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## **CHAPTER THREE**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

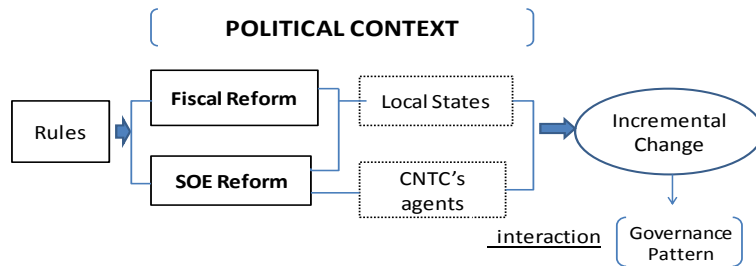
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"Federalism, Chinese Style: The Political Basis for Economic Success in China." *World Politics* 48 No. 1 (1995): 50–81; Jean C. Oi, *Rural China Takes Off*, 17-57; Jean C. Oi, "The Role of the Local States in China's Transitional Economy," *The China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

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

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

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



Source: Supplied by the author

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

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




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

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

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

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

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

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

Source: Supplied by the author

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### 3.2.2 The Reform of SOE Governance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

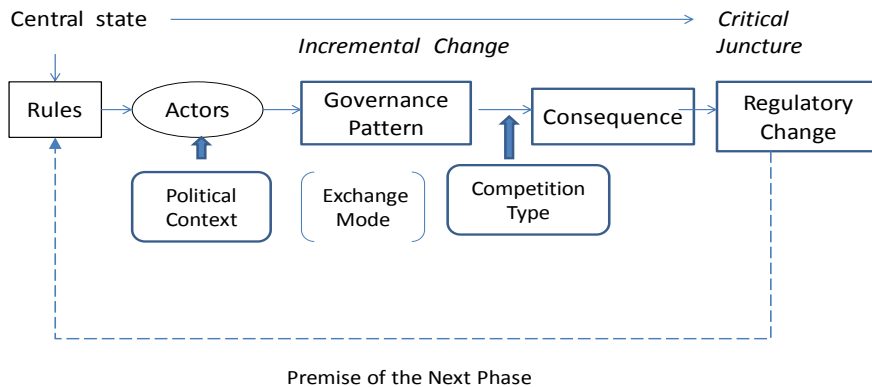
From the power-distributing perspective of historical institutionalism, in the following chapters I analyze the development of the tobacco state monopoly in each of its three phases. The analysis of each phase starts from the question: what pattern of industrial governance is configured by the interaction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

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

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

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

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

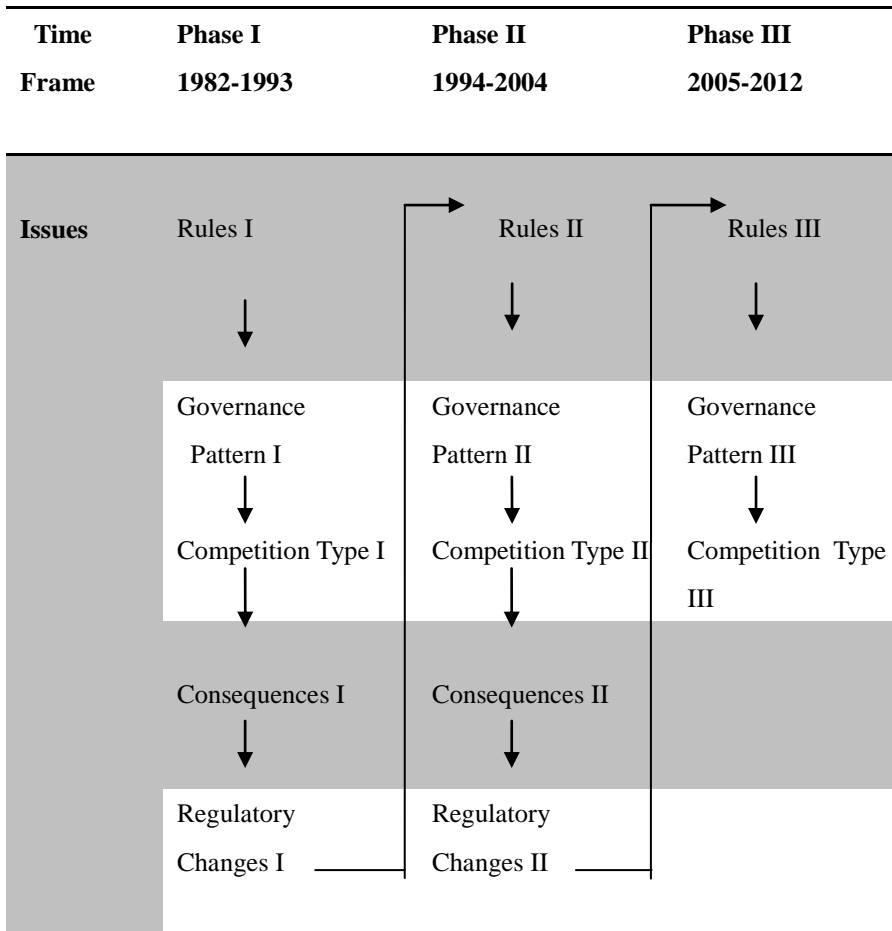


Source: Supplied by author

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

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

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



*Source:* Supplied by the author

