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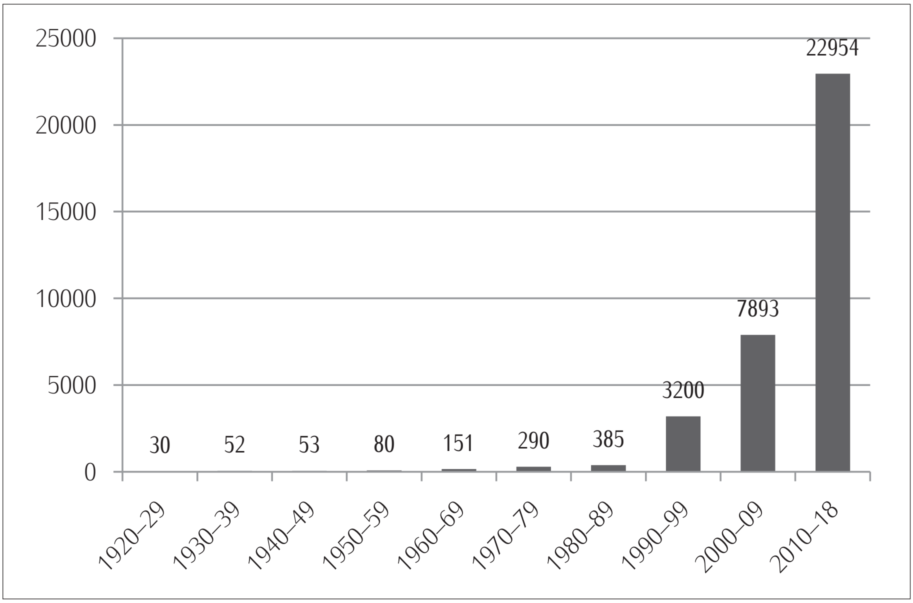
ON THE NATURE OF INSTITUTIONS

1. Introduction

An overview of contemporary economics would not be complete without mentioning the contribution made by the so-called heterodox economics, which refers to a community of thinkers who stand opposed to the mainstream. There is no doubt that economics has gained a new perspective thanks to the works published by institutionalists. Institutionalism is an area of study, which is explored by a growing number of researchers, not only economists but also representatives of other social sciences. We can observe the growth of interdisciplinary trends in social research. "[Over] the last two decades, we have seen a reversed *(from economic imperialism* – ed. by EG) process – economics uses in many different ways concepts, ideas, data and methods originating from other social sciences. This is the spirit that motivated the development of several major interdisciplinary research programmes, where economists cooperate with other scientists and use, on equal terms, tools, theories and methods which belong to different disciplines. The most important programmes of this type include behavioural economics, which draws on insights from psychology and economics, and new institutional economics (economics, sociology and other disciplines)" [Brzeziński et al., 2008: 203].

The analysis of institutions and their role in the economic activity, at the level of particular entities and markets or on the macroeconomic scale, seems to be the most productive area of research in the 21st century. The number of publications on institutional issues is gradually growing. According to the Web of Science, in the current decade (2010–2018), the average annual number of publications exploring the topic of *institutions* amounts to nearly 23 thousand articles. Compared to the previous periods, that is an enormous increase. Even with respect to the last decade, it is nearly three times more (Figure 1).

Figure 1. The average number of publications on *institutions* in the Web of Science database



Source: own calculations based on the data from the Web of Science (as of 1.12.2018).

Such a massive increase in the scale of research is a clear indication of a shift that is taking place in modern economics. The pursuits in the field of institutional economics include studying the role of institutions and institutional systems in economic mechanisms and searching for the most efficient institutional solutions that would allow for achieving desired effects. Despite the intensity of research, the essence of the institution and the character of its change still remain a matter of dispute.

This paper attempts to conceptualise the institution as a determinant of economic activity of societies and to define the sources of institutional change in modern economy.

2. What are institutions and how do they work?

Institutions are usually defined as rules created by people that shape behaviours, including economic decisions. G.M. Hodgson describes institutions as systems of established and prevalent social rules that structure social interactions [Hodgson, 2006: 2]. Institutions consist of formal rules, informal constraints and their enforcement characteristics. "The game is played within a set of formal rules, informal norms […] and the use of referees and umpires to enforce the rules and norms. How the game is actually played depends not only on the formal rules defining the incentive structure for the players and the strength of the informal norms but also on the effectiveness of enforcement of the rules" [North, 2005: 48]. Institutions are ubiquitous and refer to each person, each individual trapped in the net of social interrelations, in each place and at all times. Because of that institutions influence all social relations, including economic relations arising during the process of production, exchange and distribution of goods. It is a set of norms, behaviours, rules, bans, orders and their changes which influence the way society members perceive the world and the decisions they make [Parto, 2005: 24, 32]. People make rules, norms and regulations to order the world around them, to make it more predictable and enhance their chances for personal gain. They influence the way we see the world (e.g. regulate what is and what is not allowed, what is and what is not appropriate) and set the boundaries of our activity. Obviously, institutions do not specify in detail the type of undertaken activities, their character, direction or pace. However, when certain patterns of behaviour are deep-rooted, there is a chance that people will behave in a predictable way. "We cannot see, feel, touch, or even measure institutions; they are constructs of the human mind"

[North, 2009: 107]. Thorstein B. Veblen described institutions as prevalent habits of thought and attitudes developed by a given society/community under specific circumstances. Their existence is a consequence of repeated relations between the individual and the community. They are spiritual attitudes or dominant theories of life in force at a given time or place [Veblen, 1922: 151, 188, 190].

Institutions generate stimuli (negative and positive) and since they do not operate in autarkic conditions – they create a system of stimuli shaping or even imposing certain behaviours on individuals and communities. The impact of different institutions whose activities overlap may be far from expected. To understand the effects of institutions on human behaviour we must refer to psychological bases of people's actions, their systems of values, morality, egoistic or altruistic motivations [Hodgson, 2012: 12]: "The structure that humans create to order their political/economic environment is the basic determinant of the performance of an economy. It provides the incentives which shape the choices humans make. As with the team sport illustration, the strength of informal norms and the effectiveness of enforcement play a key part in the story" [North, 2005: 48].

According to Douglas C. North, a Nobelist, institutions consist of formal legal rules (e.g. regulations contained in constitutions and statutes as well as common law) and informal elements – conventions, social norms, customs, routines, which form personal codes of conduct) [Wätzold, 2009: 69–70]. Thus, on the one hand, institutions are established, embedded and codified rules, e.g. legal regulations (formal institutions) but, on the other hand, they can have an uncodified, "implicit" character and develop in a spontaneous way (informal institutions). To describe institutions (their profiles), the changes they undergo and the impact they exert it is necessary to refer to their degree of formality, which ranges from highly general legal regulations to social norms and conventions [Buchanan et al., 2014: 1].

To define the nature and category of an institution, we need to determine the profile of its activity and the type of effect it has on human behaviour. Institutions are constraints that structure human behaviour. Thanks to that, the environment is more understandable and less uncertain for individuals, who know the rules of the game and, since the observance of common rules is enforced, one can expect that these rules will be respected by all.

The effectiveness of law enforcement determines the level of social trust and, thus, the economic expansion. Institutions act not only in a form of orders and prohibitions but also in a softer way. Each institutional system includes moral and ethical codes of conduct. They strengthen (or – if there is a contradiction – reduce) the impact and enforcement of formal rules and regulations. Social norms, traditions and conventions resulting from cultural heritage are deep-rooted in the core of the society and, as a matter of fact, constitute the very foundations on which formal institutions are built. Informal rules of conduct are often associated with social capital and as such they are considered to be necessary to create an economic environment based on trust and willingness to cooperate. Networking facilitates the flow of information and increases business credibility in contacts with other entrepreneurs and clients, which reduces business transaction costs. Institutions encompass a much wider array of rules, i.e.: instruments, tools and devices, a system of norms, principles of operation, rules of the game, systems of constraints, social structures, systems of social and professional roles, basic forms of social order, products and elements of culture (civilisation), the effects of political will and instruments of power [Pańków, 2014: 57–73].

Institutions have an inherent ability to persist for a long time and, at the same time, to change constantly and gradually. They are like a self-sustaining organisation, whose activity is based on shared experience. And this organisation undergoes constant (self-)improvement. There is no doubt that institutions are at the core of the economic mechanism [Aoki, 2007: 6]. Repeated activities bring different outcomes which lead to decisions based on the evaluation of their efficiency. The solutions that seem to be the most beneficial become formalised. Such decisions turn into a routine and are reproduced in future actions [Berk, Galvan, 2009: 552]. Based on typical patterns of thinking and behaving, we can successfully predict what people will think or do in the future. The system of institutions provides only a general framework for the actions of the society and particular individuals. They provide models of the most desired behaviours. By accepting the existent order, individuals naturally or even automatically respect the rules created in their society (although there are individuals who do not follow the rules). The reliance on tried and tested solutions applicable to a given situation shapes the structure of social interactions [Gruszewska, 2013: 113–114].

The diversity of institutions and their impact make them difficult to measure. There are no perfect indicators of institution status or quality. Measurements are made selectively and often based on the Boolean type of data. Particular measurement difficulties are related to informal institutions, which are complicated even to enumerate. The flaws of applied indicators have been motivating researchers to construct new indices, which would, at least partially, eliminate those defects[1]. The lack of fully adequate indicators of the quality of institutions and institutional environment makes it difficult to verify empirically the research on the influence of institutions on the dynamics of economy and its particular elements. The currently applied methods of measuring different aspects of institutions are inadequate in determining the intensity of their impact on the economy [Voigt, 2013: 22].

The most significant difficulties faced by researchers include [Miłaszewicz, 2011: 23–24]:

1) the lack of a clear and commonly applied definition of the institution, which refers mostly to the empirical part of research because the definition of the institution depends on the purpose and method of a given study;
2) a multi-dimensional character of the effect of institutions on economic dynamics. As a result, the created models are highly diversified and cover many different independent variables;
3) a large number of indicators of institution quality. The results may be mutually contradictory but, on the other hand, there are strong correlations between them. What is more, institutions are endogenous to economic growth, which makes research even more difficult;
4) institutions are qualitative categories which are not easily subjected to quantification. The available statistical data is fragmentary and has rather short time spans. Also, there are very few indices of institutions which have data from periods longer than 15–20 years, which, considering the durability of institutional change, is a very short time.

Due to the difficulties presented above, institution analysis must have a fragmentary character to be conducted in a reliable way. Researchers have

[1] A collection of sample indicators includes: Zielenkiewicz [2014: 21–24], Staniek [2017: 75–70].

to resort to description as the availability of quantitative data is limited. However, that should not discourage institutionalists. It appears that the inclusion of institutional aspects of economic processes into the analysis of, for instance, economic growth factors proved to be a very valuable procedure which gave a wider perspective on economic dynamics and a fuller picture of how the economy works.

3. Institutions as an economic mechanism

According to Marek Ratajczak [2018: 328], „all (or nearly all) contemporary economists or, more broadly, representatives of social sciences, are undoubtedly institutionalists in this sense that […] they generally accept the thesis about the major role of institutions in the economic and social life". Despite the widespread belief in the fundamental function of institutions in the economy (*institutions matter*), none of the researchers or schools of economics has created a universal and generally recognised theory which would provide a coherent presentation of the influence of institutions on human behaviour. The impact of institutions on the economy is not verified. What is studied is the quality of institutions and their efficiency in achieving the desired outcomes, or the institutional balance (or institutional governance). Thus, the works of institutionalists[2] present the effects of institutions (selected ones or certain groups) on different aspects of the economic life. They try to determine institutional structures which are the best or the most adequate to a given economy although not necessarily universal. Building one model seems to be impossible because each country develops in its own way. We can only show similarities in the elements of institutional systems created in particular countries and at different stages of development [Hodgson, 1998: 168].

To assess the efficiency of particular institutions is not an easy task because their effects depend on the impact of other (complementary and/or substitute)

[2] "There are and there will be many more economists as well as other social scientists, including representatives of legal science […], who draw upon insights from institutional theory, especially in the research where an important role is played by institutional infrastructure in the realia of particular economies and societies" [Ratajczak, 2018: 328].

institutions. Institutions create a network of dependencies which develop in "time and space". In each society, the institutional system includes a certain group of fundamental institutions. It is a base which determines the nature of the whole system and gives rise to the whole "universe" of complementary institutions [North, 2005: 10].

It is a scaffolding of the institutional system to which further elements are added to complement it, develop or make it more precise. Institutionalists call it the institutional matrix. Wacław Stankiewicz wrote that this "matrix" has "an invariant character, which means that it is enr iched without losing its essence. The next generations of social institutions are not simple replicas (clones), they can form complex structures but their backbone, fixture or superstructure which ensures its coherency will always be the institutional matrix" [Stankiewicz, 2004: 61]. Thanks to this core, the society can be an integrated and, at the same time, independent community based on shared values and beliefs [Kirdina, 2001: 14]. According to Svetlana Kirdina [2010: 10], the framework of the institutional structure is formed by three subsystems-spheres:

1) **economy** – interrelations related to the allocation of resources and determining their reproduction;
2) **politics** – social relations enabling regular and organised social actions to achieve defined objectives;
3) **ideology** – interrelations embodying important social ideas and values.

Each subsystem produces further institutions in a given group. Thanks to the constant change in the institutional system, particular institutions successively adapt to each other and to other tangible and intangible components of the economy. This evolution improves the whole system and leads to an institutional balance. The efficiency of the whole institutional system depends not only on the efficiency of its constituents but also on the cooperation between all of them.

Mutual adaptation, consistency between different groups of institutions and the coherence of stimuli contribute to building a sustainable (i.e. effectively influencing the economy) economic system. Some institutions may stimulate economic growth but there are also those that hinder this process. Even the same institutions that have a positive impact on a given economy can hinder the development of another when applied under different circumstances.

The final effect of institutions on the economy is the result of all rules (formal and informal). Dani Rodrik [2007: 156–161] lists five types of institutions which support markets and play a major role in the economic development, especially in less-developed countries. These are:

1) well-protected property rights (and their control): "the establishment of secure and stable property rights has been a key element in the rise of the West and the onset of modern economic growth" [p. 156];
2) regulatory institutions: "every successful market economy is overseen by a panoply of regulatory institutions, regulating conduct in goods, services, labour, assets, and financial markets" [p. 157];
3) institutions for macroeconomic stabilisation: "All advanced economies have come to acquire fiscal and monetary institutions that perform stabilising functions, having learned the hard way about the consequences of not having them" [p. 158];
4) institutions for social insurance: "Social insurance legitimises a market economy by rendering it compatible with social stability and social cohesion" [p. 160];
5) institutions of conflict management: "They tend to increase the incentives for social groups to cooperate by reducing the payoff to socially uncooperative strategies" [p. 161].

The completeness of institutions and their cooperation with other rules determine economic dynamics on a micro- and macro-scale, including the dynamics of investments and the scale of production. The inflow of capital into the economy is a result of millions of decisions made by people acting in particular institutional circumstances. Efficient institutions reduce the uncertainty about the stability of economic environment and minimise the costs of undertaking cooperation. Maintaining a stable economic growth in adverse conditions (barriers to economic growth) requires strong institutions. In the face of an economic downturn, only the countries with strong institutions are able to achieve relatively high growth rates compared to countries with weak institutions. It is because they are able to decrease transaction costs and effectively support the markets.

Institutions influence the activity of people in multiple ways. They affect all aspects of economic and extra-economic actions. There are several features of institutions related to their influence on the economy and a number of functions they play in the economy and in the society. We can list the following functions of institutions [Bal-Woźniak, 2012: 134]:

1) a **regulatory** function – the main function attributed to institutions. Institutions influence the way people behave – they define the expected behaviours and the undesirable ones (what is and what is not allowed; what is and what is not worth doing; what should and what should not be done etc.), they provide indications;
2) a **cognitive** function – institutions provide information about the immediate and further environment, about human features and behaviours, which are embedded in traditions and customs and reflect people's mentality and prevailing world views;
3) a **stabilising** function – they protect human rights. They create a fairly safe environment for taking action and allow for a freedom of decisions within its constraints. They structure a social and economic order, increase the predictability of behaviour towards other entities;
4) an **integrating** function – they create interpersonal bonds and enable cooperation based on a shared system of values;
5) an **instrumental** function – institutions set the boundaries, differentiate between the acceptable and unacceptable actions, limit individualism, act as carriers of sanctions for breaking the rules;
6) an **effectiveness** function – thanks to institutions entities and groups obtain and increase their benefits; institutions evolve together with people to match better their interests.

The institutional system is a multi-level and multi-aspectual structure of rules which influence the life of entities. It is a system which is intricately linked to the economic mechanism. With the stimuli it generates, the system influences the type and intensity of actions undertaken by entrepreneurs, employees and decision makers. D.C. North [2005: 102] wondered how much the economic growth was the effect of institutions created by people (exogenously-given or endogenously-appearing) and if it is not only the effect of "just plain good luck". The attempts to answer this question are undertaken in numerous studies and in different ways. Surely, a country which aims at an economic success must build efficient institutions. Laws, administrative regulations, organisations and social norms give structure to the environment where business entities make transactions and start relations. The creation of a business-friendly environment seems to be a crucial element of the pursuit of prosperity. However, it is not always that such an effect is achieved. “Good institutions – the ones which are conducive to development – are those which, first of all, guarantee the security of business transactions and contribute to technical and social progress. Those countries which ensure their stability but, at the same time, know how to make them adequately flexible and allow for a smooth adaptation to the changing natural and cultural conditions affecting the economy – are the successful countries” [Kołodko, 2009: 294]. However, the belief that there is a “golden” set of institutions and it is enough to implement it to achieve economic success is rather questionable. Even the wealthiest countries, which have high rates of production dynamics and higher than other countries growth rates, do not have a permanent recipe for sustainable growth. A high rate of economic growth is not embedded in the institutional system. In order to successfully interact with the determinants of economic growth, institutions must be constantly changed and systematically improved.

4. Institutional change

“The institutional system is not a closed autarkic construct but an open, constantly changing, multi-level structure. It is always in the process of transformation, modernisation and diversification. It is this feature – constant changeability – that defines its very essence. The system undergoes a ‘creative destruction’ – institutions are successively demolished and reconstructed in new forms, areas and aspects. There are also substitutes and complements, which develop and enlarge institutions” [Gruszewska, 2012: 65]. Institutional change needs time. Although particular institutions can change faster, we need to wait much longer for the overall effect. According to Oliver E. Williamson [2000: 597], the institutional system is made up of four levels of institutions with different capacity to change. Informal institutions, the most deeply embedded and reinforced by the system of beliefs and values, are the slowest to change. They are deeply rooted in the past and take over 100 years to change. Other levels include institutions which need less time to undergo the process of change. Hence, we should consider the historical and cultural background of institutions and institutional systems (the so-called *path dependence*) [Hodgson, 2014: 9]. Institutions are strongly related to previous circumstances of human interaction and act as a link between the past and the future. It was in the previous years that the need for change appeared. Previous institutions did not tackle well certain problems and to increase economic gains, it was necessary to look for new schemes of conduct. The current status of rules and regulations is a continuity linked to institutional solutions applied in the past. The form and efficiency of today's institutions was shaped yesterday. Today, they can only be modified. In the same way, any radical changes in institutional systems must be rooted in the past. The source of each revolution rests in deep dissatisfaction with the current situation experienced by a group of people. Under the influence of new experience and information, individuals and groups confront their ideas and expectations with reality and change their way of thinking about the world around them. Also the rules of the game change.

An important feature of institutions is their bias – they always serve somebody's interests. Legal rules and social norms regulate the process of goods' distribution among individuals and social groups. Some obtain acceptable benefits while others oppose such a distribution because they lose. Institutions are created as a result of a power game. They always serve the interests and pursue the objectives of those who have designed them and control them. Obviously, certain compromises are needed to build institutional solutions but the final outcome is the effect of a power game. To understand the essence of an institution we must know the ideology it was based on. In the long run, only those institutions that serve the interests of the strongest social groups (those who have the political power) can survive [Persson, 2010: 75]. If the currently existing institutions favour strong social groups, they will not be interested in any changes they will benefit from. Institutional persistence can also be explained by several other factors. For example, informal (social and cultural) institutions that underpin the functioning of economic institutions are resistant to change [*Beyond*…, 2010: 39].

What is especially difficult for a society are fast and radical changes of the institutional system whose purpose is to break big barriers to growth and development. An example of rebuilding an institutional order is the transformation of the political and economic system. Central and Eastern European countries started to build a new system simultaneously with an aim to destroy the major part of institutions related to the previous system. Those changes were preceded by deep social dissatisfaction with the old system. The inconsistency between formal and informal institutions had been growing and that gap was the starting point to dismantling the political foundations of the economy. Once the critical point was crossed, a series of massive public protests followed and the change was unavoidable. Fundamental institutional solutions were "transplanted" from highly developed countries. Here, it is possible to list key institutional changes which paved the way for faster economic growth in Central and Eastern European countries. These are: "the privatisation of state-owned companies, the restructuring of enterprises, the development of competition, infrastructural investments, price liberalisation, public finance reforms, the development of the financial sector and the capital market, the liberalisation of foreign trade and currency exchange system". All those changes were closely associated with the prospective enlargement of the European Union (CEEC-10: Bulgaria, Czech Republic, Estonia, Lithuania, Latvia, Poland, Romania, Slovakia, Slovenia, Hungary), i.e. the "integration anchor" effect. What is more, the economic growth in CEEC-10 was also boosted by the EU policy aimed at reducing regional development disparities, which resulted, among other things, in an intensive inflow of EU aid funds to those countries" [Rapacki, Próchniak, 2012: 7–10].

The process of mutual adjustment of institutions and removing the inconsistencies between them is still in progress. It was not finished with the establishment of new formal institutions because institutional governance has not been achieved yet. Institutional incompatibilities and inconsistencies lead, among other things, to low public trust, unwillingness to take risks or tolerance to the violation of the law. The desired status of institutional system has not been reached yet. Some institutional inefficiencies are still visible. Institutions do not generate an adequately coherent set of stimuli to boost economic activity and innovation. It is only thanks to institutional governance that a society can function properly and shared values are commonly respected [Ząbkowicz, 2014: 38]. A certain institutional balance may be achieved as a result of the occurrence/development of the following features of the whole system [Staniek, 2017: 90–91]:

1) proper relations between formal and informal institutions with an adequate involvement of organisations;

2) a balance of power between different social groups of interest (it can be described as political stability);
3) properly coordinated management of expectations of business entities and their changes in order to keep a balance of expectations;
4) necessary institutional changes introduced in the context of path dependence and existent structural conditions;
5) social acceptance of income inequality;
6) a dialectic between the public interest and particular interests;
7) broadly understood financial stability in the economy.

As already mentioned, the mere existence of a set of basic institutions does not guarantee automatic success. To maintain efficient institutions, certain government actions are needed. However, there is no guarantee that the complexity of institutions will evolve in time. The lack of resources or a political instability may hinder the positive effects on the economy or cause long-term stagnation [Lubell, 2017].

Each country needs its own, country-specific institutional solutions, which will be adequate to the local conditions, legal regulations and cultural factors. Social expectations regarding the building of institutions may differ. Institutions will be efficient only when they melt with local informal norms and become embedded in people's mentality. What also matters is the readiness for change. We cannot stop at establishing some basic institutions and expect all others to adjust, create themselves or improve. To lay strong foundations for sustainable, long-term economic growth we need a wide spectrum of continuously implemented actions. Only a comprehensive modification or transformation can bring a gradual improvement in the quality of life, especially if the country has a big development gap to bridge.

5. Conclusion

An institutional approach to economic growth and development provides a fuller picture of the economy than traditional economics. It allows for taking a wider and more holistic view of the economy. Analyses of institutional conditions and factors have dominated modern economics. It is undoubtedly due to the fact that institutions have a strong influence on economic and extra-economic activities undertaken by individuals and groups. The conducted research gradually advances the knowledge about institutions: what they are and how they work. These rules and norms limit our choices but they also leave a lot of space for individual decisions and increase the chances of succeeding in a more predictable environment. Business entities which operate in a well-known environment, where they can trust their business partners, make more profits and are more likely to expand into other markets. From a macro-economic perspective, a cohesive institutional system is a prerequisite of economic change in less-developed countries and a determinant of sustainable development in other economies. Institutions are believed to be the cause of economic failure of many countries. Thus, to create a favourable environment for economic progress, it is necessary to adopt adequate, country-specific formal instruments. New formal rules will be efficient only when they have become deeply embedded in informal norms. The only question that needs to be answered is how to change institutions in a desirable way. Statutory changes are introduced under the influence of pressure groups who expect certain benefits. Eventually, the implemented formal institutions are the resultant of a conflict between the interests of different groups or communities. On the other hand, informal institutions change in an evolutionary way. We can also take different measures in order to provoke change in the desired direction. The state should get involved in the process, e.g. through social campaigns whose purpose is, among other things, to educate. Due to the nature of informal institutions, this process is progressing slowly and its effects are uncertain. The final outcome – a new institutional system – is a consequence of different processes, also such that cannot be influenced by any decision makers.

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SUMMARY

This paper attempts to conceptualise the institution as a determinant of economic activity of societies and to define the sources of institutional change in modern economy. The analysis of institutions and their role in the economic activity, at the level of particular entities and markets or on the macroeconomic scale, seems to be the most productive area of research in the 21st century. A cohesive institutional system is a prerequisite of economic change in less-developed countries and a determinant of sustainable development in other economies. Institutions are believed to be the cause of economic failure of many countries. Thus, to create a favourable environment for economic progress, it is necessary to adopt adequate, country-specific formal instruments. Despite the intensity of research, the essence of the institution and the character of its change still remain a matter of dispute. The diversity of institutions and their impact make them difficult to measure. There are no perfect indicators of institution status or quality. The lack of fully adequate indicators of the quality of institutions and institutional environment makes it difficult to verify empirically the research on the influence of institutions on the dynamics of economy and its particular elements.

Keywords: institutions, institutional system, institutional change.