

The Business Revolution of the Nineteenth Century

BY STEPHEN DAVIES



The business corporation is one of the most maligned and disliked institutions of our time. The criticism comes from many parts of the political spectrum, and its substance has become a common-sense assumption for many. As ever, much of this criticism lacks historical perspective, despite the inclusion of historical accounts of the growth of large corporations. Quite simply, the large corporate business enterprise is perhaps the key institution of the modern world. As much as anything else, the invention of this form of organization created the world we live in and transformed the conditions of life for millions of people, much for the better.

The reason the corporation is of such profound importance is that it has transformed the nature of economic growth. Historically, economic growth has been slow and patchy. Most has been what economic historians call “extensive” growth. This happens when an increase in the factors of production leads to an increase in output. So getting more production from more people or from making use of a larger amount of land is extensive growth.

But this is not the same as a growth in productivity and so may not lead to higher living standards. Less historically common, but more significant, is “intensive” growth. The main feature here is doing more with less, that is, using resources and labor more productively. It is this that leads to a real increase in output per capita and hence to a rise in living standards.

For most of human history the main source of intensive growth has been the specialization brought about by trade. Economic historians have come to call this Smithian growth, after Adam Smith. Historically, Smithian growth, even when it was sustained over a long period, as in eighteenth-century Europe or thirteenth-century China, did not exceed an average of 1 percent a year compounded. So although significant over the long term, it was slow and its effects only

became apparent over an entire lifetime or even longer. Moreover, growth was always associated with technological innovation, which was uneven, unsystematic, and most important, slow to spread.

However, from about the middle of the nineteenth century the whole nature of economic growth changed. Suddenly the compound rate of growth went up to 2 percent a year or more. At the same time technological innovation became systematic and rapid, with the gap between invention and application shrinking dramatically. The geographical diffusion of such innovations also became much swifter. Economic historians use the term “Promethean” for this kind of growth. The results were dramatic. As John Maynard Keynes noted, for a very large part of the world’s population the 50 years between 1850 and 1900 saw a bigger rise in average living standards than the previous 500. This dramatic acceleration had a number of causes, but the change in business organization was the immediate one.

Firms have been a feature of commerce and manufacturing from the very earliest times. At one time this was a puzzle for economists, since theory predicted that a market economy should consist of many small enterprises, coordinated by contracts and trade. Ronald Coase was able to show that the critical variable was the level of transaction costs—the costs of finding the other party to a transaction, making and enforcing the contract, and so forth. Transactions costs are analogous to friction in physics. If transactions costs are sufficiently high, it will be more efficient to coordinate many actions by other than market means. Hence the creation of firms. They coordinate the work and exchange of a number of people by nonmarket means, but are themselves embedded in a market, or exchange-based, system.

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Until the nineteenth century there were broadly two kinds of firms recognized in most of the world's legal systems. One had limited liability, ensuring that investors were liable only for their invested capital, but a limited lifespan. The other had perpetual succession, that is, an indefinite lifespan, but the owners had full liability for all the firm's debts. The only real exceptions were large trading companies chartered by states.

Moreover, most firms were unitary enterprises. They had only a rudimentary management hierarchy, and all activity was carried out in one single department with the owners managing the business. This was particularly the case in manufacturing. The great majority of firms were households or extended households and were owned and operated by families or coalitions of families. They raised most of their capital (or stock, as it was called) themselves, although there was an increasingly active market for trading stock from the mid-seventeenth century onward.

After about 1820 this way of organizing economic activity became less useful and governments increasingly granted special privileges to corporate businesses providing such services as canals; utilities, such as water and gas; and railroads. Legislatures did so because such enterprises required large amounts of capital and returns were long in coming.

Then, in the 1850s and 1860s, the whole structure of business was transformed. The change had two elements. The first was a set of legal changes that collectively created the modern limited-liability joint-stock company as a legal institution. In the United States this was largely done by a series of court decisions. Elsewhere it was brought about by legislation, the British Companies Act of 1855 being the model. The new laws made incorporation easy and cheap. An expensive and complex grant from the legislature was no longer needed. Moreover, limited liability was combined with perpetual succession.

Management and Complex Organization

The other crucial change was the creation of management as an occupation and the emergence of wide-ranging firms divided into departments coordinated by senior management. Together with the legal

changes, this made possible truly big firms employing many thousands of people over a wide geographical area and in many different activities. Although there had been large trading firms before, they had not generally employed large numbers of people directly; they relied instead on contracts.

This change also separated ownership and investment from control, with businesses no longer run by their owners, but by professional managers organized in a hierarchy. The second half of the nineteenth century saw the appearance of large multidivisional firms in one area after another, starting with railroads but soon spreading to both manufacturing and retailing. This revolution took place initially in the United States and Germany.

Its effects were dramatic. Investment larger than anything possible before could now be undertaken. This led to dramatic economies of scale and increases in efficiency. It brought a great increase in the productivity of unskilled labor and a sharp rise in the real wages of unskilled and semiskilled labor. Most significant in many ways was the impact on technological innovation, with the new businesses deliberately undertaking research and applying its findings. In general, what the new business organization did was to increase productivity, lower costs (and real prices), raise all forms of income, and introduce a whole range of technological innovations and new products. There had been earlier intimations of this in areas such as iron and textiles, but it was this "Second Industrial Revolution," more widespread and general in its effects, that truly created the modern world. The era from 1870 to 1914 has gone down as the "Belle Epoque," an age of optimism, dynamism, and progress.

The great businessmen, entrepreneurs, and managers who brought about this revolution had little thanks, however. Despite the fastest and most widespread growth in human history, business people were cast as "robber barons," exploiters of the poor, and parasites on the social body.

Yet as the greatest of business historians, Alfred D. Chandler, has observed, it is business that has made our world and transformed the prospects of ordinary people. 