From Law to Livelihood: How Legal Development Shapes (Informal) Social Finance?

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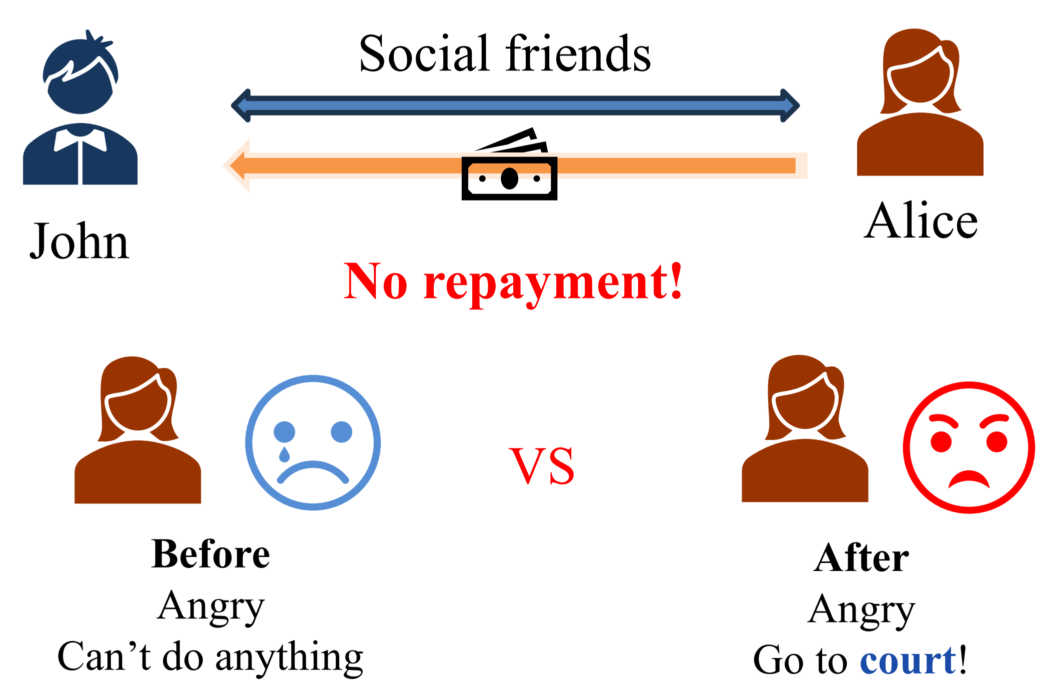
This paper

Research question: Does legal institutional development facilitate or discourage (informal) social finance [between peers]?

This paper: uses a novel dataset / DiD setting from China

- 2019 Provisions: Strengthened legal protections for digital peer lenders by making text chats legally enforceable
- Data from a large Chinese social network platform with small-value transfer services
  - Platform: 300 million active users daily; 89% penetration; 40% market share
  - Sample of 80,000 borrowers and borrowing activities from Jan 2019 to Aug 2020
- Examine whether socially distant peers are more likely to lend / borrow from each
- Examine the take-up of both formal/informal financing & consumption behavior

How does the law work?



Why does this matter?

The use of informal finance is pervasive

- ❑ $3 trillion market (Alternative Credit Council, 2024); 1.4 billion people unbanked (World Bank, 2022)
- ❑ 14% of enterprises solely on informal finance; 42% of the external finance for working capital (World Bank, 2012)
- ❑ Globally, 27% of people borrow money from relatives and friends each year; 43% in developing countries (World Bank, 2022)

Peer finance is very common but often goes away

- ❑ In China (2016 –2019), over 2 million civil cases related to informal lending annually—about 7% of all civil cases
- ❑ Informal lending represents the most significant source of lawsuits in civil courts

Experimental design

Panel structure: Lender-Borrower-Lending Month

Treatment group: Socially distant peers

- ❑ **Treatment intensity** → Social distance between lender-borrower
- ❑ Depend on: **Frequency and intensity of prior textual and financial interactions** (continuous variable, from 0 to 1)

Control group: Socially close peers

- ❑ Placebo: ending among immediate family members (excluded in empirical tests)

Empirical model:

$$Y_{i,j,t} = \beta_0 + \beta_1 \times Post_t \times Distance_{i,j} + \beta_2 \times Distance_{i,j} + \sigma_i + \gamma_j + \delta_t + \varepsilon_{i,j,t}$$

$Post_t$: a dummy variable to indicate before/after the 2019 Provisions

$Distance_{i,j}$: the distance score of each lender-borrower pair before sample period

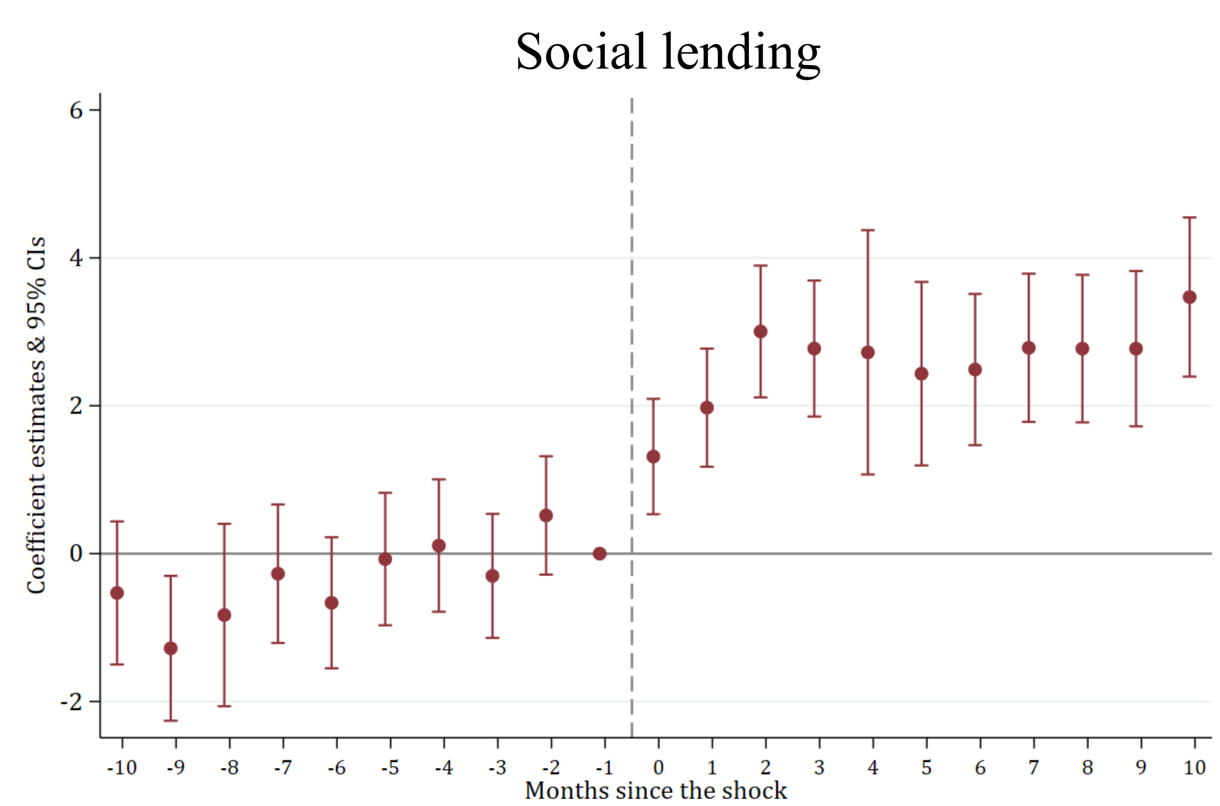
$\sigma_i, \gamma_j, \delta_t$: borrower, lender, and lending year-month fixed effects

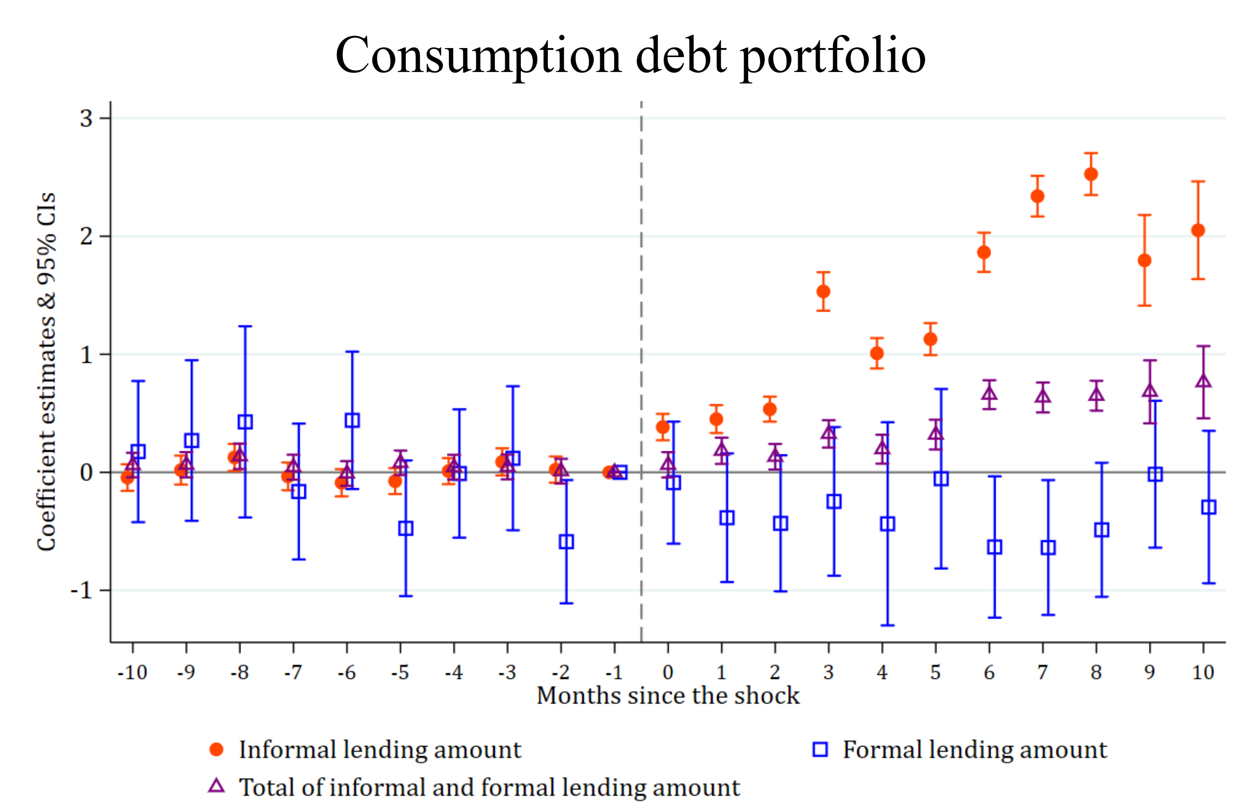
Discretionary consumption

Variable = Log(Discretionary consumption) in the time window	t + 1	[t + 1, t + 3]	[t + 1, t + 6]
	(1)	(2)	(3)
Distance × Post	3.481***	1.572***	0.819*
	(0.589)	(0.481)	(0.454)
Distance	-7.838***	-6.366***	-5.386***
	(0.307)	(0.246)	(0.226)
Lending-month FE	Yes	Yes	Yes
Borrower FE	Yes	Yes	Yes
No. of Observations	45,076	45,076	45,076
R-squared	0.682	0.813	0.875

- ✓ **25.8% increase in discretionary consumptions** within three months following the lending month
- ✓ Subcategory test: Increases spending on **adult education** and **software toolkits**

Legal development → Social finance





- ✓ Following the 2019 Provisions, 1 SD increase in social distance → an increase of **RMB 995 (32%)** in informal lending amount
- ✓ The reform leads to **11.2%** ↓ of the use of credit card and online debt, and **8.9%** ↑ in the aggregate credit access for informal borrowers

Summary of findings

This project finds that: after the shock

- ❑ Informal lending ↑ Formal consumption lending ↓ ⟹ Aggregate credit access ↑ → Aggregate discretionary consumption ↑
- ❑ Borrowers pool money from more socially distant lenders and borrow larger amounts
- ❑ Lenders write transaction notes resembling formal lending promissory agreements
- ❑ Lenders more willing to lend to borrowers even if lender had bad recent experience (default of other informal borrowers)

Heterogeneity tests: **Vulnerable populations benefit more**

- ➢ Below than median income group, without college-level education, no fixed assets borrowers

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