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Another Look at China – The Social Credit System

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In the United States, personal credit scores and corporate credit ratings establish trust that is easy to take for granted. Individuals trust that if they pay their credit card bills and student loans on time, a good credit score provides access to more credit. In turn, they could take out a loan to buy a building. They trust the building is legally theirs until they sell it. The lender trusts if the borrower defaults on their loan, there is recourse. Overall, citizens trust the system. But what if that was not the case – how would an economy-wide lack of trust hinder economic growth?

Trust is often missing in developing countries, which China accurately recognized as an economic setback. In 2014, China's State Council published the controversial Planning Outline for the Construction of a Social Credit System to tackle the issue. However, the system overlooks concepts crucial for developing trust, such as rule of law, independent legal institutions and property rights.

The Issue with Trust Issues

In China, there are no credit scores or ratings –lenders have no means to evaluate a borrower's creditworthiness. On the other side, effective laws and institutions are not in place to enforce a private lender's claims against a borrower. When private Chinese lenders take a defaulted borrower to court, the lender could win the case but still never get paid back. Hence, private lenders are few and far between, and almost all lending is through government-owned institutions.

China began the Social Credit System (SCS) to establish credit scores, which is expected to be country-wide by 2020. Think of the SCS as a reputation system – it is designed to reward trustworthiness and punish untrustworthiness for both individuals and businesses.

On an individual level, social credit scores are affected not only by financial actions, but also social actions, like quarrelling with a neighbor or parking a shared bike in an undesignated area. In some pilot cities, the SCS goes as far as publicly shaming jaywalkers by displaying their photo on downtown billboards. Not only can a low social credit score stop somebody from borrowing money, it can also prevent them from buying a plane ticket or staying at a luxury hotel.

For businesses, a company might have a low social credit score for quantifiable violations, such as pollution or tax evasion. However, more questionable and qualitative factors could influence a company's social credit score. For example, the Chinese government is using big data technology to monitor its citizens. The government might boost the credit score of a big data tech company, so the company has easier and cheaper access to capital. In turn, the government benefits from the company's advances in big data technology.

Scoring individuals and businesses is a significant step towards creating trust. However, pilot SCS programs increase the Chinese government's authoritarian control more than they increase trust and economic growth.

What's Mine is Mine and What's Yours is Mine

Land in China is entirely owned by the State, and while it issues land leases to companies, there are numerous restrictions. Furthermore, land laws are not necessarily enforced. In some instances, the government seized land from investors to give to local developers for no cited reason.

Intellectual property rights are also unreliable in China. A business can acquire a patent or copyright, but these protections are regularly violated without consequences. What incentive does an entrepreneur in China have if their business and ideas can vanish at a moment's notice? The SCS does not address the mistrust between entrepreneurs and the government.

Other Options for Establishing Trust

While China should build societal and economic trust, developed countries do so without monitoring every move of citizens and businesses. Trust is built on rigorous property rights, as well as rule of law and strong legal institutions.

We discussed China's poor rule of law last year in "The Law Deficit"[1]. Rule of law establishes trust, because every person follows the same laws, and the majority of people believe the laws are appropriate. Independent legal institutions enforce the rule of law effectively. In the example of the private Chinese lender not getting paid back, an independent legal system enforces recourse for the lender. In the U.S., it's hard to imagine a bank would provide capital to a business if the bank had no recourse if the business went under.

Formerly authoritarian countries such as South Korea and Taiwan had a choice to make when they reached similar GDP per capita to China's current GDP per capita – they could pursue rule of law or

[1]Available at: https://ghpia.com/the-law-deficit/

increase authoritarian control. Both countries' governments relinquished authoritarian control and embraced rule of law for the sake of rapid economic growth. Today, South Korea and Taiwan are wealthy countries with GDP per capita roughly 3x China's. The SCS might temporarily advance China's wealth, but ultimately, we believe it provides China's government with additional social control, not sustainable economic growth.