The Key to Industrial Capitalism: Limited Liability
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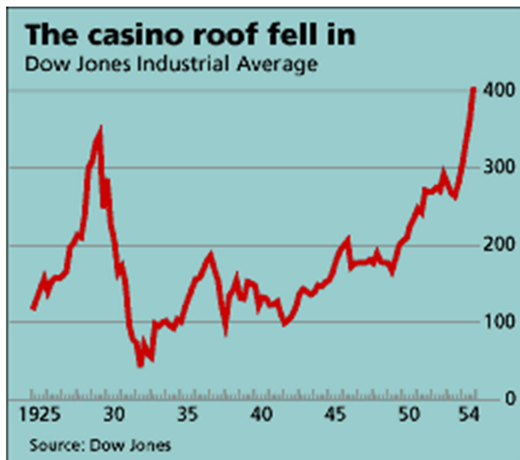
The modern world is built on two centuries of industrialisation.
Much of that was built by equity finance.
Which is built on limited liability.

THERE had been stockmarket crashes before, but never one so widely felt and so devastating. When the Dow industrial average fell by half in a few days in October 1929, it was not just rich financiers who lost their shirts. During the 1920s, share-trading had become a popular sport. Wall Streeters had persuaded the public that in the "new economy" shares were as safe as bonds; the financial district became New York's biggest tourist attraction. Passengers on Cunard liners could buy and sell shares via radio telegraphy (a Europe-bound Irving Berlin was one taker). President Herbert Hoover sniffed about bellboys speculating on share prices.

So the crash brought a political backlash, sharpened by depression: by 1932, America's GDP was around 60% of its 1929 value, 25% of the workforce out of work, and the Dow wavering at about one-seventh of its pre-crash high. The share-price excesses of the 1920s were widely blamed. How, people wondered, could America have set such store on equity, which, far from being as safe as bonds, was, in Keynes's phrase, "casino capitalism"? Seventy years on, everybody loves shares. Yet the question remains pertinent.

Shares were first issued in the 16th century, by Europe's new joint-stock companies, led by the Muscovy Company, set up in London in 1553 to trade with Russia. (Bonds, from the French government, made their debut in 1555.) Equity's popularity waxed and waned over the next 300 years or so, soaring with the South Sea and Mississippi bubbles, then slumping, after both burst in 1720. But share-owning was mainly a gamble for the wealthy few, though by the early 19th century in London, Amsterdam and New York trading had moved from the coffee houses into specialised exchanges. Yet the key to the future was already there. In 1811, from America, came the first limited-liability law.



The concept of limited liability, whereby the shareholders are not liable, in the last resort, for the debts of their company, can be traced back to the Romans. But it was rarely used, most often being granted only as a special favour to friends by those in power. Then in 1811 New York state brought in a general limited-liability law for manufacturing companies. Its popularity, and the flight of capital to states with limited liability from those without, led most American states to follow suit. In 1854, Britain, the world's leading economic power, did so too.

The Economist disapproved: if limited liability was desirable, we said, market forces would provide it. But by 1926 this paper had been converted, suggesting that the nameless inventor of the concept might earn "a place of honour with Watt, Stephenson and other pioneers of the industrial revolution".

Our second thoughts were right. Before limited liability, shareholders risked going bust, even into a debtors' prison maybe, if their company did. Few would buy shares in a firm unless they knew its managers well and could monitor their activities, especially their borrowing, closely. Now, quite passive investors could afford to risk capital—but only what they chose—with entrepreneurs. This unlocked vast sums previously put in safe investments; it also freed new companies from the burden of fixed-interest debt. The way was open to finance the mounting capital needs of the new railways and factories that were to transform the world.

But was this perhaps a zero-sum game, making equity less risky only by making debt more risky? No, argues David Moss, an economist at Harvard Business School, in a forthcoming book: the benefits of putting a ceiling on the potential losses faced by shareholders far outweighed the cost of a slightly higher risk of debt default. Certainly, the markets thought so: in 1860, British government bonds accounted for half the total market capitalisation of securities in London; by 1914,

under 5%, thanks mainly to the rise of equities. Meanwhile, the explosion of trading in railroad, steel, chemicals and other shares helped New York overtake London as the world's leading financial centre.

The crash of 1929 made the public aware for the first time that, for all their merits, equities had serious flaws (as did Wall Street brokers, happy to sell their own portfolios before those of their clients). Unsurprisingly, confidence in equities recovered only slowly, and then thanks only to tougher regulation of Wall Street and gradual economic recovery. The Dow did not exceed its 1929 high until 1954. Even then, after a bull market in the 1960s, between 1968 and 1982 the Dow lost three-quarters of its value in real terms; in August 1979 Business Week asked on its cover whether equities were dead.

Since then, however, with the notable exception of Japan, and a brief wobble in October 1987, shares in rich countries have mostly been a one-way bet, while countries that once shunned shareholder capitalism now have flourishing if volatile stockmarkets. The total value of shares in listed companies worldwide is now some $28 trillion. And the one-time yield gap, the dividend yield higher than the fixed interest paid by bonds, to make up for equity's greater risk, long since became a minus figure; for shareholders over the past 20 years capital growth has more than amply justified the risk.