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Corporate governance in new institutional economics

Key words: asymmetry of information, selected schools of new institutional economics, enterprise management

S u m m a r y: The theoretical outline of the issues which constitute the essence of corporate governance research is settled in the theories of the new institutional economics. The theory of contracts, the theory of agency, economy of transaction costs and the theory of rights of ownership are presented with the phenomenon of asymmetry of information which appears in various aspects of functioning of a company. The conclusion from the analysis within this paper is the statement that corporate supervision in any company is strongly determined with the specific nature of the activities of all its parties: the hierarchy of their objectives, expectations, competencies, willingness to undertake risk, thus including also stimulation of the level of asymmetry of information, using mechanisms of compensation or motivations used for drawing benefits from using private information.

1. Introduction

In a world with perfect information, there would be no need for existence of a specific social and economic entity that a company is. The company is an institution arising in response to the problem of lack of the complete information which business entities face.

This paper is an attempt at presentation of multi-aspect relationships arising with the origin and evolution of a company. Enhancing neoclassical analyses related to companies was to open a road for scientific exploration of the consequences of asymmetry of information existing in management. The theoretical outline of the issues which constitute the essence of corporate governance research is viewed in the light

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of such theories developed within the new institutional economics as: the theory of contracts, the theory of agency, economy of transaction costs and the theory of rights of ownership. Such approach to the issues of corporate governance deviates from two theoretical perspectives of the analysis of corporate supervision: institutional and strategic choices, although it brings additional cognitive valour into it. The institutional and strategic choices approaches constitute the ground for six theories of corporate governance: the theory of resources, the stakeholder theory, the theory of agency, the theory of steward, the institutional theory and the theory of managerial hegemony (1).

2. New institutional economics

The premises of the new institutional economics, such as: perceiving a company as a managing unit (non-producing), thus focusing on the organisational aspect (non-technological); perceiving an institution, along with economic effectiveness, as a result of human actions; introduction of transaction as a unit of analysis and recognising the costs resulting from conclusion of agreements; including costs of information and accepting the existence of unbalanced access to information, make the undertook research basically different from those undertaken within the neoclassical approach (2). Additionally, the research conducted within the new institutional economics are based on the assumption of a limited rationality and opportunism of behaviour of the observed entities. Opportunistic and not fully rational behaviour of business entities result from the phenomena of complexity and uncertainty which are related to business processes.¹

The schools arising on the ground of the new institutional economics share the attitude to the issue of social coordination addressing solution of the problem of rare resources as the departure issue in the research. These issues are reflected in the analysis of the institutional basis of the economy as a determinant of transaction costs. Transaction costs and institutions are the two dimensions of the issues related to coordination of activities of business entities. The element which is common to all the trends in the new institutional economics is the presence of the phenomenon of scarcity of information, in the form of asymmetry or incompleteness (3).

¹ Omitting the institutional aspect of the process of exchange in the neoclassical analyses was its source in keeping the assumption about instrumental rationality. The analysis of transactional costs expands studies in economy on functioning of companies which were earlier focused on technology and on the costs of production or distribution.

3. The economic theory of contracts²

The theory of contracts analyses stimuli and their structure as elements which determine the structure and results of a contract. The contract is an institution aimed at preventing opportunistic behaviour and limitation of rationality. The absence of inclinations in business entities to behave in an opportunistic way would make a contract a useless institution (a promise or a general clause would be sufficient). Under conditions of the combined existence of limited rationality, opportunism and specific nature of assets, planning turns out to be incomplete, promises are broken and the identity resulting from the specific nature of assets gains in significance. Despite existence of tools used for court settlement of problems resulting from a contract, a large part of activities in enforcement of contracts remains with the private sector institutions. The proper shape of the institutions functioning within the private sector is determined with the organisation of the transaction which makes savings on limited rationality and provides protection against opportunism (2, pp. 80–94).

The economic theory of contract is focused on the process of structuring the contract so as to reflect the structure of the stimuli aimed at achieving the objectives expected by the parties (the theory of agency, the *ex-ante* stage) and in the general process of contractual management (the economy of transaction costs, the *ex-post* stage). The simple division into *ex-ante* and *ex-post* is not always justified. One could try to consider all the possible obstacles or only these obstacles which are really in existence, and deal with them as they appear (2).

The theory of contracts constitutes part of the economics of information and it focuses its research on the possibilities of application of individual contractual mechanisms to cope with asymmetry of information.

4. The theory of agency³

The theory of agency emphasises the stimuli resulting from delegating rights and obligations within organisations (e.g. the principal—agent relation). The following are the three dimensions of asymmetry of information present in the relations between the principal and the plenipotentiary: the temptation of abuse, negative selection and non-verifiability. The temptation of abuse arises under the conditions of lack of supervision of the behaviour of the manager by the owner of the capital, so that the managers may direct the resources under their custody to the areas where personal objectives of the managers may be pursued (different from the objectives of the principal). Negative selection (hidden information) is a significant element in the relations between the principal and the plenipotentiary due to existence of uncer-

² Creator: K. Arrow, developed in 1960s.

³ Creator: K. Arrow, developed in 1960s and 1970s.

tainty and high complexity of the surroundings and the lack of the possibility of full assessment of competencies of the manager and differentiating his/ her bad and good decisions.

The relation of agency consists in entrusting by the principal caring of his/ her interests with a plenipotentiary, as only the latter has the resource of information necessary for maximising the useful functions of the former. The principal offers the plenipotentiary a remuneration system whose objective is encouraging the plenipotentiary to such using of his/ her information that he could act as best as possible in order to maximise the benefits for the principal. The lack of the possibility of observing the activities of the plenipotentiary for control purposes makes the economic stimuli the central element of the agency relationships, and their role seems to be the key one (4).

The essence of the contract between the principal and the plenipotentiary is determination by the principal of the remuneration scheme which will develop the stimuli for the plenipotentiary for acting in line with the interest of the principal as much as it is possible. The reasonable use of the agent's efforts in the activities compliant with the objectives of the principal not worse than the reasonable use of his/ her effort in any other variant (the condition of motivational correctness) and the reasonable use of the work for the principal at least identical with the reasonable use from work in any other place (the condition of participation) are the necessary elements of such a contract (5).

In general, the relation of agency induces an optimisation problem whose subject matter is developing stimuli for action of the plenipotentiary in line with the expectations of the principal. Aversion of risk by the agent is perceived as a normal attitude, principals are understood as entities with neutral attitude to risk, and any deviations from this are ignored in theories. This approach makes analyses of agency relationships static. Taking into consideration alternative motivations of the agent and a broader range of his/ her possible activities (determined with sociological and psychological factors) brings more dynamism into the agency relationships.⁴

5. The economy of transaction costs⁵

The economy of transaction costs focuses its analyses on the *ex-ante* costs of acquiring information before conclusion and execution of the contract and on the *ex-post* risk. Existence of asymmetrically distributed information and assigning meaning to the costs incurred on its reception constitute the core of the transaction costs economics (6, p. 668).

⁴ The assumptions about the difference of objectives of the agent and of the principal and about a strong asymmetry of information give the theory of agency a static nature.

⁵ Creators: R. Coase, 1937; O. Williamson.

The phenomenon of scarcity of information implies the costs of permanent lack, acquiring and processing information. Costs of this type, referred to in the theory of economics as “transaction costs”, are most often present in the form of costs of information search, costs of negotiations, costs of formulation, recording and authentication of the contract (*ex-ante* costs), costs of monitoring, costs of implementation and enforcement of execution of the contract, costs of amicable settlement of disputes, costs of demanding the terms and conditions of the contract in court, costs resulting from impossibility of meeting the requirements of the contract by the parties, costs of contract renegotiation, and costs of protection of rights of ownership (*ex-post* costs).

Transaction costs are understood as a friction present in management processes⁶. *Ex-ante* (costs of information) and *ex-post* (costs of ignorance) transaction costs are mutually dependent and their analysis should cover their entirety. Higher *ex-ante* transaction costs imply lower *ex-post* risk. Despite perceiving the existence of transaction costs mostly as an unfavourable phenomenon, leading to sub-optimal solutions, they are also viewed as a factor reducing risk and encouraging to obtain results close to the optimum (3). The correct analysis of transaction costs requires specification of the nature of exchange, consideration of the possible alternative organisational structures and their assigned stimuli structures (the method of comparative analysis of institution), assessment of the type of relationship between the type of the transaction and the existing institutional solution (in-depth examination of the structure of the stimuli), and attempts at empirical verification of the theses.

Apart from the analytical condition of the transaction costs economics, which is in the form of bilateral dependency (the specific nature of assets),⁷ the central approach to the analysis of transaction costs, specifically the one that emphasises *ex-post* management, is suitable for examining hazards from concluding agreements in general. These dangers may result from weakening of the rights of ownership, complexity of projects which require acquisition of numerous information and which have varied principals, intermediate activities management, reaction in time, strategic abuse, extended hiding, weak institutional environment related to the economic development, weak feeling of honesty in the community. Except for limitations on rationality and opportunism, all these hazards may be eliminated. Aside from the premises of limited rationality of the human factor and its susceptibility to opportunism, the economy of transaction costs indicates the specific nature of assets, uncertainty and frequency as significant elements of the description of the transaction.

⁶This kind of friction was included in the category of costs by R. Coase (7; 8; 9) and clearly named the transaction costs by Marschak and popularised by Williamson.

⁷The problem covered specific investments, different from those whose execution demanded classic market agreements where the parties of the agreement pursued the objectives in generation minimum costs. The difference of the investment resulted from the specific nature of the assets which constituted the subject matter of the executed transactions. This specific nature developed the relation of dependency between the parties of the transaction which forced the necessity of developing the mechanisms of cooperation, thus leading to friction (opportunism slowing down or paralysing changes), and additionally executed under conditions of incomplete information.

6. The theory of rights of ownership⁸

The theory of rights of ownership combines various methods of allocating rights of ownership with the structure of the stimuli. The analyses within the theory of rights of ownership refer to various forms of economic ownership which determine various systems of economic stimuli and motivations, thus affecting various levels of effectiveness of business activities.

Ownership refers to a set of rights to which the business entity is entitled for the purpose of using the assets/ managing business activities with the owned assets. The arrangements in the issues of ownership evolve so as to meet the needs of the production sector, while in financial services this refers to undertaking risk and making decisions. They also include the issues of preferences in the degree of risk of those who provide production expenditures, as well as refer to the needs of coping with the problems of agency which arise in the process of balancing the said needs and preferences. Isolation of ownership and labour in the company constitutes the basic cause of the problem of agency between the employer and the employee. Incurring risk, providing funds and making decisions are potentially separable functions, but they are usually executed jointly in market economy companies. Incurring risk and control over making decisions tend to be connected with the same persons, as the temptation of abuse means that the cost of incurring risk is inversely proportional to the degree of control over the actions of the entity incurring the given risk (10, p. 246).

The issues of the structure of the optimum contract, maximising usability within the principal—plenipotentiary relationships, activities aimed at reduction of transaction costs, and softening the owner—manager dependency all boil down to the crucial issue discussed in the chapters of this paper, that is functioning of a company under conditions of incomplete information. Asymmetry of information in a company is best reflected in the problem of separation of ownership, management and control in the company.

Increasing transparency of activities, including decision processes, optimising the number of plenipotentiaries, and the qualification requirements as the planned consequences of the implementation of corporate supervision systems will reduce the possibility of using asymmetry of information to generate allowance, thus balancing the share of individual stakeholders in the generated income.

The main objective of corporate governance is ensuring the condition in which the managers of the company pursue the objectives set forth by the shareholders and by the board of directors. The problems arising along with separation of the ownership and management functions refer mostly to the differences in motivating, differentiation of the objectives of the owners and of the management of the company, and developing the attitudes towards risk and asymmetry of information in them, as different attitudes to risk lead to achieving different objectives.

⁸Creators: A. Alchian, H. Demsetz, developed in 1970s.

Perceiving the issues of corporate governance on the basis of management dynamics, the activities in a specific social, local or historical environment is indicated as a necessary alternative to the approach which exhibits the objectives and activities or stakeholders or stockholders, where the forms of behaviour are already defined and agreed, i.e. the stockholders model, the stakeholders model, the market and the hierarchy, egoism and altruism, self-regulation and state intervention, etc.: which is called the *processual approach* (11). Thus, the strategic necessity seems to be introduction of the individual approach to examining “own” corporate supervision system in the company. None of the systems of management and supervision (be it dualistic or monistic) will bring about full effectiveness and performance. The case of each company subjected to the corporate supervision is strongly settled in such elements of the process of functioning of the company as: defining and understanding the ultimate objective of the company, expectations and coherence of objectives of the stakeholders, competencies of the members of the company bodies (supervisory boards, boards of directors), tendency to cooperate, and knowledge of proven and modern methods of management, and the results of the actions undertaken within exercising the corporate supervision depend on them (12; 13).

7. Conclusions

Stimulating intensity of asymmetry of information and using the mechanisms of compensation or motivations used for drawing benefits from using private information may determine the development of the company. High costs of multi-level relationships mostly in the areas such as: allocation of free funds, strategy on crisis conditions, capital structure, assigning a degree of independence to objectives and instruments used in managing a company make research in corporate governance an important area of the science of company, whose effective exploration may determine a strongly rooted increase in competitiveness of regions or entire economies.

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Ład korporacyjny w nowej ekonomii instytucjonalnej

Streszczenie: Teoretyczny zarys problematyki stanowiącej sedno badań ładu korporacyjnego zostaje osadzony na teoriach nowej ekonomii instytucjonalnej. Teoria kontraktów, teoria agencji, ekonomia kosztów transakcyjnych i teoria praw własności zostają zaprezentowane poprzez ekspozycję zjawiska asymetrii informacji wyłaniającego się w różnorodnych aspektach funkcjonowania przedsiębiorstwa. Wnioskiem płynącym z rozważań prowadzonych w ramach niniejszego artykułu jest stwierdzenie, że nadzór korporacyjny każdego przedsiębiorstwa jest silnie warunkowany specyfiką działania wszystkich jego interesariuszy – hierarchią ich celów, oczekiwaniami, kompetencjami, skłonnościami do ryzyka – a za tym również stymulowaniem poziomu asymetrii informacji, wykorzystaniem mechanizmów kompensacji czy motywacji służących czerpaniu korzyści z wykorzystywania informacji prywatnych.

Słowa kluczowe: asymetria informacji, wybrane szkoły nowej ekonomii instytucjonalnej, zarządzanie w przedsiębiorstwie
