*Strategic Management*, 9e: Chapter 4 study guide

Resource analysis and economic rent

To understand the role of resources in competitive advantage, it is useful to explore the underpinning concept of *economic rent*. This was ﬁrst developed by David Ricardo (1772–1823), an English economist of the early nineteenth century. After making his fortune in stockbroking, Ricardo retired at the age of 42 and devoted his life to a consideration of economic and political issues.[[1]](#endnote-1)

1. The concept of economic rent

**Definition:** *Economic rent* is deﬁned as any excess that a factor earns over the minimum amount needed to keep that factor in its present use.

It was originally explored by Ricardo, who considered the rents earned by landlords from farmland that was used to grow corn. However, it is far more readily understood in the ﬁrst half of the twenty-ﬁrst century by examining the vast wages earned by pop stars, famous footballers and highly paid TV newscasters: typically, their annual salaries run to US$500,000 or more. Yet their ability to earn much beyond US$50,000 in other occupations is quite limited, so why pay them US$500,000 when they should be willing to play music, football and read the news for a mere US$50,000? Essentially, because such people are in short and ﬁsse supply. They receive payments greatly in excess of the wages needed to stop them moving to other occupations: this excess of around US$450,000 (500,000 minus 50,000) is called *economic rent*.

2. Two main types of economic rent

In addition to some *resources* being in short supply, economic rent can also be derived from the marketplace – in strategic terms, opportunities in the organisation’s *environment*. Ricardo never considered this latter form of rent. There are two main types of rent:[[2]](#endnote-2)

 *Ricardian rents* (after David Ricardo) derive from the *resources* of the organisation; they are rents generated from those resources that possess signiﬁcant competitive advantage, allowing the company to generate signiﬁcant additional returns.

For example, the advantage derived from a unique geographical location, like that of McDonald’s outside the Zoo in Berlin, or the possession of a special patent as in the case of the Dyson vacuum cleaner.

 *Monopoly rents* derive from the *markets* in which the organisation operates; they are the rents associated with a company’s unique position in the marketplace that allows it to earn exceptional returns.

For example, a government-owned monopoly position in electricity or gas supply might generate exceptional returns. Equally, a privately owned position of market dominance can be built as a result of long and skilled investment in a market – Microsoft’s possession of its Windows software with 90 per cent world market share is an example here. It is important in this example to note that there is nothing special about Microsoft’s resources – other companies have developed similar software but have been unable to dislodge the Microsoft dominance.

There are other forms of economic rent, the most important from a strategic perspective being *Schumpeterian rents.*

**Definition:** These are rents that derive from a new and innovatory product or service that allows the organisation to charge considerably above its costs of production at least until replicated by competitors.

Such rents will often involve risk-taking and entrepreneurial activity – as, for example, at the time of writing, in the case of some forms of digital video disc and digital computer cameras. Such rents are named after the famous US economist Joseph Schumpeter (1883–1950), who wrote extensively on the role of innovation in markets.[[3]](#endnote-3) However, as Schumpeter himself recognised, such a position is inherently unstable because other organisations will enter a market place where high prices are being charged and high proﬁts are being earned. New entrants will clearly need to ﬁar their way around any barriers to entry, but the result over time is that this form of rent will either disappear or become a subset of one of the two major types identiﬁed above. For example, Xerox (USA) held patents on photocopying machinery in the 1960s and 1970s that included innovatory technology and allowed the company to earn exceptional proﬁts. But in the period 1960–85, Canon (Japan) developed an alternative photocopying system that did not rely on the Xerox patents, thus negating the Xerox resource competitive advantage over time.

3. Implications of economic rent for resource analysis: scarcity and alternative use

Beyond its examination of the environment, the concept of economic rent has two signiﬁcant implications for resource strategy:

 *Scarcity of resource*. It identiﬁes this concept and raises the possibility of developing resources that are so scarce that they can earn substantial economic rent.

 *Alternative use for resources*. The concept explores other and more proﬁtable uses for any resource beyond the one that is currently being pursued. Speciﬁcally, it considers the possibility that using the resource for another purpose might produce more rent.

Both these insights have considerable signiﬁcance for the resource strategy of individual ﬁrms. Strategic development of the individual resources of an organisation can, at least in part, be directed at exploring these two issues – scarcity and alternative use. For example, GSK has developed a series of patented drugs that are sufﬁciently different for the company to charge a price premium – economic rent. Also, British Rail in the 1980s sold parts of the land that it was not using for its rail services to other manufacturing and retailing companies. The company increased its rent from the alternative use of some of its resources.

As far as the productive alternative use of resources is concerned, this is usually treated as an ongoing issue in strategy. In practice, some resources are more ﬂexible than others in terms of alternative use. For example, once a factory has been built, it becomes difﬁcult to make major changes because of its shape, design and layout. But companies that own their own transport may well ﬁnd that they can sell it, invest the money in scarce resources and hire transport from outside companies more cheaply. At present, there is no substantive body of strategic resource theory that explores the alternative use of resources.

The characteristics of scarce resources that will generate high economic rent are explored in Section 4.6 of the main text.

4. How does economic rent relate to accounting profit?

Accounting proﬁt is the difference between total revenue and the *explicit* costs of generating this in a given time period – often over one year. Economic rent is different, because it is concerned with the difference between total revenue and the *opportunity cost* of the factors of production. The kernel of the concept of economic rent is that it is not concerned with the accounting proﬁt that will arise from the current strategy, but the extra that might be earned beyond the current proﬁt if the resources were to be used elsewhere. Accounting proﬁt makes no attempt to measure this. More broadly, rent explores strategic concepts related to the organisation’s possession and use of resources or its dominance in the marketplace. Accounting proﬁt does not undertake this task. It is important in any strategic discussion of accounting proﬁt to recognise its signiﬁcant limitations – many strategies are evaluated in terms of their accounting proﬁts and return on capital, so the problem cannot be dismissed lightly. Exhibit 1 compares the two concepts further.

**Exhibit 1 Some differences between economic rent\* and accounting profit**

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| **Economic rent\*** | **Accounting profit** |
|  Economic concept based on the alternative uses of resources |  Accounting concept based purely on artificial definitions of resources, etc. |
|  Time period unlimited |  Defined time period, e.g. one year |
|  Resources assessed for their value on the open market and for their ability to deliver future funds |  Quantification of resources based on historical costs rather than broader concept of their current usage |
|  Can be associated with specific resources and their ability to deliver unique sources of revenue |  No realistic possibility of identifying the quality of resources beyond simple numerical values |
|  Can also be associated with market dominance and its ability to deliver superior revenue |  |
|  Important conceptually but difficult to calculate in practice |  Relatively easy to measure and calculate |

\* *Note*: Sometimes, economic rent is called economic profit. They are essentially the same thing.

5. Comment on economic rent

Although economic rent is superior to accounting proﬁt as a strategic concept and is widely used by economists, it has several difﬁculties:

 It is difﬁcult to estimate because of the conceptual problem of ensuring that *all* alternative uses have been considered and accurately valued.

 It makes the simplistic assumption that every option can always be implemented, without regard for the human resource implications.

 It provides few insights on how to identify new Ricardian or monopoly rent opportunities at the commencement of strategy analysis. It is useful after the event (*ex post*) but is not so useful in advance when strategy is being formulated (*ex ante*).

Thus, its strategic beneﬁts are mainly conceptual: Figure 1 provides a post-rationalised example from the world car industry of the strategic relationships between rents and resources.

6. Key strategic principles

 Economic rent is defined as any excess that a factor earns over the minimum amount needed to keep that factor in its present use.

 There are two main types of rent: *Ricardian* rents derive from the exceptional resources of the organisation and *monopoly* rents derive from the organisation’s market position.

 Economic rent is important in strategy analysis because it highlights the scarcity of some resources and the possibility of alternative, more profitable uses for a resource.

 Economic rent is conceptually more relevant to strategic decision making than accounting profit because it is better at highlighting the main issues involved. However, economic rent is more difficult to calculate. Moreover, it oversimplifies some elements of strategy, such as human resource aspects and the strategic process itself.

1. Ricardo, D (1817) *Principles of Political Economy and Taxation*, J Murray, London. More detail on the origin of economic rent is contained in the following: Lipsey, R G and Chrystal, A (1995) *Positive Economics*, 8th edn, Oxford University Press, Oxford. [↑](#endnote-ref-1)
2. For a consideration of rent and its strategic implications, *see*: Mahoney, J and Pandian, J (1992) ‘The resource-based view within the conversation of strategic management’, *Strategic Management Journal*, 13, pp363–80. This gives a useful overall view. See also Schoemaker. [↑](#endnote-ref-2)
3. P (1990), ‘Strategy, complexity and economic rent’, *Management Science*, 36, October, pp1178–1192. [↑](#endnote-ref-3)