Form 471

SPECIAL REPORT NO.

Shanghai, China. December 11, 1933.
(City) (Country) (Date)

Subject: NEW HIGH TAXATION OF CIGARETTES THREATENS REDUCTION IN AMERICAN LEAF TOBACCO CONSUMPTION ON CHINA MARKET.

Submitted by: A. Bland Calder (Name) Assistant Commercial Attache. (Title)

GOVERNMENT PRINTING OFFICE 11—9188

7

PUB. FOR DOM. COM.
JAN 3 1934
INFORMATION SERVICE
180635

The outstanding development of recent weeks in the tobacco market has been the sudden decision of the Ministry of Finance to advance the tax on cigarettes, though the previous Ministry had apparently reached the conviction that further tobacco taxation would result in diminishing returns. Nevertheless the pressing financial demands of the country at the moment due to the requirements for military funds for pursuing the anti-bandit and anti-communist campaigns in Kiangse and other Provinces and the further threat to national solidarity arising from the rebellion in Fukien Province are such that the Ministry is reaching out in every direction for immediate augmentation of revenues. The industry was informed only on Friday December 1 of the intentions of the Ministry and the new rates went into effect on December 5 with, therefore, very little advance opportunity for the industry to adjust itself to the new circumstances.

The former rates in force were as follows, with new rates also indicated:

Grade.	Former Rate, put into effect March 21, 1932.	New Rate effective December 5, 1933.
Class I - - - - - - -	Yuan 95.00 per case.	Yuan 160. per case.
Class II - - - - - - -	Yuan 55.00 " "	Yuan 80. " "

21
25-23

SHANGHAI - SPECIAL REPORTS

The division line between class I and II was formerly Yuan 260. per case valuation, cigarettes above that valuation paying taxes as Class I and those below as Class II. The new division point, effective December 5 is Yuan 300. per case (for goods in Shanghai) and Yuan 320. per case for goods at outports.

The cigarette manufacturing industry is in a virtual quandary as to how to go about business following this stiff advance in taxation. No manufacturer can know which of his various brands will sell best at the new retail prices which will have to be established and all naturally hesitate to put out full production on the basis of former consumption until they have time to learn something of how the public may absorb the tax. Hence most factories following the imposition of the tax on December 5 have functioned under greatly reduced production schedules.

The bulk of the business in cigarettes in the past in China has been of the cheapest type consumed by the laboring and agricultural classes, cigarettes sold at retail for one copper each. When it is considered that in Shanghai it takes about 300 copper coins to equal one Yuan dollar, and that the latter unit is at present exchange valued at about 34¢ U.S. Currency, some notion of the foundations of the cigarette business in China may be understood. For example, 50,000 cigarettes at 1 copper each, in Shanghai, or rather at Shanghai exchange rates between coppers and dollars, would result in a gross retail return of only Yuan 166.66 per case. After deduction of Yuan 80. as the tax, there would be left only Yuan 86.66 or approximately U.S.$29.46 which must cover the wholesale and retail profits, the entire expense of materials (all of which pay either heavy import duties or local production taxes) such as leaf tobacco, cigarette paper, paper for wrapping, foil, cartons, and packing cases. This small sum must cover also labor costs and other factory overhead expense. The return is obviously so small that the industry is asking itself whether the one-copper cigarette is a thing of the past and whether the smoking public will pay more than one-copper, say two cigarettes for three coppers, or four cigarettes for three coppers.

It must be taken into consideration that in many districts in the interior the exchange between the Yuan dollar and copper coins is greater than in Shanghai. In some places the exchange is as high as 500 coppers to the Yuan dollar and yet the buying power of the public in coppers may be even less than is the case in the Shanghai district. Hence the net return would be even smaller than on goods sold in Shanghai. Many in the trade feel that if the one-copper cigarette ceases to be a reality a considerable section of the buying public will be eliminated as cigarette consumers and will take to smoking pipes or stop smoking altogether. This would not mean an increased market for imported prepared tobaccos, however. It would simply mean that farmers and laborers generally would go back to the small bowled Chinese pipe in which is used native tobacco.

There appears every evidence that even the Yuan 55. tax was higher than the trade could bear and still continue its normal expansion, and despite the large quantities of low priced imported tobacco which have been absorbed by the Shanghai market since the Yuan 55. tax was adopted (March, 1932) cigarette consumption for the first time in many years appears to be registering a decline.

Shanghai district taxed production of cigarettes as indicated by statistics of the Consolidated Tax Bureau register a falling off of 4½% for the first 10 months of 1933 as compared with the same period of the previous year, while the drop as compared with the same period of 1931 is as much as 7.35%. The heaviest decline has been registered since July 1, 1933, production for the four months period July-October inclusive registering 19½% decline below the production for the same period of 1932 and 16.6% decline from the figures for the same period of 1931.

On the assumption that the same rate of decline could be applied to the consumption of cigarettes in all of China as has been registered for Shanghai, we would then have a consumption curve based on figures about as follows:

China's Estimated Cigarette Consumption.

Year	Quantity (Pieces).
1900	300,000,000.
1910	7,500,000,000.
1920	22,500,000,000.
1930	70,000,000,000.
1931	75,700,000,000.
1932	73,500,000,000.
1933	70,000,000,000.

The figure for 1933 might even be smaller as no allowance has been made for possible heavier decline in November, 1933, figures not being yet available, nor for December following the drastic tax increase. Manufacturers feel that a very heavy falling off may result in 1934 from these drastic increases in the tax rate, but have apparently decided to go on operating as best they may, hoping the tax authorities may adjust the matter later should an actual heavy decline in the trade occur. The difficulty facing the industry is that a very heavy decline in trade may occur before the tax revenues are curtailed. In fact, in view of the 45% advance on Class II and of the 68% advance in the tax on Class I cigarettes, it is patent that the volume of business done could decrease correspondeingly without affecting the revenue, a rather serious outlook for the industry to face in case the public fails to absorb the new taxation. In other words the cigarette manufacturing industry might suffer a terrific decline of as much as 40% or more in its aggregate output and sales without the government suffering any loss in revenue. It is altogether possible indeed that the government might enjoy considerably augmented revenues in taxes on a very considerably reduced volume of business, hence smaller turnover and smaller returns generally to the industry. It is conceivable that the labor situation might become seriously affected by the reduction of output in case cigarette sales fail to hold up to the current volume, also that serious dislocations otherwise may result.

American leaf suppliers feel perturbed as to the probable effect of all this on the market for American leaf tobacco in China. Not only may sales drop in volume as a result of decreased consumption of cigarettes, but also manufacturers in efforts to keep brands on the market at old prices or near old prices may endeavor further to lower costs by reducing or eliminating the proportion of American tobacco in their blends. American firms are at a loss to know what quantities and grades of leaf to stock this season on the Shanghai market and it will probably be some time before the industry adjusts itself to the new circumstances to the degree that it can intelligently foretell its leaf requirements.

A. Bland Calder
Assistant Commercial Attache.

ABC/