefore also depends on the capacities of local authorities. Investors in IZs and EPZs often have fewer problems with legal regulations than FIEs in other locations.

Vietnam has made significant progress in **tax reforms**. By regional comparison, Vietnam's legislation on taxes and tax incentives for FIEs can be considered attractive. However, the empirical survey revealed that there are several basic issues where improvements are considered to be urgent. These are:

- the low capacity of the tax administration;
- the complexity of the tax system;
- the personal income tax.

Furthermore, the investigation turned up two important messages:

- FIEs do not perceive low taxes as a “decision maker” for their investment in Vietnam;
- FIEs and authorities tend to negotiate tax payments, which reduces the GoV's revenue. This practice is often related to corruption and creates an uneven playing field.

Formal, law-based procedures and relations between economic agents (i.e. foreign direct investors) and authorities are a key feature of an efficient **institutional framework**. The empirical results from the survey underlying the report reveal a different picture for Vietnam. More than two thirds of the investors interviewed describe their current relations with Vietnamese authorities as either informal (i.e. characterised by negotiations) or as a combination of both formal (i.e. law-based) and informal. Only one third of the interviewees perceive their relations with the authorities as rather formal.

A large majority of the investors interviewed agreed that they would prefer more formal procedures. While one assumption was that Asian investors are more used to informality and can better cope with it than non-Asian investors, there is a strong preference for formal procedures on both sides.

Following the indicators developed by the World Bank (predictability of rulemaking; perceptions of political stability; crime against persons and property; reliability of judicial enforcement; freedom from corruption) the results can be summarised as follows:

- The instability of rules is perceived as a greater obstacle to competitiveness than the rules themselves, even when the latter are considered as restrictive.
- The stability of Vietnam's domestic political environment enhances the country's attractiveness to foreign investors. The fact that the Vietnamese economy has been moving gradually without major political disturbances remains a positive aspect.

- Judged by international standards, the level of crime against persons and property is very low and works in favour of Vietnam's attractiveness to foreign investors.
- While for many investors law enforcement has not been a problem, for others it remains a severe challenge. The current situation is complex, which means that in some cases highly competent legal advice is required to enforce this right in court.
- Even though the Vietnamese authorities are aware of the damage corruption causes to the economy and have promulgated a set of measures to tackle the issue, corruption remains a serious problem. Many investors explicitly mentioned customs as an authority particularly prone to this phenomenon.

In general, Vietnam's **physical infrastructure** is still inadequate to satisfy the many needs and demands of local and foreign investors. All physical infrastructure – except power supply – is better developed in the South than in the North. Linkages between the different means of transport and between rural and urban areas are insufficiently developed, which results in time-consuming and expensive operations and the exclusion of remote regions from economic and social life. The subsectors are characterised as follows:

- The road network is comparatively large but in a poor state. The condition of bridges is the most serious problem and restricts access to rural areas.
- The railway system is relatively small and outdated in terms of both network and rolling stock, and it lacks logistic standards. Its future role in transport has not yet been agreed upon.
- Air transport is of growing importance only for the import-export business, but still restricted by the capacity of fleet and terminals.
- In seaports, the facilities are used inefficiently and lack international standards. It is therefore difficult to efficiently ship goods and commodities through ports. Inland waterways have no relevance for FIEs.
- The power supply is unreliable, FIEs are faced with additional investments, and only half of the country has access to electricity.
- The access to and the quantity of fresh water supply is inadequate, and insufficient sewerage systems pose growing sanitation problems.
- Conducting business in Vietnam is hindered by relatively high costs of telecommunication to international destinations and by the insufficient and controlled access to the Internet.

Concerning infrastructure services, most FIEs are confronted with the need to upgrade the public supply systems, but the majority of them do not find these extra investments in their power or water supply significant. Regarding their own interests, more than half of all FIEs pointed out that improvements in infrastructure should concentrate on roads and bridges.

Remaining Challenges for Vietnamese Authorities and Implications for Development Assistance

Challenges for Vietnamese Authorities

Considering Vietnam's regional context in Asia, the economic recovery of it's neighbouring countries from the Asian crisis and, in particular, China's recent steps towards a normalisation of trade relations with the U.S. and full membership in the WTO, there are clear and urgent signals not to slow down the reform process, but, on the contrary, to give it new momentum.

For the **trade regime**, we recommend the following measures:

- The GoV should strengthen its effort to liberalise the trade regime and should firmly follow a clearly stated agenda and timetable. An important signal for the GoV's determination to liberalise trade would be the signing of the bilateral trade agreement with the U.S.

– The GoV should reserve the right to grant certain levels of protection to selected industries over a certain period of time. The selection of these industries must be based on an analysis of whether or not they have the potential to become efficient and develop dynamic comparative advantages (i.e. infant industry rationale).

– The Ministry of Trade should expand the auctioning of garment quotas and allow quotas to be transferred between firms.

The tasks involved in creating an efficiently working **financial sector** in Vietnam are twofold: disentanglement of linkages between SOCBs and SOEs on the one hand and institution building on the other:

– To disentangle linkages, the ministry should continue its efforts to reform the financial sector. It would therefore be of central importance to rehabilitate, merge and close SOCB and JSB.

– Banking supervision in Vietnam is weak and urgently needs to be strengthened. The focus should be on solving the problem of "bad debts," including stricter regulations on loan classification, and the implementation of better risk management systems. Additionally, institutions designed to reduce asymmetric information between banks and borrowers should be strengthened. Information systems such as a credit reporting agency ought therefore to be established. Furthermore, the establishment of a stock exchange or market could improve the allocation of savings.

In order to further improve the **legal framework** for FIEs, Vietnam should make the regulations governing FIEs more coherent and improve their implementation.

The Proposals of the MPI on Amendments of, and Additions to the Law on Foreign Investment comprise a number of important improvements, namely a further streamlining of the approval procedure, more freedom in the choice of corporate form, and more possibilities for foreign investors to mortgage land use rights. The proposed amendments should be enacted as soon as possible.

Effective implementation of **tax laws**, a lower personal income tax for Vietnamese employees, and improved administrative capability are urgent requirements. We recommend the following measures:

– The MoF should focus on equipping all existing and future tax laws with a comprehensive framework for effective implementation.

– The Vietnamese tax law offers foreign investors a number of tax preferences and tax holidays. As these incentives seem not to be an important “decision maker” for investors, these regulations should be reconsidered.

The **institutional capability** in Vietnam is not (yet) adequately developed to efficiently control and regulate the economy. Many enterprises have therefore developed informal relations with the authorities that are characterised by negotiations. Activities to cope with this situation should focus on:

– the customs authorities and

– the tax administration.

In Vietnam's **physical infrastructure** there are still bottlenecks in all sub-sectors. In the short run the following steps are recommended:

– Vietnam needs to increase the share of paved, all-weather roads to improve the accessibility of rural areas, to speed up traffic, and to make traffic safer.

– The GoV needs to attract more FDI to be able to finance the required investment in roads, bridges, and power supply by easing access to projects on a BOT basis. The GoV should qualify its staff and recruit international advisors to help to negotiate these projects.

In order to reap more benefits from FIEs in the selected industries, **linkages** between FIEs and the local supplying industries are crucial. We therefore propose:

– establishing an information and coordination institution for suppliers and FIEs to increase transparency and thus to better coordinate supply and demand.

This institution should collect and provide information on inputs needed by FIEs and on inputs provided by local suppliers.

Implications for Development Cooperation

– Vietnam needs more high-level expertise in a number of trade-related issues. The consequences of further liberalising trade, especially trade in services, appear to be not fully clear to Vietnam, and not enough resources are at hand to look further into the issue.

– To improve the implementation of tax laws and the administrative capability of tax authorities, consultancy services should be provided to the MoF.

– International development assistance can help to strengthen Vietnam's customs authorities, especially in view of an ever increasing volume of trade.

– Support for credit-reporting mechanisms in co-operation with foreign financial experts can be an important contribution to reducing the asymmetric information on Vietnam's financial market.

– Technical assistance to Vietnamese authorities involved in negotiations on PPI projects, such as the MPI, the MoTC, MoE, and EVN, could be helpful in providing training and expertise to enhance their capacities for negotiations on such projects.

– In order to increase linkages between local supply industries and FIEs, we recommend activities for institution and capacity building to improve technical know-how and information on quality standards and to provide financial assistance for updating enterprise equipment of local suppliers.