THE SECRETS OF CHINA'S MOST PROFITABLE SECTORS

BY SHEN YUAN

China's burgeoning economy has enriched investors in a number of sectors, including some that may seem surprising.

People generally think of investing in the stock market or buying lottery tickets as the easiest ways to quickly make staggering amounts of money. China has 60 million stock holders, but how many millionaires like Yang Baiwan[1] has China's under-regulated and officially-manipulated stock market generated? And as for lottery tickets, the probability of winning is one in every million. In Chinese society, where illegal sales are common and no one can be trusted, illicit profits can be made in any of three hundred and sixty business sectors. However, some of the most profitable enterprises may strike some people as surprising. We will examine a few of them in detail below.

The goldmine of collusion—real estate

In *Fortune* magazine's most recent list of China's 100 wealthiest entrepreneurs, nearly half are involved in real estate (compared with only six percent worldwide). Since opening and reform was implemented in the early 1980s, private capital has poured into the real estate market. The termination of subsidized housing in the 1990s has resulted in home ownership increasing rapidly from one percent to more than 95 percent. This year, influenced by rumors of an upward reevaluation of the *renminbi*, hot money has pushed up land prices in major cities such as Shanghai, making real estate the most profitable sector in China. Every strong economy in the world has had a leading sector in its start-up stage—in Britain it was spinning and textiles, in Germany it was steel and coal, in the U.S. it was oil, in Japan, electronic appliances, and in Korea, heavy machinery—in China it is real estate.

Real estate profits worldwide hover around five percent, but in most of China's major cities it exceeds ten percent, peaking in the range of 30 to 40 percent. In Shanghai's explosive property development environment, profitability can reach a multiple of initial investment. Real estate sales since 2002 have already reached 600 billion *yuan*; estimated average gains of 20 percent mean total profits of 120 billion *yuan*. In Beijing, where annual real estate sales total 100 billion *yuan*, a 20 percent gain would mean annual total profits of up to 20 billion *yuan*. China's real estate sector can create a millionaire virtually overnight.

A typical real estate millionaire is Shanghai's Zhou Zhengyi. He doesn't run an enterprise, is not dependent on scientific technology, has no computer or foreign language skills and has only an elementary school education. While managing a small hostel on Shanghai's Huanghe Road, he established connections with senior government and banking officials through his attractive female partner, eventually transforming himself into a real estate magnate. Although he was eventually convicted on charges of "falsely reporting registered funds," he was sentenced to only three years in prison, a penalty further reduced to confinement in a medical facility.

Making a fortune in the real estate industry follows a common "operational flow chart" outlined as follows:

1. Illegally obtaining land. The key to making a fortune in real estate lies in obtaining land for development. China's market economy is still immature, and the government retains a significant administrative role. Bulk land leasing results in business-bureaucratic collusion, and has given rise to a plethora of corrupt officials. In other countries, land represents half of the cost of real estate development, but in China it is less than 20 percent. Relatives of high officials and the elite class transform their influence into land, which they resell at a profit, making money from nothing. This is a unique phenomenon of socialism with Chinese characteristics and one-party rule. According to one real estate industry insider, the cost of bribes paid to obtain the desired bundles of land can exceed 30 percent of the land price, and can reach 50 percent.

Beijing has more than 4,000 real estate developers, but fewer than five hundred are genuinely capable; the rest generally take advantage of the lack of transparency in land policy to engage in shady deals and speculate on the property market. In the first quarter of 2004 alone, 16,000 cases of illegal land transfers were uncovered nationwide. Since the 1980s, China has lost more than one billion *yuan* annually in illegal land sales and transfers. Among the properties that municipal government are currently leasing for development, only five percent are being transferred through public bidding or public sales; the remaining 95 percent are "transferred by agreement," which conceals a large variety of illegal and immoral activities. Among the petitions the government receives from members of the public, one quarter involved forced demolition or displacement as a result of real estate development.

2. Money cycling. The first trick here is to put land up as collateral for bank loans and "get eggs from a borrowed chicken." In 2003, commercial bank loans on real estate reached 700 billion *yuan*. In 2004, such loans totaled one trillion *yuan*, marking an annual growth rate of more than 25 percent. One quarter of delinquent loans processed by state-owned asset management companies were real estate loans, and a quarter of all illegal loans were also related to real estate.

The second trick is to let the contractors finance construction with their own credit. In spite of the central government's repeated injunctions against credit-based construction, such practices they have only intensified, resulting in deteriorating construction quality and default on delivery to consumers.

The third trick is the sales of nonexistent buildings. According to regulations, a building can be sold only after its construction has reached several meters above-ground and an advanced sales permit is duly obtained. However, developers typically set up a sales counter right after a widely publicized ground-breaking ceremony, complete with detailed models and advertisements, and launch "internal offerings." This arrangement can generate enormous profits.

3. Tax evasion. The majority of profit-based real estate brokers report only a miniscule profit or even net loss to the tax authorities. Measures used include reporting smaller revenue and obscuring net worth; minimizing taxable personal revenues and neglecting to pay tax on advanced funds; postponing tax filing until after the deadline to make costs difficult to calculate; taking advantage of co-op building policies to evade tax; and purposely omitting land appreciation tax, stamp duty and other related fees.

4. Skimping on construction to reduce building costs. China has more than 30,000 real estate developers in China, and most operate through several layers of subcontractors. "One or two subcontracts are not rare, three or four subcontracts are common, five or six subcontracts mean accidents," is a popular saying. Positioned at the lowest level of the real estate food chain, subcontractors eke out a profit through reduced labor costs, substandard construction and skimping on materials. Post-construction problems such as shrinkage, leakage, delays and even the notorious "bean curd-quality construction" all result from this cost-cutting. A reasonable construction process involves objective site inspections carried out by a registered inspection company. However, China's inspection companies are positioned in a buyer's market, and developers have absolute bargaining power. Many inspection companies exist in name only, and even official inspections tend to be cursory.

5. Changing terms of land use. Developers use a dazzling array of measures to change the terms of land use in order to maximize their profits. One of the more common measures is to manipulate "floor space." For example, developers may transform low-cost housing into luxury or commercial premises, raze a public building and replace it with a commercial one, or obtain land for low cost housing and develop a luxury building. One commonly used measure is to change a garage into a "cash cow" by setting the ratio of parking spaces to housing units as one to two or one to three and enabling a 300-apartment building to have 100 parking spaces. Assuming that one parking space can be sold for two hundred thousand *yuan*, the developer can earn an extra 20 million *yuan* in profits.

6. Entrapping customers. Developers set up all kinds of sales scams, such as false advertising, forcing the customer to make a payment before he signs a contract, manipulating official documents, manipulating figures to deceive buyers, and covering up extra sales. Some even go so far as to hide traps in redecoration costs.

Cashing in on education

The Constitution of the People's Republic of China provides for a nine-year compulsory education system. In the past, elementary, middle and high school education was all largely dependent on allocation of funding from the state, but in recent years the burden of these costs has shifted increasingly to Chinese households. China has 300 million school-aged children, and ruthless extraction of fees from their parents rakes in as much as 200 billion *yuan*, making education China's second major profiteering enterprise.

The use and direction of this 200 billion *yuan* is key in determining whether or not the fees are reasonable. A small portion of the funds are used to cover materials and construction costs, and another small amount may be applied to teachers' welfare, but the vast majority consists of nothing more than kickbacks or bribes that go straight into private wallets. Parents are paying the fruit of their blood and sweat to feed a bunch of government officials, corrupt elements and the dregs of the education establishment.

Among the cunningly extracted fees, the most important is the school selection fee. Beijing schools charge the highest selection fees, typically 30,000 *yuan*, but going as high as 70,000 to 80,000 *yuan*. Beijing has at least 20 secondary schools with revenues in excess of 10 million *yuan*. In Shanghai, selection fees range from 40,000 to 50,000 *yuan*. Beijing and Shanghai high school selection fees are not turned over to the government, and 70 to 75 percent of the junior high school selection fees are also retained by the schools.

The second most important fee is the "temporary enrollment" fee. Beijing's migrant population includes 240,000 children, of whom 170,000, or 71.4 percent, are enrolled in the city's public schools on a temporary basis. Based on the most conservative estimates, these schools receive 20 million *yuan* in temporary enrollment fees from these migrant families.

Third in importance are the ingenious "miscellaneous" fees, including the support fee, uniform fee, material fee, supplementary class fee, physical examination fee, swimming fee, insurance fee, water and electricity fee, movie fee, spring picnic fee, bicycle storage fee, freshman enrollment fee and so on. Numerous middle and elementary schools, as well as kindergartens and day care centers, invent an even greater variety of pretexts, such as school anniversary, system reforms and so on, to solicit support from parents and others. Illicitly collected fees at one Beijing middle school in 2003 totaled seven million *yuan*, making each of the school's administrators an instant millionaire.

With the majority of urban households having both husband and wife working outside the home, pre-school education has also become a vehicle for rampant profiteering. Quite a few kindergartens and day care centers have added foreign language courses or other specialized courses, allowing them to qualify as "elite" schools that can demand higher fees. China currently has 60,000 private schools, of which more than 40,000 are kindergartens.

The main cause of rampant fee extraction is China's lack of educational resources, which causes the quality of education to vary widely between districts and schools. China allocates only 2.5 percent of its GDP to education, far lower than the international standard. Even these pitifully meager funds are partially misappropriated or diverted to the wallets of corrupt officials before they ever reach the schools. An especially serious problem is that while more than 43 percent of children eligible for compulsory education are located in rural villages, they receive only 27.5 of the nation's educational funding allocation. In recent years, overseas charitable projects have come into vogue to address this shortfall, but how much of those patriotic contributions actually reach the schools? A telling indicator is that in China's central-western region, only 42 percent of children aged between 15 and 18 years old achieve a middle school education, and only 15 percent of the population aged between 18 and 22 receive higher education.

Since the time of Confucius, education has been considered a country's crucial foundation. But the Communist party that boasts of "serving the people" and "education in service to the proletariat" has allowed this sacred institution to fall second only to the real estate industry as one of China's major profiteering industries.

Underground publishing

The busy streets of central Beijing's Sanlihe District host first-class national organizations such as the State Development and Reform Committee, Nuclear Industry Group, Department of Finance, Chinese Science Institute and Machine Industry Committee. This area, located close to the Joint Headquarters of the People's Liberation Army, can be regarded as the heart of Chinese Communist Party.

On a small, nondescript street in this neighborhood, underground bookstands of all colors and shapes are set up, selling all sorts of banned books, pirated editions and pornography. Almost all Hong Kong and Taiwan publications and books banned by the Chinese authorities can be found here. Old issues of *Open Magazine*, *Zheng Ming* and *Beijing Spring*[2] are found everywhere. Books such as *Zhou Enlai's Later Years*, *Premier of the Red Dynasty*, *Too Hard to Call You Father*, *The Tiananmen Papers* and even Chiang Kai-Shek's *China's Fate* are all available for low prices. The bestseller used to be *The Secret Life of Chairman Mao*, written by Mao Zedong's private doctor, Li Zhisui, but nowadays Chinese people are well aware of Mao Zedong's real face, and their interest has turned to more recently fallen idols such as Zhou Enlai. Additionally, books on mainland beauties and *Serve the People*, a sexually explicit novel in which a PLA soldier defiles Mao memorabilia, also appear on the stands.

The print quality of these books is usually very poor, with typographical errors and missing or garbled words and pages far from rare. A few of the newer pirated editions are printed from computer files, and their quality is comparable to standard publications, but at prices cheap enough for the average consumer. A standard copy of *Zhou Enlai's Later Years* sells for more than HK$100 (about US$12) in Hong Kong, but in this underground book market, a pirated copy of the same book sells for only 20 *yuan* (about US$2.50). While a standard copy of *China's Secret War* sells for 45 *yuan* in China, a pirated copy costs only 10 *yuan*. A keeper of an underground book market proudly told us that he could sell us any banned bestseller from Taiwan, Hong Kong or the mainland within three days.

More than ten book markets such as the one in Sanli He can be found in Beijing, the capital of Communist China. One can easily imagine the situation in other parts of the country, where "the sky is high and the emperor is far away." At the border of Hong Kong's Lo Wu and the Special Economic Zone of Shenzhen, book hawkers can be seen toting bundles of banned books. Mobile book markets in Hong Kong's small residential districts carry such books as *The Chinese Peasant Survey*, *The Past is Not Like Smoke* and *China's Secret War*, presenting a unique reverse flow in which clever Hong Kong residents buy pirated copies of these banned Taiwan and Hong Kong-published books for a tenth of the price in Shenzhen.

Underground book markets prosper thanks to a complete underground publishing system. An underground bookseller in Beijing explained that he has a computerized layout and printing operation where he can carry out editing and proofreading, binding, art design and typesetting. He publishes all kinds of banned books and pornography, including the "Nine Commentaries on the Chinese Communist Party" originally published in *The Epoch Times*.[3] Furthermore, he can decide how many copies to print based on a book's contents. Circulation can run up to 100,000 copies, and he can guarantee delivery within three days to a nationwide distribution network of 2,600 sellers.

He can manage to do this because there are as many as 4,000 underground printing factories in poor and abandoned farming villages. These underground printing factories are tightly organized, with clear division of labor. The manufacturing process of a book is divided and allocated to several different factories at once, with each factory printing a few pages, and separate specialized factories responsible for binding and distribution through special channels. This 2,600-strong distribution network, 4,000 printing factories and hundreds of underground publishing companies form a complete and independent underground publishing empire. Nicknamed "China No. 2 Printing Factory," underground publishing constitutes the third most profitable sector in China.

Overseas there is complete freedom of publication, and no need to pay for an ISBN (International Standard Book Number) application. The Chinese government rations out ISBNs to official publications as a means of controlling publishing, and trading in ISBNs has developed into a unique business. China currently has 568 approved publishers publishing some 200,000 titles annually. About one fifth of the books that appear on the market use purchased ISBNs. China's 568 authorized publishers would have a hard time making a profit or even surviving if they couldn't depend on selling off some of their allocated ISBNs. One Beijing publisher that folded recently had "published" 290 titles in a two-year period, but 127 were under ISBNs that it had actually sold to another publisher. Nationwide, more than 50 publishers have already been ordered to close because of their involvement in ISBN trading. Some professionals in the business estimate that if each of China's 2,000-plus underground publishers produce a dozen or so titles per year, they generate a market value of some 200 million *yuan*.

In China, the ratio of legal to pirated publications is 1:1.5, clearly demonstrating the market dominance of illicit editions. At a foreign language program at a university in Wuhan, missing pages were found in an assigned textbook, *University English*. Investigation determined that the book had been pirated. The cost of pirated publications is very low—there are no royalties and virtually no fixed or advanced costs. Total costs represent only one fifth of the retail price of a pirated copy, with a profit margin ranging from one quarter to one third of the retail price. The primary reason for the market dominance of pirated publications is collusion between bona fide publishers, illegal booksellers and underground publishers, which enables underground publishers to obtain electronic copies of manuscripts or printing films in exchange for small favors, bribes or kickbacks. The second reason is the inadequacy and lack of enforcement of market control regulations. The third reason is the high cost of legal publications.

Why does the Chinese Communist Party turn a blind eye to this ticking spiritual bomb at the same time that it exerts ideological control by attacking press freedom and neutralizing the influence of the media? The Chinese authorities have an embarrassing secret. At the outset, they lost control of the situation. Then the underground publishing empire started feeding hundreds of thousands of poor farmers and poor city dwellers, while also padding the pockets of corrupt officials. If the government cracks down now, these poor farmers and city dwellers will lose their livelihoods and the corrupt officials will lose their source of revenue, causing a dreadful backlash. For the same reason, the authorities fail to control pirated CDs, the sale of official promotions and the production of counterfeit goods, since these are the bastard offspring of corrupt authoritarian rule. Of course, the underground publishing business is not entirely without merit, given its vital role in breaching the Communist Party's monopoly over publishing in China.

Motor madness

Automobile production and per capita auto ownership are a measure of a nation's economic development. In China, domestically-produced cars are becoming part of ordinary people's lives, and following several price adjustments, the auto industry remains fourth among China's top-grossing industries.

Yet the Chinese auto industry is not altogether straightforward. China currently has 130 automobile manufacturing plants, more than any other country in the world, and in 2004 its output broke through the five million vehicle barrier. But while China ranks fifth in worldwide automotive output, it produces only one-fiftieth of the world's cars, and its total annual output is less than that of General Motors (GM), a single U.S. automotive manufacturer.

In 2003, GM sold 8 million cars, recording sales of $185.5 billion and a profit of $1.1 billion. This represents a profit of less than six percent, or about $137 per vehicle, equivalent to just over 1,100 *yuan*. Ford sold more than 6 million cars for sales of over $160 billion and profit of $500 million for an earnings ratio of only 0.3 percent, an average per-vehicle profit of $62 or 680 *yuan*. In 2003, the Chinese automotive industry produced 4.5 million cars for a total of 926 billion *yuan*, a profit of 88 billion *yuan*. This represents an average per vehicle profit of 17,000 *yuan* per vehicle, or more than 15 times that of its American counterparts.

Wherever you look, companies such as First Automotive Works Corp. (FAW), Shanghai Automotive Industry Corp. (SAIC) and Tianjin Automotive Industry Group Corp., or the Guangzhou Automotive Group, Chang'an Motor Corp. or Donfeng Motor Corp., are producing models that earn mega profits. Most typical is SAIC-Volkswagen's low-end Santana. At an import cost of 26,000 *yuan*, the sticker price of this model in China is 150 percent higher than overseas, and sells at a 40 percent profit. Over the course of just a few years, the Beijing Hyundai Plant has produced more than 60,000 Sonatas for a realized profit of over 3 billion *yuan*, an average per vehicle profit of 38,000 *yuan*. Guangzhou Honda sold 100,000 cars for a realized profit of 7 billion *yuan*, an average per vehicle profit of 70,000 *yuan*. China's auto sales are unregulated, and prices are entirely arbitrary.

How did these mega-profits come about? Except for individual makes such as Zhonghua and Chery, the vast majority of cars manufactured in China are produced in joint ventures with foreign automakers, and the designs are all imported. Domestic assembly of imported parts accounts for the major portion of cost. Labor hours, management and import costs are not high, and wages are low. Importing famous designs saves on the huge cost of marketing and research and development. When production of parts for old models is domesticated, technology transfer fees as well as equipment depreciation costs fall, creating room for extraordinary profits.

The Communist government's policy of trade protectionism for backward industries is the reason for these mega-profits. Although tariffs on imported cars were abolished in 2005, after China joined the WTO, shrewd importers continue to use the WTO's agreement on customs valuation[4] to their own ends. Imported cars falsely report market prices that are impossibly low for tariff purposes, evading a huge amount of import duty in the process. The Swedish automaker Volvo's S60 has a price of $30,000 on the international market and a price of 600,000 *yuan* (approximately $75,000) in China. Importing low and selling high becomes another opportunity for mega-profits.

Added layers of exploitation show up between distributor and consumer. Methods include "sold out" sale-price stock, (bait and switch), frenzied scalping, binding loans, under-the-counter transactions, flagrant mark-ups, "cloned" accessories (counterfeit and inferior), false descriptions and cheap insurance that pays no claims.

Long-sighted profits in eyewear

Nearly a quarter of China's 1.3 billion people, some three hundred million individuals, wear glasses. Fifty million pairs are sold each year for sales worth 20 billion *yuan*. Townspeople buy new glasses once every three or four years, while people in big cities change about every two years. Calculating on this basis, annual demand in the Chinese eyewear market far exceeds 50 million pairs, not including sunglasses or professional protective eyewear. Beijing, Guangdong, Xiamen, Wenzhou, Danyang and Linhai are the main eyewear production bases. China has more than 23,000 eyewear shops, and if chain store branches are included, the total exceeds 32,000.

The large number of consumer complaints reveals the underside of the eyewear industry's mega-profits. A little jingle has become popular in the industry: "The frames cost us 20 *yuan*; if we sell them to you for 200 *yuan*, that's a favor, for 300 *yuan*, that's friendship, for 400 *yuan*, that's business." With the cost of lenses less than ten percent of the retail price, the eyewear dealers make a profit of 150 percent or more.

The source of this huge profit is consumers with "more cash than smarts." The eyewear industry requires skill in optometry from selection of materials to processing lenses. Looking at a pair of finished glasses, the consumer has no way of judging the quality of the materials or the level of skill employed. Unscrupulous merchants turn this ignorance to their own advantage, selling substandard goods at quality prices. The factory price of lenses is usually less than one *yuan*, so adding even a few *yuan* to the selling price brings considerable profit. China has a very small number of qualified optometrists and opticians; for example, there are only 60 qualified optometrists in all of Guangdong Province. The majority of those involved in the industry have had no formal training. When the consumer experiences dizziness or reduced vision due to substandard eyewear, she has no idea of the actual cause.

Like pharmaceuticals, the eyewear industry is highly segmented. In the majority of eyewear factories, the product is consigned to the factory's sales division and the price is immediately boosted by at least 5 to 12 percent. To reduce risk, the goods usually pass through three or four wholesalers before reaching the retailer, with the price marked up at least 20 percent with each transaction. But the greatest profit comes about at the retail level. The better the brand name, the more money is made, and retail profits can reach 50 to 300 percent.

There are three reasons why profits in the eyewear market are out of control. First, retail shops come in a wide variety, including state-run, collective, privately-owned, individually-owned, Chinese-foreign joint ventures and those that are entirely foreign-invested. Government-run shops make up only nine percent of the total, while the majority are privately run or individually owned. Second, shops are small but numerous. A shop's floor area may run from five square meters to nearly 1,000 square meters, with the number of staff ranging from two to 500. Thirty percent of eyewear shops record annual sales over 100,000 *yuan*; another 30 percent have annual sales of 100,000 to 500,000 *yuan*; twenty percent report annual sales of 500,000 to one million *yuan*, and the remaining twenty percent report sales over one million *yuan*. Third, shops are distributed over a wide area. There are 50 cities in China with a population over 800,000, and each is served with an average of 100 eyewear shops; 300 prefecture-level cities can expect 20 eyewear shops each, and 4,200 administrative counties rely on 5 eyewear shops each. Administration and oversight of such a huge network spread throughout urban and rural China is extremely difficult.

The quality of a pair of glasses rests on three factors: effective vision correction, comfort and attractiveness. The process involves the selection of lenses and frames, adjustment and fitting. The most important aspect is the skill of the optician, but most of China's eyewear shops rely on a manager who has taken on the business of selling and fitting eyeglasses with little or no professional training. Strictly speaking, the eyewear profession should be half-medical and half-commercial, and when optometric services are provided by an ophthalmologic hospital, the consumer will have more confidence in the quality of the eyewear. Some eyewear shops play on this consumer preference and use the name of a hospital to bring in business, while passing on a share of their income to the hospital.

Quality is compromised further through the counterfeiting of famous brands. Small commodity distributors are always copying Ray Ban, Gucci, Dunhill, Versace and other name brands. A pair of Ray Ban sunglasses has a market price of 1,300 *yuan*. A counterfeit passing off copper-nickel alloy as titanium can be produced for 20 *yuan* and sold for 1,200 *yuan*.

Ethnographic studies show that Asians have the world's highest incidence of myopia, with nearly one-tenth of their total population affected. Thirty percent of China's primary school students wear glasses, as well as 50 percent of middle-school students and 75 percent of university students. Eighty percent of the eyewear supplying this huge domestic market is produced in China. This has made the far from attractive eyewear sector one of China's mega-grossing industries.

Translated by Akiko Kageyama and a friend of HRIC.

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EDITOR'S NOTES

1. Yang Baiwan, or "Millionaire Yang," is the nickname for Yang Huaiding, formerly a worker in the Shanghai Ferrous Allow Plant, who made a fortune through treasury-bond trading in 1998.
2. *Open Magazine* and *Zheng Ming* are political monthlies published in Hong Kong. The book titles mentioned are all politically sensitive due to their depictions of modern China.
3. *The Epoch Times* is an overseas newspaper and Web site run largely by practitioners of the banned Falun Gong spiritual movement.
4. Entitled more properly "Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994," this agreement provides methods of determining the customs value through "transaction value." See http://www.wto.org/english/docs_e/legal_e/20-val.pdf.