

The Chu Lai Open Economic Zone  
and Rural Development:  
Central Planning's Laboratory  
for Policy and Institutional Innovation

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**UNDP Policy Dialogue Paper 2008/2  
Ha Noi, July 2008**



## Foreword

Viet Nam is still a predominantly rural country, and therefore the creation of good, stable jobs in rural areas is a key policy priority. Export Processing Zones (EPZ) are one of the instruments used in Viet Nam and other developing countries to spur employment growth outside of the major cities. These zones combine good infrastructure with other incentives to attract investors to locations that they may not have considered in the absence of the EPZ.

This paper examines the experience of the Chu Lai Open Economic Zone in Quang Nam province to distill some lessons about the performance of EPZs as a policy instrument to stimulate rural development.

The paper argues that local officials have invested too much time and money in the attempt to attract foreign investors rather than concentrating on the domestic private sector. Although foreign investment is desirable, Quang Nam is more likely to emerge as a domestic business hub rather than a production location for major multinational corporations. Local government should focus on the essential task of helping the domestic private sector gain legal and affordable access to land and capital. In addition, the authors recommend further decentralization of authority to local government to enable Chu Lai to engage in policy experiments without the prior approval of central government authorities.

These findings are relevant not only to the Chu Lai Open Economic Zone and Quang Nam province, but also to other rural EPZs in Viet Nam. While the ideas expressed in the paper do not represent the official view of UNDP, we hope that the recommendations presented here will stimulate discussion and debate among researchers and policy makers.

I would like to take this opportunity to thank the research team for their insightful analysis and constructive policy recommendations. We hope that this paper encourages other researchers to study the role of EPZs in job creation, economic growth and poverty reduction in rural Viet Nam.



Setsuko Yamazaki  
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## Acknowledgements

This paper was prepared jointly by the Fulbright Economics Teaching Program (FETP) in Ho Chi Minh City and Harvard University's John F. Kennedy School of Government, with financial assistance from the United Nations Development Program (UNDP) under Project No. 5088790-01, "UNDP-Vietnam Discussion Papers on Topics Relating to Decentralization and Economic Performance."

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We wish to express our gratitude for the invaluable support we received from the provincial government of Quang Nam, without which this paper could hardly been finished. We would like to thank Huynh The Du, Nguyen My Xuan, Truong Si Anh, Bui Van and Pham Tuan Anh for their invaluable contributions to this paper. we are also grateful for the insightful discussions provided by the peer-reviewer - Mr. Tran Quoc Trung - Economist, Department of Industry, Ministry of Planning and Investment. Nevertheless, the research team accepts full responsibility for the contents of this paper.

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# Executive Summary

This paper examines Viet Nam's experiment to spur rural development in Quang Nam Province by establishing the 27,000 hectare Chu Lai Open Economic Zone ("Chu Lai"). This paper studies the development of Chu Lai from its beginning in 2003 until 2006.

## **Viet Nam's Rural Development Challenge**

In less than twenty years, Viet Nam's economic reforms have dramatically raised living standards and reduced national poverty rates from over 75 percent to 27 percent. However, these reforms coincided with a growing disparity between urban and rural incomes. In Viet Nam's urban areas, foreign investment and domestic private enterprises are creating wage employment for millions of workers in industry and service. In Viet Nam's rural areas, however, the economy is characterized by informal household businesses constrained by limited access to land and capital; state sector investment producing few jobs; and the agricultural sector's conundrum that raising its productivity will require eliminating farm employment by increasing plot sizes and mechanization levels. Not surprisingly, many rural residents are migrating to Viet Nam's cities. However, policymakers and researchers believe these urban areas are not prepared to provide the millions of additional jobs, social services, and infrastructure investments for a sustained influx of rural unskilled farming households. Consequently, Viet Nam's continued accession to the category of middle income countries faces a rural development challenge: Rural areas are being asked to increase agricultural productivity, while simultaneously providing the disaffected with wage employment in the rural economy's industry and service sectors.

## **The Policy Response**

Quang Nam Province exemplifies Viet Nam's rural development challenge: It is predominantly poor and rural; it has less than a thousand formally registered private enterprises; and its 1.4 million residents are seeking better opportunities in urban centers near Da Nang and Ho Chi Minh City. By decentralizing policy and fiscal authority to leaders in the Chu Lai Open Economic Zone, Viet Nam intends to provide local officials with the regulatory space and incentives to experiment with policies and institutions spurring provincial economic development. After three years, all parties seem to agree the results are not yet inspiring. Chu Lai has five operational factories employing approximately 1000 workers. Nevertheless, nine provinces have received permission to implement the Chu Lai Model.

## **Limitations and Policy Recommendations**

This paper argues that for Chu Lai to succeed three key limitations will need to be addressed.

First, Chu Lai's exclusive focus on attracting foreign investment is at the cost of paying much less attention to the domestic private sector development. Strong evidence suggests Chu Lai's problems attracting foreign investment in manufacturing and light industry are primarily a function of its location and investment incentives, rather than the quality of its regulatory environment. This does not mean Chu Lai should abandon efforts to attract foreign participation, as discussed in detail below. However, Chu Lai's leaders will need to facilitate local private sector development to spur rural transformation in Quang Nam. Chu Lai's current industrial policy encourages committing scarce infrastructure resources to address perceived requirements of unlikely foreign investors (e.g., an international transshipment port), rather than the current needs of domestic private enterprises. Furthermore, this industrial policy also encourages Chu Lai to address perceived regulatory problems confronting the same cohort of unlikely foreign investors, rather than regulatory problems currently confronting domestic firms. This paper presents analysis and evidence supporting the following major recommendations responding to this first limitation:

- Chu Lai's administration should assess all potential investments in heavy industry and other areas in light of potential impacts on the tourism industry's development.
- Chu Lai should collaborate with the private sector to create vocational training for industry employees in foreign languages, hotel management, restaurant service, and other skill areas demanded by existing investors and enterprises in tourism.

## The Chu Lai Open Economic Zone and Rural Development

- Quang Nam and Chu Lai should strengthen efforts to formally register land use rights and other fixed assets, which will increase the private sector's access to land and capital, as well as help create sufficient demand for Viet Nam's joint-stock banks to begin lending to Quang Nam's private enterprises.
- Chu Lai should establish one or several "low-grade" industrial zones to provide domestic private enterprises with subsidized land.
- Chu Lai should implement local policies that shift government decisions from pre-approval to post-verification and reducing the current exposure of private enterprises to informal charges.
- Chu Lai should maintain sustainable tax policies to pay its officials and cover its expenses, ensuring its tax policies do not create incentives for officials to create informal charges.

Second, Chu Lai's legal design is effectively incompatible with policy experimentation and institutional innovation. In the 1990s, Viet Nam's first attempt to spur rural development with industrial zones witnessed a significant investment of state resources with little return. In contrast to highly successful urban industrial zones, policymakers believe rural industrial zones were hurt by an absence of fiscal and policy decentralization to local officials. Accordingly, Chu Lai's architecture was intended to give local leaders increased fiscal, policy, and legal authority. In reality, however, Chu Lai's legal framework divides fiscal and policy decision making authority in almost all important areas between local officials and the central government. As a result of this consensus decision making process, which includes ministries with conflicting interests in Chu Lai's experimentation and success, Chu Lai's attempts to innovate have stalled. Addressing this limitation will require policy decisions at the central government level allowing Chu Lai to perform its stated function to serve as Viet Nam's laboratory for creating "a fair investment and business environment which is suitable to international practices." This paper presents analysis and evidence supporting the following major recommendation to address this second limitation:

- A legal framework unambiguously decentralizing fiscal and policy decisions to local officials, which allows Chu Lai to have autonomy in initiating innovative policies.

Third, Chu Lai has yet to secure participation of a foreign strategic partner. Most successful economic zones in the region, and industrial zones in Viet Nam, have foreign participation in land development, governance and marketing. If Chu Lai intends to address the uphill battle of attracting foreign investment, then a foreign strategic partner is essential. Although foreign investment in Quang Nam's tourism will be naturally drawn by obvious market opportunities, foreign investors are not likely to recognize Chu Lai's less obvious advantages in manufacturing and light industry. This paper presents analysis and evidence supporting the following major recommendations:

- Chu Lai's authority to license foreign investments should be broadly expanded in areas in which Viet Nam is required to open its markets to foreign participation pursuant to international agreements, including finance and real estate.
- Chu Lai should focus its resources on attracting the participation of foreign investors to develop several of its industrial zones; this will require hiring foreign consultants to identify and recruit appropriate strategic foreign investors.
- Chu Lai should serve as a pilot region for fully implementing the *Common Investment Law's* Decree 108.

### Facilitating Markets

Researchers now believe Viet Nam's next round of economic reforms will require a successful national effort by the central government to improve policy in areas of finance, education, legal institutions, and land administration. However, the challenge of national policy reforms is to differentiate "facilitating markets" from



"planning for markets." A national policy which decentralizes fiscal and policy decisions to local authorities is a way of facilitating markets by harnessing local officials' access to information and powerful incentives to improve the living standards of their communities. A national policy encouraging provinces to apply one model of rural development, such as investing in deepwater ports, is way of planning for markets by creating conditions for foreign investment to implement national export led growth strategies. As currently designed, Chu Lai and the open economic zone model may apply key assumptions of central planning to international investors and financial markets. All of Chu Lai's current limitations (industrial policy, decentralization levels, and foreign participation) may be subsumed in importance by its major policy orientation towards planning for markets. Chu Lai's major challenge, therefore, is to define and institutionalize its role as a facilitator rather than as a planner.

# I. Introduction

Just fifty kilometres south of the bustling international tourist destination of Hoi An, the 27,000 hectare Chu Lai Open Economic Zone ("Chu Lai") is as large as the *total combined land area* of all 135 industrial zones and export processing zones established between 1991 and 2006 in Viet Nam.<sup>1</sup> In contrast to these existing industrial zones,<sup>2</sup> the Prime Minister's Decision expressly empowers Chu Lai to serve as Viet Nam's 21st century laboratory of policy experimentation and institutional innovation. Chu Lai has the most attractive investment incentives in Viet Nam; the financial autonomy to issue domestic project bonds; the legal authority to experiment with market-based solutions including auctions of land use rights; and an overriding mandate to develop and apply "new models of economic development" to "overcome entanglements" in Viet Nam's "current policies and regimes of economic management."<sup>3</sup> However, a critical question remains: will the central government's "experimental planning" in Chu Lai's 27,000 hectares produce the level of investment, jobs, growth and dynamism generated by the private sector's remarkable success in developing tourism in Hoi An's 6000 hectares? After more than three years, the results are not yet inspiring. Chu Lai has five operational factories employing approximately 1000 workers. Nevertheless, nine provinces have received permission to implement the "Chu Lai Model," and three more provinces will receive permission in 2007. A successful future will require Chu Lai and these other open economic zones to transcend daunting obstacles ranging from institutional design to human resources. At a minimum, Chu Lai must overcome: (1) an exclusive focus on foreign investment detrimental to domestic private sector development; (2) a legal framework effectively incompatible with experimentation and innovation because it includes ministries with conflicting interests in consensus decision making processes; (3) an absence of participation by strategic foreign investors in land development, governance and marketing; and (4) parts of Quang Nam's government and Chu Lai's administration unable to implement provincial policy directives.

This paper, in four parts, provides an analysis of Chu Lai's economic context, policy objectives, legal architecture, current issues, and a framework for defining Chu Lai's role in Quang Nam's development strategy highlighting several potential avenues for exploiting Chu Lai's "openness mechanism." This paper's analysis and findings also serve as a critical examination of Viet Nam's strategy to establish economic zones, and industrial zones more generally, to spur rural development.

In Part II we place the hypothesis and design of the Chu Lai experiment within the context of Viet Nam's recent economic reforms. Section II.1 describes the special role policy experimentation by local governments played in formulating *Doi Moi's* economic policies. Section II.2 explores the critical function of industrial zones in Viet Nam's early engagement with markets; these industrial zones served as nuclei of policy and institutional innovation by creating physical locations for the complex interests of foreign investors, domestic entrepreneurs and government to intersect. Section II.3 examines Viet Nam's strategy in the 1990s to mitigate growing disparities between rural and urban living standards by encouraging rural areas to establish the industrial zone model developed in its urban centres. This section presents several possible explanations for the lack of investor interest in these rural industrial zones. For instance, national policymakers believe they were principally hindered by poor regulatory environments. Other observers note the principal advantage of rural areas, an abundance of inexpensive labour, is mitigated by the mobility of Viet Nam's workforce; thus, labor-intensive investments are predictably focused in areas possessing a combination of reasonably priced land, a proximity to markets, and developed transportation systems.

In Part III we examine Viet Nam's stated objective in Chu Lai to create an engine and model of rural transformation by using policy and fiscal decentralization to provide local officials with the necessary

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<sup>1</sup> See Prime Minister's Decision No. 148/2004/QĐ-TTg, *Major Orientations for Socio-Economic Development of the Central Viet Nam Key Economic Region till 2010, with a Vision to 2020* (22 March 2004); compare with VN Economy, "Viet Nam Possesses 135 Industrial and Export Processing Zones" (26 July 2006). Retrieved August 21, 2006 from <http://www.info.vn>.

<sup>2</sup> In accordance with Article 90 of Viet Nam's 2003 *Land Law*, we use the term "industrial zone" to include industrial parks, export processing zones, and industrial clusters. In contrast, we use the term "economic zone," in accordance with Article 92 of the 2003 *Land Law*, to include open economic zones, border gate economic zones, and all other economic zones created by a decision of the Prime Minister.

<sup>3</sup> Prime Minister's Decision No. 108/2003/QĐ-TTg, *On the Establishment and Issue of Regulations on Operations of Chu Lai Open Economic Zone in Quang Nam Province* (June 5, 2003).

combination of regulatory space and incentives to develop attractive regulatory environments. Section III.1 describes the strategy of using Chu Lai and the open economic zone model to address Viet Nam's fundamental rural development challenge: to generate substantial wage employment in rural areas allowing agricultural productivity to increase without a corresponding migration of landless, unemployed and unskilled farming households to Viet Nam's cities. In this section, however, we question a critical assumption underlying the Chu Lai Model; namely, if Chu Lai and other rural economic zones successfully create good regulatory environments then foreign investment will materialize. Indeed, Viet Nam is witnessing a growing trend for foreign and domestic firms to gravitate inside industrial zone walls. However, this trend may be produced by distorted land prices and local governments "pushing" firms into state managed industrial zones to secure revenue streams, rather than superior investment environments. In many cases, industrial zones may retard rural development by encouraging infrastructure expenditures ignoring the current needs of domestic private investors in favor of the perceived needs of unlikely foreign investors. Furthermore, even assuming rural industrial zones can attract foreign investment with good regulatory environments alone, Section III.2 analysis of Chu Lai's legal foundation finds serious weaknesses in the central government's effort to design conditions and incentives for local officials to develop these good regulatory environments. Chu Lai's legal framework divides fiscal and policy authority in almost all important areas between local officials and the central government; a stark contrast to China's successful experiments with express decentralization to its special economic zones, as well as Viet Nam's experience with "bottom-up" policy reform driven by *de facto* decentralization in the 1990s.

In Part IV we provide a three year review of Chu Lai's development, and analyze four critical issues facing its leaders in infrastructure development, human capital investments, industrial policy and governance. Section IV.1 summarizes Chu Lai's investment and job creation data, and describes the views of policymakers about Chu Lai's barriers to development. In Section IV.2, we raise strong efficiency concerns about Chu Lai's plan to develop a deepwater port. This section presents analysis and evidence suggesting infrastructure investments in roads, and particularly regional investments in railroads better connecting Chu Lai with ports in Da Nang and Ho Chi Minh City, will provide potential firms with cheaper transportation alternatives than a new port. Section IV.3 proposes several policies to address Chu Lai's shortage of skilled labour. This section suggests the problem is best addressed by improving primary and secondary education. This will help attract skilled labour to Quang Nam from other provinces, and retain Quang Nam's homegrown skilled labour. Section IV.3 also discusses a private-public partnership model for vocational training developed in Penang's electronics sector, suggesting potential avenues for adapting this model to dynamic sectors in Quang Nam and Chu Lai. Section IV.4 provides Chu Lai's policymakers with a method for analyzing heavy industry investments with the potential to negatively effect Quang Nam's dynamic tourism industry. This section presents an illustrative cost-benefit analysis of a shelved plan for a coal-fired power plant on Quang Nam's coast. Finally, Section IV.5 raises concerns about plans to remedy persistent regulatory problems by seeking permission from the central government to create "a zone within a zone" in Chu Lai's Free Trade Area.

In Part V we provide a framework for defining Chu Lai's role in Quang Nam's development strategy, and specific recommendations for exploiting Chu Lai's "openness mechanism." Although analysis in Parts II, III and IV may suggest Chu Lai and other state-managed economic zones are an unlikely engine of rural transformation as presently designed, nonetheless they are likely to remain an important element of Viet Nam's rural development strategy in the near future. Section V.1 presents a definition of Chu Lai's role in Quang Nam's rural transformation. This section suggests Chu Lai address barriers to Quang Nam's domestic private enterprises, as well as obstacles to attracting significant foreign investment in manufacturing and light industry. Section V.2 provides specific policy recommendations to increase the domestic private sector's access to land and capital, as well as decreasing its exposure to informal charges. Section V.3 provides policy recommendations to increase manufacturing and light industry investments by amending existing land and decentralization policies to attract the participation of foreign strategic partners. Section V.4 provides Chu Lai with a framework for developing legal regulations. In the paper's final section, we conclude with a few observations about institutional limitations facing the central government's effort in Chu Lai and other open economic zones to design a laboratory of policy experimentation.

Before delving directly into Chu Lai's development and policy issues, the next section briefly describes Quang Nam Province's economy in 2006.

## The Study Area: Quang Nam Province

Long apart of Da Nang City, Quang Nam province split off in 1997 and became a separate province. Quang Nam's population of 1.45 million is 93 percent ethnic Vietnamese, with the rest spread among many minorities. Poor and 85 percent rural, Quang Nam is notable for its two World Heritage sites, and thus growing numbers of tourists visiting historic Hoi An City and the Cham civilization's My Son ruins. Since 1991 Quang Nam's tourism industry has emerged as a major contributor to the economy, growing from 100,000 to 1,400,000 visitors in fifteen years. Even so, the 2004 Living Standards Survey reveals a poverty rate of 27 percent in Viet Nam's South Central region, of which Quang Nam is a part, well above the 23 percent national average or the 18-20 percent in the Mekong and Red River Deltas. Quang Nam's GDP per capita is only 69 percent of the national average.

Quang Nam's population growth is slow because of outward migration. From 1995 to 2004, Quang Nam's population averaged one percent annual growth, while the national population growth was 1.45 percent over the same period. As Quang Nam's birth and death rates are similar to those for the entire nation, Quang Nam's 1 percent annual population growth implies that 30 percent of the province's potential population growth has moved. This suggests work opportunities are better elsewhere, despite a reported provincial GDP growth which is higher than the national average.<sup>4</sup>



In 2004, Quang Nam's labour force of 756,000 was 86 percent rural and 81 percent individual household earners. Farming employs 57 percent of workers; industry and construction 23 percent, and services the remaining 20 percent. Foreign invested jobs account for one percent of the total; the state sector eight percent; the private/collective sector 10 percent; and the remaining 81 percent of the labor force is self-employed.<sup>5</sup> The 2003 Enterprise Survey reveals only 35,000 wage employees in private, state and foreign firms (23,000 manufacturing jobs and 9,000 construction jobs).<sup>6</sup> As of 2003, only 22 percent of Quang Nam's labor force finished secondary school, 13 percent finished high school, and 27 percent had either failed to finish primary school or were illiterate. Skill levels of Quang Nam's labour force are well below those of the nation as a whole.

The structure of Quang Nam's GDP is surprising for a province with so much tourism. In 2004, agriculture was nearly a third of Quang Nam's total output (compared to a fifth in all of Viet Nam), while services were 36 percent (40 percent in Viet Nam). One would expect Quang Nam's service sector to be larger, but perhaps many small shops and firms in the service sector are not well counted. In terms of the structure of GDP ownership, Quang Nam's state share accounts

<sup>4</sup> This is a common problem. Provincial GDP growth rates are often reported to be very high, and if all of the provincial growth rates were summed the national GDP growth rate would be much higher. This is one reason to observe population movements rather than growth rates. Quang Nam reported real GDP growth of 8.8 percent from 2000 to 2003, while the national real GDP growth was only seven percent.

<sup>5</sup> These data are taken from Table 335 of the Statistical Data of Labour-Employment in Viet Nam 2004.

<sup>6</sup> This survey shows only 52 enterprises in "hotel and restaurant" businesses, with 1145 workers. This is very likely an understatement; probably many of the hotels and restaurants are not registered.



for 29 percent (the state accounts for 39 percent of Viet Nam's GDP), FDI's share is 1.3 percent (FDI accounts for 15 percent of Viet Nam's GDP), and the non-state share is the remaining 70 percent. Most of the "non-state" sector is household activity, rather than formal enterprises, lacking technology and capital. Quang Nam is notable for its modest number of 909 newly established domestic enterprises from 2000 to 2005, compared to over 160,000 nationally. In addition, the amount of capital per enterprise in Quang Nam was only nine billion VND in 2003, compared to VND 24 billion nationally. Clearly, the level of private activity is much lower than elsewhere. Quang Nam has 1.8 percent of Viet Nam's total labour force, but only 0.2 percent of Viet Nam's enterprise capital.

In 2003 FDI was one percent of total provincial investment. Between 1990 and 2005, Quang Nam's cumulative implemented FDI was approximately USD 57 million, or 0.2 percent of the national total (again, this percentage only represents a tenth of the province's proportional share of Viet Nam's labour force). Much of Quang Nam's FDI was in tourism or natural resource linked industries, such as sand exporting. Relatively little FDI in Quang Nam is found in the manufacturing sector. Quang Nam's major exports include seafood, sand, cashews and cinnamon. In 2004, the total export value of Quang Nam's goods was USD 75 million. Tourism, which can be regarded as a "service export," is probably of about equal value. (In 2005, Quang Nam welcomed 500,000 foreign tourists; assuming each tourist spent USD 150 million in Quang Nam, then tourism "exports" approximate USD 75 million.).<sup>7</sup> Quang Nam's major industrial production is in construction products (cement, stone, sand, bricks, and glazed tiles), frozen sea products, and farm tools. It is not clear if overnight "made-to-order" clothing bought by Hoi An's tourists are included in this data, as small informal shops typically make these garments.

Quang Nam's infrastructure is surprisingly good. Highway One has been upgraded and runs through the province along the coast. There is also a railroad, port and airport; though nearby Da Nang has an international airport and the central region's major seaport which are more heavily used.<sup>8</sup> Other roads, including one to Laos, have also been improved and electricity is widespread in almost all communes. Health centers and primary schools are in all communes, while secondary schools are in all but the most remote. Telephone use has skyrocketed and mobile connections are good along most of Highway One and in other urban and tourist areas. While the area is subject to typhoons, this is true for much of the central coast, and Quang Nam has several protected harbor areas. However, Tam Ky, the provincial capital, is exactly half way between Ha Noi and HCMC, the two major domestic markets. The distance of 860 km is a long drive even with better roads. Da Nang, with less than a million people, is simply not comparable to the two major cities as a major market. Thus, the geography of Quang Nam makes it harder for the province to serve as a supplier of major local markets, and shipping out of Da Nang or the provincial port is expensive compared to freight out of HCMC. Improving freight links to HCMC with better railroad container service would be desirable, both for exports and for supplying the HCMC market.

Quang Nam's "soft infrastructure" is not bad. The regulatory environment, as measured in the 2006 Provincial Competitiveness Index ("PCI"), is respectable, ranking Quang Nam's regulatory environment 14th among Viet Nam's 64 provinces.<sup>9</sup> Of particular note, Quang Nam ranked 3rd in the index measuring "Legal Institutions," 7th in the "Proactivity of its Provincial Leadership," 20th in the absence of "SOE Bias" and "Labour Training," 24th in "Entry Costs," and 26th in "Private Sector Development Services." However, Quang Nam shows ample room for improvement in other indices.

PCI 2006 Sub-Index	Quang Nam's Ranking (of 64)
Legal Institutions	3rd
Proactive Leaders	7th
SOE Bias	20th
Labor Training	20th
Entry Costs	24th
Priv. Sec. Develop.	26th
Time Costs	38th
Access to Land	48th
Transparency	52nd
Informal Charges	58th

<sup>7</sup> The data on total and foreign tourists was given to us in Quang Nam by the provincial leadership. These data do not agree with the official data which show 623,000 total and 260,000 foreign tourists.

<sup>8</sup> In 2004, Da Nang port had over 1000 ships calling, while Ky Ha (Quang Nam's port) had 94. Total freight was 2.3 million tons at Da Nang's port and 70 thousand tons at Ky Ha, or three percent as much.

<sup>9</sup> Viet Nam Competitiveness Initiative, (2006). Retrieved on Jun 20, 2006 at <http://www.vnci.org>. The PCI surveyed over 6,300 private domestic enterprises across all 64 provinces in Viet Nam. Controlling for exogenous factors effecting private sector development, such as a provinces proximity to major markets and infrastructure, the PCI is intended to produce a ranking focusing on indices of provincial level governance which effect domestic private firms.

Specifically, Quang Nam ranked 58th in the index measuring "Informal Charges," 52nd in "Transparency," 48th in "Access to Land," and 38th in "Time Costs." Thus, a puzzle exists: if Quang Nam has a good physical infrastructure, a relatively friendly provincial administration, and a lot of tourist traffic, why is there not more economic activity in the province? Why are young people leaving?

One issue appears to be that the major industrial investments made or likely to be made in Quang Nam are state investments or state-linked, unlikely to create many jobs or linkages (although a potential float glass plant will use local sand, this is not likely to generate much employment or lead to other activity). Quang Nam has "called" for several dozen specific investments such as a stainless steel plant, a paper manufacturing plant, a fertilizer plant and a pharmaceuticals factory. One possible, if not probable, foreign investment is a large aircraft maintenance facility using the existing underutilized airport. The project was approved but there are still regulatory and jurisdictional issues, and the presence of typhoons and a rainy season might necessitate the building of hangers - an additional expense making the facility less attractive. If approved, this could generate thousands of jobs. However, given the modest FDI in the province to this point it appears more likely that larger industrial investments will continue to have SOE backing rather than private or foreign participation. However, SOE projects tend to generate relatively few jobs.<sup>10</sup> Nationally, the growth rate of SOE industry has been only about half of other sectors. Therefore, it would be preferable for Quang Nam to attract more domestic private and FDI investment so as to diversify its reliance on state investment and take advantage of the job growth and dynamism of the non-state sectors. There are some good signs with reports that Japan's Sumitomo Corporation is interested in establishing a stronger presence in Quang Nam after finishing a recent bridge project, as well as a foreign investor's interest in developing high-end tourist resorts on a long stretch of Quang Nam's coastline.

The desire to attract more foreign and domestic investment is behind the decision to create the Chu Lai Open Economic Zone. It is hoped that by cutting red tape and creating a more open environment, Quang Nam will be able to attract investors, absorbing more of the better-educated younger workers currently leaving. This has not yet happened to any great extent. The province's success at diversifying its investment and production base, while continuing to develop linkages to a growing number of tourists, will likely determine the success of its overall development.

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<sup>10</sup> From 2000 to 2004, state owned manufacturing added only 12,000 jobs a year in all of Viet Nam. Since the workforce is increasing by one million a year, this one percent share is quite low. Total growth of industrial jobs in Viet Nam, most of which are in manufacturing, was 350,000 thousand per year (95 percent non-state).

## II. Chu Lai's Context: Local Experiments and National Policy Reforms

In the past three decades, Viet Nam's policy reforms have generally responded to four events: (1) economic crisis; (2) gaps in existing policy; (3) international economic integration; and (4) the political resistance of domestic interests, rolling back earlier reforms. Many commentators of Viet Nam's economic and legal reform concentrate on the third factor, and thus consistently lament the ability of Viet Nam to transplant reforms from blueprints provided by the US-Viet Nam Bilateral Trade Agreement or the World Trade Organization. However, many of the most important reforms in Viet Nam have emerged from domestic experiments conceived in response to various economic crisis, or policy vacuums, in the periods preceding and following the initiation of the *Doi Moi* era.

In this section we will concentrate on the role of economic crisis and policy gaps in shaping the political economy of policy innovation in Viet Nam. Most importantly, we will argue that resolution of these crisis and policy gaps has created a special role for provinces, industrial zones and other local government bodies to serve as incubators of policy innovation. In establishing the Chu Lai Open Economic Zone, policymakers were consciously aware of this history, and Chu Lai was expressly designed to formally harness the institutional design and *de facto* decentralization which drove fence breaking experimental reform efforts in the 1980s and 1990s.<sup>11</sup>

### II.1. The Role of Local Government in *Doi Moi* Economic Policy Formulation

*Doi Moi* is often identified as the beginning of Viet Nam's economic reform era. However, for many commentators on Viet Nam, the *Doi Moi* reforms represent the central government's decision to formally recognize and sanction almost a decade of fence breaking, policy experimentation, and successful responses to socioeconomic issues, caused by overly rigid central planning, emerging from provinces and local government bodies.<sup>12</sup>

From 1975 to 1986 the Vietnamese economy experienced deep turmoil. During this period, people lacked food,<sup>13</sup> and factories lacked essential inputs and machinery.<sup>14</sup> In the absence of resources and appropriate policy directives from the central government, provinces responded to these crises. In Ho Chi Minh City, for instance, the government began to "smuggle" rice from the Mekong Delta to meet citizen demands,<sup>15</sup> and policymakers began exploring avenues for increasing industrial production by importing machinery and factory tools, despite their lack of legal authority and foreign currency. In 1981, the Ho Chi Minh City government and several private citizens tacitly agreed to form Viet Nam's first joint stock company, though a legal framework authorizing private business was almost a decade away. The private citizens contributed capital - gold - and the city government provided market access. The company used gold to purchase farm products, and sold these products to buyers in Hong Kong and Taiwan. The state's share of foreign currency acquired from these export contracts was used to import factory machinery for state enterprises. Although technically illegal and outside the central government's plan, Ho Chi Minh City's experiment with private enterprise worked. Other provinces had similar experiences, some learned from Ho Chi Minh City's experiment, and as a result quasi private firms started to emerge during the pre *Doi Moi* period.<sup>16</sup> A few years later, these experiments informed Viet Nam's first company law.

<sup>11</sup> It is important to note Chu Lai is designed to encourage experimentation, not fence breaking. Although fence breaking played an important role in Viet Nam's early reforms, fence breaking responded to policy gaps and challenges facing Viet Nam in a much different economic context than currently confronting Viet Nam. Researchers now believe Viet Nam's next round of economic reforms will require national policy improvements in areas of finance, education, legal institutions, and land administration. However, the challenge of national policy reforms, as this paper will describe in its analysis of the open economic zone model, is to differentiate "facilitating markets" with quality institutions from "planning for markets" with policy informed by outdated industrialization models and cumbersome decision making processes. See Vu Thanh Tu Anh, Le Viet Thai, and Vo Tat Thang, (2007).

<sup>12</sup> See, e.g., Ha Dang, "Where and How *Doi Moi* Started? (14 October 2005), Nhan Dan Newspaper. Retrieved on August 27, 2006 at <http://www.nhandan.com.vn>.

<sup>13</sup> See Báo Tuổi Trẻ, Đêm Trước Đổi Mới: Ký ức Thời 'Sổ Gạo' (November 30, 2005). Retrieved on August 27, 2006 at <http://www.tuoiitre.com.vn>.

<sup>14</sup> See e.g., Adam Fforde and Stefan De Vylder, (1988) 62-72.

<sup>15</sup> See Báo Tuổi Trẻ, Đêm Trước Đổi Mới: Từ chạy gạo đến phá cơ chế giá" (December 7, 2005). Retrieved on August 27, 2006 at <http://www.tuoiitre.com.vn>.

<sup>16</sup> See, e.g., Leila Webster and Markus Taussig, (1999) 25-26 (survey results reveal a third of firms were formed prior to formal legal framework). Retrieved on August 10, 2006 at [www.sme.com.vn](http://www.sme.com.vn).

Like Ho Chi Minh City, Viet Nam's provincial leaders faced various demands and crisis in the period before *Doi Moi*.<sup>17</sup> Lacking a legal framework or a blueprint for action, a few provincial leaders chose to create and implement local policies and institutional arrangements which technically violated existing rules, but which could realistically respond to specific deficiencies their provincial citizens faced in dealing with Viet Nam's centrally planned economy. Recently, Viet Nam's most widely read national daily newspaper Tuoi Tre published a ten part series and several separate books exploring the role and history of provincial "fence breaking" in leading key economic reforms in Viet Nam.<sup>18</sup>

### II.2. Industrial Zones as Incubators of Policy and Institutional Reform

Viet Nam's early economic reforms required an element which provincial leaders could not directly implement; namely, foreign investment to create jobs, transfer skills, and deepen Viet Nam's economic links with the world. Ho Chi Minh City and several other provinces were able to respond with policy innovations to economic crisis in the early 1980s by cooperating with foreign buyers, however luring foreign investors to make substantial investments inside Viet Nam was another story. Before the 1990s, Viet Nam had neither a legal framework nor a track record for respecting the property rights of foreign investors.

Industrial zones provided a solution. Following the successful model of export processing zones in Taiwan and Korea, and special economic zones in China, Viet Nam's industrial zones could attract "foreign investment in various industries with preferential measures... and less bureaucratic control."<sup>19</sup> Thus, foreign investors could take advantage of Viet Nam's low cost advantages in labour and land, and the Vietnamese government could guarantee investors a "hard fence" protecting them from the regulatory problems "inside" Viet Nam. Furthermore, investors and investments could be "contained" inside industrial zones, possibly an attractive idea to a government in the 1980s yet to fully embrace markets and capitalism. There was a problem, however. Although the central government did not oppose the idea of establishing an industrial zone to attract foreign investment and generate foreign currency, it was unable to commit resources to fund essential infrastructure costs in the proposed industrial zone. In hindsight, this seems fortuitous. Without central government revenue to fund infrastructure development, the Ho Chi Minh City government was forced to attract a foreign partner as a strategic investor. In 1991, Taiwan's Central Trading and Development Group (CTD) agreed to a joint-venture with the Ho Chi Minh City Export Processing Zone Authority (HEPZA).<sup>20</sup> HEPZA contributed 30 percent of the joint-venture's value in the form of land use rights for 300 hectares of swamp land, and CTD contributed over USD 60 million to develop the basic infrastructure for the Tan Thuan Export Processing Zone.

Tan Thuan's Registered FDI (USD Millions)	
Year	FDI
1991	88,9
1992	0
1993	21,2
1994	94,4
1995	142,4
1996	120,5
1997	39,6
1998	42,1
1999	20,1
2000	22,2
2001	2,0
2002	18,1

Source: National Graduate Institute for Policy Studies

<sup>17</sup> Edmund Malesky, (2004a) (describing important instances of "fence breaking" in several policy areas including land use rights, administrative practices, legal reform, and economic policy).

<sup>18</sup> See Báo Tuổi Trẻ, *Đêm Trước Đổi Mới: Công Phá Lũy Tre* (4 December 2005). Retrieved on August 25, 2006 at <http://www.tuoitre.com.vn>. This series includes the story of Vinh Phuc province's experiment with the "household responsibility system" in the late 1960s transferring cooperative land back to farmers in an attempt to increase production (and Hai Phong's similar experiment in the mid 1970s). Although ending in severe criticisms for provincial leaders, in 1981 these experiments served as explicit models for the "Contract 100 system" and "Contract 10 system," beginning the privatization of the largest sector of Vietnam's economy. Similarly, Tuoi Tre tells the story of An Giang province's unilateral decision to abandon critical features of the cooperative model by returning farm machinery to private ownership in 1979. Subsequently, An Giang's method of decollectivization was applied broadly. Analogously, in Long An province, party leaders developed a system for paying laborers in cash, rather than in kind. The problem arose when laborers began complaining that rice and other goods distributed by state stores was poor in quality and limited in variety. Mr. Chin Can, secretary of Long An's Party, experimented by selling goods produced by cooperatives on the black market - at the market price - and distributing the cash to laborers. The results were dramatic; Long An's salary fund increased seven fold, and Long An's citizens could purchase good rice, fresh meat and fish at local markets. Within several years, Long An's experiment was also applied throughout the nation.

<sup>19</sup> Tatsuyuki Ota, (2003).

<sup>20</sup> This entity is also known as Tan Thuan Industrial Promotion Company (IPC).



Because CDT could only recover its investments by leasing Tan Thuan's land to foreign investors, CDT had strong incentives to market and recruit investors. Not surprisingly, 75 of Tan Thuan's 165 FDI projects are from Taiwan, and another 45 are from Japan and other parts of East Asia.

With a strategic investor leading Tan Thuan's development, Viet Nam's first industrial zone also spawned institutional and policy innovations. For instance, after CDT was identified as an interested partner, representatives of HEPZA and CDT developed and then proposed the necessary legal documents and implementing regulations to the central government. These laws were specific to the particular needs of the partnership; representing the interests of a Taiwanese land developer, foreign investors, Vietnamese entrepreneurs, the Ho Chi Minh City government, and central government ministries. This became Viet Nam's first law on export processing zones, and it served as a model for its first law on industrial parks. Similarly, policy innovations emerging from other early industrial zones served as persuasive models for the most important *Doi Moi* reforms including Viet Nam's *Investment Law*, *Company Law* and *Land Law*. According to a former Ho Chi Minh City policymaker, Tan Thuan's success was the result of "HEPZA's move to separate State management from a company's business activities . . . [and] its prime location."<sup>21</sup>

Within a few years of Tan Thuan's experiment, the desire to attract foreign investment and spur local economic development spilled far outside the walls of industrial zones into entire provinces like Binh Duong, Vinh Phuc, and others. For instance, from 1999 to 2002, several *provinces* outperformed Tan Thuan in real industrial output growth. In Vinh Phuc real industrial output grew by 272 percent, in Binh Duong by 229 percent, and in Bac Ninh by 227 percent (and the percentage of this growth coming from state investment accounted for only two percent in Binh Duong, six percent in Vinh Phuc, and 28 percent in Bac Ninh).<sup>22</sup> Similar to Tan Thuan, these provinces were able to develop new governance institutions and policies from the divergent interests emerging from the diversification of investment from state to a combination of foreign, state, and domestic private.

In short, several industrial zones served as critical physical locations for Viet Nam's early experiments with markets and international economic integration. In these concentrated areas, the divergent interests of foreign investors, domestic entrepreneurs, provinces, and the central government intersected. By necessity, new institutions of economic governance were created through bottom-up processes of negotiation and trial and error. These institutions were characterized by unique compromises in the industrial zones' structure of authority, maintaining state management in form, but providing foreign investors with confidence state management would defer to business judgment as a matter of practice. In the absence of a credible legal framework in the early 1990s, or the security provided by a critical mass of existing investors, these tailored-made governance structures provided investors with confidence to make essential infrastructure investments, creating an attractive foundation for subsequent foreign and domestic investment. In industrial zones, and in Viet Nam more generally, the results have obviously been dramatic in terms of investment, growth, job creation, poverty reduction, and institutional innovation. Today, industrial zones continue to play an important role in Viet Nam; in 2006 industrial zones are home to 2,400 domestic investment projects with a total registered capital of VND 116 trillion, and 2,200 foreign-invested projects with a registered capital of \$18 billion USD. Most of the implemented investments are engaged in textile, garment, and footwear production, as well as food processing. These industrial zones recorded USD 6.2 billion in exports from 1996 to 2000, and USD 22.3 billion in exports from 2001 and 2005; accounting for 10 percent of Viet Nam's total export value. Tan Thuan accounts for ten percent of Ho Chi Minh City's export revenue (and three percent of the national total).<sup>23</sup> Similarly, Ha Noi's industrial zones account for 88 percent of the city's total export value, and 18 percent of its total budget collection.<sup>24</sup>

<sup>21</sup> Viet Nam Trade, "Tan Thuan EPZ to be Developed into Value Added Processing Zone" (13 September 2001). Retrieved on September 3, 2006 at <http://www.vietnamtrade.org>.

<sup>22</sup> Nguyen Dinh Cung, Pham An Tuan, Bui Van, and David Dapice, (2004).

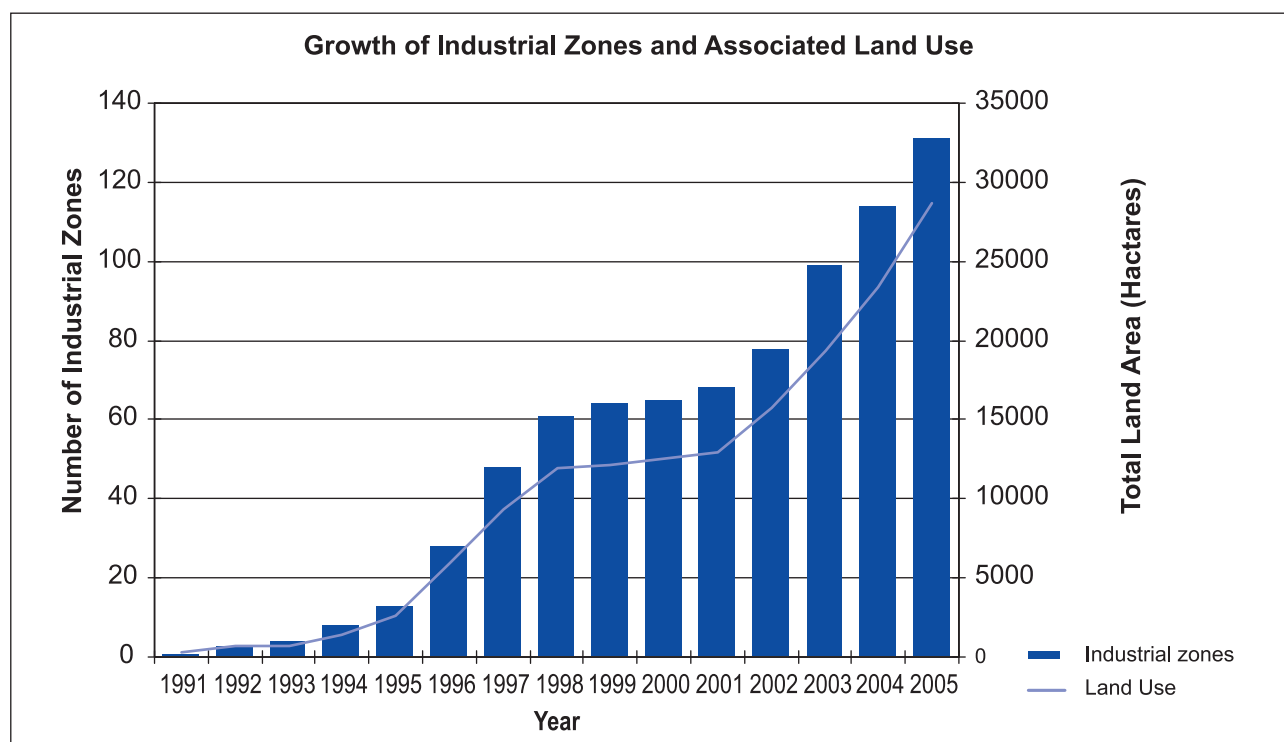
<sup>23</sup> This information was obtained from the website of the Ho Chi Minh City Export Processing Zone Authority. Retrieved on August 25, 2005 at <http://www.hepza.gov.vn>.

<sup>24</sup> See Hong Duong, "Filling Holes in IZ Planning" (23 November 2005). Retrieved August 25, 2006 at <http://www.ven.org.vn>. It is an interesting question why Hanoi's IZs account for a larger share of industrial production.

### II.3. Rural Development and Industrial Zones in the 1990s

Viet Nam's first decade of economic reform attracted investment, created jobs, and reduced urban poverty to less than ten percent. In 1998, however, 77 percent of Viet Nam's population still lived in rural areas where poverty rates hovered around 50 percent.<sup>25</sup> In contrast to urban areas, Viet Nam's rural regions generally did not attract foreign direct investment.<sup>26</sup> According to the Minister of Planning and Investment, Ho Chi Minh City, Ha Noi, and eight other provinces accounted for 86 percent of Viet Nam's total implemented FDI between 1988 and 2004. Similarly, ten provinces accounted for 75 percent of Viet Nam's domestic private investment ("DPI").<sup>27</sup> In the place of foreign and domestic enterprise investment, Viet Nam's rural economy is characterized by household businesses and state investment. However, in rural areas poverty is strongly correlated with the absence of wage employment,<sup>28</sup> and state investment is an efficient generator of jobs relative to foreign and domestic private enterprises.<sup>29</sup> As a result, Viet Nam faced a critical rural development challenge in the 1990s: discover a mechanism for attracting job-generating investment into rural areas to employ wage labour, or begin preparing the cities for a mass migration of rural citizens seeking higher living standards (prior to the 2000 *Enterprise Law* formal DPI, in contrast to informal household business, was negligible in rural areas).

Viet Nam's policymakers hoped industrial zones could provide the answer. In Viet Nam's urban areas, industrial zone investments directly created 865,000 jobs, and indirectly created 1.5 million jobs.<sup>30</sup> In the 1990s the central government enshrined the governance structures and institutional arrangements created in Tan Thuan and other zones in a formal legal regime,<sup>31</sup> and encouraged rural areas to establish industrial



<sup>25</sup> Joint Donor Report, (2004) (Table 1.1.).

<sup>26</sup> Joint Donor Report, (2006) (Table 1.6).

<sup>27</sup> David Dapice, (2004).

<sup>28</sup> Joint Donor Report (2004) 46-49 .

<sup>29</sup> Joint Donor Report (2006), (Figure 2.2 "The Cost of Creating a Job") ; and David Dapice, (2004).

<sup>30</sup> See VN Economy, "Viet Nam Possesses 135 Industrial and Export Processing Zones" (26 July 2006). Retrieved on August 25, 2006 at <http://www.info.vn>.

<sup>31</sup> Prime Minister's Decision No. 322/HDBT (18 October 1991); Prime Minister's Decision No. 394/CT (11 November 1991); State Committee for Cooperation and Investment Circular on Export Processing Zones No. 1126-HTDT-PC (20 August 20 1992); and Government Decree on Industrial Zones No. 192-CP (28 December 1994).

zones to attract investment, create wage employment, and slow the influx of rural to urban migration. From 1991 to 2005, 131 industrial zones were established in Viet Nam. (See Appendix I for a map of Viet Nam's Industrial Zones).

However, by the late 1990s government officials and observers began publicly lamenting Viet Nam's experiment with using industrial zones to spur rural development. Several successful industrial zones were developed by Japanese investors in the vicinity of Ha Noi and other urban areas. However, in more remote rural areas, and some areas closer to major cities (but perhaps less reform minded), the results were not impressive. Although industrial zones in these areas "transplanted" policy innovations and institutions of earlier zones, investors did not come. A few provinces accounted for the lion's share of FDI, eleven of Viet Nam's sixty-four provinces were responsible for over 70 percent of DPI, and most of the new industrial zones remained at less than fifty percent capacity.

Policymakers wondered, why? One strong possibility was that establishing industrial zones in rural areas was simply not the most effective rural development strategy. Why would foreign investors travel to An Giang, Nghe An or Son La to open a factory when an abundance of land and labour existed in provinces with a proximity to major markets and transportation systems? The primary advantage of rural areas, an abundance of unskilled and inexpensive labour, was mitigated by Viet Nam's labour mobility, evidenced by substantial worker migrations from central Viet Nam to fill jobs in the southeast. Thus, in the absence of economically inefficient investment incentives from Viet Nam's perspective, foreign investors had little reason to invest in rural industrial zones. Viet Nam's policymakers had some evidence to support this conclusion. For example, unlike industrial zones established in rural areas, several industrial zones created in Ha Noi during this same time period were dramatically successful. The Thang Long Industrial Zone established as a joint-venture between Japan's Sumitomo Corporation and Dong Anh Chemical Company (Ministry of Construction) quickly attracted investors, and today employs 19,200 people with a combined investment capital of USD 1 billion and an export value of USD 734 million (three percent of Viet Nam's total export revenue).<sup>32</sup> In addition to its urban location, Thang Long shared another characteristic with many of Viet Nam's most successful zones; it was conceived and developed in close partnership with a strategic foreign investor assuming some risk for infrastructure investments and the industrial zone's success. Not surprisingly, Thang Long's 48 investors are predominantly Japanese firms. This trend repeats itself in other zones managed by Japanese, Korean, Thai, Taiwanese, and other foreign partners; a substantial majority of investors in these zones tend to have the same nationality as the zone's strategic foreign partner. Likewise, a review of industrial zones with the highest registered FDI levels in Viet Nam reveals a combination of foreign strategic participation and a proximity to major markets.

Vietnam's Largest IZs by Registered FDI in 2003			
IZ Name	Province	Nationality	Total FDI
Bien Hoa II	Dong Nai	Viet Nam	1,106,917,060
Nhon Trach I	Dong Nai	Viet Nam	628,039,804
Tan Thuan	HCMC	Taiwan-Japan	611,839,946
VSIP	Binh Duong	Singapore-VN	596,051,971
Nhon Trach II	Dong Nai	Viet Nam	448,276,865
Thang Long	Ha Noi	Japan-Viet Nam	439,623,667
Amata	Dong Nai	Thai-Viet Nam	356,000,000
Sai Dong B	Ha Noi	Korea-Viet Nam	321,744,320
Kim Hoa	Vinh Phuc	Viet Nam	270,000,000
Nomura	Hai Phong	Japan-Viet Nam	221,467,508
Loteco	Dong Nai	Japan-Viet Nam	175,116,256
Phu My I	BR-VT	Viet Nam	150,839,000
Lien Trung I	HCMC	China-Viet Nam	118,771,433

Source: National Graduate Institute for Policy Studies

In contrast, Viet Nam's rural industrial zones (and many unsuccessful urban zones) are often created through a process of government allocation and without partnerships with strategic foreign investors. As a result, these industrial zones suffer from three notable competitive disadvantages. First, the zones are not located near major markets. Second, the infrastructure in rural industrial zones tends to be poorer compared with that in and near major urban cities. Third, the zones lack an internationally savvy investor possessing a critical connection with foreign markets, a rolodex of potential firms, and strong incentives to recover initial infrastructure investments. For instance, the National Graduate Institute for Policy Studies (GRIPS) in Japan

<sup>32</sup> See VN Economy, "Sumitomo Plans to Build Two More Industrial Zones" (26 July 2006). Retrieved on August 27, 2006 at <http://www.info.vn>.

maintains a database of Viet Nam's industrial zones for researchers, Japanese investors and Vietnamese officials. Although the database omits over 30 industrial zones in rural areas, the database reveals 51 industrial zones in Viet Nam failing to report more than two registered FDI projects.<sup>33</sup> Even without investors, however, industrial zones have costs. Provincial leaders in An Giang, for example, used a VND 13.9 billion World Bank loan to build a port for companies in the Binh Long Industrial Zone; however, after five years the area around the Binh Long Industrial Zone, which "was once a healthy area crowded with houses and fields," was "a sandbank" with no investors.<sup>34</sup> Unnecessary infrastructure investments are a common theme in industrial zones without strategic foreign partners, as officials attempt to attract FDI by "planning for the market" with enormous public investments.

In spite of evidence that location and lack of foreign participation were the greatest limitations of Viet Nam's industrial zone model, national policymakers and analysts believed foreign firms were instead dissuaded from investing in rural industrial zones by poor regulatory environments. Thus, they believed Viet Nam's use of industrial zones to spur rural development could work, but only if regulatory environments were improved. In light of Viet Nam's experience with *de facto* decentralization and fence breaking policy innovation by local officials, as well as its early experiments with industrial zones, analysts identified local officials' limited incentives and authority to experiment with innovative policies as the primary limitation of Viet Nam's rural industrial zone model. Thus, according to Mr. Le Xuan Trinh, Chairman of Viet Nam's Economic Zone Commission, an effective solution needed to recognize Viet Nam's existing industrial zone model was crippled by a "management mechanism [which was] not opened wide enough."<sup>35</sup>

In sum, Viet Nam's first experiment using industrial zones to spur rural development seems to have not met expectations for two reasons. These same reasons will prove relevant to our analysis of Chu Lai's limitations in 2006, and our recommendations for the future. First, industrial zones in rural areas faced an uphill battle attracting foreign investment because of their disadvantageous rural locations and infrastructure. Second, industrial zones in rural areas generally lacked participation of foreign strategic investors with incentives and means to access market information and potential investors.

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<sup>33</sup> GRIPS Development Forum, (2006). See also VN Economy, "IZ Land Grabs Force Farmers into Poverty" (21 June 2006). Retrieved on August 23, 2006 at <http://www.info.vn> (reporting that the Hai Phong Export Processing Zone - established in 1997 - leased only 1 hectare of 150; the Nomura Industrial Zone in Hai Phong - established in 1994 - leased only 39 hectares of 153; the Dai Tu Industrial Zone in Ha Noi - established in 1995 - leased only 5 hectares of 200; and the My Xuan Industrial Zone in Ba Ria-Vung Tau - established in 1996 - leased only 20 hectares of 226.).

<sup>34</sup> See VN Economy, "Mekong Delta: Many Idle Industrial Zones" (15 August 2006). Retrieved August 23, 2006 at <http://www.info.vn>.

<sup>35</sup> Le Xuan Trinh, "The Chu Lai Open Economic Zone: Objectives and Policy Developments," seminar paper presented at UNDP's Ha Noi Office on March 1, 2000. Retrieved on July 3, 2006 at [www.undp.org.vn](http://www.undp.org.vn).

### III. The Chu Lai Open Economic Zone

In the wake of the 1997 Asian Financial Crisis, facing declining economic growth and reduced FDI inflows, it became apparent to Viet Nam's policymakers that previous economic "policies and mechanisms" which provided "a strong impetus" for growth during the initial phase of *Doi Moi* were "out of date."<sup>36</sup> During this period Viet Nam unleashed its private sector with the *Enterprise Law*.<sup>37</sup> Furthermore, as other countries in the region voluntarily reduced barriers to trade in services and telecommunications, or submitted to such openness as structural adjustment requirements of IMF bailouts, Viet Nam openly recognized that its "model" for "industrial zones and processing zones" had "certain limitations."<sup>38</sup> In 1997, the Communist Party issued a directive instructing the Government to begin studying, identifying, and forming special economic zones in coastal regions with favorable conditions.

#### III.1. Chu Lai's Policy Foundations

As suggested to in Part II, special economic zones are normally established for two reasons: (1) to conduct controlled experiments with capitalism; and (2) to create a physical location free from the regulatory and administrative problems afflicting the rest of the country, and particularly the nation's domestic private sector. However, by 1992 and certainly by the 2003 establishment of the Chu Lai Open Economic Zone, Viet Nam had already decided to develop a "socialist oriented market economy," and was deeply engaged in negotiating its accession to the World Trade Organization. With provinces such as Binh Duong, Dong Nai, Ho Chi Minh City and Vinh Phuc serving as functional equivalents to "special" or "open" economic zones, Viet Nam's decision to form economic zones was not a national experiment with capitalism, but rather another experiment in rural development.

In spite of Viet Nam's attempt to spur rural development with industrial zones in the 1990s, the gap between rural and urban incomes continued to grow; after 1995, the real increase of urban incomes was thirteen times the real increase of rural incomes.<sup>39</sup> Not surprisingly with these income disparities, Viet Nam's urban population has increased 83 percent but rural population has only increased 23 percent since the beginning of *Doi Moi* Reforms in 1986 (despite significantly higher rural birth rates).<sup>40</sup> However, in many respects, facilitating the relocation of rural households away from farming and into other sectors is essential to Viet Nam's productivity growth. In Viet Nam, rural land is fragmented into small non-contiguous plots. In northern Viet Nam, the average rural household has 6.5 plots, in southern Viet Nam 3.4 plots, and as a result land parcels are not sized for efficient production and mechanization.<sup>41</sup> The consolidation of Viet Nam's agricultural land is essential, but it is not clear where the new "landless" will find employment. Viet Nam's leaders are aware of these issues, and thus the Prime Minister's Decision 148/2004/QĐ-TTg, "*Major Orientations for Socio-Economic Development of the Central Viet Nam Key Economic Region till 2010, with a Vision to 2020*," highlights the role of the Chu Lai Open Economic Zone, and other economic zones, in gradually becoming rural Viet Nam's "development nuclei" creating growth, investment, jobs, and poverty reduction.

Although Chu Lai's 27,000 hectares will facilitate the relocation of farming households, it is an open question whether Chu Lai will produce jobs for the dispossessed. Viet Nam's recent land law reforms granting farmers expanded rights to sell and transfer land appear to be a positive factor in poverty reduction thus far, despite inevitable land accumulation and landlessness. However, as a recent World Bank study aptly notes, "it is one thing to give people the opportunity to sell their land to take up more rewarding opportunities [in the labour market] but quite another to compel such changes by forcing farmers off their land."<sup>42</sup> As of 2005, Viet Nam's

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<sup>36</sup> Id.

<sup>37</sup> The Enterprise Law replaced Viet Nam's previous licensing requirements for domestic enterprises with simple registration. Prior to the Enterprise Law business registration took between 6-12 months, at a cost of between VND 15 million and VND 150 million. The Enterprise Law made business registration an individual right rather than a privilege. The results were dramatic. In 33 provinces registered capital increased by 400%, and in 11 provinces, like Vinh Phuc, registered capital grew by 2000%. New business registrations increased by over 300%, and more than 2,000,000 jobs were created within four years.

<sup>38</sup> Le Xuan Trinh, "The Chu Lai Open Economic Zone: Objectives and Policy Developments," seminar paper presented at UNDP's Hanoi office on March 1, 2000. Retrieved on July 3, 2006 at [www.undp.org.vn](http://www.undp.org.vn).

<sup>39</sup> David Dapice, (2004).

<sup>40</sup> Joint Donor Report, Statistical Appendix (Table 1.1) (2006).

<sup>41</sup> Although households in the north have more plots on average, the unit size of plots is larger in the south than north.

<sup>42</sup> Martin Ravallion and Dominique van de Wall, (2006).



experiment with industrial zones displaced 100,000 households. However, many of these new industrial zones have not provided displaced households with employment, and some local governments are not providing retraining. For example, in Long An and Can Tho eight percent of displaced households report industrial zone employment, five percent in Ha Tay and Vinh Phuc, and only four percent of households in Long An or Can Tho report access to retraining services (two percent in Quang Nam).<sup>43</sup> Policymakers in Quang Nam and Chu Lai are well aware of the importance of designing land clearance policies benefiting local farmers. These policymakers are committed to equity issues, however this commitment will need to remain resilient to pressures which have plagued land clearance policies in many other provinces.

Viet Nam's new open economic zone model promises to consolidate rural land, relocate farming households, and produce jobs. According to Viet Nam's policymakers, the fundamental problem with the expansion of industrial zones into rural areas in the 1990s was implementation. In urban areas many industrial zones clearly worked. Policymakers believe that with the right mix of policies the success of urban zones like Tan Thuan and Thang Long can be replicated in rural areas. The "open economic zone model" launched in Chu Lai is intended to solve these regulatory by providing local officials with regulatory space and incentives to experiment with policies appropriate for local economic development. Thus in 2000 Mr. Le Xuan Trinh stated Chu Lai would create an area with a "favourable atmosphere for the implementation of new economic policies, new economic models" which will continue Viet Nam's economic reform by harnessing the power of "all internal forces" and "external forces."<sup>44</sup>

### Questioning an Assumption of Chu Lai's Policy Foundation

Before delving into Chu Lai's architecture, it is important to analyze a major assumption underlying Viet Nam's second attempt to use industrial zones to spur rural development: namely, many foreign and a few domestic investors are deciding to invest in industrial zones on the basis of easier access, superior regulatory environments, and better physical infrastructure within zones as compared with those factors in other areas.<sup>45</sup> Certainly, there is a trend in Viet Nam for foreign and domestic investors to locate investments within industrial zones (khu công nghiệp) and industrial clusters (cụm công nghiệp). Between 2000 and 2005, the percentage of Viet Nam's total "new" FDI concentrated in industrial zones experienced a steady annual increase from 29 percent to 61 percent. Similarly, GTZ and CIEM's recent survey of seven rural provinces reveals 39 percent of private domestic enterprises in these provinces are located within local industrial clusters (71 percent of the private enterprises in Quang Nam). However, by the end of 2006, the number of domestic enterprises located in IZs accounts for only 1.3 percent of total registered domestic enterprises (8.7 percent in Quang Nam).<sup>46</sup> Altogether, this trend suggests that the comparative advantage created by easier access, superior regulatory environments, and better infrastructure within industrial zones mainly applies to foreign investors, who are less familiar with the local regulatory and whose opportunity costs are much higher vis-à-vis local domestic private firms.

Year	New IZ FDI Projects	New FDI in IZs (Registered. USD Bill.)	New FDI in IZs as % of VN's Total New FDI
1991-1999	582	NA	18.0%
2000	161	NA	29.0%
2001	210	1.26	39.1%
2002	291	1.29	46.8%
2003	252	1.59	51.9%
2004	277	2.16	50.1%
2005 (est.)	325	2.75	61.0%

Source: GS. TS. Võ Thanh Thu, (2006) Table 2.14).

<sup>43</sup> Mekong Private Sector Development Facility, (2006). P 1-2

<sup>44</sup> Le Xuan Trinh, (2006).

<sup>45</sup> According to CIEM's 2005 survey, in An Giang it takes a firm twenty four times as long to secure land outside of the province's industrial zones.

<sup>46</sup> GTZ and CIEM, (2005). Retrieved on August 23, 2006 at [www.sme-gtz.org.vn](http://www.sme-gtz.org.vn).

On the surface, industrial zones are essential to providing the domestic private sector and foreign investors with access to affordable land.<sup>47</sup> However, even in Binh Duong for instance, the domestic private sector is flourishing and still, not many private firms are located in industrial zones.<sup>48</sup> It is important to consider why domestic private firms do not want to move into industrial zones. There are several answers to this question; few point to the strength of policy environments within industrial zones.

Viet Nam has an abundance of agricultural land, currently deployed in relatively low value uses, and therefore, quite inexpensive compared to land in industrial zones with better location and infrastructure.

Although the agricultural land in rural areas is inexpensive and abundant, registered private enterprises face a choice of illegally operating on agricultural or residential land, securing commercial land from private markets at inflated prices, or moving into state managed industrial zones. This may help explain the high rate of informality among Viet Nam's domestic private firms.<sup>49</sup> By remaining informal, private firms are subject to less pressure to move into industrial zones, and retain greater flexibility to use land zoned for other purposes held by friends and family. As noted, in Quang Nam, business informality is substantial, and CIEM's recent survey reveals 71 percent of Quang Nam's registered domestic private enterprises are currently in local industrial clusters; no other province in the survey had more than 42 percent. In light of Quang Nam's rank of 48th among 64 provinces in the PCI's index measuring the domestic private sector's access to land, this high rate may not be a product of superior regulatory environments in Quang Nam's existing industrial zones and clusters.

A key assumption of the Chu Lai Model appears flawed with regards to the domestic private sector. Although the "policy environment" within Tan Thuan and several other early industrial zones undoubtedly played a significant role in attracting foreign investment during Viet Nam's initial experiments with markets, the recent trend for investment to gravitate inside industrial zones appears a product of land policy and infrastructure development rather than governance. Rather than facilitating the private sector with inexpensive land and good regulatory environments, industrial zones' emphasis on non-market land transactions may form a barrier to the domestic private sector's ability to serve as an engine of growth, job creation, and rural development. A danger exists that rural industrial zones may: (1) create incentives for enterprises to remain informal and small; (2) constrain enterprises' access to land outside industrial zones (and by implication land to use as collateral for capital); and (3) eliminate a number of potentially competitive markets prevented from developing by the limited supply of properly zoned land, such as commercial real estate.

### III.2. Chu Lai's Legal Architecture

The existing legal architecture of Chu Lai requires us to consider a second assumption of the open economic zone model: namely, the central government has created a legal design providing Chu Lai's officials with the regulatory space and incentives to develop a good regulatory environment. A former Binh Duong official has

Average Length of Land Acquisition (Days)		
Province	Outside IZs	Inside IZs
An Giang	245	10
Hung Yen	73	44
Quang Nam	120	43
Dak Lak	48	30
Ha Tay	270	70
Ha Nam	129	82
Lao Cai	277	188

Source: CIEM and GTZ, (2005)

Domestic Enterprises in Industrial Zones	
Quang Nam	71%
Hung Yen	42%
Ha Tay	38%
Ha Nam	35%
An Giang	29%
Dak Lak	27%
Lao Cai	26%

CIEM and GTZ (2005)

<sup>47</sup> See, e.g., Mekong Private Sector Development Facility, (2006) (noting that industrial zone land conversions are an important source of new land supply for the private sector.).

<sup>48</sup> A recent interview with a provincial leader of Binh Duong reveals that the province is now encouraging domestic private investors to locate within industrial zone for environmental reasons.

<sup>49</sup> There are certainly other factors contributing to the level of business informality in Vietnam, including issues related to land access and capital constraints, as well as a fear that becoming formal will subject firms to increased tax liability, supervision and informal charges.

said his province's biggest comparative advantage was its lack of a border with Cambodia, coastline for a port, good farm land, and proximity to Ha Noi. When asked why these were advantages rather than disadvantages, the official explained Binh Duong's lack of strategic and natural endowments limited central government investment in the province, and perhaps even more important, forces the leadership to be more innovative. Consequently, Binh Duong's officials were required to rely on themselves and look away from the central government for a development strategy. The province's comparative advantage was that this regulatory space allowed its policy environment and institutions to form and evolve around FDI attraction and private sector facilitation. In contrast, Quang Nam possess an international border, a coastline, and an intimate relationship with the central government, evidenced by Chu Lai's status as Viet Nam's first open economic zone. With such a strong orientation towards the central government, it is a daunting task to design a legal foundation for Chu Lai spawning experimental policies and institutions attracting foreign and domestic investment.

However, successful models exist. A number of nations transitioning from a command economy to a market system have tried to use economic zones to spur rural development. Successful experiments in China, and relatively unsuccessful experiments in India and Russia, reveal economic zones which successfully spur rural development have: (1) a prime location; (2) the participation of strategic foreign investors; (3) express and actual authority to experiment with the architecture of legal rules; and (4) significant fiscal decentralization. In terms of the first criteria, China had a distinct advantage in selecting "prime locations" for its rural special economic zones in Shenzhen, Shantou and Xiamen which were adjacent to international economic centers in Hong Kong, Macao, and Taiwan. Viet Nam does not have this advantage.<sup>50</sup> In contrast, the other three elements (foreign participation, legal experimentation, and fiscal decentralization) are issues heavily influenced by the central government's policy decisions in creating Chu Lai's legal design.<sup>51</sup>

The Prime Minister's Decision establishing the Chu Lai Open Economic Zone certainly experiments with Viet Nam's legal rules by creating, on paper, Viet Nam's most attractive investment environment by permitting:

- (1) all investment projects in Chu Lai to enjoy maximum preferences; (2) foreign investors to invest in telecom services; (3) foreign investors to mortgage land use rights to foreign credit institutions; (4) overseas Viet nameese, foreign investors, and other foreigners residing permanently in Viet Nam, to buy dwelling houses and erect houses for sale; (5) the experimental auction of land use rights; (6) banks, operating in the Non-Tariff Area, to open foreign exchange counters; (7) exemptions from export and import tariffs, and VAT, for goods and services produced and consumed in Non-Tariff Area; (8) easy access to multiple-entry visas for foreign investors and their families; (9) a one price policy with respect to goods, services and land rent for individuals and enterprises; and (10) domestic enterprises to have access to loans from the Fund for Development Assistance.

However, Chu Lai's legal design seems insufficient if intended to promote experimentation, innovation and incentives to create a superior regulatory environment. In contrast to successful examples of rural economic zones abroad, and urban industrial zones in Viet Nam, the Prime Minister's Decision does not create an effective mechanism encouraging the participation of foreign strategic investors in Chu Lai's development. Rather, the Decision creates the Chu Lai Management Board as the zone's governing authority. The head of the Chu Lai Management Board is appointed by the Prime Minister and the Board's deputies are appointed by the Chairman of Quang Nam's People's Committee.<sup>52</sup> Recently, the Management Board has ballooned to include 72 officials primarily drawn from Quang Nam's government departments. Thus far, Chu Lai's Management Board has not included a foreigner, and it has not developed a strategic partnership with foreign firm.

<sup>50</sup> However, the question of whether Chu Lai is a "prime location" relative to other rural locations in Viet Nam is subject to differing views. Chu Lai's proximity to Da Nang, as well as the bustling international tourist destination of Hoi An, precludes one from arguing that Chu Lai is the worst possible location for an open economic zone in Viet Nam.

<sup>51</sup> Since we submitted this report in November 2006, there has been come new development in terms of the governance of Chu Lai. For example, the issue of fiscal decentralization is addressed in Prime Minister's Decision No. 253/2006/QĐ-TTg dated 06 November 2006. The management authority of EPZ, IZ, high-tech zone and EZ Management Boards is now regulated by the Prime Minister's Decision No. 45/2007/QĐ-TTg dated 03 April 2007 regulating official. We would like to thank a anonymous referee for informing us about these regulatory changes.

<sup>52</sup> Article 27, Prime Minister's Decision No. 108/2003/QĐ-TTg, On the Establishment and Issue of Regulations on Operations of Chu Lai Open Economic Zone in Quang Nam Province (June 5, 2003).



Furthermore, despite published policy statements to the contrary, neither Chu Lai's Management Board nor any other local government body has real authority to engage in policy experimentation, as discussed below. Instead, Chu Lai appears to be an administrative apparatus of the central government's experimentation. However, experiences with special economic zones in China, India and Russia (as well as Viet nam) reveal that the decision to centrally regulate an economic zone or to decentralize policy making to local authorities, often differentiates economic zones sparking rural economic development from those failing to meet expectations. For example, in the Shenzhen Special Economic Zone ("Shenzhen"), China provided the municipal government with authority to create laws and regulations. In the five years immediately following this decision, Shenzhen's implemented FDI increased by 500 percent, from approximately \$10 billion USD to \$50 billion USD. In the Russian and Indian economic zones, on the other hand, the government decided to maintain central authority. These zones have failed to inspire investor confidence, and analysts generally regard these economic zones as existing only on paper, without substantial economic impact.

### The Shenzhen Experience with Legal and Regulatory Reform<sup>53</sup>

In 1992 Mr. Li Youwei, Chairman of the Shenzhen People's Congress, noted Shenzhen "should not only be China's experimental site for economic reform but also for its legal construction." In Shenzhen, market reforms were implemented a decade before similar reforms in mainland China, encouraging legal and economic relationships China's national law did not contemplate. In the initial stages, Shenzhen was an administrative unit of Guangdong Province, which passed approximately 25 laws regulating Shenzhen. The process of officially enacting these laws, however, was cumbersome. As a result, Shenzhen's management board adopted over 430 informal rules, such as China's first bankruptcy regulations, responding to gaps in national and provincial law. There was a problem, however. These informal rules lacked the force of law, and foreign investors began to demand more certainty. In 1992, China's supreme legislative body made the decision to formalize legal decentralization by delegating to Shenzhen "special legislative power to adopt regulations applicable to the SEZ." Shenzhen's legislative power was independent of the Guangdong provincial government. "The decision [was] intended to speed up the construction of Shenzhen, to push forward its reforms . . . and to develop the socialist commercial economy." As such, Shenzhen was the first area of China to open its real estate market to foreign nationals, and to enact a company law. Shenzhen laws served as a model for laws in Shanghai and other regions.

This is not to say Chu Lai can become Shenzhen. However, the Management Board's role appears limited to developing infrastructure, investment promotion and land administration. These are precisely the areas where foreign participation is essential! In all other areas, the Management Board's decisions are subject to approval by the provincial government, central government, or both. For instance, the Prime Minister's Decision provides that the Chu Lai "Management Board shall:

- . . . (1) develop the overall planning and charter on operations of [the] Chu Lai OEZ for [the] Quang Nam People's Committee to submit to the Prime Minister for approval; (2) prepare the Detailed Planning for Quang Nam People's Committee to submit to the Ministry of Construction for approval; (3) prepare the annual list of investment projects and plans for investment and capital construction for submission to the competent authorities for approval and organizing; and (4) issue business registration certificates, investment licenses, investment incentives certificates, certificates of origins in Chu Lai OEZ and other certificates as authorized by the competent authorities.

However, the Prime Minister's Decision appears to assign the "policy making element" - which is subject to even further approvals - of all of the aforementioned tasks to the Quang Nam People's Committee:

<sup>53</sup> For an English translation of the Standing Committee's delegation of law making authority to Shenzhen see "Legislative Affairs Commission of the Standing Committee of the National People's Congress" (compilation), *The Laws of the People's Republic of China*, Vol. 5, 524 (1993, amended 1999). See also Chen K. (1992a, 1992b, 1992c), Kwan D. (1993), Xinhua General Overseas News Service (1992a, 1992b), and Xianchu Zhang and Booth Charles D. (2001)

The Quang Nam People's Committee shall be responsible for instructing the preparation of the overall planning and the charter of operations of Chu Lai for submission to the Prime Minister for approval; (2) instructing the preparation of the detailed planning for submission to the Ministry of Construction for approval; (3) authorizing [the] Chu Lai Management Board to approve domestic investment projects under its authority; and (4) approving the list of projects of investment and development and the annual plan on investment and capital construction in Chu Lai.<sup>54</sup>

In fact, even the Management Board's title appears undermined by the provisional People's Committee's legal duty to coordinate "with relevant Ministries and branches to organize the management of Chu Lai." Furthermore, other parts of the Decision appear to expressly limit Chu Lai's experimental space by broadly giving other local and central government organs authority to make major policy decisions within the zone.

With respect to fields in which no authority is made, [the] Chu Lai Management Board, Ministries, and Quang Nam People's Committee are authorized to carry out State management of Chu Lai by way of setting up dependent units inside Chu Lai to carry out their duties and authorities in order to create favorable conditions for the operations of investors and enterprises in Chu Lai.

As a result, many of Chu Lai's policy decisions in planning, infrastructure development, licensing investments, and finance are subject to pre-approval by Quang Nam's government and central government ministries with an interest in the areas implicated by the decision.

Likewise, Chu Lai's degree of fiscal decision making authority is unclear. In principal, Chu Lai's founding documents seem to recognize the importance of fiscal decentralization. The Prime Minister's Decision provides that:

"Chu Lai . . . shall be developed with the following principal capital sources: The State budget capital in support of the construction of important infrastructure works urgently needed for the operation of the OEZ; [and] The State's development investment credit capital . . . .

The State budget shall provide infrastructure investment support[] for Chu Lai . . . in proportion to revenue amounts collected in Chu Lai [], as follows:

- (a) 100 percent of revenue amounts to be collected in [first] 10 years . . . ;
- (b) 50 percent of revenue amounts to be collected . . . from 11th year to 20th year;
- (c) From the 21st year onward, the general regulations shall apply.

[Furthermore,] [t]he Chu Lai OEZ Management Board is allowed to use the land fund to create capital for infrastructure development. The Chu Lai OEZ Management Board is allowed to issue project bonds at home to mobilize investment capital beyond the limited level prescribed for the capital mobilization by Quang Nam province. The Chu Lai OEZ Management Board is allowed to collect charge or fee for the use of infrastructural works and public facilities in Chu Lai OEZ.

Thus, a legal basis for decentralizing fiscal decision making to the Chu Lai Management Board exists. However, in reality, the Management Board's authority to render fiscal decisions is extremely limited. Although Chu Lai is guaranteed annual support from the central government's budget for infrastructure investments, this support is provided in approved parts rather than as a block grant. For instance, in order to build a road, port, or extend airport runways, the Management Board must obtain approvals from Quang Nam's People's Committee, the Ministry of Construction, and other central government authorities having a direct expertise or interest related to the project. This approval process, however, creates mixed incentives. First, ministries believing their regulatory authority and space is threatened by Chu Lai's experimentation can prevent consensus by withholding approval. Second, some ministries may have an interest in helping their state owned enterprises "win" infrastructure contracts; as a result, Chu Lai's development revenues face the possibility of waste if these enterprises have high prices, low quality, or both. Third, this approval process limits the Management Board's ability to engage foreign strategic investors to participate in Chu Lai's development. Fourth, this process requires Chu Lai's leaders to continue focusing on the central government, rather than beginning the critical process of looking inside Quang Nam and outside Viet Nam for a development strategy.

<sup>54</sup> Article 30, Prime Minister's Decision No. 108/2003/QĐ-TTg, On the Establishment and Issue of Regulations on Operations of Chu Lai Open Economic Zone in Quang Nam Province (June 5, 2003).

This division of legal and fiscal decision making authority between Chu Lai, Quang Nam, central government ministries, and the Prime Minister is problematic. Policymakers in Quang Nam and Chu Lai are aware of the limitations these ambiguities create for their development strategy. For example, several of Chu Lai's largest projects involving strategic foreign investors have encountered prolonged and unresolved delays because of required investment licenses, conflicts in central and provincial master plans, difficulties in obtaining approval for project-related infrastructure investments, and more.

In November 2005, the Chu Lai Management Board made a proposal to address ambiguities in its current degree of legal and fiscal decentralization, asking the central government to reconsider five issues about Chu Lai's policy development process.<sup>55</sup> Specifically, the Management Board asked the central government: (1) to elevate Chu Lai's legal basis from a Decision to a Government Decree; (2) to provide Chu Lai's Management Board with authority to grant investment licenses on projects exceeding \$40 million USD; (3) to resolve any conflicts in master plans produced by line ministries and the Chu Lai Management Board in favor of the Management Board's master plan; (4) to provide the Management Board with greater financial autonomy; and (5) to permit the Management Board to issue municipal bonds to finance infrastructure investments.<sup>56</sup> Although central government officials have responded by emphasizing Chu Lai's role in becoming the nucleus of the central region's future economic development, all indications are that this five point proposal will be rejected because its specific policy proposals have no precedent in Viet Nam. In reality, it appears the consensus decision making process is again the major problem, because it involves several line ministries with different and sometimes conflict interests.

Fortunately, opportunities still exist to define unambiguously the level of legal and fiscal decentralization in Chu Lai. Recently signed Decree 108, on the implementation of the Common Investment Law, appears to bestow local governments and zone management boards with far greater authority to issue investment licenses (see Part IV for further discussion of Decree 108). In the next few months, the Ministry of Planning and Investment is convening a working team to supervise issues related to implementing the Decree. The Chu Lai Management Board should consider petitioning MPI and other relevant agencies to serve as a pilot location for fully implementing Decree 108.

In sum, Chu Lai's enabling documents do not give it the level of policy making authority granted to successful models of rural economic zones in other countries. Lacking legal and fiscal decentralization, Chu Lai is confronting barriers to enlisting significant foreign participation. A central government policy change unambiguously decentralizing fiscal and policymaking authority to Chu Lai is essential. In Part 4, we return to this problem and make policy recommendations.

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<sup>55</sup> The Chu Lai Open Economic Zone, (2005). Retrieved on June 18, 2006 at <http://www.chulai.gov.vn>.

<sup>56</sup> Id.

## IV. Three Year Review of Chu Lai's Development

In the following sections we provide a three year review of Chu Lai's development, describe policymakers' views about current problems, and analyze four critical issues facing Chu Lai's leaders in infrastructure development, human capital investments, industrial policy and governance. Based on this analysis, we suggest potential policy responses.

### IV.1. Chu Lai's Development: Barriers and Solutions Identified by Policymakers

As of April 2006, Chu Lai has attracted 120 projects with registered capital of USD 1.4 billion. Of these 120 projects, five factories are operational and seven factories are in the process of being established. The five implemented investments include projects in glass production, truck assembly, sand exports, and fish food. These investments have created approximately 1000 jobs in Chu Lai, and the seven other factories are anticipated to create an additional 2000 jobs. Thus far, 65 percent of the central government's transfers to Chu Lai have been used to clear land for 70 of the 5000 households which require relocation. Less than 10 percent of these households are finding employment in Chu Lai or Quang Nam's service sector. Quang Nam's Party and Government, officials and management board officers are not satisfied with the pace of development. A leading Chu Lai policymaker recently stated "there are no new models or policies [being] applied in Chu Lai" instead Chu Lai is still applying "common policies for all industrial zones."<sup>57</sup> There is a consensus among Chu Lai's policymakers that Chu Lai has not defined or exploited its "openness mechanism" in its first three years. Conversations and interviews with Quang Nam and Chu Lai policymakers focus on problems in several areas.

First, policymakers believe Chu Lai does not effectively have authority to experiment outside of the central government's plan. When Chu Lai proposes a policy, central government ministries often withhold their approval because the proposed policy has no precedent in Viet Nam. Examples of this trend include, Chu Lai's five point proposal in 2005 and several plans to attract a strategic investor. These proposals have all been delayed or denied because of a combination of central government inertia, a consensus decision making process, and an unwillingness to experiment by interested ministries. After three years, there is a common belief that "by being open, Chu Lai risks being illegal." As a result, Chu Lai's most innovative policy in its first three years, according to several sources, is land clearance.

Second, Chu Lai lacks the participation of large strategic foreign investors. One dramatic difference between most of Viet Nam's successful industrial zones and Chu Lai is the absence of foreign participation. Chu Lai has attempted to attract a USD 500 million investment in developing the Chu Lai Airport as an international hub for airplane repair and maintenance. Although the license was approved after significant delay, Chu Lai has continued to face significant barriers from central government ministries in making necessary infrastructure investments in the runway and other locations to secure the investor's commitment. In the mean time, it appears market conditions have changed and the investor may be interested in a different location. Similarly, Chu Lai has developed a relationship with a foreign financial institution to serve as strategic investor in the Free Trade Zone. However, Viet Nam's legal framework for financial institutions is restrictive, and therefore the financial institution requires the ability to use English Law and other foreign governance structures within the Free Trade Zone. Although Chu Lai is designated as Viet Nam's national laboratory experimenting with international economic integration, and WTO commitments will soon require opening its financial sector, Chu Lai has not been given approval to further develop a relationship with this foreign financial institution. On the other hand, according to some observers, foreign participation in Chu Lai is hindered, not by the central government, but rather the Management Board's belief that it is the most important investor in Chu Lai. Although Tan Thuan's Management Board may have shared a similar view, it included foreign strategic investors in its decision making, whereas Chu Lai's Management Board is exclusively comprised of government officials. These two contrasting views suggest neither Chu Lai's legal architecture nor its Management Board's incentives favor the inclusion of foreign strategic investors.

Third, according to a number of policymakers, Quang Nam and Chu Lai simply lack the quality human resources needed to implement an openness mechanism. This is not a comment about the quality of the labour force, but rather a critique of government personnel. In Quang Nam and Chu Lai there seems to be

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<sup>57</sup> Communist Party of Viet Nam's Online Newspaper, (2006). Retrieved on September 14, 2006 at <http://www.cpv.org.vn>.

an enormous gap between the vision of the leading policymakers and the capacity and commitment of implementing officials. A few observers have noted the biggest difference between Binh Duong in the 1990s and Quang Nam and Chu Lai today is the quality of mid-level government officials, as well as local officials' degree of commitment to the province's development strategy. This is not to say government officials in early developing provinces were angels; there is some evidence that in these provinces land parcels, including those cleared to develop industrial zones, served as critical vehicles for informal salary subsidies and other benefits. However, this use of land was not necessarily "all bad" because it provided officials with strong incentives to create attractive conditions for private investment facilitating local economic development, which in turn increased demand for land and the value of their land holdings. In Chu Lai and Quang Nam, however, it appears government officials do not believe rising land prices will be a source of personal gain and wealth, and therefore are not satisfied with informal salary subsidies related to rising land prices alone. As a result, informal charges and costs created by local officials appear to be a real barrier to development.

To address these issues, Quang Nam's policymakers believe it is essential to create a new governance mechanism in Chu Lai. In the words of an observer, "Chu Lai's father is the state, and Chu Lai's mother will be private enterprise. However, the father can not give birth to the mother." As a result, the role of the Chu Lai Management Board (the father) is limited to seeking permission from the central government to expand the openness mechanism for the mother. According to these policymakers, the Management Board should try to create experimental space for private enterprises to form a powerful management board within Chu Lai's Free Trade Zone. This zone within a zone will receive its policy directives from strategic foreign investors and other firms, and it will become the new nucleus of Chu Lai's policy and institutional innovation. According to these officials, the Free Trade Zone will create a "hard fence" between this innovative board and the defunct policy environment in Quang Nam and Chu Lai. The Free Trade Zone will operate with foreign law, and will exist in a quasi international space where neither customs procedures nor Visas are necessary. According to several Chu Lai policymakers, three years of experience suggest the potential Free Trade Zone's foreign legal framework and the restricted involvement of Quang Nam and Chu Lai's administrative apparatus are necessary conditions for attracting investors.

In the following sections, we will analyze these concerns and others in the context of three current issues confronting policy leaders in Quang Nam and Chu Lai including infrastructure investments, labour skills development, and industrial policy. In the final part, we will analyze the feasibility and desirability of Quang Nam's current plan to build a "zone within a zone" in Chu Lai.

#### **IV.2. Infrastructure Development: An International Transshipment Port in Quang Nam?**

According to an observer, Chu Lai's infrastructure investments confront a dilemma: "they have not identified an industry to concentrate on, and therefore they do not know what infrastructure to prepare. It is like having a project without a purpose." Despite this uncertainty, Chu Lai's policymakers seem to uniformly believe that developing a modern port is critical to attracting investment. A natural question for Chu Lai's policymakers is whether sufficient demand exists to justify the infrastructure investments (the opportunity costs) required to develop a modern shipping port.

In Viet Nam, shipping is concentrated in the northern and southern regions. Ports in central Viet Nam only handle 10 percent of Viet Nam's total shipping demand. In terms of containers, central Viet Nam's proportion of Viet Nam's total shipping demand is even lower. In 2002, Viet Nam's ports handled 1.6 million TEUS (a TEU - an abbreviation for "twenty foot equivalent unit" is the basic standard of measurement used to count ship containers and container traffic). Central Viet Nam's ports handled less than 60,000 TEUS, or 3.75 percent of Viet Nam's total container traffic. With this relatively low level of demand, shipping services in central Viet Nam are not reaching economies of scale necessary to offer competitive freight rates. As a result, containers throughout central Viet Nam, even in provinces with ports, are currently shipped through ports in Da Nang and Qui Nhon.<sup>58</sup>

<sup>58</sup> Similarly, demand for conventional shipping (cargo without containers) is low. Central Viet Nam exports wood chips and white sand, and imports fertilizer and clinker (for cement production). The annual throughput is 9 million tons, and this throughput is spread thinly among more than 20 ports. Only Da Nang and Qui Nhon ports have sufficient throughput (more than a million tons a year) to make investments in modern facilities efficient, such as stevedores, cargo handling equipment, pilots, tug assistance, berths and warehouses.



Despite low demand, Chu Lai's policymakers (as well as policymakers in almost every province in central Viet Nam) argue that a transshipment service for Laos' exports and imports will increase demand for central Viet Nam's ports to efficient levels. However, Laos' total exports in 2004 were only \$365 million USD, and approximately 37 percent of this total was exported to Thailand or Viet Nam by road. Similarly, 70 percent of Laos' \$580 million USD in imports originated from Thailand or Viet Nam. Therefore, Laos's shipping demand is about \$400 million USD a year, or less than one percent of Viet Nam's total domestic imports and exports. Furthermore, Laos' shipping demand is currently handled by Thailand for several reasons. First, Laos' economic activities are concentrated around the capital city of Vientiane, adjacent to Thailand's border. Second, a highway system and railroad connecting Vientiane and Bangkok makes inland transportation convenient. Third, Thailand's Laem Chabang Port is served by "mother vessels," making Thailand's freight rates significantly lower than freight rates in Viet Nam. In 2005, for instance, Laos began exporting approximately 100 containers per week of copper ore and gold ore from the Sepon area, bordering central Viet Nam. Vietnamese shipping companies were keenly interested in providing services to the Sepon area. The shipping business, however, went to the Laem Chabang Port in Thailand. According to exporters, Laem Chabang Port has substantially lower freight rates than ports in central Viet Nam, and the trucking costs from Sepon to Laem Chabang - though significantly longer - are cheaper and safer.

In addition to Laos' potential demand, Chu Lai's policymakers believe there is an untapped international demand for a transshipment port in Chu Lai. According to this view, Chu Lai is strategically positioned on busy international shipping lanes and has a comparative advantage in developing into an international transshipment hub. There are several problems with this argument. First, Chu Lai's strategic position is shared by many other provinces in Central Viet Nam. As a result, the Ministry of Transportation and several other of Central Viet Nam's provinces are trying to capture this opportunity by developing ports. In Central Viet Nam, from Thanh Hoa Province to Khanh Hoa Province, eighteen large ports currently exist: Le Mon (Thanh Hoa); Nghi Son (Thanh Hoa); Cua Lo (Nghe An); Hon La (Ha Tinh); Xuan Hai (Ha Tinh); Vung Ang (Ha Tinh); Nhat Le (Quang Binh); Chan May (Hue); Tien Sa (Da Nang); Song Han (Da Nang); Ky Ha (Quang Nam); Dung Quat (Quang Ngai); Quy Nhon (Binh Dinh); Thi Nai (Binh Dinh); Van Phong; Nha Trang (Khanh Hoa); Ba Ngoi (Khanh Hoa); Vung Ro (Khanh Hoa). Most of these ports have the capacity to receive large vessels up to 20,000 DWT, and the ports in Vung Ang, Chan May, Tien Sa, Thi Nai, and Van Phong can receive vessels over 40,000 DWT. Second, in addition to domestic competition to develop an international transshipment hub, Chu Lai's potential port faces stiff competition from existing hubs in Hong Kong, Kaoshung, Singapore, and southern China.

Rather than debating whether Quang Nam or Chu Lai can develop an international transshipment hub in the future, perhaps Chu Lai's policymakers should ask themselves whether any port in Viet Nam can currently attract a "mother vessel," which is essential to maintaining competitive international shipping rates.<sup>59</sup> Presently, mother vessels do not visit Viet Nam. Instead, all container shipping from Viet Nam is placed on "feeder vessels" which travel from ports in Viet Nam to international transshipment hubs in Hong Kong, Singapore, and Kaoshung. At these ports, the containers are transferred to a "mother vessel" and shipped to their final destination countries. The typical capacity of a feeder vessel leaving Viet Nam is 300-1,000 TEUs. The typical capacity of a mother vessel leaving from an international hub in Hong Kong, Singapore, or Kaoshung is 5,000-6,000 TEUs. In 2004, the Da Nang Port handled 35,000 TEUs, or less than 100 TEUs per day. As a result of this low volume, shipping companies do not even have "direct feeder vessels" from Da Nang to "mother vessel ports" in Hong Kong, Singapore, or Kaoshung. Instead, feeder vessels serve the Da Nang port in-route from Hai Phong to Singapore or from Ho Chi Minh City to Hong Kong. Consequently, the freight rates from Da Nang are more than double the freight rates from Hai Phong and Ho Chi Minh City.

### Average Container Freight Costs (2005) <sup>60</sup>

Ho Chi Minh City - Singapore	\$180/TEU
Da Nang - Singapore	\$400/TEU
Ho Chi Minh City - Hong Kong	\$240/TEU
Da Nang - Hong Kong	\$500/TEU

<sup>59</sup> The operating cost of a mother vessel is typically several thousand dollars per hour. As a result, mother vessels only serve ports with thousands of containers to load and unload. Furthermore, whereas feeder vessels load containers destined to all countries (these containers are unloaded in Singapore, or a different transshipment center, and transferred to mother vessels headed in three main directions: Europe, America, and Japan), mother vessels only load containers headed in one of three directions.

<sup>60</sup> The cost of trucking one TEU from Da Nang to Ho Chi Minh City ranges from \$220 to \$300, depending on the weight of the container.

To determine when Viet Nam will attract mother vessels, Chu Lai's policymakers should examine Thailand's experience. Thailand has significantly higher import and export volumes than Viet Nam, and its shipping service is concentrated in Bangkok. In 1996, Thailand's total imports and exports exceeded \$120 billion USD, and only after exceeding this threshold did Laem Chabang Port begin receiving regular service from mother vessels. In 2005, Viet Nam's total imports and exports were half of Thailand's 1996 totals. Accordingly, it seems unlikely infrastructure investments in a deepwater port in central Viet Nam will receive sufficient service from "mother vessels" to realize the demand for an international transshipment hub.

There is one other element which may be motivating Chu Lai's policymakers to develop a port. Regardless of demand, policymakers often argue ports are essential to local economic development. According to this view, ports produce jobs, create spillover effects, and reduce transportation costs for local companies. However, in the past several decades port operations have changed dramatically. Previously goods were not carried by containers, and therefore a 10,000 DWT vessel required hundreds of workers more than a week to load and unload. Furthermore, because vessels remained in port for several weeks, the area adjacent to ports provided ship repair and maintenance, supplies and entertainment for ship crews, and import/export companies established representative offices in port towns. Today, however, goods are shipped in containers. In contrast to conventional shipping methods, containers are unloaded mechanically directly to trucks. As a result, container vessels often require less than 24 hours in port. Hai Phong Port is a clear example of this paradigm shift; ports are no longer a major source of job creation, and ports no longer create spillover effects for the local economy.

**Estimated Time in Ho Chi Minh City's Port (5,000 DWT Vessel)**

	<u>1980s</u>	<u>Today</u>
Waiting for Berthing.....	3-4 days	0
Unloading and Loading .....	4-5 days	0.5-1 days
Waiting for Daytime to Navigate Channel.....	0.5 day	0
Navigating Channel.....	0.5 day	0.5 day
Total.....	8-10 days	1-1.5 days

However, even if a new port will not create jobs, there remains a second part of the arguments that developing a port is good for economic development; specifically, port investments are justified by substantial benefits created for investors and potential investors. Undoubtedly, transportation costs are an important factor in locating production. Fortunately, the containerization of shipping has also made inland transportation cheaper. Within a diameter of 70-100 km from any given port, the cost of inland transportation does not vary substantially (thus, whether the port is 1km or 70km from a factory does not make a substantial difference in transportation costs). Binh Duong is an example. The province has no port; however, the distance from Binh Duong to Ho Chi Minh City Port does not reduce Binh Duong's competitiveness. On the other hand, a large investment into an under-utilized port reduces the competitiveness of a locality by crowding-out more reasonable infrastructure investments, and by also creating a stream of fixed costs. For instance, the Chan May deep sea port in Hue was started in 2000, and officially opened in May 2003. The port is under-utilized. The annual cost to the local government is the opportunity cost of a \$20 million USD investment, and the maintenance expenses.

### IV.3. Human Capital Investments: A University or a High School?

A common complaint of potential Chu Lai investors in manufacturing and light industry is the lack of skilled labour in Quang Nam prepared to serve as middle-managers or operate factory machinery. Presently, the Chu Lai Management Board does not have a significant training capacity. Therefore, the Management Board must coordinate with the private sector and Quang Nam's provincial government to satisfy investor demand for skilled workers. Quang Nam's People's Committee operates a vocational school in Tam Ky graduating 600 students a year, as well as a vocational school in Hoi An. Policymakers believe these vocational schools will not satisfy Chu Lai's future demand for skilled labour. Consequently, Quang Nam and Chu Lai are currently developing a plan to establish a general university. The Ministry of Education and Training is considering Quang Nam's proposal to transition its University of Pedagogy into a general university. Quang Nam's policymakers believe this university is essential for local economic development. Plans for the proposed

university's development differ according to which government office is asked. The education department believes developing a general university is essential. Chu Lai's policymakers believe the university will decide which departments to develop in response to local industry needs.

The 2003 Labour Force Survey has the following data for Quang Nam. Data for all of Viet Nam, Binh Duong and Da Nang are supplied for comparison.

	<u>Quang Nam</u>	<u>Viet Nam</u>	<u>Binh Duong</u>	<u>Da Nang</u>
		<i>percent of workers with:</i>		
College/University	3.3 %	4.4 %	6.1 %	14.1 %
Vocational Secondary	3.4 %	4.1 %	5.3 %	5.3 %
Skilled w/ certificate	1.4 %	3.3 %	5.1 %	6.8 %
Skilled w/o certificate	2.5 %	2.6 %	3.4 %	1.7 %
Elementary Apprentice	6.8 %	6.6 %	6.2 %	13.7 %
Unskilled worker	82.6 %	79.0 %	74.0 %	58.3 %

This table reveals Quang Nam is similar to all of Viet Nam in the three lowest skill levels, whereas Quang Nam's labour force lags behind in the three highest skill levels. This gap becomes more evident when the southern (but rural) province of Binh Duong is analyzed. The gap is even larger when the urban center of Da Nang is used for comparison. Similar patterns emerge if schooling alone, rather than skill levels, are used. In Quang Nam, only 13 percent of workers finished high school, compared to 18 percent in Viet Nam, 21 percent in Binh Duong and 38 percent in Da Nang.

To design a tailored response to this problem, Quang Nam's lack of skilled workers must be understood in light of a counter-intuitive fact; Quang Nam's secondary school enrollment relative to total population (3.8 percent) is actually higher than the same ratio in Da Nang (3.6 percent). This implies Quang Nam's labour force problem is not about enrollment levels, but rather a consequence of low industry demand and other factors encouraging high skilled workers to leave Quang Nam. This evidence suggests, Quang Nam's high school students are migrating either the short distance to Da Nang or the greater distance to the Ho Chi Minh City in search of better opportunities. This leaves fewer skilled workers behind.

Will establishing a university in Quang Nam solve this demand problem? Not necessarily; Quang Nam's college graduates - like its high school students - will still leave the province seeking better opportunities. Until nearly a decade ago, Quang Nam was joined with Da Nang. Although a long term plan to develop a general university is important, it may not make sense to immediately duplicate Da Nang's university facilities if the intention is to respond to Quang Nam's labour skills shortage. Instead, Quang Nam should commit its scarce education resources to address demands in two areas: (1) educational facilities making it easier for educated Vietnamese to decide to live in Quang Nam; and (2) adapting Quang Nam's secondary, vocational, and college curriculums to meet Chu Lai's development needs.

The overriding concern for most parents, after safety and job opportunities, is their children's education. As a leading policymaker noted, "Quang Nam needs to prepare a nest for people to lay their eggs." While children of educated Vietnamese workers often move to major urban centers for university education, these children typically stay very close to home for K-12 education. Thus, if resources are put into improving the quality of K-12 schools, it may be much easier to attract higher skilled workers to support more advanced industries and services. As the number and wealth of workers improve, a local university will become even more feasible.<sup>61</sup>

<sup>61</sup> This is not the place to discuss governance failures in Viet Nam's education system. However, one point is clear: simply dumping money into the existing system is not productive. The management and incentive system must be changed so as to regain a degree of professionalism and pride in the teaching staff. Better basic pay is part of this, but only part. Greater parental oversight and room for experimentation is also needed.



In addition to improving the quality of its primary and secondary education, Quang Nam should focus resources on connecting existing and future higher education curriculums with the development goals and demands of Chu Lai and its firms. This is a critical imperative, which remains relevant whether Quang Nam ultimately decides to develop a general university or improve its vocational training. At this stage, a communication breakdown seems to exist between Chu Lai and Quang Nam on skilled labour issues. In 2001 it seems Chu Lai officials met with government officials and estimated a demand for 250,000 skilled workers. However, this discussion - or any other discussions of educational collaboration between Chu Lai and Quang Nam - have not continued in the past five years.

In designing relevant vocational training programmes, Chu Lai's policymakers may benefit from Malaysia's experience in establishing the Penang Skills Development Centre.<sup>62</sup> The Center was established in 1989 to supply multinational corporations in Penang's electronics sector with skilled workers. Demand for the Centre arose when several major investors including Intel and Motorola invested in Penang's electronic sector. Labour costs began to rise as companies started competing over the limited number of skilled technicians. The companies formed an alliance, and proposed a plan for the local government to establish a training Centre to increase the supply of skilled labour. The Center's Management Council was comprised of the managing directors and chief executive officers of existing investors in Penang. The Centre course curriculum were reviewed and amended by a training committee, comprised of representatives from the training departments of Penang's firms. After a short time in operation, the Centre achieved a level of financial self sufficiency because students were willing to pay for a vocational educational leading directly to a job. Between 1989 and 2003, the Center trained over 105,000 workers helping Penang's electronics industry account for approximately 20 percent of the city's GDP, and 55 percent of its employment.

In Viet Nam there are several examples of public/private partnerships in developing vocational skills. For instance, the Hanoi Industrial College and the Japan International Cooperation Agency established a project to upgrade the production-engineering skills of high school graduates. Similarly, Binh Duong and the Ministry of Planning and Investment have developed several vocational programs tailored to the requirements of small and medium sized enterprises and international companies. However, Viet Nam's vocational education projects generally lack the magnitude and intensity of foreign participation which was essential to Penang's success. Quang Nam's current and future labour skills requirements are perhaps much different than either Penang or Binh Duong. Rather than investing in training capacity for potential firms in electronics and manufacturing, Quang Nam and Chu Lai should address current demands in the tourism industry. With the development of high-end resorts and services for international tourists, there is a great demand in Quang Nam for labour with foreign language and service skills. The recently established Phan Chu Trinh University in Hoi An appears to be establishing a curriculum around these needs. Quang Nam should collaborate with its current investors to brainstorm about the viability, efficiency, and possible curriculum for a training center adding value to its tourism industry.

#### **IV.4. Industrial Policy: Beach Resorts or Heavy Industry?<sup>63</sup>**

Chu Lai faces difficult dilemmas in its industrial policy. Economic zones are generally established to attract investment in manufacturing and industry. Manufacturing investments are labour intensive, providing the biggest source of wage employment for Viet Nam's rural transformation. Although capital intensive industry investments are not a major source of employment, projects in oil, gas and electricity generation provide manufacturing interests with inputs, and also give Chu Lai large investment commitments to report. Chu Lai's dilemma is that industrial policy encouraging heavy industry, as well as other poorly located investments, may dampen growth in Quang Nam's most dynamic economic sector, ecological and historical tourism.

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<sup>62</sup> Junichi Mori, (2005). Retrieved on October 16, 2006 at <http://fletcher.tufts.edu>.

<sup>63</sup> We have observed a radical and very positive re-direction in Quang Nam's development strategy started in 2006 away from heavy and polluted industries toward services, especially those related to tourism. It appears that this strategic and brave change is paying off as evident from the waiting list of foreign investors in the service sector.

Tourism is the leading, and perhaps only robust part of Quang Nam's current economy. From 1991 to 2005, Quang Nam's tourism exploded, growing from 100,000 to 1,400,000 visitors. Of the 1.4 million tourists visiting Quang Nam in 2005, 900,000 were Vietnamese and 500,000 were international. With a sustained annual growth of 20 percent, a beautiful coastline, and two World Heritage Sites in Hoi An and My Son, Quang Nam's tourist industry appears poised for sustained and perhaps explosive growth in the next several decades. While no surveys of tourist spending in Quang Nam are available, it appears most tourists spend two - four nights in the province, and many are repeat visitors. A typical international tourist in Viet Nam spent USD 540 million in 2005. If we assume a tourist spends half of their time in Quang Nam's myriad magnificent destinations, then we might expect USD 270 million of provincial revenue per tourist for all hotels, meals, tours, domestic travel, gifts, and related spending. Domestic Vietnamese tourists, on the other hand, spent an average of USD 100 million per tourist. If these assumptions are correct, then in 2005 tourists spent USD 225 million in Quang Nam; the province's 2004 GDP was only USD 450 million. Even if actual spending is less than these figures suggest, tourism is likely the single most significant non-agricultural activity in the province, particularly if direct and indirect spending, as well as job creation data are included in the calculation.<sup>64</sup> (For instance, even assuming the 500,000 international tourists only spent USD 150 million in Quang Nam, international tourists still generated approximately USD 75 million equaling Quang Nam's total export value of manufactured goods.). Clearly, if Quang Nam continues its highly successful campaign to market itself as an attractive tourist destination, and this translates into maintaining its current rate of growth in arrivals and spending per person, Quang Nam will be investing in a promising source of jobs, income and growth.

Of course, tourism as it is today may not be a stable basis for Quang Nam's economy, and Chu Lai plans to attract manufacturing and industry. As described above, Chu Lai has not yet succeeded in attracting substantial foreign or domestic investment in manufacturing or industry, and significant investment in these areas may take several more years to materialize. However, a group of foreign investors recently made a proposal to invest USD 2.4 billion in a 2000mgw coal-fired power plant. Part of Electricity of Viet Nam's plans, the plant would have contributed far more electricity than needed within the province. Fortunately, it appears Chu Lai and the leadership of the province have decided to reject this project. Policy leaders recognized an obvious problem. The coal plant's 180 meter smokestack would have produced air and visual pollution. If located near the coast as planned, the smoke stack would have been visible for tourist's to marvel at from over 50 kilometers each direction (north of Da Nang to Quang Ngai) on a clear day. The entire coast line of Quang Nam is only 80 kilometers. Of course, many days would not have been clear if the coal plant was built!

In the future, Chu Lai will certainly confront similar dilemmas. How should Chu Lai's policymakers analyze the costs and benefits of other investments posing a threat to tourism? We can use the rejected coal-fired power plant to provide an example of the type of analysis required. On the one hand, the proposed plant would have reportedly paid USD 40 million a year in taxes and fees, and also built a 60,000 ton port to allow bulk carriers to deliver coal. On the other hand, the highly specialized coal port may not have provided additional transportation benefits, and the plant would have threatened Quang Nam's lucrative and growing tourist industry.

Chu Lai and Quang Ninh are in a similar position. Quang Ninh also has a World Heritage Site, Ha Long Bay, and a major tourist industry. Quang Ninh also has a 1200mgw coal plant slated for construction near its tourist areas. The first 600 MGW plant will be operational by 2008. Observers fear Quang Ninh's unique combination of natural beauty and coal-fired power generation is inconsistent with tourism, and may inadvertently shift the kinds of tourists deciding to travel to Quang Ninh.<sup>65</sup> With Chu Lai making a preliminary decision to reject the proposed coal plant, in the next few years it will be interesting to contrast tourism industry growth in Quang Nam and Quang Ninh. An illustrative projection shows the kind of calculation

<sup>64</sup> There are various estimates of the "multiplier" to attach to tourist spending, with most estimates falling in a range of 2 to 4. No specific estimate has been made for Quang Nam. Even if the real direct spending figure is only half of the estimates made here, the "multiplied" impact would still be very large.

<sup>65</sup> Not all tourists are equal. Vietnamese on average spend less than foreign tourists. According to one survey, among foreign tourists Japanese spend the most; US tourists spend only half as much as Japanese; and Chinese tourists spend only 1/12 as much as Japanese. If this is correct, then attracting "high-end" tourists is an important part of an overall tourist development strategy. High-end tourists are less likely to tolerate highly visible heavy industry investments.

provinces with tourist destinations like Quang Ninh and Quang Nam should make when determining the actual costs and benefits of an investment. For instance, if Quang Nam's had decided to approve the coal plant and its annual tourist growth rate fell from ten percent to five percent, and the annual spending per tourist fell from eight percent growth to three percent, then the growth of tourist spending would have been only eight percent instead of 19 percent a year. If the USD 225 million estimate for 2005 is correct, then Quang Nam's "without coal" tourist growth will jump to USD 1.26 billion in 2015, whereas Quang Nam's "with coal" tourist spending would have only grown to USD 486 million, a difference of USD 774 million in 2015.

### IV.5. The Plan to Create "A Zone within a Zone"

Three years of experience suggest to Quang Nam's policymakers that the Management Board will not serve as Chu Lai's instrument of policy and institutional innovation. The Management Board, and perhaps Chu Lai more generally, is not insulated from institutional and personnel problems afflicting Quang Nam's provincial administration. The Management Board's preoccupation with infrastructure investments and its entanglement in consensus decision making processes has witnessed its evolution into an entrenched interest group. As a result, policymakers are seeking permission from the central government to establish a new management board within Chu Lai's Free Trade Zone. This new management board will combine substantial foreign and enterprise participation with an experiment space.

Quang Nam's plan to establish a new management board represents the province's and Chu Lai's largest barriers to development rather than a real solution. In the 2006 PCI, Quang Nam performed well, ranking as Viet Nam's 14th most competitive province. However, Quang Nam performs dramatically better in indices measuring major policy orientations, in contrast to indices measuring the administration's policy implementation. Specifically, survey results from Quang Nam's private sector reveal high evaluations for the proactivity of provincial leadership, legal institutions and an absence of a policy orientation biased to favor state owned enterprises. On the other hand, survey results reveal a private sector relatively burdened by informal charges, a lack of transparency in administrative decisions, land administration problems, and significant time costs.

Chu Lai, and specifically its Management Board, was created as an agent to improve provincial governance. Certainly, the Management Board is entertaining conflicting incentives and institutional inertia. However, if the Chu Lai Open Economic Zone can not address problems afflicting Quang Nam's government apparatus and domestic private sector, will building "a zone with a hard fence" within Chu Lai's "open zone" give foreign investors the breathing space to operate? More importantly, the plan to establish a new management board seems to be derived from a misguided orientation towards foreign investment. As noted, foreign investors may primarily be deterred from investing in Chu Lai and other rural economic zones by location, rather than the quality of regulatory environments. Instead, domestic private investment is the key to rural economic development and job creation. Therefore, it seems unwise for Quang Nam's leadership to waste time, energy and scarce political capital on creating more room for foreign investors at the expense of private domestic investors already struggling to survive in Quang Nam.

The Chu Lai Open Economic Zone was expressly created to respond to deficiencies in Quang Nam's investment environment, not to mention investment environments in central and rural Viet Nam generally. Chu Lai's orientation for industrial policies favoring foreign investment do not appear conducive to achieving these objectives. As we argued above, even in a perfect regulatory environment it is uncertain foreign investment will come in large numbers. However, Quang Nam's plan to abandon the Management Board's role in favor of a new entity exclusively concentrating on foreign investment moves in the wrong direction. Foreign participation is an essential ingredient in successful economic zones, and certainly Chu Lai's future development will require a significantly higher level of engagement with foreign investors and markets. However, Quang Nam's highest priority is to solve problems which Chu Lai's Management Board was purportedly designed to address; obstacles to private sector facilitation, policy implementation, and inertia in local government institutions. No matter how many zones within zones within zones Quang Nam successfully receives permission to establish, its potential engine of growth and job creation in the domestic private sector will still confront unresolved regulatory problems outside of the new zones' hard fence. The energy of policy leaders inside and outside Chu Lai should focus on eliminating barriers and creating space for domestic enterprises. In the next Part, we will provide specific recommendations for Chu Lai which facilitate the development of Quang Nam's local domestic private enterprises.

## V. Open Economic Zones: Exploiting Chu Lai's Openness Mechanism

In the following sections we provide recommendations to define and exploit Chu Lai's "openness mechanism." In Section V.1, we establish a framework for defining Chu Lai's role in Quang Nam's rural development strategy. Section V.2 provides specific policy recommendations to increase the domestic private sector's access to land and capital, as well as decreasing its exposure to informal charges. Section V.3 provides policy recommendations to attract a foreign strategic investor to develop several of Chu Lai's industrial zones. In the final section, we provide Chu Lai with a framework for developing legal regulations.

### V.1. Chu Lai's Role in Quang Nam's Rural Development Strategy: A Framework

Policy leaders need to define Chu Lai's role in Quang Nam's economic development strategy. The question of whether Quang Nam Province will experience the type and pace of growth anticipated in national and regional master plans is a policy decision. Quang Nam's tourist industry has enormous potential. Assuming Quang Nam's policymakers and business leaders manage to exploit this opportunity, it is very likely linkages and spillover effects created by more than a million visitors a year will spawn local demand for substantial service sector employment, handicraft production, some manufacturers, and certainly skilled labour. Quang Nam's short term policy should probably focus on four ingredients: (1) facilitating the development of local private firms in every sector, emphasizing tourism; (2) attracting foreign investors to develop high-end tourist resorts and services; (3) persuading Viet Nam's existing large domestic firms to relocate light industry and other production facilities from the southeast to Quang Nam; (4) connecting the equity and market expertise of large domestic investors outside Quang Nam with promising local firms and industries.

However, in Quang Nam's provincial strategy the role of the Chu Lai Open Economic Zone is still unclear. As discussed in Part 2, state managed industrial zones may form barriers to domestic private sector development by focusing resources and infrastructure investments on the perceived requirements of unlikely foreign investors, as well as by indirectly limiting the supply of non-agricultural land entering the market. Furthermore, in Quang Nam's situation, an economic zone's orientation towards industry may not be suitable with the province's advantages in developing high-end tourism. However, a major policy decision in the immediate future is unlikely to reverse Viet Nam's rural development strategy or close Chu Lai. In fact, Chu Lai's model of establishing enormous economic zones is currently being broadly applied to spur rural economic development in North, Central and South Viet Nam.<sup>66</sup>

In the absence of policy reversals, a number of policies can be crafted to increase the positive effects, and limit negative externalities, of Chu Lai and other open economic zones.

Transplanting the Chu Lai Model			
Name	Province	Date Established	Land Area (Hectares)
Lao Bao	Quang Tri	Jan. 12, 2005	15.804 ha
Dung Quat	Quang Ngai	Mar. 21, 2005	10.300 ha
Nhon Hoi	Binh Dinh	Jun. 14, 2005	12.000 ha
Chan May	TT - Hue	Jan. 5, 2006	27.108 ha
Phu Quoc	Kien Giang	Feb. 14, 2006	56.100 ha
Vung Ang	Ha Tinh	Apr. 3, 2006	22.781 ha
Van Phong	Khanh Hoa	Apr. 25, 2006	150.000 ha
Nghi Son	Thanh Hoa	May 15, 2006	18.611,8 ha
Van Don	Quang Ninh	May 31, 2006	600 Islands

<sup>66</sup> Experts estimate that for the period of 2006-2010, total public investment in infrastructure development will approach \$3 trillion VND (USD 187 million ) for each economic zone, and thus the total public investment in infrastructure development for the nine current open economic zones, and three other proposed zones, will reach VND 36 trillion (USD2.4 billion). See Pham Hung Nghi, "Tăng tốc các khu kinh tế," Bao Dien Tu - Thoi Bao Kinh Te Saigon (12 July 2006). Retrieved on June 12, 2006 at <http://www.vneconomy.com.vn>.

A natural role for Chu Lai in Quang Nam's development strategy is to employ its experimental space and financial resources to directly address barriers to Quang Nam's private sector firm creation and growth, as well as its major obstacles to attracting foreign investment. As noted in Part II, nations have generally established economic zones to conduct controlled experiments with markets, or to create physical locations for foreign investment not plagued by regulatory problems. However, Chu Lai was established to address the very different problems of rural development. In Quang Nam and many rural areas, businesses are small and informal as a result of underdeveloped market institutions, and rigidity in local government economic policy orientations and administration. Furthermore, FDI is rare principally because rural areas combine a disadvantageous location with an absence of strategic foreign partners. Accordingly, Chu Lai's imperative is to facilitate domestic private enterprise creation and growth, and the participation of foreign strategic partners.

To design a strategy, Chu Lai's policymakers have several sources of relevant information. As discussed in Part III, the 2006 PCI's survey of Quang Nam's private sector firms produces a mixed picture of positive and critical evaluations of local governance. In short, Quang Nam performs well in indices measuring its major policy orientations, and much worse in indices measuring the provincial administration's implementation of these policies. Accordingly, Chu Lai's private sector facilitation should concentrate on eliminating the provincial administration's current proclivity to interfere with normal business operations.

However, the PCI only surveyed domestic private enterprises in Quang Nam; obstacles to attracting foreign strategic investors may be different. The World Bank's 2005 Investment Climate Survey ("ICS") includes a sample of domestic private, state, and foreign enterprise. Results from ICS confirm many of the PCI's findings, and question others. However, the most important information for Chu Lai's policymakers is that Viet Nam's enterprises, in comparison to enterprises in East Asia and the rest of the world, report binding constraints related to land and finance at markedly more significant levels.<sup>67</sup>

Binding Constraints on Enterprise (% of Firms Reporting)			
Constraint	East Asia	Viet Nam	The World
Access to Finance	17.4%	37.4%	30.1%
Access to Land	9.9%	26.4%	14.5%
Labor Skills	23.8%	22.3%	20.4%
Transportation	15.2%	21.6%	12.4%
Electricity	24.4%	15.7%	24.4%
Policy Uncertainty	32.5%	14.7%	40.2%
Tax Rates	28.2%	13.8%	40.5%
Customs Regulation	20.1%	12.5%	21.6%
Telecommunications	12.9%	6.5%	10.3%
Licenses and Permits	14.4%	1.4%	15.9%

Source: World Bank (2005) Viet Nam Investment Climate Survey

In the following sections, we will provide specific recommendations responding to these limitations. The current demands of domestic private firms, as well as potential foreign investors and strategic partners, seem rather clear. Chu Lai's private domestic investors will develop businesses in every sector, and will probably focus on service sectors related to tourism. Chu Lai's ideal foreign investor will develop land and services for the tourist industry or (in the future) manufacture goods for export. Chu Lai's ideal strategic investor will assume the risk for developing an industrial zone's infrastructure, and will provide Chu Lai with much needed advice, information about foreign markets, and marketing services. These economic activities will have direct interfaces with the government's administrative apparatus related to licensing, land, finance, customs, tax, and more.

<sup>67</sup> World Bank, Vietnam's Investment Climate Survey (2005).



### V.2. Facilitating Small and Medium Enterprise Creation and Growth

#### V.2.1. Business Registration and Licensing

Chu Lai's officials often equate good local governance with the idea of a "one-stop shop" for business registration, licensing and approvals. However, business registration and licensing do not seem to be problems for Quang Nam's enterprises. A recent CIEM survey reveals that 93 percent of Quang Nam's private domestic firms receive their business registration in 15 days, and 100 percent within 30 days.<sup>68</sup> This complies with the *Enterprise Law's* requirements.<sup>69</sup> Similarly, Quang Nam ranks ninth in the PCI for the lowest percentage of firms required to wait over three months to register a business, and eighth for the fewest number of licenses required (2.87). In 2005, in a separate survey by Vision and Associates, 69 percent of formal private sector enterprises in seven rural provinces received their business certification, official seal, tax registration, VAT book, and customs registration in less than 30 days; in Quang Nam 97 percent of surveyed enterprises reported receipt of these materials.

This evidence creates a conundrum, however. If business registration is so easy in Quang Nam, why do so many household businesses decide to remain informal? Quang Nam is notable for its modest number of 909 newly registered domestic enterprises from 2000 to 2005, compared to over 160,000 nationally. In addition, the amount of capital per enterprise in Quang Nam was only VND 9 billion in 2003, compared to VND 24 billion nationally. Clearly, the level of private activity is much lower than elsewhere. As noted in the opening section of this paper, Quang Nam has 1.8 percent of Viet Nam's total labour force, but only 0.6 percent of Viet Nam's enterprises and 0.2 percent of Viet Nam's enterprise capital.

A CIEM and GTZ 2005 survey of registered domestic private enterprises in Quang Nam reveals that 55 percent of these *registered* firms believe lack of capital is a barrier to firm registration, and 35 percent believe limited access to land is a barrier to firm registration.<sup>70</sup> In contrast, only 16 percent of Quang Nam's private enterprises in the CIEM and GTZ survey believe provincial business registration procedures are a barrier to becoming formal. This survey does not even include firms which decided to remain informal; nevertheless, it is probably safe to assume informal enterprises decide to forgo formal registration for reasons which include issues related to access to land and capital. This is a problem. Experts estimate 93 percent of Viet Nam's private domestic firms are still informal household businesses.<sup>71</sup> Firms in the informal economy produce on average 40 percent less goods per worker than their counterparts in the formal economy.<sup>72</sup> In light of the size of Quang Nam's labour force and level of private sector activity in Hoi An and other tourist areas, it is reasonable to believe the percentage of informal firms in Quang Nam is significantly higher than the national average.

In sum, Quang Nam's slow domestic enterprise growth is probably not the result of a poor administrative environment in the provincial Office of Business Registration. Rather, this slow growth appears related to more endemic problems in land administration and capital allocation. The implication is that Chu Lai should probably not devote significant resources to develop a "one-stop shop."<sup>73</sup>

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<sup>68</sup> GTZ and CIEM, (2005).

<sup>69</sup> According to Viet Nam's Enterprise Law the province's business registration body has 15 days to register a firm after the enterprise's founder submits required documentation.

<sup>70</sup> GTZ and CIEM, (2005).

<sup>71</sup> Viet Nam Chamber of Commerce and Industry, (2006)

<sup>72</sup> International Finance Corporation and World Bank, (2004).

<sup>73</sup> Many countries have developed a "one-stop shop" to mitigate the negative effects of the licensing process. The one-stop shop approach, however, is not always the answer. In Thailand, for instance, the Investment Services Center can issue licenses, but new factories still must wait for official approval from the Ministry of Industry before starting production. As a result, the license from Thailand's one-stop shop is simply an additional regulatory hurdle, without adding value. Similarly, HCMC's one-stop shop merely shifted the burden of obtaining licenses from foreign enterprises to local government officials. This is a common occurrence in many developing countries; although the one-stop shop reduces the burden placed on foreign enterprises, it fails to resolve the underlying regulatory problems.

### **V.2.2. Access to Land**

Quang Nam's land administration is an obstacle to domestic private enterprise creation and growth, and thus an obstacle to rural development. According to the PCI, Quang Nam ranks 48th of 64 provinces in the domestic private sector's access to land, and sixty third of 64 provinces in the length of time (587 days!) firms must spend negotiating with the local government to purchase land. Similarly, CIEM's recent survey reveals 61 percent of Quang Nam's domestic firms confront difficulties in land acquisition (only Ha Tay and Lao Cai performed worse in the survey with 67 percent and 68 percent respectively). Resolving these issues is potentially Chu Lai's most important role in Quang Nam's rule development strategy.

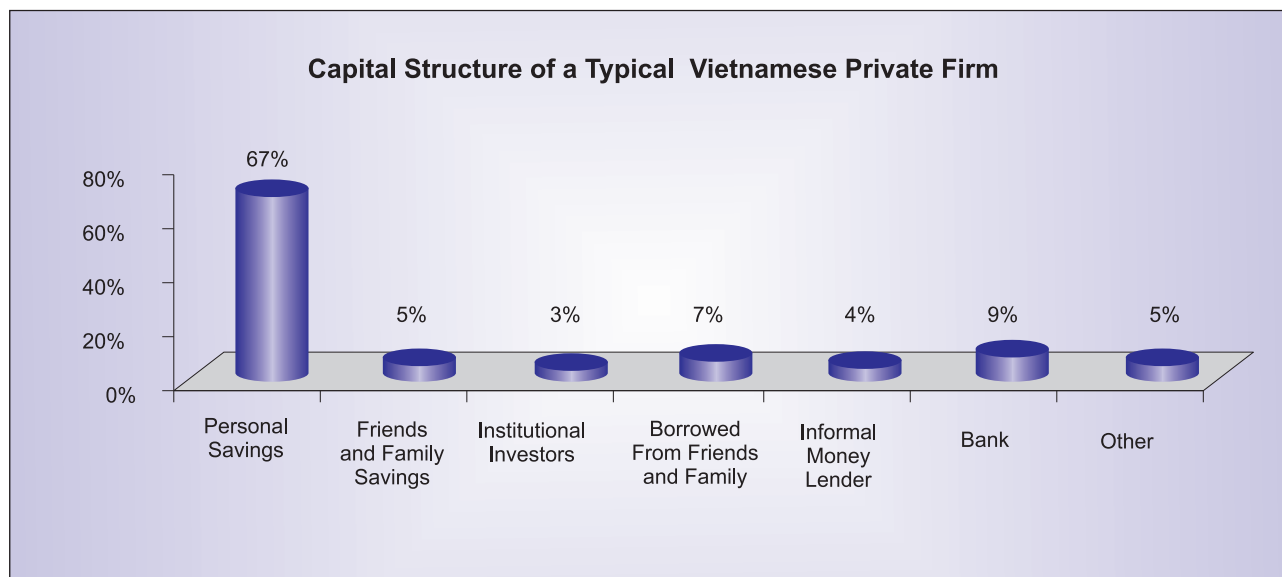
As noted in Part II, local governments have strong incentives to "push" firms inside the walls of industrial zones. In short, provinces are under pressure to report high occupancy and investment rates, and, more significantly, land fees account for a growing portion of local revenue. Although industrial zones appear on paper to offer private firms concessional land rates, in reality land converted for state managed industrial zones may be part of a larger policy regime limiting the supply and inflating the price of commercial land in the private market. Domestic private enterprises are particularly effected by this policy, which encourages continued informality and slows firm level growth. An astonishingly high proportion (71 percent) of Quang Nam's domestic private enterprises are currently in industrial zones. Several different surveys reveal these registered firms believe land access issues are major barriers to firm registration and growth. Solving this problem is difficult. In Quang Nam only 20.7 percent of the total land is formally titled with land use rights certificates (ranking sixty first of 64 provinces in the PCI). Quang Nam faces a daunting administrative task to formally register all of this property. Furthermore, Quang Nam's policy decision to create a private commercial land market must initially overcome entrenched interests, as well as the prospect of severe competition for an important source of its local revenue. However, domestic investors will benefit from the private sector's broader participation in developing, leasing and selling land. Moreover, in the long run tax revenues produced by increased private sector activity will surely exceed the revenue currently produced by (essentially) requiring a few hundred firms to rent land from the government.

Chu Lai can provide a temporary solution to this problem. Chu Lai's primary resource is land, and in the next five years there is a possibility much of the land reserved for foreign firms will remain unoccupied. Chu Lai should consider shrinking the proportion of land reserved for foreign firms to provide domestic private enterprises with heavily subsidized land in one or several low-grade industrial zones. This policy could focus on labour intensive firms or other development criteria, however unbiased implementation will be the principal challenge. Chu Lai may consider using its legal authority to auction land use rights to ensure unbiased administration of this proactive policy. In designing the low-grade industrial zones, Chu Lai should consider recruiting domestic investors from outside Quang Nam to serve as strategic private sector partners in infrastructure and land development. With an appropriate strategy, Chu Lai's policymakers may find suitable Ho Chi Minh City and Cho Lon entrepreneurs interested in the consumption demands of Quang Nam's international tourists. Playing a role similar to strategic foreign investors discussed in subsequent sections, strategic domestic investors would assume a portion of the risk for developing low-grade industrial zones. This would produce strong incentives for the strategic domestic partner to recruit other domestic investors to locate or relocate light industry projects to Quang Nam. This is the type of strategy with the potential to build a critical mass of formal private enterprises in industry and service from Quang Nam's success in tourism. At the same time as Chu Lai considers pursuing this strategy, Quang Nam should examine the costs and benefits of current policies encouraging its domestic enterprises to locate in other industrial zones. Finally, in the medium term, Quang Nam's principal task facilitating private sector land access should focus on registering existing land parcels.

### **V.2.3. Capital Constraints**

Access to capital is a major barrier to domestic private enterprise creation and growth, and thus a major barrier to rural development. According to one survey, only 55 percent of Viet Nam's formal private enterprises have access to any bank credit. Even among these firms, bank credit is used as working capital rather than for long-term fixed capital investments because of short repayment terms and significant collateral

requirements. Quang Nam and Chu Lai appear to have at least three feasible methods of increasing the amount of credit available to private enterprises. First, policymakers can prioritize the formal registration of land use rights and other fixed assets, thus increasing the private sector's collateral. Second, policymakers can create better conditions for Viet Nam's joint-stock banks to begin lending in the province. Third, policymakers can develop alternatives to bank credit, such as a leasing market.



\*Source: Edmund J. Malesky, (2004b). Figure excludes private firms in joint ventures with local government or SOEs.

In Viet Nam the private sector's access to bank credit is limited by current lending regulations and procedures, as well as a strong state sector bias in lending. Lending regulations and lending policy are established at the central government level. As a result, it is probably not feasible for Quang Nam or Chu Lai to totally eliminate state sector bias in lending on a local government level. However, Quang Nam and Chu Lai can effectively increase the private sector's access to credit by facilitating the registration of land use rights and fixed assets. In Viet Nam, an enterprise's access to credit is substantially determined by its ability to produce collateral as loan security. The biggest source of collateral in Viet Nam is land use rights. In Quang Nam, however, only 55 percent of formal enterprises report possession of formal land use rights. Furthermore, as noted, only 20.7 percent of Quang Nam's total land parcels have land use rights, limiting the ability of enterprises to use the land of owners, investors, family, and friends as collateral. In contrast, the PCI reveals that 23 provinces in Viet Nam have processed formal land use rights for at least 80 percent of their total land. Thus, Quang Nam and Chu Lai can immediately increase the private sector's access to credit by prioritizing land titling in the province.

By creating collateral for the private sector, formal land registration will also encourage Viet Nam's joint-stock banks to begin lending to Quang Nam's domestic private enterprises. Viet Nam's joint-stock banks, in contrast to state banks, almost exclusively lend to the private sector. Currently, five joint-stock banks have established branches in Quang Nam. However, these banks only provide services to Hoi An's tourists with ATMs, and have not begun lending to the province's domestic private sector. According to several sources, the major barrier to joint-stock bank lending in Quang Nam is the limited demand created by a lack of formally registered enterprises with collateral.

The development of an active leasing market in Quang Nam may provide another practical solution to the private sector's current capital constraints. Generally, leasing is a relatively low risk form of business finance; leasing companies evaluate potential leases based on the revenue generated directly from the leased asset. Consequently, in the event of non-payment, foreclosure costs are reduced because title to the leased property is retained by the leasing company. However, the development of a leasing industry hinges on the existence of an adequate legal and regulatory framework capable of recovering leased assets. In the past four years, Viet Nam has adopted a legal framework which has all of the formal elements of an excellent leasing law. Nonetheless, leasing still only accounts for 0.4 percent of domestic capital investment. By contrast, in



countries with highly developed legal systems and predictable enforcement procedures, like the United States and Hungary, leasing constitutes between 13 percent - 31 percent of domestic capital investment. Currently, leasing is not an attractive option in Viet Nam because leasing fees are substantially higher than lending interest rates and fees. It appears that leasing companies fear that when enterprises default, the judicial system will fail to facilitate cost effective seizure of leased assets.<sup>74</sup> As a result, leasing companies discount the "unenforceability risk" and require enterprises to make large down payments, produce additional collateral, or pay higher fees. This increases the total costs of leasing, which eliminates the primary advantage of leasing reducing collateral requirements, and thus renders leasing even less attractive.

### Enforcing Judgments: Coordination Problems or Lack of Political Will?

"The Thanh Hoa Border Trading Company became involved in a contractual dispute with the Thanh Ha Ha Noi Trading Company. The Thanh Hoa Border Trading Company is a state-owned enterprise from Thanh Hoa Province and the Thanh Ha, Ha Noi Trading Company is a private trading company based 400 km away in Hanoi. The case went to the People's Court of Thanh Hoa Province where a judgment for nearly \$100,000 was issued in favor of Thanh Ha, Ha Noi. Thanh Hoa Border Trading refused to pay the judgment and the local Department of Justice never pursued enforcement. Thanh Ha, Ha Noi appealed directly to the Ministry of Justice for assistance. The Ministry of Justice ultimately sent a delegation headed by a Vice Minister to call on the People's Committee of Thanh Hoa Province to enforce the order. As of 2001, six years after the judgment, it has yet to be enforced."

"[A] foreign businessman successfully sued a state-owned enterprise in Khanh Hoa Province on the south-central coast. Although there were interventions from the Supreme Court in Ha Noi, the State Prosecutor's Office, and even from the Enforcement Office of Ho Chi Minh City's Department of Justice on behalf of the investor, the People's Committee of Khanh Hoa Province refused to enforce the \$50,000 judgment against its own company."

Source: Brian J.M. Quinn, (2002).

However, experiences from China reveal a judicial system's failure to enforce judgments is often a matter of local protectionism rather than institutional quality. For instance, in China, state banks regularly cooperate with local enterprises to create multiple accounts hiding a debtor's assets. And, when the judgment debtor is a state owned enterprise, or a government agency or military unit, it is routine in China for officials to openly disregard court judgments because the judiciary is simply not politically powerful in the administrative hierarchy. Although this may benefit local interests in the short-term, this is not a successful long-term development strategy.

The World Bank's International Finance Corporation (IFC) has spent significant resources to encourage the development of Viet Nam's leasing market. Furthermore, new leasing regulations have recently been issued, and several banks have launched lease financing services. Chu Lai should arrange a strategy meeting with all stakeholders, including leasing companies, legal counsel, enterprises, and the IFC to discuss their desire to become a "pilot region" for developing an active rural leasing market.

### V.2.4. Policy Implementation and Informal Charges

Although Quang Nam has relatively low entry costs, it appears Quang Nam's administrative apparatus is increasing firm costs in the policy implementation process. According to the PCI, Quang Nam ranks 58th out of 64 provinces in the index measuring the domestic private sector's exposure to informal charges. Quang Nam ranked sixty first in the number of firms reporting informal charges were a major obstacle to doing business, and fifty second in firms reporting informal charges account for 10 percent of revenue. Why is it that Quang Nam's provincial government effectively facilitates market entry for firms, but then causes relatively large transaction costs for these same firms after market entry? One possible explanation is that Quang Nam's policy leaders have effectively eliminated administrative discretion in the registration process by

<sup>74</sup> See Phillips Fox, Vietnam Legal Update (July 2005).

implementing the *Enterprise Law's* core provisions. However, in areas related to land, tax liability, and enterprise regulation Quang Nam does not have legal rules and other tools in the mold of the *Enterprise Law*, which effectively strip government departments, offices and officials of discretion by changing the paradigm from pre-approval to post-verification.<sup>75</sup> The World Bank's 2005 Investment Climate Survey suggests that most informal charges in Viet Nam emerge from a few government organs including customs, tax, land administration, construction, import/export, market controller, and the traffic police. In the absence of an *Enterprise Law* like tool, there are at least several mechanisms for Chu Lai to begin reducing the private sector's exposure to informal charges.

First, Chu Lai should concentrate on eliminating contact between government officials and private business. Chu Lai might consider appointing an important member of the Management Board as a "gate-keeper" that government departments and officials are required to contact prior to inspecting or visiting any of Chu Lai's enterprises. This "gatekeeper" will be required to observe all inspections, and protect private enterprises from informal charges. Furthermore, this gatekeeper will serve as an ear for enterprise complaints and will cooperate with Quang Nam's government departments to eliminate unnecessary contacts with Chu Lai's enterprises. This strategy will only succeed if the "gatekeeper" has sufficient authority and incentives to insulate Chu Lai's firms from informal charges.

Second, Chu Lai should consider implementing local policies that eliminate discretion by shifting government decisions from pre-approval to post-verification. Essentially, Chu Lai should learn from Quang Nam's success with the *Enterprise Law's* registration requirements. For instance, one measure of "openness" in Chu Lai will be a function of the cost-effectiveness of its custom's service. In many developing countries, excessive discretion by customs' officials spawns time delays, informal payments and corruption. One common problem is that customs' officials fail to employ statistical methods to reduce the number of parcels actually inspected. Instead, officials check every parcel, which creates time delays and incentives for informal payments. Some countries have succeeded by introducing computerized customs' forms, which are submitted electronically. This is an effective method of reducing contacts between officials and traders. The World Bank is supporting the computerization and the use of statistics in Viet Nam's customs' procedures. As Chu Lai develops sufficient demand for import and export services, policymakers should seek to become one of the World Bank's pilot programs. Furthermore, a few countries have hired private firms to perform essential customs' procedures for a fixed term. This method has effectively streamlined procedures, assured investors, and created institutional capacity. The openness of this approach, which uses the private sector to fill a regulatory gap, may attract significant support from international donors.

Finally, Chu Lai should maintain sustainable tax policies to pay its officials and ensure it does not create incentives for its officials to create informal charges. Throughout the developing world countries, provinces, and economic zones are offering unsustainable tax and land incentives in the hope of attracting investment. However, research has demonstrated many of these incentives are not necessary and may be harmful. Although investors are fundamentally concerned with cost, investors often discount promises of extremely low tax rates with uncertainty. Investors detect signs of uncertainty from signals, and an unsustainable tax policy is a clear signal that an economic zone is either (1) planning to increase taxes after the investor makes asset specific investments, (2) making uninformed decisions, or (3) officials within the economic zone will need to use informal charges and other mechanisms to collect their salaries. Successful economic zones produce signals which convey sustainability and predictability. In Shenzhen and Hong Kong, for instance, corporate tax rates are low by international standards, 12 percent-16 percent as opposed to approximately 37 percent in the US, but these tax rates are sustainable and remain constant. In order to produce signals of predictability and openness, Chu Lai should consider implementing a tax policy that is sufficient to finance necessary public services within the zone.

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<sup>75</sup> For instance, the *Enterprise Law's* immediate effect was much more dramatic in provinces with poor governance indicators. The reason seems to be that successful provinces had previously created a substantial comparative advantage by employing good economic governance in implementing their discretion under pre *Enterprise Law* rules. However, poorly governed provinces employed this same discretion to create barriers. By eliminating discretion in business registration all together, the *Enterprise Law* essentially "leveled the playing field" between provinces. See Vu Thanh Tu Anh and Eli Mazur, "The Common Investment Law and Regional Inequality in Viet Nam," *Saigon Economic Times* (September 2005).

### V.3. Attracting Foreign Investment and Strategic Partners

In spite of its relatively friendly regulatory environment, Quang Nam is notable for its lack of foreign investment. In 2003 FDI was less than one percent of Quang Nam's total investment. Between 1990 and 2005, Quang Nam's cumulative implemented FDI was approximately USD 57 million or 0.2 percent of the national total (again, only one-tenth of the province's proportional share of Viet Nam's labour force). Relatively little FDI in Quang Nam is found in the manufacturing sector; a somewhat larger portion is in natural resource linked industries, such as sand exporting. FDI in Quang Nam's manufacturing sector does not appear likely to grow substantially in the next few years. In contrast, a significant and growing portion of Quang Nam's FDI is in tourism. As noted in Part 3, Quang Nam's revenue from international tourism is at least equivalent to Quang Nam's total export value of manufactured goods, or USD 75 million. With this level of demand and consumption, foreign investors are beginning to show an interest in developing resorts and other services for Quang Nam's international tourists. Chu Lai's ability to facilitate foreign investors' *continued interest* in Quang Nam's tourism industry is a challenge implicating Chu Lai's land and industrial policy. Chu Lai's ability to *attract* significant foreign investment in manufacturing and light industry is a vastly different challenge implicating its level of policy decentralization and land administration. After providing recommendations for these critical decentralization and land issues, the following sections turn to providing additional recommendations in the *comparatively less urgent* areas of labour law and dispute resolution.

#### V.3.1. Land Administration: Attracting Foreign Advice and Participation

In Chu Lai land administration and policy issues may create barriers to foreign investment. These barriers are different for potential foreign investors in the manufacturing sector and tourism sector, therefore tailored solutions are required. Foreign investment in tourism will benefit from Chu Lai's decision to assess the environmental impact and location of industrial investments in light of possible effects on international tourism. Foreign investment in manufacturing and light industry will benefit from a decision by Chu Lai to attract the participation of strategic foreign investors to develop land and infrastructure for industrial zones.

In the tourism industry, foreign investment is drawn to Quang Nam by obvious market opportunities.<sup>76</sup> However, continued foreign investment in developing resorts and services for high-end international tourists will require investors to have confidence Chu Lai's industrial policy will not be strongly oriented towards dirty industry or other investments (e.g., casinos) damaging Quang Nam's growing reputation as a family friendly destination for historical and ecological tourism. Chu Lai's recent decision to reject a proposed coal plant is an excellent signal of its commitment to a stable land policy suitable to developing high-end tourism. Chu Lai must identify methods for continuing to ensure potential investors of Chu Lai's stable policy orientation in this area. Chu Lai's policymakers and officials may not possess accurate market information about what types of investments have the potential to harm international tourism. Therefore, consultation with existing and potential foreign investors in tourism is essential if Chu Lai intends to create smart and environmentally conscious land policies appropriate for Quang Nam's aspirations in the tourism industry.

In manufacturing and light industry, foreign investors are less likely to independently recognize Chu Lai's market opportunities. As discussed in Part 1 and 2, Viet Nam's foreign investment in manufacturing is predictably concentrated in a few provinces combining abundant and inexpensive labour, with a proximity to markets and developed transportation systems. Chu Lai's distance from Viet Nam's major markets is a major hurdle to attracting foreign investment in manufacturing. Nevertheless, successful rural development experiments in China and elsewhere demonstrate the participation of strategic foreign investors can counterbalance the disadvantages of a rural location. In Viet Nam, the participation of strategic foreign investors in developing industrial zone infrastructure and land tends to differentiate successful and unsuccessful *urban* zones. Learning from these experiences, Da Nang, for instance, recently signed a contract with a large institutional investor in Viet Nam to build a USD 200 million commercial and office complex in Son Tra District. Not surprisingly, the absence of strategic foreign investors is perhaps the greatest

<sup>76</sup> There are some reports of policymakers' intentions to reserve seventy kilometers of Quang Nam's eighty kilometer coastline for a single foreign investor to develop. Although the foreign investor's interest in such a large scale development is a good sign, provincial leaders should be careful not to limit competition in this dynamic industry.

limitation of Viet Nam's rural industrial zone strategy. In the absence of strategic foreign investors, rural industrial zones lack important signals of policy stability for other investors, connections with potential foreign firms, and market incentives guiding industrial zone investments in infrastructure and other areas. Industrial zones developed by state companies often over-invest in infrastructure and under-investment in marketing. These state companies have strong incentives to minimize spending on acquiring market information and maximize expenditures on infrastructure investments - whether on unnecessary ports or essential highway improvements - and then to petition the provincial and central government for more money. In contrast, strategic foreign investors generally bear the financial risk of over-investing in infrastructure, because these investors can only recover these investments if the industrial zone's land is leased.<sup>77</sup>

Chu Lai's industrial zones are being developed by state infrastructure companies without the participation of strategic foreign investors. As a result, Chu Lai is arguably over-investing in infrastructure and under-investing in marketing. For instance, neither the state infrastructure company nor Chu Lai's Management Board possess a significant number of foreign language speakers despite Viet Nam's reliance on foreign investment from individuals primarily speaking Japanese, Chinese and English. Chu Lai's ability to attract foreign investments in manufacturing will likely be a product of its efforts to enlist a strategic foreign investor in developing several of its smaller industrial zones.<sup>78</sup> Chu Lai may need to spend significant resources for the services of a private consulting firm to identify and attract an appropriate strategic foreign partner. For instance, Da Nang has spent significant resources to open a representative office in Tokyo, Japan. Although Viet Nam's government bodies are not necessarily accustomed to spending scarce resources for professional advice, this will probably be essential to recruiting a strategic partner.

The following section will discuss the critical role of increased levels of decentralization in providing Chu Lai with the space to use reformed land administration policies recommended above to attract strategic foreign investors.

### V.3.2. *Licensing: Experimenting with International Economic Integration*

As noted, Quang Nam's business registration and licensing costs are already relatively low. Certainly, Quang Nam's success implementing the *Enterprise Law's* streamlined procedures must be applied to Chu Lai's implementation of the new *Common Investment Law* and *Unified Enterprise Law*. However, this is not sufficient. Chu Lai's current levels of decentralization, and thus experimental space, do not permit Chu Lai to issue investment certificates (e.g., investment licenses) for potential strategic investors in banking, financial services, or land development without consensus from ministries with conflicting interests. On several occasions in the past three years, this decision-making process has impaired Chu Lai's ability to attract strategic foreign partners to jump-start Quang Nam's implemented foreign investments in manufacturing. Although recent legal changes will in theory greatly expand Chu Lai's authority to issue investment certificates, in reality meaningful decentralization awaits a central government decision: Will Chu Lai serve as an open economic zone experimenting with international integration or simply a large rural industrial zone?

Recently issued Decree 108 reveals the *Common Investment Law* is an agent of policy decentralization.<sup>79</sup> Under Decree 108, economic zone management boards will no longer be limited to granting investment

<sup>77</sup> A strategic foreign partner could resolve a dilemma which seems to be emerging: potential investors in Chu Lai will not make solid investment commitments until land with infrastructure is available, and Chu Lai will not commit its limited resources to upgrading site specific infrastructure until investment is certain. This is a classic coordination problem, a problem that is typically mitigated by contract law and a credible legal system. However, investors are not confident Viet Nam's legal system will protect their interests in a dispute with a government supported infrastructure company. A strategic foreign investor's ability to credibly commit to international contracts, as well as interests in its reputation, may provide investors with the necessary levels of confidence.

<sup>78</sup> After successfully competing a bridge construction project, there are some reports Japan's Sumitomo Corporation may be interested in developing a larger presence in Quang Nam. This is an excellent sign.

<sup>79</sup> In theory, foreign and domestic enterprises exist on a "level playing field" as a result of the 2005 *Unified Enterprise Law* and *Common Investment Law*. Under the previous *Law on Foreign Investment*, foreign invested enterprises were required to obtain an investment license before beginning production. In contrast, domestic enterprises only needed to register under the *Enterprise Law*. Rather than eliminating investment licenses for foreign enterprises, however, the 2005 *Common Investment Law* now requires domestic enterprises investing over VND 15 billion (USD 937,500) to obtain an "investment certificate." All enterprises with foreign investment regardless of capital level are still required to apply for an investment certificate, which also serves as a business registration for foreign enterprises. The *Common Investment Law* also requires both domestic and foreign enterprises with investments exceeding VND 300 billion (USD 18,750,000) and all enterprises investing in "conditional sectors" to obtain an "investment evaluation." Consequently, the *Common Investment Law* appears to "level the playing field" more or less by creating additional hurdles for domestic investors rather than lowering current barriers to foreign investment.



certificates to FDI projects below USD 20 million. Instead, management boards have authority to issue investment certificates to all investment projects regardless of capital level and source, and provincial people's committees have the same authority for all projects outside economic and industrial zones. However, this broad local authority is subject to two important exceptions which will continue to impair Chu Lai's ability to attract strategic investors. First, central government ministries will retain their role in investment certificates granted for "investment activities provided for in specialized laws." Second, the *Common Investment Law* gives foreign investment a "conditional" status in all sectors Viet Nam is required to gradually open to competition in accordance with international treaty commitments. As a result of these two exceptions, Chu Lai's attempts to attract strategic foreign partners by experimenting with international economic integration in a number of areas, including banking, financial services, insurance, real estate and entertainment, will continue to confront consensus decision-making processes.

Improving this situation will require the central government to unambiguously expand Chu Lai's authority to license foreign investments in several areas with a Decision or a Decree. This does not seem unreasonable in light of Chu Lai's stated role "to gain experience in international and regional economic integration" by experimenting with an "investment and business environment... suitable to international practices." Viet Nam's commitments pursuant to the WTO and other international treaties require gradual opening of most sectors. At a minimum, if Chu Lai is indeed a serious effort, a new legal document should exempt Chu Lai from the second exception and provide officials with unfettered authority to issue investment certificates in sectors Viet Nam is required to open to international competition in the next several years. Furthermore, the investment areas covered by the first exception, and other areas relegated to a conditional status, read like a "to do list." There is a broad consensus Viet Nam's ascendancy to middle-income country status will require substantial improvements in its financial institutions, land markets, education system, and its provision of public health services. Yet, these are precisely the areas facing additional hurdles to foreign participation. Accordingly, the central government should also consider giving Chu Lai unfettered authority to issue investment certificates in these areas.

In sum, Chu Lai's design requiring the Management Board to achieve consensus among several ministries to issue investment certificates in key areas may prevent Chu Lai from having an opportunity to address Quang Nam's biggest obstacle to attracting substantial foreign investment in manufacturing; namely, the participation of foreign strategic investor. In the absence of a strategic foreign investor, Decree 108's decentralization to Chu Lai, and similarly situated rural economic and industrial zones, is largely irrelevant because few investments in manufacturing and light industry will exceed the previous investment law's \$20 million USD threshold.

### **V.3.3. Labour Markets**

Although barriers to foreign investment in Quang Nam created by Viet Nam's labour laws do not approximate the barriers created by land and decentralization issues, Chu Lai can facilitate foreign investment by experimenting with a few rules. In conjunction with Chu Lai's limited supply of skilled labour, the labour law's three percent ceiling on a firm's employment of foreign national may deter manufacturing and light industry investments by limiting the potential pool of qualified middle-managers; it certainly deters the development of high-value added industries requiring engineers and technicians. For several years, Viet Nam has considered eliminating the three percent ceiling on foreign employees as its international treaty commitments will eventually require, and several high-tech investments have received temporary exemptions from this policy. Chu Lai can serve its role as a laboratory to experiment with international practices by becoming the first region in Viet Nam to eliminate the three percent foreign worker limitation.

Viet Nam's labour law also creates difficulties for firms wanting to terminate redundant or poor employees. In Viet Nam, a firm's decision to terminate an employee often takes months and considerable expense. This policy may achieve unintended results, pushing labour into the informal economy and discouraging companies from creating new positions. Competitive firms engaged in manufacturing's global supply chains benefit from regulatory space to continuously retool, adapting to changing market conditions and funneling limited resources into their most productive uses. Stringent employment protections limit a firm's ability to take socially beneficial risks; a firm will be reluctant to quickly expand employment to meet growing market demands, or to enter new markets, if those workers will be difficult to terminate if market conditions fail to

meet expectations or detrimentally change. Many countries have "employment at-will" policies, giving employers the right to terminate an employee without cause. If this is option is too radical, Chu Lai should consider specifying reasons an employer can not terminate an employee, rather than the current practice of specifying twelve reasons which entitle an employer to terminate an employee. In the spirit of the *Enterprise Law*, this will alter the status of termination from a privilege to an enterprise's right. Although this is a sensitive issue, Chu Lai has the potential to develop a small comparative advantage by lowering the costs of both hiring and firing employees.

### V.3.4. *Dispute Resolution and Arbitration*

Although fears of regulatory uncertainty are a barrier deterring foreign investment, as we noted about labour regulations, this barrier does not approximate the importance of issues related to land and decentralization issues. Nonetheless, Chu Lai can facilitate foreign firms' confidence, as well as its own transparency, by using international arbitration as its exclusive means for resolving disputes with foreign investors, and domestic arbitration for Vietnamese investors.

#### Why Arbitrate?

Arbitration is the most favored form of dispute resolution in foreign direct investment contracts. Unlike negotiation and mediation, arbitration shares an essential characteristic with court; its decisions are binding and enforceable by government authority. Settling disputes in court is generally considered more expensive, time consuming, and taxing on long term business relationships than arbitration. Additionally, foreign investors perceive international arbitration as more predictable and fair than domestic court litigation, because local judges often have incentives to interpret the law in favor of local corporations and government agencies. In contrast, international arbitration allows parties to select the arbitration venue, the applicable law, and even individual arbitrators with expertise in the field. Anecdotal and empirical research from other countries suggests that effective arbitration systems encourage foreign direct investment.

Viet Nam has enacted an *Arbitration Ordinance* and a Decree resembling the United Nation's *Model Law on International Commercial Arbitration*. For instance, Viet Nam's *Arbitration Ordinance* allows for foreign arbitrators, foreign substantive law, and a foreign venue in instances in which a "foreign element" is party to the dispute. Similarly, Viet Nam's *Arbitration Ordinance* allows disputes between Vietnamese parties, including state entities, to be resolved through domestic arbitration. However, arbitration awards are not self-enforcing. The loser must either voluntarily comply or the state must employ coercive powers to force compliance. In the past, commentators believe arbitration was not popular in Viet Nam because the former ordinance did not have an enforcement provision. In contrast, Viet Nam's new *Arbitration Ordinance* has a clear enforcement procedure; "arbitration winners" can apply for enforcement 30 days after the award is issued at a Judgment Enforcement Agency where the "arbitration loser" has an office, residence or assets. Nevertheless, enforcing arbitration awards remains complex. Significantly, the Judgment Enforcement Agency does not have any authority independent from the Ministry of Justice, Public Procuracy, and provincial people's committees.

A decision to enforce and respect arbitration awards in Chu Lai will serve as a means to improve Chu Lai's transparency and investor confidence. Chu Lai's exclusive use of arbitration will signal to investors its determination to limit political considerations from dispute resolution. Furthermore, Chu Lai's experience using arbitration will allow Chu Lai to begin developing a long-term comparative advantage by providing firms with credible forms of alternative dispute resolution. The recent *Arbitration Ordinance* allows arbitration centers to be established as non-government organizations (NGOs), and several arbitration centers with Vietnamese and foreign arbitrators have already been licensed in Ho Chi Minh City. Chu Lai should consider arranging strategy meetings with these NGO arbitration centers.



#### V.4. Chu Lai's Soft Infrastructure: Developing a Legal Code?

Chu Lai's policymakers are considering developing a regulatory code for the economic zone in many areas, spanning from commercial to criminal law. However, if Chu Lai's architects intend to learn from experiences in China and India, as well as Binh Duong and Dong Nai, they will survey and meet the regulatory demands of investors, rather than writing regulations before stakeholders emerge to participate in the policymaking process. Although there is a natural inclination to draft an "open" legal framework as soon as possible, this may be a mistake. Most importantly, without investor input - which, at this stage, is premature in Chu Lai - there is a strong incentive to simply copy existing law. However, the problem with Viet Nam's existing law is not a matter of drafting, but instead an issue of transparency and implementation. To improve in these areas, as discussed, Chu Lai's architects must create incentives for regulators to be independent of undue political and economic influences, but accountable to the entities they regulate.

##### **Regulatory Restraint in Shenzhen**

Importantly, the Shenzhen SEZ made two critical decisions in its approach to drafting new laws and regulations. First, the Shenzhen SEZ only created new regulations when demand for the legal rules existed in the SEZ. Second, before writing new laws the Shenzhen SEZ consulted with the SEZ's primary stakeholders and legal experts in Hong Kong and Singapore. Both of these decisions were represented by the first law passed in the Shenzhen SEZ. This law was not a substantive law, but rather a law which explained that guaranteed investors procedural rights in creating laws, such as a right to hold consultations and rights to petition for the revision of old laws. In fact, during the Shenzhen SEZ's first year of law-making authority this was the only law enacted.

In the interim, Chu Lai may consider adopting rules of "statutory interpretation" reflecting a philosophy of openness, which bind regulators, arbitrators and judges. With these rules in hand, Chu Lai can choose to regulate the economic zone with existing national law, but decide to interpret and implement national law in accordance with a policy of openness. This strategy may ease the pressure of drafting a legal framework from scratch (or transplanting one), and will provide stakeholders with an opportunity to emerge and participate in the policymaking process. As stakeholders begin to demand legal changes, Chu Lai can slowly and deliberately allow its regulatory system to evolve into something uniquely tailored to its investors. To facilitate this process, and in the path of Shenzhen, Chu Lai may consider drafting a regulation which guarantees investors procedural rights in the creation of new rules, including the right to participate in deliberations and petition for legal change, as well as the right to petition for the revision and/or abolition of existing rules.

## VI. Conclusion

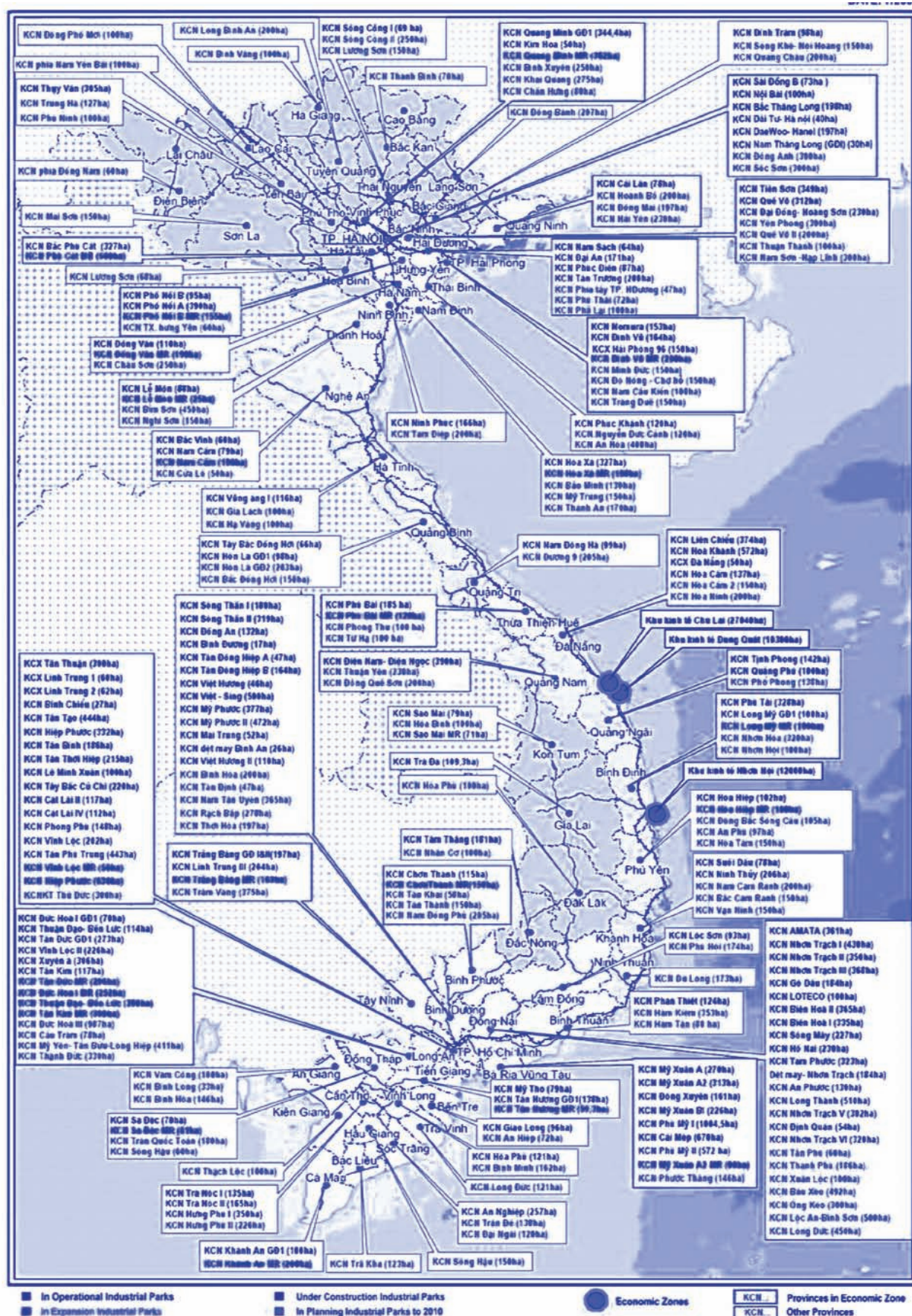
In theory, the Chu Lai Open Economic Zone was established to address Viet Nam's pressing rural development challenge of creating wage employment in rural areas, preventing a substantial influx of unskilled migrants to Viet Nam's cities. In reality, however, the current design of open economic zones and industrial zones may create more barriers than roads to rural development. These zones seem to apply key assumptions of central planning to international investors and financial markets. There seems to be a belief that it is possible to plan an economic zone, select industries to develop, and then create conditions attracting foreign investors to implement the state's industrial policy. For instance, despite evidence to the contrary, Chu Lai's policymakers seem overly confident Quang Nam's location in Southeast Asia, near international shipping lanes, is sufficient comparative advantage to commit substantial resources to developing a deepwater port in the hope it will become an international transshipment center. Even ignoring feasibility issues related to this and several other infrastructure investments, Chu Lai's industrial policy orientation encourages the Management Board and other policymakers to focus exclusively on foreign investment at the expense of domestic private enterprises, and potentially to the detriment of Quang Nam's tourism potential. However, all available evidence suggests substantial foreign investment will be hard to attract (particularly FDI requiring a port to export manufactured goods), whereas domestic private investment in tourism is *currently* the most dynamic sector in Quang Nam and promises to be a steady source of jobs and growth for the foreseeable future.

So, we are left with a conundrum. If Chu Lai was created to spawn Quang Nam's rural development, why is Chu Lai failing to focus its investments and resources on facilitating Quang Nam's only obvious engine of rural development? The answer is elusive; perhaps, *without* any foreign participation and *with* an industrial policy orientated towards attracting foreign investment, the Chu Lai Management Board's simply lacks strong incentives to invest in acquiring accurate market information, and conversely possesses strong incentives to conceive of itself as Chu Lai's most important investor.

These are difficult problems, however solutions exist. Addressing these institutional problems on the central government level may only require policymakers to provide Chu Lai with the level of decentralized policy and fiscal authority foreshadowed in public statements leading to the establishment of the open economic zone model. Addressing these same issues within Chu Lai will require local policymakers to temper the zone's industrial policy with a respect for Quang Nam's tourism potential, and focus Chu Lai's experimental space and resources on eliminating barriers to domestic private enterprises in Quang Nam, as well as obstacles to foreign investment in manufacturing.



# Appendix: Development and Planning Map of Industrial Zones to 2010 in Viet Nam



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