



## Lock-in institutions and efficiency

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### ABSTRACT

Economists who emphasize path dependence generally dispute, at first approximation, the effectiveness of rational choice in understanding institutions. Such economists, belonging to the original (old) institutional economics and the historical school maintain that the constraint function is riddled with inefficient technologies and institutions which agents fail to replace with superior ones even when the switching cost is clearly *lower* than expected benefit. The argument ultimately rests on a theory of action à la Herbert Simon—where agents become habituated for whatever is the default institution. Such a theory recognizes that agents are ready to replace habits with more viable ones—but only when agents face shocks or crises. Such recognition, though, necessarily allows rational choice, in the sense of responsiveness to incentives, to enter from the rear window: after all, shocks and crises are merely *severe* incentives.

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### 1. The question

This paper investigates one question:

Can lock-in institutions/technologies persist when the expected benefits of superior institutions/technologies is higher than the switching cost? After taking into consideration the uncertainty/ambiguity of future benefits, why would inefficient institutions/technologies persist?

This paper asks whether the neoclassical economic approach, i.e., the standard theory of rational choice, is the best entry point to explain path-dependent or lock-in institutions and technologies. Many economists, such as Hodgson (2001), are critical of the rational choice approach as expressed in the “new institutional economics” of Oliver Williamson and Douglass North.<sup>1</sup> Such critics generally express the thrust of the old German historical school associated with thinkers such as Gustav von Schmoller and Max Weber—and, more recently, the thrust of the “original institutional economics” associated with Thorstein Veblen and John Commons (see Pribram, 1983; Hodgson, 1993, 1998, 2008a).

The original institutional school contends that institutions, of which technologies is an example, are ultimately the outcome of habits—and such habits cannot be explained in terms of rational choice. Therefore, inefficient institutions cannot be replaced rationally, i.e., in light of change of constraints (incentives). This explains that institutions tend to express historical inertia by the sheer fact of their origin, namely, as non-chosen habits. To wit, for the original institutional school,

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<sup>1</sup> In contrast to his early work (e.g., North and Thomas, 1973), North (2005) actually departed from new institutional explanations towards original institutional explanations when he emphasized the primordial role of culture (see Khalil, 2012).

choices are not ultimately the product of calculation of future costs and benefits, but rather are the product of path-dependent institutions: even when better options are available, agents still choose the inefficient technology or routine simply because they became used to them, i.e., became habituated.

This paper questions the logic of the argument of the original institutional economics. Therefore, empirical relevance or econometric testing of such argument falls outside the scope of this paper. This paper undertakes the analysis of the logic of the argument in three steps, as expressed in the three succeeding sections:

1. As Section 2 maintains, the fact that existing institutions are not replaced with superior ones does not mean necessarily that existing institutions are inefficient. As Liebowitz and Margolis (1990; see also Lewin, 2002) argue, to replace an existing institution with a superior one might involve costs that are *higher* than the expected benefits of the superior one. So, if the switching costs do not justify the adoption of the superior institution, the persistence of an inferior institution would be efficient. For the institutions to be inefficient, one must put forward the following thesis: Despite the fact that the switching cost is *lower* than the expected benefit of the superior institution, agents still fail to adopt the superior institution because of the sheer force of historical inertia or path dependence. Such a thesis, irrespective of its validity as discussed below, would amount to what Liebowitz and Margolis call “third-degree of path dependency.”
2. However, as Section 3 asks, what justifies third-degree of path-dependence – how would the sheer force of historical inertia allow the persistence of inefficient institutions? The only possible justification of third-degree of path dependency is the thesis that agents, to start with, do not choose institutions on the basis of efficiency. They rather accept whatever exists out of habit. So, agents are primed to take the default institution as given—i.e., they do not, at first approximation, assess them vis-à-vis alternatives. Such a theory of habit, as shown in this paper, can be traced back to Herbert Simon’s notion of “procedural rationality.” For Simon, agents continue to use the same habits or heuristics irrespective of the change of circumstances. Agents, for Simon, question the default habits only when a crisis or a shock makes such habits non-viable.
3. However, as Section 4 shows, Simon’s thesis of habits, which is at the core of the original institutional economics, cannot be sustained. The persistence of habits cannot indicate, contrary to Simon’s thesis, that agents do not act rationally. It is part of the definition of habits that agents do not change habits in the face of minute changes of incentives. And the fact, which Simon recognizes, that agents are ready to dispose of their habits in the face of shocks, goes to show that agents do respond ultimately to incentives—but have to be severe incentives in the case of entrenched habits. So, in responding to shocks (severe incentives) agents, in the final analysis, act rationally. As such, Simon’s idea of habits cannot provide the foundation for the third-degree of path dependence thesis.

This paper ignores the radical school (Marglin, 1974; Gordon et al., 1982; Nelson, 1996; Ogilvie, 2007; see Khalil, 2010d). While the radical school also questions the fruitfulness of the rationality approach, its advocates start with power relation and ‘exploitative’ exchange as the entry point of theorizing. For the radical school, the relative power among individuals dictates the nature of institutions in such a manner that makes them biased in favor of the more powerful elite or gender in order to sustain rent transfers from the less powerful to the more powerful agents. The radical school argues that, given the supposed exploitation, it is impossible to identify the *objective* function—i.e., the social welfare function—on the ground that it cannot be feasible when some individuals or segments ‘exploit’ other individuals or segments of the population. So, given the focus of the radical school on the objective function, it is outside the scope of this paper that focuses on institutions that make up the constraint function.

This paper also ignores questions concerning institutions with regard to collective action, network externality, or reciprocity. Such institutions could become entrenched—but entrenched for reasons unrelated to habit. They rather become entrenched because of vested interests, political repression, or simply the cost of organizing collective action to move the Nash equilibrium from a suboptimal one to an efficient one.

## 2. When does path dependence entail inefficiency?

This section defines what it means for path-dependent institutions to be inefficient. We must first illustrate path dependency in general—and the best place to start is with North (1990) and how he relies on the analysis of Arthur to explain the entrenchment of technologies.

North takes on the task of explaining why, in the 19th Century, North American development succeeded, while South American development derailed (see Khalil, 1993). North discusses the institutional framework of Spain in the 17th Century as an example of how an inefficient institutional framework survived as a result of self-feeding mechanisms. The framework allowed the king to act as a predator, which hindered incentives for investments and development. In contrast, the British-North American framework limited the power of the king and, hence, limited the ability of the king to confiscate property or undermine ownership.<sup>2</sup> This explains why entrepreneurship was secured and took off in North America.

North discusses another example of efficient path-dependent development. The British common law tradition allowed for the adoption of what came to be called the 1787 Northwest Ordinance. The Ordinance laid out laws to regulate the

<sup>2</sup> McCloskey (2010), however, presents evidence that shows that, actually, English kings confiscated private property.

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