

Re: Example economic rent calculation

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- *From:* jim_bowery@xxxxxxxxxxx
 - *Date:* 24 Oct 2005 16:47:37 -0700
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So how would you rewrite the following Wikipedia article?

http://en.wikipedia.org/wiki/Economic_rent

In economic theory, economic rent is an analytic term employed to distinguish the difference between the income earned by an input or factor of production, and the cost of the factor of production. A factor of production can be put to various and alternative economic uses; the income earned by (or price paid for) a factor in its current use may be more than what is minimally necessary to draw the factor into its current use; one can imagine the price paid for the factor falling to a level at which the factor would be transferred to its next best use — that price, the income earned in its next best use, is the opportunity cost of the factor. The difference between the opportunity cost and the income earned in its present use is a rent.

Economic rent is distinct from economic profit, which is the difference between the firm's costs — what the firms pays for all the inputs it uses — and the firm's revenues. While the definition of "economic profit" is a strict one, which excludes rents, the commonsense idea of profit often confounds rents with profits. Real business enterprises typically own some of the factors of production, which they use to produce goods and services for sale, meaning that the business enterprise receives the income due to those factors of production, in addition to whatever economic profit the enterprise might earn. The commonsense idea of a highly profitable firm is typically a firm, which owns factors of production, which earn a high rent in the use to which the firm puts them — a farm, which owns highly productive farmland or a merchant, who owns a highly productive retail location, might be thought "profitable" in the common sense of the term, profit, because the firm is receiving a large rent on the factor of production, which it owns.

In classical economics, analysis focused on three factors of production — land, labor and capital — each of which earned a distinct type of income — rent, wages and interest, respectively. These three categories or types were used to explore what determined the distribution of income. It was observed that higher wages or higher interest rates might be expected to draw additional labor or capital to

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market, but higher rents did not induce God to make any more land; the owners of land rented or made useful all the land they had, regardless of the going rent. Still, some land commanded considerably higher rents than other land. Since only a minimal rent was necessary to bring land into some kind of productive use, almost all of any rent earned must be attributed to market competition to determine how land was to be allocated to particular uses.

Virtually all of rent — the income earned by land — could be assigned to the allocative function of market prices, while only a portion of wages (the income earned by labor) or interest (the income earned by capital) could be attributed to allocation, since wages and interest also serve to draw these factors into productive use. Johann Heinrich von Thünen was especially influential in developing the spatial analysis of rents, which highlighted the importance of centrality and transport. Simply put, it was high rents, which determined that land in a central city, for example, would not be allocated to farming, but would be allocated instead to high-value residential or commercial uses.

Special attributes of a particular piece of land, which made it especially productive for a particular use, might also drive up the rent. Highly productive agricultural land might be highly productive because of its fertility, or special suitability to a particular crop, as well as being well-situated in relation to transportation and access to markets. Rent attributable to special variations in resource quality are sometimes called Ricardian rents.

One implication of the classical analysis is that while a tax on wages or interest income would affect the quantity of labor or capital offered to productive use, almost the whole of land rent could be taxed away without affecting the quantity of land on offer. Henry George, seeing that a properly designed tax on land rent would have none of the efficiency-reducing distortive effects of other taxes, advocated a single-tax on land, as a way of financing government.

To Karl Marx, this land-rent was seen as a form of exploitation. Land-owners were able to get "something for nothing" just because they controlled such important natural resources. To Marx, the land-owners received a part of capitalist society's surplus-value that was redistributed from the industrial sector, where workers produced it.

Returns to sunk cost investments in specialized capital equipment have some of the same qualities as land rent, in that, once the sunk cost investment in specialized equipment is made, the price necessary to bring the capital equipment into the use for which it was designed may be much less than would be necessary to repay the original cost of investment. The difference between the amount necessary to bring a sunk cost investment into productive use and the amount actually earned has been termed a quasi-rent. It is not a true rent, because there would have to be an expectation of earning back the original investment in

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order to induce the original investment, and, if the original investment was not repaid, the specialized asset may be allowed to wear out, without repair or replenishment, in such use as could be obtained. Nevertheless, the existence of quasi-rents can create paradoxical situations. A railroad, for example, consists of large, sunk cost investments in right-of-way, rail and rolling stock, with the objective of being able to transport people or goods at a very low variable cost. The alternative uses of the specialized capital stock of a railroad, for other than railroading, are, typically, few and poor. Once the sunk cost investment is made, it is in the interest of the railroad to accept shipments at rates, which cover the low variable cost, even when the rate does not offer an adequate return on the sunk cost investment in right-of-way, rail and rolling stock.

Modern neoclassical economics has generalized the concept of rent to suggest that the owner of any kind of input can receive income for that input, in excess of what is necessary to put the factor into a particular productive use. The rent, in this conception, is the difference between what is paid and the opportunity cost, represented by the income available in the next, best use of the factor.

Rent can be viewed as an estimate of how much market prices for an input would have to change, before the allocation of that particular input would change. How much would the price of maize have to fall relative other crops, before a given field would be planted in rice or potatoes or alfalfa or some other crop instead of maize? A field particularly well-suited to maize, but not other crops, could be said to be earning a rent as a maize field, to the extent that the amount actually earned as a maize field exceeded the absolute minimum amount necessary to allocate the field to maize, as opposed to its next best use, i.e. its opportunity cost.

As another example, an excellent professional basketball player typically earns much more income than is necessary to compensate him or her for the training, effort, practice, and the like needed to become a player. In the presence of the productivity enhancing effects of large arenas and television broadcasting, which allow team owners to sell the right to view games to very large numbers of customers, a few highly talented basketball players compete for a relatively few, highly compensated slots on pro teams. The difference between the amount of money putatively needed to get a Michael Jordan to play basketball at all, and the amount actually paid Michael Jordan to play for the Chicago Bulls, may be termed a rent.

The generalization of the concept of rent to include quasi-rents and returns above opportunity cost has served to highlight the role of barriers to competition in determining and creating rents. A person seeking to become a medical doctor makes a huge sunk cost investment in medical training and education, which has limited potential application outside of medical practice. In a competitive market for medical services, a doctor's wages would be bid down, until the expected net

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return on the sunk cost investment in training would be near zero, that is, barely enough to justify making the investment. In a sense, the required investment becomes a barrier to entry, discouraging would-be doctors from making the necessary investment in training to enter the competitive market for medical services, when the return on the necessary sunk cost investment is competed away. Restrictions on the numbers of people entering into the competitive market for medical services, however, would have the effect of raising the return on investments in medical training, without increasing the number of entrants to the market. Associations of doctors have been known to lobby government to limit, in various ways, the number of medical schools training medical doctors and the number of medical students at those institutions. This kind of political activity is sometimes termed, rent-seeking, though the returns realized from such political activities might be more akin to monopoly profits than rents, as generally conceived. Monopoly profits are sometimes called monopoly rents.

[edit]

Two types of factor rent

* Classical factor rent — This is the return to a factor above and beyond the amount necessary to induce the supplier to offer the input to the market. This corresponds to the notion of a producers' surplus or "scarcity rent." This type of economic rent arises because of scarcity in the supply of inputs. If factor supply is perfectly elastic, there would be no producers' surplus and no economic rents.

* Paretian factor rent – This is the return to a factor above and beyond the amount that the factor supplier would receive in its next-best alternative use. This type of economic rent draws on the notion of opportunity costs. For example, if someone is earning \$20,000 for a job, and the next best job pays \$15,000, then the economic rent is the difference between the two: \$5,000.

[edit]

See Also

- * list of economics topics
- * Quasi-rent
- * Rent-seeking
- * Hotelling rent
- * Ricardian rent
- * von Thünen rent

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• *Follow-Ups:*

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◆ **Re: Example economic rent calculation**

◇ From: royls

• **References:**

◆ **Example economic rent calculation**

◇ From: jim_bowery

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