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RENTS vs. PROFITS

What are the appropriate goals of strategizing?

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Abstract

How firms earn profits remains the central topic within strategic management – and the most neglected. In this article, I contrast the pursuit by firms of Knightian profits with the more commonly held conceptualization that they seek rents. Knightian profits as residuals are extinguished at equilibrium, and can be earned only away from equilibrium. This gives rise to a threefold perspective on the competitive economy, and three conceptions of competition – depending on whether firms are considered at perfectly competitive equilibrium, at an imperfectly competitive equilibrium, or in disequilibrium (the general case) where profits can be secured by firms that are alive to strategic opportunities and make the effort – in terms of assembling resources, activities and routines – to take advantage of them.

RENTS vs. PROFITS:

What are the appropriate goals of strategizing?

The challenge facing a firm's managers is to identify, *ex ante*, a set of Strategic Assets as grounds for establishing the firm's sustainable competitive advantage, and thereby generate organizational rents. These are economic rents that stem from the organization's resources and capabilities, and that can be appropriated by the organization ... R. Amit and P.J.H. Schoemaker, Strategic assets and organizational rent, *Strategic Management Journal*, 14 (1993): 36.

Heterogeneity implies that firms of varying capabilities are able to compete in the marketplace and, at least, break even. Firms with marginal resources can only expect to breakeven. Firms with superior resources will earn rents.

M.A. Peteraf, The cornerstones of competitive advantage: A resource-based view, *Strategic Management Journal*, 14 (1993): 180.

... the resource-based view is simply an extension of Ricardian economics but with the assertion that many more factors of production – besides land – are inelastic in supply.

J.B. Barney, Resource-based *theories* of competitive advantage: A ten-year retrospective on the resource-based view, *Journal of Management*, 27 (2001): 645.

We argue that RBT [Resource based theory] is a theory of rents as well as a theory of sustainable competitive advantage

M.A. Peteraf and J.B. Barney, Unraveling the resource-based tangle, *Managerial and Decision Economics*, 24 (2003): 310.

As the epigraphs make clear, there can be little doubt that strategy scholars see firms as being involved in the pursuit of rents. This is no accident. In mainstream economics, rents are considered as arising where various kinds of market imperfections can be found. Thus by placing rents as the focus for firms' competitive behavior, strategic management implicitly, and sometimes explicitly, relies on a notion of market imperfection to underpin a conception of strategizing.

In this article, I take a different starting point, in order to see where it might lead us. Instead of starting with rents, and assumptions of market imperfections, I start with profits, and the general case of market disequilibrium. In this setting, I seek to outline in fundamental terms just how it is that firms earn profits. I seek to do so without carrying

across any of the restrictive assumptions of market imperfection – such as ex ante or ex post limits to competition – that are found in current strategic management discourse.

I argue in the paper that this is a fruitful direction for strategic management to pursue, because it leads to the clarification of just what we mean by resources, and how they differ from firms' activities and their routines. It is surprising that, more than 20 years after Wernerfelt (1984) first coined the term 'resource based view of the firm' there has not been greater clarification of the core category of resource. Indeed one could make the case that there has been greater confusion, as notions like 'organizational rents' and rents earned through entrepreneurship, and even rents earned through firms' exploitation of their 'identity' are now being formulated. It is not clear how such ideas will lead to clarification of the fundamental categories of strategic management.

I contrast the pursuit of rents – whether monopoly rents earned in product markets, or Ricardian rents earned in factor markets – with the pursuit of Knightian profits, which can be earned anywhere in economic space, except at equilibrium. My argument is that Knightian profits constitute a robust and theoretically coherent goal for strategizing – and that it might be worthwhile to consider how the strategizing choices made by a firm might look like when reformulated from this perspective.

Indeed it is timely to consider the fundamental issue of the goals of strategizing behavior. Scholars such as Roberts and Eisenhardt (2003) are concerned that conceptions of competition that focus on process rather than outcomes – as in the Austrian tradition – are not getting a fair hearing in strategy literature, are right to be concerned. One of the reasons that competition as a process is not more widely discussed in strategic organization is arguably the dominance of the notion of rents and the comparative static

thinking that they inspire. Likewise Bromiley and Papenhausen (2003) ask why strategy discourse burdens itself with equilibrium notions carried over from economics, when disequilibrium notions would make more sense. Again, one of the reasons for this state of affairs is arguably that rent notions do not make sense in disequilibrium. It is only Knightian profits that make sense in disequilibrium – and along with them, all the notions like increasing returns, innovation, organizational learning, network effects and modular effects that can be given no meaning at equilibrium, whether perfectly competitive or imperfectly competitive.

My approach in this article is to first sketch the elements of both Knightian profits and Ricardian rents, before drawing a comparison between them from a general, disequilibrium perspective. I then examine how the conceptualization of rents has arguably biased the field of strategy studies towards notions like organizational rents, managerial rents and most problematically of all, entrepreneurial rents, and contrast these emphases with those that are consistent with a conceptualization of strategizing in terms of Knightian profits. I emphasize that I make no claim that reasoning with the category of rents is in some sense ‘wrong’ – after all, we have all been practitioners of this approach. My quest in this article is to ask whether there might be some gains available from adopting Knightian profits as an alternative and complementary way of expressing strategic goals.

Such an approach gives rise to a threefold perspective on the competitive economy, and three conceptions of competition. Firms might be at perfectly competitive equilibrium, where both profits and rents are zero, and all strategizing has ceased. Firms might be at an imperfectly competitive equilibrium, where rents might be earned, in a

passive manner, through imperfections in markets. Or firms might be in disequilibrium (the general case) where rents cannot be earned, but profits are freely obtainable by entrepreneurial firms that are alive to the opportunities and make the effort – in terms of assembling the resources, activities and routines – to take advantage of such opportunities.

Likewise by focusing on the three fundamental categories out of which firms are built through strategic endeavor, we can formulate three fundamental sources of the generation of profits. Firms can reorganize their resource base in the pursuit of complementarities; they can reorganize their value chain in the pursuit of increasing returns; and they can modify and elaborate on the architecture of their routines, in the pursuit of dynamic organizational competences. None of these sources of profit are available to the firm at either perfectly competitive or imperfectly competitive equilibrium. It is argued therefore that the Knightian profits formulation has indeed something to offer the strategic organization community.

Knightian profits

Frank Knight developed a theory of profits and management in the early decades of the 20th century that has received universal acceptance in mainstream economics. In his 1921 book, *Risk, Uncertainty and Profit*, and subsequent elaborations, Knight introduced a fundamental distinction between *risk*, which can be observed and, at least in principle, insured against, and *uncertainty*, which cannot be estimated according to a known probability distribution, and can only be resolved by taking some real-world action. He then linked these distinctions to a notion of *profit* which he defined as a pure “residual”

income after all contractual payments for factors utilized have been paid. This cleared up the endless debates of the 19th century over whether “profit” should include interest, or wages of management, or a return to a fourth factor of production. Knight then made his *coup de grace*: he identified residual earnings with the irreducible uncertainty that attaches to every business enterprise. This cleared away previous confusion over whether profits arose only as a result of dynamics or innovation (the Schumpeterian position), or could result from disturbances of the price system. Knight made it clear that insofar as risks can be insured, they do not enter into profits, and insofar as the services of factors can be paid at a contractual rate (i.e. agreed in advance) they cannot share in the residual. Therefore, the profit as residual accrues to the bearer of uncertainty, the entrepreneur, considered either as an individual or as a firm. Contractual incomes can mitigate the effects of risk, but not of uncertainty. Thus Knight reconciled his vision with neowalrasian orthodoxy, which holds that at equilibrium, all excess earnings, i.e. non-contractual earnings, are reduced to zero.

This is a powerful theory that lies behind all serious discussion of profits in economics textbooks, and in a sense has never been surpassed. That profits constitute a residual category of income corresponding to the irreducible uncertainty associated with business enterprise, is an unshakeable feature of modern economic reasoning. But Knight’s argument does more than “save” entrepreneurship from its extinction at the hands of general equilibrium theory; it reveals that true ‘uncertainty’ about the future might allow entrepreneurial firms to earn positive profits despite perfect competition and long-run equilibrium. Thus the implications of Knight’s theory of profits are profound,

and not apparently widely understood in the economics community, and certainly not within the strategic management community, where arguably it has most relevance.

Knight was at pains to develop a theory of profits that survives a rigorous definition of perfectly competitive equilibrium, and makes space for entrepreneurship (which is otherwise banished from the neowalrasian system). Simply put, in Knight's scheme, entrepreneurs gather together as many resources as they need, and undertake production of goods and services, from which they generate revenues. After paying all contractual terms for these (in present or future terms) they keep the residual, either positive (they are in business) or negative (they declare bankruptcy). This is the Knightian definition of "pure profits" as residual. The point is that at perfectly competitive equilibrium (PCE), such pure profits sum to zero. Another way of saying the same thing, as pointed out by Knight, is that at equilibrium there is no role for management, or that management will be free from error. As he puts it: "The condition necessary for perfect equilibrium, with the absence of profit, might be stated either as the absence of 'management' as a human activity, or as management free from error" (1942: 128). Therefore, as Knight himself says, positive profits must be earned in disequilibrium. This is the region of economic space where entrepreneurs flourish. My contention is that it is also the region of economic space that should be of greatest interest to management scholars.

Let us express these ideas formally in terms of two propositions.

Proposition 1

Profits sum to zero at perfectly competitive equilibrium.

That profits sum to zero at the position of perfectly competitive equilibrium is a fundamental feature of the general equilibrium economic model. It is not contested, nor even given much prominence, in mainstream economics texts. It is not a “textbook proposition” that is later qualified in the technical literature: it stands as the centerpiece of the whole system, and has done so ever since it was first propounded by Walras in 1870.

The reason for this is contained in the very meaning of the notion of general equilibrium. It is the point at which all disruptions in the economy are finally ironed out, where the accounts are paid, where the gains are balanced by the losses. Thus there is no mystery in the notion that at equilibrium, profits sum to zero.

Yet the significance of this proposition for the strategizing firm – the firm that is looking for fresh ways of making a profit – is profound. It means that profits are actually an unusual state of affairs – an insight backed up by empirical analysis of profit levels in the economy. More fundamentally, it means that a framework for discussing strategizing by firms that simply carries over general equilibrium assumptions and methods, cannot in the end yield any insight into the strategizing process.

Proposition 2

Profits can only be won away from perfectly competitive equilibrium.

This proposition follows directly from the first. Knight put this point in a most interesting Symposium held in 1942 on the topic of “Profits and the entrepreneur” – as cited in the epigraph above. Firms do not find profits at the position termed a “perfectly competitive equilibrium” – for by definition, at such a position, all residual profits have

been competed away and all resources are being used to maximal static efficiency. Another way of saying this is that at such an equilibrium, all income is accounted for by the contractual claims of capital, labor and such other factors as have been involved in the production process – leaving nothing for the residual profits that are associated with the bearing of irreducible uncertainty.¹ This residual accrues to the person or persons ultimately responsible for the business venture, identified usually with the category of entrepreneur.

For Knight, this was a way of saving the role of the entrepreneur – who otherwise has no role in the Walrasian system (Barreto 1989). The implications have not been drawn in any obvious way in the mainstream economics literature, nor apparently in the literature on the economics of industrial organization. But there is no reason why the implications should not be drawn in the field of strategy. In particular, it may be argued that “strategic opportunities” in the sense of Denrell, Fang and Winter (2003) arise only away from equilibrium.

It was Knight who clarified once and for all the distinction between rents and pure profits. Both are residuals, and from the time of Ricardo onwards, there has been confusion over the two categories. Knight made it clear that rents constitute a category of earning that is accrued by any factor – not just land – to which competitive restrictions apply in equilibrium – either in terms of the factor itself, or in terms of the product

¹ Demsetz (1988), who was a junior faculty member at Chicago while Knight was still alive, puts the matter succinctly: “Most of the literature dealing with imperfect foresight during Knight’s time associated lack of perfect foresight with riskiness of actions. The more sophisticated explanations of profit identified it as the reward for bearing risk. This cast profit in the role of a functional return similar to the relationship between wages and work effort. If risks are to be borne, compensation through profit must be paid. Knight is critical of this interpretation of the role of imperfect knowledge. His key point ... is that some risk is merely a forecastable cost of production. As such, risk is no different from any other cost, and competition can be counted upon to bring the price paid for risk-bearing services into equality (on the margin) with the cost of providing those services. No true profit can arise from this source. Profit requires a type of riskiness that is not forecastable. Knight calls this *uncertainty*” (1988: 237).

market where the products produced by that factor are sold. As such, rents are reduced to zero at PCE, where all such competitive restrictions are lifted. By the same token, *rents have no meaning apart from the concept of equilibrium*. It is only at a partially competitive equilibrium that the calculations that declare whether rents are being earned, make sense. They can only be understood as earnings that accrue to a factor where restrictions apply (in short supply, for example) *at equilibrium*. Away from equilibrium, nothing can be said concerning rents. Thus as an economy approaches a partial equilibrium with respect to some factor – say land – then earnings cannot be attributed as “rents” until an equilibrium has been established, and the gradation in earnings according to the varying productivity (fertility) of the factor, has been demonstrated. This I take to be the essence of rents: they can only be earned at an equilibrium that is imperfect in some way.

Ricardian rents

The classical, Ricardian doctrine of rent is the fount for all that follows, so let us quickly recapitulate it.² Ricardo is concerned to abstract a pure factor “land” from the kinds of farms and groves that are familiar, where capital and labor have been added to improve the productivity of agriculture. Abstracting in this way to a pure factor, the special features of which are its *fixity*, its absence of a *cost of production*, and its *differential fertility*, Ricardo then argues that land of differing fertility will be used, giving rise to differing levels of return. Land of high fertility will be used as first preference, and profits will be earned over and above the returns to any capital and labor used; then land of diminishing fertility will be brought into production, with diminishing returns; until

² See Knight (1935) for an illuminating and critical discussion of Ricardian rent doctrine.

finally land “at the margin” will be cultivated, where the value of output will be just equalled by the costs of capital and labor employed. In other words, at the margin, capital and labor together appropriate the full value of the product (corn), and the owner of the land gets nothing. But away from the margin, capital and labor still have the same earnings, *due to competition*, and the extra fertility of the land yields a surplus that is appropriated by the owner of the land as rent. Thus it is not the price of the corn that yields rent, but the differential fertility of the land. The price of the output of the land (“corn” in Ricardo’s single product model) is regulated by the productivity of the most marginal land, with “economic rents” accruing to the farmer with more fertile land.³

Ricardo illustrated his doctrine of rent with the case of two farms. On the first farm, the soil is very fertile. The farmer puts to work 100 persons, a given amount of equipment, and produces 2000 bushels of grain. On the second farm, the soil is less fertile. A second farmer puts the same number of persons, and same amount of equipment to work, and produces only 1000 bushels. The difference, argues Ricardo, has nothing to do with the technology or organization of production, but only with the differential productivity of the scarce factor, namely fertile land. If all factors receive their market return, the farmer in the first case earns a supranormal return, which Ricardo called an *economic rent*.

Thus Ricardian rent is a residual, after the earnings of capital and labor have been deducted, and it accrues to the owner of the factor (resource) on account, not of the improvements or any other feature added to it, but strictly due to its fixity and differential

³ As Ricardo himself expressed the matter: “The value of corn is regulated by the quantity of labour bestowed on its production on that quality of land, or with that portion of capital, which pays no rent. Corn is not high because a rent is paid, but a rent is paid because corn is high; and it has been justly observed, that no reduction would take place in the price of corn, although landlords should forego the whole of their rent” (1817/1971: 98).

fertility, both of which are God-given. Ricardo's argument was skilfully contrived to imply that rents are a form of "unearned income" – consistent with his political hostility to the landowning class in Britain, which he saw as unproductive and an impediment to the progress of the capitalist economy.⁴ The essence of his doctrine is that rent is not a "cost of production" but a surplus, and therefore it cannot enter into the determination of the price of a good.

Neoclassical economists towards the end of the 19th century realized that Ricardo's arguments concerning land could be extended to any factor of production – always keeping the equilibrium as the frame of reference. So if there are restrictions to competition in the product market, such as through the operation of barriers to entry, or barriers to mobility, then these will induce partial equilibria where rents are earned by one of the productive factors. This is the situation that created great fear in the USA at the end of the 19th century, as vertical integration created giant trusts, and enabled capital employed in these trusts to earn huge monopoly rents.

Marshallian quasi-rents

Marshall in his *Principles*, canonized the Ricardian doctrine of rent as a form of surplus earnings, and extended its applicability to machinery, which he claimed earned *quasi rents*, on the argument that machinery is in relatively fixed supply, like land. Thus the cost of machinery is to be treated as a sunk cost, and cannot enter into the prices of goods

⁴ How ironic that the modern RBV theorists have likened resources to land, thus aligning themselves with the resource owners against Ricardo, the champion of capitalist progress. Note also that Ricardo ignores the "appropriability problem" whereby the factor concerned has to "appropriate" the rent from the earnings of the firm; this can be a non-trivial problem.

determined by ‘floating’ capital.⁵ In retrospect this was a grievous turn by Marshall, for it has perpetuated the doctrine of rent long after it could possibly serve any useful purpose, and has moreover extended the sway of the doctrine over machinery (and by further extension, over all productive resources, as in the case of the mainstream RBV in strategy). Whereas its applicability should rightfully have been further and further constrained, while the scope for an alternative conception of earnings by a resource, akin to the calculations made with regard to investment in machinery, should have been allowed to take its place. But this did not happen – at least in economics generally. Of course modern financial analysis deals with depreciation costs of machinery and of all other kinds of resources in the overall concept of cashflow, and Net Present Value (NPV) calculations, without any need to appeal to a doctrine of “rents” as something separate from cost-based production. Hence the irony that the doctrine is perpetuated, outside elementary introductory texts on general economics, only in the theory of competitive strategy.

⁵ The passage where this extension is made is as follows:

“So long as capital is ‘free’ ... the net money income, expected to be derived from it, can be represented at once as bearing a given ration .. to that sum [i.e. interest] But when the free capital has been invested in a particular thing, its money value cannot as a rule be ascertained except by capitalizing the net income which it will yield: and therefore the causes which govern it are likely to be akin in a greater or less degree to those which govern rents.

We are thus brought to the central doctrine of this part of economics, viz.:–“That which is rightly regarded as interest on ‘free’ or ‘floating’ capital, or on new investments of capital, is more properly treated as a sort of rent – a *Quasi-rent* – on old investments of capital. And there is no sharp line of division between floating capital and that which has been ‘sunk’ for a special branch of production, nor between old and new investments of capital; each group shades into the other gradually. And thus even the rent of land is seen, not as a thing by itself, but as the leading species of a large genus ...” (1920, Book V, Ch 8, 6; 1997: 228)

This is a famous passage, and rightly so, for it sets forth as clearly as possible a doctrine that links rent with one particular kind of earning from a resource, namely one that stems from the fixity and differential character of the resource; and differentiates it from an alternative kind of earning that is linked with economic calculation and investment, and with entrepreneurial initiative. I do not think it was an accident that Marshall produced a system of industrial economics in which rents were canonized and where entrepreneurship was extinguished.

In the mainstream RBV this perspective has been generalized to all productive factors, seen as resources, and all capable of earning Ricardian rents due to their short supply (rarity), fixity (immobility) and varying productivity. Barney (1986a) captures one aspect of this process, in his exposition that sees rents accruing from the fact that resources secured in *imperfect* “strategic factor markets” need to be bought at less than full value (thus creating a rent). Dierickx and Cool (1989) captured another aspect, in their exposition that sees rents being generated by virtue of the *incompleteness* of strategic factor markets, i.e. once one firm had secured needed resources on this market, it would be difficult for other firms to do likewise. (Think of auctions for mobile telephony licenses.) Peteraf (1993) brought the two together, capturing all such cases as *ex ante* or *ex post* restrictions in factor markets, and all generating rents (Ricardian rents). The RBV thus holds that competitive advantages derive from firms’ ability to earn rents in a Ricardian setting. It thus boxes itself into a conception of resources, as individual productive elements, that are characterized by fixity and differential qualities (just like Ricardian land) and that earn rents *independently of any management or entrepreneurial intervention*. For this is the price to be paid by anyone who utilizes the Ricardian doctrine of rent. The qualities of a resource that earns rents are God-given, and they cannot be shaped by human intervention. A doctrine less suited to modern capitalist business conditions could scarcely be imagined.

By contrast, pure Knightian profits constitute a quite different kind of residual, one that is not tied to the equilibrium concept at all. Knightian profits are earned as the residual after all returns to factors (resources) have been accounted for – present and

future contingent liabilities. Such a residual is not calculated in relation to any particular factor – like a rent, at partial equilibrium – but to the bundle of factors taken as a whole. And it is not calculated solely with respect to equilibrium, but to the operations of the firm and the economy at any point. Indeed, the point of *least interest* for pure Knightian profits is PCE, where they all are reduced to zero. At partial equilibria there could be positive Knightian profits being earned at one equilibrium and negative profits at another, depending on how conditions vary across the economy as a whole.

In disequilibrium, it is quite feasible to consider a firm as purchasing or leasing productive resources, for contracted amounts (which could be *perfectly competitive* in each of the resource markets), and putting the resource bundle to work to generate activities which earn revenues, such that net revenues (income from output less costs of inputs) exceed all such contracted payments for resources utilized. Where then does the positive pure profit come from? It comes from entrepreneurial initiative, in assembling the resources into one kind of bundle rather than another. (Or from the differential charging policies that the managers of the firm can employ, designed to capture synergies). Since PCE is not the point of reference, we can entertain the idea of multiple firms earning multiple positive Knightian profits in disequilibrium. There is no necessity for the profits to sum to zero, or to any particular amount for that matter, *in disequilibrium*. There is in effect no limit to the positive profits that can be earned in disequilibrium – nor any limit to the negative profits (losses) that can be earned as well. Nobody can predict in advance what will happen, until an entrepreneurial firm actually puts the business plan into effect, and brings the product or service to market. This is the

essence of entrepreneurship – and of Knight’s notion of pure, irreducible uncertainty which can only be resolved through entrepreneurial initiative.

Three views of profits – and three conceptions of competition

From a Knightian perspective, there are three ways in which firms can potentially earn profits – or three cases to consider. There is firstly the situation at perfectly competitive equilibrium (PCE), where profits as residual earnings (and rents) are zero, and all strategizing behavior has ceased. While this position in economic space is of overwhelming significance for microeconomics, it is of zero significance for strategizing. Constructions such as the neoclassical “theory of the firm” that are built on such foundations, have little to teach business scholars (Rumelt, Schendel and Teece 1991).

Secondly, there is the situation at *imperfectly* competitive equilibrium, where due to various kinds of impediments, rents (or supernormal profits) can be earned. There can be partial equilibria in the products markets, where rents due to restrictions on competition (*monopoly rents*) might be earned: this is the Industrial Organization (IO) tradition, as developed by Caves (1964; 1980), and culminating in Porter (Caves and Porter 1977; Porter 1979). Or there can be partial equilibria in the factor (resources) market, where rents due to restricted mobility of resources (*Ricardian rents*) can be earned; this is the mainstream RBV (Barney, Peteraf, Amit, Schoemaker et al).

Thirdly, by contrast, there is the situation in disequilibrium, where positive Knightian profits can be earned, through firms taking entrepreneurial initiatives – such as capturing increasing returns from reorganizing their activities (as in outsourcing), or

resource complementarities. The focus of such situations will be on the speed with which such profits are competed away by competitive emulation (Roberts 2001).

These three cases exhaust all possible choices for strategic positioning by firms. In turn, they provide the setting in which firms take strategic choices. They might do so either on the assumption that they are operating at PCE – as advocated in microeconomics texts and in industrial organization (where firms are advised, for example, to equate prices to marginal costs, despite all the empirical evidence that this is a suicidal strategy for real firms). As an alternative, they might make choices on the assumption that they are operating at an imperfectly competitive equilibrium, where rents are to be had for the taking. This is the setting for most of the theoretical discussion of strategic management, and in particular for the competitive forces framework, and the RBV – to be discussed in a moment. And thirdly, there is the assumption that the firm is at a position of disequilibrium, and its strategic choices are likely to carry it to a different position in economic space, but still in disequilibrium where it is able to earn positive Knightian profits.

These three cases at the same time can be seen to define *three conceptions of competition*. The first, associated with PCE, is entirely static. It is price-guided competition, where firms respond to disturbances by changing their production settings in accordance with changes in demand. Insofar as profits are equated with returns to capital, then profits are “normal.” The concept has no place for strategizing behavior, as understood in business schools. Secondly, there is a comparative static sense of competition, where firms can seek to profit by the imperfections and rigidities, or frictions, or mobility barriers in the system. These are viewed as the sources of rents. It is

external shocks that move the system from one state to another, and in doing so create opportunities for firms to erect barriers to entry, or resource-based “isolating mechanisms” that tie down resources so that they can generate rents, at imperfect equilibrium. And thirdly there is the open-ended, dynamic and entrepreneurially-driven notion of competition associated with disequilibrium, and creative destruction, where it is the evolutionary dynamics of the system that create the competitive setting.⁶

Strategic behavior by the firm

We suppose that the firm starts with simple resources, and builds these, through combination and recombination, into more complex resource bundles, the valuation of which becomes increasingly more problematic, not only for the firm itself but especially for other firms (causal ambiguity). It is this gap between the valuation possibilities available for the firm that possesses the complex resources (and its knowledge of the sets of activities that are possible with such a set of resources), and the possibilities available for other firms lacking such inside knowledge, *that constitutes the ultimate source of positive NPVs, or positive profits*. Thus in an economy without firms, i.e. an economy of sole traders, the only profits obtainable would be through arbitrage (dependent on information asymmetries). But in an economy with firms, profits can be generated through the complexity of firms themselves, and their resource-activity bundles; the knowledge available to the firm regarding its resources and the real options they represent over present and future activities, is not available through the market to others (Kogut and Kulatilaka 2001). Thus it is firms themselves, and their internal valuation procedures over

⁶ Barney (1986b) provided an interesting discussion of competitive dynamics, in which Schumpeterian competition establishes the conditions in which rents can be earned. But he seems to have abandoned this position from the evidence of his subsequent writings.

resource complexes, that are the ultimate source of an entrepreneurial residual, namely profit.

This process can be captured in terms of firms' resources, activities and the routines that link these two. Firms will combine and recombine their **resources** into more and more complex combinations, or bundles, the value of which will reflect their status as real options over future sets of activities. Thus the strategic choices made by firms, and the real options they represent, are equivalent to strategic behavior (the seeking of strategic opportunities) in disequilibrium. The absence of any need to consider resources as "under-valued" in such a setting, means that we can focus attention on the real circulation of resources that occurs in the real economy, with firms exchanging, buying and selling their parts, and sometimes their wholes, in the market for corporate acquisitions as well as in markets for technologies, for auctioned resources (such as telecoms licenses), and for operating licenses (Arora, Fosfuri and Gambardella 2001). This constant resource flux is what underpins the innovation arms race that is the key to the capitalist economy (Baumol 2002). Their strategic goal in this endeavor is the capture of resource complementarities, to make the whole of the resource bundle more valuable than the sum of its parts.

Indeed in the general framework, there is no need to assume that a strategic opportunity exists only when prices fail to reflect the value of a resource's *best* use – as argued by Denrell, Fang and Winter (2003). In a disequilibrium setting, it is sufficient to assume that such an opportunity exists whenever a firm finds resources priced in such a way that it can utilize them more efficiently than the market *at that price* – without necessarily having to discover the *optimal* use of the resources. I see strategic opportunity

as being equated with the discovery of an entrepreneurial opportunity where a mismatch between prices and values (as seen by the firm with its idiosyncratic bundle of resources) leads the firm to build a business project that will actually test whether the opportunity is real or not. The firm has no need to know – and indeed it cannot know – whether the business project will make optimal use of the resources. All it needs to know is that it can impute a value to the resources, because of its existing resource combination, that is different from the value given by current prices. If we press the argument, a firm will have discovered the *optimal* use of resources only at a point of perfectly competitive equilibrium, where everything is used to its maximal efficiency, and all profits are reduced to zero. At such a point, strategizing in any meaningful sense, must have ceased.

Firms will combine and recombine their **activities** into value chain configurations that extend beyond the firm, linking other firms, as customers and as suppliers, in economy-wide networks. Thus strategic networks, as the expression of value chain reconfiguration and activity set bundling, become the structure within which the economy grows and takes shape. Clusters, networks and competence blocks all make their appearance as a result of the strategizing behavior of firms, seeking profits in disequilibrium, through both competition and through collaborative behavior (with firms in one network collaborating with each other but competing with the firms in another). The strategic goal in this case is the capture of increasing returns, either in terms of the firm's own productivity enhancing measures, or in terms of the firm's connections to other firms in networks, or transvections, that come to span the economy.⁷

⁷ See Alderson (1965) for the original exposition of transvection, an innovative concept that anticipated value chain analysis and which was formulated in a specifically management context, and not an equilibrium-based economic setting.

Firms will combine and recombine their **routines** to form organizational architectures, at both the firm level and the suprafirm level, in cognitively efficient ways. It is the building of such routines, and their improvement over time (as their capabilities are enhanced) that accounts for the possibility of firm expansion without growth in the physical underlying resources utilized – as argued first by Penrose (1959). Firms may characterize such bundles in terms of their rarity, value and non-transferability, but there will also be other criteria, possibly of greater significance – such as the issue of open-source vs. IP-protected character of resources, or the availability of resources such as technologies in technology markets. Depending on the strategies pursued by firms, the transferability of resources may be seen as positive or negative – depending on whether they are challengers or incumbents. Thus there cannot be “objective” valuation criteria for the resources deployed by firms – which is a position consistent with “Austrian” perspective (Jacobson 1992; Roberts and Eisenhardt 2003).

Firms aggregate their resources, activities and their routines, into discrete bundles. These can then be combined with other firms’ such sets, in a process of strategic network building. Such networks span the economy in complex value chains, or transvections. Eventually, markets emerge as networks and activity sets become sufficiently complex and their participants sufficiently numerous. It is the “modular” character of firms’ activity sets that explains the emergence of economic complexity, just as argued by Herbert Simon with regard to biological complexity.⁸

⁸ Simon (1962; 1993) captured this idea of the “architecture of complexity” in a delightful parable concerning Horus, who builds watches out of modules, and Tempus, who builds them out of individual components; depending on the assumptions used, it is always Horus who does better as a productive watchmaker. Likewise, the modular structures of the economy have emerged because it is more efficient to build economic activities from these sources, rather than starting always from the simple elemental categories

The expansion of industrial clusters, and their collapse, will proceed according to strategic choices made by firms with regard to specialization, with firms looking to capture increasing returns by extending the division of labor that operates at any moment. Thus the choice to specialize, and to seek insertion in an expanding network of firms, or transvections, is a strategic choice; but the success of such a choice, will be constrained by the extent of the market, as seen so clearly by Adam Smith (Stigler 1951). In this way, Smith combines both strategizing and economizing insights into the performance of a free-agent economic system; as such he may be seen as the source for both perspectives.

The drive behind firms' search for positions in disequilibrium where positive profits can be earned, through new kinds of activities, or new combinations of resources, is the whip of competition. Innovations are introduced, in terms of new combinations of activities, resources or routines, resulting in the displacement of incumbents (or what Schumpeter (1912; 2002) called "creative destruction" in the economy as a whole). New successful positions will attract imitators, and the whittling away of such profits. The time-path of profits thus becomes a central feature of strategic industrial dynamics (Jacobson and Hansen 2001). *It is the imitability and substitutability of resources, activities and routines that ultimately drives competition in an open economy.*

The framework presented enables us to capture existing approaches in strategy, through an Activities-based view (ABV), a Resource-based view (RBV) as well as (for good measure) a routines-based view or dynamic capabilities perspective (DCP). In each case we may distinguish between the application of the perspective in a comparative

static sense, at any point in time, and its application in a dynamic sense, over time, in disequilibrium (Bromiley and Papenhausen 2003).

From the perspective of the firm, the strategic choices involved in making the selections of resources, activities and routines has an immediate interpretation as the *test of a market conjecture*. Several such conjectures are formed in the “mind” of the firm, or more immediately, in the mind of the entrepreneur. The conjecture can cover a huge array of possibilities. It might be a conjecture about the possibility of blending a technology of interactivity with a technology of digital TV reception, to generate a particular way of delivering an interactive digital TV service. It might be a proposition that lowering the price of a service by a mobile phone company will increase its marketshare. Whatever the conjecture, it is made in conditions that Knight described as uncertainty, that is, in conditions that cannot be made the subject of an insurance policy. In a free enterprise system, the only way of resolving such uncertainty, is to put the conjecture to the test (Harper 1996).

The recombination of resources, activities and linking routines within the firm is the implementation of the strategic choice, and it leads to a new set of activities, new sources of revenue, and a new business model for the firm.⁹ This constant resource flux is what underpins the innovation arms race that is the key to the capitalist economy (Baumol 2002). The “new” firm, with its recombined activities, resources and routines, now provides itself with a platform for the generation of new strategic options. The new set of resources might create a platform that could be exploited, either through a new

⁹ Just as the Greek philosopher Heraclitus stated that “you can never step into the same river twice” – meaning that the river flows along, and is always changing its identity – so the firm is constantly changing its mix of activities, resources and routines. “You never deal with the same firm twice” might be a modern equivalent to Heraclitus’ comment. Firms change through the strategic choices that they make.

diversification, or for simple growth of output in the same market. It was this feature of the firm's strategic behavior that was captured by Edith Penrose, in her notion that the rate of growth of the firm is limited by the degree of management "attention" that can be paid to any set of activities based on a set of resources. Thus the strategically active firm will be exploring new strategic options based on its new resource and activity platforms – explorations that in themselves are costly, consume resources, and are not be undertaken lightly. New strategic goals might be set as a result of such explorations, in a continuously recursive process.

This then would seem to be a reasonably consistent way of treating strategizing behavior by firms, utilizing the three fundamental categories of resources, activities and routines, and three fundamental sources of profits associated with each, earned away from equilibrium. In such a setting, which is profoundly dynamic and Schumpeterian, there is no need for assumptions such as ex ante and ex post limits to competition, because the framework does not depend on equilibrium, either perfect or imperfect. In this sense I claim that the framework formulated in disequilibrium is the general framework within which conventional resource-based views, activities-based views (or competitive forces views) and routines-based views (or dynamic capabilities views) find their place.

Strategy and economic rents

By not making a clear distinction between equilibrium-focused and disequilibrium frameworks, and holding fast to a notion of strategizing as equivalent to the earning of rents, management scholars run the risk of framing the issues in terms that miss the

essential features of firms' dynamic behavior. Consider as an illustration the case of Schoemaker (1990) where we find a discussion of strategizing as a search for "economic rent" – identified as "excess returns to resources that are in limited supply" (1990: 1179). Schoemaker identifies three views as to rent creation, namely that 1) *ex ante* rents are random; 2) only short-term rents are possible; and 3) long-term rents are attainable. Schoemaker wishes to contrast perspectives on these views between economists and strategists. By the first proposition, I take Schoemaker to mean that at PCE rents are randomly distributed, and have an expected average value of zero – which is a Knightian position, and the position of all respectable economists. It is not a position to be queried, or over which opinions may differ. If this is the case, then propositions (2) and (3) amount to the statement that profits (he calls them rents) are only possible away from equilibrium – which is Knight's starting position. But because Schoemaker (1990) is not working with an "equilibrium-disequilibrium" framework, the author sees the only way around proposition (1) as coming from cases "where competition is stifled or prohibited" (1990: 1180) – examples being special interest regulation, use of patents, trademarks etc. He sees proposition (3) as being extreme, and applying only to cases such as De Beers (in the diamond trade), or early companies with statutory monopolies such as the Hudson's Bay Company or the East India Company.

Schoemaker (1990) settles on proposition (2) as representing the position of strategic management theorists – which is perfectly acceptable, so long as we replace the term "rents" with entrepreneurial profits. But then the paper muddies the water by concluding that "To obtain positive rents (*ex ante*), one must either possess private information or unique (in the sense of non-imitable) resources" (1990: 1181). So again

strategizing is boxed into “exceptional” cases. By contrast, I have identified numerous sources of positive profits in disequilibrium, quite independent of private information and unique resources – such as the capture of increasing returns through reconfiguring the value chain, or capture of synergies through resource complementarities. If Schoemaker (1990) conceded that positive profits (he uses the term rents) could only be secured in disequilibrium, then none of these confusions would arise.

Let us press this point, since I am using this paper by Schoemaker to drive home the advantages for strategists of arguing for a conception of strategizing couched in terms of the pursuit of Knightian profits in a disequilibrium setting. In his framework, then, Schoemaker (1990) identifies strategic opportunities as arising from the *frictions* in the system of market adjustment – frictions which are suppressed or ignored in the concept of PCE. Thus the author identifies such factors as bounded rationality, information asymmetries, and asset specificities (technological conditions) as providing sources of strategic opportunities (leading to what he calls rents). All of this is easily conceded: none of these conditions fits easily with neoclassical PCE. It is only at the very end of his argument that Schoemaker mentions that strategic opportunities might be generated in disequilibrium conditions – such as by firms deliberately creating instabilities through, for example, a strategy of *complexification*. “Through continual innovation, and by offering products or services that are differentiated, complex and uncertain (such as variable rate mortgages, complex insurance contracts, etc.), it becomes increasingly difficult for consumers to shop rationally (and for markets to equilibrate)” (1990: 1183). Here comes equilibrium again – as setting the norms for expected behavior, and a view of

strategizing as representing a departure from such norms. Is this really how we wish to conceive strategy – as a departure from rationality?

Now I go through this list in some detail in order to emphasize (with apologies to Schoemaker, whose paper serves simply to explicate positions taken by many others) how much simpler things become if we assume, as is obviously the case, that profits are generated only in disequilibrium. Then we see profits as being generated from the fundamentals of disequilibrium economic dynamics, such as capture of increasing returns and capture of synergies due to resource complementarities. To be sure, there will be costs associated with these activities, and with the market adjustments they trigger – costs that may be identified as transaction costs, as well as other costs that might just as well be called *strategizing costs*. Such costs are real – but they are not the object of strategizing. They are the costs of finding and executing entrepreneurial strategies. They are incidental to the main game, which is as always focused on capturing the gains from strategizing in disequilibrium.

Organizational, managerial and entrepreneurial rents

Theorists of the RBV add a twist of their own when they introduce rent-related Ricardian categories such as “organizational rents” (Amit and Schoemaker 1993), or “managerial rents” (Castanias and Helfat 1991; 2001), or even “entrepreneurial rents” (Alvarez and Barney 2000; Alvarez and Busenitz 2001). Consider the category of *organizational rents* -- by which Amit and Schoemaker (1993) presumably mean that there is a stream of earnings to a firm that come from the differential qualities of its organization, or its management, without regard to the costs involved in forming this resource. (To earn a

rent a factor cannot enter into the cost of production.) At the margin, in the firm with the worst kind of organization, labor and capital employed by this firm will appropriate the full output (which is still consistent with the firm earning an accounting profit, which may be reckoned as the earnings of capital employed in the firm). But at the same equilibrium position, other firms, with superior organization, will earn a surplus over and above the returns to capital and labor, due to their superior organization. This is organizational rent. So far, so good. Now take firm X, with earnings Y. To what extent are its earnings to be attributed to capital and labor, and the management of their productivity, and to what extent to “organizational rent”? How do we differentiate between the management applied to the organization of the capital and labor inputs, which must be counted as active factors, and to what extent to a passive factor termed “organization”? And how is firm X ever to know this? And if firm X does not know, certainly its competitor firms will not know – and so what is the strategic value of the concept?

One could play around with these rents arguments (it becomes fun once you get the hang of it). Let us consider then an imaginary category called “virtuous rent” which accrues to a firm because of its virtuous behavior. At the margin, the least virtuous firm has all its earnings appropriated by capital and labor – but other firms, with more virtuous conduct, capture a surplus called “virtuous rent.” Again, the point is: can the firm take any action based on such a conceptualization? Can it improve its virtuousness relative to other firms, and hope that it thereby captures more of the available surplus due to virtuosity? Or do its efforts to be virtuous frustrate all its other business initiatives, leaving it worse off than before? There is no way of knowing.

Castanias and Helfat (1991; 2001) do something even more problematic, when they invent a notion of “managerial rents” that are supposed to accrue to firms on account of the “rare, valuable, inimitable and non-substitutable” quality of their management resources. Castanias and Helfat characterize senior managers as “firm resources” possessing varying qualities of skills, of both a functional and generic kind. Thus the skill differentials are utilized in the argument to generate rents, just as the varying fertility of land was used in the original Ricardian argument. The same difficulty is found here as in the case of Amit and Schoemaker (1993). The argument confuses a real resource that firms need, namely good management, with a rent-earning, variable yield resource at imperfect equilibrium. But the case is rendered more problematic because *management* as an undifferentiated *resource* can demand resource rental payments that are out of all proportion to their real contribution. That this is not a fanciful concoction, but is all too real, is evident in the series of management excess scandals of the late 1990s, culminating in the Enron affair. Where would Castanias and Helfat (2001) draw the line between “acceptable” and “unacceptable” managerial rents – or rather, how would the managerial rents framework provide such a discriminant?

Perhaps the most problematic case of this reasoning is that associated with “entrepreneurial rents” – as discussed for example by Alvarez and Barney (2000) and Alvarez and Busenitz (2001). Here the argument goes that entrepreneurial initiative is associated with some identifiable “resources” such as entrepreneurial recognition (the recognition of opportunities) and entrepreneurial resource-combining (the exercise of combinative capabilities), brought to the firm by the entrepreneur, and which then earn *entrepreneurial rents*. Apart from the fact that such rents would only be earned in

imperfect equilibrium, whereas it is much more straightforward to see entrepreneurial earnings as generated in disequilibrium, the real difficulty here is to view the entrepreneur's attributes as *resources* in themselves. If this is the case, then one must ask: who utilizes these "entrepreneurial resources" – if not the entrepreneur himself or herself? If the entrepreneur is going to pay a contractual amount for the use of the "entrepreneurial opportunity resource" then who is to seize the opportunity to utilize such a resource? There is an infinite regress involved here. The Knightian setting makes it abundantly clear that the entrepreneur mobilizes resources – *but entrepreneurship itself is not a resource*.¹⁰ On the contrary, entrepreneurship should be viewed as the engine that uses the fuel of resources to drive the economy in new directions, thereby enhancing its adaptive capacity.¹¹

The obsolete Walker notion of profits and the modern RBV

Perhaps unbeknownst to all these authors in strategy is the fact that their arguments merely rediscover those advanced in the late 19th century by a certain General Walker, the most prominent proponent of a view that sees management as making a contribution as a "fourth factor" of production and as such, earning rents. General Francis A. Walker was a self-appointed champion of industrial capitalism, and author of a celebrated textbook that

¹⁰ Perhaps the strongest statement of this view in the economics literature of the 20th century is provided by the French economist, Jean Marchal (1951):

“... the entrepreneur, although undeniably providing a factor of production, perhaps the most important one in a capitalist system, is not himself to be defined in those terms” (1951: 551). Marchal elaborates a theory of profit (published in the *American Economic Review*) that sees it as the fundamental engine of capitalism, and derived from entrepreneurial action on the market structure – not taking the structure as given, but changing it to profitable ends.

¹¹ One of the key resources hired by an entrepreneur is management itself – which then plays a fundamental role in building the routines that link the resources and activities set in motion by entrepreneurial action. There is infinite regress in identifying management as a key resource – as done so tellingly by Mahoney (1995) and Mahoney and Pandian (1992).

opposed the doctrines not just of Marx but also of Henry George. Walker simply appropriated the Ricardian doctrine and applied it to entrepreneurial profit, which he treated as a return to the factor, management. He stated the theory in these terms, in his famous 1887 article in the *Quarterly Journal of Economics*:

“Under free and full competition, the successful employers of labor would earn a remuneration which would be exactly measured, in the case of each man, by the amount of wealth which he could produce, with a given application of labor and capital, over and above what would be produced by employers of the lowest industrial, or no-profits, grade, making use of the same amounts of labor and capital, just as rent measures the surplus of the produce of the better lands over and above what would be produced by the same application of labor and capital to the least productive lands which contribute to the supply of the market, lands which themselves bear no rent.” (Walker 1887: 278)

Substitute “organizational rents” or “managerial rents” or “entrepreneurial rents” in this passage for what Walker calls the returns to “industrial management” and the argument is faithfully reproduced. I don’t think the modern theorists of the RBV had this kind of comparison in mind.

Rents, transactions costs and corporate governance

So far, my exposition has ignored the issue of transactions costs, principal-agent problems and other issues to do with corporate governance. This is because I wish to establish the fundamentals first, namely to establish just what are resources and how they

differ in a strategic setting from activities and routines. This enables us to consider how it is that firms earn profits. As I see the issues of corporate governance, they are concerned not with profit generation, but with rent distribution, as between the various claimants to the total rent generated. I do not dispute that this is of great importance in practical settings – as when the owners of a strategically vital resource (such as an airport in the case of airlines) can claim a large share of the profits generated by the firm (Foss and Foss 2005; Makadok 2003). But as every good Ricardian farmer knows, you have to put the cart before the horse. You have to know how profits are generated before discussing how they are distributed.¹²

Concluding remarks: Rents or profits?

It matters how topics are conceptualized. In this paper, I argue that it matters for the discipline of strategic organization how the goals of strategizing are to be conceptualized. If they are conceptualized as pursuit of rents, either monopoly rents earned in product markets or Ricardian rents earned in factor markets, then the emphasis of discussion – as shown in the examples taken from RBV theorists above – will inevitably tend towards strategic earnings being seen as passive outcomes of the imperfections in markets or the result of frictions in the economic system, rather than the outcome of the efforts of entrepreneurial firms to identify opportunities and build businesses around such opportunities. There will be a tendency towards identifying the rewards of strategizing

¹² For similar reasons, I do not discuss interesting contributions to the strategic management literature such as those by Makadok (2001; 2003). Makadok, as I interpret him, is seeking to effect a blending, or merger, between the dynamic capabilities perspective and the governance perspective. Again, I see this as fruitful only after the issue of the contribution of resources to profit generation has been clarified. More recently, he has been searching for the ultimate sources of profits for firms – but in my view is handicapped by not doing so in a general disequilibrium setting.

with nebulous concepts like organizational rents or entrepreneurial rents which, even when the best gloss is put on them, remain impervious to any rational explication.

If however strategizing is conceptualized in terms of Knightian profits, then the emphasis has to be placed on how entrepreneurial firms actually earn such profits, away from equilibrium. The emphasis will thus be placed on earnings from such features of the economy as capture of increasing returns; or the exploitation of complementarities between resources; or the capture of learning effects from the improvement of organizational routines. All of these notions are outlawed by the assumptions of general equilibrium – and yet they should be seen as central to the strategizing process, as understood so clearly by Schumpeter (1912a; 1912b; 1927) who should be seen as properly the founder of strategic thinking.¹³

This is why I argue that the term “rent” (and in particular Ricardian rent) is not helpful in strategizing discourse. It conjures up the wrong images, and focuses on the wrong things. When used in the Ricardian sense, it focuses on the fixity and differential character of the individual resource, to which it attaches earnings potential – rather than to entrepreneurial calculation and management effort in shaping and fitting a resource bundle, as a totality, to perceived needs. When used in the Marshallian sense, it merely extends this idea to all resources, and compounds the confusion with further abstractions concerning differences in the ways that earnings accrue from capital before it is invested and after, and in denying that costs are incurred by a machine after it has been amortized,

¹³ This is actually quite close to the spirit of the most recent theorizing in neoclassical equilibrium-based economics. Makowski and Ostroy (1995; 2001), for example, treat the proofs of the properties of equilibrium through a process of approaching more and more closely to equilibrium from a non-equilibrium position, through which the extreme conditions satisfied at equilibrium are established.

and so on.¹⁴ Attempts were made at the turn of the century to extend the notion of rents to the earnings of any resource – but this suggestion was never taken up in microeconomics.¹⁵ However the “old doctrine of rent” survives in the strategy literature (Phelan and Lewin 2000).

When used in the monopoly sense, the notion of rent carries no connotations of management or entrepreneurial skill, and merely discredits strategy as “rent-seeking” behavior. The exception to this is the case when monopoly is granted over use of a resource by statute, as in the case of a patent, or a mining lease – and in these cases the monopoly is granted for a limited duration, to the purported benefit of society at large.

Knightian profit, as earned for example by entrepreneurial initiative, is, by contrast, an entirely different category that is earned in an entirely different way. It is computed after accounting for all contractual obligations that are incurred by the entrepreneur in order to realize the business plan. As such, it is attributable directly to the skill of the entrepreneur, who has to be alert to the profit opportunity in the first place; who has to be able to identify the resources needed, and find them at a suitable price; and who has to be able to assemble resources such that complementarities are captured, making his or her particular resource bundle more competitive than another in the way that goods are actually produced with the resources assembled. I would also include the case of monopoly profit in this category, since it is entrepreneurial endeavor that results in the award of a patent, or a mining lease – not an act of God. The point is, there is no

¹⁴ For a devastating critique of the Marshallian doctrines of rent, with all their manifest contradictions, see Ogilvie (1930), who delivers himself of the judgment, obviously shared with the editor of the *Economic Journal*, that the doctrine of rent had long outlived its usefulness.

¹⁵ See Clark (1891) and Fetter (1901). These efforts were subsequently buried in the neoclassical orthodoxy.

equilibrium built into the notion of entrepreneurial profit. It happens to be competed away to zero at equilibrium, but at every other position it can be earned, and computed, without regard to equilibrium.

In this sense, the notion of entrepreneurial profit is an active concept, while that of rent is passive. Rents are not earnings that provide practicable, actionable goals for a firm to make them the target of strategy. Rents are the passive residual accruing to the passive factor, simply because it exists in a state of scarcity. So there is a gulf between the two notions of residual earnings. Strategizing discourse has everything to gain by positing entrepreneurial (Knightian) profits as the goal of strategic behavior, and leaving rents to the history of political economy, along with the wages fund and the labor theory of value.

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