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Status Quo Institutions and the Benefits of Institutional Deviations

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Status Quo Institutions and the Benefits of Institutional Deviations

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Abstract: The purpose of this paper is to nuance the widely held view that well-functioning institutions are the ultimate prerequisite for innovation and entrepreneurship. This is done by putting the spotlight on the role that formal and informal institutions have in serving the economic *status quo*, conserving old habits and incumbent economic interests. Therefore, existing institutions often act as impediments to entrepreneurship and innovation. We argue that a common yet underappreciated source of institutional change arises when individuals deviate from the behavior stipulated by existing institutions. All types of deviations are certainly not beneficial, but when they take the form of innovations introduced by entrepreneurs, they can be a particularly powerful source of economic and institutional change. An institutional setup should strike a balance between the need for stability that protects people's expectations and flexibility and adaptability to innovations and the ensuing entrepreneurship.

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1. Introduction

Today, well-functioning institutions are regarded as the ultimate prerequisite for entrepreneurship and innovation (Baumol 1990; Boettke and Coyne 2003; Acemoglu and Robinson 2012). This paper nuances this view from a Schumpeterian perspective, by highlighting the role of formal and informal institutions in serving the economic *status quo*, even in advanced countries. By nature, informal and formal institutions conserve established habits and economic interests of the past (McCloskey 2016). Therefore, they seldom adapt to the continual change, innovation and adaptation that is essential for successful economic development.

We argue that a common yet underappreciated source of institutional change arises when individuals deviate from the behavior stipulated by existing institutions. Not all deviations are beneficial—in the terminology of Baumol (1990), they can be productive, unproductive or destructive – but in some instances, it is appropriate to view them as second—best productive responses to suboptimal institutions (Douhan and Henrekson, 2010; Elert and Henrekson 2016). Notably, when they assume the form of innovations introduced by entrepreneurs, deviations can be a particularly powerful source of economic and institutional change, although their institutional consequences can be difficult to predict.

We use a number of examples to illustrate how deviations can function as a remedy for the status quo-serving nature of existing institutions, and argue for an institutional system that balances stability and the protection of people’s expectation with flexibility and adaptability to entrepreneurship and innovations.

2. The institutional status quo

The effective functioning of any society requires the reasonable protection of certain expectations of its members (Hayek 1973–1979); a completely fluid social order would be a completely uncertain one, reducing people’s incentives to learn, invest, enter into mutually beneficial contracts, and so forth (Dixit 2007). Therefore, human activity, including market activity, must be embedded in an array of institutions in order to cope with deviating behavior, whether this is labeled opportunism (Williamson 1975; Rose 2012), destructive entrepreneurship (Baumol 1990) or something else. The social science literature provides many definitions of institutions (see, e.g., North 1990; Calvert 1995; Williamson 2000; Sobel 2002; Schotter 2008), but they are generally devices that regulate human interaction, reduce

uncertainty and prevent free riding and conflict. By imposing costs on particular behavioral options, institutions produce incentives that discourage opportunistic or deviant behavior; the expected cost of an opportunistic action becomes so high that undertaking such an action would be irrational.

While a particular institutional order can satisfactorily protect people's expectations and interests, it need not be economically efficient, or even susceptible to and concordant with innovation and economic change. It is well recognized that problems caused by deficient institutions are ubiquitous in less developed countries (Hay and Shleifer 1998; Djankov and Murrell 2002). By contrast, institutions in advanced countries are relatively effective in directing economic activity toward inherently productive purposes (Murphy et al. 1991; Magee et al. 1989), and these institutions come closer to the first-best ideal of organizations such as the World Bank (Rodrik 2008). From a Schumpeterian or evolutionary perspective, however, the idea of an optimal set of legal rules ignores a central feature of successful economic development: the continual change, innovation and adaptation of institutions that are necessary in a competitive environment. Even if identifiable, the ideal institutional bundle will therefore change from one point in time to another and will, in practice, be impossible to achieve because few, if any, institutions can be adapted at the pace at which innovations occur (Downes 2009).

Not even in advanced countries do institutions cope well with adaptability and innovation. One reason is that people, as boundedly rational individuals (Simon 1955), are likely to make choices based on what norms, customs and traditions stipulate (Day 1987; Heiner 1986). Furthermore, people have an evolutionarily evolved propensity to observe and punish those who deviate from such informal institutions (Boyer 2002; Cosmides and Tooby 1992; Boyd and Richerson 1992). This often results in skepticism towards the novel and the unknown; popular resistance against innovation can even be viewed as the default response since time immemorial (Mokyr 1992). In Weber's (2002/1930, p. 31) words, "[a] flood of mistrust, sometimes hatred, above all of moral indignation, regularly opposed itself to the first innovator." Even today, citizens' attitudes toward most emerging technologies typically reflect a pattern of resistance, followed by gradual adaptation and eventual assimilation. Thierer (2016, p. 66) provides a long list of technologies to which this pattern applies—from the telegraph to wireless location-based services.

Additionally, because few potential innovations are Pareto superior, economic history is replete with important self-serving interests (such as guilds and unions) that stood to lose from the introduction of innovations, usually because these entities owned specific assets dedicated to the status quo mode of production. An asset used in a highly specialized activity can rarely be reallocated to another activity without incurring substantial costs, irrespective of whether it consists of physical, human or intangible capital (Caballero 2007). Hence, the value of the asset is contingent on its continued use precisely in its specialized activity. To protect the value of their assets, special interests resort to using non-market means to block the market selection process, notably laws and regulations barring the innovation in question (Mokyr 1998; Olson 1982; Bauer 1995). The beneficiaries of an institution thwart change in order to preserve their rents, causing it to grow entrenched and non-adaptive (Etzioni 1985). To avoid fighting the same battle repeatedly, such interests may have built an anti-innovation bias into the existing institutional structure.

All institutions impose costs on deviant behavior, but the source of the costs can differ—from self-enforcing conventions to negative feedback in the case of social norms or third-party enforcement of a non-violent or violent (usually government-instituted) type (Barzel 2000, 2001; cf. Martens 2004). Importantly, institutions of all types coexist and overlap, simultaneously affecting an individual's incentives in complicated ways (Lipford and Yandle 1997; Mantzavinos 2001). When institutions are complementary, the presence or usefulness of one increases the returns from or usefulness of the other (Hall and Soskice 2001). Therefore, different elements of a society's institutional configuration are mutually reinforcing. Once an institutional setup performs reasonably well—and often when it does not—it becomes locked in or sticky (Arthur 1989; Hall and Soskice 2001; Nelson and Winter 2002; Boettke et al. 2008); the institutional status quo becomes even more persistent and institutional change becomes more difficult (Kuran 2009).

Even in advanced countries, these innate features of institutions preserve the status quo and pose a challenge to the idea, common in economics textbooks, that an innovation exhibiting greater fitness than the state-of-the-art technology—for example, in terms of usefulness or profitability—will automatically become a success story in the market. Rather, market competition has seldom been the sole arbiter of the decision of whether a society should embrace a new innovation (Mokyr 1998).

3. Institutional deviations

The fact that the existing institutional setup favors the status quo does not mean that all economic actors accept the institutional status quo and that they are all content with simply performing as well as possible given the existing institutional constraints. The limitations of that perspective were well recognized by Schumpeter (1942, p. 84):

[T]he problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.

This point is perhaps best understood if one considers innovators and entrepreneurs as people who are less constrained by the institutional status quo than others. Indeed, researchers have shown that entrepreneurs typically rebel against traditional structures and rules (Obschonka et al. 2013). An innovation can therefore be regarded as an individual's attack on a constraint that everyone else takes for granted—constraints that may be not only technological or economic in nature but also institutional. As Lienhard (2006) claims, “[i]nventing means violating some status quo.”

Such violations are often facilitated by the fact that not all institutions are mutually reinforcing; in fact, institutional conflicts are common, such as conflicts between different centers of authority not only within the state but also across polities. Today, innovators can—and increasingly do—move to polities that provide legal and regulatory environments that are more hospitable to entrepreneurial activity at the expense of more conservative polities (Thierer 2016, p. 56).¹ The formal and informal sides of the institutional coin can also clash, as when entire communities or identity-based groups adhere to norms, values and beliefs that contradict laws and regulations (Safran 2003; Webb et al. 2009). These institutional contradictions have been described as a “complex array of interrelated but often mutually incompatible institutional arrangements” that “provide a continuous source of tensions and conflicts within and across institutions” (Seo and Creed 2002, p. 225–226; cf. DiMaggio and Powell 1991).

Institutional contradictions make it possible to circumvent or break out of the existing institutional straightjacket that may stipulate what may be produced, the production

¹ The benefits of cross-country institutional diversity were observed already by Hume (1777, p. 120): “divisions into small states are favourable to learning, by stopping the progress of authority as well as that of power.” Economic historians identify the political fragmentation of Western Europe as an important prerequisite for the region's subsequent economic miracle, as no single decision maker could turn off the intellectual and economic lights (Mokyr 1992; Jones 2003). While the price for this fragmentation was war, it also meant that inventors, philosophers and the like could relocate from an oppressive or inflexible polity to a more lenient and permissive one.

technology and how and to whom the product may be distributed. This fact has been acknowledged in the criminology and legal literature, which points to indeterminacy in rules, broad or narrow, to the scope within the law to legitimize contradictory decisions, and to a requirement to prove intentionality on the part of the alleged perpetrator. Consequently, the law need not be passively received by those who are supposedly subject to it. Rather, an institution can be actively worked on to alter its consequences, e.g., by using the law to escape legal control without actually violating legal rules, for example with respect to accounting or environmental standards (McBarnet 1984; Johnston 1991; McBarnet and Whelan 1991).

Likewise, while most entrepreneurship scholars implicitly assume that entrepreneurs act within prescribed institutional constraints (Webb et al. 2013), there is also a literature that focuses primarily on how large corporations attempt to shape government regulations in ways that are favorable to them (Hillman et al. 2004; Battilana et al. 2009; Lawton et al. 2013). However, such institution-adapting entrepreneurship is not costless and may effectively be off the table for many firms, especially if they are new or small. They will therefore employ less direct methods, for example by circumventing extant rules and regulations or exploiting institutional contradictions, through what has been labeled evasive entrepreneurship (Douhan and Henrekson 2010; Elert and Henrekson 2016; cf. Coyne and Leeson 2004).

It is perhaps understandable that many researchers perceive deviations, such as opportunism or contraventions of the spirit of the law, as a problem that may lead to welfare losses and impeded economic development (Pistor 2002, p. 112; McBarnet 2006; Rose 2012; Nurse 2015). However, this view rests on the assumption that the rule being bent is well tailored or has evolved to have beneficial effects.²

4. When are deviations beneficial?

Deviations can be beneficial rather than unproductive or destructive. Determining whether this is the case may involve comparing the deviation with some measure or standard of what would have occurred if the rules had been followed (Warren 2003). From a welfare economics perspective, an obvious standard to compare outcomes is Pareto efficiency, while a more process-oriented perspective may emphasize the factors that lead to economic development (Holcombe 2009; McCloskey 2010). However, valuable innovations sometimes do not leave any trace in the national income statistics. One telling example is the introduction

² Most institutions involve an essential hybridity of spontaneity and design (Hodgson 2016).

of anesthesia in the 19th century, which did not influence measured national income, despite its dramatic effects on perceived welfare (Mokyr 2010, p. 257). Likewise, today, people spend a substantial part of their leisure engaging in online services such as games, entertainment, and news. Based on how we spend our time, we value these new services dearly, but what we pay for them is likely to be a mere fraction of their value to us (Coyle 2014).

Furthermore, moral and ethical considerations must also be reckoned with when deviations are judged (Warren 2003). Brenkert (2009, p. 462) notes that a society may be progressing down a path toward legal and moral dissolution if people believe that they are exceptions to laws and rules. Nevertheless, he also argues for the similar dangers that may be faced by a society whose rules are so fixed and rigidly followed that no change occurs. In a similar manner, Hayek (1962, p. 60) (upon discussing moral rules) argues that:

It is, in fact, desirable that the rules should be observed only in most instances and that the individual should be able to transgress them when it seems to him worthwhile to incur the odium this will cause.... It is this flexibility of voluntary rules which in the field of morals makes gradual evolution and spontaneous growth possible, which allows further modifications and betterments.

The view of institutions as serving a status quo that is not necessarily apt to handle tomorrow's economic challenges suggests that the desirability of pliable rules applies to both formal and informal institutions.

To better understand this seemingly conflicting evidence, we can revisit Baumol's (1990, 2010) distinction between (entrepreneurial) activities that are productive, unproductive or destructive and the notion that institutions determine the relative rates of return of productive and unproductive types of activities. Notably, productive, unproductive and destructive entrepreneurship are functions that can be performed by the same individual. For example, imagine a business owner who finds his way through the bureaucratic red tape in order to acquire a production license. If he had faced first-best institutions, this entrepreneur's effort would have been wasteful because he could have instead expended this effort on directly productive activities. However, the same conclusion cannot be drawn given the actual institutional setting that the business owner faces. In that setting, the seemingly non-productive activity is a prerequisite for subsequent productive activities.

Certainly, many deviations can be detrimental for growth. For example, substantial empirical evidence suggests that corruption has large deleterious effects on economic performance (Shleifer and Vishny 1994; Mauro 1995; Aidt 2003; Pellegrini and Gerlagh 2004; Hodgson

and Jiang 2007). As Hodgson (2016, p. 339) notes, such rule-breaking behavior and weak enforcement can spread contagiously throughout society, threatening the organizational effectiveness that is critical for any developed economy. Nevertheless, findings from other studies suggest that inefficient institutions have a smaller effect when the level of corruption is high (Méon and Weill 2008; Klapper et al. 2006).

In some instances, deviations, or seemingly non-productive forms of entrepreneurship, can appropriately be viewed as second-best productive responses to suboptimal institutions (Douhan and Henrekson, 2010; Elert and Henrekson 2016). A priori unproductive activities can thus fill the gap of institutional failures and thereby provide a second-best yet positive effect. As such, deviations can function as a remedy for the status quo-serving nature of existing institutions. In times of rapid change, economic adaptability may therefore be difficult to achieve if actors invariably operate strictly within the limits of existing institutions (Etzioni 1987; Thierer 2016). In such instances, deviations can prevent existing institutions from stifling economic development.

As an illustration, consider Mokyr's (2010) account of the economic development in Britain during the Industrial Revolution, which casts considerable doubt on the importance of state enforcement of formal rules. At the time, Britain had some formal institutions that promoted economic growth, but many other institutions impeded rather than supported economic development. Growth occurred despite rather than because of some of these institutional preconditions: "By ignoring and evading rather than altogether abolishing obsolete rules and regulations, eighteenth century Britain moved slowly toward a free market society" (Mokyr 2010, p. 397).

Mokyr (2010, p. 370) instead emphasizes the importance of informal institutions: "[w]hat made commerce and credit possible in Britain during the Industrial Revolution was that most people had absorbed and internalized a set of values that made them eschew opportunistic behavior that might have been personally advantageous but socially destructive. In other words, economic agents did not play necessarily 'defect' in the famous prisoners' dilemma game." Not all informal rules were followed, however; Mokyr (1992, 2010) identifies the willingness to criticize and deviate from the conventional wisdom of past generations as an important element of a society's ability and desire to innovate. In another account, Jones (2003, p. 96) writes of the period that "[t]he lure of profit was sufficient in already commercialized economies to bite into the 'cake of custom' or to get around regulations."

Furthermore, “[w]hat happened in Britain was that growth itself stimulated individuals to find ways around customary and legislative barriers to free market activity” (p. 100).

Deviations also appear to be an important feature in the modern world, as suggested by de Soto’s (1989, 2000) analyses of the informal sector’s significance in many developing countries, where firms operate without legal titles because of excessive regulation. Certainly, such firms are seldom entrepreneurial in any meaningful sense, but they are nevertheless important as a means of alleviating poverty (Estrin and Mickiewicz 2012). Recent research on the informal economy (cf. Webb et al. 2014) provides additional examples, such as Lee and Hung’s (2014) case study of the emergence of the informal Chinese Shan-Zhai mobile phone industry, which grew to threaten the market shares of state-licensed national champions. In addition, Thierer’s (2016) recent account of so-called “permissionless innovation” comprises many examples of high-tech entrepreneurial ventures growing and flourishing in conflict with or in ignorance of extant laws and regulations.

How important is this phenomenon? Calculating the commercial potential of innovations has never been an easy task (Verspagen 2007, p. 487), but in general, the externalities of the innovation process are enormous – with the exception of a small fraction, benefits flow to consumers in the form of lower prices and higher quality (Nordhaus 2004). The estimated cost of innovations foregone as a result of institutional obstacles will always be shrouded in uncertainty because such estimation concerns what is “not seen,” in Frédéric Bastiat’s (1964/1850) words. In a given institutional setting, we see only those market transactions and those entrepreneurial activities that the institutional setting allows; innovations that do not conform to the existing economic order are suppressed – that is, unless individuals ignore or circumvent the rules and introduce them anyway. In this process, the innovation in question becomes “seen”; the deviator provides valuable information about the opportunity cost of the current institutional structure by showing what could be accomplished under a structure that is more permissive vis-à-vis this type of innovations (cf. Elert and Henrekson 2016; Elert et al. 2016).

The institutional consequences of deviations can be difficult to predict in advance. In Searle’s (1995, p. 57) view, each use of an institution is in a sense a renewal of that institution. From this perspective, deviations can imply that the institution in question gradually loses its significance to the point that it becomes meaningless to speak of it as a constraint on people’s

behavior (Ostrom 1990). This view is arguably in line with Mokyr's (2010) account of the transformation of British formal institutions, recounted above.

However, researchers have claimed (concerning the relationship between custom and law) that customary "breach is the mother of law as necessity is the mother of invention" (Seagle 1941, p. 35; quoted in Hodgson 2016, p. 92). Deviations from an institution thus provide the impetus for new law making. Widespread deviations can serve as a diagnostic indication that institutional change is necessary to promote growth and innovation; as such, it can have an important effect on norms and perceptions of what is acceptable, even honorable (Thierer 2016; McCloskey 2016), and can serve as a source of ideas that policy makers can use to determine whether and how policy can be improved (Link and Link 2009; Leyden and Link 2015). Such an indication may be particularly important in situations in which the gains from institutional reform are uncertain (Fernandez and Rodrik 1991; Alesina and Drazen 1991).

An additional and somewhat paradoxical reason why deviations in the form of new innovations may spur institutional change is that discontented incumbents may attempt to protect their positions by lobbying for stricter laws or more stringent enforcement of existing laws (Mokyr 1998). However, as Bauer (1995, p. 28) notes, resistance to new technologies can set the legal system in motion, but the type of regulation that results from such a process follows different constraints. Those who object to a new innovation may initiate the legal battle, but they cannot control its outcome any more than the innovators can.

5. Conclusions

This paper argues that a common yet underappreciated source of institutional change arises when individuals deviate from the conduct and actions stipulated by existing institutions. These deviations – in the form of innovations introduced by entrepreneurs – can be a particularly powerful source of change. The cited examples suggest that deviations from the institutional status quo have beneficial consequences in many instances, but we must emphasize that this is certainly not always the case.

This question is perhaps more relevant than ever, in today's "permission-based regulatory culture of innovation and economic renewal" (Erixon and Weigel 2016, p. 18). It seems doubtful that such a culture can cope in a socially beneficial manner with high-paced advances in areas such as the sharing economy, commercial drones, bitcoin, 3-D printing, and robotics, to name just a few, making it reasonable to assume that deviations from the

institutional status quo are likely to increase in scope and relevance in the foreseeable future. These deviations can be important as sources of growth in their own right, and, more importantly, as diagnostic indications of the need for institutional change – provided that such indications are heeded.

A great deal of additional research is needed to fully comprehend the conditions enabling wealth creation and economic growth by striking the right balance between institutions that make the future stable enough so that people are prepared to make long-term investments yet flexible enough to encourage value-enhancing innovations and entrepreneurship. As Kuran (1988, p. 145) observes, a central problem of society is achieving a balance between protecting expectations and allowing adaptation to new conditions, since civilizations flourish only when this balance has been attained.

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