Informal Finance: A Theory of Moneylenders

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Abstract

I study the coexistence of formal and informal finance in underdeveloped credit markets. Formal banks have access to unlimited funds but are unable to control the use of credit. Informal lenders can prevent non-diligent behavior but often lack the needed capital. The model implies that formal and informal credit can be either complements or substitutes. The model also explains why weak legal institutions raise the prevalence of informal finance in some markets and reduce it in others, why financial market segmentation persists, and why informal interest rates can be highly variable within the same sub economy.

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1 Introduction

Formal and informal finance coexist in markets with weak legal institutions and low levels of income (Germidis et al., 1991; Nissanke and Aryeetey, 1998). Poor people either obtain informal credit or borrow from both financial sectors at the same time. Banerjee and Duflo (2007) documented that 95 percent of all borrowers living below $2 a day in Hyderabad, India access informal credit.

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sources even when banks are present.\footnote{See Siamwalla et al. (1990) for similar findings from Thailand.} Meanwhile, Das-Gupta et al. (1989) provide evidence from Delhi, India where 70 percent of all borrowers get credit from both sectors at the same time.\footnote{See Conning (2001) and Giné (2007) for related support from Chile and Thailand.} Such financing arrangements raise a number of issues. Why do some borrowers take informal loans despite the existence of formal banks, while others obtain funds from both financial sectors simultaneously? Also, is there a causal link between institutional development, level of income, and informal lending? If so, precisely what is the connection?

Although empirically important, the coexistence of formal and informal finance has not received as much attention as recent theoretical work on microfinance (Banerjee et al., 1994; Ghatak and Guinnane, 1999; Rai and Sjöström, 2004). In this paper, I provide a theory of informal finance, whose main assumptions can be summarized as follows.

First, in line with the literature on the effect of institutions on economic performance (La Porta et al., 1997, 1998; Djankov et al., 2007; Visaria, 2009), I view legal protection of banks as essential to ensure availability of credit. To this end, I assume that borrowers may divert their bank loan (ex ante moral hazard) and that weaker contract enforcement increases the value of such diversion, which limits the supply of funds. By contrast, informal lenders are able to monitor borrowers by offering credit to a group of known clients where social ties and social sanctions induce investment (Aleem, 1990; Udry, 1990; Ghate et al., 1992).\footnote{For further evidence of the personal character of informal lending see Udry (1994), Steel et al. (1997), and La Ferrara (2003) for the case of Africa and Bell (1990) for the case of Asia. As in Besley and Coate (1995), my aim is not to explain informal lenders’ monitoring ability, but to understand its implications.}

Second, while banks have access to unlimited funds, informal lenders can be resource constrained. In a survey of financial markets in developing countries, Conning and Udry (2007) write that “financial intermediation may be held up not for lack of locally informed agents...but for lack of local intermediary capital” (Conning and Udry, 2007, p. 2892). Consequently, landlords, professional moneylenders, shopkeepers, and traders who offer informal credit frequently acquire bank funds to service borrowers’ financing needs. Ghate et al. (1992), Rahman (1992), and Irfan et al. (1999) remark that formal credit totals three quarters of the informal sector’s liabilities in many Asian countries.\footnote{Conning and Udry (2007) further write that “the trader-intermediary usually employs a combination of her own equity together with funds leveraged from less informed outside intermediaries such as banks...[leading] to the development of a system of bills of exchange...[used by the] outside creditor...as security” (Conning and Udry, 2007, pp. 2863-2864). See Harriss (1983), Bouman and Houtman (1988), Graham et al. (1988), Floro and Yotopoulos (1991), and Mansuri (2006) for additional evidence of informal lenders accessing the formal sector in India, Niger, Pakistan, Philippines, and Sri Lanka. See also Haney (1914), Gates (1977), Biggs (1991), Toby (1991), Teranishi (2005, 2007), and Wang (2008) for historical support from Japan, Taiwan, and the United States.}

Third, less developed economies are often characterized by an absence of competition. In particular, formal sector banks typically have some market power (see Barth et al., 2004 and Beck
et al., 2004 for contemporary support and Wang, 2008 and Rajan and Ramcharan, forthcoming for historical evidence).5

I show that informal finance increases poor people’s access to credit. Banks lend less to poor borrowers as the loan accounts for a substantial share of the needed investment. The resulting large interest payment leaves them a net return below the payoff from diverting bank funds and finance dries up. Meanwhile, informal lenders’ monitoring advantage facilitates lending. Agency-free informal credit also improves the investment return by lowering the relative gain of misusing formal capital. Anticipating this, banks extend more funds. Informal finance thus complements banks by permitting for larger formal sector loans.

Informal lenders’ monitoring ability also helps banks to reduce agency cost by allowing them to channel credit through the informal sector. When lending directly to poor people, banks share part of the surplus with the borrowers to keep them from diverting. Extending credit through informal lenders that are rich enough to have a stake in the financial outcome minimizes the surplus shared. In contrast to the previous argument, the credit market becomes segmented as informal finance substitutes for banks and limits borrowers’ direct bank access.

The extent to which informal finance complements or substitutes for bank credit depends on banks’ bargaining power. If formal banks are competitive, borrowers obtain capital from both financial sectors, with poor informal lenders accessing banks for extra funds. By contrast, if formal lenders have some market power, sufficiently rich (bank-financed) informal lenders are borrowers’ only source of credit. This is because borrowers’ and informal lenders’ joint return is maximized if both take competitive bank loans, while market power and subsequent credit market segmentation allows the formal institution to reduce agency costs.

The predictions are broadly consistent with existing data on formal-informal sector interactions. (See Section 5 for an extensive discussion.) The characterization of the aggregate demand for and supply of formal and informal credit also allows me to address some additional issues. For example, weaker legal institutions increase the prevalence of informal credit if borrowers obtain money from both financial sectors, while the opposite is true if informal lenders supply all capital. Moreover, the interest rates of credit-constrained informal lenders rise as legal institutions deteriorate and credit markets become segmented.

Persistence of financial underdevelopment, in the form of market segmentation, can also be understood within the model. Wealthier informal lenders (and banks) prefer the segmented outcome that arises with bank market power, as it softens competition between the financial sectors. Finally, my analysis sheds some light on credit market policy by distinguishing between the efficiency effects of wealth transfers, credit subsidies, and legal reform.

The paper relates to several strands of the literature. First, it adds to work that views informal

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5Beck et al. report a positive and significant relation between measures of bank competition and GDP per capita.
lenders either as bank competitors (Bell et al. 1997; Jain 1999; Jain and Mansuri, 2003) or as a channel of bank funds (Floro and Ray 1997; Bose, 1998; Hoff and Stiglitz, 1998). While these papers share the notion that informal lenders hold a monitoring advantage over banks, there are a number of important differences. First, in earlier work it is not clear whether informal lenders compete with banks or primarily engage in channeling funds. Second, competition theories cannot account for bank lending to the informal sector. Third, channeling theories fail to address the agency problem between the formal and the informal lender.

The present paper explains why informal lenders take bank credit in each of these instances, making competition and channeling a choice variable in a framework where monitoring problems exist between banks, informal lenders, and borrowers. Allowing for both competition and channeling thus extends and reconciles existing approaches. In addition, by deriving endogenous constraints on informal lending, I am able to account for the empirical regularity that informal credit complements as well as substitutes for formal finance.

The second line of related literature studies the interaction between modern and traditional sectors to rationalize persistence of personal exchange (Kranton, 1996; Banerjee and Newman, 1998; Rajan, 2009; Besley and Ghatak, 2010). My results also match Biais and Mariotti’s (2009) and von Lilienfeld-Toal et al.’s (2009) findings of heterogeneous effects of improved creditor rights across rich and poor agents. Finally, the paper links to research emphasizing market structure as an important cause of contractual frictions in less developed economies (Petersen and Rajan, 1995; Mookherjee and Ray, 2002; Kranton and Swamy, 2008).

The model builds on Burkart and Ellingsen’s (2004) analysis of trade credit in a competitive banking and input supplier market. The bank and the borrower in their model are analogous to the competitive formal lender and the borrower in my setting. However, their input supplier and my informal lender differ substantially. Also, in contrast to Burkart and Ellingsen, by considering credit-rationed informal lenders and bank market power, the model distinguishes whether informal lenders compete with banks or engage in channeling formal bank funds.

In the next section I introduce the model then in Section 3 present equilibrium outcomes. Sec-

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6 Also, different from existing research I study the role of legal institutions and bank market power.
7 While Kranton and Banerjee and Newman focus on how market imperfections give rise to institutions that (may) impede the development of markets, Besley and Ghatak and Rajan (like this paper) show how rent protection can hamper reform.
8 As in Petersen and Rajan and Mookherjee and Ray, I study the effects of market power on credit availability, while Kranton and Swamy investigate the implications on hold-up between exporters and textile producers.
9 Burkart and Ellingsen assume that it is less profitable for the borrower to divert inputs than to divert cash. Thus, input suppliers may lend when banks are limited due to potential agency problems.
10 While the input supplier and the (competitive) bank offer a simple debt contract, the informal lender offers a more sophisticated project-specific contract, where the investment and the subsequent repayment are determined using Nash Bargaining. More importantly, the informal lender is assumed to be able to ensure that investment is guaranteed, something that the trade creditor is unable to do.
tion 4 deals with cross-sectional predictions, persistence of market segmentation, and informal interest rates. Section 5 examines empirical evidence. Section 6 explores economic policy. I conclude by discussing robustness issues and point to possible extensions. Formal proofs are relegated to the Appendix.

2 Model

Consider a credit market consisting of risk-neutral entrepreneurs (for example, farmers, households, or small firms), banks (who provide formal finance), and moneylenders (who provide informal finance). The entrepreneur is endowed with observable wealth $\omega_E \geq 0$. She has access to a deterministic production function, $Q(I)$, where $I$ is the investment volume. The production function is concave, twice continuously differentiable, and satisfies $Q(0) = 0$ and $Q'(0) = \infty$. In a perfect credit market with interest rate $r$, the entrepreneur would like to attain first-best investment given by $Q(I^*) = 1 + r$. However, she lacks sufficient wealth, $\omega_E < I^*(r)$, and thus turns to the bank and/or the moneylender for the remaining funds.\footnote{I assume that the entrepreneur accepts the first available contract if indifferent between the contracts offered.}

While banks have an excess supply of funds, credit is limited as the entrepreneur is unable to commit to invest all available resources into her project. Specifically, I assume that she may use (part of) the assets to generate nonverifiable private benefits. Non-diligent behavior resulting in diversion of funds denotes any activity that is less productive than investment, for example, using available resources for consumption or financial saving. The diversion activity yields benefit $\phi < 1$ for every unit diverted. Creditor vulnerability is captured by $\phi$ (where a higher $\phi$ implies weaker legal protection of banks). While investment is unverifiable, the outcome of the entrepreneur’s project in terms of output and/or sales revenue may be verified. The entrepreneur thus faces the following trade-off: either she invests and realizes the net benefit of production after repaying the bank (and possibly the moneylender), or she profits directly from diverting the bank funds (the entrepreneur still pays the moneylender if she has taken an informal loan). In the case of partial diversion, any remaining returns are repaid to the bank in full. The bank does not to derive any benefit from resources that are diverted.

Informal lenders are endowed with observable wealth $\omega_M \geq 0$ and have a monitoring advantage over banks such that credit granted is fully invested. To keep the model tractable, I restrict informal lenders’ occupational choice to lending (additional sources of income do not alter the main insights). For simplicity, monitoring cost is assumed to zero.\footnote{This is not to diminish the importance of informal lenders’ monitoring cost (see Banerjee, 2003). However, the cost is set to zero as it makes no difference in the analysis that follows (unless sufficiently prohibitive to prevent banks or entrepreneurs from dealing with the informal sector altogether).} The moneylender’s superior knowledge of local borrowers grants him exclusivity (but not necessarily market power, see be-
low). In the absence of contracting problems between the moneylender and the entrepreneur, the moneylender maximizes the joint surplus derived from the investment project and divides the proceeds using Nash Bargaining. A contract is given by a pair \((B, R) \in \mathbb{R}^2_+\), where \(B\) is the amount borrowed by the entrepreneur and \(R\) the repayment obligation. Finally, if the moneylender requires additional funding he turns to a bank.

Following the same logic as above, I assume that the moneylender cannot commit to lend his bank loan and that diversion yields private benefits equivalent of \(\phi < 1\) for every unit diverted. While lending is unverifiable, the outcome of the moneylender’s operation may be verified. The moneylender thus faces the following trade-off: either he lends the bank credit to the entrepreneur, realizing the net-lending profit after compensating the bank, or he benefits directly from diverting the bank loan.

Banks have access to unlimited funds at a constant unit cost of zero. They offer a contract \((L_i, D_i)\), where \(L_i\) is the loan and \(D_i\) the interest payment, with subscripts \(i \in \{E, M\}\) indicating entrepreneur (\(E\)) and moneylender (\(M\)). When \(\phi\) is equal to zero, legal protection of banks is perfect and even a penniless entrepreneur and/or moneylender could raise an amount supporting first-best investment. To make the problem interesting, I assume that

\[
\phi > \phi \equiv \frac{Q(I^*(0)) - I^*(0)}{I^*(0)}.
\]

In words, the marginal benefit of diversion yields higher utility than the average rate of return to first-best investment at zero rate of interest [henceforth \(I^*(0) = I^*\)].

The timing is as follows:

1. Banks offer a contract, \((L_i, D_i)\), to the entrepreneur and the moneylender, respectively.
2. The moneylender offers a contract, \((B, R)\), to the entrepreneur, where \(R\) is settled through Nash Bargaining.
3. The moneylender makes his lending/diversion decision.
4. The entrepreneur makes her investment/diversion decision.
5. Repayments are made.

To distinguish formal from informal finance, I assume that banks are unable to condition their contracts on the moneylender’s contract offer, an assumption empirically supported by Giné (2007).\(^{14}\) If not, the entrepreneur could obtain an informal loan and then approach the bank. Bank credit would then depend on the informal loan and the subsequent certain investment.

Note finally that the informal sector contains a variety of lenders including input suppliers,

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\(^{13}\)The assumption that borrowers obtain funds from at most one informal source has empirical support see, for example, Aleem (1990), Siamwalla et al. (1990), and Berensmann (2002).

\(^{14}\)See also Bell et al. (1997) for evidence in support of the assumed sequence of events.
landlords, merchants, professional moneylenders, and traders. Through their occupation, they attract different borrowers (for example, trader/farmer and landlord/tenant) that may give some lenders a particular enforcement advantage. The important and uniting feature, however, is the ability to induce diligent behavior irrespective of the quality of the legal system. In the analysis that follows, the moneylender represents all informal lenders with this trait.

3 Equilibrium

I begin by analyzing each financial sector in isolation. This helps understand how the agency problem in the formal bank market generates credit rationing. It also highlights how the provision of incentives and the quality of the legal system affect lending across the two sectors.

3.1 Benchmark

There is free entry in the bank market. Without loss of generality, I follow Burkart and Ellingsen (2004) and focus on contracts of the form $f(L_E, (1+r)L_E)_{L_E \leq \bar{L}_E}$, where $L_E$ is the loan, $(1+r)L_E$ the repayment, and $\bar{L}_E$ the credit limit. The contract implies that a borrower may withdraw any amount of funds until the credit limit binds. For simplicity, entrepreneurs borrow from one bank at a time. Following a Bertrand argument, competition drives equilibrium bank profit to zero.\textsuperscript{15} Nonetheless, credit is limited as investment of bank funds cannot be ensured. Specifically (solving for the subgame-perfect equilibrium outcome), the entrepreneur chooses the amount of funds to invest, $I$, and the amount of credit, $L_E$, by maximizing

$$U_E = \max \{0, Q(I) - (1 + r)L_E\} + \phi(\omega_E + L_E - I)$$

subject to

$$\omega_E + L_E \geq I,$$

$$L_E \geq \bar{L}_E.$$  

The first part of the expression is the profit from investing, accounting for limited liability. The second part denotes the gain from diversion. The full expression is maximized subject to available funds and the credit limit. If the entrepreneur plans to repay in full, investment yields at least

\textsuperscript{15}Some developing credit markets have a sizable share of state-owned banks. I make no assumption on bank ownership but do assume that profit maximization governs bank behavior. While state ownership can be less efficient (La Porta et al., 2002) this does not bar profit maximization as a useful approximation. In Sapienza’s (2004) study of Italian banks, state-owned enterprises charge less but increase interest rates when markets become more concentrated, consistent with profit-maximizing behavior.
\(1 + r\) on every dollar of the available assets, while diversion leaves only \(\phi\). By contrast, if the entrepreneur intends to divert resources, there is no reason to invest either borrowed or internal funds as the bank would claim all of the returns. Hence, the choice is essentially binary; either the entrepreneur chooses to invest all the money or she diverts the maximum possible. The entrepreneur acts diligently if the contract satisfies the incentive constraint

\[
Q (\omega_E + L_E^u) - (1 + r) L_E^u \geq \phi (\omega_E + \bar{L}_E),
\]

where \(L_E^u = \min \{I^* (r) - \omega_E, \bar{L}_E\}\). Either the entrepreneur borrows and invests efficiently, or she exhausts the credit line extended by the bank. As there is no default in equilibrium, the only equilibrium interest rate consistent with zero profit is \(r = 0\).

At low wealth, the temptation to divert resources is too large to allow a loan in support of first best. In this case, the credit limit is given by the binding incentive constraint

\[
Q (\omega_E + \bar{L}_E) - \bar{L}_E = \phi (\omega_E + \bar{L}_E).
\]

As an increase in wealth improves the return to investment for a given loan size, the credit line and the investment rise with wealth. Similarly, better creditor protection (a lower \(\phi\)) increases the opportunity costs of diversion, making larger repayment obligations and thus higher credit limits incentive compatible. When the entrepreneur is sufficiently wealthy the constraint no longer binds and the first-best outcome is obtained.

**Proposition 1.** For all \(\phi > \phi^c\), there is a threshold \(\omega_E^c > 0\) such that entrepreneurs with wealth below \(\omega_E^c\) invest \(I < I^*\), credit \((L_E)\) and investment \((I)\) increase in \(\omega_E\) and decrease in creditor vulnerability \((\phi)\). If \(\omega_E \geq \omega_E^c\) then \(I^*\) is invested.

Like most agency models, the theory delivers the basic insight that less leveraged borrowers are better credit risks (as in the costly effort framework).\(^{16}\) The current formulation’s advantage is the direct correspondence between institutional efficiency and the degree of credit rationing.

If the entrepreneur borrows from the informal sector, the moneylender maximizes the surplus of the investment project, \(Q (\omega_E + B) - B\). Let \(B^*\) denote the loan size that solves the first-order condition \(Q' (\omega_E + B) - 1 \geq 0\). Absent contracting frictions, the efficient outcome \(B^* = I^* - \omega_E\) is obtained if the moneylender is sufficiently wealthy, while the outcome is constrained efficient otherwise, with \(B^* = \omega_M < I^* - \omega_E\). Excess moneylender funds are deposited in the bank earning a zero rate of interest. Given \(B^*\), the entrepreneur and the moneylender bargain over how to share the project gains using available resources \(\omega_E + B\), with \(\omega_M \geq B\). If they disagree, investment fails and each party is left with her/his wealth or potential loan. In case of agreement,

\(^{16}\)See Banerjee (2003) for a discussion of the similarity across different moral hazard models of credit rationing.
the moneylender offers a contract where the equilibrium repayment, using the Nash Bargaining solution, is

\[
R(B)^* = \arg \max_t \{ Q(\omega_E + B) - t - \omega_E \}^\alpha \{ t - B \}^{1-\alpha} \\
= (1 - \alpha) \left[ Q(\omega_E + B) - \omega_E \right] + \alpha B,
\]

where \( \alpha \in (0, 1) \) represents the degree of competition in the informal sector (competition increases if \( \alpha \) is high). As the evidence of the extent of informal lenders’ market power is inconclusive, no \textit{a priori} assumption is made on \( \alpha \).\footnote{Informal finance has been documented as competitive (Adams et al., 1984), monopolistically competitive (Aleem, 1990), and as a monopoly (Bhaduri, 1977).}

### 3.2 Formal and Informal Finance

Financial sector coexistence not only allows poor borrowers to raise funds from two sources, it also permits informal lenders to access banks. This introduces additional trade-offs: while (agency-free) informal credit improves the incentives of the entrepreneur, banks now have to consider the possibility of diversion on the part of the entrepreneur and the moneylender.

Proposition 1 indicated that rising wealth enables banks to lend more extensively. When banks and moneylenders both supply credit, informal capital increases the residual return to the entrepreneur’s project with the end effect equivalent to an increase in internal funds. Informal finance thus incentivizes entrepreneurs as it makes them less prone to divert bank credit. Before turning to the precise characterization, I make the additional assumption that

\[
(4) \quad \phi > \phi^* (\omega_i) \equiv \frac{Q(I^*) - (I^* - \omega_i)}{I^*}.
\]

As the moneylender’s wealth facilitates the entrepreneur’s constraint (and vice versa), this needs to be incorporated. The condition ensures that diversion benefits exceed the average return to an investment \( I^* \), accounting for entrepreneurial or informal lender wealth. If not, a penniless entrepreneur and/or moneylender could support first best.

Solving backwards and starting with the entrepreneur’s incentive constraint yields

\[
(5) \quad Q(\omega_E + L_E^u + B) - L_E^u - R(B) \geq \phi(\omega_E + \bar{L}_E),
\]

where \( L_E^u = \min \{ I^* - \omega_E - B, \bar{L}_E \} \). The only modification from above is that the amount borrowed from the moneylender, \( B \), is prudently invested.\footnote{Since returns are claimed by the bank even if the bank’s credit has been diverted, it is never optimal for the
If the moneylender needs extra funds, he turns to a bank and chooses the amount to lend to the entrepreneur, $B$, and the amount of credit, $L_M$, to satisfy the following incentive constraint

$$R(\omega_M + L_M^u) - L_M^u \geq \phi (\omega_M + \bar{L}_M),$$

where $R(B)$ is a function of the amount lent to the entrepreneur for any pair $(L_M^u, \omega_M)$, with $L_M^u = \min \{ I^* - \omega_M - \omega_E - L_E^u, \bar{L}_M \}$. The left-hand side of the inequality is the moneylender’s net-lending profit, while the right-hand side is the return from borrowing a maximum amount and then diverting all available assets.\(^{19}\)

It remains to determine the repayment using the Nash Bargaining solution. As before, I have

$$R(B)^* = (1 - \alpha) [Q(\omega_E + L_E^u + B) - L_E^u - \omega_E] + \alpha B,$$

the only difference is that each party is compensated for the cost of bank borrowing. I now characterize the resulting equilibrium constellations.

Poor entrepreneurs and poor moneylenders will be credit rationed by the bank as their stake in the financial outcome is too small. Since the surplus of the bank transaction accrues entirely to the entrepreneur and the moneylender, the residual return to investment increases if both take bank credit. Specifically, the entrepreneur exhausts her bank credit line and borrows the maximum amount made available by the moneylender. Similarly, the moneylender utilizes all available bank funds and his own capital to service the entrepreneur. Hence, the credit limits solve the following binding constraints of the entrepreneur and the moneylender

$$\alpha [Q(I) - \bar{L}_E - \bar{L}_M - \omega_M] + (1 - \alpha) \omega_E = \phi (\omega_E + \bar{L}_E)$$

and

$$(1 - \alpha) [Q(I) - \bar{L}_E - \bar{L}_M - \omega_E] + \alpha \omega_M = \phi (\omega_M + \bar{L}_M),$$

with $I = \omega_E + \bar{L}_E + \omega_M + \bar{L}_M$. For the entrepreneur to take informal credit, $\alpha$ has to satisfy $\alpha > \hat{\alpha}$. The threshold, $\hat{\alpha} > 0$, denotes the point of indifference between exclusive bank borrowing and obtaining bank and moneylender funds and is determined by

$$\alpha [Q(I) - \bar{L}_E - \bar{L}_M - \omega_M] + (1 - \alpha) \omega_E = Q(\omega_E + \bar{L}_E) - \bar{L}_E.$$
When the moneylender becomes wealthier, the net return from extending a loan exceeds the diversion gain, and his incentive constraint becomes slack. As the moneylender borrows at marginal cost, competition with the formal bank sector implies that he makes zero profit.\textsuperscript{20} Hence, the entrepreneur’s credit limit solves, \textit{independent} of the bargaining outcome

\begin{equation}
Q (\omega_E + \bar{L}_E + \omega_M + L_M) - \bar{L}_E - L_M - \omega_M = \phi (\omega_E + L_E),
\end{equation}

while the investment is given by \( I = I^* \).\textsuperscript{21} If the moneylender is rich enough to self finance large parts (or the entire amount) of first best he no longer acquires bank funds. Here the entrepreneur borrows from a bank and a self-financed moneylender. The entrepreneur’s incentive constraint is still determined by (11), with \( L_M + \omega_M \) replaced by \( B \leq \omega_M \) and \( I = I^* \).\textsuperscript{22} Finally, a sufficiently rich entrepreneur resorts to the bank alone, with \( I = I^* \).

\textbf{Proposition 2.} For all \( \phi > \phi (\omega_i) \) and: (i) \( \omega_E < \omega_E^c \), entrepreneurs borrow from a bank and a bank-financed moneylender and invest \( I < I^* \) if \( \omega_M < \omega_M^c \) and \( I^* \) if \( \omega_M \in [\omega_M^c, \bar{\omega}_M^c] \). Entrepreneurs borrow from a bank and a self-financed moneylender and invest \( I^* \) if \( \omega_M \geq \bar{\omega}_M^c \); (ii) \( \omega_E \geq \omega_E^c \), entrepreneurs borrow exclusively from a bank and invest \( I^* \).

When weak institutions constrain banks, informal finance allows poor borrowers (with wealth below \( \omega_E^c \)) to invest more than if banks were the only source of funds. Meanwhile, entrepreneurs with wealth above \( \omega_E^c \) are unaffected as they can satisfy their needs with bank credit alone. To better understand how the informal sector’s asset base matters, I explore how the credit lines change with the underlying parameters.

\textbf{Corollary 1 (Comparative Statics).} For \( \omega_M < \omega_M^c \), \( \omega_E < \omega_E^c \), and: (i) all \( \alpha \), credit (\( \bar{L}_E \)) increases in entrepreneurs’ wealth (\( \omega_E \)), decreases in creditor vulnerability (\( \phi \)), and is nondecreasing in moneylenders’ wealth (\( \omega_M \)), while \( \bar{L}_M \) increases in \( \omega_M \); (ii) all \( \alpha > \hat{\alpha} \), \( \bar{L}_M \) is nondecreasing in \( \omega_E \) and decreases in \( \phi \); (iii) \( \alpha = \hat{\alpha} \), \( \bar{L}_M \) decreases in \( \omega_E \) and is indeterminate with respect to changes in \( \phi \). For \( \omega_M \in [\omega_M^c, \bar{\omega}_M^c] \), \( \omega_E < \omega_E^c \), and all \( \alpha \), \( \bar{L}_E \) increases in \( \omega_E \), is independent of \( \omega_M \), and decreases in \( \phi \), while \( L_M \) decreases in \( \omega_i \) and increases in \( \phi \).

\textsuperscript{20}The more detailed argument why the moneylender earns a zero profit is based on contradiction and goes as follows: suppose there exist a project surplus that exceeds the sum of the entrepreneur’s and the moneylender’s outside option and the moneylender keeps part of the surplus. The bank can then offer the entrepreneur more credit which increases her value of diversion and reduces the surplus shared with the moneylender. If the surplus is positive, the entrepreneur refrains from diversion in equilibrium, while the moneylender concedes by lowering his price of credit. This is because the entrepreneur never takes informal credit while diverting bank funds, as additional returns are claimed by the bank. The process continues until the moneylender obtains his outside option, contradicting the initial claim.

\textsuperscript{21}The entrepreneur’s credit limit cannot be lower in equilibrium. Otherwise, there would exist a bank contract with a lower limit and a positive informal interest rate preferred by the bank as well as the moneylender.

\textsuperscript{22}The entrepreneur could satisfy her needs by only taking informal credit but borrows from both sectors as I assume that she accepts the first available contract if indifferent. The same conclusion follows if moneylenders’ monitoring cost was positive and constant returns to scale.
A rise in wealth allows poor entrepreneurs and poor moneylenders to take additional bank credit if they share the project’s surplus [wealth below $\omega^c_M$ and $\omega^c_E$ and $\alpha \in (\bar{\alpha}, 1)$]. In particular, a boost in moneylender wealth makes the entrepreneur’s investment of a given bank loan more valuable than the diversion of the loan, inducing an increase in the entrepreneur’s bank credit. The result hinges on the informal sector’s ability to enforce the transaction, not on being better at attracting bank funds. Indeed, worse legal protection raises the profitability of diversion relative to lending the bank credit, limiting the moneylender’s bank access. At first best, additional informal sector wealth becomes less important as a higher $\omega_M$ has no effect on the entrepreneur’s incentives.\(^{23}\)

Unlike above, weaker legal institutions increase the importance of the informal sector as diversion no longer tempts the moneylender ($L_M$ increases in $\phi$).

Since sufficiently rich moneylenders earn the opportunity cost of funds, informal sector market power only matters at wealth below $\omega^c_M$ and $\omega^c_E$. Although equilibrium outcomes remain the same for $\bar{\alpha} \leq \alpha \leq 1$, some of the variation is muted. If the moneylender is a monopolist ($\alpha = \bar{\alpha}$), the entrepreneur’s incentive constraint is given by (3) above, whereas the constraint of the moneylender becomes $Q(\omega_E + \bar{L}_E + \omega_M + \bar{L}_M) - Q(\omega_E + \bar{L}_E) - \bar{L}_M = \phi(\omega_M + \bar{L}_M)$. While a hike in $\phi$ reduces the entrepreneur’s bank credit, it also improves the moneylender’s bargaining position [as $Q(\omega_E + \bar{L}_E)$ decreases]. This raises his net return and partly counters the (direct) negative effect of $\phi$ on $L_M$. The overall change in $L_M$ depends on which effect is larger. As $\omega_M$ is absent from the entrepreneur’s constraint, it has no impact on $L_E$. If informal credit is competitive ($\alpha = 1$), the only change is that $L_M$ is independent of $\omega_E$.\(^{24}\) In sum, for informal finance to have a positive incentive effect, some of the project’s surplus has to be shared with the entrepreneur.

Because of the assumption of one entrepreneur and one moneylender, the informal sector plays an unrealistically passive role. One plausible distinction between entrepreneurs and moneylenders is the difference in technology endowments. For example, while farmers’ or street vendors’ production technology applies to managing their farm or selling fruit at the street stand, traders’ or merchants’ monitoring technology is applicable to more than one farmer or street vendor. This implies that wealth-constrained traders visit formal banks more often than a given farmer and, importantly, has less to gain from diverting bank funds. Consider for instance the modified setting where $\phi_M < \phi_E$: the opportunity cost of being diligent is higher for the entrepreneur. Here banks lend relatively more to moneylenders although entrepreneurs continue to borrow from the formal institution.\(^{25}\)

\(^{23}\)Instead, hikes in $\omega_M$ are fully compensated by decreases in $L_M$, while climbing $\omega_E$ leads to higher $\bar{L}_E$ (as the entrepreneur’s incentive constraint becomes less binding) and consequently lower $L_M$.

\(^{24}\)The constraints follow by setting $\alpha = 1$ in equations (8) and (9). As $\omega_E$ does not enter the moneylender’s constraint, $\bar{L}_M$ is independent of $\omega_E$.

\(^{25}\)Entrepreneurs always have the option of an exclusive bank contract, making it inefficient to exclude them from bank access. If moneylenders were entrepreneurs’ only source of funds, entrepreneurs earn (at least) the equivalent of a bank loan but their side payment [of value $\phi_E(\omega_E + \bar{L}_E)$] would not be invested. However, if bank credit is
3.3 Imperfect Bank Competition

Informal lenders’ monitoring ability also helps banks to reduce agency cost by allowing them to channel credit through the informal sector. To show this, formal banks need some market power. I start by outlining the case without informal lenders and then characterize the outcome under financial sector coexistence.

The bank sets $L_E$ and $D_E$ by maximizing

$$D_E - L_E$$

subject to the participation constraint

$$Q(\omega_E + L_E) - D_E \geq Q(\omega_E)$$

and the incentive constraint given by (2). The participation constraint ensures at least the utility associated with self financing the project. $D_E$ replaces $(1 + r)L_E$ with the borrower choosing whether or not to accept the bank’s take-it-or-leave-it offer and consequently the amount to invest. It follows that the relevant incentive and/or participation constraint must bind, otherwise the bank could increase $D_E$ and earn a strictly higher profit.

For low levels of wealth, the incentive constraint binds and the bank’s profit may be written as $Q(\omega_E + L_E) - \phi(\omega_E + L_E) - L_E$. The first-order condition of the profit expression determines the optimal loan size, whereas $D_E$ is defined as the solution to the incentive constraint. Hence, $L_E$ is the unique loan size that solves

$$(12) \quad Q'(\omega_E + L_E) - (1 + \phi) = 0,$$

while $D_E$ is determined by

$$(13) \quad Q(\omega_E + L_E) - D_E = \phi(\omega_E + L_E).$$

A salient feature of this outcome is that entrepreneurs are provided a constant floor rent above their outside option to satisfy the investment level, $I = \omega_E + L_E$, given by equation (12). Since higher wealth is met by a parallel decrease in credit to maintain the sub-optimal investment, any wealth improvement is pocketed by the bank. Poor entrepreneurs are thus prevented from accumulating assets.

As wealth climbs, the participation and the incentive constraint hold simultaneously. A higher debt capacity permits the bank to increase the repayment obligation such that the entrepreneur is extended to entrepreneurs and moneylenders, the side payment is part of the overall investment.
indifferent between taking credit and self financing the project. Since first best is unattainable, the loan size continues to satisfy the incentive constraint. Hence, the repayment is determined by the binding participation constraint, while the equilibrium loan size solves

\[
Q (\omega_E) = \phi (\omega_E + L_E).
\]

For rich entrepreneurs only the participation constraint binds and first best is obtained.

**Proposition 3.** For all \( \phi > \phi \), there are thresholds \( \bar{\omega}^m_E > \omega^m_E > 0 \) such that:

(i) entrepreneurs with wealth below \( \omega^m_E \) invest \( I = I' \) as given by equation (12), credit \( L_E \) decreases in \( \omega_E \), and \( I' \) is independent of \( \omega_E \); if \( \omega_E \in [\omega^m_E, \bar{\omega}^m_E] \) then \( I \in [I', I^s] \) is invested and \( L_E \) and \( I \) increase in \( \omega_E \); if \( \omega_E \geq \bar{\omega}^m_E \) then \( I^s \) is invested.

(ii) market power reduces efficiency, that is, \( \bar{\omega}^m_E > \omega^c_E \).

Bank market concentration reduces lending and investment. Intuitively, when increasing the price, the bank lowers the borrower’s incentive to repay. Hence, high interest rates must be coupled with less lending and consequently lower investment. As a large repayment burden increases both the bank’s payoff and the entrepreneur’s incentive to default, poor customers earn rent to avoid diversion of bank credit.

The existence of moneylenders modifies this trade-off. Informal lenders’ monitoring advantage implies that channelled bank capital saves the incentive rent the bank otherwise share with poor entrepreneurs. Still, forwarded bank money comes at a cost as the bank forgoes part of its surplus to prevent being cheated by the moneylenders. To illustrate this as simply as possible, attention is restricted to the range of wealth levels where entrepreneurs receive the bank’s floor utility, \( \omega_E < \omega^m_E \). Remaining cases are briefly discussed in the final section.

Specifically, if the entrepreneur and the moneylender are poor the bank lends to both. They receive floor contracts giving them utility above their outside option of pursuing the entrepreneur’s project on their own. The binding incentive constraints and the first-order condition of the bank’s profit expression determine credit extended, \( L_E \) and \( L_M \), and the aggregate repayment \( D \). More precisely

\[
\alpha [Q (I) - D - \omega_M] + (1 - \alpha) \omega_E = \phi (\omega_E + L_E),
\]

\[
(1 - \alpha) [Q (I) - D - \omega_E] + \alpha \omega_M = \phi (\omega_M + L_M),
\]

\[26\]The threshold \( \omega^m_E \) is the wealth level at which the entrepreneurs’ incentive and participation constraint both bind. It differs from \( \omega^E_E \), as the investment corresponding to \( \omega^m_E \) also depends on the moneylender’s wealth.
and

\[ Q'(I) - (1 + \phi) = 0, \]

with \( I = \omega_E + L_E + \omega_M + L_M \). The bank charges a price, \( D = D_E + D_M \), paid in proportion to the share of the surplus kept by each borrower. Informal finance permits the bank both to decrease the entrepreneur’s net surplus and to minimize the aggregate loan supporting the sub-optimal investment. The bank refrains from channeling the entire loan through the informal sector, however, since the moneylender’s temptation to divert formal credit is too large.

As the informal lender’s debt capacity improves, his participation and incentive constraint both bind at some point. The increase in moneylender wealth allows the bank to reduce the poor entrepreneur’s part of the aggregate loan to save on the incentive rent shared with her to prevent diversion. Specifically, for the same level of investment [given by equation (17)], \( L_E \) is decreased in step with a climbing \( \omega_M \) until the entire loan is extended to the moneylender, giving rise to credit market segmentation. The moneylender’s repayment obligation \( D_M \) solves the binding participation constraint

\[ (1 - \alpha) [Q(I) - D_M - \omega_E] + a \omega_M = (1 - \alpha) [Q(\omega_E + \omega_M) - \omega_E] + a \omega_M, \]

while the equilibrium loan size \( L_M \) satisfies

\[ (1 - \alpha) [Q(\omega_E + \omega_M) - \omega_E] + a \omega_M = \phi (\omega_M + L_M), \]

with \( I = \omega_E + \omega_M + L_M \). The participation constraint ensures the utility associated with the moneylender self financing the project.

A rich enough moneylender is able to support first best. Equation (18) determines \( D_M \) and \( I = I^* \). Finally, if the moneylender is sufficiently wealthy to self finance the investment, the bank and the moneylender compete in the same fashion as described by equation (11) above.

**Proposition 4.** For all \( \phi > \phi (\omega_i) \) and \( \omega_E < \omega^m_E \), entrepreneurs borrow from a bank and a bank-financed moneylender and invest \( I = I' \) as given by equation (17) if \( \omega_M < \omega^m_M \). Entrepreneurs borrow exclusively from a bank-financed moneylender and invest \( I \in [I', I^*) \) if \( \omega_M \in [\omega^m_M, \omega^m_M] \) and \( I^* \) if \( \omega_M \in [\tilde{\omega}_M, I^* - \omega_E] \). Entrepreneurs borrow from a bank and a self-financed moneylender and invest \( I^* \) if \( \omega_M \geq I^* - \omega_E \).

While informal finance raises bank-rationed borrowers’ investment, it also limits formal sector access. As moneylenders become richer, banks are able to reduce the surplus otherwise shared with poor entrepreneurs. This contrasts with and complements the findings of Proposition 2 and Corollary 1. In poor societies with weak legal institutions, moneylenders’ monitoring ability therefore
induces two opposing effects. On the one hand, informal finance complements banks by allowing more formal capital to reach borrowers directly. On the other hand, informal lenders substitute for banks by acting as a formal credit channel. The extent to which either effect dominates depends on the degree of competition in the formal bank sector.

Note that Proposition 4 is independent of informal lenders’ market power. Bank profit decreases as the informal sector becomes more competitive, by reducing moneylenders’ incentive-compatible bank loan. However, this does not affect the bank’s desire to minimize poor borrowers’ direct involvement. Also, while the analysis assumes that the formal sector is a monopoly, it is sufficient that the bank has enough market power to make informal lenders’ participation constraint bind at some point. Then the bank always finds it more profitable to contract exclusively with the informal sector rather than dealing directly with poor borrowers.

Figure (1) summarizes Propositions 2 and 4 in terms of the moneylender’s debt capacity (assuming a bank-rationed entrepreneur). The competitive benchmark is depicted above the line, with the moneylender’s incentive constraint binding below \( \omega^c_M \). The imperfectly competitive case is illustrated underneath the line. The incentive constraint binds alone below \( \omega^m_M \) and together with the participation constraint in-between \( \omega^m_M \) and \( \omega^c_M \). The participation constraint determines the outcome in-between \( \omega^m_M \) and \( I^* - \omega_E \). (The proofs of Proposition 9 and Lemmas A5 and A9 settle the relation between the thresholds.)

### 4 Institutions, Market Segmentation, and Prices

Having established the aggregate demand for and supply of formal and informal credit, I now consider factors that may help explain the prevalence and the persistence of informal finance, as well the variation in informal interest rates.

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27 For low values of \( \phi \), it is possible that \( \omega^c_M < \omega^m_M \) as \( \omega^c_M (\omega^m_M) \) increases (decreases) in \( \phi \). In what follows, I disregard this possibility.
4.1 Cross-Sectional Predictions

This section studies one of the model’s key premises: that informal finance emerges in response to banks’ inability to enforce their legal claims. It also investigates the implications of variation in income and in bank market structure. As the competitiveness of the informal sector, $\alpha$, has an effect on some of my findings, I initially explore results that are independent of $\alpha$.

I first show that weaker institutions increase the prevalence of informal credit if borrowers obtain money from both financial sectors, while the opposite is true if moneylenders supply all funds. Specifically, if entrepreneurs and moneylenders obtain bank credit and moneylenders are rich enough not to be tempted by diversion, the ratio of informal credit to investment, $B/I = (\omega_M + \bar{L}_M) / (\omega_E + \bar{L}_E + \omega_M + \bar{L}_M)$, increases in creditor vulnerability $\phi$. A hike in $\phi$ boosts the profitability of non-prudent behavior relative to investment for poor entrepreneurs, inducing a shift to agency-free informal finance (Corollary 1). Consider then the case of credit market segmentation. If bank-rationed moneylenders are the only providers of entrepreneurial credit, worse legal protection causes banks to cut the funding of the informal sector to avoid diversion. That is, the fraction $B/I$ decreases in $\phi$. At first best, more efficient institutions are irrelevant for $B/I$ since diversion no longer tempts the moneylender.

My theory further predicts that the ratio $B/I$ increases if borrowers are poor and if moneylenders are better capitalized. To see this, note that a rise in entrepreneurial wealth induces a shift from informal to formal finance and a lower $B/I$ if moneylenders are rich enough to attain first best in the competitive benchmark. If the entrepreneur and the moneylender both obtain bank credit under imperfect bank competition, increases in wealth lead to a decrease in credit to limit diversion. For example, a higher $\omega_E$ reduces the moneylender’s share of the aggregate loan $L_M$ and $B/I$ drops. By contrast, if the moneylender is the only bank borrower, bank credit increases in $\omega_M$, boosting $B$ relatively more than $I$ as the entrepreneur’s wealth is unaffected.

Proposition 5. For bank-rationed entrepreneurs, the ratio of informal credit to investment is:

(i) increasing in creditor vulnerability ($\phi$), decreasing in entrepreneurs’ wealth ($\omega_E$), and independent of moneylenders’ wealth ($\omega_M$) if banks are competitive and $\omega_M \geq \omega^c_M$;

(ii) nonincreasing in $\phi$ for $\omega_M \geq \omega^m_M$, decreasing in $\omega_E$ for $\omega_M < \omega^m_M$ and for $\omega_M \geq \omega^m_M$, and nondecreasing in $\omega_M$ if banks have market power and $\omega_M < I^\alpha - \omega_E$.

A limitation of Proposition 5 is that it does not apply if entrepreneurs and moneylenders are rationed by competitive banks. This is because variation in $\phi$, $\omega_E$, and $\omega_M$ affects $\bar{L}_E$ and $\bar{L}_M$.

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28 That is, $\bar{L}_E$ ($\bar{L}_M$) increases (decreases) following a boost in $\omega_E$ (Corollary 1). Higher moneylender wealth does not affect $B/I$ though, as hikes in $\omega_M$ are compensated by decreases in $\bar{L}_M$.

29 As investment is locked at the suboptimal level [given by equation (17)], an increase in $\omega_E$ only improves the entrepreneur’s bargaining position, forcing the bank to lower $L_M$.

30 At first best, the outcome is analogous to the competitive case described in footnote 28.
simultaneously, with the impact on \( B/I \) depending on how the project gains are shared. This is also true for some of the changes in \( \omega_E \) under market segmentation. However, by restricting attention to competitive informal credit (\( \alpha = 1 \)) and an informal monopoly (\( \alpha = \hat{\alpha} \)), the model gives consistent predictions both with respect to institutional quality and with respect to wealth.

**Corollary 2.** For bank-rationed entrepreneurs, the ratio of informal credit to investment is:

(i) increasing in creditor vulnerability (\( \phi \)) and decreasing in entrepreneurs’ wealth (\( \omega_E \)) for \( \alpha = \{\hat{\alpha}, 1\} \) and nondecreasing in moneylenders’ wealth (\( \omega_M \)) for \( \alpha = \{\hat{\alpha}\} \) if banks are competitive;

(ii) nonincreasing in \( \omega_E \) for \( \alpha = \{\hat{\alpha}, 1\} \) if banks have market power and \( \omega_M < I^* - \omega_E \).

The results presented in Proposition 5 thus continue to hold in this restricted setting. Interestingly, the first part of Corollary 2 shows that informal finance becomes more important as institutional quality deteriorates even when informal lenders are poor. This is because the reduction in entrepreneurs’ bank credit that follows from a higher \( \phi \) dominates the drop in informal lenders’ bank credit. To see this, consider a monopolistic moneylender under bank competition. A boost in \( \phi \) reduces \( \bar{L}_E \), while the effect on \( \bar{L}_M \) is ambiguous due to the moneylender’s improved bargaining position (Corollary 1). If informal credit is competitive, the decline in \( \bar{L}_E \) exceeds the fall in \( \bar{L}_M \), since the entrepreneur keeps the full surplus and subsequently holds a larger part of the aggregate bank loan. (Wealth results follow in similar fashion from Corollary 1.) Under market segmentation, the moneylender’s loan and the fraction \( B/I \) is independent of entrepreneurial wealth if \( \alpha = 1 \), as \( \omega_E \) does not enter equation (19). If \( \alpha = \hat{\alpha} \), the moneylender’s net return and, consequently, his bank loan and the ratio \( B/I \) decrease in \( \omega_E \).

Propositions 2 and 4 indicate that the relative importance of bank-financed moneylenders increases in banks’ market power. To show this formally, I first characterize the economy’s supply of bank credit. As market structure is irrelevant if moneylenders rely on internal funds, attention is restricted to wealth levels where informal lenders need external capital.

**Lemma 1.** (i) Entrepreneurs obtain more funds from competitive banks. (ii) There exists a threshold \( \hat{\omega}_M(\phi) \in (\omega_M^c, \omega_M^s) \) such that moneylenders with wealth below \( \hat{\omega}_M \) obtain more funds from competitive banks and moneylenders with wealth above \( \hat{\omega}_M \) obtain more funds under imperfect bank competition.

Since all benefits accrue to the entrepreneurs under competitive banking, banks supply more credit as a result of improved incentives. Moneylenders take more competitive bank credit up to first best \( (\omega_M^c) \), then reduce their loan in step with rising wealth. Meanwhile, the imperfectly competitive

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31 The effect of \( \phi \) on \( B/I \) is ambiguous below \( \omega_M^m \) (when entrepreneurs and moneylenders access the bank under imperfect bank competition), as a higher \( \phi \) leads to less bank lending and a lower suboptimal investment [given by (17)]. The total effect depends on which reduction is larger (independently of how project proceeds are split).
bank continues to extend additional funds as the efficient outcome \((\hat{\omega}_M^m)\) remains to be attained. [For details, see Figure (1).]

**Proposition 6.** The ratio of informal credit to investment is higher when banks have market power and \(\omega_M \in (\hat{\omega}_M, I^* - \omega_E)\) and indeterminate with respect to bank market structure for wealth below \(\hat{\omega}_M\).

While entrepreneurs obtain more funds from poor moneylenders if banks compete, they also take additional bank credit (Lemma 1), making the exact prediction imprecise. However, as moneylenders become wealthier the outcome is clear: informal finance should be more important if it allows banks to save the agency costs.

### 4.2 Welfare, Segmentation, and Financial Development

Why does financial sector underdevelopment, in the form of market segmentation, persist? One reason is that those who potentially influence the levers of power (for example, wealthy informal lenders and influential bankers) gain from status quo. I investigate this issue by considering how welfare is distributed in the economy.

**Proposition 7.** (i) Entrepreneurs and poor moneylenders, \(\omega_M < \omega_M^c\), are better off when banks are competitive, whereas banks and sufficiently wealthy moneylenders, \(\omega_M > \omega_M^c\), are better off when banks have market power. (ii) Entrepreneurs prefer a bank with market power over the coexistence of a moneylender and a bank with market power.

Informal finance supports entrepreneurs’ asset growth in the competitive setting. The reason is twofold. Competition transfers the entire surplus to the bank borrowers, allowing more credit to be extended. Moneylenders reinforce this effect by further expanding credit provision and by softening the entrepreneurs’ incentive problem. Competition also adds value to poor moneylenders as they receive more bank funds. By contrast, banks and wealthier moneylenders are better off if financial markets are segmented. This is because the segmented outcome preserves the market power that moneylenders’ enforcement advantage grants them (\(\alpha\) remains unchanged), whereas they are forced to give up all their rent under competitive banking (\(\alpha = 1\)). Part (ii) of Proposition 7 makes borrowers’ welfare loss explicit. Poor entrepreneurs receive less funds and consequently lower floor utility from the monopoly bank (for a given investment) if it also extends credit to the moneylender. If moneylenders provide all external capital, entrepreneurs earn the equivalent of doing the project alone with the informal lender, worth strictly less than the incentive rent provided by the bank.
In sum, besides allowing banks to reduce agency cost, credit market segmentation also softens competition between the formal and the informal financial sector, providing an additional rationale for its persistence.

4.3 Informal Interest Rates

Aleem (1990), Banerjee (2003), and others have shown that poor borrowers with similar characteristics face informal interest rates ranging from 0 to 200 percent annually in India, Pakistan, and Thailand.\(^{32}\) In fact, there is large variation in informal lending rates even within the same sub economy. I now examine factors that rationalize some of the observed heterogeneity.

**Proposition 8.** (i) Bank-rationed moneylenders charge positive rates of interest, \(R/B - 1 > 0\).
(ii) \(R/B - 1\) is nondecreasing in creditor vulnerability (\(\phi\)) if moneylenders keep the entire surplus.
(iii) \(R/B - 1\) is higher when banks have market power and increases as credit markets become segmented.

First, poor moneylenders charge positive rates of interest regardless of the degree of competition in the adjacent bank market. This is because the price of informal credit reflects the incentive rent moneylenders receive to ensure prudent behavior when forwarding bank funds. Competition from the bank sector is thus softened as excessive lending to poor entrepreneurs and/or poor moneylenders would result in diversion. By contrast, a self-financed informal sector offers credit at the opportunity cost of funds.

Second and related to the first point, weaker institutions cause interest rates to rise if bank-rationed moneylenders are monopolists.\(^{33}\) That is, an increase in the opportunity cost of being diligent, \(\phi\), transmits into a higher price of informal credit. Specifically, the interest rate becomes \(R/B - 1 = \left[Q(\omega_E + L_E + \omega_M + L_M) - Q(\omega_E + L_E)\right]/(\omega_M + L_M) - 1\) when banks compete. Corollary 1 states that a higher \(\phi\) reduces \(L_E\), while the effect on \(L_M\) is ambiguous. The moneylender’s stronger bargaining position thus enables him to increase the repayment obligation \(R\); an increase which dominates the ambiguous effect on the loan size \(B\).\(^{34}\) Under market segmentation, an increase in \(\phi\) limits bank lending to the moneylender but does not affect wealth, explaining why the reduction in \(B\) is larger relative to the drop in \(R\). At first-best investment, institutional changes have no bite. Moreover, if the cost of diversion \(\phi\) differs between moneylenders (not only across legal environments), perhaps because they differ in the number of formal loans

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\(^{32}\)For additional evidence, see Udry (1990, 1994) and La Ferrara (2003) for the case of Africa and Das-Gupta et al. (1989) and Siamwalla et al. (1990) for the case of Asia.

\(^{33}\)As noted in Section 4.1, general predictions on the effect of creditor vulnerability are difficult to make unless we restrict attention to either a competitive or a monopolistic informal credit market.

\(^{34}\)Similar intuition explains the outcome when the entrepreneur and the moneylender both obtain bank finance in the imperfectly competitive case.
outstanding or in the social ties with the formal banker, this generates additional variation in the
interest charged within the same sub economy.

Finally, as poor moneylenders extend more credit under competitive banking this leads to lower
interest rates due to diminishing returns to scale. Also, if moneylender wealth climbs, informal
lenders offer credit at the opportunity cost of funds in the competitive setting. Meanwhile, the
segmented outcome not only preserves moneylenders’ market power, it also increases interest rates
further as entrepreneurs lose their outside option when dealing exclusively with the informal sector.

Terms offered to the same borrower thus range from an effective price of zero to very high
rates. Accounting for informal lenders’ financing capacity, the institutional environment, and the
possibility of market segmentation complements the emphasis on monitoring cost as an explanation
for the observed steep lending rates (see Banerjee, 2003).\footnote{The zero interest result partly depends on the assumption of zero monitoring cost. However, while allowing for positive monitoring cost on part of the moneylender adds another layer, it does not qualitatively alter the findings.}

5 Empirical Evidence

The analysis in Section 3 (Propositions 2 and 4) highlights the interaction between weak institu-
tions, poor agents, and inefficient markets. As briefly reviewed in the introduction, there is am-
ple evidence showing that better legal protection alleviates credit rationing, that informal lenders
turn to the formal financial sector for additional funds, and that market power is a recurring phe-
nomenon in developing credit markets. Combining these facts, the model concludes that all but the
wealthiest borrowers turn either to both financial sectors simultaneously or to the informal sector
exclusively.

The finding that borrowers’ formal sector debt capacity increases in their wealth is consistent
with a series of empirical studies on formal-informal sector interactions in Africa (Graham et al.,
1988; Steel et al., 1997), Asia (Floro and Yotopoulos, 1991; Bell et al., 1997; Banerjee and Dufo,
2007; Giné, 2007), and South America (Key, 1997; Conning, 2001). For example, in Giné’s study
of 2,880 households and 606 small businesses in rural Thailand, the richest borrowers (measured
both by wealth and income) access the formal sector exclusively. As wealth declines, borrowers
resort either to informal lenders (including landlords, professional moneylenders, traders, and store
owners) alone or to both financial sectors. A similar pattern emerges when investigating informal
lenders’ formal sector debt capacity. In a survey of 96 wholesalers and retail merchants in Niger,
Graham et al. report that the size of retail merchants’ formal sector loan increases in their asset
base.

Several case studies illustrate the complementarity between formal and informal finance. In
particular, local traders and input suppliers, drawing on funds from banks and upstream buyers,
often provide farmers with inputs and credit in the form of cash and in-kind loans on machinery, seeds, and fertilizers.\textsuperscript{36} In these instances, informal lenders’ capital base not only raises investment but also enables borrowers to draw on additional formal finance. In their account of contract farming in North America, Latin America, and Africa, Glover and Kusterer (1990) write that the informal funding provided by traders and input suppliers “serves to assure banks of the farmer’s credit-worthiness, thus facilitating access to private [bank] credit” (Glover and Kusterer, 1990, p. 130).\textsuperscript{37} Related evidence is provided by Campion (2006) in her study of Peru’s artichoke sector. Campion documents that artichoke processors and input suppliers “provide valuable finance...to help farmers...to produce high quality artichokes in greater quantity and improve their returns on investment. Higher returns have lead to greater access to formal finance...” (Campion, 2006, p. 10). Wittlinger and Tuesta’s (2006) description of soybean farmers in Paraguay tells a similar story. Farmers sell their produce to and receive credit from upstream silos that actively oversee the production process. This phase-by-phase supervision means that the bank officers spend less time monitoring the loan, allowing for more formal capital to be lent directly to the farmers. Moreover, the silos also take bank loans to finance fertilizers, fuel, and agricultural equipment provided as in-kind inputs to the farmers.\textsuperscript{38}

The empirical regularity that wealthier informal lenders often are the exclusive clients of formal banks (rather than poor borrowers) supports the prediction that banks may prefer to channel their capital through the informal sector. In their study of Philippine agricultural finance, Floro and Yotopoulos (1991) note that formal lenders and upstream buyers rarely deal directly with smaller borrowers. Instead, the formal lenders rely on rich farmer-clients as “they [the rich farmers] have the assets required for leverage” (Floro and Yotopoulos, 1991, p. 46). Similarly, Rahman (1992) reports that although formal credit totals more than two thirds of the informal sector’s liabilities in Bangladesh, less than ten percent of the households borrow directly from the formal sector. Those that take formal credit (and on lend) are “people with sufficient collateral and credibility to borrow from formal sector financial institutions” (Rahman, 1992, p. 154). Related support is provided by Harriss (1983) in her study of 400 agricultural traders and paddy producers in Tamil Nandu, India where large farmers take formal credit to be on lent to poorer clients. Evidence from Japan’s Meiji era (1868-1912) shows a similar pattern. During this period, wealthier grain, fertilizer, or textile merchants, landlords, and professional moneylenders obtained bank credit to finance poor farmers, weavers, and silk producers otherwise unable to secure external funding (Teranishi, 2005, 2007).\textsuperscript{39}

In the model, the degree of bank competition affects formal financial sector access as well

\textsuperscript{36}See Reardon and Timmer (2007) for the importance of credit provision in the agricultural output market.
\textsuperscript{37}See also Watts (1994) for related support.
\textsuperscript{38}For a similar account from Croatia, see Matić et al. (2006).
\textsuperscript{39}See Biggs (1991) for related evidence from early twentieth century Taiwan, where larger firms on-lent commercial bank credit directly to smaller downstream customers lacking bank access.
as the role of informal lenders. This is in line with historical evidence from Plymouth County in New England, United States (Wang, 2008). Using detailed bank, census, and court records between 1803 and 1850, Wang documents how increased bank competition allowed poor farmers and artisans to partially substitute from informal finance provided by wealthier (bank-financed) merchants, to formal bank credit. Bank records show that merchants, esquires, and gentlemen (the rich) accounted for most of the transactions when the county comprised one bank. Meanwhile, the court records of debt claims identify the same wealthy group as providers of credit to farmers and artisans. After the entry of an additional bank, the proportion of bank loans to merchants declined from 60 to 25 percent while farmers and artisans increased their share from 12 to 38 percent. The court records also show that farmers and artisans were less likely to borrow from wealthy merchants. Contemporary data echo these findings. In Giné’s (2007) study of formal-informal sector interactions in Thailand, poor borrowers are less likely to access the informal sector exclusively when bank competition increases. Also, Burgess and Pande’s (2005) investigation of the effects of bank branch expansion in India (effectively, increased formal sector competition) shows a similar pattern. They find that bank borrowing as a share of total rural household debt increased from 0.3 to 29 percent between 1961 and 1991. Meanwhile, borrowing from professional moneylenders fell from 61 to 16 percent in the same period.

My model also suggests that that weaker legal institutions increase the prevalence of informal credit if borrowers obtain money from both financial sectors, while the opposite is true if informal lenders supply all funds. Using firm-level data for 26 countries in Eastern Europe and Central Asia, Dabla-Norris and Koeda (2008) broadly confirm Proposition 5 and Corollary 2. They show that the relationship between legal institutions and informal credit is indeterminate, while bank lending contracts as creditor protection worsens. More systematic evidence is offered in a recent study by Chavis et al. (2009) covering 70,000 small and medium-sized firms in over 100 countries. As implied by the model, improvements in creditor protection have a positive effect on access to bank finance, particularly for young (and small) firms. Specifically, the interaction between rule of law and firm age is significant and negative for bank finance. Meanwhile, there is no significant interactive effect of rule of law for finance coming from informal sources and trade credit. My

40Esquires and gentlemen were honorary titles given to people with more wealth and higher social status. Esquires could be merchants, large land-owning farmers, attorneys, and judges. Gentlemen were another economically better-off class, if not quite as wealthy as esquires.

41That is, the cases where farmers appeared as defendants and merchants as plaintiffs declined after the entry.

42Note that 30 percent of the households in 1991 still held loans from the government, traders, and landlords.

43Findings from China also show that informal finance is more prevalent in the central and the northwest regions where bank competition is scant and less important in the coastal region where banks are more competitive (Cull and Xu, 2005; Ayyagari et al., forthcoming; Cheng and Degryse, 2010).

44A drawback of these findings is their focus on firm age rather than firm size/collateral. Other variables, such as reputation, may have an independent effect on credit access besides collateral. However, to the extent that young firms still have lower wealth, the empirical evidence does corroborate the model’s conclusions.
theory explains the insignificant effect by showing that the relationship can go either way, while bank credit—if accessible—increases in creditor protection. Dabla-Norris and Koeda and Chavis et al. also find that the use of informal finance is consistently higher in lower-income countries. If entrepreneurial wealth is a proxy for income, this is line with the model’s prediction that informal finance grows in importance as borrower wealth declines.

Proposition 7 shows that wealthier informal lenders (and banks) prefer the segmented outcome that arises with bank market power, as it softens competition between the financial sectors. This resonates with the work of Rajan and Zingales (2003) on incumbent financial institutions’ historical support for financial repression to maintain status quo. In particular, suppose rich moneylenders and bankers have more say over local bank market structure than poor entrepreneurs, for example, through branching restrictions on banking. In this case, Proposition 7 provides a political-economy explanation as to why informal finance and bank market power are pervasive features of less developed credit markets. In line with my theory, Rajan and Ramcharan (forthcoming) find that bank markets in the early twentieth century United States were more concentrated in counties with wealthy landowners, who often engaged in lending to local farmers. These landlords frequently had ties with the local bank and the local store (that offered credit) and were, as the model predicts, against bank deregulation.⁴⁵ Rajan and Ramcharan show that there were fewer banks per capita and less formal bank lending to poor farmers (as well as higher formal interest rates) in counties with a more unequal distribution of farm land. This is consistent with the skewed distribution of wealth needed to support the theory’s predictions. In the model, relatively better-off informal lenders are more creditworthy compared to poor entrepreneurs.

6 Economic Policy

Before I consider possible reforms, let me summarize the main results so far.⁴⁶ The model’s basic distortion is the inability of formal banks to enforce their contracts. Better functioning institutions not only allow banks to lend more to poor borrowers and poor informal lenders, they can also reduce informal interest rates.⁴⁷ If the aim is to replace informal with formal finance, wealth subsidies may be more effective policy however. While the prevalence of informal finance decreases in entrepreneurial wealth, informal credit becomes more important as legal protection of banks

⁴⁵In his study of farm credit in Texas, Haney (1914) writes that the “country merchant act as the banker’s agent in making crop mortgage loans” (Haney, 1914, p. 54). Haney estimates that as much as 20 percent of all loans in Texas banks were made to country merchants for the purpose of funding crop mortgage securities.⁴⁶In what follows, I examine policies that are productivity enhancing, that is, they raise investment. This does not imply Pareto efficiency however; see Bardhan et al. (2000) for a discussion.⁴⁷The interaction between creditor vulnerability and the credit market endogenously determines the threshold of wealth necessary to attain an efficient investment using only bank funds. Hence, stronger creditor protection also implies that entrepreneurs with less wealth will succeed in securing an exclusive bank contract.
improves if credit markets are segmented.

Propositions 2 and 4 show that financial sector coexistence increases efficiency compared to a pure bank lending regime. The policy recommendations that follow are straightforward from an efficiency perspective, but less clear in terms of borrower welfare. Although regulation fostering informal sector growth is beneficial for poor borrowers in the competitive benchmark, the opposite is true under credit market segmentation (Proposition 7). Moreover, while pro-competitive bank reforms raise efficiency, help borrowers access the formal sector, and reduce informal interest rates, the caveat may be the lack of political will to introduce such policies, as discussed in Section 4.2. Hence, programs that strengthen borrowers’ outside options (similar to the empowerment strategies of poor tenants documented in Banerjee et al., 2002) offer a way to diminish the reliance on credit provided by informal lenders and banks. Specifically, it points to the importance of alternative sources of credit, such as microfinance. In fact, microfinance programs may present a more viable alternative if powerful vested interests (in the form of wealthy informal lenders and banks) are opposed to bank market reforms.

I now analyze the effects of subsidized credit by allowing for a positive cost of bank capital, $\rho$. Introducing $\rho$ has three effects: it offers a deposit return that enters the outside option in the bargaining, it affects the residual return for a given loan size, and it alters the sub-optimal investment if banks have market power. While a lower $\rho$ increases investment if the moneylender and the entrepreneur obtain bank credit—regardless of bank market structure—it decreases lending to the bank-rationed moneylender and subsequent investment under market segmentation. This is because a drop in $\rho$ weakens the moneylender’s outside option in his bargaining with the entrepreneur, while the bank’s price is unaffected [as $D_M > (1+\rho)L_M$]. The end effect is a decrease in the prevalence of informal finance and lower efficiency.

**Proposition 9.** (i) Financial sector coexistence and bank market competition increase investment ($I$). (ii) $I$ decreases in the opportunity cost of capital ($\rho$), except if moneylenders are bank rationed under credit market segmentation, then $I$ increases in $\rho$.

Which reform is most efficient? In what follows, I explore the differential impact of changes in creditor protection, cost of capital, and wealth in terms of gross benefits. Under bank competition, reduced creditor vulnerability boosts investment more than a lower cost of capital. The reason is that $\phi$ influences the marginal return to the entire investment, whereas $\rho$ only affects the return to the bank loan. Specifically, a drop in $\phi$ decreases both the opportunity cost of being diligent with bank credit ($\bar{L}_E + \bar{L}_M$) and with internal funds ($\omega_E + \omega_M$), while a reduction in $\rho$ increases the residual return for a given loan ($\bar{L}_E + \bar{L}_M$). In the imperfectly competitive scenario, two cases need

\[^{48}\text{In the proof of Proposition 9, I show that } \bar{\omega}^M > \bar{\omega}_M. \text{ That is, a moneylender stops borrowing from competitive banks before first best is attained in the imperfectly competitive case. [See Figure (1).]}\]
to be considered. When the entrepreneur and the moneylender borrow from the bank, changes in creditor vulnerability and cost of capital have an analogous impact on the sub-optimal investment given by equation (17).\(^{49}\) Under market segmentation, a lower \(\phi\) increases investment (Proposition 5), while a reduction in \(\rho\) decreases it (Proposition 9).\(^{50}\)

Wealth subsidies to borrowers follow the standard prescription in credit-rationing models, where redistribution in favor of poor entrepreneurs supports increased borrowing and investment. In my model, informal lenders also face binding credit constraints, suggesting that these policy implications need to be modified. Consider a reform that redistributes one dollar from the entrepreneur to the moneylender. If rationed entrepreneurs and moneylenders access the bank, the transfer affects the bargaining weights and subsequent bank lending, but not the project’s size since every dollar is invested. Under market segmentation, a reallocation in favor of the bank-rationed moneylender increases investment. As the moneylender’s share of the investment outcome, not the overall size, determines the incentive-compatible bank loan [equation (19)], an additional dollar of moneylender wealth draws more bank money into the project. A similar result is obtained in the competitive benchmark if entrepreneurs’ opportunity cost of being diligent exceeds moneylenders’ cost, \(\phi_M < \phi_E\). Although every dollar is invested, moneylenders attract more bank credit since they are less likely to divert the funds. In sum, while grants to poor entrepreneurs increase investment and decrease the prevalence of informal finance, transfers to the informal sector may be a more efficient policy choice.

**Proposition 10.** Investment \((I)\) increases weakly if: (i) creditor vulnerability \((\phi)\) decreases rather than the opportunity cost of capital \((\rho)\) and \(I < I^*\); (ii) wealth is redistributed from entrepreneurs to moneylenders.

Redistribution raises investment partly because of moneylenders’ perfect monitoring ability. If entrepreneurs invest a fraction of the informal loan, the statement remains correct under credit market segmentation, while the policy lowers efficiency in the competitive benchmark. Inefficient monitoring matters less under segmentation as the transfer’s main effect in this case comes through a shift in the relative bargaining weights.\(^{51}\)

\(^{49}\)More specifically, the modified equation reads \(Q'(I) - (1 + \phi + \rho) = 0.\)

\(^{50}\)At first best, variation in \(\phi\) has no effect on investment while a reduction in \(\rho\) increases investment by changing the optimal project size, determined by \(Q'(I) - (1 + \rho) = 0.\)

\(^{51}\)If the diversion return is higher for the entrepreneurs, \(\phi_M < \phi_E\). Proposition 10 is still valid even with imperfect informal monitoring, given that the monitoring technology is efficient enough and/or the difference \(\phi_E - \phi_M\) is sufficiently large.
A worthwhile question is why the bank does not merge with the moneylender, making him the local branch manager? Specifically, the bank supplies the financial resources and the moneylender the local knowledge. In the current setting, internal funds are a necessary condition however. Incentive compatibility is violated if banks extend credit to penniless informal lenders/bank employees. Consider the competitive benchmark with a competitive informal sector. In this case, moneylenders’ incentive constraint collapses to $R - \bar{L}_M = \bar{L}_M - \bar{L}_M = 0 < \phi\bar{L}_M$. But it is also true when moneylenders hold all the bargaining power.\(^{52}\) Two important observations follow. First, it is not sufficient to have a superior enforcement technology to on lend bank funds. Second, informal lenders are not bank agents; they need to put their own money at stake to facilitate the intermediation of formal credit. In sum, “bringing the market inside the firm” at best replicates the market outcome, as the branch manager has to be incentivized to act responsibly with the bank funds. However, the merger also adds a new dimension, the employer-employee relationship, which opens up for opportunistic behavior on the part of the bank as well.\(^{53}\) Hence, the overall effect is likely to be efficiency reducing, confirming why this kind of organizational design is uncommon in developing credit markets.

A related concern is whether the key insights would be altered if informal monitoring was less efficient, if other sharing rules governed the moneylender’s and the entrepreneur’s exchange, or if agents engaged in side payments? As regards the first objection, suppose the entrepreneur fails to invest a fraction $\delta \in (0, 1)$ of the moneylender’s funds.\(^{54}\) It can be shown that for $\delta$ sufficiently small, equilibrium outcomes remain the same. Pertaining to the choice of sharing rule, the Nash Bargaining solution produces an efficient outcome similar to Coasian bargaining since utility is transferable. Any sharing rule therefore yields quantitatively similar results in terms of the ensuing investment. Finally, side payments do not change the equilibrium outcomes since poor entrepreneurs and/or poor moneylenders are unable to compensate the other party and/or the bank due to their wealth constraints. That is, available funds are always used most efficiently in production.

Allowing for rising entrepreneurial wealth in the imperfectly competitive case changes little if

\(^{52}\)First, note that the project’s aggregate incentive-compatible bank loan is the same, with or without the penniless moneylender, as he does not add to investment. Second, when $\alpha = \hat{\alpha}$, the entrepreneur receives her outside option, equivalent of exclusive bank borrowing, but this is exactly the value of the entire project including the moneylender. Hence, after compensating the entrepreneur, the moneylender earns zero. When bank competition is imperfect, a loan to a penniless moneylender satisfies incentive compatibility. However, entrepreneurs prefer an exclusive bank contract as it increases their incentive rent. Since the bank is indifferent between lending to entrepreneurs alone or both (aggregate rent and loan size remain the same) and entrepreneurs are the project’s proprietors, moneylenders get shut out.

\(^{53}\)Similar in spirit to Williamson’s (1985) arguments of why “selective interventions” are hard to implement.

\(^{54}\)The value $\delta$ could be a deadweight loss or, alternatively, a benefit accruing directly to the entrepreneur.
the entrepreneur’s wealth climbs and wealth disparity is maintained. Here the bank is indifferent between dealing with the (relatively) richer moneylender alone and lending a small amount to the entrepreneur and the remainder to the moneylender. If the entrepreneur is the richer party, the outcome resembles the one analyzed in detail above, now with the bank gradually reducing its loan to the poor moneylender. If entrepreneurs and moneylenders are equally affluent though short of first best, both receive credit. Finally, similar to bank competition, rich entrepreneurs only take bank credit. Thus what matters for the results is that informal lenders hold relatively more assets compared to entrepreneurs.

As the model stands, informal lenders’ occupational choice is restricted to lending. The setup has allowed me to analyze how the basic traits uniting informal lenders: local enforcement and some wealth, shape less developed credit markets. In a more general setting, additional sources of income (and/or collateral) make it less tempting to behave non diligently, enabling the bank to supply more funds or save on incentive-related costs. Extending the theory by admitting complementary sources of income would permit for a characterization of how informal lenders’ enforcement technology and debt capacity vary across occupation and how monitoring ability and wealth interact in attracting outside funding. For example, are input suppliers better suited to extend credit to poor farmers and draw on external capital, as compared to landlords, merchants, shopkeepers, and upstream buyers? It would also be interesting to explore the question of who becomes a moneylender. Such a model has the potential to explain, among other things, how the informal sector’s market power is determined. If enforcement rests on social sanctions available within a community but all members are equally poor, anyone can become a moneylender, as well as attract outside funding. By contrast, if one villager is slightly wealthier than the rest, she will attract all outside funding and become the local monopolist. Another topic for future research would be to develop a more explicit political-economy model to understand the interaction between the credit market and the formation of interest groups.

In closing, the theory laid out in this paper lends itself to empirical testing. While the key findings stand up well to the available evidence, more quantitative work is needed to thoroughly understand how the informal sector’s resource constraints affect its ability to finance poor borrowers as well as attract outside funding. Combining systematic data on informal lenders’ debt capacity with measures of institutional quality and market structure would also allow for further tests of the model’s predictions. Detailed micro evidence that sheds light on the role played by informal finance would be an important complement to the growing experimental literature investigating microfinance in developing countries.
Appendix

The following result will be helpful in the subsequent analysis.

**Lemma A2.** \( Q'(\omega_E + \bar{L}_E) - (1 + \phi) < 0. \)

*Proof.* When the entrepreneur (henceforth E) borrows from a competitive bank (henceforth B) and the credit limit binds,

\[
(A1) \quad Q(\omega_E + \bar{L}_E) - \bar{L}_E - \phi (\omega_E + \bar{L}_E) = 0.
\]

This constraint is only binding if \( Q'(\omega_E + \bar{L}_E) - (1 + \phi) < 0. \) Otherwise, \( \bar{L}_E \) could be increased without violating the constraint.

**Proof of Proposition 1**

Proposition 1 is proved in the main text, except for the comparative static results and the existence and the uniqueness of \( \omega^c_E. \)

**Lemma A3.** There exists a unique threshold \( \omega^c_E (\phi) > 0 \) such that \( Q(\omega_E + \bar{L}_E) - \bar{L}_E - \phi (\omega_E + \bar{L}_E) = 0 \) for \( \omega_E = \omega^c_E (\phi) \) and \( \omega_E + \bar{L}_E = I^*. \)

*Proof.* The threshold \( \omega^c_E \) is the smallest wealth level that satisfies \( \omega_E + \bar{L}_E = I^*. \) As (A1) yields the maximum incentive-compatible investment level, \( \omega^c_E \) satisfies

\[
(A2) \quad Q(I^*) - I^* (1 + \phi) + \omega^c_E = 0.
\]

The threshold is unique if \( \bar{L}_E \) is increasing in \( \omega_E. \) Differentiating (A1) with respect to \( \bar{L}_E \) and \( \omega_E \) I obtain

\[
\frac{d\bar{L}_E}{d\omega_E} = \frac{\phi - Q'(\omega_E + \bar{L}_E)}{Q'(\omega_E + \bar{L}_E) - (1 + \phi)} > 0,
\]

where the inequality follows from Lemma A2, \( Q'(I) \geq 1, \) and \( \phi < 1. \) Finally, \( \omega^c_E > 0 \) is a result of the assumption that \( \phi > \phi [\text{equation (1)}]. \)

**Lemma A4.** If \( \omega_E \leq \omega^c_E \) then \( \bar{L}_E \) and \( I \) increase in \( \omega_E \) and decrease in \( \phi. \)

*Proof.* The proof that \( d\bar{L}_E / d\omega_E > 0 \) is provided in Lemma A3. As (A1) also determines the investment level, \( dI / d\omega_E > 0 \) follows. Differentiating (A1) with respect to \( \bar{L}_E \) and \( \phi \) I obtain

\[
\frac{d\bar{L}_E}{d\phi} = \frac{\omega_E + \bar{L}_E}{Q'(\omega_E + \bar{L}_E) - (1 + \phi)} < 0,
\]

where the inequality follows from Lemma A2. As (A1) also determines the investment level, \( dI / d\phi < 0 \) follows.

**Proof of Proposition 2**

I show the existence and the uniqueness of \( \omega^c_E, \omega^c_M, \) and \( \bar{\omega}^c_M \) and proceed with the equilibrium outcomes.
Lemma A5. There exist unique thresholds $\omega^c_E(\phi) > 0$, $\omega^c_M(\phi)$, and $\bar{\omega}^c_M(\phi)$ such that:

(i) $Q(\omega_E + L_E) - L_E - \phi(\omega_E + L_E) = 0$ for $\omega_E = \omega^c_E(\phi)$ and $\omega_E + L_E = I^*$;

(ii) $\alpha [Q(\omega_E + L_E + \omega_M + L_M) - L_E - L_M - \omega_M] + (1 - \alpha) \omega_E - \phi(\omega_E + L_E) = 0$ and $(1 - \alpha)[Q(\omega_E + \bar{L}_E + \omega_M + L_M) - L_E - L_M - \omega_M] + \alpha \omega_M - \phi(\omega_M + L_M) = 0$ for $\omega_M = \omega^c_M(\phi)$ and $\omega_E + \bar{L}_E + \omega_M + L_M = I^*$;

(iii) $Q(\omega_E + \bar{L}_E + \omega_M) - \bar{L}_E - \omega_M - \phi(\omega_E + \bar{L}_E) = 0$ for $\omega_M = \bar{\omega}^c_M(\phi)$ and $\omega_E + \bar{L}_E + \omega_M = I^*$; and

(iv) $\bar{\omega}^c_M(\phi) > \omega^c_M(\phi) > 0$.

Proof. Part (i): The proof is provided in Lemma A3.

Part (ii): The threshold $\omega^c_M$ is the smallest wealth level that satisfies $\omega_E + L_E + \omega_M + L_M = I^*$ when E and the moneylender (henceforth M) utilize bank funds as given by (8) and (9) in the main text. Using (8) and (9) to solve for the maximum incentive-compatible investment level I have that, for a given level of E’s wealth, $\omega_E$, $\omega^c_M$ satisfies

\[ Q(I^*) - I^* (1 + \phi) + \omega_E + \omega^c_M = 0. \]

The threshold is unique if both $L_E$ and $L_M$ are increasing in $\omega_M$. Differentiating (8) and (9) with respect to $L_E$, $L_M$ and $\omega_M$ using Cramer’s rule I obtain

\[ \frac{dL_E}{d\omega_M} = \frac{\alpha [Q'(I) - 1]}{\phi [1 + \phi - Q'(I)]} > 0 \]

and

\[ \frac{dL_M}{d\omega_M} = \frac{\phi [Q'(I) - \phi] - \alpha [Q'(I) - 1]}{\phi [1 + \phi - Q'(I)]} > 0, \]

where the inequalities follow from Lemma A2, $Q'(I) \geq 1$, and $\phi < 1$.

Part (iii): The threshold $\bar{\omega}^c_M$ is the smallest wealth level that satisfies $\omega_E + \bar{L}_E + \omega_M = I^*$ at which M is able to self finance E. Thus, for a given level of E’s wealth, $\omega_E$, $\bar{\omega}^c_M$ satisfies

\[ Q(I^*) - I^* (1 + \phi) + \omega_E + \bar{\omega}^c_M \phi = 0. \]

The threshold is unique if $\bar{L}_E (L_M)$ is independent of (decreasing in) $\omega_M$ when the relevant constraints are given by (11) in the main text and the first-order condition $Q'(I) - 1 = 0$. Differentiating (11) and the first-order condition with respect to $L_E$, $L_M$, and $\omega_M$ using Cramer’s rule I obtain

\[ \frac{dL_E}{d\omega_M} = 0 \]

and

\[ \frac{dL_M}{d\omega_M} = -1. \]

Part (iv): Combining (A3) and (A4), yields $\omega^c_M = \phi \bar{\omega}^c_M$, where $\bar{\omega}^c_M > \omega^c_M$ follows from $\phi < 1$. Finally, $\omega^c_M > 0$ is a result of the assumption that $\phi > \phi (\omega_E)$ [equation (4)].
**Lemma A6.** If (i) $\omega_E < \omega_E^c$ and $\omega_M < \omega_M^c$ then the entrepreneur borrows from a bank and a bank-financed moneylender. If (ii) $\omega_E < \omega_E^c$ and $\omega_M \geq \omega_M^c$ then the entrepreneur borrows from a bank and a self-financed moneylender. If (iii) $\omega_E \geq \omega_E^c$ then the entrepreneur borrows exclusively from a bank.

**Proof.** I consider E’s and M’s incentive constraints given that B breaks even. Five distinct cases need to be analyzed as E may borrow from: (i) B exclusively; (ii) B and a bank-financed M; (iii) a self-financed M exclusively; (iv) a self-financed M exclusively; (v) B and a self-financed M.

Part (i): First, consider $\omega_M < \omega_E^c$. Recognizing the concavity of $Q(I)$ and $Q'(I) \geq 1$, it follows that E and M prefer Case (ii) to Cases (iii)-(v) for any $\alpha$. Finally, for $\alpha > \alpha^*$ as defined in the main text, E prefers Case (ii) to Case (i) as well. Next, when $\omega_M \in [\omega_M^c, \omega_E^c]$, $\omega_E + \omega_M$ accounts for the interval of credit lines such that $\omega_M < I^* - \omega_E - L_E$, for a given $\omega_E$ and $\omega_M$. From the main text we have that Case (ii) leaves E with the full surplus, while M is indifferent and so Case (ii) remains the equilibrium outcome when $\omega_M \in [\omega_M^c, \omega_E^c]$.

Part (ii): Here, $\omega_E + \omega_M$ accounts for the interval of credit lines such that $\omega_M \geq I^* - \omega_E - L_E$, for a given $\omega_E$ and $\omega_M$. The only difference from Part (ii) is that M refrains from bank borrowing when he is able to self finance large parts of the first-best investment, making Case (ii) irrelevant. Thus, Case (v) is the only possible outcome since in Cases (iii) and (iv), E would have to share part of a (possibly smaller) surplus with M.

Part (iii): As E turns to B first and is able to satisfy first best, Case (i) is the outcome.

**Proof of Corollary 1 (Comparative Statics)**

**Proof.** For $\omega_M < \omega_E^c$ and $\omega_E < \omega_E^c$: Differentiating (8) and (9) in the main text with respect to $\bar{L}_E, \bar{L}_M, \omega_E, \omega_M,$ and $\phi$ using Cramer’s rule I obtain (for $\alpha \in (\hat{\alpha}, 1]$)

$$
\frac{d\bar{L}_E}{d\omega_E} = \frac{\phi [Q'(I) - \phi] - (1 - \alpha) [Q'(I) - 1]}{\phi [1 + \phi - Q'(I)]} > 0,
$$

$$
\frac{d\bar{L}_M}{d\omega_E} = \frac{(1 - \alpha) [Q'(I) - 1]}{\phi [1 + \phi - Q'(I)]} \geq 0,
$$

$$
\frac{d\bar{L}_E}{d\phi} = \frac{(\omega_E + \bar{L}_E) \{ (1 - \alpha) [Q'(I) - 1] - \phi \} - (\omega_M + \bar{L}_M) \alpha [Q'(I) - 1]}{\phi [1 + \phi - Q'(I)]} < 0,
$$

and

$$
\frac{d\bar{L}_M}{d\phi} = \frac{(\omega_M + \bar{L}_M) \{ \alpha [Q'(I) - 1] - \phi \} - (\omega_E + \bar{L}_E) (1 - \alpha) [Q'(I) - 1]}{\phi [1 + \phi - Q'(I)]} < 0,
$$

where the inequalities follow from Lemma A2, $Q'(I) \geq 1$, and $\phi < 1$. The proof that $d\bar{L}_E/d\omega_M \geq 0$ and $d\bar{L}_M/d\omega_M > 0$ is provided in Lemma A5. If $\alpha = \hat{\alpha}$, the relevant constraints are given by (3) in the main text and by

(A5) $Q(\omega_E + \bar{L}_E + \omega_M + L_M) - Q(\omega_E + L_E) - L_M = \phi (\omega_M + L_M)$. 

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Differentiating (3) and (A5) with respect to $L_E, L_M, \omega_E, \omega_M,$ and $\phi$ using Cramer's rule I obtain

\[
\frac{dL_E}{d\omega_E} = \frac{\phi - Q'(\omega_E + L_E)}{Q' (\omega_E + L_E) - (1 + \phi)} > 0,
\]
\[
\frac{dL_M}{d\omega_E} = \frac{Q'(I) - Q'(\omega_E + L_E)}{[Q'(\omega_E + L_E) - (1 + \phi)] [Q'(I) - (1 + \phi)]} < 0,
\]
\[
\frac{d\bar{L}_E}{d\omega_M} = 0,
\]
\[
\frac{dL_M}{d\omega_M} = \frac{\phi - Q'(I)}{Q'(I) - (1 + \phi)} > 0,
\]
\[
\frac{d\bar{L}_E}{d\phi} = \frac{\omega_E + \bar{L}_E}{Q'(\omega_E + \bar{L}_E) - (1 + \phi)} < 0,
\]

and

\[
\frac{d\bar{L}_M}{d\phi} = \frac{(\omega_M + \bar{L}_M) [Q'(\omega_E + \bar{L}_E) - (1 + \phi)] - (\omega_E + \bar{L}_E) [Q'(I) - Q'(\omega_E + \bar{L}_E)]}{[Q'(\omega_E + \bar{L}_E) - (1 + \phi)] [Q'(I) - (1 + \phi)]} \leq 0,
\]

where the inequalities and the indeterminacy follow from Lemma A2, $Q'(I) \geq 1,$ and $\phi < 1.$

For $\omega_M \in \left[\omega_M^L, \bar{\omega}_M^E\right], \omega_E < \omega_E^c,$ and all $\alpha$: The relevant constraints are given by (11) in the main text and the first-order condition $Q'(I) - 1 = 0.$ Differentiating (11) and the first-order condition with respect to $\bar{L}_E, L_M, \omega_E, \omega_M,$ and $\phi$ using Cramer's rule I obtain

\[
\frac{d\bar{L}_E}{d\omega_E} = \frac{1 - \phi}{\phi} > 0,
\]
\[
\frac{dL_M}{d\omega_E} = \frac{-1}{\phi} < 0,
\]
\[
\frac{d\bar{L}_E}{d\phi} = \frac{- (\omega_E + \bar{L}_E)}{\phi} < 0,
\]

and

\[
\frac{dL_M}{d\phi} = \frac{\omega_E + \bar{L}_E}{\phi} > 0,
\]

where the first inequality follows from $\phi < 1.$ The proof that $d\bar{L}_E/d\omega_M = 0$ and $dL_M/d\omega_M < 0$ is provided in Lemma A5.

\section*{Proof of Proposition 3}

Proposition 3 is proved in the main text, except for the comparative static results and the existence and the uniqueness of $\omega^m_E$ and $\bar{\omega}^m_E.$

\section*{Lemma A7. There exist unique thresholds $\omega^m_E(\phi)$ and $\bar{\omega}^m_E(\phi)$ such that:}

(i) $\phi(\omega_E + L_E) - Q(\omega_E) = 0$ for $\omega_E = \omega^m_E(\phi)$ and $\omega_E + L_E = I$, with the investment level given by equation (12) in the main text;

(ii) $\phi(\omega_E + L_E) - Q(\omega_E) = 0$ for $\omega_E = \bar{\omega}^m_E(\phi)$ and $\omega_E + L_E = I^*;$ and

(iii) $\omega_E + L_E = I^*.$
(iii) $\bar{\omega}_E^m(\phi) > \omega_E^m(\phi) > 0$ and $\bar{\omega}_E^m(\phi) > \omega_E^c(\phi)$.

**Proof.** Part (i): The threshold $\omega_E^m$ is the smallest wealth level at which E’s incentive constraint equals her participation constraint allowing E to invest $\omega_E + L_E = I$, with $I$ given by (12) in the main text. Thus, $\omega_E^m$ satisfies

$$(A6) \quad \phi I - Q(\omega_E^m) = 0.$$ 

The threshold is unique if $L_E$ is decreasing in $\omega_E$ when the equilibrium is given by (12) and (13) in the main text. Differentiating (12) and (13) with respect to $L_E$ and $\omega_E$ using Cramer’s rule I obtain

$$\frac{dL_E}{d\omega_E} = -1.$$ 

Finally, $\omega_E^m > 0$ follows from the assumption that $\phi > \phi$.

Part (ii): The proof is analogous to the proof of Part (ii) and omitted.

Part (iii): Solving for $\omega_E^m$ and $\bar{\omega}_E^m$ and combining the two expressions, yields $Q(\omega_E^m) I' = Q(\bar{\omega}_E^m) I^*$, with $I'$ given by (12) in the main text. By concavity, $I^* > I'$ and hence $\bar{\omega}_E^m > \omega_E^m$. Solving for $\omega_E^c$ and $\bar{\omega}_E^m$ and combining the two expressions, yields $Q(I^* - I^*) = Q(\omega_E^m) - \omega_E^c$, where $\bar{\omega}_E^m > \omega_E^c$ follows from concavity.

**Lemma A8.** If $\omega_E \leq \omega_E^m$ then $L_E$ decreases in $\omega_E$ and $I$ is independent of $\omega_E$; if $\omega_E \in (\omega_E^m, \bar{\omega}_E^m)$ then $L_E$ and $I$ increase in $\omega_E$.

**Proof.** When $\omega_E \leq \omega_E^m$, the proof that $dL_E/d\omega_E < 0$ is provided in Lemma A7. Differentiating (12) and (13) in the main text and the investment condition, $\omega_E + L_E = I$, with respect to $I$ and $\omega_E$ using Cramer’s rule I obtain

$$\frac{dI}{d\omega_E} = 0.$$ 

When $\omega_E \in (\omega_E^m, \bar{\omega}_E^m)$, the relevant constraints are given by (14) in the main text, the binding participation constraint, $Q(\omega_E + L_E) - D_E = Q(\omega_E)$, and the investment condition, $\omega_E + L_E = I$. Differentiating (14), the binding participation constraint, and the investment condition with respect to $L_E$, $I$, and $\omega_E$ using Cramer’s rule I obtain

$$\frac{dL_E}{d\omega_E} = \frac{Q'(\omega_E) - \phi}{\phi} > 0$$ 

and

$$\frac{dI}{d\omega_E} = \frac{Q'(\omega_E)}{\phi} > 0,$$

where the first inequality follows from $Q'(I) \geq 1$ and $\phi < 1$. 

**Proof of Proposition 4**

I show the existence and the uniqueness of $\omega_E^m$, $\omega_M^m$, and $\bar{\omega}_M^m$ and proceed with the equilibrium outcomes.
Lemma A9. There exist unique thresholds \( \omega_E^m (\phi) > 0, \omega_M^m (\phi), \) and \( \bar{\omega}_M^m (\phi) \) such that:

(i) \( \phi (\omega_E + L_E) - \alpha Q (\omega_E + B) - (1 - \alpha) \omega_E + \alpha B = 0 \) for \( \omega_E = \omega_E^m (\phi) \) and \( \omega_E + L_E + B = I \), with the investment level given by equation (17) in the main text;

(ii) \( \phi (\omega_M + L_M) - (1 - \alpha) [Q (\omega_E + \omega_M) - \omega_E] - \alpha \omega_M = 0 \) for \( \omega_M = \omega_M^m (\phi) \) and \( \omega_E + \omega_M + L_M = I \), with the investment level given by equation (17) in the main text;

(iii) \( \phi (\omega_M + L_M) - (1 - \alpha) [Q (\omega_E + \omega_M) - \omega_E] - \alpha \omega_M = 0 \) for \( \omega_M = \bar{\omega}_M^m (\phi) \) and \( \omega_E + \omega_M + L_M = I^* \); and

(iv) \( \bar{\omega}_M^m (\phi) > \omega_M^m (\phi) > 0 \).

Proof. Part (i): The threshold \( \omega_E^m \) is the smallest wealth level at which E’s incentive constraint equals her participation constraint allowing E to invest \( \omega_E + L_E + B = I \), with \( I \) given by (17) in the main text. Thus, for a given level of M’s wealth, \( \omega_M, \omega_E^m \) satisfies

\[
\phi (I - B) - \alpha Q (\omega^m_E + \omega_M) - (1 - \alpha) \omega^m_E + \alpha \omega_M = 0. \tag{A7}
\]

The threshold is unique if \( L_E + L_M \) decrease in \( \omega_E \) when the equilibrium is given by (15) to (17) in the main text. (The same reasoning applies when \( \omega_M \in [\omega_M^m, I^* - \omega_E] \).) Differentiating (15) to (17) with respect to \( L_E, L_M, \) and \( \omega_E \) using Cramer’s rule I obtain

\[
\frac{dL_E}{d\omega_E} = \frac{1 - \alpha - \phi}{\phi},
\]

and

\[
\frac{dL_M}{d\omega_E} = \frac{\alpha - 1}{\phi},
\]

with \( dL_E/d\omega_E + dL_M/d\omega_E = -1 \). To show \( \omega_E^m > 0 \), let \( \alpha = \tilde{\alpha} \) in (A7). This yields \( \phi (I - B) - Q (\omega^m_E) = 0 \), where \( \omega^m_E > 0 \) follows from the assumption that \( \phi > \phi^* \). Then let \( \alpha = 1 \). Here, \( \phi (I - B) - Q (\omega^m_E + \omega_M) + \omega_M = 0 \). Note that \( \omega^m_E \) decreases in \( \omega_M \) for \( \omega_M < I^* - \omega_E \). As \( \omega_M \) approaches \( I^* - \omega_E \), I have that \( \phi (I^* - \omega_M) - Q (I^*) + I^* - \omega^m_M = 0 \), which is identical to (A4). If \( \omega_E^m = 0 \) then \( \omega_M = I^* \), but this contradicts \( \omega^c_M < I^* \). Hence, \( \omega_E^m > 0 \).

Part (ii): The threshold \( \omega_M^m \) is the smallest wealth level at which M’s incentive constraint equals his participation constraint allowing an investment of \( \omega_E + \omega_M + L_M = I \), with \( I \) given by (17) in the main text. Thus, for a given level of E’s wealth, \( \omega_E, \omega_M^m \) satisfies

\[
\phi (I - \omega_E) - (1 - \alpha) [Q(\omega_E + \omega_M^m) - \omega_E] - \alpha \omega_M^m = 0. \tag{A8}
\]

The threshold is unique if \( L_E + L_M \) decrease in \( \omega_M \) when the equilibrium is given by (15) to (17) in the main text. Differentiating (15) to (17) with respect to \( L_E, L_M, \) and \( \omega_M \) using Cramer’s rule I obtain

\[
\frac{dL_E}{d\omega_M} = -\frac{\alpha}{\phi},
\]

and

\[
\frac{dL_M}{d\omega_M} = \frac{\alpha - \phi}{\phi},
\]
with \( dL_E/d\omega_M + dL_M/d\omega_M = -1 \).

Part (iii): The threshold \( \omega_M^m \) is the smallest wealth level at which M’s incentive constraint equals his participation constraint allowing an investment of \( \omega_E + \omega_M + L_M = I^* \). Thus, for a given level of E’s wealth, \( \omega_E, \omega_M^m \) satisfies

\[
(A9) \quad \phi (I^* - \omega_E) - (1 - \alpha) [Q(\omega_E + \omega_M^m) - \omega_E] - \alpha \omega_M^m = 0.
\]

The threshold is unique if \( L_M \) is increasing in \( \omega_M \) when the equilibrium is given by (18) and (19) in the main text. Differentiating (18) and (19) with respect to \( L_M \) and \( \omega_M \) using Cramer’s rule I obtain

\[
\frac{dL_M}{d\omega_M} = \frac{(1 - \alpha) Q' (\omega_E + \omega_M) + \alpha - \phi}{\phi} > 0,
\]

where the inequality follows from \( Q' (I) \geq 1 \) and \( \phi < 1 \).

Part (iv): Combining (A8) and (A9), yields \( (I' - \omega_E) \{(1 - \alpha) [Q(\omega_E + \omega_M^m) - \omega_E] + \alpha \omega_M^m \} = (I^* - \omega_E) \{(1 - \alpha) [Q(\omega_E + \omega_M^m) - \omega_E] + \alpha \omega_M^m \}, \) with \( I' \) given by (17) in the main text, and hence \( \omega_M^m > \omega_M^m \). Finally, \( \omega_M^m > 0 \) follows from the assumption that \( \phi > \phi \).

**Lemma A10.** If (i) \( \omega_E < \omega_E^m \) and \( \omega_M < \omega_M^m \) then the entrepreneur borrows from a bank and a bank-financed moneylender. If (ii) \( \omega_E < \omega_E^m \) and \( \omega_M \in [\omega_M^m, I^* - \omega_E] \) then the entrepreneur borrows exclusively from a bank-financed moneylender. If (iii) \( \omega_E < \omega_E^m \) and \( \omega_M \geq I^* - \omega_E \) then the entrepreneur borrows from a bank and a self-financed moneylender.

**Proof.** I consider B’s utility given that the relevant (incentive or participation) constraint of E and M is satisfied.

Part (i): There are two distinct cases to consider when \( \omega_E < \omega_E^m \) and \( \omega_M < \omega_M^m \). First, if the incentive constraints of E and M bind, B prefers lending to both rather than only one of them as this minimizes the aggregate loan size needed to satisfy \( I' \) [given by (17) in the main text]. When M’s participation and incentive constraint hold simultaneously, B can either: (i) scale up the loan to E and M, allowing the investment to rise above \( I' \); or (ii) maintain \( I = I' \) by reallocating the loan from E to M in response to an increase in M’s wealth. Suppose Case (i) is a candidate equilibrium, as defined by (15) to (17) in the main text. An increase in \( \omega_M \) allows B to increase \( L_M \) to the point at which M’s incentive constraint equals his participation constraint. M’s additional loan raises E’s investment return and permits a larger loan to E as well. Hence, an increase in M’s wealth increases B’s utility by (differentiating \( U_B = Q (I) - (1 - \alpha) [Q (\omega_E + \omega_M) - \omega_E] - \alpha \omega_M - \phi (\omega_E + L_E) - L_E - L_M \) with respect to \( \omega_M \))

\[
\frac{dU_B}{d\omega_M} = \frac{Q' (\omega_E + \omega_M) [Q' (I) - (1 + \phi)] + \phi}{\phi},
\]

where \( Q' (I) < 1 + \phi \) as \( I > I' \). Meanwhile, Case (ii) implies that an increase in \( \omega_M \) is met by an increase in \( L_M \) and a subsequent decrease in \( L_E \) satisfying \( dL_M/d\omega_M + d\omega_M/d\omega_M = -dL_E/d\omega_M \). Differentiating B’s utility with respect to \( \omega_M \) in this case yields

\[
\frac{dU_B}{d\omega_M} = 1 > \frac{Q' (\omega_E + \omega_M) [Q' (I) - (1 + \phi)] + \phi}{\phi}.
\]
Hence, when $\omega_E < \omega_E^M$ and $\omega_M < \omega_M^M$, E borrows from B and a bank-financed M with $\omega_E + L_E + \omega_M + L_M = I'$.

Part (ii): When $\omega_E < \omega_E^M$ and $\omega_M \in [\omega_M^M, I^* - \omega_E]$ the only difference from Part (i) is that M’s debt capacity has improved, allowing B to extend the entire loan to M as this saves the incentive rent otherwise shared with E.

Part (iii): When $\omega_E < \omega_E^M$ and $\omega_M \geq I^* - \omega_E$, M is able to self finance first-best investment and the same outcome as described in Part (ii), Lemma A6 is obtained.

Proof of Proposition 5

Proof. Differentiating the ratio of informal credit to investment, $B/I$, with respect to $\phi$, $\omega_E$, and $\omega_M$ yields $r_\phi = [(dL_M/d\phi)I - (dI/d\phi)B]/I^2$, $r_{\omega_E} = [(dL_M/d\omega_E)I - (dI/d\omega_E)B]/I^2$, and $r_{\omega_M} = \{(dL_M/d\omega_M) + (dL_M/d\omega_M)\}/I^2$, respectively. Investment is unaffected by variation in $\phi$, $\omega_E$, and $\omega_M$ ($\omega_E$ and $\omega_M$) at first best (when it is given by (17) in the main text).

Part (i): When $\omega_E < \omega_E^M$ and $\omega_M < \omega_M^M$, $r_\phi = (dL_M/d\phi)/I > 0$, $r_{\omega_E} = (dL_M/d\omega_E)/I < 0$, and $r_{\omega_M} = (1 + dL_M/d\omega_M)/I = 0$, using the comparative statics established in Corollary 1.

Part (ii): First, I derive the relevant comparative statics. When $\omega_E < \omega_E^M$ and $\omega_M \in [\omega_M^M, \omega_M^M]$, the constraints are given by (18) and (19) in the main text. Differentiating (18) and (19) with respect to $L_M$, $I$, and $\phi$ using Cramer’s rule I obtain $dL_M/d\phi = dI/d\phi = -B/\phi < 0$. When $\omega_E < \omega_E^M$ and $\omega_M < [\omega_M^M, I^* - \omega_E]$, the constraints are given by (18) in the main text and the first-order condition $Q'(I) = 0$. Differentiating (18) and the first-order condition with respect to $L_M$, $\omega_E$, and $\omega_M$ using Cramer’s rule I obtain $dL_M/d\omega_E = dL_M/d\omega_M = -1$. Next, I determine the ratios. When $\omega_E < \omega_E^M$ and $\omega_M < \omega_M^M$, then $r_{\omega_E} = (dL_M/d\omega_E)/I < 0$ and $r_{\omega_M} = (1 + dL_M/d\omega_M)/I > 0$, using the comparative statics established in Lemma A9. If $\omega_E < \omega_E^M$ and $\omega_M < [\omega_M^M, \omega_M^M]$, then $r_\phi = -B\omega_E/\phi^2 < 0$ and $r_{\omega_M} = [(1 - \alpha)Q'(\omega_E + \omega_M) + \alpha] \times \omega_E/\phi^2 > 0$, using the comparative statics established above and in Lemma A9. If $\omega_E < \omega_E^M$ and $\omega_M < [\omega_M^M, I^* - \omega_E]$, then $r_\phi = r_{\omega_M} = 0$ and $r_{\omega_E} = -1/I < 0$, using the comparative statics established above.

Proof of Corollary 2

Proof. Part (i): When $\omega_E < \omega_E^L$, $\omega_M < \omega_M^L$, and $\alpha = \alpha$ the relevant constraints are given by (3) in the main text and (A5). Differentiating (3) and (A5) with respect to $I$, $\omega_E$, $\omega_M$, and $\phi$ using Cramer’s rule I obtain $dI/d\omega_E = dI/d\omega_M = [1 + \phi - Q'(\omega_E + L_E)]/\Psi$ and $dI/d\phi = I Q'(\omega_E + L_E)/(\Psi)$, with $\Psi = [Q'(\omega_E + L_E) - (1 + \phi)]/\Psi$, where the inequality follows from Lemma A2, $Q'(I) \geq 1$, and $\phi < 1$. Using Corollary 1 and the derived comparative statics, I have that $r_\phi = \{(BQ'(\omega_E + L_E) - (1 + \phi)) - (\omega_E + L_E) \times (Q'(I) - Q'(\omega_E + L_E))I - BQ'(\omega_E + L_E) - (1 + \phi))I\}/\Psi I^2 = (\omega_E + L_E) [Q'(\omega_E + L_E) - Q'(I)]/\Psi I > 0$, $r_{\omega_E} = \{(Q'(I) - Q'(\omega_E + L_E))I - [1 + \phi - Q'(\omega_E + L_E)]B\}/\Psi I^2 < 0$, and $r_{\omega_M} = \{(Q'(\omega_E + L_E) - (1 + \phi))((\omega_E + L_E) - (1 + \phi))I - (1 + \phi - Q'(\omega_E + L_E))B\}/\Psi I^2 = (\omega_E + L_E) [1 + \phi - Q'(\omega_E + L_E)]/\Psi I^2 > 0$, where the inequalities follow from Lemma A2 and concavity. If $\alpha = 1$, the relevant constraints are given by (8) and (9) in the main text. Differentiating (8) and (9) with respect to $I$, $\omega_E$, and $\phi$ using Cramer’s rule I obtain $dI/d\phi = -\phi I/\Theta$ and $dI/d\omega_E = \phi/\Theta$, with $\Theta = \phi[1 + \phi - Q'(I)] >
0, where the inequality follows from Lemma A2. Using Corollary 1 and the derived comparative statics, I have that \( r_\phi = \{ [B (Q' (I)) - (1 + \phi)] I + B \phi I \} / \Theta I^2 = B [Q' (I) - 1] / \Theta I > 0 \) and \( r_{\omega} = -B / \Theta I^2 < 0 \), where the inequalities follow from \( Q' (I) \geq 1 \). When \( \omega_E < \omega^c_E \) and \( \omega_M \geq \omega^m_M \), the results are found in the proof of Proposition 5, Part (i).

Part (ii): When \( \omega_E \leq \omega^m_E \), \( \omega_M \in [\omega^m_M, \overline{\omega}^m_M] \), and \( \alpha = \hat{\alpha} \) the relevant constraints are given by (18) in the main text and by

\[
Q (\omega_E + \omega_M) - Q (\omega_E) = \phi (\omega_M + L_M).
\]

Differentiating (18) and (A10) with respect to \( I, L_M, \) and \( \omega_E \) using Cramer’s rule I obtain \( dI / d\omega_E = \frac{[\phi + Q' (\omega_E + \omega_M) - Q' (\omega_E)] / \phi \} \) and \( dL_M / d\omega_E = \frac{[Q' (\omega_E + \omega_M) - Q' (\omega_E)] / \phi \} \phi / \phi I^2 < 0 \), where the inequality follows from concavity. If \( \alpha = 1 \), the relevant constraints are given by (18) and (19) in the main text. Differentiating (8) and (9) with respect to \( I, L_M, \) and \( \omega_E \) using Cramer’s rule I obtain \( dI / d\omega_E = 1 \) and \( dL_M / d\omega_E = 0 \). Using the derived comparative statics I have that \( r_{\omega} = -B < 0 \). When \( \omega_E \leq \omega^m_E \) and \( \omega_M \leq \omega^m_M \) or \( \omega_M \geq \omega^m_M \), the results are found in the proof of Proposition 5, Part (ii).

\[ \square \]

**Proof of Lemma 1**

As above, the competitive (monopoly) outcome is denoted by superscript \( c \) (\( m \)).

**Proof.** Part (i): There are two distinct cases to consider. First, when \( \omega_M < \omega^m_M, I^c > I^m \) follows from Lemma A2, (17) in the main text, and concavity. Combining (8) and (9) and (15) and (16) in the main text, yields \( Q (I^c) - I^c = \phi I^c \) and \( Q (I^m) - D = \phi I^m \), respectively. Subtracting \( L^m_E \) from \( L^c_E \) using E’s incentive constraints given by (8) and (15) yields \( \omega [Q (I^c) - I^c - (Q (I^m) - D)] = \alpha (I^c - I^m) > 0 \) and hence \( L^c_E > L^m_E \). Next, when \( \omega_M \in [\omega^m_M, I^c - \omega_E) \), monopoly bank lending to E ceases, hence \( L^c_E > L^m_E = 0 \).

Part (ii): I begin by showing the existence and the uniqueness of \( \hat{\omega}^c_M \). From Lemma A5, \( dL^c_M / d\omega_M < 0 \) when \( \omega_M \in (\omega^c_M, \overline{\omega}^c_M) \). In addition, from Lemma A9, \( dL^m_M / d\omega_M > 0 \) when \( \omega_M \in (\omega^m_M, \overline{\omega}^m_M) \). By continuity and Proposition 9, there exists a unique threshold \( \omega_M = \hat{\omega}^c_M (\phi) \) for \( \omega_M \in (\omega^c_M, \overline{\omega}^c_M) \) at which \( L^c_M = L^m_M \). Having established the existence and the uniqueness of \( \hat{\omega}^c_M \), there are four distinct cases to consider. First, when \( \omega_M < \omega^m_M \), the proof is analogous to the proof of Part (i) resulting in \( L^c_M > L^m_M \). Second, suppose \( L^m_M > L^c_M \) when \( \omega_M \in [\omega^m_M, \hat{\omega}^c_M] \). This implies that \( \hat{\omega}^m_M < \overline{\omega}^c_M \), which contradicts Proposition 9 and so \( L^m_M > L^c_M \). Third, when \( \omega_M \in (\hat{\omega}^c_M, \overline{\omega}^c_M) \) I have from Lemma A10 that \( L^c_M \geq L^m_M \). Fourth, when \( \omega_M \in [\overline{\omega}^c_M, I^c - \omega_E) \), competitive bank lending to M ceases, hence \( L^m_M > L^c_M = 0 \). \[ \square \]

**Proof of Proposition 6**

**Proof.** When \( \omega_M \in (\hat{\omega}^c_M, I^c - \omega_E) \), \( B^m / I^m - B^c / I^c = (B^m I^c - B^c I^m) / I^m I^c > 0 \), since \( B^m > B^c \) from Lemma 1 and \( I^c \geq I^m \). When \( \omega_M < \hat{\omega}^c_M, B^m / I^m - B^c / I^c \) is indeterminate, as \( B^m < B^c \) from Lemma 1, while \( I^c > I^m \). \[ \square \]
Proof of Proposition 7
(Let $U^c_E$ and $U^m_M$ denote E’s and M’s respective utility.)

Proof. Part (i): First, from Lemma 1 I have that $L^c_E > L^m_E$. Hence, for $\omega_M < \omega^m_M$, $U^c_E = \phi(\omega + L^c_E) > \phi(\omega + L^m_E) = U^m_E$ and for $\omega_M \in [\omega^m_M, I^* - \omega_E)$, $U^E_E = \phi(\omega + L^c_E) > \phi(\omega + L^m_E) > \alpha Q(\omega + \omega_M) + (1 - \alpha) \omega_M - \alpha \omega_M = U^m_E$. Next, when $\omega_M < \omega^c_M$, $U^E_M = \phi(\omega_M + L_M^c) > \phi(\omega_M + L_M^m) = U^m_M$. When $\omega_M \in [\omega^m_M, I^* - \omega_E)$, $U^E_M = \omega_M < (1 - \alpha) (Q(\omega + \omega_M) - \omega_E) + \alpha \omega_M = U^m_M$.

Part (ii): Denote isolation by $U^m_E$ and coexistence by $U^m_C$. For $\omega_M < \omega^m_M$, $U^m_E = \phi(I') > \phi(I' - \omega_M - L_M) = U^m_C$ [with $I'$ given by (17) in the main text] and for $\omega_M \in [\omega^m_M, I^* - \omega_E)$, $U^m_E = \phi(I' > \phi(I' - \omega_M - L_M) > \alpha Q(\omega + \omega_M) + (1 - \alpha) \omega_E - \alpha \omega_M = U^m_C$. 

Proof of Proposition 8

Proof. Part (i): It suffices to show that $R^c/B^c - 1 > 0$ for $\omega_M < \omega^c_M$, as $R^m/B^m > R^c/B^c$ (established in Part (iii) below). Hence, from (9) in the main text, I have that $R^c/B^c - 1 = [\phi(\omega + L^c_M) - \omega_M] / (\omega + L^c_M) > 0$, where the inequality follows from $\omega_M < \omega^c_M$.

Part (ii): Differentiating the informal interest rate, $R/B - 1$, with respect to $\phi$ yields $i = [(dR/d\phi)B - (d\phi/dR)R] / B^2$. In the competitive benchmark, when $\omega_E < \omega^c_E$, $\omega_M < \omega^c_M$, and $\alpha = \hat{\alpha}$, the relevant constraints are given by (3) in the main text and (A5). Differentiating (3) and (A5) with respect to $I$ and $\phi$ using Cramer’s rule I obtain $dI/d\phi = [\hat{Q}(\omega_E + \bar{L}) - (1 + \phi)] / \Omega$, with $\Omega = (Q'(\omega_E + \bar{L}) - (1 + \phi)] [Q'(I) - (1 + \phi)] > 0$, where the inequality follows from Lemma A2. Using Corollary 1 and the derived comparative static, I have that $i = \{B[I][Q'(I) - (1 + \phi)] - (\omega_E + \bar{L}) Q'(\omega_E + \bar{L}) - Q'(I) - (1 + \phi)] / R \times [B(Q'(\omega_E + \bar{L}) - (1 + \phi)] - (\omega_E + \bar{L}) (Q'(\omega_E + \bar{L}) - Q'(I(\bar{I})) / \Omega B^2$. Note that $R|_{\alpha = \hat{\alpha}} = Q(\omega_E + \bar{L}) + B - Q(\omega_E + \bar{L})$. Applying the mean-value theorem yields $R = BQ'(\xi)$, where $Q'(\xi) = (Q'(I), Q'(\omega_E + \bar{L}))$. Inserting into $i$ and simplifying, I have that $i = \{B [Q'(\omega_E + \bar{L}) - (1 + \phi)] [Q'(I) - Q'(\xi)] + (\omega_E + \bar{L}) [Q'(\omega_E + \bar{L}) - Q'(I)] [1 + \phi - Q'(\xi)] / \Omega B^2 > 0$, where the inequality follows from Lemma A2 and concavity. At first best, variation in $\phi$ no longer affects $R/B - 1$. In the monopoly case, when $\omega_E < \omega^m_E$, $\omega_M < \omega^m_M$, and $\alpha = \hat{\alpha}$, the relevant constraints are given by

(A11) $Q(\omega_E + \beta L) - D_E = \phi(\omega_E + \beta L)$,
(A12) $Q(I) - Q(\omega_E + \beta L) - D_M = \phi(\omega_M + (1 - \beta) L)$,

and

(A13) $Q'(I) - (1 + \phi) = 0$,

with $I = \omega_E + \omega_M + L$, where $L_E = \beta L, L_M = (1 - \beta) L$, and $\beta \in (0, 1)$. Differentiating (3) and (A5) with respect to $I, L, and $\phi$ using Cramer’s rule I obtain $dI/d\phi = dL/d\phi = 1/Q''(I)$. Using the derived comparative statics and noting that $R = Q(I) - Q(\omega_E + \beta L)$, I have that $i = \{B[Q'(I) - \beta Q'(\omega_E + \beta L)] - (1 - \beta)[Q(I) - Q(\omega_E + \beta L)]\} / Q''(I) B^2$. Applying the mean-value theorem and simplifying, I have that $i = [Q'(I) - \beta Q'(\omega_E + \beta L)$.
(1 − β)Q′(θ)/Q′′(I)B > 0, with Q′(θ) ∈ (Q′(I), Q′(ωE + βL)), where the inequality follows from concavity. When ωE < ωE′, ωM ∈ [ωmM, ω′M], and α = â the relevant constraints are given by (18) in the main text and by (A10). Differentiating (18) and (A10) with respect to I, L, and φ using Cramer’s rule I obtain dl/dφ = dL/dφ = (ωM + L)/φ.

Using the derived comparative static and noting that R = Q(I) − Q(ωE), I have that i = {BQ′(I) − Q(I) − Q(ωE)} / (−φ). Applying the mean-value theorem and simplifying, I have that i = [Q′(δ) − Q′(I)] / φ > 0, with Q′(δ) ∈ (Q′(I), Q′(ωE)), where the inequality follows from concavity. At first best, variation in φ no longer affects R/B − 1.

Part (iii): I first demonstrate that Rm/Bm > R′/B′ and then show that Rm/Bm increases under credit market segmentation. First, when ωM < ωM′, let α = 1. This gives Rm/Bm − R′c/B′c = (RmBc − R′cBm)/BmBc = (Dm + ωM − ωM − Lm) / Bm = (Dm − Lm) / Bm ≥ 0.

Then let α = â. This gives {B[B(Q(I) − Q(ωE + Lc)) − Bm [Q(I) − Q(ωE + Lc)]]} / BmBc. Applying the mean-value theorem yields BmBc [Q′(ε) − Q′(δ)] / BmBc, where Q′(ε) ∈ (Q′(I), Q′(ωE + Lc)) and Q′(δ) ∈ (Q′(I), Q′(ωE + Lc)). From Lemma A2 and (17) in the main text, I have that Q′(I) > Q′(ωE + Lc) and hence Rm/Bm > R′c/B′c. Next, when ωM < [ωmM, ω′M] and proceeding in analogous fashion by taking limits, I have again that Rm/Bm > R′c/B′c. Finally, when ωM = [ωcM, ωcM], R′c/B′c = 1 and the claim follows trivially.

I now determine how Rm/Bm changes as result of segmentation. To do this, I evaluate Rm/Bm at ωM = ωM′ and compare with ˆRm/ ˆBm at ωM = ωM′ = ε. Here, L = δ, L = L (ωmM) − γ, where ε, δ, and γ are small, strictly positive, and satisfy δ = ε + γ, as investment is constant. First, let α = 1. This gives Rm/Bm − ˆRm/ ˆBm = {Bm[QI + ε − Q(ωE + ωM)] + DE − δ[Q(I) − Q(ωE + ωM) + ωM] } / Bm ˆBm, with φI = φ(ωE + δ) + φ(ωE + ωM) = φ(ωE + δ) + ωM > Q(ωE + ωM) − ωM + ωM = Q(ωE + ωM), where the inequality follows from ωE < ωE′. Hence, for δ sufficiently small, Rm/Bm > ˆRm/ ˆBm. Next, let α = â. This gives {Bm[Q(I) − Q(ωE + δ)] − δ[Q(I) − Q(ωE)]} / Bm ˆBm. Again, for δ sufficiently small, Rm/Bm > ˆRm/ ˆBm.

Proof of Proposition 9

Proof. Part (i): I start with financial sector coexistence. Under competitive banking, the relevant constraints are given by (A2) and (A3). Denote the critical ωE that satisfies (A3) by ̂ωcE. Comparison yields ωE′ > ̂ωE > 0, where the last inequality follows from the assumption that φ > φ(ωM). Under monopoly banking, two investment levels I [given by (17) in the main text] and I∗ need to be verified. Starting with I′ and combining (A6) and (A7), yields Q(ωmE) = αQ(ωmE + B) + (1 − α)ωmE − αB + φB. As the critical threshold ωmE decreases in α, it follows from concavity that ωE′ > ωE′. The proof when I = I∗ is analogous and omitted. Next, I turn to bank market power. First, note that ̂ωmM as defined by (A9) decreases in ωE. In particular, allow ωE to increase up to the point at which φ(ωE + L) − αQ(ωE + ωM) − (1 − α)(I) = 0 for ωE + L + ωM = I∗, or φ(I∗ − ωM) = ωM = Q(ωE + ωM) − (1 − α)(I) = 0. Denote the critical ωM that satisfies this last equality by ̂ωmM. From the previous argument it follows that ̂ωmM < ̂ωmM′. Hence, to show that ̂ωcM < ̂ωmM, it suffices to verify that ̂ωcM < ̂ωmM. Then, observe that ̂ωcM decreases in α. Hence, combining the expression for ̂ωmM as defined above with the expression for ̂ωcM as given by (A4) and allowing α = 1, yields I∗ − Q(I∗) − I∗ − Q(ωE + ̂ωmM) + ̂ωE + ̂ωmM + ̂ωM − ̂ωM − Q(I∗) − I∗ + ̂ωE = 0.
Let \(|Q(I^*) - I^* - Q(\omega_E + \tilde{\omega}_M^m) + \omega_E + \tilde{\omega}_M^m| \equiv \Phi\), where \(\Phi > 0\) by concavity and \(Q'(I) \geq 1\).

Suppose first that \(\tilde{\omega}_M^m = \tilde{\omega}_M^c\). This implies that \((I^* - \tilde{\omega}_M^m) \Phi = 0\). But this equality contradicts \(I^* > \tilde{\omega}_M^m\) and \(\Phi > 0\). Suppose then that \(\tilde{\omega}_M^m = \tilde{\omega}_M^c + \epsilon\). This yields \((I^* - \tilde{\omega}_M^m) \Phi + \epsilon [Q(\omega_E + \tilde{\omega}_M^m) - \tilde{\omega}_M^m] = 0\), which again generates a contradiction since \(Q(\omega_E + \tilde{\omega}_M^m) > \tilde{\omega}_M^m\).

It follows that \(\tilde{\omega}_M^c < \tilde{\omega}_M^m\), establishing the claim.

Part (ii): Opportunity cost of capital, \(\rho\), enters as a multiplicative term with respect to the credit lines, \((1 + \rho) L_i\), and the wealth, \((1 + \rho) \omega_i\), in the competitive benchmark. When \(\omega_E < \omega_E^c\) and \(\omega_M < \omega_M^c\), the relevant constraints are given by (8) and (9) in the main text. Differentiating (8) and (9) with respect to \(I\) and \(\rho\) using Cramer’s rule I obtain \(dI/d\rho = -\phi (L_E + L_M) / (1 + \rho + \phi - Q'(I)) < 0\), where the inequality follows from Lemma A2. When \(\omega_E < \omega_E^c\) and \(\omega_M > \omega_M^c\), investment is determined by the first-order condition \(Q'(I) - (1 + \rho) = 0\), with \(dI/d\rho = 1/Q''(I) < 0\), where the inequality follows from concavity. Under monopoly, investment is determined by (17) in the main text when \(\omega_E < \omega_E^m\) and \(\omega_M < \omega_M^m\). The modified equation reads, \(Q'(I) - (1 + \rho + \phi) = 0\), with \(dI/d\rho = 1/Q''(I) < 0\), where the inequality follows from concavity. When \(\omega_E < \omega_E^m\) and \(\omega_M \in (\omega_M^m, \tilde{\omega}_M^c)\) the relevant constraints are given by (18) and (19) in the main text. Here, \(\rho\) only affects the return on the outside option, \((1 + \rho) \omega_i\). Differentiating (18) and (19) with respect to \(I\) and \(\rho\) using Cramer’s rule I obtain \(dI/d\rho = [\tilde{\alpha} \omega_M - (1 - \tilde{\alpha}) \omega_E] / \tilde{n}\). The derivative is positive if \(\tilde{\alpha} > \alpha^* = \omega_E / (\omega_E + \omega_M)\). As \(\tilde{\alpha} \in (\tilde{\alpha}, 1)\), it suffices to show that \(\tilde{\alpha} > \alpha^*\). Here, \(\tilde{\alpha} = [Q(\omega_E) - \omega_E] / [Q(\omega_E + \omega_M) - (\omega_E + \omega_M)]\). Subtracting \(\alpha^*\) from \(\tilde{\alpha}\) yields \([Q(\omega_E) (\omega_E + \omega_M) - Q(\omega_E + \omega_M) \omega_E] / [Q(\omega_E + \omega_M) - (\omega_E + \omega_M)] (\omega_E + \omega_M) > 0\), where the inequality follows from concavity. When \(\omega_E < \omega_E^m\) and \(\omega_M \geq \tilde{\omega}_M^c\), investment is determined by the first-order condition \(Q'(I) - (1 + \rho) = 0\), with \(dI/d\rho = 1/Q''(I) < 0\), where the inequality follows from concavity.

\[\square\]

**Proof of Proposition 10**

**Proof.** Part (i): When \(\omega_E < \omega_E^c\) and \(\omega_M < \omega_M^c\) in the competitive benchmark, the relevant constraints are given by (8) and (9) in the main text. Differentiating (8) and (9) with respect to \(I\) and \(\phi\) using Cramer’s rule I obtain \(dI/d\phi = -\phi I / [1 + \rho + \phi - Q'(I)] < 0\), where the inequality follows from Lemma A2 (\(\phi\) is included to enable a comparison). From the proof of Proposition 9 I have that \(dI/d\rho = -\phi (L_E + L_M) / [1 + \rho + \phi - Q'(I)]\) and so \(|dI/d\phi| > |dI/d\rho|\). Under monopoly, investment is determined by (17) in the main text when \(\omega_E < \omega_E^m\) and \(\omega_M < \omega_M^m\). The modified equation reads, \(Q'(I) - (1 + \rho + \phi) = 0\), with \(dI/d\phi = dI/d\rho = 1/Q''(I) < 0\). When \(\omega_E < \omega_E^m\) and \(\omega_M \in (\omega_M^m, \tilde{\omega}_M^c)\), I have from the proof of Proposition 5 (9) that \(dI/d\phi < 0 (dI/d\phi > 0)\) and the conclusion follows.

Part (ii): When \(\omega_E < \omega_E^c\) and \(\omega_M < \omega_M^c\) in the competitive benchmark, the relevant constraints are given by (8) and (9) in the main text. Differentiating (8) and (9) with respect to \(I\), \(\omega_E\), and \(\omega_M\) setting \(d\omega_M = -d\omega_E\) using Cramer’s rule I obtain \(dI/d\omega_M = 0\). At first best, variation in \(\omega_E\) and \(\omega_M\) has no effect on investment. Under monopoly, investment is determined by (17) in the main text when \(\omega_E < \omega_E^m\) and \(\omega_M < \omega_M^m\), with \(dI/d\omega_i = 0\). When \(\omega_E < \omega_E^m\) and \(\omega_M \in (\omega_M^m, \tilde{\omega}_M^c)\), the relevant constraints are given by (18) and (19) in the main text. Differentiating (18) and (19) with respect to \(I\), \(\omega_E\), and \(\omega_M\) setting \(d\omega_M = -d\omega_E\) using Cramer’s rule I obtain \(dI/d\omega_M = (1 - \phi) / \phi > 0\), where the inequality follows from \(\phi < 1\). At first best, variation in \(\omega_E\) and \(\omega_M\) has no effect on investment.

\[\square\]
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