

The Financial Power of the Powerless

Socio-Economic Status and Interest Rates
under Partial Rule of Law

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Rule of law and finance

Public finance: Differences in the interest rates paid by states reflect differences in their creditworthiness.

Private finance: Within a country, differences in the interest rates paid by individuals reflect differences in the enforcement of private obligations.

Wealth effect vs. partiality effect

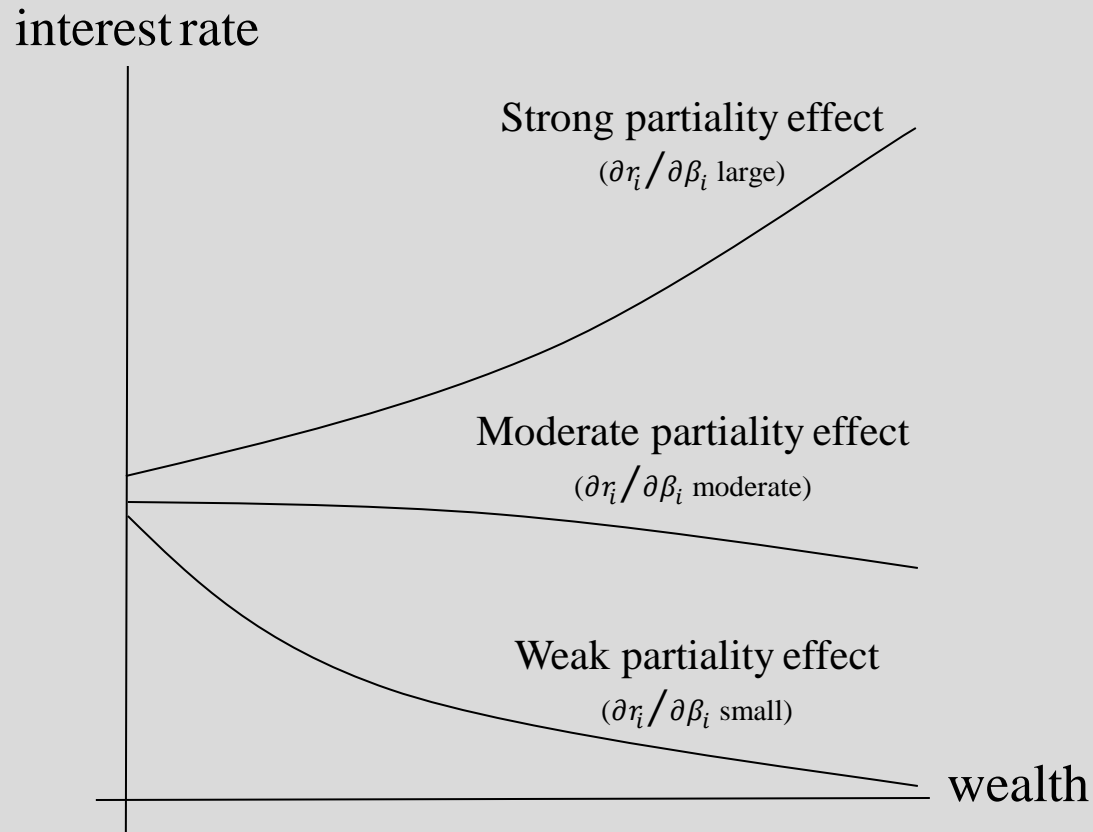
In a competitive credit market, two countervailing effects:

- 1. Wealth effect:** Equilibrium interest rate is decreasing in wealth
 - Wealthy borrowers less likely to become insolvent
 - Lower risk reduces interest rate
- 2. Judicial partiality effect:** Equilibrium interest rate is increasing in borrower's partiality
 - Higher partiality → less likely lender will win lawsuit → borrower less likely to repay loan
 - Higher risk raises interest rate

Wealth and judicial partiality

- In general, wealth and judicial partiality are positively correlated
 - Wealth correlated also with markers of high socio-economic status
- **If financial contracts are enforced in a sufficiently partial way in favor of high status individuals, the judicial partiality effect will swamp the wealth effect, and high status individuals will pay relatively high interest rates.**

Wealth and cost of credit: 3 cases



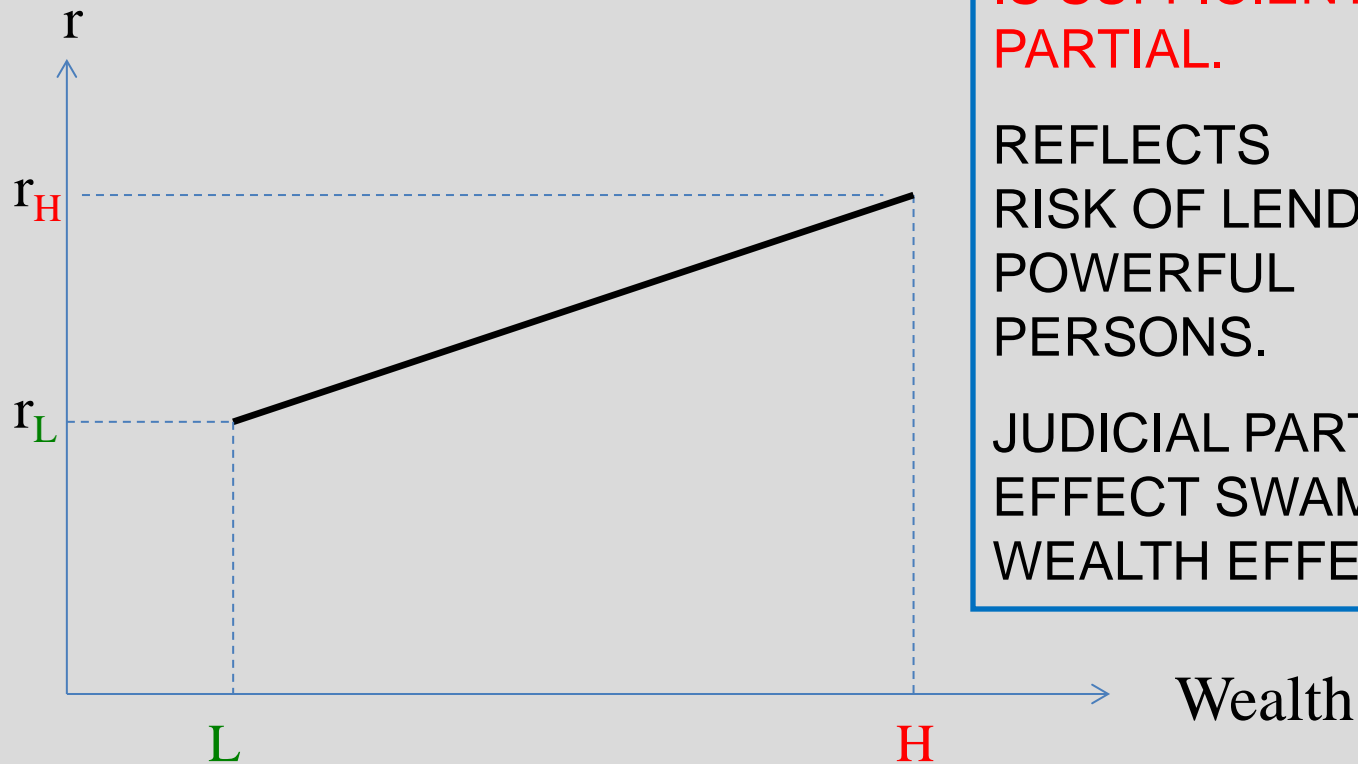
Borrowing costs and wealth

PATTERN OBSERVED WHERE
RULE OF LAW IS IMPARTIAL.

with respect to **financial contracts**



Relationship under partial rule of law



PATTERN EXPECTED
WHERE **RULE OF LAW**
IS SUFFICIENTLY
PARTIAL.

REFLECTS
RISK OF LENDING TO
POWERFUL
PERSONS.

JUDICIAL PARTIALITY
EFFECT SWAMPS
WEALTH EFFECT.

Test of Theory: Ottoman Court Records

Ottoman Istanbul provides excellent testing ground for theory

Law was partially enforced, court data well-preserved

Courts were openly biased in favor of high-status individuals:

- Muslims (58% of Istanbul's population)
- Elites
- Men

Sources of judicial bias

1. Lack of judicial independence
 - Bias in favor of elite borrowers
2. In-group bias in decision making
 - Bias in favor of Muslims, men, elites
3. Judicial procedures
 - Bias in favor of Muslims, men
4. Mobility
 - Bias in favor of men

Data: Istanbul court records, 1602-1799



28 registers of 3 courts in Istanbul, Ottoman capital and commercial center:
Galata, Central Istanbul, Bab.

Relevant records

(1) Trials, (2) Registrations of contracts and settlements

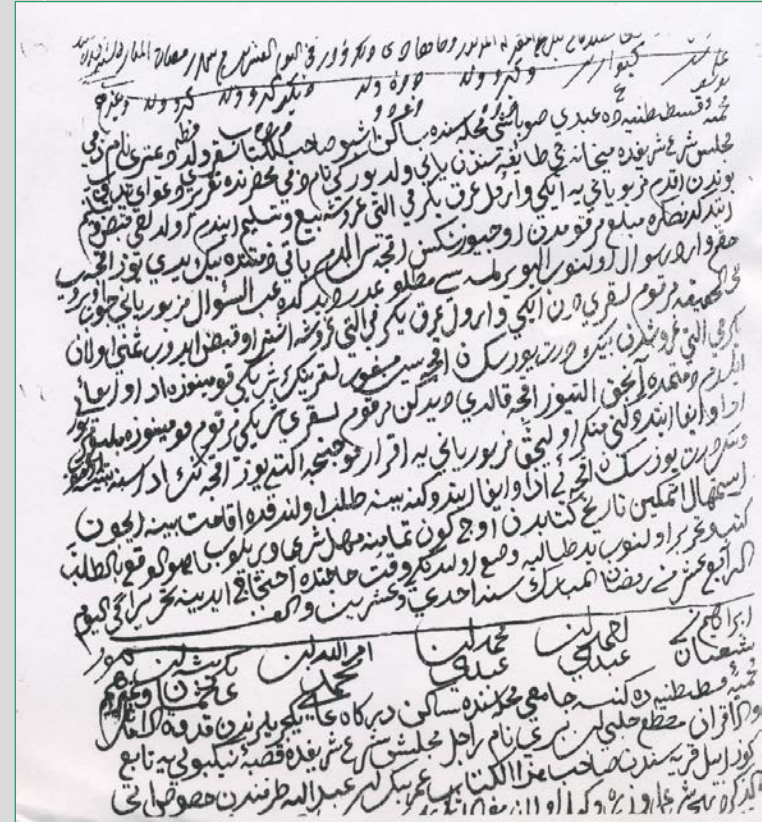
Trials subject to selection bias, so focus is on registrations.

A registration occurs before agreement is fulfilled, reneged upon, or challenged.

Variables

Information included in records of loan contracts:

- Interest rate
- Gender of borrower and lender
- Religion of borrower and lender
- Social status of borrower and lender
 - Titled (elite), non-titled (commoner)
- Other loan characteristics
 - Principal, whether loan was a mortgage, secured through surety or pawn, whether lender was a *waqf*



Avg. interest rates by social status

Lender	Borrower	Mean interest rate	Standard error	N
Elite	Elite	0.240	0.195	172
Commoner	Elite	0.191	0.122	88
Elite	Commoner	0.159	0.130	151
Commoner	Commoner	0.172	0.143	197

Avg. interest rates by religion

Lender	Borrower	Mean interest rate	Standard error	N
Muslim	Muslim	0.205	0.181	313
Non-Muslim	Muslim	0.167	0.068	5
Muslim	Non-Muslim	0.171	0.138	177
Non-Muslim	Non-Muslim	0.215	0.207	27

Avg. interest rates by gender

Lender	Borrower	Mean interest rate	Standard error	N
Male	Male	0.199	0.179	356
Female	Male	0.226	0.132	21
Male	Female	0.168	0.140	116
Female	Female	0.228	0.116	9

Gender distribution of fugitives

	Total cases	Cases involving women	
		Number	%
Loan contracts	597	147	24.6
All cases	14,004	5,243	37.4

	Fugitives in debt cases	Female fugitives	
		Number	%
Loan contracts	35	1	2.9
All cases	135	2	1.5

Dependent variable: Real interest rate

All registered contracts

Male borrowers

(1) (2) (3) (4) (5) (6)

Male borrower	0.036***			0.038***		
	[0.012]			[0.013]		
Muslim borrower		0.030**		0.022	0.034**	
		[0.013]		[0.015]	[0.016]	
Elite borrower			0.035**	0.020		0.034*
			[0.014]	[0.016]		[0.017]
Constant	0.117**	0.123**	0.132**	0.086	0.143**	0.148**
	[0.056]	[0.054]	[0.051]	[0.062]	[0.069]	[0.067]
Loan characteristics	YES	YES	YES	YES	YES	YES
Register F.E.	YES	YES	YES	YES	YES	YES
Observations	562	590	578	560	380	379
R-squared	0.536	0.531	0.554	0.569	0.514	0.547

	Dependent variable: Real interest rate					
	<u>All registered contracts</u>					
	(1)	(2)	(3)			
Male borrower, Female lender	-0.008 [0.035]					
Female borrower, male lender	-0.036** [0.013]					
Female borrower, female lender	-0.037 [0.032]					
Muslim borrower, non-Muslim lender		0.036 [0.052]				
Non-Muslim borrower, Muslim lender		-0.034** [0.013]				
Non-Muslim borrower, non-Muslim lender		-0.000 [0.035]				
Titled borrower non-titled lender			0.003 [0.022]			
Non-titled borrower titled lender			-0.032** [0.015]			
Non-titled borrower non-titled lender			-0.027 [0.018]			
Constant	0.154*** [0.047]	0.147*** [0.046]	0.162*** [0.049]			
Loan characteristics	YES	YES	YES			
Register F.E.	YES	YES	YES			
Observations	562	591	579			
R-squared	0.536	0.532	0.556			17

	Dependent variable: Real interest rate					
	<u>All registered contracts</u>					
	(1)	(2)	(3)	(4)		
Male borrower, Female lender	-0.008 [0.035]			-0.009 [0.034]		
Female borrower, male lender	-0.036** [0.013]			-0.038** [0.014]		
Female borrower, female lender	-0.037 [0.032]			-0.039 [0.033]		
Muslim borrower, non-Muslim lender		0.036 [0.052]		-0.052 [0.057]		
Non-Muslim borrower, Muslim lender		-0.034** [0.013]		-0.018 [0.014]		
Non-Muslim borrower, non-Muslim lender		-0.000 [0.035]		-0.029 [0.028]		
Titled borrower non-titled lender			0.003 [0.022]	0.005 [0.025]		
Non-titled borrower titled lender			-0.032** [0.015]	-0.022 [0.017]		
Non-titled borrower non-titled lender			-0.027 [0.018]	-0.017 [0.023]		
Constant	0.154*** [0.047]	0.147*** [0.046]	0.162*** [0.049]	0.169*** [0.047]		
Loan characteristics	YES	YES	YES	YES		
Register F.E.	YES	YES	YES	YES		
Observations	562	591	579	499		
R-squared	0.536	0.532	0.556	0.580		18

	Dependent variable: Real interest rate					
	All registered contracts				Male borrowers	
	(1)	(2)	(3)	(4)	(5)	(6)
Male borrower, Female lender	-0.008 [0.035]			-0.009 [0.034]		
Female borrower, male lender	-0.036** [0.013]			-0.038** [0.014]		
Female borrower, female lender	-0.037 [0.032]			-0.039 [0.033]		
Muslim borrower, non-Muslim lender		0.036 [0.052]		-0.052 [0.057]	0.007 [0.076]	
Non-Muslim borrower, Muslim lender		-0.034** [0.013]		-0.018 [0.014]	-0.038** [0.018]	
Non-Muslim borrower, non-Muslim lender		-0.000 [0.035]		-0.029 [0.028]	-0.010 [0.042]	
Titled borrower non-titled lender			0.003 [0.022]	0.005 [0.025]		-0.008 [0.033]
Non-titled borrower titled lender			-0.032** [0.015]	-0.022 [0.017]		-0.036* [0.018]
Non-titled borrower non-titled lender			-0.027 [0.018]	-0.017 [0.023]		-0.030 [0.025]
Constant	0.154*** [0.047]	0.147*** [0.046]	0.162*** [0.049]	0.169*** [0.047]	0.173** [0.064]	0.181** [0.067]
Loan characteristics	YES	YES	YES	YES	YES	YES
Register F.E.	YES	YES	YES	YES	YES	YES
Observations	562	591	579	499	380	379
R-squared	0.536	0.532	0.556	0.580	0.515	0.550

The cost of judicial privilege

Average real interest rate: 19% per annum

Men paid an average of 3.6 percentage points more than **women**.

Muslims paid an average of 3.0 percentage points more than **Christians** and **Jews**.

Elites paid an average of 3.5 percentage points more than **commoners**.

Cost of privilege: risk premium of 16-19% for credit

Transition to impartial rule of law

Elites can see the costs that they endure.

They have a lot to gain **collectively** from making courts impartial with respect to financial contracts.

Collective action is difficult. Often it takes a major crisis to achieve it.

Ottoman moves toward impartiality

Gülhane Decree (1839):

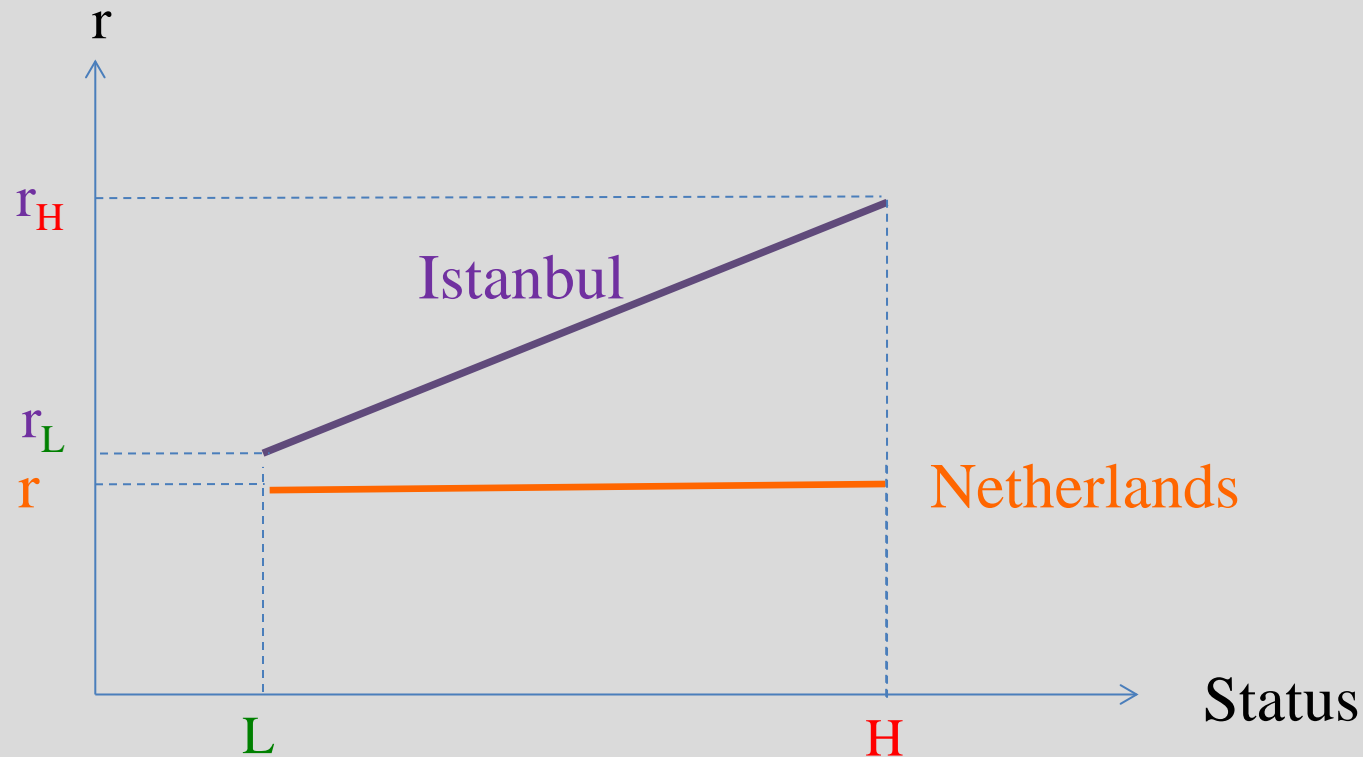
- Equality before the law regardless of religion, ethnicity
- Legal rights decoupled from rank, position, influence.

Judicial practices did not change immediately.

But the decree set the stage for opening of secular courts in the 1850s, and the opening of banks.

Collectively, elite Muslim men benefited greatly from these changes.

Istanbul vs. Netherlands, 17th c.



Source for Netherlands: Van Zanden et al. (EREH, 2012).

Summary and implications

1. Rule of law affects both public *and* private finance.
2. In competitive financial markets, the partiality of rule of law affects intergroup differences in interest rates
3. The relationship between interest rates and status changes in the course of political development

