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Entrepreneurial rents and the theory of the firm☆

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Abstract

The creation of entrepreneurial rents occurs under conditions of uncertainty. Yet current theories of rent appropriation such as transactions cost theories of the firm focus their efforts primarily on how quasi-rents – rents that have already been created – are appropriated by parties to that exchange. Entrepreneurs face a dual challenge, that of creating entrepreneurial rents and appropriating some of these rents. Moreover, this challenge usually exists at a time when the entrepreneurial rents that might be created are not known or anticipatable. Indeed, entrepreneurs not only concern themselves with ensuring that they are able to appropriate at least some of the rents that might be eventually created but in fact they may not create any rents or potentially lose value. Understanding the dual nature of the rent creation and the rent appropriation problem has a variety of implications for the study of entrepreneurial organizations and generally for theory of the firm discussions.

Keywords: Theory of the firm; Uncertainty; Entrepreneurial rents

1. Executive summary

Much of the literature in entrepreneurship and strategic management uses the terms “risk” and “uncertainty” as if they were synonyms. However, there is a long tradition in economics that distinguishes between these concepts starting with the work of Knight. Knight was the first scholar to recognize that some decisions about investments are made under conditions of uncertainty. He distinguished between risky and uncertain decision making settings. Knight distinguished between risk and uncertainty on the basis of

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whether or not the probability distribution of outcomes associated with a decision is known or not before a decision is made.

Entrepreneurs specialize in exploiting new, untried market opportunities typically suggesting conditions of uncertainty. This means that entrepreneurs often must make resource coordination decisions that create entrepreneurial rents and rent appropriation decisions before the economic value associated with exploiting a market opportunity is known, even probabilistically.

This paper describes how entrepreneurs can organize a firm to solve their rent creation and appropriation problems, even when the future economic value of exploiting a market opportunity is uncertain. The paper begins by distinguishing between risky and uncertain investments and then shows the type of rents that are generated under each type of condition. Then the problems associated with using a theory of the firm based on opportunistic forms of transactions costs and quasi-rents are addressed and how using a transactions cost view that is not based on opportunistic behavior is appropriate for entrepreneurial rent creation settings.

2. Entrepreneurial rents and the theory of the firm

Entrepreneurs looking to gain competitive advantages by exploiting market opportunities must accomplish a variety of tasks. Two of the most important of these are often, first, to coordinate all the resources necessary to exploit an opportunity in order to create entrepreneurial rents and, second, to create a setting within which at least some of the rents created by exploiting this opportunity can be appropriated by those exploiting it (Alvarez and Barney, 2004).[1]

A great deal of literature suggests that accomplishing these two tasks will often require the creation of a firm (Holmstrom and Tirole, 1989). In this sense, firms are an institutional framework where resources controlled by multiple individuals can be coordinated (Alchian and Demsetz, 1972). Moreover, the creation of a firm typically involves defining who gets to make which kinds of decisions, and the claims of various individuals on the cash flows created by exploiting an opportunity (Grossman and Hart, 1986; Hart and Moore, 1988).

Entrepreneurs, in this context, face an unusual challenge. In particular, entrepreneurs specialize in exploiting new, untried market opportunities (Schumpeter, 1934; Shane and Venkataraman, 2000). This means that entrepreneurs often must make resource coordination decisions that create entrepreneurial rents and rent appropriation decisions before the economic value associated with exploiting a market opportunity is known, even probabilistically.

If the economic value associated with a new market opportunity is uncertain, then it is difficult to know, for sure, if any entrepreneurial rents will be generated and if they are who in the exchange should appropriate these rents. In other words, when the economic

[1] Of course, the exploitation of all market opportunities does not require the coordination of multiple resources controlled by multiple actors. A single actor controlling all the resources necessary to exploit a market opportunity has been defined elsewhere as arbitrage (Alvarez and Barney, 2004).