Vietnamese Development Policy:
Upgrading the Domestic Private Sector
Through FDI Linkages

Second Year Policy Analysis

Authors: Ben Grozier and Jason Keene
Client: Ministry of Planning and Investment of the Socialist Republic of Vietnam
Advisors: Robert Lawrence, David Dapice
Section Leader: Arvind Subramanian

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Abbreviations

AEO = Authorized Economic Operators
ASEAN = Association of Southeast Asian Nations
CPV = Communist Party of Vietnam
CIEM = Central Institute for Economic Management
CPTPP = Comprehensive and Progressive Agreement for Trans-Pacific Partnership
EVFTA = European Union-Vietnam Free Trade Agreement
FDI = Foreign Direct Investment
FTA = Free Trade Agreement
GDP = Gross Domestic Product
GoV = Government of Vietnam
GSO = General Statistics Office of Vietnam
GVC = Global Value Chain
IMF = International Monetary Fund
LCR = Local Content Requirement
MoIT = Ministry of Industry and Trade
MoST = Ministry of Science and Technology
MPI = Ministry of Planning and Investment
OEM = Original Equipment Manufacturer
RCEP = Regional Comprehensive Economic Partnership
VCCI = Vietnam Chamber of Commerce and Industry
WTO = World Trade Organization
Section I: Executive Summary

Since the Doi Moi reforms of 1986, Vietnam has been an economic success story. The country has generated strong and consistent economic growth over the last three decades, lifting income per capita levels and significantly reducing poverty rates. The government’s policy towards, and aggressive courting of, foreign direct investment has been a major support anchor for Vietnam’s export-oriented economic growth engine. The country’s openness to foreign investment and trade has also helped it succeed in the current market environment as Vietnam has been a prime beneficiary of shifting global supply chains emanating from U.S.-China trade tensions.

Despite the fact that the country’s export basket is heavily concentrated in electronics, we do not find strong evidence to suggest that the country is either over-specializing or inefficiently-specializing. In fact, the country’s success in developing new products forced us to think about how Vietnam can sustain its export-led and foreign investment-driven growth model.

In interviews with foreign-owned electronics firms operating in Vietnam, we discovered that a lack of capable domestic suppliers and low levels of human capital are two of the biggest business challenges, and thus obstacles to further investment. Vietnam’s development appears to have thus outpaced its domestic capabilities, which prevents its domestic private sector from supplying high-technology electronic companies and participating in global value chains. We believe that this lack of technological diffusion is limiting the country’s ability to upskill before its demographic window begins to close.

Technological diffusion occurs when domestic firms link with, or supply into, foreign firms with a higher degree of productive capabilities. The linkage process is far from automatic and relies on the spillover potential of FDI, the absorptive capacity of domestic firms, and the host country’s business policy and institutional environment.

After identifying the absorptive capacity of domestic firms as the binding constraint in this linkage process, we explore two priority policy recommendations: i) the establishment of a business advisory council and ii) reforming existing SME support programs. We also investigate the possibility of adopting local content requirements but determine that these policies would be counterproductive to Vietnam’s development goals.
COVID-19 Update

Vietnam has been a significant beneficiary of the hyper-globalization of world trade and the internationalization of supply chains, especially in information and communication technologies. The ongoing COVID-19 pandemic presents meaningful risks to the current structure of the global economy and world trade. While not fully explored in this report due to the timing of the outbreak, Vietnam will need to maintain flexibility in adapting to a post-COVID-19 world, especially if supply chains are to become increasingly fractionalized and nationalized. While we expect policies designed to strengthen Vietnam’s domestic private sector will remain critical, Vietnam’s ability to fully leverage a foreign investment- and export-driven growth model may be challenged in the years ahead.
Section II: Background

Overview of Economic Growth

Vietnam has seen steady and consistent economic growth since the country adopted the Doi Moi market-based economic reforms after the 6th National Congress of the Communist Party in 1986. Among other reforms, the country reduced barriers to trade, permitted the rapid growth of domestic agricultural markets, promoted the production of commodities by privately-owned enterprises, and developed the 1990 Law on Private Enterprises which provided legal status and guidelines on which private sector activity could rely.

As a result of the Doi Moi reforms, and as evidenced in Figures 1 and 2 below, the Vietnamese economic growth rate increased from a historical average of 2-4% pre-1986 to consistent growth rates of 5-10% from 1986 to 2018. Annual GDP growth peaked at 9.5% in 1995 and has remained in the range of 5-8% for the entire 2000-2018 period. Correspondingly, GDP has increased eight-fold from $22.5bn in 1984 to $187.7bn in 2018 (measured in constant 2010 $),\(^1\) and the poverty headcount ratio at $1.90 per day has declined from 53% in 1992 to just 2% in 2016.\(^2\)

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A History of Foreign Direct Investment

Foreign direct investment in Vietnam has been a meaningful contributor to this long-term growth in GDP. As depicted in Figure 3 below, the number of foreign investment projects has increased at an annual growth rate of 12% from 152 in 1991 to 2,741 in 2017. Implementation capital, which incorporates both foreign and local capital invested in these projects, has increased at a cumulative annual growth rate of ~15%, from $428.5mm in 1991 to $17.5bn in 2017. As a percentage of GDP, FDI has increased from 0% in 1986 to more than 6% in 2019.

![Figure 3: Increasing Foreign Direct Investment](image)

Vietnam’s accession to the World Trade Organization (WTO) in January 2007 was particularly influential in increasing the level of foreign investment. As illustrated in Figure 3 above, in the five years prior to WTO accession (2002-2006), the volume of implementation capital in Vietnam averaged $3.1bn, while in the five years after WTO accession (2007-2011), the volume of implementation capital increased threefold, averaging $10.3bn.

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Attracting Foreign Investment

Since the initiation of the Doi Moi market reforms, the Communist Party of Vietnam has used a variety of methods by which to attract foreign investment. Specifically, the government has provided various tax incentives, priority access to critical infrastructure, and subsidized electricity prices. Beginning with the Law on Foreign Investment adopted in 1987 (later updated to the “Law on Investment”)\(^6\), foreign investors in Vietnam have paid a lower rate of corporate tax for a certain period of time or throughout project execution, have received an exemption or reduction of import tax on goods imported as fixed assets, and an exemption or reduction of land rents and land levy.\(^7\)

Foreign investors cite favorable corporate tax rates as a primary reason to invest in Vietnam over alternative options across east and southeast Asia. Under the Law on Investment, larger investments and projects can receive full tax exemptions (investors pay 0% corporate tax) for the first four years of operations and a 50% reduction of payable tax amounts for the subsequent nine years.\(^8\) For those investors meeting these specifications, it is only after year thirteen that they pay the corporate income tax rate of 20 percent applied to domestic companies.

The Vietnamese government has also provided location-based incentives, industry- and project- specific incentives, and incentives such as subsidized electricity prices for operation in economic zones.\(^9\) In addition, many foreign investors are labeled as Authorized Economic Operators (AEO) and offered priority access to critical infrastructure and expedited processes for import and export of goods permitting increasingly seamless business operations.

The Decision for Foreign Investors

While the Vietnamese government has created an attractive incentive structure for foreign investors in recent decades, investors identify more than the structured incentive programs that entice them into the country. Specifically, investors cite factors such as Vietnam’s relatively low

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\(^8\) Das, Koushan. (February 1, 2018).

\(^9\) Das, Koushan. (February 1, 2018).
labor costs, strategic location, and political stability as strategic reasons to continue investing in Vietnam.

**While labor costs in Vietnam are higher than in regional comparator countries, unit labor costs (labor costs/ value added) remain relatively modest.** As reflected in Figure 5, although unit labor costs are higher than in China, India, the Philippines and Malaysia, they are lower than in the other Southeast Asian as well as Brazilian and Russian economies. Benchmarking against these comparator countries suggests that Vietnam’s relatively higher labor costs are not disconnected from productivity. And, as the continued increase in foreign investment indicates, labor costs remain a relative advantage for foreign investors shifting labor-intensive portions of their supply chain into the country.

![Figure 4: Labor Costs](image)

![Figure 5: Unit Labor Costs](image)

Source: Akhlaque et al.

In addition to low unit labor costs, foreign investors are attracted to the strategic geographic location of Vietnam. This remains particularly true for foreign investors interested in shipping into, or out of, the Chinese, Korean, and Japanese markets—three of the largest import and export partners for Vietnam (see Figures 6 and 7). Collectively, China, Korea, and Japan accounted for $122bn (or 57%) of total imports and $67bn (or 31%) of total exports in 2017. The United States,

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11 Akhlaque et al.
another major trade partner for Vietnam, accounted for $9bn (or 4%) of total imports and $42bn (or 19%) of total exports in 2017.12

With forty-four seaports capable of handling capacity of 470-500mm tons per year, major ports located near Hanoi (Hải Phòng) and Ho Chi Minh City, and industrial zones to accommodate foreign investment operations, Vietnam has used its strategic geographic location to welcome investors from its larger and more developed Chinese, Korean, and Japanese neighbors.

**Another reason cited by foreign investors to invest in Vietnam is its relative political stability.** Since the initiation of the Doi Moi reforms in the 1980s, the CPV has maintained regulation that supports foreign investment into the country and has provided a consistently supportive environment for foreign business. The current legal framework for investment is comprised of the Law on Enterprises and the Law on Investment, which collectively regulate both domestic and foreign investment. The Law on Private Enterprises was introduced in conjunction with the Companies Law in 1990 but was superseded by the Law on Enterprises in 1999; this introduced partnerships, limited liability companies, and shareholding company structures into the legal fray. The Law on Foreign Direct Investment was first introduced in 198715 and has evolved into the

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Law on Investment through many subsequent amendments. While consistent in relevant policy measures, the country’s one-party political system also has provided an additional layer of security. This favorable political environment – with a stable, predictable outlook – makes Vietnam a very attractive investment destination relative to regional comparator countries.

The Role of the International Community

The international community, as represented by the World Bank Group and the International Monetary Fund (IMF), has been working in partnership with Vietnam since 1993. As of September 2019, the World Bank has committed a total of $24bn in loans, credits, and grants through 168 projects in Vietnam. The extensive 30-year partnership recently led to a seminal report prepared jointly by the World Bank and the Ministry of Planning and Investment of Vietnam (MPI), titled Vietnam 2035: Toward Prosperity, Creativity, Equity, and Democracy (“Vietnam 2035”).

Published in 2016, Vietnam 2035 reflects on the 30 years of reform since Doi Moi and focuses on key ongoing transformations that will help Vietnam achieve its development goals for the next couple of decades. With significant support from the Communist Party of Vietnam (CPV), lead authors included the former Vice Minister of Planning and Investment, the former Vice Minister of Justice, the Secretary General of the Vietnam Association of Economics, the former Vice President of the Vietnam Chamber of Commerce and Industry (VCCI), and the Vice President of the Central Institute for Economic Management (CIEM). The final report was signed by Nguyễn Tấn Dũng, Prime Minister of Vietnam. His signature and the broader CPV support for the reported suggested that the government was receptive to its conclusions and that it might provide a policy roadmap for short- and medium-term policy priorities.

Trade and the Open Economy

Through the series of reforms stemming from Doi Moi in 1986, Vietnam has become one of the most open economies in the world. Vietnam acceded to the WTO in 2007 and is a member of the Association of Southeast Asian Nations (ASEAN) and the ASEAN Economic Community.

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17 Cao et al.
In addition, Vietnam has signed 16 bilateral and multilateral free trade agreements (FTAs). The European Union-Vietnam Free Trade Agreement (EVFTA), the Regional Comprehensive Economic Partnership (RCEP)—a proposed FTA between the ten member states of the ASEAN, and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), represent the most recent multilateral trade efforts to which Vietnam has subscribed. In conjunction with the consistent legal reforms pushed by the CPV, these FTAs establish Vietnam’s commitment to further economic and trade integration, and bring economic opportunity to the Vietnamese people.

In conjunction with its consistent push to have a more open economy, Vietnam has also been a beneficiary of several trends emerging in China. According to the IMF, “In recent years, international firms have been moving facilities to Vietnam in response to rising costs in China and the desire to diversify production locations”. As shown in Figures 4 and 5 referenced earlier, labor costs are now approximately twice as high in China as in Vietnam, even though unit labor costs are relatively comparable. For foreign investors looking for a cheaper option for the low value-add, labor-intensive parts of their supply chains, Vietnam has been a more attractive option.

In addition to lower labor costs, Vietnam benefits from increasing policy uncertainty in China. Figure 8 highlights the highly positive relationship between policy uncertainty in China and FDI inflows into Vietnam. As demonstrated, Vietnam has been a long-term beneficiary of increasing policy uncertainty, a trend that has been accelerated by recent trade tensions between China and the United States. Year-over-year from April 2018 to April 2019, the U.S. reduced goods imports from China by more than 10% and correspondingly increased goods imports from Vietnam by close to 40%. According to latest estimates from the General Statistics Office (GSO), manufacturing production increased 10.4% from 2018 to 2019, partially as a result of shifting trade relationships. Based on additional analysis by Nomura, a Japanese bank, Vietnam’s export market has been the biggest beneficiary of the ongoing US-China Trade War.

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10 the country gained approximately 7.9% of GDP from additional Chinese and American imports attributed to the recent trade tensions.

Figure 8: FDI Inflows and China Policy

Figure 9: U.S. Goods Imports

Figure 10: Vietnam Gains 7.9% of GDP from Additional U.S. and China Imports

FDI inflows as a result of the trade tensions have been driven by regional multinational corporations as well as large U.S.-based companies. Asian manufacturers such as Kyocera, Samsung, and Sharp are shifting elements of their supply chains into the country. Other international electronics and consumer goods manufacturers have announced similar moves. Chinese companies such as GoerTek, Guizhou Tyre, HL Corp, and TCL, as well as Japan’s

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23 Shrikanth, Siddharth.
Nintendo and America’s Dell and Home Depot have announced or already launched plans to expand manufacturing activity in the country. Google, which will soon manufacture its Pixel phone in Vietnam, and Apple, which began trial production of its AirPods in Vietnam, have similar intentions. In the first three quarters of 2019, an estimated 61 companies announced shifting production, sourcing from, or increasing capacity in Vietnam. Malaysia and Thailand ranked a distant second and third with 19 and 16 company mentions, respectively.

Emerging Challenges for Vietnam

Vietnam’s success over the last thirty years does not portend future economic growth and sustainability. As Vietnam continues to develop, there are a number of emerging risks to its export-led and foreign investment-driven growth model. As cited by the World Bank,

“there are signs that the current growth model is facing emerging structural constraints. Growth has become increasingly reliant on factor accumulation (rising investment and a growing labor force), with a declining contribution from productivity growth. Productivity growth is impaired by a large state-owned sector, incomplete market institutions, and a cumbersome investment climate that is hampering private sector development.”

In addition, Vietnam will face demographic and environmental challenges. Much like China, Vietnam’s dependency ratio is projected to rise substantially over the next thirty years. Figure 11 shows historical and projected adjusted dependency ratios for Vietnam, China, and South Korea normalized for development time (South Korea 1963, China 1978, Vietnam 1986). While the country is better positioned today in 2020 than China was approximately ten years ago (t=35), this demographic advantage will fade away over the next thirty years. By 2050, Vietnam will have more people over the age of 60 than it will have between the ages of 15-59. Today, less than one in five working-age adults are over the age of 60.

28 This ratio is defined as follows: Adj. PDR = (Population Ages 0-14 + Population Ages > 65) / Population Ages 15-65 X 100, and is a measure of how many people from the non-working (dependent) population each person in working age has to maintain (on average).
Creating additional difficulty for the CPV, rapid economic development—both in terms of industrial output and urban transportation—has also generated high levels of pollution, particularly in the urban areas of Hanoi and Ho Chi Minh City. The Mekong Delta, in Vietnam’s south, is also highly susceptible to the effects of rising sea levels caused by global climate change.
Section III: Problem Statement

Risks to Vietnam’s Current Development Model

While much of the early gains of Vietnamese growth were driven by the country’s structural transformation, Vietnam’s export-led and foreign investment-driven growth model has successfully ensured macroeconomic stability and provided factory jobs to Vietnamese workers, thus raising income levels throughout the country.

Because Vietnam’s export growth has been heavily concentrated in the electronics sector, we first sought to determine whether overspecialization might present any meaningful risks. These could include stagnant global demand, sudden changes in terms of trade, or supply chain disruptions—similar to what Vietnam is currently experiencing with the COVID-19 pandemic.31 In 2010, the electronics sector comprised approximately 14% of Vietnam’s total export basket; by 2017, the sector comprised 38% of total exports.32 Figure 12 below details this concentration in export growth.

Figure 12: Concentrated Growth in Vietnamese Exports33

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However, if we remove the electronics sector from Vietnam’s export basket (see Figure 13), Vietnam’s export growth is still impressive. In fact, over the last seven years Vietnam has doubled its non-electronics exports at an annual growth rate of over 10%. Mineral exports represent the only sector that has experienced a drop since 2010.

Figure 13: Sustained Growth in Non-Electronics Exports

Moreover, Vietnam’s electronics sector appears to be well-diversified in its export partners and moderately diversified in its import partners (see Figures 14 and 15). While concentrated import reliance is to be expected (especially given the high number of intermediate inputs being reported), the lack of domestic alternatives—a problem we will turn to shortly—exacerbates the issue.

Figure 14: Export Partners, Electronics
Figure 15: Import Partners, Electronics

34 The Growth Lab at Harvard University.
35 The Growth Lab at Harvard University.
36 The Growth Lab at Harvard University.
We also sought to determine whether Vietnam was at risk, not of *over*-specialization but of *inefficient* specialization. Is Vietnam producing low value-added products (i.e. ubiquitous products that a lot of poor countries can produce), or is Vietnam producing high value-added products (i.e. rarer products that only richer countries produce); this theoretical framework provides the backbone for the Harvard University Center for International Development’s complexity analyses. Figure 16 maps Vietnam’s export growth rates by product (y-axis) against the product complexity (x-axis). While there has been some pick-up in agricultural products and textiles, much of Vietnam’s export growth has come in higher-complexity products like electrical and industrial machinery.

Figure 16: Growth in Higher Complexity Product Exports

Figure 17 offers a more detailed look at the electrical machinery and equipment product group and shows that the majority of Vietnam’s export growth has come from products with a complexity score of greater than 0.5 (i.e. the product is 0.5 standard deviations more complex than the average 4-digit HS product produced).

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38 The Growth Lab at Harvard University.
As Figure 18 details, Vietnam has also continued to add new products to its export basket, a strong signal of the country’s technological and productive capabilities. Vietnam has added 50 new export products over the last fifteen years, four fewer than China despite having less than one tenth of its population.

A broader look at Vietnam’s export basket reveals high underlying complexity scores for many of its exports. As detailed through Figures 19 and 20, the high underlying complexity scores for its exports has driven a steady rise in Vietnam’s overall economic complexity ranking from 116th in 1995 to 57th in 2017.

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40 The Growth Lab at Harvard University.
Sustaining Vietnam’s Development Model

Sustained export growth across sectors, a diversity of import and export partners, and increasing complexity indicate that Vietnam has a successful development model already in place. Our attention therefore turns to its sustainability. How can Vietnam mitigate the risks associated with a reversal in FDI? As labor costs continue to rise, what improvements must be made to ensure that Vietnam remains a viable market for foreign direct investment opportunities? Finally, how can Vietnam best internalize the lessons learned from foreign firms so that technological knowhow properly diffuses throughout the economy?

To answer these questions, we traveled to Vietnam where we spent two weeks meeting with policymakers, business associations, multilateral institutions, policy analysts, academics, former executives, and most importantly, foreign-owned companies operating in the electronics industry. Before each of our respective meetings with five foreign-owned companies (see Appendix 4), we shared a list of prepared questions that would serve as a guide to our interviews (see Appendix 5).

Interview Findings

For company confidentiality, we have aggregated our interview findings and anonymized specific comments. As elaborated in Section II, foreign firms operating in Vietnam appear to have been enticed by attractive government incentive programs. Tax holidays, preferential

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41 The Growth Lab at Harvard University.
transportation/logistics access, and in one rare case, a government grant have all been instrumental in courting foreign direct investment to the country. Other factors included: Vietnam’s strategic location, access to affordable land in industrial parks, foreign language skills, political and social stability, and free trade agreements. Vietnam has benefitted from corporate decisions to consolidate supply chains and to focus outsourced production on a smaller number of countries. When asked about barriers to future investment, most companies cited exogenous concerns such as pressures from weakened global demand. No company expressed any imminent review of its foreign investment plans, a positive sign of continued FDI in Vietnam over the medium-term.

Looking further ahead, foreign firms cited i) the lack of domestic suppliers and ii) the level of human capital as their biggest business challenges. Importing the bulk of electrical components and machines can create supply chain frictions that weigh on corporate profitability, which naturally affects the profitability of future investment and expansion opportunities in Vietnam. Our conversations indicated that foreign companies would welcome the opportunity to work with high-quality and reliable domestic suppliers; however, it is not clear that there are many that satisfy foreign firms’ production requirements.

Foreign-owned electronics companies do source some inputs locally. Notably, these inputs tend to be low-complexity products and services. For example, cardboard packaging, foam inserts, and plastic wrap were the most commonly cited domestic goods inputs. Foreign companies also consume local services, such as security, custodial, and cafeteria. While foreign firms used local logistics companies to transport finished products from the factory to the port, the Government of Vietnam (GoV) has historically forbidden foreign ownership within the logistics industry.43

While some companies claim to have a higher domestic value-added share, it becomes quite clear that many “local” suppliers are in fact foreign-owned firms that have relocated some of their production activity to Vietnam. Anecdotally, we heard that Samsung might be overstating its domestic value-add by thirty-five percentage points because it counts foreign suppliers with Vietnamese-based subsidiaries as “local”.

Box 1. The Relocation of Samsung Suppliers

Samsung Electronics Vietnam was founded in 2008 when it invested $670mm in a mobile phone manufacturing factory in Bắc Ninh province outside of Hanoi. Since then, Samsung has invested over $17bn across eight factories, including the largest household electronics factory in Southeast Asia.

Given the scale of the company’s production and operations in Vietnam, it has naturally been a consumer of intermediate goods and components for the products it exports to the rest of the world. Samsung had historically relied on its Korean supply chain for those intermediate goods, but when its lower value-added activities moved to Vietnam, transportation and logistics costs increased. Instead of continuing to source intermediate goods in Korea, Samsung chose to capitalize on existing supply chain relationships, and advised its suppliers to open production facilities in Vietnam. The World Bank reported that “Samsung…relies primarily on Korean intermediate [Tier I] suppliers which have co-located in Vietnam, with only 4 Vietnamese suppliers out of 67 total suppliers to Samsung (i.e. 53 from Korea, 7 from Japan, 1 each from Malaysia, Singapore, and the UK).”

Lack of skilled labor also appears to be limiting foreign firms’ abilities to relocate more complex production activities such as R&D to Vietnam. While this educational component is not the focus of our recommendations to the Ministry of Planning and Investment, the availability of skilled workers also inhibits the domestic private sector from establishing links to foreign firms.

Low Domestic Value-Added

To provide a comparative picture of the depth of domestic supply chains, we leveraged the OECD’s Trade in Value Added (TiVA) database. While this database aggregates across both

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45 Akhlaque et al.
product types (low complexity and high complexity products) and type of firm (FDI, SOE, or domestic private sector), it provides a useful proxy for the domestic value-added content in total exports. Figure 21 provides an overall picture of domestic value-added, which expectedly shows significant growth in line with Vietnam’s export growth, particularly in electronics.

Moving from the extensive margin to the intensive margin, Figure 22 illustrates domestic value-added as a percentage of gross exports across total exports, manufacturing, and three sub-categories within manufacturing, Vietnam ranks dead last among its East and Southeast Asian peers in all.

Figure 21: Domestic Value-Added ($bn, 2005-2016)\(^{46}\)

Figure 22: Domestic Value-Added Share of Gross Exports, by Sector\(^{47}\)

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\(^{47}\) OECD.
Low levels of a domestic value-added share are a problem, but Vietnam’s downward trend is even more concerning. While the domestically-produced portion of total exports has dropped ~7.5 percentage points over the last eleven years, the value-added share within electronics has dropped over 14 percentage points.

Figure 23: Domestic Value-Added Share of Gross Exports, Total

![Figure 23: Domestic Value-Added Share of Gross Exports, Total]

Figure 24: Domestic Value-Added Share of Gross Exports, Electronics

![Figure 24: Domestic Value-Added Share of Gross Exports, Electronics]

**Bypassing the Constraint: Local Development Teams and Internship Training**

When companies are faced with a business constraint, we are likely to observe them devising solutions or setting up their own work-arounds. In our five meetings, we identified such behavior that we classified into one of two categories: local development programs and internship training.

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48 OECD.
49 OECD.
One of the five companies detailed a local development team whose sole job was to source potential suppliers and onboard those that were best-equipped to supply the firm. The company tracked the percentage of local content across its product set and was tasked with saving money by identifying local suppliers and raising the domestic content percentages across each product. This team worked on finding capable Vietnamese suppliers, as well as advising foreign suppliers who could set up a production facility in Vietnam (similar to the Samsung case described earlier). According to management, it would take at least one year to develop the requisite skill and meet production standards to be named an official supplier.

We also met with two companies which have addressed the limited supply of skilled labor by designing internship programs in coordination with local universities. By partnering with local universities, these foreign firms can find top talent while also advising professors and university administrators on the skills that students should learn to best prepare themselves for the job market. For one of these firms, students start interning in their second year of undergraduate studies and work part-time throughout the rest of their university experience. Because this program was only recently established, there was little track record to evaluate program efficacy.

Formulating a Problem Statement
In order to sustain Vietnam’s foreign direct investment- and export-driven development model, the GoV needs to sufficiently address constraints facing its foreign firms—namely adequate access to domestic private sector supply chains and the availability of skilled labor. While both constraints proximately constrain the level of foreign direct investment, they also appear to be symptoms of a deeper problem. The lack of technological diffusion within Vietnam’s electronics industry is limiting the country’s ability to upskill before its demographic window begins to close.

Vietnam has a weak domestic private sector that is constrained both by an FDI- and SOE-centric business environment and the lack of skilled labor. At the same time, the majority of Vietnam’s foreign investors operate in the electronics sector—a high-skill industry with high barriers to supplier entry. Not only do these original equipment manufacturers (OEMs) hold suppliers to some of the highest quality and reliability standards, but they often require that the majority of Tier I suppliers hold patent protection on supplied parts and components. The Vietnamese domestic
private sector and its labor force have struggled to keep pace, creating an environment where foreign firms have been forced to import intermediate goods and relocate their existing suppliers to Vietnam. Given the level of physical inputs and technological knowhow that is imported into Vietnam, the economic complexity statistics cited above likely overstate Vietnam’s domestic capabilities given that assembly line manufacturing skills are fungible across product type.

Put simply, Vietnam’s development has outpaced its domestic capabilities.
Section IV: Theoretical Framework and its Application to Vietnam

Introduction to Theoretical Framework

To assess how we might improve the potential for linkages and spillover from FDI into the domestic private sector in Vietnam, we leverage the conceptual framework presented by Farole and Winkler (2014). While initially targeting FDI spillovers and global value chains (GVC) in Sub-Saharan Africa, we reference its application by the World Bank in “Vietnam: Enhancing Enterprise Competitiveness and SME Linkages” (2017).

Importantly, creating linkages is not automatic as there are typically a series of supply-side constraints and market failures that hinder the process. The linkage process itself “is a function of multiple factors that include (i) the spillover potential of FDI, (ii) the absorptive capacity of domestic firms, as well as (iii) the host country’s business policy and institutional environment.”

In detailing these factors, the World Bank offers the following synopsis:

“The spillover potential of foreign investors is affected by degree and structure of foreign ownership, FDI motive and global production and sourcing strategies of GVCs. This includes the extent to which FDIs share their blueprints and guide suppliers on how to meet them, and the nature of technology that multinational enterprises bring, for examples. Absorptive capacity or ability to absorb foreign technology and knowledge is in turn shaped by characteristics of domestic firms i.e. technology gaps between foreign and domestic firms, R&D, human capital, firm size, exporting sector dynamics, competition, and type of ownership. Policies at host country level can range from labor market regulations, intellectual property rights, access to finance, learning and innovation infrastructure, trade and investment policy, institutions and governance, and competition. All these processes are interdependent and dynamic. For instance, changes in domestic firm characteristics and/or host country policy changes can influence foreign investors’ production and sourcing strategies.”

50 Akhlaque et al.
51 Akhlaque et al.
To assess where there might be room for policy reform to improve linkages and spillover from FDI, we analyze each of the three factors highlighted by Farole and Winkler, summarized below.

Figure 25: Analysis of Potential for Linkages

<table>
<thead>
<tr>
<th>Potential for Linkages</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spillover potential of FDI</td>
<td>High</td>
</tr>
<tr>
<td>Absorptive capacity of domestic firms</td>
<td>Low</td>
</tr>
<tr>
<td>Vietnam's business policy and institutional environment</td>
<td>Medium</td>
</tr>
</tbody>
</table>

Spillover potential of foreign investors

The spillover potential of foreign investors, particularly in the electronics industry in Vietnam, appears to be high. A market-friendly policy approach of the last few decades has led to the proliferation of technologically-productive foreign firms operating in Vietnam, many of whom express desire to work more closely with local suppliers. As referenced earlier, in one such example a foreign firm had a "Local Development" team specifically tasked with increasing the percentage of local parts for products assembled in Vietnam.52 Guided by efforts like these, domestic suppliers would access the blueprints of international firms and gain insight into the international standards required to supply into the global value chains. Many other multinational companies have similar efforts, suggesting that foreign firms are making proactive efforts to forge linkages with domestic firms.

Early in the country’s development process, the GoV encouraged joint ventures between foreign investors and domestic firms. Projects like the Samsung Electronics – Trade Import Export Electronics Co. joint venture of 199453 presented unique opportunities for technology transfer. Although Vietnam has moved away from these interventionist efforts, it has opted instead for a more market-friendly business environment without restrictive covenants on foreign investors.

52 Authors’ interviews.
Nevertheless, the proportion of foreign-owned firms using domestic inputs remains markedly lower in Vietnam than it does in comparator countries (see Figure 26). Several other peers have foreign investment policies that mandate local content and ownership requirements in order to sell products domestically. Vietnam, on the other hand, is an export-oriented production center. While foreign investors in Vietnam might have local development efforts in place, they are still largely looking to Vietnam as a low-cost destination from which to sell abroad.54

Figure 26: Proportion of Foreign-Owned Firms Using Domestic Inputs55

Absorptive capacity of domestic firms

Alternatively, the absorptive capacity of domestic firms in Vietnam appears to be very low and, in our opinion, is the most binding constraint to linkage and spillover. There exists a large technology gap between foreign and domestic firms. Even with “Local Development” efforts in place, only ~10-20% of the parts for products assembled in Vietnam are sourced domestically, and of those nearly all are sourced from international companies with operations in Vietnam.56 Correspondingly, only ~1-2% of the parts for products assembled in Vietnam are sourced domestically from Vietnamese-owned companies. The latest Enterprise Survey data indicates the reason for this discrepancy. While half of the foreign-invested firms in Vietnam hold an internationally-recognized quality certification, less than 10 percent of domestic firms do.57

In addition to large technological gaps between foreign and domestic firms, there exist gaps in human capital that create challenges for domestic firms. On average, despite having a higher

54 Akhlaque et al.
55 Akhlaque et al.
56 Authors’ interviews.
57 Akhlaque et al.
proportion of skilled production workers and providing more formal training to their employees, firms linked into the foreign investors are found to “consider that an insufficient skills and education level of the workforce is a major constraint.”\textsuperscript{58} A critical issue for Vietnamese domestic firms is a lack of visibility into the international standards and expectations of quality that are required to supply into global value chains. Firms linked into the foreign investors recognize this deficiency and are thus better able to make steps to address it.

\textit{Business policy and institutional environment}

\textbf{Despite the CPV’s supportive business environment, there remain policy and institutional environment challenges that, if resolved, could support linkages and spillover from FDI.} Results from the latest World Bank Enterprise Survey (2015) are shared in Figure 27 below and highlight the differences in challenges facing the firms linked into the foreign sector and those that are non-linked. The results suggest non-linked domestic firms find the informal sector, access to finance, and transport and telecommunication services as the most severe obstacles or constraints. Conversely, linked firms identified workforce education, corruption, and trade regulations as the biggest constraints.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure27.png}
\caption{Business Environment Constraints Perceived as Serious Obstacles\textsuperscript{59}}
\end{figure}

\textsuperscript{58} Akhlaque et al.
\textsuperscript{59} Akhlaque et al.
In addition to the business environment constraints referenced above, a lack of balanced policy support also appears to crowd out the domestic private sector. Despite the apparently equal legal support for FDIs, SOEs, and the domestic private sector, private firms are consistently disadvantaged access to resources such as land and capital.\textsuperscript{60} Essentially, in creating an attractive environment for FDI, the GoV has also tilted the playing field away from domestic private firms.

In the 2020 edition of the “Doing Business” report, the World Bank ranked Vietnam the 70\textsuperscript{th} easiest country in the world in which to do business, down one position from its 2019 ranking of 69\textsuperscript{th}.\textsuperscript{61} Nevertheless, with an open economy, and a government indicating ongoing support for private sector development in Vietnam, the business policy environment will continue to improve. As such, while there appears to be some space for policy to support the spillover potential of foreign investors and the business policy environment, the biggest gap appears to exist in the absorptive capacity of domestic firms. Our policy recommendations are formed accordingly.

\textsuperscript{60} International Monetary Fund. (July 2019). \textit{IMF Country Report No. 19/235. Vietnam 2019 Article IV Consultation.}

Section V: Stakeholder Analysis

In assessing the environment for policy reform, it is vital to have a clear understanding of the key stakeholders, their interests, resources, and resource mobilization capacity. Addressing industrial policy issues in Vietnam means there are a series of varied interests and powers. Figure 28 summarizes this stakeholder group and begins to assess their ability to mobilize resources in their interest. See Appendix 2 for a mapping of the below stakeholders.

<table>
<thead>
<tr>
<th>Refining Vietnamese industrial policy</th>
<th>Stakeholders</th>
<th>Interest</th>
<th>Resources available</th>
<th>Resource mobilization capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minister of Planning and Investment</td>
<td>Continued, sustainable socio-economic development of Vietnam; political approval</td>
<td>Executive authority; Staff, budget, and internal MPI resources</td>
<td>High; can mobilize necessary resources with ministerial authority</td>
<td></td>
</tr>
<tr>
<td>Prime Minister, Nguyễn Xuân Phúc</td>
<td>Continued, sustainable socio-economic development of Vietnam; political approval</td>
<td>Staff, budget, and resources of the full Vietnamese government</td>
<td>High; can mobilize necessary resources with full governmental authority</td>
<td></td>
</tr>
<tr>
<td>Provinicial governments</td>
<td>Continued, sustainable socio-economic development of province; national and provincial political recognition</td>
<td>Policy-making authority; staff, budget, and resources of the provincial government</td>
<td>Mixed; can mobilize resources with provincial authority; subjugated to federal government</td>
<td></td>
</tr>
<tr>
<td>Multi- or bi-lateral development orgs (e.g. WBG, IMF, USAID)</td>
<td>Continued, sustainable socio-economic development of Vietnam</td>
<td>Staff, budget, and resources of the organization; ear of the international community; provision of funding</td>
<td>Mixed; can make funding conditional and has the ear of the international community; no direct policy influence</td>
<td></td>
</tr>
<tr>
<td>International firms (e.g. Samsung, Intel, Foxconn)</td>
<td>Profitable investment opportunities; channels for profitable export</td>
<td>Provision of employment, money, international prestige</td>
<td>Mixed; big investors have significant influence; responsive to Vietnamese policy and economic opportunity</td>
<td></td>
</tr>
<tr>
<td>VCCI and business associations</td>
<td>Expansion of business opportunities for domestic private sector; leveling of the playing field for domestic firms</td>
<td>Large private sector membership; political lobbying power</td>
<td>Mixed; can mobilize private sector membership; quasi-governmental</td>
<td></td>
</tr>
<tr>
<td>Vietnamese people</td>
<td>Continued livelihood improvement; long-term employment opportunities</td>
<td>Labor, incomes, voice, limited organizational resources</td>
<td>Limited; weak political voice and limited capacity to mobilize</td>
<td></td>
</tr>
</tbody>
</table>

The key stakeholder in any industrial policy issue in Vietnam, is the Ministry of Planning and Investment. Per its official charter, the MPI is charged with performing

“the functions of state management over planning, development investment, and statistics, including the provision of general advice on strategies, master plans, plans for national socio-economic development and public investment; on mechanism and policies for economic management; on domestic investment, foreign investment into Vietnam and Vietnam’s investment abroad; economic zones; on official development assistance (ODA) source, preferential loans and foreign non-governmental aids; on bidding; on development of enterprises, collective economy and cooperative sector; on statistics; performs the state
management over public services in sectors, fields under its state management as prescribed by laws.”\textsuperscript{62}

Beyond its official mandate however, there are external pressures on MPI, as on any government body, to receive political support for its actions. The MPI has the executive powers authorized to it (as enumerated above), as well as an annual budget and staff that it has the capacity and ability to mobilize in its interests.

**The Ministry of Planning and Investment reports to the Prime Minister, who maintains a similar interest in the continued, sustainable socio-economic development of Vietnam.** With that said, the Prime Minister notably has a political responsibility to the President. Ultimately, while the Prime Minister is the Head of Government, he is elected or dismissed by the National Assembly, at the request of the President. While the Prime Minister thus has considerable resources over the full Vietnamese government, he is constrained politically by his responsibilities to the President, and correspondingly to the General Secretary of the CPV. See Appendix 1 for a detailed overview of the Vietnam’s political structure.

**The provincial governments in Vietnam are another meaningful stakeholder in addressing industrial policy reform.** While the federal government has ultimate authority over nationwide industrial policy, provincial leaders have their own levers to attract foreign investment, register land, and enforce regulations. Provincial governments ultimately have a similar interest in the continued, sustainable socio-economic development of their province and can mobilize provincial resources accordingly. However, individual provincial government leaders might harbor separate political and career ambitions, potentially conflicting with national policy objectives.

**As described earlier, multi- and bilateral development agencies have played a long-term role in Vietnam.** The World Bank for instance, has partnered with the government since 1993, and launched its landmark Vietnam 2035 report alongside MPI in 2016. Generally, the multi- and bilateral development agencies share an interest in the continued, sustainable socio-economic

development of Vietnam. However, given they also have a larger role in the “international community”, they wield less mobilization capacity within the borders of Vietnam and may have interests that conflict with those of the Vietnamese government.

**International firms, both current and future investors in Vietnam, have an interest in increased profit potential and can wield outsized political influence.** In choosing Vietnam as the destination for meaningful parts of its supply chain in 2007, Samsung assessed the tax incentives offered by the government in addition to Vietnam’s low cost of labor, strategic geographic location, and political stability—all key factors to increased profitability for the company. With tens of billions of dollars invested into its operations, and well over 100,000 Vietnamese employees, Samsung wields significant influence on the Vietnamese government. While Samsung is the largest international investor in Vietnam, other large or landmark international investors have similar influence in the country. The CPV aims to keep these foreign investors invested in Vietnam, and so they benefit not only from the incentive programs but from an ear of the CPV.

**The Vietnam Chamber of Commerce and Industry (VCCI) as well as its business association members represent another meaningful stakeholder in issues of industrial policy.** Representing the businesses that make up the Vietnamese domestic private sector, they have an immediate interest in improving the business environment and leveling the playing field between the domestic and the international investors. While VCCI can wield meaningful political power, it remains a quasi-governmental institution and so ultimately its interests must align with the government.

**As with any policy reform in the country, the ultimate beneficiary is the people of Vietnam.** The people share the interest in continued, sustainable socio-economic development of the country, only so much as it equates to improved livelihood and long-term employment prospects. They have limited resource and limited capacity to mobilize, however can find ways to exercise a political voice through other channels such as provincial and local governments, business associations, and budding civil society organizations.

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63 Authors’ interviews.
Section VI: Policy Recommendations

In Figure 29 below, we have summarized a list of potential policy recommendations that result from our analysis. Based on our theoretical framework, we have characterized each potential recommendation by its ability to address the spillover potential of FDI, the absorptive capacity of the domestic private sector, and deficiencies in the business policy and institutional environment. We also assess each proposal against the measures of technical correctness, administrative feasibility, and political supportability.

Figure 29: Analyzing the Potential Policy Solutions

<table>
<thead>
<tr>
<th>Potential Policy Solutions</th>
<th>Technically Correct</th>
<th>Administratively Feasible</th>
<th>Politically Supportable</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Targeting the Spillover Potential of FDI</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>“Localization” - Increase localization requirements on foreign investors to ensure a higher proportion of components are manufactured and sourced domestically</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>“Local Development” department - support efforts of foreign investors to create “local development” teams</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Sponsor an FDI survey</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Establish local R&amp;D spending requirements to achieve priority enterprise status</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td><strong>Targeting the Absorptive Capacity of Domestic Private Sector</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund the establishment of a Business Advisory Council comprised of retired supply-chain experts to mentor in a high-touch engagement with domestic firms</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Reform existing SME support programs to focus on information and skills development / subsidize trainings related to enhancing global managerial skills</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Support and provide funding for the development of technical schools alongside foreign firms</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Campaign to encourage Vietnamese-American diaspora to invest in Vietnam</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td><strong>Targeting the Business Policy and Institutional Environment</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reform existing anti-corruption and transparency initiatives</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Promote independence for existing quasi-governmental business associations</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Improve support systems available for policy-makers to ensure written business law is comprehensive and effective</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Modernize education curricula and invest in further tertiary education programs</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Reform existing land ownership law to permit increased private ownership of land for domestic private firms</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
</tbody>
</table>

**Detailed Policy Recommendations**

In analyzing potential policy solutions, we revisit our theoretical framework to understand which policy solutions will explicitly address the failure of the low absorptive capacity of
**domestic firms.** We also cross-reference these policy proposals against those that we believe fall within the MPI’s mandate. Highlighted in green in Figure 29, our first two policy proposals specifically aim to upgrade the capacity of firms in the domestic private sector and enable them to participate in global value chains. Highlighted in yellow in Figure 29, we also analyze a potential policy solution regarding local content requirements. While such a direct policy intervention is financially inexpensive and popular in the region, we illustrate why local content requirements may fail and how they may even undermine Vietnam’s development agenda.

**Policy Proposal #1: Fund the Establishment of a Business Advisory Council**

*Description:* The lack of competitive local suppliers able to meet the international quality standards required for manufacturing in the global value chain for electronics is a first-order binding constraint to the maturing of the Vietnamese domestic private sector. Until local suppliers can provide the consistent quality of inputs required by foreign investors, Vietnam will remain a destination only for low value-added supply chain activities like assembly and packaging. Consisting of a handful of experienced supply chain experts, the establishment of a Business Advisory Council, which transfers advisor knowledge of global standards in electronics manufacturing otherwise unavailable to domestic firms, would address this systemic deficiency.

*Technical Correctness:* Specifically, deploying experts who built careers in the global electronics supply chain to serve in a high-touch capacity with domestic SMEs would support domestic firms in better responding to the global business standards demanded of them. These experts would share their knowledge and awareness of global standards in electronics manufacturing and be able to advise the development of internal firm capacity to meet those global standards. The Business Advisory Council should be viewed as an effort to encourage the direct diffusion of knowledge that remains otherwise unavailable to domestic firms.

We envision the “experts” represented on the Advisory Council as Vietnamese nationals who have spent considerable time throughout their careers in the global electronics manufacturing industry outside of Vietnam. Ideally, these experts would have professional experience in procurement at large multinational OEMs or in the international Tier I and Tier II suppliers into multinational

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OEMs. They are likely late-career or retired professionals with an interest in the maturing and development of Vietnamese industry.

Notably, while well-targeted, such an intervention may not achieve the scale necessary to have meaningful public policy impact, at least in the short-term. Plans to scale up a Business Advisory Council over time would be contingent upon early success, eventually including a data analytics team and middle- and back-office support that would require additional resource allocation.

Administrative Feasibility: Funding the establishment of a Business Advisory Council is a particularly attractive policy option because of its administrative feasibility and the ease of proposed implementation. The resources (personnel, funding, and time) required by the Ministry of Planning and Investment to support such a program are relatively small. To implement, the MPI needs to seek out the right international supply-chain professionals, encourage them to commit time to supporting Vietnamese domestic companies, and if appropriate, allocate funds for the provision of compensation tied in part to individual advisor effectiveness.

Securing the funding required to sponsor the program, as well as recruiting the appropriate supply-chain professionals for the Council stand out as the two most significant challenges in implementation. Our concerns regarding the funding are mitigated somewhat by the understanding that the funding required would be relatively small, including only allocations for compensation of MPI personnel tasked with management of the council, compensation of individual advisors, and any corresponding travel, accommodation, and administrative costs associated with running the program. Costs could also be minimized by selecting only those advisors who narrowly meet strict criteria for participation. As the program pilots, this is likely an appropriate starting point.

Political Supportability: Partly due to its administrative feasibility, the establishment of a Business Advisory Council is also politically supportable. The initiative aims at leveling the playing field for domestic private firms and does so without intruding on the interests of the foreign investors or state-owned enterprises with whom the CPV is intent on maintaining favorable relationships. Foreign investors and SOEs currently benefit from an unequal playing field for domestic firms but importantly, they would both benefit from a stronger domestic private sector with the capacity to
make products that meet global quality standards at lower cost. As such, in assessing the interests of the key stakeholders mentioned above, it is not clear that any would harbor strong opposition to the establishment of such a Business Advisory Council. One might even worry that political support will be too strong and that the Council will not be politically insulated from the GoV and the MPI. Ensuring both financial and technical support from multilateral and bi-lateral development organizations will help with an effective implementation strategy.

Policy Proposal #2: Reform Existing SME Support Programs to Focus on Information and Skills Development

*Description:* As demonstrated in the World Bank Enterprise Survey, domestic SMEs acknowledge that a lack of workforce skills is one of the biggest impediments to forging business links with foreign investors. Domestic firms cite challenges related to foreign language, management, and technical skills, as well as a disconnect between foreign investors and the domestic firms that results in a lack of knowledge transfer.\(^65\) Notably, between just three ministries (MPI, MoIT, and MoST) there exist 28 major SME support programs already in operation to attempt to resolve these deficiencies. Despite the breadth, there is only one training-specific SME support program aimed at developing business management skills, and on skill development, the Supporting Industry Development Program remains vague.\(^66\) Reforming these programs to align their work and prioritize the most significant constraints to domestic firms should be of highest priority for the Ministry of Planning and Investment.

*Technical Correctness:* The experience of the Thanh Long Electronics Production Company (“Thanh Long”) highlights the need for more focused SME support program efforts. Thanh Long started as a supplier of printed circuit boards (PCBs) and transformers for Jaguar Vietnam (a Japanese mini sewing machine manufacturer). Through targeted support provided by JICA (the Japanese International Cooperation Agency) and SIDE (the Supporting Industry Enterprises Development Centre), Thanh Long was able to attend European trade fairs where it increased its understanding and information of FDI-buyer demands and was introduced to a Korean PCB supplier with whom it entered a profit-sharing agreement. The Korean PCB supplier supported

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\(^65\) Akhlaque et al.

\(^66\) Akhlaque et al.
Thanh Long in production of PCBs that could meet international quality standards to the point that Thanh Long has since become a supplier to RFTech Vietnam (a Tier I supplier to Samsung), and to Canon Vietnam. With the right targeted support and partnerships, Thanh Long was able to accomplish this transition over a period of only four to five years. Thanh Long benefited merely from (i) exposure to the quality standards demanded of FDI-buyers and (ii) two Korean expert personnel sent to work in Thanh Long’s plant for a year to help upskill the Thanh Long engineers and management. To replicate the success of Thanh Long across other Vietnamese SMEs, MPI should undertake a review of the existing SME support programs to align their focus on the targeted diffusion of information and skills.

Perhaps just as importantly, SME reform must focus on providing support to the technologically-productive firms that are most capable of supplying foreign firms. Vietnam’s most recent SME Law, which went into effect in January 2018, included a number of qualifying restrictions on firm capital (less than $4.4mm), revenue (less than $13mm), and employees (fewer than 200). Eligible firms face a lower corporate income tax rate and receive preferential access to credit and land in industrial parks and high-tech zones. While Vietnamese authorities should be commended for their efforts, their decision to exclude the most successful (and therefore the most productive) Vietnamese firms compromises their ability to foster the critical supply chain links with foreign direct investors.

Administrative Feasibility: Relative to other policy options, aligning the existing cross-ministerial SME support programs will prove a significant administrative challenge. It will require coordination with the MoIT as well as the MoST, and as such would require a strong commitment of time and personnel by the MPI. Fortunately, such an effort would not require a significant budgetary commitment, and the long-term results of effective coordination could yield many more success stories like that of Thanh Long.

Political Supportability: Reforming the network of existing SME support programs will have significant long-term benefits. In the short-term however, the project will require a significant

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commitment of time and personnel from the MPI, MoIT, and MoST, meaning promoting the effort could prove politically challenging. To mitigate some of the challenges related to political supportability, the implementation team developed in the MPI should spend considerable time establishing the necessary political relationships to push such a program. Ideally, the program would have support from senior officials in the MPI, MoIT, and MoST who could create the political space internally for the program team to operate. It would be incumbent upon the MPI implementation team to create this political space, and to do so ahead of any formal discussions about program implementation.

Policy Proposal #3: Increase Localization Requirements on Foreign Investors

*Description:* Another potential solution is to force electronics manufacturers to source inputs domestically through local content requirements (LCR). While inducing foreign companies to work with domestic suppliers is appealing prima facie, the cumulative direct and indirect costs of such an intervention warrant further inspection. Moreover, we will argue that such a policy prescription is especially inappropriate given: i) Vietnam’s lack of technological and supplier capabilities, ii) an electronics industry dominated by foreign rather than domestic consumption, and iii) the government’s reputation among international investors for openness.

LCRs are “policy measures that typically require a certain percentage of intermediate goods used in the production processes to be sourced from domestic manufacturers”. While they are technically prohibited by the WTO and inconsistent with many free trade agreements (FTAs) including in Vietnam’s recently-signed trade agreement with the European Union (EVFTA), many countries are able to utilize security exceptions and other carve-outs. LCRs that strictly delineate between domestically-owned firms and foreign-owned subsidiaries often morph into local ownership requirements.

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72 Hufbauer and Schott.
According to the Peterson Institute for International Economics (PIIE), LCRs are appealing because they can i) create jobs and ii) channel business to domestic firms; they may also iii) support infant industries and iv) provide a promising path to economic development. These advantages have attracted many developing and developed countries to adopt such measures. While China is the most notable example of a country leveraging local ownership requirements to induce knowledge transfer and learning spillovers, PIIE identified 117 new cases of LCRs from 2008-2013. Indonesia adopted 12, China adopted 10, India adopted nine, and Korea adopted two. In 2016, both Indonesia and India adopted LCRs as it applied to domestic smartphone production.

The potential advantages to Vietnam of adopting LCRs are quite appealing. While businesses we interviewed are trying to identify local suppliers independently, imposing local content requirements would provide an urgency to their search process. Given the importance of high-quality components, electronic OEMs would be motivated to work closely with domestic suppliers through intensive training programs, more directly facilitating the desired knowledge transfer. To the extent that local ownership requirements are not included, many OEMs may simply have their foreign suppliers open production facilities in Vietnam—similar to the Samsung experience referenced earlier. This will create additional manufacturing jobs for Vietnamese workers while further fostering the development of an electronics manufacturing ecosystem. Finally, and unlike our other policy proposals, LCRs do not require fiscal expenditures; therefore, making them more politically-expedient.

*Technical Correctness:* **However, the broader literature on local content requirements is fairly consistent in rejecting their use on economic grounds.** By forcing foreign producers to use a specific quantity of domestic components, LCRs are more analogous to quotas than to price tariffs. In both cases, local production costs are likely to rise, but at least tariffs provide producers a choice and raise fiscal revenues. Contrary to stated policy objectives, PIIE suggests that LCRs may reduce domestic value added if higher local production costs lead to cuts in final production.

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73 Hufbauer and Schott.
74 Hufbauer and Schott.
77 Hufbauer and Schott.
In analyzing LCRs in the heavy-duty automotive sector, Deringer et al. find that LCRs raise local prices by 2-16% while reducing production in related sectors.\textsuperscript{78} Cui and Lu cite technology gaps as the primary driver of local versus global supplier costs. Their model recommends high local content requirements only when there is an increasing number of local OEMs.\textsuperscript{79}

There are additional drawbacks to implementing LCRs in Vietnam specifically. As previously articulated, the domestic private sector lacks the technological and supplier capabilities that foreign electronics manufacturers require. If there were a simply a price gap between foreign and domestic components, tariffs or LCRs might induce switching albeit at a higher cost to foreign producers. However, in Vietnam’s case, capable local suppliers simply do not exist. The industry needs to be developed, and while LCRs are designed to help with infant industry development, the required time and resources to reach a competitive state are unrealistic for foreign electronics producers. It is particularly difficult to quantify an effect from LCRs in the electronics industry because capable domestic suppliers do not appear to exist. India’s attempt to employ LCRs in solar cells failed in part because there was little upstream ecosystem to support the original equipment manufacturers.\textsuperscript{80} By similar logic, the inability for first-tier domestic suppliers to connect with second- and third-tier suppliers might inhibit the competitiveness.

In many semi-successful LCR regimes, foreign producers are attracted to a deep domestic market. Governments will simply not let foreign producers sell domestically if they do not source locally. While Vietnam has a sizable domestic market, it is not a protected one. Moreover, the electronics industry focuses on export-oriented production; only a small fraction of the electronic manufactures (e.g. phones, computers, TVs, appliances) are produced for domestic consumption. The fact that LCRs raise the cost of local production is tolerated because foreign producers simply pass along the price increase to captive consumers. In Vietnam’s case, it would become increasingly uncompetitive relative to alternative production centers that do not impose LCRs.

\textsuperscript{80} Johnson, O. (2013). Exploring the effectiveness of local content requirements in promoting solar PV manufacturing in India (No. 11/2013). Discussion Paper.
Administrative Feasibility: Passing a law and mandating compliance would be fairly straightforward. While the regulatory and compliance oversight might require additional resources, such a proposal places the onus on foreign companies to demonstrate that they are achieving mandated targets.

Political Supportability: Some political actors may be swayed by some of the purported advantages of LCRs as outlined. However, by mandating foreign producers to act in a particular way, such a policy proposal would undermine Vietnam’s favorable foreign investment climate.

We arrived at our problem statement—namely, the lack of technological diffusion within Vietnam’s electronics industry—by first identifying the need to sustain Vietnam’s export-driven and foreign investment-driven growth model. A policy enforcing LCRs would therefore be counterproductive and potentially “kill the goose that lays the golden egg.”
Section VII: Conclusion

Since opening up nearly 35 years ago, Vietnam has achieved impressive rates of economic growth. The country’s export-led, foreign-investment driven growth model has been the key engine in raising income levels throughout Vietnam and lifting tens of millions of people out of poverty. Nevertheless, Vietnam faces key demographic and environmental challenges in the years ahead. While this SYPA does not address these challenges directly, we believe that Vietnam’s ability to maintain its export- and foreign investment-driven development model gives the country the best opportunity to prosper in the future.

However, in order to achieve sustainability, it is important the GoV sufficiently address the most binding constraints facing foreign firms. Tackling the weak domestic private sector, and in particular, the very low absorptive capacity of domestic firms should be its priority. The policy recommendations offered in Section VI are designed to meet this need (technically correct), while also accounting for the political reality of divergent interests among stakeholders (political supportability), and any complicating factors in implementation (administrative feasibility).

Correspondingly, we believe that establishing a Business Advisory Council comprised of late-career, experienced supply chain experts would be an effective first step. Furthermore, the MPI can help guide the process of reforming existing SME support programs to focus more explicitly on the diffusion of information and skills development, with particular attention to the most productive firms in the Vietnamese economy. By focusing on these recommendations (and avoiding any appealing, yet problematic and inconsistent policy options such as local content requirements), the Ministry of Planning and Investment can make significant headway in bolstering the domestic private sector, ensuring technological diffusion and knowledge sharing, and sustaining Vietnamese economic development and progress for the long-term.
References


Authors’ interviews.


Appendices

Appendix 1: Political Structure of Vietnam

![Political Structure of Vietnam Diagram]


Appendix 2: Stakeholder Mapping

![Stakeholder Mapping Diagram]
Appendix 3: Structure of the Ministry of Planning and Investment

Source: Vietnamese Ministry of Planning and Investment
Appendix 4: Vietnamese Company Meetings

<table>
<thead>
<tr>
<th>Company</th>
<th>Headquarters</th>
<th>Primary business line</th>
<th>Production Center</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hon Hai Precision Industry Co. (aka Foxconn)</td>
<td>Taiwan</td>
<td>Electronics manufacturing services</td>
<td>Bác Giang</td>
</tr>
<tr>
<td>LG Electronics</td>
<td>South Korea</td>
<td>Diversified electronics manufacturing</td>
<td>Hải Phòng</td>
</tr>
<tr>
<td>Intel</td>
<td>United States</td>
<td>Semiconductor manufacturing</td>
<td>Ho Chi Minh City</td>
</tr>
<tr>
<td>Datalogic</td>
<td>Italy</td>
<td>Barcode reader manufacturing</td>
<td>Ho Chi Minh City</td>
</tr>
<tr>
<td>Dae Young</td>
<td>South Korea</td>
<td>Turbine manufacturing</td>
<td>Ho Chi Minh City</td>
</tr>
</tbody>
</table>
Appendix 5: Prepared Questions Sent to Respective Companies

Vietnam Research Project
Students: Ben Grozier, Jason Keene
January 2020

Purpose
The purpose of our trip to Vietnam, and interviews with multinational technology and electronics firms, is to better understand trends in foreign direct investment in Vietnam. Specifically, we aim to understand the operating environment in Vietnam and to assess the sustainability of investment in the electronics sector.

Indicative Questions
- What products does [Company name] manufacture in Vietnam?
- Are there other products [Company name] would like to manufacture in Vietnam?
- Are there particular obstacles [Company name] faces doing business in Vietnam?
- Does [Company name] see benefits to co-location with similar firms?
- Does [Company name] maintain active relationships with Government representatives in Vietnam?
- What types of jobs does [Company name] provide in Vietnam and to Vietnamese nationals?
- How much training does [Company name] need to provide for new employees?
- What intermediate goods does [Company name] source domestically in Vietnam? How does this compare to other countries where [Company name] has invested?
- For what reasons is Vietnam the destination of choice for [Company name], in comparison to other countries?
- How does [Company name] assess Vietnam on the below metrics:
  - Availability of skilled labor
  - Wage rates for skilled labor
  - Access to land and industrial parks
  - Ease of logistics/ infrastructure (electricity, transportation, ports)
  - Accessibility of relevant domestic goods and services
  - Benefits/ drawbacks to competition