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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.

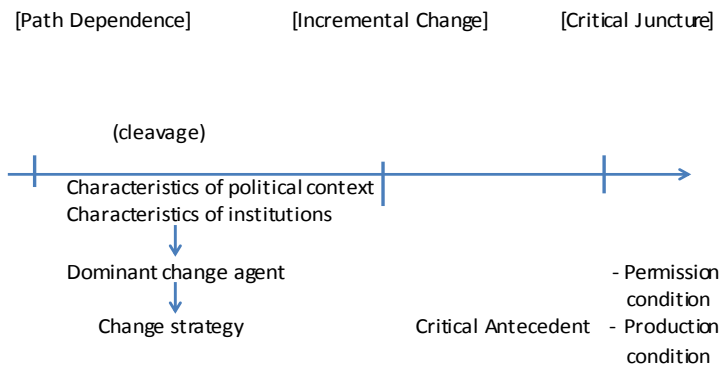
<sup>57</sup> Mahoney and Thelen, “A Theory,” 4, 8-14.

<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.

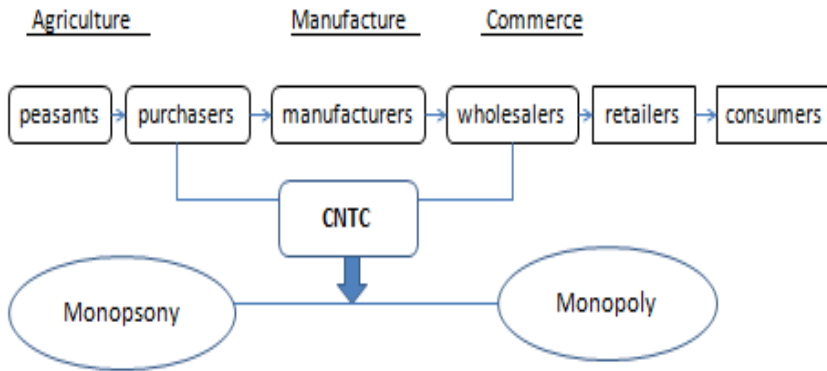
### **1.3.1 The Contrast between the Institutional Prototype and Reality**

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.