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Building a VC Market in Vietnam: VC Policy Lessons from  
Europe and Asia

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# Building a VC Market in Vietnam: VC Policy Lessons from Europe and Asia

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**ABSTRACT:** *In the 1980s, a belief was promulgated that governments should deploy public policy to create national venture capital ("VC") markets if they were not naturally occurring. This is due to the VC industry's role in driving innovation, employment and economic growth by financing and providing operational expertise to start-ups. The widespread acceptance of this norm, coupled with the spectacular returns produced by American VCs through the 1980s, drove the creation of public VC policies in over twenty countries, particularly those states competing in the global technology market. The resultant public VC policies are a form of industrial policy that is specifically focused on creating a VC industry, and consists of tax treatment, legal structures, and government funding.*

*Despite the shared motivation for VC policy, heterodoxy has persisted as policymakers have varying views of domestic VC industries: in some cases the local VC industry is seen as a capital market and desired industry in its own right; in some it is an extension of the financial services industry, whilst in others VC markets are considered solely as financial support to technology-focused entrepreneurship. VC policies have differed according to the involvement of the private sector in matching funding, openness to international investors, taxation and legal structures. VC policies designed to explicitly create a local VC market, versus those that strive to simply increase the pool of capital available to high-risk endeavours, impact the stage, size and success of the resultant domestic VC markets. This paper argues that countries that have viewed VC policy as a distinct professional industry, and work to link it with international markets through financing and regulatory efforts, have produced the most successful outcomes.*

*By analysing these various schools of thought on VC markets, this article seeks to answer the following question: how should Asian markets approach the building of new VC markets? Vietnam has been chosen as the case study due to its competitive positioning in the IT service outsourcing and technology industries; which has established the demand for early--stage investment capabilities (specifically VC). As highlighted by various Mekong Project Development Facility reports, in Vietnam there is insufficient capital available to private sector initiatives. Through 2000, the VC industry in Vietnam lagged behind its neighbours, including Indonesia, Malaysia and Thailand. In light of this contradiction, public VC policy is highly relevant to policymakers keen to continue fast-paced economic growth and further competitiveness in this 89 million person country. Thus, the paper investigates the policymakers' view of the VC industry in Vietnam, looking at the role of the private sector as well as government institutions, how they have affected public VC policy, and how a different stance may help to build a local VC market in Vietnam.*

## Introduction

Over the past twenty years Vietnam's economic trajectory has been unequivocally upward, as the Socialist Republic has indoctrinated liberal market programs and opened to international participation. Vietnam's growth rate has averaged 7.1 % per year,

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putting Vietnam in the same league as China and India as one of the world's exceptional growth stories (Alt Assets, 2011). Industry analysts are equally optimistic about Vietnam's future. In 2009 PricewaterhouseCoopers projected that Vietnam would be the world's fastest-growing media and entertainment market through 2013 (PricewaterhouseCoopers, 2009). Last year the Economist Intelligence Unit ranked Vietnam as the no 2 investment opportunity in emerging markets (Economist Intelligence Unit, 2010). The continued excitement about the Vietnamese market comes as the number of private companies grows, its middle class develops and its technology sector advances.

Fast-paced economic growth and numerous high-growth companies typically coincide with dynamic venture capital ("VC") markets. Yet Vietnam has one of the smallest VC markets in Asia. In light of Vietnam's phenomenal economic growth, why does Vietnam have such an underdeveloped VC market? Why do neighbouring Philippines, Malaysia and Thailand have more VC activity than Vietnam? The causes of the market failure thus far are said to be the state's historic control of the banking industry and failure to lay a regulatory framework for a VC industry. Despite the challenges, domestic and foreign private sector investors have begun participating in Vietnam's VC industry by investing in promising early-stage companies ("start-ups").

In Vietnam, like other Asian neighbours, the state dominated the economy until recently. The government controlled credit allocation decisions and the policymaking process was not inclusive or transparent. Starting with the *doi moi* reforms in 1986, a new constitution in the 1990s and participation in numerous international trade regimes within the past 10 years, the Vietnamese market has become more liberal and private actors now adorn the competitive landscape. With the rise of private companies and the expanded involvement of international actors comes a change in industrial policy and the ability to build new markets. In addition, the state's role has shifted from a financier with central authority over markets to a market facilitator that finances and empowers private actors. The state has afforded greater economic scope and policymaking influence to private firms, both domestic and foreign. However, this shifting power balance is still in motion and the expectation is that capital market building, including VC markets, would need to be the product of public-private partnership rather than a purely private sector effort.

The Vietnamese government and private sector alike have demonstrated an interest in furthering its VC market. In 2007, the Prime Minister's Decision 51 named the promotion of domestic VC funds as a target mechanism for support its growing IT industry (Freshfields, 2007, p. 1-2). Support for VC policy also came from the World Bank-organised multi-actor Consultative Group ("CG"). The CG brings together participants from the government, bilateral and multilateral donors, Vietnam Business Forum representatives, international and local non-government organisations ("NGO") to discuss economic policy. The 2010 mid-year CG meeting highlighted that a more efficient banking sector and developed capital markets are needed for continued growth (S.R. Vietnam M.O.F. 2010). The development of private capital markets is a priority for the government and public-private working groups.

This article, as part of the *New Approaches to Building Markets in Asia* project, looks at the policies and private sector initiatives needed to expand the fledgling VC market in Vietnam. The paper investigates the VC industry to date, the role of the private sector and government VC policy, and how a different approach may help to grow a local VC market in Vietnam. The paper first assesses the VC policies deployed across European and Asian states since the 1980s. Drawing on Asian best practices and pitfalls

in particular, the paper identifies strategies for overcoming Vietnam’s unique institutional hurdles and political legacies to create a VC market.

The paper proceeds as follows. Section II defines VC within the context of this article. It also gives a brief history of the global VC industry and the historic role of the state in its development. Section III assesses Vietnam’s unique political economy. Afterwards, Section IV analyses the current state of the Vietnamese VC industry. Sections V through VII are organised thematically: funding, taxation and regulation. Each section covers the lessons learned in other states that have deployed VC policies, outlining the best practices and pitfalls in efforts to build domestic VC markets. The last portion of each section outlines recommendations for the building of a private VC market in Vietnam through public-private collaboration. The article’s concluding remarks bring together the international best practices and recommendations for Vietnam’s VC policy.

**II. Venture capital: definition & history**

As this article examines VC policies employed to build VC markets, this section briefly defines VC and introduces VC policy. The working definition of VC is financial capital provided to start-ups with high growth potential in exchange for company equity or debt. Venture capital is a subset of the alternative investment class of “private equity”, which refers to investments in companies that are not publicly traded. The below chart highlights where VC sits within the private company investment spectrum:

Financing Stage	Period (years)	Risk level	Activity to be financed	Typical Investor
Early-stage finance / Seed	7-10	Extreme	For supporting an idea or R & D for product development	Friends, family, government grants and business angels
Start up (Seed Round)	5-9	Very high	Initialising operations or developing prototypes	Angel, government grants, seed funds (managed by VCs)
First stage (A Round)	3-7	High	Start commercial production and marketing	Venture Capitalists
Second stage (B Round)	3-5	Medium to High	Expand market & growing working capital need	Venture Capitalists
Later stage finance	1-3	Medium	Market expansion, acquisition & product development	Private Equity (or follow on rounds from VCs)
Buy out-in / Turnaround / Mezzanine / IPO	1-3	Low to Medium	Acquisition financing	Multi-national company (MNC), private equity (PE), IPO investors

*Source: Robyn Klingler-Vidra and MBA Knowledge Base*

VCs are incentivised to invest in start-ups, because of the potential for exponential returns.

The VC industry began around the time of WWII. The two entities most often cited as the first VCs were in the United States: the American Research and Development Corporation (“ARD”) and J.H. Whitney and Company (Lerner, 2009, p. 9-12)<sup>2</sup>. In 1945, another notable VC firm, 3i, was formed in the United Kingdom with £15 million in capital (3i 2011). These pioneer VC entities represent the first time that financial support of high-stakes corporations shifted out of the hands of high-net worth individuals (what we would today call “business angels”) and into organised investment management businesses. In the late 1970s the VC industry took off, mostly in the United States. American policy efforts, such as the Small Business Administration’s 1958 Small Business Investment Company (“SBIC”) program and the 1979 relaxing of the ERISA Prudent Man rule fostered an environment where pension funds, university endowment funds and foundations could invest in VCs. The industry generated phenomenal returns through to the 1980s and the new millennium as VC management companies invested in successful companies (i.e. Google and Facebook)<sup>3</sup>. By 2000 the global VC industry had over USD 100 billion in assets under management.

VC has become an increasingly international industry and public, private and international actors have all played a role in VC market building. Through 2008, 70% of the industry’s activity took place in the US. But the international VC markets have been growing over the past decade at an average annual growth rate of 5% (Ha, 2009). The growth of VC markets around the globe is the result of international capital flows and a rise in cross-border investments, and also the product of national VC policies. In the 1980s governments identified an insufficient amount of domestic investment in high-technology start-up companies<sup>4</sup>. Policymakers sought to correct the market failure of sub-optimal amounts of high-risk capital for small and medium enterprises (“SMEs”). They were also eager to replicate the success of the VC industry in the US. As an example, Singaporean policymakers recognised “the importance of VC financing in the success of countries such as the US” so the government “placed particular emphasis on the development of a venture capital industry in Singapore to boost the development of high technology start-ups and entrepreneurship” (Bruton et al., 2002, p. 199).

Despite the shared motivation for VC policy, heterodoxy has persisted as policymakers have varying views of domestic VC industries. In some cases the local VC industry is seen as a distinct capital market and professional industry in its own right; in some it is an extension of the financial services industry, whilst in others VC markets are solely considered to be financial support to technology-focused entrepreneurship. VC policies have differed according to the involvement of the private sector in matching funding, openness to international investors, taxation and legal structures. VC policies designed to explicitly create a local VC market versus those that strive to simply increase the pool of capital available to high-risk endeavours have different impacts on the stage, size and success of the resultant domestic VC markets. This paper argues that countries that have viewed VC policy as a distinct professional industry, and work to link it with international markets through financing, tax and regulatory policies have produced the most active and sustainable private VC markets.

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<sup>2</sup> Draper, Gaither, and Anderson, the first “LP” structured VC firm, was formed in 1958 (Gompers & Lerner, 1999, p. 7); the LP structure is used by the vast majority of today’s VC firms.

<sup>3</sup> See Josh Lerner’s *Boulevard of Broken Dreams* and Lerner & Gompers’ *The Venture Capital Cycle* for an excellent history of the VC industry.

<sup>4</sup> The shortage of VC funds is debated, as several recent studies give evidence to the contrary, such as the European Central Bank’s January 2005 working paper (#430). Regardless, the belief that an insufficient level of early-stage funding persists until today.

Regardless of the variance, government VC policy can be distilled into three primary features:

- 1) **Funding** – investing in privately managed VC funds, or providing loans or guarantees to VC managers via funds of VC funds (“FoVCFs”)
- 2) **Taxation** - incentives for VC investors and for VC managers, how carried interest is categorised – as capital gains, income or corporate tax, or as tax exempt
- 3) **Legal and regulatory framework** - legislation regarding ownership rights, foreign investor participation, stock exchanges, reporting requirements, and VC structures

The private sector has used its growing authority vis-à-vis governments to impact national VC policies across these three areas. Each element impacts the domestic VC market’s size and areas of activity. Therefore, we must look at the best practices for each, as well as the implications and pitfalls derived from the varieties of VC policies. Before moving onto best practices, pitfalls and recommendations for Vietnam, the following two sections outline the characteristics of Vietnam’s political economy and its VC market.

### **III. Political economy of Vietnam**

Following the *doi moi* reforms in 1986 and the opening to international trading partners in the early 1990s, Vietnam’s economic trajectory pointed strongly upwards by 2000. The Vietnamese Communist Party (“VCP”) remains in power and in operation of a single party system. However, the VCP has not conducted economic planning programs on par with the strong one-party states of Japan and Singapore. The VCP has overseen market reforms which aim to strike a balance between liberal and socialist paradigms. Caught in the middle, the VCP has simultaneously restricted private sector activity while not facilitating public economic development initiatives.

The political economy of Vietnam shapes the private sector’s authority, actors’ objectives and challenges to market building. For example, private businesses have been formed in large numbers (over 25,000 to date), and their growth rate has outperformed their public counterparts. However, an un-level playing field for state-owned enterprises over private firms persists. The following bullet points outline the aspects of the Vietnamese political economy that most impact the design of VC policy and the building of a VC market.

- Vietnam’s market governance and policymaking has been characterised as insular and non-transparent. Legislation coming from ministries and Prime Ministers’ decisions are not transparent in their process and legislative interpretations are not clear. For this reason, the World Bank has characterises Vietnam as a corrupt, difficult place to do business.
- Centralised planning and oversight was devolved to regional and municipal authorities beginning in the 1980s. As a consequence, different programs and interpretations of regulations are simultaneously practiced across cities (particular difference between Ho Chi Minh City and Hanoi) and rural areas.

- State-owned enterprises (“SOEs”) and conglomerates used to dominate the Vietnamese economy. The government has been “equitising<sup>5</sup>” SOEs since the 1990s, yet these equitised conglomerates and SOEs receive preferential treatment over private companies in terms of sectors in which they can compete, access to financing and in bidding for government contracts.
- The “white space” available to private companies was restricted historically. The 1986 *doi moi* reforms, the 1992 constitution and the 2000 and 2005 Enterprise Laws have gradually expanded how and where private companies are able to form and operate. Private sector power has grown in step with market reforms over the past twenty years.
- The financial services market in Vietnam was wholly constituted by five state-owned banks through 2000. These banks had complete control over the allocation of credit - which largely went to SOEs - thus depriving private companies access to financing. The first Vietnamese stock exchange opened in 2000 in Ho Chi Minh City (“HCMC”) and has become an avenue for start-up companies exits (as well as the public listing of equitised firms). An over-the-counter exchange was opened in Hanoi in 2003. The two exchanges have become the primary channel for Vietnamese VC exits.
- Vietnamese entrepreneurship is strong, and the number of private companies has grown exponentially since 1990. Many firms are family-owned businesses without audited financial statements. The highly fragmented SMEs in Vietnam are not prepared for investor interactions and have not been well organised for policy lobbying purposes.
- Foreign investors and corporations have been able to participate in the Vietnamese market since the 1990s, but in limited ways. Foreign ownership of local companies was limited to 33%. This restriction was raised to 49% via the September 2005 Enterprise Law. However, individual foreign entities can only own a maximum of 30% of a company, with all foreign entities together owning up to 49%. Restrictions vary according to the business sector. Technology, a favourite industry for VC investors, is a “committed sector” and WTO guidelines are such that foreigners can buy up to 100% of a Vietnamese technology company (improving foreigners’ access to the market) since 2007.

In sum, the political economy in Vietnam is such that the government has historically controlled credit decisions, the private sector is growing but unorganised, foreigners’ participation has been restricted, regional authorities exercise policy implementation power, and industrial policymaking is not characterised as transparent. The financial

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<sup>5</sup> Equitisation in Vietnam is the privatization of state-owned enterprises. The process of equitisation of SOEs is selling ownership stakes to private investors. However, the state has retained majority ownership stakes in some of the SOEs that have been equitized.



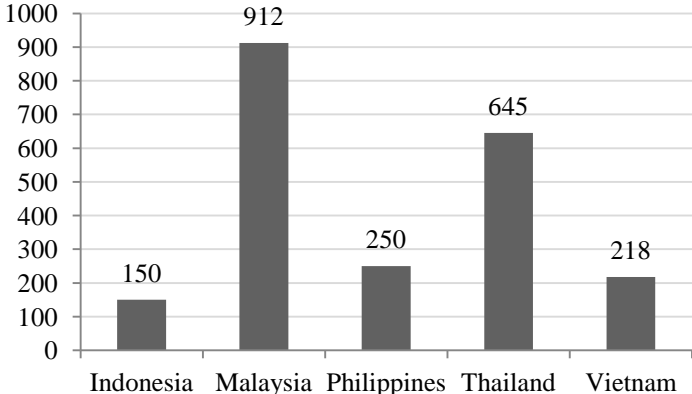
services industry is growing, but is still underdeveloped. Yet, the private sector and its authority vis-à-vis the state has expanded.

**IV. Vietnam’s VC market**

Green shoots of a VC industry in Vietnam were concurrent with the liberalisation of the economy in the 1990s. Vietnam’s political economy began changing as private firms formed and private capital needs increased. But, with the onset of the Asian financial crisis most of those VC firms (who were all foreign) left the Vietnamese market. A new batch of VC firms started operating in the early 2000s, yet the number of players, their divestments, and investments were modest. Vietnam’s lacklustre VC performance through the 1990s was, according to Sack and McKenzie (1998), due to the absence of domestic stock exchanges. They argued that the ability for VCs to cash out on their investments was hindered because companies were not able to make IPO exits. However, VC activity did not spike after the opening of the HCMC and Hanoi exchanges in 2000 and 2003 respectively. Therefore, this article explores how broader institutional reform of regulation and tax policy, and a government fund of VC fund vehicle, can help grow the Vietnamese VC market.

The Vietnamese VC market has approximately USD 150 million in assets under management (Alt Assets, 2011). Vietnam’s VC industry has remained smaller than its comparable countries, with the exception of Indonesia. Amongst the group Malaysia is the standout with nearly USD 1 billion in VC assets under management. The Malaysian government has aided industry growth by enacting regulation to encourage VC investments and has also provided funding. In the Asian Tigers, Hong Kong had over USD 26 billion in VC money, Singapore over USD 10 billion, South Korea nearly USD 10 billion and Taiwan over 6 billion in 2003. The key takeaway here is that money has been pouring into VC funds in the region, to the developed economies as well as Vietnam’s developing peer group.

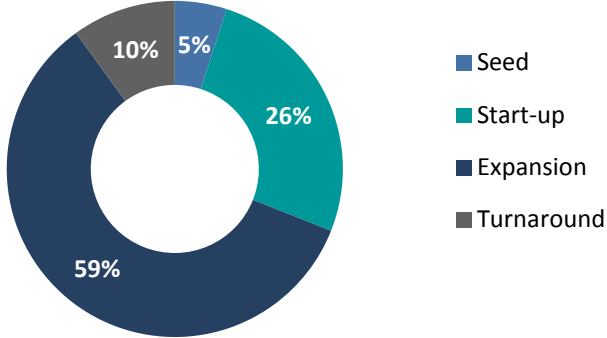
**Vietnam VC market (2003) versus emerging Asia (USD million):**



*Source: AVCJ (2005)*

At present, there are four PE/VC firms operating in Vietnam - IDG Venture Vietnam, DFJ VinaVentures, Dragon Capital, and Mekong Capital (APEC, 2010). They operate as offshore vehicles and focus on investments in companies operating in the technology, media telecommunications and consumer sectors. Investments tend to be in established companies seeking growth capital (equitised companies or pre-IPO companies), instead of in early-stage businesses. As such, the “VC” in Vietnam currently is best characterised

as “private equity”. The below chart illustrates that less than one third of the activity is VC (start-up and seed stage):



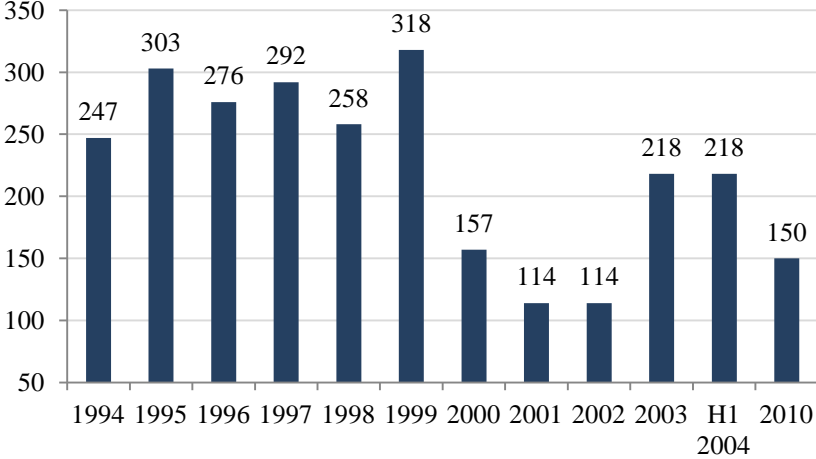
Source: Dietrich (2003)

The following quote from a Vietnamese investment bank is evidence of the insufficient amounts of early-stage financing available in Vietnam:

In Vietnam there are almost no international private equity funds, and there are only two major sources of capital: banks and funds...Vietnam is one of the few unique countries in the world that may offer lack of capital and long term high growth. (Vietnam Capital Partners, 2011)

Vietnam’s small VC market size has been consistent over time. The Vietnamese VC industry has only oscillated between peak assets under management of USD 318 million in 1999 and just over USD 100 million, as evidenced by the below chart:

Vietnam VC industry capital pool (USD million):



Sources: AVCJ (2005), AltAssets (2011)

Looking forward, firms like Vietnam-based Mekong Capital believe that demographics are in favour of a continued attractive VC environment in Vietnam. This exuberance stems from demographic trends, including the 48% growth rate of private business in Vietnam (Kim, 2008) and the fact that over 60% of the population is under 30 years old (Vietnam Capital Partners, 2011). Investors’ positive sentiment about Vietnam’s economy also comes from its 20% internet penetration rate, the 94% literacy rate and consumer spending growth of 8% annually (CIA World Factbook, 2007). Yet, industry

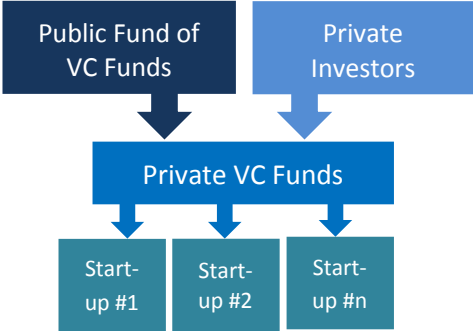
analysts point to the difficulties with bureaucracy, lack of accounting standards and insufficient administrative procedures for the low rating for the industry’s immaturity (Groh, 2011). As a result, the VC market in Vietnam remains smaller than what is needed by its entrepreneurial society, and what would be expected in such a high-growth environment.

**V. VC policy: government funding**

Countries have deployed a wide range of taxation, regulation and financing programs to build domestic VC industries over the past 25 years. This paper investigates their experiences in order to recommend public VC policy and private sector involvement that will help build a Vietnamese VC market. This comparative approach has been used in other studies, including the APEC project which recently commented “as Vietnam is a late-comer, it needs to thoroughly analyze the policies applied by other countries in order to be able to compete with them in attracting venture capital” (APEC 2010). Through the expansion of a VC market private sector firms will be able to participate in credit allocation decisions in Vietnam (through better access to growth capital) and further their authority in industrial policymaking.

A primary mechanism of government funding to the VC industry is the government fund of VC fund (“FoVCF”). FoVCFs are designed such that the state gives money to VC managers who are highly trained to ‘pick winning’ SMEs for investment. To launch a FoVCF the state first creates a government fund, or pool of capital. This pool of money is distributed across a select number of private VC firms after the government does due diligence on their professional investment and operational abilities. The objective is to supply initial investment to VC managers so that private capital will flow into domestic VC funds. Typically, FoVCFs structures partner public and private investors to jumpstart a VC market:

*Illustration 1: Government FoVCF structure*



*Source: Robyn Klingler-Vidra*

The FoVCFs that have been launched over the past twenty years have been varied in their size, terms and objectives. The assets under management of funds range from USD 100 million to more than USD 1 billion. A driver of the variations in FoVCF terms is the view that governments have of the VC industry and their objective in launching the FoVCFs. In some cases, governments have managed FoVCFs with the goal of supplying money to start-ups and producing a return on their investment (“ROI”). In other states FoVCFs are an injection of capital that is lent the money at a nominal interest rate repayment. The FoVCFs goal is to create a self-sustaining, private-sector led VC market.

The terms and design of FoVCFs impact the VC market's creation and future investor base, which is why the next section explores FoVCF variation.

### **a). Funding best practices and pitfalls**

The United States and Hong Kong, two of the heavy-hitters in the VC industry, have not launched national FoVCFs. Other states, such as Taiwan, have not had FoVCFs as the central element of their VC policy. But, for over twenty countries, FoVCFs have been deployed as a central means of jump starting national VC markets. Across these cases, four main areas of variance have been identified: the time frame, the involvement of foreign investors, the repayment terms, and regional versus national funding schemes.

#### *Set FoVCF time-frame*

Successful FoVCF programs have been defined in their duration and intended to be a jumpstart as opposed to an ongoing solution (OECD, 1997, p. 4). In the Israeli and Singaporean cases, the FoVCFs had a defined time period (five years) in which the government VC funds were deployed in promising domestic VC managers. Their FoVCFs (*Yozma* and the *Technopreneurship Investment Fund*) were designed to be booster shots, or one time programs. With several managers (eight in the case of Israel) receiving funding at once, there was effectively a class of new VC managers, who established positive investment track records that created buzz. These VC managers generated returns that attracted private sector investors.

In contrast, other states have created FoVCFs that allocate funding to VC management firms annually, such as Finland's *Finnish Industry Investments ("FII")*. *FII* has been funded through its own profits (called "greenfield budgeting") and has annualised 5% since its inception in 1995. This paper argues that the annual funding and greenfield budgeting do not support the objective of helping to start a VC industry for two primary reasons<sup>6</sup>. First, in order to make a return each year, the types of VC managers the FoVCF can invest in must be later stage and therefore lower risk. To earn a profit, and to do so regularly, does not match the cyclical risk-return profile of the VC industry. Second, by providing funding to the industry each year the government may support an industry that is not able to raise private capital. Local VC managers may become dependent on government money instead of becoming capable of fundraising from private investors. Time-bound FoVCFs are associated with policy to create professional VC industries, whereas greenfield budgeted FoVCFs are designed by stakeholders seeking an expanded pool of capital. Policymakers' view of VC is clearly seen in this aspect of FoVCF design.

#### *Involvement of private and international investors*

FoVCFs have worked to attract international investors to the domestic VC market. One way of doing this is to require that VC managers that receive funds

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<sup>6</sup> The argument in favour of ongoing funding for a domestic VC industry draws on three points. First, that VC is a cyclical business, and investors in VC are therefore not steady in their investment in the industry. So, to ensure that a local VC industry is able to grow and survive through market cycles, government funding is given on a steady basis. Second, not all institutional investors have the bandwidth or asset class expertise to make investing in small VC transactions worthwhile. The last reason for having a profitable, ongoing government FoVCF is that it is a revenue generator for the government, which simultaneously allocates money to the local private sector. Because the FoVCF agency is earning enough return to pay for their own operations and future investments, it is not a subsidy or liability. So, supporters of ongoing FoVCFs would ask why cut a self-funding and beneficial entity?

matching those from the government FoVCF from foreign investors. This has been done in an effort to link fledgling VC industries with established and experienced investors. Both Israel and Singapore utilised this policy element in an effort to ensure that domestic VCs would learn best practices from world-class international investors. As the VC industry is increasingly global, VCs rely on connections with investors, bankers, industry leaders and others to do their job well. FoVCFs that require funding from international investors take a step in fostering these links. Others, such as Finland's *FII* did not require private nor foreign participation. Instead, the government acted alone as the capital provider to the VC market.

### *Repayment terms*

Policymakers may place less important on FoVCF financial return on investment ("ROI") than societal goals of building a VC market, and vice versa. In the Israeli case, *Yozma* investments were loans repayable in five years' time, at an interest rate of 5%. *Yozma* did not want the share in the big upside – if there was any – of the VC managers it had funded. So, if the funds that received *Yozma* money made 100% on their investment portfolio, they would only return the government their initial investment plus 5% interest. In other FoVCFs, such as Finland's *FII*, the government's return was linked to the VC funds' performance. This means that the revenue for the government FoVCF could be significant, but it also decreases the potential gains of the VC managers that they are supporting. As the FoVCFs objective is to build a market by increasing the incentive for investors to participate in the market, the best practice for repayment is a nominal interest rate.

### *National versus regional levels*

Regionally focused, and administered, FoVCFs are potentially relevant to Vietnam given its history of regional governance and municipality initiatives. Several states have FoVCFs on regional, or industry-specific, basis. In the US, 45 of the 50 American states have deployed government funding to support early-stage financing within their state, and in Finland the national government organised funds (Finnvera) that were to be deployed spatially (Lerner, 2009). In China, until the national FoVCF launched in 2008, the vast majority of SME and VC support came from regional and provincial departments. One benefit of the regional FoVCF is the ability to experiment with different structures and also to tailor programs according to regional differences. The downside is that the amount of funding available in each FoVCF is less, and therefore the potential impact may be smaller. Regional FoVCFs may be viewed as both local funding to "even the playing field" (aka a pool of funding) and as a distinct professional capital markets industry.

## **b). Funding recommendations for Vietnam**

High net worth individuals, corporations, pension funds and other institutional investors that constitute the global VC investor base do not have a history of investing in private equity vehicles in Vietnam. For an early-stage VC industry to be established in Vietnam, the VC managers need to build a track record so that private investors will have the confidence to invest in local VC funds. And to have the chance to build this track record, VC managers in HCMC, Hanoi or elsewhere in Vietnam need capital. Drawing

from the best practices this paper proposes that the government allocate money along with private sector matching funds in a FoVCF to fill this void. Vietnamese FoVCFs would provide capital to a class of Vietnamese VCs so they can establish a track record and then attract more private, and foreign, investors.

The article recommends fixed time duration – of five to seven years – for the FoVCF time frame. As demonstrated in the previous section on international best practices, a defined tenure for a government FoVCF helps ensure that the funding acts as a jumpstart to a private sector-led VC industry. VC funds with defined time periods, such as Israel’s *Yozma* program, give domestic VC managers time to develop a track record so that they are then able to raise funds privately. If funding to VC managers is continued indefinitely then the VC managers would not be adequately incentivised to be competitive, because they would not have to raise private money.

Private sector co-investment at the outset is crucial to building a VC market. Therefore, the article recommends that FoVCF-receiving VC managers are required to raise matching funding from international financial institutions. International links will help bring foreign VCs who can effectively train local VCs and will better link Vietnamese markets with world capital markets, as Singapore’s *TIF* did successfully. This point is relevant to policy design aimed at creating a professional, world-class VC industry. VC managers wishing to participate in the Vietnamese FoVCF program would need to private raise matching funds equal to half of the government money<sup>7</sup>. The half matching funds requirement is due to the low starting point of private capital in Vietnam. Until recent years private company financing was virtually non-existent. Requiring an early-stage focused Vietnamese VC manager to secure an equal amount of capital from the private sector would be prohibitive to VC market building, while requiring 50% matching funds seems motivating but reasonable.

Regional FoVCFs are suggested as jumpstarts to local VC industries in HCMC and Hanoi. As highlighted in the political economy scan, HCMC and Hanoi have different levels of entrepreneurial activity, their own stock exchanges, and a history of creating and enforcing varied policies. Instead of deploying a national government FoVCF, the recommendation is to take advantage of these differences. FoVCFs that are city-focused could test various matching and duration terms simultaneously, instead of one national FoVCF deploying money across the entire state. In addition, the terms of the fund can be shaped according to the cities’ unique regulatory and entrepreneurial landscapes. China historically delegated VC and SME funding decisions to provincial governments. These regional Chinese funds can be used as a blue print for provincially-funded and administered Vietnamese FoVCFs.

Therefore, the recommendations for Vietnamese VC industry funding are:

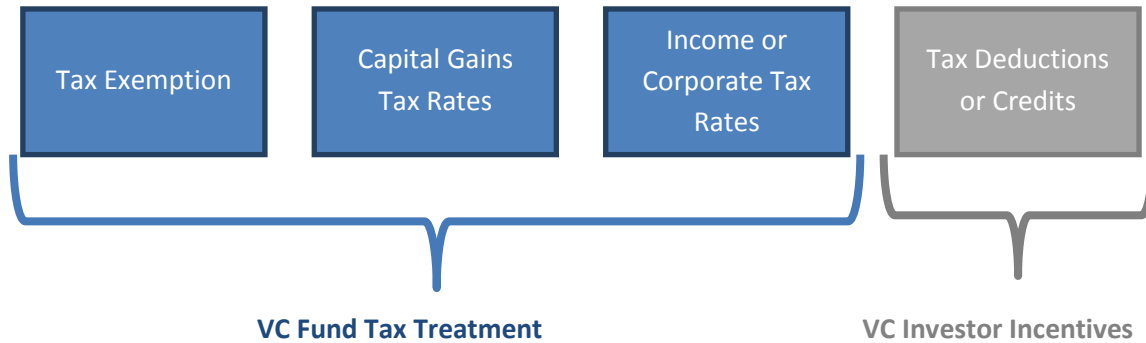
Regional FoVCFs that would (1) require international investor matching, (2) allow VC managers to repay the investment at a fixed interest rate, and (3) only be deployed for a defined period of time of 5 to 7 years.

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<sup>7</sup> So, if the government gave USD 10 million to a VC manager through the FoVCF, the VC manager would need to raise USD 5 million from private investors, USD 2.5 million of which would be from domestic investors and USD 2.5 million of which from international investors.

## VC policy: taxation

Taxation impacts the VC industry's profitability and tax incentives can be used as a tool to attract private capital to the asset class. The below illustration summarises the VC tax policy tools available:



*Source: Robyn Klingler-Vidra*

A tax exempt program implies that VC managers pay zero tax on their profits (or carry). If VCs are not tax exempt, then they are classified in one of two main ways: as capital gains tax eligible or income tax eligible. A capital gains tax classification exists for the sale of “non-inventory assets”. Typically this refers to the sale of stocks and other investment vehicles. Not all states have capital gains taxation, but those who do typically have their capital gains rate set lower than that of income or corporate tax rates. As such, tax systems that treat returns on VC investments as capital gains tend to be more attractive than systems which treat VC carry as income or corporate tax eligible. In states that treat VC profits with progressive income tax rate rates, such as Denmark, taxes depend upon the individuals’ income level and can therefore be more than 50%. In summary, tax rate decisions range from zero tax to over 50% tax, and have an impact on the profitability of the VC market.

The other tax policy tool utilised across Europe and Asia is the tax deduction or credit. Whereas the tax rate decision affects the profitability of the VC manager, the tax credit is aimed at the VC investor. A tax credit gives VC investors a discount on the amount of tax they need to pay for the fiscal year. In so doing, the tax credit decreases the risk of investment in VC by effectively reducing the amount of tax that individuals or companies need to pay.

### **a). Taxation: best practices and pitfalls**

Low or zero tax rates for VC funds have been effective means of incentivising private investment in local VC funds. Singapore launched a 10 year tax break for VCs via Section 13H and Hong Kong enacted a similar tax exemption via the 2005 Revenue Bill. In September 2009, the Malaysian Securities Commission released new VC tax incentive guidelines for inclusion in the Income Tax Order 2009. These are just a few examples of states that enacted tax exemptions or tax rate reductions. Given the prevalence of low VC tax rates in Asia, employing a tax exemption, or low tax rate, has become a best practice, and near necessity.

In addition, states have offered tax deductions to investors in VC funds. Taiwan successfully deployed the tax deduction strategy. In the 1980s the Taiwanese

government started offering a 20% tax deduction to investors in Taiwanese VC funds. This helped lower the risk of investments to 80 cents on the dollar as 20% of the investment was effectively returned as a tax credit. The scheme was so successful in raising money for VCs – and thus filling the market failure of insufficient funding for VC managers – that it was discontinued in 1999. Tax credits for VC investors have mobilised private investor interest in VC funds.

### **b). Taxation recommendations for Vietnam**

Currently the taxation scheme in Vietnam is a blanket rate across industries and company types. However, attractive tax rates are given as incentives to select sectors, such as technology, which is taxed at 10% in the high-tech zones (Grant Thornton, 2010, p. 26). VC profits are currently taxed at the general corporate tax rate of 25%. By matching the technology industry tax rate of 10%, Vietnamese VC funds would experience a spike in profit margins. Or, giving a tax exemption, as Hong Kong did in 2005, is another tool for attracting investors to the Vietnamese market. Vietnam runs the risk of not having VC funds set up locally, and instead having VC funds from Hong Kong or Singapore investing in domestic companies. To attract the establishment of Vietnamese VC funds, local VC tax rates need to be competitive.

On the investor tax incentive side, following the Taiwanese model, a tax deduction for VC investors would be recommended. Vietnamese conglomerates, who are not currently investing in early-stage opportunities, may be incentivised by a 20% tax deduction. The overall risk of their investment in early-stage VCs would be lowered through their tax payment savings. The tax deduction for VC investor could be piloted for five years. Depending upon its ability to increase the amount of capital available to domestic VC funds it could then be discontinued or extended for another set period of time.

In sum, the taxation recommendations for Vietnam are:

(1) offer a discounted tax rate to VC funds domiciled in Vietnam of zero (tax exempt for 5 years) to 10% (make VC a strategic industry), or (2) offer a tax credit or deduction to investors in Vietnamese VC funds of up to 20%.

### **Legal and regulatory framework**

VC-specific regulatory frameworks establish legal structures, give guidance on ownership rights, enforce property rights, and more. Regulations on accounting and reporting requirements have been established as necessary foundations for domestic VC industries. Regulations such as the American ERISA Prudent Man Rule in the 1970s, which allowed pension funds and other institutional investors to invest in high-risk asset classes such as VC, can be vital to private capital being available for investment in local VC markets. VC-relevant regulation also includes investment restrictions and the industrial policymaking process.

In terms of legal structures, the American and British limited partnership (“LP”) structure legally decreases the amount of the investors’ assets that are at stake as a result of their investment. In jurisdictions with legal mechanisms for decreasing risk,



such as the limited, or limited liability, partnership (LP or LLP) the net worth of the investor is not on the line (only the invested amount can be lost). In others, such as Japan through the 1990s, the choices were either an anonymous investment or a full liability investment<sup>8</sup>. Other legal fund structures include Taiwan's paper company. Two implications of the Taiwanese paper company structure are that investors have power over decisions (instead of the VC manager being solely responsible for investment decisions) and that employees of the VC management firm do not have equity in the funds. As a result, VCs in Taiwan cannot make investment decisions as quickly as elsewhere, and VC managers' incentives are not aligned with those of the investors. In addition, non-LP fund structures are not harmonised with the international norm for VC funds, and therefore act as a hurdle for international investors.

Other legal restrictions on VC relate to the allowance of foreign investor participation. In China, as an example, the maximum foreign investment was capped at 33% until 2004, and then rose to only 49% (Dietrich, 2003, p. 38). The cap on foreign ownership has impacted the Vietnamese VC market to date. The legal and regulatory terms impact the ability for private investors, and in particular foreign capital holders, to participate, so regulatory harmonisation is vital to VC market building.

#### **a). *VC regulation best practices and pitfalls***

Regulations regarding the rights of investors in VC, and incentives to raise capital from non-state investors, have implications on VC markets. Finland's and Taiwan's VC structures require VC management firms to involve their investors in all investment decisions. Thus, before being able to invest, or exit from a holding, the VC manager needs to organise a meeting and vote for all investors. The stipulation stemmed from the initial hesitancy of investors to allocate to an unfamiliar and high-risk asset class. Having power over investment decisions was said to give confidence to private sector VC investors. However, this regulation discouraged participation from international investors as it slowed down the investment process, and introduced a further element of uncertainty.

Restrictions on foreign investment in domestic companies dampen VC activity. China, similar to Vietnam, has had a cap on the percent of company ownership available to foreigners. These limits on foreign ownership slow down speculative activity, warding off investment bubbles. However, from a VC market perspective, a maximum on ownership by one company, or by a group of foreign entities, restricts both the ability for VC funds to invest in a start-up and their ability to sell the company. Therefore, foreign ownership restrictions are not considered a best practice for VC – as they are not used in the world's largest or most active VC markets.

#### **b). *Regulation recommendations for Vietnam***

Vietnam has been slow to offer a regulatory framework for non-bank financial institutions, including VCs. In contrast, Indonesia, Malaysia and Thailand have all created frameworks for VC. International investors interested in Vietnam have been quoted as

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<sup>8</sup> Before the Diet's 1999 legislation creating an LP structure, there were two types of legal entities VCs could incorporate as in Japan. The first, the Tokumei kumiai structure, offered limited liability, however, only to anonymous people. The alternative structure, the Goshi gaisha, is a corporation in which investors have unlimited liability. Thus, investors' net worth was on the line in Japan if an investment incurred a loss.

saying that whilst the market is attractive the policies are not clear, and thus increase risk and uncertainty (APEC, 2010). The 2011 Annual Global Venture Capital and Private Equity Country Attractiveness Index similarly noted the following weaknesses for the Vietnamese VC market: administrative procedures still lagging behind regional peers, underdeveloped financial markets, relatively weak corporate governance and financial reporting not yet in line with international standards (Groh, 2011). Thus both investors who want to enter the Vietnamese VC market and industry research groups note the regulatory, governance and accounting deficiencies as detractors to an otherwise promising market.

There has been modest progress in creating a regulatory framework that is conducive to VC funds operating in Vietnam. In March of 2003, Decision 36:

Served to improve conditions in a number of respects, most notably: i) Removing the requirement that foreign investors must hold their shares for between 1-3 years; ii) Removal of the need for the prime minister's approval on each individual deal (instead, the investee company need now only inform the government of the share sale); iii) Removal of the restriction that foreign investors may only invest in joint stock companies (Freeman, 2004, p. 35).

Yet, the cap on the size of foreign ownership stakes in Vietnamese companies, through the Law on Companies, is still at 49%. Over the past decade VCs wishing to invest in Vietnamese companies have gained more flexible liquidity terms and access to a broader universe of companies. But, there remain limitations on foreign ownership of local companies and the methods by which they can conduct investment transactions.

Policymaking has been criticised for its lack of transparency and predictability. In light of the insular policymaking fashion of Vietnam today, my recommendation for building a private VC market is to create committees that link the government, industry and academics together to design and implement VC industrial policy. A committee of public and private sector members would be helpful in creating VC policy that is capable of market building as it would include more people's expertise when designing the structure of the policy and would come with private sector buy-in. Singapore has done this with the EDB's International Advisory Councils. Vietnamese industrial policymakers should involve the private sector on policy design, building upon the work of the CG on economic policy. Private sector participants, such as a VC association, NGOs, foreign investors, domestic banks and VC managers, need to be brought into the policymaking process via committees like the CG, focused on VC. To increase the expertise of local VC stakeholders the paper recommends that the government organise a VC industry association, as Singapore did in the early 1990s. Going forward the VC association will be a resource for policy recommendations, best practices sharing and be an actor at the policy negotiating table.

There are insufficient reporting and transparency requirements for private Vietnamese companies. Investors operating in Vietnam, and foreign investors looking to invest in Vietnamese start-ups, both point to the lack of audited financial statements and general lack of transparency into the operations and financial of Vietnamese SMEs as an impediment to investment. Statutory audit laws in Vietnam only require independent annual audits on private companies in the financial sector, public companies and foreign invested entities (Grant Thornton, 2010, p. 43). All other private companies are not required to have audited financials. The Unlisted Public Company Market ("UPCoM")

was established in 2009 as an over-the-counter market for Vietnam's 3000+ unlisted companies in an effort to improve transparency for investors (Grant Thornton, 2010, p. 40). Yet, private Vietnamese companies are novices when it comes to presenting business plans and financials when raising capital from private sources or via the Vietnamese stock exchange.

To date VCs have had to wire their money in Vietnamese Dong only via a regulated bank to invest in a Vietnamese SME (Do 2008). These capital controls add to the distance between the Vietnamese VC market and international standards and practices. The recommendation would be to allow investment in local companies in foreign currency, or at least partially in foreign currency.

Finally, Vietnamese VC would benefit from harmonising with international standards on the structure of VC funds. To do this, my recommendation is that Vietnam adopts a limited partnership ("LP") structure. This will enable the formation of more "onshore" vehicles, which will help keep VC fund revenue in Vietnam, bring investments from Vietnamese institutional investors and also encourage the development of domestic VC expertise. This gets at the notion of designing policy to encourage a distinct VC market, and not just expanding the pool of early-stage financing.

In sum, the recommendations for regulations for VC in Vietnam are as follows:

(1) harmonise with international structure standards by adopting the LP structure, (2) loosen the cap on foreign company ownership of Vietnamese companies, (3) require private companies to have annual audits of their financial statements, (4) create an international advisory board to improve transparency in industrial policymaking and (5) lift capital controls that require investments be done via regulated banks in Vietnamese Dong.

## **Concluding remarks**

Vietnam has a history of state-owned banks, a relatively new openness to private companies and a trend towards regional governance. The availability of early-stage financing in Vietnam has increased over the past decade. However, there is still a disproportionately small amount of financing available to high growth Vietnamese companies, particularly in the technology sector. Vietnam has been ranked as one of the world's most promising markets, in terms of economic growth and investment opportunities. To help realise the potential of the private sector a domestic VC market needs to be built.

Yet, industrial policy for market building remains a challenge. The process of industrial policymaking has been insular and non-transparent. The private sector has been weak, not well organised and not included in the policymaking process. But in recent years private sector firms have achieved financial success and are growing in number. Their authority over economic policy has not kept pace with their economic advancement. As a remedy, further institutionalisation of private businesses, industry associations, regional organisations and investors in the policymaking process is needed. The argument advanced in this paper is that a productive VC policy and

sustainable VC market can be facilitated by bringing private actors into the government's policymaking process and learning from international VC policy experiences.

To form policy recommendations for Vietnam the article examined VC policy efforts across Europe and Asia over the past thirty years. In choosing countries for comparison the paper kept in mind that "for both Vietnam and China the foreign example that matters most is not the West, as the European Community was for Eastern Europe, but economically successful Asian neighbours" (Turley, 1993, p. 3-4). The Asian Tigers act as valuable examples of successful development strategies that coupled capitalist economic management with single-party leadership and the state's "governing of the market" (Wade 1990). Thus, the successful tax policies deployed in Taiwan and Hong Kong were covered and the regulatory framework best practices and pitfalls in Singapore, Hong Kong and Taiwan were investigated. Though the Tigers utilised markedly different policy tools, policymakers were similar in their involvement of the private sector in the policymaking process and in their view of VC as a distinct professional industry. Their policies established linked with international investors to distil best operational and investment practices and discouraged a dependency on state funding.

Work needs to be done at the VC policy level in Vietnam. This paper has recommended that Vietnam create a regulatory framework specific to the VC industry that is harmonised with world standards. In addition, the article suggests a low (or no) tax offer for VC funds for a set time period as well as a tax credit for private VC investors. A FoVCF with a pre-determined duration that required private and foreign investor participation would help increase the amount of investment available. It would link Vietnamese VC managers with international investors to gain operational expertise. Helping domestic VCs to have international networks and to learn best practices are critical steps in building a professional VC market, rather than simply a pool of capital.

The multi-level private sector, through its participation in policy committees and Consultative Group, can help shape Vietnam's VC policy framework and policymakers' view of the industry. Vietnamese policymaking has been driven by Prime Minister Decisions but now cross-functional groups such as the CG are making policy recommendations. This new tradition of involving domestic businesses, NGOs and investors in the policymaking process is positive and should be expanded to the VC policymaking arena. Public-private cooperation in VC policy will help build a robust, internationally-linked VC market in Vietnam that is capable of supporting its entrepreneurial 89 million person population. To do this, Vietnamese policymakers need to see VC as a distinct market, as several Asian and European countries have done. A jumpstart to the languishing local VC market, through a FoVCF, tax policy shift and regulatory environment are essential.

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