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## **State monopoly, Chinese style : a case study of the tobacco industry**

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## **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*.

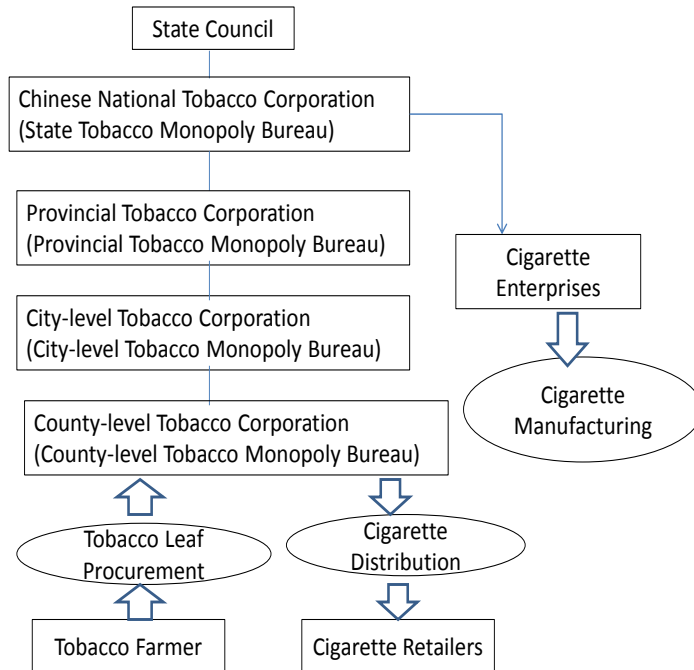
<sup>12</sup> See Articles 4 and 8 of the *Rules on the Tobacco Monopoly*.

<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



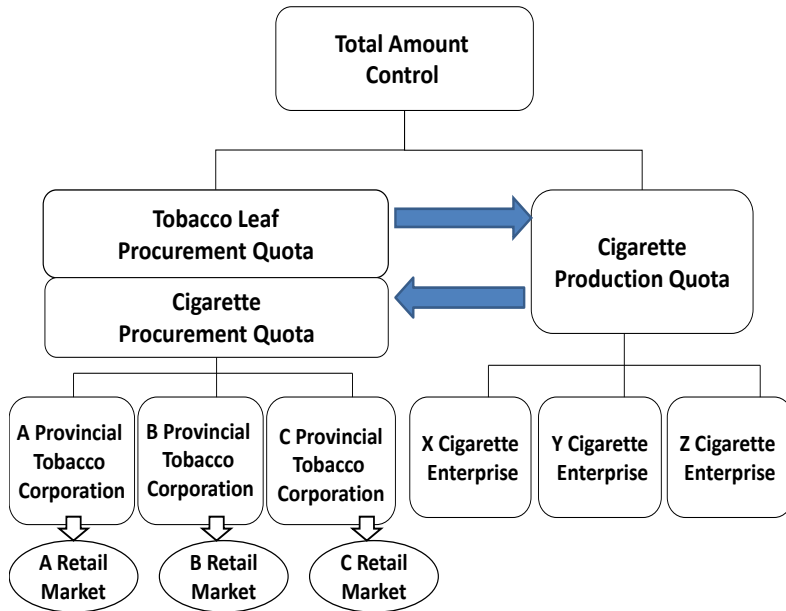
be implemented according to the set criteria. Next, the CNTC would sell the tobacco leaves to the cigarette factories according to their demand, which was based on individually assigned production quotas. The whole system was designed to match the supply of agricultural material to the demand for cigarette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

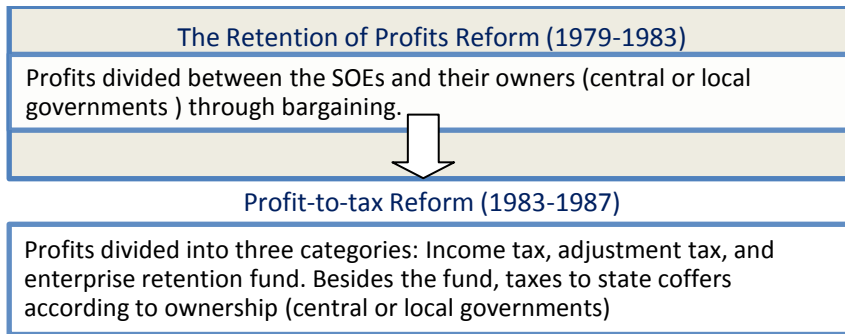
When the local governments were granted greater fiscal capacity under the fiscal decentralization reform, however, they were also required to balance their own budgets, promote local economic growth, and fulfill the tasks handed down by higher levels of government in return. An unintended consequence 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

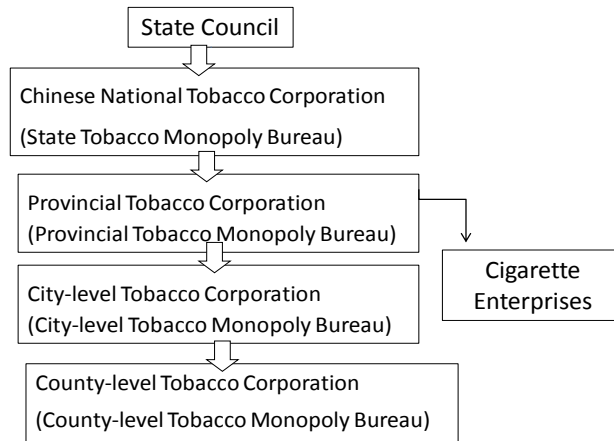
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<sup>29</sup> The Editorial Board of Hongta Group, *Hongta jintuan zhi 1956-2005* (The chronicle of the Hongta Group 1956-2005) (Kunming, China: Yunnan People’s Publishing House, 2006), CD-ROM; Interviewee No. 57.



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

<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.