

Public Finance in China since the Late Qing Dynasty

Barbara Krug

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Email address corresponding author	bkrug@rsm.nl
Address	Erasmus Research Institute of Management (ERIM) RSM Erasmus University / Erasmus School of Economics Erasmus Universiteit Rotterdam P.O.Box 1738 3000 DR Rotterdam, The Netherlands Phone: + 31 10 408 1182 Fax: + 31 10 408 9640 Email: info@erim.eur.nl Internet: www.erim.eur.nl

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Abstract	<p>How is "public finance" organized in China? Is China's public finance system different from that of other countries? Can we detect features which link today's system to the past?</p> <p>Public finance refers to more than annual state budgets and constitutional procedures. It includes foreign debt, state monopolies or monetary policies, all of which played a crucial role in China's public finance during the last hundred years. A purely legislative definition obscures the fact that changes in public finance have contributed to the collapse of political regimes such as Imperial China (1911), Republican China (1927), and KMT-China (1945), as well engendered regime changes in 1949, 1961 and 1978. From a more comprehensive economic perspective public finance in China encompasses institutions, organizations and policies.</p>
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Barbara Krug.

“Public Finance in China since the late Qing dynasty”

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PUBLIC FINANCE

Questions

How is “public finance” organized in China? Is China’s public finance system different from that of other countries? Can we detect features which link today’s system to the past?

Definition and concepts

Public finance refers to more than annual state budgets and constitutional procedures. It includes foreign debt, state monopolies or monetary policies, all of which played a crucial role in China’s public finance during the last hundred years. A purely legislative definition obscures the fact that changes in public finance have contributed to the collapse of political regimes such as Imperial China (1911), Republican China (1927), and KMT-China (1945), as well engendered regime changes in 1949, 1961 and 1978. From a more comprehensive economic perspective public finance in China encompasses institutions, organizations and policies.

The authority to tax. The right to tax can be invested in an emperor, a cabinet, a president, parliament or a political Party; it can be limited to a central government or supplemented by provincial and local tax authority. The power to tax can lie with informal power holders or social groups. In the last one hundred years or so, China experimented with all these forms of tax authority.

Tax administration. There are two recognized forms of effective taxation. One is tax farming, i.e. the delegation of the power to tax, to local administrations, such as provinces, magistrates, social groups or individual middlemen. The other, dominant model is a national tax administration operating a unified tax code.

Characteristically, in China these two systems have never been seen as mutually exclusive. Neither Imperial Edicts (1906), constitutional amendments (1913; 1931) nor government regulations (1984) were successful in establishing one centralized tax authority. Instead China's public finance system is characterized by fluctuations between the two systems at the national level, while at the local level co-existence prevailed.

Monetary policy. While it has been known since Late Qing-dynasty that inflation needs to be controlled by linking (paper) money to gold or silver standards and asks the State to refinance itself through domestic (Public) Banks or capital markets, several attempts to introduce a monetary as opposed to a fiscal policy failed. Inflation was and is responded to by regulation and administrative control. Whether in form of closing the opium trade as a means to stem the silver outflow in the middle of the 19th century, compulsory sales of government bonds in the middle of the 1930s, indiscriminately ordering budget cuts at the end of the 1990s or recently price control, regulations takes precedence over monetary policy which asks to employ tools such as money supply, interest rates and tighter control of interbank refinancing methods.

Historic Development

Imperial China. These three features suggest that China's public finance system has always known strong formal and informal elements and state interference. Arguably, the Western-inspired, formal constitutional phase in Public Finance started with an Imperial Edict of November 6th, 1906 when the Court in order to stem the financial anarchy into which China has fallen since the Opium Wars acknowledged that the traditional way of public accounting was unable to cope with war expenditures, war indemnities and rapidly increasing imports. The 1906

Edict concentrated on reforms in tax administration rather than searching for new revenue sources and failed to institute ministerial responsibility for a Board of Finance, functional instead of the inherited Ming-dynasty territorial divisions and, bank control in loan management.

[Republican China](#). Before the Imperial reforms could have been tested China politically disintegrated. Nationalist Party cliques in different political and military alliances represented “national” governments which seldom controlled more than the vicinity of their respective capitals in Beijing, Nanjing or Chongqing. Different constitutions (1913, 1931) or programs aimed at reforming public finance remained futile exercises. What characterized the period between 1911 and 1949 is that (1) the size of the jurisdiction where public finance management was possible depended on alliances between different political forces, for example, the size of the Red Army or Warlord controlled territories and eventually Japanese occupied territories; (2) the self-styled national governments were unable to tax agriculture, leaving only the narrow base of the nascent urban sector as revenue source as no national government had control over collecting revenues from regional or local semi-autonomous interest groups; (3) intergovernmental transfers were in fact not regular fiscal transfers, but money flows in return for political support or war expenditure.

[Socialist China](#). A socialist system of public finance is primarily characterized by de-monetization of the economy. Flows of goods, services, income, investment, let alone profit follow a united, consolidated plan, which relies on (physical) quantities rather than monetary value. When all assets are under central or local state control, most (corporate) tax obligations are replaced by (profit) transfer as the dominant revenue source. Such profit transfer, for example, contributed 51 per cent of total central state revenue in 1978. Between 1949 and 1983 taxes were limited to three kinds: tax on industrial production and commerce, agriculture tax and tariffs. In a de-monetized Planned Economy inflation is side-stepped at the cost of waiting lists or queues emerging when demand for goods or capital does not meet appropriate (real) supply. In monetary terms, the volume of public finance in the PRC indicates a small size of government because the huge and increasing outlays for social security that characterize market economies are missing. However, in real terms the scope of government activities is maximized as the state-owned corporate sector takes on public finance responsibilities.

[Reform China](#). The challenge for Reform China has been to design a new public finance system able to mobilize resources from the growing non-state sector of the economy, such as private firms and individuals, and new sectors (e.g. modern service industries such as IT and marketing), while ensuring at the same time that the habitually heavy hand of the state did not hinder new market-conforming organizations and innovation to emerge. Traumatized by inflation and the debt

crisis in the 20th century, China's leaders in contrast to other transition economies, pursued strict anti-inflationary policy, and a foreign trade policy which facilitates the hoarding for foreign exchange. Domestic reforms first turned state-owned companies and later collective and private enterprises into taxpayers, following the examples set by Chinese-foreign joint venture firms which led the way to incorporation from the mid 1990s. Corporate income tax was first introduced for foreign joint ventures yet, since 2005 is applied to all corporations irrespective of ownership. In order to streamline the numerous taxes on specific goods most of which being levied by local government agencies, a value added tax (VAT) with a unified rate was introduced in 1994.

The most striking feature of the public finance system however is China's specific form of Fiscal Federalism which has two parallel tax systems, namely the national tax administration in charge of standardized national taxes and tax sharing contracts, and the independent local tax system at provincial level and below which controls its own tax base. Tax sharing has two meanings here. One refers to tax sharing contracts between central and local governments. The other refers to revenue from specific taxes raised by these two tax agencies, which is split between central and provincial level according to specified formulas. Thus, public finance becomes a problem of central-local politics where the centre (Beijing) transfers regulatory power to the local state as an incentive to promote local economic growth. Initially, in the 1980s, local governments more than Beijing had benefited from local economic development. Since then the central

government has redressed the financial balance by introducing the VAT of which 70 per cent revert to the centre and by banning surtaxes and local levies, and by generally strengthening changing the sharing local and central tax administration. Though the reforms improved the revenue appropriation for the central government, their overall effect is limited. China is still or once more operating with the coexistence of a modified version of tax farming and a national tax administration that does not reach to the lowest local level.

HISTORICAL CONTINUITIES

From an economic perspective, public finance in China appears as a “hybrid” between a constitutional form of public finance and features that can be linked to China’s Socialist past, if not Republican and Imperial, institutional heritage. If there is a path dependency that underlies its economic dynamism, this institutional continuity would be unique and with a rationality of its own. Three features are “Chinese” in the sense that they can be found in the different political regimes that have been tried out in the last some 100 years in China; at the same time they are features one would not find in other public finance systems worldwide today.

- Financial indifference toward “monetary” matters
- Ambivalence in Central-local relations

- Fiscal indifference toward local funding

Financial indifference toward “monetary” matters

Those who wonder today why the political leadership in Reform China does not see reasons, let alone any urgency to allow private banking, and subsequently a domestic capital market to emerge, are reminded of a similar indifference of Imperial China and Republican China in the face of competition from the Non-Chinese commercial banks in Shanghai. Without private modern banks absorbing household deposits and firms borrowing investment funds, China never developed a functioning capital market able to calculate the price of capital by letting interest rates reflect scarcity of capital required by different users of capital. Today as in the past, private lending and borrowing predominantly depends on informal banking, networking or allocation of financial means by state agencies. The disjuncture between capital market and monetary policy on one hand and public finance and financial policy on the other can be illustrated by some examples.

(1) As [national and local deficits](#) are not bank-managed but remain state-controlled, the absorptive capacity of the domestic capital market was and is not

seriously tested. Instead, when debt cannot be served from expected (tax) revenue or when current budget deficits need to be (re-)financed, the state forces compulsory loans on economic agents (individuals and firms) which are designed to serve budgetary purposes, i.e. low debt service and too low annuity.

(2) Regardless of whether China is a [major debtor](#) as in the past or a major lender of international liquidity and capital as today, foreign reserve and exchange rates are seen as a part of international politics. While in the past when China was burdened with large international debt, loans from donor countries were judged as a proof for the willingness of countries to support China as an ally in the 1930s and 1940s, or as a comrade in arms in the 1950. Today China uses its foreign reserves for state investment in countries of her choice, following international strategic rather than domestic economic considerations.

(3) The sensitivity concerning China's [external financial position](#) is in striking contrast to the indifference Chinese governments displayed towards domestic monetary matters. Thus, for example, the Qing Dynasty never made use of *seignorage* by raising revenue from the difference between the face value of coins and the real production and distribution costs, which was a major source of revenue for other large states. The Qing's use of a bimetallic silver-copper standard meant that the *tael* as a weight of metal rather than a standardized measurement for relative prices, it could not be used to fund investment. When foreign exchange reserve based (paper) money replaced the *tael* in 1933 issuance was privatized, thus contributing to hyperinflation hindering rather than facilitating the emergence of a domestic capital market. China, outside the

foreign bank sector in Shanghai, has never had investment banks, let alone a corporate capital market. Socialist China would not change this picture being even more determined than other Socialist Economies to dismiss notions of money and capital. This might account for the fact that after 1978, reforms of the banking sector started much later than the reforms in other sectors and only gained pace when WTO-regulation and increasing international integration made partial liberalization of the banking sector and capital market inevitable.

(4) The response of all different regimes to a monetary and financial crisis or a mix of both has always been to ask for [administrative reforms and administrative interference](#). Each new political regime asked for more centralization of state power, and better and more honest administrators.

In other words, the Chinese state has traditionally kept a financial distance to the commercial sector and allowed informal structures to persist rather than to enforce formal structures that would require strong state control down to the enterprise level.

[Ambivalence in Central-local relations](#)

The question how to govern an empire from one political centre accompanies all political regimes. History shows experiments with different degrees of decentralization follow political functional (transaction cost) and power, i.e. the need to compromise with local power holders' considerations: Usually a political centre transfers regulatory power to territorial jurisdictions (kingdom, province,

states) in return for political support (and peace) and stable revenues. China has specific modes.

Modes of governance.

Traditionally, China has employed two modes of fiscal governance characterized by distinctive administrative devices and different personnel, namely centralized tax administration and decentralized tax farming. While in the socialist era, a centralized state bureaucracy prevailed, China revived tax farming in the 1980s and introduced a widespread (tax) sharing system in the 1990s. Thus, today's China distinguishes between national tax (*guojia shui*) managed by a centrally appointed state bureaucracy operating unified tax codes, and local tax (*difang shui*) connected to the national tax bureaus via provincial level tax contracts. Within the local tax administration, tax contracts are also used between local tax administrators and individual firms. The contracts define the total tax obligation which is then allocated to different tax bases.

Fiscal Federalism. Institutional change in the Public finance system in Reform China does not mean the introduction of a Fiscal Federalist System, in the same sense that the Ming dynasty's fiscal administration following provincial borders has not been a Federalist System. As in the past, China's form of Fiscal Federalism refers to decentralization of regulatory power, and negotiated revenue sharing within an unitary regime, rather than a constitution-based separation of power and allocation of tasks to different representative governments.

The missing link at the grass root level. Closely linked to the problem of competing tax administrations and revenue sharing is the third feature, namely indifference toward or even the failure to build up a (tax) bureaucracy below the county level. Traditionally, the reach of the central state extended down to the county level. The question is whether the different regimes did not want to penetrate the Chinese economy further, as for example the Qing-dynasty which originally as an occupying force expected the domestic (Han)-magistrates to transfer revenues to the central (Manchu) coffer. In this case the boundary between tax farming and tribute payment is blurred. Another example is Nationalist China where shaky alliances

with local warlords left local tax authority, in particular the right to raise land tax, in the hands of those who actually controlled the land. The most serious attempt to extend the reach of the state into the country side was made during the Great Leap Forward with the establishment of People's Communes as basic economic units. This attempt was abandoned in the early 1960s.

The indifference is reflected in today's financial constitution which differentiates only between national and local taxes without specifying which sub-provincial level executes which kind of tax authority. It is rather up to the province how to further decentralize regulatory power.

Central indifference toward local funding

Central indifference with respect to local funding is a consequence of financial indifference in the sense that without the necessary fiscal and banking infrastructure, the financial reach of the central state remains weak, including its ability to regularize vertical transfers. As a result the localities provide both the infrastructure and financial control. Whether driven by the need to find revenue sources independent from transfers from the national government, or motivated by an entrepreneurial spirit to increase local resources and income, local government agencies whether magistrates or township governments have always relied on alternative revenue sources a great part of which are still or once again in use today.

Surtaxes and customary fees. One of the most striking features in Reform China's public finance system are the so-called Extra-budgetary Revenues (EBRs) and Off-budgetary Revenues (OBRs), sources for local governments unknown outside China, yet dating back centuries in China's history. The EBRs, also used during the Socialist (and Republican-era) refer to surtaxes on production, income, cash flow of state controlled enterprises, and usage of local infrastructure. The latter refer to "voluntary" contributions by individuals or the local business community, i.e. gifts for special purposes. Today as in the case of, for example the notorious "meltage fee" (a surtax legitimized by the inevitable loss of silver when tax silver was melted into the ingots for transport) of the Ming- and Qing-dynasty, the discussion is dominated by two issues. In the economic controversy views are divided on whether the surtax (EBR) system threatens economic stability and the functioning of the central government, or whether surtaxes set incentives for

local entrepreneurship and tax competition, and by doing so contribute to overall economic development. In the political debate views are divided between those who see the EBR/OBR system as the core for a new local state corporatism where the central state has relinquished its hold on local economic development and those who see the risk of corruption as local economies become uncontrollable. The point to stress here is that the ambivalence with which the political leadership reacts to the consequences of such a system is not new. Today as in the past the different political regimes seem to shy away from either introducing a “hard” federalist system, in which political tasks and revenue sources are allocated to specific layers of government (and assessed by a vote) or a national tax system based on a unified tax code implemented by a national tax bureaucracy. As the recent tax reforms in 1994 and 2004 showed the central government tries to move into the direction of the latter by reducing the scope of EBR and OBR. The fact that local government agencies can informally levy surtaxes or fees so long as superior Party organization consent, gives these sources a “semi-legal” status which differentiates them from corruption, even though the border line can be thin in such a highly informal environment.

Informal networks for funding. Surtaxes are not the only way by which local government agencies supplement revenues. As poor counties and villages in the past and present know their normal functioning can crucially depend on co-operation with or co-optation of the “gentry”, such as land-owners, merchants in the past and private owners of companies or foreign firms today.

This is in contrast to rich villages where today co-operation with the local business community can make local governments rich despite shrinking direct control of resources. In other words, what further characterizes China’s public finance system at the local level is its reliance on informal networks for securing a sufficient resource if not a prospering tax base.

(1) One such source are local banks which are neither sub-branches of state banks nor “private” companies. As in the past these banks do not need to follow “sound” business practices, since the scope of business depends less on private savings than on financial transfer from superior bureaucracies and the cash flow companies are forced to keep in these banks. In most cases the banks today represent a kind of joint

venture between the successors of the old merchants, i.e. the new local business community and local government agencies. These informal financial intermediaries provide the local state not only with cash but also with “venture capital” access to which as in the past depends on networking and negotiation.

(2) Another revenue source is [minority shares](#) local government agencies keep in commercial companies. These shares do not merely indicate a yet not finished privatization of the local industrial sector. Instead, often enough local government agencies, if not individual bureaucrats, are invited to become co-owners in return for patronage and bureaucratic support. In other words, while government officials assume some entrepreneurial roles on behalf of their local companies, usually in regard to interactions with higher level bureaucracies, the local business community reciprocates by contributing to the local economy and local welfare - just as in the past.

(3) By far the most crucial source of funding in the past ten years, however, has been [land](#) which is controlled by local government agencies or in rural areas by villages. There are documented cases where in townships and villages in the richer areas in South-East China profits from land and real estate deals can add up to sixty per cent of total revenue to the effect that the local government agencies become independent from the provincial or central money purse. Land ownership and lease contracts have re-appeared on the political agenda in China, with the difference that today peasants face a “corporate” landlord in form of local government agencies in co-operation with development firms. The central government’s policy is tighten regulation, but even this is reminiscent of past experience where lack of enforcement makes this a strategy to fight off protest and unrest rather than an outright ban of local government business activity.

All in all, at the local level, the system of informal funding leads to special, highly individual tax contracts in which the local governments negotiate overall tax obligations with firms and augment their formal revenue through informal business activities which, though officially not approved or even forbidden, are tolerated in the interest of local economic development. Parallel to these highly informal structures operates the national tax system which is developing towards the direction of “modern” taxation as used in

developed economies. The national, 'rational' tax system is constantly exerting pressure on the informal system, which keeps local finance in a constant state of flux. While this is not in conformity with constitutional rule, it provides relative stability across an economy with vast geographical, institutional and developmental differences.

HISTORICAL DISCONTINUITIES

The argument that the reform of China's public finance will only be complete once China has fully implemented a constitution-based institutional structure and corresponding organizations reflects the dominant view among economic analysts and the advice of multinational organizations. Yet, the factual coexistence of this merging formal system with local, informal structures is undisputed. From an institutional perspective, the informal-local features outlined above are not just remnants of the Socialist past, but have antecedents in China's Imperial and short Republican history that make them part of China's institutional infrastructure and organizational tradition. These informal structures have enabled China to initiate and sustain economic growth in the absence of formal, legal structures, property rights and constitutional governance. While there is no doubt that these structures are changing, the question is what lasting impact will they have on China's emerging public finance system. The most likely scenario is that the impact of the globalization process that drives reform in China in the direction of increasing professionalization will continue to be counterbalanced by the traditional politicization of central-local relations.

The professionalization in public finance. A clear break with the past is the fact that fiscal policy replaced regulation, direct resource or price control and state planning as major tool for implementing economic policy. Taxation, i.e. monetary (dis-)incentives for stimulating or discouraging certain economic activities, came under central control. With the consolidation of the VAT and the abolishment of surtaxes in the national tax codes, indirect taxation became the dominant revenue source for redistributive purposes. In contrast direct taxes (income and corporate tax) are used for development policy: While the tax base and

rates encourage saving and capital accumulation, national and local tax privileges such as tax exemptions or different tax rates are used for stimulating foreign and increasingly domestic investment of certain industries, in particular the IT And High Tech sectors in special economic zones. Though this change has become effective predominantly in the national tax administration, a professional and streamlined tax administration is filtering down to local tax administrations. China today follows the notion of effective tax policy as do other developed economies.

The politicization of central-local relations. While one part of the inherited state bureaucracy is making the transition towards a professionalized fiscal policy acting as an agent of the central government, the other part retains a political role by lobbying for and representing local interests. Local government agencies acting as agents for local business interests, including capital, land and labor, continue to shift the process of central-local relations and revenue sharing towards a debate about policy making and expenditure best suited to serve local economic development.

Overall, state expenditure is determined in a semi-public negotiation process between the private sector, local governments and the political centre. While the central government sets guidelines for labor conditions, health care, pensions, education, privatization of public utilities, implementation depends on political negotiations between different levels of the political hierarchy. In this context, central-local relations need not be seen as part of a traditional bureaucratic procedures but as the closest equivalent to a representation of public interests that is possible in a closed and centralized political system., The economic outcome will be on-going divergent local growth and a distant future for an egalitarian nation-wide welfare regime.

(4,203 words)

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