

**The Construction of State Extractive Capacity:  
Wuhan, 1949-1953**

**Shaoguang Wang**

Department of Political Science  
Yale University  
New Haven, CT 06520  
USA  
Tel: 203-432-5262  
Tax: 203-432-6196  
Email: <shaoguang.wang@yale.edu>

Department of Government and Public Administration  
The Chinese University of Hong Kong  
Shatin, NT  
HONG KONG  
Tel: 852-2609-7515  
Fax: 852-2603-5229  
Email: <wangshaoguang@cuhk.edu.hk>

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In imperial China, the government revenues never exceeded 4 percent of the country's Gross Domestic Product (GDP).<sup>1</sup> Even after the collapse of the Qing dynasty, the share of national income allocated through the

government budget remained very small. In 1936, probably the best year of the Republican era, the total government budget still accounted only for 8.8 percent of GDP.<sup>2</sup> However, soon after the Chinese Communists seized power in 1949, the ratio of the new regime's budget revenue to national income rose to unprecedentedly high levels. As Table 1 shows, in 1950, only one year after the establishment of the People's Republic of China (PRC), the ratio already approached 16 percent. Three years later, the ratio was above 30 percent. Thereafter, except in two chaotic years of the Cultural Revolution (1967 and 1968), the ratio had never fallen below 30 percent until the beginning of Deng's reform in 1979.<sup>3</sup> The level of budgetary revenue relative to national income in the Communist China was high not only in historical perspective but also in comparative perspective. In none of the eleven countries listed in Table 1 that had about the same per capita income as China did in the 1950s, for instance, the size of the public sector even came close to China's.

[Table 1 about here]

How could the Chinese Communists do what its predecessors and its counterparts in the Third World were not able to do? Why was the new regime's extractive capacity so strong? Those are the questions this essay attempts to explore. It focuses on Wuhan of 1949-53, the largest metropolis of central China in the crucial phase of state building of the PRC. The basic mechanism for raising revenue in the other parts of the country was more or less the same in this period. Therefore, what I discuss here may extend beyond Wuhan. The first section provides a theoretical framework for analyzing state extractive capacity. The next section identifies the major sources of budget revenue in those years. The third section examines the means, which the state used to create tax collector compliance and taxpayer compliance.

### **Analytical Framework**

Governments need money. Without a steady flow of revenue, there can simply be no government. The insight that effective government has to be fiscally viable is by no means noble. It is plain to everyone that, for a government to perform the political tasks it selects as goals for the nation, it has to be able to mobilize sufficient resources into a national

pool and use them to achieve these goals. The concept of state extractive capacity used in this study thus is defined as the ability of the state to extract resources from society in support of national objectives.

Given the importance of revenue availability, all governments are inclined to extract as much resources from society as possible. However, the levels of extractive capacity achieved vary widely from country to country, and, even within the same country, from time to time. What variables affect variation in state extractive capacity?

### **Taxpayer Compliance**

Ultimately, the extractive capacity of a government depends on the extent to which it procures taxpayer compliance. Widespread compliance would secure the state with sufficient revenues. If tax evasion becomes a national sport, however, the state would find it difficult to make ends meet.

Taxpayer compliance has always been a problem for the state regardless of taxpayers' general attitude towards their government. "Certainly, if citizens vest rulers with the right to tax and spend in their behalf, without demanding special privileges, the budget game is easier."<sup>4</sup> However, legitimacy cannot solve the free-rider problem. A person who supports a regime politically may very well want to receive benefits without incurring costs.<sup>5</sup>

The Chinese Communists came to power with an overwhelming popular support, which was a favorable condition for the new regime to promote cooperation among its subjects. Other thing being equal, the popular support would enable the new regime to create taxpayer compliance at relatively low costs. This, however, would not eliminate taxpayers' incentives to minimize tax payments. To maximize revenue, the new Communist regime thus had to find ways of minimizing tax evasion and avoidance, just as governments in other periods and in other countries had to.

Since voluntary taxpayer compliance is normally unattainable, the state has to create compliance by establishing institutions of monitoring and enforcement. The monitoring system is necessary because taxpayers tend to have incentives to withhold or misrepresent private information about their situations. To bring about taxpayer compliance, the monitoring system has to be able to perform the following three functions. First, it should be able to identify those who are supposed to pay taxes. Second, it

should be able to obtain information essential for the assessment of tax burden of each and every taxpayer. Only with such information can the state determine how much payment each taxpayer owes. Third, it should be able to detect the noncompliance. It is important for the state to know who pay their dues in full and who do not. Otherwise, honest taxpayers would feel they are "suckers." The perception of exploitation would make them unhappy with paying their due in full. In other words, a deficient monitoring system would not only allow dishonest taxpayers to evade taxes but also encourage initially honest taxpayers to be less compliant.<sup>6</sup>

The monitoring system in itself, however, cannot bring about taxpayer compliance, because there are always some taxpayers who would not comply unless they are coerced. Thus, the monitoring system has to be accompanied by an enforcement system. Without the support of the latter, tax evasion would still be rampant no matter how efficient the former is. If non-compliant taxpayers were not penalized, they might produce "demonstration effects" on others, which might in turn lead to more widespread non-compliance. To bring about compliance, the state has to make the non-compliant action less attractive than the compliant action. Only when the cost of evading taxes is made sufficiently high would the incentives to evade taxes be dampened. How high is sufficiently high? This question can be answered only in practice. In any case, people must be penalized if they do not pay their taxes, underreport taxable material, fail to pay taxes on time, or more generally, refuse to cooperate with the state taxation authorities. The function of the enforcement institutions is to make credible the penalties for tax avoidance, evasion, arrears, and other noncompliant behaviors.

It is not costless to build the institutions of monitoring and enforcement and to apply technologies of monitoring and enforcement, however. If the cost of creating taxpayer compliance is so high that further revenue extraction is no longer profitable, it would make little sense for the state to do so. Ideally, the state would stop pushing for a higher degree of compliance at the point where marginal revenue equals marginal cost. Of course, it is impossible to locate such an equilibrium point. In practice, when facing objective constraints, state policy-makers are often willing to settle with "second best" institutions and technologies of monitoring and enforcement. As we will see, this was the Communist government did in the early 1950s.

### **Tax Collector Compliance**

The state as such does not monitor taxpayers' behavior and enforce tax law. The monitoring and enforcement systems are operated by tax collectors. The state hires tax collectors to collect taxes on its behalf and accordingly delegates the authority of operating the monitoring and enforcement systems to them. The tax collectors, however, may not be willing and/or able to act in the best interest of the state. For the monitoring and enforcement systems to be effective, the state has to make sure that tax collectors are both competent and incorrupt.

Tax collectors have to learn a lot about how to monitor taxpayers' behavior. Since taxpayers are interested in minimizing the taxes they pay, they will evade taxation by concealing assets whenever they can. They will be able to do so when tax collectors are unable to adequately measure taxable assets. Especially, when taxable assets are mobile and/or variable over time (e.g., indirect taxes), it is hard even for experienced tax collectors to detect evasion by taxpayers. Incompetent tax collectors thus can at best seize only a fraction of available revenues.

Even if tax collectors are largely competent for their jobs, they may have no strong incentive to maximize the state revenue by strictly enforcing tax law. To minimize the tax they pay, taxpayers may use bribery to get lower tax assessments when they find that tax collectors have strong monitoring capacity. Tax collectors, on the other hand, may have incentive to take bribes and embezzlement, since their income is increased without any countervailing loss. Collusive trades of bribes for underassessment of assets thus may occur between tax collectors and taxpayers. In such a collusive environment, tax fraud cases would be harder to establish and the practices of tax evasion would become rampant. As a result, the government might suffer a substantial loss in revenue. When corruption is widespread, conventional evasion-counteracting policies (lowering tax rates, increasing penalties, and enhancing detection) would become ineffective.<sup>7</sup> The most efficient way against tax evasion then is to combat corruption.<sup>8</sup>

In sum, the state must find ways to obtain tax collector compliance before it can obtain taxpayer compliance.

### **Main Sources of Revenue**

During the Nationalist government's "golden years," the customs and salt tax were its two financial pillars. In the nine years from 1928 to 1936, there were five years in which collections from the two sources accounted for more than 85 percent of total revenue receipts (see Table 2). In the provinces, land tax alone occupied more than a half of local revenue receipts.<sup>9</sup> The salt tax and land tax were traditional taxes, and the customs were relatively easy to collect. That the Nationalist government relied heavily on those three sources for its revenue was an indication that its extractive capacity was extremely weak.

[Table 2 about here]

From the very beginning, the PRC tried to explore for new sources of revenue. In its consolidated budget, which included the revenues of all levels of government, the shares of the customs, salt tax, and agricultural taxes all declined markedly during the period under discussion. By contrast, the "profits from state enterprises" and "industrial and commercial taxes" expanded steadily, becoming the two most lucrative sources of revenue for the government. The change in tax structure resulted in an enormous increase of budgetary income. The size of the public sector more than tripled in the four years between 1950 and 1953 (see Table 3).

[Table 3 about here]

In those years, Wuhan also witnessed a drastic growth of receipts from "profits from state enterprises" and "industrial and commercial taxes" (see Table 4). However, two points need to be noted. First, despite the rapid expansion of the absolute size of "profits from state enterprises," its share was considerably smaller than its counterpart in the national budget. This was so because there were only a few state enterprises in the city at that time. Most of China's state enterprises then were concentrated in the Northeast and Shanghai. Second, the "industrial and commercial taxes" were made up of more than a dozen of taxes, among which the three most important ones were gross receipts tax, net income tax, and excise tax. The gross receipts tax was levied on total gross income before the deduction of operating costs, the net income tax on the net profit earned from business operations and the excise tax on the sale of specific commodities.

[Table 4 about here]

To a large extent, the growth of the public sector was attributable to the new regime's ability to extract resources from where the old regimes had failed to extract. The lack of space prevents me from dealing with all the four main sources of revenue for the new regime (i.e., "profits from state enterprises," the excise tax, the gross receipts tax, and the net income tax). In what follows, I will use the mobilization of the gross receipts tax and the net income tax in Wuhan as an example to explain why the new regime could enlarge the size of the public sector in a short period of time. I make this choice for three reasons. First, the two taxes then were officially treated as if they were one tax ("business tax") instead of two, and they were often collected at the same time. Together, they accounted for 40 percent of total revenue, contributing more to the budget than any other single tax. Therefore, the government regarded them as the most important sources of income. Second, without receipts from the two taxes, the government might have had much less resources to be invested in state enterprises, which would mean much less "profits from state enterprises." Moreover, unlike "profits from state enterprises," the two taxes were imposed on all kinds of businesses, state-owned, cooperative, and private alike.<sup>10</sup> An investigation of the mobilization of the two taxes, therefore, is probably more instructive to the study of the government's extractive capacity than focusing on the collection of "profits from state enterprises." Third, unlike the excise tax the assessment and collection of which were relatively easy and inexpensive, the mobilization of the gross receipts tax and the net income tax required the state to have a strong capacity for creating taxpayer compliance. A survey of contemporary local publications reveals that the local authorities devoted more time and energy to the collection of the two taxes than to the collection of all other revenues. As far as tax collection was concerned, the collection of the gross receipts and the net income tax thus was most challenging.

#### **Constraints on the New Regime**

When the Communists took over control, they faced many objective constraints that limited their ability to achieve compliance, among which the most important were the miniature size of businesses and the deficient institutions of tax collection the Communists inherited from the Nationalists.

For obvious reasons, it would be relatively easier to collect taxes from large socialized enterprises than from small ones. Up to 1953, however, there were only 532 state enterprises, 31 joint state-private enterprises, and a few hundreds of cooperative enterprises in Wuhan. The private sector was dominated by a large number of small enterprises. At the end of 1949, for instance, there were altogether 18,701 private enterprises in Wuhan, among which 2,629 were factories. Most factories hired no more than eight workers and had less than 3,500 Yuan's worth of capital. Only 571 were categorized as "modern factories." Even they, on average, had only thirty-six employees and less than 100,000 Yuan of investment. As for the commercial enterprises, few had more than four employees and 4,000 Yuan's worth of asset.<sup>11</sup> As Table 5 indicates, this situation didn't change much in the following four years. In addition to private enterprises, there were also tens of thousands of self-employed artisans and street peddlers scattering all over the city.

[Table 5 about here]

Small firms in general lacked even the basic idea of bookkeeping. Double-entry bookkeeping was foreign to all but few large "modern" enterprises. Most storekeepers, mill owners, and artisans were illiterate. Given the small size of their business, even if they were able to read, it made little sense for them to keep accounts in a systematic manner. Those who did keep accounts more often than not used traditional ways of bookkeeping in which profit, spending, and borrowing were fused. Even professionally trained tax collectors might not be able to decipher them.<sup>12</sup> With accounts in chaotic condition, it was next to impossible to establish the gross receipts and net earnings of this kind of firms.

The quality of tax collectors was also problematic. In May 1949, right before the Communist forces took over Wuhan, there were nineteen tax collection agencies separately belonging to the national, provincial, and municipal systems. Each system had its own taxes to collect, and the agencies of the three systems often collided with one another. Altogether,

the three systems had 1,622 employees. Five hundred-eighty employees of those agencies retained their jobs after the city fell into the hands of the Communists on May 16. Among them, 116 were the members of the Nationalist Party and 60 the members of the Nationalist youth organization. The majority of them came from non-proletarian family backgrounds.<sup>13</sup>

For obvious reasons, the new regime didn't trust the retained Nationalist officials. As a result, 180 veteran Communist cadres, and pro-Communist students and workers were assigned to leading posts in various tax collection agencies.<sup>14</sup> Thus, there appeared an awkward combination of two kinds of tax collectors. Retained personnel were relatively well trained. They had at least junior high education and some had college degrees. In addition, they had experience in tax collection. However, many of them were corrupted. Taking bribes by colluding with taxpayers in evasion had been a commonplace during the Nationalist era. Some were almost addicted to such practice. Moreover, many of them were not ready to support the new regime wholeheartedly. Communist cadres were dedicated to the new system and clean, but few of them had formal education, let alone experience in tax collection.<sup>15</sup>

To create taxpayer compliance, the government had first to make individual tax collectors competent and loyal to the new regime and to make tax collection agencies efficient.

### **The Creation of Tax Collector Compliance**

The first thing the new city government did to the inherited Nationalist tax collection agencies was to streamline them into an integrated system. The core of the new system was Wuhan Municipal Tax Bureau that supervised five branches in the five districts of the city, thirty-seven sub branches in neighborhoods, and twenty-seven check stations posted at various ports. During the Nationalist era, a large percentage of people working in tax collection agencies were involved in office work rather than in direct collection. The new government transferred a half of office workers to the sub branches and check stations.<sup>16</sup> The unified three-tier network enabled the Communists to penetrate much deeper than the Nationalists into Wuhan society.

In the view of the Communist government, the new organizational structure should be staffed by a new kind of tax collectors, ones who combined strong points of both retained Nationalist officials and veteran

Communist cadres without their respective deficiencies. For this purpose, retained officials and veteran cadres were encouraged to learn from and help each other. The former were supposed to accept the latter's ideological indoctrination and the latter the former's professional training. The relationship between the two groups was by no means equal. The revolutionary cadres were in a position of dominance. A system of political study designed specifically for retained Nationalist official was established on the first day when the Communists took control over the tax collection agencies. In study sessions, every retained official was required to make a clean breast of his political history as well as his past corruption practices. They were exhorted to be honest in serving the new regime and to show respect for revolutionary cadres. To force the retained officials to cooperate under the new order, the government declared that it didn't recognize the old ranking arrangement. All retained officials were temporarily reduced to the lowest rank. They would not be appointed to higher positions (or reinstated) unless they proved that they became both politically and professionally qualified.<sup>17</sup>

At the same time when retained officials were compelled to remold their ideologies, revolutionary cadres were urged to improve their professional skills. At first, training classes were organized within the tax agencies and some retained officials were asked to teach revolutionary cadres the basics in calculation with the abacus, accounting, and tax law. Later, revolutionary cadres were often sent to special schools or colleges for intensive training. By the end of 1953, 437 out of about 1,500 revolutionary cadres and other new recruits had received some kinds of training.<sup>18</sup>

During the Nationalist era, corruption was common. Corruption damaged the Nationalist government's extractive capacity in two ways: taxpayers might reduce tax outlays by bribing corrupt tax collectors and tax collectors might embezzle some of tax money. As corruption became more and more widespread, the difference between the taxes imposed on the people and the revenue collected by state budget expanded. The result was that at the same time when the tax burden of the population was becoming heavier the shortage of government revenue became more severe. The Communist government was determined to fight against corruption. The prevention of corruption was a main element in routine ideological education. Anyone who was found guilty of corruption was subject to severe punishment. In addition to routine check-ups, the government periodically launched

political campaign against corruption. In mid-1950, the tax collectors of Wuhan experienced a two-month long rectification campaign. A few months later, a nationwide campaign against the "three evils" of corruption, waste, and bureaucracy started, in which tax collection agencies were made one of the focal points. Under an enormous political pressure, about two hundreds of Wuhan's tax collectors confessed to having been involved in corruption of varying degrees. Altogether, they had misappropriated 3,700 Yuan, or less than 20 Yuan per person on average, which indicated that corruption had by then no longer been a serious problem.<sup>19</sup> The government, however, could not tolerate even such minor misconducts. In 1953, the government initiated yet another nationwide check-up campaign specifically targeting the tax collection system. In Wuhan, fifty-nine tax collectors were caught and punished.<sup>20</sup>

The efforts discussed above of course did not make all tax collectors both "red" and "expert." Nevertheless, by making revolutionary cadres professionally more proficient, retained officials politically more amenable, and all of them more disciplined, those measures enabled the new regime to achieve a higher degree of tax collector compliance than the Nationalist government. The Communists' reorganization and reorientation of tax collection agencies significantly reduced "leaks" caused by corruption and "wastes" caused by inefficient organizational arrangements, thus increasing the new regime's extractive capacity.

### **The Creation of Taxpayer Compliance**

The tax collector compliance is the precondition of taxpayer compliance, but it cannot automatically bring about taxpayer compliance. To bring about taxpayer compliance, tax collectors have to develop efficient technologies and institutions for monitoring taxpayers' behaviors and enforcing tax laws. More precisely, they should be able (1) to identify who are taxpayers, (2) to determine how much payment each taxpayer owes the government, and (3) to make credible the penalties for tax avoidance, evasion, and arrears. The tax collection authorities of Wuhan were very innovative in all the three aspects in the early 1950s.

#### **Surveillance**

It was not easy to identify all those who were obligated to pay the gross receipts tax and the net income tax in the period of 1949-1953 for

two reasons. First, most businesses were small and many small businesses did not register themselves with the tax authorities. Second, the economic situation in those years was extremely volatile, going through a number of mini-booms and mini-recessions. As a result of a great number of firms entering into and exiting from business, it would be prohibitively expensive if the tax authorities attempted to keep track of who were in and who were out. One way to cut such administration costs was to use existing communal institutions or to create new communal institutions to identify taxpayers.

#### (1) Identifying Taxpayers through Guild Organizations

Since the late-nineteenth century, *tongye gonghui* or guilds founded on principles of common occupation or trade had played important economic, political, and cultural roles in Wuhan. A guild was supposed to encompass all participants in a trade or profession. In the chaotic political situation of the early-twentieth century, there even emerged inclusive citywide guild confederations to assume some governmental functions.<sup>21</sup>

At the time the Communists took over the tricity of Wuhan, there were 181 guilds in Hankou, 87 guilds in Wuchang, and about 30 guilds in Hanyang. Individual guilds could have from a few dozens to several hundreds of member firms. Guilds were divided into two categories: industrial and commercial. In each of the three parts of the city, there were a region-wide industrial council and a region-wide commercial council, which supervised local industrial and commercial guilds, respectively. The existing structure of guilds provided the new regime with a ready-made mechanism for identifying taxpayers.

From June 1949 to May 1950, the city government launched four intensive campaigns to collect the gross receipts tax and net income tax. In all the four campaigns, guild organizations were utilized as tax agents. Take the first campaign as an example. The campaign started on June 20, 1949, which targeted to collect 128,000 Yuan by July 15. The city government first divided the total into three quotas, with Hankou bearing 120,000 Yuan, Wuchang 7,000 Yuan, and Hanyang 1,000 Yuan. The industrial and commercial councils of each part of the city then had to negotiate with one another over how to divide their quota between the two sectors. Once a council knew the amount for which it was responsible, it further divided that number among guilds under its supervision, which in turn allocated their total shares among their member firms.<sup>22</sup> This procedure was awfully

complicated, involving many rounds of bargaining, but it was probably the only method of identifying taxpayers that did not require the government to have knowledge of actual situation of the city. The newly established Communist government did not have such knowledge. Therefore, it was rational for the new government to adopt this method. By levying taxes on the industrial and commercial community as a whole rather than on individual taxpayers, the government could leave the problem of taxpayer identification to guilds. When a tax quota was imposed on a guild as a whole, it was in the interests of the guild to make sure that every member paid its share. If some members did not pay, the others had to pay more. The clash of conflicting interests thus could automatically lead the guild to identify all taxpayers in its trade.

The method of identifying taxpayers through guild organizations was quite effective. When the Nationalists collected the net income tax in Hankou for the last time in the second half of 1948, only 11,632 firms of 135 trades paid. In the Communist first tax collection campaign, however, 19,488 of 179 trades paid the net income tax. By the time of the third campaign (from November 27 to December 18, 1949), the number of firms that paid the net income tax had increased to 23,313 in 207 trades. The increase of the number of taxpayers was an important factor that contributed to the growth of the government revenue in Wuhan.<sup>23</sup>

## (2) Identifying Taxpayers through Neighborhood-based Organizations

The method of identifying taxpayers through guild organizations had three drawbacks. First, many taxpayers were not guild members. On the one hand, no guild encompassed all practitioners in the trade. A survey of 1950 found that about 3,000 firms that were supposed to be guild members did not join any guild, and thus had evaded payment of the gross receipts tax and the net income tax in 1949.<sup>24</sup> On the other hand, some taxpayers did not have guild to join. For instance, there was no guild for more than 30,000 street peddlers.<sup>25</sup> Moreover, in some trade, guilds existed only in name, having no authorities over their members. About 2,000 tailors and chicken traders faced such a situation.<sup>26</sup>

Second, this method works best only when the government assigns a tax quota for each guild. When a required quota is fixed for each guild, however, what the guild pays to the government is not tax in the modern sense but contribution. This kind of extraction, when providing the monetary means to the government, cannot play economic, social, and

political functions taxation is expected to play in addition to its fiscal function. Real taxes have to be founded on specific notions of bases and rates. When the government began to introduce the notions of bases and rates into its taxation system in 1950, it found that guild organizations were not very helpful to the estimation of gross receipts and net income. The reason was quite simple. Although the members of a guild were from the same trade, they were scattered all over the city. Therefore, they usually did not know much about each other's business. How large share of the tax burden on the guild a member firm shouldered to a large extent depended on its misinformation skill and bargaining power. The members thus might end up with paying different rates of tax. It was also very likely that two neighboring firms of different trades came to pay substantially different rates of tax.

Third, guilds were traditional secondary groups, which had once filled the power vacuum left by the collapse of the city government.<sup>27</sup> Although they were cooperative with the new regime, they nevertheless had the potential of become independent power centers. Therefore, the Communists hoped to weaken and eventually eliminate them.

For those reasons, the government began a process of gradually replacing guild organizations with neighborhood-based organizations in June 1950. Each of the five administrative districts of Wuhan was divided into four to five "tax areas." Within each area, every fifteen neighboring firms formed a "small tax group," five to seven small groups formed a "large tax group," and two to four large groups formed a "tax section." No firm was left untended. And neighbors probably knew each other's business very well. In this four-tier system, three tiers were operated by businessmen themselves rather than by state officials. The government thus did not have to bear the cost of their operation. Yet, unlike the structure of guild organizations, the system was state-centered. Each "tax area" was headed by a sub branch of the Municipal Tax Bureau, which was responsible for business registration, tax assessment, tax audit, tax collection, and above all, coordinating and supervising the lower tiers of the new system within the area. The small groups, large groups, and sections of the area were supposed to be the sub branch's transmission belts and their function was to smooth tax collection.<sup>28</sup> Altogether, 30 areas, 98 sections, 171 large groups, and 1809 small groups were established in the city in 1950.<sup>29</sup>

The government did not immediately abandon guild organizations after the establishment of neighborhood-based organizations. At least in the following one and half years, the latter still worked as a supplement to the former. With the two systems coexisting side by side, the government was in a much better position to identify taxpayers. Only after the campaign against the "three-evils" of 1952 did guild organizations begin to fade away. By then, the local tax authorities had already possessed fairly rich knowledge about taxpayers.

### **Assessment**

By using existing communal institutions and creating new communal institutions to identify taxpayers, the new regime significantly enlarged its revenue base. However, an efficient taxation system needs to be supported not only by institutions that monitor who pay taxes and who do not, but also by institutions that monitor who pay their dues in full and who do not. Without the latter institutions, honest taxpayers would feel they are being "suckers." The perception of exploitation would make them unhappy with paying their due in full. In other words, a deficient tax assessment system would not only allow dishonest taxpayers to evade taxes but also encourage initially honest taxpayers to be less compliant.<sup>30</sup>

In Wuhan of 1949, over 90 percent of firms did not have systematic accounts at all, and in the rest of firms, over 90 percent of their accounts were not reliable.<sup>31</sup> In the absence of adequate accounting practices, it was exceedingly difficult to determine the gross receipts and net income of a firm. The new government, however, could not afford to wait until the establishment of proper bookkeeping in most businesses before levying taxes. Under such a circumstance, what it needed was a second-best solution to the problem of tax assessment. And it did find a second-best solution, which involved the following two processes.

#### (1) The Application of Some Interim Measures

As mentioned above, in the three tax collection campaigns of 1949, the taxes were levied on the guild as a whole, which then devised its own means of allocating the tax quota. This method did not require the government to know exact gross receipts and net income of firms, thus largely relieving it from the burden of tax assessment. In February 1950, the central government passed a law on business taxes, which stipulated that all business taxes should be levied on individual firms rather than on some

corporate entities. Thus, in April 1950, when the Wuhan government began to collect the gross receipts tax and the net income tax of the first three months of the year, a new way of collection was introduced. Firms were divided into three categories, for which methods of collection were different.

First, firms whose bookkeeping records were reasonably sound were permitted to file their own tax returns, subject to later audit by the local tax bureau. These tended to be large firms. Indeed, the larger the firms, the more sophisticated their organizations, and the more difficult it was for them to indulge in systematic tax evasion. 158 firms of 19 trades fell into this category. They accounted for 0.4 percent of the total number of firms in the city, but paid over one tenth of the total of the gross receipts tax and the net income tax.<sup>32</sup>

Second, for firms that did not have accounting records at all, each of them was required to pay a fixed sum for both gross receipts tax and net income tax. The allotment was determined by the tax bureau according to its one-time estimation of the firm's business. The fixed sum would not be changed unless the business of the firm would noticeably improve or deteriorate. Over a half of firms in Hankou, the majority of firms in Wuchang, and all firms in Hanyang fell into this category. However, their payments of the gross receipts tax and the net income tax accounted only for a small proportion of the total income from the two taxes, because they were primarily very small firms.<sup>33</sup>

Third, a special procedure of tax assessment was applied to firms whose accounting records were not adequate, which was called "democratic appraisal of taxes." This procedure was "democratic" in that the determination was the result of interactions between the individual taxpayer, the guild (or the small tax group) concerned, and the tax authorities.<sup>34</sup> When the new collection method was first introduced in the spring of 1950, the procedure comprises three steps. First, the tax bureau made an estimation of the total gross receipts and the average profit rate of a trade on the basis of its sampling of a few "typical firms" in the trade. Second, the members of the guild negotiated with one another over how to allocate the estimated total gross receipts among themselves. Once the estimated sales of a firm was determined, its estimated net income could be calculated by applying the stipulated average profit rate to its estimated sales. Finally, individual firms paid their taxes according to their estimated sales and net incomes.<sup>35</sup>

Among the three steps, the first was apparently most crucial. However, it was extremely time-consuming. For instance, it took more than 100 tax officials about two months to complete a survey of 245 firms, which was just a part of the preparation for the collection of taxes of three months.<sup>36</sup> Obviously, the local tax authorities could not afford to have this kind of survey on a regular basis. Moreover, many taxpayers protested that estimations made by the tax bureau often were very arbitrary.<sup>37</sup>

In the second half of 1950, the Wuhan tax authorities modified the procedure of the democratic appraisal. The modified procedure had six steps. First, each firm made a self-assessment of its gross receipts and net income. Second, it presented the self-assessment to the guild (or the tax group) it belonged to for comments. Third, if some questions arose, other members of the guild (or the group), who were often its competitors, had the right to check its records. Fourth, if those who examined the records concluded that the firm had underreported its sales and profits, the guild (or the group) would advise the firm to adjust its self-assessment. Fifth, the guild (or the group) made its final estimation of the firm's gross receipts and net income. Finally, the tax bureau decided if the guild's estimation was acceptable.

Some firms complained that the modified procedure was the tax bureau's scheme to "incite businessmen to undermine each other." It was. By making use of the competitive relations between firms in the same trade or in the same neighborhood to get more accurate information about their business, the tax bureau could save a great deal of its manpower for other purposes.<sup>38</sup> However, not all firms fell into the trap. In some trades, firms colluded not to question each other's self-assessment. As a result, they all ended up with paying fewer taxes than otherwise.<sup>39</sup>

To overcome taxpayers' collusion and other types of evasion, the local government developed two control devices. First, it applied the "mass line" to tax collection. At first, individual workers were encouraged to provide tax officials with information about the real situation of their enterprises. After trade unions were established, unions were given an important role in evaluating their firms' self-assessments. Many workers were not very enthusiastic about the role because they had a stake in their firms. For one thing, if the firms they were working for were in financial trouble, their jobs would be in danger. Nevertheless, there were a large number of workers who were willing to cooperate with the government. The information those activists provided were invaluable for tax officials to

enforce compliance among private businessmen.<sup>40</sup> Second, the tax bureau concentrated its manpower on selective audit. If an individual firm was found to have engaged in tax falsification and evasion, it would be fined three to ten times the amount it was believed to have evaded. If an audit revealed that a guild (or a tax group) had not taken proper measures to check members' self-assessments, every member's tax due would be increased.<sup>41</sup> The surveillance by workers and periodical audit must have made private businessmen think twice before attempting to underreport their taxes. In this way, they helped improve the efficacy of the democratic appraisal of taxes.

The democratic appraisal of taxes was used to assess the tax payment of about 40 percent of Wuhan's firms, but the revenue from those firms probably accounted for 80 percent of the total receipts from the two taxes under discussion. That was why the local tax authorities had devoted a great deal of resources to implementing and perfecting the procedure.<sup>42</sup>

The three methods of tax assessment might seem clumsy compared to those used in advanced countries, but, given the limitations in bookkeeping and administration, their combination might very well be the most efficient way for maximizing revenues and minimizing administrative costs at that time. The innovative use of the three methods significantly enhanced the extractive capacity of the government, thus contributing to the rapid expansion of the public sector in the early years of the PRC.

## (2) The Drive to Establish Reliable Accounts

Despite their usefulness, the government, from the very beginning, regarded the democratic appraisal and the imposition of fixed sum as expedient measures. Its goal was eventually to base its taxation solely on accounting records rather than on presumptive figures. For this purpose, at the same time when the government was using the three aforementioned methods to collect taxes, it invested a great deal of its resource trying to introduce uniform methods of accounting to the city.

In the second half of 1950, the city government launched its first account-building drive. A municipal commission of account building was formed to coordinate activities of the drive. Hundreds of firms were selected as experimental units. Those experimental units were instructed to prepare their accounts according to specific guidelines. If a selected firm refused to cooperate, the industrial and commercial administration offices could revoke its business license.<sup>43</sup> Moreover, the Municipal

Association of Industry and Commerce, the authoritative city-wide guild alliance, was asked to start training classes to teach small businessmen how to read and how to count. Tax offices were also required to help enterprises set up and improve their financial and accounting systems.<sup>44</sup> Without state intervention, it might take decades to develop a uniform accounting system. The forced drive sponsored and dictated by the Communist government, however, sped the process. By the end of 1950, more than 4,000 firms, or one-fifth of Wuhan's firms, had established accounting records according to new standards. Two years later, the proportion increased to about two-thirds.<sup>45</sup>

As more and more firms established formal accounting records, the local tax authorities began to permit more taxpayers to file their own tax returns. The number of firms that filed their own tax returns increased from 158 in 1950 to 2,700 in 1953, whose tax payments accounted for 65 percent of the total.<sup>46</sup> Those firms no longer needed to go through the annoying democratic appraisal, though they were still subject to audit by tax offices.

### **Enforcement**

Tax evasion was a characteristic of traditional China. It was widely believed in Wuhan during the Republican period that the government was able to collect only one-third of taxes.<sup>47</sup> Many then held that tax evasion was an "incurable social disease." Instead of accepting tax evasion as a normal and inevitable feature of the social scene, the Communists were determined to fight against it. The development of monitoring institutions enabled the government to identify taxpayers and to assess their tax payments. However, the monitoring institutions have to be accompanied by enforcement institutions. Without the support of the latter, tax evasion would still be rampant no matter how efficient the former is. Only when the cost of evading taxes is made sufficiently high would the incentives to evade taxes be dampened. How high is sufficiently high? This question can be answered only in practice.

At the beginning of the Communist rule, the new regime did not use severe punishment to deter non-compliance. In its first tax collection campaign of 1949, the deadline of tax payment was set on July 15. It was said that whoever delayed their payments would be fined. On July 15, there were still 7 percent of the city's firms that did not pay their bills. The tax bureau gave them oral warnings but at the same time decided to extend

the deadline to July 19. Twenty-seven guilds missed that deadline again. They then were asked to pay a fine worth of one-tenth of their tax payments.<sup>48</sup> In a situation where monthly inflation rate was over 50 percent, however, the fine was in fact negative.<sup>49</sup>

In early 1950, fine on overdue tax payment was increased to 3 percent per day. The substantial increase was necessary because the later two collection campaigns of 1949 showed that when the fine rate was lower than the inflation rate, taxpayers would rather pay fines than pay their taxes on time.<sup>50</sup> However, soon after the increase of fine, Wuhan, and the whole China for that matter, experienced a mini-recession. To stimulate the economy, the government softened its tax policy somewhat. Taxpayers were allowed to delay their payments of taxes of the first quarter of 1950 for three months. They were also told that if they still felt financially difficult, they could negotiate with tax offices about possible tax reduction and exemption.<sup>51</sup> Altogether, 700,000 Yuan of taxes were remitted.<sup>52</sup>

The policy change produced a unexpected result: many taxpayers no longer took their obligations as seriously and some even went so far as refusing to pay taxes. The taxes of the second quarter of 1950 were supposed to be paid off before August 31, but as late as September 20, only 38 percent of firms paid in full and about 5,000 firms did not pay a penny! A businessman reportedly said, "In the past, I thought the government was a real 'tiger' so that I paid my taxes. The government turns out to be a 'paper tiger.' I am not afraid of it any more."<sup>53</sup> The quiet tax revolt alarmed the government. In mid-October, it made a decision to revoke the business licenses of firms that had owed the government taxes for more than a month. Those firms were given fifteen days to pay off their overdue tax payments plus fines. If they met the deadline, they could get their licenses back; if they failed to do so, the government would confiscate part of their properties to pay their debts.<sup>54</sup> However, a month later, there were still about 4,000 firms that did not pay their taxes.<sup>55</sup> To make credible the penalties for non-compliance, the government sealed up and confiscated the properties of a number of firms in late November.<sup>56</sup> The punishment of few was hoped to serve as a warning to many.<sup>57</sup>

The crackdown was apparently very effective. In 1951, few businessmen dared to delay their tax payments. At least there was no report about such incident on local newspapers. 1952 started with the famous "three-antis" and "five-antis" campaigns, in which tax evasion was a main target. Under

the enormous political pressures, about 70 percent of Wuhan's businessmen admitted that they had engaged in some forms of tax evasion.<sup>58</sup> One may expect that such intensive a crackdown would eliminate non-compliance. Ironically, however, there was marked rise in delayed tax payment and various forms of tax evasion in Wuhan after the campaign. At the end of the year, overdue tax payments amounted to 4.6 million Yuan, which was equivalent to 4 percent of the total tax revenue.<sup>59</sup> There may be several explanations for this change. (1) "Many businessmen could foresee the ultimate end of the private sector and may have used every subterfuge available, including tax evasion, to recoup as much of their investments as possible."<sup>60</sup> (2) In the mini-recession caused by the "three-antis" and "five-antis" campaigns, many private enterprises were suffering financial difficulties. So they were not able to pay. (3) During the campaigns, firms were too busy to keep proper accounts and tax offices were too busy to keep track of their accounts, which made it easy to practice tax evasion.<sup>61</sup>

From the viewpoint of the government, the rise in taxpayer non-compliance after the "five-antis" campaign unmistakably demonstrated that "lawbreaking capitalists" had to be suppressed by more severe measures. Thus, 1953 witnessed a wave of the arrests of tax evaders in Wuhan. Yangtze Daily, a local newspaper, alone reported two dozens of such arrests. Offenders were sentenced to from two months' to three years' imprisonment. In most cases, verdicts were pronounced at public meetings which hundreds or even thousands of private businessmen were "invited" to attend. Occasionally, after the sentences, one or two alleged tax evaders among the audience were singled out and arrested right on the spot. Such dramatic scenes must have produced great psychological impacts on the participants of those meetings. Some paid off their overdue taxes then and there, and more made promises to pay in the front of the crowd.<sup>62</sup> Probably no private businessman of the city could avoid being "invited" to attend such meetings. Those meetings had every taxpayer of the city warned that he could be the next target if he continued trying to outsmart the tax authorities.

From oral warning to fine, from small fine to substantial fine, from fine to revoking business license, from revoking license to confiscating property, and finally, from confiscating property to imprisonment, the Communist regime steadily increased the cost of non-compliance in those years. As the incidence of non-compliance became less frequent, the

government seemed to have become more impatient with offenders. The rationale for adopting increasingly harsher punishment probably lay in the belief that leniency might spoil all that had been achieved.

### **Conclusion**

Despite numerous constraints on the new regime, the Chinese Communist state demonstrated a strong extractive capacity in its early years. In the final analysis, the strong extractive capacity was attributable to two factors: the autonomy of the state and the internal coherence of the state apparatus. Without a degree of autonomy from dominant and subordinate social classes and from highly mobilized political groups, the state can hardly formulate its own preferences, much less imposing its own agenda on the society. In the early 1950s, however, war and revolution had pulverized China's old social structure so that no social group was in a position to challenge the new regime. The state thus could in effect use whatever means it saw fit to pursue its goals. That was why the tax authorities of Wuhan were able to overcome societal resistance and to enforce taxpayer compliance with ease. The internal coherence of the state apparatus was equally important. If individual bureaucrats are corrupt and government agencies compete with each other and with central decision makers over resources, what are at the center's disposal are very likely to be much less than what are extracted from society in the name of the state. A tree with a slender trunk and thick branches could not be strong. In the early 1950s, state officials were by and large clean. Fiscal "drain" resulted from corruption thus were significantly reduced. Moreover, newly established state agencies then were still too young to spout strong independent policy preferences of their own. Thus, it was relatively easy for the center to concentrate most of state revenues in its own hands and to allocate them according to centrally coordinated plans.

Thanks to its strong extractive capacity, the Chinese Communists were able to finance the building of state socialism in the economically backward country without much foreign aids. Chinese used to be very proud of this great achievement. Few foresaw that what they worked so hard to build would one day become a problem they would have to work hard to solve.

**Table 1. State Extractive Capacity in Developing Countries in the 1950s**

<u>Country</u>	<u>Revenue as % of National Income</u>
China 1950	15.8
China 1951	25.1
China 1952	29.5
China 1953	30.1
Afghanistan	5
Burma	19
Cambodia	12
Ethiopia	5
India	10
Indonesia	13
Liberia	16
Nigeria	11
Pakistan	10
Sudan	12
Thailand	12

**Source:** Ministry of Finance, Zhongguo Caizheng Tongji, 1950-1985 [Chinese Public Finance Statistics, 1950-1985], pp. 15, 152; Nicholas R. Lardy, Economic Growth and Distribution in China, p. 41.

**Table 2. The Share of Customs and Salt Tax in the Total Revenue of the Nationalist Government.**

<b>Year</b>	<b>Share</b>
1928	62.7%
1929	90.8%
1930	93.1%
1931	92.9%
1932	86.5%
1933	85.2%
1934	43.5%
1935	40.7%
1936	68.4%

**Source:** Yang Yinpu, Minguo Caizheng Shi [A History of Public Finance during the Republican Period], pp. 44-47.

**Table 3. Structure of Budgetary Revenue**  
1950-1953

	1950	1951	1952	1953
Total Revenue (Million Yuan)	6,519	13,314	18,372	22,286
Agricultural Taxes (%)	29.3	18.7	15.7	12.9
Salt Tax (%)	4.1	2.7	2.3	2.2
Customs Receipts (%)	5.5	5.6	2.8	2.4
Industrial and Commercial Taxes (%)	32.3	38.0	35.4	38.7
Profits from State Enterprises (%)	13.3	24.4	32.9	36.0

**Source:** Ministry of Finance, Zhongguo Caizheng Tongji, 1950-1985  
[Chinese Public Finance Statistics, 1950-1985], pp. 15, 42-43.

**Table 4. Main Sources of Budgetary Revenue, Wuhan, 1950-1953**

(Million Yuan)

	1950	1951	1952	1953
Profits from				
State Enterprises	0.08 (0.1%)	3.17 (2.6%)	5.17 (3.7%)	14.74 (7.9%)
Gross Receipts				
Tax	17.06 (26.2%)	28.58 (24.0%)	34.30 (24.8%)	53.66 (28.7%)
Net income				
Tax	4.46 (6.9%)	17.94 (15.0%)	22.08 (16.0%)	21.93 (11.7%)
Excise Tax	19.31 (29.7%)	24.80 (20.8%)	30.02 (21.7%)	72.46 (38.7%)
Other Income	24.12 (37.1%)	44.77 (37.6%)	46.56 (33.8%)	24.31 (13.0%)
Total	65.03 (100%)	119.26 (100%)	138.13 (100%)	187.13 (100%)

**Source:** Wuhan Statistics Bureau, Wuhan Sishinian [Forty Years of Wuhan], pp. 386-87.

Table 5. Private Enterprises, Wuhan, 1949-1953

	No. of Enterprise	No. of Employee	Capital (million)
1949	18,701	113,387	120.9
1950	19,569	115,621	122.3
1951	21,784	117,788	136.1
1952	19,765	99,381	115.3
1953	19,063	95,695	114.5

**Source:** Wuhan Industrial and Commercial Administration Bureau, Wuhan Gongshang Xinzheng Guanli Zhi [The History of Industrial and Commercial Administration in Wuhan], p. 160.

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## Endnotes

- <sup>1</sup>. Dwight Perkins, "Government as an Obstacle to Industrialization: The Case of Nineteenth-Century China," Journal of Economic History, vol. 27, no. 4, pp. 478-92.
- <sup>2</sup>. Wong Zhiyong, Minguo Caizheng Jianlun [A Critique of Fiscal Policies during the Republican Period] (Taipei: Huaguo Publishing House, 1952), pp. 115-116.
- <sup>3</sup>. Comprehensive Planning Division of Ministry of Finance, Zhongguo Caizheng Tongji [China's Statistics of Public Finance] (Beijing: Chinese Public Finance Publishing House, 1987), pp. 15, 152, 156.
- <sup>4</sup>. Carolyn Webber and Aaron Wildavsky, A History of Taxation and Expenditure in the Western World (New York: Simon and Schuster, 1986), p. 33.
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- <sup>7</sup>. C.Y. Cyrus Chu, "A Model of Income Tax Evasion with Vental Tax Officials: The Case of Taiwan," Public Finance, Vol. 45, No. 3 (1990), pp. 392-407.
- <sup>8</sup>. Wei Shu, "Income Tax Evasion and Enforcement: A Purely Theoretical Analysis of Chinese Income Tax System," Public Finance, Vol. 47, No. 2 (1992), pp. 287-302.
- <sup>9</sup>. Yang Yinpu, Minguo Caizheng Shi [A History of Public Finance during the Republican Period] (Beijing: Chinese Public Finance Publishing House, 1985), p. 82.
- <sup>10</sup>. After September 1951, state-owned enterprises were exempt from the net income tax. They then remitted their profits to the state treasury. But they were still required to pay the gross receipts tax where applicable.
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