

## Taking the Next Step : What Influences the Decision of Household Businesses to Formalize into Companies?<sup>1</sup>

The introduction of the Enterprise Law in 2000 has encouraged a large number of household businesses register to become companies in Viet Nam<sup>2</sup>. Such a movement is defined as a formalization process in this bulletin. Although this formalization process has been rapid in the last five years, the informal sector (including household businesses) still accounts for a large share of Viet Nam's economy. The bulletin first provides an overview of the household enterprise sector in Viet Nam. Next, it focuses on the benefits and costs of the formalization process. Then the bulletin discusses issues influencing the decision to formalize. In the last section, it highlights measures at central and provincial level that could encourage formalization.

### Overview and Background

The formalization of businesses is the process of making business activities more transparent and bringing them under a comprehensive, stable system of laws and administrative measures. Formalization, so defined, leads to greater predictability and better-informed decisions by investors, managers, employees, and government authorities alike. As such, formalization can contribute to a better allocation of a country's resources and more efficient functioning of the economy.

Household businesses in Viet Nam are certainly not a fully informal form of

enterprise, as they are registered with state authorities at the district level. Furthermore, many regulations governing the setup and basic operations of household enterprises are the same as those governing sole proprietorships, the simplest form of company. Thus, companies can be considered to be relatively formal and household businesses can be considered as relatively informal in the Vietnamese context. Nonetheless, it is useful to discuss issues surrounding the movement of firms from the household business sector to the company sector. Figure 1 below explains the degree of formality of Vietnamese businesses:

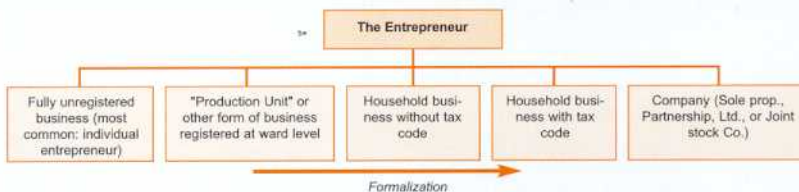


Figure 1: The Entrepreneur's Decision: Which Degree of Formality?

Currently the official legal framework for household businesses is not consistent and transparent. Household businesses and formal companies of similar size and undertaking similar activities are covered by different regulations. On the other hand, similar sized household businesses can be treated very differently depending on their location and the attitude of local authorities. In general, the regulatory framework that covers the activities of household businesses is less comprehensive, less transparent, and less strictly implemented than the one that covers companies.

Private and household owned businesses have long been a part of Viet Nam's economy. Even during central planning - when these forms of enterprise ownership were not legal - they were nonetheless crucial to the functioning of the economy and to social welfare. Two decades of doi moi reforms - especially the last five years - has witnessed an accelerated process of formalization of household businesses into companies.

Recent research under the Making Markets Work Better for the Poor project shows that the process of formalization

of household businesses into companies accounts for a significant proportion of total newly registered companies<sup>3</sup>. Among companies surveyed, nearly half operated informally for some period of time prior to formalization, and nearly a quarter operated for some time prior to formalization as a household enterprise. In the survey sample there are, on average, four years between the date of starting operations and the date for formally registering as a company.

The survey findings also showed that the formalization of household businesses into companies boomed in the early part of the year 2000 when the Enterprise Law took effect. This was particularly true for businesses located in the North. While three quarters of formalized businesses in the North operated before the promulgation of the Enterprise Law and were formalized into companies as soon as the Law took effect, the figure in the South is 40 percent.

Household businesses in Viet Nam outnumber companies by about 43 times. In 2003, there were 2.6 million household businesses and 60,000 private companies in operation in Viet Nam according to General Statistics Office's figures. There are no specific figures available for the gross domestic product (GDP) share of household businesses. Official statistics only show the share of household ownership sector which was 30.11 percent of GDP in 2004.

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<sup>1</sup> The term company is used in this bulletin to refer to the four forms of enterprises governed by Vietnam's Enterprise Law: sole proprietorship companies, partnership companies, limited liability companies, and joint-stock companies.

<sup>2</sup> The term household business in this bulletin refers only to non-farm household businesses, i.e. *ho kinh doanh ca the*.

<sup>3</sup> See "Private Enterprise Formality and the Role of Local Government", Discussion Paper No. 2, *Making Markets Work Better for the Poor*, Asian Development Bank, 2005 available at <http://www.markets4poor.org>. The study included surveys in 3 Northern provinces (Ha Noi, Ha Tay and Thanh Hoa) and 3 Southern provinces (Ho Chi Minh City, Dong Thap and Ca Mau) which covered 120 companies, 120 household businesses, 50 credit institutions, and 96 state offices in six provinces.

## Formalization Comes with Benefits and Costs

Increased formalization of household businesses will yield benefits to Vietnamese economy as a whole. This happens as the results of the increase in the standardization of labor conditions and environmental impact, clarity in division of government responsibilities, information inputs for policy analysis and formulation, revenues into national tax system and capital mobilization from greater investor confidence. However, more formalization may increase workload for government, especially local authorities whose existing capacities are already strained.

At the same time, formalization to company status brings about certain benefits for entrepreneurs. Vietnamese law stipulates some specific rights for companies including: the right to legally employ more than 10 workers, the right to officially enter into commercial transactions, the right to have value-added tax (VAT) invoices, the right to open branches, the right to mobilize equity capital, the right to legally access broader markets, both domestic and abroad, through direct import and export contract. These rights create favorable conditions for business expansion and development. Of course, company owners also have to take some responsibilities such as company registration with public announcement, employing a certified chief accountant, reporting to local authorities and paying tax in a standard tax calculation instead of a lump sum tax amount.

The major benefits and costs of formalization for the economy and for the enterprise are summarized in the Table 1.

### Factors Influencing Formalization Decision

Whilst many benefits of formalization accrue to the economy as a whole, the process of formalization will not occur if benefits are not apparent at the firm

level. Thus, it is the entrepreneur who makes the final decision on whether to formalize. In theory, some factors that may influence an entrepreneur's decision to formalize include:

- *Size of enterprise*: the numbers of workers or capital investment may significantly influence formalization
- *Enterprise performance*: better performing business ventures may be more likely to formalize than others.
- *Entrepreneur's background*: political connections or previous business experience may influence the formalization decision.
- *Infrastructure*: better and cheaper access to roads and certain utilities may influence the formalization decision.
- *Accessibility to markets*: a larger, more established local market may influence formalization
- *Industry*: participation in certain industries may increase or lessen chances of formalizing.

In addition to the above factors, the aforementioned survey revealed other factors that significantly influence entrepreneurs' formalization decisions:

*Provincial business environment*: The survey showed that provincial business environment has a great influence on company registration or formalization. Private sector development remains highly concentrated in a selected number of provinces and cities. In Ho Chi Minh City, in particular, about 90 percent of the surveyed companies started operations only after registering since the Enterprise Law took effect. The city was also the first to make registration of businesses available online. This provides some evidence of the important role of a business environment with greater transparency and rule of law in promoting the growth of formal businesses.

*Tax Policies*: A complicated tax system with different tax incentives and tax rates is considered one of the main factors influencing the movement between household business and company

forms. According to the surveys, more companies are able to get preferential tax benefits than household businesses, with 30.8 percent of the total sampled company owners able to receive preferential tax benefits while only 7.5 percent of household enterprise owners enjoyed such benefits. On the other hand, unreasonable and imprecise regulations governing taxes and tax calculation in many cases have led companies and household businesses to switch their ownership form. In An Giang province, for example, 279 companies submitted official paperwork for closing their businesses over the period of 2000-2003. In September of 2003 alone, 120 did so, nearly all of which were gold and silver traders and pawn shops who had decided that the tripling of the annual registration fee for companies meant that it made more sense for them to operate as household businesses. At the other end of the spectrum is Ho Chi Minh City, where a change in tax regime at An Dong market led many household businesses to formalize into companies.

Meanwhile, access to credit is found to be relatively unimportant in the formalization process. The ability of private companies to access bank financing was greatest in the rural Northern provinces, i.e. the provinces home to the smallest numbers of private companies.

### Uniform Measures are Needed to Encourage Formalization

There is a clear and substantial variation in the formality of household enterprise across provinces in Viet Nam. Businesses of the same size are making different decisions about whether or not to operate as companies depending on their location. This bulletin offers some recommendations for economic governance at the central and provincial levels.

At national level, laws need to be clearer, more concise, and targeted for a more uniform business regulation and greater formality. This is important as unrealistically complicated, broad or vague laws are more likely to be interpreted in significantly different ways across provinces in Viet Nam's highly decentralized system. For example, Viet Nam's complicated tax regime would require simplifications which could potentially replicate the success of the Enterprise Law and give another boost to formalization

At the provincial level, there is also scope for improvements of state management of business activities. A transparent implementation of policy process that deal objectively with all enterprise forms, minimizing subjective decisions to which firms need to be regulated and which do not, will create a level playing field for businesses. However, when implementing a wider coverage of policy to different type of enterprise forms, the increased inspections and harassment of existing companies should be avoided. Reducing differences and subjectivity in the way local officials apply the national tax regime across different enterprise ownership types would certainly help the formalization process.

Table 1: Main Benefits and Consequences of Formalization in Viet Nam

	Main Benefits	Main Costs
<b>Economy</b>	<ul style="list-style-type: none"> <li>• Increased standardization of regulation of labor conditions and environmental impact</li> <li>• Increased clarity in division of Government responsibilities, especially at local level</li> <li>• Increased information inputs for policy analysis and formulation</li> <li>• Increased tax collection revenues into tax system</li> <li>• Greater investor confidence leading to increased mobilization of capital</li> </ul>	<ul style="list-style-type: none"> <li>• Increased workload for Government, especially local authorities</li> </ul>
<b>Enterprise</b>	<ul style="list-style-type: none"> <li>• Right to legally access broader markets (i.e. trade beyond district)</li> <li>• Right to legally employ more than 10 workers</li> <li>• Stamp for making transactions more official</li> <li>• VAT invoice</li> <li>• Right to set up branch</li> <li>• More predictable, law-based relationship with Government</li> <li>• Ability to mobilize equity capital (Ltd. &amp; JS Cos. only)</li> <li>• Greater access to Government investment incentives</li> </ul>	<ul style="list-style-type: none"> <li>• Greater costs of registration (and required public announcement)</li> <li>• Requirement for certified chief accountant</li> <li>• Increased State reporting requirements</li> <li>• Increased restrictions due to labor contracts requirements</li> <li>• Potential of increased attention from local authorities (regulators)</li> <li>• Potential for increased taxes (with move from lump sum to standard tax calculation).</li> </ul>

## Viewpoints

**Household businesses have an important role in the economy of Viet Nam**

Household businesses are legally recognized form of business in Viet Nam. Although they are not considered as a fully formal form of enterprise, they are the suitable for start-up entrepreneurs, handicrafts makers, and petty traders. In the transition to a market economy in Viet Nam, household businesses still exist as an appropriate form of business for many people.

*Dang Minh Tuan, Head of Business Registration Office, Hanoi Department of Planning and Investment.*

In the private economic sector, household businesses far outnumber companies and have their presence even in remote areas. They contribute significantly to employment creation, investment capital, GDP and state budget. Household businesses are also a very important distribution channel, meeting the needs for food, consumer goods and services, stabilizing prices, eventually making markets work better for the poor. Thus, they help to eliminate hunger and reduce poverty and act as the incubator for the development of private enterprises, production units and cooperatives.

*Ngo Thanh Nhon, Head of Business Registration Office, Ca Mau Department of Planning and Investment.*

Household businesses in Viet Nam will continue to exist as the economy is transforming from an agricultural based economy with small scale production to a market-oriented economy. Decree No. 109/ND-CP on business registration by Prime Minister stipulating that any household businesses either with 10 or more workers or with 2 business locations or more must register as formal enterprises and companies encourages business operate in a clearer manner and eliminate the scattered activities. This does not mean limiting or preventing the development of household businesses, as this group is a very important distribution channel in rural and remote areas. In my opinion, Decree No. 109 aims at encouraging those with a certain level of business performance and production scale to register as formal companies so that they can be under a comprehensive system of business management.

*Vu Quoc Tuan, Senior Expert, Prime Minister Research Commission (PMRC)*

**Benefits and costs of formalization in Viet Nam**

Formal enterprises and companies

will get more benefits as they can broaden the scope and network of business operations, and have relatively easier access to credit and land. They also enjoy favorable policies in domestic investment, industrial zones and export processing zones, and incentives in certain industries. Formal enterprises or companies have legal entity status with a stamp to make official business transactions at home and overseas. For the state, management and tax collection will be easier and more effective with formal private enterprises and companies.

*Vu Quoc Tuan, Senior Expert, PMRC*



I know that small household businesses without valuable assets have little chance to borrow from the banks. Although the banks have their own principles, I think they

should make it easier for the genuinely poor household businesses to access loans. Banks should find the way to work with them and understand their businesses so that loans will come to the right businesses who need such loans.

*Vo Tan Phung, Owner of Shrimp Breeding Production Unit, Ca Mau*



When my business was still a household enterprise, and even now when it has been registered as a formal private enterprise, I have not benefited from any special treatment

for my needs in production space, export partners and bank loans. Workshops on small and medium enterprises appeal for the development of handicrafts production but when it comes to the local level I face real difficulties. When I asked for a loan to build a production workshop, it was not approved from the basis that it would take long to pay back. Also, I got no support from the local authority when requesting for land to rent.

*Ho Thi Bach Tuyet, Business Owner, Traditional Doll Production Enterprise*



At present, household businesses do not have to comply with regulations on insurance, fire prevention, environment, etc. whilst formal business must

comply with these regulations. For credit, the regulations are the same for both a household enterprise and a formal enterprise - a loan is approved after requirements by the bank

including collateral are met. Household businesses cannot import and export directly, but they can export through an agent. Therefore, if household businesses are not well managed and classified it will not be fair for the formal enterprises.

*Vu Duy Thai, Deputy President cum General Secretary, Ha Noi Industry and Commerce Association*



The Bank for Investment and Development of Vietnam's policy is to treat all clients fairly and create the favorable conditions for them in accordance with its

rules. However, different "ceiling" levels for loans are applied to different business types. The difference in the ceiling of loans are set due to BIDV's understanding that different levels of business form, scale, performance and administration will result in different demands for loan. In case two clients are a household enterprise and a formal company of the same size who meet BIDV's requirements, they will be treated equally within the ceiling applied to each of them.

*Nguyen Dac Thanh, Credit Manager, Bank for Investment and Development of Vietnam - Saigon Branch*

**Issues affecting entrepreneur's decision on degree of formality**

When I began my business in 2000, I chose the form of a household business because I wanted to see how it would go on and expand if successful. Two years later, I decided to change into a formal private enterprise because I felt this form is suitable for the size of my business with more than 10 regular workers. Moreover, I think it will be easier to ask for a bank loan and access land, as a formal enterprise. Besides, the tax calculation for a formal enterprise will be clearer and more rational.

*Nguyen Minh Thang, Owner, Minh Ngoc Private Enterprise, Ca Mau*



Our business was established in 1921 by my grandfather. During the last 60 years we operated as a household business. My business size is

relatively small with only one machine to make pho noodle and 2 to 3 workers, serving some regular customers within the local area. So it will be ridiculous if I register my business as a company. I will do that only when I have an export

contract so that I can make direct transactions with foreign partners without involving an intermediary.

*Tang Quang Ha, Owner of Da Kao Noodle Making Production Unit, Ho Chi Minh City*



Because I have certain understanding about laws and regulations, I registered a limited liability company when I left the state sector and started my business. In my opinion, limited liability company is best suited for my business. First, it is easier for a company with full legal status to access bank loan or land to expand production, to recruit more workers and to participate in various programs. Second, standard tax calculation is applied without an imposition of lump sum tax applied to household enterprises. Third, as a registered company, I can open branches and sign import and export contracts which I would not be able to do as a household business.

*Le Trung Hieu, Director, Le Tri Limited Liability Company, Ho Chi Minh City*

In my opinion the decision to choose the form of business by the owner is based not only on the production scale but also on the business customs and psychology. It is easy to realize that most of the businesses owned by the Chinese Vietnamese in District 5 of Ho Chi Minh city are household businesses despite their large capital, sometimes amounting to billions of dong. One of the reasons for this is that these people do not like to show off their businesses. They just need good business partners and fellow traders for a good business. They tend to avoid dealing with administrative procedures regulated by the state authorities.

*Nguyen Duc Thanh, Credit Manager, Bank for Investment and Development of Vietnam - Saigon Branch*



Most of those who choose to establish household businesses think it is suitable for their production scale, management ability and labor resource. In addition, business registration procedures for this type of business are relatively simple and quick. They do not have to do submit accounting reports and

prepare balance sheets. Only when they want to expand production scale, look for trading partners for import and export contracts and access bank loan and land, do they register a company.

*Ngo Thanh Nhon, Head of Business Registration Office, Department for Planning and Investment, Ca Mau province*

### Taking uniform measures to encourage formalization



The regulations for business formalization under Decree No. 109 are nothing more than administrative regulations. In my opinion, other measures, especially economic ones, have to be taken in parallel to promote this process. In particular, a number of uniform measures to encourage, guide and assist the formalization from household businesses to companies are needed. For example, they include granting tax code to all household businesses to create equality in tax payment to all sectors, assisting businesses during their start-up phase in preparing business plan, providing loan and production space, creating an enabling environment at local level and directly assisting enterprises to overcome difficulties. These are very important as the central policy is open and clear but not implemented at the local level.

*Vu Quoc Tuan, Senior Expert, PMRC*

The case of District 10, Ho Chi Minh city shows that the guidance, assistance and advice on tax policy has made most enterprises feel secure enough to do business. In District 10, there are about 20 newly registered companies every month, half of which are formalized household businesses. In my opinion, the Government should refund a portion of VAT to consumers when they buy goods and services with VAT invoices. This will promote household businesses to do the accounts and use VAT invoices in doing business. In the long term, it will help household businesses meet accounting requirements to become companies.

*Bui Van Tuong, Head of District 10 Tax Authority Branch, Ho Chi Minh City*

It is necessary to classify household businesses to have reasonable and effective policy. In my opinion, we can divide them into 3 groups. The first

group consisting of petty trade businesses carrying activities at a certain location to earn a living such as greengrocer's, fruit shops... should get tax exemption. The second group composing of small businesses serving residents within a limited area (a street, for example) should be assigned an annual fixed amount of tax, be granted "mon bai" card (a kind of business registration license) without tax code and be administered by local authority. The third group including relatively big businesses supplying a large amount of goods and services in a large area should be formalized to a company through encouragement and other sanction measures. This classification brings about many benefits such as more effective management, fairer government treatment, taxing the right businesses and giving better statistics.

*Vu Duy Thai, Deputy President cum General Secretary, Ha Noi Industry and Commerce Association*



There clearly are significantly different levels of formality across provinces in Vietnam today. Provinces with more formal economies are also the provinces with more jobs and higher incomes. The more rules-based, transparent business environments of Ho Chi Minh City and Binh Duong, for example, have drawn large inflows of domestic capital from investors in other parts of the country. Even highly rural Mekong Delta provinces like Ca Mau and An Giang are drawing investors from far off northern Vietnam. This reflects the close relationship between local business environment and the degree of formalization. A better business environment should convince more entrepreneurs to operate formally, while a greater degree of formalization will make business more transparent, build up investors' confidence, attract more capital and create more jobs. It is imperative that other poor provinces in Vietnam come to understand these lessons and make efforts to establish a healthy business environment to reinforce the formalization into company. As we have seen in our research, simply throwing more financing at the problem has not proved effective.

*Markus Taussig, Strategy Unit, Harvard Business School*