

# **Policy Brief**

## **Based on the PhD thesis**

### **“Firms and workers in transition: A series of micro-studies on Vietnam”**

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#### **Executive summary**

Small and medium enterprises (SMEs) constitute an important and growing component of the Vietnamese landscape, in terms of both employment generation and their contribution to economic growth. However, our knowledge of the smallest SMEs, namely household firms – the majority of which operate informally – remains limited, as does evidence on the interplay with the formal sector. Based on unique survey data of Vietnamese manufacturing SMEs this project explores the informal-formal sector nexus and looks at the implications of formalization for both firms and workers. In addition, the project examines the role played by formal labour institutions, in particular trade unions, in ensuring the protection of the rights and interests of workers. The project findings and conclusions lead to a number of clear and concise policy implications and recommendations.

#### **Introduction**

The overall purpose of the research project was to carry out an empirical examination of the relationship between labour market regulation and productive employment in Vietnamese SMEs. In pursuing this objective, the project has produced four self-contained academic articles, each of which has its own immediate aim, results and conclusions, yet with labour market issues as the common thread. The first two studies centre on informal-formal sector dynamics and show that firms which become legally registered are more profitable, undertake larger investments, have increased credit access and provide more stable contracts for workers. Moreover, formalized firms have higher average wages, and the wage gap is largely explained by differences in characteristics between formal and informal firms. Thus, as firms become more established (formal) they tend to adopt a longer-term business approach, including hiring workers on a more permanent basis.

Focusing on formal labour institutions the third study finds that trade unions play an important role in protecting the rights and interests of their members in the form of ensuring higher wages and the mandatory provision of social protection. Finally, the fourth study reveals that there is a substantial individual wage gain associated with obtaining a job through a social contact, pointing to the importance of informal job finding methods in a country like Vietnam.

## **Background**

Vietnam's transition from a centrally planned system to a socialist-oriented market economy has resulted in tremendous economic growth, averaging more than 7 pct. annually between 1990 and 2010 coupled with unprecedented poverty reduction: by more than 40 percentage points from 1993 to 2006. Central to the structural transition process is a growing private sector, contributing to increasing shares of employment and economic output. This private sector boom can be attributed almost exclusively to the entry of newly established SMEs, today accounting for more than 97 percent of total enterprises in Vietnam, employing more than half of the total workforce and contributing to around 50 percent of GDP. Among SMEs, household firms make up the largest category, and the vast majority of these operate informally. In fact, the informal sector is estimated to generate 25 percent of the total number of jobs in Vietnam and account for about 20 percent of GDP. Despite its economic importance, knowledge of the informal sector remains limited – especially in terms of the interplay with the formal sector and in this context the role of the regulatory framework. In order to examine these dynamics in more detail, the project applies econometric techniques on recent survey data of Vietnamese SMEs including informal firms. The quantitative analysis is complemented with qualitative information thereby contributing to an enhanced understanding of the informal sector segment of the economy. Furthermore, the project sheds light on the role of enterprise-based trade unions in terms of their capacity to represent the interests of their members. The context in which Vietnamese trade unions operate: under the oversight of the Communist Party and usually with a manager as the union chair makes for a particularly interesting case. In order to explore this topic further, the project makes use of the matched employer-employee aspect of the SME data, thereby adding value to the relatively scarce literature on labour regulations in a transition country context.

## **Main Results<sup>1</sup>**

Each of the four academic articles which together make up the project produced their own set of results, the key aspects of which are described in turn. From the first study on informal-formal sector dynamics we learn that firms shifting from informal to formal status experience a gross profit increase of between 10 to 20 percent, and a fall in the temporary workforce share varying from 12 to 16 percentage points. Moreover, further empirical analysis reveals that the channels through which the improved firm performance arises is via increased investments and improved credit access. With regard to the improvements in working conditions, this results from a combination of improved regulatory compliance as firms formalize, and a willingness to invest more in their workers with a view to improving the long-term stability of their business. The main result emerging from the second study is that average wages are about 17 percent higher in formal firms compared with informal firms, and that the majority of this wage gap comes from differences in endowments with formal firms generally being larger, located in more urban areas and better at attracting more qualified and productive workers. This in turn supports the findings of the first study that firm formalization leads to a higher share of contracted workers. The third study reveals that among formal firms, non-compliance with mandatory regulations is widespread - not least when it comes to social protection for workers. In this regard, local trade unions (when they exist) are shown to represent an important mechanism through which workers' concerns are voiced and their rights are protected. More specifically union membership is associated with a wage premium of between 5 to 15 percent depending on exact estimation method and an increased probability of receiving social insurance. The findings are particularly strong in Southern provinces where firms generally have more modern human resource management practices and trade unions tend to be more independent. Finally, from the fourth study we learn that workers who are hired informally – through knowing the manager or another co-workers – receive wages that are between 6 and 9 percent higher, compared with workers that obtain their job via a more formal method, such as through a job agency, advertisement or similar.

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<sup>1</sup> It is important to keep in mind that although all of the results outlined above have been subjected to various robustness tests, they remain country and time specific and as such cannot be generalized to a more general context.

## Conclusions and Policy Implications

The results emerging from the work on informal sector dynamics lead to the conclusion that firm formalization is beneficial both to firms and to workers. Thus, there is a clear need to encourage firms to shift out of informality by (a) exposing the gains associated with firm formalization; (b) enhancing information on registration requirements and procedures and (c) providing incentives for firms to become legally registered, for instance by allowing an initial period of reduced social security costs. Once formalized, firms must be urged to comply with labour related regulations, including the mandatory establishment of independent trade unions capable of acting in the interest of their members. In this regard, the revised Trade Union Law, which came into effect at the beginning of 2013, seems to provide a step in the right direction by enforcing a 2 percent trade union fee on all employers – regardless of the presence of a trade union. Furthermore, more effective labour inspection systems and an increased focus on improving workers' awareness of their rights must be pushed for in order to ensure complete compliance with social security provisions, as specified in the Law on Social Insurance.

## Follow-up reading

Larsen, A.F., Rand, J. and Torm, N. (2011). Do Recruitment Ties Affect Wages? An Analysis using Matched Employer-Employee Data from Vietnam. *Review of Development Economics*, 15(3): 541-555.

Rand, J, and Torm, N. (2012). The Benefits of Formalization: Evidence from Vietnamese SMEs. *World Development*, 40 (5): 983–998.

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Torm, N. (2012). The Role of Trade Unions in Vietnam: A Case Study of Small and Medium Enterprises, *Journal of International Development*. J. Int. Dev.. doi: 10.1002/jid.2881.

Torm, N. (2013). *Firm and Workers in Transition: A Series of Micro Studies on Vietnam*. Department of Economics PhD series, no. 159. University of Copenhagen.