Lecture 17: Economic Rents and Rent Seeking

Clicker Question
Economic Rent: Example

- Manove has been contacted by a publisher who wants to buy his EC101 slides as an input for a textbook package.

- Manove decides that he would be willing to sell his slides for $1,000 …

- but to his amazement, the publisher offers him $12,000.

- He sells.
  - $12,000 is the market price.
  - $1,000 is his reservation price (willingness to sell).
  - The difference, $12,000 − $1,000 = $11,000 is Manove’s economic rent.

Economic Rent

- When a person (or firm) provides an input for production,
  - his reservation price is the minimum price he would be willing to accept for the input,
  - and any amount he receives above his reservation price is an economic rent.

- Economic rent is the part of social surplus that goes to the people who provide the inputs,…

- …just as consumer surplus is the part of social surplus that goes to the people who buy the outputs.

IMPORTANT: Economic rents are different from the “rental payments” that you pay when you rent an apartment or a car. Do not confuse them.
Example: Cristiano Ronaldo

- Cristiano Ronaldo, a superstar soccer player, provides a critical input for Real Madrid, his team.
- Ronaldo has a salary of $26 (€21) million / year (after taxes).
- He loves soccer, and would have been willing to play for only $30,000 / year (his reservation price).
- He is earning an economic rent of $26,000,000 − $30,000 = $25,970,000 per year.
- His reservation price is compensation for the hard work and difficult training that any great athlete must endure.
- But his economic rent arises from competition for his prodigious talent, which he can use without sacrifice.

Where do economic rents come from?

- Economic rents arise from scarce resources owned or controlled by some individuals or firms but not by others; for example:
Sometimes rent-creating inputs are naturally scarce,…

because it would be costly or impossible to produce more of them:

Example: Farmer Jones

Farmer Jones and his neighbors all grow corn, and sell it at the market price.

However, Farmer Jones has better land than all the other farmers do,…

and thus lower marginal costs.
Because his costs are low, Farmer Jones would be willing, if necessary, to sell his corn for less than the other farmers do (his reservation price is lower).

But he can and will sell at the market price.

The difference between the market price and Jones’ reservation price is an economic rent.

His economic rent arises from his own high-quality land…

…and will be reflected in his producer surplus.

Economic Rents and Social Surplus

Economic rents are amounts of social surplus captured by those who provide inputs for production.

For inputs that a firm owns, economic rents appear as producer surplus.

For inputs that a firm buys, economic rents appear as part of the firm’s cost,…

but those economic rents would appear as producer surplus in the input market.
Economic Rents and Opportunity Cost

- The *reservation price* of an input is the minimum amount its owner would be willing to accept for it.
  - The reservation price reflects the opportunity cost (sacrifice) required to make an input available,...
  - which is why its owner is unwilling to sell the input for less than the reservation price,
  - although he is happy to sell for more when he can.

- *Economic rent* is what a seller receives in excess of his reservation price.

Example: Ronaldo Again

- Cristiano Ronaldo earns millions as an economic rent for his talent.
  - Aside from his strenuous training, he doesn’t have to sacrifice to use his talent—that’s why his reservation price is very low.
  - It certainly didn’t cost him anything to create his talent—he was born with it.

- Did he *deserve* to earn all that money? Is it fair?
  - Is it equitable to pay rents for inborn talents?
Example: BU Students

Clicker Survey
Efficiency and Economic Rents

■ By definition, economic rents are payments in excess of the cost of making an input available.

■ Therefore, economic rents are never “earned.”

■ Perhaps, in the interest of fairness, the payment of economic rents should be limited.

■ ¡Not a good idea!

Example: Salary Cap

■ Suppose that FIFA had decided that since all soccer players have a reservation price less than $50,000,

■ they would limit the salary of all soccer players to $50,000.

■ Ronaldo plays for Real Madrid, one of the most important European teams.

■ But with the salary cap, even teams in small towns would have been able to afford his services.

■ Maybe Ronaldo would have left Real Madrid and gone to Madeira, a small Portuguese island 600 miles out to sea.

■ Anything wrong with that?
An Important Function of Rents

- The *payment* of economic rents helps channel resources to their most valued use; e.g.
  - expose the best soccer players to the most soccer fans, and…
  - send the most talented computer programmers to firms that make good use of their services.

- Without the *payment* of economic rents, income distribution might be fairer,…

- …but the allocation of productive resources would be inefficient.

- Allowing the payment of rents, and taxing rents to increase fairness, may increase efficiency and equity.
Rent-Seeking

A Nonproductive Effort to Obtain Economic Rents

- Economic rents are often generated by the productive use of naturally scarce inputs…
- But sometimes people obtain rents by means of costly nonproductive activities:

- Using costly nonproductive activities to obtain economic rents is called *rent-seeking*.
- Rent-seeking creates inefficiency and destroys social surplus.
Rent Seeking by Creating Artificial Scarcities

- Sometimes businesses or governments deliberately create *artificial scarcities* ... by constructing a scarce rent-producing input.
- Artificial scarcities restrict production to a level below its competitive equilibrium, ...
- and that restriction almost always reduces economic efficiency.
- Moreover, the costs of the rent-seeking activities reduce efficiency further.

**Example: Liquor Licenses for Bars and Restaurants**

- In most of Europe, any restaurant or bar is allowed to serve alcoholic beverages.
- In Massachusetts (and most other states) bars and restaurants must obtain liquor licenses from the state government.
- The liquor licenses are used as a scarce rent-producing input, ...
  - though some people may seem them as an effort to promote public safety.
Establishments with liquor licenses can
- raise the prices of their food and
- sell alcoholic drinks at high prices.

In short, liquor licenses create an artificial scarcity of restaurants that can serve alcoholic drinks,…

…which yields economic rents for the owners of licensed bars and restaurants…

…and for the people who control the liquor licenses.

To obtain a liquor license, an owner must engage in costly nonproductive rent-seeking activities:

If an owner already has a liquor license, she may attempt to prevent competitors from getting them.

These activities create no additional social surplus, but use up social surplus instead.
The liquor-license requirement hurts consumers.

The net result is greatly reduced social surplus.

Graphical Analysis of Licensing

- Suppose liquor licenses aren’t required.
- Now, licenses become required.
- The price of meals increases.
- Grey areas represent surplus lost because of licensing.
- We assumed that the low-cost firms get the licenses.
- Otherwise, the surplus loss would be larger. Why?
Rent-Seeking by Manipulating the Economic Environment

**Example:** Jorge stays in his office until 9:00 pm every night.

- He is hoping for a large salary increase.

- Jorge’s behavior is a classic example of *rent-seeking*.

- Because Jorge’s efforts do not add to social surplus,…

- the rents he obtains will be in the form of surplus diverted from other people.
Professor Teresa Suárez works until 9pm, too.

- She prepares her class and works on her research projects.

- Teresa also hopes for a large raise.

Professor Suárez is *not* rent-seeking.

- Her work is productive and creates surplus.
- Some of that surplus will be returned to her in the form of compensation and economic rents.
- Total social surplus will be increased.
End of File