Stanford | Center on China's Economy and Institutions
Freeman Spogli Institute and Stanford Institute for Economic Policy Research

SCCEI CHINA BRIEFS
Updated January 15, 2023

# China's Corporate Social Credit System And Its Implications

Lauren Yu-Hsin Lin and Curtis J. Milhaupt (2021). **China's Corporate Social Credit System: The Dawn of Surveillance State Capitalism?** European Corporate Governance Institute, Law Working Paper No. 610/2021.

China's corporate social credit system (CSCS) is a data-driven scoring system based on a wide array of information to rate the "trustworthiness" of all business entities registered in China. The researchers conducted the first empirical analysis of the CSCS based on its implementation in Zhejiang, the first province in China to publish scores from the public credit assessment exercise.
Their analysis provides preliminary insights into the potential determinants of these corporate scores and the possible effects of the CSCS on firm compliance and behavior.

**China's corporate social credit system.** The CSCS is a technology-assisted corporate compliance project based on a nationwide collection of information on every company registered in China, including foreign firms. While still under construction nationwide, two basic types of information will be collected on each company once the CSCS is fully operational: a) public credit information, gathered from regulatory agencies, central and local governments, and the judiciary regarding fines, judgments, business licenses, and credit information associated with the enterprise; and b) market credit information, generated by consumers, industry associations, third-party credit rating agencies, and by the enterprise itself regarding the company's financial, management, and contract performances.

**China's corporate social credit system has the potential to modify business behaviors toward policies favored by the CCP**

## INSIGHTS

- China's corporate social credit system (CSCS) is a data-driven scoring system to rate the "trustworthiness" of all business entities registered in China.
- In the first publicly-available CSCS scores from Zhejiang Province, neither better-governed nor more profitable firms received higher overall scores, but highly-leveraged firms subject to higher default risks were associated with lower total scores.

The CSCS is linked to a system of rewards (red listings) and punishments (black listings) maintained by government agencies. Inclusion on the black list triggers market barriers, such as restrictions on obtaining government approvals, greater frequency of inspections, and prohibitions on obtaining credit or issuing stock. Inclusion on the red list can confer a variety of benefits, ranging from expansion of access to loans to a reduction in the frequency of inspections. Importantly, because data on rewards and punishments are centralized, black listing (or red listing) by one agency can trigger punishments (or rewards) by an array of other agencies in what is effectively a system of collective enforcement.

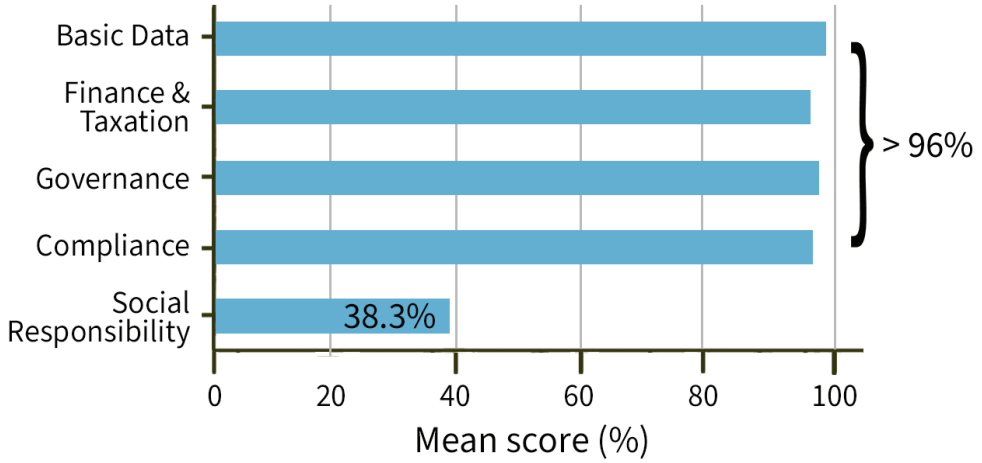
**The data.** Researchers collected the first publicly-available credit scores of all 531 A-share listed companies headquartered in Zhejiang Province from the local government website as of July 2021. Fifteen percent of the companies were state-owned and 85% were privately-owned enterprises.

The following five categories comprise the first tier of indices measuring each company's public credit scores: a) *Basic Data* aggregates information regarding any dishonest acts or abnormal operations committed by key personnel or the business itself (comprising 8% of the total score); b) *Finance & Taxation* includes information on the creditworthiness of the enterprise (19.5% of the total score); c) *Governance* aggregates information related to an enterprise's product quality, safety record, and environmental compliance (9% of the total); d) *Compliance* aggregates information regarding the firm's record of adherence to rules and judgments issued by government agencies and judicial authorities (45% of the total); and e) *Social Responsibility* aggregates information on awards from government organs, CCP-sanctioned charitable donations, and volunteer activities (18.5% of the total).

## INSIGHTS

- This research finds that politically-connected firms received higher CSCS scores, primarily by accumulating soft merits for charitable donations sanctioned by the party-state, volunteer activities, and awards from government organs.
- The findings underscore the CSCS's potential to nudge firms to adopt the preferred policies of the CCP and to exhibit increasing fealty to the CCP.

*Average scores of first-level indicators measuring company public credit scores*




**The largest payoff.** The researchers find that 74.2% of the listed firms in Zhejiang are rated Excellent, while only about 2% of the firms are rated Fair or Poor. Overall, around 90% of the firms are ranked Excellent or Good, suggesting either the quality of Zhejiang's listed firms are comparatively high or the quality of the data in the rollout phase is relatively poor. They also found that among the five categories set forth above, the lowest average scores were in the *Social Responsibility* category: 38.3%, compared to > 96% for each of the other four categories. The *Social Responsibility* category also generated the greatest variation in scores among firms. As such, the researchers suggest that the largest payoff to companies hoping to raise their CSCS scores may be to engage in more "socially responsible" actions, such as donations to CCP-sanctioned organs and volunteer actions.

**Determinants of the scores.** The researchers sought to identify the determinants of a firm's corporate social credit score. Using the China Stock Market and Accounting Research Database and the Wind Financial Database, researchers collected data on each firm's quality of corporate governance (as proxied by the percentage of independent directors on the board), the firm's financial condition (level of indebtedness and return on assets), the degree of formal party-state connections (such as the extent of state equity ownership), and the company's political connectedness (whether any director or the chief executive officer served in high-level government or party positions). The researchers found no correlation between higher overall scores and better-governed firms or more profitable firms. Highly-leveraged firms, which are subject to higher default risks, were associated with lower total scores. They found that politically-connected firms were associated with higher CSCS scores, not as a result of better compliance or superior administrative track records, but by accumulating soft merits from party-state organs under the *Social Responsibility* category.

**Incentivizing corporate fealty.** Although the findings are limited to Zhejiang Province and the first publicly-available scores, the research nevertheless raises meaningful questions regarding the implications of the CSCS. For example, as a system of evaluation structured by rewards and punishments, the research suggests that the CSCS has powerful behavioral modification potential, nudging businesses to adopt the industrial and social policies favored by the CCP, possibly even if they hurt the company's bottom line. Foreign companies registered in China are also subject to the CSCS, potentially deepening the complexity of operating in China's economy. Lastly, the CSCS raises the specter of high-tech central planning — and the potentially troubling prospects of such a development for China's own economic productivity.