EVALUATION OF FDI POLICIES IN VIETNAM USING FDI INDEXES

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Abstract

In the context of international economic integration, FDI enterprises have become an important part of Vietnam's economy. The government has established a number of policies in order to make the most of FDI. This paper re-evaluates the effectiveness of FDI policies in Vietnam when the country becomes a member of TPP using FDI Indexes. We adapt a conceptual framework of FDI policies that presents a taxonomy of global FDI policies as: (1) Policies towards attracting FDI; (2) Policies towards upgrading FDI; (3) Policies towards enhancing linkages between MNCs and domestic firms; (4) Policies reducing FDI side effects to classify contemporary FDI policies in Vietnam. The effectiveness of FDI policies is measured by a set of FDI indexes including Global Opportunity Index, Inward FDI Performance Index and Inward FDI Potential Index. The findings show that FDI performance in Vietnam has been improved over the years with increasing Inward FDI Performance Index. This implies that there are effective policies towards attracting FDI in Vietnam. However, a low level of Vietnam Global Opportunity Index and Inward FDI Potential Index suggest that there is a lack of advanced policies towards upgrading FDI and enhancing linkages and spillovers to domestic firms. Based on these findings, some policy implications are suggested.

Keywords: FDI Index, FDI Policy & Vietnam.

1. Introduction

Foreign direct investment (FDI) is considered as an important source for achieving greater and faster economic growth in many developing countries. The benefits and costs from FDI for a host country have been emphasized in a numerous studies such as OECD (2002), Wei (2005), Chakraborty and Basu (2002), Rajan (2005). Although overall benefits are considered greater than costs, it is argued that benefits of FDI are not automatic. Despite the fact that different models or approaches are applied, most studies agree that the impact of FDI on a host economy is mainly dependent on the country's policies in place. The policy factors can be classified into 4 levels: (1) Policies towards attracting FDI; (2) Policies towards upgrading FDI; (3) Policies enhancing linkages between MNCs and domestic firms; (4) Policies reducing FDI side effects. Which policies are important in a host country depends on how they fit in with the development strategy and the contemporary absorptive capacity level (Te Velde, 2001). In order to facilitate host countries in choosing relevant policies to take full advantages from FDI enterprises, different organizations offered various means to investigate the performance and potential of FDI, such as Global Opportunity Index, Inward FDI Performance Index, Inward FDI Potential Index. These indexes are not only the tools for measuring the performance and potential of FDI, but also reveal many policy implications.

This study adapts the conceptual framework of FDI policies and FDI indexes to revisit the effectiveness of Vietnam FDI policies and performance in the context that the country becomes a member of TPP, then suggests some policy implications.

2. Conceptual Framework

2.1. Policies towards FDI

There are a number of FDI strategies implying different degrees of interventionist policies. Based on development strategy and characteristics of each country, relevant FDI policies are selected and flexibly applied. In general, FDI policies can be classified into 4 categories: (1)

Policies towards attracting FDI; (2) Policies towards upgrading FDI; (3) Policies towards enhancing linkages between MNCs and domestic firms; (4) Policies reducing FDI side effects.

Policies aimed at attracting FDI aim to enhance the attractiveness of investment environment to foreign investors, thereby increasing FDI inflows into the host country. They consist of: Improving macro-economic performance and prospects; Creating a certain level of infrastructure; Developing skilled workforce and good labour relations; Financial and fiscal incentives and bargaining to FDI firms; Developing key sectors (agglomeration and clustering); etc.

When a country recognized that policies towards attracting FDI are not enough to boost up economic growth, they will create a set of *advanced policies towards upgrading FDI* in order to orient FDI inflows to serve their development strategy. These policies are based on the priority of the government, in which projects in selected sectors or industries have more incentives than the others. In other words, the government pays more attention to the quality of FDI (i.e. high value added or high technology FDI). The tools that policy makers use to upgrade FDI include: Developing labour market policy; Improving trade policies, export promotion; Encouraging FDI projects that develop infrastructure; Developing competition policy; Developing financial market; Taxation and financial incentives for selected sectors or industries; Setting up performance requirements; Encouragement of R&D; Interaction with research institutions and other firms; etc.

Due to the fact that relying on high quality FDI sometimes does not guarantee the improvement of local capabilities, *policies enhancing linkages between multinationals and domestic firms* are constructed as a part of industrial policies in order to make positive spillovers to the local economy. The linkages between local suppliers and FDI enterprises are important in developing local firms via linkage programs or in a cluster development strategy. These policies also encourage exchange programs between foreign and domestic training centers/institutions to boost up the level of local human capital. The policies include: Education and skill generation; Labour mobility; Improve competition policy; Export promotion; Encouragement of linkages with multinationals; Encouraging technological capabilities; Encouraging human resources via training; etc.

Moreover, the quantity of FDI inflows is so important for developing countries that some of them loosen their requirements of inward FDI in terms of registration procedure, quality and performance of FDI projects to attract more FDI. As a consequence, FDI may have negative effects for the host economy such as environment pollution, transfer pricing in MNCs for tax evasion, dependence of the local economy on FDI. Therefore, *policies reducing FDI side effects* are set up, including: Environmental policy (i.e. strict technical requirements in terms of environment safety, regulations on importing, exporting and transiting technologies and dangerous/polluted waste, encouragement of green FDI and non-carbonic FDI); Policies avoiding transfer pricing (i.e. flat tax rate for all enterprises, regulations on non-consolidated tax obligations, database for anti-transfer-pricing investigation, etc.); Diversify sources of social investment; Enhance regulations to prevent corruptions. The effectiveness of these policies is guaranteed by the strictness of instruments, including financial and non-financial sanctions.

Table1: Classification of FDI Policies

	Macroeconomic policies towards FDI	**Industrial policies towards FDI**
Policies towards attracting FDI	- Improving macro-economic performance and prospects - Creating an infrastructure as a foundation to attract FDI - Developing a skilled workforce	- Financial and fiscal incentives and bargaining to FDI firms - Efficient administrative procedures and rules on ownership - Promotion, targeting and image

	and good labour relations - Creating privatization opportunities - Developing financial market - No impediments to trade of goods and services	building -Developing key sectors (agglomeration and clustering) - Developing free zones and export platforms
Policies towards upgrading FDI	- Developing labour market policy - Improving trade policies, export promotion - Encouraging FDI projects that develop infrastructure - Developing competition policy - Developing financial market	- Taxation and financial incentives for selected sectors or industries. - Setting up performance requirements (TRIMS etc.) - Encouragement of R&D -Interaction with research institutions and other firms - Creating funds for employees training
Policies enhancing linkages between MNCs and domestic firms	- Education and skill generation - Labour mobility - Improve competition policy - Export promotion	- Encouragement of linkages with multinationals - Encouraging technological capabilities - Encouraging human resources via training - Supply side management
Policies reducing negative effects of FDI	- Diversify sources of social investment - Enhance regulations to prevent corruptions	- Exploitation in parallel with conservation of natural resources - Encouragement of green investment project (green FDI, non-carbonic FDI) - Strengthening regulations towards importing and exporting technologies - Improve policies avoiding transfer pricing

**Source: derived from Te Velde (2001) and author's collection*

2.3. FDI Indexes

In order to evaluate the effectiveness of FDI policies, there are a number of qualitative and quantitative measures. This study focuses only on quantitative measures (i.e. FDI Indexes). They are Global Opportunity Index, Inward FDI Performance Index, and Inward FDI Potential Index.

Global Opportunity Index

Global Opportunity Index is one of basic indexes to explore FDI opportunities in a country. It is designed to give a baseline assessment for a country looking for improving their business environment and attracting foreign investors. The index benchmarks and observes the progress of a country on 61 variables, aggregated in 4 categories: (1) Economic Fundamentals; (2) Ease of Doing Business; (3) Regulatory Quality; (4) Rule of Law. Thefinal index value is the average score of the four categories.

According to Milken Institute (2015), the higher the score of Global Opportunity Index, the greater the FDI inflows. Based on this estimated relationship, each one-unit increase in the index is associated with a 42% increase in FDI per capita (Milken Institute, 2015, p.6). Because the index focuses on institutional determinants, the higher score also implies more effective policies towards attracting FDI.

Inward FDI Potential Index

Inward FDI Potential Index is introduced by UNCTAD (2002) to rank countries according to their potential to attract FDI vis-a-vis other countries. The index is constructed on 12 quantifiable factors which are classified into 4 categories: (1) Attractiveness of business

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environment; (2) Labour market; (3) Nature sources; (4) Infrastructure. The final index is an unweighted average of their normalized value. The index is estimated for three-year periods.

In contrast to the Performance Index that is based on FDI inflows, this index is based mainly on structural economic factors that are likely to change fairly slowly over time. An increase in the index value is treated as a development in the FDI potential.

Inward FDI Performance Index

Inward FDI Performance Index is constructed by UNCTAD (2002) to benchmark a country's success in attracting FDI. This is a ratio of a country's share in global FDI flows to its share in global GDP. The index is formulated as:

$$\textit{Inward FDI Performance Index} = \frac{FDI_i/FDI_w}{GDP_i/GDP_w}$$

In which: FDI_i is FDI inflows in the ith country; FDI_w is world FDI inflows; GDP_i is GDP in the ith country; GDP_w is world GDP.

Due to the fact that some countries may apply short term tax havens, newly discovered resources, mega M&A involving foreign investors or large privatizations, that lead to lumpy inflows in short period, Inward FDI Performance Index uses data for three-year periods rather than a single year (UNCTAD, 2002).

A negative index value means foreign investors disinvested in the period. If a country receives FDI exactly in line with their relative economic size, the index value will be equal to 1. If the index value is greater than 1, it means that the country attracts more FDI than expected on the basis of relative GDP. This also implies that the country may have exceptionally welcoming regulatory regimes and offer competitive attractions. In such case, the country is suggested to enhance absorptive capacity to take the advantages of FDI for the host economy. In other words, advanced policies towards upgrading FDI and enhancing linkages between MNCs and domestic firms need to be developed.

In contrast, the index value below 1 indicates that the amount of FDI inflows is smaller than expected on the basis of economy size. In other words, the economy may suffer from instability, poor policy design and implementation or competitive weaknesses in their economy. This also refers to the weak policies towards attracting FDI.

3. Statistical Analysis

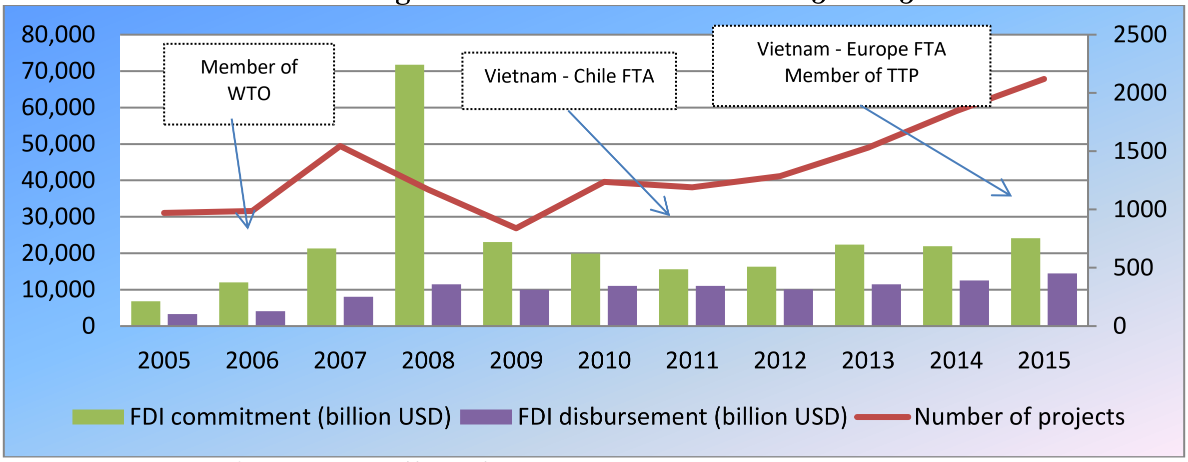
3.1. FDI Inflows in Vietnam

Starting with no foreign investment in 1986, FDI recently becomes the most dynamic part of Vietnam's economy. Except crisis period 2008 – 2009, FDI inflows into Vietnam have increased rapidly. By the end of 2015, Vietnam had received281 billion USD for 20.069FDI projects. FDI has also reached all provinces and cities in Vietnam.

This paper focuses on the changes of FDI in international economic integrations. Therefore, the study only analyses the period from its international economic integration via WTO (2005) until now. The fluctuation of FDI inflows into Vietnam from 2005 to 2015 can be divided into two periods. Period 2005 – 2008 is considered as the new wave of FDI into Vietnam. The total FDI commitment jumped from 6.83 billion USD in 2005 to 71.726 billion USD in 2008. The total FDI disbursement in this period accounts for 24% of the commitment capital, 1.5 times higher than the previous level. After the peak of investment in 2008, the FDI commitment has significantly declined, however, the disbursement remains stably around 10 – 11 billion USD for period 2008 - 2015.

The changes in FDI inflows were basically influenced by Vietnam economic integration and changes in its policies which have taken place right before or after integration events. Figure 1 shows that FDI commitment into Vietnam tended to increase after every policy adjustment.

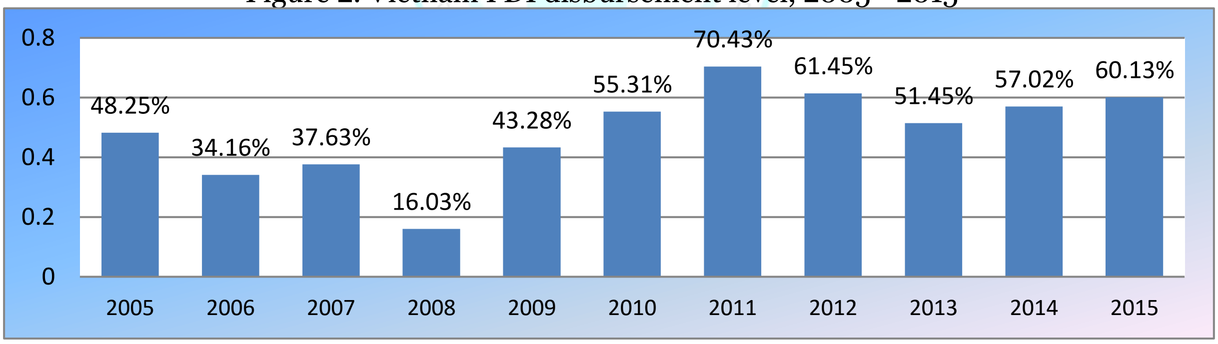
Figure1. FDI net inflows from 2005 - 2015



**Source: General Statistics Office of Vietnam, 2016*

However, as can be seen from Figure 2, the FDI disbursement level is quite low, especially in the period 2005 – 2008. It indicates a big gap between the FDI disbursement and commitment, implying the limited absorptive capacity of the country. The absorptive capacity of a country includes level of human capital, infrastructure, governance, technology, etc. Therefore, in order to shorten the gap and accelerate the investment progress, besides investment policies to attract FDI, it is necessary for Vietnam to improve its own capacity to absorb this kind of capital.

Figure 2. Vietnam FDI disbursement level, 2005 - 2015



**Source: General Statistics Office of Vietnam, 2016*

3.2. An evaluation of FDI policies in Vietnam using FDI Indexes

Using dataset of Milken Institution (2015), UNCTAD (2016) and World Bank (2016), the paper calculates FDI Indexes to evaluate the effectiveness of Vietnam FDI policies. In general, the index values of Vietnam increased over the years, indicating the improvement in its FDI policies. However, compared to other countries, the index scores are relatively low. This also implies the competitive weakness of Vietnam policies towards FDI.

As can be seen in Figure 3, the *Global Opportunity Index* has been improved from 4.13 in 2005 to 4.79 in 2015. This indicates the improvement in Vietnam policies towards attracting FDI. However, in comparison with its neighborhoods, the scores of Vietnam are only higher than those of Philippines and Cambodia, but much lower than other countries such as Malaysia, Thailand, China, and Indonesia. The constant low index scores over the years indicate that Vietnam has less opportunity to attract FDI than the others.

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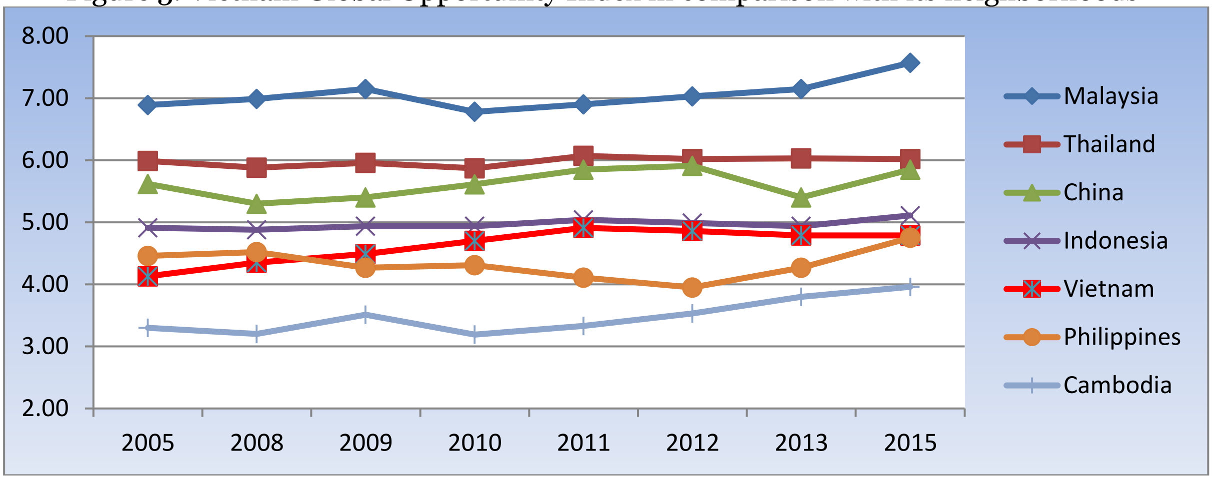
Figure 3. Vietnam Global Opportunity Index in comparison with its neighborhoods



**Source: Global Opportunity Index, Milken Institution, 2015*

Overall, Vietnam ranks 86th out of 136 countries on the 2015 Global Opportunity Index. Compared to ranking group averages, although the composite score of Vietnam is higher than Bottom 50%, it is still much lower than the average *(see Table 2)*.In addition, Table 3 breaks out average component scores for member nations of OECD and developing countries based on geographic region. It can be seen that Vietnam has lower component scores than country group averages (particularly the scores of developing Asia), presenting the weakness of Vietnam in terms of *Ease of Doing Business, Regulation Quality* and *Rule of Law*.

Table 2: Vietnam Global Opportunity Index in comparison with ranking group averages, 2015

	Composite Score	**Economic Fundamentals**	**Ease of Doing Business**	**Quality of Regulations**	**Rule of Law**
Top 20	7.58	6.62	7.75	7.93	8.04
Top 50%	6.52	5.88	7	6.71	6.48
All	5.37	4.76	5.95	5.61	5.18
Vietnam	**4.79**	**5.14**	**5.21**	**5**	**3.8**
Bottom 50%	4.21	3.62	4.89	4.48	3.87
Bottom 20	3.36	2.65	4.24	3.49	3.05

	Composite Score	**Economic Fundamentals**	**Ease of Doing Business**	**Quality of Regulations**	**Rule of Law**
OECD	6.93	6.40	7.25	7.07	6.99
Dev Europe	5.57	5.38	6.64	5.30	4.97
MENA	5.28	4.81	6.17	5.39	4.74
Dev Asia	5.12	4.57	5.58	5.10	5.23
Vietnam	**4.79**	**5.14**	**5.21**	**5**	**3.8**
Americas	4.73	4.37	5.29	5.44	3.83
Sub-Saharan Africa	4.26	2.93	4.74	4.79	4.59

Table 3: Vietnam Global Opportunity Index in comparison with country group averages, 2015

**Source: Global Opportunity Index, Milken Institution, 2015*

Although Vietnam has improved its competitiveness to attract FDI, its institutional factors are still limited. Especially, the component scores in 2015 indicate that Vietnam's weakest performance was in Rule of Law. In 2015, it scored only 3.8, much lower than the average of developing Asia (5.23) and the overall average (5.18).

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Table 4: Vietnam Global Opportunity Index Ranking 2015

	Score	Rank
Economic Fundamentals	5.14	60
Ease of Doing Business	5.21	92
Quality of Regulations	5.00	86
Rule of Law	3.8	102
Composite Score	**4.79**	**86**

**Source: Global Opportunity Index, Milken Institution, 2016*

Inward FDI Potential Index is calculated on UNCTAD's FDI dataset for countries. The examination of the index reveals an overall improvement in FDI potential of Vietnam. However, this improvement is relatively small. This is reflected as the small changes in the index scores. Over the past 10 years, Vietnam Inward FDI Potential Index increased by only 0.068 points.

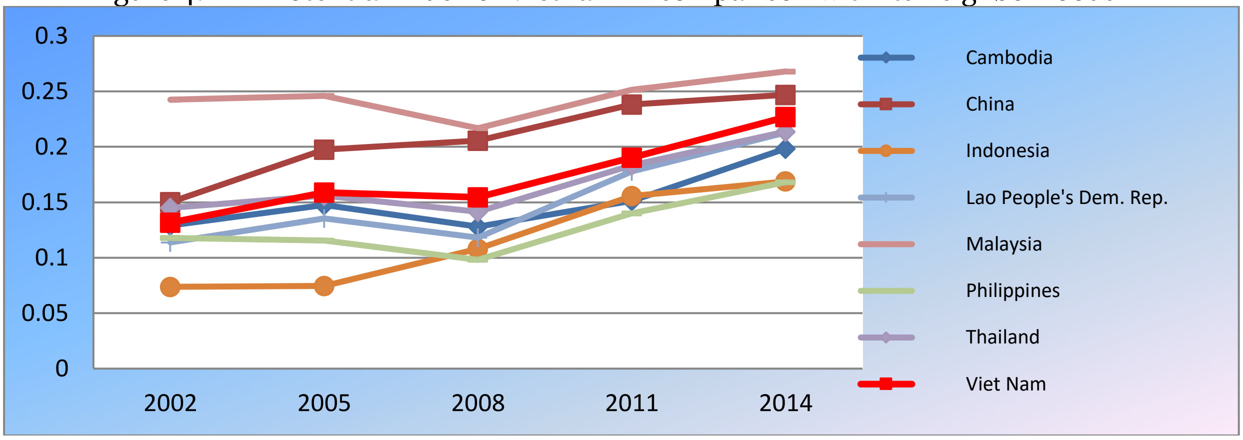
Table 5: Vietnam Inward FDI Potential Index

Year	Score	Rank
2005	0.158878	117
2008	0.154514	108
2011	0.190416	112
2014	0.226801	93

**Source: Author's calculation based on data from UNCTAD, WorldBank, 2016*[1]

Compared to other countries, Vietnam FDI potential is far below those of its neighborhoods *(see Figure 4)*. This implies that policy makers in Vietnam should work on policies to increase their FDI potential.

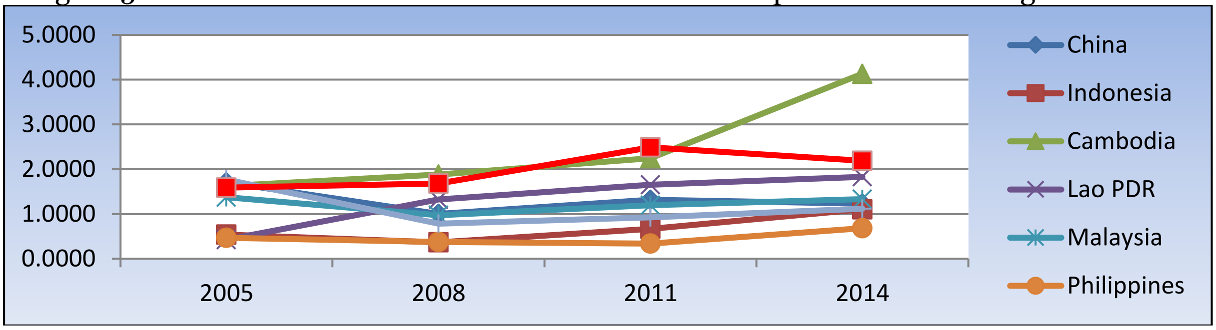
Figure 4: FDI Potential Index of Vietnam in comparison with its neighborhoods



Source: Author's calculation based on data from UNCTAD, WorldBank, 2016[1]

Regarding *Inward FDI Performance Index*,the index of Vietnam is improved over the years. The FDI performance of Vietnam has increased 0.7952 points from 1.3938 in 2002 to 2.1980 in 2014[1]. In comparison with its neighbourhoods, the FDI performance index of Vietnam is quite high (*see Figure 5)*.This means Vietnam has successfully attracted an increasing amount of FDI.

Figure 5: Vietnam Inward FDI Performance Index in comparison with its neighborhoods

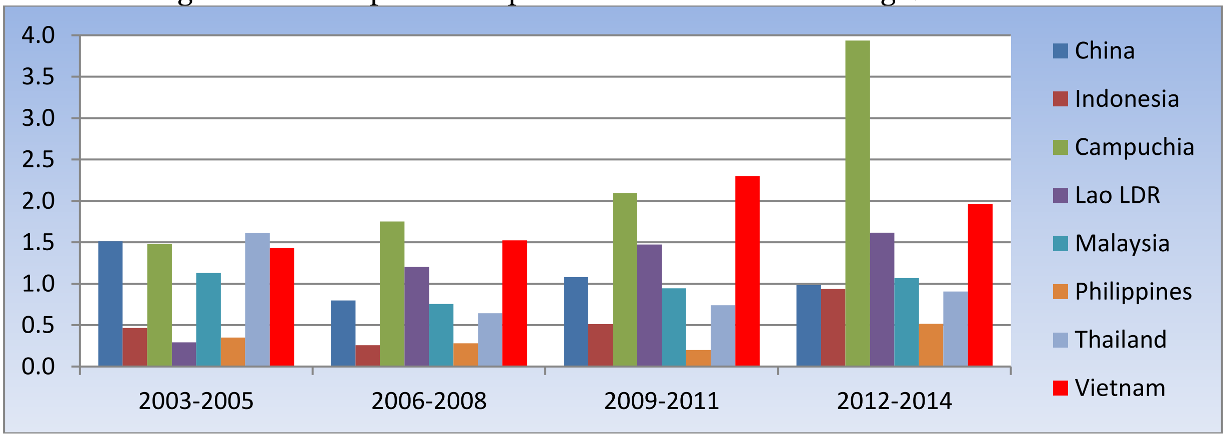


Source: Author's calculation based on UNCTAD data, 2016[1]

The FDI Performance Index of Vietnam has been usually larger than 1, especially in the 2010s it is even greater than 2. The high score indicates that the country have larger share of FDI relative to its economic size. It implies that Vietnam has attracted a huge amount of FDI, compared to its GDP. However, it also presents a big gap between FDI inflows into Vietnam and its absorptive capacity. In addition, in the 2010s, Vietnam performed relatively worse that the FDI Performance Index drop from 2.4896 in 2011 to 2.1890 in 2014. These figures imply that there are some problems in Vietnam FDI policies. In fact, Vietnam has poor institutional reforms related with trade and FDI, policies toward investing into infrastructure have been not effective, provision of public services such as health and education was insufficient. These raised concerns among foreign investors.

In addition, we use the FDI performance and potential indexes to calculate the FDI gaps and surpluses in Vietnam and its neighbourhoods. The positive difference between the FDI performance and potential indexes is labelled as "FDI surplus". Theoretically, FDI surpluses associate with higher growth rates that enhance economic development. Surpluses mainly stem from the existence of sound macroeconomic policies and stability. However, it also implies that the volume of FDI inflows into the country is excess its absorptive capacity. If the difference between FDI performance and potential is negative, it is labelled as "FDI gap". The existence of FDI gap implies an underperformance of FDI relative to its potential.

Figure 6: FDI Gaps and Surpluses of Vietnam and its neighbourhoods



Source: Author's calculation based on data from UNCTAD, WorldBank, 2016[1]

[1]Latest data available on UNCTADStat (2016) is only updated to 2014.

Figure 6 presents the FDI gaps and surpluses calculated for Vietnam and its neighbourhoods between 2005 and 2014. According to Figure 6, Vietnam generated relatively high FDI surpluses compared to the others. The increasing FDI surplus scores show the widened difference between FDI performance and potential of Vietnam. That means the volume of FDI inflows that Vietnam has attracted is more than the amount that its FDI potential suggests. On one hand, this represents Vietnam efforts in improving policies towards FDI. On the other hand, this implies Vietnam's absorptive capacity is still limited to receive such big volume of FDI. In other words, this reflects the unbalance in FDI policies of Vietnam.

This point is also supported by the fact that in over 28 years of attracting FDI, only policies towards attracting FDI in Vietnam has been focused and significantly improved. In contrast, the government has not paid much attention on policies at advanced levels *(see Table 6).*

Table 6: Availability and effectiveness of FDI Policies in Vietnam

	Macroeconomic policies towards FDI	**Availability**	**Effectiveness**
Policies towards attracting FDI	Improving macro-economic performance and prospects	x	x
	Creating an infrastructure as a foundation to attract FDI	x	x
	Developing a skilled workforce and good labour relations	x	x
	Creating privatization opportunities	x	x
	Developing financial market	x	x
	No impediments to trade of goods and services	x	x
	Financial and fiscal incentives and bargaining to FDI firms	x	x
	Efficient administrative procedures and rules on ownership	x	
	Promotion, targeting and image building	x	x
	Developing key sectors (agglomeration and clustering)	x	
	Developing free zones and export platforms	x	
Policies towards upgrading FDI	Developing labour market policy		
	Improving trade policies, export promotion	x	x
	Encouraging FDI projects that develop infrastructure	x	
	Developing competition policy		
	Developing financial market	x	
	Taxation and financial incentives for selected sectors or industries.	x	
	Setting up performance requirements (TRIMS etc.)	x	
	Encouragement of R&D	x	
	Interaction with research institutions and other firms		
	Creating funds for employees training		
Policies towards enhancing linkages	Education and skill generation		
	Labour mobility		
	Improve competition policy		
	Export promotion	x	
	Encouragement of linkages with multinationals	x	

and spillovers to domestic firms	Encouraging technological capabilities		
	Encouraging human resources via training		
	Supply side management		
Policies reducing negative effects of FDI	Diversify sources of social investment	x	
	Enhance regulations to prevent corruptions	x	
	Exploitation in parallel with conservation of natural resources		
	Encouragement of green investment project (green FDI, non-carbonic FDI)	x	
	Strengthening regulations towards importing and exporting technologies	x	
	Improve policies avoiding transfer pricing	x	

Source: Author's collection from Investment Law 2014 and other law documents

3.3. Concluding remarks and policy implications

Given the results and discussion above, it is clear that Vietnam have done a great job in attracting a huge volume of FDI. The policies towards attracting FDI have been effective with a high Inward FDI Performance Index. However, the Global Opportunity Index of Vietnam is relatively low, implying a smaller opportunity of attracting FDI compared to other countries. Low component scores present the competitive weakness of Vietnam in terms of Ease of Doing Business, Quality Regulation, and Rule of Law. There is only a small improvement in Vietnam FDI Potential, reflected as insignificant changes in Inward FDI Potential Index. In addition, the big FDI surpluses of Vietnam also indicate that the country has attracted larger share of FDI than its potential and absorptive capacity. So, instead of focusing on policies towards attracting more FDI, it is necessary for Vietnam to pay more attention on advanced levels of policies towards FDI (i.e. upgrading FDI, enhancing linkages, and reducing FDI side effects). Some specific policy implications can be listed as follows:

First, although the policies towards attracting FDI have been working well to attract a larger share of FDI, the government is recommended not to offer too many incentives to foreign investors. Over the last few decades, Vietnamese government has applied many unnecessary welcoming regulatory regimes to attract more FDI. Some provinces in Vietnam focus on the quantity of FDI too much to concern about its quality. Therefore, it is necessary to limit the incentives towards FDI to only selected projects and investors that are relevant to the country's development strategy, rather than offering investment incentives to all kinds of FDI projects.

Second, the government should pay more attention on the quality of FDI. Requirements of FDI technology, technology transferring, environmental safety need to be tightened up. Financial and non-financial sanctions are necessary to guarantee the effectiveness of laws and regulations.

Third, the low Global Opportunity Index shows the weakness of Vietnam in institutional quality. Therefore, it is important to comprehensively upgrade the institutional quality. The country needs to perform a SWOT analysis for the quality of its institution, in which the priority areas should be clearly identified by the government to implement an effective institutional reform agenda.

Forth, Rule of Law can be improved by stricter financial and non-financial sanctions. Corruption problem which is one of the key obstacles that limits Rule of Law and Quality of Regulation should be eliminated. In order to enhance Ease of Doing Business, it is necessary to evaluate and reform the quality and effectiveness of the existing agencies. Vietnam should form national FDI promotion agencies with a view of one-stop-shop for foreign investors.

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Fifth, to improve Vietnam's absorptive capacity, the government should focus more on human capital. Labour market needs to be reformed to meet the working standards of investors. In order to do so, labour law should target to reach the International Labour Organization standards. Vocational education needs to be promoted and training programs should aim to upgrade their skill and knowledge. Policies towards promoting foreign language education would also increase the number of worker with a foreign language. In addition, it is necessary to design training program for bureaucrats on how to handle with inquiries and how to communicate with foreign investors.

Sixth, in order to make the most of FDI, policies enhancing linkages need to be developed. The policies should guarantee the spillover effects from MNCs to domestic firms. It is very important for the country to develop its supporting industry, industrial clusters, special economic zones as to increase exchange opportunities in terms of skill and knowledge. Cooperation in business, manufacturing and research should be also encouraged by either government incentives or compulsory regulations.

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