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1. Preface

There is a saying of “three one-third” about China’s cigarette market in the world that is more than 300 million smokers, accounts for one-third of the world’s total smokers; China grows one-third of the world’s tobacco leaves and produces and sells one-third of the world’s cigarettes. China’s tobacco industry is the main contributor of the state revenue which contributes as much as 10% of the total annually. Such enormous contribution has been achieved under the lower tax rate of no more than 46%.

The objective of my thesis is:

To comprehensively introduce the generation, the development and the present situation of the China’s tobacco taxation system as well as the state tobacco monopoly system; and to deeply analyze the significant impacts of the China’s tobacco taxation on the tobacco industry, the government action, the tobacco control and the national economy and so on.

The thesis is divided into several chapters as follows:

China’s tobacco monopoly system is introduced in the second chapter. Different from most of the other countries in the world China implements a tobacco monopoly system, i.e. a state monopoly on the tobacco industry. The industry monopoly resulted from the monopoly system generated huge monopoly profits, and certainly brought forth huge tax revenue to the state finance as well.

The third chapter presents the structure of China’s tobacco tax and its distribution. China’s tobacco tax items include mainly the tobacco leaf tax, cigarette tax and other tobacco-industry-related taxes. And these taxes are collected and distributed in the tax distribution system.

The four reforms of China’s tobacco taxation are presented in the fourth

and fifth chapters. Each reform of the Chinese tobacco taxation had a huge impact on the tobacco industry and even the national economy. The latest adjustment started from May 2009. Its aim is not only to raise the government's financial revenue, but also to meet international anti-smoking trend. The fourth reform increased the state revenue, but the result of the tobacco control was much less than expected.

The sixth chapter explains the influences of China's tobacco taxation on the action of the local government. As the financial revenues are largely supported by the tobacco tax, some local governments are over dependant on the tax revenue of the tobacco industry. In order to get more benefits, these local governments used and even abused the policy of the Chinese tobacco taxation to interfere with the tobacco industry.

Raising the tobacco tax is recognized by the international community as a most effective economic measure for the tobacco control. This point is analyzed in depth in the seventh chapter.

The WTO impacts on China's tobacco taxation are presented in the eighth chapter. With the accession to the WTO the strict control of importing and exporting tobacco has been loosened step by step. It has great influence on China's tobacco taxation. With the changes of various tariff and non-tariff policies, China must accordingly adjust and improve the tobacco tax system.

In the last chapter, on the base of the presentations and analyses in the preceding chapters I have some suggestions to China's tobacco taxation.

2. China's tobacco monopoly system

The tobacco industry management systems in most countries tend to change to be more market-oriented from the previously government-monopolized. For example: (1) With the integration of the EU, many EU-countries reformed the tobacco management system: to end up the monopoly system that's been through for nearly one hundred years and to accomplish the reform of marketization and corporatization. (2) Due to the change of the social system, the tobacco monopoly system was replaced by the liberalization and privatization in the former Soviet Union and Eastern Europe. (3) Similar policies were adopted in Africa and South America, especially in the last twenty years the marketization and privatization (demutualization) of the tobacco management have gone forward even faster. (4) In Asia, Japan, South Korea and Thailand etc. abolished the tobacco monopoly system.

There are two distinctive features reflected in the reformation of the tobacco industry management across different countries of the world: first, tobacco industries all adopted a state monopoly system; second, the management system of the tobacco industries changed from state monopoly to market-oriented evolution.

Since 1980s more and more countries have abolished the tobacco monopoly system, but the government controls, such as the tobacco franchising, administrative license etc. are still there.

For example,:

① France In 1995, with the privatization of Seita, the tobacco monopoly system was completely abolished in France. But the French government does not give up the government control on the tobacco by implementing

administrative licensing and franchise system. E.g. the importers and distributors of the tobacco must obtain the special permit and the retailers are also required to obtain a permit. The prices of domestic and imported cigarettes are all decided on by the French Ministry of Finance and were unified for retails nationwide. The wholesale business of cigarette is monopolized by Seita. The import business from outside the EU must be operated by Seita. No foreign investment is allowed to build new cigarette manufactory.

② Spain The Spanish government regulates the tobacco business by implementing the permit system. The permits are required throughout the whole process of the cigarette sales either for retails or the wholesales.

③ Japan In 1985, Japan canceled the tobacco monopoly system, however continues to maintain the monopoly of the tobacco production and the control on cigarette price, meanwhile implement the administrative permit system in the cigarette retail. In 1994, the state-owned enterprise – Japan Tobacco Inc. (JT) was restructured into joint-stock limited company. The Japanese government holds more than half of the JT's shares by law, actually holds two-thirds of the shares.

④ USA Never before has the U.S. government implemented a tobacco monopoly system, but the tobacco control has always existed. The U.S. also carried out the license system on the production and sales of tobacco product. According to the law, it must owe to the federal government instead of the state to start a manufacturing enterprise.

China is one of the only two countries which implement state tobacco monopoly system (the other one is North Korea). The Chinese government plays so important role through the tobacco monopoly system that it strictly controls the production of tobacco leaves and the manufacture and the sales of cigarettes for the entire country. This system has a far-reaching impact on China's tobacco tax. Therefore, it is important for us to know China's tobacco

monopoly system before making the analysis on China's tobacco tax.

2.1. Establishment and legalization of China's tobacco monopoly system

- In 1981, the State Council decided to make a big reformation on the contemporary tobacco management system which is to initiate to establish China National Tobacco Company (CNTC) and to implement the national tobacco monopoly. Later on CNTC was formally founded on January 1, 1982.
- In 1983, the State Council approved and formed the State Tobacco Monopoly Administration (STMA) which bears the responsibility of the administration on the tobacco monopoly.
- Still in 1983, the “Regulations of the Peoples Republic of China on Tobacco Monopoly” was issued by the State Council on September 23 and was put into effect from November 1, 1983. This law marked the official implementation of China's tobacco monopoly system that has lasted till today.
- On June 29, 1991, China National People's Congress ratified the first law ever in history of the China's tobacco industry – “Law of the Peoples Republic of China on Tobacco Monopoly”. This law legalized the statement on the tobacco monopoly system, the unified management and the vertical leadership system of the tobacco industry.
- July 3, 1997, the State Council promulgated the “Regulation for the Implementation of the Law of the Peoples Republic of China on Tobacco Monopoly”. This regulation refined and extended the Principles of the “Law on Tobacco Monopoly”, and further consolidated and developed the tobacco monopoly system.

2.2. The tobacco monopoly

STMA and CNTC are the real combination of government administration and business operation. Being the mechanism that implement the tobacco monopoly system they strictly take control of every aspect of the tobacco production, sales and policy settings, etc.. CNTC and its regional branch offices throughout China constitute a huge business monopoly organization.

- The cigarettes production plan is designated by CNTC, and then each province is assigned for different production quota. This means that the output of cigarettes is controlled by CNTC. In the case of a certain domestic demand, the control of the output would inevitably result in a high monopoly price of the cigarette.
- The production and the sales of cigarettes are controlled by STMA through the production permit and the sales permit. In order to ensure the control be effective very few or no tobacco products are imported from foreign countries.
- STMA also determined the planting areas of the tobacco leaf. Tobacco growers are allowed to sell the tobacco leaves only to the regional office of CNTC. Thus the production materials are in good control as well.

2.3. Impacts of China's tobacco monopoly system

2.3.1. The positive impacts

Before the tobacco monopoly system was introduced China's tobacco industry was in a chaotic situation which was e.g. the blind development, the management confusion, the quality decline of cigarettes and the serious disconnection between production and marketing of the cigarette. The newly-implemented monopoly ended up the chaos. The new system balanced

the production, supply and sales of the cigarette; improved the cigarette quality; satisfied the cigarette consumption demand and contributed a lot to the state revenue.

2.3.2. The negative impacts

The essence of the tobacco monopoly system is the administrative monopoly: It's in nature against the marketing competition.

- As the planting area of the tobacco leaf and the tobacco production are decided by the quotas offered and the local tax revenues are closely related to the tobacco production, even the regions without comparative advantages of tobacco planting planted tobacco leaves. Each provinces vied with each other to build a lot of tobacco manufacturing enterprises. This caused enterprises with high production efficiency not to achieve economies of scale because of the deficient production quotas, whereas enterprises with low production efficiency made undue profits because they had the production quotas.
- The local government takes the advantage of tobacco monopoly preventing the foreign tobacco products going into the local market. The restriction aggravated the regional segmentation of the tobacco market and was more likely to make the monopoly a tool for local protectionism.
- The market monopoly resulted in the high monopoly price of the cigarettes. And meanwhile consumers are limited to consume the local cigarettes only.
- In an industry of competition inefficient production resource allocation may occur due to the government monopoly which subjectively limited the market competition. The resources of the tobacco production in China are allocated usually not by the market, but by the production planning and quotas of CNCT. It is thus difficult to optimize the allocation of the resource. If the enterprises are private, they would at least consider saving costs to

maximize the profits. However, in order to ensure the implementation of the tobacco monopoly system, all the Chinese tobacco enterprises are state-owned. Due to the hollow position of the subject of state ownership, and the production and operation of state-owned enterprises are often costly. Both of above caused the double inefficient allocation of resources.

- Under the monopoly the price of the tobacco product is much higher than it should be in the free competitive marketing environment. Out of the drive of pursuing high profits, smuggling activities and counterfeit cigarettes emerge endlessly.

2.4. China's tobacco monopoly system will continue

China's tobacco monopoly system is a complete monopoly, i.e. a state monopoly. It's structured by "the unified leadership, the vertical administration and the monopoly franchises". It is an important economic and legal system that ensures the state revenue.

The commissioner of STMA, Jiang Chengkang, made it clear that the tobacco monopoly system will continue to be implemented as long as the annual profit and tax of the tobacco remain over RMB 100 billion.

According to the data of the Ministry of Industry and Information Technology (MIIT), the profit and the tax of the tobacco industry in 2008 totaled RMB 457.18 billion, accounted for 7% of the total fiscal revenue. And the tobacco industry accounted for 2/3 of the consumption taxes (RMB 256.78 billion) in 2008. The data shows that the tobacco industry is the undoubted major tax contributor of the state revenue. Such huge profit and tax were created in the tobacco monopoly system. Therefore, China's tobacco monopoly system will not be repealed and will continue to perform.

3. Breakdown of China's tobacco tax and its distribution

China's tax revenue consists of two parts, one is for the central government and the other for the local. The central government collects value-added tax, personal and enterprise income tax, consumption tax, and customs tax. The local government collects business tax, special tobacco leaf tax, and city maintenance tax and construction tax. There are two tobacco-oriented taxes: the tobacco leaf tax and the cigarette tax.

3.1. Breakdown of China's tobacco tax

Table 1: China's tobacco tax

Type of tax	Tax rate	Revenue beneficiary
1. Tobacco leaf tax	20%	100% local government
2. Value-added tax at cigarette manufacture	17%	75% central government; 25% local government
3. Consumption tax		
3.1. Specific excise tax	RMB 0.60/carton (or RMB 0.06/pack)	
3.2. Ad valorem tax		
$\geq$ RMB 70/carton	56%	
< RMB 70/carton	36%	
3.3. Ad valorem tax at wholesale link	5%	100% central government
1 carton = 10 packs or 200 cigarettes		

3.1.1. Tobacco leaf tax

The tobacco leaf is an agricultural product. From the end of 1994 a tax rate of 31% had been imposed on the tobacco leaf growers in the process of tobacco leaf purchasing in the name of “Agricultural Product Tax”. In 1999, the tax rate was reduced from 31% to 20%. The tax is collected by the local tax authorities and goes to the local government

In 2006, the central government decided to relieve farmers’ financial burdens by eliminating all agricultural product taxes. However, the agricultural product tax of the tobacco leaf was retained, renamed “tobacco leaf tax”, tax rate is 20%. These tax revenues are withheld by CNTC at the point of tobacco leaf procurement, and then are turned over to the local government.

3.1.2. Cigarette tax

China’s cigarette tax consists of value-added tax (VAT) and consumption tax (specific excise tax and ad valorem tax).

1) Value-added tax

Since 1994, the Chinese government has levied VAT on the cigarette production by 17%. One of the main features is that this tax is charged in the manufacturing process that is to charge the cigarette manufacturers.

2) Consumption tax

① Specific excise tax

Such kind of tax is based on the amount, i.e. taxation according to quantity. Since 2001, a specific excise tax of RMB 150 per case (50000 cigarettes or 2500 packs or RMB 0.06 per pack) has been imposed on all cigarettes.

② Ad valorem tax

Such kind of the tax is based on the price, i.e. taxation according to price.

The sales price (the appropriation price) is the transaction price between cigarette manufacturers and wholesalers, which does not include the VAT.

From May 2009 onward the most recently updated ad valorem tax rate are shown below:

- υ 56% for cigarettes with an appropriation price higher than or equal to RMB 70 per carton;
- υ 36% for cigarettes with an appropriation price less than RMB 70 per carton.
- υ A new ad valorem tax has been imposed at wholesale link by 5% of the wholesale price.

3.1.3. Other tobacco industry relevant tax items

The tax revenue from the tobacco industry, in addition to the tobacco leaf tax and the cigarette tax, include also other tax items:

- 1.5% “Educational Surtax”;
- 15% of the after-tax profit as a “Tobacco Monopoly Profits” is levied at commercial tobacco enterprises;
- 25% of the taxable income as “Enterprise Income Tax”;
- Other “Business Tax” and “City Maintenance and Construction Tax”, etc.

3.2. The Chinese import tax on foreign cigarettes

The consumption tax for imported cigarettes and the domestic ones are the same:

- The Chinese Customs Office first levies a specific excises tax, at RMB 150 per case.

- Then, based on the price of the imported foreign cigarettes (also taken into account the customs tax) 56% of the ad valorem tax levied for those priced higher than or equal to RMB 70 per carton; 36% for those priced less than RMB 70 per carton.

3.3. Distribution of the China's tobacco tax

- First, the tobacco leaf tax, as the only preserved agricultural tax, goes to the local government.
- Cigarette tax is the dominant part of the tobacco tax as well as an important source of local revenue for the tobacco production areas. At the current stage the revenues from the cigarette tax are shared as follows:
 - ⌚ As what's dealt with the general merchandise 75% of VAT goes to the central government while 25% goes to the local.
 - ⌚ Consumption tax belongs to the central government. However, in most cases the central government transfers a portion of the consumption tax to local government. The eligibility and the amount of the transferable tax depend on the growth of the "two taxes" in local areas (VAT and consumption tax) the same year.
- Enterprise income tax is mutually shared by both the central and local government. Each accounts for 50%
- Both city construction and maintenance tax and education surtax are local government taxes.

It's just due to such kind of distribution relationship that the local government, especially the government of the main producing area, has relied excessively on the tax of tobacco industry, which led to some unreasonable acts of the local government. I will further explain this in Chapter 6.

4. Reforms of China's tobacco tax

For fifteen years of time between 1994 and 2009 China had gone through three major reforms on the tobacco tax. The latest adjustment started from May 2009 and marked a new round of reformation. From the past experience each reform would result in a reshuffle of the China's tobacco industry.

4.1. The first reform of China's tobacco tax

Before 1994 China's tobacco industry had enjoyed a uniform 60% production tax as the other industries did. After the "tax distribution system" was implemented from 1994 onwards the production tax was transformed to 17% VAT and the new consumption tax. Tobacco product became the main targeted item of the consumption tax. A uniform 40% consumption tax was imposed on all types of cigarettes based on the factory price.

At the same time, cigarettes were divided into five classes (the price of the cigarette excl. VAT): class 1: over RMB 25.64 / carton; class 2: RMB 17.09 ~ 25.64 / carton; class 3: RMB 8.55 ~ 17.09 / carton; class 4: RMB 4.27 ~ 8.55 / carton; class 5: less than RMB 4.72 / carton.

This was the first tax reform on the tobacco industry. As on all different classes of cigarettes a uniform 40% consumption tax was levied, the tobacco manufacturers would prefer to produce more profitable higher class cigarettes. The tobacco product focus shifted from low-grade to top-grade cigarettes. Hence, the supply of the low-grade cigarette was unable to meet the needs of the market. This tax policy imposed great losses on small and medium cigarette manufacturers.

4.2. The second reform of China's tobacco tax

To July 1, 1998, in order to promote the rationalization of product structure of the cigarette, the Chinese government reformed the cigarette excise tax again, adjusted the rate structure of the cigarette excise tax. The cigarette tax resisted into three excise tax rates: 50% for the class 1 cigarette; 40% for the class 2 and 3 cigarettes and 25% for the class 4 and 5 cigarettes. Thus, the different tax rates replaced the single tax rate. The tax rate on class 1 cigarettes increased by 10%, and the tax rate on class 4 and 5 cigarettes was reduced by 15%.

After the implementation of this tobacco tax policy, the production and sales volume of the low-grade cigarette increased significantly. Some small and medium cigarette manufacturers' productions recovered because of the tax cuts. Meanwhile the profits of large cigarette manufacturers which produce more top-grade cigarettes dropped sharply because of the tax increase. The dominance of the large cigarette manufacturer was weakened. It was more difficult for small cigarette manufacturers to shut down, stop down, merge, change products or move to other sites. To the organizational restructuring of the tobacco industry had made a negative impact.

In addition, during this time the cigarette excise tax had been levied according to the factory price at the production link. A lot of cigarette manufacturers avoided the tax through transfer pricing¹.

4.3. The third reform of China's tobacco tax

On June 2001, in order to promote the internal restructuring on the tobacco

¹ For example: A tobacco group corporation subordinate cigarette manufactory produces a kind of cigarette. The market price of the kind of cigarette is RMB 70 per carton (exclude VAT). The manufactory sold its independent accounting marketing department 100 cases (250 cartons per case) cigarettes for RMB 50 per carton. Before the transfer pricing: the payable cigarette consumption tax: $70 \times 250 \times 100 \times 40\% = \text{RMB } 700,000$. After the transfer pricing: the payable cigarette consumption tax: $50 \times 250 \times 100 \times 40\% = \text{RMB } 500,000$. Difference between before and after transfer pricing: $700,000 - 500,000 = \text{RMB } 200,000$. The transfer pricing reduced RMB 200,000 tax burden of the manufactory.

industry, the Chinese government carried out the third reform on the tobacco tax. This was an adjustment of taxation method and tax rate on cigarette excise tax. It implements a compound taxation method, combines a specific excise tax and an ad valorem tax, i.e.:

- υ Taxation according to quantity, a specific excise tax of RMB 150 per case;
- υ Taxation according to price, the cigarette tax was revised from three into two tax rate: a 45% tax rate for cigarette with an appropriation price higher than or equal to RMB 50 per carton and a 30% tax rate for cigarette with an appropriation price less than RMB 50 per carton.

This reform reduced the excise tax rate of the top-grade cigarette from 50% to 45%, enhanced the excise tax rate of the low-grade cigarette from 25% to 30%. A specific excise tax was introduced on cigarette for the first time, at a fixed tax of RMB 150 per case. This increased significantly the tax of the low-grade cigarette.

This adjustment did not have huge impact on large cigarette manufacturers which produce mainly medium- and top-grade cigarette. But the small and medium cigarette manufacturers which produce mainly low-grade cigarettes suffered serious losses. Many of them had to shut down and to get out of the market.

In addition to the adjustments of taxation method and tax rate, the taxable price was adjusted from “factory price” to “an appropriation price or an authorized price²”. This reduced the tax avoidance space of the tobacco enterprises to a certain extent.

² An appropriation price refers to the mutually agreed trading price through the cigarette market between the cigarette manufacturer and the purchaser. It is determined by the State Administration of Taxation according to the last year's appropriation price on various brand and specification of cigarette in China's tobacco trading center (www.tobt.com.cn) and the provincial tobacco trade fairs. The others excluded in China's tobacco trading center and the trade fairs are priced by the tax authorities through the reverse calculation of their marketing retail prices.

This reform of the tobacco tax again affected the cigarette product structure. It resulted in oversupply of top-grade cigarettes and in shortage of low-grade cigarettes. And the shortage of the low-grade cigarette in the market also provided a living environment for the illegal and counterfeit cigarettes. This had made an unfavorable impact on the healthy development of China's tobacco industry.

4.4. The latest reform of China's tobacco tax

The Chinese government has adjusted China's tobacco tax for the fourth time in May 2009. The latest adjustment was restricted to the cigarette excise tax, and still focused on the production and wholesale links:

- At the cigarette production link adjusted both the taxable price and the ad valorem tax rate. And the new bottom taxable prices are authorized and issued by the State Administration of Taxation (SAT).
 - υ The ad valorem tax rate: the tax rate of the class A cigarette rose 56% from the previous 45%; the tax rate of the class B cigarette rose from 30% to 36%; the tax of the cigars rose from 25% to 36%.
 - υ The classification standard of the cigarette has been adjusted: the dividing line between the class A and B cigarette went up from RMB 50 to RMB 70, i.e. the appropriation price equal to or higher than RMB 70 per carton (excl. VAT) is class A cigarette; less than RMB 70 per carton is class B cigarette.
- Meanwhile an ad valorem tax, levied at the wholesale link, was introduced on the tobacco products for the first time, at 5%.

According to the information from STMA showed: in 2009, the tax and profits of industry and commerce on the tobacco industry for the first time exceeded RMB 500 billion, achieved RMB 513.11 billion, grew 12.% year on

year, in which the tax fee achieved RMB 416.34 billion, the year to year growth was RMB 86.42 billion, increased 26.2%. The growth of 26.2% on the tax fee largely depended on the increase of the tobacco tax rate.

However, the RMB 513.11 billion profits and taxes of industry and commerce on the tobacco industry did not bring down the house. Instead, because the increase of the tobacco tax did not reduce the tobacco consumption and the smoking rate, the associations for the tobacco control at home and abroad and some experts questioned the earning way of the tobacco industry.

The international experiences showed that increasing the tobacco tax, on the one hand can increase the financial revenue to enrich the state treasury; on the other hand it can raise the cigarette price, so that smokers reduce the tobacco consumption. The World Health Organization (WHO) recommended also using the tobacco tax to control the tobacco consumption. But this method was useless in China.

Then, what was the significance of the increase on the tobacco tax in 2009? Experts agreed that “profitable state revenue and weak tobacco control” was the best summary.

Why did China increase the tobacco tax, but the cigarette price stood still? Why was the most internationally regarded effectual means of tobacco control useless in China? For these special phenomena, I will analyze in detail in the next chapter.

5. Influences of the China's tobacco excise increase in 2009

All along China's tobacco tax has been low. Before the latest increase of the tobacco excise tax, the cigarette tax rate was about 40% of the retail price, much lower than the international median tax rate, which amounts to 65% – 70% of the retail price.

In May 2009, the Ministry of Finance and the State Administration of Taxation (SAT) jointly said, an ad valorem tax went up on cigarette carton costing RMB 70 or more to 56% from the previous 45% rate, and another ad valorem tax for cigarette carton costing less than RMB 70 rose from 30% to 36%. The tax on cigars rose to 36% from 25%.

Meanwhile an ad valorem tax, based on the real value (less inflation factors) of the product at the wholesale link, was introduced on tobacco products for the first time, at 5%.

After the tax increase, the tobacco tax rose to 48.7% from the previous 40% of the retail price, but it is still much lower than the international tobacco tax. Thus, there is ample room for China to raise the tax on cigarettes.

There are three points for this time adjustment on the tobacco tax:

First, the tax rates were raised.

Cigarettes are classified into class A and B in China. This reform of the tobacco tax increased the tax rate of each class cigarette. The class A rose to 56%, and class B to 36%.

Second, the classification standard of the cigarette was changed.

The dividing line of cigarette class was changed to RMB 70 instead of RMB 50, equal to or higher than RMB 70 per carton is the class A cigarette, less than

RMB 70 is the class B.

Such a change was attacked, and considered as a “conspiracy”: in fact, because the dividing line changed to RMB 70 from RMB 50, the previous class A cigarettes in the range of RMB 50 ~ 70 per carton were set to the class B. This means that the tax rate in the range of RMB 50 ~ 70 per carton not only did not rise, but also decreased to 36% from 45%, thus by 9%.

Third, the retail price of the cigarette remained unchanged.

Through the observation of China’s tobacco retail market it was discovered that the retail prices of the cigarette, except for a few top-grade cigarettes, remained constant after the tobacco tax increase.

5.1. With the move up of tobacco tax the Government makes bigger profit.

There are at least two aspects that should be affected by the move up of the tobacco tax. One is the national tax revenue, the other is the smoking control which is closely related to the consumption behavior.

According to a survey made by the World Bank in 2001: if the tobacco excise tax increased, the cigarette price would consequently move up as well, however, the cigarette consumption would drop down. As the range of the consumption decline was usually less than that of the increase of the price, in general the national tax revenue rises. The survey also indicated that it’s easier for the government to collect the cigarette tax by monitoring strictly the output. Thus, in virtue of the rise of the tax rate the overall state tax revenue would not drop down though the cigarette consumption declined.

In fact, many countries’ government have regarded it an efficient means to increase the revenue by moving up the tobacco tax rate. For example in Canada as long as the government raised the tobacco tax the state revenue

would increase significantly; and whenever the state government of the United States was in shortage of money the first that comes to its mind was the tobacco business.

In the year of 2009, besides China, Ukraine, Iceland, Greece and Thailand all raised the tobacco tax rate. The UK even had made double rise. The United States raised the tobacco tax from 39 cents per pack to 1.01 US dollar, which was the greatest adjustment in its history.

Before May 2009 when the Chinese government announced to adjust the tobacco tax, China's financial revenue had experienced seven consecutive months negative growth year-on-year, and meanwhile the government increased its expenditures sharply in order to stimulate the economy. The treasury had experienced huge pressure. The aim of easing the financial pressure was obviously see as to why the Chinese government chose to introduce this new tobacco excise tax policy at this moment. Actually, it was already evident in increasing the financial revenue. The taxes and profits on the tobacco industry achieved RMB 513.11 billion in 2009, in which the tax fee covered RMB 416.34 billion, grew 26.2% year-on-year.

5.2. Tobacco tax moved up: the smoking control turned to be weak

Increasing the tobacco tax has been regarded as the most effective way to reduce the tobacco consumption worldwide. But, there are some prerequisites on this that is the increased tax finally would be reflected in the price. Unless smoking becomes more expensive, cigarette consumption will not be reduced.

A World Bank survey showed that cigarette consumption would be reduced by 4% in developed countries, and by 8% in developing countries, if the cigarette price increased by 10%. And the survey emphasized the important role that the tobacco tax increase has played to reduce the smoking of

teenagers. Due to their weak economic capability, young people are more sensitive to the cigarette price. If the cigarette price is raised by 10%, the same proportion of the young people will reduce smoking. More importantly, the higher price will prevent some young people from smoking who never did it before.

As a matter of fact there had been many successful cases in the world about controlling the tobacco consumption by raising the tax³: A U.S. statistic showed that 7.9% to 12% of the young people would reduce buying cigarettes, if the tobacco tax were raised by 10%; and a survey from Hong Kong indicated that there are two main reasons for quitting smoking: one is the personal health, and the other is the financial burden; in 1983, the British authorities in Hong Kong had a huge increase in tobacco tax by 300%, the number of the smoking population immediately decreased by 20%. The effect was obvious, so was it in Canada and the United Kingdom. Hence the World Health Organization (WHO) more than ten years ago had called for its members to increase the tobacco tax preventing the teenagers from buying cigarettes.

A report (Hu et al. 2008) assessed the potential impact of raising cigarette taxes on the smoking prevalence rate, number of lives saved, and government tax revenue in China. By simulation resulted that adding an excise tax of 1 RMB per pack, assuming a total price elasticity of -0.50, the prevalence rate of smoking would be reduced further from 30% to 28.67%, or in other words, reduction of 13.7 million smokers. Using the estimated epidemiology analysis reported by the 1999 World Bank report, assuming 25% of smokers will die from tobacco-related illness, an additional 1 RMB specific excise tax would mean 3.42 million lives could be saved, and would increase government revenue by RMB 64.9 billion, reduce medical costs by RMB 2.68 billion and generate a productivity gain of RMB 9.92 billion for the Chinese economy.

However, after China increased the tobacco tax, the expected

³ <http://biz.16888.com.cn/20096/24155018.html>

consumption drop-down did not show up. The market feedback was that, apart from a few top-grade cigarettes, most of the tobacco products' wholesale and retail prices had not changed. In other words, the new tax policy did not raise the cigarette price, so that the smokers did not have more economic pressure. Therefore they lacked the motivation to quit smoking or to smoke less.

The adjustment of the tobacco tax did not cause the linkage of the tax and the price, because the tax changed, but the price did not. Cigarette consumption was not affected, thus no tobacco control effect emerged.

5.3. Reasons for the unchanged cigarette price

From a global perspective, every time when the government raised the tobacco tax, the tobacco companies would react quickly to add the cigarette price. But, why the cigarette price stood still after the rise in China?

5.3.1. The tobacco monopoly controls the price

Although Chinese government had gone through several reforms on tobacco management system the tobacco industry has remained one of the least marketized. Under the “Law of the Peoples Republic of China on Tobacco Monopoly”, China implements the monopoly system under the unified leadership. Such system determined the basic features of the monopoly on the tobacco industry that is everything, from planting the purchasing of the tobacco leaf to the production, sales and management of the tobacco is unexceptionally determined by the government. And of course the cigarette price is set by the government as well.

In short, STMA (CNTC) has the pricing power. Due to China's tobacco monopoly system, the tobacco manufacturers and retailers do not have the right to raise the tobacco price. For protecting their own interests, STMA and CNTC would not allow a decline in the number of smokers and in tobacco

consumption because of the price increase on tobacco. In order to maintain the stability of the tobacco consumption, they wanted to keep a constant tobacco price.

5.3.2. The high monopoly profits, the tax increase was internally absorbed

Here, I use an example of the most popular cigarette “Jin Huang Dihao” in province Henan to explain the distribution of the monopoly earnings on the tobacco industry:

The retail price of a case of “Jin Huang Dihao” is RMB 25,000. Its cost is about RMB 6,225. The gross profit is RMB 18,775, in which the tobacco manufactory earned RMB 8,652, the commercial link (CNTC) earned RMB 5,223, as the tax was levied RMB 8,652, and the tobacco retailers earned RMB 2,400. I.e. the tobacco manufactory and the retail link each account for 13%, CNTC 28% and the taxation 46%. Obviously, apart from the taxation, CNTC took a large part of the earnings.

China’s tobacco monopoly system grants a monopoly to the tobacco industry. And monopoly pricing resulted in a high monopoly rent. Because of the large profit margin, even if the tobacco tax was raised, CNTC could still convert a part of the profit in to the tax revenue so as to ensure the price unchanged. This implies that the tax increase was internally absorbed by the tobacco industry.

In fact, this is an important business strategy of CNTC, i.e. using the profit of the expensive cigarette to subsidize the cheap cigarette. Through this way to keep the low price of the cheap cigarette, so as to do its utmost to maintain the number of the smokers and the tobacco consumption.

From another perspective, this also showed that this tobacco tax increase

was not enough. The tobacco industry had still the ability to absorb this part of the tax within the industry. Even after the tax adjustment, compared with the international tobacco rate, there is still room for China to raise the tobacco tax in the future.

5.3.3. Changed the classification standard of the cigarette, the tax of a part of cigarette declined

As I mentioned in the beginning of this chapter, the border of China's class A and B cigarettes was changed to RMB 70 from RMB 50. This change resulted directly in a reclassification of cigarettes in the range of RMB 50 ~ 70 per carton from class A to class B. Therefore, even though the rate of each class cigarette was raised, actually the excise tax in the range of RMB 50 ~ 70 dropped by 9%. The reason for this phenomenon, to tell the truth, was the result of a game between the interest-relevant department of the tobacco industry and the taxation department. In other words, it's the tobacco-related departments that resisted the increase of the tobacco tax in disguise.

As the integration of the government functions and enterprise management China's tobacco monopoly system on one hand gained huge profits for tobacco manufactories, and on the other hand has had great impact on the government's macroeconomic strategy. The largest tobacco enterprise – CNTC, actually is another identity of the government authority (STMA).

Knowing this we can understand why the cigarette classification standard was changed as well when the cigarette excise tax was raised in 2009. This not only satisfied the governments' needs for the financial revenue, but also protected the interests of the tobacco industry.

All in all, the reasons why the price of China tobacco does not increase with the rise of the tax are that under the tobacco monopoly system the tobacco industry has a huge profit margin and that in some circumstances part of tax for

cigarette actually decreased. Due to these two factors the tobacco industry itself was able to absorb the impact brought forth by the tax increase. This is to say that the monopoly system leaves no room at all for China's tobacco industry to make free marketing choice since usually a price increase should follow higher taxes.

6. China's tobacco taxation system influenced the action of local government

In China's current collection and distribution system of the tobacco taxation, the local government got huge tax revenues from the tobacco industry. Thus, it caused the local governments, especially the local governments of the major tobacco producing areas, to have the over-dependence of finance revenue on the tobacco industry. The over-dependence led to some unreasonable acts of the local government, such as: through administrative intervention forced farmers to plant tobacco leaves; the local protectionism, etc. Next, I will be taking Yunnan Province, the China's biggest tobacco producing areas, as an example, to further elaborate.

6.1. Interventions of the local government on China's tobacco industry

6.1.1. The local government intervening in tobacco leaf planting

1. The costs and risks of the tobacco leaf planting are high, the cost-profit rate of the tobacco leaf continued declining, and the farmers did not want to grow the tobacco leaves.

① The cost-profit rate of the tobacco leaf was at a disadvantage compared to other crops in tobacco producing areas. Take China's biggest flue-cured tobacco⁴ production base, Qujing City, Yunnan Province, as an example:

⁴ Tobacco could be divided into flue-cured tobacco, sun-cured tobacco, burley tobacco, oriental tobacco and cigar tobacco etc. The flue-cured tobacco war originally strung onto tobacco sticks, which were hung from tier-poles in curing barns. These barns have flues which run from externally fed fire boxes, heat-curing the tobacco without exposing it to smoke, slowly raising the temperature over the course of the curing. The process will generally take about a week (Source: http://en.wikipedia.org/wiki/Curing_of_tobacco).

**Table 2: The production cost and profit of Qujing City's
main grain and economic crops in 2007** Unit: Yuan / Mu⁵

Item	Unit	Japonica rice	Flue-cured tobacco	Rapeseed	Potato
Total output value	Yuan	942.05	1551.12	565.14	1475.67
Total costs	Yuan	766.11	1556.43	369.96	969.58
Net profits	Yuan	175.94	-5.13	195.18	506.09
Cash costs	Yuan	270.08	769.76	177.13	616.54
Cash earnings	Yuan	617.97	781.36	388.01	859.13
Cost-profit rate	%	22.97	-0.33	52.76	52.20

Source: Qujing Municipal Commission of Development and Reform: "The data collection of Qujing City's main agricultural products cost-earnings"

- ② The cost of flue-cured tobacco continued increasing, and its cost-profit rate decreased, the tobacco growers had only meager profits (see Table 3).
- ③ The tobacco growers have to take a huge risk in the whole growing and preliminary processing links.

Because of the weather and terrain factors, the major tobacco producing areas are frequently affected by hail disasters. Compared to other crops, the flue-cured tobacco has weak resistance to hail disaster. In case it suffers from a hail disaster, usually half or even the whole of the harvest is lost. Moreover, the tobacco leaf curing makes a high request for the technology and experience of the tobacco growers. A slightest mistake would affect directly the grade of the tobacco leaf.

⁵ Yuan: RMB currency units, 1 US Dollar $\approx$ 6.76 Yuan
Mu: a unit of area, 1 Mu = 0.0667 Hectares

**Table 3: Comparison between the years 2007 and 2004, 2005 and 2006
on the flue-cured tobacco costs and benefits**

Item	Unit	2004	2005	2006	2007	Comp. 07 & 04(%)	Comp. 07 & 05(%)	Comp. 07 & 06(%)
Average price	Yuan /kg	11.05	11.46	11.54	11.75	6.30	2.50	1.78
Total costs	Yuan /kg	1059.05	1259.63	1338.12	1527.19	44.20	21.24	14.30
Material and service costs	Yuan /Mu	433.2	556.50	595.69	742.49	71.39	33.42	24.64
Labor costs	Yuan /Mu	556.16	578.83	613.99	634.88	14.15	8.00	3.40
Land costs	Yuan /Mu	69.67	115.30	126.44	150.14	115.50	30.22	18.74
profits	Yuan /Mu	381.16	284.50	209.42	-6.57	-101.7	-102.3	-103.1
Cash costs	Yuan /Mu	438.01	562.18	603.72	765.42	74.75	36.15	26.78
Cash earnings	Yuan /Mu	1002.2	981.95	941.64	755.50	-24.62	-23.06	-19.77
Cost-profit rate	%	35.99	22.59	15.66	-0.42	-101.2	-101.9	-102.7

Source: Qujing Municipal Commission of Development and Reform: “The data collection of Qujing City’s main agricultural products cost-earnings”

2. The taxes related to the tobacco industry brought huge revenue to the local governments, caused the local governments through administrative means to urge farmers to grow tobacco leaves.

On the one hand, “tobacco leaf tax”, “city construction and maintenance tax” and “education surtax”, etc. local government taxes support the local

government revenue; on the other hand, the local government can also share the central and local government sharing taxes and the central government taxes, such as: “VAT”, “enterprise income tax” and “consumption tax”, etc. Therefore, some local governments disregarded the wishes of the farmers and urged them to plant tobacco. For example, the tobacco leaf purchasing station by CNTC asked farmers to plant tobacco leaves. If farmer grew other crops, the local government would force them pulling out. The local STMA also confirmed that the tobacco leaf planting is planned, controlled and managed by government. The size of the tobacco leaf planting areas is regulated. To ensure the number of the tobacco leaf planting, sometimes mandatory measures were needed.

6.1.2. The local government intervening in cigarette production

Because the cigarette excise tax is collected at the production link, the revenue earnings of the cigarette production region are much more than cigarette marketing region. The local government paid more attention to the cigarette production than to the tobacco business or other industries, even did a lot of administrative intervention on the cigarette manufactories. Actually, they played a role of encouraging production and inhibiting circulation on the cigarette.

Because the cigarette excise tax is paid by the cigarette manufactories at the production link, the cigarette output became an important factor which decides how many disposable financial revenues can have the local governments. Driven by local interests, the local governments of the tobacco producing areas applied more administrative intervention and protection on the local tobacco enterprises, blockaded the local cigarette market, developed local cigarette brands, put up barriers to prevent foreign cigarettes from entering the local market. It can be said that the close ties between the tobacco taxation and the local financial revenue directly caused the rise of local

protectionism.

6.2. The “tobacco dependence” of the local government – an analysis on the tobacco industry relevant tax items

1. Tobacco leaf tax

The tobacco leaf tax revenue belongs to the local government. It always becomes the backbone of the local tax revenue, because the development of the commodity economy is always lagging behind in most of tobacco producing areas. In addition, during the purchasing of the tobacco leaves, the purchasing stations are centralized, not only low costs but also high efficiency. It benefits the local tax authorities to collect and manage.

2. Consumption tax

Although the consumption tax is a central government tax, the central government every year must return a part of the tax revenue to the local governments. Whether they can get the tax return and how much they can get, depends on the growth of the local “two taxes” (VAT and consumption tax). Therefore, this means that, the higher consumption tax revenue, the more tax return the local government can get.

The tobacco producing areas are always China's central and western economically underdeveloped areas. The huge consumption tax paid by the tobacco industry is a major part of the local consumption tax revenue. In order to facilitate the collection and management, China's tobacco consumption taxes are levied at the production link. This led the local governments of the tobacco producing areas to depend on tobacco consumption.

3. VAT

The revenues from VAT are shared between the central and local government. The central share is 75% and the local share is 25%. Like the

consumption tax, the collection of the VAT has a close bearing on the tax return, and also has a direct influence on the disposable revenue of the local government.

Table 4: Comparison between “two taxes” revenue of cigarette and the total tax revenue in Yunnan Province (years 1994 - 2005)

year	Total central and local tax (100 Mio. Yuan)	“Two taxes” revenue on cigarette (100 Mio. Yuan)	Proportion of “two taxes” to total tax revenue
1994	266.79	155.57	58.3%
1995	289.44	164.14	56.7%
1996	328.66	171.96	52.3%
1997	355.97	180.52	50.7%
1998	406.72	207.46	51.7%
1999	412.42	219.31	53.2%
2000	424.97	210.74	49.6%
2001	423.01	194.97	46.1%
2002	453.29	209.79	46.3%
2003	491.96	224.92	45.7%
2004	604.35	268.52	44.4%
2005	676.78	265.80	39.3%

Source: Yunnan Province Office, State Administration Taxation

4. Enterprise income tax

The tobacco enterprise should pay the enterprise income tax according to the 25% of their taxable income. The enterprise tax is a tax shared between the central and local government, each of which accounts for 50%.

5. City maintenance and construction tax and education surtax

Both are local government taxes, their tax basis is the sum of the consumption tax, VAT and business tax. As the tobacco industry created huge consumption tax and VAT revenues, the city maintenance and construction tax and education surtax, which are collected by the local government from the tobacco industry, support largely the urban construction and education expenditure of the local government.

6.3. The harms of the local government's interventions on the tobacco industry

First, the tobacco leaf tax brought great tax revenue to the local governments. In order to get more tobacco leaf tax revenue, they overdid the administrative interventions in the tobacco leaf planting. This harmed directly the interests of farmers. They were deprived of the right to free choosing crops to grow. Meanwhile, forcing farmers to plant tobacco leaf often caused that yield of the tobacco leaf exceeded the CNTC quotas. The farmers had to sell their leftover tobacco leaves to underground private cigarette manufactories for counterfeit cigarettes.

Second, as the local government can share the huge tobacco tax revenue with the central government, the local governments are willing to support those tobacco enterprises with low benefits, so that they can benefit from the tobacco tax revenue. Over attention, intervention and protection of the local government on the tobacco enterprise interfered directly with the regular production and operation of these enterprises, caused the rise of the local protectionism and hindered the formation of a unified national tobacco market. Tobacco enterprises could not create economies of scale. This has undermined the competitiveness of China's tobacco industry.

Third, local governments of the tobacco producing areas depend much on

tobacco taxation. The main reason is that the local economies are incompletely developed. The local governments could not receive sufficient revenue support in the other economic sectors or industries. But if the local governments through the growth of the tobacco taxation were able to meet the needs of financial expenditure, complete the task of taxes to obtain more tax return from the central government, the local governments would increase their dependence on the tobacco taxation. They would lack the motivation to develop other industries, the local economy would still develop lopsidedly – the tobacco industry is unique outshining and other industries develop slowly. This is a vicious circle.

Therefore, only decreasing the tax benefits which the local governments obtain from the tobacco taxation can reduce their over-dependence of the tax revenue on the tobacco tax, so as to reduce and even completely eliminate the unreasonable interventions of the local government on the tobacco industry.

7. The tobacco tax and the tobacco control in China

7.1. Framework Convention on Tobacco Control and China

WHO Framework Convention on Tobacco Control (WHO FCTC) is the first legal global public health treaty and is the first worldwide multilateral agreement on the tobacco.

In the convention WHO urged all governments to raise the price of tobacco products by the means of tax charge. To reduce tobacco consumption by raising the price of tobacco is an important provision which all governments are requested to perform.

Each member country of the WHO FCTC is committed to ensure the health of its people protected by joining the tobacco control. To assist its members in fulfilling the commitment, WHO has announced a policy called “MPOWER”, a package of six tobacco control measures (WHO 2008):

“M”, monitor tobacco use and prevention policies; “P”, protect people from smoking; “O”, offer help to quit tobacco use; “W”, warn about the dangers; “E”, enforce bans on tobacco advertising, promotion and sponsorship; “R”, raise taxes on tobacco.

The tobacco control measures can be either economic or non-economic. The real economic measure of the tobacco control can be “R”, i.e. raise taxes on tobacco. To raise the tobacco tax means that the tobacco price might be increased. The economic measure can reduce the tobacco consumption. MPOWER quoted data from South Africa: “cigarette consumption fell by 5% to 7% for every 10% increase in the price of cigarettes, resulting in a sharp decline in consumption, with the largest smoking decreases among the young and the poor” (WHO 2008). MPOWER said that taxation is the best way to cut tobacco use.

The Chinese government signed the WHO FCTC in 2003. And approved by the National People's Congress the treaty came into effect in January 2006. According to the convention, by 2011, smoking shall be restricted at all indoor public places, indoor workplaces, public transportation and other possible public places. A totally non-smoking environment has to be achieved.

7.2. Analysis of the efficiency on the tobacco control through tax

Because of the addictive nature of cigarette many people distinctively think that smoking has nothing or little to do with the cigarette price. People consequently judge that it may not be a good idea to control the tobacco use by raising the tax. However, the price is actually a truly important factor in the decision of smoking or not. Among the existing smokers, the influence caused by price change is differentiated by the incomes, ages, and some people are greatly influenced by the price.

7.2.1. An analysis on the efficiency of tobacco control through tax based on the price elasticity

Whether the high price caused by the taxation can restrain the consumption relies a lot on the price elasticity of demand. As the price elasticity of the demand for tobacco products is great, the high price caused by the high tax is effective for the tobacco control.

1. The price elasticity of smoking participation and the price elasticity of smoking

The price elasticity of demand on the tobacco product can be divided into the price elasticity of smoking participation and the price elasticity of smoking. The price elasticity of smoking participation means the influence degree of the

price as people make the decision whether to start smoking; the price elasticity of smoking means the influence degree of the price on smoking after people have already started smoking.

The price plays an important role when people make a decision whether to start smoking, therefore, the price elasticity of smoking participation is larger. In contrast, to those who have been smoking, the price has less influence on their smoking. The price elasticity of smoking participation was estimated between $-0.17 \sim -0.54$, and the price elasticity of smoking was between $-0.10 \sim -0.22$ in developed countries. The price elasticity of smoking participation was estimated by -0.89 , and the price elasticity of smoking was -0.18 in China (Mao 1997).

This showed that the price has more influence on whether to start smoking in China than in developed countries. To those who have been smoking, due to the addiction, the price has little impact on smoking both in China and in other countries.

Therefore, although the high price with the high tax has little impact on the smoking of the addicts, it plays a positive role in discouraging people from starting to smoke. From this perspective, the high tax can help to control the tobacco use.

2. The price elasticity of demand of the different groups for the tobacco product

① Different income groups

The price elasticity of demand is closely related with a person's income. The price elasticity of the demand of the lower income group is greater. And their demands are more easily affected by the price change, the opposite for the high income group. Mao et al. (2005) had estimated the price elasticity of demand of China's different income groups for cigarettes, the result in table 2:

**Table 5: The price elasticity of demand of
China's different income groups for cigarettes**

Price elasticity \ Groups	Poor group	Low income group	Middle income group	High income group
Price elasticity of smoking participation	-0.692	-0.286	0.131	0.441
Price elasticity of smoking	-0.111	-0.035	-0.111	-0.083
The annual average income: Poor group: less than RMB 5000; Low income group: RMB 5000 ~ 10000; Middle income group: RMB 10000 ~ 50000; High income group: more than RMB 50000.				

The price elasticity of smoking participation of the poor and low income groups is negative, which means that the increase of the price would reduce their smoking participation. The lower income the people have, the more sensitive to the price they will be. A price increase would significantly reduce the smoking participation of the poor and the low income groups. The price elasticity of smoking participation of the middle and high income groups is positive, meaning that an increase of the price would rather raise their smoking participation. The more income the people have, the higher is the smoking participation probability as the pricing increases.

The data also showed that, to whichever of these groups, the price elasticity of smoking is negative, which means that the increase of the cigarette price would reduce the smoking of various group.

The World Bank's research report (1999) showed that the smoking rate of the poor and the less educated is higher than of those who are wealthier and better educated, around the world. A Chinese survey (Zhang 2006) showed that the low-grade cigarette consumption accounted for 62.58% of the total

rural cigarette consumption in 2005. According to a survey of the cigarette consumption in Beijing Market (2005), in Beijing's cigarette consumption groups, low-grade cigarette consumption groups accounted for 75%, top-grade cigarette consumption groups just accounted for 5%; the sales of the low-grade cigarette accounted for 31% of the total sales, the middle-grade was 68% and the top-grade was only 1%. It is thus clear that the low income group accounts for most of the smokers in China. Accordingly, the price elasticity of demand for the tobacco product is greater.

② Different age groups

Gruber (2002) found that, in the 1980s, in the US, the smoking rate of the teenagers dropped sharply after the raising of the cigarette price. When the cigarette price declined, the smoking rate of the teenagers rose rapidly. In the 1990s, when the price increased again, the smoking rate of the teenagers dropped very fast again. He estimated that the price elasticity of demand of the teenagers for the cigarette was -0.66 which was about three times the price elasticity of the adult smokers.

Mao et al. (2002) showed that the price had an obvious influence on the demand of the teenagers for the cigarette in China. The price elasticity of smoking participation was -1.15, and the price elasticity of smoking was -0.46, much higher than the adult smokers. All the research results showed that using the tax to control the tobacco use can effectively protect the teenagers from starting to smoke and reduce the smoking of the young people.

3. The general price elasticity for tobacco product

Frank et al. (1999) studied the price elasticity of demand for tobacco products and obtained the following estimates for the general price elasticity of demand for tobacco: the wide range was -0.14 ~ -1.23, the narrow range was -0.3 ~ -0.5. Bai et al. (2005) according to data from 30 provinces of the Chinese mainland (excl. Tibet), obtained China's price elasticity of demand for the

cigarette as -0.852, in which the less developed areas was -0.962, the medium developed areas was -0.957, and the developed areas was -0.722.

From what has been discussed above, all of the studies showed that using the high tax to cause the high price could have an effective effect on the tobacco control.

7.2.2. The experience worldwide proved the application of the tobacco control through tax

The price increase of the tobacco product resulted in the decline of the tobacco consumption. This rule applies to both the developed and the developing countries.

In Canadian data (Beyer and Brigden 2003), during 1985–1991, the “Tobacco Tax Plan” caused the increase of the tobacco price, led to a drop of 40% in domestic sales in which the average cigarette consumption of teenagers decreased by 60%. In 1979, 42% of teenagers between 15 and 19 were habitual smokers, but in 1991, the proportion fell to 16%. The South Korean statistics showed that the average price of a pack cigarette had risen by 50% since 2005 the government had raised the tax rate of the cigarette. After three months, the smoking rate decreased to 53.3% from 57.8%, and six months later, decreased to 52.3%⁶.

7.2.3. The price elasticity of the top-grade cigarette in China

It is to be noted that China’s top-grade cigarette consumption is quite different from that of other countries. Most of these top-grade cigarettes are used as the gift consumption or government consumption, i.e. buy the top-grade cigarettes as gifts or using the public funds to buy the top-grade cigarette. This ironically means that, “smokers do not buy, and buyer do not

⁶ <http://www.yan.la/xinwen/guoji/yaowen/20091214-11706.html>

smoke”. When purchasing top-grade cigarettes, few people would care about the high price. The price elasticity for the top-grade cigarette is small. And it goes even further - the higher the price is, the more are consumed. Thus, although a few top-grade cigarettes increased the price after the Chinese government had raised the tobacco tax, sales were not affected. Therefore, it is very difficult to control the consumption of the top-grade cigarette just by raising tax.

7.3. A survey of raising tobacco tax in China

In 2009 a public survey⁷ was conducted nationwide in China for the purpose of knowing how the public think about raising the tobacco tax. This survey was executed by a research team namely “Study of Chinese Cigarette Tax” which was formed by Tsinghua University, Ministry of Finance People’s Republic of China and Harvard University. The survey result showed that the public had a clear understanding about the hazards of smoking and supported the tobacco control by tax increase.

7.3.1. The public had a clear understanding in the China’s tobacco consumption and the hazards of smoking

The residents had a basic understanding of China’s tobacco production and sales which are the largest in the world. The majority of the public thought that smoking has caused serious hazards to public health, and smoking of teenagers is a serious social problem. Meanwhile, over 90% of the non-smokers had hazards of passive smoking.

⁷ http://www.cmmr.com.cn/_d269715297.htm

7.3.2. The public highly support the tobacco tax increase

**Table 6: The public support and oppose rate
for the tobacco tax increase (%)**

Option	Total	Non-smoker	Smoker
Support rate (very support + support)	85.6	87.1	80.5
Very support	65.5	67.9	57.8
support	20.1	19.2	22.7
Indifferent	7.2	6.5	9.5
Oppose rate (very oppose + oppose)	7.2	6.4	10.0
Very oppose	4.1	3.3	6.4
Oppose	3.2	3.0	3.6
Total	100.0	100.0	100.0

The survey showed that more than 80% of the residents supported the increase in tobacco tax, in which “very support” accounted for 65.5%, and “support” accounted for 20.1%, clearly oppose to only 7.2%. And non-smokers supported the increase of the tobacco tax even more; the rate reached to 87.1%, higher than the smokers 6.6%. The survey also found that the higher educated residents more supported the tobacco tax increase. The support rate of the urban residents was higher than the rural. Moreover, most of the residents supported using the increased tobacco tax to expand the medical insurance and the tobacco control etc.

7.3.3. The tobacco tax increase would restrain smoking effectively

Smokers accounted for about 23.8% of the total respondents in this survey. The survey investigated the smokers' responses for various degrees of the tobacco tax increase, aimed to understand whether the economic means of the tax can achieve the goal of controlling smoking.

1. The higher the tax increased, the larger inhibiting effect for the smoking made.

The survey result showed that, if a pack of cigarette increase by RMB 0.6 after the tobacco tax is raised, 54.5% of the smokers would be willing to quit or reduce smoking; if the cigarette price is raised by RMB 2, 73.3% of the smokers would have the same intention; if the price is raised by RMB 10 or more, 88.6% of the smokers would be willing to quit or reduce smoking.

2. Smokers with very little or with strong daily cigarette consumption are less sensitive to the cigarette price.

Those who smoke little do not feel the cost increase. Therefore the cigarette price does not have a significant impact on their expenditure. And those who smoke often may find it difficult to reduce their smoking habit.

3. The increase of the tobacco tax has a greater influence on the smokers who smoke low-grade cigarettes.

Most of those smokers who smoke lower-grade cigarette are low income groups or teenagers. Thus, increasing taxes to reduce the smoking of the low income groups and of teenagers is more effective.

4. The increase of the tobacco tax would cause a part of the smokers to smoke lower-grade cigarette.

If a pack of cigarette price is raised by RMB 0.6, 10.5% of the smokers

would be willing to smoke lower-grade cigarette; if the price is raised by RMB 2, the proportion would rise to 17.3%. This showed that a “substitution effect” exists among the various grade cigarettes. Rural smokers have a more obvious “substitution effect” than urban smokers. Overall, the proportion of those who choose the lower-grade cigarette is not high. There, it has little impact on the total tobacco control.

7.4. Two propositions on the tobacco control by raising tax

7.4.1. Proposition 1

Hu et al. (2008) proposed that the Chinese government should increase the specific excise tax from the previous RMB 0.6 per pack to RMB 1 per pack. They performed a simulation based on two different price elasticities (-0.15 and -0.50):

“with a 1 RMB per pack tax increase ... with a total price elasticity of -0.15, smoking participation elasticity would be -0.06, and the prevalence rate of smoking would be reduced from 30 percent to 29.6 percent, representing a reduction of 4.1 million smokers ... assuming a total price elasticity of -0.50 (i.e. smoking participation elasticity at -0.20) ... the prevalence rate of smoking would be reduced further 30 percent to 28.67 percent, or a reduction of 13.7 million smokers ...”

That means “an increase in the specific excise tax of RMB 1 on a pack of cigarettes would increase government revenue by RMB 64.9 billion, save 3.4 million lives, reduce medical costs by RMB 2.68 billion and generate a productivity gain of RMB 9.92 billion for the Chinese economy”.

The proposal mainly called for “increasing the specific excise tax” to reduce the price difference between the high- and low-price cigarettes so as to restrain the people from smoking, in particular reduce the smoking of the low

income groups and teenagers, because they smoke mainly the low-price cigarette.

7.4.2. Proposition 2

This proposal had been formally submitted by “Study of Chinese Cigarette tax” task force to the Chinese government before China raised the tobacco tax in May 2009. The main idea was also by means of tax to control the tobacco use, and to reduce the price difference between the high- and low-price cigarettes, mainly included:

- υ Raising the ad valorem tax rate of the class B cigarette to the previous tax rate of the class A cigarette, i.e. the ad valorem tax of both class A and B cigarettes are by 45%. Increasing the specific excise tax of all cigarettes to RMB 0.3 per pack. Taken together, the retail price of a pack of cigarettes will increase by 17.7%.
- υ Collect the cigarette excise tax from the production link to the wholesale link. Because the regularization degree of the cigarette retail link in China is relative low, it is difficult to collect and manage the cigarette excise tax in the link, but in the wholesale link is fully operational.

Both proposals of above discussed how to adjust the tobacco tax and price. Although different, the essences are the same, i.e.: the first is to increase tax; second, the increase of tax should be reflected in the cigarette price. The purposes and principles of the two proposals are the same, that is, through increasing the tax and the price to control the tobacco consumption.

The two proposals both referred a concept of the “Earmarked Tax”, i.e. the increase of the finance revenue are earmarked for improving the people’s livelihood, such as increasing the healthcare, the tobacco control, etc.

Both the international voice and the wishes of the domestic public are urging China to accelerate the pace of the tobacco control. The international experiences showed that raising the tax is the best economic way for the tobacco control. After China's increase of the tobacco tax in 2009, the government revenue increased obviously, but the tobacco control was useless (see Chapter 5). The main reason was that the tax changed but the price did not change. Therefore, how to further adjust the tobacco tax system? How to reform the current tobacco monopoly system, and to establish the linkage mechanism of the tax and the price make the tax policy to play a real role in the tobacco control? These are important issues which the Chinese government must think about and resolve in the future.

8. The WTO impact on China's tobacco taxation

China has implemented strict control on the import and export of tobacco products which resulted in less dependence on foreign trade. The development of Chinese tobacco basically relied on the domestic market.

After joining the WTO, China's tobacco industry is obliged to reduce tariffs, release and even dismantle tariff barriers, progressively open up the market and revise or renew the rules.

Owning the largest amount of smoking population China has to become the most focused market of all the multinational tobacco companies. However, as the international competitiveness of China's tobacco enterprises is relatively weak, it gives a great impact on China's domestic tobacco market. Meanwhile, China's traditional administrative system, the taxation system, the legal system and the enterprise system also have to be confronted with great challenges.

8.1. Tariff policy

China had always adopted a high tariff policy on imports of tobacco products. After joining the WTO China had a substantial reduction in import tariffs on variety of tobacco products. According to the commitments to WTO, China's import tariff on cigarettes was reduced from previous 60% to 25% in 2003, the import tariff of the tobacco leaf was reduced to 10% from 40% in 2004.

8.2. Consumption tax policy

As China's tobacco enterprises do not have economics of scale, probably they have to lose market shares to foreign multinational cigarette companies following the opening of the domestic market. Therefore, a higher tax rate will

be a good way to maintain the tobacco tax revenue when the production and sales of the domestic cigarettes reduce.

China's cigarette excise tax is the tax included in price⁸, the tax sharing is not clear. But in other countries is the tax excluded in price⁹. According to the WTO's "Transparency" principle, it is most possible to change the tax included in price to the tax excluded in price and unify the tax rate, and then, to be a gradual transition to paying the excise tax in cigarette marketing regions. Speed up the innovation of tax system, as far as possible to eliminate local protectionism.

8.3. Enterprise income tax policy

Joint ventures have enjoyed favorable tax policies in the past dozen of years in China. In other words, for quite long time foreign companies have received the "Ultra-National Treatment". Because of the difference of the two enterprise income tax policies, the enterprise income tax burden of foreign companies has always been much lower than Chinese enterprises. This is not conducive for the Chinese tobacco enterprises to compete with foreign ones. China's accession to the WTO provided more opportunities for more new joint ventures, thus, to unify the enterprise income tax of the domestic and foreign enterprises is imperative.

^{8 & 8} ① Tax included in price: is undertaken by the seller. Price of goods which is obtained by sellers is the selling price, and the tax is to go with the selling price, in which the tax will be deducted. i.e. price of goods (inclusive tax) = selling price; tax = price of goods (selling price) × tax rate.

② Tax excluded in price: is undertaken by the purchaser. Price of goods which is obtained by sellers consists of the selling price and the tax. i.e. price of goods = selling price + tax. Due to: tax = selling price × tax rate, and the price of goods (i.e. a tax-inclusive price) subtracts the tax, i.e. a tax-exclusive price, therefore, the tax = price of goods – selling price = price of goods – tax / tax rate. The resulting:

Tax included in price = price of goods (selling price) × tax rate = a tax-inclusive price × tax rate

Tax excluded in price = [price of goods / (1 + tax rate)] × tax rate = a tax-exclusive price × tax rate

In most of the western countries, the consumption tax is the tax excluded in price, i.e. the buyer need to pay the tax when shopping. For example: if a goods price of \$100 and the tax rate of 25%, the buyer need to pay $100 + 100 \times 25\% = \125 .

In China, the consumption tax belongs to tax included in price, i.e. the price of goods includes the tax, the buyer need not to pay an additional tax. For example: if a goods price of \$125 and the tax rate of 20%, the buyer just pay \$125, and the seller need to deduct the tax of $125 \times 20\% = \$25$, i.e. $125 - 25 = \$100$ is the real price which is belong to the seller.

From the above examples we found that both the price and the tax in two tax modes are the same: \$100 and \$25, the payments of the buyers are both \$125, the difference is that the tax rates are different: one is 25% and another is 20%.

8.4. Non-tariff measure policy

China has implemented strict planning and “Special Retail Permit” management system on tobacco production and sales. And it’s even more restrictive on the foreign tobacco companies. After China joined WTO the planning and the special retail permit system still existed, however, foreign tobacco companies wouldn’t be locked out of the Chinese market by administrative means and the quotas. According to the principles of “Market Opening” and “National Treatment”, foreign tobacco companies may obtain the special retail permit and compete fairly with the Chinese tobacco enterprises.

8.5. Export tax rebate policy

After accession to the WTO, China’s many preferential policies to encourage exports were abolished. Export subsidies are no longer applicable. But the export tax rebate policy in accordance with international practice does not belong to the export subsidies. Therefore, the export tax rebate policy will serve as one of China’s major means of foreign trade support to encourage export.

As the foreign trade dependence of the China’s tobacco industry has been always low, to improve the export tax rebate policy is particularly important. This means that, to raise tax refund rate for export, as far as possible to implement the principle of “refund the tax which be levied”, so that China’s tobacco products can with the zero tax rate enter the international market, expand exports and enhance the international competitiveness.

9. Suggestion

China's tobacco tax has made great contribution to Chinese financial revenue. Since 1994 the Chinese government has been constantly adjusting and improving the tobacco taxation system. However, as the tobacco markets at home and abroad have been continually developing and changing and the tobacco control has become a global trend, the Chinese government should act more positively to adjust and improve the China's tobacco taxation system.

9.1. Gradually phasing out the tobacco tax

In 2006, China eliminated all agricultural product taxes to relieve farmers' financial burdens. But the tobacco leaf was excluded in the tax exemption. It was renamed as a tobacco leaf tax. The main reason for imposing the tobacco tax is that the tobacco leaf tax accounted for a much higher proportion of the local government tax revenue. The abolition of the tobacco leaf tax will have a huge impact on the local economy. But I think that the tobacco leaf tax should be eliminated:

1. The continued tobacco leaf tax charge not only violates the justice principle of taxation, but also hindered the farmers' incentive for planting.

Tobacco growers are also farmers. They should have the right to enjoy the tax exemption policy as other farmers do. Although the tobacco leaf tax is not directly charged on the tobacco growers, but to the purchaser at the purchasing process, finally the tax burden is transferred to the tobacco growers (because the purchasing price includes the tax).

2. High tobacco leaf tax revenues belong to the local governments. This led to their excessive administrative intervention in the tobacco leaf production.

In order to levy more tobacco leaf tax, the local government emphasized

the quantity rather than the quality of the tobacco leaf. The blind development of the tobacco production is not conducive to the optimization of the production distribution on tobacco leaf.

3. The high tobacco leaf tax reduced the competitiveness

While the tobacco leaf tax is not levied in most other countries, China levies so high tobacco leaf tax that it must inevitably affect the export competitiveness of China's tobacco leaf. Far beyond that, but comparison with the import tobacco leaves the Chinese tobacco leaf had lost its price advantage in the domestic market, as the tobacco leaf tariff reduced substantially after China's accession to the WTO.

Certainly, the Chinese government can gradually reduce the tobacco leaf tax until it's totally eliminated if the abolition of the tobacco leaf tax could have immediately financial pressure on the local government.

To compensate for the lack of the local revenue resulting from the reduction and elimination of the tobacco leaf tax, the central government could increase the cigarette excise tax and transfer parts of the additional cigarette tax revenue back to the local government.

9.2. Adjusting the cigarette excise tax

9.2.1. Raising the cigarette excise tax

In recent years, due to the global booming tobacco control activities, a lot of countries raised the tobacco excise tax, so as to control and reduce smoking. Even many countries and international organizations asked for unifying the global tobacco tax standard and proposed to raise the tax rate to 70%. Following the WHO FCTC guidelines, China as the contracting party must continue to increase the tax and the price of tobacco.

After the latest adjustment of the tobacco tax, China's tobacco tax rose to

48.7%. In spite of that, it is much lower than the international median tax rate, which is around 65–70%. This leaves big room for China to raise the tax in the future.

At present, China's excise tax is dominated by ad valorem tax, that is, the tax of the high-price cigarette is higher, and the specific excise tax accounts for a very small proportion of the cigarette tax, less than 10%. To increase the specific excise tax is relatively more effective to achieve the effect of the tobacco control, i.e. taxation according to quantity. In this way, it cannot only increase the cigarette price as a whole, but also reduce the difference on the tax and the price among various class cigarettes and reduce the substitution of the low-price cigarette.

Hu et al. (2008) proposed that the Chinese government should consider significantly increasing the cigarette-specific excise tax from RMB 0.06 per pack to RMB 1 per pack. The specific excise tax has a direct effect on consumers. Buyers of a pack of cigarettes must pay the tax of RMB 1. The cheaper is the cigarette, the higher is the tax; the more cigarettes the consumers buy, the more taxes they pay. This has great psychological impact on the consumers.

Of course, some people worry that the increase of the tax on and the price of tobacco will lead to an increase of tobacco smuggling. But some international experience showed that the intensity of smuggling in a region is closely related to the law enforcement by the government. For example, in Northern Europe, the tobacco price is pretty high, but smuggling activity is low. In Italy, the tobacco price is relatively low, but smuggling is rampant. Thus, this does not mean that the price increase must lead to smuggling. If the government can adopt effective measures to crack down on the smuggling, this problem can be prevented. In fact, China's tobacco monopoly system is very powerful in cracking down on the smuggling.

9.2.2. Changing the collection link of the cigarette excise tax

The aim is that changing the collection link of the cigarette excise tax adjusts the taxation distribution, i.e. changing the collection on the production link to both the production and the wholesale links. The new tobacco tax policy added an ad valorem tax by 5% on the wholesale link for the first time. But the ad valorem tax of 5% is not enough to change the absolute dependence of the local government on the tobacco leaf tax and the production tax. Therefore, the Chinese government needs to further make the adjustment on the collection link of the tobacco tax.

Later, with the improving of the tax collection and management and the enhancing of the tax consciousness, tax collection should gradually shift to the cigarette excise tax at the retail link, in accordance with international practice. This can reduce the dependence of the local financial revenue on the tobacco production. The tax revenue can be associated with the tobacco marketing. The local protectionism will be weakened and market blockades will be broken. A unified tobacco market will be established in China.

9.3. Changing “tax included in price” to “tax excluded in price” on the cigarette excise tax

The advantage of tax included in price is that since tax are included in the price and the price has been set, the state can regulate the economy by adjusting the proportion of the tax inside the price. But the disadvantage is that under the condition of freely pricing the price need to be flexible, however, from the perspective of the government the taxation should remain stable within a certain period of time, the relatively fixed tax included in the price would have the price and the tax restrain each other, hence would make it difficult for the two sides to react flexibly.

The advantages of tax excluded in price are that the price and the tax are separated and the transparency is high. This makes it easy for consumers to monitor the price and the tax, and also facilitates enterprises to determine the price based on the market conditions.

The comparatively higher cigarette tax aims primarily at curbing consumption. The consumers themselves shall be responsible for the higher cost as smoking cigarette may cause harms to health and society. In some developed countries the consumers are clear of how much tax to pay when buying cigarettes as the tax excluded in price was used. On the contrary Chinese consumers are not as the tax included in price was applied, neither do they understand that this part of tax is collected by the state to curb their cigarette consumption. Thus, the collection of the cigarette excise tax has little effect on cigarette consumption in China.

The main reason why the tax included in price applied in China is because the tobacco tax was charged during the production process. Therefore, only in pace with the adjustment on the tax charge process can the tobacco tax be reformed into tax excluded in price at unified rate by changing the tax charge terminal from production to retails and wholesales (see 9.2.2.).

9.4. Establishing the “Linkage of Tax and Price” mechanism of the tobacco

The prospects for successful tobacco control by raising price depend on various conditions. The first condition is that the increase of the tax should be reflected in the price. The Chinese latest tax increase was ineffective to the tobacco control. The basic reason is that the tax increase was not reflected in the cigarette price. The tax changed, but the price did not. Therefore, it is impossible to have an impact on the cigarette consumption.

In China, it is difficult to establish a natural “linkage of tax and price” on

tobacco because of the tobacco monopoly system. Since the tobacco management system can not completely be changed, the government should take full advantage of its pricing power. Hu Angang in a proposal which he submitted to the Chinese State Council¹⁰ opines that, in the tobacco monopoly system, the government may directly raise the price of the tobacco product through various means. It is an advantage that other countries do not have. But the increase of the cigarette price should be tied to the increase of the cigarette tax. And after the increase of the price, the new increased profits should be turned over to the central finance, so as to support the tobacco control and other health service, etc.

9.5. Reforming the distribution system of the tobacco tax

China's current tobacco tax distribution system made local government over dependent on the tobacco industry. In order to maintain the local fiscal revenue and to offer the local areas employ abilities, the government over protected and expanded the local tobacco industry (include the tobacco leaf production and the cigarette manufacturing).

Instead of sharing the tobacco tax with the local government the Chinese central government should consider collecting and keeping the entire tobacco tax revenue and let the Ministry of Finance and other central government agencies address revenue allocation to local government (Hu et al 2008). This can prevent the local government for its own interests from developing the tobacco industry blindly.

9.6. Setting up the earmarked tax

An earmarked tax designates its revenue on specific government programs. The Chinese government has already implemented earmarked

¹⁰ <http://news.sina.com.cn/c/2010-01-20/161419509150.shtml>

taxes, including educational taxes, environmental protection taxes, and gasoline taxes (Hu et al 2008).

The fund for China's tobacco control was very poor and mainly sourced from abroad. Little can be gained from the government support. This is very abnormal. The Chinese government should consider using the increased part of the tobacco tax or the 1% of the tobacco tax revenue specially for the tobacco control, health promotion and service, environmental protection and so on. This will greatly put forward China's tobacco control activities.

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Appendix 1

Abstract

China's tobacco industry is the main contributor of the state revenue. The huge amount of China's tobacco tax revenue is inseparable from China's tobacco taxation system and tobacco monopoly system. This thesis, in addition to the introduction of the establishment, the development and the reformations of these systems, analyzes the great impact of the tobacco taxation on the local government; the important role that the tobacco tax plays on the tobacco control as an economic means; the influence on the Chinese tobacco taxation with China's joining the WTO. And meanwhile some suggestions are proposed on China's tobacco taxation system.

Keywords: Tobacco tax; Tobacco monopoly system; Tobacco control.

Zusammenfassung

Die chinesische Tabakindustrie ist der wichtigste Träger der staatlichen Einnahmen. Die riesigen Einnahmen der chinesischen Tabaksteuer sind untrennbar verbunden mit dem chinesischen Tabakbesteuerungssystem und dem System des Tabakmonopols. Neben der Einführung in die Entstehung, Entwicklung und Reformen dieser Systeme werden auch die große Auswirkung der Tabaksteuer auf die lokale Regierung sowie derer Einfluß als ein ökonomisches Mittel auf die Tabakkontrolle in der Arbeit analysiert. Darüber hinaus wird der Einfluß des Beitritts Chinas zur WTO auf die Tabakbesteuerung geschildert. Zum Schluß werden auch einige Vorschläge über das chinesische Tabakbesteuerungssystem gemacht.

Schlagwörter: Tabaksteuer; System des Tabakmonopols, Tabakkontrolle.

Appendix 2

Curriculum Vitae

Personal information

First name / Surname	Qian Liu
E-mail	deutschdelphin@gmail.com
Nationality	China
Date of birth	27/02/1980
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Work experience

Dates	02/2002 - 07/2002
Occupation or position held	Internship
Main activities and responsibilities	Editor
Name of employer	Chinese Mining Industry Newspaper, Wealth and Jewelry Weekly
Type of business or sector	Journalism
Dates	08/2002 - 08/2003
Occupation or position held	Office clerk
Main activities and responsibilities	Marketing Planning
Name of employer	Henan Province Electric Power Design Institute
Type of business or sector	Electricity
Dates	03/2007 - 03/2008
Occupation or position held	Internship
Main activities and responsibilities	Insurance Broker
Name of employer	CHANG'AN INSURANCE BROKERS CO.,LTD
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Education

Dates	10/2009 - 10/2010
Title of qualification awarded	Master of Social and Economics
Principal subjects	Financial Service, Controlling
Name of organisation	University of Vienna
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Languages

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