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The Construction of State Extractive Capacity

Wuhan, 1949-1953

SHAOGUANG WANG

Chinese University of Hong Kong

The understandable focus on the remarkable changes in China over the past two decades has diverted attention from earlier efforts to build a modern Chinese state. Since 1978, the state's role in Chinese socio-economic and political life has been redefined. To fully appreciate the historical meaning of these reforms, one must grasp the creation of the modern Chinese state. This article examines a crucial moment of state building for China: 1949 to 1953. The period covered is short, but significant transformations were wrought in those few years.

State building has multiple meanings, but at its most fundamental, it involves state penetration of society to extract resources from it. This point is driven home by Almond and Powell (1966: 35, 244) when they point out that to a large extent, extraction is the "inseparable twin of the modern state." Without a steady flow of revenue, there can simply be no government. As early as the sixteenth century, when the modern European state was still in its formative phase, Jean Bodin's understanding of this is revealed in his assertion that "financial means are the nerves of the states" (Braun, 1975: 243). By the twentieth century, it had become plain that states could do nothing unless they had adequate extractive capacity. That is why Schumpeter (1954) labels the modern state the "tax state." Indeed, taxation, extractive capacity, underlies all other state capacities. For a government to perform the political tasks it targets, it has to be able to mobilize sufficient resources and use them to achieve these goals.



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Given the importance of revenue availability, strengthening extractive capacity is a central task of any state-building attempt. However, extraction is by no means easy. The levels of extractive capacity vary widely from country to country and, even within the same country, from time to time. One way to assess progress in state building is to measure the resources flowing to various levels of government because "each increase in the power of states was linked to an increased possibility of levying taxes" (Ardant, 1975: 174).

From this angle, the Communist government's early 1950s achievement was astonishing. In imperial China, the state's financial size constituted a tiny share of the economy. Imperial government revenues never exceeded 4% of the country's gross domestic product (GDP) (Perkins, 1967: 478-92). Even after the collapse of the Qing dynasty, the share of national income allocated through government remained small. Between 1916 and 1928, there was no national fiscal system to speak of in China. The successive Beijing regimes lived largely on foreign and domestic loans (Young, 1971: 1-11). When the Nationalists came to power in 1928, it was apparent that traditional methods and levels of extraction were manifestly incapable of meeting new challenges. Despite the Nanjing government's painstaking efforts to transform its fiscal system, however, the share of the economy extracted by the state grew only marginally.¹ In 1936, probably the Nationalist government's best year, the total government budget still accounted for no more than 8.8% of GDP (Wang Zhiyong, 1952: 115-16).² Yet, soon after the Communists seized power in 1949, the share of the new regime's budget revenue to national income rose to unprecedented levels. As Figure 1 shows, in 1950, the first full year after the establishment of the People's Republic of China (PRC), the share approached 16%. Three years later, the ratio was above 30%. The level of budgetary revenue relative to national income in the new China was high not only in historical perspective but also in comparative perspective. None of the eleven countries listed in Table 1 that in the 1950s had comparable levels of per capita income had public sectors anywhere near as large as China's.

In retrospect, the newly founded PRC would not have been able to control inflation, consolidate the regime, sustain the costs of the Korean War, restore the economy to its prewar level, and lay the

TABLE 1: State Extractive Capacity in Developing Countries in the 1950s

| Country | Revenue As % of National Income |
|-------------|---------------------------------|
| 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: Caizhengbu (1985: 15, 152); Lardy (1978: 41).

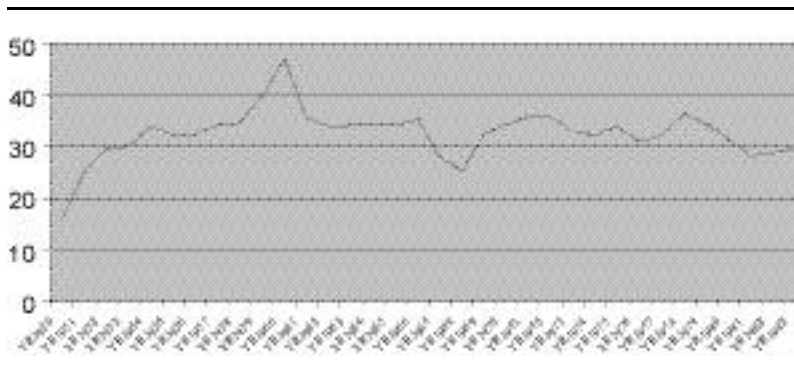


Figure 1: Government Revenue As % of National Income 1950-1983

SOURCE: Caizhengbu (1985: 152-53).

foundations for the upcoming socialist transformation had the Communists failed to develop larger revenue streams.

How was the new regime able to achieve what the preceding regimes had failed to achieve? This question is especially intriguing because by 1953, the PRC had not yet brought industry and commerce

under state or collective control. Presumably, a centrally planned economy is good at extraction because it has small numbers of relatively large economic entities to monitor and because the state owns or controls the firms and appoints their managers. But in 1949-1953, the PRC did not have a full-fledged centrally planned economy. The private sector, though shrinking in relative size, still accounted for a large portion of the national economy. Thousands of private firms and millions of handicraftsmen and shop owners were still in business. In fact, the socialist transformation, which would begin in 1955 and end in 1957, did not substantially increase the share of state revenue in the national income. Until the start of the reform era in 1978, the share of state revenue in national income generally fluctuated between 30% and 35%, roughly the level reached in 1953 (Caizhengbu, 1987: 15, 152, 156). Socialist reconstruction of industry and commerce, therefore, does not explain the PRC's strong extractive capacity because the largest changes had already occurred.

This article takes on the questions of how this new regime was able to do what its predecessors and its Third World counterparts could not. I focus on Wuhan, central China's largest city, during 1949-1953, the crucial phase of PRC state building. Given that the basic mechanism for raising revenue used in Wuhan was also employed elsewhere, this case study sheds light on the general question of PRC government resource extraction. First, I provide a theoretical framework for analyzing the institutional conditions of strong extractive capacity. Then I identify the major sources of budget revenue in those years and examine constraints on the new regime. In the article's final two sections, I review the means by which the state secured tax collector and taxpayer compliance.

EXPLANATORY FRAMEWORK

The literature on state extractive capacity focuses too heavily on the level of extraction states achieve and too little on what mechanisms the state uses to extract resources from society.³ In the final analysis, the extractive capacity of a political system depends on whether the system can develop a set of sound institutions to tax society. Extractive capacity cannot be strengthened unless the tax rules are unambiguously

defined and unwaveringly enforced; the tax collectors are properly staffed, trained, organized, and disciplined; taxpayers are located, placed on the rolls, and their returns adequately audited; other governmental agencies are in full cooperation with the tax administration in enforcing tax rules; taxes due are collected; and penalties are properly applied (Surrey, 1958). For this to be done, however, the state has to be able to act autonomously and coherently. It must, therefore, insulate its bureaucracy from capture by special interests.

TAXPAYER COMPLIANCE

Ultimately, the extractive capacity of a government depends on the extent to which it procures taxpayer compliance. Widespread compliance provides the state with sufficient revenues. If tax evasion becomes widespread or, worse yet, a national pastime, on the other hand, the state will likely not make ends meet.

Taxpayer compliance has always been a problem for the state regardless of taxpayers' general attitude toward their government. Of course, if citizens view their government as legitimate, tax collection is easier (Webber and Wildavsky, 1986: 33). But legitimacy cannot solve the free-rider problem. A person who supports a regime politically may well seek to receive benefits without incurring costs (Levi, 1988: 48-50).

The Chinese Communists came to power with overwhelming popular support and were therefore in a position to promote citizen cooperation with their measures. Other things being equal, such popular support would enable the new regime to create taxpayer compliance at relatively low cost. This, however, would not eliminate taxpayer incentive to minimize tax payments. To maximize revenue, the new regime thus had to find ways of reducing tax evasion and avoidance, just as governments in other periods and in other countries have had to do.

Since voluntary taxpayer compliance is normally unattainable, states create compliance by establishing monitoring and enforcement institutions. A monitoring system is necessary because taxpayers tend to have incentives to withhold or misrepresent information about their economic situations. To bring about taxpayer compliance, the monitoring system has to be able to perform three functions. First, it should

be able to identify those who are supposed to pay taxes. Simply registering potential taxpayers is the vital first step in effective tax administration. Second, it should be able to obtain the information needed to assess taxpayers' tax burdens. Only with such information can the state determine how much each taxpayer owes. Third, it should be able to detect noncompliance. It is important for the state to identify those who meet their obligations and those who do not. Otherwise, honest taxpayers would feel they are "suckers," and their perception of exploitation would make them unhappy about their taxes and less likely to pay in full. In other words, a deficient monitoring system not only allows dishonest taxpayers to evade taxes but also encourages initially compliant taxpayers to reconsider their compliance.⁴

By itself, however, the monitoring system cannot ensure taxpayer compliance. There are always some taxpayers who would not comply without coercion. The taxpayer monitoring system has to be accompanied by an enforcement system. Left unpunished, non-compliant taxpayers have a "demonstration effect" on others, which would likely lead to even more widespread noncompliance. To bring about compliance, the state has to make the noncompliant action less attractive than the compliant action. Only if taxpayers believe that they will be caught and that punishment will be imposed will there be any deterrent effect. Furthermore, only when the cost of evading taxes is sufficiently high are the incentives to evade taxes dampened.⁵ How high is sufficiently high? This question can only be answered in practice. Certainly, little overall deterrent effect will be accomplished if only interest or nominal fines are collected. The public must witness the serious attempts of the administration to punish tax evasion. Sanctions, including seizure of property or jail sentences for tax cheaters, may be necessary to produce a strong deterrent effect (Gordon, 1990), but in any event, people must be penalized if they fail to pay their taxes, underreport taxable material, do not pay their taxes on time, or, more generally, refuse to cooperate with state taxation authorities. Enforcement institutions make credible the penalties for tax avoidance, evasion, arrears, and other noncompliant behaviors.

Building monitoring and enforcement institutions and carrying out monitoring and enforcement are essential, but they are not cost free. If taxpayer compliance costs are so high that further revenue extraction is no longer profitable, it makes little sense for the state to further

expand monitoring and enforcement. Ideally (from the point of view of the state builders), the state stops pushing for a higher degree of compliance at the point when marginal revenue equals marginal cost (Goode, 1990). Of course, it is impossible to precisely 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. Later, we will see that this was what the Communist government did in the early 1950s.

The above discussion assumes that the state has the will to enforce the tax laws. In reality, this is not always the case. In many developing countries, state extractive capacity is low because the tax burdens bear unduly on those least able to support it, while the rich are so powerful that the state has to somehow tailor the tax laws to their interests or/and turn a blind eye to their evasive behaviors. Thus, the relative autonomy of the state becomes one of the political preconditions for strong extractive capacity. Without a degree of autonomy from dominant social classes and from highly mobilized political groups, the state can hardly formulate its own preferences, much less impose its own agenda on society.

The Nationalist government lacked such autonomy. Though the Nationalist regime knew of ways to increase government revenues, it never seriously attempted to implement them because, according to Arthur Young, an adviser and supporter of the regime, “ruling circles (landholding, business and military elements) either nationally or in the provinces” lacked the desire to see state extractive capacity developed (Young, 1970: 117). By the early 1950s, however, war and revolution had so decimated China’s old social structure that no social group was in a position to challenge the new regime. The new regime in effect could use whatever means it saw fit to pursue its goals. Indeed, as will be shown below, the tax authorities of Wuhan were able to overcome societal resistance and enforce taxpayer compliance with relative ease.

TAX COLLECTOR COMPLIANCE

The state, of course, relies on tax collectors to monitor taxpayers’ behavior and enforce tax law. The tax collectors, however, may not be

willing or able to act in the state's best interests. For the monitoring and enforcement systems to be effective, the state has to ensure that tax collectors are competent and incorruptible.

Tax collectors have to learn how to monitor taxpayers' behavior. Since taxpayers are interested in minimizing their taxes, they will evade taxation by concealing assets whenever they can. Such evasion will succeed when tax collectors are unable to adequately measure taxable assets. Even experienced tax collectors have trouble detecting evasion when taxable assets are mobile or vary over time (e.g., indirect taxes). Incompetent tax collectors thus can at best tax only a fraction of available revenues.

Even if tax collectors are largely competent in their jobs, they may have no strong incentive to maximize state revenues by strictly enforcing tax law. To minimize the tax they pay, some taxpayers may use bribery to get lower tax assessments when they find that tax collectors have strong monitoring ability. Tax collectors, on the other hand, may have incentive to accept bribes and embezzle funds since their income is increased without any countervailing loss. In such an environment, tax fraud cases would be hard to establish, and tax evasion would become rampant. As a result, the government would likely suffer a substantial loss in revenue. When corruption is rife, conventional evasion-counteracting policies (lowering tax rates, enhancing detection, and increasing penalties) become ineffective (Chu, 1990). The best defense against tax evasion, then, is to combat corruption (Shu, 1992).

The state must find ways to obtain compliance not only from individual tax collectors but also from tax-collecting agencies. Those agencies are supposed to be central decision makers' tools with no preferences or interests of their own. Their mission is to mobilize revenue at the direction of the central authorities. But over time, such agencies may gradually develop their own identities and become aware of their own interests, interests distinctive from others, including their overlord—the center. Such growing consciousness of self-interest in turn may foster a desire among those agencies to retain a growing share of the resources they mobilize in the name of the state. When each tax-collecting agency strives for control over more resources to pursue its own aims, the state's effective extractive capacity is weakened. To maximize its control over extracted resources, the state thus

must gain or sustain the institutional cohesiveness of the state bureaucracy.

Even though the Nationalist government made some effort to overhaul its civil service system, as Arthur Young, a Nationalist adviser, observed, "little was accomplished and plans were mostly on paper" by the time the Sino-Japanese War broke out in 1937 (Young, 1971: 159). There were sincere and loyal men working in the government, but most officials simply used their positions to advance personal interests.⁶ Not only was corruption common among individual tax collectors, but the system also allowed tax agencies as corporate entities to "squeeze" the people beyond formal taxes, which led to "the all too common practice of official rapacity" (Young, 1971: 13). Furthermore, this combination of corrupt and extralegal collection encouraged a climate of tax avoidance.

By contrast, in the early 1950s, PRC state officials were generally considered "clean." The fiscal "drain" from corruption thus was significantly reduced. Moreover, newly established state agencies then were still too young to have developed 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.

MAIN SOURCES OF REVENUE

During the Nanjing Decade (1927-1937), the Nationalist regime's "golden years," customs duties and the salt tax were the financial pillars of the central government. The Chinese customs had been administered since 1854 by Chinese and foreign officers under British leadership. Prior to 1928, nearly all customs receipts were used to repay foreign loans or to pay the Boxer Indemnity. The Nationalist government was able to secure full tariff autonomy in 1928. The regime soon introduced higher tariff rates, and customs revenues rose dramatically.⁷ Between 1929 and 1937, customs duties were the largest single state revenue source, several times providing more than half of total state revenues. The salt tax provided roughly a quarter of the revenue after 1929.⁸ Together, these two sources accounted for more than 85% of total revenues for five years in the nine-year period from 1928 to

TABLE 2: The Share of Customs and Salt Tax in the Total Revenue of the Nationalist Government (in percentages)

| <i>Year</i> | <i>Share</i> |
|-------------|--------------|
| 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 (1985: 44-47).

1936 (see Table 2). At the provincial level, land taxes provided more than half of total revenues (Yang Yinpu, 1985: 82). The salt tax and land tax were traditional taxes, and customs duties were relatively easy to collect. That the Nationalist government relied heavily on those three sources for its revenue was an indication that it was incapable of tapping other domestic resources and its extractive capacity was weak.⁹

From the beginning, the PRC government sought new sources of revenue. In its consolidated budget, which included revenues at all levels of government, the shares of the customs, salt, and agricultural taxes all declined markedly during 1949 to 1953. By contrast, “profits from state enterprises”¹⁰ and “industrial and commercial taxes” expanded steadily, becoming the two most lucrative sources of revenue for the government. This development of new revenue streams greatly expanded the government’s income and permitted the undertaking of new projects. The absolute size of the public sector more than tripled in the four years between 1950 and 1953 (see Table 3).

Wuhan shared in this dramatic growth of receipts from “profits from state enterprises” and “industrial and commercial taxes” (see Table 4). Wuhan had a few state enterprises, so despite the rapid expansion of the absolute size of “profits from state enterprises,” the portion it occupied in Wuhan city revenues was considerably smaller

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 |
| Other income (%) | 15.5 | 10.6 | 10.9 | 7.8 |
| Total (%) | 100.0 | 100.0 | 100.0 | 100.0 |

SOURCE: Caizhengbu (1985: 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) | 187.10 (100) |

SOURCE: Wuhan tongjiju (1989: 386-87).

NOTE: Percentages are in parentheses.

than in the national budget. Most state enterprises were concentrated in the northeast and Shanghai.

“Industrial and commercial taxes” were primarily responsible for the growth of Wuhan government revenues. These taxes included more than a dozen different taxes. The three most important of these were the gross receipts tax, the net income tax, and the 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 after deducting operation costs, and the excise tax on the sale of specific commodities.

Space constraints prevent me from dealing with all the four main sources of revenue for the new regime in Wuhan and nationally (i.e., “profits from state enterprises,” the excise tax, the gross receipts tax, and the net income tax), so I will use the collection of the gross receipts tax and the net income tax in Wuhan to explain how the new regime was able to rapidly raise revenues and expand the state’s share of the national economy. This focus is dictated by three concerns. First, at the time, these two taxes 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% of total revenue, contributing more to the budget than any other single tax. The government regarded them as the most important sources of income. Second, the expansion of the state sector was based on increasing government financial resources. Without receipts from the two taxes, the government might have had much less capital to invest in state enterprises, which would mean much fewer “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.¹¹ An investigation of the collection of these two taxes is therefore 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 was relatively easy and inexpensive, the collection of the gross receipts tax and the net income tax required institutional innovations to create taxpayer compliance. Contemporary publications reveal that local authorities devoted more time and energy to the collection of these two taxes than to the collection of all other revenues. The collection of the gross receipts and net income taxes thus was most important and challenging.

CONSTRAINTS ON THE NEW REGIME

When the Communists took control, several constraints challenged their ability to compel taxpayer compliance. The most important of

TABLE 5: Private Enterprises, Wuhan, 1949-1953

| | <i>Number of Enterprises</i> | <i>Number of Employees</i> | <i>Capital (million)</i> |
|------|------------------------------|----------------------------|--------------------------|
| 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 gongshang xingzheng guanliju (1986: 160).

these constraints were the multitude and small scale of businesses and the weak tax collection apparatus they inherited from the Nationalists.

For obvious reasons, it would be relatively easier to collect taxes from large state-controlled enterprises than from small privately held ones. Up to 1953, however, there were only 532 state enterprises, 31 joint state-private enterprises, and a few hundred cooperative enterprises in Wuhan. The larger 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 had 8 or fewer workers and were capitalized at less than 3,500 yuan. Only 571 were categorized as “modern factories.” Even these averaged only 36 employees and capitalization levels under 100,000 yuan. As for commercial enterprises, few had more than 4 employees and 4,000 yuan in assets (Wuhan gongshang xingzheng guanliju, 1986: 158). As Table 5 indicates, this situation did not 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 scattered all over the city.

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 nearly illiterate. Given the small size of their businesses, it made little sense for them to spend much, if any, time on their accounts. Those who did keep accounts more often than not used traditional ways of bookkeeping in which profit, spending, and borrowing were mixed up. Even professionally trained tax collectors might not be able to decipher them (Changjiang ribao, 18 September 1950). With accounts such as

these, it was next to impossible to establish the gross receipts and net earnings of these economic entities.

The ability and integrity of tax collectors were also problematic. In May 1949, right before Communist forces took 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. The new Communist regime retained 580 of these. Among them, 116 were Nationalist Party members, and 60 were members of the Nationalist youth organization. The majority came from nonproletarian family backgrounds (Changjiang ribao, 7 November 1949).

Though it felt a need to retain some of the Nationalist-era officials, the new regime did not trust them. As a result, 180 Communist cadres and pro-Communist students and workers were assigned to leading posts in various tax collection agencies (Wuhan difangzhi bianzuan weiyuanhui, 1992: 258). An awkward combination of old and new tax collectors was produced. The retained personnel were relatively well educated (all had at least junior high education and some had college degrees) and were experienced. Many, however, were corrupt, since accepting bribes and colluding in tax evasion were common in Nationalist-era Wuhan. Moreover, many of these holdovers were not fully supportive of the new regime. In contrast, the Communist cadres assigned to the agencies were dedicated to the new regime and had not been corrupted but generally lacked formal education and tax collection experience (Changjiang ribao, 13 September 1949, 13 May 1950). Developing taxpayer compliance required the new government to make individual tax collectors competent in their job 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 with the inherited Nationalist tax collection agencies was to merge them into a single new structure. The Wuhan Municipal Tax Bureau formed the core of the structure. It supervised 5 branches in the five city districts, 37

neighborhood subbranches of the city,¹² and 27 check stations at river ports. During the Nationalist era, tax collection agencies were top-heavy, with large percentages of their employees working in head-quarter offices rather than in direct field collection. The new government transferred half these office workers to the subbranches and check stations (Wuhan difangzhi bianzuan weiyuanhui, 1992: 247-53). This three-tier network under centralized control enabled the Communists to penetrate much deeper into Wuhan society than the Nationalists had managed.

The new regime wanted to staff its new organizational structure with a new kind of tax collector, one who combined the strong points of the retained Nationalist-era officials and the Communist cadres without their respective deficiencies. Tax bureau leaders encouraged the officials to learn from and help each other. Nationalist-era hold-overs were supposed to accept the new officials' ideological strengths, and the newcomers were to acknowledge the veterans' training and experience. The relationship between the two groups was by no means equal since the revolutionary cadres assumed leadership posts. A political indoctrination program for the retained Nationalist-era officials was established on the day the Communists took control of the tax collection agencies. In study sessions, every retained official was required to detail his political history and reveal any past corrupt practices he had engaged in. They were exhorted to be honest in serving the new regime and to show respect for the revolutionaries who had joined them. To vividly demonstrate that a new order had been established, the government temporarily demoted each retained official to the lowest rank and announced they would not be promoted (or reinstated to their previous ranks) until they had proved that they were both politically and professionally qualified (Changjiang ribao, 13 May 1950).

At the same time the retained officials were compelled to remold their ideologies, revolutionary cadres were urged to improve their professional skills. Training classes were organized within the tax units, and some retained officials were asked to teach the newcomers the basics of calculation with an abacus, accounting, and tax law. Later, the newer officials were sent to special schools or colleges for intensive training. By the end of 1953, 437 out of about 1,500 Wuhan's new tax officials had received some kind of training (Wuhan difangzhi bianzuan weiyuanhui, 1992: 259).

A far more serious challenge for the new regime was how to stamp out chronic corruption among tax collectors. Corruption damaged the Nationalist government's extractive capacity in two ways: taxpayers reduced their payments through bribes, and tax collectors embezzled tax receipts. As corruption became more and more widespread, the difference between the taxes imposed on the people and the revenue collected by state budget grew larger. The result was devastating to the Nationalist regime: the people's tax burden increased, but the government was forever starved for revenues.

The Communist government was determined to fight this endemic corruption. Its prevention was a key concern of the regime's ideological education. Anyone found guilty of corruption was subject to severe punishment. In addition to routine checks, the government periodically launched political campaigns against corruption. In mid-1950, Wuhan tax collectors went through a two-month rectification campaign. In December 1951, the national government launched a campaign against the "three evils" of corruption, waste, and bureaucracy and made tax collection agencies one of the campaign's focal points. Under enormous political pressure, about 200 of Wuhan's tax collectors confessed to having been involved in corruption of some sort. This investigation could have reassured the regime for, altogether, these 200 officials had misappropriated just 3,700 yuan, or an average of less than 20 yuan per person. This low figure indicates that corruption was no longer a serious problem (Changjiang ribao, 14 January 1952, 22 February 1952). The government, however, could not tolerate even such minor misconduct. In 1953, it initiated yet another nationwide campaign to specifically review tax collectors. In Wuhan, 59 tax collectors were caught and punished (Wuhan difangzhi bianzuan weiyuanhui, 1992: 262).

The efforts discussed above, of course, did not make all of Wuhan's tax collectors both "red" and "expert." Nevertheless, by making new officials more technically 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 had managed. The new regime's reorganization and reorientation of tax collection agencies significantly reduced the revenue leaks caused by corruption and the

wastes caused by organizational inefficiencies, thus increasing the new regime's extractive capacity.

THE CREATION OF TAXPAYER COMPLIANCE

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

MONITORING

It was not easy to identify all those who were obligated to pay the gross receipts tax and the net income tax during 1949 to 1953. Most businesses were small, and many small businesses did not bother to register with the government. Moreover, the economic situation in those years was extremely volatile, going through a number of mini-booms and minirecessions. These cycles meant that there were a great number of firms entering into and exiting from business, making it difficult and expensive for tax authorities to keep track of who was in and who was out. One way to cut such administrative costs was to rely on 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 (Rowe, 1984: 252-340).

At the time the Communists assumed control of the tricity of Wuhan, there were 181 guilds in Hankou, 87 in Wuchang, and about 30 in Hanyang. Individual guilds could have anywhere from a few dozen to several hundred member firms. Guilds were divided into two categories: industrial and commercial. In each of the three parts of the city, there were a regionwide industrial council and a regionwide commercial council, which supervised local industrial and commercial guilds. This existing guild structure 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 four, guild organizations were used as tax agents. The first campaign, for example, started on 20 June 1949 and aimed to collect 128,000 yuan by 15 July. 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 (Changjiang ribao, 20 June 1949). This complicated procedure involved many rounds of bargaining but was probably the only method of identifying taxpayers that did not require the government to actually know who was doing business where. The newly established Communist-led government did not have such knowledge. Therefore, this was a rational solution to the problem of gathering revenue. By levying taxes on the industrial and commercial community as a whole rather than on individual taxpayers, the government left 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, others had to pay more than their share. The clash of conflicting interests thus could automatically lead the guild to identify all taxpayers in its trade.

The new regime made effective use of this tax collection method. When the Nationalists collected the net income tax in Hankou for the

last time in the second half of 1948, only 11,632 firms in 135 trades paid. In the first PRC tax collection campaign, however, 19,488 firms in 179 trades paid the net income tax. By the time of the third campaign (from 27 November to 18 December 1949), the number of firms paying the net income tax increased to 23,313 in 207 trades. This increase of the number of taxpayers was an important factor that contributed to the growth of the government revenue in Wuhan (Changjiang ribao, 19 April 1950).

2. Identifying Taxpayers through Neighborhood-Based Organizations

Identifying taxpayers through guild organizations, while an effective short-term solution, had three drawbacks. First, many taxpayers were not guild members. No guild included every practitioner in the trade. A survey of 1950 found that about 3,000 firms that were supposed to belong to guilds did not belong to any guild and thus had evaded payment of the gross receipts tax and the net income tax in 1949 (Changjiang ribao, 11 November 1950). In addition, some lacked a guild to join. For example, there was no guild for Wuhan's more than 30,000 street peddlers (Changjiang ribao, 2 March 1950). Moreover, in some trades, guilds existed in name only, with no actual authority over their members. About 2,000 tailors and chicken traders "belonged" to such a guild (Changjiang ribao, 12 September 1950).

Second, relying on guilds works best only when the government assigns a tax quota to each guild. But what the guild pays to the government in this method is not a tax in the modern sense but a contribution. This kind of extraction, while providing revenue to the government, cannot perform the economic, social, and political functions that 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 notion 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 and usually did not know much about each other's business. How much of the guild's tax

quota a member firm shouldered depended to a large extent on its skill in concealing information as well as its bargaining power. Guild members thus might end up paying different tax rates. And it was likely that two neighboring firms belonging to different trade guilds paid taxes at substantially different rates.

Third, guilds were traditional groups that had once filled the power vacuum left by the collapse of the city government in the early Republican years (Rowe, 1984: 334). Although they cooperated with the new regime, they nevertheless had the potential of becoming independent power centers. Consequently, the Communist regime planned to weaken and eventually eliminate them.

For those reasons, the government began to gradually replace guild organizations with neighborhood-based organizations in June 1950. Each of the five administrative districts of Wuhan was divided into four or five "tax areas" (*pian*). Within each area, every fifteen neighboring firms formed a "small tax group" (*xiaozu*), five to seven small groups formed a "large tax group" (*dazu*), and two to four large groups formed a "tax section" (*duan*). No firm was left unattached. This system had several advantages over the guild-based system. Neighboring firms (competitors) probably knew each other's business well so that concealment of assets and income was more difficult. Also in this four-tier system, the three lower tiers were run by the businessmen themselves rather than by state officials, which meant that the government 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 subbranch of the Municipal Tax Bureau, which was responsible for business registration, tax assessment, tax audit, tax collection, and, above all, coordination and supervision of the lower tiers of the new system within the area. The small groups, large groups, and sections were the subbranch's tax collection instruments (Changjiang ribao, 27 July 1950; Wuhan difangzhi bianzuan weiyuanhui, 1992: 195). Altogether, 30 areas, 98 sections, 171 large groups, and 1,809 small groups were established in the city in 1950 (Changjiang ribao, 10 August 1950).¹⁵

While creating neighborhood-based organizations, the new regime did not immediately abandon guild organizations as instruments of economic monitoring and control. For at least a year and a half, guilds supplemented the work of the neighborhood-based organizations.

These two systems left the government 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 already possessed fairly rich knowledge about taxpayers.

ASSESSMENT¹⁴

By using existing communal institutions and creating new ones 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 but also by institutions that monitor who pay their dues in full. Without the latter institutions, dishonest taxpayers would be able to evade taxes, and honest taxpayers might think themselves “suckers” (Levi, 1988: 53).

In 1949, Wuhan’s government believed that more than 90% of the city’s firms did not keep systematic accounts at all, and among those who did, more than 90% of their accounts were not reliable (Changjiang ribao, 4 April 1950). 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. What it did, instead, was to apply a second-best solution to the problem of tax assessment, an interim solution.

As noted, in the three 1949 tax collection campaigns, taxes were levied on guilds, which then devised their own means of allocating shares to their members. This method did not require the government to know the 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 such taxes should be levied on individual firms rather than on guilds. As a result, in April 1950, when the Wuhan government began to collect the first quarter’s gross receipts tax and the net income tax, it needed to introduce a new way of collection. Firms were divided into three categories, for which the methods of collection were different.

Firms whose records were reasonably sound made up the first category. They were permitted to file their own tax returns, subject to audit by the local tax bureau. These tended to be large firms. Indeed, the

larger the firm, the more sophisticated its organizations and the more difficult it was to systematically evade taxes. A total of 158 firms in 19 trades qualified for this treatment. They accounted for only 0.4% of the total number of firms in the city but paid more than one-tenth of the total of the gross receipts tax and the net income tax (Wuhan difangzhi bianzuan weiyuanhui, 1992: 199).

Firms having no records at all constituted the second category. Each of these firms was required to pay a fixed sum for both the gross receipts tax and the net income tax. The allotment was determined by the tax bureau according to its one-time estimate of the size of the firm's business. The fixed sum would not be changed unless this trade noticeably improved or deteriorated. More than half of the firms in Hankou, most firms in Wuchang, and all firms in Hanyang fell into this category. However, their payment 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 mostly very small firms (Changjiang ribao, 6 April 1950).

Firms with inadequate records fell into the third category. A special procedure of tax assessment, called "democratic appraisal of taxes," was applied to such firms. This procedure was "democratic" in that the determination was the result of discussion among individual taxpayers, the guilds (or the small tax groups) concerned, and the tax authorities (Ecklund, 1966: 36). When the new collection method was first introduced in the spring of 1950, the procedure comprised three steps. First, the tax bureau estimated 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, 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 were 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 (Changjiang ribao, 16 July 1950).

Of the three steps, the first was crucial and 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 for three months (Changjiang ribao, 16 July 1950). Obviously, local tax authorities could not afford to undertake

this kind of survey on a regular basis. Moreover, many taxpayers protested that tax bureau estimations were often arbitrary (Changjiang ribao, 26 September 1950).

In the second half of 1950, the Wuhan tax authorities modified the democratic appraisal procedure. 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) to which it belonged for comments. Third, if 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 estimate of the firm's gross receipts and net income. Finally, the tax bureau decided if the guild's estimate was acceptable.

Some firms complained, with justification, that the modified procedure "incite[d] businessmen to undermine each other." 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 apply its scarce staff resources elsewhere (Changjiang ribao, 16 August 1950). 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 less in tax than they would have otherwise (Changjiang ribao, 27 August 1950).

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 their firms' sales and profits. After trade unions were established, unions were given an important role in evaluating their firms' self-assessments. Many workers, especially those in weaker companies, believed they had a stake in minimizing their firms' tax payments and were not enthusiastic about carrying out this monitoring. Nevertheless, a large number of workers cooperated with the government. These activists provided invaluable information, enabling tax officials to enforce compliance among private businessmen (Changjiang ribao, 25 April 1950, 8 September 1950, 11 March 1951). Second, the tax bureau used its staff to conduct selective audits. Firms found to have engaged in tax falsification and

evasion were to be fined three to ten times the amount of tax they were believed to have evaded. Furthermore, 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 bill was to be increased (Changjiang ribao, 4 December 1950). Surveillance by workers and the threat of audits caused private businessmen to think twice before attempting to underreport their taxes. Such measures improved the efficacy of the democratic appraisal of taxes.

This "democratic" assessment was used to determine what roughly 40% of Wuhan's firms owed in taxes. Revenue from these firms probably accounted for 80% of the total gross receipts and net income taxes collected in Wuhan. This accounts for why local tax authorities devoted considerable energy to implementing and perfecting the procedure (Changjiang ribao, 16 July 1950).

These three methods of tax assessment might seem clumsy compared with those used in more economically advanced countries, but given the limitations in bookkeeping and administration, their combination might have been 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.

Despite their usefulness, the government, from the very beginning, regarded the democratic appraisal and the imposition of fixed quotas as expedient measures. Its goal was to eventually base its taxation solely on full and reliable records rather than on estimates. Toward this end, even as it used these three interim methods to collect taxes, the new regime invested considerable resources working to introduce uniform accounting methods throughout the city.

Wuhan's government launched its first "account building" (*jianzhang*) drive in the second half of 1950. A municipal commission of account building was formed to coordinate the drive. Hundreds of firms were selected as experimental units and 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 (Changjiang ribao, 18 September 1950). Moreover, the Municipal Association of Industry and Commerce, the citywide guild alliance, was asked to start literacy and

accounting training programs for small businessmen. Tax offices were also required to help enterprises set up and improve their financial and accounting systems (Changjiang ribao, 27 July 1950). Without such state intervention, it might have taken decades to develop a uniform accounting system. The forced drive sponsored and dictated by the new regime, however, accelerated the process. By the end of 1950, more than 4,000 firms, or one-fifth of Wuhan's firms, were keeping records in accordance with the new standards. Two years later, the proportion of firms adhering to the standards increased to about two-thirds (Wuhan difangzhi bianzuan weiyuanhui, 1992: 201).

As more and more firms established formal and standardized accounting practices, the local tax authorities began to permit more taxpayers to file their own tax returns. The number of firms that did so increased from 158 in 1950 to 2,700 in 1953, by which time their tax payments accounted for 65% of the total (Wuhan difangzhi bianzuan weiyuanhui, 1992: 199). Those firms no longer needed to go through the bothersome democratic appraisal, though they were still subject to audit by tax offices.

ENFORCEMENT

In 1950, the main Wuhan newspaper reported that the Republican-era government was only able to collect one-third of the taxes it should have collected (Changjiang ribao, 19 April 1950). At that time, many held that tax evasion was an "incurable social disease." Instead of accepting tax evasion as a normal and inevitable feature of the fiscal system, the PRC government was determined to fight it. The development of monitoring institutions enabled the government to identify taxpayers and to assess their tax payments. These monitoring institutions had to be accompanied by efficient enforcement institutions. Only when the potential cost of tax evasion was sufficiently high and the likelihood of detection sufficiently certain would the incentive to evade taxes be dampened. Only through practice, however, could the "sufficiently high" and "sufficiently certain" points be ascertained.

At the outset of its reign, the socialist regime did not use severe punishments to deter noncompliance. In its first tax collection campaign of 1949, the deadline for tax payment was set for 15 July. The city government proclaimed that whoever was delinquent would be fined. On

15 July, 7% of the city's firms still had not paid their dues. The tax bureau issued oral warnings but at the same time extended the deadline four days. Twenty-seven guilds missed that deadline, too. They then were asked to pay a fine of one-tenth of the tax due (Changjiang ribao, 23 July 1949). But given that the monthly inflation rate was more than 50%, the fine carried no punch (Wuhan jingji yanjiusuo, 1989: 32-33).

In early 1950, the effective fine for overdue tax payments was increased to 3% for each day the payment was delinquent. The clear and increased standard was necessary because the later two collection campaigns of 1949 showed that when the fine rate was lower than the inflation rate, taxpayers elected to pay fines in cheapened currency rather than pay their taxes on time (Changjiang ribao, 9 April 1950). However, soon after the increase of the fine, Wuhan and the rest of the nation experienced a minirecession. To stimulate the economy, the government softened its tax policy. Taxpayers were allowed to delay their payments of taxes for the first quarter of 1950 for three months. They were also told that if they still had financial difficulties, they could negotiate with tax offices about possible tax reduction and exemption (Changjiang ribao, 26 September 1950). Altogether, 700,000 yuan of taxes were remitted (Changjiang ribao, 22 January 1951). This shows that the new government was quite flexible in its taxation policy. It treated taxation not as a goal in itself but as a tool serving the overall development of China.

The policy change, however, produced an unexpected result: many taxpayers no longer took their obligations seriously, and some even went so far as refusing to pay any taxes at all. The taxes for the second quarter of 1950 were supposed to be paid off before 31 August, but as late as 20 September, only 38% of firms had paid in full, and about 5,000 firms had not paid a cent. 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" (Changjiang ribao, 26 September 1950).

The quiet tax revolt alarmed the authorities. In mid-October, they decided to revoke the business licenses of firms that had owed the government taxes for more than a month. Such firms were given fifteen days to pay their overdue taxes and fines. If they met the deadline, they were to get their licenses back; if they failed to do so, the govern-

ment would confiscate part of their properties to pay their debts (Changjiang ribao, 16 October 1950). This threat did not immediately produce the desired effect. A month later, some 4,000 firms had still not paid their taxes (Changjiang ribao, 11 November 1950). To make credible the penalties for noncompliance, the government sealed up and confiscated the properties of a number of firms in late November (Changjiang ribao, 21 November 1950, 23 November 1950). It was hoped that the punishment of a few would serve as a warning to the many (Changjiang ribao, 19 December 1950). The crackdown was effective. In 1951, the lack of news reports about tax delinquency suggests that few business owners dared to delay paying their taxes.

Two famous campaigns, the “three-antis” campaign and the “five-antis” campaign, were launched at the start of 1952. Both campaigns targeted tax evasion. About 70% of Wuhan’s business owners yielded to the pressures of the day and admitted that they had engaged in some form of tax evasion (Wuhan jingji yanjiusuo, 1989: 54-57). One may expect that so intensive a crackdown would have eliminated non-compliance. Ironically, however, there was marked rise in delayed tax payment and various forms of tax evasion in Wuhan after the campaigns. At the end of 1952, overdue tax payments amounted to 4.6 million yuan, which was equivalent to 4% of the total tax revenue (Changjiang ribao, 17 June 1954). Several factors may account for this. Many owners may have anticipated the elimination of private ownership and thus may have used every possible subterfuge, including tax evasion, to acquire as many liquid assets as possible (Ecklund, 1966: 42). In the minirecession caused by the three-antis and five-antis campaigns, many private enterprises were suffering genuine financial difficulties and hence were not able to pay tax. And the campaigns themselves may have kept businesspeople too busy to keep proper accounts and tax officers too busy to keep track of their accounts, which made it easier to evade taxes (Changjiang ribao, 8 January 1953).

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. *Yangzi Daily* (Changjiang ribao), a local newspaper, reported two dozen such arrests. Offenders were sentenced to prison sentences of two months to three years. In most cases, verdicts were pronounced

at public meetings, which hundreds or even thousands of private businesspeople were “invited” to attend. Occasionally, after the sentencing, one or two alleged tax evaders among the audience were singled out and arrested on the spot. Such dramatic scenes must have had a great psychological impact on those witnessing them. Some paid their overdue taxes then and there, and more made public promises to pay (*Changjiang ribao*, 3 January, 26 September, 24 October, 11 November, 21 December 1953; 14 January 1954). Probably no Wuhan businessperson could avoid being “invited” to such meetings. These meetings put every potential Wuhan taxpayer on notice that he could be the next target if he continued to try to outsmart the tax authorities.

From oral warning to pecuniary fine, from small fine to substantial fine, from fine to revocation of business licenses, from revocation of licenses to confiscation of property, and from confiscation of property to imprisonment, the Communist Party–led state steadily increased the costs of noncompliance in the early 1950s. As noncompliance became rare, 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. While criminal penalties did have the effect of finally breaking the back of lingering tax resistance, it does not follow that the government’s earlier efforts in building monitoring and enforcement institutions were inconsequential. In fact, before the three-antis and five-antis campaigns, mass evasion had already been reduced to much below the pre-1949 level. Only in such a favorable environment could criminal sanctions be effective. Had the government begun to use tax prosecutions when almost everyone was evading tax, harsh sanctions might have backfired. In any event, without the support of functioning monitoring mechanisms, severe sanctions might often hit wrong targets and thereby become politically too unpopular to enforce.

LESSONS FROM THE PRC EXPERIENCE

In the 1950s, after examining the taxation systems of several developing countries, Nicholas Kaldor (1963) concluded that there were no

intrinsic obstacles to raising the rate of government fiscal extraction. Few countries, however, adopted his advice. Later, Kaldor published an essay whose title reflected his frustration with the inability of governments to follow his prescriptions: "Will Underdeveloped Countries Learn to Tax?" (Kaldor, 1963). The case of China shows that Kaldor was both right and wrong. He was certainly right that there were no inherent obstacles to increasing taxation. Otherwise, it would be hard to explain how the new regime could extract resources so much more efficiently than its predecessor—even while the urban economic structure remained more or less the same. But Kaldor clearly underestimated the political impediments to building a strong extractive capacity. For many systems, the problem is not that they are unwilling to learn to tax. Rather, the problem is that institutional constraints limit their ability to obtain compliance from both tax collectors and taxpayers. Such institutional constraints can be altered only under certain favorable political conditions.

This brief account tracks the successful evolution of institutional forms that permitted the rapid growth of the PRC state's extractive capacity. Three conclusions can be drawn from the preceding discussion.

First, institutional innovations allowed the new regime to substantially increase its extractive capacity. Institutions work through establishing and implementing rules. By guiding, obligating, commanding, prohibiting, penalizing, licensing, and facilitating, such rules raise the potential costs of certain actions and also reward other actions (Knight, 1992: 67). By altering people's relative payoffs and hence their relative preferences, institutions effectively limit people's choices, thus encouraging them to behave in particular ways. Compelling tax collectors and taxpayers to behave in the state's interest allowed the concentration of resources rather than having them spread about in minute amounts (Hardin, 1989). Of course, institutions are not uniformly effective. This study suggests that defects in institutional arrangements during the Republican era might be responsible for that state's inability to extract resources. By contrast, the new Communist-led regime adapted, co-opted, and created a diverse array of institutions into a system that effectively trained and disciplined tax collectors and obtained taxpayer compliance.

Second, state building involves not only dramatic acts such as political campaigns and nationalization of businesses but also seemingly insignificant institutional building. Matters such as reforming book-keeping and identifying taxpayers may appear less significant but are indispensable building blocks of a modern state. Many modern states have acquired strong extractive capacity without resorting to political campaigns or nationalization, but all have functioning tax monitoring and enforcement mechanisms. In this sense, what appear to be trivial and preliminary at first glance are probably more fundamental and imperative than what appear to be decisive in certain contexts, such as political campaigns in China.

Third, institutions critical for strengthening extractive capacity are conditioned by the relationship between the state and dominant social classes. Without a degree of autonomy from highly mobilized social groups, the state cannot formulate its own priorities, much less impose its own agenda on society. Relative autonomy is also important for insulating the state bureaucracy from piecemeal captures, which may destroy the cohesiveness of the state itself. In the early 1950s, the state apparatus of the new regime was both autonomous and internally coherent. That was why, despite numerous constraints on the new regime, the Chinese Communist state was able to introduce rapid and comprehensive institutional changes and attain a strong extractive capacity in just a few years.

NOTES

1. For a detailed account about the fiscal reforms in this period, see Young (1971). Young served as a financial adviser to the Nationalist government between 1929 and 1947.

2. This represents the highest estimate. Thomas Rawski (1989) estimates that in the early 1930s, central, provincial, and local taxes altogether amounted to only about 5% to 7% of China's total output. Arthur Young (1971: 102-3) comes up with an even lower estimate: "The public sector was not large, being only perhaps 5 percent of total gross national product."

3. See Kugler et al. (1983), Kugler and Domke (1986), Snider (1988), and Arbetman and Kugler (1997).

4. Witte and Woodbury (1983) found that the perceived probability that noncompliance would not be detected was the most important factor in increasing noncompliance.

5. This is based on the assumption that taxpayers are rational actors who try to maximize their utility by multiplying the perceived chances of detection and successful prosecution by the amount of money to be saved by evasion and comparing that with the amount of potential fines.

6. In Young's (1971: 160) own words, "Far too many used official position for personal advantage, sometimes subtly, but sometimes crudely."

7. Customs revenues averaged 121 million yuan per year between 1924 and 1928. It shot up to 244 million yuan in 1929, 290 million in 1930, and 385 million in 1931 (Young, 1971: 20).

8. The Sino-Foreign Inspectorate (also under British leadership) from 1913 also administered the salt revenue to provide security for foreign loans. Because salt was mostly produced in inland provinces, salt revenues had been subject to seizure by warlords, which led to declining revenue for the central government. The Nationalist government integrated the salt administration into the Finance Ministry in 1928, and salt revenue grew from 54 million yuan in 1928 to 213 million in 1937 (Young, 1971: 56).

9. One example shows how vulnerable such a fiscal system was. In the fiscal year 1935-1936, smuggling became rampant in north China under the de facto control of the Japanese, which resulted in a sharp decrease of the customs revenue. As a consequence, the ratio of the government's total current revenue (excluding borrowing) in its total receipts (including borrowing) dropped to 40% (Chou, 1963: 40).

10. During this period, these state-owned enterprises were mostly Nationalist government-owned businesses (which the new regime called "bureaucrat capitalist enterprises" [*guanliao ziben zhuyi qiye*]).

11. After September 1951, state-owned enterprises were exempt from the net income tax. Their profits were then remitted directly to the state treasury. They were still required to pay the gross receipts tax.

12. Wuhan consists of three towns: Hankou, Wuchang, and Hanyang. In the early 1950s, while Wuchang and Hanyang each constituted single administrative districts, Hankou was divided into three administrative districts—namely, Jiang'an, Jianghan, and Qiaokou.

13. These figures suggest that in actual practice, the four-tier system structural guidelines could not be followed precisely.

14. The assessment schemes described here are by no means unique to China in this particular period. Confronted with myriad small scattered businesses, many governments choose to tax artisans and small enterprises using approximations of their profits. One approach, for instance, is to establish an identical tax for all artisan enterprises of a given type, leaving the occupational group itself to assess and collect it. For instance, in many European countries, approximate estimates of wealth were accepted before the nineteenth century. Each community was assigned a collective sum due in taxes and then elected men who would work out the assessment of the tax based on their own knowledge of the resources of their neighbors. Even in today's developed economies, there are fiscal problems arising in the cases of small distilleries (Ardant, 1975: 178-79).

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Shaoguang Wang is an associate professor of political science at the Chinese University of Hong Kong. His most recent books are The Political Economy of Uneven Development: The Case of China (coauthor, M. E. Sharpe), Duoyuan yu tongyi: disan bumen guoji bijiao yanjiu (The Third Sector in Comparative Perspective), Fenquan de dixian (The Limits of Decentralization), and Taozhan shichang shenhua (Challenging the Market Myth).