**A Retrospective on Past 30 Years of Development in Vietnam**

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## I. Introduction

Over the past 30 years, the process of economic transition in Vietnam has been very successful. Thanks to impressive economic growth, Vietnam has risen from the rank of the worldôs poorest nations to join the middle income group. Tens of millions of Vietnamese have escaped poverty. The majority of the people have shared the fruits of economic reform. The political support as well as the legitimacy of the Communist Party has been strengthened.

But the economic transition from a centrally planned to a market economy has been politically risky for the Vietnamese communist party-state. Arguably the biggest risk facing the party-state is that economic reforms undermine its comprehensive monopoly in allocating economic resources, redistributing income, and granting political favors and social status. At the outset of reforms, existential threats to regime survival, caused by political and economic crisis, coalesced a high degree of political consensus around the reform machine. But immediately after the initial success, the conservativesô perception of political risk became clearer and more pronounced, making political resistance the biggest barrier to economic reforms.

The fundamental dilemma facing the top Vietnamese leaders is that if they do not reform the economy, their economic legitimacy and hence the survival of the party will be challenged. But in order to reform, the orthodox political ideology has to be compromised. Once a certain level of ideological compromise has been established, state effectiveness comes into play in determining the outcomes of reform efforts.

This paper offers a retrospective on the past thirty years of development in Vietnam, covering key achievements, missed opportunities, and the role of government since the onset of *Doi Moi* (ñrenovationò) in 1986. It is a positive analysis of how differences in power structure, ideological compromise, and state effectiveness help to explain key economic reforms undertaken by the government of Vietnam and its economic performance in comparison with China and other Asian countries.

The paper is structured as follows. Section II provides an overview of the Vietnamôs economic development in comparison with other developing countries in Asia. Section III discusses the interplay of ideologies, political power structure and state effectiveness in determining different policy choices confronting the Vietnamese leadership from the start of *Doi Moi* up to now. The framework developed in section III is then used to analyze policy decisions, and reform successes and failures in agriculture (section IV), state-owned enterprises (section V), private sector development (section VI), and financial market development (section VII).

## II. Vietnam in Comparison to Other Asian Nations

The purpose of this section is to compare the growth experience of Vietnam with those of broadly comparable Asian economies. For the purposes of this paper, these will be China, India, Indonesia, Malaysia, the Philippines and Thailand. The comparison will consider overall growth, investment, FDI, exports and imports, social progress, and trends in governance.

### 1. Economic Growth

Vietnamôs real GDP grew at 7.7% from 1990 to 2010 and then slowed to 5.4% from 2010 to 2014.[1] The average for the entire period is 7.35%, which compares favorably with other nations except China as Table 2.1 shows.

**Table 2.1: Real GDP Growth (annual %) 1990-2014, Selected Countries**

| | GDP | | 1990 to 2014 | |
|---|---|---|---|---|
| | **1990-2010** | **2010-2014** | **GDP** | **Per Capita GDP** |
| **China** | 10.7 | 8.0 | 10.3 | 9.5 |
| **India** | 7.0 | 5.5 | 6.8 | 5.1 |
| **Indonesia** | 4.7 | 5.9 | 4.9 | 3.5 |
| **Malaysia** | 6.0 | 5.3 | 5.9 | 3.7 |
| **Philippines** | 4.1 | 6.0 | 4.4 | 2.3 |
| **Thailand** | 4.4 | 2.5 | 4.1 | 3.3 |
| **Vietnam** | **7.7** | **5.4** | **7.4** | **6.0** |

Sources: 1990-2010 from World Development Indicators 2012, Table 4.1 (World Bank); 2010-14 from online data base of World Bank accessed in February 2015. Population data are from online US Census. (http://www.census.gov/population/international/data/idb/informationGateway.php)

While Vietnamôs GDP growth was high to 2010, it fits into a pattern where low per capita income nations grow fast and then slow down (admittedly at different rates) as they become middle-income. Putting the Philippines before 2010 aside, the rest of ASEAN in this analysis grew at 3-4% per capita, and India ï with a similar per capita GDP ï grew as fast as Vietnam after 2010. The main exception is China, which reported growth much faster than the others and is now richer than any save Thailand and Malaysia. A reasonable question is if at least some of this difference is due to overstated GDP growth in the 1990ôs before Deng Xiao Ping restrained the ñoverenthusiasticò local officials hoping to be promoted. One way to examine this is to look at electricity consumption per capita growth from 1990 to 2010 in China and Vietnam, shown in Table 2.2. Electricity and GDP growth are often related, though not perfectly. However, many analysts have suggested that at least some of Chinaôs growth is overstated.

[1] Data for Vietnam prior to 1990 are not very accurate, as it was a time of high inflation and socialist accounting in net material product terms, which excluded services. But crude estimates put real GDP growth at 3.4% in 1986-89, 6% from 1981 to 1986 and 0.2% from 1976-80 for an average of 3.4% and per capita growth of 1.3% a year. See ñSocio-Economic Development in Vietnam, The Agenda for the 1990sò, edited by Per Ronnas and Orjan Sjoberg, SIDA, 1991. (Table 3.1 on page 41)

**Table 2.2: Electricity Per Capita and Rates of Growth in China and Vietnam**

| | kWh per capita | | | Growth Rate (% per year) | | |
|---|---|---|---|---|---|---|
| | **1990** | **2000** | **2010** | **1990-2000** | **2000-2010** | **1990-2010** |
| **China** | 511 | 993 | 2944 | 6.9% | 11.5% | 9.2% |
| **Vietnam** | 98 | 295 | 1035 | 11.7% | 13.4% | 12.5% |

Source: Online World Bank data base, accessed in February 2015; Production per capita in 2013 was 4000 kWh for China and 1458 for Vietnam, a faster rate of growth (41% versus 36%) for Vietnam since 2010.

It is quite normal for electricity demand to grow faster than real GDP, especially when heavy industries are being developed. Since China may have started with more heavy industry, it is possible that its relatively low electricity growth in the 1990ôs reflected a high initial heavy industry starting point and more stress on light industry in the 1990ôs. On the other hand, even if electricity use per capita grew only in line with real per capita GDP (and this is probably too conservative), we would have an implied rate of GDP per capita growth not very different from Vietnamôs in the 1990ôs. In the 2000-2010 period, the quality of Chinaôs GDP data likely improved and electricity in that decade grows 1.5% per year more than per capita GDP, a plausible result. A cautious conclusion is that China and Vietnam are closer in actual GDP growth than the official data suggest, at least for this period.[2]

## 2. Investment

Capital increases are an important source of growth and additions to capital come from investment. Not all investment is driven by efficiency considerations ï sometimes public investment in backward areas is made for equity reasons and at other times investments are made for prestige reasons. So the productivity of investment will not be the same from country to country or even from year to year in the same country. Even so, the ability to mobilize savings and invest it relatively efficiently is a prerequisite for rapid growth. The following table gives the rate of investment growth in the 1990ôs and 2000-2010 periods, as well as the rate for 2010-2013. After 2010, the previously rapid growers (China, India and Vietnam) slowed down and Vietnamôs investment **level** fell, not merely its ratio of investment to GDP, though it grew again in 2014. The slower investment growers all sped up after 2010. While Chinese investment growth rates stayed high, the quality of that investment has been widely questioned and may reflect state-led attempts to maintain growth without adequate demand.

**Table 2.3: Rates of Real Investment Growth, Selected Economies (% per Year)**

| | **1990-2000** | **2000-2010** | **2010-2013** | **2013 Inv/GDP** |
|---|---|---|---|---|
| **China** | 10.8 | 13.3 | 9.0 | .493 |
| **India** | 6.9 | 12.9 | 1.7 | .322 |
| **Indonesia** | - 0.6 | 6.1 | 7.6 | .336 |
| **Malaysia** | 5.3 | 3.0 | 9.5 | .263 |
| **Philippines** | 2.1 | 2.8 | 4.5 | .197 |
| **Thailand** | -4.0 | 4.5 | 8.0 | .290 |
| **Vietnam** | 19.8 | 12.0 | -4.0 | .266* |

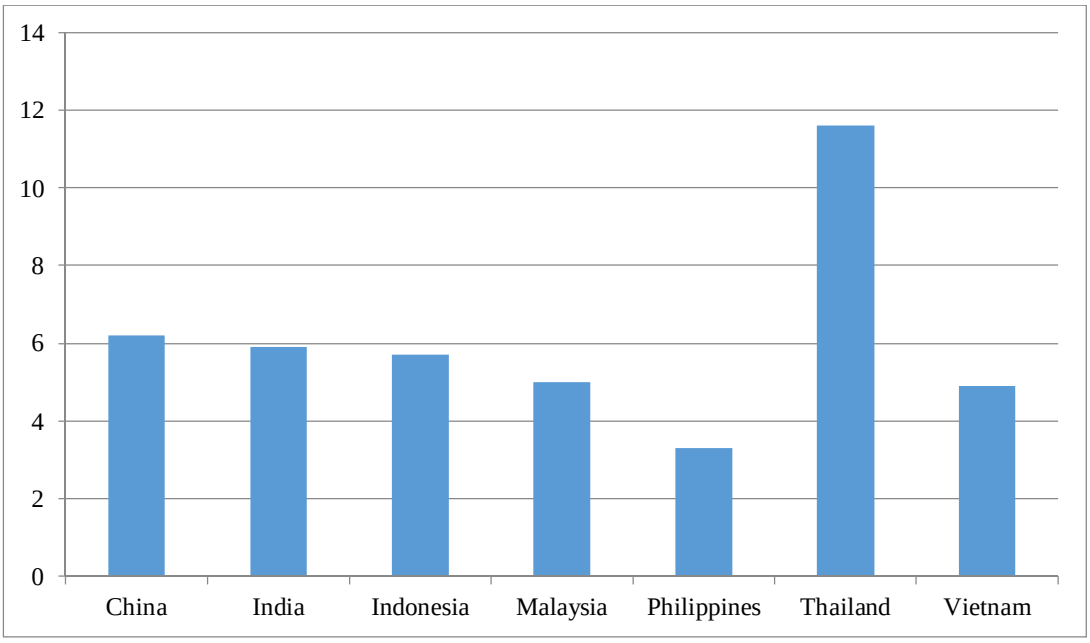
[2] In the last few years, an energy conservation policy in China allowed the reduction of electricity use per unit of GDP. It is also possible that in some years the GDP data for Vietnam were overstated, especially in slow years.

Notes: 1990-2010 growth rates are from Table 4.9 of World Development Indicators 2012. After 2010, ADB Key Indicators are used, applying the share of investment at current price GDP to constant price GDP and calculating growth rates.

*Vietnamôs ratio improved to 31.3% in 2014.

Notice the ratio of investment to GDP varies wildly ï from about half of all GDP in China to less than a fifth in the Philippines. Notice too that the growth rate (6% a year since 2010) for the Philippines is only a little lower than the reported 8% for China, suggesting very different investment efficiencies. Figure 2.1 shows the ratio of investment to GDP in 2013 divided by the 2010-2014 growth rates.

**Figure 2.1: Capital-Output Ratios**

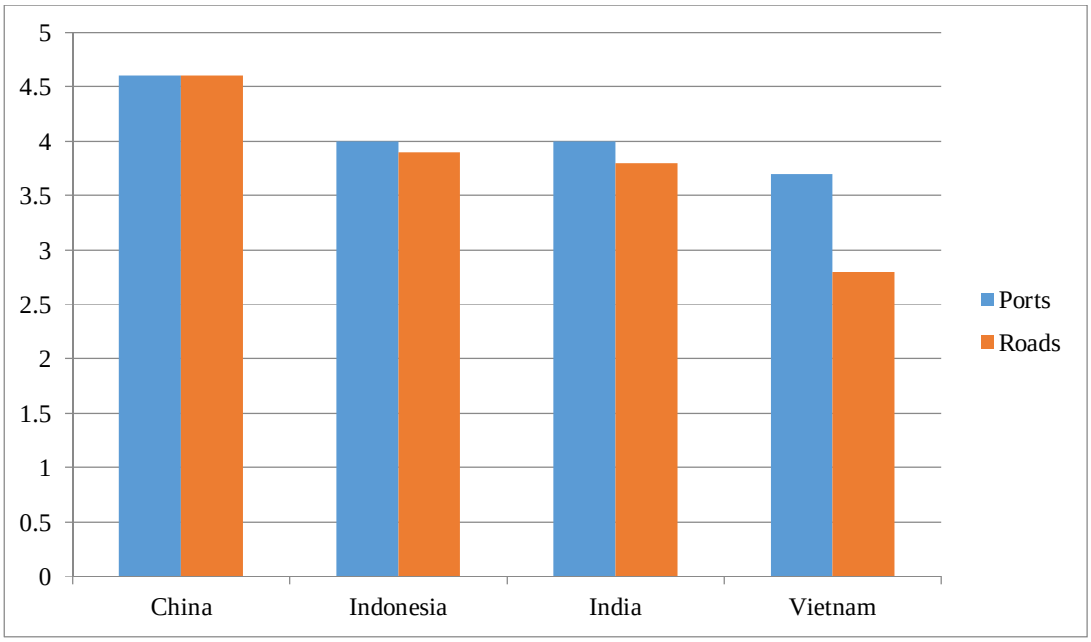



Source: Authorsô calculation using the ICOR method and based on the World Bankôs World Development Indicators Database.

Most of the countries have a capital to output ratio of roughly five to six, with only the Philippines (3.3) well below ï which is good ï and Thailand (11.6) well above. Vietnamôs capital-output ratio (4.9) is marginally lower than most, but Vietnam is also poorer than the others, which should boost the effectiveness of each unit of investment. Also, we would normally expect a lower investment ratio to be associated with a lower capital to output ratio because many marginal projects are not selected, as is true for the Philippines, but not for Vietnam. In short, Vietnam is about average in investment efficiency, even though it ñshouldò be better than it is.

One result of investment is the quality of infrastructure. The World Economic Forum interviewed relevant parties in 2013-14 about the quality of road and port infrastructure. The rating scale ranged from 7 (excellent) to 1 (very bad). The scores for Vietnam, Indonesia, India and China are shown in Figure 2.2. It indicates Vietnam is behind while investing less relative to GDP than the others.

**Figure 2.2: Quality of Infrastructure**

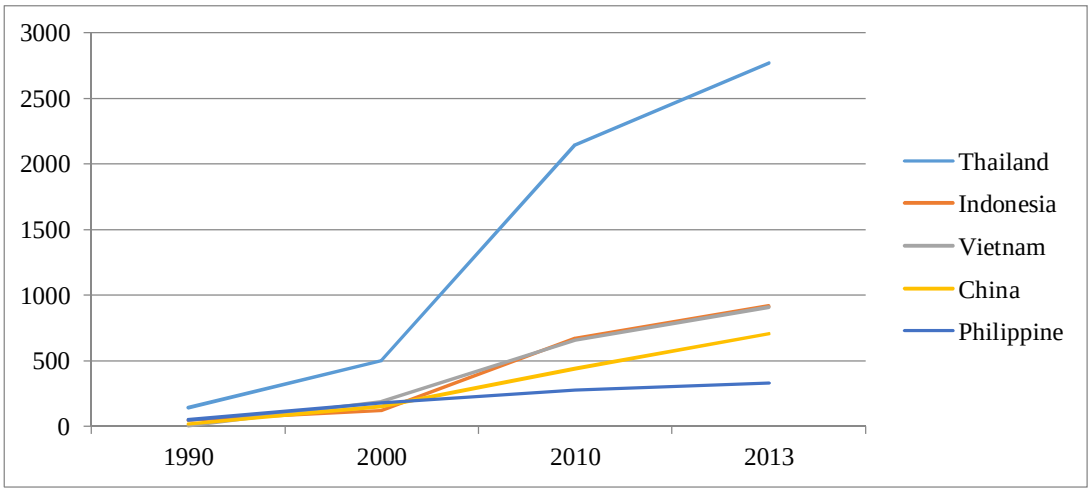



Source: World Economic Forum, Global Competitiveness Report 2013-2014.

### 3. Foreign Direct Investment

Foreign Direct Investment (FDI) is often viewed as an important driver of growth, though the quality and type of FDI can vary considerably. FDI in manufacturing for export is often thought to contain positive externalities in the form of technology transfer, employment, skill acquisition and management upgrading. On the other hand, FDI in raw material extraction may be something of an ñenclaveò and have fewer benefits, aside from tax payments, to the economy. At a first cut, Figure 2.3 provides a look at the development of the stock of FDI per capita at ten year intervals from 1990 to 2010 and also in 2013, the last year currently available from UNCTADôs data base. Indonesia and Vietnam have very similar per capita values for recent years and so are hard to distinguish. The Philippines has the least FDI per capita (excluding India) and China ends up below Indonesia and Vietnam, while Thailand is the highest.

**Figure 2.3: FDI Stock Per Capita, Current US$, 1990, 2000, 2010 and 2013**



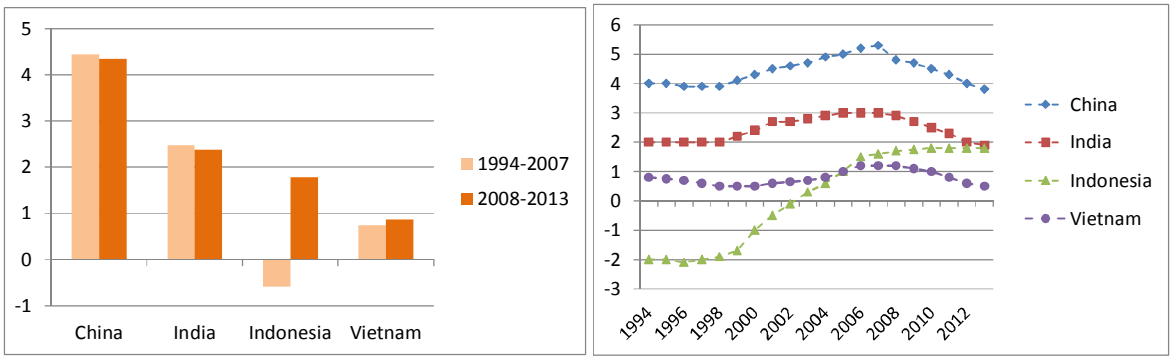
Source: UNCTAD FDI data base (stocks) and World Bank population data. India, not shown, is below the Philippines.

## 4. Total Factor Productivity

The capital to output ratio is a crude measure of capital efficiency and the growth of output per worker is a measure of labor productivity. A more satisfactory overall measure of the growth in efficiency is ñtotal factor productivityò ï a measure of output per combined unit of capital and labor. The following graphs are from a 2014 IMF study of TFP in Asia.

It is striking that in this analysis the TFP contribution to economic growth is extremely low in Vietnam. While Indonesiaôs TFP went negative during the 1990ôs and up to 2001, it has risen since. Vietnam remained near zero and has been declining since 2007. From 2008 to 2013, its TFP was 40% of Indonesiaôs and a quarter of Indiaôs. It is contributing only about ½ of one percent a year to growth. This means its economic growth depends on factor inputs (including education) growing with almost unchanged efficiency. Physical labor growth is close to zero (reflecting higher enrollment rates) while the contribution of capital is declining. Education continues to play a modestly positive role, but overall a sustained 4-4.5% year growth each year in real GDP is suggested. This is much slower than Indonesiaôs 5-6% and 6-6.5% for India. No currently rich country has succeeded with such a low growth rate of TFP at this level of per capita income. Improving TFP growth so little while so relatively poor (about $5,000 in PPP GDP per capita) is worrisome. No successful nation relies mainly on increasing inputs to get rich.

**Figure 2.4: Total Factor Productivity Growth for Selected Asian Nations**

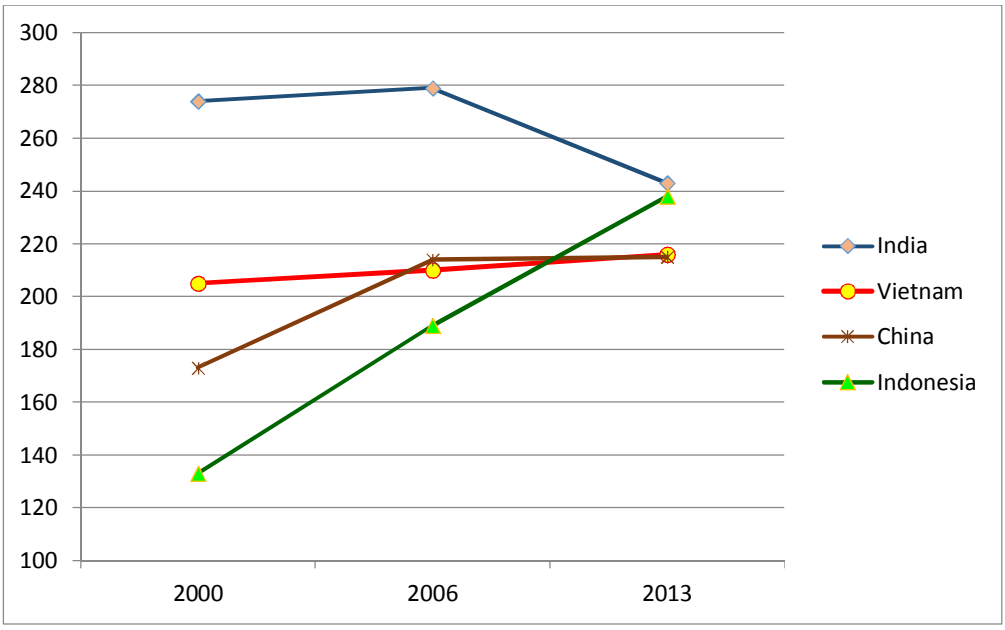



Source: IMF, Potential Growth in Emerging Asia, 2014

## 5. Governance Changes

The governance of an economy or country is not normally included in a macroeconomic overview. However, looking at changes in 2000, 2006 and 2013 as measured by the World Bankôs governance survey is instructive. The following graph provides the sum of percentiles of China, India, Indonesia and Vietnam since 2000. (Among nations not shown, Thailand fell sharply in this period; Malaysia and the Philippines had modest improvement from 2000.) A maximum score is 600 since there are six dimensions of governance measured. India has dropped considerably, from 274 to 243, while Indonesia has jumped from 133 to 238. Vietnam and China have more or less moved sideways in more than a decade.

**Figure 2.5: World Bank Governance Indicators for Selected Asian Economies**




Source: World Bank, The Worldwide Governance Indicators Database.

When there has been relatively rapid economic growth and sluggish institutional change, it is frequently the case that blockages build up to rapid future growth. India partly defies this analysis, though it is a democratic system that is trying out a new government that may achieve some of the needed reforms, much as Indonesia did recently. China appears to be slowing markedly and is an open question for future growth. Many expect an even slower performance in the next decade, in part because Chinaôs PPP GDP per capita already exceeds US$12,000,a level at which growth normally slows. However, Vietnam has less than half of Chinaôs PPP GDP per capita and should be able to match India in both growth and governance. It has higher human capital per worker, more natural resources, better geography and much higher FDI per capita. However, it shows no sign of overtaking India in either dimension. This suggests that the economic policies are not taking full advantage of Vietnamôs potential. VELP (2013) argued that the state sector absorbs too much capital relative to its contributions to output or job creation.[3] It has been given a monopolistic ñleading roleò leading to a weak private domestic sector, an FDI sector with low value added, and poor performance in critical areas rendered non-competitive through state policy. The banks are also weak and not transparent, with overdue loans reported at 5% or so while outside estimates put the ratio at 15-20%. Plans to take bad loans off the books (again) are not well executed and going very slowly, so finance remains an issue for many firms. So the abstract concept of governance appears to have very concrete manifestations in economic variables, and these act as a drag on economic performance.

### 6. Inflation, Money and Interest Rates

Vietnam came off hyperinflation in the 1980ôs but slowed the consumer price index measure down to 30% a year by 1990-95 and 3-5% a year for 1995-2005. After that it accelerated to

[3] Vietnam Executive Leadership Program paper from Harvard and Fulbright. Available at: http://www.ash.harvard.edu/extension/ash/docs/VELP.pdf

10.8% in 2005-10 and 9.4% in 2010-14. The relative stability of prices in a low global inflation environment is not surprising,[4] given the relatively stable exchange rate to the dollar since 2010.[5] However, if inflation continues in the high single digits (though it was only 4% in 2014, helped by falling commodity prices ï 2013 saw inflation around 10%), then a greater exchange rate adjustment would probably eventually be needed to maintain export competitiveness.

Interest rates on time deposits had been negative in real terms from 2004 up to 2010 but have been positive since then. They have also been positive in the latter half of the 1990ôs. This gives savers an incentive to put savings into banks rather than gold or real estate. In 2000, M2 (currency, checking and time deposits) were half of GDP (VELP 2012). By 2013 they were 123% of GDP. Credit growth tended to follow the growth of M2 ï the former grew nearly 20 times in nominal terms since 2000 while credit grew 25 times. By 2008, bank credit had grown to more than 100% of GDP. While credit growth has slowed down in recent years, it is still at a much higher level than a decade ago. A banking crisis would be much more costly to fix, so the importance of improving bank capital, regulation and oversight is high.[6] The bank sector is widely seen as overcrowded and undercapitalized with poor risk controls. The high level of cross share-holdings and other practices have led outside risk evaluation firms to estimate problem loans in the 15% range, much higher than the official data which are around 3-5%.[7] If this is true, then credit may be much tighter than it would be with healthy banks, since there is a need to ñevergreenò shaky loans by relending money to weak firms. The standard cleanup method is to create a ñbad bankò or asset management company to buy questionable or overdue loans for more than they are really worth and free up banks to lend normally. The bad bank is a government entity and liquidates the bad loans, getting what it can for them. However, the Vietnamese version of this has operated sluggishly and with inadequate speed. The result is that many private firms find it hard to get adequate credit and economic growth is restrained. Plans announced in 2015 to encourage mergers may be of some help and if the asset management company buys more bad loans, the remaining banks will be better able to offer new loans. It remains to be seen if they offer better quality loans, once they are able to lend more.

## 7. Trade

One area in which Vietnam has excelled is in its growth in exports. Exports in 1990 were US$2.4 billion. By 2000 they had jumped to US$14.5 billion and by 2010 to US$72 billion. By 2014, they had more than doubled to US$150 billion. The following graph shows that Vietnam, over the quarter century, was faster than other Asian economies, even including China. Of course, Vietnam was starting from a very low base and a lot of its manufactured exports have low value added relative to some of the other economies. Even so, its export/GDP ratio was 81%, a very high ratio for a country of 90 million. Merchandise import growth has matched or even exceeded merchandise export growth in most years, so the net merchandise trade position has been mostly

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[4] Using GDP deflators, Indonesia and Vietnam averaged 9-10% annual inflation from 2000 to 2013, while Malaysia, Thailand and the Philippines averaged 3-4%. (IMF data) GDP deflators are often a better measure of inflation without the influence of subsidies. Vietnam did better than Indonesia at keeping its real exchange rate stable.

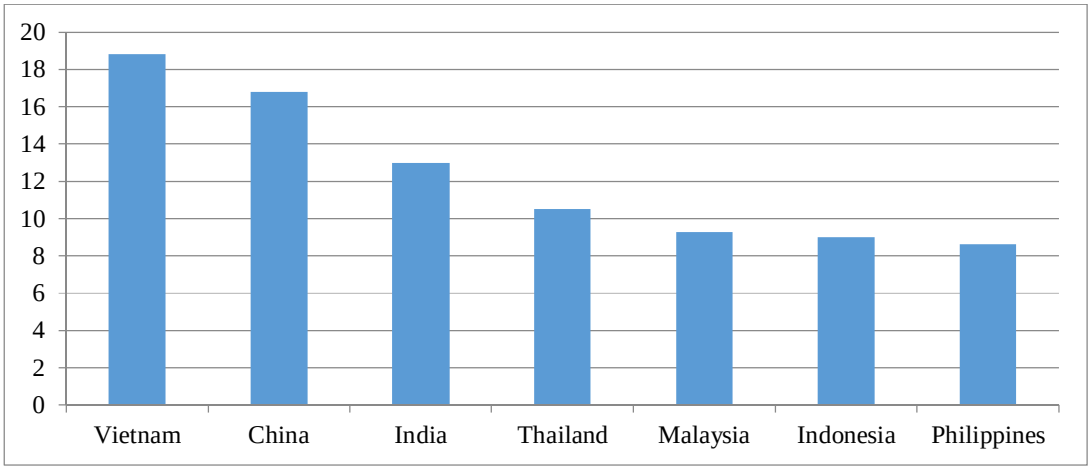
[5] It was 18.9 thousand at the end of 2010 and is currently 21.3 thousand, a movement of only 2-3% a year.

[6] An alternative is to use foreign exchange reserves to ñbail outò the banks but with only 2-3 months of imports worth of reserves (China has more than 20 months), this is not a useful option.

[7] Source: http://www.economist.com/news/finance-and-economics/21632650-what-spate-arrests-says-about-vietnams-banking-sector-drop-ocean

negative, though it turned slightly positive in 2012-14 as domestic credit growth slowed. A small deficit in services made the overall balance slightly negative. For a developing economy getting capital inflows, a trade deficit is quite normal and not a sign of trouble unless the deficit becomes hard to finance. Manufactured products account for three-quarters of all exports, and the share has been increasing. This is true in spite of growing agricultural and fish exports.

**Figure 2.6: Average Annual Rates of Merchandise Export Growth, 1990-2014 (Current US$)**

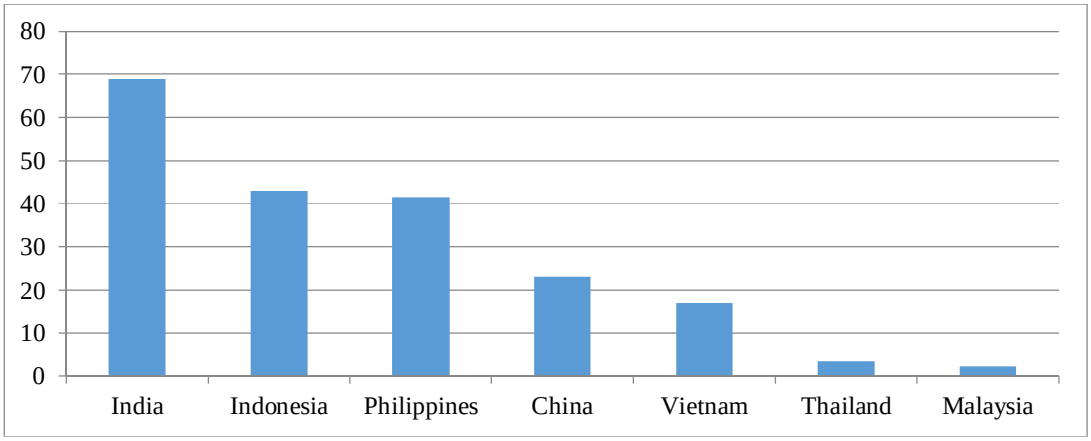



Source: World Bank, World Development Indicators Database

**8. Changes in Poverty and Well-Being**

The next graph shows the share of population living on less than US$2 a day, a ñmediumò poverty level probably more appropriate for middle-income nations. Except possibly for the Philippines, all of these nations have had significant declines in poverty since 1990. However, earlier estimates of US$2 poverty are not always available. Note that India, with the same PPP GDP per capita as Vietnam has much higher poverty. This suggests that the pattern of growth in Vietnam has been more pro-poor than Indiaôs.

**Figure 2.7: US$2/Day Poverty Rates around 2010**




Source: World Bank, World Development Indicators Database

However, Vietnam does not just compare favorably with India. Indonesia and the Philippines have much higher PPP GDP per capita but have much higher poverty rates. Even China, with

more than twice as much GDP per capita has a higher US$2 poverty rate than Vietnam. Only Thailand and Malaysia have lifted virtually everyone out of US$2 poverty. But Vietnam has income per capita about half of Thailandôs and a quarter of Malaysiaôs incomes per capita. It should be noted that poverty measurements are moving on to ñmulti-dimensional povertyò to assess risk and access to services, but these are not available for all countries and there is no time series for them.

Vietnam has built on rapid agricultural growth primarily from the smallholder sector, added a great deal of new jobs from labor-intensive exports, and invested heavily (if not always efficiently) in health and education. There have also been transfers for the very poor. Initial endowments of wealth were also less unequal than in many other ASEAN economies. Political pressures as well as a dedication to providing power and access led to roads and electricity to almost every town and most villages. The reliability and capacity of the power was often modest, but it still existed. Taken together, these have reduced poverty very considerably since 1990.

The improvement in consumption is indicated by the jump in the number of motorcycles from about 10 million in 2004 to 37 million in 2013. Since there are only about 22 million households, on average there is now more than one motor cycle per household, compared to less than half that in 2000. One measure of consumption that is skewed towards the poor is the caloric intake. This was less than 2000 calories per capita per day in 1992 but more than 2700 calories in 2011, according to FAO data. On the other hand, an indicator of nutrition adequacy is height for age, or stunting in children less than five years of age. This indicates long term challenges rather than an immediate shortage of food. Vietnam has significantly reduced stunting in those more than two standard deviations below the median ï from 61% in 1993 to 23% in 2010. This is more stunting than Thailand (it decreased modestly from 21% to 16% in 20 years) and China (32% to 9%), but then both nations started much lower and are much richer. Indonesia and the Philippines have stunting rates at about 35%, even though they also have higher income per capita. In terms of the under-five mortality rate, which tends to be associated with malnutrition, Vietnam at 24 per 1,000 is better than Indonesia and the Philippines (about 30/1,000) but higher than China and Thailand (13/1,000) and much better than Bangladesh and India (41 and 53). Again, for its level of per capita income, it does better in this respect than its moderately richer neighbors, but not as well as those that are considerably richer.

In short, there are strengths and weaknesses in Vietnamôs record since it instituted *Doi Moi* and began its run of export, consumption and GDP growth. The strengths are obvious:

1. Rapid GDP growth, especially from 1990 to 2007; since then, moderate growth of 5-6% a year.
2. Export growth more rapid than any other comparable nation.
3. Deep declines in poverty and malnutrition
4. Significant extension of roads and electricity into rural areas
5. A briskly growing agricultural sector with significant exports of rice, fish, coffee and rubber.
6. High levels of FDI per capita, much of it aimed at manufactured exports
7. Rapid growth in electricity output

Against these considerable accomplishments, there are some problems:

1. Total Factor Productivity growth is very low.

2. Agricultural growth is mining soil and water resources
3. Governance is not improving much
4. Banks are troubled and need further reform
5. Foreign exchange reserves are low compared to imports and possible debt problems
6. Investment has dropped in real terms and is not high relative to GDP
7. Infrastructure quality is said (by the World Economic Forum) to be low.

The ñproblemò list does not indicate other problems such as the slow development of supplier industries for manufactured exports or the perceived weakness of private sector firms.[8] These are harder to document but are much discussed. The legal system is also widely viewed as politically controlled, making certain types of investments and transactions less secure. Inflation, while no longer double digit, has tended to be high single digit in recent years, though this may be coming under control ï it has averaged nearly 10% a year from 2010 to 2014 but was only 4% last year. Educational quality at the university level is often criticized. Ethnic poverty remains troublesome in spite of some gains. Overall, it would appear that Vietnam needs to allow a second (or third) stage of reforms to rejuvenate its economy, improve its public investment, and spark greater productivity growth in all sectors. It is not that some progress has not been made ï the continuing rapid growth of assembled electronics shows the strengths of Vietnamôs economy, but also its weaknesses. Until they can add value to more of these assembled exports, they will be vulnerable to ñfootlooseò companies that may shift to cheaper locations. By providing more parts and materials and services, Vietnam can deepen and make more sustainable its future growth. These changes will require both political and economic reforms so that the incentives for both business owners and government officials are to support more efficient policies and investments than is now the case. If the returns to investment could improve due to reforms, it is likely that the amount of investment would grow and GDP growth would accelerate. What has been missing with a weak private sector and strong state sector is an influential group arguing for more growth and productivity-friendly policies.

## III. Political Ideology, Power Structure, and State Effectiveness

This section seeks to explain the observed comparative economic performance in the above section from a political economy perspective. In essence, the economic transition in Vietnam has been the gradual withdrawal of the state in favor of the market, the decrease of state ownership in favor of an increase of private ownership, and the abandonment of import substitution in favor of export promotion. The biggest political risk for the ruling party is that this transition process gradually takes away the comprehensive monopoly of the state system, from its monopoly in access, use, and allocation of resources to its monopoly power in redistribution of economic benefits, as well as its monopoly in granting political perquisites and social status.

### 1. Ideological Compromise

The question is why, when faced with such serious political risks, the CPV still determined to carry out economic reform. As will be seen later, at the moment of major reforms, the CPV has

[8] This, in itself, is interesting insofar as the Enterprise Law in 1999 made registration of private business easy. However, legal uncertainty and financial and land problems as well as interference from authorities in taxation and other issues have made private firms reluctant to invest for the long term or become too large.

often faced a difficult trade-off. Without reform, economic legitimacy and even the survival of the party will be challenged. But in order to reform, the official ideology has to be compromised.

The ideological conflict is clearly reflected in the ñfour threatsò that were identified in the CPV mid-term congress held in January 1994, just seven years after *Doi Moi*, on the eve of Vietnamôs normalization of diplomatic relations with the United States and entry into ASEAN. In this list, the first threat is economic backwardness, followed immediately by the risk of socialist diversion.[9] Thus, in the process of economic transition, arguably the biggest challenge facing the CPV was how to maintain a balance between political ideology and economic legitimacy, or how to boost economic development while keeping its absolute power and comprehensive leadership. An understanding of how this dilemma has unfolded is critical for explaining the directions of economic policies not only of the CPV but also of the CCP.

The fundamental ideological conflict of the CPV is reflected in the very names of its political and economic systems. The CPVôs goal of developing a market economy with socialist orientation reflects a strong desire to preserve the Communist party-stateôs political legitimacy (by continuing the socialist orientation) and economic legitimacy (by adopting the market economy). Arguably, the most serious problem of this model is the systemic incompatibility or ideological conflict between socialist ideology and a market economy.[10] To maintain the socialist orientation, it is imperative that the political dictatorship of the Communist Party be maintained, and that public ownership be given priority over private ownership. At the same time, a well-functioning market economy requires that private property must be honored, even-handed competition between economic agents regardless of the ownership must be maintained, and economic efficiency must be the ultimate criterion for deciding who will prevail in the competition, although taxes and transfers soften the resulting inequities in most market economies.

More than a quarter-century into reform, the CPV still struggles over how to strike a balance between socialism and market economy. In the running up to the next Party Congress, there has been a vibrant debate in Vietnam about how to redefine the ñmarket economy with socialist orientationò to pave a way for further market reforms. It is expected that a new definition will be ratified during the next CPV Party Congress in 2016. This implies that the CPV itself is also aware that the internal contradictions and ambiguity of the concept has hampered reform, and therefore need to change. Interestingly, Vietnamôs Minister of Planning and Investment Bui Quang Vinh, when commenting on the socialist-oriented market institutions, has publicly said that ñwe keep studying that model, searching it in vain. There is no such a model to be found.ò[11]

The ideological conflict has had wide-ranging and profound impacts on the economic reform process in Vietnam. Unlike transition economies in Eastern Europe, Vietnam (and China), have been pushing forward with economic reforms while stalling on political reforms. Therefore, political opposition, often disguised under ideological cover, becomes the biggest barrier to

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[9] The other two threats are ñcorruption and social evilsò, and ñpeaceful evolution of the hostile forcesò.

[10] In the language of Marxism, the Chinese and Vietnamese economies have reached a level of development at which the productive forces of society come into conflict with, and are inhibited by, the existing relations of production. There is also a conflict between the economic infrastructure on the one hand, and the legal and political superstructure on the other hand, in which the later holds back the former.

[11] Source: http://www.thesaigontimes.vn/114301/Cai-cach-the-che-tu-cau-hoi-chua-co-loi-giai.html

economic reform. In Vietnam, there has always existed conflict between the two groups, so-called the ñprogressiveò and ñconservativeò.[12] In a nutshell, this conflict is most profound and consequential in four areas. The first is the role of the state versus market as the key mechanism for economic coordination and allocation of resources. The second conflict is about the status of state ownership versus private ownership. The progressives emphasize the ñmarketò dimension and the need to create an equal playing field between private and state businesses, while the conservative emphasize the ñsocialistò dimension and the need to maintain the leading role of state ownership and downplay the status of private firms.[13] The third conflict is between inward-looking import substitutions versus outward-looking export promotion strategy. And the fourth conflict is whether the Communist Party should firmly maintain the traditional alliance with the working class or actively expanding alliances to include also private capitalists.

It is pretty clear how each group will take side in these conflicts. In general, the conservatives want to keep the old political and economic system to protect their interests and political base. In contrast, the progressive wants to change the status quo so as to create economic growth and new political support. How the CPV deals with the ideological conflict has had profound impacts on the economic reform process as well as its outcome. In most cases, the two sides have to accept compromises in order to strengthen the legitimacy and maintain the survival of the regime, which is the ultimate common goal of both groups.

**2. Political Power Structure**

An important political feature of many communist parties is the principle of ñdemocratic centralismò, which implies collective decision making at the center and unquestioning obedience at the lower levels. The collective decision making at the center (i.e., in the politburo) implies that there are many veto players, especially when there is no paramount leader and power at the top is fragmented. Major state-driven policy changes can happen only if a consensus can be reached among the top leaders who have veto power.

During the first three years of *Doi Moi* in (1986-88), there were endless debates within the CPV about the path of reform. As a result, there was no major reform initiative until late 1989. Not only that, there was even policy that went against the reform spirit endorsed in the Sixth Party Congress Resolution in 1986.[14] This situation is partly due to the lack of an understanding of the market economy and how it operates. But more importantly, it is due to the fact that among the new leadership and ministerial personnel, many officials were not directly involved in the process of formulating *Doi Moi* economic strategy, and therefore neither understood nor shared the reform direction (Dao Xuan Sam 2008).

Throughout the 1990s and 2000s, the fragmentation of power in Vietnam became more and more complex. Similar to China in the first phase of reform, the three Vietnamese supreme leaders in

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[12] These two groups are not always well-defined. It is worth noting that initially, conflicts between these two groups are mostly political and ideological. As time goes by, the political and ideological causes gradually fades away, but are still used to disguise the deepening conflicts of interest and political power within the party.

[13] Other areas of debates derived from this conflict are the scale and scope of the state monopoly, economic openness, and market competition.

[14] A typical example is the Resolution of the Second Plenum of the Party Central Committee on the distribution of goods (1987).

the first generation retired into the ñAdvisory Commission of the Central Communist Partyò (the equivalent of Chinese ñCentral Advisory Commissionò).

This practice, which only ended in 2001, made the power structure became even more fragmented.[15] Although these senior advisors no longer held any formal position in the party, they continued to have important, even decisive voice in many key issues of the party and state.[16] For example, the objection of just one senior advisor was sufficient to stop the signing of the Bilateral Trade Agreement (BTA) between Vietnam and the United States intended to proceed in Auckland, New Zealand in September 1999 during the APEC Summit.

China has for a long time unified the party and state apparatus, meaning that, the Communist Secretary General is also the President. In Vietnam, although this issue has been discussed within the CPV for years, until today the two positions remain separate. Moreover, recently there has appeared a new phenomenon, which is the divergence, and even rivalry between the party (represented by the Secretary General) and the government (represented by the Prime Minister). One of the most obvious signs of this divergence is the re-establishment of the Committee of Internal Affairs and the Committee of Economic Affairs in 2012, both under the Central Party, in order to put a check on the government.[17]

Within the Vietnamese Politburo, the degree of power concentration has also been declining. Since the death of the first generation of leaders (Le Duan, Truong Chinh) in the 1980s, no Secretary General can, whether by personal charisma or formal authority, effectively consolidate power. Moreover, during the period 1986-2001, the number of members of the Politburo constantly increased, from 13 during the period 1986-1991 to 17 during the period 1991-1996 and 23 in the period 1996-2001. Since the 2001-2006 term, the number of Politburo members declined to 15, but has recently increased again.[18]

### 3. State Effectiveness

The presence of an effective state is crucial to facilitate economic growth.[19] In the current empirical literature, state effectiveness in developing countries is often measured as stateôs capability to raise revenue, provide public goods and services, and formulate and implement policy in an efficient and effective manner.

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[15] Similar to the situation in China as described by Naughton (2008: 101), these senior advisors (as well as other top party leaders) often exercised power informally via their former extensive patronage networks throughout the hierarchical system.

[16] The three supreme leaders were Truong Chinh (President cum Acting General Secretary), Pham Van Dong (Chairman of the Council of Ministers or Prime Minister), and Le Duc Tho (Head of the Party Central Organization).

[17] These two committees used to exist but were merged to the Office of the Central Committee in 2007 as the result of a new policy aimed at streamlining the party apparatus.

[18] It was originally expected that in the 2011-2016 term, the number of the politburo members would increase to 17. Indeed, the current Politburo has only 16 members because the two candidates nominated by the General Secretary were not elected. Compared with China, a country with 1.3 billion people with more than 80 million party members but has only 7 members of the Politburo and 25 members of the Politburo Standing Committee, it seems that with a population of about 90 million and more than 3 million party members, the number of Politburo members in Vietnam is highly unproportional..

[19] See Johnson 1987, Amsden 1989, Kohli 2004, Fukuyama 2011; Evans, Huber, and Stephens 2015.

With a long history of state building and national defense, the Vietnamese state has always been able to maintain a central government bureaucracy with a certain degree of effectiveness. These basic capacities of the state are clearly very important for Vietnam both at the start and throughout the 30 years of reforms. In the mid-1980s, the budget revenue of the central government in Vietnam was less than 9% of GDP, but increased steadily (except for two periods of crisis in the late 1990s and 2000s) to more than 20%. This indicator shows that even in early years of reforms the Vietnamese state has been quite effective in terms of resource mobilization.

Because the Vietnamese state has the primarily responsibility for providing infrastructure, education, and healthcare, state capacity in these areas is an indicator for the state effectiveness in providing public goods and services. Generally speaking, the good level of state effectiveness in Vietnam has also been shown by the improvements of basic health, education and infrastructure in the last 30 years.

The state capacity is also demonstrated in the governmentôs ability to implement policy in the area of disaster and crisis management. Vietnam has frequent been cited as a good case where a low-income country can deal effectively with natural disasters. The episodes of the Asian financial crisis in the late 1990s and the global financial crisis in the late 2000s also show that facing the imminent risk of financial meltdown, the Vietnamese government was able to draw on its existing capacity within its own system and implement politically-difficult policies to bring back stability to the economy.

However, as discussed in the previous section as well as the following ones, the state effectiveness is often questioned in the areas of state-owned enterprises, public investment, and financial regulation. Here, it is the interaction of the ideological compromise and the political power structure that negatively affects the state effectiveness.

In the following sections we will use this framework to analyze Vietnamôs reform experience in specific areas including agriculture, state-owned enterprises, private sector development, trade, fiscal decentralization, macroeconomic management, and financial regulation. We will show that power structure, the changing political ideologies of the Vietnamese Communist Party (CPV) overtime, and state effectiveness are the three key determinants of Vietnamôs past economic performance. We will also draw lessons for successful implementation of future reforms.

## IV. Agricultural Reform and Land Policy

### 1. Growth and Productivity

Vietnam has had a vibrant agricultural sector[20] since *Doi Moi* with farmers reverting to private plots more than 30 years ago, but of late there are increasing challenges. Groundwater extraction and rising sea levels, along with variability in climate, present challenges to sustainability. The tendency to emphasize physical targets has sometimes led to low quality and crop prices, impairing farmersô incomes and profitability. Land policy has reduced land security and desirable consolidation of small plots. And poverty reductions in rural areas, while large, are

[20] The ñagricultural sectorò will include forestry and fishing, but is about ¾ farming by value and nearly 90% by employment. Farming is largely smallholder based, with labor about 99% non-state farmers and workers. The rate of real value added growth of the sector was 4% a year from 1990 to 2010.

harder to sustain due to remote locations and ethnic diversity in remaining pockets of poverty. Finally, the tendency has been for the government to invest far less in farming than its share of output or employment. As a result, some public goods may be undersupplied.

These problems were summarized in World Bank (2014) in a Sustainable Agriculture Transformation Project:

Over the last two decades, Vietnamôs agricultural sector has made enormous progress, realizing major gains in productivity and output and contributing to national goals related to food security, poverty reduction, social stability, and trade. Although its contribution to GDP has decreased from 31% to 17%, the agriculture section remains the main sources for livelihoods of two thirds of Vietnam population and of over 90% of poor people (World Bank 2014).

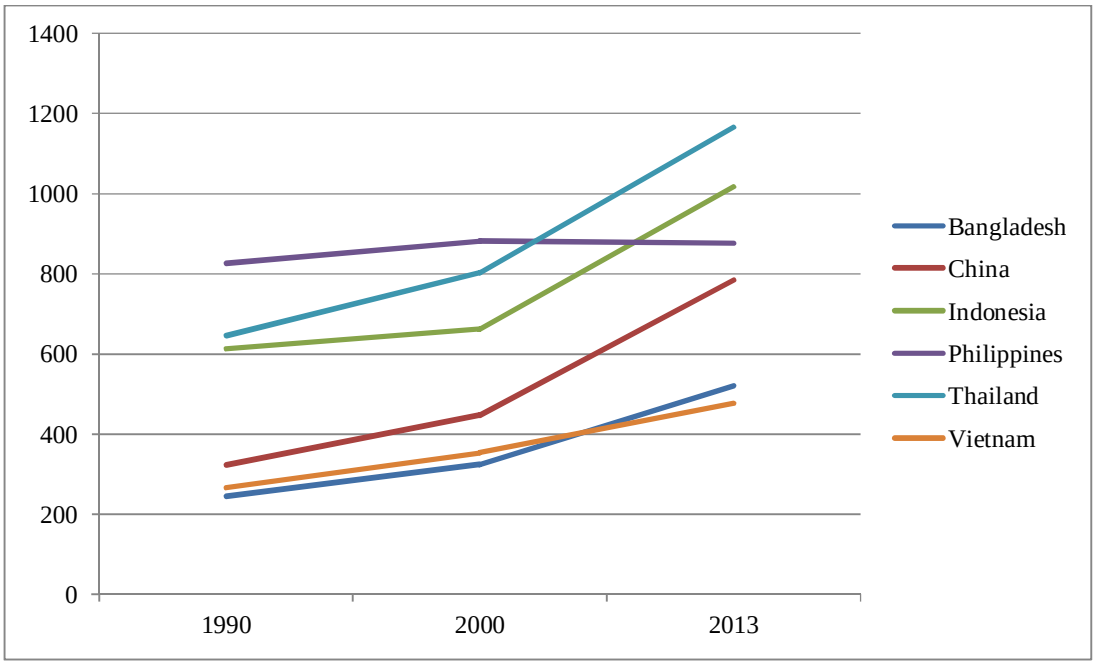
Agriculture provides a socially stabilizing role in the face of volatile macroeconomic conditions and has provided the country with a secure, affordable, and increasingly diversified source of food, generating employment for a segment of unemployed urban laborers and contributing to mitigation of trade deficits.

However, the agricultural sector growth has begun to slow down in recent years and unsustainable elements for growth have emerged. The agricultural sector now faces growing domestic competition from cities, industry, and services for labor, land and water. Rising labor costs are beginning to inhibit the sectorôs ability to compete internationally as a low cost producer of bulk undifferentiated commodities. The consequences of over intensive input and natural resource use both for the environment and for farmer profitability are being increasingly recognized.

To overcome these challenges, Vietnamôs agriculture will need to generate more economic value and farmer and consumer welfare using less natural, human, and other resources. And, it will need to increasingly compete on the bases of reliable supply, predictable quality, assured food safety and value addition. Vietnam needs to change not only in the growth model for agriculture, but also in the structural patterns of production and supply chain organization, which are currently loosely organized and lack of synergy between farmers and other actors in the value chain. Change is also needed in the model of óstate managementô in the sector in the technical and regulatory services provided by the state, in public investments and expenditures in the sector, and in the policies applied to foster farmer and agribusiness investment. A demand-driven economy needs flexibility. These changes are becoming increasingly urgent in the context of changing market demand and opportunities, as well as market oriented development needs. These changes will create a transformation for the agriculture, a sector of significant importance to transforming the country economy given its current position, resources and competitive advantages.

This statement is correct so far as it goes, but leaves out one important fact about Vietnamôs agriculture: it has very low value added per agricultural worker. Figure 4.1 shows agricultural value added (in 2005$) for 1990, 2000 and 2013 per agricultural worker in several nations.

**Figure 4.1: Agricultural Value Added per Worker in 2005 US$**




Source: World Bank, World Development Indicators Database.

Figure 4.1 shows that labor productivity in agriculture in Vietnam is similar to, but now slightly behinds, that of Bangladesh ï and well below that of other neighbors. The rate of productivity growth since 2000 is also the slowest, except for the Philippines. The labor productivity growth in Vietnamôs agriculture has been 35% since 2000, a compound rate of growth of only 2.3% a year. There is already a relatively low relative productivity of labor in agriculture relative to nonfarm jobs - 17% of output and 46.6% of workers in agriculture in 2014 implies output per agricultural worker is but 37% of the average and only a quarter of average nonfarm productivity. Such a slow rate of productivity growth from such a low base suggests that agriculture will not play an important future role in raising incomes of the poor. If challenges from climate change, groundwater depletion, and rising land prices further limit productivity gains for labor, the future role of agriculture will be modest. Labor will (or *should*) flow out of the sector while area gains are likely to be limited. Without a productivity transformation, agriculture will simply lose much of its future economic relevance. Of course, some of the productivity improvement will come from a better choice of crops, better growing, processing and marketing, and upgrading technical skills and infrastructure. However, a great deal of equalization will have to come from shrinking the numbers engaged in farming. Yet current land policies do not support such necessary land consolidation nor encourage investments in land that are costly but productive in the long term. Sagging commodity prices could intensify these pressures to expand farm size and mechanization.

In terms of output per hectare, Vietnam is lower than China but higher than its neighbors. However, its 1997-2012 growth rate in constant price output per hectare as measured by the FAO is growing more slowly than growth rates in China, India, Thailand and Bangladesh. It is about equal to Indonesia from 1997 but is lower in the last decade. Its growth is decisively better only compared to the Philippines. The table shows both 2012 output per hectare in 2005 constant prices and annual growth rates in value per hectare from 1997 to 2012.

**Table 4.1: Output per Hectare Levels and Their Growth from 1997-2012**

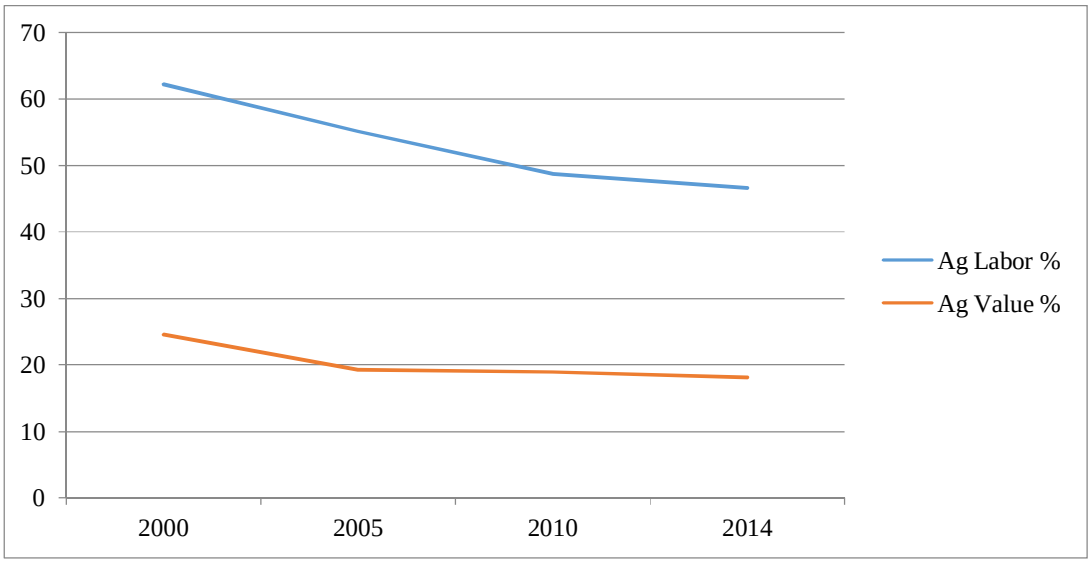
| | China | Vietnam | Bangladesh | Thailand | Indonesia | India |
|---|---|---|---|---|---|---|
| Output/hectare, 2012 | 3,143 | 2,333 | 1,795 | 1,326 | 1,254 | 1,065 |
| Growth, 1997-2012 | 4.0% | 1.8% | 2.8% | 2.5% | 1.7% | 2.9% |

Source: FAOôs Database

The output value per hectare is mainly a function of irrigation and input application, such as fertilizer, although extensive tree crop area can also influence the totals. Vietnam has clearly attained a high intensity of inputs and irrigation, but is only 75% of Chinaôs productivity and growing much more slowly. With area gains in agriculture in Vietnam now very low, it will be necessary to improve the growth rate of yields and value per hectare to sustain growth. The fact that others are able to have their values per hectare grow faster and China can grow more than twice as fast even with higher yields suggests that Vietnamôs agriculture is lagging in important respects.

It is already true that the share of agriculture in output and workforce has been falling, as the graph below shows. It presents the share of agriculture to GDP in Vietnam in 2000, 2005, 2010 and 2014.

**Figure 4.2: Agriculture Share of GDP (Current Prices) and Employed Workforce, 2000-2014**




Source: FAO Database

Figure 4.2 shows that in 2000, 64% of employed workers were in agriculture but only a quarter of GDP came from that sector, meaning the average output per farm workers was only 38.3% of average output per worker. By 2014, the agricultural output share had declined to 17%[21] and its employment share was 46.7%, implying farm output per worker was 36.6% of the average ï relative agricultural productivity had fallen. This suggests that the transfer of labor out of

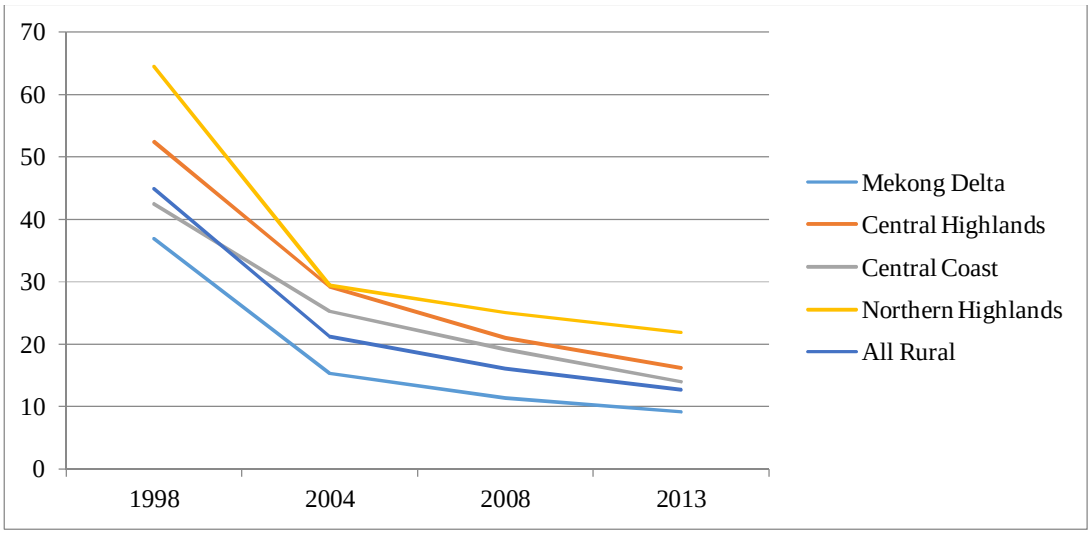
[21] Vietnamôs 17% share of agricultural GDP over total GDP is higher than Chinaôs 10%, Malaysiaôs 9%, Thailandôs 12% or Indonesiaôs 14%. This is not unusual for poorer economies, but does reflect slower structural change.

agriculture hadnôt been sufficient to begin to close the gap. Since overall incomes have risen sharply since 2000, the absolute gap between farm and nonfarm productivity has risen markedly. Also, sector growth since 2011 is only 3% a year.

The actual number of agricultural workers has stayed close to 24.5 million since before 2000.[22] This represents a declining share (as shown above) but agricultural output in constant prices rose by 35% from 2005 to 2014, a compound rate of growth of 3.4%.[23] This is also about the rate of output growth per capita in the sector. Total real GDP rose 70% from 2005 to 2014, a compound growth of 6.1% a year. Total labor force grew 2.4% a year, so total output per worker grew 3.6% a year. The share of agriculture at *current prices* has changed less since 2005 because relative prices of food rose more than other goods. However, real productivity trends slightly favor the nonfarm sector.

Poverty rates in Vietnam have been falling steadily since the 1990ôs, from 37.4% in 1998 to 9.8% in 2013. Rural poverty has fallen from 44.9% to 12.7% in the same period while urban poverty has all but disappeared at 3.7% in 2013. Still, the rate of poverty reduction in mostly rural regions has been slower in recent years as shown in Figure 4.3 below.

**Figure 4.3: Rates of Regional Poverty in Vietnam, 1998-2013**




Source: General Statistics Office of Vietnam

The sharp drop in poverty rates from 1998 to 2004 is partly an artifact of statistics, since the methodology changed, but the definitions are more consistent (though still being modified yearly for inflation) from 2004 to 2013. The overall rural poverty rate dropped 1.3 percentage points a year from 2004 to 2008 but only 0.7 percentage points a year from 2008 to 2013 ï a drop of nearly half. This suggests that the pace and type of rural growth is not having the same impact on poverty as earlier, though it is also true that the last 10% or so in poverty are always harder to reach than those in more moderate circumstances. It may also be the case that slower overall

[22] Chinaôs number of farmers or farm workers peaked in 2002, suggesting Vietnam may be ready for a similar trend.
[23] This calculation uses data from the Vietnam General Statistics Office and is based in constant dong. There is a shift in the deflator in 2005 and earlier years are harder to combine meaningfully. The first graph, with a 2.3% growth in output per worker since 2000, was based on 2005 constant dollars from the World Bank.

national growth is reducing demand for nonfarm labor and slowing poverty reductions through less migration to better-paying nonfarm or urban jobs. The considerable regional differences in poverty also point out problems with geographic remoteness and ethnic differences.

An important counterpoint is that the ratio of average rural to urban income per capita has been rising, even if agricultural productivity has fallen in relative terms. In 1999, the average per capita rural income was 44% of urban per capita income but by 2012, the ratio rose to 57%. This reflects transfers and nonfarm income sources in rural areas. It may also reflect more ñcommutingò with better transport (more motor cycles, for example) and improved roads.

**2. Challenges to Agriculture Going Forward**

Several challenges have been identified by previous analytical work:

1. There has been a tendency to ñmineò groundwater in both the Mekong Delta and Central Highlands. This leads to deeper wells, more saline intrusion in the Delta as land sinks even faster before rising sea levels, and groundwater contamination. As wells must be drilled deeper and water pumped up using more energy, the cost-effectiveness of irrigation ï even with good quality water ï is reduced. In the Mekong Delta, irrigation channels mix delivery and drainage water, degrading both water quality and land. If climate change leads to shorter and more intensive rainfall and longer dry periods, these trends could interact with the reduced prospects for groundwater irrigation to impair prospective areas and yields and also reduce shrimp raising.[24]
2. Rising temperatures alone from climate change could reduce yields, in addition to the water and salinity impacts cited above. More extreme and unpredictable weather could increase the difficulty of timing planting and fertilizing. Adaptive investments and management can offset some of these impacts but they will require more research and extension than is now made. There may also be a need for more diversified or larger farm sizes.
3. Past research and policy emphasis has centered on rice. Some high quality rice varieties are highly profitable, but ordinary rice is in many cases only close to break-even. Public policy and regulation has to move towards a more varied and flexible cropping regime. The large surplus in rice allows Vietnam some latitude with rice-first policies without damaging food security.[25]
4. Land security for farmers is inferior to that of urban home and property owners. It remains true that a major source of finance and income for provinces and cities is the taking of land with modest (agricultural value based) compensation and then reassigning the land for nonfarm uses which have a much higher value. This essentially strips the rising value of land from the farmer and assigns it to various urban groups. These policies reduce already low rural incomes, impede labor mobility and farm consolidation, and

[24] An excellent recent (2012) book on the Mekong Delta agriculture and water resources is: The Mekong Delta System: Interdisciplinary Analyses of a River Delta, Renaud and Kuenzer, editors, Springer. It is free online at: http://link.springer.com/chapter/10.1007%2F978-94-007-3962-8_7

[25] According to FAO food balance sheet data, the rice supply (net of exports, seed, waste, etc.) was 164 kg per capita per year in 2000 but only 145 kg pc per year in 2011. This suggests that total demand for rice in Vietnam will not grow much and may fall even as population grows. With ample exports, the need to require or prioritize rice production is questionable. Farmers should be allowed to increase their income and not be pushed to grow rice.

make investments in farm land more risky. This is true in spite of improvements made in the 2013 Land Law.

5. The amount of state investment in agriculture and rural areas generally is well below the share of agriculture in GDP or of farmers in the workforce. This was noted ten years ago in a World Bank document, ñAccelerating Rural Development in Vietnamò and little has changed since.
6. Food quality, especially for exports, is of growing importance. Rising standards for food purity and safety mean that shortfalls cause steep price cuts. Better policies ï which may mean more of a role for private or public-private partnerships to manage quality standards ï are needed.

***Can Farmers Manage The Sale of Their Land?***

One objection to giving clear ownership rights to farmers is that they would lose their land and end up in poverty as they wasted the money from the sale of their land. No such concern is shown for poor and less educated people owning urban land. This objection is even used to object to land consolidation ï there is a fear that a class of large landowners and displaced peasants would arise, much as in Latin America. How does one understand these concerns and what could be a response?

If larger farm plots are objectively more productive, then a moderate land tax on larger holdings would not prevent productive consolidation. If land acquisition is primarily for speculative purposes, then allowing poor farmers to sell at a higher price would diminish such activity, as would a land tax. Having a certain amount of farm land (it might vary by quality and by province) be tax free and the rest pay a tax would hold back undesirable land transfers.

The farmers who want to sell may often have a new place or project in mind ï it could be another farm or an urban place to live or a business idea. They may require capital from their land to allow themselves the chance for a better life. Some of these moves will fail, and in that case, the family will depend on their own labor as millions of others do. Many will succeed and some will employ others, creating employment demand that will prevent the rise of unemployed workers.

If this is felt to be too risky, there could be a program (perhaps for older farmers) where some part of their land sales are put in a bank account or government bonds and pay a monthly income. This may not be necessary, but it is better to have this kind of paternalism with the freedom to sell land use rights than to have a system that effectively traps unwilling farmers in a low-income situation.

## 3. Water Use and Climate Change

One reason it is hard to persuade local or even national officials to take environmental issues seriously is that agricultural production in the Mekong Delta and nationally has been rising steadily. This is true of cereals, other foods, tree crops, livestock and fisheries. While area gains for cereals have been modest (about 1% a year), yield gains have allowed output to grow at roughly 3% a year. Output growth for higher valued crops, livestock and fish are even greater. The relevant question is if these impressive growth rates reflect underlying improvements in capital, technology and sustainable inputs or if they reflect mining of soil and water resources. Beyond that, will climate change threaten the gains in the intermediate term?

There is no doubt that ground water levels are falling in both the Central Highlands and the Mekong Delta.[26] Given the 126% rise in coffee production from 2005 to 2013, this has not yet had any negative impact on production. Likewise, there has been a 126% rise since 2005 in tons of shrimp and raised fish in the Mekong Delta, along with improved output of many fruits, poultry and paddy (30%).[27]

It is probable that the water mining impact will be non-linear ï that it will be possible to pump more and further deplete water levels until it gets to be too expensive or the water gets too brackish. It would be useful to know how long current practices could continue. Even then, farmers might stop raising higher-valued shrimp (which need fresh water) and raise more fish, which can function in salty water. Switching to drip irrigation of coffee, rubber and fruit trees could help restrain water use in both regions ï low cost solar drip technologies being developed might be useful even if electricity is irregular.[28]

One aspect of the water mining is that some of the subsurface soils become compacted after being drained and do not accept water even if water is later available to trickle down for recharging. This could lead to a permanent fall in ground water levels and the costs associated with that. Mapping those zones or, if already mapped, acting on that information might give an added impetus to water management and conservation.

There has been some investigation of the impact of climate change on crop yields. The main dangers are highly irregular rainfall patterns, rising sea levels, and increased temperatures that hold back optimal plant growth, yields and crop quality.[29] Slowing or stopping groundwater depletion by more efficient water use would help to deal with the first two. Better seed varieties, cultural practices (e.g. shading or mulching) and crop selection will be needed to deal with temperatures that rise markedly from current levels. The footnoted studies suggest approaches to responding to that longer-run challenge.

### 4. Rice and Other Crops

Vietnam exports 6-7 million tons of rice a year, nearly a quarter of its 45 million tons of paddy production. During the monsoon season, and where irrigation is done in large blocks, it is hard to

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[26] http://iopscience.iop.org/1748-9326/9/8/084010/article suggests a one meter rise in flooding by 2050 in the Delta, due mainly to ground subsidence. A one meter rise would flood a third of the land and displace a quarter of the population. For the Central Highlands, there are the 2005-09 Australian studies (see: http://aciar.gov.au/files/node/10734/SMCN-2002-015%20Final%20Report.pdf), and more recent anecdotal news stories such as http://www.talkvietnam.com/2013/04/underground-water-runs-out-in-central-highlands/ and very provisional more recent work: http://tapchi.vnu.edu.vn/upload/2014/04/1312/7.pdf It appears that inefficient irrigation practices contribute to the mining of groundwater for coffee production.

[27] Statistical Yearbook of Vietnam 2014, Vietnam General Statistics Office, various agricultural tables at: http://www.gso.gov.vn/default_en.aspx?tabid=515&idmid=5&ItemID=14278

[28] http://www.pub.iaea.org/MTCD/Meetings/PDFplus/2012/cn191/presentations/PDF%20Session%205/DUONG_13.pdf reports on a pilot study that reduced water use by up to 38% and improved coffee yields by 19% over furrow irrigation. A case study: http://www.ashden.org/files/case_studies/PROXIMITY%20DESIGNS%20case%20study.pdf describes a low cost drip technology with its costs and benefits in Myanmar.

[29] See: http://www.researchgate.net/publication/251449027_High-Temperature_Effects_on_Rice_Growth_Yield_and_Grain_Quality for rice; for coffee, ñCoffee and Climate Change: Impacts and Options for adaptation in Brazil, Guatemala, Tanzania and Vietnam,ò by J. Haggar and K. Schepp, Natural Resources Institute, University of Greenwich, February 2012. Can be accessed at: http://www.nri.org/promotional-material/coffee-and-climate-change-1-53mb

grow anything else but rice. But in the dry season and in some other circumstances, it is possible for the farmer to choose between rice and other crops. As population growth slows and the per capita amount of rice consumed continues to decline in favor of higher value-added foods, it is quite possible that total domestic rice consumption will increase very slowly, level off or even be reduced.[30] This lessens the urgency of putting a very high priority on rice production and setting aside rice land for only growing rice. It is already true that it is easier than before to switch out of rice into another seasonal crop but it is much harder to plant fruit trees or otherwise convert paddy land to other uses.[31] While some varieties of rice are profitable[32] many farmers grow less profitable low and medium quality rice.[33] Further relaxation of cropping choice would allow farmers to make the decisions that most benefit them and might also allow easier consolidation of plots. As argued previously, this is inevitable and desirable if not done too quickly. Given the low relative productivity of labor in agriculture and the level farm work force with low levels of mechanization on tiny plots, it does not make sense to tie poor farmers to their land or to an unprofitable crop if they feel they have better prospects elsewhere, or at least better prospects growing other crops than rice.[34]

Another point concerns the concept of ñfood securityò as it applies to growing rice. There is absolutely no shortage of physical rice in Vietnam ï that is why it exports so much. The issue from a household point of view is more access to food. If rural families (especially) are able to generate adequate incomes *from any and all sources* they will have better food security. Insisting on rice or even annual crops when other uses produce more income is not ensuring food security but rather the opposite. Switching from a focus on rice surpluses to adequate incomes for all ï especially those in ethnic areas ï would help to assure household level food security. National level food availability is already achieved.

**5. Land Policy**

The new land law allows farmers to get fifty year leases, a big improvement over twenty years. However, the inflexibility of land use is still a factor, as discussed above. A farmer may want to raise poultry or pigs in a building on her land or plant fruit trees on his farm land but not be allowed. Those restrictions lower the value of his or her land ï and make it less likely that the land will be sold to allow a move to a town or city. Younger rural workers will anyway tend to leave farming, reflecting their higher educational levels, preferences and greater mobility. However, older (above 40 years or so) and female farmers will tend to stay. That is one reason for the relatively low and slowly growing labor productivity levels noted earlier.

This concern that if agricultural use strays too far from single crop rotation, then one is on a slippery slope that will inevitably lead to the conversion of land to non-farm uses is curious.

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[30] FAO data suggest falling rice consumption per capita for the last decade or so. The decline in per capita rice consumption is largely offsetting the rise in population. Taiwanôs per capita rice consumption is about 70 kg., less than half of Vietnamôs current consumption level.

[31] This may reflect a fear that the land may slip out of the ñagriculturalò use category and acquire a higher value that would have to be paid in compensation if the land were taken by authorities for public or other private use.

[32] https://openknowledge.worldbank.org/handle/10986/16037

[33] http://www.economist.com/news/asia/21594338-vietnams-farmers-are-growing-crop-no-longer-pays-its-way-against-grain

[34] The FAO reports that output per hectare in constant prices grew 1.8% per year from 1997 to 2012 and 1.6% per year from 2007 to 2012. Unless this is greatly accelerated, farmers with small plots cannot hope for high incomes.

There is a clear dividing line between land used for any kind of agricultural/livestock/fishery production and for non-farm uses. If local officials enforce a law that allows flexible farm use but not non-farm use, the benefits of agricultural land to its owner could be fully realized without threatening the private conversion of land to nonfarm use.[35] It is perhaps more likely that government officials think that any gains from land conversions should not go to farmers but to the locality or even to the official. A contrary view is that displacing poor rural people who have land use rights with minimal payment is not just compensation and they should get a substantial portion of the market value of their land.[36]

While the age structure by occupation of the workforce is not available, it is already clear that many more educated workers choose urban over rural residence, while older workers tend to congregate in the rural areas ï of those over 20 years of age in the labor force, nearly 30% are over fifty years of age in the rural areas but less than a quarter in the cities. Likewise, a third of urban workers have a vocational or higher educational qualification while only 12% of rural workers are so qualified. The difference for college or university educated is even larger ï more than a fifth of workers in the cities but less than 5% in the rural areas. If the rural areas are going to attract more productive and trained workers, those skilled workers will have to be able to earn more ï which means larger farm sizes as well as a better mix of crops with higher quality and productivity. And if the less qualified workers with tiny plots are going to earn more, they had better get to cities or towns where wages are higher. In QIII of 2014, urban wages in the non-state sector were 28% higher than non-state rural wages. This is not a large difference when cost of living differences are considered ï but training and a variety of job possibilities are perhaps more likely in an urban setting and it is likely still a net gain. So, allowing farm land consolidation could revitalize the rural areas with more progressive farmers while allowing those who prefer higher urban wages to choose that option more easily.

It is important to note that farming will continue to play an important social role in allowing older workers with no desire for mobility and limited urban skills to stay where they are.[37] No suggestion is being made that any farmer should be forced to sell his land use rights. (Many are now forced to do so, but to officials using their land for various projects.) The point is rather that refocusing land policy so that voluntary farm consolidation is easy and seen as desirable rather than a return of large landlords. In a modern society, farm land is not a major source of wealth nor is agriculture a large share of output. Farms of moderately large sizes do not constitute an important socio-economic class as they did in earlier times.[38] That is why the workforce in

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[35] Unless huge amounts of land were converted, it is not clear why higher productivity use for (say) a factory or residence on a plot should not be allowed. Given the comfortable margin with rice exports and other major agricultural exports such as fish, shrimp, coffee, rubber, tea, etc., the focus should be on giving farmers the flexibility to raise their own incomes, not to restrict the use of their own land.

[36] The UNDP-funded study, ñLand Policy for Socioeconomic Development in Vietnam,ò 2010, by Ho Dang Hoa, Le Thi Quynh Tram, Pham Duy Nghia, and Malcolm McPherson covers this and other related land issues. Although partly overtaken by the latest revision of the land law, it is still an excellent analysis of land issues. It can be accessed at: http://ash.harvard.edu/links/land-policy-socioeconomic-development-vietnam

[37] Much rural income is now coming from rural nonfarm sources and remittances from cities, so a full analysis should consider these sources and how they could be enhanced for those unwilling or unable to leave.

[38] Professor Thomas Reardon has pointed out that post-harvest processing, logistics and wholesale trade constitute 30-40% of the value added in food value chains and can be as important as crop production in food security. See, for example, ñThe Hidden Middle: The Quiet Revolution in the Midstream of Agrifood Value Chains in Developing Countriesò om the Oxford Economic Review of Economic Policy, 2015, 31 (1), Spring, by Thomas Reardon

agriculture shrinks in all richer countries. While this should not be artificially accelerated, neither should it be prohibited or discouraged. Natural economic pressures lead those with some mobility to choose higher incomes in nonfarm occupations. Vietnam is at a point where the number of farmers should begin to shrink, not just as a share of the workforce. This would be especially true if overall growth accelerated and more factory jobs, along with associated service and construction jobs, were generated by large inflows of FDI and non-state supplier investments.

**6. Investment in Agriculture**

It is not easy to produce realistic recent estimates of investment in agriculture in recent years. A 2010 FAO study[39] found that from 2005 to 2010 the state budget directed about 6% of total state investment to agriculture ï far below the share of agriculture in GDP or labor force. Investment in agriculture from all sources was 6.4% of total investment in 2010. A MARD presentation from 2012 stated the agricultural share of state investment had fallen to 5.6% in 2012.[40] FDI in 2012 in agriculture had fallen to 0.6% of the flow and 2% of the cumulative stock of total FDI. Public research in agriculture as a share of total public research funding was only 2% in 2010 ï even though studies showed it was as productive as or more productive than irrigation.[41] Some spending is not ñagriculturalò but may be helpful to it ï rural infrastructure and electrification, disaster-management efforts, and so on. But, on the whole, it is hard to avoid the feeling that investment in rural areas is not proportional to its share in output, employment, or potential productivity. In particular, research and development on things like water management, cropping systems or seed breeding and selection for climate change could almost certainly be productively built up to combat the looming challenges.

In a presentation in 2013, it was stated that in 2010 that 34% of total investment in agriculture came from state sources; 56% from private and 10% from international.[42] Given public investment in agriculture of 18.5 trillion dong ($994 million) in 2010, that would suggest total investment in agriculture in 2010 of $2.94 billion. Total agricultural output in that year was $22 billion, so agricultural investment /agricultural GDP was 13.4%. This is well below the average 30% or so of GDP invested overall each year. Nothing has recently appeared which would suggest much change in that magnitude. Low investment is consistent with less than 2% per year productivity improvements in both land and labor since 2008, at least according to World Bank and FAO sources.

There will likely have to be a major private infusion of investment in order to achieve higher land and labor productivity. This would be complemented by better focused R&D and public policy towards water use. There are also high post-harvest losses and a lack of good integration between production and agricultural processing and marketing. These observations were made

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[39] http://www.fao.org/fileadmin/templates/tci/pdf/CorporatePrivateSector/Vietnam_-_Private_Sector_Investments_in_Agriculture__Final_Report.pdf

[40] http://www.apip-apec.com/multi/plan/2013/11/15/files/3-5.pdf Slide #8

[41] One IFPRI/CIEM study covering 1993-2002 found that 1000 dong of agricultural research produced 12,200 VND of extra output. More recent estimates of agricultural research productivity could not be found by the author.

[42] http://ap.fftc.agnet.org/ap_db.php?id=106&print=1, a slide presentation by Dao The Anh and Nguyen Van Son, ñVietnam Agricultural Value Chain in the FTA of the Asian Regionò, 10-31-2013.

by Professor Vuong Dinh Hue. He suggested that restructuring agriculture was needed.[43] He observed that Vietnam typically fetches lower prices for its agricultural products than its neighbors due to poor quality and a low level of processing. He had a range of measures, one of which included the creation of large scale farms of thousands of hectares that would be modern and capital intensive. That particular approach has been tried elsewhere in Southeast Asia and generally not found to be as efficient as its proponents suggest ï at least if implicit subsidies in land and capital costs were included. A more organic and ñbottom upò approach would allow successful farmers to expand to farms of dozens or perhaps hundreds of hectares and provide financing for land improvements, machinery and agro-processing at market rates.

An alternative would be for groups of farmers to grow crops on larger plots ï a kind of rebirth of cooperatives. This was also suggested in a World Bank study[44] on rice and other crop competitiveness. Cooperatives have worked in some Asian countries with market systems such as Taiwan, but overcoming past problems of Vietnamese cooperatives would involve some effort. Allowing successful farmers to acquire plots of neighbors who wish to leave would be an alternative that would require far less organizational effort. If the government felt there was a danger from large land owners, it could impose a land tax on holdings of more than some size, which might vary depending on the region and quality of land. If such a tax were applied, it should also apply to state enterprises as well as private holdings.[45]

In short, agriculture value added has grown rapidly since 1990 ï roughly 4% a year from 1990 to 2010, and just over 3% since 2010. However, structural problems have emerged as the nonfarm sector has grown and attracted virtually all of the labor force growth since the later 1990ôs, while many of those remaining have a growing absolute, though not relative, gap compared to urban households. Environmental challenges suggest future gains will be harder without policy changes and adjustments to input use. Rice growing in many cases is not privately profitable and even socially burdensome. Yet land policy remains tilted towards rice or perhaps now annual crops. The quality of produce is often not sufficient for higher value export markets and the small scale of many operators constrains the use of mechanization and perhaps technology. Above all, the productivity of both labor and land appears to be low and/or slowly growing. Given these trends, a faster shift of workers out of agriculture might be expected but the numbers identified as working in agriculture have been close to 24 million for nearly two decades.

This section has argued that allowing farmers to sell their long-term land use rights at a price more nearly reflecting the market value of their land rather than only the agricultural value

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[43]Source: http://english.tapchicongsan.org.vn/Home/Socialist-oriented-Market-Economy/2014/407/Current-restructure-of-Vietnamese-agriculture.aspx Professor Hue is the Chairman of the Central Economic Commission of the Central Committee. His comments are dated April 15, 2014. The article first appeared in the Communist Review, #854, 12/2013.

[44] Source: http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2013/07/23/000442464_20130723110845/Rendered/PDF/ACS43250ESW00P0Box0377384B00PUBLIC0.pdf, ñThe Financial and Economic Competitiveness of Rice and Selected Feed Crops in Northern and Southern Vietnam,ò Report AC54325, January 2013, World Bank, page 33.

[45] Land or property taxes exist but they are normally set at very low levels so as to be insignificant. Especially for land on urban fringes, this often leads local governments to take agricultural land use rights, pay a low amount to its owner and convert the land to nonfarm uses ï thereby boosting its value considerably. A significant land tax, perhaps with a certain zero tax rate on small holdings, would allow local revenues to be generated without such land takings.

would allow for a natural and voluntary consolidation of plots into more efficient units at a rate chosen by the farmers. Many farmers will choose to remain on small plots due to age, ethnicity, skill level or family obligations. They would benefit from special programs that could engage in more R&D and make the knowledge and seeds available so that they could grow higher value crops. This kind of effort lends itself naturally to public-private partnerships. Industry groups could also play a role in developing and enforcing quality standards that would help raise the reputation and price of Vietnamese products. Adding a land tax to large land holdings would help to compensate for lost revenue to local officials who have been used to taking the appreciated value of land for their own purposes when it is switched from agricultural to non-agricultural use. A land tax is also a more sustainable source of local revenue.

Increasing investments in agriculture, particularly R&D and extension, but also in rural infrastructure and electrification (at a higher power level for pumps and machinery, with more reliability), would help those who remain ï both small and larger scale. Experimental attempts at very large scale farms can proceed but carefully and with a full analytical appreciation of all of the implicit subsidies such projects often receive.

Dealing with water issues is important and may become critical in the near future. As groundwater is depleted, it may become more risky or unprofitable to grow existing crops and aquatic products. More understanding of the ñbreak pointsò where severe costs are imposed is a priority for research. Admittedly, there is not much evidence of it so far, aside from an agricultural growth rate closer to 3% than 4%. But the government should ñlook around the cornerò to prevent sharp reductions in yields or severe adjustments to cropping patterns.

The section has not especially analyzed the situation of ethnic highland minorities, but land security improvements, better research and extension, and improved post-harvest processing and marketing would improve their conditions if extension messages were crafted for them.

## V. SOE Reforms

### 1. From the Contract Responsibility System to Equitization

In early 1980s, the aim of the CPVô s economic development strategy was to build an economy with two essential components - the state and the collective sectors, in which the state sector played the leading role (Vietnamôs 1980 Constitution, Article 18). Vietnamôs private economy was then considered a ñnon-socialist sectorò that needed to be transformed.

Even with *Doi Moi,* state ownership still has special significance in Vietnam where the market economy is accepted but the communist orthodox ideology is still preserved. The coordination system (market vs. plan) and the characteristics of ownership (private vs. public) are the two most important criteria that distinguish different economic systems.[46] Since the central plan was abandoned, public ownership and state intervention have become the only economic ñsocialistò characteristics in the new ñsocialist market economyò. Moreover, traditional state-owned enterprises (SOEs) also have ñsocial functions,ò the most important of which are to provide their employees with the ñiron bowlò, social security, pensions, housing, schooling, and medical

[46] The power of the Marxist ï Leninist Party and its associated official ideology is the political criterion to distinguish between economic systems (Kornai 2000, pp.28-34)

benefits. These explain why the ownership issue is extremely important to the Vietnamese party-state. State ownership in industry has been a life-or-death issue for the communist party because its legitimacy greatly depends on the industrial performance of SOEs. Moreover, the state industry provides both a material base and a political base for the party-state, and by holding control over the key industries, the party-state hopes that it can control the economy.

The issue of state ownership is manifested first and foremost in SOEs. Right from the beginning of *Doi Moi*, a series of reforms were designed and implemented to increase the autonomy of SOEs and to make them more profit oriented. The contract responsibility system was applied under which the state delegated the control rights to the SOEs but maintained the residual rights. Early experimentation with mergers and acquisitions (the so-called ñarranged marriageò) in the 1990s focused on small and non-strategic firms. The main objective of these measures was to escape the fiscal burden caused by loss-making SOEs (Jefferson and Rawski, 2002). In spite of all these extensive reform experiments, losses of SOEs mounted steadily in the early 1990s, leading to enormous contingent liabilities and nonperforming loans in state-owned banks.

Privatization was then contemplated, but the term was considered too much against the socialist orientation to be officially used. In the end, the term equitization was adopted, referring to the transformation of an SOE into a joint-stock company by one of the following methods: (1) keeping the state shares intact and issuing new shares; (2) selling part of the state shares; (3) detaching and then privatizing parts of a SOE; and (4) [since June 1998] selling off all state shares to workers and private shareholders.

In 1992, Vietnam started its pilot equitization program, in which small- and medium-sized SOEs (among the total of 6,500 SOEs) were encouraged to voluntarily participate. However, with a strong ideology of preserving 100%-owned SOEs and significant resistance from managers of SOEs and their superiors, the results of this pilot program were minimal: between 1992 and 1996, only 5 SOEs were equitized. The pilot program was then expanded in 1996 but without much success: between 1996 and mid-1998, only 25 additional SOEs were equitized. The equitization program only moved ahead when SOEs were no longer given the option but were forced to participate in the equitization program, according to which the state would keep 1,200 ñstrategically importantò SOEs completely owned by the state and all others SOEs were subject to equitization to varying degrees. Despite this decisive move, the equitization program met with limited success. Between 1992 and 2005, 3,384 SOEs had been equitized, i.e. 52% of the total number of SOEs, whose capital amounted to less than 15% of the total state capital of all SOEs (Vu Thanh- Tu Anh 2005).

In the early days of the equitization program, the party also paid a lot of attention to the layoff of workers. As a result, the SOE reform in the 1990s did not cause any major disturbance in terms of labor as witnessed in other transition economies. Employment in the state industrial sector fell from 2.5 million in 1990 to around 1.6 million in 2000. As for the laid-off workers, considerable efforts have been made to deal with those most adversely affected by this policy change during and after equitization. The government has established funds to provide assistance to redundant workers. These workers are given opportunities for re-training or they are entitled to full salary for a certain period if they decide to find a new job. In the event that workers are unable to find new jobs, they receive benefits under the Labor Code. Redundant workers who wish to retire

early can still benefit from social insurance policies. Thanks to these employment and social safety net policies, workers are rarely a major obstacle on the way of equitization.

**2. State Economic Groups (SEGs)**

The defining feature of the Vietnamese economy during the 2000s has been dualism, a strategy of the Party and the Government of Vietnam that sought to retain the dominance of the state sector while opening to foreign investment and permitting the emergence of a vibrant private sector. Dualism was thought to be necessary to ensure political support for the transition to a market economy. On the one hand, the leading role of the state-owned sector was reiterated with public resources being channeled to newly-formed state economic groups. On the other hand, a liberal enterprise law was adopted to unleash the potential of domestic private entrepreneurship and deeper integration was sought to promote foreign direct investment.

The central industrial policy initiative was the governmentôs decision to create state-owned conglomerates called state economic groups (SEGs). The stated goal was to create large corporations with sufficient resources to enter into a wide range of business areas. The Korean model was very much the inspiration behind the adoption of this policy. Korea, it is argued, built its large conglomerates with substantial support from the government and Vietnam should try to do the same. But there are at least two fundamental differences between Vietnamôs and Koreaôs efforts to create large conglomerates. In Korea most of these firms were private whereas most of the conglomerates in Vietnam are state owned with their boards of directors and top management selected by the government. Second, in Korea all of the large chaebols, in exchange for temporary government support lasting in most cases for only a few years, were expected to become internationally competitive exporters. Vietnamôs conglomerates are still largely oriented toward import substitution. Vietnamôs compliance with the rules that go with its membership in the World Trade Organization (WTO) were supposed to produce competitive pressure for the conglomerates, but there is now suggestive evidence that these conglomerates were designed in part to get around some of the WTO restrictions on protection of domestic firms.

Current literature suggests that trade reforms and economic integration can be used as external pressures and credible commitments to overcome opposition and lock in domestic economic reforms.[47] In particular, WTO accession and implementation of reform commitments under the agreement can have important effects on the operation of SOEs in Vietnam. First of all, in order to gain access to the WTO, the whole legal framework had to be adjusted to accommodate the core underlying values of the WTO such as free trade, fair competition, and non-discrimination.[48] Not only does WTO accession help change rules of the game, it also provides externally credible enforcement mechanisms to facilitate market transactions. This implies that SOEs now face more competition and are subject to harder budget constraints, the two conditions widely accepted by economists as essential for firm efficiency.

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[47] See Staiger and Tabellini 1999; Davis 2006; Allee and Scalera 2012; Lamy 2012; Zoellick 2014.

[48] It is estimated that for Vietnam to meet the requirements of joining the WTO, around 500 laws and regulations have been either created or modified.

WTO accession is a key long-term strategy for Vietnam in order to attract foreign capital and technology as well as to expand export markets. However, the path to join the WTO was arduous because of tough opposition from the party hard-liners as well as from other vested interest groups. There were intense debates between the reformists who want to promote international integration and the conservatives, who want to protect the ñindependent and self-reliantò economy (Perkins and Vu Thanh- Tu Anh 2011). As far as the SOEs are concerned, they worried that with their inherent weaknesses, SOEs would fail to face international competition both at home and abroad, while the reformists believed that exposing SOEs to international competition was the best way to overcome their weaknesses and thereby reducing the burden for the economy.

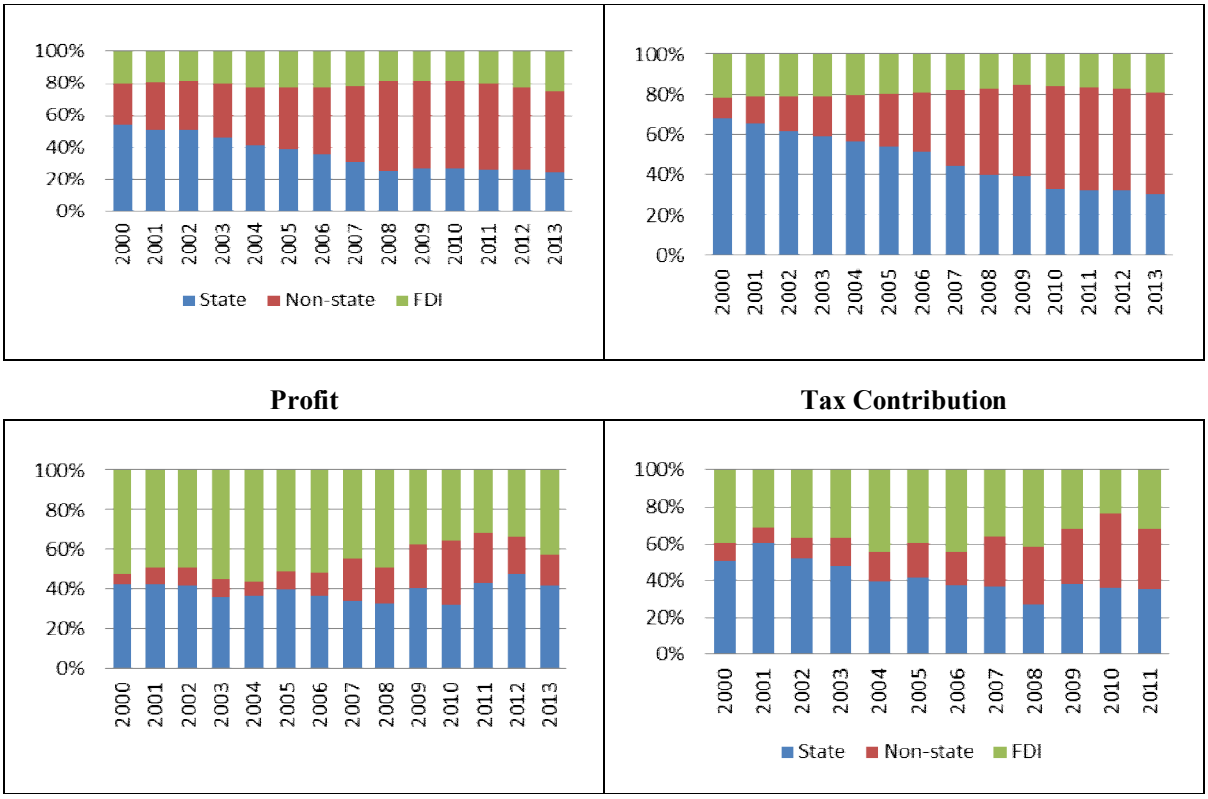
In the end, a compromise was reached under which Vietnam would move forward with WTO accession and at the same time more public resources would be used to support large state economic groups and state general corporations. This strategy was supported politically because nominally it does not conflict with Vietnamôs WTO commitments and resonates with the party-state goal of ñfostering the state sectorò, with its principle of ñproactive integrationò, and with its desire to be ñindependent and self-reliantò. Most importantly, this option is consistent with Vietnamôs ñpolitical economic constantò, i.e., the primacy of the state sector, as well as the personal preferences of the Prime Minister who has decided to fulfill his ambition by means of state corporations.

The decision to form SEGs is a strategically important one, and as such, requires consensus agreement at the very top of the Vietnamese party-state decision making body. It was even more so given the fact that the multiplication of the SEG model went against existing policies adopted by both the party and the government in the first half of the 2000s, in which ñ[a] key part of SOE reforms were measures to encourage large enterprises to restructure and downsize in order to reduce losses and unserviceable debts, and to improve competitiveness.ò (Abonyi et al. 2013: 99). Moreover, Prime Minister Phan Van Khaiôs original intention was not to quickly extend the SEG model but to experiment with it so that informed decisions could be made about the next step of the SGC reform. Indeed, in the early 2000s, both experiments with the state business model, namely Vinatex (textiles and garments) and Constrexim (construction), were rolled back.[49]

**Figure 5.1: Share in business revenue, assets, profit, and taxes by ownership**

| Revenue | Assets |
|---|---|

[49] Phan Van Khai is the Prime Minister for two terms (1997-2006) and succeeded by Nguyen Tan Dung.




Source: Authorôs calculation from data provided by the General Statistics Office of Vietnam.

Throughout the 2000s, as the internal structure of the state was altered by decentralization, the status of the SEGs was also adjusted continually with changes in the political leadership. In terms of supervision, the SEGs have increasingly moved away from the line ministries towards the Prime Minister, and have even become economic means for building political support. Decentralization has intensified competition among provinces in Vietnam. On the one hand, this competition increases the leverage of those who now can use SEGs as their óinvestment vehiclesô in provinces. On the other hand, it encourages local governments to stay closer to businesses, especially the larger ones. Consequently, while the local business climates have generally been improved across provinces, clientelism and collusive behavior in the relationship between the state and business at both the central and local levels has become widespread.

Towards the second half of the 2000s, problems with SEGs began to emerge as the whole economy was affected by both domestic macroeconomic imbalances and the global financial crisis. According to the governmentôs own estimates in 2010, SOEs controlled 70 percent of fixed assets and accounted for 45 percent of new investment. Yet they were responsible for only about one-fourth of employment, and in fact the number of jobs in SOEs shrank by 22 percentage points from 2006 to 2010. They accounted for only 19 percent of GDP growth and eight percent of growth in the industrial sector. They are not export-oriented and have failed to develop technological capabilities in new industries. SOEs are heavily indebted, as demonstrated by debt-equity ratios that are much higher than those recorded in the foreign-invested and domestic non-state sectors (see VELP 2013). The underlying causes of such a situation are institutional. First, as the governmentôs designated leaders, SOEs do not need to compete to be the ñwinners,ò at least within the domestic market. Second, sizable SOEs inherently enjoy a monopolistic status in key or requisite areas and operate as market commander-in-chief in any

markets in which they participate. Third, state-owned groups and corporations also control business rights and opportunities through related mechanisms and institutions, especially through the drafting and implementation of industry development plans and strategies, which, in most cases, are directly appointed by the Government and ministries to state-owned groups and corporations. Fourth, by transforming SOEs into groups and eventually sizable corporations, the State has not only favored them with many resources, but has also created an unfair field of competition, notably a legal framework and policies that discriminate against the private sector, especially domestic private enterprises.

In short, when faced with significant challenges brought about by the WTO accession (e.g., weaknesses of the SOE sector and opposition from the hard-liners and vested interest groups), the Vietnamese party-state decided to use WTO as a threat to convince even reform-minded politicians that the pre-emptive strategy of building up and supporting SEGs in order to confront international competition was not such a bad idea. In this way, the WTO challenges had played the role of a consensus builder in the expansion of the SEG model at the cost of the rest of the Vietnamese economy (see Vu Thanh 2014).

## 4. SOE Restructuring

With inefficiencies and mismanagement within large and small SOEs being exposed, the government has been put under increasing pressure to announce new reform initiatives. In 2014, a plan to equitize 432 SOEs during 2014-2015 was put forward. Overcoming the ideological constraint and fragmented power structure, a policy consensus has been formed in forcing all SOEs that are not in a strategic/sensitive sector to be equitized, with the objective of attracting local and/or international strategic investors. Currently, this SOE equitization program is receiving the highest policy priority. The list of SOEs to be equitized has been drawn up, and central ministries and provincial governments are asked to go work out specific plans. However, even if this extremely ambitious equitization program is realized, many large SOEs, particularly economic groups, will still be in the hands of the state, and institutional reforms are needed to improve their corporate governance and operational/financial efficiency.

Within the framework of the overall economic restructuring program, the state must redefine its role, and must strictly adhere to the principle that the state should only do what the private sector does not want to or cannot do. Provision of public goods and correcting market failures should be the overriding role of the state. At the same time, it must be understood that the market is an institution independent of and parallel to the state and is not subservient to and subject to the dictate of the state, though subject to some regulation. As the governmentôs ambitious and large-scale program of SOE equitization during 2014-2015 is gaining momentum, there will be opportunity to reform the corporate governance of SOEs. At the system level, it is necessary to clearly separate the functions of state management, regulation, and direct business activities. At the corporate level, the business operations of the SOEs must be made as transparent as possible. With the exception of special cases related to national defense, security, or foreign policy, SOEs, especially conglomerates and general corporations must make their accounting reports public as a publicly listed company would, in order to strengthen the ability of external experts and society at large to monitor their activities. The people, as the ultimate owners of the SOEs, should at least have the right to know the actual conditions of the enterprises.

The analysis in this section offers several implications. First, Vietnamôs experience has been consistent with the statist literature in suggesting that a prerequisite for rapid industrial growth in the late- industrializers is that the leaders single-mindedly commit to economic growth and put national interests above political, ideological and personal interests. These are preconditions for the ruling elites to form a close alliance with the most productive forces, build strong reform coalitions, and create a meritocratic bureaucracyð all of which are the óusual suspectsô behind the success of Japan, South Korea, and Taiwan. Second, because the alliance with the most dynamic and efficient sectors was viewed by many as a temporary concession rather than a coherent strategy, the success was only partial. More fundamentally, because of the orthodox ideology at the beginning of reforms and later on due to a symbiotic economic relationship with the SOEs, the Vietnamese party-state has chosen to rely on the SOEs, which are persistently the least efficient sector in the economy. Additionally, the fragmentation of power and inherent lack of effectiveness render the state incapable of imposing hard budget constraints on the SOEs or sanctions on them for underperformance. Without effective ósticksô, and an over reliance on ócarrotsô for political support rather than development goalsð the state-business relationships run the risk of being degraded into clientelism and corruption.

## VI. Private Sector Development

### 1. Private Sector under the Multi-Sectoral Economy

In April 1992, Vietnam adopted a new Constitution that redefined its economic regime as ña multi-sectoral commodity economy functioning in accordance with market mechanisms under the management of the state and following a socialist orientation.ò[50] For the first time, market mechanisms and private property rights were acknowledged in the Vietnamese Constitution.[51] However, the term ñmarket economyò was still considered inappropriate. It took another ten years, until the Ninth Party Congress (April 2001), for the CPV to accept the ñsocialist-oriented market economyò as the official way to describe its political economy system.

At the beginning their economic reforms, the private sector in China was almost non-existent. Even until 2000, the non-state sector in China contributed only 8% of the total industrial production value. In contrast, private economic activities existed in Vietnam under central planning. Before 1992, the private sector already played a very important role in agriculture and services; it was mainly in Vietnam's industrial sector where the government's role was disproportionately large. By early 1990s, the agricultural sector was almost entirely private. Household farms accounted for 97.1 percent of agricultural value-added in 1990. In the service sector private firms (mostly in trade) accounted for 55.8 percent of value-added in 1990. In the industrial sector, non-state enterprises accounted for 37.2 percent of value-added in 1990. According to Lich (1996), a significant proportion of HCMCôs economic activities in trade and small-scale manufacturing continued to exist outside of the state plans and were subject to market forces during the 1980s. However, almost all of private businesses existed as household-

[50] Article 15 of the 1992 Constitution of Vietnam.
[51] This expression was first articulated in the ñStrategy for Social and Economic Stabilization and Development Until 2000ò, which was adopted at the 7th Party Congress in 1991.

based and/or informal units. As can be seen from Table 6.1, Vietnam had a very small number of formal private manufacturing companies in 1991 and throughout the first half of 1990s.

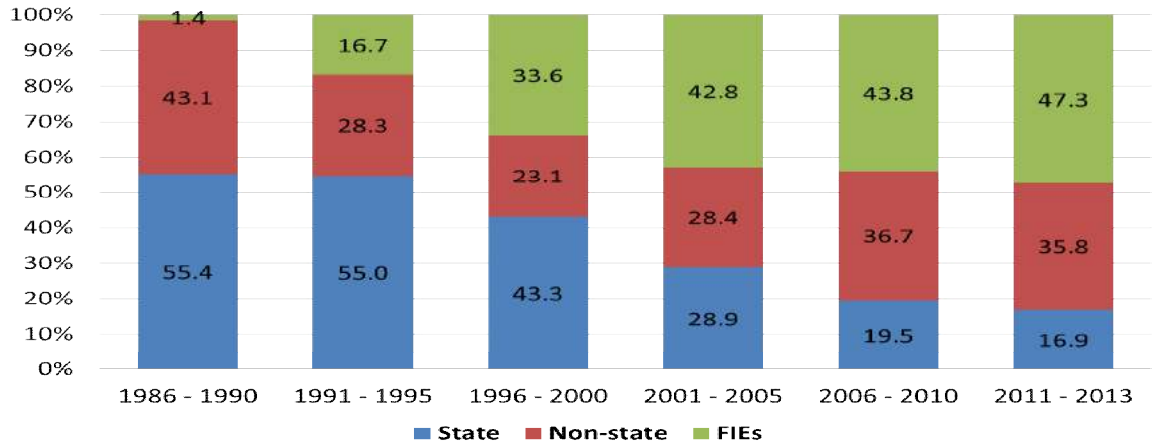
**Table 6.1: The Number and Registered Capital of Private Industrial Companies, 1991-1996**

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|
| **Number of Companies** | | | | | | |
| Sole Proprietorships | 76 | 3,126 | 8,690 | 1,4165 | 18,243 | 21,000 |
| Limited Liability Co. | 43 | 1,170 | 3,389 | 5,310 | 7,346 | 8,900 |
| Joint ï Stock Co. | 3 | 65 | 106 | 134 | 165 | 190 |
| **Capital in VND billions** | | | | | | |
| Sole Proprietorships | n/a | 930 | 1,351 | 2,090 | 2,500 | 3,000 |
| Limited Liability Co. | n/a | 1,490 | 2,723 | 3,882 | 4,237 | 7,300 |
| Joint ï Stock Co. | n/a | 310 | 850 | 1,071 | 1,244 | 2,500 |

Source: Adapted from Riedel (1997) ñEmerging Private Sector and Industrialization in Vietnam.ò

By accepting the co-existence and competition of the private sector with the state and the collective sectors, the 1992 Constitution marked a big change in the official attitude towards private ownership and market economy. However, the official CPV documents continued to affirm the predominance of state economy and collective economy. Compared to the state sector, private businesses faced a very unfavorable treatment in terms of access to land, credit, trading rights, and tax application. Even setting up a business was difficult and time- and resource-consuming with a complicated licensing regime. To start a business it was necessary to get a license from the provincial planning committee, after securing approval in principle from the provincial people's committee. During this process, private entrepreneurs also had to obtain many sub-licenses from various government agencies with authorities at various levels of government having excessive discretionary power. Thus despite significant growth, the share of private sector in industrial output declined steadily from during 1986-2000 and only increased with the implementation of the 1999 Enterprise Law (see Figure 6.1).

**Figure 6.1: Vietnam's Industrial Output Share by Ownership (1986-2013)**

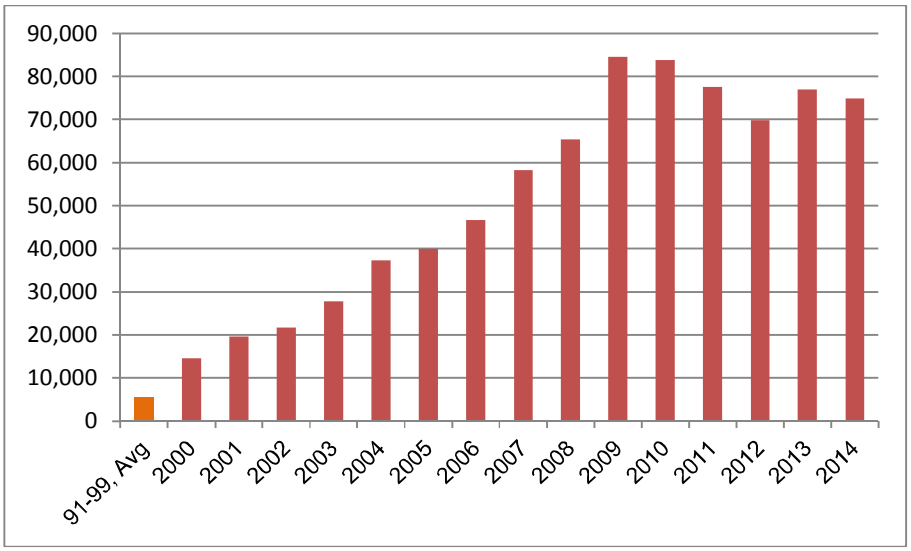



Source: Authorôs calculation based on Vietnamôs Statistical Yearbooks, 1987-2013.

## 2. The Enterprise Law, FDI, Economic Integration and the Emergence of Industrial Clusters

Overall, Vietnam had done very well over a decade since the launch of *Doi Moi*. The economy grew fast up to 1997, averaging 8.3% per year during 1991-1997. While avoiding serious damage from the Asian Crisis and the slowdown in the world economy, Vietnamôs GDP growth fell to 5.8% in 1998 and 4.8% in 1999. At the time, Prime Minister Phan Van Khaið a dedicated technocratð with the support of the Prime Minister Research Council (PMRC) and the Central Institute for Economic Management (CIEM), successfully designed and implemented the 1999 Law on Enterprise. The main effects of the new law were the simplification of the procedures needed to start a new business and abolishment of sub-licenses. An explosion of new private companies was recorded immediately after the implementation of the Enterprise Law (Figure 6.2).

**Figure 6.2: Number of Newly-Registered Companies**



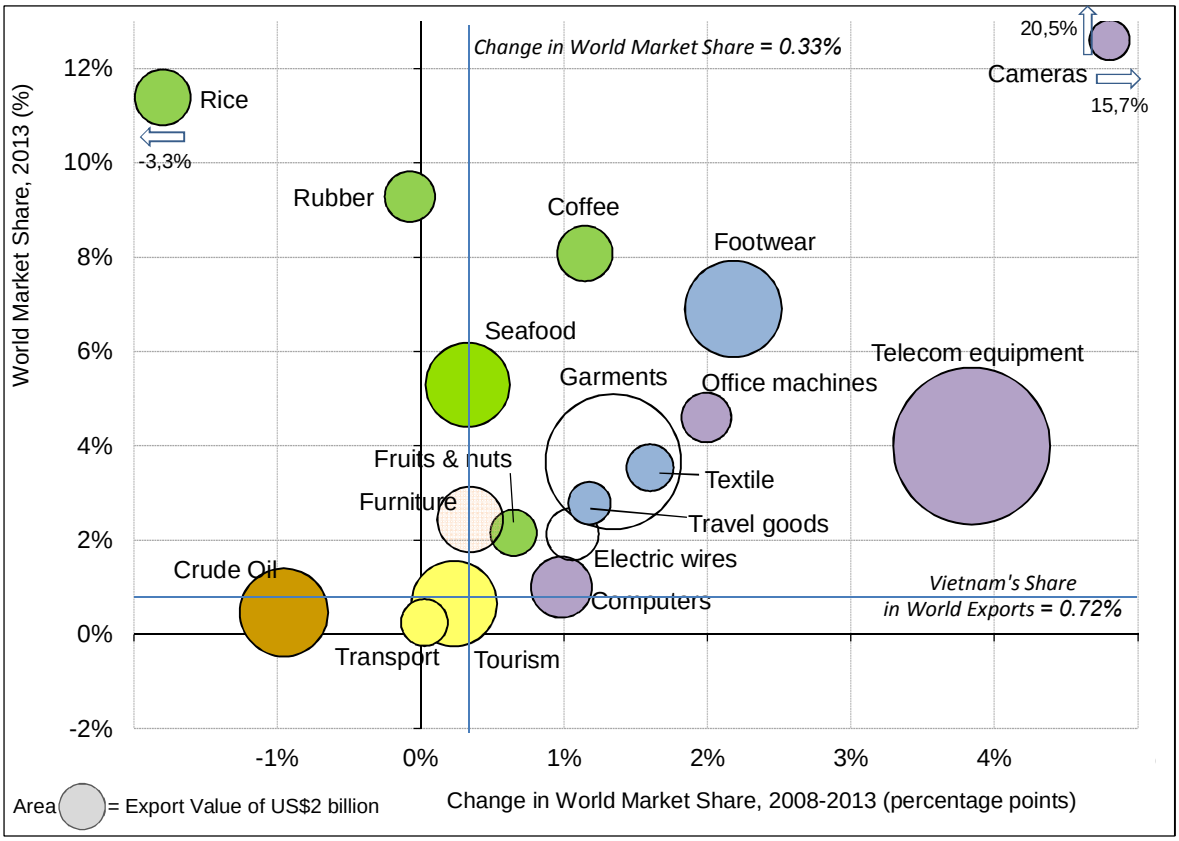

Source: Agency of Business Registration, Ministry of Planning and Investment.

As argued in the earlier section, the dualistic reform strategy of the Vietnamese party-state is to maintain the leading role of the state and at the same time promote private sector development. And trade liberalization and economic integration has been an integral part of this strategy. Vietnam participated in the ASEAN Free Trade Area (AFTA) in 1996, normalized trade relation with the US in 2001, joined the World Trade Organization (WTO) in 2007. And for a while rapid economic growth was achieved under this strategy. The Vietnamese leadership tried very hard at each and every stage of different trade negotiations to shield the state-owned sector from competition. But a successful enterprise law, a quite liberal foreign investment law, and expanded market access provided by the trade agreements were the driving forces for the growth of export-oriented local and foreign companies. By 2014, exports have increased more than five-fold in real value since 2000, and manufactured goods now account for seventy five percent of merchandise exports, up from 43 percent ten years ago.[52]

[52] Data are taken from the World Bankôs World Development Indicators.

Trade and investment liberalization has also allowed industrial clusters to emerge with the presence of both local private and FDI firms (see Figure 6.3). A high concentration of labor-intensive garment companies is found the southeast comprising of Ho Chi Minh City, Dong Nai, and Binh Duong. The region also attracts local investments in plastics, rubber, and chemicals, and foreign investments in electrical equipment and machinery. Outdoor furniture products and animal feeds are concentrated in the south central coast. An export-oriented food processing cluster is growing fast in the Mekong Delta. Large-scale investments by Intel in Ho Chi Minh City, and Samsung and Canon in the Northern provinces surrounding Hanoi are beginning to attract other investors in supporting and related industries, signaling the rise of the electronics and IT clusters. Tourism in several coastal regions in Vietnam still has a lot of potential for growth.

**Figure 6.3: Vietnam's Export-oriented Industrial Clusters**




Source: Authorsô calculation based on the UNComtrade database.

However, it is important to emphasize that in Vietnam, the foreign investment enterprise (FIE) sector has been treated more favorably vis-à-vis the domestic private sector. There are at least two reasons for this situation. First, it has been argued that in order to compete with other countries in the region in attracting FDI, it is imperative that incentives provided to FIEs should be on a par with the regional competitors. Second, thanks to its political neutrality, the FIE sector can be promoted without the risk of ñsocialist diversionò.

The preference given to FIE sector has inherently contributed to the growth of this sector in Vietnam. However, a more important reason for the growth of FIE sector is that, FIEs have generally been able to avoid Vietnamese institutions and rely mostly on external institutions.

These facts help explain why when facing a weak global economy and a structurally problematic domestic economy, domestic private firms struggle whereas FDI firms continue to grow. Not only that FIEs have avoided these high interest rates and limited access to credit that negatively impacted domestic firms, but they also rely on the foreign legal system that manages contractual relationships and international production networks to operate their businesses. In short, FDI firms have side stepped most of Vietnamôs institutions, which have inhibited domestic private firms. As long as Vietnam fails to develop effective market-supporting institutions which foreign investors can rely on to expand their business activities, the current manufacturing process of low value added products based on imported inputs and domestic assembly will continue.

## VII. Decentralization

This section discusses the decentralization policy and its implications for the power relation between central and local governments as well as its implications for stateï business relationship at the local level in Vietnam. Although Vietnam is a unitary party-state, decentralizationð in the sense of the transfer of power from the central to local governmentsð is built into its internal structure. Two of the most important collective decision making institutionsð namely the Central Committee of the Communist Party and the National Assemblyð are both heavily local-based as evidence in the overwhelming local representation, and therefore voting power. It follows that even when the central government is strong (e.g., under a paramount leader as in the 1960s to mid-1980s), a certain degree of local consensus is called for when it comes to the most important decisions.

Pressures for further decentralization have been growing since *Doi Moi*. Economic successes in the 1990s and early 2000s generated stronger pressures for decentralization, simply because the old óoperating systemô under central planning proved to be incompatible with the new economy, which is increasingly market-oriented and internationalized. To remedy this situation, the Government enacted the new Budget Law 2002 (which became effective on January 1st, 2004) to accelerate fiscal decentralization and issued Resolution 08 in June 2004 to further decentralize state management, according to which, the central government will accelerate decentralization in important dimensions, including the management of development investment, budget, land and natural resources, and SOE autonomy. These two policies have led to important changes in relationships within the state system itself as well as between the state and business at the local level.

The immediate implication of fiscal decentralization is that provincial governments now have to increase their budget to meet a higher spending responsibility while the revenue sharing structure with the central government remains largely unchanged and the transfers from the central government are significantly curtailed.[53] For local governments in Vietnam, most of their revenue comes from three sources. The first is land-related revenue (mainly tax on land use and on the transfer of land use rights) and the natural resources tax which, according to the budget law, local governments can retain entirely. The two other sources of revenue are corporate

[53] Indeed, between 2000 and 2010, the ratio of local revenue to total national revenue increased from 25 per cent to 38 per cent while the ratio of local spending to total national expenditure increased from 45 per cent to 53 per cent. During the same period, subsidy from central government as a percentage of total local expenditure significantly reduced from about 50 per cent to 30 per cent (Vu Thanh 2012: 16).

income tax and value-added tax, of which local governments can retain a certain proportion, depending on their negotiations with the Ministry of Finance. All three sources of revenue have one thing in common: they all depend on the existence of businesses, especially large ones. This is relatively easy to understand for the latter two sources of revenue, but even for the first source, revenue from land and natural resources usually correlates with the degree of vibrancy of local economy. Thus, decentralization changes not only the status of the business sector in general, but also the relative role of the three business sectors in the calculation of the local government.

Fiscal decentralization has different consequences for the 63 provinces in Vietnam in terms of their budget. For the dozen provinces that are capable of balancing their budgets (thanks to a strong business base or abundant natural resources), decentralization helps expand their fiscal space considerably, and they thus become more independent from the central government. In contrast, fiscal decentralization tends to increase the dependence on the center for the remaining 50-plus provinces which currently receive transfers from the central government.

This situation has several important consequences for the state-business relationship. First, at the national level, the Prime Ministerð who has already consolidated the control over the SEGsð now can use these óweaponsô to serve his interests. For instance, to obtain the local support in the Party Central Committee, the Prime Minister may suggest SEGs to invest simultaneously in many provinces.[54] During the boom time, this suggestion is often welcome by both SEGs and local governments because SEGs can seize the opportunity to extract rents, and local governments can benefit from big investments. Of course, the state budget cannot accommodate every investment project.[55] And when the economy slows downð as it does currentlyð these politically-driven projects become a huge burden for all parties involved, especially for the state expenditure, which ultimately falls onto shoulders of tax payers.

Decentralization has both positive and negative impacts on the relationship between local governments and businesses. Probably the most important positive impact is that many local governments become more pro-active in improving the business environment for economic development. Some of the most successful examples include Ha Tay (before being merged into Ha Noi) and Vinh Phuc in the north, Da Nang in the central, Binh Duong and Dong Thap in the south. These provinces have been either consistently at the top or greatly improving their ranking in the Provincial Competitiveness Index (PCI) compiled by VCCI and Vietnam Competitiveness Initiative since 2005.[56]

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[54] For a detailed discussion of this phenomenon, see Pincus et al. (2012).

[55] The total investment estimate for an incomplete list of public investment projects is about US$150 billion for the 2011-20 period, or approximately US$15 billion each year, which is equivalent to about one third of the total annual budget expenditure.

[56] PCI is a non-government initiative, jointly developed by the VCCI and USAID, designed to assess the ease of doing business, quality of economic governance, and progress of administrative reform in all 63 provinces in Vietnam. PCI is constructed using opinion data provided by domestic private businesses as well as published data regarding ten dimensions of provincial economic governance, namely (1) entry costs for business start-up; (2) access to land and security of business premises; (3) information transparency and equitability; (4) time requirements for bureaucratic procedures and inspections; (5) informal charges; (6) policy biases toward state, foreign, or connected firms; (7) proactivity of provincial leadership in solving problems for enterprises; (8) business support services; (9) labour and training policies; and (10) fair and effective legal procedures for business dispute resolution. Since the PCI was first introduced in 2005, it has been actively used by provincial governments to monitor and benchmark the

The improvement in the relationship between businesses and provincial governments, and thus the quality of the business environment, generally helps provinces attract additional foreign direct investment. In turn, these FIEs ï acting as ñagents of changeò ï contribute to a better business environment (Malesky 2008), especially where FIEs are significant contributors to the provinceôs GDP and industrial production.

However, although provincial governments can support the business expansion, they often fail to facilitate cluster development as in the case of local governments in China. One of the main reasons is due to the fact that provinces ï which are the decentralized units in Vietnam ï are quite small.[57] As a result, industrial clusters often spread across several provinces, while unfortunately these provinces have little incentives to coordinate but instead compete with each other. For instance, industrial clusters such as catfish, shrimp, and rice ï those agricultural processing industries that Vietnam has outstanding comparative advantage ï spread over provinces in the Mekong Delta. But so far, despite commitments made by leadership of these provinces, ñpublic goodò activities such as export market database and regulations as well as trade promotion activities of the thirteen provinces in the Mekong Delta remained isolated (Vu Thanh et al. 2011). Similarly, the southern textile clusters ï one of Vietnamese leading exports ï located in Ho Chi Minh, Binh Duong and Dong Nai, but these provincial governments hardly have any cooperation or coordination efforts for improving or upgrading the cluster.

In addition to the clientelism described above, two of the most serious negative impacts are the emergence of rent-seeking and state-business collusive activities. In the short-run, the largest, and also fast and simple, source of revenue comes from land and natural resources. For example, to increase tax revenue, the provincial people committee can now simply issue an administrative decision to convert hundreds of hectares of land from agricultural to industrial or urban uses, then transfer the land use rights to investors at much higher value. The enormous rent generated from land and natural resources is the greatest source of corruption at the local level. *Nhân Dân* (The People)ð the mouthpiece of the VCPð quoted a report by the Government Inspectorate acknowledging that between 2003 and 2010, the state administrative organs at all levels have received more than 1.2 million complaints and denunciations in which 70 per cent is related to land.[58] Similarly, according to the Ministry of Natural Resources and Environment, land-related complaints have always accounted for about 70-90 per cent of total complaints received by this ministry. This number was tripled between 2004 and 2007, right after the revised Land Law came into effect in 1 July 2004.

In many provinces, decentralization pressures make the local government feel the need to build up a number of key local SOEs to become its right arm in raising funds as well as implementing infrastructure projects.[59] These companies can be either rent-seeking or welfare-improving or

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competitiveness of their business environment. The PCI is, however, rarely used by the central government as an input to its policy formulation. For more information on the PCI, see http://eng.pcivietnam.org

[57] By ways of comparison, in 2010 an average province in China (Vietnam) has an area of 282,264 (5,257) $km^2$, a population of 38.6 (1.4) million, and a GDP of US$ 175 (1.6) billion.

[58] Source: http://www.nhandan.com.vn/mobile/_mobile_chinhtri/_mobile_tintucsukien/item/788102.html, accessed on October 12, 2014.

[59] Many examples can be found, for instance Ho Chi Minh City Finance and Investment State-Owned Company (HFIC), Hanoi Housing Development and Investment Corporation (Handico), Investment and Industrial

both, depending critically on the degree of commitment to economic development of the local government. Very little is known, however, why some local governments are more benevolent than others.

Some provinces even nurture crony private companies to help them mobilize resources from the central government. Nominally, these firms are delegated by local governments to raise funds for local development projects. With this delegation, not necessarily in official form, these companies start their lobbying efforts, possibly first by lobbying the centerð e.g., the planning agencies and line ministriesð to insert their projects into the master plan. They then take this master plan to the Ministry of Finance to apply for disbursement. Another channel is that, under the name of raising funds for local economic development, the crony companies can directly ólobbyô the Vietnam Development Bank, state-owned commercial banks, and the Economic Stimulus Funds for outright subsidies or loans with preferential interest rates. For example, during the period of economic stagnation, subsidies from central government to Ninh Binh province in 2009 increased by 1.8 times compared to 2008 (while on average, the subsidy increased only 1.4 times), thanks in significant part to the óeffortsô of a couple of key private domestic firms in the province.

## VIII. Financial Market Reforms

### 1. Inflation Control Following Doi Moi

*Doi Moi* took place in 1986 when the economy faced a huge macroeconomic challenge and was on the verge of a financial crisis. The liberalization of prices, elimination of stamps (permissions paid for ordinary activities), and cutting of subsidies exposed losses of state-owned companies and widened budget deficits. The resort to deficit financing led to the consumer price index rising in hundreds of percent a year for three years. By 1990, it was clear that hyper-inflation was not only threatening the entire *Doi Moi* program but the whole political system. The Party leadership, which went through the first generational change in 1986, decided to let the technocrats at the Office of the Council of Ministers, the State Bank of Vietnam (SBV), and the Ministry of Finance to implement a comprehensive inflation control program. On the fiscal side, the state budget deficits were reduced in 1990. By 1991, the entire budget deficit was financed through government bond issuance rather than money printing (see HIID 1994). On the monetary side, SBV succeeded in limiting the amount of money created. Inflation slowed down remarkably to 5% in 1993 (see Figure 8.1). This successful experience with macroeconomic management points to the state effectiveness helped by decisive political leadership at a time when not many government officials had any training in macroeconomic management.

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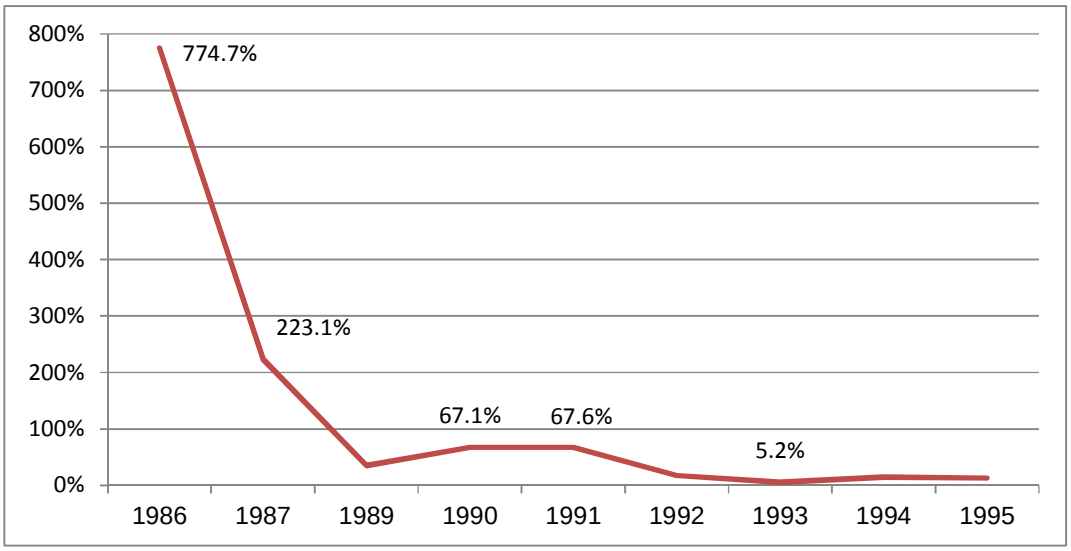
Development Corporation (Becamex IDC) in Bình Dương province and Tín Nghĩa Corporation in Dong Nai province.

**Figure 8.1: Inflation in Vietnam, 1986-2014**




Source: General Statistics Office of Vietnam

## 2. From a Mono-Banking to a Two-Tiered Banking System

Vietnam has moved in a relatively short period of time from a rudimentary financial system dominated by state banks to a diversified financial system consisting of state, private and foreign banks, government and corporate bonds, two equity markets, insurance, leasing and non-bank finance companies.

Under the central planning system, the entire financial system was characterized by a mono-bank structure under which all formal financial transactions were undertaken only through one institution called the State Bank of Vietnam (SBV) acting as both a central bank and a commercial bank. SBVôs mandate was to support central planning by channeling financial resources to various sectors of the economy under the direction of the State Planning Commission. In addition, the Government also owned and controlled directly two specialized banks, the Bank for Foreign Trade of Vietnam (Vietcombank) and the Bank for Investment and Development of Vietnam (BIDV). VCB financed foreign trade activities and governed foreign exchange in addition to supporting state-owned enterprises (SOEs), while BIDV provided long-term capital to infrastructure projects and public works. The banking system was a tool to implement the government's policies, to meet fiscal needs and to meet the financial needs of SOEs. Directed credit at low nominal interest rates combined with high inflation created negative real interest rates. Lending rates were set lower than deposit rates, reflecting the government policy of supplying credit subsidies.

The year 1988 saw the first major reform in the Vietnamese financial and banking system. Decree No. 53/HDBT dated March 26, 1988 issued by the Council of Ministers triggered a shake-up of banking with three important reforms: (i) the fiscal management function was separated from the SBV to form the State Treasury system; (ii) the commercial function was taken out from the SBV and assigned to the specialized banks; (iii) two more specialized banks were formed: the Industrial and Commercial Bank of Vietnam (Vietinbank), and the Bank for Agricultural Development of Vietnam which was later renamed the Vietnam Bank for Agriculture and Rural Development (Agribank). The four specialized banks operated exclusively

in their own fields until this restriction was abolished and private commercial banks were formed following the promulgation of the Law on the State Bank and the Law on Credit Institutions in 1990.

The economy, however, faced a serious shock in 1989-90 when many credit cooperatives, the main source of finance for the private sector at the time, became very fragile. Most of them eventually became bankrupt with losses born by depositors. The root cause of this financial collapse was actually the eagerness of the party-state to solve the credit bottleneck for both the state-owned companies and private businesses. It became much easier to enter into the financial sector and this resulted in a rapidly growing number of credit cooperatives and credit funds. From the first one founded in the south in 1983, the total number of credit cooperatives and credit funds increased to 7,180 by the end of the 1980s (Vuong Nhat Huong et al. 2002). Starting from 1988, not only credit cooperatives but any non-financial private business could mobilize funds from the public without any interest rate control or financial regulation from the government.[60] Ponzi schemes quickly arose with the most spectacular scandal of Thanh Huong Perfume Company.

### 3. From Financial Repression to Financial Deepening in the 1990s

After the successful establishment of the two-tiered banking system and on the back of the costly credit cooperative crisis, the government was quick to put in place a new regime of financial regulations including a licensing procedure for new and branch establishments, reserve requirements, interest rate controls, and taxation. However, this regulatory change was implemented both for better prudential regulation and to support financial repression. Under the new system the government intervened in the financial sector by imposing quantitative or qualitative restrictions on the activities of financial institutions and markets so that financial resources could be mobilized cheaply and directed towards SOEs and public investment projects (Nguyen Xuan Thanh 2003). The four state-owned commercial banks were seen as the primary instruments of financial repression. The current Vietnamôs development model of investment-led growth with low TFP growth and inefficient SOEs has a lot to do with the changes in the financial system in the early 1990s.

McKinnon (1973) and Shaw (1973) have argued extensively that financial repression in the forms of interest rate controls, high reserve requirements and heavy taxation, and predominance of directed credit reduces real interest rates, and the size and quality of loanable funds all of which lead to a low level of financial development. However, what happened in Vietnam during the 1990s and 2000s was an impressive financial deepening process with all measures of financial assets and credit rising as a percentage of GDP. Two other major policies help explain this experience, besides the obvious fact that initial M2/GDP ratios started at a low level due to the hyperinflation that ended only in the early 1990ôs.

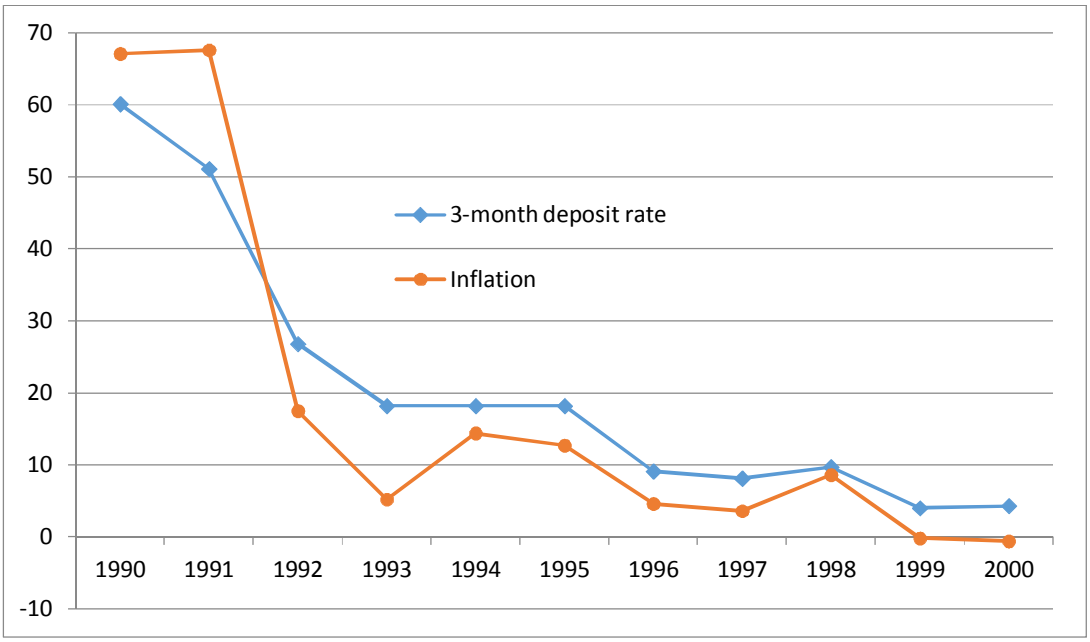
Firstly, while financial repression was pursued, the Vietnam senior political leaders (not just the technocrats) through their own experience of the late 1980s understood very early on the importance macroeconomic stability and started to look to East Asian economies for

[60] Decree 27-HĐ BT of the Council of Ministers dated March 9, 1988 on the promulgation of policy to support private industrial, services, construction, and transport businesses.

development experience. One lesson they learned was keeping real interest rates in the positive territory. As shown in Figure 8.2, deposit rates were kept above inflation during a period in which there were interest rate ceilings. This policy greatly improved public confidence in the banking system. Broad money (M2) remained more or less unchanged during the first half of 1990s, but increased from 23.0% in 1995 to 50.5% in 2000.[61]

Secondly, joint-stock commercial banks (JSCBs) were allowed. Many of the first JSCBs were setup through mergers and consolidations of surviving credit cooperatives.[62] As argued in the above sections, while the CPVôs ideology of maintaining the dominance role for the state, the government was also under pressure to create growth and jobs that it knew could only come from domestic private and foreign companies. Just within the financial sector, what was accepted by the Party and implemented by the government was the creation of domestic private banking to serve private companies and foreign and joint-venture banking for FDI firms (see Table 8.1). Domestic credit to the non-state sector of the economy rose from 2.5% in 1992 to 8.0% in 1995 and 14.6% in 1999.

**Figure 8.2: Nominal Deposit Rate and Inflation (%), 1990-2000**




Source: Vietnam General Statistics Office for inflation data, World Bank, Vietnam Financial Sector Review, 1995 for interest data from 1990 to 1994, and IMF, Vietnam: Selected Issues, IMF Staff Country Reports, 1998-2002 for interest data from 1990 to 2000.

**Table 8.1: Vietnam's Banking System, 1988- 2014**

| Commercial Bank | 1988 | 1994 | | 1998 | | 2014 | |
|---|---|---|---|---|---|---|---|
| | Number of banks | Share of total assets (%) | Number of banks | Share of total assets (%) | Number of banks | Share of total assets (%) | Number of banks |
| **State-owned banks** | **4** | **89** | **4** | **82** | **4** | **44** | **5** |

[61] IMF, Vietnam: Selected Issues, IMF Staff Country Reports, from 1998 to 2002.
[62] Twenty two out of thirty three JSCBs today were originally established during 1991-1994.

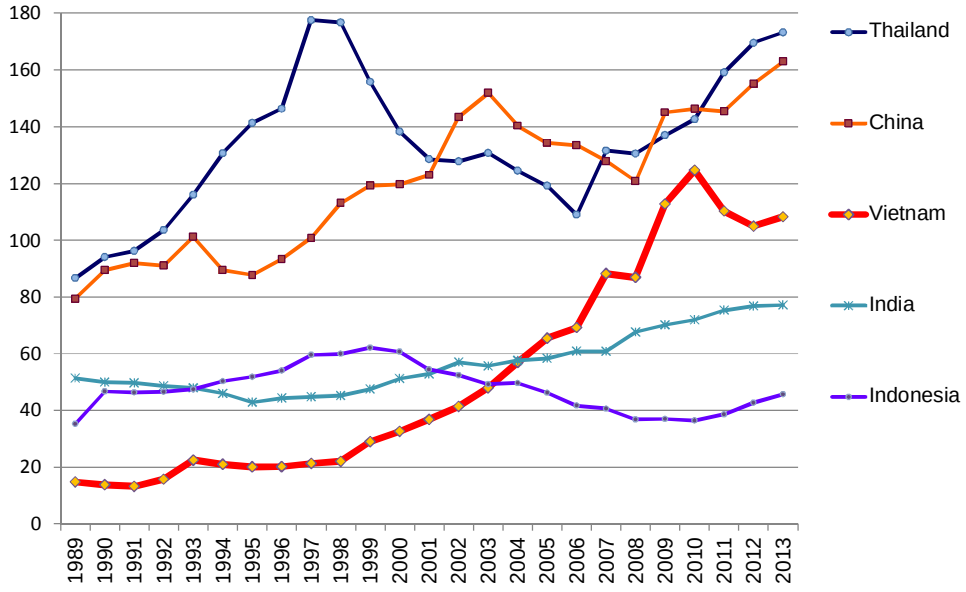
| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Vietcombank | | 33 | | 22 | | 8.9 | | |
| Agribank | | 20 | | 19 | | 14.5 | | |
| BIDV | | 16 | | 22 | | 10 | | |
| Vietinbank | | 21 | | 19 | | 10.2 | | |
| **Other Banks** | **0** | **11** | | **18** | | **56** | | |
| Joint-stock banks | | ... | 46 | 10 | 51 | 42.7 | 33 | |
| Joint-venture banks | | ... | 3 | 8 | 4 | 10.8 | 4 | |
| Foreign banks & branches | | ... | 13 | | 23 | | 46 | |

Source: World Bank, Vietnam Financial Sector Review, World Bank Country Report, 1995; and IMF, Vietnam Selected Issues, IMF Staff Country Report No 99/55, 7/1999. The 2014 data are provided by SBV.

### 4. Financial Deregulation, Cross-ownership, and Restructuring

The 2000s saw further rapid expansion of the banking sector in Vietnam. Bank credit relative to GDP increased from 20 percent in the late 1990s to 124 percent at the end of 2010 (Figure 8.3). While the credit expansion in the 1990s and the early 2000s was associated with real financial deepening, in recent years it was the result of loose monetary policy and financial deregulation. After many considerations and gradual steps, interest rates were liberalized in 2002. Banks could price their loans according to borrowersô risks and compete in attracting deposits. Not only the banking sector, but also non-bank financial institutions such as life-insurance companies and the stock markets are able to mobilize large sums of money from the public (VELP 2012).

**Figure 8.3: Domestic Credit Provided by the Financial Sector as a Percentage of GDP (%)**




Source: State Bank of Vietnam for Vietnam from 1989 to 1991 and World Bank, World Development Indicators Database for others..

However, cross-country evidence has shown that the impact of the financial system on long-term economic growth happens more through improving the productivity of capital than through increasing the degree of capital intensity. In other words, increasing the amount of loanable funds and investment does not guarantee fast economic growth in the long run; the economy needs its financial system to screen investment projects, distribute and transfer risks, and monitor

managers so that the growing loanable funds go to the most productive uses. It is the latter that the financial system in Vietnam has not been able to do (VELP 2012).

Even though state-owned banksô shares of domestic lending and assets are falling, their influence on the macroeconomy is still substantial through state directed-lending. They remain the main source of financing for state owned enterprises, and they are subject to political pressure to make loans to favored SOEs by central and provincial governments. The equitizations of Vietcombank, Vietinbank and BIDV were still nominal with the banks remaining essentially state-owned and state-directed.

From 2005 to 2008, it was too easy to open a private bank in Vietnam. Like Argentina and Chile in the 1970s, and Indonesia in the 1980s, the government was not sufficiently selective in the awarding of bank licenses. Within a short period of time, ten small rural banks were allowed to become urban commercial banks operating nationally. The result was rapid credit growth as inexperienced bankers acquire high risk assets and fail to diversify their portfolios. International experience has also shown over and over again that easy money coupled with weak governance over an extended period of time always results in banking system problems.

Vietnamôs banking sector is subject to pervasive cross-ownership and connected lending with SOEs owning banks, banks owning non-financial companies and other banks, and many joint-stocks banks falling under the control of well-connected investors through special investment vehicles.[63] Though different schemes of cross shareholding, the banks and their owners can evade most of the prudential regulations, even if some of these regulations conform to international standards (Nguyen-Xuan Thanh et al. 2013).[64]

Cross shareholdings may enable companies to secure stable sources of funding from the banks that they partly own. Current regulations prevent banks from lending to their own shareholders. However, this rule is often sidestepped as banks choose to lend to subsidiaries instead of parent companies. Japan, Korea, Thailand, and Indonesia all suffered severe economic difficulties resulting from cross-shareholding between banks and industrial companies. Because of connected lending, banks fail to appraise and monitor their loans properly when lending to their corporate shareholders, resulting in large non-performing loans. The relationship between state owned enterprises and some joint stock banks provides a valuable cautionary lesson (Nguyen-Xuan Thanh et al. 2013).

The involvement of SOEs in bank cross-shareholdings was a direct result of the state-economic-group policy discussed in the Section V. As the SEGs and general corporations were not only allowed but encouraged to go into new businesses, taking stakes in joint-stock banks became attractive. While state-owned banks were directed by the government to lend to SOEs, the joint-stock banks were under no such pressure. However, SOEs have acquired shares of many joint stock banks, which then bought bonds issued by the same SOEs or lent money to their

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[63] See Vietnam Program at Harvard Kennedy School, Structural Reform for Growth, Equity, and National Sovereignty, Policy Discussion Paper prepared for the Vietnam Executive Leadership Program, 2012.

[64] See Nguyen-Xuan Thanh, Vu Thanh Tu Anh, Tran Thi-Que Giang, Do Thien-Anh Tuan et a. (2013). ñCross Ownership of Financial Institutions and Corporations in Vietnam ï An Assessment and Recommendations.ò The Vietnam Economic Committee of National Assembly and UNPD Vietnam.

subsidiaries. These loans are political rather than commercial in nature. If the companies cannot service their debts, the joint stock banks involved in these transactions are at risk of failure.

The 2000s also saw the rise of Vietnamese oligarchs who build their private businesses based on connections with the state system. These connections allowed them to take control of many banks which were established in the early 1990s as well as the newly upgraded rural banks in in the mid-2000s. However, unlike the credit cooperatives in the late 1990s and private bank owners in the early 1990s who could freely engage in connected lending in the absence of relevant laws, there are now financial regulations.

2006-2011 was actually a time period when both the legal framework and banking supervision processes were continuously reformed and improved. Prudential regulations have been extended to cover capital adequacy, credit and investment restrictions, liquidity, solvency, and loan loss provisioning. Cross-shareholding became a mechanism for the banks and their large shareholders to evade and even neutralize these regulations. For example, by owning multiple banks, a group of shareholders could borrow from one bank to increase equity of another, making the capital adequacy regulation meaningless. By disguising ownership through investment vehicles, they can also overcome legal restrictions on banksô ability to extend credit to or make investments in the shareholdersô other businesses. Bad assets and non-performing loans can also be easily hidden by transferring them across financial and non-financial institutions controlled by the same group of investors.

Towards the end of 2011, the vulnerability of the banking sector was totally exposed with a significant number of banks suffering from serious liquidity problems as the corporate sector weakened and the real estate market froze. SBV was forced to provide liquidity support to many banks, and later produced a system-wide restructuring plan. From November 2011 to February 2012, SBV focused on nine ñweakò joint-stock banks, which were deemed to be illiquid, could become insolvent in the near future, and thus would require significant recapitalization. As directed by the government, SBV was to supervise the restructuring process of the weak banks in the following pecking order: (1) existing shareholders recapitalized their banks with new equity infusion; (2) if option 1 was not feasible then existing shareholders would have to find outside investors to recapitalize their banks through M&A; and (3) if option 2 was also not feasible then SBV would assign other financial institutions to take over (VELP 2013).

The efforts of liquidity support and restructuring of weak banks by SBV have helped stabilize the banking sector. By mid-2013, liquidity was more or less restored across the whole banking system. However, non-performing loans (NPLs) continue to rise and credit growth remains weak. While the officially-reported average NPL ratio is in the 3.2-4.7 percent range during 2014-2015,[65] the ñrealò number given by SBVôs inspection department was as high as 9 percent.[66] The NPL numbers given by international credit rating agencies are even higher.

[65] NPL statistics officially reported on SBV website, http://www.sbv.gov.vn/portal/faces/vi/vim/vipages_trangchu/tkttnh/hdhttctd/tlnx?_adf.ctrl-state=1dohn3qov1_4&_afrLoop=7370169402856800

[66] SBVôs Press Release, 21 February 2014.

Moodyôs estimate problem loans in Vietnamôs banking sector to be around 15 percent of total assets.[67]

A public sector solution was evidently needed to correct the NPL problem. Given a strong public opposition to any explicit bailout of banks, SBV setup the Vietnam Asset Management Company (VAMC) to buy bad debt from banks through the issue of government-backed special bonds. The key challenge is that VAMC is still struggling to build up capacity (in financial and human capital), and to find ways to quickly liquidate and/or restructure the purchased bad assets. Even if the NPLs transferred to the VAMC are not addressed the banks can immediately reduce their NPL ratio on their book to under 3 percent and use the special bonds to borrow from the State Bank of Vietnam (SBV). The policy objective is to relieve the banks of the NPL burden and encourage them to make fresh loans (VELP 2013).

However, a thoroughgoing structural reform is still needed to bring the banking sector to a healthy state. Essentially, many banks will have to be recapitalized with real equity. The opportunity here is to use recapitalization of weak banks as an effort to reduce the extent of cross-ownership in the banking sector. It is, however, proving very politically difficult to restructure the private JOCBs whose major shareholders are well connected. Again, similar to Vietnamôs reform and restructuring experience in other areas, it was ideology that kept the financial sector stuck with state-owned commercial banks making inefficient lending and investments while resisting reform efforts with the help of special interest groups. At the same time the fragmented political power structure gives rise to the prevalence of what is often referred to as regulatory forbearance with regard to private financial transactions. All of this happened while the technical capacity of SBV and many other economic ministries were continually strengthened and better regulatory instruments were made available.

## IX. Conclusion

This paper is a positive analysis of how differences in power structure, ideological compromise, and state effectiveness help explain major economic reforms and economic performance in Vietnam over the past 30 years.

First, Vietnamôs experience has been consistent with the statist literature in suggesting that a prerequisite for rapid growth in a developing country is that its leaders single-mindedly commit to economic growth and put national interests above political, ideological and personal interests. These are preconditions for the ruling elites to form a close alliance with the most productive forces, build strong reform coalitions, and create a meritocratic bureaucracy.

In the Vietnamese case, because the alliance with the most dynamic and efficient sectors was viewed by many as a temporary concession rather than a coherent strategy, the success was only partial. More fundamentally, because of the orthodox ideology at the beginning of reforms and later on due to a symbiotic economic relationship with the SOEs, the Vietnamese party-state has chosen to rely on the SOEs, which are persistently the least efficient sector in the economy. Additionally, the fragmentation of power and inherent lack of effectiveness render the state incapable of imposing hard budget constraints on the SOEs or sanctions them for

[67] Moodyôs Investors Service, Vietnam Banking System Outlook, 18 February 2014.

underperformance. Without effective ósticksô, and an over reliance on ócarrotsô for political support, the state-business relationships run the risk of being degraded into clientelism and corruption rather than accomplishing developmental goals.

Second, the relationship between the state and business will influence the institutions and the quality of co-ordination between them. In Vietnam before 1986, when private businesses were deemed to be subjects of ósocialist rehabilitationô, there could hardly be any possibility of co-ordination between the state and the private sector. True co-ordination first requires a certain degree of equality between the parties involved, and therefore never exists when the state assumes the dominant role and the private sector is merely subservient. This implies that, for non-capitalist countries, before discussions about the optimal institutions for effective state-business co-ordination, it is necessary to analyze the role of the business sector in the vision and strategy of the ruling elites.

Third, it has long been asserted that industrial development requires effective co-ordination between the public sector and businesses.[68] This co-ordination, in turn, requires effective co-ordination in the state system itself as well as in the business sector. In Vietnam, the co-ordination within the business sector is inefficient, partly because of the clear hierarchical structure dominated by SOEs, and partly because business associations are often designed as extended arms of the party-state rather than representatives of business community. In addition, there is no incentive for different government agencies to coordinate on policy implementation. Under these conditions, the consolidation of state-business co-ordination authority can be necessary. Although Vietnam has never had any institutions even close to the Economic Planning Board in South Korea or the Council for Economic Planning and Development in Taiwan, the co-ordination by the PMRC and the Implementation Task Force led to the impressive success of the 1999 Law on Enterprise. In contrast, with the concentration of controlling power over SEGs and the disbandment of the PMRC right after taking office, the new Prime Minister has, on the one hand, created ósocialist cronyismô and, on the other hand, destroyed the very little ócorporate coherenceô and óembedded autonomyô existed in the bureaucracy. A strategy is needed to achieve productive coordination.

Fourth, the greatest effect on development does not necessarily come from narrowly-defined industrial policy per se, or even from purely economic policy. As evidence in the case of Vietnam, political compromises about the role of the private sector are the foundation in which economic and industrial policies are shaped. This also implies that industrial development runs the risk of being reversed because of changes in leadership or political coalition. If domestic private investments are always insecure, fewer of them will be made.

Fifth, state effectiveness plays a critical role to the success of the reform in general and in the formulation and implementation of reform policies in particular. In a market economy which is becoming more complex and integrated, state effectiveness can be enhanced not only by strengthening the technical capacity of public agencies, but also by focusing on the core role such as to establish modern market institutions, correct market failures, and improve economic

[68] See Amsden 1989, Johnson 1987, Evans 1995, Kohli 2004, Schneider 2013.

equality. In the case of Vietnam, state effectiveness is also reflected by its ability to overcome the opposition of the privileged groups who would become disadvantaged in the reform process.

Finally, a qualification should be added to our discussion on the impact of decentralization on the state-business relationship. Our analysis of the serious negative implications of decentralization in Vietnam by no means implies that decentralization is necessarily ineffective and should not be implemented. Quite to the contrary, decentralization is necessary because it provides incentives for local governments to stay closer to local people and businesses. What this paper does suggest is that the effects of decentralizationð both positive and negativeð with respect to the state-business relationship should be seriously taken into account for an effective decentralization program. A stronger and neutral legal system would help the creation of an effective program.

This paper also offers some implications with respect to the reform trajectory in Vietnam. The nature of fragmented power and the inherent differences between the reform-minded and conservative-minded party members make it almost certain that reform is an incremental process. Vietnamôs reform experience to date shows that decisive reform breakthroughs can only emerge under crisis conditions, when the preference differences between reform-minded and conservative-minded groups can be narrowed since both groups are forced to put their own preferences aside for the sake of preserving the regimeôs legitimacy.

Since mid-2000s, the emergence of the state conglomerates, economic fragmentation and divergence among provinces, and the emergence of private cronyism all together have profoundly transformed the political economy of Vietnam. This means that the privileged group is now not only more powerful but also has become more organized. It can, therefore, be foreseen that the path of reform ahead will even be rougher, and that if the political power structure in Vietnam continues to be fragmented, then there will not be any decisive reforms away from the status quo.

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