State Forestry Enterprise Reform in Vietnam

Unlocking the potential for commercial wood growing

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This Technical Note was prepared for on-going dialogue on State Forest Enterprise Reform in Vietnam. Technical notes are prepared as part of World Bank work. The contents do not necessarily represent the official Bank view, nor have been formally reviewed with government.
List of Abbreviations

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<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>DARD</td>
<td>Department of Agriculture and Rural Development</td>
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<td>IGCRAO</td>
<td>Income Generating Cost Recovery Administrative Organization</td>
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<td>MARD</td>
<td>Ministry of Agriculture and Rural Development</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>PFMB</td>
<td>Protection Forest Management Board</td>
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<td>PPC</td>
<td>Provincial Peoples Committee</td>
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<td>SFE</td>
<td>State forestry enterprise</td>
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<td>SOE</td>
<td>State-owned enterprise</td>
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<tr>
<td>Vinafor Vietnam</td>
<td>Forest General Corporation</td>
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<td>Vinapimex</td>
<td>Vietnam Pulp and Paper General Corporation</td>
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<td>WB</td>
<td>World Bank</td>
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<td>OMLLLC</td>
<td>One-member limited liability company</td>
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Glossary

**Critical Protection Forest**: areas with medium level of slope, medium risk of erosion, and medium demand for water regulation and areas where the threat of sand movement and sea waves is less than in the cases of very critical protection forests.

**Very Critical Protection Forest**: watershed areas with steep slopes, located close to rivers and lakes, having a high risk of erosion and strong demand for water regulation. It also includes areas with strong movement of sand, coastal areas where landslides are frequent and where sea waves regularly threaten production and livelihood of local people.

**Enterprise commercial viability** is the ability to cover costs of production and compete in the market with a long-term potential of delivering profits.
Acknowledgements

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Introduction

Forests, arable land, and pastureland—the three major division of the world’s productive land—are constantly changing due to human intervention, climate changes, and natural disasters. The area of arable land, despite encroachments due to urbanization, generally is expanding through even faster conversion of forests. Deforestation and erosion of arable land are also increasing the area of pastureland.

The destruction of forests has become the main cause of productive land loss, as much of the arable or pastureland created by clearing forests becomes unsuitable for plowing or pasturage after several cycles, and is abandoned. Forested land, which maintains precipitation levels, prevents floods, cleans the air, slows soil erosion, and provides construction materials, furniture, paper and firewood, is constantly decreasing.

These worrisome trends in productive land use are manifested most in developing countries, particular tropical countries with significant forest cover. For these countries, reforestation of degraded and denuded forest land is a priority, as it would allow them to tap a major resource to fight poverty and improve the quality of life.

Vietnam has about 33 million ha of land, of which about 11 million ha are classified as forested. Some 7 to 8 million ha have been degraded and denuded through widespread deforestation over several decades that has reduced natural forest cover almost by one quarter. The government has launched ambitious programs to rehabilitate large areas of degraded forest. These programs have slowed deforestation, improved protection of the environment, and increased the supply of wood for industry.

Although the forest sector’s contribution to Vietnam’s GDP is estimated only at 1.4 percent, its economic significance is much higher if its environmental and social importance is taken into account.

Forestry is a socially diverse sector. The note focuses on commercial wood growing in Vietnam. Favorable natural conditions in many regions give Vietnam a comparative advantage in forest-based industries. The note will not look at the social and ethnic aspects of rural development, which might justify different criteria in implementing institutional changes in, for example, Vietnam’s highlands. Because of the importance of transportation and handling costs, commercial wood growing is concentrated mostly in lowland areas close to towns and ports where processing and exports take place and the recommendations in this note are applicable to lowland state forestry enterprises located within 50 to 80 km of urban centers or terminals.

State forestry enterprises (SFEs) have played a pivotal role in the development of Vietnam’s forestry and wood-growing sector; they and other state-owned enterprises were greatly influenced by the radical transformations in the economy introduced by the market-oriented doi moi reforms of the early 1990s.

Under those reforms the central government turned most SFE’s over to provincial authorities and SFE restructuring because of budget constraints massively reduced employment; permanent staff fell from 220,000 to 28,000, and seasonal workers from 180,000 to 27,000. The reduction in forestry employment was offset by making contractual arrangements with households living on SFE land. While this restructuring reduced fiscal pressure from the forestry sector, there was no organizational restructuring. Without central government funding SFEs were unable to mobilize investment to plant, grow, and market wood, or maintain the forestry base.
Although the decline in forest cover was reversed, forest quality continued to decline. Vietnamese forestry continued to be plagued by low yields from planted forests, unsustainable harvesting in natural forests, and inflexible institutional and market structures that did not provide sufficient incentives to develop commercial forestry.

**Forest sector reform**

Efforts to reform SFEs have focused on changing the organization and management of these relatively small units without offering ownership transformation options widely used in other industries. Under a September 1999 government decision (Decision 187) Provincial Peoples Committees (PPCs) were to review forest and barren land use and come up with comprehensive forest land use plans.

As Vietnam adopted forest sector reforms in 1999 the Asian Development Bank commissioned a study to evaluate SFE performance and recommend improvements in their operations. The SFE profile below uses 1996-97 figures from that study’s database.

- SFEs are semi-autonomous state-owned entities that were initially created and responsible for managing all production forest land.
- There were 403 SFEs in 43 provinces. Five provinces, mainly in the Central Highlands, accounted for about a third of Vietnam’s SFEs.
- The overwhelming majority of SFEs (367) were under the control of provincial Departments of Agriculture and Rural Development (DARDs). Of these, 349 were directly administered by DARDs, while the other 18 had less direct links. Only 36 SFEs were administered by government-owned raw material companies.
- Land allocated to or managed by SFEs totaled 6.8 million ha, of which 29 percent was protection forest, 44 percent production forest, 22 percent was barren, and 5 percent was agricultural land. Plantation forests occupied 7 percent of SFE-managed land.
- Some 253 SFEs harvested wood from natural and plantation forests, and 83 operated saw mills; 401 had forest plantations.
- Staff numbered 28,800, an average of 71 per SFE.
- Average annual turnover was $133,00 per SFE. SFEs were generally marginally profitable, earning an average of $17,000 in surplus revenues and paying an average of $34,500 in taxes.
- Most SFEs were small; their fixed assets usually consist of buildings and wood processing and transport equipment; most lacked full legal property rights to the forest land that was their most precious asset.

More recent data from Vietnam’s Ministry of Agriculture and Rural Development shows that the number of SFEs had fallen to 368—and some 5 million ha—by 2002, and the SFE labor force had been reduced to 26,843.

**SFE reforms**

Under the September 1999 reform decision SFEs with commercially viable assets—mostly production forests with higher than average annual harvest levels—were to develop
business plans and become fully autonomous profit-making enterprises. The remainder, whose focus was on managing large areas of protection forest, were to be converted into Protection Forest Management Boards (PFMBs) charged with preserving critical protection and special use forests. PFMBs were to continue as semiautonomous entities and were to develop plans to cover their costs through income generating activities. Those plans had to be approved by PPCs, which would provide subsidies if income from commercial activities was insufficient to cover costs.

Non-viable SFEs with less than 1,000 ha could exit the forestry sector by moving into other fields—agricultural production, agro-processing, or service provision—or staying in the sector and converting into other forms of organization, such as shareholding or limited liability companies. Insolvent SFEs could be liquidated.

**Institutional setup of SFE reform**

SFE reform has been carried out using both top-down administrative tools from provincial institutions and bottom-up initiatives from the enterprises themselves. In some provinces PPC SOE Reform Committees prepared SFE reform plans; in others they were drawn up by DARD technical departments and submitted to provincial authorities.

SFE reform strategies were supposed to be developed by March 2000, but were delayed over a year, and have not yet been completed in some provinces. The strategies contain very preliminary projections of the organizational forms SFEs may take in the future, the costs involved, how land will be reallocated, and the organizational and staffing implications. It remains unclear whether approval of SFE strategies includes plans for land reallocation. Provincial SFE strategies prepared by technical departments seem to be in line with the criteria proposed in the September 1999 reform plan; those drawn up by PPCs less so.

Establishing PFMBs can impose financial burdens on provincial budgets. Many provinces, therefore, have proposed that most SFEs be converted to commercial entities, even though it is unclear how many of these would be financially viable.

**Progress in implementing SFE reform**

Three years after the September 1999 decision MARD reviewed progress toward reform and found that SFE transformation was taking place “rather slowly.” By mid-2002 only one province—Binh Dinh—had completed the review of SFE forest lands required under the reform program. Only 86 SFEs—a fifth of the total—had prepared business plans that had been approved by PPCs. Another 134 SFEs were awaiting provincial approval of their plans, while almost half the 403 SFEs had yet to finalize these plans (Table 1). MARD noted conflict at the provincial level between pressures to allocate land to protection forests and the financial burdens implied by protection forests. Currently, there are twice as many approved plans for establishing autonomous profit-making business SFEs as PFMBs. Introducing economic efficiency criteria for classifying SFEs would facilitate restructuring of these enterprises.
Table 1. Status of SFE Reform, September 2002

<table>
<thead>
<tr>
<th>Transformation measures Proposed by Provincial Peoples Committees</th>
<th>Of which, SFEs with Business or service plans approved by PPCs</th>
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<tr>
<td></td>
<td>Business or service plans prepared for PPC approval</td>
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<tr>
<td>Conversion into business SFEs</td>
<td>248</td>
</tr>
<tr>
<td></td>
<td>89</td>
</tr>
<tr>
<td></td>
<td>53</td>
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<tr>
<td>Establishment of PFMB</td>
<td>114</td>
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<tr>
<td></td>
<td>45</td>
</tr>
<tr>
<td></td>
<td>27</td>
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<tr>
<td>Conversion into other business forms</td>
<td>2</td>
</tr>
<tr>
<td>Liquidation through dissolution or merger</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>6</td>
</tr>
<tr>
<td>Converted into public utility SOEs</td>
<td>27</td>
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<tr>
<td>Total</td>
<td>370</td>
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<tr>
<td></td>
<td>134</td>
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<td>86</td>
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*Source:* MARD report on implementation of SFE reform plan, September 2002

SFE reform plans demonstrate limited use of the most effective methods of enterprise transformation, such as conversion into shareholding and limited liability companies, or liquidation of unviable SFEs. Only a few SFE plans filed with PPCs contain proposals to go into other businesses (2) or be liquidated (6).

**Separating public from business functions**

Vietnam's legal and regulatory framework does not provide for clear separation of SFE public service and business activities. SFEs are required to protect forests under their supervision and often play an important role in delivering social services to remote areas. They also act as key intermediaries in national reforestation, poverty alleviation, and resettlement programs. SFEs are allowed to undertake for-profit activities, such as logging, processing, seedling production, construction, and transportation on land allocated to them.

**Business SFEs**

The September 1999 reform plan aimed at terminating state subsidies to potentially viable SFEs by converting them into business-oriented SFEs that were expected to earn profits without subsidies to cover their operating costs. SFEs whose main purpose was protection of large areas of valuable or critically important natural forest (e.g., watersheds) were to be converted into PFMBs whose operations could be subsidized.

In October 2000 a joint MOF/MARD implementation circular specified that SFEs should apply business cost accounting methods and set out the assets that should be on their books: fixed assets, working capital, and planted forest. Natural forest is in the public domain and usually cannot be an SFE-owned asset. But if it is managed by business SFEs in accordance with the Law on Forest Protection and Development and regulations on natural forest management it can be counted as part of an SFE’s assets. As valuation of natural and planted forests is not based on current market prices and very few people in Vietnam are competent in forest valuation, the assets of SFEs tend to be vastly undervalued.

1 The circular excludes from accounting as assets borrowed funds, goods on consignment and under processing contracts, or taken for re-sale on commission.
The circular specified that business SFEs must account separately for proceeds from forestry business activities, forestry-related business activities, and other business activities. The circular allows business SFEs to receive budgetary transfers for afforestation and management and use of natural forest. But in reality it is easy to mix these transfers with business income, as many business SFEs manage scattered, but sizable, very critical and critical protection forests, the circular stated that any income from sale of products from these forests would become part of the proceeds of an SFE.

**Separating SFE public and business functions**

The 1999 reform plan prescribed that SFEs should prepare detailed surveys of their holdings and land use plans before selecting reform options. Land-use supervising bodies—usually PPC land administrations—were to give priority to surveying SFE land and, ideally, issue land use right certificates classifying them as business SFEs or PFMBs. The surveys were to make the most rational distribution of forest land under SFE control, including transfer of barren land and scattered forest land to municipalities and households. SFE land use plan and reform choices were to be approved by provincial authorities.²

The MARD report noted that land planning and allocation was far behind schedule because land administrations and PPCs had given priority to agricultural land. Some localities approved SFE business plans but surveys were slow or not started at all. By early 2001 only 28 provinces with forest resources (62 percent) had provided long-term land use certificates to 95 SFEs (24 percent), which managed 962,621 ha (20 percent) of forest land.

Most provinces have fallen behind in land use planning and SFE classification because of weak capacity to survey land allocation, and conflicting land use claims by SFEs and households. Also, the intertwining of protection and production forests has given PPCs perhaps too much flexibility in classifying SFEs into the business or protection categories—and deciding how to protect critical natural forest scattered among production plantations, or grow production forest in protected areas. This frequently led to compromise solutions, and more importantly, did not take into account SFE commercial viability, thus discouraging private sector participation in forest-based industries.³ The reform program and ensuing regulations did not provide simple yardsticks for assessing how effectively SFEs use their land resources, making classification very difficult

Separation of public and business activities is very important for transition economies and clear guidelines should be provided. Developed market economies have institutional setups in their forestry sectors ranging from clear separation of public and private function to merging many of these functions under public forestry services. The public/business merger works better when understanding of the substance and purpose of each function is more complete. In emerging markets clear dividing lines between functions improve the chances for liberalization and increased efficiency.

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² For more details see Martin Geiger, international forestry consultant, reports prepared in April and July 2002
³ Decision 187 did not mention ownership transformation as a reform option for SFEs.
PFMBs

Decision 187 specified that PFMBs would be converted into Income Generating Cost Recovery Administrative Organizations (IGCRAOs)\(^4\) and implementation guidelines issued by the Ministry of Finance set out how such organizations should be established and funded.

IGCRAOs can be fully or partly self-financing, depending on the scope of financial guarantees extended to PFMBs by provincial committees. Provincial committees are required to agree to allocate subsidies to cover the operating deficits of PFMBs whose revenues fall short of their costs.

The supervising authorities and IGCRAOs are supposed to agree in advance on three-year budgetary allocations, which are confirmed annually. Prices for IGCRAO goods and services are also regulated—salaries and wages are capped at 2.5 times the minimum national wage for fully self-financing IGCRAOs and twice the minimum wage for partially self-financing ones.\(^5\) It is not surprising that the IGCRAO model is less appealing to forestry enterprise managements than the business model, which faces fewer restrictions on staff compensation and no price controls on services and products.

Many business SFEs established under the reform program are not commercially viable, as PPCs are often more interested in avoiding paying subsidies than starting profit-making enterprises.

Some provinces—such as Binh Dinh—have sought maximum separation of business and public service functions by requiring that SFEs transfer all critical and very critical protection forests to PFMBs if they want to be classified as business SFEs. This initiative is worth studying and, if found practical for scattered forests, should be disseminated as best practice among provincial authorities.

Staying within the existing legal framework

Business SFEs and PFMBs also have to follow different accounting criteria. Business SFEs are independently accounting SOEs that keep their financial accounts separate from those of their supervisory bodies, while PFMB accounts are dependent on funding from their supervisory bodies. More importantly, business SFEs treat profit as their main performance objective, while PFMBs aim only for cost recovery.

Differences in the organization and management of business SFEs and PFMBs are not significant. SOE organizational autonomy and financial and managerial decisions are limited by law, which links initial capital allocations and payroll to state government decisions and compensation of civil employees. The law provides that major SOEs should have managing boards, while smaller SOEs usually have a director assisted by management staff. All SFEs fall into the second group because of their small size and SFE directors are usually appointed by PPCs on the recommendation of provincial DARDs. The law requires that SOE directors must be law abiding Vietnamese citizens, in good health, and of high ethical standards. They must be professionally competent, and cannot participate in any state bodies. Managers may not serve if their previous businesses ended up in bankruptcy, and cannot be close relatives of other managers working at the enterprise, or do business with firms/organizations led by such relatives.

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\(^4\) Other translations of the term are “recurrent cost organizations with revenue”, “administrative units having some economic activities and revenue”, “income-earning administrative economic units”, “revenue-raising public service entities”.

\(^5\) Higher caps are allowed if PFMB financial results improve over time.
DARDs also have to approve proposed changes in SFE strategies and development plans, and modifications in organization structure and investment. DARD interference in SFE affairs is unlimited and omnipresent, SFEs could benefit from greater autonomy and independence. Lam Dong province recently decided to give two business SFEs autonomy, but their directors have not succeeded yet in establishing their independence from the provincial DARD.

Evolving from SFEs to other business forms

Many SFE directors lack business backgrounds or entrepreneurial skills. Many of those who want to expand their businesses try to diversify into related areas, such as transportation, construction, wood processing, and extension services that are not as regulated as forestry enterprises. Vertical or lateral integration can provide more autonomy and motivation for SFE managers.

The classification of SFEs as business SFEs does not change the legal framework and does not require registration as a new entity; it often involves no meaningful change except a land survey and reallocation. Classification, thus, can be interpreted essentially as a mission statement that an enterprise is willing to become commercially independent and profit making by controlling valuable forest resources, being competitive on the market, or both. Approval of business SFE status should be also interpreted as a commitment by provincial authorities to terminate subsidies to such enterprises because they are no longer engaged in public service activities and do not deserve transfers of public funds for their for-profit operations.

Classification of forest enterprises as business SFEs is a step toward setting up for-profit forestry businesses. But SFE autonomy is limited by the hostile attitude of state sector management, which often does not allow business initiatives to realize their potential. SFEs can, however, bring themselves under the much more liberal 1998 Law on Cooperatives or the 1999 Law on Enterprises by exiting the forestry sector and changing their legal form to joint stock companies with Vietnamese SOEs, or joint ventures with foreign partners or by merging with a processing or marketing enterprise.

The Law on Enterprises provides rules for establishing, registering, and operating limited liability companies, shareholding companies, partnerships, and private enterprises. This company law contains all key provisions for business operations and lays out acceptable standards of corporate governance. The Law on Cooperatives also corresponds to business needs and was radically redrafted to allow greater autonomy than that granted the rural state-controlled cooperatives that proliferated under the command economy.

The least popular SFE transformation method is exit from the forestry sector. The 1999 reform program clearly allows an SFE to convert into another form of business—agro-forestry enterprise, agro-forest products collection and purchase enterprise, plant nursery, or provider of other services—if it develops a business plan stating the land needs of the new organization and reallocates its remaining land to local authorities for use by organizations, individuals, and households. Existing debt burdens and difficulties in reallocating land are the major reasons why this form of transformation is seldom used; only two such proposals have been filed nationwide.

SFE managers who are keen on developing commercial forestry are looking for opportunities to do business with partners from the both state and non-state sectors, including

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6Amendment to the Law on State Enterprise are being prepared; proposed changes are aimed at increasing the economic autonomy of SOEs, but the new law is not expected to be enacted earlier than 2004.
firms with foreign investment. Such alliances may allow them to move into a better business environment with less administrative interference into their commercial operations.\(^7\)

**One-member Limited Liability Companies**

To escape the provisions of the Law on State Enterprises and convert to commercial enterprises SFEs must cease to exist as forestry enterprises. This requires that an SFE face difficulties in commercial production, manage less than 1,000 ha of production forest, and have land interspersed with agricultural land or located close to residential areas. These definitions give great discretion to supervising bodies, especially as the law is vaguely drafted so that meeting any of these three criteria can be interpreted as adequate. Proposals to set up organizations under Law on Enterprises often come up in provincial SOE reform plans.

SFEs can theoretically be brought under the Law on Enterprises through One-member Limited Liability Companies (OMLLCs), 100-percent state-owned firms established by “founding members,” usually provinces or districts. OMLLCs have no right to issue shares,\(^8\) and thus cannot mobilize funds through equity placements, although these small SFEs would be unlikely to draw much from capital markets. The major difference between OMLLCs and business SFEs is not in their degree of autonomy, as they are controlled by the same authorities, but in the looser accountability and disclosure requirements under the Law on Enterprises. Implementation regulations for OMLLCs have not yet been drawn up, but may be finalized when pilots for conversion of the first 10 SOEs—none of them forest enterprises—into OMLLCs are completed during 2003.

**Other conversion options**

Entrepreneurial SFE managers who are not willing to exit forestry have two other options for converting their businesses. They can integrate forestry enterprises into processing and marketing entities being transformed into commercial companies, or set up joint ventures or joint stock companies with such firms. Neither of these options was contemplated under the 1999 reform program—and they do not address sustainability issues—but they are strongly supported by more recent resolutions of the Party and government.

Downstream sectors (saw milling, wood chips, pulp, furniture, plywood, etc.) are important for SFE reform as they provide a cash flow gateway for commercial forestry activities. In Vietnam’s present business environment commercial forestry cannot be developed without integrating it with downstream operations due to inefficient market structures and price controls that restrict wood growing and upstream production. Before the 1999 reform plan was adopted, ADB consultants tried to encourage the MARD drafting team to introduce equitization and less rigid market structures as part of the reform. These recommendations were not accepted and incentives to grow wood for profit are still low in Vietnam. A solution for this problem has been found by moving profit centers down the value-added chain from forestry to processing

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\(^7\) The Bank team visiting SFEs found management was often fully dependent on DARD decisions. Having invested in growing several thousands hectares of plantations and having standing mature forest worth millions of dollars ready for felling, management often had no information as to when the wood would be harvested, its selling price, or the markets to which the wood would be delivered. Other managers with more political clout were able to influence provincial authorities in choosing the reform option for their enterprise via administrative bargaining.

\(^8\) Presumably the purpose of converting SOEs into OMLLCs was to provide a legal bridge for transition from SOE to publicly traded company status, paradoxically with the aim of raising capital. There are no international precedents for such LLCs (except reportedly in Singapore). In most countries the purpose of raising capital is best satisfied by the shareholding form, also allowed by Law on Enterprises.
operations where they are easier to maintain within the current legal framework, and where it is easier to accumulate capital. This approach has been supported by the authorities.

Reductions in logging quotas in many provinces in recent years, and logging bans in some, e.g., Quang Nam, have had a major impact on SFE reform plans because harvesting natural forest wood is still the main source of SFE revenues. Deprived of their main cash flow source and public sector investments into upstream forestry, SFEs tend to diversify into processing imported or planted wood, trading, forest extension services, transportation, and construction works for rural development. Some are simply looking for public subsidies and have given up their processing facilities.

Processors who need secure sources of wood supply for processing are demonstrating rising interest in industrial wood plantations. SFEs with planted forest are being taken over by manufacturers of wood products, and scattered trees on farm plots are being increasingly bought up by brokers working for wood chip exporters. Central general corporations in pulp and paper (Vinapimex), and forestry products (Vinafor), which directly control 36 SFEs, are seeking more takeovers, as security of supply is the key bottleneck to their expansion. They are increasingly competing with provincial wood processors and chip exporters for reliable supplies.

**Forging vertical ownership links**

Wood processor interest in upstream activities was given a strong political boost by a September 2001 resolution of the 3d Meeting of the IX Central Party Committee on restructuring, reforming, developing, and improving the efficiency of SOEs. The resolution allowed upstream producers in agriculture, forestry and aquaculture access to shares of the equitizing enterprises processing their products. Upstream producers were also allowed to convert the debt of processing SOEs into equity. This means that an SFE can become a shareholder in a furniture factory, to which its wood is supplied by converting furniture factory debt to the SFE into shares upon equitization of the furniture factory.

The World Bank team that visited the central coastal provinces identified several PPC proposals to equitize forest-based SOEs. SFEs and forestry-based SOEs contacted were unable to confirm plans to equitize, but said that they were planning to equitize one or two processing companies in a few years. The team found no information on plans to consolidate ownership of upstream and downstream parts of forest-based SOEs under the September 2001 Party Committee resolution, and it is unclear how these regulations will be applied, or who will benefit from preferential sales of shares of processing SOEs—SFEs, smallholders, or both. Competition in processing from the private sector could not be assessed, but it is likely that a relatively strong competition exists, in particular for sawmills and in garden furniture production.
SFEs and state industrial holdings

Vietnam’s five-year SOE reform program aims at restructuring a third of its SOEs through equitization, divestiture, and liquidation of smaller SOEs, banning creation of new SOEs, except in industries in which the state needs to keep monopolies or with strong public good characteristics.\(^9\)

Wood processing is gaining priority in government plans, as shown by sizable public investment projections in these industries and emerging plans to establish a larger industrial holding structure in this sector.

Provincial governments, preoccupied with enhancing the welfare of their enterprises and industries, began following concentration policies long before the new industry targeting policies were adopted on the central level. To maximize welfare effects, mergers occurred first among SOEs in industries in which the provinces possessed comparative advantage and where commercial margins were highest. In forestry, concentration progressed furthest in high value-added processing, such as furniture production for export. The four provinces involved in the World Bank’s proposed Forest Sector Development Project have integrated forest-based SOEs with full cycle of growing, production, and exports, which is usually one of the most profitable enterprises in the province.

Concentration had not progressed much in upstream forestry in which numerous small, undercapitalized SFEs continued to operate, often in remote areas, handicapped by constraints in transport infrastructure. Provincial processing champions have increasingly expanded upstream, engulfing small SFEs with good standing wood or planted forests to meet their production needs.\(^10\)

Box 1. VIJACHIP
The Vijachip joint venture was established in 1989 by Oji Paper Company (Nisho Iwai Group of Japan) which holds 60 percent of its stock and the Vietnamese government, with 40 percent. The Vietnamese side is represented with unequal shares by four provinces (Quang Nam, Quang Ngai, Quang Tri and TT Hue), the city of Danang and Vietnam Forestry General Corporation (Vinafor). Vijachip became operation in 1994 and has become a strong catalyst for commercial wood growing in the region with an estimated 30 percent of woodchip exports. The woodchips are shipped to Oji Paper for paper production.

Joint ventures in forest-based industries: catalysts of change

The opening of Vietnam’s wood sector for exports in the 1990s, led by vast demand for woodchips from Asian countries, especially Japan, triggered further commercialization of SFEs in the Forest Sector Development Project provinces. An example of this trend was the Vietnamese-Japanese joint venture Vijachip, registered under the Law on Domestic Investment Promotion. Since its establishment in 1989 Vijachip has provided seedlings, cuttings, and fertilizer for 12,500 ha of plantations. Until 2001 this support was provided on credit, but form

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\(^9\) The reform plan also calls for and nurturing and strengthening large state industrial holdings in key industries targeted by the authorities as crucial for “insuring balanced development and macroeconomic stability, secure supply of essential products for national economy and exports, raise efficiency of production and competitiveness on domestic and international markets.

\(^10\) In Thua Thien Hue an opposite trend is being observed: three SFEs have been separated from the provincial wood trading company.
2002 inputs were provided free of charge. Since Vijachip’s investment program in upstream forestry started in 1989 standing wood is close to stage at many participating SFEs and will be soon supplied to Vijachip.

SFEs are also being commercialized through one-year to medium-term contractual arrangements between provincial wood processing enterprises and international furniture exporting companies (Scanco, Ikea, Pierre Import 1, others). The furniture firms provide design and quality specifications and require strict verification of rules of origin to preclude wood from illegal logging. Due to increasing demand for garden furniture in developed countries, processing of large-diameter acacia logs for furniture production pays the highest margin to producers and exporters of these end-of-the-value-added-chain products, some of which trickles down to growers. The provincial processing enterprises, looking for ways to internalize these margins, are taking over SFEs with large areas of planted large-diameter wood.

Until recently, these takeovers could have happened by administrative fiat only because one SOE could not legally own another unless it was converted into a shareholding or limited liability company. The 3d Conference of the IX Central Party Committee, however, allowed establishment of joint stock companies, and in October 2002 an official letter was issued encouraging the establishment of new state-owned joint stock companies.

**Commercial operators need a level playing field**

Private plantations and scattered wood lots provide wood to international and provincial wood chip and furniture plants. Thus, the emergence of joint ventures gives a boost to small-scale private sector development, albeit the private plantations may use SFE land and labor.

Some emerging forms of private sector development may be sub-optimal and even hinder competition due to monopolies on wood collection in the provinces where foreign joint ventures operate. More importantly, private growers are totally dependent on vertically integrated forestry-based SOEs that are assigned exclusive rights by PPCs to provincial wood collection through networks of dealers with territorial franchises that show little propensity to compete with each other. As a result, prices for small diameter logs remain depressed\(^{11}\) and are too low to induce growers to plant, let alone to borrow to plant trees.\(^{12}\)

Many provincial SOE reform plans contain proposals to convert provincial collection monopolies in wood chip production into OMLLCs. These companies are also involved in wood processing (mostly furniture production) and other commercial activities, and there are proposals to equitize some of these furniture plants. Spin-off and equitization of some parts of these holdings is a step forward and should be supported, provided that the competitive implications for constituent SFEs in vertically integrated groupings are carefully considered. Equitized firms should be provided a level playing field and allowed to compete at arm’s length for wood with vertically integrated companies, otherwise they will be captive producers and will be used to maximize cash flow for the managers and *de facto* owners of forest-based SOEs.

The dominance of provincial monopolies is detrimental to wood markets because they extract high rents by keeping purchasing prices from smallholders and SFEs low. Many such

\(^{11}\) Dr. Vu Huu Tuynh provides a typical example: A pulp joint venture in Binh Dinh buys block logs at VND 340,000/m\(^3\) ($22/m\(^3\)) and exports wood chips at $34/ton, gaining a margin of $12/ton! The WM mission visiting Quang Nam also found that plantation wood was collected by brokers at an average price of VND 540,000/m\(^3\) and was sold to Vijachip at $30/ton by the wood supply monopoly and exported to Japan at a declared price of $36/ton.

\(^{12}\) Experts call the current system of wood collections “rent seeking.”
monopsonies now will be allowed to own SFEs. These captive SFEs will be totally dependent on their parents’ needs, which will perpetuate the depressed wood-growing markets. These provincial collection monopolies should not be equitized,\(^\text{13}\) as monopolies in this market can lead to dominance in processing. Equitizing individual furniture plants or smaller integrated companies would, however, reduce organizational slack and raise efficiencies if competition is enhanced.

### Liquidation

The fourth option under Decision 187 is liquidation of unviable SFEs, which offers opportunities to replace ineffective owners and managers with others who can use SFE assets more effectively. The implications of liquidation are important, as the assets of a liquidated SFE may be taken over by another SFE in a merger, or new players may enter the market after an SFE has been liquidated. Liquidation of an SOE—closing its banks accounts, winding up business activities, competitive sale of assets to new owners, and removal of the SOE name from the business registry—constitutes a major reform measure when implemented with due care for the interests of creditors and employees of the liquidated enterprise.

A genuine liquidation (and even more so, a legitimate bankruptcy) is normally a lengthy and convoluted process in a market economy with developed regulatory rules and judicial institutions. In a transition economy such as Vietnam’s, liquidation as a form of enterprise restructuring faces many uncertainties due to gaps in the regulatory and institutional framework, and faces much psychological resistance because of a view that no enterprise in a state socialist economy should fail.\(^\text{14}\)

Liquidations of SOEs have also not been used as an enterprise restructuring tool because of Vietnam’s undeveloped social safety net. With the April 2002 adoption of basic decrees establishing a SOE Reform Compensation Fund to which all proceeds from equitization and divestiture will be channeled to pay redundant employees, this radical SOE reform measure can be implemented more easily.

Since the method of appraising the assets of liquidated SFEs, and most other SOE assets in Vietnam, is usually cost based, standing wood tends to be vastly undervalued. In the Dai Loc liquidation the value of planted forest was estimated at VND162,000,000, less than $12,000. This seems very low, considering that Dai Loc had been one of the four main recipients of quality seedlings from Vijachip from the 1990s until 2001 when the enterprise was already legally in liquidation. If market-based valuation techniques had been used the value of the on Dai Loc plantations would have been much higher.

\(^{13}\) Some PPCs seem to understand the detrimental effects of equitizing provincial monopolies, and are proposing to convert them into OMLLCs that, while remaining under control of the provincial authorities, will gain operational autonomy. Similar autonomy seems difficult to achieve under the business SOE option. This leaves OMLLCs as a feasible alternative.

\(^{14}\) There have been less than 70 SOE liquidations in Vietnam since January 2001, in contrast to late 1980s-early 90s when half of about 12,000 SOEs were merged or liquidated.
Box 2. Liquidation of Dai Loc SFE

1993 Dai Loc SFE established in Dai Quang and Dai Loc communes Dai Loc district, Quang Nam province, by restructuring Dai Loc Forest Enterprise set up in 1983.

**Regular staff:** 14 employees

**Land:**
- Forest land – 15,347 ha
- Agricultural land – 422 ha
- Other land – 1,287 ha

**Activities:**
- Management of protection forests and plantation of new forests
- Agro-forest production
- Harvesting in natural forest

1998 Due to financial insolvency Quang Nam PPC took decision to dissolve Dai Loc SFE

2000 Dai Loc ceased to exist as a commercial entity (bank accounts closed, employees released, assets sold, and name of the enterprise removed from the business registry)

Dai Loc’s plantations were not abandoned and, after redistribution of land by local authorities, new owners are managing them. And these owners are more likely to be commercial smallholders than project smallholders, which are much more numerous in the wood growing provinces (Table 2). The distribution of plantations between the two groups of smallholders is unknown.

Liquidations of non-viable SFEs should be encouraged and the number of liquidation plans recorded to date—six—is not adequate. Liquidations of unviable SFEs should release land for more efficient use, raising yields and improving welfare in the rural areas. As the transfer of plantation land to new users seems to happen at below market prices, it is important that transparency and equality be introduced in the land re-distribution process.

**Smallholders**

SFEs largely rely on households to manage their forest land. In addition, smallholders play a crucial role in afforestation, protection, maintenance, and regeneration of more than 450,000 ha of provincial forest land outside the SFEs.

However, tenure security remains very weak, particularly for project smallholders, who are the poorest and the least connected to the corridors of provincial power. The issuance of certificates for the use of forest land lags, limiting smallholder access to low-interest formal credit. A November 2001 Prime Minister’s Decision providing guidance on production sharing on forest land contracted by households still lacks an implementation circular.
Table 2. Characteristics of Two Types of Vietnamese Forestry Smallholders

<table>
<thead>
<tr>
<th>National Project or Program smallholder</th>
<th>Commercial smallholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grows wood on the land for which a long-term land use certificate may not have been issued. It may be an SFE land allotment with an unclear—or no—benefit sharing agreement.</td>
<td>Grows wood on land for which a long-term land use certificate has been issued or land rented from an SFE under contract for a specific shares of the proceeds.</td>
</tr>
<tr>
<td>Forest plantation areas are typically 1 to 3 ha per household</td>
<td>The scale is normally larger, at 5 to 30 ha, with plantations of up 100 ha.</td>
</tr>
<tr>
<td>Investment funding, such as seedlings and fertilizer, provided by project or program VND2,500,000/ha.</td>
<td>Financing uses loans from processors or own funds</td>
</tr>
<tr>
<td>Technical guidelines, species, planting methods provided by an SFE using project or program funds</td>
<td>Technical guidance provided by lenders</td>
</tr>
<tr>
<td>Largely use their own or family labor</td>
<td>Commonly use hired labor</td>
</tr>
<tr>
<td>Commonly no real commercial purpose</td>
<td>Commercial purpose identified at the beginning of the plantation cycle</td>
</tr>
<tr>
<td>Have policy for end products, such as firewood</td>
<td>Able to sell products to different markets</td>
</tr>
<tr>
<td>Productivity is low, at around 5 m3/ha.</td>
<td>Generally higher productivity using semi-intensive methods and fertilizer</td>
</tr>
<tr>
<td>Commonly plant a single yearly rotation.</td>
<td>Will undertake multiple rotations where there is a commercial benefit</td>
</tr>
</tbody>
</table>


Moreover, contracting households and independent tree growers seem to benefit only marginally from forestry activities. Farmer rights are often based on unwritten understandings with SFE management or district administrators. Standard SFE protection, plantation, and regeneration contracts are usually nonspecific regarding the production sharing of wood on the land the farmers maintain—often investing significant labor and their own funds. Most of these contracts should be amended to conform with Decision 178 production sharing arrangements. This could be easily done, following the examples of centrally managed SFEs under the supervision of VINAFORE and VINAPAPER general corporations, which need to be more widely disseminated.

The Need for Further Reform

SFEs continue to remain a major player in the upstream forestry sector and still manage most of Vietnam’s forest land. The September 1999 decision guiding SFE reform, aimed to separate business and public functions in forest management. As a result, by 2003 provinces have proposed to convert three fourths of their SFEs into business SFEs and another fifth into PFMBs or Special-use Forest Management Boards. However, the government, particularly MARD, does not believe that this many SFEs can become profitable businesses. MARD proposes, perhaps more realistically, that the 368 remaining SFEs be transformed into 113 business SFEs (31 percent), 214 PFMBs (58 percent), and 18 non-forestry businesses by 2005 (5 percent). This is a positive outcome, because only PFMBs/ SFMBs would be allowed to be explicitly subsidized by provinces. The central government and provinces will need to confirm sources of funding to manage protection forests and special-use forests adequately. This will be difficult for relatively

15 This implies that 11SFEs will be dissolved and 12 merged into others.
poor provinces, which often manage large forest areas. It is unclear whether these sources will be actually identified and how the central and provincial roles will be shaped.

Further restructuring SFEs will require a number of policy changes. One recent positive development has been a growing understanding by provinces that a stricter dividing line should be drawn between public and private functions and that subsidization of public activities by SFE business operations is likely to be detrimental to both. Separate accounting of these functions at the SFE level is unlikely to work, and will only perpetuate diversion of resources and unfocused business management. More provincial leaders understand that only full separation will allow them to raise the efficiency of commercial wood growing\textsuperscript{16} which, when properly taxed, will provide sufficient funding to support PFMBs. There is an urgent need to revise Decision 187 and Decree 10 and related regulations—particularly those governing interspersed small areas of protection or production forest—to remove the gray areas that allow SFEs to remain in mixed commercial and public situations.

Decision 187 was issued with the assumption that wood growing would be able to support two thirds of existing SFEs, but this assumption now seems too optimistic. Adequate incentives to grow wood as a commercial activity are still missing, and provincial logging quotas and bans on harvesting natural wood deprive SFEs of their commercial base. The criteria for classifying SFEs should be complemented by a set of criteria that define the economic potential and viability of SFEs.

Maximum areas should be defined for SFEs and PFMBs managed by provincial or district bodies to avoid further ineffective land use and loss of forests. These ceilings should not apply to business SFEs that become part of public or private industrial groupings and expand to realize economies of scale. On the other hand, these measures should be accompanied by accelerated allocation of forest land to households, community or other ownership sectors with long-term secured land use certificates to promote their investment into sustainable forestry.

SFEs and forestry-based SOEs should be included in the pilot project on testing the model of OMLLCs. This model may prove to be suitable for provincial wood processing “champions,” for which equitization would be detrimental to competition due to their dominant positions in wood markets and monopsonistic roles in wood collection.\textsuperscript{17} If OMLLCs prove a viable organization form for commercial activity, they may be a suitable alternative for managing these regional firms in a more transparent and responsible way without crowding out private sector and foreign investment.

In spite of recommendations from consultants,\textsuperscript{18} Decision 187 overlooked most effective reform instruments linked to ownership transformations of SFEs, condemning them to the less effective forms of management envisaged in Law on State Enterprises. The ADB’s recommendations are worth repeating here because they are as valid as in early 1999:

“many of the SFEs involved in commercial plantation activities, plus some which are operating as contractual service providers (supply of seedlings/plantation

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\textsuperscript{16} E.g., in Binh Dinh province all production forests were taken away from PMFBs. In Thua Thien Hue province the PPC asked for a clear separation to prevent business SFEs from managing protection forests by business SFEs and ban commercial activities by PFMBs.

\textsuperscript{17} Equitization of separate parts of these provincial companies (e.g., furniture factories, seedling nurseries, high yield wood plantations) should be encouraged.

\textsuperscript{18} ADB. Evaluation of State Forestry Enterprises Draft Report, April 1999. This section and its recommendations were dropped in the final report.
inputs, and marketing of forest products) are suitable for rapid equitization. An immediate case study/pilot project to equitize say 6 SFEs is recommended.”

Decision 187 should be amended to explicitly allow application of the basic equitization Decree to forestry enterprises to make the pilots effective. This was proposed under the 2001 Forest Sector Support Program in 2001, but has not been implemented.

Equitization may also apply to sizable forestry-based enterprises. There is no rationale for converting small SFEs with one or two dozen employees into joint stock companies. Most SFEs and related businesses are so small that they are better suited to divestiture under Decree 49—which allows outright sale of enterprises that have had three years of losses as going concerns or their transfer to employees free of charge—than equitization. The decree should be amended to allow its application to forestry enterprises with adequate treatment of land user rights.

The lack of a legal framework for reforms in the upstream forestry sector is forcing SFEs to move out of the sector to implement reforms. By moving profit centers down the value added chain where they are easier to maintain and where it is easier to accumulate capital, SFEs are able to expand operations. Vertically integrated forestry-based SOEs controlling the full production cycle (from logging to export) are becoming the main source of re-capitalization of SFE activities—but very little capital is being recycled back to upstream forestry. The latest decisions of the Party and government favoring industrial groupings in forest-based industries should be implemented in a way that benefits downstream and upstream forestry sectors equally. So far, rents extracted in the downstream sector tend to ruin the production base for upstream SFEs, which cross-subsidizes processing operations. Among measures to remedy this situation are taxing rents extracted by provincial wood collection monopsonies to return a portion to wood growers as incentives, or revamping the rent-seeking wood collection system by providing a level playing field to all market participants.

Improvements in marketing channels should lead to price increases for wood growers who have access to information about prices and marketing opportunities. Special measures may be needed to enhance the bargaining power of wood growers by creating plantation wood auction centers. Most provincial wood collection monopsonies should be replaced with long-term contracts with commercial wood growers to enhance their security of tenure and make benefit sharing transparent. Alternatively, grouping of smallholders into association could increase their power in bargaining for higher prices.

Liquidation of unviable SFEs should be encouraged by streamlining the procedure for closing SOEs and selling assets in a transparent and competitive manner. The most valuable resource SFEs possess—land—should be properly valued and redistributed. Capacity needs to be developed to assess the value of the SFEs to be liquidated. Liquidation/bankruptcy processes should be de-stigmatized and managers should not be penalized for initiating legitimate liquidations. The ongoing process of amending the basic 1996 decree on SOE establishment, reorganization, dissolution and bankruptcy should reflect this recommendation.

Decision 187 should be adjusted to the resolutions of the 3rd Session of the Party’s 9th Central Committee on SOE reform. In particular, implementation regulations should be issued to enable emerging industrial groupings to forge links integrating upstream forestry enterprises with their processing and marketing entities, transforming them into fully commercial companies under the Law on Enterprises, including through equitization and participation in state-controlled joint stock companies.

Adjustment should aim at preserving the interests of sustainable commercial development of the forestry base, and redistribution of rents from upstream to downstream forestry entities.
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