6 Factor Market

Unit 3 : Rent & Land

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I The Origin of Rent On Land

Rent, in its daily usage, is commonly treated as the ***payment*** on hiring anything especially on a piece of land. The owner receives the payment and treats it as a source of income.
One of the classical economist, David Ricardo (1772-1823), regarded that a piece of land has no alternative use except for the growing of corn. (***Note*** : He is referring to the 17th c.)
So the use of land involves only one option, i.e. the cultivation of corn.
As there is no knowledge of reclamation at that time, land bears the following characteristics :
* It is relatively fixed in supply.
* It is geographically immobile.
* It has no cost in production and involves zero opportunity cost.

From the above properties, the return from land - commonly called " ***rent*** " - becomes ***an excess gain or surplus over and above the (zero) opportunity cost*** which is necessary to keep the piece of land in its present use.
As the supply is relatively fixed, the value of land depends on the demand condition of land.
The economists here are referring something different from our daily use in the meaning of land.
We call this return as the ***Ricardian rent.***

II Modern Concept On (Economic) Rent

Recently, economists interpret the meaning of rent in a broader perspective.

Rent is the amount of **payment** per unit of time for the services of any **durable goods or assets,** particularly land or any **relatively fixed** factor inputs.

Rent is a payment to **any factor** of production **over and above** what is necessary to keep a given quantity of this factor forever in existence in its current employment and quality.

In the production aspect, rent like wage, is also a part of the total cost of a producer.
Based on this view, the return to a factor of production consists of 2 parts :

Transfer Earnings
It is the **minimum amount** paid to (or earned by) a factor of production in order to prevent it from transferring to another alternative use. The amount itself depends on the highest-valued option forgone, i.e. the value of the opportunity cost. It is another term for opportunity cost but this term goes on to emphasize the return of a factor ; instead of merely a choice among options.

Economic Rent
It refers to the **excess** amount over the transfer earning that a factor actually earns. It is that part of return to the factor owner in excess of the minimum amount required to induce it to stay in its present employment.
In other words, rent is that part of return to a factor owner which is unnecessary to keep a factor in existence.

Economic Rent = Actual Earning - Transfer Earning

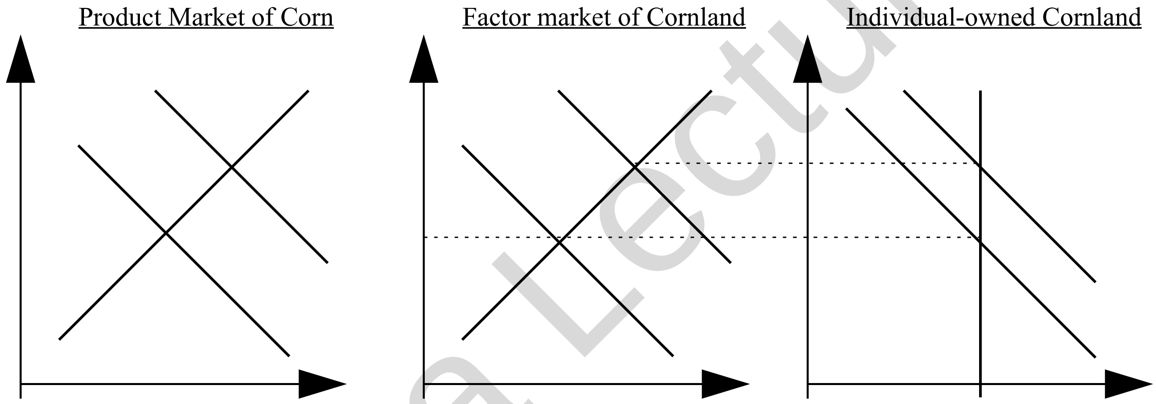
This presence of this excess payment to a factor owner over its opportunity cost is due to the inelasticity of supply of this factor.

Case 1 : Perfectly Elastic Supply
The whole amount of payment is the transfer earning with zero economic rent.
Case 2 : Perfectly Inelastic Supply
The whole amount is the economic rent with zero transfer earning, i.e. the case of the Ricardian rent. The value of land depends on the demand condition in the market.
Case 3 : The Usual Case of An Upward-sloping Supply Curve
Both economic rent and transfer earning exist in this case. The amount of economic rent is a similar term of the producer surplus. Economic rent refers to the case concerning a factor market. Producer surplus refers to the case concerning a product market.

Remarks On Rent

1 A high amount of rent (of any factor input) does **not cause** a high price of the final product produced. It is the demand (with competitive uses) for this factor that determines the amount of economic rent.

Illustration of The Argument : Price Affects Cost or Rent



When the demand for corn increases, the market price of corn rises. The demand for cornland is the derived demand based on the MRP of cornland which is affected by the price of corn, i.e. MRP = MR x MP.
As a result, the demand for cornland also increases. The market price (or rental charge) of a piece of cornland is bid up. If the supply of cornland is perfectly inelastic, the demand for individual-owned cornland will also increase. The increase will finally lead to a rise in economic rent received by the individual cornland owner.
So, economists often say :

Rent is **not** price-determining. (Rent does **not** determine the price of the product.)
Rent is price-determined. (Rent is determined by the price of the product.)

2 If the supply of a factor is fixed, the amount of economic rent cannot affect the incentive of the factor owner to supply more quantities of the factor even if demand increases.
The amount of rent will still affect the allocation of resources. In a competitive market, rent serves as
a guide to the efficient use of resources by rationing the supply available to the highest-valued (most efficient) alternative use.

Rent has its importance in economic theory because it affects the allocation of resources.

III Other Types of Rent

1 <u>Rent In The Short Run & Long Run</u>

In the short run, suppose the only variable factor is labour and the only fixed factor is called capital. A price-taking firm in a competitive product market may find its total revenue greater than its total cost. If we treat the wage as a **measure** of the contribution of labour in production, then the amount of total revenue after deducting the wage could be treated as the measure of the contribution of capital to the firm. The contribution includes the opportunity cost of capital itself **plus** an amount in excess of its total cost. This amount is also that part of earning of the fixed factor over its opportunity cost.

This gain in wealth is called **economic rent in the short run**.

In the long run, a capital good must wear out over time due to the very fact of depreciation, i.e. it had to be replaced after a certain period of time. If the capital can earn an amount over time so as to allow the owner to replace the depreciated one in the future, the firm will be willing to use and be able to use this capital **in the long run**.

If the capital cannot earn back this amount, the firm has not enough fund to replace it. In the long run, this capital good will not exist but will be replaced by some other forms of factors of production.

In the long run, the capital or any factor input earns **only** its transfer earning.

The concept of rent is important because it still affects the supply or resources allocation in the long run although it does not affect the supply or resources allocation in the short run.

(In the short run, the amount of rent is the excess earning of a fixed capital, therefore it does not affect the existence of the fixed factor itself.)

2 <u>Monopoly Rent</u>

It is the income derived from the owning of the monopoly right in production. The word " monopoly " refers to the right of the monopolist to restrict entry of others. The word " rent " refers to the idea that the existence of this amount does not affect the output of the monopolist.

It is also a (factor) cost to a producer because the monopolist may offer the business to someone else and get back an amount of earning due to the monopoly right.

If the monopolist keeps on staying in the business, it forgoes the value (amount) of the monopoly right sold out. The amount of monopoly rent is therefore **a cost instead of a profit**.

3 <u>Imputed Rent</u>

It refers to the amount of rent accrued to the owner-supplied resources, e.g. payment to the entrepreneurial skills of an executive. It is the amount of the opportunity cost of factor inputs owned by a firm, i.e. it **supplies to itself** and has alternative uses. (It is **not** fixed in supply.)

The owner of the firm does not need to pay any price **explicitly** for the use of these inputs. He simply takes the excess over the total revenue after all cost payments have been made to the owners of other factors of production.

On the one hand, the owner bears no money cost explicitly. On the other hand, he bears **implicitly** the opportunity cost of using the factor elsewhere. This amount of opportunity cost is called imputed rent or even imputed interest for a capital, or imputed wage for himself.

4 <u>Differential Rent</u> (***Optional***)

It refers to the differences in rent accruing to various units of a factor of production which have different opportunity costs, but with the same amount of payment earned in their present employment.

IV <u>An Overview On Rent</u>

* Rent is a stream of **payment** for the services of any durable goods, not only land.
* Rent is a **part of cost**. It reflects a certain degree of inelastcity of the supply of a factor.
* Rent is determined partly by the price of the final goods but **not** vice versa.
* Rent has an allocative function though it does not affect the supply in the short run.
* The concept of monopoly rent emphasizes the option of the outright sale of a business. It is a part of cost. The amount of it may vary according to the degree of competition posed by the competitors of similar substitutes.

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