

# The Political Economy of Small and Medium-Sized Enterprise Development

## Characteristics, Productive Value and Market Constraints in Industrial Manufacturing

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*This paper highlights the importance of small and medium-sized enterprise (SME) development and introduces the theoretical concept of productive value for qualitative analysis of firms. Vietnam's industrial development experience is used as a case study. Although the Vietnamese government has channelled rents and business opportunities towards the state sector, the domestic private sector has been crucial to the country's industrial development. Given this context, this study analyses how Vietnamese SMEs in the private sector generate productive value and overcome market failures that constrain their growth. Research findings demonstrate that most local SMEs in the industrial sectors rely on low pricing strategy to attract buyers. However, those that grow in size frequently go beyond price competition and concentrate on creating new productive value in their production and services. Furthermore, unlike SMEs in developed countries, in Vietnam, firm size is an indicator of productive value and strength. From this perspective, SME development policies in emerging economies must focus on promoting the growth of domestic firms over time.*

**Keywords:** SME development, industrial policy, productive value, value-added, mixed research method, Vietnam.

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### 1. Introduction

Development success among developing countries is rare. Other than the Asian Tigers and Japan's successful experience in the first half of the twentieth century, few countries, most notably China, have

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been successful in transforming their economies sustainably. Without exception, the successful experience has involved growth and development of key industrial sectors as well as entrepreneurs and firms that force the necessary process of economic and industrial transformation. Vietnam is a latecomer among the few countries that have hit significant milestones, achieving economic and industrial transformation fairly recently. When Vietnam embarked on its economic reform programme in 1986, the government was intentional in using state-owned enterprises (SOEs) and the public sector to maintain control of the development process. In consequence, state resources, rents and investment opportunities were often prioritized towards SOEs and key sectors such as telecommunications, oil and gas, and electricity. Other than the creation of the Vietnam Law on Investment—passed by the National Assembly in 1987 and 1990, and most recently revised in 2014—that lays out the legal framework for market-oriented activities and investment, the private sector was largely neglected. In other words, private firms and entrepreneurs were left to fend for themselves with little government support.<sup>1</sup>

Despite an uneven playing field while competing with both public and foreign enterprises, local private firms have contributed substantially to Vietnam's economic development in the last few decades. In its 2019 "Productivity and Competitiveness of Vietnam's Enterprises" report, the United Nations Development Programme (UNDP) highlighted that, in the manufacturing sector, private firms generate substantially higher—approximately six times—value-added than SOEs (UNDP 2019). Furthermore, in 2015, private Vietnamese firms hired 7.71 million workers compared to approximately 1.37 million workers employed by SOEs (Ministry of Planning and Investment 2017). Finally, Vietnamese private firms contributed 41.7 per cent to Vietnam's GDP in 2017, compared to the 28.6 per cent contribution by the state-owned sector (Cameron et al. 2019). Vietnam's economy is largely dominated by small and medium-sized firms (SMEs). Therefore, the growth and contribution of the private sector can be attributed mainly to the successful capacity-building of SMEs.

Industrialization in the manufacturing sector has three main drivers: first, improvement in productivity to expand production at lower costs; second, improvement in value-added of output; and third, adoption of new production techniques and technological innovations by adapting them to local input factors. In the context of a transition economy where firms face a number of constraints and setbacks, satisfying all three performance criteria can be challenging. Combined with investment risks and a severe lack of resources, the probability of failure immediately soars.

In the context of economic transition and political economy of socialist transformation, Vietnamese firms not only proved to be extremely resilient when faced with challenges, but also achieved a certain level of industrial capacity (Gray 2018; Ngo 2016b, 2020). The measured but successful industrial development of Vietnamese SMEs provides helpful lessons for development. From this perspective, this paper attempts to answer three research questions. First, how have Vietnamese SMEs created enough productive value in their industrial activities to become competitive within production networks at home and abroad? Second, how have they overcome market and institutional failures that are pervasive in the country? And third, what are some of the policy options to further promote the development of SMEs given Vietnam's political economy. This study primarily focuses on the manufacturing sector because it embeds the largest benefits of firms' growth and spillover effects to the country's overall growth and development (Cimoli, Dosi, and Stiglitz 2009; List 1984).

## **2. Research Method and Data**

This paper utilizes qualitative research, especially analytical case studies, to assess the transformation of Vietnamese SMEs and their contribution to the industrial sectors. We separately observe small and medium firms to tease out details and nuances in their evolution of development, as well as the characteristic

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differences of the two groups given their size. Based on the insights provided in the case studies, we put forward practical policy suggestions to further promote Vietnamese SMEs. In order to support this qualitative study with statistical analyses and findings, the Appendix presents useful data from a recent survey of SMEs in Vietnam to contextualize some key aspects of their business activities, the constraints they face, and the policies they consider most useful for expansion.

This paper adopts the World Bank classification of enterprises, which separates all enterprises into three groups. Small enterprises have up to fifty employees,<sup>2</sup> medium enterprises between 51 and 300 employees, and large enterprises over 300 employees.<sup>3</sup> The qualitative data are primarily based on two fieldwork trips conducted in June, July and November 2016, including thirty-four in-depth semi-structured interviews with firms' owners and/or managers, government officials, bank managers and experts. These interviews spanned seven different provinces and cities in Vietnam—Hanoi, Ho Chi Minh City, Hai Duong, Hung Yen, Binh Duong, Vinh Phuc and Dong Nai. We interviewed a total of twenty-six manufacturing firms, including nine small enterprises, seven medium enterprises, six large enterprises, and four large foreign companies that source industrial components from Vietnamese producers. During the interviews, we sought to identify key factors that either enhance the productive value of the firm's output or impede its performance. The interviews were up to three hours long. All thirty interviews were conducted by one of the authors in Vietnamese. The remaining four that involved foreign investors were in English. Most interviews were recorded with the permission of the interviewees and later transcribed into text. If we could not obtain permission to record the interview, notes were taken, and a detailed summary of the interview was prepared later. All qualitative data presented in the case studies were carefully triangulated and cross-checked across different interviews and the literature.

The rest of the paper is organized as follows. The next section puts forward the conceptual and analytical framework underlying the case studies, with a particular focus on constructing the theoretical concept of "productive value". Further, this section reviews major market failures frequently faced by SMEs and the factors that affect their overall growth. The fourth section analyses how Vietnamese SMEs create productive value and overcome market failures. The subsequent section offers policy suggestions for the development of SMEs in Vietnam. The final section concludes by highlighting the contribution of the paper within the economic development literature.

### 3. Conceptual and Analytical Framework

This section provides a conceptual framework of three important aspects of SME development: first, productive value generated by firms' activities and organization; second, identifiable market failures that explain the bottlenecks undermining SMEs' efforts to acquire industrial competitiveness; and third, factors that explain differentials in firm performance.

#### 3.1 Firms' Creation of Productive Value

*3.1.1 Definition of Productive Value:* Conceptually, productive value is defined as the advantages that firms gain through improvements in production, management and business practices. This is achieved through, for example, increasing product quality, improving customer service, guaranteeing product quality and performance after sales, reducing costs and reliance on intermediate goods, and increasing labour productivity by upgrading technical capability, production organization and managerial skills (Cimoli, Dosi, and Stiglitz 2009; Khan 2019; Penrose 2013).

Economic literature is prolific in identifying the factors contributing to firms' productive value. First, the literature focusing on firm's development stresses the importance of learning by doing and cumulation

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of tacit knowledge in production (Arrow 1962; Khan 2019; Lall 1992). In their in-depth research into an auto assembly plant over a one-year period, Levitt, List, and Syverson (2013) find “considerable evidence of learning by doing in quality and quantity productivity performance, particularly early in the production year” (p. 635). Interestingly, the researchers found that “most of the knowledge stock built by learning does not stay with the plant’s line workers” (ibid., p. 645). “Instead, it quickly becomes embodied in the physical or broader organizational capital of the plant,” allowing for tacit knowledge to be permanently integrated into the production processes of the firm (ibid., p. 645). Therefore, productive value created through learning by doing is not a temporary improvement, but would enhance firm’s capacity perpetually.

Second, the availability and effective use of capital and labour are also important for the enhancement of productive value. Tran, Grafton, and Kompas (2009) develop an indexing method that “decomposes the contribution of productivity, prices and firm size to the firm’s value-added” (p. 283). Using survey data from 1996 to 2001, the authors find that, in Vietnam, “large firms use capital more efficiently than smaller firms, while labour productivity is somewhat similar among different firm sizes” (ibid., p. 283). In most factories, careful management and arrangement of input/output inventory on the manufacturing floor allow for extra productive space and time, and thus lead to higher output per hour. This is the added value created by a firm’s production organization that leads to higher productive value. Therefore, productive value could be improved by effectively organizing capital such as land, machines and inventories of intermediate goods.

Finally, government and its institutions can also support firms’ productive value (Deraniyagala 2000; Ngo 2016a). Institutional economic literature argues that industrial policies are crucial in assisting firms with capital, labour, infrastructure and market access necessary to motivate long-term investment and to boost industrial capability, thus, productive value (Cimoli, Dosi, and Stiglitz 2009). Hansen, Rand, and Tarp (2009) utilize survey data in Vietnam during the 1990–2000 period to analyse the effects of government assistance. Their research finds that “initial government support to enterprises has been a statistically significant determinant of firm growth, and this is so even when controlling for relations with the state” (ibid., p. 1064). In the motorcycle industry in Vietnam, Ngo (2016b) finds that domestic firms are able to participate in Japanese firms’ production chains given a period of policy protection, such as the local content requirement, imposed by the Vietnamese government. Overall, government policies could provide much-needed support in either minimizing market and institutional failures or offering additional resources, for example, investment capital and skill training, that lead to new business opportunities and promote industrial upgrades across all segments of the economy.

*3.1.2 From Improvements in Productive Value to Development Outcomes:* Improvements in productive value enable SMEs to boost competitiveness and productivity, enhance value-added in their production, and impose a higher mark-up price for manufactured goods. All of these factors could potentially lead to higher profits allowing firms to further invest in their productive value and uphold market power in the long term. Furthermore, an increase in productive value could also lead to critical but unmeasurable benefits such as customer loyalty, brand recognition, and access to the global market. For example, four manufacturing firms that we interviewed explained that customer retention is rare in the manufacturing industries because buyers frequently look to save costs. On the other hand, returned customers are extremely valuable. They offer stable demand of outputs and regular cash flow, giving SMEs the means to invest in technological upgrades and long-term capability building (interviews, four manufacturing firms, June–July 2016).<sup>4</sup>

The concept of productive value is important in qualitative analysis. It enables in-depth assessment of strengths and weaknesses of SMEs beyond standard measurements such as profit, value-added and total factor productivity used in quantitative research. In fact, productive value captures these quantifiable factors

as well as critical unquantifiable factors such as customer loyalty, brand recognition, and trust embedded in the supplier-buyer relationship. In developing countries where the rule of law and contract enforcement are unreliable and costly, many firms operate on the basis of trust gained either through their dealing experience with the customers or by gathering information within the professional network (interviews, eight manufacturing firms' owners and experts, June–July 2016). Similarly, Lim (2016) points out that Vietnamese firms commonly force socio-economic ties with overseas business communities, especially when the business owners share social and intraethnic ties. From this perspective, the unquantifiable factors mentioned above are possibly more significant than the quantifiable factors in analysing how productive value is generated among domestic firms in developing countries. Two case studies in the subsequent section incorporate this crucial theoretical concept. The statistical analysis in the Appendix utilizes value-added and profit as approximate indicators of the productive value of the firms surveyed. In this paper and the survey, value-added is defined as a firm's contribution to the production of goods and services other than intermediate inputs by virtue of its productive activities. In other words, it is the difference between the value of output and the value of intermediate inputs.

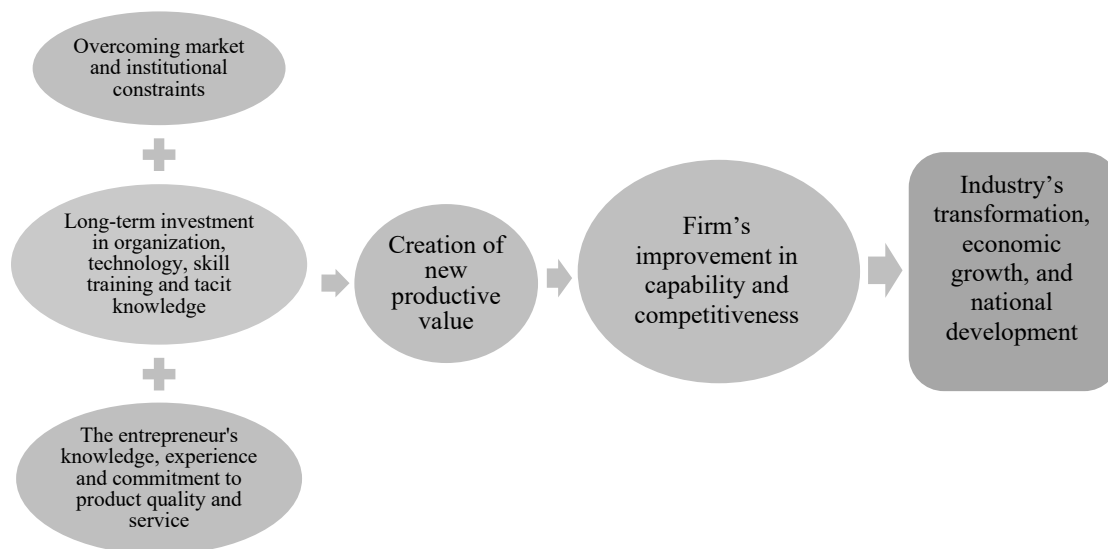
### *3.2 Market Constraints in Developing Economies*

Development economics literature has been prolific in describing market and institutional factors that constrain firms' development and growth. Khan (2019) points out that the absence of investments in formal skill training, advanced technology, co-ordination among state agencies and firms, and learning and organizational capability on the manufacturing floor can severely hinder firms' ability to develop their competitiveness. Similarly, Ngo (2020) reviews and emphasizes the role of market failures hindering firms' ability to adopt new technology and update technical skills. Market failures in technical learning (Stiglitz 2013), learning by discovery (Hausmann and Rodrik 2003), and building organization capability and high learning efforts (Khan 2019) are identified as critical. In addition, uncertain business environments such as major changes in inputs or demand shocks can discourage firms from making a long-term investment in new technologies (Lambson 1991; Tybout 2000). Together, these market failures hinder firms' structural development and thus force local firms to rely on their existing comparative advantage rather than developing new ones. In the context of low-skilled labour and lack of technical training in developing countries, firms can be locked into low-cost and low-skill production, thus preventing them from developing new capabilities (Ngo 2016b, 2020).

In addition to market failures in technology acquisition and learning, failure in the credit market is pervasive, and frequently impedes new investment among SMEs in industrial manufacturing. Some of the key characteristics of transition economies are weak institutions, persistent lack of contract enforcement, and the embedded high investment risk. These factors make lending a risky business for banks and creditors in developing countries. In the absence of development funds from the government or international agencies, private lending credit is extremely limited, and often comes with strict conditions for selection and monitoring (Stiglitz 1993). Furthermore, banks usually prefer to lend to established businesses with verifiable collaterals—most small and new firms in developing countries do not meet these conditions. Consequently, they frequently borrow from informal sources such as family members, friends or social networks (interviews, eight manufacturing firms' owners and experts, June–July 2016). While the conditions for informal lending are more relaxed and there is no application process, the interest rate is often much higher than via the formal channel. For example, in 2016, when interest rates varied between 4 and 17 per cent annually among Vietnamese commercial banks, interest rates for private lending were frequently set at 10 per cent a month (interviews, three small firms and a bank manager, June–July 2017).

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FIGURE 1  
Conceptual Framework of Firm's Productive Value Leading to Economic Development



SOURCE: Authors' illustration.

More significantly, the lack of information regarding changes in market demand, inputs, new technologies, credit, and consumer taste and preference severely impairs SMEs in finding customers and cheaper inputs, and in making informed investment decisions (Sengupta 2012; Stiglitz 1993). Finally, local manufacturing firms surveyed in 2015 reported that their immediate constraints to growth included: what they perceived to be unfair competition with foreign firms and state-owned enterprises; severe lack of marketing services; undeveloped logistics and transport facilities; uncertain government policies; and inadequate or costly access to land for manufacturing facilities. The statistical results describing Vietnamese SMEs' perception of their major constraints to growth are shown in the Appendix Table 2.

In Figure 1, the theoretical relationships among market failures, productive value and SMEs' development are demonstrated. It shows layers of difficulty that domestic firms must overcome, and the essential qualities required of the entrepreneurs. From this perspective, developing successful and capable firms and industries to achieve industrial transformation in developing countries is a challenging process. It requires the government's policies to address the inherent and critical market failures to enable a thriving economic environment for the SMEs.

Based on our conceptual framework and the relevant literature, Table 1 sets up a broad analytical framework for the development of small and medium enterprises. The table presents the factors that influence SMEs' ability to generate additional productive value. Similar to Syverson (2011), we categorize all factors into two groups: internal and external. We ask: to what extent do these factors play a role in either creating new productive value or weakening market failures? And whether their roles vary depending on the firm size? For instance, product innovation may play a larger role in creating extra value in the niche market for small firms than for medium firms, which largely rely on scaled production of basic components for global buyers.

TABLE 1  
Factors That Either Create or Hinder Productive Value of SMEs

<i>Internal Factors</i>	<i>External Factors</i>
<ul style="list-style-type: none"> <li>• Managerial practices</li> <li>• Quality of general labour and capital inputs</li> <li>• Adoption and management of new technology</li> <li>• Involvement in research and development</li> <li>• Learning-by-doing</li> <li>• Product and production innovations</li> <li>• Effective decision-making structure</li> <li>• Production organization</li> <li>• Access to market, inputs, and consumer information</li> </ul>	<ul style="list-style-type: none"> <li>• Productivity spillovers within the economy</li> <li>• Competition: intramarket and trade competition</li> <li>• Quality of institutions and regulations: investment law, labour law, and industrial policies</li> <li>• Stable and/or flexible input markets</li> <li>• Coordination between state agencies and firms, as well as firms within the supply network</li> <li>• Availability of financial credit with favourable lending conditions</li> <li>• Quantity and quality of the labour supply</li> <li>• New market access vs. demand volatility in the global, regional, and domestic markets</li> <li>• Access to industrial land that is in proximity to ports and transport facilities</li> </ul>

SOURCE: Authors' compilation.

By inference, the lack of one or more of these factors imposes constraints on SMEs and hinders their growth potential. This could be due to market and institutional failures preventing SMEs' access to the necessary information, capital and new market discussed above. For example, if a manager of a medium firm lacks technical and organizational experiences in managing 50–300 employees and the medium scale of operation that requires more advanced production techniques, he could undermine the productivity of labour, inputs and machines, and thus operate at higher average costs, or lower productivity levels. Worse, he could make ill-informed business decisions and either revert to being a small firm or exit the industry. In this context, Table 1 provides a guideline for the analysis of SMEs' performance discussed in our case studies. In addition, the factors presented in the table are also important considerations to support SME development.

#### 4. Productive Value and Market Failures of SMEs: Qualitative Analysis

This section analyses how Vietnamese SMEs generate productive value and how some of them overcome institutional and market failures to thrive within the government's SOE-centric agenda. Our qualitative data suggest notable differences in business practices, performance and productive capacity among small and medium firms. This observation is further supported in the statistical analysis showing substantial variations in profit and value-added (Appendix Table 1). Two case studies are presented to demonstrate the comparative differences between these two groups—one case study analyses small manufacturing firms and the other assesses medium firms. In 2015, there were 442,486 enterprises operating in Vietnam, among which, small and medium-sized enterprises made up 433,674 businesses, or 98 per cent of all enterprises (Ministry of Planning and Investment 2017). This leaves large firms with the smallest share,

about 2 per cent of total enterprises. Medium enterprises frequently hover around 8 per cent of the total number. Small firms take up the largest portion, approximately 90 per cent of all enterprises (Ministry of Planning and Investment 2015, 2017).

#### *4.1 Small Manufacturing Firms*

Vietnamese small manufacturing firms display some common characteristics. First, the barriers to entry for many firms in industrial manufacturing are few, as the fixed and start-up costs are relatively small due to the size of the firms and the scale of their operation. As a consequence, there is high turnover among these firms (interviews with five small firms, June–July 2016; see also Tybout 2000). In the component manufacturing industry, small component suppliers only need to buy second-hand machines, hire some workers, and purchase inputs in the local market, and they can already begin to produce in small quantities, especially for aftermarket products and simple components that do not require complex technical skills (interviews, four managers of small firms, June–July and November 2016). Because of limited barriers to entry, the manufacturing industry tends to consist of a high number of firms competing intensely in a small domestic market. Therefore, small firms tend to face fierce competition, which sometimes ends with a price war, low profit and low value-added (interviews, managers of five small firms, June–July and November 2016). This observation is consistent with the descriptive statistics shown in the Appendix Table 1—small firms exhibit the lowest value-added followed by medium firms, though with a wide margin.

*4.1.1 Productive Value:* In industrial manufacturing, small firms are heterogeneous, dynamic and adaptive. The distinctly productive small firms that we interviewed demonstrated awareness of their limitations and strove to generate higher productive value through quality customer service, use of advanced technology for quality production and improved production capacity (interviews, three small firms, June and November 2016). Owners and managers of the productive small firms tend to have more education (most of them are college-educated engineers) as well as training and work experience at foreign companies. Small business owners are often more hands-on with management and production, such that they save costs in management and labour.

More importantly, small firms in Vietnam's industrial sectors frequently act as buffers or lower-tier suppliers for medium and large firms in the local supply chains. One small garment manufacturer that we interviewed explained that other than taking orders directly from buyers, the company often received orders from medium and large firms that would subcontract the job to them, because either the order was too small for these firms or they had reached maximum production capacity (interview, small manufacturing firm, Ho Chi Minh City, June 2016). Such scenarios are unpredictable and often require small firms to be extremely flexible with their production capacity given the volatile demand for their outputs. In addition, the nature of the buyer-seller relationship is uncertain as buyers frequently switch suppliers as they seek to reduce costs. Without loyal customers, small firms are more vulnerable to market conditions and demand shocks compared to medium and large firms. This constraint prevents them from generating sustained productive value by undertaking advanced planning for investment expansion or upgrading (interviews with five managers of small firms, June–July and November 2016). As a consequence, most small firms frequently rely on their existing comparative advantage in cheap labour, land and other inputs. Therefore, most of them only engage in relatively low-tech, low-skilled and low-value production.

*4.1.2 Market Constraints:* Small manufacturing firms in Vietnam face a number of internal constraints such as the lack of market information, weak cash flow, limited management capacity, as well as the



pervasiveness of competition. Therefore, most small firms have less productive value compared to medium firms. First, small firms lack capacity particularly in production management, information on market trends, knowledge of input sources, and managerial practices. Not coincidentally, they also pay the least for management costs, as the owners tend to run the business themselves. Two of the owners/managers of the small firms we interviewed explained that they lacked information to help them identify or predict changes in the local market, consumer taste and preference, technology and the global economy (interviews, two small firms, Hanoi and Ho Chi Minh City, June and November 2016). Further, small firms tend to have weak networks and relationships with suppliers within the industry. Most of the firms that we interviewed did not take part in their industry association and/or information-sharing events with their managing ministry. Finally, small firms often do not have spare financial and human capacity to improve product management or to invest in marketing and branding (interviews, two small firms, Hanoi, June 2016). Small firms that are more successful have owners or managers who had previously worked for a foreign company or gone abroad as exported workers. They learned the trade through working and observing good business practices and thus could orient their firm towards higher value-added production. These firms are scarce among small enterprises.

Although small enterprises save costs in management, they incur higher average costs—defined as total costs divided by the number of units of output—than medium firms. This is because, for small firms, the size of customer orders and the customers themselves frequently change, thus requiring great flexibility in the firms' production capacity. This implies that small firms frequently operate at high average costs to sustain spare production capacity for the occasional large orders (interviews, four small firms, Hanoi and Ho Chi Minh City, June–July and November 2016). In addition, due to intense competition, small firms tend to experience frequent downtimes, which also results in high average costs. The manager of a medium-sized firm that often sourced its orders from smaller component manufacturers explained in an interview that there were over 100 small firms in his industry—mechanical and precision manufacturing—from which his company could source orders. However, reliable small firms capable of providing consistent quality products were few. The same manager said that there were about five small firms that his company often used to source orders from when his company was not willing to fulfil the order itself given the high costs of production for small-volume orders (interview, medium firm, Binh Duong, June 2016). He frequently rotated business orders among these five firms intending to maintain a good business relationship with all of them.

Finally, small firms appear to have limited access to the formal credit market. Six small firms explained that the majority of their investment in the business was from retained earnings and informal sources such as their own savings and borrowings from family or friends (interviews, June–July and November 2016). This observation is consistent with the 2015 Enterprise Survey by UNU-WIDER (2016). The survey reports that, among 1,275 firms that made new investment since 2013, small firms acquired 44.4 per cent of their new investment capital outside formal lending mechanism. Compared to small firms, medium firms drew less from informal sources of capital, at 31.2 per cent (UNU-WIDER 2016). Only one of our interviewees in the small firm group mentioned banks as their main source of borrowing. We asked our interviewees why they did not leverage the investment through bank loans, they explained that commercial and state banks had strict requirements for lending. For instance, firms needed to use land and/or machines as collateral, neither of which the firms had in sufficient quantities, if at all. In addition, there were requirements for tax filings and income statements for the last three to five years, which small firms often did not have either (interviews, six small firms, June–July and November 2016).

We interviewed a branch manager at Asian Commercial Bank, a large private joint-stock bank in Ho Chi Minh City, who made similar remarks about lending requirements for small firms (interview, November 2016). The severe constraint in financing explains the responses from the 2015 Enterprise

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TABLE 2  
Factors Affecting Productive Value of Small Firms

	<i>Internal Factors</i>	<i>External Factors</i>
Strengths that create productive value	<ul style="list-style-type: none"> <li>• Flexible and dynamic</li> <li>• Low fixed cost and management cost</li> <li>• Act as lower tier suppliers and producers for local medium enterprises when they decide not to produce in-house</li> </ul>	<ul style="list-style-type: none"> <li>• Investment law framework allows for business freedom in starting a new enterprise, obtaining a business licence, and securing financing</li> </ul>
Constraints that hinder productive value and development	<ul style="list-style-type: none"> <li>• Severe lack of information on market, technology, domestic suppliers, and consumer preferences</li> <li>• Weak cash flow and difficulty in accessing formal loans</li> <li>• Inconsistent management practices</li> <li>• Inadequate technology adoption</li> </ul>	<ul style="list-style-type: none"> <li>• Low barriers to entry, leading to intense competition in low-tech, low-skilled and low-volume manufacturing</li> <li>• Fragmented and inadequate policy support for SMEs</li> </ul>

SOURCE: Authors' compilation.

Survey. Small firms in the survey mentioned that the government could best help them by providing easier access to credit (Appendix Table 3). The lack of access to credit and finance also explains the low level of new technology adoption among small firms. The Enterprise Survey shows that the percentage of small firms that adopted new technology (roughly 4.1 per cent) was much lower than the percentage of medium firms that did so (17.4 per cent) (Appendix Table 1). Table 2 summarizes the internal and external factors affecting the productive value of small firms based on our interviews and analyses.

#### 4.2 Medium Manufacturing Firms

In general, Vietnamese medium-sized firms share some common characteristics. They make up a much smaller percentage than small enterprises, approximately 8 per cent of the total enterprises. Within the local market, medium firms compete intensely among themselves, and also with foreign suppliers that come to Vietnam to supply components and intermediate inputs for major multinational corporations (MNCs). Most Vietnamese medium-sized firms that we interviewed were lower-tier suppliers for foreign firms looking to diversify suppliers outside of China and to reduce costs. Compared to small firms, medium firms appear to make better use of market information, and of their own productive strengths and weaknesses. While they focus on product quality, they continue to keep prices relatively low in order to stay competitive in the supply chain. As a result, they create more value-added in their production at a stunning scale—seventeen times higher than small firms (Appendix Table 1).

Our interviews with government offices supporting SMEs within the Ministry of Industry suggest that many government policies and subsidies have (intentionally or not) benefited medium and large enterprises rather than small ones (interviews, two government officials, Hanoi, June 2016). One director of a research institute inside the Ministry of Industry stated that it was better that government policies focused on medium and large firms since the strength of these groups would generate spillovers for

small enterprises. The director remarked that, for small firms, it was unclear how they would make the best use of the subsidies since a number of them lacked capacity and might exit the market. On the other hand, medium-sized firms seemed to have proven their ability to develop industrial strengths and competitiveness. Many of the incumbents had survived multiple market downturns over the last two decades (interview, government official, Hanoi, June 2016).

*4.2.1 Productive Value:* Having grown from small and low-capacity production to medium firms, this group of enterprises acquires basic strengths in production, management, and customer service. They often have a long tenure in the industry; some firms even experienced and survived the Global Financial Crisis in 2008–9 and a major downturn in the region in 2012. Vietnamese medium-sized firms also have a clear competitive advantage in (low) price compared to their Chinese, Thai and Malaysian counterparts, especially when taking into account the home market effects, after-sale service and product quality. Three MNCs in Hanoi and Ho Chi Minh City observed that Vietnamese producers offered cheaper pricing options than their competitors in China, Thailand and Malaysia. They explained that the price difference varied from 10 to 30 per cent (interviews, three MNCs, Hanoi and Ho Chi Minh City, June–July 2016). Vietnamese SMEs' competitive advantage in pricing, particularly among medium enterprises, suggests that these firms have a window of opportunity to compete and expand in the international market.

Among the medium-sized firms that we interviewed and visited, some were more active than others in improving their productive value, which was visible in their production plants. These firms paid more attention to improving their production process, maintenance of machines, inventory of intermediate goods, and the discipline of the workers. The firms that were more competitive were also more proactive in promoting their brands, training their workers on a regular basis, and gaining higher levels of international certification. They also maintained contact with supervising government agencies for information on foreign buyers and on government policies, which from time to time provide additional subsidies. Medium enterprises regularly seek out new markets and buyers both locally and abroad.

The differences between high-value firms and low-value ones are visible both at the production facilities and in discussions of their business plans and strategies (interviews and onsite visits, seven medium firms, June–July and November 2016). Low-value medium firms tend to be more passive in seeking new businesses, employ older technology and equipment, and utilize lower-skilled workers. Their production plants are less organized, and their machines are noticeably older, some of which are second-hand equipment imported from China. This is very much in contrast with high-value firms whose facilities are modern and equipped with advanced equipment and technologies. In the context of severe competition with other domestic firms (which tend to compete in terms of price) and foreign firms (which compete in terms of quality), the mid-range medium firms are under tremendous pressure, and yet are highly dynamic in seeking ways to stay competitive in the market. They constantly work towards improving the quality of their products, while still keeping prices low. A manager of a medium firm in Binh Duong province told us that, in order to add extra value to its sales, his company ensured that the delivery took place on time while meeting all the terms set out in the contract. The company also offered after-sale services, which included staying in touch with customers, and fixing any defective products. He explained that it was extremely important that his company was always honest with buyers about possible product defects, provided accurate information regarding the causes, and worked with buyers to remedy any problems with products after sale. In addition, his company maintained close communication with buyers to understand and satisfy their needs, such as delivery methods and payment options. The firm also stayed flexible by accepting rushed orders or delayed payment (up to three months) after delivery (interview, owner of a medium firm, Binh Duong, June 2016). As a result, this company has developed into a respected brand in the industry, and benefited from customer loyalty and referrals from its foreign clients.

Because medium firms often receive larger orders (in terms of quantity) than small firms, the per-unit profit margin is lower for medium firms. Generally, medium-sized firms make up for the loss in profit per output by increasing the volume of production, and thus they earn higher total revenue and profit compared to small firms. Medium firms appear to have a stable and repeated set of customers and are able to focus more on quality production and customer service. The same manager of the medium firm interviewed in Binh Duong explained that, in a given year, he met with over 100 potential customers but only sealed contracts with roughly five new buyers. However, his customers tended to be loyal, and the company had a strong retention rate. Furthermore, he always aimed to develop a strong relationship with customers over the years, whether through technology transfer, communication on product requirements and quality, or just trying to meet the product's requirements while staying flexible with buyers' needs (interview, medium firm, Binh Duong, June 2016).

*4.2.2 Market Constraints:* When we asked medium firms about their constraints, the interviewees tended to answer in two parts—internal and external constraints. Internally, medium firms can often access the credit market through bank loans, although the cost of credit and conditions required to access loans are high, varying between 4 and 17 per cent. Two mechanical parts manufacturing firms in Binh Duong and Dong Nai explained to us that, to grow bigger, they needed lower lending rates so that they could make new long-term investments in machinery, technology, and labour training. Given the high rates of interest in Vietnam, the interviewed firms only borrowed when their clients required new technology investment

TABLE 3  
Factors Affecting the Productive Value of Medium Firms

	<i>Internal Factors</i>	<i>External Factors</i>
Strengths that create productive value	<ul style="list-style-type: none"> <li>• Flexible and dynamic</li> <li>• Customer-oriented</li> <li>• Frequently looking to improve comparative advantage and capacity</li> <li>• Capable management; some firms employ good business practices such as frequent labour training, continuous improvements in production organization, and upgrade of machinery</li> </ul>	<ul style="list-style-type: none"> <li>• Investment law framework allows for business freedom in starting a new enterprise, obtaining business licence and securing financing</li> </ul>
Constraints that hinder development	<ul style="list-style-type: none"> <li>• Severe competition among local and foreign firms</li> <li>• Lack of information and training to broaden market access in regional and global markets</li> <li>• High borrowing cost</li> <li>• Weak labour market that results in high cost of training</li> <li>• Some firms experience increased cost of land in recent years</li> <li>• Heavy reliance on inputs from abroad while lacking information on local suppliers</li> </ul>	<ul style="list-style-type: none"> <li>• Low barrier to entry leading to lots of competition</li> <li>• Fragmented regulations and weak institutional support for SMEs</li> </ul>

SOURCE: Authors' compilation.

or to cover variable costs incurred between production and payment, a period that could vary from three to six months (interviews, June–July 2016).

UNU-WIDER's 2015 Enterprise Survey points out that medium-sized firms are more likely to export. The data show that 42 per cent of medium firms export, compared to 13 per cent of small firms and 1 per cent of micro firms (UNU-WIDER, 2016). To grow larger and achieve higher productive value, medium firms are aware that they need to expand their customer base and access the international market. However, interviewed firms admitted that they lacked the information and capacity to participate in regional and global value chains (interviews, three medium firms, June–July 2016). The same medium firms said that they would like to supply parts and components to international buyers, effectively integrating deeper into more profitable segments of global value chains. However, they simply do not know how to approach new clients and are often quite passive in marketing, branding or acquiring higher international-standard certification to meet buyers' requirements. Medium firms also need support to optimize production and labour management that could improve the overall level of their competitiveness. In sum, the factors behind medium-sized enterprises becoming more competitive in the medium term are: first, access to cheaper credit; second, entry to foreign markets; and third, improvement in production management.

Table 3 summarizes the factors that affect medium firms' productive value and their major constraints discussed throughout this section. Many of the constraints suggested by the interviewees are consistent with the descriptive statistics shown in Appendix Tables 1 and 2.

## 5. Comparative Observations, Challenges and Policy Options

### 5.1 Investment Capital for Technology Upgrade

The small and medium-sized enterprises we interviewed remarked that, to increase investment and productive capability, they needed to make extra investments in labour, technology, machinery and the organization of their production. However, they normally did not look to expand until the demand for their products came close to or exceeded their capacity, or until customers requested products requiring different production or technique (interviews, sixteen SMEs, June–July and November 2016). In this context, accessing capital is crucial for SMEs and Vietnam's industrial upgrading. Nonetheless, our analysis suggests that the effects of financial constraints imposed on small and medium firms vary greatly between the two groups. It is difficult for small firms to obtain bank loans because of their lack of collateral. On the contrary, medium firms find it much easier to borrow because they can use their land, machinery, or a valid contract with foreign buyers as collateral to borrow from banks. However, the rates of interest on traditional borrowing options are too high and thus impose extra investment risks. In this context, policies intended to correct market failure in financing should be targeted more towards the critical differentials in the constraints that this market failure imposes on each enterprise group. Lending from development funds should focus on not only providing easier access to credit but also low-cost lending for qualified small and medium firms, such that they can truly benefit from government policies.

### 5.2 Market Access

More importantly, both groups of firms need new markets to develop. As mentioned, Vietnamese SMEs possess the comparative advantages that allow them to become global suppliers. However, both enterprise groups are bewildered about accessing the international market and approaching foreign buyers. They also seem passive in the domestic market—waiting for potential customers to come to them instead of making the first contact with the buyers. Here, the government could take the lead in attracting foreign buyers, matching interested ones with local firms, and providing training for SMEs on going to international

supplier fairs, bidding for contracts, and making contact with foreign buyers. The Vietnamese embassies, the Vietnam Chamber of Commerce and industry associations should be more actively engaged with SMEs and act as intermediaries between foreign buyers and local enterprises. Furthermore, information sharing and networking between input suppliers and manufacturing firms are lacking among SMEs and could certainly improve with local and central government agencies acting as channels of information and opportunities among firms.

A problem we found in our fieldwork was that domestic small and medium firms are not actively looking for local suppliers, since many of them have customarily sourced inputs from China. This is due to the lack of information available to domestic firms and the availability of cheap Chinese imports. If Vietnamese firms can produce inputs of similar quality and price to foreign ones, the government should provide incentives encouraging local manufacturers to procure materials and intermediate inputs locally rather than from abroad. In addition, government agencies should actively provide information and connect input suppliers to buyers. Many countries promote the practice of “buy local” to ensure strong demand for domestically produced outputs. This practice will help Vietnamese suppliers gain a larger market share at home. It will also enable SMEs to learn and develop capability in its own economy, until they become globally competitive to enter the global supply chain.

### *5.3 Policy Recommendations*

In the short term, government policies supporting small firms should, first, focus on improving their access to information regarding domestic and foreign market opportunities, suppliers, technology and regulations. The policy benefits could be substantial, especially if local value chains are strengthened and further developed. If training is provided by various government agencies, training programmes should ensure that small firms also gain access to this information. Developing and publicizing a completely free and accessible directory that lists names of products and the capacity of each domestic supplier could be extremely useful, especially for firms looking to find cheaper and closer suppliers in the domestic market. Second, it is unrealistic to expect commercial banks to relax their lending criteria for small firms. However, Vietnamese state-owned development banks should loosen their application and collateral requirements for small private firms (not just SOEs) so that credit is more readily available for new investment. They should especially give preference to small firms that demonstrate sound business development plans, technological capacity and long-term objectives.<sup>5</sup>

Finally, our statistical and qualitative analyses point out that small firms fall far behind medium firms in their ability to generate productive value, value-added and profit. This could be due to economies of scale in production, specialization, and high volumes of repeat customers, which together help medium-sized firms outperform small firms. In this context, the size of the firm matters for development. If market demand for the products of small firms becomes more stable, consistent and even expands over time, a large number of Vietnamese small enterprises could take the opportunity to upgrade capability and grow in size. They will then be able to add jobs, outputs, and spillovers to the Vietnamese economy. This must be a policy priority in the Vietnamese government’s SME development strategy.

With regard to medium firms, first, having access to cheaper credit is crucial for the upgrading of these firms. Second, medium firms could benefit from the government’s assistance in market information and consultation in accessing international markets. More specifically, training could focus on how medium firms should present their products and production capacity in regional and international supplier fairs, how to make contact with foreign buyers, and how to prepare and market their products abroad. Third, medium firms also require better access to skilled labour, as this would reduce the cost of on-the-job training and allow the firms to upgrade capacity and productive value over time. Vietnamese universities

should devise programmes that encourage university students to participate in summer apprenticeships that allow them to acquire hands-on experience on the manufacturing floor and to learn more about the production and management of businesses.

Fourth, although the issue of capability building, particularly in production organization and management practices among medium firms, is not as urgent as it is for small firms, the medium enterprises that we interviewed were aware that their capability did not measure up to international standards and there was much room for improvement. This is especially vital if these medium firms aim to expand and grow to become large firms. The medium enterprise that we interviewed in Binh Duong explained that it had been sending managers to business schools and recruiting foreign consultants to help the company expand its operation (interview, June 2016). These activities are costly in terms of time and capital. Government policies could systematically support these activities so that a substantially larger number of firms may benefit from them.

Finally, some medium-sized firms have improved and profited from technology spillovers by collaborating with foreign buyers. Others seem to have learnt more from their training while obtaining international certificates, such as the ISO9000. The Vietnamese government has successfully subsidized some of these training programmes. Nonetheless, a more long-term strategy is needed. The government should consider designing a national system of innovation with SME development as the driving objective. Vietnam, for example, can learn from Germany's skilful use of non-profit research think-tanks such as the Fraunhofer Society tasked to provide direct applied research and development that support German SMEs in manufacturing (Allen 2010). The Fraunhofer Society's research labs frequently work with individual SMEs on short-term projects, either to improve their production process or to reconfigure their product features and quality so that they can stay competitive in the global manufacturing market (Allen 2010). Similarly, Vietnamese SMEs can benefit from R&D institutes designed to support SMEs on product development and/or production improvement.

## 6. Conclusion

Economic development in poor countries is a multifaceted process involving not only institutional, social and industrial development but also the transformation of the firms. Business enterprises are where technology is learned, capacity developed, and workers accumulate new skills as companies enter and exit, entrepreneurs rise and fall, and products become popular only to be outmoded overtime. From this perspective, economic development is a relentless process of change and improvements, starting, among others, from small and medium-sized enterprises. Although the Vietnamese government has channelled rents and business opportunities towards the state sector, the domestic private sector has been crucial in the industrial development of the country. We ask, in the context of the government's SOE-centric policy agenda, how Vietnamese SMEs in the private sector generate productive value and overcome market failures that constrain their growth.

This paper demonstrates that Vietnamese SMEs rely on low pricing strategy to attract buyers. However, those that grow in size over time frequently go beyond pricing and concentrate on creating new productive value in their production and services. The focus on productive value (rather than price) is the sustaining source of strength, market power and competitiveness, allowing them to grow in size and value. In addition, there exist substantial differences in the overall performance of small versus medium enterprises. Unlike SMEs in developed countries where a firm's size is not deterministic of its value, in developing economies, the size of a firm is an indicator of productive value and strength. This is because, as firms grow, they do not expand in just labour and physical capital but also the value that they add to the production process. From this perspective, the aim of SME development in developing countries

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must involve an agenda that promotes the growth of the firm over time. This could be done by reducing constraints that they regularly face, and by providing them with new market access where the possibility of profit encourages risk-taking and investing for the long term.

This study offers three contributions to the political economy of development literature. First, it highlights the importance of SME development in economic transformation and introduces an original theoretical concept of “productive value” for qualitative analysis of the firm. The conceptual and analytical framework presented in this paper adds to the literature an approach to examine the mechanisms that lead to the high or low performance of SMEs in development. Second, using Vietnam as a case study, the research findings explain SMEs’ ability, or inability, to create high productive value and identify the critical market failures that undermine their growth. Finally, our research elucidates and describes specific government policies that support SMEs’ capability building and upgrading in transition economies.

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## APPENDIX

### Descriptive Statistics of Vietnamese SMEs

This appendix provides some descriptive statistics to demonstrate key characteristics of small and medium-sized enterprises in Vietnam. The data presented in the descriptive statistics is provided by the United Nations University – World Institute for Development Economics Research (UNU-WIDER), which conducted the Vietnam 2015 Enterprise Survey.<sup>6</sup> As mentioned, the survey adopts the World Bank classification of enterprises which classifies enterprises into three groups of firms. Small enterprises are those with up to fifty employees, medium enterprises are between 51 and 300 employees, and large enterprises over 300 employees. The enterprise survey was conducted in June and July 2015, and was administered to 2,648 formal and informal small, medium and large enterprises engaged in the private manufacturing sector in nine provinces of Vietnam. The enterprises are distributed across approximately eighteen manufacturing sectors. Among the 2,648 firms surveyed, there were 2,487 small firms, 149 medium firms, and twelve large firms. The wide range of detailed questions in the survey enables us to unveil important factors that influence SMEs' productive value and growth potential.

Appendix Table 1 provides some important summary statistics. Large firms had the highest total value-added (revenues from sales minus total costs of intermediate, indirect, and raw materials) in 2014 at an average of VND21,455 million, followed by medium firms at VND15,177 million. Small firms had the lowest value-added among the three groups with the value of VND885 million, substantially lower than medium and large firms. In terms of total gross profit (total value-added minus total labour costs), medium firms had the highest total gross profit averaging at VND9,085 million followed by large firms with an average profit of VND7,709 million. Once again, small firms fell far behind medium and large firms in terms of profit averaging only at VND519 million. The data show that once small firms grow to become medium firms, they not only grow in size but also in terms of employment, profit and value-added which overall contribute to industry and economy-wide growth and development.

APPENDIX TABLE 1  
Summary Statistics

	<i>Value-added in 2014 (VND million)</i>	<i>Profit (VND million)</i>	<i>Tech</i>	<i>Internet</i>	<i>Difficulties in Recruiting</i>	<i>Red Tape</i>	<i>Informal/ Bribe</i>	<i>Constraints to Growth</i>	<i>Observations</i>
Small	885.7	519.4	4.1%	37.6%	19.0%	1.8%	40.7%	91.6%	2,487
Medium	15,177.8	9,085.7	17.4%	99.3%	36.7%	3.2%	83.9%	99.3%	149
Large	21,455.9	7,709.6	7.1%	66.7%	28.6%	2.0%	33.3%	64.3%	12

SOURCE: Authors' analysis based on Vietnam 2015 Enterprise Survey.

In addition, medium firms also ranked the highest in terms of introducing new production processes/new technology since 2013 (at 17.4 per cent, over four times the share of small firms adopting new technology); Internet access (99.3 per cent); experienced difficulties in recruiting workers with the required/appropriate skill level (36.7 per cent); management's working time spent each month dealing with government regulations and officials including taxes, permits, licences, businesses, and trade regulations (3.2 per cent); paid informal/communication fees (83.9 per cent); and faced major constraints on growth as of 2015 (99.3 per cent).

Small firms had the worst performance compared to other firm sizes; their average value-added in 2014 was only 5.8 per cent of medium firms. Only 4.1 per cent of small firms had adopted new technology since 2013, and only 37.6 per cent had internet access (Appendix Table 1). Despite having the lowest value-added and profits, small firms were the least likely to have difficulties in recruiting labour, were second lowest in paying informal fees, spent

the least time dealing with red tape, and were less likely to face major constraints to growth compared to medium firms.

Appendix Table 2 lists the top three most important constraints to growth, sorted by the shares of firms identifying each. Firms consistently singled out the following three constraints: too much competition/unfair competition; current products/services have limited/reduced demand; and shortage of capital/credit. Large firms also noted the lack of skilled workers, marketing services, logistics, infrastructures, uncertain government policy and inadequate land.

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APPENDIX TABLE 2  
Major Constraints to Growth

	<i>Most Mentioned</i>	<i>%</i>	<i>Second Most Mentioned</i>	<i>%</i>	<i>Third Most Mentioned</i>	<i>%</i>	<i>Observations</i>
Small		41.7%	Shortage of capital/credit	19.6%	Current products/ services have limited/ reduced demand	19.1%	2,277
Medium		31.1%		25.0%		14.9%	
Large	Too much competition/ unfair competition	22.2%	—		Lack of skilled workers in the local job market	11.1%	9
					Lack marketing services or transport facilities	11.1%	
	Current products/ services have limited/reduced demand	22.2%	Government policies uncertain	11.1%			
					Inadequate premises/ land	11.1%	

SOURCE: Authors' analysis based on Vietnam 2015 Enterprise Survey.

Appendix Table 3 reports the shares of firms identifying how the government authorities could best help to expand and increase the enterprise's profits. The top three answers provided by firms of all three sizes were: by providing easier access to credit; by further removing bureaucratic requirements/restrictions; and through better private sector policies.

APPENDIX TABLE 3  
Government Support

	<i>Most Important Help</i>	<i>%</i>	<i>Second Important Help</i>	<i>%</i>	<i>Third Important Help</i>	<i>%</i>	<i>Observations</i>
Small	By providing easier access to credit	18.5%	Through better private sector policies	12.8%	Through better private sector policies	22.1%	2,241
Medium	By further removing bureaucratic requirements/restrictions	22.9%	Through better private sector policies	14.1%	Through better private sector policies	25.5%	144
Large	Assistance with premises/land	30.0%	Through assistance with marketing	33.3%	Through better private sector policies	40.0%	10
					By restricting competition from imported goods (illegally)	40.0%	

SOURCE: Authors' analysis based on Vietnam 2015 Enterprise Survey.

## NOTES

1. In the early period, from 1986 to the 2000s, some private firms were connected to either central or local governments and were more likely to survive.
2. The World Bank, government statistics and research papers occasionally further divide small enterprises into two groups: micro firms with 0–10 employees and small firms with 11–50 employees. This paper refers to small firms as those with 0–50 employees.
3. Vietnamese government, however, classifies small firms to have up to 200 employees, medium firms with between 200 and 300 employees, and large firms with over 300 employees. This classification substantially reduces the number of medium firms compared to the World Bank's classification.
4. When citing more than two firms, we omit the interview locations to retain brevity.
5. Our fieldwork data is inconclusive on whether there is a close local supply network between the state-owned conglomerates and the SMEs given the peculiar characteristics of Vietnamese SOEs and the specific context of the industry that they are in (see Ngo 2020). It is, therefore, uncertain that Vietnamese government could direct SOEs to source inputs from Vietnamese SMEs, as the Chinese government did successfully.
6. Unpublished data collected as part of the project “The small and medium enterprise (SME) survey”, [www.wider.unu.edu/project/small-and-medium-enterprise-sme-survey](http://www.wider.unu.edu/project/small-and-medium-enterprise-sme-survey) (accessed 3 April 2016).

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