

discussion paper

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Private Enterprise Formality and the Role of Local Government

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Introduction

The research* question behind this paper emerged from earlier research on the development of the domestic private sector in the Mekong Delta.¹ Despite being highly rural in character, and having some of the lowest education indicators in the country, the Mekong Delta is home to a disproportionately high number of private companies.² The vast majority of these firms are sole proprietorships that employ a few workers, often in the food or beverage processing industries. However, the southern delta is also home to some of Viet Nam's largest private firms.³ In other words, the southern delta's company sector encompasses the full spectrum of enterprise sizes. While the region's relatively high number of companies could be attributed to having shared cultural values, such as a uniquely entrepreneurial spirit, most of its provinces do not have corresponding high numbers of household businesses (*ho kinh doanh ca the*: the most common legal form for small nonfarm enterprises in Viet Nam).⁴

Based on these observations, the question emerged: ***Why is an entrepreneur more likely to register their small off-farm business as a company if it is located in this particular group of provinces, while an entrepreneur with the same business located in another province is less likely to do so? And perhaps more importantly: Can lessons be learned from these provinces that could help stimulate the growth of companies in other rural provinces in Viet Nam?***

The significance of these questions relates to important issues of enterprise formality and formalization. Formalization of enterprises, in its idealized form, is the process of making business activities more transparent and bringing them under a comprehensive, stable system of laws and administrative measures. A highly formalized system is one in which all players know, and are required to abide by, the same set of rules. Formalization thus leads to greater predictability and better-informed decisions by investors, managers, employees, and government authorities alike. As such, formalization contributes to the better allocation of a country's resources and more efficient functioning of its economy.

While the main benefits of formalization accrue to the economy as a whole, formalization will not come about if benefits are not apparent at the firm-level. This report explores the current environment for formalization of private enterprise activities in Viet Nam, with a particular aim to understanding and highlighting the entrepreneur's perspective in this

* This research was conducted under the aegis of the Making Markets Work Better for the Poor Project that is jointly funded by the Asian Development Bank (ADB) and the United Kingdom's Department for International Development (DFID). The general aim of the project is twofold: to conduct analytical work on the functioning of markets and the extent to which the poor are able to benefit from them; and to build capacity to support pro-poor market development through research activities, networking, and promoting policy dialogue. This research was implemented by researchers affiliated with the Viet Nam Chamber of Commerce and Industry (VCCI) and economic researcher Markus Taussig from June to September 2004.

¹ Taussig et al. *Private Enterprises in the Mekong Delta: A Baseline Study of One of Vietnams Most Dynamic Regions for Rural Entrepreneurship*, GTZ (German Development Cooperation). Hanoi, Viet Nam. December 2003.

² The word "company" refers to the four main forms of enterprises governed by Viet Nam's Enterprise Law: sole proprietorship companies, partnership companies, limited liability companies, and joint-stock companies.

³ For example, Kim Anh Ltd. Co. in Soc Trang, and AGIFISH Joint Stock Co. in An Giang. Kim Anh was Viet Nam's leading exporter of seafood products in 2003 with exports valued at about \$120 million, while AGIFISH is one of the few companies to list on Viet Nam's fledgling stock market (Huynh Kim, "Top Ten Exporters," *Saigon Times Weekly*, 2 September 2003).

⁴ "Household business" in this report refers only to nonfarm household businesses, i.e., *ho kinh doanh ca the*. Analyzed data, in fact, is limited to household businesses operating in manufacturing, trade, and services. This excludes, for example, household businesses in construction.

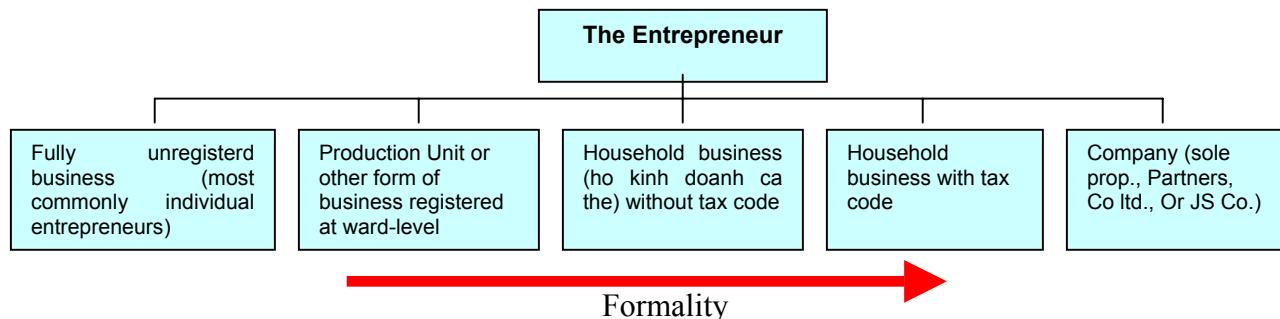
process. The desire to focus on the entrepreneur's perspective is based on the fact that it is always the entrepreneur who makes the final decision, and who does so based on a reasonably rational analysis of the costs and benefits—formalizing only at “the point at which the expected marginal benefits of doing so equal the (risk-adjusted) expected marginal costs,” and not before.⁵

The starting hypothesis of the research team was that ***provincial governments in Viet Nam have the power to directly affect the formalization decision calculus faced by entrepreneurs through their implementation of national policies.*** The research project was designed to test this hypothesis.

The Relative Formality of Household Businesses and Companies

In this study, companies are defined as *relatively* formal and household businesses as *relatively* informal. Household businesses in Viet Nam are certainly not a fully informal form of enterprise, as they are indeed registered with State authorities at the district level. In fact, there are more informal enterprise forms in Viet Nam than household businesses (see Figure 1).⁶ Furthermore, many laws governing the setup and basic operations of household businesses are the same as those governing sole proprietorships, the simplest form of company.⁷ Nonetheless, the decision in this paper to associate movement of firms from the household business sector to the company sector with formalization is still justified. This is because household businesses plainly do represent a *less* formal form of enterprise than companies.⁸

Figure 1: The Entrepreneur's Decision: Which Degree of Formality?



In addition to the differences in the official legal framework for the two business ownership forms (see Figure 2), household businesses are deemed relatively less formal than companies because of the way local governments actually carry out enterprise regulation. In general, it appears that most local governments in Viet Nam feel somewhat

⁵ Daniel Kaufmann and Aleksander Kaliberda, “Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies: A Framework of Analysis and Evidence,” August 1996.

⁶ For example, “production units” (*to san xuat*), a term used for private enterprises during central planning (when private enterprise was not yet legal), are the very small collective-style enterprises that register only at the ward level. There are no statistics on how many such entities exist in Viet Nam. Statistics are also unavailable on semi-formal plantations (*trang trai*), industrial/craft villages (*lang nghe*), and the country’s many fully unregistered independent entrepreneurs.

⁷ CIEM (Central Institute for Economic Management) has written: “Legally speaking, a household business is identical to a sole proprietorship.” CIEM, *Assessment of the Strengths and Weaknesses of the Enterprise Law: Recommendations for Amendments and Additions (Draft)*, 2004, p. 62. The difficulty in identifying formal differences between the two legal forms leads to the natural question of what purpose is served by maintaining both forms.

⁸ It is also true that it would be difficult to call Viet Nam’s company sector a fully formal sector, given the lengths to which companies appear to go to avoid regulation—and, of course, most importantly, taxation. Nevertheless, the analysis done here is of the relative formality of the two forms and what they tell us about overall formality and the process of formalization in Viet Nam’s private sector.

overwhelmed and under-equipped for the rapidly expanding tasks of enterprise regulation. To cope with the situation, most appear to subjectively prioritize which enterprises most need to be regulated. This gives smaller businesses the sense that they have opportunities to avoid the costs of regulation. With regard to all-important taxes, in particular, only a small share of household businesses actually register for a tax code at all, although, legally, the same tax laws applying to these businesses are applied to companies.⁹ In sum, the regulatory framework that covers the activities of household businesses is less comprehensive, less transparent, and less strictly implemented than the one that covers companies.¹⁰

Figure 2: Main Benefits and Consequences of Formalization in Viet Nam

	Main Benefits	Main Consequences
Economy	<ul style="list-style-type: none"> • Increased standardization of regulation of labor conditions and environmental impact • Increased clarity in division of government responsibilities, especially at local level • Increase information inputs for policy analysis and formulation • Greater investor confidence leading to increased mobilization of capital • Increased revenues into national tax system 	<ul style="list-style-type: none"> • Increased responsibilities for the Government, especially local authorities (straining existing capacity)
Enterprise	<ul style="list-style-type: none"> • Right to legally access broader markets (i.e., trade beyond district) • Right to legally employ more than 10 workers • Stamp for making transactions more official • Value-added tax receipts • Right to set up branch establishments • More predictable, law-based relationship with the Government • Ability to access equity capital (Ltd. & JS Cos. only) • Greater access to government investment incentives 	<ul style="list-style-type: none"> • Greater costs of registration (and required public announcement) • Annual registration fee (<i>thue mon bai</i>) • Requirement for certified chief accountant • Increased state reporting requirements • Increased restrictions due to labor contracts • Potential for increased attention from local authorities (regulators) • Potential for increased taxes (with move from lump sum to standard tax calculation)

Informality has long been a core characteristic of Viet Nam's economy. This was true even in the headiest days of communist central planning when private enterprise was not legal, yet was nonetheless crucial to the functioning of the economy and to social welfare.¹¹ Most transition economies have actually seen significant, rapid growth of their

⁹ The same paragraph of the CIEM report cited in the earlier footnote further notes: "In reality, household businesses may enjoy some tax advantages over enterprises" (CIEM, 2004).

¹⁰ United Nations' Industrial Development Organization (UNIDO) has written: "Another impediment for incorporation as a sole proprietorship is that the enterprise has to adhere to more regulations and enters into a much smaller group of enterprises than household businesses, which means that it is much easier for authorities at the Provincial and District level to subject it to various kinds of fees and local regulations...The higher 'visibility' of sole proprietorship enterprises compared with household businesses, and the fact that the former are considered 'richer', makes them more vulnerable to various perceived obstacles" (Rural Industrial Development in Viet Nam: Strategy for Employment Generation and Regionally Balanced Development, Prepared by UNIDO under project VIE/98/022/08/UNIDO and funded by UNDP in collaboration with the Ministry of Agriculture and Rural Development, p. 49).

¹¹ Despite significant risk of punishment of participants, the informal sector accounted for 19.9% of total retail sales in Viet Nam in 1960, according to official statistics. This share had actually grown to 28.6% by 1974. This number naturally increased dramatically with the unification of the northern and southern halves of the country, but intensive collectivization efforts in the 1977-1979 period did curtail informal activities in both the North and South. This effort to strengthen central control was followed by another period of relaxation that saw the formal sector share grow from 50.1% of retail sales in 1979 to 58.6% in

informal sectors while they have dismantled their much larger state sector systems. Starting from a relatively high level of informality, Viet Nam has not. Nevertheless, after nearly 2 decades of *doi moi* reforms, informal private enterprises in Viet Nam still dwarf the country's formal domestic private sector. As such, the challenge of enterprise formalization is one that largely still lies ahead, and one that may define Viet Nam's degree of success in developing a stable market economy.

Methodology

This paper is based on an analysis of three main complementing sources of information¹²:

1	The Big Picture	Documents and statistics on private sector and small and medium enterprise development
2	Similar Cases	A database of firms with tax codes in 14 provinces ¹³
3	Dissimilar Cases	A survey of enterprises, financial institutions, and officials in six provinces ¹⁴

The Big Picture: Private Sector Development and Formality in Viet Nam Today

The Macro Picture. Identifying the current size of Viet Nam's informal sector depends heavily on which definition of the informal sector is applied.¹⁵ The research team was, unfortunately, unable to access specific numbers on the gross domestic product (GDP) share of household businesses. One particularly simple definition for the informal sector for which statistics are available is: the remainder after the formal sector of state-owned enterprises (SOEs), foreign direct investment, and domestic companies has been subtracted from the whole. When seen this way, through official statistics, the formal sector accounts for nearly two thirds of the economy and is growing, albeit very slowly (see Figure 3). This, however, is influenced by the clear downward trend in the relative GDP share of agriculture.

¹² 1983 (Vu Thu Giang and Tran Thi Thi, *Women's Labour in the Informal Sector in Ha Noi—Fact and Selection*, National Economic University, Ha Noi, 1999).

¹³ For more details on methodology and all other components of the study, contact Markus Taussig at markustaussig@mac.com and/or Pham Thi Thu Hang at vcci@smelink.netnam.vn.

¹⁴ Provinces were chosen to match with the provinces chosen for the new provincial governance index created by The Asia Foundation and Viet Nam Chamber of Commerce and Industry - VCCI's Legal Department. See (forthcoming): TAF-VCCI, 2004, *Mid-Term Report: Study of Best Practices in Provincial Economic Governance, Measuring Variance on Key Indicators of Provincial Business Environments*, Hanoi: Viet Nam. Provinces include two groups: (i) Bac Ninh, Ha Nam, Ha Tay, Hai Duong, Hung Yen, Nam Dinh, Ninh Binh, Thai Binh, and Vinh Phuc in the North; and (ii) Ba Ria-Vung Tau, Binh Duong, Binh Thuan, Dong Nai, and Long An in the South.

¹⁵ The survey sample included 120 companies, 120 household businesses, 50 credit institutions, and 96 state offices in six provinces. The six surveyed provinces included two groups: (i) Ha Noi, Ha Tay, and Thanh Hoa in the North; and (ii) Ho Chi Minh City, Dong Thap, and Ca Mau in the South.

¹⁶ For example, the informal sector can be defined to not only include the activities of informal economic actors, but also the informal activities of fully formal economic actors.

Figure 3: GDP, 1995, 2000-2003

Sector	1995	2000	2001	2002	Estimate 2003
State	40.2%	38.5%	38.4%	38.38%	39.1%
Private	7.4%	7.3%	8.0%	8.3%	8.2%
Foreign	6.3%	13.3%	13.8%	13.8%	14.5%
Total Formal	53.9%	59.1%	60.1%	60.4%	61.8%
Collective ¹⁶	10.1%	8.6%	8.1%	8.0%	7.5%
The Rest: including household businesses, individuals, and agriculture	36.0%	32.3%	31.8%	31.6%	30.7%

Source: GSO, 2004

There is good reason, however, to suspect that official statistics fail to fully capture total economic activity in Viet Nam and, therefore, are likely to also underestimate the size of the actual informal sector. Applying its "macro-electric approach," the World Bank Group has suggested that Viet Nam's "shadow economy" may have grown by two thirds from 1997 to 2001, and may now add over 50% on top of officially calculated GDP.¹⁷ If this is nearly accurate, such un-captured production would translate into an increase of the actual annual per capita income in Viet Nam from about \$450 to at least \$675. When GDP is seen this way, the formal sector's share decreases substantially to only 40% of the total economy, with the formal private sector reduced to a share of only 6%. Furthermore, when seen this way, the overall formal sector's share of the total economy is steadily falling.

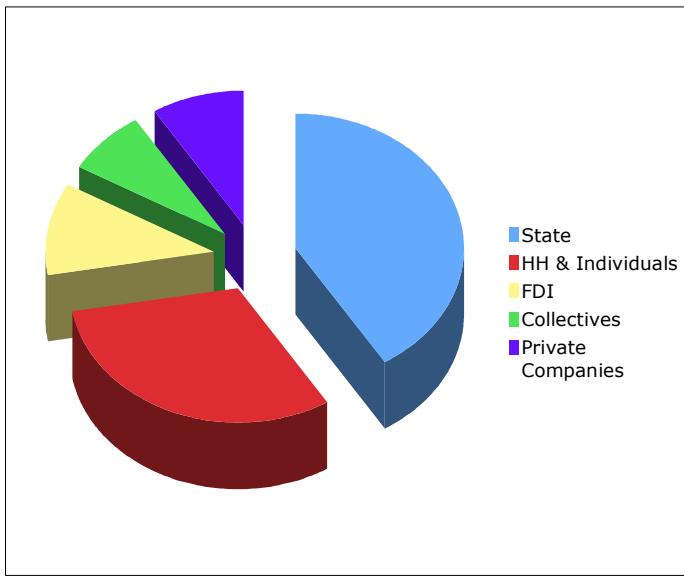


Figure 4: GDP by Enterprise Form, 2002

Source: GSO (2004)

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Regardless of the size of the formal and informal sectors, within the realm of the formal sector, Viet Nam's state sector remains far larger than its private sector.

¹⁶ The collective sector is hard to place as state or nonstate, formal or informal. The General Statistical Office categorizes collectives as non-state, despite their long history under communism and the presence of a dedicated state support agency (Viet Nam Cooperatives Alliance) with offices at the local and national levels. Further questions about the non-state status of collectives are raised by the resistance being demonstrated toward bringing collectives under the Unified Enterprise Law currently under construction. It appears that some collectives are more accurately categorized as non-state than are others (see Adam Fforde and Nguyen Dinh Huan, *Vietnamese Rural Society and Its Institutions: Results of a Study of Cooperative Groups and Cooperatives in Three Provinces*, June 2001).

¹⁷ Estimate is based on the World Bank's "macro-electric model," a method that has been used to understand informality in Eastern Europe and the former Soviet Union based on calculations of electricity consumption (see Stoyan Tenev, Amanda Carlier, Omar Chaudry, and Quynh-Trang Nguyen, *Informality and the Playing Field in Viet Nam's Business Sector* (MPDF), Washington, DC, 2003, p. 15). The larger overall GDP figures, however, are rarely referred to in other World Bank analysis of Viet Nam's economy.

Despite significant reforms, surprisingly little has changed in either's relative share of GDP for more than a decade (see Figures 3 and 4). As implied by the World Bank research, this must, to a certain extent, be the result of a significant level of activity by private companies going unrecorded. On the other hand, unrecorded economic activities are also likely to encompass a substantial amount of SOE activities.

A more positive growth trend is evident in the official employment statistics: it is likely that—based on 2002 data and growth rates over the first 3 years under the Enterprise Law—the number of official employees of private companies will have passed that of state enterprises within 2004, or at least by 2005. If the uncontracted and part-time labor of private companies is accounted for, private companies have surely already surpassed their state sector counterparts.¹⁸

The Micro Picture. Registrations under the first 4 years of the Enterprise Law totaled some 70,000—a near fourfold increase in average per year registrations relative to the 9 years under the previous legislation. As Viet Nam's private sector environment matures and grows more competitive, growth in the number of companies in operation has, however, naturally been slower than growth in registrations.¹⁹ In fact, company survival rates appear to be falling. Consistent with this idea that business failures and competitiveness are linked is the fact that both are much more significant in the south than the north.²⁰ Still, General Statistical Office (GSO) data indicates an increase in active private companies from about 28,000 when the Enterprise Law was introduced at the start of 2000 to 51,295 at the end of 2002 (Figure 5).²¹ This near doubling over 3 years is particularly significant and impressive when seen in the context of the regional financial crisis and the stagnating domestic private sector growth that immediately preceded it in the late 1990s.

Figure 5: Number of Firms by Legal Ownership Forms, 2000 and 2002

Enterprise Form	2000	2002
Household Businesses	1.78 million	2.28 million
Private Companies	29,515	51,295
Collectives	3,237	4,104
State Owned Enterprises	5,759	5,364

Source: GSO (2004)

Enterprise growth, however, has not been limited to private companies. The number of household businesses has increased far more since the introduction of the Enterprise Law than the number of companies – albeit from a substantially greater base that means

¹⁸ See Liesbet Steer and Markus Taussig, *A Little Engine that Could...: Domestic Private Companies and Viet Nam's Pressing Need for Wage Employment*, World Bank Policy Research Working Paper 2873, August 2002.

¹⁹ A new report by the World Bank Group seeks to explain these differences between Ministry of Planning and Investment (MPI) registration numbers and GSO active companies numbers (Amanda Carlier and Son Thanh Tran, *Firm Dynamism: Beyond Registration, How are Viet Nam's New Domestic Private Firms Faring?*, Viet Nam Private Sector Development Policy Note, June 2004).

²⁰ The above mentioned new World Bank report notes that some of the discrepancy between registration numbers and GSO numbers may be due to the difficulty of locating highly mobile, and sometimes uncooperative, companies. This issue may be more significant in Ho chi Minh city, given its large size and more dynamic land market. Still, there is every reason to still believe that HCMC does indeed have the country's highest failure rates.

²¹ Unfortunately, problems with GSO's enterprise data are particularly severe in 1999, making it difficult to judge changes in the number of firms in operation over the full Enterprise Law era. According to GSO, the comprehensive national survey, which is now carried out annually, was not implemented in 1999.

that the former's rate of growth is much lower. The recorded aggregate number of household businesses in Viet Nam increased by half a million from 2000 to 2002, that is,

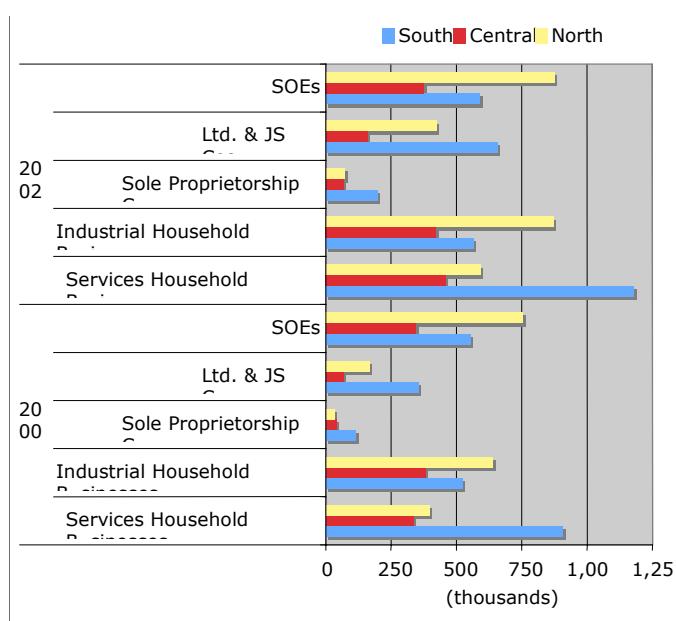


Figure 6: Employment by Enterprise Form and Region, 2000 and 2002

a 28% increase (from 1.78 million to 2.28 million). Included in these figures is an increase of 120,000 additional industrial household businesses, or 20%, over the same period. Both the aggregate total and growth rate of industrial household firms are higher in the north than in the south (Figure 6).

This substantial growth in industrial businesses outside of the company sector runs counter to the overall formalization trend. Generally speaking, firms in industry are likely to have greater potential to impact on the public good of their local communities, through greater use of labor, more dangerous work conditions, and the larger threat they pose to the surrounding environment. As

such, industrial enterprises are particularly worthy of government regulation. Their longer-term investment perspective and greater reliance on tangible assets also make industrial businesses easier to account for and regulate. Therefore, the degree to which industrial enterprises are instead operating in the household business sector (as opposed to the company sector) is a good measure of enterprise formality, or lack thereof, in a particular locality. This interpretation of the significance of industrial household businesses is important to later analysis in this paper, serving as an indicator of differences in formalization across provinces.

Firm Size in the Formal and Informal Sectors

Firm size is usually considered key in determining what distinguishes enterprises in the formal and informal sectors. The rational from the perspective of the Government is that some enterprises are too small to merit expenditure of the resources required to regulate them. Central to the hypothesis put forth in this report (that provincial business environments affect entrepreneurs' decisions whether or not to formalize) is the assumption that both choices are viable options, i.e., there is significant overlap in the main characteristics of formal and informal enterprises, including overlap in their sizes. This assumption is born out in the numbers.

Figure 7: Average Firm Size by Enterprise Ownership Form, 2002

	Employees	Revenues (Vietnamese dong)	Assets (Vietnamese dong)
Household businesses	2	NA	NA
Private Companies	30	7.1 billion	4.7 billion
- Sole Proprietorships	14	3.7 billion	1.3 billion
- Partnerships	20	114.2 billion	4 billion
- Limited Liability Cos.	39	8.7 billion	5.1 billion
- Joint-Stock Cos. w/ > 50% State ownership	208	51.7 billion	77 billion
- JSCs w/ <= 50% State ownership	258	54.7 billion	77.9 billion
- JSCs w/o State ownership	62	10.9 billion	14.3 billion
Collectives	39	2.8 billion	2.5 billion
State Owned Enterprises	481	133.7 billion	247.5 billion

Source: GSO (2004)

Overall, private company size has increased in terms of labor, revenues, and assets per firm in recent years. Companies have, on average, grown in size—in terms of labor, revenues, and assets (see Figure 7). From 2000 to 2002, the average private company increased its labor force by nearly 15%, from 26.4 workers to 30.8 workers per firm.²² Official labor statistics certainly underestimate actual workers per firm, possibly by as much as 50% if uncontracted and seasonal workers are included.²³ Growth in private companies' formally declared annual revenues and their assets was higher, with growth of 70% to Vietnamese dong (D) 7.1 billion in revenues and 27% to D4.7 billion in assets over the same 2 years. These numbers, too, are likely to underrepresent reality.

More relevant, however, to the issue of overlap between companies and household businesses is the fact that, while the spectrum of company sizes has expanded at the top end, it has also seen an increase in the number of firms at the bottom end. GSO statistics for 2002 show that 37% of all sole proprietorships employed less than five workers, qualifying them for classification as microenterprises. This was also true of 10% of both limited liability companies and joint-stock companies without state capital.

Describing the size of household businesses is more difficult than describing the size of companies, but available statistics indicate that they too are growing in size. The difficulty arises because of household businesses' frequent employment of family members and friends, and the fact that they very rarely sign any sort of contract with their workers. According to GSO statistics, household businesses employed an average of 1.8 workers per firm in 2002. Industrial household businesses are almost 50% larger, with an average recorded employment of 2.5 per firm.

Information from household-level surveys is actually quite useful in filling out the picture of household business employment. According to the Viet Nam Living Standards Survey (VLSS), about 10% of all workers are employed by household businesses. This is

²² These numbers are slightly different from numbers quoted in the new World Bank Group report. This may, in part, be due to the differing decisions by this report and the World Bank report on whether to include joint-stock banks in which the State holds equity within the definition of the private sector. For clarity's sake, however, this difference once again stresses the benefits of a greater public availability of detailed enterprise statistics from the GSO.

²³ Steer and Taussig (2002), p. 11.

actually reasonably consistent with GSO's 4.1 million employment figure. The VLSS further shows, however, that another 14% of all workers are employed part-time in household businesses.²⁴ Based on this figure, it would seem that the average household is likely to be regularly supplementing its two full-time workers with another two part-time or seasonal workers. This average of 4-5 workers per household business shows a significant overlap, in terms of size, with companies, especially sole proprietorships.

Private Sector Development and Formalization Across Regions and Provinces

While the pattern of private sector growth has leveled somewhat since the introduction of the Enterprise Law, there are still nearly twice as many private companies in the southern third of Viet Nam than in the northern third (Figure 8). More significant, however, is the large differences across specific provinces, including among provinces in the same region. Private sector development remains highly concentrated in a select number of provinces and provincial status cities, particularly in the main urban commercial centers.

Figure 8: Companies by Region, 2002

	<i>South</i>	<i>Central</i>	<i>North</i>
2000	17,903	4,947	6,664
2002	27,919	8,069	15,281

Source: (GSO (2004)

Variance across provinces is a central element of this study because a regional government in Viet Nam does not exist. To connect differences in business environments with economic governance issues, analysis must be done at the provincial level. Analysis of regional differences can also have value, however, as these differences are indicative of historical and cultural differences. Unfortunately, concrete identification and analysis of such regional characteristics are difficult.

While the north has slightly increased its share of total private companies, the more significant trend was the further increase in concentration of firms in the two main cities. Ho Chi Minh City and Hanoi increased their combined share of private companies from 36% in 2000 to 41% in 2002. When the next 10 provinces and provincial status cities are added on, the combined 2002 total comes to 62%.²⁵ The presence of five Mekong Delta provinces among the 10 second-tier provinces continues to prove that there is no reason to believe private company development cannot occur in Viet Nam's countryside.²⁶ Nevertheless, no other rural provinces in any other region of the country have yet emerged to replicate the Mekong Delta experience.²⁷

²⁴ For more on what the VLSS says about enterprise development, see Vijverberg and Haughton. See also Dominique van de Walle and Dorothyjean Cratty, *Is the Emerging Non-Farm Market Economy the Route Out of Poverty in Viet Nam?*, World Bank Policy Research Working Paper 2950, January 2003. The shortcoming of these papers is the difficulty of doing targeted analysis despite the fact that the VLSS does not appear to distinguish effectively between the legal forms of household businesses and private companies—let alone the various other less formal enterprises forms.

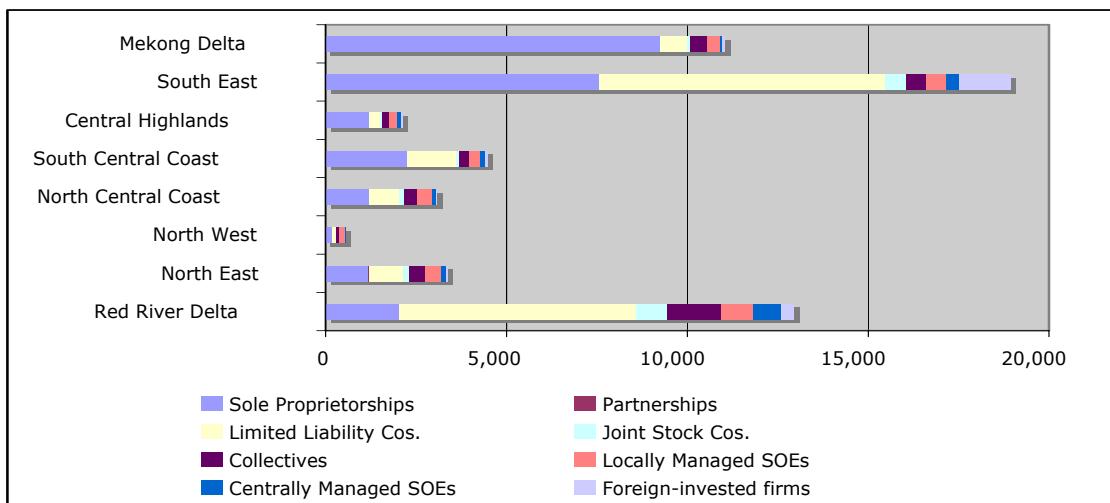
²⁵ As pointed out in the new World Bank report on Viet Nam's private sector, the top seven provinces account for half of the total (Carlier and Tran, 2004).

²⁶ Taussig et al (2003).

²⁷ Particularly significant in the Mekong Delta is the large number of private companies in manufacturing. Unfortunately, 2002 statistics on manufacturing companies by province were not available to the authors at the time of writing this report. Earlier figures from 2000, however, illustrate the point: 37% of all private companies in manufacturing were located in the Mekong Delta. This actually involved a significant decrease over the 51% share the region held in 1998—a decrease that occurred both to an overall increase in private manufacturers throughout the country and a substantial fall in the region in particular.

Small sole proprietorship companies are particularly common in the Mekong Delta. Indeed, the share of sole proprietorships of total enterprises decreases quite steadily as one moves from south to north (Figure 9). The number of household businesses is almost equal between north and south, despite the higher population in the south. More specifically, the number of household businesses in industry decreases as one moves from north to south, exactly the opposite trend as seen for small enterprises in the formal company sector. The Red River Delta, in particular, increased its share of the country's industrial household businesses to more than 40% in 2002.

Figure 9: Firms by Formal Enterprise Form and Region, 2002

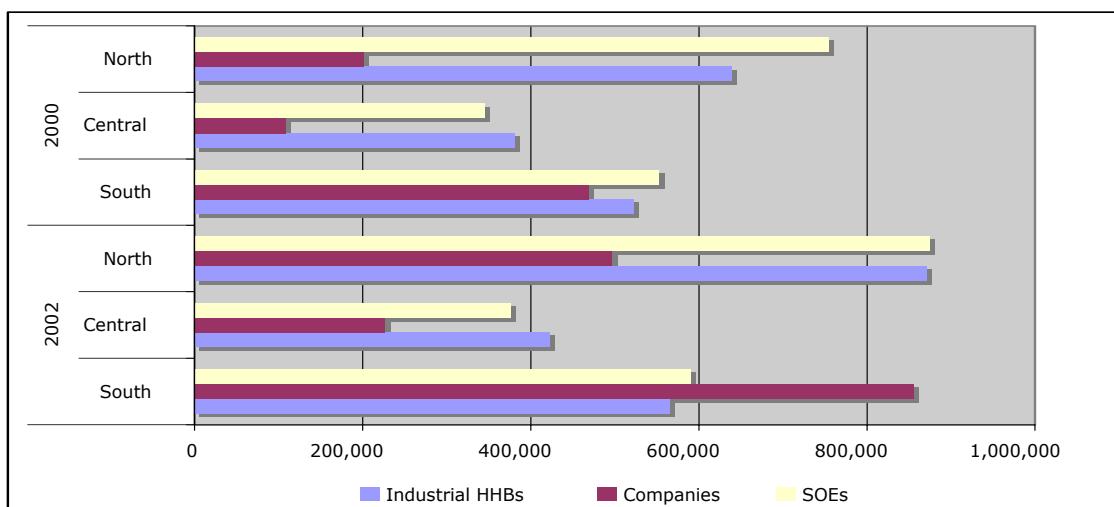


Source: GSO (2004)

Total employment in the formal domestic private sector is now significantly greater than employment in the State sector in the southern third of Viet Nam. This is still far from the case in the rest of the country (Figure 10). While total employment with private companies grew by 147% in the North from 2000 to 2002, it did so from a small base, so that absolute employment growth was still significantly higher in the South. In contrast, both growth and the aggregate increase in employment among household businesses in industry were substantially higher in the North than in the South. The same was true regarding regional trends for SOEs.

It seems unlikely that this trend had continued, given the overall growth of companies in the southern Delta in subsequent years.

Figure 10: Employees by Region and Business Ownership Form, 2000 and 2002



Source: GSO (2004)

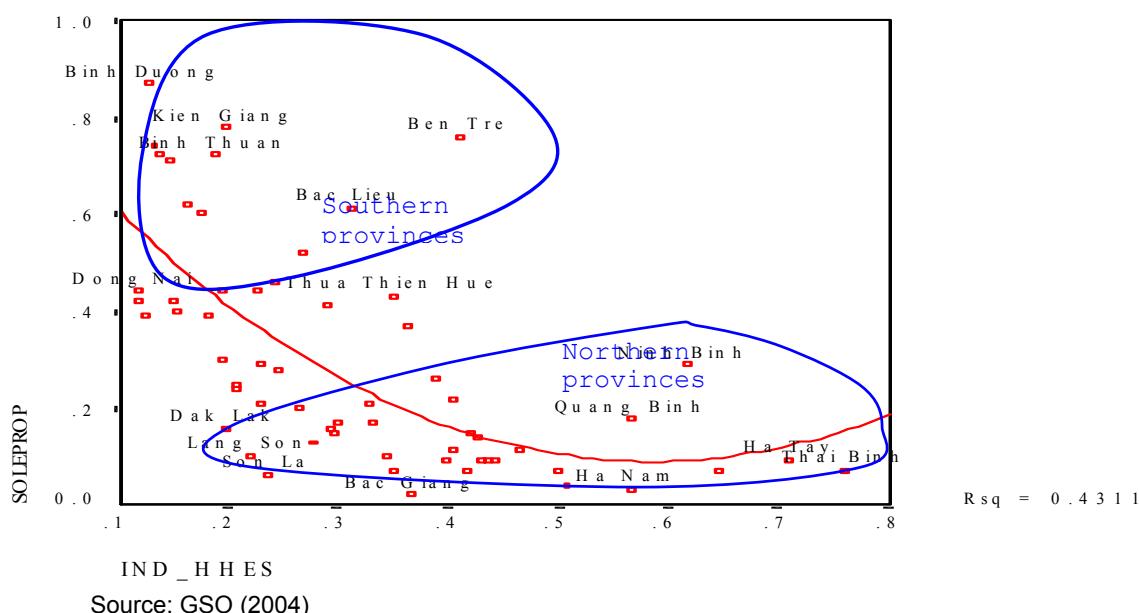
The Relationship between Formal and Informal Enterprise across Provinces

Analysis of GSO enterprise statistics for all 61 provinces²⁸ in Viet Nam shows an inverse relationship between stocks of household businesses and companies. This inverse relationship is most robust when one focuses on the share of household businesses in each province that are in industry and compares it to active sole proprietorships per thousand residents (see Figure 11).²⁹ The rational for focusing on sole proprietorships is their status as the smallest form of company, i.e., the form of company where firms are most similar to household businesses. Figure 11 relies on the following variables:

IND_HHB: industrial household businesses/ total household businesses
SOLEPROP: sole proprietorships per thousand local residents

Figure 11 reveals regional differences. Provinces in the top left corner (i.e., those with a high frequency of sole proprietorships and low share of household businesses in industry) are southern, while those in the bottom right (i.e., with low frequency of sole proprietorships and high share of household businesses in industry) are northern. Provinces in the bottom left corner, where numbers show a generally underdeveloped enterprise sector, are predominantly located in the particularly poor and remote northeast region.

Figure 11: Sole Proprietorships and the Share of HHBs in Industry



Another means of comparing enterprise formalization across provinces is comparing GSO household business numbers with Tax Authority figures on household businesses with registered tax codes.³⁰ This exercise indicates the degree to which household businesses are participating in the same national tax regime as companies. This is a

²⁸ Viet Nam currently has 64 provinces, but had only 61 as of 2002.

²⁹ Vietnam currently has 54 provinces, but had only 34 as of 2002. A better analysis, of course, would be comparison with active sole proprietorships in industry, but the research team was unable to secure such statistics for 2002 from GSO.

30 There is a mismatch in the comparative data, in that GSO data used here is for the end of 2002, while Tax Authority data is from early-mid 2004. This may have an impact on the accuracy of analysis, given that some provinces may have seen more rapid growth in the number of household businesses between 2002 and 2004. This could lead to an overestimation of formality in such provinces.

significant issue, given that Vietnamese tax law requires that household businesses fall under the same taxation rules as companies. Individual provincial governments, therefore, are responsible for the differing degrees to which the reality of implementation in their respective provinces coincides with national law. As such, this comparison can be understood to measure degrees of formality within the household business sector, and possibly be indicative of individual provincial governments' commitment to the rules of law and formalization.

Again, a major difference exists between north and south. While GSO numbers show 30% more household businesses per thousand people in the north, the Tax Authority records nearly 90% more such firms in the south. These numbers are particularly dramatic when one focuses on individual provinces. In Binh Duong, for example, there is little difference between the statistics of the two government sources, with tax numbers on household businesses only 16% lower than GSO numbers. In dramatic contrast, tax officials in Bac Ninh have accounted for only 4% of the household businesses recorded by the province's statistics division.

The relationship between these two numbers at the provincial level can be expressed through the equation:

$$\text{HHB_FORM: Household businesses with registered tax codes}^{31}/ \text{Total household businesses}$$

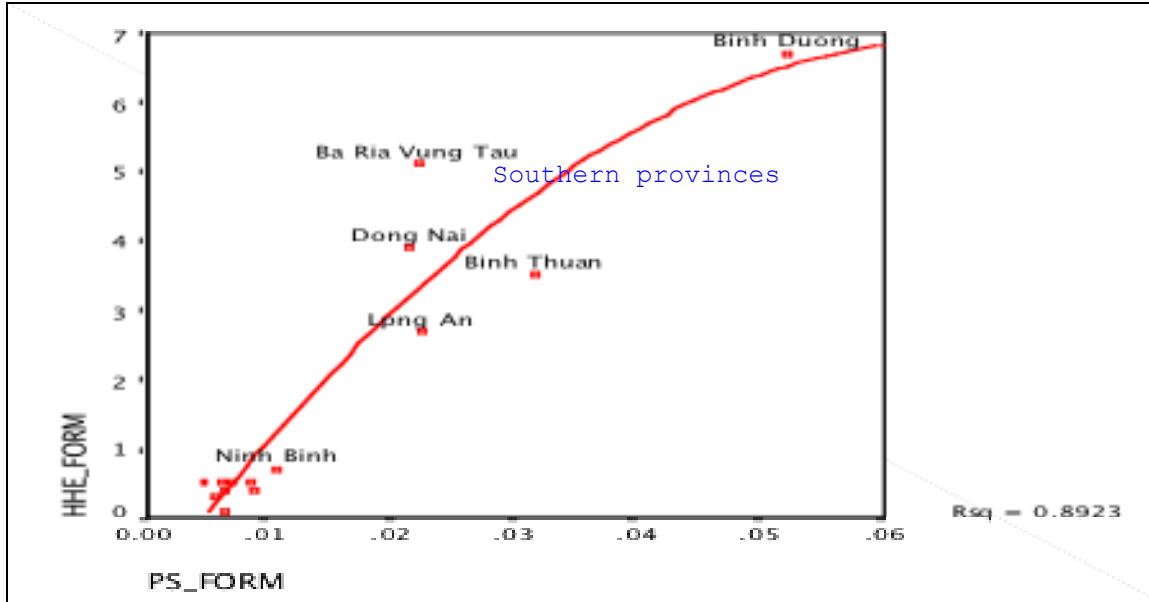
This measure of formality within the household business sector highly correlates with the following simple equation expressing the degree of formality in a province's overall private enterprise sector:

$$\text{PS_FORM: Companies/ (Companies + Household businesses)}$$

The higher the share of household businesses with registered tax codes, the higher the share of total private businesses registered as companies (see Figure 12). The R-square indicator of the significance of this relationship is 0.89. The implication is that the broader the scope of the Tax Authority's management over private enterprise, the more formalized the entire private sector is likely to be. Conversely, when the Tax Authority's reach is limited, and more household businesses are able to operate outside its realm of management and tax collection, entrepreneurs are more likely to avoid registration as companies.

³¹ Perhaps an even more interesting measure would be the share of household businesses that are actually paying taxes. This would be a more stringent measure that would help cut out the remaining issue: that of some enterprises with tax codes, which may not yet, or may no longer, be in operation. Another interesting measure would be one that took into account the percentage of companies that are fulfilling financial statement reporting requirements. Central Institute for Economic Management (CIEM) has regularly reported that this percentage is very low.

Figure 12: Taxation of HHBs and Private Enterprise Formality

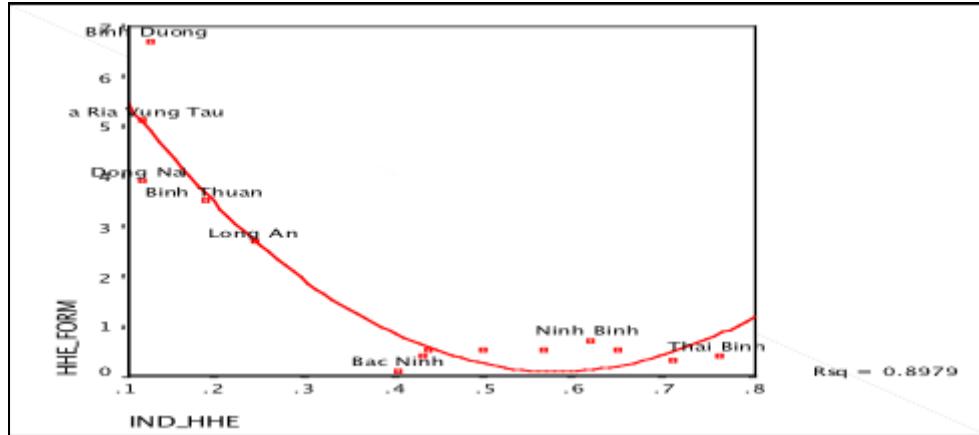


Source: GSO (2004) and Tax Authority (2004)

Two main possible explanations stand out in the latter situation where the Tax Authority's reach is limited. Firstly, the greater possibility of operating outside the reach of tax authorities is a draw that pulls more entrepreneurs into the informal sector. Secondly, the limited capacity of tax officials and limited number of enterprises with tax codes lead to excessive pressure on officials to maximize collection from the most visible firms, i.e., companies. This then provides a push away from registration as a company. In contrast, when the Tax Authority's reach is wide, both the pull and the push are mitigated, and entrepreneurs are more likely to consider the other advantages of registering their businesses as companies (for example, visibility to customers, access to value-added tax receipts, official stamp for contracts, and the legal right to access broader markets). The strength of this relationship between formality in the household business sector, in particular, and formality across the full spectrum of private enterprise would appear to be a powerful indicator of the impact of clear, transparent local governance on formalization and private sector development.

Again, a clear difference exists between north and south. Northern provinces are all bunched along the mean line in the bottom left corner, while the southern firms are more dispersed but still all significantly higher toward the top right corner (Figure 12). Ba Ria Vung Tau has fewer companies as a share of total enterprises than one would expect based on its high share of household businesses with tax codes.

Figure 13: Taxation of HHBs and Share of HHBs in Industry



Source: GSO (2004) and Tax Authority (2004)

The regional divide is even more striking when one compares tax figures with GSO numbers on household businesses in industry (see Figure 13). The number of industrial household businesses in the northern group of provinces is 42% higher than the total number of household businesses recorded for those provinces by the Tax Authority. In the southern group, on the other hand, the tax officials' number is nearly four times higher than the GSO industrial household businesses figure. Focusing on the provincial level, a very strong relationship exists: the higher the share of household businesses with tax codes, the lower the share of household businesses in industry. Binh Duong, as usual, stands out with its extraordinarily high level of formality in the household business sector, while Bac Ninh distinguishes itself for the lowest by far.

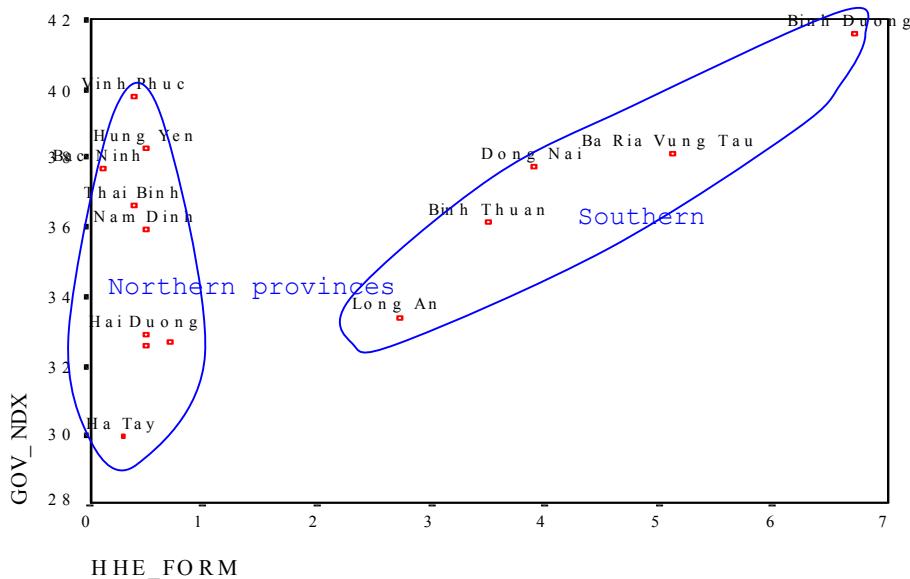
The Relationship between Formality and Economic Governance

A clear relationship was not established by the research team between provincial governance and formalization through bivariate analysis of the The Asia Foundation (TAF)/VCCI economic governance index and the formality measures used in the previous section (see Figure 14).³² Particularly in the low formality north, the relationship between governance and formality is probably too complex for such simple analysis and requires a multivariate approach.³³ A very strong relationship, however, was found when analysis was limited to the more formal southern provinces: the higher the overall governance score, the greater the household business sector formality (see Figure 15). A similar focus on northern provinces did not show any correlation.

³² Simple bivariate analysis of the subindexes that make up the overall index was also done, but no significant relationships were found. For more on the actual substance of the index, see forthcoming TAF-VCCI, 2004, *Mid-Term Report: Study of Best Practices in Provincial Economic Governance, Measuring Variance on Key Indicators of Provincial Business Environments*, Hanoi: Viet Nam.

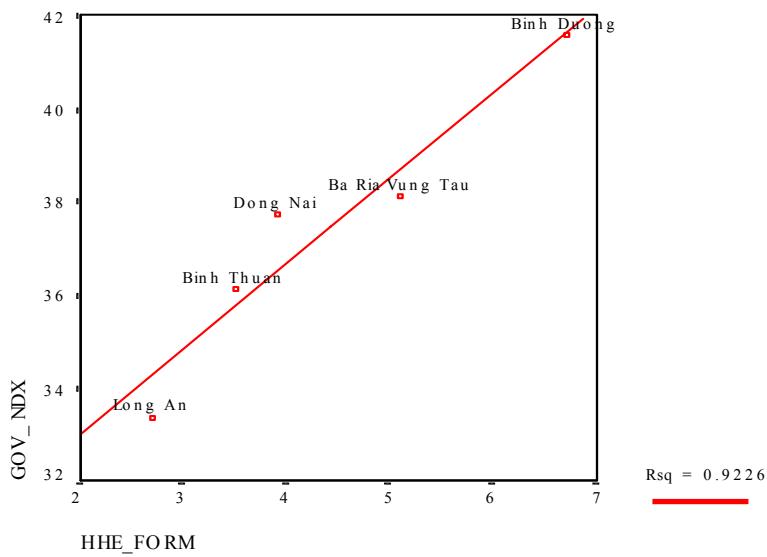
³³ For more on the relative state of development in the north, see Nguyen Dinh Cung, Pham Tuan Anh, Bui Van, and David Dapice, *History or Policy: Why Northern Provinces Do Not Have Faster Growth*, United Nations Development Programme, 2004.

Figure 14: Provincial Governance and Taxation of HHBs



Source: TAF/VCCI (2004) and Tax Authority (2004)

Figure 15: Provincial Governance and Taxation of HHBs in the South



Source: TAF/VCCI (2004) and Tax Authority (2004)

Case Studies in Contrast: Findings from the Six-Province Survey

The provinces selected for the survey are prime examples of the inverse relationship between the frequency of household businesses in industry and of small companies. Thanh Hoa and Ha Tay in the north have some of the highest numbers of household businesses in the country, especially in industry, while also having some of the lowest company numbers, especially companies with less than 10 workers (Figure 16). Ca Mau in the south, in contrast, is home to one of the lowest frequencies of industrial household businesses and highest frequencies of small companies. Dong Thap, also in the south, stakes out much more of a middle ground with relatively high numbers in both ownership forms. The extremely low numbers of household businesses in industry in the two

surveyed urban centers are probably the result of policies aimed at reducing the impact of manufacturing enterprises on residential communities.

Figure 16: Formality of Small Businesses by Surveyed Province

Province	Industrial Household Businesses Per Company	Share of Registered Companies with < 10 workers (%)
Ha Noi	2.4	46
Ha Tay	124.2	34
Thanh Hoa	108.0	30
Ho Chi Minh City	2.2	53
Dong Thap	15.3	70
Ca Mau	4.9	82

Source: GSO (2004)

The Firm-level Formalization Decision. The survey supported the assumption that there is significant overlap between the characteristics of sole proprietorship companies and that of household businesses (Figure 17). In Ha Tay, mean employees per firm were nearly equal for the two ownership forms. In Dong Thap, where means were very different because of the existence of some very large single owner companies, median employment figures were still nearly equal. Both household businesses and companies were also found to be active in a broad range of industries. In other words, it is difficult to identify specific firm characteristics that clearly differentiate household businesses from companies and especially from sole proprietorship companies.

Figure 17: Full-Time Labor across Provinces and Enterprise Forms

	Households		Sole Proprietorships	
	Mean	Median	Mean	Median
Ha Noi	3.4	2.0	19.6	8.5
Ha Tay	7.6	3.0	8.1	5.0
Thanh Hoa	5.9	3.0	44.7	20.0
Ho Chi Minh City	6.0	5.0	40.8	9.0
Dong Thap	6.8	5.0	56.7	6.5
Ca Mau	4.4	2.0	5.7	6.0

Source: Survey Data (2004)

Thanh Hoa and Ca Mau, the two surveyed provinces on the farthest opposing ends of the formalization spectrum, according to GSO statistics, also provided the greatest clarity and differentiation with their responses in the survey. Interviewees in Thanh Hoa, home to the country's highest number of industrial household businesses, identified industrial household businesses in the region with as many as 100 employees (not much smaller than the largest sole proprietorship in the survey). Large household businesses were, in contrast, clearly rare in Ca Mau, where instead small companies of less than 10 workers were the norm. The research team, in fact, had a very difficult time locating any household businesses in industry at all in Ca Mau.

Thanh Hoa and Ca Mau entrepreneurs were also on opposing sides of whether a manufacturing business of 11-12 workers is more likely to register as a household business or a company, with Thanh Hoa respondents among the most likely to say "household business" and those in Ca Mau the most likely to say "company". The fact that Ca Mau was also where former SOE managers were most likely to have switched to

company ownership, while no such cases existed in Thanh Hoa, further emphasizes the differences in the appeal of the formal private sector in those two provinces.

Across provinces, surveyed entrepreneurs were nearly unanimous in their agreement that companies face a greater amount of regulations than do household businesses. Most (63%) also agreed that a firm would pay more taxes if it was registered as a company than if the same firm were registered as a household business. Rural northern enterprises were most likely to hold this position on taxes, including 93% of those surveyed in Thanh Hoa. Firms in Ca Mau, in contrast, were most uncertain, with 43% believing that household businesses faced a higher tax rate than companies. Ca Mau enterprises, in fact, were quite consistent in their relatively less positive feelings on the attractiveness of operating in the household business sector (Figure 18).

Figure 18: Ca Mau Entrepreneurs vs. the Rest on Costs in the Household Business Sector

	Ca Mau	The Rest
A firm will pay more non-tax fees as a household business than as a company	25.0%	3.5%
A firm will pay more in unofficial payments to local officials as a household enterprise than as a company	55.0%	11.5%
A firm will host more visits from local officials as a household business than as a company	52.5%	15.0%

Source: Survey Data (2004)

The Role of Formalization in New Company Registrations. Survey findings also show that the process of firm-level formalization, i.e., converting from household business status to company status, is a significant component of Viet Nam's private sector development. Nearly half of all sample companies operated informally for some period of time, and nearly a quarter operated for some time as a household business. A significant 4 years separates the average date for starting up operations and the date for registering as a company within the survey sample. This extends to over 7 years, when only those that operated informally are considered. Local government respondents varied significantly in estimating the share of companies with informal roots, with most falling within the still very broad range of 10-50%. In Thanh Hoa, the lowest government estimate was 45%.

Overall survey findings actually offer a somewhat more conservative estimate of the role of formalization than put forth in recent studies funded by the World Bank Group and by the Swedish International Development Agency (SIDA).³⁴ The SIDA study's use of panel data offers a different perspective on the issue of formalization, showing what share of households have formalized, rather than what share of companies are formalized households. The SIDA study finds that about 2-3% of households formalize into

³⁴ The World Bank Group found that a majority of firms had emerged from the household business sector. This was influenced by their limited focus on the greater Ha Noi area (including three surrounding provinces). The findings in their study are actually quite compatible with the higher share of formalizers found among firms in this report's survey that were located in the north and registered after implementation of the Enterprise Law. In the case of the SIDA research, in turn, it would appear that there may be methodological reasons to believe that they underestimated the role of formalization in their sample. Firms that exited the household business sector and then re-appeared in the company sector, but at a different address, were unlikely to be included among survivors. An effort was made by the SIDA study to follow up with former owners of the firms that, according to the study's definition, did not survive, so this issue could be researched empirically.

companies over any 5- to 6-year period.³⁵ This is substantial, considering that Viet Nam has more than 2 million household businesses, with hundreds of thousands more being created every year.

The nonrepresentative distribution of firms in the survey must be taken into account, when trying to generalize conclusions to the entire country. Formalizing households were, for example, least likely to be located in Ho Chi Minh City—the dynamic home to about a quarter of all Viet Nam's private companies, where almost all company startups are new initiatives. It may be more realistic to conservatively estimate, based on survey findings, that about 15% of new registrations nationwide are household formalizations. Survey findings, however, give good cause to believe that this percentage would rise if rural business environments were to continue their improvements.

This is because the survey shows that formalization has been particularly important in rural areas, where entrepreneurs and local officials may be more conservative and less familiar with the day-to-day realities of the developing state management system for enterprises. It has also been particularly important in those provinces that had most underperformed previous to the Enterprise Law and are now beginning to make up some ground. In Thanh Hoa, for example, nearly two thirds of all companies had started up operations before the Enterprise Law, but were not registered until after. The pivotal role of the Enterprise Law in these provinces would seem to indicate that the law met a need in these provinces to place limits on the negative influence of local officials on private sector development. The common theme is that lack of clarity is a major incentive for entrepreneurs to take the precautionary measure of testing conditions via the household business sector before registering as a full-fledged company. These findings provide reason for optimism regarding the existing entrepreneurial talent and investment capital that are beginning to be tapped for rural development.

The Role of Credit in Formalization and New Company Registrations. Probably the most controversial finding of the survey is the relative lack of importance of credit in the establishment of private companies. The ability of private companies to access bank financing was distinctly greatest in the rural northern provinces, i.e., the provinces that are home to the smallest numbers of private companies. Nearly four out of five Thanh Hoa businesses—including both companies and household businesses—had accessed bank loans, almost all from state banks. Almost 90% of Thanh Hoa and Ha Tay businesses claimed it was easy or very easy to get bank credit. In Ho Chi Minh City, in contrast, bank loans had been accessed by only one in five of the sample, with loans from state banks, in particular, received by only one in 12. Hanoi businesses were, nevertheless, actually more negative about the accessibility of bank credit, with nearly three quarters saying it was difficult or very difficult, compared with less than one quarter (23%) in Ho Chi Minh City (see Figure 19 for overall averages for all six provinces).

³⁵ In the SIDA funded study, 0.9% of households enterprises surveyed in 1991 had reregistered as sole proprietorships by 1997. Another 1.8% had reregistered as limited liability companies. These percentages increase to 2.4% and 4.8%, respectively, for sole proprietorships and limited liabilities when seen in terms of household businesses that had survived the 6-year period. Of the new sample of household businesses surveyed in 1997, 1.9% reregistered as sole proprietorships and 0.4% reregistered as limited liability companies. The change in preference for sole proprietorships (despite the overall trend among new companies toward limited liability companies) may reflect that the reregistrations that overlapped the introduction of the Enterprise Law did not necessarily result from firm growth, but instead resulted from the greater ease with which even quite small businesses could make the transition. Further research on this issue would be interesting.

Figure 19: Entrepreneurs' Perspective on Ability to Access Bank Loans (%)

Very Easy	Easy	Normal	Difficult	Very Difficult	No Answer
5	22	26	18	13	17

Source: Survey Data (2004)

These findings on credit should not be taken to mean that there is no urgent need for reform, but simply that problems in the banking system do not serve as key explanatory factors for slow growth in the number of companies in rural provinces. On the other hand, it does seem likely that rapid growth in the availability of credit to private companies in the Mekong Delta is a key, determining factor for growth in average firm size in that region. Meanwhile, despite the apparent ready accessibility of credit in Thanh Hoa, there should be concern over the systemic implications that it is also the province where entrepreneurs were most likely to say connections and payments were crucial to accessing capital. Entrepreneurs in Ca Mau are in contrast again, with respondents there most likely in the sample to claim that enterprise profitability is a key to credit access (see Figure 20 for the total responses for all six provinces).

Figure 20: Main Determinants of Bank Loan Access

	First	Second	Third
Collateral	165	27	9
Firm Profitability	4	53	31
Personal Relations	15	26	29
Investment Plan	6	35	20
Industry	3	11	27
Credit History	5	14	15
Firm Size	7	8	18
Informal Costs	2	2	6
Others	3	9	8

Source: Survey Data (2004)

Summary of Findings

The data analyzed in this study shows clear and substantial variation in the formality of private enterprise across provinces in Viet Nam. The extreme cases of provinces such as Thanh Hoa and Bac Ninh, on the one side, and Binh Duong and Ca Mau, on the other, show that businesses of the same size are making different decisions on whether to operate as companies depending on their location. Particularly striking is the degree to which more formalized provinces tend to be located in the south. Even after implementation of the Enterprise Law, regional difference is reflected in the southern provinces' higher shares of small enterprises in the company sector, higher shares of household businesses with tax codes, and lower incidences of household businesses in industry or with large numbers of employees—as well as a greater sense among southern entrepreneurs that company registration is appropriate for small business.

The study also found clear correlation between more comprehensive coverage of private enterprises by local tax officials and greater private sector formality. It is attractive to draw the conclusion that more uniform application of tax policy to a broader range of private enterprises, particularly small industrial ventures, makes them more likely to formally register as companies. Correlation of formality with more favorable evaluations of provincial governance (though only in the south) implies that a more even-handed approach in other areas of enterprise regulation may also have this same impact. The study, however, does not establish clear proof of *causality* that broader application of

regulations leads to greater formality. It is conceivable, for example, that cultural characteristics, which might make entrepreneurs in some provinces more likely to operate formally as companies, might also make the remaining entrepreneurs operating as household businesses more likely to register for tax codes.

Finally, the availability of credit to small and medium enterprises (SMEs) does not appear to be a key factor in determining business establishment and formalization. Private companies in provinces dominated by high numbers of household businesses, such as Thanh Hoa and Ha Tay, had more positive experiences with, and opinions of, access to bank financing than did companies in provinces with far more formalized enterprises sectors. Bank lending in these provinces, however, may still be more hampered by inefficient allocation of credit, partly due to the continued role of “relationships.” The correlation of rapid expansion in lending to the private sector, and the increase in average company size in the Mekong Delta, does indicate improving allocation of credit and confirmation of the expected relationship between credit access and firm-level growth.

Recommendations

Despite the lack of a clear causal relationship, it is still possible to draw lessons from the study's findings relevant to economic governance at both the central and local levels:

- *For central Government*, the relationship of more uniform business regulation with formality underscores the importance of clearer, more concise, and targeted national laws. Unrealistically complicated, broad, or vague laws are more likely to be interpreted in significantly different ways across provinces in Viet Nam's highly decentralized system. The success of the Enterprise Law in creating a uniform registration system, and thereby stimulating growth of companies and wage jobs in areas that had previously struggled, is a prime example of how this can work. Viet Nam's complicated tax regime, while improved in recent years, would, in turn, appear to be an excellent example of an area with significant room for improvement.³⁶
- *For provincial governments*, the relationship between broader enterprise regulation and formality emphasizes the value of transparent implementation processes that deal objectively with all enterprise forms, limiting decisions on which firms need to be regulated. Such a broadening of regulation must be distinguished clearly from an intensification of regulation. The latter would not only frighten the business community and discourage investment, but would also worsen the local authorities' already limited capacity to achieve more investment.³⁷ The study showed the benefits of reducing differences and subjectivity in the way local officials apply the national tax regime across different enterprise ownership types.

³⁶ This recommendation is also supported by a recent survey and paper by the Viet Nam Competitiveness Initiative. See Nguyen Thi Canh et al, *An Empirical Study of Corporate Income Tax Investment Incentives for Domestic Companies in Viet Nam*, Viet Nam Competitiveness Initiative, Ho Chi Minh City, October 2004.

³⁷ Participants in the final workshop of this project were highly concerned that a critique of insufficient enterprise regulation would be taken to justify increased inspections and harassment of existing formal companies.

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