Contingent judicial deference: theory and application to usury laws

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Courts exercise judgment about legislation and refrain from enforcing it when they deem it sufficiently unlikely to be appropriate. Hence a piece of legislation is not only a set of instructions to be followed: it also conveys information to courts about its own appropriateness. The probability that a statute will be enforced in court is endogenous to the statute itself. This has non-trivial implications to the interaction between written legislation and court decisions. This paper proposes a model to study this issue.

We propose a model of Bayesian adjudicators that use their own prior knowledge to evaluate the appropriateness of legislation. The model yields a non-monotonic relation between written rules and effectively enforced rules. Hence the enactment of legislation prohibiting contracts with certain characteristics raises the probability that courts will allow related contracts not expressly forbidden.

We apply the model to study the effect of usury laws on credit markets. In equilibrium, a statutory interest rate ceiling not only makes it more likely that courts will invalidate contracts with interest rates above the cap, but it can also make it more likely that courts will validate contracts with interest rates below the legislated cap. A key implication of the model is that a (well-calibrated) usury cap might actually raise the volume of credit.

We discuss how the model sheds light to some seemingly counter intuitive effect of legislated prohibitions. We discuss the effects of interest caps in several contexts and pay particular attention to the Money-Lenders Acts (1900 and 1927) in the United Kingdom.