

Diversification of Institutional Economics

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Abstract

In the article the author intends to provide a selective, yet fairly comprehensive review of historical roots and trends of Institutional Economics. Institutional Economics is not an integrated theory based on a set of common hypotheses, but rather a combination of various elements coming from different traditions and different social sciences. However, despite diversity there is a central tenet of both the 'old' and the 'new' institutionalism: that institutions matter in shaping economic performance and economic behavior. Economic processes do not take place outside of the historical or social context; they take place within given institutions. The author attempts to classify different views concerning these issues and explain how institutional economics relates to neoclassical economics and other social sciences.

The growth in interest in institutions can be treated as a particular 'return to the source', that is to the classics of economics (A. Smith, D. Ricardo), where the analyses of the economic system were conducted in the institutional, historical and evolutionary context (Nelson, Sampat 2001). The term 'institutional economics' is highly controversial and has its origins in the American institutionalism of the early 20th century (T. Veblen, J.R. Commons, W.C. Mitchell, J.M. Clark) (Blaug 1994: 710–712). This institutionalism despite certain common features (such as the need for the historical context of economic analyses, a criticism of excessively formalized

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models, disapproval for the ‘equilibrium’ approach, etc.) revealed the **differences in the approaches of T. Veblen and J. R. Commons** (Hodgson 2003).

T. Veblen stressed the decisive role of informal institutions (instincts and habits); J.R. Commons on the other hand wrote about two mechanisms: ‘the invisible hand of the market and the visible hand of courts’. J.R. Commons finds formal institutions to be of basic significance. They are rather created at the top, than as a result of the bottom-up interaction of entities and individuals. T. Veblen finds the relations between the technical and technological changes and the inertia of the institutional system to be particularly important; institutions can both hamper the development of production technology and foster it – the endogenous institutional change. Just as T. Veblen is more engaged in evolution (along with its mechanisms of natural selection) and the historic variability of economic analyses, so does J.R. Commons underline the importance of the social frames for business (‘collective action’). These actions form prerequisites for drawing the law and habitual norms. The phenomena of collective action can be observed in the operation of companies, state administration, associations and trade unions. The cooperation of these entities, for instance, through contracts and transactions or organizational relations requires legal regulations. J.R. Commons devotes a lot of attention to the issues of transactions and transactional costs, mainly in the microeconomic approach. The whole output of the American institutionalism did not create a coherent and developed theoretical concept; it, however laid the foundations for the later development of the new institutional economics¹. The institutional approach was gradually being introduced to fit into the output of the theory of economics, neoclassical and post-Keynesian included.

Today, one can rather talk of various trends within institutional economics rather than about a single and consistent theory. The trends are connected by the fact that they all appreciate the role of institutions in the social process of management. The understanding of the term ‘institution’ itself and application of methodology differ. D. North is an author of the commonly known definition of the term institution as ‘the rules of the game in a society, or more formal limitations structured by people, which shape their interactions. As a result they determine the structure of stimuli in the process of economic, political and social exchange. Institutional changes

¹ One could advance a thesis that T. Veblen’s work relates more to the ‘new institutionalism’, while J.R. Commons’s should rather be referred to as ‘neoclassical institutional economics’, which are both trends of the new institutional economics. W.C. Mitchell focused in particular on the role of empirical and statistical research, which is favored by standardization of the behavior of individuals as a result of the influence of institutions.

shape the evolution of societies in time and are the key to the understanding of historical changes...’ (North 1994: 3). Considering organizations to be institutions is disputable. In practice organizations are rather a form in which institutions operate; some organizations tend to ‘institutionalize’ them, to which joint actions to reach common goals contribute. Companies and the state are the example of such organizations-institutions. The **analysis of the institutional system** on the general economic scale as on the of a given market comprises the analysis of three mutually conditioned elements:

- **the set of institutions-organizations** (e.g. job centers, product exchanges or trade agencies on the goods market, financial agencies or supervisory bodies on the financial market, political parties and voters on the political market),
- **formal institutions** (laws regulating product manufacturing and sales, labor law, energy law, voting law, financial law, tax solutions, forms of drawing agreements and contracts, etc.),
- **informal institutions** (various forms of social capital: trust, networking, behavioral norms, cultural patterns, ability to solve common problems, codes of conduct, etc.).

The institutional approach in the theory of economics underlines the need to consider economic and social issues jointly rather than to oppose them in an artificial manner. This means that correct proportions between modeling and describing a given reality is maintained. Many representatives of institutional economics trends criticize structuring economic models of universal and timeless regularities. Management processes do not take place outside the historical or social context; they take place within given institutions. These institutions make up various institutional systems that make various management models stand out within market economy. Unification and diversification processes of solutions co-exist in world economy. The expansion of various entities and their communities results from a sequence of mutually conditioned events, depending on the previous states (path dependence). Institutions (institutions-organizations included) come into being as a result of social interactions; at the same time, institutional structures affect individuals and their preferences. Institutions are a certain type of social structure. Institutions both precondition and limit business activity of entities. They are an element of external conditions of management and also directly shape individual preferences and systems of values. Institutions facilitate cooperation and coordination of business activity in parallel to the conditions of ‘fair’ competition. The role of empiric falsification to confirm that the declared economic views are right is also stressed. Chiefly adaptation mechanisms are emphasized rather than the issues of effective allocation

of resources and optimization problems (Rutherford 1996). Businesses are motivated in their operations by the search for solutions rather than those used, which does not mean they are optimal in the sense of model assumptions. Entities base their decisions on the principle of limited rationality, which results from the fact that information available is incomplete or asymmetric, businesses are opportunistic in their activity, there is behavioral insecurity, and emotions and cognitive limitations of individuals also play a role. Search for better institutional arrangements remains in agreement with the implementation of their own interests and mainly follows the hit-or-miss method. A system of stimuli serves the cause. The stimuli are equally important, or even sometimes more important, than the flow of product factors for the manufacturing of products in accordance with the function of the business entity's goals. The system of stimuli results from such factors as the character of property title, organization and management structures, the type of contracts signed, social capital, etc.

Institutional economy prefers the vision of the business person as one entangled in the knot of social and institutional ties who signs various types of agreements and contracts. The name **homo contractor** (Lissowska 2004: 24–26) seems to be adequate. This concept sees an individual focused both on rivalry and cooperation, with a diversity of attitudes and beliefs. The institutional approach is best illustrated within the framework of the new institutional economics.

The new institutional economics saw two general directions for research isolated from it, one of them developing the traditional institutionalism, **new institutionalism**, and the second one combining the institutional approach with neoclassical economy, the **neoclassical institutional economics**. **The latter** comprises of such theories as: **theory of property rights** and other property theories (such as the common pool resources by E. Ostrom and the concept of divisibility of property rights), **contract theory**, **institutional theories of the firm**, contractual theory of the firm, behavioural and managerial theories of the firm, **transaction cost theory**, **agency theory** (including the principal-agent model), **corporate governance theory** (with the concept of stakeholders). **New institutionalism** comprises four blocks of theories: **theories of historical and evolutionary type** (D. North's theory, evolutionary institutional economics, for example G.M. Hodgson's, theories of institutional change, for instance R. Nurkse's concept of industrialization or G. Myrdal's concept of social reform); **economic interest theories** (public interest theory, rent-seeking theory, Downs's theory of democracy, Olson's theory of groups, Niskanen's theory of bureaucracy); **collective decision-making theories** (social choice theory – welfare economics, public choice theory, new political macroeconomics, constitutional economics);

theories of regulation (positive – normative theory of regulation, economic theory of regulation, theory of capture, French regulation school). Theoretical cohesion continues to be debatable within the framework of these trends (Ratajczak 2005).

The dependence of economic results on institutional behavioral conditions and institutional environment is the subject of research for both disciplines of the new institutional economy. New institutionalism underlines the evolutionary character of social and economic development, while neoinstitutionalism stressed the need to create models like the neoclassical and Keynesian models. There are also two definitions of individual: one (dominating) understands individuals as entrepreneurs (neoinstitutional economics), and the other considers individuals to be entities that reconcile individual interests with the common interests of the communities (new institutionalism). Interest of an individual is the starting point for neoinstitutionalism, while new institutionalism focuses on the interests of communities (groups or society). In neoclassical institutional economics subjects of the economic system are motivated by their own interest without any reference to the public interest. Behavior in favor of one's own interest is rational with its goal being maximal usefulness. Aiming at maximization one must consider the factors limiting the traditional understanding of rational behavior (this makes neoinstitutionalism differ from the neoclassical approach). New Institutionalism stresses the role of interest groups. The discussion also focuses on whether the institutional change is exogenous or endogenous. In the neoclassical approach these changes are external to the economic system. In the institutional neoclassical approach a particular stress is put on legal and organizational solutions within companies, other entities and the state, while in the historical and sociological approach of the new institutionalism researchers look into the institutional environment of business units. This is particularly important. New institutional economics (mainly in the new institutionalism) stresses the significance of the stability of routine actions and the possibility to adapt institutional solutions verified in the past. The issue of complementariness and substitutability is important. The analysis of selected institutional aspects are also the subject of research for those economic trends that are considered to be a part of 'institutional economy', such as for example Schumpeter economics, the new Austrian school, Marxist school, development economics, the comparative analysis of economic systems, experimental economics and behavioural finances.

Institutional economics (in its diversity) **demands** more and more to **have its output included** in mainstream economics, or at least to reject the thesis about the neutrality and exogenous character of institutions for economic growth and operation of the economy. Such factors as for example production organization,

ways to attribute property rights, ways to conduct transactions, co-situation of state and market, motives of cooperation and coordination of groups and individuals or the trust between entities are becoming more and more important. Mainstream economists also point to the institutional aspects of management, these include postulates to formalize institutions in macroeconomic models (Blanchard 2000: 38–39). This is, for example, expressed in for example in including institutional elements in macroeconomics (e.g. economic growth models, models AD-AS or IS-LM-BP) and microeconomics (e.g. Coase theorem, information asymmetry and free riding model, company equilibrium and economy of scale, principal-agent model).

To understand the differences of economic growth between countries, and to explain the issues of convergence (absolute and conditional convergence) or divergence, it is not enough to reach for traditional **models of economic growth** and to refer to direct growth determinants (work, capita, technological progress)². Institutions influence both the accumulation of capital (assets) and human capital, also the productivity of manufacturing factors. This refers to such institutions as: market institutions, state institutions, the system of political democracy, ownership rights, transaction costs, social capital, instances of corruption and others. There is a feedback between growth and institutions. Empirical research shows that richer countries have better institutions, which makes it impossible for poorer countries to reduce the technological gap (Barro 2000). Better institutions take advantage of the economy of scale, that is why developed countries are in a more advantageous situation than less developed countries. In richer countries is easier to ensure the necessary complementariness of the institutional system. At the same time certain institutions must be implemented before an economy can be introduced on a path of faster growth. Criticism of Solow's model led to the development of endogenous models of growth along with the direct modeling of technological progress, underlining the role of the human capital and knowledge production. These models have denied the assumption that marginal capital production is decreasing. They analyze such phenomena as: positive external effects, learning through action, technological innovations, etc. Growth research starts to reach to the concept of social capital and the relations between the scope of political democracy or economic freedom and growth. Transaction costs are included in the so-called monetary growth models. Endogenous models of growth in combination with the history of

² The neoclassical paradigm is not enough in a complete analysis of growth, its factors and preconditions. Other economic trends such as new Keynesian theory, Schumpeter economics and institutional economics have an important role to play.

economy will allow for deeper analysis of the influence of institutions and politics on economic growth (Meier 2001: 24). There are attempts to introduce institutional factors to formal growth models; the measurement of institutional factors remains to be a problem³.

Application of institutional problems to the **AD-AS model** (D. Colander's approach) is yet another example (Matczuk 2006: 99). The complete scheme of procedures in case of institutional problems prepared by E. Ostrom can be helpful here (such as the Institutional Analysis and Development – IAD program). If the AD (elimination of coefficient effects) and AS (correct definition of production function) curves are correctly modified, the macroeconomic coordination path determined by the institutional factor X can be introduced. This path includes the possible combinations of product and price during dynamic adaptations. The path tilt indicates various price rigidities determined by institutional factors. It shows the influence of formal institutions and informal ones such as the relations between aggregated demand and offer. The introduction of various functional forms of the macroeconomic coordination path is the key to the differentiation of institutional characteristics of various countries.

Institutional factors in macroeconomics can, for example, be looked into through the **Coase theorem**. This theorem expresses the mutual relations between the property rights, transaction costs and external effects (Coase 1960: 1–44). The issue is to choose the most effective institutional solutions. To solve the problem of external effects, property rights must be closely determined and free exchange of these rights between interested parties must be ensured. Property rights should be defined in such a way that it is easy to determine the entity of property rights clusters. In the situation when property rights and zero (or low) transaction costs are well defined, direct contracts between entities lead to optimal solutions. These optimal solutions will be achieved regardless of the initial arrangement of property rights. The market corrects the erroneous allocation of property rights. This results from a smaller asymmetry of information of the parties that participate in the market transactions. When the costs are high, it is possible to achieve effective market agreement if the initial property rights are assigned, which is the role of the state. At the same time, the state can directly reduce transaction costs by way of, for instance, standard agreements and

³ Measuring institutions can be divided into descriptive features of institutions and their operations. The basic indicators of institutional quality include: BERI risk index, ICRG risk index, Heritage Foundation Economic Freedom Index, Euromoney risk index, Fraser Institute index and others (Kosior 2006: 61–65).

contracts. External effects problems can be solved by the market if the negotiations of the parties, the party that caused the negative external effects and the damaged party, are voluntary (the parties of the conflict bidding). These negotiations can give better results than government regulations and related instances of government failures. The lower the transaction costs, the higher the probability. It is the task of the state to ensure that the contracts and agreements are abided by and to create conditions in which that right can be claimed effectively if violated. This problem can be presented by comparing Coase's solution with Pigou's (government intervention in the form of a tax).

Advantages of using the market mechanism are underlined in microeconomic analysis. Attention is drawn, however to market failures, one of these being the failure of the market to deliver **public goods**. Public goods are characterized by: lack of competitiveness, that is they can be consumed by all willing to do so; lack of the exclusion mechanism, which is a result of the fact that the property right is not completely determined; large costs of any exclusion (transaction costs); strong external effects; high fixed costs and zero marginal costs: domination of the free rider attitude and uncooperative behavior; difficulty to reveal the preferences of entities; no market prices, financing from tax income; distribution of goods by the public budget; possibility to supply public goods by companies of the private sector by way of government contracts and determination of the production level of public goods at discretion and administrative power of the public authorities. The market mechanism is unable to reveal the consumer preferences towards these goods. No entity can contribute to the public goods supply, because their total supply is shaped independently of the decisions of individual consumers. Market failure is the prerequisite to the state supply of public goods. Three issues are related to the public goods supply: determination of the quantity of goods as expected by the society, its financing and selection of entities that will produce them. To determine the quantity of goods it will suffice to go through mechanism of social consultations and agreements, which is presented in the model of the so-called Lindahl equilibrium or various methods of voting. Both public and private sector companies can produce public goods. Some goods (pure public goods) such as national defense are directly supplied by the state, because the private sector is unable to supply them. This is financed by taxes or other forms of payment. Other goods (the so-called quasi-goods that can be excluded, sometimes identified with public services) are subject to choice, for instance in the form of public orders or in the form of public and private partnership. The financing of private goods is a proper tax system of the lowest possible fiscal costs and at the same time it enables to amass proper means to finance

production of public goods. J.M. Buchanan argued against determination of tax rates independently of the quantity of public goods in demand (Buchanan 1997).

The problem of the functioning of the economy **in the area of increasing economies of scale** is another example. In many new economic industries production effectiveness increases along with the growth of the economies of scale, which is expressed in the decrease of marginal costs and unit productions. This refers to sectors with a high percentage of fixed costs because of spending on, for example, R+D, where learning through practice effects are widely used and where the usefulness for one part of entities increases when the number of users of the goods increases. In these area the rate at which unit and marginal costs decrease can differ, especially in relation to the end revenue decrease rate. According to the marginal analysis of the enterprise, there are two conditions that must be met to maximize corporate profit: the first condition (required) to equalize marginal costs with marginal revenues ($MR=MC$) and the second preconditions (sufficient), when the marginal revenue MR decreases faster than the marginal cost MC ($dMR/dX < dMC/dX$). If the economies of scale are increasing, there are more points than in one in which these two requirements are met; this is situation of multi-point equilibrium. Companies can generate the same total profits at different levels of production, costs and prices. This has an effect from the point of view of the whole economy and society. Social preferences apply to the points of equilibrium, that is the maximization of profit at higher production and lower prices. This solution requires properly structured institutions, for instance, tax system solutions.

The new institutional economics stressed **various levels of research** of social and economic processes:

- **analysis of the social environment** – informal institutions (traditions, customs, norms, culture, religion, etc.), the role of social capital;
- **analysis of institutional environment** (constitutional and legal regulations, property rights, politics and bureaucracy, groups of interest);
- **management analysis** as part of the existing property relations (management structures, contracts and agreements);
- **analysis of resources allocation mechanisms** (market and political mechanisms) (Williamson 2000: 595–613).

At the first level there are historical, evolutionary and sociological theories. The holistic approach dominates. The analysis of the social evolution process in the cultural context becomes the basic issue here; evolution similar to the evolution of the natural environment. Institutions are characterized by change as part of certain fixed relations sometimes called the institutional matrix. Changes of economic structures

take place gradually and are continuous although undetermined. The fact that some disappear and others are created is the effect of natural selection, which is especially stressed by the evolutionary institutional economics. Institutional change takes place because of the process of seeking solutions that are better than the ones before. This search takes place using the experience gained, the level of social capital and the dominating system of values. Effective institutions find wider application in the economy which is expressed in the change of rules of operation and existing habits. Institutional changes are related to the dissemination of innovation in the economy. Actions of the whole social and economic system cannot be explained only through the behavior of individuals; groups of individuals reveal characteristics that are not a simple sum of individual characteristics (Hodgson 1999). This is the phenomenon of institutional emergencies. In this sense the market and the society are not discussed separately, but are a type of feedbacks. The theory focuses on business market society as the subject for its research.

In **D. North's** theory changes of informal institutions take place slower than in the case of formal institutions, which reduces the effectiveness of current institutional changes. The scope of norms and rules used depends on the compatibility of the type of rules with the system of values that dominates in the society. At the same time if external norms are to meet their regulatory functions, they should be subjectively internalized by individuals and groups. Only then legal regulations can be transformed into stimuli and motivations for actions undertaken by each entity. The change of one set of legal regulations requires adaptation of others, which involves time and certain costs (mainly costs of meeting formal norms and punishment for avoiding them). The monitoring and punishment are the domains of state and local government institutions. To function effectively markets need a coherent system of formal norms that agree in terms of goal with informal norms and an effective and fast execution of the law by state institutions. In some cases, informal institutions can disable the actions of formal institutions. Social norms must also be compatible with legal norms. The degrading of social norms in the form of a growth of theft leads to the growth of costs of property title protection and limits the value of the property. Informal rules subject to the process of gradual institutionalization are transformed into formal institutions. **The social capital** is the synthetic expression of informal institutions (Putnam or Coleman approach). One can talk of two effects in the shaping of social capital (growth of trust): the Putnam effect and the Olson effect. The first is expressed in the growth of trust when an increasing number of individuals and groups participate in the formal and informal relations and in various forms of cooperating networks. This breaks the asymmetry of information and creates models

of repeated behavior, which facilitates contract-making and reduces transaction costs. The Olson effect is a domination of individual interests in created associations and organizations; the social capital which strengthens internal links contributes to the growth of contradictions between different groups of interest.

High social capital is an ability of entities to effectively coordinate and cooperate and reduce transaction costs. Social capital can substitute many formal institutions. The higher the tendency to follow the law, the lower the need to regulate many area of human activity. Coordination shortcomings, information limitations, uncertainty of the behavior of other entities or opportunistic behavior of business units lead to phenomena called the coordination failure. The richer the society, the smaller the extent of coordination failures.

The significance of informal business rules increases if the market freedom business entities enjoy is wider. As the level of income per capita increases, the market system becomes more complex and varied. There are new markets, for instance those that protect against the risk of negative economic effects (insurance markets). Financial market institutions (e.g. banks) are public trust institutions. All this relates to A. Smith's ethic principles and business preconditions. The role of **Schumpeter economics** can be considered in the same spirit. It not formally considered a part of institutional economics (Glapiński 2005). In this economics, the dynamics of economy, which is manifested in innovations, is shaped by the competition between entrepreneurs, which needs proper institutions in the economy. These institutions could include, e.g. corporations that help reconcile elements of competition, individual entrepreneurship and social solidarism. The output of **economic development** may be applied at the level of analyses (Todaro, Smith 2002). Economic development is determined by the ability to produce capital and technical progress, in which institutional factors play an important role. Ability to coordinate economic activity plays an important role. This coordination is easier when entities act in accordance with popular expectations, these shape the accepted behavioral norms of informal character. Economic growth accompanied by the reduction of social inequalities preconditions economic development. Much attention is paid to economic policy and a certain type of 'institutional policy', which requires a longer time. **Comparative analysis of economic systems** is one of the theories stressing the role of institutional factors. This analysis compares various different varieties of market economy that differ with institutions that are formal and informal. A discipline of the so-called comparative institutional analysis is thus created. It applied the historical analysis and game theory methods (Aoki 2001). Comparative studies of economic systems show that institutional solutions, always adapted to

the culture and experience of a given society are indispensable. There is no single, universal model of institutional solutions in market economy. Institutions are subject to change under the influence of the expansion of production techniques, technologies, cultural and social changes.

The second level is occupied chiefly by the economics of property rights and regulatory theories. This is the place to situate the state in the economy, mutual state-market relations or the public sector-private sector relations. Constitutional norm plays a decisive role here.

The basic institutions in the economy include property rights that area analyzed and whose role is assessed by the **theory of property rights**. This theory analyses property rights of business entities resulting not only from the legal regulations. Property rights give various rights to each entity⁴. This depends on the type and form of property. The way of ascribing property rights has a decisive influence on the operation of a given economic entity . The way in which property rights clusters are connected results in various systems of rights as the basis for different institutional systems. In practice each cluster can be ascribed various significance depending on their stimulating power or the costs of precise definition of these rights. It is not the produced goods, but rather rights of property to them and the resources from which they are produced that are the subject of this exchange. These rights are necessary to develop market competition. Property rights would not have this significance if it were possible to sign exhaustive contracts, which is not very possible in the conditions of information limitations and information asymmetry. In the economic sense several other institution, especially the state system and finance regulations affect them. Relative economic effectiveness and the system of social preferences determine the structure of ownership rights. The property rights structure is determined by relative economic effectiveness and the system of social preferences. Property rights are not absolute and the society can change them or correctly modify them with regard to the public interest. Property rights in the economic sense include social behavior norms.

⁴ Property rights are not absolute and the society can Property rights include the right to use the property at one's own will (right of ownership), the right to control the property (right to rule and use), the right to manage the property, the right to have profits from the property (for instance lease, consumption), the right to sell shares (transfer of property), the right to change the characteristics or assignment of the property, right to transfer the property in the form of legacy (transfer of property), right to protection against expropriation, right to unlimited use, right prohibiting the negative use of one property against another, right to use property as security of transaction, the right to retrieve full power granted at the end of the dates determined in the signed contracts (Stankiewicz 2005: 47).

Property rights require definition, application in practice and protection⁵. The precise definition of property rights (relating a given object with a given subject) prevents formation of negative external effects, such as ecological loss. Private property is determined by way of creation of new private sector properties from scratch (the so-called foundation privatization in the form of greenfield investments) and through transfer of property rights from the public sector (privatization of state-owned property). There is an on-going exchange of property rights on the capital market. The protection of property rights signified by other entities are excluded from using the property. Too large costs of rights protection may make constitution of exclusive property rights unprofitable. Property rights are: exclusive, transferable and constitutionally protected. Exclusivity means exclusion of others and elimination of free rider problem. Exclusive property rights result in strong stimuli making the owners seek the highest value of a given property. Profits thus obtained increase in a situation where more valuable assets are secured by exclusive rights and if the exclusion of others is highly probable. Exclusivity entails transaction costs to ensure economic unity and the formal and legal form of property. Transferability is the flow of rights for better use. Lack of property rights to the resource results in its waste, and erroneous attribution of property right influences market shortcomings and poorer results than potentially possible. It is important to differentiate the temporal and permanent transfer of property rights. In both cases, there are a different ways to manage the property and draw its characteristics. Constitutional guarantee of property protects private property against the rule of the 'majority' and political group in power. State interference is only possible in particular cases and against payment of full damages. This principle helps separate economic riches from the political power.

Property rights do not apply in every area of the economy, e.g. in the area of public goods, goods that are desired by the society or in the sectors that are considered to be strategically important. For in these area the costs of determination and protection of property rights can exceed expected profits. These high costs justify state regulation and/or existence of relatively stable public, including state-owned, sector companies⁶. The basic difference between state-owned and private property is the fact that shares of this property cannot be sold, which limits the scope of stimuli. Property rights are subject to state regulations, which includes all types and forms of property. Too many

⁵ This three elements are sometimes referred to as 'property rights production' (Eggertsson 1990: 113).

⁶ This does not mean public goods and the public sector are the same thing. Public goods can be produced by private sector companies as a result of contracts signed with the state.

regulations can, in the economic sense, make a private property 'state-owned' (in the formal and legal sense). On the other hand lack of precision in the determination of responsibility and the scope of power of the entities aspiring to state-owned property can lead to its actual 'privatization'.

The character of the state interventions and regulations related to it are of great significance for the effective allocation and protection of property rights. In most countries in the world property rights and their protection are one of the main constitutional norms. Constitutional economics is based on the analysis of collective decisions in the framework of current politics (constitutional politics) and the decision-making in current politics⁷. Constitutional economics studies the basic principles of social order within which business entities operate (Buchanan, Tullock 1997). The constitution is perceived as a kind of a basic social contract that ensures equal treatment to all individuals and entities; it is the basic task of the state to create conditions for the execution of transactions at the lowest possible transaction costs. The constitutional contract as the expression of setting the institutional framework lays out the rights and duties of individuals and indicates the role of social institutions. Constitutional norms protect individuals and business entities against excessive intervention of the state, especially in a Leviathan kind of state. Constitutional economics is also trying to explain the reasons for the existence of various institutional solutions in international economy. Empirical studies confirm the relations of economic effectiveness with the character of the institutional system, constitutional solutions included (Scully 1992).

As part of the constitution there is a wide field of organizational and institutional solutions that will include the determination of interrelations between regulations and deregulations. In the wider context regulations (institutional adaptation) can be understood as the expression of a certain tuning of the economic and social systems. This is the subject of studies of the **French regulatory school** (Gardawski 2005: 195). Institutions are subject to continuous change along with the changes in production techniques and social structures; the changes are chiefly the result of a certain constructivism. The institutional system focuses more on the process of the foundation of institutions than on their preservation, which is related to the flexibility of the post-Fordist period and the need to restructure Fordist-type structures.

⁷ There are also constitutional regulations (e.g. Art. 20 of the Constitution of the Republic of Poland, which states that social market economy is the basis of the economic system), which are not manifested in the economic practice. It is yet another issue, to what extent the conditions and economic possibilities permit the execution of a given constitutional regulation.

Purely economical issues are the subject of study for various **theories of regulation** (positive – normative theory of regulation, theory of capture, economic theory of regulation). These theories are based on the complementary need towards the role of the state in the economy, which has improvement of the coordinating function of the markets as one of its basic tasks. Anti-monopoly policy plays a certain role here⁸. Modern legislature is more about creating conditions for market operation than controlling. This concerns both reality and the financial market. Regulations can also contribute to the creation of new markets by founding indispensable market institutions that favor competition and protect consumer interests. Regulatory decisions should always be preceded by an analysis of the advantages and costs of regulation (deregulation) achieved by interested entities. The situation can differ depending on the type of business activity; in some cases more regulations are needed (e.g. in the area of operations of natural monopolies) and in others deregulation is necessary (e.g. deregulation of airlines). Institutional and organizational forms on various markets depend on technical and technological changes, e.g. the complementary rather than substituting character of production factors, development of the internet, technological possibilities of access to the power grid, etc. State regulations enhance the creation of a certain market of regulatory services with the cases of corruption and strengthening of groups of interest. The presence of regulatory markets expands the scope of regulations. The market of regulating services comes into being as a manifestation of expectations of various groups of interest, politicians, state administration officers, companies demanding regulations, regulatory offices and consumers. Regulation is here the result of the game of interests between entities, not a result of the imperfections of the market (these imperfections only increase the potential for regulation). These issues are studied in detail by the **economic theory of regulations**, e.g. S. Peltzman model (Sztaba 2006: 239–243). The model is based on the assumption that the usefulness of all entities must be maximized; producers want maximum profits, consumers

⁸ Anti-monopoly legislation serves to fight the abuse of monopolistic positions. This legislation includes both the practices of creating conditions for monopoly (e.g. price setting, production quantity limits, mergers and takeovers) and taking advantage of such conditions (price variation, overstated sale prices, entry barriers). Legislation is to protect economic freedom, control companies' political and economic power and increase economic effectiveness (allocation and adaptation). In the conditions of the development of international markets, increasing flow of production factors and stronger role of transnational corporations, the role of national anti-monopoly practices is decreasing. International competition also limits the power of national monopolies. It must be remembered here that monopolies can enhance technical progress.

want low prices, politicians and officers want social support (e.g. votes). Social support requires reconciliation of the size of profits with prices for consumers. In the model it is assumed that producers' and consumers' interests are equally taken into consideration by regulatory offices. It is also assumed that market powers play freely. The issues of the relations of power and subordination are ignored. The problem of inequality of the parties cannot be limited to the asymmetry of information. The regulatory market is dominated by the supply entities, which can impose regulatory solutions. **The theory of capture** analyzes the problem of capturing regulatory offices by various groups of interest. Groups of interest are trying to influence the policy of the offices and strain to give a certain direction to political control. The capture of an office prevents bureaucrats from seeking their own interests. In this understanding, regulatory policy is executed not in the public interest, but in the interest of the entities of the given sector. These entities are particularly interested in barriers of entry created by regulatory offices and proportionally higher prices of regulated goods and services. Pressure is constantly exerted on legislative decision-making. **The role of the state** in economy remains an open issue.

The basic issue is to find a solution between 'too large a state' and 'too weak or insufficiently empowered state'. The problem of too big or too small a budget that plays a regulatory role and has an actual dimension is related to the issue. A large budget means the role of the state is larger, a smaller budget means there is less state in the economy. Historical experience of many countries do not give a definite answer as to the results of this situation for the economy (Madej 1998). It is the role of the state to jointly create an effective institutional system in the whole economy and in various markets. The issue is to adapt pro-market reforms to the existing institutional potential and create new institutions at the same time. It, however, takes place in the situation of diverging economic interests of various entities. In **G. Myrdal's 'soft state'** (e.g. insufficient legislation, corruption, law violations, domination of private interests, excessive corporatism, etc.) even the best programs and solutions lead to institutional incoherence. A strong state (it does not have to be big) is a state that effectively executes assumed goals and executes the existing law.

The state is both the entity that pursues the execution of the public interest and the mediator in the game of diverging economic interests. The analysis of these interests is of interest to various theories, such as **M. Olson's theory**. This theory assumes that smaller but well organized groups of interest have advantage over large groups characterized by poor internal integration. Small and condensed groups are more likely to execute their own interests than large and dispersed groups. Groups of interest are also trying to take advantage of the institutional system (mainly the

institution of the state) to profit from the social and political life, the profit is the rent. These actions sometimes take the form of rent seeking practices. The concept of active rent seeking should be referred to the situation in which resources to obtain the monopoly rent – this is described by the **rent seeking theory**. This theory justifies the actions taken by entities unlike the Pareto optimum concept, where the issue is to improve one's condition at the expense of the condition of other entities. The growth of significance of smaller but well organized groups of interest is enhanced by the phenomenon of rational ignorance of the voters and the random distribution of preferences of disorganized voters. These groups can decide about the results of elections. Politicians are forced to take into consideration the postulates of these groups, which is discussed in more detail by the **Downs's theory of democracy**. This theory superimposes the abstract assumptions of the free market on the political market. In reality, political markets are dominated by smaller but well organized private groups of interest. These phenomena explain the domination of particular interests over the public interest (hard to identify)⁹ in many areas of economic activity. M. Olson also draws the concept of the 'dominating interest' related to a given institutional system (Olson 1982). **W.A. Niskanen's theory of bureaucracy** can also be helpful in institutional analysis (Niskanen 1996). Bureaucrats are always in favor of a larger institution of the state, various types of agencies and offices. It is in the interest of bureaucracy to increase the number of delivered services. The quantity of supplies may exceed the social optimum or the supplies may be delivered at excessive prices. The functions of the usefulness of bureaucrats are, in general, not compatible with the public interest.

At the third level there is, in particular, the transaction costs theory and the theories of contracts. This is also the place of the theory of corporate supervision.

It is the **theory of contracts** that draws our attention to the problem of completeness of incompleteness of agreements, transactions and contracts (Williamson 1998: 43–90). Contracts can be signed directly on various markets¹⁰, within organizations (companies) and indirectly e.g. by way of strategic alliances or joint-ventures. The

⁹ Welfare economics for instance made attempts (theoretical and abstract) to identify the public interest in the form of social welfare functions. Welfare economics formulates various proposals for social welfare functions such as e.g. Rawls's function, Nozick's function, Nietzsche's function, Bentham's function, Bergson-Samuels function, Nash's function and Sen's function.

¹⁰ There is the example of the role of unwritten contracts (as grasped by M. Baily, D. Gordon, C. Azariadis or S. Grossman and O. Hart) on the job market. These contracts are free agreements between employers and employees on the employment and payments in the business cycle. The agreement to have lower (stable) wages during good and bad situations signifies employees can also be laid off. These

theory of contracts focuses on various forms of contract, agreements and transactions in terms of such criteria as: completeness of commitments of the parties (complete and incomplete contracts), attitude to risk (classic contracts, implicational and relational), superior-subordinate relations (trade-tender contracts, managerial contracts, rationing contracts), place where contracts are drawn (classic market contracts, bilateral contracts e.g. between a monopoly and a monopsony, internal contracts) or towards the institutional system (contracts as part of the existing institutions and contracts related to new institutions). The theory of contracts indicates methods of counteracting the growth of transactional costs as a result of incompleteness of contracts.

The transaction cost theory by R. Coase and O. Williamson focuses on institutional preconditions for the effectiveness of the market mechanism¹¹. Various classified and described transaction costs are the subject matter of the analysis. Transaction costs can be divided into: ex ante and ex post and market, managerial and public (political and legal) (Furubotn, Richter 2000: 39–67). The level of transaction costs depends on six basic factors: the number of participants in the transaction, market structure (competition, monopoly), description of the resources and assets that are subject to transaction, the type of contracts, the extent to which there is uncertainty as to the action of the transaction partners and the type and form of property.

Transaction costs can be to a larger extent identified with the costs of collecting and processing information. Business activity is preconditioned by access to information, understood as a purchasable good (service). It costs to obtain information – that is why seeking lower transaction costs cannot mean ‘savings’ in spending on access to necessary information. Transaction costs of collecting, processing and using necessary information are the precondition for good business. At the same time, in practice, there are information limitations and phenomena of information asymmetry that are objective and subjective. Creation of institutions is to a larger extent an answer to information limitations and their effectiveness can be expressed

contracts require a certain level to trust from both the parties of the contract, which is an element of social capital.

¹¹ In mainstream economics literature (academic textbooks) the problem of transaction costs is rarely discussed. For instance, there are deliberations on the financial market, e.g. on the equilibrium of the monetary market where the location of the money demand curve depends on the transaction costs. Growth of these costs signifies a growing demand for money and as a result a raise of interest rates. Transaction costs to a larger extent explain the expansion of e-banking and the growth of financial intermediary institutions.

by eliminating these limitations. The type of information channels is of particular importance here, especially in regards to the quality of obtained information, and the information circulation profits and costs balance. The smaller the information limitations the lower the transaction costs. The state can favor this by obliging companies to publish financial reports, determining accounting standards and ensuring access to external investors' information. It is also possible to create special government institutions. Information granting legal regulations and habits do not, however, fully do away with information limitations resulting from opportunistic behavior. A series of institutions can contribute to preventing the negative effects of opportunistic behavior, e.g. the extensive, low-price and available mediation system to adjudicate disputes as a result of the execution of contracts.

The issue of **transaction costs** can be presented as a model by adapting **neoclassical models**. This adaptation requires an assumption that either of the parties of the transaction have no complete information (supplier-client) and that the rationality of the actions is limited. The concept of the transaction function of similar properties to those of the production function can for instance be used here. At the same time the enterprise as the mediator in the transactions can be introduced to the study¹². By treating an enterprise as an institution-organization, one can determine its optimal size following the criterion of transaction costs in relation to production costs. Effective organizations are organizations with lower general costs, total costs production and transaction costs.

Transaction costs contribute to the determination of the proportions of the extent to which the state, market and firms have influencing power as resource allocating mechanisms. The development of markets results from the reduction of transaction costs to the limits where market failure occurs. Transaction costs related to those failures are an argument for organizational coordination of many transactions within the company and not directly on the market¹³. This is the so-called phenomenon of administrative adaptation. Savings on adaptation costs should, however, exceed, the costs of bureaucratic operation and agency costs. Here comes the problem of state regulation and the costs of this regulation. Transaction costs increase when there is more corruption and bureaucracy, and these phenomena are the manifestoes of 'state failures'. The size of the transaction costs influences competitiveness of companies.

¹² Examples of such modeling can be found in the paper (Staniek 2005: 151–155).

¹³ The fact companies exist results from the pursuing transaction cost savings. Companies help rationalize the number of transactions and reduce the unit cost of a transaction. Transaction costs are an important element of discussion for contemporary theories of firms.

This is affected by e.g. safety of economic turnover, effective execution of debts, the scope of debtors rights, functioning of the system of mortgage registers, etc. Seeking transaction costs savings is also manifested in better defined property rights such as dispersed shareholders increases agency costs. If shareholders are dispersed the spending on internal supervision exceeds the profits of having a small block of shares.

The character of the market also influences the level of transaction costs. In some markets (e.g. insurance markets or health benefits market) there is the so-called third party (payer who participates in the process. The payer (state, insurance company) has the basic role to pay for the product or service chosen by the buyer or to buy this product/service on behalf of or for the buyer. Prices are determined not only as a result of buy-sell relationships, but also mediation processes with the decisive role of the payer. The variety of contractual and management structures (not only classic) signifies the variety of methods for determining, controlling and regulating prices. On these types of markets there is a process of transferring the current competition from the *ex ante* to the *ex post* phase. The *ex ante* phase determines the formal and informal conditions to execute the transaction in the *ex post* phase. The level of transaction costs of the selection of the correct contractual and management structures depends on these conditions. Here come the concepts of vertical integration and organization limits. Institutional changes that take place in contemporary economy try to combine the strategies of rivalry and competition of entities with the benefits of collaboration and cooperation (that do not have the characteristics of oligopolistic settings) – multidimensional relation networks. These are flexible institutions that adapt to the changing environment. The state should support the control functions of various institutions so that the cooperation does not change into informal, mafia or oligarchy like connections. Reduction of transaction costs is possible if an effective system of supervision and execution of contracts is selected. These costs are reduced by good legislation.

Corporate governance theory exceeds the analysis of principles of owner's supervision and management determined by the theory of property rights and the theory of agencies. This theory focuses on shareholders and stakeholders. The concept of stakeholders refers to entities of the external environment of a given company, which influence or are subject to the influence of the goals implemented by the company. These concepts are widely used in the corporate and project management (Freeman 1984). Corporate supervision which has owner's supervision as its internal component, takes into consideration the goals stakeholders and shareholders have and the influence of external environment entities, such as capital market institutions or trade unions. To a larger extent, the institutions of corporate supervision

ensure coherence of the so-called institutions mediating on the product markets, production factors markets and the market of financial brokerage. The coherence of solutions requires complementarity of institutions, both in the formal institutions and informal institutions, market institutions and non-market institutions and institutions on various markets. Corporate governance is a system of relations of a given entity with the units of external environment (on and outside the market) and the social organization of the company. A given corporate governance depends on legal regulations, property rights structures, type and rules of owner's supervision and social pressure (Canon 1994).

The fourth level refers to allocation choices and is most visible in the agency theory. This is also the area for such areas of economics as the theory of public choice and welfare economics. The lower the level of deliberations, the greater need for modeling (in mainstream economics) of the analyzed processes and phenomena.

The agency theory studies various types of agency relations (included in nearly every transaction) including relations between the property and the decision-making system where the interactions of ownership and control are important (Jensen, Meckling 1976). The problem of agencies which is the effect of the separation of ownership and management is manifested in the fact that it is impossible to sign a complete contract. The agency theory analyses the complex relations between parties defined as 'superior' or 'principal' and 'subordinate' or 'agent'. Indeed the whole economy creates a network of principal-agent type relations. This refers to, for example, the relations of investors and contractors, owners and managers, managers and workers¹⁴, state and officers, voters and politicians, doctors and patients and many others. The problems of agency are present also as part of financial brokerage institutions, which results from the difference of operational perspectives and managerial assessment, e.g. those who manage pension funds and the perspectives of the funds themselves, that is their members who pay their contributions. In the Polish economy, the interests of the Open Pension Funds (Otwarte Fundusze Emerytalne, OFE) do not have to be and are not completely concurrent with the interests of the Pension Societies (Powszechne Towarzystwa Emerytalne, PTE). The annual reporting and remuneration system can stand in opposition to the effective allocation of assets in the long run. The working horizon of financial managers is shorter than

¹⁴ The problem of agency and asymmetrical information is manifested on the job market in the effectiveness payment model (Kwiatkowski 2002: 179–196). Higher wages are to bring savings in the transaction costs of monitoring every employee and reduce the cost of administrative supervision. It is the precondition of the contract that higher wages result in the reduction of (wage) costs for unit production.

the horizon of long-term investments in the interest of future pensioners. Agency problems take place here together with the phenomena of short-term aversion to loss. This explains, for instance, the high premium for risks, which is some kind of equivalent of too frequent valuation of investment portfolios.

The divergence of principal's and agent's interests in the contracts is assumed. In every one of the above-mentioned cases the agent's behavior influences the principals situation. At the same time, information asymmetry does not allow complete observation of agents' behavior, which results in phenomena called the information rent. **The information rent**, which is the redistribution effect of information asymmetry, is created when contracts are signed by the principal and varying agents. The principal wants to execute the contract at the lowest possible transfer of funds to various agents. Agents, on the other hand, are attempting to obtain the highest possible transfers to execute one task foreseen by the contract. Contracts are signed when on the one hand agents reveal production costs and then the principal offers a contract. Agents reject or accept the principal's offer. The condition that must be met for the agent to accept the contract is that the agent's profits will be higher than if the agent independently acted on the market or accepted other contracts offered. In the principal-agent model this is called 'agent participation forcing'. In the conditions of full information it is possible for the principal to differentiate a better agent from a worse agent. A better agent is characterized by lower production costs. In the situation of incomplete or asymmetrical information, a better agency can be interested in increasing production costs excessively. Better agents pretend to be worse to obtain relatively higher transfers than the production tasks would require. In the conditions of informational asymmetry, the set of offered contracts is not concurrent in terms of stimuli. The size of the information rent, which is appropriated by the better agent, depends on the size of the production of the worse agent. Limitation of this type of phenomena entails costs of agent monitoring and prolongation of the time horizon for the transactions. Information rent can also be reduced by developing auction markets, where contracts are implemented in various forms by e.g. auctions, written bidding or Dutch auctions. Information transaction costs can also be reduced by developing various forms of market intermediaries (Laffont, Martimort 2000). The agency theory underlines the need to differentiate institutions in the economy. Institutional and organizational solutions in the economy should aim at agency costs reduction and a greater compatibility of agent's and superior's goals. The issues of information rent and the general balance of costs and benefits in the agent-principal relations indicate on the basic problems of effective institutional solutions, which is the issue of optimal property structure and owner's effective supervision.

In market economy, production factor's resources are mainly located and based on market mechanisms. These mechanisms are in general more effective than **political mechanisms**, where particular interests are expressed strongly. A given part of production resources is, however, subject to allocation outside the market by the political mechanism of a complex character (Buchanan 1997: 21). These problems are in the **theories of social choice** (normative theory of choice) and **public choice**. These theories are based on the assumption that the extent of non-market political decision is minimal and market methods are used to make collective decisions. Collective decisions make sense when the market way of supplying goods and services is more costly or completely impossible. The mechanism of social negotiations and agreements is applied in practice. The rules and methods of voting are chosen (majority, unanimity, sequential elimination method, Bordy method and others) and this is accompanied by various paradoxes (e.g. Arrow's impossibility theorem, Condorcet's paradox and others).

Welfare economics attempts (theoretically and abstractly) to identify public interest in the form of social welfare functions, which was discussed earlier. Accepting these welfare functions as the general guideline in economic polity has various social and economic results (Acocella 2002: 79–87). These effects are analyzed in the context of mutual 'effectiveness' and division relations. Welfare economics determines the criteria of social choice as adapted to various institutional systems. Selection of a given institutional system, ways of taking collective decisions (e.g. as regards the quantity of supplied public goods), analysis of the political market, economic problems of the authority (e.g. mutual relations of the legislature, the executive and the judiciary) or the analysis of groups of interest are examples of areas of study for the **theory of public choice**. Strong institutional accents are observed in the so-called '**new political macroeconomics**', which is a synthesis of macroeconomics, theory of social choice and games theory (Snowdon, Vane 2003: 73). This is expressed in W. Nordhaus's theory of political conjunctural cycle or A. Alesina's theory of rational program differences. Representatives of this economic trend underline the significance of the central bank and social control of fiscal policy (which has been accepted by mainstream economics). The role of stable rules in state economic polity at the expense of discretionary polity should be related to this issue. Application of rules limits opportunism in the behavior of entities, limits rent seeking practices, reduces discretionary decision-making, limits short-term influence of politicians and ensures better transparency and foreseeability of polity. The rules may, however, 'stiffen' potential ways in which the economic polity can react to unexpected economic shocks. The effectiveness of the fiscal and monetary polity depends to a large extent on

the institutional preconditions for **financial stability**, which is in turn an expression of institutional equilibrium¹⁵. This stability is manifested in the proper policy of the Central Bank, effective system of bank supervision and to a wider extent supervision over various segments of the financial market and the safety of business entities' deposits and savings in the financial system institutions. The role of financial brokers (markets and financial institutions) is important because they enhance relations between saving and investing entities in the conditions of information asymmetry. The need to regulate the financial market (regulated much stronger than the other markets) by the state results from the inclination of financial brokers to take too high risks and using their advantage resulting from information asymmetry.

There is an interest to protect the interests of other entitle, especially those who save and to maintain a required financial liquidity in the whole economy. Therefore, the cases of bankruptcy of financial system entities should be limited so as not to protect constantly ineffective entities but to ensure the safety of operation of the whole financial system.

Problems of allocation in the area of goods: market, social, club and public goods, are shown both in the model and abstract way and in the descriptive way. Models fitted with institutional factors become less abstract and can be used more in practice. Their analysis can serve to make rational institutional choices, including the drawing of various rules and norms. There is, therefore, a problem of the structure of rules and they are congruent with potential events, such as supply and demand shocks (Taylor's rule in monetary polity).

Determination of the effectiveness of the institutional system in relation to institutional equilibrium is one of the key problems of institutional economics, which is to serve economic growth. To be determined this issue must include the output of analysis of all four levels described above. This can be called the need for synthesis of achievements of various trends of institutional economics. It is important in this synthesis to include the specific character of a given institutional system. In practice there are attempts to impose the Anglo-Saxon institutional system to other countries in international economy in the name of 'objective globalization processes'. The experience of many countries shows that import of institutional solutions is limited.

¹⁵ Institutional equilibrium manifests itself in the set of institutions and their interrelations that permit implementation of the basic functions of the institutional system. This equilibrium signifies a relative stability of the institutional environment of economic entities in case of varying conditions. The equilibrium has various dimensions and levels, such as the coordination equilibrium of various groups of interest.

For an **institutional system to be effective**, it must have a coherent system of institutions increasing the rate of adaptation of the economic system as a whole. **The effectiveness of an institutional system** is linked with a complex theoretical issue of **economic effectiveness** interrelations (e.g. Pareto optimum), **social effectiveness** (function of social welfare) and **political effectiveness** (e.g. the balanced influence of groups of interest, the stability of power in the conditions of democratic elections). The problems of effectiveness are studied by various branches of institutional economics; there is still no 'effectiveness synthesis'. The richer the institutional infrastructure the higher the effectiveness of business, adaptation effectiveness included. The limited rationality of entities and the dominating customs have a decisive influence on choices made and the rules of cooperation (contract-making) towards 'better' solutions. The better solutions are a manifestations of the adaptation effectiveness of the institutional system (Staniek 2005: 125–180). Adaptation effectiveness is a institution systems ability to solve social and economic problems. D. North enumerates the problems: a society's ability to accumulate knowledge, ability to generate innovation, to release the inclination to take risks, to free entrepreneurial behavior or eliminate bottlenecks in the social system (North 1994: 80). All this is to serve economic growth. The basic indicator of adaptation effectiveness is when institutions that reduce transaction costs are implemented while a series of limiting conditions are met, these include the need for necessary information, the level of social capital and the creation of institutions that coordinate economic activity.

The effectiveness of institutional changes on all markets is mainly manifested by better relations between the transaction parties. Ineffective institutions may cause accumulation of unwanted phenomena that are also an indicator of lack of equilibrium, and these include unemployment on the job market, excess or insufficient quantity of goods, undesired changes of interest rates and 'missed credits', etc. It is the main role of the operating institutions to link supply and demand of goods (services) on a given market better. On the job market this may be indicated by the so-called parameter of effective adaptations at the Beveridge curve, with the institutional factors such as labor law, operations of job centers and other entities, employment protection rate, negotiation system, social protection or the level of minimal wages, being of basic importance.

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