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

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CHAPTER SIX

PHASE 3 - THE RISE OF THE CENTRAL-LED COMPETITIVE MONOPOLY

Generally speaking, the state-market interaction in the previous phase was much more complicated than as described in Wang's tobacco study. Although she pointed out that some local governments belonging to the "importing" camp could function, albeit in a protective manner, as a helping hand for local cigarette manufacturers by pressuring local cigarette wholesalers, she overlooked that other "exporting" local governments that would not gain more benefits from the tobacco business could turn to meddling in cigarette companies' diversified undertakings. In reality, these were two sides of the same coin under the local protectionism, and neither was conducive to forging large cigarette SOEs. In the face of China's accession to the WTO, then, the central authorities were eager to build national teams in strategic industries. They therefore set out to transform the CNTC's governing framework from a decentralized to a centralized one by introducing the corporatization reform in 2005, which further removed the trade barriers under local protectionism.

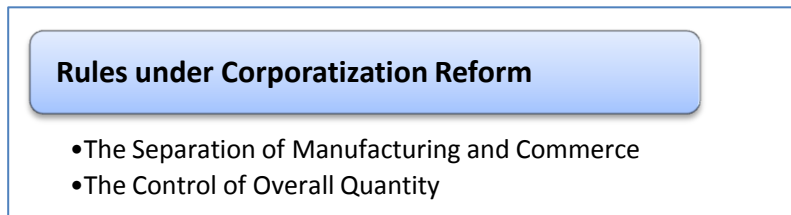
In this chapter, I first elaborate the specifics of this centralized governance in the CNTC, which constituted the new foundation for the rules of the game—i.e., the separation of manufacturing and commerce, and the control of overall quantity—during this phase (2005-2012)(see Figure 6.1.). Further, I analyze the industrial policy adopted by the STMB under this new, centralized regulatory framework intended to forge the large cigarette SOEs. Last, I describe how interactions between local governments and the CNTC's local agents under these new institutional arrangements illuminate how "central-led competitive monopoly" and the resulting "quasi-oligopoly competition" would emerge, as now seen in China.

6.1 The Centralized Regulatory Framework of the CNTC

This phase is contextualized by the combination of the previous recentralization of fiscal revenue reforms and the SOE governance recentralization reforms after 2005 (as discussed in Chapter Three). As the former, embodied in the

tax-sharing system, continued into this phase, the latter embodied a centralized governance framework within the CNTC under the term “corporatization.” As Oi points out, rather than putting firms at the center of analysis in corporate restructuring, the state often played an explicit and determining role in the restructuring of SOEs in China.¹ The introduction of the corporatization reform of the CNTC verifies this argument.

Figure 6.1 - Primary Rules of the Tobacco State Monopoly in the Third Phase



Source: Supplied by the author

6.1.1 The Process of Corporatization

According to the original institutional design, the leverage of local governments in the tobacco state monopoly system should have been relatively limited, but the actual situation was often different, as previous chapters have demonstrated. From the outset, this deviation was derived from the establishment process, through which the CNTC had little choice but to rely on local governments to complete the infrastructure of the entire system. Under such circumstances, even though the “administrative subordination” aspect took hold in the 1980s, the CNTC was unable to control its local agents in an efficient manner. Under the low level of accountability, the CNTC’s local agents began to collude with local governments. Their interactions led in the first phase to the expansion of the market and a resulting quasi-free competition, and then moved on in the second phase to segment the domestic market and constrain the competition in the cigarette trade.

The corporatization reform initiated in this phase aimed at strengthening the CNTC’s steering capacity by clarifying asset relationships between different levels of the CNTC so that the leverage of local governments under the centralized regulatory framework could be wiped out. This asset relationship had not existed

¹ Jean C. Oi, “Politics in China’s Corporate Restructuring,” in *Going Private in China*, 16-7.

prior to the reform; a situation exposed clearly by Zhang Yuxia (张玉霞), the director of the STMB's finance division, at an interview in 2006:

The concept of 'property right' did not take shape at that time (when the CNTC was established), and only administrative management could be perceived in our minds. Compared with other industries, the administrative management was regarded as more comprehensive in this industry since it was under the framework of the state monopoly. So outsiders would see us as a unified entity, and no one could break in. However, this viewpoint could not apply to our financial situations as presented in the ledger. In other words, there was no asset connection between the CNTC and its subordinates.²

As market-oriented reform proceeded, the idea of property right was gradually constructed in China, beginning in the 1980s. Under these circumstances, the *Rules of Procedure Concerning the State Asset Transfer without Compensation* was issued by the Ministry of Finance in 1999.³ Here "the transfer without compensation" was based on the premise that all of the assets were of the same state and that the purpose of the transfer was to reset the powers of asset usage according to certain clearly-defined asset relationships.

The principle of asset transfer without compensation was applied to the restructuring of the CNTC as soon as the document the *Opinions Further Clarifying Asset Management in the Tobacco Industry and Elaborating the Tobacco Corporation Reform* was issued by the State Council in 2005.⁴ This crucial

² The complete interview can be seen in "Bixu hangshi zhege jichu" (It is necessary to consolidate this base), *China Tobacco*, April 15, 2006, accessed April 15, 2009, http://www.tobacco.gov.cn/html/14/1401/58145_n.html.

³ For more details, please see the document issued by the Ministry of Finance, "Guanyu qiye guoyou zichan banli wuchang huazhuan shouxu de guiding, no. ca- guan-zi (1999)301" (The rules of procedure concerning the state asset transfer without compensation), http://www.caac.gov.cn/dev/cws/ZCFB/200707/t20070710_6236.html (accessed March 10, 2011).

⁴ For more details, please see the document issued by the Ministry of Finance, "Caizheng bu guanyu yancao hungye guoyou zichan guanli rougan wenti de yijian, no. cai-jian (2006) 310" (Opinions about the management of state assets in the tobacco industry from the Ministry of Finance), <http://www.cntiegc.com/src/2011-10/10005556.html> (accessed March

document (known as Document No. 57 in the tobacco sector) signaled the onset of the CNTC's corporatization during the post-WTO era. According to this document, all local tobacco corporation and cigarette enterprise assets were to be turned over to the Ministry of Finance without compensation by the end of 2005, as they were all central assets that had been validated by administrative subordination during the 1980s.

This means that, although the corporatization of the CNTC was triggered by China's accession to the WTO, it did not occur in a vacuum. After the transfer, the Ministry of Finance allocated all of these assets to the CNTC. As the sole stockholder, the CNTC handed over its net assets to all of the provincial tobacco corporations and tobacco industrial corporations as long-term investments. These provincial-level corporations subsequently invested in their city corporations and local cigarette enterprises. Through this rearrangement of all of the assets, a new type of parent-subsidary corporate structure was thus institutionalized throughout the entire tobacco sector. Following on the context of dividing manufacturing and commerce, three levels of parent-subsidary relationship—the CNTC, the provincial industrial tobacco corporations/provincial tobacco corporations, and the cigarette enterprises/city tobacco corporations—were set up in the manufacturing and commercial divisions separately. Thus, while the CNTC's local agents had already adopted a “corporate form” as legal entities previously, they were formally turned into “subsidiaries” and incorporated into the corporate framework of the CNTC in this phase.⁵

11, 2011).

⁵ Tobacco China Online, “57hao wenjian: Yanco qiyetizhi gaige fengxiang biao” (No. 57 document: the reform signal of tobacco SOEs), accessed July 19, 2010, http://www.tobaccochina.com/zt/chanquan/jiedu_02.html; Tobacco China, “Kengqiang zuyin-hungye wunian gaige yu fazhang lichen” (The sonorous voice of footsteps—the five-year process of reform and development in this industry), accessed September 19, 2011, http://www.tobaccochina.com/news/analysis/wu/20083/200831383548_293020.shtml; Tobacco Market, “lishun chanquan: Yunnan gongye maichu gaige guanjian bufā” (Clarifying the property right: Yunnan tobacco industry making the crucial stride), accessed March 25, 2009, <http://www.etmoc.com/look/looklist.asp?id=4599>; Interviewee No. 26.

6.1.2 The New Division of Labor within the CNTC

It was not just asset relationships that underwent great changes with corporatization reform: the division of labor within the CNTC itself also experienced reorganization. Prior to this, each level of the tobacco corporations, from the central authority down to the county level, was able to take part in the wholesale business where tobacco products were concerned, while the division of labor among them remained not clearly regulated. One informant who used to work at the Guizhou Province Tobacco Corporation explained the situation of the cigarette trade before the corporatization reform took effect:

Tobacco corporations of all levels were able to conduct cigarette wholesale business in the past. For example, the provincial corporations would sell the cigarettes they purchased to the city and county corporations. But the county corporations could also buy cigarettes from cigarette manufacturers directly... It was no problem for the county corporations to procure cigarettes from the local manufacturers as well... So the province and city corporations would even charge their subordinates [county corporations] 'administrative fees,' sometimes in order to increase their revenues...⁶

The situation described above was altered by the new division of labor following corporatization. First, the independent legal personality of the county corporations was annulled under the new corporate structure: the county corporations were thus restructured as branches of city tobacco corporations. In particular, they became responsible for executing the tasks assigned by their superiors, e.g., city corporations. Second, city corporations became the only entities qualified to operate the wholesale business for tobacco products under the supervision of provincial corporations. Third, in addition to supervising the wholesale business of the city corporations, the provincial corporations had to formulate the general guidelines for cigarette procurement. Finally, the CNTC assumed an investor's responsibilities in maintaining and raising the value for all assets. In other words, under this new division of labor, all wholesale activities were concentrated with the municipal-level agents of the CNTC, and the province- and

⁶ Interviewee No. 40.

county-level agents quit from the wholesale business altogether. As a result, the number of cigarette wholesalers was dramatically reduced, and those who remained became more able to monopolize local markets under this highly organized governance framework.

6.1.3 Uprooting the Leverage of Local Governments

Similar to the role which the SASAC played in other industries, the CNTC on behalf of the state assumed the task of preserving and increasing the asset value of the entire sector after the corporatization reform. However, different other central SOEs under the SASAC's management, the CNTC has held the form of a government-business synthesis, i.e. the CNTC-STMB combined entity, so that it has remained its own regulatory regime under the leadership of the Minister of Industry and Information Technology⁷ rather than being incorporated into the authority of the SASAC. Thus, the CNTC began to centralize its corporate governance on the basis of asset relationships, while personnel appointments for its subsidiaries were placed in its hands rather than being handled by local governments as had previously been the case. Those deciding on personnel assignments only needed to inform local governments of their decisions—according to the new structure, so no permission or approval whatsoever was required for their actions.⁸ The initiation of corporatization reform, then, terminated local governments' right to appoint personnel, which removed a powerful leverage point they had used to manipulate local wholesalers.

In addition, the cigarette manufacturers' autonomy was further regulated under the parent-subsidary corporate framework of the CNTC, with the result that local governments became more constrained to a certain degree in the ability to intervene into tobacco industry operations. In accordance with the *Trial Rules for Managing the CNTC's Assets* issued in 2006, each subsidiary's autonomy to dispose of corporate assets became relatively limited.⁹ For example, the Hongta Group was

⁷ The CNTC/STMB has been under the leadership of the Minister of Industry and Information Technology since 2008; before that, it was supervised by the State Economic and Trade Commission (SETC) from 2003.

⁸ Interviewee No. 4; Interviewee No. 27.

⁹ For more information, please see the document issued by the STMB, "Guojia yancao zhuanmai ju guanyu yinfa 'zhongguo yancao zonggongsi guoyou zichan guanli guiding(shihing)' de tongzhi" (The trial rules for managing the CNTC's assets), http://yingtan.gov.cn/bmgkxx/syczmj/fgwj/fg/200804/t20080429_2352.htm (accessed May

now obligated to get permission from the CNTC if it wanted to invest more than five million RMB in businesses not related to the tobacco industry.¹⁰ The CNTC therefore made it more difficult for local governments to ask the Hongta Group for help in investing large amounts of capital locally in other non-tobacco concerns; something they had easily done before.

In addition, “target management” along the vertical line of authority was set in motion within the CNTC. Under this, a range of indices were formulated by the parent corporation, i.e., the CNTC, to evaluate the performance of its subsidiaries, and the results of this evaluation would determine rewards and penalties, if any, that the leading cadres of the subsidiaries would receive. This set of targets helped the CNTC to direct the operations of its subsidiaries level by level (see the example in Table 6.1).

This target management turned out to be an effective control method under the new corporate framework. It, along with the new division of labor, were vividly described by an interviewee who worked at a county tobacco corporation in Guizhou Province:

Our county corporation was very rich before the legal personality was annulled. Unlike many county corporations elsewhere, we did not need to get loans for purchasing cigarettes. Since the annulment, we are currently just the executive department [of the city tobacco corporations]... All financial expenditure is regulated by the city corporation, and we cannot even decide which brands of cigarettes to sell either. What we can do is just sell the cigarettes which the city corporation ordered, and we are responsible for executing the annual sales plan made by the city corporation. Then the city corporation evaluates our work performance according to a number of targets including the sales volume. If we cannot sell all of the cigarettes they ordered, our salaries will be deducted accordingly... do you think this is fair?¹¹

In this new division of labor, if one focuses only on the operation of county tobacco corporations, it indeed looks like the return of a planned-economy model.

20, 2011).

¹⁰ Interviewee No. 11.

¹¹ Interviewee No. 38.

However, this division occurs within the context of corporatization reform, whereby county tobacco corporations act as a branch of the city tobacco corporations, which are the main actors conducting procurements in the market. Through this division of labor and the accompanying target management, the CNTC became more capable of constraining the protectionist behaviors of its local agents under the new parent-subsidiary corporate framework.

In Wedeman’s study, he argued that the practices of local protectionism would gradually disappear with the deepening of the market economy in China, since local governments would realize that no one could truly benefit by the mutual trade barriers.¹² However, in analyzing the development of the tobacco industry, it is clear that market forces did not automatically make local protectionism go away. On the contrary, local protectionism was constrained by the corporatization reform, which was introduced by the central authorities to strengthen the controlling capacity of the CNTC after China’s WTO accession. Corporatization in this context was more akin to a shortcut to centralization of the industrial governance than a halfway house on the road to privatization.

In addition to securing the power of personnel appointment and asset management, the CNTC now had greater ability to limit local governmental interference and to implement vertical management on all fronts of the tobacco sector. Table 6.1 below shows how the evaluated targets under the new target management included not only the procurement ratio of cigarettes outside of the local province but also the profit ratio, measures that both further hampered the protectionist measures exercised by local governments. In this context, the fragmented domestic market began to move toward unification as the monopoly management decoupled from local practices.

Table 6.1 The Evaluated Target List of the Guizhou Province Tobacco Corporation

The Target Category	The Evaluated Target and Its Ratio	
Economic Performance (35%)	Tobacco Leaf (50%)	Product amount
		Quality
		Skill
	Cigarette	Sales amount
		The procurement ratio of the top

¹² Wedeman, *From Mao to Market*, 215.

	(50%)	30 brands
		The procurement ratio of cigarettes outside the local province
Management Capacity of State Assets (35%)	The fiscal contribution	
	The capital maintenance and appreciation ratio	
	The profit ratio	
	The ratio of turnover on current assets	
Innovation Capacity (15%)		
Comprehensive Management (15%)		

Source: Provided by Interviewee

6.2 Making Big Brands as an Industrial Policy

In addition to establishing a parent-subsidiary corporate framework for the CNTC, the STMB in this phase began to formulate an industrial policy for forging giant cigarette SOEs. Although the barriers to trade were significantly reduced and the trade market was unified following corporatization, by no means were the central authorities suddenly to abandon the existing practice of quota assignments. In fact, maintenance of the quota allocation in cigarette production proved to be a way of attending to the local governments' vested fiscal interests as the corporatization reform came into being since the quota figures were directly related to local fiscal incomes. Under this premise, "the making of big brands" turned out to be the main industrial policy employed by the STMB to stimulate competition among the existing cigarette manufacturers and thus cause large cigarette conglomerations to come into existence. Therefore, rather than breaking the existing quota allocation directly, several measures were used by the STMB to shape the big brands. These will be discussed in the following section.

6.2.1 The Catalog of the Top 100 Brands

In 2004—before the corporatization reform came into effect—the STMB had already undertaken administrative measures to create a range of potential big brands by issuing a "Catalog of the Top 100 Brands." Given that the international tobacco industry's strategies were intimately linked with the idea of global big brands and

that there existed more than five hundred cigarette brands in China in 2003,¹³ a goal of the Top 100 catalog was to limit the number of brands on the market to just one hundred, with any of the others not listed being forced to stop production within three years in 2007.¹⁴ This type of catalog management had been used as well for setting entry barriers to China's auto industry in 1989, such that only those enterprises listed in the catalog were allowed to produce cars.¹⁵ Unlike the appearance of this earlier catalog, however, the new tobacco industry catalog arose as a result of the STMB's belief that it would provide an efficient way to produce the aggregate brands. Although at core an administrative measure, the STMB took each brand's growth potential into consideration when picking the winners for the catalog. In other words, the Top 100 catalog aimed to identify those brands that were perceived to have a competitive advantage and thus a greater potential in market. The STMB ultimately included 121 brands in the catalog.¹⁶

Motivated by the Top 100, cigarette manufacturers began to concentrate their resources to make only the cigarette brands that appeared in this catalog. As a result, more quotas were released and then used in manufacturing the brands in the catalog. However, none of this guaranteed that the Top 100 brands would survive in the market. Rather, the catalog broke new ground for another round of competition among cigarette manufacturers.¹⁷

¹³ Derek Yach and Douglas Bettcher, "Globalization of Tobacco Marketing, Research, and Industry Influence," accessed March 15, 2011, <http://legacy.library.ucsf.edu/tid/hjh23a99/pdf;jsessionid=82BFC555B552037F46645D5B89AABCBC.tobacco03>.

¹⁴ The catalog here only included high- and middle-class cigarettes. Low-class cigarette brands were not regulated by it.

¹⁵ Yilin Chen, "Xunzu moshi de bianhua yu zhongguo zizhu pinpai qiche qiye de xingqi" (The transformation of the rent-seeking mode and the rising of independent brands in the Chinese auto industry), in *Xunzu yu zhongguo changye fazhan*, 142-3.

¹⁶ See the document issued by the STMB, "Juanyan chanpin baipaihao mulu, no. guo-yan-yun (2004) 542" (The catalog of Top 100 cigarette brands), <http://law.lawtime.cn/d371899376993.html> (accessed April 20, 2012).

¹⁷ Tobacco China, "Shishi baipaihao zhanlue, tishen zhongguo yancao zhengti jingzhen shili" (Implementing the strategy of top 100 brands, improving the competition of China's tobacco industry), accessed April 10, 2009, http://www.tobacco.gov.cn/html/14/1401/57204_n.html.

6.2.2 The Catalog of 20 plus 10

On the basis of the Top 100 catalog, the STMB decided to conduct another round of selection to determine the next group of “winners” following corporatization reform. In 2008, the STMB chose the “top core brands” according to a range of indices (see Table 6.2) and listed them in another catalog: “20 plus 10” (also known as “the Top 30”).¹⁸ From Table 6.2, it can be seen that most indices had to do with the brands’ market performance, e.g., market share and growth rate.

Table 6.2 Indices for Selecting Top Core Brands

Category	Index	Sub-index
Market Growth	Market Share	Sales volume
		Sales revenue
	Market Coverage	Sales volume in non-local provinces
		Percentage of sales volume in non-local provinces vs. total sales volume
		Sales revenue in non-local provinces
		Number of non-local provinces where brand is sold
	Shelf Sales Ratio	Stock-to-sales ratio of brands at end of month
		Shelf sales ratio of brands
	Performance in International Markets	Quantity for export
Brand Development	Brand Grade	Percentage of sales volume within grade
	Brand Growth	Growth rate
		Growth rate in non-local provinces
	Brand Performance	Average profit for per case
		Realized tax amount
Brand Quality and Innovation	Product Quality	Random testing of product quality

¹⁸ They initially chose 20 brands and added 10 later, thus the name “Catalog of 20 plus 10.”

	Capacity to Guarantee Quality	Prizes and awards
		The certification of management system
	Research & Development	Innovativeness of enterprise
Enterprise Capacity	Enterprise Scale	Sales volume of enterprise
		Gross of industrial output value
	Level of Economic Benefits	Realized tax and profit

Source: Provided by Interviewee

In contrast to the Top 100 catalog, this new catalog aimed at fostering the top core brands by pouring more policy resources into their cultivation, with the provision of resources being closely associated with the corporatization reform. For example, the CNTC introduced “the procurement ratio of the top 30 brands (to the total procured volume)” as one of the major targets to be evaluated for its subsidiaries (see Table 6.1). Moreover, the procurement ratio also had to rise on an annual basis. If no improvement was shown over the course of three successive years, the chief managers not only would lose their bonuses but also would be suspended.¹⁹

Accordingly, the implementation of this target became an imperative for all of the CNTC’s subsidiaries. In other words, the corporatization reform strengthened the CNTC’s steering capacity through targeted management, which had become a vital tool for fostering the top core brands through directing the purchase behavior of all the tobacco corporations after the separation of manufacturing and commerce in the tobacco sector. In this context, both the architecture of the government-business synthesis and the newly-built structure of parent-subsidiary corporate were able to ensure the effect of catalog management in the tobacco sector, and the market shares of top 30 brands would be further expanded accordingly.²⁰

In addition, the STMB simultaneously attempted to foster the top core brands by increasing production quotas. Given that the production of each cigarette manufacturer was limited by the quotas specified, the supply of Top 30 brand

¹⁹ Interviewee No. 10.

²⁰ Li Zehua, “Jinzhua peiyu pinpai diyi yaowu, zengqiang hangye hexin jingzheng shili” (Making the creation of big brands the first priority, strengthening the competitive capacity of this industry), *China Tobacco*, December 15, 2009, accessed June 10, 2014, <http://www.echinatobacco.com/101588/101727/102002/48607.html>.

cigarettes might not fully satisfy the demand of wholesalers across the country. In this case, the STMB also promulgated a measure called “brand-oriented integration” in 2008.²¹ According to this measure, only the cigarette companies owning the top core brands were authorized to negotiate with the other cigarette manufacturers to acquire their production quotas for these brands. For those companies that did not produce the top core brands, they became willing to produce those of other cigarette manufacturers, since this was a feasible way to retain their existing quota assignments.

Although the STMB was not able to make sudden, dramatic changes in quota allocations, it could incrementally adjust the quotas according to the market dynamic. Hence, if cigarette manufacturers were unable to receive sufficient orders via the centralized order-placing meetings, they stood to lose some of their quotas in the coming year.²² In this respect, the “brand-oriented integration” measure was not only an expedient under the quota limits but also a method of resource provision for empowering the top core brands. The allocation of quotas was thus employed as a means for further motivating cigarette companies to develop big brands. Consequently, while the total number of cigarette brands declined significantly under the new regulations, the concentration ratio of cigarette brands also increased, as was to be expected. This development is shown in Table 6.3 below.

Table 6.3 Concentration Ratios of Cigarette Brands (2003–2008)

	2003	2004	2005	2006	2007	2008
Average sales volume of each brand (unit: 10 thousand cases)	3.68	6.51	9.98	10.24	14.63	20.55

²¹ Tobacco China, “Disange ‘shi’: 08 nian pinpai dingxiang zhenghe mulu” (The third ‘ten’: the joint- produced brands in 2008), http://www.tobaccochina.com/news/analysis/wu/20085/200852614712_304453.shtml (accessed March 10, 2012).

²² After the separation of the local and inter-provincial cigarette trades was done away with in 2006, all of the cigarette manufacturers traded with the city tobacco corporations, regardless of whether these were within or outside of the province. This was done via centralized online meetings to place orders every half year. The online transactions took place on the website of the Chinese Tobacco Electronic Commerce Corporation (中烟电子商务网).

CR4*	10.04%	11.59%	13.78%	15.06%	18.29%	18.53%
CR8	13.59%	18.81%	23.21%	25.69%	32.02%	33.13%
CR10	17.94%	19.3%	26.4%	31.9%	37.8%	39.55%
* CR4: The concentration ratio of the four largest cigarette brands; likewise for CR8 and CR10.						

Source: Adopted from “Zhuanmai tizhi xia juanyan pinpai buju yanjiu” (A study on the distribution of cigarette brands under the monopoly system), by Chang Yongkai, PhD diss., Tianjin University, 2009; *Zhongguo yancao nianjian* 2008 (China tobacco yearbook 2008) (p. 218), by the STMB, 2009, Beijing, China: Economic Daily Press.

After the two catalogs, the STMB continued this strategy by announcing the “235” policy guideline in 2010. According to this guideline, the STMB would be reducing the top core brands from 30 to 10—including *two* brands with a five-million-case production volume, *three* brands with three million, and *five* brands with two million—by 2015.²³ In addition, the STMB then proposed another policy guideline called “461” to supplement “235”. This new guideline was aimed at promoting twelve brands representing more than 40 billion RMB in sales revenue, six of them more than 60 billion RMB, and one of them *over 100* billion RMB—in order to emphasize the value enhancement.²⁴ The 235 and 461 guidelines meant that cigarette manufacturers as a whole would have to make substantial efforts to increase their existing brands’ competitiveness. This was, after all, the only way to keep their places in the catalog for the next round of game.

In general, this developmental trend demonstrated that the corporatization reform led to the centralized regulatory framework of the CNTC, where the making of big brands became an effective strategy for pushing the existing cigarette manufacturers to compete with each other to expand their market shares, even though the quota system remained in place. In this context, the brand catalogs

²³ These production figures were established by working from the 2008 volumes of the top five foreign brands – Marlboro (9.04 million cases), Winston (2.52 million cases), Mild Seven (1.96 million cases), Rothmans (1.8 million cases), and Pall Mall (1.41 million cases).

²⁴ Tobacco China, “2010 nian zhongguo yancao pinpai zhanlue guihua tanjou – qiwen ‘235’”(The exploration of formulating China’s cigarette brand strategy in 2010 – seven questions on ‘235’), accessed January 12, 2013, http://www.tobaccochina.com/news/analysis/wu/20102/2010221152433_396583.shtml; Shucai Wang, “‘532’, ‘461’: dapinpai shidai yijing lailin” (‘532’, ‘461’: the time of large brands is coming), *China Tobacco*, August 11, 2010, accessed February 28, 2012, http://www.tobacco.gov.cn/html/21/2105/210502/21050203/2807882_n.html.

embodied the industrial policy of picking the winners, which led to the formation of the governance pattern in this phase: “competitive monopoly led by the central government.” In the following sections, I explore further how this governance pattern was constantly strengthened through interactions between local governments and the CNTC’s local agents under their context of dual centralization.

6.3 The Transformation of Local Governments in the Tobacco Monopsony

Under the corporatization reform and the resulting strategy of making big brands, interaction between the local governments and the CNTC’s local agents also took a new turn in this stage. First, after losing their leverage in the tobacco sector, local governments, driven by fiscal pressure under the tax-sharing system, turned to facilitate the work of the CNTC’s local agents instead. In this section, I explore the operation of the tobacco monopsony—i.e., that the CNTC operated as the only purchaser of tobacco leaves—in order to illustrate how local governments became the *de facto* agents of the CNTC in this phase, with the result that these new circumstances constantly fortified the emergent, central-led competitive monopoly.

6.3.1 The Tobacco Monopsony in the Last Phase

Since China is the largest cigarette producing country in the world, it has faced a perennial problem where its national tobacco industry is concerned: how to secure a sufficient and stable supply of tobacco leaves. In light of the sizable demand for this core ingredient of cigarettes, a tobacco monopsony was introduced from the beginning into the state monopoly system as a way to guarantee domestic self-sufficiency and reduce the risk of international price fluctuation. As a consequence, even after the import tariff on tobacco leaves decreased following China’s accession to the WTO, the country continued to grow more than 40 percent of the world’s tobacco leaves in 2009, while 95 percent of its production was consumed domestically.²⁵ Notwithstanding, this industry’s operations in monopsony would also go through a shift from decentralization to centralization in this phase.

²⁵ Michael Eriksen, Judith Mackay, and Hans Ross, *The Tobacco Atlas, Fourth Edition* (New York, NY: World Lung Foundation, 2012), accessed January 22, 2013, http://tobaccoatlas.org/industry/growing_tobacco/leading_producers/.

According to the original design, the overall arrangement of the tobacco monopsony aimed to achieve a state plan; social responsiveness to local situations had a limited role to play. The actual activity of tobacco procurement, however, worked otherwise and was reflected in the “three-in-one” system of the first phase. The creation of this three-in-one system had enabled local cigarette enterprises to obtain a sufficient supply of qualified tobacco leaves by establishing their own workshops in the tobacco fields themselves. Moreover, cigarette manufacturers had encouraged the farmers to grow tobacco by offering them a range of subsidies, thus producing more tobacco than what the plan indicated.²⁶

After the *Tobacco Monopoly Law* was promulgated in 1992, strict monitoring of the total production in tobacco growing was not carried out in actual practice. The difference was mainly due to the fact that, unlike in industrial manufacturing, it was difficult to predict and control the volumes of the agricultural products produced in any precise way. Local tobacco stations would therefore conduct procurements in a relatively loose manner. The local stations usually purchased the extra tobacco leaves from farmers, a practice which was further tolerated under the pressure of local governments.

Moreover, unlike many other commercial crops, tobacco leaves had only one destination: cigarette production. If the local tobacco corporations refused to buy surplus tobacco leaves, this would have had disastrous consequences for the tobacco farmers. In order to prevent the social unrest that would have arisen from such an event, most local tobacco corporations assented to their local governments’ requests to purchase all of the tobacco leaves. Under these circumstances, local tobacco corporations often had no choice and purchased all of the tobacco leaves from the farmers, who in turn came to expect all their yields to be bought. This soon became the standard practice.²⁷ That is to say, the supply of tobacco leaves was shaped by

²⁶ From The Editing Board of Hongta Group, *Hongta jituan zhi*, for example, according to the document *The Economic Analysis of Tobacco Leaves in Yuxi during the Past Five Years*, 47 percent of the tobacco farmers’ total revenue had been paid by the tobacco corporations according to the official prices, while the remaining 53 percent had been subsidized by the Yuxi Cigarette Enterprise in the early 1990s. In addition, Yuxi had provided other forms of support during the growing process, including technical training and instruction and fertilizers as indicated in Chapter Four.

²⁷ Wong and Deepak, *Zhuoguo: Guojia fazhan*, 57-9, 72-3; Huang Huixiang and Tan Yuquan, “Cunji caizheng bianqian yu cunmin zizhi fazhan: Kunjing yu chulu” (Rural fiscal change and the development of village self-governance: the predicament and its solutions), *Southeast Academic Research* 4 (2007): 40.

local governments, and their intervention did not respond to the actual demand of cigarette companies. Consequently, there arose a clash of interests between the local governments and tobacco corporations/cigarette companies. The overproduction crisis of 1997 was a prime example of this development.

6.3.2 The Overproduction Crisis of 1997

In 1996, when the change in local finances under the tax-sharing system coincided with a considerable price drop in the grain market, farmers were motivated to grow more tobacco leaves in order to maintain their incomes. In 1997, the results of this were apparent: tobacco leaf overproduction plagued the industry. Compelled by the local governments to purchase the surplus, local tobacco corporations and cigarette companies suffered considerably from the surfeit. Some tobacco corporations were unable to pay for the tobacco they had acquired and had to issue IOUs (*da baitiao* 打白条) to the farmers. A senior employee at the ZY Cigarette Factory in Guizhou complained bitterly when thinking back on the crisis:

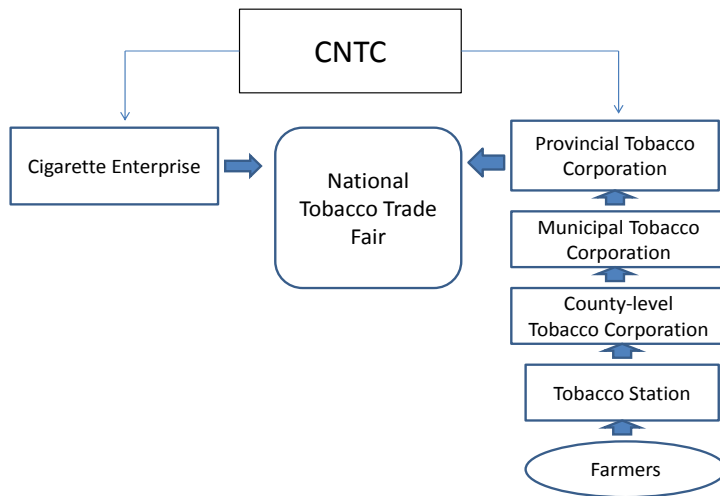
The local government was constantly pushing us... How could you [buy it all] when the farmers had already produced so many leaves? If we had not collected them, serious social disturbance might have arisen.²⁸

A year after the crisis in 1998, the STMB attempted a new scheme entitled “planned planting based on market guidance.” In this scheme, each cigarette company was required to purchase tobacco leaves at the “National Tobacco Leaf Trade Fair” and signed a letter of intent with the tobacco corporations they planned to conduct business with for each year. The amounts to be purchased were based on quotas assigned in the cigarette production plan. Based on these letters of intent, the STMB would formulate a plan for tobacco cultivation in each province, including the areas covered and the production amounts. In formulating these plans, the STMB also would take past records on cultivation and regional balances into consideration. The plan figures would then be broken down from the provincial to the village level. Tobacco corporations at the lowest level would sign a procurement contract with tobacco farmers in accordance with the planting plan (see Figure 6.2).

²⁸ Interviewee No. 33.

This new scheme was actually a return of the planned-economy model where not only were tobacco corporations not permitted to purchase any surplus tobacco leaves beyond the contract, but the farmers also had to limit their planting areas. Nonetheless, this scheme was never fully implemented until the corporatization reform came into effect in the third phase.

Figure 6.2 Scheme of “Planned Planting Based on Market Guidance” in 1998



Source: Adopted from Jinji zhuangui guocheng zhong de chanye zhongzu: Yi yancaoye wei li (Industrial restructuring during the economic transition: the example of the tobacco industry) (p. 178), by Liu Wei, 2005, Beijing, China: China Social Science Press.

6.3.3 The Tobacco Monopsony under the Centralized Regulatory Framework

With the termination of the three-in-one system and the arrival of corporatization, cigarette manufacturers were no longer able to involve themselves in tobacco planting as before. The scheme of “planned planting based on market guidance” previously proposed was finally implemented under this centralized regulatory framework. A cigarette enterprise was now permitted to purchase at most 0.9 *dan* (45 kilograms) of tobacco leaves for each case of cigarettes produced in 2009.²⁹ Additionally, they were no longer allowed to buy tobacco leaves from the tobacco corporations above the amounts specified by the CNTC according to the cigarette production quotas of that year.

In practice, cigarette companies were not forced by local governments to buy any extra tobacco leaves beyond the contracts, yet neither could they guarantee that the supply of tobacco leaves would neatly meet the companies’ demands under the quota system. This was because tobacco leaves procured by cigarette companies had to be alcoholized for around two years in order to be used for cigarette manufacturing. Under this time lag, a gap between supply and demand would appear; the supply of tobacco leaves, ready only two years after harvest, could not precisely match what a cigarette enterprise might need. Therefore, although it was possible to curb overproduction under the centralized regulatory framework, this delay usually led to tobacco shortages confronting cigarette manufacturers during the actual production process. A senior employee at the HT Group explained the situation:

The key point is that the tobacco leaves we purchase every year are not used immediately. We have to wait for 1.5 years during alcoholization at least. During this period, our brands may expand from three million to five million cases. So we face this problem of not having enough almost every year and never stop asking the CNTC for more tobacco leaves.³⁰

As cigarette companies were unable to obtain the tobacco leaves they needed, they turned to the CNTC for help when the shortages occurred. The CNTC would keep a certain reserve of tobacco leaves on hand each year, and it would first allot

²⁹ Interviewee No. 61.

³⁰ Interviewee No. 62.

them to the cigarette companies which owned the top core brands. As a result, the supply of such reserved tobacco leaves became another “policy resource” for cultivating the big brands.³¹ Paradoxically, the existence of these shortages derived from the precise implementation of plan production in tobacco leaves. In a sense, when cigarette manufacturers could get sufficient or even excess tobacco leaves as previously, then tobacco provision could not be leveraged as a means of control.

In fact, this precise implementation reflected a transformation of local governments in the tobacco monopsony during this period of time. In the centralized regulatory framework, local governments were unable to manipulate the tobacco corporations; instead, they had to watch carefully what the local tobacco corporations required in order to secure the taxation on tobacco leaves. When the Chinese authorities abolished the agricultural tax and special agricultural product tax in 2006 to reduce financial burdens on farmers, the tobacco leaf tax was not cancelled with them. As the only exception, this tax was still classified as a local tax, and its rate remained at 20 percent. However, given that the agricultural tax and special agricultural product tax on average constituted 70 to 80 percent of revenues in rural areas before the abolition of the tax, many local governments in this phase found themselves in a serious fiscal predicament and were more dependent on the transfer payment from the higher local governments.³² Under such circumstances, the tobacco leaf tax was naturally more significant for local fiscal revenues in the tobacco growing areas. In fact, this was exactly why the central state would keep the tobacco leaf tax in the post-agriculture tax era. As the State Council explained:

Some new problems would arise if we were to stop levying the tobacco leaf tax. Firstly, it would hit the fiscal situation hard in tobacco-growing areas, especially for the county and township governments. According to the current fiscal system, the tobacco leaf tax is totally allocated to them, and it occupies a large proportion. Without the tobacco leaf tax, their fiscal plight would certainly further worsen. Secondly, it would have a negative impact on the operation of local governments at the grass-roots level and on the provision of local public services. Most

³¹ Interviewee No. 61.

³² Liu Leshan and He Liancheng, “Quxiao nongyeshui ho de xianxiang caizheng kunnan wenti yanjiu” (A study of the fiscal predicaments of county and township governments after the abolition of the agriculture tax), *Reform of Economic System* 3 (2005): 82.

tobacco-growing regions are located in the west or in remote areas, and they usually do not have diverse financial sources. Therefore, local economies and public services heavily rely on the local governments. Termination of the tobacco leaf tax would lead to the decline of local fiscal income. Accordingly, it would be harmful for local development on all fronts. Thirdly, it would hurt the development of the tobacco industry. Tobacco is the main raw material in the production of cigarette products, so the elimination of the tobacco tax would seriously affect the tobacco industry since local governments would no longer have any incentive to promote tobacco-related activities.³³

In this context, county governments would use this taxation as a means of compelling local township governments to complete the tobacco procurement task. For example, the share of tobacco leaf tax revenue that township governments would receive from their superior county government depended on the extent to which they fulfilled the tobacco procurement quotas. In some areas, county governments would award a portion of the tobacco leaf tax as a bonus to the leading cadres of townships when they successfully reached the required quotas.³⁴

Given the fiscal significance of the tobacco tax, county governments would also make use of duty contracts (*zeren zhuang* 责任状). In these contracts, a number of evaluation indices were established to discipline township governments into completing the tobacco-related tasks required by tobacco corporations. Generally speaking, duty contracts would be passed down the administrative hierarchy from county governments to village committees, with increasingly detailed evaluation indices as one proceeded down the command chain and with a range of rewards and penalties linked to the outcomes. This arrangement introduced a vigorous system of

³³ The Legislative Affairs Office of State Council, “Youguan fuzeren jiu zhonghua renmin gongheguo yanyeshui zhanxing tiaoli da jizhe wen” (Q&A on China’s provisional regulations for the tobacco leaf tax), <http://www.chinalaw.gov.cn/article/fgkd/xfgwd/200612/20061200020938.shtml> (accessed September 11, 2009).

³⁴ Jianyong County Government, “Jiangyongxian renmin zhengfu guanyu erlingyiling nian kaoyan shengchan shougou youguan zhengce de yijian” (Opinions on 2010 tobacco production and procurement policies from Jianyong county government), <http://www.jiangyong.gov.cn/File/zfwj/2010011117224073499.htm> (accessed August 7, 2011).

administrative accountability and shifted the behavior of local authorities from merely responding to local needs and more to obeying higher level administrative instructions. The duty contract thus became an effective instrument for ensuring local compliance with regard to tobacco cultivation. An example of such evaluation indices on a duty contract can be seen in Table 6.4. This contract was signed between DJ Town and its village committees in Yunnan Province in 2008.

Table 6.4 An Example of Duty Contract Evaluation Indices (DJ Town, Yunnan)

Index	Rewards and Penalties
Success of planting areas	<ul style="list-style-type: none"> - Award of 1500-2000 RMB to village committees - Penalizing village committees 1000 RMB for failure with regard to planting area
Executing collective tobacco seeding in floating tray*	<ul style="list-style-type: none"> - Penalizing village committees 1000 RMB for failure on this index and compensating 5 RMB for each seeding tray - When the village committees finish the index, neither penalty nor reward incentive provided
Best transplanting time from floating tray to farmland	<ul style="list-style-type: none"> - Awarding 500 RMB when the village committees ensure tobacco seed transplantation is completed within 3 days during prime planting season
Expansion of scale planting by combining individual farmland in the same area	<ul style="list-style-type: none"> - Award of 200 RMB for each parcel of tobacco farmland greater than 100 <i>mu</i> (1 <i>mu</i> = 600 square meters) - Award of 100 RMB for each lot of tobacco farmland greater than 50 <i>mu</i>
Fulfilling tobacco procurement amount	<ul style="list-style-type: none"> - Award of 1500-2000 RMB to each village committees for successful fulfillment of plan - Penalizing village committees 200 RMB for every 1000 kilograms below procurement amount
Implementing safety regulations for tobacco flue curing	<ul style="list-style-type: none"> - Award of 1000-1500 RMB to each village committees without any fire accidents caused by tobacco flue-curing - Penalizing 500 RMB for each fire accident caused by tobacco flue-curing
Flue-cured tobacco leaves with	<ul style="list-style-type: none"> - Award of 4 RMB to each village committees and

superior/medium rate quality	2 RMB to each village group for every <i>dan</i> of superior/medium class tobacco leaves once the village committees fulfills the procurement amount and the portion of superior/medium class tobacco is over 50%
Exclusive award for village party branch secretary (first person in charge)	- The township government gives an exclusive award to the village party branch secretaries once they “pass” all the evaluation indexes
* This index is listed here as the CNTC promoted “collective tobacco seeding” by subcontracting seeding cultivation in floating trays to specific contractors and then selling the results to tobacco farmers under the village committees’ supervision in order to maintain seed quality. This was part of the CNTC’s project of “establishing modern tobacco agriculture.”	

Source: Provided by interviewee

As fulfillment of the evaluation indices linked directly to monetary rewards and penalties, their implementation was taken seriously by local authorities, especially at the village level. In fact, the rewards constituted an important source of fiscal income for many village committees because the transfer payments from higher government levels turned out to be far from adequate for local expenditure after the agricultural tax was abolished.³⁵ Thus many village committees supplemented their incomes by cashing in on the money rewards given to them when they reached the indices on the duty contracts. Under the circumstances, the local governments and the village committees came to act as the *de facto* agents of tobacco corporations. A cadre in DJ Town commented on such a relationship:

It would seem that our main job is to serve the local tobacco corporation. We must finish the job assigned by them so that we can receive the money. It is a very important income for us.³⁶

Under the dual centralizations in fiscal revenue and SOEs governance, local governments were converted to ensure precision in tobacco provision. Rather than manipulating the CNTC’s local agents as in the last phase, local governments now had to control or limit any possible uncertainty and risk in tobacco production and try to avoid the undesirable outcomes—shortage or overproduction—in order to

³⁵ Interviewee No. 14.

³⁶ Interviewee No. 60.

secure the tobacco tax and the monetary rewards. This implementation was also extended to support the CNTC in restructuring the production process and organizations in rural areas as exemplified in the project called “establishing modern tobacco agriculture.”

6.3.4 Establishing Modern Tobacco Agriculture

From Table 6.4, we can see that the village committees were required not only to meet specific production quotas in certain planting areas but also to grow tobacco leaves in specific ways. These included scale planting and collective seeding, which were promoted by a CNTC project known as “establishing modern tobacco agriculture.” Initiated in 2007, this project aimed to improve and equalize tobacco quality, increase the productivity of tobacco cultivation, decrease the demands of the labor force, and reduce costs. Specifically, the CNTC wanted to create favorable conditions for further stabilizing production without raising purchase prices in order to accelerate capital accumulation. One hundred thirty-five villages throughout China participated in the trial scheme in 2008.

As part of this project, the CNTC formulated four measures—scale planting, intensive operation, professional division of labor, and technological management—as the main methods for achieving the project’s goals. Among these measures, scale planting was viewed as the most fundamental. Taking scale planting as its basis, the production process was formulated as “intensive operation at the two ends, mechanization in between” so that a professional division of labor could be implemented. That is, cultivating seeds and flue-curing tobacco leaves (the two ends) would be subcontracted to “professional contractors” who would collectively operate under the village committees’ supervision. Agricultural machines would then be introduced to facilitate the growing process between the two ends. Through this rearrangement of the production process, it was envisaged that the demands of the labor force would decrease substantially.³⁷ In order to fulfill the intensive operation at the two ends, the CNTC also funded local governments to establish collective seeding workshops and flue-curing barns where professional contractors would work, and farmers needed to pay the required fees to make use of the services. In this context, some evaluation indices derived from this project, such as scale

³⁷ East Tobacco, “Yitiao xinlu – xiandai yancao nongye jianshe huigu zhiyi” (One new road – part one of the review of establishing modern tobacco agriculture), accessed January 22, 2013, http://www.easttobacco.com/ycny/yysc/201212/t20121226_285924.html.

planting and collective tobacco seeding, were already listed on the duty contracts (see Table 6.4).

In addition, the CNTC sought to transform individual, small-scale tobacco cultivation under the existing household contract system into the new forms of production organization including cooperatives, family farms, and professional tobacco growers so that it could continue to effect the shift to scale planting and then approach the project's goals as indicated in Figure 6.3 below.³⁸ In this context, a number of demonstration sites for restructuring production organizations were set up. For example, during my fieldwork in 2009, Mile County³⁹ was designated as one such site in Yunnan Province. Its scheme for rearranging production organization is shown in Table 6.5 below.⁴⁰ From this table, one can see that the transfer of farmland usage was fundamental in all kinds of new production organizations. In fact, the CNTC would also employ a subsidy provision for local infrastructures, including irrigation projects and road construction, as a means for compelling local governments to conduct scale planting based on the restructuring of production organizations.⁴¹

³⁸ East Tobacco, "Ruhe zhenzheng shixian yanye shengchan jiangong jiangben" (How to truly reduce the workload and costs in tobacco growing?), accessed January 23, 2013, http://hangye.brandcn.com/yancao/080825_149569_2.html; East Tobacco, "Yimudi – xiandai yancao nongye jianshe huigu zhisan" (One-mu land – part three of the review of establishing modern tobacco agriculture), accessed January 22, 2013, http://www.easttobacco.com/ycny/yysc/201212/t20121231_286219.html;

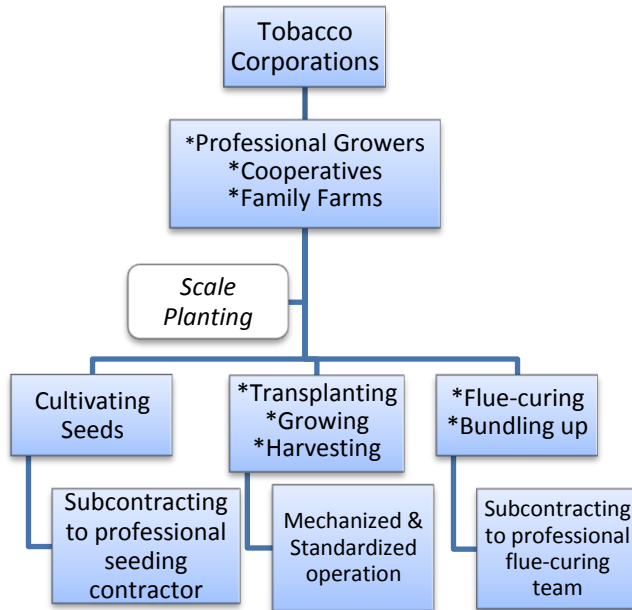
Zhang Fangyuan, "Tansuo, shijian, changxin – Dui xiandai yancao nongye shidian de zongjie yu sikao" (Exploration, action, and innovation: Summary and ideas on the trial scheme of modern tobacco agriculture), *China Tobacco*, December 1, 2008, accessed January 21, 2013, <http://www.echinatobacco.com/101588/101728/101752/21956.html>.

³⁹ Mile County has upgraded into Mile City since 2013.

⁴⁰ See the document issued by the Honghe Tobacco Corporation (2009): "Honghe zhou mile xian xinshao zhen xiandai yancao nongye shidian jianshe shishi fangan" (The trial scheme of modern tobacco agriculture in Xinshao Town of Mile County, Honghe State).

⁴¹ Anonymous, "Jiang chengkang: yancao 'fanbu' ce" (Chengkang Jiang: The strategy of feeding back to tobacco agriculture), *China Business*, January 11, 2009, accessed on January 23, 2013, <http://finance.jrj.com.cn/people/2009/01/1113563292251.shtml>; The Yunnan Provincial Tobacco Monopoly Bureau, "Yunnan sheng xiandai yancao nongye jianshe qingkuang" (The situation of establishing modern tobacco agriculture in Yunnan Province), accessed January 26, 2013, <http://www.echinatobacco.com/101542/101576/102161/102162/23786.html>; Interviewee No. 60.

Figure 6.3 The Scheme of Major Tobacco Agriculture



Source: Summarized by the author

Table 6.5 Scheme for Restructuring Tobacco Production Organization (2009)

Form	Method
Family Farm	<ul style="list-style-type: none"> - Village committees responsible for combining individual land in the same area - Village committees subcontracting the unification of farmland to capable contractors - Contractors employ mechanized and standardized methods of operation in areas where tobacco is cultivated - Contractors employ local farmers to handle any work which cannot be done by machines - Goal: Construction of two family farms, each with 218 <i>mu</i>* of arable land in the trial site.
Cooperative	<ul style="list-style-type: none"> - Cooperatives built in villages where arable land is concentrated

	<ul style="list-style-type: none"> - Farmers become the cooperative shareholders via their land, one <i>mu</i> amounts to one share - The investment of labor force according to number of shares for each farmer household - All shareholders elect capable manager(s) or local cadre(s) as the contractor to conduct general management including allocation of production materials, coordination of work teams, etc. - Farmers share production income according to their shares - Contractors receive 20 percent of the income above 2200 RMB - Goal: Construction of three cooperatives in the town, each with 315 <i>mu</i> of arable land in the trial site.
Professional Tobacco Grower	<ul style="list-style-type: none"> - Selecting capable farmers to form a “professional grower” and assigning 15-20 <i>mu</i> of arable land to them for growing tobacco - Providing subsidies/support to them for production materials, small agricultural machines, and training - Setting up a flue-curing barn for each professional grower in the collective - Goal: Construction of 225 professional tobacco growers, each with around 15 <i>mu</i> of arable land in the trial site
* One <i>mu</i> (亩) amounts to 667 square meters.	

Source: The trial scheme of modern tobacco agriculture in Xinshao Town of Mile County, Honghe State), Honghe Tobacco Corporation, 2009.

The CNTC’s scheme for production organization was actually consistent with the policy of farmland transfer, which was passed in the third Plenum of the 17th Communist Party of China Central Committee in 2008.⁴² According to that policy, farmers could transfer their land usage by lease, exchange, or shareholding cooperatives, and the transfer could only be effected with their consent. However, the complaint that local cadres forced farmers to rent out their lands to professional contractors began to appear, and this became yet another conflict between local

⁴² The Xinhua Agency, “Zhonggong zhongyang guanyu nongcun gaige ruogan zhongda wentu jue ding” (The decision on several big issues on rural reform made by the Communist Party of China Central Committee), accessed January 25, 2013, http://www.gov.cn/jrzq/2008-10/19/content_1125094.htm.

cadres and farmers during this period of time (more discussion of this point follows in the next section).⁴³ The conflict also explained why there existed a higher percentage of “professional tobacco growers” in all forms of the new production organizations, since the obstacles to transferring farmland in this form were lower than others due to their relatively smaller scale.⁴⁴ Even so, in 2012 the then head of the CNTC Jiang Chengkang (姜成康) confirmed that the project would proceed given that it had already demonstrated that overall expenditure could be reduced to a certain degree through the new production processes and method.⁴⁵

6.3.5 The Implication of Local Governance

While “establishing modern tobacco agriculture” aimed to stabilize the provision of tobacco leaves, it sought to do this by creating a new group of contractors—in the form of collectives, family farms, and/or professional tobacco growers—to conduct scale planting in order to control the cost rather than by granting a large number of subsidies to individual households as appearing under the three-in-one system. This change demonstrated very clearly the situation that, when the local governments could no longer manipulate the CNTC’s local agents, they began to turn their back on the tobacco farmers when confronted with contradictory responsibilities: i.e., balancing their budgets versus protecting the livelihoods of the farmers. Under the circumstance, this caused some impacts on local governance since local governments had to handle an increased tension and conflict when dealing with tobacco-related matters. These conflicts, which I observed firsthand during my fieldwork and which served to show that the local authorities had already become *de facto* local agents of the CNTC, will be discussed in this section.

As shown in table 6.6, incomes for tobacco farmers generally declined after the overproduction crisis of 1997, resulting in a greater reluctance to grow tobacco.

⁴³ Zhao Junchen and Zhao Hailan, “Nongcun ‘fanzu daobao’ xianxiang yanjiou” (A study on renting out household contract farmland in rural areas), accessed January 28, 2013, <http://www.aisixiang.com/data/detail.php?id=41678>; Zhang Fanyuan, “Tudi liuzhuan: Guimohua zhongzhi poti zhi bi” (Land transfer: The key point of scale planting), *China Tobacco*, September 1, 2007, accessed January 29, 2013, <http://www.echinatobacco.com/101542/101576/101938/101999/102000/15930.html>.

⁴⁴ Liu Haiwen, “Tudi Liuzhuan: xiao shanban quxiang da jiandui” (Land transfer: a small boat turning into a huge fleet), *China Tobacco*, November 15, 2009, accessed January 30, 2013, <http://www.echinatobacco.com/101588/101727/101769/21197.html>.

⁴⁵ Anonymous, “Jiang chengkang: yancao ‘fanbu’ ce.”

The profit-to-cost ratio per *mu* of tobacco cultivation was 64.3 percent in 1996. This figure fell dramatically to 21.9 percent in the following year and then plummeted to 2.5 percent in 2007 (see Figure 6.6). Part of the reason for the substantial drop was the abolition of subsidies from cigarette enterprises. While the cigarette enterprises' autonomy for granting subsidies was also eliminated in the centralized regulatory framework, the CNTC did not raise purchase prices accordingly. Hence, while the income of tobacco farmers declined in this phase, local governments were increasingly dependent on the revenues generated by tobacco cultivation. The tension between the two parties arose in this context. A local cadre in JC town of Yunnan described the reduction of the tobacco farmers' revenues:

The purchase price is indeed too low. Let me give you an example that most tobacco farmers would give you in our town. In the past, the same quantity of tobacco leaves farmers sold could buy pork of two or three *jin* (斤, one *jin* amounts to 500 kilograms), but now this is only one *jin*. Even though the official purchase prices have risen this year, they cannot catch up with the rising cost of living. This makes it difficult for us to implement the tobacco work.⁴⁶

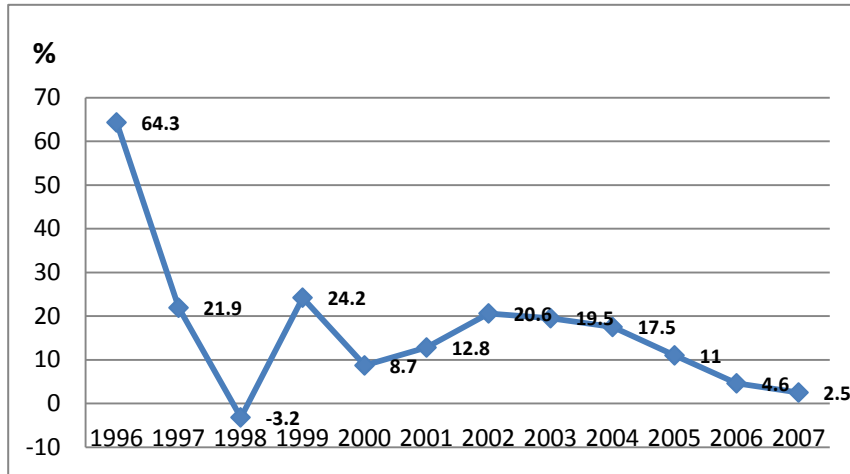
Growing tobacco, then, became a focal point of contention from the outset since the declining profitability of tobacco leaves made farmers lose interest. In addition, while the purchase prices could not match the rise in living expenses, at the same time the benefit-cost ratio of growing tobacco was also lower than that of other major agricultural products such as grapes, soybeans, and fruits.⁴⁷ The speech delivered at a national meeting of the tobacco industry in 2005 by the vice-director of the STMB He Zehua (何泽华) already confirmed this trend, which increased the pressure on local cadres who were responsible for organizing the tobacco planting, particularly in the economically developed areas.⁴⁸ Yet local authorities still had strong incentives to maintain tobacco cultivation for the fiscal reasons; thus local cadres could and did persuade and compel farmers to grow tobacco.

⁴⁶ Interviewee No. 13.

⁴⁷ Teh-wei Hu et al, "The Role of Government in Tobacco Leaf Production in China," in *Tobacco Control Policy Analysis in China*, 202.

⁴⁸ Xu, "Zhongguo yancao hungye," 290.

Figure 6.5 The Profit-to-Cost Ratio of Tobacco per mu (1996-2007)



Source: Adopted from “Yanye shougou zhengce yu yannong liyi fenxi ji jiani” (An analysis and suggestion on the tobacco procurement policy and tobacco interests), by Wang Mingru, 2006, Rural Finance and Financial Affair 12, p. 30; Quanguo nongchanpin chengben shouyi ziliao huibian (National collection of agriculture products on cost-to-benefit data) (p. 197), by the Price Office of the National Development and Reform Committee, 2009, Beijing, China: China Statistics Press.

In principle, tobacco contract farming was based on an agreement signed by mutual consent. In practice, however, farmers had little choice but to grow tobacco if their farmlands were included in the tobacco zone as formulated by local governments.⁴⁹ Otherwise they might be asked to rent out their farmland, as a local cadre in QF town of Liaoning Province explained:

If farmers don't want to grow tobacco, we would still continue to exercise influence on them in any way possible. For example, we could exchange farmland so that they would be able to grow the other products on another piece of land. Or we could convince them to rent the land to someone else who is willing to grow tobacco.⁵⁰

⁴⁹ After receiving the decision on planting size, local officials would begin to formulate the tobacco zone in December and then inform farmers. (Interviewee No. 13)

⁵⁰ Interviewee No. 22.

Another source of conflict arose when local governments and farmers clashed over the practice of intercropping in the process of cultivating tobacco. Intercropping refers to the growing of two or more crops simultaneously on the same field. This was a common practice in many rural areas in China. Intercropping could produce a greater yield on a given piece of land and hence would increase farmers' incomes. Moreover, it took tobacco farmers at least seven months to complete the cycle from seeding to sale, so they often had good reasons for intercropping other vegetables that had shorter growing periods. This allowed them to continue to earn while waiting for the income from their tobacco crop.

Such a practice, however, was usually prohibited by local governments because it would affect both the quantity and quality of the leaves of the intercropped tobacco.⁵¹ Such prohibitions then not only limited the farmers' freedom to plant what they wanted but also adversely hit their incomes. Given that the majority of tobacco farmers would prefer to augment their incomes by planting other crops alongside tobacco, the ban on intercropping aroused serious opposition among them. To ease the discontent, some local governments were pushed to find a balance. They tried allowing tobacco farmers to practice intercropping, but only in the late harvest season so that the quality and quantity of the tobacco leaves would be kept at certain levels.⁵²

Tensions could also arise in the procurement process when tobacco farmers were dissatisfied with the grading results. After flue-curing, the tobacco farmers would bring their tobacco leaves to the local tobacco station, where they sold their products according to the grading criteria issued by the STMB. However, the problem of "tobacco patronage" (*renqingyan* 人情烟) caused by unfair grading was widespread. That is, some farmers' tobacco leaves might be graded higher if they had a good personal relationship with the grader and vice versa. A common saying in tobacco-growing areas maintained that one had to "squat down to grow tobacco but kneel down to sell it."⁵³ This seeking of patronage grew even more competitive under the centralized regulatory framework because the CNTC began to set

⁵¹ Interviewee No. 13.

⁵² Interviewee No. 54.

⁵³ China Youth Online, "Yunnan yannong shengcun zhuangkuang diaocha: Dun zhe zaiyan, gui zhe maiyan" (The investigation of Yunnan tobacco farmers: Squatting down to grow tobacco and kneeling down to sell it), 21 May, 2009, accessed June 20, 2009, <http://www.chinanews.com/sh/news/2009/05-21/1701614.shtml>.

maximum limits for the top grade proportion in order to control the general costs.⁵⁴
A tobacco farmer in FW town of Yunnan complained:

The selling price of different tobaccos of exactly the same quality may have a price difference of around 5 or 6 *yuan* per kilogram. This depends on your personal relationship with the grader. The employees who are responsible for purchasing tobacco leaves at the station are the most powerful officials here. They even lower the grade [when buying] and deliver the product to their superiors with a higher grade to take advantage of the price difference.⁵⁵

Some farmers responded to such unfair practices by secretly selling their tobacco to smugglers or to another station. This invited intervention from the local authorities as the local cadres were concerned that such illegal sales would impact their production quotas. A local official in DJ town of Yunnan pointed out:

Meeting the tobacco purchase procurement quotas is the most important target we have to achieve. Otherwise we would be punished. We would try every means to reach the assigned quotas, even to the point of buying tobacco leaves from smugglers sometimes.⁵⁶

Ironically, although selling tobacco leaves illegally was officially prohibited, it did offer local governments a certain degree of flexibility when enforcing the tobacco monopsony. Given that agricultural yields anywhere can be subject to a high degree of uncertainty due to environmental fluctuations, obtaining tobacco leaves from smugglers became a simple solution for local governments when they were unable to meet their quotas. Also, when production output rose and went beyond the contracted requirements, the extra leaves could be disposed of by having smugglers buy the surplus. In this sense, such illegal transactions helped to maintain social

⁵⁴ The Information Website of Yunnan Tobacco, “Shangdeng yan bili shifou yui kao yui hao?” (Is it better to have a higher proportion of the top tobacco leaves?), accessed April 20, 2012, http://www.tobacco.gov.cn/html/21/2106/210602/21060205/2106020503/69481_n.html.

⁵⁵ Interviewee No. 49.

⁵⁶ Interviewee No. 60.

stability in tobacco-growing regions during this phase. The “black market” in tobacco was thus a necessary evil.⁵⁷

In general, tobacco corporations were responsible for enforcing and monitoring the production contracts signed by the farmers. If a farmer failed to meet his/her obligations according to the contract, the tobacco corporation would in principle not renew the contract the following year. In practice, however, the tobacco corporations had already shifted the responsibility for fulfilling the procurement contracts to local governments. Taking advantage of the local fiscal predicament in this phase, tobacco corporations institutionalized their leverage and manipulated local governments to work for them. In this context, as the tensions and conflict revolving around tobacco cultivation and procurement increased in local governance, a situation arose whereby the CNTC increasingly pushed local governments to finalize the restructuring of the production process. Consequently, the interactions between local governments and the CNTC’s local agents further consolidated the CNTC’s controlling capacity with regard to tobacco provision, which in turn led to another kind of incremental change: the strengthening of the central-led competitive monopoly.

6.4 The Formation of Large Cigarette Conglomerations

Under the central-led competitive monopoly, large cigarette conglomerates based on “substantial” mergers began to form in this phase. In contrast to the “nominal” mergers of the last phase, the mergers occurring here would generally lead to a united production plan where all the production materials were coordinated and all the production quotas were combined for the purpose of cultivating specific big brands. In this section, I discuss how these substantial mergers could occur under the current governance pattern and how, as the substantial mergers and inter-province restructuring process continued, a type of competition known as “quasi-oligopoly” came to appear.

6.4.1 Substantial Mergers within the Provinces

In contrast to mergers in the previous phase, the mergers in this phase among separate cigarette companies within individual provinces proceeded differently. For

⁵⁷ Interviewee No. 15.

one, provincial governments were transformed from actors with a passive role that had shaped groups through “welding” into aggressive actors that promoted complete integration. Where previous mergers were created from several cigarette manufacturers that retained independent legal status within the group, now the mergers effectively meant that cigarette companies were incorporated into a conglomeration that canceled their previous legal status, thereby turning them into mere production branches or factories without any decision-making power.

The industrial policy of making big brands also helped to trigger this transformation. Once a local cigarette brand made it into the catalog and more policy resources were devoted to it, both the cigarette companies as well as the provincial governments benefitted via the growing profits and tax revenue. Given that the number of top core brands continued to atrophy under the STMB’s catalog management, provincial governments under the fiscal pressure of the tax-sharing system were driven to facilitate mergers within their provinces in order to concentrate resources and make specific brands more competitive. In this context, provincial governments began actively promoting substantial mergers within their provinces so that all of the production materials and quota assignments would be better coordinated for greater efficiency under the concentrated management. They became active mediators continually looking for ways of to make up for the fiscal loss suffered by their sub-provincial governments in jurisdictions where merged cigarette enterprises were located.

This stage also saw cases of “strong and strong” mergers within the same province, which had previously been uncommon.⁵⁸ For example, when the Yunnan Province Government promoted the merging of the Qujing Cigarette Company with the Kunming Cigarette Company in 2004, both of them were seen as large-scale companies, each producing cigarettes more than a million cases of cigarettes per year. In order to persuade these two large companies to agree to the merger, the provincial government worked out a formula to divide the taxation. By this calculation, the Qujing City Government would continue to receive tax returns according to the formula, even though the tax would be collected in Kunming after the merger.⁵⁹ This method guaranteed that the municipal governments would not

⁵⁸ East Tobacco, “Zouxiang lianhe – zhongguo yancao gaige fazhan pingshu zier” (Toward conglomeration – part two of China’s tobacco reform development), accessed January 10, 2013, http://www.easttobacco.com/dfycb/201207/t20120710_242848.html.

⁵⁹ Anonymous, “Qujing ruku shuishou liangnian zengjia 17.7 yi” (The tobacco tax revenue of Qujing increased 1770 million RMB after the merger in the past two years), *Yunnan Daily*,

lose their fiscal revenues from tobacco, and therefore the merger was accepted. This success also meant that the approach was applied to later mergers. In Yunnan, mergers made the number of cigarette companies drop from nine in 2003 to two in 2008.

The accelerating pace of such mergers did not occur only in Yunnan. Most cigarette companies were integrated into provincial tobacco industrial corporations, such that a two-level, parent-subsidiary framework in cigarette manufacturing gradually began to take shape across the country.⁶⁰ Under these new circumstances, the merged cigarette companies turned into production branches under the command of provincial industrial tobacco corporations. Overall, the number of cigarette enterprises nationwide had decreased to 30 by 2009, down from 151 in 2001 when China entered the WTO.⁶¹

Wang's study ignores entirely this industrial policy of making big brands, which therefore oversimplifies her analysis of state-business interactions in the tobacco sector after China's WTO accession. This overly simplistic analysis led her to conclude, incorrectly, that the merger movement led by the central government rapidly reorganized the enterprise system in China's tobacco sector and condensed China's tobacco industrial body during this period of time.⁶² While it was indeed true that the STMB produced several documents from 2003 onward to restate its determination to close down cigarette manufacturers with an annual output lower than 100 thousand cases, while incorporating the cigarette manufacturers with an annual output between 100 to 300 thousand cases into large companies and supporting the large-scale cigarette manufacturers in the tobacco sector,⁶³ in fact, similar policy guides had already been issued previously (as indicated in Chapter Five), but they had failed to take effect under the local protectionism then prevailing. By contrast, this phase's substantial mergers within the provinces proceeded rapidly

March 13, 2008, accessed January 11, 2013,
http://paper.yunnan.cn/html/20080313/news_98_137493.html.

⁶⁰ Given its huge scale, Yunnan province has been the only exception keeping the three-level parent-subsidiary framework in cigarette manufacturing (CNTC-provincial tobacco industrial corporation-cigarette groups).

⁶¹ Wang Jiannan, "Zhongguo yancao hangye gaige yu fazhan yanjiu" (Research on reform and development of tobacco industry in China) (PhD diss., Jiling University, 2011).

⁶² Wang, *State-market Interaction*, 108.

⁶³ *Ibid.*; The Research Institute of Tobacco Economy of the CNTC/STMB, *Zhongguo yancao zhongzu zhenghe ji zouchuqu* (China tobacco restructuring, integrating and going outside) (Beijing, China: Capital University of Economics and Business Press), 60.

with the support of provincial governments. Looking at just this comparison, Wang also did not analyze appropriately the ways by which local governments pursued their interests in different phases. However, precisely this point explains why the “substantial” mergers within the provinces grew so significantly. Even though the central government had authored the merger policy, it could not be achieved efficiently until the local governments began to be converted into aggressive mediators within the context of dual centralization. In this sense, the emergence of substantial mergers arose not only as an accompanying result of the central-led competitive monopoly but also through the support of local governments.

6.4.2 Inter-Provincial Restructuring

In this phase, inter-provincial restructuring also appeared as an effect of making big brands. Compared to the relative ease of substantial mergers within the provinces, the current fiscal system made arranging fiscal transfers of tobacco revenues across provinces difficult. Therefore, “across-province” mergers did not happen on a large scale, but inter-provincial restructuring still moved forward in the form of sharing or holding certain equities.

Distinct from how inter-provincial restructuring had occurred in previous phase, the emergent form of restructuring in this phase was driven by the joint production of specific top core brands during the past years. Some cigarette companies were motivated to produce the big brands for others mainly because they did not have the top core brands listed in the catalog. Lacking their own top core brands, they would likely face shrinking market shares. In this case, joint production of specific core brands for other manufacturers located outside the provinces became a feasible option for retaining existing quotas.

As the market shares of the joint-production brands grew, they increasingly came to share common interests with the brand-owning companies. Thus, inter-province cooperation was further stimulated in the form of investment. For example, through joint-production of the *Baisha* (白沙) brand, the Hebei Baisha Corporation Limited, receiving investment from both the Hebei Industrial Tobacco Corporation and the Changsha Cigarette Enterprise in Hunan Province, was established in 2005. Inter-provincial restructuring also appeared in the industrial tobacco corporations of Guangdong and Guangxi through mutual equity participation in 2008. In the same year, the Gangshu Industrial Tobacco Corporation was restructured via equity investment from the Zhejiang Industrial Tobacco

Corporation. In general, the method of jointly producing brands led to more equity participation inter-provincial restructuring in this phase. Though the developmental trend was shaped under the constraints of the current fiscal policy, it was expected to create more space for inter-provincial mergers in the future.⁶⁴

6.4.3 The Rising Quasi-Oligopoly Competition

As the total number of cigarette companies decreased due to the mergers within individual provinces, and the scale of inter-provincial investments constantly expanded, a number of giant cigarette conglomerations gradually took shape. Under these circumstances, a type of “quasi-oligopoly competition” appeared, seen in a higher market concentration ratio of those cigarette manufacturers (see Table 6.7).

Table 6.6 Market Concentration Ratios of Cigarette Enterprises

Year CR	2003	2004	2005	2006	2007
CR4*	19.6	23.9	24	25	27.3
CR8	31.4	39.9	41.4	44.8	49.6
CR12	39.5	46.3	48.2	60.2	67.5
*CR4: The concentration ratio of the largest four cigarette enterprises in relation to production amount; likewise in CR8 and CR12.					

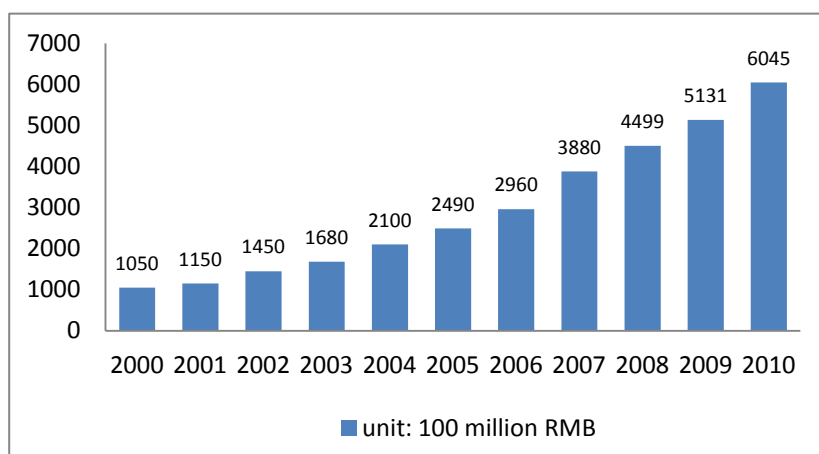
Source: Adopted from “Zhuanmai tizhi xia juanyan gongye shichang jigou yu jixiao shizheng yanjiu” (An empirical study of the market structure and performance of cigarette enterprises), by Chen Baosen, 2010, ACTA Tabacaria Sinica 16, p. 100.

The emergence of quasi-oligopolies in the tobacco industry also demonstrated the reversal of the relationship between “*tiao*” and “*kuai*”—the local governments (*kuai*) again became *de facto* agents serving the CNTC system (*tiao*) in merger deals. This reversal did not mean that the central state was abandoning its market-oriented reform from the late 1970s or that the tobacco sector would completely go back to planned-economy fashion as before. Instead, it implied a fortification of the CNTC’s steering capacity in the

⁶⁴ Tan Yuansong, “Xishou pobing cu fazhan—hungye kuasheng lianghe congzu jinru gongjian qi” (Hand in hand, breaking the ice—the inter-province restructuring entering the crucial period of time), *China Tobacco*, November 1, 2009, accessed January 11, 2012, <http://www.echinatobacco.com/101588/101728/101752/45429.html>.

nationally integrated market. In this situation, intense competition among emerging national cigarette champions further stimulated the boost of profits and taxation derived from this industry as seen in Figure 6.4 below. As a result, more and more capital has accumulated in the CNTC and its subsidiaries such that they have since been more capable of making overseas investments, promoted by the central authorities under the strategy of “going abroad.”⁶⁵

Figure 6.5 - Sum of Taxation and Profits in China’s Tobacco Industry (2000–2010)



Source: Adopted from *China Tobacco*, 392, p. 42, accessed October 15, 2012, <http://health.people.com.cn/GB/14740/22121/17311892.html>

6.5 Conclusion

In the globalization-state debate, the so-called “globalization-as-constraint” school argues that the policy choices of nation-states are straitjacketed by the twin pressures of the growth of capital mobility and the rules of multilateralism. As such,

⁶⁵ Tobacco China, “Zhongguo juanyan xiang guoji juanyan shichang kuayue” (China’s cigarette enterprises moving toward international cigarette market), accessed August 5, 2014, http://www.tobaccochina.com/news/analysis/wu/200810/20081024122611_329426.shtml.

nation-states are virtually reduced to the role of adjusting national economies to the dynamics of the global economy.⁶⁶ Seen from the point of view of the development of China's tobacco sector after its accession to the WTO, however, this presents another different trajectory. Despite being under the pressures of globalization, the Chinese government took advantage of its entry to the WTO to set up a centralized regulatory framework in the CNTC via a form of "corporatization." This developmental trajectory was also different from what Wang described as "more global, deeper local." By this, she meant that the formation of national cigarette champions in the tobacco sector amounted to a "deeper economic decentralization" since local governments could continue to enjoy "decentralized economic power" only when they demonstrated their ability to make cigarette SOEs under their jurisdiction survive or thrive within the competition of the domestic market. That is to say, she claimed that the central government's ambition for having bigger and better SOEs after the WTO accession was consistent with that of the "winning" those local governments that wanted to expand the scale of economy of the SOEs, thereby causing globalization and decentralization to go hand in hand in China's context.⁶⁷

This study shows how the "more global, deeper local" argument errs, since Wang did not adequately take account of the effects of the centralized governance of the SOE reform in this phase. Through the corporatization reform, local governments could not intervene into the tobacco business taking place within their jurisdictions as before. In this sense, their power of manipulation was largely constrained in the tobacco sector, but this did not mean that the leverage of the central authorities was constrained as well. On the contrary, this reform provided more favorable conditions for the central state to carry out its industrial policy of making big brands when the synthesis of the CNTC and the STMB remained in this sector.

Under these circumstances, the central-led competitive monopoly arose and was constantly reinforced through the support of local governments. As a consequence, trades between cigarette manufacturers and wholesalers were directed by state control in the form of industrial policy. In this context, the quasi-oligopolies gradually took shape with increasing mergers and restructurings, but it was difficult for them to collude with each other in divvying up the domestic market because the

⁶⁶ Linda Weiss, "Bring domestic institutions back in," in *States in the Global Economy*, ed. Linda Weiss (New York, NY: Cambridge University Press, 2003), 5.

⁶⁷ Wang, *State-Market Interactions*, 118-9.

rules of the game were dictated by the central authorities. More specifically, when the central state exerted its bureaucratic domination over the SOEs by setting the game rules, the existing cigarette enterprises were further pushed to compete with one another for survival in the central-led game, trying to stay in the catalog into the next round. As such, state control and competition have been equally strengthened in the tobacco state monopoly in today's China.

