WHAT DOES PROFIT MEAN FOR ALFRED MARSHALL?

*Jesus M. Zaratiegui**

ABSTRACT

The article intents to justify that Alfred Marshall (1842-1924) is the foremost economist in the elaboration of a complete and analytically coherent theory of the entrerpreneurial profit. The central issue which needs to be addressed is to ÔmeasureÕ the contribution of the businessman to the productive process which justifies the receiving of profits, a rent with a residual character (what remains after every single factor of production has already received its share).

Our contention is that the ingredients for a correct analysis of business gains are fully developed in his thought despite the fact that he mixed a number of elements of profit in relation to capital, management and entrepreneurship. For him the main sources of profit can be assigned to the third block of elements: bearing non-insurable uncertainty; new findings and innovation; creation of market power; and good luck. The question that is begging is whether or not Marshall was an Schumpeterian *avant la lettre*. And, connected to it, what are the analogies and the differences of the two theories.

The second conclusion of the article is that the businessman can combine efficiency (profit search) and equality (ethical behavior that Marshall names as Ôeconomic chivalryÕ.).

The attention given by Alfred Marshall to the English businessmen of his era is well-known. He writes with the aim of gaining their understanding and dedicates his best energies to procuring the establishment of some studies in economics, specifically designed to facilitate entrance into the business world.

Gathering disparate elements, he elaborates one of the first theories of

* Department of Economics, University of Navarra, Spain.

International Journal of Applied Economics and Econometrics, July-September 2002, Vol. 10, No. 3, pp. 381-402.

businessmen as such, the merit of which resides in his assigning them a specific place within economic analysis. To accomplish this end he coins the idea of the "fourth factor" of production, which comes to be united to the classical three of land, work, and capital. Our question is whether Marshall was an Schumpeterian *avant la lettre*. What are the analogies and the differences of the two theories of entrepreneurship?

In Walras' neoclassical equilibrium there is no permanent place for the businessman, only for the auctioneer, whose role disappears once he has matched all the offers and demands present in the market. Profits have an occasional, contingent character and disappear once the new position of equilibrium is obtained (the entrepreneur who obtains neither losses nor profits). Thus there is no place for profits nor for the firms themselves. But, certainly, there is one theory of profits in Marshall, easy to find by the reader of *Principles.*

According to Casson (1990: XIV) Marshall understands the entrepreneur as a distributor of profit. However, from Smith's perspective, which Marshall broadly accepted, profit was an incentive, and sometimes a reward, for improvements. Competition is characterized not by oscillations around an equilibrium but by experiment, error, adjustment and re-adjustment. It is a process in which the individual tries to better his condition in face of the unplannable chaos around him. Smith's frugal, penny-pinching businessman serves as his inspiration for explaining what profit is and where it originates.

There is a fundamental ambivalence in Marshall's thought in the *Principles.* He feels compelled to offer a theory of long-period sustainable stationary equilibrium and factor pricing in a hypothetical unchanging environment. And at the same time he wants to talk about a real world dominated by change and evolution, hence the Schumpeterian parallels. As to the first, Marshall's theory is subtle and complex (and not entirely unproblematic) but the general outlines seem clear enough.

In particular, the *ex-ante* conditions sustaining a steady flow of new businesses to replace expiring ones —the life-cycle of the firm is crucial and Marshall's theory is hardly attuned to the dominance of the corporate form of organisation— need to be distinguished clearly from the *ex-post* outcomes.

Some businessmen will do better than they anticipated at the outset, and others worse, but in the long-period equilibrium the distribution of outcomes will remain stable over time as businesses enter and expire. There is a close analogy to the professions, such as law or medicine.

Marshall's tendency to want to deal with the subject in a more "realistic" way is perhaps also reflected in his treatment of short-period phenomena and the adjustment processes interrupting or conditioning the economy's evolution to long-period equilibrium given no long-term change in the underlying conditions defining the latter. Some attention deserves here to creative adaptation on the part of the businessman.

But it is the pioneering discovery of new goods and new methods, which inevitably destroy long-period equilibrium, that lies at the heart of Marshall's passionate defense of a free enterprise system against the threat of collective control of production (see for example *Memorials* pp. 283-4). Does he have a profit theory for such an evolutionary setting? How is it related to Schumpeter, even to Nietzsche?

This double source of inspiration is translated into an equally dual formulation of the theory of profit. We argue that the classical focus appears to be united in the Marshallian model to extraordinary profits obtained by the successful entrepreneur, which serves in turn as the inspiration for Schumpeter's theory. By way of contrast, the neoclassical element becomes associated with the figure of the manager, who undertakes routine tasks within the business ("follow beaten tracks") and receives a normal profit, an idea that Schumpeter wrongly proximates to Marshall's quasi-rents.

Many of these Marshallian intuitions remained outside later analysis of entrepreneurial profit. What happened in the years following his death in 1924 is relatively easy to explain. His insights about the businessman who makes improvements were taken over by Schumpeter —although he did not always recognize it— and became the theory of the innovative businessman. On the other hand, the concept of Marshallian "normal profits" did not have sense anymore and was eliminated from the dominant theory of equilibrium.

The debate continues to be open from the moment in which Schumpeter expressed his doubt that Marshall's formulations contain anything innovative or distinct from simple retribution due to capital's contribution (the classical idea), or pay for routine management work (manager versus entrepreneur). It becomes necessary to explain in what consists the novelty, and to what extent it has lasted until our own time.

This paper shows the relationship between Marshall's theory of profit and his conception of business men as combining, in varying degrees, the supply of capital, the organization of production, the superintendence of work (including brainwork) and the organization of novelty. The scheme we follow begins by analyzing the elements of Marshall's theory of profit. This leads us to our economist's innovative contributions to the idea of profit. We show then that Schumpeter was a true Marshallian, but that he introduced into the analysis the process of creative destruction found in Nietzsche's ideas.

1. THE INGREDIENTS

Marshall's analysis of business profit combines the English tradition (Adam Smith, Mill) with the French which had reached him via the German school (Von Thünen). But showing lineage is always a difficult task. This paper does nor purport to demonstrate the influence of precursors on Marshall, but to make a few remarks on it for a better understanding of the idea of profit he has in mind. It would be very difficult to examine the notion of profit in all of these writers and to trace the links among them in such a short piece.

The theory of the entrepreneur was for a long time dominated by the idea that the English economists, from Adam Smith onwards, ignored his role, because they concentrated on the view of the entrepreneur who contributes capital to the business. For this reason so much emphasis had been placed on Smith's capitalist-entrepreneur, but so much less in the businessman who 'is engaged in plans and projects' (WN, I, 265) and 'live by profit'.

In this context, the debate between Smith and Bentham (Pesciarelli, 1989) on usury is very illuminating, because it contrasts two models of entrepreneur that have become commonplaces in economic writing: the Smithian view, that this type is widespread in society; and the Benthamite one, that it is a minority. These lead to two different kinds of economic development: one that is gradual and not subject to sudden variations; and another that is characterized by changes caused by 'improvements' and which is open to interpretations in which equilibrium is not needed.

Marshall continues along the same line: improvements were associated with an understanding of every day management, notably in his summary of the requirements of the ordinary manufacturer: "the power of forecasting the broad movements of production and consumption, of seeing where there is an opportunity for supplying a new commodity ... or improving the plan of producing an old commodity" (PE: 297).

He also shares the Smithian point of view that part of the capitalist entrepreneur's profits are the result of the work that he does , and not due to his holding the capital: 'should be regarded as the salary for his work'. He recognizes that profits contain an element which is not interest on capital: he differentiates remuneration for work from the care which goes into the mere supervision. Marshall viewed the total sum of things requiring explanation in practically the same way as Mill and Smith, and his efforts were directed towards explaining these things more satisfactorily.

The writings of John S. Mill are another source of inspiration. In Mill's eyes, the entrepreneur is first a capitalist, the owner of the business, who advances and risks his capital; but besides this —we sense the influence of the French school— he is a worker who controls the business's operations. He should be remunerated for his time and skills.

Marshall's 'directors' salary' is already present in Mill's concept of 'gains of superintendence', although the latter adds to this a substantive force in a way that is somewhat different. 'Marshall went further in his careful analysis of earnings of management that expanded and deepened Mill's wages of superintendence so greatly as to make practically something new out of them' (Schumpeter, 1961: 646). He thus opened up the way to recognize a duality of sources in the businessman's profits: the directors' earnings are the part of the profit that is not paid as interest on the capital.

This means a modification of Ricardo's view: the central figures are no longer the capitalists but the entrepreneurs and their businesses. Mill introduces this idea into England, assigning them a decisive role in the determination of profits. Directors' salaries are determined in a different way from other salaries— they have a residual nature. Mill indicates that profits include payment reflecting possible risk, as well as the salaries of the directors, and the interest. The similarity with "normal profits" developed by Marshall is clear, but Mill subordinates 'the minimum valuation of profit' to the cost of labor.

Authors such as Bagehot contested the inclusion of interest in the profit, but there was always a tendency in England to confuse the two concepts. Up to the last quarter of the nineteenth century, English economists went on believing that the capitalist advances the salaries, and they did not understand that they could include a profit received by the entrepreneur not by this route but as a result of the success of his business. 'When at last the wage-fund theory of wages expired, the way was open for the classification of the earnings of undertaker's labor along with that of other kinds of labor' (Cannan, 1964: 308).

The tradition of the German school counts for much in Marshall's thoughts. His intellectual curiosity brought him to this country, where he was able to read the principal authors in their original language, many years before they were rediscovered by another scholar (Streissler, 1990: 58). The references to German authors are plentiful in *Principles*. Among other things, he owes to the Germans his theory of entrepreneurial 'organization' as a fourth agent of production.

According to M. Blaug, the first correct analysis of business profits was made around 1850 by the German economist Von Thünen. He considers that profit is what remains of the gross profit (it is therefore a residue) after the interest on the capital, insurance against the risk of losses and direction's salaries have been paid. It is the compensation, which may work positively or negatively, for running non-insurable risks, plus the productivity of the work of the directors that exceeds the normal expectations. He completes Cantillon's analysis by distinguishing between the two concepts: it is uncertainty that produces pure profits. He integrates in an original way the French tradition —which viewed the businessman as the recipient of a residual, uncertain and non-contractual income— with the English heritage —which equates the businessman with the capitalist—, which was unprecedented in economic theory. Starting from Von Thünen's ideas, Marshall developed his view of business profit as a result of risk and uncertainty.

Marshall explicitly recognizes his debt to Von Thünen in his treatment of profit: "I was unwilling [in 1879] to write upon distribution at all, because I did not then see my way clearly as to some parts of it. But I had settled the main outlines of the problem to my own satisfaction very early, under the good guidance of Von Thünen" (PE, II: 232-3).

The influence of Von Thünen on Marshall is also present in: 1) the idea of marginal productivity, which is the base upon which he sustains his later theory of distribution among work, interest and profit; 2) the analysis of the premium [on scarcity] of those risks that cannot be shifted by insurance; they are all due to the limitation of special capacities; 3) to include in the 'entrepreneur's income' in the broad sense that part of the interest and the businessman's salary which is the result of special capital investment or productive effort, and which cannot be exploited by anyone who is not their owner (Santos, 1988: 92); that is, they do not have opportunity cost, but do yield a profit for their owner; 4) to assign a separate income to the entrepreneur even in equilibrium, treating entrepreneurial activity as a fourth factor of production.

2. WHAT DOES BUSINESS PROFIT CONSIST OF?

As we have seen, Marshall composes a new theory of entrepreneurial profit. But 'the nature of that reward is, however, complex, since the actual payment which the businessman receives is in truth a mix of rewards in turn for a mix of services. The economist must dig deep and desegregate fully if he is to grasp adequately the nature of the *quo* which occasioned the *quid*' (Reisman, 1988: 316).

This is quite serious because Marshall usually fails adequately to define and discuss the notions of rent, profits, salaries (e.g. for superintendence), or quasi rents. Sometimes the term profit is used and then it becomes clear that in fact a rent is being discussed. Another times, by contrast, rents are discussed as distinct from profits. Frequently profit is used to refer to economic profit (profits above a normal rate of return) and sometimes profit is used to refer to the normal rate of return. But none of this is clearly spelled out.

From his point of view, the organizer's profits include very different ingredients: insurance against risks; the costs of bearing non-insurable risks;

earnings for routine management functions; earnings as a result of exceptional skill; the recompense for bearing non-insurable uncertainty; there is a reward for the ability to administer capital; there are also profits which are the result of good luck, or the creation of monopolies which eliminate uncertainty (PE: 613). As a result the reader is left reading and re-reading passages in order to come to some understanding of the analytical framework under discussion.

In Marshall's framework, there are several elements that differentiate purely entrepreneurial profit from other kinds of profit. Actually, he doesn't call this profit (uses term income). Having in mind the problems we have mentioned, the following points are of particular importance:

1) It is a form of profit which fluctuates in relation to prices in a way that is more than proportional: that is, it is more sensitive than are the employees' salaries, which experience only a delayed form of change and undergo smaller fluctuations. Marshall takes account of the time element: "in the first place the undertaker's profits bear the first brunt of any change in the price of those things which are the product of his capital (including his business organization), of his labor and of the labor of his employees; and as a result fluctuations of his profits generally precede fluctuations of their wages, and are much more extensive' (PE: 620).

> The income which the large-scale businessman receives ... is so great, and liable to such violent fluctuations ... that he often thinks very little of his own work in the matter. If profitable business opens out to him, he regards the harvest accruing from it as almost pure gain; there is so little difference between the trouble of having his business on his hands only partially active, and that of working it to its full capacity, that as a rule it scarcely occurs to him to offset his own extra labor as a deduction from those gains: they do not present themselves to his mind as to any considerable extent earnings purchased by extra fatigue, in the same way as the extra earnings obtained by ... the artisan. This fact is the chief cause of the imperfect recognition ... of the fundamental unity underlying the causes that determine normal profits (PE: 622-3).

2) It is much greater than the ordinary earnings for organization because no account is taken of the businessmen who fail and lose all their capital: "in reference to normal prices, it is to be classed rather with the

profits derived by free settlers from the cultivation of new land, or again with the find of the pearl-fisher. The plot of one settler turns out better and that of another worse that was expected; the good find of one dive of the pearl-fisher compensates for many others that are fruitless: and the high income of those who earn by their natural genius has to be counted with the comparative failure of many others" (PE: 664).

The focus is very different when the matter at hand is the earnings for routine management: "in trades in which the speculative element is not very important, so that the work of management consists chiefly of superintendence, the earnings of management will follow pretty closely on the amount of work done in the business" (PE: 613-4). In essence, it is simply the competitive earnings of a specialist kind of labor in a competitive labor market.

Again, the same confusion regarding rents versus profits versus income appears. Here Marshall is using earnings also using income (above, p. 5). This suggests we shouldn't be using the term profit for such returns.

3) The part of the businessman's profit attributable to his efforts is the smallest, whereas in other professions it constitutes a large proportion of the earnings. The greater part of the businessman's profits is made up of quasi-rents or economic rents, which have little to do with the amount of work that is done.

> When the artisan or professional man has once obtained the skill required for his work, a part of his earnings are really a quasi-rent of the capital and labor invested in fitting him for his work, in obtaining his start of life, his business connections, and generally his opportunity for turning his faculties to good account; and only the remainder of his income is true earnings of effort. But this remainder is generally a large part of the whole. And here lies the contrast. For when a similar analysis is made of the profits of the business man, the proportions are found to be different: in his case the greater part is quasi-rent (PE: 622).

Short-term adjustments underlie his assertion that "the greater part of incomes earned by exceptionally successful business man may be classed as quasi-rents" (PE: 623); "we must regard the price of the business undertaker's own work as part of the original outlay" (PE: 353). Marshall concludes that "when [businessmen] have exceptional natural abilities, which are not made by human effort, and are not the result of sacrifices undergone for a future gain, they obtain a surplus which is of the nature of rent" (PE: 623).

4) Most of the businessman's profit results from the possession of certain natural skills: it must therefore be related to the difficulty of finding people who have such abilities. Most of the earnings correspond to the function proper to the businessman of guiding the direction the firm is taking:

> The class of business undertakers contains a disproportionately large number of persons with high natural ability; since, in addition to the able men born within its ranks it includes also a large share of the best natural abilities born in the lower ranks of industry. And thus the rent of rare natural abilities may be regarded as a specially important element in the income of the business man (PE: 623).

The profits earned for the possession of exceptional qualities are growing to an extraordinary degree: "the relative fall in the incomes to be earned by moderate ability, however carefully trained, is accentuated by the rise in those that are obtained by many men of extraordinary ability" (PE: 685). In reply to observations made by F.A. Walker on his book *The Economics of Industry*, Marshall wrote in 1887:

> That part of his earnings which he owes to his education may be regarded as a kind of profit on the capital invested in it; that part which he owes to exceptional natural qualities may be regarded as a kind of rent, that is, is the income derived from an agent of production, the supply of which is determinate by natural causes (PE, II: 670-1).

Marshall's emphasis on intangible capital is a central theme in his writings, not only that embodied in the business man, but also that represented by the firm's internal and external organization (PE: 458): thus the activity of organizing builds assets, and some part of profit should be treated as a return on the organizational capital created by past activity. How this capital should be valued, and over what period it should be expected to generate profit, were questions which he recognized could never be answered with any precision; he took an interest in accounting, and recognized the need for, and the limitations of, conventions.

(5) The businessman's profit is high in proportion to capital when his work as a director is taxed: "The normal earnings of management are of course high in proportion to the capital, and therefore the rate of profits per annum on the capital is high, when the work of management is heavy in proportion to the capital. The work of management may be heavy because it involves great mental strain in organizing and devising new methods, or because it involves great anxiety and risk" (PE: 612) (from 1895, 3rd ed.).

6) The earnings are the consequence of commitment to a particular business, i.e., taking into account its opportunity cost. Part of a businessman's profits are derived from his contacts and commercial organization, and they might be foregone, at least in part, should he dedicate himself to other activities.

> The earnings of a successful business, looked at from the point of view of the business man himself, are the aggregate of the earnings of his own ability, of his plant and other material capital, and of his good-will, or business organization and connection. But really it is more than the sum of these: for his efficiency depends partly on his being in that particular business; and if he were to sell it at a fair price, and then engage himself in another business, his income would probably be much diminished. The whole value of his business connection to him when working is a notable instance of Conjuncture or Opportunity value. It is mainly a product of ability and labor, though good fortune may have contributed to it. That part which is transferable, and may be bought ... is in a sense an Opportunity cost (PE: 625).

Williamson considers this idea in the context of his own concept of the 'specificity of the assets'. This is the fact of specializing in a particular activity—with all the knowledge, skills and other advantages this may entail—that cannot be capitalized on in the market place; it is a cost of opportunity. Conjuncture earnings derive from the fact that agents are more productive when combined in businesses than elsewhere (he uses the word "particular").

3. EVOLUTION OF THE CONCEPT OF PROFIT IN MARSHALL'S WRITINGS

Marshall's earliest ideas about business profit are to be found in *Economics of Industry,* in which he establishes two different classifications. 'In one, income is classed as (1) rent, (2) profits consisting of (a) interest and (b) earnings of management, and (3) wages and salaries; in the other, the classification is (1) income, (2) interest, (3) earnings, consisting of (a) earnings of management and (b) wages and salaries' (Cannan, 1964: 310-1). 'The kind of confusion likely to result is illustrated in Marshall's own exposition: he says, "the earnings of a business man are uncertain, but so are those of a fisherman" (EI: 95-6), where he is showing the contrast between wage-paid and profit-paid labor. The fisherman is profit-paid and not wage-paid. If he happens to be wage paid, his earnings cease to be uncertain ... the uncertainty is essential to profits, and certainty in the inverse sense is essential to wages'.

That early approach to the gains of entrepreneurs is based in the fact that 'organization' (i. e., the business man) must receive his reward, though its nature and reach is very complex, because the benefits of the organizer include very different ingredients. Nevertheless, Marshall created a rather normal rate of profit out of this compound, who can be defined as the rate that makes it worthwhile to enter and to stay in business. "These gains or profit contain many elements, some of which belong to interest for the use of capital, ... the reward of managing ability and of enterprise, including the bearing of risks" (PE: 582-3).

Once he has refined his analytical equipment, Marshall proposes new classifications of business profit. In the first, he distinguishes between the net income of the managers (it is "the supply price of business ability and energy"), and the gross incomes (the sum of net incomes plus the supply price of the organization that unites the entrepreneurial ability and the capital).

> We may regard the supply price of business ability in command of capital as composed of three elements: the supply price of capital; of business ability and energy; and of that organization by which the appropriate business ability and the requisite capital are brought together. We have called the price of the three elements: interest; net earnings of management; and gross earnings of management (PE: 313).

The net managerial earnings are what has been called the 'salary of the managers'. The gross income seems to correspond to the common definition of profits when these are calculated to include the salaries of the administrators (their net earnings).

The net managerial earnings ("the supply price of business ability and energy") depend on the person's possession of two qualities (the "ability" or knowledge that can be learnt; and the "energy" or creativity that is something innate) which the "capable and energetic man" has, as opposed to other "weaker" characters. Marshall thus shows himself to be aware of the growing role of the new managerial methods in businesses, and of the increasing space occupied by net earnings within the broadest category of gross managerial earnings. He develops this describing the impact of the life-cycle of innovations on different classes of economic agent: he takes the case of the innovator industrialist who has an advantage at the outset, but who is then copied by others — the consumer wins out in the resulting drop in prices. O'Brien (1990: 73) insists that the role which Marshall attributes to competition in the leveling out of profits should not be interpreted as an argument against the role of innovations, 'because this very competitive equalization of returns ensured that the entrepreneur had a continual incentive to search for new methods and new products'.

A second classification which he sets up is that which distinguishes between entrepreneurial profits and the salary of supervision that is assigned to the salaried director. 'After deducting all other costs from gross profits there remains a residual or surplus reward, and it is this reward which the organizer pays himself ' (Reisman, 1988: 317). Is this really a surplus we are talking about? How is a payment for the tasks of supervision and organization, a surplus? I am not quite sure of the right answer. These are 'direction's earnings', which include payment for two different tasks: supervision to make sure that tasks are carried out, and organization of production: the latter is the function proper to the entrepreneur.

In *The Economics of Industry*, Marshall states that "the work by which an employer gets Earnings of Management is of two kinds. The first is that of organizing the production; of determining what shall be made and how it shall be made; and of deciding where and when to buy and sell. We shall adopt an American term, and call this Engineering the business. The second part of the work, which may be called that of Superintendence, consists in providing for the proper carrying out of his instructions" (EI: 221). The businessman's function as the organizer of production is one of the concepts underlying management schools teaching.

Marshall explains it with the example of the carpenter paying for his own work (EI: 74), when he does the calculations about his profits, he "must reckon in the value of his own work and time" (PE: 354) and make a deduction for his own work ("earnings purchased by extra fatigue") (PE: 622) from the gross profits of the business. In an essay of the 1870s entitled *The Wages of Superintendence* he already recognizes that the directors' earnings contain elements both of salary and of profit (EEW: 205-12). Business profit is distinguished from the superintendent's salary, as Marshall asserts from the third edition (1895) of *Principles*:

> The order of mind required for interpreting rightly and reducing to the proper proportions the causes that are likely to affect prices is rare, and can command high earnings. The allowance to be made for this is so important in certain trades as to have induced some American writers to regard profit as remuneration of risk simply; and as consisting of what remains after deducting interest and earnings of management from gross profit. But this use of the term seems on the whole not advantageous, because it tends to class the work of management with mere routine superintendence (PE: 613).

From the moment when innovator activity turns into routine administration, he no longer deserves this entrepreneurial profit of a residual nature. The following paragraph appears in the first edition of *Principles*, though it is omitted in the later editions: "As soon as any method of manufacturing is reduced to routine, and no longer requires exceptional ability, those who follow it will be unable to get the earnings of work that is really difficult. For those who merely follow the beaten track do not render as important services to society as they would have done if they had to think out the method for themselves" (PE, II: 647).

The third distinction is the one that he establishes between normal and extraordinary earnings. In every industry there is a "normal profit" that is regulated by market forces, in which the businessman's work is essential: "we see that there is no general tendency of profits on the turnover to equality; but there is in each trade, a more or less definite rate of profits on the turnover which is regarded as a 'fair' or normal rate" (PE: 617). When we analyze the causes that determine the price of the effort needed to direct a business, he says that "the normal earnings of management are of course high when the work of management is heavy in proportion to the capital, because it involves great mental strain in organizing and devising new methods, or because it involves great anxiety and risk" (PE: 612). Competition between the businessmen brings supply and demand into accord (PE: 600; 618), so that their profits settle at a reasonable level.

In Marshall's view, the analysis of the "organizational factor", or the businessman, is no different from that of capital and work. The commercial enterprise is composed of three elements: capital, the "faculty for business in those who have to direct them," and the organization, by means of which both of the other elements are placed in contact and made effective for production (Santos: 126). The causes that regulate these elements are less arbitrary than is usually supposed, and present analogies with which they determine other types of earnings such as salaries (PE: 596). Marshall's principal thesis is that there exists a defined price —normal profits, which is part of the business' costs— for the "capacity offer for business that have capital". He considers that the application in business of one or the other methods will be extended to the limit or margin in which their advantages outweigh their disadvantages.

Schumpeter misunderstands the Marshall's scheme when he relates these normal profits with the concept of quasi-rent (PE: 622-4): the very essence of normal profit is that it has to be earned to keep the capital in the industry; the essence of any kind of rent, whether quasi or otherwise, is that it does not. The idea that normal profit in Marshall is related to quasi-rents is impossible to reconcile with Marshall's own text.

The Marshallian distinction between "rents" (gifts of nature) and "quasi-rents" (owed to a superior management) is somewhat confused when he applies it to the natural talent contributed by the businessman. On the one hand, "that part of a man's income which he owes to the possession of extraordinary natural abilities is a free boon to him; and bears some resemblance to the rent of other free gifts of nature" (PE: 664). On the other hand, it is a scarcity income : "in relation to normal value the earnings even of rare abilities are, as we have seen, to be regarded rather as a quasi-rent than as a rent proper" (PE: 623).

For Marshall, the quasi-rents are scarcity rents and are the result of the failure to achieve complete adjustment in any given time and will disappear in the long run as all costs become variable (Blaug, 1962: 357). The individual entrepreneur may be a low-cost producer because of a favorable site or superior management, because competition has not been able to convert these quasi-rents into payment to the factors. A period so short as to prevent the entrepreneur from adding to capacity may be long enough to overcome the immobility of resources that alone permits him to collect the intramarginal surplus.

"Nearly the whole income of business may be regarded as a quasi-rent, that is, an income determined for the time by the state of the market for its wares, with but little reference to the cost of preparing for their work the various things and persons engaged in it" (PE: 626). In the long run the cost ladder must straighten out, and when all adjustments are completed each firm will produce along identical cost curves that include 'rents'.

For Marshall, in the long run, the gains and "the supply of each agent will be closely governed by its cost of production" (PE: 537). But what matters is the short run, and Marshall brings entrepreneurial success into a relationship with its immediate effectiveness: "the struggle for survival tends to make those methods of organization prevail, which are best fitted to thrive in their environment; but not necessarily those best fitted to benefit their environment" (PE, II: 596-7). Given perfect competition, the profit in equilibrium in the long term is zero: we can define it as a residue that is left after all the contractual costs have been paid. The businessman's short-term profit bears within it the seeds of its own disappearance, as it will attract new businessmen.

4. THE NEW ELEMENT IN THE MARSHALLIAN CONCEPT OF PROFIT

Up to this point, no extraordinary earnings appear: the businessman's salary is payment for the work of supervising the business, or if extraordinary payments do exist, they are random, as Walras assumed. However, Marshall does allow for what we might call 'Schumpeterian entrepreneurs', that is, those that do "not follow beaten tracks". He states nothing about the reasons why these men do well (Santos, 1988: 145-6). It is possible to recognize such businessmen in paragraphs like this: "a manufacturer of exceptional ability and energy will apply better methods than his rivals ... if he is only one among many producers his increased output will not materially lower the prices of his goods, and nearly all the benefit of his economies will accrue to himself" (PE: 614-5).

Marshall distinguishes normal profits from those windfall ones that result mainly from the operation of the monetary system, which contains the germs of a windfall theory of this type, as his treatment of the earnings of management contains the substance of the theory of normal profit. When he argues that "exceptional success may be balanced against exceptional failure," he is thinking of normal earnings but, above all, "they assume the first rank, and exert a predominating influence, with regard to the incomes earned by particular individuals at particular times" (PE: 619).

He tries to distinguish the normal earnings associated with management from those that are obtained by exceptional means — these are the truly entrepreneurial gains: "Since these disturbing causes affect profits and the earnings of management in very different ways from those in which they affect ordinary earnings, there is a scientific necessity for treating differently profits and ordinary earnings when we are discussing temporary fluctuations and individual incidents" (PE: 619-20). He constructed two different theories about the entrepreneurial income: a) 'normal' earnings correspond fairly exactly to the businessman's duties of direction, superintendence, and risk taking; b) 'extraordinary' earnings are important because they show the others which route to follow; yet "the exceptional earnings do not form part of the supply price" of a business's capacity.

These 'Schumpeterian earnings' are closely linked to the individual's genetic make-up: "those who have exceptional natural abilities (and average good fortune) get earnings exceeding normal profit ... and this excess I proposed to call rent" (PE, II: 674). Kirzner thinks that Marshall mixes up the two kinds of earning. But what he is really saying is that in modern management methods, the functioning of the substitution mechanism (which makes any of the other elements capable of functioning like the organizational factor) is more important than the existence of innovative businessmen and extraordinary earnings (Santos, 1988: 145-6, 182). Schumpeter's insistence that no "normal earnings" exist that are sufficient to call into being the necessary supply of entrepreneurial ability is a response to Marshall's ideas.

Close to this central theme is Marshall's Principle of Substitution, which combines what is now thought of as a rule of efficient allocation and a principle of experimentation and discovery. Marshall does not appear to have employed the distinction between moving to a well-defined alternative factor combination and trying out an alternative factor combination, which has not previously been employed; business men can sometimes hardly escape being a little entrepreneurial in the ordinary course of business. But this distinction does correspond to all theories, notably Schumpeter's, which seek to divide entrepreneurship from management.

The previous criticism is present in MacNulty (1984: 243) when he asserts that in the neoclassical writers there is a continued relative neglect of both the firm and the entrepreneur, because the neoclassical theory of factor pricing and income distribution, grounded as it was in the concept of marginal productivity, failed to apply to entrepreneurship and to its return, profit.

According to him, there is no explanation of the entrepreneurial income. 'In the case of partial equilibrium, the marginal product of the entrepreneur to the firm has no meaning, since entrepreneurship was traditionally conceived of as one and indivisible, while under the conditions of general equilibrium in perfect competition, entrepreneurs, as Knight pointed out, would have no functions and receive no income. There is truth in his argument that the profits became explained as the payment of the undertaking of non-insurable risks, the return for innovation, or as a temporary windfall or monopoly gains'.

Summing up, Table 1 presents a summary of all the elements of profit found in Marshall's writings.

Table 1 :
Elements of profit

A) *In relation to capital:*
   1) Interest on capital
   2) Bearing non-insurable risk
   3) Ability to administer capital
   4) Quasi-rents on capital

B) *In relation to management:*
   1) Routine management of superintendence

2) Mental strain in organizing and devising new methods
3) Profit on the capital invested in the education of the manager
4) Value of connections
5) Rent of exceptional natural skills (ability or energy)
6) Quasi-rents of business undertaker's own work
7) Windfalls of macroeconomics policies (first brunch of changes)

C) *In relation to entrepreneurship:*
1) Bearing non-insurable uncertainty
2) New findings and innovation
3) Creation of market power
4) Good luck

I have shown that for Marshall the main elements of profit can be assigned to the third block of elements. But this idea is not common among the economists of today. The extensive identification of his thought with the model of equilibrium and normal profits lead to the ignorance or distortion of his more valuable intuitions, specially about the true nature of entrepreneurial profit.

Economic literature after 1890 is full of comments and explanations of Marshallian theses. Business and the businessman became one of the most notable dead ends in Economics. In the later development of the theory, the businessman was made to disappear, to the point of converting him into mere fiction. Business was reduced to looking for combinations of factors to exploit market opportunities. The error consisted, as O'Brien (1990) pointed out, in the belief that in economic analysis 'competition' had to mean 'perfect competition'. It gives the businessman a single solution for each business problem, instead of the complete set of possibilities which Marshall had foreseen.

In this way one eliminates 'the awkward problem of explaining profits, which was avoided and banished in modern general equilibrium treatments, which have no need for factor rewards; entrepreneurship and profit disappear from theory which formally excludes change' (Loasby, 1982: 239-40). The popularity of the theory of general equilibrium was a break to studying in depth the theory of the businessman in line with his contributions.

Walras can be censured for having excluded the business function from his economic views. The arbitrageur's concern was that markets reach equilibrium but once this is achieved, Walras abandons the entrepreneur and centers his interest in the deduction of the basic laws of a state of general equilibrium. This focus distracts attention concerning processes towards an equilibrium that is never attained, in which Marshall was more interested. Confining economic activities to situations of equilibrium means little attention to explaining what is the nature of business profit.

Furthermore, 'with a redefinition of the entrepreneurial function as something which is external to the firm, Marshall's life cycle effectively disappears and what remains internal to the firm is the managerial function, and effectively eliminates the entrepreneurial function' (Niman, 1991: 166). Education in the 50s and 60s had the result that no one read *Principles*.

The Schumpeterian flavor of Marshall's writings disappeared. But, what are the main differences between those two big thinkers about profit and entrepreneurship? Schumpeter finds his inspiration in the writings of Nietzsche (one of the reduced number of thinkers who does not appear in the *History*). In Also *Sprach Zaratrusta* Nietzsche explains in two chapters the concept of creative destruction and how the energy of the entrepreneur is not so important to guarantee the discipline of work in the firm as to oppose the reactions of the losers in front of the innovation. But Nietzsche was not only influential in Harvard through Schumpeter. He was also very influential in Chicago through Knight. In his Essays in Competition he explains the Nietzschean theory of man as always a child who likes to play, ready to pay with losses for the pleasure to participate in such an interesting game as entrepreneurship. You are fortunate if you can work for these kind of people! They value the factors of production much more than others!

6. CONCLUSIONS

Marshallian profit theory takes its basic elements from two different intellectual traditions, the German and the English (classical) traditions. From these two sources of inspiration Marshall derives the two formulations that he makes of profit: (1) the neoclassical, in which "normal profit" is the reward for routine administrative tasks carried out by managers in the business; (2) extraordinary profits received by the pure *entrepreneur* —seed for the

Schumpeterian entrepreneur— who moves away from the "beaten tracks" by the improvements (innovations) which he puts into effect.

The initial formulations were not far from those of Von Thünen and Mill, when they record exhaustively the compensation received by the businessman for the various tasks he undertakes. From this point forward, he begins to separate the managerial and entrepreneurial tasks as different sources of profit. The contraposition of these two polar figures (*entrepreneur* and *manager*) will be converted into a cliché of economic literature.

Marshall goes further and elaborates an analysis of extraordinary profits that are the result of the exceptional ability and energy of the *entrepreneur*. 'Extraordinary' earnings show the others which route to follow; yet "the exceptional earnings do not form part of the supply price" of business's capacity: what Marshall wants to demonstrate is that such a price does exist — but that it is untenable if we include these extraordinary earnings within it. Marshall's insights about the businessman who innovates were taken over by Schumpeter and the later literature that addressed the business innovator. Marshall was not very receptive to Nietzsche's ideas about the losses-prone or conflict-creator entrepreneur.

REFERENCES

Blaug, M. (1962), *Economic Theory in Retrospect*. Homewood, Ill.: Irwin.

Cannan, E. (1964), *A Review of Economic Theory*. London: Cass.

Casson, M. (ed.) (1990), *Entrepreneurship*. Aldershot: Elgar.

Knight, F. H. (1921), *Risk, Uncertainty and Profit*. New York: Houghton Mifflin.

Loasby, B. J. (1982), The Entrepreneur in Economic Theory. *Scottish Journal of Political Economy*, XXIX (3), pp. 235-45.

Marshall, A. [1881], *The Economics of Industry*. London: MacMillan (with Mary Paley).

Marshall, A. [1890] (1961), *Principles of Economics*. London: MacMillan. Ninth Edition (Variorum), with annotations by C. W. Guillebaud (two vols.).

Marshall, A. [1919], *Industry and Trade*. London: MacMillan.

Marshall, A. [1923], *Money, Credit and Commerce*. London: Mac Millan.

Moss, S. (1984), The History of the Theory of the Firm from Marshall to Robinson and Chamberlain: the Source of Positivism in Economics. *Economica*, 51, pp. 307-18.

McNulty, P. J. (1984), On the nature and theory of economic organization: the role of the firm reconsidered. *History of Political Economy*, 16: 2, pp. 233-53.

Nietzsche, F. W. (1997), *Also Sprach Zaratustra*. Madrid: Alianza.

Niman, N. B. (1991), The Entrepreneurial Function in the Theory of the Firm. *Scottish Journal of Political Economy*, 38, 162-77.

O'Brien, D. P. (1990), Marshall's Industrial Analysis. *Scottish Journal of Political Economy*, 37: 1, pp. 61-84.

Pesciarelli, E. (1989), Smith, Bentham, and the Development of Contrasting Ideas on Entrepreneurship. *History of Political Economy*, 21:3, pp. 520-40.

Reisman, D. (1987), *Alfred Marshall, Progress and Politics*. New York: St. Martin Press.

Reisman, D. (1988), *The Economics of Alfred Marshall*. Basingstoke: MacMillan.

Santos, M. (1997), *Los economistas y la empresa*. Madrid: Alianza.

Schumpeter, J. A. (1961), *History of Economic Analysis*. New York: Oxford Univ. Press.

Streissler, E. W. (1990), The influence of German economics on the work of Menger and Marshall. *History of Political Economy*, 22: 5, pp. 31-68.