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Incomplete Reform of State-owned Enterprises: The Missing Precondition for External Integration and Industrial Progress of Vietnam

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Abstract.

The inefficient and non-profitable State-owned enterprises sector of Vietnam, which still accounts for an important part of the economy seems to become a major obstacle and risk factor to an intended further economic growth of the country, particularly when the government pursues integration into the regional and world economic system.

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Economic Transition and Trade Reform of Vietnam

In 1986, the Sixth National Conference of Vietnam's Communist Party decided to set on the pace of economic renovation, known nowadays as DOIMOI, with the ultimate objective of moving from a centrally planned economy to a market-oriented system. Fujita (1999)[1] summarized the major contents of the DOIMOI policy in both domestic and foreign areas, creating a new set of policies emphasizing agricultural and light industries; acceptance of the principles of a market economy and private ownership; and adoption of an 'open door policy' in pursuit of improved foreign economic relations.

The following section describes in some detail the important advances that Vietnam has made on the international elements of its DOIMOI system. We will then show how the lack of parallel progress in the domestic reform process reduces the effectiveness of these policies.

<u>Reform of the Foreign Trade System:</u>

The foreign trade policy reform, along with the liberalization in foreign investment, has been the central feature of the 'open door policy' of Vietnam since that was launched as a part of the DOI MOI. In order to open up the domestic economy and to integrate into the regional market and world economic system, Vietnamese government has adopted a series of adjustments, which are needed to build up a more effective structure for foreign trade

[1] Mai Fujita, "Vietnam in APEC: Changes in Trade Pattern after the Open Door Policy," Chapter III in "Documents of Trade Liberalization and Facilitation in APEC – A Re-evaluation of APEC Activities," Edited by Satoru Okuda, APEC Study Center, Institute of Developing Economies, Japan (1999), available at <http://www.ide.go.jp>.

expansion[2]. These adjustments are reflected in the following attempts: relaxation of controls on entry into foreign trade activities; mitigation of controls used to strictly manage imports and exports, and introduction of a change in policy stance from direct control toward tariffs system; adoption of a more market oriented exchange rate regime (this was in fact accompanied by a large devaluation of Vietnamese currency dong against the U.S. dollar closer to the level of more appropriate market rate)[3].

In addition, Vietnam joined and actively participates in regional and multilateral trading agreements. Vietnam has signed, as the first step, the trade agreement with the European Union in 1992. Then, the country joined the Association of Southeast Asian Nations (ASEAN) and became a full-fledged member of ASEAN Free Trade Area (AFTA) in 1995. It joined the Asian Pacific Economic Corporation (APEC) in 1998. In 2001, Vietnam signed a bilateral trade agreement (BTA) with the United States. As one of the definitely desired goals, Vietnam expressed her willingness to obtain a full-fledged membership of World Trade Organization (WTO), and then the tireless negotiation efforts have been maintained since 1995. As a consequence, it is internationally agreed that Vietnam will win to become an

[2] A comprehensive analysis about foreign trade related policy reforms undertaken by Vietnamese government can be found in "Vietnam's Trade Policies 1998," Center for International Economics (December, 1998), available at <http://www.thecie.com.au/>, and "Trade Reform in Vietnam: Opportunities with Emerging Challenges," Philippe Auffret, *World Bank Policy Research Paper 3076* (June, 2003), available at <http://econ.worldbank.org>.

[3] It is worth noting that prior to the reform the market determined price of foreign exchange was in many cases regarded almost 20 times higher than the officially determined rate.

official member of WTO by the end of 2005[4].

As a result of series of the economic reforms and trade liberalization, foreign trade performance of Vietnam so far has demonstrated an outstanding record. The annual average growth rates of both exports and imports had been maintained at a pace of about 30 percent up until the onset of the Asian Financial Crisis in 1997. The share of foreign trade in total GDP expanded from the level of about 20 percent in 1990 to the astonishing level of more than 110 percent in 2004. The number of enterprises involved in foreign trade activities has blossomed to thousands compare with only some handful State-monopoly Foreign Trade Corporations that dominated prior to the reforms[5]. The values of both her exports and imports, in term of the U.S. dollars, expanded approximately tenfold within the period from 1990 up to 2004. Previous studies, including Hal Hill (2000)[6], have pointed out without exception that key factors of Vietnamese export success during the first half of the 1990s could be found mainly on the external side. However, if one carefully examines this during that time period, one finds such acceleration could have been attributed to both internal and external factors. Firstly, the domestic productive forces that had been long repressed prior to the DOIMOI policy are now extensively liberalized, particularly in agricultural and light

[4] So far, Vietnam has finished 9 rounds of WTO negotiations and recently reached the bilateral agreements within WTO framework with 6 countries/regions, includes EU, Cuba, Argentina, Brazil, Chile and Singapore.

[5] The present trade activities are carried out by a huge number of private enterprises those were virtually non-existent before the policy reforms.

[6] Hal Hill, "Export Success against the Odds: A Vietnamese Case Study," *World Development* 28: 2 (2000), pp. 283 – 300.

manufacturing sectors. This definitely helped to promote a production boom in the early 1990s. Secondly, various external factors unquestionably supported the continuously expanding market size and potentiality in favor of Vietnam due to the 'open door policy' as firms were emancipated by the government. The high economic growth momentum in the East and Southeast Asian region in that period contributed significantly to help absorb almost 70 percent of Vietnam's exports. Lastly, we cannot neglect the drastic depreciation of the dong against the US Dollar since the late 1980's. This triggered the process of export promotion. This bold reform definitely improved its international competitiveness, and eventually has assisted many exporters to find more international opportunities.

All the efforts in the last 15 years seem to prove that trade liberalization, in fact, smoothes the transition of the Vietnamese economy to adapt the market mechanism: this has helped create markets for Vietnamese products and as a consequence provided a huge amount of foreign exchange to serve the need for industrialization of the economy.

While the incentives for increased exports have worked rather well, there are still significant restrictions on imports that are not essential for the export of final products. Support for domestic firms, via restrictions on imports in many important sectors, make it difficult for the international changes to have their full impact on the domestic economy.

Even after a period of successful economic transition and 'opened-door policy' reforms, one should not ignore a simple fact that Vietnam's foreign trade regime is still regarded as highly restrictive. Trade performance has been often restrained by sizable and frequently changed tariff rates, many remaining import quotas and bans as well as extensive bureaucratic impediments[7]. In reality, trade liberalization in Vietnam has been only implemented in the limited sectors such as agricultural, primary and labor intensive industries, while other manufacturing industries, occupying the considerable portion of the economy, are still highly protected for solely domestic reasons. This fact reveals that Vietnam started its economic reforms initially from a very narrow base of industries. This reflected a view that the government needs to rely on a trade protection policy with the hope to modernize and enhance the existing industrial sector. This strategic approach seems only justifiable in the very limited sense, therefore the government has to acknowledge a much broader view in order to inevitably encourage the wide-scale industrial sector to accept a notion of the present international economic environment.

In order to maintain the high economic growth pace and continue the transition process, Vietnamese government has facilitated the pace of trade reform by actively engaging in many external commitments such as those made under AFTA[8] as well as WTO. At the same time, there exists a growing concern within Vietnamese policy-makers whether the expected

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[7] International Monetary Fund, "Vietnam: Selected Issues," *IMF Staff Country Report* No.03/381, (December, 2003), available at <http://www.imf.org>.

[8] The ASEAN Free Trade Area (AFTA) was established in 1992 by 6 original members of ASEAN to create a free trade area within the region by 2003. The Common Effective Preferential Tariff (CEPT) scheme was designed to bring down tariffs on all manufactured and processed agricultural products to 0-5 percent range within 10 year time-frame beginning 1993. In 1995, Vietnam became formal member of ASEAN and at the same time gained the AFTA membership. However, as a late-comer country Vietnam was granted an extended time-frame up to 2006 to finalize the commitments.

economic impacts of those liberalization packages are genuinely favorable under the frameworks of AFTA and WTO. Various studies have been attempted to address the costs and benefits once Vietnam would be involved in the international economic framework. In this paper, we will first review two widely cited studies and clarify the problems associated with the needed policy debates.

Policies for Internationalization: How Those to Be Assessed

Academic have used conventional macro-econometric models to estimate the benefits to Vietnam of its integration into regional and global economic systems. We will argue, however, that these models make assumptions about the operation of markets that are not appropriate for the current economic system of Vietnam. We will point out that both of the quantitative studies make use of the conventional competitive model, in which the behavior of the modeled firm is far different from the actual behavior of the current Vietnamese State-owned enterprises. While the modeled firm responds to the incentive changes in market place according to their profit-maximization mandate, Vietnamese State-owned enterprises, in contrary, act under the motive of maximizing the utilities of the managers and employees and at the same time minimizing the profits of the firm.

The first study [9] is a research project organized and implemented by a group of foreign and Vietnamese researchers, who belong to Vietnam's Central Institute for Economic

[9] David Roland-Holst, Finn Tarp, Dinh Van An, Vo Tri Thanh, Pham Lan Huong and Dinh Hien Minh, "Vietnam's Accession to the World Trade Organization: Economic Projection to 2020," *Discussion Paper No. 0204*, Vietnam's Central Institute for Economic Management (2002).

Management (CIEM) in the Ministry of Planning and Investment. This study has applied a computable general equilibrium methodology (that is called the CIEM-NIAS Analytical Model of the Vietnam's economy or in short CNAM) to assess the economic effects of Vietnam's accession to the World Trade Organization. The model has a feature of being dynamic in nature, which incorporates the investment adjustments of productive firms and the model can be passively applied to access the long term economic impacts of the trade policy reforms. The study finds that the considerable gains of accession to WTO would only be achieved if Vietnam can sustain their rate of productivity growth. This is equally suggesting that domestic reform stance has to be strengthened to manage to keep the rate of growth on track. The study provides another crucial massage, in which the expected economic benefits of participation into WTO would be realized by accompanying them with the liberalization of the capital market. At present, capital insufficiency is unquestionably certain and has become a very serious constraining factor on the prospect for future economic growth and diversification. The authors argue that one of the most chronic constraints on economic modernization, diversification, and productivity/wage growth, which are rather commonly observed in many developing countries, is the capital scarcity, often induced by the policy fetters.

The second paper, a study by Fukase and Martin[10], concentrates on quantitative evaluation of the macro-economic impacts of Vietnam's accession to AFTA employing the

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[10] Emiko Fukase and Will Martin, "A Quantitative Evaluation of Vietnam's Accession to the ASEAN Free Trade Area," *Journal of Economic Integration* 16: 4 (2001), pp. 545 – 567.

standard GTAP model[11] - a comparative static multi-region, multi-sector, comprehensive computable general equilibrium model. The general equilibrium nature of this model allows the authors to examine the economy-wide effects of various trade liberalization packages that appear in the changes in welfare position, direction of trade, output level and industrial structure. Based upon a detailed analysis of the economic structure and trade linkage between Vietnam and ASEAN members and upon the results of each simulation, the authors have drawn some conclusive insights summarized as follows:

- first, the static economy-wide effects of Vietnam's accession to AFTA are small for three reasons: 1) the sizable number of excluded products appear to limit the scope of trade creation; 2) the discriminatory nature of AFTA liberalization diverts Vietnam's trade from non-ASEAN members; and 3) the relatively small initial trade volumes of Vietnam with ASEAN member countries ;
- second, if Vietnam extends its commitments made under AFTA to the rest of the world on the reciprocal foundation, the welfare effects would be substantially improved, because the wider scale and non-discriminatory nature of trade liberalization and the more efficient allocation of resources among Vietnam's industries can be achieved;
- lastly, the results of the study identify that sectoral protection measures currently given to capital-intensive and strategic industries impose a cost on Vietnam's overall economy, that is, imposing implicit taxes, not trivial but substantial, on other sectors of the economy.

[11] Thomas Hertel, "Global Trade Analysis: Modeling and Application," Cambridge University Press (1997).

Crucial but Dubious Assumption in the Applied Models

The above studies generally provide a prospective view on the economic impacts of Vietnam's participation in various trade agreements. However, it seems that any existing study fails to point out the vital assumption underlying the working set-up of their applied CGE models that is believed less appropriate for the current economic structure of Vietnam. If the key assumption looks irrelevant, the estimated outcomes regarding the policy reforms have to be dealt with cautiously otherwise that information tends to become misleading and often unacceptable.

In any CGE modeling, one of the important subjects is whether the full equilibrium condition of the model can be genuinely fulfilled when all subjects of the model would be able to obtain their maximization points. In other words, for the case of production firm, it has to be addressed whether the profit maximization condition would be simultaneously satisfied with when the model reaches the equilibrium point. Quantitative analysis of policy changes, as seen in such as the case of Vietnam's accession to AFTA and WTO, involves a process of altering rates of import taxes levied on products, which are imported to Vietnam and exported from Vietnam into counterpart countries. As an obvious result, the relative prices of imported products in Vietnam decline, therefore such an alteration would serve a meaningful incentive available to both consumers and production firms. In this respect the model is not in the full equilibrium point while all subjects included in the model are responding to any changes in combination of inputs and outputs to fully reach their new maximization points. To maximize their profit under new price structures, production firms need to make all necessary adjustments for their combination of outputs and inputs. That restructuring process of the entire model, in particular of the producer side, contributes to attain the improved efficiency of the economy and leads to increased income level as a whole. Under such new incentive structures, the production function needs to be solved until the new equilibrium point will fully meet the economic premise of profit-maximization. That is the primary and necessary assumption throughout the working of the CGE models discussed above. Now the issue is whether the case of Vietnam's economy at the moment well fits in such analytical setting.

The unilateral trade liberalization of Vietnam made possible and implemented during the 1990s to open agricultural and labor intensive light manufacturing sectors, in which it was simply believed Vietnam should possess natural comparative advantage in the international market. The prospective trade liberalization of Vietnam under AFTA and WTO frameworks will lessen any protection on the domestic manufacturing sector, a sector made up primarily of the dominant state-owned enterprises (SOEs)[12]. Nevertheless, the two models mentioned above are based on a strong, but necessary, assumption for computational purpose that the changing incentives, available after accession to AFTA and WTO, will drive all production firms in affected sectors to improve their position by altering the combination of input and output structures. Furthermore, it is assumed that additional investment will enable them to improve their productivity, at least to the level where they are ready to compete with foreign supplied products.

Even after 15 years of extensive efforts toward economic reforms and trade liberalization, the foreign trade regime of Vietnam is constantly criticized as highly,

[12] A major portion of productive firms in Vietnam, those capital expenditures belong entirely to the state budget.

sometimes excessively, protected in favor of the manufacturing industries at the cost of other sectors in the economy. It is theoretically possible to state that prospective trade liberalization would help to reduce protection and provide incentives for firms to quickly react to become more efficient by incorporating any profit maximization motives. It could be also be inferred that if such a successful move starts from an inefficient local equilibrium, then the move to an open system has two benefits, one that moves the firms to the production possibility frontier, and then the further move to one that adjusts for the proper production point for efficient trading.

However, it is unfortunately questionable to infer from the progressive trade liberalization under such agreements as made under AFTA and WTO to generate large and wide-scale positive shocks on the domestic manufacturing industries, which are dominated by SOEs. In contrast to private enterprises, the standard industrial organization economics suggests that the state-owned business institutions are rather sluggish, or less responsive, particularly in developing countries with socialist tradition, even to the profit maximizing incentives.

In the above studies, it is the central feature that the smooth adjustment process is expected to work in Vietnam. It is of course understandable that the authors need to build their Computable General Equilibrium Models along with ordinary assumptions of microeconomics. This is tantamount to saying that the positive effects of trade liberalization in Vietnam will bring swift and effective responses to any change appeared in the market places. The central controversial issue is thus the Vietnamese SOEs would be expected to engage in the desired process, from the equilibrating point of view, which will eventually bring the full-fledged equilibrium for the entire economy.

Quite interestingly, a recent survey conducted by the Ministry of Finance[13] discloses that all of the surveyed 42 large SOEs, including 9 biggest state-owned corporations have been operating at far below capacity level. The report states the clear reason for such an underperformance by explicitly pointing out that the present institutional structure *per se* is not likely to create any positive incentive for them to initiate effective and forward looking strategies.

Contrary to this current structural setting, most of the studies about economic integration and trade liberalization made a rather simple prediction: if Vietnam keeps an extensive liberalization stance, the country will achieve a higher rate of growth, of course relying on the pre-condition of the positive response of 'all' production firms in Vietnam. Nevertheless, it is our central conclusion that it seems more realistic to accept a rather more pessimistic stance regarding the behavior of state-owned firms. It should not be understated that restructuring of SOEs in Vietnam toward privatization and equitization occupies a vital role to ensure the positive merits from trade liberalization in Vietnam that is certainly a long run issue. However, with respect to stability and sustainable growth of Vietnam, the key question to be addressed is how quickly Vietnam will be able to build successfully the full-fledged pro-business environment, clearly departing from the current reality. Obviously this cannot be attained solely by the exercise of economic policy, but it also requires incorporating the social, cultural and perhaps psychological challenges imposed on the entire Vietnamese environment. Quantitative evaluation, although powerful and instructive to

[13] The survey is under a Technical Assistance Project financed by the World Bank and conducted by KPMG and Ernst & Young Auditing Companies.

digest the economic interactions among variables involved in the model, needs to be cautiously applied to the case with rather inflexible structure of the economy such as Vietnam.

Reforming SOEs[14] and Present Industrial Structure

Even though the transitional efforts have an extensive history, the Vietnamese SOEs are still playing a leading and significant role in the economy particularly in the industrial and service sectors. The government so far had not adopted a broad-based privatization program, rather permitting a dominating role of SOEs in strategic industries. The government is hoping to pursue gradual equitization[15] of non-strategic SOEs. However the execution of those program has been relatively slow, thus tending to become rather visibly behind the desired progress.

Despite their long standing problems and constantly required restructurings, SOEs sector still accounts for about 30 percent of Vietnam's GDP and 40 percent of industrial production. Their activities make up approximately 35 percent of non-oil exports, 20 percent of total investment, 15 percent of non-agricultural employment, and absorb almost half of the outstanding domestic bank credits. They deal with oil, cement, chemicals, steel,

14 A more detailed analysis on the process, achievements and remaining problems of State-owned enterprises sector reform can be found in Vu Quoc Ngu, "The State-Owned Enterprises Reform in Vietnam: Process and Achievements", Visiting researchers series No.4, Institute of Southeast Asia Studies, Singapore (2002), available at <http://www.iseas.edu.sg/pub.html>

15 Equitization consists of selling a fraction of state capital in the form of shares at book value.

and various key service sectors, including, for example, energy, finance, telecommunications and transportation. So far, more than 2,000 SOEs have undergone rationalization and equitization. However, there still remain about 4,000 SOEs at the end of 2004.

Regarding the financial and economic performance of the SOEs sector, one-half of SOEs were reportedly classified as loss-makers, or at least marginally profitable. It is reported that almost 10 percent of bank debts to SOEs were calculated to have fallen into non-performing status at the end of 2003[16].

The poor performance of SOEs sector stems primarily from the complex governance structure of the SOEs itself. They are basically characterized by multiple mandates and a non-transparent structure of accountability, along with poor corporate disciplines. SOEs management is not necessarily working under the profit motive behavioral principle, therefore in many cases their operation tends to generate the inefficient outcomes and often results into chronic financial troubles. In order to keep even those inefficient SOEs sector functioning, the government is inevitably forced to protect them from competition and to provide unduly attractive privileges in various types. One of them is, probably by a tacit consent, an easier accessing channel to bank loans. Consequently and unfortunately, the system looks to be self-generating a vicious circle reflecting the persistent protection and preferential treatment from government.

There can be no doubt that SOEs reforms of Vietnam during the 1990s progressed but the reform have been extremely slow. At the beginning period of 1989 up to 1992, the

[16] This is from the presentation made by the Prime Minister at the "National Meeting on Reviewing the State-owned Enterprises Reform Program" in Hanoi, March 16, 2004.

number of SOEs was drastically cut from 12,000 to 6,000 through mergers and rationalizations. The process of equitization was launched in mid-1992, however only 20 enterprises were recorded equitized by 1997. In early 1998, after an active review of the SOEs reform program, especially the equitization program, and upon recognition of the need to accelerate the reform progress in response to the regional crisis at that time, several initiatives were in fact attempted. Despite those efforts, actual reforms were not sufficiently enacted. Once the deterioration in the financial position of the SOEs became clear then more bank credits and higher foreign trade protection measures were called in. It is almost certain to state that this slow pace corresponds to the weakened pressure for reform.

Only around 2001 was the SOEs reform program again facilitated. This time a Five-Year SOEs Reform Plan[17] was installed by the government initiative, with clear annual targets specified for the first three years (2001-2003). The planned scheme insists that around 1,800 out of 5,571 SOEs would be subject to reform measures, mostly in the form of equitization, divestiture, or liquidation. These enterprises account for 31 percent of entire SOEs employment, 11 percent of state capital, and 10 percent of SOEs debts. The notable key components of the plan, which are designed exclusively to seek the intended outcomes, are to strengthen governance structures, enforce the reporting requirements along with accountability, and conduct operational reviews (i.e., diagnostic audits), which are imposed especially on 100 large SOEs.

It was recently reported that there are some visible progresses in strengthened

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[17] World Bank, "Vietnam: Delivering on its Promise," *Development Report 2003*, Washington D.C. (November 21, 2002), p.22, available at <http://www-wds.worldbank.org>.

equitization process and improved transparency. This includes specifically: first removing ceiling caps on shareholdings in equitized enterprises (with a 30 percent limit on foreign shareholding); secondly improving transparency in the equitizing process; and lastly establishing a redesigned Social Safety Net Fund to cover voluntary and involuntary redundancy stemming from SOEs reforms. The survey by the Vietnam's Central Institute for Economic Management[18] presents that enterprises that have been equitized look to be performing far better after equitization. This survey has focused upon 422 SOEs for the extensive examination. All of them were in fact equitized prior to 2001. These firms have shown outstanding improvement, as clearly reflected in performance indicators in terms of sales, asset position and value added.

Factors Determine the Behavior of Vietnamese SOEs[19].

Before the economic transition in 1986, Vietnamese SOEs sector was forced to follow the central planning economic mechanism. That means SOEs were given the annual production plan including production target as well as the needed inputs from line ministries or local government. All of the outputs produced by manufacturing SOEs were transferred to trading SOEs for distribution purpose. All the value indicators such as prices, profits and

[18] Vietnam's Central Institute for Economic Management, "Vietnam's Equitized Enterprises," *Draft Discussion Paper* (2002), Ministry of Planning and Investment, Hanoi, Vietnam.

[19] The model in mathematical form of the behavior of Vietnamese SOEs was developed in Quoc Ngu Vu, "A Model of the Behavior of Vietnamese SOEs during the Reform Period", Asia Pacific School of Economics and Management, The Australia National University, available at <http://dspace.anu.edu.au>

wages were predetermined in the imposed production plans. When SOEs realized profits, they were transferred back to the government; losses were made up from government budget expenditure. Under this system, the incomes of workers consisted only of the wages as specified in the plans. This mechanism has been criticized in the literature for discouraging workers from enhancing productivity. The institutional arrangement at that time, where only planned production was allowed, did not encourage workers to exert effort beyond the level that they were supposed to generate in order to receive the fixed wages. The managers and workers need not to worry about what, how and at what cost to produce as well as the profit level of their firm.

Consistent with the transition of the economy from centrally planned mechanism toward market-based system, the decision 217/HDBT (enacted in November, 1987) and other following measures have completely changed the operation of SOEs in Vietnam. They now have much greater freedom and autonomy to decide what and how much to produce and where to source inputs and to market their outputs. They are also allowed to hire and fire employees and set wages, within policy guidelines. However, they have to preserve and develop the capital that government has entrusted them with and to pay taxes and other levies as stipulated in the laws. All after-tax profits belong to SOEs, hence the decision has turned managers and employers into effective owners. In addition, SOEs now are not under as tight and direct control and inspection of different line ministries or local government as before. This relaxation of control, as seen in standard principle-agent literature, enables workers of SOEs to try different ways to benefit themselves. The workers of an SOE – being the effective owners - naturally prefer to maximize their incomes, hence maximizing their own utility. This is done by the standard method of minimizing the direct costs of producing a given quantity of output. Furthermore, an SOE can do even better by minimizing all kind of production costs and at the same time minimizing profits tax, because profits tax is seen as another direct cost that it has to pay. Profits tax is minimized by ***minimizing before-tax profits***[20], which in turn requires the inflation of expenditures. As wages and manipulated indirect expenses[21] serve as two of the major sources of income of managers and workers in Vietnam's SOEs. Given constraints on wages[22] and other legitimate expenses of direct production cost, which an SOE finds difficult to manipulate, it tends to manipulate indirect production costs in arriving at before-tax profits.

However, it is obvious that the SOE can not keep inflating the indirect expense indefinitely, as doing so will cause profits to be abnormally negative. According to current policies and regulations, the director of an SOE making losses for three consecutive years will be fined and may be sacked. This regulation prevents SOEs from depleting all true profits. Even though, as they are still better off by minimizing profits, they will tend to inflate the manipulated indirect expenses[23] to a level which leaves reported profits not at zero but equal

[20] According to normal accounting standards, before-tax profit is calculated as total sales revenue minus total indirect taxes, minus total direct production cost minus total indirect production costs.

[21] This is the income received from artificially manipulating marketing and administrative expenses.

[22] Wages are normally determined through government policies. Actual wages paid are calculated by SOEs based on those policies and need to be approved by higher authorities.

[23] The indirect expenses consist of two parts: the legitimate indirect expenses, and the manipulated indirect expenses.

to a predetermined positive level. This level will be normally the common level among SOEs operating in the same field or at the level achieved in the previous year.

In addition, present policies still permit a loss-making SOEs to claim some types of implicit subsidy. Those are usually in the form of delays in paying taxes, rolling overdue debts, or writing off bad debts. Consequently, these kinds of support are similar to providing a loss-making SOE an explicit subsidy. It should be believed that an SOE knows that if it makes a loss, it will receive an explicit level of financial supports. In order to understand the consequent behavior of that SOE, two cases are considered. First, the subsidy level is equivalent to the amount of loss. In this case, an SOE will always inflate manipulated indirect expenses to an infinite level because all losses will be covered by the government, even though this can never happen in practice. In the other case, when subsidy is fixed at a certain level, it could be expected that the SOE will inflate manipulated indirect expenses to the level equal to the sum of true profit and the fixed level of subsidy.

Reforms, Challenges and Prospects

A lot of attentions have been paid on Vietnam's efforts to pursue integration with the world economy. Various research and studies were conducted to mostly estimate the expected impacts caused by such trade agreements on Vietnam's economic growth prospects in both the short- and the long-run perspective. Most of the Vietnam's trade policy reform measures to date are primarily unilateral in nature. Although those measures are rather non-sophisticated, excessive protection demanded by selected industries is not yet eliminated and the practical schemes are still far from transparent. It should be honestly acknowledged that, this in fact causes further unfavorable environment toward export-oriented and other low-cost industries, which are supposed to play extremely vital roles in Vietnam's economic development in coming growth stage.

Vietnam has already become a solid member of AFTA and the country is expected to obtain its membership of WTO by the end of 2005. Current and prospective requirements as a member of such regional and multilateral trade agreements impose on Vietnam obligations to reduce protective measures and/or their magnitude, especially in the manufacturing industrial sector. These imposed reforms are obviously tantamount to more pressures on inward-looking domestic firms. They need to react in order to reestablish their position in the new outward-looking business environment. The industrial sector, which will be affected mostly by further integration and trade liberalization, is still dominated by the non-profitable SOEs. Both from the practical and theoretical perspectives, it is hard to expect that those SOEs could respond positively when incentive environment changes as the impact of trade liberalization. This lack of quick response seems to make policy-makers of Vietnam become less confident to pursue the next step of external trade liberalization.

To realize the full potential benefits of trade liberalization, the process of SOEs reforms, believed to be the core for success, needs to be pushed ahead aggressively. With the legal framework for equitization now being strengthened, the pace of the reform should pick up but will require resolute implementation to overcome vested interests, capacity and technical obstacles. SOEs should be encouraged to convert into limited liability companies, while the new SOE law should aim to promote simple channels of control, profit-focus mandates and corporate disciplines that would ensure efficiency improvement of the sector. This seems at the present the only viable way for Vietnam to attain the prospects of more pronounced growth. The country has a lot of challenges to go through, but those are not impregnable obstacles, although not easy but challengeable, for her future development.

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