THE BUSINESS OF LOTTERY AND GAMING IN CHINA

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Executive Summary

From a gaming operator's perspective, China represents a much-coveted prize. Not only is it the world's most populous country, it also has a culture which is deeply ingrained in gaming, stretching back over 3,700 years. Despite China's hostile operating environment, both politically and legally, the business has continued to flourish and, since the turn of the new millennium, gaming across the region has been experiencing faster than ever growth.

Gaming in China takes two different forms: the official lottery, which is administered and operated by the national government; and unofficial or underground gambling activities, which are defined as illegal according to Chinese criminal law. Measured at the end of 2006, the official lottery generated annual sales of nearly RMB 82 billion (approximately US$13 billion) while estimates of the value of illegal gambling activity were at least RMB 1,000 billion ($166 billion). The total value of gaming in China in 2006 was therefore around RMB 1,082 billion (approximately $175 billion).

China's National Bureau of Statistics' last available data for 2006 shows the Chinese population stands at 1.3 billion with income per capita of $2,010. This gives an estimated total income of $2,613 billion for the year meaning that spending on gaming accounted for over 6% of total national income. This indicates just how important an element this is in the Chinese way of life.

Gaming for the Chinese is analogous to the dominant role football plays in the social cultures of most European countries. It forms an intrinsic part of life at all levels of society. Gambling has a longer history than almost every other form of entertainment in China and has evolved to fit itself to the nation's social, political and economical environment. It is common to see people playing mah-jong or poker by the roadside and for many it forms part of the rhythm of everyday life. It is quite normal to bet on boxing, horse racing, or dog racing, but can anyone imagine betting on a cricket contest? That is the small insect, not the sport. The Chinese regularly bet on cricket fights held in a pot.

The Chinese have therefore acquired a well-deserved reputation for their extreme gambling tendencies. They will bet on almost anything with almost anyone: friends, colleagues, even strangers. No leisure pursuit really counts for anything unless money is at stake on the outcome. Even the government's attempts to block illegal gambling have had to take account of this. They classify individuals gambling together with reasonable odds not as illegal gaming but as leisure and entertainment. It is only seen as illegal where there is a pre-defined intention to make a profit.

There are essentially two kinds of gaming consumers as defined by consumption habits and psychology. One is the leisure player who plays moderately for entertainment and fun, with a desire to gain financially but a realistic grasp of the odds of doing so. Winning brings excitement but losing will do them no real harm. The other kind is the obsessive, potentially addicted gambler, for whom winning money is the only goal and who sees gaming as a quick and easy way to acquire a fortune.

One of the striking differences between the average lottery player and the gambler who prefers illegal gambling is their comparative income levels. The majority of lottery players tend to come from the lower income groups although, conversely, they do not account for the bulk of lottery revenue. By contrast, in the unofficial gambling market, players are overwhelmingly made up of middle-income groups both in the numbers playing and in spending per head.

The gaming industry is well developed in almost every region in China with the exception of the North West. South-East China is responsible for around a third of the total value of the Chinese gaming market. It is the most advanced in part because of its close proximity to the sophisticated gaming markets of Hong Kong and Macao and partly because of its distance from Beijing and its comparatively well-developed local economy. This market is predicted to be the fastest growing over the next three to five years.

East China is the second most important gaming region and has the dubious reputation as being the home of one of the largest illegal gambling operations in China, which police closed down in Shanghai. Gaming is developing rapidly in the region in line with its fast-paced economic growth.

South-West China is regarded as the most promising new market for gaming. This area has the most populated province in China, Sichuan, where the people are characteristically known for their appetite for enjoying life and are prepared to spend in pursuit of entertainment. East China and South-West China together account for another third of the total gaming market in China. The other three areas are less developed due to their less advanced economies and a more controlled legal and political environment.

China had a total of 70 million lottery buyers by the end of 2006, according to the statistics of the Ministry of Finance, whilst the underground market is estimated, by the Ministry of Public Security, to involve some 30 million participants. Most of these (over 70%) are in the 18-44 age range, although in the rapidly developing world of internet gaming the customers tend to be younger.

Yet, the lottery industry's relatively short history in China is evident from the gap that exists in its organisational and administrative effectiveness, compared to more mature markets.

Competition between the two monopolistic organisations has contributed in some measure to initial market improvements, such as a more rapid rollout of retail outlets and innovations in sales techniques and game design. However, the duopolistic structure has also hindered progress in certain aspects which has, in effect, acted as a brake on further development. For example, it has resulted in much unnecessary duplication. Maintaining two sales and distribution networks wastes considerable resources and increases running costs.

Similarly in management, whilst differentiation between the sports and welfare lotteries should encourage both to develop robust rules and regulatory structures, in reality this simply adds complexity and duplicates the legal processes. This in turn adds to costs and compromises effective management supervision.

Innovation in game design and issuance has also been disadvantaged. The current collection of games and outlet channels worked well when the lottery was a new concept – it enabled rapid introduction in new markets – but these are now struggling to keep pace with the demands of consumers. Some recent game innovations, such as the China Welfare Lottery Online, and the resulting rapid expansion show the scope for getting this right and the results that are likely to follow.

Conversely, the over-centralised nature of the systems has resulted in a certain level of homogeneity, which takes no account of strong regional differences. Focusing on sport and a particular type of welfare has, in the view of some, been over restrictive and has prevented funds from going to causes in other areas, such as education or the environment. This highlights the strong demand that exists with the public in support of causes but also indicates that there is some confusion as to the purpose and character of the lottery as an entertainment medium.

While there may be issues with the mechanisms involved, the overriding purpose of a national lottery is to raise funds for the development of public welfare projects and thereby to improve the welfare of society as a whole. The global growth of national lotteries after the 1950s coincided with a philosophy of wealth redistribution and a growing realisation that the state should not necessarily have responsibility for all forms of social welfare.

The way in which these funds are managed under the Chinese system has obvious advantages in ensuring the implementation of key public welfare programmes and raising public consciousness of the impact that an injection of capital can have. But it also brings with it certain problems.

Firstly, there is a long time lapse between the collection of funds and their distribution to public welfare projects. It is estimated that up to one quarter of lottery funds are held on deposit at any given time whilst distributors go through the highly bureaucratic processes involved for the allocation of funds to social causes.

Secondly, any welfare fund that handles large quantities of money is open to abuse. Supervision can only be effective up to a certain point and the power of central government over local administrations is limited. Controls are fundamentally weak and the illegal use of funds almost inevitable.

And thirdly, the priorities set by the lottery operators will always appear unfair to those causes which do not receive support. This has led to much debate in recent years with some critics seriously questioning the value of sport over education or the environment and asking whether these independent and sometimes unaccountable bodies should really have so much power in dictating how funds are spent.

Internet gaming, which only really exists unofficially in China, is becoming an increasingly popular format and the potential that it offers to gaming operators as an enticing prospect in the Chinese gaming market is obvious.

Among the 30 million unofficial gaming customers, it is estimated that 14% to 22% play online. This would indicate that, at the start of 2007, internet gaming had a customer base of between 4.2 million and 6.6 million people. At the time, according to China Internet Network Information Centre (CNNIC) data, China had a total of over 137 million internet users, indicating that between 3.1% to 4.8% of all Chinese internet users are internet gaming customers. With data from CNNIC indicating 200 million Chinese internet users by the end of 2007, this suggests that current levels of internet gaming usage could be as high as 10 million. And all the evidence is that these figures will keep increasing rapidly.

The structure of this report revolves around the three key aspects of gaming in China. The first section (chapters 1 to 6) deals with all aspects of the official side of gaming activity, namely the Lottery in China, its structure, character and evolution. Appendices 1-11, included at the end of the report, contain relevant additional supporting sales data.

The second (chapters 7 and 8) looks at the growth of underground gaming, its history, development and current impact on the economy. In addition to the negative social consequences, underground gambling has had some effect on China's economic progress: because gamblers will always lose more than they win a great deal of capital has flowed offshore resulting in fewer resources to reinvest locally. This section also analyses the impact illegal gaming has had on government legislation, its marketing and business models and the pattern of regional penetration, including game formats and other gaming activities.

Finally, the third section (chapters 9 and 10) examines the impact of the internet on China's gaming market as a whole, in terms of the development of both its 'legal' and 'illegal' formats. It assesses the technological and business opportunities offered by this highly accessible form of gambling, against the backdrop of China's current legislative restrictions, and discusses the possible future gains and pitfalls of embracing this potential 'enfant terrible' of the gaming world.

Methodology

Because of the nature of the gaming industry, data and information is not trasparent and is, by definition, difficult to find. Face-to-face interviews with contacts at official organisations have been conducted to obtain reliable first-hand information, including: the China Welfare Lottery Issuance and Administration Centre and regional welfare lottery centres; the General Administration of Sports, China Sports Lottery Administration Centre and regional sports lottery centres; the Ministry of Public Security; the Gaming Research Institute of Peking University; major gateway financial services companies (3); major online joint-purchase agencies (5); lottery and gaming content-related media companies(12); and domestic and international internet gaming companies (4 and 3 respectively). To guarantee the reliability and accuracy of data, this report only uses data which has been authenticated by the relevant lottery centre personnel.