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

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CHAPTER FOUR

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

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

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

4.1 The Political Context: Decentralization Reforms on Two Fronts

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

4.1.1 The Profit Incentive for Local Governments

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

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

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

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

³ *Ibid.*, 1411.

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

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

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

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

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

⁶ Jin, *Yunnan sheng juanyan xiaoshou*, 102-3.

4.1.2 The Financial Incentive of the SOEs

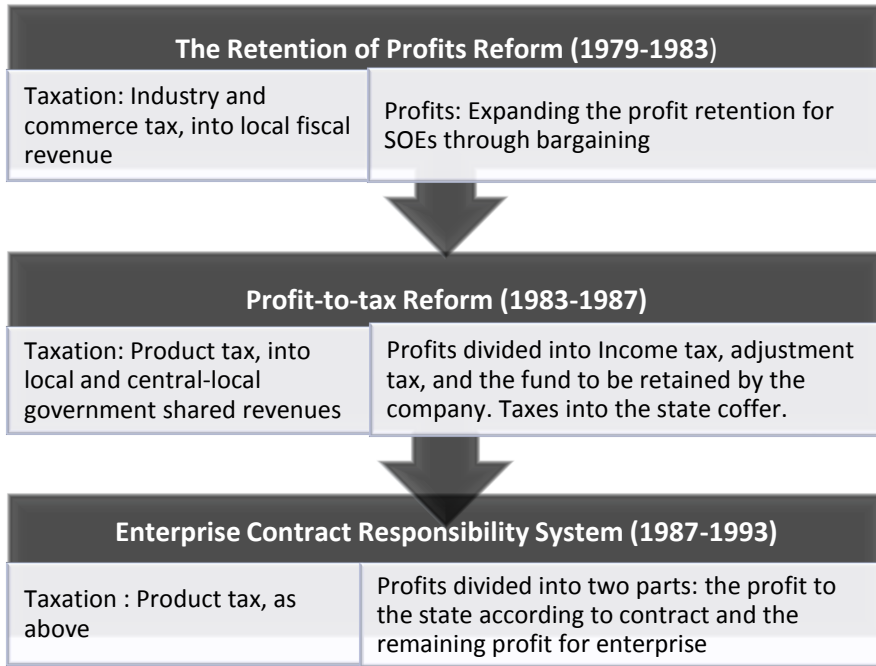
The first step of the SOE reform involved granting greater decision-making autonomy and retained higher profit-sharing to SOEs in the late 1970s. For example, the cigarette enterprises in Yunnan Province could retain 90 percent of after-tax profits before 1983.⁷ In order to prevent constant renegotiations about how profits were to be shared between the SOEs and states, the central authorities introduced a profit-to-tax reform in 1983 (see Chapter Two). Under this policy, profit was divided into three categories: income tax, adjustment tax, and the fund to be retained by the company. This meant that the cigarette firms and tobacco corporations could retain what was left after paying the two new taxes.

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

⁷ The Editorial Board of the Chronicle of Yunnan Province, *Yunnan shengzhi*, 336.

⁸ Yang, *Zhongguo yancao*, 1428.

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



Source: Summarized by the author

4.2 The Incremental Change under the Two-Track System

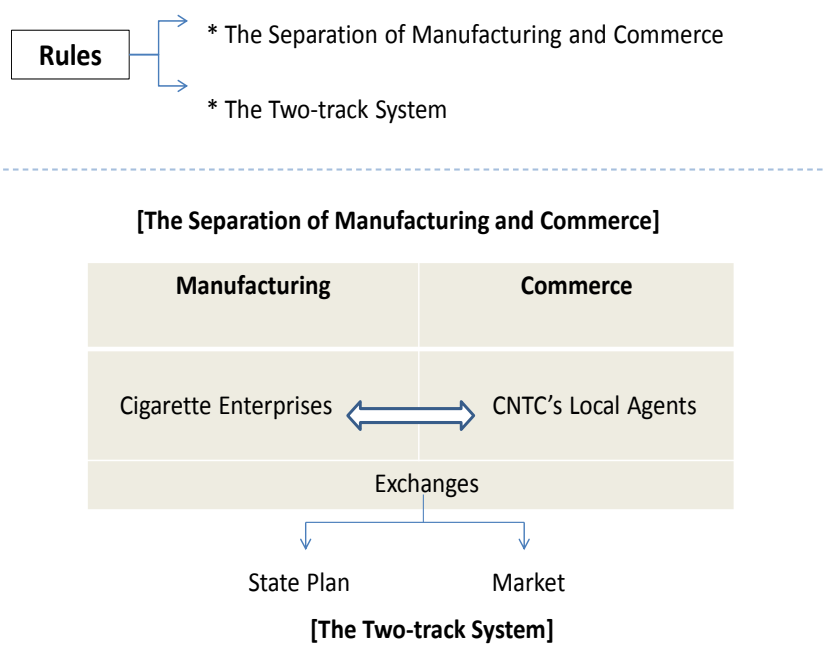
Driven by these financial incentives, discovering the means for steadily raising production became a common concern for the local governments and the CNTC's local agents in the political context of the twofold decentralization reforms. With this goal of increasing production in mind, two issues in particular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

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

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

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

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



Source: Supplied by the author

4.3 The Introduction of a Three-in-One System

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

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

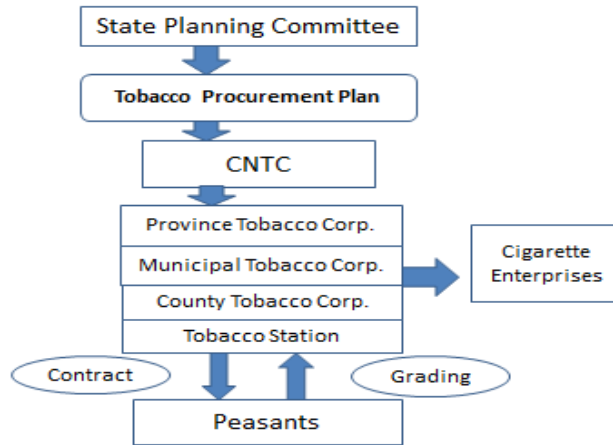
In addition to the state-planned arrangements under this tobacco monopsony, growing tobacco in excess of the state-planned quota was actually permitted and encouraged by the local governments in which the tobacco fields were located, since they would collect further product tax on tobacco leaves from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

⁹ See Articles 5 and 6 of the *Rules of Tobacco State Monopoly*.

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

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

Figure 4.3 - Institutional Arrangement of Tobacco Monopsony



Source: Supplied by the author

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

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

¹² Interviewee No. 66.

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

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

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

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

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

¹³ Wang, *State-Market Interactions*, 54.

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

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

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

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

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

¹⁵ *Ibid.*, 73-5.

Tobacco Corporation will work with the Yuxi Cigarette Enterprise.¹⁶

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

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

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

¹⁶ Wang, *State-Market Interactions*, 76.

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

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

¹⁹ Interviewee No. 66.

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

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

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

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

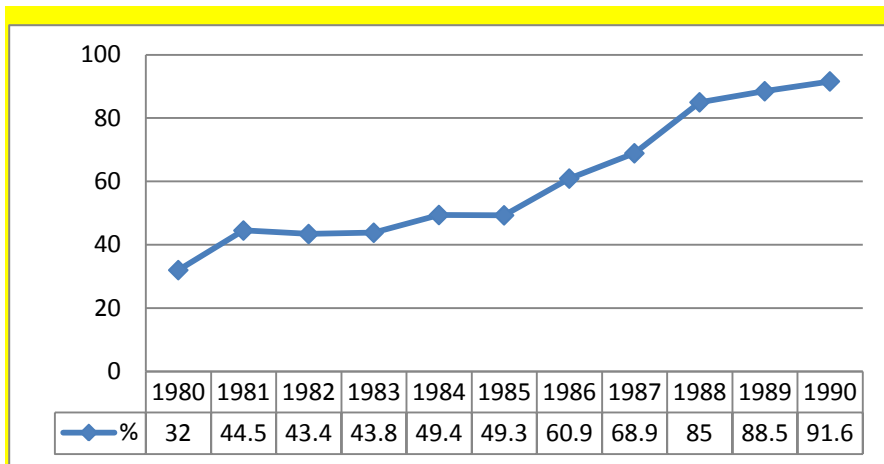
²¹ Walder, "Local Governments as Industrial Firms," 270-3; Oi, *Rural China Takes Off*.

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

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

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

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



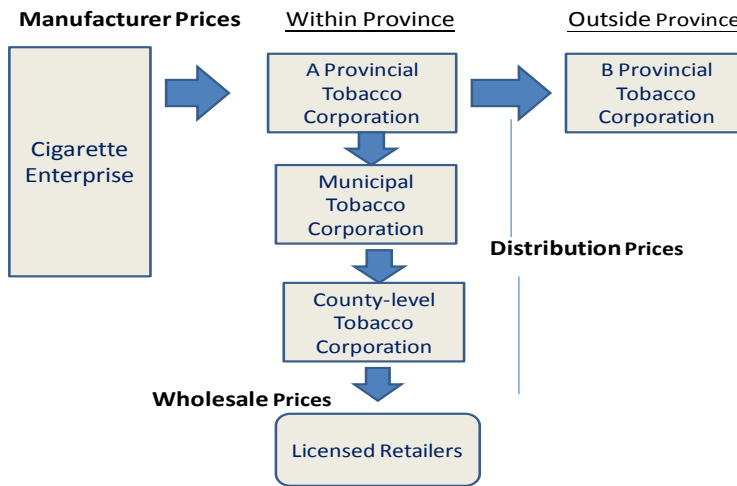
Source: Adapted from Yunnan sheng juanyan xiaoshou gongsizhi 1982–2006 (p. 258), by Jin Yibing, 2008, Kunming, China: Yunnan People's Publishing House, 2008.

4.3.1 The Prevalence of Illicit Wholesalers

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

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

Figure 4.5 - Distribution of the Plan-specific Cigarettes



Source: Supplied by the author

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

²⁴ Jin, *Yunnan sheng juanyan xiaoshou*, 78, 114.

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

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

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

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

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

²⁶ Tao, *Zhuanmai tizhi*, 226.

²⁷ Interviewee No. 76.

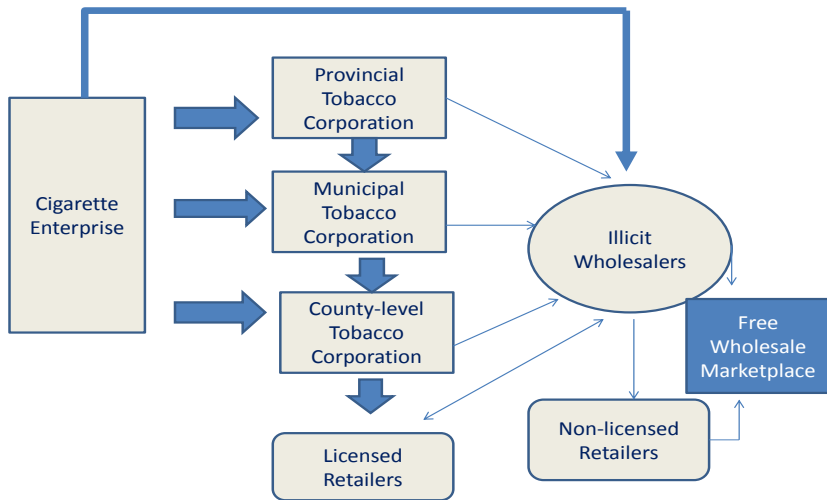
²⁸ The “free” wholesale market was translated from Chinese literally.

CNTC but protected by local governments. In fact, many local governments were active participants in creating free wholesale cigarette marketplace.²⁹ By establishing these wholesale marketplaces, the local governments not only profited from charging rents and service fees but also could facilitate the distribution of local cigarette products. These “illegal” wholesale marketplaces, which had not obtained permission from the CNTC, mushroomed in 1980s and in the following years rapidly spread across the country (see Figure 4.6). Their existence further contributed to the growth of illicit wholesalers. According to the survey conducted by the STMB, there were 264 illegal wholesale cigarette marketplaces in China by 1992.³⁰

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

³⁰ Tan, “Zhuanmai,” *China Tobacco*.

Figure 4.6 Distribution of Non-Plan-Specific Cigarettes



Source: Supplied by the author

4.3.2 The Expanding Market under the Two-Track System

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

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

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

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

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

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

³¹ Li, “Shiying shichang,” *China Tobacco*.

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

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

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

4.4 The Consequences under the Pattern of Governance

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

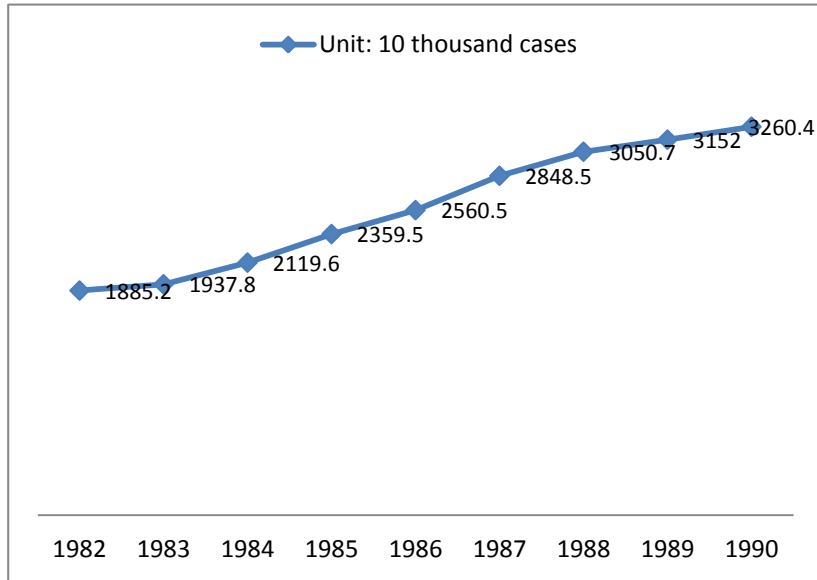
³⁴ Mahoney and Thelen, "A Theory of Gradual Institutional Change," 16-7.

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

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

³⁷ Yang, *Zhongguo yancao*, 1446-7.

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



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

4.4.1 Conflicts with the Non-State Actors

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

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

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

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

³⁸ Yang, *Zhongguo yancao*, 676.

³⁹ *Ibid.*, 672.

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

⁴¹ Yang, *Zhongguo yancao*, 674-5.

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

4.4.2 The Termination of the Two-Track Pricing System

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

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

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

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

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

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

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

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

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

4.5 The Regulatory Change of the Tobacco State Monopoly System

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

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

⁴⁷ Wedeman, *From Mao to Market*, 21-2.

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

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

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

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

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

⁴⁹ Interviewee No. 75.

⁵⁰ Yu, “gaige fazhan.”

⁵¹ Wang, *State-Market Interactions*, 15.

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

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

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

4.6 Conclusion

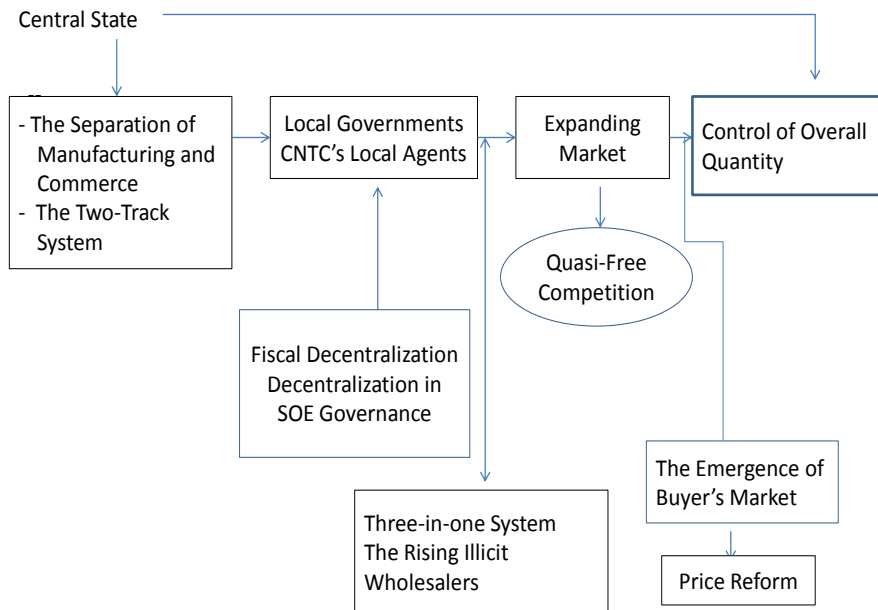
My analysis of this phase first examines how the market expanded through cooperation between local states and the CNTC's local agents in the 1980s. As the market dynamic changed, however, tension between formal and informal actors—i.e., the CNTC's agents and illicit wholesalers, respectively—as well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

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

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

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

Figure 4.8 Summary of Institutional Change Process in the First Phase



Source: Summarized by the author

