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## Economic History as Legal History

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## Economic History as Legal History

The relationship between a jurisdiction's legal system and its economy is inherently complex and dynamic, one which has been examined and understood in a variety of ways. Motivating questions have included to what extent do legal regimes affect business opportunities? Is economic performance prescribed by legal regimes? How have lawyers, judges and politicians reacted to business behaviour and the changing fibre of economic relations? In discussing these and related questions in her chapter in the *Oxford Handbook on Legal History* (207–220), Anne Fleming examines scholarship in legal history that might also be considered economic history.

Rather than seeing work in legal history as economic history, as Fleming does, this paper reverses the order, seeing work in economic (and business) history as legal history. In so doing, we seek to provide a complement to her chapter, tracing out key debates in these areas and »prospecting« how legal historians might contribute. This, of course, is not meant to imply a devaluing or denigration of Fleming's vision of legal history mixed with economic history. She situates seminal works in legal history within the context of economic history exceptionally well. Her chapter might also have overlapped with other contributions to the *Handbook* by Ron Harris on »The History and Historical Stance of Law and Economics« and Daniel Klerman on »Quantitative Legal History«, but the chapter works as a standalone and as an engaging piece. This comment paper seeks to add to many of the important points and perceptive observations which Fleming has already made in her piece.

That said, this paper is not written with the question »what can legal historians offer the study of economic history?«. Our concern is explicitly not with relegating legal history to a subordinate role: it clearly has its own questions, debates and issues. Rather, we wish to emphasise how this work may be of utility to other historians, especially those studying businesses and economics. In three sections – one on the Industrial Revolution, one on theories of the firm, and one on the managerial revolution – we will outline how legal historians offer methodologies, theories and empirical insights into enquiries about the operation and

meaning of the law, which cannot be gained by other means. We believe these insights could be beneficially adopted – were they better known. This paper thus tackles the question of how legal and historical research can intersect with debates about businesses and the economy.

### The Industrial Revolution

Starting in England during the 18<sup>th</sup> century, the Industrial Revolution was an event of first-order global importance, marking the beginning of sustained long-term economic growth. Over the past 200 years, real wages in the West have grown by a factor of up to 100. In its transformation of humanity's material conditions, only the transition from hunting and gathering to settled agriculture during the Neolithic Revolution bares comparison. However, despite its importance and relative immediacy, we still lack a convincing explanation for why the Industrial Revolution began where and when it did, and indeed, why it occurred at all.

In broad strokes, it can be said that there are three competing accounts of the Industrial Revolution. The first sees it as an essentially social/cultural event, the outcome of new ideas and ways of thinking that emerged out of the scientific revolution and/or the Enlightenment. Deirdre McCloskey (2016), for instance, has emphasised how new »bourgeois« ideals and rhetoric increased the supply of innovation and enterprise. Joel Mokyr (2009, 272) also argues for the primary importance of the supply of new ideas, stressing that although economic factors »might have determined the direction of technological change, the power and intensity of improvements were a function of technological capabilities and motives that had deeper causes«. Conversely, a second account views the roots of the Industrial Revolution as essentially economic. Robert Allen (2011), for instance, argues that the pattern of demand for invention was dictated by the unique structure of factor prices in the British economy – expensive wages combined with cheap energy and capital. These factor prices incentivised the development of technologies that substituted capital and fuel for labour (e.g. the steam engine), which, Allen

suggests, characterises the most important inventions of the Industrial Revolution. Stephen Broadberry and Bishnupriya Gupta (2009) also argue that high wages in England (relative to its then European and Asian counterparts) incentivised the invention and adoption of capital-intensive methods of production which once established proved to be more susceptible to sustained technological improvement than methods based on traditional handiwork.

Neither literature places »law« at the centre of its analysis, although legal matters pertain to both. If we take the example of patents – an inherently legal construct that can only be enforced in court – Allen, Broadberry and Gupta have all noted how the provision of the patent system in England incentivised the development of new technology, enabling inventors to recoup the costs of research and development. Mokyr (1992), by contrast, has been more sceptical concerning the role of patents. Following the growing societal esteem for innovators and entrepreneurs, he has instead emphasised how the English law courts allowed for the vigorous prosecution of machine breakers (the Ludites). Unlike some prior instances of technological development, especially those that introduced labour saving machinery, it would not be successfully opposed by those that stood to lose their livelihoods.

A third account, though, places the law, and more broadly institutions – conventionally defined as formal rules (constitutions, laws, property rights), informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and their related enforcement mechanisms – at the centre of its analysis: the new institutional economics. In brief, the argument is that the key determinant of long-term economic performance are institutions, and it has proven tremendously influential within economic history, earning one of its progenitors Douglass North the Nobel Prize in 1993. In the context of the Industrial Revolution, new institutional economists have commonly argued that Britain benefited from uniquely secure property rights and reliable contracting, courtesy of its precocious constitutional/institutional arrangement. Enabled to engage in ever more sophisticated business ventures and confident that the proceeds of private endeavour would accrue to them rather than to a predatory state or stronger neighbours, individuals were incentivised to engage in ever more productive activities and invest-

ments that would ultimately result in the Industrial Revolution. Mancur Olson (1993, 574) provides the clearest summary of this position:

With a carefully constrained monarchy, an independent judiciary, and a Bill of Rights, people in England in due course came to have a relatively high degree of confidence that any contracts they entered into would be enforced and that private property rights, even for critics of the government, were relatively secure. Individual rights to property and contract enforcement were probably more secure in Britain after 1689 than anywhere else, and it was in Britain, not very long after the Glorious revolution, that the Industrial revolution began.

This is economic history as legal history.

Critics of the new institutional economics have argued that this presents a grossly simplified narrative of events, especially that property rights had been secure long before the Glorious Revolution. Clearly, here is an opportunity for the materials and methodologies of legal history to address directly questions of significance in other fields. The argument of the new institutional economists also carries an international, comparative component as well: Can it be safely claimed that property rights, or the law of contracting, was more conducive to economic development in Britain than was the case in Europe at this time?

#### Law and firms

While the literature on the origins and diffusion of the Industrial Revolution mainly focuses on national economies and their respective institutions, that is, the macro-level, another strand of literature focused on the firm as central agent in these economies, thus emphasising the micro-level. For a long time, however, economic historians' work was hampered by the fact that the firm, while clearly being the centre of economic development in the real world, was a »black box« for economic theorists. It is mainly due to the works of Ronald Coase and Edith Penrose that today's economic historians can base their research on concepts such as transaction costs, path-dependency and firm heterogeneity to understand the emergence and growth of firms. More generally, these market-based concepts help to render institutional change

intelligible, a core agenda for the social sciences, not just economic history.

In *The Nature of the Firm* (1937), Coase explained why individuals decide to form firms rather than trading bilaterally through contracts on a market. He based his analysis on the concept of transaction costs, which corrected an important omission in neoclassical economics, namely that rational choice is context bound. To understand real-world economic behaviour, historians have studied economic behaviour within the constraints imposed by social institutions. These institutions can include formal rules such as constitutions, laws or property rights, but also informal elements such as taboos, customs, or code of conduct – and Coase's paper was clearly a foundational text for the new institutional economics discussed in the prior section.

In essence, transaction costs are the costs of establishment and use of institutions (R. Richter 1990), meaning that all these institutions matter because they shape the structure of incentives. Coase maintained that companies would emerge when this yielded transaction cost advantages over the market, i. e. if transaction costs internal to the firm were lower than external transaction costs. His framework was subsequently deepened, notably by Oliver Williamson (1975), who reasoned that while markets rely on formal contracts (enforceable by a court), which are typically incomplete, firms use »relational contracts« (not adjudicated by courts) to overcome some of the formal contracts' difficulties.

Coase (1960) also pointed to the importance of property rights in shaping incentive structures. To illustrate the underlying problem, one can refer to the historic example of *allmende* (pastureland) shared by a village community. Resource scarcity means that after a certain point, each additional cow placed on the *allmende* will reduce the overall yield. However, an additional cow will as such increase the yield of the individual who places it there, implying that the sum of individual, rational decision-making will result in the disastrous overuse of a common resource. If one introduces private property though, perhaps by auctioning off the *allmende*, the situation changes. The new owner is now incentivised to account for the negative externality of too many cows, and will act accordingly. This possibility of internalising externalities through purely private negotiations, which thereby prevents a possible market failure

without state intervention, is now known as the Coase solution.

In many real-world contexts, though, the Coase solution is not feasible, for instance, when it is impossible or prohibitively expensive to allocate property rights. If the property rights are assigned only incompletely, transaction costs arise, so that an efficient allocation can no longer be achieved through private negotiations. Scenarios wherein the Coase solution is unattainable are of particular interest to legal and economic historians, since alternative solutions include formal legal institutions, such as international agreements, but also more informal institutions such as social norms. A good example might be comprehensive and enforceable liability rules, which would eliminate the externalities based on the polluter-pays principle. Despite its origins in economic theory, this principle is recognised internationally as a legal principle since 1990 and features prominently in the European Community's Single European Act (1987) and the Rio Declaration (1992). Introducing liability rules to address path-dependent *allmende* situations has been invoked by the OECD for countries such as Slovakia with its history of collectively organised production (OECD 2007). By opening a conventional newspaper these days, one can easily detect further examples of the »tragedy of the commons« situation described above, such as overfishing, climate change or air pollution, but history provides an even larger repository of examples that can be investigated via case studies or even econometrically. For instance, scholars such as Dahlman, McCloskey, Fenoaltea, North and Thomas have shown that, given certain historic constraints, communal property rights, the manor system and the open-field system can be viewed as rational and efficient by avoiding and spreading risk.

Following Coase's approach, transaction costs became the core concept of the new institutional economics mentioned earlier, and it was soon complemented by the idea of path-dependency. Path-dependency refers to the locking in effects stemming from initial conditions. Economic historians have used this perspective to understand the stability of institutions and the persistence of institutional arrangements that may later be inefficient for economic agents given changes in relative prices. Most prominently, Douglass North utilised this perspective when explaining the rise and evolution of market capitalism. Likewise, legal

history can analyse how diverse agents have dealt with the transaction cost problem in different historical settings, e.g. examining the solutions these agents designed as well as the legal and economic repercussions their behaviour had.

However, this is only one way of re-telling the »market revolution«. More heterodox literature, such as feminist economics, argues that such a perspective reflects too narrow a focus on exchange among individuals via markets. This self-limitation, it is argued, was fuelled by an underlying shift in the research agenda of economics, which accompanied the historic withdrawal of the state to activities that economic agents could not do alone in the marketplace (Nelson 1993). As shown, this is also the intuition behind the Coase solution. To widen the scope of economic history, it is therefore constructive to complement the »Coasian firm« framework with ideas surrounding the »Penrosian firm«, named after Edith Penrose.

In *The Theory of the Growth of the Firm* (1959), Penrose argued that resources (including technological and entrepreneurial) were not simply purchased in markets but developed jointly within firms over time, thereby providing an historical perspective on industrial organisation that accounts for firm heterogeneity and the role of knowledge in growth. While economists recognise Penrose as the founder of the resource-based theory of the firm, economic and legal historians can use her work also as a methodological guide (Best and Humphries 2003). In particular, Penrose elaborates a concept of individual agency in which reflexivity is integral: The environment of the »Penrosian firm« is constituted via legal institutions like rules that structure an individual's actions, but at the same time, it is open to reconstitution by dynamic, entrepreneurial processes. Penrose's agent, unlike the *homo oeconomicus* in the Coasian firm, must interpret the world around her in a process that in turn is influenced by her role and by her personal perspective on how this world operates. Analogous to the integral role played by knowledge creation in Penrose's framework, legal historians can place biographies at the heart of their approaches, for instance, by tracing the development and propagation of legal doctrine or by investigating whether judges were motivated by concerns not expressed in their written reasons (Fernandez 2018). Moreover, for the reflexive agents in Penrose's firm, a change in the interpretative framework can have real-world effects. Sim-

ilarly, legal historians can analyse the effects of legal ideas and paradigm shifts on both the mindsets of legal agents and their actions. In short, theory is not external to history but entangled with it. While the focus of Coase is on information asymmetry and resulting information costs, Penrose highlights the role of organisation and knowledge. Both perspectives of the firm are important for a modern history at the intersection of law and economics.

### The managerial revolution

Economists and economic historians are not only concerned with why firms have emerged but also with why firms have grown to become big businesses. This study tended to take place within business history where the traditional unit of analysis is the firm itself. While the preceding literature aimed to build a theory around the firm, this work usually follows a case study approach with questions being asked about the business's growth or decline and how the firm was able to achieve its size. Gras's *Casebook in American Business History*, published in 1939, was the first of its kind. Charles Wilson's study of Unilever in 1954 was the first major business history in Great Britain. These historians collected facts somewhat uncritically until the work of Alfred Chandler in the mid-late 20<sup>th</sup> century. Chandler's work combined theory with empirics in a way that had not been seen before in business history.

The title of Chandler's book, *The Visible Hand and the Managerial Revolution in American Business* (1977), reflected upon the ideas of Adam Smith. Smith contended that markets were moved by the invisible forces of supply and demand. Chandler, on the other hand, argued that managers superseded the market function and that the visible hand of managers controlled markets. It was through mechanisation, manufacturing and technological change that managers increased supply. With a cheaper and greater supply of goods, they increased demand for the product through marketing. In Chandler's theory of the growth of big business, the presence of a managerial hierarchy was essential to the growth of the company. With a managerial structure, those at the top were not overburdened by day-to-day activities and could strategise, plan and coordinate the market functions. The managerial class had become, in the

Chandlerian narrative, the most influential group in society. To show this, Chandler explored a number of case studies in American big business.

Chandler's analysis, however, was not confined to businesses just in the United States. In *Scale and Scope* (1990), he expanded his analysis to account for the rise of American, British and German big business. This part of his work was based in large part on *The Modern Corporation and Private Property*, a foundational text by Berle and Means. Here they argued that large stock exchanges resulted in the diffusion of corporate ownership; moreover, where the ownership of a corporation was widely diffused, there were no majority owners. In firms that had this pattern of diffused ownership, owners did not have enough votes to control policy – a divorce between ownership and control had occurred.

This shift in ownership patterns gave rise to what Chandler termed an autonomous managerial hierarchy. It emerged, Chandler claimed, first in the United States as part of managerial capitalism. This development was the result of an evolutionary two-phase transformation from personal, entrepreneurial, to managerial. Chandler believed that within managerial enterprises, the divorce between ownership and control of the firm had been affected and managers had attained autonomy. They were therefore able to co-ordinate and organise market functions within the firm. Managerial enterprises, which Chandler considered to be typically American and German, also appointed upon the basis of qualification (indicative of competency and capability), and consequently, managers were able to re-invest effectively and create growth. He argued that they were motivated to do so as they had a personal interest in the firm's continuation, which in turn increased the relative rate of investment and the firm's long-term growth.

Personal capitalism, which Chandler thought of as a British phenomenon, was the antithesis to managerial enterprise. These entities lacked organisational capabilities because the owners manage and the managers own. Therefore, personal enterprises were family firms in which nepotism was the basis of appointment and managerial competency rejected. As a result, personal enterprises could not possess the managerial organisation capabilities that were required to supersede the market and co-ordinate its functions. The language used here was heavily influenced by that of Penrose's work. Re-investment was subsequently cautious and ineffective, but also minimal, a preference for short-

term profits. An entrepreneurial enterprise, according to Chandler, was typically Japanese and had features of both.

Chandler's work was a dominating force in the study of business history for the next few decades. Some of his empirical conclusions were challenged, while others were taken in wholesale. The task of refuting his conclusions was taken up most notably in Britain. Chandler's work was treated critically by those who saw his work as unfavourable. Leslie Hannah has argued that Chandler engaged in a process of national stereotyping. His recent work, in particular together with Foreman-Peck, has shown that British firms were not managed by owners and those in control did not have a large proportion of the vote. Twenty years on, Chandler's work is no longer central to the debate about the performance of firms. Linked to Hannah's work, other scholarship has sought new empirical evidence to test and re-examine some assumptions about investor behaviour, the diffusion of share ownership, the size of the London stock exchange and standards of corporate governance. This is where legal historians can contribute most.

While legal historians and those working on private law have added enormously to the empirical work undertaken in this area, the theoretical frameworks underpinning assumptions and beliefs concerning organisational form and size have been developed by those outside of the field of law working in economics and business and management. Questions of the impact of the legal suppression of share ownership, the frequency of the use of the corporate form, the legal and non-legal meaning of the term »corporation« and the nature of relationship between owners and managers remain. These issues can be understood as questions of legal regulation as well as ones of business or organisational form. Law regulated the ability to operate as a single commercial entity and a group of individuals; it gave legal meaning to social constructs, it provides obligations and duties to those in positions of power, and it gave rights to those who were not in equal positions.

## Conclusion

This review paper has sought to add to the discussion of legal and economic history as presented in the *Oxford Handbooks*. Alongside Flem-

ing's chapter, it details some of the ways that legal history might contribute to broader debates within the social sciences, especially economic and business history. Specifically, there are instances where theories of economic and business change, be it in the new institutional economics or theories of the firm, have been insufficiently attuned to or even neglectful of the empirics of legal history; their explanatory power would be bolstered were this not so. The methodologies of comparative legal

history can also contribute to similar debates in the industrial and managerial revolutions. Overall, it remains a challenging task for both legal historians and economic historians to understand the theoretical developments in the other discipline and to apply their methodological tools in interdisciplinary, especially comparative, analyses. ■