Abstract

This paper proposes a model in which government policy to improve imperfect credit markets is decided through a democratic political process, and analyzes interaction between the politically implemented policy and economic development. The policy increases the welfare of middle-income individuals who can newly start investment in a project at the cost of poor and rich individuals. The preferences for the policy are thus non-monotonic over income levels. Whether the policy is supported or not strongly depends on the level of capital accumulation and the extent of income inequality. The policy does not realize under low levels of capital because a large fraction of individuals are unwilling to bear the cost of improving the credit markets. Furthermore, high levels of income inequality make the policy hard to be implemented, which causes the economy likely to fall into a development trap.