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Abstract

The reduced influence of soft budget constraints is often seen as an explanations for the successful growth of China's non-state sector. Views differ, however, as to whether collectively owned rural enterprise are in fact subject to hard financial discipline. This paper reports an inquiry into the issue. The study examines the financial behaviour of REs, particularly that of loss-making enterprises, by scrutinising a set of survey data of 630 rural enterprises in Sichuan and Zhejiang (China). Being primarily explorative and conceptual in nature, our study reveals that soft budget constraints can still be observed to be enjoyed by many rural enterprises, in particular among those collectively owned. As the budget constraints do appear to become more rigid, however, enterprises look for other opportunities to ease the financial discipline forced upon them by the market and by increasingly illiquid local governments. Accumulating inter-enterprise arrears, as well as withholding wage payments, are identified as means frequently used towards this end by REs in transitional Chinese economy.

Key words: Soft budget constraints, economic transition, China, rural industry, township and village enterprises, inter-enterprise arrears.

JEL Classification: P21, P32

SOFT BUDGET CONSTRAINTS: AN ANALYSIS BASED ON A SURVEY OF CHINESE TOWNSHIP ENTERPRISES

I. Introduction

One of the most important reasons identified for the inefficient mode of operation of publicly controlled enterprise is the prevalence of soft budget constraints. The term, originally suggested by Hungarian economist János Kornai (1979, 1980, 1982), implies that enterprises do not face penalties for overspending, and that they readily adjust to the perceived or actual lack of sanctions. In subsequent works Kornai (1986, 1992) distinguishes four basic types of external support contributing to the soft budget constraint: soft subsidies, soft taxes, soft credit and soft administrative pricing. The predominant characteristic of such assistance is that conditions are negotiable and are therefore usually bargained over at more or less regular intervals. These subsidies, in turn, often help insulate enterprises from the need of maintaining even a semblance of efficiency, thereby undermining the viability of the entire economy.

The concept has proved intuitively attractive to scholars and commentators addressing issues of ailing enterprises, both in centrally planned economies and elsewhere, including in public entities in market economies and parastatals in developing countries. Despite that some of the implications of the soft budget constraint is open to dispute (Gomulka 1983; Knell 1988; Bajt 1990; Szego 1990/91), as a heuristic device it remains unmatched in the study of public sector enterprises. The elegant simplicity of the concept itself has an immediate appeal to economists and non-economists alike. Knowledgeable observers will also point to the empirically well established fact that many unhealthy state companies continue to be bailed out, no matter the deficits they may accumulate, thereby contributing both to macro-economic imbalances and distortions in the market. The real world phenomenon as such is thus of considerable importance, while the soft budget constraint approach holds out the promise of offering critical insights as regards the nature of the problem. As such, it also has important implications for the attempts to move away from central planning (e.g., Staehr 1993; Buch *et al*. 1994; Qian 1994; Raiser 1994).

In practice, and short of challenging its very existence (as does Menshikov 1994, pp. 301-304),[1] it has proved difficult to analyse soft budget constraints with any measure of detail and precision. This is readily reflected in the fact that, as yet, only a handful of empirical studies have been reported, some of which are explorative and tentative rather than fully developed and conclusive (Kornai and Matits 1984; Kraft and Vodopivec 1992; Whiting 1993; Eriksson 1993, 1994; Hay *et al*. 1994; Reiman 1994). This stands in contrast to the rather more abundant literature on the theoretical modelling of various aspects of budget softness or the implications thereof (e.g., Goldfeld and Quandt 1988, 1990a, 1990b, 1992, 1993; Mitchell 1989; Schaffer 1989: 369-371, 378; Hardy 1992; Magee and Quandt 1994; Qian 1994; Qian and Roland 1994; Valbonesi 1995: 49-52).

The reasons for the scant attention given to the factual substantiation of the existence, nature and magnitude of the soft budget constraints are straightforward. Researchers have found it exceedingly difficult to collect the data needed for an in-depth analysis of the various subsidies typically bargained over and received by state enterprises. Formal exercises have done little to improve the situation, as most resulting models would appear

[1] Or by proposing alternative explanations for the phenomena the soft budget constraint approach tries to explain, as does Shleifer and Vishny (1992) by introducing what may be called a 'conspiracy theory of shortages'. With a fair dose of alacrity Shleifer and Vishny argue that planners are archetypal rent- seekers and that they 'intentionally plan shortages in order to invite bribes from rationed consumers' (the argument applying to the supply of luxuries, necessities and intermediate goods alike). Cf. the review by van Brabant (1990).

to have exceedingly stringent data requirements, no matter the possibility of deriving nominally testable implications from them. In effect, at best of times formal models as exist provide little more than illuminating rules of thumb (e.g. Qian and Roland 1994). By implication, few appraisals of the full relevance and conceptual appropriateness of Kornai's original framework have been made (Hare 1989).

This paper reports research which may help fill part of this void. Focusing on a case where soft budget constraints are widely acknowledged to have become increasingly hard, the purpose is to investigate the ability of enterprises to maintain soft conditions. Once accustomed to lenient terms, Chinese rural enter- prises have emerged as a formidable force under China's economic reforms. Improved competitive strength implies an end to inefficiencies, including those induced by soft budget constraints. However, indications are that township and village enterprise, while considerably more successful and quite possibly more efficient than their state sector counterparts, have had difficulties in severing ties with sources of soft finance. We shall therefore investigate the extent to which soft terms persist and the strategies of rural enterprises designed to cushion the impact of the withdrawal (if at all) of such terms. If successful, we should be able not only to extend existing empirical knowledge but also, and as importantly, contribute some preliminaries towards the evaluation of the utility of the concept itself.

The remainder of report is organised as follows. The next section, II, scans the existing literature on soft budget constraints in Chinese enterprises with a view of establishing the role and nature of the phenomenon in an economy in transition away from central planning. Section III takes a closer look at the sector where reforms appear to have been most successful, that of rural enterprises, surveying the conflicting information on the persistence of soft terms. Section IV outlines the research design and presents the data upon which our analysis is based. The empirical study based on the survey data proceeds in two analytical steps in Section V. Section VI draws the findings together and summarises the study.

II. Soft budget constraints: the Chinese case

China is no exception to the general pattern of ambiguity surrounding the existence and nature of enterprise budget constraints. Although the `hardening of the soft budget constraint´ has become one of the most cherished metaphors describing the core characteristics of post-Mao economic development, opinions differ as to its utility as an explanation for the success of the current reforms. For the most part observers will concur that change has been slower to come about in the state enterprise sector than in the cooperative and private ones, but the fact that one sector can be assumed to be lagging behind says little about achievements in absolute terms of the others. Therefore it is perhaps not surprising that diverging assessments are stock in trade.

On the one hand, some scholars contend that China during the past decade or so of reform has successfully `imposed very hard budget constraints on, and gave little bank credit to, the newly liberalised non-state sectors in industry and agriculture´ (McKinnon 1994: 439).[2] This, it is said, stands in marked contrast to the state enterprise sector, where the perseverance of soft budget constraints is the single most important obstacle to reforms (e.g., Vahabi, 1995: 174). Others will take the opposite view arguing that `[i]f the intention of the banking reforms has been to harden enterprise credit constraints by increasing the autonomy and commercial orientation of the banks, the evidence to date, after eight years of reform, suggests that this has not been realised. In fact, the credit constraint may have become softer´, the reason being that `banks, although technically more independent, are not using that power to impose financial discipline on enterprises and thus the credit constraint continues to be soft´ (Bowles and White 1989: 487-488 and 489, respectively).

[2] While well known to China specialists, it may nevertheless be useful to point out that state and publicly owned enterprises are not identical universes. The cooperative (or collective) sector, largely composed of township and village or urban enterprises controlled by local authorities, is non-state only in the sense of not being controlled by the centre (i.e., not subject to the plan). With the notable exception of private enterprises masquerading as collectives, the majority can by no stretch of imagination can be considered private, even though local officials may at times act is if these enterprises in fact were in their own possession. For a useful survey of the various types of collectives, see Goodman (1995).

Part of the answer to the puzzle is perhaps, as is indeed hinted by the above quotations, to be found in the sector subjected to analysis: it is conceivable that whereas state sector enterprises continue to be protected, private firms typically face hard financial and budgetary terms, cooperatives in this regard occupying the middle ground. Indeed, explicitly or implicitly the degree of exposure to market forces is sometimes seen as the major determinant, and the best proxy, of budget softness (Nee 1992; Chen *et al*. 1994). Any analysis of the soft budget constraints in Chinese enterprises would therefore do well to consider differences between sectors—state, cooperative and private—or other categories reflecting differentials in market exposure.

On the other hand, some authors claim that also state enterprises do indeed face hard budget constraints (e.g., Granick 1990: 154-156). Such arguments, which are typically based on analyses of the monetary policy of the central government, point to another distinction that should be made: that of macro-economic and micro-economic budget constraints (e.g., Bowles and White 1993: 63). The former refers to the removal, wittingly or unwittingly, of the financial constraints faced by the entire economy while the latter, which appears closer to Kornai's original conception, pertains to the constraints faced by individual enterprises. The point is that widely diverging assessments may be more apparent than real, simply because they apply the same concept and similar modes of reasoning to differing domains of analysis. Only recently have explicit attempts been made to bridge this divide empirically (e.g. Bowles and White 1993) and analytically (e.g., Qian and Roland 1994).

The diverging assessments referred to above may also reflect a shift in the sources of soft terms. Not only may, for instance, soft taxes have been substituted for soft subsidies, but the dispenser of soft resources may have changed as well. Thus, while the Centre may have been able to abandon the habit of bailing out loss making firms local level government or locally controlled financial institutions can perhaps be found to have shouldered the `responsibility´ of propping up ailing (or potentially ailing) businesses. Finally, the possibility that soft terms not only have changed in character over time but have become increasingly rare should not be discounted.

However, although the above observations seem to sort out existing conceptual ambiguities, and those arising from features of individual research designs, they do little to reconcile the findings stressing the continuing existence of soft terms with China's much touted record of more than a decade of rapid economic growth. After all, the co-existence of these patterns would seem to contradict the generally accepted view that the propensity to bail out loss making enterprises leads to a sub-optimal allocation of resources and hence impedes economic growth. An at least partial solution to this seeming paradox is offered by Walder (1994: 54), who contends that `[p]ervasive bargaining over terms of taxation and finance and extensive government redistribution among firms do not rule out the possibility that financial constraints nonetheless may increasingly influence the behaviour of managers´. There is thus a case to be made for the distinction between `soft´ and `flexible´ budget constraints, where the hardness of the latter `depends ultimately on the fiscal resources of the government entity with which an enterprise bargains and on the incentives and constraints presented by fiscal mechanisms to government overseers in the bargaining process´ (Walder 1994: 54). With the continuing devolvement of central control over production units, and as a result of the changing nature of China's system of taxation, the bargaining process unfolds within a setting of changing—and increasingly compelling—constraints and incentives facing both enterprise managers and local officials. Indeed, Walder (1994: 61) continues, the intensity of bargaining may in fact increase as closer supervision and a tighter financial reign are substituted for the previously lax controls.

While conceptually distinct, Walder's formulation shares some features with Ericson's (1988) concept of priority development, as subsequently applied by Davis (1989; 1990), Oxenstierna (1990) and others. For instance, Reiman (1994), using Hungarian production cost data in a shadow cost model, concludes that over-utilisation of inputs in priority sectors is clearly observable from the empirical information at hand. His findings thereby confirm the observation made by Ericson (1988: 6) that a priority sector can be expected to `[absorb] resources independent of true opportunity costs´, in the process imposing additional costs arising from reduced flexibility.[3] Thus, pronounced budget softness is not a universal phenomenon of centrally planned economies, but nevertheless has economy wide implications; the degree to which enterprises face a soft budget constraint depends on which sector they belong to or which point in time we focus our attention on. Whether be it because a somewhat less diluted inducement to save (Kornai 1986: 24-26) or because of as a result of reform 'the heightened fiscal constraints facing governments are most immediate and hardest at lower levels, which have a more limited industrial (and tax) base' (Walder 1994: 62),[4] the result is much the same. Given the right environment, these less favoured entities are likely to do better than priority sector enterprises habitually cushioned from many, if not most, of the adverse effects of the shortage economy and their own sluggish performance. Hence, the apparent success of township enterprises in China, to which we now turn.

III. Soft budget constraints in Chinese rural enterprises

The above introductory considerations are of relevance as we narrowing the focus to rural enterprises. Thus, a number of observations by students of China's township and village enterprise (TVE) sector suggest a continuing practice of soft terms. Despite statements to the effect that `these enterprises are subject to hard budget constraints, since ultimately they have to depend on their viability in the market´ (Chen *et al*. 1994: 16), others have noted that there is more to it than meets the eye. For instance, Young and Yang (1994: 33-34) draw our attention to the sometimes deliberately lax collection of taxes; on the other hand collective and private TVEs often face a plethora of fees imposed by local authorities. While the role of non-tax charges as a substitute for tax collection proper can best be explained by recourse to strong incentives to hide local revenue from the purview of higher level authorities (hence contributing to local retention of funds), the actual mix between the two can, depending on circumstances, represent either a net gain to the enterprise or to the local administration, or both.

Precisely for the reason that local authorities earn most of their revenue from the TVE sector, it is in the interest of township governments to support rural enterprises; to the extent we focus on the cooperative sector it is indeed their `right as well as the duty to manage this property´ (Song and Du 1990: 349). To this end, one may expect that enterprises do receive preferential treatment in various forms, including those categorised by Kornai as support to soften the budget constraint.

An obvious case in point is the reports that the Agricultural Bank of China and the Rural Credit Cooperatives not infrequently allowed debtors -- among which collective TVEs figure prominently -- default on payments due and that the payment of overdue loans sometimes were put off indefinitely (Byrd 1990). By a similar token collective TVEs enjoy privileges in the form of preferential access to investment funds and land for enterprise premises (Zhang 1993/1994: 60-62). Not only do administrative and physical restrictions appear lax, but collective entities seldom have to bear the full opportunity cost of such start-up expenditures (Chang and Wang 1994:445). Indeed, drawing upon a survey of 90 enterprises conducted in 1991, Yuan (1994:105) maintains `that many private enterprises operate under the disguise of being rural collective enterprises in order to obtain preferential credit´ and other similar benefits, which in turn is suggestive of the powerful attraction of trying to secure soft terms.

Although the above summary as regards the continuing existence of soft budget constraints at times may seem contradictory, it is possible to accommodate the seemingly conflicting observations by noting that cross subsidisation between sectors and enterprises within a township is an entirely feasible option. Thanks to discretionary control of locally collected revenue, budgets of township governments are not necessarily as

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[3] On the other hand, and contrary to what the soft budget constraint thesis would lead one to expect, earlier work by Reiman (1992: 223) points to the existence 'of substantial short and long run shadow prise responsiveness with respect to material inputs' in a number of industries surveyed. Reiman (1994) does not explicitly attempt to reconcile these somewhat conflicting findings, nor does he use them to evaluate the overall applicability of Kornai's concept.

[4] Walder (1995) furthers this line of reasoning by noting that budget softness varies with the number of entities owned or supervised by a given level with in the administrative hierarchy, lower levels typically implying more direct control and hence better financial performance or management.

hard as them may at first seem. For, while deficit financing is strictly speaking not allowed (Byrd and Gelb 1990: 370), the non-remittance of resources that have, or should have, been collected on behalf of the Centre still leaves township governments with a measure of manoeuvrability. Moreover, local governments' budget constraints can also be softened by the fact that specified budgetary resources, such as funds allocated for purchasing agricultural products, are often abused for other usage. Thus, although Qian and Roland (1994) plausibly suggest that the possibilities for cross-subsidisation increase with increasing (relative) size of the TVE sector, this must not be construed to imply that the phenomenon is precluded in localities with a small TVE sector. Similarly, local governments' influence over banks operating in the community may well be used to dispense credits on soft terms (Wang 1990: 224-226; also, e.g., Byrd 1990: 214-215). This can be, and obviously has been, done by shifting the responsibility to repay loans from loss making to profitable TVEs, or by township and county governments pressuring banks into continuing providing funds for enterprises already heavily in debt.

To find out whether these statements are simply artefacts of a state of knowledge lagging behind actual developments or is indeed a fact of live, we propose to investigate the behaviour of China's thriving township and village enterprises. We shall survey a sample of enterprises within the rural enterprise sector with a view to establishing to what extent traces of soft budget constraints can in fact be found in this, as is generally acknowledged, successful segment of the economy of China. In particular, we are interested in finding out in what manner soft terms are made available to locally controlled enterprises.

IV. Research design and data

The focus of the study will be on the micro-level, that is, budget constraints as they apply to producing enterprises, set against a situation where local governments can be expected to experience ever harder financial constraints themselves (for instance, as a result of the introduction of financial contracting and recent tax reform). Given the conflicting theoretical reasoning found in the literature regarding the relevance and, hence, the existence of soft budget constraints in the non-state sector, and given the lack of systematic empirical evidence supporting either of these opinions, our primary concern is to establish empirically the existence of the SBCs as it is the case in the rural enterprises. To this end preliminary evidence of budget softness in TVEs is identified in a first step by comparing the total capital structure and the composition of total liability of loss making firms (LMEs).

In a second step the investigation will focus on the financial characteristics and behaviour of LMEs *ex post* financial losses by using a one year time lag in the analysis. More specifically, the financial characteristics and changes in the loss making enterprises during the year *ex post* their financial losses, rather than during the loss making year, are studies and compared with those of the profitable ones. This design is motivated by the theoretical understanding that SBC is a time inconsistency problem on the part of government as a source of SBC.

The one year time lag is used to highlight the causal relation between the observed behaviour of the LMEs and the losses incurred in their operation during the previous years. This relates to our primary focus on LMEs for identifying soft budget constraints, which is based on the assumption that these enterprises are particularly motivated to exploit the advantages of soft budget terms. However, such a focus on LMEs does not mean to preclude the possibility that soft budget constraints may occur in firms that appear financially healthy and profitable. Thus, profitable firms are not only used as a control group, but also are made subject to inquiry in the study.

The concept of soft budget constraints is considered to be stochastic in nature (Kornai 1992: 143). To accommodate this particular feature, the study employs survey data of a three year period (1987-1989) to reduce the influence of stochastic factors of any particular year. Although our findings based on the data of the three-years period may shed light on the tendencies of SBCs in the rural enterprise sector during the period under study, they are not meant to be interpreted as the trends of SBCs for any longer period of time, as the number of years covered by the study is too short to yield any reliable information of that kind.

Finally, findings emerging from the aforementioned two analytical steps are synthesised and preliminary conclusions based on these findings will be drawn. Such a study design, which is meant to reinforce and cross-check the findings in order to facilitate the interpretation of them, is considered necessary due to the tricky nature of the task of identifying SBCs by using pre-existing survey data. Although the design makes the study cumbersome and causes some overlaps between the two analytical steps, the method is a justifiable one given the nature of the task and the limitations of the existing survey data on which the study is based.

The difficulty of empirically investigating SBC is partly a consequence of the broadness and ambiguity of its conceptual framework, which turns to make any unambiguous interpretation of data difficult on a large scale basis. It is relatively strait forward to conclude on whether or not a certain financial behaviour of the firms under study indicates SBCs, when applying the theory to one or a few firms. However, such an exercise becomes increasingly difficult when the study is based on the data of a large survey sample, as one would then lack the information on internal and external conditions under which budget constraints are softened for each and every firms in the sample. This difficulty can be reduced, if stratification procedure is applied in selecting the survey sample to insure that the data yielded from the survey can be interpreted in the light of SBCs. However, such an attempt has not yet been reported in the literature. When one relies on pre-existing survey data to study the SBCs, as it is the case of the present exercise, it further complicates the study.

The Data and Data Limitations

The assessment is based on a pre-existing survey of township enterprises in China’s booming rural industrial sector conducted in Sichuan and Zhejiang in 1990-91 (Islam 1991; Ronnås 1993a; Saith 1995; Zhang and Sjöberg 1992). A full set of accounting statistics was collected at the time and the data thus acquired are amenable to an analysis of the proposed kind. The level of detail and reliability of this particular set of data is such that it presents a quite unique opportunity to evaluate the utility and salience of the concept of the soft budget constraint. Additionally, as an important spin-off more light will be shed on the workings of the perhaps most dynamic sector of the Chinese economy.

The paper draws upon the returns from the 630 enterprises included in the original survey. The surveyed entities were culled from a sample frame including township enterprises in five counties (16 townships) representing a wide selection of economic development levels and managerial strategies as well as export and locally oriented production units (Ronnås 1993b, 1993c; Ronnås and Sjöberg 1993). By focusing on collective rural enterprises (i.e., those owned and operated by local governments), and comparing them to private ones, important aspects of enterprise-government interaction can be analysed in terms of implications for SBCs.

It is useful to bear in mind that the survey, as is also the case with a recent study of soft budget constraints in Chinese state owned enterprises (Hay *et al*. 1994), was not specifically designed to investigate the existence of soft budget constraints, although the wealth and the quality of the survey data make it possible to probe some of the issues at hand in considerable depth. This suggests that the data may better enable us to put the conceptual apparatus to test, but to address the phenomenon in a quantitative manner. It should be also kept in mind that because the questionnaire used in the enterprise survey was not designed for collecting data for the present study, some critical themes can only be analysed in a rather circumabout manner. Furthermore, it should be noted that no stratification procedure was employed to ensure the representativity of the sub-sample of loss making firms analysed in the following sections. The under-representation of LMEs, together with other limitations of our data, implies that the immediate aim of our study is to further enhance our empirical understanding of SBCs in Chinese rural enterprises rather than to arrive at any quantitative and general statements as to the incidence and magnitude of the problem.

Furthermore, although the consistency of the questionnaire returns is high, indicating an acceptable level of reliability, we are aware that many pitfalls still exist. From the point of view of our present concern, the most critical aspect is the likelihood of accounting data being improved upon. However, as such manipulation is likely to understate revenue, including transfers, and overstate expenditure any indication of budget softness can be thought of as reflecting minimum levels of support. In this context, and for reasons explained in earlier sections, care should be exercised in distinguishing between the effects of soft taxes and tax evasion, the latter of which may, but certainly need not, take place with the tacit consent of community governments.

V. Evidence of soft budget constraints

1. The Loss-making Enterprises in the Sample

Table 1 displays the profitability distribution of the survey sample from 1987 to 1989. It appears that the loss-making enterprises account for less than ten per cent of the total sample in all the three years. Furthermore, the proportion of LMEs in the sample is fairly stable across these years. Moreover, the majority of the LMEs tend to improve their performance in the year after, which means that the LMEs are not the same group of enterprises across years.[5] Enterprises in the red for successive two years account for between 40 to 25 per cent of the loss-making sub-sample of different years. But losses of more than two years are uncommon in the survey sample, and just two such cases (out of 20 LMEs) were found between 1986 and 1989, and four (out of 19 LMEs) between 1987 and 1989. The low proportion of LMEs in each year and the fact that the majority of them improved rather quickly once financial losses occurred may be a proof of the much cited market identity of the Chinese rural enterprises. The data in Table 1 thus highlights the performance difference between the REs and state-owned enterprises, of which some 40 to 60 per cent are estimated to run losses year after years.[6]

Table 1. Profitability Distribution of the Sample, 1987-1989. Enterprises.

	Total	Profitable	Non-profit	Loss Making (LM)			% of LM
				Total	1-y LM	2-y LM	
1987	325	295	3	27	19	8	8.3
- Non-collective	151	147	2	2	2	0	1.3
- Collective	174	148	1	25	17	8	14.4
1988	476	433	7	36	29	7	7.6
- Non-collective	254	233	5	16	14	2	6.3
- Collective	222	200	2	20	15	5	9.0
1989	630	559	16	55	44	11	8.7
- Non-collective	368	326	14	28	23	5	7.6
- Collective	262	233	2	27	21	6	10.3

Note: 1-y LM = 1 year loss making enterprises; 2-y LM = 2 year loss making enterprises.

Table 1 also shows that in all three years the proportion of LMEs is higher in the collective REs than it is the case in non-collective REs. Thus, figures in Table 1 indicate the likelihood that chances for surviving losses are greater for the collective REs than for the non-collective ones. Such a tendency may further suggest that REs run by local governments have a relatively soft budget constraint than do the non-collective REs. This proposition will be further examined in this study.

However, records on temporary loss may not necessarily reflect the financial solidity of enterprises, and long term and temporary LMEs are found to be different in their capital structures and in their financial behaviour (Hay *et al*. 1994:325-365). It is thus important to distinguish temporary loss-making enterprises, e.g. for a year, from those that made losses for a longer period of time. Therefore, firms that made losses in a given year and in two successive years are, wherever possible, treated in this study.

[5] It presumably reduces the comparability of the data regarding the financial behaviours of LMEs across different years.

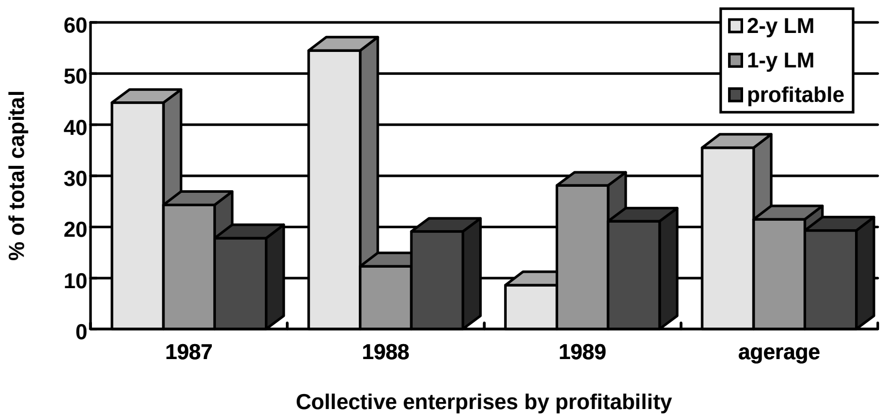
[6] Estimates on the percentage of loss making state owned enterprises differ between sources, *The Economist* quotes the estimate of Mckinsey (Hong Kong) as ‘at least half of them are losing money’. See *The Economist*, August 27, 1994 p. 49.

2. Total Capital Structure and Total Liability Composition

Figure 1 (last page) illustrates the sources of total capital of Chinese rural enterprises. Among these some, such as the investment by local governments and bank loans, may have more direct bearing on the budget softness in the REs than some others, e.g. enterprise´s own capital.

Government Investments. On the equity capital side, since collective REs are owned by the local government, the local government investments are likely to contribute to the softness of budget constrains in a similar way as resource handed to state firms by the central government. It is shown in Figure 2 that the share of local government investment in the total capital is generally higher in the LMEs as compared to that of the profitable group. This tendency is particularly pronounced in the 2-year LMEs, although it is observable also among the 1-year LMEs in both 1987 and 1989. It shows that the reliance of loss making enterprises on the local government investment increases as their losses continued. This suggests that local government investments may be a main source of SBCs in the collective rural enterprises, although its role appears to have reduced in 1989, as can be seen from Figure 2.[7]

Fig. 2. Share of local government Investment in total capital, 1987-1989.



Bank Loans. In China, bank loans are considered soft as they may be issued for the survival of LMEs, and that interest payment and loan repayment cannot be always enforced, etc.[8] The root of bank loan softness lays in the lack of independence of Chinese banks. While at the central level recent financial reforms have taken big steps towards making Chinese banks more independent, it is still often heard that at local level banks listen more to the local governments than to the Centre (see, e. g., *Financial Times* , Dec. 1, 1994, p. 18).

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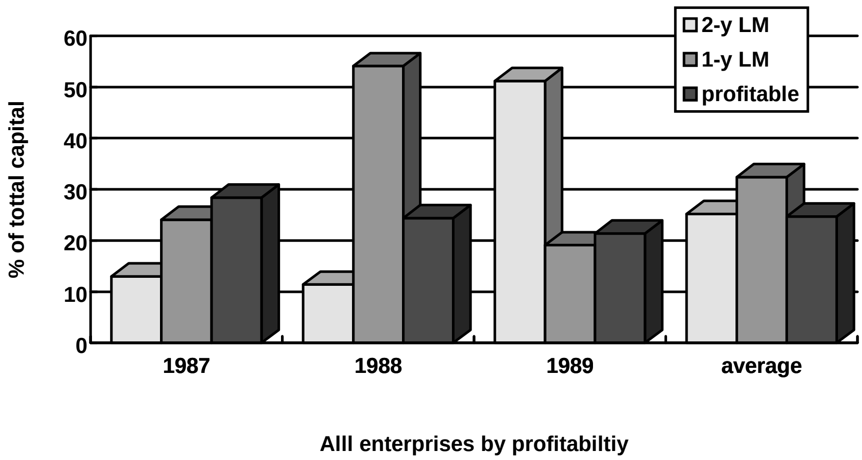
[7] The variation of local government investment in total capital is further discussed in connection with Figure 4.

[8] According to a recent estimation, more than half of the People's Bank of China's loans are not repaid, and all state banks are overwhelmingly burdened by their obligation to continue funding the ailing state enterprise. See *Financial Times*, Nov. 7. 1994, P. VII.

Fig. 3. Share of bank loans in total capital, 1987-1989.



In general, Figure 3 does not seem to suggest any strong evidence of bank loan softness as the share of bank loans in total capital tend to be slightly higher for the profitable enterprises than for the loss making ones.[9] The noticeable exception to this is year 1988, in which case bank loans accounted for more than 50 per cent, twice the level of the profitable enterprises, of the total capital of the temporary loss-making enterprises. This seems to be attributable to the exceptionally rapid growth of the RE sector in 1988, which was partially fuelled by bank credits resulting in the high level of bank borrowing in total capital of that year.[10] The high level of bank borrowing was carried on by the 2-year LMEs in 1989 as shown in Figure 3.[11] It should be mentioned at this point that bank credit is a scarce resource in rural China and that the RE sector as a whole was badly affected by the central government's tight credit policy in 1989 (Ody 1992: 12, 29-30). Thus, as the level of bank loans remained as high while the enterprises continued making losses, the high ratio of bank loans to total capital in the LMEs during the period of severe credit squeeze is likely to indicate the existence of both bank loan softness and of the repayment problem.[12]

Since local governments are known to have a strong influence over the banks (reference.), they have a certain room for manoeuvre as regards the use between bank loans and their investment capital. In normal situation, bank loans may be used as a supplement of local government investment fund. When bank credit is tightened by the Centre, as the case in 1989, local governments may supply more investment capital to ease the lack of credit. It is therefore important to look into the relation between the share of local government investment and that of bank loans in total capital.

Figure 4 shows a relatively stable pattern: all three years the share of the two capital sources combined is the lowest for the profitable enterprises. It tends to increase when losses occur, and becomes higher still in case losses continue into a second year. Furthermore, Figure 4 reveals a supplementary relationship between the local government investment and bank loans, which combined maintained at stable levels across the years, but the share of each capital source in total capital varied from one year to another. Indeed, Figure 4 does illustrate the expected substitution between decrease of bank loans and corresponding increase of local government investment in total capital (of the profitable group and the 1-year LMEs) during the credit squeeze of 1989.

[9] According to the study by Lin *et al*. (1992), bank loans in comparison to other investment funds are considered among difficult funds to obtain and use by the rural enterprises in their survey sample.

[10] The total output of REs and its industrial output grew by 36 and 37 per cent in real terms in 1988 respectively. See China Township Enterprises Year Book (1989: 76), and Ody (1992: 6), respectively. Of the 1-year LMEs in 1988 nearly 60 per cent were established in that year. It further suggests a correlation between credit expansion and rapid growth of REs, on one hand, and the high proportion of bank loans of the LMEs in that year, on the other hand.

[11] As high as 46 per cent of the 2-year LMEs in 1989 was set up in 1988.

[12] Note that the bulk of bank loans, e.g. 70 per cent of bank loans outstanding at the end of 1993, is for working capital, hence short term loans.

The observed substitution effect of the two capital sources helps to explain the cross-year variations found in Figure 2 and Figure 3, respectively. Meanwhile, it also suggests that the relative budget softness of different capital sources are likely to vary with the major policy and institutional changes that take place at a given time.

Fig. 4. Share of government investment and bank loan in total capital, 1987-1989.

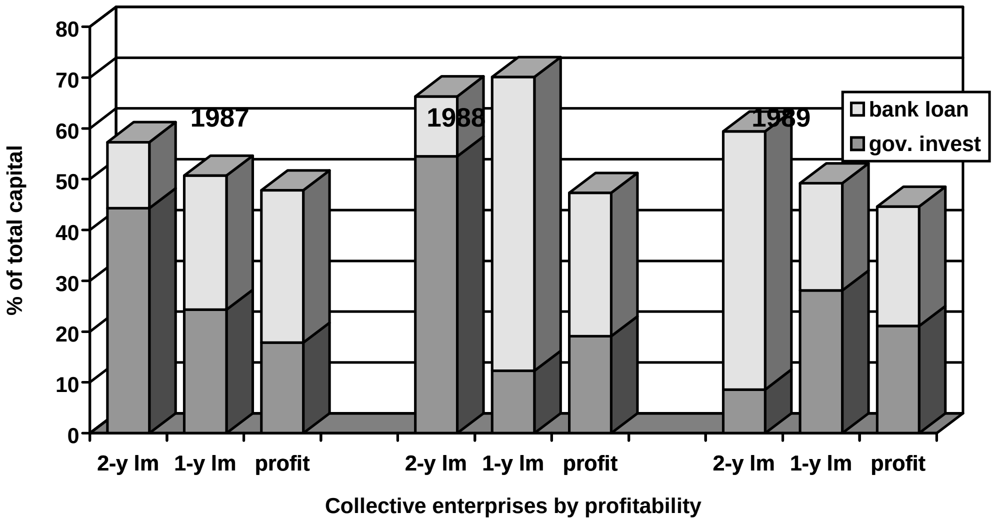
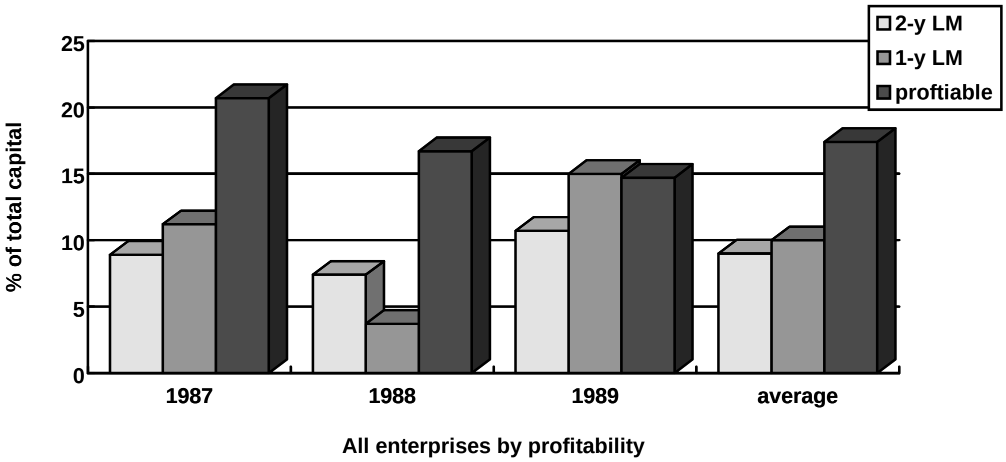


Fig. 5. Share of enterprise's own funds in total capital, 1987-1989.



Enterprise Own Funds. Figure 5 illustrates the share of enterprise own funds, which refer to enterprise's retained profits in the forms of accumulated profit and of special funds in total capital. It appears from Figure 5 that the share of this capital tends to be higher in the profitable REs than in the LMEs, which may be an indication of worsened financial situation of the latter.[13] However, its implication for the nature of soft budget constraints may not be as straightforward.

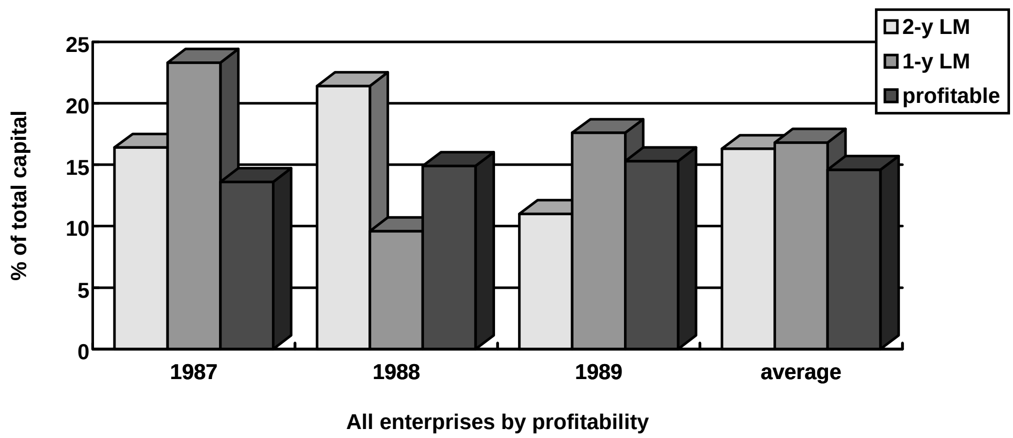
First, assume that budget constraints are reasonably hard, a lower share of own funds in total capital of the LMEs then means that enterprises write down of own capital and, meanwhile, own funds halt from growing

[13] Hay *et al.* (1992: 337-338) notes that long term loss-makers display an increased reliance on own funds. However, in their study own fund comprises subsidies which chiefly account for the increased share of own funds.

due to losses made. Second, however, if budget constraints are soft, e.g. subsidies and/or bank loans are available for paying for the losses *ex post*, increased subsidies or bank loans in total capital on one hand, and the unchanged amount of own funds due to loss-making on the other hand may also result in a lowered share of own funds in total capital of the LMEs. Since Figure 5 refers to the situation of the year when losses incurred rather than the year after, it is more likely that the first scenario was in action.[14]

Arrears to Other Firms. The so called triangle debts, which refer to arrears that firms owe to each other for purchase of goods and services with its most severe scale and pervasiveness reached in the end of 1980's, has in fact been an important source of informal credit for firms in China. This source of capital in normal cases, i.e. profitable enterprises, accounts for about 15 per cent of the total capital in REs in our sample (Figure 6). The magnitude of such arrears is a manifestation of weakness of China's institutions for contract enforcement. Since firms do not pay any penalty for delay or even default of payments, arrears function as *de facto* costless credits which serves to soften the budget constraints of firms. It also illustrates the fact that in the reformed socialist economies like China firms tend to exploit some new opportunities of SBCs by taking advantages of the severe lack of market institutions.

Fig. 6. Share of arrears to other firms in total capital, 1987-1989.

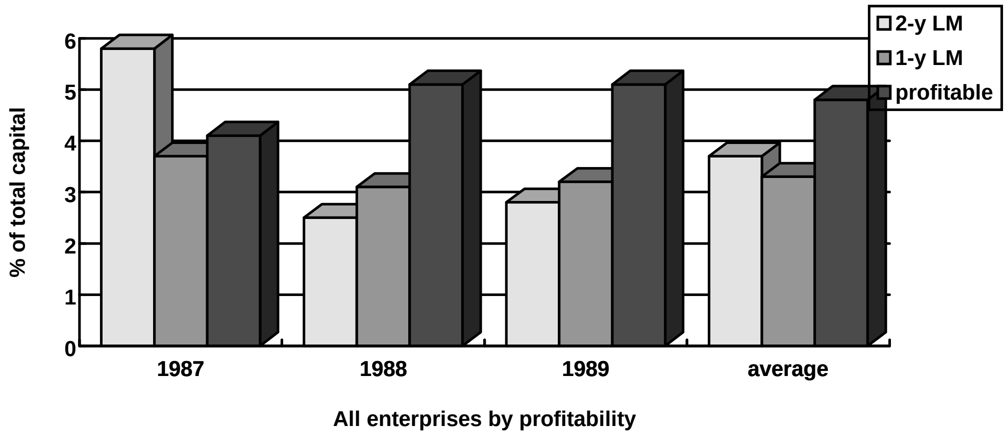


By and large, an impression can be gained from Figure 6 that LMEs, especially the 1-year group, normally have a higher percentage of arrears in their total capital than profitable firms have, albeit variations between years and between the two types of LMEs tend to somewhat attenuate the outcome. Such a tendency can be reasonable in that when firms confronted losses they would then have an active motive to first make use of the easiest available substitutes for soft terms negotiated with local government, i. e. default payments. Thus, losses and increase of default payments take place simultaneously. On the other hand, given the opportunity to benefit from a certain level of arrears in total capital is independent to the firm's profitability, it would suggest that if firms, profitable and loss maker alike, engage in the exploitation of the opportunity to a similar degree.

Payments Outstanding to Government. All rural enterprises are subject to various taxes and local levies. In addition, collective REs are obliged to deliver part of their profits to the local government that owns the enterprises. Payments outstanding to government therefore refer to the sum of unpaid taxes and other payments that the surveyed enterprises owed to the local government. Taxes in China are collected by local governments and shared with central government. It raises the possibility for local governments to exempt local enterprises from paying taxes at the cost of the Centre, i.e. soft taxation from the point of view of SBCs. The various levies concerned are local in nature, and therefore they are subject to local rules and regulations.

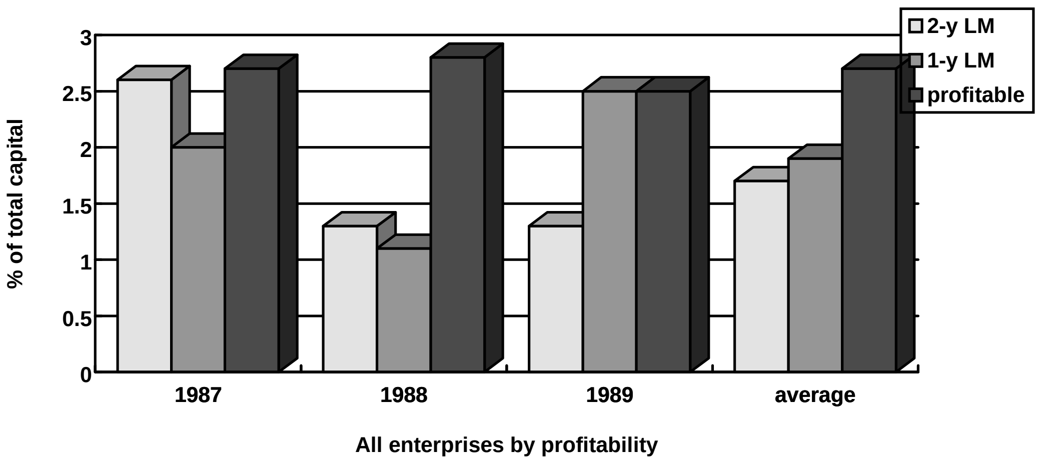
[14] Whether loss making REs received *ex post* help in the form of extra local government investment and bank loans, etc. will be dealt in section 3.

Fig. 7. Share of payment outstanding to government in total capital, 1987-1989.



The fact that a large number of REs, both profitable and loss-making ones, did not pay the full amount of taxes and other levies to the authorities may be a proof of SBCs in the form of soft taxation. The magnitude of the payments outstanding to government accounts for five per cent of total capital of the profitable REs, and around three per cent in the case the LMEs as shown in Figure 7. The tendency that profitable enterprises had a higher share of outstanding payment to local governments may reflect two facts: (1) everything else being equal, profitable REs have a larger fiscal obligation to local authorities as they are subject to income tax, and (2) they may, because of (1), be in a better position to negotiate soft tax terms with these authorities. The observation that profitable REs tend to have a large share of outstanding payment to local governments is interesting in that it alters the traditional impression that loss-making enterprises benefit the most from SBCs.

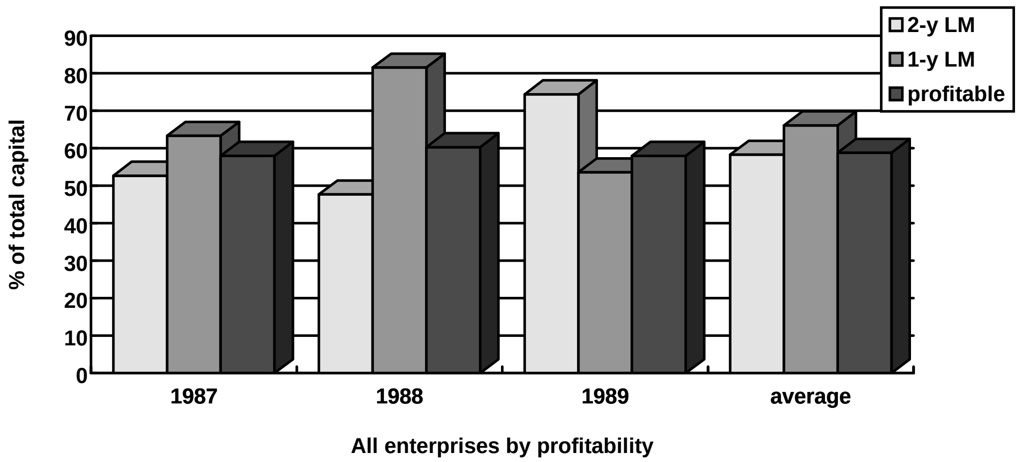
Fig. 8. Share of unpaid wages in total capital, 1987-1989.



The Unpaid Wages. The rationale for considering unpaid wages in this context is that the fact that the lack of institutions of modern labour relations in rural enterprises makes the enterprises able to ease their liquidity constraints by not paying their employees the full amount due in wages or by regularly delaying wage payments. The magnitude of the problem is reflected in Figure 8, which shows that for the majority of REs unpaid wages account for some 2.5 per cent of total capital. With the exception of 1988, the levels of unpaid wages in total capital are somewhat similar in the profitable and in loss-making REs. To the extent the data may refer to the phenomenon of soft budget constraints, it suggests that the extent that firms can manipulate the delayed wage payment as a source of SBCs is quite independent to their profitability.

Level of Total Liability and Liability Composition. Figure 9 shows the level of indebtedness of the sample enterprises as measured by the ratio of total liability, which refers to all types of external capital, to total capital. Firstly, it is noted that across the years the share of external capital is more stable in the profitable enterprises, levelling off at around 60 per cent of total capital, than in the case of LMEs. The relatively disparate levels of external capital of the LMEs is likely to be a reflection of the more precarious financial situation, which often means a more pronounced need for external capital, of these firms. It is presumably why the 1-year LMEs illustrate to have a higher level of total liability in total capital. It appears from Figure 9 that the level of total liability in the continued loss-making enterprises is likely to fall somewhere below that of profitable, although the year 1989 made an exception of this observation, possibly due to the excessive indebtedness transferred from the 1-year LMEs in the year before. Such a tendency would indicate that although most LMEs may manage to raise external capital when they first appear in the red, their abilities to further finance losses by external capital is eroded should the enterprises suffer from continuing losses.

Fig. 9. Share of total liability in total capital, 1987-1989.



Figures 10 through 12 display the total liability composition of the different sample groups by profitability, 1987 through 1989. The collective enterprises are separated in order to shed some light on any major differences in liability structure, and, in turn, on its possible implications for the SBCs, due to the collective ownership of these REs. Information contained in Figures 10 - 12 contributes to the discussion on the capital structure and its important implications for SBCs as elucidated by Figures 2 - 8.

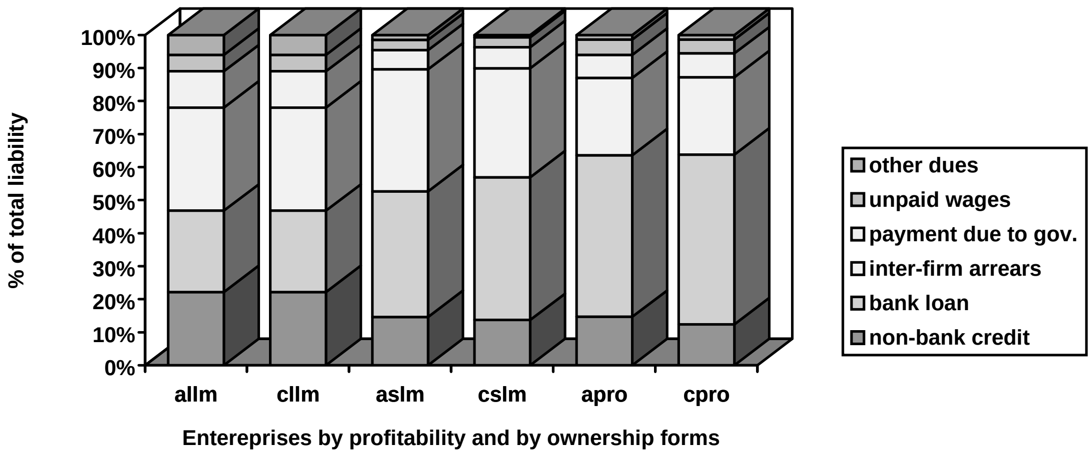
The patterns of liability composition of the sample enterprises can thus be summarised as follows:

1. The liability composition of the profitable groups is apparently dominated by bank loans and arrears to other firms, and this structure is seen stable over the years. Against such a steady picture, it can, nevertheless, be noted that over time (i) the share of bank loans in total liability has been reduced, while (ii) the share of payments outstanding to government increased slightly.
2. By contrast, the 1-year loss-making group illustrates the largest variations of debt structure between years, which tend to reflect the fact that the relative availability of various forms of external capital is affected by government policies and other similar factors. Drastic changes in the debt structure such as the surge of bank loans in 1988 deserve further attention for sounding the implications for bank loans as a source of soft budget constraints.
3. There is a clear continuation of the debt structure of 1-year loss-making groups in that of 2-year loss-making group, as the case between 1987 and 1988, and between 1988 and 1989, respectively. Along side the stability of the liability structure, LMEs appear to display increased reliance on the non-bank credits as they continued in the red for the second year. A further breakdown of the non-bank loans reveals that such a change may be attributable to the share of governmental loans, which accounted for some 5 and 3.5 per cent of total liability of the 2-year LMEs in 1987 and 1988, respectively. The equivalent share was 2.2 per cent (in both years) in the case of profitable groups. Since these loans are controlled by local

governments, they may have been given to the rural enterprises in a way similar to that of subsidies to the ailing state enterprises. Thus, behind the increased reliance on non-bank loans there may actually be a sign of SBCs.

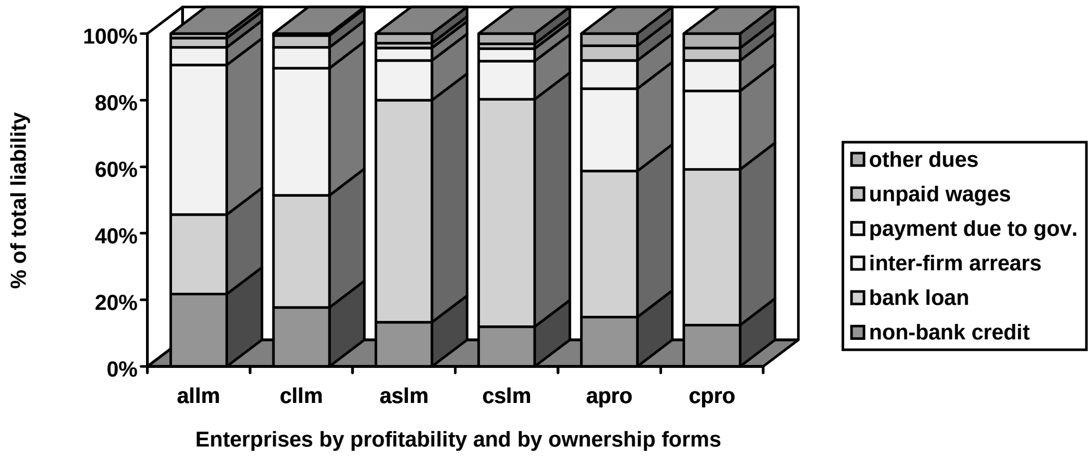
4. There is, by and large, no marked differences between the debt structure of the collective sub-group and that of the entire group of each profitability categories. The apparent similarity of debt structures in this case can presumably be attributed to two factors. Firstly, it can be because that the collective enterprises in the sample tend to be more capital intensive, and therefore their debt structure weighs more dominantly in each sample group. Second, as far as loss-making enterprises are concerned, the number of collective REs tend to dominate in the sample groups, and the pattern of their debt structure can be over-represented in such a case. Albeit the overall similarity found, minor differences exist in that (i) collective REs tend to have a higher share of bank loans than the comparable group, which possibly indicates an advantageous access to bank loans of the former, while the later tends to have a higher reliance on the non-bank credits; (ii) occasionally, the share of payment outstanding to government is higher in collective REs than in the comparable groups, e.g. 1-year LMEs in 1989, and 2-year LMEs in 1988. The role of collective ownership in affecting the budget constrains will be further explored in the following sections.

Fig. 10. Total liability composition by profitability and ownership forms, 1987.



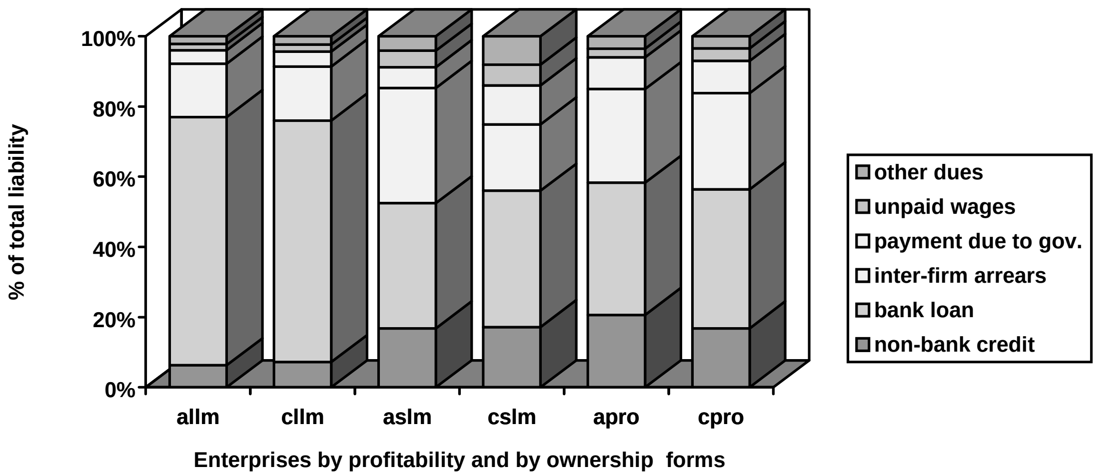
Codes: allm = all long term loss-making enterprises; cllm = collective long term loss making enterprises; aslm = all short term loss-making enterprises; cslm = collective short term loss-making enterprises; apro = all profit making enterprises; cpro = collective profit making enterprises.

Fig. 11. Total liability composition by profitability and ownership forms, 1988.



Codes: See Figure 10.

Fig. 12. Total liability composition by profitability and ownership forms, 1989.



Codes: See Figure 10.

3. Financial Dynamics and Soft Budget Constraints

This section analyses the financial changes *ex post* losses. Soft budget constraint is recognised as a dynamic commitment problem related to financial discipline (Qian and Roland 1994: 1) and is typically brought into effect *ex post* enterprise's financial losses. It therefore is important for our purposes to look at the enterprise's financial changes *ex post* losses, i.e. financial adjustments made in responding to the losses, and sources from which financial assistance are derived. In order to highlight major financial changes related to the losses, the survey sample is divided into loss-making the profitable groups, and changes in total capital and of various capital sources are compared between the two groups.

3.1. The analysis of capital use

The Expansion of Total Asset. It has been argued that soft budget constraints can often be noted from the expansion drive observable in the socialist type economies (Kornai 1992: 144, 162-163).[15] Since under soft budget constraints firms need not base their investment decisions on the rate of capital return, expansion in the form of capital investment can take place even when firms are running losses.[16] What is more crucial for judging whether the expansion of LMEs implies SBCs is perhaps the ownership and the mechanism of resource allocation of an economy. Because of the public ownership and the resource allocation by administrative means, which in turn implies a considerable scope for negotiations, SBCs are thought to be most relevant to the socialist economies. It has recently been noted that the state sector in China, despite its shrinking share in total industrial output and growing losses, claims an increasing share of investment capital of the economy.[17] Since the investment capital in the Chinese state sector is not allocated through markets, such an investment pattern obviously suggests the existence of the budget softness. By a similar token, collective ownership of REs suggests that resource allocation in these firms is unlikely to fully follow the profit maximisation principle.

Table 2. Total Asset Expansion by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of enterprise	295(1)	27	433(1)	36(1)	-	-
- % with increased total asset	72.8	66.7	70.4	75.0	71.6	70.8
Increase of average total asset from previous year, %	33.4	17.4	23.9	29.1	28.7	23.3
- Collective	30.9	18.7	23.3	31.6	27.1	25.2
- Non-collective	44.0	6.8	26.4	18.5	35.2	12.7

Note: Figures in parentheses = number of missing observations.

Table 2 compares the expansion of total asset of the LMEs with that of profitable REs during the period of 1987 to 1989. Of the profitable REs some 72 per cent increased their total assets, i.e. the total value of fixed

[15] The author further maintains that '[t]here is only a loose relation between the firms past and future (expected) profitability and its investment, growth and technical development.' (Kornai 1992: 490).

[16] It is, however, noted that not all investment made after financial losses can be interpreted in the light of SBCs. For example, it is recently reported that although Jaguar, the British luxury car maker, has registered financial losses since late 1980's, Ford, Jaguar's US owner after 1989, is doubling its stake rather than quitting, and plans for further investment aimed at transforming the fortunes of Jaguar. See *Financial Times*, 28 Sept. 1994, p.11.

[17] While the state sector now accounted for less than half of China's total industrial output, down from 78 per cent in 1978, it used up 70 per cent of total investment in 1993, up from 61 per cent in 1989. See *Far Eastern Economic Review*, July 7, 1994, p. 60.

capital and working capital, during 1988 and 1989, respectively. There was a similar portion, i.e. 71 per cent, of loss-making enterprise that had increased total asset for the same periods. In terms of percentage increase, LMEs had on average a lower rate of asset expansion than had the profitable ones, but on a yearly basis the rate of asset expansion of LMEs was above that of the profitable group for certain year.

Further breaking down the LMEs group by main ownership forms, i.e. collective and non-collective, it becomes clear that the collective LMEs tend to have a higher rate of expansion (at 25 per cent) than does the non-collective ones (13 per cent). Table 2 also shows that the rate of investment increase in non-collective LMEs is effectively reduced as compared with the profitable counter group. In contrast, non-collective group of profitable REs demonstrates the highest investment momentum, higher than that of collective profitable enterprises, among all the sub-sample groups. These combined illustrates that the capital investment in the non-collective REs is sensitive to the enterprises' profitability. Since non-collective REs primarily rely on their own resource for risk capital, it is not at all surprising that they tend to slow down investment when having confronted losses. On the contrary, collective LMEs show little reduction of investment momentum in the year after losses. It is all likely that the observed lack of sensitivity of capital investment to the enterprise profitability is due to the relatively soft budget constraint facing to the collective REs.

The Growth of Fixed Capital. The total asset of enterprises is registered under the entry of fixed capital and working capital. Table 3 and Table 4 look into the expansion of fixed capital and working capital, respectively, in order to gain further information on capital investment behaviour of the REs. Table 3 shows that the rates of fixed capital growth of the collective are one half, and non-collective two thirds, below that of respective profitable groups. This indicates that fixed capital investment in both collective and non-collective loss-making enterprises is, to a different degree, restrained by the losses occurred in the previous years. Insofar as fixed capital is concerned, it modifies the impression on the lack of response of asset expansion in collective LMEs to their losses.

Table 3. Fixed Capital Expansion by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of enterprise	295(1)	27	433(1)	36	-	-
- % with increased fixed capital	43.5	51.9	39.4	41.7	41.5	46.8
Increase of fixed capital over previous year, %	14.5	7.2	18.1	6.1	16.3	6.7
- Collective	12.6	7.4	12.0	3.6	12.3	5.5
- Non-collective	23.6	4.2	49.8	17.7	36.7	11.0

Note: Figures in parentheses = number of missing observation.

On the other hand, the proportion of LMEs with increased fixed capital shows that losses do not seem to have any major impact on reducing the number of LMEs undertaking fixed capital investment. Rather, the proportion is slightly higher for the LMEs than for the profitable group. Table 3 thus suggests that LMEs tend to react on their financial losses by reducing the *scale* of investment rather than by cutting back the investment completely. To interpret this behaviour in the light of budget constraint, it shows that the budget constraint is relatively hard in the REs so far as fixed capital investment is concerned.

Working Capital Expansion. It is well understood that loss-making enterprises often have a pressing need for additional working capital to cover their losses and possibly the increase of inventories at the same time. It explains why for loss-making groups the rate of working capital increase (Table 4) is on average much higher than that of fixed capital increase (Table 3) in both years. Although needs for more working capital may be equally pressing in collective and non-collective LMEs, their ability to raise the needed capital appears to be unequal according Table 4. The collective LMEs had a significantly higher rate of working capital increment than had the non-collective ones for two years, i.e. 28 per cent versus 7.7 in 1988, and 55 to 19 per cent in 1989. It shows that access to working capital is preferential to the collective REs, and again suggests that budget constraint is relatively soft in these enterprises. This impression is further confirmed by comparisons within each ownership category: on average working capital in collective REs increased at a rate exceeding that of profitable enterprises; the increase in the non-collective LMEs was less than half that in its profitable counter sub-group. It preliminarily shows that the extent of SBCs is a function of ownership among REs.

Table 4. Working Capital Increase by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of enterprises	295(1)	27	433(1)	36	-	-
- % with increased working capital,	73.8	70.4	72.2	75.0	73.0	72.7
Increase of working capital over previous year, %	43.2	25.0	26.6	47.8	34.9	36.4
- Collective	40.9	28.0	28.7	55.3	34.2	41.7
- Non-collective	52.8	7.7	18.5	19.0	35.7	13.4

Note: Figures in parentheses = number of missing observations.

3.2 The analysis of capital sources

Local Government Investment. The bulk of equity capital of collective rural enterprises comes from local government investments. Despite that local governments themselves are often considered to face a relatively hard budget constraint compared to the central government, the relationship between local government and the collective REs can sometimes be comparable to that between the state and the state-owned firms. Moreover, the public ownership of the local government investment capital suggests the likelihood of it being a source of SBCs. Table 5 shows that the percentage of enterprise with increased local government investment is somewhat higher among LMEs than profitable enterprises. But, the rate of local government investment increase in the profitable group is twice as high as that of the LMEs group. This shows that local government investment is mainly sensitive to the return of its investment.[18] Thus, this result goes some way towards suggesting that the hard budget faced by local government has served to harden the budget constraints in local firms.

Table 5. Increase of Local Government Investment by Profitability, 1987-1989

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of Enterprise	148	25	200	20	-	-
- % with LGI	79.7	72.0	80.5	80.0	80.1	76.0
- % with increased LGI,	33.1	40.0	14.6	40.0	31.6	40.0
Change of LGI over previous year, %	26.8	4.0	32.3	17.2	29.6	10.6

Notes: LGI = local government investment which includes risk capital investment by township and village authorities
in the rural enterprises. Collective enterprises only.

Total liability, Indebtedness and SBCs. Apart from the local government investment, soft budget constraints in the case of rural enterprises are most likely to be related to the sources of external capital. As regards the

[18] This is also the impression gained during a recent field visit in Sichuan, where government officials voiced concern about the return of their investment in the rural enterprises.

reliance of REs on external capital Zhang and Ronnås (1994: 26) finds against an overall picture of a high dependence on equity capital that the collective REs tend to have a higher reliance on external capital than do non-collective enterprises. The different dependence on external capital may to some extent reflect that the access to formal credit has been unequal between the two types of REs. Due partly to this reason, collective and non-collective REs tend also to rely on different sources for external capital (Zhang and Ronnås, 1994: 26-32). One may then ask whether and, if so, how different sources of external capital have contributed to the emergence of SBCs in REs, and to what extent their roles have been different in the collective and the non-collective sectors of rural industries? Furthermore, what is the relative softness of the different external capital sources? These questions will be focused on in the rest of this section.

Table 6. Increase of Total Liability by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of Enterprise	295(1)	27	433(1)	36	-	-
- % with liabilities	69.0	96.3	71.8	88.9	70.4	92.6
- % with increased total liability	45.6	55.6	45.8	63.9	45.7	59.8
Mean of total liability '000 yuan (1987 & 1988 resp.)	110.3	193.2	140.2	241.0	125.2	217.1
- Collective	178.4	179.5	245.8	354.8	212.1	267.2
- Non-collective	41.2	365.1	49.1	98.8	45.2	232
Increase of total liability over previous year, %	40.0	21.2	19.5	21.1	29.8	21.2
- Collective	35.8	23.0	21.6	25.2	28.7	24.1
- Non-collective	58.8	9.9	10.3	3.1	34.6	6.5

Note: Figures in parentheses = number of missing observations. Total liability covers all external capital.

Table 6 compares the increase of total liability (TL) in profitable and loss-making REs. It shows that in both years LMEs demonstrated a tendency of higher reliance on external capital than that of the profitable group. In fact the higher reliance of LMEs on external capital can be collated in several ways. Firstly, a higher proportion of LMEs, i.e. 93 per cent on average, rely on external capital as compared to approximately 70 per cent of the profitable group. Secondly, the share of external capital in total capital (Table 7) (as well as the mean of external capital) is much larger in LMEs than in profitable REs. Furthermore, the percentage of enterprises with increased total liability is higher in the loss-making group than in the profitable group. The observed tendency of high and increasing reliance of the LMEs on liabilities shows that external budget resources tend to be used to cover losses, and budget constraints of LMEs are thus softened.

In terms of rate of total liability increase over the previous year, Table 6 shows that it increased faster in the profitable than in the non-profitable group, i.e. on average 30 per cent against 21 per cent, respectively. However, such a comparison between the profitable and the loss-making groups should be seen against the background of a larger mean value of total liability and, more importantly, a higher ratio of total liability to total asset (TA) (Table 7) of the latter. Among the loss-making enterprises, it can be seen that collective LMEs were characterised by a much larger increase of total liability than their non-collective counterparts. The contrasts between the collective and non-collective LMEs became particularly pronounced in 1989, a year characterised by the tight credit policy of the central government and during which, as is shown in Table 7, all but collective LM sub-sample group demonstrated a reduced increase of total liability compared with the year before.

Table 7 illustrates the ratio of total liability to total asset, a measure of enterprise's indebtedness, and its changes in 1988 and 1989, respectively.[19] As expected, the figures show that the percentage of enterprises with increased TL/TA ratio is in both years higher in the LMEs group than in the profitable one, and on average it is 12 percentage points higher in the former than in the latter. In fact, not only are LMEs characterised by a higher incidence of increased indebtedness, their indebtedness appear also high in absolute terms by Chinese REs' standard (cf. Zhang and Ronnås, 1994: 24-27). By contrast, LMEs' TL/TA ratio is significantly, i.e. on average 20 percentage points, higher than that of the profitable group. The change of TL/TA ratio is on average very limited in both profitable and LMEs groups. However, in the case of LMEs this should be seen against the fact that the indebtedness of the LMEs is already very high by the standards of rural enterprises.

Table 7. Total Liability/Total Asset Ratio by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of Enterprise	295	27	433	36	--	--
- % with increased TL/TA ratio	34.0	48.1	33.6	44.4	33.8	46.3
Average TL/TA ratio, %	33.0	57.8	34.1	49.7	33.6	53.8
(1987 & 1988 respectively)	(58.0)	(60.8)	(60.3)	(71.7)	(59.2)	(66.3)
	35.5	56.4	39.6	57.0	37.6	56.7
- Collective	(58.4)	(58.9)	(60.3)	(72.5)	(59.4)	(65.7)
	30.5	75.4	29.4	40.7	30.0	58.1
- Non-collective	(57.0)	(75.3)	(59.9)	(68.4)	(58.5)	(71.9)
Change of average TL/TA ratio	-0.6	0.6	-1.2	-3.2	-0.9	-1.3
from previous year (% points)	(2.1)	(2.0)	(-2.2)	(-4.4)	(-0.1)	(-2.4)
- Collective	0.6	0.4	-1.1	-5.1	-0.3	-2.4
	(2.0)	(2.2)	(-0.8)	(-3.6)	(1.4)	(-1.4)
- Non-collective	-1.9	1.9	-1.4	-0.8	-1.7	0.6
	(6.0)	(2.2)	(-7.6)	(-8.9)	(-1.6)	(-6.7)

Notes: TL = total liability and TA = total asset.
Figures in parentheses are TL/TA ratios calculated from aggregate total liability and total asset of each sample group.

The decline of TL/TA ratio in 1989 may indicate that all categories of rural enterprises experienced the impact of tight credit policy carried out in that year, and that LMEs appeared to have been more severely affected by the situation judging both from the point of view of individual enterprise as well as a sector. This shows some budget hardening effects of the central government's tight credit control of 1989. That LMEs are featured with high and increasing TL/TA ratio is little surprising, but the question is from what sources do LMEs raise more external capital and whether it implies SBCs in such cases. For answers to such questions we now turn to look into the major sources of liability and their changes in relation to the enterprises financial performance.

[19] Table 7 contains total liability to total asset ratios that are calculated by two methods. Figures without brackets are the averages of individual enterprise's TL/TA ratio, while figures in the brackets are calculated from the aggregate total liability and total asset of each subsample group. The ratios calculated by the second method are dominated by the large enterprises in each group, and therefore may under-represent the smaller ones. By contrast, the figures calculated by the first method give better information of each sample group as individual enterprises are treated with equal weight regardless their size. However, a problem of this method is that the change of total liability to total asset ratio in this case may appear inconsistent with the respective changes of total liability (Table 6) and total asset (Table 2).

Bank Loans. Bank loans is a scarce resource, but an important source of credit for rural enterprises. Table 8 shows that the percentage of LMEs managed to obtain bank loans is on average twice as high as that for the profit-making REs. Moreover, the percentage of enterprises with increased bank loans is also higher among the LMEs than the profitable ones, i.e. 27 and 18 per cent, respectively. In particular, the 1989 figures show that 36 per cent of LMEs, compared to some 18 per cent of profitable ones, were given increased amounts of bank loans during that year. The fact that twice as high a proportion of LMEs as that of profitable REs received increased amounts of bank loans at the time of credit squeeze is indicative of the softness in bank loans. The above figures tend to suggest that access to scarce credit may have been bent in favour to LMEs. However, the profitable and loss-making sub-groups are on average not markedly different in terms of the rate of bank loans increase.

Table 8. Bank Loans Increase by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of enterprise	259(1)	27	433(1)	36	-	-
- % with bank loans	32.0	77.8	36.1	61.1	34.1	69.5
- % with increased bank loans	17.0	18.5	18.3	36.1	17.7	27.3
Increase of bank loans over previous year, %	21.0	7.1	4.7	13.4	12.9	10.3
- Collective	17.8	7.1	5.4	11.9	11.6	9.5
- Non-collective	41.4	6.9	0.7	25.9	21.1	16.4

Note: Figures in parentheses = number of missing observation.

Non-bank Loans. Apart from borrowing from formal banking institutions, rural enterprises often take loans from other sources including government sources, other enterprises and their own employees. Loans raised from such sources are so-called non-bank loans. The incidence of such non-bank loans is, as shown in Table 9, lower among profitable enterprises than LMEs with the average of 41 against 60 per cent, respectively. There was in both years a larger percentage of LMEs with increased non-bank loans than the profitable group. On average, the rate of non-bank loans increase is higher for the collective profitable group than for its loss-making counterpart, but it is the same between the two non-collective comparable groups.

Table 9. Increase of Non-Bank Loans by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of enterprise	295(1)	27	433(1)	36	-	-
- % with non-bank loans	40.8	55.6	41.2	63.9	41.0	59.8
- % with increased non-bank loans	22.8	44.4	26.2	38.9	24.5	41.7
- % with governmental loans	6.1	18.5	6.0	13.9	6.1	16.2
Increase of non-bank loans over previous year, %	25.3	9.2	45.6	33.8	35.5	21.5
- Collective	20.1	1.1	55.5	44.3	37.8	22.7
- Non-collective	36.8	50.0	24.5	10.2	30.7	30.17
Change of governmental loans over previous year, %	72.3	9.5	38.0	-12.3	55.5	-1.4
- Collective	24.3	44.5	46.6	-12.3	35.5	16.1
- Non-collective	641.9	-100.0	17.0	--	329.5	--

Note: Figures in parentheses = number of missing observation.

Of particular interest in this context are loans made available directly from governmental sources. However, as shown in Table 9, the incidence of governmental loans is extremely limited, affecting only six per cent of the profitable enterprises and 16 per cent of loss-making ones. The *ad hoc* nature of such loans may lead one to surmise that they actually serve as soft credits given on a case to case basis. Table 9 shows that a relatively higher percentage of LMEs received such loans, but the extremely low incidence of it makes the sample size too small to say anything general about its use.

Other Liabilities. All external liabilities are not in the form of loans. Figure 1 shows what are referred to as other liabilities to the REs. Table 10 treats the other liabilities as a whole, and Table 11 trough 17 treat the main sources of other liability one at a time.

No matter whether profitable or loss making, the majority of REs rely on other liabilities as a source of capital. However, as shown in Table 9, other liabilities is to a greater extent common among the LMEs than among the profitable REs. And so is the incidence of enterprises with increased other liabilities between the two groups, i.e. 59 per cent of the LMEs and 41 per cent of the profitable, respectively. In terms of the average rate of increase of other liabilities, the loss making sub-sample group is almost identical to the profitable one in the collective sector. However, there is a marked disparity between the two sub-sample groups in the non-collective sector. More differences regarding the pattern of other liability changes can be noted from inter-ownership comparisons within the loss making sub-sample, It shows that in non-collective LMEs other liabilities reduced in both years, while they increased by more than 40 per cent per year for the same period in collective LMEs. Albeit that other factors may also have contributed to such differences, it appears that enterprises' collective ownership has played an essential role in affecting their accesses to unorthodox liabilities.

Table 10. Increase of other Liabilities by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of enterprise	295(1)	27	433(1)	36	-	-
- % with other liabilities	57.1	92.6	59.3	80.6	58.2	86.6
- % with increased other liabilities	42.5	59.3	40.0	58.3	41.3	58.8
Change of other liabilities over previous year, %	71.1	35.4	25.6	31.7	48.4	33.6
- Collective	66.2	44.1	29.6	52.6	47.9	48.4
- Non-collective	91.9	-0.9	9.2	-19.2	50.6	-10.1

Note: Figures in parentheses = number of missing observation.

Table 11. Increase of Arrears to other Firms by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of enterprise	295(1)	27	433	36	-	-
- % with ATOF	46.3	88.9	46.5	75.0	46.4	82,0
- % with increased arrears,	30.6	55.6	31.2	58.3	30.9	57.0
Change of average ATOF over previous year, %	56.1	33.9	30.3	43.2	43.2	38.6
- Collective	41.2	42.0	37.4	75.4	39.3	58.7
- Non-collective	120.4	4.4	6.0	-18.5	63.2	7.17

Notes: Figures in parentheses = number of missing observation.
ATOF = arrears to other firms.

Arrears to other Firms. The phenomenon of so-called triangle debts in China refers to the arrears that firms owe each other for payment of goods and services. Table 11 shows that almost 50 per cent of the profitable REs have arrears to other firms, while the corresponding figure is much higher, i.e. on average 82 per cent, among loss makers. With regard to the incidence of increase of arrears over the previous years, the figure is 31 per cent for the profitable group and 57 per cent for the loss-making group. The rate of this increase is, however, marginally higher for the profitable group than for the LMEs, i.e. 43 per cent versus 39 per cent on average, respectively. Thus, the overall picture is that the LMEs are characterised by a wider incidence of commercial arrears and that of further amounting up such arrears once having confronted losses in their business operations.

In addition, figures disaggregated by ownership forms show that among the loss-making enterprises the rate of the increase is faster for the collective sub-group than for the non-collective sub-group. And this is so both with regard to the average as well as the yearly rates. It actually indicates that the budget constraint of collective LMEs is weakened by the lack of market institutions for enforcing economic contracts, and it is the collective REs that appear able to tap this particular source of soft capital.

Unpaid Wages. Table 12 illustrates that some 37 per cent of profitable and 70 per cent loss making rural enterprises owed wage payments to their employees. The unpaid wages as a source of liability owe its origin to the lack of institutions for modern labour relations in Chinese REs. The phenomenon is one of SBCs so long as the unpaid wages serve as a means to soften the financial discipline of the enterprises. As may be seen from Table 12, the incidence of increase of unpaid wages is wider for loss-making REs than that for the profitable group both measured as a share in total liability and that in total wage. On average, the unpaid wages as a share of total liability increased at an almost equal rate for the profitable as for the loss-making group. Unpaid wages as a share of the total wage bill, however, appear to have changed by a greater measure in the LMEs than in the profitable sub-sample: that is eight per cent increase for the former but 0.8 per cent decrease for the latter.[20]

Table 12. Change of Unpaid Wages by Profitability and Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	Profit-able	LMEs	Profit-able	LMEs	Profit-able	LMEs
Number of enterprises	295(1)	27	433(1)	36	-	-
- % with UW	35.4	88.9	38.7	50.0	37.1	69.5
- % with increased UW	22.1	51.9	23.6	30.9	22.9	41.3
- % with increased UW/TL ratio	18.0	37.0	18.5	27.8	18.3	32.4
- % with increased UW/TW ratio	16.0	33.3	19.3	27.8	17.7	30.6
Change of UW/TL ratio from previous year (% points)	0.4	0.1	0.4	1.0	0.4	0.6
- Collective	-1.1	0.1	0.1	1.6	-0.5	0.9
- Non-collective	2.1	-1.3	0.5	0.1	1.3	-0.6
Change of UW/TW ratio from previous year (% points)	-1.8	18.2	0.3	-1.4	-0.8	8.4
- Collective	-1.7	21.7	2.0	-2.6	0.2	9.6
- Non-collective	-1.7	-22.9	1.1	0.1	-0.3	-11.4

Notes: UW = unpaid wages, TL = total liability, TW = total wage.
Figures in parentheses = number of missing observation.

Payment outstanding to Government. As a general observation, the financial discipline of REs is weak since taxes and other payments from REs to government are not strictly collected. As a result, arrears of these payments are referred to as payments outstanding to government (POTG) [*Ying Jiao Kuan* in Chinese] under the entry of liability in the bookkeeping of REs. Rural enterprises with POTG are many. Table 13 shows that

[20] For the loss making group total wage bill increased by 27 per cent in 1988 and 5.7 per cent in 1989, respectively. The corresponding figures for the profitable group were 30.4 and 13 per cent, respectively.

almost 40 per cent of the profitable rural enterprises in the survey sample maintain payments outstanding to local governments and the percentage for loss-making enterprises is even higher, nearly 75 per cent. The proportion of enterprises with POTG increased from previous year is 43 per cent for the LM group and 27 per cent for the profitable one. These figures suggest that soft discipline in taxation is a much widely spread phenomenon among the LM than among the financially healthy enterprises. This squares with the impression that rules of taxation are readily amendable at the local level, and soft taxation is particularly common among loss-making enterprises.

The amount of unpaid taxes and other liabilities to local governments tend to rise from year to year, as shown in Table 13. At an average of 61 per cent per annual, the increase is particularly rapid for the collective profitable group during 1987 and 1989. For the non-collective profitable group, the increase is about half that of the collective one, averaging at 32 per cent for the same period. On the whole as well as by ownership, the POTG increased less for the LM group than for the profitable one, which tends to indicate the opportunity of benefiting from soft taxation is biased in favour of the profitable REs.

There are pronounced differences between the periods of 1987/88 and 1988/89 in terms of softness of taxation, which can been seen in the following ways. The year 1989 was marked by a tightening of bank credit supply imposed from the Centre, and it effectively hardened the budget constraint for local governments, which in turn motivated the local government to implement harder fiscal discipline on local REs. As can be seen from Table 13, the proportion of LM with POTG reduced from 85 per cent to 64 per cent between 1988 and 1989. And for both LM and profitable groups, enterprises with increased POTG accounted for a lesser proportion in 1989 than in 1988, i.e. 56 against 31 per cent for the former and 31 against 23 per cent for the later, respectively.

Table 13. Increase of Payments Outstanding to Governments by Profitability and by Ownership Form, 1987-1989.

	1987/88		1988/89		Average	
	LMEs	Profit-able	LMEs	Profit-able	LMEs	Profit-able
Number of enterprise	27	295(1)	36	433(1)	-	-
- % with POTG	85.2	38.4	63.9	38.7	74.5	38.6
- % with increased POTG	55.6	30.6	30.6	22.9	43.1	26.8
Change of POTG over previous year, %	61.7	89.6	18.3	24.0	40.0	56.8
- Collective	62.9	97.0	32.1	25.5	47.5	61.3
- Non-collective	45.1	50.4	-38.8	13.9	3.2	32.2
Means of POTG, yuan (87 & 88 respectively)	13,274	7,710	9,767	11,784	11,521	9,747
- Collective	13,372	12,775	14,165	22,175	13,769	17,475
- Non-collective	12,058	2,575	4,270	2,827	8,164	2,701

Note: POTG = payment outstanding to government includes all kinds of outstanding payments, but primarily taxes and local levies.

The impact of fiscal austerity in 1989 is also clearly illustrated by a reduction of the increase in POTG for that year. For all categories of enterprises, the increase of POTG was much reduced in 1989 as compared to 1988, during which year the POTG in the collective profitable group increased 97 per cent. Rather, for the profitable sub-groups, the increase of POTG in 1989 was less than one thirds of that in 1988; while the increase also slowed down substantially in loss-making enterprises. The most apparent contrast is seen in the non-collective loss making group, for which POTG increased by 45 per cent in 1988 but decreased by 39 per cent in 1989. Meanwhile, POTG in non-collective profitable group increased least in 1989 among all other enterprises categories. These data provide empirical evidence to the effect that the softness of taxation is negatively related to the budget hardness facing the local government, and that the provision of soft taxation is first withdrawn from the non-collective REs when the local government is under fiscal strain.

3.3. Taxes, Local Levies and SBCs

The tax-sharing scheme between the central and local government before 1994 has been considered to have had the shortcoming of motivating local governments to give the central government's interest short shrift by allowing tax erosions and by granting tax exemptions to the REs. REs are thus left with more after-tax profit, and local government can then derive more local revenues from them by informal levies (see Blejer and Szapary 1990: 466, Tsang and Cheng 1994: 774, 778). On the other hand, since administrative fees levied on REs are not shared with the central government, it is conceivable that local governments are motivated to impose the fees by more strict measures. It further postulates that formal taxation and local levies may have different bearings on the SBCs in REs. Table 14 through Table 17 therefore further analyse the softness of taxation and REs' tax behaviour by breaking POTG into national taxes and local levies.

Table 14 shows that for both years, a higher percentage of LMEs were granted tax exemption than that of profitable enterprises, and the same goes for the proportion of enterprises with outstanding tax payment. This characterisation primarily illustrates that LMEs are more motivated to strive for softness in taxation. Further looking at the proportion of taxes paid, the above impression tends to be somehow modified since the profitable group paid a lower percentage of total taxes than did the LM group.

The figures by ownership forms reveal that it is the collective REs that are responsible for the low percentage of taxes paid by the profitable group as a whole. In both years, the collective profitable group paid on average less than 60 per cent of total taxes, the lowest of all categories. It is followed by collective LMEs (68 per cent), then by non-collective LMEs (76 per cent), and the non-collective profitable group paid the highest percentage of taxes at 95 per cent. These figures suggest that softness in taxation is primarily related to the collective ownership of REs, and the enterprises' status with respect to profitability is of secondary importance. The collective ownership of REs thus tends to increase the degree of softness in taxation (measured in percentage of taxes not paid); whereas, the enterprise's profitability tends to be inversely related to the incidence of soft taxation (measured by incidence of tax exemptions and delays in tax payment).

Table 14. Outstanding Tax Payments by Profitability and Ownership Form, 1988-1989.

	1988		1989		Average	
	LMEs	Profit-able	LMEs	Profit-able	LMEs	Profit-able
Number of enterprises	36	433	55	559(1)	-	-
- % granted tax exemption	13.9	9.3	12.7	8.2	13.3	8.8
- % with outstanding taxes	16.7	15.0	25.5	14.0	21.1	14.5
Percentage of total taxes paid	72.5	70.7	71.0	66.2	71.8	68.5
- Collective	73.3	61.1	62.3	57.3	67.8	59.2
- Non-collective	70.7	100.0	80.9	90.0	75.8	95.0

Note: Total taxes include sales tax and income tax.

REs are subject to sales tax and income tax. Sales tax, which is a business turnover tax,[21] is charged based on enterprises' business income; whereas income tax[22] is laid on enterprises' taxable incomes, i.e. income less costs, expenses and other specified deductible items. For each of these taxes, two tax rates, viz. nominal rate and effective rate, are calculated based on accounting information of the survey sample. The nominal rates reflect the rates that the enterprises were liable to pay, and the effective rates are the rates that the enterprises

[21] In the context of REs, most of their business activities were subject to either of the two turnover taxes applied at the time the survey was taken. Manufacturing industries were subject to a Product Tax, for which there were 26 different rates ranging from 3 to 15 per cent for necessities and industrial raw materials, and 40 to 60 per cent for luxury goods. Business activities other than manufacturing industry were subject to a Business Tax with tax rates ranging from 3 to 15 per cent. See Li (1991: 33-34, 39-41).

[22] Collective and non-collective REs were subject to different income taxes. The former was subject to Collective Enterprise Income Tax with an eight-grade progressive rate ranging from 7 to 55 per cent; while the latter was liable to Private Enterprise Income Tax at a 35 per cent flat rate. See Li (1991: 80, 86).

actually paid.[23] In most cases, tax exemptions and outstanding tax payments that are registered in the REs' books mean that these tax concessions were endorsed by the local authorities. Therefore, it can be regarded as `legal´ in the Chinese context. Thus, statistics on tax exemptions and outstanding tax payments would demonstrate only part of the problem in taxation, which we call it the open softness in taxation. A more severe problem of taxation, however, is tax evasions that are off records from the enterprises' bookkeeping. To give an account on the off-record tax evasions, survey enterprises that registered neither any amounts of tax exemption, nor any outstanding tax payment, and nor any tax payments are counted the case of tax evasions below.

Sales Tax. With regard to the payment of sales tax, figures in Table 15 shows the following features. First, the loss making group in both years feature a higher rate of tax exemptions than does the profitable group. Second, delay in tax payments tend to occur at a higher rate among the LMEs than among the profitable REs. That between 14 to 17 per cent of REs in the sample did not pay sales tax in time indicates the extent of the open softness in taxation. Thirdly, there is on average 20 per cent profitable enterprises that evaded sales tax in both 1988 and 1989, while the comparable figure, i.e. 2.8 per cent, is markedly lower for the LM group. These figures show that tax evasion is a serious problem at the local level and that it is more likely to occur among profit-making REs than among loss-making ones. The percentage of tax evasions illustrates the extent of hidden softness in taxation.

Table 15. Sales Tax Rates and Implementation Record by Profitability, 1988-1989.

	1988		1989		Average	
	LMEs	Profit-able	LMEs	Profit-able	LMEs	Profit-able
Enterprises liable to sales tax	36	433(3)	55	557(2)	-	-
- % of sales tax exemptions	13.9	8.4	12.7	7.5	13.3	8.0
- % with unpaid sales tax	13.9	14.7	20.0	13.5	17.0	14.1
- % evaded sales tax	0	20.0	5.5(3)	18.9	2.8	19.5
Sales tax rates, %						
- Nominal rate (NR)	7.48	4.96	6.13	5.24	6.81	5.10
- Effective rate (ER)	5.56	4.70	4.61	4.42	5.09	4.56
- Difference of NR & ER	1.92	0.26	1.52	0.82	1.72	0.54

Notes: Nominal rate = total liable income tax/taxable income; Effective rate = submitted income tax/taxable. Enterprises that reported a positive taxable income are regarded liable to income tax; and evasion is defined here as enterprises that were liable to income tax but actually paid zero income tax and had shown no bookkeeping records on income tax exemption nor on outstanding income tax.
Number of missing observations and number of observations, if below five, is given in brackets.

As can be seen in Table 15, the profitable group in both years was subject to sales tax rates that were lower than those for the LM groups: The nominal rate is on average 1.7 percentage points lower for the profitable group than for the LM group, while the effective rates of the two groups are less different. Furthermore, there are positive residuals between the two tax rates for both groups, and in both years. The residuals indicate the existence of softness in taxation as a positive residual implies the enterprises paid tax at a rate below that they were supposed to.

The residual of the LM group illustrates an interesting case. Since the LM group was subject to a relatively high nominal rate, it resulted in a larger residual (1.72 per cent), despite that it paid a higher effective tax rate in absolute terms. It thus showes that the residual between the nominal and effective tax rates cannot always serve as a reliable measure of relative budget softness. It appears from Table 15 that given the inequality in

[23] Footnotes of Table 15 and Table 16 explain how these rates are calculated in the respective table. The nominal rates here do not refer to the rates at which sample enterprises should have been taxed according to the tax law. Rather, they are based on the figures on the amount of taxes given by the enterprises themselves. Thus, the difference between nominal and effective rates does not capture the deviation between the should-be tax rates and the rates that were effectively paid by the enterprises. Instead, it refers to the difference between the rates that were nominally imposed on the enterprises and the rates at which enterprises actually paid their taxes.

nominal rates, it is difficult to conclude on the relative budget softness for the different sample groups from the size of residuals.

Income Tax. With regards to the payment of income tax, Table 16 shows that registered exemptions were few, only four per cent of profitable group and none of LMEs. The LMEs, however, is featured by a higher rate of delays of tax payments than the profitable group. Thus, the degree of open softness in taxation is less in income tax than in sales tax. On the other hand, no fewer than 44 per cent of the profitable and 33 per cent of the loss-making REs evaded income tax in the period 1988 and 1989. These figures show that the hidden soft taxation is a pervasive and severe problem in the RE sector.[24]

Table 16. Income Tax Rates and Implementation Record by Profitability, 1988-1989.

	1988		1989		Average	
	LMEs	Profit-able	LMEs	Profit-able	LMEs	Profit-able
Enterprises liable to income tax	18	411	24	527	-	-
- % of income tax exemptions	0.0	4.1	0.0	4.2	0.0	4.2
- % with unpaid income tax	11.1(2)	8.5	12.5(3)	7.2	11.8	7.9
- % of evaded income tax	33.3	42.3	33.3	45.4	33.3	43.9
Income tax rates, %						
- Nominal rate (NR)	15.9	14.4	24.0	14.4	20.0	14.4
- Effective rate (ER)	14.0	11.5	16.1	10.9	15.0	11.2
- Difference of NR & ER	1.9	2.9	7.9	3.5	4.9	3.2

Notes: Nominal rate = total liable income tax/taxable income; Effective rate = submitted income tax/taxable income. Enterprises that reported a positive taxable income are regarded liable to income tax; and evasion is defined here as enterprises that were liable to income tax but actually paid zero income tax and had shown no bookkeeping records for income tax exemption nor on outstanding income tax.
Number of observations, if below five, is given in brackets.

Logic suggests that profitable enterprises as a group should pay a higher rate of income tax than LM group as income tax is levied on enterprises' taxable profits. However, figures in Table 14 show that it is not the case. Surprisingly, both in terms of nominal rate and that of effective rate, the profitable enterprises as a whole paid a lower income tax than did the LMEs.[25] The low average income tax rate is of course a result of high percentage of evasions by the profitable group. These figures also illustrate the possibility that some enterprises were profitable owing to the exemptions and other concessions, but foremost evasion, of income tax in the first place.

Despite paid higher effective tax rates, the LMEs are featured by larger residuals due to the higher nominal rates imposed on them. As a result, the residuals for the loss-making REs increased from below two per cent in 1988 to nearly eight per cent in 1989, due purely to the increase in nominal rate of the latter year. While the increase in the nominal rate would seem to reflect the effort of local governments to discipline the loss-making REs in response to the central government's austerity program, the enlarged residual may indicate that these efforts produced little improvement on the part of enterprises. In fact, the outcome of higher nominal rate appears limited as the increase in the effective rate was much less than that in the nominal one during the period. The stickiness of the effective rate in face of an increased nominal rate indicates the difficulty in hardening the budget constraints at the local level. Meanwhile, the fact that no changes were registered in the effective tax rate of the profitable group during 1989 suggests that the central government's policy produced

[24] New REs are eligible for a tax holiday of the first year of their business operations, but it can often be extended to up to three years by local authorities. In the latter case, tax holidays are not legal, and the central government repeatedly issued decrees to ban such practices by local governments. To exclude the cases of new enterprise tax holidays for the year 1989, 1988 and 1987 (on which the survey data are not available), the percentage of tax evasion is calculated for sample groups established before 1988, 1987 and 1986, respectively. The results are virtually the same as that for the profitable subsample for 1989.

[25] In addition, average income tax rates for both collective and non-collective profitable group appear too low compared to the legal rates, i.e. 7 to 55 per cent for collective and 35 per cent for non-collective REs, respectively.

little effect on improving taxation disciplines on the majority of REs. In sum, the figures on tax evasion and on the residuals of income tax rates in both years confirm the existence of budget softness in the way of soft taxation.

Local Levies. Table 17 gives some information on the collection of local levies. Although the bookkeeping data of the survey sample contained no record on official exemption of local levies, on average some 16 per cent of LMEs and as many as 26 per cent of profitable ones registered as having paid no levies anyway. Furthermore, some 9 per cent of profitable REs and a proportion twice as high among the loss-making ones registered outstanding levies in their liability account. These figures show the softness of financial discipline in REs.

Figures on the percentages of levies submitted put the profitable REs as a group at a pair with the LM group - each paid 81 per cent of the total fees - albeit one group paid a higher percentage than the other in alternate years. Between ownership categories within each profitability group, the non-collective REs on average paid a higher percentage than did their collective counterparts.

Table 17. Outstanding payments of Local Levies by Profitability and Ownership Form, 1988-1989.

	1988		1989		Average	
	LMEs	Profit-able	LMEs	Profit-able	LMEs	Profit-able
Number of enterprise	36	433(1)	55(1)	559(1)	-	-
- % paid levies	86.1	74.8	81.8	73.5	84.0	74.2
- % with outstanding levies	22.2	10.0	12.7	7.9	17.5	9.0
Percentage of total levies paid						
- Collective	79.9	87.9	82.5	74.2	81.2	81.2
- Non-collective	67.6	89.0	76.1	70.3	71.9	79.7
	99.3	85.3	88.3	82.7	93.8	84.0
Rate of administrative fee, %						
- Nominal rate	0.92	1.06	1.19	0.86	1.06	0.96
- Effective rate	0.83	0.96	1.04	0.76	0.94	0.86
- Difference of NR & ER	0.09	0.10	0.15	0.10	0.12	0.10

Notes: Local levies include administrative fee and agricultural assistance fee.
Nominal rate = total liable administrative fee/sales income;
Effective rate = submitted administrative fee/sales income, of respective years.
Central government's regulation stipulates the rate of administrative fee for rural enterprises to be at maximum one per cent of the enterprise's sales income.

The survey data on the rates of administrative fees, which is stipulated by the central government to be a maximum of one per cent of REs' sales income, yield the following information. Firstly, the nominal rate and effective rate were both higher for the LM group than for the profitable group, which implies that the profitable REs enjoyed concessionary rates of the administrative levy. Secondly, the existence of nominal rates exceeding one per cent reveals that REs may face excessive charges levied by the local government. Indeed, the LM group even paid an effective rate in excess to the official maximum rate in 1989. Contrasting with its lax attitude in collecting national taxes, local governments appear predatory towards the REs when it comes to incomes of direct relevance to local revenues. Thirdly, the residuals between the nominal and effective rates in principle illustrate once again the existence of budget softness in the REs. However, unlike the case of taxation, when REs were charged by an excessive rate the residual may show the will and ability of the REs to protect themselves from being over-levied.

Lastly, changes in the rates in 1989 tend to tell something about the local government's behaviour during the financial austerity in that year. As can be seen, both nominal and effective rates increased for the LM group but decreased for the profitable group in that year. The changes in the levy of administrative fees, and those of income tax in 1989 (see Table 16), seem to suggest that when local government faced a tightened fiscal discipline as in 1989, it would first tend to harden the budget constraint on loss-making REs, while at the meantime providing certain financial relief for the profit-making ones . To harden the budget constrains on loss-making REs may prove logical in this situation since it can hardly lead to a reduction, but maybe some increase, of revenue paid from the LM enterprises. However, by giving some relief to profitable REs, local governments may protect the base for local revenues and local employment, which are the two important objectives of local governments. It implies that local governments intended to carry out cross-taxation among the REs. This taxation policy would seem to make some sense provided that the profit-making REs do pay more to the coffers of local governments than do the LM ones. As shown above, however, it is not at all so in the reality due to the softness of the taxation system.

VI. Summary of Findings and Concluding Remarks

This section summarises the findings of the study under three headings. Firstly, findings on the softness of the major capital sources and their implications on REs' behaviour, as they emerged from the various sections, are synthesised. Secondly, the softness of formal taxation and that of local levies are compared. Thirdly, the impact of the central government's fiscal austerity policy in 1989 and its implications on SBCs of REs are outlined.

1. Softness of Capital Sources and Behaviour of REs

The fact that local government investment tends to account for a higher percentage in the ttal capital of collective loss-making REs is suggestive of some soft usage of local government investment. However, the reduced rate of local government investment in the LMEs seems to indicate that this source of capital is sensitive to REs' financial losses. These combined illustrate a dual feature of local government investment: the capital already invested in the REs tends to be lenient in the case of loss making enterprises; but new investment capital is basically sensitive towards the enterprise's performance.

While bank loan seems to be a relatively hard capital source, the continuous high component of bank loans in the total capital of the loss making enterprises is illustrative of the repayment problem. For the LMEs, the reduced share of own fund in total capital suggests that LMEs may have to write down their equity capital to cover the losses. It indicates the hardness in budget constraints in REs, as compared to the case of state enterprises that have always been bailed out by fresh credits.

However, arrears to other firms appear to function as a soft capital credit for REs as its share in total capital tends to increase in the loss-making enterprises. The phenomenon that the majority of LMEs, and 40 per cent of profitable ones, in the sample kept payments outstanding to government illustrates the softness in taxation, which is further discussed below. Unpaid wages are a relatively minor source of budget softness, as it accounts for just around 2.5 per cent of total capital for both profitable and loss-making REs. Even so, it is worthy of note that enterprises may search out this option as a resort for rising funds on soft terms if needed.

Regarding the investment behaviour of REs, investments by non-collective REs are highly sensitive to their financial performance. Such observed behaviour is consistent with the logic dictated by the private ownership of investment capital of non-collective REs. While collective LMEs tend to reduce the scale of fixed capital investment undertaken, they often managed to increase their working capital by a higher rate, which would allow them to better survive the losses, than that of non-collective REs. Thus, it indicates that the budget softness exists in the collectively owned REs, although the degree and the sources of budget softness may differ in this sector from that of state sector.

Other major financial tactics employed by LMEs can be deduced from the following aspects. They tend to be characterised by an increasing total liability, and consequently by a higher level of indebtedness as compared to the profitable control group. Regarding the sources of liability increase, LMEs tend to expand their borrowing from banks as well as that of non-bank loans. Likewise, the majority of LMEs are in debts to other firms and are more likely to withhold wage payments to their employees. In addition, their liabilities to other firms and to their employees tend to rise after losses being make. On the other hand, LMEs are characterised by less an increase of outstanding payment to government relative to that of the profitable sub-sample.

2. Softness in Taxation and Local Levies.

While the survey data show that the pervasiveness of unpaid taxes is higher among the LMEs, the LMEs tend to end up paying actually a higher percentage of total taxes than do the profitable ones. A clear tendency of preferential taxation emerges from the study. On one hand, collective REs tend to pay less a percentage of total taxes than do the non-collective ones. On the other hand, profitable REs are often subject to paying lower rates of tax than those for the loss-making ones. This study shows that on average, the degree of taxation softness is firstly of a positive relation of the collective ownership of REs and, secondly, of an negative relation of the enterprise's profitability. This pattern basically holds for payments of both sales tax and income tax. In sum, the data on tax evasion and on the residuals between the nominal tax rates and effective tax rate confirm the existence of budget softness in the form of soft taxation.

3. The 1989 Fiscal Policy Impact and Implications on SBCs

The survey data drawn upon this study provide an opportunity to assess some impact of China's central government austerity policy in 1989. Our study suggests that the increase in local government investment played an important role in reducing the impact of the severe credit squeeze targeted at the RE sector in 1989. This leads to the conclusion that local governments tend to farther mobilise own capital resources in order to maintain a high growth of rural industries, if supply of credit is tightened by the Centre.

On the whole, the tightening of credit supply in 1989 produced an impact for bringing down the level of total liability of REs, and LMEs appeared to be most severely affected. This result goes to show an effect of tight credit policy on the hardening of budget constraint of REs. However, the data also reveals that twice as high a proportion of LMEs as the profitable REs managed to increase their bank borrowings during 1989. Thus, it shows that the budget hardening effect of the central government's policy measure was in part frustrated by local banks' inclined lending towards the LMEs.

The credit squeeze of 1989 also produced certain pressure on local governments for imposing harder disciplines in taxation. The effects are shown in the following ways. The percentage of enterprises with unpaid taxes was reduced in both profitable and LM groups in the sample. The tendency of an increasing outstanding payment to governments was to a large extent curbed, and the number of REs managed to increased the amount of POTG in 1989 was less than the year before. However, despite the higher nominal income tax rate imposed on the LMEs in 1989, the effectively paid rate increased relatively little. Moreover, the local governments appeared to have employed cross-taxation measures to protect particularly the profitable firms from the pressure of the central government policy. It further reduced the budget hardening effect of the central policy on the local firms.

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