

The Role of the State and the Market in the Economy of Viet Nam

A report to:

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Executive Summary

The aim of this report is to review the available evidence from Vietnam and around the world on how the State can best play its role in a market economy with circumstances like those in Vietnam and dedicated to Vietnam's goals of growth, stability and equity. Before summarizing the findings and recommendations, let us go directly to the bottom line, the main conclusion of this study.

1. The main conclusion

The main conclusion of this study can be put very simply: *Vietnam desperately needs a dynamic private corporate sector*. The seeds of a private corporate sector have been planted, but inconsistencies in the policy framework and, more importantly, the lack of a strategic vision about how to achieve sustainable, long-term growth in Vietnam are undermining private investors' confidence and deterring its development, especially in manufacturing. Private manufacturing companies are the country's best hope for providing productive employment for the millions of unemployed and underemployed workers, for generating the foreign exchange needed to run the economy, and for contributing the tax revenues required to finance increased government spending, especially on social and economic infrastructure. If the private corporate sector is not given the encouragement it needs to undertake long-term investment, especially in labor-intensive manufacturing, it is difficult to imagine how Vietnam can achieve its stated development objectives.

Embracing the strategic vision suggested here and giving the private corporate sector the encouragement and confidence it needs to make long-term investment does not require any radical change of the overall policy. Indeed, it is perfectly consistent with the stated aim of the State's economic policy as described in the Constitution of Vietnam:

“The aim of the State's economic policy is to make the people rich and the country strong...by releasing all the productive potential [and] developing all the

latent possibilities of all components of the economy—the State sector, the collective sector, the private individual sector, the private capitalist sector and the State capitalist sector in various forms.”

The reforms undertaken over the past ten years under the banner of *doi moi* achieved remarkable success precisely because they did what the Constitution requires. They improved the performance of the State enterprise sector and they “released the productive potential and latent possibilities” of private individuals in the rural and urban areas, resulting in a flourishing of private economic activity, mainly in the traditional sectors of agriculture and commerce. The *doi moi* reforms also allowed the seeds of a private corporate sector to be planted, but so far they have not created an environment that is conducive for the private corporate sector to grow and to fulfill its essential role in the economy. Providing such an environment—releasing the productive potential of private companies—should, in our view, be an overriding objective of Vietnam’s new socio-economic development strategy for the next ten or twenty years.

2. Summary of Findings and Recommendations

On ownership (Chapter 2):

- State ownership of land is not intrinsically inefficient. Inefficiency arises from the restrictions and limitations imposed on the rights to use, transfer and mortgage land. The issue is a policy matter, not one about ownership.
- The inefficiency and unprofitability of State-owned enterprises is a major problem for Vietnam because these enterprises constitute a large part of the economy and claim a disproportionate share of the nation’s savings, especially those savings channeled through the formal financial system.
- This problem is being dealt with mainly through the process of equitization of state enterprises. However, the evidence from China and other transition economies suggests that the equitization program in Vietnam, as it is currently formulated, is unlikely to yield significant improvements in enterprise efficiency or profitability.

When a significant share of the equity of equitized firms is retained by the State or held by a large number of individual shareholders (e.g., enterprise employees) the management status quo is largely unaffected.

- The issue of inefficient and unprofitable SOEs and the difficulty of equitizing and/or privatizing SOEs are exacerbated by the absence of a strong private corporate sector. Indeed, the evidence from Taiwan, China and other Southeast Asian countries is that equitization or privatization of SOEs is not a necessary condition for rapid growth, provided that a dynamic private corporate sector emerges. Furthermore, given the availability of labor at almost zero opportunity cost, and the potential for increasing the availability of investible funds through rising savings rates, there is no reason why a private corporate sector should not be able to emerge in Vietnam, even if the State-owned enterprise sector is maintained at its current level or allowed to expand moderately.
- The question of whether a rapidly growing private corporate sector puts in jeopardy the State's "leading role" or control of the "commanding heights" in the economy depends on how these terms are defined. Certainly a rapidly expanding private corporate sector does not preclude expansion in absolute terms of the State enterprise sector, though its share may very well fall (as it did in China and most other East Asian countries). In any case, there is no question that the economic success or failure of the economy is in the hands of the government, as it is everywhere in the world. So in a fundamental sense, every government controls the commanding heights and plays a leading role in its economy, regardless of what kind of political-economic system it has.

On Doing the Basics (Chapter 3):

- While there are some economic activities the market performs better than the State, there others that require State involvement. The most basic obligation of the State in a market economy is to provide "public goods," those goods and services that the

market does not provide or provides inefficiently, essentially the social and economic infrastructure of the economy.

- Public investment in social and economic infrastructure has both positive and negative effects on growth. The negative effect arises from the crowding out of private saving and investment by the taxes collected to finance public infrastructure investment. The positive effects result from the impact of public spending on infrastructure on the rate of return to investment and, from that, the potential for increasing the rate of investment, what is known as the “crowding in” effect. Empirical evidence based on the experience of a sample of 31 countries over two decades is presented in Chapter 3. The findings suggest that public infrastructure investment has a statistically significant effect on the return to investment and further that by raising the return to investment, public infrastructure investment raises the rate of investment.
- In spite of a major expansion in the provision of infrastructure services in Vietnam, the foundation of the social and economic infrastructure remains weak. The problem is not only a deficiency of infrastructure capital assets, but also the poor performance of State-owned enterprises supplying infrastructure services. The important causes of the lack of investment and low level of efficiency in infrastructure services, according to published reports, are price controls which keep tariffs below costs and the lack of competition from the private sector.
- A minimum annual investment of US\$ 3 billion, or 12 percent of GDP, is required in the coming years to meet the nation’s infrastructure needs. The government budget is able to meet only about one-quarter of the amount (3 percent of GDP). ODA is also expected to cover up to about one-quarter of the required amount (2 to 3 percent of GDP). This leaves a financing gap of around US\$ 2 billion (6 to 7 percent of GDP). The most likely potential source for the remaining financing is the private (mainly foreign) sector. However, while private companies invested US\$ 352 billion in infrastructure in developing countries between 1990 and 1997, much of it in

Southeast Asia, hardly any found its way to Vietnam. A number of reforms are required to remove the impediments to private participation in infrastructure, including: the removal of price controls that make infrastructure projects unprofitable, providing a proper legal framework, eliminating the excessive bureaucracy that prolongs negotiations, strengthening the regulatory regime, and making the bidding process more transparent.

- Ultimately, the government is going to have to finance a larger proportion of infrastructure investment by itself. This can be achieved, without raising tax rates, only if growth is accelerated and substantially more tax revenue is generated, which in our view requires a rapid expansion of the private corporate sector. This underscores the complementary and symbiotic relationship between the public and private sectors—each needs the other to perform its proper role in the economy.

On market intervention (Chapter 4):

- Government has an important responsibility for correcting naturally occurring market failures (making the market work efficiently) and for removing the obstacles to an efficient market that the government itself creates (letting the market work efficiently).
- A review of the theory of market failure (externalities) reveals the enormous difficulty of designing policies to correct market failures. Unless a market failure is identified correctly, measured accurately, and the optimal policy instrument chosen, then intervention can make things worse rather than better. In other words, when the government lacks the information needed to design remedies for market failures, the best policy may be no policy. In the case of Vietnam, where the market economy has hardly had a chance to operate, the priority should be on letting the market work (i.e., by removing policy-induced distortions) rather than trying to correct market failures, with certain exceptions such as in the area of environmental regulation.

- One of the most important things the government can do to make and let the market work efficiently is to provide the market with a sound legal framework, which is not only a set of laws and regulations, but also the institutions needed to implement and enforce the law and resolve disputes under them.
- The findings of a number of studies surveyed show that countries with legal systems that more effectively enforce contracts have better developed financial systems. In Vietnam, the financial system is especially weak and an important reason is the difficulty borrowers have in giving and lenders have in enforcing pledges and mortgages.
- Creating a so-called level playing field for business is another important responsibility of the government. Numerous surveys report the widespread view among businessmen that the playing field in Vietnam is very un-level. The government is aware of these problems and is making efforts to redress them, important among these being the new Enterprise Law. However, while the government is attempting to make the playing field more level, what seems not to have changed is the view that the government, in the role of umpire of the game, should control every play. The players must be left on their own to win or lose.
- One of the most serious obstacles to a level playing field is trade barriers. The ostensible purpose of trade barriers is to give domestic firms an advantage over their foreign competitors, but the inescapable fact is that they also put domestic consumers and non-protected domestic industries and firms, especially those that export, at an economic disadvantage.
- In Vietnam the government has made substantial progress in liberalizing trade and its international obligations under AFTA and WTO require it to take further steps. What is especially important is that export-oriented manufacturers be given access to imported capital and intermediate inputs at world prices.

On a Long-term Strategy (Chapter 5):

- In each sector of the economy there are major policy issues to be tackled. However, even if the authorities were willing to tackle them all at once, they would lack the resources and administrative ability to do so. What is needed is a set of reform priorities based on a strategic vision of long-term development in Vietnam. The strategy or vision that has worked in every other successful East Asian country is export-oriented industrialization.
- This strategy can also work in Vietnam. Vietnam satisfies the preconditions in terms of resource endowment. It has also established the policy framework that is needed to make the strategy successful (although there are many areas in which in the policy framework could be improved). There is only one critical ingredient of the strategy that is missing—the network of private small and medium-sized companies that was the backbone of the export-oriented industrialization strategy everywhere that it succeeded.
- The importance of private companies in export-oriented industrialization is grounded not on theory or ideology, but on the fact that this form of industrial organization is the most successful in low-wage, labor-abundant, open economies whose industrialization strategy follows its comparative advantage. Given a reasonably level playing field, there is every reason to expect that these companies will also be the most successful, which is to say profitable, in Vietnam as well.
- Although low, the number of private companies in Vietnam has been increasing rapidly, and their shares in output and employment have been rising in every sector except the manufacturing sector. What is deterring private investment in manufacturing? We conjecture that it is the relatively high capital requirements and the relatively long timeframe of investment in manufacturing that explains why entrepreneurs, lacking a high level of confidence in the local business environment,

are willing to form new companies in the trade and commercial sectors, but not in manufacturing.

- Building investors' confidence is a paramount and urgent responsibility of the government. Many reforms have been recommended to do just that, including financial sector reforms, land reforms, trade policy reforms, regulatory reforms and State-owned enterprise reforms. It is our concern, however, that these reforms on their own will not be sufficient. Something more is needed, namely a strategic vision that recognizes that the only viable basis for long-term development is export-oriented industrialization, driven mainly by private, mostly small- and medium-sized companies.

Outline

<i>Executive Summary</i>	i
<i>Outline</i>	1
<i>List of Tables and Figures</i>	3
<i>Preface</i>	5
<i>Chapter One: Redefining the Role of the State and the Market</i>	7
1. Introduction	
2. Redefining the State-market relationship worldwide	
3. Redefining the State-market relationship in Vietnam	
4. The development challenge facing Vietnam	
<i>Chapter Two: The Issue of Ownership</i>	15
1. State ownership in a market economy	
2. State ownership and the efficient use of land	
3. State enterprises and economic efficiency	
4. Reforming State-owned enterprises	
5. Equitization and Efficiency	
6. State ownership and long-term growth	
7. Conclusion	
<i>Chapter Three: Doing the Basics: Providing Social and Economic Infrastructure</i>	31
1. Doing the basics: the minimal role of government	
2. The theory of public goods	
3. Public infrastructure investment and economic growth	
4. Empirical evidence on the relationship between government spending and growth	
5. Infrastructure in Vietnam	
6. Infrastructure finance in Vietnam	
7. Private Participation in infrastructure	
8. Conclusion	
<i>Chapter Four: Government Intervention: Making and Letting Markets Work Efficiently</i>	47

1. Correcting market failures
2. Making and letting the market work in Vietnam
3. Building the institutional foundations of a market economy
4. Leveling the playing field
5. Liberalizing foreign trade

Chapter Five: A Strategy for Long-term Growth.....63

1. The urgent need for export-oriented industrialization
2. Why export-oriented industrialization is appropriate for Vietnam
3. The role of private small- and medium-sized companies
4. Shifting the center of gravity of the Vietnamese economy
5. The missing ingredient: Private companies
6. Creating an environment conducive to private domestic investment

Chapter Six: Implementing of a Strategy for Long-term Growth.....76

References.....79

List of Tables

- Table 1.1: Government revenue and consumption as a percent of GDP in selected countries: 1980 and 1997
- Table 1.2: Structure of GDP at current prices by ownership
- Table 1.3: Structure of investment outlays by source: 1995-1998
- Table 1.4: Structure of employment by ownership: 1995-98
- Table 2.1: Financial ratios of state enterprises in 1997
- Table 2.2: State enterprise borrowing from the banking system: 1995-98
- Table 2.3: The number of companies by sector in 1994 and 1998
- Table 3.1: Estimates of the relationship between government spending and the rate of return to capital
- Table 3.2: Comparative indicators of infrastructure development in selected Asian countries
- Table 3.3: Comparative public expenditures in selected Southeast Asian countries
- Table 4.1: Financial deepening: M2 as a percent of GDP in selected countries
- Table 4.2: Domestic and international price comparisons for goods subject to import restrictions
- Table 4.3: Gross output, employment and imports in Vietnam's most protected manufacturing sectors in 1997
- Table 5.1: Comparative economic and social indicators
- Table 5.2: Sector shares, growth rates and contribution to GDP growth
- Table 5.3: Export structure and growth: 1995-98
- Table 5.4: GDP and employment by type of ownership
- Table 5.5: Manufacturing value-added by type of ownership
- Table 5.6: The number of private companies by type and sector

List of Figures:

Figure 2.1: State-owned and private manufacturing value-added in Taiwan: 1960-97

Figure 3.1: Pure and impure public goods

Figure 3.2: Government spending and growth

Figure 3.3: Government spending and growth with a crowding-in effect

Figure 4.1: Illustration of a market failure

Figure 5.1: Ratio of value-added to fixed capital by firm type in Taiwan manufacturing: 1986

Preface

This project (VIE/002/99) is a collaborative effort between the UNDP, which funded project, and the Development Strategy Institute (DSI) of the Ministry of Planning and Investment (MPI), which served as the implementing agency. The reports were prepared by small teams of local experts, led by an international consultant. The present report was written by **James Riedel**, professor of international economics at the Johns Hopkins School of Advanced International Studies and chairman of James Riedel Associates, Inc., an economic and management consulting company focused on Vietnam, with contributions from the local team members, **Bui Tat Thang**, Head of the Department of Vietnam's External Relations, Institute of Economics, National Centre for Social and Human Sciences, and **Nguyen Van Phuc**, Head of the Marketing and Operations Management Department, Business School, National Economics University.

The purpose of this project is to contribute to the preparation of Vietnam's Long-term Socio-Economic Development Strategy for the period 2000-2010, as well as to provide background analysis for the upcoming Ninth Congress of the Communist Party of Vietnam. The topic addressed in this report, the role of the State and the market in the economy of Vietnam, is as sweeping in scope as it is important as an issue of debate both within and outside of government and Party circles. Because of the limitations imposed on resources and time available to do the study, we were not able to undertake a comprehensive study of all, or even all of the most important, issues related to the role of the State in the economy. Instead, we have had to focus on those issues that we, in consultation with Dr. Luu Bich Ho and the staff of the Development Strategies Institute, deemed to be the very most important and those on which we could make the greatest contribution given the time and resources available to do the study. The study does not, therefore, purport to be a comprehensive treatment of the subject, but it has nonetheless covered quite a lot of ground.

Among the issues addressed in the report is the question of whether socialist ownership of the means of production is consistent with an efficient market economy. In addition, we examine the role of government in supplying those goods and services that the market, left to its own, supplies inefficiently or not at all, so-called public goods. We examine the role of the government in correcting naturally occurring market failures, i.e., making the market work efficiently, but also the role of the government in removing policy-induced market inefficiencies, i.e., letting the market work efficiently. And, finally, we examine the role of the State and the private sector in achieving efficient industrialization, which is a necessary condition for sustained growth, stability and equity in the economy.

In addressing each of these topics, our approach is pragmatic. We use economic theory to guide our analysis, but we rely on the cumulative empirical evidence of Vietnam and other countries, especially those in this region, to lead us to our conclusions. What we want to discover and explain is what kind of relationship between the State and the market works best, according to the evidence, to achieve Vietnam's stated development objective—growth, stability and equity.

In undertaking this study we have benefited from the advice, suggestions and comments of many local and international experts. At the outset of the project we met frequently to receive the views and advice of the President of DSI, Dr. Luu Bich Ho, and his staff, in particular Ms. Le Thi Kim Dung and Mr. Nguyen Van Linh. Throughout the study, we worked with the assistance and support of Dr. Lars Holstrom, the Senior Technical Advisor to the project, and his dedicated staff, Ms. Nguyen Nam Phuong, Ms. Dang Thi Tan Huong, and Ms. Nguyen Minh Ha. We wish to recognize the many who commented on the draft version of the report. The two peer reviewers, who contributed insightful comments, were Dr. Suiwah Leong of the Australian National University, and Dr. Adam Fforde of the National University of Singapore. At the workshop held to discuss the draft report we received very useful comments from Dr. Adam McCarty, Director of the Netherlands Economics MA Program at the National Economics University, Dr. Le Dang Doanh, President of the Central Institute of Economic Management, Professor Nguyen Dinh Huong, Rector of the National Economics University, Dr. Do Hai Nam, Vice Director of the Center for Social and Humanity Sciences, Mr. Le Hieu Cat Dien, Assistant Resident Representative of the UNDP, Professor Tran Viet Phuong of the Prime Minister's Research Council, Mr. Ray Mallon, advisor to CIEM, Mr. John Mody, ADB Resident Representative, Mr. Gus Edgren, Swedish Ambassador to Vietnam and from UNDP economists, Mr. Robert Glofshefski, Dr. Vu Quoc Huy, and Mr. Johan Fredriksson.

Finally, we acknowledge very special appreciation to Ms. Tran Thi Kim Chi, who translated the English version into Vietnamese, and through her exceptional dedication and talent made the report better in translation than in the original English

We are indebted to many for assistance, but none of those who are acknowledged here bears any blame for the remaining shortcomings, which are solely the responsibility of the authors.

Chapter One: Redefining the Role of the State and the Market

1. Introduction

In preparing a new socio-economic development strategy for the next ten years, no issue is more central or more critical than that of *the role of the state and the market in the economy*. The remarkable achievements of the past ten years were possible only because the State expanded the scope and freedom of the market to operate. It is unlikely, however, that the rapid growth and economic stability of the past ten years can be sustained for another decade or longer without a further redefinition of the role of the state and the market in the economy.

The aim of this report is to provide insights and recommendations on what changes in the role of the State and the market may be necessary in order for Vietnam to achieve its long-term economic development objectives of growth, stability and equity. In approaching this task, we rely on theory to help us pose the questions to be addressed, but we rely entirely on hard empirical evidence from the experience of Vietnam and many countries around the world to provide the answers. Our recommendations on what role the State should play and what role the market should play are based on what, according to the evidence, works and what doesn't work for a country in Vietnam's circumstances to achieve the economic development objectives it has set.

2. Redefining the State-market relationship worldwide

Not just in Vietnam, but practically everywhere, in developed as well as developing countries, the relationship between the State and the market is being redefined. Many goods and services that used to be the exclusive domain of the public sector are increasingly being supplied by the private sector. In developed countries, technological changes, allowing private companies to compete in certain markets that traditionally were considered to be natural monopolies, have been an impetus for the changing relationship between the State and the market (Belli, 1999, p 2). In developing

countries, the main motivation has been a growing realization that the state-led model of development, widely advocated in the 1950s and 1960s, simply does not work. In both developed and developing countries, a growing body of evidence that public enterprises are less efficient than private ones when engaged in market-related activities has motivated governments to privatize publicly-owned enterprises.

While governments worldwide are increasingly getting out of the business of business, their role in their national economies shows no clear sign of diminishing. Government intervention in markets, ostensibly to cure so-called market failures, is pervasive. The economics of government market intervention was initially conceived as a prescriptive model, describing what a welfare maximizing government should do to raise economic welfare. Increasingly, however, it has been viewed instead as a descriptive model, explaining not what governments should do but instead what they actually do, more often to serve political goals. Thus the “helping hand” model of the State-market relationship is increasingly being redefined as a “grabbing hand” model, in which governments use their authority to intervene in the market to serve their own political and bureaucratic interests (Schleifer and Vishny, 1998, p.3).

Not only is government intervention as pervasive as ever, but governments’ claim on the national product through taxation is as great as it has ever been. The tax reform revolution launch by President Reagan and Prime Minister Thatcher in the 1980s, which brought down marginal tax rates in most developed and many developing countries, did nothing to lessen the share of GDP extracted by governments through taxation. Indeed, as Table 1.1 shows, government revenue is rising as a share of GDP in both developed and developing countries, and on average is significantly higher in developed countries than in developing countries, including Vietnam.

Table 1.1: Government revenue and consumption as a percentage of GDP in selected countries: 1980 and 1997

	Government Current Tax and Non-tax Revenue		Government Current Expenditure	
	1980	1997	1980	1997
Sweden	35.0	42.0	37.5	43.2
Germany	49.0	49.2	31.0	32.1
United Kingdom	35.2	36.2	36.4	39.6
United States	20.2	21.3	20.7	21.0
Korea	17.7	21.5	14.8	14.7
Malaysia	26.3	23.6	19.2	15.5
Philippines	14.0	19.0	9.9	16.3
Thailand	14.3	18.0	14.4	11.0
Indonesia	21.2	17.0	11.7	8.7
<i>Vietnam</i>		22.4		12.2

Source: World Bank, *World Development Indicators*, 1998 except Germany.

Since government involvement in an economy takes many forms, some of which are quantifiable and some of which are not, it is impossible to construct a single index that allows one to measure or compare across countries or regions the extent of state involvement in market economies. In terms of directly supplying goods and service through state-owned enterprises, developing countries are probably more active than developed countries, as a legacy of years of state-led industrial development. In terms of market intervention, the picture is less clear. Certainly developing countries intervene to a much greater extent in international trade and finance than do developed countries, but in other areas, such as in labor markets and environmental regulation, the developed countries are more active. In terms of their claim on the national product through taxation, developed countries are significantly ahead of developing countries, even the more advanced ones and those that adhere to a socialist doctrine, such as China and Vietnam.

3. Redefining the State-market relationship in Vietnam

A redefinition of the State-market relationship in Vietnam did not begin with the Sixth Party Congress in 1986, when the famous slogan “*doi moi*” was coined. A re-orientation of the economy away from the rigid central planning model was underway from the early 1980s, with much of the impetus for change occurring spontaneously in the local communes and state-owned factories (Fforde and de Vylder, 1996). However, the bold measures taken at the Sixth Party Congress, which launched *doi moi*, did far more than simply make *de jure* the changes that had already become *de facto*. The Party at its Sixth Congress initiated a fundamental redefinition of the state-market relationship, at the core of which was the rejection of central planning in favor of a “market-based, multi-sector economy with a socialist orientation.” As set out in the 1992 Constitution:

“The aim of the State’s economic policy is to make the people rich and the country strong...by releasing all productive potential [and] developing all latent possibilities of all components of the economy—the State sector, the collective sector, the private individual sector, the private capitalist sector and the State capitalist sector in various forms...”¹

How far has Vietnam gone in redefining the State-market relationship? In terms of the share of GDP contributed by the State versus the non-State sectors, shown in Table 1.2, the answer is very far, indeed.² From a base near zero a decade and a half ago, the non-State sector has grown to account for about 60 percent of GDP in 1998. An important caveat discussed in depth in subsequent chapters of this report is, however, that more than two-thirds of the non-State sector is accounted for by collectives, household businesses and farms. Furthermore, the foreign invested sector, which makes a major contribution GDP (10 percent), is mainly invested in joint-ventures with State-owned

¹ Cited in UNDP-B, 1999, p. 3.

² In the official parlance the distinction between the State and the market is not equivalent to the distinction between the State and Non-state sectors, but the latter is less ambiguous, more quantifiable and is certainly indicative of the State-market relationship.

enterprises. Thus, the private corporate sector, whose legal foundation was established only in 1992, still accounts for but a tiny fraction of GDP (3.4 percent in 1998).

**Table 1.2: Structure of GDP at current prices by ownership
(percentages)**

	1995	1996	1997	1998
Total	100,0	100,0	100,0	100,0
<i>Domestic sector</i>	93,7	92,6	90,9	89,9
State	40,2	39,9	40,5	40,1
Collective	10,1	10,0	8,9	8,8
Private	3,1	3,4	3,4	3,4
Household	36,0	35,3	34,3	33,9
Mixed	4,3	4,1	3,8	3,6
<i>Foreign invested sector</i>	6,3	7,4	9,1	10,1

Source: Statistical Yearbook 1998, Statistical publishing house, Hanoi 1999, p. 24.

In order to get a perspective on the current State-market relationship it is useful to consider not only the structure of output by ownership, but also the allocation of the primary factors of production, capital and labor, by ownership. Table 1.3 shows the investment outlays in the State sector, the non-State domestic sector and the foreign sector. What is especially remarkable in Table 1.3 is the observation that the domestic non-State sector, while accounting for about 50 percent of GDP, is allocated little more than 20 percent of the nation's scarce capital resources.

**Table 1.3: Structure of investment outlays by source: 1995-1998
(percentages)**

	1995	1996	1997	1998
Total	100,0	100,0	100,0	100,0
<i>State invested</i>	38,3	45,2	48,1	53,5
State budget	19,9	20,8	21,2	21,5
Central	11,5	11,3	10,2	9,3
Local	8,4	9,5	11,1	12,1
Credit	4,5	10,4	13,1	15,4
SOEs	13,8	13,9	13,7	16,7
<i>Non state invested</i>	29,4	26,2	20,6	21,3
<i>Foreign invested sector</i>	32,3	28,6	31,3	25,2

Source: *Statistical Yearbook 1998*, Statistical publishing house, Hanoi 1999, p.. 227.

Vietnam's most abundant resource, labor, is allocated between the State and non-State sectors very differently from the scarce resource, capital. See Table 1.4. The non-State domestic sector, which gets only about 20 percent of the nation's investment capital, absorbs almost 90 percent of the nation's labor force, mainly in farming and household businesses in the rural and urban areas.

**Table 1.4: The Structure of employment by ownership: 1995-98
(percentages)**

	1995	1996	1997	1998
Total	100.0	100.0	100.0	100.0
Public	9.6	9.1	9.2	9.1
State Enterprises	5.1	5.1	5.2	5.2
State Administration	4.3	3.6	3.7	3.6
Collective	0.3	0.3	0.4	0.3
Private	90.1	90.3	90.2	90.2
Households & Farms	89.1	89.2	89.0	88.9
Private Companies	1.0	1.1	1.2	1.3
Foreign Invested Sector	0.28	0.64	0.64	0.67

Source: GSO 1999.

4. The development challenge facing Vietnam

The data in the above Tables indicate very clearly the development challenge facing Vietnam. The aim is, as the Constitution of Vietnam states, “to make the people rich.” The way that is done is by giving people human and physical capital to work with, allowing them thereby to raise their productivity. Currently, however, a disproportionate share of the nation’s capital resources is concentrated on a fairly narrow sector of the economy, the state-owned industrial enterprises. This must change if growth is to be restored and sustained over the long-term. More investment must be made in those sectors that have the capacity to create productive employment for the millions of unemployed and underemployed people in the rural and urban areas. More investment must be made in those enterprises (both existing and potential ones) that have the capability of competing in world markets and earning the foreign exchange needed to keep the growth engine running. More investment must be made in building the social and economic infrastructure that provides the foundation of a well-running market economy. And to do that, more investment must be made in enterprises that are profitable and capable of paying the taxes that are necessary to finance the government and allow it to play its essential role in the economy.

How to do that? Leave it to the market? Leave it to the State? Or, make it the shared responsibility of the State and the market, the public and the private sectors? If shared, then how? Specifically:

- If the market, and in particular the private sector, is to assume a bigger role in the economy, does the level of State ownership need to be reduced? Is it necessary for the State to allow for private ownership of land or to privatize state-owned companies in order to achieve rapid long-term growth? Does an expanded role for the market necessarily challenge the State’s “leading role” in the economy? (See Chapter 2 on “The Ownership Issue.”)

- If the market is to assume a bigger role, does that mean that the State is left with less to do? Are there not some goods and services that markets do not provide, or at least not efficiently? Are these so-called “public goods” being adequately supplied in Vietnam? What needs to be done to increase the efficiency with which public goods are provided? How should they be financed? What is the scope for private provision of public goods? (See Chapter 3 on “Doing the Basics: Providing the Social and Economic Infrastructure.”)
- What if markets do not work efficiently? Should government attempt to correct market failures, and if so how? What must the government do to make markets work well? And, importantly, what should government do to let markets work efficiently when the government itself is responsible for market inefficiency? (See Chapter Four on “Market Intervention: Making and Letting the Market Work Efficiently.”)
- What is the best way for a country in Vietnam’s circumstances to achieve rapid, sustainable, long-term growth? What does the government need to do to achieve this objective? Does this involve a fundamental redefinition of the State-market relationship? (See Chapter Five on “A Long-term Development Strategy for Vietnam.”)
- As Vietnam goes about the task of setting out a new socio-economic development strategy for the next ten or twenty years, what should be the role of the state and the market in the economy? What are the most fundamental and potentially useful insights regarding the State-market relationship that should help guide the development of a strategy or vision for long-term economic development? (See Chapter 6 on “Summary and Conclusions.”)

Chapter Two: The issue of ownership

1. State ownership in a market economy

Vietnam is a socialist country in deed as well as name. In accordance with the constitution of Vietnam, land is entirely owned by the State in the name of the people. The constitution allows for private ownership of capital, but a significant proportion of the nation's capital stock is publicly owned and the State has reaffirmed its intention to maintain control of the “commanding heights” and play a “leading role” in the economy (meaning State ownership and control of a dominant segment of the economy, especially in the financial and industrial sectors).

Vietnam is also a market economy. Most of the vestiges of central planning have been removed. Certainly output quotas and targets exist in some sectors and some prices are fixed or closely regulated by the government, but most inputs and outputs are allocated through the market mechanism and most prices are set by market supply and demand. The market allocates resources in Vietnam much as it does in other so-called market economies, the differences being only a matter of degree and indeed the markets for some things are freer in Vietnam than in some non-socialist market economies.

Is there a fundamental inconsistency between the principle of socialist ownership of the means of production and the efficient operation of a market economy? In theory, the answer is “no.” In theory, a state that owns and controls firms can use market prices to direct the allocation of inputs and outputs such that all markets clear with an efficient outcome identical to what would obtain with free enterprise, but with the additional advantage of greater equity (Lange, 1936).

The critical assumption in the theory of market socialism is, however, that the state pursues the overriding goal of efficient resource allocation and not political or bureaucratic goals that may hinder economic efficiency. This assumption turns out to be

the weak link in the theory. Thus, while in theory state ownership does not matter for market efficiency, in practice it does matter a great deal. Self-interest is a compelling force not just of private entrepreneurs but of all people, including politicians and bureaucrats (Schleifer and Vishny, 1994). The experience of countries worldwide shows that when the state owns and controls firms it tends to use its ownership and control to serve the interests of politicians and bureaucrats, which are very often at variance with the goal of market efficiency (Nellis, 1988).

Public ownership of the means of production, in particular land, is not, it should be stressed, a unique feature of socialist economies. In many so-called capitalist economies, the State owns and leases vast amounts of land. Indeed, in the most freewheeling, laissez-faire capitalistic economy in the world, Hong Kong, all land was owned by the Crown (before 1997) and leased to private individuals and firms for a fixed period of time. Nor are the incentive problems arising from the separation of ownership and management unique to state owned enterprises, they exist in capitalist market economies as well, and are particularly acute in large corporations where the interests of stockholders and management often diverge to the detriment of economic efficiency.

State ownership of the means of production and market efficiency is, therefore, an empirical, not a theoretical, issue. As such, the impact on efficiency of the ownership structure will vary case by case according to the circumstances of the country in question, its legal and regulatory framework and the functioning of its markets. In the case of Vietnam, the key question is to what extent does State ownership of land and industrial capital deter economic efficiency and stifle growth?

2. State ownership and the efficient use of land

In principle a market for privately owned land and a market for the rights to use publicly owned land could operate identically. If the rights to use publicly owned land are as secure and free as the rights to own land privately then one system should be as efficient as the other. If public ownership of land is associated with more inefficiency

than private ownership, then it is because of restrictions and limitations imposed by the government on the rights to use, transfer and mortgage land. The issue is therefore a policy matter rather than one about ownership per se.

Laws enacted in 1988 and 1993 established a system of land-use rights in Vietnam. Farmers are granted 20-year right to use land for rice and other annual crops, and 50-year right for perennial crops. However, as has been reported “Despite their new rights, farmers still lack complete control of their land assets. Maximum ceilings on land holdings, set by government and based on food security and equity concerns, as well as restrictions on the use to which land may be put, continue to constrain household decision-making (UNDP-A, p. 71).” In the rural sector, the government specifies the use to which land may be put and requires that those wishing to transfer land acquire permission of the local authorities. Land taxes are fixed not according to the market value of land, but instead on location and how the land is used. In addition, land transfers are heavily taxed. It has been argued that “In Vietnam, where fragmentation of agricultural land is a significant problem, the taxes on sales and exchanges inhibit land amalgamation (DSI-UNDP Report on Agriculture and Rural Development, p. 37).”

In urban areas land use rights in Vietnam are also subject to numerous restrictions which create anomalies that would not exist under a system of private land ownership. For example, individuals who use land for residential purposes are allotted land for an indefinite period and are free to transfer or bequeath the land. On the other hand, companies who use land for commercial purposes can only lease land, and such leases cannot be transferred without official approval, cannot be mortgaged (except by Vietnamese banks), and on termination revert to the State (MPDP, No. 10, p. 25). A recent survey of larger private companies in Vietnam reported that managers are often unclear themselves about laws and regulations on land use (MPDF, No. 8, p.36). Most private firms did not have formal documentation of land use rights in the form of the “red book,” which is the document generally required for securing loans or selling equity and reported difficulties in getting such documentation.

Foreign investors also report that anomalies in rules and regulations governing land use restrict business. Foreign invested firms complain that they have difficulty financing projects in Vietnam because neither they nor their joint-venture partner can mortgage land to overseas lenders or to foreign branch banks in Vietnam. In addition, foreign investors complain that land valuation is often not based on market prices but instead on regulations of the Ministry of Finance and decisions of the local People's Committee (Vietnam-CG Meeting, Private Sector Forum, p. 61). The result is that Vietnamese partners contribution to a joint venture in the form of land is overvalued and rental rates for land “in many cases were not realistic in relation to market values (ibid., p. 62).”

It is apparent that the market for land, or more accurately land-use rights, in Vietnam is far from efficient. The source of inefficiency is not ownership per se, however, but instead restrictions on the so-called “five rights” to those possessing land: the rights to transfer, exchange, lease, inheritance and mortgage (UNDP, p. 71). The issue of efficiency in land use is a policy matter, and one that clearly deserves priority attention, since access to land is a key requirement for efficient industrialization and long-term growth.

3. State enterprises and economic efficiency

The efficiency of State enterprises is a matter of great importance to Vietnam because it has a major influence on both the level of national income and the rate of economic growth. SOEs account for a large part of the economy (about 30 percent of GDP) and they claim a disproportionate share of the nation's savings, especially those savings channeled through the formal financial system (about 50 percent of outstanding bank credit). SOEs do not absorb proportionately as much labor (only about 5 percent of the total and 15 percent of the non-agricultural labor force), but this is hardly a

commendation since it is estimated that upwards of two-fifths of the labor force (about 12-15 million people) are unemployed or underemployed.³

As in most other countries, State enterprises in Vietnam are plagued by inefficiency. The main manifestation of inefficiency in the SOE sector is low or negative profitability, even after having received protection from international and domestic competition, and in many cases having been accorded a monopoly advantage in the domestic market. Since operating losses of SOEs have to be financed, either by subsidies from the state budget or by loans from the banking system, the problem of SOE inefficiency spreads throughout the entire economy, either through macroeconomic instability and/or crowding more worthy borrowers out of the financial system. When the SOEs cannot repay the their loans, the entire financial system may be put in jeopardy.

The available evidence suggests that inefficiency in Vietnam's SOEs sector has already put the financial system in jeopardy, continues to crowd out private investment and is beginning to constitute a threat to macroeconomic stability. Even though the available evidence significantly understates the magnitude of the problem of SOEs' inefficiency and unprofitability, it nonetheless paints a dismal picture. Table 2.1 reports the results of a Ministry of Finance study of 5,429 SOEs (out of a total of 5,800) which classified enterprises into categories of profitable, temporarily loss-making, and permanently loss-making.⁴ As the Table shows, only about 40 percent of SOEs (accounting for about 58 percent of SOE employment) were found to be profitable in 1997.⁵

³ This figure is according to a Ministry of Agriculture report.

⁴ This study is reported in the International Monetary Fund Staff Report Number 99/55, p. 42-53.

⁵ No doubt the number of so-called profitable firms would have been even smaller were the criterion a rate of return equal to or greater than the opportunity cost of capital, and even small yet were adjustment were made for explicit and implicit subsidies, including as trade protection.

Table 2.1: Financial ratios of state enterprises in 1997

	Number of SOEs (No.)	Debt/ Assets (%)	Overdues/ ST Loans (%)	Output/ Labor (mill. dong)	Exports/ Sales (%)
Total	5,249	58.9	5.9	124	28.7
Profit making	2,196	53.9	1.4	148	36.8
Temp. loss making	2,393	64.1	4.8	90	10.0
Perm. loss making	840	84.9	32.6	89	2.5

Source: IMF Staff Country Report No. 99/55, p. 55.

The loss-making SOEs share certain characteristics. They tend to be the smaller firms, with relatively low labor productivity, highly dependent on the domestic market and severely leveraged financially, with an average debt asset ratio of about 0.8 and about one-third of outstanding short-term loans overdue. Furthermore, as the IMF Report notes, “In almost every case, the main source of indebtedness [of the unprofitable enterprises] was the domestic banking system.” Since the end of 1997 when the Ministry of Finance study was done, the situation in the SOE sector has deteriorated further, with domestic demand weakening and inventories of key industrial commodities rising significantly, financed in large part by borrowing at an accelerated rate from the banking system.

The implications of SOE inefficiency for the viability and strength of the domestic financial system are indicated in Table 2.2. SOEs are the dominant borrower in the financial system, and in particular from the State-owned commercial banks (SOCBs). Furthermore, it is apparent that with the deterioration in SOE profitability in 1998, the problem of crowding out was severely exacerbated, as SOEs accelerated their borrowing to finance inventory accumulation and financial losses. Not only have SOEs absorbed the bulk of domestic currency credits, they also enjoy privileged access to foreign currency credit, receiving more than 90 percent of foreign currency credit issued by the SOCBs.

Table 2.2: State enterprises borrowing from the banking system: 1995-98

	1995	1996	1997	1998
Credit to SOEs/Credit to the Economy	56.8	52.7	49.7	52.0
SOCB Credit to SOEs/Total SOCB Credit	62.5	57.5	55.4	57.2
SOCB Foreign Currency Loans to SOEs/Total	90.6	93.2	90.0	91.0
Growth Rate of Credit to the Economy	26.9	20.1	22.6	16.4
Growth Rate of Credit to SOEs	17.7	11.3	15.6	21.7
Growth Rate of SOE Industrial Production	13.6	11.9	10.8	8.0
Growth Rate of Real GDP	9.5	9.3	8.2	5.8
Inflation Rate	14.3	3.7	3.8	9.4

Source: IMF Staff Country Report No. 99/55, statistical appendix.

4. Reforming State-owned enterprises

Vietnam knows well from its experience in the late 1980s how State enterprise inefficiency can stifle growth and create macroeconomic instability. As part of a sweeping program of structural change and macroeconomic stabilization, Vietnam launched a program of SOE reform in 1989, mainly in the form of mergers and liquidations of smaller loss-making firms administered by local authorities, which reduced the number of SOEs from about 12,000 to 6,000. Subsequently, the government extended the SOE reform program to include equitization, but by 1998 only 17 enterprises had been equitized.

In light of the deteriorating financial condition of SOEs and the threat that poses to the banking system, the government issued several decrees in 1998 to simplify and accelerate the process of equitizing SOEs. Additionally, the government established equitization targets year-by-year: 150 enterprises by the end of 1998, 400 by the end of 1999 and 1000 by the end of the year 2000.

The latest framework for equitization (Decree 44, June 1998) allows for all SOEs to be equitized except for enterprises producing explosives, radioactive or toxic chemicals, printing money and operating communications networks. In addition, the State intends to continue to hold a dominant share in “strategic enterprises,” which include public service enterprises, large-scale mineral and petroleum enterprises, and those producing fertilizers, petrochemicals, tobacco, alcohol, pharmaceuticals, aircraft repair, large-scale electricity production, transmission and distribution, post and telecommunication services, rail, sea and air transport, printing and publishing, and investment banks and banks for the poor (IMF, 1999, p. 47).

“Equitization,” as formulated in the various decrees and decisions of the government, is subject to numerous limitations and restrictions and falls far short of what would normally constitute “privatization.”⁶ A number of restrictions exist to limit the concentration of ownership: (1) Employees may purchase a maximum of 10 shares (VND 100,000 per share) each for each year of employment; (2) In equitized enterprises with controlling or special State shares, no legal entity can hold more than 10 percent and no individual more than 5 percent of shares;⁷ (3) Foreign shareholding is limited to 30 percent and also limited to certain sectors, including garments, footwear, food processing.

Other features of the equitization framework serve to limit the impact of the process on firm efficiency, including such provisions as: (1) Allowing equitized enterprises to continue to receive preferential tax and trade policy treatment as well as bank credit on the same preferential terms as SOEs; (2) Disallowing equitized enterprises from involuntarily laying off workers during the first twelve months after equitization; (3) Putting the design and implementation of equitization in the hands of a committee comprising the management of the enterprise, the local party secretary and the chairman of the trade union.

⁶ The following is drawn from a description of Decree 44 in the IMF Staff Report 99/55.

5. Equitization and Efficiency

Will an acceleration of the equitization process significantly raise the efficiency of state owned enterprises? Hard evidence is scarce. Although some 150 enterprises have come up for equitization since 1998, no data or analysis of their experience is yet available. An IFC study of 14 of the 17 enterprises equitized by early 1998 gives a positive picture, but not one that affords any general conclusions. At the time of equitization all 14 enterprises were profitable and none had excessive debt. After equitization they remained profitable, and indeed in the case of those equitized earliest revenue and profits increased after equitization. However, the success of the equitized firms is attributed to favorable initial conditions (profitable, little debt, no redundant workers) rather than to a change in ownership. Indeed, 80 percent of the equity of the equitized firms is held by the state and the enterprise employees, and many firms reported that the state continued to have significant influence over company affairs (Amin and Webster, 1998, p.x).

Evidence on the relation between ownership and firm performance must be found elsewhere, and one source is China, where SOE reform is much farther advanced than in Vietnam. In the case of China, there is clear evidence of a negative relation between state ownership and firm performance. In the 1980s, before the privatization of SOEs began, total factor productivity growth in the town and village enterprises, which operate much like private companies, was shown to be five times higher than in SOEs (Svejnar, 1990). In the late 1990s, after almost a decade of SOE reform, a study of privatized enterprises found that ownership structure was a significant determinant of firm performance, with the share equity owned by the state being significantly negatively correlated with firm efficiency and profitability (Xu and Yan, 1997).

The Chinese evidence thus suggests that the larger the share of state equity in privatized enterprises the less improvement is gained in firms' performance. Equitization

⁷ In equitized enterprises where there are state held shares, but not a controlling interest, the limit is 20 percent for legal entities and 10 percent for individuals.

is not sufficient, ownership must be private to get the full benefits. However, it was also found that the structure of private ownership is important. In particular, the more that ownership is concentrated in the hands of institutional investors the greater the efficiency and profitability of privatized firms (Xu and Yan. 1997). Indeed, there was no correlation between the share of individual shareholders and firm profitability, suggesting that individual shareholders (e.g., workers) have neither the incentive nor the ability to monitor and influence the behavior of management.⁸ Thus the study concluded that ownership concentration, especially in the hands of institutional investors, is important for ensuring efficiency, a result that is consistent with studies of large stockholder activism in the United States and elsewhere (McConnel and Servaes. 1990).

The evidence summarized above suggests that the equitization framework currently in place in Vietnam is not likely to lead to significant increases in enterprise efficiency. The State's share in equitized firms is sufficiently large that equitized firms will remain under the influence of the State. The restrictions on concentration of ownership limit the interest and ability of private shareholders to monitor and control management. The role of SOE management in designing and implementing the equitization process encourages insider domination and the status quo. Finally, the extension of protection and special privileges to equitized SOEs removes the incentive to change their modus operandi and to become more efficient. Most of the limitations on privatization/equitization are correctable, though perhaps not without putting into jeopardy the state's determination to play a "leading role" and control the "commanding heights" of economy, and in particular the industrial sectors.

6. State ownership and long-term growth

Is State ownership, and the inefficiency associated with state-owned enterprises, an obstacle to long-term growth? The answer is yes and no. Yes, it is a serious obstacle as long as State-owned enterprises dominate the industrial sector as they do currently.

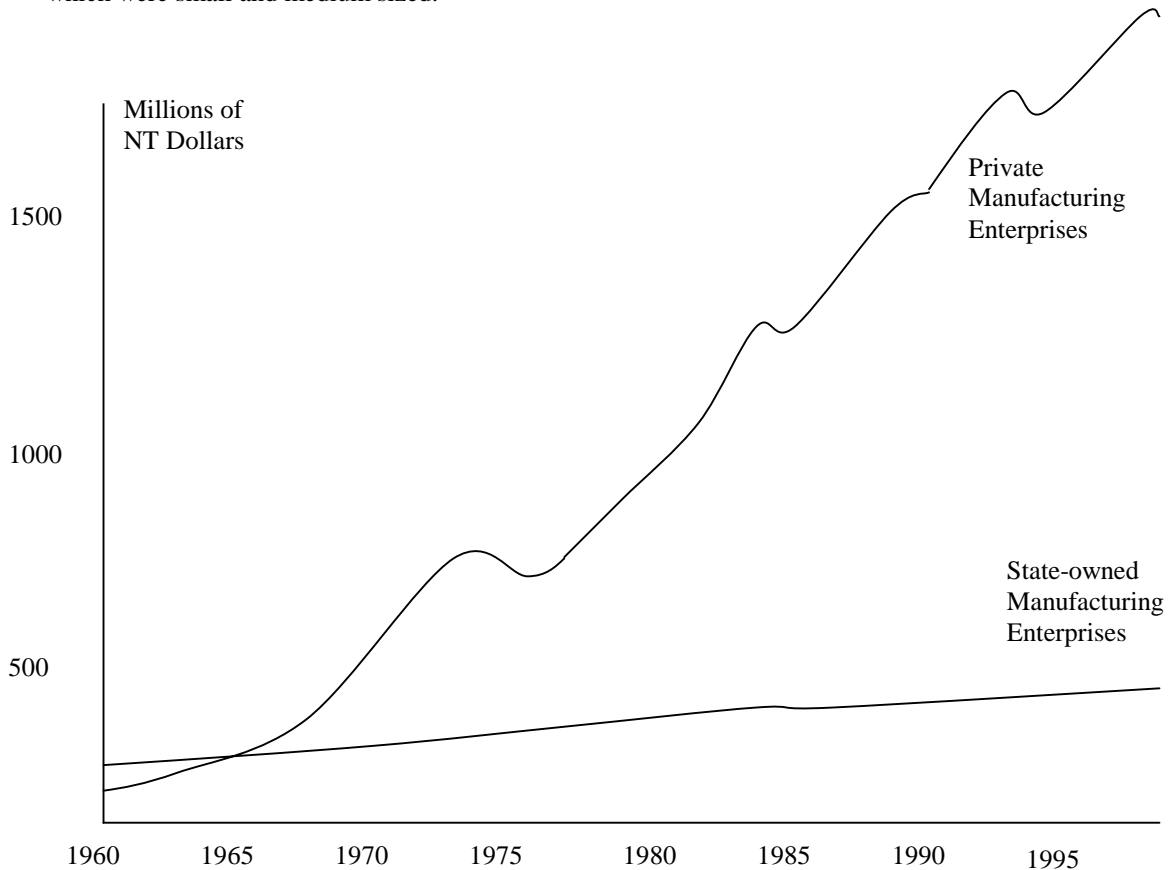
⁸ Similar findings are reported for privatized firms in the Czech Republic, Hungary and Poland (Frydman, Gray, Hessel and Rapaczynski, 1997).

But, no, rapid long-term economic is achievable without privatization of existing State-owned enterprises, *provided that a dynamic private corporate sector emerges*. Indeed, it is our contention that the absence of a strong private corporate sector is what makes the problem of SOE inefficiency especially critical. Furthermore, the absence of a strong private corporate sector also makes the privatization of SOEs especially difficult and costly, for without a private corporate sector there is neither the money nor expertise to take over a significant number of State-owned enterprises and make them into efficient private companies.

If privatization were a necessary condition for rapid economic growth and industrialization, then neither Taiwan nor China—nor indeed any other countries in Southeast Asia—would have achieved the progress they did. Consider Taiwan, for example. In 1960, when Taiwan undertook its own version of *doi moi*, state-owned companies accounted for over 50 percent of manufacturing value-added and absorbed about 75 percent of capital investment in the manufacturing sector. Thereafter, as shown in Figure 2.1, state-owned companies continued to expand, their output growing at a respectable rate of about seven percent per year. Proportionately, however, their position in the manufacturing sector declined dramatically to only about 8 percent of manufacturing value added in 1997 due to the superlative performance of private companies, which in Taiwan were mainly small- and medium-sized, and grew at around 30 percent per year. Only in the 1990s did Taiwan begin to address the problem of privatizing state-owned enterprises.

Figure 2.1: State-Owned and Private Manufacturing Value-added In Taiwan: 1960 to 1997

Until about 1960 Taiwan followed an import-substitution industrialization strategy with heavy reliance on state-owned manufacturing enterprises, which by 1960 accounted for about 60 % of value-added and about 75 percent of fixed investment in manufacturing. Taiwan did not privatize its SOEs, but instead created an environment conducive to the formation of new private companies, most of which were small and medium sized.



Source: Industrial Census of Taiwan, ROC, 1985; Riedel, 1993.

A similar story can be told about China. Between 1985 and 1995, real industrial output of state-owned industrial enterprises grew at about 17 percent per year, and yet the state-owned industrial sector declined from 65 percent to 34 percent of total industrial output. As in Taiwan, SOEs expanded in absolute terms, but their share in the industrial sector declined because of the much stronger performance of the so-called town and village enterprises (TVEs), which operated as quasi-private companies.

How was it that, in Taiwan and China, as well as other Southeast Asian countries, relatively inefficient state enterprises were able to continue to grow while at the same time a dynamic private manufacturing sector was able to emerge and come to occupy a disproportionately large share of the manufacturing sector? It is often regarded as axiomatic that without a shrinking the state-owned sector the private sector cannot expand, and yet that is not the experience of the successful Asian countries. The much-discussed problem of crowding out does not appear to have operated in the industrial sectors of the East Asian countries. Why?

The answer to this question is mainly found in key the structural characteristics of the successful East Asian countries. Firstly, the East Asia countries, when they began to industrialize were, like Vietnam today, densely populated with enormous reservoirs of unemployed and underemployed labor residing mainly in the rural sector. Because wages were low, these countries found their comparative advantage in relatively labor-intensive industrial activities. Since the key ingredient, low-wage labor, was in excess supply, private companies specialized in labor-intensive manufacturing could expand without any opportunity cost to other sectors of the economy, including the state-owned enterprises. This characteristic of East Asian transition economies stands in stark contrast to their Eastern European counterparts where, at the time of transition, most of the wealth was in state-owned heavy industry rather than, as in the East Asian countries, in mostly idle human resources. Thus, the main challenge of transition in Eastern Europe—making inefficient industry efficient—was very different from that in East Asia—finding productive employment for masses of underemployed in the rural sector. In Eastern Europe the privatization of state-owned companies was imperative, in East Asia it was not.

Even labor-intensive companies, however, need capital and access to credit. Why did not the domination of state-owned companies in financial markets crowd-out private investors and prevent them from expanding? There are of course many reasons, including financial sector reforms, which improved the access of private companies to

formal credit. However, by far and away the most important reason was that, with the take-off of a dynamic private sector, the overall availability of funds for investment in both state-owned and private enterprises expanded dramatically as a result of rising savings rates. In Taiwan the rate of private saving rose from about 10 percent of GDP in 1960 to over 30 percent by the mid 1990s (Taiwan Statistical Data Book, 1998). In China, household savings in both the rural and urban areas rose from about 1 percent of GDP in 1980 to over 20 percent by the early 1990s (World Bank, 1999-C). The virtuous circles of accelerating growth and rising savings rates is one of the most striking features of economic development in Southeast Asia. As income rises and employment opportunities expand, aspirations also rise and as a result households begin to save for things that previously were unattainable. These savings financed additional investment, generated additional growth and further fueled aspirations for greater wealth accumulation.

In Vietnam, where private savings amount to no more than about 10 percent of GDP, the potential for increasing the availability of funds for investment by increasing the savings rate is enormous. Given the availability of labor at almost zero social opportunity cost, and the potential availability of rising savings for investment, there is no reason why a dynamic private corporate sector should be not be able emerge, even if the State-owned enterprise sector is maintained at its current level. The fact of the matter is, however, that a private corporate sector has not yet emerged, especially in the manufacturing sector where Vietnam's potential for long-term growth is greatest. As shown in Table 2.3, there has been a flourishing of private companies in every sector except manufacturing, which should be a matter of grave concern to policy makers since it not only constitutes a critical missing ingredient to long-term growth (as we shall discuss in a subsequent chapter), but also makes the problem of dealing with State-owned enterprises especially critical and difficult.

Figure 2.3: The number of private companies by sector in 1994 and 1998

Sector \ Year	1994	1998	Percentage Increase 1994 to 1998
Trade	3,894	12,753	228
Manufacturing	4,392	5,620	28
Construction	892	1,672	87
Other	1703	5976	251
TOTAL	10,881	26,021	139

Source: General Statistical Office (1999) as reported in MPDF, *SMEs in Vietnam: On the Road to Prosperity* November 26, 1999, p. 88.

7. Conclusion

State ownership of land and capital is not intrinsically inconsistent with an efficient market economy, although State ownership is associated with inefficiency in most countries, including Vietnam. Inefficiency in State-owned enterprises does not, however, preclude rapid economic growth. In countries where there is an overabundance of low-wage labor and the potential for increased savings, such as existed in Taiwan in the 1960s and China in the 1980s, as well as in Vietnam today, the emergence of a dynamic private corporate sector is achievable, even when State-owned enterprises initially have a dominant position in the industrial sector.

Is the emergence of a dynamic private corporate sector consistent with State control of the “commanding heights” of and playing a “leading role” in the economy? It all depends, of course, on how these terms are defined. If commanding heights or leading role is defined as a percentage of GDP directly contributed by the State sector, then there may be an inconsistency, since this would mean the private sector could only grow as fast as the State sector. On the other hand, if they are defined in absolute terms, rather than proportional terms, then there need be no inconsistency, since in both China and Taiwan

the direct contribution of the State sector increased at the same time its proportional share of contribution to GDP declined. If commanding heights is defined, not in terms of the State's direct contribution to GDP, but instead in terms of its command over the nation's gross domestic product, e.g., through taxation, then again there is no inconsistency. Indeed, governments in most industrial market economies command a larger share of GDP through taxation than does the government in Vietnam, directly or indirectly.

Finally, it should be underscored that no matter how one defines "commanding heights," the role of the government is critical. Economic success and failure is mainly determined by the way governments perform their essential role in the economy (Reynolds, 1983). As such, one can say the government controls the commanding heights in every economy, even the most laissez faire ones. The question is whether the government uses its command over the economy to stifle economic initiative or to nurture and encourage it.

Chapter Three: Doing the Basics: Providing Social and Economic Infrastructure

1. Doing the basics: The minimal role of government

While there are some economic activities that the market performs better than the State, there are others that require state involvement. There are no grounds in economic theory for a pure laissez-faire policy. No economy can operate efficiently without government playing its proper role and even if its role is limited to a bare minimum that role is enormous, as the following quotation from Adam Smith (1776), famous for the principle of the “invisible hand,” indicates:

According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understanding: first, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be in the interest of any individual, or small number of individuals, to erect and maintain because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.

As Smith recognized two hundred years ago, there are some goods and services that the market either does not provide or provides inefficiently—national defense, a system of justice and many elements of the social and economic infrastructure—what in economics are known as “public goods”.

2. The theory of public goods

Private enterprise is motivated by profit and so must be able to charge a price for the things it supplies sufficient to cover its costs and earn a reasonable return. There is,

however, a broad category of goods—public goods—for which it is either impossible or undesirable to charge a price to consumers of the good. Such goods the private sector does not provide, or if it does provide them it usually charges a price that is too high and/or supplies a quantity that is too little to satisfy efficiency criteria.

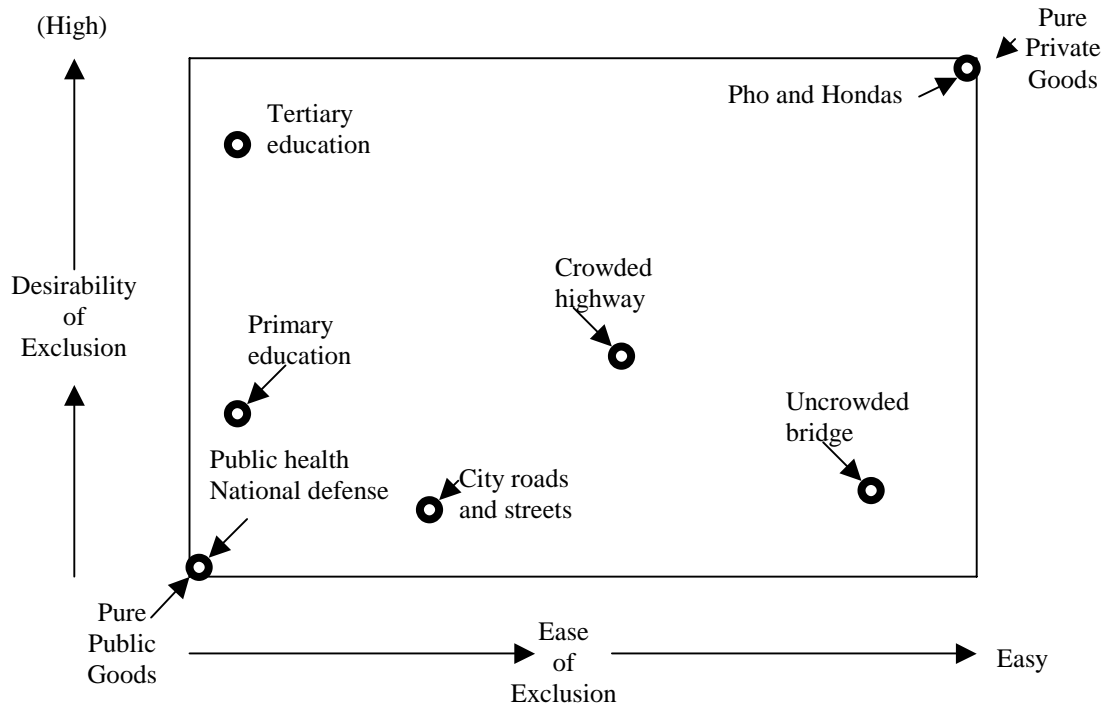
The market failure in supplying public goods derives from the two key characteristics of public goods: “nonexcludability” and “nonrivalness.” So-called “private goods,” those that the market tends to supply efficiently, are “excludable.” That is, if the consumer does not pay for them, he or she will be excluded from consuming them. There are, however, some goods for which it is difficult or impossible to exclude consumption even when the consumers refuse to pay the cost of supplying the good. National defense is a classic example. When the nation is defended, everyone living within its boundary enjoys the benefits of national defense, even those who do not pay the cost of supplying national defense. It is impossible to provide national defense to those who are willing to pay and exclude it to those who are not willing to pay. Most roads are also nonexcludable, since it is either impossible or prohibitively expensive to charge for the use of a road (the exception being limited access toll roads). The market will, therefore, not supply these goods even though their social benefit may well exceed their social cost. The state must therefore play a role in the provision of national defense, a network of roads, and many other goods that share the characteristic of nonexcludability.

The second characteristic of public goods is nonrivalness. Private goods are rival goods, meaning that consumption by one person precludes consumption by another. In other words, the marginal cost of consumption is high. In the case of nonrival public goods, however, the marginal cost of consumption is low or zero. Again, national defense is a good example. The marginal cost of supplying national defense to one more citizen is zero, so the efficiency price is zero. Roads are another example, if they are not congested. When roads are congested, however, they lose the characteristic of nonrivalness, since one more auto or motorbike on a congested road is at the expense of other

users of the road. It is undesirable to use the price system to ration goods that are nonrival in consumption—where the marginal cost of consumption is low or zero—since the price set in the market would exceed the marginal cost of consumption and hence would be inefficient. Left to the market, the quantity of nonrival public goods available would be less than optimal.

Some public goods are both nonexcludable and nonrival, e.g., national defense and some roads. Most private goods are both excludable and rival, e.g., pho and Honda motorbikes. In between there is a wide range of goods and services that are only partially nonexcludable and partially nonrival. Figure 3.1 illustrates the range of pure and impure public goods (Belli, date?).

Figure 3.1: Pure and Impure Public Goods



There are many, many examples of pure private goods, but very few examples pure public goods. Most goods and services provided by the government are at best only quasi-public goods. Education is an example. It is easy to exclude non fee-paying

students from the classroom, but it is not desirable to do so because society, as well as the individual, benefits from education, especially at the primary level. At the tertiary level, university education and vocational training, more of the benefits accrue to the individual receiving the education and so the case for public provision of higher education is weaker.

In the case of private goods, the provider incurs the costs of supplying the good, but he also reaps the benefits (by charging a price and excluding those who do not pay). In the case of public goods for which it is difficult or undesirable to charge a fee, the government bears the cost of providing the good or service, but society at large enjoys the benefits. Since it is difficult or undesirable to charge a fee for the use of many public goods, the government generally must rely on compulsory taxation to finance the provision of public goods.

3. Public infrastructure investment and economic growth

There is a great debate in the literature about the determinants of the rate of economic growth (g), but for the purposes of exposition we can reduce the problem to the two key determinants of growth: the rate of saving and investment (s), and the rate of return to investment (r):

$$(1) \quad g = r \cdot s$$

Public spending on social and economic infrastructure has both positive and negative effects on economic growth. Public spending generally (not just on infrastructure) has a negative effect on growth because the taxes that finance public spending crowd out private savings, and the less that is saved, the less that is invested, and the lower the rate of growth. If for example government spending is financed by a simple flat tax at the rate t then the growth rate is:

$$(2) \quad g = r \cdot (1-t) \cdot s$$

Government spending can also have a positive effect on growth if, by developing the social and economic infrastructure, it raises the return to investment ($r \uparrow$). Moreover, if, as a result of a higher return, households and businesses are induced to save and invest a larger proportion of income, then government spending is in effect “crowding in” saving and investment ($r \uparrow \Rightarrow s \uparrow$). Thus there are three effects of government infrastructure spending on economic growth—(1) the negative crowding-out effect of taxation, (2) the positive effect on the return to private investment, and (3) a possible crowding-in effect on the rate of investment. The higher the overall tax rate, the greater the negative crowding-out effect, and the higher the share of infrastructure spending (G_I) in total government expenditure (G), the greater the positive effect of government spending on the rate of return, the greater the potential for a positive crowding-in effect.

The three effects of government infrastructure spending on economic growth are illustrated in the following Figures. In these simulations it is assumed that the investment rate is fixed at 25 percent and that the return on investment with a fixed level of public infrastructure is 10 percent. As the top Figure shows, as government spending rises, given a positive fixed share of spending on infrastructure, the rate of growth rises due to higher returns on investment, but eventually the negative effect of crowding-out private saving and investment outweighs the positive effect on the return and the growth rate diminishes. Of course the higher the share of government spending on infrastructure, the greater the growth effects. If we allow for a higher return on investment to raise the saving and investment rate, then the pattern is the same, but more amplified, as illustrated in the bottom Figure.

Figure 3.2: Government Spending and Growth

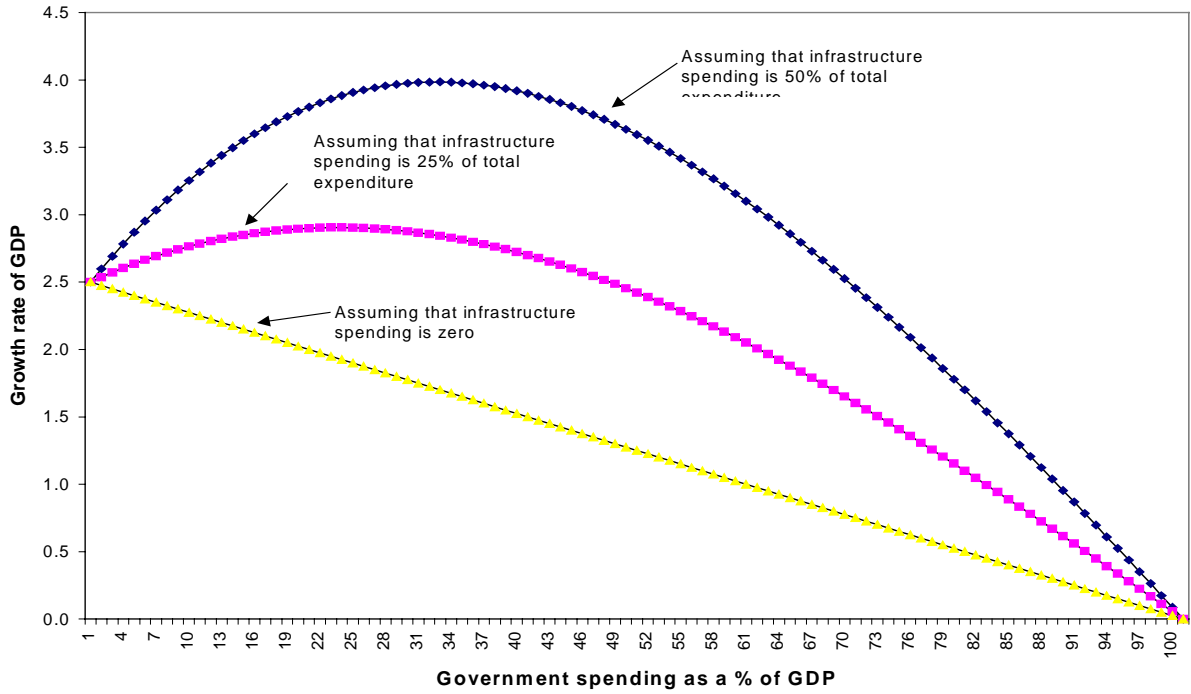
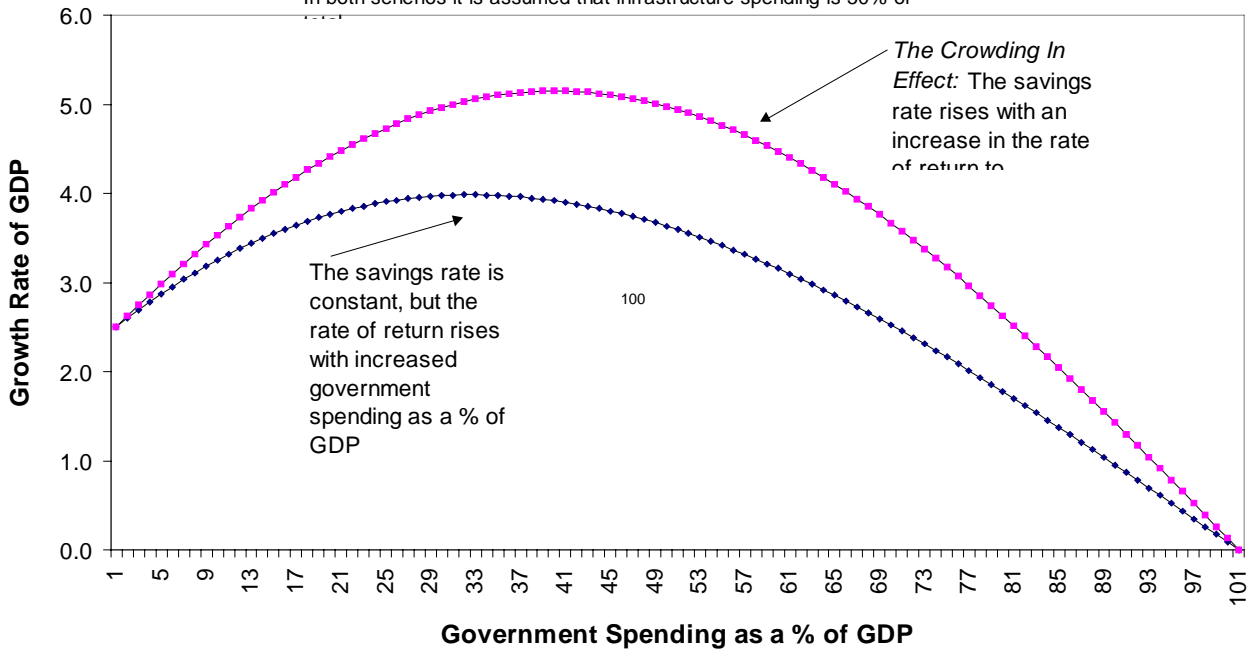


Figure 3.3: Growth and Government Spending:
The Crowding-In Effect

In both senerios it is assumed that infrastructure spending is 50% of



4. Empirical Evidence on the Relation between Government Spending and Growth

There is a large and rapidly growing empirical literature on the determinants of growth. In many studies, aggregate government spending enters as an explanatory variable, but it almost always is found to be negatively correlated, or not correlated at all, with economic growth (e.g., Blejer and Khan, 1984). This finding is hardly surprising, however, since as we have shown above, the relation between government spending and growth is non-linear and thus any test of a linear relationship is likely to fail. Only a few studies have tested the relationship between infrastructure spending and growth, but they too have failed to find a significant positive relationship (e.g., Khan and Reinhart, 1990). Again we are not surprised because, as argued above, the effect of infrastructure spending on growth works through the rate of return on investment rather than directly on growth. Put another way, building new and better infrastructure will not raise the rate of growth unless firms are induced, as a result of a positive effect of infrastructure spending on the rate of return, to invest. Thus, in our view the proper way to test for the positive effect of infrastructure is directly on the return to investment rather than on the rate of growth, *per se*.

Here we examine the relationship between public capital spending and the return on investment for a sample of 31 countries with observations for each of two decades. The dependent variable is the decade average rate of return (r):

$$(3) \quad r = \frac{g - \lambda \cdot g_{LA}}{I/Y}$$

In the numerator we have the rate of growth of non-government business activity minus the contribution to growth of the labor force (λ is labor's share of national income and g_{LA} is the growth of the labor force adjust for changes in the level of educational attainment of the labor force). The denominator is the rate of investment. Thus the measure of r is similar to the inverse incremental capital output ratio, but adjusted for the

contribution to growth of labor and increases in the educational attainment of the labor force.

Two sets of variables are used to explain cross-country variation in r : one, variables relating to the level and composition of government spending and, two, variables which attempt to proxy for policy induced distortions. The government expenditure variables used are (1) central government capital expenditures as a percent of total government expenditures (G_I/G) and (2) total government consumption spending as a percent of GDP (G_C/Y). Alternatively, in place of capital spending, the shares in government spending on economic services (G_{ES}/G) and on education (G_{ED}/G) are used.

Two variables are chosen to capture the effect of policy distortion on the rate of return. As a measure of openness we use the rate of growth of exports, the premise being that where export growth is high trade regimes are more open and the incentive structure is less distorted. The other policy variable used is the black market exchange rate premium. In addition to these variables we have also included a dummy variable for Latin American since our data coincide with the period of the debt crisis in Latin America in the 1980s.

The regression results for the sample of 62 observations (31 countries and two decades) are reported in Table 3.1. They indicate a powerful role for government, deriving both from its spending policies and its trade and industrial policies (the topic of the following chapter). The export growth rate and the black market exchange rate premium are both statistically significant and carry the expected sign. The share of government spending on capital expenditures, or alternatively the share of government spending on economic services, are also statistically significant explanatory variables of the rate of return and have the expected positive sign. Of course government spending on consumption is not correlated positively with the rate of return since its effect is mainly to crowd-out private savings and investment. The only surprising result is the negative sign on the share of education spending, which is not especially alarming since an adjustment for the contribution of increasing educational attainment was already made in computing the decade average rate of return. The dummy variable for Latin American

indicates the negative contagion effects of the debt crisis that spread across Latin America in the 1980s.

Table 3.1: Estimates of the relationship between government spending and the rate of return to Capital
(T-statistics in parentheses)

Explanatory Variable	Regression 1	Regression 2	Regression 3
Constant	14.11 (2.38)	7.00 (0.98)	13.39 (1.63)
Growth of exports	0.62 (2.06)	0.64 (2.36)	0.63 (2.27)
Black market ER premium	-0.11 (-3.43)	-0.11 (-3.39)	-0.12 (-3.67)
G capital spending as a % of total (G_I/G)	0.36 (2.58)		
G spending on economic Services in total (G_{ES}/G)		0.32 (2.24)	0.19 (1.97)
G spending on education as % of total (G_{ED}/G)			-0.53 (-2.10)
G consumption spending as % of total (G_C/G)	-0.51 (-1.32)	-0.35 (-0.88)	-0.19 (-0.44)
Dummy variable for Latin America	-9.58 (-3.19)	-9.37 (-2.83)	-7.68 (-2.17)
Adjusted R-squared	0.46	0.43	0.48
S.E. of regression	10.16	10.46	10.27
F-statistic	11.15	9.58	9.09

See appendix for data sources.

We have presented evidence that public spending crowds out private saving and investment and further that public spending on infrastructure raises the return to investment, the two effects off-setting each other to some extent. What is left to examine

is whether public spending on infrastructure crowds-in private investment through its positive effect on the rate of return. The data set used in the previous regressions can be employed to test whether the investment rate (I/Y) is significantly influenced by the rate of return. In testing this relationship it is necessary to control for the effect on the investment rate of other structural variables. Taking an admittedly ad hoc approach, we regress the investment rate (I/Y) on the real return to investment (r), the share of industry in GDP (Y_{IND}/Y) and per capita income (Y/P), with the following result obtained (T-statistics in parentheses):

$$(4) \quad I/Y = 8.80 + 0.16 \cdot r + 0.33 \cdot (Y_{IND}/Y) + 1.28 \cdot (Y/P)$$

(3.34)
(3.54)
(4.65)
(2.59)

$$R^2 = 0.39 \quad S.E.E. = 5.04 \quad F = 14.87$$

The results reported in regression (4) provide support for the crowding-in proposition. Thus, we find that public infrastructure investment promotes growth both through raising the return on private investment, but also, as a result of the positive effect on the return, by inducing a higher level of investment than otherwise. These results complement those for the United States, where it has been shown that public investment raises the return to investment and thereby induces a higher level of investment (Aschauer, 1989-a and 1989-b). Of course any kind of government spending also has a crowding out effect, but Aschauer found that in the long-run the crowding-in effect dominated the crowding-out effect.

5. Infrastructure in Vietnam

A recent World Bank study notes that “The dramatic increase in the provision of infrastructure services in Vietnam since the late 1980s greatly facilitated rapid growth in GDP and exports. In the transport sector, the Government has accepted several large loans to rehabilitate and expand the roads and waterway networks while in the power sector, electricity generation has doubled and crude oil production tripled. Historically, increased public spending and institutional reforms in the state sector have contributed to

this marked expansion in infrastructure services (Vietnam-CG meeting, Public Sector Forum, p. 48).”

In spite of these advances, the infrastructure foundation in Vietnam is extremely weak and the historical reasons for its underdevelopment are well known. It is useful nonetheless to put the problem in perspective. Table 3.2 presents some figures on infrastructure availability in Vietnam and neighboring countries.

Table 3.2: Comparative Indicators of Infrastructure Development in Selected East Asian Countries.

	Access to electricity (%)	Access to save water (%)	Telephone mainlines per capita	Electricity production per capita
Indonesia	39	65	25	225
Philippines	58	83	29	
Thailand	87	89	80	
Malaysia	90	89	195	
Vietnam	51	47	21	185

Source: Vietnam Private Sector Forum, 13-12-99, p.49.

Infrastructure problems in Vietnam stem not only from a lack of infrastructure assets, but also from the poor performance of State-owned firms supplying infrastructure services. As a recent report notes, “In Vietnam, too much water is lost, too much power is wasted, too many roads are in poor condition, and too much rolling stock is not operational (World Bank, 1998, p.67).” Twenty percent of produced electricity and thirty percent of piped water is lost before it reaches consumers (ibid. p. 68). According to the World Bank, “vehicle operating costs are nearly twice as high in Vietnam as in countries

with well maintained roads (ibid. p.69).” It is estimated that existing ports could ship three times more freight than they do if access to land transport were improved. On inland waterways, poor maintenance reduces the productivity of ships and boats by 40 percent (ibid. p. 69).

Among the reasons for the poor performance of firms supplying infrastructure service, the most important, according to recent reports, are price controls and a lack of competition from the private sector. It is noted that “In no infrastructure service in Vietnam do tariffs meet the long-run marginal cost of supply. In many cases, regulated tariffs cannot cover even routine operation and maintenance cost (ibid. p.73).” Thus, even if private participation in infrastructure were encouraged, private firms would have little incentive to invest. Fixing prices for infrastructure services at below costs also undermines efficiency in state-owned infrastructure enterprises. At a time when the State budget is being squeezed, the funding required to improve the efficiency of delivery is sorely lacking. Thus, the intended beneficiary of price controls, the consumer, turns out to be the victim as a result of the poor quality and lack of access to infrastructure services.

6. Infrastructure Finance

According to the government estimates, a minimum annual investment of US\$ 3 billion, or 12 percent of GDP, is required in the coming years to meet the nation’s infrastructure needs. There are four potential sources of funding: (1) the government budget, (2) self-financing by state-owned infrastructure enterprises, funded mainly by credit from state-owned banks, (3) overseas development assistance (ODA), and (4) private (mainly foreign) investment.

As shown in Table 3.3, the level of government spending, at about 24 percent of GDP, is not much different from that in other countries in the region. Furthermore, capital spending as a percent of total spending, at about 28 percent, is also fairly typical. Out of capital spending, about 60 percent is allocated to infrastructure, according to the 1996 Public Investment Review. These numbers suggest that, at best, the government budget can be expected to contribute only about one-fourth of the total financial

requirement for infrastructure investment, or three percent of GDP. Furthermore, although hard figures are not available, the general view of many observers is that there is little scope for increasing infrastructure spending from the government budget without significant increases in revenues.

Table 3.3: Comparative public expenditures in selected Southeast Asian countries

	Gov't spending / GDP (%)	Capital spending / total spending (%)	Spending on health / total (%)	Spending on education / total (%)
Indonesia	16.2	48.6	2.8	9.8
Philippines	18.4	17.8	3.8	15.7
Thailand	18.8	28.6	7.6	21.3
Malaysia	29.1	19.6	5.6	20.4
Vietnam	23.4	28.5	3.9	9.28

Source: World Bank, World Development Indicators, 1999.

Aside from the government budget, the other main source of finance for infrastructure investment is ODA. Since the 1980s, Vietnam received about US\$ 13 billion in ODA loans, however, it is reported that only 60 percent of this has been dispersed (Ha Dong, 1999, p.2). In the coming years, according to the World Bank, ODA flows to Vietnam are unlikely to be more than about 2 percent of GDP annually, even if disbursements are accelerated (Vietnam-CG meeting, 1999). This leaves an infrastructure financing gap of about 6 to 7 percent of GDP, or about US\$ 2 billion to be met through self-financing by infrastructure SOEs and from private sources.

Unfortunately, there is little likelihood that these targets will be met. SOEs are likely to receive lower, rather than higher, levels of bank credit for infrastructure

investment, given that the State-owned banks are in financial difficulty (mainly due to SOE debt) and are undergoing restructuring. Furthermore, private investment in infrastructure is still very modest and not likely to increase significantly without major policy changes.

7. Private Participation in Infrastructure

Private participation in infrastructure is a relatively recent development, but one that is rapidly expanding. It is estimated that, on a global basis, private companies invested US\$ 352 billion in infrastructure between 1990 and 1997, of which over 36 percent went to neighboring Southeast Asian countries (Vietnam-CG meeting, 1999). Unfortunately, Vietnam has yet to attract any significant amount of private foreign investment in infrastructure. Only one foreign investment in the power sector is in operation (Hiep Phuoc) and the two BOT power projects (Wartsila and Phu My) in the pipeline have been stalled in negotiations for some time. There are one or two foreign financed infrastructure projects supplying water, a couple of investments in port facilities, and a few transport projects, but altogether they do not amount to a fraction of the private investment that is required.

The government of Vietnam has taken measures to encourage private participation in infrastructure, including various decrees to permit and encourage BOT projects. However, serious impediments remain, including price controls that make infrastructure projects unprofitable, the lack of a proper legal framework, excessive bureaucracy and prolonged negotiations, a weak regulatory regime, and the lack of a transparent bidding process (Vietnam-CG meeting, 1999, p. 45). Removing these obstacles and tapping the potential of private investment in infrastructure is of utmost importance given the existing financing gap infrastructure investment. In addition, foreign participation in infrastructure can contribute significantly to raising the efficiency of infrastructure providers by introducing competition in the provision of infrastructure services and gaining access to new technologies and management practices. What is called for, according to most observers, is a strategy of mixed public-private provision of

infrastructure, which will generate the needed resources and raise the efficiency of existing infrastructure operations.

8. Conclusion

Doing the basics, supplying public goods and services, mainly social and economic infrastructure, is the paramount responsibility of government. The government of Vietnam, starting from a low base, has made a valiant effort to provide the country with essential infrastructure services, and much of Vietnam's remarkable economic growth can be credited to government doing the basics reasonably well in very difficult circumstances. However, in order to keep the growth engine running, much more needs to be done. Unfortunately, the resources required to provide Vietnam with an adequate infrastructure foundation are not there. The government's budgetary resources are already strained and there is little scope for significantly increasing ODA flows. The unavoidable conclusion is that the nation needs to unleash the potential of the private sector, not as a substitute but as a complement to public sector provision of infrastructure.

The private sector can contribute in two ways. Firstly, it can directly participate in the provision of infrastructure services, freeing the government to concentrate on those activities in which it has comparative advantage. In this way the private sector can expand the stock of infrastructure capital and raise the efficiency with which it is used by both by both public and private providers.

Secondly, the private sector can make an indirect contribution to the supply of infrastructure by paying taxes. Ultimately, the government is going to have to finance itself a larger proportion of infrastructure investment. The government can raise tax revenue by raising tax rates, but as explained above that recourse creates negative crowding out effects that can be self-defeating. The preferable approach is to take measures to accelerate growth, thereby generating more tax revenue from a constant rate of taxation. In most successful countries, infrastructure investment kept pace with growth, but with a lag, since the revenues that financed infrastructure derived primarily from growth and, as will be explained in a subsequent chapter, the main source of growth in every country in the region, has been the private sector. Without the emergence of a

dynamic, tax-paying private sector, it is hard to imagine how government revenues will be able to keep up with the growing demand for infrastructure and allow the government to do the basics well. And, if the government does not do the basics well, it is unlikely that Vietnam will be able to sustain long-term growth.

Chapter Four: Government Intervention: Making and Letting Markets Work Efficiently

Some market failures may require the direct involvement of government in providing a good or service—this is the case of public goods, discussed in the previous chapter. Other market failures may not require direct government participation, but instead may justify government market intervention via tax and subsidy measures or market regulations that correct the market failures and induce the market to work more efficiently. There are also many instances in which governments intervene in the market for non-economic reasons or simply because of misguided policy, and the result is often to create (rather than eliminate) market inefficiency. The government has an important responsibility, not only to correct naturally occurring market failures (making the market work efficiently), but also for removing the obstacles to an efficient market that the government itself has created (letting the market work efficiently).

1. Correcting market failures

Designing policies to correct market failures is very difficult. First, it is difficult to identify market failures. As explained below, most market failures arise from “externalities,” which by their very nature are hard to identify precisely because they are external to the market. Secondly, even when a market failure is identified, it is difficult to quantify the problem, which is usually required in order to design an appropriate policy response. Thirdly, the availability of policy instruments for dealing with market failures is often limited. Finally, unless a market failure is identified correctly, measured accurately, and the optimal (so-called “first-best”) policy instrument chosen, intervention can make matters worse rather than better, even when the intervention is very well intended.

Externalities

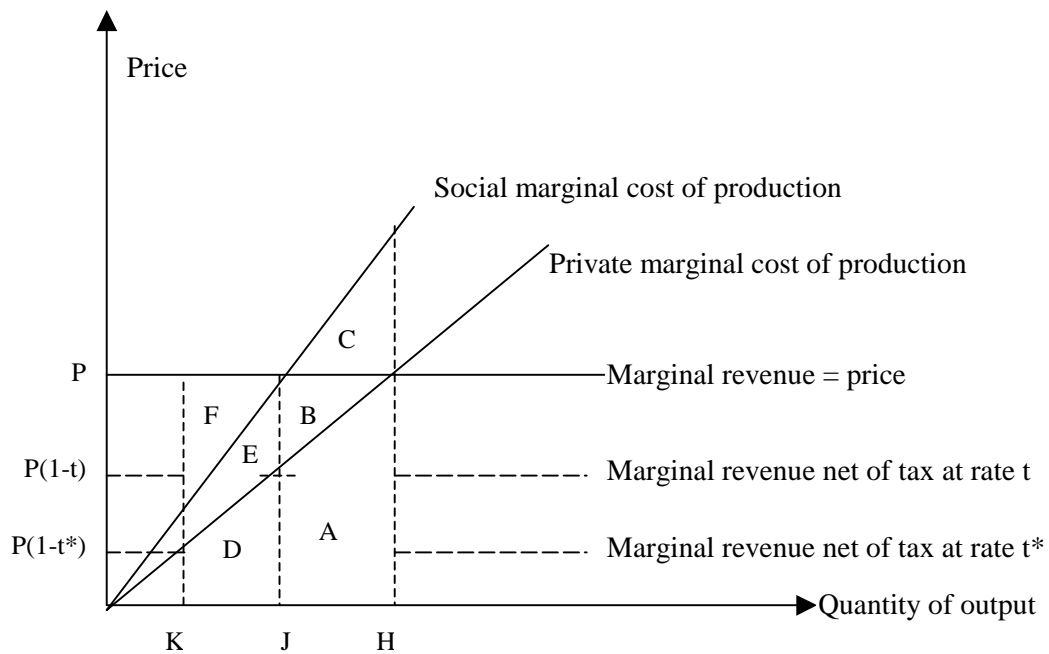
The difficulties associated with government intervention to make the market work efficiently can be best explained by illustration. Most market failures (other than those created by the government itself) derive from what are known as “externalities.”

Externalities are simply costs and benefits of economic activities that are not taken into account in the market. Pollution is a classic example of a negative production externality. Firms have to pay for labor and capital and so in maximizing profit use those resources efficiently (that is up to the point where the marginal benefit from using labor and capital is equal to their marginal cost). However, firms generally do not have to pay the social cost of the clean air or water they use up in the production process. Since the social costs of many environmental resources are not taken into account in the market, the market outcome is inefficient. A case can thus be made for government intervention. However, as is illustrated below, unless the intervention is optimally designed it can have the perverse effect of reducing, rather than raising, market efficiency and economic welfare.

Figure 4.1 illustrates the case of pollution, a negative production externality. A profit-maximizing firm equates marginal (private) cost and revenue and produces quantity H. This is not an optimal outcome because the social marginal cost exceeds marginal revenue for all output levels above J. When the market produces H, there is a social loss measured by area C, the excess of the social cost (A+B+C) over the value of output (A+B) above output J. The optimal intervention is a tax at rate t , which induces the firm to cut production to quantity J, where the private marginal cost equals marginal revenue (price minus tax) and the social marginal cost is equal to the market price (excluding tax). The tax causes a loss of output whose value is A+B, but offsetting that loss is the release of resources whose value is A and a reduction in pollution whose value is B+C. The net outcome is a social gain of area C. Government intervention has improved economic welfare by “internalizing an externality,” i.e., correcting a market failure.

It is easy to find the optimal solution to a market failure in the classroom, but considerably more difficult in the real world. We were able to devise the optimal tax measure to deal with pollution in this hypothetical case because we have assumed we know exactly the private costs of production and the amount of pollution that is generated at every level of output. Furthermore, we have assumed that we know exactly how much society values clean air relative to polluted air and so can attach a monetary value to it. These are, of course, heroic and absurdly unrealistic assumptions. In the real world this information is not available.

Figure 4.1 Illustration of a Market Failure



Suppose, lacking information, the government were to set the production tax too high, say at level t^* (instead of t), then the welfare effects of the intervention are ambiguous. At tax t^* the domestic industry would cut production to K . The value of output lost due to the tax is $A+B+D+E+F$. Offsetting this loss are the resources released from the industry whose value is $A+D$ and the reduction in pollution whose value is

E+B+C. The net welfare effect is then measured by the difference between C and F, and is therefore ambiguous. The tax at rate t^* gets rid of the excess of pollution (area C), but at the cost of creating another distortion in the market, measured by area F. If F is larger than C, then it would have been better for government to have done nothing rather than to have intervened with a sub-optimal policy. The same ambiguous result would obtain for other tax rates (not just t^*) that are not the optimal one. Thus, the case for intervention rests not just on the presence of a market failure, but also on the availability of reasonably good information on which to base a policy solution to the market failure.

This illustrates a very important result of the theory of the second-best. When externalities are present the market outcome is sub-optimal, and the potential exists for government to raise economic welfare by intervening in the market. However, unless government uses “first-best” policy instruments, the outcome of intervention is ambiguous. Some market failures are blatant and the need for intervention is obvious (e.g., environmental degradation). In many other instances, however, the case for intervention is problematic because the information required to design an optimal policy solution is not available. In these cases, doing nothing may well be the best policy.

Monopolies

Monopolies provide another justification for government intervention. When firms are free from competition, they can raise the selling price above the marginal cost of production, generating for themselves monopoly profit and for the market an inefficiency. By raising prices and earning an excessive return, however, monopolies create an incentive for competitors to enter the market to capture a share of the excess returns. Monopolies exist, therefore, only when there are high barriers to the entry of new firms. Such barriers may arise naturally, as for example when there are economies of scale which lower costs as output rises, or they may be created by government policies which protect firms and industries from domestic and foreign competition (i.e., tariffs and quotas).

In the case of a natural monopoly the market will be dominated by one or a few large firms, which left to their own devices will tend to produce less and charge a price higher than is optimal. The traditional solution to the problem of natural monopolies, such as in electricity distribution, water, and railroads, for example, is to have a public enterprise take over. The assumption is that public enterprises will not exploit the natural monopoly to gain a profit, but instead will maximize the social welfare. Unfortunately, ensuring that public enterprises maximize social welfare is difficult. In many countries, including Vietnam (see previous chapter), public enterprises supplying utilities charge prices that are too low, rather than too high, for political reasons. Of course, setting prices too low is potentially as inefficient as setting them too high.

Except for natural monopolies where scale economies are present, monopolies exist mainly by virtue of government policies that restrict domestic and foreign competition. In many countries, trade and industrial policies that are adopted to encourage domestic production have the perverse effect of creating domestic monopolies that keep output and employment low and prices high. Having created domestic monopolies, governments are then obliged to regulate them. The result is successive layers of rules and regulations that raise barriers to market entry and compound the problems of inefficiency. If governments simply eliminated the barriers to competition, they would not need extensive legislation and large bureaucracies to deal with monopolies. Indeed, trade and industrial policy liberalization has proved to be by far and away the most effective means of limiting monopoly power.

2. Making and letting the market work in Vietnam

Making and letting the market work efficiently are both responsibilities of the government, but at the current stage in Vietnam's transition from a centrally planned to a market economy the latter should take precedence over the former. It is more important for the government to concern itself with removing policy-induced market distortions and building the institutional foundations of a market economy, than to search out and correct inherent market failures. Before tinkering with the structure of market incentives so as to

achieve some ideal outcome, the government should first give the market a chance to operate as freely as possible. One wouldn't try to fix a motor without first starting it up to see how it runs. The same logic applies to fixing the economy.

There are, of course, exceptions to this general proposition, and one is environmental regulation. The market mechanism does not properly value environmental resources, and are environmental consideration fully factored into production and consumption decisions. Even though the government lacks the information required to design a "first-best" policy to internalize environmental costs and benefits, it is obvious that measures are needed, even if they are second-best ones. A recent UNDP report, *Looking Ahead (1999-A)*, describes the environmental challenges facing Vietnam, the government's laudable efforts to deal with them, and the additional measures that are required. We need not go over the same ground here, other than to note that clearly this is a market failure that demands, and indeed is receiving, government attention.

Monopolies constitute another market failure that may require government intervention. A recent UNDP report notes that "there is no comprehensive legislation against monopoly and monopolistic practices or restrictive trade practices in Vietnam."⁹ The reason for this is no doubt that heretofore the only monopolies in Vietnam were State-owned. If the private corporate sector begins to grow, non-state monopolies could conceivably arise, though it is hard to imagine how without the benefit of government protection from domestic and international competition. Introducing anti-monopoly laws *ex ante* is, however, potentially dangerous since such laws can work to stifle rather than promote competition if the rather complex economic issue of what constitutes a monopoly is not well understood.

⁹ UNDP, *Completion of Vietnam's Legal Framework for Economic Development*, UNDP Discussion Paper, No. 2, March 1999, p.61.

3. Building the institutional foundations of a market economy

One of the most important ways the government can make and let the market work efficiently is by providing the market with a sound legal framework, which is not only a set of laws and regulations, but also the institutions needed to implement and enforce the laws, such as courts, law enforcement agencies, registers for land, mortgagers and enterprises (UNDP-B. 1999. p. 2). In market economies, most transactions are based on contracts. When laws governing property rights are clear and the mechanisms for enforcing them are well functioning, the costs of doing business are lower and the market works more efficiently.

With the adoption of *doi moi*, the State recognized the need for a legal framework to replace the bureaucratic directives that governed economic transactions under the centrally planned economy and issued two ordinances, one for economic contracts (between registered businesses) and one for civil contracts (for other transactions). The civil contract ordinance was subsequently superseded by the enactment of the Civil Code in 1995, and rules for making contracts involving trade were enacted with the Commercial Code in 1997. The issue in Vietnam is not that there are too few laws governing contracts, but too many. According to a recent study of Vietnam's legal framework, "it is not clear what the relationship is between the Civil Code, the Ordinance on Economic Contracts and the Commercial Law. For this reason, it is not clear which of the laws applies to certain contracts (UNDP-B. 1999. P 52)." Not only is there confusion about which laws apply to contracts, there is also confusion about which courts have jurisdiction in settling contract disputes, economic courts or civil courts. Thus, the UNDP study recommends eliminating the distinction between economic and civil courts as well as the distinction between economic and civil contracts.

One area in which a sound legal and regulatory environment is especially important is the financial sector. There is a very strong linkage between the strength of a country's legal framework, the level of development of its financial system and its

economic growth performance. According to a recent cross-country study (Levine, 1997, p. 4),

“The data show that countries with legal systems that assign a higher priority to creditors extracting the full present value of their claims against corporations in the case of corporate bankruptcy or reorganization have more developed financial intermediaries. Similarly, countries with legal systems that more effectively enforce contracts have better developed financial intermediaries than countries where contract enforcement is more lax. Furthermore, information disclosure matters. While less robust than the creditor rights and legal efficiency variables, the data also illustrate a strong positive link between financial intermediary development and the degree to which corporations publish comprehensive and comparable information.”

The importance of a legal and regulatory framework for financial development is that it facilitates secured lending. The ability of a creditor to levy on collateral, enforce the terms of a loan, and draw on a guarantee of the debtor’s obligation, in court and if necessary with the police power of the state enhances efficiency (UNDP-B, 1999). This reduces the cost to creditors of acquiring information about the borrower since the creditor only needs information about the collateral, not the entire enterprise and reduces the cost to the creditor of monitoring borrowers to make sure they are using their loans efficiently (Pistor and Wellons, 1999, p.156). By reducing costs, secured lending facilitates a larger volume of credit transactions and allows a higher level of investment and growth.

In Vietnam, financial development, as measured by the ratio of the money supply (M2) to GDP, is comparatively low, as Table 4.1 shows. One of the main reasons for this are the problems of securing loans in Vietnam. The laws and regulations in Vietnam make it difficult for borrowers to give and lenders to enforce pledges and mortgages. To redress these problems, the UNDP study on the legal system advocates the establishment

of a registration system for mortgages, pledges, leases and other secured transaction devices that is accessible to all members of the public (UNDP-B, 1999, p. 35).

Table 4.1: Financial deepening: M2 as a percent of GDP in selected years

South Korea	Taiwan	Thailand	China	Vietnam
1970: 44	1960: 24	1970: 28	1980: 43	1994: 24
1980: 33	1970: 25	1980: 38	1990: 80	1996: 24
1997: 48	1990: 143	1997: 90	1997: 120	1998: 27

Source: IMF, *International Financial Statistics*.

Another impediment to financial development is the weakness of the banking system, which stems in large part from the lack of a comprehensive and sound regulatory system for banks and credit institutions. A legal framework for regulating banks and other financial institutions is on the books (The Law on the State Bank of Viet Nam and the Law on Credit Institutions, both enacted in 1997), but the implementing regulations and a staff of well-trained bank examiners are not in place. Nor are the accounting and auditing standards in Vietnam consistent with international practices, which is another element that undermines confidence in the banking system (UNDP-B. 1999, p.37). Other recommendations to encourage development of the banking system include (1) eliminating excessive rules and restrictions on the use of checking accounts, (2) adoption of a deposit insurance scheme and (3) the enactment of a bank secrecy law.

4. Leveling the playing field

Numerous surveys of business managers have documented the widely held view that the playing field of business in Vietnam is not level. A recent survey carried out by the *Saigon Economic Times* reported that over half of managers do not believe that “the country’s laws relate closely to the reality of doing business in Vietnam (Ngo Hong Hanh, 2000. P. 5). A significant number of managers were of the view that “the present

legal system did not dish out equal treatment to all kinds of enterprises (*ibid.*.)” Similar findings were reported in an IFC/MPDF survey of 95 larger private companies:¹⁰

- “These private manufacturers did not feel that they could count on government protection of his/her (*sic.*) legal rights as a company (p. 18).”
- “Managers complained bitterly about unclear and frequently changing government regulations that have direct impact on their businesses. In their view, regulations too often are changed without warning, and the lack of specificity of laws and regulations allows mid-level officials too much discretion. (p. 19)”
- As pertains to foreign invested business, it is reported that “The Vietnamese bureaucracy is complex and opaque, and over a hundred different permits—the majority of which must be renewed annually—reportedly must be obtained in order to operate. Investment licenses require the approval of as many as 12 different government ministries (p. 20).”

The government is of course well aware of these problems and is making efforts to redress them. Especially important in this regard is the new Enterprise Law, which aims to simplify the licensing system for new companies and expands the range of activities in which registered companies may engage. The Enterprise Law, which was to come into effect in January 2000, still lacks, however, the implementing regulations which will largely determine the effectiveness of the law in leveling the playing field.

The lack of stability and predictability in the regulatory framework seriously undermines investor confidence. Those who are affected by changes in laws and regulations have little opportunity to review them in advance and offer input and hence

¹⁰ The following quotes are from a summary of the results of the survey reported in “Leila Webster, “SMEs in Vietnam: On the Road to Prosperity,” MPDF Report Number 10, November 1999.

are often “shocked” or “surprised” by the changes. It has been suggested, therefore, that “such shocks and surprises could be avoided by requiring ministries and agencies to publish draft regulations well in advance and offering all interested persons the opportunity to comment on them before promulgation (UNDP-B, 1999s, p. 56).”

There are many complaints in the business community that the rules of the game are too numerous and unfair. The government, on its part, has acknowledged the problem and has attempted to make the rules simpler and fairer. However, what seems not to have changed is the view that the government, in the role of the umpire of the game, should control every play. Bureaucratic intervention is essential in a centrally planned economy since it is the mechanism that ensures that transactions are carried out in accordance with the plan. In a market economy, however, business is carried out by countless individuals and firms and involves an infinite number of transactions that are far beyond the scope of government to control. Government’s role is to facilitate the game by setting and enforcing a coherent and consistent set of rule, then getting out of the way and letting the game proceed. The players have to win on their own, and they also must be free to lose. Many of the complex rules and regulations in Vietnam seem intended to prevent business failure, but the right to fail (allowing for what Schumpeter called ‘creative destruction’) is integral to the effective working of a market economy.

5. Liberalizing foreign trade

Trade barriers constitute another important obstacle to a level playing field for doing business. Of course the ostensible purpose of trade barriers is to give domestic firms an advantage over their foreign competitors, but the inescapable fact is that they also put domestic consumers and non-protected domestic industries and firms at an economic disadvantage. The iron law of economic policy is that the government cannot help any one sector of the economy (such as import-competing industry) without hurting some other sector (such as the export industry and especially, in the case of Vietnam, the agricultural sector). The reason is simply that all sectors of a market economy compete for the nation’s scarce resources, and by giving one sector of the economy an advantage

in this competition, the government inevitably puts other sectors at a disadvantage, i.e., it un-levels the playing field of business.

The one positive purpose served by import barriers, when they take the form of tariffs, is that they generate revenue for government. In 1999, import and export taxes accounted for 20 percent of government total tax revenue (*Vietnam Investment Review*, 10-16 January, 2000, p. 1). Trade taxes are, however, a notoriously inefficient and unfair form of taxation. Trade taxes impose much higher “excess burden” (the welfare cost of taxation) than do income taxes or value-added taxes. Trade taxes are also inherently unfair, since they concentrate the burden of taxation narrowly on importers rather than spreading it evenly over the taxpaying public. Tariffs are also non-transparent, which allows government to avoid accountability for its tax and spending policies.

When trade barriers take the form of quotas they also generate revenue, but for those who get the right to import under the quota, not for government treasury. As harmful as tariffs are, quotas are even worse. Quotas segment domestic and international markets, which contributes to market instability (commonly referred to as “price fevers” in Vietnam). Quotas also give monopoly power to domestic firms in concentrated industries, which is an especially acute problem in Vietnam, where many branches of industry are in the hands of one or two State-owned companies. No doubt the most costly effect of quotas, however, is the rent-seeking activity that they encourage as a result of the scarcity primia or economic rents that accrue to quota-holders under a system of quotas. When there are quota rents to be captured, firms and individuals will compete for them by trying to influence the allocation of licenses to import under the quota. This kind of rent-seeking entails two costs. One, it leads to the diversion of real resources from productive activities into unproductive rent-seeking. Two, it creates strong incentives for various kinds of illegal activities, such as smuggling, bribery and corruption, which increase the cost of doing business and create market inefficiency.

The most damaging feature of the tariff schedule in Vietnam is not the level of tariffs, which on average was 15.5 percent in 1999, but the dispersion of tariff rates from

as high as 50 percent, compounded by the levy of various customs surcharges. Measuring the barrier to trade from quotas is far more difficult. One often-used measure is the volume of trade that is subject to quotas and other non-tariff barriers (NTBs), but this method is seriously flawed. A small volume of trade subject to NTBs could mean either that NTBs are trivial because they apply to goods the country does not wish to import, or that they are very severe because they effectively prevent all but a small volume of imports into the country. In the case of Vietnam, imports subject to quantitative restrictions account for about 25 to 30 percent of total imports.

A more appropriate measure of the protective effect of NTBs is their impact on domestic prices, which can be judged by comparing domestic and international prices. This too is difficult, however, because quality differences, transportation costs and other indirect tax effects complicate cross-country price comparisons. Table 4.2 presents available evidence on the price effects of Vietnam's quantitative restrictions. As Table 4.2 indicates, Vietnam's quantitative import restrictions, in most cases, have substantial price effects and imply relatively high "tariff equivalents." The data required to measure the welfare losses from Vietnam's NTBs are not available, but the price differences suggest that they impose a substantial cost, at least to consumers and users of imported inputs.

Another useful perspective on the importance of quantitative restrictions is the relative size of the sectors they are intended to protect. In Vietnam, virtually all of the imports subject to quota or quantitative targets are manufactured products, mostly belonging to capital-intensive sectors dominated by state-owned enterprises. Table 4.3 indicates the relative importance these protected sectors in the Vietnamese economy. What stands out in the Table is the small size of Vietnam's manufacturing sector as a whole. The manufacturing sector accounts for only 16 percent of GDP and employs less than 10 percent of the labor force (of about 40 million people).¹¹ State-owned enterprises in all manufactured branches, both protected and unprotected, only employ about 640

¹¹ As noted above, the physical output of key manufactured products in Vietnam is only about one-twentieth of that in Taiwan in 1960 or China in 1980, when those countries launched the export-oriented industrialization strategy.

thousand people. Even including the foreign-invested enterprises, most of which are joint ventures with state-owned enterprises, total employment does not exceed one million.

Table 4.2: Domestic and international price comparisons for goods subject to import restrictions

Item	Vietnam Price	World Price	% difference
Petroleum products (LPG)	310 USD/tonne	183 USD/tonne ¹	70%
Fertilizer			
Urea	1900-2300 VND/kg	135-157 USD/tonne ²	3%
Motorcycles	2000-2500 USD/pc	1400 USD/pc ³	40-80%
Autos (up to 15 seats)			
Iron and Steel	287.7-302 USD/tonne	230-240 USD/tonne ⁴	25%
Cement	58 USD/tonne	45 USD/tonne ⁵	28%
Sugar	493 USD/tonne	211 USD/tonne ⁶	133%
Paper			
Alcohol			
Construction glass	59,091 VND/sq.m.	2.42 USD/sq.m. ⁷	75%
Consumer electric fans	190,000 VND/pc	100,000 VND/pc ⁸	90%
Ceramic tiles	72,000-75,000 VND/sq.m.	45,000-50,000 VND/sq.m. ⁹	54%
Ceramic consumer goods			
Clinker			
Liquid NaOH soda	3,600,000 VND/tonne	The same ¹⁰	0%
Bicycles	40-45 USD/pc	30 USD/pc ¹¹	41%

¹ Price announced in Saudi Arabia in July 1999, *Thoi bao Kinh te Sai Gon*, 446, 15-07-1999, p. 17.

² Import price.

³ *Vietnam News*, 2854, 24-07-1999, p. 6.

⁴ *Thoi bao Kinh te Viet Nam*, 21, 13-03-1999.

⁵ CIF Price of ASEAN cement on Vietnam market, *Thoi bao Kinh te Sai Gon*, 444, 01-07-1999, p. 15.

⁶ Price on the London market in June 1999, *Thoi bao Kinh te Sai Gon*, 444, 01-07-1999, p. 13.

⁷ Import price, *Thi truong*, 2584, 22-07-1999, p.7.

⁸ *Vietnam News*, 2854, 24-07-1999, p. 6.

⁹ Price of smuggled China tiles with supposedly lower quality on Vietnam market, *Thoi bao Kinh te Viet Nam*, 31,17-04-1999, p. 15.

¹⁰ VICACO – Vietnam Chemical Corporation, July 1999.

¹¹ Prices of Vietnam and China bicycles on Cuba market, *Tap chi Thuong mai Viet Nam*, 18, 1998, p. 2-3.

Furthermore, as Table 4.3 shows, within the manufacturing branches in which there are quantitative restrictions on imports, employment overall is only about 1 million and manufacturing value added is only about US \$ 1.4 billion (i.e., approximately 40

percent of gross industrial output of US \$ 3.4 billion). In other words, Vietnam's quantitative restrictions are protecting only a small fraction of GDP and no more than a few hundred thousand jobs.

Table 4.3: Gross output, employment and imports in Vietnam's most protected manufacturing sectors in 1997

	Gross output 1997 (US \$ millions)	Imports 1997 (US \$ millions)	Domestic Employment (millions)
Most protected sectors:			
Cigarettes & tobacco	372.0	83.0	
Paper & paper products	269.4	94.9	
Petroleum products	7.9	1094.2	
Chemicals & fertilizer	678.5	285.6	
Rubber & plastic products	364.2	283.7	
Non-metallic mineral prod.	1139.0	91.7	
Metals (incl. Iron and steel)	405.7	700.0	
Machinery and equipment	163.9	1777.0	
TOTAL	3400.6	4410.1	1.010
Total manufacturing	11351.6	10300.0	3,292
State-owned mfg enterprises	8172.7		0.640
Foreign invested enterprises	2610.7		0.204

Source: *Niem Giam Thong Ke 1998* GSO, 1999, *Vietnam Economic News*, Selected issues.

Vietnam's participation in the Asean Free Trade Area (AFTA) and its application to join the World Trade Organization (WTO) have made trade liberalization a matter of necessity. Nevertheless, trade reform heretofore has been slow and lacked direction, as often liberalization measures are accompanied by new restrictions to protect specific industries. The government has, however, set an ambitious agenda of trade reform. According to a World Bank report (submitted to the Vietnam CG meeting, December 1999, p. 7), "Over the next three years, Government is considering moving the trade

regime to the use of tariffs as the only instrument for protection and ensuring access of all enterprises to import and export outlets.”

If this agenda of trade reform is achieved it will have a significant positive impact on the economy and the potential for long-term growth. The elimination of quantitative restrictions will impose discipline on state-owned enterprises, enhance competition in the economy, and reduce the potential for legal and illegal rent-seeking activities. Expanding further the right to trade, such that any firm can import directly all non-restricted products, not just those listed on the firm’s business license, is essential for a level playing field. If these measures and the others reviewed above are carried out swiftly, private investment in export-oriented manufacturing can be expected to expand rapidly, which as we shall argue in the following chapter is an essential requirement for the long-term growth of output, employment, foreign exchange earnings, and tax revenue in Vietnam.

Chapter Five: A Strategy for Long-term Growth¹²

Vietnam has made great progress in its transition from a centrally planned to a market economy. The issue is no longer whether Vietnam will have a market economy, but rather what kind it will have – a dynamic, prosperous one, or a cumbersome, inefficient one like many in the developing world. Looking back over the past decade of economic accomplishments – near double-digit growth rates, inflation in the single-digit range and foreign direct investment (FDI) flooding in – one might be persuaded that Vietnam has already laid the foundation for a dynamic, prosperous market economy. That of course would be a mistake, as it is well recognized both inside and outside of the government that without further reforms the strong performance of the past cannot be sustained (Le Dang Doanh, 1999).

In each sector of the economy there are major policy issues to be tackled—trade policy, financial policy, state-owned enterprises and so forth. However, even if the authorities were willing to tackle them all at once, they would lack the resources and administrative ability to do so. What is necessary, therefore, is to establish a set of reform priorities based on a strategic vision of long-term economic development in Vietnam. At present there is no consensus in the government about such a strategy, and so there is no consensus as to what the priorities of reform should be.

A long-term economic development strategy that is appropriate for Vietnam's circumstances cannot be invented *de novo*, it can only be found by studying the experiences of other countries in similar circumstances. Many, indeed most, developing countries have tried to chart a new course—a 'third way'—a strategy custom-designed to fit what they perceived to be their unique economic and political circumstances. But in every case they have been forced to abandon their 'third way' and look to the experiences of other countries for guidance. Since 1985 nothing short of a revolution in policy making has swept the developing world, as one country after another has undertaken to

¹² Parts of this chapter are drawn from Riedel (forthcoming).

liberalize its trade and industrial policy in an effort to emulate the success of the East Asian ‘tigers’ (Dean, Desai and Riedel, 1994).

It is ironic that Vietnam, which lies in the very midst of these economic tigers, has been one of the last countries to embrace the strategy that propelled their success. In fact, there is no other proven path to rapid, long-term growth for a country in Vietnam’s circumstances than the export-oriented industrialization strategy that each and every one of the successful East Asian countries followed. Here we argue that Vietnam is poised to replicate their success: it satisfies the preconditions in terms of resource endowment; and it has to a large extent established the policy framework needed to make the strategy work (although there are many areas in which the policy framework could be improved). However, one critical ingredient of the strategy is missing – the network of private small and medium-sized companies that was the backbone of export-oriented industrialization everywhere that it succeeded. Correcting this deficiency by providing an economic environment conducive to the emergence and growth of private companies is, we argue, essential for achieving stable long-term growth in Vietnam.

The argument that private small and medium-sized companies are critically important to Vietnam’s economic development is based on three fundamental propositions that are solidly supported by empirical evidence. These are: (1) that export-oriented industrialization is the only viable strategy for rapid economic growth in Vietnam; (2) that Vietnam satisfies the prerequisites of the strategy in terms of the resource endowment and policy framework needed to make the strategy work; and (3) that critical to the success of the export-oriented industrialization strategy is the emergence of private small and medium-sized companies as the dominant (but not exclusive) form of industrial organisation in the manufacturing sector.

1. The Urgent Need for Export-Oriented Industrialization

In the vast literature on economic development over the past 100 years, there is no empirical regularity that is more robust and universal across time and across countries

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

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

The second premise – that scale economies and learning by doing would allow developing countries to revoke the law of comparative advantage and instead put their scarce investable resources into capital-intensive, high-technology industry – proved equally false and was disastrously costly for developing countries. Certainly the import substitution strategy did create large industrial bases in the larger continental developing

countries (China, India, Brazil, Turkey), but in every case it carried an enormous cost in terms of economic inefficiency and often brought with it macroeconomic instability.

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

2. Why an export-oriented industrialization strategy is appropriate for Vietnam

The export-oriented industrialization strategy is appropriate for Vietnam for two reasons: (1) there is no alternative strategy that will work as well; and (2) economic conditions in Vietnam are similar to those that existed in other countries that have succeeded with an export-oriented strategy.

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

Vietnam is also blessed with about 70,000 square kilometers of fertile agricultural land, which at present provide employment for about 80 per cent of the population and in good monsoon years generate a food surplus (mainly of rice) for export. Relative to the population of about 77 million, however, Vietnam's agriculture is already close to the limit of its capacity to feed the country, and agricultural productivity will therefore need

to rise. An export-oriented industrialization strategy will not relieve Vietnam of the necessity of having to invest heavily in the agricultural sector to raise productivity. Even with substantial investment in agriculture, the sector will not be able to provide productive employment for the millions of people who reside in the countryside and the millions more who will be born into the rural sector in the years to come. Indeed, the only way to raise agricultural labor productivity is to transfer a large proportion of the agricultural labor force to the industrial sector.

Industrialization is therefore the key to raising per capita income in Vietnam over the long term. Moreover, industrialization must follow Vietnam's comparative advantage and be, for the most part, labor intensive and export oriented. As shown in Table 5.1, Vietnam's comparative advantage lies first and foremost in the abundance of its human resources. Like all other East Asian countries that have succeeded with export-oriented industrialization, Vietnam is a densely populated country with meager natural resources and with the majority of its population in the rural sector. Furthermore, as the table shows, Vietnam has achieved levels of human resource development comparable to those that existed in other East Asian countries when they launched their export-oriented industrialization strategies.

One area in which Vietnam is relatively deficient is industrial development; current levels are far below those achieved by other countries when they shifted from an inward looking import substitution strategy to an outward looking export-oriented strategy. Per capita output of Vietnam's principal industrial products is only about one-tenth to one-twentieth that of, for example, Taiwan or China when they launched their industrialization strategies.

Because Vietnam's industrial base is relatively small, some might be led to suggest that, like most other countries, Vietnam should follow an inward looking policy to build up its industrial base before undertaking an export-oriented industrialization strategy. This would be a major mistake, for the export-oriented strategy succeeded elsewhere by being 'footloose' and hence able to circumvent the inefficient industrial

base built up during the earlier import substitution phase. The essence of the strategy is, for the most part, to combine low-cost labor, drawn chiefly from the rural sector, with mainly imported raw materials and capital goods. Seen in this light, the relatively small size of Vietnam's industrial base is an advantage rather than a disadvantage, because it largely obviates the necessity (though not the desirability) of attempting to privatise or close down large numbers of state-owned industries that are unable to compete internationally.

Table 5.1: Comparative Economic and Social Indicators

	Taiwan (35–40 years ago)	Thailand (20–25 years ago)	China (10–15 years ago)	Vietnam (most recent)
Population density (population/sq km)	300	108	96	195
Agricultural population density (population/sq km)	629	240	219	934
Agricultural land/total land (%)	24	45	44	21
Life expectancy (years)	63	60	65	67
Secondary school enrolments (% school age children)	30	26	47	42
Illiteracy rate (% population over 15 years)	30	7	27	16

Source: Riedel (1993).

Vietnam meets the prerequisites for a successful export-oriented industrialization strategy not only in terms of resource endowment, but also in terms of the macroeconomic framework that is required. At least three macroeconomic conditions are common to all the successful applications of such a strategy: (1) macroeconomic stability; (2) relatively high and rising domestic saving and investment rates; and (3) if

not free trade, as in Hong Kong and Singapore, then free access for exporters to imported inputs and capital goods.

One of Vietnam's most remarkable achievements has been its ability to reduce inflation and keep it down, a tribute to the government's commitment to a prudent fiscal policy. Moreover, in the past six years Vietnam has achieved a doubling of the share of gross domestic investment in GDP and a tripling of the private saving rate. Finally, it must be acknowledged that Vietnam has gone a long way toward lowering trade barriers, especially for exporters, although much remains to be done to put them on an equal footing with their competitors in world markets (see previous chapter). Of the three key ingredients of the policy framework for export-oriented industrialization, this final one has suffered the most in recent years as the government has tried to manage an incipient foreign exchange crisis by compressing imports. Nevertheless, for the most part the ingredients of a successful export-oriented industrialization strategy are in place, all, that is, except one: the private companies whose role it is to implement the strategy.

3. The Role of Private Small and Medium-Sized Enterprises¹³

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

The importance of private companies in export-oriented industrialization is grounded not in theory or ideology, but in the fact that this form of industrial organization

is the most successful in low-wage, labor-abundant, open economies. By ‘most successful’ what is meant is that, if treated fairly, private companies earn higher returns on investment than larger SOEs or smaller private household businesses. As a result they are better able to compete for scarce investible resources and emerge as the predominant form of business enterprise in relatively labor-intensive, export-oriented branches of manufacturing.

Evidence of the superior performance of private companies in labor-abundant countries can be found in any of the successful East Asian countries. Here we draw evidence from Taiwan, which is the most successful of all the East Asian countries and the one most appropriate for purposes of comparison with Vietnam since, as shown in Table 1, Vietnam bears a striking resemblance to Taiwan as it was 35–40 years ago.

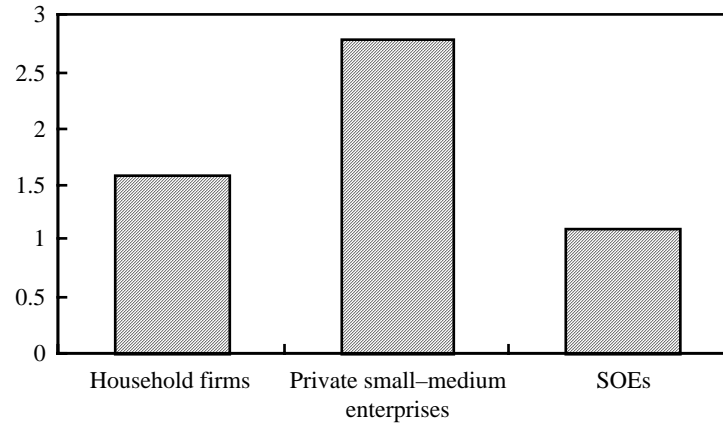
One similarity that would come as a surprise to many is that SOEs dominated the manufacturing sector in Taiwan in the late 1950s, just as they do in Vietnam today. Indeed, the real (US dollar) value added of state-owned manufacturing firms in Taiwan in the late 1950s was greater than that of such firms in Vietnam currently. However, the contribution of state-owned manufacturing firms was entirely eclipsed by the growth of private manufacturing after the export-oriented industrialization strategy was launched in the 1960s (see Figure 2.1, Chapter 2).

The private companies that grew to overwhelm SOEs in Taiwan were mostly small- and medium-sized companies with an average of about 40 employees per firm. Their share of manufacturing value added rose from about 35 per cent in 1960 to about 85 per cent in 1995. It is apparent why such companies emerged as the dominant form of enterprise in Taiwan. As shown in Figure 5.1, the average return on capital in Taiwan’s private small and medium-sized companies is almost three times higher than in the much larger and more capital-intensive SOEs, and about two times higher than in the smaller and slightly more labor-intensive family firms. In a labor-abundant, low-wage, open economy, the private companies predominate because they are small enough to be

¹³ This section draws on Riedel and Tran (1997).

flexible and large enough to be efficient. Their beauty is not in their size but in their profitability.

Figure 5.1: Ratio of value-added to fixed capital by firm type in Taiwan manufacturing, 1986



4. Shifting the Center of Gravity of the Economy

In order for Vietnam to sustain high rates of per capita income growth, it must shift the center of gravity of the economy to sectors where productivity is high and grows rapidly. As the data in Table 5.2 show, in Vietnam, as in other countries, the sector in which productivity is high and grows rapidly is industry, in particular manufacturing. That the share of industry in GDP (at 32 percent) is comparable to that of most high-income countries, is an entirely misleading statistic. As Table 5.2 further shows, more than two thirds of the labor force is still in agriculture, which absorbed over half (58 percent) of the increase in the labor force between 1995 and 1998. Most of the rest (40.7 percent of the incremental increase in the labor force) found employment in the service sector, where productivity is low and has increased hardly at all (shown by the difference between growth rates of value-added and employment). The only sector where productivity growth has been (and will continue to be) high is industry, and in particular in the labor-intensive manufacturing branches of industry. Unfortunately, manufacturing only accounts for about 17 percent of GDP and about 9 percent of total employment.

Table 5.2: Sector shares, growth rates and contributions GDP growth (percentages)

	1998 Sectoral Share in:		1995-98 Sectoral Growth Rates of:		Direct contribution to growth of:	
	GDP	Empl.	GDP	Empl	GDP	Empl.
Primary	25.2	68.7	4.1	2.7	22.1	58.0
Industry & Const.	32.0	12.57	12.0	1.5	37.2	5.9
<i>Manufacturing</i>	<i>17.2</i>		<i>12.1</i>		<i>20.0</i>	
Service Sector	42.8	18.77	7.0	6.7	40.7	36.1
Total	100.0	100.0	7.8	3.4	100.0	100.0

Source: GSO, 1999.

The relatively rapid growth of manufacturing (12.1 percent from 1995 to 1998) has been accompanied by relatively rapid growth of exports of labor-intensive light manufactures and handicrafts (almost 30 percent per annum from 1995 to 1998). See Table 5.3. However, this growth is from an extremely low base of only US\$ 1.5 billion in 1995, which is less than one percent of Taiwan's manufactured exports. When Taiwan launched the export-oriented industrialization strategy in 1960, its export structure was very much like Vietnam's today, with manufactures accounting for only about 30 percent. However, over the succeeding decades, manufactures share rose to 96 percent and accounted for the rapid expansion of exports, which grew at an annual rate of about 35 percent steadily over three decades. What Vietnam has achieved with export-oriented industrialization is, therefore, but a small fraction of its enormous potential.

Table 5.3: Export structure and growth 1995-98 (percentages)

	1998 Share in Total Exports	Growth Rate 1995-98
Total Exports	100.0	20.4
Heavy Industrial Products & Minerals	23.7	17.2
Light Industrial Products & Handicrafts	35.9	29.4
Agriculture, Forest & Aquatic Products	40.4	14.5

Source: GSO, 1999.

5. The Missing Ingredient: Private Companies

It is our contention that the reason Vietnam has not realized more of its potential in export-oriented manufacturing is because of one missing ingredient—the small and medium sized companies that propelled export-oriented industrialization everywhere else in the region. Table 5.4 shows the contribution of public and private companies to GDP and employment. Private companies claim the smallest share in both output (value-added) and employment. State-owned enterprises, while accounting for almost 50 percent of GDP, provide employment for less than 10 percent of the labor force. In the three years from 1995 to 1998, the labor force expanded by 3.5 million jobs, of which the state-owned enterprises provided employment for only 3.8 percent, about the same proportion as accounted for by foreign invested enterprises (4.4 percent) and private companies (4.6 percent). The rest, 87.2 percent of incremental employment, was absorbed by household enterprises and farming, which underscores again that the gravitational center of the economy still rests in the traditional, low productivity sectors of the economy.

**Table 5.4: GDP and employment by type of ownership
(percentages)**

	GDP by Ownership		Employment by Ownership	
	Share in 1998	Growth 1995-1998	Share in 1998	Growth 1995-1998
Total GDP	100.0	7.8	100.0	3.4
Public (State & collective)	49.1	7.7	9.1	1.3
Private (Total)	41.1	5.8	90.3	3.3
Households & Farms	34.0	5.4	88.9	3.2
<i>Private Companies</i>	<i>7.1</i>	<i>7.4</i>	<i>1.3</i>	<i>14.0</i>
Foreign Invested Companies	9.8	19.4	0.6	37.3

Source: GSO, 1999.

In manufacturing, where private companies should be especially strong, their shares in value-added and employment are only about 9 percent. (See Table 5.5.) Foreign invested enterprises, mainly in joint-ventures with state-owned companies, have the best growth record by far, but to what extent this reflects the favorable treatment they

receive in terms of taxation and access to credit and foreign exchange is an important and unanswered question. Certainly the role of foreign direct investment in Vietnam is disproportionately large as compared to its role in other countries in the region. While foreign direct investment is indispensable for a country at Vietnam's level of development, it is not capable of providing an engine for growth and employment. That will only come from domestic investment in the areas of Vietnam's comparative advantage, in which private small and medium sized companies are an essential, but still missing, ingredient.

Table 5.5: Manufacturing value-added by type of ownership (percentages)

	Manufacturing GDP by Ownership	
	Share in 1998	Growth 95-98
Total GDP	100.0	12.1
Public (State & collective)	50.1	7.7
Private (Total)	26.5	11.0
Household enterprises	17.5	12.2
<i>Private Companies</i>	9.0	8.7
Foreign Invested Companies	22.4	35.3

Since 1992, when Vietnam's Constitution laid the legal foundation for private sector, private companies have flourished, quadrupling in number since 1993 (when there were about 6000 companies). However, as Table 5.6 indicates, about 80 percent of Vietnam's new companies are in the form of household enterprises and most are in the trade and commercial sectors. Private corporations, in the form of limited liability and joint stock companies, still number less than 8,000. Moreover, as Table 6 further shows, very few of the new companies have been established in manufacturing, where their potential to generate growth and employment is greatest. An important question is why have private companies flourish in every sector except manufacturing?

Table 5.6: The number of private companies by type and sector

	1995	1998		1995	1998
Total	15,276	26,021	Total	15,276	26,021
Household enterprises	10,916	18,750	Trade	7,645	12,753
Limited Liability Companies	4,242	7,100	Manufacturing	5,006	5,620
Joint-stock Companies	118	171	Other	2,625	7,648

Source: GSO, 1999.

What is deterring private domestic investment in manufacturing? Why are entrepreneurs willing to form new companies in the trade and commercial sectors, but not in manufacturing? Relevant to this question is no doubt the fact that in manufacturing the capital requirements are relatively high and the timeframe for investment is relatively long. This makes investment in manufacturing relatively risky when investors' confidence in the economic system is weak.

Chapter Six: Implementing a Strategy for Long-term Growth

In this report we have discussed a number of important areas in which a redefinition of the role of the State in the economy of Vietnam is required in order for Vietnam to achieve its stated development objectives. It has not been suggested that the State should play a smaller role, but rather that it should play a somewhat different role, placing relatively more emphasis on those activities in which it has a comparative advantage (supplying public goods and making and letting the market work efficiently) and by necessity becoming less involved in areas where the market operates relatively efficiently.

Among the important duties of government, none is paramount to nor more urgent than that of building investor confidence, especially in the private sector. Many recommendations of policy reform to this end have been put forward in numerous studies and reports, the most important of which include:¹⁴

- Financial sector reforms that improve the access to credit of private companies;
- Land reforms that give private companies rights to land use that are transferable and can be used for collateral;
- Trade reforms that improve private companies' access to imported machinery and material inputs at world market prices;
- Regulatory reforms that simplify the establishment and registration of companies and remove the need for licenses, except in a few highly-regulated businesses such as banking and food processing;

¹⁴ See for example Mallon, 1996; Riedel and Tran, 1997; MPDF, No. 10, 1999; UNDP-B, 1999; World Bank, CG Meeting Reports for 1998 and 1999; Vu Quoc Tuan, Prime Minister's Research Committee on SME Promotion, October 15, 1999.

- Accelerate the reform of state-owned enterprises, eliminating the privileges they currently enjoy and establishing a more level field of competition between private and publicly owned companies.

Carrying out these recommendations, as the government is currently doing, will no doubt improve the business environment for private domestic investment in manufacturing and elsewhere in the economy. The abolition of some 84 business licenses, as part of the implementation of the new Enterprise Law, is reported to have already had a significant effect on the number of new business registrations (Vietnam News, p.1, 9/5/2000). The changes adopted by the National Assembly to the Foreign Investment Law which are aimed at making it easier for foreign investors to transfer ownership of joint venture capital, to purchase foreign currencies, to open overseas bank accounts and to mortgage land-use rights to obtain bank loans should also have a positive effect on the level and efficiency of foreign investment (Vietnam News, p.1, 16/5/2000). In addition, the government is undertaking reforms targeted specifically to benefit (mostly private) SMEs, including a Fund for Investment Assistance for SMEs and a Credit Guarantee Fund for SMEs.¹⁵

There are grounds for concern, however, as to whether these incremental policy reforms and initiatives in and of themselves are sufficient to build the level of investor confidence that is needed to launch the take-off of export-oriented industrialization. Moving forward with policy reform is certainly not enough, the movement must be consistently in the direction of positive change—two steps forward and one step backward does not necessarily constitute progress when the objective is to build confidence in the economic system and policy framework. The problem of inconsistency is further exacerbated when the policy process is not transparent and when investors cannot see the ultimate goal the policy reforms aim to achieve. General pronouncements of support for private sector development, such as the resolution of the 8th Party Congress

to “Create a favorable environment and conditions for the development of private economy without any limits in scale and fields of operation is not prohibited by law,” are also not sufficient to overcome investors’ concerns and fears about how the system works against them. Something more is needed, namely a “strategic vision,” or a consensus view, that the only viable basis for long-term development is export-oriented industrialization, driven mainly by private, mostly small- and medium-sized companies.

What makes this strategic vision compelling is simply that it works. It has worked in every East Asian developing country that has adopted it, and it can also work in Vietnam. In order for it to work, however, the government must create conditions that are favorable to private sector development. The case can be made no better than has been made by Mr. Vu Quoc Tuan, of the Prime Minister’s Research Committee:

“The market based economy itself can regulate economic units to find their way to success. The State’s function is to guide all economic sectors and create favorable conditions for production in the orientation of the market economy, control and deal with law breaking cases, encourage legal competition, reject monopoly, ensure the social development harmonized with that of the economy. The State is the guider (*sic.*), not the doer (p. 7).”

¹⁵ See the Report of the Study Team of the Prime Minister at the conference on Measures for SMEs development, dated October 15, 1999.

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