Business Ownership and Organisation

Aldous, M. (2018). Business Ownership and Organisation. In C. Colvin, & M. Blum (Eds.), *An Economist's Guide to Economic History* Palgrave Macmillan.

Published in:
An Economist's Guide to Economic History

Document Version:
Peer reviewed version

Queen's University Belfast - Research Portal:
[Link to publication record in Queen's University Belfast Research Portal](#)

Publisher rights
© 2018 Palgrave Macmillan.
This work is made available online in accordance with the publisher's policies. Please refer to any applicable terms of use of the publisher.

General rights
Copyright for the publications made accessible via the Queen's University Belfast Research Portal is retained by the author(s) and / or other copyright owners and it is a condition of accessing these publications that users recognise and abide by the legal requirements associated with these rights.

Take down policy
The Research Portal is Queen's institutional repository that provides access to Queen's research output. Every effort has been made to ensure that content in the Research Portal does not infringe any person's rights, or applicable UK laws. If you discover content in the Research Portal that you believe breaches copyright or violates any law, please contact openaccess@qub.ac.uk.

Business Ownership and Organisation

Michael Aldous

Queen's University Belfast

Understanding the relationship between the different ways in which business is owned and organised, and the effects these choices have on the performance of firms and economies, is widely debated in economics, management, finance, law, business and economic history. Optimising the form of ownership and organisation can increase the scale and scope of operations, whilst improving productivity, efficiency, and the capacity for innovation. The role of the Corporation, or the Joint-Stock company, has been central to these debates.

The benefits of incorporation run as follows. The Corporation is underpinned by five basic legal characteristics – separate legal personality, limited liability, transferable stock, delegated management, and investor ownership (Kraakman et al., 2004). In particular, limited liability and transferable stock incentivise individual investors, their risk diversified amongst multiple shareholders and protected by liabilities limited to the extent of their shareholding. This allows corporations to form deeper capital reserves and retain them for longer periods of time, as investors can sell their shares rather than take their capital out of the firm. A separate legal personality, deeper capital and longer investment horizons allow corporations to invest in fixed assets and undertake activities such as R&D on a greater scale than other forms of ownership such as the partnership.

This has provoked three main areas of study in economics: (1) Identifying the legal and institutional conditions required to enable efficient incorporation; (2) Quantifying the effects of incorporation on firm and economic performance; and (3) Examining how corporations can be effectively managed. In particular, how to address the principal-agent problems created by the separation of owners and managers inherent in the corporate ownership structure. The interest in performance and institutions has encouraged historical study to provide longitudinal data and understand the context in which institutions have emerged and evolved.

Corporations in Economic History

The dominant historical narrative describing the role and importance of the corporation, shows that from the mid-nineteenth century institutional developments in the UK and US completed the legal formation of the corporation significantly reducing costs and barriers to incorporation. This led to a rapid proliferation in the number of corporations in the late nineteenth century.

They dominated emerging asset intensive industries which required extensive capital investments such as railways, oil, chemicals and automobiles (Schmitz, 1993). This period also saw experimentation with the organisation and management of firms, as new hierarchical structures such as the Multidivisional-form were used to allow managers to efficiently integrate and control larger organisations (Chandler, 1977). By the early twentieth century, firms of unprecedented scale and scope, predominantly organised as corporations, became the dominant form of business organization in industrial economies.

Whilst providing some support for the notion that the corporation was a key enabler in the transformation of industrial economies, historical study has raised a number of further questions that challenge and nuance the contemporary study of firms. Questions related to timing, causality and the long-run effects on development, have led economic historians to rethink the debates around corporate law and institutions, the effects on performance and management of the corporations. These continue to be highly active research areas which address both historical and contemporary audiences. This chapter outlines three key debates surrounding the corporation from the perspective of economic history, and relates them to wider discussions in economics.

Institutions and the Law

The evolution of the corporation as a distinct legal entity was a historical process and economic historians have sought to identify when, where, and why they occurred, particularly seeking to establish the emergence of the 'modern corporation'. This was initially identified as occurring in the US in the early twentieth century, as legal changes secured protection for investors and growing capital markets encouraged tens of thousands of Americans to buy shares (Berle and Means, 1932). Individual shareholders were now part of highly diffuse bodies of ownership which meant control of the firm was vested in the salaried managers, as individual shareholders could no longer exercise legal ownership rights to dictate the running of the firm. Economists are especially interested in the corporate governance issues raised by this extreme separation of ownership, discussed later in this essay, but it also provoked examination of why conditions in the US had been particularly favourable to this process.

The dominant thesis has focused on the historical common law origins of the US legal system, which is claimed to be more flexible and favourable towards commerce, as opposed to the restrictive civil law systems found in France and Germany (La Porta, Lopez-De-Silanes, Shleifer, and Vishny, 1998). Known as the 'law and finance school', this approach has been widely used to claim causation between commercial law and economic development, with

comparative research revealing that nations and regions lacking the institutions to shape flexible commercial law perform relatively worse (Kuran, 2012).

Yet, the timing and location of the divorce between owners and managers has been reassessed, with extensive evidence showing that these features were already present in Britain in the late nineteenth century (Foreman-Peck and Hannah, 2011). Similarly, the legal origins thesis has been roundly attacked, predominantly on the grounds that, although it pertains to be a historically grounded argument, empirical historical studies do not bare out clear causation between common law and commercial development (Turner and Mussachio, 2013).

These findings have spurred further efforts to examine the legal origins and evolution of the corporation, investigating antecedents dating from late medieval roots. Research shows a long and convoluted process driven by competing interests, much of which occurred outside of the US and Britain, in advanced financial markets such as the Netherlands (Gelderblom and Jonker, 2004; Harris, 2000). Accepting that there is no defined trajectory to form the 'right' institutions opens many possibilities for further research to understand the emergence and effects of institutional arrangements on commercial activity.

Owners, Managers, Principals and Agents

The separation of owners and managers wrought by the corporate ownership structure created distinct challenges of governance. The critical question being, how can the owners, or principals, ensure that their managers, or agents, act in their interests? These problems are exacerbated as firms increase in size, increasing threats of opportunism and moral hazard, whilst complicating the coordination and the alignment of interests. In economics, the challenges of these principal-agent problems have been extensively theorised (Jensen and Meckling, 1976; Alchian and Demsetz, 1972).

This body of theory has been adopted by economic historians to explain the historical evolution of corporations. In particular, it has been used to examine the growth of early corporations such as the chartered trading companies including the East India Company and Hudson's Bay Company (Carlos and Nicholas, 1990). Due to the geographically-dispersed nature of their activities the owners of these firms needed to find ways to align the interests of their distant managers. Innovations in the structures of reporting, monitoring and incentives enabled these firms to reduce the costs of agents, allowing them to expand their operations in the 18th century and open up international markets (Heejibu, 2005; Yates et al., 2002). Similarly, innovations in monitoring and incentives in the early 20th century allowed more effective control of giant industrial firms (Chandler, 1990).

Yet, research drawing on agency cost theory has shown that the corporation failed in certain industries due to the inherent organisational problems caused by the separation of owners and managers (Hilt, 2006). Historical study has shown that business forms, such as the cooperative and partnership, have governance features that resolve agency problems more efficiently than the corporation. In industries where monitoring of agents and customers was difficult the corporations often failed, as the incentive structure of the partnership and cooperative bonded distant agents and monitored customers more efficiently (Guinnane, 2001; Henricksen, 1999; Aldous, 2015). The historical analysis of principal agent problems has done much to reveal the importance of other forms of business ownership, and offers great scope for further investigation to assess which forms of ownership and governance matter in addressing different challenges.

Do Corporations Matter?

The argument that large, hierarchically integrated firms, organised as corporations, are the optimal form of business organisation was strongly linked to the rapid economic growth of the US across the twentieth century (Chandler, 1977). Dramatic increases in productivity enabled by integrated corporations were correlated to rising GDP and other measures of living standards (Broadberry, 1997). Similar to the 'Law and Finance' argument these claims were strengthened by comparative research between nations, where a lack of widespread incorporation and large vertically integrated firms was seen as a key factor in limiting productivity and economic growth. In particular, the growth of the US was contrasted with the economic stagnation of the UK in the early twentieth century, and presented as a function of British entrepreneurs' failure to widely adopt the corporate form (Lazonick, 1991).

The importance of the corporation as an engine of economic growth saw pronouncements such as this from Micklethwait and Wooldridge (2005: xv), "The most important organisation in the world is the [joint-stock] company: the basis of the prosperity of the west and the best hope for the future of the rest of the world," become common. However, others are less sure, as Jensen (2000: 3) noted, "in spite of this relative success it is clear from the evidence of the last twenty five years that the corporation has failed in many ways as an organising device." These competing claims are widely debated in economic history, with both theoretical and empirical studies challenging the importance and dominance of the corporation.

Studies have questioned the preference for the corporate form when entrepreneurs could select from a menu of organizational forms. By the early twentieth century a range of legal forms of business ownership were available in the leading industrial nations. Quantifying the

choice of different forms overtime has revealed a preference for privately-owned companies in the UK, France and Germany (Guinanne, Harris, Lamoreaux, and Rosenthal, 2007). This has motivated the question, why would entrepreneurs make the mistake of choosing another form of organisation when incorporation was freely available? (Lamoreaux and Rosenthal, 2006).

Further, the extent to which the corporation did 'win the competition', has been questioned. Increasingly the corporation is regarded as critical for industries with intense fixed asset investments and high costs of hold-up, but less important in other sectors (Hannah, 1999). Indeed, as industrial structures changed across the twentieth century, the rationale for the widespread use of the corporation has become less clear. Further historical study will help to contextualise the role of the corporation, both at the level of individual industries and national economies, improving our understanding of where and when incorporation is effective.

The Importance of History

These debates have opened a rich seam of opportunity for both historians and economists. In Economic History there is no consensus on a historically or theoretically optimal firm type and debate continues to rage around the role and importance of the corporation. Why different business forms emerge, proliferate or fail, and the effect this has on performance and economic development, remain open questions. Similarly, historical study has raised questions about how institutional arrangements affect commercial law, and therefore which institutions matter in enabling entrepreneurs to respond successfully to the challenges they face.

Conversely much current research in economics continues to focus on modelling optimal structures and systems to resolve principal-agent problems within corporations. Little interest has been spent in considering the importance of other forms of business ownership in addressing economic challenges, or assessing the impact that use of different forms of ownership has on industry and economic performance. Economic history has fundamentally challenged and advanced the debates around business organization. It offers the opportunity to improve understanding of the rationale by which entrepreneurs make choices on firm ownership and to assess the impact of their decisions.

A Plurality of Methods

Historical research on the corporation has drawn on a wide-range of theory and methodologies. Detailed industry and case studies (Carlos and Nicholas, 1990) are extensively used to identify how firms and institutions have functioned. To capture the evolution and effects of processes more effectively longitudinal (Chandler, 1974) and comparative studies (La Porta et al., 1998)

have been employed, whilst efforts to quantify scale and change draw on a range of descriptive statistics (Aldous, 2015; Guinnane et al., 2007). Interest in the causal relationships between choice of organisation form and subsequent effect on economic performance has seen more formalised modelling (Lamoreaux and Rosenthal, 2006) and econometric methods (Hilt, 2006) used. This plurality offers economists and historians interesting opportunities for collaboration.

Bibliography

- Aldous, Michael, 2015. "Avoiding Negligence and Profusion: The failure of the Joint-Stock form in the Anglo-Indian Tea Trade, 1840-1870." *Enterprise and Society* 16 (3): 648-685
- Alchian, Armen and Harold Demsetz, 1972. "Production, information costs, and economic organization," *American Economic Review*, 62 (5): 777-795.
- Broadberry, Stephen, 1997. *The Productivity Race: British manufacturing in international perspective 1850-1990*. Cambridge University Press.
- Carlos, Ann and Steve Nicholas, 1990. "Agency problems in the early chartered companies: The case of the Hudson's Bay Company," *Journal of Economic History*, 50 (4): 853-57.
- Chandler, Alfred, 1974. *Strategy and structure: Chapters in the History of the American Industrial Enterprise*. MIT Press Reprint.
- Chandler, Alfred, 1977. *The Visible Hand: Managerial Revolution in American Business*. Harvard University Press.
- Foreman-Peck, James, and Leslie Hannah, 2012. "Extreme divorce: the managerial revolution in UK companies before 1914," *Economic History Review*, 65 (4): 1217-1238.
- Gelderblom, Oscar and Joost Jonker, 2004. "Completing a Financial Revolution. The Finance of the Dutch East India Trade and the Rise of the Amsterdam Capital Market, 1595-1612," *The Journal of Economic History*, 64 (3): 641-672.
- Guinnane, Timothy, 2001. "Cooperatives as Information Machines: German Rural Credit Cooperatives, 1883-1914," *Journal of Economic History*, 61 (2): 366-389.
- Guinnane, Timothy, Ron Harris, Naomi Lamoreaux, and Jean-Laurent Rosenthal, 2007. "Putting the Corporation in Its Place." *Enterprise and Society*, 8 (3): 687-729.
- Hannah, Leslie, 1999. "Marshall's 'Trees' and the Global 'Forest': Were Giant Redwoods Different?" in *Learning by doing in Markets, Firms, and Countries*, edited by Naomi Lamoreaux et al., University of Chicago Press, 253-294.
- Hejeebu, Santhi, 2005. "Contract Enforcement in the English East India Company," *Journal of Economic History*, 65 (2): 496-523.

- Henriksen, Ingrid, 1999. "Avoiding lock-in: Cooperative creameries in Denmark, 1882-1903," *European Review of Economic History*, 3 (1): 57-78.
- Hilt, Eric, 2006. "Incentives in Corporations: Evidence from the American Whaling Industry." *Journal of Law and Economics*, 49 (1): 197–227.
- Jensen, Michael, 2000. *Theory of the firm Governance, Residual Claims, and Organisational forms*. Harvard University Press.
- Jensen, Michael, and William Meckling, 1976. "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure," *Journal of Financial Economics*, 3 (4): 305-360.
- Kraakman, Reiner R., Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda and Edward B. Rock, 2004. *The Anatomy of Corporate Law: A Comparative and Functional Approach*. Oxford University Press.
- Kuran, Timur, 2012. *The Long Divergence: How Islamic Law Held Back the Middle East*. Oxford University Press.
- Lamoreaux, Naomi, and Jean-Laurent Rosenthal, 2006. "Contractual trade-offs and SMEs' choice of organizational form: a view from U.S. and French history, 1830-2000," *NBER Working Paper* 12455.
- La Porta, Rafael, Florencio Lopez-De-Silanes, Andrei Shleifer, and Robert W. Vishny. 1998. "Law and Finance." *Journal of Political Economy*, 106 (6): 1113–1155.
- Lazonick, William, 1992. *Organization and technology in capitalist development*. Edward Elgar Publishing.
- Micklethwait, John, and Adrian Wooldridge, *The Company: A short history of a revolutionary idea*. Modern Library.
- Schmitz, Christopher, 1993. *The growth of big business in the United States and Western Europe, 1850-1939*. Cambridge University Press.
- JoAnne Yates et al., 2002. "Distributed Work over the centuries: Trust and Control in the Hudson's Bay Company, 1670–1826", in Pamela Hinds and Sara Kiesler, Eds, *Distributed Work*, MIT Press, 27-54.