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**State monopoly, Chinese style : a case study of the tobacco industry**  
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**State Monopoly, Chinese Style:**  
**A Case Study of the Tobacco Industry**

**Yi-Wen Cheng**

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# **State Monopoly, Chinese Style: A Case Study of the Tobacco Industry**

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# CHAPTER ONE

## INTRODUCTION

In the late 1970s, China initiated a series of market-oriented reforms by dismantling the previous forms of economic management, which the state had used to control all of the industries and the price system to achieve its industrialization goals. Since the start of that transformation from a planned economy to one governed by market economics, the Chinese authorities have continually tried to facilitate market conditions and have them function properly; but, in all this time, the central state has never completely abandoned its monopoly in a range of industries such as petroleum, telecommunications, and electricity. Here a state monopoly in a given industry means that the industry is monopolized by the Chinese government through its central state-owned enterprises (SOEs).

While the number of private companies in China has grown substantially over the years, state control has not declined much in certain industries following these market-oriented reforms. A number of market economy countries also continued to maintain state monopolies, which are created, promoted, and sustained by the political authorities in various industries for the sake of public interest or greater economy of scale. With the rise of neo-liberalism in the 1970s, however, decreasing faith in the ability of public authorities to manage these industries has largely yielded to market ideologies and solutions. Neoliberal discourse claims that only guaranteed private property rights provide the necessary foundation for a market economy to function properly. Consequently, while many Western countries have gone on to privatize industries once monopolized by the state, in China, state-monopolized industries in several sectors have only become more formidable, especially over the past decade. These industries are exempt even from regulation by the *Anti-Monopoly Law* enacted in 2008, which was designed to restrain monopolistic behavior and protect market competition. According to the *Anti-Monopoly Law*, it identifies categories of industries protected by other laws, such as the *Tobacco Monopoly Law*, in order to preserve their state monopoly status, and those that support national security and constitute the core industries of the

nation's economy but do not fall under its cover.<sup>1</sup> While it does not clearly specify what industries are included in the latter, telecommunications, electricity, petroleum, aviation, and defense are generally regarded within this category. Though not legislatively protected by law in order to block the entry of non-state capital into the market, the central authorities use other means for keeping the central SOEs dominant in these industries. In China's context, therefore, these are all defined as state-monopolized industries.<sup>2</sup>

Even more confusing than the noticeable presence of these monopolies is how fierce the competition is with regard to price, production differentiation, sales management, advertising, and so forth in these monopolized industries. Monopoly literatures generally argue that competition cannot live in government-run monopolies, and scholars criticize state monopolies for eradicating competition, violating the producer's autonomy, and hurting consumer welfare. Nevertheless, far from being extinguished, observers have noted not only that a competitive aspect has been maintained, but on the contrary, has continued to grow and develop in some of the industries monopolized in China.<sup>3</sup>

We may ask then why the usual binary opposition of competition versus monopoly does not apply to China's state-monopolized industries? Or, to put it another way: what exactly is the nature of the industrial state monopoly in China?

This thesis aims to explain the coexistence of state monopoly and competition and examines how competition has evolved within current

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<sup>1</sup> For the relevant regulations please see Articles 7, 15 and 28 of the *Anti-Monopoly Law*.

<sup>2</sup> Jiang Yang, "(Anti-) Monopoly in China" (paper presented at "Globalization and Public Sector Reforms in China and India" conference in Copenhagen, Denmark, September 23-24, 2011); Hsin-Hsien Wang, "Shui tongzhi? Lun zhongguo de zhengce zhiding guocheng : yi fanlongduanfa weili" (Who governs? The dynamics of policy-making in China: The case of Antitrust Law), *Mainland China Studies* 53 No. 1 (2010): 54-5.

<sup>3</sup> For example, please see Eric Harwit, *China's Telecommunications Revolution* (Oxford, UK: Oxford University Press, 2008); Zhi-hui Li, *Development and Reform of China's Banking System* (Lorong Chuan, Singapore: Cengage Learning Asia Pte Limited, 2011); Sarah Eaton, "Political Economy of the Advancing State: The Case of China's Airlines Reform," *The China Journal* 69 (2013): 64-86; Shaofeng Chen, "State-Managed Marketization: A Revisit of the Role of the Chinese State in the Petroleum Industry," *The Copenhagen Journal of Asian Studies* 30 No. 2 (2012): 29-60; Chunbo Ma and Lining He, "From State Monopoly to Renewable Portfolio: Restructuring China's Electric Utility," *Energy Policy* 36 No. 5 (2008): 1697-711; Peter Nolan, Jin Zhang, and Chunhang Liu, "The Global Business Revolution and Developing Countries," in *Integrating China: Towards the Coordinated Market Economy*, ed. Peter Nolan (London, UK: Anthem Press, 2008), 19-42.

state-monopoly sectors in China over the past three decades. Rather than an accidental phenomenon, I argue that the emergence of competition in a state monopoly resulted from a certain “governance pattern” that formed up incrementally and was strengthened by interactions between local governments and multiple players in the state monopoly. A range of interdependent players—such as suppliers of raw materials, manufacturers, and distributors—conducted exchanges within the governance pattern in order to allow economic activity to continue within the industries concerned. In this context, the governance pattern has also continually changed as the power-distributing arrangements between the central authorities, local governments, and central SOEs have been successively re-configured from the late 1970s onward.

Accordingly, different types of competition have appeared at distinctive stages within that governance pattern. As a consequence, state monopoly in China has evolved into what I call a central (state)-led competitive monopoly where state control and competition continue to coexist, interact, and grow side by side, developing together within China’s economy. In other words, by looking more deeply into broad term of state monopoly, this thesis uncovers the different ways of organizing state-monopoly activities that have emerged through its engagement with the phenomenon of competition. The varieties of this organization have been generally ignored by researchers on monopoly subjects but nonetheless can exemplify the dynamics of state-market relationship vividly.

## **1.1 Theoretical Contribution**

In the existing literature, many debates on monopoly and competition revolve around why and how to carry out anti-monopoly regulations. According to different understandings of the market process, ideas about monopoly and its relationship to competition vary. In reviewing the literature, we find that they all but invariably fall into a dichotomy between market and state so that they cannot provide a proper analytical framework for discussing the coexistence of state monopoly and competition within the specific context of China. On these grounds, the present research challenges existing monopoly and anti-monopoly studies while developing its own explanatory arguments to analyze the enigma presented by China’s state-monopoly sectors, particularly in the tobacco industry.



### 1.1.1 Existing Literatures on Monopoly Studies

A neoclassical theory of monopoly employs the model of “perfect competition” as the benchmark for making a comparison with a monopolistic situation. Under such perfect competition, there exist numerous buyers and sellers who enter the market without any barriers, and no companies are large enough to have the power to manipulate the prices of their homogeneous products. Resource allocation may thus be as efficient as possible, and all trades are mutually beneficial to sellers and buyers. By contrast, a monopolist is a firm which faces the entire demand for the products so that it is capable of influencing market prices by substantially affecting the market supply through its production decisions. As it could charge too much and produce too little output, the market could eventually fail and consumer welfare could be affected negatively. From the neoclassical perspective, therefore, “more competition” is a necessary situation in order to structurally approach perfect competition. Here, monopoly and competition constitute the two opposite extremes, where if one does not prevent the competition from being violated, then competitive markets could or will eventually deteriorate into a monopoly. Viewed in this light, anti-monopoly aims to maintain an ideal market environment for unhindered competition. The *Sherman Antitrust Act* passed by the US Congress in 1890 was just such a product of this perspective.<sup>4</sup>

Criticism of perfect competition triggered other views of monopoly. One of the most serious problems involves the fundamentally static character of this model, which assumes that all the existing conditions would automatically result in equilibrium.<sup>5</sup> Market competition, however, is a dynamic process in which opportunities for profit forever require discovery and exploitation in uncertain circumstances. Viewed in this light, while the abovementioned antitrust law is intended to promote competition, it might actually restrain the competitive market process by protecting the existing industrial structure.<sup>6</sup> Joseph Schumpeter, for

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<sup>4</sup> Dominick T. Armentano, *Antitrust and Monopoly: Anatomy of a Policy Failure* (Oakland, CA: Independent Institute, 1996), 5-7, 14-9; Richard B. McKenzie and Dwight R. Lee, *In Defense of Monopoly* (Ann Arbor, MI: The University of Michigan Press, 2008), 26; Stephen Wilks, *In the Public Interest: Competition Policy and the Monopolies and Mergers Commission* (Manchester, UK: Manchester University Press, 2000), 23.

<sup>5</sup> Armentano, *Antitrust and Monopoly*, 22-8.

<sup>6</sup> Bruce Doern and Stephen Wilks, *Comparative Competition Policy: National Institutions in a Global Market* (New York, NY: Oxford University Press, 1996), 10-2; Dominick T. Armentano, “A Critique of Neoclassical and Austrian Monopoly Theory,” in *New*

example, contends that new firms, in seeking to earn monopolist profits, are constantly motivated to destroy the existing monopolies by creating new products, technologies, and organizational forms. This process is signaled by Schumpeter as the “creative destruction” energized by the prospect of monopoly. He further argues that what matters most are the waves of innovation that revolutionize “the economic structure from within, incessantly destroying the old one, incessantly creating the new one. This process of creative destruction is the essential fact about capitalism.”<sup>7</sup> On this view, the giant monopolistic firms remain under “competitive pressure” from the outside in the sense that failure to continue to innovate could lead to a weakening of the barriers to entry. Schumpeter goes on to combine realism with a defense of “monopolistic practices,” which are viewed as logically consistent with competition.<sup>8</sup> In this perspective, monopoly is seen as a “necessary evil” for economic growth so that the weaker anti-monopoly regulations being enforced are favored.

The Chicago School, emerging from the 1970s, further maintains that monopoly is naturally fleeting and rapidly turns into competition so that it may actually be ignored.<sup>9</sup> Moreover, this camp proposes different ideas with respect to competition. For example, in the 1980s Baumol advanced the “contestable market theory,” arguing that competition and efficiency do not require large numbers of producing firms, each of whom is small, independent in decision-making, and producing homogeneous products so unable to affect price as indicated in the model of perfect competition. Rather, a contestable market is one into which entry is

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*Directions in Austrian Economics*, ed. Louis M. Spadaro (Kansas City, MO: Sheed, Andrews and McMeel, Inc., 1978), 95; Dominick T. Armentano, *Antitrust: The Case for Repeal* (Auburn, AL: Ludwig von Mises Institute, 2007), 106.

<sup>7</sup> Joseph Schumpeter, *Capitalism, Socialism and Democracy* (New York, NY: Routledge, 2006), 102-6.

<sup>8</sup> John Bellamy Foster, Robert W. McChesnay and R. Jamil Jonna, “Monopoly and Competition in Twenty-First Century Capitalism,” *Monthly Review* 62 No. 11 (2011), accessed March 25, 2014, <http://monthlyreview.org/2011/04/01/monopoly-and-competition-in-twenty-first-century-capitalism>.

<sup>9</sup> I. Schmidt and J.B. Rittaler, *A Critical Evaluation of the Chicago School of Antitrust Analysis* (New York, NY: Springer, 1989), 72; “Antitrust Policy,” accessed November 12, 2013, [http://www.law.berkeley.edu/faculty/rubinfeld/Antitrust/antitrust\\_intl.encyclopedia.pdf](http://www.law.berkeley.edu/faculty/rubinfeld/Antitrust/antitrust_intl.encyclopedia.pdf); McKenzie and Lee, *In Defense of Monopoly*, 15; Doern and Wilks, *Comparative Competition Policy*, 12.

absolutely free, and exit is absolutely costless. That is, contestable markets are characterized by “hit and run” competition—if a firm in a contestable market raises its prices much beyond the average price level of the market, potential rivals will enter the market; conversely, when the original firm responds by returning prices to levels consistent with normal profits, the new firms will exit. This argument thus rejects the neoclassical economic notion that competition exists when each business unit has no significant control over price, output, and investments largely determined by market forces beyond its control. Instead, competition here is used to refer to potential rivalry derived from an assumption of ultra-free entry and exit. Even a single-firm market might therefore show highly competitive behavior, so that antitrust actions are no longer necessary.<sup>10</sup> This notion is clearly expressed by Robert Bork’s book *The Antitrust Paradox*, concluding that the law should never attack the monopolistic market structure, as it actually embodies the proper balance of forces for consumer welfare.<sup>11</sup>

Though the views on monopoly and competition differ as stated above, they are all united in the belief that the state monopoly, which is established by the government for its own purposes, is the genuine source of “pernicious” monopoly power. More specifically, it is generally agreed that the state monopoly derives this power from a coercive entry barrier and must inevitably stifle competition. In addition, exchange under any state monopoly remains controlled by the political authority so that it cannot approximate that certain level of efficiency a free market can create.<sup>12</sup> In function, this assessment insists that the free market is necessarily the dominant form for all economic activities. In the free market, each exchange is assumed to be undertaken as a voluntary agreement between two parties under the conditions of private ownership, and the emergent system of price results from a vast number of those voluntary transactions rather than of political decrees. From this perspective, the free market is represented as an apolitical realm vis-à-vis the state, whereas a state monopoly definitively distorts the market.

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<sup>10</sup> William Baumol, “Contestable Markets: An Uprising in the Theory of Industry Structure,” *The American Economic Review* 72 No. 1 (1982): 3-4; William Baumol, John Panzer, and Robert Willig, *Contestable Markets and the Theory of Industry Structure* (New York, NY: Harcourt Brace Jovanovich, 1982), xix; Rudolph J.R. Peritz, *Competition Policy in America: History, Rhetoric, Law* (New York, NY: Oxford University Press, 1996), 270.

<sup>11</sup> Robert H. Bork, *The Antitrust Paradox* (New York, NY: Basic Books, 1978), 164.

<sup>12</sup> Peritz, *Competition Policy in America*, 229-64; McKenzie and Lee, *In Defense of Monopoly*, 226; Armentano, “A Critique of Neoclassical,” 109-10; Armentano, *Antitrust and Monopoly*, 42-3, 271-8.

Adam Smith's *Wealth of Nations* first proposes this dichotomy between market and state, arguing that in a free market, in the process involving the exchange of goods or services each individual tries to maximize self-interest and that, as a result of this, resources are allocated in the most efficient way possible via competition. Guided by this "invisible hand," the free market economic system does not require the state. The state is only required to secure property rights and contract freedom in order to maintain the spontaneous order of the market.<sup>13</sup> From Smith's original introduction, numerous criticisms of this dichotomy have arisen in different strands of literatures.

### **The Debate on the Duality of State and Market**

For one, as a hegemonic discourse, the free market condenses heterogeneous economic activities into a single form of economic exchange. Lindberg, Campbell, and Hollingsworth study the dynamics of the U.S. economy from 1870 through the late-twentieth century and disclosed a typology of governance mechanism in the real world that includes markets, bureaucratic hierarchies, associations, and different types of network, which are individually characterized by certain terms of exchange between economic actors. These mechanisms variously combine in order to coordinate activities among different actors within an industry.<sup>14</sup> Exploring the practices of transaction in Asia, Riggs also stresses the "heterogeneity" of economic exchanges and argues that a model featuring only one element in a heterogeneous mix cannot be seen as a suitable representation of the whole, no matter how important the element is.<sup>15</sup> In a similar sense, Gibson-Graham proposes another typology of transaction, covering formal market, non-market, and alternative market exchange, where, in each category, there still exists a variety of socially, culturally, or governmentally constructed contexts for goods exchange. By presenting a diversity of economic exchange, she unfixes the conventional identity of the economy and disarms the "naturalized" free market.<sup>16</sup> In sum, these works identify

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<sup>13</sup> Adam Smith, *The Wealth of Nations* (New York, NY: Modern Library, 1977), 9, 682-90.

<sup>14</sup> Leon N. Lindberg, John L. Campbell, and J. Rogers Hollingsworth, "Economic Governance and the Analysis of Structural Change in the American Economy," in *Governance of the American Economy*, ed. Leon N. Lindberg, John L. Campbell, and J. Rogers Hollingsworth (Cambridge, UK: Cambridge University Press, 1991), 12-28.

<sup>15</sup> Fred W. Riggs, *Administration in Developing Countries: The Theory of Prismatic Society* (Boston, MA: Houghton Mifflin Company, 1964), 13.

<sup>16</sup> J.K. Gibson-Graham, *A Postcapitalist Politics* (Minneapolis, MI: The University of Minnesota Press, 2006), 60-2.

a shift from the dominance of an ostensibly free market to one that focuses on the qualitatively different types of exchange that multiple actors engage in the real world.<sup>17</sup>

Further, any “ostensibly” free market also requires the state to exercise power aggressively. Decades ago, Polanyi questioned whether a free market, completely free of the “distortions” of state policy, even could exist. He unambiguously contended that the rise of the market economy went hand-in-hand with the emergence of the modern state and that the two developments were historically interconnected.<sup>18</sup> His emphasis on the critical role of the state in the market has inspired generations of scholars. In *Postindustrial Possibilities*, Block argues that in order to capture a better understanding of postindustrial development, we should realize that no market is a “pure” market in the way that neoclassical economics assumes, because every economy is the result of a complex interaction of markets, state actions, and social regulations.<sup>19</sup> Similarly, Fligstein proposes a political-cultural approach to explain market-building as part of state-building. Focused on more than only the property right, he points out that states try to stabilize markets by setting up a series of institutional conditions, including governance structures, conceptions of control, the rules of exchange, and so on.<sup>20</sup> Based on comparative political economy studies, Soskice and Hall argue that the institutions developed by states are crucial for resolving “coordination” problems for firms in the spheres of industrial relations, vocational training, inter-firm relations, corporate governance, and so on.<sup>21</sup> Rather than making rational choices in response to given signals, White argues that market actors are more interested in seeking to protect, consolidate, or extend their power within the market. From this point of view, he identifies four different types of power involved in market politics: the politics of state involvement, the politics of market organization, the politics of market

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<sup>17</sup> Tak-Wing Ngo, “Asia and the Historicity of the Market Economy,” *Verge* 1 No. 1 (Forthcoming 2015).

<sup>18</sup> Karl Polanyi, *The Great Transformation* (Boston, MA: Beacon Press, 1944).

<sup>19</sup> Fred Block, *Postindustrial Possibilities: A Critique of Economic Discourse* (Berkeley, CA: University of California Press, 1990).

<sup>20</sup> Neil Fligstein, “Markets as Politics: A Political-Cultural Approach to Market Institutions,” *American Sociological Review* 61 (1996): 657; Neil Fligstein, *The Architecture of Markets* (Princeton, NJ: Princeton University Press, 2002).

<sup>21</sup> Peter A. Hall and David Soskice, “An Introduction to Varieties of Capitalism,” in *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, ed. Peter A. Hall and David Soskice (New York, NY: Oxford University Press, 2001), 6-8.

structure, and the politics of social embeddedness.<sup>22</sup> In sum, the state actually plays an activist role in the real world rather than a minimalist one. Thus, a need for political analysis of the market has already been recognized, largely in existing literature regarding economic sociology and political economy.<sup>23</sup>

Another great challenge to the dichotomy of market and state originates in the “developmental state literatures.” By investigating the economic growth of East Asia in the late twentieth century, strands of this literature note how state intervention can employ “market-conforming” methods to promote economic growth. In addition to acknowledging the need for state intervention, they further explore which capacities such developmental states have at their disposal for governing the markets more efficiently. Chalmers Johnson, who pioneered the concept of the developmental state, analyzed Japan’s development and concluded that the Japanese state has a small but professional bureaucracy with a high degree of prestige, legitimacy, and authority both for crafting state interventions into the economy and fostering productive ties with the private sectors.<sup>24</sup> Like Johnson’s studies, many developmental state analyses are country-specific, e.g., Amsden’s Korea study and Wade in reference to Taiwan, and they tend to highlight an unusual degree of bureaucratic autonomy and cohesiveness as well as public-private cooperation (or state-business alliance) that together constitute the institutional foundation for effective state intervention in the form of industrial policy.<sup>25</sup> Based on the rich literatures focused on East Asian development, Stubbs summarizes three key features of the developmental state: first, a cohesive set of state bureaucrats with a relatively autonomous capacity to implement a planned strategy for economic growth; second, relational aspects that emphasize the interaction between the elite bureaucracy and private business as a

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<sup>22</sup> Gordon White, “Towards a Political Analysis of Markets,” *IDS (Institute of Development Studies) Bulletin* 24 No. 3 (1993): 1-10.

<sup>23</sup> Richard Swedberg, *Principles of Economic Sociology* (Princeton, NJ: Princeton University Press, 2003); Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York, NY: Oxford University Press, 2001).

<sup>24</sup> Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Stanford, CA: Stanford University Press, 1982), 314-20.

<sup>25</sup> Ziya Onis, “The Logic of the Developmental State,” *Comparative Politics* 24 No. 1 (1991): 114; Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton, NJ: Princeton University Press, 1995), 234-50; Alice Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (Oxford, UK: Oxford University Press, 1989); Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, NJ: Princeton University Press, 1992).

“seamless web of influences”); and third, an ideational aspect with particular attention to nationalism, economic transformation, rapid industrialization, and so on.<sup>26</sup> While a danger of the thesis of the developmental state is that it may have reduced the study of the Asian political economy to the study of economic growth,<sup>27</sup> this strand of literature demonstrates that states are capable of intervening in markets in a much deeper way to structure domestic industry and enhance a nation’s international competitiveness in general.<sup>28</sup>

While these challenges to a dualistic, mutual independence of market and state have been acknowledged and widely discussed, state monopoly through this dualist lens has rarely been challenged. On the contrary, since the 1970s across the Western industrialized countries, the position has been extensively employed to legitimize privatization of the public-utility sectors, which previously had held “exempt” status due to their nature of natural monopoly.<sup>29</sup> However, given that the dichotomy between market and state is questionable, we must similarly reexamine the concept of state monopoly from an alternative perspective. In this context, this study offers a theoretical contribution by developing a new analysis to explain why state monopoly and competition may not only coexist but also complement one another.

### **1.1.2 Existing Literatures on China’s Monopolized Industries**

Due to their obvious presence in China’s economic landscape and the growing disputes surrounding them, issues concerning state-monopolized industries have been given top priority in China’s political agenda in recent years. Some commentators hold that the record-breaking profitability of the central SOE in these industries during the past decade arises from a range of preferential subsidies or treatment granted exclusively by the central authorities.<sup>30</sup> However, while many

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<sup>26</sup> Richard Stubbs, “Whatever Happened to the Developmental State? The Unfolding Debate,” *The Pacific Review* 22 No. 1 (2009): 5-6.

<sup>27</sup> Richard Boyd and Tak-Wing Ngo, *Asian States: Beyond the Developmental Perspective* (New York, NY: Routledge, 2009), 3-16.

<sup>28</sup> Harwit, *China’s Telecommunications Revolution*, 3-9; Anne Mette Kjaer, *Governance* (Stafford, Australia: Polity Press, 2004), 133-5.

<sup>29</sup> Alan Cawson et al., *Hostile Brothers: Competition and Closure in the European Electronics Industry* (Oxford, UK: Oxford University Press, 1990), 87-120; Ioannis Kessides, *Reforming Infrastructure: Privatization, Regulation, and Competition* (Washington, DC: World Bank Publications, 2005), 1-9.

<sup>30</sup> Andrew Szamosszegi and Cole Kyle, *An Analysis of State-owned Enterprises and State Capitalism in China* (Washington, DC: Capital Trade, Incorporated, 2011), 2.

common problems, such as repeated corruption scandals, have continued to plague the central SOEs of state monopolies and the call for privatization has gone on unabated, China's state-monopolized industries have not been diminished dramatically: rather, their power on their respective industries has been reinforced, and their rapid expansion has even been used to symbolize "the rising of China," especially after the global financial crisis in 2008. In this context, empirical studies on these state-monopolized sectors, e.g. petroleum, telecommunications, electricity, banking, aviation, and so on, have continued to appear within academia over the past decade.<sup>31</sup>

Some existing studies have recognized competition as arising within state-monopolized industries, and it is argued that the existence of an oligopolistic market is the root of that competition. In Harwit's study on the telecommunications industry, the author maintains that fierce competition among China Telecom, China Unicom, and others accounts for the success to date of China's telecommunications industry, given that this industry has progressed much faster than nearly any other such industrial sector in the world. By analyzing China's telecommunications industry, he demonstrates that, even though all of the central SOEs are under the same government roof, its oligopolistic market structure can generate the dynamic required for stimulating both price competition and the desire to expand services quickly to meet the market demand.<sup>32</sup> Promoted by industrial policy, the formation of oligopolies thus prompted competition to appear in this sector. Other studies also demonstrate that fierce competition exists in China's banking, electricity, petroleum, and airline industries, where the central authorities have managed to shape highly

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<sup>31</sup> For example, see Jae Ho Chung, "The Political Economy of Industrial Restructuring in China: The Case of Civil Aviation," *The China Journal* 50 (2003): 61-82; Emily T. Yeh and Joanna I. Lewis, "State Power and the Logic of Reform in China's Electricity Sector," *Pacific Affairs* 77 No. 3 (2004): 437-65; Irene S. Wu, *From Iron Fist to Invisible Hand: The Uneven Path of Telecommunications Reform in China* (Stanford, CA: Stanford University Press, 2009); Ding Lu and Chee K. Wong, *China's Telecommunications Market: Entering a New Competitive Age* (Cheltenham Glos, UK: Edward Elgar, 2004); Jin Zhang, *Catch-up and Competitiveness in China: The Case of Large Firms in the Oil Industry* (New York, NY: Routledge, 2004); Tun-jen Cheng and Chung-min Tsai, "Powering Rent-seeking in the Electricity Industry" in *Rent Seeking in China*, ed. Tak-Wing Ngo and Yongping Wu (New York, NY: Routledge, 2009), 117-44; Kun-Chin Lin, "Macroeconomic Disequilibria and Enterprise Reform: Restructuring the Chinese Oil and Petrochemical Industries in the 1990s," *The China Journal* 60 (2008): 49-79.

<sup>32</sup> Harwit, *China's Telecommunications Revolution*, 43-78.



oligopolistic markets populated by giant central SOEs.<sup>33</sup> Based on these findings, it is claimed that the heightened intensity of the competition between powerful oligopolistic SOEs further drives the state monopolies to increase their efficiency.<sup>34</sup>

These studies appear to cast light on the question of why competition should occur in the state-monopoly sectors. They reveal that the state monopoly in China is a group of entities rather than a single-minded one. However, this observation is at best superficial. In fact, the existence of oligopolies does not necessarily guarantee greater competition. Collusion often takes place within the oligopolies, and their joint decisions can significantly impact the market as a whole and thus effectively inhibit competition.<sup>35</sup> The cartel—which agrees to fix prices, marketing, and production among competing firms in order to increase the individual firms' profits by reducing competition—provides the most explicit case of this, and it usually arises in an oligopolistic market structure. As Baran and Sweezy wrote in *Monopoly Capital*, one result of oligopolistic markets is a “powerful taboo” on price cutting; through tacit collusion, giant oligopolistic firms are price makers rather than price takers, and their collusive pricing strategies make the price system work upwards only. According to their observations, in the early twentieth century oligopolistic market structures were actually turned into “shared monopolies” as a result.<sup>36</sup> This finding is also confirmed by John Kenneth Galbraith, who wrote in *American Capitalism* that “not only does oligopoly lead away from the world of competition ... but it leads toward the world of monopoly.”<sup>37</sup> Thus, while multiple players exist in an oligopolistic market, it does not automatically or naturally lead to the appearance of competition.

In order to look a step beyond the nature of such oligopolistic structures, we must pose a new question: what “mechanism” enables oligopolies to engage in

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<sup>33</sup> Li, *Development and Reform of China's Banking System*, 247-9; Eaton, “Political Economy of the Advancing State,” 64-86; Chen, “State-Managed Marketization,” 29-60; Chunbo Ma and Lining He, “From State Monopoly to Renewable Portfolio: Restructuring China's Electric Utility,” *Energy Policy* 36 No. 5 (2008): 1697-711.

<sup>34</sup> Nolan, Zhang, and Liu, “The Global Business Revolution and Developing Countries,” 36.

<sup>35</sup> Jose A. Gomez-Ibanez, *Regulating Infrastructure: Monopoly, Contracts, and Discretion* (Cambridge, MA: Harvard University Press, 2003), 6.

<sup>36</sup> Paul Sweezy and Paul A. Baran, *Monopoly Capital: An Essay on the American Economic and Social Order* (New York, NY: Monthly Review Press, 1966), 57-64.

<sup>37</sup> John Kenneth Galbraith, *American Capitalism: The Concept of Countervailing Power* (Livingston, NJ: Transaction Publishers, 1993), 32-44.

competition rather than collusion, and how does or has this mechanism come about? Available empirical studies have actually remained unclear on this point.

In addition, it should be noted that only after China entered the World Trade Organization (WTO) over a decade ago did the oligopolistic market structures take shape in the state-monopolized industries in any significant way. Prior to the creation of the oligopolies, competition had already appeared in some of these industries as indicated in the extant literatures. For example, Eaton's study on China's airline industry illustrates that before the formation of the "Big Three" state-owned carriers in the early 2000s, the intensified competition expressed by the price war among a large number of airlines during the 1990s caused a collapse in the industry's revenue beginning in 1997. Under these circumstances, the central authorities began to restructure the industry around the "Big Three" oligopolies as the "national champions" before the heated competition could bankrupt much of the sector.<sup>38</sup> A similar situation could also be found in China's electricity industry. For example, Tsai's study argues that without a functional regulatory regime, the reform of the electricity sector in the 1990s heralded increasing chaos in this industry. In the face of such predicaments, the oligopolies arose afterwards as a solution.<sup>39</sup> The creation of oligopolies here was not, however, intended to introduce competition in the state-monopolized industries. In China's context, there had already existed other kinds of industrial structures, governance patterns, and competition before the oligopolies took shape within these industries, and what the oligopolistic structures have brought in is actually another type of competition. Nonetheless, while the existing literatures demonstrate that the creation of the oligopolies was in response to industrial predicaments that had emerged previously, they do not systematically discuss how competition, including the mechanism of its formation and its type of operation, developed in the current state-monopolized sectors since the late 1970s. As a consequence, the oligopolistic structure turns out to be an "easy answer" when attempting to account for the birth of competition in the state monopolies.

To use Pierson's term, this easy answer actually only takes a "snapshot view" torn out of its temporal context. It ignores the profound temporal dimensions of real processes that can unfold over an extended period of time such that this snapshot not only fails to identify relevant and fundamental questions, e.g., those involving the

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<sup>38</sup> Eaton, "Political Economy of the Advancing State," 64-86.

<sup>39</sup> Chung-min Tsai, "The Reform Paradox and Regulatory Dilemma in China's Electricity Industry," *Asian Survey* 51 No. 3 (2011): 520-39.

incentives of competition, but also end up inverting the causal relationships.<sup>40</sup> Therefore, unlike such an analysis based on this snapshot view, the present thesis reintroduces the temporal dimension and constructs a “moving picture” of the situation by exploring questions about how competition could appear from the outset and how it has evolved to the present day from the time of the market-oriented reform initiated more than three decades ago.

## 1.2 The Approach of Historical Institutionalism

Given its emphasis on the temporal dimension, this study adopts a historical institutionalist approach to address and explore the abovementioned questions. Different from other institutionalist approaches, historical institutionalism gives temporality prime importance for examining causal relationships. It does this by specifying sequences and systematically tracing transformations and processes on varying scales and timeframes so that a dynamic view emerges when examining the process from its institutional origins through its development.<sup>41</sup> In this approach, institutions are broadly defined as the formal and informal procedures, routines, norms, and conventions embedded in the organizational structure of a political economy. Historical institutionalists focus on institutions that not only embody power relationships but that also shape interactions between individual actors in the system in order to develop explanatory arguments about important outcomes or puzzles in those institutions.<sup>42</sup>

To contrast, rational choice institutionalism views institutions as coordinating mechanisms that sustain a particular equilibrium, while tending to assume that institutional effects are derived from design in a straightforward way. From this functionalist perspective, institutional creation is framed as highly intentional and

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<sup>40</sup> Paul Pierson, *Politics in Time: History, Institutions, and Social Analysis* (Princeton, NJ: Princeton University Press, 2004), 2, 152-3.

<sup>41</sup> Peter A. Hall and Rosemary C. R. Taylor, “Political Science and the Three New Institutionalisms,” *Political Studies* 44 No. 5 (1996): 938-9; Kathleen Thelen and Sven Steinmo, “Historical Institutionalism in Comparative Politics,” *Annual Review of Political Science* 2 (1999): 16-7.

<sup>42</sup> Paul Pierson and Theda Skocpol, “Historical Institutionalism in Contemporary Politics,” in *Political Science: The State of the Discipline*, ed. Ira Katznelson and Helen V. Milner (New York, NY: W.W. Norton & Company, 2002), 695-6; Tsung-hao Huang, “Lishi zhidulun de fangfa lichang yu lilun jiangou” (The characteristics of theory and method in historical institutionalism), *Issues & Studies* 49 No. 3 (2010): 158.

falling under the control of far-sighted creators who correctly perceive the effects of the institutions they establish and build them precisely in order to secure those effects. This point of view often seems to oversimplify institutional development so that it has difficulties answering both why institutional effects would deviate from the original design or change over time.<sup>43</sup>

Operating on an inductive logic, historical institutionalism views institutions as a legacy of concrete historical processes and calls for more empirical investigations into how institutions arise and change over time. As Pierson puts it, historical institutionalism “stresses that many of the contemporary implications of ... temporal processes are embedded in institutions, whether these be formal rules, policy structures, or social norms.”<sup>44</sup> In other words, contrary to the assumption that the same operative forces generate the same result everywhere, historical institutionalism focuses on how the effects of such forces are mediated by the features of a given temporal context. From this perspective, institutions are seen as relatively persistent features of the historical landscape, so they cannot be understood in isolation from the political or social settings where they are embedded.<sup>45</sup> Likewise, historical institutionalists often conduct meso- or macro-level analyses that discuss multiple institutions interacting with, operating within, and/or influenced by, broader contexts. Therefore, historical institutionalists tend to investigate the rise and decline of institutions, including probing the genesis, impact, and stability or instability of specific institutions along with broader institutional configurations. Sometimes their goal is to analyze the institutional arrangements themselves and at other times to use institutional configurations as variables to explain other outcomes.<sup>46</sup> In the following, I summarize historical institutionalism’s main arguments for explaining institutional continuity and change, which will then be applied to analyze the establishment process for institutions. This will serve also to construct an analytical framework for subsequent chapters.

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<sup>43</sup> Thelen and Steinmo, “Historical Institutionalism,” 8; Hall and Taylor, “Political Science,” 944-5; Kathleen Thelen, “How Institutions Evolve: Insights from Comparative Historical Analysis,” in *Comparative Historical Analysis in the Social Sciences*, ed. James Mahoney and Dietrich Reuschemeyer (Cambridge, UK: Cambridge University Press, 2003), 215.

<sup>44</sup> Paul Pierson, “The Path to European Integration: A Historical Institutional Approach,” *Comparative Politics Studies* 29 No. 2 (1996): 126.

<sup>45</sup> Hall and Taylor, “Political Science,” 941; Thelen and Steinmo, “Historical Institutionalism,” 384.

<sup>46</sup> Pierson and Skocpol, “Historical Institutionalism,” 706.

First, historical institutionalism uses the concept of “path dependence” to account for institutional continuity. The idea of path dependence, whereby the preceding steps of a particular direction induce further movement in the same direction, includes a self-reinforcing or positive feedback process. By this, the probability of future steps along the same path increases with each move down that path, and the cost of exiting from the existing arrangements rises greatly. As a result, the actors find it difficult to reverse an existing course.<sup>47</sup> In this sense, historical institutionalists embrace a power-political view of institutions that emphasizes their distribution effects, and they explain institutional persistence in terms of increasing returns or a positive feedback of power. Thus, while path dependence can help us to understand the powerful, inertial stickiness that characterizes many aspects of political development, it also provides a useful corrective against the tendency to assume a functionalist explanation for important outcomes while paying attention to the temporal dimensions of political processes. In addition, the dynamics of increasing return highlights the issue of “timing and sequencing” in path-dependent processes, i.e., that the order of events may make a fundamental difference in outcomes. In this, earlier events matter much more than later ones and, hence, different sequences may produce different consequences. It entails also that even when policymakers set out to redesign institutions, they remain constrained in what they are able to conceive due to the previous embeddedness of circumstance. The issue of timing and sequence, then, becomes the critical aspect of institutional analysis, since *when* things happen within a sequence affects *how* they happen.<sup>48</sup>

While path dependence helps us to understand the powerful inertia that leads to institutional continuity, it does not propose a story of inevitability whereby the past neatly or easily predicts the future.<sup>49</sup> When it comes to explaining institutional change, historical institutionalists frequently call attention to “critical junctures,” those periods of contingency during which the usual constraints on action are eased

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<sup>47</sup> Paul Pierson, “The Limits of Design: Explaining Institutional Origins and Change,” *Governance* 13 No. 4 (2000): 492; Paul Pierson, “Increasing Returns, Path Dependence, and the Study of Politics,” *American Political Science Review* 92 No. 2 (2000): 251; Paul Pierson, “Not Just What, but When: Timing and Sequence in Political Processes,” *Studies in American Political Development* 14 No. 1 (2000): 74.

<sup>48</sup> Charles Tilly, *Big Structures, Large Processes, Huge Comparisons* (New York, NY: Russell Sage Foundation, 1984), 14; Paul Pierson, “Increasing Returns,” 252-3; Thelen and Steinmo, “Historical Institutionalism,” 386; Pierson and Skocpol, “Historical Institutionalism,” 700; Pierson, *Politics in Time*, 63-7.

<sup>49</sup> Pierson, *Politics in Time*, 52.

and significant change can occur in a distinctive way.<sup>50</sup> Path dependence supplies an important causal mechanism for historical institutionalists, and critical junctures constitute the starting points for many path-dependent processes.<sup>51</sup>

Analyses of critical junctures often connect to the notion about relative weight of agency versus structure in various phases. For example, Katznelson considers institutions as constraining in periods of stable politics, but he points out that critical junctures create opportunities for historic agents to alter the trajectory of development.<sup>52</sup> Mahoney also emphasizes the importance of agency and meaningful choice: “In many cases, critical junctures are moments of relative structural indeterminism when willful actors shape outcomes in a more voluntaristic fashion than normal circumstances permit.”<sup>53</sup> Soifer further proposes two conditions—permissive and productive—to explain the causal logic of critical junctures. The former represents the removal of structural constraints and makes change possible, while the latter acts within the context of the permissive condition to produce outcomes divergent from the past.<sup>54</sup> In general, political science analyses of critical junctures often focus on decisions made by influential actors at those junctures to examine how they steer outcomes in a phase of institutional fluidity.<sup>55</sup>

When critical juncture is deployed to illustrate a discontinuous model of change whereby enduring historical pathways rapidly transform or get punctuated by moments of agency and choice, then a gradualist view that stresses how institutions change in subtle and slow ways begins to surface that supplements the accounts of

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<sup>50</sup> Giovanni Capoccia and R. Daniel Kelemen, “The Study of Critical Junctures: Theory, Narrative, and Counterfactuals in Historical Institutionalism,” *World Politics* 59 No. 3 (2007): 343; Ruth Berins Collier and David Collier, *Shaping the Political Arena: Critical Junctures, the Labor Movement, and Regime Dynamics in Latin America* (Notre Dame, IN: University of Notre Dame Press, 2002), 27-39.

<sup>51</sup> Capoccia and Kelemen, “The Study of Critical Juncture,” 342.

<sup>52</sup> Ira Katznelson, “Periodization and Preferences: Reflections on Purposive Action in Comparative Historical Social Science,” in *Comparative Historical Analysis in the Social Sciences*, 270-303.

<sup>53</sup> James Mahoney, *The Legacies of Liberalism: Path Dependence and Political Regimes in Central America* (Baltimore, MD: Johns Hopkins University Press, 2002), 7.

<sup>54</sup> Hillel David Soifer, “The Causal Logic of Critical Juncture,” *Comparative Political Studies* 45 No. 2 (2012): 1573-6.

<sup>55</sup> Andrew Cortell and Susan Peterson, “Altered States: Explaining Domestic Institutional Change,” *British Journal of Political Science* 29 (1999): 187-9; Capoccia and Kelemen, “The Study of Critical Juncture,” 354.

causal processes of institutional change found in historical institutionalist literature. This insight has grown out of debates about path dependence, and it suggests that a complete “lock-in” of path dependence is not a common phenomenon in actual circumstances, if institutions normally evolve in more incremental ways.<sup>56</sup> In particular, given that institutions are conceived in this approach as distributional instruments laden with power implications, those that benefit from existing arrangements indeed have an objective preference for continuity, but ensuring such continuity requires the ongoing mobilization of political supports and active efforts to resolve institutional ambiguities, which often arise given that the operational rules can never be precise enough to cover the complexities of all possible situations in the real world. In this sense, institutional stability rests not only on the accumulation indicated by “path dependence” but also on this ongoing mobilization. However, once shifts in the balance of power occur, an existing stability may be broken and thus lead to change.

Along with dramatic changes based on the exogenous conditions presented by a “critical juncture,” shifts also may derive from endogenous developments that often gradually unfold. Mahoney and Thelen argue that gradual institutional change often occurs when problems of rule interpretation and enforcement create space or cleavage for actors to implement existing rules in new ways. In this sense, the issue of compliance emerges as a crucial variable in accounting for change.<sup>57</sup> Moreover, as Pierson and Skocpol emphasize in the “combined effects of institutions,” actors are usually embedded in a multiplicity of institutions, and there exist incongruities, interdependencies, or intersections between different institutional realms in a given temporal process that may generate complexity and have unintended consequences on the actors’ behavior. In other words, the interactions and conflicts among them may trigger the actors who play a role in the dominant power to take a strategy for incremental change.<sup>58</sup> Therefore, interactions between the features of the political context and the properties of the institutions themselves usually constitute the determining factor for explaining incremental changes of this type.

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<sup>56</sup> James Mahoney and Kathleen Thelen, “A Theory of Gradual Institutional Change,” in *Explaining Institutional Change: Ambiguity, Agency, and Power*, ed. James Mahoney and Kathleen Thelen (Cambridge, UK: Cambridge University Press, 2009), 1; Pierson and Skocpol, “Historical Institutionalism,” 703; Soifer, “The Causal Logic,” 1580; Pierson, *Politics in Time*, 82-90.

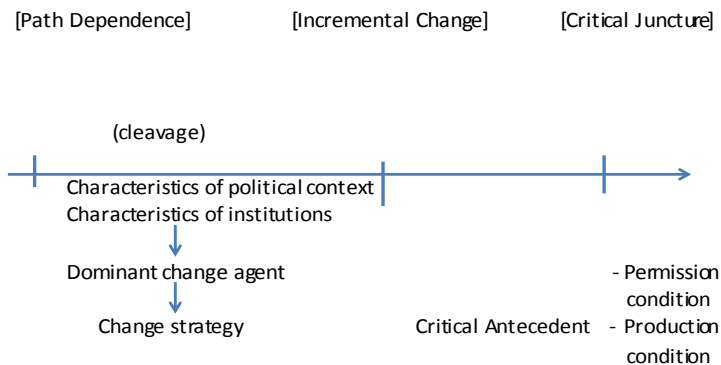
<sup>57</sup> Mahoney and Thelen, “A Theory,” 4, 8-14.

<sup>58</sup> Pierson and Skocpol, “Historical Institutionalism,” 695.

In general, this argument for gradual change suggests that dynamic tensions and pressures for change are built-in and that this change would emerge in the gaps between the rules and their interpretation or enforcement.<sup>59</sup> Incremental change may then develop into a “critical antecedent,” which plays a causal role in outcomes at “critical junctures.” As Slater and Simmons demonstrate in their study, such critical antecedents influence the value taken by the productive condition such that a divergence occurs during or at the critical juncture.<sup>60</sup>

Thus, multistage causal processes exist from the starting point of path dependence to a given critical juncture. In this causal chain, critical antecedents based on incremental changes are often connected to the production condition of that critical juncture. Consequently, path dependence, critical juncture, and gradual change constitute the major types of causal mechanisms within historical institutionalism for explaining how institutions evolve and change (see Figure 1.1). In the chapters that follow, I apply these dynamic insights in order to develop explanatory arguments bearing on the single case study of this research, the tobacco industry.

**Figure 1.1 - Multi-Stage Causal Mechanisms of Institutional Development**



Source: Summarized by the author

<sup>59</sup> Mahoney and Thelen, “A Theory,” 8, 31-2.

<sup>60</sup> Dan Slater and Erica Simmons, “Informative Regress: Critical Antecedents in Comparative Politics,” *Comparative Political Studies* 43 No. 7 (2010): 891.



### 1.3 The Tobacco Industry as a Case Study

Following the approach of historical institutionalism, this thesis selects the tobacco industry as a single case study for delving into two main threads of analysis: 1) How was the tobacco state monopoly established in the beginning? And 2) How have the industrial governance patterns been formed over a range of temporal phases? In fact, the two questions are closely related—the former is the foundation of the latter, and the latter will account for how competition could emerge and change in the tobacco state monopoly over the past decades by distinguishing its various phases of institutional configuration.

Although competition also appears in other state-monopolized industries, the tobacco industry is an excellent case for studying the correlation between monopoly and competition because it has the most comprehensive and strictest central state control among all of the state-monopolized industries in China, being solely owned by the Chinese government and run by the China's National Tobacco Corporation (CNTC). Further, its monopoly status is protected by the *Tobacco Monopoly Law*, which formally bars the entry of non-state capital across the entire production chain apart from that of farmers and retailers. In this regard, the extent of state regulation is higher than in other state-monopolized industries, such as telecommunications or electricity, where the government does not officially prohibit the entry of non-state capital with any laws or rules, while nevertheless employing other means to keep the central SOEs dominant. In addition, the reform of “separating government administration from enterprise business” (*zhengqi fenkai* 政企分开), which aims to distinguish the roles of the state and SOEs and pave the way for establishing another set of regulatory institutions,<sup>61</sup> has not been initiated in the tobacco sector so far. Most other state-monopolized industries completed this separation during the 1990s,<sup>62</sup> though the regulatory institutions have not functioned properly since then.<sup>63</sup> The tobacco sector, by contrast, has retained the structure of a

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<sup>61</sup> Margaret M. Pearson, “The Business of Governing Business in China: Institutions and Norms of the Emerging Regulatory State,” *World Politics* 57 No. 2 (2005): 302-4.

<sup>62</sup> For example, please see the document issued by the Commission of State Economic and Trade, “Guanyu yinfā ‘guanyu zuohao dianli gongye zhengqi fenkai gaige gongzuo de yijian’ de tong zhi” (The opinion about separating government administration from enterprise business in the electricity industry), [http://www.law-lib.com/law/law\\_view.asp?id=112572](http://www.law-lib.com/law/law_view.asp?id=112572) (accessed November 15, 2012).

<sup>63</sup> Chung-min Tsai, “Regulating China's Power Sector: Creating an Independent Regulator without Autonomy,” *The China Quarterly* 218 (2014): 452.

government-business synthesis since the early 1980s. In this regard, state control in the tobacco industry is indeed much more formidable than in other state-monopoly industries. What is more, as originally formulated by the China's central authorities in the early 1980s, market should have been stifled from the outset in the tobacco state monopoly; however, the sharp contrast between the institutional design and the current reality of tobacco state monopoly came into existence from the outset. In the next section, I outline this gap between the monopolistic institutional prototype and the actual industry situation.

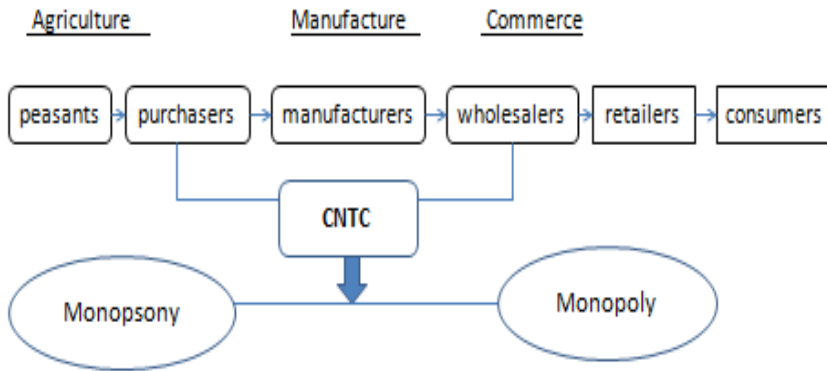
### **1.3.1 The Contrast between the Institutional Prototype and Reality**

When China's tobacco sector was designated a state monopoly, China's National Tobacco Corporation (CNTC) was set up to represent the central state for managing the entire sector in 1982. As the monopolist, the CNTC was formulated to monopolize the production chain from agriculture (growing tobacco leaves), manufacture (producing cigarettes) to commerce (selling cigarettes); that is, only the CNTC would be allowed to buy tobacco leaves from peasants and to sell leaves to its affiliated cigarette factories. These state cigarette factories could only engage in cigarette manufacturing and would then sell all of their products back to the CNTC. The only cigarette wholesaler was the CNTC where all the state-licensed retailers procured cigarette products. This institutional design meant that China's tobacco system was actually a monopoly-cum-monopsony arrangement (see Figure 1.2).<sup>64</sup> By this, the CNTC carried out its monopoly and monopsony activities through its local agents, which were required to follow the production quantities and transaction prices specified by the state. The logic of this institutional design basically derived from the planned economy of Mao's era, so that the tobacco industry would be called "the last brick of China's planned economy wall" during the reform era.

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<sup>64</sup> In this thesis, the tobacco state monopoly system refers to the monopoly-cum-monopsony arrangement.

**Figure 1.2 - The Production Chain under the Tobacco State Monopoly System**



Source: Supplied by the author

Paradoxically, this monopoly-cum-monopsony arrangement has not eradicated competition in the trades between the cigarette manufacturers and wholesalers. Despite the fiat of monopolistic control, the CNTC's local agents, including cigarette manufacturers and wholesalers, have turned out to be the “multiple players” in this industry. For example, there were 29 cigarette manufacturers and more than three hundred cigarette wholesalers in 2011.<sup>65</sup> In addition, the prices of cigarette transaction between manufacturers and wholesalers have been driven by supply and demand in a market manner rather than as specified by the state. Therefore, I target this disparity via a historical institutionalist lens to investigate how the tobacco state monopoly deviated from its original design in the first place and how this disparity evolved out of the various processes involved.

### **1.3.2 Existing Empirical Studies on China's Tobacco Industry**

Given the extent of central state control in the tobacco industry, this sector provides an ideal case for studying the relationship between state monopoly and competition. However, while several studies of state-monopoly industries focus on telecommunication, electricity, petroleum, aviation, and so on,<sup>66</sup> the tobacco industry has drawn little attention. This low degree of analysis may be partially due

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<sup>65</sup> State Tobacco Monopoly Bureau, *Zhongguo yancao nianjian 2011-2012* (China tobacco yearbook 2011-2012) (Beijing, China: China Science & Technology Press, 2012), 2-15.

<sup>66</sup> With reference to footnotes 31 and 33.

to the fact that the fiscal significance of this sector for the Chinese government has been little noted. In fact, the Chinese government made this industry a state monopoly from the beginning precisely due to fiscal concerns, as detailed more in Chapter Two. On other hand, the industry has been kept low key because, with the largest smoking population and the highest death toll caused by tobacco-related diseases in the world, the international anti-smoking campaign has chosen China as its primary target.<sup>67</sup> Though China already signed the World Health Organization Framework Convention on Tobacco Control (FCTC) in 2003, aiming to reduce the production and consumption of tobacco products, it is actually reluctant to implement the tobacco control policy given that this industry has remained one of the most important sources of national fiscal revenues so far. In 1996, the tobacco income constituted 11.2 percent of national income, and even though this later dropped, it still maintained more than 7 percent of national revenue during the past years. (see Table 1.1). Given its financial significance, this sector has strategic value for the central authorities and does not constitute a sunset industry. However, only limited attention has gone into investigating this important industry so that little was known about its operation as compared with other state-monopolized industries. This provides another rationale for targeting at this industry in this study.

**Table 1.1 - The Ratio of Tobacco Income to National Revenue (1976–2007)**

<b>Period / Year</b>	<b>Tobacco Income</b> (RMB, hundred million)	<b>National Revenue</b> (RMB, hundred million)	<b>Ratio of Tobacco Income to National Revenue (%)</b>
Fifth five-year plan period (1976-1980)	200.24	4960.66	4.04
Sixth five-year plan period (1981-1985)	377.07	6830.68	5.52
Seventh five-year plan period (1986-1990)	1065	13421.16	7.93
Eighth five-year	2261	24256.08	9.32

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<sup>67</sup> Please refer to this link for more details:

[http://global.tobaccofreekids.org/en/global\\_epidemic/china](http://global.tobaccofreekids.org/en/global_epidemic/china).

plan period (1991-1995)			
1996	830	7408	11.2
1997	900	8651.1	10.4
1998	950	9876	9.6
1999	989	11444.1	8.6
2000	1050	13380.1	7.8
2001	1150	16371	7.0
2002	1400	18914	7.4
2003	1600	21715.3	7.4
2004	2100	25178	8.3
2005	2400	31649.29	7.6
2006	2900	39373.2	7.4
2007	3880	51304.03	7.6
2008	4499	61330.3	7.3
2009	5131	68518.3	7.5
2010	6046	83101.5	7.2
2011	7530	103874.4	7.2

*Source:* Adapted from “Zhuanmai zhidu xia woguo yancao chanye de gaige yu fazhan,” (The reform and development of China’s tobacco industry under the state monopoly system) by H. Wang, 2009, *Shanghai Economic Review*, 23; *Zhongguo yancao nianjian 2008* (China tobacco yearbook 2008) (p. 223), by the State Tobacco Monopoly Bureau, 2008, Beijing: China Science & Technology Press; *Zhongguo yancao nianjian 2009* (China tobacco yearbook 2009)(p. 197); *Zhongguo yancao nianjian 2010* (China tobacco yearbook 2010) (p. 175); *Zhongguo yancao nianjian 2011-12* (China tobacco yearbook 2011-12) (p. 80); *Zhongguo caizheng nianjian 2012* (China’s annual financial report 2012)(p. 458), by He Jieping, 2012, Beijing: China State Finance.

In the few empirical studies of the tobacco industry, they concentrate almost exclusively on investigating the interplay of local government action in this sector. In Eng’s study, she illustrates by analyzing local governmental action why agglomeration—the concentration of tobacco economic activities—would take place in Yunnan Province and how it was advanced in the 1980s.<sup>68</sup> Zhou’s paper discusses how local governmental competition affected enterprise behavior and market performance in the tobacco industry from 1980s to 1990s under fiscal

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<sup>68</sup> Irene Eng, “Agglomeration and the Local State: the Tobacco Economy of Yunnan, China,” *Transactions of the Institute of British Geographers* 24 No. 3 (1999): 315-29.

decentralization. By discussing the development of the tobacco industry, he argues that fiscal decentralization provides incentives for local governments to promote economic development but that the same motive to increase local tax can make local governments take protectionist measures too.<sup>69</sup> Different from Eng's and Zhou's studies, Peng's paper explores how local governments in Quizhou Province aggressively intervened in the peasants' production of tobacco leaves during the 1990s. Peng demonstrates that decentralization of a previously planned economy does not automatically equate to a retreat of the state.<sup>70</sup> In general, these studies recognize the incentives for local governments to meddle in local tobacco business, but they all ignore a most fundamental issue: why were local governments able to get involved in the operation of this state-monopoly sector? In general, these studies usually take the capacity of local governments' intervention in local tobacco business for granted, even though this industry by design should be highly controlled and regulated by the central authorities.

Junmin Wang's *State-Market Interactions in China's Reform Era* offers the most detailed and in-depth monograph on China's tobacco industry so far. She proposes "market-building as state-building" as the framework to analyze how China's tobacco industry was influenced by state and market in an iterative process once market-oriented reform was set into motion. Extending the research timeframe from the 1980s to the early 2000s, she discovers that the market dynamics created the driving force by which the state restructured itself to cope with emergent market competition, and that, in turn, the rebuilding of the state structures caused the specific institutional conditions that set new market circumstances into motion.<sup>71</sup>

Though Wang presents a dynamic analysis of relationships between government and market by identifying the distinctive processes of state-market interactions in this industry, the study has two crucial disadvantages. First, without any analysis on the formation of the market, it seems to assume that a market would naturally emerge in this state-monopolized industry; however, how a market comes into being denotes precisely the onset of state-market interaction. Though Wang observes that "decentralized and dispersed state ownership" creates a market in the

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<sup>69</sup> Huizhong Zhou, "Fiscal Decentralization and the Development of the Tobacco Industry in China," *China Economic Review* 11 (2000): 114-33.

<sup>70</sup> Yali Peng, "The Politics of Tobacco: Relations between Framers and Local Governments in China's Southwest," *The China Journal* 36 (1996): 67-82.

<sup>71</sup> Junmin Wang, *State-Market Interactions in China's Reform Era: Local State Competition and Global Market-building in the Tobacco Industry* (New York, NY: Routledge, 2013).

tobacco sector,<sup>72</sup> she does not explain why this kind of state ownership would appear, especially given that the market should have been stifled from the beginning under a central planned model according to the original institutional design. Second, while emphasizing state-building, Wang's analysis neglects the power relationship between different levels of the state as well as the power dynamic between the vertical and horizontal bureaucratic domains.<sup>73</sup> As a result, it oversimplifies the analysis on the mutual construction between state and market and fails to make clear how state control and competition would complement each other in the tobacco industry as currently. I address and fill in these disadvantages in the chapters that follow in order to further enrich the body of empirical studies on China's tobacco industry.

## 1.4 Research Methodology & Chapter Outline

For this single case study, two major methods were adopted to obtain empirical data. First, I collected a plethora of documentation to map the picture of China's tobacco industry policies, structures, and developmental histories since the 1980s. The documentation include the yearbooks of the tobacco industry as edited by all levels of the State Tobacco Monopoly Bureau (STMB), the annuals of the tobacco enterprises, local chronicles, monographs regarding China's tobacco development, and articles in a variety of journals and newspapers. Second, I collected ethnographic data from fieldwork conducted in China. From 2008 to 2011, I stayed in Yunnan (Kunming, Yuxi, Dali, Mile and Qujing), Guizhou (Guiyang and Zunyi), Liaoning (Fuxi), Zhejiang (Shaoxing), Beijing, and Shanghai to conduct in-depth interviews and make ethnographic observations. Over a period of august months, I interviewed 70 people, some of them multiple times (See Appendix B). Among those interviewed were tobacco farmers, local government cadres, tobacco corporation officials, cigarette enterprise employees (including some now retired), and researches who participated in the policymaking process in advisory capacities. These interviews allowed access to the actual actors involved in running the tobacco state monopoly in order to further validate the accuracy of the documentary data and to develop deeper insights into this industry.

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<sup>72</sup> Ibid., 8.

<sup>73</sup> Meg Rithmire, review of *State-Market Interactions in China's Reform Era: Local State Competition and Global Market-building in the Tobacco Industry* by Junmin Wang, *The China Quarterly* 215 (2013): 775-6.

Having presented the phenomena and problems to be explored in this chapter, along with the conceptual and research approach and methodology adopted for this research, in the next chapter, I discuss how the tobacco state monopoly was established in the early 1980s. By exploring this process, the leverage of local governments in the tobacco sector comes to light. Out of this finding, Chapter Three further articulates an analytical framework to discuss how three different governance patterns have developed via interactions between local governments and multiple players in the tobacco sector. Chapters Four through Chapter Six elaborate the details of those governance patterns along with their associated type of competition. These analyses disclose the thirty-year evolution of the tobacco state monopoly into a “state-led competitive monopoly.” In Chapter Seven, I extend the theoretical implications of this study to look at the crises that have been emerging recently in the current form of the tobacco state monopoly system.



## **CHAPTER TWO**

### **THE PROCESS OF BUILDING THE TOBACCO STATE MONOPOLY**

When the Chinese government decided to institute a tobacco state monopoly in the early 1980s, it aroused a great deal of controversy and skepticism since this proposed to restore a planned economy on the tobacco sector. This policy was seen as antithetical to the trend of SOE reform as well given the general advance of market-oriented reforms initiated in the late 1970s.

This chapter first unravels why the Chinese government elected to establish a tobacco state monopoly at this particular juncture and how it formulated the institutional arrangements for this. Drawing from insights provided by path dependence—the notion that the order in which things happen affects how they happen—I further explore the question of how, in practical terms, a state monopoly on tobacco sector could be achieved when market-oriented reforms had already been set in motion. Through an analysis of this establishment process, not only will the gap between the original formulation of a state monopoly and the actual industry outcome become more evident, but also the leverage of local governments in this industry from the outset will become clear. From this context, we will see how local governments would go on to become crucial actors in shaping the operation of the tobacco state monopoly system. Their interaction with the agents responsible for implementing the tobacco state monopoly along the entire chain of production would ultimately determine the industrial governance pattern once the establishment process completed in the 1980s.

#### **2.1 The Background to Instituting the Tobacco Monopoly System**

The establishment of the tobacco state monopoly in the early 1980s represented an attempt by the Beijing government to regain its control over the industry. In fact, a similar attempt was made as early as 1964 when Beijing created the Chinese Tobacco Industrial Corporation as a national trust. Its task was to manage and organize the entire production of tobacco sector from a vertical

perspective. However, the Corporation was abolished during the Cultural Revolution and its duties devolved to local authorities.<sup>1</sup>

In this wave of devolution, a substantial number of SOEs were handed to local governments, but these SOEs had no power to determine capital investment, material procurement, or profit disposal, unlike SOEs in the post-Mao era. It was during this period, however, that many local cigarette factories began to mushroom in rural people's communes and production brigades since state control here was not as strict as in urban regions. As a result, by 1977 there were, according to an investigation conducted by the Ministry of Light Industries in that year, over two hundred non-state planned cigarette factories in operation. With the growth of the non-planned cigarette factories, the factories that fell under the state plan were forced to reduce or even cease production because of the short supply of raw materials snatched up by the non-planned ones. Many state factories failed to reach production targets assigned under the national plan, which in turn affected the national fiscal revenue extracted from the tobacco industry. From the central authority's point of view, the proliferation of local cigarette manufacturers fragmented the production linkage in this industry. In order to fix the mismatch between the supply of tobacco leaves and the production of cigarettes, the State Council began to order a clampdown on local non-planned factories in 1977.<sup>2</sup> As such, while "the growing out of plan" indicated in Barry Naughton's study had already occurred before the introduction of market-oriented reform, the central authorities had targeted this situation for elimination during this period of time.<sup>3</sup>

But it was not long before China began experimenting with market-oriented reforms, and local governments were driven to operate their own cigarette factories once again under the measure of fiscal decentralization. In light of the low technology levels and available capital for this industry, the surge in local cigarette manufacturers—increasing by more than one hundred cigarette factories from 1977

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<sup>1</sup> Wang Yizhi, "Yancao tuolasi zhi yuanqi" (The origin of the tobacco trust), *China Tobacco*, September 20, 2009, accessed March 10, 2010, <http://www.echinatobacco.com/101588/102041/102524/43534.html>; Liu Zhen, "Yancao tuolasi de shiban licheng" (The trail of building the tobacco trust), *China Tobacco*, September 20, 2009, accessed March 10, 2010, <http://www.echinatobacco.com/101588/102041/102524/43535.html>.

<sup>2</sup> Yang Guoan, *Zhongguo yancao tongzhi* (The annals of Chinese tobacco) (Beijing, China: Zhonghua Book Company, 2009), 1133.

<sup>3</sup> Barry Naughton, *Growing out of the Plan: Chinese Economic Reform, 1978-1993* (Cambridge, UK: Cambridge University Press).

to 1981—resulted in an extremely acute shortage of tobacco leaves.<sup>4</sup> Under these circumstances, the Ministry of Light Industry was required by the central state to urgently seek out a solution. In the wake of this, in 1981 the Ministry of Light Industry proposed to the State Council rebuilding a vertically integrated industrial system, akin to the Chinese Tobacco Industrial Corporation in the 1960s, in order to reorganize the entire production chain and place it under the state’s control.<sup>5</sup>

In addition to consolidating the industrial production chain, the fiscal deficits the central state faced at that time also motivated it to set up a tobacco state monopoly system. These fiscal deficits arose from measures for granting further benefits to the agriculture sector and state-owned enterprises in the early stage of economic reform, which included raising the purchase prices of agricultural products, increasing profit sharing to SOEs, and so on.<sup>6</sup> Accordingly, the consolidated government budget as a share of national income shrank from 41.5 percent in 1978 to 33.1 percent in 1982. While a reduction in the size of the budget should have been expected, the rapidity of this decline seems to have caught officials by surprise.<sup>7</sup> In view of worsening fiscal pressure, the harmful and addictive attributes of tobacco products ironically granted the Chinese government the legitimacy to levy higher taxes on them. The establishment of a tobacco state monopoly was seen as a reliable and rapid method for securing higher taxes and profits from this industry<sup>8</sup>.

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<sup>4</sup> See the document “Guowuyuan pizhuan guojia jihua wuyuanhui den bumen guanyu dui jihuawai yanchang tiaozheng yijian de baogao de tongzhi” (The notification of the State Council approving and forwarding the report made by the State Plan Commission and other related departments on the adjustment about the cigarette factories beyond the state plan) issued by the State Council (1982),

<http://www.chinabaike.com/law/zy/xz/gwy/1332135.html> (accessed March 8, 2010).

<sup>5</sup> The institute of tobacco economy of the Chinese National Tobacco Corporation, *Zhongguo yancao chongzu zhenghe ji zouchuqu* (China tobacco restructuring, integrating and going outside) (Beijing, China: Capital University of Economics and Business Press, 2006), 52-3.

<sup>6</sup> Kao Peiyong, “Zhongguo caizheng kunnan de youlai: cong yunxing jizhi jiaodu de fenxi” (The origin of fiscal issues in China: The analysis from the perspective on operative mechanism), *Economic Science* 5 (1995): 16-22; Christine P. W. Wong, “Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China,” *The China Quarterly* 128 (1991): 695.

<sup>7</sup> Wong, “Central-Local Relations”, 691-2.

<sup>8</sup> The logic will be explained in the next section where I explore the design of this institutional arrangement.

Driven by the abovementioned concerns, the State Council finally decided in 1982 to adopt the Ministry of Light Industry's proposal to establish the China National Tobacco Corporation (CNTC), which would manage the running of the entire industry.<sup>9</sup> In the following year, the *Rules on the Tobacco Monopoly* was promulgated, thus officially proclaiming the establishment of the tobacco state monopoly system. In order to quell doubts voiced by advocates of market-oriented reforms at that time, the State Council even published an article titled "It is Necessary to Build a Tobacco State Monopoly" in the *People's Daily (Renmin Ribao 人民日报)* soon after the announcement of the *Rules*. The article stressed that the tobacco state monopoly was the most efficient way to "ensure orderly production, raise product quality, improve market supply, and assure state fiscal revenue."<sup>10</sup> To sum up, initially triggered by a severe shortage of raw materials, the proposal to set up a tobacco state monopoly was finally implemented as a result of the fiscal pressures created under the market-oriented reforms.

## 2.2 Formulating the Tobacco State Monopoly

Given that the aim of establishing the tobacco state monopoly was to improve industrial production management as well as to create a secure mechanism of fiscal extraction, in this section I shall elaborate how the system was designed to achieve those goals. The main features of the system's formulation will be set out as follows.

### 2.2.1 A Complete Monopoly

As stated in the Chapter One, the entire production chain—from tobacco growing to cigarette manufacturing and sales—were all placed under national control. In accordance with the *Rules*, only the CNTC could buy tobacco leaves from farmers and sell them to the state-planned cigarette factories. The thinking was that if the CNTC controlled the tobacco leaf supply, then the likelihood of non-state

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<sup>9</sup> Guowuyuan pizhuan qinggongbu guanyu shixing yancao zhuanying baogao de tongzhi (The notification of the State Council approving and forwarding the report made by the Ministry of Light Industry on implementing the tobacco monopoly) issued by the State Council (1981), <http://sd.infobase.gov.cn/bin/mse.exe?seachword=&K=a&A=27&rec=234&run=13> (accessed March 8, 2010).

<sup>10</sup> Yang, *Zhongguo yancao*, 1131-2; Tan Yuansong, "Zhuanmai: Hangye jiankang fazhan de jishi" (State monopoly: The foundation of healthy development in tobacco Industry), *China Tobacco*, December 18, 2010, accessed March 10, 2010, <http://www.echinatobacco.com/101542/101576/101938/102053/102055/22764.html>.

planned factories surviving would be severely reduced. All state cigarette factories were placed under the CNTC's authority and were permitted only to manufacture cigarettes, which were then sold to the CNTC. With the CNTC as the sole wholesaler and consequently a monopoly of the entire distribution network, this would further minimize opportunities for any non-state-planned factories. In general, this monopoly-cum-monopsony aimed at ensuring that the CNTC could control the entire industry, exercising power on behalf of the central state.<sup>11</sup>

### 2.2.2 The Multi-Level Governance of Government-Business Synthesis

Under the *Rules*, the CNTC implemented its monopoly and monopsony through local agencies at the provincial, city, and county levels. It set the tobacco procurement and cigarette production “quotas” for each level in order to implement centralized production management (see Figure 2.1).<sup>12</sup> Further in accordance with the *Rules*, each local tobacco corporation was led by the tobacco corporation above it together with the local government, but the former, referred to as *tiao* (条), was superior to the latter, referred to as the *kuai* (块). In Chinese, *tiao* (条) means the vertical lines of authority over various sector reaching down from the ministries of the central government, while *kuai* (块) refers to the horizontal level of authority of the territorial government. At each level of the hierarchy, then, a higher-level tobacco corporation would oversee its subordinates to ensure that the tobacco industry was subject to this form of “vertical management.”<sup>13</sup>

As stipulated by the provisions of the *Rules*, the State Tobacco Monopoly Bureau (STMB) was also established to enforce regulations pertaining to the tobacco monopoly, deal with infringements, and so on.<sup>14</sup> In essence, the STMB was responsible for enforcing industrial administration while the CNTC was engaged in the actual business of tobacco. However, the division of labor between the CNTC and the STMB was anything but clear, since they shared the same set of personnel within a unified line of command—a common organizational form in China known as “one crew with two separate titles” (*yitao renma, liangkuai paizi* 一套人马, 两块牌子). In other words, they constituted the vertical management of the government-business synthesis all the way from the central authorities down to the counties.

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<sup>11</sup> See Articles 6, 7, 9 and 14 of *the Rules on the Tobacco Monopoly*.

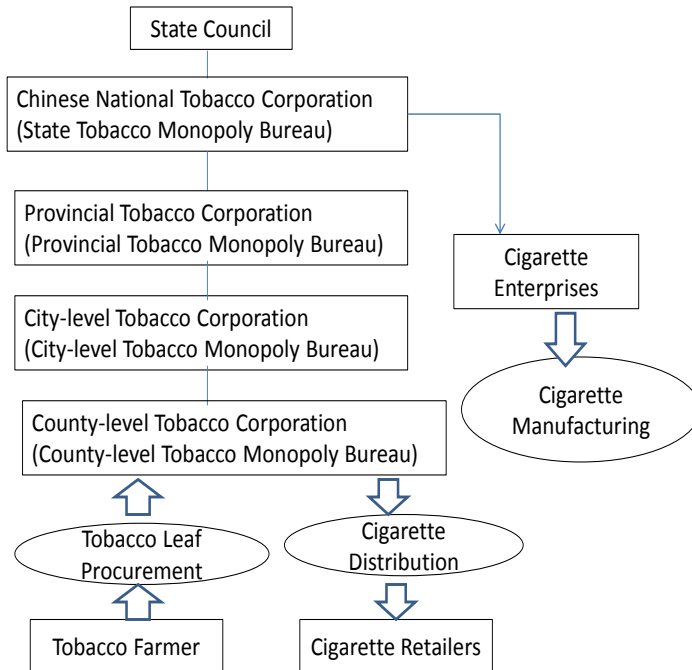
<sup>12</sup> See Articles 4 and 8 of *the Rules on the Tobacco Monopoly*.

<sup>13</sup> See Article 3 of *the Rules on the Tobacco Monopoly*.

<sup>14</sup> *Ibid.*

**Figure 2.1 - The Structure of the Tobacco State Monopoly**

*Source: Supplied by the author*



### 2.2.3 Control of Overall Quantity

Under this structure, the CNTC would be obliged to adhere to the annual planned total figures for tobacco leaf procurement and cigarette production, which were to be formulated by the central planning authority. The CNTC would further break down the totals into different quotas which the local tobacco corporations and cigarette factories were compelled to follow. The first step entailed tobacco procurement, where the local tobacco corporations would sign contracts with tobacco growers with a specified planting area and for a specified quantity. After flue-curing, tobacco growers were required to sell their output to the CNTC at the fixed official prices on the basis of leaf quality. The tobacco growers naturally had little choice but to sell their tobacco leaves to the CNTC as the sole purchaser. In this vein, the monopsony could guarantee that the central procurement plan would

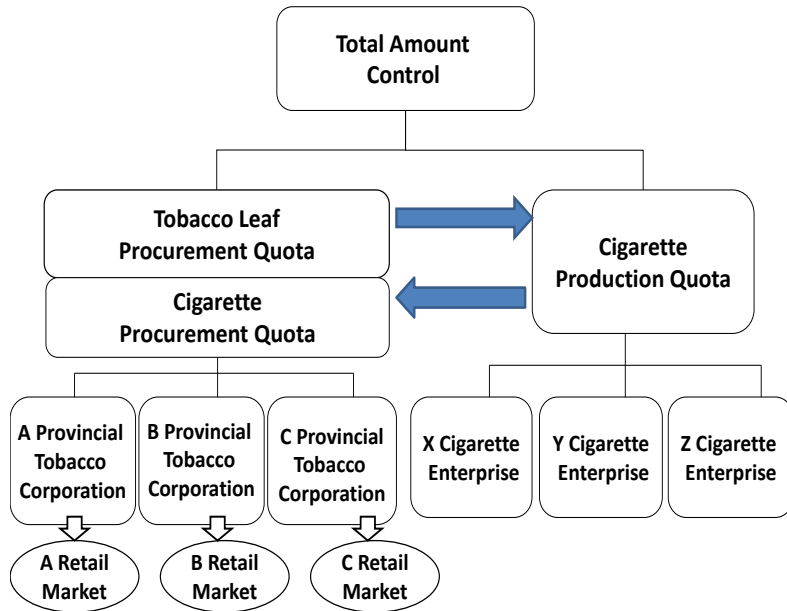
be implemented according to the set criteria. Next, the CNTC would sell the tobacco leaves to the cigarette factories according to their demand, which was based on individually assigned production quotas. The whole system was designed to match the supply of agricultural material to the demand for cigarette production under the control of overall quantity.

Under this design, there was little consideration for any local variations in this monopoly system. The circumstances of individual tobacco farmers or local tobacco corporations played no role in the plan. In addition, all the tobacco corporations under the CNTC had to buy cigarettes from the industrial enterprises according to the assigned procurement quotas, which, when added together, would be equal to the total cigarette production figure (see Figure 2.2).<sup>15</sup> In this vein, CNTC's monopoly of the wholesale market ensured that all cigarettes would be sold. After that, all state-licensed retailers were compelled to purchase the cigarettes from the tobacco corporations. This meant that the entirety of all tobacco products under the national plan could be cleared at the state-specified prices so that the incomes of the entire CNTC system would be stabilized and its contribution to the state coffer in the form of profits and taxes would be safely maintained. That was the general logic behind how the tobacco state monopoly system would be able to constitute a highly secure mechanism for fiscal extraction.

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<sup>15</sup> See Articles 4, 8, 13, 15 of *the Rules on the Tobacco Monopoly*.

**Figure 2.2 - The Design of Control of Overall Quantity**



Source: Supplied by the author

In summary, this institutional design was based on an integrated framework within the CNTC, where all the production activities, from tobacco procurement and cigarette manufacturing to distribution, had to adhere to the annual plans from the top down. The method was in fact derived from past attempts for a planned economy. Without doubt, its logic deviated from the course of market-oriented reform; the central authority wished to revive a planned-economy model in this sector so that it could secure “monopoly profits” even as it had to be embedded in a more general scenario where market-oriented reform had already been set in motion.

## **2.3 Finalizing the Tobacco State Monopoly**

In 1983, when the *Rules* were passed and came into effect, the establishment of the tobacco state monopoly *in toto* remained far from complete. When first established in 1982, the CNTC had just over 20 staff who had been transferred there



from other governmental departments, e.g., the Ministry of Light Industry, the Ministry of Commerce, and the Bureau of Supply and Sales. Most of these had previously been responsible for tobacco-related work in these departments. Initially, the CNTC was unable to establish its local agents and instead depended on local authorities to fulfill that task.<sup>16</sup> In this context, local tobacco corporations at the provincial level were established by the provincial governments. However, given that the entire infrastructure—including the manpower and administrative and other resources—was provided by the provincial governments, these provincial tobacco corporations were not immediately turned into “agents” of the CNTC but rather fell under the authority of the provincial governments.

As soon as the provincial corporations were established, the existing cigarette factories owned by the provincial governments became directly affiliated to these corporations. In addition, the provincial governments required their subordinate local governments at the municipal and county levels to build the tobacco corporations in their jurisdictions, which were under the dual leadership of the host local governments and the superior tobacco corporations. For example, after the government of Yunnan Province established the Yunnan Province Tobacco Corporation in 1983, several cigarette factories, including Yuxi, Qujing, Zhaotong, and Kunming, were placed under the purview of the provincial corporation.<sup>17</sup> The Yunnan Province government later asked the municipality and county governments to establish the local tobacco corporations.<sup>18</sup> Consequently, once all of the tobacco corporations under the provincial level had been subsequently established, the vertically administrative relationship between the supervisor (the CNTC) and its subordinates (the provincial tobacco corporations) were not yet instituted until after negotiations on converting the administrative subordination of provincial tobacco corporations were completed.

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<sup>16</sup> Xie Na, “Liu zhiguang: Rencai yindao fazhang, shiye zhaojiou rencao” (Interview with Zhiguang Liu: The talents contribute to the development, the industry creates the talents), *China Tobacco*, December 18, 2008, accessed March 12, 2010, <http://www.echinatobacco.com/101542/101576/101938/102053/102059/22771.html>.

<sup>17</sup> The Editorial Board of the Chronicle of Yunnan Province, *Yunnan shengzhi: Yancao zhi* (The chronicle of Yunnan Province: The tobacco chapter) (Kunming, China: Yunnan People’s Publishing House, 2000), 417-8.

<sup>18</sup> *Ibid.*, 421-2.

### 2.3.1 The Obstacle to Converting Administrative Subordination

Once the local tobacco corporations were successfully established, the CNTC launched negotiations with provincial governments around the country to bring local tobacco corporations under its authority. Nonetheless, moving administrative subordination from the provincial governments to the CNTC turned out to be a very tough task, especially in some provinces, such as Yunnan, where the tobacco industry had already become a crucial source of revenue.

Local governments' fiscal gains obtained from the tobacco industry, which had been constantly formed and strengthened under fiscal decentralization and SOE reform, became a major barrier to accomplishing administrative subordination. For one, when provincial tobacco corporations were led by provincial governments, those profits exceeding the portion retained by the corporations would flow into local governments coffers, as stipulated by the SOE reform at that time. Meanwhile, from the context of fiscal decentralization, the local governments did not have to remit all taxes and profits collected from the SOEs in their geographical territories to the central government. Rather, they could retain a certain amount once they fulfilled their obligations to the central government under the fiscal contracts that were formulated via repeated central-local bargaining every year.

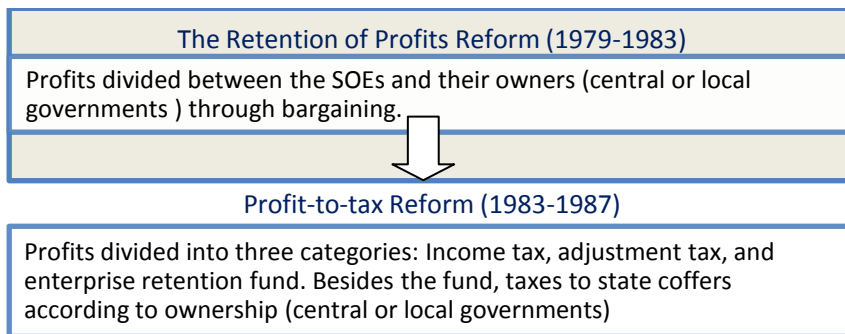
When the local governments were granted greater fiscal capacity under the fiscal decentralization reform, however, they were also required to balance their own budgets, promote local economic growth, and fulfill the tasks handed down by higher levels of government in return. An unintended consequence of fiscal decentralization was thus the strengthening of financial links between local governments and local SOEs, as the more revenue local governments collected, the more they could keep for themselves.<sup>19</sup> In this context, once the administrative leadership was shifted from the local governments to the CNTC, the existing interests that local governments derived from the tobacco corporations would be under threat. In particular, while the negotiations were set in motion, the SOE reform already launched new arrangements for profit-and-tax allocation from the end of 1983. Under this Profit-to-Tax policy (*ligaishui* 利改税), the SOEs could keep all of the remaining profits after paying taxes in the newly specified categories so that the financial relationship between the SOEs and the governments would be clear without repeated bargaining being necessitated.

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<sup>19</sup> Fox Z.Y. Hu, "Deconstructing State-owned Enterprises in Socialist China under Reform: A Scalar Examination," *Environment and Planning A* 37 No. 4 (2005): 715-6.

By replacing profit delivery, the original share of the profits was thus divided into three categories: income tax, adjustment tax, and enterprise retention fund (i.e., company retained profit); the taxes here flowed into state coffers according to ownership (i.e., the local or central government). Before the change of administrative subordination, the income tax and adjustment tax from provincial tobacco corporations were classified as local, fiscal revenue under the Profit-to-Tax policy (see Figure 2.3).<sup>20</sup> However, once administrative subordination was realized, the above taxes channeled into the central state’s revenue. In such a context, local governments would resist administrative subordination in order to protect their vested interests. And so the CNTC could do nothing but compromise with the local governments in order to complete the change to administrative subordination.<sup>21</sup>

**Figure 2.3 - Profit Allocation in the Tobacco Industry under the SOE Reform (1979-1987)**



Source: Supplied by the author

### 2.3.2 The Trade-offs for Changing Administrative Subordination

Amidst all of the bargaining over subordination, the negotiations with the Yunnan Province Government—as one of the most important tobacco-growing and cigarette-manufacturing provinces at that time— was highlighted as the most crucial “battle.” The outcome there would greatly influence other provinces’ stances with regard to administrative subordination. Tobacco taxation and profits made up almost half of the fiscal income for Yunnan Province in 1984—the year in which the

<sup>20</sup> The Editorial Board of the Chronicle of Yunnan Province, *Yunnan shengzhi*, 422-3.

<sup>21</sup> Zhang Yan, “Ma Erchi: Zhuanmai jiye molichu” (Interview with Ma Erchi: The ordeal of running the tobacco monopoly), *China Tobacco*, December 18, 2008, accessed March 20, 2010, <http://www.echinatobacco.com/101542/101576/101938/102053/102059/22773.html>.

negotiation was undertaken.<sup>22</sup> The first manager of the CNTC, Li Yisan (李益三), recalled after arriving in the province in 1984 how the bargaining process was consumed by hardship. During the process, Li once asked for help from the secretary general of the State Council, Du Xingyuan (杜星垣), when visiting Yunnan. Even though Li continually tried to draw support from the central authorities, many trade-offs were still made in the negotiation so that the administrative subordination agreement could finally be signed, forty-six days after his team first arrived in Yunnan.<sup>23</sup>

The trade-offs included the most important control mechanisms in the original formulation: the shared authority for personnel appointments and the autonomy to produce more cigarettes than stipulated under the state plan. In this sense, the result was that local governments began to hold institutionalized power within the tobacco state monopoly system, so that the requirement of “dual leadership” stipulated in the *Rules* — *tiao* superior to *kuai* — became a blurred one. The first trade-off meant that when the CNTC appointed leading managers in local tobacco corporations and cigarette enterprises, they had to seek approval from the local governments.<sup>24</sup> In this regard, this compromise gave the local governments a powerful means to intervene in the local tobacco corporations and cigarette enterprises. Yi-min Lin employs the concept of “particularistic (local) state action” to explain why a political market would emerge where enterprises were constantly engaged in seeking favor from the local governments, which controlled large amounts of local resources, had considerable regulatory power, and selectively distributed liabilities after the decentralization reform was initiated. But this notion does not sufficiently explain why local governments were able to intervene in tobacco business by manipulating the CNTC’s local agents in the first place.<sup>25</sup> While local governments could

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<sup>22</sup> Jin Yibing, *Yunnan sheng juanyan xiaoshou gongsizhi 1982-2006* (The chronicle of the Yunnan Cigarette Sales Company 1982-2006) (Kunming, China: Yunnan People’s Publishing House, 2008), 258.

<sup>23</sup> Si Cuihua, “Li Yishan: ‘Guantingbingzhuanhou,’ zong gongsi jiannan qibu” (Interview with Li Yishan: Closure and merger, the arduous initial steps of the CNTC), *China Tobacco*, December 18, 2008, accessed March 15, 2010, <http://www.echinatobacco.com/101542/101576/101938/102053/102059/22775.html>.

<sup>24</sup> Interviewee No. 58.

<sup>25</sup> Yi-min Lin, *Between Politics and Markets — Firms, Competition, and Institutional Change in Post-Mao China* (Cambridge, UK: Cambridge University Press, 2004), 68-97; some regard “the particularistic state action” as the informal mechanism of local control. For example, see Christine P.W. Wong, “Between Plan and Market: The Role of the Local

influence the activities of SOEs in their geographical territories through particularistic state action, the veto power for personnel appointments—emerging as a term of exchange for completing the construction of a tobacco state monopoly—in reality constituted the fundamental source of local governments’ controlling capacity.

A second concession—the autonomy to produce more than the stipulated number of cigarettes—meant that, aside from meeting the production quotas assigned by the CNTC, the cigarette firms could also enjoy autonomy in terms of non-plan-specific production. For example, in the subordination agreement for the Yunnan Province Tobacco Corporation, the profits from that excess production, i.e. non-plan specific production, would remain within the province.<sup>26</sup> A similar trade-off also appeared in talks with other provinces over the following years, and negotiations throughout the country concerning administrative subordination were finally concluded in 1986.

Excess cigarette production under the negotiations of administrative subordination was a legacy adopted by SOE reform dating from the late 1970s. In order to transform the planned economy regime then, the first step implemented by the central government was to expand the managerial autonomy of SOEs, rather than immediately abolishing the state production plan entirely. In the document “Several Regulations Concerning the Expansion of SOE Managerial Autonomy” issued by the State Council in 1979, expanding the autonomy and rights of SOEs regarding excess production (producing beyond the state plan-specific quantities), product sale, profit distribution, employment, and the usage of capital were all clearly specified.<sup>27</sup> By this, SOEs could manufacture extra products after fulfilling production requirements under the state compulsory plan and sell them to other buyers who were not necessarily specified by the state. Compared with the reforms in Eastern Europe and the former Soviet Union, the growing of non-plan-specific production was characterized as one of the distinctive features of China’s gradualist reform program.<sup>28</sup>

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Sector in Post-Mao China,” *Journal of Comparative Economics* 11 (1987): 391-5.

<sup>26</sup> The Editorial Board of the Chronicle of Yunnan Province, *Yunnan shengzhi*, 427-9.

<sup>27</sup> Chen Jiaqui, *Zhongguo guoyou qiye gaige shanshi nian yanjiu* (The study of China’s SOE reform for thirty years) (Beijing, China: Economy and Management Publishing House, 2008), 20-1.

<sup>28</sup> Naughton, *Growing out of the Plan*, 8-9, 18-24.

Without exception, the state-owned cigarette enterprises also started to increase beyond-plan production under the SOE reform. For example, in 1980 the Yuxi Cigarette Factory (the predecessor of the Hongta Tobacco Group) was granted by the Yunnan Province Government the right to sell fifty percent of its beyond-plan products and retain the profits for its own usage. After the establishment of the Yunnan Tobacco Corporation in 1982, the provincial tobacco corporation took over distribution of all plan-specific cigarettes and twenty percent of non-plan-specific cigarettes from the Yuxi Cigarette Factory, while the Yuxi Factory continued to hold the selling right of the remaining eighty percent of its non-plan-specific cigarettes. The profits derived from the non-plan-specific sales could then be used to buy auxiliary materials for cigarette production, such as rolling paper, filters, package paper, and tobacco leaves for greater production investment. While the *Rules* did prohibit “non-plan-specific growth” in the tobacco sector, even though it was a very common phenomenon in various industries in the 1980s, it turned out to be a *de facto* occurrence in the tobacco industry as well—a factor that the CNTC had little option but to accept in order to complete administrative subordination. As a consequence, as long as the cigarette factories could obtain sufficient production materials, they could continue to produce more than the quota limit specified by the state plan under the current SOE reform.<sup>29</sup>

In this context, the fulfilling of a “state plan” became a “bare minimum” rather than a total capacity figure. Thus, the control of monopolistic output was not totally in place from the outset, even though the CNTC had finally concluded all of the administrative handover throughout the country by 1986. After that, all the local tobacco corporations were officially turned into the local agents of the CNTC, and the cigarette firms became central SOEs under the CNTC’s purview (See Figure 2.4).

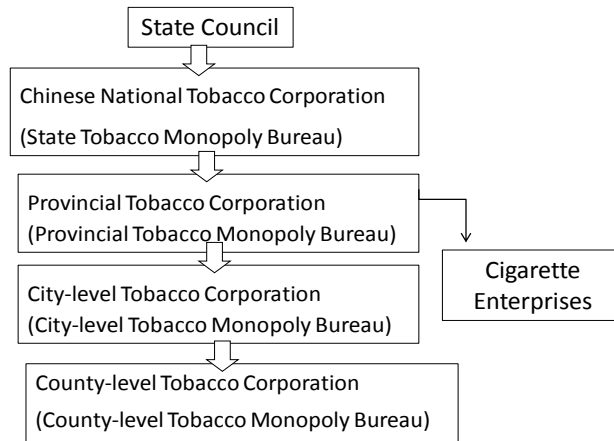
But there existed many breaks in the chain of command. On the one hand, the CNTC had to share authority with the local governments for making personnel appointments, while on the other, the CNTC’s local agents continued to be responsible for their own individual budgetary accounts and had abundant autonomy with regard to producing and selling the non-plan-specific products. In consequence, the outcome of establishing a tobacco state monopoly through trade-offs had the same result ultimately as the current SOE reform. Thus, while the administrative

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<sup>29</sup> The Editorial Board of Hongta Group, *Hongta jintuan zhi 1956-2005* (The chronicle of the Hongta Group 1956-2005) (Kunming, China: Yunnan People’s Publishing House, 2006), CD-ROM; Interviewee No. 57.

subordination was conducive to fulfillment of the state plan formulated by the CNTC, the CNTC as a whole was actually far from being an integrated framework.<sup>30</sup>

**Figure 2.4 - Tobacco State Monopoly Structure after Administrative Subordination**



Source: Supplied by the author

### 2.3.3 The Emergence of a Two-Track System

In this context, a two-track system—whereby a state planning program coexisted with free-market elements that permitted non-plan-specific products to be transacted—appeared in this sector instead of the revival of a “planned economy” once the tobacco state monopoly was established. Under the state-planned track, the plan-specific cigarettes were distributed via the multi-tiered wholesale system of the CNTC. For example, once the Yunnan Province Tobacco Corporation was established in 1982, it took on full responsibility for distributing the plan-specific

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<sup>30</sup> Kenneth G Lieberthal, “Introduction: The ‘Fragmented Authoritarianism’ Model and its Limitation,” in *Bureaucracy, Politics, and Decision Making in Post-Mao China*, ed. Kenneth G. Lieberthal and David M. Lampton (Berkeley, CA: University of California Press, 1992), 1-31.

cigarettes manufactured by the Yuxi Cigarette Factory up until 1992. Within the province, the cigarettes were distributed from provincial-, municipal-, and county-level corporations to licensed retailers at the state-specified prices (producer, distributor and wholesale prices). Moreover, the Yunnan Province Tobacco Corporation also sold the plan-specific cigarettes to other provinces.<sup>31</sup>

Alongside the state-planned distribution, cigarette enterprises could sell their non-plan-specific products to the tobacco corporations at different levels and in different regions. Also, private individuals who had special connections with the cigarette firms or who “borrowed the hat” from other tobacco corporations (i.e. colluded with other tobacco corporations in guise of their staff), began to purchase the non-plan-specific cigarettes directly from the cigarette manufacturers. In these transactions, the prices were dictated by supply and demand according to the market rather than as specified by the state. Thus, a trade market between the cigarette manufacturers and the wholesalers arose and subsequently continued to expand its sphere of activity (more discussion on the development of the market is presented in Chapter Four). Without the two-track system, a market would not have developed in the tobacco sector, since all the transactions had to comply with state directives, including those dealing with price and quantity. In addition, from the outset this territory where the local governments could continue to expand their influence and where competition would originate and grow in the tobacco state monopoly system.

## 2.4 Conclusion

When historical institutionalists consider “compliance” as a variable in discussing institutional change and stability, they imply that the implementation of institutions is always subject to interpretation and contestation, even though they are formally codified. This chapter returns the debate on struggles over the application and enforcement of institutions to an earlier stage—to the question of how to establish the executive body of an institution in the first place—that has remained an overlooked issue but one of crucial importance in the context of China as a transitional economy. For example, Wang’s tobacco study apparently neglected to investigate this process, the result being that she attributed the possibility of local governments’ intervention to the principle-agent problem, whereby the central level of the CNTC/STMB could not obtain sufficient information so that in practice its provincial agents became the most powerful decision-makers and worked together

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<sup>31</sup> Jin, *Yunnan sheng*, 78, 114.



with local governments.<sup>32</sup> Nonetheless, the reality was far more complicated than such an information gap, since it was extremely challenging to rebuild a state-monopoly sector against a backdrop where the planned-economy system was gradually being dismantled and replaced by market-oriented mechanisms. This is exactly why the creation of the tobacco state monopoly gave rise to such controversy in the early 1980s. In this respect, the manner in which this institutional system was to be created supplies an important point for analysis.

By exploring the construction process of the tobacco state monopoly, this chapter demonstrates that the temporal order of processes provides a crucial determinant in the formation of an institutional system, as path dependence would indicate. As discussed above, once the local tobacco corporations were set up by the local governments, from the outset their connections with the local governments were continuously secured, especially under the scenario of SOE reform and fiscal decentralization. This situation resulted, therefore, in strong constraints on converting these corporations into the CNTC's local agencies with the aim of establishing a vertical management system in the tobacco industry, as initially formulated. In changing the administrative subordination of these local tobacco corporations, the CNTC could not avoid compromises with the local governments. Though the administrative subordination process finally came to an end after more than four years of bargaining, the concessions made meant that the tobacco state monopoly had already deviated from its original design.

For one, having satisfied the requirements of the state plan, the cigarette firms and tobacco corporations at each level continued to enjoy autonomy in manufacturing and selling the surplus products under the current path of SOE reform. Meanwhile, local governments were able to manipulate the CNTC's local agents, which were granted a great deal of autonomy, by taking advantage of the leverage they had in personnel appointments. In this context, local governments turned out to be crucial actors in shaping the working of the tobacco state monopoly system. In this light, the interaction between local governments and CNTC's local agents would largely determine the industrial governance pattern, which accounted for how the exchanges were conducted between the suppliers of raw materials, the manufacturers, and the wholesalers in the production chain, and thus, the way in which the tobacco state monopoly worked overall.

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<sup>32</sup> Wang, *State-Market Interactions*, 51-2.

## **CHAPTER THREE**

### **THE THREE PHASES OF INSTITUTIONAL ARRANGEMENTS**

In this chapter, I employ the analytical tools of institutional change—i.e., incremental change and critical juncture—to develop a framework for three distinct phases in the history of the tobacco state monopoly: first, from the establishment of the CNTC to the initiation of tax-sharing system (1982–1993); second, from the inception of the tax-sharing system until a recentralization reform for the CNTC was introduced (1994–2004); and third, the period over the time when the recentralization reform for the CNTC was initiated and then suspended (2005–2012), by which time the collection of data for this study was concluded. This temporal division is based on the premise outlined in Chapter Two that “local governments” became crucial actors in the tobacco state monopoly system once they were granted a degree of influence in the local tobacco industry via their say in the personnel appointment for the CNTC’s local agents.

The “incentives” and “opportunities” provided to the local governments by their intervention into the tobacco industry, however, have not always been constant over the past three decades. From a historical institutionalist approach, an institution does not exist in a vacuum but takes form in a given political context linked to a range of variables. Thus, when some variable changes, actors within an institution may shift their preference with regard to behavioral strategies and then alter the goals of that institution.

In this light, I first identify the different policy realms that decided not only the incentives for local governments but also the available opportunities for pulling strings behind the backs of the CNTC’s agents. Given that each policy realm had its own course of development, the political context can thus act as a framework for presenting the various ways in which these realms were interconnected at different times. This resulted in three particular phases of institutional arrangement whereby interaction between the local governments and the CNTC’s local agents initiated incremental changes in the implementation of the tobacco state monopoly. The “patterns of governance” that emerge exemplify how a range of interdependent players along the production chain—from suppliers of raw materials, cigarette manufacturers, and distributors of cigarette products—conducted exchanges to allow

economic activity to continue. Under these patterns of governance, different types of competition emerged that then triggered consequences pertinent to the production conditions for a new critical juncture arising at the conclusion of each phase.

In this way, regulatory change of the tobacco state monopoly occurred in a more fundamental way at these critical junctures. There, new rules of the game came to be laid down by the central authorities and thus constituted a new premise for the next institutional phase and the governance pattern that arose with it. The analytical framework developed in this chapter, then, provides the foundation required for exploring in the following chapters the institutional development of the tobacco state monopoly in each phase—from the incremental change in the patterns of governance to regulatory changes of the tobacco state monopoly system at critical junctures.

### **3.1 Implementing the Tobacco State Monopoly: the Political Context**

By identifying the policy realms in which the principal actors of the tobacco state monopoly—the local governments and the CNTC’s local agents—were located, the political context in which the tobacco state monopoly arose was already revealed in the preceding chapter.

Local authorities had resisted conversion to administrative subordination, principally because it would result in the loss of their tobacco industry revenues. This high degree of sensitivity to fiscal interests reflected perfectly in the policy of fiscal decentralization that was then current. In the early days of market-oriented reform, fiscal decentralization aimed to create an emerging market economy by mobilizing local initiatives. Under this reform, the central government transferred a huge number of resources to local governments through a variety of fiscal contract systems: lower-level governments were obliged to remit a certain amount of revenue to the governmental tiers above them but were able to retain the remainder. In this context, a quasi-fiscal federalist framework appeared, by which local governments had primary authority and responsibility for their local economies while being subject to strict budgetary constraints. Local governments, then, were motivated to increase revenue collection in any way possible.<sup>1</sup> Fiscal reform policy thus created a

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<sup>1</sup> Jia Hao and Mingxia Wang, “Market and State: Changing Central-Local Relations in China,” in *Changing Central-Local Relations in China*, ed. Jia Hao and Zhimin Lin (Boulder, CO: Westview Press, 1994), 38; Gabriella Montinola, Yingyi Qian, and Barry R. Weingast,

strong incentive compelling local states to become involved in the local tobacco industry in order to increase their fiscal revenues, even after the conversion to administrative subordination.

Second, CNTC local agents continued to retain a great deal of autonomy under the SOE reform, even after administrative subordination. Rather than privatizing SOEs, the Chinese SOE reform was initiated by the central state by delegating increased decision-making autonomy and rights for profit retention to the companies in order to improve productivity and efficiency. In the mid-1980s, the major endeavor in extending the autonomy of SOEs evolved to promoting a contract responsibility system, under which many contractual and residual rights were delegated to managers in order to motivate them to maximize profits by exercising greater authority in the SOEs.<sup>2</sup>

In fact, the autonomy created by the SOE reform prepared the ground for local government manipulation of the tobacco corporations and cigarette companies in their regions. The existence of autonomy supplied the precondition that allowed local authorities to intervene in the activities of the CNTC's agents by any means available. In this regard, the course of the SOE reform involved not only the institutional setting in which the CNTC's agents were embedded, but also the analytical thread for exploring the opportunities (or constraints) on local authorities with respect to manipulating the CNTC's agents.

In sum, fiscal and SOE reforms provided the political context in which local governments and the CNTC's agents were shaped with respect to implementing the rules of the tobacco state monopoly as designed. Under those circumstances, interactions between local authorities and the CNTC's local agents created space for

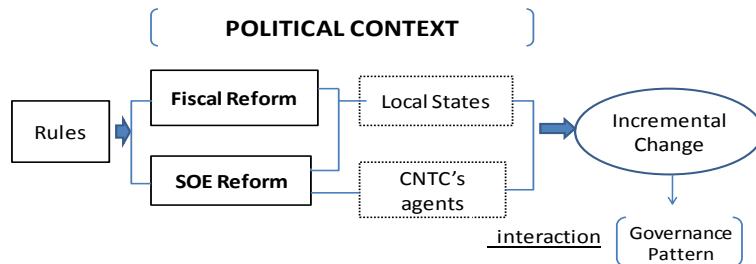
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"Federalism, Chinese Style: The Political Basis for Economic Success in China." *World Politics* 48 No. 1 (1995): 50–81; Jean C. Oi, *Rural China Takes Off*, 17-57; Jean C. Oi, "The Role of the Local States in China's Transitional Economy," *The China Quarterly* 144 (1995): 1139-46; Yingyi Qian and Barry R. Weingast. "**Federalism as a Commitment to Preserving Market Incentives**," *The Journal of Economic Perspectives* 11 No. 4 (1997): 83–92; Andrew G. Walder, "Local Governments as Industrial Firms: An Organizational Analysis of China's Transitional Economy," *The American Journal of Sociology* 101 No. 2 (1995): 276-81.

<sup>2</sup> Suisheng Zhao, "China's Central-Local Relationship: A Historical Perspective," in *Changing Central-Local Relations*, 25; Geng Xiao, "Central-Local Relations From the Perspective of State and Non-State Industries," in *Changing Central-Local Relations*, 135; Naughton, *Growing out of the Plan*, 204-7.

incremental change in the industrial governance pattern of the tobacco sector, as illustrated in Figure 3.1.

**Figure 3.1 - Political Context for Implementing Tobacco State Monopoly Rules**



Source: Supplied by the author

### 3.2 The Varied Political Contexts of the Three Phases

In general, the fiscal and SOE reforms initiated a series of measures for the “devolution of power and transfer of profit” (*fangquan rangli* 放权让利), which comprised at root the motives and opportunities that local authorities could initially use to intervene into the local tobacco business. These two reform measures, however, gradually came to cause more breakdowns and crises for the governance of the entire state apparatus in general. Out of this, rising concerns with regard to the capacity of the central state to address these issues triggered various “recentralization” programs for both fiscal revenue and SOE governance.




Over the past few decades, both reform measures have traveled a similar path from decentralization to recentralization, though it should be noted that the movements were not simultaneous. While recentralization of fiscal revenue was initiated in 1994, SOE governance was not geared toward recentralization until after China’s entry to the WTO. This time lag between the two threads of reform would

bring about distinctive institutional settings that influenced how local authorities interacted with the CNTC's local agents. The interactions of these two reforms influenced the three distinct patterns of governance noted below:

- During the first phase (1983-1993), from the establishment of the CNTC to the initiation of tax-sharing system, it was characterized by a combination of decentralization measures in the fiscal policy and SOE governance.
- During the second phase (1994-2004), from the inception of tax-sharing system until the recentralization reform for the CNTC was set into motion, it was characterized by a combination of fiscal revenue recentralization reform and SOE governance decentralization.
- During the third phase (2005-2012), beginning from when the recentralization reform for the CNTC was implemented and suspended in 2012, it was characterized by a combination of recentralization measures for both fiscal revenue and SOE governance.

Below, I illustrate how these two threads of reform proceeded in parallel from the early 1980s onward. By reviewing their paths of development separately, this discloses how the three distinctive phases exemplify not only the varying combinations of the two reform measures, but also how the different degrees of incentive and constraint at play functioned with respect to the local authorities' interventions into the local tobacco industry (see Figure 3.2).

**Figure 3.2 - The Combination of Local States' Incentives and Constraints**

<b>Incentive</b> 	<b>Increasing</b>	
	<b>Constraint</b> 	<b>First Phase (1982-1993)</b>
<b>Increasing</b> 	<b>Third Phase (2005-2012)</b>	

Source: Supplied by the author

### 3.2.1 The Fiscal Reform under the Central-Local Relationship

After fiscal decentralization was set into motion, local states had the incentive as well as the discretionary authority to conduct jurisdictional economic activities. With this, a profusion of theoretical models for analyzing the local state-market relationship appeared.<sup>3</sup> While these abundant case studies mapped the diversity of the local government-business relationship, many of them also disclosed how local states had pursued their own interests by circumventing central control. In other words, though the fiscal decentralization effectively motivated local officials to revitalize local economies, it also resulted in the unintended consequence that those same officials would provide a minimum rather than a maximum of compliance in terms of central policy implementation on a number of fronts.<sup>4</sup>

<sup>3</sup> For example, see Jane Duckett, *The Entrepreneurial State in China: Real Estate and Commerce Departments in Reform Era Tianjin* (New York, NY: Routledge, 1998); Jean C. Oi, *Rural China Takes Off: Institutional Foundations of Economic Reform* (Berkeley, CA: University of California Press, 1999); David L. Wank, *Commodifying Communism: Business, Trust, and Politics in a Chinese City* (New York, NY: Cambridge University Press, 1999); Tony Saich, "The Blind Man and the Elephant: Analyzing the Local State in China," in *East Asian Capitalism: Conflicts and the Roots of Growth and Crisis*, ed. Luigi Tomba (Milan, Italy: Feltrinelli, 2002), 75-99; Richard Baum and Alexei Shevchenko, "The 'State of State,'" in *The Paradox of China's Post-Mao Reforms*, ed. Merle Goldman and Roderick MacFarquhar (Cambridge, MA: Harvard University Press, 1999), 333-60.

<sup>4</sup> Oi, *Rural China Takes Off*, 139-90; Shaun G. Breslin, "China: Developmental State or Dysfunctional Development?" *Third World Quarterly* 17 No. 4 (1996): 689-706; Benjamin Van Rooij, *Regulating Land and Pollution in China Lawmaking, Compliance and Enforcement: Theory and Cases* (Leiden, NL: Leiden University Press, 2006), 227-60;

A plethora of studies on China's central-local relationship discussed the capacity of the central state in this circumstance, and some began to examine the central government's reaction and strategy toward local governmental dissidence.<sup>5</sup> In these studies, the cadre responsibility system emerged as the crucial mechanism for strengthening the ability of the central government to exercise control. This system was created by the Communist Party of China (CPC) at the same time as the fiscal decentralization program to ensure that local decisions conformed to the requirements set by the central authorities. Under this system, cadre performance was evaluated on the basis of a variety of targets identified in a performance contract created with the next level of government. The evaluation results not only would affect cadre bonuses but also would determine their promotion, demotion, and even dismissal.<sup>6</sup> In this way, the CPC attempted to maintain an iron grip on personnel appointments, which were the key weapon for conducting what Landry calls "controlling decentralization."<sup>7</sup>

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Susan H. Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* (New York, NY: Cambridge University Press, 2001), 93-6; Thomas P. Bernstein and Xiaobo Lu, *Taxation without Representation in Contemporary Rural China* (Cambridge, UK: Cambridge University Press, 2003), 245; Tim Wright, "State Capacity in Contemporary China: 'Closing the Pits and Reducing Coal Production'," *Journal of Contemporary China* 16 No. 51 (2007): 173-94.

<sup>5</sup> For example, see Yongnian Zheng, "Institutional Economics and Central-Local Relations in China: Evolving Research," *China: An International Journal* 3 No. 2 (2005): 240-69; Linda Chelan Li, "Central-Local Relations in the People's Republic of China: Trends, Processes and Impacts for Policy Implementation," *Public Administration and Development* 30 (2012): 178-81; Dorothy J. Solinger, "Despite Decentralization: Disadvantages, Dependence and Ongoing Central Power in the Inland—The Case of Wuhan," *The China Quarterly* 145 (1996): 1-34; Yasheng Huang, *Inflation and Investment Controls in China* (New York, NY: Cambridge University Press, 1996); Andre C. Mertha, "China's 'Soft' Centralization: Shifting Tiao/Kusi Authority Relations," *The China Quarterly* 184 (2005): 791-810.

<sup>6</sup> Whiting, *Power and Wealth in Rural China*, 100-23; Yasheng Huang, "Central-Local Relations in China during the Reform Era: The Economic and Institutional Dimensions," *World Development* 24 No. 4 (1996): 661-2; Maria Edin, *Market Forces and Communist Power – Local Political Institutions and Economic Development in China* (Uppsala, Sweden: Uppsala University Press, 2000 ); Maria Edin, "State Capacity and Local Agent Control in China: CCP Cadre Management from a Township Perspective," *The China Quarterly* 173 (2003): 35-52.

<sup>7</sup> Pierre Landry, *Decentralized Authoritarianism in China* (New York, NY: Cambridge University Press, 2008), 9-18



This dual approach for controlling personnel appointments and cadre evaluation did indeed make it easier to hold local cadres accountable, but it was not an absolute panacea, given both that China's bureaucratic system was exceptionally large and that the fiscal decentralization reform made its workings even more complex and fragmented. First proposed by Lieberthal and Oksenberg, a "fragmented authoritarianism" model was used to describe the Chinese government after the market-oriented reform. This model argued that authority below the top tier of the Chinese political system was disjointed, so that it emphasized the importance of bureaucratic bargaining and negotiation to shape a so-called "negotiated economy" in place of the previous planned economy.

However, this fragmented situation—reflected in this negotiated economy—gradually became seen by the early 1990s as a sign that the central state was in the midst of a crisis of governance.<sup>8</sup> The central state consequently decided to strengthen its authority by recentralizing fiscal revenue.

The logic underpinning this policy decision can be found in the book, *A Study of China's State Capacity*, edited by Shaoguang Wang and Angang Hu and published in 1993.<sup>9</sup> The state capacity referred to by the book points primarily to the capacity of the central government, and the authors construe state capacity as having included four different types: an extractive capacity (the capacity to mobilize economic resources), a steering capacity (the capacity to guide the economic development of society), a legitimating capacity (the capacity of the state to employ political symbols to create consensus among the citizens), and a coercive capacity (the capacity of the state to employ violent means to maintain its status). Of the four types, the authors clearly stated that "the state's capacity to mobilize and extract financial resources is the core of state capacity and the foundation of the state's

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<sup>8</sup> Kenneth G. Lieberthal and Michel Oksenberg, *Policy Making in China: Leaders, Structures, and Processes* (Princeton, NJ: Princeton University Press, 1988), 137-51; Kenneth G. Lieberthal, "Introduction: The 'Fragmented Authoritarianism' Model and its Limitation," in *Bureaucracy, Politics, and Decision Making in Post-Mao China*, 1-32; David M. Lampton, "A Plum for a Peach: Bargaining, Interest, and Bureaucratic Politics in China," in *Bureaucracy, Politics, and Decision Making*, 33-58; Barry Naughton, "Hierarchy and the Bargaining Economy: Government and Enterprise in the Reform Process," in *Bureaucracy, Politics, and Decision Making*, 248-82; Kenneth G. Lieberthal, *Governing China: From Revolution Through Reform* (New York, NY: W. W. Norton & Company, Inc., 1995), 169-74.

<sup>9</sup> Shaoguang Wang and Angang Hu, *Zhuoguo guojia nengli baogao* (A study of China's state capacity) (Sheyang, China: Liaoning People's Publisher, 1993).

ability to realize the other capacities.”<sup>10</sup> The authors contended that economic reforms had already undermined the (central) state capacity in general terms and warned that the decline of the central state’s fiscal revenue would continue. The book argues that a strong (central) state is necessary for market reform. The Chinese government accepted this argument, thus triggering a tax-sharing reform in order to readjust the central-local power relations in 1994.<sup>11</sup>

This tax-sharing system fundamentally strengthened the control of the central government over fiscal revenues in three ways. First, the previous fiscal contract system between the central and local governments was terminated. With repeated bargaining with local authorities out of the picture, the central government now owned its own independent tax category—the central tax—under the new fiscal system. Under this new fiscal system, all tax revenue was divided into three categories—a central tax, a local tax, and a central-local shared tax. By this, the ratio of central fiscal income to national revenue greatly increased; for example, prior to the tax-sharing reform, tax distribution between the central and local governments stood at 22 percent and 78 percent in 1993, respectively, but became 55.7 percent and 44.3 percent the very next year.<sup>12</sup> Second, the central government’s authority to collect tax had ceased to be delegated to the local governments, and the central government now had its own independent agencies in all provinces. This allowed it to collect the central tax directly through its own institutions rather than having to rely on local remittances as before. Moreover, when a national tax system to collect central taxes was established, this established also a local tax system to collect local taxes. This meant that tax diversions by local governments could to some extent be reduced. Third, a series of fiscal transfer arrangements was established, which made it easier for the central state to adjust the developmental gaps in different regions. In general, these institutional changes in themselves already greatly shifted fiscal authority from the provinces to the central state.<sup>13</sup>

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<sup>10</sup> Shaoguang Wang and Angang Hu, *The Chinese Economy in Crisis: State Capacity and Tax Reform*, (Armonk, NY: M. E. Sharpe, Inc., 2001), 27.

<sup>11</sup> Wang and Hu, *The Chinese Economy in Crisis*, 185-211.

<sup>12</sup> Zhiyong Yang and Zhigang Yang, *Zhongguo caizheng zhidu gaige sanshi nian* (Thirty years of fiscal reform in China) (Shanghai, China: Turith & Wisdom Press, 2008), 47.

<sup>13</sup> Christine P. W. Wong and Deepak Bhattasali, *China: Zhong guo: guojia fazhan yu difang caizheng* (China: National development and sub-national finance), trans. Wu Suping and Wang Guijuan (Beijing, China: Citic Publishing House, 2003), 34.

At the same as the tax-sharing system, an enterprise contract management responsibility system under the SOE reform also came to an end. Once the tax-sharing reform was launched, the SOEs were no longer obliged to surrender their profits since they were generally in a poor financial position at that time.<sup>14</sup> All SOEs had to pay were the central and local taxes under the new tax code; the requirement for paying profits to the state was accordingly removed.

In this way, the tax-sharing system became a comprehensive package of measures designed to deal with the financial relationship between the central-local authorities and the SOEs. It could be viewed as a first step toward establishing a more rule-based, modern fiscal system. But when fiscal revenue was recentralized under the tax-sharing system, expenditures required for executing local obligations and projects were not concurrently removed. For example, while the ratio of local fiscal income to national revenue dramatically declined from 78 percent in 1993 to 44.3 percent in 1994, the ratio of local fiscal expense to national expenditure only slightly decreased from 71.7 percent to 69.7 percent in the same period. This unbalance between local fiscal revenue and expenditure did not change afterwards but actually worsened (see Table 3.1).

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<sup>14</sup> See the document “Guowu yuan guanyu shixing fenshui caizheng guanli tizhi de jue ding” (The decisions made by the State Council on implementing the tax-sharing system), [http://news.xinhuanet.com/ziliao/2005-03/17/content\\_2709622.htm](http://news.xinhuanet.com/ziliao/2005-03/17/content_2709622.htm) (accessed April 10, 2010).

**Table 3.1 - Ratios of Central and Local Fiscal Revenue and Expenditure (1991–2011)**

<b>Year</b>	<b>Ratio of Central Fiscal Income to National Revenue</b>	<b>Ratio of Local Fiscal Income to National Revenue</b>	<b>Ratio of Central Fiscal Expense to National Expenditure</b>	<b>Ratio of Local Fiscal Expense to National Expenditure</b>
<b>1991</b>	29.8	70.2	32.2	67.8
<b>1992</b>	28.1	71.9	31.3	68.7
<b>1993</b>	22.0	78.0	28.3	71.7
<b>1994</b>	55.7	44.3	30.3	69.7
<b>1995</b>	52.2	47.8	29.2	70.8
<b>1996</b>	49.4	50.6	27.1	72.9
<b>1997</b>	48.9	51.1	27.4	72.6
<b>1998</b>	49.5	50.5	28.9	71.1
<b>1999</b>	51.1	48.9	31.5	68.5
<b>2000</b>	52.2	47.8	34.7	65.3
<b>2001</b>	52.4	47.6	30.5	69.5
<b>2002</b>	55.0	45.0	30.7	69.3
<b>2003</b>	54.6	45.4	30.1	69.9
<b>2004</b>	54.9	45.1	27.7	72.3
<b>2005</b>	52.3	47.7	25.9	74.1
<b>2006</b>	52.8	47.2	24.7	75.3
<b>2007</b>	54.1	45.9	23.0	77.0
<b>2008</b>	53.3	46.7	21.3	78.7
<b>2009</b>	52.4	47.6	20.0	80.0
<b>2010</b>	51.1	48.9	17.8	82.2
<b>2011</b>	49.4	50.6	15.1	84.9

*Source:* Adapted from Zhongguo caizheng nianjian 2012 (China's annual financial report 2012) (p. 459-62), by He Jieping, 2012, Beijing: China State Finance.

Under the new budget constraints, greater fiscal burdens were placed on local governments, which intensified competition between local governments with regard to increasing their incomes. Under the circumstances, the relationship between companies and local states also changed. For example, many local governments had aided township and village enterprises (TVEs), which had prospered rapidly in the

1980s, by not demanding taxes thus allowing more profits to be retained by the TVEs and shared with the host governments. But under the tax-sharing system, these TVEs now had to pay central and local taxes through specific tax institutions, which meant that income diverted to local governments was reduced. As a consequence, local governments lost the motivation to support the development of TVEs, which constitutes one of the major factors for the decline of the TVEs during the 1990s.<sup>15</sup> In addition, many local SOEs were sold off when they could not produce income for the local authorities. In general terms, local governments became keen to disassociate themselves from companies running at a loss.

In these ways, state-enterprise relationships were indirectly reshaped by the tax-sharing system put in place after 1994.<sup>16</sup> In this context, the interrelationship between local governments and tobacco corporations and cigarette enterprises also changed, albeit in different way. Given that the high tax rate for the tobacco industry under the new tax-sharing system would directly influence local fiscal income, the incentive for the local states to become involved in the local tobacco industry actually increased. This will be further discussed in Chapter Five.

### 3.2.2 The Reform of SOE Governance

In general, productivity within the SOEs improved in the 1980s when they were granted greater autonomy under a more decentralized structure, but during the 1990s their profitability declined dramatically, principally due to increased competition from the emerging non-state sector and the social welfare they assumed. This proved to be a major issue that required much attention from the central state, and so the focus in SOE reform began to shift from delegating authority to restructuring ownership through the introduction of a shareholding system in the

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<sup>15</sup> Feizhou Zhou, “Fenshuizhi shinian: zhidu jiqi yingxiang” (The ten years of a tax-sharing system: the institution of its influence), *Social Sciences in China* 6 (2006): 114-5; Whiting, *Power and Wealth in Rural China*, 265-99.

<sup>16</sup> Jin Zheng and Kellee Tsai, “The Local Politics of Restructuring State-owned Enterprises in China,” in *Going Private in China: The Politics of Corporate Restructuring and System Reform*, ed. Jean C. Oi (Washington, DC: the Brookings Institution Press, 2010), 44-69; Guy S. Liu, Pei Sun, and Wing T. Woo, “Chinese-style Privatization: Motives and Constraints,” in *Exit the Dragon? Privatization and State Control in China*, ed. Stephen Green and Guy S. Liu. (London, UK: Chatham House, 2005), 60-3; Hai-tao Tsao and Ryh-song Yeh, “Zhuoguo dalu gongyou qiye de minyinghua: Zhongyang yu defang quanxi de fenxi tuijin” (Privatization of Chinese SOEs – a perspective on central-local relations), *Mainland China Studies* 53 No. 4 (2000): 113-25.

early 1990s. The introduction of this shareholding system resulted in the privatization of small and medium-sized SOEs, most of which were owned by local states and were active in competitive industries such as machinery, textiles, food processing, and so on. Given that these gradually deteriorated into fiscal burdens for local states, over half of these small SOEs were privatized by the end of 1996.<sup>17</sup>

While local states were encouraging the privatization of small and medium-sized SOEs in their jurisdictions through shareholding reforms in the 1990s, most of the large SOEs in a number of strategic industries, including national security, technological innovation, and the domestic economy, remained under the control of the central state. Moreover, the central authority not only decided to reserve the ownership rights of these central state-run SOEs but also endeavored to reorganize and refinance them so that they would become a part of even bigger groups.

A policy of “grasping the large, letting the small go” (*zhuada fangxiao* 抓大放小) was thus introduced in 1997, officially confirming the different state strategies concerning SOE reform in competitive and strategic sectors.<sup>18</sup> The objective was stated explicitly in President Jiang Zemin’s speech at the 15<sup>th</sup> Party Conference in 1997:

The leading role of the state-owned sectors should manifest itself mainly in its control power. We should make a readjustment of the state-owned sector of the economy. The SOEs must be in a dominant position in major industries and key areas that concern the life-blood of the national economy... we shall effectuate a strategic reorganization of SOEs by properly managing large enterprises while adopting a flexible policy towards small ones.<sup>19</sup>

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<sup>17</sup> Tian Zhu, “China’s Corporatization Drive: An Evaluation and Policy Implication,” *Contemporary Economic Policy* 17 No. 4 (1999): 530-3; Lixin Colin Xu, Tian Zhu, and Yi-min Lin, “Politician Control, Agency Problem and Ownership Reform: Evidence from China,” *Economics of Transition* 13 No. 1 (2005): 6; Yuanzheng Cao, Yingyi Qian, and Barry R. Weingast, “From Federalism, Chinese Style to Privatization, Chinese Style,” *Economics of Transition* 7 No. 1 (1999): 105.

<sup>18</sup> Stephen Green and Guy S. Liu, “China’s Industrial Reform Strategy: Retreat and Retain,” in *Exit the Dragon?*, 15-41.

<sup>19</sup> The Database of Each National Congress of the Communist Party, “Jiang Zemin zai zhongguo gongchandang di shiwuci quanguo daibiao dahui shang de baogao” (Jiang

In 1998, the then Vice-Premier Wu Bangguo also re-emphasized the goal of creating a group of globally competitive large enterprises:

International economic comparison shows us that if a country has several large companies or groups, it will be assured of maintaining a certain market share and a position in the international economic order. The US, for example, relies on General Motors, Boeing, Du Pont, and a batch of other multinational companies. Japan relies on six large groups and Korea relies on ten large commercial groupings. In the same way, both today and in the next century our nation's position in the international economic order will to a large extent be determined by the position of our nation's large companies and groups.<sup>20</sup>

It was argued that the decision to nurture a batch of large SOEs as the “national team”—those capable of competing with the large firms—stemmed mainly from a detailed study of the experiences of the East Asian developmental countries that had gradually built up globally powerful, large corporations via state support. In studying their developmental experiences, the Chinese government believed that it was necessary to create these large enterprises as pillars of China's national economy, but, unlike other East Asian developmental states, only the central SOEs would fulfill this role, guaranteeing the state's capacity to steer economic development in China.<sup>21</sup> Negotiations revolving around joining the WTO during the 1990s further created a powerful rationale—one which was fundamentally based on

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Zemin's Report to the Fifteenth Party Conference), <http://cpc.people.com.cn/GB/64162/64168/64568/65445/4526288.html> (accessed May 10, 2012).

<sup>20</sup> Peter Nolan, *Is China Buying the World?* (Stafford, Australia: Polity Press, 2012), 58.

<sup>21</sup> Peter Nolan, *China and the Global Economy: National Champions, Industrial Policy and the Big Business Revolution* (New York, NY: Palgrave Macmillan, 2001), 3-15; Yongnian Zheng and Minjia Chen, “China's State-Owned Enterprise Reform and its Discontents,” *Problems of Post-Communism* 56 No. 2 (2009): 37; Peter Nolan and Xiaoqiang Wang, “Beyond Privatization: Institutional Innovation and Growth in China's Large State-Owned Enterprises,” *World Development* 27 No. 1 (1999): 177-86; Seung-Wook Baek, “Does China Follow ‘the East Asian Developmental Model’?,” *Journal of Contemporary Asia* 35 No. 4 (2005): 493-5.

national pride—for establishing strong and large SOEs/groups in order to counteract foreign companies.<sup>22</sup>

However, since the introduction of the policy of “grasping the large,” a number of policies and special rights aimed at enlarging the selected SOEs did not function well. For one, the endeavor to construct large, state-owned corporate groups through mergers and acquisitions within the relevant core businesses were seriously thwarted by local governments that feared losing their vested interests, especially in the case of a merger involving two dominant companies (i.e. strong and strong merger).<sup>23</sup> Though the attempt to construct vertically integrated multi-plant companies in some key industries emerged during the 1990s—i.e., restructuring Sinopec and CNPC in the petroleum industry—, the “subordinate” enterprises had gained so much autonomy and developed their own business activities under the SOE reform in the preceding stage that it proved difficult to reintegrate the various subordinate companies.<sup>24</sup> As a result, the failure to establish giant SOEs prevailed across industries to such a degree in the 1990s that the question was once asked: how could the Chinese state, an authoritarian regime with plentiful experience in central planning, seem incapable of steering industrial restructuring?<sup>25</sup>

The apparent growth of central SOEs once China had joined the WTO negated this question. As China’s WTO entry neared, the nation’s leadership had a much stronger motivation for initiating a new round of SOE reforms to integrate their fragmented control over the assets of centrally-run SOEs. In the negotiations leading up to its WTO membership, and even though China had committed to liberalizing foreign direct investments (FDI) in sectors that had been previously closed, this liberalization was not a uniform but rather sector-specific process. Given that China joined the WTO with the status of a developing country, it could retain selective control in the important sectors. However, even so, the Chinese government was

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<sup>22</sup> Mary Gallagher, *Contagious Capitalism: Globalization and Politics of Labor in China* (Princeton, NJ: Princeton University Press, 2005), 133-53.

<sup>23</sup> Nolan, *China and the Global Economy*, 85-6; Nolan and Wang, “Beyond Privatization,” 189.

<sup>24</sup> Jin Zhang, *Catch-up and Competitiveness in China*, 134-62; Peter Nolan, *Transforming China: Globalization, Transition and Development* (London, UK: Anthem Press, 2004), 166-72.

<sup>25</sup> Pei Sun, “Is the State-led Industrial Restructuring Effective in Transition China? Evidence from the Steel Sector,” *Cambridge Journal of Economics* 31 (2007): 612.



eager to develop their “national champions” in these sectors for fear that the government would be forced to further open domestic markets in the future.<sup>26</sup>

This provides the context for the SOE governance recentralization reform initiated after China’s entry into the WTO. The establishment of the State-owned Assets Supervision and Administration Commission (SASAC) in 2003 stood as the milestone for this round of reforms, which were intended to clarify and solve the problem of central property rights via new agency responsible for managing state assets on behalf of the central state. This reform allowed once-dispersed control and management to be collated and placed exclusively in the hands of the central state via the SASAC and other counterparts.<sup>27</sup> On the basis of this clarified structure of central property rights, the SASAC has played a redefined role—a combination of regulator and investor with a mandate to keep the state asset growing. Under this centralized management framework, the central SOEs have been transformed through a series of mergers over the preceding decade into a handful of large companies in a number of state monopolies or strategic industries.<sup>28</sup>

Although the CNTC has not fallen under SASAC, it launched its own recentralization program by following the mode of SASAC in 2005. Under this recentralized framework, the autonomy of the CNTC’s local agents has been relatively constrained, and they were now accountable to their superiors within the tobacco state monopoly regime. Accordingly, this likewise eroded the ability of local states to manipulate the CNTC’s local agents. Thus, the opportunities available for local states to intervene in the tobacco industry were further limited by increased constraints.

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<sup>26</sup> Jean-François Huchet and Xavier Richet, “Between Bureaucracy and Market: Chinese Industrial Groups in Search of New Forms of Corporate Governance,” in *Globalisation in China, India & Russia: Emergence of National Groups and Global Strategies of Firms*, ed. Jean-François Huchet, Xavier Richer and Joël Ruet (New Delhi, India: Academic Foundation, 2007), 51; Christopher A. McNally, “China’s Capitalist Transition: The Making of a New Variety of Capitalism,” in *Capitalisms Compared*, ed. Lars Mjøset and Tommy H. Clausen (Bingley, UK: Emerald Group Publishing Limited, 2007), 195.

<sup>27</sup> Not all central SOEs fell under the SASAC’s authority but others also adopted a similar recentralization reform after China’s WTO entry.

<sup>28</sup> See Joo-Youn Jung, “Reinvented Intervention: The Chinese Central State and State-owned Enterprise Reform in the WTO Era,” in *Going Private in China*, 130-2; Maikael Mattlin, “Chinese Strategic State-owned Enterprises and Ownership Control,” *Brussels Institute of Contemporary Chins Studies Asia Paper* 4 No. 6 (2009): 8; Barry Naughton, “SASAC and Rising Corporate Power in China,” *China Leadership Monitor* 24 (2008): 2.

In summary, a fragmentation of the multilevel governmental system and its dispersed control over the central SOEs in the pillar industries were offset separately by the “recentralization” measures for fiscal revenue and SOE governance. However, once the central state’s capacity to obtain financial resources increased in light of fiscal reform, the motivation driving local states to become involved in the local tobacco industry likewise intensified. As vertical management (*tiao*) was gradually introduced into a number of pillar-sector central SOEs after the latest SOE reform went into motion, opportunities for local states to manipulate the CNTC’s local agents declined. The opposing developmental trends, expressed in the incentives and capacities of the local governments, would bring about different dynamics and tensions between local governments and the CNTC’s agents and result in distinctive patterns of industrial governance.

### **3.3 The Links between the Different Phases**

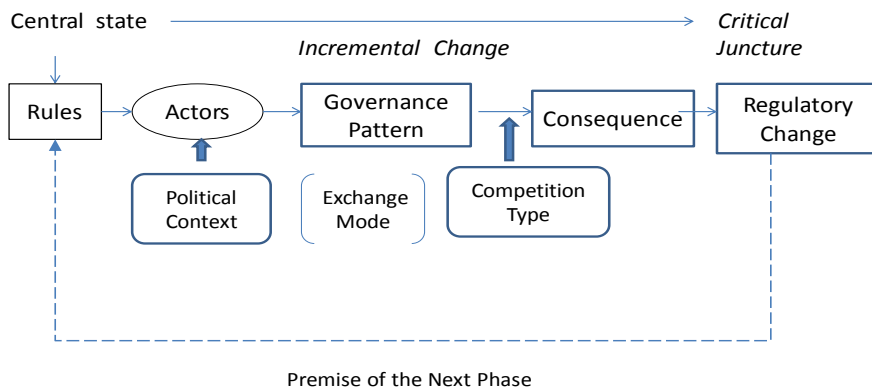
From the power-distributing perspective of historical institutionalism, in the following chapters I analyze the development of the tobacco state monopoly in each of its three phases. The analysis of each phase starts from the question: what pattern of industrial governance is configured by the interaction between local states and the CNTC’s agents. In this respect, the formation of some governance pattern points to how modes of exchange between the multiple players in the production chain would change incrementally and deviate from the originally intended rules of operation for the monopoly. However, given that each phase is subject to a varying political context, which determines the distinctive pattern of governance, one must ask how these phases link sequentially, so that we may see the evolving process of the tobacco state monopoly system as a “moving picture” during the past three decades.

Drawing on insights from historical institutionalism, two important points of analysis enter into this study: the consequences of the industrial pattern of governance, and regulatory change at critical junctures. In fact, the former constitutes a critical antecedent connected to the production condition for the latter’s occurrence. That is to say, the consequence that takes shape under the governance pattern produces a degree of tension and dynamism becomes an internal force that leads to the eventuation of critical juncture. Moreover, since the governance pattern refers to the actual modes of exchange between multiple players along the production chain, different types of competition occurring amongst the trades between cigarette manufacturers and wholesale distributors would accordingly occur

according to those distinctive patterns of governance. In this sense, because competition under each pattern of governance triggers the abovementioned consequence, it becomes necessary to carefully characterize and understand the consequence, since it connects the “incremental change” presented through the pattern of governance and the “abrupt change” of the regulatory regime of the tobacco state monopoly at each critical juncture.

As opposed to the gradual changes prompted by interactions between local governments and the CNTC’s local agents, the regulatory changes initiated by the central authorities are exemplified by the new rules of the tobacco state monopoly itself and are converted into a new premise at the start of each subsequent phase. For this reason, regulatory change arising at the critical juncture also then becomes a linking point between two different phases (see Figure 3.3).

**Figure 3.3 - Analytical Framework in Each Phase**

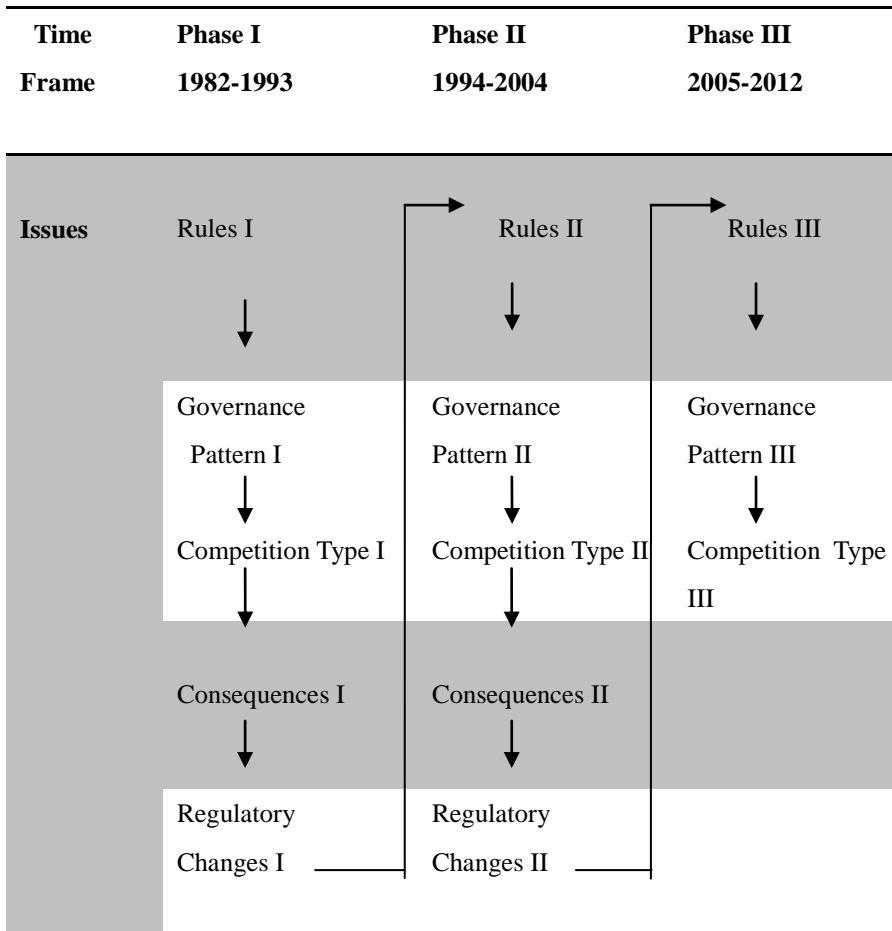


Source: Supplied by author

By employing the main arguments—gradual change and critical juncture—of historical institutionalist approach, the analytic framework illustrated in Figure 3.3 is used for the discussion over the following three chapters. Under this framework, while these issues—including the original monopoly rules, governance pattern, competition type, resulting consequence, and regulatory change—are closely

examined, the institutional development of the tobacco state monopoly system phase by phase over the past three decades becomes clear, as presented in Figure 3.4 below.

**Figure 3.4 - Three-Phase Flow Chart**



Source: Supplied by the author



## **CHAPTER FOUR**

### **PHASE 1 - THE TWO-TRACK SYSTEM: FROM START TO END**

Building from Chapter Two, the emergence of the two-track system rather than the original institutional design of the tobacco monopoly serves as the starting point of analysis for this chapter. When the CNTC was established 1982, it was shaped by institutional settings already in place—i.e., the decentralization reforms in fiscal policy and SOE governance—and this resulted at a very early stage in the entire institutional architecture deviating from the original formulation of state-planned control. The market, aside from the state-planned facilities, growing out of the trade in non-plan-specific products brought the two-track system into being in the tobacco sector.

Recognizing this, I first delve into how interactions between local governments and the CNTC's local agents made the primary rules of the game change incrementally and finally result in an alternative pattern of industrial governance for the tobacco sector. By exploring this process, it will be seen why this type of “quasi-free competition” could occur in the tobacco state monopoly at all. I also investigate the consequences under this governance pattern and discuss further how these consequences would bring about an abrupt change to monopoly regulations in the early 1990s.

#### **4.1 The Political Context: Decentralization Reforms on Two Fronts**

As indicated in Chapter Three, a feature of the 1982–1993 phase was the twofold decentralization reforms. In this section, I further elaborate how the fiscal distribution design under the fiscal policy motivated local states to get involved in the local tobacco industry and also how the formulation of SOE profit-sharing under the SOE reform drove the CNTC's local agents to constantly raise production during this phase.

#### 4.1.1 The Profit Incentive for Local Governments

The fiscal decentralization reform was formally initiated by the central authorities upon this measure—sharing revenues according to specific sources and classifying payments according to the contract system—throughout the country in 1980. Under this policy, while the fixed income at each level of local government basically consisted of the taxes and the profits remitted by local SOEs, they also had to hand a portion of the income to higher-level governments according to agreements reached during revenue-sharing negotiations between the center and the provinces. Though the fiscal contract system was modified several times through revenue-sharing negotiations in the following years, the logic remained similar. In general, after the revenue-sharing arrangements were confirmed through central-local negotiations, the more revenue local governments collected, the more they could keep for themselves. So rather than acting as collection agents for the Ministry of Finance, local governments could now directly take a certain portion of taxes they collected under the policy of fiscal decentralization.<sup>1</sup>

In view of this, local governments were unlikely to dissociate themselves from the tobacco industry because of the high tax rates imposed on this sector. Before the CNTC was created in 1982, the industry and commerce tax (*gongshang shui* 工商稅) on tobacco products had been classified as local fiscal revenue. At the time, the industry and commerce tax constituted the largest tax source in China, and in this tax category the rates on tobacco products—between 40 and 66 percent—were much higher than other rates, given the unhealthy and addictive ingredients.<sup>2</sup> When the *Rules on the Tobacco Monopoly* was instituted in 1983, the Ministry of Finance proclaimed a new regulation that restructured the industry and commerce tax levy on tobacco products. The new approach meant that the tax on tobacco leaves would be retained at a local level, but the tax on cigarette products would be shared between the central and local governments, in view of the fact that it constituted such a large sum. The cigarette tax collected in 1981 was thus seen as a benchmark, which could in the future be retained by local governments. Anything over that benchmark was split 50-50 between the central and local governments.<sup>3</sup> As a result, the fiscal

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<sup>1</sup> Wong, “Central-Local Relations”, 699-701; Yang and Yang, *Zhongguo caizheng*, 75-6.

<sup>2</sup> Yang, *Zhongguo yancao tongzhi* (The annals of Chinese tobacco)(Beijing, China: Zhonghua Book Company, 2009), 1400, 1410.

<sup>3</sup> *Ibid.*, 1411.

incentive for local states remained after the industry and commerce tax on cigarettes was transformed from a local to a central-local shared tax in 1983.

The following year, the product tax (*chanpin shui* 产品税) replaced the industry and commerce tax, but the rates on tobacco products continued to be higher than for any other product (between 32 and 60 percent). The product tax was paid by the cigarette manufacturers on the basis of three factors: their official selling price to the tobacco corporations (manufacturer price, *chuchangjia* 出厂价), the tax rate, and the quantities sold.<sup>4</sup> Moreover, this levy also covered the non-plan-specific tobacco products. The upshot of this was that the more cigarettes the local enterprises produced, the bigger the share of taxes to the local states. In this light, it made sense that, when Yunnan was devastated by an earthquake in 1988, the Yunnan Province Government asked the central state to provide loans for importing more cigarette manufacturing machines to make up for the loss in capacity caused by the earthquake rather than asking for funds to be transferred to rebuild the disaster-hit areas. The local government believed that greater financial income would be realized from increased cigarette production rather than from relief aid.<sup>5</sup>

Moreover, with tolerances for non-plan-specific production in the wake of administrative subordination agreements, local governments could now also obtain a “bonus” from cigarette enterprises, such as the share of “retained cigarettes” (*zhengfu liuchengyan* 政府留成烟). Allocated by cigarette enterprises in their geographical territories, this share of “retained cigarettes” could mean extra income for the local governments. In 1990, for instance, Yunnan Province Government received 70 thousand cases of retained cigarettes from the cigarette enterprises in the province, which the government made a profit from by selling them through the Yunnan Province Tobacco Corporation.<sup>6</sup> As a consequence, both taxation and profits could persuade local governments to collude with local cigarette enterprises to maximize the production figures.

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<sup>4</sup> Ibid., 1405. The rates on cigarettes were 32 to 60 percent and 35 percent on tobacco leaves.

<sup>5</sup> Tao Ming, *Zhuanmai tizhi xia de zhongguo yancaoye—lilun, wenti yu zhidu biange* (China's tobacco industry under state monopoly)(Shanghai, China: Academia Press, 2005), 224-5; The Editorial Board of Hongta Group, *Hongta jintuan zhi*; Cai Chongda, “Cu shijian zhihou de Yunnan yancao ” (Yunnan tobacco after shijian Cu), *Life Week*, March 9, 2005, accessed January 15, 2010, <http://www.lifeweek.com.cn/2005/0309/11278.shtml>.

<sup>6</sup> Jin, *Yunnan sheng juanyan xiaoshou*, 102-3.



#### 4.1.2 The Financial Incentive of the SOEs

The first step of the SOE reform involved granting greater decision-making autonomy and retained higher profit-sharing to SOEs in the late 1970s. For example, the cigarette enterprises in Yunnan Province could retain 90 percent of after-tax profits before 1983.<sup>7</sup> In order to prevent constant renegotiations about how profits were to be shared between the SOEs and states, the central authorities introduced a profit-to-tax reform in 1983 (see Chapter Two). Under this policy, profit was divided into three categories: income tax, adjustment tax, and the fund to be retained by the company. This meant that the cigarette firms and tobacco corporations could retain what was left after paying the two new taxes.

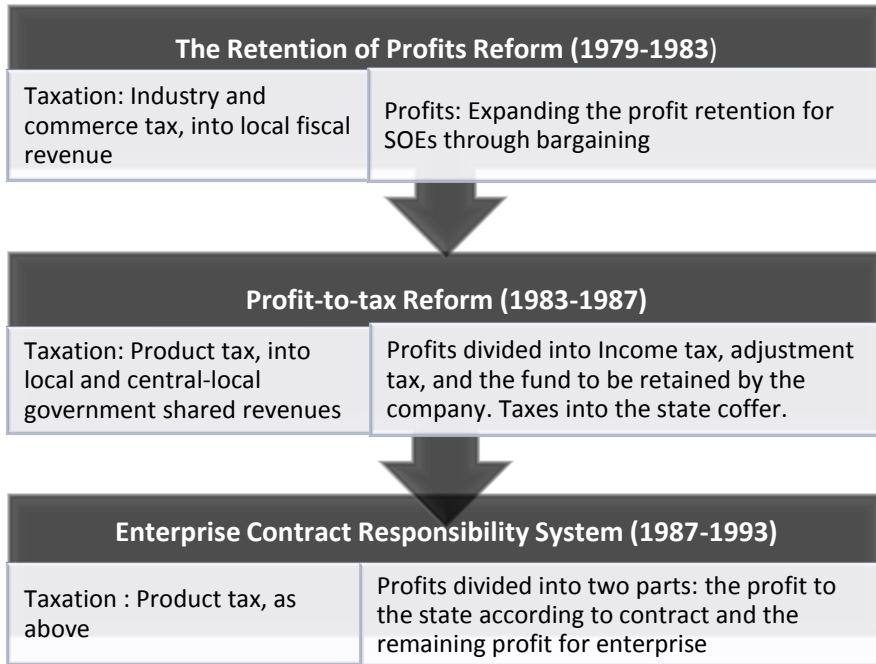
With the conversion to administrative subordination, cigarette enterprises and tobacco corporations continued to keep the funds in their own individual financial accounts under the SOE reform. In 1987, the enterprise contract responsibility system replaced the profit-to-tax system, and the tobacco corporations gained further managerial autonomy, since their only obligations now were contractually-stipulated financial duties (see Figure 4.1). Under the enterprise contract responsibility system, the CNTC handed over profits to the Ministry of Finance in accordance with its contract. Under this premise, the CNTC would subcontract payment obligations to provincial tobacco corporations throughout the country.<sup>8</sup> After fulfilling these payment obligations, all local tobacco corporations and cigarette enterprises could retain the remainder. In this way, the enterprise contract responsibility system did not change the incentive structure for local cigarette enterprises in increasing non-plan-specific production that would generate greater profits for themselves.

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<sup>7</sup> The Editorial Board of the Chronicle of Yunnan Province, *Yunnan shengzhi*, 336.

<sup>8</sup> Yang, *Zhongguo yancao*, 1428.

**Figure 4.1 - Profit-and-Tax Allocations in the Tobacco Sector under SOE Reform**



*Source:* Summarized by the author

## 4.2 The Incremental Change under the Two-Track System

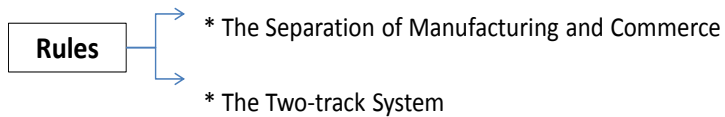
Driven by these financial incentives, discovering the means for steadily raising production became a common concern for the local governments and the CNTC's local agents in the political context of the twofold decentralization reforms. With this goal of increasing production in mind, two issues in particular needed to be tackled in the 1980s. First was how to ensure that the supply of raw materials—i.e., tobacco leaves—quantitatively and qualitatively sufficed for the cigarette manufacturers; second involved the problem of selling the non-plan-specific products in a way that both taxation and profits were increased smoothly.

Below, I shift the focus to discuss how local governments cooperated with the CNTC's local agents to seek solutions regarding these two aspects. This provides the background for how incremental change would occur in this phase of the state tobacco monopoly. Before analyzing that change, however, the rules of the game in

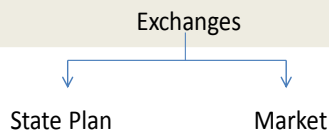
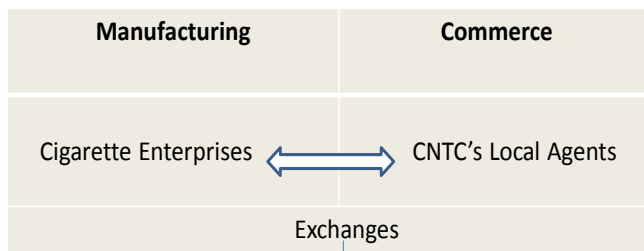
the tobacco state monopoly at the start of this phase need to be identified, since these rules supply the baseline for comparing to outcomes of later incremental changes.

Here, the rules mainly covered two dimensions: the separation of manufacturing and commerce (the trade of tobacco leaves and of cigarette products) along the production chain, and the two-track system of state plan and market. In reality, these two dimensions remained closely related, because it was a prerequisite that the modes of exchange presented by the latter were nested in the former (see Figure 4.2).

**Figure 4.2 - Primary Rules of the Tobacco State Monopoly in the First Phase**



**[The Separation of Manufacturing and Commerce]**



**[The Two-track System]**

*Source:* Supplied by the author

### 4.3 The Introduction of a Three-in-One System

Cigarette manufacturers required a greater supply of tobacco leaves in order to feed their non-plan-specific production under the two-track system. In this section, I first illuminate how the tobacco “monopsony” was implemented on the state-planned track and then explain how the resulting three-in-one system, which not only ensured the quantity but also the quality of tobacco leaves, came into being.

The basic operating principles of a tobacco monopsony can be seen in the *Rules of Tobacco Monopoly*. Under the *Rules*, the State Planning Committee would formulate a tobacco procurement plan, corresponding to the cigarette production plan for the same year. Based on this plan, county tobacco corporations would then sign procurement contracts that specified the planting area and production quantity with tobacco farmers through their local tobacco stations. After flue-curing, tobacco farmers were required to sell their outputs to the local tobacco corporations at fixed prices set according to the evaluated quality grades via its local agents.<sup>9</sup> In this, tobacco growers had no choice but to sell their tobacco leaves to the local tobacco corporation as the monopsonistic purchaser, and the tobacco corporations would in turn sell the flue-cured leaves to cigarette manufactures under the state-planned arrangements. The operation guaranteed that the state plan, including procurement and distribution of tobacco leaves, would be implemented according to the set criteria (see Figure 4.3).

In addition to the state-planned arrangements under this tobacco monopsony, growing tobacco in excess of the state-planned quota was actually permitted and encouraged by the local governments in which the tobacco fields were located, since they would collect further product tax on tobacco leaves from local tobacco corporations in line with the quantities purchased, the official prices, and the tax rate.<sup>10</sup> In Yunnan Province, for example, taxes on both plan-specific and non-plan-specific tobacco leaves were retained at a local level throughout the Sixth Five-Year Plan (1981–5). Under the circumstances, the shortage of tobacco leaves for state-planned production was substantially reduced, but most cigarette enterprises instead faced a severe shortage of high quality tobacco leaves in the

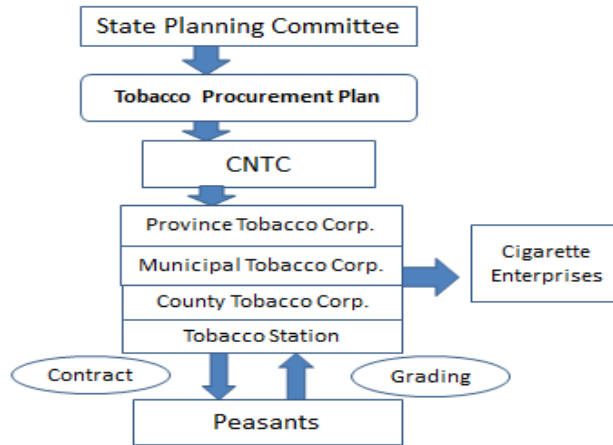
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<sup>9</sup> See Articles 5 and 6 of the *Rules of Tobacco State Monopoly*.

<sup>10</sup> Before 1984, local governments collected a 40 percent industrial-commercial tax on tobacco leaves. As of 1984 this became a 35 percent production tax. The tax rate for tobacco leaves was the highest rate among the entire range of agricultural products.

1980s. So, contrary to earlier tobacco shortages, another kind of “tobacco war” emerged in this phase.<sup>11</sup>

**Figure 4.3 - Institutional Arrangement of Tobacco Monopsony**



Source: Supplied by the author

In general, shortages like these were common, because it was not easy for individual farmers to improve their agricultural skills under the household contract responsibility system that was in place in the 1980s. Moreover, even when the local tobacco corporations could obtain a quantity of high-quality tobacco leaves, they were not necessarily guaranteed to local cigarette enterprises, as the state-planned arrangements stipulated that they could be distributed to others.<sup>12</sup> However, high-quality tobacco leaves were essential for producing high-class cigarettes that would result in higher profit margins and taxes for the cigarette enterprises and the local governments, respectively, as specified by the central authorities (see Table

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<sup>11</sup> Wang, *State-Market Interactions*, 54-8; Andrew H. Wedeman, *From Mao to Market: Rent Seeking, Local Protectionism and Marketization in China* (Cambridge, UK: Cambridge University Press, 2003), 113-27.

<sup>12</sup> Interviewee No. 66.

4.1).<sup>13</sup> In this context, some experimental projects began to be conducted locally in order to obtain greater quantities of high-quality tobacco leaves.

**Table 4.1 Cigarette Manufacturer Prices and Proclaimed Tax Rates (1984)**

<b>Cigarette Class</b>	<b>Manf. Price (RMB per case)*</b>	<b>Tax Rate (%)</b>
<b>First Class</b>	Above 1200	60
<b>Second Class</b>	680-1200	60
<b>Third Class</b>	430-680	56
<b>Fourth Class</b>	280-430	50
<b>Fifth Class</b>	Below 280	32
*As a standard, a case of cigarettes has 10 thousand cigarettes (a case has 50 cartons, a carton has 10 packs, a pack has 20 cigarettes)		

*Source:* Adapted from Zhongguo yancao tongzhi (p. 1405), by Yang Guoan, Beijing, China: Zhonghua Book Company, 2009.

The Yuxi Cigarette Enterprise was the first to take the initiative in proposing in the mid-1980s a trial project to set up the “first workshop” (*diyì chējiān* 第一车间) for tobacco growers to improve the quality of tobacco leaves. The intention behind this first workshop was to get the cigarette company to grow its own main ingredient directly so that the quality would satisfy demand. However, given that the cultivation of tobacco, the purchase of leaves, and the manufacture of cigarettes were undertaken by different and separate bodies under the then-current structure of tobacco state monopoly structure, the Yuxi Cigarette Enterprise was unable to realize its plan without the support of the local governments. In 1985, the Yuxi Cigarette Enterprise was able, with the aid of the Honghai County Government, to cultivate and manage its own tobacco fields for the first time by directly offering the specific seeds to farmers and asking them to plant tobacco according to its instructions. In circumventing the local tobacco corporation, the Yuxi Cigarette Enterprise became responsible for the entire investment, including irrigation facilities and other subsidies, and fertilizer during the growing process. As a result, the high-quality tobacco leaves produced amounted to 42.12 percent of the total crop, much higher

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<sup>13</sup> Wang, *State-Market Interactions*, 54.

than the average percentage (16.2) for the Yuxi area. The total harvest was over double the average production output.<sup>14</sup>

In view of these satisfying results, the Yuxi Cigarette Enterprise attempted to introduce trial projects in other counties in the Yuxi area in 1986. However, discontent voiced by the local tobacco corporations in Yunnan started arose, asserting the kinds of experiments were destroying their authority. In order to quell this disquiet, the then-governor of Yunnan Province, He Zhiqiang (和志强), called a meeting where he expressed his strong support for Yuxi's projects and efforts. Yunnan Province Government took this step further and began to assist the Yuxi Cigarette Enterprise in conducting its first workshop project in other regions within the province.<sup>15</sup>

In 1987, the director of the Yuxi Cigarette Enterprise, Chu Shijian (褚时健), proposed a more radical idea: to establish a "three-in-one" combined system to replace the earlier trial project. This involved merging the Yuxi Tobacco Corporation, the Yuxi Tobacco Monopoly Bureau, and the Yuxi Cigarette Enterprise into a single entity. In terms of organizational structure, this restructuring of the existing production chain was intended to further stabilize cigarette production by closing the gap between the supply of tobacco leaves and the demand by cigarette manufacturers by internalizing the exchanges within the same entity. Chu's proposal was enthusiastically endorsed by the Yuxi Government, as the following demonstrates:

The establishment of the three-in-one system is consistent with the spirit of economic reforms enforced by the central government. It will serve as a good example of how to activate the SOEs. This reform will also effectively solve the problems in tobacco and cigarette production which our area has been facing. Under the three-in-one system, the Yuxi Cigarette Enterprise will play the leading role, and the Yuxi Tobacco Monopoly Bureau and Yuxi

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<sup>14</sup> Chinese STMB Yuxi Bureau and Yuxi Tobacco Corporation, *Yuxi yancao shi 1978-2005* (The chronicle of Yuxi tobacco 1978-2005), 2007, CD-ROM; Yuan Maoquan and Cheng Yongzhou, *Di yi chejian qishilu* (The revelation from the first workshop)(Beijing, China: Economic Daily Press, 1995), 64-72.

<sup>15</sup> *Ibid.*, 73-5.

Tobacco Corporation will work with the Yuxi Cigarette Enterprise.<sup>16</sup>

With the backing of the Yuxi Government, Yunnan Province Government followed suit and supported the proposed three-in-one system. With the local governments wholeheartedly endorsing the proposal, the Yunnan Tobacco Corporation also began to push for it and finally obtained the approval of the CNTC in 1987. Chu was then appointed as manager of the Yuxi Tobacco Corporation, head of the Yuxi Tobacco Monopoly Bureau, and director of the Yuxi Cigarette Enterprise under the three-in-one system. This new system saw concentrated decision-making power to further facilitate the provision of high-quality tobacco leaves while maintaining a sufficient supply for non-plan-specific cigarette production.

After its inception, local governments further strengthened the three-in-one combined system. For example, as one of the tobacco bases for the Yuxi Cigarette Enterprise, Jiangchuan County Government took several steps to encourage villages and peasants to raise both the production levels and the proportion of high-quality tobacco leaves. In 1988, the county government allocated 0.3 RMB per *dan* (担; one *dan* is equal to 50 kilograms) to facilitate production above 1987 levels and 800 RMB for increasing the output of high-quality tobacco leaves by one percent for each village.<sup>17</sup> Under the circumstances, at a time when many cigarette enterprises were struggling with a shortage of high-quality leaves in the 1980s, the Yuxi Cigarette Enterprise had already taken advantage of their quality tobacco supply to become a nationally recognized company, thanks to famous brands such as *Hongtashan* (红塔山).<sup>18</sup>

As a result, the Yuxi company grew rapidly in the 1980s, and, in view of its success, the three-in-one system was consequently promoted by the Yunnan Tobacco Corporation and implemented in other regions, where other cigarette enterprises such as Dali and Honghe were located.<sup>19</sup> This also explains how taxes and profits

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<sup>16</sup> Wang, *State-Market Interactions*, 76.

<sup>17</sup> The STMB of Jiangchuan County, *Jiangchuan xian yancaozhi* (The chronicle of tobacco in Jiangchuan County) (Dehong, China: Dehong Nationality Publishing House, 2006), 165-70.

<sup>18</sup> Huang Fengling, "Shankao renweifeng" (If you are determined to climb, you can reach the top), *China Tobacco*, December 18, 2010, accessed March 15, 2012, <http://www.echinatobacco.com/101542/101576/101938/102053/102065/22785.html>

<sup>19</sup> Interviewee No. 66.



collected from the tobacco industry for Yunnan's fiscal revenue rose dramatically from the mid-1980s onwards—the ratio of taxes on and profits from tobacco for the provincial fiscal revenue in Yunnan Province climbed from 49.3 % in 1985 to 91.6 % in 1990 (see Figure 4.4). Other provinces around the country went on to copy system in the following years.

Like many experiments and trials initiated by local authorities and approved after the fact by the central state during the initial reform stage,<sup>20</sup> this three-in-one system inserted into the tobacco state monopoly aimed at solving a shortage of high-quality tobacco leaves while upgrading cigarette company operations via whatever means seemed appropriate. The creation of the three-in-one system demonstrated that, while the ownership of the cigarette enterprises still rested with the central state and local governments were not the residual claimants (as for instance in the case of the TVEs),<sup>21</sup> local governments were given incentives to support and spur development under the fiscal decentralization reform. Moreover, the proposal to create the three-in-one system proved that SOEs could be motivated to pursue output and production growth aggressively under a framework of SOE reform and not simply depend on government bailouts or subsidies, as suggested in Kornai's "soft budget constraint syndrome" or Steinfeld's "nested problem dynamic."<sup>22</sup>

The combination of the two decentralization reforms engendered the birth of the three-in-one system, with due regard for the cooperation between the local governments and the cigarette enterprises. The separation of commerce and manufacturing was inverted and became the combination of commerce and manufacturing, which allowed cigarette manufacturers to efficiently manage their own tobacco fields and ensure that the quality and quantity of tobacco leaves were substantially able to meet their needs. In view of the result, even though the three-in-one system was not a compulsory policy formulated by the central state, it was continually mimicked and adopted in regions beyond the province of Yunnan and gradually led to "institutional isomorphism" throughout the country.<sup>23</sup>

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<sup>20</sup> For example, see John McMillan and Barry Naughton, *Reforming Asian Socialism: The Growth of Market Institutions* (Ann Arbor, MI: University of Michigan Press, 1996).

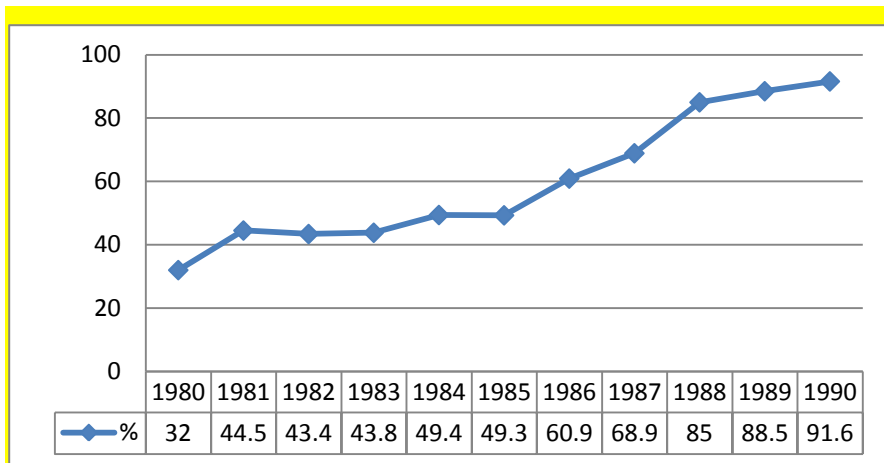
<sup>21</sup> Walder, "Local Governments as Industrial Firms," 270-3; Oi, *Rural China Takes Off*.

<sup>22</sup> Janos Kornai, "The Soft Budget Constraint," *Kyklos* 39 No. 1 (1986): 4-9; Edward S. Steinfeld, *Forging Reform in China: The Fate of State-Owned Industry* (Cambridge, UK: Cambridge University Press, 1998), 45-77.

<sup>23</sup> Paul J. DiMaggio and Walter W. Powell, "The Iron Cage Revisited: Institutional

Nonetheless, this development also further fragmented the authority of the state tobacco monopoly regime.

**Figure 4.4 - Ratio of Taxes on and Profits from Tobacco for the Provincial Fiscal Revenue in Yunnan Province (1980–1990)**



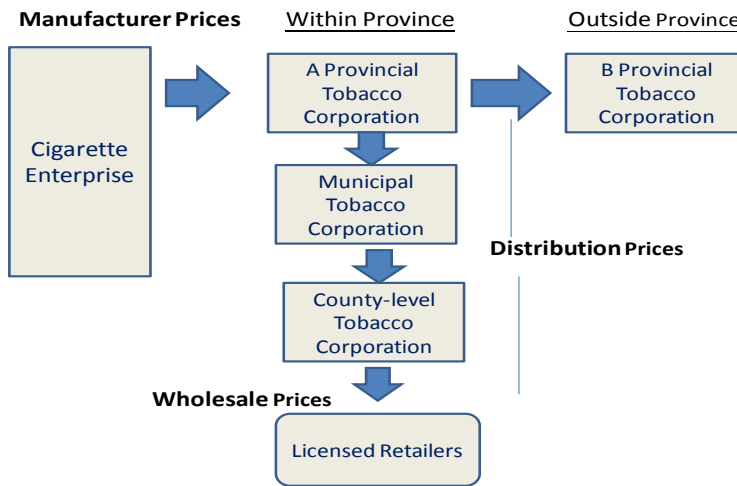
Source: Adapted from Yunnan sheng juanyan xiaoshou gongsizhi 1982–2006 (p. 258), by Jin Yibing, 2008, Kunming, China: Yunnan People’s Publishing House, 2008.

### 4.3.1 The Prevalence of Illicit Wholesalers

Once raw material supply issues were resolved through the introduction of the three-in-one system, selling the entire non-plan-specific cigarette output turned out also to be an urgent issue. According to the original institutional design, the tobacco corporation was the only legal local cigarette wholesaler, and only state-licensed retailers were permitted to purchase cigarettes from them. Under these state-planned arrangements, the plan-specific cigarettes would be distributed via the multi-tiered CNTC wholesale system. For example, after the Yunnan Province Tobacco Corporation was established in 1982, it became responsible for distributing the plan-specific cigarettes manufactured by the Yuxi Cigarette Enterprise. Within the province, the cigarettes circulated from provincial, municipal, and county corporations to licensed retailers at the state-specified prices (manufacturer,

distributor, wholesale prices). The retailers were also required to adhere to the retail prices when selling the cigarette to customers. In addition to the inter-provincial trade, the Yunnan Province Tobacco Corporation also sold the plan-specific cigarettes to other provinces (see Figure 4.5).<sup>24</sup>

**Figure 4.5 - Distribution of the Plan-specific Cigarettes**



Source: Supplied by the author

Alongside this circulation under the state-planned arrangements, the cigarette enterprises began to sell their non-plan-specific products to the tobacco corporations at different levels and in different regions. However, as the non-plan-specific production grew constantly throughout this phase, cigarette enterprises were forced to find additional channels to clear their stock. And so a number of private individuals with connections to the cigarette enterprises, or who “borrowed the hat” from other tobacco corporations to masquerade as one of their employees, began to purchase the non-plan-specific cigarettes directly from cigarette manufacturers. Prices in these transactions were driven by supply and demand on a “free market” basis rather than as specified by the state. Thus, the two-track system here embodied not only state-planned and non-plan-specific production but also the resultant state-specified prices as well as “free market” prices.

<sup>24</sup> Jin, *Yunnan sheng juanyan xiaoshou*, 78, 114.

These private individuals also assisted local tobacco corporations to clear their inventories. Although tobacco corporations were entitled to monopolize local wholesale markets, there was no guarantee they could sell their entire inventory, since not all cigarette brands were equally popular, e.g., *Hongtashan* brand in the 1980s. In particular, most tobacco corporations in the 1980s relied on the traditional retailers inherited from the Mao era, i.e., the state-owned shops and *supply* and marketing *cooperatives (SMCs) in the rural areas, which were compelled to call on the regional tobacco corporations in person to collect the products.*

County tobacco corporation staff often preferred sitting in their offices (*zuoshang* 坐商) instead of working actively to create and expand distribution networks.<sup>25</sup> Taking advantage of this inconvenient situation, some private individuals began to purchase the cigarettes in bulk from the tobacco corporations and non-licensed retailers. They were seen as the illicit wholesalers (*dahu* 大户), who colluded with tobacco corporations to clear their inventory.<sup>26</sup> A former official of the Shaoxing County Tobacco Corporation recalled how cigarette distribution was handled in the 1980s:

It was very common to sell our cigarette products to *dahu*. In fact, we preferred selling products to the competent *dahu*. Why? We were doing business and they could buy our products in larger quantities. That meant we could get our money back quickly!<sup>27</sup>

Moreover, influence of *dahu* grew constantly under the shield of local governments during this period. They not only created their own retailing networks but also autonomously established “free” cigarette wholesale marketplaces where they made deals directly with customers in public places.<sup>28</sup> Here, the meaning of “free” contrasts with traditional circulation within the CNTC’s multi-level wholesale distribution. In other words, these physical marketplaces were not approved by the

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<sup>25</sup> Pan Yunzhe, “Con gezi shang zhili zhengdun juanyan lioutong hunluan de zhuangkuang” (Regulating the chaotic situation of cigarette circulation fundamentally), *Commercial Industry and Management* 2 (1990): 27; Wu Jianhui, “‘Lao yancao’ hua juanyan pifa shanshi nian” (The “old tobacco” taking about cigarette wholesale for thirty years), *China Tobacco*, December 1, 2008, accessed March 10, 2010, [http://www.echinatobacco.com/zhongguoyancao/2008-12/01/content\\_125483.htm](http://www.echinatobacco.com/zhongguoyancao/2008-12/01/content_125483.htm).

<sup>26</sup> Tao, *Zhuanmai tizhi*, 226.

<sup>27</sup> Interviewee No. 76.

<sup>28</sup> The “free” wholesale market was translated from Chinese literally.

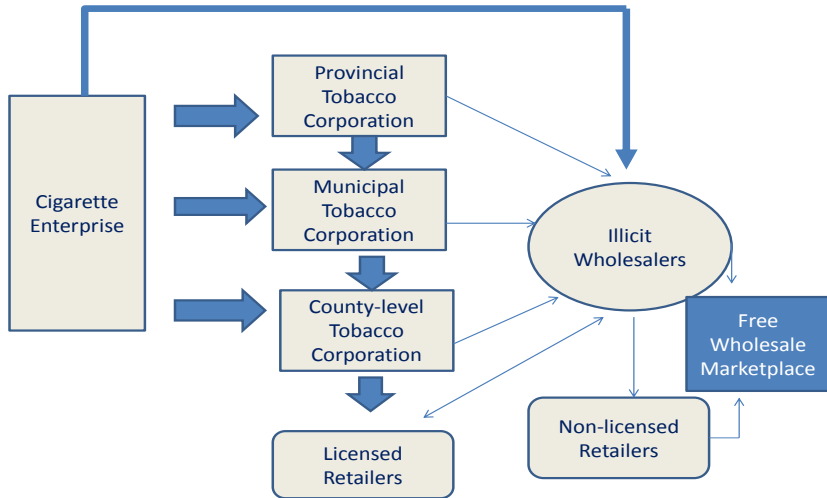
CNTC but protected by local governments. In fact, many local governments were active participants in creating free wholesale cigarette marketplace.<sup>29</sup> By establishing these wholesale marketplaces, the local governments not only profited from charging rents and service fees but also could facilitate the distribution of local cigarette products. These “illegal” wholesale marketplaces, which had not obtained permission from the CNTC, mushroomed in 1980s and in the following years rapidly spread across the country (see Figure 4.6). Their existence further contributed to the growth of illicit wholesalers. According to the survey conducted by the STMB, there were 264 illegal wholesale cigarette marketplaces in China by 1992.<sup>30</sup>

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<sup>29</sup> The Jiangsu Provincial Tobacco Monopoly Bureau, “Jiedongfeng kaozhengche du yuantou zhuaguanjian jianjuei qudi feifa juanyan pifa jiaoyi shichang” (The determination to crackdown the illegal cigarette wholesale market by policy support, blocking the origin, and finding the key), *China Tobacco*, March 1, 1999, accessed July 10, 2012, [http://www.echinatobacco.com/zhongguoyancao/2012-07/01/content\\_343733.htm](http://www.echinatobacco.com/zhongguoyancao/2012-07/01/content_343733.htm); Lu Jiamin, “Lashou zhilun gonggu he wanshan yancao zhuanmai zhidu” (Strengthening the tobacco monopoly by strong measures), *China Tobacco*, September 20, 2009, accessed July 10, 2012, [http://www.echinatobacco.com/zhongguoyancao/2009-09/20/content\\_101268.htm](http://www.echinatobacco.com/zhongguoyancao/2009-09/20/content_101268.htm); Tao, *Zhuanmai tizhi*, 227; Li Zhongguo, “Shiying shichang jingji yaoqiu , zonghe zhili feifa juanyan pifa shichang” (Adapting to market economy, governing illegal cigarette wholesale marketplaces), *China Tobacco*, June 1, 1994, accessed March 15, 2014, <http://www.echinatobacco.com/101588/102220/102468/102474/40498.html>.

<sup>30</sup> Tan, “Zhuanmai,” *China Tobacco*.

**Figure 4.6 Distribution of Non-Plan-Specific Cigarettes**



Source: Supplied by the author

### 4.3.2 The Expanding Market under the Two-Track System

Under the decentralization reforms in fiscal policy and SOE governance, local governments continued to aid the CNTC's local agents in expanding non-plan-specific cigarette production for the purpose of financial gain. Through this interaction and cooperation, the three-in-one system emerged to stabilize the supply of high-quality tobacco leaves, while illicit wholesalers helped to accelerate the distribution of cigarette products throughout the country. In this context, with the increase of non-plan-specific production, the market was continuously enlarged. This expanding cigarette trade market under the two-track system gradually became the dominant pattern of governance during this phase.

Under this pattern of governance, though the state-planned track remained in place, an ever-increasing number of cigarette products were exchanged through the market channel and a type of "quasi-free competition" began to emerge. Firstly, although the barrier to entering this industry was set by state regulations, the prohibition was constantly sabotaged by the allied interests of local governments and cigarette enterprises. The rise of illicit wholesalers served as a clear example of

this. In addition, the unsanctioned cigarette manufacturers were able to survive as long as they could obtain non-plan-specific tobacco leaves and sell their cigarette products via the informal distribution networks.<sup>31</sup> This meant that not all cigarette manufacturers and wholesalers were approved by the STMB for entry but still survived within the industry. And so, even though over three hundred non-plan-specific manufacturers had been closed down by 1985, non-state cigarette factories continued to spring up.<sup>32</sup>

Moreover, while the central authorities envisaged the CNTC as a multi-tier system to run the entire sector, their local agents, including wholesalers and manufacturers who were delegated to monopolize the local wholesale markets and produce the cigarette products, were seldom accountable to the CNTC in terms of the business they conducted during this phase. Aside from sharing profits with their superior corporations, the agents could produce and purchase any products in any quantity after satisfying the CNTC state mandates. As a result, this low degree of “formalization” and “accountability” led to a quasi-free competitive situation in which a wide range of non-legal transactions co-existed with legal ones.

Under this quasi-free competition, though some relatively large cigarette firms, such as Yuxi, carved out market niches in the late 1980s with high-quality cigarettes like *Hongtashan* as their flagship products, a significant number of small cigarette firms continued to survive, and they generally sold more homogenous products. Under the circumstances, this industry was shaped by the low market concentration of cigarette manufacturers: according to the data, there were already over 150 licensed cigarette (and cigar) manufacturers in 1990, not to mention the unsanctioned ones.<sup>33</sup>

In summary, in the political context of the two decentralization reforms, interaction and cooperation between local governments and the CNTC’s local agents led to an incremental change seen in the expanding market of the two-track system. This incremental change, of a type Mahoney and Thelen describe as a mode of “layering,” supplied additions or revisions to existing institutions or regulations

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<sup>31</sup> Li, “Shiying shichang,” *China Tobacco*.

<sup>32</sup> “Jihuawai yanchang de guanting zhilu” (The closure history of out-of-plan cigarette factories), *China Tobacco Online*, May 8, 2005, accessed on March 14, 2014, <http://www.tobaccochina.com/culture/data/20055/c8094616.htm>; Wedeman, *From Mao to Market*, 118-9.

<sup>33</sup> The STMB/ CNTC, *Yancao hangye lishi ziliao 1986-1990* (The historical data of tobacco industry 1986-1990), (Beijing, China: State Tobacco Monopoly Bureau, 1992), 11-2.

rather than introducing wholly new ones, thereby changing the manner in which the original rules structured exchange behavior.<sup>34</sup> By this layering mode, the state-planned track did not disappear; rather, a market channel became increasingly prominent. With the growth in non-plan-specific cigarette production, not only did quasi-free competition come into being, but the existing state-planned arrangements also began to erode as the market track swelled.

#### 4.4 The Consequences under the Pattern of Governance

The cooperation between local governments, the CNTC's local agents, and non-state actors (illicit wholesalers) saw the aggregate supply of cigarette products rise on a continuous basis. But the incremental growth of non-plan-specific production also meant not only that the market was expanding but also gradually becoming saturated, with the exception of some high-quality cigarette brands. In 1990, with over 32 million cases of cigarettes brought to market, the glut only became worse (see Figure 4.7).<sup>35</sup> This led to one-third of the total production capacity being mothballed in the early 1990s.<sup>36</sup> Under the quasi-free competition, cigarette manufacturers were compelled to lower their prices in market. As a result, most companies at that time—with the exception of the profit-making Yuxi, Kuming, Shanghai, and Changsha cigarette enterprises—were in the red and were even forced to take out loans to pay their taxes.<sup>37</sup> In other words, the entire market had already changed from a seller's market into a buyer's market—an evolution that was to become the critical antecedent for the regulatory change to the tobacco state monopoly system.

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<sup>34</sup> Mahoney and Thelen, "A Theory of Gradual Institutional Change," 16-7.

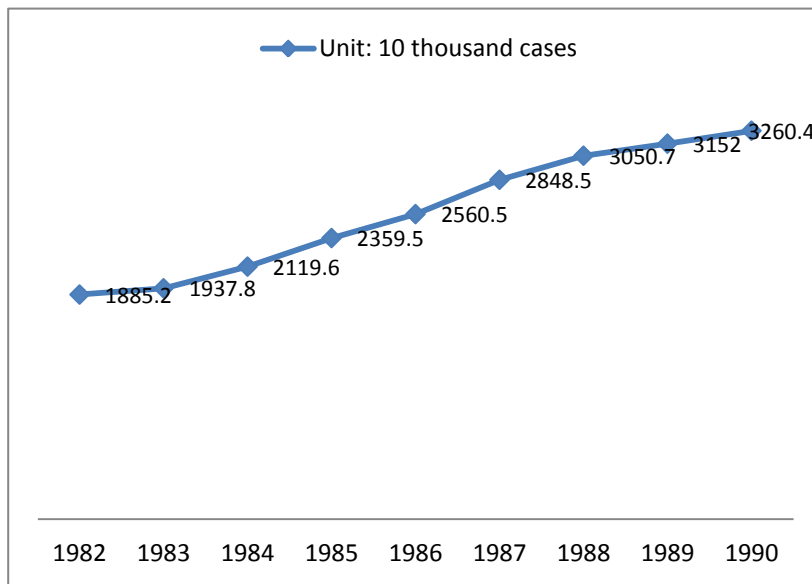
<sup>35</sup> Fu Shangshang, "Zhongguo yancao: yu gaige kaifang gong chengzhang" (China tobacco: Growing with the economic reform), *China Tobacco*, 18 December, 2008, accessed 16 March, 2014, <http://www.echinatobacco.com/101542/101576/101938/102053/102055/22766.html>

<sup>36</sup> Zhou, "Fiscal Decentralization," 131; Yu Li, "gaige fazhan zhong de yancao guanli tizhi yu jigou diaozheng" (The Adjustment of tobacco management system and structure under the reform), *China Tobacco*, 18 December, 2008, accessed 17 March, 2014, <http://www.echinatobacco.com/101588/102041/102042/102046/22582.html>

<sup>37</sup> Yang, *Zhongguo yancao*, 1446-7.



**Figure 4.7 - National Production Figures of Cigarette Products (1982–1990)**



*Source:* Adapted from Zhongguo yancao fazhan baogao 1949–1999 (The report on China’s tobacco development 1949–1999) (p. 615), by STMB, 1999, Beijing, China: Industry and Commerce Press.

#### **4.4.1 Conflicts with the Non-State Actors**

When this buyer’s market emerged in the early 1990s, the illicit wholesalers gradually came to dominate the market distribution networks. Required to adhere to official retail prices, the traditional retailers did not have the leeway that the illicit wholesalers and retailers had to freely lower their sales prices for products procured through the state-planned track. Conversely, the illicit wholesalers could take advantage of their flexible pricing to enlarge their market share. Under the circumstances, a great number of state-owned shops and SMCs were compelled to abandon the cigarette retail market as they could not compete, especially with the ever-increasing glut. According to a survey conducted by Hebei Province Government, more than 85 percent of SMCs in the rural areas of Hebei Province struggled to sell their allocated cigarettes in early 1990s, and most farmers bought

cigarettes through alternative channels.<sup>38</sup> Meanwhile, another survey also revealed that illicit wholesalers occupied an average of more than 50 percent of the rural market share, even reaching up to 90 percent in some areas.<sup>39</sup> In this context, the traditional retailers had little choice but to purchase more from the illicit wholesalers if they hoped to survive. And so the illicit wholesalers gradually consolidated their grip and dominated the wholesale market.<sup>40</sup>

As the illicit wholesalers continuously expanded their operations, they were even able to force local tobacco corporations to adhere to the wholesale prices they set. For example, the Bazhou City Tobacco Corporation in Hebei Province was compelled to follow the prices set by the local Shengfang wholesale marketplace, where more than 60 illicit wholesalers gathered and sold a plethora of cigarette brands in the early 1990s.<sup>41</sup> Instead of cooperating with each other, a clash of interests began to appear between the illicit wholesalers and the CNTC's local agents. The result was that state fiscal revenue and cigarette company profits were adversely hit. By the end of 1991, the collective debt of the cigarette enterprises under the CNTC's framework had exceeded 78 billion RMB.<sup>42</sup>

In view of the serious threat from illicit wholesalers and the resulting losses suffered by the cigarette enterprises, the State Council proclaimed *The Notification on Further Strengthening the Management of the Tobacco State Monopoly* in 1991, which required all levels of local governments to obtain approval from the CNTC when establishing wholesale marketplaces. Local governments, the State Council announced, were not entitled to approve these marketplaces, and the CNTC began to crack down on all the illegal wholesale marketplaces in order to recover pricing dominance. While the existence of these illicit wholesalers had once facilitated the circulation of cigarette products for a net gain, now they became a target for eradication as a net loss after the buyer's market emerged.

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<sup>38</sup> Yang, *Zhongguo yancao*, 676.

<sup>39</sup> *Ibid.*, 672.

<sup>40</sup> Guo Xiquan and Li Zhanzhou, "Jianli he wanshan juanyan jiage guanli tizhi" (Establishing and improving the cigarette price system), *Price Theory and Practice* 11 (1994): 11.

<sup>41</sup> Yang, *Zhongguo yancao*, 674-5.

<sup>42</sup> Yang Ning, "Shenhua juanyan jiage gaige jiaqiang hongguan diaokong he guanli" (Deepening the cigarette price reform, strengthening macro control and management), *Price Theory and Practice* 11 (1994):14.

#### 4.4.2 The Termination of the Two-Track Pricing System

Aside from the crackdown on illicit wholesale marketplaces, the central authorities also decided to implement a price reform for all cigarette products in 1992 to further shut out the illicit wholesalers. By this reform, cigarette manufactures were granted the right to price all cigarette products from manufacturing, distribution, wholesale, to retail.<sup>43</sup> By no longer using state-specified prices, the state-licensed retailers became more responsive to market dynamics so that the advantage that illicit wholesalers enjoyed would be constrained to a certain degree.<sup>44</sup>

The central authorities had in fact already annulled the state-specified prices on thirteen well-known brands of high-class cigarettes, such as *Hongtashan*, and permitted the cigarette enterprises to set the prices for these brands themselves in 1988. Under the quasi-free competition, these brands had become so popular that their prices in the market were much higher than the official prices under the state-planned track. Given this situation, tobacco corporations and illicit wholesalers alike had fought to get as many of these high-class cigarettes as possible, since selling these products meant enormous profits. Also, these high-class cigarettes had become difficult to find in the traditional retailers' shops because illicit wholesalers often bought them immediately and then re-sold them in the coastal areas at higher prices.<sup>45</sup> In order to combat the variety of profiteering activities, price reform had first been initiated in 1988 but was limited at the time only to specific high-class cigarette brands.

The price gap between the two tracks had created a huge source for rent-seeking not only in the tobacco sector but also across different industries during the 1980s.<sup>46</sup> Wedeman's study demonstrated that when the central authorities could not or did not control this unbridled rent-seeking, the resulting competition would

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<sup>43</sup> Under the price reform, the pricing rights were granted to cigarette manufacturers; however, in principle, they still must get the approval from the CNTC on the prices they formulated before selling products.

<sup>44</sup> Xue Shi, "Tantan juanyan jiage shuanggui zhi" (The discussion of cigarette double track system), *China Tobacco*, August 1, 1991, accessed on March 23, 2014, <http://www.echinatobacco.com/101588/102220/102430/102438/34678.html>

<sup>45</sup> Han Zhankui, "Qianyi juanyan jiage gaige mubiao" (The analysis of cigarette price reform), *Price Theory and Practice* 4 (1994): 40; Yang, "Shenhua juanyan," 14; Yang, *Zhongguo yancao*, 660.

<sup>46</sup> This situation is evident in the corruption case against Chu Shijian, see Appendix A.

drive the prices from those fixed by administrative fiat toward market-clearing levels. In other words, the competitive rent-seeking would trigger the dissipation of rent, thereby driving the economy closer to a market and thus contributing to the necessity of price reform at a later stage.<sup>47</sup>

Here, the partial price reform in the tobacco industry was consistent with Wedeman's argument, but this present study would extend the observation to the other side as well: when the shortage becomes a glut, the gap between a higher state-specified price and a lower market price makes the two-track system difficult to sustain. A price gap like that seen in this study provided a great opportunity for empowering the illicit wholesalers to conquer a retail market. Therefore, rather than suppressing the rent-seeking activities, the comprehensive price reform initiated in 1992 became a method for suffocating the illicit wholesalers. Price reform in this sense became a means by which CNTC's leverage in the industry could be recovered from non-state actors, rather than a policy that led to further deregulation.

#### **4.5 The Regulatory Change of the Tobacco State Monopoly System**

When the price reform was fully set into motion, bringing an end to the two-track system for pricing in the tobacco sector, it also created the necessary conditions for transforming the existing rules of the tobacco state monopoly. While the price reform did introduce a market mechanism into the tobacco industry, it did not automatically lead to a solution for overproduction. High taxation encouraged local governments to pressure cigarette enterprises to raise production continually even though the glut problem had already emerged. But if overproduction were not limited, the price reform alone would instead see profits cut for the CNTC's local agents and further intensify the conflict between local governments and cigarette manufacturers. In this way, the introduction of price reforms generated the occurrence of a critical juncture whereby the central state decided to initiate a regulatory change—setting the “control of overall quantity” regulation in the tobacco state monopoly system—in order to strengthen the authority of the CNTC regime as well as maintain fiscal returns from this industry.

The trend of overproduction driven by local governments had in fact already been predicted. In a report titled “Improving Economic Efficiency in the Chinese Tobacco Industry,” conducted by the Institute of Industrial Economics at the Chinese

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<sup>47</sup> Wedeman, *From Mao to Market*, 21-2.

Academy of Social Sciences in 1986, it stated that local governments would be pushed toward unconstrained production for the sake of fiscal revenue; the authors suggested, then, the introduction of a “tobacco monopoly tax” to be levied and collected exclusively by the central state in order to partially replace the existing Product Tax of cigarettes shared by the central state and local governments. The report suggested that when local governments could not gain more revenue from the tobacco tax, they would lose the incentive to engage in excessive production.<sup>48</sup>

The proposal was not, however, adopted at that time. Opposition came not only from the local governments but also from the State Administration of Taxation, which feared that the introduction of such a new tax would destroy the hard-won consensus of central-local fiscal relations then in place.<sup>49</sup> The potential problem of overproduction would not be rectified, then, until the early 1990s, when the central authorities required all the taxes on the non-plan-specific production to be considered as central fiscal revenue in 1991, in an attempt to constrain the rise in overproduction.<sup>50</sup> In conjunction with the price reform, the central state also further promulgated the *Tobacco Monopoly Law* to fulfill the control of overall quantity for cigarette production in the following year.

In Wang’s study on the Chinese tobacco industry, she argued that local governments were “pragmatic” market competitors, who would respond to competitive pressure and make demands that purely political actors would not.<sup>51</sup> I basically agree that local governments were in a constant state of flux, as Wang suggests, but it must also be pointed out that local governmental interests were not always consistent with those of the CNTC’s local agents. In places where a shared a common interest for increasing the production levels arose, then local governments might act as a “market competitor”—as Wang suggested—e.g., in the active role seen in building the three-in-one system in Yunnan Province.

However, while Wang paid much attention to exploring how local governments promoted the development of the SOEs, she did not analyze the incremental change presented in industrial governance after the introduction of the three-in-one system. Here, by contrast, this study uncovers how the cooperation

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<sup>48</sup> Chen Shuxun, *Chen Shuxun chanye jingji wenxuan* (The selection of Chen Shuxun’s articles on industrial economy) (Beijing, China: Chinese Agriculture Science and Technology Publishing House, 2007), 285-9.

<sup>49</sup> Interviewee No. 75.

<sup>50</sup> Yu, “gaige fazhan.”

<sup>51</sup> Wang, *State-Market Interactions*, 15.

between local governments and the CNTC's local agents to raise production was already transformed as the market dynamic changed. When the cigarette enterprises could not benefit from increasing production due to the gluts, local governments were still motivated to pressure them to raise the levels, since the conduct of the local governments was basically driven by fiscal concerns. In this light, the clash of interests between the local governments and the CNTC's local agents was exacerbated, which in turn compelled the central state to make more fundamental changes to regulations in order to protect the tobacco state monopoly system.

In this context, the *Tobacco State Monopoly Law* formally stipulated that the cigarette manufacturers had to stick to the quotas set under the state plan, which became a binding rule rather than the previous bare minimum. In other words, the *Law* officially prohibited non-plan-specific cigarette production. Here, the content of the "state plan" was substituted with control for the overall quantity in the industry. In this sense, there was no longer a distinction between state-planned and non-plan-specific cigarette production, as had previously existed.

With the two separate tracks of production scrapped, production levels for each cigarette enterprise had to adhere to the annual quotas set by the state, but cigarette manufacturers now had pricing autonomy for their products once the price reform was instituted. Cigarette enterprises were now fully responsible for freely exchanging their products with the tobacco corporations throughout the country, but they could not decide own production levels under the new rule of overall quantity control. Launched by the central authorities, this regulatory change to the state tobacco monopoly demonstrated the outcome of a critical juncture by the end of this phase: while the market had displaced state-planned arrangements, it was placed under another kind of state control: quota allocations in the tobacco sector.

## **4.6 Conclusion**

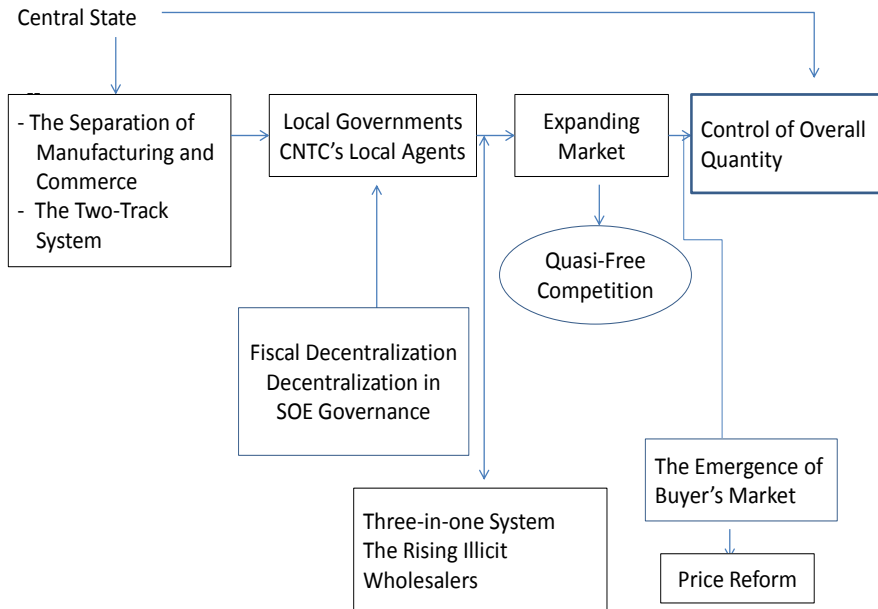
My analysis of this phase first examines how the market expanded through cooperation between local states and the CNTC's local agents in the 1980s. As the market dynamic changed, however, tension between formal and informal actors—i.e., the CNTC's agents and illicit wholesalers, respectively—as well as contradictions between local governments and cigarette manufactures were tackled. At the end of this phase, the "market architecture" differed greatly from when it started (see Figure 4.8) and became a new condition for the next phase.

Under the decentralization reforms in fiscal policy and SOE governance, local governments worked under the two-track system with the CNTC's local agents to constantly increase the non-plan-specific cigarette production. Their cooperation not only gradually led to the prevalence of the three-in-one system but also resulted in the rise of illicit wholesalers. Driven by the rapid growth of non-plan-specific production, an expanding market under the two-track system turned out to be the leading pattern of governance and brought about the emergence of quasi-free competition in the tobacco monopoly system in the 1980s.

Under this pattern of governance, a series of gluts beginning in the late 1980s transformed the market from a seller's to a buyer's. Under these conditions, traditional retailers under the CNTC multilevel framework failed to compete with illicit wholesalers and were forced out. The cooperative relationship between the CNTC's local agents and the informal wholesalers deteriorated into conflicts and, in order to squeeze out the illicit wholesalers and maintain the authority of the CNTC regime in the tobacco sector, the central state not only began to crack down on the illicit wholesale marketplaces but also to implement fully price reform to constrain the illicit wholesalers' activities.

Once the price reform was fully initiated, it further exposed the inconsistency between the interests of the local states and the cigarette manufacturers with regard to production levels. It was in this context that the regulatory change to the tobacco monopoly system was introduced, which represented the desire to control overall quantities and the resulting quota allocations under the *Tobacco State Monopoly Law* promulgated in 1992. By this, the two-track system was abolished, and a "market" covered all trade in tobacco products. However, this market obviously deviated from one in a "free market" model, representing rather a mixture of market elements and state control by which manufacturers had autonomy in terms of exchange and pricing but could not determine their production levels. The outcome of this transformation provided a new premise for the second phase that began in 1994.

**Figure 4.8 Summary of Institutional Change Process in the First Phase**



*Source:* Summarized by the author





## **CHAPTER FIVE**

### **PHASE 2 - THE PREVALENCE OF LOCAL PROTECTIONISM**

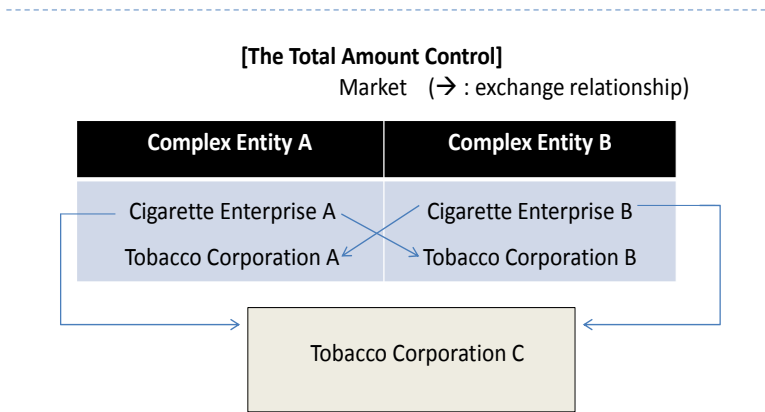
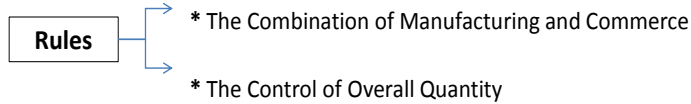
When the *Tobacco Monopoly Law* was promulgated in 1992, it created a legal foundation to formally implement the control of overall quantity in the tobacco state monopoly. Coupled with the earlier change, the rules of the game at the starting point for this second phase exhibited two factors: a combination of manufacturing and commerce, and a control of overall quantity. As summarized in Figure 5.1, a great many complex manufacturing and commercial entities existed under the three-in-one system along with parties acting exclusively as wholesalers (where there were no cigarette manufacturers in the same region) who officially enjoyed the autonomous transactions within the market.

This situation constituted the starting condition for the process of institutional change during the second phase (1994-2004). In this chapter, I first examine how interactions between local governments and the CNTC's local agents led to a specific type of incremental change in industrial governance and its resulting type of competition. This makes clear also the consequences under this pattern of governance and how they would trigger yet another more fundamental regulatory change in the tobacco state monopoly system at the conclusion of this phase.

#### **5.1 The Political Context in the Second Phase**

In this section, I elaborate how the tax-sharing system implemented in 1994 changed fiscal arrangements between the central and local governments concerning tobacco in order to examine why the “incentive” of intervention on the part of local governments into the local tobacco industry would grow under these new fiscal arrangements. I then discuss SOE reform measures implemented during this phase and subsequently identify the developmental trends of interaction between local governments and CNTC local agents that resulted from this new political context.

**Figure 5.1 Primary Rules of the Tobacco State Monopoly during the Second Phase**



Source: Summarized by the author

### 5.1.1 Fiscal Arrangements for Tobacco under the 1994 Tax-Sharing System

Under the new tax policy, instead of being forced to return to the bargaining table each year, all tax revenue could now be collected under three distinct categories: a central tax, a local tax, and a central-local shared tax. The tax codes under this new fiscal system stipulated that the tobacco-specific taxable goods covered all three categories, as summarized in Table 5.1.

**Table 5.1 Principal Tobacco-Specific Taxes under the Tax-sharing System\***

Tax Category	Tax Payer	Tax Formula	Recipient
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Sales tax	Cigarette manufacturers	Total sum of sales x 40% or 45%	Central tax
Value-added tax (VAT)	Cigarette manufacturers & tobacco corporations	Value-added amount (i.e. sales income - cost of purchase) x 17 %	Central-local shared tax (central 75%; local 25%)
Special agricultural tax**	Tobacco corporations	Tobacco cost price (i.e. purchase amount x prices) x 31%	Local tax
Income tax	Cigarette manufacturers & tobacco corporations	Taxable income x 33%	Local Tax ***
<p>* This table is based on the situation as it stood in 1994; some rates were modified at a later stage.</p> <p>** The special agricultural tax was scrapped for all agricultural products in 2004 except for tobacco leaves, which is now subject to the tobacco leaf tax.</p> <p>*** Income tax became the central-local shared tax in 2002.</p>			

Source: "Xuenzu, changye zhengce yu difang baohu zhuyi" ( p. 114), by Yi-Wen Cheng, in Xuenzu yu zhongguo changye fazhan, ed., Yongping Wu and Tak-Wing Ngo, 2010, Beijing, China: The Commercial Press.

Sales tax and value-added tax (VAT) were the major taxes in the fiscal revenue extracted from the tobacco sector under the tax-sharing system. When VAT replaced the original product tax for all products, sales tax was introduced, but only for the purpose of levying tax on eleven specific goods that were normally regarded as "non-essential supplies." The sales tax was created to guarantee that general fiscal incomes were not lower than previous levels. All cigarette products were included on the sales tax list; their rates, although amended several times in this phase,<sup>1</sup> remained among the highest of all taxed goods (see Table 5.2).<sup>2</sup>

**Table 5.2 Sales Tax Rates on Cigarette Products**

Year	Tax Rates
1994	● 45% for cigarettes priced above 780 RMB per case

<sup>1</sup> Yang, *Zhongguo yancao tongzhi*, 1416-7.

<sup>2</sup> The second highest tax rate amongst all the taxed goods under the sales tax was for cosmetics, the tax rate of which was 30%, according to the latest adjustment in 2011, much lower than what now became the highest one (56%) for cigarette products. For details please refer to the website of the China State Administration of Taxation, <http://www.chinatax.gov.cn/n8136506/n8136608/n8138877/n8139027/8357266.html>.

	<ul style="list-style-type: none"> <li>● 40% for the all cigarettes priced below 780 RMB per case</li> </ul>
1998	<ul style="list-style-type: none"> <li>● 50% for cigarettes priced above 6,410 RMB per case</li> <li>● 40% for cigarettes priced between 2,137 to 6,410 RMB per case</li> <li>● 25% for cigarettes priced below 2,137 RMB per case</li> </ul>
2001	<ul style="list-style-type: none"> <li>● Initially every case of cigarettes was taxed 150 RMB</li> <li>● Later, 45% for the cigarettes priced above 12,500 RMB per case; 30% for the all cigarettes priced below 12,500 RMB per case</li> </ul>

Source: Tao Ming (2005), Shanghai, China: Academia Press, p. 248.

On the face of it, sales tax was intended to go wholly to the central state, but it played a crucial role in local fiscal income through a “tax refund” policy (*shuishou fanhuan* 税收返还). In order to persuade local governments to accept this tax-sharing reform, the central state designed this tax refund measure as a compromise. Under this, the central state would first approve provincial revenue transferred to the central coffers as the “refund base.” Once all payments had been made and the sum of the sales tax and VAT (hereafter to be referred to as “the two taxes”) had increased by one percent, this then obliged the central state to refund the provincial governments 0.3 percent of the central tax on that part above the base level; this, in order to protect the existing local income.

In this way, local governments received not only 25 percent of the VAT revenue but also a share of the two taxes. The greater the revenue collected under the two taxes, the greater the refund the provinces would receive from the central state. In other words, although the central authorities formulated several measures for the transfer of fiscal revenue in order to correct the developmental gap between different provinces, the tax refund as a single category of all the fiscal transfer measures had the effect of protecting local vested interests. By 1996, the amount of tax refund had reached 72 percent of the whole transfer of fiscal revenue. And although it declined to 45.1 percent by 2001, the sum of the two taxes remained a large determining factor when it came to what income local governments could obtain from the central state through the transfer of fiscal revenue.<sup>3</sup>

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<sup>3</sup> Lo Meijuan, “Zhongguo yancao changye huanjing yu hongta jituan weilai zhanlue quxiang yanjiu – yancao changye de zhengzhi jingjixue yu feiguifan shichang jingzheng yanjiu” (The study of China’s tobacco industrial competitive environment and the future strategy of Hongta Group – the political economy of the tobacco industry and the study of informal competition) (Post Doc. Diss., Hongta Group, 2004); Tao, *Zhuanmai tizhixia*, 247-9; Wang Shigu and Li Baojiang, “Yancao hangye ‘qiangzhe quruo’ de zhiduxing gengzu – cong

This method of fiscal redistribution was particularly influential in the major cigarette-producing provinces, as measured by the ratios of the sum of the two taxes from the tobacco industry compared to totality of the two taxes paid to the central state; data for 1995 is summarized in Table 5.3 below.

**Table 5.3 Ratios of the Two Taxes from the Tobacco Industry to the Totalities of the Two Taxes Paid to the Central State (year: 1995)**

Province	Ratio (%)	Province	Ratio (%)
Yunnan	83	Fujian	31
Guizhou	57	Henan	26.5
Hunan	41.2	Shanxi	25
Anhui	40	Hubei	24.6
Hainan	32.1	Sichuan	24

*Source:* Adapted from Shuizhi gaige yilai shuishou tongji ziliao, 1994-1998 (The statistic data of tax income since the fiscal reform, 1994-1998), by the State Administration of Taxation, 2000, Beijing, China: China Taxation Publishing House.

In this sense, the tax refund policy made not only the VAT but also the sales tax a central-local shared tax. These two taxes also determined how much local governments could collect in the other minor categories of local fiscal income, such as the city establishment tax and the education surcharge fee, because they functioned as the benchmark for calculating these local taxes.<sup>4</sup> Additionally, until 2002, income tax also flowed into the coffers of the local governments.<sup>5</sup>

In general, then, local fiscal revenue continued to be of greater significance to the tobacco industry after 1994, such that when a local fiscal situation degenerated under the tax-sharing system (see Table 3.1), fiscal revenue obtained by the local governments from the tobacco sector became even more crucial.<sup>6</sup>

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yancao shuishou ji xiangguan caizheng zhengce jiaodu fenxi” (The institutional barriers making the winners lose their advantages in the tobacco industry), *China Industry Economy* 4 (2002): 14-6.

<sup>4</sup> The city establishment tax = (sales tax + VAT + business tax) x 7 %; the education surcharge fee = (sales tax + VAT + business tax) x 1.5%.

<sup>5</sup> The income tax became the central-local shared tax after 2002, with 60 percent going to the central and 40 percent to local governments.

<sup>6</sup> Lo, “Zhongguo yancao”; Liu Wei, *Jingji zhuangui guocheng zhongde chanye chongzu: yi yancaoye weili* (The industrial restructuring in the economy transition: the example of

### 5.1.2 Cigarette Manufacturers under SOE Reform

While changes in fiscal structure played an important role in determining the political context for this phase, such changes occurred along with modifications to SOE governance as well. Replacing a previous enterprise contract responsibility system, the central authorities decided to move towards a policy of “building the modern enterprise system,” which aimed for further removing SOEs from the previous state redistribution system.<sup>7</sup> Different from policies that granted greater decision-making autonomy to the SOEs and allowed them to retain greater profits than during the previous phase, these new reforms aimed to create a new corporate form after the introduction of the *Company Law* in 1994, which provided the first legal basis for transforming the SOEs into autonomous legal entities. In many ways, this “modern enterprise system” was a rhetorical stand-in for Occidental-style management practices,<sup>8</sup> where managers were expected to act more like entrepreneurs. Meanwhile, the central state also converted the previous “governmental appropriations” granted to SOEs into “loans”—entailing that companies had to pay interest on the principal—in order to further harden the budgetary constraint. Once these reform measures were set into motion, however, the SOEs still had to cover social welfare provisions, such as healthcare and housing, for their workers. In light of the additional financial burden this assumed, the central authorities decided that SOEs did not need to share their dividends with the state once the tax-sharing system was initiated.<sup>9</sup>

In general, these measures were intended to create the institutional arrangements under which SOEs would further be compelled to take greater responsibility for their own profits and losses. In this context, many cigarette manufacturers applied for a change in status according to the *Company Law* and

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tobacco industry) (Beijing, China: China Social Sciences Press, 2005), 109; Yang and Yang, *Zhongguo caizheng*, 127.

<sup>7</sup> See the document “Zhonggong zhongyang guanyu jianli shehuizhuyi shichang jingji tizhi ruogan wenti de jue ding” (The decisions of several issues about building socialist market economy), <http://cpc.people.com.cn/GB/64162/134902/8092314.html> (accessed Sept 1, 2013).

<sup>8</sup> Doug Guthrie, *China and Globalization: The Social, Economic, and Political Transformation of Chinese Society* (New York, NY: Routledge, 2006), 54-7.

<sup>9</sup> Zhang Zhuoyuan and Zheng Haihang, *Zhongguo guoyou qiye gaige 30 nian huigu yu zhanwang* (The review and outlook of China’s SOE reform during the past 30 years)(Beijing, China: People’s Publishing House, 2008), 290.

consequently became legal entities. The Yuxi Cigarette Enterprise, for instance, was restructured into the Yuxi-Hongta Tobacco (Group) Corporation in 1995.<sup>10</sup> Despite this, no clear relationship existed with respect to assets between the cigarette companies and their “superiors” within the CNTC regime. Moreover, once profit-sharing was suspended under the tax-sharing system, the original subcontracts pertaining to the financial duties of the entities at different levels were accordingly annulled. As a result, while each cigarette company could in principal control their own budgets and enjoy autonomy in terms of actual operations by keeping their own separate legal status, the parent-subsidiary corporate structure had yet to be created within the CNTC. Under this circumstance, the decentralized form of governance remained with the CNTC.<sup>11</sup>

Against this backdrop, most cigarette manufacturers were determined to grab every available advantage from their fixed quota allocations to produce high-class products. And so, while the entire volume of cigarette production did not grow under the policy of controlling for overall quantity, continuously hovering at around 33 to 34 million cases during this phase (see Table 5.4), a glut in upper-end cigarette products began to occur.<sup>12</sup> A deputy chief for the STMB confirmed this trend for producing more expensive cigarettes, noting for example that during the first nine months of 1996, the production of first- (highest) class cigarettes increased by 53.8%, while that of the second- and the third- class cigarettes increased by only 16% and 18% respectively. At the same time, production levels for fourth- and the fifth- (lowest) class cigarettes declined by 11.9% and 51.1%, respectively. During the first half of 1997, the total production output of first-class cigarettes increased by 30.6% compared to the same period in 1996, while the wholesalers’ inventories at the end of that period increased by 43.8%.<sup>13</sup>

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<sup>10</sup> In the meantime, the Yuxi-Hongta Tobacco Corporation became the core body of the Hongta Group set up in 1995. For more information see *Hongta jintuan zhi*.

<sup>11</sup> It should be noted, however, that even if their assets were not interlinked, the cigarette companies still had an “administrative relationship” with their superiors under the CNTC umbrella, so that the monopoly regulations such as the control of overall quantity could still be implemented.

<sup>12</sup> Tao, *Zhuanmai tizhixia*, 200-5.

<sup>13</sup> Zhou, “Fiscal Decentralization,” 114-33.



**Table 5.4 The Sum of Cigarette Production (1994–2002)**

<b>Year</b>	<b>Production Sum (in millions of cases)</b>
1994	34.2
1995	34.8
1996	34.01
1997	33.68
1998	33.49
1999	32.87
2000	33.36
2001	33.99
2002	34.44

*Source:* Adapted from Zhongguo yancao chanye, by Lo Meijuan, Post Doc. Diss., Hongta Group, 2004

It must be added that this development was also encouraged by local governments, since the higher prices of high-class cigarettes would mean more sales tax. Where the two taxes for the tobacco industry contributed to raising local fiscal revenue via the tax refund, amounts from sales tax considerably exceed VAT (see Table 5.5). From 1994 to 2000, the sales tax paid by cigarette companies was responsible, on average, for 75 percent of the two taxes. In addition, differently than from other countries, sales tax in China was levied on cigarette manufacturers on the basis of three factors: tax rates, production levels, and manufacturer prices. This method was formulated mainly for the sake of convenience, since it would be much easier in China's context than collecting taxes from numerous wholesalers or retailers.

While this method of levying taxes would indeed simplify the collecting process, it did not guarantee that all the taxes would be received, especially when cigarette manufacturers were unable to shrink their inventories when faced by gluts. In this context, local governments began to collude with the cigarette companies in their geographic locales in order to clear local products to ensure that high profits and corresponding taxation levels could be easily obtained. Thus, a variety of local protectionism measures emerged to gradually become the dominant pattern of governance for this phase.

**Table 5.5 The Sales Tax and VAT from the Tobacco Industry\***

<b>Year</b>	<b>Sales Tax</b>	<b>VAT</b>
1994	342.6	111.1
1995	372.1	136.8
1996	438.8	166.8
1997	478.5	179.2
1998	497.0	196.2
1999	514.1	205.3
2000	544.8	225.3
*Unit: 100 million RMB		

*Source:* Adapted from Zhongguo yancao tongzhi (p. 1416, 1420), by Yang Guoan, 2009, Beijing, China: Zhonghua Book Company.

## **5.2 The Surge in Local Protectionism**

Local protectionism here refers to a situation where local governments, through administrative controls, make nonlocal cigarette products difficult to obtain in their geographic jurisdictions in order to protect local fiscal interests. This type of local protectionism became widespread throughout China in the mid-1990s. Local governments would create trade barriers in order to afford this protection to those local cigarette companies that could not produce well-known brands. In addition, the major “importing” provinces in terms of cigarette consumption, like Zhejiang and Jiangsu provinces, engaged a number of protective measures, as their fiscal revenues became eroded when increased flow of cigarettes from other regions diluted the market share of local products.<sup>14</sup>

Below, I first examine how this protectionist conduct was exercised by local governments along with its resulting change in competition type, after which I will further discuss the consequences, including both the failure of the “quota trade” program and the emergence of “victims.”

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<sup>14</sup> Lo, “Zhongguo yancao chanye.”

### 5.2.1 The Means of Local Protectionism

The introduction of the *Tobacco Monopoly Law* did not lead to centralized governance in the tobacco sector during this phase, and in practice all the tobacco corporations in the CNTC regime still controlled their own budgets and enjoyed substantial autonomy. This kind of “decentralized” framework provided plenty of room for local governments to interfere in the tobacco industry, especially as they continued to retain leverage with regard to personnel appointments to local tobacco corporations. Even though local tobacco corporations could have independent legal status, the opportunity for local governments to intervene in their operations did not disappear. Under these circumstances, and aside from a few local tobacco corporations that existed under the three-in-one system and had a strong incentive to promote their local cigarette products since they were in the same boat as the cigarette manufacturers, the remaining local tobacco corporations found themselves under constant pressure from local governments to procure the bulk of their cigarette products from amongst those made within the province.

In addition, efforts to improve distribution networks created further conditions facilitating protectionism by local governments. In 1994, the CNTC began to improve its own wholesale and retail networks in order to further constrain the growth of illicit wholesalers. The first measure that the CNTC implemented involved creating more wholesale centers accessible to retailers in rural regions. Due to technological developments, phone-based ordering began to replace on-location pickups, and local tobacco corporations now became responsible for delivering cigarettes to their retail customers.<sup>15</sup>

The CNTC also initiated the first “national ordering meeting” of cigarette wholesalers, at which all inter-provincial deals between cigarette enterprises and tobacco corporations were required to be made through the signing of procurement contracts. This was the first regular, national meeting for the inter-provincial cigarette trade, the prior absence of which had in part allowed illicit wholesalers to fill the voids and expand their spheres of influence. From the time of that first national trade meeting for cigarettes in 1994, it has since been held twice a year on a regular basis.

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<sup>15</sup> Peng Juan, “Cong chuantong shangye xiang xiandai liutong zhuanbian” (The transformation from traditional commerce to modern distribution), *China Tobacco*, September 20, 2009, accessed October 20, 2010, <http://www.echinatobacco.com/101588/102041/102524/43647.html>.

This concentrated administration of the procurement procedure meant that only CNTC-certified members could join the meeting to undertake trade activities. Under such circumstances, intra-provincial and inter-provincial cigarette trade came to be conducted separately.<sup>16</sup> Ironically, this united national ordering meeting for inter-provincial cigarette wholesalers thus paved the way for local governments to stop cigarettes from other provinces entering their local markets during this period. Local governments would often require local tobacco corporations to directly restrict inter-provincial procurement activities.

Some even forbade local tobacco corporations from participating in the national ordering meeting at all. According to an article in the monthly publication of the STMB, *Tobacco Economic Information*, very few tobacco corporations attended the Spring national wholesale ordering meeting in 1997 that did not have permission from their provincial governments. The result was that the total volume transacted during that meeting was down 26.52 percent from the previous year. Under these circumstances, a boycotting of nonlocal cigarettes soon had a ripple effect, such that when a province's products were boycotted by other provinces, local governments had little option but to sell those products at home by reducing its orders from outside of their province.<sup>17</sup>

Under pressure from local governments, provincial tobacco corporations would also order subordinate companies—including city- and county-level tobacco corporations—to sell a given quantity of local cigarettes through their own channels. In this context, the strengthening of the CNTC's distribution networks actually granted more favorable conditions to local governments in terms of their protectionist measures. Some local governments would conduct occasional inspections to check whether local retailers were selling cigarettes made outside of the province. For example, in Jiangsu Province, the local licensed retailers were fined 50 RMB for each pack of nonlocal cigarettes found. These measures were a common maneuver employed by local governments during this period.<sup>18</sup>

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<sup>16</sup> Huang Xueqin, "Cong chuantong yancao shangye dao xiandai lioutong de 'huali zhuanshen'" (The great transformation from traditional tobacco commerce into modern distribution), *China Tobacco*, December 18, 2008, accessed November 15, 2010, [http://www.echinatobacco.com/zhongguoyancao/2008-12/18/content\\_111112.htm](http://www.echinatobacco.com/zhongguoyancao/2008-12/18/content_111112.htm).

<sup>17</sup> Zhou, "Fiscal Decentralization," 114-33; Ceng Wei, "Lun woguo yancao zhuanmai zhidu" (The analysis of China's tobacco state monopoly system) (MA diss., Hunan University, 2006).

<sup>18</sup> Liu, *Jingji zhuangui*, 123; Junming Wang, "Global-market building as state building: China's entry into the WTO and market reforms of China's tobacco industry," *Theory and*

As a result, unlike the “enclave SOEs” referred to in Yi-min Lin’s study as vulnerable targets for predatory local state action due to their central-state ownerships, local governments could now provide massive levels of protection to cigarette companies in their geographical jurisdictions, even though they were the central SOEs.<sup>19</sup>

### 5.2.2 The Failure of the Quota Trade Program

With this prevalence of local protectionism, in 1997, the CNTC had little choice but to scrap the “quota trade” program it had introduced. When the *Tobacco Monopoly Law* was promulgated in 1992, many provincial governors endeavored to bargain with the CNTC in order to obtain higher cigarette product quotas. But it was extremely difficult to adjust those quotas to any significant degree once they were assigned, as doing so would directly influence local fiscal revenue. Faced with resistance from local governments, the CNTC decided to maintain the existing quota allocations but also introduced a program of “quota trade” in 1994 so that greater flexibility became available to cigarette manufacturers for responding to market demand.

Under this program, cigarette enterprises were permitted to transfer their quotas to other manufacturers who could produce popular and high-class cigarette brands, receiving “compensation” in return from these quota buyers. Formulated by the CNTC, this compensation amounted to the quota sellers receiving fifty percent of the goods manufactured under these “transferred quotas” conditions and at discount prices from the quota buyers, so that the quota sellers could benefit from selling the popular products in the market.<sup>20</sup>

The practice of quota trading proved controversial and was subject to attacks from different camps. Those determined to maintain the integrity of quota allocations argued that quotas should not become tradable commodities. Those advocating a free market, meanwhile, opposed the program on the grounds that the trade in quotas would protect poorly-performing cigarette enterprises such that the provinces where those substandard cigarette firms were located would object to any

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*Society* 38 No. 2 (2009): 179-81; Liu Jianhua, “lun zhongguo yancao zhuanmai tizhi xia de hingzheng longduan” (The analysis of the administration monopoly in China’s tobacco sector”), *Research on Economics and Management* 4 (2004): 23.

<sup>19</sup> Lin, *Between Politics and Markets*, 122-50.

<sup>20</sup> Liu, *Jingji zhuangui*, 145, Yang, *Zhongguo yancao tongzhi*, 453.

further cuts to their existing quotas.<sup>21</sup> While controversial, the program was nevertheless seen as the best possible option under the circumstances; it survived only for three years and was scrapped in 1997 as a failure.

Studies identify the main reason for its failure hinged on its inability to meet the fiscal demands of local governments,<sup>22</sup> since quotas were transferred, local fiscal revenue would decline in proportion to the cigarette production quota transferred. Although local cigarette enterprises could receive compensation, this loss of fiscal revenue to local governments could not be offset. As a result, local governments intervened to prevent cigarette companies from conducting quota trades and chose instead to adopt local protectionism measures in order to sell local products at the levels assigned by the quota allocations. After three years, the quota trading program had made little headway. In this light, its failure resulted directly from local protectionism.

### 5.2.3 The Emergence of “Victims”

While a number of relatively large cigarette manufacturers had come into being during the previous phase, production and market share alike barely increased under the quota trading program and the local protectionism of this phase. Given this circumstance, they controversially came to be labeled as “victims.” This designation had some merit for those heavily reliant on exports to other provinces, since local markets could not absorb their entire production outputs; Table 5.6 displays the eight provinces with the greatest local production output exceeding sales in 2001. Yunnan Province, the largest cigarette-producing province in China, made the situation clearer than in the other provinces. For example, when Yunnan’s cigarette production output stood at around 6.2 million cases in 2001, only 1.2 million cases were consumed within the province and the rest—nearly 5 million cases—had to be sold to other provinces.<sup>23</sup>

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<sup>21</sup> Zhou, “Fiscal Decentralization,” 114-33.

<sup>22</sup> Liu, *Jingji zhuanggui*, 148-9; Jiang Xiaojuan and Liu Shijin, “‘Jihai zhibiao shichanghua’ yu tequan hungye de shichanghua xiaoying” (The commoditization of plan quotas and the marketization reform of the privileged industries), in *Zhongguo zhidu bianqian de anli yanjiou: di er ji* (Case studies of China’s institutional changes: Vol. 2), ed. Zhang Shuguang (Beijing, China: China Financial and Economic Publishing House, 1996), accessed February 28, 2012, <http://www.usc.cuhk.edu.hk/PaperCollection/Details.aspx?id=1403>.

<sup>23</sup> Lo, “Zhongguo yancao chanye.”

**Table 5.6 Top Eight Provinces in Terms of Local Production Output\***

Province	Local Production	Local Sale	Production-Sale Gap
Yunnan	618.04	121.53	496.51
Guizhou	180.79	86.25	94.54
Shanghai	130.83	61.98	68.94
Henan	291.56	236.23	55.38
Hunan	244.22	191.28	52.94
Anhui	171.36	145.61	25.75
Shandong	233.17	209.85	23.32
Hubei	188.93	168.18	20.75

\*Unit: 10 thousand cases

Source: Adapted from Zhongguo yancao nianjian 2001 (p. 20–24; 372–377), by the STMB, 2002, Beijing, China: China Science & Technology Press.

In the above case, cigarette enterprises in Yunnan, including the largest—the Yuxi-Hongta Tobacco Corporation—faced a dire situation. Even the high-class brand of cigarettes *Hongtashan* manufactured by Yuxi-Hongta, which had been extremely popular in China throughout the 1980s, were unable to sustain their sales figures in late 1990s. Consequently, the quantity of *Hongtashan* sold in 2000 was down 40 percent from 1996, while the taxes and profits generated by Yuxi-Hongta fell by approximately 70 percent during the same period.<sup>24</sup> This predicament resulted in the STMB launching a public campaign to “promote *Hongtashan*, protect the tobacco industry” in 1999.<sup>25</sup> The STMB continued to issue regulations prohibiting local protectionism, but the trade barriers erected were not significantly removed until after the SOE governance centralization reform was set into motion in 2005.<sup>26</sup>

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<sup>24</sup> Yuan Hongquan, “Yancao hangye de tizhi kunjing” (The structural difficulty of tobacco industry), *Outlook Weekly*, February 21, 2005, 56.

<sup>25</sup> Huang Fengling, “Shankao renweifeng,” 82-3.

<sup>26</sup> See the document “Guojia yancao zhuanmai ju guanyu jin zhi juanyan jingying shixing xiqu fengsuo de quding” (The rules instituted by the STMB forbidding local barriers on cigarette trades),

<http://www.hflib.gov.cn/law/law/falvfagui2/JJF/FLFG/FBZDJZF%20FOX/1016.htm>

(accessed August 30, 2013).

The emergence of local protectionism in this respect was evidently contrary to the notion “Federalism, Chinese style” proposed by Montinola Gabriella, Yingyi Qian, and Barry R. Weingast.<sup>27</sup> They coined this concept by comparing China’s case with Occidental, market-preserving federalism and found that a range of actions in China under the market-oriented reforms were consistent with the features of such federalism, e.g., the effect of inter-jurisdictional competition under a decentralization of authority, which served both to constrain the predatory behavior of local governments and to provide them to a considerable extent with a range of positive motivations to foster China’s economic prosperity as a whole. Although the authors also highlighted the differences between China’s system and Occidental federalism—for example, that China lacked an adequate mechanism for policing the domestic common market—this analogy actually overstated the merits that resulted from the inter-jurisdictional competition under fiscal incentives since local institutional arrangements could also hinder economic development in China’s context, as Eric Thun observed in his study.<sup>28</sup>

In summary, the collusion between local cigarette manufacturers and local governments led incrementally to a widespread prevalence of local protectionism. This became a dominant pattern of governance in the industry and saw “restricted competition” arise in the cigarette trading market. In this governance pattern, the autonomy on exchange, which cigarette manufacturers and tobacco corporations had begun to officially enjoy after the termination of the two-track system, was now largely “usurped” by local governments. As a result, the domestic market for the cigarette trade became fragmented by local governments pressuring local wholesalers to restrict cigarette procurement from other provinces. Under this restricted competition, the market concentration for the relatively large cigarette manufacturers that had emerged during the previous phase floundered. As Mahoney and Thelen note, the situation perfectly demonstrated the gradual change model of “conversion,” whereby actors exploit an inherent ambiguity in institutions to convert them toward a new function, purpose, or to have a different impact.<sup>29</sup> In this context, the “state monopoly” had transformed into “local monopolies” in all but name.

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<sup>27</sup> Montinola Gabriella, Yingyi Qian, and Barry R. Weingast, “Federalism, Chinese Style: The Political Basis for Economic Success,” *World Politics* 48 No. 1 (1995): 53, 79.

<sup>28</sup> Eric Thun, “Keeping up with Jones: Decentralization, Policy Imitation, and Industrial Development in China,” *World Development* 32 No. 8 (2004): 1289.

<sup>29</sup> Mahoney and Thelen, “A Theory of Gradual Institutional Change,” 16-7.



## 5.3 The Consequences of Local Protectionism

When the potentially large cigarette manufacturers that had previously surfaced were unable to grow, but instead shrank under local protectionism, they were compelled to find new strategies in order to escape their predicament, since exporting local cigarette products was already beyond the capacity of the local governments where these manufacturers were based. Under restricted competition, they began to pursue two policies: the exchange of investment for market shares and diversification of investment in non-tobacco business. These became the salient consequences for the pattern of governance in this phase.

### 5.3.1 The Exchange of Investment for Market Shares

After termination of the quota trade program, the STMB again endeavored to restructure through mergers the small and medium cigarette enterprises, i.e., those producing less than 300 thousand cases per year.<sup>30</sup> The first case of this kind of trans-provincial merger involving the Changchun Cigarette Enterprise in Jilin Province and the Yuxi-Hongta Tobacco Corporation in Yunnan Province occurred in 1999.

The Changchun Cigarette Enterprise, the first cigarette company established in Northeast China in 1934, was approaching bankruptcy by 1997. With no liquid capital, its debts to assets ratio stood at 152 percent. Under the circumstances, the STMB proposed merging Changchun with the Yuxi-Hongta Tobacco (Group) Corporation. Led by the STMB, the Changchun City Government, the Yuxi City Government, the Jilin Province Government, the Yunnan Province Government, the two provincial-level tobacco monopoly bureaus, and the two corporations themselves negotiated the merger in 1998, with the deal sealed and the merger agreement signed the following year.

Following the merger, Changchun was renamed the Hongta-Changchun Cigarette Enterprise, and Yuxi obtained 50 thousand cases of cigarettes in quotas from Changchun per year under the signed agreement. Aside from these additional quotas, the merger also meant another significant benefit for Yuxi-Hongta: it finally had the

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<sup>30</sup> See the document “Guanyu yancao hungye juanyan gongye qiye zuzhi jiegou tiaozheng de shishi yijian, no. guo-yan-fa (1998) 259” (Opinions on implementing the structural restructuring in the cigarette enterprises), [http://www.tobacco.gov.cn/html/27/2701/270114/766148\\_n.html](http://www.tobacco.gov.cn/html/27/2701/270114/766148_n.html) (accessed 25 August, 2013).

opportunity to break the trade barriers of local protectionism and enlarge its market share in the northeast region of the country.<sup>31</sup>

This “merger” however did not actually involve the complete integration of the two companies. There was no unified production scheme to determine which brands and quantities Hongta-Changchu or Yuxi would produce, and the Changchu City Government also did not lose its leverage over the newly restructured firm. Consequently, while Hongta-Changchu as a legal entity received financial and management support from Yuxi-Hongta after the merger, it continued to maintain its autonomy with regard to manufacturing its own brands using the rest of its quotas. In this sense, the merger, though pushed by the STMB, was more akin to an exchange of investment for the local market share, with an added benefit of additional quotas for Yuxi.<sup>32</sup>

Given local protectionism and the resulting restricted competition, cigarette companies whose production output far exceeded local sales had few options except to assent to this kind of exchange of investment for market shares as a strategy. In fact, this situation was not unique only to be the tobacco industry. In China’s beer industry, similar problems of local protectionism occurred during the 1990s.<sup>33</sup>

Along with abovementioned merger case, Yuxi-Hongta also invested further in cigarette enterprises in other provinces in order to overcome the difficulties under local protectionism. In 2002, they cooperated with the Hainan Tobacco Corporation to establish the Hainan-Hongta Cigarette Company as a “joint investment.” Yuxi-Hongta later used this same strategy to set up the Hongta-Liaoning Cigarette Company together with the Liaoning Tobacco Corporation. Under these joint investments, these non-provincial cigarette companies began to produce Yuxi-Hongta brand cigarettes and distribute them through local networks.

Along with investing in tobacco businesses, cigarette companies also negotiated with other local governments to obtain market access via non-tobacco

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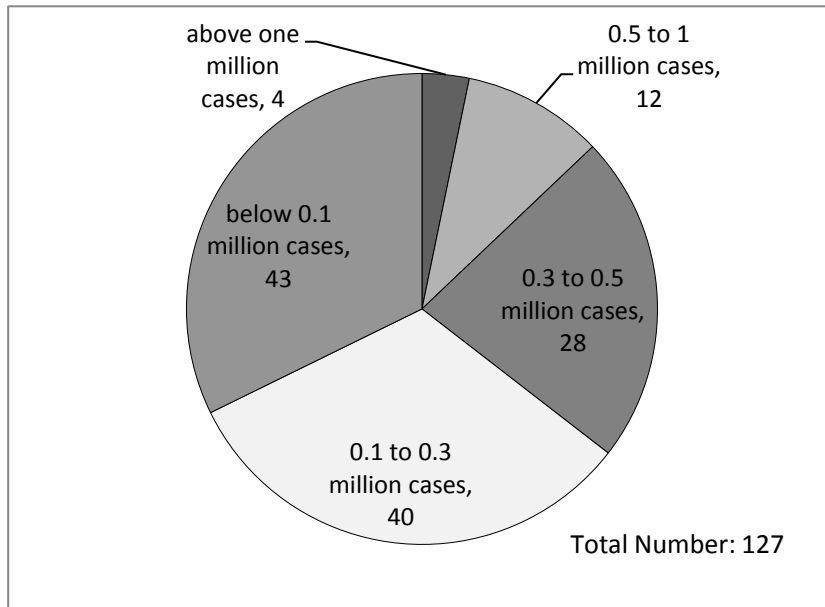
<sup>31</sup> Zhang Xiaole, “Erjin maibu cong tong yue-yuxi hongta changchu yanchang gaige fazhan jishi” (Making great strides from a new beginning—the report of Yuxi Changchu Cigarette Enterprise reform), *China Tobacco*, September 1, 2000, accessed December 20, 2012, <http://www.echinatobacco.com/101588/102220/102333/102362/32641.html>; The Editorial Board of Hongta Group, *Hongta jintuan zhi 1956-2005*.

<sup>32</sup> Interviewee No. 10.

<sup>33</sup> Biao Jin, “Xunzu de jingji yingxiang zai tantao- yi zhongguo pijiu chanye weili” (The reexamination on the economic impact of rent seeking- a case study of beer industry), in *Xuenzu yu zhongguo changye fazhan* (Rent-seeking and China’s industrial development), ed. Yongping Wu and Tak-Wing Ngo, 204-5. Beijing, China: The Commercial Press, 2010.

investments, such as by building hotels.<sup>34</sup> These kinds of exchange practices were common, but the effect they had was relatively limited. As a result, a large number of small-scale cigarette manufacturers continued to survive. By the end of 2002, there were 127 cigarette companies under the CNTC, though only four companies produced more than one million cases of cigarettes per year; most were producing less than 300 thousand cases (see Figure 5.2). Even the largest national brand, *Hongtashan*, held a mere two percent market share, while market concentration figures for the largest cigarette companies actually continued to decrease between 2000 and 2002 (see Table 5.7).

**Figure 5.2 - Distribution of Production Figures across all Cigarette Enterprises**



Source: Adapted from *Zhongguo yancao chanye*, by Lo Meijuan, Post Doc. Diss., Hongta Group, 2004

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<sup>34</sup> Interviewee No. 11.

**Table 5.7 The Market Concentration of Cigarette Companies (%)**

<b>Year</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>CR</b>			
CR1*	6.6	5.6	5.0
CR4	17.8	16.8	16.1
CR8	28.2	27.1	26.4
*CR1, CR4, and CR8 here separately refer to the market share of the largest company, the largest four companies, and the largest eight companies across the entire market.			

*Source:* Adapted from “Woguo yancao hangye jizhongdu yanjiu”, by Huang Bo and Li Xinghua, 2004, Journal of Guangdong University of Technology (Social Science Edition) 4 No. 4, p. 37.

### **5.3.2 Investment Diversification in Non-Tobacco Business**

Given that it was difficult to increase market share in the face of local protectionism, cigarette manufacturers turned to non-tobacco investments. Here again, this strategy of diversifying investments through non-core business investments was not limited to the tobacco industry,<sup>35</sup> but the unique characteristics of the tobacco industry—fixed cigarette quotas and high tax rates—further catalyzed the exacerbating trend for local protectionism and thus proved a driving force for a great many more diversified undertakings by cigarette manufacturers than in other sectors.

The various investments of the Yuxi-Hongta Tobacco (Group) Corporation typify this diversification. Prior to the mid-1990s, Yuxi had already been engaged in diversified investments, but most of these were linked to the tobacco industry and included printing, packaging, and machinery associated with cigarette manufacturing. The purpose of investing in this category was to reduce transaction costs by internalizing the components required for end products. But investment started to dwindle as the total production capacity for cigarettes came to far exceed the actual demand after 1995.

In view of these impediments to expanding its core industry, Yuxi-Hongta decided to expand its non-tobacco business by devoting 40 percent of its core business profits to creating “another peak.” By 1995, the enterprise had forty-one

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<sup>35</sup> Nolan, *China and the Global Economy*, 89-91.

diversified investment interests, although the total monetary sum was relatively small (2,670 million RMB). By contrast, between 1996 and 2000 the non-tobacco investments by Yuxi-Hongta reached 8,450 million RMB.<sup>36</sup>

This rapid and large-scale diversification to non-tobacco investments did not prove as profitable as Yuxi-Hongta anticipated. The rate of return on total assets shrank consistently from 1997 to 2001, and the ratios on the non-tobacco business were actually much lower than the core industry (see Table 5.8). In 2001, twenty of the seventy enterprises the company had invested in were running at a loss; the diversified undertakings had actually worsened Yuxi-Hongta's overall financial position. Some of these undertakings even had to be financed by the tobacco sector.<sup>37</sup>

**Table 5.8 Yuxi-Hongta Tobacco (Group) Corporation's Rates of Returns on Total Assets for Diversified Undertakings and on Tobacco Business (1997-2001)**

Year	Diversified Undertakings (%)	Tobacco Business (%)
1997	1.61	19.75
1998	2.95	19.60
1999	4.56	12.89
2000	3.75	9.83
2001	2.68	7.32

*Source:* Adapted from Zhongguo yancao chanye, by Lo Meijuan, Post Doc. Diss., Hongta Group, 2004

According to Lo's study on the diversified investments of the Hongta Group, intervention by local governments exacerbated its overall financial position.<sup>38</sup> As local fiscal revenue plummeted under the tax-sharing system, the diversified investments of Yuxi-Hongta gave the local governments the opportunity to take advantage of the situation. With fiscal revenue from the tobacco industry dwindling under local protectionism, local governments now jumped at the chance to hijack the non-tobacco investments of Yuxi-Hongta in its favor.

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<sup>36</sup> Lo, "Zhongguo yancao chanye."

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

According to one interviewed source, who had been involved in Yuxi-Hongta's diversified investments from 1996, sixty percent of the investment projects were dominated by the local authorities, though half of them could not actually meet Yuxi-Hongta's demand. Though Yuxi-Hongta created the Hongta Industrial Corporation for the specific purpose of overseeing diversified investments, its business interests were widely scattered, and there was little or no united and deliberate plan or targeted evaluation. The company's investments covered more than seventy projects in thirteen different industries by the late 1990s, and there was no clear connection between them, with the result that some investment projects in the same sector—such as hydropower and building materials—actually competed with each other and thereby cut potential profits.

Consequently, when Yuxi-Hongta faced those trade barriers set by other local governments in order to block their cigarette products, its investments in non-tobacco business, which were intervened in by its own local host governments, could not become more profitable either.<sup>39</sup> This situation seems to demonstrate that the host local governments had become “predatory,” in line with Pei's assertion: that the autonomy of a local government could be expected to prey upon society when effective structural constraints were lacking.<sup>40</sup> However, in the 1980s the selfsame local governments had acted as a “helping hand” when it came to supporting the local cigarette manufacturer: by setting up the three-in-one system. A decade later, however, it became a “grabbing hand” as the local governments sought to get more from the non-tobacco business interests.

The fluid role of local governments here demonstrates how they might be either developmental or predatory. That is to say, developmentalism or predation are not the nature of local governments; the mode of their operation is determined by other institutional incentive mechanisms rather than something intrinsic to local governmental structures. Driven by the pressure of raising fiscal income, local governments had a great deal of flexibility in terms of adjusting or covering up their actions according to the institutional context and/or dynamics in which such actions occurred.

## **5.4 Production Conditions for Regulatory Change to the State**

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<sup>39</sup> Ibid.

<sup>40</sup> Minxin Pei, *China's Trapped Transition: The Limits of Developmental Autocracy* (Cambridge, MA: Harvard University Press), 38-9.

## Tobacco Monopoly

The abovementioned consequences not only exposed the problems the tobacco sector faced under the governance pattern of local protectionism, but also demonstrated the failure of the “grasping the large” policy proposed by the central state in the mid-1990s, which was aimed at establishing gigantic, indigenous groups to compete with large transnational corporations from other developed countries. Aside from the inter-province mergers that lacked substantial integration, intra-province mergers also were not truly formed in the tobacco sector during this phase. After China’s accession to the WTO in 2001, however, the threat of globalization transformed the policy failure into a perception of vulnerability that required a new institutional response.

Out of this, the CNTC was further urged to take seriously the issue of creating a “big and strong” national team of cigarette enterprises. Below, I further characterize the failure of the “grasping big” policy in terms of intra-province mergers and then elaborate why China’s accession to the WTO would act as a trigger for the CNTC to restructure the tobacco sector. This involved an initial step—the separation of manufacturing and commerce—carried out in order to curb the rise of local protectionism, which then led to centralization reform of CNTC governance at the end of this phase.

### 5.4.1 Intra-Province Mergers without Substance

Led by the policy of “grasping the large,” the central authorities viewed the establishment of a “group” (*jítuan* 集团) as the principal method for forging large SOEs in the 1990s; the tobacco industry would be no exception. In fact, the STMB had already started promoting the creation of conglomerates in the tobacco industry after the publication of *the Opinions on Establishing Trial Tobacco Groups* in 1993.<sup>41</sup> Several tobacco groups were established in the following years; Shandong and Henan provinces, for instance, entered the first round and established two groups. But the main intent behind creating tobacco groups in the provinces was to rescue a number of local cigarette enterprises from the brink of bankruptcy. To tie a strong, core enterprise with several weaker companies in one group became the most

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<sup>41</sup> See the document “Guanyu zujian yancao qiye jituan de yijian (shixing), no. guo-yan-ren (1993) 42” (Opinions on establishing trial tobacco groups), [http://code.fabao365.com/law\\_229708.html](http://code.fabao365.com/law_229708.html) (accessed July 30, 2013).

common arrangement.<sup>42</sup> Led by provincial governments, this sort of “welded” form, based on the administrative tools for establishing a group, lacked true integration, meaning that the different parts of a tobacco group were usually only loosely connected. This same dynamic appeared commonly in other industries as well after the advent of the policy of “grasping the large” during the 1990s. In a study on China’s steer industry from the late 1980s to early 2000s, Sun found that the Chinese government’s consolidation policy was, by and large, not successful.<sup>43</sup>

Created in 1995, the Hongta Group is a good example of the welded structural characteristics for these types of intra-province mergers. Besides the Yuxi-Hongta Tobacco (Group) Corporation making up the core body, the Hongta Group also included four other cigarette companies in Yunnan Province (see Figure 5.3). However, each of them still had independent legal status, and they shared no unified production scheme. Thus, even after becoming a part of the group, these cigarette companies continued to be independently responsible for their production plans and management. This loosely integrated feature was not recognized in Wang’s tobacco study, but it actually constitutes the main backdrop to illustrate the distinction between intra-provincial mergers in this phase and the next phase when the centralization of SOE reform was initiated.<sup>44</sup>

It should also be noted, however, that some differences did indeed exist under the umbrella of a “group” in this phase. For example, as the strong core body, Yuxi would offer loans and transfer senior management cadres to the other cigarette enterprises in order to improve their position. In view of the support provided by the core body, the local governments, which did not lose control over the cigarette enterprises in their jurisdictions, would welcome the fact that local cigarette companies were “incorporated” into the group.<sup>45</sup> Without true integration, this kind of loosely-coupled organizational relation echoes the inter-province mergers described earlier. Consequently, the policy of “grasping the large” in the tobacco

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<sup>42</sup> Xu Zhengli, “Guanyu yancao qiye jituan de diaocha sikao” (Survey ideas on tobacco groups), *China Tobacco*, September 1, 1994, accessed December 15, 2012, <http://www.echinatobacco.com/101588/102220/102468/102477/36623.html>.

<sup>43</sup> Hsin-Hsien Wang, “Zhongguo dalu guoqi gaige de ‘zuzhi hanjie’ – ‘wujiang’ sichou gufen youxian gongsi chouzu zhi fenxi ” (SOE reform in China: An analysis of the establishment of Wujiang Silk Ltd.), *Mainland China Studies* 43 No. 12 (2000): 49-58; Sun, “Is the State-Led Industrial Restructuring Effective in Transition China?” 605.

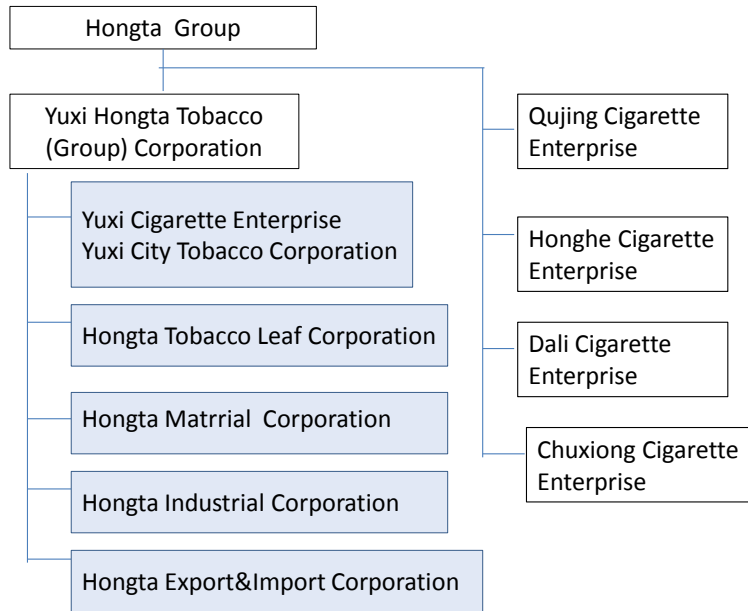
<sup>44</sup> Wang, *State-market interactions*, 110.

<sup>45</sup> The Editorial Board of Hongta Group, *Hongta jintuan zhi 1956-2005*; Interviewee No. 10.



industry was not truly realized during this period so that mergers without substantial integration became common under decentralized governance of the CNTC.

**Figure 5.3 Structure of the Hongta Group in 1995**



Source: Hongta jintuan zhi 1956-2005 (CD-ROM)

### 5.4.2 The “Open but Heavily Guarded” Door under the WTO

In recent decades, China’s cigarette market has been seen as an ultimate prize by all of the transnational tobacco companies (TTCs).<sup>46</sup> According to a survey conducted in 2011, China had the world’s largest proportion of smokers in the world—more than 300 million; nearly 3.5 times the size of the U.S. cigarette market and over 12 times the size of the German market, the largest market in Western Europe.<sup>47</sup> Most transnational tobacco companies saw China’s accession to the WTO

<sup>46</sup> Kelley Lee, Anna Gilmore, and Jeff Collin, “Breaking and Re-entering: British American Tobacco in China 1979-2000,” *Tobacco Control* 13 Suppl. 2 (2004): 88.

<sup>47</sup> Chuck Bonnett, “Biggest in the World,” *Tobacco Reporter*, September, 1999, accessed

as a great opportunity for expanding their business territory, especially with tobacco consumption in North America and Western Europe steadily declining as a result of the growing anti-tobacco campaign that started in the 1970s.

Since the 1970s, transnational tobacco companies from the United States and Western Europe began expanding into untapped markets abroad, first in Asian countries in the 1980s, by forcing lower tariffs, and then in the former Soviet Union (FSU) in the 1990s, by taking over the former state-owned tobacco corporations.<sup>48</sup> While the TTCs were able to continually enlarge their territories in these areas, it was much more difficult to gain accesses to China's market. For one, China had re-created its tobacco state monopoly in the 1980s rather than privatizing its SOEs, as had happened in the former Soviet Union. For another, China's tobacco industry was protected by high tariffs. Given the oversupply on the domestic market during the 1980s, the import quota of foreign cigarettes was strictly controlled and restricted by the Chinese authorities, since the CNTC was the sole legal importer of foreign cigarettes.<sup>49</sup>

The transnational tobacco companies were also prohibited from establishing their own cigarette enterprises in China, although joint ventures were permitted during the early stages of economic reform if the Chinese government considered these as a way to obtain technical assistance from TTCs.<sup>50</sup> Nonetheless, only three joint ventures were permitted before China joined the WTO.<sup>51</sup> As a result,

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January 15, 2012, <http://legacy.library.ucsf.edu/tid/qq55a00/pdf>;

The Collection of RJ Reynolds, "China," accessed January 5, 2012,

<http://legacy.library.ucsf.edu/tid/umh70d00/pdf;jsessionid=7E76E8C5E2F9DA7C817D65BABC05F5A2.tobacco03>

<sup>48</sup> Ally Taylor et al., "The Impact of Trade Liberalization on Tobacco Consumption," in *Tobacco Control in Developing Countries*, ed. Prabhat Jha and Frank Chaloupka (New York, NY: Oxford University Press, 2000), 355; Anna Gilmore and Martin Mckee, "Tobacco and transition: an overview of industry investments, impact and influence in the former Soviet Union," *Tobacco Control* 13 No. 2(2004): 136–42; Anna Gilmore, Gary Fooks, Martin Mckee, "The International Monetary Fund and Tobacco: A Product Like any Other?," *International Journal of Health Service* 39 No. 4: 789; Anna Gilmore and Martin Mckee, "Moving East: How the Transitional Tobacco Industry Gained Entry to the Emerging Markets of the Former Soviet Union-Part 1: Establishing Cigarette Imports," *Tobacco Control* 13 No. 2 (2004): 148.

<sup>49</sup> The Collection of RJ Reynolds, "China."

<sup>50</sup> Belinda O'Sullivan and Simon Chapman, "Eyes on the Prize: Transnational Tobacco Companies in China 1976-1997," *Tobacco Control* 9 (2000): 293.

<sup>51</sup> These three joint ventures were: the Huamei Company (华美), a joint-venture between the

according to official statistics, the market share of foreign brands never exceeded one percent throughout the 1990s.<sup>52</sup>

In this context, large-scale smuggling of foreign cigarettes into China in order to circumvent barriers to market access turned out to be a “workable” channel for the transnational tobacco companies. According to internal documents from British American Tobacco (BAT), the illegal import of cigarettes to China grew rapidly from the early 1980s and dramatically exceeded legal imports. The CNTC estimated that 99 percent of foreign cigarettes sold in China in 1996 were contraband. In 1998, Premier Zhu Rongji and President Jiang Zemin launched a long-running, anti-smuggling campaign, which included investigating the suspected involvement of the People’s Liberation Army in the illegal trade of cigarettes. In Hong Kong, investigations conducted by the Independent Commission against Corruption led to the murder of a key witness, and a Hong Kong BAT executive was convicted of taking bribes related to cigarette smuggling.<sup>53</sup>

With the situation becoming more and more volatile, TTCs took China’s accession to the WTO as an unprecedented opportunity, and embarked on lobbying activities in the US and EU during the negotiation process for China’s WTO membership. The BAT lobbying team, for example, advanced four priorities in their dealings with the US and EU, including a reduction of tariffs, the abolition of retail licenses to sell foreign cigarette brands, the abolition of a distribution monopoly, and the abolition of restrictions on advertising and marketing.<sup>54</sup> Despite the fact that TTCs took advantage of this negotiating stage to aggressively promote their interests, the Chinese government nonetheless kept a tight rein on the domestic market after joining the WTO in 2001.

Roselyn Hsueh used a cross-industry study to argue that the Chinese government employed a bifurcated strategy while conducting regulatory reform

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Xiamen Cigarette Enterprise and R.J. Reynolds of the US in 1986; the Huayin Company (华英), a joint-venture between the Shandong Cigarette Enterprise and Rothmans of the UK in 1991 (merged with the British American Tobacco in 1999); and the Gaoyang Company (高扬), a joint-venture between the Shanghai Cigarette Enterprise and Japan Tobacco in 1992. See Tobacco Market, “Waiyan zai zhongguo de jizhong touzi fangshi” (The several ways of foreign investment in China’s tobacco industry), accessed December 20, 2012, <http://www.etmoc.com/look/looklist.asp?id=20667>.

<sup>52</sup> The Collection of RJ Reynolds, “China.”

<sup>53</sup> Lee, Gilmore, and Collin, “Breaking and Re-entering,” 91.

<sup>54</sup> Fei Zhong and Eiji Yano, “British American Tobacco’s Tactics during China’s Accession to the World Trade Organization,” *Tobacco Control* 16 (2007): 134.

under globalization. By this strategy, it relinquished control of what were perceived as non-strategic industries while enhancing its control over strategic ones, determined according to their significance for national security, technological innovation, and the domestic economy. Hence, the strategic value of a sector came to determine the Chinese government's attitude toward it during the WTO negotiations. The greater the degree of strategic value, the more likely the state would exercise deliberate control; the lower the degree of strategic value, the more likely the state would exercise only incidental control.<sup>55</sup>

This analysis readily accounts for China's stance on the tobacco industry in the WTO agreement. While China was strongly committed to securing WTO membership, its tobacco industry still provided over seven percent of the national fiscal revenue. The tobacco industry constituted one of the largest fiscal contributors of all the industries in China, even though its growth was frustrated by the prevalent local protectionism. Given the fiscal significance of the industry, the Chinese government elected to retain its state monopoly and guard the domestic market while also agreeing to liberalize some aspects of it as a concession. Consequently, under the WTO terms for tobacco, China had to: reduce the import tariff on tobacco leaves from 28 percent in 2001 to 10 percent by 2004; reduce the cigarette tariffs from 49 percent in 2001 to 25 percent by 2004; scrap the export rebate for flue-cured tobacco leaves and cigarettes; scrap the bonus awarded for exporting cigarettes; scrap the "Special Tobacco Retail Sale Permit" by 2003; and scrap the import quota imposed on foreign cigarettes by 2005.<sup>56</sup>

In general, China's accession to the WTO did remove some obstacles to the TTC's penetration of the Chinese market, but the CNTC's grip on distribution and imports remained. For one, while the Retail Sale Permit for foreign cigarettes was abolished, foreign cigarette corporations were still not permitted to establish distribution systems in China. For another, despite the non-existence of an import quota, the *de facto* quota remained controlled by the CNTC, since it monopolized the entire cigarette importation business. Similarly, while joint ventures constituted a

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<sup>55</sup> Roselyn Hsueh, *China's Regulatory State—A New Strategy for Globalization* (Ithaca, NY: Cornell University Press, 2011), 16-8.

<sup>56</sup> Teh-wei Hu et al., *Tobacco Taxation and its Potential Impact in China* (Paris, France: International Union against Tuberculosis and Lung Disease, 2008), 30; Elisa Tong et al., "China's Tobacco Industry and the World Trade Organization," in *Tobacco Control Policy Analysis in China: Economics and Health*, ed. Teh-wei Hu (Hackensack, NJ: World Scientific Publishing, 2008), 221-2.

special exemption, official sanction had to be given in advance, and these joint ventures were in any case not encouraged by the Chinese authorities since domestic technology for cigarette production had already made great progress.<sup>57</sup> In fact, no new joint ventures were created once China became a WTO member.

This “open but still heavily guarded door” policy ensured that TTCs were unable to dramatically extend their market share into China, but the WTO accession did pressure the CNTC—in anticipation of further, future liberalization—to initiate a restructuring reform of China’s tobacco industry.<sup>58</sup> Thus, even though China did not entirely open its domestic market to the TTCs after the country’s WTO accession, the potential threats of liberalization had already been identified toward specific reform agendas.

### 5.4.3 The Separation of Manufacturing and Commerce

Given that most TTCs had already taken advantage of a variety of bilateral, regional, and international trade agreements to further conduct mergers and acquisitions around the world, China’s accession to the WTO made the CNTC more eager to increase the economies of scale for the domestic cigarette enterprises in order to raise their competitiveness. The obvious sales gap between TTCs and Yuxi, the largest cigarette manufacturer in China, acutely illustrated this.<sup>59</sup> In 2002, the sales volume of Yuxi was only 10 percent of Phillip Morris, the largest tobacco group in the world at that time,<sup>60</sup> while occupying only approximately five percent of China’s national market (see Table 5.9). In this context, the CNTC believed it was necessary to tackle the prevailing local protectionism so that large, indigenous

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<sup>57</sup> Yang Yungao, “Huamei yanchan shouzhong zhengqin waizi juanyan zuan chukou?” (The end of the Huamei Cigarette Enterprise, foreign-investment cigarettes turning to export?), *Business Perspective*, September 5, 2004, accessed January 5, 2012, <http://finance.sina.com.cn/tz/20040905/17421000921.shtml>.

<sup>58</sup> Chris Holden et al., “Trade Policy, Health, and Corporate Influence: British American Tobacco and China’s Accession to the World Trade Organization,” *International Journal of Health Services* 40 No. 3 (2010): 421.

<sup>59</sup> Physicians for a Smoke-Free Canada, “The Global Tobacco Economy,” accessed December 20, 2011, [http://www.smoke-free.ca/pdf\\_1/GlobalTobaccoEconomy-2009.pdf](http://www.smoke-free.ca/pdf_1/GlobalTobaccoEconomy-2009.pdf).

<sup>60</sup> Philip Morris Companies Inc. changed its name to Altria Group in 2003. In 2008, Philip Morris International (PMI) was spun off from Altria. Since then PMI and Altria have operate in tandem: the same brands that are sold by Altria in the United States are sold by PMI in other parts of the world.

tobacco SOEs could be established. From this perspective, “the separation of manufacturing and commerce” emerged in 2003 as an initial effort towards this goal.

**Table 5.9 A Comparison of the Top Three TTCs and the Yuxi Cigarette Enterprise\***

Enterprises	Phillip Morris	BAT	Japan Tobacco	Yuxi	Total Cigarette Enterprises of the CNTC
Revenue	804.1	389.7	371.4	18.4	203.7
Returns	111.0	20.4	30.0	3.5	19.3
Sales Volume (10 thousand cases)	1829.4	1554.6	907	190.2	3399.6
*Unit: US \$ 100 M					

*Source:* Adapted from “China’s Tobacco Industry and the World Trade Organization” (p. 221), by Elisa Tong et al., 2008, in *Tobacco Control Policy Analysis in China*, ed. Teh-wei Hu, Hackensack, NJ: World Scientific.

The underlying logic in separating the two wings of manufacturing and commerce was to sever the bonds between local tobacco corporations and local cigarette manufacturers so that the former could purchase more nonlocal cigarette products and thus benefit its own survival. The combination of manufacturing and commerce arose initially out of a concern for raw materials but became a means to implement local protectionism during this phase, since local tobacco corporations and cigarette manufacturers shared a common interest. The intention behind the separation, then, was to remove local protectionism by breaking up the existing three-in-one system.

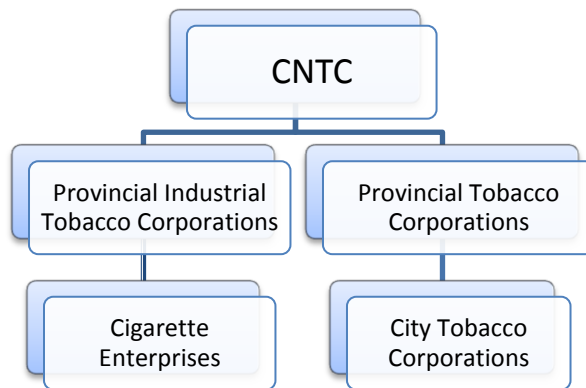
Once this occurred in 2003, cigarette manufacturers were placed under the purview of the newly-created provincial “tobacco industrial corporations.” As new entities, the provincial tobacco industrial corporations were responsible for managing the cigarette manufacturers within their jurisdictions, but remained agents of the CNTC (see Figure 5.4). By the end of 2004, eighteen provincial-level tobacco industrial corporations had already been established.<sup>61</sup>

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<sup>61</sup> Tobacco China, “Gongshangfenli – chuixiang zhongguo yancao de haojiao” (The separation of manufacturing and commerce – signaling China’s tobacco reform), April 18, 2003, accessed July 19, 2011, [http://www.tobaccochina.com/news/analysis/wu/20034/200341894934\\_138065.shtml](http://www.tobaccochina.com/news/analysis/wu/20034/200341894934_138065.shtml).

Under these new institutional arrangements, local tobacco corporations were required to meet the targets set by their new superior, rather than ones in the interest of local cigarette enterprises. But separation was unable to truly root out local protectionism since local governments retained their local leverage. These limited results spurred the CNTC to then introduce an even more fundamental change in 2005—the centralization reform of the CNTC regime—in order to annul the leverage held by local governments in the tobacco sector.<sup>62</sup>

**Figure 5.4 - The New Structure of the CNTC after the Separation**



Source: Supplied by the author

## 5.5 Conclusion

Once the “market” replaced the two-track system in the tobacco sector at the beginning of this phase, interactions between local governments and cigarette manufacturers incrementally fragmented the domestic market through the manipulations by local cigarette wholesalers. This method of interaction was driven mainly by the new political context of this phase. That is, when the recentralization of fiscal revenue under the tax-sharing system caused local governments to further intensify their intervention into the tobacco industry, they would collude with local

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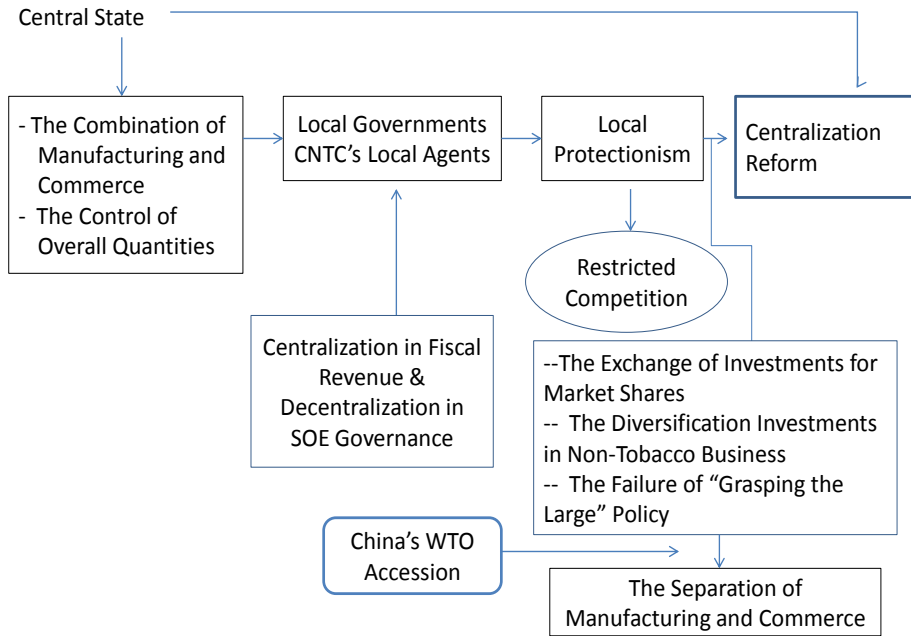
<sup>62</sup> Yang Xiaohong, “Zhongguo yancao de gongshang fenli jiqi kunjing yu genben chulu” (The separation of manufacturing and commerce and its predicament and solution), *Journal of Yunnan Finance & Economics University* 19 No. 6 (2004): 43-4; Tobacco China, “Gongshangfenli”; Interviewee No. 27.

cigarette manufacturers through their leverage in the local tobacco corporations to maximize the procurement of local products by introducing trade barriers so that high taxes and profits could be obtained. This wave of local protectionism became prevalent in the cigarette trade, and the resultant restricted competition turned the tobacco state monopoly into more of a local monopoly.

As such, the relatively large cigarette enterprises that had emerged in the previous phase barely expanded their market share or production scale and were consequently compelled to invest not only in other cigarette manufacturers in other provinces in exchange for further market accesses and production quotas but also in non-tobacco interests for the purpose of improving their financial positions. Limited success in this at times instead further worsened the overall finances of these enterprises. Faced with these developmental difficulties and threats posed by China's accession to the WTO, the CNTC decided to actively curb local protectionism by separating cigarette manufacturing and commerce as an initial measure in 2003. Although the result was not sufficiently significant, it did trigger a more radical regulatory opportunity. In consequence, the tobacco sector now underwent a formal transformation from a decentralized to a "centralized" stage in 2005. Figure 5.5 below summarizes the process of the institutional change in this phase.



**Figure 5.5 Summary of the Institutional Change Process in the Second Phase**



Source: Summarized by the author



## **CHAPTER SIX**

### **PHASE 3 - THE RISE OF THE CENTRAL-LED COMPETITIVE MONOPOLY**

Generally speaking, the state-market interaction in the previous phase was much more complicated than as described in Wang's tobacco study. Although she pointed out that some local governments belonging to the "importing" camp could function, albeit in a protective manner, as a helping hand for local cigarette manufacturers by pressuring local cigarette wholesalers, she overlooked that other "exporting" local governments that would not gain more benefits from the tobacco business could turn to meddling in cigarette companies' diversified undertakings. In reality, these were two sides of the same coin under the local protectionism, and neither was conducive to forging large cigarette SOEs. In the face of China's accession to the WTO, then, the central authorities were eager to build national teams in strategic industries. They therefore set out to transform the CNTC's governing framework from a decentralized to a centralized one by introducing the corporatization reform in 2005, which further removed the trade barriers under local protectionism.

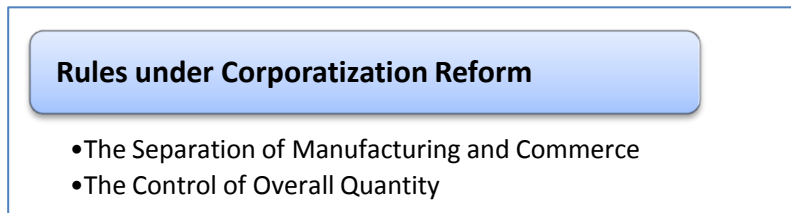
In this chapter, I first elaborate the specifics of this centralized governance in the CNTC, which constituted the new foundation for the rules of the game—i.e., the separation of manufacturing and commerce, and the control of overall quantity—during this phase (2005-2012)(see Figure 6.1.). Further, I analyze the industrial policy adopted by the STMB under this new, centralized regulatory framework intended to forge the large cigarette SOEs. Last, I describe how interactions between local governments and the CNTC's local agents under these new institutional arrangements illuminate how "central-led competitive monopoly" and the resulting "quasi-oligopoly competition" would emerge, as now seen in China.

#### **6.1 The Centralized Regulatory Framework of the CNTC**

This phase is contextualized by the combination of the previous recentralization of fiscal revenue reforms and the SOE governance recentralization reforms after 2005 (as discussed in Chapter Three). As the former, embodied in the

tax-sharing system, continued into this phase, the latter embodied a centralized governance framework within the CNTC under the term “corporatization.” As Oi points out, rather than putting firms at the center of analysis in corporate restructuring, the state often played an explicit and determining role in the restructuring of SOEs in China.<sup>1</sup> The introduction of the corporatization reform of the CNTC verifies this argument.

**Figure 6.1 - Primary Rules of the Tobacco State Monopoly in the Third Phase**



*Source:* Supplied by the author

### **6.1.1 The Process of Corporatization**

According to the original institutional design, the leverage of local governments in the tobacco state monopoly system should have been relatively limited, but the actual situation was often different, as previous chapters have demonstrated. From the outset, this deviation was derived from the establishment process, through which the CNTC had little choice but to rely on local governments to complete the infrastructure of the entire system. Under such circumstances, even though the “administrative subordination” aspect took hold in the 1980s, the CNTC was unable to control its local agents in an efficient manner. Under the low level of accountability, the CNTC’s local agents began to collude with local governments. Their interactions led in the first phase to the expansion of the market and a resulting quasi-free competition, and then moved on in the second phase to segment the domestic market and constrain the competition in the cigarette trade.

The corporatization reform initiated in this phase aimed at strengthening the CNTC’s steering capacity by clarifying asset relationships between different levels of the CNTC so that the leverage of local governments under the centralized regulatory framework could be wiped out. This asset relationship had not existed

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<sup>1</sup> Jean C. Oi, “Politics in China’s Corporate Restructuring,” in *Going Private in China*, 16-7.

prior to the reform; a situation exposed clearly by Zhang Yuxia (张玉霞), the director of the STMB's finance division, at an interview in 2006:

The concept of 'property right' did not take shape at that time (when the CNTC was established), and only administrative management could be perceived in our minds. Compared with other industries, the administrative management was regarded as more comprehensive in this industry since it was under the framework of the state monopoly. So outsiders would see us as a unified entity, and no one could break in. However, this viewpoint could not apply to our financial situations as presented in the ledger. In other words, there was no asset connection between the CNTC and its subordinates.<sup>2</sup>

As market-oriented reform proceeded, the idea of property right was gradually constructed in China, beginning in the 1980s. Under these circumstances, the *Rules of Procedure Concerning the State Asset Transfer without Compensation* was issued by the Ministry of Finance in 1999.<sup>3</sup> Here "the transfer without compensation" was based on the premise that all of the assets were of the same state and that the purpose of the transfer was to reset the powers of asset usage according to certain clearly-defined asset relationships.

The principle of asset transfer without compensation was applied to the restructuring of the CNTC as soon as the document the *Opinions Further Clarifying Asset Management in the Tobacco Industry and Elaborating the Tobacco Corporation Reform* was issued by the State Council in 2005.<sup>4</sup> This crucial

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<sup>2</sup> The complete interview can be seen in "Bixu hangshi zhege jichu" (It is necessary to consolidate this base), *China Tobacco*, April 15, 2006, accessed April 15, 2009, [http://www.tobacco.gov.cn/html/14/1401/58145\\_n.html](http://www.tobacco.gov.cn/html/14/1401/58145_n.html).

<sup>3</sup> For more details, please see the document issued by the Ministry of Finance, "Guanyu qiye guoyou zichan banli wuchang huazhuan shouxu de guiding, no. ca- guan-zi (1999)301" (The rules of procedure concerning the state asset transfer without compensation), [http://www.caac.gov.cn/dev/cws/ZCFB/200707/t20070710\\_6236.html](http://www.caac.gov.cn/dev/cws/ZCFB/200707/t20070710_6236.html) (accessed March 10, 2011).

<sup>4</sup> For more details, please see the document issued by the Ministry of Finance, "Caizheng bu guanyu yancao hungye guoyou zichan guanli rougan wenti de yijian, no. cai-jian (2006) 310" (Opinions about the management of state assets in the tobacco industry from the Ministry of Finance), <http://www.cntiegc.com/src/2011-10/10005556.html> (accessed March

document (known as Document No. 57 in the tobacco sector) signaled the onset of the CNTC's corporatization during the post-WTO era. According to this document, all local tobacco corporation and cigarette enterprise assets were to be turned over to the Ministry of Finance without compensation by the end of 2005, as they were all central assets that had been validated by administrative subordination during the 1980s.

This means that, although the corporatization of the CNTC was triggered by China's accession to the WTO, it did not occur in a vacuum. After the transfer, the Ministry of Finance allocated all of these assets to the CNTC. As the sole stockholder, the CNTC handed over its net assets to all of the provincial tobacco corporations and tobacco industrial corporations as long-term investments. These provincial-level corporations subsequently invested in their city corporations and local cigarette enterprises. Through this rearrangement of all of the assets, a new type of parent-subsidiary corporate structure was thus institutionalized throughout the entire tobacco sector. Following on the context of dividing manufacturing and commerce, three levels of parent-subsidiary relationship—the CNTC, the provincial industrial tobacco corporations/provincial tobacco corporations, and the cigarette enterprises/city tobacco corporations—were set up in the manufacturing and commercial divisions separately. Thus, while the CNTC's local agents had already adopted a “corporate form” as legal entities previously, they were formally turned into “subsidiaries” and incorporated into the corporate framework of the CNTC in this phase.<sup>5</sup>

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11, 2011).

<sup>5</sup> Tobacco China Online, “57hao wenjian: Yanco qiyetizhi gaige fengxiang biao” (No. 57 document: the reform signal of tobacco SOEs), accessed July 19, 2010, [http://www.tobaccochina.com/zt/chanquan/jiedu\\_02.html](http://www.tobaccochina.com/zt/chanquan/jiedu_02.html); Tobacco China, “Kengqiang zuyin–hungye wunian gaige yu fazhang lichen” (The sonorous voice of footsteps—the five-year process of reform and development in this industry), accessed September 19, 2011, [http://www.tobaccochina.com/news/analysis/wu/20083/200831383548\\_293020.shtml](http://www.tobaccochina.com/news/analysis/wu/20083/200831383548_293020.shtml); Tobacco Market, “lishun chanquan: Yunnan gongye maichu gaige guanjian bufu” (Clarifying the property right: Yunnan tobacco industry making the crucial stride), accessed March 25, 2009, <http://www.etmoc.com/look/looklist.asp?id=4599>; Interviewee No. 26.

### 6.1.2 The New Division of Labor within the CNTC

It was not just asset relationships that underwent great changes with corporatization reform: the division of labor within the CNTC itself also experienced reorganization. Prior to this, each level of the tobacco corporations, from the central authority down to the county level, was able to take part in the wholesale business where tobacco products were concerned, while the division of labor among them remained not clearly regulated. One informant who used to work at the Guizhou Province Tobacco Corporation explained the situation of the cigarette trade before the corporatization reform took effect:

Tobacco corporations of all levels were able to conduct cigarette wholesale business in the past. For example, the provincial corporations would sell the cigarettes they purchased to the city and county corporations. But the county corporations could also buy cigarettes from cigarette manufacturers directly... It was no problem for the county corporations to procure cigarettes from the local manufacturers as well... So the province and city corporations would even charge their subordinates [county corporations] 'administrative fees,' sometimes in order to increase their revenues...<sup>6</sup>

The situation described above was altered by the new division of labor following corporatization. First, the independent legal personality of the county corporations was annulled under the new corporate structure: the county corporations were thus restructured as branches of city tobacco corporations. In particular, they became responsible for executing the tasks assigned by their superiors, e.g., city corporations. Second, city corporations became the only entities qualified to operate the wholesale business for tobacco products under the supervision of provincial corporations. Third, in addition to supervising the wholesale business of the city corporations, the provincial corporations had to formulate the general guidelines for cigarette procurement. Finally, the CNTC assumed an investor's responsibilities in maintaining and raising the value for all assets. In other words, under this new division of labor, all wholesale activities were concentrated with the municipal-level agents of the CNTC, and the province- and

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<sup>6</sup> Interviewee No. 40.

county-level agents quit from the wholesale business altogether. As a result, the number of cigarette wholesalers was dramatically reduced, and those who remained became more able to monopolize local markets under this highly organized governance framework.

### 6.1.3 Uprooting the Leverage of Local Governments

Similar to the role which the SASAC played in other industries, the CNTC on behalf of the state assumed the task of preserving and increasing the asset value of the entire sector after the corporatization reform. However, different other central SOEs under the SASAC's management, the CNTC has held the form of a government-business synthesis, i.e. the CNTC-STMB combined entity, so that it has remained its own regulatory regime under the leadership of the Minister of Industry and Information Technology<sup>7</sup> rather than being incorporated into the authority of the SASAC. Thus, the CNTC began to centralize its corporate governance on the basis of asset relationships, while personnel appointments for its subsidiaries were placed in its hands rather than being handled by local governments as had previously been the case. Those deciding on personnel assignments only needed to inform local governments of their decisions—according to the new structure, so no permission or approval whatsoever was required for their actions.<sup>8</sup> The initiation of corporatization reform, then, terminated local governments' right to appoint personnel, which removed a powerful leverage point they had used to manipulate local wholesalers.

In addition, the cigarette manufacturers' autonomy was further regulated under the parent-subsidiary corporate framework of the CNTC, with the result that local governments became more constrained to a certain degree in the ability to intervene into tobacco industry operations. In accordance with the *Trial Rules for Managing the CNTC's Assets* issued in 2006, each subsidiary's autonomy to dispose of corporate assets became relatively limited.<sup>9</sup> For example, the Hongta Group was

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<sup>7</sup> The CNTC/STMB has been under the leadership of the Minister of Industry and Information Technology since 2008; before that, it was supervised by the State Economic and Trade Commission (SETC) from 2003.

<sup>8</sup> Interviewee No. 4; Interviewee No. 27.

<sup>9</sup> For more information, please see the document issued by the STMB, "Guojia yancao zhuanmajiu guanyu yinfa 'zhongguo yancao zonggongsi guoyou zichan guanli guiding(shihing)' de tongzhi" (The trial rules for managing the CNTC's assets), [http://yingtan.gov.cn/bmgkxx/syczmj/fgwj/fg/200804/t20080429\\_2352.htm](http://yingtan.gov.cn/bmgkxx/syczmj/fgwj/fg/200804/t20080429_2352.htm) (accessed May



now obligated to get permission from the CNTC if it wanted to invest more than five million RMB in businesses not related to the tobacco industry.<sup>10</sup> The CNTC therefore made it more difficult for local governments to ask the Hongta Group for help in investing large amounts of capital locally in other non-tobacco concerns; something they had easily done before.

In addition, “target management” along the vertical line of authority was set in motion within the CNTC. Under this, a range of indices were formulated by the parent corporation, i.e., the CNTC, to evaluate the performance of its subsidiaries, and the results of this evaluation would determine rewards and penalties, if any, that the leading cadres of the subsidiaries would receive. This set of targets helped the CNTC to direct the operations of its subsidiaries level by level (see the example in Table 6.1).

This target management turned out to be an effective control method under the new corporate framework. It, along with the new division of labor, were vividly described by an interviewee who worked at a county tobacco corporation in Guizhou Province:

Our county corporation was very rich before the legal personality was annulled. Unlike many county corporations elsewhere, we did not need to get loans for purchasing cigarettes. Since the annulment, we are currently just the executive department [of the city tobacco corporations]... All financial expenditure is regulated by the city corporation, and we cannot even decide which brands of cigarettes to sell either. What we can do is just sell the cigarettes which the city corporation ordered, and we are responsible for executing the annual sales plan made by the city corporation. Then the city corporation evaluates our work performance according to a number of targets including the sales volume. If we cannot sell all of the cigarettes they ordered, our salaries will be deducted accordingly... do you think this is fair?<sup>11</sup>

In this new division of labor, if one focuses only on the operation of county tobacco corporations, it indeed looks like the return of a planned-economy model.

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20, 2011).

<sup>10</sup> Interviewee No. 11.

<sup>11</sup> Interviewee No. 38.

However, this division occurs within the context of corporatization reform, whereby county tobacco corporations act as a branch of the city tobacco corporations, which are the main actors conducting procurements in the market. Through this division of labor and the accompanying target management, the CNTC became more capable of constraining the protectionist behaviors of its local agents under the new parent-subsiary corporate framework.

In Wedeman’s study, he argued that the practices of local protectionism would gradually disappear with the deepening of the market economy in China, since local governments would realize that no one could truly benefit by the mutual trade barriers.<sup>12</sup> However, in analyzing the development of the tobacco industry, it is clear that market forces did not automatically make local protectionism go away. On the contrary, local protectionism was constrained by the corporatization reform, which was introduced by the central authorities to strengthen the controlling capacity of the CNTC after China’s WTO accession. Corporatization in this context was more akin to a shortcut to centralization of the industrial governance than a halfway house on the road to privatization.

In addition to securing the power of personnel appointment and asset management, the CNTC now had greater ability to limit local governmental interference and to implement vertical management on all fronts of the tobacco sector. Table 6.1 below shows how the evaluated targets under the new target management included not only the procurement ratio of cigarettes outside of the local province but also the profit ratio, measures that both further hampered the protectionist measures exercised by local governments. In this context, the fragmented domestic market began to move toward unification as the monopoly management decoupled from local practices.

**Table 6.1 The Evaluated Target List of the Guizhou Province Tobacco Corporation**

The Target Category	The Evaluated Target and Its Ratio	
Economic Performance (35%)	Tobacco Leaf  (50%)	Product amount
		Quality
		Skill
	Cigarette	Sales amount
		The procurement ratio of the top

<sup>12</sup> Wedeman, *From Mao to Market*, 215.

	(50%)	30 brands
		The procurement ratio of cigarettes outside the local province
Management Capacity of State Assets (35%)	The fiscal contribution	
	The capital maintenance and appreciation ratio	
	The profit ratio	
	The ratio of turnover on current assets	
Innovation Capacity (15%)		
Comprehensive Management (15%)		

*Source:* Provided by Interviewee

## 6.2 Making Big Brands as an Industrial Policy

In addition to establishing a parent-subsidiary corporate framework for the CNTC, the STMB in this phase began to formulate an industrial policy for forging giant cigarette SOEs. Although the barriers to trade were significantly reduced and the trade market was unified following corporatization, by no means were the central authorities suddenly to abandon the existing practice of quota assignments. In fact, maintenance of the quota allocation in cigarette production proved to be a way of attending to the local governments' vested fiscal interests as the corporatization reform came into being since the quota figures were directly related to local fiscal incomes. Under this premise, "the making of big brands" turned out to be the main industrial policy employed by the STMB to stimulate competition among the existing cigarette manufacturers and thus cause large cigarette conglomerations to come into existence. Therefore, rather than breaking the existing quota allocation directly, several measures were used by the STMB to shape the big brands. These will be discussed in the following section.

### 6.2.1 The Catalog of the Top 100 Brands

In 2004—before the corporatization reform came into effect—the STMB had already undertaken administrative measures to create a range of potential big brands by issuing a "Catalog of the Top 100 Brands." Given that the international tobacco industry's strategies were intimately linked with the idea of global big brands and

that there existed more than five hundred cigarette brands in China in 2003,<sup>13</sup> a goal of the Top 100 catalog was to limit the number of brands on the market to just one hundred, with any of the others not listed being forced to stop production within three years in 2007.<sup>14</sup> This type of catalog management had been used as well for setting entry barriers to China's auto industry in 1989, such that only those enterprises listed in the catalog were allowed to produce cars.<sup>15</sup> Unlike the appearance of this earlier catalog, however, the new tobacco industry catalog arose as a result of the STMB's belief that it would provide an efficient way to produce the aggregate brands. Although at core an administrative measure, the STMB took each brand's growth potential into consideration when picking the winners for the catalog. In other words, the Top 100 catalog aimed to identify those brands that were perceived to have a competitive advantage and thus a greater potential in market. The STMB ultimately included 121 brands in the catalog.<sup>16</sup>

Motivated by the Top 100, cigarette manufacturers began to concentrate their resources to make only the cigarette brands that appeared in this catalog. As a result, more quotas were released and then used in manufacturing the brands in the catalog. However, none of this guaranteed that the Top 100 brands would survive in the market. Rather, the catalog broke new ground for another round of competition among cigarette manufacturers.<sup>17</sup>

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<sup>13</sup> Derek Yach and Douglas Bettcher, "Globalization of Tobacco Marketing, Research, and Industry Influence," accessed March 15, 2011, <http://legacy.library.ucsf.edu/tid/hjh23a99/pdf;jsessionid=82BFC555B552037F46645D5B89AABCBC.tobacco03>.

<sup>14</sup> The catalog here only included high- and middle-class cigarettes. Low-class cigarette brands were not regulated by it.

<sup>15</sup> Yilin Chen, "Xunzu moshi de bianhua yu zhongguo zizhu pinpai qiche qiye de xingqi"(The transformation of the rent-seeking mode and the rising of independent brands in the Chinese auto industry), in *Xuenzu yu zhongguo changye fazhan*, 142-3.

<sup>16</sup> See the document issued by the STMB, "Juanyan chanpin baipaihao mulu, no. guo-yan-yun (2004) 542" (The catalog of Top 100 cigarette brands), <http://law.lawtime.cn/d371899376993.html> (accessed April 20, 2012).

<sup>17</sup> Tobacco China, "Shishi baipaihao zhanlue, tishen zhongguo yancao zhengti jingzhen shili" (Implementing the strategy of top 100 brands, improving the competition of China's tobacco industry), accessed April 10, 2009, [http://www.tobacco.gov.cn/html/14/1401/57204\\_n.html](http://www.tobacco.gov.cn/html/14/1401/57204_n.html).

## 6.2.2 The Catalog of 20 plus 10

On the basis of the Top 100 catalog, the STMB decided to conduct another round of selection to determine the next group of “winners” following corporatization reform. In 2008, the STMB chose the “top core brands” according to a range of indices (see Table 6.2) and listed them in another catalog: “20 plus 10” (also known as “the Top 30”).<sup>18</sup> From Table 6.2, it can be seen that most indices had to do with the brands’ market performance, e.g., market share and growth rate.

**Table 6.2 Indices for Selecting Top Core Brands**

Category	Index	Sub-index
Market Growth	Market Share	Sales volume
		Sales revenue
	Market Coverage	Sales volume in non-local provinces
		Percentage of sales volume in non-local provinces vs. total sales volume
		Sales revenue in non-local provinces
	Shelf Sales Ratio	Number of non-local provinces where brand is sold
		Stock-to-sales ratio of brands at end of month
	Performance in International Markets	Shelf sales ratio of brands
Quantity for export		
Brand Development	Brand Grade	Percentage of sales volume within grade
	Brand Growth	Growth rate
		Growth rate in non-local provinces
	Brand Performance	Average profit for per case
Realized tax amount		
Brand Quality and Innovation	Product Quality	Random testing of product quality

<sup>18</sup> They initially chose 20 brands and added 10 later, thus the name “Catalog of 20 plus 10.”

	Capacity to Guarantee Quality	Prizes and awards
		The certification of management system
	Research & Development	Innovativeness of enterprise
Enterprise Capacity	Enterprise Scale	Sales volume of enterprise
		Gross of industrial output value
	Level of Economic Benefits	Realized tax and profit

Source: Provided by Interviewee

In contrast to the Top 100 catalog, this new catalog aimed at fostering the top core brands by pouring more policy resources into their cultivation, with the provision of resources being closely associated with the corporatization reform. For example, the CNTC introduced “the procurement ratio of the top 30 brands (to the total procured volume)” as one of the major targets to be evaluated for its subsidiaries (see Table 6.1). Moreover, the procurement ratio also had to rise on an annual basis. If no improvement was shown over the course of three successive years, the chief managers not only would lose their bonuses but also would be suspended.<sup>19</sup>

Accordingly, the implementation of this target became an imperative for all of the CNTC’s subsidiaries. In other words, the corporatization reform strengthened the CNTC’s steering capacity through targeted management, which had become a vital tool for fostering the top core brands through directing the purchase behavior of all the tobacco corporations after the separation of manufacturing and commerce in the tobacco sector. In this context, both the architecture of the government-business synthesis and the newly-built structure of parent-subsidiary corporate were able to ensure the effect of catalog management in the tobacco sector, and the market shares of top 30 brands would be further expanded accordingly.<sup>20</sup>

In addition, the STMB simultaneously attempted to foster the top core brands by increasing production quotas. Given that the production of each cigarette manufacturer was limited by the quotas specified, the supply of Top 30 brand

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<sup>19</sup> Interviewee No. 10.

<sup>20</sup> Li Zehua, “Jinzhua peiyu pinpai diyi yaowu, zengqiang hangye hexin jingzheng shili” (Making the creation of big brands the first priority, strengthening the competitive capacity of this industry), *China Tobacco*, December 15, 2009, accessed June 10, 2014, <http://www.echinatobacco.com/101588/101727/102002/48607.html>.

cigarettes might not fully satisfy the demand of wholesalers across the country. In this case, the STMB also promulgated a measure called “brand-oriented integration” in 2008.<sup>21</sup> According to this measure, only the cigarette companies owning the top core brands were authorized to negotiate with the other cigarette manufacturers to acquire their production quotas for these brands. For those companies that did not produce the top core brands, they became willing to produce those of other cigarette manufacturers, since this was a feasible way to retain their existing quota assignments.

Although the STMB was not able to make sudden, dramatic changes in quota allocations, it could incrementally adjust the quotas according to the market dynamic. Hence, if cigarette manufacturers were unable to receive sufficient orders via the centralized order-placing meetings, they stood to lose some of their quotas in the coming year.<sup>22</sup> In this respect, the “brand-oriented integration” measure was not only an expedient under the quota limits but also a method of resource provision for empowering the top core brands. The allocation of quotas was thus employed as a means for further motivating cigarette companies to develop big brands. Consequently, while the total number of cigarette brands declined significantly under the new regulations, the concentration ratio of cigarette brands also increased, as was to be expected. This development is shown in Table 6.3 below.

**Table 6.3 Concentration Ratios of Cigarette Brands (2003–2008)**

	2003	2004	2005	2006	2007	2008
<b>Average sales volume of each brand (unit: 10 thousand cases)</b>	3.68	6.51	9.98	10.24	14.63	20.55

<sup>21</sup> Tobacco China, “Disange ‘shi’: 08 nian pinpai dingxiang zhenghe mulu” (The third ‘ten’: the joint- produced brands in 2008), [http://www.tobaccochina.com/news/analysis/wu/20085/200852614712\\_304453.shtml](http://www.tobaccochina.com/news/analysis/wu/20085/200852614712_304453.shtml) (accessed March 10, 2012).

<sup>22</sup> After the separation of the local and inter-provincial cigarette trades was done away with in 2006, all of the cigarette manufacturers traded with the city tobacco corporations, regardless of whether these were within or outside of the province. This was done via centralized online meetings to place orders every half year. The online transactions took place on the website of the Chinese Tobacco Electronic Commerce Corporation (中烟电子商务网).

<b>CR4*</b>	10.04%	11.59%	13.78%	15.06%	18.29%	18.53%
<b>CR8</b>	13.59%	18.81%	23.21%	25.69%	32.02%	33.13%
<b>CR10</b>	17.94%	19.3%	26.4%	31.9%	37.8%	39.55%
* CR4: The concentration ratio of the four largest cigarette brands; likewise for CR8 and CR10.						

*Source:* Adopted from “Zhuanmai tizhi xia juanyan pinpai buju yanjiu” (A study on the distribution of cigarette brands under the monopoly system), by Chang Yongkai, PhD diss., Tianjin University, 2009; *Zhongguo yancao nianjian* 2008 (China tobacco yearbook 2008) (p. 218), by the STMB, 2009, Beijing, China: Economic Daily Press.

After the two catalogs, the STMB continued this strategy by announcing the “235” policy guideline in 2010. According to this guideline, the STMB would be reducing the top core brands from 30 to 10—including *two* brands with a five-million-case production volume, *three* brands with three million, and *five* brands with two million—by 2015.<sup>23</sup> In addition, the STMB then proposed another policy guideline called “461” to supplement “235”. This new guideline was aimed at promoting twelve brands representing more than 40 billion RMB in sales revenue, six of them more than 60 billion RMB, and one of them *over 100* billion RMB—in order to emphasize the value enhancement.<sup>24</sup> The 235 and 461 guidelines meant that cigarette manufacturers as a whole would have to make substantial efforts to increase their existing brands’ competitiveness. This was, after all, the only way to keep their places in the catalog for the next round of game.

In general, this developmental trend demonstrated that the corporatization reform led to the centralized regulatory framework of the CNTC, where the making of big brands became an effective strategy for pushing the existing cigarette manufacturers to compete with each other to expand their market shares, even though the quota system remained in place. In this context, the brand catalogs

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<sup>23</sup> These production figures were established by working from the 2008 volumes of the top five foreign brands – Marlboro (9.04 million cases), Winston (2.52 million cases), Mild Seven (1.96 million cases), Rothmans (1.8 million cases), and Pall Mall (1.41 million cases).

<sup>24</sup> Tobacco China, “2010 nian zhongguo yancao pinpai zhanlue guihua tanjou – qiwen ‘235’”(The exploration of formulating China’s cigarette brand strategy in 2010 – seven questions on ‘235’), accessed January 12, 2013, [http://www.tobaccochina.com/news/analysis/wu/20102/2010221152433\\_396583.shtml](http://www.tobaccochina.com/news/analysis/wu/20102/2010221152433_396583.shtml); Shucai Wang, “‘532’, ‘461’: dapinpai shidai yijing lailin” (‘532’, ‘461’: the time of large brands is coming), *China Tobacco*, August 11, 2010, accessed February 28, 2012, [http://www.tobacco.gov.cn/html/21/2105/210502/21050203/2807882\\_n.html](http://www.tobacco.gov.cn/html/21/2105/210502/21050203/2807882_n.html).



embodied the industrial policy of picking the winners, which led to the formation of the governance pattern in this phase: “competitive monopoly led by the central government.” In the following sections, I explore further how this governance pattern was constantly strengthened through interactions between local governments and the CNTC’s local agents under their context of dual centralization.

### **6.3 The Transformation of Local Governments in the Tobacco Monopsony**

Under the corporatization reform and the resulting strategy of making big brands, interaction between the local governments and the CNTC’s local agents also took a new turn in this stage. First, after losing their leverage in the tobacco sector, local governments, driven by fiscal pressure under the tax-sharing system, turned to facilitate the work of the CNTC’s local agents instead. In this section, I explore the operation of the tobacco monopsony—i.e., that the CNTC operated as the only purchaser of tobacco leaves—in order to illustrate how local governments became the *de facto* agents of the CNTC in this phase, with the result that these new circumstances constantly fortified the emergent, central-led competitive monopoly.

#### **6.3.1 The Tobacco Monopsony in the Last Phase**

Since China is the largest cigarette producing country in the world, it has faced a perennial problem where its national tobacco industry is concerned: how to secure a sufficient and stable supply of tobacco leaves. In light of the sizable demand for this core ingredient of cigarettes, a tobacco monopsony was introduced from the beginning into the state monopoly system as a way to guarantee domestic self-sufficiency and reduce the risk of international price fluctuation. As a consequence, even after the import tariff on tobacco leaves decreased following China’s accession to the WTO, the country continued to grow more than 40 percent of the world’s tobacco leaves in 2009, while 95 percent of its production was consumed domestically.<sup>25</sup> Notwithstanding, this industry’s operations in monopsony would also go through a shift from decentralization to centralization in this phase.

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<sup>25</sup> Michael Eriksen, Judith Mackay, and Hans Ross, *The Tobacco Atlas, Fourth Edition* (New York, NY: World Lung Foundation, 2012), accessed January 22, 2013, [http://tobaccoatlas.org/industry/growing\\_tobacco/leading\\_producers/](http://tobaccoatlas.org/industry/growing_tobacco/leading_producers/).

According to the original design, the overall arrangement of the tobacco monopsony aimed to achieve a state plan; social responsiveness to local situations had a limited role to play. The actual activity of tobacco procurement, however, worked otherwise and was reflected in the “three-in-one” system of the first phase. The creation of this three-in-one system had enabled local cigarette enterprises to obtain a sufficient supply of qualified tobacco leaves by establishing their own workshops in the tobacco fields themselves. Moreover, cigarette manufacturers had encouraged the farmers to grow tobacco by offering them a range of subsidies, thus producing more tobacco than what the plan indicated.<sup>26</sup>

After *the Tobacco Monopoly Law* was promulgated in 1992, strict monitoring of the total production in tobacco growing was not carried out in actual practice. The difference was mainly due to the fact that, unlike in industrial manufacturing, it was difficult to predict and control the volumes of the agricultural products produced in any precise way. Local tobacco stations would therefore conduct procurements in a relatively loose manner. The local stations usually purchased the extra tobacco leaves from farmers, a practice which was further tolerated under the pressure of local governments.

Moreover, unlike many other commercial crops, tobacco leaves had only one destination: cigarette production. If the local tobacco corporations refused to buy surplus tobacco leaves, this would have had disastrous consequences for the tobacco farmers. In order to prevent the social unrest that would have arisen from such an event, most local tobacco corporations assented to their local governments’ requests to purchase all of the tobacco leaves. Under these circumstances, local tobacco corporations often had no choice and purchased all of the tobacco leaves from the farmers, who in turn came to expect all their yields to be bought. This soon became the standard practice.<sup>27</sup> That is to say, the supply of tobacco leaves was shaped by

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<sup>26</sup> From The Editing Board of Hongta Group, *Hongta jituan zhi*, for example, according to the document *The Economic Analysis of Tobacco Leaves in Yuxi during the Past Five Years*, 47 percent of the tobacco farmers’ total revenue had been paid by the tobacco corporations according to the official prices, while the remaining 53 percent had been subsidized by the Yuxi Cigarette Enterprise in the early 1990s. In addition, Yuxi had provided other forms of support during the growing process, including technical training and instruction and fertilizers as indicated in Chapter Four.

<sup>27</sup> Wong and Deepak, *Zhuoguo: Guojia fazhan*, 57-9, 72-3; Huang Huixiang and Tan Yuquan, “Cunji caizheng bianqian yu cunmin zizhi fazhan: Kunjing yu chulu” (Rural fiscal change and the development of village self-governance: the predicament and its solutions), *Southeast Academic Research* 4 (2007): 40.

local governments, and their intervention did not respond to the actual demand of cigarette companies. Consequently, there arose a clash of interests between the local governments and tobacco corporations/cigarette companies. The overproduction crisis of 1997 was a prime example of this development.

### 6.3.2 The Overproduction Crisis of 1997

In 1996, when the change in local finances under the tax-sharing system coincided with a considerable price drop in the grain market, farmers were motivated to grow more tobacco leaves in order to maintain their incomes. In 1997, the results of this were apparent: tobacco leaf overproduction plagued the industry. Compelled by the local governments to purchase the surplus, local tobacco corporations and cigarette companies suffered considerably from the surfeit. Some tobacco corporations were unable to pay for the tobacco they had acquired and had to issue IOUs (*da baitiao* 打白条) to the farmers. A senior employee at the ZY Cigarette Factory in Guizhou complained bitterly when thinking back on the crisis:

The local government was constantly pushing us... How could you [buy it all] when the farmers had already produced so many leaves? If we had not collected them, serious social disturbance might have arisen.<sup>28</sup>

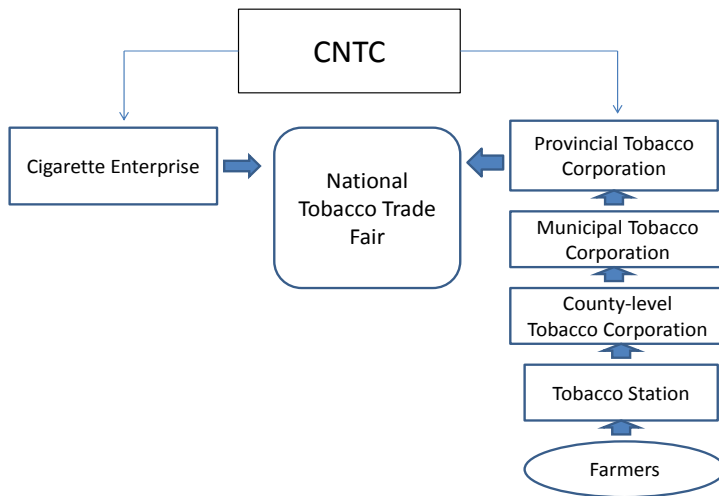
A year after the crisis in 1998, the STMB attempted a new scheme entitled “planned planting based on market guidance.” In this scheme, each cigarette company was required to purchase tobacco leaves at the “National Tobacco Leaf Trade Fair” and signed a letter of intent with the tobacco corporations they planned to conduct business with for each year. The amounts to be purchased were based on quotas assigned in the cigarette production plan. Based on these letters of intent, the STMB would formulate a plan for tobacco cultivation in each province, including the areas covered and the production amounts. In formulating these plans, the STMB also would take past records on cultivation and regional balances into consideration. The plan figures would then be broken down from the provincial to the village level. Tobacco corporations at the lowest level would sign a procurement contract with tobacco farmers in accordance with the planting plan (see Figure 6.2).

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<sup>28</sup> Interviewee No. 33.

This new scheme was actually a return of the planned-economy model where not only were tobacco corporations not permitted to purchase any surplus tobacco leaves beyond the contract, but the farmers also had to limit their planting areas. Nonetheless, this scheme was never fully implemented until the corporatization reform came into effect in the third phase.

**Figure 6.2 Scheme of “Planned Planting Based on Market Guidance” in 1998**



*Source:* Adopted from Jinji zhuangui guochen zhong de chanye zhongzu: Yi yancaoye wei li (Industrial restructuring during the economic transition: the example of the tobacco industry) (p. 178), by Liu Wei, 2005, Beijing, China: China Social Science Press.

### **6.3.3 The Tobacco Monopsony under the Centralized Regulatory Framework**

With the termination of the three-in-one system and the arrival of corporatization, cigarette manufacturers were no longer able to involve themselves in tobacco planting as before. The scheme of “planned planting based on market guidance” previously proposed was finally implemented under this centralized regulatory framework. A cigarette enterprise was now permitted to purchase at most 0.9 *dan* (45 kilograms) of tobacco leaves for each case of cigarettes produced in 2009.<sup>29</sup> Additionally, they were no longer allowed to buy tobacco leaves from the tobacco corporations above the amounts specified by the CNTC according to the cigarette production quotas of that year.

In practice, cigarette companies were not forced by local governments to buy any extra tobacco leaves beyond the contracts, yet neither could they guarantee that the supply of tobacco leaves would neatly meet the companies’ demands under the quota system. This was because tobacco leaves procured by cigarette companies had to be alcoholized for around two years in order to be used for cigarette manufacturing. Under this time lag, a gap between supply and demand would appear; the supply of tobacco leaves, ready only two years after harvest, could not precisely match what a cigarette enterprise might need. Therefore, although it was possible to curb overproduction under the centralized regulatory framework, this delay usually led to tobacco shortages confronting cigarette manufacturers during the actual production process. A senior employee at the HT Group explained the situation:

The key point is that the tobacco leaves we purchase every year are not used immediately. We have to wait for 1.5 years during alcoholization at least. During this period, our brands may expand from three million to five million cases. So we face this problem of not having enough almost every year and never stop asking the CNTC for more tobacco leaves.<sup>30</sup>

As cigarette companies were unable to obtain the tobacco leaves they needed, they turned to the CNTC for help when the shortages occurred. The CNTC would keep a certain reserve of tobacco leaves on hand each year, and it would first allot

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<sup>29</sup> Interviewee No. 61.

<sup>30</sup> Interviewee No. 62.

them to the cigarette companies which owned the top core brands. As a result, the supply of such reserved tobacco leaves became another “policy resource” for cultivating the big brands.<sup>31</sup> Paradoxically, the existence of these shortages derived from the precise implementation of plan production in tobacco leaves. In a sense, when cigarette manufacturers could get sufficient or even excess tobacco leaves as previously, then tobacco provision could not be leveraged as a means of control.

In fact, this precise implementation reflected a transformation of local governments in the tobacco monopsony during this period of time. In the centralized regulatory framework, local governments were unable to manipulate the tobacco corporations; instead, they had to watch carefully what the local tobacco corporations required in order to secure the taxation on tobacco leaves. When the Chinese authorities abolished the agricultural tax and special agricultural product tax in 2006 to reduce financial burdens on farmers, the tobacco leaf tax was not cancelled with them. As the only exception, this tax was still classified as a local tax, and its rate remained at 20 percent. However, given that the agricultural tax and special agricultural product tax on average constituted 70 to 80 percent of revenues in rural areas before the abolition of the tax, many local governments in this phase found themselves in a serious fiscal predicament and were more dependent on the transfer payment from the higher local governments.<sup>32</sup> Under such circumstances, the tobacco leaf tax was naturally more significant for local fiscal revenues in the tobacco growing areas. In fact, this was exactly why the central state would keep the tobacco leaf tax in the post-agriculture tax era. As the State Council explained:

Some new problems would arise if we were to stop levying the tobacco leaf tax. Firstly, it would hit the fiscal situation hard in tobacco-growing areas, especially for the county and township governments. According to the current fiscal system, the tobacco leaf tax is totally allocated to them, and it occupies a large proportion. Without the tobacco leaf tax, their fiscal plight would certainly further worsen. Secondly, it would have a negative impact on the operation of local governments at the grass-roots level and on the provision of local public services. Most

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<sup>31</sup> Interviewee No. 61.

<sup>32</sup> Liu Leshan and He Liancheng, “Quxiao nongyeshui ho de xianxiang caizheng kunnan wenti yanjiu” (A study of the fiscal predicaments of county and township governments after the abolition of the agriculture tax), *Reform of Economic System* 3 (2005): 82.

tobacco-growing regions are located in the west or in remote areas, and they usually do not have diverse financial sources. Therefore, local economies and public services heavily rely on the local governments. Termination of the tobacco leaf tax would lead to the decline of local fiscal income. Accordingly, it would be harmful for local development on all fronts. Thirdly, it would hurt the development of the tobacco industry. Tobacco is the main raw material in the production of cigarette products, so the elimination of the tobacco tax would seriously affect the tobacco industry since local governments would no longer have any incentive to promote tobacco-related activities.<sup>33</sup>

In this context, county governments would use this taxation as a means of compelling local township governments to complete the tobacco procurement task. For example, the share of tobacco leaf tax revenue that township governments would receive from their superior county government depended on the extent to which they fulfilled the tobacco procurement quotas. In some areas, county governments would award a portion of the tobacco leaf tax as a bonus to the leading cadres of townships when they successfully reached the required quotas.<sup>34</sup>

Given the fiscal significance of the tobacco tax, county governments would also make use of duty contracts (*zeren zhuang* 责任状). In these contracts, a number of evaluation indices were established to discipline township governments into completing the tobacco-related tasks required by tobacco corporations. Generally speaking, duty contracts would be passed down the administrative hierarchy from county governments to village committees, with increasingly detailed evaluation indices as one proceeded down the command chain and with a range of rewards and penalties linked to the outcomes. This arrangement introduced a vigorous system of

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<sup>33</sup> The Legislative Affairs Office of State Council, “Youguan fuzeren jiu zhonghua renmin gongheguo yanyeshui zhanxing tiaoli da jizhe wen” (Q&A on China’s provisional regulations for the tobacco leaf tax ), <http://www.chinalaw.gov.cn/article/fgkd/xfpwd/200612/20061200020938.shtml> (accessed September 11, 2009).

<sup>34</sup> Jianyong County Government, “Jiangyongxian renmin zhengfu guanyu erlingyiling nian kaoyan shengchan shougou youguan zhengce de yijian” (Opinions on 2010 tobacco production and procurement policies from Jianyong county government), <http://www.jiangyong.gov.cn/File/zfwj/2010011117224073499.htm> (accessed August 7, 2011).

administrative accountability and shifted the behavior of local authorities from merely responding to local needs and more to obeying higher level administrative instructions. The duty contract thus became an effective instrument for ensuring local compliance with regard to tobacco cultivation. An example of such evaluation indices on a duty contract can be seen in Table 6.4. This contract was signed between DJ Town and its village committees in Yunnan Province in 2008.

**Table 6.4 An Example of Duty Contract Evaluation Indices (DJ Town, Yunnan)**

<b>Index</b>	<b>Rewards and Penalties</b>
Success of planting areas	- Award of 1500-2000 RMB to village committees - Penalizing village committees 1000 RMB for failure with regard to planting area
Executing collective tobacco seeding in floating tray*	- Penalizing village committees 1000 RMB for failure on this index and compensating 5 RMB for each seeding tray - When the village committees finish the index, neither penalty nor reward incentive provided
Best transplanting time from floating tray to farmland	- Awarding 500 RMB when the village committees ensure tobacco seed transplantation is completed within 3 days during prime planting season
Expansion of scale planting by combining individual farmland in the same area	- Award of 200 RMB for each parcel of tobacco farmland greater than 100 <i>mu</i> (1 <i>mu</i> = 600 square meters) - Award of 100 RMB for each lot of tobacco farmland greater than 50 <i>mu</i>
Fulfilling tobacco procurement amount	- Award of 1500-2000 RMB to each village committees for successful fulfillment of plan - Penalizing village committees 200 RMB for every 1000 kilograms below procurement amount
Implementing safety regulations for tobacco flue curing	- Award of 1000-1500 RMB to each village committees without any fire accidents caused by tobacco flue-curing - Penalizing 500 RMB for each fire accident caused by tobacco flue-curing
Flue-cured tobacco leaves with	- Award of 4 RMB to each village committees and



superior/medium rate quality	2 RMB to each village group for every <i>dan</i> of superior/medium class tobacco leaves once the village committees fulfills the procurement amount and the portion of superior/medium class tobacco is over 50%
Exclusive award for village party branch secretary (first person in charge)	- The township government gives an exclusive award to the village party branch secretaries once they “pass” all the evaluation indexes
* This index is listed here as the CNTC promoted “collective tobacco seeding” by subcontracting seeding cultivation in floating trays to specific contractors and then selling the results to tobacco farmers under the village committees’ supervision in order to maintain seed quality. This was part of the CNTC’s project of “establishing modern tobacco agriculture.”	

*Source:* Provided by interviewee

As fulfillment of the evaluation indices linked directly to monetary rewards and penalties, their implementation was taken seriously by local authorities, especially at the village level. In fact, the rewards constituted an important source of fiscal income for many village committees because the transfer payments from higher government levels turned out to be far from adequate for local expenditure after the agricultural tax was abolished.<sup>35</sup> Thus many village committees supplemented their incomes by cashing in on the money rewards given to them when they reached the indices on the duty contracts. Under the circumstances, the local governments and the village committees came to act as the *de facto* agents of tobacco corporations. A cadre in DJ Town commented on such a relationship:

It would seem that our main job is to serve the local tobacco corporation. We must finish the job assigned by them so that we can receive the money. It is a very important income for us.<sup>36</sup>

Under the dual centralizations in fiscal revenue and SOEs governance, local governments were converted to ensure precision in tobacco provision. Rather than manipulating the CNTC’s local agents as in the last phase, local governments now had to control or limit any possible uncertainty and risk in tobacco production and try to avoid the undesirable outcomes—shortage or overproduction—in order to

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<sup>35</sup> Interviewee No. 14.

<sup>36</sup> Interviewee No. 60.

secure the tobacco tax and the monetary rewards. This implementation was also extended to support the CNTC in restructuring the production process and organizations in rural areas as exemplified in the project called “establishing modern tobacco agriculture.”

#### **6.3.4 Establishing Modern Tobacco Agriculture**

From Table 6.4, we can see that the village committees were required not only to meet specific production quotas in certain planting areas but also to grow tobacco leaves in specific ways. These included scale planting and collective seeding, which were promoted by a CNTC project known as “establishing modern tobacco agriculture.” Initiated in 2007, this project aimed to improve and equalize tobacco quality, increase the productivity of tobacco cultivation, decrease the demands of the labor force, and reduce costs. Specifically, the CNTC wanted to create favorable conditions for further stabilizing production without raising purchase prices in order to accelerate capital accumulation. One hundred thirty-five villages throughout China participated in the trial scheme in 2008.

As part of this project, the CNTC formulated four measures—scale planting, intensive operation, professional division of labor, and technological management—as the main methods for achieving the project’s goals. Among these measures, scale planting was viewed as the most fundamental. Taking scale planting as its basis, the production process was formulated as “intensive operation at the two ends, mechanization in between” so that a professional division of labor could be implemented. That is, cultivating seeds and flue-curing tobacco leaves (the two ends) would be subcontracted to “professional contractors” who would collectively operate under the village committees’ supervision. Agricultural machines would then be introduced to facilitate the growing process between the two ends. Through this rearrangement of the production process, it was envisaged that the demands of the labor force would decrease substantially.<sup>37</sup> In order to fulfill the intensive operation at the two ends, the CNTC also funded local governments to establish collective seeding workshops and flue-curing barns where professional contractors would work, and farmers needed to pay the required fees to make use of the services. In this context, some evaluation indices derived from this project, such as scale

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<sup>37</sup> East Tobacco, “Yitiao xinlu – xiandai yancao nongye jianshe huigu zhiyi” (One new road – part one of the review of establishing modern tobacco agriculture), accessed January 22, 2013, [http://www.eastobacco.com/ycny/yysc/201212/t20121226\\_285924.html](http://www.eastobacco.com/ycny/yysc/201212/t20121226_285924.html).

planting and collective tobacco seeding, were already listed on the duty contracts (see Table 6.4).

In addition, the CNTC sought to transform individual, small-scale tobacco cultivation under the existing household contract system into the new forms of production organization including cooperatives, family farms, and professional tobacco growers so that it could continue to effect the shift to scale planting and then approach the project's goals as indicated in Figure 6.3 below.<sup>38</sup> In this context, a number of demonstration sites for restructuring production organizations were set up. For example, during my fieldwork in 2009, Mile County<sup>39</sup> was designated as one such site in Yunnan Province. Its scheme for rearranging production organization is shown in Table 6.5 below.<sup>40</sup> From this table, one can see that the transfer of farmland usage was fundamental in all kinds of new production organizations. In fact, the CNTC would also employ a subsidy provision for local infrastructures, including irrigation projects and road construction, as a means for compelling local governments to conduct scale planting based on the restructuring of production organizations.<sup>41</sup>

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<sup>38</sup> East Tobacco, "Ruhe zhenzheng shixian yanye shengchan jiangong jiangben" (How to truly reduce the workload and costs in tobacco growing?), accessed January 23, 2013, [http://hangye.brandcn.com/yancao/080825\\_149569\\_2.html](http://hangye.brandcn.com/yancao/080825_149569_2.html); East Tobacco, "Yimudi – xiandai yancao nongye jianshe huigu zhisan" (One-mu land – part three of the review of establishing modern tobacco agriculture), accessed January 22, 2013, [http://www.easttobacco.com/ycny/yysc/201212/t20121231\\_286219.html](http://www.easttobacco.com/ycny/yysc/201212/t20121231_286219.html);

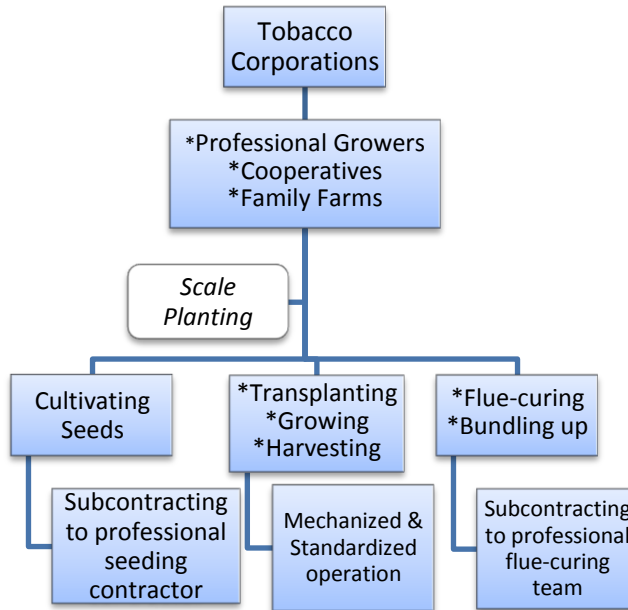
Zhang Fangyuan, "Tansuo, shijian, changxin – Dui xiandai yancao nongye shidian de zongjie yu sikao" (Exploration, action, and innovation: Summary and ideas on the trial scheme of modern tobacco agriculture), *China Tobacco*, December 1, 2008, accessed January 21, 2013, <http://www.echinatobacco.com/101588/101728/101752/21956.html>.

<sup>39</sup> Mile County has upgraded into Mile City since 2013.

<sup>40</sup> See the document issued by the Honghe Tobacco Corporation (2009): "Honghe zhou mile xian xinshao zhen xiandai yancao nongye shidian jianshe shishi fangan" (The trial scheme of modern tobacco agriculture in Xinshao Town of Mile County, Honghe State).

<sup>41</sup> Anonymous, "Jiang chengkang: yancao 'fanbu' ce" (Chengkang Jiang: The strategy of feeding back to tobacco agriculture), *China Business*, January 11, 2009, accessed on January 23, 2013, <http://finance.jrj.com.cn/people/2009/01/1113563292251.shtml>; The Yunnan Provincial Tobacco Monopoly Bureau, "Yunnan sheng xiandai yancao nongye jianshe qingkuang" (The situation of establishing modern tobacco agriculture in Yunnan Province), accessed January 26, 2013, <http://www.echinatobacco.com/101542/101576/102161/102162/23786.html>; Interviewee No. 60.

**Figure 6.3 The Scheme of Major Tobacco Agriculture**



Source: Summarized by the author

**Table 6.5 Scheme for Restructuring Tobacco Production Organization (2009)**

<b>Form</b>	<b>Method</b>
Family Farm	<ul style="list-style-type: none"> <li>- Village committees responsible for combining individual land in the same area</li> <li>- Village committees subcontracting the unification of farmland to capable contractors</li> <li>- Contractors employ mechanized and standardized methods of operation in areas where tobacco is cultivated</li> <li>- Contractors employ local farmers to handle any work which cannot be done by machines</li> <li>- Goal: Construction of two family farms, each with 218 <i>mu</i>* of arable land in the trial site.</li> </ul>
Cooperative	<ul style="list-style-type: none"> <li>- Cooperatives built in villages where arable land is concentrated</li> </ul>

	<ul style="list-style-type: none"> <li>- Farmers become the cooperative shareholders via their land, one <i>mu</i> amounts to one share</li> <li>- The investment of labor force according to number of shares for each farmer household</li> <li>- All shareholders elect capable manager(s) or local cadre(s) as the contractor to conduct general management including allocation of production materials, coordination of work teams, etc.</li> <li>- Farmers share production income according to their shares</li> <li>- Contractors receive 20 percent of the income above 2200 RMB</li> <li>- Goal: Construction of three cooperatives in the town, each with 315 <i>mu</i> of arable land in the trial site.</li> </ul>
Professional Tobacco Grower	<ul style="list-style-type: none"> <li>- Selecting capable farmers to form a “professional grower” and assigning 15-20 <i>mu</i> of arable land to them for growing tobacco</li> <li>- Providing subsidies/support to them for production materials, small agricultural machines, and training</li> <li>- Setting up a flue-curing barn for each professional grower in the collective</li> <li>- Goal: Construction of 225 professional tobacco growers, each with around 15 <i>mu</i> of arable land in the trial site</li> </ul>
<p>* One <i>mu</i> (亩) amounts to 667 square meters.</p>	

*Source:* The trial scheme of modern tobacco agriculture in Xinshao Town of Mile County, Honghe State), Honghe Tobacco Corporation, 2009.

The CNTC’s scheme for production organization was actually consistent with the policy of farmland transfer, which was passed in the third Plenum of the 17<sup>th</sup> Communist Party of China Central Committee in 2008.<sup>42</sup> According to that policy, farmers could transfer their land usage by lease, exchange, or shareholding cooperatives, and the transfer could only be effected with their consent. However, the complaint that local cadres forced farmers to rent out their lands to professional contractors began to appear, and this became yet another conflict between local

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<sup>42</sup> The Xinhua Agency, “Zhonggong zhongyang guanyu nongcun gaige ruogan zhongda wentu jue ding” (The decision on several big issues on rural reform made by the Communist Party of China Central Committee), accessed January 25, 2013, [http://www.gov.cn/jrzq/2008-10/19/content\\_1125094.htm](http://www.gov.cn/jrzq/2008-10/19/content_1125094.htm).

cadres and farmers during this period of time (more discussion of this point follows in the next section).<sup>43</sup> The conflict also explained why there existed a higher percentage of “professional tobacco growers” in all forms of the new production organizations, since the obstacles to transferring farmland in this form were lower than others due to their relatively smaller scale.<sup>44</sup> Even so, in 2012 the then head of the CNTC Jiang Chengkang (姜成康) confirmed that the project would proceed given that it had already demonstrated that overall expenditure could be reduced to a certain degree through the new production processes and method.<sup>45</sup>

### 6.3.5 The Implication of Local Governance

While “establishing modern tobacco agriculture” aimed to stabilize the provision of tobacco leaves, it sought to do this by creating a new group of contractors—in the form of collectives, family farms, and/or professional tobacco growers—to conduct scale planting in order to control the cost rather than by granting a large number of subsidies to individual households as appearing under the three-in-one system. This change demonstrated very clearly the situation that, when the local governments could no longer manipulate the CNTC’s local agents, they began to turn their back on the tobacco farmers when confronted with contradictory responsibilities: i.e., balancing their budgets versus protecting the livelihoods of the farmers. Under the circumstance, this caused some impacts on local governance since local governments had to handle an increased tension and conflict when dealing with tobacco-related matters. These conflicts, which I observed firsthand during my fieldwork and which served to show that the local authorities had already become *de facto* local agents of the CNTC, will be discussed in this section.

As shown in table 6.6, incomes for tobacco farmers generally declined after the overproduction crisis of 1997, resulting in a greater reluctance to grow tobacco.

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<sup>43</sup> Zhao Junchen and Zhao Hailan, “Nongcun ‘fanzu daobao’ xianxiang yanjiou” (A study on renting out household contract farmland in rural areas), accessed January 28, 2013, <http://www.aisixiang.com/data/detail.php?id=41678>; Zhang Fanyuan, “Tudi liuzhuan: Guimohua zhongzhi poti zhi bi” (Land transfer: The key point of scale planting), *China Tobacco*, September 1, 2007, accessed January 29, 2013, <http://www.echinatobacco.com/101542/101576/101938/101999/102000/15930.html>.

<sup>44</sup> Liu Haiwen, “Tudi Liuzhuan: xiao shanban quxiang da jianhui” (Land transfer: a small boat turning into a huge fleet), *China Tobacco*, November 15, 2009, accessed January 30, 2013, <http://www.echinatobacco.com/101588/101727/101769/21197.html>.

<sup>45</sup> Anonymous, “Jiang chengkang: yancao ‘fanbu’ ce.”

The profit-to-cost ratio per *mu* of tobacco cultivation was 64.3 percent in 1996. This figure fell dramatically to 21.9 percent in the following year and then plummeted to 2.5 percent in 2007 (see Figure 6.6). Part of the reason for the substantial drop was the abolition of subsidies from cigarette enterprises. While the cigarette enterprises' autonomy for granting subsidies was also eliminated in the centralized regulatory framework, the CNTC did not raise purchase prices accordingly. Hence, while the income of tobacco farmers declined in this phase, local governments were increasingly dependent on the revenues generated by tobacco cultivation. The tension between the two parties arose in this context. A local cadre in JC town of Yunnan described the reduction of the tobacco farmers' revenues:

The purchase price is indeed too low. Let me give you an example that most tobacco farmers would give you in our town. In the past, the same quantity of tobacco leaves farmers sold could buy pork of two or three *jin* (斤, one *jin* amounts to 500 kilograms), but now this is only one *jin*. Even though the official purchase prices have risen this year, they cannot catch up with the rising cost of living. This makes it difficult for us to implement the tobacco work.<sup>46</sup>

Growing tobacco, then, became a focal point of contention from the outset since the declining profitability of tobacco leaves made farmers lose interest. In addition, while the purchase prices could not match the rise in living expenses, at the same time the benefit-cost ratio of growing tobacco was also lower than that of other major agricultural products such as grapes, soybeans, and fruits.<sup>47</sup> The speech delivered at a national meeting of the tobacco industry in 2005 by the vice-director of the STMB He Zehua (何泽华) already confirmed this trend, which increased the pressure on local cadres who were responsible for organizing the tobacco planting, particularly in the economically developed areas.<sup>48</sup> Yet local authorities still had strong incentives to maintain tobacco cultivation for the fiscal reasons; thus local cadres could and did persuade and compel farmers to grow tobacco.

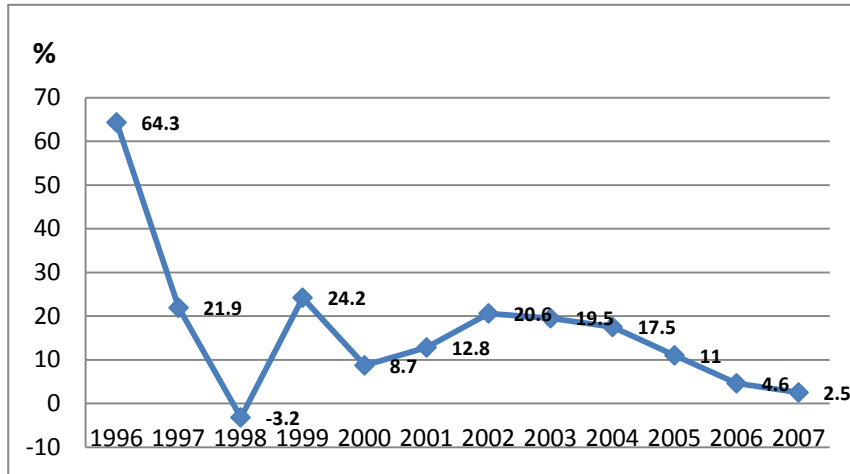
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<sup>46</sup> Interviewee No. 13.

<sup>47</sup> Teh-wei Hu et al, "The Role of Government in Tobacco Leaf Production in China," in *Tobacco Control Policy Analysis in China*, 202.

<sup>48</sup> Xu, "Zhongguo yancao hungye," 290.

**Figure 6.5 The Profit-to-Cost Ratio of Tobacco per mu (1996-2007)**



*Source:* Adopted from “Yanye shougou zhengce yu yannong liyi fenxi ji jiani” (An analysis and suggestion on the tobacco procurement policy and tobacco interests), by Wang Mingru, 2006, Rural Finance and Financial Affair 12, p. 30; Quanguo nongchanpin chengben shouyi ziliao huibian (National collection of agriculture products on cost-to-benefit data) (p. 197), by the Price Office of the National Development and Reform Committee, 2009, Beijing, China: China Statistics Press.

In principle, tobacco contract farming was based on an agreement signed by mutual consent. In practice, however, farmers had little choice but to grow tobacco if their farmlands were included in the tobacco zone as formulated by local governments.<sup>49</sup> Otherwise they might be asked to rent out their farmland, as a local cadre in QF town of Liaoning Province explained:

If farmers don't want to grow tobacco, we would still continue to exercise influence on them in any way possible. For example, we could exchange farmland so that they would be able to grow the other products on another piece of land. Or we could convince them to rent the land to someone else who is willing to grow tobacco.<sup>50</sup>

<sup>49</sup> After receiving the decision on planting size, local officials would begin to formulate the tobacco zone in December and then inform farmers. (Interviewee No. 13)

<sup>50</sup> Interviewee No. 22.



Another source of conflict arose when local governments and farmers clashed over the practice of intercropping in the process of cultivating tobacco. Intercropping refers to the growing of two or more crops simultaneously on the same field. This was a common practice in many rural areas in China. Intercropping could produce a greater yield on a given piece of land and hence would increase farmers' incomes. Moreover, it took tobacco farmers at least seven months to complete the cycle from seeding to sale, so they often had good reasons for intercropping other vegetables that had shorter growing periods. This allowed them to continue to earn while waiting for the income from their tobacco crop.

Such a practice, however, was usually prohibited by local governments because it would affect both the quantity and quality of the leaves of the intercropped tobacco.<sup>51</sup> Such prohibitions then not only limited the farmers' freedom to plant what they wanted but also adversely hit their incomes. Given that the majority of tobacco farmers would prefer to augment their incomes by planting other crops alongside tobacco, the ban on intercropping aroused serious opposition among them. To ease the discontent, some local governments were pushed to find a balance. They tried allowing tobacco farmers to practice intercropping, but only in the late harvest season so that the quality and quantity of the tobacco leaves would be kept at certain levels.<sup>52</sup>

Tensions could also arise in the procurement process when tobacco farmers were dissatisfied with the grading results. After flue-curing, the tobacco farmers would bring their tobacco leaves to the local tobacco station, where they sold their products according to the grading criteria issued by the STMB. However, the problem of "tobacco patronage" (*renqingyan* 人情烟) caused by unfair grading was widespread. That is, some farmers' tobacco leaves might be graded higher if they had a good personal relationship with the grader and vice versa. A common saying in tobacco-growing areas maintained that one had to "squat down to grow tobacco but kneel down to sell it."<sup>53</sup> This seeking of patronage grew even more competitive under the centralized regulatory framework because the CNTC began to set

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<sup>51</sup> Interviewee No. 13.

<sup>52</sup> Interviewee No. 54.

<sup>53</sup> China Youth Online, "Yunnan yannong shengcun zhuangkuang diaocha: Dun zhe zaiyan, gui zhe maiyan" (The investigation of Yunnan tobacco farmers: Squatting down to grow tobacco and kneeling down to sell it), 21 May, 2009, accessed June 20, 2009, <http://www.chinanews.com/sh/news/2009/05-21/1701614.shtml>.

maximum limits for the top grade proportion in order to control the general costs.<sup>54</sup>

A tobacco farmer in FW town of Yunnan complained:

The selling price of different tobaccos of exactly the same quality may have a price difference of around 5 or 6 *yuan* per kilogram. This depends on your personal relationship with the grader. The employees who are responsible for purchasing tobacco leaves at the station are the most powerful officials here. They even lower the grade [when buying] and deliver the product to their superiors with a higher grade to take advantage of the price difference.<sup>55</sup>

Some farmers responded to such unfair practices by secretly selling their tobacco to smugglers or to another station. This invited intervention from the local authorities as the local cadres were concerned that such illegal sales would impact their production quotas. A local official in DJ town of Yunnan pointed out:

Meeting the tobacco purchase procurement quotas is the most important target we have to achieve. Otherwise we would be punished. We would try every means to reach the assigned quotas, even to the point of buying tobacco leaves from smugglers sometimes.<sup>56</sup>

Ironically, although selling tobacco leaves illegally was officially prohibited, it did offer local governments a certain degree of flexibility when enforcing the tobacco monopsony. Given that agricultural yields anywhere can be subject to a high degree of uncertainty due to environmental fluctuations, obtaining tobacco leaves from smugglers became a simple solution for local governments when they were unable to meet their quotas. Also, when production output rose and went beyond the contracted requirements, the extra leaves could be disposed of by having smugglers buy the surplus. In this sense, such illegal transactions helped to maintain social

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<sup>54</sup> The Information Website of Yunnan Tobacco, “Shangdeng yan bili shifou yui kao yui hao?” (Is it better to have a higher proportion of the top tobacco leaves?), accessed April 20, 2012, [http://www.tobacco.gov.cn/html/21/2106/210602/21060205/2106020503/69481\\_n.html](http://www.tobacco.gov.cn/html/21/2106/210602/21060205/2106020503/69481_n.html).

<sup>55</sup> Interviewee No. 49.

<sup>56</sup> Interviewee No. 60.

stability in tobacco-growing regions during this phase. The “black market” in tobacco was thus a necessary evil.<sup>57</sup>

In general, tobacco corporations were responsible for enforcing and monitoring the production contracts signed by the farmers. If a farmer failed to meet his/her obligations according to the contract, the tobacco corporation would in principle not renew the contract the following year. In practice, however, the tobacco corporations had already shifted the responsibility for fulfilling the procurement contracts to local governments. Taking advantage of the local fiscal predicament in this phase, tobacco corporations institutionalized their leverage and manipulated local governments to work for them. In this context, as the tensions and conflict revolving around tobacco cultivation and procurement increased in local governance, a situation arose whereby the CNTC increasingly pushed local governments to finalize the restructuring of the production process. Consequently, the interactions between local governments and the CNTC’s local agents further consolidated the CNTC’s controlling capacity with regard to tobacco provision, which in turn led to another kind of incremental change: the strengthening of the central-led competitive monopoly.

## **6.4 The Formation of Large Cigarette Conglomerations**

Under the central-led competitive monopoly, large cigarette conglomerates based on “substantial” mergers began to form in this phase. In contrast to the “nominal” mergers of the last phase, the mergers occurring here would generally lead to a united production plan where all the production materials were coordinated and all the production quotas were combined for the purpose of cultivating specific big brands. In this section, I discuss how these substantial mergers could occur under the current governance pattern and how, as the substantial mergers and inter-province restructuring process continued, a type of competition known as “quasi-oligopoly” came to appear.

### **6.4.1 Substantial Mergers within the Provinces**

In contrast to mergers in the previous phase, the mergers in this phase among separate cigarette companies within individual provinces proceeded differently. For

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<sup>57</sup> Interviewee No. 15.

one, provincial governments were transformed from actors with a passive role that had shaped groups through “welding” into aggressive actors that promoted complete integration. Where previous mergers were created from several cigarette manufacturers that retained independent legal status within the group, now the mergers effectively meant that cigarette companies were incorporated into a conglomeration that canceled their previous legal status, thereby turning them into mere production branches or factories without any decision-making power.

The industrial policy of making big brands also helped to trigger this transformation. Once a local cigarette brand made it into the catalog and more policy resources were devoted to it, both the cigarette companies as well as the provincial governments benefitted via the growing profits and tax revenue. Given that the number of top core brands continued to atrophy under the STMB’s catalog management, provincial governments under the fiscal pressure of the tax-sharing system were driven to facilitate mergers within their provinces in order to concentrate resources and make specific brands more competitive. In this context, provincial governments began actively promoting substantial mergers within their provinces so that all of the production materials and quota assignments would be better coordinated for greater efficiency under the concentrated management. They became active mediators continually looking for ways of to make up for the fiscal loss suffered by their sub-provincial governments in jurisdictions where merged cigarette enterprises were located.

This stage also saw cases of “strong and strong” mergers within the same province, which had previously been uncommon.<sup>58</sup> For example, when the Yunnan Province Government promoted the merging of the Qujing Cigarette Company with the Kunming Cigarette Company in 2004, both of them were seen as large-scale companies, each producing cigarettes more than a million cases of cigarettes per year. In order to persuade these two large companies to agree to the merger, the provincial government worked out a formula to divide the taxation. By this calculation, the Qujing City Government would continue to receive tax returns according to the formula, even though the tax would be collected in Kunming after the merger.<sup>59</sup> This method guaranteed that the municipal governments would not

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<sup>58</sup> East Tobacco, “Zouxiang lianhe – zhongguo yancao gaige fazhan pingshu zier” (Toward conglomeration – part two of China’s tobacco reform development), accessed January 10, 2013, [http://www.eastobacco.com/dfyeb/201207/t20120710\\_242848.html](http://www.eastobacco.com/dfyeb/201207/t20120710_242848.html).

<sup>59</sup> Anonymous, “Qujing ruku shuishou liangnian zengjia 17.7 yi” (The tobacco tax revenue of Qujing increased 1770 million RMB after the merger in the past two years), *Yunnan Daily*,

lose their fiscal revenues from tobacco, and therefore the merger was accepted. This success also meant that the approach was applied to later mergers. In Yunnan, mergers made the number of cigarette companies drop from nine in 2003 to two in 2008.

The accelerating pace of such mergers did not occur only in Yunnan. Most cigarette companies were integrated into provincial tobacco industrial corporations, such that a two-level, parent-subsidiary framework in cigarette manufacturing gradually began to take shape across the country.<sup>60</sup> Under these new circumstances, the merged cigarette companies turned into production branches under the command of provincial industrial tobacco corporations. Overall, the number of cigarette enterprises nationwide had decreased to 30 by 2009, down from 151 in 2001 when China entered the WTO.<sup>61</sup>

Wang's study ignores entirely this industrial policy of making big brands, which therefore oversimplifies her analysis of state-business interactions in the tobacco sector after China's WTO accession. This overly simplistic analysis led her to conclude, incorrectly, that the merger movement led by the central government rapidly reorganized the enterprise system in China's tobacco sector and condensed China's tobacco industrial body during this period of time.<sup>62</sup> While it was indeed true that the STMB produced several documents from 2003 onward to restate its determination to close down cigarette manufacturers with an annual output lower than 100 thousand cases, while incorporating the cigarette manufacturers with an annual output between 100 to 300 thousand cases into large companies and supporting the large-scale cigarette manufacturers in the tobacco sector,<sup>63</sup> in fact, similar policy guides had already been issued previously (as indicated in Chapter Five), but they had failed to take effect under the local protectionism then prevailing. By contrast, this phase's substantial mergers within the provinces proceeded rapidly

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March 13, 2008, accessed January 11, 2013,

[http://paper.yunnan.cn/html/20080313/news\\_98\\_137493.html](http://paper.yunnan.cn/html/20080313/news_98_137493.html).

<sup>60</sup> Given its huge scale, Yunnan province has been the only exception keeping the three-level parent-subsidiary framework in cigarette manufacturing (CNTC-provincial tobacco industrial corporation-cigarette groups).

<sup>61</sup> Wang Jiannan, "Zhongguo yancao hangye gaige yu fazhan yanjiu" (Research on reform and development of tobacco industry in China) (PhD diss., Jiling University, 2011).

<sup>62</sup> Wang, *State-market Interaction*, 108.

<sup>63</sup> *Ibid.*; The Research Institute of Tobacco Economy of the CNTC/STMB, *Zhongguo yancao zhongzu zhenghe ji zouchuqu* (China tobacco restructuring, integrating and going outside) (Beijing, China: Capital University of Economics and Business Press), 60.

with the support of provincial governments. Looking at just this comparison, Wang also did not analyze appropriately the ways by which local governments pursued their interests in different phases. However, precisely this point explains why the “substantial” mergers within the provinces grew so significantly. Even though the central government had authored the merger policy, it could not be achieved efficiently until the local governments began to be converted into aggressive mediators within the context of dual centralization. In this sense, the emergence of substantial mergers arose not only as an accompanying result of the central-led competitive monopoly but also through the support of local governments.

#### **6.4.2 Inter-Provincial Restructuring**

In this phase, inter-provincial restructuring also appeared as an effect of making big brands. Compared to the relative ease of substantial mergers within the provinces, the current fiscal system made arranging fiscal transfers of tobacco revenues across provinces difficult. Therefore, “across-province” mergers did not happen on a large scale, but inter-provincial restructuring still moved forward in the form of sharing or holding certain equities.

Distinct from how inter-provincial restructuring had occurred in previous phase, the emergent form of restructuring in this phase was driven by the joint production of specific top core brands during the past years. Some cigarette companies were motivated to produce the big brands for others mainly because they did not have the top core brands listed in the catalog. Lacking their own top core brands, they would likely face shrinking market shares. In this case, joint production of specific core brands for other manufacturers located outside the provinces became a feasible option for retaining existing quotas.

As the market shares of the joint-production brands grew, they increasingly came to share common interests with the brand-owning companies. Thus, inter-province cooperation was further stimulated in the form of investment. For example, through joint-production of the *Baisha* (白沙) brand, the Hebei Baisha Corporation Limited, receiving investment from both the Hebei Industrial Tobacco Corporation and the Changsha Cigarette Enterprise in Hunan Province, was established in 2005. Inter-provincial restructuring also appeared in the industrial tobacco corporations of Guangdong and Guangxi through mutual equity participation in 2008. In the same year, the Gangshu Industrial Tobacco Corporation was restructured via equity investment from the Zhejiang Industrial Tobacco

Corporation. In general, the method of jointly producing brands led to more equity participation inter-provincial restructuring in this phase. Though the developmental trend was shaped under the constraints of the current fiscal policy, it was expected to create more space for inter-provincial mergers in the future.<sup>64</sup>

### 6.4.3 The Rising Quasi-Oligopoly Competition

As the total number of cigarette companies decreased due to the mergers within individual provinces, and the scale of inter-provincial investments constantly expanded, a number of giant cigarette conglomerations gradually took shape. Under these circumstances, a type of “quasi-oligopoly competition” appeared, seen in a higher market concentration ratio of those cigarette manufacturers (see Table 6.7).

**Table 6.6 Market Concentration Ratios of Cigarette Enterprises**

Year \ CR	2003	2004	2005	2006	2007
CR4*	19.6	23.9	24	25	27.3
CR8	31.4	39.9	41.4	44.8	49.6
CR12	39.5	46.3	48.2	60.2	67.5

\*CR4: The concentration ratio of the largest four cigarette enterprises in relation to production amount; likewise in CR8 and CR12.

*Source:* Adopted from “Zhuanmai tizhi xia juanyan gongye shichang jiegou yu jixiao shizheng yanjiu” (An empirical study of the market structure and performance of cigarette enterprises), by Chen Baosen, 2010, ACTA Tabacaria Sinica 16, p. 100.

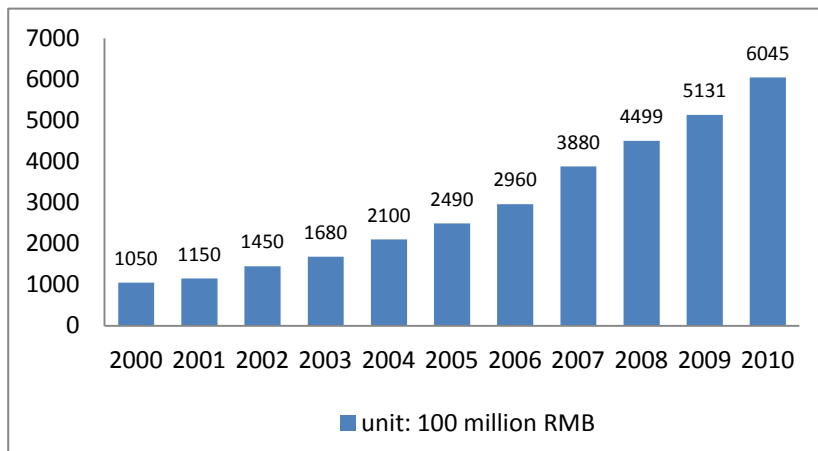
The emergence of quasi-oligopolies in the tobacco industry also demonstrated the reversal of the relationship between “*tiao*” and “*kuai*”—the local governments (*kuai*) again became *de facto* agents serving the CNTC system (*tiao*) in merger deals. This reversal did not mean that the central state was abandoning its market-oriented reform from the late 1970s or that the tobacco sector would completely go back to planned-economy fashion as before. Instead, it implied a fortification of the CNTC’s steering capacity in the

<sup>64</sup> Tan Yuansong, “Xishou pobing cu fazhan—hungye kuasheng lianghe congzu jinru gongjian qi” (Hand in hand, breaking the ice—the inter-province restructuring entering the crucial period of time), *China Tobacco*, November 1, 2009, accessed January 11, 2012, <http://www.echinatobacco.com/101588/101728/101752/45429.html>.

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nationally integrated market. In this situation, intense competition among emerging national cigarette champions further stimulated the boost of profits and taxation derived from this industry as seen in Figure 6.4 below. As a result, more and more capital has accumulated in the CNTC and its subsidiaries such that they have since been more capable of making overseas investments, promoted by the central authorities under the strategy of “going abroad.”<sup>65</sup>

**Figure 6.5 - Sum of Taxation and Profits in China’s Tobacco Industry (2000–2010)**



Source: Adopted from *China Tobacco*, 392, p. 42, accessed October 15, 2012, <http://health.people.com.cn/GB/14740/22121/17311892.html>

## 6.5 Conclusion

In the globalization-state debate, the so-called “globalization-as-constraint” school argues that the policy choices of nation-states are straitjacketed by the twin pressures of the growth of capital mobility and the rules of multilateralism. As such,

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<sup>65</sup> Tobacco China, “Zhongguo juanyan xiang guoji juanyan shichang kuayue” (China’s cigarette enterprises moving toward international cigarette market), accessed August 5, 2014, [http://www.tobaccochina.com/news/analysis/wu/200810/20081024122611\\_329426.shtml](http://www.tobaccochina.com/news/analysis/wu/200810/20081024122611_329426.shtml).



nation-states are virtually reduced to the role of adjusting national economies to the dynamics of the global economy.<sup>66</sup> Seen from the point of view of the development of China's tobacco sector after its accession to the WTO, however, this presents another different trajectory. Despite being under the pressures of globalization, the Chinese government took advantage of its entry to the WTO to set up a centralized regulatory framework in the CNTC via a form of "corporatization." This developmental trajectory was also different from what Wang described as "more global, deeper local." By this, she meant that the formation of national cigarette champions in the tobacco sector amounted to a "deeper economic decentralization" since local governments could continue to enjoy "decentralized economic power" only when they demonstrated their ability to make cigarette SOEs under their jurisdiction survive or thrive within the competition of the domestic market. That is to say, she claimed that the central government's ambition for having bigger and better SOEs after the WTO accession was consistent with that of the "winning" those local governments that wanted to expand the scale of economy of the SOEs, thereby causing globalization and decentralization to go hand in hand in China's context.<sup>67</sup>

This study shows how the "more global, deeper local" argument errs, since Wang did not adequately take account of the effects of the centralized governance of the SOE reform in this phase. Through the corporatization reform, local governments could not intervene into the tobacco business taking place within their jurisdictions as before. In this sense, their power of manipulation was largely constrained in the tobacco sector, but this did not mean that the leverage of the central authorities was constrained as well. On the contrary, this reform provided more favorable conditions for the central state to carry out its industrial policy of making big brands when the synthesis of the CNTC and the STMB remained in this sector.

Under these circumstances, the central-led competitive monopoly arose and was constantly reinforced through the support of local governments. As a consequence, trades between cigarette manufacturers and wholesalers were directed by state control in the form of industrial policy. In this context, the quasi-oligopolies gradually took shape with increasing mergers and restructurings, but it was difficult for them to collude with each other in divvying up the domestic market because the

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<sup>66</sup> Linda Weiss, "Bring domestic institutions back in," in *States in the Global Economy*, ed. Linda Weiss (New York, NY: Cambridge University Press, 2003), 5.

<sup>67</sup> Wang, *State-Market Interactions*, 118-9.

rules of the game were dictated by the central authorities. More specifically, when the central state exerted its bureaucratic domination over the SOEs by setting the game rules, the existing cigarette enterprises were further pushed to compete with one another for survival in the central-led game, trying to stay in the catalog into the next round. As such, state control and competition have been equally strengthened in the tobacco state monopoly in today's China.



# CHAPTER SEVEN

## CONCLUSION

In neoliberal discourse, SOEs are seen as economically inefficient and incapable of generating the necessary dynamic for economic development since only the private property right can assure that market economics function properly. From this perspective, SOEs are a barrier to China's transformation from a planned economy to a truly Occidental-style market economy. According to neoliberal propositions, then, China must thoroughly privatize the existing SOEs so that resource distribution is fully optimized. However, against this hegemonic neoliberal ideology, China's SOEs have continued to evolve since the late 1970s and experience dramatic growth particularly after China's WTO accession. As the *Economist* noted in 2011, "as the economy grows at double-digit rates year after year [in China], vast state-owned enterprises are climbing the world's league tables in every industry from oil to banking."<sup>1</sup> Currently China has, after the United States and Japan, the third largest concentration of Global Fortune 500 companies, and more than two-thirds of the Chinese firms on the list are SOEs.<sup>2</sup> Most of these are central SOEs, which typically take the form of an oligopoly within the state-monopolized sectors. They are the major drivers of economic growth in China in the first decade of the twenty-first century.

In this context, China's developmental model, frequently labeled "state capitalism," has triggered a heated debate in recent years. In the debate, China is viewed as the leading proponent of state capitalism nowadays, where decisions on how to distribute resources are made by state officials according to set political goals. Some argue that the rise of this form of capitalism in China presents a challenge to the free market economies in the developed world.<sup>3</sup> Accordingly, a new term has

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<sup>1</sup> Anonymous, "Let a Million Flowers Bloom," *The Economist*, March 12, 2011, accessed October 15, 2012, <http://www.economist.com/node/18330120>.

<sup>2</sup> Fortune 500 rankings are based on revenues. See Li-Wen Lin and Curtis J. Milhaupt, "We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Columbia Law and Economics Working Paper* 49 (2011): 2, accessed August 5, 2012, <http://ssrn.com/abstract=1952623>.

<sup>3</sup> Ian Bremmer and Devin T. Stewart, "China's State Capitalism Poses Ethical Challenges," *Policy Innovation for a Fairer Globalization*, August 10, 2010, accessed August 18 2012,

arisen for this model of relatively steady economic growth in China, particularly after the breakout of the global financial crises in 2008: the “Beijing Consensus” (sometimes used interchangeably with the “China Model”) is characterized by state-led economic sectors, state-constructed markets, and an authoritarian political regime.<sup>4</sup> Unlike the “Washington Consensus,” which used to be the standard formula employed by developing countries for establishing functioning economies through the espousal of the virtues of free markets, private property rights, and political democracy, the Beijing Consensus replaces trust in the free market with growth through “a more muscular state hand on the levers of capitalism.”<sup>5</sup> Other similar ideas characterize China’s developmental mode. For example, Nan Lin proposed “centrally managed capitalism” (CMC), under which the party-state commands the economy by controlling personnel, organizations, and capital in both the political and economic arenas and also delegating administrative authorities to diversely formed corporations to compete in the marketplace at the same time.<sup>6</sup>

In the growing rhetoric about the Beijing Consensus, the most striking contrast with the core assumption in the neoliberal doctrine lies in the state ownership of enterprises, through which the state is engaged in the economy. While state-monopolized industries, composed of several central SOEs, present a more comprehensive involvement of the state in the current economy, we still know very little about the substance of state monopolies in China; how they were constructed within China’s market-oriented reform and how they have developed over the past three decades remain open questions. By studying the state monopolies in China, the biggest question remaining to be answered is: how have the state and the market combined and engaged with one another under an authoritarian regime? How, in China’s context specifically, have they done this?

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<http://www.policyinnovations.org/ideas/commentary/data/000198/>.

<sup>4</sup> The term “Beijing Consensus” first made its appearance in the mainstream political lexicon in 2004, when the UK Foreign Policy Centre published a paper by Joshua Cooper Ramo titled *The Beijing Consensus*. A number of studies have subsequently discussed this concept: Stefan A. Halper, *The Beijing Consensus: How China's Authoritarian Model Will Dominate the Twenty-first Century* (Jackson, TN: Basic Books, 2010); John Williamson, “Is the ‘Beijing Consensus’ Now Dominant?” *Asia Policy* 13 (2012): 1-16.

<sup>5</sup> Anonymous, “Beware the Beijing Model,” *The Economist*, May 26, 2009, accessed August 3, 2014, <http://www.economist.com/node/13721724>.

<sup>6</sup> Nan Lin, “Capitalism in China: A Centrally Managed Capitalism (CMC) and its Future,” *Management and Organization Review* 7 No. 1 (2011): 63.

Adopting the approach of historical institutionalism, this thesis selects the tobacco industry as a single case study to explore the abovementioned questions by answering why competition would happen in the tobacco state monopoly from the outset and how it has evolved in China. Seen as a form of monopoly controlled by fiat, most monopoly literatures criticize state monopolies as eradicating competition. However, fierce competition exists within China's state-monopolized industries. Given that competition is regarded as the essence of "normal" market economics, this paradoxical phenomenon—the coexistence of state monopoly and competition—would be a critical ingredient in any discussion on the dynamic state-market relationship in China.

Moreover, while competition has also occurred in other state-monopolized sectors, the tobacco industry is an ideal case for studying the correlation between state monopoly and competition because it has, of all the state monopolies, clearly exemplified a type of central state control that is the most comprehensive. Led by their theoretical biases, neoliberals would normally not bother to research this topic, but the insights provided by this study help to understand not only the complexity of China's state-market relationship—that there have existed many ways of organizing the state monopolies—but also the legitimacy crisis that the Chinese authorities now face today.

In the following, I first summarize and then conclude the theoretical implications derived from this research. Although it may be too early to tell what direction the existing tobacco state monopoly is taking or when the next critical juncture will happen, some critical problems are already surfacing under the current governance pattern. These will be explored in the final section.

## **7.1 Summary**

In this study, I argue that the emergence of competition in the tobacco state monopoly resulted from a certain industrial governance pattern, which emerged incrementally and was strengthened through interactions between local governments and the local agents of China's National Tobacco Corporation. As the institutional settings where local governments and the CNTC's local agents were embedded changed, the governance pattern and the resulting competition type transformed as well over three distinctive phases—quasi-free competition under the two-track system in the first phase (1982-1993), restrained competition under prevalent local

protectionism in the second phase (1994-2004), and quasi-oligopoly competition under the central-led competitive monopoly in the third phase (2005-2012).

The consequences of competition in each phase would then trigger a regulatory change in the tobacco state monopoly at critical junctures, which would constitute the new premise for the following stage where another governance pattern would emerge. By tracing the development of these three temporal phases, we see that not only have the local governments already become the *de facto* agents for serving the CNTC while indirectly strengthening its control capacity, but also that the state control and the competition alike would both be reinforced and intensify. At the same time, the current central-led competitive monopoly prevents collusion between emergent oligopolies. In contrast to the typical dualist dichotomy of mutually exclusive state control and competition, “state monopoly, Chinese style” has been formed in this context.

## 7.2 Theoretical Implications

A single case study based on one state monopoly in China makes generalizing about the characteristics of all state-monopolized industries in China challenging, since the nature of the regulation varies from sector to sector. However, the tobacco industry, in light of its most comprehensive and strict regulation, may provide an ideal benchmark for comparing the features of other state-monopolized industries. From this research, then, theoretical implications in the field of China’s contemporary political economy, along with the state-market relationship in general, may be summarized as follows.

### 7.2.1 The Changing *Tiao-Kuai* Matrix in China’s Central-Local Relationship

Local governments’ involvement in the state tobacco monopoly is the crucial factor for explaining the coexistence of state monopoly and competition and their evolution. On the surface, the state tobacco monopoly was formulated as a vertical management system (*tiao*), but local governments (*kuai*) had their own forms of leverage in this system from the beginning. Therefore, the developmental history of the *tiao-kuai* relationship reflects the developmental trajectory of the tobacco industry.

From phases one to three, the *tiao-kuai* relationship has experienced cooperation, usurpation, and reversal. At the outset, the *tiao* could not have been set

up without cooperation from the *kuai*. However, exchange and compromise were involved in this “cooperation” such that the *kuai* could influence the operation of the *tiao* within their own geographical jurisdictions. This participation gradually prompted the *tiao* to deviate from its original design of total state-monopoly such that the authority of *kuai* came to dominate locally more than the *tiao*. Given that the state monopoly had already deteriorated into local monopolies, the central state sought to rebuild the authority of the *tiao* in order to block further manipulation by the *kuai*. In addition to restoring the domination of the *tiao* in this sectoral governance, the *kuai* in fact were compelled to serve the *tiao* to further consolidate its steering capacity. In this context, the *tiao-kuai* relationship has been completely reversed.

This reversal provides an insight to better understand the prevailing notion of “fragmented authoritarianism,” which argues that authority below the top of China’s bureaucratic system is disjointed, with the fragmentation intensified by the course of market-oriented reform. Since this idea first appeared, the argument has remained one of the most frequently mentioned frameworks for describing the inner workings of the Chinese bureaucracy; the importance of bureaucratic bargaining is emphasized in this vein.<sup>7</sup> Many studies have continued to flesh out this concept, and the fragmented market in the tobacco sector during the 1990s would bear it out as well. However, this study demonstrates that the fragmentation state of China’s authoritarian regime has not always been static. On the contrary, it has evolved, continuing to change and moving into a more integrative situation by transforming the *tiao-kuai* matrix. In this sense, this study offers a theoretical reframing for the now-current argument for China’s fragmented authoritarianism.

The reversal of *tiao-kuai* relationship also makes clear one of the major features of China’s state capitalism that is rarely recognized in the extant debates, including Wang’s. One of the most remarkable changes of the market-oriented reform was to give the horizontal line of authority priority over its vertical counterpart in a range of spheres by introducing a series of decentralization measures. Consequently, the function of *tiao* was largely eroded under those circumstances. Starting in the mid-1990s, however, the situation changed when the central state created a vertical chain of command for collecting taxes under the tax-sharing system. Such rebuilding of the *tiao* also occurred in a number of key regulatory departments to discipline local governments in their economic

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<sup>7</sup> More references in Lieberthal and Lampton, *Bureaucracy, Politics, and Decision Making in Post-Mao China*.



management. For example, in Mertha's study, he recognized that the Administration for Industry and Commerce and the Quality Technology Supervision Bureau were ordered to alter their relationship with regard to authority, changing from a decentralized (*kuai*-based) structure to a centralized (*tiao*-based) one in the late 1990s in order to counter local protectionism and establish standardization in policy enforcement. In the new "vertical management" system (*chui zhi guan li* 垂直管理), these bureaucracies were directly controlled by their functional administrative superiors (*tiao*) rather than by the local governments (*kuai*) so that the central policies were more likely to get implemented.<sup>8</sup>

As indicated in this study, the *tiao* also reappeared in state monopolies in the past decade. One could, however, distinguish this from the recentralization measures in other regulatory departments. In fact, the departments of the state monopoly formed the pivotal *tiao* during the time of planned economy but have since experienced a dramatic transformation under the SOEs reform once market-oriented reform was initiated.

Viewed from the standpoint of tobacco, a first difference may be found in the method of recentralization. Rather than reallocating administrative authorities, here the *tiao* was rebuilt through corporatization reform, which created centralized governance within the parent-subsidiary corporate framework and formally removed the leverage of local governments. The second difference was that, after the *tiao* was set up, the *tiao-kuai* relationship was reversed. This has rarely been the case in other administrative departments where the *tiao* have been reshaped. As analyzed in Chapter Six, the CNTC would go on to take advantage of the fiscal predicaments of local governments in order to force them to act as its *de facto* agents for the purposes of accelerating capital accumulation.

This reversal was not only caused by the straightforward process of redistributing authority; it was also propelled by the fiscal plight of local governments under the tax-sharing system. In fact, this converted *tiao-kuai* relationship has grown increasingly obvious, especially after the global financial crisis in 2008. Taking the place of foreign direct investment, the central SOEs of state monopolies have grown to become the most desirable source of investment for many local governments. This situation is even called "the central SOEs buying their

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<sup>8</sup> Yongnian Zheng, "Power to Dominate, Not to Change: How China's Central-Local Relations Constrain its Reform", *EAI Working Paper* 153 (2009):16-9, accessed January 12, 2012, <http://www.eai.nus.edu.sg/EWP153.pdf>; Mertha, "China's 'Soft' Centralization," 794-5.

local maid” by China’s media.<sup>9</sup> Moreover, given that the personnel appointments of central SOEs in the state monopolies are controlled by the central state, the reversed *tiao-kuai* relationship actually implies another determinant by which the central state could further exercise its influence over localities.<sup>10</sup>

The rebuilding of a vertical line of command in the tobacco state monopoly has also further pushed the central SOEs of state monopolies to become profit-seeking entities in the market rather than executors of planned economy. Therefore, the reversed *tiao-kuai* relationship here is not a return to the old planned-economy regime where market mechanisms were eliminated; rather, it represents a move toward a type of capitalism led by the central state where state control and market mechanism are combined and engaged with one another. In this vein, this study further expands our understanding of the “Beijing Consensus.”

Lastly, this changing *tiao-kuai* relationship also provides a testing ground for existing state-rescaling literatures, which emerged to decipher how inherited global, national, regional, and local relations were being recalibrated through capitalist restructuring and state retrenchment in the 1990s.<sup>11</sup> While the economic restructuring from a Keynesian welfare regime to a neoliberal competition state appeared in Western Europe, a parallel transformation from planned economy to market economy appeared in China’s context. From the late-1970s, China underwent a process of state rescaling similar to what was identified in the post-Fordist Occidental countries as decentralization. However, after that, China’s state rescaling has followed a different route compared to Occidental countries, even though they all have been under the pressure of economic globalization. What is more, the

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<sup>9</sup> Jiang Chenghua, “Yangqi zai defang ‘mai ya huan’, anzang jiecao buhele yinyou” (Central SOEs buying maids locally, implying the problem of unreasonable structure), *China Enterprise News*, March 20, 2012, accessed April 6, 2013,

<http://finance.jrj.com.cn/2012/03/20011112526499.shtml>; Qiang Wang, “Yangqi weihe gan yaoxie defang zhengfu” (Why dare central SOEs to threaten local governments), *New York Times* (Chinese edition), October 11, 2012, accessed April 6, 2013, <http://cn.nytimes.com/article/china/2012/10/11/cc11wangqiang/>.

<sup>10</sup> Kjeld Erik Brødsgaard, “Politics and Business Group Formation in China: The Party in Control,” *The China Quarterly* 211 (2012): 624.

<sup>11</sup> Neil Brenner, “Beyond State-centrism: Space, Territoriality, and Geographical Scale in Globalization Studies,” *Theory and Society* 28 (1999): 39-78; Bob Jessop, “Institutional Re(turns) and the Strategic-relational Approach,” *Environment and Planning A* 33 (2001): 1220-32.

Chinese government took advantage of its entry to the WTO to strengthen its state monopolies and made a central-led competitive monopoly.

Where many state-rescaling literatures based on Occidental experiences have tended to accept the premise of the neoliberal capitalist state, where state practices are significantly minimized under globalization, we cannot simply apply it to China's development.<sup>12</sup> The changing *tiao-kuai* relationship, moreover, further demonstrates that state rescaling in such a huge transitional post-socialist economy like China is a complicated process and involves the combinations of institutional interaction in both the horizontal and vertical domains at different stages. Namely, the changing path of *tiao-kuai* matrix in China's context provides unique insights into the extant state-rescaling literatures: the decentralized powers are not simply "fixed" at lower levels of state administration but may be reshaped by interactive relations between vertical and horizontal bureaucratic systems. This may even push in the opposite direction of state rescaling, as the reversed *tiao-kuai* relationship demonstrates from this study.

### **7.2.2 The State-Market Relationship under the State Monopoly**

This study argues that competition, rather than merely existing, has evolved within the state tobacco monopoly. By exploring its developmental trajectory along three temporal phases, this study demonstrates that the state/market interaction has been dynamic under the state monopoly framework; a point rarely discussed in most monopoly literatures. This demonstrates there exist many ways to organize a state monopoly, not just one, but this variety too has been ignored or overlooked in general.

Conversely, this study could illuminate those literatures on the developmental state that hold states may intervene into markets strategically and aggressively to help the nation's economic growth. But China's development, compared with that of other East Asian countries, is more complex where the state-market relationship is concerned. Firstly, one core feature of the developmental state is its close public-private cooperation (or the so-called state-business alliance), which constitutes an institutional foundation for effective state intervention in private business. Nonetheless, unlike the dominance of private ownership in other East Asian countries, China has preserved a certain proportion of SOEs in its national

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<sup>12</sup> Carolyn Cartier, "City-space: Scale relations and China's spatial administrative hierarchy," in *Restructuring the Chinese City: Changing Society, Economy and Space*, ed. Laurence J.C. Ma and Fulong Wu (New York, NY: Routledge, 2005), 23-5.

economy. This feature of state ownership even extends to cover entire sectors, i.e., state-monopolized industries as exemplified by the tobacco industry. Without the private-public link, this study indicates that in spite of the state monopoly, the Chinese government could create competitive mechanisms via its industrial policy such that national teams could be forged and then further go abroad under such circumstances. This state capacity, however, results from a constant, dialectic evolution and is based on the multi-level state-market interactions of the previous three decades.

Unlike other East Asian countries, these multi-level state-market interactions reflect yet another distinctive feature of China: a transitional economy with a massive bureaucratic system. As a post-socialist state, China had to create market circumstances from its planned economy, and the method it chose for this was not direct privatization of the SOEs but the granting of greater autonomy to its local governments and SOEs by means of a series of decentralization measures. Taking the tobacco industry as a point of reference, one can see that there have been two main threads in the state-market relationship: 1) market/local government, and 2) market/central government. All of the players have, through their interactions, experienced great change and undergone change themselves.

At first, when the central state initiated the market-oriented reform via decentralization in its fiscal policy and SOE governance, the interaction between local governments and the CNTC's local agents led to the expansion of markets under the two-track system. In this, local governments acted both as promoters of the market and participants in it; without their involvement, the market track might not have grown so fast in this phase. Accordingly, quasi-free competition began to arise in the enlarging market. However, after moving into the second phase, local governments pressured by the tax-sharing system sought to manipulate the CNTC's local agents by placing trade barriers to protect the market shares of cigarette manufacturers in their geographical jurisdictions. Under such circumstances, local protectionism arose and led to constricted competition in this sector.

From this perspective, local governments became the initiators of market fragmentation so that few if any large cigarette conglomerations were established during this period. However, after China's accession to the WTO, the central state was further motivated to build a national team for the Chinese tobacco industry. In the third phase, then, the central state centralized authority through its corporatization reform so that the barriers to trade would largely be removed. By this, the domestic market began to transform, moving from fragmentation to

unification, while interactions between local governments and the CNTC's local agents would trigger the formation of large cigarette manufacturers in the market, thus bringing about a quasi-oligopoly competition across the industry.

From this developmental trajectory, it can be seen that local governments have evolved first from market promoters to market dividers to facilitators of market competition. Following the incremental changes caused by interactions between the local governments and the CNTC's local agents, the central state-market relationship has also continued to develop along with the temporal phases. For example, when quasi-free competition gradually led to the chaos of gluts, the central state became a market regulator by introducing controls on overall quantity. Also, when the market was fragmented by local protectionism, the central state turned into an initiator of market integration by introducing the corporatization reform.

In discussing these three phases, the state/market interaction in the state monopoly does not emerge in a simple one-to-one relationship. In light of the multi-tier governmental system and the gradual market-oriented reform, state/market interaction in China's context has found itself in dialectically dynamic situations, even under the framework of state monopoly. Not only were local government-market relationships able to change incrementally with interactions between the local governments and the CNTC's local agents, it also could also be dramatically transformed by the central state-market relationship. Without an elaborate investigation and analysis of the multi-tier state-market relationship, it would be difficult to grasp why state control and market competition reinforce and intensify each other simultaneously as presented in the regime of central-led competitive monopoly nowadays.

### **7.3 The Crises of the Existing State Tobacco Monopoly System**

By analyzing how state and market have combined in a typical state-monopolized sector like the tobacco industry, this study attempts to flesh out China's developmental model rather than attempting to determine whether the Beijing or Washington Consensus is superior. In fact, although the central-led competitive monopoly in the tobacco sector goes against the neoliberal doctrine, the two seemingly opposite approaches actually produce a similar consequence in the form of increasing economic inequality. Thus, a legitimacy crisis now looms in China's state tobacco monopoly.

### 7.3.1 Increasing Economic Inequality and Distributive Injustice

As the profits and taxation of the tobacco industry grew under the central-led competitive monopoly, disputes regarding economic inequality and distributive injustice continued to rise. For one, economic inequality has been revealed as a feature of this sector; as mentioned in Chapter Six, tobacco procurement prices were not adjusted upwards to match the growth of profits and tax revenues. Instead, the STMB decided to restructure the tobacco-producing process and related organizations through the “modern tobacco agriculture” project in order to lower tobacco production costs rather than raising the procurement prices. As a result, the income distribution gap between the agricultural department and the industrial/commerce departments in this industry has widened. Accordingly, the real income of tobacco farmers has actually declined compared to the period of the three-in-one system. Moreover, given that the size of scale planting has not increased significantly, local governments have continued to push to implement the restructuring project in rural areas. Under the circumstances, it can be predicted that the procurement prices for tobacco leaves will not rise greatly since this will not move forward the land transfer needed for the modern tobacco agriculture project.

Accordingly, whenever local governments for the fiscal reasons have assumed the duty of ensuring tobacco procurements, tension between local governments and tobacco farmers becomes exacerbated, further endangering local governance. In fact, this developmental trend reveals that the “statist approach” practiced here is not necessary for guaranteeing a more equal economic distribution. In other words, the state capacity presented in a state-led market is bolstered by a certain set of state/society relationships whereby local governments, especially those at the grassroots level, have to confront the discontents and protests from individual farmers directly. In this context, when economic inequality becomes a predicament for local governance, it implies also that the crisis has already arisen in the state tobacco monopoly since local governments act as the CNTC’s *de facto* agents.

Moreover, distributive injustice revolves around the dividends submitted from the SOEs to the state and the resulting allocation. In fact, the distributive dispute has occurred not only in the tobacco industry but also in other state monopolies. When the tax-sharing system was initiated in 1994, the SOEs were exempted from paying dividends to the state coffer since most were in dire straits at the time.<sup>13</sup> In this

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<sup>13</sup> Mikael Mattlin, “Chinese Strategic State-owned Enterprises and Ownership Control,” *Asian Paper* 6 (2009): 6, accessed March 5, 2013,

context, payment of taxes was the only obligation SOEs had to the state. The situation did not change until the *Interim Management Measures of Collecting Capital Gains from Central SOEs* was promulgated in 2007.<sup>14</sup> Given that many previous loss-makers had already been turned into profit-makers over the past decade, with some in strategic sectors that are even highly profitable, the *Interim Management Measures* was issued and three different rates of dividend—zero, five, and ten percent—were formulated to apply to a variety of central SOEs.

In light of the lavish profits, the dividend rates of central SOEs have been criticized as too low, and a high level of profit retention has been blamed for exacerbating economic inequality. According to the statistics released by China's Ministry of Human Resources and Social Security in 2009, the average salaries of employees in central SOEs of state monopolies—including electricity, banking, tobacco, telecommunications—were two to three times higher than the average in other industries. If non-salary income, such as housing funds and a range of other benefits, is included, then the income gap balloons to five to ten times higher.<sup>15</sup>

Even within state monopoly industries, the income gap between senior SOE executives and other employees has continually widened, increasing to 17 times the average salary of the companies' regular employees in 2011 from 8.68 times in

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[http://www.vub.ac.be/biccs/site/assets/files/apapers/Asia%20papers/Asia%20Paper%204\(6\).pdf](http://www.vub.ac.be/biccs/site/assets/files/apapers/Asia%20papers/Asia%20Paper%204(6).pdf).

<sup>14</sup> See the document issued by the Ministry of Finance and the State-owned Assets Supervision and Administration Commission, "Cai zheng bu guoziwei guanyu yinfa 'zhongyang qiye guoyou ziben shouyi shouqu guanli zhanxing ban fa 'de tong zhi, no. cai-qi (2007) 309" (The notification of 'the interim management measures for collecting capital gains from central SOEs' printed by the Ministry of Finance and SASAC ), [http://big5.gov.cn/gate/big5/www.gov.cn/zwgk/2007-12/17/content\\_836608.htm](http://big5.gov.cn/gate/big5/www.gov.cn/zwgk/2007-12/17/content_836608.htm)(accessed April 8, 2013).

<sup>15</sup> Wang Renqui, "Gao shouru hungye sanshi nian bianqian: longduan hungye shouru gaoyu yiban hungye da shibe" (The development of high-income industries over three decades: the income of monopoly industries ten times higher than the others), *Xinhua News*, May 18, 2009, accessed March 30, 2013, <http://biz.icxo.com/htmlnews/2009/05/18/1382467.htm>; Anonymous, "Gongjijin qinan fangda bugong" (How could the housing provident fund expand social inequality?), *Information Times*, December 20, 2012, accessed April 5, 2013, [http://informationtimes.dayoo.com/html/2012-12/20/content\\_2079010.htm](http://informationtimes.dayoo.com/html/2012-12/20/content_2079010.htm); Zao Yong, "Yuanze shang guanbuzhu tuojiang de longduan fuli"(Unable to manage the impertinent monopoly benefits in principle), *Qiliu Evening News*, April 3, 2013, accessed April 10, 2013, <http://epaper.qilwb.com.cn/qilwb/content/20130403/ArticleA02005FM.htm>.

2000.<sup>16</sup> Consequently, the question of how to deal with the distributive controversy of central SOEs has been placed on the political agenda and discussed heatedly in the National People's Congress and the Chinese People's Political Consultative Conference in recent years.<sup>17</sup>

Against this background of rising discontent, the highest dividend rates for central SOEs rose to five, ten, and fifteen percent in 2011, while the rate for the tobacco sector increased to twenty percent in 2012—the highest of all industries, with the CNTC producing the highest profits for the state coffer.<sup>18</sup> Even so, the raising dividend rates have not solved the problem of worsening economic inequality, as most of the submitted profits have actually been returned in order to nurture the existing central SOEs (see Table 7.1 below).

One sees clearly that the general public has rarely benefited from the profit contribution of the central SOEs. Apart from the seven percent used for social security, the rest more or less went back to the SOEs themselves.<sup>19</sup> Thus, even though the dividends they have submitted to the state appear to grow, their usage allocation does not contribute to the public welfare. Instead, this allocation method

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<sup>16</sup> Sina News, “Yangqi gaoguan jiang shxing chayihua xin Zhou, zhe wu xiafei jiang she shangxian” (The reform of central SOEs’ executives’ salary will be carried out and setting the ceiling on their position-related consumption), accessed Sept 3, 2014, <http://m.news.sina.com.tw/article/20140830/13238943.html>.

<sup>17</sup> Ifen Net, “Lianghui gongshi zhi dapo longduo guoqi” (Breaking the monopoly SOEs as the consensus in NPC & CPPCC), accessed April 3, 2013, <http://finance.ifeng.com/news/special/gongshiguoqi/>; Wang Weiguo, “Weiyuan jujiao kuoqi gao shouru: longduan hongye hongli ying zhishao shangjiao 50%” (CPPCC members targeting the high-come SOEs: the dividends of monopoly SOEs should pass to the state upward 50%), *South China*, accessed March 29, 2013, <http://finance.ifeng.com/news/special/2013lianghui/20130310/7753354.shtml>.

<sup>18</sup> People's Daily Online, “Yangqi shangjiao hongli bili yunniang shangtiao, zhuanjia cheng xianyou bili taidi” (The profit submission of central SOEs should rise, the experts argue that the existing rates are too low), accessed April 15, 2013, [http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/fortune/2013-02/16/c\\_124349894.htm](http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/fortune/2013-02/16/c_124349894.htm); The tobacco industry passed profits of around 30,000 million to the state coffers in 2013; the petroleum industry was second with 28,760 million. For more information see: <http://dhnews.zjol.com.cn/dhnews/system/2013/03/26/016240682.shtml>.

<sup>19</sup> Huang Chen, “Jinnian yangqi hongli 76 yiyuan yongyu minsheng, zhanbi bushing fanjiang” (7600 million of central SOE profit used in public benefits this year, the proportion declining instead of rising), *Caixinwang*, March 27, 2013, accessed April 15, 2013, <http://special.caixin.com/2013-03-27/100506931.html>.



provides more capital to the central SOEs, with some even turning to speculative business. For example, the CNTC emerged as the “new king of land” in Beijing real estate speculation in 2010, further fostering the public’s discontent with around unaffordable housing.<sup>20</sup> In this sense, the existence of central SOEs in the state monopolies seems to lead to a further deterioration with respect to economic inequality.

**Table 7.1 Expenditure Allocation of Central SOE Submitted Profit in 2013**

<b>Category</b>	<b>Details</b>	<b>Amount (100 million RMB)</b>	<b>Percent age (%)</b>
Restructuring of State-owned Economy	-Supporting the mergers between central SOEs -Strengthening the control capacity of central SOEs in the field of state security -Solving historical problems of central SOEs	379.88	35
Investment in Key Projects of Central SOEs	-Supporting key projects of central SOEs in the fields of state security, national core competitiveness and comprehensive national strength	336.12	31
Industrial Upgrading and Development	-Strengthening the innovative capacity of central SOEs	176.76	16.3
Expenditure on Social Security		76.34	7
Investment and Cooperation abroad	-Supporting central SOEs to purchase strategic resources and enterprises with core technology abroad	67.9	6.2
Reserved Fund	-Used for emergency situations regarding central SOEs	21.11	1.9
Subsidy to Retired	-Subsidizing medical and living expenses for retired staff of central	20	1.8

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<sup>20</sup> Lu Huan and Zhai Hui, “Beijing maidi rijin baiyi, yangqi fawei yitian pengchu sandiwang” (Beijing earning 1000 million per day by selling land, three kings of land emerging from central SOEs within a day), *Beijing Times*, March 16, 2010, accessed April 10, 2013, <http://money.huagu.com/financing/0000021552.html>.

Employees	SOEs		
Other		5	0.4
Total		1083.11	100

Source: Adapted from China's Ministry of Finance, accessed April 6, 2013,

[http://yss.mof.gov.cn/2013zyczys/201303/t20130322\\_784806.html](http://yss.mof.gov.cn/2013zyczys/201303/t20130322_784806.html)

In this light, state monopolies are becoming increasingly suspect, even without the ever-emerging corruption scandals. More and more often, questions are being asked about them: With such unprecedented profitability, where should the profits of the central SOEs go? And apart from their increasing power and influence, what is most important about the central SOEs of state monopolies in today's China?<sup>21</sup>

### 7.3.2 The Rising Medical Costs

Along with the abovementioned inequality and distributive injustice, controversy surrounding the state tobacco monopoly becomes even more serious in light of harm caused by tobacco products. With the largest population of smokers in the world, China suffers significantly from tobacco-related diseases, annually resulting in more than 1.2 million fatalities, or 12 percent of all mortality. China also has the largest population of lung cancer patients in the world; smoking has already become the main cause of death for Chinese people. The Ministry of Health announced in 2008 that the tobacco-related death toll in China will reach 100 million by the middle of the twenty-first century if smoking levels do not drop in the coming decades. Smoking and its harmful effects have been clearly identified as one of the greatest challenges confronting China's public health system.<sup>22</sup>

Given that the tobacco industry is such a major contributor of tax revenue, it is not hard to understand the Chinese government's resistance to reducing cigarette production, despite its having already signed the World Health Organization Framework Convention on Tobacco Control (FCTC) in 2003, the core of which aims to lessen the production and consumption of tobacco products. In fact, the Chinese government has been continually urged by the international public health

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<sup>21</sup> Zheng and Chen, "China's State-Owned Enterprise Reform," 39-40.

<sup>22</sup> The Office of the Leading Group for Implementing the Framework Convention on Tobacco Control, *2008 nian zhongguo kongzhi xiyan baogao* (2008 China tobacco control report) (Beijing, China: Ministry of Health Publication, 2008), 2; Cheng Li, *The Political Mapping of China's Tobacco Industry and Anti-Smoking Campaign* (Washington, DC: Brookings, 2012), 2-3, 28-9.

community to take initiatives on tobacco control, as it is impossible to have a breakthrough in the international anti-smoking campaign without a success in China.

Under this international pressure, the Twelfth Five-Year Plan finally adopted a resolution calling for “the overall implementation of a smoking ban in public places” at the meeting of National People’s Congress in 2011.<sup>23</sup> However, the gap between the regulation itself and the reality of its enforcement has not closed, particularly when tax revenue from the tobacco industry remains steady at more than seven percent of the total annual central government revenue. This is why the Minister of Industry and Information Technology (the supervising authority of the STMB), Li Yizhong (李毅中), would tell the media bluntly in 2010 that China’s tobacco industry had made the greatest contribution to China’s economic recovery during the global financial crisis.<sup>24</sup>

However, it has been shown that the medical expense of treating those with smoking-related illnesses had already begun to surpass the tax revenue and profits generated from the tobacco industry after 2000.<sup>25</sup> What is worse, the share of medical expenditure paid by individuals is much higher than what is covered by the state so that the poor suffer the most, hardly being able to afford the necessary healthcare in today’s China. In other words, while individuals and their families are largely responsible for the cost of care for problems related to cigarette consumption, the government and enterprises benefit through tax revenues and the profits from cigarette production. Furthermore, the study conducted by Hu’s research team proves that medical expenses resulting from smoking have increased the poverty level in China.<sup>26</sup> It is no exaggeration to say that the disparity between costs and benefits where ordinary people and the government are concerned may lead to even greater economic inequality and increasing political tension in years to come.<sup>27</sup>

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<sup>23</sup> See the document issued by the General Administration of Quality Supervision, Inspection, and Quarantine, “Zhongguo yancao kungzhi kuihua (2012-2015)” (The plan for China’s tobacco control 2012-2015), [http://guoqing.china.com.cn/zwx/2013-02/25/content\\_28046824.htm](http://guoqing.china.com.cn/zwx/2013-02/25/content_28046824.htm) (accessed March 25, 2013).

<sup>24</sup> Miao Xiaojuan and Wang Cong, “Ahead of the World Expo, China acts to promote smoking controls,” *Xinhua News*, March 10, 2010, accessed March 5, 2013, [http://news.xinhuanet.com/english2010/china/2010-03/10/c\\_13205579.htm](http://news.xinhuanet.com/english2010/china/2010-03/10/c_13205579.htm).

<sup>25</sup> Tao, *Zhuanmai tizhixia*, 149-50.

<sup>26</sup> Teh-wei Hu and Zhengzhong Mao, *Zhongguo yancao kongzhi de jingji yanjiu* (Economic research on China’s tobacco control) (Beijing, China: Economic Science Press, 2008), 109.

<sup>27</sup> Cheng Li, *The Political Mapping*, 31-7.

From the case of the tobacco industry, one can see that, although the Chinese government has demonstrated that it is capable of shaping competitive circumstances in the state monopoly to make the central SOEs more powerful and influential, doing this does not alleviate the existing economic inequalities and distributive injustice and may in fact exacerbate them. The problems illustrated above, all of which may be found in the current state tobacco monopoly, do not imply that privatization would be a better option, but they are issues with which the Chinese government must contend. Otherwise, the legitimacy of state monopolies in general will have gradually been eroded.



## Appendices

### Appendix A: The Corruption Case of Chu Shijian

Chu Shijian was famous throughout China in the 1980s, not only as the first figure amongst multiple leaders under the three-in-one system in the tobacco industry, but also for being accused of corruption in 1998. His verdict caused a sensation, as he had enjoyed a great reputation as the “tobacco king” after the Yuxi Cigarette Enterprise grew into the largest Asian cigarette enterprise in the 1990s under his leadership. He was even named the entrepreneur of the year in 1990.

During his 17-year tenure, the Yuxi Cigarette Enterprise contributed at least 800 billion RMB in profits and taxes to the state. But Chu's criminal activities exposed non-plan-specific production and the resulting chaotic situation of the cigarette market in the 1980s. When Yuxi products first became popular, especially in the coastal regions, most tobacco corporations and illicit wholesalers tried to obtain more cigarettes from Yuxi by any means possible. And so, even though Yuxi already produced more cigarettes than permitted under the state plan, its well-known brands could still not meet the market demand and the market prices were much higher than the official production prices as set by the CNTC before price reform was initiated. So even though Yuxi charged more than the official prices for its products so that the surplus poured into a secret coffer—which was used in part as a private source of funds by Chu—the wholesalers could still make huge profits even when they paid in excess of the official prices.

Using personal connections, some relations of high-ranking officials in the Yunnan Province Government thus made a fortune through their involvement in the Yuxi cigarette trades. Their collusion drew the attention of the Central Commission for Discipline Inspection Commission in 1994, which in the following years collected evidence of bribes paid to Chu and his family in exchange for his consent (*pitiao* 批条) to supply Yuxi products. In 1999, Chu was sentenced to *life imprisonment*. He was released in 2002 on medical parole.

## **Appendix B: List of Interviewees**

1. Former Researcher, HT Group, Yunnan, November 6, 2008
2. Researcher, Yunnan University of Finance and Economics, November 7, 2008
3. Employee, HH Group, Yunnan, November 9, 2008
4. Government official, Yunnan Provincial Tobacco Monopoly Bureau, November 11, 2008
5. Researcher, Yunnan University, November 12, 2008
6. Counselor of Promoting New Rural Area, JC County, Yunnan, November 15, 2008
7. Government official, Yunnan Provincial Tobacco Monopoly Bureau, November 17, 2008
8. Employee, HH Group, Yunnan, November 21, 2008
9. Retired employee, HT Group, Yunnan, November 24, 2008
10. Employee, HT Group, Yunnan, November 25, 2008
11. Employee, HT Group, Yunnan, November 25, 2008
12. Government official, Yunnan Provincial Tobacco Monopoly Bureau, November 25, 2008
13. Government official, JC County, Yunnan, November 26, 2008
14. Government official, JC County, Yunnan, November 27, 2008
15. Government official, JC County, Yunnan, November 28, 2008
16. Government official, YX Municipal Tobacco Monopoly Bureau, Yunnan, November 30, 2008
17. Government official, ES County, Yunnan, December 2, 2008
18. Director of Tobacco Procurement Station, ES County, Yunnan, December 2, 2008
19. Government official, ES County, Yunnan, December 2, 2008
20. Employee, HH Group, Yunnan, December 12, 2008
21. Local Correspondent, Yunnan, December 13, 2008
22. Director of Tobacco Procurement Station, ZW County, Liaoning, May 27, 2009
23. Government official, ZW County, Liaoning, May 28, 2009
24. Government official, ZW County Tobacco Monopoly Bureau, Liaoning, May 28, 2009

25. Government official, ZW County Tobacco Monopoly Bureau, Liaoning, May 28, 2009
26. Government official, the STMB/ CNTC, Beijing, May 30, 2009
27. Government official, the STMB/ CNTC, Beijing, May 30, 2009
28. Researcher, *Yunnan* Provincial Academy of Social Sciences Institute, June 30, 2009
29. Researcher, Kunming Institute of Botany, June 30, 2009
30. Government official, YX Municipal Tobacco Monopoly Bureau, Yunnan, July 1, 2009
31. Researcher, Yunnan University, July 6, 2009
32. Government official, the STMB of Yunnan, July 7, 2009
33. Employee, ZY Cigarette Factory, Guizhou, July 15, 2009
34. Employee, ZY Cigarette Factory, Guizhou, July 15, 2009
35. Government official, ZY Municipal Tobacco Monopoly Bureau, Guizhou, July 15, 2009
36. Government official, ZY Municipal Tobacco Monopoly Bureau, Guizhou, July 15, 2009
37. Government official, MT County Tobacco Monopoly Bureau, Guizhou, July 15, 2009
38. Government official, MT County Tobacco Monopoly Bureau, Guizhou, July 16, 2009
39. Government official, MT County Tobacco Monopoly Bureau, Guizhou, July 16, 2009
40. Government official, Guizhou Provincial Tobacco Monopoly Bureau, July 19, 2009
41. Government official, Guizhou Provincial Tobacco Monopoly Bureau, July 19, 2009
42. Government official, Guizhou Provincial Tobacco Monopoly Bureau, July 19, 2009
43. Government official, Yunnan Provincial Tobacco Monopoly Bureau, August 3, 2009
44. Researcher, Anti-smoking Ngo, Yunnan, August 5, 2009
45. Researcher, Consultancy Company, Yunnan, August 5, 2009
46. Former employee, KM Cigarette Factory, Yunnan, August 10, 2009



47. Former Legal Consultant, HT Group, Yunnan, August 14, 2009
48. Tobacco Farmer, LL County, Yunnan, August 21, 2009
49. Tobacco Farmer, LL County, Yunnan, August 22, 2009
50. Tobacco Farmer, LL County, Yunnan, August 22, 2009
51. Tobacco Farmer, LL County, Yunnan, August 22, 2009
52. Tobacco Farmer, LL County, Yunnan, August 22, 2009
53. Tobacco Smuggler, LL County, Yunnan, August 22, 2009
54. Tobacco Farmer, LL County, Yunnan, August 23, 2009
55. Tobacco Farmer, LL County, Yunnan, August 23, 2009
56. Tobacco Farmer, LL County, Yunnan, August 23, 2009
57. Retired Vice-Director, HT Group, Yunnan, September 7, 2009
58. Retired Vice-Director, HT Group, Yunnan, September 8, 2009
59. Retired Vice-Director, HT Group, Yunnan, September 9, 2009
60. Government official, JC County, Yunnan, September 9, 2009
61. Employee, HT Group, Yunnan, September 10, 2009
62. Employee, HT Group, Yunnan, September 10, 2009
63. Employee, HH Group, Yunnan, September 11, 2009
64. Employee, HH Group, Yunnan, September 13, 2009
65. Employee, HH Group, Yunnan, September 13, 2009
66. Retired official, Yunnan Provincial Tobacco Monopoly Bureau, September 15, 2009
67. Former Staff, KM Cigarette Factory, Yunnan, August 10, 2009
68. Staff, HH Cigarette Factory, Yunnan, September 23, 2009
69. Staff, HH Cigarette Factory, Yunnan, September 23, 2009
70. Government official, ML City, Yunnan, September 24, 2009
71. Government official, ML Municipal Tobacco Monopoly Bureau, Yunnan, September 24, 2009
72. Government official, ML County Tobacco Monopoly Bureau, Yunnan, September 24, 2009
73. Government official, ML County Tobacco Monopoly Bureau, Yunnan, September 24, 2009
74. Government official, ML County Tobacco Monopoly Bureau, Yunnan, September 24, 2009
75. Retired researcher, Chinese Academy of Social Science, Beijing, March 4, 2010

76. Former Government official, SX Municipal Tobacco Monopoly Bureau, Zhejiang, January 10, 2011
77. Government official, SX Municipal Tobacco Monopoly Bureau, Zhejiang, January 10, 20

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## Summary

*State Monopoly, Chinese Style: A Case Study of the Tobacco Industry* examines how state and market elements have combined and engaged with one another in China's state-monopoly industry over the past three decades. While the number of private companies in China has grown substantially, state control—in the form of central state-owned enterprises (SOEs)—has not declined much in certain monopolized industries following the initiation of market-oriented reform within the economy. Although a number of other market-economy countries continued to maintain state monopolies—i.e., monopolies created, promoted, and sustained by the political authorities in various industries for the sake of public interest or greater economy of scale—with the rise of neoliberalism in the 1970s, decreasing faith in the ability of public authorities to manage these ventures has largely yielded to market ideologies and solutions, i.e. privatization. In China, however, state-monopolized industries have become more formidable, despite the country's membership in the WTO for more than a decade now. Even more confusing than their noticeable presence is how fierce the competition is within China's state-monopolized industries with regard to price, production differentiation, sales management, advertising, and so on.

Adopting a historical institutionalist approach, this study focuses on the tobacco industry as a single case study to explore why competition would happen in this state-monopoly regime from its outset and how it evolved in China. Given that competition is usually regarded as the essence of “normal” market economics and that state monopolies, seen as a form of monopoly controlled by fiat, have been criticized for eradicating competition, this paradoxical phenomenon—the coexistence of state monopoly and competition—forms a critical ingredient in any discussion on the dynamic state/market relationship in China. With their attention directed elsewhere by theoretical biases, neoliberal researchers have little studied this topic, but the insights drawn from this study illuminate not only the complexity of China's state/market relationship—there have existed many ways of organizing a state monopoly—but also the legitimacy crisis that the Chinese authorities now face.

I argue that the emergence of competition in the tobacco state monopoly resulted from a particular industrial governance pattern, which formed up incrementally and became strengthened via interactions between local governments and the local agents of China's National Tobacco Corporation (CNTC). As the institutional settings where local governments and the CNTC's local agents were

embedded changed, the governance pattern and the resulting competition type continually transformed over three distinctive phases: quasi-free competition under the two-track system (1982-1993), restrained competition under prevalent local protectionism (1994-2004), and quasi-oligopoly competition under the central-led competitive monopoly (2005-2012). The consequences of this competition in each phase then triggered regulatory changes in the tobacco state monopoly at the critical junctures where new premises for the next phase formed to generate the next governance pattern.

Tracing the development of these three phases discloses not only how local governments have already become the de facto agents for serving the CNTC but also how this circumstance has indirectly strengthened the control capacity of the monopoly, thus reinforcing and intensifying state control and the competition alike. From these dynamics, China not only avoided that familiar collusion between emerging oligopolies characteristic under the “central-led competitive monopoly” but also that dualist antithesis of state control versus competition. It was in this context that the “state monopoly, Chinese style” was formed.

## Samenvatting

*Staatsmonopolie in Chinese stijl: een gevalstudie van de tabaksindustrie* bestudeert hoe staats- en marktelementen met elkaar verbonden kwamen en op elkaar hebben ingewerkt in China's staatsmonopolistische industrie gedurende de laatste drie decennia. Hoewel het aantal privé-bedrijven in China substantieel is gegroeid, is staatscontrole – in de vorm van ondernemingen in eigendom van de centrale staat (SOE's) – niet veel afgenomen in bepaalde gemonopoliseerde industrieën na de invoering van marktgeoriënteerde hervormingen in de economie. Hoewel een aantal andere landen met een markteconomie staatsmonopolies bleef houden – d.w.z. monopolies gecreëerd, bevorderd, en ondersteund door de politieke autoriteiten in diverse industrieën ten behoeve van openbaar belang of grotere schaalvoordelen – met de opkomst van het neoliberalisme in de zeventiger jaren, heeft afnemend geloof in het vermogen van overheden om deze ondernemingen te beheren grotendeels terrein verloren aan marktideologieën en –oplossingen, d.w.z. privatisering. In China zijn staatsmonopolistische industrieën echter belangwekkender geworden, ondanks het WTO-lidmaatschap van het land gedurende inmiddels meer dan een decennium. Nog verwarrender dan hun opmerkelijke aanwezigheid is hoe krachtig de competitie is tussen China's staatsmonopolistische industrieën betreffende prijs, productiedifferentiatie, verkoopmanagement, reclame, enzovoort.

Deze studie gaat uit van een historisch-institutionalistische benadering en concentreert zich op de tabaksindustrie als een aparte gevalstudie om te onderzoeken waarom er in dit regime van staatsmonopolie vanaf het begin competitie bestond en hoe zich dit ontwikkelde in China. Gezien het feit dat competitie meestal wordt opgevat als de essentie van “normale” markteconomieën en dat staatsmonopolies, beschouwd als een vorm van monopolie gecontroleerd bij decreet, zijn bekritiseerd als fnuikend voor competitie, vormt dit paradoxale verschijnsel – het tegelijkertijd bestaan van staatsmonopolie en competitie – een cruciaal bestanddeel in elke discussie over de dynamiek staat/markt in China. Met hun aandacht elders gericht door theoretische vooringenomenheden hebben neoliberale onderzoekers dit onderwerp weinig bestudeerd, maar de inzichten afkomstig uit deze studie werpen niet alleen licht op de complexiteit van China's staat/markt relatie – er hebben veel manieren bestaan om een staatsmonopolie te organiseren – maar ook op de legitimiteitscrisis waar de Chinese autoriteiten nu mee te maken hebben.

Ik beargumenteer dat de opkomst van competitie in het staatsmonopolie op tabak voortkwam uit een bepaald industrieel bestuurspatroon, dat incrementeel vorm kreeg en versterkt werd via interacties tussen lokale overheden en de lokale vertegenwoordigers van de Chinese Nationale Tabak Corporatie (CNTC).

Toen de institutionele omgevingen waarin lokale overheden en de lokale vertegenwoordigers van de CNTC gesitueerd waren veranderden, transformeerden het bestuurspatroon en het resulterende competitietype zich continu gedurende drie verschillende fasen: quasi-vrije competitie onder het tweesporensysteem (1982-1993), beperkte competitie onder onderheersende lokale protectie (1994-2004), en quasi-oligopolische competitie onder het centraal geleide competitieve monopolie (2005-2012). De consequenties van deze competitie in elke fase nu brachten veranderingen in regelgeving teweeg in de staatsmonopolie op tabak op de cruciale punten waar nieuwe grondslagen voor de volgende fase tot stand kwamen om het volgende beheerspatroon te genereren.

Het traceren van de ontwikkeling van deze drie fasen onthult niet alleen hoe lokale overheden al de facto vertegenwoordigers zijn geworden ten dienste van de CNTC maar ook hoe deze omstandigheid indirect de controlecapaciteit van het monopolie versterkte, en zodoende zowel staatscontrole en competitie verstevigde en intensiverde. Door deze dynamieken vermeed China niet alleen de gebruikelijke samenspanning tussen opkomende oligopolies kenmerkend onder het “centraal-geleide competitieve monopolie”, maar ook de dualistische antithese van staatscontrole versus competitie. Het was in deze context dat het “staatsmonopolie Chinese stijl” werd gevormd.

## **CURRICULUM VITAE**

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