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CHAPTER FIVE

PHASE 2 - THE PREVALENCE OF LOCAL PROTECTIONISM

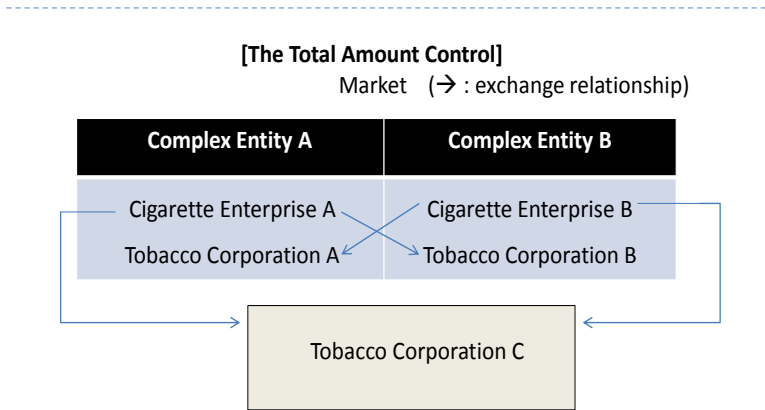
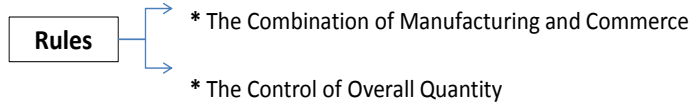
When the *Tobacco Monopoly Law* was promulgated in 1992, it created a legal foundation to formally implement the control of overall quantity in the tobacco state monopoly. Coupled with the earlier change, the rules of the game at the starting point for this second phase exhibited two factors: a combination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

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

5.1 The Political Context in the Second Phase

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

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



Source: Summarized by the author

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

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

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

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

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

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

Table 5.2 Sales Tax Rates on Cigarette Products

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

¹ Yang, *Zhongguo yancao tongzhi*, 1416-7.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

5.1.2 Cigarette Manufacturers under SOE Reform

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

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

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

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

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

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

consequently became legal entities. The Yuxi Cigarette Enterprise, for instance, was restructured into the Yuxi-Hongta Tobacco (Group) Corporation in 1995.¹⁰ Despite this, no clear relationship existed with respect to assets between the cigarette companies and their “superiors” within the CNTC regime. Moreover, once profit-sharing was suspended under the tax-sharing system, the original subcontracts pertaining to the financial duties of the entities at different levels were accordingly annulled. As a result, while each cigarette company could in principal control their own budgets and enjoy autonomy in terms of actual operations by keeping their own separate legal status, the parent-subsidiary corporate structure had yet to be created within the CNTC. Under this circumstance, the decentralized form of governance remained with the CNTC.¹¹

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

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

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

¹² Tao, *Zhuanmai tizhixia*, 200-5.

¹³ Zhou, “Fiscal Decentralization,” 114-33.

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

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

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

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

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

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

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

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

5.2 The Surge in Local Protectionism

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

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

¹⁴ Lo, “Zhongguo yancao chanye.”

5.2.1 The Means of Local Protectionism

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

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

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

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

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

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

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

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

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

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

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

5.2.2 The Failure of the Quota Trade Program

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

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

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

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

¹⁹ Lin, *Between Politics and Markets*, 122-50.

²⁰ Liu, *Jingji zhuangui*, 145, Yang, *Zhongguo yancao tongzhi*, 453.

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

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

5.2.3 The Emergence of “Victims”

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

²¹ Zhou, “Fiscal Decentralization,” 114-33.

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

²³ Lo, “Zhongguo yancao chanye.”

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

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

*Unit: 10 thousand cases

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

In the above case, cigarette enterprises in Yunnan, including the largest—the Yuxi-Hongta Tobacco Corporation—faced a dire situation. Even the high-class brand of cigarettes *Hongtashan* manufactured by Yuxi-Hongta, which had been extremely popular in China throughout the 1980s, were unable to sustain their sales figures in late 1990s. Consequently, the quantity of *Hongtashan* sold in 2000 was down 40 percent from 1996, while the taxes and profits generated by Yuxi-Hongta fell by approximately 70 percent during the same period.²⁴ This predicament resulted in the STMB launching a public campaign to “promote *Hongtashan*, protect the tobacco industry” in 1999.²⁵ The STMB continued to issue regulations prohibiting local protectionism, but the trade barriers erected were not significantly removed until after the SOE governance centralization reform was set into motion in 2005.²⁶

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

²⁵ Huang Fengling, “Shankao renweifeng,” 82-3.

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

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

(accessed August 30, 2013).

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

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

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

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

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

5.3 The Consequences of Local Protectionism

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

5.3.1 The Exchange of Investment for Market Shares

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

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

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

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

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

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

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

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

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

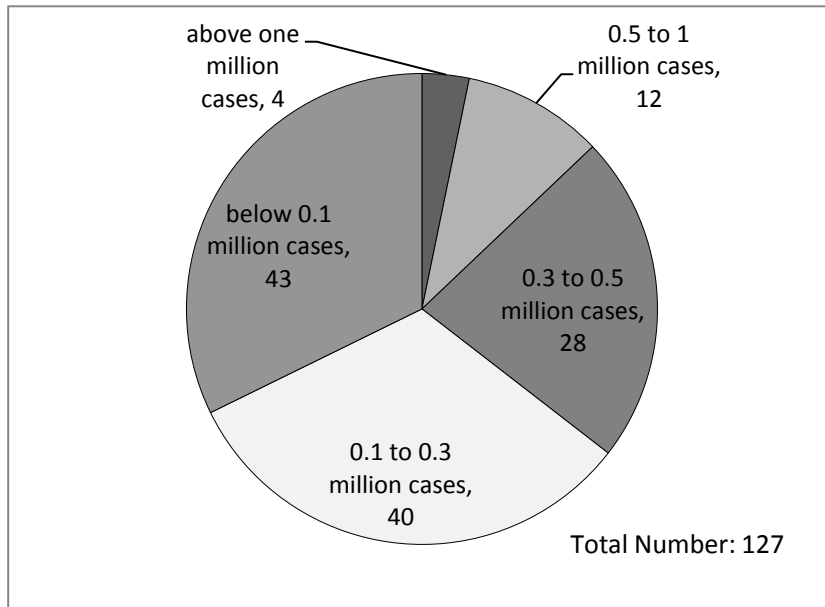
³¹ Zhang Xiaole, “Erjin maibu cong tong yue-yuxi hongta changchu yanchang gaige fazhan jishi” (Making great strides from a new beginning—the report of Yuxi Changchu Cigarette Enterprise reform), *China Tobacco*, September 1, 2000, accessed December 20, 2012, <http://www.echinatobacco.com/101588/102220/102333/102362/32641.html>;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

³² Interviewee No. 10.

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

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

Figure 5.2 - Distribution of Production Figures across all Cigarette Enterprises



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

³⁴ Interviewee No. 11.

Table 5.7 The Market Concentration of Cigarette Companies (%)

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

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

5.3.2 Investment Diversification in Non-Tobacco Business

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

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

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

³⁵ Nolan, *China and the Global Economy*, 89-91.

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

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

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

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

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

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

³⁶ Lo, "Zhongguo yancao chanye."

³⁷ Ibid.

³⁸ Ibid.

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

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

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

5.4 Production Conditions for Regulatory Change to the State

³⁹ Ibid.

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

Tobacco Monopoly

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

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

5.4.1 Intra-Province Mergers without Substance

Led by the policy of “grasping the large,” the central authorities viewed the establishment of a “group” (*jítuan* 集团) as the principal method for forging large SOEs in the 1990s; the tobacco industry would be no exception. In fact, the STMB had already started promoting the creation of conglomerates in the tobacco industry after the publication of *the Opinions on Establishing Trial Tobacco Groups* in 1993.⁴¹ Several tobacco groups were established in the following years; Shandong and Henan provinces, for instance, entered the first round and established two groups. But the main intent behind creating tobacco groups in the provinces was to rescue a number of local cigarette enterprises from the brink of bankruptcy. To tie a strong, core enterprise with several weaker companies in one group became the most

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

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

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

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

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

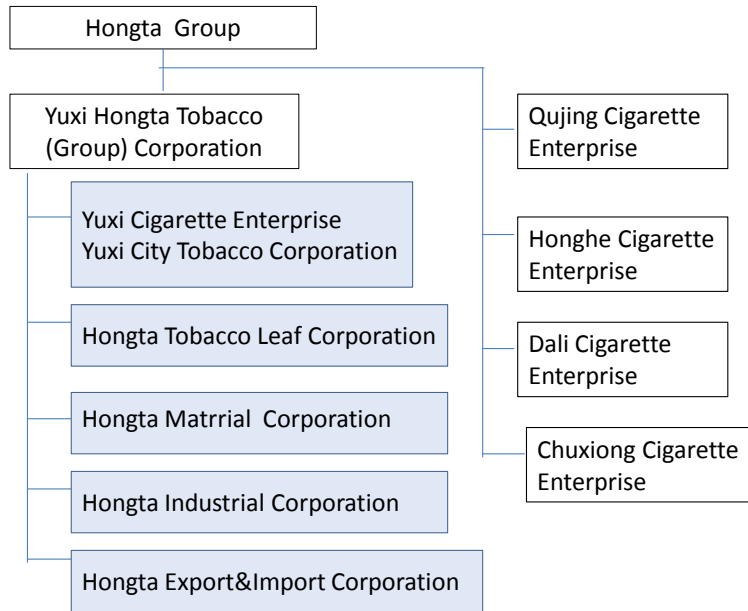
⁴³ Hsin-Hsien Wang, “Zhongguo dalu guoqi gaige de ‘zuzhi hanjie’ – ‘wujiang’ sichou gufen youxian gongsi chouzu zhi fenxi” (SOE reform in China: An analysis of the establishment of Wujiang Silk Ltd.), *Mainland China Studies* 43 No. 12 (2000): 49-58; Sun, “Is the State-Led Industrial Restructuring Effective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

⁴⁴ Wang, *State-market interactions*, 110.

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

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

Figure 5.3 Structure of the Hongta Group in 1995



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

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

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

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

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

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

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

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

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

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

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

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

⁴⁹ The Collection of RJ Reynolds, "China."

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

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

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

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

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

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

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

⁵² The Collection of RJ Reynolds, “China.”

⁵³ Lee, Gilmore, and Collin, “Breaking and Re-entering,” 91.

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

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

This analysis readily accounts for China's stance on the tobacco industry in the WTO agreement. While China was strongly committed to securing WTO membership, its tobacco industry still provided over seven percent of the national fiscal revenue. The tobacco industry constituted one of the largest fiscal contributors of all the industries in China, even though its growth was frustrated by the prevalent local protectionism. Given the fiscal significance of the industry, the Chinese government elected to retain its state monopoly and guard the domestic market while also agreeing to liberalize some aspects of it as a concession. Consequently, under the WTO terms for tobacco, China had to: reduce the import tariff on tobacco leaves from 28 percent in 2001 to 10 percent by 2004; reduce the cigarette tariffs from 49 percent in 2001 to 25 percent by 2004; scrap the export rebate for flue-cured tobacco leaves and cigarettes; scrap the bonus awarded for exporting cigarettes; scrap the "Special Tobacco Retail Sale Permit" by 2003; and scrap the import quota imposed on foreign cigarettes by 2005.⁵⁶

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

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

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

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

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

5.4.3 The Separation of Manufacturing and Commerce

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

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

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

⁵⁹ Physicians for a Smoke-Free Canada, “The Global Tobacco Economy,” accessed December 20, 2011, http://www.smoke-free.ca/pdf_1/GlobalTobaccoEconomy-2009.pdf.

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

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

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

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

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

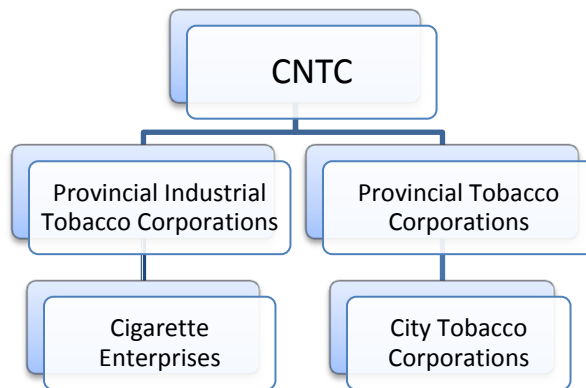
The underlying logic in separating the two wings of manufacturing and commerce was to sever the bonds between local tobacco corporations and local cigarette manufacturers so that the former could purchase more nonlocal cigarette products and thus benefit its own survival. The combination of manufacturing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

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

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

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

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



Source: Supplied by the author

5.5 Conclusion

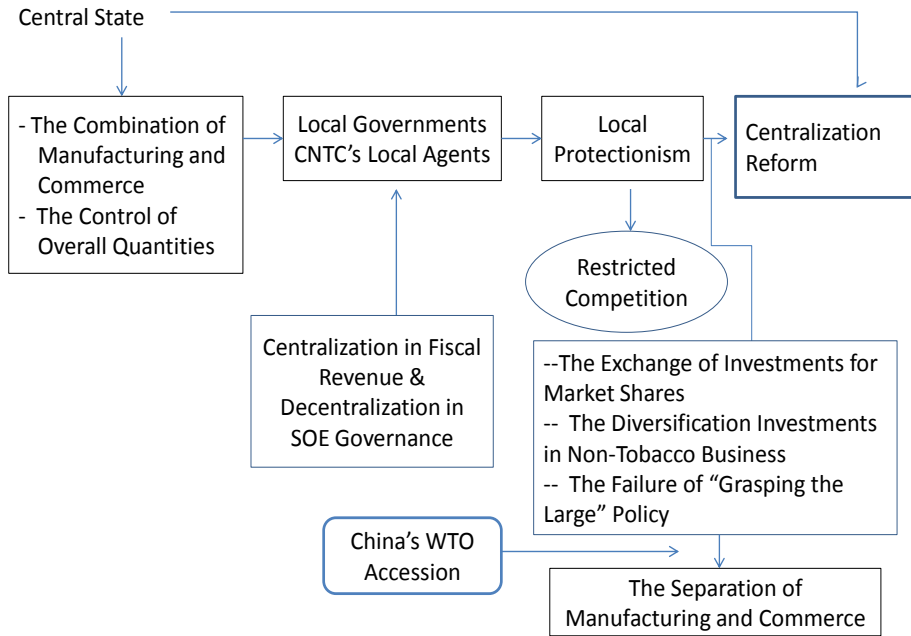
Once the “market” replaced the two-track system in the tobacco sector at the beginning of this phase, interactions between local governments and cigarette manufacturers incrementally fragmented the domestic market through the manipulations by local cigarette wholesalers. This method of interaction was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

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

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

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

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



Source: Summarized by the author

