

State and Market Relationships: Public Financial Policy Support for SMEs Growth in Vietnam

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This paper investigates the role of the state institutions in creating financial market conditions for SMEs growth. The adequacy of the financial policy regime and the effectiveness of the financial support infrastructure have been discussed to identify the problems of the market development process under the socialist market economy model of Vietnam. The findings indicate that in the context of Vietnam's move towards a market economy, where defective financial market factors and inadequate institutional support mechanisms are evident, it is vital that the state pursues a more entrepreneurial role. Such a role, with adequate financial policy support, tax policy is required to facilitate the development of SMEs. It is also found that the informal sector provided financial resources, such as social networks and private credit for the development of SMEs in the early stages of Vietnam's journey to market economy. An alarming trend is that this informal financial support infrastructure still plays a key role. In addition, there is significant gap between the formulation and implication of financial policy support for SMEs. Furthermore, the SMEs sector has not yet been recognized by the government and society as one of the key driving forces to the development of market economy in Viet Nam.

Field of research: Management

1. Introduction

Transitional economies need to take some specific measures to create conditions so that entrepreneurial activities are encouraged and Small and Medium Enterprises (SMEs) find opportunities to grow in different sectors of the economy. In the absence of a strong market force in a transitional economy, the state has to play a decisive role to create those conditions. The experiences of some transitional economies suggest that in order to attain the critical mass needed to create financial support infrastructure the entrepreneurial role of the state is vital for creating the support infrastructures and institutions adequately resourced to facilitate the development of SMEs.

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Vietnam has been pursuing economic reforms to support marketization process and the development of SMEs. The current situation of business environment in Vietnam is being improved significantly. However, Vietnam is at the early stage of its transition to a socialist market economy. Unskilled labours, poor capital for business activities, lack of lands for business premises, weak supporting services on technology and information are the main weaknesses that Vietnam has to deal with to create supportive market environment for business to grow. These adequate market factors limit the level of the support and make some policy initiatives ineffective. It is apparent from anecdotal evidence that the institutions responsible for devising policies and provide action plans for implementation of support policies are not fully equipped to support SMEs. Furthermore, social discriminations against SMEs still exist strongly. As a result, SMEs do not have adequate access to public resources, especially public financial and credit resource. This has created significant barriers for SMEs to grow. Surprisingly, public credit affordability could be no longer a dream for many Vietnamese SME due to the reason that most of the credit supplies for SMEs are from informal sources or black market with very high interest rates. This paper examines the extent to which the state financial policy of Vietnam effectively supports the development of market principles for the growth of SMEs.

2. Literature Review

2.1 The Socialist Market Economy Model

The Central and Eastern European (CEE) experience suggests that the reduction of government ownership and control in business, business support infrastructure, financial support, legal and institutional framework, cluster and network relationships play fundamental role for business development (Katz, 1995; Assaf, 1998; Konopielko and Bell, 1997; McIntyre, 2002). However, a small or weak public sector may also hinder the growth of the private sector, as experienced by CEE countries when private enterprises operating in a framework of market-determined prices. In the initial stage of transition, these countries suffered some setbacks when SMEs operated in imperfect markets that lacked institutional support (Katz, 1995). In a similar pattern, the public sector has been playing a key role in strengthening the development of a dynamic private enterprise sector and efficient market in the context of Asian socialist market economy model. State and market have been working together to create sustainable market conditions for private sector business development and especially for the development of SMEs. Unfortunately, in Vietnam, informal financial market source is still playing a key role.

2.2 State Financial Policy for SMEs Growth

Support policies for SMEs vary from country to country and from developed countries to less developed countries due to differences in business contexts, culture, and the level of industrialization. The CEE experience suggests that business support infrastructure, financial support, legal and institutional framework, cluster and network relationships play vital role for business development. According to Batra and Mahmood (2003), SMEs in developing countries in East Asia receive support from local governments in the form of micro finance, interventions to increase private sector training, technology development, and market information. China, Malaysia,

Indonesia and Thailand benefited from these policy reforms, network relationship, and the new support infrastructure (Brimble, Oldfield and Monsakul, 2002; Harvie, 2002; Tambunan, 2005) In Vietnam, policies support including financial aids plays a critical role to SMEs' growth (Harvie , 2001).

2.3 Market Factors

In CEE countries, privatisation was introduced to restructure large State Owned Enterprises (SOEs) into SMEs (Gibb and Lyapunov, 1996). McIntyre (2002) argues that disassembling large firms may not sustain SME growth. In Asia, due to the absence of adequate support regime, this idea has proven reasonable, since SMEs in China still need support from large firms. From the experiences of CEE countries, Dallago, and McIntyre (2003) state that SMEs are not themselves sufficient to grow without the proper development of institutions and supporting structures. Identifying the importance of institutional change for the growth of entrepreneurs, Smallbone (2004) suggests that businesses need to adhere to the following conditions: a legal infrastructure that is appropriate to market conditions; the creation of a legal framework that facilitates the development of entrepreneurs; and the creation of commodity, capital, and labour markets.

2.4 Economic Reforms in Vietnam and SMEs

Vietnam has been implementing its national economic renovation program since the 1980s. This economic reform has had remarkable influences on the country's business and economic activities. Weeks (1998) argues that the success of economic transition in Vietnam depends on the role played by the state in managing the transition, rather than leaving modifications to the dictates of market. It could be said that Vietnam does enjoy a significant economic advantage since the government has been able to learn from the experiences of other transitional countries in Asian, Central, and Eastern European countries and has the potential to bridge the gap with step-by-step incremental economic transition processes. Vietnam has been pursuing policies to transform itself from a centrally planned economy to a socialist market economy. However, for this transformation to take place successfully, there needs a policy regime that creates and supports an entrepreneurial culture.

2.5. Previous Studies and Contribution of Our Study

Our research are supported by evidence from studies, reports, and secondary data such as James and Chuong (1997), McMillan and Woodruff (1999), Vu (2001), Nguyen, Bui, Han, Hoang, and Nguyen (2001), Le and Ngo (2002), Ho, Do and Chu (2002), Pham (2002), GSO (2004). Although numerous studies have been conducted on SMEs in Vietnam, only a few studies focused on public financial policy to support SMEs. This paper is significant for the following reasons: Support policies for the development of SMEs may differ from country to country. A successful model in one country may be inappropriate if it is applied in another due to different political, legal, historical, economic, social, cultural, and resource conditions. For that reason, this paper hopes to fill the gap in existing literature by identifying critical financial support policy for SMEs in Vietnam.

3. Methodology and Research Design

3.1 Conceptual Framework

A conceptual framework was applied to examine the evolving relationship between state and market and the impact of that relationship on local SMEs (See Figure1). The conceptual framework included enabling or hindering factors associated with (1) the entrepreneurial role of the state through finance, taxation policy and (2) the role of financial market factors. The SMEs' heavy reliance on informal financial support infrastructure could be considered as enabling factors for SMEs to overcome financial resource constraints. On the other hand, in order to access to those informal credits, SMEs have to pay for very high interest rates. As a result, these difficulties also create hindering factors that could impede the SMEs growth.

This study uses qualitative data drawn from a number of semi-structured interviews held in Hochiminh city, Vietnam. In order to identify key themes in this data, a content analytic approach was taken. For the purposes of reliability and subjectivity in examining the effectiveness of SMEs supporting policies in Vietnam, three groups were selected randomly from public telephone directory books. These groups comprised of six private manufacturers of food and beverage in Hochiminh city; a group of five economic experts, researchers, and government officers working closely with SMEs; and a group of six supporting business agencies whose directors are currently involved in business associations or are running businesses providing consulting services to SMEs. Seventeen respondents were selected randomly and interviewed in June 2006. Semi-structured interviews were conducted. Using the conceptual model, a group - comprehensive questionnaire was developed to address the research issues and to identify the effectiveness and problems of SME-related financial and tax policies. NVivo technique was used to identify themes for a qualitative analysis.

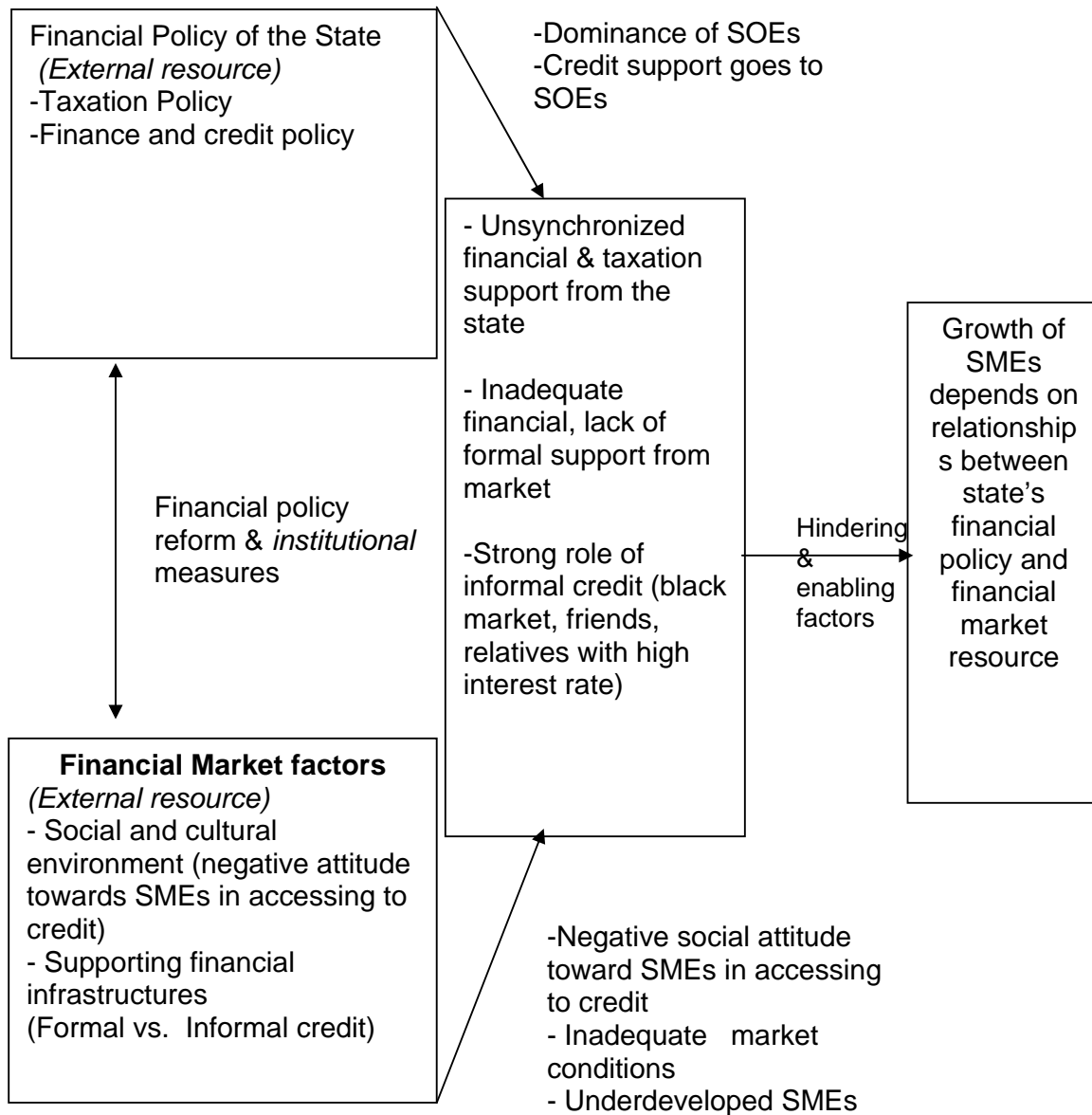


Figure 1. State and Financial Market Factor affecting SMEs in Vietnam

4. Findings

4.1 Summary of Major Finding

The findings clearly show a significant prevalence of hindering factors as opposed to enabling factors in relation to SME support. Collectively, these factors are discussed in relation to the potential entrepreneurial role of the state. The factors encompass policies, resources and infrastructure concerning taxation, and finance.

4.2 Taxation Policy

During the past decade, tax policy has been being used by the government as an important tool to encourage investment. This has created a new environment for an entrepreneurial business development. However, tax policy has not been effective to facilitate business investments.

Unreasonable Favourable Taxation Policy

According to the new taxation law, new start up business can ask for tax moratorium for two years. SMEs in preferential projects and from rural and mountainous areas can ask for more tax incentives. In reality, the tax policy has made no significant change. One respondent states that:

“We would be very happy if the government can offer more incentives to different business forms. I suggest that government should have a special incentive policy for SMEs. However, I do not know how to get such incentive supports and what the prerequisites for applying it are. We do concern about the possibility of getting tax incentive if we want to buy more hi-tech equipments. Is there any clear regulation for such tax incentive policies? Many of my friends have said that the hidden cost of applying for such investment incentives would be higher than the benefit of receiving the tax incentives (SME3-Group1)”

Problems Of Tax Calculation, Collection, And Tax Return Methods

The current tax calculations, collections, and tax return methods have serious weakness. The weaknesses affecting the SMEs growth have been cited by 16 out of 17 respondents during the interview. According to a respondent:

“Information about tax is not updated and the way to calculate the annual income tax is unreasonable. VAT rates may be different from city to city when applying this tax method to different manufacturing SMEs. For example, the rates may be applied differently and depended on whether the entrepreneur has a proper accounting system or not. If an entrepreneur does not have enough invoices, documents, then VAT will be directly collected and imposed by tax officers. The tax rates may be significant different even if applied to the same product category or the same product (SME1-Group 1)”

No significant differences are found concerning the evaluation of the ineffectiveness of the taxation policy in term of tax collections, tax calculations, and tax return methods among the three groups of respondents. However, group 2 and group 3 seem to have clearer views on identifying some major defective points in the current preferential taxation policy. According to them, corruptions in assessment of the tax incentive applications have led to unfair conducts in provisions of tax incentives and created significant hidden costs for SMEs. In addition, the current criteria for receiving tax incentives for firms who are investing their business in hi technology seems to be unclear and inadequate. This is because SMEs do not know what concessionary tax rates that they could receive and how to apply for such incentives. Finally, difficulties in applying for tax incentives have deterred many SMEs from applying for tax incentives.

A shortage of information about tax incentive policies including difficulties and hidden costs in the application procedure for tax incentives and unclear tax incentives policies deterred SMEs from applying for them. Taxation officers appear to have strong power to enforce the tax rates, and this is creating tax return and tax incentive's application difficulties for SMEs. Hidden costs and delays in application processing for tax incentives and tax-free arrangements cause difficulties for both taxpayers and tax collectors. An inconsistently imposed VAT rate also indirectly encourages corruption and tax evasion. The results indicate that there were two main problems in regarding to taxation policies: Problems at the preferential tax policy for SMEs, and problems at tax calculation, collection, and tax return methods. As a result, the current situation of Vietnamese economic development requires a more reasonable taxation policy to encourage investments in establishing new business entrepreneurs and to create the favourable conditions for SMEs to grow

4.3 Financial Policy

During the last few years, financial policy has been improved by number of changes in regulations on the provisions of credits to private sector. In theory, financial supports to SMEs have sharply increased. Due to defective financial support mechanisms that obstruct the flows of capital and savings to business investment, capital mobilisation is unbalanced and cannot satisfy SMEs' needs. In contrast, informal financial credits have been playing an important role to SMEs' needs for capital investments and business developments. It is because the disbursements of public financial supporting institutions and other international financial funds have really driven SMEs away from accessing to those resources.

Problems of Credit Policy

Financial support in the form of industrial loans, subsidies, could be seen as a key driving force to promote SMEs' development. Currently, the shortage of working capital is an acute problem affecting the development of SMEs . As a result, credit funding has become a disincentive factor for SMEs as it has become difficult to reach the supply of credit. The government still does not have any fund to act as guarantor for debtors. Banks tend to reserve credits to SOEs and large enterprises with out asking for securities. SMEs do not have that option and are heavily dependent upon on informal credit sources.

"The complexity of application procedures and bureaucratic behaviours of banks officials do not encourage SMEs to borrow from public sector lending institutions"
(Respondent 2-Group 2)

The problem in credit policy suggests that most of the SMEs' borrowed credits from informal sources such as friends, relatives, and black markets. This transaction affected the growth of market practices in the SMEs sector and distorted the potential for the growth of SMEs. Accessing to other external financial resources was not that easy either. The credit policy has deterred SMEs from accessing to formal public credits. SMEs had difficulties in accessing to other financial sources such as ventures capital, foreign funds, and capital market.

Difficulties in Accessing To Foreign Credit Funds

“The percentages of SMEs who have access to these foreign funds are limited. It is because these funds are not willing to take risks by providing credit to private SMEs as there is no certainty about the future sustainability of these businesses. The lending agencies mainly focus on feasibility of their return from capital investment and try to avoid risk as much as possible” (Respondent 3-Group 2)

Some variations are visible concerning the ways businesses view the usefulness of the present credit policy. SMEs in the group 1 tend to focus on describing the nature of problems that they face in accessing to credit, group 2 and group 3 tend to emphasize more on why the current credit policies are not adequate. The ineffective roles of supporting institutions in helping SMEs to access to credits, inadequate supporting policies and the poor internal resources of SMEs have also deterred SMEs from taking initiatives. One respondent states, *“Supporting institutions are not strong enough to help SMEs” (SME 5-Group 3)*. Other observes, *“The prerequisites for receiving financial support are not adequately defined and publicized that has created opportunities for corruption and inefficiency” (Respondent 2-Group 2)*

Negative views on the current situation of SMEs in accessing to other external financial resource are similar among the three groups, except a respondent in the group two points out that there should be *“rules that require banks and investment funds to reserve a specific proportion of credit to SMEs” (Respondent 5-Group 2)*. The problems of credit policy are: discrimination against SMEs; corruption; strict application procedures; unreasonable credit policy; inadequate land laws concerning land use rights; a shortage of government monitoring; vague roles for supporting agencies in helping SMEs to overcomes financial constraints. The above discussion also highlights numbers of issues: a lack of information about credit policy; and the lack of credit insurance funds to act as guarantors for SMEs to access credit. In addition, while SOEs may have longer terms and lower interest rates for credit without the need for mortgages, due to guarantees given by the government, SMEs are not able to access these advantages. SMEs in Vietnam are currently facing considerable difficulties in accessing to formal credit and they have to rely seriously on informal credit. They also find difficulties in approaching to international formal credits.

5. Discussions and Conclusions

5.1 Poor Financial and Capital Market in Vietnam

Working capital is vital to the development of SMEs. According to Ho, Do and Chu (2002, p 64), *“69.5% of the surveyed small firms and 47% of the surveyed medium firms in Vietnam are currently facing the difficulties of capital constraints. 53% of the total respondents include small firms and medium firms claim that inability to access to public credit funds is the greatest challenge that they have to deal with.”*

The results of this study indicate that SMEs in Vietnam are currently facing significant difficulties in accessing to formal credit and they have to rely heavily on informal credit. In another study, Pham (2002) observes that credits for SMEs from venture capital and foreign funds are very small. This is consistent with our research findings.

In addition, due to poor internal capital resource, SMEs have to rely heavily on external capital funds. There are two sources of financial funds in Vietnam. First, the informal credit funds from relatives, friends, and black market. Second, the formal credit funds from the state owned banks and other financial institutions. Unfortunately, according to GSO (2004, p 65) *“Data on structure of additional investment in 2002 shows that credit capital shared only 38% of total additional invested during the year. Among the 38% of credit capital, SOEs occupy 56.4%, of which 63.4% is concessionaire credit capital of the state.”*

Although credit capital is too low, more than half of the credits are reserved for SOEs. This clearly depicts the fact that SMEs in Vietnam are currently facing significant difficulties in accessing to formal credit and they have to rely heavily on informal credit source (see table 1)

Table 1. Ability to approach credit capital of the SMEs in private sector	
Credit capital from commercial banks (formal credits)	11%
Credit capital from Stated owned banks (formal credits)	21%
Credit capital from relatives and friends, black market (informal credits)	45%

Source:Ho, et al. (2002)

Currently, in order to get access to public credit from banks, SMEs have to satisfy a number of requirements from the banks and other credit institutions. As stated by respondents, SMEs are a bit reluctant to approach to formal credit source because of lack of support. In order to access to credit loans SMEs need to be reliable and have equity. It seems to be impossible for those SMEs, who first attempt to borrow money from the banks. It is because most of the SMEs do not have any borrowing records. In addition, the assessments of value of mortgages are mainly enforced by the banks. These assessments are not verified by any independent assessing authorities so the evaluated value is very subjective and significant lower than the market value. For many SMEs, the most valuable asset that can be used as mortgages is land. However, banks tend to undervalue the lands and provide short-term loans that are equivalent to only 70% of the assessed value of the lands. This has really created difficulties for SMEs who want to invest in business premises or equipments because short-tem credits account for 80% of the total credit funds distributed by commercial banks (Ho, et al., 2002)

5.2 Poor Quality of Financial Supporting Services for SMEs

It could be said that due to many defective market factors, the current unfavourable business environment does not allow SMEs to utilize their creativity and further business expansion due to lacking of information about legalistic and business environment. Moreover, the results of our study indicate that SMEs are neglected by many consulting firms and financial institutions. As a result, they tend to seek guidance from unofficial sources or from their hired advisors for market information and financial advices. Consequently, there is a gap between SMEs' needs and services available for SMEs. According to Ho, et al. (2002), export credit funds can

only satisfy 26% of the real demands. Hence, only a limited number of SMEs and other business firms can access to such funds.

5.3 Social and Cultural Environment

Discrimination among Business Sectors

The research findings reveal that the government and the Vietnamese society do not commonly acknowledge the SMEs' vital roles. Le (2006) and Pham (2002) also suggest that social perception towards private business sector is not encouraging for SMEs. Labourers and the public viewed SMEs as a high-risk business sector. As a result, it is very tough for SMEs to attract qualified labours and access to adequate supports such as credits, lands, and other external resources. Negative social perceptions towards the roles of SMEs would have a significant influence to the development of this private business sector and discourage SMEs intention for business development in many ways. Although the current legal system do ensure the fairness of competition among public and private business sectors, the so-called "unwritten laws" of discrimination against SMEs still exists strongly in the society. Operating in such unflavoured environment, together with defective supporting institutional developments, inadequate regulatory frameworks, and SMEs' poor internal resources, it is obvious that, SMEs are struggling intensively to survive and develop.

Strong Uncertainty Avoidances And Distrust Attitudes

Our findings show that there are strong uncertainty avoidance, distrust attitudes exist among SMEs and other business forms. Having no reliable information, about business opportunities for cooperation, poor internal resource, and social discriminations against SMEs may also deter them from seeking the chance to have strategic alliances, business cooperation with other firms and financial supporting institutions and having better performances. Nguyen (2005); Nguyen, Le, and Freeman (2006); Nguyen, Weinstein, and Meyer (2005); and Ha and Swierczek (2003) also observe that the social perception and distrust have strong negative impact on SMEs' performance.

5.4 Conclusions

The support policies for SMEs in Vietnam are inconsistent and SMEs in the public sector are treated favourably. While private firms are believed as a key driving force of the economy in many regional countries and CEE countries, SOEs are still considered as the main player in the Vietnamese transitional economy. According to Peng and Heath (1996), when formal institutions (e.g., laws and regulations) are weak, informal institutions (e.g., interpersonal ties) may play important roles in facilitating economic exchange and therefore form a more considerable influence on the performance of the firms. The Vietnam experience suggests that SMEs are heavily depended on informal credit sources to overcome resource constraints. McMillan and Woodruff (1999) also state that the growth and sustainability of SMEs is critically influenced by informal credit sources. Such insufficient financial aids have really inhibited SMEs from emerging and maintaining sustainability. The results of this study clearly indicate that after more than 8 years of this journey (since the study of McMillan and Woodruff was published in 1999) to market socialist economy, Vietnam

has not yet successfully created a sustainable market conditions for SMEs to flourish. There is sufficient evidence to conclude that public financial institutions have not played any significant role in supporting SMEs.

In the context of an emerging state and market relationship where large SOEs are still dominant, SMEs in Vietnam need to develop networked relationships and operate within a semi-cluster environment in order to form the critical mass to attract the attention of important policy actors. At the same time, a legal framework and adequate business laws need to be put in practice so that support institutions can work in a more coordinated manner to create a sustainable market framework for SMEs to grow. Vietnam is not in a position to create large internationally competitive business enterprises. To make proper use of its comparative advantages Vietnam needs to develop state and SME relationship and devise market practices around SME activities to build a road to socialist market economy. Efficient, competent, and innovative SMES will pave the way for large domestic and international companies to invest in the sectors that Vietnam has competitive advantage.

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