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# An Examination of the Impact of State Governance on Foreign Direct Investment in Vietnam

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**Abstract**

1986 marked the start of Vietnam's 'Doi Moi' or period of renovation. During this time, Vietnam began to liberalize their economy and began to open and globalize the country. For the first time the government encouraged foreign direct investment, and allowed the creation of non-state controlled businesses. Later becoming part of the World Trade Organization in 2007, the 'renovation' of Vietnam continued to progress. Though improving significantly, Vietnam still lacks effective state governance. This paper examines the relationship between state governance and degree of foreign direct investment. Using linear regression techniques, 20 years of foreign direct investment data, and a specific state governance dataset, this paper begins define that relationship. The results show that looking back in the long term there is no significant relationship between the quality of government and number of foreign direct investment projects. However, looking back in the short term, a positive significant relationship is found between the quality of governance and number of licensed FDI projects a year.

**Keywords:** Developing countries, development, foreign direct investment, globalization, and state governance

## Introduction

The Communist Party of Vietnam (CPV) and its grip loom over the country and government entangling itself, using its influence, and permeating daily life. Though, when walking down the sidewalk of Ho Chi Minh City, you would have difficulty not comparing it, at times, to Paris or New York City. Vietnam is balancing a communist-capitalist ideal, which is most visible in urbanized areas. In 1976, the CPV took control of the country after North Vietnam invaded and took control of South Vietnam.

In 1986, a "New Vietnam" emerged as the country attempted to modernize and open its borders to the international and the global economy. For the first time the government encouraged foreign direct investment, and allowed the creation of non-state controlled business. This was a time of transition (or 'Doi Moi' meaning renovation) between the old and new Vietnam. Later, with increased exports, Vietnam's 1999 Enterprise Law, the 2001 Bilateral Trade agreement with the U.S., and accession to the World Trade Organization in 2007, multinational companies like Clark and Timberland began to open manufacturing plants in Vietnam (Xuan Hai & Nunoi, 2008). These FDI pioneers faced economic instability, poor infrastructure, government mismanagement, and corruption.

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The goal of this paper is to examine the relationship between good country governance and the level of foreign direct investment. The scope of the study begins with a regression analysis for the years 1991 to 2011. For more specific analysis, a second overlapping regression was created for the years of 2001-2011, beginning toward the end of the "Reconciliation Period" (BBC Monitoring, 2013). The central research question of this study is:

*Is the level of good country governance in Vietnam related to the number of foreign direct investment projects within the country?*

Throughout this paper, government and governance are used similarly. Due to the overarching impact of the CVP, as the country's sole political party, and its extensive influence over the government, it is difficult to separate these terms as it is difficult to separate the CPV's influence over the country's institutions. The Central Committee of the CPV is informally at the top of the government hierarchy. Additionally, there are many gray areas where and when the CVP can interfere or directly influence the structure of state governance, and decision-making by government officials.

**FDI theory and framework**

This section of the paper will review international, foreign direct investment and governance theories as well as examine and support the relationship between state governance, as an organization, political influence, and decision-making, supported by existing research and literature.

UNCTAD defines foreign direct investment as:

An investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (UNCTAD, 2007).

Dunning and Rugman state that foreign direct investment is "a modality by which firms extends their territorial horizons abroad" (Dunning & Rugman, 1985). Whether the compulsion to internationalize is related to a firm benefiting from: ownership, location, or internal advantage, as in Dunning's OLI Paradigm; domestic manufacturing and sales decline, Vernon's Product Life Cycle Theory; or business risk reduction as related to Kwok and Reeb's Upstream-Downstream Hypothesis; each related action is consistent with the goal of the firm to minimize risk and maximize profit. Yet, Dunning and Rugman also agree that in expanding into foreign countries through FDI, there is an additional level of risk involved.

The state governance of emerging market countries is an important factor in their development. A productive organization to the government and its subsidiaries can lead as an example to the rest of the country. "Emerging market countries lack the long-standing governance institutions that benefit developed counties. The developed infrastructure helps governments to use existing models of governance to improve upon those that are ineffective" (McGee, 2010). In the absence of these institutions, "emerging market countries typically have issues with poor economic policies, deprived civil society, low levels of education, and weak accountability of public institutions" (Caron *et al.,* 2012).

Stephen Korbin defines political risk as "government interference with business operations" (Korbin, 1979). For managers considering foreign direct investment, Aharoni (1966) explains that managers "not only shy away from uncertainty, they also are not willing to take more than a certain degree of risk." He states that one of the factors influencing the degree of risk is the fear of government control over the investment, "thus when a businessman says 'the political risks abroad are high,' he may be referring to the possibility of losing his freedom of decision making because of a

high degree of governmental regulation" (Aharoni, 1966). Buckley reinforces Aharoni's assertion by expressing that the exposure of a SME to political and institutional risk needs to be "stressed" rather than minimized (Buckley, 1989).A weak judicial system, politically influenced courts, poor investor protection and contract enforcement, characterize the economic environment and degree of risk firms face when choosing Vietnam as an investment destination. Due, in part, to government officials lacking the knowledge and experience of business management, the country has accepted WTO recommendations and is working on improving state governance, transparency and investor protection (Khanna & Palepu, 2010; Socialist Republic of Vietnam, 2006; Socialist Republic of Vietnam, 2009; Toan Tran, 2008; World Bank, 2006; Xuan Hai & Nunoi, 2008). If "politics largely determines the framework of economic activity" then a thorough political and government assessment is needed on the part of MNCs as emerging markets pose a significant political risk (Gilpin, 1975).

**Brief overview of FDI in Vietnam**

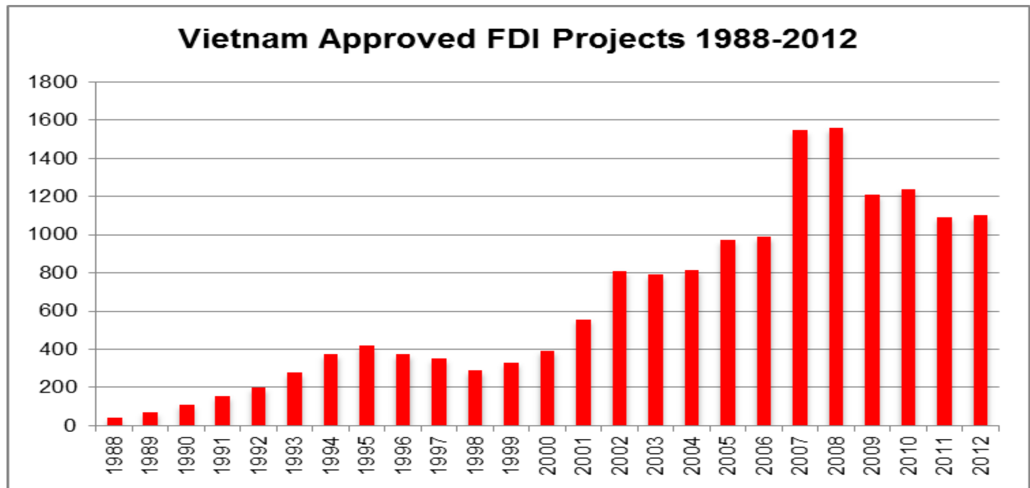
Throughout the 1990s FDI in Vietnam remained relatively small, averaging only about 285 licensed projects per year (MPI, 2012). It was not until after Vietnam's joining regional trade agreements, ASEAN in 1995 and APEC 1998, and the 1997 East Asian Economic Crisis that FDI began to grow significantly in the 2000s (International Finance Corporation, 2009; International Finance Corporation, 2010). Following the Bilateral Trade Agreement with the United States in 2001, the number of FDI projects in Vietnam increased 68.7 percent from 2001 to 2002 (MPI, 2012; UNCTAD, 2008). In 2007, Vietnam became a member of the World Trade Organization. The 11 year accession process further liberalized trade policies, and created a shared context for investors - foreign and domestic - as well as creating a level playing field for public and private companies (Bechter *et al.*, 2009). According to the American Chamber of Commerce in Vietnam, Vietnam's recent success with FDI is due to reduced import tariffs, membership in the WTO, and the liberalization of foreign investment regulations; including the lifting of the ownership cap with international joint ventures and the ability for MNCs to create 100% foreign owned companies within the country. Each of these resolutions has attracted international investors to the country (Cochran, 2012).

The relaxing of constrictive investment regulations indicates that the Vietnamese government views globalization as "a natural and inevitable global trend" (Melina, 1999). This has created a type of "communist capitalist playground" ideal and tension within the country, as globalization tends to lead to market economies and an expansion of democratic institutions (Grindle, 2000; Hayton, 2011). As such, the Economist Intelligence Unit from 2008-2010 characterized Vietnam as a top emerging market destination for FDI only behind the BRIC nations (Breu *et al.*, 2012). Additionally, the World Investment Report, "gave an optimistic forecast with regard to Vietnam's FDI" (Bechter *et al.*, 2009). Gueorguiev and Malesky (2012) state: "[O]ver the past two decades, Vietnam has benefited tremendously from Foreign Direct Investment inflows.

Yet, for most emerging markets, internationalization poses a significant degree of risk. "Emerging markets are characterized by the combination of investment barriers, low market liquidity, low accounting standards, and weak investor protection" (Roosenboom & van Dijk, 2009). While there is a positive relationship between internationalization and risk, a large part of this risk can be attributed to state governance and political institutions of the host country (Kwok & Reeb, 2000; Reeb *et al.*, 1998). Inflation, corruption, lengthy administrative and contradictory procedures, poor infrastructure, real estate, weak banking system, and SOE preference,

present major concerns and obstacles for attracting FDI (Bechter *et al.*, 2009).

It would be easy to say when considering investment in Vietnam, that it presents too large a risk for FDI. However, FDI in Vietnam has grown over 1,000% from 1990-2012 with 107 projects in 1990 and 1100 projects in 2012 (MPI, 2012).



**Data source:** Ministry of Planning and Investment

To help explain this increase, this paper proposes the following hypothesis: *As the practice of good state governance develops in Vietnam, it has a positive influence on the number of licensed foreign direct investment projects in the country.*

## Methodology

To examine if there was a relationship between FDI and country governance, two regression models were created using Stata/SE version 12. The first model used FDI project data from the Ministry of Planning and Investment of Vietnam for the time period of 1991 to 2011. Governance data was collected from PRS Group via QoG Standard Dataset for the same time period using the ICRG indicator of Quality of Government. This regression model provided a 20-year long-term view of the relationship of governance to FDI.

A second overlapping regression model was created using the same data but limiting the model to a 10 year series from 2001 to 2011. This model allowed an examination of the same relationship, beginning the year the BTA was established with the U. S. This period, containing the BTA and WTO agreements, and post the East Asian Economic Crisis, allowed a more specific, but shorter term, view of the relationship, taking into account the significant policy changes in governance and its influence on foreign direct investment.

$H_0$ = The governance structure in Vietnam is not related to the country's number of FDI projects.

$H_a$ = The governance structure in Vietnam is related to the country's number of FDI projects. Therefore, there a significant relationship exists between the QoG (as independent variable) and the number of FDI projects (as dependent variable).

| Year | Number of FDI Projects Licensed | ICRG Quality of Governance Indicator |
|---|---|---|
| 1991 | 152 | 0.416666657 |
| 1992 | 196 | 0.412037045 |
| 1993 | 274 | 0.453703701 |
| 1994 | 372 | 0.518518567 |
| 1995 | 415 | 0.611111104 |
| 1996 | 372 | 0.611111104 |
| 1997 | 349 | 0.578703701 |
| 1998 | 285 | 0.555555582 |
| 1999 | 327 | 0.555555582 |
| 2000 | 391 | 0.555555582 |
| 2001 | 555 | 0.490740716 |
| 2002 | 808 | 0.472222239 |
| 2003 | 791 | 0.472222239 |
| 2004 | 811 | 0.472222239 |
| 2005 | 970 | 0.472222239 |
| 2006 | 987 | 0.525462985 |
| 2007 | 1544 | 0.553240776 |
| 2008 | 1557 | 0.583333313 |
| 2009 | 1208 | 0.583333313 |
| 2010 | 1237 | 0.541666687 |
| 2011 | 1594 | 0.527777791 |

**Description of data sources**

The Ministry of Planning and Investment is located in Hanoi, Vietnam. It oversees the promotionist Foreign Investment Agency that monitors inward and outward foreign direct investment. It also provides through its Investment Promotion Centers, as part of the People's Committee, information regarding opportunities and procedures for international business and investment (MPI, 2012).

The ICRG indicator of *Quality of Government* (QoG) is a composite measurement of corruption, law and order, and bureaucracy quality indicators by the PRS Group. As listed in QoG Standard Dataset it consists of combining the mean value of the variables indicated resulting in a scale of 0-1. A value of 1 indicates the highest quality of government possible 2012).

**Variable definitions**

$FDI_{P1}$ = Number of licensed FDI projects per year from 1991 to 2011

$FDI_{P2}$ = Number of licensed FDI projects per year from 2001 to 2011

$X_{QG1}$ = ICRG Quality of Government indicator from 1991 to 2011

$X_{QG2}$ = ICRG Quality of Government indicator from 2001 to 2011

**Regression 1**

To test if there is a relationship between quality of governance and number of FDI licensed projects from 1991 to 2001, an initial linear regression model was created. The model used $FDI_{P_1}$ as the dependent variable and $X_{QG_1}$ as the independent variable, where:

$$FDI_{P_1} = \beta_0 + \beta_{QG_1} X_{QG_1}$$

At an $\alpha = 0.05$, the following model achieved a $R^2 = 0.057$ indicating a relationship that is not significant between $X_{QG_1}$ and $FDI_{P_1}$.

| Source | SS | df | MS | | Number of obs = 21 | |
|---|---|---|---|---|---|---|
| Model | 257801.844 | 1 | 257801.844 | | F(1, 19) = 1.14 | |
| Residual | 4293769.3 | 19 | 225987.858 | | Prob > F = 0.2989 | |
| Total | 4551571.14 | 20 | 227578.55 | | R-squared = 0.0566 | |
| | | | | | Adj R-squared = 0.007 | |
| | | | | | Root MSE = 475.38 | |
| **FDIp_1** | **Coef.** | **Std. Err.** | **t** | **P>t** | **[95% Conf. Interval]** | |
| Xqg_1 | 1916.917 | 1794.745 | 1.07 | 0.299 | -1839.528 | 5673.361 |
| _cons | -277.147 | 942.6646 | -0.29 | 0.772 | -2250.167 | 1695.873 |

**Regression 2**
To test if there is a relationship between quality of governance and number of FDI licensed projects from 2001 to 2011, a second linear regression model was created. The model used $FDI_{P_2}$ as the dependent variable and $X_{QG_2}$ as the independent variable, where:

$$FDI_{P_2} = \beta_0 + \beta_{QG_2} X_{QG_2}$$

At an $\alpha = 0.05$, the following model achieved a $R^2 = 0.59$ indicating a significant positive relationship between $X_{QG_2}$ and. $FDI_{P_2}$.

| Source | SS | df | MS | | Number of obs = 11 | |
|---|---|---|---|---|---|---|
| Model | 750473.626 | 1 | 750473.626 | | F(1, 9) = 12.97 | |
| Residual | 520809.102 | 9 | 57867.678 | | Prob > F = 0.0057 | |
| Total | 1271282.73 | 10 | 127128.273 | | R-squared = 0.5903 | |
| | | | | | Adj R-squared = 0.5448 | |
| | | | | | Root MSE = 240.56 | |
| **FDIp_2** | **Coef.** | **Std. Err.** | **t** | **P>t** | **[95% Conf. Interval]** | |
| Xqg_2 | 6185.554 | 1717.627 | 3.60 | 0.006 | 2300.011 | 10071.1 |
| _cons | -2105.572 | 892.1291 | -2.36 | 0.043 | -4123.709 | -87.43625 |

## Discussion

Regression 1 achieved a $R^2$ of 0.057 at an $\alpha$ of 0.05. This indicates that from 1991 to 2011 the relationship between the quality of governance and the number of FDI projects in Vietnam is not statistically significant. Regression 2 achieved a $R^2$ of 0.59 at an $\alpha$ of 0.05. This shows that for the ten year time period of 2001 to 2011 the relationship between the quality of governance and the number of licensed FDI projects in Vietnam is significant and positive. This regression rejects the null hypothesis and validates the alternative.

To revisit the initial research question:
*Is the level of good country governance in Vietnam related to the number of foreign direct investment projects within the country?*

According to the results, for the 20 year period of 1991 to 2011 there seems to be no

statistical significance between the two variables. However, if we look at the 10 year period from 2001 to 2011, the results show that there is a positive significant relationship between good country governance and the number of foreign direct investment projects in Vietnam.

The long-term impact of governance on FDI projects fails to show in the above regression model. Though Vietnam began its economic reform in 1986, it was not until the late 1990s, after joining ASEAN in 1995 and APEC in 1998, that the foreign direct investment projects began to increase. After recovering from the Asian Financial Crisis in 1998, foreign direct investment projects grew significantly through the 2000s and continue to grow today. In the more short term, regression 2 shows that good governance does have an impact on foreign direct investment. This may be a result of the further liberalization of trade policy, the Bilateral Trade Agreement with the United States in 2001, and Vietnam's accession to the World Trade Organization in 2007. These two events may be the reason behind the boom in the number of foreign direct investment projects. Both of the events required significant governance and legal reforms to protect foreign investors.

The limitations of this methodology and regression models is due primarily to the lack of data to appropriately evaluate trends. Though this paper examines a 20 year time series, this research has shown that the main impact of good governance has been in the more recent years and may not yet be fully realized. Therefore, the assertion of the relationship between good governance and FDI may be premature. We will have to look to the future to fully realize the relationship and potential impact of good governance on the number of foreign direct investment projects in Vietnam.

Future research would benefit by the inclusion of additional variables, considering the impact of equalization of state owned enterprises, and the opening of Ho Chi Minh Stock exchange (HOSE) in 2000, and Hanoi Securities Trading Center (Hanoi STC) in 2005. Of course, this research will benefit most from the passage of time, and the ability to look back in future years with access to larger data pools.

## Conclusion

The main accomplishment of this paper is that it partially confirmed the research hypothesis statement that: *As the practice of good state governance develops in Vietnam, it has a positive influence on the number of licensed foreign direct investment projects in the country.* Though the 20 year regression model did not indicate an impact of good governance on FDI, the 10 year regression model showed the level of good governance positively impacts the number of FDI projects in Vietnam.

This study's contribution to the field of international business is that there are few studies that focus on Vietnam and governance reform. More research is needed to fully understand the implications of having a communist-capitalist society. Vietnam is a young country having only gained independence in 1976. Vietnam may be the country to watch as it struggles with state governance, dismantles its state-owned enterprises, further opens their economy to the world, and see how having an open capitalist marketplace fuses with this Socialist Republic, and communist government.

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