FDI in Vietnam – policies, effects, and linkages to the local economy

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Introduction

Vietnam has emerged as one of the most attractive emerging market destinations for foreign direct investment (FDI) over the past decades. Foreign investors have contributed significantly to the country's economic development since the early stages of the economic reform and transition process that was launched in the late 1980s, and the importance of FDI has grown since 2007, when the country joined the WTO. FDI inflows jumped from USD 4.1 billion in 2006 to more than USD 8 billion in 2007 and averaged over USD 15 billion per year in 2015-2019.[1] Among developing economies, only the BRICs (Brazil, Russia, India, China) and Singapore, Mexico, and Turkey have managed to achieve notably higher FDI inflows during the past few years. Although FDI has mainly focused on labor-intensive manufacturing, Vietnam has also become a destination for high-tech enterprises. For example, the leading foreign investor in Vietnam is now South Korea's Samsung. The company's first investment in the country was made already in 1996 (production of color television sets for the domestic market), but its presence has increased strongly since 2009, when it established a factory complex in the northern Bac Ninh

[1] Data provided by Foreign Investment Agency, Hanoi.

province and began to shift its export-oriented production of mobile telephones from China to Vietnam. Vietnam accounted for nearly half of Samsung's global production of mobile telephones in 2017, when the direct employment in its main production facilities outside Hanoi reached 107,000 people. At the same time, Samsung alone stood for a staggering 26% of Vietnam's total exports. Vietnam's success in attracting firms like Samsung has led the country's leaders to be optimistic about future economic development, and it has been assumed that FDI will help Vietnam reach the objective from the 11th Party Congress in 2011 to become "a modern and industrialized nation." Apart from the direct effects of FDI on employment, household income, tax payments, and infrastructure, it has been expected that foreign investors will contribute to the development of local industrial capacity through various kinds of spillover effects. Empirical evidence from Vietnam as well as other countries suggests that some of the modern technologies used by foreign multinational enterprises (MNEs) can be diffused to local firms, raising their productivity and competitiveness.[2] The literature on spillovers has identified a potential for horizontal spillovers, where local firms learn from FDI in their own industry, but tended to emphasize the importance of vertical spillovers, which occur as a result of linkages between local firms and foreign MNEs, e.g. in the form of supplier or subcontracting relationships.[3]

However, the Samsung example has raised concerns about the development impact of FDI. While Samsung's direct contributions to the national economy in terms of employment, incomes, and export revenue were substantial already in 2014, the record with respect to vertical spillovers was disappointing. At that time, there were only four domestic first-tier suppliers in

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[2] See Blomström and Kokko, "Multinational Corporations and Spillovers" and Nestor, "Technical Intensity of FDI".
[3] Giroud, "MNEs Vertical Linkages" and Giroud, "Mind the Gap".

the company's Vietnamese value chain, mainly producing the cardboard boxes into which the mobile phones were packaged – the other 63 first-tier suppliers in Vietnam were all foreign-invested enterprises (FIEs), mostly Korean and Japanese firms that had already been part of Samsung's Chinese supply chain.[4] Given the relatively simple tasks assigned to the domestic suppliers, there was little scope for spillovers of advanced technology. The weak integration between FIEs and local firms – and the observation that Vietnam has not quite managed to become a "modern and industrialized nation" despite the large inflow of FDI – has contributed to an ongoing critical discussion about Vietnam's FDI policies. Foreign investors like Samsung have benefited from various FDI incentives, including tax holidays and reduced land rents. The formal arguments for providing such incentives typically emphasize the existence of spillovers, which mean that free market solutions will generate too little FDI.[5] Yet, if there are only marginal spillovers, then the main result of FDI incentives may be to cement the competitive disadvantages of local investors who do not qualify for tax holidays and other benefits that are available mainly for FIEs.

The purpose of this chapter is to describe and discuss Vietnam's FDI policies and the effects of FDI from the early 1990s to the present. The analysis consists of four parts. The first of these summarizes data on FDI inflows and FDI policies during the period 1988-2019. This section also discusses the determinants of FDI inflows, where trade liberalization and global economic events like financial crises have moderated the impact of regulatory reform. The second section turns to a discussion of the productivity and spillover effects of FDI. The main question is how FDI has influenced local firms – what has been the impact of FDI on local

[4] Tong, Kokko, and Seric, "Linking FDI and Local Firms".
[5] Blomström and Kokko, "Economics of FDI Incentives" and Le, "Impact of Investment Promotion".

competitiveness, growth, productivity, and technological competence? Here, the general pattern seems to resemble the Samsung case mentioned above. Vietnam has managed to attract large amounts of FDI that have created millions of jobs, directly (in the MNEs) as well as indirectly (through various demand and multiplier effects), but the results in terms of FDI spillovers have been weak. One reason is the weakness of the domestic supporting industries (SI) sector. It is hard for FIEs to find local suppliers that can meet the required standards related to technology, quality, delivery times, and contract volumes. Section three provides a brief discussion of how the FDI policy framework for the period 2020-2030 may look. The major challenge is the need to shift from simply attracting FDI to strengthening the linkages to the local economy and upgrading the position of local firms in global value chains (GVCs). At the time of writing (mid-2022), the "Strategy for Foreign Investment Cooperation 2021-2030" has just been approved, but its implementation is awaiting guiding regulation in several different policy areas. However, the relatively open debate on FDI policy during the past few years gives some useful insights into the plans and considerations of Vietnamese policymakers. Our tentative assessment of the new policy framework is spelled out in the concluding remarks section at the end of this chapter. We agree that the shift in focus from aiming to attract FDI to optimizing the development impact of FDI is well founded, but there is a risk that the necessary reforms require larger changes than what Vietnamese leaders are prepared to carry out. To fully benefit from FDI inflows, more resources should be used to empower the private sector and raise the capacity and competence of local firms, to make them more attractive as partners to foreign MNEs and better able to take advantage of the potential spillover benefits from FDI. A stronger focus on local firms would also improve the resilience of the domestic economy in case international developments result in fundamental restructuring of GVCs, international trade, and FDI linkages. However, it is not clear how eager the Communist Party of Vietnam is to support the emergence of a strong private sector, which would by nature be fragmented, unpredictable, and relatively difficult to control.

FDI Inflows and FDI Policy

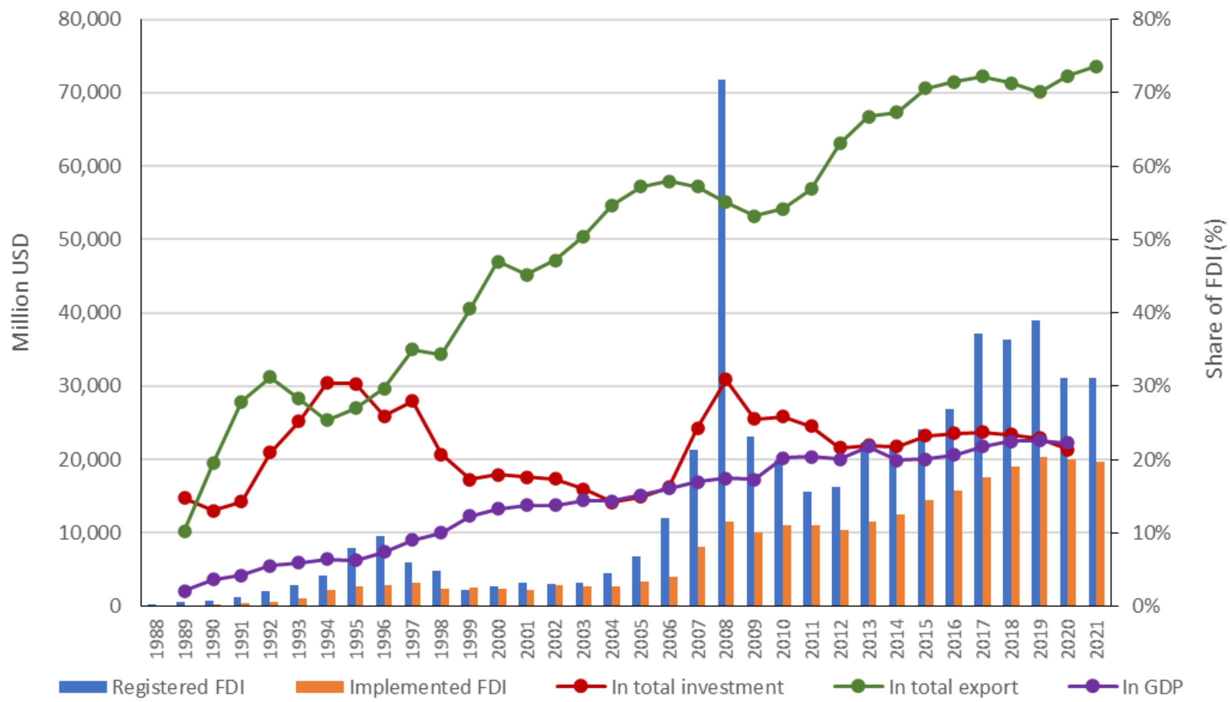
FDI Inflows 1988-2021

FDI has become an increasingly important part of the Vietnamese economy since 1988, when legislation allowing and encouraging inward investment was introduced. According to Vietnam's Foreign Investment Agency (FIA 2022), more than 34,500 FIEs had been established in in the country by the end of 2021. In total, these enterprises represented USD 408 billion in registered approved investment capital, of which USD 251 billion had been implemented.[6] Despite the ongoing Covid-19 pandemic during 2020-2021, inflows in FDI continued at a remarkably high rate, with registered and implemented FDI reaching nearly the same levels as during 2019.

Figure 1 summarizes full year data on FDI inflows 1988-2021 and provides some broad indicators of the role of FDI in the national economy during this period. Both registered and implemented FDI have fluctuated over time, with notable dips in connection with the Asian financial crisis and the global financial crisis when external events have reduced FDI flows across the world. The notable peak is 2008, when WTO membership boosted the attractiveness of the Vietnamese market and several mega-projects with values at above one billion USD were registered. However, the underlying trend is one of substantial increases over time, and Vietnam is now a major emerging market destination for FDI.

Figure 1. Overview of FDI in Vietnam 1988 – 2021

[6] Data on registered FDI reflect foreign investors' capital commitments based on estimated project costs, as approved by Vietnamese authorities. Data on disbursements refer to the actual implementation of committed capital over time.



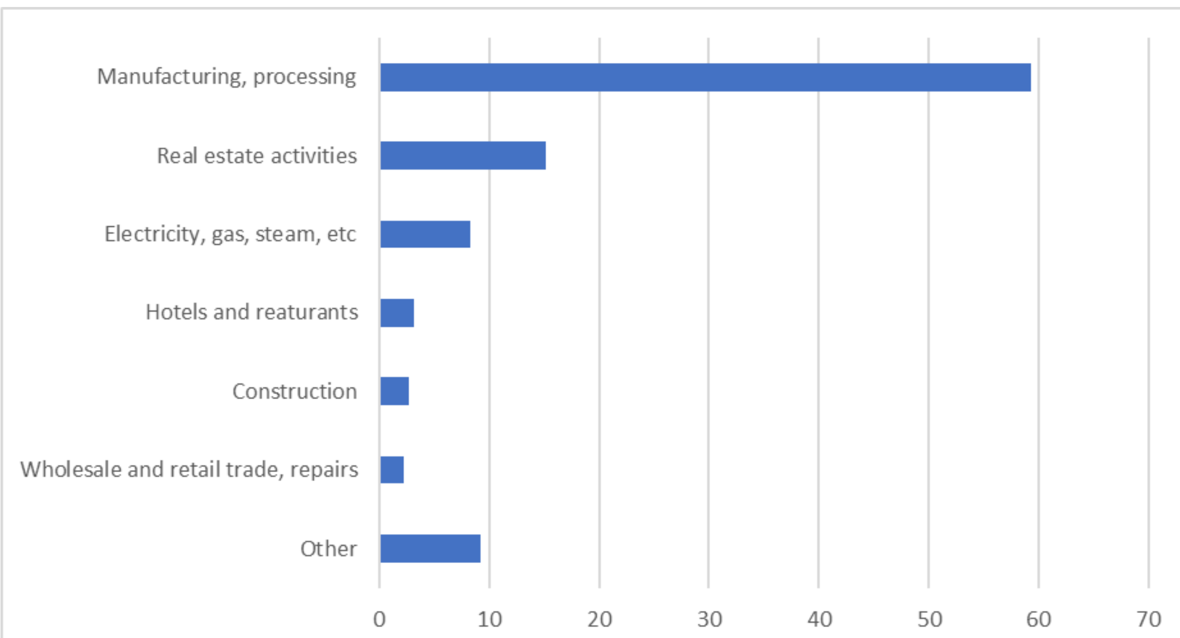
Source: FIA (2022); Ministry of Planning and Investment internal database.

Although FDI inflows (in particular, implemented FDI) were small in absolute amounts and did not exceed 10% of GDP during the first decade after 1988, FDI still left a notable mark on the local economy already at that time. Foreign-invested enterprises accounted for 30% of exports already in the early 1990s, and their share of total investment reached nearly one-third by the mid-1990s, before the outbreak of the Asian financial crisis. Since then, the ratio of FDI inflows to GDP has increased gradually, reaching above 20% in the last few years. The share of FDI in total investment has fluctuated more and stabilized at a somewhat lower level than in the mid-1990s. The area where the role of FDI has expanded most remarkably is exports. In recent years, FIEs have accounted for around 70 percent of Vietnam’s exports. As a result of FDI, Vietnam has entered GVCs in several industries, such as garments, footwear, furniture, and electronics.

Figures 2 – 3 illustrate the distribution of the stock of registered FDI capital across broad industry groups and investor source countries by the end of 2021. Figure 2 shows that the manufacturing and processing industry dominates with more than one-half of total investment. Manufacturing investments have dominated FDI inflows, in particular during the last decade. Real estate and construction jointly account for about 18 percent of the FDI stock, the capital-intensive energy / utility sector holds 8 percent, and wholesale and retail trade and the hospitality sector account for 5 percent of the FDI stock (but a much larger share of the number of investment projects). The remaining 13 industry categories in the Vietnamese statistics accounted for less than 10 percent of the aggregate FDI stock.

Figure 2. Cumulative FDI stock per industry, end of 2021

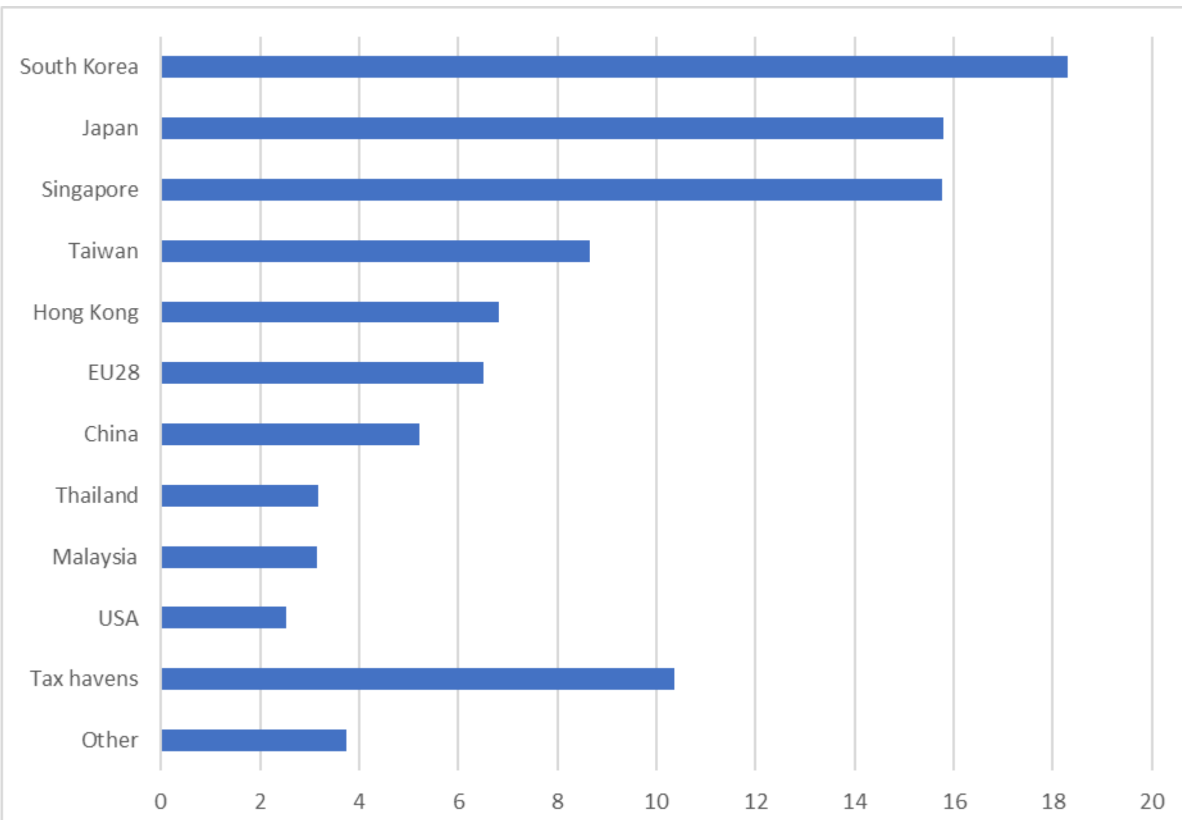
(percent of registered capital)



Source: FIA (2022).

Figure 3 shows that the distribution of FDI across investor countries is relatively concentrated. Excluding tax havens, the top-ten source countries cover 86 percent of the registered FDI capital stock. The dominance of Vietnam's East Asian neighbors is obvious, with South Korea, Japan, Singapore, Taiwan, and Hong Kong/China as the largest investors. FDI sourced from the EU, primarily the Netherlands, UK, and France, accounts for 6.5 percent. The role of US investors (2.5 percent) is probably underestimated since many American FDI projects are conducted by US affiliates in other Asian countries.

Figure 3. Cumulative FDI stock per investor country, end of 2021
(percent of registered capital)



Source: FIA (2022); calculation by authors .

Even though FDI reached all 63 provinces in Vietnam, the geographical distribution of FDI is heavily skewed towards more developed provinces. By the end of 2021, more than three quarters of the FDI inflows were concentrated to HCM City and adjacent provinces in the South (44.0 percent), Hanoi with hinterland in the North (27.1 percent), and to smaller extent Da Nang with surrounding provinces in the Central part of the country (4.7 percent) (FIA2022).

FDI policy: gradual reform over time

Vietnam's economic reforms during the past 30-plus years have not only affected domestic economic actors, but also changed the legal framework for foreign direct investors operating in or contemplating entering Vietnam. These changes explain much of the fluctuation in FDI flows outlined in Figure 1. The policy reforms reflect to some extent an ideological shift in the CPV, but FDI policy has also responded to foreign investors' complaints and changes in the external environment, such as changes in the FDI regimes of competing host countries. The FDI policy framework during the past decades can roughly be divided into four phases. The first phase, in which the Vietnamese economy was gradually opened for foreign investors, lasted from the earliest reforms in 1988 to 1996, the year before the onset of the Asian financial crisis. The second phase, from 1997 to 2005, was characterized by efforts to overcome the negative impacts of the regional financial crisis and deepen Vietnam's integration with the world economy. The promulgation of the common investment law in 2006, which introduced the same legal framework for domestic and foreign investors, marked the beginning of the third phase. This phase was also strongly influenced by Vietnam's accession to the WTO in 2007. The fourth and current phase is Vietnam's international integration process is driven by major changes in foreign investment policies, reflecting the ambition to increase the development impact of FDI.

From 1988 to 1996

The Vietnamese Government issued the first set of regulations governing FDI already in 1977, two years ahead of China's legislation on FDI.[7] However, the international political situation at the time, and notably the US trade and investment embargo imposed on Vietnam, effectively blocked the inflow of foreign investment. Vietnam's first Foreign Investment Law (FIL) was instead approved in December 1987 and came into effect in 1988. The ambition was to attract foreign capital, modern resources, technology and advanced management skills for economic development. FDI inflows were promoted in sectors where new ventures would create employment, produce import substitutes and export goods, contribute to the efficient exploitation of natural resources, build infrastructure, and increase the supply of foreign currency.

Little of this happened during the first years. After the long period of socialist planning and isolation from the global economy following Vietnam's invasion of Cambodia, the policy environment was complex and highly restrictive; unsurprisingly, the initial responses of foreign investors were cautious. Much of the capital invested in the first years was registered in joint ventures for offshore oil exploration projects. Other FDI projects were small joint venture operations with Vietnamese SOEs, typically located in Ho Chi Minh City. Many of the early ventures failed – the investment permits of more than half of the FDI projects licensed in 1988-1990 were withdrawn before the completion of the project, and there was often a long lag between the initiation of the FDI project and its implementation.[8]

New legislation introduced in 1990 supported the development of the nascent domestic private sector. The FIL was also amended in 1990, to allow private firms to participate in joint ventures, but it took many years before any domestic private firms grew strong enough to be

[7] Government Decree no 115/CP, dated 18 April 1977.
[8] Kokko, Kotoglou, and Krohwinkel-Karlsson, "Implementation of FDI".

attractive as joint venture partners. Amendments to the FIL were introduced in 1992, and a new FDI law was eventually promulgated in 1996. The formal changes introduced during this period aimed to make Vietnam more open to foreign investors by liberalizing investment requirements and adding sectors where FDI was allowed. To reduce bureaucracy and red tape, licensing processes were gradually standardized and simplified, foreign investors were permitted to establish wholly foreign-owned subsidiaries rather than joint ventures, and policies were adjusted to promote export-oriented FDI.

Foreign investors were also strongly influenced by other dimensions of the legal framework. A pilot project for setting up the first export-processing zone (EPZ) was carried out in Ho Chi Minh City in 1991. This provided both a legal and physical base for foreign export-oriented companies. The Management Board of Tan Thuan EPZ (now the Ho Chi Minh City Export Processing and Industrial Zones Authority) was established in 1992 to further facilitate foreign investment by simplifying administrative procedures. This was the first provincial body authorized to issue licenses for foreign investment. New regulations introduced in 1994 allowed Management Boards of IZs in selected provinces to license FDI projects with registered capital up to USD 5 million – the licensing of larger projects was still the prerogative of central authorities.

By that time, trade liberalization had added significantly to the attractiveness of Vietnam as a location for export-oriented FDI. The US trade embargo on Vietnam that had been in force since the unification of the country in 1975 was lifted in 1994, and diplomatic relations with the US were normalized in 1995. This made it possible for American firms to consider Vietnam as a potential trade partner and investment location. Other potential investors, e.g. Japanese MNEs, also saw the end of US sanctions as a cue to increase their engagement in Vietnam. In the same year, Vietnam joined the ASEAN and its Free Trade Area AFTA, which provided a boost to FDI inflows from its Southeast Asian neighbors.

FDI inflows gradually increased in response to the more open policy framework. Registered FDI grew from a few hundred million USD per year in 1988-89 to nearly USD 10 billion in 1996. However, given the complex business environment and high risk of the Vietnamese market, implemented FDI remained much lower, reaching USD 2.9 billion in 1996. Although well below registered FDI, implemented FDI still accounted for nearly one-third of total investment in the mid-1990s. The exports of FIEs grew from USD 199 million to USD 2.2 billion between 1989 and 1996, with a large change in export structure from crude oil to an increasing share of manufactured goods.

From 1997 to 2005

The objectives of the second FIL issued in 1996 were to attract more FDI to support the industrialization and modernization of the economy, to raise export capacity, and to reallocate resources to develop the underdeveloped and remote areas. The law and supporting decrees delegated licensing responsibility to provincial authorities and opened new sectors for FDI. For example, new regulations in 1997 allowed provincial People's Committees to grant investment licenses for non-conditional projects with total registered capital up to USD 10 million in Hanoi and Ho Chi Minh City, and up to USD 5 million in neighboring provinces – a right which was further extended to all provinces in 1998.

The sectors and areas where FDI inflows were considered particularly important were identified in special lists of priority sectors and districts announced in 1998. Moreover, central and provincial authorities were authorized to encourage FDI in these priority sectors and locations through special preferential fiscal and financial incentives. This included, for example, more generous tax credits and simpler procedures for land leasing and site clearance.[9] In most cases, the incentives offered to foreign investors were more generous than those available for domestic private investors. The promulgation of numerous Bilateral Investment Treaties (BITs) and Double Taxation Treaties (DTTs) during the late 1990s added to the bias in favor of foreign investors. BITs were considered important for reducing the perceived risks among foreign investors contemplating entry into an emerging economy with complex regulation and government interventions. The investment guarantees provided by the BITs have allowed foreign investors to enjoy a level of political risk insurance that is still not available for domestic investors.

The most important formal incentive for inward FDI around the turn of the millennium was the Bilateral Trade Agreement (BTA) with the US. The removal of the embargo in 1994 had resulted in the establishment of some trade and FDI linkages, but the US remained a marginal destination for Vietnamese exports because of high US import tariffs. When the BTA went into effect in late 2001, tariffs on imports of Vietnamese goods were substantially reduced. Vietnamese exports to the US doubled in one year and grew five-fold in three years after the agreement came into effect.[10] Reforms focusing on the service sector were particularly important. Before the BTA, there had been substantial FDI inflows in services, but mainly concentrated to development of hotels, restaurants, and resorts. Now, FDI was gradually allowed also in business services like auditing, IT services, and banking and finance. However, the slow phasing-in of the commitment to liberalize service FDI delayed much of the sector's FDI inflows to 2007-2008. Moreover, the various reforms called for in the agreement were designed to be

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[9] Huynh *et al.*, "Productivity Spillover from FDI".
[10] Parker, Phan, and Nguyen, "US-Vietnam Bilateral Trade Agreement".

WTO-consistent – the BTA could be interpreted as a credible commitment pointing towards Vietnamese WTO membership.

Despite the more favorable legal environment and the strong increase in trade with the US, FDI did not grow much during the 1997-2005 period. FDI inflows contracted during three consecutive years (1997-1999) because of the Asian crisis. The initial fall in registered FDI was dramatic, from the nearly USD 10 billion recorded in 1996 to USD 2.2 billion in 1999. During the years before the Asian crisis, FDI had been dominated by regional investors that were now weakened by their domestic financial troubles. As a response, the Vietnamese government emphasized the importance of facilitating already existing investors, and government missions were assigned to provinces to identify problem areas and discuss solutions. As a result, realized FDI did not fall as dramatically as registered FDI.

Revisions of the FIL in 2000 and 2003 also aimed to maintain FDI inflows. In addition to simplification of investment procedures, the revisions introduced rules for re-structuring FIEs, including regulation for Mergers and Acquisitions (M&A) activities, incentives for expansion projects, and reductions of withholding taxes for foreign investors. This resulted in growing levels of registered FDI from around 2004.

Although FDI inflows remained lower during the post-crisis years, there were important changes in the structure of FDI. The export orientation of FDI started increasing already during the Asian crisis. In 1997, FIEs had accounted for about one-third of Vietnam's exports, and this share grew to nearly 60 percent by 2005, although the FDI share of total investment and GPD did not change much. Increasing exports of garments, textiles, furniture, and other consumer goods to the US market contributed to this development. US firms had increased their FDI in Vietnam (including FDI from their regional affiliates) in response to the BTA, temporarily overtaking the "traditional" Asian top performers in the rankings of foreign investors.[11]

From 2006 to 2020

The common Investment Law promulgated in 2005 (in effect in 2006) ended the distinction between domestic and foreign investment. Under the new legal framework, the provincial People's Committees were given full authorization to govern all FDI projects in their province. Similarly, the Management Boards of IZs and EPZs were granted control over all projects in their zones. Vietnam's accession to the World Trade Organization (WTO) in 2007 and the opening of additional sectors for foreign competition (as promised in the US BTA from 2001) created new opportunities and investment motives for foreign investors. As a member of the WTO, Vietnam does not only have access to the export markets of other member countries at relatively low MFN tariffs, but membership also brings a more predictable business environment at home, to the benefit of foreign as well as domestic investors. FIEs participating in GVCs are among the main beneficiaries of the more open and transparent trade environment brought by the WTO.

The decentralization of FDI management to provinces and industrial zones was accompanied by a range of provincial level policies to accelerate FDI inflows. One consequence was increasingly intensive competition between provinces in attracting investment in general and FDI in particular. In some cases, provincial level FDI policies offered investment incentives that were significantly more generous than those provided by the national policy framework. A large number of provincial Investment Promotion Centers were set up during this period. Almost all of

[11] Parker, Phan, and Nguyen, "US-Vietnam Bilateral Trade Agreement".

Vietnam’s giant FDI projects (i.e. projects with registered capital of more than one billion USD) were also registered during this time. The peak, with eleven licenses for such mega-projects, came in 2008. Like other WTO members, Vietnam could no longer require FIEs to meet specific export targets, and with increasing domestic demand and purchasing power, foreign investors clearly preferred to locate in IZs rather than EPZs. This led to a boom in IZ development; already by 2012, Vietnam had established 283 IZs located in 58 out of the country’s 63 provinces/cities.[12]

Apart from WTO membership and changes in domestic FDI policies, there were important external events that influenced FDI during the 2006-2015 period. The rapid increases in Chinese labor cost had started cutting into the competitiveness of the most labor-intensive manufacturing operations in China’s coastal provinces already at this time.[13] Vietnam was considered a feasible alternative location, given its high political stability, low labor cost, and proximity to China’s coastal manufacturing hubs. Samsung’s decision to establish production of mobile telephones in Vietnam is one illustration of this specific investment motive.

However, the boom in inward FDI during 2007 and 2008 was short-lived because of another external event – the global financial crisis that erupted in October 2008. The crisis resulted in a sharp drop in international trade and investment and a recession affecting most OECD countries during 2008 and 2009, and actually implemented FDI in Vietnam remained below the 2008 level until 2014.

The introduction of a new Law on Investment and a new Law on Enterprise in 2015 has contributed to the increase in FDI inflows since that time. The new laws confirmed the principle

[12] Vo and Nguyen, “Experiences of Vietnam”.
[13] Yang, Chen, and Monarch, “Rising Wages”.

of free enterprise in Vietnam, removed most foreign ownership restrictions in Vietnamese companies, reduced bureaucracy in the foreign investment approval process, and brought corporate governance rules closer to international standards. The 49 percent foreign ownership cap in Vietnamese joint-stock companies was abolished, which facilitated FDI in the form of M&As as well as foreign portfolio investment in the Vietnamese securities and stock markets.

In addition to the more favorable legal framework, the FDI boom in the last few years is also related to several important external drivers of FDI. For example, Vietnam has recently entered into several broad plurilateral trade agreements – including the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the free trade agreement with the European Union (EVFTA) and most recently the Regional Comprehensive Economic Partnership (RCEP) – which reduce trade barriers between the member countries and require institutional reforms for transparency and harmonization of regulations.[14] Moreover, continuing increases in Chinese labor costs and the trade conflict between the US and China since early 2018 contribute to a shift of labor-intensive export-oriented manufacturing from China to Vietnam.

From 2020: the next generation of FDI policy

The next generation of FDI policy is currently under development following a broad consultancy process started in 2017. The new policy framework is intended to result in a shift of focus from the volume of FDI to the quality and development impact of FDI: key features are higher value added, better jobs, stronger linkages between FIEs and local firms, and stronger spillover benefits of FDI. The formal laws and regulations making up the new FDI policy framework were still under development at the time of writing (mid-2022), but we will return to a discussion of

[14] World Bank, "Investment Policy and Regulatory Review".

the objectives and possible features of the policy package in our concluding remarks at the end of this chapter.

Spillover effects of FDI

Technology diffusion and spillovers

FDI has a very visible and important direct role in the Vietnamese economy, accounting for large shares of investment and formal employment and most of the country's manufacturing exports, as shown in the previous section. Demand and income multipliers linked to FDI contribute to large amounts of indirect employment. FIEs source inputs from local firms, which creates employment and income, and the earnings from FDI-related employment are largely spent on goods and services supplied by local firms, adding further to aggregate demand. However, it is widely debated how FDI has influenced the technology and productivity of local firms. Has FDI resulted in technology transfer and technology spillovers that have raised the capacity of local industry, or has it instead crowded out local firms and led to slower growth and development of domestic capability than what might have been possible with a less FDI-dependent industrialization strategy? These are obviously difficult questions, since nobody knows how the alternative development path would have looked. The discourse has therefore focused on identifying correlations between FDI and the growth rates of productivity or efficiency in local firms. This has also turned out to be a complex task.

One reason is that FDI influences local firms in several different ways. The productivity of local firms may be affected by FDI in their own industry (horizontal FDI) through demonstration effects, labor mobility, and competition for market shares, but FDI in other industries is also likely to matter. FDI in upstream sectors changes the cost and quality of necessary intermediate inputs, while FDI in downstream industries may change the demand for the goods produced by local firms. These vertical effects may take place purely through the market, or they may operate through the formal linkages between local firms and FIEs, when local companies source inputs directly from FIEs, or act as suppliers and subcontractors to them. In some instances, it is possible that learning and spillovers of foreign technologies take place between local firms (some of which are linked to FIEs), and not only through direct links between FIEs and local firms. Moreover, the diffusion of foreign technology is likely to depend on the technology gap between foreign and local firms and the absorptive capacity of local firms. Generally, there will be both winners and losers – the most likely beneficiaries are those local firms that have both the human resources to understand foreign technology and the financial resources to invest in the new technologies. These resources are not evenly spread between industries and geographic locations, which adds further complications. Moreover, even a strong positive correlation between foreign presence and local productivity growth does not prove causality: foreign firms may simply be attracted to those industries and locations that grow fast for other reasons.

Hence, it is not surprising that the results from studies on the impact of FDI on local industry vary widely and are sometimes contradictory. In addition to the complications discussed above, results diverge depending on the periods of analysis, data sets, and empirical methodologies.

Early studies: industry and provincial data

The first generation of studies on the impact of FDI dates to the late 1990s and early 2000s and used aggregated industry and province level data to explore the impact of FDI. For example, Hemmer and Nguyen (2002) analyzed the role of FDI for poverty reduction during the 1990s and distinguished between a direct effect of FDI through employment creation and indirect effects that worked through the impact of FDI on provincial economic growth. They could not find any significant employment effects, but a strong provincial growth effect that was assumed to promote poverty reduction. Pham (2002 and 2003) studied the growth effects of FDI and found that foreign presence resulted in higher domestic savings and investment rates (hence faster output growth) during the period 1988–1998. The results also suggested that differences in FDI flows across regions tended to increase the gap between rich and poor provinces.

A few years later, Hoang, Wiboonchutikula, and Tubtimtong (2010) examined provincial growth during the period 1995-2006, and confirmed the positive direct impact of FDI, but noted that it was hard to find any clear signs of indirect effects or spillovers. Anwar and Nguyen (2010a) also looked at provincial growth in 1995-2006 and argued that only some Vietnamese regions had sufficient absorptive capacity (in terms of human capital and technology) to benefit from spillovers. Vu, Gagnes, and Noy (2008) distinguished between different sectors in 1990-2004 and found that the growth effects of FDI were much higher in manufacturing than in food production or services. In a second paper, Anwar and Nguyen (2010b) analyzed a panel covering 22 manufacturing industries in 1995-2005 to distinguish between horizontal and vertical spillover effects. They found no signs of the former (presumably because negative competition effects neutralized any positive spillovers from demonstration effects and labor mobility). However, they did find strong signs of spillovers from backward linkages, i.e. spillovers related to contacts with the FIEs purchasing inputs from local firms. In addition, their results highlighted the importance of absorptive capacity: "industries with a higher stock of human capital gain more benefits from vertical backward spillovers."[15]. Overall, the findings from these early

[15] Anwar and Nguyen, "Absorptive Capacity and FDI-Linked Spillovers," 565.

province or sector level studies showed strong growth effects of FDI that differed across regions and industries, weak evidence of horizontal spillovers, but some signs of spillover benefits from linkages to foreign investors in downstream sectors. Large technology gaps and weak absorptive capacity were the likely reasons for the relatively weak impact on local productivity.

Summarizing a review of the development effects of FDI, Schaumburg-Müller (2003) had already concluded that results had not lived up to expectations. Apart from the arguments mentioned above, he noted that most of the early FDI went into joint ventures with SOEs, while the underdeveloped private sector was largely neglected. By the early 2000s, the new enterprise law and other policy reforms had strengthened the position of the private sector, but it was still not closely connected to FIEs through linkages and subcontracting relationships.

This notwithstanding, there were studies providing case-based evidence of spillovers and learning from foreign investors. For example, Le (2008) reported that foreign firms contributed significantly to human capital development through on-the-job training. By the early 2000s, summary data indicated that 300,000 workers, 25,000 technicians, and 6,000 managers had been trained by FIEs in Vietnam. Some of these had transferred their skills to local industry, contributing to "observed improvements" in local firms in sectors like trade, tourism, machinery and equipment, and construction. The study also referred to case studies showing technology spillovers from foreign firms to their Vietnamese joint venture partners, and from the joint ventures to other Vietnamese firms.

Firm-level data: focus on vertical spillovers

From the early 2000s, researchers gained access to micro-data sets that make it possible to study the effects of FDI across different types of local firms. This has helped bridge the seemingly contradictory results from macro-level studies that only find limited spillovers and case studies where learning and technology transfer are more visible. Surveying the first round of Vietnamese micro-data analyses, Pham (2009) concluded that they added support to the hypothesis that there are positive FDI spillovers in Vietnamese industry. Among other contributions, the survey highlighted Nguyen Dinh Chuc *et al.* (2008) who added evidence of positive productivity effects from access to new, improved, or less costly intermediate inputs supplied by FIEs, and Nguyen Ngoc Anh, *et al.* (2008), who confirmed the importance of vertical spillovers from supply chain linkages in manufacturing.

Most of these early micro-data studies were carried out by Vietnamese research groups and were rarely published in leading journals. However, several qualified publications have appeared after 2010. One of the earliest was Le and Pomfret (2010), who reported positive wage spillovers from horizontal as well as vertical FDI, particularly when both foreign and domestic firms were engaged in training activities. One of the few later studies focusing on wage spillovers is Nguyen, Sun, and Beg (2019), who found on balance a negative effect of FDI. The likely reason is that FIEs generally pay higher wages and attract most high-quality workers, leaving domestic firms with less qualified workers who are likely to be paid less.

Using firm-level data for the manufacturing industry in 2000-2006, Le and Pomfret (2011) went on to examine the distinction between horizontal and vertical productivity spillovers and found evidence of spillovers from backward linkages from FIEs. These spillovers were larger for local firms with higher labor quality (suggesting higher absorptive capacity). The estimated horizontal spillover effect was negative, presumably because the tougher competition from more productive FIEs outweighed any positive effects of demonstration and imitation. Export-oriented FIEs did not generate any negative competition effects of this type. The authors also recorded some differences between wholly-owned FIEs and joint ventures: the positive vertical spillovers were larger and the negative horizontal spillovers were smaller for joint ventures. One reason could be that the technologies of wholly-owned FIEs were more advanced, more difficult to absorb, and connected to stronger competition effects. The joint ventures' stronger networks with local industry could also explain their more positive impact. The main policy recommendation suggested by Le and Pomfret (2011) was to strengthen the linkages between FIEs and domestic firms. An important prerequisite for this would be additional investment in relevant education and training, as well as incentives for domestic firms to engage in R&D and human capital upgrading to bolster their absorptive capacity.

Newman *et al.* (2015) added a dimension to the debate about vertical spillovers by distinguishing between those effects that operate through direct linkages with foreign firms and those that work through the market. Like most other studies, they found backward spillovers from FDI. These effects were particularly strong for local firms with formal supply linkages to joint ventures (rather than wholly-owned FIEs). They also found negative forward spillovers affecting local firms purchasing inputs from upstream sectors with FDI. The proposed reason for this finding was that FIEs often gain a dominant market position and raise input prices for domestic downstream producers. However, these negative effects were significantly smaller for local firms with direct linkages to upstream FIEs, perhaps because these firms could simultaneously benefit from productivity-enhancing technology and knowledge transfers. The study did not find any evidence of horizontal spillovers, presumably because any positive effects of labor mobility, demonstration, and imitation were offset by negative competition effects.

Focusing on vertical spillovers through value chain participation, Ni *et al.* (2017) looked at how the origin of the foreign investors affected outcomes. Their assumption was that the degree of local sourcing could be affected by factors such as distance, preferential trade agreements, and institutional or technological differences between the investor and Vietnam. Their findings for 2000–2011 suggested that FDI from Asian firms generated positive backward spillovers to domestic firms but negative horizontal spillovers – FDI from non-Asian MNEs did not generate any significant spillovers at all. Furthermore, distinguishing between Asian investors, they found that Chinese and Taiwanese MNEs were the main sources of the significant spillover effects, while MNEs from Japan, Korea, and other Asian countries did not generate significant spillovers of any kind. The proposed reasons were differences in the sourcing behavior of MNEs. Firms from South Korea and Japan preferred using suppliers from their own country or other foreign partners, because Vietnamese suppliers were often not able to meet their quality, cost, and delivery requirements. Chinese and Taiwanese investors, by contrast, operated with less sophisticated technologies and tended to choose local suppliers to minimize costs. Hence, Ni *et al.* (2017) emphasized the importance of supply chain linkages and highlighted the crucial role of local technological competence: when the gap with respect to foreign technologies is too high, there is little local sourcing and spillover benefits are limited.

The importance of local technological capability and absorptive capacity has recently been stressed also by Wrana and Nguyen (2019), who examined the "strategic coupling" between MNEs and local industry. They argued that even if Vietnamese firms were to some extent integrated into global value chains operated by foreign MNEs, and even if there were transfers of technology from the MNEs to local firms, the impact on the technical efficiency of local industry was small. Vietnamese suppliers gained access to new machinery and production technology, but their total factor productivity did not improve much as a result. Referring to the Global Competitiveness Report 2016-2017, they noted that the efficiency of technology transfer from MNEs to domestic firms in Vietnam ranked among the lowest in Asia, even behind regional neighbors like Indonesia and Cambodia.[16] The performance of local suppliers in the Vietnam's Red River Delta was reported to be particularly disappointing, as the Total Factor Productivity (TFP) growth rates among MNE suppliers were no higher than those of non-suppliers. The main reason was arguably a relatively large technology gap between local and foreign firms, coupled with the low absorptive capacity of local firms.

Firm-level data: regional patterns

The regional patterns of FDI spillovers have been explored in several of the recent studies. Revisiting their earlier 2010 study on regional growth using detailed firm-level data to estimate TFP in eight Vietnamese regions in 2000-2005, Anwar and Nguyen (2014) largely confirmed their initial finding that the impact of FDI varied systematically across regions. In the updated analysis, they argued that the positive effects in provinces with higher absorptive capacity were mainly generated through vertical backward spillovers, i.e. through supplier relationships with foreign MNEs. These backward spillovers were absent in regions with low absorptive capacity. Their conclusion was that regions with better technology, a larger stock of human capital, and a more developed financial system would gain more from FDI spillovers, both because foreign investors would be attracted by these qualities and because they would raise the absorptive capacity of local firms.

Tran, Pham, and Barnes (2016) looked deeper into the geographical pattern of FDI effects by estimating spatial spillover models on the firm-level data set used by Anwar and Nguyen. They found that productivity spillovers decayed quickly with increasing distance

[16] Schwab, ed., *Global Competitiveness Report*.

between foreign and local firms, so that intra-regional spillovers were much larger than inter-regional spillovers. The intra-regional (i.e. provincial) effects of FDI included positive spillovers to local firms in supplier sectors (backward spillovers), but negative effect on firms in customer sectors (forward spillovers) and firms in the same sector (horizontal spillovers). FDI in neighboring provinces generated positive spillovers in all three dimensions, but these effects were much smaller in magnitude than the intra-provincial spillovers. Interestingly, they also recognized a social interaction effect among local firms. Contacts between local firms seemed to strengthen the positive backward spillovers and reduce the negative horizontal and forward spillovers. These benefits are probably linked to agglomeration effects and knowledge flows between local firms that strengthen their absorptive capability and competitiveness. Hence, one of the policy recommendations is to encourage clustering of local firms in relative proximity to downstream FIEs.

In another recent contribution, Huynh *et al.* (2019) explored an updated firm-level data set for 2011-2015 and detected a slightly worrying pattern for regional spillovers. In qualitative terms, they found similar positive backward spillovers and negative forward and horizontal spillovers as many other studies. However, they also found that the negative effects tended to outweigh the positive spillovers during this period. Their four policy conclusions were to (a) continue supporting backward FDI spillovers through participation in the value chains of FIEs, (b) to raise the absorptive capacity and competence of local industry through investment in human capital and technology, (c) to promote supporting industries through incentives for technology transfer and upgrading, and (d) to provide a "truly fair business environment" for local firms. This new angle to the debate on the need to create a level playing field – the time, from the perspective of local private firms – provides an interesting flashback to an older discourse on FDI promotion and the need to establish a level playing field for foreign investors. Now, the level playing field argument is put forth not to maximize the inflow of FDI, but rather to promote the competence of local firms and the development effects of FDI. Wrana and Nguyen (2019) make a similar argument in their discussion of the disappointing spillover effects of FDI (especially in the Red River Delta). They claim that institutional entrepreneurship initiatives, e.g. cooperative vocational training programs, have almost exclusively focused on the FIEs' specific skill demands and that they have barely reached local firms. Their main policy recommendation is therefore that "national and local authorities must increasingly consider the needs of private domestic firms" in industrial and development policy reforms.[17]

Summary: spillover effects and FDI linkages

Summarizing the empirical evidence on the spillover effects, two observations stand out. First, the signs of horizontal spillovers are weak, but local firms seem to benefit from backward spillovers from FDI. These spillovers are particularly strong for local firms with formal linkages to FIEs. In other words, firms that have managed to enter the supply chains of FIEs record higher productivity. Forward spillovers are generally negative, except for firms with formal linkages to upstream FIEs. Second, the impacts of FDI vary across the provinces of Vietnam, with stronger positive effects in more developed provinces. One reason seems to be the higher education level and absorptive capacity in these locations, but it is also likely that agglomeration effects are important. Local firms that operate in clusters seem to be better at learning from FIEs and responding to negative horizontal spillovers. This finding highlights the importance of the match

[17] Wrana and Nguyen, "Strategic Coupling and Regional Development", 10.

between FIEs and local firms. If FIEs operate in sectors that are not vertically linked to local industry, then it is likely that learning and spillovers will remain limited.

Both observations emphasize the vertical links between FIEs and local industry: the Vietnamese economy generates spillover benefits from FDI mainly when local firms qualify as suppliers to FIEs. However, in many locations and industries, this does not happen, primarily because the technological and industrial capabilities of local firms are too weak. Hence, FIEs rely to a large extent on imports or prefer to employ other foreign firms as suppliers. Apart from stronger technological capabilities and larger scale, the foreign-invested suppliers benefit from a more favorable regulatory and institutional environment than local firms. Many of the fiscal and financial incentives provided to foreign investors have not been available for domestic investors, the investment guarantees from BITs do not apply for domestic firms, and even the institutional initiatives that are available sometimes focus on the needs of FIEs rather than local industry.

The weakness of the Vietnamese supporting industry (SI) sector was painfully demonstrated in 2014 when Vietnam's domestic manufacturing industries inadvertently gained the reputation of "not being able to produce screws": after publishing an invitation to tender, Samsung's procurement division failed to find local suppliers capable of meeting the required standards and order volumes of screws and other less sophisticated inputs.[18] Government surveys confirmed the weak state of the sector. It was estimated that domestic enterprises were only capable of providing about 10 percent of the total demand for materials, parts and components in manufacturing in 2016, and that only 300 local Vietnamese enterprises were taking part in FIE-led supply chains in Vietnam.[19] At that time, the Vietnamese SI sector comprised around 3,300

[18] VietnamNet, "Vietnam Can Produce PhDs".
[19] MOIT, " Báo cáo về thực trạng".

enterprises, with 1,800 enterprises producing parts and components and 1,500 enterprises providing inputs to the garment and footwear sector. Most of the SI sector's leading firms were FIEs. The great majority of domestic firms were SMEs, with 70 percent employing fewer than 100 workers and 91 percent employing fewer than 500 workers.

The small size and low productivity of local firms are the main reasons for the weakness of the domestic SI sector.[20] GVC suppliers face strict quality standards, technological requirements, and delivery terms, order volumes are large, and price-cost margins small. Small firms rarely have the resources or technical capabilities to engage in the R&D, innovation, and specialization needed to meet the specific demands from large industrial customers. Small size also means that they are unable to compete on price with FIEs that benefit from scale economies. To strengthen the linkages with FIEs, Vietnam will need a more productive and competitive domestic private sectors where firms have opportunities to grow over time. This calls for comprehensive reforms that go beyond traditional FDI policy, and include investments in education, skills, and technology, measures to improve the business environment for private firms, including SMEs, programs to match local suppliers with FIEs, and institutional reforms to create a level playing field for the domestic private sector.[21]

Next-generation FDI policy

Vietnamese authorities are acutely aware that the development effects of FDI have not been as positive as expected, that the value added in the operations of FIEs has been too low, and that the

[20] World Bank, *Enhancing Enterprise Competitiveness*.
[21] World Bank, *Enhancing Enterprise Competitiveness* and Hollweg, Smith, and Taglioni, *Vietnam at a Crossroads.*

linkages and spillover effects of FDI have remained small. In addition to launching a *Supporting Industry Development Program* in 2017, the government therefore initiated a process to revise the broad policy framework for FDI. The main objective of this revision is to increase the focus on the quality and development impact of FDI. The outcome – a twelve-page policy document entitled "Strategy for Foreign Investment Cooperation 2021-2030" – was approved in June 2022. The guiding legislation necessary for implementation of the strategy had not been published at the time of writing (September 2022) but tracing the steps of the legislative process may give some insights into the challenges faced by Vietnamese policymakers aiming to strengthen the development effects of FDI inflows. The relatively open consultancy process during the early stages of the process, when the Ministry of Planning and Investment (MPI) and the World Bank affiliate IFC circulated their joint analysis and recommendations for next-generation FDI policy,[22] reveals some of the objectives and core considerations of Vietnamese authorities as well as other stakeholders. Before turning to these, however, it is appropriate to note that the government's policy decisions are subject to several constraints.

Constraints on government policy

Some decades ago, a developing country government might have tried to maximize linkages and spillover effects of FDI using a policy mix including local content, joint venture, and technology transfer requirements and other interventions directly affecting the production decisions of foreign investors. Today, governments have less discretionary power in the FDI policy area. It is risky to discriminate against foreign firms and difficult to impose strict performance requirements on them. WTO rules and various international investment agreements circumscribe

[22] MPI/IFC, *Recommendations on Next Generation FDI Strategy*.

trade measures such as trade barriers, export subsidies, and quantitative restrictions, but also instruments used to regulate the behavior of FIEs, such as local content and technology transfer requirements.[23] The policy space is further constrained by conditions attached to grants and credits in bilateral and multilateral development cooperation, as well as regional integration agreements.[24]

These policy restrictions are highly relevant for Vietnam. In addition to being a member of WTO since 2007, by 2019 Vietnam had signed 71 double taxation agreements, 61 bilateral investment treaties, and 26 plurilateral or bilateral treaties with investment provisions.[25] The treaties with investment provisions include ASEAN and AFTA, the USBTA, the EVFTA, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and the Regional Comprehensive Economic Partnership (RCEP), most of which contain promises to open the Vietnamese market to foreign investors and rules constraining Vietnam's ability to manipulate the behavior of FIEs. At the same time, agreements like the CPTPP, the EVFTA, and the RCEP provide opportunities to connect to new GVCs and strong motives for the government to introduce reforms that help local firms diversify and enter these GVCs with higher value-added activities.

Domestic considerations may also limit the policy space. Apart from purely political and ideological preferences, it is likely that specific interest groups may influence policy decisions. For example, World Bank (2016) discusses the "commercialization" of state institutions and the granting of various privileges (related e.g. to taxation, public procurement, and access to land and finance) to SOEs, FIEs, and a limited number of well-connected domestic private firms.

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[23] Trasher and Gallagher, "21st Century Trade Agreements".
[24] Johnson, "Space for Local Content Policies" and Tong, Kokko, and Seric. "Linking FDI and Local Firms".
[25] World Bank, "Investment Policy and Regulatory Review".

While the international agreements discussed above aim to ensure that foreign firms are not discriminated against, they do not ban bad treatment of some domestic firms. In the past, this has meant that the relatively weak efforts to build critical market institutions and guarantee property rights and fair competition have limited the growth potential of private SMEs, leading to the emergence of new large enterprises.[26] In the current context, this is worrying because most of the enterprises in the Vietnamese economy, including the strategically important SI sector, are privately-owned SMEs that have not had any large voice in the Vietnamese policymaking process in the past. There is a risk that future policies will also cater primarily to SOEs, FIEs, and the few privileged private firms that have the ear of Vietnam's political decision-makers (see chapters by Nguyen Xuan Thanh and Le Dang Doanh in this volume).

Recommendations for "Next-Generation FDI Strategy 2020-2030"

To promote an inclusive policymaking deabate, MPI and IFC presented their joint recommendations for Vietnam's "Next-Generation FDI Strategy" in 2018. Their broad recommendations focused on a set of priority sectors to be targeted for FDI promotion and a number of "breakthrough reforms" needed to attract the kind of FDI that Vietnam needs in the future.[27]

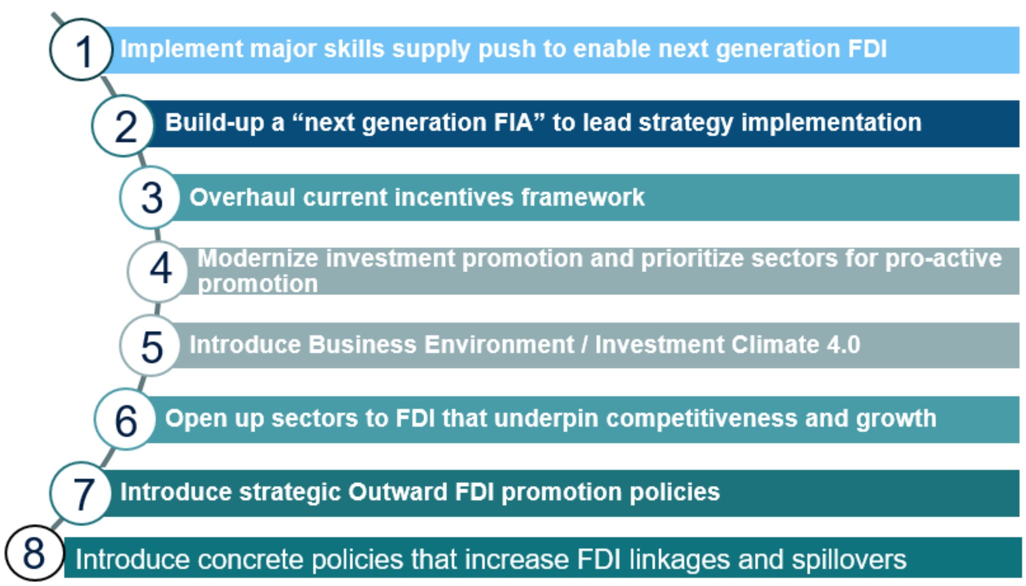
The short-term priorities for proactive investment promotion comprised SI sectors such as high-grade metals, plastics, high-tech components, industrial machinery and equipment, and services such as logistics and maintenance. Other short-term priority industries were automotive and transport equipment and environmental technologies. To exploit existing natural resources, high-value innovative agricultural products and niche tourism services were targeted. The

[26] World Bank, "Enhancing Enterprise Competitiveness".
[27] MPI/IFC, *Recommendations on Next Generation FDI Strategy*.

medium-term priorities included pharmaceuticals and medical equipment, IT and knowledge process outsourcing, fintech, and education and healthcare services. To make up for the limited number of jobs provided by these new priority sectors, it was also recognized that other types of FDI, including basic assembly and business processing operations, would be necessary for employment generation for a long time, especially in less developed provinces.

Figure 4 shows the eight "breakthrough reforms" that MPI and IFC considered necessary to realize the shift to next-generation FDI. While some of them focused on the way FDI policy was carried out, others addressed more fundamental reform needs in policy areas that are not directly under the control of the agencies directly responsible for FDI policy (such as FIA).

Figure 4: Eight breakthrough reforms for next-generation FDI



Source: MPI/IFC, Re*commendations on Vietnam Next Generation FDI Strategy and Vision 2020-2030*. Hanoi: MPI and IFC, 2018

The reforms dealing with the efficiency of investment promotion (reforms 2, 3, 4, and 7 in Figure 4) are relatively uncontroversial, and require primarily that FIA – the part of the MPI managing FDI policy – is granted sufficient resources in terms of financial and human capital to take on more demanding tasks. The establishment of a “next-generation FIA” (reform 2) would be the most challenging of these reforms, and would require changes in the relations between different government agencies – to lead in strategy implementation, the new FIA would need a broader mandate to initiate policy reforms involving not only FDI promotion but also export promotion, SME development, FDI linkages, special economic zones, innovation, and outward FDI. Considering the existing shortcomings related to horizontal policy coordination – e.g. overlaps and insufficient cooperation between ministries[28] – such a mandate to lead and coordinate strategy implementation would be valuable, but probably also hard to achieve precisely because of the weak coordination and cooperation between ministries.

The other four reform requirements address some of the fundamental weaknesses in the Vietnamese economy. These are not only reasons why linkages and spillovers from FDI have been weak, but also why Vietnam is not a more prosperous and developed economy. The shortage of skills (reform 1) is a problem for FIEs looking for Vietnamese suppliers, but it is also a challenge for the economy at large. The weaknesses in the Vietnamese business environment and investment climate (reform 5) have probably scared away some foreign investors and add to the operating costs of those MNEs that have nevertheless entered Vietnam, but they are even more costly for domestic SMEs trying to grow and prosper. Entry barriers and other rules that restrict FDI in sectors such as communications, logistics, education, health and financial services (reform 6) limit the efficiency and competitiveness of FIEs as well as domestic firms. The need for policies that increase FDI linkages and spillovers (reform 8) is obvious, and various initiatives have already been launched, for example in the form of the SIDP and other schemes.

[28] Kelhofer, ”Recommendations on Next-Generation FDI Strategy”.

What would be needed on this front is perhaps more effective implementation of existing policies rather than entirely new polices.

Overall, the proposed “breakthrough reforms” included important policy improvements with a high payoff. Comprehensive investment in education and skill development, improvements in the business environment for private firms, reductions in regulatory entry barriers, and stronger efforts to implement economic reforms that have already been announced would be low-risk investments. They would strengthen the local economy and generate growth and development irrespective of how foreign investors respond to them in the short term. If they also succeeded in attracting new FDI to Vietnam, returns would be larger, not only because of the direct benefits of FDI but also because stronger and more competitive local firms would be better able to collaborate with and learn from FIEs.

A major challenge in this context is that the proposed ”breakthrough reforms” would require comprehensive change in the Vietnamese policy environment. Commenting on the reform proposal, Kelhofer (2019) argued that it required change not only in policy, but also in the motivations and mindsets of both investors and policymakers. Table 1 illustrates the nature of this fundamental shift. It also reveals how broad and deep the reforms would need to be in order to reach the next-generation strategy targets. The gap between the existing motives of foreign investors (low costs) and the envisioned status of Vietnam as an economy that has highly skilled labor and resource-efficient technologies to attract investors is particularly wide. Clearly, it will take years to create long-term competitive advantages that are based on abundant labor skills and technological assets. This should therefore be the time frame for the new policy framework. The gap also highlights the systemic nature of the necessary reform process. FDI policy on its own cannot create skilled labor and resource-efficient technologies – these will require more comprehensive reforms that cover education, innovation policy, and the business environment at large.

Table 1. Changes in investment motives and policies for next-generation FDI strategy

Existing situation	Next-Generation FDI Strategy Targets
Investors' primary motives: • Low labor costs • Low-cost utilities • Risk-diversification alternative to China	**Investors' primary motives:** • High labor skills • Resource-efficient technologies • Superior location within ASEAN FTA
Nature of investment promotion: • Reactive, cross-sector, open-door • "When investors come"	**Nature of investment promotion:** • Proactive, targeted promotion • "To attract the investors Vietnam wants"
Main marketing tools: • Broad incentives to attract investors • Based on short-term cost advantages	**Main marketing tools:** • Holistic sector strategies to attract investors • Based on long-term competitive advantages
Incentives focus: • Fiscal incentives • Based on dollar value of FDI	**Incentives focus:** • Performance-based incentives • Based on local value-addition
Consequences • Dual economy with little local content	**Consequences:** • High local value-addition

Source: Adapted from Kyle Kelhofer, "Recommendations for a Next Generation FDI Strategy 2020-2030", 2019.

The Strategy for Foreign Investment Cooperation 2021-2030

Following the debate around the "Next Generation FDI Strategy", Vietnamese authorities have taken several steps to prepare the ground for the necessary reforms. In August 2019, the Politburo issued a resolution calling for fundamental changes in FDI promotion policy to overcome the shortcomings of the institutional framework and to improve the international competitiveness of the domestic business and investment environment. The resolution resulted in several initiatives, such as a government action program to improve the FDI environment issued in April 2020, the establishment of a special inter-ministerial working group in charge of proactive FDI promotion (June 2020), and a revision of the Law on Investment (June 2020, in effect from 2021). Further guidance on the implementation of the Law of Investment was issued in 2021, including a revised list of foreign-invested business activities subject to market access restrictions, a set of selective investment incentives for prioritized FDI projects, and a list of 157 projects, mainly in infrastructure, calling for calling for over USD 71 billion in FDI during the period 2021-2025. Finally, in early June 2022, the government approved “The Strategy for Foreign Investment Cooperation 2021-2030” (Decision 677/QD-Ttg).

The twelve-page policy document outlines several quantitative objectives for FDI inflows, such as targeting investment from more developed economies in Asia, Europe and the USA, increasing the number of Fortune Global 500-listed MNEs investing in Vietnam, and improving the position of Vietnam in the World Bank’s Business Environment ranking. Nine measures are proposed for increasing the efficacy of FDI, partly overlapping with the recommendations from MPI and IFC. Four of these measures address the effectiveness and efficiency of FDI promotion and the management of FDI, while the other five focus on the need for comprehensive reform to strengthen the economy’s quality and competitiveness. The objectives include developing an ecosystem of science, technology, and innovation, strengthening the SI sector and its linkages to global value chains, and deepening Vietnam’s integration with the international economy.

The actual implementation of the FDI strategy is pending the promulgation of guiding legislation in a wide range of policy areas. The success of next-generation FDI policy will to a large extent depend on how far this reform process will reach. In other words, the key reforms for improving the development effects of FDI in Vietnam will not be those focusing directly on potential foreign investors or incumbent FIEs, but rather those that aim to create an enabling environment for the domestic private sector.

Concluding remarks

Vietnam's rapid development over the past thirty years is the result of a continuous reform process where an inward-oriented economic system characterized by central planning and control has gradually given way to a more market-oriented and internationalized economy. The development has been particularly fast in some dimensions. For example. the ratio of exports to GDP exceeds 100 percent – the only countries recording higher ratios are small economies like Luxembourg, Hong Kong, Singapore, Malta, and Ireland.[29] The inflow of FDI as a share of GDP (at over 6 percent) and the inward FDI stock as a share of GDP (around 50 percent) are also remarkably high for a country at Vietnam's income level. Reforms focusing on decentralization, deregulation, trade liberalization, and investment in IZs and other forms of infrastructure, together with an abundant supply of low-cost labor, have clearly been effective in enticing foreign MNEs to locate export-oriented activities in Vietnam.

However, not all dimensions of development have evolved equally fast. The challenge highlighted in this chapter is the relatively weak integration between FIEs and domestic firms. The lack of strong linkages has meant that some of the potential benefits of FDI have been lost: the technology and productivity spillovers that could have helped domestic firms become more competitive and move into higher value-added activities have been limited. One reason for the

[29] Vietnam's relatively low level of development is a partial explanation for the high export ratio: the numerator (export) is measured in international prices, whereas the denominator (GDP) is largely based on lower domestic prices for goods and services (such as labor and domestically produced non-tradables). Vietnam's PPP-adjusted GDP is roughly three times larger than GDP at nominal prices and exchange rates.

“missing linkages” is the weakness of the Vietnamese private sector. Few domestic firms have been able to meet the tough conditions for joining foreign-controlled GVCs, and the lead MNEs have therefore often chosen to bring their foreign suppliers to Vietnam or import the needed materials and components.

The crucial question is why the domestic private sector has not been able to respond more strongly to the opportunities that emerged with the inflows of FDI. Some answers have been suggested above. Most of Vietnam’s private firms are too small to invest efficiently in R&D, innovation, and specialization. It is hard to find highly skilled workers, and the competition from SOEs and FIEs is tough because both types of firms enjoy various privileges and incentives that are not available for private SMEs. In short, too few SMEs have managed to grow large enough to become attractive partners to FIEs. As discussed in the chapter by Le Dang Doanh in this volume, the Vietnamese private sector, with emphasis on SMEs, is still struggling to remain competitive in a setting with heavy government intervention and FIEs and SOEs that enjoy various policy-related privileges. A relevant question for future research is why the Vietnamese private sector has not managed to copy the Chinese private sector’s success in generating “Capitalism from Below”, as discussed by Nee and Opper (2012).

The main objective of Vietnam’s “Next-Generation FDI Strategy” is to improve the development effects of FDI by strengthening the linkages between FIEs and the local economy. Some of the “breakthrough reforms” called for by Vietnamese authorities and Vietnam’s development partners address the key issues directly.[30] Investment in education and skill development, improvements in market institutions and the business environment, and lower

[30] MPI/IFC, *Recommendations on Next Generation FDI Strategy*; GoV, *Strategy for Foreign Investment Cooperation 2021-2030.*

regulatory entry barriers are necessary for promoting and empowering the domestic private sector. If these reforms are carried out, there are good chances that Vietnam will be better able to leverage FDI to reach the next stage of development.

Will this happen? At present, in mid-2022, forecasting the future is unusually difficult. There is substantial uncertainty connected to current global events, such as the rapid pace of technological change, sometimes summarized in the term Industry 4.0, the COVID-19 pandemic, and the drawn-out trade conflict between the US and China. Each of these could by itself lead to changes in global trade and investment patterns that would impact Vietnam and the perceived need to carry out radical reform. For example, Vietnam's relative success in maintaining export production during the pandemic could add to its attractiveness as an investment location and reduce pressure for other reforms. The most likely scenario is perhaps one where the impacts of different global events are contradictory, and where Vietnam takes some steps in the right direction but stops short of fundamental systemic reform. Such a gradual reform process would be historically consistent with Vietnam's experiences of economic transformation during the past thirty years. However, at the same time as gradualism might guarantee a high degree of political continuity, it would leave the private sector in a relatively weak position. If domestic private firms are unable to link up with and learn from the FIEs operating in Vietnam, it will also be difficult for them to develop the sustainable competitive advantages that Vietnam needs to become a modern and industrialized nation.