The Diversified Business Group as an Innovative Organizational Model for Large State-Enterprise Reform in China and Vietnam

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Abstract

The diversified business group (DBG) is a ubiquitous institution in developing economies. It is a formal inter-firm network that typically involves financial institutions, distributors and manufacturers. Groupwise diversification is viewed by some as a novel form of organizational innovation by entrepreneurial tycoons while others see it as an instrument for rent seeking. Inspired by Korean chaebols but chastened by Russian financial-industrial groups, China and Vietnam are creating business groups out of state enterprises. After reviewing the theory and cross-country experience, this paper concludes that selective economic grouping can be an efficient transitional organization. DBGs can facilitate government monitoring, exploitation of scale economies for scarce managerial talent, better risk management, and realization of network and scope economies. Success in incubating national champions is, however, predicated on a high technocratic capability for restraining abuse of market power, nurturing competitive market institutions, properly sequencing large scale privatization, and crafting WTO-compatible industrial and technology policies.

JEL Codes: G3, L2, L3, O3, P5

Keywords: Diversified business group; Organizational innovation; State enterprises; China; Vietnam.

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1  Introduction

Much like their counterparts in the history of the developed countries, industrial entrepreneurs in late industrializing economies and their technocratic allies have responded in myriad ways to the dearth of knowledge-based assets at their disposal (Amsden, 2001). An intriguing strategy for telescoping the large technological gap with leaders has taken the form of organizational adaptation. Three variants are worth noting.

The first, taken to an extreme point by the formerly socialist countries, is preference for large-scale firms to take advantage of scale economies (Schumpeter, 1934; Gerschenkron, 1962; Chandler, 1990). The second, a much less understood and appreciated response, is group-wise diversification especially into unrelated activities. The central goal in this case is exploiting scope and learning economies, or overcoming market-based coordination failure (Strachan, 1976; Leff, 1978; Goto, 1982; Granovetter, 1994). The third, a recent development, is network-wise specialization by suppliers seeking profitable nodes and technology-upgrading opportunities in global value chains (Mathews, 2002; UNIDO, 2002).

Diversified business groups (DBGs) have two key characteristics: they are diversified across distinct markets, and they include a large number of member firms in a formal group. The most salient features of group networks involve a group governance system undergirded by varying and ever-changing mixes of director interlocks, mutual equity ownership, debt relationships, trade relationships, personnel exchanges, political ties with state actors, and social ties among key players.

Economic grouping is a prominent feature especially of the industrial landscape of late industrializing countries. DBGs, whether market-induced or state-orchestrated, have a prominent presence in the industrial and business-service sectors especially in the larger economies of Latin America, Asia and post-socialist Russia.

The DBG does not have a standard definition. Common usage excludes such business relationships as temporary and strategic inter-firm alliances, location in informal industrial districts, independent multi-divisional firms, or most conglomerates and holding companies with single ownership (see Leff, 1978; and Granovetter, 1994). It will be defined here as an enduring network that satisfies four conditions: (i) each affiliate is a legally independent entity (diversity of membership); (ii) affiliates are represented in a variety of industries or markets (diversity of assets); (c) affiliates are bound together by a medley of business, shareholding and social ties
The regional patterns of group organization that more or less satisfy this definition include Korea’s chaebol (jae-bul), Japan’s prewar zaibatsu and postwar keiretsu, Italy’s tightly knit industrial-district groups, China’s qiye jituan, some of Taiwan’s guanxi qiye, Russia’s financial-industrial groups or FIGs (semibankirshchina), India’s large business houses, Indonesia’s konglomerat, and Latin America’s grupos economicos. Despite the diversity of the contexts in which economic groups exist, we argue below that there is sufficient similarity among DBGs across regions for comparisons to be validly made.

Why do DBGs exist at all? While the nature of state-group relations vary across regions, groupwise diversification and developmentalist states are viewed by many as effective strategic responses, planned or evolutionary, to the conditions faced by late developers.

The prevalence of weak domestic markets and the need to build up local capability for technological learning offered by uneven global development means that the propensity for grouping can be explained as an effective vehicle for catching up. Economic grouping is value-adding insofar as it helps associated firms to exploit resource specificity and to substitute for missing markets or for poor contract enforcement. Long-term relationships and cross-holding among assemblers, input suppliers, credit providers, distributors, and investors generate a dense enough internal market (especially for capital and managerial skills) that can be shared across affiliates. This institutional innovation provides a stepping stone to organizational forms (such as traditional conglomeration or arms-length market contracting among stand-alone firms) that are generally more efficient when extensive markets are in place (Leff, 1978).

Groups can also have a dark side arising mainly from agency problems. The most notable liabilities, a favourite of the corporate finance literature, involves rent seeking, including tunnelling of returns away from minority shareholders. Again, as budding industries mature and the sources of long-term financing are diversified market forces disfavour formal economic groups into giving way to looser business alliances. The advantages of competition eventually outweigh those of cooperation.

This paper critically examines these issues by focusing on two interrelated questions regarding organizational innovation in developing countries. Has groupwise diversification been an effective mechanism for enhancing the productivity and competitiveness of fledgling enterprises in the incentive environment of late-industrializing market economies? If so, could a
suitable version of it serve as a template for reorganizing large state enterprises in the Asian transition economies, at least until the appropriate market infrastructures and the political will are mustered for undertaking large-scale privatization?

Drawing on the literature at the intersection of development economics, industrial organization, corporate finance and post-socialist transition, we aim to contribute to this debate in three ways. Firstly, we offer an analytical framework for thinking about the multi-faceted task of assessing the competitive advantage of network synergy over corporate focus. This will be done in a Schumpeterian spirit by relating groupwise diversification to the domestic and external environments that have shaped firm behaviour in the emerging economies. Secondly, we review the recently available econometric evidence as well as country case studies on the impact of group affiliation on firm performance. Thirdly, in the light of the preference for hybrid institutions in the Asian post-socialist transition, we tease out the implications for second-generation state enterprise reform in China and Vietnam.

We conclude that, while business groups tend to be rent seeking in the extreme cases where markets are either poorly developed or well established, they are on the whole paragons in those middle-income economies whose fledgling industrial systems badly need patient capital and flexible organization in order to reach the threshold of global competitiveness. Given the political unpalatability of, and arguably large welfare losses associated with, large-scale privatization (i.e., on account of the absence of the requisite market and regulatory institutions), China and Vietnam might very well find well-regulated business groups an attractive transitional model for cultivating dynamically efficient networks that cut across ownership forms. Such networks can, under a good policy framework, help promising firms in the two countries to economize on scarce managerial skills and high transaction costs, ease risk management by providing a mechanism for mutual insurance, and accelerate technological diffusion.

The discussion proceeds as follows. The evolution and economic performance of business groups in developing economies is briefly reviewed in section 2. The most distinctive features of business groups in the East and Southeast Asian market economies are outlined in section 3. Emerging business groups in post-socialist Russia are examined in section 4 as counterexamples, while nascent group formation in China and Vietnam is reviewed in section 5. The lessons for large-scale state-enterprise reform are distilled in section 6, and recapped in the concluding section.
That groupwise diversification has historically been pervasive in successful late industrializers does not necessarily imply that such an organizational form is necessary for the industrialization of latecomers. Its ubiquity, however, suggests that there is something structural about the phenomenon that calls for an explanation. The appropriateness of particular forms of enterprise organization and firm behaviour must, therefore, be viewed in the context of the institutional and incentive environment that prevails at the various stages in the evolution of markets.

2.1 The evolution of DBGs

There are two interrelated theoretical issues that lurk behind the debate on the significance of DBGs. The first pertains to the very existence of firms, stand-alone or networked. Neoclassical theories, institutional or organizational, posit well-functioning markets as ultimate causes of economic development and accordingly rationalize the existence of large business organizations in terms of imperfections or even failures of markets (Williamson, 1985; North, 1990). Critics argue for reversing the direction of causality. It is organizations (firms, governments), rather than markets, that play the lead role in allocating resources and introducing innovations (product and process) to spearhead both market deepening and economic development (Schumpeter, 1934; Lazonick, 1991).

The second issue has to do with the relationship between the structure of business organization and firm strategy. The orthodox view is Chandlerian. That is, organizational structure follows strategy. In a world of dispersed ownership, competitive advantage originates in the firm’s capability for endogenous organizational innovation. This is attributed to strategies, such as large-scale production, flexible specialization, or diversified product lines that reflect the external conditions faced by the firm including those related to factor supplies, domestic and international demand, supporting services, and infrastructure (Chandler, 1990).

The innovativeness of enterprise organization and behavior is related, in a stylized form, in Table 1 to the ‘selection environments’ of emerging economies. If one assumes reasonably that the learning process is collective, cumulative and uncertain, then rational entrepreneurs respond to, or seek to shape, the institutional and policy environment. This process would involve a co-evolution of market and non-market allocation mechanisms (Schumpeter, 1934; Nelson and

A sequential conceptualization of the evolution of business organization is also depicted schematically in Figure 1. For comparative purposes, three possible models of DBG can be identified in terms of the tightness of the network: a *keiretsu*-type confederal model of loose affiliation, a *grupos*-type federal model of close affiliation (with minority co-ownership), and a *chaebol*-type quasi-unitary model of tight grouping (with majority ownership of stocks in member firms by the core firm).

Company histories suggest strongly that modern DBGs evolved out of family business groups (FBGs) that were established by resourceful business tycoons who, more by trial and error than by grandiose plan, diversified their asset portfolios in response to the absence of efficiently functioning markets. State support or discrimination (as in the case of Chinese minorities in Southeast Asia) was as an important a feature of group formation in Asia and elsewhere (Carney and Gedajlovic, 2003; Kim, Hoskisson and Hong, 2004).

In the earliest stage of industrialization, markets are poorly developed on both the supply side and demand side of the equation. Generic features of underdeveloped markets include lack of access to a highly skilled workforce; repressive labour relations; low domestic demand due to low per capita incomes; limited access to modern technology; insufficient industrial management experience; unstable macroeconomic conditions; poor infrastructure, particularly for transportation and communication; and inadequate sources of long-term bank as well as venture capital. Furthermore, the political environment is typically pervaded by authoritarian, parasitic and personal rule.

An important asset of ambitious entrepreneurs at this early stage is ‘connection’ which often permits the full play of extremely scarce organizational or technical skills. The fusion of wealth and political power in such a capricious environment leads to a strong preference by firms for capturing pure rent, or short-term cash flows over long-term profitability. In other words, the prevailing selection environment, which is characterized by high risk, low trust and high social embeddeness of business activity, favours those firms that are engaged in related as well as in unrelated diversification under tight family control. This process has historically produced mercantile business empires, trading houses, and import-substituting firms operating in a wide array of (initially) protected domestic markets (Strachan, 1976; Leff, 1978; Jones and Wale, 1998).
Under more propitious environments (such as those that combine government support with reciprocity), however, entrepreneurs enjoy adequate expected returns to engage in the risky task of building up domestic industrial capacity. This puts a high premium on technological diffusion and incubation of new firms to fill missing links in domestic value chains (Garrido and Peres, 1998; UNIDO, 2002; Carney and Gedajlovic, 2003).

Long gestation lags are also involved in training skilled workers, in identifying secure markets, and in building up networks of finance and distribution. Even where local firms are well established, the self-limiting nature of import substitution and family management (and inheritance customs that may lead to inefficient fragmentation) frustrates the transition into professionally-managed and outward-oriented industrial corporations (Leff, 1978; World Bank, 1993; Garrido and Peres, 1998; Kock and Guillen, 2001).

The discernible patterns of group formation and growth, in fact, suggest an inverted-U relationship between the index of groupwise diversification and the level of industrial development. In this stylized, three-stage conceptualization of the history of industrial deepening, the more flexible networks of family enterprises give rise to modern DBGs which, in turn, yield to publicly-traded multidivisional corporations or holding companies. In the last stage, as the Japanese and Korean experiences clearly shows, tight grouping becomes more of a liability than an asset. Loose alliances among firms and arms-length relationships between business groups and the state bureaucracy eventually become the new norm (Aoki, 1990; Yafeh, 2002).

2.2 A parasite-to-paragon hypothesis

A hypothesis, therefore, suggests itself concerning the economic significance of business groups in the course of economic development. That is:

*Business groups tend to be rent seeking 'parasites' in the early and late stages of industrialization while they are on the whole innovative 'paragons' in the intermediate stage.*

This hypothesis, in fact, suggests a reconciliation of two apparently conflicting but stage-specific claims. The positive view argues for viewing, at least post hoc, the diversified business group as an effective endogenous response to the structural constraints of weakly-developed domestic markets and uneven global industrial development (Goto, 1982). A growing number of studies of business organization in latecomers (see, for example, Amsden, 2001; Kock and
Guillen, 2001) strongly suggest that the propensity to engage in groupwise diversification under a strategic controller reflects a rational response by innovative entrepreneurs to pervasive market failures and, to what may be called the ‘disadvantages of backwardness’ with regard to industrial capabilities (management, finance, marketing and technological knowledge).

The negative view accentuates the dark side of grouping as an organizational mechanism for unproductive activities. Socially and politically well-connected tycoons expend scarce resources on unproductive rent-creating and rent-dissipating activities. These redistributive efforts are directed especially at exploiting social and political connections to obtain exclusive licenses and subsidies or to over-exploit first-mover advantages from introducing new industries. In modern settings, groups are also used as instruments for the expropriation of minority investors.

While it is difficult to offer a definitive test in the absence of a robust theory and counterfactuals, it is possible to offer highly suggestive evidence for or against the hypothesis. In this regard, a number of econometric studies that analyze cross-sectional data on DBGs have appeared in the past few years.

Gauging the net economic effects of economic groups econometrically is, as Khanna (2000) rightly points out, fraught with problems. First, most studies are limited to publicly traded firms although the bulk of groups in emerging markets are unlisted. Second, reverse causality, arising from possible endogeneity, is a potential problem. The latter problem is, however, mitigated by the fact that the core firm in the group generally controls the admission of new members or the creation of new firms.

The readily available cross-country evidence does paint a somewhat mixed picture. Some studies show that dominant members of DBGs engage in tunnelling (see Bertrand, et al., 2002; Bae, et al., 2002). It is not, however, clear why minority shareholders would knowingly tolerate this expropriation unless countervailing benefits are derived from group affiliation.

Other studies suggest that DBGs in emerging markets are value adding. It shows up in the form higher profitability or higher productivity (Khanna and Rivkin, 1999; Keister, 1998; Perotti and Gelfer, 2001). Studies based on rates of asset returns and Tobin’s q also show that firms that belong to DBGs in emerging economies perform much better than non-affiliated firms.

For the developed countries, the available econometric evidence shows that groups have lower rates of return than non-affiliated firms do. Headquarters of groups and conglomerates are sometimes accused of practicing a kind of ‘socialism’ by under-investing in divisions with relatively good prospects. The stock markets react unfavourably to such unwarranted decreases in
corporate focus and fear of expropriation of minority owners by imposing an over-diversification

Further insight into the political economy of grouping can be gleaned from the experience
of East Asia and Russia with such groups. We take them up next since the nuanced case studies
also offer instructive, albeit sobering, lessons for Chinese and Vietnamese policymakers.

3 Business groups in East Asian market economies

Industrial companies in capitalist East Asia are typically bank-led or family-held entities
(Claessens, Djankov, Fan and Lang, 1998; 1999; 2000). They display a strong investment drive,
orientation toward increasing market share, varying degrees of price-making power in domestic
markets, and a paternalistic relationship between employer and employee. The culture of
companyism and labour repression, at least until very recently, is complemented by government
paternalism toward large business (Amsden, 2001; Lall, 1997).

Leaving aside the special case of Japan, the emerging East Asian market economies boast a
high level of group affiliation most notably among industrial firms. Business groups are
prominent in Indonesia, South Korea, the Philippines, Malaysia, Thailand, and even Hong Kong.
Average asset size for multi-segment groups exceeded half a billion US dollars in the mid-1990s
in all but the Philippines. They are much less important in Taiwan and Singapore though state-led
groups are prominent players in the latter (Wade, 1990; Chung, 2003).

The role of the Korean government, as guarantor and taskmaster, is particularly instructive.
It provides credit-subsidy and guarantees for hard-to-get foreign loans to the chaebols. What
makes this support novel is that it is conditioned on the family-owned conglomerates committing a
significant amount of own resources to investment, moving into capital and skill intensive
industries, and expeditiously attaining competitiveness in export markets (Amsden, 1989; World
Bank, 1993; Choi and Cowing, 2002).

A central feature of Korea’s industrial landscape is the prominence of highly leveraged and
vertically integrated business groups. They are major players, even after the 1997 financial crisis
exposed the weakness of unrestrained diversification and led to the demise or significant
streamlining of many groups (Kim, Hoskisson and Hong, 2004). They still remain prominent in
heavy and chemical industries accounting for 25-66 percent of value added. In the mid-1980s, the
top 50 Korean business groups accounted for one-fifth of GDP.\(^1\)
The significance of large diversified firms in the industrial and tertiary sectors of East Asian economies can be gleaned from the data analyzed by Claessens, Djankov, Fan and Lang (1998; 1999; 2000). Nearly two-thirds of some 13,000 publicly listed firms in East Asian market economies have multi-industry presence even at the broad two-digit ISIC level. Interestingly, firm-level diversification by affiliates is a complement rather than a substitute for group-level diversification.

Claessens, Djankov, Fan and Lang (1998; 1999; 2000), using data for from nine middle-income countries on listed companies affiliated with corporate groups, also uncover interesting patterns. First, group-affiliated firms, most of which are controlled by financial institutions, have lower accounting profitability, higher leverage, and larger size than independent firms do. This reflects their propensity for high investment rates and the resulting debt/equity ratios that are over twice those of Europe or North America. Second, industrial houses in the more developed East Asian countries benefit from diversification (i.e., learn faster) than their counterparts in the less developed countries of the region.

Third, coupling firm-level diversification with group affiliation, far from being overkill, can be an effective way of creating efficiency-enhancing internal markets. Groupwise diversification appears to circumvent high market-contracting costs. Lastly, some dominant stockholders use their control over groups as a means of expropriating minority holders. In another study (Claessens, Djankov, Fan and Lang, 2002), the authors show that mature and slow-growing firms financially benefit more from affiliation than young and high-growth firms.

4 Business groups in post-socialist Russia

As noted above, government support for DBGs followed their genesis in the private sector. By contrast, DBGs in post-socialist economies were creations of the state under schemes involving varying degrees and forms of privatization.

Transition economies, needless to say, are confronted by twin development challenges. As middle-income countries, they face the challenge of technologically upgrading their economies and integrating themselves with the world economy along sensible lines. Furthermore, as post-socialist economies, they need to restructure or mobilize their considerable industrial and human resource bases to generate broadly shared economic growth. Organizational innovation, therefore, plays a key role in technological upgrading as in the case of other developing economies.
It would also be useful to note here that the classical socialist enterprise operated in a selection environment characterized by pervasive shortage (see Table 1). That was why it was biased toward output maximization (but against innovation), input hoarding, hyper-vertical integration to deal with unreliable supply chains, provision of a wide array of social services to its employees, and accumulation of political capital (Kornai, 1992; EBRD, 1991; Aslund, 2002). On the positive side, the socialist legacies include such growth-friendly attributes as a rich base of human capital, substantial industrial experience, and low inequality in the distribution of wealth (Easterly, 2001).

The collapse of central planning inevitably paved the way for the emergence of extensive market relations. Long-established economic linkages were dissolved along with the destruction of an unprecedented amount of economic information. Longstanding relationships between suppliers and users became untenable in the twilight zone between plan and market. Large state enterprises beset by huge bad debts and redundant workforce, followed various defensive strategies to cope with what has come to be called transformational depression (see Blanchard, 1997; Megginson and Netter, 2001).

The twin strategies of lobbying for more state support and exploring new market linkages met with varying degrees of success depending on initial conditions and policies. In a world of weak regulation and decentralized administrative guidance, alliances with local authorities and industrial-ministry patrons remained important. This proved useful for a while in protecting regional markets, improving leverage over organized workers, ensuring maintenance of public infrastructure, and securing access to state financial institutions. A growing number of companies, especially in countries with gradualist reform programs, formed powerful industry associations and loose alliances often at the instigation of overburdened regional governments (Blanchard, 1997; Qian, 2000; Recanatini and Ryterman, 2000).

It is in this less than auspicious environment that grouping emerged as an appealing form of strategic (i.e., defensive) reorganization for partially or fully privatized firms in Russia. The most powerful groupings took the form of financial-industrial groups under the control of a handful of politically astute young oligarchs—men who successfully sought to convert power into private wealth.

FIGs are defined in Russian Law simply as ‘a group of enterprises, institutions, organizations, lending and financial institutions and investment institutions officially registered at the federal level’ (Johnson, 1997, p. 334). The growth of economic groups parallels the three
waves of privatization in Russia during 1992-99: mass (voucher) privatization, loans-for-share swaps, and case-by-case-privatization. The morphing of the financial entities as leaders of FIGs was more or less completed as the new cadre of oligarchs successfully pushed Boris Yeltsin into a hard-fought second term. Unprecedented rewards soon came in the form of loan-for-equity swaps. The banks owned by the oligarchs, using mostly the government’s own funds deposited with them, advanced large loans to the cash-strapped federal government (Aslund, 2002; Hoffman, 2002).

Following the election, the private banks were permitted to cash the high-yield government bonds and to redeem the blocs of state-enterprise shares they had held as collateral in strategic industrial and extractive sectors. The captains of finance understandably proceeded to acquire a foothold in industry by purchasing the shares themselves at fire sale prices in blatantly rigged auctions.

By 1997, there were 36 registered (bank-led as well as industry-led) groups comprising over 500 enterprises and 70 banks which together accounted for nearly one-third of Russia’s GDP. In 2002, just eight business groups control 85 percent of revenue from Russia’s 64 biggest private companies (Travernise, 2002). The big eight financial-industrial giants (by ultimate owner) were: Logovaz (Berezovsky), Menatep (Khodorokovsky), SBS-Agro (Smolensky), Alfa Bank (Fridman-Aven), Mikrodin (Yefanov), Gazprom (Cheronomyrdin-Vyakhirev), Inkombank (Vinogradov), and Uneximbank (Potanin).

Overall, the performance of Russia’s bank-led groups has been less than stellar. Perotti and Gelfer (2001), using a broader definition of groups that includes sector-oriented conglomerates, arrive at two conclusions: (1) bank-led groups benefit from a more efficient allocation of investable funds than the loosely organized industry-led groups, and (2) investment is equally insensitive to internal finance as between members of industry-affiliated firms and unaffiliated firms. A notable inference is that core banks contributed to group success by acting as a central planning board for coordinating key investment decisions. Core manufacturers, on the other hand, provided leadership for such purposes as marketing and political influence.

It would be useful to note here that, under V. Putin, who once promised to liquidate the oligarchs as a class, two important developments have taken place (Lloyd, 2000; Travernise, 2002). The first is that, in a climate of semi- legality, the large business groups continue their strategy of buying up entire industries and consolidating their far-flung holdings. Currently, the most prominent tycoons include O. Deripaska, R. Abramovich, M. Fridman, M. Khodorkovsky,
V. Potanin, V. Aekperov, V. Kadannikov, V. Bogdanov and V. Yevtushenkov. The second is that, the oligarchs are increasingly abandoning the strategy of kleptocratic accumulation by corrupting the political system as king-makers. The few who insist on aggressively seeking to be big players in both the political and economic spheres appear to have been outmanoeuvred by the Kremlin. The most prominent examples are Berezovsky (exiled) and Khodorkovsky (under detention on charges of massive tax evasion, and his Yukos oil giant auctioned off and will likely be absorbed by Gasprom).

5 Group formation in China and Vietnam

In the light of the weaknesses of the legal system and significant state ownership of assets even in privatized enterprises, economic groups in China and Vietnam do not strictly meet all four criteria that we used to define DBGs. The potential for corruption and regulatory capture is, therefore, potentially high so long as the state remains both regulator and significant shareholder.

Furthermore, the SOE sector in Vietnam and China remains highly concentrated and omnipresent. In Vietnam, it accounts for one-third of government revenues, half of export proceeds and outstanding domestic bank credit, one-fifth of total investment, and one-sixth of non-agricultural employment. The 200 largest Vietnamese SOEs claim some 60 percent of state capital, 40 percent of total debt and most of the operating profit.

The biggest Chinese SOEs, quite large in terms of employment by international standards, contribute over two-thirds of industrial value added. The biggest 500 private enterprises in China, by comparison, report barely two percent of the sales revenue generated by state enterprises (World Bank, 2000; 2002; IMF, 2003). The current status of ownership and governance structures of large, strategic SOEs in China and Vietnam is shown in a condensed form in Table 2.

5.1 China’s Jituan

Inspired by the unprecedented technological achievements of the Korean chaebol, the Chinese began to experiment with group formation in the second half of the 1980s which resulted in the establishment of some 50 groups by 1990. Initially, grouping took the form of industry-wide mergers and acquisitions involving downstream and upstream enterprises that belong to various industrial bureaus (Keister, 2000).
This process of unbundling of large state monopolies and rejigging them into groups accelerated in the 1990s especially after the Fifteenth Party Congress in 1997. The first track of China’s dual-track approach to economic reform focused on privatization (including constitutionally guaranteed equal treatment for private property and state property). It took the form of outright sale and shareholding schemes for small and medium-size enterprises. Non-state enterprises, which recorded strong productivity growth, account for more half of industrial output and two-thirds of the enterprises (Jefferson, et al., 2000).

The second track aims at converting 500-1000 large SOEs into holding companies or business groups (qiye jituan). Many employ a pyramiding structure thereby giving the state (as the lead principal) more control rights than is warranted by its income rights (Watanabe, 2002). Core firms applying for registration are required to provide a strong economic rationale for grouping and a clear plan to deal with the concomitant shedding of excess labour. While many of the hundreds of groups are led by medium-sized, regional players, a few are led by nascent national champions (Nolan, 2002).²

Keister (1998; 2000) provides a good glimpse of the structure and conduct of Chinese groups. Her findings, based on two rounds of sample surveys of 40 of the largest jituan in 1990 and again in 1998, suggest that well-regulated groups hold high promise.

First, the attraction of groups for potential affiliates is described by managers as an application of the bigger-is-better principle. Belonging to a group is perceived as advantageous in terms of scale economies in production, distribution and management of technology, greater political influence, greater access to finance, a more stable supply of key inputs and markets for output, higher status and prestige (especially brand name recognition), and higher trust rooted in strong social, regional and administrative ties developed under central planning.

Second, in terms of the structure of authority, the large jituan resemble the Japanese ‘industrial’ kereitsu in that the core firm made key decisions on behalf of the group. Other areas of resemblance include interlocking directorates, financial linkages, commercial ties and manager rotations. Third, the exchange of board members, commercial goods and managers within groups was reciprocal while the exchange of capital was largely from the more secure core firm or finance company to affiliates with limited extra-group options.

Fourth, controlling for other determinants of financial performance, firms belonging to densely connected groups performed better financially than those in loosely connected groups. Denser inter-firm connections within groups were also positively correlated with higher financial
performance and productivity performance. Furthermore, firms in groups with interlocking
directorates, finance companies, and research and development companies performed better than
those belonging to groups without these features.

5.2  *Vietnam’s General Corporation*

In Vietnam, corporatization and equitization (i.e., partial privatization) are in their early stages of
development (Fforde and de Vylder, 1996; Lavigne, 2000). Despite slow but steady liberalization
of trade and investment codes, the state still intends to control the commanding heights as the sole
or the controlling owner. The distribution of industrial output is currently 42 percent in the state
sector proper, 22 percent in the non-state collective sector, and 36 percent in the foreign-invested
sector. FDI in resource- and labour-intensive manufacturing is likely to remain important since
oil, textiles and footwear account for half of exports (IMF, 2003).

Vietnam’s largest 200 SOEs, much like China’s largest 500 SOEs, are on the whole financially (but not necessarily economically) profitable. They contribute a substantial portion of the revenue collected by the Treasury. Large SOEs absorb a lion’s share of state-bank credit, and their average debt-to-equity ratios and productivity are far better than those of medium-scale public enterprises. The average size of even the top 100 Vietnamese SOEs is, however, rather small reflecting a history of small-scale industrialization (see Table 3)\(^3\).

\[\text{Table 3 about here}\]

Group formation in Vietnam is in its infancy, and the inspiration seems to come from
China and South Korea. The leadership’s intention to establish conglomerates can be inferred
from the 1995 (and 2001) Vietnamese Law on Enterprises. The Law permitted, following the
Chinese example, the establishment of conglomerates (if not full-fledged groups) known as
General Corporations (GC).

A bona fide GC is envisaged to satisfy three of expectations that it be involved more than
one industry; have a particular orientation or core competence that justifies the links among
disparate firms; and establish own finance company to mobilize and allocate capital for the group.
Eighteen GCs have been established so far with the following sectoral orientation: 5 in public
utilities and business services, 4 in mining and agriculture, and 9 in manufacturing. Sub-sectors of
manufacturing without GCs include skill-intensive branches such as machinery, and labour-
intensive branches such as fabricated metals, wood, furniture and non-metallic products.
The current conceptualization of the GC is full of ambiguities (World Bank, 1995). The definition of a ‘strategic’ sector goes far beyond public goods, or private goods that cannot be competitively provided by the private sector albeit with some assistance.

Furthermore, there is a multiplicity of principals (central, regional, industrial bureau or ministry), objectives (fiscal, social, efficiency), and roles (the State as owner versus as regulator). In those sectors where SOEs enjoy monopoly power (such as cement and textiles), there are few safeguards against asset stripping and related non-competitive behaviour—a feature that is likely to be accentuated by the proliferation of such GCs.

6 The post-socialist DBG: model or muddle?

The foregoing review of the role of tightly-knit business groups in emerging economies holds valuable lessons for China and Vietnam as they seek to establish comprehensive codes for group affiliation, mergers and acquisitions. The bottom line is that the unbundling of the largest state monopolies has to be done with great care. It should be designed to judiciously facilitate the emergence of competitive enterprises, including from greenfield privatization, which can exploit the opportunities presented by domestic networks of varying tightness as well as global value chains.

Policymakers in the two ‘unorthodox reformers’ face a broad array of conflicting goals that are still shaped, to a significant extent, by the inherited industrial landscape (Steinfeld, 1998; Sachs and Woo, 2000; Lavigne, 2000; Tenev and Zhang, 2002). The main tasks involved in modernizing the industrial structure include: (i) building up equitized financial and nonfinancial corporations with clean balance sheets, including the transfer of social welfare functions (housing, health care, education) to fiscally sound local governments, (ii) identifying core manufacturers (and perhaps core banks) to lead economically sensible business groups, especially where the state is likely to remain an important shareholder, (iii) permitting mutually beneficial affiliation between state and non-state enterprises as well as joining global value chains, (iv) facilitating the emergence of supra-regional and inter-ministerial asset management bodies to stem coordination failure in the absence of sufficient market (or plan) discipline, and (v) formulating enforceable regulations that ensure intra-group equity, foster inter-group competition, and create the proverbial ‘firewall’ between independent companies and politicians.
The foregoing review suggests another hypothesis concerning Sino-Viet model of economic grouping. That is:

*Well-regulated groups, led by strategically placed state enterprises, can serve as an effective organizational model for reducing transaction costs in a weak legal environment, channelling investment in strategic and complementary activities, sharing key resources via internal markets, pooling risk, exploiting market niches in the global economies, and facilitating state guidance with reciprocity.*

A case can certainly be made against adopting a MITI-style, much less a Korean-style, strategic industrial planning in socialist East Asia. The litany of arguments for accelerating privatization and marketization are based on the need to fully appreciate the initial conditions of reforming China and Vietnam. The two transition economies have inherited an economic bureaucracy predisposed to command-and-control directives rather than to guidance planning; have contradictory policy goals of picking winners while shielding losers; cannot effectively insulate technocrats from political interference and corruption; and WTO rules preclude the kinds of industrial policies followed by Korea in the 1970s. Grouping without aggressive privatization would, therefore, amount to little more than reshuffling enterprises into clusters with little or no prospects for constructive change in managerial behaviour (see, for example, Perkins 2001).

Jefferson, et al. (2000), on the other hand, note that China’s foreign-invested as well as shareholding enterprises have failed to deliver significant productivity gains in the 1990s. That is because sustained growth of total factor productivity depends on a supportive economic environment (legal, financial and regulatory) and an enterprise system that would make hybrid ownership workable. There is, in fact, little or no evidence of a latecomer producing leading industries and national champions by eschewing government promotion in favour of rule-based, non-discretionary industrial policy (see Amsden, 2001).

Given the respectable economic record of groupwise diversification in wide-ranging emerging market economies, and China’s own tentative experiment with the jituan, the more fruitful question may have to do with identifying the right sequence of enterprise reforms that would facilitate the speedy emergence of a vibrant market for corporate control (see Stiglitz, 1999; Qian, 2000; World Bank, 2002).
Grouping in China and Vietnam may, therefore, be usefully approached in the context of two distinct phases of market-socialist reform. During the ‘phase-in’ period currently underway, the focus of reform has rightly been on ensuring macroeconomic stability, cleaning up of the bad debts of large enterprises and state banks, and laying down the foundation for the assumption of social spending obligations by local governments. The portfolios of business networks are to be strictly justified on the basis of potential net welfare gains in terms of scale, scope and learning economies. With less than a US$1000 of per capita income, the two countries, with a reputation for pragmatism, cannot afford to waste scarce resource on far-fetched experiments.

During the ‘phase-out’ period, the orientation of industrial policy must switch from selective to functional within the scope of what some consider are unduly restrictive WTO rules. Policy focus shifts to streamlining over-diversified groups, creating sufficient oversight over fragile capital markets, and undertaking deeper privatization to stem asset stripping by state agents enjoying a powerful mix of controlling and income rights in mixed-ownership enterprises. A case in point is the resolution of the Central Committee (passed on 14 October 2003) to move away China from the policy of zhuada fangxiao (grasp the large, release the small) to one of controlling-private ownership and rules-based business environment (Tenev and Zhang, 2002). The state now intends to sell stakes in 190 state conglomerates (with assets of more than US$300 billion).

It would be fair to say that the Asian financial crisis has reaffirmed the findings of the econometric studies on DBGs. The very attributes that made business networks successful (such as economizing on scarce resources, facilitating innovation, reducing financial risk, and countervailing power against a rigid bureaucracy) eventually become fetters as markets become sufficiently developed and local firms progressively integrated with the global markets. The ongoing cross-kereitsu mergers among historically fiefdom-oriented banks or tie-ups among rival trading houses in Japan, and the collapse as well as rationalization of many of Korea’s chaebols point to the capacity of this model to evolve (Mody, 1999; Goto, 1982; Yafeh, 2002; Kim, Hoskisson and Hong, 2004).

The Nipponean DBG, which relied neither on state shareholding nor on foreign direct investment, will have to be adapted to the needs of the state-dominated but FDI-seeking market economies of Southeast Asia as well as China and Vietnam. A nimbler cousin of the chaebol presents a more attractive transitional model worthy of imitation than the muddle that is the Russian FIG.
The phase-out stage, when completed, would likely leave a legacy of an efficiently diversified domestic industrial base. A variety of DBGs are likely to emerge across different ownership lines: state-state, state-private, and private-private. Where DBGs lack competitive advantage, other forms of networking such as clusters of specialized but complementary firms evolve into ‘industrial districts’ which is currently underway in the eastern seaboard of China with regional governments supplying the missing links.4

7 Conclusion

This paper critically examined the relevance of the diversified business group for the challenge of going beyond defensive restructuring or willy-nilly privatization of selected large-scale SOEs in China and Vietnam. It suggests that suitably-adapted business grouping is a promising model for large-scale state enterprises in the two countries at the intermediate stage of reform.

The primary advantages of groupwise diversification, a hybrid institution that melds elements of central planning and market competition, lie in converting the disadvantages of late development into an opportunity. It could help to overcome pervasive market failures (using closely linked supplier-manufacturer relations, internal capital markets, and investment in skills), high agency costs (via dominant ownership, close supervision and monitoring by key lenders), high risk (mitigated by affiliate and market diversification), significant barriers to cost-efficient acquisition and diffusion of technological information across firm boundaries (via coordinated negotiation and internal sharing), scarce managerial skills, and inadequate publicly-provided infrastructure (through self-provision and lobbying). On the other hand, poorly structured or regulated groups may bring potentially large welfare losses, including a propensity for rent seeking and unjustifiable access to state financial capital, stifling competition from small firms and foreign investors, and frustrating effective monitoring by lenders and stakeholders.

That is why the DBG is best viewed as a potentially effective transitional organizational innovation for promoting industrial deepening in those sectors where markets are too shallow, capital and entrepreneurship too scarce, and entry barriers into global markets too strong. If the two post-socialist reformers manage to develop groups that are relatively free of control by rent-seeking oligarchs and corrupt apparatchiks, China and Vietnam stand a good chance of moving to the frontline of the ‘flying geese’ of East Asian development.5
8 Notes

1. The top 30 chaebols had an average of 616 affiliates while the top 5 had an average of 40 affiliates. Much of the growth for these fiercely competitive groups came from the establishment of new subsidiaries rather than from recruitment of non-affiliated firms. Even in Taiwan, not known for its industrial (firm) concentration, some 100 of the biggest groups accounted for one-fifth of manufacturing value added.

2. Nolan (2002, p. 121) sums up the nature of state support to selected SOEs, 11 of whom made it in Fortune 500 in 2001, this way: ‘China’s chosen global giant corporations were supported through industrial policies, which included: tariffs, which still were significant in many sectors at the end of the 1990s; non-tariff barriers, including limitations on access to domestic marketing channels, requirements for technology transfer and to sub-contract to selected domestic forms as the price for market access; government procurement policy; government selection of the partners for major international joint ventures; preferential loans from state banks; and privileged access to listings on international stock markets.’ Parenthetically, some two-thirds of the large stock of FDI (US$700 billion) that China has received in the past two decades went into the modern industrial sector—a sector that provides employment for over 40 million workers.

3. Although most of the 5,500 SOE are quite small, Vietnam does not yet have anything comparable to China’s dynamic TVEs. Of the 2280 SOEs planned for restructuring in 2000, some 380 were to be divested by 2002 of which fewer than 200 had assets valued in excess of 1 million USD. Average assets (fixed plus working capital) for the largest 100 SOEs are, however, valued at US$70 million—about one-tenth of the average size of 117 diversified firms in Indonesia (World Bank, 2000). The stock of FDI in Vietnam currently stands at about US$20 billion.

4. Industrial districts are regions that enjoy agglomeration or cluster economies where flexible specialization and competition over product innovation enable small firms to gain access to large domestic and export markets. National and local governments stem coordination failure by providing essential infrastructure and other business services. In the large textile and apparel districts of the Yangtze River, for example, ‘The Chinese government has played a crucial role, opening huge swaths of land for development,
forming giant industrial parks, doling out tax benefits and developing the infrastructure and transportation networks needed to move products quickly to market’ (Barboza, 2004, p. 3).

5. The flying geese (FG) model of East Asian development, proposed in the 1930s by Akimatsu (1962), posits a sequential and ever-changing division of labour between the industrial leader (Japan) and its followers. Efficient latecomers can move up, even leapfrog, the ladder of comparative advantage by using labour- and resource-intensive manufacturing as a springboard for upgrading national technological capability.

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York: Oxford University Press.


Figure 1  Paths of business diversification and control in the course of industrialization

UNITARY MODEL  (high relatedness and control)  FEDERAL MODEL  (low relatedness and control)

STATE-LED GROUPS  MARKET-LED GROUPS

Diversified Business Groups (DBG)  Family Business Groups (FBG)

Holding and Multidivisional Conglomerates (HMC)

Joint Ventures and Spin-offs (China)  State-owned Core Enterprises (China, Russia)  National Leaders or Champions (Asia, L. America)  Transnational-led Networks (Latin America)

Branches of an organizational form  Projected post-socialist evolution

Historical evolution of business organization (FBG to DBG to HMC)
Table 1  Stylized Selection Environments and Corporate Structures of Latecomers

<table>
<thead>
<tr>
<th>Feature</th>
<th>Emerging Market Economies</th>
<th>Emerging Transition Economies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Selection Environment</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Factor Markets</td>
<td>- Bank-centered financial markets</td>
<td>- State bank-dominated markets</td>
</tr>
<tr>
<td></td>
<td>- Unreliable input suppliers</td>
<td>- Seller’s market or shortage economy</td>
</tr>
<tr>
<td></td>
<td>- Good formal property rights regime</td>
<td>- Ambiguous property rights regime</td>
</tr>
<tr>
<td></td>
<td>- Fair to good supply of high skills</td>
<td>- Good (Europe) to fair (Asia)</td>
</tr>
<tr>
<td>B. Product Markets</td>
<td>- Inadequate distribution system</td>
<td>- Poor distribution system</td>
</tr>
<tr>
<td></td>
<td>- Competition from imports and SMEs</td>
<td>- Limited but strong as in China</td>
</tr>
<tr>
<td></td>
<td>- State procurement is important</td>
<td>- State procurement is paramount</td>
</tr>
<tr>
<td>C. Infrastructure</td>
<td>- Uneven quality of utilities, transportation and communication</td>
<td>- Outdated utilities, transportation and communication</td>
</tr>
<tr>
<td></td>
<td>- Public sector is important</td>
<td>- Public sector is primary supplier</td>
</tr>
<tr>
<td>D. Industrial Policy</td>
<td>- State-business reciprocity</td>
<td>- State capture or partnership</td>
</tr>
<tr>
<td></td>
<td>- Strategic or functional</td>
<td>- Haphazardly selective</td>
</tr>
<tr>
<td></td>
<td>- Emerging regulatory framework</td>
<td>- High formal to non-existent</td>
</tr>
<tr>
<td></td>
<td>- Development banks are important</td>
<td>- Quasi-development banks</td>
</tr>
<tr>
<td></td>
<td>- From result to rule orientation</td>
<td>- Lingering commandism and gigantism</td>
</tr>
<tr>
<td>E. Global</td>
<td>- Globally integrated value chains</td>
<td>- Globally integrated value chains</td>
</tr>
<tr>
<td></td>
<td>- Soft-hearted GATT rules</td>
<td>- Hard-headed WTO rules</td>
</tr>
<tr>
<td></td>
<td>- Access to FDI and portfolio</td>
<td>- Access to export-oriented FDI</td>
</tr>
<tr>
<td><strong>II. Organization and Behavior of Firms</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Core Capability</td>
<td>- Managerial and technical capability in industry</td>
<td>- Rentier connections plus technical skills</td>
</tr>
<tr>
<td></td>
<td>- Domestic firm-led or MNC-led</td>
<td>- Domestic firm-led: state sector</td>
</tr>
<tr>
<td></td>
<td>- Learning: process-oriented</td>
<td>- Learning: process and product</td>
</tr>
<tr>
<td>B. Firm’s Strategy</td>
<td>- Debt-financed growth</td>
<td>- Bank-financed and state-captive</td>
</tr>
<tr>
<td></td>
<td>- Knowledge acquisition and spillovers</td>
<td>- Knowledge acquisition and spillovers</td>
</tr>
<tr>
<td></td>
<td>- Market share then profitability</td>
<td>- Market share then profitability</td>
</tr>
<tr>
<td></td>
<td>- Transaction cost then agency cost</td>
<td>- Agency cost then transaction cost</td>
</tr>
<tr>
<td>C. Group Network</td>
<td>- Moderately-related diversification</td>
<td>- Related and unrelated, including cash cows</td>
</tr>
<tr>
<td></td>
<td>- Pyramids and family control</td>
<td>- Highly concentrated: state or family</td>
</tr>
<tr>
<td></td>
<td>- Internal capital and managerial markets</td>
<td>- Controlling firm as central planner</td>
</tr>
<tr>
<td></td>
<td>- Managing economic and political risk</td>
<td>- Managing economic and political risk</td>
</tr>
<tr>
<td></td>
<td>- Varying forms of coordination, but favour greater focus</td>
<td>- From centralization to disorganization and then to reorganization</td>
</tr>
</tbody>
</table>

Sources: Various.
Table 2  Major features of state enterprise reform in China and Vietnam, *circa* 2000

<table>
<thead>
<tr>
<th>Item</th>
<th>China</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. OVERVIEW</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. The New Constitution</td>
<td>- Equality of private and public</td>
<td>- Equality of both</td>
</tr>
<tr>
<td>b. Output Share</td>
<td>- 25% of IVA</td>
<td>- 45% of IVA</td>
</tr>
<tr>
<td>c. Large SOEs</td>
<td>- 70% of assets and IVA</td>
<td>- 60% of assets and credit</td>
</tr>
<tr>
<td>d. Reserved Areas</td>
<td>- Utilities, military, infrastructure, capital intensive, key services</td>
<td>- Negative List, People’s Committee can veto any item</td>
</tr>
<tr>
<td><strong>A. SECOND-GENERATION REFORMS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Focus</td>
<td>- Governance of large SOEs</td>
<td>- Small SOE privatization</td>
</tr>
<tr>
<td>b. Budget Constraint</td>
<td>- Hardened for most SOEs</td>
<td>- Hardened for few</td>
</tr>
<tr>
<td>c. Social Welfare</td>
<td>- Transferred to government</td>
<td>- SOE did not provide much</td>
</tr>
<tr>
<td>d. SOE Management</td>
<td>- Large SOEs corporatized; managerial autonomy</td>
<td>- Limited equitization so far; non-financial autonomy</td>
</tr>
<tr>
<td>e. Ownership</td>
<td>- Equity sale by large SOEs</td>
<td>- Limited sale of equity</td>
</tr>
<tr>
<td>f. Non-state Sector</td>
<td>- 120 SOEs to form holding cos.</td>
<td>- GCs for strategic SOEs</td>
</tr>
<tr>
<td>g. FDI Joint Ventures</td>
<td>- JVs are competitive: exports</td>
<td>- JVs are non-competitive</td>
</tr>
<tr>
<td>h. Commitments</td>
<td>- Accession to WTO in 2001</td>
<td>- Regional and bilateral</td>
</tr>
<tr>
<td><strong>B. GROUP FORMATION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Timing</td>
<td>- Since late 1980s</td>
<td>- Since mid-1990s</td>
</tr>
<tr>
<td>b. Initiative</td>
<td>- Regional gvts. and bureaus</td>
<td>- State-led conglomerates</td>
</tr>
<tr>
<td>c. Types</td>
<td>- Small and large groups</td>
<td>- To be led by large SOEs</td>
</tr>
</tbody>
</table>

Sources and notes:

IVA = industrial value added  PE = private enterprise
SOE = state-owned enterprise  GC = general corporation

Table 3  Vietnam: plans for state enterprise restructuring, 2000-2002

<table>
<thead>
<tr>
<th>By Capital:</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than 10 billion VND(^a)</td>
<td>54</td>
<td>68</td>
<td>94</td>
<td>216</td>
</tr>
<tr>
<td>1-10 billion VND</td>
<td>452</td>
<td>415</td>
<td>366</td>
<td>1233</td>
</tr>
<tr>
<td>Less than 1 billion VND</td>
<td>292</td>
<td>250</td>
<td>289</td>
<td>831</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>By Policy Measure:</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merger</td>
<td>179</td>
<td>107</td>
<td>94</td>
<td>380</td>
</tr>
<tr>
<td>Divestiture(^b)</td>
<td>508</td>
<td>481</td>
<td>500</td>
<td>1489</td>
</tr>
<tr>
<td>Liquidation and Bankruptcy</td>
<td>95</td>
<td>132</td>
<td>141</td>
<td>368</td>
</tr>
<tr>
<td>Convert to Non-Profit</td>
<td>16</td>
<td>13</td>
<td>14</td>
<td>43</td>
</tr>
<tr>
<td>TOTAL</td>
<td>798</td>
<td>733</td>
<td>749</td>
<td>2280</td>
</tr>
</tbody>
</table>

Sources and notes:

a. VND = Vietnamese Dong. 1 USD = 14,000 VND in October 2000.

b. Divestiture includes equitization and other forms of privatization (free transfer, sale, lease, and contract-out). As of June 2000, the five-year experiment has resulted in the equitization of 421 state enterprises, of which 305 have sold more than 65% of their shares to non-state holders.

World Bank (2000), Tables 1, 2, 3 and 4.