



EXECUTIVE SUMMARY - A STUDY ON

“FORMALIZATION” OF HOUSEHOLD BUSINESS IN VIETNAM



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I. Research rationale and methodology

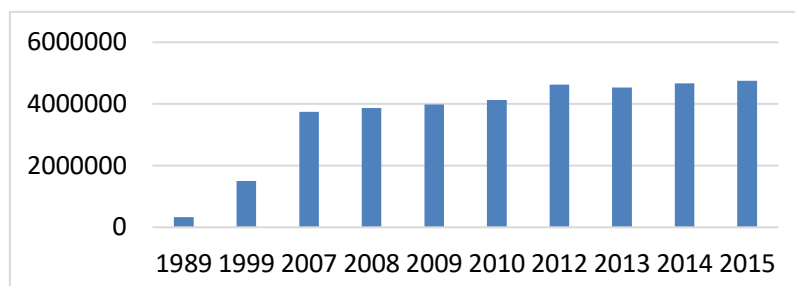
Review of international experiences shows that formalization of private business entities in many developing countries is complex mainly because of the existence of multiple regulations which lengthen the process and increase the cost of formalization. Major barriers to business formalization include: (i) legal and administrative obstacles; (ii) financial and expense requirements; (iii) corruption in public administration; (iv) social and culture attitude; and (v) the lack of important business development services...

Business formalization in Vietnam occurs at two level: (i) unregistered household businesses register to operate under the law; and (ii) registered household businesses convert into other form of businesses registered under the Enterprise Law. This report only examines the second aspect of converting household businesses into one of the four types of companies specified under the Enterprise law ("formalization" of household businesses in short).

Currently, household business is one of the key business player in the Vietnamese economy. According to the Survey of Non-Agriculture Business Establishments in Vietnam conducted by the General Statistics Office, by 2015, there were 4.75 million household businesses in Vietnam (which is about 10 times the number of total enterprises registered under the Enterprise Law), generating a total revenue of VND 2,249 billion dong and creating jobs for nearly 8 million people. However, this sector's contribution to the state budget is still

limited, with total tax contributions accounted for only 2% of total domestic revenues in 2014¹.

Figure 1. Number of household businesses through time



Source: General Statistics Office (2016, 2005), Ministry of Planning and Investment (1999)

The establishment and operation of a business entity in Vietnam are mainly covered by the Enterprise Law and its implementing documents. Accordingly, in Vietnam, an investor may choose to establish and operate in the one of the following forms: (i) household business; (ii) private enterprise; (iii) partnership; (iv) limited liability company; and (v) joint stock company. Among these, the establishment and operation of the four forms of business of private enterprise, partnership, limited company and joint stock company (hereinafter referred to as "enterprises") is governed directly by the Enterprise Law while that of household businesses is laid down in a government decree (Decree 78/2015/ND-CP dated 14 September 2015).

The Government of Vietnam has had a policy of encouraging household businesses to convert into enterprises governed by the Enterprise Law for a long time. As early as dated back to 1999, the Enterprise Law then provided that "the Government guides and facilitates the conversion of large-size household

¹ [http://www.vietnamnet/Why do more than 3 million household businesses disappear?](http://www.vietnamnet/Why%20do%20more%20than%203%20million%20household%20businesses%20disappear?)

businesses operating under Decree 66/HDBT dated 2 March 1992 of the Council of Ministers into businesses registering and operating under this Law"². More recently, the Enterprise Law of 2014 and its guiding documents continue to require household businesses frequently employing more than 10 people to register as businesses under the Law.

As such, the requirement that household businesses having having more than 10 frequent employees to convert and register in other forms of businesses has been effective for more than 16 years. That is the only requirement for household business to 'formalize', as the Enterprise Law of 1999, 2005 and 2014 all abandoned the minimum registered capital requirement for private enterprise, partnership, limited liability company and joint stock one. However, the reality is that only a small percentage of household businesses registered and turned into other forms of businesses as required by the Law.

This raises the following valid questions: what are the differences between a household business and the other four forms of entities? Why do household businesses not want to convert into other forms of business under the Enterprise Law? And What are the main causes of the situation?

This study aims to answer the above questions and make some recommendations to revise and supplement current laws and regulations on promoting "formalization" of household businesses and the Enterprise Law, to contribute to the development of the Law on SME Support, as a result, it contributes to realizing the objective of having at least one million enterprises

² Clause 2 Article 123 of the Enterprise Law 1999

as specified in Resolution 35/NQ-CP dated 16 May 2016 of the Government on supporting and promoting businesses by 2020.

Since the Enterprise Law and its implementing documents do not have direct regulations on the mechanism and policies for "formalization" of household businesses, the Study tries to answer the above questions as well as to understand why eligible household businesses do not want to convert into other forms of business by examining advantages and disadvantages of household businesses over other forms of business through a legal review, a literature review of existing studies, a survey coupled with some in-depth interviews with relevant stakeholders from both private and public sectors.

With such an indirect approach, the Study utilized the following research methodology:

- **Desk study:** the research team conducted a review of all existing studies and current regulations to identify similarities and differences, advantages and disadvantages of household businesses versus other forms of business;
- **Survey and interview:** A survey was conducted with 374 household businesses and 46 enterprises; and in-depth interviews with 30 household business owners, experts, and public officials in concerned agencies in 6 provinces of An Giang, Bac Ninh, Dong Nai, Ha Noi, Phu Tho and Ho Chi Minh City. A breakdown of survey participants is provided in the below table.

Table 1: Survey structure

	No. of observations	Percentage (%)
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By location			
An Giang	Enterprise	5	1.2
	Household business	45	10.7
Bac Ninh	Enterprise	4	1.0
	Household business	29	6.9
Dong Nai	Enterprise	4	1.0
	Household business	43	10.2
Ha Noi	Enterprise	12	2.9
	Household business	110	26.2
Phu Tho	Enterprise	4	1.0
	Household business	20	4.8
Ho Chi Minh City	Enterprise	17	4.0
	Household business	127	30.2
Total		420	100.0
By form of business			
Household business (HB)	Family owned HB	170	40.5
	HB owned by a group of individuals	61	14.5
	Individual owned HB	143	34.0
Other forms of business	Private enterprise	8	1.9
	One member ltd company	21	5.0
	Two member ltd company	15	3.6
	Others	2	0.5
Total		420	100.0
By line of business			
Manufacturing and processing		72	17.1
Construction		8	1.9
Wholesale, retail and repair		240	57.1
Hotel and restaurants		62	14.8
Others		38	9.0
Total		420	100.0
By sex			

Female	244	58.1
Male	176	41.9
Total	420	100.0
By registration status		
Not yet registered, not having a tax code	69	16.4
Already registered, having a tax code	351	83.6
Total	420	100.0

Source: Survey results

Consultation: Relevant experts were consulted through one consultation workshop and meetings to reach agreement on assessments and recommendations of the Study on solutions to incentivize household businesses to convert and register in other forms of business governed by the Enterprise Law.

Among 420 household businesses and enterprises surveyed, more than half (58.1%) were owned by women, therefore, the research findings and recommendations below apply for both male and female owned businesses.

2. Current Situation of Household Businesses in Vietnam

Table 2: Household Businesses in Vietnam - A Snapshot

Indicators	Household Businesses
Number of establishment	4,7548,000
Sectors	80% in trade and services; 20% in manufacturing and construction
Total size of capital	17% GDP
Number of workers	7,987,457
Share of tax contributions	2%
Average size of capital (thousand VND)	150,610
Share of equity	91.2%
Sales/workers (VND million)	280

2.1 Household businesses play an important role in creating jobs, yet productivity is low

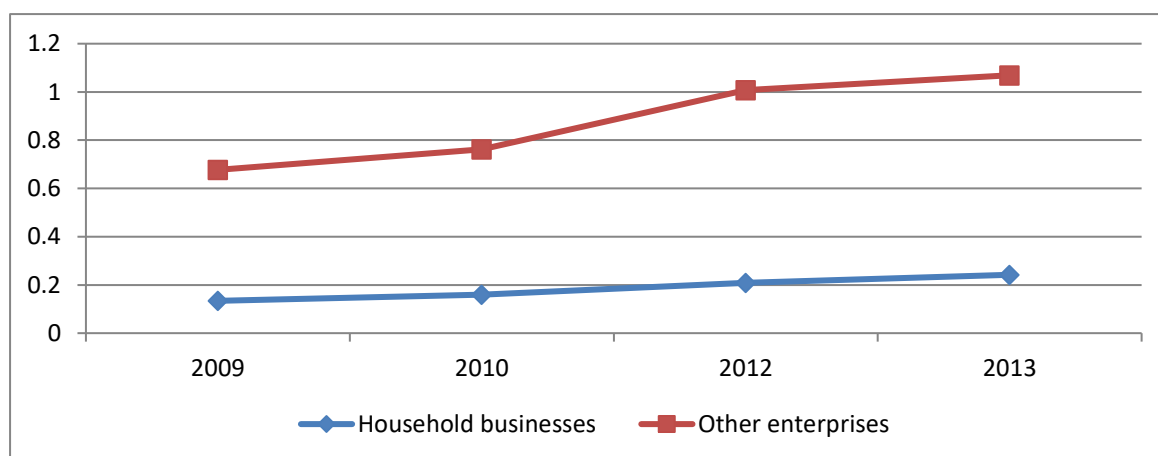
The number of people working for household businesses has kept increasing steadily through the years as the number of registered household businesses went up. The sector employed 6.5 people in 2007, 7.6 million in 2010, and nearly 8 million in 2015.

In terms of the labor size, household businesses are mainly categorized as micro by Decree 56/2009/ND-CP. Survey results show that up to 88.67% of registered household businesses employ less than 10 people; and the remaining 11.33% have 10-40 employees. It means that these 11.33% of household businesses are required to register as an enterprise under the Enterprise Law, but have not yet done so.

Another feature that is worth mentioning is the low productivity of this sector. Even though there has been some improvement, the indicator of average revenue per worker of household businesses remains much lower than that of other types of enterprises, and the gap keeps broadening.

Figure 2: Average revenue per worker of household businesses and other types of companies

Unit of measurement: billion dong per person



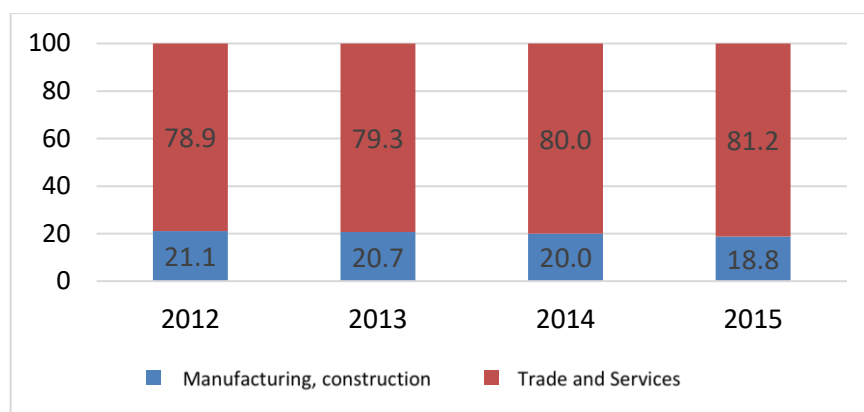
2.2 Household businesses are considered as an engine for entrepreneurship, still, they operate in low value added sectors at small scale

Household businesses can be seen as an engine driving up entrepreneurship due to its simple market entry regulations, low capital requirement, and low operation and compliance costs. In 2015, there is one household business for every 19.3 citizens in Vietnam.³

Household businesses mainly operate in trade and services. In fact, 80% of them are in this industry, and the rest 20% is in construction and manufacturing. Looking at a longer time horizon, the proportion of household businesses in trade and services has been increasing, and that of those in construction and manufacturing keeps declining. This trend can be explained by the fact that construction and manufacturing businesses have grown in size, thus they have converted into other forms of businesses under the Enterprise Law (these two industries have witnessed high rates of new company registration of 28%% and 21.8% respectively).

Figure 3: Non-agriculture Household Businesses by Industry

³ In comparison, for the other four types of enterprises, there were on average one enterprise per every 356 people in 2009, 305 people in 2010, 265 in 2011, 232 in 2013 and 188 in 2015



Source: GSO (2016)

As regards the size of capital, data from GSO 2016 shows that the total value of capital of household businesses by 1 July 2015 was 716.13 trillion dong, accounting for 17% of Vietnam's GDP.

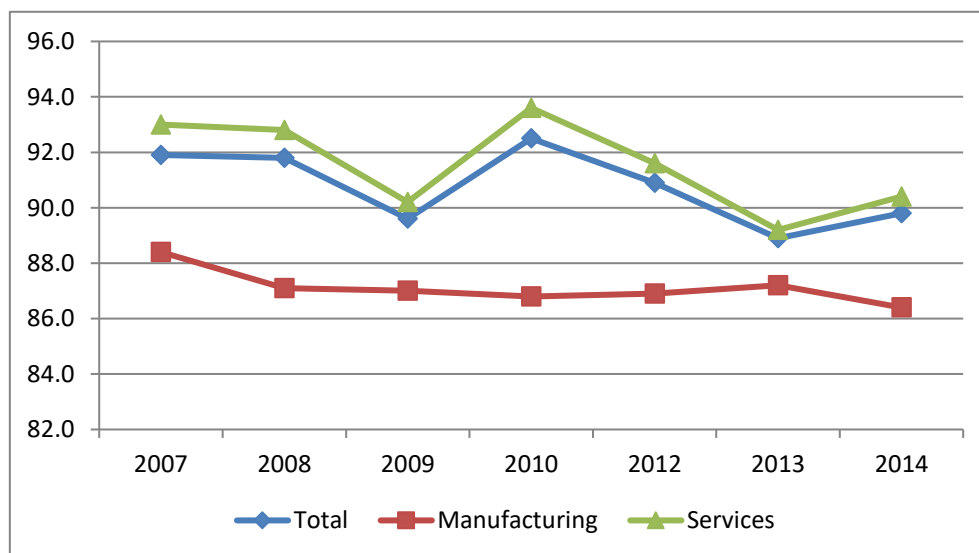
Even though the size of average capital and asset of household businesses keeps growing over the years, they are still mainly small scale according to classification of Decree 56/2009/ND-CP (below 20 billion dong for manufacturing and construction businesses and below 10 billion dong for trade and service ones).

The survey and interviews found that 97.1% of unregistered household businesses have capital of below VND 300 million, while the corresponding figure for registered ones is 74%. The survey also showed that only around 7.5% of household businesses have capital of more than 1 billion dong, and only 1.3% have more than 5 billion dong (as compared with 26% of other forms of enterprises). However, in-depth interviews revealed a fact that quite a few household businesses declared low value of capital and fixed assets than they actually have to avoid "attention" of competent authorities.

2.3 Household businesses are efficiently making use of resources in the society, yet, contribution to the state budget is still limited

A rather outstanding feature of household businesses is that they mainly use their own capital (equity capital) for their production and business. The rate of borrowings is rather low. On average, in 2014, while the debt/equity ratio of other forms of enterprises was 220%, that of household businesses was only 8.8%.

Figure 4. Equity/Asset Ratio of Household Businesses



Source: GSO, 2015

This is also confirmed by the survey and interviews, which found that 82-85% of surveyed household businesses did not borrow during the period of 2013-2015 (and the corresponding number for unregistered group amounted to 90-91.8%).

The fact that household businesses do not borrow mainly comes from their difficulty to access to other sources of financing, especially from banks and credit institutions. On the other hand, it reflects the lack of security and stability of financing for this sector.

One noteworthy characteristic is the low level of contribution to the state budget of the sector. Total tax payments of household businesses in 2014 were 12,362 billion dong, making up only 2% of total domestic revenues⁴.

⁴ [http://www.vietnamnet/Why do more than 3 million household business disappear?](http://www.vietnamnet/Why%20do%20more%20than%203%20million%20household%20business%20disappear?)

3. Reasons for Household Businesses Not Converting into Other Forms of Enterprises

The conversion of eligible household businesses into other forms of enterprises has been stipulated in the Enterprise Law of 1999, which said "the Government guides and facilitates the conversion of large scale household businesses operating under Decree 66/HDBT dated 2 March 1992 of the Council of Ministers into other types of enterprises registered and operating under the Enterprise Law" ⁵. The Enterprise Law of 2005 further specified that "household businesses frequently using 10 employees or more have to register as an enterprise governed by this Law"⁶. The current Enterprise Law of 2014 continues to affirm this direction. However, up to now, there has been no official statistics on the number of household businesses which convert into other forms of enterprises as provided for by the Enterprise Law.

Beside national legislation, many sub-national governments have introduced mechanisms and policies to encourage this conversion process, especially conversion of those already meeting the requirement to register and operate under the Enterprise Law. Incentives can be in the form of preferential registration fees, low charges on seal making, preferential business registration

⁵ Clause 2 Article 123 The Enterprise Law of 1999

⁶ Clause 4 Article 170 The Enterprise Law of 2005

tax, support for purchase of company accounting software or purchase of company signage...

However, the reality is that only a small number of household businesses have converted into other forms of enterprises. The survey with 46 enterprises showed that only 17.8% of them were registered and established on the basis of an existing household business, and the rest were newly established.

As mentioned earlier, the survey also found that 11.3% of the 374 household businesses are required to register under the Enterprise Law due to their size of employment, but have not yet done so. Only 5.63% of the respondents indicated plans to convert into other forms of business.

So what are the differences that lead to the fact that household businesses do not want to convert?

In principle, all businesses, household and non-household, have to comply with applicable laws, regulations and inspections in their operation. The difference is that while businesses registered under the Enterprise Law are subject to the provisions of this Law, as well as to management and checks/inspections by province level agencies, household businesses operate under a decree and are subject to management/checks/inspections by district level ones.

A review of the legal framework for these two groups revealed certain advantages and disadvantages of household businesses over other types. From the legal perspective, it can be seen that household businesses encounter quite a few disadvantages in terms of trading rights; the right to contribute equity capital, to buy shares or equity of other limited liability and joint stock companies; liabilities; the ability to mobilize capital... However, generally

speaking, they still have more advantages over other types of enterprises with regard to who can establish and register business; registration documents and procedures; organization and management requirements; accounting, book keeping and tax payment obligations; and information disclosure requirement...

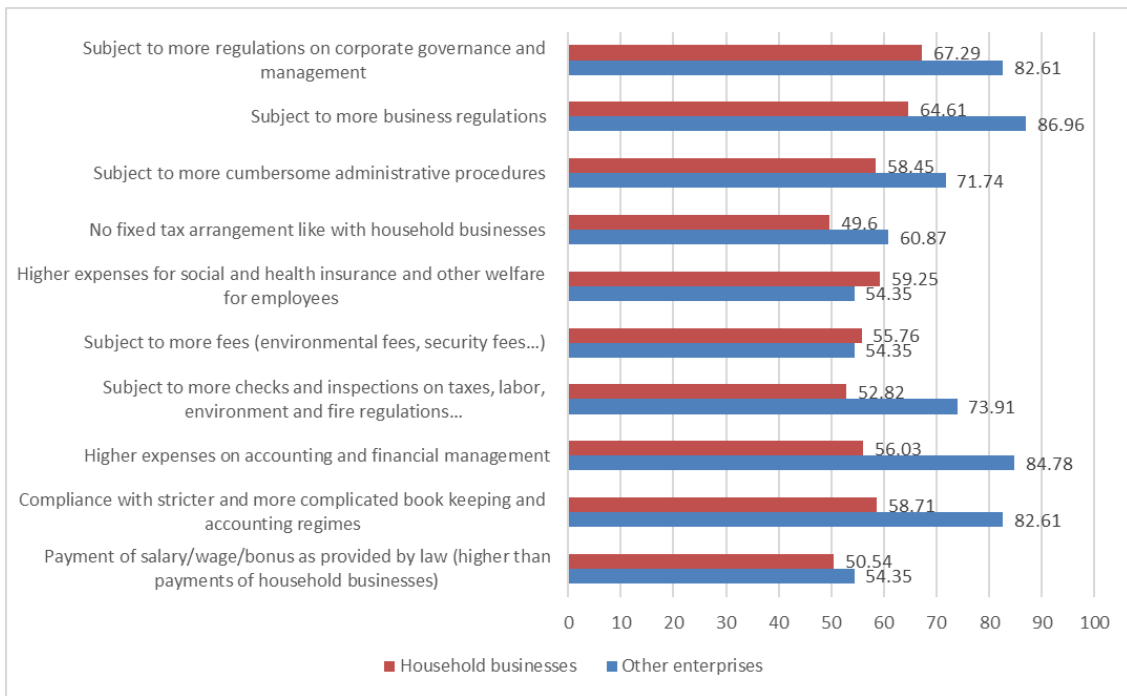
Table 3. Differences Between Household Businesses And Others From A Legal Perspective

Area	Ltd and joint stock companies	Household Business
Legal Entity	Yes	No
Liability with debts and other assets of the business	Limited Liability	Unlimited Liability
Ability to issue securities (shares and/or bonds)	Yes	No
Ability to have more than one location, to open representative office or branch	Yes	No
Number of employees	Unlimited	Less than 10
Place of registration, number of documents required and registration fee	Province-level registration office 4 documents required Higher registration fee	District-level registration office 2 documents required Lower registration fee (half)

Accounting regime and method of tax calculation and payment	Full system needed Need to maintain up to 37 account books (Decision 48/2006/QD-BTC)	Simple system Tax is fixed in advance No VAT and PIT required if revenue is lower than 100 million dong/month
Subjectivity to Bankruptcy Law	Yes	No

This is confirmed by the survey findings. **A high percentage of household businesses surveyed and interviewed within the Study perceived more disadvantages for other types of enterprises as compared with household businesses.** Major disadvantages include "stricter business rules and regulations"; "higher costs for financial management and accounting"; "more legal obligations in terms of company organization and management"; "more complex accounting and book keeping standards"; "subject to increased inspections and checks from relevant tax/labor/environment/security agencies..." These drawbacks lead to higher compliance costs for companies over household businesses.

Figure 5: Perceptions of disadvantages of other forms of companies as compared with household businesses



Source: Survey Results

In-depth interviews with many household business owners showed that they are “reluctant” to switch their business model, because of the required changes in the accounting system (from fixed tax to self declaration, self payment and the need to use invoices), the requirement on book keeping, and the need to have more personnel, to develop corporate governance system... All these changes are accompanied by more costs and can lead to disruption in their current businesses. Household businesses also seemed not want to “grow” due to their reluctance to scope with more administrative procedures and regulations, especially those concerning administrative penalties which are doubly complicated for enterprises as compared with household ones. This is the psychological barrier that prevents household businesses to convert into other forms of business governed by the Enterprise Law.

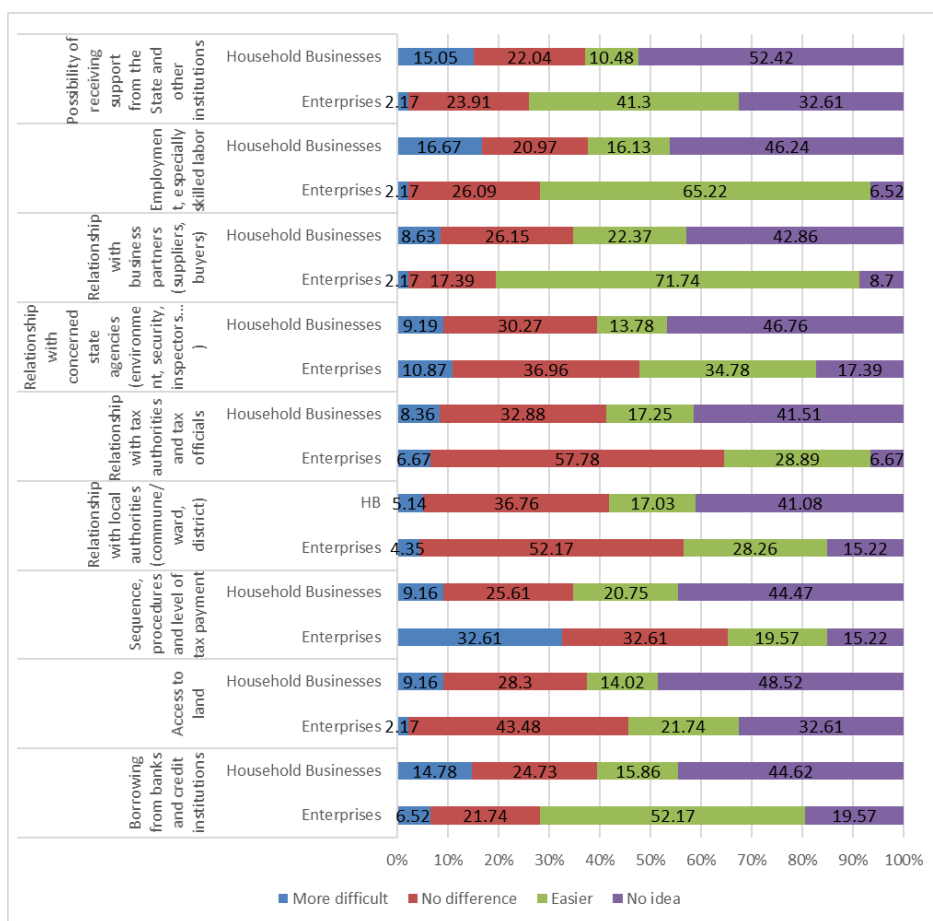
Moreover, loose management of household businesses is also one of the reasons why their owners do not want to change. In fact, compliance with laws and regulations, particularly those on salary management, social insurance, work

safety, environmental hygiene... is much lower at the household business level. For instance: (i) the majority of household businesses hire seasonal employees to avoid the need to sign standard employment contracts (thereby they do not need to pay salary and social insurance as required by laws); (ii) most of household businesses operate at their own houses (where they live) with a low level of capital, therefore, they cannot conform to environmental and safety regulations; and (iii) competent authorities (at district and commune level) lack capacity, which results in lower level of compliance checks and inspections of household businesses as compared with others.

The study also reveals inconsistency in the legal requirements over which businesses have to turn into companies; a lack of procedure(s) permitting household businesses to convert easily into enterprises (they need to terminate as household businesses, then register as new enterprises); an absence of enforcement of compulsory conversion; as well as inefficient SME support policies which lead to low incentive for conversion into enterprises. In addition, the majority of household businesses are used to small-scale and family operation practices, hence are reluctant to change.

In the meantime, advantages of being an enterprise under the Enterprise Law are not enough attractive.

Figure 6. Perceptions on similarities and differences of household businesses and others in business operation



From all analyses above, the reasons for household businesses not wishing to convert into other forms of businesses can be summarized in the following box.

BOX 1: REASONS FOR LACK OF FORMALIZATION OF HOUSEHOLD BUSINESSES

1. Household businesses perceive more benefits in terms of lower compliance costs
2. The legal requirement over the number of employees (whether frequent or not) is inconsistent among applicable regulations. The Enterprise Law mentions "household businesses using 10 frequent employees or more", while Decree 78/2015 uses the criterion of "using less than 10 employees".
3. Enforcement regime is not available
4. Conversion is not easy due to the lack of continuity (a household business has to stop their operation and register business anew)
5. Support to SMEs is inefficient, leading to lower advantages of being an enterprise under the Enterprise Law.

V. Recommendations

To achieve the objective of having one million enterprises in Vietnam by 2020, this Study recommends that household businesses need to be encouraged to turn into other forms of enterprises through the following actions:

(i) It is necessary to develop an action plan to encourage 'household business formalization';

(ii) There needs to be in place regulations in terms of timing and enforcement mechanisms for household businesses meeting the criterion to take action;

(iii) It is necessary to have policies and regimes to ensure smooth operation and development after conversion;

(iv) It is important to ensure transparency and sufficient information disclosure on tax management of household businesses;

(v) It is recommended to increase awareness over the advantages and opportunities for development of businesses registered under the Enterprise Law; and

(vi) It is imperative to continue simplifying regulations and procedures for registration, tax payment, accounting system, book keeping and other administrative procedures to reduce compliance costs for enterprises registered and operating under the Enterprise Law.