



The nature of institutions in a process approach

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Abstract

Motivation: The importance of institutions, understood as common social norms (process approach), is undeniable. As they affect all processes occurring in the economy, it seems crucial to gain a thorough knowledge of their nature. Understanding how institutions work, how they function and how they change would allow for a better explanation of many socio-economic processes occurring in production, exchange and consumption.

Aim: The main purpose of this article is to conceptualize institutions in the process approach and to identify the most important features that characterize them. The paper is theoretical and interdisciplinary in nature.

Results: The result of the analysis carried out in this article is the identification of the following characteristics of institutions in the process approach: universality, heterogeneity (originality), endogeneity, variability over time (spontaneous and constituted), dependence on the past (historicity), immateriality and direct non-observability. The study also allowed to identify the following features of the institutional system: internal complexity and internal interdependence, which can take the form of relationships of substitutability, complementarity or mutual exclusion.

Keywords: institutions; features of institutions; institutional economics

JEL: B50; E02; O43

1. Introduction

Economics has for many years been unable to adequately explain the variability of processes in the economy. The mainstream schools were based on many un-

realistic assumptions, the existence of which significantly limited the research perspective (Colander, 2000, pp.134–135). A better understanding of economic processes was made possible by the institutional trend, which placed institutions at the centre of the research. Despite the early stage of development, this school already substantially contributed to a better understanding of the processes occurring in the society, thus becoming a crucial element of contemporary economic theory (Searle, 2005, p. 22).

For many years institutions were subject to the *ceteris paribus* rule in economic research. They were treated as constant over time, or even in extreme cases, it was assumed that their influence on the progress of processes occurring in the economy was negligible. Since the 1990s, the phrase by North (1992, pp. 477–479): “institutions matter” has been repeated like a mantra. Today, there is no doubt that institutions are among the most important categories in the social sciences.

Institutions constantly accompany all processes in the economy. They determine possible solutions, create opportunities, but they also define the limits of individual functioning. They create a safe field of interaction, allowing for increased predictability of individual behaviour (Iwanek & Wilkin, 1997, pp.18–20). Moreover, not only do they generate incentives that affect the behaviour of individuals, but also shape their mentality as well as identity (Douglas, 2011, p. 64). The importance of institutions in the economy and society is undeniable: therefore, their thorough understanding seems to be an important research objective.

The main purpose of this study is to conceptualize institutions using a process approach and to identify the most important features that characterize them. The article is theoretical and interdisciplinary in nature.

2. Literature review

Defining the term “institution” is a problematic task. Although the concept has a long history, dating back approximately three hundred years in the social sciences (Hodgson, 2006, p. 1), there is still no consensus on what exactly it means. The difficulties in conceptualising institutions are related to their multidimensional and interdisciplinary nature. In general, there are three main (Scheme 1) ways of defining institutions within the social sciences (Staniek, 2017, p. 35):

- institutions as customs, patterns, rules, principles, norms, and constraints, which may be formal or informal, that are embedded in a society and influence all socio-economic processes (process approach);
- institutions as organisations (entity approach);
- institutions as both norms and organisations; following the principle that “every organisation is an institution, but not every institution is an organisation” (Hodgson, 2019, p. 226) (process-entity approach).

The process approach to institutions is the most used within the institutional school. Its essence is the treatment of social norms as elements constantly accompanying all processes occurring in a society. One of the first, if not the first, definition of institutions in the process approach is the one formulated by Veblen (1924, p. 101), according to which “an institution is of the nature of a usage which has become axiomatic and indispensable by habituation and general acceptance”. Moreover, they are “(...) products of the past process, are adapted to past circumstances, and are therefore never in full accord with the requirements of the present” (Veblen, 2016, p. 88). According to Veblen’s definition, institutions are established customs, as well as patterns of behaviour. On the one hand, they are established ways of thinking, assimilated by society, which, over time, become an integral part of human mentality (Gruszevska, 2013, p. 112), and on the other hand, they are patterns chosen by individuals, based on which decisions of individuals are made (Khalil, 1999, p. 66).

In a similar way, institutions were defined by Durkheim (1982, p. 5), who identified them as “certain ways of acting (...) impostem, or at least suggested from outside the individual and (...) added on to his own nature”. In his theory, institutions were defined as beliefs, ways of behaviour, values, and social facts which shape human conscience. In his view, the science of institutions, their formation, functioning and change, was sociology (Thompson, 2002, p. 41). Durkheim stated that, sociology is the science that investigates institutions: their formation, functioning and changes (Thompson, 2002, p. 41).

One of the most frequently mentioned and at the same time most important definitions of institutions in the process approach is the one developed by North (1990, p. 3). Nobelist defined them as “the rules of the game in a society or, more formally, (...) the humanly devised constraints that shape human interaction”. According to North (1984, p. 8), not only are institutions a set of written rules and regulations, but also moral and ethical unwritten norms. His definition indicates that institutions can be of two natures. They can take the form of written, legislated rules, or exist in the form of unwritten, customary social norms. His theory distinguishes two basic groups of institutions: formal and informal. Additionally, an important element of the institutional set-up is the mechanisms that support the enforcement of both formal and informal rules (North, 1992, p. 447).

Original definitions of institutions from a process perspective are also presented by other institutionalists. Ostrom (2005, p. 3), defines them as “the prescriptions that humans use to organize all forms of repetitive and structured interactions, including those within families, neighbourhoods, markets, firms, sports leagues, churches, private associations, and governments at all scales”. Whereas Aoki (2007, p. 6), in his definition emphasises the self-regulatory (“self-sustaining”) character of institutions, claiming that they are “self-sustaining, salient patterns of social interactions, as represented by meaningful rules that every agent knows and are incorporated as agents’ shared beliefs about how the game is played and to be played”. Whereas Searle (2005, p. 22)

believes that institutions are “any collectively accepted system of rules (procedures, practices) that enable us to create institutional facts”.

The second approach, less frequently (even marginally) used in institutional research compared with the process perspective, is the entity approach. That understanding reduces the meaning of institutions only to different types of organizations (entities) and is characteristic for colloquial and everyday speech (Gancarczyk, 2002, p. 82). More often, one can meet the process-entity, than entity approach, which is particularly characteristic of representatives of neo-classical economics and legal sciences. According to this way of defining institutions, social norms are equated with organizations.

The process-entity approach is commonly encountered in the works of New Institutional Economics’ representatives. According to Williamson (1985, p.19), institutions, apart from social norms, are also firms. In his theory, the term is used to describe both firms and the contracting rules associated with them. Hodgson (2006, p. 2) defines institutions as “the kinds of structures that matter most in the social realm: they make up the stuff of social life. (They are — M.B.) systems of established and prevalent social rules that structure social interaction”. Among their examples he mentions: “language, money, law, systems of weights and measures, table manners, and firms (and other organizations)”. Hodgson (2019, pp. 226–227) makes it clear that, in his opinion, every organisation can be specified as an institution, but not every institution can be defined as an organisation. Stiglitz (2001, p. 19) pointed out that the concept of “institution”, semantically limited only to norms and social rules, is not meaningful enough. According to the Nobelist, organisations are also institutions in contemporary economic thought.

Although the process-entity view of institutions is standard in New Institutional Economics, there is a tendency within contemporary institutionalism to separate the concept of “organization” from “institution”. That division seems essential for building a theory of institutions, and in particular of their changes¹ (Bouma, 1998, p. 234). Organisations, despite their strong connection with institutions, are not them — they are only their kind of superstructure (Owczarczuk, 2013, p. 35). North (1990, p. 4) wrote that the relationship of institutions and organizations can be described as a relationship of the rules of the game and its participants. Institutions are a set of rules of conduct, while organisations are material entities with offices, workforce, budget and, most often, legal personality (Parto, 2005, p. 24).

Within institutional theory, there are also many other approaches to defining institutions, that are complementary to those previously presented. In that perspectives institutions can be understood as:

¹ It should be noted that organisations are the agents, whereas it is the institutions that are the subject of institutional change.



- a collective action of different actors (Commons, 1924);
- a state of equilibrium in a social game (Hindriks & Guala, 2015, pp. 463–464), it is a specific outcome of the behaviour of individuals, which has achieved in an autonomous way (Aoki, 2007, p. 8);
- the market, or more precisely its mechanism, which influences people’s behaviour (Wilkin, 2016, p. 104);
- a cognitive script, sign and cultural symbol, which shapes people’s behaviour, mentality and identity (Czech, 2019, pp. 36–37).

In this article, the process approach of defining institutions is applied. This understanding of social norms takes priority over the others. Institutions, in contrast to organisations, are universal — they accompany all processes taking place in the economy (Iwanek & Wilkin, 1997, p. 19). Entities have a specific, limited area of activity, which is connected with their much weaker impact on the development of the economy.

This paper considers institutions to be relatively persistent, with universal formal and informal norms, customs, rules, principles, and constraints, that are embedded in society, shaping human behaviour and relations in the economic, social and political spheres. This definition is eclectic and interdisciplinary in nature — it derives from both the Old and New Institutional Economics traditions.

The importance of institutions in the economy is indisputable. They give a sense of activity to all individuals in the economy, create a safe area for the interpersonal and interorganisational relations, and thus contribute to increasing the predictability of behaviour of other entities. Moreover, they determine permissible solutions, create opportunities, but also set boundaries for individuals in society (Gruszevska, 2013, p. 136). In addition to regulating and stabilising economic processes, they serve many other functions. These include (Bal-Woźniak, 2012, pp. 133–134): an cognitive function (they make it possible to gain knowledge about the socio-economic environment, they are a reflection of people’s mentality), an integrating function (they integrate and strengthen interpersonal relations) and an efficiency function (they make it possible to improve the welfare of entities without worsening the situation of other individuals).

Social norms play also an essential role in reducing transaction costs and improving information flow. Their high efficiency contributes to increasing the predictability of behaviour and, consequently, to the creation of a relatively safe field of interaction, which provides the best conditions for production, exchange and consumption in society (Dobler, 2011, p. 21).

3. Methods

The article applies a critical review of institutional literature and descriptive analysis as research methods. The qualitative analysis method used in the paper is based on logical inference and the interpretation of existing theory models.

The article summarizes and organizes institutional theory and is theoretical as well as interdisciplinary in nature.

4. Results

Understanding the nature of institutions in a process approach, which is identifying the features that distinguish them, is crucial for a better understanding of the socio-economic processes occurring in contemporary economies².

Unlike organisations, whose scope is most often limited, institutions influence all relations taking place in the economy. The universality of institutions means that they are regulators of all relations of different nature — economic, political, social, etc. (Vitola & Šenfelde, 2015, p. 278). The action of institutions cannot be avoided in any way. Every individual, regardless of whether one wants to, functions within the influence of institutions.

An important feature of institutions in the process approach is their heterogeneity (originality). Each social norm is original: it is impossible to find two identical rules. In economic practice, there is the phenomenon of “transplanting” institutions from other economies, that is, de facto copying efficient institutional solutions (Owczarczuk, 2013, p. 33). It should be noted, however, that this process never leads to taking norms in a one-to-one manner, only their certain mechanism (way of operation) is imitated. Exact reproduction, even copying of institutions is unlikely to be associated with any positive effect, because as Gruszewska (2018, p.146) notes: “Each country needs its own, country-specific institutional solutions, which will be adequate to the local conditions, legal regulations, and cultural factors”.

Institutions have for many years been considered in economic theory as emerging exogenous to society, which can be considered a significant omission. However, social norms are characterised by their endogenous emergence (Dinar & Aydin, 2010, p. 280). Institutions arise and change within the economy, as a product of conscious (legislated rules), or not (informal norms), human activity. Thus, they originate in an evolutionary, spontaneous way or they are consciously created, as instruments regulating various aspects of socio-economic life (Wilkin, 2016, p. 99).

An inherent characteristic of any institution is its variability over time. Social norms are subject to a process of change, which consists of a “constant ‘clash’ of the rules and their adaptation to social interactions” (Gruszewska, 2011, p. 41). The incentive for their change can come from a wide range of socio-economic phenomena that range across society. As institutions are heterogeneous in nature, the mechanism of institutional change is also completely different for each social norm. They can evolve through (Mazur, 2013, p. 40): design (teleological creation or reconstruction), adaptation (adjustment under pressure from society), diffusion (spontaneous dissemination of norms and patterns of behav-

² The author first attempted to identify the characteristics of institutions in the following publication: Borkowski (2022).

ior), or differentiation and selection (change based on experience, learning). Thus, the institutional variability can take the form of spontaneous (self-determination, self-regulation) or constituted (creation and external modification) nature.

Change does not always mean complete replacement of existing institutional solutions with new ones. It can take many forms (Table 1). Institutional theory distinguishes at least five types of institutional change (Streeck & Thelen, 2005, p. 31):

- displacement — the complete replacement of the existing institutions with new ones: this form of change results in the substitution of past, outdated rules with new ones that are better suited to present socio-economic realities;
- exhaustion — over time, institutions cease to be valid, rules become outdated, and new norms do not emerge in their place, because the area they regulate has significantly lost its importance in the economy;
- layering — complementing the institutional structure with new social norms that help to seal it and strengthen it;
- drift — modification of existing institutions due to significant changes in the environment, adapting the rules to the present conditions;
- conversion, which involves a complete transformation of institutions: it is a change in the nature and mechanism of existing social norms.

An important aspect in the analysis of institutional change is the concept of *path dependence*. This is the link between the dynamics of a process and its initial conditions (Liebowitz & Margolis, 1995, pp. 205–206). The shape of current institutions is strongly related to past institutional solutions (Hodgson, 2014, p. 601). A consequence of this is the high persistence of social norms (especially informal ones), the persistence of which is strongly influenced by historical and cultural conditions. A strong stimulus that leads to a modification or a complete change in the trajectory of institutional development is necessary to change the adopted path (Urbanek, 2020, p. 101). On this basis, another feature of institutions can be observed, namely their dependence on the past (historicity).

Another feature of institutions in process approach is their immateriality. Institutions cannot be directly observed. As Ostrom (2008, p. 822) notes, they are invisible. The lack of materiality makes institutions directly unobservable. It is not, and probably never will be, possible to measure the efficiency of their functioning accurately quantitatively. Institutional theory distinguishes three, main perspectives for assessing the quality of institutions (Milczarek, 2006, pp. 22–23):

- verification as to whether institutions effectively fulfil the functions for which they were created;
- assessment of the efficiency of institutions from the point of view of their impact on the process of redistribution of income in the economy;
- assessment of the quality of institutions from the perspective of their impact on the process of economic growth and development.

In practice, there is another, complementary and more universal (allowing the efficiency measurement of both constituted and spontaneous norms) approach to measuring the quality of institutions. Namely, in assessing the quality of institutions one can use quantitative measures, developed by international statistical organisations (for example: World Bank, Fraser Institute, Heritage Foundation, and Freedom House). Such measures are increasingly used in quantifying the efficiency of institutions. However, it should be noted that they are subject of criticism from the institutionalist. Doubts are related to the methodological side of creating these measures: in particular they are connected to (Giannone, 2010, p. 69; Kurtz & Schrank, 2007, p. 543; Voigt, 2013, p. 22):

- the lack of transparency in the presentation of raw data;
- the lack, or partial information, on how research was funded;
- the method of data collection/creation (surveys vs. expert opinions);
- (too) high level of aggregation, which leads to the creation of new, abstract, unspecific and imprecise terms (e.g., dimensions of institutional performance);
- the preference for deregulation and purely free-market solutions.

Abstracting from the great aversion of institutionalists (and others) to these measures, their use can be a valuable complement, as well as extension, of institutional analyses (Hodgson, 2014, p. 592). However, it should be borne in mind that institutional quality measures are only a certain, inaccurate approximation of socio-economic reality, and not an exact reflection of it, so the interpretation of obtained through them, should be carried out with great caution (Alonso & Garcimartín, 2013, pp. 210–211).

Social norms in the economy are organised into a certain structure. Every economy has a system whose elements are universal, heterogeneous, endogenous, variable over time, and directly unobservable and intangible institutions. In addition to the features concerning the institutions themselves, those concerning the institutional system can also be distinguished.

The first feature of the institutional structure is its internal complexity. Every institutional system is composed of many groups of institutions, among which it is possible to distinguish individual social norms, which have their own elements, and so on. Many divisions of the institutional structure can be distinguished in the institutional literature. North (1992, p. 447) is the author of one of the most popular classifications of institutions in terms of how social norms are formed. He divided the institutional system into two groups of social norms: constituted, written formal norms, whose obedience has the character of external coercion; and strongly rooted, not written and spontaneous informal rules. In the group of formal norms, one can distinguish such institutions as: legal order (including: the system of property rights), or regulations (e.g. of economic activity); while among informal ones: culture (including economic culture and social capital), religion and beliefs, patterns of behaviour, and so-called “mental models” (Fiedor, 2015, pp. 93–94).

Another example illustrating the internal complexity of the institutional system is its division by Williamson (2000, p. 597), according to the increasing rate of change of social norms. This view distinguishes four main groups of institutions³:

- embeddedness, the elements of which (customs, traditions, religious norms, morals and ethics) change over a period of 100 to 1000 years;
- the institutional environment, i.e., the rules of the game, politics, ownership and bureaucracy, which change over a period of 10 to 100 years;
- governance: play of the game (contracting, transactions, cooperation and supervision), which changes at a slightly faster pace, estimated at between 1 and 10 years;
- resource allocation and employment linked to price changes and the creation of market incentives, which change continuously.

The institutional system is dynamic. Not only are its elements, that are institutions, subject to constant change, but they also interact with each other. On this basis, another feature of the institutional structure can be identified, which is its internal interdependence (Moszyński, 2013, p. 288). The following types of relationships can occur between social norms⁴:

- complementarity — social norms can complement and reinforce each other, improve mutual functioning as well as stability (Höpner, 2005, p. 333), with the aim of jointly contributing to a given institutional outcome (Amable, 2016, p. 82); institutional complementarity most often consists in complementing formal norms, with the informal ones, that “‘fill in gaps’ either by addressing contingencies not dealt with in the formal rules or by facilitating the pursuit of individual goals within the formal institutional framework” (Helmke & Levitsky, 2004, p. 728);
- substitutability — institutions can replace each other; institutional substitution takes two forms: 1) replacement of outdated institutions with new ones, that are better adapted to the conditions of the present (Gruszevska, 2011, p. 55) and, 2) functional substitution, which is related to the coexistence of different rules that enable the achievement of specific, the same institutional outcomes (goals)⁵;

³ The proposition of Williamson can be considered as an extension of North’s division of the institutional system. The informal institutional subsystem is embeddedness, while the other groups, that is the institutional environment, governance and resource allocation and employment make up the formal institutional subsystem.

⁴ Relationships can exist between: 1) formal norms among themselves; 2) informal rules among themselves; and 3) between formal and informal institutions.

⁵ In practice, there are different patterns of conduct, so-called “normative sets”, which enable individuals to achieve the same objectives, but may differ in the elements that condition their realisation (Chmielnicki, 2014, p. 12). Thanks to institutional substitutability, there are multiple paths leading to an identical institutional outcome. It is therefore natural that actors will choose a path using the criterion of minimising transaction costs.

- competition (mutual rivalry or exclusion) — social norms can also be a barrier to the functioning of other ones in the institutional system, they can limit each other or mutually weaken incentives for interaction, and also they can compete with each other (Leković, 2011, p. 364); it seems that this is a type of institutional interdependence, which indicates a state of strong disintegration of the institutional structure (Sukiennik et al., 2017, p. 131);
- non-dependence — that is, coexistence of social rules (ignoring or being neutral towards other elements of the institutional structure (Pejovich, 1999, p. 170)), which is the least common form of internal institutional interdependence;

The identification of the type(s) of institutional interdependence(s) is not a simple task. This is the case for at least the following three reasons:

- simultaneous functioning of many social norms in the economy;
- the dependence of institutions on too many external conditions — for example: time, place, or community (its mentality, knowledge, preferences);
- institutions, or more precisely the bundles of stimuli they induce, generate cumulative effects (Robinson, 2013, pp. 28–29).

The category of institutional equilibrium (order) is closely related with the internal interdependence feature. The continuous adjustment processes between social norms indicate that the institutional system is in constant disequilibrium. Institutional order, that is the state of stability, permanence, transparency, compatibility and efficiency of the institutional system, is a fundamental factor that dynamises the activity of individuals in the economy (Zenka, 2009, p. 245). Institutional coherence is essential — incentives generated by elements of the institutional system should have the same, and not mutually exclusive, direction of influence (Platje, 2008, pp. 146–147). It is preferable to create institutions that are complementary or substitutive, but not competitive, with the others⁶. Institutional structures should aspire to achieve equilibrium, that is a state in which (Wilkin, 2011, p. 32): all the needs of the members of society are balanced, the continuity of the prevailing rules and mechanisms is guaranteed, and a high degree of predictability of the behaviour of other members of the community is ensured.

5. Conclusions

The main aim of the paper was to conceptualise institutions in process approach and to distinguish their most important characteristics. A review of the institutional literature indicates that there are many approaches to defining insti-

⁶ The cooperation of the elements of the institutional system is much more important than the individual efficiency of the selected institutions. As Gruszevska (2015, p. 62) notes: “(...) the most important cross-section is not the efficiency of individual institution, but their cooperation (...). Activity undertaken in the economy will then be realised under conditions of low transaction costs and relatively high predictability of the behaviour of other units”.

tutions. There are basically three perspectives of understanding this category: process-oriented, entity-oriented, and process-entity-oriented. In institutional theory, there are also definitions complementary to the previously mentioned—among others, the term “institution” is given to: collective action, social game equilibrium, market mechanism or scripts, signs, and cultural symbols.

The paper adapts the author’s process-based definition of institutions, according to which they are relatively permanent, universal social norms embedded in society, whose functioning shapes human behaviour and relations in the economic, social, and political spheres. The choice of the process view of institutions was not random. This understanding seems superior to the others for two main reasons:

- it enables the proper construction of institutional theory (especially of institutional change, where an important aspect is the separation of institutions — subject of change — from organizations — entities of change) — as an advantage over the process-entity approach;
- the universality of social norms — the area of influence of institutions is not only much larger, but also stronger, than that of organisations (entities) — as an advantage over the entity approach;

The result of the analysis carried out in this article is the identification of the following characteristics of institutions in the process approach: universality, heterogeneity (originality), endogeneity, variability over time (spontaneous and constituted), dependence on the past (historicity), immateriality, and direct non-observability. The study also allowed to identify the following features of the institutional system: internal complexity and internal interdependence, which can take the form of relationships of substitutability, complementarity, or mutual exclusion.

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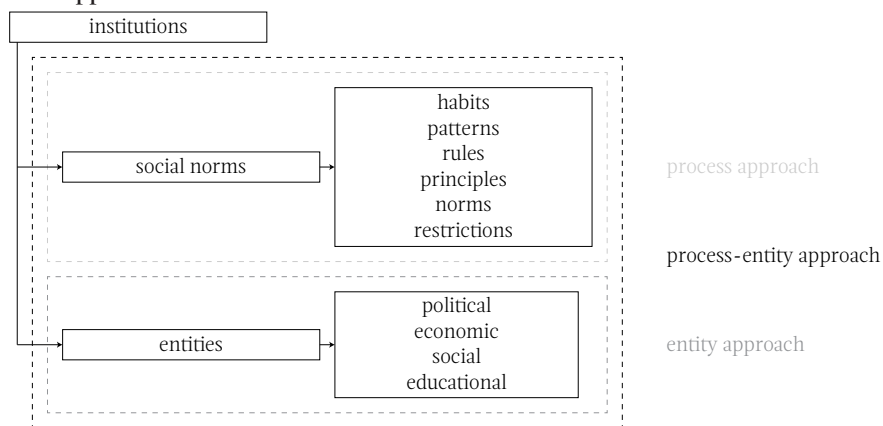
Appendix

Table 1.
Types of institutional change

Specification	Displacement	Exhaustion	Layering	Drift	Conversion
removal of old rules	yes	yes	no	no	no
neglect of old rules	–	–	no	yes	no
changed impact of old rules	–	–	no	yes	yes
introduction of new rules	yes	no	yes	no	no

Source: Own preparation based on Mahoney & Thelen, (2010, p.16).

Scheme 1.
Main approaches to institutions in the social sciences



Source: Own preparation.