

# **THE INSTITUTIONAL SYSTEM AS A FOUNDATION OF THE "NEW ECONOMY". THE COMPARISON OF THE UNITED STATES AND SOME CHOSEN COUNTRIES OF THE EURO ZONE<sup>1</sup>**

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**Key words:** "New Economy", institutional system, entrepreneurship culture, venture capital, international openness, competitive intensity, labor market flexibility, transaction costs.

## **Abstract**

After pricking the Internet bubble on the American financial market, some skeptics of the idea of the "New Economy" announced the end of this phenomenon and a fortunate return to the "Old Economy". However, companies dealing with the "New Economy" have already overcome their losses; they seem to be strong again and they have become an even more important development advantage of highly industrialized countries.

The experiences of the first wave of Internet shock suggest that not all industrialized economies were able to harness all potential generated by the positive technological change of the 90's. The United States has become the first beneficiary of the new reality. In Europe only the economies of Ireland, Sweden and Finland have properly harnessed the new conditions, whereas the most important economies of the euro zone: Germany, France and Italy were not able to improve their economic growth.

It seems that some cultural and institutional differences, though underestimated, are very important factors distinguishing the American economy from big European economies that have not been able to harness the potential of the "New Economy" yet. The paper presents a hypothesis that an institutional system is the factor that determines the utilization of the potential of the "New Economy".

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**SYSTEM INSTYTUCJONALNY JAKO FUNDAMENT „NOWEJ GOSPODARKI”.  
ANALIZA PORÓWNAWCZA STANÓW ZJEDNOCZONYCH  
I WYBRANYCH KRAJÓW STREFY EURO**

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**Słowa kluczowe:** „nowa gospodarka”, system instytucjonalny, kultura przedsiębiorczości, venture capital, otwartość na handel międzynarodowy, intensywność konkurencyjności, elastyczność rynku pracy, koszty transakcyjne.

**Abstrakt**

W czasie pęknięcia tzw. bańki internetowej na amerykańskim rynku finansowym sceptycy idei „nowej gospodarki” zdążyli już ogłosić upadek owej koncepcji i „szczęśliwy powrót” do tzw. starej gospodarki. Jednak przedsiębiorstwa związane z „nową gospodarką” szybko pokryły straty i ponownie nabierają wiatru w żagle, stając się coraz ważniejszym czynnikiem rozwojowym gospodarki wysoko rozwiniętej.

Doświadczenia z pierwszej fali szoku internetowego wskazują, że nie wszystkie kraje wysoko rozwinięte potrafiły właściwie wykorzystać potencjał generowany przez rozwój technologiczny lat 90. Pierwszym beneficjentem nowych realiów okazały się Stany Zjednoczone. W Europie właściwie nowe warunki skapitalizowała tylko gospodarka Irlandii, Szwecji i Finlandii, podczas gdy najważniejsza gospodarka strefy euro: Niemcy, Francja czy Włochy, nie odnotowały przyspieszenia wzrostu gospodarczego.

Wydaje się, że istotnym czynnikiem odróżniającym gospodarkę amerykańską od gospodarki europejskiej, która dotychczas nie potrafiła wykorzystać potencjału tkwiącego w „nowej gospodarce”, są różnice kulturowe i instytucjonalne. W opracowaniu postawiono hipotezę, że jednym z istotnych determinantów efektywnego wykorzystania potencjału generowanego przez „nową gospodarkę” jest system instytucjonalny.

## **Introduction**

Within the confines of research on the "New Economy" many papers were written that prove the divergence between industrialized countries and developing ones. That is the result of the acceleration of growth processes in the technologically advanced countries. Nearly all commentators notice that some developing economies, which suffer from serious deficiency of infrastructure and are often in the underdevelopment trap, are not able to harness the potential of the "New Economy". However, little space is devoted to the fact that there are serious differences in exploiting the opportunities offered by the "New Economy" even in the case of industrialized countries that are at the same level of infrastructural and technological advance. That can be especially noticed when one compares the results obtained by the United States (the leader of the "New Economy"), and the most important economies of the euro zone: Germany, France and Italy.

Some economists, especially the ones who belong to so called mainstream economics, often ignore the facts which prove that the institutional

infrastructure is an important determinant of the economic development of a society<sup>2</sup>. When one analyses literature concerning the "New Economy", one can find many papers concentrating on some technical aspects of that phenomenon, mainly the usage of the Internet. Similarly, one can find some papers concerning the significance of fiscal and monetary policy for creating the "New Economy". On the other hand, there are only a few papers that analyse the role of the institutional infrastructure in creating the "New Economy". As a result, the aim of this paper is to assess the role of the institutional system in harnessing the potential of the "New Economy". Some selected characteristics of the institutional infrastructure that dominate in the United States and in the mentioned European countries will be analysed.

### **The conception of the "New Economy"**

Many papers concerning the "New Economy" were written in recent years. However, the definition of this phenomenon is still a subject of controversy. Martin Baily says that there are many pitfalls in the term "New Economy", "New Economy" is probably too broad a term and implies both more change and more permanent change than actually took place. But 'information technology' seems too narrow a term to describe the set of interrelated forces bringing about change in the economy, that include increased globalization, a more intense pressure of competition, the rapid development, adaptation and use of information and communications technology and a favorable economic policy environment." (BAILY 2001)

In the case of the majority of papers on the "New Economy" research is concentrated on the influence of the Internet on the production growth. However, Robert Atkinson and Rick Coduri suggest that, "(...) the New Economy was never just about the Internet, (...) Rather, the New Economy is about the transformation of all industries and the overall economy. As such, the New Economy represents a complex array of forces. These include the reorganization of firms, more efficient and dynamic capital markets, more economic "churning" and entrepreneurial dynamism, relentless globalization, continuing economic competition, and increasingly volatile labor markets" (ATKINSON, CODURI 2002). This approach seems to be quite appropriate to present the role of the institutional system in creating the "New Economy".

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<sup>2</sup> Recently, one can see a tendency for better understanding of the role of institutions in economics. This is mostly possible due to the contribution of "New Institutional Economy" theoreticians, who try to integrate their works with mainstream neoclassical economics.

## **The United States as the first beneficiary of the "New Economy"**

Chronologically, most of the commentators combine the "New Economy" with the period of vigorous economic growth of the American economy in the last decade of the 20<sup>th</sup> century. In the 90s the American economy was growing continuously for eight years, which was the longest period of incessant, sustainable growth in the previous century. Moreover, the decrease of the unemployment rate was unprecedented in that period. The economy created 17 million jobs, driving unemployment down to a 30 year low of 4.1%. Though it all, inflation was kept very low. Consumer prices rose 5% per year at the beginning of the 90s but less than 2% a year from 1996 on (Cox, ALM 1999). Consequently, some economists seem to perceive the serious change in the inflation processes, the traditional wisdom of trade-offs between unemployment and inflation is defied again. The enthusiasts of the "New Economy" believe that the "New Economy" is able to sustain stronger growth for a long time with little danger of inflation.

Nonetheless, these changes seem to avoid continental Europe, where besides the economies of Ireland, Sweden and Finland, the biggest economies of the euro zone, Germany, France and Italy, are not able to accelerate their economic growth. In the years 1991-2003 these economies obtained the average GDP growth of 1.51%, whereas in the same time the American economy was growing at the average annual rate of 2.97%<sup>3</sup>.

A vigorous discussion about the potential sources of this favorable growth of the American economy is under way. Among the most popular hypotheses one can find the assertion attributing this growth to the very good monetary policy of the FED (TAYLOR 1998); some economists underscore the technological change that results from the proliferation of the Internet (JORGENSEN, STIROH 2000); others concentrate on the benefits of America from globalization (ROGOFF 2003). However, there are also serious arguments for a notion that an appropriate institutional infrastructure is a factor that joins all these positive tendencies. Vito Tanzi said, "It is no accident that the New Economy revolution started in the United States and not in Japan. Japan was very advanced in terms of technology, but the revolution started in the United States. The reason is that the United States had far less regulations, far less obstacles to the introduction of these new ideas. The fact that the United States was better placed in terms of regulations, in terms of organization for this, meant that the United States was much quicker, much more ready to take advantage of this new trend" (TANZI 2001).

In the next section some characteristics of the American institutional system, which seems to enable this country to harness the potential of the "New Economy", will be discussed.

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<sup>3</sup> Calculations of the author based on: *Economic Survey of Europe*, United Nations, New York and Geneva 2004.

## **The institutional infrastructure of the "New Economy"**

Douglas North, an eminent economist rated among the New Institutional Economy school, defines an institutional system as a set of formal (juridical regulations, laws and constitutions) and informal (norms of behavior, social conventions and self imposed codes of conduct) constraints and their enforcement characteristics. These "rules of the game", which are deeply rooted in the social, cultural and political life of society, form the economic incentives that are the underlying determinants of long term economic growth (NORTH 1994).

Among the factors that form the institutional system of society, one can usually find: the quality of the juridical system which enforces contracts and protects property rights; development of the economic infrastructure, international openness, development of financial markets, quality of human capital and flexibility of labor markets, entrepreneurial culture, political stability and others.

In the case of economies of the US and Europe the biggest institutional differences concern entrepreneurship competitiveness, elasticity of labor markets and characteristics of financial markets. William Sahlman as Vito Tanzi finds the roots of the successful and effective exploiting of the "New Economy" by the American economy in the following institutional characteristics of that country:

1. Very high social status of private entrepreneurs and big tolerance towards their failure, which is often the result of the endeavor that is aimed at finding new solutions;
2. Attracting the best human capital to the "New Economy" companies, whereas in the past the best people were absorbed by traditional financial sectors;
3. Easy access to capital for private entrepreneurs (SAHLMAN 1999).

Unlike Europe, American society loves its entrepreneurs, one can say that the most successful ones enjoy the popularity of celebrities and show business stars. This very high social prestige of private entrepreneurs is a factor that encourages the best educated people to set up new companies, which often grow in the way described by the Shumpeterian paradigm of "creative destruction" (SCHUMPTER 1995). According to William Sahlman in the year 1999 35% of Harvard Business School graduates decided to start their careers in companies that are associated with the "New Economy", or work in venture capital companies that seriously support the "New Economy" (SAHLMAN 1999). In the case of Europe most graduates want to follow careers in the traditional financial sector or in state and government bureaucracy. As a result, according to Paul Reynolds, Micheal Hay and Michael Camp's report the US (next to Israel and Canada) was placed in the highest group on the basis of entrepreneurial activity with an average level



of entrepreneurial activity of 6.9%, whereas the economies of France and Germany were placed to the lowest group with an average level of entrepreneurial activity of 1.8% (REYNOLDS et al. 1999).

International empirical comparisons tend to prove that financial markets have a key role in effective allocation of savings, hence, they are an important determinant of GDP growth<sup>4</sup> (KING, LEVINE 1993, LEVINE 1997). A highly developed financial market, especially its venture capital sector, is considered as a foundation of the "New Economy". Venture capital is the most important source of finance for start-ups that are often a source of innovations and new solutions. When one compares the financial markets of continental Europe with the US financial markets, one can see the serious deficiency of European financial markets. According to Global Entrepreneurship Monitor 2000 in 1999 the ratio of venture capital invested domestically to GDP for the US equaled 5.3%, whereas in Germany it equaled 1%, in France 0.9% and in Italy only 0.5% (ZACHARAKIS et al. 2000).

Some other institutional characteristics that support the "New Economy" were listed by Martin Baily. He underscores the role of international openness, competition and proliferation of best practices, and especially the elasticity of labor markets which seems to be a basic condition of building the "New Economy" (BAILY 2001).

International openness of a market is the factor that enables the fast spreading of innovation and knowledge. It makes the market highly competitive which forces companies to improve their product and develop new ones. Despite building the common market in the EU, according to research quoted by Martin Baily prices in the US, on average, were 15% above the lowest international prices, whereas for Germany and other European countries the figure was above 60%. These price data seem to support the view that openness and competitive intensity are substantially lower in continental Europe than in the United States (BAILY 2001).

Creating and implementing the new organizational and technological solutions is a foundation of the "New Economy". It basically depends on smooth and fast reallocation of the best human capital from sectors that tend to be in stagnation to sectors that are the most productive. High elasticity of a labor market is the factor that makes this reallocation smooth and enables the economy to adjust to changing conditions. On the other hand, the inelastic labor markets create many constraints for fast and effective reallocation of human capital, which impedes building the "New Economy".

The American labor market is considered the most flexible labor market in highly developed countries. On the other hand, the European labor market, which struggles with a chronically high rate of unemployment, despite the need for reform, is still characterized by generous unemployment, disability or early retirement programs and high minimum wages. That kind of institutional

<sup>4</sup> Robert King and Ross Levin comment that there is a group of eminent economists who seem to underestimate the importance of financial markets for long term growth; however, the majority of recent empirical studies prove a serious correlation between the development of financial markets and economic growth.

infrastructure of a labor market makes it highly inflexible. According to Donald Johnson, who quoted Alan Greenspan, the main reason why France and Germany were not able to take full advantage of the "New Economy", notwithstanding the high skill level and the availability of technology, is the inflexible labor market. He stressed, "The labor market rigidities make it difficult for some countries to re-allocate employment and thus they are put in a position where they are not as capable of taking advantage of the new technologies through employing new skills." (JOHNSTON 2001).

Already in the early 1960s, Ronald Coase proved that some habits, social norms and tradition can create serious constraints influencing the behavior of market actors. These factors can help to reduce uncertainty and influence the level of transaction costs that is a significant constraint to economic development (Coase 1960). In the context of Ronald Coase's research, one can say that the institutional factors stressed by Vito Tanzi, William Sahlman and Martin Baily, in the case of the US, reduce transaction costs significantly and make favorable conditions for harnessing the potential of the "New Economy". *The Economist* argues that setting up a company in Europe can take ten times more time and can be four times more expensive than in the United States (*The Economist* 2000).

## Conclusions

William Sahlman says, "The economic, social, and cultural factors undergirding the new economy are rock solid" (SAHLMAN 1999). These words harmonize with the notions of Leonard Nakamura who summarizes the American institutional advantages over other economies, "The U.S. has a well-educated, diverse, and disciplined workforce; access to the most recent research; a deregulated economy relatively unencumbered by bureaucratic restrictions; moderate taxes; a smoothly functioning financial market to finance investment; a long history of rule by law and democracy." (NAKAMURA 2000). All these institutions make perfect foundations for the "New Economy".

On the other hand, the European institutional infrastructure of the "New Economy" needs serious reform. The change of cultural context and entrepreneurship attitude is unfortunately a very long process. However, Europeans have to start this institutional reform with making labor markets more flexible, increasing the openness and competition intensity of the European market. The bureaucratic constraints have to be also reduced and, last but definitely not least, the financial market must be improved.

It is very difficult, or maybe even not possible, to provide a sophisticated model that gives some hard scientific proofs of the influence of the institutional system on the creation of the "New Economy". Nevertheless, the research into the influence of the institutional system on the growth process can indeed help to recognize some sources of tendencies that lead to

serious divergence of development between economies. This paper supports the notion that the institutional infrastructure and organization of a society determines its growth possibilities.

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