Vietnamese State-Owned Enterprises after Equitization: Performance, Emerging Issues, and Policy Recommendations

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ABSTRACT

Equitization is the sole method of state-owned enterprise reform in Vietnam. This paper analyzes the results of a survey on the performance of equitized enterprises. Its findings clarify the causes of pre- and post-equitization differences and the impact of ownership structure on the performance of equitized enterprises, focusing on arising problems in the post-equitization period, particularly those regarding corporate governance. Based on the results of survey, the paper also provides some policy recommendations to speed up the equitization process and enhance post-equitization corporate governance in the years to come.

Introduction

As at June 2005, 2,461 state-owned enterprises (SOEs) and their integral parts had been equitized in Vietnam. Although the equitization process was substantially accelerated in 2003-2004, its pace was still slower than planned and it was difficult to achieve the goal of Communist Party Congress IX to complete the transformation of SOEs by 2005.

In that circumstance, the questions raised are: (1) what are the changes in the SOEs equitization process and post-equitization problems in the three years since the last survey was conducted in 2002, especially when subjects, scope, and modes of equitization have been expanded; and (2) since its advantages and benefits are recognized, why has SOE equitization not achieved the objectives set.

To answer these questions, in early 2005 the research team at the Central Institute for Economic Management (under the Ministry of Planning and Investment) carried out a comprehensive survey on the post-equitization performance of more than 500 equitized SOEs

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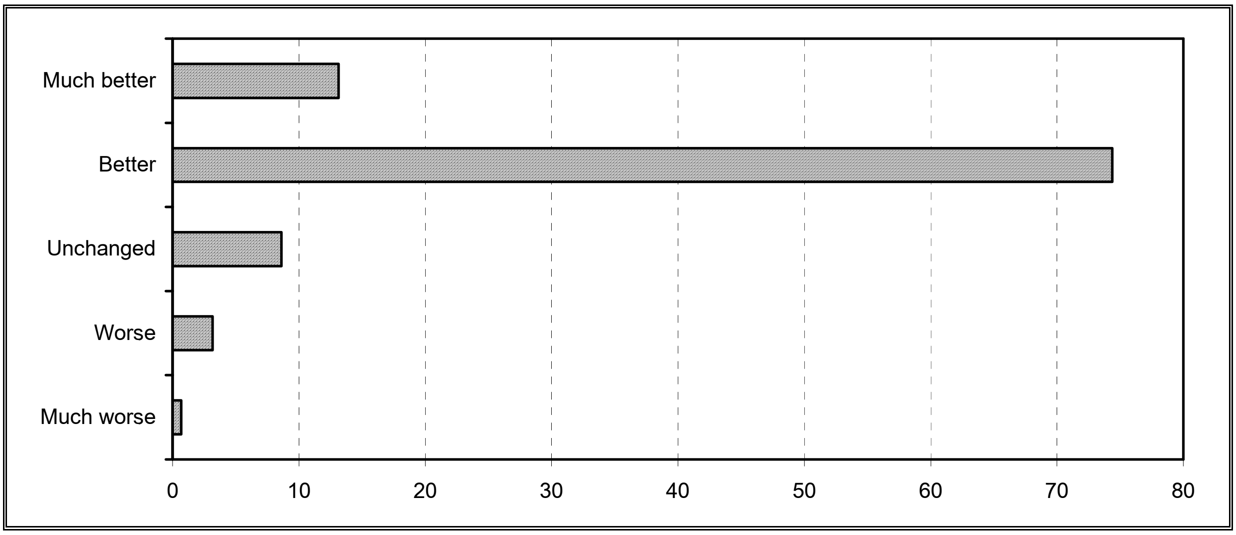
in ten northern provinces, five central provinces and eight southern provinces[1]. In this paper, the team would like to present the main outcomes of the research, featured in two issues of this journal. In addition to the Introduction, the paper consists of five sections. In the first issue we provide an analysis of the performance of SOEs after equitization (Section 1) and the causes of increased growth in equitized SOEs (Section 2). In the second issue it will discuss emerging issues during the equitization process (Section 3), problems after equitization (Section 4), and suggest some policy recommendations (Final Section).

1. Performance of SOEs after equitization

The survey outcomes generally show the positive effect of equitization on the SOEs' performance. The majority thought that their financial performance had improved after equitization, of which 87.53% were certain that financial performance was better or much better. Only 8.62% of enterprises thought that their financial situation did not change. The proportion of enterprises that performed less efficiently after equitization was very small, with 3.17% believing that their financial situation was worse and the only 0.68% enduring a worse financial situation than in the pre-equitization period (see Chart 1).

Chart 1: Perception of equitized enterprises on financial performance before and after equitization (% respondents)



This was within expectations because it can also be seen in other research studies. Research conducted in 2002 produced the same result, confirming the economic benefits of equitization, which have been recognized for years.

Details of the operational efficiency of equitized SOEs can be seen as follows.

1.1. Performance of SOEs before and after equitization

Due to the short time span of the equitization process, the research could only compare basic production/business indicators of the year after corporate transformation (into the joint-stock company model) with that of the year prior to transformation (the SOEs model).

While turnover increased by about 13% on average, after-tax profit increased by up to 48.8% shortly after equitization. The disproportion in growth led to the increase in the rate of after-tax returns on turnover, at 31.7%.

This shows that in the first year of equitization, the SOEs' transformation into the new corporate model does not induce an immediate effect on factors directly relating to turnover (for example, consumption of goods, productivity, and increased purchasing power of customers toward products of the enterprises), but strongly affects after-tax profits and after-tax returns (being indicators of business efficiency).

In the first year after equitization, the "revenue per permanent worker" indicator, that is used to measure productivity,[2] increased 26.1%, average wages increased 20.8%, and investment in fixed assets grew 23.1% compared with those when the enterprises were still SOEs.

Among these indicators, the growth rate of productivity is the factor that has the most positive impact on the performance and business efficiency of equitized enterprises. The productivity increase has partly been due to the increase in turnover and the decrease in labor and, more importantly, the motivation and sharing of interest of all managers and workers towards their enterprise. This will be discussed in more detail later.

Regarding the investment growth in fixed assets, there are two reasons for this: (i) enterprises made additional investment efforts immediately after equitization, and (ii) fixed assets increased due to asset re-valuation. The second reason exists in only some cases, and existing statistical data as well as the survey questionnaire do not deal with this issue. A more detailed comparison also revealed that the investment growth in fixed assets does not correlate to growth in after-tax profits, which means in the first year after equitization the surveyed enterprises did not allocate an adequate proportion of profits to development investment.

1.2. Annual growth of equitized SOEs

The growth of equitized SOEs has been maintained at quite stable rates, indicating the positive effect of equitization. The turnover increase of 13.4% was not a low level, especially in comparison with that of the SOE sector. The after-tax profits increase of 54.3% per year was higher than that in other corporate types. However, pre-tax profit growth only stands at 9.4%. The increase in the rate of after-tax returns on turnover, at 37% per year, is a reasonable growth rate because after-tax profit increased much faster than turnover.

Labor productivity (equal to turnover on employee numbers) increased 18.3% per year, which is higher than the growth rate of turnover.

Average wages increased 11.4% per year, similar to the results of the 2002 survey and corresponding to the growth rates of turnover and labor.

Investment in fixed assets increased by 11.5%, which is equivalent to the average growth rate in the entire private sector, but lower than the rate in the SOE sector and much lower than the rate recorded in the 2002 post-equitization survey (19%). This shows that the financial sources for investment in equitized enterprises are limited compared with SOEs. However, if the investment growth stemmed from new investment and profits from reinvestment, it presents the growth sustainability of the equitized enterprises. This is because of the financial sources for SOEs investment being not only mobilized from their own sources but also from state budget funding.

By share-owned structure, the growth rate of investment in fixed assets and average wages of state-controlling share enterprises were maintained at the same level as those of the non state-controlling share enterprises. The rates of revenue, labor productivity and profit in state-controlling share enterprises were slightly higher than in non state-controlling share enterprises.

By economic activity, turnover of enterprises operating in the commercial-services sector increased at a higher rate than that of the industry-construction and agriculture-forestry-fishery sectors. This closely followed the trend in the domestic market over recent years. However, another picture can be seen in after-tax profit growth: enterprises operating in the agriculture-forestry-fishery sector recorded the highest profit growth rate, followed by those in industry-construction and commercial-services.

Large enterprises grew much faster in all criteria than small ones, but the growth rate tended to slow down when enterprises reached a certain scale. Evidence for this was that the growth rate of after-tax profits, turnover, and average wages of enterprises with assets ranging from VND 5 to 10 billion were higher than those with assets of over VND 10 billion and lower than those with less than VND 5 billion.

The fact that large enterprises grew faster than small ones could be explained by state–controlling share enterprises growing faster than non state-controlling share enterprises. This is because large-scale enterprises have usually been controlled by the state share. In addition, this situation also calls for the need to accelerate the equitization of state-owned corporations and large state-owned companies.

1.3. Profits and profitability in equitized enterprises

As at 2004, the proportion of non-profitable equitized enterprises was relatively low (3.7%), with remaining enterprises averaging a profitability rate of 0.17%, i.e. 1.5 times higher than the year prior to equitization. The most “successful” enterprises were those that had been equitized for 2-3 years. One year prior to equitization, this group of enterprises recorded the heaviest loss. However, in 2004, they gained the highest profitability, even higher than those enterprises that had been equitized for 7-8 years (Table 1).

Table 1: The proportion of profit- and loss-making equitized enterprises in 2004, by the number of years of transformation into joint-stock companies (%)

Years after transformation into joint-stock companies	1-2 years	3 years	4 years	5 years	6 years	7 years or more
Profit-making enterprises	96.7	100.0	92.6	96.9	96.2	93.7
Loss-making enterprises	3.3	0.0	7.4	3.1	3.8	6.3
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

There are a number of reasons for this phenomenon, which will be discussed in detail in the next section. However, one important reason has been preferential treatment (for example, corporate income tax exemptions) provided to equitized enterprises. Generally, the longer enterprises have operated after equitization the less preferential treatment they enjoy.

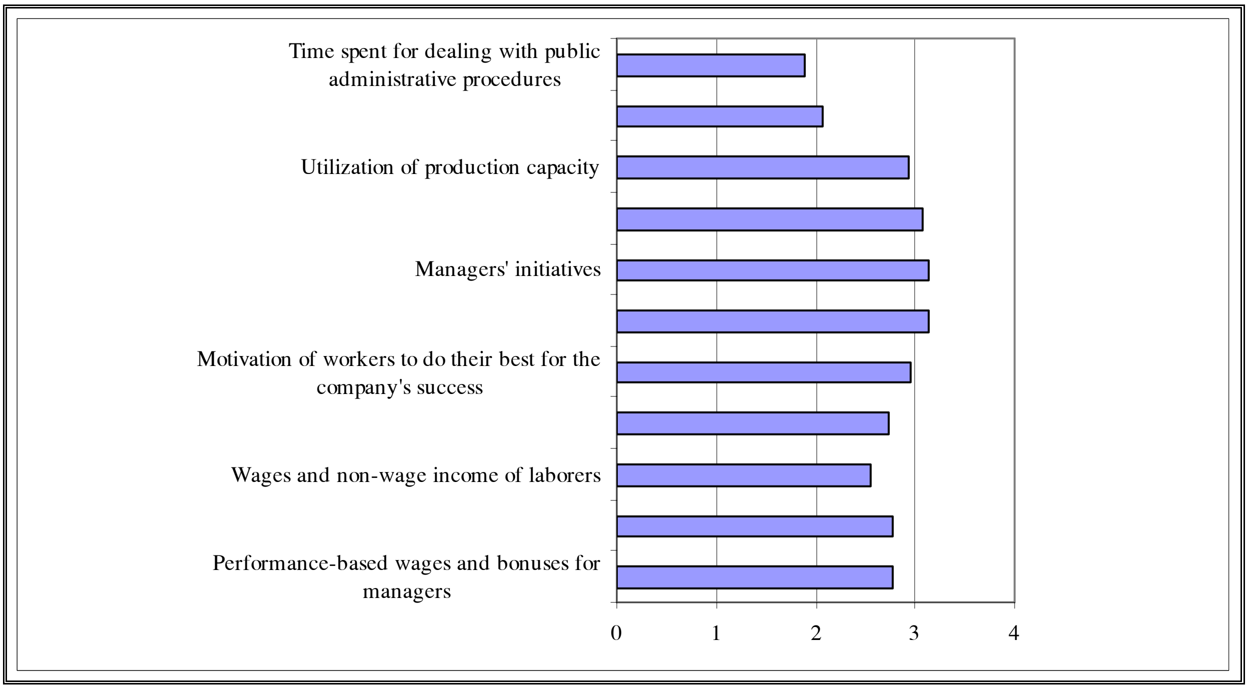
With the profitability analysis, although it cannot be certain that equitization was the best solution as there were still loss-making equitized enterprises, it must be said that equitization could be an effective way of enhancing the efficiency of ailing SOEs, especially those that have persistently reported losses and even for those that are in a state of bankruptcy.

2. Analysis of the causes of growth

2.1. Changes in motivation

More than 96% of enterprises thought that managers paid more attention to the performance and efficiency of business/production of enterprises; equitization had raised the sense of initiative among managers in achieving profit and efficiency objectives. However, enterprises at the central level have been more proactive than local enterprises and corporations; the degree of self-determination of managers in state-controlling share enterprises has been insignificantly lower than non-state controlling ones. Coherent interests and responsibilities of managers and workers make it easier to more efficiently utilize physical facilities and enterprise resources. This was the reason why 85% of enterprises perceive that they must utilize enterprise production capacity more efficiently than prior to equitization. For workers, compared to the pre-equitization period, the setting of wages and bonuses has been based more on business/production performance (Chart 2).

Chart 2: Perception on changes in equitized enterprises after equitization



Notes: 0 = much less; 1 = less; 2 = unchanged; 3 = more; 4 = much more.

2.2. Changes in business and production performance

The majority of enterprises after equitization have, to a certain extent, changed in product and market structure, production technology, and product quality. Specifically, there were 25% of equitized enterprises that adopted changes in market and product structure; about 28% carried out innovation in techniques, technologies and production procedures. In respect to product quality, in the post-equitization period 40% of enterprises have taken measures to enhance product quality.

2.3. Changes in corporate governance

Decision making in important issues has seen some changes. Prior to equitization, decisions regarding important issues in enterprises came from outside. After equitization, this was devolved to the equitized enterprises. Thus, these decisions have cohered more to an enterprise's interests and also paid more attention to economic objectives, namely:

Mechanism for appointing executive managers

During the equitization process, the influence of subjective agencies, general corporations, and parent companies were obvious. This is because these stakeholders had the most influence in selecting directors, although 22% of enterprises thought that workers have had much influence in appointing a director. This was understandable because, when appointing a director during the equitization period, workers were the founding shareholders and had a major influence on deciding upon and appointing a director.

After transforming into equitized enterprises, the board of directors would be the most influential in selecting a director of a company. Nevertheless, apart from the board's vital role, workers have still had a certain right in selecting a director.

The results of the survey showed that the influence of former (state) governing bodies in appointing a director after equitization fell significantly compared to that during equitization, amongst which the impacts tended to lessen in relation to the reduction of the state-share proportion. This occurred not only after equitization, but also during the equitization process.

The handover of power from enterprises' external governing bodies to a board of directors has had a much more positive impact from the viewpoint of corporate governance. There has been a separation of owning and governing within an equitized enterprise. This separation, along with an effective supervision mechanism, has created powers and responsibilities of enterprise governing bodies in a transparent way.

Role of decision makers in important issues

Prior to equitization, governance in SOEs often overlapped and lacked transparency, especially in enforcing decisions. There was still participation from many stakeholders such as the board of directors, the director, and the governing body in deciding upon a company's important issues.

The survey showed that there were changes after equitization in the authority of the individuals and organizations mentioned above. At the same time, compared to the pre-equitization period, there was observed a declining role by workers, local authorities, central authorities and Party organizations in directly participating in administrative decisions (workers were considered as "pure" laborers who worked to earn money, rather than as shareholders with an increasing role after equitization). The decline in the role of organizations and individuals in corporate governance was equal to the centralization of powers in the board of directors and the director and, at the same time, enhanced the responsibilities of the latter for the sake of company's business development. However, the reduced role of the former compared with the pre-equitization period did not mean that they did not have any influence on administrative decisions. This conclusion was verified after interviews at some equitized enterprises.

Scrutinizing the degree of the stakeholders' engagement in each specific decision in equitized enterprises provided us with the following observations.

The board of directors held the most influential role in deciding major investment by equitized enterprises. This was reasonable because the main function of the board of directors is to focus on solving the strategic issues of the company. Conversely, although a company director has certain influence, this significantly reduced compared with that in the SOEs model. A director was the one who had power and the greatest influence on deciding matters such as quantities, salaries and interests of workers in a company. This is in accordance with current regulations. A director's impact on decision making about product marketing and distribution is also similar. It seems unreasonable that a director has more influence than the board of directors in deciding product structure and technologies. However, this is perhaps understandable when considering the fact that the majority of equitized Vietnamese enterprises have had simple and virtually unchanged product structures and technologies compared with the pre-transformation period.

Changes in senior managers

Equitization did not bring about major disorder in personnel. The survey showed that 80-90% of enterprises said that there have been no changes in the position of president, the board of directors, the director, the deputy director, or the chief accountant. Thus, on the one hand, SOEs equitization did not necessarily need too much change in personnel; while on the other hand, more importantly, it guaranteed that equitized enterprises could still achieve effective business and production with the human resources left by the SOE model. In other words, the changes that helped bring about success for enterprises recently was not personnel innovation, but motivation, self-determination and, in a broader sense, the acting mechanism and the corporate governance model. However, little change in personnel has also had certain disadvantages, which will be analyzed in more detail in the Section "Corporate Governance after Equitization".

Workers

Equitized enterprises still have, to different extents, redundant workers. Statistics from the survey show that, prior to equitization, redundant workers accounted for 13-14% of the workforce at over-staffed enterprises.

Carrying out policies to deal with redundant workers during the equitization process helped enterprises to reduce their number. One year after equitization, the number of such workers fell to 6.6%, and 4.4% in 2004. Reduced redundancy cuts costs for equitized enterprises and contributes greatly to improving the performance and efficiency of business and production.

In addition, enterprises made enormous efforts to create jobs and expand production and business rather than simply retrench workers. Worker lay-offs were only adopted after enterprises tried their utmost to create jobs but failed to do so in accordance with Government Decree 41/2002/ND-CP on redundant workers and its amending and supplementing documents. Redundant workers are also encouraged to voluntarily resign rather than wait for compulsory termination. At the same time, in all cases, laid-off workers are entitled to enjoy privileges to different degrees, depending on the nature of their labor contracts (open-ended or fixed-term). Moreover, equitized enterprises receive financial support from the State to settle the matter. This might be an important reason why workers support the equitization process. The 2002 survey showed that, normally, the privatization of SOEs around the world is strongly opposed by workers. This is simply because they fear losing their jobs after privatization.

2.4. Financial causes

Analysis of the survey results shows that the most noticeable point in the production and business achievements of equitized enterprises is the growth rate of after-tax profit. Like in other corporate forms, after-tax profits of the equitized enterprises depend on net turnover, operational costs, financial and other returns, and corporate income tax. Nevertheless, the most decisive factor for after-tax profit growth is corporate income tax.

Costs impact on profit growth

Logically, if the growth rate of costs were lower than the growth rate of turnover, profits would increase. However, the survey results showed that while overhead expenses and sales prime costs increased at a slower rate than net turnover, sales costs increased too much and resulted in the growth rate in costs of equitized enterprises not being lower than that of turnover. Thus, the cost factor does not cause any major effect on after-tax profit growth.

Impact of other revenues on after-tax profit growth

In addition to net turnover, the equitized enterprises have other revenues from financial activities, as well as other "financial returns" (equal to financial revenue minus financial costs) and other profit (depending on specific activities). However, the effect of these factors on profit growth is still weak, as shown below (based on the total of the surveyed enterprises):

- The finance investment performance is very weak, which is not profitable but actually at a loss (i.e. financial costs are higher than financial turnover). Some of the enterprises even have losses increasing over time. The value of these losses is not relatively high, equal to 0.03% of the total revenue in the year prior to equitization and 0.23% in 2004 (Table 2), which certainly reduces total profits and cannot be an engine for the growth in after-tax profits of equitized enterprises.
- "Other returns" of equitized enterprises account for a very small share of the total revenue and remain virtually unchanged during the enterprises' operation (about 0.3%), thus, they have an insignificant effect on after-tax profit growth.

Table 2: Changes in the income distribution flow of the surveyed enterprises (%)

	Year before equitization	2004	Increase/decrease
+ Net turnover	99.71	99.92	+0.21
+ Returns from financial performance	-0.03	-0.23	-0.20
+ Other returns	0.32	0.31	-0.01
= Total revenue	**100.00**	**100.00**	**0.00**
- Sales prime costs	85.21	87.10	+1.89
- Sales costs	6.06	4.61	-1.45
- Overhead expenses	3.49	3.30	-0.19
- Corporate income tax	1.61	0.32	-1.29
= After-tax profit	**3.63**	**4.67**	**+1.04**

Thus, in the flow of income distribution of equitized enterprises, only corporate income tax has some effect on the growth of after-tax profit. The degree of the effect is reflected in Table 3.

The question that arises is what are the causes of the reduction of corporate income tax while the total revenue of the equitized enterprises, mainly turnover, continues increasing by 13.4% a year? The answer is linked to the policies on tax exemptions and reductions for equitized enterprises. According to regulations, those enterprises that transformed from the equitization of SOEs are entitled to exemptions or reductions of corporate income tax for a period of 2-4 years after transforming into joint-stock companies, and a reduction of 50% for the following 2-9 years depending on their business line, domain, and geographical area.

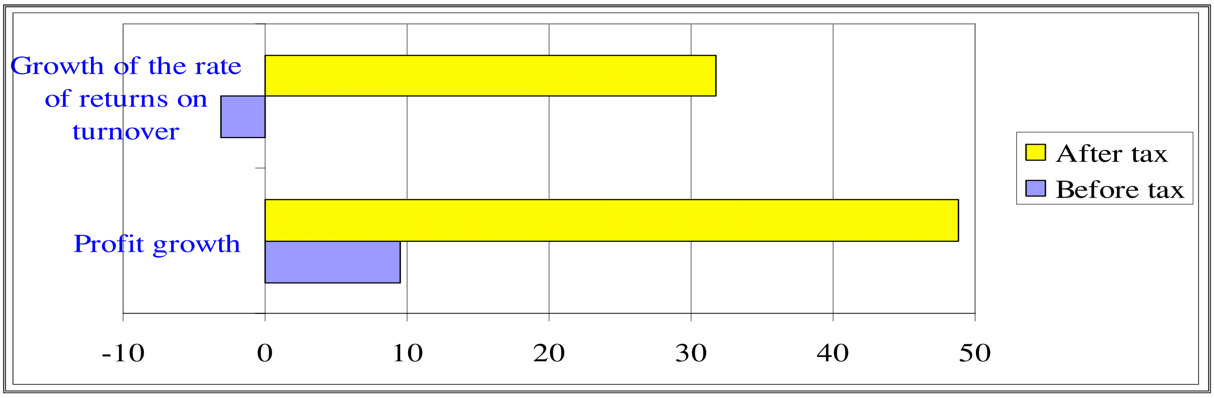
Table 3: The structure of total revenue of equitized enterprises

(% of total turnover)

	Year before equitization	2004
Total revenue of all types (net turnover, financial returns, and other returns)	**100.00**	**100.00**
Production and business costs	94.76	95.01
Corporate income tax	1.61	0.32
After-tax profits	3.63	4.67

In a nutshell, after-tax profits of equitized enterprises have increased at quite high rates of growth compared to other business types. In this regard, the preferential policies towards the reform of SOEs in general, and equitization in particular, including exemptions and reductions of corporate income tax, have an important role to play.

Chart 3: Growth of the rate of returns on turnover in the year prior to equitization and the year after equitization, (%)



Another question that arises is what is the "true" efficiency of the equitized enterprises if the impacts of the policies on exemptions and reductions of corporate income tax are not taken into account. To answer this question, the chart below compares the effect of pre-tax profit and after-tax profit on the rate of returns.

It is worth noting that if after-tax profit in the first year after equitization increased by 48.8% compared to the year prior to equitization, pre-tax profit increased by only 9.04%. The rate of returns on turnover, based on after-tax profit, increased 31.7% in the first year after equitization as compared to the preceding year, and the rate of returns on turnover based on pre-tax profits fell by 3.1% in the first year after equitization compared to the preceding year. This is because the growth rate of pre-tax profits is slower than the growth rate of turnover. In other words, taking into consideration the pre-tax profits, i.e. excluding the impact of preferential policies on taxes (corporate income tax), the profit growth rate of equitized enterprises in the first year after equitization is not high.

Regarding the annual growth rate after the transformation into the joint-stock company model, while after-tax profit increased nearly 54%, pre-tax profit increased by only 46%. Similarly, the growth rate of the rate of returns on turnover based on pre-tax profit is much lower than the rate based on after-tax profit.

Thus, the abovementioned calculations of production and business performance of the equitized enterprises show that equitization is an important solution to enhancing business performance and efficiency of many SOEs. After equitization, performance of the enterprises has, in general, improved. Key indicators such as turnover, profits, rate of returns, and worker incomes have increased impressively and much better than when the enterprises were state-owned.

There are a number of reasons behind this success, including the positive effect of the changes in organizational structure and management, and especially the enhanced motivation of managers and workers. Policies supporting the equitized enterprises also play a significant role, particularly those on exemptions and reductions of corporate income tax in the initial years of transformation.

With much improvement in the financial situation after equitization at equitized enterprises compared to SOEs, another question is where have all of the pre-equitization bad debts gone. This could be explained from the financial (debt dealing) policies towards the enterprises before equitization. These policies have made a significant contribution to improving the financial situation, thus they have also improved the performance of the equitized enterprises, especially enterprises that enjoyed debt elimination, delay or extension.

(To be continued in next issue)

Notes

1. The survey was conducted on 559 equitized SOEs, of which 5.9% did not return the questionnaire and 14.6% were statistically unsuitable for analysis. The ten northern cities and provinces were Hanoi, Hai Phong, Thanh Hoa, Quang Ninh, Nam Dinh, Ha Tay, Bac Giang, Phu Tho, Hoa Binh, and Hai Duong. The five central cities and provinces were Da Nang, Nghe An, Khanh Hoa, Dac Lac, and Lam Dong. The eight southern cities and provinces were Ho Chi Minh City, Can Tho, Dong Nai, An Giang, Ba Ria Vung Tau, Ca Mau, Tien Giang, and Binh Duong.
2. According to previous understandings, productivity was measured by revenue per permanent worker. However, under the conventional approach, productivity is measured by both revenue and cost per employee. Due to a lack of data, this paper could only use the indicator of revenue per permanent worker. A reduced indicator of revenue per permanent worker does not mean a decrease in the total number of workers. Figures from enterprises that answered all labor-related questions show that the total number of employees (including both regular and irregular employees) at equitized enterprises rose by 1.806%.