

Reasons and Possible Countermeasures for the Imperfection of Pre-sale System in China

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Abstract: Ever since the presale mechanism was invented in 1953, it has been welcomed all over the world, especially in real estate purchases. In recent years, the real estate industry in China has been developing since the reform and opening-up policy made by Deng. As it developed, problems also arose as huge numbers of uncomplete building sites started to emerge throughout China's mainland, causing millions of people to end up in poverty or bankruptcy. The research is conducted to seek what actually caused the mentioned situations as well as find possible countermeasures to help avoid them to some extent. This passage lists several main existing problems including flaws in the system, vulnerable reaction systems, and the lack of government management. and to each of them, a correspondent measurement is given as a better solution or a tip for not repeating the same mistake. There are mature systems of presale in regions from Hong Kong to the USA.

Keywords: presale system, unfinished building, Chinese real estate

1. Introduction

The pre-sale system of commercial housing is collectively referred to as the pre-sale permit system of commercial housing. As an important factor to boost the real estate market. This policy has been welcomed in China since it was allowed by the CCP for its high efficiency. The pre-sale system of real estate in mainland China began in 1994 and is one of the important designs of China's market-oriented reform of commercial housing. It played an important role in solving the supply and demand structure of China's real estate market in the past. However, since the beginning of the 21st century, due to the serious lack of supervision over the pre-sale system, unfinished buildings are now frequently appearing, and developers are also missing [1]. It's obvious that something or some part of the system has gone wrong. This research has retrieved many related papers to seek out what caused the problems and possible countermeasures.

A brief description of the presale mechanism: To pre-purchase the under-construction house, the buyers will have to make a down payment to show their will to buy the estate. After that, they will take the title deed to the bank to mortgage their house to pay the rest of the house's price. The prepayment will be divided into several parts, one to pay tax, one being paid directly to the developer,

and the rest are stored in an account supervised by the bank with the mortgage of the rest house price. Money in this account is supposed to be paid to the developer periodically regarding the progress of the construction. The proportion of different periods varies from one city to another.

2. China's Real Estate Industry

At an important historical crossroads. The past two years have been a tumultuous period for China's real estate industry: the introduction of the "Three Red Lines" policy, frequent debt defaults by real estate companies, the emergence of overdue housing deliveries, the sudden collapse of celebrity enterprises, and the recent "Financial 16" (Notice on Doing a Good Job in Supporting the Stable and Healthy Development of the Real Estate Market) and other real estate financial stability policies to attempt to rebalance the market.

Since the reform of housing commercialization, China's real estate development has made tremendous achievements, with a significant increase in per capita living area (an increase of 2.5 times from 1995 to 2020); It occupies an important position in the economic market (with real estate and upstream and downstream industries accounting for about 30% of GDP) and has a systematic impact on the national economy. On the other hand, phenomena such as high housing prices and high leverage have had an increasing negative impact on economic development, financial stability, and people's livelihood. In recent years, the central government has continuously emphasized the principle that "housing should not be speculation". In order to curb the high growth of housing prices, regulatory authorities have taken many measures, including administrative measures such as purchase restrictions, loan restrictions, and price limits.

The "three red lines" that have had a significant impact in the past two years are the deleveraging requirements for real estate enterprises, which have had a profound impact on the industry. However, this research believes that these methods cannot fundamentally solve the current problems of China's real estate industry and will bring secondary problems. For example, price limits trigger a gray market, and excessive deleveraging leads to industry and industry chain liquidity crises. The underlying reason for the high housing prices in urban areas is the imbalance between supply and demand, and it is necessary to find the root cause of the imbalance in order to fundamentally find a solution to the problem. This research further found that there are actually three interrelated systemic imbalances in China's real estate industry. By sorting out these three imbalances, the solutions to China's real estate problems will be clearer.

In the era of innovative internet, network information technology is rapidly developing. The increasing popularity and application of information technology in various industries has brought great convenience and challenges to various industries in society. For the real estate industry, which is both an opportunity and a challenge, the rapid development of Internet information technology has led to an increase in online trading behavior and a decrease in offline trading behavior. With the popularity and convenience of electronic contracts, online transactions are becoming more attractive to some younger consumer groups. However, due to the difficulty in regulating online trading behavior and the inability to effectively control the process of online trading behavior, it is difficult for online trading behavior to receive supervision from relevant national departments, which brings great regulatory difficulties to the real estate industry's trading work. While facilitating the understanding of real estate industry trading behavior, it also brings many regulatory blind spots to the trading supervision work [2].

Characteristics of cash flow in real estate enterprises are:

(1) Large demand for funds and high cash flow

Due to the fact that real estate enterprises require a large number of funds as support in implementing project development and promoting project construction, and with the development of the national economy, land prices in various regions of China are also constantly rising, which further

increases the financial pressure on real estate enterprises. Whether used for purchasing land, paying loans, or in the implementation process of related projects, funds must be used as support, and this also increases the cash flow of real estate enterprises to a certain extent. There will be cash flow circulation in various stages of project development, engineering construction, and later delivery, which requires real estate enterprises to strengthen their management of cash flow.

(2) Long fund recovery cycle, difficult cash flow management

Generally speaking, from the development of real estate project engineering to the completion acceptance. It takes about 2 years to go through, and the cycle span is relatively long, resulting in a relatively long fund recovery cycle. Moreover, due to the inconsistent acceptance cycles and policies in different regions and projects, real estate enterprises often use installment payments in their later sales work, which further prolongs the time for fund recovery and increases the pressure on fund recovery. The difficulty of managing cash flow for real estate enterprises will also continue to increase.

(3) The distribution of cash flow is uneven, with significant differences between inflow and outflow

Firstly, when real estate companies are planning a new project, they usually raise a large amount of funds externally to ensure the normal operation of the project, which is called cash flow inflow. Secondly, when real estate companies raise the above-mentioned funds, they will invest these funds into their investment projects, which is called cash flow outflow. Finally, real estate companies recover a large amount of funds from this project for profit [3].

3. “Rotten-Tail” Building in China

An unfinished building refers to a real estate project that has completed land use and planning procedures but has been suspended for more than one year after the project starts due to the developer's inability to continue investment or debt disputes. There are many reasons for the formation of unfinished buildings, such as the bankruptcy of developers under construction, lack of construction funds, economic disputes involved in the project, and project shutdowns caused by developers violating laws and regulations. Most of these reasons are due to a broken funding chain, unfinished projects, developers no longer able to make money, banks unwilling to continue lending, and the project cannot be transferred to other investors. The unfinished buildings damage the city's image, wasteland resources, and undermine investor confidence [4].

There are many reasons for the formation of unfinished buildings, such as the bankruptcy of developers under construction, lack of construction funds, economic disputes involved in the project, and project shutdowns caused by developers violating laws and regulations. Most of this is due to a broken funding chain, incomplete completion of the project, developers no longer being able to make money, banks unwilling to continue payment, and the project being unable to be transferred to other investors, forcing the project to be shut down. In China's construction market, there are many examples of this, making the disposal of unfinished buildings a long-term "concern" for local governments.

3.1. Fund Chain Breakage

The real estate market in some areas has overheated, and after macroeconomic regulation, credit funds have shrunk, and the subsequent funds for the project cannot keep up, so the project has to be put on hold. For example, most of the unfinished buildings in Hainan Province, Beihai City, Guangxi and other places were the "sequelae" of the real estate overheating phenomenon in some areas in 1993. At that time, the growth rate of real estate investment was much higher than the growth rate of sales, many of which were the result of blind investment and excessive speculation on land and projects.

Due to the drastic changes in the international economic environment, the real estate developer's capital chain has broken, and the construction party has been forced to stop work. For example, most of the unfinished buildings in Nanning, Guangxi were formed during the 1997 Southeast Asian financial crisis.

3.2. Inaccurate Market Positioning

The mismatch between the original investor's positioning in the real estate project market and the market environment led to a bleak sales outlook for the property, forcing the original investor to make changes. The reason why real estate developers have built and stopped during the year is due to their insufficient understanding of product positioning and market risks when making investment decisions.

3.3. Construction Quality Leading to Shutdown

Due to the use of unqualified contractors, the construction quality of the invested property was poor and was suspended without pay. For example, a dilapidated building in Wenzhou City is located in the city center of every inch of land and every inch of gold. It was built for 8 years and ultimately failed to pass the completion inspection.

3.4. Debts and Debts Disputes

Due to the lack of standardized management or inadequate management during the business process, disputes over creditor's rights and debts have become entangled, leading to the suspension of the project. The unfinished building project of a certain company in the district had chaotic management of the original project and unclear accounts, resulting in multiple disputes over creditors' rights and debts, and ultimately had to be suspended [5].

First, the aging of the population in China has been a controversial problem for decades. Old people somehow do not deserve better shelters and dwellings, as some of our population thought.

What's more? There is a foam in China's real estate market in which, to pursue high profits, some developers blindly expand and over-invest, leading to the rupture of the capital chain and failure to complete projects on time, resulting in uncompleted residential buildings. Investors often rush into projects hoping for quick returns, but when demand doesn't meet expectations, construction halts.

Moreover, China has limited land resources and insufficient land supply, leading to high land prices. Some developers are willing to bid at high prices in order to compete for land, resulting in excessive financial pressure and inability to complete projects on time, resulting in unfinished buildings.

In addition, there are some non-standard developers in the real estate market in China who have violated regulations in project initiation, approval, and other aspects. The government's weak approval has led to some projects being unable to receive effective supervision and management, resulting in unfinished buildings.

Furthermore, there is insufficient market demand in some regions of China's real estate market, and some developers blindly expand and invest excessively in pursuit of high profits, resulting in projects being unable to be completed on time and resulting in unfinished buildings. Last but not least, China's financial policies are constantly adjusting, and some developers, after obtaining loans, are unable to complete projects on time due to policy adjustments, resulting in unfinished buildings.

To sum up, there are many reasons for uncompleted residential buildings in China. The government, developers, and regulatory authorities need to work together to avoid the emergence of uncompleted residential buildings and realize the healthy development of the real estate market by strengthening supervision, improving the approval system, controlling the foam in the real estate market, and other measures.

The existing system is vulnerable to the unfinished building. If the construction site was really suspended due to reasons like a break in the developer's finance chain, there seems to be no method for the buyers to safeguard their rights or be compensated. As a result, when the project went south, many buyers found themselves in a desperate and helpless position. Neither pressing charge to the bank nor to the developers seems to go well. All they could do was sit on their hands and wait until the construction was outsourced to some other developers or the developers somehow managed to receive enough funds to pay all the debt and still willing to finish the project. The former solution is only suitable for small projects in small cities, while the big ones shall be too much to be handled by small developers. The latter one just seems even more unrealistic.

4. Flaws in Chinese Pre-Sale-System

China's pre-sale system is imperfect in some perspectives. The essence of the pre-sale system of real estate is that the purchaser delivers a deposit or advance payment to the real estate agent who is still developing the property. The date of completion of the house is agreed upon in a contract between the two parties. Over the past 20 years, the pre-sale system has been crucial to the continuous growth of the real estate market in mainland China. It resolves the issue of insufficient funding for commercial property construction, quickens capital turnover, raises the project's internal rate of return, further encourages the growth of the enterprise scale, and finally raises the rate of return for shareholders. In mainland China, the urban residential stock increased from less than 1.4 billion square feet to 31.32 billion square feet between 1978 and 2020, according to the China Housing Stock Report [6].

However, the imperfections of China's pre-sale system have to some extent contributed to the emergence of rotten buildings in China. China has not implemented unified pre-sale fund supervision for many years. Even cities have their own rules for oversight. Cities like Zhengzhou, Fuzhou, and Hefei oversee a portion of funds based on projected investment, while cities like Taiyuan, Kunming, Chongqing, and Changsha focus on overseeing the proportion of funds of about 15–40% of the total pre-sale amount [6]. Confusion over regulatory standards can lead to lax and difficult regulation, ultimately leading to non-compliant real estate companies abusing buyers' prepayment deposits or even running away with the money.

Unlike the pre-sale system in foreign countries, where buyers pay in installments according to the developer's progress until the house is completely built, Chinese buyers usually take out a one-time loan from the bank to pay for the house after making a down payment [7].

What's more, there are not so many strict regulations on pre-sale law in China. In this way, prepayments are more like interest-free loans for real estate developers. Many small real estate developers usually sneak the prepayment into other projects under other names, as most of the risk is borne by the buyer at this time. Other builders, developers, and suppliers have used legal loopholes to fraudulently issue bills and misrepresent the status of construction projects to withdraw pre-sale monies in advance [8]. It also happens frequently for pre-sale cash to be misappropriated. Some real estate corporations will use the pre-sale proceeds for loan repayment, land payment, and employee wage payment. These operations on prepayments will not reveal major problems when China's housing prices are rising or are bullish, but once the country's economy starts to decline and real estate starts to experience a decline in sales and supply exceeds demand, the capital chain can easily break, leading to the cessation of construction of many projects. Thus, as China's economy suffers from COVID-19, more and more ugly-looking rotting houses are appearing in China.

5. Possible Counter Measurements

Firstly, choose high-quality developers. Choosing high-quality developers will be more secure and can largely avoid buying unfinished buildings. Secondly, check whether the procedures for real estate development are formal and legal. A property needs to have certain qualifications for pre-sale. If the procedures are not complete and the documents are insufficient, pre-sale is not protected by law. Finally, don't buy a house too early. When buying a house, everyone must be careful not to buy it too early because it is cheap. At least we should see the progress of the property first, and the construction of the property has been completed by more than half [9].

The phenomenon of numerous unfinished buildings cannot be solely attributed to the pre-sale system. The pre-sale system has been in use for many decades in countries like America, yet we rarely hear about unfinished projects there. The reasons behind this issue are complex. Therefore, to address this problem effectively, policymakers need to think more deeply and adjust from both social and economic perspectives.

China can look to Hong Kong as a compelling example to study. Although Hong Kong shares many similarities with the mainland, it doesn't experience as many unfinished projects. One significant reason is its more comprehensive financial system. In the way the pre-sale system operates, there is an account supervised by the bank, as required by law. The bank should withdraw money from this account regularly and provide it to the developer to complete the building. However, due to real estate companies being vital clients for banks, they often request early withdrawals for their company's expansion rather than project completion. In Hong Kong, this is not the case. The account is managed by a law firm, not a bank. Law firms lack the incentive to engage in risky practices since real estate companies are not significant clients for them [10]. This setup helps prevent unauthorized use of the funds.

Additionally, the government should increase its scrutiny of real estate companies. In China, many real estate firms do not appear financially healthy in their reports due to the rapid expansion of the housing market in previous years. For such companies, they should not be permitted to start new projects or should be limited to building commercial structures rather than residential housing. These developers often acquire large amounts of land in undeveloped cities because it is affordable. However, their financial situation prevents them from completing the buildings, causing significant harm to consumers. Houses represent a substantial portion of the net worth of people living in undeveloped cities. For projects that have already been halted, banks or companies should compensate customers. It is their responsibility to address situations like this, but they often evade accountability through various means, including declaring bankruptcy. There should be stricter laws in place to determine who bears the responsibility for incomplete buildings. Currently, many projects are abandoned because companies can avoid significant losses even if they fail to complete them.

6. Conclusions

Overall, there are many different reasons for China's rotten buildings, but the main reason lies in the loopholes in the Chinese government's regulation of real estate and related policies. By doing research on relevant studies and reviewing the history, this paper identified reasons including fund chain breakage, inaccurate market positioning, construction quality leading to shutdown, and debts and debts disputes. To tackle these problems, in the future, some measures should be used, like choosing high-quality developers and the government should increase its scrutiny of real estate companies. And it should be noted that Hong Kong, as a model, could offer relatively practical solutions. Of course, it is also possible to imitate foreign policies on real estate regulation.

Authors Contribution

All the authors contributed equally and their names were listed in alphabetical order.

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