
by

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Declaration

In compliance with the rules of the Degree of Doctor of Philosophy of the Australian National University, it is affirmed that, except where otherwise stated, the work contained in this thesis is my own.

Dung Tuan Nguyen
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ABSTRACT

Foreign Direct Investment (FDI) benefits the recipient country in a number of ways: it provides additional capital resources to finance investment activities in the country; and it often transfers new technologies, management and marketing skills into the host country. In many developing countries, special incentive measures to attract FDI have been granted by the host governments to foreign investors.

Recognising the important role of FDI in economic development, Vietnam provides investment incentives with fewer requirements to foreign investors, allows foreigners to invest in any sector of the Vietnamese economy, and does not limit participation of foreign investors. After ten years of implementing modest investment policies, Vietnam has gained favourable initial results. FDI has increased rapidly since 1992. The rapid economic growth and import-substitution policies have been the most important factors attracting FDI flow into Vietnam. FDI has already made a significant contribution to Vietnam's economic development, and has become an important source of capital for the country's economy.

However, the government policy that gives state-owned enterprises privileges over private ones, and policies of protectionism are distorting FDI away from taking advantage of Vietnam's low-cost labour. Moreover, the country's foreign investment legal systems are incomplete and constantly being modified; in the process of implementation, there is a gap between legislation and practice. This has had negative effects on FDI inflow to Vietnam, and limited benefits from FDI that Vietnam could have had in recent years. Thus, Vietnam has to improve, and adjust to become more attractive to foreign investors. The main guideline for further reform is that FDI can be made more effective by giving domestic and foreign investors the same treatment
and improving the general investment climate. In terms of policy, the latter means that FDI policy should be part of a larger, more general investment policy reform where several policy areas need to be liberalised or rationalised. In terms of procedure, the whole regulatory framework needs to be streamlined to achieve greater transparency and stability.
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Chapter 1: INTRODUCTION

Foreign investment can take two forms: portfolio investment and direct investment. In the first form, foreign investors buy a stake in an enterprise to earn profits or to gain capital appreciation, while “a foreign investment is treated as direct if the entity has a financial equity interest in a foreign company sufficient to give it some control or influence over the latter’s decision taking” (Dunning 1994: 62). According to data collecting agencies, in order to have control or influence over a company’s decision making, an investor has to hold somewhere between 10 percent to 20 percent of the equity of an enterprise. Direct investment may be designed to inject new resources and management skills into an enterprise or to acquire new profitable assets. Firms that establish affiliates abroad are distinguished from existing firms in the host country by the fact that they bring with them not only capital but different technology, production management, and organisational and marketing systems that constitute their firm-specific advantage and allow them to compete successfully with local firms which have superior knowledge of local markets.

The growing share of foreign direct investment (FDI) in the total net resource flows to less developed countries (LDCs) has revived interest in the costs and benefits arising from foreign investment flows. The average inflows of FDI to LDCs over the period 1983-87 was only US $18 billion; it exceeded US $130 billion in 1996, a more than fivefold increase (IFC 1997). Portfolio investment in developing countries has also increased rapidly from a few billion US dollars in 1987 to over $40 billion in 1996.

East Asia is a major destination for FDI, accounting for over half of total direct and portfolio flows to all developing countries, and it is expected to remain the leading
recipient region. FDI inflows to East Asian countries grew from $1.3 billion US dollars in 1980 (equal to 10 percent of net capital flows), to $43 billion US dollars in 1994 (or 50 percent of net capital flows) (World Bank 1996a). Strong market-opening reforms in the form of the liberalisation of trade and investment regimes, and the subsequent high economic performances in East Asian countries, are believed to be the main factors behind this increase.

Until the 1950s, the theory of international capital movement, based on differences in the rates of return to capital between different countries, was used to explain the FDI phenomenon. It helped to explain portfolio investment, but failed to explain FDI flows, which often travel in the opposite direction. A new approach, which attempted to explain FDI flows from a firm’s point of view, utilising microeconomic theory, especially the oligopolistic theory of the firm, was offered by Hymer (1960). This framework was developed by Kindleberger (1969) and Dunning (1977, 1981).

According to this approach, a firm, which chooses to invest abroad enjoys three kinds of advantages: firm (ownership), location, and internalisation advantages. First, the firm must possess a firm-specific advantage (such as superior technology, proprietary rights or firm-specific production), which gives it some degree of monopolistic power in the market. Second, there must be a location-specific advantage (such as natural resources, or government policies) in the recipient (host) country, which make international production more profitable than direct exports. Finally, there may be an internalisation advantage which makes FDI more attractive compared with licensing or exporting.

It is now widely accepted that recipient countries can benefit from FDI, which brings much needed capital that helps host countries to fill the gap between domestic
savings and investment demand. Another advantage of foreign direct investment over other types of external capital and domestic capital is that it provides not only financial flows but also brings additional benefits in the form of technology transfer, enhanced technical and management skills, and improved access to export markets through existing marketing and distribution networks. The host country can also benefit from foreign direct investment through job creation, increased tax revenues, a positive impact on trade and the balance of payments, increased competition in the domestic market, and reduction of monopoly profits.

Observing the successful lessons from East Asian countries over recent decades, many LDCs which were formerly closed to FDI now encourage it, and actively compete by removing inhibiting regulations and offering incentives for foreign firms. In the 1970s and 1980s, Vietnam experienced prolonged recessions and economic crises caused by a combination of central planning, and poor management. With the difficulties experienced by the former Soviet Union in the 1980s, the biggest donor to Vietnam at that time, Vietnam’s economic position became more critical due to a sharp reduction in Soviet financial assistance. Facing these critical problems, in 1986, the Vietnamese government openly committed itself to economic reform (doi moi) in many aspects of society.

In 1986, along with efforts to expand trade based on outward-oriented policies, the Vietnamese government recognised that FDI inflows could make an important contribution to economic development. To open the door to foreign investment has been considered an important component of the economic reforms of the Vietnamese government. To attract foreign investment, the Vietnamese government promulgated the New Foreign Investment Law (FIL) in 1987. In accordance with other steps to
create a more attractive environment for foreign investment, the Law has been revised and amended several times (in 1990, 1992, 1994 and 1996).

In the ten years after the implementation of Vietnam’s FIL, foreign direct investment inflows increased strongly - from $60 million USD in 1988 to over $2 billion in 1996, and 1997, a tenfold increase. Foreign-invested enterprises are now present in almost all industries and provinces of the country. The foreign-invested sector (including all enterprises with foreign invested capital) has positively affected Vietnamese economic development through its significant contribution to the country’s output growth, exports, job creation, and technical development and training.

Despite the above mentioned developments, however, FDI in Vietnam remains constrained by an incomplete and frequently changing legal system and complicated regulations governing investment. The positive effects of FDI on the economy are limited by the recent trend towards protectionist policies and import-substitution. As well, they are hindered by the lack of competition in the domestic market caused by discrimination against the private sector and the privileges given to the less efficient state sector (such as easy access to land, bank credit, and import-export facilities). An improved regulatory and legal framework would encourage other foreign investors to invest, while further state-owned enterprise reforms to remove the disincentives to private sector development could create more favourable conditions for attracting foreign firms into the domestic private (rather than the state) sector, and strengthen the positive effects of FDI in Vietnam.

Understanding the nature, motives and possible impact of FDI on the country’s economic development is essential to devising policies that encourage FDI inflows as well as strengthen the positive effects of FDI. This study examines the determinants
and effects of FDI in Vietnam. To investigate factors influencing foreign firms’
decisions to invest in Vietnam, the Vietnamese government’s policy towards FDI is
assessed first; then quantitative studies are carried out to test some “pull” factors, such
as market size, import substitution policy, and labour costs, that may attract foreign
investors to do business in Vietnam. “Push” factors (such as changes in economic
conditions in source countries, and transport costs) from investing countries are also
analysed. Further empirical study is undertaken to determine the effects of FDI on
Vietnam’s economic growth. The study also analyses other effects of FDI on the
country’s development (such as capital formation, job creation, technology innovation,
and the balance of payments). Results indicate a need to encourage FDI inflows as well
as strengthen the positive effects of FDI on the country’s development through
improvement of the investment climate, reduction of controls, trade liberalisation, SOE
reform, and promotion of the private sector.

The study is organised as follows. Chapter 2 reviews the main theories and
empirical studies of determinants of FDI and its impact on the host country to provide
the analytical framework. The advantages and disadvantages of the main economic
theories concerning FDI - the theory of capital movement and the oligopolistic theory
of FDI - are discussed in the first part of this chapter. The second part reviews the
main economic effects of FDI such as on economic growth, aggregate income and
distribution effects, employment, transfer of technology and labour training, saving and
capital formation, and balance of payments.

To put FDI into perspective in Vietnam, the Vietnamese economy is discussed
in Chapter 3. Economic conditions and policies (such as trade and exchange rate
policies) directly or indirectly affecting foreign direct investment are addressed in this
chapter. The chapter also includes a discussion of the expected benefits that FDI can bring to Vietnam. Chapter 4 compares Vietnam’s foreign investment policies with those of other Asian developing countries, particularly Indonesia - a major competitor of Vietnam's in attracting FDI. The comparison emphasises the advantages and disadvantages of Vietnam's foreign investment law in attracting foreign investors. Characteristics of FDI in Vietnam are also presented in this chapter.

In Chapter 5, the “pull” factors of FDI in Vietnam, such as political and macroeconomic stability, market size, labour costs, profitability, as well as investment incentives provided by the government are discussed. The impact of some of these factors is tested using secondary data on FDI for the period 1988-92. The “push” factors of FDI (such as changes in economic conditions and in external policies in source countries) are examined in the chapter as well. The determinants of the location of foreign investment projects in Vietnam are analysed in Chapter 6.

The positive and negative impacts of FDI on Vietnam's economic development are examined in Chapter 7. An econometric model is developed to test the effects of FDI on the country’s economic growth. Chapter 8 draws conclusions and policy implications from the analyses in the previous chapters.
Chapter 2: THEORIES OF FOREIGN DIRECT INVESTMENT

2.1. Determinants of foreign direct investment

Prior to the 1950s, explanations for the existence of FDI were based on theories of international capital movement whose fundamental premise was the theory of comparative advantage. Later, industrial organisation theory was developed to answer the main questions of “why”, “how” and “where” foreign investment takes place; questions which the theories of international capital movement could not answer. This chapter discusses the advantages and disadvantages of the main economic theories - the theory of international capital movement, and the oligopolistic theory of the firm - in explaining foreign direct investment.

2.1.1. The theory of capital movement

Prior to the 1950s, the neo-classical model whose fundamental premise was the theory of comparative advantage - the dominant paradigm in international economics at that time- was used to explain international production. Under the assumptions that a market is perfectly competitive, risk and uncertainty are absent, technology is free and instantaneously transferable between firms and countries, and that investors are concerned to maximise the rate of return on their investments, the neo-classical model says that capital will move from one country to another in response to differences in the rate of the return to capital, i.e., capital moves from where it is relatively abundant and cheap to where it is scarce and dear. This theory is able to explain international portfolio investment.

However, when applied to FDI, this model of capital movement hardly provides an adequate explanation for several observed facts. First, it is common today that large corporations in capital-rich countries with similar relative factor endowments
penetrate each other by two-way investment which appears in the same industry. In addition, empirical evidence in LDCs shows that an increasing number of capital-poor countries invest in other countries at the same income level or even in capital-rich countries. For example, some firms from Vietnam—one of the most capital-poor countries in the world—have invested in Japan, the second largest capital-rich country in the world. Second, if the difference in rates of return in two countries is really important for capital movement, it will create a flow of portfolio capital rather than FDI which has a much higher cost of establishment and risk. Third, since FDI also brings in not only capital but also other production factors such as technology, and managerial and marketing skills, capital may be simply a conduit for the transfer of these factors rather than a reason for the existence of FDI. Finally, the key assumption of a perfect competitive market in the neo-classical model may not be valid in the case of FDI because most of the firms with foreign operations are large corporations possessing considerable monopolistic power:

"...In a world of perfect competition for goods and factors, FDI cannot exist. In these conditions, domestic firms would have an advantage over foreign firms in the proximity of their decision-making centres, so that no firm could survive in foreign operation."

Kindleberger (1969: 13)

2.1.2. Oligopolistic theory of FDI

By 1960 the neo-classical model of capital movement with its restrictive assumptions of perfect competition, zero transaction costs, and interest rate differentials as the sole driving force of foreign value-added activities of firms was still the most accepted explanation of international capital movement. However, it was widely recognised that this model failed to address the central questions of “why” and “how” FDI takes place. In 1960, the oligopolistic theory of multinational enterprises
(MNEs), that broke the intellectual straitjacket of the neo-classical theory, was first propounded by Hymer (1960). It was later further developed by Kindleberger (1969) and Dunning (1981). This approach shifts the focus from macro theories of capital movement to a microeconomic explanation of firm behaviour.

This theory provides a much more realistic and comprehensive explanation of the existence and growth of FDI, and also of two-way direct investment among different countries. The oligopolistic theory attempts to explain the conditions under which a particular market will be supplied by foreign subsidiaries rather than local firms or imports. The essence of the oligopolistic theory is that a firm which undertakes direct investment abroad would normally be at a disadvantage compared with existing or potential local competitors in the host economy, due to additional costs of travel, communication, and lack of knowledge about local markets. Given these disadvantages, if the local market is perfectly competitive, there will not be direct investment because the host market would be served by local firms. Therefore, the firm must possess some special advantages which at least offset these costs of producing abroad and keep it in steady competition with existing and local competitors (Liu 1997, Dunning 1994, McKiernan 1992).

Firms' decisions to involve foreign production depends on their possessing or being able to acquire certain assets not available, or not available at such favourable terms, to local firms. These assets include not only tangible assets, such as natural endowment, manpower and capital, but intangible assets (capabilities) such as technology and information, managerial, marketing and entrepreneurial skills, organisational systems, and access to intermediate or final goods markets.
This rationale suggests that FDI will be undertaken when there is either some imperfection in product and factor markets including, among other things, the latest technology, marketing and management skills, or else interference of government or firms in competition. Therefore, a necessary condition for FDI to take place is that the advantages of investors are firm-specific or monopolistic, i.e., not possessed by actual and potential local competitive firms (Lall and Streeten 1977). However, it should be clear that the monopolistic or firm-specific advantages, while they are necessary, are certainly not sufficient for FDI. Still left open are many important questions, such as: Why do not all firms with similar advantages invest abroad? Why do firms choose FDI as a form of internalising rather than producing domestically and then exporting? Why do firms not sell (externalise) their advantage rather than directly internalise?

To address these issues three additional theories have been proposed to explain sources of firm-specific monopolistic advantages of foreign firms over local firms: internationalisation and externalisation of firm-specific advantages, and the eclectic approach to FDI. The first two theories can help to explain which industries are likely to be supplied mainly by foreign subsidiaries and imports rather than by local producers. The last helps to ascertain why foreign firms choose to utilise their firm-specific advantages in production abroad rather than through domestic production and exports to foreign markets.

2.1.2.1 Sources of firm-specific advantage

Generally, sources of firm-specific advantage are divided into four categories: product market imperfections; factor market imperfections; economies of scale; and multinationality. Obviously, foreign firms may possess one or more of these sources of advantages while one may be more significant than another.
Product market imperfections

Some firm-specific advantages result from product market imperfections, including product differentiation, unique marketing skills and some collusion in pricing. Product differentiation is normally based on slight variations in presentation, appearance and performance. The technology, design, brand name or other subjective distinctions are main keys of product differentiation and are usually protected by patents or copyrights and can be transferred to foreign affiliates with little or no cost. Product differentiation can be found in those industries with heavy advertising and design expenditure such as automobiles, chemicals, electrical appliances, soft drinks, office equipment as well as in standardised industries such as textiles (Krugman 1996, Kindleberger 1969). This source of advantage is well-known in international economics. Because of the high fixed expenses of design and advertising, the local firms cannot compete with the foreign subsidiaries of MNEs unless they are large enough to engage in world-wide production and can finance product differentiation and development.

Nowadays, manufactures are highly differentiated, and their production involves a number of different stages. Production differentiation creates the ability for producers to slice up the value chain, breaking a production process into many geographical stages. When these stages take place in different countries through FDI to exploit the lowest real factor costs, they become a source of increased trade volume (Krugman 1996). Attempts to differentiate their products are another way that firms respond to stiff import competition (Cooper 1996). Therefore, product differentiation is a powerful firm-specific advantage of MNEs.
Marketing skills are closely associated with product differentiation through market research, advertising and promotion, and distribution. Efficient market research, like other research and development (R&D), needs an adequate market size before it is economic. Only large firms can afford this type of expenditure. Thus, the pure nature of oligopolistic, non-price competition with product differentiation is based on a system of powerful and sophisticated marketing. Using advertising intensity as a proxy, several empirical studies have found a significant correlation between the level of product differentiation and the extent of foreign production (Kumar 1994, Lall 1980).

**Factor Market Imperfections**

Factor market imperfections such as in technology, management skills, or barriers and discrimination in access to capital markets may become another firm-specific advantage. Many empirical studies have emphasised possession of superior technology by MNCs as an important factor of FDI (Chen 1983, Caves 1971, 1982). This means that MNCs may discover new products or new, more efficient methods of production, which are unavailable to other firms and usually protected by patent right or by other safeguards. The sources of the technological advantage of MNCs relative to other firms can be distinguished as follows:

First, a successful innovation of new technology or new method of production often requires a very high level of R&D expenditure;

Second, in general, a large firm with other monopolistic advantages, especially in marketing, can put the innovation into commercial use more efficiently than a small firm; and
Third, if the cost of R&D is higher than the available financial support, larger firms are often better able to attract government and private finance (Lall and Streeten 1977).

In general, MNCs may have a technological advantage because they have large financial resources, a more efficient marketing framework, access to related technology, and an ability to use restrictive practices (Lall and Streeten 1977).

Management skills are also relevant. The superiority of management skills takes one of two forms: greater efficiency of operations or specifically, higher entrepreneurial ability as compared with their local competitors. The complementary nature of management ability to production makes management skills hardly a causal factor in foreign production. It often serves as a permissive factor or the consequence of world-wide expansion of large MNCs. Usually, management skills must be combined with other monopolistic advantages such as economies of scale in order to form a basis for operating in foreign markets (Kindleberger 1969).

The other firm-specific advantage of the firm that is often mentioned in the literature under the heading of factor market imperfections is the possession of or access to a large and/or cheaper source of capital than their local competitors. However, this kind of advantage usually serves as only a permissive factor in FDI (Dunning 1994, Lall and Streeten 1977).

**Economies of Scale**

A firm-specific advantage may be derived from internal and external economies of scale. With internal economies of scale, the advantage often comes from the large facilities which need a large amount of capital, technology and expertise to become established and operational. Another type of economies of scale is that some multi-
product plants in oligopolistic industries producing differentiated products may gain "dynamic" economies of scale from longer production runs (Grubel and Loyd 1975). However, both these kinds of economies of scale are available to all firms which can reach the requisite size. Therefore, economies of scale can be attained only by having other firm-monopolistic advantages as complementary factors.

While some of the sources of firm-monopolistic advantages discussed above are decisive causal factors inducing firms to invest abroad such as technology and marketing skills, some are just permissive or consequential factors which reinforce the main ones. This helps explain why some firms go abroad, while others do not. However, some important questions such as why firms choose to supply foreign markets through direct foreign investment instead of exploring other alternatives are still left unanswered. These issues are discussed below.

2.1.2.2. Internalisation versus externalisation

This section attempts to answer the question of why firms choose to invest abroad (internalise) instead of exploring (externalising) other alternatives, ie., exports or licensing. The essence of internalisation is that a firm recognises the imperfection or failures of mechanisms of resource allocation which prevent the efficient operation of international trade and investment (Mckiehan 1992, Rugman 1980). Thus, the firm is likely to engage in FDI whenever it perceives that the net benefits of its joint ownership of domestic and foreign activities, and transactions arising from them, seem to exceed those offered by external relationships. Following this line of thinking, it can be seen that the MNC has developed in response to both exogenous, government-induced regulations and controls as well as other types of market failures. In order to avoid the costs (such as transaction and enforcement costs) and government
regulations in the product and factor markets, and to capitalise on the benefits of the imperfections, the firm chooses to internalise its specific monopolistic advantages (Dunning 1994).

The main factors which encourage the internalisation of firm-specific advantages are as follows: first, insecurity of property rights in information and high costs of enforcing the rights and controlling information flows; second, the importance of quality control over products and services and its incapability under licensing arrangements; third, government intervention in the allocation of resources and legislation toward production and licensing of technology and differential tax and exchange rate policies, which MNCs may wish to avoid or exploit (Casson 1979).

There are costs of internalisation such as additional communication costs, administrative costs of managing an internal market across national boundaries, the costs of acquiring diverse information, the costs of market fragmentation, and the risk of expropriation. Thus, the firm will internalise its monopolistic advantages, particularly technology, marketing and management skills and brand name, if benefits from circumventing market imperfections and government intervention will be able to compensate for the costs of control and coordinating internal uses of those advantages.

Market imperfections also often raise uncertainty in predicting future activities and income, and lead to distortions in price setting. Therefore, direct investment is a way to minimise the costs of uncertainty, and a strategy for negotiating with other oligopolists in setting prices. Another reason for foreign direct investment is that with direct ownership foreign firms can prevent buyers from using licensed information to develop a better technique or products that would compete. Moreover, licensing may be accompanied by high transfer costs, including the costs of transferred property
rights which do not occur in the case of transfers from the parent company to its subsidiary.

Another reason why MNCs internalise their specific monopolistic advantages rather than externalise them by selling or leasing them to an independent producer for the production of those goods is that many advantages of the firm cannot be sold because of being impossible to define, value and transfer. For instance, the experience and the spirit of its executives, its standing in financial markets, historical contact with others and organisation are inherent and cannot be sold to others. In addition, these advantages grow cumulatively with size and international expansion, so successful MNCs would want to internalise their benefits rather than dissipate them by licensing (Lall and Streeten 1977).

2.1.2.3. Direct foreign investment versus exporting

This section explains why the firm chooses foreign production rather than production at home and then export. One reason is that exporting is often excluded by tariff and non-tariff barriers imposed by local governments or by transport costs, or by other advantages of direct presence in local markets such as adapting products to local conditions. The other main factors affecting firms' decisions to choose to exploit their monopolistic advantages through foreign production are divided into four categories: cost considerations, government policies, oligopolistic reaction and product cycle.

Cost considerations

The argument about cost considerations is mainly based on the analytical frameworks of location and international trade theories. Given a set of transportation costs, costs of transferring technology, production functions, exchange rates, incidence of government restrictions, and a range of different factor endowments or factor
prices, some countries have a comparative advantage over others as a manufacturing base. A given market will be served by a firm from the manufacturing base which gives it the minimum costs of production. Given production cost considerations, for instance, MNCs generally invest in LDCs, in labour-intensive industries especially, because of their low labour costs.

In the case of investment in raw materials production, the stability of the source of supply is another reason for MNCs to choose foreign production in particular countries. Thus the host country’s endowments, as well as the local suitability are important factors for FDI, especially in developed countries.

Firms may invest abroad in order to save marketing costs, or to service the local market better. In the case of exporting, marketing across national boundaries usually involves additional costs, such as transportation and double handling, than servicing locally. Servicing a foreign market by local production can provide MNCs with a chance for better adaptation to the local conditions and faster adjustment to local tastes (Hirsch 1967).

**Government policies**

The government policies of both host and home countries are another important influence on FDI. In the host country, policies which directly or indirectly affect FDI are political and economic stability, tariffs against imports, import quotas, subsidies for exports, tax holidays, guarantees against currency inconvertibility, expropriation, and other discrimination against foreigners.

Empirical evidence shows that import-substitution (IS) policies, whose main tools are tariffs and non-tariff trade barriers against imports, have been responsible for inducing foreign firms to establish their subsidiaries in LDCs. They may invest because
they have been promised such protection, or MNCs may choose to invest in the protected industries of the host country to overcome the trade barriers.

However, an IS-induced FDI policy often attracts less FDI inflow than does an export-oriented (EO) FDI policy. This is simply because IS policy is often designed to protect the host-country market and attract home-based investment to serve that market; therefore the character of the market which induces FDI inflow in the first place would limit FDI inflows (Balasubramanyam et al 1996, 1991, and Bhagwati 1998). Moreover, Bhagwati (1973), Brecher and Alejandro (1977), Buffie (1987), and Balasubramanyam and Salisu (1996) have demonstrated that there is the possibility of immiserizing growth caused by tariff-induced FDI. This issue will be discussed in detail in part 2 of this chapter.

In contrast, an EO policy with its neutrality as between import and export sectors of the host country does not provide artificial and transitory incentives to FDI. This regime “allows for a free play of market forces and the allocation of resources on the basis of comparative advantage” (Balasubramanyam and Salicu 1996:94). The major incentive for FDI inflows that EO strategy provides is “simply the conjunction of cheaper costs and the export promoting orientation” (Bhagwati 1998:351). Because of being independent from the character of host country market, EO-induced FDI (mainly serving the home country or third markets) does not face the market limitation problem that IS-induced FDI does. Therefore, an EO-induced FDI policy is likely to both attract a larger amount of FDI and promote more efficient utilisation of resources than is an IS-induced FDI policy.

By allowing domestic and foreign investment to operate in a distortion-free environment, many developing countries - particularly Asian newly industrialising
countries (NICs), that pursue an EO strategy - encourage foreign firms possessing specific advantages in terms of high production differentiation, to slice up the production of goods traditionally viewed as skill-, capital-, or technology-intensive and put the labour-intensive slices in low-wage locations (Krugman 1996). By providing a variety of incentives such as the removal of tariffs or at least duty drawback of tariffs on goods imported for the production of exports, the host country may encourage FDI for EO production.

Home government policies also affect the firm’s decision to produce abroad. These may include: investment guarantee schemes; double tax agreements; tax credit and tax deferral schemes; antitrust policy; and foreign aid and trade policies. A study of the impact of the US tax policy on firms’ investment decisions showed that deferral (taxing the dividends, but not the retained earnings, of a subsidiary) may reduce US taxes and encourage American investors to favour foreign over domestic investment: 1) the lower the foreign income tax rate; 2) the lower the rate of dividend repatriation; 3) the lower the ratio of debt to new capital; and 4) the lower the interest charged on intra-firm debt (Horst 1977). The study also demonstrated that eliminating deferral may reduce the rates of new foreign investment and new funds transferred to the foreign subsidiary.

Several countries have enacted policies in favour of outward FDI such as “offshore assembly” incentives (Bhagwati 1998). Under tariff items 806.30 and 807.00, for example, the United States permits the duty-free entry of US components sent overseas for processing or assembly. The countries of the European Union have similar “outward production” provisions that encourage foreign assembly, often through FDI in countries with cheaper labour.
Oligopolistic reactions

When one mutually interdependent firm in an oligopoly undertakes foreign production, it may induce its rivals to follow or counter move - defensive investment-in order to maintain the status quo. The extent and speed of the reaction will differ from industry to industry, depending on the extent of concentration, the stability of the oligopoly, and the product range (Lall and Streeten 1977). The reaction tends to be more intense in a market with prospective demand than in a large existing one. Thus, while the first move in the oligopoly may be induced by government policies or other factors, the subsequent reaction is a defensive pattern in which the firms tend to ignore scale or other cost considerations. Knickerbocker's study (1976) based on the investment behaviour of 180 MNCs in the US showed the importance of such reactions as a defence as distinct from profit maximising actions.

Product cycle hypothesis

The 'product cycle' model, introduced by Vernon (1965), and Hirsch (1967), provides a dynamic picture of a sequential choice between FDI and exports. According to this model, a firm's international involvement follows sequential stages in the life cycle of the product it innovated.

The first stage is the new product stage when a new product is introduced, developed, and produced in the innovating country that normally is one with high income and skills. In the high income countries the price elasticity of demand for the product is comparatively low and coordination between production, R&D and marketing can be easily maintained. If the product becomes successful in the innovating country, the firm will expand production and export initially to other rich countries. FDI is still not in contention in this stage.
The second stage is the ‘mature product stage’ that starts when the product can be produced by other competitors who may be protected by government policy or other factors. In this stage the innovating firm has to consider economies of scale and production costs in different locations that may encourage the firm to invest abroad.

The third stage arrives when the product becomes standardised and the market is more competitive. In order to maintain its profits, the innovating firm invests abroad in the cheaper locations and nearer to foreign markets.

The final stage starts when the production at home becomes less profitable and rents now accrue from marketing rather than from technological advantages. In this stage foreign production locations, especially those in the LDCs, gain competitive advantage over the innovating country, and then may be used as a base to export back to the innovating country.

2.1.3 The eclectic paradigm

The eclectic paradigm seeks to offer a general framework for the extent and pattern of foreign-owned production undertaken. Such a framework is not able to be provided fully by any of the above mentioned theories (firm-specific advantage, internalisation and product cycle hypothesis). The product cycle hypothesis, for example, pays little attention to the kinds of advantages that arise from the internalisation of cross-border markets, while internalisation theory is not much concerned with the location of foreign production (Dunning 1994).

The eclectic paradigm was developed by Dunning (1981). This paradigm links ownership (firm-specific) (O), internalisation advantages (I), which were discussed earlier, and location-specific advantages (L), to explain why firms engage in foreign production.
Location-specific assets or advantages are “assets that might be specific to a particular location in their origin and use, but available to all firms” (Dunning 1994:77). The location advantages may derive from factor endowments, market characteristics, trade restrictions, or government policies (host or home country as discussed in Section 2.1.2.3).

According to the eclectic paradigm, the level and structure of a firm’s foreign value-adding activities will depend on the following four conditions being satisfied:

1. The extent to which the firm possesses sustainable ownership-specific advantages vis-a-vis firms of other nationalities in the particular markets it serves or is contemplating serving. These advantages and the use made of them (see 2 and 3 below) are assumed to increase the wealth-creating capacity of the firm, and hence the value of its assets.

2. Assuming the first condition is satisfied, the extent to which the firm perceives it to be in its best interest to add value to its O advantages rather than to sell them, or their use rights, to a foreign firm. These are I advantages.

3. Assuming the first and the second conditions are satisfied, the extent to which the global interests of the firm are served by creating, or utilising, its O advantages in a foreign location which is influenced by L advantages.

4. Given the configuration of the ownership, location and internalisation (OLI) advantages facing a particular firm, the extent to which the firm believes that foreign production is consistent with its long-term management strategy.
According to Dunning (1994), the generalised predictions of this paradigm are straightforward. "At any given moment of time, the more a country's enterprises - relative to those of another - possess O advantages, the greater the incentive they have to internalise rather than externalise their use, the more they find it in their interest to exploit them from a foreign location, then the more they are likely to engage in outbound production" (Dunning 1994:80).

The main groups of theories concerning causes and determinants of FDI have been discussed above. Besides these theories, in recent years there has been a tendency to emphasise knowledge-based, firm-specific assets as the cornerstone of the theory of MNC. However, it should be noted that the oligopolistic and eclectic theories of the determinants of FDI do provide relevant explanations concerning FDI and MNCs.

In the next section the effect of FDI on the welfare of host countries is discussed.

2.2. The economic effects of FDI on a host country

Depending on conditions in the host country (e.g., the level of human capital, location and infrastructure, and trade policies), FDI can have both positive and negative effects on host countries. This section discusses the main economic impacts of FDI on economic growth, income and income distribution effects, employment, transfer of technology and labour training, savings and capital formation, and balance of payments in the host country.

2.2.1. Effect of FDI on economic growth

The stock of productive resources (including capital, labour, technology, management skills and natural resources) available for an economy, and the utilisation of these resources are the main factors explaining economic growth in both the
classical (eg, Ricardo and Harrod-Domar models of growth) and neo-classical (eg., Solow model) models of growth. According to the Ricardo model of growth, an increase in capital and labour would result in the growth of output. The Harrod-Domar model demonstrated that an increase in investment will lead to a rise in income, and for a given amount of capital, the income is determined by the marginal capital productivity (Sun 1998, Le 1996).

In Solow’s neo-classical model of growth, not only the stock of capital and labour, but also capital-labour ratios are the main factors influencing economic growth. If capital increases faster than labour (termed ‘capital deepening’), the capital-labour ratio will increase and result in the growth of labour productivity, and hence economic growth. Technology and exports have been included in the new theories of economic growth. Technological progress, export expansion, capital deepening, and rational management and development strategies are now believed to be important factors influencing economic growth.

For developing countries, the shortage of capital, technology, skilled workers and management expertise, and foreign exchange cause the bottlenecks in their economic development. It is believed that these countries will achieve economic growth if they are able to remove or alleviate these bottlenecks (Sun 1998). In the light of the theories of economic growth, FDI is a crucial factor because it can contribute to economic growth in the host country through contributing to the capital formation of the host country, transferring technology, improving efficiency, stimulating and supplementing domestic saving and investment, promoting productivity and the production of domestic firms, promoting exports, and creating jobs (Borensztein et al. 1998, Wu 1999, Sun 1998, Le 1996, Todaro 1994).
Using different models, many researchers, such as Borensztein et al. (1998), Jansen (1995), Fry (1993), Blomstrom et al. (1992), Rothgeb (1989), Ulmer (1980), Kobrin (1977), and Papanek (1973) have found a positive relationship between foreign investment and economic growth. For example, Borensztein’s (1998) study of 69 developing countries over the period 1970-89 supported the hypothesis that through technological transfer, foreign private capital inflows contributed to the economic growth of developing countries even more significantly than did domestic investment. He also found that “foreign direct investment exerts a positive, though not strong, effect on domestic investment” (Borensztein et al. 1998:123).

Developing a five-equation macroeconomic model with lagged FDI to differentiate the impacts of FDI on East Asian and non-East Asian developing countries, Fry (1993) found a positive effect on economic growth for both groups of sampled countries. He concluded that FDI increases the rate of economic growth in all sampled countries.

However, the effect of FDI on economic growth depends on a set of conditions in the host countries such as the level of human capital, location and infrastructure, and the host country’s development strategy. Borensztein et al. (1998) have shown that the contribution of FDI to economic growth is related to its interaction with the level of human capital in the host country. They found that “the nature of the interaction of FDI with human capital is such that for countries with a very low level of human capital the direct effect of FDI is negative” (Borensztein et al. 1998:123).

According to Balasubramanyam (1996), in the absence of preconditions such as certain income level, infrastructure development, and general education, FDI may serve to enhance the private return to investment while exerting little positive impact in
the host country. It may even thwart rather than promote growth. Furthermore, foreign firms may displace indigenous entrepreneurship and crowd out domestic investment due to technical superiority, import advantages and by creating effective entry barriers through their monopolist power, and due to competing with local firms for use of scarce resources, eg., import licenses, skilled manpower etc., and increasing their market share in the host country (Wu 1999, Sun 1998, Papanek 1973).

Using the concept of de-capitalisation (decrease in accumulated capital) and using a model which differentiated between the impact of the flow and stock of transactional capital on a cross-section of 90 developing countries, Bornschier (1980) found that the net effect of FDI was to reduce the long-term rate of growth of developing countries. He maintained that subsidiaries of multinational corporations are likely, in the long run, to de-capitalise the host country.

Thus, it appears generally agreed that investment - foreign or domestic - is necessary for economic growth, but there is little consensus as to the effect of present investment on future national economic growth (Caves 1996). Empirical evidence shows that the impacts of FDI also depend to a great deal on the economic development strategy pursued by the host country. The main economic policies that developing countries have followed are import substitution (IS), and export-oriented (EO) strategies.

An import-substitution (IS) policy, whose main tools are tariff and non-tariff trade barriers against imports, is often used to protect domestic (so-called “infant”) industries in LDCs. As discussed in part 1 of this chapter, this policy can attract FDI flows into protected industries in the host country.
Empirical evidence reveals that an IS strategy can induce inefficiencies. The heavy reliance of an IS-strategy on tariffs and quotas on trade as the principal instruments of this policy, leads to a serious distortion in factor and product markets. The strategy encourages the adoption of production techniques that are not aligned with the comparative advantages of the country. It also widens income disparities and encourages X-inefficiency (Kokko 1997, Le 1996, Balasubramanyam 1996, Greenaway and Nam 1988, Bhagwati and Srinivasan 1979, 1975, Bhagwati 1978, Kreuger 1975). As a result, an IS policy is unlikely to provide an economic environment conducive to the efficient operations of domestic and foreign enterprises, and may bias investment away from activities in which the host country has comparative advantages. Investment in activities in which the country does not possess comparative advantages is likely to frustrate the increasing returns to scale, spill-over effects of FDI, and the generation of human capital, and hence economic growth (Balasunbramanyam 1996).

Thus, protection-induced inflows of FDI may actually be harmful for economic growth of the host countries. The immiserisation of growth from protection-induced FDI flows into import competing industries has been extensively analysed (Bhagwati 1973, Brecher and Diaz-Alejandro 1977, and Buffie 1987). Using the standard 2 x 2 model of international trade, Bhagwati (1973) demonstrated the possibility of immiserizing growth caused by tariff-induced FDI inflows, assuming that the host country is small and continues to import the capital intensive good while remaining incompletely specialised. The combination of the following three contributing effects can lead to a deterioration in welfare:

1. The well-known loss due to tariff-created distortions in consumption and production, given only the initial factor endowments.
2. The capital influx implies ‘growth’, at constant tariff-inclusive domestic prices faced by producers, which may imply a gain or loss in welfare.

3. The loss arising when foreign profits are subtracted to determine national income of the tariff-imposing country.

Under the assumption that foreign capital receives the full (untaxed) value of its marginal product, Bhagwati shows that the ambiguous effect (2) plus the negative effect (3) necessarily yields a net loss. Therefore, on balance, a welfare reduction must result, even before the negative effect (1) is added to the ‘net-inflow-impact’ (ie., the combination of effect (3) and (2)). Brecher and Diaz-Alejandro (1977, p. 317-22) supported Bhagwati’s hypothesis. Their result implies that FDI will be welfare-worsening if the trade regime is inward-oriented, but welfare-improving if it is outward-oriented. The hypothesis has been supported by the empirical evidence (Balasunbramanyam 1996).

In contrast, as stated earlier, an EO strategy is trade neutral or bias free (ie, there is no difference between the average effective exchange rates on exports and imports). The free play of market forces and competition promotes the efficient allocation of resources and provides an ideal climate for the exploitation of the potential of FDI to promote growth, and a powerful stimulus for investment in technology and human capital. Therefore, Bhagwati and Srinivasan (1979, p. 1-34) suggested that the differing welfare effects of FDI are an important reason why countries following an outward-oriented trade strategy have fared better than those pursuing protectionist policies. The empirical study of Balasunbramanyam (1996) shows that the growth-enhancing effects of FDI are stronger in countries pursuing EO policies than in those following an IS policy.
Below, each impact of FDI on economic development in the host country is discussed separately.

2.2.2. Savings and capital formation effects

A high national savings rate plays an important role in the economic growth of a country, since it permits a high rate of investment. Classical, neo-classical and endogenous new theories of growth have argued that investment is one of the driving factors of growth. In general, the higher the income, the higher the savings and the higher the investment.

The classical school of thought believes that FDI will lead to the stock of capital in the host country being higher in the future, which consequently, given the capital-output ratio, leads to higher future income, and hence higher national savings. Analysing the welfare effects of FDI in the classical framework, MacDougall (1960) suggested that the host country is better off because part of the higher output is captured by labour and other non-capital factors which more than offsets the loss of capital-owners. Moreover, if a profit tax is introduced, there may be an additional gain in the form of government tax revenues.

The results of studies by Bhagwati (1973), and Brecher and Diaz-Alejandro (1977), as mentioned above, imply that the FDI will be welfare-improving if the trade regime is outward-oriented, hence positively contributing to the savings of the host country.

The total effect of FDI on domestic savings can be demonstrated formally by the following simple simultaneous model:

\[ S = a_1 + b_1 Y + c_1 F \]
\[ Y = a_2 + b_2S + c_2F \]

where \( S \) is domestic savings, \( Y \) is national income, and \( F \) is foreign capital inflows. The empirical studies show that the expected signs of the coefficients are \( b_1 > 0 \), \( c_1 < 0 \), and \( c_2 > 0 \). However, the total effect, \( \frac{dS}{dF} = \frac{b_1 c_2 + c_1}{1 - b_1 b_2} \), is ambiguous. The net effect will be positive if the indirect effect, \( b_1 c_2 \), outweighs the direct effect, \( c_1 \).

Papanek (1973), and Fry (1984) have argued that domestic savings are discouraged by capital inflows. However, Gupta (1983) found that FDI has had a favourable impact on savings in Asian countries, although the causal linkages are doubtful.

The possibility of a reduction in savings and investment in the host country in the future may arise as follows: first, the inter- or intra-factor redistribution of income may result in a net decrease in savings, assuming there are different propensities to save among capitalists and labourers. Second, the savings and capital stock of the nationals will decline if the foreign investors take over local firms and may foreclose investment opportunities for local investors based on their technology advantage and market power. Therefore, the proceeds may be spent on consumption rather than investment. Third, local firms may shut down due to competition from a new foreign subsidiary, and then part of their capital will be consumed due to investment opportunities foreclosed by the foreign-invested firms. Fourth, the foreign firms may pre-empt the most profitable investment opportunities, which possibly reduces the incentive for local investors to save and invest (Sun 1998, Griffin 1970).

Through positive contributions to capital formation, FDI may encourage growth of the host economy. FDI is an important supplementation to the domestic savings of the host country, especially a poor developing country, where there is a big gap between savings and investment possibilities. This will increase the financial
resources available for domestic investment. FDI can also contribute to capital formation through bringing advanced equipment and machinery to the host country or importing capital goods that cannot be produced in the host country.

Through backward and forward linkage effects, FDI can encourage domestic investment and production. Purchasing materials, intermediate products and services produced by indigenous producers (i.e., backward linkage effects), foreign-invested enterprises (FIEs) can create additional demand for products and services made by local enterprises. Therefore, this will stimulate local investment to expand their production. On the other hand, through supplying equipment, machinery, materials and other intermediate goods to indigenous producers, FIEs can increase the availability of these inputs, and thus encourage the expansion of local production (Sun 1998, Le 1996).

In summary, although FDI inflows may have some negative effects on savings and investment of the host country, their positive effects are also prominent, if they are well managed. The experience of newly industrialised countries (NICs) in Asia shows that following an export-oriented strategy can strengthen the positive effects of FDI on savings and investment, and hence economic growth, while limiting its negative effects.

### 2.2.3. Transfer of technology and labour training

Technological progress - the creation of new products or the adoption of more efficient methods of production - is the main source of economic growth and enhanced quality of life (OECD 1997, Marceau et al. 1997). The most crucial result of technological progress is enhanced growth of productivity of production factors. Recent growth theory has emphasised the dependence of the growth rate on the state of the domestic technology level relative to that of the rest of the world. For
developing countries, where domestic enterprises are likely to be relatively small, weak, and technologically backward, their fast rates of growth are partly explained by ‘catch up’ progress in the technology level.

To upgrade the technology level, developing countries can import technologically advanced goods, model technology, purchase licences, and acquire human capital through formal markets or non-market mediated channels. However, the limitation of financial sources in most developing countries does not allow these countries to speed up the upgrading process. Moreover, as mentioned earlier, the product and factor market imperfections prevent developing countries from buying the model technology and high-technology products they want. Bringing with them some proprietary technology, FDI inflows by MNCs therefore have long been recognised as an important source of technology and know-how for developing countries (Borenstein 1998, Blomstrom and Kokko 1997, Balasubramanyam 1996). It is also widely recognised that the most powerful effects of FDI on economic development of the host country are associated with the transfer of organisation practices, management and marketing skills, and especially technology to the host country (Sun 1998, Caves 1982).

The transfer of technology through MNCs is considered an important benefit to LDCs, because MNCs are the prime innovators and the most efficient in realising the potential of new technology. However, it should be noted that any technology must be adapted to the economic, cultural and social characteristics of the society to which it is transferred. Otherwise, there will be a high risk of technological failure (Fischer 1987). Moreover, as mentioned earlier, the application of the technology transferred through FDI also requires a certain level of human capital, which reflects the absorptive
capability of the host country. In addition, the costs of the transfer of technology may be higher if MNEs use any monopolistic power that they have and exploit any administrative weakness in the host countries to import outdated technology at an artificially high price.

One of the major concerns is the appropriateness of the transferred technology. Appropriateness may be defined in terms of technology which makes optimal use of available resources in a given environment. There are three major types of technology transfer: hardware transfer, when only access to the technology itself is desired; information transfer, when hardware alone is not enough and "know-how" is desired; and capacity transfer, when the ability to translate the technology into locally produced new generations of technology is desired (Fischer 1987). When industrialisation is the ultimate goal, capacity transfer is likely to be the most desirable because mastery of the technology guarantees the independence, viability and stability of the entire industrialisation process. In general, the relative degree of appropriateness depends on both the technology and the host countries policies. The major argument is that since the technology used by MNEs is developed for resource availabilities that are different from those present in LDCs, the technologies are often "inappropriate" with respect to national resource endowments, eg., capital intensive technology that relies on imported inputs.

In order to avoid the transfer of inappropriate technologies, the government of a developing country may, for example, introduce policies that will force MNEs to discover more quickly where the comparative advantage of the host country lies, and to adopt more appropriate technologies and techniques in their production. Distortions in the labour market, such as a minimum wage rate which makes labour artificially
expensive, or in the capital market such as subsidies to capital and imported materials, should also be removed to encourage the transfer of technologies that suit the host country's conditions.

Spill-over effects, or externalities, that are often associated with technology transfer of FDI, have also been recognised as a major benefit accruing to host country from FDI. According to the eclectic paradigm, by investing in a foreign country MNCs bring with them some amount of proprietary technology that is their firm-specific advantage and allow them to compete successfully with local firms who have advantage in knowledge of local markets, consumer preferences, and business practices. Moreover, the MNC affiliate with superior technology and management skills forces local firms to take action to protect their market shares and profits. Both these factors are likely to cause various types of spill-over effects that lead to productivity increases in local firms.

There are several kinds of spill-over effects of FDI. The first case is that where a local firm improves its productivity by copying some technology and management methods used by MNC subsidiaries operating in the local market. Another kind of spill-over effect occurs when the entry of a foreign firm leads to more severe competition in the host country, so that local enterprises have to utilise existing technology and resources more efficiently. The third type of spill-over effect takes place when the competition forces local firms to search for new, more efficient technologies and managerial methods. In turn, increased competition from local firms through investments in innovation and improvement of productivity may force foreign-invested firms to bring in more efficient technologies and know-how. In sum, imported skills improve the marginal productivity of the capital stock in the host country and

Besides incorporating modern technology, a package of FDI may also offer training for local workers and management in more advanced techniques. This is important since the low productivity of many firms in LDCs is partly due to the lack of appropriate professional training and inefficient management. The issue of labour training is closely related to the problem of technology transfer, since local industries can benefit from the experience and knowledge of employees working for foreign subsidiaries only if the technology employed in these local industries is at a level sufficient to take advantage of this knowledge and experience. Analogously, if employment associated with FDI is mostly unskilled, while managerial and other key positions are held by foreigners, then the benefits accrued via this channel are minimal (OECD 1987).

In summary, transnational activities, especially FDI, are one way of bringing advanced technology, management and marketing skills, and access to the world markets into an economy. However, the success of an FDI project depends on both home and host countries policies.

2.2.4. Balance of payments effects

Whether FDI contributes capital to the host economy is a matter subordinate to the question of how the balance of payments is affected. The net effect hinges on the inflows and outflows of capital, as well as the effects on the current account. Concerning the current account, FDI tends to stimulate exports and /or substitute for imports. In addition, MNCs may reduce the growth of barriers to trade in the home country, to the benefit of domestic exporting firms. Taken together, such influences on
export activity may outweigh the repatriation of profits and capital by foreign firms, improve the balance of payments and give rise to an overall economic expansion.

On the other hand, MNCs are often found to be more dependent than local firms on imported inputs, so that a positive effect on the current account cannot be taken for granted. The proper way to study them is a stage-by-stage comprehensive analysis, including both direct and indirect effects over time (Julius 1990). But it is clear that if FDI leads to increased exports in host countries, then the balance of payments should be improved.

The trade policy of the host country may strengthen positive or negative effects of FDI inflows on the balance of payments. As discussed earlier, an IS trade regime distorts the allocation of resources, and biases export and investment towards industries in which the host country does not have a comparative advantage. The empirical evidence in LDCs shows that IS industries are often capital-intensive. Therefore, IS FDI is also capital-intensive. Being capital intensive, IS industries normally require a large amount of foreign exchange for importing equipment and machinery. The volume of foreign exchange needed for this purpose is often much larger than the amount of foreign exchange saved because some goods that used to be imported are now produced domestically. Therefore, the net effect on trade is negative (Le 1996).

In contrast, for developing countries whose comparative advantage is in low-wage labour activities, EO FDI attracted on the basis of comparative advantage of the host countries will go into labour-intensive industries to produce goods for exports, and thereby improve the trade balance, and hence the balance of payments, as well as increasing employment.
2.2.5. Effects of FDI on employment

Under the assumption of full employment of factors, the MacDougall model (1960) implies that FDI creates no additional employment. This is unrealistic, particularly for the LDCs where unemployment and underemployment are common. Given such circumstances, foreign investment may not only raise the productivity of labour, but also increase the number of people employed. Obviously, through establishing an affiliate in a foreign country, the investing firm has to employ indigenous workers. However, the direct employment effect of FDI is only a part of the story. A comprehensive evaluation would be required to look at its indirect effects too (Le 1996, OECD 1995).

FDI can positively affect the employment in the host country through backward and forward linkages. In the case of backward linkages, by buying locally-made inputs of production, FIEs can create a greater demand for inputs from domestic producers, causing an expansion of domestic production and thereby an increase in employment. On the other hand, increasing the availability of equipment, machinery, materials and other intermediate products supplied by FIEs to domestic firms stimulates the production of the domestic firms, causing an expansion of employment (Sun 1998, Le 1996, OECD 1995, and Morawetz 1974). However, the employment effect may also be negative if the number of jobs created by the FDI project is less than the number of jobs lost due to displacement of less competitive local plants.

For developing countries whose comparative advantage lies in low-wage labour, EO FDI attracted on the basis of the comparative advantage of the host countries goes into labour-intensive industries to produce goods for exports, and thereby increase employment. In contrast, IS FDI induced by tariff and non-tariff
barriers competes for a relatively static domestic market, and flows into protected industries that are normally capital-intensive. Due to competition for the limited domestic markets from IS FDI, less-competitive local firms will close down, thereby increasing unemployment.

In summary, the oligopolistic theory of FDI dealing with the configuration of firm, location and internalisation advantages can answer more relevant questions concerning FDI than can others. The contributions of FDI to employment and income in host countries can be substantial. Moreover, transnational activities, especially FDI, are one way of bringing advanced technology, management and marketing skills, and access to the world markets into an economy. However, the success of an FDI project depends on both home and host countries’ policies. Following an EO strategy which attracts FDI on the basis of the comparative advantages of the host country, and provides a distortion-free environment for domestic and foreign investment, a host country may attract more FDI.
Chapter 3: Vietnam’s Economic Development

As mentioned in the previous chapter, location-specific advantages resulting from factor endowments, the level of economic development, and government policies which influence the business environment in host countries are crucial in determining whether a MNC exploits its ownership advantages in its home country or abroad. Thus, before analysing the determinants of FDI in Vietnam, it is useful to look at factor endowments, economic development, and government policies which have direct or indirect effects on a foreign firm’s decision to invest in the country.

3.1. Overview of the Vietnamese economy

With about 76.5 million people, Vietnam is the thirteenth most populous country in the world. The total labour force comprises 39 million people, 36 million of whom were employed in 1996 (Table 3.1), resulting in an unemployment rate of 6 percent. The population is relatively young (75 percent are under 35 years of age) and Vietnam has developed a highly literate and skilled labour force (the literacy rate is approximately 95 percent) that includes a considerable number of postgraduates. However, Vietnam remains one of the poorest countries, with per capita GNP of some US $300 per year (Robinson 1995, World Bank 1997).

Vietnam is still basically an agricultural economy with close to 80 percent of the population and 78 percent of the labour force living and working in the rural areas, engaged in farming, forestry and fishing. The share of agriculture in GDP was 27.2 percent in 1996.

Vietnam is rich in natural resources. It has substantial oil and gas reserves, very rich agricultural land (for growing tropical products such as rice, coffee, natural
rubber, and fruit) and virtually untouched reserves of minerals such as iron ore, tin, copper, gold and coal (Grub and Oanh 1992; and Robinson 1995).

(Millions of Persons)

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<td>66.9</td>
<td>68</td>
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<td>71.5</td>
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<td>73.9</td>
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<td>2.25</td>
<td>2.18</td>
<td>2.3</td>
<td>2.3</td>
<td>2.2</td>
<td>2</td>
<td>1.88</td>
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<td>State Sector</td>
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<td>3.42</td>
<td>3.14</td>
<td>2.98</td>
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<td>Cooperatives</td>
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<td>18.07</td>
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<td>-</td>
<td>-</td>
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<td>Private</td>
<td>5.39</td>
<td>6.45</td>
<td>9.66</td>
<td>10.21</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>32.55</td>
<td>33.62</td>
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<tr>
<td>Employment by Sector</td>
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<tr>
<td>Construction</td>
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<td>0.82</td>
<td>0.83</td>
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<td>0.97</td>
<td>1.00</td>
<td>0.97</td>
<td>0.98</td>
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<td>0.22</td>
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<td>Transportation</td>
<td>0.45</td>
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<td>0.484</td>
<td>0.496</td>
<td>0.499</td>
<td>0.512</td>
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<td>0.04</td>
<td>0.047</td>
<td>0.051</td>
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<td>0.056</td>
<td>0.056</td>
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<td>-</td>
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<tr>
<td>Trade and Supply</td>
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<td>1.681</td>
<td>1.719</td>
<td>1.735</td>
<td>1.776</td>
<td>2.07</td>
<td>2.90</td>
<td>2.311</td>
<td>2.25</td>
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<td>2.001</td>
<td>2.031</td>
<td>2.008</td>
<td>2.125</td>
<td>2.419</td>
<td>2.483</td>
<td>2.85</td>
<td>2.87</td>
</tr>
</tbody>
</table>


Oil is found in Vietnam’s long continental shelf, and deposits are believed to exist in the Mekong delta. The extent of oil reserves has not been established, but rough estimates place them at 3-5 billion barrels. Gas reserves are estimated to be 235 billion cubic metres. Crude oil is the most important single export from Vietnam.

Vietnam’s mineral resources are relatively undeveloped. There are a number of significant deposits which are widely believed to be commercially viable. Reserves of coal have been estimated to be several hundred billion tons, of varying quality. Almost all the coal currently mined in Vietnam is high quality anthracite. Deposits of iron ore are believed to be 700 million tons. The ore quality is high, with an iron content of 60-
65 percent. Other mineral deposits which offer the opportunity for large scale development include apatite (a source of phosphorus for fertilisers), with estimated reserves of over 1 billion tones, bauxite deposits estimated at 4 billion tons in deposits, and copper reserves of 1 billion tons.

Vietnam's considerable natural attractions, particularly its sandy beaches and its tropical climate, provide potential for a thriving tourist industry. In 1994, over 1 million people visited Vietnam. Vietnam plans to increase annual visitor arrivals to 4 million by the year 2000.

On a per capita basis, Vietnam's mineral resources are not overwhelming. So, while in the short-run the country's economic development may be based on natural resources, in the long-run the country will have to develop on the basis of human resources rather than natural resources.

One of the bottlenecks to the country's development affecting its attraction to foreign investors is that its physical infrastructure on which the economy depends is quite weak compared with some other developing countries in the region (such as Indonesia, the Philippines, and Thailand) (Table 5.1). For nearly two decades (in the 1970s and 1980s) the government financed almost no investment out of its own savings. All investment programs of the government generally depended on Soviet aid. One of the distinctive features of Vietnam - in sharp contrast to China and other East Asian economies - is that the savings rate has been very low. Indeed, prior to 1991, the public savings rate was negative. The poor savings rate was one of the reasons why inflation was very high throughout the 1980s (World Bank 1993).
3.2. Economic development in Vietnam

Vietnam's economic development path since the country’s reunification in 1975 can be divided into two stages. The period 1976-85 can be characterised as a period of economic recession and crisis. From 1986 to the present has been a period of economic reform and growth.

3.2.1. The economy in the 1975-85 period

In the period 1975-1985, the economic development strategy was based on central planning and self sufficiency. The main feature of a planned system is that production and distribution decisions are made under the guidance of plan targets. Collectivised organisation of production, state-owned marketing monopolies, and price regulation were the main measures used to fulfil the plan targets. Cooperatives in the agricultural sector and state-owned enterprises in the industrial sector were the dominant production units. A low price was often set for agricultural output to provide subsidised food for the urban population and cheap inputs for the industrial sector. Thus, farmers were reluctant to improve their productivity, while the profitability and capital accumulation of industrial enterprises were artificially supported.

Investment in this period was focused on heavy industries, but without adequate provision for supporting investments in the maintenance and rehabilitation of existing capital stock. As a result, the capital stock was very run-down, and industry frequently suffered from shortages of electricity, materials and spare parts, especially those needed to be imported. Consequently, the industrial sector’s capacity utilisation was low and unit production costs were high.

During that time, Vietnam also faced an unfavourable external political climate, particularly after the Cambodian war in 1978. The country was economically isolated.
from the West and from several Asian neighbouring countries. Therefore, Vietnam's external trade was primarily in the form of barter arrangements negotiated between socialist economies. As part of these arrangements, Vietnam received large amounts of credit at very low interest rates, as well as grant financing that covered part of the government budget deficits, and financed most government investment programs. This resulted in the economy's dependence on external financing for a large part of the public investment program as well as recurrent spending.

Economic performance during this period was very poor, especially in 1979 and 1980. National income increased at an average annual rate of 0.4 percent in the period 1976-80. The growth rate was negative for 1979 and 1980. Grain production dropped sharply from 13 million tons in 1976 to 12 million tons in 1978, equivalent to 57 percent of the plan target. Total industrial production increased by 0.6 percent per year, while state-owned industry production fell by 2.6 percent in the period 1976-80 (Tran 1993).

These circumstances prompted the Vietnamese leaders to look for new approaches to development to avoid an economic collapse. Limited reforms were undertaken in 1981 in both the industrial and agricultural sectors that gave greater scope to private sector production. In agriculture, farm households were allocated specific plots of land on short-term contracts, and allowed to sell their remaining output after paying agricultural taxes and other duties. The contract system in agriculture later on led to the recognition of the farm family as an economic unit and the effective privatisation of the agricultural sector.

In the industrial sector, enterprises were allowed to mobilise other resources than the state allotted budget and to sell part of their output at market prices. Official
prices were changed substantially by the government to better reflect relative scarcities and to reduce the disparity between official and free market prices.

**Table 3.2. The Key Reforms in Vietnam**

<table>
<thead>
<tr>
<th>Year</th>
<th>Reforms</th>
</tr>
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</table>
| 1979 | • Limited agricultural reform—introduction of quotas and contract system  
• Greater autonomy for SOEs  
• Additional lending to local enterprises from the State Bank |
| 1980 | • Trade reform (removal of import duties on industrial inputs) |
| 1981 | • Introduction of product contract system in agriculture  
• Agricultural price reform  
• Decentralisation of foreign-trade sector  
• New system of enterprise management in industrial sector |
| 1985 | • Decentralisation of SOE sector  
• Price reform, wage adjustments  
• Currency reform  
• Greater autonomy given to SOEs |
| 1987 | • Adjustment of prices of nonessential consumer goods  
• Devaluation of exchange rate  
• Removal of restrictions on private-sector trade and transport  
• Introduction of a new foreign investment law  
• Restructuring of the banking system |
| 1989 | • Elimination of price control  
• Positive real interest rate policy  
• Elimination of subsidies to SOEs  
• Unification and major devaluation of the exchange rate |
| 1990 | • Reform of financial sector  
• Introduction of new instruments for the state bank to control the money supply |
| 1991 | • Decree on foreign bank branches  
• Introduction of Export Processing Zones |
| 1992 | • Constitution amended proclaiming individual rights and guaranteeing against the nationalisation of foreign investments  
• Approval to privatise state firms and amendment of foreign investment law |
| 1993 | • Law on land  
• Oil and gas law  
• Bankruptcy law  
• Environment law |
| 1996 | • The Public Investment Program (PIP) envisages a larger role for foreign investment and private sector financing, but keeps SOEs at the core of economic development |
| 1998 | • Initial measures designed to speed up the equitisation of state-owned corporations promise to increase the number of firms equitised. |
| 1999 | • Value-added tax replaces the outdated turnover tax. |
These new incentives led to a surge in agricultural and industrial output. During the period 1981-85, agricultural and industrial output rose at an average annual rate of 5.2 percent and 9.5 percent, respectively.

In 1985, a currency reform (substitution of one “new dong” for ten “old dong”) combined with structural problems adversely affected the SOEs. The cash shortages of SOEs were met by the government through printing money. Consequently, prices increased sharply. In the second half of 1985 the monthly price index rose by 30 percent, and accelerated rapidly in the following years. Large budget deficits exacerbated the inflation problems.

The combination of the economic crisis and an economic embargo imposed by Western and other Asian countries, created an extremely unfavourable business climate for attracting foreign investment.

Although the limited reforms enacted in the early 1980s had some positive effects, the economy remained rigid and centrally planned. The basic causes of the structural problem (such as lack of financial discipline for SOEs and the government administration) were not addressed in these reforms. These reforms needed to be followed up by more fundamental policy changes.

3.2.2. The economy since renovation (Doi Moi) in 1986

By 1986, macro-economic problems (large public sector deficits, and persistent high inflation) had become acute. Facing these problems, in December 1986, the Sixth Congress of the Vietnamese Communist Party openly committed itself to policy reform in all aspects of the economy. The main goal of the so-called Renovation policy (Doi Moi) was to reorganise the economy’s management system, both at the micro level
(management of farms and enterprises) and the macro level (money supply, taxes and government expenditure). However, reforms were implemented slowly and only partially in 1987 and 1988. As a result, reforms carried out up to the late 1980s failed to achieve macro-economic stability and sustainable rapid growth (Probert and Young 1995).

In 1988, the macro-economic imbalances, hyperinflation (30% per month) and the rapid fell in financial assistance from the former Soviet Union, as well as adverse weather, worsened the economic situation. In the second half of 1988 and the first half of 1989, radical new reforms were introduced to bring inflation under control and stimulate production. The key reform measures included price liberalisation, a large devaluation of the exchange rate, the elimination of virtually all direct subsidies to SOEs, reduction of budget deficits through tax and expenditure reforms, greater autonomy for SOE managers, trade and investment liberalisation, reform in the financial sector, and decollectivization of the agricultural sector (Table 3.2).

**Agricultural reforms**

Agricultural reform, a key component of doi moi, was started as early as 1981 when the contract system was introduced. However, until April 1988, the continuing unclear tenure arrangements, and the unfavourable procurement prices of agricultural products led to inconsistent and unpredictable yields. In April 1988, Resolution No. 10-radical policies governing the agricultural sector-was introduced. Under this Resolution, the farming cooperatives were largely dismantled, and agriculture returned to family farming on the basis of long-term leases (at least 15 years). Since then, agriculture has become the most privatised sector in the Vietnamese economy.
Resolution No. 10 also abolished price controls and centrally planned production targets. Farmers are now free to sell their output at negotiated or market prices. However, they are not free to select crops mixes to maximise returns to the land, as controls remain over land that is to be dedicated to rice. Rights of land use, inheritance, and transfer have been recognised by the state. Long-term leases were extended from 15 years to 20 years for annual crops and to 50 years for tree crops. These measures and price reform in 1989 (that increased the controlled price of rice by more than ten times, from 50 to 550 dong/kg) provided more incentives for farmers to improve their productivity as well as the quality of production. The major devaluation of the exchange rate in 1989, combined with the price decontrol as well as the removal of internal trade barriers, led to a surge in agricultural output. Agricultural output rose by 7.2 percent in 1989, and increased at a robust rate of growth of over 4 percent annually in the period 1990-98. As a result, from being a grain importer in 1980s, Vietnam has become the third largest rice exporter (behind Thailand and the US) since 1992.

Price reform

The price liberalisation in 1989 has been “the most far-reaching among socialist countries” (World Bank 1991:20). Domestic prices of agricultural and industrial goods and services (except for prices of essential services such as electricity, telecommunications and postage, and transport fuels for some uses) are now freely negotiated between buyers and sellers. Together with other stabilisation measures, the price decontrol has rapidly reduced shortages of many consumer goods, especially agricultural products whose prices were set at very low level in the central planning system, and services (World Bank 1990, 1994).
Faced with market pricing, many enterprises have to rationalise their production and reduce production costs in order to stay competitive. Although price reform, together with other stabilisation measures (such as positive real interest rates, devaluation of the dong, and reduction of subsidies to SOEs), contributed significantly to the large increase in agriculture output, and the sharp drop of inflation from 393.8 percent in 1988 to 35 percent in 1989, the price reforms have been less effective than they could be. This is due to the fact that the state sector remains dominant in many areas, particularly in industrial production and international trade, especially the so-called General Corporations.

Since 1989, there has been a shift by the Vietnamese government in its recognition of inflation from being a “structural” problem to a money phenomenon. Before 1989 it was thought that the excess demand for goods resulted from supply-side bottlenecks. Therefore, the government increased credit and subsidies to SOEs in the hope that they could increase output. Moreover, budget deficits were mainly financed by money creation. As a result, inflation rose to 393.8 percent in 1988. In April 1989 a positive real interest rate policy was introduced as the first step towards asserting monetary control. Banks were required to set uniform positive real interest rates. At the same time, a policy of unifying the exchange rate was announced and effectively realised by mid-1991. These reforms restored some confidence in the local currency (Pomfret 1996, Leipziger 1994, World Bank 1991, 1993).

*Interest Rate Reform*

The positive real interest rates had an immediate impact on the growth of the money supply. Dong deposits responded very quickly to the new monetary circumstances as depositors rushed to take advantage of real positive gains. Household
savings deposits increased by more than five times over the period 1989-91. Devaluation-cum-positive real interest rates persuaded individuals long accustomed to keeping their wealth in the form of US dollars or gold to switch to domestic currency.

Setting uniform positive real interest rates was also a crucial step in hardening the budget constraint facing the SOEs. Bank credit to SOEs increased by only 28 percent during the first half of 1989 - a sharp reduction from 350 percent increase in 1988. Hardening financial constraints and allowing banks greater leeway in their credit decisions forced SOEs to reduce inventories and sell idle equipment.

As a result of these measures, inflation was reduced quite dramatically. The rate of consumer price inflation declined from 393.8 percent in 1988 to 35 percent in 1989. Moreover, GDP increased by 8 percent, the best performance for a decade. However, the macro-economic situation deteriorated at the end of 1989. Soviet aid declined sharply, subsidies continued to be given to SOEs that were hardest hit by the 1989 reforms, the budget deficits continued to be financed by money creation, and the real interest rates became negative again. Inflation re-emerged to 70 percent in 1990 and 1991. In December 1991, reducing inflation again became the top priority.

To bring inflation under control again the Vietnamese government reduced the public sector deficits by cutting its investment program, removing most subsidies to SOEs, regaining positive real interest rates, restraining increases in state employment, and demobilising a half million soldiers. Most important was the denial of money creation as the method of financing the budget deficit. Inflation fell from 67 percent in 1991 to 18 percent in 1992, to 12.7 percent in 1995, 4.5 percent in 1996, and 4 percent in 1997 (EIU 1999, Riedel 1993, World Bank 1991).

*Tax Reforms*
The SOEs, whose transfers were the main source of central government revenues under the system of central planning, were hardest hit by the price liberalisation, the interest rate reform and the removal of state subsidies in 1989. These reforms revealed that many enterprises were unprofitable and subsequently many of them were closed. The bad financial position of the SOEs and the sharp decline in Soviet aid worsened the government budget. Transfers to the government from SOEs declined from 9.2 percent of GDP in 1987 to 2.6 percent in 1991. However, a rise in revenues from expanding rice and oil exports offset the decline in revenues from SOEs and in foreign aid, and provided an important source of budget revenues (EIU 1999, Leipziger 1994, Riedel 1993).

To improve budgetary revenues, tax reform was introduced in mid-1989 with two key elements: replacement of the current tax regime based on decrees and regulations, with a system with explicit legislation of tax laws; and commensurate taxation of both state and non-state sectors. Early tax measures included agricultural taxes, turnover taxes, excise taxes, and profits tax (October 1990), personal income tax (April 1991), a natural resources tax (March 1992), and revised agricultural, land and housing taxes (1993). More recently, in 1999, along with a simplified corporate income tax, a value-added tax has been adopted. The new tax system replaced enterprise transfers. It has been successful in raising revenue from 3.7 percent of GDP in 1989 to 24 percent in 1995 and 1996.

**SOE management reform**

The reform of the SOE management system was another feature of Vietnam’s stabilisation program in 1989. Decision-making was decentralised to the firm level, and the plan targets were virtually abolished. Now SOEs are authorised to adjust their
product mix to maximise profits, borrow funds, make their own investment, procure inputs and sell output through markets, introduce new technology, acquire and lease assets, hire and fire workers, set salaries, wages and other benefits, and allocate after-tax profits. The SOE reforms also allow SOEs that lose money to go bankrupt and close (Bui 1996, World Bank 1991, 1995).

These changes led to a rationalisation of the sector. In 1990, the total number of SOEs was approximately 12,000, but by late 1994, the number of SOEs had been reduced to about 6,000 (through liquidation and the closing-down of over 2,000, and the merger of over 3,000 SOEs with other SOEs). Employment in SOEs dropped from 2.1 million people in 1990 to 1.7 million by the end of 1993. Following the stagnation in 1989 and 1990, output from the state sector has been growing very rapidly, indicating that the reforms led to higher productivity. However, Vietnam's industrial sector is still dominated by SOEs, especially in many of the major industries such as cement, steel, electricity, oil and gas, and posts and telecommunications (Pomfret 1996, Pham 1995).

In 1992, under Decree 462, a further package of SOE reforms was implemented to improve the policy mechanism, regulate the reorganisation of SOEs, and to encourage the potential development of both state and non-state sectors. At the same time, the government issued Decision 202 to proceed with a pilot program equitising (privatising) a limited number of small and medium-scale and non-strategic SOEs. However, the pace of equitisation is slow. About 200, relatively small, SOEs have been equitised. The resistance of party leaders, managers and employees of SOEs to equitisation, and the lack of clear guidelines for the equitisation process, are suggested as the main reasons of the slow pace (EIU 1999, IMF 1996).
Promotion of the private sector

Along with efforts to improve the efficiency of SOEs, there was a shift in attitude towards the private sector - a sector that suppressed under the central planning system. In 1988, the government issued the Resolution on New Regulations for the Non-state Economic Sector which provides principles for the activities of the non-state economic sector, and allows non-state enterprises to negotiate foreign sales contracts directly, and to retain foreign exchange earned through exports for the importing of materials and machinery (Pham 1995, World Bank 1991). Non-discriminatory treatment between SOEs and private enterprises (PEs) by government institutions was also announced in the Resolution.

In 1991, the Law on Private Business was promulgated formally to allow the private sector to be involved in business activities for the first time in many years. At the end of 1991 there were 76 private enterprises, by January 1993 there were 4403 PEs, accounting for 70 percent of domestic trade, and 60 percent of transport services (Pomfret 1996). Private sector involvement in industry also grew significantly. The emergence of the private sector has changed the structure of the economy significantly.

However, the progress achieved in the private sector in the 1990s is far behind that in the state sector. The share of the domestic non-state sector, which is considered to be the most dynamic and sensitive to markets, has decreased considerably from 70.7 percent of GDP in 1990 to 50 percent in 1998. The share of PEs in total industrial output also declined from about 35 percent in 1990 to 22 percent in 1998, indicating the uncertainty, ambiguous policies and regulations, and the discriminatory practices that PEs still face (CIEM 1999, Riedel 1997).

Foreign Trade and Investment Reforms
Trade liberalisation was another key pillar of *doi moi*. Under the system of central planning, international trade was tightly controlled by the government through trade agreements with foreign governments - mainly with the former Soviet Union and Eastern European socialist countries. Central state trade corporations dominated all foreign trade transactions. Adding to difficulties of trading, prices were administered, and a complex system of exchange rates was maintained by the government.

**Table 3.3. Official and Parallel Exchange Rates**

<table>
<thead>
<tr>
<th>Year</th>
<th>Official rate Dong/$US</th>
<th>Parallel Rate Dong/$US</th>
<th>Ratio of Official to Parallel Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>18</td>
<td>425</td>
<td>0.04</td>
</tr>
<tr>
<td>1987</td>
<td>225</td>
<td>1270</td>
<td>0.18</td>
</tr>
<tr>
<td>1988</td>
<td>900</td>
<td>5000</td>
<td>0.18</td>
</tr>
<tr>
<td>1989</td>
<td>3900</td>
<td>4100</td>
<td>0.95</td>
</tr>
<tr>
<td>1990</td>
<td>6300</td>
<td>6500</td>
<td>0.96</td>
</tr>
</tbody>
</table>


Along with devaluation of the exchange rate in early 1989, which narrowed the difference between official and parallel market rates (Table 3.3), there was substantial liberalisation of the trade regime. State and private enterprises were given more freedom to trade directly with foreigners. As well, provincial and local authorities were given rights to establish competing foreign-trade companies. Private companies were allowed to compete equally with state companies in all areas of trade (Quinlan 1996, Riedel 1993).

Since 1989, most import and export quotas have been lifted. Other non-tariff barriers have been abolished, such as export shipment licenses (July 1994) and import shipment licenses (January 1996), and there has been a reduction in coverage of import
permits (quotas) from 15 commodity groups to 7 (December 1994) and then to 5 (December 1995). As well, the liberalisation of licensing procedures to engage in foreign trade were made (CIE 1999, IMF 1996). However, the foreign trade reform is incomplete and Vietnam still relies heavily on the use of quantitative restrictions. For example, a number of key traded goods (such as steel, cement, and fertiliser) are subject to management through quantitative restrictions (CIE 1999, EIU 1999, IMF 1996).

Openness to foreign direct investment was another hallmark of doi moi. A new investment law (January 1988) and subsequent revisions demonstrated the government’s willingness to see the participation of a foreign private sector. This issue is addressed in more detail in the next chapter.

3.2.3 The results of the reforms

The results of the reforms have been very positive, although further reforms are necessary to ensure continued development of the economy. The reforms in 1989 brought about an initial surge in output, particularly in agriculture and services. GDP increased 8 percent in 1989 and 11.1 percent in 1990. The decline in Soviet assistance had an adverse effect on economic growth in 1991 (GDP growth declined to 6 percent). In 1992, the economy recovered from the shock occasioned by the collapse of the former Soviet Union. The GDP growth in that year returned to over 8 percent, and reached 8.8 percent in 1994, 9.5 percent in 1995, 9.3 percent in 1996, and 8.7 percent in 1997. The GDP growth rate fell to 5.8 percent in 1998, largely it seems because of the lacks of progress with liberalisation of the economy which in turn led to a sharp decline in FDI.

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<td>8.6</td>
<td>8.1</td>
<td>8.8</td>
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<td>9.3</td>
<td>8.1</td>
<td>5.8</td>
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<tr>
<td>Agriculture</td>
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<td>1.5</td>
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<td>7.2</td>
<td>3.8</td>
<td>3.9</td>
<td>4.7</td>
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<td>4.3</td>
<td>3.5</td>
</tr>
<tr>
<td>Industry</td>
<td>-2.7</td>
<td>2.9</td>
<td>9</td>
<td>14</td>
<td>13.1</td>
<td>14.1</td>
<td>13.9</td>
<td>14.1</td>
<td>12.6</td>
<td>8.6</td>
</tr>
<tr>
<td>Services</td>
<td>17.7</td>
<td>11.3</td>
<td>8.3</td>
<td>7</td>
<td>9.2</td>
<td>10.2</td>
<td>10.9</td>
<td>10.1</td>
<td>7.1</td>
<td>4.3</td>
</tr>
<tr>
<td>Sector share</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>38.7</td>
<td>40.5</td>
<td>39.2</td>
<td>38.6</td>
<td>37.1</td>
<td>27.4</td>
<td>26.2</td>
<td>25</td>
<td>24.2</td>
<td>23.6</td>
</tr>
<tr>
<td>Industry</td>
<td>18.5</td>
<td>22.4</td>
<td>23.1</td>
<td>24.2</td>
<td>25.4</td>
<td>28.8</td>
<td>29.9</td>
<td>31.3</td>
<td>32.6</td>
<td>33.5</td>
</tr>
<tr>
<td>Construction</td>
<td>4.2</td>
<td>4.0</td>
<td>5.6</td>
<td>7.4</td>
<td>7.6</td>
<td>7.1</td>
<td>7.4</td>
<td>7.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Services</td>
<td>38.6</td>
<td>36.9</td>
<td>37.7</td>
<td>37.1</td>
<td>37.5</td>
<td>43.7</td>
<td>43.8</td>
<td>43.6</td>
<td>43.2</td>
<td>42.3</td>
</tr>
</tbody>
</table>


As shown in Table 3.4, all sectors of the economy have developed rapidly since 1989. Industrial output growth was a negative 2.7 percent in 1989, but increased to about 14 percent in 1994, 1995 and 1996, led by output in consumer goods and other light industries, fuelled by export growth. The services sector has also shown good performance with a double digit rate of growth. After growth reached 7.2 percent in 1992, the rate of growth of agriculture GDP increased at a lower rate of about 4.5 percent in 1995 and 1996, and 4.8 percent in 1997. As a result of these differing sectoral growth rates, the sectoral structure of the economy has changed substantially. The share of industry in GDP increased from 18.5 percent in 1989 to 24.5 percent in 1996, while the share of agriculture in GDP fell from 44.7 percent in 1988 to 26 percent in 1998.

The 1989 reforms have resulted in an investment expansion from 11 percent of GDP to 27.5 percent between 1989 and 1997. There was also a change in the composition of investment during the period. The government's share of total investment declined from 6.7 percent of GDP in 1989 to 3.1 percent in 1991 and rose back to about 6.4 percent in 1995. At the same time, private investment increased from
5 percent of GDP in 1989 to 13.3 percent in 1994 and 12.4 percent in 1995. However, even with the substantial growth in the share of investment in GDP, it is still quite low for an economy that has grown at an average rate of 8.4 percent during the reform period. The country requires a very substantial increase in investment in order to achieve rapid growth on a sustained basis. According to the World Bank (1998), to sustain growth in the 8 percent range will require:

- strengthened incentives for private savings and investment;
- an increase in government savings to 5-10 percent of GDP and
- ODA (official development assistance) commitments of around US $1 billion per year over the next few years.

The strong response of private savings is the reason why Vietnam has been able to maintain its investment despite the decline in foreign aid. In 1989, the foreign savings inflow was over 9 percent of GDP, while national savings were around 2 percent. In 1992 the contribution of foreign savings was only 1.6 percent while national savings had climbed to 10.5 percent, and it reached 17 percent of GDP in 1994, 1995 and 1996 (Vu Doan 1994, World Bank 1997). However, the savings rate is not sufficient to support the needed investment.

Until 1989, the Council of Mutual Economic Assistance (CMEA) was the biggest trade partner of Vietnam (accounting for 83.5 percent and 70 percent of Vietnam's exports and imports, respectively) (Phuong Le 1996). However, in the period 1989-91, the collapse of the former Soviet Union and the break-up of the CMEA led to a sharp reduction in Vietnam-CMEA trade and CMEA aid to Vietnam. The share of both Vietnam's exports to and imports from the CMEA declined to about 4.1 percent of the country's total exports and imports.
Since 1989, trade liberalisation has significantly improved the country's economic performance and its external trade. After the loss of CMEA markets, the country switched its trade to convertible currency areas in a remarkably short time. In 1989, exports to convertible currency areas increased by 154 percent, while imports from this area rose by 60 percent. Nowadays, Asian developing countries, Japan, and the European Union are Vietnam's largest trading partners, accounting for over 90 percent of total Vietnamese exports and imports of all merchandise in 1993 (World Bank 1995).

Exports grew at an average rate of 20 percent during the period 1991-95, with the share of exports in GDP increasing from 5.6 percent in 1987 to 32 percent in 1995, 1996 and 1997 (Doanh 1996, APEG 1998). The main exports are crude oil, rice and agricultural goods such as rubber, coffee, fruit, marine products, and light manufactured products. Vietnam's exports have been increasingly diversified. The share of two major export goods - crude oil and rice - in total exports decreased from 43 percent in 1992 to less than 30 percent in 1995. The share of manufactured exports, especially garments and footwear, has been steadily increasing.

Imports have continued to rise at a rapid rate since 1991. The main imports are capital goods and intermediate goods. The shares of capital goods and raw materials and intermediate goods accounted for 37.3 percent and 18 percent, respectively, of the country's imports in 1995. This reflects the overall increase in investment.

The trade balance improved steadily from a deficit of $350 million USD in 1989 (still financed by Soviet aid) to a surplus of over $100 million USD in 1992. This was accomplished through rapid growth of exports combined with slow growth of imports. However, the trade account deficit has expanded rapidly since 1993. The
trade account deficit reached US $1 billion in 1994, $2 billion in 1995, and $4 billion in 1996. Although there have been large increases in net transfers, of about $476.7 million USD in 1994 and $4 billion in 1996, the current account deficit reached an estimated 15 percent of GDP against 8.6 percent in 1994 (World Bank 1996, 1997). The current account deficit was financed mostly by FDI and ODA.

3.2.4. Remaining Problems

Although Vietnam’s achievements since the enactment of doi moi in 1986 to the present are impressive, the downwards trend in economic growth since 1996 indicates the serious structural weakness of the economy. The problems include some reluctance to address the tougher areas of SOE and financial reform, inefficient SOEs and banks, the restrictive trade regime in favour of import substitution, and restraints on the development of the private sector.

The view that doi moi has been incomplete and run out of steam has been mentioned by many scholars (such as Pomfret (1996), Quinlan (1996), and Doanh (1996)) and international organisations (such as World Bank (1995, 1997), IMF (1996, 1999), and UNDP (1996)). It is argued that, as a result, the high economic growth is not sustainable. To maintain rapid growth, fundamental reform changes, including measures to simplify and liberalise the trade regime, reform SOE management, strengthen the financial system, promote the private sector, and increase transparency at all levels of the economy, needs to be adopted.

However, there is reluctance to address the most difficult issue: industrial and financial reforms. Generally, the government seems to be unwilling to loosen its detailed grip over economic decision making. Recently, it seems the government has tried to recentralise the economy. The introduction of decrees 90/TTg and 91/TTg
(March 1994), which allowed the grouping of a number of SOEs into State and General Corporations under a single management, and policies toward the “guiding role” of the state sector (announced by the June 1996 Eighth Party Congress) indicates efforts by the government to regain control over the economy (Riedel 1997, Kokko 1998, Gates and Truong 1996, Pomfret 1996). The reluctance to deregulate and to decentralise partly reflect the party’s determination to retain political power and a fear of high unemployment and regional inequality.

To enhance the state sector’s “guiding role” in the economy, SOEs are provided with many privileges that are not given to the private sector. SOEs hold advantages over PEs in terms of easier access to credit in domestic as well as foreign currencies, to loans with subsidised interest rates and less stringent collateral requirements than PEs, and to the land-use rights that are highly valued contributions of SOEs to a joint venture with foreign investors. SOEs are also favoured in government contracts and in the awarding of international trade and other licenses. SOEs are dominant in import-substitution industries, and highly protected by non-quantitative barriers (EIU 1999, Kokko 1998, 1997, UNDP 1996).

Although SOEs have privileges in many areas, most of them are operating with obsolete machinery and equipment, resulting in low productivity and poor quality of output. Many of the SOEs which dominate the manufacturing sector are reported to be inefficient and heavily indebted. The financial situation of SOEs in 1998 looked much like that of eight years ago. In 1990, over 20 percent of the centrally-controlled and 60 percent of the locally-controlled enterprises were loss-makers (World Bank 1995). In 1998, unprofitable SOEs accounted for 67 percent of the total number of SOEs. Many SOEs have been loss-makers for a long time (CIEM 1999).
The financial sector has been obliged to support the leading role of the state sector. Thus, objectives of state-owned banks (SOBs) are not only commercial, but also political. Moreover, as the government is often involved in resolving debt problems of the SOEs, SOBs feel less responsibility to the debt of SOEs than to the debt of PEs. Consequently, SOBs prefer to lend their money to SOEs rather than to PEs.

As a result, the financial system is suffering from a substantial amount of bad debt owed by SOEs. More than half of the aggregate lending of the banking system, where the state-owned banks dominate and account for 80 percent of assets and credits, is directed to SOEs. Thus, the banks are heavily exposed to the weakness of the SOEs. By the end of 1998, the total debt of SOEs was 170,000 billion Dong, equivalent to 46.1 percent of GDP in 1998. To solve this situation, the PM promulgated Decree 95 to discharge the debts of SOEs and to create favourable conditions for integrating, dissolving or equitizing SOEs (CIEM 1999).

Although exports and imports have increased rapidly since the introduction of the 1989 reforms, Vietnam's trade regime is inefficient in a number of ways and foreign trade reforms are incomplete. The number of permitted trading companies is still partially controlled. If a company wants to engage in international trade, it must obtain government certification or work through a company with the necessary trading rights. In recent years, trading permits have been issued mostly to larger SOEs. Consequently, the majority of private exporters have to operate through permitted trading companies which charge substantial fees. This increases the cost of foreign trade generally. Such a system is highly inefficient, and encourages the vast amount of smuggling that is visible all over the country. It is difficult legally to import the
necessary inputs, while much foreign exchange is used in the illegal import of consumption items such as beer and cigarettes (Dollar 1993).

Another weakness of the trade regime is that tariff rates are constantly being changed. This creates difficulties for businesses in making the long-term investment commitments that are the basis of productivity improvements. Moreover, tariff rates are structured so as to provide high levels of protection to some sectors, including car assembly, sugar, cement, steel, and other consumer goods (CIEM 1999, Kokko 1997). Non tariff barriers such as specialised licensing for certain goods, certain customs surcharges, special sales taxes, minimum pricing at customs, quotas, foreign exchange allocation restrictions, and other quantitative restrictions are used to protect domestic industry and applied to around 40 percent of imports. SOEs and MNEs, often in joint ventures, are the largest beneficiaries from the protectionism. This import substitution trade regime distorts the allocation of scarce resources, creates inefficient industry and damages economic performance.

On becoming a member of ASEAN, Vietnam has made a commitment to the ASEAN Free Trade Agreement (AFTA) program to reduce the majority of its tariff and non-tariff barriers to 0-5 percent by the year 2006, four years later than other members.

Along with the attempt to improve physical infrastructure, such as roads and communication systems, the Vietnamese government has tried to establish and improve legal systems, including economic laws and regulations that fulfil the requirements of a market economy and economic reforms. Since 1987, a number of important laws have been introduced (Table 3.5). Many laws included in Table 3.5 have been amended (some several times) to provide a better framework for the operation of markets. The
Ministry of Justice was established in 1991 to take care of all aspects of the legal system.

### Table 3.5: Number of Laws Passed since 1987

<table>
<thead>
<tr>
<th>Date</th>
<th>Laws</th>
<th>Date</th>
<th>Laws</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/1989</td>
<td>Ordinance on Civil Procedure</td>
<td>12/1993</td>
<td>Bankruptcy Law</td>
</tr>
<tr>
<td>9/1989</td>
<td>Ordinance on Economic Contracts</td>
<td>12/1993</td>
<td>Environmental Protection Law</td>
</tr>
<tr>
<td>5/1990</td>
<td>Ordinance on Commercial Banks</td>
<td>3/1996</td>
<td>Mining Law</td>
</tr>
<tr>
<td>4/1991</td>
<td>Ordinance on Civil Contracts</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

However, the Vietnamese legal system is regarded by most foreigners as inadequate. A shortcoming of the legal system is its ambiguities and the contradictions among some of the laws, decrees, and circulars, the different interpretation and implementation of laws by different ministries and provincial authorities, and the frequency with which the laws are changed. This makes the environment for doing business in Vietnam quite uncertain.

In summary, Vietnam has strong comparative advantages. Included among these are its geographical position, its abundant work force with very low wages but high literacy rates, and the many unexploited natural resources and mineral reserves. However, the effective exploitation of these resources requires large amounts of
capital coupled with appropriate technology, organisation capability, and good management and marketing skills. Although the achievements of the *doi moi* have been impressive, there are still many obstacles to growth that the Vietnamese government has to overcome. The fundamental reforms needed in management of SOEs and banks, and in the trade regime remain to be undertaken. A healthy private sector has to be promoted. Without these changes, and without policy certainty, the current structural weakness of the economy will add much uncertainty to the Vietnamese policy and business environments, and thus make them unattractive to foreign investors.
Chapter 4: CHARACTERISTICS OF FOREIGN INVESTMENT IN VIETNAM

4.1. The development of the legal framework for foreign investment

Vietnam promulgated its first Regulation on Foreign Investment in 1977, shortly after the country's reunification in 1975. However, at that time, under a highly controlled economic regime, the Law imposed many restrictions and requirements upon the activities of foreign investment firms. The economic embargos imposed by many countries after the Cambodian event in 1979 added to the difficult business environment in Vietnam. As a result, there was no foreign investment (Le 1995).

In 1986, in an effort to boost the domestic private sector and to attract foreign investment, Vietnam started to create the necessary legal framework for a multi-sectoral market economy. Openness to foreign direct investment was one of the hallmarks of the doi moi program. In December 1987, a new Foreign Investment Law (FIL) was introduced, intended as evidence of a fundamental policy shift on foreign investment and economic openness in Vietnam. The main objectives of the Law were as follows:

- to attract foreign investment and the needed technologies for the country’s economic development;

- to increase employment;

- to encourage exports and increase foreign exchange earnings;

- to encourage exploration of the country’s natural resources; and
• to improve the skills of Vietnamese managers and workers through acquiring advanced knowledge (ie., new technology, marketing skills, management know-how) and increase competition in the domestic market.

To attain these goals the Law provided conditions and preferential measures concerning the establishment, ownership, management, employment, and dissolution of foreign-invested enterprises, such as security of investment capital and the interests of foreign investors, no restrictions on ownership, or on remittance of capital and profits abroad, and provision of privileged tax rates for FDI projects in encouraged industries.

However, there were many restrictions on foreign investment. The Law allowed only two parties - one Vietnamese and one foreign party - to form a joint venture. All FDI projects producing goods for export were granted greater incentives than import-substitution FDI projects. Also, domestic private enterprises were not allowed by the Law to engage in a joint venture with foreign investors, while foreign-invested joint ventures with state-owned enterprises were given the most privileges. Moreover, at that time, the economy began to shift from a highly controlled one to a market-oriented one. Therefore, the economic management was still heavily bureaucratic although a market legal framework was in the process of establishment (Athukorala 1998, Hoang et al 1998).

The FIL was later amended in 1990, and again in 1992, to reduce the extent of restrictions and make the investment climate more attractive to foreign investors. These were attempts by Vietnamese policy makers to expand the scope of coverage, and clarify the legal framework in order to fit foreign investment to Vietnam's development program (Athukorala 1998, Truong and Gates 1996). The main amendments in 1990 and 1992 included the following:
• domestic private firms were allowed to engage in joint ventures or business cooperation contracts with foreign firms;

• wholly-owned foreign-invested enterprises could enjoy the same preferences as joint ventures;

• the duration of foreign investment projects was extended from 20 years to 50 years, and in some cases up to 70 years;

• export processing zones (EPZs) were opened to both foreign and Vietnamese investors; and

• a new type of foreign investment project - Build-Operate-Transfer (BOT) - was introduced to enhance foreign investment in infrastructure such as power plants, seaports, airports, and roads. A BOT project is a contract between foreign investors and Vietnamese authorised organisations to build and operate a project for a certain period of time, and then transfer it to the Vietnamese government without any compensation. BOT projects enjoy privileges which are not available to other forms of foreign investment.

To strengthen the FIL and the business environment, the government passed a series of laws, decrees, and regulations on investment, trade, property rights, and other related issues (Table 3.4).

By 1994, as mentioned in the previous chapter, there were further changes in the political-economic environment. Economic achievements after five years of economic reforms led Party leaders to believe that the social-economic crisis had been resolved. As a result, the reform process slowed, and the policy course moved towards so-called market socialism, in which the state sector remains dominant. There were
efforts by the government to recentralise economic activity through creating large-scale state conglomerates (so-called state corporations) that were believed to be able to compete with foreign companies (Riedel 1997, Truong and Gates 1996).

The changes in the political-economic climate have affected the institutional arrangements facing FDI. Although foreign investment is still viewed as important for Vietnam's economic development, it is no longer the centre piece of the economic development strategy as it was in the 1987 Foreign Investment Law. Therefore, foreign investment has become subject to the more selective criteria and stricter regulations rooted in the 1995 administrative reform. The administrative reform was launched to combat structural weaknesses of the state apparatus (such as corruption, waste and bureaucratic incompetence) by streamlining the bureaucracy and strengthening the key administrative organisations, and to reduce constraints on foreign investment such as high transaction costs and excessive red tape. However, the reform also established tighter regulations and selective criteria for the approval of FDI which was partly reflected in a new Law on Foreign Investment amended by the end of 1996 (Truong and Gates 1996). The new features of the new FIL are the following:

a) More liberal issuing of investment licences:

- decentralisation of the issuance of investment licences. Some provincial people's committees and boards of management of industrial and export processing zones were granted the right to issue investment licenses for FDI projects worth less than US $40 million. It was hoped that this would speed up the project approval process, and introduce competition for foreign investment among the provinces;

- a reduction in the requirements for the granting of tax preferences. An FDI project could qualify for the 15 and 20 percent tax rates by meeting only one criterion,
instead of having to meet two as previously. The list of criteria was also expanded to include highly technical projects, animal husbandry and agricultural processing, and efficient processing of natural resources. The export percentage needed to quality for the 20 percent tax rate was reduced from 80 percent to 50 percent;

- the elimination of unanimous approval requirements. The resolutions on matters may now be passed by a majority, instead of requiring unanimous approval, except “all the most important issues concerning the organisation and operation of a joint venture” which still require a unanimous decision. This reflects an attempt to protect the role of the local partner, usually a minority, in the joint venture;

- allowing a foreign firm to be involved in more than one joint venture project;

- the introduction of two new types of FDI projects, build and transfer (BT) and build-transfer and operate (BTO), to enhance foreign investment in infrastructure. Additional incentives (such as exemptions from land rent and import duties, and access to the lowest profit and withholding tax rates) are now given to these types of FDI;

b) More restrictions:

- export requirements imposed upon the activities of FDI in some industries, such as garments, construction materials, detergents, and sugar. In order to enter these industries, foreign investors have to commit that all their product will be exported;

- requirement that the value of equipment and machinery brought in by foreign investors as a capital contribution in a joint venture should be assessed;

- requirement to conform to the Vietnamese accounting system;

- restriction on the amount of refund of the profit tax already paid on that part of the profits reinvested. Previously, the tax refund was applied to all kinds of projects.
In the new law, the reimbursed portion depends on the importance given to the investment project.

Beyond the stricter regulations in the new FIL, new constraints can be found in regulations related to foreign investment that were introduced by a number of Ministries. A regulation, for instance, imposed by the Ministry of Labour, Invalids and Social Affairs and the Ministry of Interior allows foreigners working for foreign projects to stay in Vietnam only up to three years maximum. The changes in political-economic environment, and in the law on foreign investment have adversely affected FDI inflows to Vietnam. The situation of FDI in Vietnam since 1989 is presented in detail in section 3 of this chapter. The section below compares Vietnam’s FIL to those in other Asian developing countries to expose its advantages and disadvantages.

4.2. A comparison of Vietnam’s foreign investment law with those in other Asian countries

Investment incentives granted by host governments to foreign investors can be effective in altering the location choices of foreign firms (UNCTC 1992, Caves 1996). Nowadays, in competition for FDI, many LDCs provide substantial investment incentives to attract foreign investors. To reveal the advantages and disadvantages of Vietnam's Law on foreign investment, a comparison between Vietnam’s Foreign Investment Law and foreign investment policies of other Asian developing countries—especially Indonesia, which is considered one of the main competitors of Vietnam in attracting FDI (Cuong 1994, MoF 1998), is presented below. Problems in implementation of the Law on foreign investment and in the business environment in Vietnam are examined in detail in the last section of this chapter.
Like Vietnam, Indonesia attracts foreign investment into resource development (especially gas and oil exploration and refining), and into labour-intensive production using local materials and natural resources, as well as into activities protected against imports. Until 1998, Indonesia’s political structure was similar to that of Vietnam: one political party had been in power for a long time. Like Vietnam, the agricultural sector in Indonesia accounts for the largest share of the labour force (56 percent) (APEG 1997).

The main investment incentives and disincentives in Vietnam and Indonesia are compared in Table 4.1. In Vietnam, except for what are seen as defence-related industries, all economic sectors are open to foreign investors. However, export performance is required for some industries such as garments, construction materials, detergents and sugar. Vietnam does not impose a minimum capital investment requirement for wholly foreign-owned enterprises but does require the foreign party in a joint venture to contribute at least 30 percent of the prescribed capital which, in turn, must comprise at least 30 percent of the total capital needs of the joint venture. Indonesia also does not allow foreign investment in some economic sectors (eg., communications, airports, seaports). A minimum on capital investment is also not imposed in Indonesia. Vietnam guarantees the duration of enterprises with foreign invested capital up to 70 years, while foreign investment enterprises are guaranteed for up to 60 years in Indonesia.

Vietnam’s investment law does not put restrictions on foreign participation in equity. Foreign investors are allowed to own up to 100 percent of any business. In Indonesia, the government allows foreign investors to own 100 percent of the enterprise in some sectors, but after 15 years of commercial operation, some
divestment is required. In joint ventures, the Indonesian shareholding at the time of the company’s establishment must be at least 5 percent.

Table 4.1: Comparing Investment Incentives Provided by Laws on Foreign Investment in Vietnam and Indonesia

<table>
<thead>
<tr>
<th>Incentives</th>
<th>Vietnam</th>
<th>Indonesia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment priorities</td>
<td>Heavy industries; infrastructure; Export-oriented production;</td>
<td>Export-oriented production; labour-intensive industries; essential goods</td>
</tr>
<tr>
<td></td>
<td>labour-intensive industries; foreign exchange earning</td>
<td>and services</td>
</tr>
<tr>
<td>Restrictions on foreign</td>
<td>All economic sectors</td>
<td>Not all sectors open to FDI</td>
</tr>
<tr>
<td>investment</td>
<td>National defence related industries</td>
<td>Military industry, 14 fields absolutely closed for FDI</td>
</tr>
<tr>
<td>- Areas open to FI</td>
<td>Maximum 70 years</td>
<td>Maximum 60 years</td>
</tr>
<tr>
<td>- Sectors closed to FI</td>
<td>No limit on the minimum investment capital</td>
<td>No limit on the minimum investment capital</td>
</tr>
<tr>
<td>- Duration of investment</td>
<td>Foreign investors are allowed to own up to 100% of any business;</td>
<td>Foreign investors are allowed to own up to 100% in some sectors. The</td>
</tr>
<tr>
<td></td>
<td>The foreign share in a joint venture should not be less than 30%.</td>
<td>Indonesian share in a joint venture should not be less than 5%.</td>
</tr>
<tr>
<td>- Minimum investment</td>
<td>Free transfer of capital and profits abroad; foreign exchange</td>
<td>Free transfer of capital and profits abroad</td>
</tr>
<tr>
<td></td>
<td>balancing requirements</td>
<td></td>
</tr>
<tr>
<td>- Ownership and foreign</td>
<td>No private and foreign land ownership, land use rights allowed as</td>
<td>The right of ownership is not granted to foreign investors; land use</td>
</tr>
<tr>
<td>equity participation</td>
<td>capital contribution of Vietnamese partners in State sector</td>
<td>rights cannot be used as a capital contribution by Indonesian partners</td>
</tr>
<tr>
<td>- Foreign exchange control</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Alien land holding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulation of FI</td>
<td>MPI screening of important FDI projects and those worth over US $40</td>
<td>Board of Investment and provinces screening FDI projects</td>
</tr>
<tr>
<td></td>
<td>million; in some cities, provinces and EPZs, IPs are allowed to</td>
<td></td>
</tr>
<tr>
<td></td>
<td>approve projects worth less than US $40 million</td>
<td></td>
</tr>
<tr>
<td>Forms of Investment</td>
<td>100% foreign ownership company; contractual business co-operations;</td>
<td>100% foreign ownership companies; joint-venture companies.</td>
</tr>
<tr>
<td></td>
<td>joint-venture companies</td>
<td></td>
</tr>
<tr>
<td>Investment incentives</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-tax incentives</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| - Nationalisation         | Foreign capital and assets guaranteed not to be nationalised.          | Foreign capital and assets guaranteed not to be nationalised.            
| - Convertibility of currency | None | In bilateral treaties, foreign investors may have a guarantee against losses due to inconvertibility of currency |
| - Investment guarantee agreement | Investment guarantees and double taxation agreements with a number of countries | Investment guarantees and double taxation agreements with a number of countries |
| - Export processing zones | Enterprises operating in the EPZs are entitled to the following: | Enterprises operating in the EPZs are entitled to the following: |
| | - exemption from import-export duty; | - exemption from import-export duty; |
| | - tax holidays: 4 years | - no tax holidays |
| | - income tax rate: 10-25%; | - income tax rate: 15-35%; |
| | - withholding tax rate: 5%; | - withholding tax rate: 20%; |
| | - foreign equity participation: no limit, up to 100% foreign ownership | - initial foreign equity participation up to 100%, then within 15 years must be reduced to 95% or below in the joint ventures |

**Tax incentives**

- **Tax holiday/ reduction**: 1-4 years and 50% reductions for the next 2-4 years
- **Lower income tax rates**: 10-20% of earned profits
- **Reduced withholding tax rate**: 5 - 7%
- **Refunds of profits tax**: Refund of the amount of profit tax already paid on that part of the profits reinvested

**Taxation**

- **Corporate income tax rate**: 10-25%
- **Withholding tax rate**: 5-10%
- **Accelerated depreciation**: None

**Labour relations**

**Minimum wages:**
- **Unskilled labourer**: 30-35 $US/month
- **Skilled labourer**: 35-50 $US/month

**Working hours**: 48 hours/week

**Intellectual Property Rights**

Trademark, copyright and patent laws and regulations

**Source:** Vietnam Foreign Investment Law (1997), IFC (1997),

Neither Vietnam nor Indonesia imposes restrictions on remittances of earnings, profits, or dividends from investment. Foreign investors have the right to repatriate the
following: earnings (after payment of all taxes due); profits derived from business operations; payments for provision of technology or services; repayments of principal and interest on any loan; and their share of invested or reinvested capital, and other money and assets in their legal ownership. However, in Vietnam, to purchase foreign currency for the purposes of remitting profits, share of invested and reinvested capital, and other payments, FIEs have to get an approval from the MPI and the State Bank.

The system of investment incentives may play an important role in investment decisions. The main incentives are as follows:

**Non-tax incentives.** Both the Vietnamese and Indonesian governments guarantee against nationalisation or revocation of ownership rights of enterprises with foreign capital, and against restriction of the rights of control and management of enterprises.

Both governments are involved in investment guarantee agreements and double taxation avoidance agreements with a number of countries. These agreements are intended to reassure foreign investors.

**Tax incentives.** Tax incentives consist of tax exemptions (tax holidays), accelerated depreciation, investment allowances and tax rate reductions. Vietnam offers more concessions than Indonesia. Vietnam grants a fiscal incentives package consisting of a tax holiday of four years, and then up to four years at 50 percent of the regular tax rate, as well as a preferential corporate income tax rate of 10-15 percent for FDI in the priority sectors (as against the standard rate of 21-25 percent). The withholding tax rate for standard projects is 10 percent. Indonesia does not grant any tax holidays for an enterprise with foreign invested capital; the standard income tax rate for joint ventures in Indonesia is 35 percent; the withholding tax rate is 20 percent.
However, to attract FDI, the Indonesian government uses accelerated capital depreciation rates that vary from 10 to 50 percent per year depending on the useful life of assets. To encourage reinvestment, Vietnam grants refunds of profit taxes to foreign investors reinvesting any part of their profits for a period of three years and in important investment projects.

A Vietnamese company with foreign capital is also exempt from duties on machinery and equipment imports, raw materials, spare parts, and other inputs and components that are used either in the manufacture of exports or as a contribution to the total capital of the company.

The list of priority industries and incentive levels corresponding to these priorities are carefully defined in Vietnam, while Indonesia has a negative list, which only defines which sectors are closed to foreign investment. The requirement of foreign exchange balancing for joint venture companies is a constraint imposed by Vietnam. Joint ventures have to earn sufficient foreign exchange to meet all their foreign-currency needs. This requirement of foreign exchange balancing is a major obstacle for projects involving import-substitution and infrastructure which would be beneficial for Vietnam’s development but generate little foreign exchange earnings in the short term.

Both Vietnam and Indonesia have strict controls on real estate acquisitions by foreign investors. Foreign investors may be granted the right to use land, but they cannot become land owners\(^1\). In Vietnam, land-use rights often represent the local capital contribution to a joint venture. Establishing a value for the land is difficult for foreign investors because of the absence of a formal land market. Strict controls on real estate acquisitions by foreign investors is one of the reasons why there are relatively few approved projects with 100 percent foreign ownership in Vietnam.
### Table 4.2. Foreign Investment Incentives in ASEAN Countries and Vietnam

<table>
<thead>
<tr>
<th>ASEAN countries</th>
<th>Tax incentives</th>
<th>Import Tariffs</th>
<th>EPZ and/other free trade instruments</th>
<th>Other incentives and/ or conditionality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>None</td>
<td>Duty drawback for export production</td>
<td>Bonded zones</td>
<td>- Joint ventures required of FDI</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Five-year tax holiday</td>
<td>Exemption for machinery and raw materials for approved projects</td>
<td>Several EPZs</td>
<td>- Loans for government-sponsored banks - available R&amp;D expenditures tax deductible</td>
</tr>
<tr>
<td>Philippine</td>
<td>Five to eight years tax holiday</td>
<td>Exemption for machinery Post-operative tariff protection available</td>
<td>Several EPZs</td>
<td>- Tax incentives for projects in underdeveloped areas - R&amp;D expenditures tax deductible</td>
</tr>
<tr>
<td>Singapore</td>
<td>Five to ten years tax holiday</td>
<td>Exemption for nearly all imports including for FDI</td>
<td>Several free trade zones</td>
<td>Loans at concessionary rates for targeted industries - R&amp;D expenditures tax deductible</td>
</tr>
<tr>
<td>Thailand</td>
<td>Three to five years tax holiday</td>
<td>Exemption for machinery and selected raw materials</td>
<td>Two EPZs</td>
<td>- Tax credits for projects outside Bangkok - Infrastructure support for large projects</td>
</tr>
<tr>
<td>Vietnam</td>
<td>Two year tax holiday plus another two year tax holiday at 50 percent</td>
<td>Exemption for machinery and for raw materials for approved projects</td>
<td>- Two EPZs - Other EPZs planned</td>
<td>- Lower corporate rates for FDI on priority industries list - 100 percent owned FDI allowed</td>
</tr>
</tbody>
</table>

**Sources:** World Bank (1995), Vietnam Foreign Investment Law (1997)

In summary, Vietnam provides more incentives and has fewer requirements for foreign investors than Indonesia. Vietnam allows foreigners to invest in any sector of the Vietnamese economy; provides tax holidays, reductions from income tax, privileged income tax and withholding tax rates; and does not impose a restriction on the share of foreign ownership. The Indonesian government, on the other hand, imposes some restrictions on foreign participation in economic activities, as well as ownership, and does not grant any tax incentives to foreign investors.

Vietnam’s FDI incentives are similar to those of other ASEAN countries (Table 4.2). Vietnam offers more concessions than Indonesia, but fewer than Singapore,
Malaysia and the Philippines in terms of tax holidays. Vietnam offers lower corporate tax rates for FDI projects in priority industries. However, it does not grant any tax reductions for the research and development expenditures of enterprises with foreign capital, while some other countries do. As in other ASEAN countries, an enterprise with foreign capital in Vietnam is exempt from duties on machinery and equipment imports, raw materials, and components used either in the production of exports or as a contribution to the total capital of the enterprise. In the next chapter, the impact of tax incentives provided by Vietnam’s investment law in attracting FDI is tested.

4.3. FDI in Vietnam in the post-reform period

4.3.1 Volume and scale of FDI

FDI started flowing into Vietnam in 1988 after the introduction of the December 1987 FIL. In the first year less than 40 projects worth about US $360 million were approved. In 1989, the number of approved projects and the investment capital of these projects increased slightly to 60 and US $520 million, respectively. The situation did not change much in 1990. The fact that the economy was in the beginning stage of restructuring and establishing an appropriate legal framework to private market and organisations was the main reason for the slow growth of FDI inflow in Vietnam in the period 1987-90.

The growth of FDI approvals increased rapidly after 1991 (Figure 4.1). Following the 1990 and 1992 revisions that clarified provisions in the original version of the FIL, and the introduction of a number of ordinances and laws, the business environment was improved. Therefore, the value of foreign investment approved for 1991 doubled. The upward trend continued in 1992 and accelerated in 1993.
The removal of the economic embargo by the US in 1994 allowed foreign investors from America, Japan and other western countries to invest freely in Vietnam. FDI inflow in Vietnam continued to increase in 1994 and 1995, but at lower growth rate than in the period 1991-93. In 1996, the trend would have been downward if two mega projects had not been approved on the last day of the year. Although the amount of approved investment capital peaked in 1996, the number of approved FDI projects was lower than in 1994 and 1995. Foreign direct investment approvals plunged further in 1997 (Figure 4.1, Table 4.3).

Figure 4.1. Approved Foreign Investment in Vietnam, 1988-90 and 1997.

Improvement of the legal framework, the high economic stability and growth rate in the period 1991-96, and the improvement in the international relationships of Vietnam with other countries resulted in a substantial amount of FDI inflow in Vietnam in the period 1989-96. However, the lower growth rates of FDI in the period 1994-96, and the sharp decrease in FDI inflow since 1997 have reflected the impact of the slowing of economic reforms, and the recent policies which have attempted to keep the dominant role for the state sector in the economy and impose stricter regulations
on foreign investment. The failure of the 1996 administrative reform, which has sought to combat structural weaknesses, namely corruption, waste and bureaucratic incompetence, by streamlining the bureaucracy and strengthening important administrative organisations, has also contributed to the declining of FDI inflow in Vietnam in recent years. Indeed, the favourable international conditions since 1994, especially after the removal of the embargo by the US, could well have partly offset the negative impact of the changes in the political-economic climate on the FDI inflow. When the international conditions worsened after the Asian financial crisis in the middle of 1997, there was a sharp decline in FDI inflow in Vietnam in 1997, 1998 and 1999. Approved foreign investment capital dropped sharply from US $8.6 billion in 1996 to US $4.6 billion in 1997, $3.9 billions in 1998, and US $1.5 billion in 1999.

Most foreign investment projects are small to medium size with investment capital less than US $5 million. Such projects accounted for 77 percent of total foreign investment projects operating in Vietnam in the period 1988-96, but because of the relatively small size of the investments, they accounted for only 12 percent of total committed foreign investment capital. Small to medium sized projects are concentrated mainly in agriculture, forestry, fisheries, and some manufacturing industries, such as electronic and electrical appliances, garments and textiles, and maintenance and repair of equipment (MPI 1997).

By contrast, foreign investment projects in oil and gas, heavy industries (i.e., cement, steel and metallurgy, and automobiles), telecommunications, and housing development are much more capital intensive with average investment capital per project over US $10 million. These FDI projects are mostly IS or non-tradeable.
Over time, there has been a tendency for the average size of projects to increase. The average size of FDI projects increased from US $9.2 million in 1988 to over US $20 million in 1996. Compared to the average size of FDI projects in China, FDI projects in Vietnam are much more capital intensive. The average size of FDI projects in China in the period 1979-1981 was US $5.21 million. However, the average size in China has decreased substantially, to US $0.91 million in 1990 and US $2.98 million in 1996, about one-tenth the size in Vietnam over the same period. According to Vietnam’s law on foreign investment, foreign investors are encouraged to invest in both labour-intensive and heavy industries. However, the upward trend of the average investment capital per project indicates a shift of FDI towards more capital-intensive projects, and reflects the Vietnamese government’s preference for large, capital intensive projects, mainly in heavy industries, over small ones which are often labour-intensive projects.

4.3.2. Sectoral distribution of FDI

The structure, composition and distribution of FDI in Vietnam continue to change. Between 1988 and 1990, most FDI went into natural resource development, especially oil and gas (34 percent of cumulative FDI), and the tourism and service sectors (almost 24 percent of cumulative FDI). Foreign investment flows into manufacturing in this period were a small proportion (14.9 percent) of total foreign investment capital approved. By encouraging FDI flow into the tourism and service sectors, the government has hoped to earn foreign exchanges. Also, by investing in these sectors, which were less developed in Vietnam, foreign investors have expected that the reforms introduced in 1989 will attract more foreigners (including tourists, investors and people who come to Vietnam to find opportunity to do business) and overseas Vietnamese. In this early period, Vietnam could not legally and physically
accommodate manufacturing investment projects due to poor physical and legal frameworks.

Table 4.3. Foreign Investment by Sectors (as of June 19, 1997) (US $ million)

<table>
<thead>
<tr>
<th>Industries</th>
<th>Number of projects (No)</th>
<th>Share of Total projects (%)</th>
<th>Total Approval Capital (US$M)</th>
<th>Share of Total Approval Capital (%)</th>
<th>Realised Capital (US $M)</th>
<th>Share of Realised Capital (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Heavy Industry</td>
<td>329</td>
<td>19.92</td>
<td>4768.7</td>
<td>16.96</td>
<td>1501.5</td>
<td>15.34</td>
</tr>
<tr>
<td>Light Industry</td>
<td>347</td>
<td>21.00</td>
<td>2689.3</td>
<td>9.57</td>
<td>1085.2</td>
<td>11.08</td>
</tr>
<tr>
<td>Food Processing</td>
<td>102</td>
<td>6.17</td>
<td>1766.1</td>
<td>6.28</td>
<td>752.1</td>
<td>7.68</td>
</tr>
<tr>
<td>Oil and Gas</td>
<td>29</td>
<td>1.76</td>
<td>1301.9</td>
<td>4.63</td>
<td>2016.4</td>
<td>20.60</td>
</tr>
<tr>
<td>Agriculture</td>
<td>179</td>
<td>10.84</td>
<td>1331.8</td>
<td>4.74</td>
<td>413.6</td>
<td>4.22</td>
</tr>
<tr>
<td>Marine Industry</td>
<td>34</td>
<td>2.06</td>
<td>134.9</td>
<td>0.48</td>
<td>46.2</td>
<td>0.47</td>
</tr>
<tr>
<td>Transport and Communication</td>
<td>82</td>
<td>4.96</td>
<td>1993.7</td>
<td>7.09</td>
<td>539.5</td>
<td>5.51</td>
</tr>
<tr>
<td>Hotel and Tourism</td>
<td>143</td>
<td>8.66</td>
<td>3280.8</td>
<td>11.67</td>
<td>1484</td>
<td>15.16</td>
</tr>
<tr>
<td>Construction</td>
<td>166</td>
<td>10.05</td>
<td>2332.8</td>
<td>8.30</td>
<td>682.1</td>
<td>6.97</td>
</tr>
<tr>
<td>Development of Offices and Apartments</td>
<td>116</td>
<td>7.02</td>
<td>7068.1</td>
<td>25.14</td>
<td>635.9</td>
<td>6.50</td>
</tr>
<tr>
<td>Construction of IZs and EPZs</td>
<td>9</td>
<td>0.54</td>
<td>601</td>
<td>2.14</td>
<td>236.7</td>
<td>2.42</td>
</tr>
<tr>
<td>Culture, Health and Education</td>
<td>50</td>
<td>3.03</td>
<td>348.2</td>
<td>1.24</td>
<td>54.3</td>
<td>0.55</td>
</tr>
<tr>
<td>Finance and Banking</td>
<td>25</td>
<td>1.51</td>
<td>268.8</td>
<td>0.96</td>
<td>256</td>
<td>2.61</td>
</tr>
<tr>
<td>Other Services</td>
<td>41</td>
<td>2.48</td>
<td>228.9</td>
<td>0.81</td>
<td>86.8</td>
<td>0.89</td>
</tr>
<tr>
<td>Total</td>
<td>1652</td>
<td>100</td>
<td>28115</td>
<td>100</td>
<td>9790.3</td>
<td>100</td>
</tr>
</tbody>
</table>


Late in 1991, when the legal framework for a market economy was improved through the introduction of a number of laws (Chapter 3) and the reduction of restrictions on foreign investment, the government began to encourage investment in industry by using different tax rates and expansion of the priority list of projects. FDI started to flows into manufacturing as a result, and investment in this sector has continued to increase. Its share in total commitments increased from about 15 percent in the period 1988-1991 to 37.4 percent in 1998. By contrast, foreign investment flows into oil and gas exploration and exploitation, and agriculture, dropped from 12.0 and 3.5 percent in 1994 to 4.3 and 1.4 percent in 1997, respectively. FDI in the real estate
and tourism sectors continues to hold the second largest share in total commitments (behind FDI flow into industry) (Table 4.3).

However, compared to FDI in the industrial sector in China and Thailand after about 8 to 10 years of an export-oriented strategy, FDI in the industrial sector in Vietnam was much lower. After 10 years of pursuing an open door policy, FDI in the industrial sector in Vietnam accounted for only 37.4 percent of total commitments, while the share of FDI in industry was 81 percent in China in the period 1988-91, and 57 percent in Thailand in 1988. The sectoral distribution of FDI in the industrial sector in Vietnam has also been different from these countries. While labour intensive industries (such as textile and clothing, footwear, processed food, electronics, and miscellaneous manufacturing) are the preferred areas of foreign investment in China and Thailand, much of FDI in Vietnam was tapped into capital-intensive heavy industries (such as cement, steel, and automobiles). FDI in labour-intensive industries (most of which are exporting sectors) accounted for over 60 percent of total pledged FDI in the industrial sector in China in the period 1984-89. In Vietnam, the share of FDI in light industries was about 29 percent of total commitments, and 29.3 percent of total implemented FDI in the period 1994-98. This reflects the fact that the government has preferred foreign investment in the heavy industry and non-tradeable to export-oriented FDI projects. As a result, much of FDI has been channelled to heavy industry and non-tradeables (hotel, office property and apartments, construction, transportation and telecommunication) in Vietnam.

Foreign investors from developed countries, i.e., Western European, American and Japanese firms, direct their investment mainly into Vietnam’s oil and gas industry, automobiles, and telecommunications. East Asian (NICs and Japan) countries
emphasise export-oriented projects that use low-wage local labour in light industries, such as footwear and garments. However, investment from East Asia is also flowing into heavy industries (eg., cement, steel, and metallurgy), paper and pulp production, assembly of motor vehicles, components and spare parts production, complex electronic products, and also the food industry where seafood processing for export is the main activity (Table 4.7).

4.3.3. Forms of investment

The majority of foreign investment projects in Vietnam are joint ventures (Table 4.4) which constituted 66.5 percent of total commitments during 1991-98. State-owned enterprises or state agencies which contribute land are the major local partners in joint ventures with foreign firms. Joint ventures with state-owned enterprises or state agencies accounted for 64.6 percent of total commitments and 53.3 percent of total implemented FDI in the period 1991-98. There are some reasons to explain this high percentage of joint ventures in Vietnam.

Firstly, the knowledge of local partners about local market conditions, legislation and relationships with authorities is important for foreign investors in overcoming obstacles in the host country, especially in a country like Vietnam in which market structures are being developed. Most foreign investors complain about the red tape and the incomplete legal system. Therefore, a potential local partner who is politically well-connected, in good standing with appropriate ministries at central or local levels, or both, and has land use rights and access to state credit and to key decision-makers within the bureaucracy, can help foreign investors get things done smoothly.
As mentioned in chapter 3, the government policies which favour state-owned enterprises (SOEs) over domestic private enterprises (PEs) have made SOEs the most likely potential local partners. SOEs have land use rights on a stable and long-term basis that are allowed by law to be used as contributions of capital to a joint venture. Until recently, land use rights were not granted to any individual or private enterprise, including foreign-owned firms. Some domestic private enterprises have land use rights for historical reasons, but they are not allowed by law to contribute land use rights as part of the capital of a joint venture. PEs were also not allowed to use their land as collateral for bank loans. Moreover, SOEs are also provided with easy access to credit and export-import facilities and are politically well connected with ministries and local government, and protected by high import tariffs and entry restrictions (i.e., granting licences to private firms in areas where there are few or no SOEs operating) (World Bank 1997). Therefore, by entering into a joint venture with SOEs, foreign investors have been able to gain access to land use rights and the domestic capital market more easily, and overcome entry restrictions and trade protection. In contrast, PEs which are the most dynamic economic units in the economy and allowed by law to engage in joint ventures with foreign firms, face many constraints in terms of land use rights and access to financial and international trade facilities, and therefore have not been able to be local partners.

Secondly, there is an unwritten policy that the government directs foreign investors to joint ventures with SOEs (World Bank 1997, Levine 1998). As discussed in Section 4.2, the Foreign Investment Law of Vietnam allows foreign investment in all economic sectors (except defence related industries) but, in fact, many industries (such
as telecommunications, hotels and tourism, and insurance) are open only to joint ventures or business co-operation contracts.

Recently, the share of joint ventures in total commitments declined from 76.6 percent in 1996 to 50.1 percent in 1997 and 57 percent in 1998. The decrease in capital investment in joint ventures indicates that complaints about administrative hurdles and protection of the minority (often local partners) has spread widely among foreign investors.

Table 4.4. Foreign Investment by Investment Categories, 1991-98

<table>
<thead>
<tr>
<th></th>
<th>Invested Capital (US $ million)</th>
<th>Investment Realised (US $ million)</th>
<th>Local Labour* (1000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint Venture Share in Total (%)</td>
<td>21,627</td>
<td>5,449</td>
<td>81.12</td>
</tr>
<tr>
<td></td>
<td>66.5%</td>
<td>53.7%</td>
<td>58%</td>
</tr>
<tr>
<td>100% Foreign Capital Share in Total (%)</td>
<td>7,005</td>
<td>2,271</td>
<td>56.11</td>
</tr>
<tr>
<td></td>
<td>21.5%</td>
<td>22.4%</td>
<td>40%</td>
</tr>
<tr>
<td>Business Cooperation Contracts Share in Total (%)</td>
<td>3,096</td>
<td>2,402</td>
<td>2.44</td>
</tr>
<tr>
<td></td>
<td>9.5%</td>
<td>23.8%</td>
<td>2%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>32,542</td>
<td>10,140</td>
<td>139.67</td>
</tr>
</tbody>
</table>

Note: * - data in 1995.

There has been a growing tendency among investors to have 100 percent foreign-owned capital projects since the December 1992 amendments to the FIL and the ensuing regulations of April 16, 1993, which treat 100 percent foreign-owned capital projects the same as joint-venture projects. At the end of 1992, 100 percent foreign-owned enterprises accounted for only 15 percent of projects and 14 percent of total registered capital. They rose to 17.5 percent of total commitments in 1995, to 20.8 percent in 1996, and to 25.3 percent in 1998. There are three main reasons for the increasing tendency to set up wholly foreign-owned subsidiaries in Vietnam.
First, when the 1987 FIL was implemented, foreign investors lacked information about Vietnam, its economic conditions, and the legal system. Therefore, foreign businessmen were reluctant to set up their own subsidiaries. In the first year after the introduction of the FIL, there was only one wholly foreign-owned enterprise in Vietnam. Gradually, foreign firms have gained confidence concerning the country’s economic conditions, the government’s policies toward foreign investment, and how to get things done smoothly. This has led foreign investors to prefer wholly-owned ventures to ensure full control over the firm and greater confidentiality in their processes.

Second, the development of three EPZs and 27 industrial parks (IPs) has helped to solve the land use rights problems. Foreign investors can easily rent a site for their factories in EPZs or IPs.

The third reason for the increase in 100 percent foreign-owned enterprises is the financial and managerial limitations of Vietnamese partners. Although Vietnamese partners, in general, hold a minor share in the total investment capital of a joint-venture, the FIL before 1997 required unanimous agreements in decision-making which granted Vietnamese partners the same power as foreign partners, who have the major share in the ventures. By setting up an affiliate, a foreign firm avoids sharing the decision making power with Vietnamese partners.

Foreign investors from Asian countries which have cultures and customs to some extent similar to those in Vietnam set up wholly foreign-owned subsidiaries more frequently than do investors from western developed countries. This may be because Asian foreign firms can adapt to the business environment in Vietnam more quickly than foreign investors from other regions.
Wholly foreign-owned firms concentrate mainly on labour-intensive industries, such as agriculture, textiles and garments, footwear, leather products, electronics, toys, and electrical appliances. In general, the average size of projects in this form of foreign investment is small to medium. This indicates that foreign investors attempt to exploit the country’s advantage in cheap labour and to limit the risks due to constant changes in laws and regulations. By being more flexible in their production plans and operations, wholly foreign-owned enterprises can adapt to a new business climate more quickly than can joint ventures, in which unanimous agreement among the board of management is required.

Another form of FDI in Vietnam is the business cooperation contract (BCC) between foreign investors and Vietnamese firms. The contract is based on the mutual allocation of resources and the distribution of profits without establishing a joint venture. In this form, the foreign party has no separate legal existence in Vietnam. This form of investment is highly flexible for both partners without involving the incorporation of a Vietnamese company. That is why in the first years of implementing the FIL, when the legal framework for a market economy began to develop, this was the prevailing form of foreign involvement in Vietnam, accounting for 20 percent of total approved projects, and 60 percent of commitments. However, many tax holidays and exemptions that are available to joint ventures and wholly foreign-owned firms are not available to BCCs. Therefore, since 1992 when the legal framework was improved, the shift of FDI into manufacturing has been accompanied by a sharp drop in this form of investment. By the end of 1996, the share of this form of investment in total approved projects and commitments had fallen to 5.2 and 7.7 percent, respectively. Oil and gas projects must take this form. Besides projects in the oil and gas sector, and in
telecommunications, other projects in this form are, in general, small projects, producing goods for export, using simple technology and having a high rate of return.

Table 4.4 shows the differences in implementation of different forms of investment in Vietnam. Business cooperation contracts have the highest rate of realisation (77.8 percent), followed by the 100 percent foreign capital form (32.4 percent). Joint ventures has the largest share in total disbursements (53.7 percent), but lowest implementation rate of 25.2 percent. This suggests that many joint ventures are capital-intensive projects, and many foreign investors faced administrative hurdles and had to change their approach after initially committing investments to joint ventures with SOEs. In terms of employment, the 100 percent foreign capital form of investment has made a very significant contribution to job creation in Vietnam. Accounting for only 22.4 percent of realised capital, wholly foreign-owned firms have created 40 percent of total jobs for Vietnamese workers working in all foreign-invested enterprises - a result of their concentration in labour-intensive activities.

4.3.4 Geographic distribution and investing sources

The geographic distribution of foreign investment in Vietnam has changed substantially over the past eight years. Initially, foreign investment was concentrated in the south where infrastructure was better developed. In the first four years (1988-91), only 25 percent of projects (20 percent of total invested capital) were in the provinces in the north. Since 1992, the north has caught up quickly, and in 1995, it attracted 41 percent of total commitments. This change has resulted from much lower average wages and rents, reliable energy supplies, and granting privileges (lower minimum wage rate, longer tax holidays) and licenses more easily to foreign investors to invest in the north and the central regions. The south received 53 percent while central Vietnam
received 6.7 percent of total foreign invested capital in 1996. However, as is the case in other Asian countries, foreign investment in Vietnam remains quite concentrated. Foreign investment inflows have been heavily concentrated around the major cities - Ho Chi Minh City (28.9 percent of total commitments), Hanoi (23.8 percent), Dong Nai (11 percent), Khanh Hoa, and Hai Phong - where there is good infrastructure, a well developed industrial base, the availability of skilled labour, and large domestic markets. These cities and provinces, which hold only 16 percent of the total population, have received over 75 percent of cumulative FDI. However, an attempt by the government to redirect FDI inflows to other provinces led to the withdrawal of a $1.2 billion USD oil refinery project by the Total Company of France.

Between 1988 and 1990, when most FDI went to natural resource development, firms from the United Kingdom, France, Norway and the Netherlands dominated Vietnam’s oil and gas industry. Later in 1990 and in 1991, the Asian newly industrialising countries (Singapore, Hong Kong, Taiwan, and South Korea) began to invest in Vietnam’s manufacturing industries, and by late 1992, Asian FDI exceeded European investment and became the most important source of foreign capital for Vietnam (Table 4.7). Currently, 57 countries and territories have invested in Vietnam. Investment from Asian countries accounted for around 70 percent of total foreign investment in Vietnam over the period 1988-96. Foreign investors from five East Asian countries, Singapore, Taiwan, Japan, South Korea and Hong Kong, held two-thirds of total foreign investment commitments (Table 4.5). In the early stage of FDI, foreign investors from Taiwan and Hong Kong engaged in small and medium projects, later on MNEs from Singapore, South Korea, and Japan started to invest in large scale projects.
Table 4.5 Leading Investors in Vietnam, 1988-1998

<table>
<thead>
<tr>
<th>Country</th>
<th>Capital commitments (US $ million)</th>
<th>Implemented Investment capital (US $ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Share (%)</td>
</tr>
<tr>
<td>1. Singapore</td>
<td>5857</td>
<td>18.0</td>
</tr>
<tr>
<td>2. Taiwan</td>
<td>4028</td>
<td>12.4</td>
</tr>
<tr>
<td>3. Japan</td>
<td>3266</td>
<td>10.0</td>
</tr>
<tr>
<td>4. South Korea</td>
<td>2903</td>
<td>8.9</td>
</tr>
<tr>
<td>5. British Virgin Islands</td>
<td>2772</td>
<td>8.5</td>
</tr>
<tr>
<td>6. Hong Kong</td>
<td>2671</td>
<td>8.2</td>
</tr>
<tr>
<td>7. France</td>
<td>1489</td>
<td>4.6</td>
</tr>
<tr>
<td>8. Malaysia</td>
<td>1182</td>
<td>3.6</td>
</tr>
<tr>
<td>9. USA</td>
<td>1059</td>
<td>3.3</td>
</tr>
<tr>
<td>10. Other countries</td>
<td>7315</td>
<td>22.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>32542</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>


Singapore leads with involvement in 156 projects with total capital commitments of $5.16 billion USD (18.4 percent of total foreign investment commitments) invested, mainly in hotel and housing development, construction, heavy and light industries, and food processing. Taiwan with 270 projects worth US $3.88 billion (13.8 percent) is the second largest foreign investor, investing also mainly in hotel and housing development, services (such as trade, restaurants, business services), heavy industries, manufacturing construction materials, food processing, and manufacturing for the export of footwear, textiles and clothing (Table 4.8). Taiwanese and Hong Kong manufacturers have their historical ties to ethnic Chinese businessmen in Ho Chi Minh city. In terms of disbursements, Taiwan is the largest foreign investor in Vietnam, accounting for 13.4 percent of total implemented foreign investment
capital in the period 1988-98. Hong Kong is the fourth largest foreign investor behind Japan and Singapore.

Japan and US shares have been rising rapidly since the lifting of the US embargo in early 1994. In 1994, Japan and the US were the fifth and thirteenth largest investors, respectively. By 1998, however, they became the third and ninth largest investors, respectively. In terms of disbursements, Japan is the second largest investor, accounting for 11.7 percent of total realised capital in the period 1988-98. The relative importance of Australia and France, early leaders when Vietnam opened up to foreign investment in 1988, has declined (MPI 1996). Malaysia and South Korea are among countries which have the highest realisation rates (Table 4.5).

**Figure 4.2. The implementation rate of FDI in Vietnam**

![Graph showing the implementation rate of FDI in Vietnam from 1991 to 1998.](image)

The financial transfers from overseas Vietnamese must be considered in any analysis of investment in Vietnam because of their significance. According to official Vietnamese data, in 1993, overseas Vietnamese remitted over US $700 million; in 1994 the figure is believed to have been over US $1 billion. This form of capital inflow was equivalent to 67 percent of Vietnam’s realised FDI in 1994. These transfers are especially significant in the private and household sectors in urban areas (Gates and Truong 1995, World Bank 1997).
4.3.5 Implementation of FDI

Although FDI approvals (in terms of both numbers and volume) have increased rapidly in Vietnam, the implementation of FDI projects has been slow. Total investments realised in the past nine years amount to US $8401 million or only 29.1 percent of total investments approved (Table 4.7). This figure includes the full amount of the Vietnamese contributions to joint ventures, mostly in the form of land and buildings (2). Hence, discounting for the share of Vietnamese partners, realised FDI is just 25.2 percent of investment approvals. The rate of implementation rose sharply between 1992 and 1994 but declined sharply in 1996 (Figure 4.2). The problems impeding the realisation of FDI are as follows:

- Cumbersome administrative procedures and bureaucratic requirements are still slowing the issuance of project licenses. Multiple approvals are required, and many difficulties are encountered in negotiating foreign investment contracts. The issuing of project and related licences, and the implementation of projects have led to long delays and slow implementation rates. These are the reasons why in 1995, only 31 percent of foreign investment projects applying for licences were successful within 45 days (MPI 1996). According to a survey of foreign-investment enterprises conducted by the Saigon Times (March 24-30, 1994), it took 100 percent foreign-owned enterprises about two years to receive the necessary licenses (construction, import-export, land use rights, etc), twice as long as joint ventures. Another survey conducted by the Indochina Project Management Company (October, 1994) reported that 44 percent of interviewed foreign investors considered coping with the bureaucracy as the biggest problem they faced. Despite the government's policy of making the State Committee for Cooperation and Investment (SCCI), nowadays the Ministry of Planning and
Investment (MPI) a “one-door” service, most project sponsors need to go themselves to various agencies to speed up the approval process (Ha Anh 1998).

- The overlapping authorities of national and provincial governments complicate the process of approvals and cause long delays. Some provincial authorities have laid down regulations which contradict national laws and regulations. Currently, foreign investors find fewer problems in the approval process at the central level than face at the local and ministerial level. Experience shows that the important approvals foreign investors need are from the provincial People’s Committees.

- Foreign investors cite difficulties and delays in securing land use rights as one of the most important impediments to doing business in Vietnam. According to a report of the Ministry of Planning and Investment (1996), in 1995, a very small number of projects received land use rights within 30 days after project licenses were granted.

- Labour regulations weaken the attractiveness of Vietnam’s low-cost labour and slow the implementation of FDI projects. The FIL allows foreign investors to hire and fire local workers. However, hiring is restricted in three ways:

  (i) It must be done through the local government labour office or by a labour supply company, by paying the institutions a fee (3 percent of monthly salary for referral and up to 8 percent for an appointment). If this is not successful, then the enterprise may advertise directly. However, when they decide to hire Vietnamese employees directly, foreign enterprises encounter strong opposition from service companies (labour offices or labour supply companies), owned by the local people’s committees. Moreover, under local regulations, foreign organisations may be required to recruit through service companies, and be charged from two to four times the wage
received by the Vietnamese workers (Burke 1993). This makes labour costs in Vietnam higher than expected.

(ii) Local workers are preferred to expatriates who can be recruited only if requirements cannot be met by nationals.

(iii) The minimum wage for foreign investments is currently set at US $35 per month. This is about twice the domestic private sector wages of US $15-20 per month. Vietnam’s minimum wage for foreign investors is high compared with minimum wages in Sri Lanka, Bangladesh and Pakistan (Oanh and Grub 1992). Moreover, each month, employers are required to contribute an amount equal to 10 percent of the total monthly payroll to their employees’ social insurance fund.

Table 4.6. Prices of Land, Electricity, and Water of Industrial Zones and EPZs in Selected Asian Countries, April 1997

<table>
<thead>
<tr>
<th>Country</th>
<th>Land US$/m²</th>
<th>Electricity US$/KWh</th>
<th>Water US$/m³</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>0.06-3.2 (per year)</td>
<td>0.015-0.037</td>
<td>0.02-0.06</td>
</tr>
<tr>
<td>Thailand</td>
<td>39.5-66.7 (for project life)</td>
<td>0.1</td>
<td>0.36</td>
</tr>
<tr>
<td>Malaysia</td>
<td>6.2-22.2 (for project life)</td>
<td>0.62</td>
<td>0.35-0.46</td>
</tr>
<tr>
<td>Indonesia</td>
<td>45-61.7 (for project life)</td>
<td>0.05</td>
<td>0.42</td>
</tr>
<tr>
<td>Philippines</td>
<td>2.4-2.48 (per year)</td>
<td>0.037-0.073</td>
<td>n.a.</td>
</tr>
<tr>
<td>Vietnam</td>
<td>65-150 (for 50 year) or 1.3-3 (per year)</td>
<td>0.08</td>
<td>0.45</td>
</tr>
</tbody>
</table>


- Enterprises with foreign-invested capital are exempted from import duties on capital goods and materials to be used in the manufacture of exports. However, import trading permits are required for every shipment into the country, and lack of knowledge by customs officials about imported goods has created costly delays with cargo clearing and added another layer of bureaucratic barriers. To avoid expensive delays, foreign investors have to allow plenty of time for document approval (Mai Dung 1994). Foreign firms are not attracted to an environment in which the delivery of
necessary inputs can be held up by administrative interference. It also provides many opportunities for corruption.

• The dual price system in which foreigners have to pay twice as much as local people for travel, hotels, phone calls, electricity, water and other services makes the costs of doing business expensive and weakens the attractiveness of the country. For example, the cost of land, electricity and water in Vietnam is higher than in other Asian countries (Table 4.6). Recently, the dual prices for some services have been removed. However, according to foreign investors, the change has had very little effect.

• Another major reason for the slow implementation of FDI projects in Vietnam is lack of domestic financing within an undeveloped banking system. Although foreign and domestic investors are allowed to borrow on the domestic capital market, the majority of their investments must be self-financing from the beginning of a project’s implementation. Forcing foreign investors to arrange all financing overseas is another reason for the low implementation rate of projects.

In summary, recognising the important role of FDI for Vietnam’s economic development, the Vietnamese government has given high priority to the task of creating a legal environment that is liberal and attractive to foreign investors. Vietnam provides more incentives and imposes fewer requirements on foreign investors than some other south-east Asian countries; it allows foreigners to invest in any sector of the Vietnamese economy; and it does not limit the share of foreign ownership. Through tax holidays, reductions in income tax, privileged income tax and withholding tax rates, the government encourages investment in priority areas. However, the country’s foreign investment legal system is incomplete and is constantly being modified. Moreover, in the process of implementation there is a large gap between
legislation and practice which makes the environment for foreign investment still very
difficult in Vietnam.

Foreign investments have been made in most industries. However, the
government’s preference of foreign investment in the heavy industry and non-tradables
has resulted in much of the FDI being channelled to heavy industry and non-tradables
(hotels, office property and apartments, construction, transportation and
communications) in Vietnam. By comparison, the discrimination against the domestic
private sector has mostly prevented domestic private enterprises from being partners in
joint ventures with foreign firms. With their many privileges in terms of land use rights,
access to finance, export, and import facilities, and protection by high tariff and non-
tariff barriers, SOEs have been the major local partners in joint ventures with foreign
firms.

Notes

1. The Land Law promulgated in 1993 stipulates land use rights on land for use
on a stable and long-term basis (LLB), and land for use on a rental basis (LRB).
However, LLB is allowed to transfer freely, while transferability of LRB is subject to
regulations. Vietnamese citizens and foreigners cannot formally own land, though they
can own a house or factory. Non-state and foreign-owned enterprises do not receive
land in the form of LLB for historic reasons, while LLB is distributed to state-owned
enterprises (SOEs), households and individuals. The Law also stipulates that SOEs can
use the land they hold as part of their capital contribution to joint ventures. To acquire
land use rights, foreign-owned enterprises have to pay for land use rights as well as
compensating the former users. Therefore, the amount that foreign-owned enterprises
have to pay to acquire land use rights is frequently much higher than the rate stipulated by the Ministry of Finance.

2. In 1988-95, Vietnamese parties contributed $1,844 million USD to joint ventures, 99 percent of which was in the form of land and buildings.
<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
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<tr>
<td><strong>Approved projects</strong></td>
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<td></td>
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<tr>
<td>Approved capital (US $ million)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1775.3</td>
<td>1,533.00</td>
<td>2,432.40</td>
<td>3,699.60</td>
<td>4,393.40</td>
<td>6,577.40</td>
<td>8,516.80</td>
<td>5572.1</td>
<td>4060</td>
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<tr>
<td>Revoked projects</td>
<td>3</td>
<td>6</td>
<td>38</td>
<td>48</td>
<td>34</td>
<td>58</td>
<td>56</td>
<td>54</td>
<td>64</td>
<td>na</td>
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<tr>
<td>Capital of revoked projects (US $ million)</td>
<td>4</td>
<td>26.4</td>
<td>292.90</td>
<td>401.80</td>
<td>79.50</td>
<td>217.20</td>
<td>477.10</td>
<td>1,034.90</td>
<td>230.2</td>
<td>165</td>
</tr>
<tr>
<td>Finished projects</td>
<td>5</td>
<td>4</td>
<td>2</td>
<td>3</td>
<td>5</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>5</td>
<td>Na</td>
</tr>
<tr>
<td>Capital of finished projects (US $ million)</td>
<td>6</td>
<td>0.4</td>
<td>2</td>
<td>13.8</td>
<td>29</td>
<td>0.1</td>
<td>0.4</td>
<td>74.6</td>
<td>305.5</td>
<td>19</td>
</tr>
<tr>
<td>Operating projects (1)-(3)-(5)</td>
<td>7</td>
<td>203</td>
<td>111</td>
<td>146</td>
<td>228</td>
<td>282</td>
<td>311</td>
<td>269</td>
<td>245</td>
<td>na</td>
</tr>
<tr>
<td>Capital of operating projects (2)-(4)-(6) (US $ million)</td>
<td>8</td>
<td>1748.9</td>
<td>1,238.10</td>
<td>2,016.80</td>
<td>3,591.10</td>
<td>4,176.10</td>
<td>6,099.90</td>
<td>7,407.30</td>
<td>5036.4</td>
<td>3876</td>
</tr>
<tr>
<td>Realised investment capital (US $ million)</td>
<td>9</td>
<td>206</td>
<td>213.2</td>
<td>398.3</td>
<td>1087.2</td>
<td>1954</td>
<td>2632</td>
<td>2116.3</td>
<td>2300(a)</td>
<td>801</td>
</tr>
<tr>
<td>Realisation rate (%)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>11.6%</td>
<td>13.91%</td>
<td>16.37%</td>
<td>29.39%</td>
<td>44.48%</td>
<td>40.02%</td>
<td>24.85%</td>
<td>41.28%</td>
<td>19.7%</td>
<td>29.82%</td>
</tr>
</tbody>
</table>

Note (a): data is estimated.
Table 4.8. FDI in Vietnam: Sector Distribution by Major Investing Countries, as end of 1995 (million USD)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Australia</th>
<th>British Island</th>
<th>Hong Kong</th>
<th>Japan</th>
<th>Korea</th>
<th>Malaysia</th>
<th>Singapore</th>
<th>Taiwan</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>project</td>
<td>capital</td>
<td>project</td>
<td>capital</td>
<td>project</td>
<td>capital</td>
<td>project</td>
<td>capital</td>
<td>project</td>
</tr>
<tr>
<td><strong>Primary sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>agriculture, fishing &amp; forestry</td>
<td>3</td>
<td>1.9694</td>
<td>361.055</td>
<td>11</td>
<td>27.51</td>
<td>11</td>
<td>39.467</td>
<td>3</td>
<td>21.12</td>
</tr>
<tr>
<td>mining</td>
<td>1</td>
<td>18</td>
<td>2</td>
<td>2.67</td>
<td>1</td>
<td>1.2</td>
<td>1</td>
<td>0.3</td>
<td>1</td>
</tr>
<tr>
<td>oil and gas</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>15.65</td>
<td>4</td>
<td>7.195</td>
<td>1</td>
<td>1.15</td>
<td>6</td>
</tr>
<tr>
<td><strong>Secondary sector</strong></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>electric and electronic products</td>
<td>2</td>
<td>2</td>
<td>5</td>
<td>30.725</td>
<td>4</td>
<td>98.4</td>
<td>9</td>
<td>287.42</td>
<td>2</td>
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<tr>
<td>food processing</td>
<td>2</td>
<td>1.96</td>
<td>1</td>
<td>1.06</td>
<td>39</td>
<td>184.39</td>
<td>10</td>
<td>16.153</td>
<td>5</td>
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<td>garment industry</td>
<td>2</td>
<td>1.1</td>
<td>14</td>
<td>20.67</td>
<td>10</td>
<td>15.564</td>
<td>27</td>
<td>63.16</td>
<td>1</td>
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<tr>
<td>manufacture of construction</td>
<td>7</td>
<td>9.22</td>
<td>4</td>
<td>36.85</td>
<td>9</td>
<td>116.77</td>
<td>4</td>
<td>27.75</td>
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<td>materials</td>
<td>2</td>
<td>4.16</td>
<td>4</td>
<td>94.92</td>
<td>7</td>
<td>44.53</td>
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<td>2.5</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>0.65</td>
<td>2</td>
<td>7.45</td>
<td>4</td>
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<td>machineries</td>
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<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>manufacture of other metal</td>
<td>1</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
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<td>manufacture of fiels</td>
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<td>205</td>
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<td>4.93</td>
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<td>44.72</td>
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<td>1.29</td>
<td>4</td>
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<td>manufacture of metal</td>
<td>2</td>
<td>116.61</td>
<td>3</td>
<td>50.78</td>
<td>6</td>
<td>105.11</td>
<td>2</td>
<td>18.67</td>
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<td>metallurgy</td>
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</tr>
<tr>
<td>paper industry</td>
<td>4</td>
<td>3.68</td>
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<td></td>
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</tr>
<tr>
<td>textile and leather</td>
<td>7</td>
<td>73.58</td>
<td>1</td>
<td>0.5</td>
<td>24</td>
<td>282.04</td>
<td>1</td>
<td>0.75</td>
<td>0</td>
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<tr>
<td>Other industries</td>
<td>9</td>
<td>103.46</td>
<td>1</td>
<td>33.25</td>
<td>14</td>
<td>98.15</td>
<td>14</td>
<td>689.87</td>
<td>10</td>
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<tr>
<td><strong>Tertiary sector</strong></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
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<tr>
<td>construction</td>
<td>3</td>
<td>3.135</td>
<td>9</td>
<td>55.083</td>
<td>4</td>
<td>2.66</td>
<td>2</td>
<td>2.85</td>
<td>1</td>
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<tr>
<td>finance &amp; banking</td>
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<td>1</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>hotels and housing development</td>
<td>1</td>
<td>52.09</td>
<td>8</td>
<td>179.56</td>
<td>41</td>
<td>443.9</td>
<td>12</td>
<td>225.16</td>
<td>3</td>
</tr>
<tr>
<td>post &amp; telecommunication</td>
<td>1</td>
<td>86</td>
<td>6</td>
<td>19.93</td>
<td>1</td>
<td>2.08</td>
<td>6</td>
<td>29.86</td>
<td>1</td>
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<tr>
<td>transportation</td>
<td>4</td>
<td>12.2</td>
<td>10</td>
<td>171.55</td>
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<td>2</td>
<td>4</td>
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<td>8</td>
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<td>14</td>
<td>1</td>
<td>3.7</td>
<td>3</td>
<td>5.38</td>
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</tbody>
</table>

**Source:** State Committee for Cooperation and Investment (1992, 1993, 1996)
Chapter 5: DETERMINANTS OF FDI IN VIETNAM

Chapter 2 discussed theories of the determinants of FDI, among which oligopolistic theory and the eclectic paradigm of FDI appear to provide the more convincing explanations. According to the eclectic theory, a firm which undertakes FDI must possess some firm-specific advantages over rival firms in the host country in the form of technology, management and marketing, organisational systems, access to financial sources or product and factor markets. Next, it must be more profitable for the firm to internalise its firm-specific advantages rather than to produce at home and export, or sell or lease these advantages to foreign firms. Finally, the firm must believe that its advantages can be better utilised if combined with location-specific advantages (Gastanaga et al 1998, Sun 1998, Dunning 1994, Santiago 1987).

In the case of FDI in Vietnam, it is likely that most foreign firms have advantages over Vietnamese domestic firms in the form of technology, managerial and marketing skills, and access to financial sources. Most foreign investing firms in Vietnam are from countries where the level of development is significantly higher than in Vietnam and have been market-oriented for a long time. Therefore, they are much better equipped than Vietnamese enterprises, most of which have operated with machinery and equipment of low productivity and quality (CIEM 1999, 1996, Kokko 1998, MPI 1997, MOSTE 1995). The average capital-labour ratio - a proxy for the level of technology - in FIEs is about ten times higher than in SOEs and 20 times higher than in PEs (Table 7.6). As mentioned in Chapter 3, the shortage in capital of SOEs and PEs, and the general weakness of the financial sector have limited technical innovation in Vietnam.
Managerial and marketing skills are poorly developed in Vietnamese firms. These skills can only be developed over a considerable period of time and with substantial training and experience, especially experience of marketing and distribution networks in foreign countries.

In the transition from a highly commanded system to a market-oriented system, the institutional framework necessary to the effective operation of markets is probably the most important gap to be filled. The lack of or incompleteness of laws necessary to support the operation of private markets, the weak enforcement of laws-especially those relating to contracts-and the limitations on reliable information make the business climate in Vietnam highly uncertain. These conditions lead to high transaction costs in terms of search and negotiation, and contract enforcement for a foreign firm that would lease or sell its technology to indigenous firms. The weakness of the copyright law and its enforcement, for example, increases seller’s uncertainty, because the buyer can resell or transfer leased technology to other firms without the permission of the foreign firm. Therefore, to avoid the high costs of search and negotiation, and of contract enforcement, and to take advantage of the investment incentives offered by the Vietnamese government, foreign firms choose to internalise their firm-specific advantages through FDI in Vietnam.

Given a set of firm-specific and internalisation advantages, location-specific factors will determine where MNEs will invest. These factors typically reflect local market potential, costs of production, the cost of transport, the treatment of foreign investors, and investment incentives. Thus, location-specific factors not only determine where MNEs will make direct investment, but are also able to influence the types of FDI (such as domestic
market-oriented or export-oriented FDI). Location-specific factors include both ‘pull’ and ‘push’ factors. ‘Pull’ factors typically reflect the political and economic conditions of the host country such as political and macroeconomic stability, market size and demand, and labour costs, as well as the investment incentives provided by the host country including the provision of protection for the local market. The ‘push’ factors of FDI are those outside the host country (such as geographical distance, costs of production, and trade policies in the source countries).

Since FDI has flowed into Vietnam for only about 11 years, it is impossible to carry out a time-series test for location specific factors affecting the FDI inflow in Vietnam at the country level. However, explaining the determinants of FDI inflows into Vietnamese industries can help to assess the attractiveness of the country and the effectiveness of the government’s foreign investment and industrial policies. Using available data on FDI projects and other economic indicators of the Vietnamese economy in the period 1987-93, the rest of this chapter analyses the importance of the various location-specific factors that determine foreign direct investment in industrial activities in Vietnam. The first part of the chapter analyses the ‘pull’ factors in Vietnam using an econometric model, while ‘push’ factors are analysed in the last part of the chapter. The ‘push’ factors are tested using a gravity model.

5.1. ‘Pull’ determinants of FDI inflow in the Vietnamese Industrial Sector

The ‘pull’ factors are categorised as those factors in the recipient country which might affect the profitability of foreign investment. These factors may consist of the host country’s policies toward FDI, market size, rates of return, access to scarce natural
resources (minerals) or an abundance of high-quality, low-wage labour, and the availability of tariffs and non-tariff barriers to provide protection to FDI.

Time-series data have been used to test the determinants of FDI in the EU, the US, Taiwan, and other countries (Goldberg 1972; Scaperlanda 1983; and Pan Long Tsai 1991). The basic model used by Goldberg and Pan Long Tsai, for example, is as follows:

\[ FDI = F(Y, D_1, D_2,...) \]

Where

- \( FDI \) - inflows of FDI into the host country;
- \( Y \) - GDP or change in GDP in the host country;
- \( D_i \) - dummy variables representing major domestic economic policy changes related to FDI.

However, this model cannot be used for a country which has been open to FDI for such a short period as Vietnam.

A model using cross-section data to test the 'pull' determinants of FDI is more relevant for countries which have received FDI only for short periods, such as Vietnam and China. Cross-section analysis can be applied by industry or by country.

**5.1.1. Model specification**

The model used here has the usual specifications for cross-section analysis (Dunning 1979, Kumar 1990; Yang 1992). However, the choice of the variables used in the model has been determined to a large degree by data availability. Demand for sectoral inflows of FDI in manufacturing is therefore hypothesised to depend on industry-specific
characteristics such as the rate of output growth, the rate of return, labour costs, and import barriers.

The model using cross-section industry data to test the determinants of FDI inflows into Vietnam is specified as follows:

\[ \text{FDI}_i = F(\text{RR}_i, \text{AG}_i, \text{WO}_i, \text{IS}_i) \]

Where \( \text{FDI}_i \) - FDI inflows into industry \( i \) in the period 1988-92;

\( \text{RR}_i \) - Average rate of return in the industry \( i \) in the period 1988-92.

\( \text{AG}_i \) - Average real growth rate of output in industry \( i \) in the period 1988-92.

\( \text{AW}_i \) - Average labour intensity measured by wage as a share of output in industry \( i \).

\( \text{IS}_i \) - Proxy for import substitution.

**Profitability**

The primary objective of firms is to maximise profit. Although in the short-run, maximising profit may not be the primary objective of firms (Dunning 1994), in the long-run it has to be. Therefore, it is likely true that if a foreign investor chooses to invest in a particular industry, it must be expected to be more profitable in that industry than in another. A high rate of profitability in an industry should thus have positive effects on FDI flows.

The real rates of return (\( \text{RR}_i \)) in Vietnamese industries is used to represent expected industry profitability. The data on this variable is available in *Vietnam Industrial*
Data published by GSO (1994). The coefficient on this variable is expected to be positively correlated to the level of FDI inflows.

However, the profitability of an industry can reflect only the potential return on investment in the short term. Over the long run, profitability depends on many factors such as the entry of new competitors, changes in industry technology, changes in the preferences of customers for the products of the industry, and changes in the factor market. However, there is no way in which these factors can be captured in Vietnam where the statistical system is poor.

Domestic market

The size and characteristics of domestic and adjacent markets are argued to be some of the most powerful variables influencing the location of industrial investment by multinational enterprises (Dunning 1994). Using Gross National Product (GNP) or Gross Domestic Product (GDP) as a measure of market size, researchers have demonstrated that this variable is positively and significantly associated with inward direct investment (Dunning, 1980, p. 9-31; Schneider and Frey, 1985). However, these indicators have explanatory limitations for developing countries where levels of national income are as low as in Vietnam. They can lead to the biased conclusion that developing countries with low national income levels attract little inward investment, compared to those with higher national income levels. In their comprehensive analysis of FDI in developing countries, Root and Ahmed (1979) concluded that the GDP growth rate was more relevant as a determinant of FDI in developing countries than the size of GDP.
At the sectoral level, the growth rate of an industry can reflect the increase in demand for goods produced by the industry. In this study, the average growth rate of output of an industry ($AG_i$) is used as a proxy for the market demand. The coefficient of $AG$ is expected to be positive. However, it is worth noting that if investment goes into production of goods and services for local markets, then market demand is an important factors for investors. For investors who intends to invest in production of goods for export, the growth of international markets, production costs, and transport cost are crucial, while the local market demand may play a minor role.

*Labour costs*

Among the location specific factors that might influence the structure of MNEs in particular host countries, relative labour costs are among those most often cited. It is argued that, everything else equal, to minimise costs of production MNCs will choose a place where labour costs are lowest. FDI is expected to take advantage of the low unit labour costs in developing countries, yet the statistical evidence is mixed. Some analyses show a positive relationship between FDI and real wages in the host country (Agarwal 1980, p. 739:73). Wu (1980) found low labour costs to be important in attracting FDI into South Korea. In contrast, Gang Yang (1992) pointed out that low labour costs in China did not have any significance in stimulating FDI. It is argued that changes in technology in some sectors have altered the economic scale of production, weakening the case for offshore production in low labour-cost countries (Dunning, 1980; Yang, 1992; World Bank, 1993).
Table 5.1: Main Economic Indicators in Vietnam, Indonesia, the Philippines and Thailand, 1996.

<table>
<thead>
<tr>
<th>Population (million people)</th>
<th>Indonesia</th>
<th>Philippines</th>
<th>Thailand</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td>198.3</td>
<td>69.7</td>
<td>61.2</td>
<td>75.5</td>
<td></td>
</tr>
<tr>
<td>Growth rate</td>
<td>1.53%</td>
<td>2.18%</td>
<td>1.4%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Literacy</td>
<td>83.8%</td>
<td>94.6%</td>
<td>93.8%</td>
<td>93.7%</td>
</tr>
<tr>
<td>Labour force (million people)</td>
<td>67</td>
<td>24.12</td>
<td>32.2</td>
<td>38.7</td>
</tr>
</tbody>
</table>

Labour structure:
- Agricultural: 55% 46% 57% 70%
- Industrial: 14% 16% 17% 11.3%
- Service: na 19% 15% na

Average wage of labourers, working in the foreign-invested sector (US$/month):
- Worker: 48(a) 138(a) 136(a) 46
- Manager: 226(a) 340(a) 1167(a) 360
- Engineer: 169(a) 290(a) 400(a) 450

GDP (US$ bn):
- Indonesia: 223.3
- Philippines: 83.5
- Thailand: 185
- Vietnam: 22.2

Growth rate in 1996 (% pa):
- Indonesia: 7.8%
- Philippines: 5.5%
- Thailand: 6.8%
- Vietnam: 9.3%

GDP per capital (US$):
- Indonesia: 1,078
- Philippines: 1,209
- Thailand: 3,028
- Vietnam: 294

Share in GDP (%):
- Agriculture: 16.8% 21.1% 10% 26.3%
- Industry: 43.2% 35.7% 40% 31.4%
- Services: 42.3% 43.2% 49.6% 42.3%

Exports of goods (US$ bn):
- Indonesia: 49.5
- Philippines: 20.2
- Thailand: 56.2
- Vietnam: 7.1

% change:
- Indonesia: 4.2
- Philippines: 17.6
- Thailand: 1
- Vietnam: 34

Imports of goods (US$ bn):
- Indonesia: 44
- Philippines: 34.3
- Thailand: 68.1
- Vietnam: 11.1

% change:
- Indonesia: 7.6
- Philippines: 23.4
- Thailand: 8.1
- Vietnam: 48

Foreign trade (% of GDP):
- Indonesia: 41.9%
- Philippines: 65.3%
- Thailand: 67.2%
- Vietnam: 82.0%


Note: (a) Data in 1989
      (b) Data in 1996

As mentioned earlier, Vietnam's comparative advantage would appear to lie in its low-wage labour force. Data in Table 5.1 reveals that labour costs in Vietnam in 1996 were close to those in Indonesia, Philippines, and Thailand seven years ago (in 1989). However, the working hours per week in Vietnam have been 48 hours - 8 hours longer than in Indonesia, Philippines, and Thailand - making the wage rate per hour in Vietnam
lower than in the comparison countries. Therefore, it is expected that the low-wage labour force in Vietnam could play an important role in drawing FDI. But it is not wage costs per se that are important, but unit labour costs, i.e., wage costs deflated by the productivity level.

However, information to derive real wages or unit labour costs in Vietnam is not available. Low-cost labour could be expected to be attractive to labour-intensive activity, i.e., industries in which the share of labour costs is relatively high. Data are available on total wages by industry which does allow the calculation of the share of wages by industry, and this is the variable used.

**Import Substitution**

While it is widely recognised that relative labour costs are important for export-oriented FDI projects, they are likely less crucial for IS FDI projects. Trade policies in the host country, notably tariff and non-tariff barriers, will be the major determinant of IS FDI. Multinational enterprises may choose to invest in protected industries to circumvent tariffs and other import controls, or to take advantage of the 'quiet life' that the protection offers. It might be expected, therefore, that inward investment will be positively related to levels of effective protection. Econometric research in other countries has demonstrated that effective protection is a persistently significant determinant of FDI (Gupta 1983; Kumar, 1990). However, in the case of efficiency-seeking and some asset-acquiring FDI, barriers to trade are likely to have a negative effect (Dunning 1994).

Vietnam has focused on promoting industrial development through import-substitution policies and has continued to provide assistance, including quantitative import
restrictions, tariffs, tax concessions and foreign exchange instruments, to attract foreign investors. According to the law on foreign investment, FDI projects in import-substitution industries, especially in heavy industries, can enjoy a preferential tax rate of 15 percent. These measures have contributed to the overvaluation of the currency, and a bias against exports, leading to balance of payments deficits. Since late 1994, for example, there has been a sharp increase in the number of FDI projects involving the automobile industry, in which tariffs are very high (up to 200%).

Two measures of import substitution have been used in empirical analysis. The first measures changes in the proportion of imports in total supply. According to this approach, import substitution is the change in output attributed to the change in the total supply (Chenery 1960, p. 624-54). Total supply is defined as imports plus domestic production. The second measures the increase in domestic production as import substitution, as the equivalent quantity of goods would have been imported if the increase in domestic output had not taken place.

In the case of Vietnam, there are many problems with the data on trade. Some imports are measured in Rubles-Dollars while others are measured in volume units. The limitations on reliable data on imports in Vietnam does not allow calculation of the import substitution variable following the first formula. Therefore, the second measure of import substitution is used. If import protection is important for attracting FDI, the coefficient on this variable will be positive. It should be noted, however, that import substitution industries are likely to be capital-intensive rather than labour-intensive, i.e., investment is not taking advantage of the comparative advantage that Vietnam should have in labour-
intensive activities. Hence, it is of interest to see whether the coefficient on this variable or that on the labour intensity variable is significant. Or indeed, whether the coefficient on the labour-intensity variable is positive or negative. A negative coefficient would be consistent with a capital-intensive, import substitution policy.

5.1.2. Data and results of estimation

As previously mentioned, foreign direct investment in Vietnam takes the form of equity joint ventures, wholly foreign-owned subsidiaries or partly-owned subsidiaries, and business cooperation contracts. FDI may consist of three components: new equity capital, reinvested earnings, or inter-company borrowing (UNCTC 1988). Reinvested earnings data are not published in Vietnam. Only data on new equity investment are available. With the available data, 26 industries are covered, which makes cross-section analysis feasible.

However, data related to the explanatory variables are only available for the period 1988-92 (GSO 1993). Since the data on implemented FDI and the share of FIEs' output in total output of industries are not available, the data on FDI approvals is used. The primary FDI data cover the 536 licensed projects in Vietnam in the period 1988-92. These 536 licensed projects then were grouped into 23 industries, following the industrial classification by GSO and SCCI. The real growth rate variable \( (AG_i) \) and the rate of return \( (RR_i) \) are measured as averages for each industry over the period 1988-92. Data on the labour-intensity variable is available only for the year 1993. Therefore, this data is used to estimate the model for the determinants of FDI as a whole (ie., FDI from all source countries). Then, the ‘pull’ factors drawing FDI from Asian NICs and from the rest of the world are estimated separately to see whether the motives of foreign firms from Asian NICs differ from those from other regions.
Firstly, the unscaled data on the dependent variable (FDI) and the independent variables were used to estimate the parameters of the model. However, the estimated results did not pass the test for heteroskedasticity (heteroskedasticity was over 78%). Consequently, results of estimation and diagnostic tests are inconsistent. It is suggested that to remedy this problem, the logarithm form of the data may be used (Maddala 1992). Using logarithms of the FDI and IS variables helped to reduce heteroskedasticity from 78% to 32% and make the estimated results more consistent. Only the results of the model with FDI and IS variables expressed as logarithms are presented in Table 5.2 (t-ratios are shown in parentheses).

<table>
<thead>
<tr>
<th></th>
<th>AW</th>
<th>AG</th>
<th>RR</th>
<th>IS</th>
<th>Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. FDI from all</td>
<td>-4.407(-0.594)</td>
<td>5.804(1.811)**</td>
<td>8.114(0.637)</td>
<td>0.222(2.295)**</td>
<td>R2 = 0.30  DW = 1.94</td>
</tr>
<tr>
<td>investing countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. FDI from NICs</td>
<td>-4.794(-0.662)</td>
<td>12.47(1.786)**</td>
<td>10.170(0.383)</td>
<td>0.022(2.000)**</td>
<td>R2 = 0.37  DW = 2.26</td>
</tr>
<tr>
<td>3. FDI from</td>
<td>-4.88 (-0.643)</td>
<td>6.036(1.843)**</td>
<td>15.103(1.194)</td>
<td>0.233(2.377)*</td>
<td>R2 = 0.326 DW = 1.87</td>
</tr>
<tr>
<td>countries other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>than NICs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NICs- newly industrialising countries including Hong Kong, Taiwan, Singapore and South Korea

* Significant at the 5% level of confidence
** Significant at the 10% level of confidence

Test and LM test are used to test for misspecification of the functional form. To test for heteroskedasticity, Ramsey’s RESET, White and Glejser tests were applied, while the Bera and Jarque test is used to test for normality. The diagnostic tests of the results of the estimation are satisfied.
All coefficients of the explanatory variables have the expected signs - average output growth rate (AG), rate of return (RR), and import substitution (IS) have a positive sign, while labour intensity (AW) is negatively correlated to the FDI inflow. However, the coefficients on AW and RR are not significant. These results show that prospective domestic market growth and import substitution policies are the major determinants of FDI in Vietnam. While it is not significant, the fact that the coefficient on AW could be negative indicates that the import substitution policy is distorting FDI away from taking advantage of Vietnam's low-cost labour.

The statistical significance of the AG and IS variables support the findings of other research (Root and Ahmed 1979, Kumar 1990). These results indicate that most FDI flows result from rapid economic growth and import-substitution policies. The insignificance of the rates of return variable may be the result of the likely difficulties in calculating this variable with any degree of precision. Also, the estimated rates of return may be poor proxies for expected long-run profits.

The results are also consistent with the findings of a survey mailed to 35 Australian companies operating projects in Vietnam (Maitland 1995) and another survey conducted by the Indochina Project Management Company (October, 1994). These surveys indicated that foreign investors are not attracted to Vietnam for immediate profit and cheap inputs for production of exports, but to establish a long-term presence in an economy with strong growth prospects.
5.2. *Push* factors behind FDI in Vietnam

Foreign capital inflows to developing countries constitute part of the world’s savings. Over the past two decades, world savings have fallen. In fact, savings and investment ratios have fallen in all regions of the world since 1982 (Table 5.3). Because of this savings decline, especially in the industrial world, the real interest rate rose from 1.5 percent during the period 1970-80 to 4.5 percent in the following decade (Fry 1993). This led to constraints on the expansion of FDI in many parts of the world. The tightening of international capital markets has also been due to growing demands for reconstruction and restructuring in the transitional economies (the former Soviet Union, Eastern Europe, and the war-torn Arab Gulf region) (Gates and Truong 1995).

### Table 5.3 Domestic Savings as Percentage of GDP, 1983-1998 (Percentage).

<table>
<thead>
<tr>
<th>Year</th>
<th>Sub-Saharan Africa</th>
<th>South Asia</th>
<th>East Asia and Pacific</th>
<th>Latin America and Caribbean</th>
<th>Middle East and North Africa</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>16.5</td>
<td>16.3</td>
<td>35.8</td>
<td>21.6</td>
<td>25.2</td>
<td>21.7</td>
</tr>
<tr>
<td>1984</td>
<td>17.1</td>
<td>16.3</td>
<td>36.4</td>
<td>22.6</td>
<td>24.2</td>
<td>22.5</td>
</tr>
<tr>
<td>1985</td>
<td>16.9</td>
<td>17.8</td>
<td>28.2</td>
<td>23.4</td>
<td>21.6</td>
<td>21.6</td>
</tr>
<tr>
<td>1986</td>
<td>16.9</td>
<td>17.9</td>
<td>30.5</td>
<td>20.6</td>
<td>17.0</td>
<td>21.5</td>
</tr>
<tr>
<td>1987</td>
<td>18.4</td>
<td>17.9</td>
<td>30.7</td>
<td>23.1</td>
<td>22.0</td>
<td>21.8</td>
</tr>
<tr>
<td>1988</td>
<td>18.7</td>
<td>18.6</td>
<td>31.8</td>
<td>23.9</td>
<td>20.2</td>
<td>22.7</td>
</tr>
<tr>
<td>1989</td>
<td>19.2</td>
<td>19.0</td>
<td>32.3</td>
<td>24.7</td>
<td>24.0</td>
<td>23.2</td>
</tr>
<tr>
<td>1990</td>
<td>19.0</td>
<td>20.0</td>
<td>34.0</td>
<td>21.8</td>
<td>26.9</td>
<td>22.5</td>
</tr>
<tr>
<td>1991</td>
<td>17.4</td>
<td>19.8</td>
<td>33.6</td>
<td>19.9</td>
<td>24.6</td>
<td>22.1</td>
</tr>
<tr>
<td>1992</td>
<td>15.2</td>
<td>20.3</td>
<td>33.8</td>
<td>19.1</td>
<td>27.0</td>
<td>21.6</td>
</tr>
<tr>
<td>1993</td>
<td>14.3</td>
<td>18.6</td>
<td>36.7</td>
<td>18.9</td>
<td>na</td>
<td>20.8</td>
</tr>
<tr>
<td>1994</td>
<td>15.6</td>
<td>19.7</td>
<td>37.2</td>
<td>19.1</td>
<td>24.2</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>16.3</td>
<td>19.7</td>
<td>37.6</td>
<td>19.0</td>
<td>25.3</td>
<td>21.0</td>
</tr>
<tr>
<td>1996</td>
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<td>17.8</td>
<td>36.1</td>
<td>20.1</td>
<td>24.1</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>16.1</td>
<td>18.2</td>
<td>36.3</td>
<td>20.0</td>
<td>23.5</td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>15.0</td>
<td>19.3</td>
<td>37.0</td>
<td>19.0</td>
<td>19.1</td>
<td></td>
</tr>
</tbody>
</table>

*Source:* World Bank Table in DX database, ANU (1999).
Table 5.4 Foreign Direct Investment in Developing Regions, 1980-98
(US $ Billion)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia</td>
<td>1.3</td>
<td>3.2</td>
<td>11.0</td>
<td>13.9</td>
<td>21.7</td>
<td>37.9</td>
<td>43.0</td>
<td>64.1</td>
<td>64.2</td>
</tr>
<tr>
<td>Share (%)</td>
<td>25.9</td>
<td>28.1</td>
<td>43.9</td>
<td>39.7</td>
<td>46.5</td>
<td>55.5</td>
<td>53.7</td>
<td>37.7</td>
<td>37.5</td>
</tr>
<tr>
<td>South Asia</td>
<td>0.2</td>
<td>0.3</td>
<td>0.5</td>
<td>0.5</td>
<td>0.6</td>
<td>0.8</td>
<td>1.2</td>
<td>4.9</td>
<td>3.7</td>
</tr>
<tr>
<td>Share (%)</td>
<td>3.6</td>
<td>2.3</td>
<td>1.9</td>
<td>1.3</td>
<td>1.3</td>
<td>1.2</td>
<td>1.6</td>
<td>2.9</td>
<td>2.2</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>0.0</td>
<td>1.0</td>
<td>0.9</td>
<td>1.8</td>
<td>1.5</td>
<td>1.8</td>
<td>3.0</td>
<td>7.7</td>
<td>4.4</td>
</tr>
<tr>
<td>Share (%)</td>
<td>0.7</td>
<td>8.4</td>
<td>3.5</td>
<td>5.2</td>
<td>3.2</td>
<td>2.6</td>
<td>3.7</td>
<td>4.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>6.1</td>
<td>4.4</td>
<td>7.8</td>
<td>12.6</td>
<td>14.5</td>
<td>15.7</td>
<td>20.8</td>
<td>64.7</td>
<td>69.3</td>
</tr>
<tr>
<td>Share (%)</td>
<td>121</td>
<td>38.6</td>
<td>31.4</td>
<td>36.0</td>
<td>31.0</td>
<td>23.0</td>
<td>26.0</td>
<td>38.0</td>
<td>40.5</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>-3.3</td>
<td>2.0</td>
<td>2.8</td>
<td>1.8</td>
<td>2.1</td>
<td>3.8</td>
<td>3.7</td>
<td>5.9</td>
<td>5.1</td>
</tr>
<tr>
<td>Share (%)</td>
<td>-65.0</td>
<td>17.4</td>
<td>11.0</td>
<td>5.2</td>
<td>4.5</td>
<td>5.5</td>
<td>4.6</td>
<td>3.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>0.7</td>
<td>0.6</td>
<td>2.1</td>
<td>4.4</td>
<td>6.3</td>
<td>8.3</td>
<td>8.4</td>
<td>22.8</td>
<td>24.3</td>
</tr>
<tr>
<td>Share (%)</td>
<td>14.3</td>
<td>5.2</td>
<td>8.4</td>
<td>12.6</td>
<td>13.5</td>
<td>12.2</td>
<td>10.4</td>
<td>13.4</td>
<td>14.2</td>
</tr>
<tr>
<td>Total Developing Countries</td>
<td>5.1</td>
<td>11.3</td>
<td>25.0</td>
<td>35.0</td>
<td>46.6</td>
<td>68.3</td>
<td>80.1</td>
<td>170</td>
<td>171</td>
</tr>
<tr>
<td>Share (%)</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>


However, until the first half of 1997, the tighter credit market seems not to have affected FDI flows into Vietnam for the following reasons. Firstly, Vietnam is located in a region where the decline in savings is lowest (Fry 1993); moreover, the economic growth rate is high and the investment environment has been stable. The average real rate of growth of the Dynamic Asian countries (DACs) (eg., East Asian economies and southern China) has exceeded 7 per cent since 1991. Macro-economic stability and the high economic growth rate, combined with government efforts to liberalise capital markets and
to open investment opportunities to foreign and domestic investors, have been making the investment environment in Asian Pacific region much more stable and attractive than that in other developing parts of the world (World Bank 1996, Suh 1996, and Langhammer 1995). As a result, East Asia attracted substantial FDI in the 1980s, and has been the favourite region for FDI in the 1990s. FDI grew US $1.3 billion in 1980 to $43.0 billion in 1994 (Table 5.4). The East Asian region is now attracting over half of total FDI to all developing countries. The substantial FDI inflows to the region have spread to Vietnam since 1990.

Secondly, Asia includes one of the largest capital exporters - Japan since 1985 - plus from the 1990s, other East and Southeast Asian countries, in particular Taiwan, Hong Kong, South Korea, and Singapore. Moreover, the economies in the region have become more and more inter-related with one another due to the increased trade and investment flows within the region (Suh 1996, Langhammer 1995, and Tho 1993). For example, the share of Taiwan’s outward FDI directed to Asia increased from 10 percent in 1985 to 56 percent in 1991. For the Republic of Korea, the share rose from 19 percent in 1986 to 31 percent in 1990 (Chen 1993, p. 24-59). These facts suggest that international capital is readily available to countries that can provide favourable growth and profit opportunities. These international supply conditions favoured Vietnam. Currently, firms from Asian NICs and Japan hold the largest share of FDI in Vietnamese manufacturing (Table 4.4).

The main factors accounting for the expansion of FDI from East Asian countries since the second half of the 1980s are the appreciation of the Japanese Yen and local currencies of the Asian NICs relative to the US dollar, trade conflicts between Japan and
NICs, on the one hand, and the US and EU, on the other hand, and the sharp rise in real wages in Japan and the NICs due to both the tight labour markets and the improved standards of living. As a result, there has been a massive relocation of industries from Japan and NICs to Asian neighbour countries (such as Thailand, Malaysia, Indonesia, the Philippines, China and Vietnam).

Thirdly, the lifting of the trade embargo, normalising the relationship between Vietnam and the US, removed the main obstacle facing large US and Japanese firms wishing to invest in Vietnam.

Prior to 1997, regional conditions were favourable to Vietnam. However, the financial crisis in Asian countries, which began in the middle of 1997, has affected FDI inflows to Vietnam. At present, Asian nations account for up to 60 percent of total FDI in Vietnam. The economic distress in Asian countries has forced foreign investors from these countries, especially investors from South Korea, Japan, Thailand and Indonesia, to cut overseas investment (World Bank 1997, Saigon Times 6/5/1998). Moreover, since the economic crisis started in the middle of 1997, investors and bankers from Europe and the US have become increasingly cautious about investing in East and Southeast Asia, including Vietnam. Although the international conditions are not very favourable to Vietnam, Vietnam would be still attractive to foreign investors due to its low-cost labour force, and rich natural resources (World Bank 1998). Therefore, further reform that can continue the process of macroeconomic stabilisation and structural adjustment, create credible policies that will lead to a more stable macroeconomic environment and reduce
politico-economic risk and uncertainty, and encourage investment efficiency and effectiveness is necessary for Vietnam’s continued economic development.

Another determinant of FDI in Vietnam may be the geographical and cultural closeness between Vietnam and the NICs, Japan (the biggest investing countries in Vietnam), and other Asian investing countries (such as Malaysia, Thailand, Indonesia and the Philippines). Geographical proximity to some extent reflects differences in transportation costs (e.g., a greater distance between economic centres may imply higher transportation costs), in culture, and institutions.

A simple gravity model can be used to explain the geographical pattern of foreign production in Vietnam. The gravity model was first introduced by Tinbergen (1962) to investigate bilateral trade flows, using the economic size of countries, and the geographical distance between them which affects transportation costs. Other researchers have modified the original model by introducing new explanatory variables (such as cultural similarity, political stability, and labour force) in order to capture other factors determining bilateral trade and foreign production. The most recent applications of this kind of model to determine the effect of geographical distance on the pattern of FDI are Brainard (1993) and Ekholm (1998, p. 49-75).

The crucial variables in such a model are economic size and the distance between economic centres. This analysis is carried out by regressing the real FDI inflows to Vietnam from source countries up to 1996 on geographical distance, DIST\textsubscript{j}, and the absolute difference in GDP, DIFGDP\textsubscript{j}, between Vietnam and the jth source country. The sign of the DIFGDP\textsubscript{j} variable is expected to be positive. This means that in a country with
a higher economic development level, the technological level and production costs are likely higher than those in Vietnam. Therefore, investors from this country have an advantage over the local firms in terms of technology, and by investing in Vietnam they may save trading costs. A dummy for adjacent countries, $D_j$, which is customary in gravity models, is also included in the model (Ekholm 1998, and Brainard 1993)

The data on real FDI inflows from 57 countries and territories to Vietnam are from reports of MPI (1997) and World Bank (1997). The data on GDP was taken from Pen World Tables Mark 5.6. The GDP data are based on purchasing power parity (PPP) values because they may reflect better the true situation in Vietnam. For the $DIST_j$ variable, the distance between Hanoi (capital of Vietnam) and the capital of the jth source country is used. The regression results are presented in Table 5.5.

**Table 5.5 Result: Explaining the Pattern of Vietnam’s FDI Source.**

<table>
<thead>
<tr>
<th>Explanatory Variables</th>
<th>Coefficient</th>
<th>t-ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-24.20</td>
<td>-2.97</td>
</tr>
<tr>
<td>DIST</td>
<td>-1.93</td>
<td>-3.10</td>
</tr>
<tr>
<td>DIFGDP</td>
<td>0.63</td>
<td>1.95</td>
</tr>
<tr>
<td>Dummy</td>
<td>0.087</td>
<td>0.32</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.67</td>
<td></td>
</tr>
</tbody>
</table>

The regression estimates in Table 5.5 show that all independent variables have the expected signs - the difference in GDP (DIFGDP) and the dummy for adjacent countries have a positive sign, while the distance between Vietnam and source countries (DIST) is negatively correlated to FDI inflow. However, only the coefficients of DIST and DIFGDP are statistically significant at the 1 or 10 per cent level, supporting the findings of other research (Ekholm 1998, and Brainard 1993). The results indicate that geographical
distance, the proxy for transportation costs and cultural and institutional similarity, has a negative relationship with FDI inflow to Vietnam, while the level of economic development in source countries is positively related to FDI flows. These results also suggest that geographical closeness may be one of the driving forces for the regionalisation process of FDI and trade within Southeast Asia.

In summary, the 'push' factors behind FDI into Vietnam appear to be the following. Firstly, Vietnam lies within the East Asian region where economic growth and trade prospects are very good. Secondly, the East Asian countries, which are the largest investing countries in Vietnam, are running large trade surpluses and providing a major source of further investment. Moreover, because they are becoming high-cost producers of standardised, mature manufactures, the East Asian countries may perceive Vietnam to be an attractive site to produce goods for international and regional markets to counter current or potential problems with the General System of Preference (GSP) benefits, currency appreciation, the increase in real wages, and protectionism. Thirdly, due to geographical and cultural closeness, the costs of technology transfer (which include communication, transport, and the travel of personnel in charge of the project) among the Asian Pacific countries are low.
Chapter 6: The locational choices of foreign firms in Vietnam

An important question for policy makers of the host country is what factors are important in attracting FDI inflows, as many developing countries see attracting FDI as an important element in their economic development strategy. Vietnam has been among these countries. Locational factors may influence the decision of foreign firms to invest in Vietnam. Therefore, this chapter attempts to provide insights into how locational factors affect FDI in Vietnam.

The determinants of the location of foreign investment projects are of interest for other reasons. Any tendency for foreign companies to concentrate investment in particular regions can create pressure on regional infrastructure (such as transport, housing, water supply, and energy) and draw resources away from other regions and industries. Also, where governments provide incentives (such as preferential tax rates and land rent, and lower minimum wage rates) to attract FDI into designated regions, the effectiveness of these policies should be evaluated in terms of the amount of FDI flowing into those regions. Foreign investors obviously need to know in detail the economic, political and social conditions of a place where they intend to locate their businesses. For their part government decision makers need to know the best way to attract foreign investment flows.

The literature points to the main factors affecting the locational decision of firms as being market demand, characteristics of the local labour force, the transportation network, and government policy toward foreign investment (Carlton 1983, Luger and Shetty 1985,
and Coughlin 1990, 1991). This study begins with the assumption that these are the most important factors, and using FDI and province-level data for the years 1992 and 1993, tests the determinants of the location of foreign direct investment in Vietnam. Following Carlton (1983), Bartik (1985), Luger and Shetty (1985), and Coughlin (1991), a conditional logit model (CLM) is specified and estimated.

The above authors developed CLM models to determine which locational factors influence the location of foreign firms in the US. This kind of model can be applied to the case of Vietnam, even though the government does influence the direction of FDI. The simple reason is the fact that MNEs are profit maximisers; they only invest in a region if they believe they thereby maximise their profits. Therefore, the government of the host country cannot be thought to direct MNEs’ decisions where they will establish their subsidiaries, except through the conditions that they establish for investment. An attempt by the Vietnamese government to direct foreign investment into the central region of Vietnam, for example, led to the withdrawal of the French Total company and refusal of other foreign firms to invest in that region. Moreover, in the case of Vietnam, each province or major city can offer different incentives or interpret various regulations according to its own needs; thus foreign investors may compare a set of incentives offered by a province or city to another to obtain the most favourable conditions for doing business.

6.1. The conditional logit model (CLM)

The conditional logit model is a multinominal (multiple choice) logit model pioneered by McFadden (1974). It considers the effects of choice characteristics on the determinants of choice probabilities. It is often used to examine the effects of choice-
specific characteristics on the behaviour of decision makers. This model allows the spatial distribution of a number of new plants to be analysed.

The basic problem faced in CLM or discrete choice analysis is the modeling of choice from a set of mutually exclusive and collectively exhaustive alternatives. The basic assumption is that any decision maker (such as an investor) is rational in the sense that he or she selects from among the possibilities available the action that maximises his or her objective function (in this case profits).

However, because of imperfect information it is very difficult for an analyst to observe and measure all the relevant variables that influence the decision of the investor. In fact, only the choices made by decision makers and the choice characteristics are observable. Using observed choices made by decision makers and their characteristics, a conditional logit model can be built to analyse the effects of choice-specific characteristics on the choice behaviour of decision makers. The model consists of parametrised profit functions in term of observable explanatory variables and unknown parameters that are estimated from a sample of observed choices made by decision makers when confronted with a choice situation.

In this study, the province-level determinants of a frequency distribution of foreign direct investment across the 53 provinces in Vietnam comprise the available data. It is assumed that individual firms choose from among 53 provinces in which to locate their business, based on those provinces' characteristics. Plant location is considered as a discrete choice problem facing profit maximising firms.
The population of foreign manufacturing firms which decided to invest in Vietnam in the period 1992-93 was the basic data for the analysis (Table 6.1). The total number of FDI manufacturing projects in Vietnam during this period was 480. Ho Chi Minh city was the leading recipient with 110, while seven provinces had no foreign investment.

Table 6.1: Manufacturing Foreign Direct Investment by Region, 1992-1993

<table>
<thead>
<tr>
<th>Province</th>
<th>Number of Projects</th>
<th>Invested Capital (US$ Mill.)</th>
<th>Province</th>
<th>Number of Projects</th>
<th>Invested Capital (US$ mill.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>An Giang</td>
<td>4</td>
<td>6.27</td>
<td>Lao Cai</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ba Ria - Vung Tau</td>
<td>3</td>
<td>40.09</td>
<td>Long An</td>
<td>4</td>
<td>27.2</td>
</tr>
<tr>
<td>Bac Thai</td>
<td>2</td>
<td>23.66</td>
<td>Minh Hai</td>
<td>1</td>
<td>0.8</td>
</tr>
<tr>
<td>Ben Tre</td>
<td>1</td>
<td>0.48</td>
<td>Nam Ha</td>
<td>1</td>
<td>8.64</td>
</tr>
<tr>
<td>Binh Dinh</td>
<td>3</td>
<td>9.61</td>
<td>Nghe An</td>
<td>3</td>
<td>8.56</td>
</tr>
<tr>
<td>Binh Thuan</td>
<td>4</td>
<td>14.8</td>
<td>Ninh Binh</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Can Tho</td>
<td>1</td>
<td>1.52</td>
<td>Ninh Thuan</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Cao bang</td>
<td>0</td>
<td>0</td>
<td>Phu Yen</td>
<td>2</td>
<td>1.26</td>
</tr>
<tr>
<td>Dac Lac</td>
<td>0</td>
<td>0</td>
<td>Quang Binh</td>
<td>1</td>
<td>1.58</td>
</tr>
<tr>
<td>Dong Nai</td>
<td>33</td>
<td>197.16</td>
<td>Quang Nam-Da Nang</td>
<td>12</td>
<td>72.9</td>
</tr>
<tr>
<td>Dong Thap</td>
<td>0</td>
<td>0</td>
<td>Quang Ngai</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Gia Lai</td>
<td>1</td>
<td>2</td>
<td>Quang Ninh</td>
<td>1</td>
<td>0.15</td>
</tr>
<tr>
<td>Ha Bac</td>
<td>3</td>
<td>0.95</td>
<td>Quang Tri</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ha Giang</td>
<td>0</td>
<td>0</td>
<td>Soc Trang</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ha Tay</td>
<td>3</td>
<td>2.04</td>
<td>Son La</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ha Tinh</td>
<td>2</td>
<td>35.5</td>
<td>Song Be</td>
<td>16</td>
<td>43.16</td>
</tr>
<tr>
<td>Hai Hung</td>
<td>1</td>
<td>1.06</td>
<td>Tay Ninh</td>
<td>2</td>
<td>3.86</td>
</tr>
<tr>
<td>Hai Phong</td>
<td>8</td>
<td>316.69</td>
<td>Thai Binh</td>
<td>1</td>
<td>1.65</td>
</tr>
<tr>
<td>Hanoi</td>
<td>51</td>
<td>499.26</td>
<td>Thanh Hoa</td>
<td>1</td>
<td>1.48</td>
</tr>
<tr>
<td>Hoa Binh</td>
<td>2</td>
<td>4.8</td>
<td>Thua thien Hue</td>
<td>1</td>
<td>31</td>
</tr>
<tr>
<td>Hochi Minh City</td>
<td>110</td>
<td>618.98</td>
<td>Tien Giang</td>
<td>3</td>
<td>49.36</td>
</tr>
<tr>
<td>Khanh Hoa</td>
<td>4</td>
<td>14.97</td>
<td>Tra Vinh</td>
<td>2</td>
<td>1.94</td>
</tr>
<tr>
<td>Kien Giang</td>
<td>0</td>
<td>0</td>
<td>Tuyen quang</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Kon tum</td>
<td>0</td>
<td>0</td>
<td>Vinh Long</td>
<td>2</td>
<td>4.35</td>
</tr>
<tr>
<td>Lai Chau</td>
<td>0</td>
<td>0</td>
<td>Vinh Phu</td>
<td>2</td>
<td>13.72</td>
</tr>
<tr>
<td>Lam Dong</td>
<td>7</td>
<td>14.81</td>
<td>Yen Bai</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Lang Son</td>
<td>2</td>
<td>0.84</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: SCCI 1995
Let the profit of the foreign firm locating in the \( j \)th province be \( \Pi_j \). Note that it is assumed that the firm chooses to locate in the \( j \)th province only if it expects to obtain the highest profit there. Mathematically,

\[
\Pi_j = \text{max} \{ \Pi_m; m=1,2,...,53 \}
\]

where \( m \) is the \( m \)th province (\( m=1,2,...,53 \)). \( \Pi_j \) is not observed; only the choice made by the firm is observed. Let \( Y_j \) be a dummy variable describing choice selection. \( Y_j \) is equal to one if the \( j \)th province is chosen by the firm to; and equal to zero if that province is not chosen. Since foreign investors are assumed to be rational, the observed variables \( Y_j \) can also be interpreted as follows:

\[
Y_j = 1 \text{ if } \Pi_j = \text{max} \{ \Pi_m; m=1,2,...,53 \}
\]

\[
Y_j = 0 \text{ otherwise}
\]

It is hypothesised that \( \Pi_j \) is made up of two components, one nonstochastic and the other random, i.e.,

\[
\Pi_j = F(X_j) + \epsilon_j
\]

where \( F(X_j) \) is assumed to depend solely on a vector \( X_j \) which consists of observable characteristics for the \( j \)th province, and \( \epsilon_j \) is the random term denoting the unobservable characteristics of the \( j \)th province. Following Coughlin (1991), we assume

\[
F(X_j) = \sum \beta_i \ln(x_{ij})
\]

where \( \beta_i \) is a vector of unknown coefficients to be estimated, and \( x_{ij} \) is the \( i \)th characteristic of the vector \( X_j \) that corresponds to the \( j \)th alternative (province).
Assuming that the $\varepsilon_j$'s are independent log-Weibull distributed, McFadden (1974) shows that the probability of location in the $j^{th}$ province, $P_j$, is

$$P_j = \frac{\exp(\sum_i \beta_i \ln(x_{ij}))}{\sum_{j=1}^{53} \exp(\sum_i \beta_i \ln(x_{ij}))} \quad (4)$$

The maximum likelihood estimate of $\beta_i$ is obtained by maximising the following likelihood function:

$$L(\beta) = \prod_{j=1}^{53} P_j \quad (5)$$

The probability of a foreign investment firm selecting a specific province depends on the levels of the province's characteristics that affect firm profits relative to the levels of these characteristics in other provinces.

**6.2 Location determinants**

The factors affecting profits are obviously those affecting the revenues and costs of the foreign firms. On the revenue side, province GDP (Gross Domestic Product) or province GDP per capita can be used as a measure of market demand in the province. Thus, if this variable is a statistically significant factor, its expected effect on foreign direct investment is positive (Coughlin 1991). However, province GDP or GDP per capita would likely be an unimportant consideration for a manufacturing firm that serves the national market or overseas markets.

Another variable that may be used as a proxy for market demand as well as for agglomeration economies is manufacturing density. It is expected that a province with a higher level of manufacturing activities could attract more foreign direct investment,
because the new firms might be serving existing manufacturing firms. For agglomeration economies, Luger and Shetty (1985) found that foreign plant start-ups were related positively to agglomeration economies.

The effectiveness of the labour market plays an important role in cost considerations. Wage rates, the skill level of the labour force, and the availability of labour are potentially important for investors. Wage rates are expected to be related inversely to foreign direct investment. Studying foreign manufacturing firms' location across the US, Little (1978), Bartik (1985), Luger and Shetty (1985), and Coughlin (1991) found evidence that higher wages were a statistically significant negative determinant of the probability of locating a new foreign firm in a state. However, changes in technologies in some sectors have altered the economic scale of production, weakening the case for offshore production in low labour-cost countries (Dunning 1980, Yang 1992, World Bank 1993). Because data on wage rates are not available for Vietnam, this study uses province real income per capita as a proxy variable for labour cost.

The skill composition of each province's labour force is included because the availability of skilled labour is expected to encourage businesses to locate in a region, particularly technologically-sophisticated industries. Luger and Shetty (1985) found that this variable related positively to foreign direct investment. However, there is no single, all-inclusive measure of the skill level of a province's labour force. Since the number of skilled and technical workers is not available for all provinces, the study uses the percentage of high school, technical high school and training school, college and university
students in the total labour force in the province as a proxy for the potential skill level of the province’s labour force.

A province’s unemployment rate reflects the pool of potential workers. A high unemployment rate should relate positively to foreign direct investment. Empirical support for the importance of the unemployment rate in the location of new foreign firms has been presented by Coughlin (1991).

The probability of FDI in manufacturing in a province may depend on the number of potential sites. Using the area of state land as a proxy for the number of potential sites, Bartik (1985) and Coughlin (1991) found that this variable related positively to FDI. In the case of Vietnam, the lack of infrastructure is one of the most important obstacles to attracting foreign direct investment. Therefore, towns where infrastructure is well established could provide more attractive sites for locating foreign investment.

A highly developed transportation network has also been found to be an important factor attracting foreign direct investment (Bartik 1985, Coughlin 1990, 1991). A higher density of highways and railroads could be therefore expected to be related positively to foreign direct investment. Transport density can be derived as the ratio of kilometres of road to the area of public land available. Public expenditures on education and highways could be alternative proxies for skill levels and levels of transportation infrastructure. Luger and Shetty (1985), and Coughlin (1990, 1991) have presented evidence supporting this case.

Other government policies toward foreign direct investment may play an important role in the business location decisions of foreign investors. To encourage foreign
investment into some targeted provinces, the Vietnamese government provides investment incentive packages such as preferential tax treatment (tax exemptions and tax rate reductions) and a lower minimum wage. According to Vietnam’s Foreign Investment Law (FIL), if a project is located in one of the disadvantaged regions, the profits tax rate is set at 10%, or full exemption from tax may be granted for two years and a 50% reduction extended in the following two years. For projects qualifying for the 20% tax rate, full exemption from profits tax may be granted for two years from the first profit-making year, and a reduction of 50% for the next two years. For other regions, a tax rate at 25%, a full exemption from profits tax for one year and a 50% reduction in the following two years may be applied to projects.

The fact that the Vietnamese government imposes different minimum wages on different provinces may also affect location decisions. By applying different minimum wages to different regions, the government hopes to encourage foreign investors to locate their businesses in targeted provinces. A minimum wage rate of US $35 has been set for Hanoi and Ho Chi Minh city and US $30 for the other provinces.

Another policy variable that could be important for locating foreign investment is the provision of an EPZ or IP in a province. The Vietnamese government has strict controls on real estate acquisitions by foreign investors. Land-use rights often represent the local capital contribution to a joint venture. However, foreign investors can gain access to land if they invest in an EPZ or IP.

The definitions of explanatory variables and their expected effects on foreign direct investment are given in Table 6.2.
Table 6.2: Definition of Independent Variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>LDNB</td>
<td>Natural logarithm of number of enterprises in 1992-93, an agglomeration economies measure (+)</td>
</tr>
<tr>
<td>LGDP</td>
<td>Natural logarithm of province GDP in 1992-93, market size variable (+)</td>
</tr>
<tr>
<td>LIM</td>
<td>Natural logarithm of average province real income per head, market demand variable (+)</td>
</tr>
<tr>
<td>LDP</td>
<td>Natural logarithm of population density in 1992-93 (+)</td>
</tr>
<tr>
<td>LUNL</td>
<td>Natural logarithm of province unemployment rate in 1992-93, a labour availability measure (+)</td>
</tr>
<tr>
<td>LHTL</td>
<td>Natural logarithm of province potential high skill labour level, a skilled labour availability measure (+)</td>
</tr>
<tr>
<td>LARO</td>
<td>Natural logarithm of province asphalted roads, infrastructure availability measure (+)</td>
</tr>
<tr>
<td>LIP</td>
<td>Natural logarithm of public investment in province in 1992-93, infrastructure variable (+)</td>
</tr>
<tr>
<td>TAX1</td>
<td>Dummy of tax treatment for disadvantaged province with 10% tax rate</td>
</tr>
<tr>
<td>TAX2</td>
<td>Dummy of tax treatment for province with 20% tax rate</td>
</tr>
<tr>
<td>TAX3</td>
<td>Dummy of tax treatment for province with 25% tax rate</td>
</tr>
<tr>
<td>Wage</td>
<td>Minimum wage dummy, 1 if US $30, 0 if US $35 (-)</td>
</tr>
<tr>
<td>Zone</td>
<td>Dummy for Export Processing and Industrial Zones (+)</td>
</tr>
<tr>
<td>LS</td>
<td>Natural logarithm of province land available, a measure of availability of investment sites (+)</td>
</tr>
<tr>
<td>LTO</td>
<td>Natural logarithm of number of towns in a province, a measure of availability of investment sites (+)</td>
</tr>
</tbody>
</table>

*Note: Sign in parentheses indicates expected effect*

### 6.3. Data and results of estimation

This chapter analyses the determinants of foreign investment location in Vietnam in the period 1992-93 only, since data related to the explanatory variables is available only for this period. This data was made available by the GSO (1994, 1995) and Dao Thien and Nguyen Manh Hung (1994). The primary data on new foreign investment locations are derived from the 480 licensed manufacturing projects in Vietnam in the period 1992-93.
Foreign manufacturing investment projects are divided into two groups, export-oriented and import-substitution, based on the declared objectives of the activity shown in their application forms submitted to the SCCI (SCCI 1993, 1994). The results of the CLM estimations are presented for three different data sets: foreign manufacturing investment projects as a whole, foreign manufacturing investment projects for export, and foreign manufacturing investment projects for import substitution (Table 6.3).

Where the necessary data were available annually, the average value of the independent variables over the relevant period was used. For explanatory variables where averaging was not possible, a single annual value was used.

Since the underlying profit function is log-linear, the coefficient of each independent variable can be interpreted as the proportional change in location probability due to a one percent change in the value of that variable.

All estimated coefficients have the expected signs. The statistical significance of manufacturing density, LDNB, (a proxy for market demand, or for agglomeration economies) for all FDI and for import substitution FDI indicates the importance of domestic demand for FDI. Although this variable has the correct sign, it is not statistically significant as a determinant of foreign export oriented investment firms’ location. This result supports the result in the previous chapter, indicating the importance of protection for FDI in Vietnam.

There are similar results for the province GDP (LGDP) variable, another proxy for market demand. These results further support the conclusion that, during this period at
least, FDI was primarily intended to serve the protected domestic market, rather than export markets.

Table 6.3: Econometric estimates for locational determinants

<table>
<thead>
<tr>
<th>Foreign Investment as a Whole</th>
<th>Export Oriented Foreign Investment</th>
<th>Import Substitution Foreign Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>LDNB 0.64 (2.389)\textsuperscript{b}</td>
<td>1.071 (0.438)</td>
<td>1.13 (4.172)\textsuperscript{a}</td>
</tr>
<tr>
<td>LGDP 1.095 (2.821)\textsuperscript{b}</td>
<td>2.093 (0.451)</td>
<td>1.23 (3.174)\textsuperscript{a}</td>
</tr>
<tr>
<td>LIM - 3.45 (-1.091)</td>
<td>-5.29 (-6.166)\textsuperscript{a}</td>
<td>-0.69 (-0.251)</td>
</tr>
<tr>
<td>LDP 2.70 (3.864)\textsuperscript{a}</td>
<td>2.05 (3.435)\textsuperscript{a}</td>
<td>0.78 (3.131)\textsuperscript{a}</td>
</tr>
<tr>
<td>LUNL 0.61 (3.67)\textsuperscript{a}</td>
<td>0.67 (5.576)\textsuperscript{a}</td>
<td>0.43 (1.790)\textsuperscript{c}</td>
</tr>
<tr>
<td>LHTL 4.34 (5.028)\textsuperscript{a}</td>
<td>1.29 (1.960)\textsuperscript{b}</td>
<td>3.50 (2.453)\textsuperscript{b}</td>
</tr>
<tr>
<td>LARO 1.86 (4.587)\textsuperscript{a}</td>
<td>1.53 (6.633)\textsuperscript{a}</td>
<td>2.93 (4.801)\textsuperscript{a}</td>
</tr>
<tr>
<td>LIP 2.07 (4.447)\textsuperscript{a}</td>
<td>1.82 (6.027)\textsuperscript{a}</td>
<td>1.83 (3.943)\textsuperscript{a}</td>
</tr>
<tr>
<td>TAX1 - 0.049 (-0.045)</td>
<td>-0.47 (-0.718)</td>
<td>-4.59 (-0.349)</td>
</tr>
<tr>
<td>TAX2 - 5.43 (-0.470)</td>
<td>-0.91 (-1.654)</td>
<td>-11.51 (0.745)</td>
</tr>
<tr>
<td>TAX3 - 2.73 (-0.213)</td>
<td>-4.82 (-0.539)</td>
<td>-10.65 (-0.635)</td>
</tr>
<tr>
<td>Wage - 7.54 (-0.626)</td>
<td>-4.36 (-4.762)\textsuperscript{a}</td>
<td>-8.09 (-0.635)</td>
</tr>
<tr>
<td>Zone 4.62 (0.879)</td>
<td>0.69 (1.111)</td>
<td>7.24 (0.957)</td>
</tr>
<tr>
<td>LS 0.94 (2.026)\textsuperscript{b}</td>
<td>0.88 (2.847)\textsuperscript{a}</td>
<td>0.75 (1.397)</td>
</tr>
<tr>
<td>LTO 0.40 (0.881)</td>
<td>0.063 (0.195)</td>
<td>0.61 (1.379)</td>
</tr>
</tbody>
</table>

\[ R^2 = 0.712 \quad R^2 = 0.541 \quad R^2 = 0.62 \]

Note: t-ratios in parentheses; \textsuperscript{a}, \textsuperscript{b} and \textsuperscript{c} - Statistically significant at the 1%, 5% and 10% respectively.

The results for the real per capita income (LIM) variable, the proxy for provincial wage costs, also support the above conclusion. Real per capita income only affects the location decisions of export-oriented investment firms, and the coefficient has a negative sign. This result suggests that export-oriented firms are attracted to locations with lower wage costs - which takes advantage of Vietnam's comparative advantage. The result for the minimum wage rate (Wage) dummy is consistent with this finding. It is also not an
important factor affecting foreign investment inflows in the general and import substitution cases. However, it is a statistically significant negative determinant of foreign investment to produce goods for export, i.e., export-oriented firms are attracted to locations with lower minimum wages. This is a further indication of the distorting effects of industrial policies, whereby import substitution activities do not have concern for minimum wage rates.

Other labour market characteristics that may affect foreign investors’ location decisions are population density (LDP), the unemployment rate (LUNL) and the skill level of the provincial labour force (LHTL). All these variables are statistically significant, positive determinants of foreign direct investment. Population density could also be an indicator of market size. If so, the results are still consistent. The availability of skilled labour is apparently an important factor in the establishment of import-substituting, usually capital-intensive activities, attracted to Vietnam.

The transportation infrastructure (LARO) and public investment (LIP) of a province also appear to affect the location of foreign direct investment. Both variables are statistically significant at the one percent level and both are important determinants for import substitution and export oriented investment.

The provincial tax treatment variables have the expected signs, although they are not statistically significant determinants of foreign investment location. Since Vietnam’s tax system is complex and tax rates are negotiated on a case-by-case basis, foreign investors may pay more attention to the actual tax rates that they have to pay (following negotiation), rather than the tax rates declared in the Foreign Investment Law.
Finally, while land area (LS), the proxy for the number of sites, is a positive, statistically significant determinant of foreign investment location, the number of EPZs and IPs and the number of towns in a province are not important factors affecting foreign investors. These results may arise because of the fact that FDI has been largely confined to joint ventures with SOEs because of their access to land use rights. The number or size of SOEs in a province may also be a good proxy for the availability of sites for the establishment of FDI.

In summary, the results of estimations in this chapter have shown that the provincial concentration of FDI inflows in Vietnam in the period 1988 to 1992 was strongly related to the growth rate of the domestic market and import substitution policies. This result supports the results in the previous chapter, indicating the importance of protection for FDI in Vietnam. Estimation results also show that education, transportation infrastructure, and public investment are key determinants of foreign direct investment. For foreign investment which is intended to produce goods for export a province’s wage rate is an important factor, while a province’s GDP and manufacturing density are very important for foreign investment for import substitution. The published tax incentives do not appear to have any location-determining impact. This result is consistent with other research that has shown that tax incentives are not important in attracting FDI (IFC 1997, IMF 1985); although published tax rates may bear little relation to the actual tax rates paid due to the extent of discretionary behaviour of provincial leaders in determining tax rates.
Chapter 7 : THE ROLE OF FOREIGN DIRECT INVESTMENT IN VIETNAM'S ECONOMIC DEVELOPMENT

As discussed in Section 2 of Chapter 2, as well as transferring financial resources for development, FDI can also transfer technology and management know-how, create jobs, upgrade local labour force skills, promote exports, and generally contribute to the growth of output and incomes of host countries. However, FDI needs to be managed carefully as it can also pose some dangers, such as currency appreciation, demands for protection in local markets, and reduction of scope for independent macroeconomic policy actions, that can disrupt the development process in receiving countries. Also, the economic strategy followed by the host country, particularly an import substitution (IS) or an export orientation (EO) strategy, can affect the benefit FDI will bring to the host country. Under an IS strategy - which, as noted earlier, often induces inefficiencies by creating serious distortions in factor and product markets, encouraging X-inefficiency, and biasing investment away from activities in which the host country has comparative advantages - protection-induced inflows of FDI will likely be harmful to economic growth of the host countries.

In contrast, an EO strategy - with its emphasis on the free play of market forces and competition that in turn promotes the efficient allocation of resources on the basis of comparative advantages - provides a sound climate for the exploitation of the potential of FDI to promote economic growth, and a powerful stimulus for investment in technology and human capital.
A full evaluation of the overall effects of FDI on Vietnam’s economy is difficult at this time, because the bulk of these investments is relatively recent (most FDI has flowed in since 1994) and many of the long term effects have not yet materialised. However, a preliminary assessment of the role of FDI in Vietnam’s economic growth is developed in this Chapter.

### 7.1. Foreign direct investment and Vietnam’s economic growth

Vietnam has shown strong growth throughout its reform period. The annual growth rate of GDP in the period 1989-97 has been over 8% pa. The foreign invested sector has grown even more rapidly (Table 7.1), and it is considered to be an important driver of Vietnam’s economic growth (IMF 1996, World Bank 1997, and EIU 1997).

Empirical studies on the linkages between FDI and economic growth in Asian countries (Husain and Jun 1992, Fry 1993, and World Bank 1996) have found significant positive effects of FDI.

#### Table 7.1. Performance of the Foreign Invested Sector in Vietnam, 1988-97

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover, excluding oil (million US $)</td>
<td>192</td>
<td>230</td>
<td>358</td>
<td>850</td>
<td>1277</td>
<td>1629</td>
<td>2350</td>
</tr>
<tr>
<td>Annual growth in turnover (%)</td>
<td>--</td>
<td>19.8</td>
<td>55.6</td>
<td>137.4</td>
<td>50.2</td>
<td>27.6</td>
<td>43</td>
</tr>
<tr>
<td>Exports, excluding oil exports (million US $)</td>
<td>52</td>
<td>112</td>
<td>115</td>
<td>350</td>
<td>400</td>
<td>786</td>
<td>1225</td>
</tr>
<tr>
<td>Exports as a percentage of turnover (%)</td>
<td>27.1</td>
<td>48.7</td>
<td>32.1</td>
<td>41.2</td>
<td>31.3</td>
<td>48.2</td>
<td>33.8</td>
</tr>
<tr>
<td>Share in total exports (%)</td>
<td>0.89</td>
<td>4.5</td>
<td>3.8</td>
<td>8.6</td>
<td>7.7</td>
<td>10.8</td>
<td>13.4</td>
</tr>
<tr>
<td>Imports (million US $)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>600.5</td>
<td>1468.1</td>
</tr>
<tr>
<td>Trade deficit (mill. US $)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>439.4</td>
<td>1028</td>
</tr>
</tbody>
</table>

The neoclassical framework of Solow (1956) may be used to model the relationship between FDI and Vietnam’s economic growth. This framework can provide a model of the relationship between private and government investment and economic growth:

\[ Y = A\varepsilon(K,L,\Theta) \tag{7.1} \]

where \( Y \) is the potential output; \( K \) is the stock of physical capital; \( L \) is the labour force; and \( \Theta \) is a vector of other factors affecting growth. The variable \( A \) is used to measure factor productivity that is generally assumed to grow at a constant exogenous rate. The signs of all first partial derivatives of \( Y \) with respect to the variables in \( \varepsilon(\bullet) \) as well as \( A \) are assumed to be positive.

In terms of growth rates, equation (7.1) can be expressed as

\[
\frac{dY}{Y} = \frac{dA}{A} + \left( A \frac{\partial Y}{\partial K} \right) \frac{dK}{Y} + \left( A \frac{\partial Y}{\partial L} \right) \frac{dL}{L} + \left( A \frac{\partial Y}{\partial \Theta} \right) \frac{d\Theta}{\Theta} \tag{7.2}
\]

For estimation purposes, equation (7.2) can be rewritten

\[
\frac{\Delta Y}{Y_{-1}} = \alpha_0 + \alpha_1 \frac{L}{Y_{-1}} + \alpha_2 \frac{\Delta L}{L_{-1}} + \alpha_3 \frac{\Delta \Theta}{\Theta_{-1}} \tag{7.3}
\]

where \( \alpha_0 = \frac{dA}{A} \)

\( \alpha_1 = A \frac{\partial Y}{\partial K} \)

\( \alpha_2 = A \frac{\partial Y}{\partial L} \cdot \frac{L}{Y} \)
\[
\alpha_3 = A \frac{\partial Y}{\partial \Theta} \cdot \frac{\Theta}{Y}
\]

and \(I = \Delta K\)

The constant term, \(\alpha_0\), is assumed to capture the growth in productivity; \(\alpha_1\) is the marginal capital productivity; \(\alpha_2\) is the elasticity of output with respect to labour; and \(\alpha_3\) is the elasticity of output with respect to other factors affecting economic growth. \(I\) is total investment which consists of private (\(I^p\)) and public (\(I^s\)) investment. The private investment includes foreign direct investment (\(I^f\)) and other private investment (\(I^{op}\)). To test whether public investment, FDI and other private investment have different effects on Vietnam’s economic growth, equation (7.3) can be modified to:

\[
\frac{\Delta Y}{Y_{-1}} = \beta_0 + \beta_1 \frac{I^f}{Y_{-1}} + \beta_2 \frac{I^{op}}{Y_{-1}} + \beta_3 \frac{I^g}{Y_{-1}} + \beta_4 \frac{\Delta L}{L_{-1}} + \beta_5 \frac{\Delta \Theta}{\Theta_{-1}} \tag{7.4}
\]

This is a simple model which has been used in empirical analyses of growth in developing countries by many economists, such as Balassa (1978), Tyler (1981), Ram (1985), and Khan and Reinhart (1990, p. 19-27). However, in the case of Vietnam, since most foreign direct investment in Vietnam is less than ten years old, a period too short to properly analyse growth effects (given the lag time between FDI commitment, investment and production), it is impossible to estimate directly the effects of FDI on growth. In this study, therefore, the effects of private and public investment on growth are tested, and a dummy variable used to represent the existence of FDI in Vietnam since 1988. It has the value of one for years when FDI flowed into the country, and the value of zero for years without FDI inflows.
The growth of trade is also included in the model. An increase in exports leads to the development of infrastructure, transport and communications, etc, which in turn encourages the production of other related goods and services (Balassa 1978, Khan and Reinhart 1990). Openness to trade can also be thought of as a proxy for the development of institutions favourable to economic growth. Investors will only invest if they can be assured that their property rights will be respected. Moreover, Vietnam is restructuring its economy, therefore the country is also dependent on imports of capital and intermediate goods as inputs into production. Capital and intermediate goods have been accounting for over 80 percent of the country's imports. Therefore, the variable $\Theta$ could also include imported inputs.

Annual data for the period 1983-96 was employed to conduct the analysis. The models estimated in this study are as follows:

\[
\frac{\Delta Y}{Y_{-1}} = \beta_0 + \beta_1 \frac{I^p}{Y_{-1}} + \beta_2 \frac{I^g}{Y_{-1}} + \beta_3 \frac{\Delta L}{L_{-1}} + \beta_4 \frac{\Delta TR}{TR_{-1}} + \varepsilon (7.5a)
\]

\[
\frac{\Delta Y}{Y_{-1}} = \beta_0 + \beta_1 \frac{I^{op}}{Y_{-1}} + \beta_2 \frac{I^g}{Y_{-1}} + \beta_3 \frac{\Delta L}{L_{-1}} + \beta_4 \frac{\Delta TR}{TR_{-1}} + \beta_5 D^f + \varepsilon (7.5b)
\]

where $D^f$ is a dummy variable which equals one for every year in the period 1988-96 when foreign direct investment flowed into the country, and zero for other years. Equation (7.5a) aggregates total private investment ($I^p=I^{op}+I^f$) while equation (7.5b) includes a separate variable for private investment other than foreign investment, $I^{op}$, and a dummy variable for foreign investment, $D^f$. TR is the trade variable, comprising the sum of exports and imports.
Empirical estimates

Although in theory, the minimum number of observations that allows the estimated results and its diagnostic tests to be consistent is 12, the theory as well as empirical evidence also warns that the smaller the number of observations the lower the consistency of the estimated results and the diagnostic tests. Therefore, with only 14 observations used in the estimation, the estimated results of the equations (7.5a) and (7.5b) have a low level of consistency. Because of the lack of reliable data and the short time period, the estimated results can only be considered as a rough estimation of the impact of FDI on economic growth in Vietnam. Results from the models may describe the impacts of FDI on economic growth better when the number of years for which Vietnam has experienced FDI inflows is larger (say about 20 years).

The results for the estimated equations (7.5a) and (7.5b) are shown in Table 7.2. Equation (7.5a) was estimated to provide a benchmark against which to compare results when private investment is disaggregated into foreign investment and other private investment.

In both models it is found that public, private, foreign and other domestic investment were positively correlated to the growth of real GDP in Vietnam during the period 1983-96. These coefficients have the correct sign and are significantly different from zero, at least at the 5 percent level - the coefficients of public investment are significant at the 1 percent level of confidence in both cases; the coefficient of other private investment is significant at the 1 percent level; and the coefficient of the dummy
variable representing the existence of foreign investment is significant at the 5 percent level.

The results also support the role of external trade in the growth process. The trade coefficient is highly significant in both models. Labour force growth is the only variable that has the wrong sign. This perverse result may be explained by the policies being followed in the agricultural and industrial sectors whereby labour is being retained in agriculture through the forced development of marginal areas, while industrial policies are concentrating on capital-intensive development.

Table 7.2. Results of growth models

<table>
<thead>
<tr>
<th>Coefficients</th>
<th>Model 7.5a</th>
<th>Model 7.5b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant (β₀)</td>
<td>2.313**</td>
<td>1.817*</td>
</tr>
<tr>
<td></td>
<td>(3.00)</td>
<td>(6.807)</td>
</tr>
<tr>
<td>Private investment (Iₚ)</td>
<td>0.162*</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>(3.819)</td>
<td></td>
</tr>
<tr>
<td>Other private investment (Iₚ₀)</td>
<td>--</td>
<td>0.300*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(13.538)</td>
</tr>
<tr>
<td>Public investment (Iₚ)</td>
<td>0.386*</td>
<td>0.411*</td>
</tr>
<tr>
<td></td>
<td>(7.143)</td>
<td>(14.237)</td>
</tr>
<tr>
<td>Growth of labour (ΔL/L₋₁)</td>
<td>-0.351***</td>
<td>-0.442*</td>
</tr>
<tr>
<td></td>
<td>(-1.838)</td>
<td>(-5.701)</td>
</tr>
<tr>
<td>Growth of Trade (ΔTR/TR₋₁)</td>
<td>0.082**</td>
<td>0.042*</td>
</tr>
<tr>
<td></td>
<td>(2.597)</td>
<td>(6.496)</td>
</tr>
<tr>
<td>Dₑ</td>
<td>--</td>
<td>0.330**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2.024)</td>
</tr>
<tr>
<td>R²</td>
<td>0.904</td>
<td>0.993</td>
</tr>
<tr>
<td>DW</td>
<td>1.945</td>
<td>3.828</td>
</tr>
</tbody>
</table>

T-values in parentheses below coefficients; R² is the coefficient of determination
* Statistically significant at the 1% level;
** Statistically significant at the 5% level;
*** Statistically significant at the 10% level.

The results for equations (7.5a) and (7.5b) point to the conclusion that foreign investment along with public and other domestic investment, as well as external trade, has played an important role in economic growth in Vietnam in recent years.
The contribution of FDI to the economic growth of Vietnam in recent years can also be analysed by examining the growth rate of the foreign-invested sector and the changes in its share in total industrial output. The foreign-invested sector has had the highest growth rate of all sectors in recent years. In the period 1995-98, the output of FIEs grew at an average annual rate of 18.3 percent, which was twice as high as the average growth rate of national GDP. At the same time, the state-owned enterprises and the private industrial sector grew at an average annual rate of 9 percent and 6.1 percent, respectively (Table 7.3). The high growth rate of foreign-invested enterprises is most evident in the steel, chemical, electronic, and leather industries (Table 7.4).

**Table 7.3.** Economic Growth by Sectors in 1995-1998 (percentage).

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth</th>
<th>Average in 1995-98</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>9.5</td>
<td>8.2</td>
</tr>
<tr>
<td>1996</td>
<td>9.3</td>
<td>9</td>
</tr>
<tr>
<td>1997</td>
<td>8.2</td>
<td>5.8</td>
</tr>
<tr>
<td>1998</td>
<td>5.8</td>
<td>9</td>
</tr>
</tbody>
</table>

| Source: MPI 1998

The share of foreign-invested industries in total industrial output has also increased rapidly. In 1991, the foreign-invested sector accounted for 16.9 percent in total industrial output. Its share increased to 25.1 percent in 1996 and to 28 percent in 1997 (MPI 1997, and Le Van Toan 1998). In some important industries, foreign-invested enterprises account for a considerable share, such as 100 percent in oil and gas output, 63 percent in the automobile industry, and 40 percent in the leather and electronic industries (MPIa...
This clearly indicates that FIEs have become a dynamic force in the industrial sector and play an important role in promoting industrial growth.

**Table 7.4.** Growth Rate of Foreign-Invested Industries in 1996 (%).

<table>
<thead>
<tr>
<th>Sector</th>
<th>Growth rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign-invested sector:</td>
<td>21.6</td>
</tr>
<tr>
<td>Oil and gas</td>
<td>15.2</td>
</tr>
<tr>
<td>Manufacturing:</td>
<td>21.4</td>
</tr>
<tr>
<td>Food processing</td>
<td>19.5</td>
</tr>
<tr>
<td>Leather</td>
<td>23.5</td>
</tr>
<tr>
<td>Steel</td>
<td>164.2</td>
</tr>
<tr>
<td>Electronic products</td>
<td>32.7</td>
</tr>
<tr>
<td>Chemical products</td>
<td>39.0</td>
</tr>
</tbody>
</table>

**Source:** General Statistical Office (1998).

Although FDI has played an important role in Vietnam’s economic development in the 1990s, the high growth rate of foreign-invested enterprises and their large share in heavy industry (such as steel, chemical, automobile, transportation and communication) indicate that much of FDI has been attracted into import-substituting industries. The share of heavy industry in total turnover by foreign-invested enterprises increased rapidly from 4.7 percent in 1991 to nearly 46 percent in 1998.

The large share of transportation and communications in the total turnover of foreign-invested enterprises, followed by heavy industry, light industries, agriculture and forestry, hotel and tourism, and construction, are another indication of the import-substitution bias of FDI inflows in Vietnam (Table 7.5).
(in millions of US dollars)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture and forestry</td>
<td>8</td>
<td>11</td>
<td>29</td>
<td>86</td>
<td>141</td>
<td>165</td>
<td>313</td>
<td>278</td>
<td></td>
</tr>
<tr>
<td>Share in total (percent)</td>
<td>5</td>
<td>5.1</td>
<td>6</td>
<td>8.4</td>
<td>6.9</td>
<td>6.1</td>
<td>8.6</td>
<td>8.3</td>
<td>6.8</td>
</tr>
<tr>
<td>Fisheries</td>
<td>55</td>
<td>19</td>
<td>11</td>
<td>11</td>
<td>19</td>
<td>23</td>
<td>20</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>Share in total (percent)</td>
<td>36.3</td>
<td>8.6</td>
<td>2.3</td>
<td>1.1</td>
<td>0.9</td>
<td>0.8</td>
<td>0.5</td>
<td>0.3</td>
<td>6.4</td>
</tr>
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<td>0</td>
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<td>65</td>
<td>167</td>
<td>414</td>
<td>683</td>
<td>1232</td>
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<tr>
<td>Share in total (percent)</td>
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<td>12.4</td>
<td>13.4</td>
<td>16.3</td>
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<td>33.9</td>
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<td>380</td>
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<td>734</td>
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<td>8.5</td>
<td>15.0</td>
<td>17.6</td>
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<td>21.6</td>
<td>20.2</td>
<td>23.5</td>
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<td>162</td>
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<td>442</td>
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<tr>
<td>Share in total (percent)</td>
<td>0.7</td>
<td>1.3</td>
<td>13.1</td>
<td>15.8</td>
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<td>12</td>
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<td>14</td>
<td>43</td>
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<td>0.3</td>
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<tr>
<td>Share in total (percent)</td>
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<td>17</td>
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<td>80</td>
<td>169</td>
<td>89</td>
<td>182</td>
<td>47</td>
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<td>3.3</td>
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<td>5.8</td>
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<td>4</td>
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<td>8</td>
<td>28</td>
<td>23</td>
<td>12</td>
<td>12</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>Share in total (percent)</td>
<td>0</td>
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<td>1.6</td>
<td>2.7</td>
<td>1.1</td>
<td>0.5</td>
<td>0.3</td>
<td>0.4</td>
<td>1.2</td>
</tr>
<tr>
<td>Transportation and communication</td>
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<td>115</td>
<td>191</td>
<td>250</td>
<td>399</td>
<td>445</td>
<td>361</td>
<td>54</td>
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<tr>
<td>Share in total (percent)</td>
<td>41.4</td>
<td>51.2</td>
<td>39.4</td>
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<td>19.4</td>
<td>16.5</td>
<td>10</td>
<td>1.6</td>
<td>25.5</td>
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<td>0</td>
<td>26</td>
<td>41</td>
<td>92</td>
<td>43</td>
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<tr>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>1.3</td>
<td>1.5</td>
<td>2.5</td>
<td>1.3</td>
<td>0.8</td>
</tr>
<tr>
<td>Culture, health, and education</td>
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<td>2</td>
<td>6</td>
<td>18</td>
<td>25</td>
<td>27</td>
<td>40</td>
<td>48</td>
<td></td>
</tr>
<tr>
<td>Share in total (percent)</td>
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<td>1.0</td>
<td>1.3</td>
<td>1.8</td>
<td>1.0</td>
<td>1.0</td>
<td>1.1</td>
<td>1.4</td>
<td>1.1</td>
</tr>
<tr>
<td>Total</td>
<td>151</td>
<td>224</td>
<td>485</td>
<td>1025</td>
<td>2057</td>
<td>2699</td>
<td>3628</td>
<td>3343</td>
<td></td>
</tr>
<tr>
<td>Turnover as percent of GDP</td>
<td>1.9</td>
<td>2.3</td>
<td>3.8</td>
<td>6.9</td>
<td>10.2</td>
<td>11.5</td>
<td>14.2</td>
<td>13.3</td>
<td>8.0</td>
</tr>
</tbody>
</table>

Source: International Monetary Fund 1999.

The results of studies of Bhagwati (1973), and Brecher and Diaz-Alejandro (1977) show that IS-induced FDI may cause immiserizing growth of the host country with loss of consumer welfare and a misallocation of resources, and the setting up of inefficient local production in industries where in the country does not have comparative advantage. Their analysis has been supported by the empirical evidence (Balasunbramanyam 1996).
In Vietnam, the government policy bias in favour of import-substitution investment has provided incentives for IS FDI. Therefore, much of FDI has been channelled to import competing industries which are often capital intensive and where Vietnam does not have comparative advantage. Investment in activities in which the country does not have comparative advantage is likely to frustrate the increasing returns to scale, spill-over effects of FDI and the generation of human capital, and hence economic growth.

**Table 7.6. Share of Capital by Sectors (%), 1991-1995.**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>State Enterprises</td>
<td>88.25</td>
<td>78.2</td>
<td>71</td>
<td>63.2</td>
<td>58.1</td>
</tr>
<tr>
<td>Non State Enterprises</td>
<td>0.15</td>
<td>4.1</td>
<td>6.2</td>
<td>6.6</td>
<td>5.7</td>
</tr>
<tr>
<td>Foreign-Invested enterprises</td>
<td>11.6</td>
<td>17.7</td>
<td>22.8</td>
<td>30.2</td>
<td>36.2</td>
</tr>
</tbody>
</table>


**7.2. Foreign direct investment and capital formation and savings in Vietnam**

**7.2.1. Capital formation**

The impact of FDI on the host country may also be analysed through examining the contribution of FDI to capital formation. The investment requirements for Vietnam’s rapid economic restructuring and modernisation are too large to be met by domestic savings. To maintain a high growth rate of about 8 percent per annum, annual investment requirements are estimated to be over 25 percent of GDP (World Bank 1996). However, national savings were about 17-18 percent of GDP in the period 1993-97, falling well short of the investment requirements. Since Vietnam promulgated the new Foreign Investment Law in 1988, over US $11 billion of FDI has flowed into the country. This has
served as an important supplement to domestic savings, keeping total investment of the country at over 25 percent of GDP since 1994 (CIEM 1999).

In 1991, the share of FDI inflow in total gross domestic investment was 16.7 percent, and it has increased rapidly to 30 percent since 1996 (Figure 6.1). The total capital of foreign-invested enterprises also rose rapidly from 11.6 percent of the country’s capital in 1991 to 36.2 percent in 1995 (Table 7.6). FDI has also resulted in the mobilisation of domestic savings through joint ventures.

Figure 7.1. Share of FDI in Total Investment

Foreign direct investment has facilitated the structural transformation of the economy and the upgrading of some domestic industries, especially some key industries such as oil and gas, steel, automobiles, telecommunications, and chemicals. Since 1995, over 60 percent of foreign direct investment in the productive sector has been used to expand and upgrade existing production capacities.

However, there are some problems or potential problems that are worth noting. First, many foreign-invested enterprises have taken measures to implement transfer pricing
in their operational activities which leads to lost tax revenue. Transfer pricing is usually found in the form of charging higher than market prices for imported equipment, technology and raw materials and lower than market prices on exported goods and services to their parent firm. For example, an inspection of 13 foreign-invested enterprises, conducted by a Swiss international inspection firm hired by the Vietnamese government, revealed that seven of them declared imported equipment that was overvalued by 23.6 percent (MPI 1997). Such overvaluation distorts the figures for FDI.

Transfer pricing usually results from one or a combination of factors such as exchange rate overvaluation, a taxation system that is not internationally competitive, or concerns about the ability to repatriate profits or capital. Correcting these problems are all within the ambit of the host country, and Vietnam should see transfer pricing as an indicator of the need to adjust its policies towards foreign investment.

Second, taking advantage of foreign savings in the form of foreign direct investment is less risky and costly than external debt, especially if the government in the host country directly or indirectly guarantees the debt or such investments made by foreign-invested enterprises. The host country will bear a substantial part of the financial losses in the case of bad business decisions and bankruptcies of foreign-invested firms (World Bank 1996a, UNDP 1996). In such cases, the debt service obligations will become a burden on government finances since the government has an obligation to help repay the full value of the debt. This can cause financial unsustainability of the development process, reduce public investment, and make investors careless in making decisions.
This seems to be the case in Vietnam where the Foreign Investment Law allows for up to 70 percent of FDI to be in the form of loans. In 1995, 77 percent of the US $1,780 million dollars of implemented foreign investment was in the form of loans (MPI 1996). According to the Foreign Investment Law, if the capital contribution of local partners was about 30 percent, they may have an obligation to repay up to 30 percent of this debt. Also, in the case of loss making projects, local partners not only have to pay part of the debt, but also use a part of their contributed capital to help to cover the losses.

In Vietnam, most FDI has been in the form of joint-ventures (64 percent of the number of projects and 77 percent of total registered investment capital) with state-owned enterprises as the local partner. State-owned enterprises have accounted for 96 percent of the total Vietnamese partners in joint-ventures and business contractual projects with foreign investors. These ventures and projects account for about 99 percent of total registered foreign investment (MPI 1997). Therefore, the government is implicitly guaranteeing to help repay the debts as well as the losses made by joint-ventures.

7.2.2. FDI and savings

In Section 2.4 in Chapter 2, the effects of FDI on domestic savings were discussed. FDI may lead to an increase in national savings in the host countries through promoting a higher national income, but it may also result in a decrease in savings by substituting for domestic savings. A simple simultaneous model to test the effects of FDI on national savings in the host country was outlined. In the case of Vietnam, the limitation of unreliable data and the short period of FDI flows do not allow us to estimate econometrically the effects of FDI on domestic savings, even using a simple model as outlined in Section 4, Chapter 2.
However, one may argue that FDI can affect national savings in Vietnam in several ways. Firstly, in the classical framework of the welfare effects of FDI, the host country is better off because part of the higher output is captured by labour and other non-capital factors. In the case of Vietnam, workers employed by FIEs often earn an income of US $94/month, that is, 2-3 times higher than the national income level (which is about US $30-$40/month) (MPI 1997). Therefore, they may generate some savings. However, this argument is weak in the case of Vietnam, because the number of employees working in FIEs is small, accounting for only about 0.73 percent of the country’s work force of about 34 million people in 1996. Therefore, their contribution to national savings should be very little.

<table>
<thead>
<tr>
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<td>FDI</td>
<td>2.6</td>
<td>2.6</td>
<td>6.5</td>
<td>6.8</td>
<td>8.8</td>
<td>9.7</td>
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<tr>
<td>National Savings</td>
<td>13.2</td>
<td>16.3</td>
<td>17.4</td>
<td>16.9</td>
<td>17.1</td>
<td>17</td>
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<tr>
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<td>2.5</td>
<td>5</td>
<td>5.2</td>
<td>6</td>
</tr>
<tr>
<td>Non-Government</td>
<td>11.9</td>
<td>12.2</td>
<td>14.6</td>
<td>11.9</td>
<td>11.9</td>
<td>10.6</td>
</tr>
</tbody>
</table>


Perhaps, the more important impact of FDI on national savings is its contribution to the high economic growth in Vietnam in recent years which increased national savings. However, if the increase in real income in recent years is considered to be permanent, so that people have raised their permanent consumption, national savings will not be improved (World Bank 1997).
On the other hand, FDI may have a negative impact on national savings. Recent government policies in favour of SOEs and discriminating against the private sector in terms of access to financial sources, land use rights, and international trade and other entry restrictions, allow SOEs and MNCs (which mainly have engaged in joint ventures with SOEs) to foreclose investment opportunities. Therefore, the proceeds may be spent on consumption rather than savings and investment. In this way, FDI may contribute to the decreasing growth rates of non-government savings and investment in recent years.

7.3. Foreign direct investment and technology transfer and training

7.3.1. Foreign direct investment and technology transfer

It is widely recognised that the most powerful effects of FDI on economic development of a recipient country are associated with the transfer of technology, knowledge, and management and marketing skills to the host country. The transfer of new technologies and know-how is able to contribute significantly to product and process innovation in the host country and, thus, promote technical change, an essential element of industrialisation and development. The introduction of inappropriate technology, however, can have a negative effect on employment, on efficiency in the allocation of resources, and on the effective utilisation of the country's comparative advantages.

Vietnam has developed from a very low starting point in terms of technology. Reports of the Ministry of Science, Technology, and Environment (MOSTE) (1995) and the General Statistical Office (1996) revealed that the technology level is 50 to 100 years behind that of the most advanced countries. The consequences of using backward technology are very high energy and material costs, low productivity and low value of products in terms of quality and forms that are not able to compete in the world market. It
has been estimated that to produce the same product, Vietnamese producers have to use an amount of energy over ten times higher with productivity ten times lower than that in an advanced plant (Ta Kim Ngoc 1996).

Recognising technology renovation as an essential factor for fast industrialisation and development and the important role of FDI in the transfer of technology and know-how, the Vietnamese government through its Foreign Investment Law has been offering a package of incentives (such as tax holidays and preferential tax rates) to foreign investors who apply high technology using local labour and materials (Table 3.1). Since the implementation of the FIL in 1987, renovation through technological transfer has been conducted on a much larger scale and at a higher speed than before.

Thanks to the application of new technology, many products (such as garments, textiles and leather, food, and electronics) of the foreign-invested sector are competitive in the world market. Technologies provided by foreign investors in the oil and gas industry, telecommunications, engineering, automobile and motorbike manufacturing, electrical appliances, sugar, and electronic equipment industries are among the most modern in the world (MPI 1997, Ta Kim Ngoc 1996, MOSTE 1995). The share of value of equipment in total capital contributed by foreign partners is about 32.3 percent (CIEM 1996).

A survey conducted by the CIEM (1996) showed that these enterprises are equipped much better than local (state-owned and private) ones: 93.3 percent of 100 percent foreign-owned enterprises and 88 percent of joint ventures in the survey had modern equipment and machines more than 90 percent of the time. Most state-owned enterprises, on the other hand, used equipment and machines that had depreciated in value
by more than 50 percent. The average capital per worker (another indicator that can be used as a proxy for technological level) in the surveyed foreign-invested enterprises was about ten times higher than that in SOEs and 20 times higher than in private firms (Table 7.8). Foreign-invested enterprises in the garment and leather industry had the lowest average capital per worker, US $4,700 dollars. But it was still higher than in the SOEs.


<table>
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<th>State-Owned Enterprises</th>
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<th>Foreign-Invested Enterprises</th>
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</thead>
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<td>20.6</td>
</tr>
<tr>
<td>Share in Industrial Output (%)</td>
<td>48.3</td>
<td>23.2</td>
<td>28.5</td>
</tr>
<tr>
<td>Capital per worker (US $)</td>
<td>4,000</td>
<td>1,818</td>
<td>44,000</td>
</tr>
</tbody>
</table>

Note: a - Data of 1996.

Besides the benefits from FDI that have been discussed above, there have been problems. In many cases, foreign investors have used technology transfer as a measure to implement transfer pricing. As mentioned in Section 2 of this chapter, much of the equipment and machinery brought into the country by foreign investors is valued above market prices. There are also cases in which foreign partners provide technology that is not advanced by world standards, but have forced their Vietnamese partners to sign a technology transfer contract with fees 2 to 5 percent of the annual turnover in a period of 5 to 7 years. Through technology transfer some foreign partners have tried to sell second hand or backward equipment (MOSTE 1995, MPI 1997). This is caused partly by the lack of information about technologies used in the rest of the world, and because Vietnamese
staff have insufficient knowledge to assess the technology provided by foreign-funded enterprises.

According to an assessment of MOSTE (1996), technologies transferred by foreign investors were much the same as those in many countries. However, some foreign investment projects in mining, animal feed processing and the footwear industry used backward technology that has had negative effects on the environment. The MOSTE report assessed that the technologies transferred by FDI were far from meeting the desires of the Vietnamese government. The very low technological level in most industries, the shortage of capital of SOEs and private firms, and the shortage of technical workers, as well as the low quality of education and training in Vietnam, are the main reasons for technologies transferred into the country not being of as high a standard as expected by the Vietnamese government. However, it must be recognised that at the current technological level in Vietnam, the requirement of transferring very highly advanced technologies seems to be not appropriate because very high technologies may not make optimum use of the available resources and the comparative advantage of Vietnam at present.

Moreover, the high protection provided by the Vietnamese government encourages a substantial amount of FDI to go into heavy industries which, typically, are capital intensive. For Vietnam, whose comparative advantage lies in labour intensive industries, the introduction of high capital intensive technologies biased in favour of capital and against labour may have a net positive effect on aggregate output, but a negative impact on employment, efficiency in the allocation of resources, and effective
utilisation of the country's comparative advantage, and hence on the long term
development of Vietnam. This has prevented Vietnam from gaining maximum benefit from
the technology transfer from FDI.

7.3.2. Spill-over effect of FDI

Along with benefits from technological transfer, Vietnam can also benefit from
external effects or "spillovers" from foreign direct investment. Foreign firms bring with
them some amount of the proprietary technology that constitutes their firm-specific
advantage and allows them to compete successfully with local firms that have superior
knowledge of local markets, consumers, preferences and business practices. The entry of
foreign firms forces local firms to improve their productivity by copying some technology
used by foreign firms, to use existing technology and resources more efficiently, and to
search for new, more efficient technology to protect their market shares and profits.
Nowadays, for example, many new methods of advertisement which are used by foreign
firms, but were not familiar to Vietnamese local firms are now used frequently by local
firms.

Although the entry of foreign firms forces local firms to improve their productivity
through upgrading their existing technology, and copying some technology used by
foreign firms, performance of local firms in development technology depends on its
capability, which in turn is based on the financial situation. In the case, if financial situation
of local firms is poor, the spill-over effect of FDI is therefore limited.

The effect of spillovers from the technology transfer of foreign investment in
Vietnam is also limited because of the poor performance of SOEs and severe shortage of
capital in state and private sectors. The Vietnamese government continues to follow a policy that keeps the state sector dominant in the economy. Currently, SOEs dominate many sectors in the economy. Although the state sector’s share in GDP has been increasing from 32.5 percent in 1990 to 37.8 percent in 1997, its performance in recent years has been poor. The number of loss-making SOEs rose from 20 percent of total SOEs in 1990 to 35-50 percent in 1997. While in 1990 the average ratio of profits to capital was 10 percent, in 1997 it declined to just 8 percent (Vo 1998, Levine 1998). The poor financial performance of SOEs has limited their financial capability in obtaining new, more advanced technology, and hence limiting their ability to improve productivity. The slow improvement in productivity and competitiveness in SOEs provides a weak incentive to foreign firms to improve themselves by bringing in a more advanced technology.

A shortage of capital faced by SOEs and private PEs also limited the positive spill-over effect of FDI. According to Bui Duc Tuyen (1996), the resources of SOEs are able to meet only 60 percent of their capital needs. SOEs are short not only of funds for obtaining new, more advanced technology, and expanding production capability, but also of operating capital. A survey of 311 SOEs in Ho Chi Minh City revealed that only 8 percent of them had investment worth about US $800,000 to renovate technology in 3 years, while the rest had very low investment levels for renovating technology (Saigon Times 12/4/1996). Moreover, the public ownership of SOEs leads to poor incentives for these firms to improve technology.

Having a soft budget, and a clear ownership structure, operating basically in accordance with market forces, and having much greater autonomy over their own
production decisions, non-state enterprises can gain greater benefits from the spill-over effects of the transfer of knowledge through FDI than SOEs can. However, the most practical obstacle facing the Vietnamese PEs in bringing about technological change is the fact that PEs have faced many more restrictions on entry, access to imported inputs, and credit (because of banks’ biases against them) relative to SOEs and to other countries in the region. As a result, PEs always face a shortage of capital. Currently, private firms have to use their own capital (which is very limited) to import more advanced technology. Therefore, the process of technical change in the private sector has occurred slowly.

7.3.3. FDI and Training

The upgrading of the work force in foreign-invested enterprises through training is another benefit to Vietnam. Modern marketing and management skills brought into the country by foreign investors also help to improve the management and business skills of Vietnamese managers in foreign-invested enterprises as well as in state-owned and private enterprises. Despite the fact that Vietnam provides diversified vocational training and technical education, demand for skilled workers is still not being met. The existing education and training system has not been able to satisfy the demand for technicians and managers in terms of quantity and quality (Dam Hanh 1996). Foreign-invested enterprises have been beneficial here since, in general, they have organised their own training programs. This has helped to reduce the pressure on the supply of skilled labour.

However, the contribution of FDI to training skilled workers is limited. A survey conducted by the CIEM on 154 foreign-funded enterprises in 29 industries found that less than half of them have training programs, although, if they have a training fund, that fund per worker per year is normally 3 to 30 times higher than the national average level (US
$50 per scientific cadre per year) (CIEM 1996). The main reason is that a large number of Vietnamese skilled workers and managers working in foreign-invested enterprises have been drawn from state-owned enterprises (CIEM 1996, MPI 1997). In 1995, for example, 70 percent of total labour employed directly by foreign-invested enterprises previously worked in state-owned enterprises (MPI 1996).

7.4. Foreign direct investment's effect on employment

Up to the end of June, 1997 about 200 thousand labourers were employed by foreign-invested enterprises. Of them, 97 percent were Vietnamese and 3 percent were foreign workers. Foreign workers are mainly employed in the oil and gas industry, and in foreign legal firms.

Labourers working in foreign-invested enterprises in the industrial sector accounted for about 84 percent of total workers recruited by enterprises with foreign investment. Foreign-owned enterprises have the highest average rate of employment per project. Although in 1996, this form of FDI accounted for 32.7 percent of total approved projects and 18.3 percent of total realised investment capital, it recruited more than 40 percent of the total number of labourers working in foreign-invested enterprises against 62, 57 and 58 percent respectively in joint-ventures with foreign enterprises, and 5.2, 24.5 and 2 percent respectively in business cooperation contracts. On average, each 100 percent foreign investment project employed about 110 Vietnamese workers, while joint ventures on average only employed about 88 people.

Foreign investment also has had an indirect impact on employment in related industries. The rapid growth of FDI inflows in Vietnam has led to a boom in the
construction and service industries. Employment in these industries has increased rapidly since 1990. The number of labourers working in construction and services increased from 817 and 2198 thousand people in 1990 to 1.1 and 2.8 million people respectively in 1995 (Table 7.7). Part of this increase was certainly the result of FDI projects. According to an MPI report (1997), FDI projects have created indirectly 100,000 jobs in construction and related industries and services.

Table 7.7. Employment in Selected Sectors (thousand people)

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>State-owned Enterprises (SOEs)</strong></td>
<td>2100</td>
<td>1759</td>
<td>1745</td>
<td>1800</td>
<td></td>
</tr>
<tr>
<td>Private Sector</td>
<td>26873</td>
<td>30680</td>
<td>31597</td>
<td>32399</td>
<td>33727</td>
</tr>
<tr>
<td>Foreign-Invested Enterprises</td>
<td>na</td>
<td>65</td>
<td>90</td>
<td>150</td>
<td>290</td>
</tr>
<tr>
<td>Industry</td>
<td>3394</td>
<td>3380</td>
<td>3395</td>
<td>3442</td>
<td>3656</td>
</tr>
<tr>
<td>Construction</td>
<td>817</td>
<td>972</td>
<td>996</td>
<td>975</td>
<td>977</td>
</tr>
<tr>
<td>Trade, Transport, and Communications</td>
<td>2198</td>
<td>2762</td>
<td>2858</td>
<td>3533</td>
<td>3528</td>
</tr>
</tbody>
</table>


However, the direct impact of FDI on employment remains insignificant. In a country where the labour force is increasing each year by some one million, the number of workers recruited by FDI projects per year (50,000 people) is small. In 1996, the employment generated by FDI accounted for only 0.29 percent of the total workforce in Vietnam. Table 7.7 reveals that the number of jobs created by FDI projects in recent years was much less than the number of jobs lost in the SOEs.

The main reason for the inconsiderable contribution of FDI to employment creation is that the government policy bias in favour of import-substitution has provided incentives to IS FDI to channel into import competing industries (heavy industry, light industries produced consumer goods) which are often highly capital intensive. According
to Bui Anh Tuan (1999), the amount of capital which is needed to create one industrial job in Vietnam is about $2000 US dollars. The average amount of capital which foreign-invested enterprises spent to create the same job was much bigger: $32,000 US dollars/job (16 times higher than in domestic enterprises) in 1994, and $59,000 US dollars/job in 1996 (nearly 30 times higher than in domestic enterprises). The increase in the amount of capital needed to create a job in foreign-invested enterprises indicates that FDI projects in Vietnam are import-substituting and highly capital intensive. The fact that the average investment capital per project in Vietnam was about ten times higher than China is another indication of more capital intensive FDI projects in Vietnam. For Vietnam, whose comparative advantage lies in labour intensive industries, the large amount of FDI that went into import-substituting, highly capital intensive industries may have a net positive effect on aggregate output, but a negative impact on employment. That is why employment generated by FDI is small.

Besides the question of the effects of FDI on employment creation, the issue of labour relations in the foreign-invested sector should be mentioned. It appears that foreign-controlled management of foreign-invested enterprises in Vietnam is causing labour unrest. In two years, 1995 and 1996, 36 strikes hit foreign-invested enterprises in Ho Chi Minh City; most of these occurred in textile, garment and footwear enterprises with foreign investment originating from South Korea (19 strikes), and Taiwan (12 strikes). Reasons for striking which have been cited are as follows: compulsory overtime, low wages, late wage payments, and rude treatment. There were many cases in which foreign companies had not applied Vietnamese labour regulations, including the minimum wage.
Table 7.8. Summary of the Balance of Payments, 1992-98

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports (US $ Mill.)</td>
<td>2581</td>
<td>2985</td>
<td>4054</td>
<td>5449</td>
<td>7256</td>
<td>9145</td>
<td>9323</td>
</tr>
<tr>
<td>Imports (US $ Mill.)</td>
<td>2541</td>
<td>3924</td>
<td>5826</td>
<td>8155</td>
<td>11144</td>
<td>11622</td>
<td>11494</td>
</tr>
<tr>
<td>Trade Deficit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>As Percentage of GDP</td>
<td>0.4</td>
<td>-7.3</td>
<td>-11.0</td>
<td>-12.9</td>
<td>-15.2</td>
<td>-9.9</td>
<td>-8.4</td>
</tr>
<tr>
<td>Current Account Deficit</td>
<td>-8</td>
<td>-767</td>
<td>-1166</td>
<td>-2132</td>
<td>-2294</td>
<td>-1625</td>
<td>1050</td>
</tr>
<tr>
<td>As Percentage of GDP</td>
<td>-1.3</td>
<td>-8</td>
<td>-8.5</td>
<td>-10.1</td>
<td>-11.3</td>
<td>-6.5</td>
<td>-4.2</td>
</tr>
<tr>
<td>Capital Account</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>FDI (net)</td>
<td>260</td>
<td>832</td>
<td>1048</td>
<td>1800</td>
<td>2000</td>
<td>2074</td>
<td>800</td>
</tr>
<tr>
<td>Medium- and Long Term Loans (net)</td>
<td>52</td>
<td>-597</td>
<td>-275</td>
<td>-174</td>
<td>-215</td>
<td>375</td>
<td>432</td>
</tr>
<tr>
<td>Short-Term (net)</td>
<td>-41</td>
<td>117</td>
<td>124</td>
<td>-225</td>
<td>285</td>
<td>-534</td>
<td>-190</td>
</tr>
<tr>
<td>Memorandum Items</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Official Reserves</td>
<td>465</td>
<td>404</td>
<td>876</td>
<td>1376</td>
<td>1789</td>
<td>2085</td>
<td>2098</td>
</tr>
<tr>
<td>Debt Services (% of Exports)</td>
<td>22.4</td>
<td>26.1</td>
<td>14</td>
<td>14.1</td>
<td>14.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Debts (Mill US $)</td>
<td>3957</td>
<td>4788</td>
<td>5473</td>
<td>6741</td>
<td>8357</td>
<td>9590</td>
<td>10760</td>
</tr>
</tbody>
</table>


7.5. Foreign direct investment and the balance of payments

Vietnam's trade and current account deficit have widened substantially since 1993 with the trade deficit reaching a record 17 percent of GDP in 1996 (Table 7.8, and Chapter 3). FDI inflows have recently been the most important source of foreign currency to cover the trade deficit. The rest of the trade deficit has been financed by official development aid (ODA) and private transfers (ie, remittances from overseas Vietnamese and Vietnamese labourers working abroad). FDI inflows, and official and private transfers have also improved Vietnam's international reserves significantly (Kokko 1997).

The empirical evidence shows that import-export activities of foreign-invested enterprises can affect the balance of payments. Foreign direct investment can help to
channel capital into industries which are able to take advantage of the country’s comparative advantage to produce goods for export. Moreover, the global linkages of MNEs can also facilitate local firms’ access to foreign markets (Sun 1998, Rana 1985).

However, the trade policy of the host countries can determine whether effects of FDI inflows on balance of payments are positive or negative. Attracted on the basis of comparative advantage of the host countries, EO FDI in developing countries often goes into labour-intensive industries to produce goods for exports, thereby to improve trade balance, and hence the balance of payments, and to increase employment in the recipient countries. In contrast, an IS trade regime distorts the allocation of resources, and biases export and investment towards industries where the host country does not have a comparative advantage. Biasing exports, and being capital intensive, IS industries in developing countries normally require a large amount of foreign exchanges for importing equipment and machinery. This amount of foreign exchange is often much bigger than the amount of foreign exchange saved due to some goods that used to be imported being now produced domestically. Therefore, the net effect of IS FDI inflows on trade is negative (LE 1996).

In Vietnam, although on a positive list regulations favour projects which are export-oriented and import-substituting, the restrictive trade regime has provided strong incentives to IS FDI inflows. As a result, a large amount of FDI has flowed into import competing industries such as heavy industries, light industries producing consumer goods, transportation and communication. Going to import-substituting industries which are often capital intensive, and in which Vietnam does not have comparative advantage, FDI inflows
have a small effect on employment and negative effects on trade balance, hence balance of payments.

Foreign-invested enterprises have created a large trade deficit in Vietnam. In 1996, the trade deficit of the foreign-invested enterprises accounted for 33.2 percent of the country’s trade deficit. The share of foreign-invested enterprises’ exports in total Vietnamese exports is relatively small, accounting for, on average, only 8.5 percent in the period 1991-98. Although exports by foreign-invested enterprises have increased from a negligible amount in the period of 1988-91 to 8.6 percent of Vietnam’s export in 1994 and 16.4 percent in 1998, their share in total Vietnamese exports is small in comparison to China where the share of foreign-invested enterprises’ exports in total exports of China was 31.5 percent in 1995. Moreover, even though the exports by foreign-invested enterprises reached a new record of US $1,500 millions in 1998, these exports accounted for less than a third of total turnover of foreign-invested enterprises.

The lack of comprehensive data on trade and the contradiction in data sets on the exports of foreign-invested enterprises from different sources do not allow an assessment of structure of the exports generated by foreign-invested enterprises. However, according to the IMF’s latest data (1999), almost 90 percent of exports generated by foreign-invested enterprises came from oil and gas, and food industries. This means that other industries such as agricultural, footwear, textiles and garments in which Vietnam has export potential have not been very attractive to foreign investors.

While the share of exports by foreign-invested enterprises is relatively small, their import is very large. Total imports of foreign-invested enterprises was about US $2.7
billion, accounting for 26 percent of total imports of Vietnam in 1998. This amount of imports was almost 80 percent higher than total exports of foreign-invested enterprises. Import-substituting and non-tradeable industries accounted for 57 percent of total imports of foreign-invested enterprises. This indicates the import-substitution bias of FDI inflows in Vietnam.

The result of these developments has been a widening of the gap between the trade and current account deficits. This, in turn, has had a negative effect on the balance of payments position. Therefore, the large trade deficit created by foreign-invested enterprises may be seen as calling attention to the need to reform the industry structure and trade policy in order to avoid persistent current account imbalances and related macroeconomic problems.

As discussed in Section 2 of this chapter, most local partners in joint ventures with foreign firms, which in turn represent the largest number of FDI projects as well as FDI commitments, are state-owned enterprises. Therefore, the government directly or indirectly guarantees debts made by joint ventures. In the case of poor performance by the joint ventures, the debt service obligations will become a burden on government finances and reduce the country's future import capacity.

The increase in the number of foreign-invested enterprises making losses in recent years, especially in the industrial sector where most FDI has gone, should be taken as an alarming sign that debt may grow faster than the ability to repay. In 1994, 213 foreign-invested enterprises made losses totaling US $54.3 million; in 1995, 317 foreign-invested firms lost a total of US $133.4 million; and in the first six months of 1996, the number of
loss-making foreign-invested enterprises increased to 342 (MPI 1997). In 1996, 80 percent of foreign-invested enterprises in Ho Chi Minh City reported losses (Saigon Newsreader 25/7/1997).

7.6. Other effects of FDI

Within the broad context of market-oriented reforms, the role of FDI can be found mainly in three broad areas: stimulating and, in some areas, leading the move towards economic reform by promoting a market-oriented institutional framework; promoting competition and improving economic efficiency; and integrating Vietnam into the world economy.

7.6.1 Establishing and improving the country’s institutional framework

In general, the effort to attract FDI has contributed to the introduction of market-oriented reforms. The liberalisation of policies towards FDI can be taken as an example. According to McMillan (1993, p. 97-148), to be maximally effective, a foreign investment policy should be embedded in an overall legal framework conducive to foreign and domestic investment. The liberalisation of foreign investment policies has, thus, imposed a constant pressure for introducing other market mechanisms. The introduction of numerous regulations and laws, such as the Intellectual Property Law, Company Law, Land Law, Bankruptcy Law, Mining Law, and State Enterprise Liquidation Regulations, resulted from requirements of a market economy and foreign investors to create a more favourable business environment.

The fact that the Foreign Investment Law was revised several times (in 1992, 1994, and 1996) is also evidence of the effects of FDI on the legal framework. The
government views the promulgation of the revised Foreign Investment Law as a radical reform of procedures which would lead to dramatic improvement in the investment climate.

7.6.2. Promoting competition

The entry of foreign firms was regarded as an effective way of breaking existing monopolies and enhancing competition in Vietnam. The potential role of FDI in this respect is sizeable, particularly given the strength of SOEs in Vietnam.

The entry of foreign firms into Vietnam has led to a reduction in industrial concentration by diminishing the role of large-scale SOEs. State-owned and private enterprises have had to respond to the presence and increasing competitive pressure of the new market entrants by improving their own efficiency. FDI has created more competition in domestic services as well as in export-oriented industries, including textiles and clothing, electrical appliances, food processing, and footwear.

There is also room for greater competition not only between domestic and foreign firms but also between foreign firms themselves. This is, in fact, the case in the automobile (12 leading motor MNEs), sugar, and cement industries. As a result of the entry of MNEs and other private enterprises, SOEs now face active competition that forces them to improve the efficiency of their own operations.

7.6.3 Integrating Vietnam into the world economy

The activities of foreign firms from more than 50 countries and territories around the world have contributed to the integration of Vietnam into the world economy by strengthening linkages with international markets. Foreign investors have brought
technology to produce goods of export quality, skills and attitudes to ensure their prompt delivery, the dependability required for export marketing, and knowledge of international markets. Simultaneously, they have helped to promote exports through ties with their home and other foreign markets and well established marketing networks. The survey conducted by the CIEM (1996) showed that although the observed foreign-invested enterprises’ share of exports in their total turnover has dropped, the number of foreign invested enterprises engaging in exporting their products has increased. The rapid increase was most evidenced in the number of 100 percent foreign-owned enterprises.
Chapter 8: Conclusions and Policy Implications

8.1. Summary of results

The main economic theories concerning foreign direct investment have been reviewed. It is concluded that understanding of the behaviour of FDI and MNEs can be found more in the theory of industrial organisation than in neoclassical or portfolio theories. More specifically, the oligopolistic theory of the firm provides better insights concerning the behaviour of FDI and MNEs than can others.

The contributions of FDI to employment and income in host countries are substantial in many cases. Moreover, transnational activities, especially FDI, are one way of bringing into an economy advanced technology, management and marketing skills, and access to the world markets. However, the returns from FDI depend on both home and host countries' policies. The economic strategy pursued by the host country, particularly an IS or an EO strategy, can influence the amount of FDI flows into, and the benefit FDI will bring to the host country. Following an EO strategy with its emphasis on the free play of market forces and competition that provide a sound climate for the exploitation of the potential of FDI as well as domestic investment to promote economic growth, a host country can attract more FDI and obtain greater benefits from FDI. In contrast, under an IS strategy which often induces inefficiencies by creating serious distortions in factor and product markets, protection-induced inflows of FDI will likely be harmful to the economic growth of the host country.
Recognising the important role of FDI for Vietnam's economic development, the Vietnamese government has given high priority to the task of creating a legal environment that is liberal and attractive to foreign investors. In comparison with Indonesia, for example, Vietnam provides more incentives and places fewer requirements on foreign investors, allowing foreigners to invest in any sector of the Vietnamese economy, and does not limit the share of foreign ownership. Through tax holidays, reductions from income tax, privileged income tax and withholding tax rates, the government encourages investors into priority areas.

However, the country's legal system, in general, and foreign investment framework in particular are incomplete and need further modifications; moreover, in the process of implementation, there is a significant gap between legislation and practice. These deficiencies have been adversely affecting the country's attractiveness to foreign investors. The import substitution and other policies in favour in the SOEs have contributed substantially to the deficiencies that plague the business climate in Vietnam. Therefore, although Vietnam has gained favourable initial results since it implemented modest investment policies in 1988, after reaching a peak in 1995, FDI has declined rapidly since 1996.

Understanding the determinants of foreign direct investment inflows is necessary for an assessment of the effectiveness of host country policies toward foreign direct investment. Two different models were used to investigate the main determinants of FDI in Vietnam. One model used data on 26 industries over the period from 1988 to 1995 to test the determinants of FDI such as gross domestic product (GDP), import-substitution
policy, profitability, and labour costs. The results of estimations of this model showed that the sectoral concentration of FDI inflow in Vietnam’s manufacturing in the period 1988-95 was mainly related to the growth rate of the domestic market, and import substitution policies. Import substitution policies, with the incentive of a monopolistic position in a growing market, appear to have severely distorted investment. This also shows up in the result that the labour intensity variable is negative - indicating that foreign investment is not taking advantage of Vietnam’s comparative advantage: well-educated, low-cost labour.

The second model analysed the determinants of location decisions of foreign investment firms across provinces in Vietnam. The framework used for the estimation in this study is applicable to the problem of location choice. A conditional logit model of the foreign firm’s investment location decision based on profit maximisation was used to study the factors affecting the choice between different location alternatives.

Estimation results showed that education, transportation infrastructure, and public investment are key determinants of foreign direct investment. For foreign investment to produce goods for export, a province’s wage rate is an important factor, while a province’s GDP and manufacturing density are very important determinants of foreign investment for import substitution. Tax incentives do not appear to be important. However, the complexity of Vietnam’s tax system and its wide scope for discretionary behaviour by national and provincial governments, means that it is difficult to know what tax incentives FDI firms are receiving.
The findings from the estimation of these models imply several important messages. Firstly, government policies which to result in a high economic growth rate play a very important role in attracting FDI inflows. Secondly, a public investment program which can improve the country’s infrastructure (physical infrastructure, education, and legal framework) will strengthen Vietnam's competitiveness in attracting foreign investors. Thirdly, import-substitution policies in combination with market growth can be very attractive to FDI, but the import-substitution FDI often leads to inefficiency in resource use. This will likely have negative effects on the long-term development of Vietnam. At some point it will become difficult to attract FDI as there will be no longer be profitable domestic monopolies to offer. This may already have begun to happen as indicated by the drying up of FDI and the sharp slow-down in GDP growth. Fourthly, industrial and FDI policies have been biased against the development of labour-intensive industries. This has had adverse implications for employment creation, and particularly for off-farm employment opportunities for the large numbers of rural labourers likely to leave farming now that its productivity is steadily increasing. The recent sharp slow-down in FDI may also be explained by the unfriendly attitudes that the state expresses toward FDI and private activity. Policies which could help to solve the above problems are addressed in detail in Section 8.2 of this chapter.

The “push” factors of FDI in Vietnam have also been favourable. They can be found in the geographical position of Vietnam within the East Asian region where economic growth, trade and outward foreign investment have developed rapidly. Although a financial crisis has been experienced in some of the East Asian countries in 1997 and 1998, upon recovery these countries will be a major source of investment. Moreover, the
increase in real wages and other costs of producing standardised, mature manufactures in the East Asian countries has made Vietnam an attractive site to produce goods for international and regional markets. However, with its present policies favouring state-owned, capital-intensive, and domestically-oriented activities, Vietnam has been able to take little advantage of these favourable factors.

Foreign direct investment has already made a significant contribution to Vietnam’s economic development, and has become an important source of capital for the Vietnamese economy, assisting with the change necessary in the structure of the economy, creating jobs, pushing up domestic savings, and increasing trade volumes. Estimation results of a Solow-type growth model showed that along with public and domestic private investment, and external trade, FDI has played an important role in Vietnam’s economic development. In recent years, the foreign invested sector achieved the highest growth rate of over 20 percent per year among sectors in the country.

There are problems, however. Many foreign-invested enterprises have been found to be using transfer pricing in their operational activities by charging higher than market prices for imported equipment, technology and raw materials, and quoting lower than market prices on exported goods to their parent firms. This kind of activity leads to losses of tax revenue. However, it should be taken as a sign that the exchange rate or tax rates are not at internationally competitive levels, or that foreign investors have concerns about their ability to repatriate profits or capital.

Encouraging foreign firms to engage in joint-ventures with SOEs, which has been the effect of policies to date, creates a contingent liability for the government, especially
where foreign loans are guaranteed by the government. The large trade deficit created by foreign-invested enterprises has had a negative effect on the balance of payments. The large import surplus in the foreign-invested sector is a consequence of the weakness of local firms in the domestic market and of the policy of protectionism that encourages foreign investors to invest into capital-intensive industries.

To overcome the above problems and to obtain the maximum benefits from FDI, Vietnam should continue its reform process, reducing the politico-economic risk and uncertainty facing firms, and encouraging development along the lines of comparative advantage.

8.2. Policy implications

The incomplete and constantly changing legal framework for foreign investment, the significant gap between legislation and practice, and the severe competition in attracting FDI from other developing countries challenge Vietnam in maintaining the growth rate of FDI inflows, and in improving the efficiency of utilisation of FDI. In order to attract more FDI and improve the utilisation of FDI, further reforms in the main areas, such as the legal system, and reform of the public sector, especially SOEs, should be implemented. Policies which may improve the business environment, strengthen Vietnam's comparative advantages and competitiveness in the domestic and international markets, are addressed below.

8.2.1. Improving the investment climate

Vietnam's incentives package for FDI must be comparable with that of other Asian countries. Research and empirical evidence show that the effects of incentive packages on investment levels are either inconclusive or insignificant (IMF 1985). Indonesia's
experience shows that, although it offers fewer actual incentives than Vietnam, its FDI flows are higher than FDI flows into Vietnam (US $14.1 billion against US $4.3 billion in 1994). According to Osada, "the increase of FDI was not caused by Indonesia's FDI policy per se but by the combination of FDI policy and many other related deregulations" (Osada 1994).

To foreign investors, economic policy stability is the most important consideration. A favourable environment is also created by a stable legal framework, a transparent and predictable, efficient and "light" regulatory framework, an open and effective labour market, easy access to utilities, good physical trade infrastructure (export facilities, customs clearance) and a welcoming administrative environment. In the case of Vietnam, the climate for investors has shown some improvement with emerging private sector development. However, bureaucratic procedures, particularly at provincial and district level, remain heavy-handed.

8.2.2 Promoting investment

Promoting investment requires reduction of control and the extensive discretionary behaviour. Vietnam has to redirect FDI policy away from active promotion towards reduction of the remaining controls. Reform is necessary in four key areas: first, there is a need to abolish the current "priority industries" list. It is too broad to be meaningful, and it is also ineffective. The best approach would be to have a single negative list based on security requirements. Outside this list, all other industries should be open to FDI on an equal footing.
Second, the number of agencies required to approve FDI proposals at the central level should be reduced. At present, there are eight agencies involved in this process (Ministry of Planning and Investment (MPI), Finance Ministry, Ministry of Commerce and Trade, Ministry of Science, Ministry of Construction, Central Bank (State Bank) and other Ministries relevant to the sub-sector in question). By reducing the number of approval agencies, the authority of the MPI would be strengthened, and a ‘one-door’ service could be created for large and important foreign investment projects. The most serious problem in the process of approval is the overlapping authorities of provincial governments that confuse foreign investors and cause considerably delays in the approval process. The overlapping authorities of provincial governments can be eliminated by removing the evaluation role of the local government as a separate step of the approval process because the same evaluation will be done again at the central level.

Third, a general liberalisation of trade policy is desirable as part of economic reform, as well as for FDI and export expansion. The opening of world markets has made it possible for Vietnam to attract FDI on the basis of its comparative advantages (human, natural, and locational). At present, however, high import tariffs and quantitative restrictions used as a measure of protection of domestic industries have been encouraging a substantial amount of FDI into heavy industries which, typically, are capital-intensive ones. This has had a negative impact on employment, on efficiency in the allocation of resources, on effective utilisation of the country’s comparative advantage, and hence on the long term development of Vietnam.
Moreover, serving the uncompetitive domestic market allows foreign-invested enterprises to develop with obsolete technologies and with limited linkages to international markets, instead of bringing the host country new technologies and marketing links. Also, the technologies used in those import-substituting industries are mostly inappropriate for the factor endowments of the country.

High import tariffs and quantitative restrictions are biased against export-oriented industries (which are based mainly on low labour costs) and encourage smuggling. Therefore, in the program of tariff reform in Vietnam, the first step should be to collapse the present system of import and export licenses, to improve cooperation between custom and trade authorities, and to replace the existing tariff schedule with a set of moderate tariffs in the 10-20 per cent range. This tariff schedule could make a substantial contribution to economic transition and increase government revenue. Greater openness to the world market will enable Vietnam to benefit from the reduction of static inefficiencies arising from the misallocation of resources, encourage learning from technological change, promote economic growth and competition among domestic enterprises while reducing their monopolies, improve flexibility in the face of external shocks, and reduce wasteful rent-seeking activities. In brief, a liberal trade regime is very important to facilitate increased flows of efficient FDI, promote competition in the domestic market, encourage technology transfer and its spillover effects from foreign direct investment, and improve economic welfare and long-term growth.

Fourth, Vietnam could benefit from the relaxation of its labour market regulations. Interventions in the labour market, such as minimum wage rates, make labour artificially
expensive and discourage labour-intensive industries in which Vietnam should have a comparative advantage. One adverse consequence of inappropriate labour regulations may be the transfer of technologies that are not suited to Vietnam's factor endowment conditions. Moreover, in Vietnam, the highly protectionist policy, together with the exemptions from duties on capital equipment, tend to lower the cost of capital and encourage substitution of capital for labour. Relaxation of labour regulations could still give preferences to local workers, but foreign firms could recruit directly, and wages, like other prices, could be decontrolled. Local workers in managerial and technical categories should still be cheaper than expatriates.

8.2.3. Reforming state-owned enterprise and promoting of the development of an active domestic private sector

Reform of state-owned enterprises is urgently needed to improve the efficiency of SOEs and the competitiveness of domestic (state and non-state) enterprises in the domestic as well as in international markets. Competition can play a very important role in the country's development since it forces domestic and foreign-invested enterprises to improve continuously by learning, applying and developing new technologies and management skills. This will improve the country's productivity and economic growth. In recent years, the poor performance and the weak competitiveness of SOEs have adversely affected Vietnam's economic development, and prevented the country from gaining maximum benefits from technology transfer and its spillover effects from FDI. This calls for further SOE reform that will help to improve SOE efficiency and competitiveness and reduce government management costs.
SOE reform is also needed to ensure a rational response to trade liberalisation. Eliminating distortion in prices caused by protectionist policies is essential so that weak and financially unsustainable SOEs can be closed. Equitisation (privatisation) of SOEs should be speeded up. The equitisation of SOEs will reduce government management costs, and at the same time make funds available to upgrade physical infrastructure and the education and training system which, in turn, will strengthen the country's attractiveness to foreign investors. Through the equitisation of SOEs the government will be able to avoid the financial burden which may be caused by debts of joint-ventures between foreign firms and SOEs (currently, the main local partners).

Privatisation experiences both in Vietnam and abroad have revealed that after equitising, privatised SOEs become more profitable, create more jobs, and contribute more to government revenue (World Bank 1997). SOEs need to be put on the same playing field as non-state enterprises so that the healthy non-state firms are not crowded out due to less accessibility to important inputs such as land, credit and licenses.

Promotion of the development of an active non-state sector, including 100 percent foreign-invested enterprises, will play an important role in increasing competition in the domestic market, and is essential to the sustainability of the country’s development process. Developing a vibrant non-state sector is crucial to maintaining the stability of the investment level because this sector can create favourable conditions to attract small and medium FDI projects that often are more export-oriented, and have a higher implementation rate than big FDI projects. Further development of the private sector will also encourage the spillover effects of FDI.
8.2.4. Creating a level playing field

Creation of level playing field between state and private sectors is essential for a sound business environment and for the sustainability of the country’s development process. Creation of a level playing field for all sectors in the economy involves eliminating distortions in resource allocation and will improve utilisation of the country’s comparative advantages and competitiveness of sectors, and enhance the benefits from FDI technology transfer and its spillover effects.

To create a level playing field to promote competitiveness and productivity of state and non-state sectors, the unequal and distorted advantages of SOEs over the non-state sector in access to land, credit and import-export facilities should be removed, and entry restrictions have to be lessened.

Vietnam introduced a law to encourage domestic investment in 1994, which was amended in 1998. This legislation provides for foreign and domestic investors to be treated equally in areas such as exemptions from import duty on equipment, machinery, and spare parts. On the other hand, foreign investors have clear advantages over domestic investors with tax holidays and exemption from import duties on raw materials, while they are disadvantaged in the labour markets where minimum wages are set at higher level. In the long term, Vietnam’s development will depend on an enabling environment that is conducive to both foreign and domestic investment. To improve the economic environment, Vietnam must introduce an incentive regime in which foreign investors have no special privileges, but also face no special discrimination in comparison with domestic investors.
8.2.5. Diversifying foreign capital inflows

Diversification of FDI flows is important policy. Vietnam will be able to receive a substantial amount of foreign portfolio investment through liberalising the financial sector and developing a capital market as well as allowing foreign investors to buy into privatised SOEs. Lack of local financing and the undeveloped state of the banking system in Vietnam has slowed implementation of FDI projects and exposed the increasing constraints to new FDI inflows (Information Center 1997). Thus, development of the financial sector and capital market will make a considerable contribution not only to mobilisation of domestic resources, but also to financial integration with the rest of the world and promotion of portfolio investment activities in the medium and long term.

8.2.6. Improving infrastructure

Widespread investment in infrastructure is urgently needed for the country’s industrialisation and modernisation and to attract FDI inflows. Currently, the government is paying much attention to upgrading and developing the country’s physical infrastructure such as telecommunications and transport networks, including roads, railway, and water transport. However, priorities in terms of public investment need to be studied carefully.

The shortage of technical and skilled workers, and managers, and the declining quality of the education and training system have, to a certain extent, negated the attractiveness of low labour costs, slowed the implementation process of FDI, and prevented Vietnam from benefiting substantially from the technology transfer of FDI and its spillover effects. Therefore, improvement of the education and training system so that it can provide the country with a sufficient quantity of highly qualified labour is essential to Vietnam’s development. To increase the quality of education and training, training and
extension need to be made relevant to market conditions. Job training programs have to be tied to current market needs.

In summary, the ‘pull’ and ‘push’ factors of FDI favour Vietnam, but Vietnam has to improve its policies - in particular those making it attractive to FDI and improving the ways in which FDI is used. The findings of this study suggest that to attract greater amounts of FDI and gain maximum benefit from it, Vietnam should continue its process of macroeconomic stabilisation and structural adjustment, creating credible policies that will lead to a more stable macroeconomic environment and reduce politico-economic risk and uncertainty. Attention should be paid not only to streamlining the whole regulatory framework to achieve greater transparency and stability, but also to improving competitiveness in the domestic markets, improving physical infrastructure as well as education and training, and simplifying the tax system and making it transparent.
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