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Red Carpets and Red Tape: Institutions and the Geography of FDI in Vietnam[1]

Prepared for the workshop

"FDI in Developing Countries: Leveraging the Role of Multinationals"

Paris: Institut français des relations internationales (IFRI)

June 10, 2004

Revised version: June 25, 2004

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[1] Acknowledgement: financial support for this research from the UK Department of International Development (ESCOR project no. R7844, Center for New and Emerging Markets, London Business School) and Danish Social Science Foundation (grant number 24-01-0152) is gratefully acknowledged. We also thank Yen Thi Thu Tran and Curt Nestor for their helpful comments on an earlier version of this paper.

Red Carpets and Red Tape:

Institutions and the Geography of FDI in Vietnam

Abstract

Government policy and, more generally, the institutional framework of developing economies have widely been recognized as major determinants of the inflow of FDI. In this paper, we argue that also the variation of institutions within a country is crucial for FDI as foreign investors seek locations with favourable local business climate. In consequence, the implementation of centrally-initiated reforms at the local level is crucial for both the volume and the types of FDI attracted to a certain location.

We outline the interaction between national institutions and provincial institutions in Vietnam, and discuss the implications of these dynamics for foreign investors considering FDI in Vietnam. We specifically investigate these issues with respect to a province known to be particularly successful in attracting FDI. We argue that decentralization of administrative responsibilities has created opportunities for entrepreneurial-minded local authorities to push forward economic reform, and thus foster the development of both local businesses and foreign investment. Yet this decentralization requires the development of supporting institutions at provincial level.

1. Introduction

A market-based institutional framework is essential for attracting FDI to a country (World Bank 2002). Yet foreign investors consider more then the formal national institutions when deciding how and where to set-up their operations. In addition, foreign investors are concerned with local institutions, and with informal, often less evident aspects of the institutional framework. These institutions co-evolve in complex interactions between formal and informal institutions (North 1990) at national as well as local level. Moreover, institutions co-evolve with organizations as an institutional set-up favours the development of certain types of organizations, and organizations support the institutions they have come to rely on (Lewin et al. 1998, Hall and Soskice 2001).

The interaction between national and local institutions may well result in a situation where a favourably minded national government is rolling out a *'red carpet'* for foreign investors, while bureaucratic minded local governments create *'red tape'*. Or an entrepreneurial local authority rolls out the *red carpet*, and thus moderates the deterring effect of *red tape* created by a bureaucracy in the central government. Developing countries that are large and administratively decentralized thus have to manage this dual tension between national and local institutions, as well as between formal and informal institutions.

The complexity of co-evolution of institutions, and their impact on FDI, can be observed in Vietnam. Formally, Vietnam has been a socialist republic with state-ownership central planning for more then a decade before embarking on reform in the late 1980's (and even longer in the North). However, traditional value systems and entrepreneurial spirits survived in the informal sector. Economic reform was initiated in 1986 with many small changes in the formal institutions at national level. Yet the implementation of reform, and the development of market-oriented institutions, depends very much on initiatives taken by local authorities and organizations. In consequence the institutional framework faced by business varies within Vietnam, especially with respect to informal aspects.

Foreign investors take this institutional variation into account when making their investment decisions. Thus, we observe that FDI in Vietnam is concentrated in the traditional economic hubs, Hanoi and HCMC, as well as a small number of other provinces that made deliberate attempts at creating a business friendly institutional environment (Meyer and Nguyen 2004).

This chapter explores the relationship between the pattern of FDI and institutions at local level. In the next section, we set the stage by reviewing the economic geography literature on FDI. In section 3, we present an institutional perspective on foreign investment strategies and develop our own theoretical framework. This framework is in section 4 applied to interpret the institutional change processes currently under way in Vietnam. In section 5 we present empirical evidence in form of patterns of FDI, and we summarize an empirical study showing the impact of local institutions on FDI. This quantitative evidence is then further elaborated by drawing on interviews that we conducted in a particular successful province, and with foreign investors operating nation wide. Section 6 concludes with policy implications for large and administratively decentralized emerging economies. Handing over responsibilities to local authorities opens opportunities for entrepreneurial initiatives, but it may also increase risks and transaction costs.

2. Economic Reform in Vietnam

Vietnam started a gradual path of reform in 1986 following the Chinese example of gradualism. However, the communist party remains firmly in power, and many aspects of the economy are subject to regulation or direct interference by the government or the party. The legal framework for FDI has evolved with major and minor changes throughout the 1990's, after the first FDI law has been passed in 1987. Yet other legal and administrative changes have been equally important for foreign investors, including the rules and procedures concerning investment licenses, land lease, recruitment and salaries, investment guarantees, and taxation (Gates 2000, van Arkadie and Mallon 2003, Nguyen et al. 2004).

However, compared to neighbouring countries, "many areas, such as retail trade, goods distribution service, finance, insurance, and real estate business are still very restricted to foreign investors … while … lists [of industries open or closed to FDI] are general and unclear, leading to difficulties in practical implementation" (CIEM 1999, p. 52). Moreover, 100% foreign ownership is not permitted in a wide range of industries, and Vietnam lacks a one-stop agency supporting potential investors in implementing their projects (CIEM 1999). Private ownership of land by foreigners is also limited, which make land-use-rights a key contribution of local partners to joint ventures in Vietnam.

The reforms have decentralized some policy responsibilities, delegated some budgetary responsibilities to provinces and gave them some autonomy with respect to the FDI policies. Decentralization was stipulated in the foreign investment law in 1996 and came into effect in 1997. It has given provincial authorities an active role in dealing with FDI. For the first time, local authorities have gained responsibilities to grant investment licenses for FDI projects at scale of up to US$ 5 million (US$ 10m for Hanoi and HCMC) that not belong to a sensitive or regulated sector. For larger

FDI projects, provincial authorities are responsible to support foreign investors in the preparation of the documentations to apply for investment licenses at a higher level of authorities (Nguyen et al. 2004). Moreover, since 1997, many regulatory and supervisory functions related to FDI have been delegated, for instance land lease rate (within the centrally mandated range), import & export licenses, labour recruitment etc. This allowed provincial authorities to develop innovative ways of dealing with foreign investors. Yet, their newly gained authority is used quite differently, not only between the urban centres and rural areas, but also between the North and the South.

The pattern of business organizations varies from other countries, and reflects the path of reform over the past decade. State-owned firms still generate more output than the domestic private sector, but their share has fallen below 40% by the turn of the millennium (Nguyen et al. 2004). A restructuring program for state-owned firms, supported by multilateral institutions such as the World Bank, envisages "equitization" (a synonym for privatisation), reduction of subsidies, and restructuring of non-performing loans. Vietnam's state-owned firms thus gradually have to face more market-oriented performance criteria, yet, for the time being, they remain major economic and political agents both at the national and the local level (van Arkadie and Mallon 2003).

The private sector had historically been restricted and was subject to substantial discretionary interference by governmental authorities. Only in 1999, policy changed towards supporting the establishment and operation of private enterprises, leading to a surge in registration with 56,000 new enterprises and registered capital of US$ 6.7 billion in 2000 to 2002 (compared to 45,000 new enterprises in 1991 to 1999). Yet since most of these private businesses are still small, they have little political influence on the national stage, despite their increasing economic importance (Tenev et al. 2003).

Foreign investment was first permitted in 1987, and over the next years FDI regulations were gradually liberalized. Annual FDI capital inflows increased to over US$ 2 billion by 1995, when it stabilized at that level before falling in the late 1990's. Rather then these absolute numbers, the relative importance of FDI for Vietnamese GDP and international trade are remarkable. In 2002, FDI accounted for 35% of industrial output, 34% of imports, and 47% of exports (Statistics Publishing House, 2004a). By July 2002, FDI enterprises employed 596,016 persons, which corresponds to 15.5% of employment in enterprises (Statistics Publishing House, 2004b).

3. The Economic Geography of FDI

The location of production is first and foremost a function of the costs and quality of local **factors of production**, i.e. comparative advantages of resource endowments. Labour costs and productivity are a prime concern for many industries that manufacture in emerging markets for export, for instance for textiles or electronics. Efficiency- or resource seeking investors would consider the costs and quality of those local resources that they require for their operations, including natural assets, like the local workforce and natural resources, and increasingly 'created assets' such as human capital and infrastructure (Narula and Dunning 2000). These factor costs have to be balanced with the costs of bringing goods to market, which depend among other influences on the traffic infrastructure, distance to markets, and trade barriers in key export markets. Empirical studies confirm that FDI follows factor endowments, for example in China (Head and Ries 1996, Cheng and Kwan 2000).

Secondly foreign investors set up production near their markets. The **attraction of markets** is first and foremost a function of their size, their expected growth and their sophistication. The location of market-seeking investment aims to obtain market access, often by establishing operations in the main commercial hub of the host economy (especially for consumer goods), or in close proximity to key customers (when selling B2B goods). The empirical relationship between FDI and the GDP level and growth of host economies supports this line of argument.

A different theoretical foundation to explain the location of FDI is **economic agglomeration**. This literature stipulates that firms benefit from locating in the vicinity of other firms in the same industry, i.e. in a cluster. They benefit from specialized labour markets, the availability of suppliers to the industry, and the exchange of knowledge with other firms in the cluster. Moreover, new investors may use the experiences and performance of earlier investors as indicators of the underlying business climate at the location. Thus strong forces lead to a centralization of economic activity, while countervailing effects of, for instance, real estate costs favour decentralization. With respect to the location of FDI, the economic agglomeration literature suggest the following effects:

- FDI locate where other firms in the same industry are already established.
- FDI locate where other FDI firms are already established.
- FDI locate where other FDI firms from the same country of origin are already established.

Empirical evidence supports all three propositions. The second proposition has been demonstrated empirically showing that new FDI locates where there is already a large stock of FDI (Cheng and Kwan 2000, Head and Ries 1996), and including the stock of FDI at any given location in as an independent variable. Agglomeration effects have been shown specific to FDI from the same country origin, in the USA for Japanese investors (Head et al. 1999), and in China for Taiwanese and Hong Kong investors (He 2003).

The fourth theoretical foundation is the **institutional perspective**, which is the focus of this chapter. FDI research has considered institutions when analysing FDI flows between countries. This literature points out that investment incentives, tax rates and absence of performance requirements encourages FDI (Loree and Guisinger 1995) and, more generally, market-oriented institutions and a private property rights regime attracts more foreign investment (Globerman and Shapiro 2003). Empirical research in emerging economies finds major institutional influences of the strategies of both domestic firms (Peng 2000, Khanna and Palepu 2000) and foreign direct investors (Meyer 2001, Bevan et al. 2003).

Yet there is little research on institutions and FDI at sub-national level. Some studies consider formal institutions, especially taxation policy in the case of the USA, and the existence of special economic zones in the case of China. In the USA, Coughlin et al. (1991) find that higher taxes deterred FDI, while promotional activities and transportation infrastructure increased FDI. Hines (1996) finds that state corporate taxation lowered FDI from those countries of origin where investors are not taxed for foreign profits; while there was no effect on FDI from Japan and the United Kingdom, where foreign profits are taxed yet credits are provided for tax paid in the USA. Head et al. (1999) find that states' tax policy, and the existence of a free trade zone attract FDI, while the existence of a promotional office is insignificant. In China, the incidence of special economic zones has been introduced as a policy factor as a dummy variable (Head and Ries 1996).

However, a broader setting of influence FDI strategies in emerging markets. We find that, in addition, the size of industrial parks in terms of real estate is important for FDI, as is the ownership structure of the local industry (Meyer and Nguyen 2004). These influences are part of a complex interaction between institutions, institutional change and FDI, that we explore in the next section.

4. Institutions and FDI

4.1. A Conceptual Framework

Institutional economics has explored how the institutional set-up influences economic activity (North 1990) and thus the strategies pursued by firms. This literature distinguishes formal institutions, such as laws and regulations, and informal dimensions that are grounded in customs, traditions, and codes of conduct. In the sociology literature, Scott (1996) describes institutional frameworks as consisting of three pillars: regulatory, normative and cognitive institutions, where the regulatory dimension roughly corresponds to formal institution in North's terminology.

These institutions are mostly analysed at a national level, but they may vary within a country as well. Some countries allow regional authorities to set certain laws. Moreover, even where local authorities do not have law-setting authority, informal institutions may vary due to variations of normative or cognitive aspects of institutions.

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Figure 1 approximately here

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Foreign investors thus face a complex institutional environment with both formal and informal aspects. Figure 1 presents our conceptualisation of the institutional framework faced by foreign investors. It is based draws on the on the notion of formal and informal institutions as introduced by North (1990) and the co-evolution of institutions and organization, as analysed by Lewin et al. (1998). Moreover, we have added to the prior theoretical work by elaborating on the interaction between institutions and organizations at national and local levels.

The power of local authorities arises from both formal institutions and informal institutions, such as the effectiveness of implementation of centrally mandated economic reforms. In industrialized countries with a federal structure, such as Australia, Germany or the USA, the responsibilities of different levels of government are clearly deliminated by law. In contrast, emerging economies have formal institutions are somewhat vague, such that the actual influence of provincial authorities is to a much higher degree based on informal institutions.

Many national governments, including Vietnam, may have adopted favourable attitudes to FDI, yet the implementation of these policies is often local. Foreign investors have to negotiate with local authorities over business licenses, real estate, access to public utilities, and in some countries also tax incentives and subsidies. Such policy variation is related to administrative decentralization, as local authorities can decide how to implement policies set at central level. (This does not necessarily require political autonomy). Informal local institutions draw on distinct local traditions and cultures, may thus show some degree of variations of normative values.

Organizations and institutions co-evolve (Lewin et al. 1998, Peng 2000). Firms gravitate towards organizational forms for which they find institutional support. For individual firms, institutions may be exogenous but the population of firms creates pressures to create institutions that best meet their needs. Thus, political and social institutions determine the nature of firms, and the firms support the institutions they come to reply on (Hall and Soskice 2001).

Feedback effects emerge from local to national levels, and from informal to formal institutions (indicated by dashed lines in Figure 1). Lawmakers and ministries are subject to institutional pressures to adjust the legal framework to the expectations of influential groups. In a democracy such pressures are channelled through parliaments as well as informal channels such as lobbying, while in less democratic societies, informal channels may dominate. While developing incrementally, at critical points, informal feedback from below may lead to major reform in formal institutions, such as the revolutions that occurred in Eastern Europe around 1989.

4.2. Institutional Change Processes

Initial reforms concerned first and foremost formal institutions at central level. When the regulatory framework is changed at the centre, this directly affects formal institutions at local level. However, the informal institutions adapt only with considerable delays, and be a major source of inertia (North 1990). We propose to model these changes of institutions in the following way (Figure 2). Reform formally starts with legal changes of the formal institutional framework. Yet new laws do not stipulate everything, and reform thus creates space for administrative decisions at lower levels of the public sector. Individual bureaucrats have some degree of autonomy within the scope of interpretation of new laws due to lack of legal precedent in applying the new law.

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Figure 2 approximately here

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Let us depicts each bureaucrat's decision as choice between interpreting the law in a restrictive, incumbent-protecting or self-serving way, or in a business-friendly way allowing for entry and dynamic market forces. We refer to these two options as *'red carpet'* and *'red tape'*. The *red carpet* treatment may imply enforcement of law supporting in a market economy, and rejection of traditional networking based strategies. It also includes local authorities developing innovative approaches to solving emergent obstacles to business, without waiting for decisions by central authorities, potentially even creating templates that are later adopted elsewhere in the country.

In a complex public sector, many decision makers influence the implementation of institutional change, each choosing between *red carpet* and *red tape* treatment based on his/her individually held norms and cognition. Thus, “simply enacting market-friendly rules is not enough. The next hurdle is their enactment” (Peng 2003: p. 292). If conservative inherited norms and lack of recognition of the purpose of regulatory changes dominate, then businesses may experience a lot of *red tape* at local level. Similarly, corruption creates *red tape*. On the other hand, equally possible is a *red carpet* treatment at the local level to the limits of what new legislation permits. Figure 2 illustrates the varying decisions at multiple points in an administrative system, which leads to a favourable investment climate in some locations, but not necessarily across the country.

Note that we placed normative and cognitive institutions above the hierarchy of the formal structure. Individuals taking decisions are subject to their individually and socially held norms as well as their cognition of the issues at hand. In this way, local history and traditions as well as particular old and new cultural influences affect the institutional set-up that governs business. These informal aspects of institutions tend to be more stable and do not adjust quickly to changes in the legal framework (North 1990, Peng 2003). However, they allow for individual entrepreneurial initiative. While changes in the formal framework being observable while informal aspects may be less transparent.

Thus, the inherent ambiguity of laws and regulations issued centrally assigns local authorities an important role in establishing how rules are implemented. The local business climate is thus an outcome of many decisions taken by individuals at various places in society. Formal legislative changes initiate institutional change, yet cognitive and normative institutions have a strong moderating influence on the actual local institutional framework.

5. Empirical Evidence

5.1. The pattern of FDI

FDI in Vietnam is highly concentrated in and around two economic hubs (Figure 3). The South-East Region around Ho-Chi-Minh-City (HCMC) has received 2739 FDI projects in the period 1998-

2002, and thus accounts for 63% of all projects. Within the region, the province of HCMC alone accounts for 1391 projects, with most of the remainder accounted for by provinces directly neighbouring HCMC to the North. These provinces had little industrial infrastructure in the 1980s, but dramatically increased their share of FDI in the late 1990s.

In the North, most FDI is located in Hanoi province (567 projects), or in the coastal provinces Haiphong (142) and Quang Ninh (75 projects). Here too, we observe a trend over time from the city of Hanoi to greenfield sites outside the city limits. On the other hand, many of the 61 provinces in Vietnam received very few projects, as 10 provinces received less then four projects.

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Figure 3: (Geographic Distribution of FDI in Vietnam)

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This pattern of FDI is driven both by traditional location advantages and agglomeration effects as well as the institutional framework at province level. On the basis of recent survey data (Estrin and Meyer 2004), we have analysed both the determinants of locations of FDI, and investors' propensity to choose greenfield entry rather then joint ventures (Meyer and Nguyen 2004), and find that:

- Provinces with industrial zones attract more FDI; yet beyond the establishment of zones,[2] the availability of real estate in such zones attracts FDI, and greenfield investment in particular. This effect persists even when controlling the agglomeration benefits created by past FDI. Provincial authorities providing land to industrial zones not only create real estate markets,[3] but they also signal a commitment to creating a favourable investment climate.
- Incumbent state-owned enterprises appear to influence the institutional framework such as to encourage foreign investors to partner with them, yet they do not have a significant deterrent effect on FDI. Weak SOEs may thus see JVs primarily as means to enhance their competitiveness, rather than a threat to their market position.

[2] The establishment of industrial zones requires case-by-case approval by central government authorities, they are thus also an outcome of local initiatives. If successful in lobbying the central government to approve an industrial zone, the province can also offer certain tax benefits for businesses investing in the zone.

[3] In Vietnam, real estate markets are underdeveloped as foreign investors may not normally acquire real estate or land use rights.

- Institutions establish the range of permissible strategies, including industries open to FDI, investment locations, and entry modes. In Vietnam, the FDI-law did not permit acquisitions for foreign investors, except for special cases such as acquisitions from other foreign owners. This reduces the options for entry modes, and may thus deter some investors.
- Investors' exposure to local institutions varies with the investment objectives. We found that early entrants and local market oriented businesses, which are more likely to encounter conflicts with local incumbents, are more likely to enter by JV.

Overall, this empirical analysis illustrates that institutions at provincial level in Vietnam – in addition to national institutions – affect foreign investors entry strategies. Certain institutional conditions – such as local firms controlling access to critical resources – may inhibit some investors, but induce others to overcome these institutional barriers by establishing a JV.

5.2 Case Study of Dong Nai province

We have interviewed businesspersons and government officials in one of the provinces that attracted much FDI, and often in form of greenfield projects: Dong Nai. The province has inherited some industrial infrastructure, having been an industrial production area before reunification of Vietnam in 1975, then known as Bienhoa Industrial Zone. After the country reopened to FDI in the late 1980s, the relatively good infrastructure and the proximity to HCMC attracted some foreign investors to the province.

Yet, initiatives of the local authorities made the province a prime destination for FDI. In the early 1990s, Dong Nai developed master plans for multiple industrial zones. In 2001, 10 zones covering 2,725 hectares had been opened and occupancy rate reached 55.31%. Foreign investment surged: by the end of 2002, Dong Nai had 476 projects with total registered capital of US$4.3 billion, and employing over 100,000 people. Taiwanese investors are the largest group of investors with 118 projects (US$ 1.5 billion), followed by Japanese with 35 projects (US$ 838 million).

Beyond the establishment of industrial zones, the provincial authorities aimed to create a *red carpet* for foreign investors using both formal and informal means. Businesspersons operating in the province pointed out the following aspects:

- Local authorities provide a timely, clearly and consistent interpretation of laws and regulations. Elsewhere, foreign investors may complain about uncertainty created by inconsistent application of the law, but in Dong Nai, they would know the 'rules of the game' before committing to invest.

- The local authorities have created flexible mechanisms to facilitate the process of obtaining investment licenses. In some cases, the chairman of the Provincial Peoples Committee (effectively, the provincial governor) accompanied investors in person to support investment plan in front of higher authorities. Such visible commitment is highly appreciated by investors.
- First try, report later: Local authorities took a pragmatic approach in some incidences where the formal regulations were too complicated without providing clear benefits. They applied them in a simplified form, and only later reported to higher level of authorities to have formal rules amended.
- The authorities support FDI enterprises beyond issuing investment licenses, for instance by providing advice on how to deal with the complex regulations on import, export, labour recruitment, construction, land lease, etc.
- Within their authority, local authorities provide favourable terms with respect to, for instance, land lease rates and tax rates.
- Last not least, the infrastructure has been developed in line with needs of foreign investors, including transport, electricity, water supply, and human capital.

The relative attraction of Dong Nai as investment location can thus be attributed to a combination of favourable initial conditions, and investor-friendly development of formal and informal institutions at local level. The local authorities, not withstanding their association with the communist party, thus acted as entrepreneurs, sizing the opportunities created by national reform, and advancing capitalist economic development. They matched the *red carpet* offered by the central government by rolling out *red carpets* locally.

In recent years, other provinces follow the lead of Dong Nai, which strengthens the decentralization of Vietnam. However, Dong Nai benefits from a first-mover advantage and has become the core of a foreign investment cluster outside the traditional hub of HCMC.

5.3. Risks of Decentralization

While decentralization creates opportunities for entrepreneurial local authorities, it is also a risky political strategy. The success of the reform depends on decisions made in the provinces that are – by definition – not centrally controlled. The main risks include the possibilities of insufficient administrative capabilities, or self-serving policy decisions made to protect local interests or creating rents for the officials in charge (popularly known as bribes).

Moreover, decentralisation of authority also implies that rules may be different across the country. This is of great concern to some businesspersons. Our interviews with foreign executives in Vietnam point to some of the increased transaction costs associated with decentralization:

- An executive of a large Hong Kong based trading house was concerned about different product classification in different ports. If a given product is classified slightly differently, this may trigger the application of a different tariff rate. Thus, importers are very concerned through which port they import to Vietnam as it affects the tariff rates to be paid.
- A manger in an international IT firm has to explain to their customers why they have to pay different rates for the same IT training course in respectively Hanoi and HCMC. This is because they have to charge value-added tax (VAT) in one city but not in the other, as a result of the course being classified a ‘education service’ only in one city, which triggers VAT exemption. This creates additional administrative costs, and confuses customers that operate in both cities.

Thus, decentralization opens opportunities for local authorities to press ahead with institutional reform, thus creating templates for others to imitate. Yet such uneven progress of reform also creates transaction costs that may inhibit business development, both because of additional risks of institutional changes, and because of adjustment costs for businesses operating across multiple provinces.

6. Policy Implications

Decentralization is a double-edged policy, creating both opportunities and risks for economic reform, and for the attraction of foreign direct investment. In this chapter, we have outlined the opportunities for facilitating foreign investment by allowing local authorities to take initiatives, and we show that the substantial variation of FDI within Vietnam is to a large extend induced by the diverse development of informal institutions and the uneven implementation of reform initiatives. Provinces that pursue FDI-friendly policies in the liberalization process, such as Dong Nai, may benefit from first-mover advantages in the long run, and develop into a hub of economic activity (see also Graham 2004).

Thus policies to improve the investment climate in emerging economies ought to incorporate both reform at the national level, and means to encourage local authorities to pursue policies in the same spirit of reform. Decentralization can lead to competition between regions for FDI, but also to central government rolling out the *red carpet*, while bureaucrats in specialist ministries or local authorities create *red tape*. Decentralization of FDI-related responsibilities thus requires development of institutions at the local level. This can take many forms.

- Technical assistance may support the creation of administrative capabilities at local level, for instance by training local officials.
- A common institutional framework may inhibit excessive 'competition by subsidies' (Oman 2000), or a 'race to the bottom' in labour standards (Spar and Yoffie 1999), and provide monitoring mechanisms that prevent self-serving administrative governance and corruption.
- Rather then finding case-by-case solutions for each investor, authorities would be better advised to develop the general legal framework governing business. This would both improve transparency and reduce institutionally-induced uncertainty.
- Beyond changing formal institutions, reform minded government may aim to influence informal institutions: Don't just change of the law, but build political support, and create awareness for the benefits of new rules. For example, it does not suffice to declare a special economic zone; rather the quality of the entire institutional framework pertaining to the zone is crucial to attract FDI.
- Incentive systems may allow provinces to retain the benefits of accelerated economic development, such as tax revenues. At the same time, incentives for individual decision makers should discourage them seeking private benefits at the expense of social benefits.
- The *horizontal* exchange of information and experiences between provinces and middle-levels in ministries should be encouraged. In other words, the highly departmentalised structure of the public sector in Vietnam should be opened to facilitate cross-departmental and cross-provincial communication and learning.

While our research has been conducted in Vietnam, we believe that the policy lessons are also relevant for other developing countries that are large and administratively decentralized. Many countries, including China and India, have seen a very unequal distribution of FDI with focus on a small number of locations, and are concerned about attracting FDI to other places. If done well, they may benefit from decentralization of policy responsibilities to allow local authorities to take their own entrepreneurial initiative.

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Figure 1: Investment climate and coevolution of national and local institutions and organizations

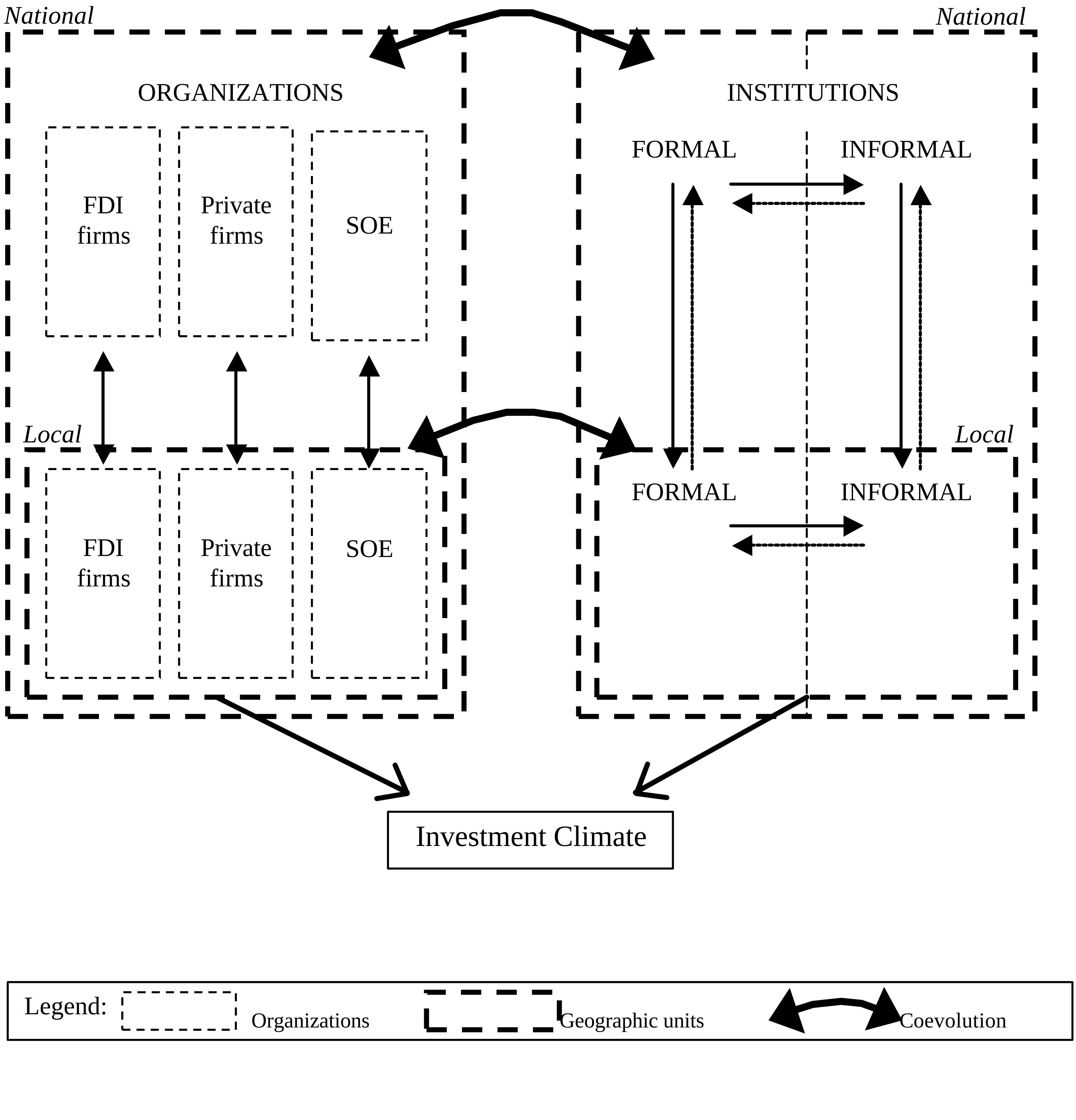


Figure 2: Implementation of reform: A formal-informal institutions interpretation

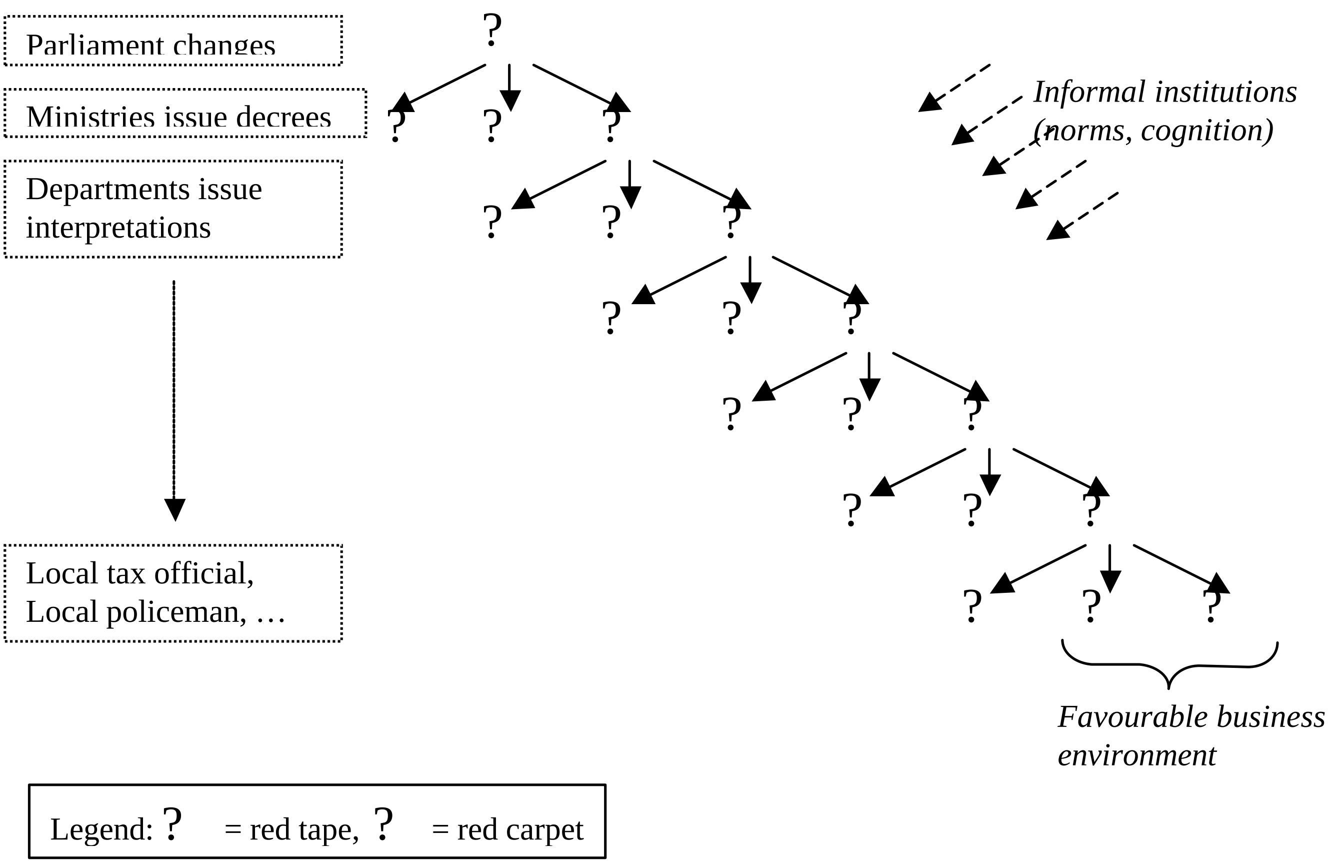
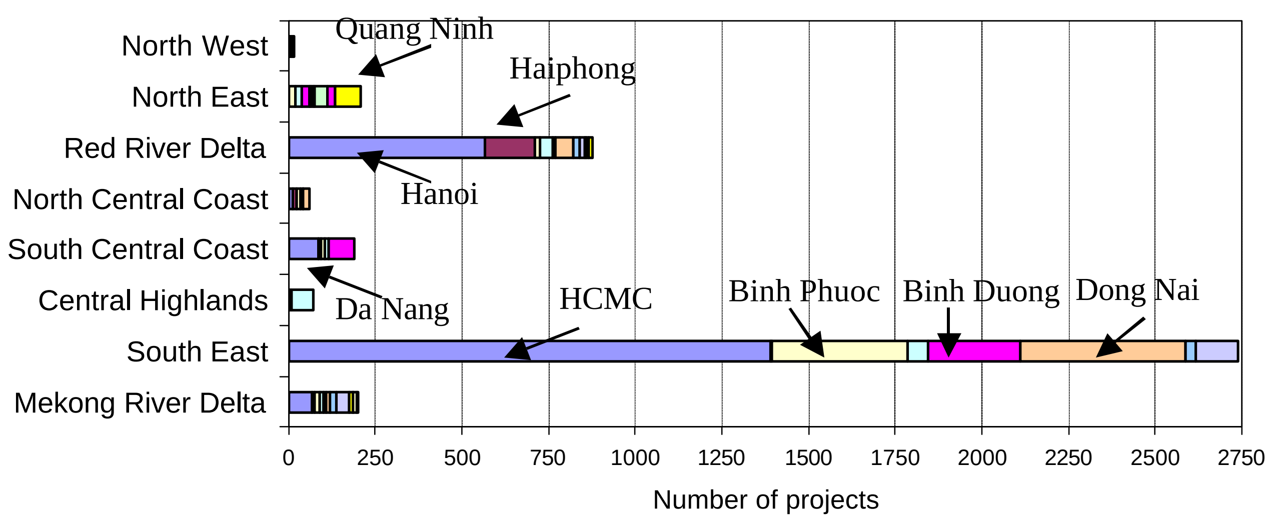


Figure3: Location of FDI in Vietnam



Data source: Statistics Publishing House, 2004a.