



# Developing Small and Medium Enterprises (SMEs) in a Transitional Economy-from Theory to Practice: An Operational Model for Vietnamese SMEs

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## Abstract

This paper examines the factors contributing to the growth of SMEs by using a conceptual framework derived from the concept of resource; cluster; networking; and institutional theories. The Vietnamese experience suggests that institutional weakness and lack of proper coordination between policy making, implementation and market conditions has made the support regime ineffective. Literature review indicates that Vietnamese government has mainly focused on increase the number of SMEs rather than improving the performance of SMEs and strengthening the business competitiveness. This must be facilitated by the critical entrepreneurial role of the state. Furthermore, this paper argues that no adopted model from one country to another country would be suitable without consideration. It is vital to address the issues of external business environment, market environment, and social culture. The paper then recommends that the evolving relationship between the state's entrepreneurial role and market factors are parts of the success picture. More importantly, support policies may be invalidated by the unbalance relationship between the state and market. Unfortunately, such important relationship has not thoroughly been identified by the Vietnamese government.

**Keywords:** SMEs, Transitional economies, Support policies

## 1. Introduction

SMEs in Asian developing countries, Central and Eastern European countries require strong aids from the governments in finance, technology, logistic, training, human resource development and entrepreneurship development. In Vietnam, the development of SMEs not only needs for the above mentioned policies but also have the need for stronger supports from the state in legal framework, information, credit, export promotion, tax, land, institutional and banking reform (US/Viet/95/004).

Furthermore, a recent study that was conducted by Ha and Swierczek (2003) has found that the performance of SMEs in Vietnam was positively related to entrepreneurial culture. Thus, it seems that informal institutional development (in this case is the development of entrepreneurial culture) is as important as formal institutional development to the growth of SMEs in Vietnam. This paper examines how key physical, managerial, technological, strategic, cultural and organizational factors influence the business operation process of SMEs in Vietnam. The resource based theory, clustering, networking, and institutional theories provide an analytical framework to explain how a well-defined support regime can provide policy support, resource, and institutional infrastructure for the growth of SMEs.

## 2. Literature review

### 2.1 SMEs Growth Pattern

SMEs growth depends on many factors that vary from country to country. McIntyre (2002) argues that a synergistic relationship between the SMEs and the larger enterprise sector is a critical factor. Havie (2002) observes that in China,

the development of the Township and Village Enterprises (TVEs) is an important aspect for the growth of SMEs. McIntyre (2002) also recommends synergistic relationship and the process of urbanization, based on both horizontal and vertical linkages such as industrial district and cluster (cited in Julien 1993, and You 1995), and the external economies of agglomeration and scope that played a large role in the post-World War II successes of Northern Italy.

Regnier (1994) examines the overall experience of the four Asian newly industrialized countries (Singapore, Korea, Hong Kong and Taiwan) as examples for the need to promote the SMEs sector and also to encourage linkages between large and the small-scale enterprises. Empirical evidences in some developing Asian countries also support this trend: large firms (particularly state enterprises) sponsored and promoted local SMEs in Indonesia (Hill, 2002); the Department of Industrial Promotion (DIP) in Thailand implemented programs for promotion of linkages between SMEs and large firms, and develops SMEs clustering and networking (Brimble, Oldfield and Monsakul, 2002).

Various theories have explained that SMEs' growth from different perspectives. However, in order for a SME to develop its core competency, adequate resource (both internal and external) is an importance prerequisite.

## *2.2 Resource Based Theory*

Rindova and Fombrun (1999) argue that resources, capabilities and core competencies are essential for a firm's competitive advantage. Therefore, adequate resource support and policies to create capability are critical for SMEs' growth as they are small in size and need assistance. Resource based theory provides a framework to explain how business can identify suitable measures to overcome growth obstacles, have better access to technology resources, manpower resources, financial resources, natural, and infrastructure, and access to the market.

According to Barney (1991) and Grant (1991), the four types of tangible resources are financial, organizational, physical, and technological. The three types of intangible resources are human, innovation and reputational resources. An example is the TVEs model in China, where TVEs rely on the state sector as a source of capital, materials, equipment, specialised personnel, technology, subcontracting arrangement and sales revenues (Harvie, 2002).

## *2.3 Approaches to develop a firm's resource*

### *2.3.1 Clustering approach*

Porter (1998a) proposes that industrial cluster policies can be a growth strategy for a firm and cluster is a geographic concentration of interconnected companies and institutions in a particular field. This argument is strongly supported by Enright and Robert (2001), Dijk and Sverrisson (2003), and Nadvi's (1995) since SMEs can receive external economic advantages (economies of scale and scope) if clustering and networking offer a potential growth path for SMEs.

Many Central and East European countries have used clustering approach for assisting the development of SMEs such as Poland, Hungary, Slovenia, the Czech Republic, Slovakia, Ukraine, Lithuania, Estonia and Latvia, (Ionescu, 2003). Examples of cluster theory in practice in East Asia and Latin America include surgical instrument clusters in Sialkot, Pakistan; electronic clusters in Penang, Malaysia; knitwear in Tiruppur, India; software in Bangalore, India; leather shoes in the Sinos Valley, Brazil (Abonyi, 2003).. Tambunan (2005) also suggests that experiences in many European countries show that clustering approach can be a powerful means for overcoming resource constraints that SMEs in transitional economies lack.

### *2.3.2 Networking approach*

'Firms should not be seen in isolation but as being connected in business systems' (Ritter, Wilkinson, and Johnston, 2003, p.175). Lechner and Dowling (2000) define networks as the relationship of individual with other individuals, or relations between organizations that can have various functions.. Therefore, network relationships can be considered as an important intangible resource to support for SMEs who do not have sufficient resources since it help SMEs to develop the links with suppliers, distributors and customers, or utilization of social contacts, including acquaintances, friends, family and kin.

Networking approach is applied in Moldavia, the Ukraine and Belarus (Smallbone and Welter, 2001); Thailand (Brimble, Oldfield and Monsakul 2002); Zhejiang, China (Krug and Hendrichske, 2003); Taiwan (Ngui, 2002) and Korea (Gregory, 2002). In addition, Nadvi (1995) suggests that both local associations and government support bodies facilitated the development of clusters and networks of SMEs in Brazil, Mexico, India and South Korea.

### *2.3.3 The application of Institutional theory*

North (1990) emphasizes that market economies convert resources - land, labour, energy, and capital - into manufacture services and goods. To make this conversion a success, institutions must also help and guide those transformations in predictable ways. Kartz (1995) observes from the economic histories of both newer and mature markets based in Asia, North America and Western Europe that private enterprises cannot emerge and prosper in an imperfect market without a conducive policy environment and institutional support system. Murrell (2003) also states that at the beginning of economic transition, institutional support is vital. Institutions must be designed so that they are able to work in the

environment in which they are to be implemented. The success of China indicates that transitional institutions, formed by incremental change, can be helpful. In China, there was much enthusiasm for accepting new measures to improve the economic situation, but under the condition of not moving too far from the existing system.

#### *2.4 Business environment and supporting infrastructure*

SMEs need to identify key success factors such as finance, technology transfer, taxation, market promotion, export opportunities, and research and development strategies that determine the conditions for them to overcome difficulties in both their internal and external environments (Petri, 1995; Assaf, 1998). Wattanapruttipaisan (2002) proposes that competitiveness can be leveraged by factors other than location and natural resources such as: on-going access to global information and knowledge (market standards, marketing opportunities and technology); participation in clusters of firms, networks with suppliers, producers or complementary product distributors and consumers; and on-going learning and improvements in efficiency and flexibility. This network relationship created a new information flow and knowledge base for SMEs that could be the model for the efficiency of resource distribution to SMEs by numerous policy packages from the state and the market.

### **3. From theory to practice**

#### *3.1 SMEs in transitional economies*

##### *3.1.2 Transitional Economy and Market Reform*

Transitional countries in Central and Eastern Europe (CEE) applied the rapid change “shock therapy” to put the economy on “automatic-pilot.” As a result the market determined supply, demand, prices, and economic transformation. Government sectors played no significant role in this economic system. Contrary to the CEE approach, the Asian “gradualism” approach was an incremental process. Although private enterprises and the free market were seen to be the driving forces for this process, the public sector still played an active role in supporting and moderating market-based reform and private sector development at a macroeconomic level (Katz, 1995). It is vital that a centrally planned economy moves to market-oriented economy through the reduction of government ownership and control in business. However, a small or weak public sector may also hinder the growth of the private sector, as experienced by CEE countries when private enterprises operating in a framework of market-determined prices continued after the involvement of the public sector were eradicated. In contrast, the public sector continues to play key role in strengthening and sustaining the development of a dynamic private enterprise sector and efficient market (Katz, 1995) in Asian countries such as Japan, South Korea, and Taiwan and even in the United States, Germany and the United Kingdom.

##### *3.1.3 Policy Regime in Central and Eastern Europe (CEE)*

Support policies for SMEs vary from country to country and from developed countries to less developed countries due to differences in business contexts, culture and the level of industrialization. Since East European countries are now EU members, there are various EU programmes for SMEs that cover a range of needs. These include vocational training and education, infrastructure projects, individual and information technology development (Konopielko and Bell, 1997). In addition, SMEs in these countries also receive direct support from local authorities and the government.

Poland and Bulgaria are a case in point where SMEs are provided with training and advisory services, management, market information, credit access, exports promotions and the introduction of high-tech production. In the initial stage of transition, these countries suffered some setbacks when SMEs operated in imperfect markets that lacked institutional support. The CEE experience suggests that business support infrastructure, financial support, legal and institutional framework, cluster and network relationships play vital role for business development.

##### *3.1.4 Policy Regime in Asian Industrialised Countries*

SME development is becoming increasingly important to many industrialized countries such as Korea, Taiwan, Singapore, and Australia. Singaporean government identified four key problem areas of SMEs: access to technology, manpower, finance, and market (Lee, and Tan, 2002). In 1998, the Korean government employed a number of policies to foster the growth of SMEs and their involvement in the global economy. This was done by ensuring access to finance, supporting human resource development program, developing technology and scientific achievements so that business can develop extensive relationship with global market (Gregory, 2002).

According to Ngui (2002), SMEs in Taiwan have the following features: network-based industrial systems; minimum efficiency sizes and entry barriers and; low agency and transaction costs. In Australia, special attention is given to key issues affecting the development of SMEs. These are access to finance, the importance of culture/networking in the conduct of business, access to technology and the adoption of information technology, and progress made in regard to human resource development (Nguyen, Gregory, Harvie, Lee, and Ngui, 2002). The most common key features among Korea, Taiwan, Singapore, and Australia are support for technology and financial access, manpower access, and

networking. The Korean government paid attention to developing ties between large firms and SMEs and the fact that large and small electronic firms' network clustered in Seoul, Korea is a good lesson for other countries to study.

### 3.1.5 Policy Regime in East Asian Developing Countries

Harvie (2002) identifies the case of TVE in China as providing important lessons for other economies in transition. To support private sector, China has reformed its financial system, tax and revenue system, enhanced technical innovation system, improved legal protection of property rights, devised education and training program, and opened up more sectors for private investment and competition.

The Malaysian government has supported SMEs by providing financial and credit assistance, assisting entrepreneurial development, improving business management and human resource management, allowing consultancy and marketing services to grow, introducing technical and vocational programs, offering location and infrastructure facilities and providing fiscal incentives (Abdullah, 2002).

In Thailand, the government introduced financial incentive package, technology development program, provision of benchmarks (in technology, marketing, management, and governance), policies were devised so that SMEs can integrate effectively into various industry value chains or clusters and become involved in more supportive networks such as academic institutions, government agencies and other firms in related and supportive industries (Brimble, Oldfield and Monsakul, 2002). This network relationship created new information flow and knowledge base for SMEs. China, Malaysia and Thailand benefited from these policies reform, network relationship and the new support infrastructure. The Indonesia's experience suggests that neglected cluster linkage to markets was one of the reasons for which SMEs failure. That is, economic advantages can only be achieved if the cluster has a well-developed network both internally and externally (Tambunan, 2005).

Katz (1995) argues that the transitional countries of Asia - Laos, Mongolia, Myanmar, and Vietnam - enjoy a significant economic advantage since they can learn from the experiences of other transitional countries in Asian and Central and Eastern European countries with less political change and step by step incremental processes. These countries enjoy cheap labor and strategic locations with a reasonably large market in Asia and the Pacific. However, they do not enjoy a high level of industrialization. As a result, the change to a market economy and the integration into a global market requires a gradual approach to change. The development of SMEs in Vietnam requires a well-designed policy package, infrastructure development program and effective institutional framework.

### 3.2 *The Vietnamese policies experience*

Recognising the important role that private sector can play in the transition process, Vietnamese government has made great efforts to encourage the development of the privately owned SMEs. Due to rapid change in the current international economy, further restructuring efforts and strategic policies for support are required for the development of SMEs. The development of SMEs through supporting infrastructure policies, legal and institutional frameworks were of special importance.

According to GSO (2004), the number of enterprises is large but size of enterprises is small and they are spread over the country with backwards technology. The figures show that about 48% of firms have lower than 10 employees, 32.9% of firms with 10 to less than 50 employees, and 14.1% of firms with 50 to less than 300 employees. Most of them are poor of resources (unskilled labour, small capital, and land, lack of supporting service on technology, legislation and information). Approximately 50.6% employees are not trained; 86.2% of firms have less than 550,000 USD; on average, a private firm uses only 0.17 ha of land while a states enterprise uses 1.61 ha; furthermore, there are about 48% of surveyed respondents informed that they met difficulties in gaining access to information; significantly, 72% informed that they had backwards technology. In accessing to credit, 49% of capital is capital of owner equity; only 4% is provided by government budget; 9% from other sources and 38% is from credit capital. Among this 38% of credit capital, state enterprises occupy 56.4%, of which 63.4% is concessionaire credit capital of state. According to Ho, Do, and Chu (2002), about 53% of the surveyed SMEs owners indicate that credit access is the most critical factor to private SMEs. Although credit capital is too low, more than half of the credits are reserved for SOEs. This clearly depicts the fact that SMEs in Vietnam are currently facing significant difficulties in accessing to formal credit and they have to rely heavily on informal credit source (see figure1 at the appendix).

## 4. **An operational framework model for supporting SMEs**

The above examples suggest that resource based theory; clustering, networking approach and application of institutional theory are not separated. The main argument is that, in gaining better access and utilizing resources, firms need to cluster in suitable locations, build strategic alliances or network in a cluster of firms. This is in order to attain the critical mass needed to create support infrastructure. These theories also emphasize the role of supporting institutions as agents for facilitating the development of firms' cluster and network, improving technology flow, and knowledge is vital. And the context of economic transition in Vietnam would require a conceptual framework in order to examine how SMEs

can pool the resources together and effectively use of them, seeking supports from government and institutions (both formal and informal) to sustain the SMEs and to create a favourable business environment for them to growth.

A study on the effectiveness of supporting policies is crucial to identify the difficulties that SMEs have been facing in Vietnam. The resource base, clustering, networking, and institutional theories referred to by Petri (1995), Assaf (1998), Brimble, Oldfield and Monsakul (2002), Harvie (2002), Tambunan (2005), Ha and Swierczek (2003), and Gibb (1996) provide an understanding of the factors supporting SME development in developing countries. These authors infer that a well-defined support regime from the state can coordinate with existing market factors to provide policy support, external resources, and institutional infrastructure for the growth of SMEs (Please refer to the appendix for the conceptual model).

## **5. Discussion and conclusion**

The policies of the government have not been strong enough to direct the firms for their investment. This has led to the situation that in many provinces and cities there are thousand of firms engaging in only one economic sector but they are not key sectors and do not affect much to local economy. The Vietnamese government seems to focus on increasing the number of SMEs (quantity) rather than improving their performance (quality). According to GSO (2004), the contribution by the private sector to GDP did not grow much between 1995 and 2001 (8.6% and 8.8% respectively). This would indicate that private sector still not plays a key role in driving the economy and although private sector are encouraged to be widely developed, the state sector are the firm foundation of the national multi sector economy. Additionally, the efficiency of doing business in private sectors is still not high. The ratio of profit per capital is only 2.3% in private firms. By 2002, the number of established enterprises rose to 63,000, but only 68% were actual real operating firms. This is consistent with the survival rate during 1996-2002 of private firms in the country economic report of Koko and Tingvall (2005) which is only 61.44%. Basing on the report of the GSO (2004), it seems that SMEs are in the embarrassing situation of finding supporting service on technology and information. NORAD (2003), and James and Chuong (1997), reveal the irrationality of tax system and in which the way it is administered; bureaucracy and red tape; imperfect market regulation, property rights and competition has restrained SMEs development. It seems that the support policies for SMEs in Vietnam are inconsistent and SMEs in the public sector are treated favourably. While private firms are being seen as a key driving force of the economy in many regional countries and CEE countries, and private firms in Vietnam are allowed and encouraged to develop, State owned firms still be considered to play a key role in the Vietnamese transitional economy. No specific strategies have been developed to establish links between SMEs in both public and private sector. No clear policies guideline has been designed to support SMEs to work in partnership with large business as suppliers, buyers or manufacturers. In addition, there is no clear policy direction on how businesses in related and supporting industries can support each other by transferring knowledge, infrastructure, and resources, which are critically. When formal institutions (e.g., laws and regulations) are weak, informal institutions (e.g., interpersonal ties) may play important roles in facilitating economic exchange and therefore assert a more considerable influence on the performance of firms (Peng & Heath, 1996). The Vietnam experience could be the case in point where SMEs have to rely heavily on informal credit as source of capital for overcoming resource constraints. SMEs have tended to be viewed negatively by labourers and the public as a high-risk policy that would generate insecurity in the job market. As a result, it is very tough for SMEs to attract qualified labour and access adequate support such as credit, land, and other external resources. Negative social perceptions towards the roles of SMEs would have a significant influence on the development of this private business sector and discourage SMEs from business development in many ways. Although the current legal regimes do ensure fairness of competition between the public and private business sectors, so-called "unwritten laws" of discrimination against SMEs still exist strongly in society. Operating in such unfavourable environment, together with defective supporting institutional developments, inadequate regulatory frameworks and the SMEs' poor internal resources, it is obvious that SMEs are struggling to survive and develop. The paper is based on the concepts of resource based and tries to suggest that clustering, networking, and institutional approaches can be a powerful vehicle for overcoming resource constraints of SMEs. The operational model incorporates experiences from transitional economies in CEE countries and South East Asian countries with the Tanaka Sakai-Takada framework model that designed specifically for Vietnam's context. The policies framework is also an extension of the four-part policy framework proposed by Sakai and Takada (2000) since their model has not successfully addressed some of the critical support policies for the growth of SMEs in Vietnam. It has reviewed a number of concepts to apply to the new operational framework for examining the critical support policies for developing SMEs in Vietnam. The operational policies framework is essential for the following reasons:

Supporting policies for the development of SMEs may differ from country to country. A successful model in one country may be inappropriate if it is applied in another due to different political, legal, historical, economic, social, cultural, and resource conditions; although numerous studies have been conducted on SMEs in many transitional economies, few are in the context of Vietnam. This paper hopes to fill the gap in existing literature by identifying critical support policies for SMEs in Vietnam.

Hence, it could be concluded that an overall strategic policy is critical for supporting SMEs in Vietnam. The policy should be focus on how to support SMEs effectively rather than how to increase the number of SMEs in Vietnam. It is important to highlight that, a holistic approach is needed for supporting SMEs in Vietnam. It is not only what policies the government is pursuing but how they can utilize the existing market condition which is important. It would be misleading if the government just focus on the role of the state as other transitional countries did and do not take into account the importance of existing market factors and business environments. However, this is not to ignore the critical entrepreneurial role of the state in facilitating the evolving relationship between the State and Market. Balancing such evolving relationship between the state and market will dictate the direction for implication of policies to support SMEs. In regard to future research, this conceptual model addresses a number of issues that needed to be examined in order to identify factors contributing to the growth of SMEs in Vietnam. This could be the limitation of this conceptual model and needed to be addressed in both exploratory and explanatory study stages of the research.

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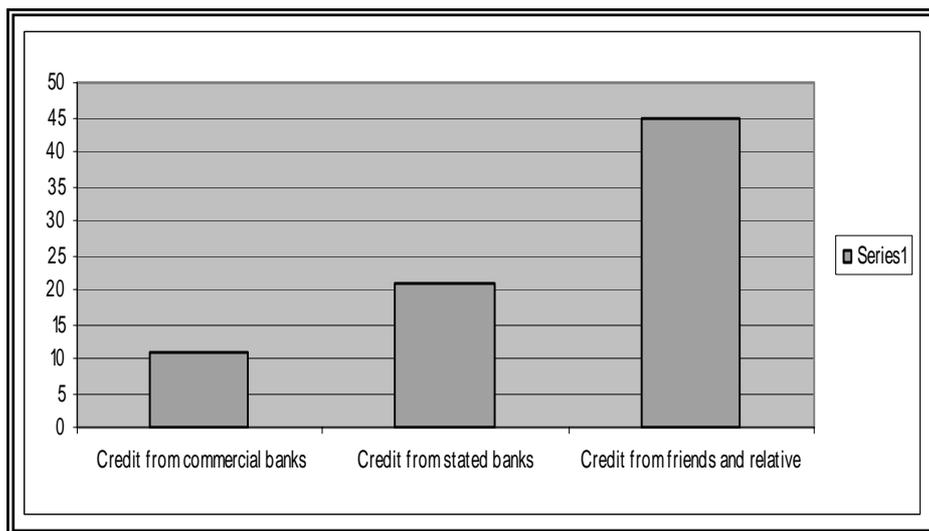


Figure 1. Credit accessibility of SMEs

(Source: Ho, Do, and Chu 2002)

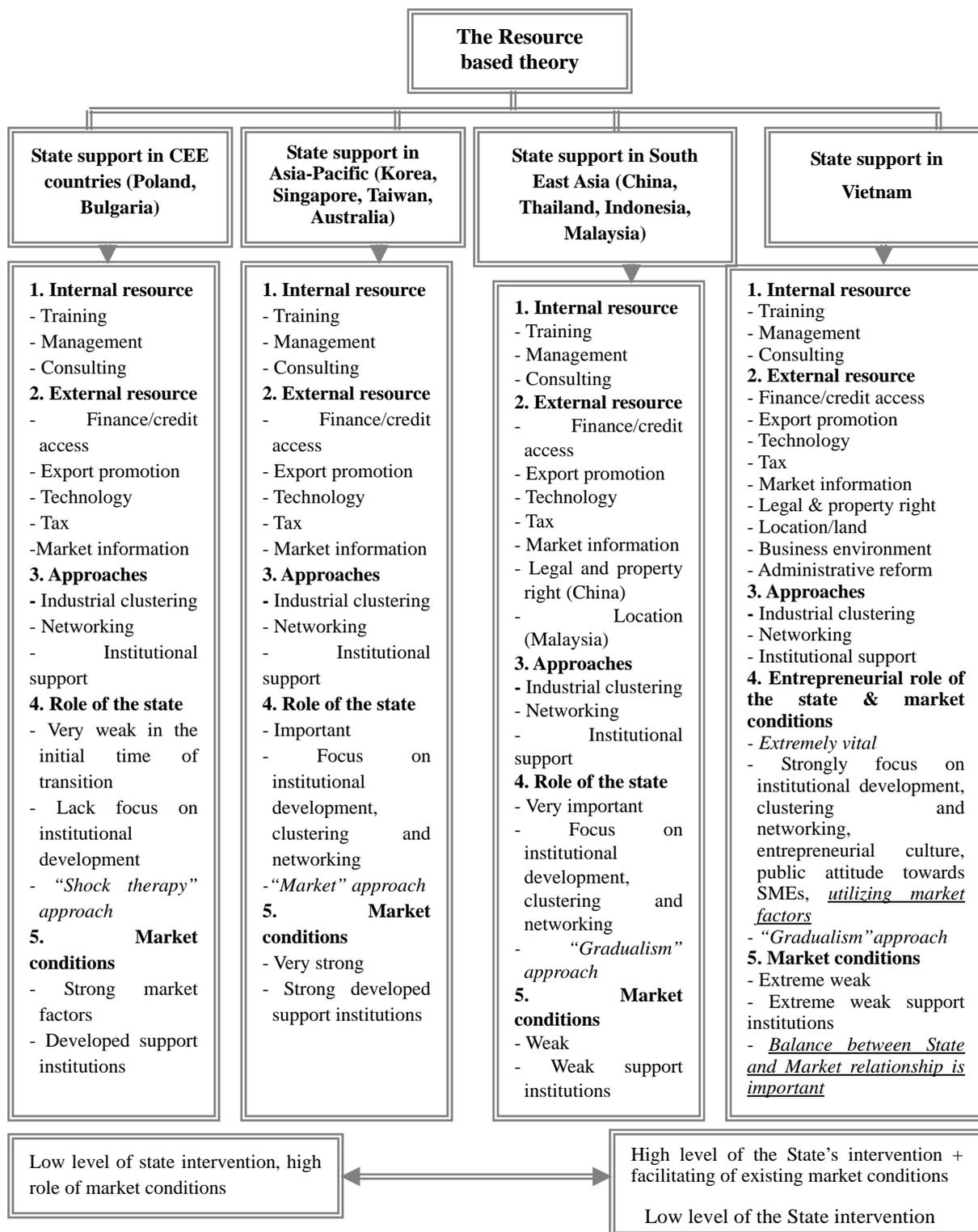


Figure 2. Conceptual model