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The Party-state, Business and a Half Kilo of Milk:
A study of the dynamics of regulation in China's dairy industry

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UNIVERSITY OF SUSSEX

SABRINA SNELL PHD DEVELOPMENT STUDIES

THE PARTY-STATE, BUSINESS AND A HALF KILO OF MILK: A STUDY OF
THE DYNAMICS OF REGULATION IN CHINA'S DAIRY INDUSTRY

SUMMARY

This thesis examines the challenge of regulation in China's dairy industry—a sector that went from being the country's fastest growing food product to the 2008 melamine-milk incident and a nationwide food safety crisis. In this pursuit, it attempts to bridge the gap between analyses that view food safety problems through the separate lenses of the state regulatory apparatus and industry governance. It offers state-business interaction as a critical and fundamental component in both of these food safety mechanisms, particularly in the case of China where certain party-state activities can operate within industry chains. Using this framework, it traces party-state involvement in the dairy value chain from the industry's initial takeoff in the late 1990s and early 2000s through the years leading up to and following the melamine-milk incident. It reveals that the realities of upstream dairy production diverged significantly from party-state and industry demands, creating space for food safety issues. At the same time, state-business interaction—particularly at the local level—limited the ability of actors to address these vulnerabilities. It constrained coordination and control between lead firms and their suppliers, between chain actors and party-state institutions and within the operations of vertically integrated enterprises. In sum, dairy's regulatory challenges stemmed from structural issues in the way that the party-state interacted with business, and not necessarily from a lack of appropriate legislation or value chain models. The thesis draws on fieldwork conducted from 2009-2010 and incorporates material from relevant government policy as well as from a set of internal documents detailing the operations of a particular Chinese dairy processor, here called "Company X," one year prior to the melamine-milk incident.

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Abbreviations

AQSIQ	General Administration for Quality Supervision, Inspection and Quarantine
CCAP	Center for Chinese Agricultural Policy
CDIA	China Dairy Industry Association
COFCO	China National Oils, Foodstuffs and Cereals Corporation
CASS	Chinese Academy of Social Sciences
CPC	Communist Party of China
DAC	Dairy Association of China
DAIM	Dairy Association of Inner Mongolia
DHI	Dairy herd improvement program
DRC	Development Research Center of the State Council
FDA	United States Food and Drug Administration
GAIN	Global Agricultural Information Network
MOA	Ministry of Agriculture
NDRC	National Development and Reform Commission
NPC	National People's Congress
PLA	People's Liberation Army
PSB	Public Security Bureau
SAIC	State Administration for Industry and Commerce
SFDA	State Food and Drug Administration
TDI	Tolerable daily intake
UHT	Ultra high temperature
USDA FAS	United States Department of Agriculture Foreign Agriculture Service
WHO	World Health Organization
WTO	World Trade Organization

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1 Chapter One: Introduction

“I have a dream that every Chinese person, especially the children, will be able to drink one *jin* [500g] of milk each day.”

- Chinese Premier Wen Jiabao, April 23, 2006, Chongqing¹

On September 11, 2008, Premier Wen Jiabao’s dream turned into nightmare. After a decade of uninterrupted growth that led China’s dairy industry from obscurity to national prominence and 21 billion USD in annual sales, reports began to surface in the state-run media disclosing a food safety scandal of unprecedented proportions: infant formula produced by one of the largest domestic milk powder companies, Sanlu, had been tainted with melamine, an industrial chemical used to make plastics (Xinhua 2008).

Chinese dairy executives would thereafter refer to the incident as their industry’s “9.11.”

As more details were released, the public learned that products from 22 dairy companies, including the well-established brands of Yili, Mengniu and Guangming, had also tested positive for melamine, causing nationwide consumer panic and dairy sales to plummet by 80%. Reports revealed milk collection stations had adulterated their tanks with melamine in order to increase nitrogen levels, the principal measure of protein and a key quality indicator used in negotiating milk prices. Equally shocking was the news that both company executives and party-state officials had known about the contamination as early as May 2008, and yet failed to issue a recall.² By January 2009, the medical consequences were manifest as the Ministry of Health verified 6 deaths and more than 296,000 cases of infants with kidney stones and acute urinary disorders across Mainland China, Taiwan and Hong Kong (Barboza 2008; Reuters 2008a, 2008b).

¹ Toward the end of his April 23, 2006 tour of the Gonda Dairy Cow Science and Technology Park in Chongqing, Premier Wen Jiabao wrote this line in the company’s visitors’ book (Chongqing Morning Post 2006). It immediately became a pervasive mantra of the Chinese dairy industry.

² This thesis understands the Chinese political regime as a “party-state” (党政), and thus uses the term interchangeably with references to “government” and “state.”

The damage wrought by the melamine incident stood in stark contrast with the apparent successes of the dairy industry over the last decade. In just ten years, with tremendous support from the Chinese party-state, dairy had transformed into the country's fastest growing food product. Between 1998 and 2008, annual milk production had expanded from 6.6 to 35.5 million tons. Dairy consumption in urban areas had also taken off, increasing from approximately 6 to 24.8 kg per capita over the same period. By 2008, the Chinese dairy market had become the largest in the Asia-Pacific region (including South Asia) with a 35.8% share of total sector revenues (Datamonitor 2008; China Statistical Yearbook 2009).

Despite the industry's successes, the melamine incident revealed extensive regulatory failure; neither the party-state nor dairy companies had managed to control the quality of products reaching the Chinese market. In the months that followed the scandal, the central government moved quickly to restore consumer confidence and rescue the dairy sector from financial ruin. It took legal action against a few key perpetrators, issued a broad new food safety law, revised several industry regulations and called for an overhaul of the dairy value chain. As this thesis will show, however, the adulteration of the country's milk had been an ongoing issue throughout the previous several years and various tactics to rectify and restructure the industry had already been in play long before the scandal emerged—in some cases, exacerbating the situation. Resolving food safety issues was thus not just a question of designing appropriate policy and regulation, but also of ensuring their proper implementation. Indeed, even post-melamine, food safety lapses continued to plague the dairy industry.

The details of dairy's "9.11" immediately call up a series of questions: for an industry so heavily promoted by the government and that held such promise, indeed a so-called "sunrise industry" (朝阳行业), where did things go wrong? Furthermore, if party-state and business were aware of the contamination, how did it reach such calamitous proportions? What had they been doing to resolve the industry's problems, and why had they been so lacking in success? With these questions as its entry point, the thesis here endeavors to examine the challenge of regulation and of reconciling growth and food safety in China's dairy sector. It places this persistent problem for dairy in the context of state-business interaction, hoping to contribute to the urgent debate concerning food safety in China.

Indeed, just four years prior to the melamine-milk incident, in Fuyang, Anhui, at least 13 infants died and several hundred others suffered acute malnutrition as a result of consuming fake or substandard formula (Zhou 2007). When the central party-state launched a national investigation into the incident, it discovered substandard milk powder in ten other provinces (Tam and Yang 2005). Around the same time, the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) tested 2,000 different food products, concluding that one-fifth failed to meet government standards (*ibid.*). Since then, investigators have found clenbuterol in pork, formaldehyde in whitebait, melamine in eggs, sodium cyclamate in jujubes, recycled “gutter” oil in restaurant food, among myriad other violations (Li 2009; USDA FAS 2009b; Barboza 2010).

These incidents have alarmed consumers and undermined trust in the “Made in China” brand. Baidu, the country’s principal online search engine, reported that “food safety” was the fifth most searched term in 2011, and the first among health concerns (Chin 2011).³ That year, a national survey by *Insight China* and Tsinghua Media Survey Lab revealed that almost 70% of respondents lacked confidence in the country’s food safety, and more than 42% considered state regulation and supervision to be “far from sufficient” (Shan 2011).⁴ With China a major global exporter, the domestic food safety situation likewise caused anxiety abroad among consumers and trading partners. In order to strengthen supervision over imports, the US Food and Drug Administration (FDA) opened its first foreign office at the US Embassy in Beijing, becoming fully operational in mid-2009.

Despite the strong mandate from both the Chinese public and international actors, the country’s leadership struggled to improve food safety, raising broader questions about whether inherent contradictions existed between industry development and regulation. In other words, did China’s high-speed growth model preclude an effective food safety regime? Dairy’s development trajectory—rapid expansion and massive food safety crisis—served as just one example. Debating the diversity of policy

³ Four out of five web searches in China use Baidu.

⁴ *Insight China* is a monthly financial and economic news magazine affiliated with *Qiushi*, the bi-monthly political theory periodical published by the CCCPC and Central Party School.

outcomes in China, Naughton and Yang declared, "...the achievements and problems are intertwined, with the achievements possible only because certain problems could be left unaddressed, deferred to an uncertain future" (2004: 5). Others characterized food safety problems as "growing pains," and not "irreconcilable contradictions in China's chosen path of reform" (Walder in Oi et al. eds. 2010: xix).

This study does not tackle the larger question of national reform models, but on a much smaller scale, also recognizes development and regulation to be interrelated, and not necessarily irreconcilable. Here, it avers that state-business interaction is the key to understanding the connection between growth and food safety outcomes in the dairy industry. In the literature, food safety failures tend to be explored from the separate perspectives of government and industry, with the former analyzing deficiencies in the state regulatory apparatus and the latter, in value chain governance. Where studies examine both of these mechanisms at once, they often position state regulation external to the value chain. The Chinese party-state, however, penetrates business. Whether through policy or direct engagement in enterprise, it can act as a key chain coordinator along with lead firms. As such, certain activities of the party-state exist and operate within the chain, simultaneously enabling and/or constraining industry governance and state regulation. This thesis thus contends that the examination of state-business interaction—particularly where it occurs inside the value chain—is critical to understanding the ability of actors to coordinate and control industry performance.

Using this framework, the study draws on twelve months of fieldwork (2009-2010), principally located in Beijing and Hohhot, Inner Mongolia, the country's "Milk Capital." It utilizes ethnographic evidence accumulated during numerous interactions with key members of local, provincial and central party-state, dairy processor executives and managers, small and large-scale farmers, milk station operators, industry association leaders, sector experts and academics. It also incorporates material from relevant government policy and from a set of internal documents detailing the daily operations and future plans of a particular Chinese dairy processor, here called "Company X," in the months leading up to the melamine-milk incident.

Following the introduction, the thesis consists of six chapters. Chapter two expands on the analytical framework presented above, reviewing the existing literature on state-market relations, regulation and value chain governance. It then discusses the

Chinese field with its various research limitations and opportunities and describes the methods used to undertake this study. Chapter three traces the history and development of dairy in China, demonstrating that the industry's incredible growth beginning in the late 1990s and early 2000s owed itself chiefly to the central party-state's effort to industrialize agriculture, boost urban consumption and improve nutrition. It details the party-state's positioning of dragonhead enterprises (龙头企业) as the drivers of these processes and the subsequent rise of the country's two top dairy brands, Yili and Mengniu, both headquartered in Inner Mongolia. Chapter four moves forward to 2008 and dairy's "9.11" to describe the melamine incident, its immediate ramifications and the party-state's response. Underscoring the difficulty of regulating dairy, it focuses on three important elements of the crisis, namely, the fact that melamine had been an "open secret," the return of dismissed officials and melamine-tainted products and consumers' pivot toward dairy imports.

Chapter five and six examine in depth the years leading up to and after the melamine incident in order to understand the role of state-business interaction in the failure to produce safe milk. Chapter five follows the party-state's campaign to modernize agriculture and improve chain governance through *sanhua* (三化), or the three -izations: scalization, standardization and integration. As the chapter reveals, this effort foundered severely with significant ramifications for food safety. To explain the structural problems that lay beneath *sanhua*, Chapter six delves into the "fish-water relationship" (鱼水关系) between party-state and business. Dividing state-business interaction into three components, it analyzes mechanisms for coordinating dairy industry development within the party-state, between the party-state and business and within business. Specifically, it investigates the political and economic incentives that simultaneously motivated local cadres toward industry development and encouraged their disobedience. It then explores the role of industry associations—a potential external authority—in mediating local party-state and business interests. And last, it moves inside dairy companies to examine an emerging form of party corporate governance. Chapter seven concludes with a summary of the study's key findings and a discussion of the party-state's recent efforts to adjust the fish-water relationship and improve food safety in China.

2 Chapter Two: Literature, Frameworks and Methods

2.1 Introduction

A quick review of China's last decade would reveal that the melamine-milk scandal was neither an isolated incident nor was dairy the only industry that experienced significant food safety issues. Given the frequency and severity of these incidents, academics within China and abroad have sought to uncover the root causes of the country's failure to provide safe food and guide policymakers toward viable solutions. Their analyses tend to fall into two different realms of investigation—and by extension, their recommendations point to two separate sites for policy improvement and implementation. One group of scholars has focused on China's state regulatory institutions, concluding that these sections of the bureaucracy have been undermined by such factors as institutional fragmentation, overlapping regulation, corruption and rent-seeking, ineffective enforcement and punishment regimes and limited autonomy among regulatory actors (Lu 1999, 2002; Tam and Yang 2005; Guo 2006; Thompson and Hu 2007; Liu 2008; Yang 2009).

Acknowledging this weak regulatory regime, another group of scholars has turned its attention to the country's agri-food chains and how different governance choices might affect food safety outcomes. For example, some research teams have explored the persistence of spot market exchanges in agri-food sectors, concluding that while inclusive and pro-poor, these traditional marketing channels failed to provide guarantees for safe food (Huang et al. 2009). In general, this body of literature has portrayed China's food safety problems in terms of transaction costs, agency dilemmas and information asymmetries (Zhang and Aramyan 2009; Gale and Hu 2012).

So while some faulted weak state regulatory capacity and others inadequate agri-food chain governance in markets, a growing body of literature suggested important linkages between these two discussions. In their book on regulatory governance in developing countries, Minogue and Cariño asserted, "...the analysis of regulation must go beyond examination of the formal rules that govern relationships between the public and private sectors, to the broader framework of state-market relations..." (2006: 4). In other words, regulation did not merely comprise a legal institution (with written laws and punitive procedures), but rather entailed a mode of governance shaped by both political and economic processes. At the same time, within the value chain literature,

academics began to point out how “external” contexts and environments (such as state regulation) significantly impacted operations and governance relationships “internal” to the chain. For example, a series of key studies explored the dynamic interaction between value chains and food standard setting and enforcement schemes (Dolan and Humphrey 2004; Gereffi and Lee 2009; Hammoudi, Hoffman and Surry 2009; Henson and Humphrey 2009). In their research on South Indian coffee and tea plantations, Neilsen and Pritchard (2009) demonstrated how institutional environments significantly influenced value chain governance. In China, value chain researchers also investigated these issues, analyzing government intervention in the development of beef chains and its implications for food safety (Waldron, Brown and Longworth 2010), and evaluating the impact of government funding and public certification programs on contractual governance (Jia and Huang 2011).

In sum, both literatures appear to indicate that state-business interaction comprises a critical and fundamental component underlying state regulation and value chain governance. Using China’s dairy industry as its lens, this thesis thus aims to investigate the role of state-business interaction in the provision of safe food. In the following pages, it reviews the relevant bodies of literature, and then crafts analytical and methodological frameworks appropriate for this study.

2.2 Literature review

As indicated above, this thesis draws together two bodies of literature in an effort to demonstrate the complex and dynamic links between regulatory and value chain governance in China. The first section of this literature review examines state-market relations (i.e., Minogue and Cariño’s broader understanding of regulatory governance). It begins by tracing the post-Mao transformation of state and business, and then details two interactions that function at the heart of the country’s regulatory regime: 1) the interaction between local party-state and business, and 2) between central and local cadres. The second section explores value chain governance, first identifying key concepts and then discussing different theoretical approaches.

2.2.1 *State-market relations in reform era China*

An overview

To understand state-market relations in China, it is essential first to consider how the definition of state and market has changed dramatically since the Communist Party of China (CPC) first rose to power in 1949. During the Mao era, the party-state exerted total control over the economy and any activity outside of the plan was considered illegitimate, immoral, bourgeois and punishable by death. In 1978, two years after Mao's death, the spaces of legitimate economic activity began to shift. The Chairman's successor, Deng Xiaoping, realized the nation had arrived at a critical juncture: the CPC had been largely discredited by the past decade's unrest, and while many other countries in East Asia were demonstrating significant economic growth, China's centrally planned economy exhibited evidence of stagnation, particularly in rural areas. The nation's rapidly expanding population and lack of employment opportunities for youth returning to urban centers from the countryside further compounded the situation (Tsai 2007: 50). As Lieberthal explained, the Chinese leadership recognized the "need to deliver material rewards to a population that had become bitterly disillusioned with ideological hyperbole by the end of the Mao era" (2004: 246).

In this pursuit, Deng sought to re-legitimize the CPC and ensure the party's preservation through a series of gradual, Chinese-style market reforms aimed at bringing the people *xiaokang* (小康), or modest living standards. These reforms began in rural areas with de-collectivization and the creation of township-village enterprises and later, in the Special Economic Zones and urban centers, with private sector development and the corporatization of state-owned enterprises (SOEs). In this second phase of reform, Deng began the managerial and economic decentralization of the state sector, endeavoring to shift the role of the government from economic administrator to regulator (Lieberthal 2004: 249).

In analyzing China's reform sequence, scholars pointed out three pervasive trends. One, economic activity often emerged from informal and unregulated market realms, only later to be sanctioned officially as "reform" (Wu 2007). This was particularly true in the case of the rural economy and small private enterprise. In the countryside, a number of studies documented informal and experimental de-

collectivization preceding Deng's reforms (Kelliher 1993; Yang 1996). Others detailed the practice of "wearing a red hat," or the registering of private businesses as collective enterprises (Naughton 1994; Oi 1999; Tsai 2007). Tsai presented a range of "adaptive informal strategies" that firms used to influence and challenge policy from below, arguing that the "actual causal dynamics leading to elite-level decisions arise from grassroots interactions among entrepreneurs and between entrepreneurs and officials" (2007: 9). These findings indicated the existence of important forms of agency among non-state actors and at the local level. Specifically, they suggested that enterprises played a critical role in the operationalization of state control on the ground, ultimately affecting policy implementation and the outcome of national objectives.⁵ This potential for "endogenous institutional change" highlighted the importance of analyzing firm-level debates and the interaction between local party-state and business.

Two, the selective process of formalization has been modulated by cycles of fluctuating party-state intervention, or as Shevchenko described, by the regime's "letting go" and "tightening up" of control over economic activity (2004: 174). Indeed, in more recent years, experts observed persistent and/or renewed emphasis on state control in the domestic sector, dispelling the idea of China's linear progression toward economic liberalization. Huang argued that the entrepreneurial capitalism encouraged earlier in the 1980s was checked in favor of a "state-led brand of capitalism" characterized by the predominance of interventionist industrial policy and government investment drives (2008: 8-9). At the more radical end, a number of private enterprises have been "re-nationalized," a process popularly referred to as *guojinmintui* (国进民退) (Anderlini 2009).⁶

Three, the reform process has been guided by a combination of social and economic objectives, or by what Pearson (2005) termed, the party-state's "metavision." She described this metavision as "the need to control and maintain a revenue stream from major state assets, the creation of national champions, and the achievement of employment, universal services, and social security goals" (ibid. 314). Furthermore, she

⁵ It is worth mentioning here that Tsai was referring to adaptive entrepreneurs running small businesses. The case of large dairy firms thus provides an important area for further investigation.

⁶ The phrase can be translated as "the state advances as the private sector retreats."

argued that this particular metavision had created a regulatory regime that followed two key norms: “preference for ‘orderly’ competition and preference for a small number of dominant, state-owned players in the market” (ibid. 312). While Pearson’s study focused on pillar industries in urban areas, others have noted similar socio-economic objectives steering rural development in China, including those related to poverty reduction, employment, environmental protection, food security and safety, trade and industry development (Waldron, Brown and Longworth 2010; Delman and Yang 2012).⁷

Taken together, these trends underscore the complexity of capitalist development in China: this was not a straightforward case of managerial and economic decentralization followed by the emergence of a clear boundary separating party-state and enterprise. Rather, as the political-economic system evolved, so did the forms of party-state intervention and control in the domestic sector.

On local party-state and business interaction

Myriad studies have detailed the local party-state’s heavy involvement in the economy as a result of the processes described above. Exploring Chinese state-business interaction is thus not a question of whether the former intervenes in the latter, but rather of how and with what implications for industry development and regulation. Baum and Shevchenko (1999) summarized this wide variety of research with a useful typology, dividing party-state economic behaviour into four categories: entrepreneurial, predatory, clientelist and developmental. The entrepreneurial state referred to cadres who directly engaged in profit-making activities, establishing their own businesses, sitting on boards of directors and personally investing in local projects. This type was also used to describe particular agencies, whole localities and even the CPC itself (Duckett 1998; Gore 1998; Shevchenko 2004). It was distinguished from the predatory state in that it comprised a productive—rather than extractive and damaging—engagement in the economy.

Literature on the predatory state largely focused on the widespread evidence of corruption across China. Lu (2002) argued that the country exhibited a form of

⁷ Chapter three explains in greater detail how the party-state’s “metavision” has shaped dairy industry development.

“organizational rent-seeking,” where entire agencies extracted profits through monopolies over resources.⁸ He cited increased extra-budgetary fees in the countryside and chronicled stories of regulatory authorities using inspection trips to collect illicit funds (e.g., through bribes, gifts, etc.). Cao (2000) highlighted other examples of predation, detailing cases where even failing enterprises were subjected to extremely high taxes and fees. Reflecting on this deleterious behaviour, Pei (2006) contended that China’s predatory state would eventually lead to a national crisis in political legitimacy. Furthermore, he argued that this same system precluded continued reform as it was “trapped” by its own authoritarian power (*ibid.*). In her study on entrepreneurialism among the Tianjin real estate and commerce departments, Duckett (1998) demonstrated, however, that predation was a not uniform phenomenon; government bureaus often ridiculed for succumbing to rent-seeking managed to set up profitable and innovative enterprises.

In the clientelist state, cadres and entrepreneurs attempted to generate profits and secure access to resources through personal and individualized connections. In his ethnographic study on new urban entrepreneurs, Wank (2001) discovered that many of these entrepreneurs had previously held positions in the party-state and thus, often relied on personal ties to former colleagues and friends to facilitate their entrepreneurial endeavors. He concluded that the commodification of local bureaucratic power did not lend itself to entrepreneurial autonomy, but rather created “new patterns of bargaining and alliance across local boundaries of state and society” (*ibid.* 9-10). As Sun and Wong described, enterprises became dependent on the party-state for institutional capital. They wrote, “...private enterprises often go along with government policy, which often contradicts their interests, in exchange for more governmental and social support, trust, and recognition.” (2002: 81). Cadres became “gatekeepers” to the market, in charge of key decisions about the amount of regulation and resources enterprises would receive (Lin 2001). Thus, in the clientelist state, a significant portion of state-business interaction involved building social relationships, or *guanxi* (关系), an activity that has been well documented in the literature.

⁸ In other words, corruption did not merely consist of individual actors seeking to enhance their own personal gain but rather a systematic engagement in illegitimate activities across an entire agency.

The developmental state referred to local cadres who did not participate in the economy but rather attempted to craft policies and strengthen institutions that facilitated enterprise growth. Blecher and Shue (2001) provided a clear example of this type of state-business interaction in their study on the leather and fur industry in Xinji, Hebei. They detailed how the local state established this sector as a pillar industry and subsequently devoted considerable effort toward creating a favorable economic environment (e.g., advertising and constructing a massive leather trading centre). Using such a development model, they noted, local officials aimed to benefit from the political and economic prestige—and promotion potential—that would arrive with the industry’s success. As will be discussed further in the section on central-local cadre interaction, their observation underscored the crucial role that both political and economic incentive mechanisms played in driving cadres to promote development.

In this discussion on state-business interaction, it is also necessary to explore how the party-state has attempted to direct industry through various institutional linkages with entrepreneurs. For example, on July 1, 2001, Jiang Zemin officially announced the lifting of the ban on party recruitment among private entrepreneurs; the latter was no longer regarded as a class enemy but instead offered full-fledged party membership. As Dickson (2003) argued, this move led to the successful co-optation of private entrepreneurs, or “red capitalists,” into the party. Unger and Chan (1996) described how the party-state employed a strategy of “state corporatism,” authorizing a single organization to represent a particular sector of civil society and then incorporating it into policy processes.⁹ Dickson (2003) elaborated on one such corporatist institution that has sought to enhance state-firm interaction and communication: the country’s business associations. According to Dickson, “...not only do the business associations play a dual role of representing both the state’s and members’ interests, the entrepreneurs themselves see the government-business relationship as a symbiotic one” (ibid. 85). Foster (2002), however, complicated this picture by asserting that associations should not be used to analyze state-society relations. As he documented in his study in Yantai, Shandong, these organizations were “in essence appendages of government or Party organization” and therefore should be

⁹ Baum and Shevchenko (1999) concluded that state corporatism represented another manifestation of the developmental state.

regarded as “new elements of the state’s administrative system” (ibid. 42). Moreover, he maintained that many of the Yantai associations were redundant and seldom performed any function of significance.

The ensuing relationship among party-state and business actors has been referred to as one of “interest convergence,” “mutual dependence” or “symbiosis” (Wank 2001; Dickson 2003). Nevertheless, these studies as well as others have pointed out that the relationships often held certain consequences for economic growth. Liu, Pei and Woo called the collaboration among local officials and enterprise a “value-destroying collusion” (2006: 2033). A significant portion of the literature on linkages between the state and entrepreneurs ended up tackling the question of whether the latter would eventually resist the intrusions of the former in the economy and push for more autonomy. Dickson observed, “Instead of seeking an officially recognized and protected autonomy, [entrepreneurs] seek to be embedded in the state, and the state in turn has created the institutional means for linking itself with private business interests” (2003: 84-85). Both Tsai (2007) and Chen and Dickson (2010) concluded in their respective studies that entrepreneurs did not pose a challenge to the state as they were neither a cohesive class nor did they harbour aspirations for democratic reform. Instead, as Chen and Dickson (2010) contended, they were “allies of the state.”

While Tsai, Chen and Dickson were concerned with issues of entrepreneurial autonomy and the potential for democratic reform, the crucial question here for this thesis is how did the state’s alliance with business impact regulation and the ability of the latter to steer the former toward the production of safe food. Part of the answer can be found in the unclear boundaries between state and business that facilitated dependencies among regulators and regulated. Specifically, state ownership, the revolving personnel door between government and enterprise, institutional linkages and other forms of state engagement in industry all positioned the party-state to act often as both market player and regulator. As Pearson noted, this institutional context combined with the party-state’s normative preferences for orderly and limited competition hindered “the emergence of truly independent regulators” (2005: 320). She termed the tangled relationship among business, regulatory and state actors, the “Gordian Knot,” where not only was the regulator tied to the state, but business to regulator, and state to business (ibid. 297). This arrangement stood in stark contrast to the “independent regulator model” promoted by the World Bank and World Trade Organization (WTO)

as an essential part of what they believed was “good governance.” Pearson remarked in her study, “...while impressive changes during the past decade have given the agencies that regulate China’s strategic industries the initial appearance of independent regulators, the actual function of an independent regulatory structure is far from established” (ibid.).¹⁰

On central-local cadre interaction

The fact that the party-state could not rely on external agents of regulatory control meant that another site of governance played a particularly vital role in the efficacy of the country’s regulatory regime: the internal compliance mechanisms used to keep local cadres in line with central directives. Indeed, much of the debate on central-local relations focused on how the central party-state has motivated local cadres toward achieving national development objectives, particularly economic growth, and to what extent it has been successful. In the years following the 1994 tax reform and fiscal decentralization, scholars explored this apparent diffusion of power to the provinces and localities. They asked whether making local governments responsible for their own budgets created strong enough economic incentives to secure compliance with central directives. For some authorities on China, center-province relations appeared increasingly tenuous, with provincial leaders frequently reinterpreting—or even completely disregarding—national policy. Lieberthal commented, “Although Beijing retains important resources to bring provinces to heel, provincial leaders often evade orders that are not quite specific or are not given high priority by the national leaders” (2004: 181). Economy (1999) provided examples of this provincial non-compliance, citing the National People’s Congress’s shelving of bills aimed at halting extra-budgetary practices and the dismissal of local government officials without central Party approval. She also highlighted former Vice Premier Zhu Rongji’s attempts at punishing errant Guangdong and Shenzhen, suggesting that such punitive measures revealed a center struggling to regain authority and assert legitimacy (ibid. 28).

¹⁰ A number of case studies focusing on China’s high-tech, drug and other strategic industries have provided detailed evidence of the lack of regulatory independence (Bach, Newman and Weber 2006; Pearson 2007; Liu 2008).

Breslin pointed to fiscal decentralization as a key factor in understanding the behavior of provincial party-state actors. He argued that by increasing “the importance of provincial boundaries as determinants of economic activity,” decentralization contributed directly to the emergence of a dangerous phenomenon: provincial autarky (2000: 205; 1996: 9). More specifically, it created “dukedom economies” (Shen and Tai qtd. in Breslin 2000: 210), inhibiting inter-provincial trade as provincial officials responded to fiscal pressure with policies protecting their own local producers from those in “rival” provinces. This “new warlordism” adversely impacted the very objective that decentralization was meant to achieve: the development of a healthy domestic economy (Feinerman 1998: 22). Breslin wrote, “...leadership has had more success in facilitating China’s opening up to the outside world than it has in opening its own domestic market” (1996: 10).

Still, other China scholars contended that decentralization had not resulted in the loss of central political authority and a crippled domestic economy. They underscored the profound influence of political mechanisms in integrating different levels of the Chinese bureaucracy and directing cadres toward development goals. Moreover, they argued that these mechanisms served as institutional substitutes for macro-economic policy (Huang 1996; Gore 1998; Shevchenko 2004; Whiting 2004; Pieke 2009). For example, Gore (1998), Edin (2003), Whiting (2004) and Liu, Pei and Woo (2006) cited the cadre evaluation system (考核制度) as an absolutely critical mechanism of reform era political control. Officially piloted in November 1979 by the Central Organization Department, this party-based public administration system linked local officials’ political aspirations with the implementation of national development policy. Specifically, it required cadres to meet a number of “hard” and “priority” objectives, such as production targets, tax revenue and family planning (Edin 2003; Whiting 2004).¹¹ In order to foster competition among officials of the same rank, these targets were accompanied by a scheme of rewards and penalties whereby successful cadres received salary bonuses and promotions while their more reticent colleagues saw deductions, transfers and demotions. With appointment and promotion cycles occurring

¹¹ As Whiting (2004) describes in her study, the cadre evaluation system gradually moved from using qualitative and subjective criteria, such as political style and ideology, to concrete indicators that could be measured more easily.

every two to four years, it created cadres focussed on boosting GDP figures within the shortest time possible—even becoming personally involved in enterprise and profit-making activities.

In response to earlier critiques of declining central power, Landry (2008) asserted that the adaptive allocation of political power under the cadre appointments and promotions system allowed Beijing to carry out fiscal decentralization without ultimately relinquishing its authoritarian control. Specifically, he demonstrated how the system's big rewards and small penalties continued to provide "reform losers" with a modest political stake while the accelerated turnover of mayoral positions prevented the retrenchment of local interests. Nonetheless, the cadre evaluation system's emphasis on short-term economic growth over other development metrics presented a number of "moral hazard problems," such as blind investment and overcapacity, local protectionism and lack of environmental protection and work production safety (Whiting 2004; Chan and Gao 2012). Similarly, Shevchenko (2004) noted that the cadre evaluation system established a new layer of incentives for cadres that did not always overlap with those of business. Not unlike fiscal decentralization, it also led to the selective implementation of national policy. O'Brien and Li (1999) detailed how the system increased "street-level discretion," particularly in regards to soft targets that could not be readily measured, such as respecting village autonomy and democratic work style.

In addition to the cadre evaluation system, researchers emphasized other sources of political control, linking central and local cadres. Huang (1996) examined cross-posting, a practice in which provincial leaders concurrently held positions in the Politburo and/or in other top central government offices. As a consequence of this arrangement, the center kept a close watch on provincial officials' activities as well as redirected their career ambitions toward national agendas. Concluding his study, Huang insisted, "...economic decentralization has been accompanied by a strengthening of China's unitary political system" (1996: 655). In subsequent research, one decade later, Huang (2008) again arrived at this conclusion, citing the consistent relinquishing of local tax revenues to Beijing and lower inflationary investment demand as key indicators of central control.

Sheng (2005) complemented Huang's findings with evidence of declining provincial shares in full Central Committee (CC) membership but rising ones in alternate CC and Politburo memberships. Not only did this trend highlight the center's uninterrupted domination of the CC selection process (and by extension, of one of the country's most important policy-making bodies), it also suggested Beijing was trying to co-opt provincial officials either through the benefits—albeit restricted—of alternate membership or by cross-posting in the Politburo (Sheng 2005: 346). With his research on cadre training and party schools, Pieke (2009) provided another view into how the central party-state managed to create local cadres that were both disciplined and market-oriented. He explained how adaptive party education kept cadres in line with its Leninist organizational discipline while simultaneously updating its fundamental ideology with themes of modernization and capitalist development.

With regard to the state's regulatory capacity, these governance mechanisms created a multi-layered regulatory landscape where the relationships between different levels could significantly impact policy implementation.¹² In the case of food safety, research revealed significant variation in the local implementation of regulation across China. Tam and Yang (2005) cited several examples of regulatory “forbearance,” arguing that revenue imperatives and corruption prompted local cadres to ignore or distort food safety policies.¹³ In their study on the beef industry, Brown, Longworth and Waldron (2002) found that “...local governments have been able to interpret the regulations to suit their own objectives. Local governments must have both the political will as well as the administrative capacity if the regulations are to be enforced vigorously as intended” (2002: 278). Within the Chinese context, the cadre evaluation system largely determined the level and direction of this “political will.”

¹² For the purpose of simplification, this thesis uses the central and local levels to refer to the national government in Beijing and all other administrative divisions (including the provinces, autonomous regions, direct-municipalities, prefectures, counties, townships and villages), respectively. When describing a particular event or policy, it names specifically which “local” level of government is involved. In the case of Inner Mongolia, an autonomous region, some policy refers to “banners,” a Qing dynasty term for counties still used today.

¹³ In a discussion on organizational corruption in China's regulatory agencies, Lu detailed a common practice where provincial, county and district offices designed and issued their own “excellent quality item” labels. The labels were in no way associated with actual quality standards set by official product assessment teams, and were obtained through *guanxi* and gifts (2002: 213-214).

It is clear that reform era China has produced a complex regulatory environment. While juggling dual roles of market player and regulator, the party-state strived to direct its diverse ranks toward common reform objectives. As discussed above, it did not always achieve positive outcomes, particularly for food safety. This situation might have obliged party-state actors to rely less on formal regulatory institutions, and increasingly on direct industry intervention, to pursue agendas balancing economic growth and food safety. Highlighting a general trend toward alternative modes of regulatory governance, Phillips averred that developing countries often were “characterised more by ‘regulation without a regulatory state’ than with the sorts of institutional and strategic structures stipulated by the regulatory state model” (2006: 35). Her observation not only called into question the utility of such models, but also underscored the importance of rethinking regulation and how evolving state-market relations engendered new and different forms of governance.

The first section of this literature review explored state-market relations and regulatory governance—and primarily from the party-state’s perspective. The next section examines the role of firms in food safety outcomes, a focus that has received limited treatment in regulation literature. Specifically, it presents important contributions from research on value chain governance, including those investigating firm behavior as a strategic response to (or consequence of) state regulation and/or intervention. The relationship between the two literatures and its implications for the framework adopted in the thesis follows in the third part of this chapter.

2.2.2 *Value chain governance*

In the agri-food industry, the processes required to bring products from farm to table may be long and complicated, often scattered among different actors and locations. In spite of this lengthening complication, it is essential that food products are safe for human consumption and satisfy consumer demands. In the past, meeting these requirements could be characterized as a technical feat, and thus, when problems arose, technological solutions were proposed. More recently, scholars, policymakers and industry players have used the concept of “value chains” as an important analytical tool for understanding the production process and its coordination. Value chains recast the production process as a system of value-adding activities—rather than technical procedures—often involving complex inter-firm relationships. Value chain researchers

characterised chains as sets of interdependent activities where the performance of one part of the production process had non-trivial consequences for actors and activities in other parts of the process. Moreover, they examined how actors might attempt—within their power and resources—to manage interdependencies by employing some form of behavioural control, or governance, along the chain.

Originally introduced by Porter (1985) for application in business management, value chains have since been adapted for use across a range of disciplines. Many different variants of products/commodity analysis have been developed, as detailed by Nielsen and Pritchard (2009). The discussion here focuses on the global value chain framework (GVC), which comprises a key approach to understanding value chains and their governance. It draws together theoretical and analytical contributions from earlier research in/on global commodity chains (GCC), new institutional economics (NIE) and social network analysis (SNA). The following summarizes these contributions as well as GVC itself and then discusses its three most important elements: governance, power and institutions (Gereffi 1994, 1999; Humphrey and Schmitz 2000, 2001; Gereffi, Humphrey and Sturgeon 2005).

In the mid-1990s, Gereffi developed the commodity chain approach as a means for studying the impact of globalization on production systems and industrial organization. Aiming for a middle ground between the broad lens of world-systems literature and the narrower, state-centered concerns of international political economy, the approach focused on the firm-level and analysed commodity chains according to four main dimensions: input-output structure, territoriality, governance structure and institutional framework (Gereffi 1994, 1999). The first two dimensions described the chain in terms of which actors performed what processes and where they were located geographically. The fourth dimension detailed the institutional framework within which the chain operated, encompassing a range of structures from organizations to rules and regulations to norms and beliefs.

The third dimension, governance, would become the primary focus of many value chain studies. Humphrey and Schmitz defined value chain governance as “the inter-firm relationships and institutional mechanisms through which non-market coordination of activities in the chain takes place” (2001: 1). The motivation for such non-market coordination originated from the “non-trivial consequences” mentioned

above. Indeed, the level of control that agents tried to exert on the chain depended fundamentally on the risks and responsibilities they faced in terms of product performance and conformance (Humphrey and Schmitz 2001). These risks could either be real (e.g., food safety crises) or perceived (e.g., consumer anxiety) (Henson and Humphrey 2009). For example, if a product performed poorly with consumers, then shareholders might hold company executives accountable. Similarly, if a product did not conform to food safety standards, then a company might be fined or prosecuted, and the company's brand image damaged.

In order to manage such consequences, value chain governance introduced mechanisms to monitor and control the behaviour of businesses integrated into value chains. At the same time, resource flows, contractual obligations and penalties were used to provide incentives (positive and negative) to comply with the behavioural specifications established for particular points in the chain.¹⁴ In addition, the value chain literature recognized that performance requirements and behavioral controls could be set, implemented and enforced by a variety of actors, and not just those within the chain. Seemingly "external" agents, including government, international organizations and third-party inspectors, could all play a role in chain governance (Humphrey and Schmitz 2001; Kaplinsky and Morris 2001).

Within the GCC approach, Gereffi distinguished two types of commodity chains according to the position of the "lead firm," or that actor driving chain coordination. Where producers governed chain activities, he described these chains as "producer-driven," and where buyers assumed this role, "buyer-driven." He pointed to the automobile industry, in particular, as an example of the former and branded retailers like Gap and Target as examples of the latter. In each case, the lead firm dominated the chain, sustaining and reproducing power through its control over key barriers to entry.

¹⁴ Kaplinsky and Morris asserted that the different expressions of value chain governance resembled the separation of powers in government; indeed, not unlike officials of the legislative, executive and judicial branches, actors governed the chain by setting, implementing and enforcing rules (2001: 30). In this case, however, these rules comprised product and process parameters prescribing what was to be produced as well as how, when, how much and at what price it was to be produced (Humphrey and Schmitz 2001: 5). With regard to the inclusion of price in this list of parameters, Humphrey and Schmitz wrote, "Although prices are usually treated as a variable determined in the market, it is frequently the case that major customers (particularly those competing more on price than, for example, product quality) insist that their suppliers design products and processes in order to meet a particular target price" (ibid.).

As Gereffi explained, “What distinguishes lead firms from their followers or subordinates is that they control access to major resources (such as product design, new technologies, brand names, or consumer demand) that generate the most profitable returns in the industry” (1999: 3). With lead firms commanding resources and rents, they also held the power to shape value chains, leading Gereffi to assert that, “One of the major hypotheses of the global commodity chains approach is that development requires linking up with the most significant ‘lead firms’ in an industry” (ibid.).

Building on the GCC approach, the GVC framework called for replacing the term, “commodity chain,” with the more inclusive, “value chain,” and reformulated the key chain dimensions from four to three: firm-level governance, power and institutions.¹⁵ At the same time, GVC drew in important contributions from new institutional economics (NIE) and social network analysis (SNA). Heavily influenced by economic theories of the firm (e.g., those of Coase and North), the NIE approach focused on the organization and governance of inter-firm transactions, primarily utilizing the analytical frameworks provided by transaction cost economics (Williamson 1981) and agency theory (Eisenhardt 1989). The former framework analyzed firm behaviour in terms of the costs associated with economic exchange and participating in the market, including information, bargaining and enforcement costs; the latter framework described these costs as agency costs, or the cost incurred by a principal attempting to control the behaviour of an agent (e.g., manager and employee or buyer and supplier). Accordingly, NIE regarded governance as an effort to mitigate these costs and employ strategies whereby the long-term benefits of sustaining an economic relationship outweighed the short-term gains of opportunism (Eisenhardt 1985).

In the Williamson framework, the optimal form of governance would be determined by two major characteristics: the degree of asset specificity required to construct and maintain a relationship between two firms and the frequency of

¹⁵ The GVC framework emerged in 2001 following a series of meetings and workshops as part of the “Global Value Chain Initiative” led by a group of researchers affiliated with the Institute of Development Studies (UK). The group elected to use the term, “value chain,” as commodities usually referred to undifferentiated, large-volume products only. With regard to the key chain dimensions, it retained “institutions,” incorporated chain structure and geography within “governance,” and emphasized Gereffi’s ideas about lead firms by adding “power” (Sturgeon, Biesebroeck and Gereffi 2008).

transactions. Infrequent transactions requiring investments in specific assets would be managed best through “hierarchical governance” (i.e., kept within the boundary of the enterprise), while frequent transactions that did not require asset-specific investments would be optimally managed through “market governance.” In between these two forms, Williamson referred to “mixed forms” of governance that required some customised investments (1979: 247).

Although NIE was initially concerned with governance at one particular value chain dyad, additional research expanded the framework to include the entire chain as an important unit of analysis. Antia and Frazier (2001) contended that factors external to a specific dyad impacted contract enforcement within that dyad. In their study on the US apparel industry, Wathne and Heide (2004) demonstrated that governance mechanisms employed among upstream suppliers ultimately shaped flexibility toward the downstream customer. Gereffi et al. (2005) and Ponte et al. (2011) also elaborated on this theme of governance extended along the value chain so that buyer requirements were transmitted across multiple linkages in the chain. Together, these studies underscored the dynamic nature of governance.

SNA further broadened the scope of approaches to chain governance, including socio-economic interactions as key determinants of both vertical and horizontal relationships. As such, it frequently investigated those organizations formed through horizontal relationships among firms and actors performing similar or complementary activities, i.e., business associations, cooperatives and industry clusters. It also asserted that trust and social capital comprised “informal” modes of behaviour control and should be considered alongside “formal” governance strategies. In other words, inter-firm relationships were framed by more than the simple calculation of short and long-term interests suggested by Eisenstadt above. Kaplinsky and Morris thus argued that trust was crucial for gauging long-term chain viability, stating, “The effectiveness of a governor’s command of a chain does not only reflect the power of its sanction, but also the trust which its suppliers or customers have in it” (2001: 73). Humphrey, Kaplinsky and Saraph (1998) enumerated some indicators of high and low-trust environments, including contract length, inspection mode, dependence, technical assistance, price determination, payment method, among others, while Humphrey and Schmitz (1998) discussed the ways in which companies established trust with customers and suppliers.

Given the importance of *guanxi* in China, Zhang and Aramyan (2009) called for incorporating trust and social capital into domestic value chain research.

Both NIE and SNA recognized governance as existing somewhere on a spectrum between a purely market relationship to some form of network relationship to a hierarchical relationship. In other words, chain actors could be linked and governed merely by prices in the spot market or through more complex production networks or fully integrated into one firm. GCC, however, only offered two governance types (i.e., producer-driven and buyer-driven) and could not explain the network types suggested by NIE and SNA theory. Moreover, empirical research presented numerous cases where trends toward de-verticalization and outsourcing among branded manufacturing firms had blurred the distinction between buyers and producers (Sturgeon 2008). In their seminal paper, Gereffi, Humphrey and Sturgeon (2005) combined these contributions from NIE and SNA to provide a different view on governance types, abandoning the producer/buyer-driven distinction in favor of a classification of chain organization with five types: markets, modular, relational, captive and hierarchy. They then utilized three variables of inter-firm transactions—complexity, ability to codify information and supplier capability—to explain the formation and dynamic evolution of these chain-wide governance types.¹⁶ Carrying forward GCC's conceptualization of chain power dynamics, they demonstrated how the position of the lead firm relative to the supply base reflected the level of explicit coordination and distribution of bargaining power within each type.

Implicit in the GVC approach was the recognition that all three industry features—governance, power and institutions—were interrelated. First of all, governance operated within and through institutional environments. Positioning the co-production of governance and institutions as the centerpiece of their GVC study on South Indian coffee and tea plantations, Neilson and Pritchard (2009) wrote:

¹⁶ Using these variables, Sturgeon described the five types as follows:

1) simple *market* linkages, governed by price; 2) *modular* linkages, where complex information regarding the transaction is codified and often digitized before being passed to highly competent suppliers; 3) *relational* linkages, where tacit information is exchanged between buyers and highly competent suppliers; 4) *captive* linkages, where less competent suppliers are provided with detailed instructions; and 5) linkages within the same firm, governed by management *hierarchy* (2008: 10).

Systems of value chain governance intermesh with the institutional life of territorially embedded production arrangements; institutions shape governance forms, and governance is enacted through institutions. The point is: institutional formations and governance arrangements coexist in an iterative nexus within global value chains (2009: 9).

Indeed, institutions could significantly impact an industry's "economic geography," dictating investment location and rearranging producer-consumer relationships across local, regional and national boundaries (Sturgeon 2008: 25). Furthermore, where neither spot markets nor full vertical integration governed the chain, institutions provided the tools and mechanisms for "control without ownership" – the capacity to specify behavior in other businesses. Neilson and Pritchard explained, "Institutions are not just framing devices external to product/commodity systems ('out there'), but exist also as the rules, norms and behavioural vehicles that shape the very essences of how product/commodity systems are organized ('in here')" (2009: 9).

Likewise, the GVC theory's three variables pointed back to inherent links among governance, power and institutions. Government policy, consumer habits and international trade organizations—all varying types of institutions—could create demands for new or different products and production processes, increasing or decreasing the complexity of transaction information. A firm's ability to codify this information depended critically on the availability and functionality of national / local and public / private regulative institutions, such as contracts, quality standards and certification schemes. Meanwhile, the capabilities of a specific industry's supply base could be enhanced or constrained by a range of social, economic and cultural institutions, including education, religion, development policy, etc., while new regulatory demands could also produce new capability challenges in the value chain. A firm's ability to adapt to changing variables and take advantage of institutional resources depended largely on its relative power within the chain (Sturgeon 2008).

It is important to point out here that institutions could serve as both resource and constraint. Sturgeon stated, "At the firm-level, routines of interaction between suppliers and lead firms can be deeply rooted in domestic and even local institutions and culture, and often structure (enable or limit) firm-level GVC governance in an ongoing manner" (2008: 25). Also, as Trienekens (2009) suggested, the lack of certain institutions, or

“institutional voids,” could hinder value chain development and governance. Institutional mechanisms could even alter profit distribution, bargaining power, risk and responsibility along the chain, ultimately damaging inter-firm relationships and undermining actors’ original objectives (Hammoundi, Hoffman and Surry 2009).

Within this body of research, many scholars examined the role of state institutions as potential resources and/or constraints. Pointing to the state as a resource, Chen (1994) maintained that the state policy played a critical role in initiating the development and integration of value chain networks connecting Mainland China with Taiwan and Hong Kong. In their study on global value chain governance, Humphrey and Schmitz suggested that where “agents outside of the chain” (e.g., the public sector) could produce credible monitoring and enforcement schemes, firms would externalize governance activities, reducing internal costs and responsibility. They noted, however, an important limitation to this trend: firms might determine that these public standards and certification programs were ineffective, unreliable or otherwise an incomplete substitute for internal chain governance (2001: 8-11).

Other scholars have documented cases in which state institutions constrained value chain governance and/or negatively impacted chain actors. Indeed, public intervention through standards could result in market distortion. In their study, Anders and Caswell (2009) revealed that new HACCP regulations for US seafood imports adversely affected the global seafood export market. Exporters from developing countries suffered as those from developed countries gained and within individual countries, larger exporters gained at the expense of smaller exporters. In a Chinese case, Brown, Longworth and Waldron (2002) asserted that new regulations requiring the centralization of beef slaughterhouses had created new risks for food safety. They suggested that as a result of this policy, beef prices would increase, reducing demand, inhibiting industry development and encouraging firms to cut corners on quality.

Not unlike state institutions, private governance mechanisms have also been the subject of much debate. In some cases, it has been argued that they empower large corporations, particularly those in developed nations, who in turn exploit smallholders in less developed areas. However, various writers on standards have criticized such generalizations (Henson and Jaffee 2006; Gibbon, Ponte and Lazaro 2010). Responding to this debate, Neilson and Pritchard (2009) pointed out that explaining the diversity of

outcomes was in itself the more important site of investigation, and not which generalization about public versus private governance was more applicable. More specifically, they considered the crucial questions to be “*why* economic activity takes its particular spatial forms, and *how* it accrues advantage and disadvantage in different measure to place-bound interests” (ibid. 7). Part of the answer resided in what they termed, “the ‘stickiness’ of places;” in other words, value chain outcomes were “steeped” in local institutions, including history, culture and geography (ibid. 9). Humphrey and Schmitz (2000) put forth a similar argument, contending that the interaction between local governance (whether through public, private or public-private institutions) and global value chain governance fundamentally shaped firm competitiveness and opportunities for upgrading.

For this thesis, the value chain governance literature contributes three key ideas: 1) value chain governance can be understood as the non-market coordination of interdependent productive activities with non-trivial consequences; 2) with lead firms driving governance, value chains are dynamic and constantly evolving, assuming a spectrum of organizational types; and 3) a strong relationship exists among governance, institutions and power. The following part draws together important concepts from the two bodies of literature presented above to craft the analytical framework to be used in this study. It also discusses where it aims to augment current literature on food safety in China, particularly that related to the dairy industry and the melamine incident.

2.3 State-market relations, value chain governance and food safety in China’s dairy industry: an analytical framework

By drawing together the global value chain framework with literature on China’s regulatory regime, this study provides an analytical approach to understanding the country’s food safety challenges that goes beyond the two approaches outlined in the introduction to this chapter. The study explores how institutional environments enable and/or constrain value chain governance. In this pursuit, it conceptualizes food safety issues as a breakdown in value chain governance. It argues that this loss of control and coordination can occur between lead firms and their suppliers, or even within the operations of vertically integrated companies, and in the interaction between firms and party-state institutions. In the case of China’s dairy industry, it thus avers that the key to understanding food safety rests not only with the form in which governance takes, but

also with the institutional environment in which it operates.¹⁷ As demonstrated above, the party-state's interaction with and engagement in business as well as its effort to manage this relationship across multiple administrative layers complicated state regulatory governance. Within this institutional context, there was often no clear separation between party-state and business, with firms seldom fitting neatly into categories of "public" or "private." At the same time, the potential for horizontal or external regulatory control was very limited; instead, state-market relations functioned largely according to a vertical, internal chain of command between central and local party-state. This study thus aims to move beyond the public versus private dichotomy that dominates current discussion on regulation and value chain governance. It contends that in China, western notions of distinct realms for state and business, public and private must be replaced with the recognition that the party-state has specific development objectives and it intervenes in order to attain those objectives. As such, certain activities of the party-state can exist and operate within the value chain, enabling and/or constraining state regulation and industry governance.

Food safety issues are often viewed through either regulatory state or value chain frameworks. By bringing together these two analytical approaches, the study establishes an investigative terrain where the party-state is one of many actors. In this manner, it can avoid overemphasis on the state and examine the roles of other key players, including enterprises, farmers, consumers and intermediaries. Similarly, it allows us to focus on the firm itself as a crucial part of state-business interaction. A number of scholars have asserted that debates occurring between and within enterprises are absolutely critical to understanding development outcomes and institutional change (Cheung 2005; Thun 2006; Tsai 2007; Chen 2008). As described in the literature review above, Tsai and others documented how entrepreneurs significantly influenced policy formulation, suggesting that negotiations between state and business were dynamic and multi-dimensional not only in terms of strategy but with regard to power as well. Firms were not powerless, and possessed interests and objectives that both converged and

¹⁷ Given that this study intends to examine an industry with upstream and downstream components predominantly located within China, it is important to point out that the GVC framework can be applied to any value chain regardless of its actual "global" presence. As Sturgeon explained, "Regional, national and local value chains are nested firmly within global value chains, as we perceive them, and GVC governance theory operates equally well at any and all of these spatial scales" (2008: 15).

diverged with those of cadres. In his study on the Chinese automobile industry, Thun wrote, “My starting premise is that firms are at the heart of the industrial development process” (2006: 8). This study also regards dairy processors and their actions as central to understanding industry development.

Value chain researchers focusing on China have also highlighted the link between state-business interaction and food safety outcomes. In their review of recent efforts to integrate agricultural chains, Gale and Hu (2012) concluded that not even hierarchical governance could guarantee safe food when such close relationships existed between local party-state and company subsidiaries. To prove their point, they cited one case where a local pork subsidiary colluded with inspectors, traders and farmers to use feed additives banned by the parent company, eventually resulting in an industry-wide lean meat powder scandal (*ibid.* 487). In their study on China’s beef value chains, Waldron, Brown and Longworth, likewise, observed that state intervention in industry had produced “perverse outcomes” (2010: 479). They found that the party-state’s push to modernize agriculture and promote rural development through an accelerated shift from low-value to high-value supply chains had created an overcrowded modern abattoir sector with limited opportunities to market high-value beef products.¹⁸ Facing declining returns, abattoirs sought to reduce costs by taking shortcuts and compromising food safety (e.g., infusing beef with water or marketing lower-grade beef as A grade) (*ibid.*).

The study here hopes to augment this research on how institutional environments impact value chain governance by focusing on China’s dairy industry. This particular lens is important for two reasons. First, it allows us to examine a clear crisis in value chain governance: the melamine incident. At present, a handful of value chain studies have analyzed the melamine incident. Gale and Hu (2009) provided a comprehensive review of the market conditions and incentives along the chain that contributed to the adulteration of China’s milk supply. In their value chain analysis, Delman and Yang (2012) demonstrated how Sanlu’s role in rural socio-political organization created divergent interests among different stakeholders along the processor’s value chain. As they pointed out, this role had been assigned by the local party-state, highlighting another important connection between state-business interaction and chain decisions.

¹⁸ Policymakers assumed that increased incomes would lead to the growth of a high-value beef market.

Gereffi and Lee (2009) analyzed the melamine incident according to a typology they generated demonstrating the relationship among value chain governance, food standards systems and degree of food safety. They discovered, however, that China's dairy industry did not fit their model, which predicted producer-driven chains to exist in tandem with public and private standards as well as with safety and quality-focused process standards. Instead, they observed "thin public standards," non-existent private standards and corruption. This finding, they wrote, "...highlights that the food standards system in the sector failed to align with drastically shifting industry structures, thus generating vulnerable points within the chain" (ibid. 21). While a misalignment between standards and value chain governance could partly explain why dairy was susceptible to food safety problems, the study here intends to explore this relationship more in depth—even questioning whether dairy governance has in reality shifted from fragmented, traditional markets to producer-driven chains.

Second, this study can be compared alongside research on other Chinese agri-food industries to provide a more complete picture of agricultural development trends and challenges. It can help point out which issues may be industry specific and which may comprise symptoms of more fundamental, systemic problems. Similarly, it can be used as a source of comparison with dairy governance elsewhere in the world. In their study comparing governance arrangements in the dairy industries of Britain, Austria and Germany, Traxler and Unger observed that national systems governing this sector frequently involved "highly corporatist institutions" where there existed close cooperation between the state and industry associations (1994: 183). Explaining this trend, they wrote, "Basically, governance tends to become more corporatist the higher a product's political relevance is. What renders a certain food more politically relevant than others depends on a complex interplay of economic, cultural, and natural conditions" (ibid. 200). Accordingly, they regarded dairy—with its centrality in the Western European diet, economy and agricultural landscape—to be a product of "special political relevance." This, in turn, they asserted, called for a nonmarket type of governance where "the way in which the actors involved tend to perceive the sector and to deal with its problems is to consider it an infrastructure of society rather than a 'conventional' industry" (ibid. 201). As a result, Traxler and Unger documented a variety of circumstances across the three countries in which industry associations assumed a "burden of governance" from the state and performed regulatory functions,

transforming, in a virtual sense, into “private governments” (ibid. 196). Traxler and Unger’s findings raised questions about the regulatory role of dairy associations in China, particularly in light of Foster’s argument that Chinese associations were often insignificant.

Using the dairy industry as a case study poses some limitations. First, given time and resource constraints, it is impossible to explain all of the interactions and practices within a given industry, particularly one that is as large as dairy. Second, the experiences of one industry are not applicable to all other sectors. For example, the political nature of milk distinguishes it from less sensitive industries. However, considering the systematic character of food safety issues as well as the fact that dairy is subject to many of the same institutional environments as other industries, it might be reasonable to suggest some measure of representativeness. With regard to the broader analytical framework, this study cannot explore all of the factors, relationships and mechanisms influencing food safety (e.g., the moral void and post-communist personality argument in Yang 2008). By focusing on state-business interaction and the dynamics of state regulation and value chain governance, this study hopes at least to explain an important part of how and why food safety systems break down.

2.4 State-market relations, value chain governance and food safety in China’s dairy industry: a methodological framework

2.4.1 The Chinese field

Before detailing the methods used here in this study, it is necessary to consider the opportunities and constraints that conducting research in China presented as well as my position within that field. In 2009-2010, the period during which fieldwork was carried out, the melamine incident was still a sensitive subject. The crisis had severely damaged the credibility of the industry and it was clear that the party-state had attempted to suppress media coverage of the incident as well as general food safety issues. This situation created difficulties related to access, as few people would talk openly to an unknown researcher. That said, China scholars have argued—and I noticed myself—that foreigners have some measure of autonomy when negotiating the Chinese field (Carlson et al. eds. 2010): unlike their local colleagues, they are not constrained by institutional research restrictions and censorship issues. In light of these circumstances

and the continued sensitivity of the dairy industry, all sources in this thesis are referred to with anonymity, save a few details describing their general occupation.

Another oft-mentioned challenge to conducting research on China is the reliability of information, particularly state-generated statistics. Throughout fieldwork, I was told many times over, the “statistics are all fabricated.” As subsequent chapters will detail, the lack of reliable data creates difficulties not just for researchers, but also for those within the industry. When describing industry growth, it is difficult to avoid numbers. For example, this study cites state-generated statistics about dairy production and consumption levels. In general, I follow the example of Chen in Carlson et al. eds. (2010) in his research on petition filings and try to treat government data (including policy and state-media reports) as a useful view into the party-state perspective. At the same time, I have attempted to corroborate information where possible and balance numbers with qualitative material.

When interacting with individuals in the field, I was both open and clear about my position and status as a visiting scholar affiliated with the College of Humanities and Development at China Agricultural University in Beijing and conducting research on the dairy industry for a PhD thesis based at the Institute of Development Studies in the UK.

2.4.2 *Methods*

To examine the dynamics of state-business interaction, I conducted twelve months of fieldwork (2009-2010), principally located in Beijing and Hohhot, Inner Mongolia (see map below, Figure 1). I chose these two sites for a number of reasons. As the country’s capital, Beijing provided access to the view from above—or central party-state actors—as well as to the many academic institutions and government think tanks that conducted research on the dairy industry. It was also home to my affiliated institution. For the view from below, I selected Hohhot, the autonomous region’s capital and China’s “Milk Capital.” I chose to focus a large portion of my fieldwork there as it served as the headquarters for the country’s two top dairy brands, Yili and Mengniu, which together represented nearly half of total dairy sales in China. Inner Mongolia also produced 28% of the industry’s milk, almost twice the amount of the nation’s second largest producer, Heilongjiang. In addition, other research on the melamine incident had principally concentrated on Sanlu and its home province of Hebei (e.g., McGregor

2010; Delman and Yang 2012). I could not research Sanlu *in situ* as the company was dissolved in 2009 and I was equally reticent to base myself in Hebei, where the central party-state had focused much of its post-melamine punitive measures. Early on in my fieldwork, industry experts confirmed that, as the “epicenter” of the incident, Hebei would not be representative of action taken elsewhere in the dairy industry. There was, however, a drawback to using Hohhot as a key site; local state-business interaction was heavily influenced by the fact that Yili and Mengniu were national companies and that the market structure at the firm level would not likely experience much change (i.e., limited entrance of new competitors).

This discussion of fieldwork sites brings up the issue of whether state-business interaction in Hohhot could be considered representative, particularly when many studies concluded that local party-state created substantial variation in business strategy across a given industry. I would aver here that Hohhot could be considered representative for three reasons. One, the outsourcing model that Mengniu and Yili used in the areas surrounding Hohhot was employed throughout the country. Two, my trips to other regions as well as conversations with dairy experts and industry representatives from all over China confirmed that many of the issues prevalent in Hohhot existed elsewhere.¹⁹ Three, the scope of the melamine incident indicated a systematic problem in the dairy industry. Concurrently, it is important to point out that Hohhot provided important access to the executives and managers of national dairy processors, who discussed strategy not just in terms of Inner Mongolia but the whole country. Moreover, as Blecher and Shue (2001) suggested in their study, the decisions and results of one local developmental state had the potential to affect competing localities; hence, the dynamics in Hohhot were imperative for understanding dairy development in other regions.

Throughout the course of fieldwork, I relied primarily on the techniques of ethnographic investigation and on anthropology’s actor-centred approach to examine state-business interaction through the perspectives and experiences of the individuals involved (Spradley and McCurdy 1972; Long 1992). I established relationships of trust

¹⁹ In addition to Inner Mongolia, I also traveled to Shandong, Jiangsu, Shanghai and Xinjiang.

with “gatekeepers” within the dairy industry (Whyte 1955; Neyland 2007). In China, this involved the patient practice of building *guanxi*, which is achieved through introductions from the “right” person, friendship and often, alcohol. In this manner, I interacted with key members of local, provincial and central party-state, dairy processor executives and managers, milk station operators, raising zone and cooperative owners, farmers (small and large-scale), business association leaders (from most provinces and the national level), sector experts and academics. Considering this study’s focus on relationships, I paid close attention to the formal and informal interactions that existed among these actors as well as to how they were introduced to me and through whom.

Utilizing ethnography’s attention to seemingly “mundane” details (Pollner 1987), I conducted a review of relevant policy literature and attended numerous association meetings, banquets, tours/trips and conferences ranging in subject from food safety to dairy industry development to animal health to the school milk program. I also visited a wide variety of farms and factories (from backyard farms with just two cows to raising zones to cooperatives to 10,000-head industrial dairy complexes to state-of-the-art dairy processing plants). Finally, I was provided with a substantial number of internal documents detailing the daily operations and future plans of a particular Chinese dairy processor, here called “Company X,” in the months leading up to the melamine-milk incident. These documents comprised a crucial source of data difficult to collect using other social science methods (i.e., surveys and interviews).²⁰ In the text, the documents are listed by number. Unless otherwise cited, all material was drawn from these interactions and sources, and the translations are my own.

²⁰ It must be stated here that although these documents are internal, they might not always represent the “truth,” firm actors are also motivated to present “facts” according to company and individual interests.

Figure 1: Map of China



Source: Wikipedia, "China administrative claimed included" (public dom.)

3 Chapter Three: Contextualizing the Chinese Dairy Industry

3.1 Introduction

Premier Wen Jiabao's dream highlighted a key factor about Chinese dairy: from the very beginning of its rapid growth over a decade ago, this sector was central to the national agenda. Like much of industrial policy in reform era China, it served as a strategic tool for achieving a range of social, economic and political objectives. Divided into two parts, this chapter will shed some light on the high-level objectives that drove dairy's takeoff in the late 1990s and early 2000s. In the first part, it explores the history and development of dairy in China. In the second part, it details the dairy value chain and how national objectives led to its reverse construction.

3.2 From barbarian product to sunrise industry: dairy in China

In reviewing the history of dairy in China, it is important to understand that milk did not emerge post-Mao as yet another sign of the country opening up to the West and its barrage of consumer goods. Over the centuries and up until the present, different regimes have regarded dairy as a politically sensitive product and therefore, carefully limited and controlled its distribution according to the particular agenda of the prevailing leadership. Only in the late 1990s and early 2000s, with the convergence of active campaigns to industrialize agriculture and boost urban consumption, did the industry begin to see exponential growth. This part first traces dairy's development course, beginning with dynastic times and quickly moving through the Mao era to the second decade of the reform era. It then explores the launch of agricultural industrialization and its "go-west" campaign, detailing the rise of Inner Mongolia as the headquarters for the country's top two dairy processors, Yili and Mengniu.

3.2.1 Kublai Khan to Mao to the early reform era

In dynastic times, mainstream dairy consumption correlated closely with rulers' origins and influential trade routes.²¹ While Kublai Khan's Yuan dynasty regularly

²¹ Milk products, especially from goats, horses and camels, have always featured prominently in the cuisine of western China's ethnic minorities. From the Wei through the Tang dynasties, the Silk Road and culinary exchanges with Central Asian cultures brought new forms of dairy production and consumption into East Asia.

consumed fermented mare's milk, or *kumis*, as part of ceremonial and daily life, the succeeding Han-led Ming dynasty deliberately suppressed foods associated with the "enemies" and "barbarian" Mongols (Anderson 1988: 81). Portrayed as a non-native invader, dairy production remained marginalized, even into the first half of the twentieth century. During the Qing and republican eras, it could be found principally in the foreign concessions of Shanghai, Tianjin and Dalian. In the early post-liberation period, the state recorded a national herd of just 1,500 dairy cattle, which produced no more than 2,000 tons of milk a year. Throughout the Mao era, milk continued to be a strictly controlled commodity, available only to those with designated ration cards and special needs, either physical (infants, sports players and the disabled and infirm) or intellectual (high-ranking cadres and social figures) (Gorissen and Vermeer 1985). To meet this limited demand, fresh milk-producing state dairy farms were established near major urban centers, including, in 1956, the Shanghai Milk Company (now, Guangming) and the Beijing Milk Station (now, Sanyuan).

In the 1960s, when the communist revolution no longer required active combat, the People's Liberation Army (PLA) sought employment for restless soldiers without fully compromising military objectives. It eventually decided to send forces to the northern and western borders of China (namely, Heilongjiang and Xinjiang) to engage in agricultural work. There, soldiers were organized into small industries (兵团) tasked with producing agricultural goods, such as dairy, primarily for army consumption while simultaneously maintaining the geopolitical integrity of the surrounding area. Unlike their neighbouring farmers who were under the jurisdiction of the local government, they reported all activities, agricultural or otherwise, to the central government and PLA.²² Later, during the Cultural Revolution and the Red Guard's attempt to purge the country of privilege and foreign influence, numerous Party cadres and intellectuals were "sent down" to the countryside (下乡) for work and reeducation. Consequently, the dairy industry lost a significant proportion of its privileged urban consumers and,

²² In the 1980s, the purges and Mao era over, a second round of demobilization occurred and the agricultural soldier industries once again grew considerably. In recent years, more stable border regions (e.g., Heilongjiang) have seen the corporatization of these industries and the building of national brands (e.g., Wandashan). In Xinjiang, an area marked by ethnic tension and unrest, the soldier-industries still remain intimately connected with the region's military organization.

outside of the military farms, almost completely disappeared (Gorissen and Vermeer 1985).

Two years after the death of Mao Zedong in 1978 and the end of the tumultuous Cultural Revolution, the Chairman's successor, Deng Xiaoping, realized the nation had arrived at a critical juncture: the CPC had been largely discredited by the past decade's unrest, and while many other countries in East Asia were demonstrating significant economic growth, China's centrally planned economy exhibited evidence of stagnation, particularly in rural areas. As such, Deng sought to re-legitimize the CPC and ensure the party's preservation through a series of Chinese-style market reforms, or *gaige kaifang* (改革开放).

Deng's first round of reforms focused on de-collectivization and sanctioning officially a process that had already begun informally in many rural areas (Kelliher 1993; Yang 1996). Under the new household responsibility system, communal land was redistributed to rural households with contracts permitting use—but not ownership—of land. The policy granted farmers the freedom to make market-oriented production decisions; they could now freely purchase, raise and sell dairy cows. In 1979, the number of dairy cattle nationwide increased to 500,000 (Delman 2003). Rural residents were also encouraged to engage in small to medium-scale business with the creation of rural credit schemes and township-village enterprises.²³ As a result of these reforms, rural incomes began to rise steadily.²⁴

²³ For the Chinese dairy industry, the reforms of the late 1970s through 1980s also meant the arrival of foreign development assistance. In March 1984, the United Nations International Fund for Agricultural Development provided a 50-year loan of 30 million USD for the construction of a milk powder factory in Heilongjiang. That same year, the World Food Program also initiated a number of projects totaling 156 million USD for the improvement of milk supplies to 20 medium and large-sized cities (Hu 2009). Then, there was the China-EU Dairy Project in 1988-2001 as well as a host of other agreements—involving either governments or individual companies, or both (e.g., Sweden, Denmark, New Zealand, United States, France, Australia, among others).

²⁴ Based on China's official poverty line, between 1978 and 1985, the number of impoverished citizens dropped from 250 million to 125 million while the incidence of poverty declined from 30.7% to 14.8% (the vast majority of the country's poor are rural residents) (Wang et al. 2012). Likewise, rural-urban income gaps narrowed, with ratios decreasing from 2.56 in 1978 to an all-time low of 1.82 in 1983 (China National Bureau of Statistics 2010).

In the late 1980s and early 1990s, the country's top leadership began to direct their energy and resources toward economic, rather than ideological, construction and “deepening reform” in coastal cities and special economic zones. This shift away from grassroots rural development was in no small part due to a post-Tiananmen conservative backlash and the urgent need to appease those urban classes dissatisfied with the reform (Zhao 1993). Upon arrival to Zhongnanhai in 1992, and especially following his predecessor's Southern Tour, Jiang Zemin adopted Deng's economic vision for China, positioning urban, state-led growth as the centrepiece of an increasingly technocratic and industrialist national development policy (Huang 2008; McGregor 2010).²⁵ Under this framework, the countryside's primary function soon became providing cities with the natural resources, agricultural produce and landless labour necessary to fuel and feed rapid growth.

Unlike in the early years of the reform era, the Jiang administration attempted to lock rural residents into agricultural production through a series of top-down regulations (e.g., grain procurement quotas) and restrictions on non-farm activities (Tao et al. 2003; Huang 2008; Su 2009).²⁶ During the last few years of the decade, the sustained grain regulations and inflated price supports led to massive growth in agricultural output and abundant national grain stores. Meanwhile, around mid-1996, international grain prices began to plunge, eventually falling below the subsidized domestic market price. While Beijing eased back on grain quotas and intensified its call for diversified agricultural production through the “non-staple food program” (菜篮子), many local governments

²⁵ In February 1992, Deng reemerged from semi-retirement to make an extensive tour of the south, visiting Guangzhou, Shenzhen, Zhuhai and Shanghai to praise their tremendous economic progress.

²⁶ In the 1990s, the tax burden on rural residents reached its highest levels, further limiting farmers' ability to leave agriculture. During this period, local governments demanded farmers pay a number of extra fees that, according to central regulations, were not supposed to exceed 5% of net income. Nevertheless, between 1988 and 1995, the average tax rate for the poorest 10% of rural residents rose from 7.5% to 13.9%. A study conducted by the State Council's Development Research Center even found counties with total per capita taxes and fees at 28%. This burden begins to decline after the initiation of pilot reforms eliminating the agricultural tax in 2000. By 2006 and the official abolishment of the agricultural tax, the burden is negligible at 0.3% (Li 2011).

attempted to meet budget constraints by setting up grain-milk exchanges (以奶换料) (Hu 2009).²⁷

By the end of the 1990s, Jiang's urban, state-led development plan had created booming coastal cities but left the rest of interior China, particularly rural areas, lagging behind. Rural-urban income ratios, which had been declining in the early reform years, rose steadily from 1.82 in 1983 to 2.79 in 2000 (China Statistical Yearbook 2010).²⁸ Similarly, coastal-inland per capita GDP ratios increased from 1.7 in the late 1980s to 2.4 in 2004 (Huang and Luo 2009). In his now famous open letter to Premier Zhu Rongji in 2000, Li Changping, party secretary of a township in Hubei, described the extent of the situation as the "three rural crises" (三农危机) in farmer livelihoods, village governance and agricultural production.²⁹

3.2.2 *China's agricultural industrialization: enter the dragonheads*

With the situation in the countryside deteriorating, on January 24, 1998, the CPC Central Committee and the State Council jointly issued an opinion on the future of agriculture and rural work whereby the nation would embark upon a new campaign toward agricultural industrialization (CPC Central Committee and State Council 1998). Specifically, they aimed to stabilize grain output, diversify production and improve rural livelihoods through the commercialization, specialization and modernization of agriculture (ibid.).³⁰ While these objectives differed little from past rural policy, the way

²⁷ Initiated in 1989, by the Ministry of Agriculture, the non-staple food program charges city mayors with the task of guaranteeing their municipalities receive sufficient supply of those non-staple products deemed essential for improved nutrition, including meat, eggs, fruit, vegetables and, in 1991, dairy. The grain-milk exchanges provided farmers with feed in return for switching to milk production.

²⁸ During the worst period for rural income growth, from 1984 to 1989, the number of rural poor actually increased from 89 million to 103 million (Fan, Hazell and Thorat 1999).

²⁹ The term sannong continues to be used today to describe policy targeting these three areas of rural development (i.e., farmer livelihoods, village governance and agricultural production). It is also often referred to as the "three rural issues" (三农问题).

³⁰ For that year, the party-state hoped to increase rural incomes by 5% and reduce the number of rural poor by at least 10 million.

in which the central party-state sought to encourage and direct agricultural production was evolving.³¹

Accordingly, the State Planning Commission declared that “dragonhead” enterprises (龙头企业) would lead agricultural industrialization, “entering and driving all-around rural economic development” (State Planning Commission 1998). Nominated by local government, endorsed at the provincial level and finally confirmed by nine central party-state mechanisms, these aspiring industry champions would forge a new type of relationship among business, local party-state and rural labour. They would use their ability to open markets and process agricultural goods to assist farmers and stimulate them to produce commodities. They would be responsible for establishing “fair relations of interest” with farmers and providing them with the “tangible benefits” of “collaborative” development (CPC Central Committee 1998). Most importantly, they would fill the organizational and motivational void that had been left by the departure of the revolutionary socialist state from rural areas. The party-state drew on “ruralist” conceptualizations of farmers as “low quality” (低素质), backward and vulnerable to justify the dragonheads’ new role as the guiders, protectors and providers of “modern” knowledge (Chang 2005; Feng in Jeffreys ed. 2009; Delman and Yang 2012).³²

Although the Chinese leadership promised that agricultural industrialization would principally benefit rural residents, it afforded the dragonheads numerous privileges, a move suggesting an altogether different outcome. For example, it declared, “[Dragonheads] should not only enjoy the national preferential policies already

³¹ As Su contends in his study, the fundamental objective of the central party-state has been, and continues to be, “extracting food to feed a large population and taxes and raw materials to fund industrialization as a part of China’s overall development and modernization” (2009: 36). During the Mao era, the peasant figured centrally in the state’s communist ideology and rural production was promoted as one of the most fundamental forms of revolutionary activity. Any potentially dissident elements, particularly those arising from “primordial peasant localism,” were “domesticated” and integrated into a variety of socialist state structures (Shue 1988). In the reform era, however, many of these structures were dismantled and leaders could no longer rely on collectives and revolutionary ideology to motivate the rural majority toward production; thus, they sought other avenues for maintaining high agricultural output.

³² According to policy, this “modern” knowledge meant, “The development orientation of ‘dragonhead’ enterprises should stress ‘large’ (large-scale enterprise, large impact), ‘high’ (high-tech enterprise, high value-added products), ‘external’ (outwardly directed), ‘new’ (new products) [and] ‘many’ (multi-varied ownership and models)” (State Planning Commission 1998).

available to agricultural enterprises, but also receive support in areas regarding credit funds, project planning, tax fee collection and land usage. ‘Dragonhead’ enterprises that meet the appropriate criteria have the right to participate in foreign trade and export and are given priority for stock market listings” (State Planning Commission 1998). In addition, it instructed the Agricultural Bank, Rural Development Bank and Rural Credit Cooperatives—previously focused on providing support to farmers—to raise funds for and actively support dragonheads instead.

This approach to rural development became a critical element of the Jiang administration’s agricultural industrialization campaign. For both party-state and business, it held important advantages. The party-state could relinquish some responsibility for rural livelihoods while still maintaining control over key decisions through its enterprise party committees and the local cadre evaluation and appointment system. Dragonheads (i.e., lead firms), meanwhile, were afforded substantial flexibility in their interactions with farmers, organizing rural production according to company needs and objectives. Three years later, at the 2001 Central Economic Work Conference, the country’s leaders reiterated the merits of industry-led rural development, declaring, “To support the agricultural industrialization is to support agriculture. To support the dragonhead enterprises is to support farmers” (People’s Daily 2001).³³

3.2.3 Dairy goes west and the rise of Inner Mongolia

To address the lagging growth of China’s interior, the agricultural industrialization plan placed particular emphasis on promoting economic development in central and western regions of the country (i.e., all areas outside of the 12 coastal provinces and Beijing). As elaborated in the CPC Central Committee’s October 1998 “Decision on Certain Major Issues in Agriculture and Rural Work,” the eastern regions would continue to focus on science and technology, developing high value-added products in an export-oriented economy. The central and western regions, by contrast, would devote their efforts toward concentrated labour and natural resource processing industries. Moreover, they would capitalize on their “superior production” of staple foods and livestock products to become “the nation’s primary base for agricultural

³³ The development strategy this phrase represents still shapes important national and local agricultural policies today.

commodities” (CPC Central Committee 1998). The coastal regions were expected to forge relationships of economic cooperation with the interior and “assist and drive the rural development of [these areas], gradually achieving joint prosperity” (ibid.).

In the decade following the initiation of the go-west campaign, the dominant areas of dairy production and processing moved from their former location along the eastern seaboard into central and western China. In 2000, only one interior region, Inner Mongolia, managed to make it onto the list of top ten liquid milk producing areas. Just eight years later, however, the interior represented half of the regions on the list. While the total liquid milk output of the top ten eastern regions increased by 5 times, that of the interior increased by 44 times. In her study of regional dairy trends in China, Li documented this shift from east to west and, echoing national policy discourse, commented, “This type of industry shift toward the promotion of interior economic development holds important significance for reducing the income gap between the eastern and central regions” (Li in Liu and Li eds. 2010: 29).³⁴

The introduction of Ultra High Temperature (UHT) technology in the late 1990s facilitated dairy’s participation in this go-west campaign. Previously, liquid milk production principally consisted of fresh milk, which needed to be located close to its main market (i.e., large coastal cities). With UHT, however, companies could transfer base operations to more distant regions as the transportation of long life milk did not require highly developed cold chain logistics. For a government looking to develop the interior quickly while building national brands and promoting urban consumption, the technology was ideal. It also lessened the likelihood of food safety issues related to spoilage or bacterial contamination.

At the time, Tetra Pak, the Swedish aseptic packaging giant key to the development of UHT technology, had already been in the country close to two decades and even partnered with Shanghai Guangming, one of the largest state-owned dairy processors. Guangming, however, was located in a market accustomed to fresh milk and

³⁴ Compared with liquid milk, the regional development initiatives had relatively little impact on the location of dry powder production. Between 2000 and 2008, output among the top ten regions grew by 4.3 times for central and western areas and 2.7 times for the coast. Li posits that, unlike liquid milk, dry powder faced a market with much more intense competition by multinational companies providing a range of high-tech, low-cost products to urban consumers (ibid.).

thus, resisted Tetra Pak's UHT technology. In her memoirs, the CEO of Guangming, Wang Jiafen, wrote, "We were unable to tolerate Tetra Pak confusing right from wrong when it came to fresh and room temperature milk" (Wang 2008). Indeed, it was not until the push to increase dairy consumption converged with the go-west campaign that Tetra Pak found the central party-state eager to back companies using UHT technology. In just five years, from 1999 to 2004, the quantity of UHT milk produced annually increased from 2 to 48 million tons (Hu 2009). UHT's share of the liquid milk market also expanded rapidly to overtake pasteurized milk as the dominant product (see Table 1).

Table 1: Share of Liquid Milk Market, by type (%)

<i>Year</i>	<i>UHT</i>	<i>Pasteurized</i>
2000	14.17	85.83
2005	68.51	31.49
2009	71.50	28.50

Source: China Dairy Yearbook 2010

Tetra Pak's UHT technology propelled one particular region to the helm of the entire dairy industry. Following the installation of the country's first UHT lines in two Inner Mongolian companies (in 1997 and 2000), this northern autonomous region quickly became a major base for dairy production and processing. Between 2000 and 2008, Inner Mongolia moved from its third place position among the nation's top ten dairy producing regions to the first, maintaining an annual growth rate of 35.6% over that period. In contrast, the provinces formerly occupying the first and second place positions, Heilongjiang and Hebei, only saw 16.07% and 25.08% annual growth, respectively. By 2008, Inner Mongolia dominated the industry with 28.1% of national dairy production; meanwhile, second and third place contenders Heilongjiang and Hebei produced slightly more than half of what Inner Mongolia produced (Li in Liu and Li eds. 2010).

According to government policy and company statements, Inner Mongolia was presented as the "natural" choice for dairy industry development in China. Local policy highlighted the region's grasslands and their suitability for raising dairy cattle, especially given their location within the latitudes of the global "dairy belt." Dairy

product advertisements reinforced this view of Inner Mongolia, often featuring scenes of contented ruminants grazing in lush fields of grass. It would seem consumers were convinced; a 2007 market study surveying 2,300 consumers across ten cities nationwide concluded, “Originating from Inner Mongolia and being inextricably linked with the grasslands, [Company A] gives people a green and natural image” (Document #38).

Government and company officials also maintained that the growth of Inner Mongolian dairy was a win-win situation for the region’s economy and environment. One executive explained:

In recent years, ferocious sandstorms from the north have blown regularly through Beijing. And what is the reason? Inner Mongolia’s grasslands have been destroyed. As a consequence of economic development, not much attention was paid to the ecological system. Therefore, the government has invested substantially in encouraging farmers to raise cows. The companies are also leading and encouraging farmers. If they raise cows, for sure, they will plant grass instead of corn and wheat and like this, slowly, the ecological system will recover.

As such, dairy initiatives often arrived in conjunction with efforts ostensibly for curbing desertification and land rehabilitation (以粮换绿). For example, a 2002 Beidaolaban plan drawn up according to the central party-state’s “Few Ideas On Further Betterment For The Policy Of ‘Returning The Grain Plots To Forestry’” included tree plantings and farmland reclamation as well as the purchase and maintenance of 1,500 dairy cows (Webber and Wang 2005: 731). This pairing in Inner Mongolian policy has been particularly pervasive under the country’s regional development campaign. In an article he wrote for the autonomous region’s 3rd Annual International Dairy Development Forum, Party Secretary and Chief of Hohhot’s Animal Husbandry Bureau Fan Aiji averred, “Proper ecological construction is both the focus and point of penetration for the Opening-up of the West. With grass production as its prerequisite, dairy industry development agrees completely with the restoration of land to forest and grass” (Fan 2010).

At the same time, Genghis Khan’s recent renovation as a victorious leader—in place of his former manifestation as barbarian conqueror—further strengthened Inner

Mongolia and dairy's position in the national consciousness.³⁵ In recounting the long history of dairy in Inner Mongolia, one company executive asserted it was Genghis Khan who first brought milk to the Europeans and that his incredible success at war and conquest owed itself to his armies' abundant reserve of milk and meat. The re-interpretation—and, in some respects, co-optation—of history in favour of milk and Mongol conquerors served the important purpose of framing dairy as a local product with an unbroken and victorious tradition. This transformed milk from a product that previously conjured up feelings of disgust and unfamiliarity to one that was regarded as natural and native.

The validity of this image, however, was highly questionable, with one Beijing official saying, "They are all cooked up stories." Indeed, while many contended Inner Mongolia was chosen for its expansive grasslands, environmental conservation efforts and dairy tradition, three crucial facts suggested otherwise. First, the vast majority of the industry's cows were housed indoors and consumed corn silage. Far from promoting the re-planting of various grasses and curbing of desertification, the dairy industry has intensified corn cultivation. Even the dairy cattle feed standards issued by the Ministry of Agriculture in 2003—which were optimistic at best—only required 9% hay, while corn silage dominated at 65%.³⁶ This situation often meant that in order to meet protein requirements, supplements had to be added, either to the feed or the milk, as corn contributed much less protein than grasses or hay. Hence, this diet created a greater likelihood of reduced milk quality.³⁷

Second, as a result of environmental mismanagement that began during Mao era collectivization, the Gobi Desert has steadily consumed Inner Mongolia's grasslands. Most of the region now sits across a swath of non-arable land, with water, a resource needed in abundance for dairy production, scarce. The president of a dairy technology firm in Beijing also questioned the location of the country's dragonhead dairy

³⁵ Uradyn Bulag's *The Mongols at China's Edge: History and the Politics of National Unity* (2002) provides detailed discussions of the renovation of Genghis Khan and other Mongolian leaders in the post-Mao era.

³⁶ Interestingly, Hohhot even increased the permitted corn contribution by 4% or 500kg.

³⁷ As will be mentioned in the next chapter, the Ministry of Health cited this very problem as a contributing factor in its decision to lower the national protein standard for raw milk.

enterprises, commenting, “I have never understood why there is such a huge push in Inner Mongolia. It does not seem like a logical place to produce milk.” He instead suggested the northeast, China’s breadbasket (i.e., Heilongjiang, Jilin and Liaoning), as a more appropriate area for dairy, with its ample supply of feed and water.

Third, while it was argued that historical ties to milk accounted for the priority given to Inner Mongolia, other “traditional” regions did not experience rapid dairy growth over the last twenty years. For example, Xizang (Tibet) and Qinghai contained large populations of ethnic minorities that consumed dairy. Similarly, Shanghai and Beijing had considerable experience with the industry, whether as sites of large foreign concessions or of state-run dairy farms. And yet, by 2008, these four regions all disappeared from the list of the country’s top ten producers; dairy in Xizang and Qinghai failed to exhibit any growth at all, remaining close to their 1990 levels.

In sum, Inner Mongolia’s grasslands, or what was left of them, served a purpose quite apart from pastures for dairy cattle. Rather, it would seem that it was the image of them that was of paramount importance, signalling to the Chinese public that milk was a natural and native product. It could also be argued that this particular conceptualization of Inner Mongolia simultaneously fulfilled another objective: it incorporated the region into the national imaginary as an area of ecological and historical value. As for other possible motives for promoting Inner Mongolian dairy, one could only conjecture that perhaps leadership hoped economic growth, particularly in some of the country’s poorest rural areas, would ensure the stability of a region that was geopolitically strategic to Beijing. A major natural resource base (e.g., rare earth metals, coal, iron ore, gas, lead, etc.) and historically “autonomous” border region, there were myriad reasons for the capital to keep Inner Mongolia close and well assimilated across economic, cultural and political landscapes.³⁸

³⁸ Inner Mongolia enjoys the world’s largest deposit of rare earth metals, with one city, Baotou, contributing over 45% of global supply. It also holds the country’s largest supply of coal and has recently replaced Shanxi as the top-producing region. The highway leading from Hohhot to Beijing is infamous for its days-long traffic jams, hundreds of kilometers of bumper-to-bumper lorries carrying coal into the capital city.

3.2.4 Inner Mongolia's dairy dragonheads: Yili and Mengniu

The two companies driving the rapid growth of Inner Mongolia's dairy industry were Yili and Mengniu, dragonheads both headquartered in Hohhot. Originally named the Hohhot Huimin Dairy Products Factory, state-owned Yili underwent corporate restructuring in February 1993 and changed its name to Inner Mongolia Yili Industrial Group. Just three years later, it became the first Chinese dairy company to be listed on the Shanghai Stock Exchange, beating out the older, state-owned powerhouses Guangming and Sanyuan for the honour. As one Chinese academic assured, this selection for listing was by no means random; only those companies handpicked for future market domination were allowed access to the prized external (i.e., foreign) sources of funding.³⁹ That same year, Yili purchased a brand new UHT processing line from Tetra Pak, and when the line went into operation in 1997, it introduced Chinese consumers to domestically-produced long life milk.

On October 20, 1998, Yili's Vice President of Production Operations, Niu Gensheng, along with a small group of other high-level managers, left to form their own dairy company.⁴⁰ Just two months after their departure from Yili, on January 13, 1999, the group officially registered Mengniu as a privately owned company. With Hohhot city proper considered the domain of Yili and thus, fiercely guarded by the municipal government, Niu's group ended up locating their new company just outside the city

³⁹ Zheng Junhuai, who led Huimin's corporatization and later steered Yili toward national prominence, was not only a forceful and determined individual, he was also well connected. Just prior to his campaign to corporatize Huimin, he relinquished his joint position as the deputy head of Hohhot's branch of the China Animal Husbandry Group, at the time under the organization and supervision of the Ministry of Agriculture. That same year, the Group also underwent corporate restructuring and is now the largest state-owned enterprise in the country's animal health and agribusiness industry. According to the book *Mengniu's Inside Story*, Zheng Junhuai convinced Huimin's six top managers to join him in threatening to resign unless the municipal government granted the company permission to begin corporatization. Apparently, the mayor's office regarded the move less as a threat and more as an admirable sign of fortitude and grit, with Mayor Bai Yin stating, "Within Hohhot's circle of enterprises, many companies ask the government for money, for reduced taxes, but to go it alone [they] do not want at all. They just want policies and a corporate structure. Having expressed a surprising amount of courage, the municipal government decided to agree in principle with Huimin Dairy Products Factory's corporatization" (qtd. in Sun and Zhang 2005: 31).

⁴⁰ Over the previous decade and a half at Yili, Niu Gensheng had steadily climbed the ranks from bottle washer to the company's "Ice Cream King," earning the respect and loyalty of many colleagues as well as the ire of CEO Zheng Junhuai.

limits, signing a contract with the Helinge'er county government in April 1999.⁴¹ At the same time, Beijing contributed 1 million RMB toward the conversion of the new site in Helinge'er into the Shengle Economic Park. Over the next several months, officials from every level of the Inner Mongolian party-state, including the autonomous region's Chairman and Party Secretary, visited the Helinge'er site to complete inspection tours and extol the dragonhead's tremendous progress. Within a matter of a few years, Mengniu conquered national markets at record pace, joining Yili, Sanyuan and Guangming as one of China's top dairy processors.

In January 2000, the Hohhot Municipal Committee's 6th Enlarged Plenary Session decided that the autonomous region's capital would "seize dairy as the industry that would lift up the city of Hohhot in the 21st century," by implementing a strategy called, Milk Enriches the City (奶业兴市) (qtd. in Fan 2010). Over the next several years, Hohhot's two dairy processors benefited from generous preferential treatment that facilitated their access to rural milk and feed supply bases. As detailed in the 2003 "Decision on Accelerating the Implementation of the Milk Enriches the City Strategy," the city government directed a wide range of bureaus to devote planning, financial and technical resources to the development of the dairy industry. It called for the commerce and tax bureaus to exempt milk stations and animal husbandry companies from any registration, contract or administrative fees as well as from all taxes save those related to labour and inputs. It designated lands used for raising dairy cattle, constructing milk stations or housing breeding facilities as agricultural purpose—even though they more closely resembled industrial operations. In addition, it tasked indirectly related bureaus, such as those of external affairs, public security, propaganda, justice, health, inspection, rural electricity, labour, human resources and education, with maintaining a supporting

⁴¹ One manager remarked, "[Local officials] decide whether you are along a highway or a dirt road." Helinge'er, a national poverty area and annual recipient of central government assistance as the poorest county in Hohhot, did not comprise a choice piece of land; indeed, before construction could even begin, this "desolate and uninhabited" low-lying place had to be levelled. Lacking any infrastructure, water was brought in by truck and electricity supplied by diesel generator (Sun and Zhang 2005: 81). As has been suggested in the previous discussion on Inner Mongolia, the condition of the land was perhaps not of primary importance.

role and “formulating corresponding preferential policies” (Hohhot People’s Government 2003b).⁴²

While the local party-state put forth great fiscal effort transforming the countryside into dairy production zones, processors were always expected to meet the government halfway. In the 2003 Decision, Hohhot government sought “to encourage dragonhead enterprises to support rural households in developing the dairy cattle sector and to establish their own milk supply bases” (Hohhot People’s Government 2003b). In other words, processors would be responsible for working out their relationship with farmers, a move that was lauded as a step toward market liberalization. Furthermore, they would be required to guarantee microcredit and loan schemes for farmers as well as furnish a significant proportion of the subsidies for milk station construction and cow purchases.⁴³ Both guiding rural areas to economic prosperity and helping officials fulfil local growth benchmarks, Hohhot’s dragonheads thus assumed a dual responsibility with considerable implications for the future of the Inner Mongolian dairy industry.

3.3 Building the dairy value chain in reverse

As the centerpiece of its plan for agricultural industrialization, the party-state set up dragonheads to operate as lead firms in value chains linking rural producers to urban markets. In the dairy industry, dragonhead processors thus opted for a high-growth development strategy—which Mengniu called, “market first, then factory” (先建市场，后建工厂)—focusing their resources on downstream activities and driving demand for milk while “outsourcing” production to rural farmers (Sun and Zhang 2005; Yang and Li 2010).⁴⁴ By starting with the market prior to developing production, they built the value chain in “reverse.” To succeed, however, both industry and government recognized that they would need to reinvent dairy in the eyes of the Chinese public. In this pursuit, they promoted dairy as a key product not just for healthy children, but also

⁴² The propaganda department would “publicise vigorously the city’s green milk supply and superior products, striving to create a favourable atmosphere in society” (Hohhot People’s Government 2003b).

⁴³ Both Yili and Mengniu were referred to by name in many of these policies, indicating their incorporation into local policy processes.

⁴⁴ The full phrase can be translated as “first build the market, then build the factory.”

for a healthy China. Divided into three sections, the following pages detail the market first strategy, outsourcing model and reinvention of dairy.

3.3.1 *Market first, then factory* (先建市场，后建工厂)

Aiming to develop rapidly, dairy processors decided to forgo traditional growth models that encouraged initial investment in or acquisition of capital-intensive production facilities followed by the marketing of finished products. Instead, they channelled their resources into building brand recognition and driving market demand, intending to carve out their competitive advantage at the downstream end of the dairy value chain. The following pages examine this “market first, then factory” development strategy, highlighting four key characteristics: 1) prioritization of downstream activities, 2) significant government collaboration, 3) high investment in advertising campaigns and 4) factory and farm construction for marketing, not production.

Mengniu’s first year of development presents us with an instructive view into the “market first, then factory” strategy. On March 10, 1999, a little over a week after the company’s founders rented their first office in Hohhot, they signed a contract with Lule’er in Harbin, Heilongjiang for the production of pasteurized milk and yogurt. By the beginning of the next month, they had already put up advertisements throughout Hohhot anticipating the Inner Mongolian capital’s next big dairy brand. Concurrently, they signed another production contract, this time, with Baotou Yichang for ice cream. By May 1, all three products were on the market using the Mengniu brand. That June, the barely three-month-old company ran a summer-long advertising campaign on CCTV-6, the national television channel for movies.

All of this marketing activity occurred before Mengniu had a single milk station or factory of its own. Instead, Mengniu contracted out activities to other companies that already possessed processing facilities. This particular path of development hinted that, from the beginning, Mengniu’s objective was to build the brand and a new image of dairy as quickly as possible in the country’s major urban centres; the production and upstream end of the chain was to come later. At the same time, it also demonstrated that the company’s founders had well-placed partners, both in local and central party-state, that facilitated their rapid entry into the dairy market. Without such contacts, Mengniu would have been considered extremely high-risk and been forced to prove itself locally

before being allowed onto national television and into such important markets like the country's capital, where the company opened a sales office in January 2000, a month ahead of its first birthday.

Yili similarly capitalized on this relationship with government when breaking into new markets. In 1994, as the company was planning to expand its ice cream operations into Wuhan, crossing the Yangtze River and into southern China for the first time, it realized that just launching a major advertising campaign would not be a viable option; costs in Wuhan were considerably higher than those in Inner Mongolia. Fortunately for Yili, the current party secretary of Inner Mongolia had also previously been the secretary of the Wuhan municipal party committee and so the company seized upon this opportunity to craft a new strategy: “政治搭台，经济唱戏” or “politics builds the stage, economics performs the opera.” Specifically, it sent a group of 12 party-state representatives from Inner Mongolia to be hosted by their Wuhan counterparts and followed closely by local media throughout the duration of the marketing campaign.

At the time, Niu Gensheng was still head of Yili's ice cream division. His assistant later wrote about the episode in *Mengniu Inside Story*, asserting that the collaborative effort proved key to the company's success in Wuhan. He stated, “The high construction of the ‘political stage’ and the resonant singing of the ‘economic opera’ moved people” (Sun and Zhang 2005: 26). In addition to the economic advantages of breaking into a market like Wuhan—ice cream sold for 10 RMB in Hubei's capital as opposed to 1 RMB in Inner Mongolia—the campaign also improved Yili's public relations. Niu's assistant explained, “In the past, some leaders misunderstood Yili, but through this activity, the distance between company and government was pulled closer together” (ibid.). Marketing thus became a tool not only for generating sales, but also for networking and building relationships among local officials.

In a similar manner, extensive marketing strengthened processors' connection with another important actor: the media. Company X claimed to maintain a vast array of “bound” (捆绑) media partners, including 40 national print media (e.g., People's Daily and Economy Daily) and industry-specific periodicals (e.g., China Food Quality News, China Women's News and China Consumer News), 12 Beijing print media (e.g., New

Capital News) and over 50 web portals and online media (e.g., Xinhua, Baidu, Sina and Sohu). It also enjoyed contracts with CCTV and three top satellite channels. In 2007, it budgeted over 407 million RMB for media advertising (Document #26).

In addition to normal advertising, this relationship involved content and brand image control. Like the CPC's Propaganda Department, Company X maintained a very close watch over the country's media, particularly the Internet. As part of its partnership with Sina and Sohu, China's two largest web portals, the processor had a contingency plan ready for "removing negative news from Sina and Sohu within two hours" (Document #6). In the third quarter of 2007, these two sources eliminated 62 pieces of negative news about Company X. At the same time, much of Chinese media was tied to the party-state in some form or another, and thus, it was neither independent from government nor industry; instead, it served both.

As their relationship with the media suggested and the market first strategy required, Chinese processors allocated a substantial percentage of their financial resources to advertising campaigns. From January to October 2007, the national dairy industry was estimated to have spent 13.7 billion RMB on advertising, with the largest percentages devoted to promoting infant formula (29%) and milk drinks (19%). Over the same period, Mengniu spent 1.7 billion RMB, Yili, 1.4 billion RMB and Guangming, 790 million RMB (Document #26). At the 2011 CCTV auction for top commercial slots, Mengniu beat out multinational heavyweights Proctor & Gamble and Coca-Cola, placing the highest bid at 230.5 million RMB for a half-year of prime time drama programming (Burkitt 2010). While Yili became an official sponsor of the 2008 Beijing Olympics, Mengniu was selected to be the "product of astronauts," providing milk for the national space program. In 2007, Mengniu teamed up with NBA China, creating specialized packaging and a national reality show competition. A manager at NBA China commented on this particular project, "We don't treat partnerships like an advertising venture but they treat us like an advertising company so we have to satisfy the customer."

In this promotion strategy, processors also used their own production facilities for marketing purposes. One manager equated factory construction with "building the brand" (做品牌). Indeed, Mengniu's headquarters just outside of Hohhot was designated a "national industry tourist site," complete with tours through the main

“demonstration” plant in converted golf cart-vans.⁴⁵ After twenty years working in China as a business consultant, Midler asserted in his book, “Chinese manufacturers built new plants, not because they needed the capacity, but so that these plants might serve as an advertisement—like some kind of billboard sign” (2009: 219). Company X’s capacity utilization rates appeared to be slightly below the national average calculated for China.⁴⁶ In their 2008 production plans, fresh milk facilities were scheduled to operate between 40-60% capacity while those for UHT milk would operate at 74% capacity (Document #22).⁴⁷

Not unlike their factories, many of the processors’ large-scale dairy farms also served the purpose of brand building. One company official acknowledged, “The 10,000 head ranches are not sustainable. All of those farms, they are just for demonstration, for show, just to make the customers drink more of our milk. But they are impossible to maintain given the resources and management capacity.” This phenomenon of excess capacity and “demonstration” facilities was found across many industries in China, and in recent years, central policy began to call for an end to “blind” (盲目) investment and development (e.g., in the State Council’s 2007 “Recommendation on Promoting the Dairy Industry’s Sustainable and Healthy Development” as well as in the 12th Five-year Plan).

In defence of the “market first” strategy, one executive contended that it enabled his company to change consumer behaviour while under the constraints of limited funding, eventually driving production capacity and attracting foreign investment. Moreover, it was able to achieve this in a very short period of time. Other dairy companies that did not outsource their milk supply and focused equally on up and downstream (i.e., Sanyuan and Guangming), by contrast, were criticized as slow growing and inflexible. A dairy expert explained that, as a result of this complete

⁴⁵ This particular factory holds state-of-the-art, advanced technology, including a completely automated storage facility. When asked whether the processor’s other factories used similar technology, the guide replied, “No, not at all.”

⁴⁶ According to IMF calculations, China’s average capacity utilization was ~75-80% between 2007 and 2008; it later fell to ~60% in 2011 (IMF 2012).

⁴⁷ The Technical Assistance Unit for the EU-China Dairy Development Project found many processors with capacity utilization rates closer to 25% (2000: 98).

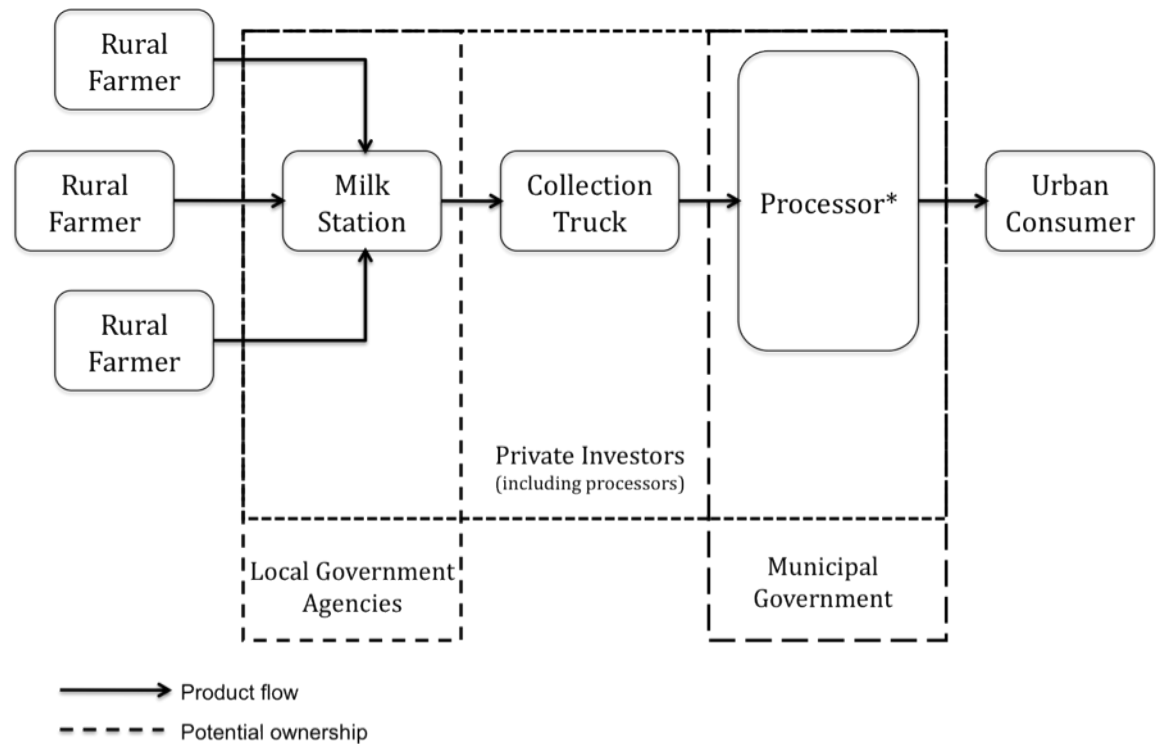
ownership model, the companies “shouldered comparatively more burdens,” including social security responsibilities. He provided the example of one company that had twice the number of pensioners as current workers. The general manager for another major processor was more sceptical of the market first strategy, indicating that this “reverse” development and over-emphasis on the downstream constituted a deliberate attempt to mislead consumers and obscure from view a less than desirable relationship with producers. He said, “Because of this division by the processor between a front and backstage [前台, 后台], the consumer cannot see behind. The consumer doesn’t know that this industry’s milk is produced by rural farmers [农民].”

3.3.2 *The outsourcing model*

A crucial component of dairy processors’ high-growth strategy—particularly in the case of Yili and Mengniu—was their decision to outsource milk production in a value chain model referred to as “company + base + rural household” (公司+基地+农户). This model was in part a means of modernizing agriculture, with the intention of increasing efficiency and quality at the farm-gate; it was also a way of rapidly expanding production with limited investment by the dragonheads themselves. According to the model, processors sourced milk from a “base,” or a cluster of villages in which households were given purchase subsidies and encouraged to raise dairy cows. Each of these “dairy villages” contained at least one milk collection station where farmers could take their cows to be milked. At the station, milk was collected by hand or machine and stored in a single tank. It was then sold either to processor representatives who used company collection trucks or to middlemen using their own modes of transport (e.g., trucks, tractors or motorcycles).⁴⁸ While farmers were compensated at the end of the month based on the quantity of milk they contributed, the milk station operators received a management fee per kilo that varied according to the grade of the milk supplied.⁴⁹

⁴⁸ In some places, another intermediary station collected and consolidated milk from smaller stations in the region before selling it on to processors and/or middlemen (Gale and Hu 2009: 6).

⁴⁹ The exact origin of this model is unclear. While Delman and Yang (2012) cited Hebei’s Sanlu as the first dairy processor to outsource its milk supply in 1986, the Hohhot municipal government heralded the model as an “original innovation of Hohhot” (Fan 2010). In his

Figure 2: The Dairy Value Chain – Outsourcing Model

* As illustrated in the case of Mengniu's early development, a "processor" might contract out the actual processing of its dairy products to another company, using the latter's facilities but the former's brand.

The model introduced a number of different players into the dairy value chain, creating a complicated web of owners, investors and managers. Among processors, there were both state and non-state companies; Mengniu was privately owned whereas the Hohhot municipal government held a majority stake in Yili.⁵⁰ Milk collection

address at the 2007 International Summit for Dairy Industry Development, Hohhot Mayor Tang Aijun explained, "Beginning in 1998, Yili Corporation started building milk stations, becoming the first in the country to create a method for 'separated rearing, centralized milking, scheduled accounting, timely payment,' forming the 'company + base + rural household' industrialization pattern. In succession, every part of the country imitated [this model], leading the dairy industry's industrialization" (Tang 2007). Provincial subsidiaries of Sanyuan and Guangming adopted this model only very recently. Their parent companies continued to rely on their own farms to supply fresh milk to their principal markets, Beijing and Shanghai, respectively.

⁵⁰ In September 2004, Yili chairman and CEO Zheng Junhuai was arrested on suspicion of embezzling public funds and orchestrating an unlawful management buyout. While Zheng was sent away to prison for six years, Yili faced massive internal turmoil and collapse appeared imminent. The processor had no leadership and its largest shareholder, a trust fund, was believed to be a false front set up by the chairman himself. Over the next several weeks, the Hohhot municipal committee and government decided to purchase back the 14.33% majority stake that its financial bureau had sold to the trust fund just one year prior as part of an effort toward privatization. In April 2005, it finalized the acquisition through the Hohhot Investment Company and reorganized the processor's board of directors. The national media declared the

involved a combination of independent operators and processor representatives using individually and company-owned vehicles. And while processors, local party-state and private entrepreneurs jointly invested in the construction of milk stations, the actual management of these facilities was often outsourced to another independent operator or handled by personnel from the investing government agency.

As for the dairy villages, they frequently consisted of households that had been relocated from other regions under a variety of initiatives. One farmer recounted her story of how she arrived to Hohhot from Taiyuan, in neighbouring Shanxi province, explaining that she and her family had been “removed” (移除) when the local government decided to construct a reservoir encompassing their lands. Other farmers migrated into areas designated for dairy production as a result of environmental policies. Webber and Wang detailed one project whereby the Inner Mongolian government offered incentives to herders in the area surrounding Hohhot “to give up extensive grazing and to relocate into compact villages away from the mountains, where dairy farming is to be the main business” (2004: 726). As described in the last section, party-state and industry alike frequently touted the dairy sector as central to grassland restoration efforts.

Whether concern for the environment comprised the primary motivation for rural residents’ relocation into dairy villages is a question that will likely remain unanswered. It is clear, however, that rural livelihoods were expected to conform to the demands of modernization and a top-down approach to agricultural industrialization.⁵¹

move “a model case of *guojinmintui*,” where “private enterprise had left Yili’s stage and state capital once again had a voice” (Zhao 2006). It argued that to allow just any company to acquire the majority stake would be tantamount to “not considering the economic and social stability of local dairy farmers and of the whole of Hohhot” (ibid.).

The Hohhot municipal party-state held a 51% stake in the Hohhot Investment Company while the Shanghai Electricity and Gas Company (under the authority of the Shanghai municipal party-state) held another 35% as part of the two cities’ paired cooperation for poverty alleviation. Following the Yili stake sale, Chinese media commented, “The local government is concerned that if the Shanghai Electricity and Gas Company were to achieve a majority share in the investment company, then the government’s voice within Yili would diminish, Yili’s corporate structure would change and its operations and management would be destabilized. The government is not willing to see the company go through another upheaval” (Zhao 2006).

⁵¹ Throughout history, the Chinese state has played an active role in the regulation and restructuring of the country’s human landscape according to prevailing geopolitical objectives. During various waves of dynastic expansion, it orchestrated strategic migrations and the

The transformation from a nomadic to sedentary lifestyle, and from seasonal harvests to a monthly milk check, was portrayed as an improvement for all involved. Indeed, as processors began to construct and consolidate their milk “bases,” farmers were assured that by raising a couple of cows they could increase their incomes substantially. In his January 2, 2003 interview with President Hu Jintao, Mengniu’s co-founder Niu Gensheng repeated a common rhyming slogan proclaiming dairy’s promise of prosperity: “with one family, one household and one cow, your wife and child can warm the fire; with one family, one household and two cows, you do not need to worry about food and clothing; with one family, one household and three cows, within three to five years, you can build a foreign-style storied house” (Employee Handbook).⁵²

Hohhot Animal Husbandry Bureau Party Secretary Fan Aiji declared the model a “win-win situation for company and farmer” as it “protected dairy farmers’ interests comparatively well and generated shared profits” (Fan 2010). Furthermore, in areas like Hohhot where the milk supply was dispersed across numerous villages and households, he explained, it “successfully resolved the contradiction between small-scale production and large-scale markets” (ibid.). Indeed, over the early years of dairy’s development in Inner Mongolia, dispersed farming had faced a number of problems, which he enumerated as the prevalence of mixed breeds, low yields and uneven rearing practices along with difficulties in disease prevention and the verification of milk quality. According to Fan, “In order to surmount the challenges of this type of production, Hohhot’s companies and dairy farmers jointly created the new ‘company + base + rural household’ model of dairy farming and fresh milk collection” (ibid.). He detailed:

colonisation of frontier regions. Today, it attempts to control the ebb and flow of rural-urban migration through the *hukou*, or household registration system. China is by no means alone in this type of activity. Most governments attempt to influence the physical organization of their populations, whether through subtle means (e.g., interstate highways and zoning) or more coercive and violent methods (e.g., forced migration and war). These tools are often employed under a process of state formation (Scott 1999).

Recent unrest in Inner Mongolia has highlighted the deep resentment and tension caused by the region’s migration efforts (both forced and otherwise) along with the gross exploitation of the environment and its natural resources (Jacobs 2011).

⁵² The slogan: 一家一户一头牛，老婆孩子热炕头；一家一户两头牛，生活吃穿不用愁；一家一户三头牛，三五年内盖洋楼。

Every dispersed household must milk cows at a centralized milking parlor constructed in the village. Collected milk goes directly into refrigerated tanks to be transported to production facilities. Centralized milk collection put an end to the adulteration of milk with water and other items, and provided a reliable guarantee for milk quality. The milk station is both a fresh milk collection point and a milk quality inspection point.... Under the strict supervision of milk station managers, the adulteration of the milk tank with water is not at all possible. In those mechanized milking parlors using automated equipment, the adulteration with water has been even less of a problem. Like this, Hohhot's 'pure natural uncontaminated' brand has been safeguarded (ibid.).

For farmers, the model also appeared to offer a strategy for relatively low-cost production whereby they could use unpaid family labour to grow their own feed and collect forage grasses (Gale and Hu 2009: 4). Processors were equally supportive of the model, as they did not have to maintain their own herds and could reserve their financial resources for marketing and the downstream end of the chain, the link with the highest investment-to-profit ratios (Delman and Yang 2012).⁵³

At the downstream end of the chain, processors principally targeted urban consumers. From the former's perspective, the prioritization of urban markets held a number of advantages. Most importantly, cities offered the quickest route to high sales. With the proliferation of supermarkets, companies could minimize distribution costs while maximizing access to customers. In addition, supermarkets offered faster information feedback, improved cold storage, enhanced procurement abilities and more product choice. A 2001 study on dairy consumption in Beijing, Guangzhou and Shanghai found the majority of respondents consumed milk and yogurt purchased from the supermarket, 58.5 and 80.5%, respectively (Fuller et al. 2007).⁵⁴ For these reasons,

⁵³ Delman and Yang provided a table of investment and profit ratios in China's dairy industry. The rates of investment for production, processing and retail were 7.5, 1.5 and 1, respectively. Meanwhile, the profit rates for the same three activities were 1, 3.5, and 5.5, respectively (2012: 212).

⁵⁴ Company X also predicted that between 2008-2012, in first through third tier cities, the growth in dairy sales at supermarkets (20%) would outpace all other channels (8%). It thus referred to supermarkets as "priority clients" and their "principal cooperative partners" for the future (Document #26).

it is not surprising then that Company X's selection criteria for new provincial markets consisted of the following: 1) urban population size, 2) urban average disposable income, 3) urban dairy consumption habits and 4) cities where the company did not already have a strong presence (Document #28). The industry was thus divided along rural and urban lines, with the former serving primarily as an area of production and the latter, consumption. A deliberate development strategy, party-state and business hoped that when "the city drinks one more glass of milk, the countryside enriches one more family" (城市多喝一杯奶, 农村致富一家人) (Jiang and Wang 2010).⁵⁵ In other words, they expected urban consumption to drive rural production, inevitably boosting farmer incomes.

Nonetheless, leaders recognized the outsourcing model's potential weaknesses. In their 2003 conversation, Inner Mongolia Party Secretary Chu Bo expressed to Hu Jintao and Niu Gensheng, "I am both delighted and concerned for the dragonheads and industrialized development. I am delighted that dairy industry development will drive agricultural development, promote the readjustment of the agricultural mechanism and enrich farmers; I am concerned that once companies [or] products have a problem, it will cause problems not only for farmers, but for the region as well." To this comment, Hu Jintao responded, "Correct, and it will also trigger problems for society. This industry is very fragile, so it requires our increased attention, care and support" (Employee Handbook).

3.3.3 Reinventing dairy: healthy children, healthy nation

A significant portion of this attention, care and support was devoted to creating a robust market for dairy products. Here, processors' focus on downstream activities and resulting value chain structure largely aided government and industry in shaping milk's image in China. Given that dairy had been absent from the mainstream diet for centuries and much of the population was lactose intolerant, they needed to reinvent dairy in such a way so as to persuade consumers to start drinking milk despite potential discomfort. More importantly, they needed to convince consumers to buy milk for their child, creating a new more lactose-tolerant generation and ensuring sustained demand into the

⁵⁵ This strategy is also referred to as "cows go to the countryside, milk enters the city" (奶牛下乡, 牛奶进城) (Delman and Yang 2012).

future. As described above, promoting “natural” and “green” Inner Mongolian dairy brands comprised an important part of this effort. Another part was the presentation of milk as essential for raising a healthy child and constructing a stronger, healthier China.

Both government and industry endorsed dairy consumption as necessary for improving nutrition and ultimately, enhancing *shenti suzhi*, or “physical quality.”⁵⁶ Indeed, almost every major dairy policy in China cited the industry’s crucial role in “improving citizens’ physical quality” (提高国民身体素质). Likewise, in his January 2003 conversation with Hu Jintao and Chu Bo, Mengniu’s Niu Gensheng asserted, “Dairy is not only a sunrise industry, it is also a healthy industry, affecting the future of one nation’s quality” (Employee Handbook). As such, the Ministry of Health frequently took advantage of government immunization drives to promote higher calcium intake (i.e., dairy) among citizens (Jing 2000). By making such endorsements in the context of public health campaigns, the government placed milk consumption in the same category as immunizations: a modern, scientific practice essential for wellbeing. A survey by Fuller and team showed that in more than 25% of households sampled in Beijing, Shanghai and Guangzhou, a healthcare professional had recommended regular milk consumption (Fuller et al. 2006).

From the perspective of the party-state, the promotion of dairy as healthy, particularly for children, served another crucial purpose: the one-child policy depended fundamentally on the regime’s ability to secure society’s health and wellbeing. This was especially true for urban families, where enforcement tended to be stricter and perhaps expectations of the state, higher. If parents believed their child’s future—and by extension, their own—was being compromised, the policy could be severely undermined. Thus, as others noted, the one-child policy was accompanied by myriad public health projects. Jing detailed, “One of the Chinese government’s primary means of winning support for its population policy is the launching of publicity campaigns to demonstrate that its efforts to improve children’s health are based on the scientific

⁵⁶ According to the country’s *Dictionary of Population Studies*, physical quality (身体素质) referred to a composite measure of the population’s physical attributes, including average height and weight, youth growth rate, infant mortality rate, proportion of disabled, proportion of ill, life expectancy, among others (Liu ed. 1986).

principles of modern nutrition and Western medicine” (2000: 157). Here, dairy was promoted as the quintessential product for the modern, healthy child.⁵⁷

The question of children’s health was often tied to discourse on national strength. In the 1980s, the Chinese media became focused on a particular piece of news arriving from neighboring Japan. In his 1984 article for *Human Biology*, Japanese physical anthropologist Takahashi reported, “From the 1960s to the 1970s there has been an unprecedented acceleration of growth in height of children in Japan as well as great economic growth...This reconfirms the importance of the spread of milk drinking, a part of the National School Lunch Program, as a primary influence on the growth of Japanese children” (1984: 427). More significantly, however, the article revealed that, in the decades following World War II, the height of Japanese youth had surpassed that of Chinese youth, news that sparked debate with strong nationalistic undertones.

In its report for the EU-China Dairy Cooperation, the Beijing-based Research Center for Rural Economy commented, “It surprised the world that on the whole Chinese juveniles are smaller than Japanese, which showed that Chinese youth were seriously lacking in nutrition. In the 1930s, the average height of Japanese at eighteen is 161.8 cm for males and 151.2 cm for females; while in the 1980s, it has reached 170.8 cm and 157.8cm” (Research Center for Rural Economy 2001: 84).⁵⁸ A Company X executive, likewise, mentioned the influence of these messages, remarking, “We can think of Japan and how they said, ‘Drinking one glass of milk strengthens a whole nation’s people.’ They encouraged everyone to drink milk and now have a relatively strong, robust body. So like this, the Chinese government is also actively promoting milk.” In addition to strengthening the connection between national and physical health, this focus on Japan also reminded Chinese that a seemingly lactose-intolerant nation could embrace milk to widespread effect.

⁵⁷ In light of this push for youth nutrition, many domestic companies have reconsidered their product offerings. For example, Wahaha switched their main product from a nutritional herbal drink to a milk beverage. This move would have important implications for the future of the company. As Zhao stated, “It can be argued that one of the crucial steps taken by Wahaha in the process of making itself into a nationally renowned enterprise was the tailoring of the company’s business decisions to state policies directly concerned with children” (Zhao in Jing ed. 2000: 193).

⁵⁸ This was perhaps considered “surprising” as a result of the Chinese stereotype of the Japanese as small or short (e.g., “小日本,” an offensive term).

More recently, advertising campaigns by the country's top processors continue to frame milk and health in the context of nationalism. During its official sponsorship of the 2008 Beijing Olympics, Yili used the slogan, "With me, China is strong" (有我, 中国强), linking individual consumption habits to national strength. Mengniu also capitalized on its sponsorship of the National Space Program to create an image of milk and the company as patriotic. On October 16, 2003, the day that the Shenzhou V spacecraft returned safely to Earth, Mengniu covered the cities of Beijing, Shanghai and Guangzhou with street posters, proclaiming, "Raise your right hand and cheer for China" (举起你的右手, 为中国喝彩). The *North News* reported on this message and its overnight appearance in the country's most important metropolises. It stated, "[Mengniu's poster] spoke for the pride of millions and millions of Chinese children," elaborating that the newspaper's telephones had become a "Mengniu hotline, as many readers expressed praise for the way in which Mengniu cheered for China" (North News 2003).⁵⁹

One program in particular symbolized the party-state's campaign to portray dairy consumption as a scientific habit essential to the health of both the nation and its future consumers: the national school milk program. In December 1999, an inter-ministerial coordination group convened to discuss the possibility of introducing a national school milk program.⁶⁰ On August 29, 2000, the group released a formal implementation plan, declaring that the new program "fully embodies the CPC Central Committee and State Council's high degree of attention to and concern for the nutritional health of the country's youth, and inevitably, plays an important role in improving citizens' physical quality" (Ministry of Agriculture 2000). As stated in the plan, the program was to be piloted in primary and secondary schools first in Beijing,

⁵⁹ Japan and China are not alone in this conflation of nationalism with dairy and the pursuit of healthy bodies. Similar efforts can be seen in the Netherland's "Milk. The White Motor" campaign whose logo carried the national flag colors as well as resembled a car emblem, and in the US's "Got milk?" campaign featuring celebrities, sport players and other high-profile figures.

⁶⁰ The group included representatives from an exhaustive list of different government branches, namely, the Ministries of Agriculture, Education, Finance and Health, Department of Propaganda, State Development Planning Committee (now NDRC), National Bureau of Quality, Technology and Inspection (now AQSIQ), National Bureau of Light Industry and National Food and Nutrition Consultative Committee.

Tianjin, Shanghai, Guangzhou and Shenyang, then in provincial capitals in 2001, and later, in medium to small-sized cities.⁶¹ Local government was directed to encourage “large key enterprises with a good reputation” to carry out large-scale production for the program (*ibid.*).

The plan also provided guidelines for generating widespread media “fanfare.” For example, it advised regular public service announcements to be broadcast on CCTV and furnished news media reporting on the program with three focal points: “the significance, objectives, principles and guidelines of the national school milk program; scientific information about dairy products and nutritional health, dairy industry invigoration and the people’s strength and prosperity; the CPC Central Committee and State Council’s concern for and attention to youth nutrition and health.” In addition, for the purposes of establishing “scientific food and drink habits,” the plan instructed the Ministry of Education to enrich school curriculums with educational content about dairy and health (Ministry of Agriculture 2000). In less than a decade, the program expanded from the provision of 350,000 units of milk in 2000 to 4,700,000 units in 2009 (Jiang and Wang 2010).

The 2009 China Children and Women Industry Expo, held in Beijing’s National Convention Center, offered another clear example of the intimate connection between milk and the country’s children. Not only was the China Dairy Industry Association a major sponsor—in addition to the National Women’s Union and International Trade Commission (Beijing section)—milk and infant formula companies dominated the exhibition area. Moreover, the expo’s key conference was the “2009 Summit of China’s Dairy Industry,” led by a well-known CCTV host and featuring speeches from the executives of China’s major dairy brands. Toward the end of the summit, exemplary young dairy consumers in red neckties were commended as part of the Compassionate Milk Project (爱心牛奶项目). Upon receiving their awards, they each in turn gave a right-handed salute to the dairy executives and association leaders present on stage.

Overall, the strategy achieved widespread success as the Chinese public increasingly regarded milk as critical to a healthy diet. In 2007, Company X contracted out a consumer survey on the industry’s high-end products, compiling data from more

⁶¹ There was no mention of rural areas.

than 1,500 respondents across seven cities, namely Beijing, Shanghai, Chengdu, Wuhan, Fuzhou, Qingdao and Shenzhen. It found that an overwhelming proportion (80.3%) based their purchasing decisions on which “nutritional content was better” (Document #30).⁶² That same year, in their study on urban consumption in China, Fuller and team discovered “a doctor’s recommendation is one of the most significant and positive influences on the decision to purchase milk powder” (Fuller et al. 2007: 468). Not unlike in Company X’s survey, respondents were motivated to consume dairy based on the notion that it was the healthy choice, that science—not price or taste—had been the deciding factor.

The emphasis on scientific nutrition also influenced mothers’ attitudes toward breastfeeding. In Gottshang’s (2000) study on infant feeding in Beijing hospitals, mothers chose whether to breastfeed or use infant formula based on how “scientific” they perceived the two methods.⁶³ A scientific choice ensured their baby received the most “modern” care possible. According to government surveys, exclusive breastfeeding rates at six months of life declined from 51% in 2003 to 28% in 2008 (Harney 2013). Another study conducted by researchers at Zhejiang University and Australia’s Curtin University of Technology surveying 1,520 Zhejiang mothers revealed much lower percentages, with 4.7% of mothers exclusively breastfeeding at six months (Qiu et al. 2010). Meanwhile, the Zhejiang study found that 98% of mothers had introduced infant formula by six months, and among urban respondents, 67.7% had already used formula at discharge from the hospital (*ibid.*). In light of these statistics, it is not surprising then that in 2008, China eclipsed the US as the number one infant formula market in the world.

It was, thus, not until the late 1990s and early 2000s, well after the denouement of the Mao era, that dairy transformed from an obscure product into a “sunrise industry,” exhibiting exponential growth. In just ten years, it became the fastest growing food sector in China. Between 1998 and 2008, annual milk production expanded from

⁶² Consumers described “better or higher nutritional content” as higher calcium content, improved promotion of calcium absorption and superior protein (Document #30).

⁶³ Advertisements for infant formula listed *ad infinitum* the various vitamins and minerals that the milk contained and/or had been added to it. Some even claimed that these nutrients could enhance intellectual performance, an appealing message for competitive urban parents.

6.6 to 35.5 million tons, an almost six-fold increase (see Figure 3 following chapter conclusion). Dairy consumption in urban areas likewise took off, increasing from approximately 6 to 24.8 kg per capita over the same period (see Figure 4 following chapter conclusion). For a nation that, in recent history, had not supported a substantial dairy industry and was also strongly lactose intolerant, the jump in dairy consumption rates was remarkable, causing a shift in the overall composition of urban diets. From 1990 to 2007, the amount of grain consumed annually per person dropped from 131 to 78 kg while that of vegetables also declined from 139 to 118 kg.⁶⁴ In turn, these foods were replaced by vegetable oil, aquatics, fowl and milk, which increased by 50%, 85%, 182% and 280%, respectively (China Statistical Yearbook 2009). By 2008, the Chinese dairy market had become the largest in the Asia-Pacific region (including South Asia) with a 35.8% share of total dairy revenues (Datamonitor 2008). That year, total dairy sales amounted to more than 143.8 billion RMB (21.1 billion USD), or a turnover of 20% of the whole food industry.

At the same time, however, consumption increased unevenly across China. In 2009, city residents comprised 46% of the national population and yet, 80% of dairy consumption. While urban consumption maintained an average growth rate of 8% per year, that of rural areas hovered around 3%, resulting in a gap of about 21.4 kg per capita by the time the melamine incident occurred (Han in Liu and Li eds. 2010: 15).⁶⁵ Likewise, a distinct division between rural and urban breastfeeding practices emerged. While urban mothers were opting for infant formula, their rural counterparts continued to breastfeed.⁶⁶ The gap was also noticeable in the national school milk program. For example, 24 provinces participated in the program, making it ostensibly national in scope. And yet, in 2008, students in just four regions—Jiangsu, Guangdong, Shanghai

⁶⁴ Over this period, urban consumption of red meat (i.e., pork, beef and lamb) varied very little (China Statistical Yearbook 2009).

⁶⁵ Between 1998 and 2008, rural consumption barely increased from 1 to 3.43 kg per capita (Han in Liu and Li eds. 2010).

⁶⁶ Attempting to explain the relatively slow growth of formula markets in the countryside, Company X also noted the sustained prevalence of breastfeeding there. It forecasted second and third tier cities to be the fastest growing formula markets in the future, followed by first tier cities and then rural areas (Document #31).

and Hunan—represented 47% of the program’s beneficiaries (Jiang and Wang 2010).⁶⁷ Not surprisingly, three of these four regions were coastal, wealthy and home to large urban populations.⁶⁸

3.4 Conclusion

As this chapter demonstrates, the increased prominence of milk in China largely resulted from a strategic national campaign to industrialize agriculture and boost urban consumption. Under the dragonhead-led agricultural industrialization, the dairy industry developed rapidly, yet in “reverse.” Rather than improving and expanding the milk supply from the bottom up—in other words, supporting farmers—the plan focused initial investment on creating strong processors, who outsourced production and then turned their efforts toward building market demand. Together with the party-state, processors successfully marketed milk as natural and healthy—in contrast to its former depiction as non-native, barbarian and unpalatable. They not only reformulated the image of dairy, but also renovated Inner Mongolia’s place in the national imaginary as an area of ecological and historical importance. Negotiating this space between producer and consumer, processors enjoyed considerable power over information and resources; they also captured the highest returns. As such, in 2008, processing was heavily consolidated among a handful of brands. In the liquid milk market, three companies accounted for more than 64% of annual sales volume, with Mengniu at 26.9%, Yili at 21.3% and Wahaha at 16.1%. Sanlu, Guangming and Sanyuan followed

⁶⁷ There have been several problems with the school milk program. While the program was projected to provide a total of 3,910,000 units in 2005 and 11,940,000 in 2010, it only reached 2,500,000 in 2005 and 4,700,000 in 2009, or 2% of national school children. A research team from the Chinese Academy of Social Sciences investigated the primary reasons for this disparity and for the program’s failure to reach its targets. It found that without local government support and subsidies, companies faced substantial losses, selling school milk at prices lower than market value. There was also the question of milk quality, which was frequently unreliable and unverifiable. In addition, both local bureaus of education and parents often treated the program like a business (Yao, Liu and Li in Liu and Li eds. 2010).

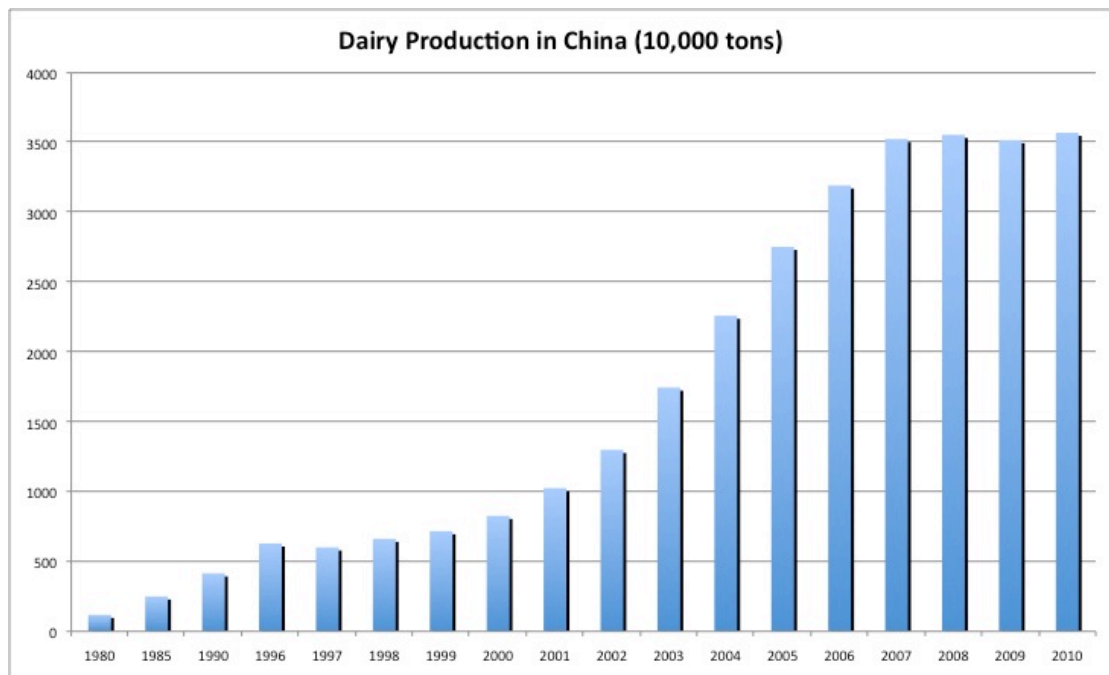
⁶⁸ One might conclude that these trends merely reflected the unequal distribution of resources among households and local party-state. Indeed, companies and policymakers contended that low rural incomes and underdeveloped economies comprised key reasons for the lack of dairy in the countryside. This argument only captured part of the picture. It could not explain high consumption in some of the poorest, most underdeveloped regions of the country, like Qinghai, Xizang and Xinjiang. Instead, in these areas of western China, agricultural conditions and tradition were determining factors in the amount of dairy consumed.

far behind with 4.8%, 4.6% and 1.2%, respectively (see Figure 5 following chapter conclusion).⁶⁹ Production, by contrast, continued to be dominated by small-scale farmers, with about 64% of farmers owning fewer than 20 cows and 80%, less than 100 (Yang and Hu 2010a).⁷⁰

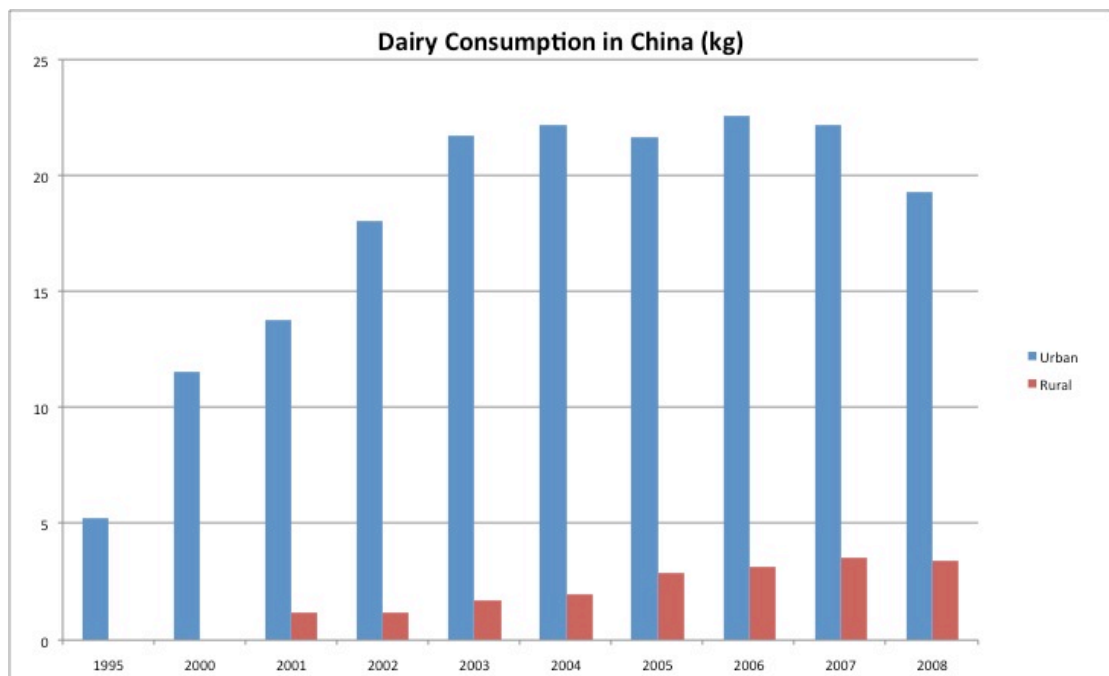
In the value chain literature, scholars have pointed to a key link between branding and value chain governance. Humphrey and Schmitz explained, “Because brands stand for high quality or well-defined images, they need to define and enforce product and process parameters. Branding and chain governance thus tend to go together” (2001: 12). In the case of the dairy industry in China, it is clear that the country’s processors devoted substantial resources toward building their brands and promoting particular images of milk. It is less evident, however, that the brand protection measures referred to by Humphrey and Schmitz were high on the priorities of Chinese milk processors. As shown above, the characteristics of upstream production were strongly influenced by national political objectives, local political concerns, an overall project of agricultural industrialization and modernization, and the goal of securing low-cost raw milk for processing. In 2008, the melamine incident brought the realities of Chinese dairy production sharply into focus: chain governance and controls for safe milk had failed to keep pace with the high-quality images and brands that the industry strived to create. The next chapter details this case of regulatory failure and the nationwide food safety crisis that ensued.

⁶⁹ A number of smaller companies with no more than 1-2% market share comprised the remaining portion of the liquid milk market. At the end of 2006, the powder market (primarily infant formula) exhibited a slightly more competitive environment, with foreign brands dominating the top five positions in terms of sales value, namely, Mead Johnson (12.9%), Dumex (11%), Nestle (11.3%), Wyeth (8.8%) and Abbott (8.8%). Liquid milk, fresh yogurt, powder and other products represented about 83%, 10%, 4% and 3% of the dairy sector, respectively (Document #39; China Dairy Yearbook 2009).

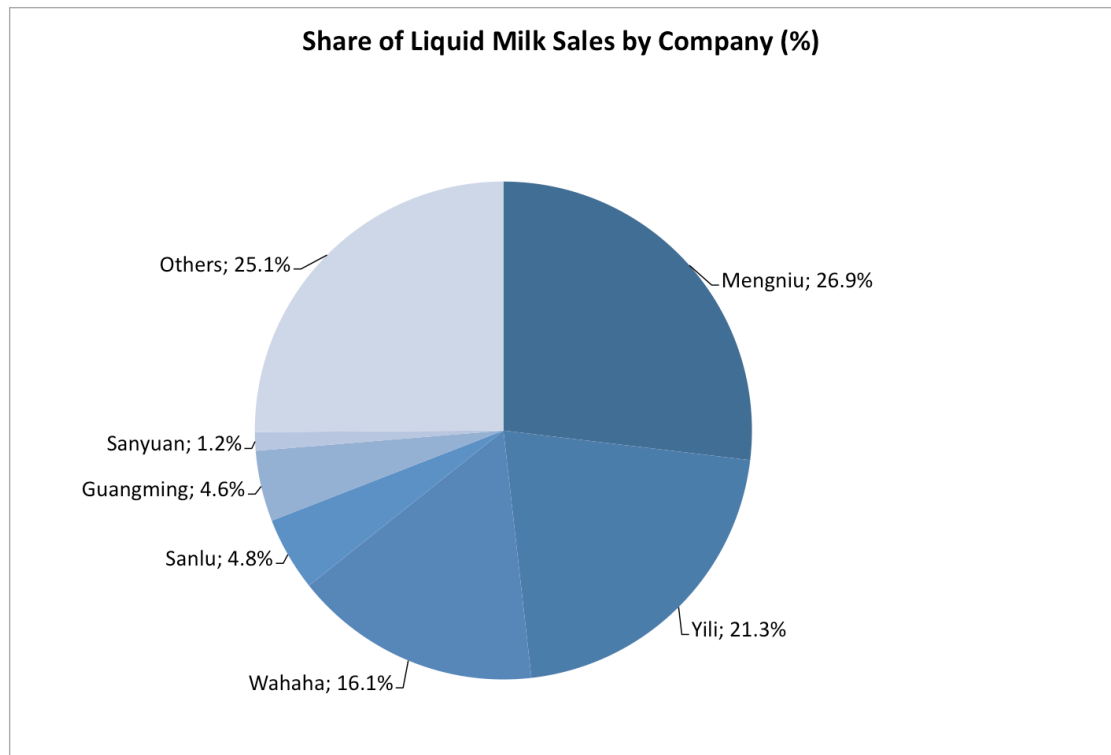
⁷⁰ These 2008 figures for herd size were broken down as follows: 32.42% owned 1-4 cows; 31.53% owned 5-19 cows; and 16.51% owned 20-99 cows (Yang and Hu 2010a).

Figure 3: Dairy Production in China

Source: China Dairy Yearbook 2011

Figure 4: Dairy Consumption in China

Source: China Dairy Yearbook 2011

Figure 5: China's Liquid Milk Market

Source: Document #38

4 Chapter Four: From Takeoff to Melamine – Dairy’s “9.11”

4.1 Introduction

At the beginning of 2008, China’s dairy industry appeared to have overcome tremendous odds to achieve rapid, healthy development. Indeed, after a decade of uninterrupted growth, it was heralded as a model for other agricultural sectors while its top dragonheads received multiple commendations from local and national government agencies. By the end of 2008, the industry was reeling from a massive public food safety crisis: the melamine incident, or dairy’s “9.11.” Divided into three parts, the chapter here explores the shock of this nationwide regulatory failure—particularly its ramifications for consumers, processors and producers as well as the response it garnered from the party-state—and begins to show that all was not well with the country’s dairy industry and food safety systems. In the first part, it details the melamine incident and its immediate consequences. In the second part, it summarizes the party-state’s response to the crisis. In the third part, it discusses three important elements of the melamine incident that highlight the challenge of regulation in China’s dairy industry.

4.2 The melamine incident

On September 11, 2008, *Xinhua* reported that infant formula produced by one of the largest domestic milk powder companies, Sanlu, had been tainted with melamine, an industrial chemical used in plastics and laminates. As more details were released, the public learned that milk supplies from 22 dairy companies located all across the country, including Mengniu, Yili and a Guangming subsidiary, had also tested positive for melamine. Reports revealed milk station operators had adulterated milk with melamine in order to increase nitrogen levels, the principal measure of protein and a key quality indicator used in negotiating milk prices (Barboza 2008; Reuters 2008a, 2008b; Xinhua 2008).⁷¹

Apart from falsifying the protein count in milk, melamine had a decidedly deleterious impact on the human body. According to a 2009 World Health Organization

⁷¹ The method primarily used during milk purchases in China, an indirect protein assay, cannot distinguish between non-protein and protein nitrogen.

(WHO) toxicology report, when ingested in large amounts, this industrial chemical combined with uric acid to form calculi, or stones, in the kidneys, urethra and bladder. Tests conducted by China's General Administration for Quality Supervision, Inspection and Quarantine (AQSIQ) detected melamine levels ranging between 0.09 and 2,563 mg/kg for infant formula and up to 8.6 mg/kg for liquid milk. Later, tests on Sanlu infant formula revealed melamine levels higher than 4,700 mg/kg, with an average of 1,212 mg/kg. Using data from recent laboratory experiments, the WHO report estimated melamine's tolerable daily intake (TDI) for all ages to be 0.2 mg/kg body weight. Given the AQSIQ test results, it determined that the dietary exposure for consumers of Sanlu infant formula was 8.6 to 23.4 mg/kg body weight per day, or 40-120 times the TDI. Similarly, it determined that adults consuming liquid milk products with melamine would have been exposed to levels 0.8 to 3.4 times the TDI (WHO 2009).

For a number of reasons, infants were particularly susceptible to melamine poisoning and the development of medical complications. First of all, they consumed a larger percentage of food per unit of body weight, resulting in higher concentrations of melamine in their kidneys and urinary tract. Second, infants naturally produced more uric acid—the compound with which melamine combined to form stones—than adults. Third, in the case where melamine was used to falsify protein levels, it could be assumed that the actual amount of real protein was lower than it should have been in order to provide adequate nutrition; for infant consumers, where formula comprised their primary source of food, they were doubly affected and rendered vulnerable by a lack of proper nutrition (WHO 2009).

In the months following the revelations, Chinese consumers frantically sought medical services to determine whether their children suffered from melamine poisoning. According to the Ministry of Health, over 22 million infants underwent examination, and among those, more than 296,000 were diagnosed with kidney stones and acute urinary tract disorders; 51,900 were hospitalized. Cases appeared throughout Mainland China, Taiwan and Hong Kong—even in children who had ceased to consume milk two years prior to the incident. By January 2009, the government confirmed 6 infant deaths related to melamine-tainted milk.⁷²

⁷² In each case, recent medical records were used to determine cause of death.

Around the same time, it was discovered that dairy exports to thirteen countries (including those in Asia, Europe, Oceania and North America) also showed traces of melamine. Almost immediately, Taiwan, Bangladesh, India, Japan, Indonesia, Malaysia, Brunei, Myanmar, Singapore, Vietnam, Philippines and Tanzania issued bans on Chinese dairy imports. In January 2009, Venezuela joined this list of countries, imposing a ban with considerable repercussions for the industry; previously, the country had served as the destination for over 79% of full-fat milk powder exports (approx. 5,250 tons). The US Food and Drug Administration (FDA), likewise, issued an “Import Alert” for the “Detention Without Physical Examination of All Milk Products, Milk Derived Ingredients and Finished Food Products Containing Milk from China Due to the Presence of Melamine and/or Melamine Analogs.” Any shipment arriving in the US suspected of containing dairy could be automatically detained and released only once third party testing verified the absence of melamine. First issued on November 13, 2008, this alert continues to remain in effect. In another significant move to protect consumers, the FDA established a local office in Beijing—the first of its kind outside the US.⁷³

As consumers—both at home and abroad—reacted to the news of the scandal, the Chinese dairy industry faced economic disaster, sales plummeting 80%. Yili suffered 1.74 billion RMB in profit losses while Mengniu lost 925 million RMB and Guangming, 268 million RMB. The Hong Kong Stock Exchange suspended trading in shares of Mengniu. When trading resumed on September 23, Mengniu’s shares fell 60%, the largest decline since the company’s IPO in 2004. Domestic milk production meanwhile dropped 8-15% lower than projections for that year. One Chinese plant head for American infant formula giant Wyeth recounted, “When we found out about the scandal, I attended a meeting where some managers [of other dairy brands] expressed excitement that they had not been listed in the CCTV media report. They said that if their products had had problems, then they would have jumped out of the building’s windows.” Indeed, as some executives would find out, their involvement in the scandal would mean the end of their careers.

⁷³ The fact that the FDA chose to open its first foreign office in Beijing indicated both the magnitude of trade between these two nations and the growing concern in Washington over food safety issues in China.

At the other end of the dairy industry chain, farmers also felt the ramifications of the scandal. As demand for milk declined rapidly, processors began to slow milk purchases. At the same time, the increased focus on product quality and standards provided processors with a ready excuse to reject milk. Given the particular characteristics of dairy farming, farmers faced a bleak outlook. They had to continue milking daily lest their cows stop lactating and enter a dry period. Meanwhile, they could not store raw milk for long periods. Farmers and milk stations, thus, began to dump milk, their primary source of income. A study by the Center for Chinese Agricultural Policy (CCAP) conducted in the Greater Beijing region found 80.5% of surveyed households dumped milk as a result of its rejection by processors post-melamine (Jia, unpublished).⁷⁴

With mounting supply and limited demand, milk prices fell rapidly. In Inner Mongolia, pre-melamine prices had been 2.0-2.4 RMB/kg. By March 2009, they were 0.7-0.8 RMB/kg; raw milk had lost two thirds of its value. Five months later and almost one year after dairy's "9.11," milk prices showed little improvement, increasing to only 0.8-1.5 RMB/kg. To cut their losses, farmers resorted to selling cows to the slaughterhouse. Industry experts estimated that in the year following the incident, more than 2 million cows were slaughtered (Dou in Liu and Li eds. 2010). The decision to slaughter cows caused a ripple effect along the dairy chain, slowing down the recovery process and ultimately impeding future industry development. Once milk stations started receiving less than 1-2 tons of raw milk daily, they were no longer breaking even. To avoid significant economic losses, these stations were shut down. As the number of operational stations in a particular region dwindled, processors ceased to supply there, forcing nearby farmers to quit the industry altogether.

In CCAP's Greater Beijing study, over half of surveyed households slaughtered and/or sold cows, resulting in a clear decline in herd size and farmer participation in dairy. More specifically, between 2008 and 2009, the participation rate of farmers in dairy decreased from 52% to 45%, and the average herd size shrank from 9.3 to 8.6 head of cattle. The decline in the participation rate was greater among wealthier farmers and more educated farmers. The rate for wealthier farmers dropped from 51.3% to

⁷⁴ The Greater Beijing region includes areas in surrounding Hebei province and produces about 15% of the national milk supply.

42.1%, compared with 59.7% to 53.2% among poor ones. This decline in wealthier households' participation in dairy intensified a trend that had emerged in the latter half of the 2000s: in dairy, poor farmers had begun to outnumber the wealthier ones, suggesting that the industry was trapping its poorer participants, losing important sources of investment and heading away from modern industrialization. Similarly, over this same five-year period, the participation rate among the most educated farmers (i.e., >9 years of schooling) also fell sharply from 76.9% to 46.2%, while that among less educated farmers dropped from 60.1% to 38.7% (Jia, unpublished).

4.3 The party-state responds

With dairy in a state of crisis and the reputation of the country's food safety system severely damaged, the party-state urgently sought to restore consumer confidence and put the industry back on track toward modern, healthy development. On November 19, 2008, the NDRC and twelve other ministry-level organs jointly announced their "Plan for Rectifying and Promoting the Dairy Industry." In this document, they acknowledged that the "infant formula incident reflected long-running contradictions and problems that had accumulated over the development of the country's dairy industry" (NDRC 2008). They enumerated six critical issues, namely: 1) the industry's singular pursuit of quantity at the expense of quality, 2) a severe lack of quality regulation, supervision and standards for dairy products, 3) dairy companies' blind development, overcapacity, "disordered" competition and lack of social responsibility, 4) loose and perfunctory inspection of milk stations, 5) backward dairy farming methods, limited scalization and standardization and irrational interest relations between processors and farmers, and 6) the lagging development of legal institutions (ibid.). Accordingly, the party-state moved to discipline cadres and business, restructure the dairy value chain and strengthen regulatory institutions. The following three sections summarize these actions.

4.3.1 *Disciplining cadres and business*

From late 2008 through early 2009, the party-state punished the officials and executives it held accountable for the contamination of the country's milk supply. Errant public officials were condemned by the party and removed from office, actions standard of cadre discipline. The first round of dismissals in September 2008 included

AQSIQ chief, Li Changjiang, Shijiazhuang party secretary, Wu Xianguo and Shijiazhuang mayor, Ji Chuntang.⁷⁵ Six months later, the CPC's Central Commission for Disciplinary Inspection dismissed another eight senior regulators from the health and agriculture ministries, the State Administration for Industry and Commerce (SAIC), the State Food and Drug Administration (SFDA) and AQSIQ for their lack of oversight. The dismissed included Wang Bubu, the chief of the AQSIQ's law enforcement division, Bao Junkai, the deputy director general of the AQSIQ's food production supervision division, and Liu Daqun, head of Hebei's provincial department of agriculture (Barboza 2009).

Industry actors were subject to legal action and punishment by the country's courts. On January 22, 2009, the Shijiazhuang Intermediate People's Court sentenced 21 individuals for their involvement in the milk incident. Sanlu's CEO, Tian Wenhua, was sentenced to life in prison while three other Sanlu executives received sentences of 5-15 years.⁷⁶ Zhang Yujun, a manufacturer of melamine-laced "protein powder," and Geng Jinping, a milk station operator, received the death penalty. For the remaining 15 defendants, the court handed down a suspended death sentence, two life sentences and imprisonments ranging from 2-15 years. It also punished Sanlu economically, fining the processor 50 million RMB in liabilities (Xinhua 2009a).

Despite the number of companies with contaminated products, the party-state chose to direct its energies primarily toward punishing Sanlu and its executives. Similarly, there were only a few national-level and Hebei cadres disciplined. It could be suggested that perhaps the party-state wanted to control how much the public knew about the scale of the contamination and present the incident as being relatively isolated.⁷⁷ Moreover, it could not punish all offenders; such a move would severely damage the dairy industry along with a number of local governments. Most likely, it opted to punish Sanlu because the latter was considered to be the industry's worst

⁷⁵ The capital of Hebei and Sanlu's headquarters, Shijiazhuang is often referred to as the epicenter of the melamine incident.

⁷⁶ A party member, Tian Wenhua was first removed from her position at Sanlu by the Hebei provincial party committee as an "organizational matter," and then later, by the board of directors for breaching company regulations (McGregor 2010: 188).

⁷⁷ The contamination is often referred to as the "Sanlu Incident" (三鹿事件).

offender with the highest levels of melamine contamination. One 2009 study interviewing dairy farmers in Tangshan, Hebei recounted, “When [raw] milk was rejected by Mengniu, Yili, Sanyuan and other companies because of quality, the milk stations would take all of the below standard milk and give it to Sanlu; Sanlu refused nobody. Consequently, two years ago, the local people stopped drinking Sanlu’s milk” (Liu and Li in Liu and Li eds. 2010: 99).

Conceivably in a preemptive move to prevent victims’ families from filing civil lawsuits, the other 21 dairy brands implicated in the melamine incident contributed to a compensation fund jointly managed by the China Dairy Industry Association and China Life Insurance Company. Sanlu supplied 900 million RMB to the fund while the remaining companies provided a total of 200 million RMB for victims’ future medical expenses. For each death, families would be compensated 200,000 RMB, for serious cases, 30,000 RMB and for ordinary cases, 2,000 RMB.⁷⁸

4.3.2 Restructuring the dairy value chain

Following the melamine incident, both party-state and processors portrayed the industry as having failed to modernize adequately, blaming the “backward,” “low-quality” farmers that produced the vast majority of the country’s milk. They also recognized that state regulation had been ineffective in preventing the adulteration of the milk supply. As such, they advocated direct interventions in value chain governance and placed renewed emphasis on modernizing the industry through the three –izations (三化), or scalization (规模化), standardization (标准化) and integration (一体化). In other words, they called for the development of large-scale, standardized operations that enhanced processors’ control over upstream production. Given that, in 2008, the upstream end of the value chain relied heavily on small-scale farmers and the outsourcing model, this effort entailed two courses of action: 1) the consolidation of dispersed dairy households into standardized and integrated raising zones (养殖小区),

⁷⁸ The compensation fund has been a source of controversy. The Shanghai Daily reported that the media had been denied information regarding the fund as it was considered a “state secret” (Shanghai Daily 2011). In May 2010, four families sued Sanlu’s foreign partner, New Zealand-based Fonterra, through the Hong Kong courts, contending that 2,000 RMB was insufficient to cover medical expenses. Companies have argued that civil suits are unnecessary as victims are covered by the compensation fund (Lee 2010).

“dairy hotels” (托牛所) and cooperatives (合作社), and 2) the investment in and construction of large to mega-scale farms by processors, individual entrepreneurs and party-state (e.g., 万头牧场, or 10,000-head dairy ranches).⁷⁹

In more general terms, this modernization of the dairy industry became a question of how the value chain should be governed and how much of the raw milk supply processors should actually own or “control.” In June 2009, the NDRC issued a revised version of its mid-2008 (i.e., pre-melamine) “Dairy Products Industrial Policy.” Both versions—and even more so in the 2009 revision—directed their instructions at processors, indicating that the party-state continued to regard processors rather than farmers as key actors and coordinators in chain governance and rural production. In both versions, the NDRC required processors producing liquid milk to “stably control” 100% of their raw milk supply base while those producing milk powder only needed to control 50%.⁸⁰ It also obligated processors to contract registered milk stations and use registered milk transport vehicles. Finally, it urged processors to build up their own milk bases by constructing, investing in and/or acquiring large-scale farms, raising zones and milk stations (NDRC 2008, 2009).

As part of this effort to increase controls along the milk value chain, the NDRC included new barriers on investment and market entry, aiming to eliminate “vicious competition” and restore “market order” (NDRC 2009). Specifically, it required companies and/or individuals hoping to enter the industry to demonstrate net assets no less than twice the proposed investment. It also dictated that in major dairy regions new projects would have to produce at least 300 tons/day for milk powder operations and at least 500 tons/day for liquid milk operations. To inhibit companies from competing over the same supply, it increased the proportion of raw milk that new processing projects could already “stably control” from 30% to 40% of their processing capacity; renovations or expansions needed to prove they could “stably control” 75% of their processing capacity (NDRC 2009).

⁷⁹ *Sanhua* and these farming models will be discussed in more detail in the next chapter.

⁸⁰ The policy defined this “stable control” of the milk supply base (稳定可控奶源基地) as: “self-constructed ranches, jointly-constructed ranches, invested raising zones and contracts with legitimate milk collection stations” (NDRC 2009).

The post-melamine industry restructuring also entailed two major acquisitions of private dairy brands by state-owned firms, both of which were framed as rescue measures. In a sector with a very limited number of players, these changes in the two processors' ownership structure held considerable significance for the industry as a whole. The first acquisition involved Sanyuan, a state-owned enterprise under the authority of the Beijing municipal government that had tested negative for adulterated milk, and Sanlu, the discredited and bankrupted Hebei processor. In late September 2008, Sanyuan had already expressed interest in acquiring Sanlu, and by December, it signed a deal to lease Sanlu's factories and restart its production lines—which had been shutdown since September 12. On March 4, 2009, Sanyuan formally acquired Sanlu for 616.5 million RMB in an auction held by the Hebei Intermediate Court with just two other unnamed bidders (Xinhua 2009b).⁸¹

On July 6, 2009, the dairy industry witnessed its second major acquisition, with Mengniu selling a 20% stake to state-owned China National Oils, Foodstuffs and Cereals Corporation (COFCO) and Hopu Investment Management Company, a Chinese private equity fund, for approximately 5.4 billion RMB. The purchase, equivalent to about 800 million USD, represented the largest in the Chinese food industry and allowed COFCO and Hopu to become Mengniu's largest shareholders (Liu 2009; Anderlini 2009). Two and a half years later, on December 30, 2011, COFCO increased its ownership stake to 28.09%, at which point, the last of Mengniu's original leadership, Yang Wenjun, stepped down to be replaced by a former COFCO manager, Sun Yiping (China Daily 2012).⁸²

⁸¹ Prior to its acquisition of Sanlu, Sanyuan was a relatively small player among national dairy brands, primarily serving the Beijing fresh milk market. While Sanlu had focused on milk powder products, Sanyuan produced none. The former sourced milk from dispersed farmers and the latter, from its own farms. It was not exactly the most appropriate match for Sanyuan (not to mention the millions in debt and penalties they would have to shoulder). The relationship between Hebei and Beijing, however, had grown closer in the past few years—especially during the Olympics when all of the latter's factories had to be moved outside the municipal limits and into surrounding Hebei. Moreover, Beijing relied heavily on its neighbour for important natural resources. In the case of the dairy industry, some assert, the Beijing municipal government desperately wanted water and feed (Delman and Yang 2012). According to Sanyuan, the deal held promise of future expansion in the dairy market. Indeed, from 2008 to 2009—a disastrous period for other processors—Sanyuan emerged as a leading brand, its profits increasing 87% to 40.75 million RMB and sales jumping 28% to 1.41 billion RMB (Ding 2009).

⁸² Chapter seven discusses this acquisition more in depth.

Concurrently, the party-state used other measures to rescue processors from economic crisis. The Ministry of Finance agreed to subsidize up to 3.105% on dairy firms' loan interest payments until the end of 2009 for a total of 75 million RMB in financial assistance (Ministry of Finance 2009). In collaboration with the Ministry of Commerce, it also consented to two sequential purchases of 50,000 tons of milk powder at 29,000 and 24,000 RMB/ton (paid 5.31% per ton per year). Meanwhile, the Inner Mongolian government pledged 100 million RMB to its two top processors, Yili and Mengniu, and requested permission from Beijing to exempt the firms from taxes for the period of September 2008 to January 2009 (Liang 2008).

4.3.3 Strengthening regulatory institutions

The party-state's synopsis of the melamine incident largely blamed China's regulatory system for its lax supervision, quality control loopholes and inadequate standards. Industry representatives likewise frequently attributed these deficiencies to the fragmentation of regulatory authority across several different departments, using the metaphor of "railway police" (铁路警察) checking each car separately to describe the system. Indeed, within China's food safety mechanism, authority was divided according to the stage of the production process, with the Ministry of Agriculture (MOA) at the upstream end, the AQSIQ and SAIC in the middle, and the Ministry of Health at the other end. Meanwhile, the SFDA was tasked with the general supervision and coordination of inter-departmental regulation as well as with the prosecution of food safety incidents. Further complicating this situation, the SFDA did not possess the same level of authority as the rest of the regulatory apparatus; unlike the other ministry-level departments, it only held the status of vice-ministry.⁸³ It is important to note here, though, that China had no lack of regulations—over 2,000 national food regulations and 2,900 industry-related regulations—and that harmful additives such as melamine had been explicitly declared illegal.

On February 28, 2009, the National People's Congress (NPC) issued a new Food Safety Law, updating the 2001 Food Hygiene Law. It positioned the Ministry of

⁸³ Following the July 2007 execution of its head, Zheng Xiaoyu, for corruption and fraudulent licensing, the SFDA was removed from the authority of the State Council and placed under the Ministry of Health.

Health as the principal authority in food safety supervision, coordination and standard setting while permitting local government more flexibility in implementation strategies. In addition, it expanded process-oriented regulation, guaranteed consumer rights and called for the establishment of a high-level committee to direct the national food safety agenda.⁸⁴ Although this piece of legislation followed shortly after the melamine incident and thus, appeared to have been crafted in response to the current food safety crisis, it actually represented the final draft of a five-year effort (NPC Standing Committee 2009; USDA FAS 2009a).⁸⁵

After the new food safety law went into effect, the Ministry of Health began to issue revised product standards. At that time, the standards for dairy principally resided in legislation from 1986 and 2003. In 2009, the Ministry of Health, with assistance from the Ministry of Agriculture and National Bureau of Standards, drafted new regulations and submitted them for comment (including from the public and the WTO). In March 2010, the revised dairy standards were ratified. Four months later, the Ministry of Health publically announced that the standard for protein in raw milk had been lowered from 2.95 to 2.8% to dissuade milk station operators from continuing to adulterate the country's dairy supply with melamine (Gao 2010). The ministry's decision generated furious debate; many saw the move as a step backward for food safety regulation while

⁸⁴ Almost one year later, on February 6, 2010, the State Council established the new ministry-level commission mandated by the food safety law. With Vice Premier Li Keqiang (the expected successor of Wen Jiabao) at its helm, the 18-member commission was charged with overseeing the national food safety agenda and included leaders from the health, finance and agriculture ministries. Vice Premiers Hui Liangyu and Wang Qishan were subsequently appointed deputy heads.

⁸⁵ This fact, however, did not diminish the importance of the law in understanding the post-melamine reaction. The extensive amount of drafting provided a window into the evolution of party-state consensus on food safety. The United States Department of Agriculture Foreign Agriculture Service (USDA FAS) in Beijing compared an April 2008 draft with the final version to discern how the public reaction to the melamine incident might have possibly influenced the law's content. The resulting GAIN report details those sections added or expanded in the final version that were most likely related to recent food safety incidents. These regulations included: a comprehensive recordkeeping and recall system, the rescinding of inspection exemptions for leading labels, liabilities for false advertising and new unified national food safety standards (USDA FAS 2009a).

others contended it would force processors to deal more fairly with farmers (Nadamude and Wang 2011).⁸⁶

4.4 Rethinking melamine and the challenge of regulation

The melamine incident clearly demonstrated to both the Chinese leadership and public that the country's regulatory regime had failed. As discussed in the preceding part, the party-state moved quickly to assure consumers that it intended to fix both the dairy industry and the food safety system. It thus took steps to restructure the dairy value chain and improve governance, discipline errant officials and industry players and strengthen regulatory institutions. Nevertheless, certain elements of the melamine incident and its aftermath revealed the challenge of regulation in China's dairy industry and suggested that the party-state's measures might not achieve the desired results. The following sections examine three of these elements: 1) for years, the adulteration of the milk supply was an "open secret" and the effort to improve chain governance had been ongoing; 2) from 2009-2011, a number of dismissed officials received new positions and/or promotions, while melamine-tainted milk resurfaced repeatedly; and 3) post-melamine, consumers continued to embrace dairy but not necessarily that produced domestically.

4.4.1 *The dairy industry's "open secret"*

According to the story disclosed gradually to the public, dairy processors first learned of the contamination in May 2008. Then, in July, they along with the Ministry

⁸⁶ The ministry subsequently published a detailed explanation of its decision to lower the protein standard. It provided the following reasons: 1) throughout farms nationwide, the quality of feed tended to be low (mostly corn silage), greatly influencing milk protein levels; 2) protein levels varied according to season and lactation schedule, i.e., during high yield periods, protein levels decreased. In China, the high yield periods occurred during May-September, very hot months causing additional decreases in protein; 3) the new protein standard acknowledged the "objective facts" of the domestic dairy industry: in the summers of 2007 and 2008, provinces in northern China reported that 75-90% of the milk supply was below the 2.95% protein standard. One company reported their supply in northwest, central and eastern China at 75.8%, 33.8% and 24.9% below the old standard, respectively; and 4) the new standard promised smoother implementation of regulation and enhanced benefits to raw milk quality and safety supervision (Ministry of Health 2010b).

It is interesting to note that the draft regulation submitted for public comment stated the protein standard as 2.95%, except during the months of May-September, when it would be 2.8%. This was obviously changed in the final version to be 2.8% year round (Ministry of Health 2010a).

of Health became aware of melamine's medical consequences from doctors concerned about the growing number of infant patients with urinary ailments.⁸⁷ Afterward, it took another two months for news of the contamination to reach the public and for a nationwide recall to be issued—a delay attributed to the ban on negative news in anticipation of the 2008 Beijing Summer Olympics.

In subsequent revelations, the public would discover that the exact timing of the exposure involved international pressure. In late August 2008, New Zealand-based Fonterra, Sanlu's major foreign partner, reported the milk adulteration to its embassy in Beijing, claiming that it had been informed only earlier that month in a meeting with Sanlu and the Shijiazhuang government. The New Zealand embassy, in turn, communicated the news to Wellington and "the whistle was finally blown by the New Zealand government on September 9" (Spencer 2008). This particular sequence of events, thus, raised the question: if New Zealand had not pressed the Chinese government to issue a nationwide recall, would the public have ever learned of the melamine contamination?

While the query evoked a number of hypothetical scenarios that could never be explored completely, a key fact remained: for years up until the incident, the adulteration of the milk supply was an "open secret" (公开的秘密). As will be detailed in subsequent chapters, it was well known within the industry and among government officials that the milk in several regions was contaminated with a wide variety of harmful chemicals—not just melamine. They also knew that these chemicals had been added to the milk at various points along the value chain, including at the milk station, in the collection truck and by the processor; in some cases, melamine was even added to the feed. At the same time, they were fully aware of the particular medical consequences that resulted from consuming the tainted milk. And most significantly, they had struggled to restructure the dairy value chain and improve governance using the same methods mandated by the central party-state in the aftermath of the melamine incident.⁸⁸

⁸⁷ Sanlu CEO Tian Wenhua's court testimony contained the earliest public admission of knowledge about the adulteration (i.e., May 2008).

⁸⁸ Chapter five will provide detailed evidence.

News of this open secret never reached urban consumers primarily because of the strict media control exercised by party-state and processor. Both before and after the melamine incident, the central and local party-state severely restricted reporting on food safety issues. And though this clampdown was attributed to China's effort to maintain a good image in the lead up to the 2008 Beijing Olympics, evidence of the adulteration's scale and prolonged existence points to systematic media control over a much longer period of time. It would appear that processors also played a critical role in suppressing negative news about food safety issues.⁸⁹ Company X's employee evaluation for 2007 included a section regarding media containment, whereby the more exposure a product quality incident received (i.e., local, city, provincial or central), the more pay was deducted from salaries. On top of that, the responsible employees were required to compensate the company 3% of the total financial loss incurred, and no less than 1000 RMB (Document #23). These stipulations most likely deterred employees from leaking information to the public.

Similarly, in the aftermath of the scandal, reporters could only redistribute information provided by the state-run media, such as *Xinhua* and *China Daily*, and were told to limit content to "positive reporting of the Government's handling of the crisis" (IFJ 2008). The Central Propaganda Department prohibited journalists from reporting on a lawsuit filed in Yunnan against the AQSIQ by one victim's family as well as removed reporters (both Chinese and foreign) from Hebei, the province where Sanlu was headquartered (ibid.). These types of media controls did not comprise exceptional measures. Each day, media establishments in China (including those that were foreign) received an email and/or fax indicating the general topics and specific stories that had been banned.⁹⁰

Taken together, this evidence would seem to suggest that, at best, the party-state and dairy industry actors did not inform the public of the contamination as they hoped to resolve quality problems on their own terms; at worst, they chose to sacrifice the

⁸⁹ See McGregor (2010) and Delman and Yang (2012) for details on the effort by Sanlu executives and local Shijiazhuang, Hebei government to conceal news of melamine in milk products.

⁹⁰ Knowledge of this "blacklist" is widespread among members of the media community in China. A blog also exists—albeit, blocked domestically—that publishes and comments on the list.

public's safety in the pursuit of other objectives. This thesis posits that the answer lies somewhere in between. Long before the melamine incident, government and industry had already begun to implement various strategies for improving chain governance. And yet, despite their efforts, they continued to struggle with quality control issues, failing to prevent and resolve the contamination of the milk supply. One part of the problem resided in the mismatch between the leadership's aspirations for the dairy industry and the realities of production on the ground. In other words, the dairy value chain—particularly upstream—could not meet the demands of agricultural industrialization and modernization as envisioned and promoted by the party-state.

With the public outrage that followed the melamine incident, the central government issued a stricter, more urgent mandate to modernize agricultural chains and secure food safety. Nevertheless, as this thesis intends to show, another problem existed well beyond the design of regulation and industry restructuring (i.e., it was not just about finding the “correct” dairy standard or value chain model). Indeed, more fundamental issues stymied state regulation and value chain governance: state-business interaction within the county's regulatory regime established mixed incentives and facilitated dependencies. This institutional environment not only weakened state regulation and value chain governance, but also rendered some strategies counter-productive to food safety. Meanwhile, the media control orchestrated at local and national levels further hindered the ability of government and industry actors to assess and resolve industry problems openly. Likewise, it precluded the role of consumers and third-party organizations in regulatory processes, limiting the possibility for external agents of institutional change.

4.4.2 The return of dismissed officials and melamine

Another series of events suggested that strengthening regulation and deterring food safety violations would prove challenging. Over the course of 2009 (and later), a number of disciplined officials were reassigned to new posts—and not just in the same line of work, but also often in the form of a promotion. Following his dismissal from the AQSIQ's food production supervision division, in March 2009, Bao Junkai was promoted to party secretary and head of Anhui's Entry-Exit Inspection and Quarantine Bureau. Two months later, he was called back to Beijing to the position of deputy chief of the AQSIQ's science and technology division. While this sudden re-appointment

might have been in response to public backlash, it still does not comprise harsh condemnation. Li Changjiang, the former head of the AQSIQ, was sent to lead the National Office against Pornographic and Illegal Publications, and in March 2010, was selected as a delegate to the Chinese People's Political Consultative Conference, an honour. Similarly, Liu Daqun, the dismissed head of Hebei's department of agriculture, was transferred to the position of mayor and deputy party secretary of Xingtai, Hebei (Xie 2009). One *China Daily* editorial remarked on the situation, "Yet no sooner have the scandals faded from the limelight than the 'guilty' officials find their way back, one after another.... What is truly disturbing is the absence of proper procedure to regulate reappointment of disciplined officials" (China Daily 2009). One official took a little longer to "find his way back," and most likely because news of his promotion would have caused considerable indignation in the immediate aftermath of the incident: in September 2012, Sun Xianze, who had been given an administrative demerit and dismissed from his position as the head of the SFDA's food safety department, was promoted to the position of SFDA deputy director (People's Daily 2012).

It is important to point out here that these officials were never handed over to the courts for punishment, but instead saw the possibility of future promotion. As Pei demonstrated in his 2004 study, only 2.9% of party members and officials disciplined for corruption were recommended to judicial authorities for prosecution, and an overwhelming majority of those disciplined by the party received "no more than a symbolic reprimand carrying no substantive administrative or financial penalties" (2006: 151). With such low criminal investigation rates, the abuse of duties is thus regarded a "low-risk and high-return activity that is extremely attractive to officials" (ibid. 150).⁹¹

While dismissed officials returned to government positions, melamine-tainted products also reappeared on the market. In the years since the 2008 scandal, China witnessed a string of food safety incidents involving melamine and dairy. On December 31, 2009, the state-run media reported that Shanghai Panda Dairy, one of the 22

⁹¹ In 2010, a story that was widely recounted within industry circles involved a Tianjin manufacturer of melamine-laced milk powder. The manufacturer is reported to have told his wife following his prison sentencing, "It doesn't matter. After three years, I will already be back."

companies initially found to have products containing melamine, had failed to destroy contaminated goods and instead, reconstituted them into new milk products sold in local markets. While the authorities began their investigation into the company in February 2009 and made three arrests in June, the news did not reach the public until the end of the year (Aredy 2010a). A couple weeks later, in January 2010, a similar story emerged stating that products from three other dairy companies in Shandong and Liaoning had been removed from shelves in Guizhou earlier that year while a fourth company in Shaanxi had been caught purchasing tainted powder from a Guangdong company (Aredy 2010b).⁹² This news was soon followed by a report that Ningxia's Tiantian Dairy Co. had repackaged and sold 164 tons of melamine-tainted powder.⁹³ Even more than a year later, companies still dared to circulate melamine-tainted milk powder. In April 2011, police confiscated more than 26 tons of contaminated products that had been produced in Inner Mongolia and subsequently sold in 2009 to a company in Guangxi that then, in turn, resold them to a Chongqing company (Reuters 2011).

Some argued that the new food safety incidents reflected the positive results of increased regulatory supervision and successful inspection campaigns to root out illegal business practices. While this might be partly accurate, the reappearance and reselling of tainted milk also showed that local industry—possibly in concert with the local party-state—was undeterred by the threat of punishment and continued to regard criminal behavior as low risk. Furthermore, very similar assertions of regulatory success had been made pre-melamine. Just one year prior to the incident, on August 23, 2007, the government launched a four-month national campaign to enhance product quality and food safety. Toward the end of the campaign, Vice Premier Wu Yi, the leading official in charge of the initiative, asserted, “During this national campaign, inspection officials at all levels have faithfully implemented laws and regulated companies by law. Problems solved in these three months would have taken one or two years in the past” (qtd. in Lan 2007: 22). The *Beijing Review* reported, “The results of these inspections

⁹² Not unlike in the original 2008 incident, the party-state—here, the Guangdong Provincial Propaganda Department—issued a ban on independent reporting of the recent spate of food safety incidents involving melamine-tainted milk (AFP 2010).

⁹³ It was that same week—most likely in response to public uproar—that the State Council formally established the new ministerial-level food safety commission led by Vice Premier Li Keqiang.

indicated that the national campaign to strengthen product quality and food safety has achieved remarkable success” (ibid.). And yet, as victory was being declared for food safety, the dairy industry was experiencing a massive crisis, calling into question the effectiveness of these campaigns.⁹⁴

4.4.3 Consumers’ reaction to melamine

The immediate and adverse reaction to news that the milk supply had been tainted with melamine indicated that Chinese consumers were acutely attuned to concerns about food safety, quality and their health. Between the third and fourth quarter of 2008, fresh milk consumption in urban areas fell from 4.02 to 3.14 kg per capita, milk powder from 0.16 to 0.13 kg per capita and yogurt from 0.98 to 0.71 kg per capita. Compared with the previous year, fresh milk consumption declined 14.5% to pre-2002 levels and yogurt consumption shrank for the first time since 2001, by 10.8% (China Dairy Yearbook 2009).

During this same period, however, milk powder consumption rose by 26.7% and household expenditures on fresh milk, yogurt and milk powder increased by 26.2%, 15.9% and 70.7%, respectively (China Dairy Yearbook 2009). These figures pointed to a critical phenomenon in the Chinese dairy industry: following the melamine incident and the deep distrust it engendered, consumers began to buy imported milk powder en masse. While October 2008 domestic milk powder sales were practically zero, the first quarter of 2009 witnessed full-fat milk powder imports increase by 267.49% and fresh milk by 147.56%. Over the course of the year, many local factories halted production as 246,800 tons of milk powder poured into the country, principally through the ports of Tianjin, Shandong, Shanghai and Guangdong.⁹⁵ By the end of 2009, China had

⁹⁴ Some argue that the campaigns have “created new opportunities for wrongdoing” as officials use inspection trips to facilitate the collection of illicit funds (e.g., through bribes, gifts, etc.) (Lu 2002: 225-226).

⁹⁵ Many dairy insiders have claimed that the official figure published by the PRC Customs Bureau was far lower than the actual amount of milk powder imported into the country. High demand and import restrictions have created a very lucrative black market for foreign infant formula.

imported 50 million USD in milk powder, a 50% increase over the previous year (Qiao and Wang in Liu and Li eds. 2010).⁹⁶

Consumers also began to purchase more high-end dairy products, such as organic and hormone-free milk. Among the various product lines at the top domestic dairy processors, high-end sales experienced the fastest growth. In 2009, Mengniu and Yili together pulled in over 300 million RMB. At Mengniu, the proportion of organic milk among high-end product sales increased from 3.54% to 25.45%. Yili's high-end line grew from 11.18% to 38.11%, and its organic milk, from 1.42% to 8.71% (Yao and Liu in Liu and Li eds. 2010). So as consumers opted to purchase imported milk powder and high-end products, total expenditures rose while overall dairy consumption declined.⁹⁷ The year ended with an excess supply of more than 300,000 tons of domestic dairy products (Liu et al. Liu and Li eds. 2010).

Not surprisingly, the massive increase in imported milk powder garnered the attention of the central party-state. On July 10, 2009, the Ministry of Commerce responded by adding fresh milk, milk powder and whey to the list of imported products that had to be reported and regulated through an Automatic Registration Form. Specifically, before any shipments could be received, dairy importers were required to register with both the China Chamber of Commerce of Foodstuffs and Native Produce and the provincial commerce bureau (Ministry of Commerce 2009). That year, 99% of dairy imports arrived from three countries—New Zealand, Australia and France—and more than 83% from New Zealand alone. While New Zealand enjoyed most-favoured-nation status, the Chinese government also desired to protect its domestic dairy companies. When imports exceeded the quotas set under New Zealand's free trade

⁹⁶ Concurrently, the financial crisis caused the world milk price to drop 57% between mid-2008 and 2009, leaving China with no competitive advantage. Milk powder exports subsequently fell 84% to 9,000 tons. On top of this, other countries, especially in Asia and Africa, placed restrictions on milk imports fearing food safety issues. Nevertheless, the impact of the melamine incident was "far and away greater" than that of the financial crisis (Liu et al. in Liu and Li eds. 2010: 162).

⁹⁷ From 2008 to 2009, rural dairy consumption appeared to rise slightly from 3.43 to 3.6 kg per capita. This statistic was misleading, however. As the 2010 China Dairy Yearbook explained, prior to the melamine incident, dairy consumption in the countryside predominantly consisted of milk powder. Afterward, many rural households switched to fresh milk and yogurt, influencing the total weight. If the reconstituted weight of milk powder (1:7) is used to measure consumption, the figure declines over 2007-2009, from 10.90 to 10.39 to 10.20 kg per capita.

agreement with China, the latter immediately declared that all subsequent shipments, even those in route, would not receive the low, preferential tax. By April 10, >1% fat milk surpassed the 1,365-ton quota. Three months later, butter reached the 9,870-ton limit, and then soon after, on August 27, milk solids surpassed 99,750 tons. Meanwhile, US importers reported delays in the processing and issuing of import permits as well as heightened enforcement of import standards (e.g., requiring products to meet standards for nitrites and benzoic acid stricter than those set at international levels) (USDA FAS 2009c).

Nevertheless, these efforts did little to slow the stream of dairy imports; in 2010, the total rose further to 414,000 tons, with foreign and domestic brands more or less splitting the market equally. Experts estimated 2011 imports to exceed 600,000 tons allowing foreign brands to capture 60-65% of the market (China Daily 2011). At the same time, parents urgently sought new channels through which to secure foreign infant formula for their child. Local and international media reported on the emergence of milk powder couriers operating between Macau, Hong Kong and Mainland China, on long queues and altercations among parents in supermarkets and on the implementation of purchase quotas for foreign formula (New York Times 2010; People's Daily 2011).

The fact that consumers chose to purchase expensive, imported/high-end products rather than abandon dairy altogether highlighted an important trend. Not only were consumers more attuned to nutrition and physical quality, they continued to pursue its improvement even at the expense of the domestic economy. In other words, there existed more loyalty to the product itself than to national brands. At the same time, the emphasis on health and improved physical quality created increased awareness and concern among consumers. For instance, the word, "safety," made it onto a list of top ten "media buzzwords" for 2011, compiled by the Communication University of China using news reports from 6 national newspapers, 26 television and radio stations and major web portals such as sina.com and QQ.com (Liu 2011). Similarly, Baidu, the country's principal online search engine, reported that "food safety" was the fifth most searched term in 2011, and the first among health concerns (Chin 2011).⁹⁸

⁹⁸ Four out of five web searches in China use Baidu.

This clear display of concern among consumers, however, did not necessarily translate into demands against the party-state for improved legislation and stricter enforcement. During his presentation at the 2009 China International Food Safety and Quality Conference, Yuan Liang, Division Director of State Council Legislative Affairs Office, made some incisive remarks about public participation in the new Food Safety Law. He insisted that Chinese public participation rights were underdeveloped and as such, “most people were silent.” Moreover, he commented, “They think the legislation has nothing to do with their families and their lives.” An influential Chinese consumer advocate provided an additional explanation, asserting, “Ordinary people don’t contribute because they are not informed or they do not understand the standards. Only if they can expand their knowledge and develop a [consumer] consciousness, then they will comment publicly on new policies.” Part of this lack of information was largely connected to the close relationship between state media and business and these actors’ active suppression of any news that might damage their interests.⁹⁹ It also linked back to the general manager’s keen observation that the industry structure created a profound disconnect between farmer and consumer, allowing processors to construct deceptive images to fill the void.

The reaction of the Chinese public to the melamine incident suggested consumers, rather than demanding safe milk through legislation, regarded market decisions as their greatest source of influence. Indeed, in drinking less milk and/or switching to imported products, consumers meted out “economic punishment” (经济处罚) to the domestic dairy industry. As indicated above, Yili, Mengniu and Guangming

⁹⁹ The Chinese media was simultaneously portrayed as the protagonist and antagonist in food safety initiatives. In the former role, the media was expected to serve as a consumer watchdog. For example, Article 8 of the Food Safety Law declared, “The news media shall publicize food safety laws, regulations, standards and knowledge for free and provide public oversight on acts that violate the Law” (NPC Standing Committee 2009). At the 2009 Infant Food Safety Forum in Beijing, event organizer and online media giant Sohu also expressed its “hope that all traditional and online media unite together and enhance attention on infant food safety, increasing positive news dissemination, actively engaging in public oversight...vigorously advocating scientific, healthy infant nutrition and providing strong public support for the remoulding of domestic infant food brands” (Sohu). Meanwhile, the media was often subject to heavy censorship and disparaged as a tool for manipulating public sentiment and generating mass panic. It was blamed for distributing “false news” and inflicting injury on innocent companies and industries. One official contended, “The media today will try to attract eyes however it can. It does not care at all about what the facts are.”

lost 1.74 billion RMB, 925 million RMB and 268 million RMB, respectively (Qiao and Wang in Liu and Li eds. 2010). The consumer advocate noted, “Consumers have tried to use the market to affect company profits, replacing legal punishment with economic punishment.” Similarly, when late 2011 reports surfaced of yet another food safety incident in the dairy industry involving aflatoxins in Mengniu milk, consumers did not attack the party-state and its failure to rectify the troubled industry, but rather called for a boycott of Mengniu products (Yang 2011). Meanwhile, the main page of the company website was hacked and replaced with a black notice condemning Mengniu for its lack of responsibility to the Chinese people. That day, investors also punished the company, with shares dropping 24% on the Hong Kong Stock Exchange (Wei 2011).

This type of reaction could be examined from two disparate viewpoints. First, perhaps, it demonstrated a society that understood their primary channel of action and expression resided in the decision of which products to purchase. A growing body of literature on Chinese civil society has highlighted the conceptualization of citizenship as “socio-economic benefits” endowed by the state, rather than a political or natural right (Hooper 2005; Keane 2001). The market was a space for the negotiation and expression of these benefits. As Hooper explained, “In the area of consumerism, therefore, people are basically asserting rights not *vis a vis* the state, which is the focus of much of the debate about the nascent growth of civil society in China, but *vis a vis* the market, with the endorsement and encouragement of the state” (2005: 2). From the perspective of the party-state, this behaviour presented some key advantages. In addition to putting pressure on companies to improve goods and services, it also steered clear of any political debate (*ibid.*). In this regard, it pointed to the de-politicization of daily life and limited access to the political sphere.

Second, it also could be a sign that consumers considered the pursuit of bureaucratic action to be futile. One popular phrase satirized these fruitless attempts to seek redress from the party-state: “人难见，脸难看，事难办.” First, “people are difficult to meet.” Typical responses from officials to citizens with grievances included, “on vacation,” “in a meeting,” “away on business” or “[it is] inconvenient.” Second, in the event they managed to see the official, the latter often expressed anger and annoyance, or “a face difficult to look at.” Third, if the first two strategies did not successfully discourage the petitioner, then the official presented a final, insurmountable hurdle: bureaucracy, or “matters are difficult to deal with.” The

consumer advocate provided one oft-heard excuse: “This is an important problem but it does not fall under the responsibility of my department and so I will still need to check with my superiors, ask for instructions, coordinate with others, make some consultations, etc.” As a result, he explained, “The ordinary citizen feels that resolving a problem is very complicated.”

Petitioning the party-state was also dangerous, particularly when it involved sensitive issues like the melamine incident. In some moments, the party-state tightly controlled all opinion about the incident, how it happened, who was guilty and how they should be punished. In others, it would call on civil society to serve as a check on greedy business and dishonest officials. Its attitude toward civil society undulated between offering certain rights and proscribing them severely. For example, the new Food Safety Law included one of the highest-level references to establishing consumer rights. Article 10 stated, “Any organization or individual has the right to report any act during food production and trade that violates this Law and has the right to inquire food safety information from relevant agencies and provide comments and suggestions about food safety regulation” (NPC Standing Committee 2009).

The trial of Zhao Lianhai, however, suggested an altogether different outcome for consumer advocates. Zhao, whose three-year-old son developed kidney stones after drinking contaminated milk, had launched a website, “Kidney Stone Babies,” where victims’ families could find updated information about the extent of the melamine contamination as well as avenues of redress. State censors blocked access to the site, and in November 2009, police arrested and detained Zhao. A year later, he was sentenced to 2.5 years in prison for “inciting social disorder,” a charge which included speaking with foreign media, protesting in front of the Beijing public security bureau and encouraging victims’ families to file civil lawsuits. During the trial, Zhao and his lawyer were neither permitted to present evidence nor call witnesses. Following the sentencing, Zhao insisted he would file for appeal, but the request was dropped shortly after his lawyer was detained for 48 hours in an undisclosed location north of Beijing. A month later, he was unexpectedly released to a hospital on medical parole; he wrote on his blog, “I support, acknowledge and thank the government and I express deep regret for my previous extreme opinions towards the government” (Burkitt 2010; Jacobs 2010 and McDonell 2010).

4.5 Conclusion

In reviewing the recent development of the Chinese dairy industry, it is clear that the melamine incident revealed a serious crisis at the root of what had seemed to be an incredibly successful sector. Acknowledging the gravity of the situation, the party-state moved quickly to restore consumer confidence by punishing key culprits, repairing the industry's weaknesses and issuing new food safety regulation. Restoring consumer confidence and putting the industry back on track toward healthy development would prove difficult, however. As discussed above, consumers' reaction to the incident revealed very low levels of trust in domestic dairy and the country's regulatory system. The fact that many dismissed officials returned to government and/or received promotions further weakened confidence in the system. With limited access to media and opaque regulatory processes, they turned instead toward economic channels as a means of expression and punishment. Even then, though, consumers' economic punishment was too lenient—particularly in the absence of strong legal institutions—and many companies still found cheating standards, cutting corners and reselling tainted product worth the risk.

Meanwhile, the fact that the contamination had been an open secret and that government and industry had struggled to deal with quality control issues also suggested the effort to rectify the troubled sector faced enormous challenges. The following chapters provide evidence that there were two layers of problems. First, the capabilities of the upstream production system could not meet the demands set forth by the party-state and its campaign for agricultural modernization. Second, when it became obvious that controls for safe milk were insufficient, neither state regulation nor direct intervention in value chain governance could improve the situation because of the mixed incentives and dependent relationships that persisted among local party-state and business actors. In the next two chapters, this thesis explores each of these layers. Chapter five examines the problems upstream in the value chain, pointing not just to a lack of capacity to produce safe milk but also to state-business interaction that rendered quality supervision and oversight exceedingly difficult. Chapter six delves into this interaction, detailing how it impacted dairy industry development and regulation at the local level.

5 Chapter Five: *Sanhua* and the Modernization of Rural Production

5.1 Introduction

On July 16, 2010, at Hohhot's International Dairy Industry Development Forum, Vice Secretary of the Municipal Committee and Organization Department Chief Lan Enhua delivered the keynote address, titled, "Aiming toward 'the three -izations' to develop a modern dairy industry." Echoing nationwide policy discussion on the problematic sector, he asserted that the key to putting dairy back on track toward healthy development was *sanhua* (三化), or scalization (规模化), standardization (标准化) and integration (一体化) (Lan).¹⁰⁰ Vice Secretary Lan's push for interventions in value chain governance was not new to the industry. Over the past decade, central dairy policy had repeatedly championed these three governance strategies as critical to "scientific development" and the modernization of agriculture. Following the melamine incident, both party-state and industry grew even more insistent in their calls for *sanhua*. As this chapter reveals, however, dragonhead-led development rendered the upstream production system unable to meet the demands of the three -izations. In the years leading up to and after the incident, producers saw little incentive to conform to *sanhua*, while processors primarily coordinated chain activities to pursue short-term cost and production objectives rather than to control for product quality. For its part, the local party-state could not stop the production and processing of unsafe milk because of its own interests in the sector.

Divided into four parts, the chapter begins by briefly describing *sanhua* and its principal objectives. In the three subsequent parts, it delves into each of the -izations, moving between periods pre and post-melamine to examine the challenges of chain governance and food safety in China's dairy industry.

¹⁰⁰ Hua (化) means to make, to change into or to transform, and is frequently used as the Mandarin Chinese equivalent for the English suffix, -ization.

5.2 *Sanhua* and the liberation of farmers

In the late 1990s, the central party-state initiated its campaign for agricultural industrialization, hoping ultimately to modernize rural production and transform peasants into workers. *Sanhua* represented the chain governance strategies that would facilitate this effort. Through scalization, the dominant model of upstream production would transition from small-scale dispersed farmers to medium and large-scale farming operations. According to Vice Secretary Lan, scaled-up operations were an “objective requirement” of industrial development and would improve hygiene, technology, purchase price, milk yield and quality, among other factors. Standardization would see that industry actors received the training, technology and management schemes necessary to “scientifically, rationally and autonomously implement every type of standard” (Lan). Integration would improve chain coordination between processors and producers while still ensuring shared risk and mutual benefit along all segments of the industry value chain. Vice Secretary Lan summarized integration as a question of “how to respect fundamentally the laws of the market economy, and under government guidance, rationally divide and distribute the dairy industry cake” (ibid.). In other words, *sanhua* entailed the development of large-scale, standardized operations that integrated supplier-buyer relationships, enhanced coordination and spread gains more fairly along the value chain.

The Hu-Wen administration placed increasing emphasis on integration as a result of its effort to build a harmonious society, reduce regional disparities and resolve the three rural crises in farmer livelihoods, village governance and agricultural production. According to literature from the Development Research Center of the State Council (DRC), China had already passed a period of development where “industry promotes agriculture” and “cities lead the countryside.”¹⁰¹ Now, the country was entering a new phase that endorsed “policies for strengthening agriculture and privileging farmers” as well as provided “an institutional framework for the integrated socio-economic development of rural and urban areas.” These measures were regarded as critical not just for the future of agriculture in China, but for achieving national

¹⁰¹ The DRC is a state agency under the authority of the State Council that conducts research on social and economic development issues with relevance for Mainland China and provides policy recommendations to the CPC Central Committee and State Council.

integrity and stability as well. As the DRC maintained, “Without well-off farmers, the whole of society is not fundamentally harmonious” (2010: 2).

Under *sanhua*, farmers thus would be “liberated to prosper” as modern workers.¹⁰² This objective also formed a key component of the 12th Five-year Plan’s rural reform and development strategy: to “accelerate rural labour mobility and advance the transformation of rural workers into city residents,” whereby “peasants undergo not only a change of profession but also a holistic transformation away from village tradition toward modern urban civilized ways” (DRC 2010: 1, 11-12).¹⁰³ Company X officials as well as independent large-scale ranch owners both stated that they hoped *sanhua* would turn farms into modern factories, providing new, improved sources of employment for workers and former farmers. One Company X manager detailed, “In the best scenario, small farms are slowly bought up and consolidated into larger ones. Farmers are then liberated to be workers in the cities or they can be workers on the large-scale farms.” The Inner Mongolia Shengmu High-tech Animal Husbandry Company promised similar “benefits to society” as a result of its scaled-up development.¹⁰⁴

Through the integration of raising, feed cultivation and ecological cycles, [our] project will harmonize, to the greatest extent, the industrial chain and rural employment; it will guide farmers into stable employment within the modern agricultural industry chain and clearly improve farmers’ wellbeing. By offering payment for cows brought onto the farms, project construction will absorb dairy farmers, transforming them into staff on modern ranches and pastures. These staff’s wages, welfare and educational training opportunities will all surpass the average levels for people working in nearby urban areas. In this manner, the

¹⁰² A dairy processor representative used this particular phrase.

¹⁰³ As seen here, the goal to transform farmers into modern workers also tied into policy on migration and urbanization.

¹⁰⁴ Co-founded by the former executive director and CFO of Mengniu, Yao Tongshan, this company operates a number of large-scale dairy farms and breeding facilities outside of Hohhot and Bayannur. Its first objective calls for an investment of 1.5 billion RMB over a three-year period in the construction of 50 “standardized and scaled” ranches, for a total company herd of 100,000 dairy cattle. Its second objective calls for a subsequent investment of 3 billion RMB over another three-year period in the construction of 100 “standardized and scaled” ranches, for a total company herd of 300,000 dairy cattle (company literature).

completion of the project's first objective can assist 30,000 farmers in finding employment within the modern industrialized animal husbandry system; the completion of the project's second objective can assist 100,000 farmers in finding employment within a new model of modern industrialized animal husbandry, helping them achieve long-term, stable, modest incomes (company literature).

Processors believed that the movement of small-scale farmers either into raising zones or completely out of dairy would also help solve the sector's quality problems. A Company X official commented:

During the melamine incident, everything was because farmers wanted to generate profit and needed to find a way to meet companies' rising demands. So afterward, [the national government] said, 'Farmers, don't raise cows anymore. It isn't your expertise. People with experience, money and market know-how should raise cows. Farmers should raise something else.' Principally, the government was considering consumers' food safety. Consumers' food safety is also why we are gradually moving toward relying on models of raising zones and large-scale ranches.

This complicated transformation, however, needed to be measured over decades and not mere years. The outflow of labour had to coincide with improvements in agricultural technology and production, lest food security become an issue. A national association leader explained, "The large-scale ranches need time, companies need capital, and land is in very short supply. The biggest problem is the social contradiction that [the ranches] produce. Where will the old cows go? Ordinary people need to be able to raise cows and make money. If you completely get rid of [the farmers], what will they do? Then when there is not enough food, Hu Jintao will be out [of a job]." As discussed in previous chapters, the country's largest processors focused their resources on the downstream consumer end of the chain, causing the industry to develop in reverse with demand far outpacing domestic supply. The following three parts show how the push toward *sanhua* would further exacerbate the situation, doing little to upgrade dairy production and catalyze farmers' transformation into modern workers.

5.3 Scalization (规模化)

According to the 2000 EU-China Dairy Project, the Provincial Animal Husbandry Office in Jinan, Shandong was one of the first agencies to experiment with the scalization of dairy production through the construction of “raising zones” (养殖小区).¹⁰⁵ These zones were essentially medium-scale farms (i.e., 500-1,000 cows) that had been divided into a number of feedlots and rented out to individual farmers who lived in rooms adjacent to their feedlots or in dormitory-style zone housing.¹⁰⁶ Each zone also contained a central milking parlor where farmers could milk their cows. In 2003, following Shandong’s example, Hohhot began to advocate the relocation and consolidation of small-scale dairy farmers into these zones, contending that the latter were “backward” and lacked the appropriate skills and technology for raising cattle on their own (Hohhot People’s Government 2003b). To facilitate this process, the local party-state required dairy processors to contribute to the zones’ construction through the procurement of loans, subsidies and/or milking equipment.

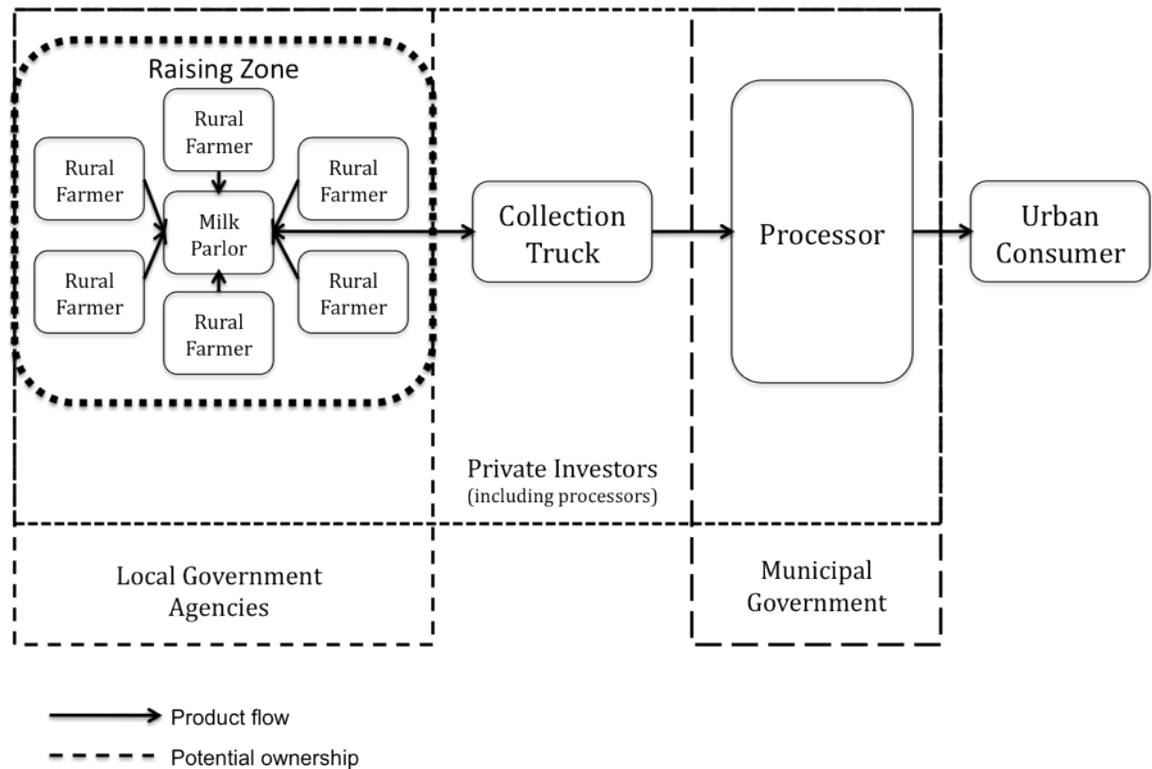
Within the zones, farmers raised their cows under the supervision of the zone owners or managers. Company X’s documents referred to the zone owners as “independent members of society” (社会自由人士). Government policy frequently used the term, “wealthy and influential households” (大户), while officials added to this, those of “high quality,” or more colloquially, “big heads” (大头) or “bosses” (老板). Often, these local elites were entrepreneurs or ex-officials turned businessmen with substantial *guanxi*, or connections, with the local party-state; some were even government agency personnel from nearby towns. Many of them had no prior experience in dairy, or even in agricultural production. The local party-state encouraged their participation in the dairy industry for two important reasons: one, they could provide private capital to complement the joint processor-government investment (unlike impoverished small-scale farmers); two, as described previously, “ruralist” ideas

¹⁰⁵ Shandong is also credited as the first province to pilot agricultural industrialization in 1993, later convincing the Chinese leadership to promote similar policies nationally.

¹⁰⁶ There are numerous translations for this particular farming model, including production complex / center / zone, breeding / raising area, cow borough and dairy plot. The study here uses “raising zone.”

about poor farmers' backwardness pervaded officialdom, leading many to believe that raising zones and the farmers living within them should be organized and managed by someone of superior quality.¹⁰⁷

Figure 6: The Dairy Value Chain – Raising Zones



Hohhot's plan for constructing raising zones remained vague, however, until mid-2007, when the municipal party committee released its "Recommendation on Promoting the Sustainable Healthy Development of the Dairy Industry." It called for the proportion of local dairy cows located in raising zones to reach 80% before the end of the central government's 11th Five-year Plan in 2011. Furthermore, it advised that each raising zone hold at least 500 cows, while "gradually eliminating dispersed small-scale households and low profit farms" (Hohhot Municipal Committee 2007). A couple months following this "Recommendation," the State Council released a very similar

¹⁰⁷ For similar reasons, other initiatives aimed at improving dairy farmer livelihoods also positioned local elites in a guiding role. For example, in 2003, when the Hohhot government endeavoured to set up a dairy farming mutual aid society, it urged, "especially to seize hold of wealthy and influential households as a key breakthrough point and to mobilize each dragonhead enterprise and large household to take the lead and be the first to join the society, setting an example and serving as a driving force" (Hohhot Municipal Government Office 2003).

proclamation of the same name, reaffirming officially, and more generally, the suggestions set out by Hohhot's government. Instead of requiring definite targets for raising zone development, it merely stated, "By 2012, the proportion of scaled dairy farming should have increased by a comparatively large extent." And like most State Council policy, it left the details of central financial support to be laid out by the NDRC and Ministry of Agriculture while the task of "rationally planning raising zones' construction and land usage" went to the local party-state (State Council 2007).

For its part, the Hohhot city government outlined the financial and logistical details for the first year of this scalization campaign. It stipulated the construction of 60 zones by the end of 2007. The city and county governments would both provide every new raising zone with a 100,000 RMB subsidy. The area's two dragonheads, Mengniu and Yili, were each required to furnish subsidies of 200,000 RMB as well as ten-year loans of 1 million RMB to 30 zones. With this particular division of financial responsibility, the policy noted, processors and the city and county governments would shoulder an equal portion of the financial burden, or 6 million RMB each (Hohhot People's Government 2007).

At the end of 2007, Company X also laid out its objectives and five-year strategy for consolidating milk production in raising zones and large-scale farms. Over the next five years, it aimed to "transition from dispersed raising and centralized milking to centralized raising and centralized milking, gradually achieving the scalization, standardization, mechanization and servitization of the milk supply base." Specifically, it hoped to decrease the proportion of milk supplied by independent stations from 55% to 40%, while increasing that of raising zones from 25% to 30% and that of large-scale ranches from 20% to 30%. To realize these goals by 2012, Company X planned to build 98 500-head raising zones and 145 1,000-head raising zones as well as renovate 206 raising zones. Concurrently, it would also build a significant number of self-owned and operated large-scale ranches, including 111 100-head ranches, 227 300-head ranches and 10 10,000-head ranches. To finance the construction of the raising zones, Company X emphasized the importance of joint investment from "government, enterprise and independent members of society." Citing the State Council's 2007 "Recommendation" as its reference, the processor would provide each 1,000-head

raising zone with a 100,000 RMB subsidy for land, roads and utilities as well as a 1 million RMB ten-year loan (Document #1).¹⁰⁸

While Company X might have fully intended to accomplish these objectives in the long run (i.e., by 2012), trend data from the previous two years as well as its immediate plans for the following year, 2008, seemed to indicate that, at least in the short term, another course of action was being undertaken. From 2006 to 2007, the percentage of milk sourced from raising zones did not increase, but rather decreased slightly while that of 2007 to 2008 was projected to stay more or less the same (an almost negligible decrease). Between 2006 and 2008, ten of the nineteen regions in which Company X operated saw a decrease in supply from raising zones. The projections for 2008 also forecasted a slight decline in the percentage of milk supplied from all large-scale operations (i.e., from both raising zones and ranches together), indicating that, at least for that year, the processor would not cut back on its supply from independent milk stations; instead, it would continue to rely on milk stations for just over 55% of its supply. Here, again, ten of the nineteen regions would experience minute to modest de-scalization, from -0.04% to -14.6% (Documents #1 & 24).

As Company X's predictions for the 2008 milk supply showed a decrease in both types of scaled operations throughout a number of regions, the decline in sourcing from raising zones could not be explained by a switch from the milk station model (i.e., dispersed farmer households milking cows at a local collection station) to large-scale ranches. Indeed, in 2008, the number of milk stations the processor expected to incorporate newly into its supply far exceeded that of raising zones and ranches in every region but the central east.¹⁰⁹ Specifically, Company X projected an additional 264 milk stations, 71 raising zones and 58 ranches. Even taking into account those operations with whom it intended to terminate supply—164 milk stations, 5 raising zones and 6 ranches—the processor would still be developing a significantly higher number of milk stations than other larger-scale production units (Document #1). Specifically, 46% of

¹⁰⁸ Note the subsidy was 100,000 RMB short of that amount stipulated by the local government. The loan, however, was the same amount.

¹⁰⁹ Zero new milk stations would be added in the central east region. Instead, 77 raising zones and 31 large-scale ranches would be added. This region includes the wealthiest, most developed areas of Company X's milk supply.

the processor's new suppliers were milk stations, 30% were raising zones and 24% were ranches.

According to its records for 2006-2007, Company X explained that, in some cases, supply from raising zones had been reduced as a result of "milk parlors in non-conforming zones successively losing their qualifications" (Document #24). In other regions, where the milk supply was still under development, it reasoned that the quantity of milk produced by common milk stations outpaced that of raising zones.¹¹⁰ Perhaps of equal importance, the processor asserted that competitors were building milk stations in its key supply areas and "in order to prevent competitors from disturbing our milk supply, [we] must build our own milk stations in the competitors' core milk supply bases" (Document #1). In addition, it argued that there was a distinct disadvantage in having only a couple large farms in one region: in the event that the processor lowered the raw milk price, "there was the possibility that [the farms] would join together and strike" (Document #24).

In examining the trends in scaled milk production across different regions, another potential explanation emerged for why Company X was not pushing the development of raising zones as extensively as policy suggested it would. First of all, the construction of milk stations was much less expensive than that of raising zones or ranches and involved far less risk for the processor.¹¹¹ In addition, the management fee for raising zones was higher than that for ordinary milk stations, at 0.22 RMB/kg and 0.18 RMB/kg, respectively (Document #1). It is quite likely that Company X did not see any benefit in paying more for milk that was of equal quality. As policy shows, raising zones required joint financial commitment from both company and local party-state. In areas with either tight budget constraints or lax oversight, local governments might be less willing to part with financial resources. The fact that Company X was only expanding its large-scale operations in the central eastern region seemed to support this conjecture; China's coast is home to its most wealthy localities.

¹¹⁰ It even cited regions where milk stations were outpacing both raising zones and ranches.

¹¹¹ Gale and Hu cited costs for building milk stations at 500,000 to 1 million RMB (2009: 6). Raising zones required an initial investment of approximately 10 to 20 million RMB depending on their size; smaller ranches required about the same level of investment as raising zones while the larger ones (~3,000 to 10,000 head) could involve anywhere from 80 to 350 million RMB (Yao in Liu and Li eds. 2010; National Dairy Cow Science and Technology Office 2010).

A manager with Company X lamented this problem with local party-state investment, saying, “They don’t want to give their share because the returns are slow. They only care about what looks good in the short run. And [the enterprise] doesn’t have the money to do this themselves.” An agricultural economist focusing on the dairy industry contended that processors were equally reticent to invest in improving supply and technology that could be “stolen” by the competitor.¹¹² Likewise, dairy companies’ “market first, factory later” strategy meant expensive advertising campaigns were prioritized over investment in upstream activities.

One study conducted in 2009 by a team of researchers from the Chinese Academy of Social Sciences (CASS) revealed other problems with the raising zones. In Ulanhot, Inner Mongolia, they discovered the local party-state had supported the construction of about a dozen raising zones and large-scale farms. However, due to management issues and operation costs, all but one had failed. They provided three specific reasons for the projects’ demise. First, the zones lacked any semblance of economies of scale as all farm operations—whether raising, management or marketing—were carried out individually by farmers. Second, the zones were thoroughly entwined with party-state interests. The team detailed, “Most of these zones have been made by the authorities. Much of the investment is public funds. The managers are personnel working in local agencies and cannot completely devote themselves to the daily operation of the raising zones.” Third, the cost of operating raising zones “far and away surpassed that of common dairy farmers.” Factoring in worker salaries, higher-priced feed and rent, the team calculated the breakeven price of a raising zone in Ulanhot to be 2.3 RMB/kg. This did not compare favourably with that of nearby small-scale farmers, at 1.3 RMB/kg (Li et al. in Liu and Li eds. 2010: 106-107). In a dairy village near Hohhot, farmers there also expressed reservations about the raising zones, claiming that they would make even less money if they moved into the zones.

Farmers living in the zones echoed this sentiment. They spoke bitterly about their financial situation and the industry’s complete lack of “benefit” (效益). During

¹¹² Even after signing an exclusivity agreement in exchange for equipment or financing, processors could not prevent station operators or farm owners from violating these contracts and selling milk to competitors.

one zone visit near Hohhot, in summer 2010, a farmer pointed out that half of his neighbours had already quit and sold off their cows. In a zone on the outskirts of Beijing, CASS researchers also found farmers in dire financial circumstances. One farmer they interviewed explained that his daily costs for raising 40 cows amounted to 790.3 RMB, and yet, he was only receiving 480 RMB/day in raw milk sales, a loss of 310 RMB/day. According to the zone manager, half of the zone's 22 families were operating at a loss (Yao in Liu and Li eds. 2010: 139).

Another source of tension among farmers was the zone boss, who often they contended, "could not be trusted." Indeed, in the same zone near Hohhot mentioned above, farmers were quoting milk prices of 2.6 to 2.8 RMB/kg while the zone boss reported the price was 3.0 RMB/kg. The farmers complained that the constant change in prices and their lack of transparency made them feel like they had little control and thus, never knew whether they should buy another cow or leave the industry altogether. Commenting on the situation, an Inner Mongolian dairy association leader acknowledged, "Before [the farmers] were happy, but now they are suffering. They are not making any money."

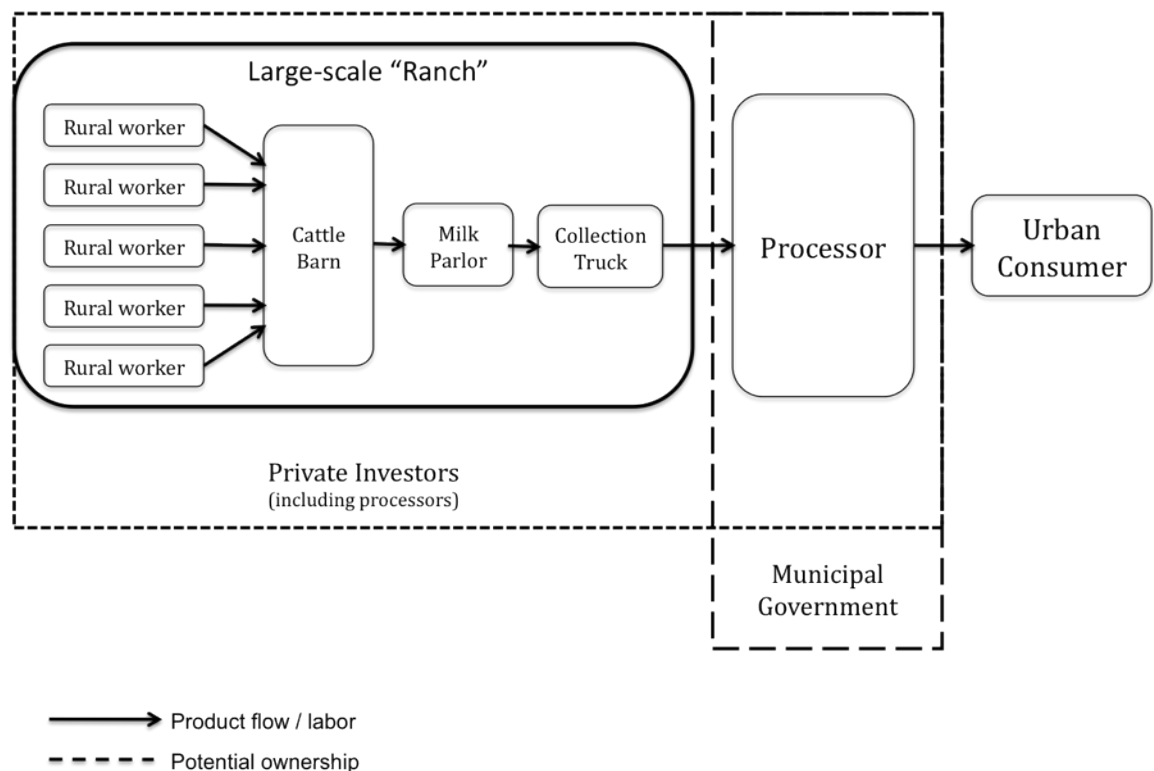
Zone owners encountered during fieldwork were simultaneously involved in much more lucrative, well-connected sectors, from real estate and construction to telecommunications. They did not live in the zones, but in nearby towns or cities.¹¹³ An official from the Ministry of Agriculture summarized the zones as the "bosses' hobby." Company X also complained about this lack of full commitment on the part of the zone bosses, reporting, "Currently, the members of society managing milk stations have not genuinely provided farmers with assistance" (Document #1). The zone bosses likewise expressed dissatisfaction with the industry and its return on their investment. When one particular boss was asked about how the raising zone differed from his job in real estate development, he answered pithily, "It doesn't make money."¹¹⁴

¹¹³ The EU-China Dairy Project noted these "wealthy entrants" into the dairy sector, commenting, "They erect buildings which are often lavish but of totally unsuitable design and staff the units with the cheapest un-skilled labour available and rarely visit the farm in the belief that milk production is a straightforward and simple venture" (2000: 12).

¹¹⁴ The boss stated that he had invested 8 million RMB in the construction of the zone but that despite its meager returns, he would not leave the industry: "If I quit now, I will lose it all. Maybe sometime in the future, there will be a small profit."

In response to these issues, disparate actors have asserted that the raising zones should be regarded as merely a step in the “transition” (过渡) to large-scale, industrialized farms. An executive from Company X asserted, “The raising zone is a temporary solution. Rearing must be scientific and scaled in order to make money. The future model will definitely be the large-scale ranch.” In addition to ensuring profits, this continued scalization would also bring the industry closer to achieving another important goal: the transformation of rural labour into modern workers. The director of a large-scale cooperative explained, “The ranches must become like factories through scalization.” Only then, he argued, would “the youth start coming back to work on the ranches.” In other words, he anticipated that, with investment in large-scale farms, those same higher-paying manufacturing jobs that millions of young rural migrants sought in the nation’s cities and special economic zones could be created closer to home, drawing wealth, youth and skills back into the interior.

Figure 7: The Dairy Value Chain – Large-scale “Ranches”



Although mega-scale industrialized farms were billed as the future of the dairy industry, they were equally problematic. Many of the country’s 10,000 head ranches (万头牧场) barely contained half that number of cows and some existed on paper only.

These phantom farms, or face projects (形象工程), were a common occurrence throughout China, and not just in the dairy industry. Eager to meet central objectives and/or boost production numbers, local officials commissioned the construction of large agricultural projects.¹¹⁵ Given their location and the resources available, however, many projects of this size were unsustainable, both economically and environmentally, and thus, ended up either never being built or operating at half capacity.¹¹⁶

As such, actual milk production was still dominated by small-scale farmers, the majority of whom were over 40 years old. According to the CCAP study conducted in the Greater Beijing Area, between 2004 and 2009, the percentage of wealthier, younger, more educated, higher off-farm labour households participating in dairy declined considerably faster than that of their older, poorer counterparts. The average age of dairy farmers surveyed was found to be 46.9 years old (Jia, unpublished). An official from the Inner Mongolian Agriculture Department explained that the age issue among dairy farmers was not related to the overall demographics of the area, but instead to the sector's lack of economic incentives; the older farmers represented those rural parents and grandparents who had been left behind by children who now worked in the cities. This trend appeared to indicate that bottom-up improvement of agricultural production would prove more difficult in coming years. Embittered by their own experience in the dairy industry, Hohhot farmers encountered during fieldwork vigorously opposed the idea of their children returning to the countryside.

In sum, the actual process of “scalization” revealed quite a different picture. While farmers resisted moving into raising zones they saw as providing little economic benefit and led by untrustworthy bosses, local government was equally reticent to invest in agricultural projects with slow returns and meagre impact on their GDP-based political portfolios. It was probably most telling that around the same time that

¹¹⁵ Chapter six provides an in-depth discussion on face projects and their connection to the cadre evaluation system.

¹¹⁶ During fieldwork, industry experts discussed several reasons for why particular large and mega-scale projects had failed and/or become unsustainable: 1) lack of capital; 2) lack of land or usage of land inappropriate for large-scale dairy farming; 3) inadequate sources of water; 4) lack of skilled staff and mismanagement; and 5) improper waste management (i.e., disposal of manure and methane) or limited options for redistribution to farmers as fertilizer and/or for biogas production.

Company X was dealing with the adulteration of the milk supply, it did not launch an aggressive scalization campaign and increase sourcing from raising zones and ranches. Instead, at least in the short term, the processor built more milk stations and continued to rely on them for the majority of its milk supply.

5.4 Standardization (标准化)

Not unlike its push for scalization, the party-state also regarded standardization as a process by which to remedy the backward and anti-modern practices of small-scale farmers. In standardized raising zones, it expected farmers to function instead like factory workers, following a uniform program of feeding, milking, veterinary care, sanitation and hygiene under the direction and supervision of zone owners. At both the central and local levels, the party-state introduced a plethora of policy and regulations dictating optimal and “standardized” practices for raising and milking cows. It also instituted the practice of negotiating raw milk prices based on a number of product quality indicators (以质论价), hoping that this economic incentive would encourage compliance and motivate producers to raise milk quality through investment in their herds and improved farm practices.¹¹⁷

Nevertheless, the effort to centralize farmers in raising zones and standardize dairy production faced serious challenges. Most significantly, few raising zones actually exhibited standardized production. While farmers lived in structurally identical facilities, they continued to follow individual rearing practices, securing feed and other necessary supplies according to their own resources. In zones just outside of Beijing, a CASS researcher summarized the problem: “‘centralized’ [集中] was not the same as

¹¹⁷ The Shanghai Bureau of Prices first piloted this practice in 1996 with a “quality-oriented pricing system” based on butterfat and protein content. In 2000, it added the bacteria count and antibiotics level to this formula (Research Center for Rural Economy 2001). By 2003, Hohhot had adopted the practice as well (Hohhot People’s Government 2003a). In the US, dairy farmers and processors use a component pricing system where milk checks are calculated based on the percentage of individual components in the milk, namely, butterfat, protein and other solids. Each month, the US Department of Agriculture announces the component prices (\$/lb.) taking into consideration supply/demand and average dairy commodity prices. Premiums and deductions are then made for lower and higher somatic cell counts (but all within the national standard for Grade A milk). While this system might appear to resemble China’s quality-oriented pricing mechanism, it differs in a major way: component prices are set by the government, and not by processors.

‘intensive’ [集约]” (Yao in Liu and Li eds. 2010: 140). In other words, consolidating farmers under one roof did not automatically transform them into factory workers. Indeed, a number of factors prevented the emergence of standardized production. One, as mentioned above, farmers tended not to trust zone owners; likewise, they expressed reservations about the abilities of their neighbours. Two, many zone owners were either unwilling to cover the costs of cow nutrition, training and veterinary care or did not have access to these resources. Three, as will be explained below, the quality-oriented pricing system did not always function as intended, diminishing incentives for farmers to improve milk quality and/or cooperate with others.

The combination of physically concentrated dairy production with independent rearing held consequences for the cows: by clustering cattle that received uneven veterinary treatment, raising zones facilitated the spread of contagions, leading to increased herd illness and death. Company X stated, “Disease prevention among dairy cows is hard to control and there is a high incidence of mastitis” (Document #1).¹¹⁸ In turn, the overuse and misuse of antibiotics also affected the quality of the milk supply. Toward the end of 2007, the processor reported that only 38% of its milk contained acceptable levels of antibiotics (Document #1).

Unable to reach the goals of standardized farm management and production, upstream actors often could not meet national dairy standards. For example, the pre-melamine national bacterial limit for raw milk was 500,000 cfu/ml (Ministry of Health 2003).¹¹⁹ Company X’s objectives, though, were much less stringent, and in 2007, its bacteria count targets were 56% under 1 million cfu/ml, 38% between 1 and 5 million cfu/ml and 6% over 5 million cfu/ml. It was possible that the processor allowed for such high levels of bacterial contamination because a vast majority of its supply would end up as either UHT milk or powder, processes whose extremely high temperatures

¹¹⁸ Mastitis is a potentially fatal infection and inflammation of the mammary gland and udder tissue.

¹¹⁹ In the US, any commingled raw milk above 300,000 cfu/ml is considered “undergrade” and cannot be processed for fluid consumption (USPHS/FDA 2009: 29). As a majority of US dairy farms can produce raw milk with less than 10,000 cfu/ml, many states maintain raw milk standards that are stricter than those at the federal level.

sterilized most microbial life.¹²⁰ Nonetheless, these numbers demonstrated that quality controls limiting bacterial contamination (before milk reached the processor)—such as standardized milking procedures, equipment sanitation, cow hygiene/health and proper cooling and storage—were inadequate and far from achieving compliance with either national or company standards. Indeed, for 2008, Company X only expected 30% of milk stations to meet its standardization criteria (Document #24).¹²¹

As many upstream actors lacked the capabilities to meet national dairy standards, processors formulated their own flexible purchasing standards, which they then applied to price negotiations and milk collection. For instance, Company X employed different purchasing standards for each region in which it sourced milk and varied these formulations according to season, supply/demand and local capacity (Document #24).¹²² Although processors might have set standards to reflect more closely the reality of milk production, they did not enforce these standards consistently or fairly—or even for the purpose of quality control. Instead, they often used enforcement, or lack thereof, to meet cost and production objectives. Specifically, some processors and milk traders abused the quality-oriented pricing system and engaged in grade-price discounting (压级压价), declaring milk substandard and exacting price penalties in order to cut costs; others chose whether and how to enforce standards in accordance with market demand and production schedules. Liu and Li found cases where processors would readily accept milk from one particular station during the high season, but then later, when demand was low and milk was more abundant, reject the same station's milk based on problems with “taste” or “flavour” (2010: 99). Processors thus transformed a potential quality control mechanism into a tool for achieving short-term cost and production targets, all irrespective of farmer livelihoods.¹²³

¹²⁰ The enzymes produced by some of the most common bacteria, however, can survive UHT processing, continuing to degrade milk protein, fat and other components while on the shelf.

¹²¹ The criteria included process controls related to facility sanitation, hygiene, milking procedures and equipment installation, repair, cleaning and disinfection.

¹²² Like other processors, Company X used bacteria count, milk solids and protein as the principal indicators of milk quality. In the more developed coastal regions, its standards were higher overall.

¹²³ By nature, milk supply is not attuned to short-term demand. Lactating cows must produce daily, regardless of the consumer. As a result, producers were already in compromised position.

So rather than motivating producers toward standardized farm practices, processors weakened supplier-buyer relationships and provided upstream actors with cause to adulterate the milk supply. Attempting to satisfy stricter purchasing standards, milk station operators, traders and collection truck drivers sought various means to falsify protein levels. In early 2007, a year and a half before the public first learned about melamine, Company X discovered 16% of inspected milk stations were engaging in some sort of adulteration, a figure amounting to about 1,500 tons/day.¹²⁴ By the third quarter, employing a variety of tactics including warnings, fines, price penalties, rejecting milk and dumping milk “on the spot,” the processor claimed to have reduced this number significantly (Document #24 and #35). During a second round of 2,827 inspections, it found an average of 5.37% stations engaged in adulteration, or approximately 500 tons/day. Some of the most commonly used products included a host of “fresh milk serums,” “fat powder,” nitrates, salts, food preservatives, carbon phosphoric acid, plant proteins, anti-bacterials, glacial acetic acid (as a solvent for other chemicals), ammonium phosphate and carbamide (i.e., urea). Company X also referred to the “most significant adulteration” as that involving *erheyi* (二合一), or two-in-one, its name for the protein powder that contained melamine. In response, the processor had developed a detection method that it planned to implement nationally beginning in October 2007. It warned that consumption of two-in-one could lead to kidney failure and insisted that local divisions make every effort to lower the incidence of *erheyi* by 20% each month (Document #35).

In December 2007, Company X cited the government’s “evaluation of milk supply challenges.” At the top of the list, it stated, “Dairy companies’ formulation of purchasing standards is too high, causing milk station operators to adulterate.” It went on to add, “Dairy companies’ taste testing is too ambiguous, relying on artificial [subjective] factors. Inspection is not scientific.” In response to this criticism, Company X claimed that it would adjust some purchasing standards downwards for the following

¹²⁴ This figure includes all types of milk stations, including independent operations that serviced dispersed farmers and milk parlors located within raising zones or on large-scale farms. Company X also complained that “a portion of milk collection truck drivers are adulterating, counterfeiting and stealing and selling off [to competitors] milk while en route” (Document #1). Gale and Hu detailed one case where a driver claimed to adulterate the truck’s milk tank with a whole assortment of items, including melamine, hydrogen peroxide, antibiotics, vitamin C, whey powder, fat and occasionally sulphuric acid (2009: 10).

year, “...in order to avoid this type of problem from happening again.” Thus, it lowered the protein standard to 2.8% (officially set at 2.95% by the Ministry of Health) as well as decreased the percentage of supply that was required to meet this standard from 97.41-99.51% in 2007 to 95.67-95.86% in 2008. Concurrently, it made the bacteria count standards 0.5% stricter at both the high and low-end values (potentially, to maintain the same overall percentage of “high quality” milk) (Document #24).

Company X also pledged to intensify efforts to combat adulteration of the milk supply through “night searches” (夜查) coordinated with the local public security bureau (PSB) and industry and commerce bureau (Document #1 & 24). In essence, these “searches” were police raids under the cover of darkness on “problem milk stations.” Those operators found with products commonly used to adulterate milk hidden in their storage facilities were arrested and the products, burned. According to the processor, stations caught twice would be “banned.” From the processor’s records, it is clear that the company did actually coordinate night raids on milk stations with the assistance of the local PSB; it would also appear that station managers were “arrested”—albeit in the middle of the night and using unmarked cars.¹²⁵ Nevertheless, one processor employee acknowledged that many of the arrested milk station operators were released without any sentencing. This lenience most likely reflected the fact that local party-state and processors had invested in many milk stations and thus, they did not wish to see them fail, especially when milk was already in short supply. Speaking more generally about lenience toward food safety offenders, the consumer advocate asserted, “Lawbreakers are not afraid of law enforcement. Why? Because they are the ones supporting law enforcement and giving them money. With such a significant financial relationship, law enforcement cannot arrest the lawbreakers. So instead, they protect them.”¹²⁶

¹²⁵ This is based on photo documentation from Company X.

¹²⁶ In their study on China’s regulatory regime in the wake of the spring 2004 Fuyang (Anhui) milk powder incident, Tam and Yang (2005) contended that the lax enforcement of food safety regulation largely resulted from local regulatory agencies’ efforts to generate revenue and meet budget objectives. They found that although the central party-state prohibited fines and fees from being used to support the regulatory apparatus, less wealthy regions continued to pursue this “revenue imperative.” As a consequence, they explained, food safety regulators often substituted fines for criminal prosecution, a practice called *yifa daixing* (以罚代刑). In their analysis of the Fuyang incident, it was clear that this practice played a decidedly deleterious

It would seem that even post-melamine much of the conduct that had weakened control over product quality persisted upstream. Following the incident, when demand for milk declined sharply, processors used this period of intense focus on food safety in China to once again raise purchasing standards and “regulate” supply.¹²⁷ According to the 2009 CASS study in Ulanhot, companies frequently cited stricter purchasing standards in order to reject milk and/or push down grade and price. Similar to pre-melamine years, they also used disparate formulas of standards to negotiate milk prices, creating various combinations of protein, fat, milk solids and bacteria count indicators. Some companies followed national regulations, while others invented their own. There even existed discrepancies between the standards companies used during price negotiations and those they used at inspections (Li et al. in Liu and Li eds. 2010). Pointing out the unfair nature of these practices, the CASS research team reported, “Companies’ standards are formulated unilaterally; milk stations and farmers have no authority to speak on the matter. It is generally difficult for farmers to reach the standards set by the companies, allowing [the latter] often to use all kinds of excuses to reject milk” (ibid. 107). Farmers thus had few opportunities to “self-regulate” and were often completely in the dark about fluctuations in milk prices. These practices not only antagonised farmers’ relationship with processors, but also that with milk stations, as farmers were left questioning who to believe about rejected milk and low prices.¹²⁸

In sum, low upstream capabilities combined with irregular enforcement impeded the campaign for standardization both pre and post-melamine. Farmers did not have access to the resources and training needed to undertake “standardized” milk production

role. Almost a year before the scandal reached national news, the local AQSIQ discovered that an infant had died after consuming fake milk powder. Rather than taking criminal action against the producer and shuttering its operations, the agency only fined the producer, who subsequently continued to market the fake powder until the central government launched an investigation ten months later. Summarizing this case, Tam and Yang wrote, “In effect, regulators depended on such wayward businesses’ illegalities to generate fines and levies; closing such businesses down would be akin to killing the goose that lays the golden egg” (2005: 18-19).

¹²⁷ Peverelli (2004) provided evidence of similar behavior among Chinese dairy processors after the Fuyang milk powder incident.

¹²⁸ In Ulanhot, the team also found that grade-price discounting and rejection of milk reduced raw milk prices from 1.9 RMB/kg to 1.5 RMB/kg, 0.2 RMB/kg below the breakeven point, impinging on farmer incomes (Li et al. in Liu and Li eds.: 104-105).

and achieve quality requirements naturally. In other words, the lack of investment in the upstream had resulted in poor quality milk and low yields—and the construction of raising zones had done little to improve the situation. Fully aware of producers' inability to reach national dairy standards, processors set and enforced their own standards, often according to cost and production objectives. This type of behaviour discouraged producers from investing in an industry they could not trust. Moreover, it engendered antagonistic, asymmetric relations among chain actors, and in the absence of reliable and effective enforcement, it provided milk station operators with ample incentive to adulterate the supply. In dealing with the adulteration, processors lowered purchasing standards and coordinated night raids with the local party-state. With these two actions, they admitted to a key reality: they had lost control of the dairy value chain.

5.5 Integration (一体化)

It became increasingly obvious that the dragonheads' preferred method of upstream organization and production—i.e., the outsourcing model—would not result in upgrading along the value chain, whether in the form of improved rural livelihoods or higher quality milk; raising zones appeared to face similar challenges. As such, both central and local party-state began to emphasize the integration of the dairy value chain. More specifically, they sought to strengthen supplier-buyer relationships, enhancing the ability of processors to control upstream practices and ensuring all chain actors enjoyed fair prices and increased benefits. With well-coordinated and equitable relations along the value chain, they hoped the quality of the milk supply would improve. To this end, various strategies were crafted at the national and local levels, two of which were the promotion of cooperatives as a new model of dairy farming and the “one village, one company” policy.

5.5.1 Cooperatives

In 2004, in an effort to promote the integration of agricultural supply chains and fairer distribution of economic benefits among farmers, the central party-state began encouraging the establishment of cooperatives. Two years later, it passed the Farmer Professional Cooperative Law, officially defining cooperatives as formal entities that could provide their membership with information and assistance in marketing,

processing, transportation, technology and input acquisition and storage.¹²⁹ Following the law's promulgation in July 2007, Hohhot began to set up its own cooperatives as one of the key models that could "solve the bottleneck problem of dispersed dairy farming" (Tang 2007). It suggested two methods for creating cooperatives: enterprise-organized and village-based. The first method encouraged high-tech companies to establish cooperatives that leased cows from local farmers, providing the latter with annual dividends based on their cows' contribution to the cooperative milk supply. The second method urged villages dominated by dairy production to transform themselves into cooperatives that unified separate households' technology, management and price transactions (*ibid.*).

One of the key differences between the two methods resided in which actor established the cooperative and eventually managed its daily operations. While the first method clearly suggested a leading role by business, the second allowed for both bottom-up and top-down approaches to cooperative organization. From a value chain perspective, the first method would completely remove small-scale farmers from the production process and homogenize farm practices; the second, by contrast, might continue to involve farmers using heterogeneous practices.

Established in April 2007 by the Inner Mongolia Dairy United Science and Technology Company and jointly-invested by the Hohhot municipal government, Dairy United (奶联社) exemplified the first method. Specifically, it took "low-quality" cows from dispersed households and provided them with "high-quality," unified management

¹²⁹ Based on their national survey of 380 villages, Deng et al. found that the percentage of villages with at least one cooperative grew from 1.04% in 1999 to 4.9% in 2005 (before the FPC law) to 20.75% in 2008 (after the FPC law); there was no evidence of cooperatives in the period 1984-1998 (2010: 496). They attributed this substantial and rapid growth in cooperatives to a shift in the central party-state's attitude toward rural organization and market access, and to its subsequent policy support. Specifically, they cited two key factors that convinced leaders to abandon their concerns about FPCs fostering "alternative bases of political power" in the countryside: one, between 1984 and 2003, average farm size steadily declined from 0.73 to 0.54 hectares; two, farmers could use cooperatives to link into growing markets for higher-value crops and specialized products (*ibid.* 499). Following the FPC law, the party-state expanded its policy support measures, including direct funding (e.g., cash awards), tax exemptions, credit, technical training and land or office space. In their study, Deng et al. pointed to a direct correlation between these measures and the establishment of FPCs, finding that only 7.3% of villages without any policy supports had FPCs in 2008. By contrast, in villages with policy supports, 26.3% had FPCs (*ibid.* 502).

and feeding regimes. Early on in its development, Dairy United was lauded as an “innovative model of dairy cooperative organization” that both consolidated milk production and ensured that small-scale farmers continued to benefit from the industry. One year after its founding, “under the vigorous support of the Tumotezuqi People’s Government,” it signed a contract of strategic cooperation with national processor, Yili, receiving 300 million RMB for the construction of 20 1,000-head farms in Tumotezuqi (company literature).¹³⁰ In return, the cooperative promised Yili exclusive rights to its milk supply.

Despite Dairy United’s intentions, industry experts claimed that the cooperative provided more benefit to the Hohhot government than to member farmers. Specifically, they contended that dividends were too low and that a model like Dairy United continued to exist in Hohhot—and nowhere else in the country—solely because of the cooperative’s close relationship with the municipal government. In other words, without the support of the local party-state and Yili, it would fail. Furthermore, they explained that this relationship largely explained why Yili had been chosen as the cooperative’s partner (instead of Mengniu). One processor’s experience with Dairy United appeared to support this assertion that the cooperative relied heavily on Hohhot and Yili’s patronage. The processor had contacted the cooperative in the hope that the latter would help consolidate and integrate its milk supply in a particular province. Dairy United refused and when the processor asked the cooperative to explain its profit model, Dairy United replied, “We do not have a profit model.” The person recounting this story concluded, “So I think Dairy United is just there to raise cows for Yili. It is not actually a real cooperative.”¹³¹

Village-based dairy cooperatives (i.e., the second method) also experienced serious problems, many of which closely resembled those of the raising zones. This semblance was not coincidental and even led to cooperatives often being mistakenly referred to as raising zones and vice versa. Further complicating the situation, numerous raising zones and milk stations existed as cooperatives in name only in an attempt to

¹³⁰ Tumotezuqi is an autonomous banner (equivalent to a county elsewhere in China) under the jurisdiction of the Hohhot municipal government and considered Yili’s “territory.”

¹³¹ For its part, Dairy United reasoned that it had not expanded into other regions because “it required investment and talent.”

capture state subsidies, and in no way whatsoever, operated like one. In Ulanhot, the CASS team found that following the melamine incident, all raising zones and milk stations in that particular locality had registered to become so-called “cooperatives” in order to comply with new policy and receive certification (Li et al. in Liu and Li eds. 2010). These “cooperatives” thus continued to experience problems related to heterogeneous farm practices and uneven veterinary treatment.

Meanwhile, farmers resisted joining dairy cooperatives as the latter were frequently run by local elites with government backing (Yang and Hu 2010b).¹³² An official with the Inner Mongolian party-state admitted, “Cooperatives should be established organically by farmers with equal benefits, but instead they are mostly organized by the bosses.” In some cases, cooperatives were even organized by party-state actors, maintaining concurrent postings as cooperative directors, supervisors and secretaries (Zhang 2007: 148). It is possible to posit here that some of the reservations about cooperatives resulted from historical factors. In an era beginning with de-collectivization and the redistribution of land to rural households, cooperatives with significant government involvement might have been regarded as a step back into the Mao era.¹³³ Nevertheless, Zhang defended the party-state’s role, arguing that “under present conditions” it was “indispensible” (ibid. 149). He explained, “To rely just on rural households to organize spontaneously presents relatively substantial challenges, but by taking advantage of the county-township government’s superior resources,

¹³² Following their national representative survey of 157 FPCs, Jia and Huang reported that 28% of cooperatives had been initiated by government exclusively, 36% by both government and farmers, 21% by farmers only and 15% by agro-industrial firms (2011: 659). Yang and Hu (2010b) observed that dairy farmer attitudes toward cooperatives were not just related to government investment, but also to who had been placed in charge of farm management and how that decision impacted trust and the cooperative governance structure. They explained, “In general, cooperative leaders are arranged directly by higher authorities without any democratic selection process; without high quality and a dedicated spirit, they are unable to obtain widespread trust among farmers. Furthermore, their organizational and motivational capabilities are not strong” (ibid. 9). At the same time, they found that these leaders could influence their cooperatives’ governance structure, unfairly distributing profit or benefits among management and farmers. As a consequence, they added, ordinary cooperative members were likely to suffer “a serious crisis of confidence in the cooperative’s distribution of benefits, thereby withdrawing from the cooperative” (ibid. 8).

¹³³ Explaining this trepidation, Zhang wrote, “[M]any people express anxiety and are concerned that excessive administrative intervention will influence the healthy development of cooperative economic organizations, so much so that it will follow the same road as the disastrous policy of “people’s communes” (2007: 148).

cooperative economic organizations can be quickly and conveniently established” (ibid.). He added that “at the appropriate time” government should extricate itself from cooperatives, transitioning “from the ‘administrative leadership model’ to the ‘administrative service model’” (ibid.).

Following the melamine incident, farmers’ support for cooperatives declined even further—ironically, in direct opposition to the increasing interest coming from the party-state.¹³⁴ According to central policy, all milk stations and cooperative-operated milking parlors were required to employ a representative from the processor with which they were contracted. Processors subsequently revoked the management fee that previously they had paid out per kilo of milk sourced. As Yang and Hu (2010b) demonstrated in their study, this management fee was of critical importance to cooperatives, comprising members’ principal source of income. In many cases, the fee was the difference between economic success and failure.

In its report on rural reform for the 12th Five-year Plan, the Development Research Center of the State Council admitted, “Currently, the new models of farmer cooperative organization still function insufficiently” (2010: 5). It went on to hint at what this meant, imploring cooperatives to follow the Farmer Professional Cooperative Law and its core objectives of “farmer assistance, freedom of membership, equal privileges and democratic management” (ibid.). It also emphasized the role of dragonheads in “forming an alliance with industrialized rural household operations and guiding farmers’ market entrance” (ibid. 5-6). From the details presented above, it was clear that this alliance continued to be unstable with many farmers finding little incentive to join cooperatives and possibly upgrade farm practices. Their reticence often was linked to cooperative business models and management structures featuring significant party-state influence or presence. Ultimately, these factors slowed cooperative development in the dairy industry and limited the ability of dragonhead processors to integrate the value chain and increase controls over food safety.

¹³⁴ The survey conducted by Deng et al. revealed significant growth in government support for cooperatives over the last decade. The percentage of villages with policy support measures rose from 12.2% in 1998 to 52.1% in 2006 to 68.2% in 2008 (2010: 502).

5.5.2 *From one village, one company to “stealing milk”*

In November 2003, the Hohhot municipal government implemented a new policy that prohibited milk stations from selling to more than one company. Created under the pretext of “guaranteeing high quality milk” and orderly, “healthy” competition, this “one village, one company” (一村一企) policy essentially meant that rural space would be divided into territorial monopolies; local processors could then set milk prices however they wanted with little fear of farmers abandoning them for the competitor. Aware of the disadvantages and dangers of this exclusive arrangement, the policy implored companies and farmers to “set milk purchasing prices according to the principles of the market and quality-based price negotiations [以质论价].” It went on, “Both parties must abide by their contract, and should not, for whatever reason, push down grade and price [压等压价] or engage in adulteration” (Hohhot People’s Government 2003a). In some respects, this policy comprised a local party-state solution to the problem of integrating disordered links of the milk value chain and establishing an exclusive relationship between processor and farmer (i.e., captive governance). It, however, assumed an equal division of power and some form of partnership existing between the two groups of actors. It also implied a self-regulating mechanism to enforce this division of rural space and economic activity. At least in Hohhot, none of these were present.¹³⁵

Around the time that the Hohhot government issued the one village, one company policy, China was experiencing an incredible surge in milk consumption, particularly in urban coastal regions. Over the next five years, demand continued to rise, far surpassing the growth rate of the country’s milk supply. From 1996 to 2006, the amount of dairy products grew by approximately 24%, while the raw milk supply increased by only 14% (China Dairy Yearbook 2007). For many of the reasons presented in previous sections, processors and local government were reluctant to invest in building supply, focusing primarily on encouraging increased consumption. In their records, Company X admitted that the construction of new supply was relatively small, and that even those newly established offices had all been located in old supply areas

¹³⁵ Hohhot has one of the lowest raw milk prices in the country. In early 2007, it was 1.8 RMB/kg, while the average for northern China was 1.9-2.0 RMB/kg.

(Document #1). It also pointed out that poor genetics—an estimated 44% of the country's cows were deemed to be of “good pedigree”—and improper nutrition had adversely impacted milk yields. While the world average annual milk yield was 6 tons/head in 2006, China's was less than 4 tons/head. The US, by contrast, averaged 8.5 tons/head and Japan, 7.4 tons/head. One Company X manager remarked frustratingly how it seemed that “the more they invested in the dairy industry, the smaller the milk yields were.”

Beginning in 2006, this shortage was further compounded by developments in the international and domestic milk powder markets. Throughout that year and the next, international milk powder prices rose rapidly as a result of natural disaster, biofuel development and increasing oil prices. By the third quarter of 2007, they were 9.5 times higher than domestic prices, making production both for export and local consumption extremely attractive to Chinese enterprises. Accordingly, in the first seven months of 2007, imports dropped 33.31% while exports shot up by 138.66% (Document #1). Company X bemoaned the “global milk supply crisis” and its “resurrection of small spray dryers.” It estimated that 1,000 of these factories operated nationally and that new milk powder production lines had been installed in almost half of the domestic dairy companies. It contended that the situation had led to “fiercer competition over the milk supply and exacerbated the supply-demand imbalance.” It provided the example of one region where this shortage had been particularly acute; between 2006 and 2007, growth in milk supplied to the processor reversed dramatically, from 9% to -16% (*ibid.*).

Desperate to meet production targets, dairy processors began to adopt various strategies to maintain control over their milk supply. Company X, like many of its competitors, decided to “steal milk” (抢奶), or to purchase from farms and stations contracted to competitors and/or located in their established territories (formally or informally). In its records for the third quarter of 2007, it stated, “Facing a serious milk shortage in August and September, measures for stealing milk were formulated” (Document #24). As processors had made little effort in the past to establish a relationship with producers—beyond that of milk collection—it only took raising prices above that of competitors to convince milk station operators to break with the

“contracted” buyer.¹³⁶ Indeed, once a majority of the processors started engaging in this type of behaviour, contracts were already meaningless.

While processors tried to outbid one another and “steal” each other’s supply, domestic milk prices began to rise rapidly. At the same time, the substantial profit margins promised by the milk powder market allowed the “resurrected” enterprises to present farmers with even higher prices in order to capture their share of the supply. In a western region of the country where Company X purchased milk at about 1.9 RMB/kg, competing milk powder enterprises were offering 2.5 to 2.9 RMB/kg. Documents warned, “[They] are making considerable profits and pose a threat to our company’s milk supply” (Document #24). As a result, costs for the processors also began to increase. Citing prices’ “historic heights,” Company X’s finance division stated that cost targets were in “a state of warning” (Document #25).

In order to meet cost objectives, processors did not cut back on marketing expenditures, but rather opted to manipulate the market and squeeze farmers.¹³⁷ For example, in one province, Company X endeavoured to collude with two other competitors to lower prices jointly by 0.2 RMB/kg. This move, illegal under the PRC’s Price Law, called into question the party-state’s assessment of the industry as having fallen victim to a cycle of “vicious” (恶性) and “excessive” (过度) market competition.¹³⁸ Price fixing pointed to monopolistic behaviour, and not competition; indeed, the involved companies were not really competing at all. Ironically, for the same reasons that companies could flout the Price Law, they could also take advantage of one another. According to internal complaints from Company X, “[One of the competitors] did not keep its promise” (Document #24). That the competitor would

¹³⁶ Company X also offered large-scale ranch owners stock options in some of its affiliated operations in order to “safeguard the milk supply” and “increase a sense of belonging” (Document #1).

¹³⁷ Company X also changed some product compositions so that they could “lower procurement costs.” The ice cream division switched product ingredients from imported to domestic milk powder, indicating that the processor was more concerned about cutting costs than food safety (Document #32).

¹³⁸ In 2007, both the Price Law of China and the Interim Provisions on Preventing the Acts of Price Monopoly deemed horizontal price fixing to be illegal. Nonetheless, this “anti-competitive” behavior was widespread and rarely punished with more than a reprimand from the government. On December 29, 2010, the NDRC issued new regulations against price fixing (effective Feb. 2011), and in May 2011, Unilever was fined 2 million RMB under the new law.

break with the decision to collude was not surprising given that the province served as its headquarters and primary milk supply base. If challenged, it could rely on the full support of the local government.

As processors urgently sought to push prices back down, small-scale farmers faced rising feed costs. Specifically, the increases in oil prices and biofuel development in 2006 had translated not only to higher global milk powder prices, but to more expensive feed as well.¹³⁹ Thus, even though farm gate prices rose in the fight over a limited milk supply, farmers' profit margins were not growing as quickly, and in some cases, were shrinking. Jia et al. (2012) reported that in 2006, 40% of the country's dairy farmers were operating at a loss, and another 30% were merely breaking even. In addition, they discovered that even in the face of processors' growing demand for milk, some farmers decided to cull their herds, selling them for slaughter (*ibid.* 391). This decision would mean a reduction in the following year's milk supply, further compounding upstream production shortages. Meanwhile, the party-state was engaged in a concerted effort to control inflation in retail prices. As a consequence, Jia et al. explained, "Government officials across China were encouraging the large downstream dairy companies, who often were directly owned by or indirectly tied to the government, not to raise prices" (*ibid.*). In 2008, the central government went on to implement a price control measure requiring dairy companies to obtain permission from the NDRC before increasing retail prices (Gale and Hu 2009). In sum, upstream actors confronted a grim outlook as production costs rose and processors—unable to increase product prices and unwilling to cut other expenditures—sought to push down farm gate prices.

All along, small-scale farmers had very little say in the whole process. As one central agricultural official commented, "Companies and dairy farmers have no relationship whatsoever." Likewise, farmers could not rely on milk station operators to bargain on their behalf. As a result, they often chose to voice their complaints to the local government rather than to any of the persons with whom they actually conducted daily business. A manager with Company X insisted that the processor "had no other

¹³⁹ Part of a decade-long upward trend, from 2000 to 2008, Inner Mongolian corn, soymeal and wheat bran prices rose from 1.2 RMB/kg to 2.5 RMB/kg, with the steepest increase between 2006 and 2008 (Gale and Hu 2009: 9). This trend stood in marked contrast to that which dominated the 1980s and 1990s, where more abundant grain supplies had encouraged government to lift grain quotas and set up milk exchange programs.

option” but to ignore farmers, compelling the latter to turn to government “to call a meeting and negotiate prices.”

In May 2007, Hohhot responded to the situation by drafting policy calling for an increase in raw milk prices and management fees (Hohhot People’s Government 2007). Four months later, the State Council put forth a very similar policy requiring that “local people’s governments strengthen their direction over raw milk purchase prices, preventing milk prices from being too low and harming dairy farmers’ profits” (State Council 2007). In its records, Company X acknowledged this latter policy as the guiding principle for its plan to adjust milk prices in 2008 (Document #1). Earlier in 2007, the processor had been paying farmers in northern China 1.90-2.00 RMB/kg and in southern China, 2.20 RMB/kg. Management fees were equally low, at 0.18 RMB/kg for milk stations and 0.22 RMB/kg for raising zones. Large-scale ranches received a composite price of 2.44 RMB/kg. Originally, the processor had aimed to provide producers with a 20% return on investment, or approximately 3000 RMB per cow, equivalent to a price of 2.45 RMB/kg.¹⁴⁰ Their current prices, however, were barely above the breakeven point.¹⁴¹ The processor remarked, “[Prices] have not yet reached a 20% return on investment and profits are meagre; as a result, operations are unmotivated” (ibid.). For the following year, Company X planned to raise milk prices, but not enough to achieve the 20% objective due to cost considerations. Instead, it would keep prices around 2.22 RMB/kg.

While processors continued to lower prices by whatever means necessary, suppliers increasingly chose to sell their milk to the powder factory merchants who offered high prices and minimal quality requirements. Not surprisingly, Company X complained bitterly about this situation, stating, “Driven by high profits, the small domestic spray dryers collect low quality milk from dispersed sources at high prices, causing the milk supply market to enter a situation of unprecedented chaos and making the work of quality control difficult to undertake normally” (Document #1). Moreover,

¹⁴⁰ It is not clear why Company X set 20% as its target.

¹⁴¹ The breakeven milk prices calculated by Company X for northern farmers, southern farmers and large-scale ranches were 1.67, 2.04 and 2.23 RMB/kg, respectively. The breakeven management fees calculated for milk stations and raising zones were 0.13 and 0.15 RMB/kg, respectively (Document #1).

as collection trucks made their rounds, most “stolen milk” ended up mixed in with that which was legitimately acquired, “causing the overall percentage of quality milk to drop” (Document #24).

To contend with this “unprecedented chaos,” Company X sought government assistance. The processor wrote, “Government resources should be used to stop companies that are disordering the milk supply market” (Document #1). In Hohhot, the local government decided to renew efforts to enforce the one village, one company policy. As one processor manager recounted, it sent the PSB out to patrol the highways at night for “milk thieves,” or collection trucks sneaking into a competitor’s territory. Similar to the night raids on milk stations, processors and local police once again collaborated to “regulate” the dairy supply. At the height of this fight over milk, it would appear that villages and even larger administrative regions transformed into territories or turfs to be protected vigilantly—and even violently. A journalist with the Southern Weekend reported on an incident from 2007 where two Shaanxi milk collectors (a married couple) tried to procure milk from a neighbouring county and were repeatedly stopped, their transport destroyed and in one instance, physically assaulted (the wife’s arm was broken) (Xu 2008).

Following the melamine incident, central party-state legislation—for example, the “Regulations on the Supervision and Administration of Dairy Products Quality” that Wen Jiabao signed on October 9, 2008—did not include any reference to the one village, one company policy. In Hohhot, however, the local version of that particular piece of legislation did indeed reaffirm the territory policy, calling for all banners to ensure that “existing milk stations conform to the principles of one village, one company and appropriate scale” (Hohhot People’s Government 2008). In the case that a station did not produce a daily minimum of one ton, the policy required that “measures were adopted to concentrate cows within one village, making sure it reached more than one ton” (*ibid.*). In 2009-2010, the period during which fieldwork was conducted in Hohhot, many actors indicated that milk thievery was still rampant, continuing to present major problems for the local supply. This time, though, the situation was complicated by the fact that international dairy prices had reversed radically, falling to levels that made it increasingly attractive for processors to import milk powder wherever they saw a potential shortage and/or conflict over local raw milk prices. Accordingly, local party-state was even more reticent to argue on the farmers’ behalf for better treatment.

As evidenced above, these two key strategies of integration did not help to resolve the disconnect that existed between processors and producers. At their core, neither strategy possessed a mechanism for enforcing—or even incentivizing—cooperation and coordination along the dairy value chain. Instead, processors used cooperatives and the one village, one company policy as yet another means for monopolizing the milk supply without fundamentally altering the inequitable relationship with farmers.¹⁴² Even as the quality of milk declined, they continued to pursue this insular objective. An internal memo circulated in late 2007 implored Company X's division heads to deal quickly and effectively with the adulteration of the milk supply, warning of the tainted products' medical consequences and the “grave hidden danger” that food safety presented; it admitted, “Currently, there still exists the phenomenon where, for the purposes of fulfilling quantity and obtaining large supply as well as of guaranteeing production and market demands, large amounts of raw milk known undoubtedly to be unqualified have been put into use during the production process” (Document #2).

5.6 Conclusion

Under agricultural industrialization and modernization, the Chinese party-state had envisioned dragonheads linking rural farmers into markets and leading them to prosperity. *Sanhua* was supposed to advance this process, transforming farms into modern factories and farmers into modern workers. In the dairy industry, however, dragonhead processors fostered an unequal and unstable relationship with milk producers and provided them with little benefit. Focusing their resources on downstream marketing, they did not make the long-term investments needed to improve upstream activities, concerned primarily with short-term production objectives and reducing costs.¹⁴³ As a result, instead of “the countryside enriches one more family,”

¹⁴² Some value chain scholars indicated that certain governance mechanisms described by Williamson (1983), including “hostages” and asset specific investments, could prove counter-productive to supplier-buyer relationships. According to Wathne and Heide, “unilateral supplier lock-in may actually reduce, rather than increase, the supplier’s willingness to support the manufacturer (2004: 76). Here, the one village, one company policy illustrated how a “hostage” situation with unilateral supplier lock-in (i.e., farmers had no leverage or bargaining power) failed to improve processors’ control over milk production and its quality.

¹⁴³ As Huang (2008) observed in his study, this prioritization of low costs over upgrading technology served as a key guiding principle within many firms’ business models. Furthermore,

other catch phrases were often used to describe dairy farmers' predicament, including "hopeless for milk" (望奶兴叹) and the more colloquial rhyming version, "Those you hate, make them raise cows" (和谁有仇, 让谁养牛)."¹⁴⁴

Meanwhile, the local party-state intervened to protect its own interests in the sector, ultimately protecting and privileging processors. On the one hand, it did not want farmers completely out of the industry, as this would impact rural income objectives and aggravate short-term supply problems. On the other hand, it did not wish to harm processors' economic interests and/or force them to relocate to more favourable localities, as this would impact GDP figures and tax revenue; it would also disrupt those government organs and actors directly involved in the dairy value chain. Alluding to the challenge of balancing local interests, an Inner Mongolian agricultural official claimed, "If the processors aren't there, then the farmers have no way to sell their milk so we cannot formulate policies that make the companies want to leave."

Inevitably, the party-state and processors' actions rendered policy initiatives like *sanhua* useless. They fell short of providing any real incentives for scale, standardization and integration along the value chain; likewise, they failed to create any real controls for food safety. As a result, they resorted to what one industry expert termed, "night law enforcement" (晚上执法), a form of coercive and capricious control that stood in direct opposition to the tenets of *sanhua*. In the end, there was no exit for undesirable market players. Food safety violators were not properly punished, processors were protected and farmers were promised through policy and subsidies that they would eventually benefit from dairy.¹⁴⁵

he argued that this principle often superseded concerns about food safety, stating, "...in China many of the quality problems were not due to lack of knowledge. Chinese firms knowingly and deliberately committed fraudulent business practices in order to skimp on costs" (ibid. 290).

¹⁴⁴ "Hopeless for milk" (望奶兴叹) is a play on the 4th century BC Daoist author Zhuangzi's famous phrase, "to gaze upon the vastness of the ocean and lament one's inadequacy" (望洋兴叹), in his work *Qiusui*.

¹⁴⁵ In her research on the characteristics of "Chinese privatization," Cao detailed extensively the lack of "bankruptcy-induced market exits" in the country's state sector (2000: 60). Here, this thesis posits that even in cases where a processor was not state-owned, it was protected like one due to dairy's role as a strategic industry for national and local policy objectives.

Research evidence from other sectors revealed problems closely resembling those of the dairy industry, suggesting that China's agricultural modernization and the provision of safe food faced fundamental and systemic challenges.¹⁴⁶ In response to these issues, some researchers urged changes in value chain models. For example, in the country's beef industry, Waldron, Brown and Longworth (2010) proposed a shift toward mid-value chains characterized by specialized production, group marketing and centralized processing. Specifically, they recommended, "Rather than seek to replace small-scale slaughter households and beef traders with modern structures, measures should be taken to assimilate these chain actors into more centralized and hygienic structures, such as (collective) designated slaughter areas and better-inspected wet markets" (ibid. 486).

Evidence from this chapter, however, demonstrated that at least for dairy, mid-value models like raising zones and cooperatives did not enhance chain governance.¹⁴⁷ Although party-state interventions in the value chain (i.e., the policies under *sanhua*)

¹⁴⁶ In China's beef industry, Brown, Longworth and Waldron (2002) discovered that efforts to centralize slaughter facilities had not resulted in the elimination of small-scale slaughter households. They explained that due to low costs and intense competition, "[slaughter households] are unlikely to use these centralized facilities unless there are financial benefits for them to do so or unless they are coerced to do so" (ibid. 281). They also stated that the sector's large, high-value abattoirs did not appear to comprise financially sustainable operations—a situation similar to dairy's mega-scale farms. In a later study, the team noted that abattoirs did not enforce compliance with national quality standards; instead, they used "in-house, subjective" grading systems and engaged in grade-price discounting (压级压价) to shape marketing practices (Waldron, Brown and Longworth 2010: 483-484). Moreover, they asserted that contract breaching was commonplace, remarking, "Formal contracts systems break down due to the conduct of all actors in the supply chain" (ibid. 484). In their survey of 329 Shandong tomato and cucumber farmers, Huang et al. (2009) also observed virtually zero marketing activity based on either contracts or pesticide inspection routines. With regard to the latter, they declared, "Not one farmer that we ever met in any of our interviews or surveys had ever had his tomatoes or cucumbers tested. In fact, when we interviewed traders in wholesale markets, we likewise never found even one person who said that their tomatoes or cucumbers had been tested" (ibid. 5).

¹⁴⁷ Other research on China's cooperatives also indicated that this particular mid-value model did little to improve quality controls. In a representative survey of 157 FPCs across China and sectors, Jia and Huang (2011) found that agricultural FPCs led to increased contract use; nevertheless, they noted that these cooperatives seldom utilized contracts to set and enforce process and product standards. Furthermore, they discovered that while FPC branding increased contracts with buyers, public certification and competition decreased contract use.¹⁴⁷ Concluding their study, Jia and Huang wrote, "...contractors do not have better control over production than through open-market coordination, and the control transferred across stages is usually minimal. China faces challenges to coordinate the agrofood chain for offering safe food" (ibid. 665).

aimed to shift governance of upstream milk production from market to various network forms to hierarchy and strengthen food safety, they fell short of accomplishing this goal. Even where the industry appeared on the surface to reflect integration, chain coordinators were unable to maintain the level of control over product quality that these forms implied. This was due to two key factors: 1) the realities of upstream dairy production diverged significantly from party-state and industry demands, and 2) the enforcement of food safety controls was inconsistent and partial as a result of party-state activities within the dairy value chain. In sum, it would appear that resolving food safety challenges in the dairy industry was not just a question of finding and implementing the correct value chain model. As this thesis contends and the next chapter seeks to illustrate, state-business interaction precipitated *sanhua*'s adverse outcomes and prevented guarantees for safe milk. Operating within and through this institutional environment, neither government nor industry could fully control the course of agricultural modernization and food safety.

6 Chapter Six: The Fish-Water Relationship (鱼水关系)

6.1 Introduction

On July 3, 2005, in Tumotezuoqi, Tabusai village, in the inner courtyard of General Ulanhu's former residence, twenty-five employees of Mengniu stood facing the CPC flag that hung from the eaves. With their right arm raised in a fist, they began to recite, "I volunteer to join the Communist Party of China, to support its guiding principles, to abide by its constitution, to carry out the obligations of a party member...." As the new inductees pledged their allegiance, more than 200 older party members looked on in a ceremony also marking the 84th anniversary of the CPC and a tribute to General Ulanhu, a communist revolutionary hero, founder of the Inner Mongolia Autonomous Region and former vice president of China. Among those attending were the processor's top executives as well as the heads of the Helinge'er county party-state apparatus. Mengniu president and vice-party secretary Niu Gensheng addressed this joint gathering of state and business, declaring, "Mengniu's past and present development have been possible only with the steadfast insistence on party leadership and on the party-state's 'fish-water' relationship" (Employee Handbook).

With these words, Niu Gensheng confirmed that the party-state had been absolutely critical to the processor's success and rapid rise. Indeed, the initial takeoff of the Chinese dairy industry in the late 1990s and early 2000s owed itself chiefly to the central party-state and its national development objectives. In the countryside, it positioned dragonheads as key players in the campaign for agricultural industrialization, relying on the latter to drive the modernization of rural production. Meanwhile, in the cities, it assisted processors in building demand quickly, promoting dairy as a natural, nutritious product vital to improving individual and national health. As the previous chapters demonstrated, the campaign to increase urban dairy consumption was largely successful; the industrialization and modernization of production, however, faced substantial difficulties, a divergence in outcomes that spelled supply-demand imbalances and eventually saw a major food safety disaster.

This chapter delves into the structural problems behind the challenge of regulation in the dairy industry. Dividing the fish-water relationship into three components, it examines how different activities of the party-state ended up inside of

the value chain and/or significantly influencing its development and regulation at the local level. It first explores the political and economic incentives that simultaneously motivated local cadres toward industry development and encouraged their disobedience. It then details how an important institution—industry associations—was unable to operate as an independent external authority and instead, further entangled party-state and business interests. And last, it moves inside processors to examine an emerging form of internal corporate governance that used party discipline to pursue company interests with unfortunate consequences for food safety.

6.2 Cadre compliance and defiance

As detailed in prior chapters, local party-state played a key role in the implementation of national objectives regarding dairy. To understand why certain decisions were made over the course of the industry's development, it is necessary to explore the political and economic incentive mechanisms that influenced and shaped local cadre behavior. This section examines these two types of incentives and then describes how cadres' efforts to "comply" often ended up defying the original objective.

6.2.1 Political incentives: the cadre evaluation system

The cadre evaluation system (考核制度) comprised a reform era effort by the central party-state to secure local compliance with national initiatives, tying political careers to a number of "hard" and "priority" objectives, such as production targets, tax revenue and family planning (Edin 2003). While superiors were allowed to adjust their subordinates' evaluations to local circumstances, they had to do so in such a way as to guarantee compliance with overall objectives (O'Brien and Li 1999; Whiting 2004). With appointment and promotion cycles occurring every two to four years, it effectively created cadres focused on boosting GDP figures within the shortest possible time—hence, the country's astounding growth pace (Liu, Pei and Woo 2006). At the same time, it de-prioritized other aspects of development. For example, lawfulness and environmental protection often were sacrificed in the pursuit of other more heavily

weighted objectives.¹⁴⁸ Before 2012, food safety was not even included as a criterion in local party-state evaluations.

In terms of the dairy industry, development targets were split among a number of different departments and agencies. For instance, cadres under the Ministry of Agriculture were responsible for farmers and upstream development while those with Ministry of Light Industry and Information and Ministry of Commerce focused on processors and the downstream. At the municipal level, however, the city administration (i.e., the party secretary, mayor and other “leading cadres”) held the most power and authority. Given that their primary responsibilities entailed raising production and tax revenue as well as guaranteeing the non-staple food supply, these officials often concentrated on processor development. In other words, they paid more attention to building production facilities and large-scale ranches than to investing in the improvement of small-scale farms.¹⁴⁹ A national dairy association leader explained, “[The mayor] will thus choose to listen to and converse with the commerce bureau, hoping to support the industrial side more. In just one year, he can have a factory, have production and have inaugurated a large local project.”¹⁵⁰

This preference for industrial (i.e., processing) over agricultural investment served as a source of tension among different local government bureaus. For example, when a national processor was looking to expand large-scale production into a particular area of Shandong province, a conflict arose between the city administration and animal husbandry bureau. While the latter wanted to protect small-scale farmers’

¹⁴⁸ The *Economist* article, “Suppressing dissent,” cited an example from one Chinese township where economic development accounted for 40% of leading cadre evaluation points while lawfulness only 10% (Economist 2012). Using older data, Whiting found that at the county-level, in 1989, objectives related to education received 9 points while industry and agricultural production received the most emphasis with 33 and 30 points, respectively (2004: 107).

¹⁴⁹ As a result of the 1994 tax reform and fiscal decentralization, local governments were largely responsible for their own budgets. In 2006, with the elimination of all agricultural taxes, they began to rely more heavily on enterprise for local tax revenue—despite an increase in central transfers to prevent budget deficits. The national dairy association leader also pointed out the effect of this measure on local party-state development priorities, stating, “The mayor’s good results come from taxes. And so now that the agricultural tax has been cancelled, the farmers have absolutely no relationship with the government.”

¹⁵⁰ Sun and Wong (2002) also observed that large-scale projects were favored due to the cadre evaluation system and efforts to raise local tax revenue.

relationship with local companies as well as guarantee high raw milk prices, the former was more concerned with boosting investment and collecting taxes. A similar incident occurred in Heilongjiang, where the mayor himself invited a national processor to develop locally even though the company was offering a farm gate price deemed too low by other bureaus. In both cases, the mayor's office eventually succeeded. One manager with a multinational dairy brand operating in China commented, "You only need the city administration to ok the project and then everyone else works with you."

In the case of Hohhot, policy issued by the municipal government as part of its "Milk Enriches the City" campaign specifically requested officials to "see through the firm implementation of every policy project for the development of the dairy industry, inserting the strict management and responsibility of dairy industry objectives into the evaluation system criteria of leading cadres at each level of government..." (Hohhot People's Government 2003b). It would appear that this inclusion of dairy objectives in local evaluations has been maintained. The 2010 evaluation criteria for Tumotezuqi, a county-level banner under Hohhot's jurisdiction, included both general economic indicators as well as objectives related to specific dairy projects.¹⁵¹ For example, it called for the expansion of its Jinshan industrial zone through the development of the high-end dairy industry.¹⁵² It also urged the strengthening of Chilechuan's milk supply base for "national-level quality products" (Sun 2011).¹⁵³

6.2.2 Economic incentives: on government subsidies and investment

In addition to the political incentives provided by the cadre evaluation system, the central party-state attempted to motivate the lower levels toward particular development goals using economic incentives, such as subsidies and government-led investment. As detailed in chapter three, it initially hoped to stimulate the growth of the dairy industry by channeling funds into dragonhead processors—a decision which

¹⁵¹ There were nine overall economic indicators, including local fiscal revenue, rural and urban incomes, value of scaled-industry and service sector, GDP and GDP growth, consumer sales volume, local and foreign investment and fixed asset investment.

¹⁵² Yili's operations are heavily concentrated in Jinshan.

¹⁵³ This information was obtained from copies of the 2010 Tumotezuqi evaluation targets that were included in the master's dissertation of a student at the University of Inner Mongolia.

would lead to the industry's reverse development and the processors' domination of the value chain. Later, however, recognizing processors' reluctance to transfer any benefits on to farmers, it began to provide an additional range of subsidies directly targeting the milk supply and farmer livelihoods. To ensure local implementation, it often allocated a portion of the financial responsibility to the provinces, municipalities and counties (with poorer, western regions receiving larger central transfers). Some of these programs included purchase subsidies for dairy cattle, feed, genetics and agricultural equipment as well as financial assistance toward the construction of large-scale, consolidated milk production and toward the maintenance of an agricultural insurance scheme.¹⁵⁴

One key purchase subsidy was that provided under the Ministry of Agriculture's dairy herd improvement program (DHI). An important component of the central party-state's 2005 "No. 1 Document," the program aimed to increase milk yields and lower herd death by expanding farmers' access to "superior quality" pedigrees.¹⁵⁵ In this pursuit, it subsidized the purchase of frozen bull semen by provincial animal husbandry bureaus, which in turn sold the reduced cost genetics to local dairy farmers (approx. 10-15 RMB cheaper depending on the breed). From 2005 to 2008, the central party-state provided a total of 455 million RMB in funding for the DHI.

Another important subsidy program was implemented as part of the effort to consolidate small-scale dairy farming and augment the nation's milk supply. In September 2007, the State Council announced that it would begin to offer subsidies for the construction of large-scale, standardized raising zones and ranches. The following

¹⁵⁴ In addition, the central party-state directly invested in specific local projects. For example, in 2010, using funds earmarked for "national industrialization operations," it contributed 300,000 RMB toward the construction of a 500-head milk production center in Dengkou, Inner Mongolia. The provincial party-state contributed 100,000 RMB while the municipal and county levels each provided 10,000 RMB. In another 2010 project, the central and provincial party-state jointly awarded 7 million RMB to upgrade and standardize feed and sanitation equipment at two large-scale farms and two cooperatives for the purpose of popularizing these new technologies in concert with the county animal husbandry bureau. The municipal level provided 1.4 million RMB, and the county, 5 million RMB (National Dairy Cow Science and Technology Office 2010). Many of these direct investments were located in impoverished areas—Dengkou is a "nationally-designated poor county"—and/or served as a demonstration center for new advanced technologies, largely explaining the greater proportion of central funding.

¹⁵⁵ The "No. 1 Document" is the CPC Central Committee and State Council's first policy announcement dealing with agricultural issues (especially *sannong*) for that particular year. No. 1 Documents were issued for the years from 1982 to 1986 and from 2004 to 2012.

year, the NDRC and Ministry of Agriculture allocated 200 million RMB toward this scalization and standardization campaign. Specifically, they outlined a plan whereby 200-499 head farms would receive subsidies of 500,000 RMB, 500-999 head farms, 1 million RMB and 1000 and above head farms, 1.5 million RMB. In contrast with other subsidy policies, they did not require a local contribution.

In 2004, the central party-state began to experiment with the establishment of an agricultural insurance scheme where farmers cultivating essential crops (i.e., corn, rice, wheat, cotton and oil-bearing seeds) and livestock (i.e., dairy cows and pigs) would be compensated for economic losses incurred as a result of natural disasters and disease.¹⁵⁶ Three years later, the State Council officially piloted the scheme in six provinces (including Inner Mongolia), and by 2009, the program reached a total of 19 provinces. In the interior regions, the central party-state covered 30% of the insurance fee for dairy cows, while local party-state, enterprises and farmers shared responsibility for the remaining portion.¹⁵⁷

Following the melamine incident, all three of these programs received a substantial boost in central investment. In 2009, the Ministry of Finance allocated 260 million RMB in subsidies for the dairy herd improvement program, an increase of 20 million RMB over the previous year. Similarly, between 2008 and 2009, the NDRC and Ministry of Agriculture more than doubled funding for the construction of standardized large-scale raising zones and ranches, from 200 million RMB to 500 million RMB. In 2011, in a slightly delayed but most likely related move, the Ministry of Finance significantly raised the proportion of central funding for dairy cow coverage under the agricultural insurance scheme from 30% to 50%.¹⁵⁸ The overall increase in post-

¹⁵⁶ Hohhot was one such city that experimented with this scheme. In 2004, it issued policy for setting up a “dairy cow risk fund,” with money coming from the municipal government and its nine counties, from Yili and Mengniu and from a 0.01 RMB/kg fee placed on all raw milk transactions (Hohhot People’s Government 2004).

¹⁵⁷ Before 2011, the east received no central transfers for dairy cows. Inner Mongolia subsequently divided this remaining portion as follows: province (40%), municipality and county (15%) and individual households and enterprises (15%) (Inner Mongolia People’s Government 2010).

¹⁵⁸ From 2007 to 2009, the program was still in pilot phases. Also, the extent of the damage to the national cattle population following the melamine incident and the 2009-2010 foot-and-mouth epidemic was probably not immediately obvious. For that year, no other crops or

melamine funding highlighted the central party-state's determination to rectify the troubled industry and especially, its prioritization of the milk supply. The decrease in local fiscal responsibility under the agricultural insurance scheme also implied the center's acknowledgement that the localities had been either unwilling or unable to implement this program effectively.

At the provincial level, it would appear that, at least in policy provisions, these economic incentives managed to secure a certain measure of compliance. Even in cases where a subsidy's local contribution was not fixed, the provincial party-state declared that it would match central funding, hoping to make projects more attractive to private investors and ultimately, to bolster their own performance evaluations. For example, in 2009, the Inner Mongolian party-state issued its "Plan for the Autonomous Region's Standardized and Scaled Dairy Cow Ranch (Raising Zone) Construction," aiming to match central funds 1:1 and build 2,000 500-head standardized raising zones in four years. As subsidy funds would only cover 10% of the total investment needed, it called on Yili and Mengniu to build and/or invest in 800 of the raising zones, enabling the processors to meet provincial mandates and establish control over 50% of their milk supply (central policy only required 40%). The remaining 1,200 zones would receive funding from other public and private investors (Inner Mongolia People's Government 2009).

Municipal policy also reflected national and provincial economic incentives in terms of their general targets, i.e., herd improvement, scalization and agricultural insurance, likewise increasing the amount of funding for these programs post-melamine.¹⁵⁹ Here, however, the municipalities enjoyed significant latitude in program implementation. They decided which subsidies and land would be designated to whom

livestock received such a generous central subsidy and, in another unusual gesture, it was offered to all regions of the country, coastal and interior.

Inner Mongolia divided the regional responsibility as follows: municipality (5-15%), individual households or enterprises (15%) and province (the remainder) (Inner Mongolia People's Government 2012).

¹⁵⁹ For example, in 2007, Hohhot provided every new raising zone or ranch with 500-1000 dairy cows with 200,000 RMB. The next year, it allocated a similar quantity of money but for farms with far fewer cows, offering 300,000-500,000 RMB for projects with 300-500 heads. By 2010, it was extending subsidies of 300,000 RMB and 1 million RMB for 100-head and 1000-head farms, respectively.

and for building what projects as well as how much relevant counties and business partners would be required to contribute financially. In return, processors and other dairy enterprises offered tax revenue, production, rural employment and better cadre performance evaluations. The ensuing negotiation fortified dependencies among local party-state and business actors, at times undermining the programs' original objectives.¹⁶⁰ The following section takes a closer look at this process.

6.2.3 *The phantom dairy industry*

Given these political and economic incentive mechanisms, it is not surprising then that more than a few cadres tried to manipulate performance evaluations and/or capture subsidy funds. As a consequence, the local levels were rife with misreporting and “face projects” (形象工程), development that merely enhanced the image and portfolio of local party-state officials but was never intended to function normally. This phenomenon seemed to be particularly pervasive in dairy, an industry with slow upstream returns and requiring a long-term outlook on development. To illustrate, one national association leader provided the following scenario: “Ok, the two of us are mayors. We want achievements. How should we get them? The dairy industry is too slow and in four years, our term will end. We cannot wait so how do we turn out good results? We just don't think about objective reasoning or whether they are genuine or false accomplishments.” These “false accomplishments” could be found in all aspects of China's dairy industry, from the farms to genetics to the milk itself.

For example, local officials frequently sought shortcuts to achieving dairy production objectives and demonstrating to the central party-state that they were on board with the campaign for scalization and modernizing the industry—particularly following the melamine incident.¹⁶¹ In some cases, they lied outright, outlining plans to build mega-scale farms but never actually realizing them. A national association leader detailed the typical sequence of events, “They make an agreement, give the land, cut the

¹⁶⁰ Moreover, it further incorporated business actors into policy processes and institutionalized them as key components of party-state agricultural development programs. Processors were even referred to directly by name in policy documents.

¹⁶¹ Indeed, in the months following the melamine incident, every major processor announced that it would be building a whole new series of mega-scale, state-of-the-art farms under direct ownership of the company or one of its affiliates.

red tape, have a celebratory ceremony and then a couple of years later you go to see the farm and nothing is there.” A manager with a dairy farm construction firm confirmed this phenomenon, stating, “The local government says they want a 10,000 head ranch so that they can have a big name [大名], but in reality they won’t build it.” One processor executive criticized the mega-scale farm campaign, “It is more talking than doing. The 10,000-head ranches are a meaningless concept. They only represent an idea for attracting attention.”¹⁶²

In other cases, the local party-state collaborated with processors to build mega-scale farms that from the outside looked advanced and fully functional. In contrast with their appearance, many of these so-called 10,000-head ranches barely contained half that number of cows. The farm contractor explained, “The government has this requirement for a 10,000-head ranch, but perhaps there is neither enough land nor funding. So farms that only reach 6,000 cows, they will go ahead and count as 10,000-head.” For processors, these ranches served the dual purpose of maintaining good relations with officials and projecting a particular image to consumers about the brand’s seemingly large-scale, high-tech and safe milk supply. One ministry official commented on this deception about the milk supply, stating, “Maybe some big companies took you to go see these nice places and you think, ‘Wow!’ In reality, however, very few [farms] are like this. They are just there for people to see, for the company to advertise itself. It is definitely not there for genuine production.”

In this win-win situation for local party-state and processors, both actors benefited from the fact that these half-empty farms required much less investment than what was most likely declared to the public. Meanwhile, under the scalization campaign, there were generous subsidies for the construction of large-scale dairy projects. As one industry expert detailed, “The whole thing with the projects is that it is just people following the money. There are subsidies available and so they write-up the project, and its got all the planning and benchmarks in there, but whether they achieve any of those is irrelevant.” Often, these investors were opportunists and not dairy specialists; they

¹⁶² O’Brien and Li also observed similar types of image projects, or their words, attempts at “noteworthy achievements” (1999: 175). They explained that subordinate agencies were often compelled to allocate a portion of their own funding toward the projects, placing increased strains on local budgets.

regarded the projects solely as a chance to earn the difference between the subsidized price and the selling price a few years down the line when the dairy market recovered.¹⁶³ In addition to subsidies, land transactions also became a space for capturing funds. One official claimed that the local party-state and companies often “built relationships in the gray area,” and particularly, through bribes and cutbacks furnished during the transfer of land to be used for large-scale dairy projects.¹⁶⁴

This practice of manipulating targets and capturing subsidy funds has impacted the genetics side of the industry as well. Under the DHI program, the provinces were tasked with inviting bull stations nationwide, both state-owned and private, to participate in a bidding process. Prior to the DHI’s introduction, some of the country’s more successful bull stations (e.g., Beijing and Shanghai) had been buying up and consolidating smaller ones while upgrading the overall quality of the genetics market. The tendering program halted this consolidation trend, and as an industry expert asserted, “set back genetic improvement in China.” According to the rules governing the bidding, the provinces were directed to take milk yield as the most important selection criterion, followed by milk composition (Ministry of Agriculture 2005). It was widely claimed, however, that many bull stations fabricated this data in hopes of securing a higher percentage of government tenders. As the Ministry of Agriculture evaluators did not require parent verification or recessive trait testing, bull stations could pass off poor genetics as high quality and healthy; in other words, no one tested to make sure the bull being marketed and the genetic material were related, and that the latter did not possess traits that could harm the next generation of cows.

¹⁶³ Chapter five also discusses these investors. A Ministry of Agriculture official pointed out, “You should look at the background of those who invest in these large-scale farms. Not even a handful of them are specialists. Most specialists do not dare to get involved because they know that the risk is too large.” Yang (2009) observed similar investment behavior in the pharmaceutical industry where lax drug certification had created low barriers to entry and a rise in non-expert investors. He wrote, “Seeing the ease with which one could obtain approvals to produce copies of existing drugs and make money, even some real estate developers decided to shift gears and get into the pharmaceutical industry, though their sole purpose for entering the industry was to make quick profits and they didn’t tend to have a long-term vision” (ibid. 151).

¹⁶⁴ The 10,000-head farms could entail enormous sums of money. For example, one 2010 project in Heilongjiang cost a total of 350 million RMB for the land, farm construction and purchase of cattle (National Dairy Cow Science and Technology Office 2010).

The widespread manipulation made distinguishing quality genetics a difficult task. Consequently, as an industry expert described, the national index of bull pedigrees compiled by the Dairy Association of China (DAC) using data submitted by local DHI programs was also “very questionable.” One of the DAC’s chief geneticists apparently quit over perpetual problems in data quality. According to a peer, “he couldn’t take it anymore.” He explained:

[The chief geneticist] told me he always wanted to be able to publish a list on the genetic merit of all the bulls in China but that he can’t publish the list because he knows it’s wrong. The two biggest stations, Beijing and Shanghai, actually have programs in place with reasonably reliable data. When he does his calculations, though, they don’t have any bulls at the top of the list because the information that is coming in from all these obscure places is just garbage that they put into a computer so that they can get their animals near the top. Nobody seems willing to fight back.

Company X also complained about the impact of poor genetics on milk yields, asserting that the need for dairy herd improvement was becoming “more and more pressing.” It stated, “At present, the whole country’s dairy cow pedigree is poor,” underscoring high costs and “inferior government regulation” as key factors. Specifically, it lamented that “the implementation of current government policy is not thorough” and “the level of supervision is weak” (Document #1).

The dubious genetics were only further encouraged and propagated through protectionist behaviour by the provinces. National regulation stipulated that no more than 50% of total bids could come from within the province in an attempt to prevent inbreeding and encourage competition (Ministry of Agriculture 2012). Nevertheless, according to the manager of one company involved in the tendering program, many provinces “put their own twist on things” and gave the entire 50% to the state-owned provincial bull station in an effort to keep locally as much revenue as possible.¹⁶⁵ As such, he argued, the DHI tendering served as “a cash flow towards stations that should

¹⁶⁵ Some provinces dictated their purchase requirements while others included requests from the counties. In detailing its experience in Inner Mongolia, one private company commented that it had “minimal success” there, or 1% of its total government tenders for that year. Moreover, it described the region’s bid process as “very top-down.”

have been out of business a long time ago.” Another genetics company manager complained that artificial insemination agents sent out to assist farmers were refused licenses if they did not agree to cooperate with the local government and promote the state-owned bull stations. Ironically, the very initiative meant to improve the quality of the country’s dairy herd and boost milk yields achieved the exact opposite, as local party-state used bull stations to divert central funds.

While poor genetics perpetuated low milk yields, phantom farms did little to improve the country’s raw milk supply, leading many to suspect the industry’s extraordinary growth figures. One expert stated, “The reality is so different from the numbers.” Others contended more boldly that the numbers were indeed impossible given the state of the Chinese dairy industry. An official explained, “This year’s dairy development numbers, did you see them? Something like 31 million tons of milk were produced, including domestic milk. So the Ministry of Agriculture slapped a number on its forehead and announced that there were 9.7 million dairy cows. Where are these numbers from? They are reported by the provinces, which receive them from each locality and municipality. And do you think these numbers are correct? No, they are all fictitious.” In light of figures like dairy consumption and product sales that seemed to verify the numbers’ validity, he added, “But these factories are not really using raw milk to produce goods. They are taking imported milk powder and making recombined milk products. Right now, what factory doesn’t have equipment for recombining milk powder? So I personally think whatever numbers the localities are reporting, there is actually not that much.”

If many of China’s dairy products were in fact made with recombined milk powder, then much more powder must have been entering the country than that reported by customs. As the official averred, “Whether you are looking at customs’ statistics or the amount of smuggled milk powder, there is no one who can confirm these calculations. With smuggled goods, you can never find the true figures.” This would seem to explain how an industry with such low milk yields (i.e., 3-4 tons/head) was able to meet domestic demand before global milk prices surged in the years leading up to the

melamine-milk incident. A processor executive confirmed, “China’s dairy industry has developed rapidly because it can rely on imported milk powder.”¹⁶⁶

The level of misreporting and projects for capturing subsidies in the dairy industry raised some important questions about the efficacy of the country’s economic and political incentive mechanisms. While local cadres’ actions demonstrated “compliance,” they eventually damaged the industry’s overall development rather than strengthening it. More precisely, they diverted critical resources away from those chain actors who needed them most and aggravated supply-demand imbalances, a major contributing factor in the milk adulteration. One Ministry of Agriculture official lamented, “Honestly, from top to bottom everybody just wants face, no matter if the ordinary people live or die.” In light of this predatory behaviour, several studies argued that while incentive mechanisms did in fact encourage some disobedience, they ultimately served to integrate cadres into the country’s prevailing power structures (Edin 2003; Shevchenko 2004; Whiting 2004; Landry 2008; Pieke 2009). Shevchenko (2004) averred that the combination of economic and political incentives in the Chinese administrative system created a strong party-based organizational logic that mitigated the negative effects of corruption and rent-seeking. Whiting contended that the evaluation system’s competitive framework would compel cadres to expose their colleagues’ misbehaviour so that they themselves might receive a better evaluation and/or promotion (2004: 118). Landry (2008) pointed out that the accelerated turnover of mayoral positions (approx. 2.5 years) prevented the development of “local caciques” that flouted national objectives for their own benefit. He added, however, that long-term “qualitative changes” would be a challenge given the shortened mayoral terms and evaluation criteria (ibid. 114-115).

Taken together, these studies would seem to indicate that misreporting and face projects did not necessarily translate into an intention to subvert the system (as in Rev’s [1987] understanding of socialist Eastern Europe), but instead comprised further evidence of cadres’ behaviour as center-seeking. Nevertheless, at least in the case of the dairy industry, center-seeking behaviour primarily facilitated rapid, short-term growth

¹⁶⁶ As chapters four and five pointed out, this dependence on imported milk powder had its disadvantages as well. When global milk prices surged in 2006-2007, processors had to cut back on imported milk powder while facing competition from new domestic powder producers over the raw milk supply.

and did not serve to strengthen state regulation and the country's food safety system. In terms of food safety, the central and local party-state exhibited little integration or coordination.

6.3 On industry associations

As an important civil society institution, industry associations might have represented interests beyond those of the party-state and business (such as those of farmers and consumers), possibly strengthening regulation and preventing some of the problems described above. Unfortunately, China's two key dairy-related associations did not operate as independent external authorities, but rather further contributed to the entanglement of party-state and business interests. The following two sections examine the role that these associations played.

6.3.1 Welcome to the leaders' playground

The country's two key dairy-related associations are the China Dairy Industry Association (CDIA) and the Dairy Association of China (DAC). Established in 1995 under the purview of the Ministry of Light Industry and Information, the CDIA was tasked with linking party-state and downstream actors, such as processors, retailers and consumers. Four years later, in 1999, the Ministry of Agriculture merged two former dairy cow and farming associations to form the DAC, intending to provide new links among party-state, processors and the upstream end of the dairy value chain, i.e., farmers and milk station operators. While both associations functioned at the national-level as non-profit "social organizations," the DAC also counted local dairy association leaders among its membership, more or less vertically integrating the national office and local affiliates. For example, Inner Mongolia possessed a provincial association (DAIM) as well as several municipal level organizations in areas where dairy was a major industry, such as in Hohhot, Baotou and Ulaanchab.

According to the State Council's 2007 "Recommendation for Promoting the Dairy Industry's Sustainable and Healthy Development," the associations were expected to serve as a "bridge between the government and enterprise and dairy farmers," enhancing coordination, service, rights protection and self-discipline within the industry (State Council 2007). Following the melamine incident, the party-state increasingly stressed the importance of associations as regulatory authorities. In its

October 2008 “Dairy Product Quality and Safety Supervision and Management Regulations,” the State Council directed, “Relevant industry associations should strengthen industry self-discipline and drive the construction of honest and sincere industry, guiding and regulating the operations of dairy farmers, raw milk purchasers, dairy products enterprises and retailers according to the law” (State Council 2008).

In contrast with major dairy associations elsewhere in the world that received funding through a small fee on raw milk transactions, the CDIA and DAC were funded by their affiliated ministry as well as through membership fees, advertising and company sponsorship. Meanwhile, the associations’ leadership was principally comprised of retired or near-retirement party-state officials along with the current heads of the country’s largest dairy brands, prominent academics and other industry executives. One processor executive recounted, “There are about to be some retired dairy officials and so [the government] asks, ‘Is there no place for them to go?’ Ok, let’s put them in the associations.” The consumer advocate also highlighted this practice, remarking, “For government leaders nearing retirement, the associations are their playground [乐园].”

For example, before arriving to the helm of the DAC, the association’s leader had served as vice-party secretary of Heilongjiang province as well as vice-minister and vice-party secretary of the Ministry of Agriculture and vice-chief of the State Council Leading Group on Poverty Alleviation. The head of the CDIA, likewise, had served formerly in his association’s superior authority, working for over a decade in the Ministry of Light Industry and Information. Other association members included various representatives of party-state, industry and academia. For instance, the Inner Mongolian delegation in the DAC’s permanent council consisted of the chairmen of Mengniu and Yili, Baotou vice mayor, Hohhot vice-party secretary, DAIM secretary-general and the vice-chief of the provincial agriculture and livestock department.

Both the systematic placement of near-retirement officials in associations and their particular membership composition (i.e., party-state and business) were replicated at the local level as well. In 2000, Inner Mongolia’s former vice-chairman was appointed as the director general emeritus of the DAIM. The head of the provincial agriculture and livestock department became the association’s director general, the current chairman and president of Yili, its vice-director general, and the former director

of the provincial DHI station, its secretary general. In 2006, this exact selection of association leadership was repeated again, with the president of Mengniu invited to join as an additional vice-director general. Similarly, the director general of the Beijing Dairy Association was also concurrently the vice secretary of Sanyuan, the major dairy processor owned by the Beijing municipal government.

The associations' mix of party-state and industry leaders impacted significantly which interests they represented and protected. The head of one provincial dairy association acknowledged, "Most of our members are company leaders so you can imagine whom we favour. We should be helping the dairy farmers, but honestly speaking we are mostly supporting what the companies want." Indeed, they rarely intervened on behalf of small-scale farmers, particularly when it came to negotiating raw milk prices. The farmers interviewed during fieldwork confirmed that they had not received any assistance—technical or otherwise—from their local associations. When asked about what types of services had been provided, one farmer replied, "You should go put your questions to [the head of the municipal dairy association]. He would know."¹⁶⁷ By and large neglecting farmers, the associations instead gravitated toward processors, the more powerful link in the dairy value chain. Referring to the associations attached to his ministry, the MOA official admitted, "Really, the associations serve enterprises and not dairy farmers."¹⁶⁸ At the same time, neither association assumed a regulatory role; rather, they both provided an arena where corporate, academic and party-state players could *kaihui* (开会), or call meetings and conferences. Resembling a public relations coordinator, they performed two functions with these events, namely, advertising and networking.

The close relationship among local party-state, association and industry allowed for a substantial amount of informal cooperation. Specifically, industry actors used the association as a networking tool when they needed assistance with a particular issue. For example, at the request of a large-scale cooperative owner having problems with

¹⁶⁷ Recognizing that processors and associations would do nothing to address their grievances, farmers thus complained directly to the government—a situation also described in chapter five.

¹⁶⁸ Other studies on dairy in China noted a similar lack of support from associations for household farms (Technical Assistance Unit 2000; Delman 2003).

disease and veterinary care, the local association leader called together a dinner that included a veterinarian at the provincial agricultural university and an official from the animal husbandry bureau. Over the course of the meal, the cooperative owner discussed how they might possibly work out an agreement whereby the university could use the farms as a training site for their veterinary students. In return, the cooperative would benefit from more consistent—and most likely, low cost—veterinary care. While this informal cooperation might here entail a laudable initiative, it was not a uniform service provided to all farmers. The associations only served large-scale, well-connected farms and enterprises.

The MOA official pointed out another factor contributing to this preference of large-scale enterprise over small-scale farmers: there were a lot fewer companies than farmers and so associations chose the easier group to represent and assist. Similarly, when they were compelled to work with farmers, he commented, “They chose the big farms, not the small ones.” Those present at many of the training sessions conducted in 2009-2010 and sponsored by the MOA and DAC were overwhelmingly managers on large-scale farms, agricultural equipment company representatives and local bureau chiefs. The national association leader likewise complained that these trainings covered a miniscule percentage of the industry, and even then, “They just show up, get their certificates, and then there is no further contact afterward.” Echoing this sentiment, a provincial association leader asserted that with “too many farmers and not enough funding,” the technical training that they were able to provide “did not really amount to anything.”

6.3.2 *“It’s a system problem”*

Representatives of both party-state and business described the associations’ failure to support farmers as a “system problem,” blaming the “very awkward intermediary role” to which they had been circumscribed.¹⁶⁹ The consumer advocate likened the relationship between party-state and association to that of keeping a mistress (包二奶). The association was neither an official government department—or as he described, “It is not the first wife [元配]”—nor was it a completely independent and

¹⁶⁹ In this regard, one processor executive contended, “This intermediary role was decided by the government; it is not the behavior of marketization.”

self-reliant organization. With retiring officials in leadership positions and a heavily business-oriented membership, the associations simultaneously represented two powerful interest groups, a situation which engendered collusion not regulation. Specifically, it led to decisions that favored large-scale over small-scale farmers and processors over consumers.

In addition to their entangled and dependent interests, as the “mistress” of the party-state, associations were largely a redundant organization. The party-state itself was more than capable of carrying out most of the functions with which the associations had also been tasked. The consumer advocate explained, “[The government] does not need the association. It has the power to issue policy directly, resolve problems and make announcements. Additionally, the associations do not have the authority to enforce the law. They can only transmit information to those above and below.” In China, the NDRC and various ministries were responsible for formulating and issuing policy related to the dairy industry.¹⁷⁰ Meanwhile, the associations could not go after delinquent business and officials. Only the party-state and its law enforcement agencies were permitted that power.¹⁷¹

In many regards, it would seem the party-state was unable to tolerate potential external authorities and thus, associations were not allowed to stray far from their parent organization and the party line. For example, associations saw their ability to conduct and publish research severely restricted. One national association leader lamented, “The associations should be doing research, but they have no power. In the Chinese system, they are the government’s subordinates, one of its subdivisions. Whatever [the government] wants them to say, they say it. Whatever it doesn’t want them to say, they cannot say it.”¹⁷² Similarly, the associations could not use the media as a tool for

¹⁷⁰ Foster (2002) described how associations were equally redundant at the local level and often left “dormant” by their parent party-state agency as the latter did not wish to see its own level of funding decreased due to diminished responsibilities.

¹⁷¹ Traxler and Unger (1994) documented European dairy associations assuming a “burden of governance” from the state and performing regulatory functions. It would appear that this was not the case in China.

¹⁷² In one case, a researcher affiliated with the DAC wanted to publish a series of articles on genetic abnormalities in dairy herds nationwide. However, according to a colleague, the articles showed “severe weaknesses in the industry” and thus, “he is not allowed to publish because it will upset the industry.”

regulation and self-discipline. The consumer advocate summarized this weakened role, stating, “[The association] is the government’s mouthpiece. It cannot independently solve industry issues. It cannot go to the media and expose the industry’s problems because if it does, then it will make the government look bad.” As such, the associations were limited to those activities that posed no threat to the authority of the party-state apparatus, such as facilitating business-to-business negotiations, conferences and events.

In the literature, the associations’ awkward intermediary role has been viewed from disparate perspectives. On the one hand, as Delman observed in his research, restraints placed on autonomy compromised the ability of associations to deliver necessary services to their members (2003: 24-29). On the other hand, closeness to the state, as some contended, also entailed certain benefits—which might even outweigh the consequences of forgone autonomy. In his study on business associations and lobbying in China, Kennedy commented, “The assumption is that the greater the associations’ autonomy, the more they are able to challenge or criticize the state. This assumption overlooks the possibility that an association may gain state access, and hence influence, by marginally sacrificing some autonomy” (2005: 13). O’Brien described this strategy of organizational “embeddedness,” explaining that “the agents of change seek proximity to existing centers of power (i.e., entwinement) rather than distance...[because] they realize that independence at this point means irrelevance and that future development demands sensitivity to existing power relations” (1994: 101). Zhang argued that this closeness to the party-state brought associations benefits similar to those afforded other cooperative economic organizations (e.g., farmer cooperatives): unified planning, publicity and direction as well as financial, human and physical resources and technology, information and professional services (2007: 148-149). With access to government resources, organizations could take the fast track, or shortcut, to development.

In the Chinese dairy industry, both party-state and business purposely used associations to reduce their institutional distance. At the same time, unable to exert any real regulatory influence, the associations exchanged autonomy for relevance and a

position closer to this nexus of power and resources. This did not necessarily mean, however, that they lobbied the party-state on behalf of everyone in their sector, as Kennedy seemed to suggest they would. Rather, they assisted processors and large-scale farm owners at the expense of marginalized interests, i.e., rural farmers. In a system with limited external authorities, the party-state thus employed internal controls of cadres and business. The first part of this chapter covered the incentive mechanisms used to direct local cadre behavior; the following part examines how the party-state shaped business from the inside out, creating a unique form of party corporate governance.

6.4 Party corporate governance

6.4.1 *Mengniu's first order of business: establish a "fourth party"*

In late 1998, as Mengniu's founder and future president Niu Gensheng was preparing to depart Yili, he first asked his colleague, Lu Jun, if she would leave with him. The invitation was by no means arbitrary; Lu Jun was Yili's vice party secretary. As Mengniu's biographers wrote, "From its very first day facing the world, [the enterprise] wanted the party to set the course;" in other words, they explained, Niu Gensheng wanted Lu Jun to join Mengniu for the express purpose of setting up a party committee within the new processor (Sun and Zhang 2010: 262).¹⁷³ On June 1, 2000, the nascent company celebrated the anniversary of the founding of the CPC with a flag raising ceremony. Both Niu Gensheng and Lu Jun delivered speeches, "calling for all employees to make certain to unite in an inseparable bond with the party realm and resolutely implement the party line, guidelines and policy, together expanding and strengthening Mengniu's development" (Employee Handbook). Just two months later, on August 8, the Helinge'er Party Committee Organization Department formally approved the establishment of a company party branch with Lu and Niu as the first and second in command.¹⁷⁴

¹⁷³ Referred to as "Mengniu's mother," Lu Jun had worked many years at the China Securities Regulatory Commission prior to her position at Yili and is credited with leading Mengniu's listing on the Hong Kong Stock Exchange (Sun and Zhang 2010).

¹⁷⁴ On May 8, 2001, Mengniu's party branch became a full committee, eventually expanding to 5 major divisions and 47 branches with 800 members (out of a total of 30,000 employees). Similar to CPC organization in other sectors of Chinese society, the company party consisted of

It might seem peculiar that an ostensibly private company felt compelled to establish a party committee so early on in its development—even if it had indeed benefited significantly from the party-state’s preferential policies. According to company biographers, Mengniu executives believed that “great victory relies on ethics; in our country, the party is the highest flag and most faithful practitioner of ‘ethics,’ and therefore, enterprise should be brought under party supervision” (Sun and Zhang 2010: 262). As Niu Gensheng went on to explain, this incorporation of party ethics into business was especially necessary for private enterprise. He contended:

The party committee’s role within private enterprise is even larger than that within state-owned enterprise! State-owned enterprises themselves belong to the country and antagonism among employees is not easily provoked; by contrast, private enterprises do not belong to the country, and none of the owners, managers and laborers represents the country. Therefore, it is necessary to have an impartial ‘fourth party’ [第四方] to mediate their interests—the party organization. Only with the party standing outside of the ‘interest circle’ and following the principles and aims of the ‘Three Represents’ can all types of problems and contradictions be handled well (qtd. in *ibid.* 263).

Specifically, this “fourth party” would resolve conflict through education and discipline. It would use the lessons conveyed within Deng Xiaoping Theory and the Three Represents “to arm party members’ minds and educate party members and employees to love ardently the party, the motherland, socialism, enterprise and their own job, striving to create a new type of ‘Four Haves’ people” (Employee Handbook).¹⁷⁵ To ensure the proper internalization and implementation of this education, the company hoped to “fully utilize the party’s superior internal supervision mechanism and ideological and political work” (Sun and Zhang 2010: 263). In other

a committee, worker union and communist youth league (党工团). It is important to note that all of this activity occurred before Jiang Zemin’s famous speech on July 1, 2001, officially welcoming private entrepreneurs into the CPC; this confirmed once again that most central policy was piloted first on the ground and later formalized.

¹⁷⁵ The Four Haves signify the possession of revolutionary ideals, sound morals, good education and a strong sense of discipline. The Three Represents is a theory introduced by Jiang Zemin declaring that the CPC must represent advanced economic production, advanced culture and political consensus.

words, it wanted to establish an institution similar to the Party Commission for Discipline Inspection and integrate it into company operations in an effort to regulate employee behavior and prevent malfeasance. It regarded this “party-style honest and clean governance” as an “important guarantee for the construction of a harmonious enterprise” and for steering clear of “the mistaken road of family-controlled management” (ibid.; Employee Handbook).¹⁷⁶

In this pursuit, Mengniu instated a number of important central party policies and institutions, including the “Party Membership Development System” and “Leading Party Cadres System for Building Honest and Clean Governance.” In its “Mengniu Corporation Party Group Work Evaluation Detailed Rules and Regulations,” the company adapted the cadre evaluation system to the particular operations of a dairy processor and positioned anti-corruption as a key target. It also tasked the committee with carrying out biannual evaluations of company party members, the results of which were combined with their yearly performance evaluations. The processor maintained that the party’s impartiality would be guaranteed by a governance structure where “power was not consolidated within one person,” but rather distributed among the board of directors, party committee and operations units. It asserted that this policy of “establishing three separate powers” (三权分设) would “strengthen the enterprise’s democratic and scientific management, implement a lasting and effective supervision system...and under fierce market competition, guarantee sustainable and healthy development” (Employee Handbook).¹⁷⁷

The actual composition of the company’s party committee raised some questions about whether interests were in fact completely separate. Its leadership overlapped heavily with the executive level, including with the board of directors. The party secretary typically served as vice-chairman and the chairman and president as vice party secretary. Within the operations units, most of the division heads were also party members. It was likewise not entirely clear to what extent this organization was

¹⁷⁶ This is a common criticism of private enterprise in China.

¹⁷⁷ At a March 2007 meeting announcing the selection of a new party secretary, Mengniu reaffirmed this policy. The previous party secretary, who held the position temporarily for four months, had also been the chairman of the company.

integrated into the local and central party-state mechanism.¹⁷⁸ The fact that both company party members and local officials attended Mengniu's annual party congresses appeared to indicate that the company party was not totally disconnected from outside structures.¹⁷⁹ Furthermore, as a formal part of the CPC, the company party committee and its members were evaluated by and ultimately responsible to their superiors within the party apparatus. The processor summarized their duties as:

Hereafter, the company party committee should follow the central authorities' entire assignment, strengthening party members' advanced education and strictly and quickly investigating and prosecuting unlawful and undisciplined behavior, in order to reduce and put a stop to the dereliction of duty and corruption (Employee Handbook).

At the very least, the party-state highly approved of Mengniu's party activity, holding it up as an exemplary model for other companies to follow. In the processor's second year, Lu delivered the keynote address at "Hohhot's Non-public Economic Organization Party Building Work Symposium," and then again, at the invitation of the Central Organization Department, at a similar forum held nationally. In April 2003, the Central Propaganda Department selected Mengniu as a "nationally recommended key work unit for the dissemination of ideological and political work."

6.4.2 Company X and the party as disciplinarian

Within Company X, the party organization also functioned as the primary disciplinary body. And true to the broad Foucauldian understanding of discipline, its various organs were in charge of a range of activities from enhancing social life to educating employees to investigating complaints of poor performance and corruption.

¹⁷⁸ In 1996, the Hohhot government issued its "Hohhot municipal, banner, county and district / department, committee, office and division / large and medium sized enterprise party-state leading group and leading cadres work performance evaluation provisional method." ("呼和浩特市旗县区，部办局，大中型企业党政领导班子和领导干部工作实绩考核暂行办法"). This policy created a local cadre evaluation system that combined enterprise performance results with the guidelines for leading cadre promotions and civil servant evaluations. It also ostensibly linked leading party members at large and medium enterprises into the local cadre evaluation system (Sun 2011).

¹⁷⁹ Some of these officials included Helinge'er vice party secretary, its organization bureau head and Shengle Economic Zone vice party secretary.

With regard to social life, the party arranged mixers to “resolve the marriage problem among older singles,” organized athletic competitions and visited sick employees (Document #7). As an educator, it taught party ideology combined with a significant amount of material on modern business management and administration, a curriculum similar to that found currently in the nation’s party cadre schools.¹⁸⁰ While the first two activities resembled those of labour unions in other countries, the party’s role as an investigator of corporate corruption was unique to China. Moreover, here, it often crossed the line between an impartial judge meting out punishments and a crucial player in the company’s daily operations. The following two sections present a selection of cases demonstrating this traversal of roles and authority.

The party investigates corruption: cases of fraud, embezzlement and bribery

According to Company X’s monthly evaluation criteria, employees were required to “oppose corruption and advocate honesty” (反腐倡廉) and to “guarantee throughout the whole year that no incidents of corruption whatsoever occur.” They were advised to pay particular attention to “all divisions’ costs and expenditures, employment, vehicle use, instructors, inspectors and other positions that easily engender corruption” (Document #24). In the case that an employee engaged in corruption, “punishment would be carried out in accordance with the party group office’s assessment outcome” (Document #23). Full descriptions of these investigations were subsequently compiled in internal monthly reports.

In one monthly corruption report, Company X’s local distributor in Province P twice submitted inflated expense reports.¹⁸¹ Upon completing their investigation, Company X’s party committee wrote, “[Our local distributor] seriously violated [Company X]’s system, engaging in fraud and illegally obtaining company funds;

¹⁸⁰ For example, it required all mid-level and lower level managers to download and watch entrepreneur Yu Shiwei’s four-part lecture, “Successful Managers,” and submit a 500-character response to the party committee, drawing on past work experiences and detailing measures for future self-improvement. It stipulated that the managers engage in “deep discussion and not treat the task lightly.” Those that did not turn in their response on time would see it reflected in their evaluation (Document #10).

¹⁸¹ More precisely, the local distributor had been tasked with decorating the interiors of three supermarkets with Company X’s advertisements. It contracted the work to another agency at a price of 45 RMB / m². However, the local distributor reported this expense as 90 RMB / m², hoping to pocket the difference (in this case, 9,112.5 RMB).

furthermore, the amount was fairly large, requiring the case to be dealt with severely.” As such, it fined the local distributor 10,000 RMB and automatically deducted the amount from the latter’s budget. It held the previous city manager responsible for neglect of duty, regarding his behavior as worthy of dismissal had he not already resigned. It also faulted one of the provincial managers with “perfunctory supervision” and requested the corresponding party branch to determine an adequate punishment. Lastly, it credited an anonymous employee for tipping off the committee and assisting in the investigation. In this regard, it recommended the corresponding party branch to provide a reward in order to “express gratitude and at the same time also encourage more employees to tip-off future incidents of this type” (Document #11).

Similar cases of fraud emerged in two other Province P cities. There, the party committee discovered that a local distributor had falsified information in every single one of its advertising expense reports for one particular month. While the reports claimed that the distributor had covered a store surface area totaling 2,346 m², the party committee team sent to investigate measured only 779 m², determining that the distributor had inflated expenses by 32%, or 31,192 RMB. The team also discovered discrepancies between the distributor’s payrolls and the salaries employees had actually received (approx. 200 RMB/person). Likewise, the signatures on the pay slips did not belong to the employees. When the team requested to see financial records, the office manager alleged that the former accountant had taken all of them; meanwhile, he refused to allow the team access to the storeroom and admitted that inventory records had been falsified. Upon further investigation, the team discovered that the person under whom the agency had been registered actually had nothing to do with its operations and had no contact with its employees. Instead, the “real” owner was the boss of a distributor in another city with whom Company X had already experienced many problems.

In response to the situation, the party committee demanded that the local company office immediately draw up new contracts with the “real” operator in order to “prevent the actual distributor from obtaining sales power under false pretenses while unable to devote complete mental and physical energy to operations.” Concurrently, it asked the office to determine whether the distributor should be replaced altogether. For lack of supervision and neglect of duty, the party committee fired the city manager and another employee. It also fined the central provincial manager 1,000 RMB and put the

manager on three months probation. Lastly, given the multi-city scope of the incident, it recommended a thorough investigation of all offices in the central provincial market and requested a follow-up report be sent to the party organization (Document #11).¹⁸²

In another case, an employee from a Company X subsidiary included his own travel in transportation and petrol expense reports submitted to the parent company while, at the same time, adding a transportation subsidy to his monthly salary. Discovering this redundancy, the party organization demanded that the employee return the total subsidy amount to the company (approx. 2,800 RMB) as well as fined him 840 RMB. It then gave all subsidiaries a deadline by which to return any funds embezzled through duplicated reimbursements, “or else they will have to pay a fine of five times the duplicated amount and face public criticism in a company-wide circular” (Document #15).

Company X’s party organization also dealt with a number of bribery cases. For example, it investigated an employee that had accepted an expensive cell phone and two-year service plan from a contracted business partner. According to the company’s “honest and clean governance system” and in discussion with “relevant personnel,” it concluded that the employee exhibited corrupt behavior. It dealt with the matter by firing the latter, turning the cell phone over to the corresponding party branch and fining two levels of superiors. In addition, following the rules of the company’s anti-commercial bribery contract, it fined the business partner three times the amount of the bribe, or 30,000 RMB. It required the fine to be paid to the finance department, “or else it would be taken directly out of the security deposit and the business relationship would be terminated.” Directing its final comment to the rest of the company, it stated, “It is hoped this serves as a warning to other cooperative partners and relevant staff” (Document #33).

The party audits company operations and business practices

The party organization also reviewed company practices outside of the scope of corruption. For example, price negotiations with a major raw milk supplier involved both Company X’s party discipline inspection personnel and staff from its milk supply

¹⁸² Perhaps this request was also made in light of the growing number of corruption incidents occurring throughout Province P.

division. The team made two separate weeklong trips to the regions where the supplier owned farms. During this time, it also visited 27 other raising zones and ranches in the area in order to assess whether the raw milk purchase price followed the principle of “quality-oriented pricing” and how it compared with those prices offered by nearby competing processors. Following their visits, the team compiled a detailed report of purchase pricing and milk quality in the region (Document #20).

In another instance, Company X’s party organization investigated a particular subsidiary’s entire operations following allegations that the latter’s head manager “was taking advantage of his position,” engaging in nepotism, misusing the evaluation system and embezzling funds. While its inquiry into nepotism and embezzlement clearly belonged to the realm of corruption, it went a step further than merely punishing the manager’s errant behavior; it discussed in detail and provided reflections on the subsidiary’s operations models for transport, franchise pricing and retail. For example, it demonstrated how product pricing at different franchises resulted in financial losses, but not before the distributor had already taken its cut of 300,000 RMB, money which it now owed the company and could not be readily retrieved as no security deposit had been paid at the contract signing. The party organization also laid out the division of responsibilities and costs under the local subsidiary – sales broker – retailer model and concluded that the company had little control over product pricing while the sales broker remained free from contributing to a number of expenses, such as overhead, product display, training and costs related to expired and expiring products. Reflecting on this situation, it questioned, “whether a balance existed between the profit incentives and responsibilities of the sales broker and the profits of the subsidiary” (Document #16).

As described above, the company party organization held the power and authority not only to discipline corrupt behavior, but also to educate employees in business management and to evaluate and recommend changes to other company practices. In some respects, it would appear that party discipline afforded Company X with a surrogate internal corporate governance regime; this observation was underscored by the fact that in other countries, enterprises carried out these tasks on their own without the involvement of outside political authorities. Cao (2000) provided a potential explanation for the party’s insertion into enterprise operations. She noted that while decentralization afforded Chinese enterprises more autonomy, the latter often

lacked an internal governance regime. As a consequence, she commented, "...autonomy without governance or accountability has not produced market actors who act in asset-enhancing ways" (2000: 61). Perhaps, then, the party's role within Company X represented an effort to remedy these accountability issues and introduce an effective internal governance mechanism into key enterprises. Indeed, a number of China scholars have argued persuasively that the CPC served as a substitute for macro-economic policy and weak market institutions (Huang 1996; Gore 1998; Shevchenko 2004; Whiting 2004; Pieke 2009). It would seem here that Company X presented further evidence of the party as an institutional substitute that brought economic actors under its political supervision.

At the same time, it could be argued that the party's role within Company X was entirely mechanical—involving no more than the interpretation and execution of company bylaws. Nevertheless, it remained significant for two reasons. One, the company bylaws themselves were determined by executives who were simultaneously party members. As such, their content most likely reflected these dual roles. Two, the party organization's systematic investigation of business operations and disciplinary action, mechanical or not, ultimately influenced employee behavior and institutionalized the party as a company structure. In other words, it created a new space for party-led endogenous change in corporate governance.

6.4.3 *Which hat? Distinguishing company party priorities*

The question of whether the company party pursued enterprise or party-state priorities, or both, was complicated and difficult to answer. On the one hand, the party's role within the company closely resembled party-state mechanisms in Chinese society at large, such as the organization and propaganda departments and the discipline inspection commission.¹⁸³ Furthermore, like the central party-state, it took corruption as the primary target of its disciplinary energies. This would seem to suggest that at least the tools and key objective were the same as those of party-state. On the other hand, it was also possible that the processor hoped to capitalize on the party's tremendous organizational and disciplinary capabilities as well as recognized the benefits of a close

¹⁸³ The company party organization's reports even followed the same format (colors, heading, layout, numbering, etc.) as those issued by the party-state apparatus.

connection to the party-state. Indeed, as others have found, Chinese enterprises could be using the party and its tools for their own purposes, quelling labour disputes and resolving other internal matters to further economic, rather than political, objectives (Chen 2008). Even then, however, the question of whose priorities was still difficult to untangle. As discussed in the first part of this chapter, local political careers were linked to economic targets and enterprise performance, rendering officials dependent on the economic health of companies in their jurisdiction. Thus, when it came to industry development, local party-state and company priorities often overlapped.

The adulteration of the milk supply provided important insight into company party priorities. Specifically, it highlighted the fact that, despite the party's investigative authority and strict discipline, it neither cracked down on the illegal practices of milk station operators nor prevented adulterated products from reaching the market.¹⁸⁴ These omissions would seem to indicate that the priorities of the company party were almost entirely dedicated to maintaining the financial health of its parent enterprise. While the party did in fact play a regulatory role, its supervision and discipline did not extend to food safety and thus, did little to strengthen internal quality control.¹⁸⁵ The party targeted illegal behavior and reformed business practices only where it served the company's bottom line; in all other situations, it left responsibility to external authorities. Two cases from a Company X subsidiary appeared to support this conjecture. In the first case, a milk sales and delivery person "secretly pocketed" 13,000 RMB in payments. Upon discovery of the theft, the money was recuperated and the employee, directly handed over to the local PSB. In the second case, an employee

¹⁸⁴ The company party's lack of attention on milk station operators could not be explained by limited authority over external actors; it readily terminated relations with downstream business partners engaged in unsavory practices as well as with milk collection truck drivers who were consistently behind schedule. It is also interesting to note that Company X strictly enforced contracts with its distributors but had no problem formulating policies to compel milk station operators to break contracts with their competitors.

¹⁸⁵ From Company X's documents, it was evident that keeping adulterated milk out of production lines was just as much a problem as upstream value chain governance. The processor's internal quality control mechanism was plagued by significant coordination issues and conflicting objectives among the divisions responsible for technology and quality control and those in charge of milk supply and product manufacturing. Recognizing these limitations, the processor intended to use the next three to five years to re-organize its quality management system so that new vertical lines of command and responsibility linked the quality control division with personnel in each of the production divisions (Document #35).

submitted two false reimbursement reports, totaling 83,000 RMB—a more substantial sum of money than the first case. The money was also recuperated, but here the employee was only dismissed (Document #37). It would seem that stealing from the company elicited action by the party, whereas stealing from clients and customers was passed over to law enforcement. So perhaps milk station operators represented an analogous situation: they were harming consumers while only posing a potential financial threat to the company.¹⁸⁶ Likewise, a weak internal quality control mechanism could only result in profit losses if consumers were informed about the actual quality of dairy products.

Looking back on the melamine incident, it thus became clearer why the late 2007 warning letter circulated among Company X's division heads would not stop the production of unsafe milk; and a recall would have been unthinkable. Most likely, the strong language of the letter reminding employees of the “ruinous blow to the infant formula industry during the Fuyang fake milk powder incident” and “the possibility of the company and even the whole dairy industry being plunged into the abyss” was met with redoubled efforts to contain exposure rather than to resolve fundamental weaknesses in the sector's food safety mechanism (Document #2).

6.5 Conclusion

In summary, the political and economic incentive mechanisms directing cadres toward particular development objectives led to an entangled local party-state and business relationship. While enterprises bargained with municipalities over favorable policies, subsidies and land, the local party-state became increasingly invested—personally and financially—in the dairy value chain. In some cases, this involvement damaged the long-term development of the domestic liquid milk supply, as poor genetics and phantom projects undermined the improvement of upstream capabilities. It

¹⁸⁶ Unfortunately, as the last chapter demonstrated, local authorities were equally reticent to punish milk station operators to the full extent of the law and effectively put the latter out of business. Some of the key reasons were as follows: 1) station owners were often tied to local party-state through investment and/or employment; 2) fines—rather than prison time or forced closure—provided a source of revenue for local agencies; 3) if stations were closed down, dairy farmers would have nowhere to milk their cows, possibly giving rise to instability; and 4) the cadre evaluation system required certain targets to be met lest political careers suffer; production and stability were at the top of the list while lawfulness was relatively low down (food safety did not even feature until 2012).

also adversely impacted market competition and regulation. As local government sought to privilege and protect its own interests in the value chain, it weakened central-local coordination for food safety and made impartial supervision impossible. This conflict of interest and limited enforcement constrained many of the governance mechanisms introduced by *sanhua*, and food safety controls along the dairy value chain eventually broke down. One Ministry of Agriculture official summarized, “Problems emerged in China’s milk because for many years no one went to supervise milk purchasing.”

The local party-state’s inability to control food safety violators appeared to be particularly acute closest to value chain operations and farthest from the center. As the consumer advocate recounted, “In my experience, when I reported [an incident] to the county level authorities, they did not do anything. Afterward, if I went to the municipal authorities, they were a little bit better but still troublesome. The provincial level was much better because they thought about their leaders in the ministries and their relationship with the localities was not as intimate.” One might have assumed that nearby food safety problems would be the easiest to assess and resolve. This sequence of events, however, implied that there was a negative correlation between the proximity to an incident and regulation. As the chapter detailed, the “fish-water relationship” largely explained the negative correlation: at the local level, many potential regulators were either tied to and/or involved in the value chain and thus, could not address food safety issues.

Similarly unable to play any sort of regulatory role, the country’s dairy associations gravitated toward the “fish-water relationship” and the opportunities it offered. Instead of regulating and mediating diverse interests along the dairy value chain, they essentially operated as a public relations coordinator for the party-state and large enterprise (i.e., processors, feed and equipment companies, farm construction firms, etc.). Inside processors, the party likewise served a specific set of company interests, steering clear of food safety and quality control. Employing a system of internal supervision similar to that in the Chinese party-state at large, it investigated and punished only those practices that compromised the company’s financial welfare. Ultimately, within this environment, no mechanism—whether inside or outside processors, upstream or downstream, party-state or industry—could effectively regulate for safe milk. In other words, the failure of regulation was structural; at the heart of the dairy industry’s problems was not a void of appropriate food safety legislation or value

chain models but rather the existence of a relationship between party-state and business not unlike that between fish and water.

7 Chapter Seven: Drinking the Northwest Wind

“What remains of this industry? Everybody drinks the northwest wind.”

“这个产业还有什么？大家都喝西北风。”

- Ministry of Agriculture official, Beijing

In China, the northwest wind is that which sweeps down through Inner Mongolia's Gobi Desert and chokes Beijing with tremendous sandstorms; it is also a metaphor for poverty, referring to the situation where there is nothing left to eat or drink but the cold, hard wind. To compare dairy to drinking the northwest wind might seem harsh, but in light of the high expectations that many Chinese held for the industry, perhaps its shortcomings have been felt acutely. Indeed, the dairy industry was central to the party-state's national development objectives. In many respects, it embodied the Chinese quest for modernity, promising improved nutrition and industrialized agriculture. After just one decade of fast growth, it appeared to be on track toward achieving these goals. Nevertheless, like the northwest wind, dairy ultimately brought problems to Beijing in the form of food safety crises and to the countryside in the form of persistent poverty.

As described in the preceding pages, the national objectives that retrieved dairy from the edges of its “barbarian” existence and renovated it as the quintessential modern product played a key role in shaping its development. From the beginning, the party-state regarded the industry as politically strategic and subsequent state-business interaction reflected this fact; indeed, whether through policy or direct engagement in enterprise, party-state activities interpenetrated the dairy value chain. Chapter three detailed how the party-state positioned dragonhead processors as its partner in carrying out modernization goals. It incorporated companies like Yili and Mengniu into national and local policy processes, instructing them to link rural producers into urban consumer markets. In turn, these companies pursued a high-growth development strategy and constructed the value chain in reverse, focusing their resources on downstream activities while outsourcing production to rural farmers. Given other circumstances, this strategy might have been more successful. Here, though, the outsourcing model was employed within an institutional environment that could not provide the necessary controls along the value chain.

As the next chapter fast-forwarded to the melamine incident, it became clear that incongruities existed between the industry's seemingly high-quality brands and the realities of upstream production. Likewise, it was evident that controls for food safety had broken down; the melamine incident pointed to widespread regulatory failure across both government and industry food safety mechanisms. And although the party-state sought to rectify the situation—punishing key perpetrators, restructuring the industry and strengthening state regulatory institutions—the chapter contended that the sector's problems had more to do with the relationship between government and industry than with the lack of appropriate value chain models or food safety legislation.

Chapter five and six provided evidence to support this contention that state-business interaction complicated food safety regulation in the dairy industry. Chapter five followed the party-state's pre and post-melamine campaign to modernize the dairy value chain and improve governance through *sanhua*, or scalization, standardization and integration. The chapter revealed, however, that the upstream production system struggled to meet the demands of *sanhua*. For their part, processors focused singularly on short-term cost and production objectives, often squeezing upstream actors and reducing raw milk prices where possible. The local party-state, meanwhile, intervened to protect its own interests in the sector, ultimately privileging processors and weakening regulation. Within this environment, there were no real incentives for *sanhua* along the milk value chain, and no exits for those that did not comply. In due course, both processors and party-state found themselves unable to control for food safety.

Chapter six explored relationships between the party-state and the dairy industry, showing how, far from being an external actor to the industry, different activities of the party-state ended up inside of the dairy value chain and/or significantly influencing its development and regulation at the local level. Dividing state-business interaction into three critical components, it examined mechanisms for coordinating dairy industry development within the party-state, between the party-state and business and within business. Among cadres, the party-state used the evaluation system and targeted central transfers to encourage local compliance with national objectives. Meanwhile, it set up industry associations as a quasi-state institution integrating—not regulating—party-state and business interests. Within business, it used party recruitment and a form of party corporate governance to target corruption and influence

management strategy. The chapter showed that the resulting “fish-water relationship” between government and industry did not always produce positive development outcomes, as some resources were redirected toward phantom or underperforming projects that tended to aggravate problems in the upstream production system. Likewise, the relationship did not always produce positive food safety outcomes, as ultimately it could not direct local cadres and chain actors to conduct themselves in ways that strengthened state regulation and value chain governance.

In the introductory chapter, the thesis set out to examine the challenge of regulation and of reconciling growth and food safety in China’s dairy sector. In this pursuit, it drew together literature on the country’s regulatory regime with the global value chain framework to argue that institutional environments—specifically, state-business interaction—could constrain the ability of actors to coordinate and control value chains. It contended that the distinction between “inside the chain” (productive enterprises) and “outside the chain” (the policy and regulatory environment) did not correspond to the functions and activities of dairy businesses and the Chinese party-state because the latter permeated the former. Different activities of the party-state could operate inside of the value chain, changing the way state regulation and industry governance functioned. Throughout the dairy industry, the study found diverse forms of party-state engagement in the economy, including all of the types summarized by Baum and Shevchenko (1999), i.e., predatory, entrepreneurial, developmental and clientelist.¹⁸⁷ It saw party-state actors assume a variety of roles within the value chain itself from investors to milk station operators to company party committee members to raising zone and cooperative owners. At the same time, it saw the party-state often cast as a key chain coordinator in central and local policy (e.g., *sanhua*, “one village, one company” and the NDRC’s post-melamine guidelines).

¹⁸⁷ These forms of engagement were not mutually exclusive and could be exhibited by the same locality, agency and actor. For example, Hohhot exhibited elements of entrepreneurial, developmental and predatory behaviour, depending on the perspective; in policy, it made every effort to create a favourable environment for dairy, and in practice, it became directly involved profit-making and extraction. Much of the phantom dairy industry entailed predation by a range of actors and agencies. Dairy associations, which were essentially a government organ, fostered clientelist relationships among their membership while themselves engaging in developmental activities that were borderline entrepreneurial.

As market players or otherwise tied to upstream dairy production, local cadres faced mixed incentives regarding food safety regulation. Bound in a “Gordian Knot” (Pearson 2005), they were unable to exercise regulation adequately. During the adulteration of the milk supply, their resort to “night law enforcement” underscored the fact that normal daytime routines of inspection and more transparent forms of arrest and punishment had all failed. This environment directly impacted the effort to improve value chain governance. Even under the pressure of *sanhua*, chain actors could neither implement nor enforce the mechanisms that the transition from spot markets to more integrated modes of governance required. As such, both producers and processors continued to regard market exchange as the most efficient form of governance (but only in terms of cost, not quality).

The thesis thus demonstrated that the government-industry relationship in the dairy sector constrained coordination and control between lead firms and suppliers and between chain actors and party-state institutions. Furthermore, it showed that even within the operations of vertically integrated enterprises, this relationship adversely affected food safety controls. Food safety was a structural problem, indicating that changes in state regulation and value chain governance would not necessarily guarantee safer milk. These findings confirmed that examining state-market structures was critical to the study of food safety regulation. They also provided global value chain literature with further evidence illustrating the “stickiness of places” and the crucial linkages between institutions and governance (Humphrey and Schmitz 2001; Sturgeon 2008; Neilson and Pritchard 2009).

Over the course of dairy’s rise in China, the party-state struggled to reconcile growth and food safety. The thesis showed that actions taken to achieve the former objective could compromise the latter. For example, dragonhead-led growth strategies (e.g., “market first” combined with the outsourcing model) impacted upstream capabilities and led to a lack of control that made misconduct possible. These vulnerabilities were often overlooked in order to satisfy cost and production requirements. Eventually, the situation reached crisis levels because mixed incentives weakened impartial regulation of the value chain. In each case, the fundamental issue was not the objectives themselves but rather that they were operationalized through a network of actors who could not regulate. In other words, under different state-market structures, growth might not necessarily preclude food safety. As described in the

literature review, China maintains a unitary political system largely dependent on internal controls of state and market, where the line demarcating these two realms is both blurred and constantly evolving. The Chinese party-state has taken advantage of its top-down authority and ambiguous relationship with business to learn and adapt. By adjusting state-market structures within the constraints of the overall system, it could potentially secure both sustained growth and safe food.

Although the melamine incident clearly presented a case of regulatory failure and a negative outcome of state-business interaction in the dairy sector, it also provided a view into the evolution of food safety regulation in China. Specifically, it revealed that the party-state has acted pragmatically and experimentally to compensate for weaknesses in regulation and value chain governance while at the same time carefully adjusting the government-industry relationship. For instance, the party-state often informally piloted various policies at the firm or local level, later formalizing and expanding at the national level those strategies with some measure of success. Chapter five described how three years before the Ministry of Health officially lowered the national raw milk standard for protein content, Company X had already begun responding to government complaints by lowering the purchasing requirement for protein from 2.95% to 2.8%. This sequence of events demonstrated not only the party-state's ability to circumvent policy and communicate directly with business, but also its recognition of a link between adulteration and upstream capabilities. Another practice piloted locally, expanded nationally and then incorporated into central policy was the consolidation of small-scale farmers into raising zones and cooperatives. It could be posited that the push for (physically) integrated dairy chains comprised in part an admission by central leadership that state regulation was ineffective, thus necessitating that lead firms internalize governance activities. While the thesis highlighted challenges associated with this effort and argued that the strategy might not solve food safety issues in the long run, it nonetheless revealed a central party-state that was reflective and adaptive.

In addition to these pragmatic and short-term measures, the central party-state has taken steps to adjust state-business interaction in the dairy industry and in society at large by centralizing authority over cadres and enterprises. In the 2009 "No. 1 Document," it instructed provinces to begin piloting a new set of fiscal reforms that, over the next four years, would gradually replace the old system of municipal

supervision of the counties (市管县) with direct provincial supervision of the counties (省直管县) (CPC Central Committee and State Council 2009). This move echoed a broader trend cited in the literature whereby over the last two decades, China had “shifted dramatically away from continuous decentralization and weakening of government power...toward moderate recentralization in certain areas” (Naughton and Yang 2004: 8). Indeed, working from within the state apparatus, the party-state endeavoured to strengthen control over lower levels of government and bring cadres closer in line with central leadership.

The central party-state also began to use this vertical, internal chain of command to communicate specific objectives regarding food safety and reorient cadres’ priorities. On June 23, 2012, in its “Decision on the Strengthening of Food Safety Work,” the State Council announced that for the first time, food safety would be inserted into the criteria for local cadre evaluations. More specifically, it mandated that “higher level government conduct annual food safety evaluations of lower level government and regard the results as a significant part of local leadership and leading cadres’ composite evaluation assessment” (State Council 2012). Under the new plan, the central party-state set out to curb substantially food safety offences over the next three years and to perfect a “scientific” national food safety regulatory mechanism within five years. To meet these goals, it promised increased financial support and investment from the center, particularly for interior regions, as well as called on the local party-state to ensure expenses related to implementing food safety regulation were included within city budgets.

By defining responsibilities more clearly and giving officials political incentive to pursue food safety violators, the central party-state targeted regulation where previously it had been weakest—the local party-state. It also acquired an alternative measure of food safety success and failure across diverse localities, allowing it to make more informed decisions about future policy. Changing the cadre evaluation criteria alone might not necessarily eliminate food safety problems, however. As they did in the pursuit of production objectives, some local officials might still attempt to secure good evaluations and a better promotion by falsifying statistics and covering-up food safety

incidents.¹⁸⁸ That said, recent policies for more centralized authority over local cadres might make cheating food safety evaluations exceedingly difficult.

Concurrently, the central party-state has sought to strengthen its direct control over one of the country's largest dairy brands. In July 2009, centrally owned COFCO purchased a majority stake (20%) in Mengniu. Shortly after the sale, the latter's employees were assured that the acquisition would be beneficial for the processor and did not automatically imply increased interference by the central party-state and its formidable grains giant. It stated, "On the basis of neither participating in specific daily operations nor changing the existing operations team and current development strategy direction, [COFCO] will bring Mengniu abundant industry experience, sharing the resources and support of a global client network and mature food safety system" (Employee Handbook). Others within the company asserted that the stake sale guaranteed Mengniu's future growth as well as protected the company from international interests. As one manager detailed, "If COFCO hadn't bought the shares, then perhaps a foreign company or group would have. We wanted to keep [Mengniu] a domestic company."¹⁸⁹

In subsequent months, however, Mengniu leaders would successively step down and/or be replaced by COFCO executives. In August 2009, Mengniu co-founder and CEO Niu Gensheng was re-designated to the post of chairman of the board; his top position was then given to COFCO's CEO Yu Xubo. Almost a year later, Niu moved from being an executive to non-executive director and his chairmanship was eventually taken by COFCO chairman Ning Gaoning. On January 6, 2012, COFCO increased its ownership stake to 28.09%, and four months later, company president Yang Wenjun, whose second tenure would expire shortly, was replaced by Sun Yiping, a former deputy general manager at COFCO. Yang Wenjun's departure signaled the arrival of a new era in Mengniu leadership as COFCO personnel now occupied all of the top positions. According to news reports, Chairman Ning Gaoning remarked on this transformation in leadership, "COFCO will have more of a say in Mengniu's daily

¹⁸⁸ Chan and Gao (2012) noted in their study that following the insertion of work safety into the cadre evaluation criteria, this "line-item veto" adversely impacted honest reporting and led to severe fluctuations in the number of work safety incidents.

¹⁸⁹ Another bonus of the deal was privileged access to COFCO's feed and sugar.

management from now on, and we will adjust its previous high-growth model” (Caijing 2012). He expressed his dissatisfaction with Mengniu’s performance over the previous three years, emphasizing that the processor must first consider quality before other factors such as scale and profit. Immediately prior to issuing these comments, Ning relinquished his position as chairman of the board at COFCO, a decision implying that he intended to focus more attention on his role at Mengniu (*ibid.*).

Despite COFCO’s initial promises not to interfere in the operations of the processor, this sequence of events pointed to another trend: the central party-state was stepping in and taking more control of a company beset with problems. As COFCO continued to be dissatisfied with Mengniu’s recurring food safety lapses (e.g., the 2011 aflatoxins incident), it gradually increased its share in the processor while simultaneously taking over management control. In this case, the option of transferring the business to local party-state control was not available as the Hohhot municipal government owned a majority stake in Yili, the principal competition. Also, it would appear from events described in previous chapters that local party-state control did not necessarily guarantee the diminution of food safety problems. Moreover, Mengniu was already linked into the local party-state through its company party committee, a connection that was equally problematic given the two entities’ entangled business interests. Thus, the central party-state likely regarded direct ownership as the most effective—and possibly, the only—strategy available for bringing the processor in line.

Over the last decade, the Chinese dairy industry witnessed two other major takeovers involving its top national brands and the reacquisition of private capital by the state. In each case, the party-state portrayed the takeover as a rescue effort undertaken only in exceptional circumstances.¹⁹⁰ In a market with a very limited number of players, the subsequent changes in ownership structure, corporate governance and overall strategy held considerable implications for the industry as a whole. These acquisitions, along with a number of others, led to a growing debate about the extent to which

¹⁹⁰ In the first acquisition, the Hohhot municipal government bought back a majority stake in Yili following the imprisonment of the processor’s chairman on corruption charges; in the second, Beijing-owned Sanyuan acquired the scandal-mired and bankrupted Sanlu (described in chapters three and four, respectively).

guojinmintui (i.e., re-nationalization) actually existed in China.¹⁹¹ Some scholars suggested that latest trends did not indicate a linear progression toward increased economic liberalization but rather exhibited a renewed emphasis on party-state control in the domestic sector. As mentioned in chapter two, Huang (2008) argued that the entrepreneurial capitalism of the reform's early years had been checked in favor of a "state-led brand of capitalism."

The party-state's recent efforts to address food safety issues in the dairy industry and in society at large appeared to reflect the convergence of two trends, centralization of state authority and increased state control of capital. As exemplified by Mengniu, this convergence could imply more central party-state ownership of lead firms, particularly in sectors with frequent food safety lapses. By recentralizing authority over cadres and lead firms, China could end up with a regulatory regime antipodal to the independent regulatory state model; and yet, it is very possible that this new arrangement could strengthen internal policing of chain actors, enhance industry governance and guarantee food safety. If so, Chinese consumers would not only cease to drink the northwest wind but also, finally, realize Premier Wen Jiabao's dairy dream.

¹⁹¹ In November 2009, at the Annual Forum of Chinese Economists, National Bureau of Statistics chief Ma Jiantang devoted his entire speech to refuting *guojinmintui* and argued that 2005-2008 statistics did not support the idea that the party-state was driving out private capital. He specifically mentioned Mengniu along with a number of steel and coal companies that had been purchased by state enterprises that year and averred that these examples did not account for a nationwide trend (Xi'an Evening Paper 2009). One editorial published after the forum disagreed with the bureau chief contending that 2008-2009 data should be taken into account as well. Others concurred with the exclusion of this data, arguing that recent trends toward state ownership had been influenced by the financial crisis (Zhu 2009).

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