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Economic rent

In economics, **economic rent** is any payment to an owner or factor of production in excess of the costs needed to bring that factor into production. In classical economics, economic rent is any payment made (including imputed value) or benefit received for non-produced inputs such as location (land) and for assets formed by creating official privilege over natural opportunities (e.g., patents). In the moral economy of neoclassical economics, economic rent includes income gained by labor or state beneficiaries of other "contrived" (assuming the market is natural, and does not come about by state and social contrivance) exclusivity, such as labor guilds and unofficial corruption.

In the moral economy of the economics tradition broadly, economic rent is opposed to producer surplus, or normal profit, both of which are theorized to involve productive human action. Economic rent is also independent of opportunity cost, unlike economic profit, where opportunity cost is an essential component. Economic rent is viewed as unearned revenue, whereas economic profit is a narrower term describing surplus income greater than the next best risk-adjusted alternative. Unlike economic profit, economic rent cannot be theoretically eliminated by competition, since all value from natural resources and locations yields economic rent.

For a produced commodity, economic rent may be due to the legal ownership of a patent (a politically enforced right to the use of a process or ingredient). For education and occupational licensing, it is the knowledge, performance, and ethical standards, as well as the cost of permits and licenses that are collectively controlled as to their number, regardless of the competence and willingness of those who wish to compete on price alone in the area being licensed. In regard to labor, economic rent can be created by the existence of mass education, labor laws, state social reproduction supports, democracy, guilds, and labor unions (e.g., higher pay for some workers, where collective action creates a scarcity of such workers, as opposed to an ideal condition where labor competes with other factors of production on price alone). For most other production, including agriculture and extraction, economic rent is due to a scarcity (uneven distribution) of natural resources (e.g., land, oil, or minerals).

When economic rent is privatized, the recipient of economic rent is referred to as a **rentier**.

By contrast, in production theory, if there is no exclusivity and there is perfect competition, there are no economic rents, as competition drives prices down to their floor.[1][2]

Economic rent is different from other unearned and passive income, including contract rent. This distinction has important implications for public revenue and tax policy.[3][4][5] As long as there is sufficient accounting profit, governments can collect a portion of economic rent for the purpose of public finance. For example, economic rent can be collected by a government as royalties or extraction fees in the case of resources such as minerals and oil and gas.

Historically, theories of rent have typically applied to rent received by different factor owners within a single economy. Hossein Mahdavy was the first to introduce the concept of "external rent", whereby one economy received rent from other economies.[6]

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Definitions

According to Robert Tollison (1982), economic rents are "excess returns" above the "normal levels" that are generated in competitive markets. More specifically, a rent is "a return in excess of the resource owner's opportunity cost".[7]

Henry George, best known for his proposal for a single tax on land, defines rent as "the part of the produce that accrues to the owners of land (or other natural capabilities) by virtue of ownership" and as "the share of wealth given to landowners because they have an exclusive right to the use of those natural capabilities."[8]

The law professors Lucian Bebchuk and Jesse Fried define the term as "extra returns that firms or individuals obtain due to their positional advantages."[9]

In simple terms, economic rent is an excess where there is no enterprise or costs of production.

Classical rent (land rent)

In political economy, including physiocracy, classical economics, Georgism, and other schools of economic thought, land is recognized as an inelastic factor of production. Land, in this sense, means exclusive access rights to any natural opportunity. Rent is the share paid to freeholders for allowing production on the land they control.

> As soon as the land of any country has all become private property, the landlords, like all other men, love to reap where they never sowed, and demand a rent even for its natural produce. The wood of the forest, the grass of the field, and all the natural fruits of the earth, which, when land was in common, cost the labourer only the trouble of gathering them, come, even to him, to have an additional price fixed upon them. He must then pay for the licence to gather them; and must give up to the landlord a portion of what his labour either collects or produces. This portion, or, what comes to the same thing, the price of this portion, constitutes the rent of land ....
>
> — Adam Smith: *The Wealth of Nations*[10]

David Ricardo is credited with the first clear and comprehensive analysis of differential land rent and the associated economic relationships (Law of Rent).

Johann Heinrich von Thünen was influential in developing the spatial analysis of rents, which highlighted the importance of centrality and transport. Simply put, it was density of population, increasing the profitability of commerce and providing for the division and specialization of labor, that commanded higher municipal rents. These high rents determined that land in a central city would not be allocated to farming but be allocated instead to more profitable residential or commercial uses.

Observing that a tax on the unearned rent of land would not distort economic activities, Henry George proposed that publicly collected land rents (land value taxation) should be the primary (or only) source of public revenue, though he also advocated public ownership, taxation, and regulation of natural monopolies and monopolies of scale that cannot be eliminated by regulation.

Neoclassical Paretian rent

Neoclassical economics extends the concept of rent to include factors other than natural resource rents.

- "The excess earnings over the amount necessary to keep the factor in its current occupation."[11]
- "The difference between what a factor of production is paid and how much it would need to be paid to remain in its current use."[12]
- "A return over and above opportunity costs, or the normal return necessary to keep a resource in its current use."[13]

The labeling of this version of rent as "Paretian" may be a misnomer in that Vilfredo Pareto, the economist for whom this kind of rent was named, may or may not have proffered any conceptual formulation of rent.[14][15]

Monopoly rent

Some returns are associated with legally enforced monopolies like patents or copyrights. In addition, companies like Microsoft and Intel have important *de facto* monopolies that can be quite valuable. Some businesses, like public utilities, are by their nature monopolies.

Labour

The generalization of the concept of rent to include opportunity cost has served to highlight the role of political barriers in creating and privatizing rents. For example, a person seeking to become a member of a medieval guild makes a huge investment in training and education, which has limited potential application outside of that guild. In a competitive market, the wages of a member of the guild would be set so that the expected net return on the investment in training would be just enough to justify making the investment. In a sense, the required investment is a natural barrier to entry, discouraging some would-be members from making the necessary investment in training to enter the competitive market for the services of the guild. This is a natural "free market" self-limiting control on the number of guild members and/or the cost of training necessitated by certification. Some of those who would have opted for a particular guild may decide to join a different guild or occupation.

However, a political restriction on the number of people entering into the competitive market for services of the guild has the effect of raising the return on investments in the guild's training, especially for those already practicing, by creating an artificial scarcity of guild members. To the extent that a constraint on entrants to the guild actually increases the returns to guild members as opposed to ensuring competence, then the practice of limiting entrants to the field[16] is a **rent-seeking** activity, and the excess return realized by the guild members is economic rent.

The same model explains the high wages in some modern professions that have been able to both obtain legal protection from competition and limit their membership, notably medical doctors, actuaries, and lawyers. In countries where the creation of new universities is limited by legal charter, such as the UK, it also applies to professors. It may also apply to careers that are inherently competitive in the sense that there is a fixed number of slots, such as football league positions, music charts, or urban territory for illegal drug selling. These jobs are characterised by the existence of a small number of rich members of the guild, along with a much larger surrounding of poor people competing against each other under very poor conditions as they "pay their dues" to try to join the guild. (Reference: "Freakonomics: Why do drug dealers live with their Moms?").

Terminology relating to rent

Gross rent

Gross rent refers to the rent paid for the services of land and the capital invested on it. It consists of economic rent, interest on capital invested for improvement of land, and reward for the risk taken by the landlord in investing his or her capital.

Scarcity rent

Scarcity rent refers to the price paid for the use of homogeneous land when its supply is limited in relation to demand. If all units of land are homogeneous but demand exceeds supply, all land will earn economic rent by virtue of its scarcity.

Differential rent

Differential rent refers to the rent that arises owing to differences in fertility of land. The surplus that arises due to difference between the marginal and intra-marginal land is the differential rent. It is generally accrued under conditions of extensive land cultivation. The term was first proposed by David Ricardo.

Contract rent

Contract rent refers to rent that is mutually agreed upon between the landowner and the user. It may be equal to the economic rent of the factor.

Information rent

Information rent is rent an agent derives from having information not provided to the principal.

See also

- Georgism
- Ground rent
- Land (economics)
- List of economics topics
- Quasi-rent
- Rent seeking
- FIRE economy (finance, insurance and real estate)
- Rentier state
- Hotelling's rule
- Law of rent
- Schumpeterian rent
- Johann Heinrich von Thünen
- Differential and absolute ground rent
- Property income
- Unearned income

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External links

- Definition of economic rent at Economist.com
- The Art of Rent, a series of seminars at Queen Mary University of London.
- *Rent-Seeking Network* Rent-Seeking papers by Behrooz Hassani

- Agricultural economic rent

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Rent-seeking

In economics and in public-choice theory, **rent-seeking** involves seeking to increase one's share of existing wealth without creating new wealth. Rent-seeking results in reduced economic efficiency through poor allocation of resources, reduced actual wealth-creation, lost government revenue, increased income inequality,[1] and (potentially) national decline.

Attempts at capture of regulatory agencies to gain a coercive monopoly can result in advantages for the rent seeker in a market while imposing disadvantages on (incorrupt) competitors. This constitutes one of many possible forms of rent-seeking behavior.

Gordon Tullock (1922–2014) originated the concept of rent-seeking; Anne Krueger coined the term in a 1974 essay.[2]

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Description

The idea of *rent-seeking* was developed by Gordon Tullock in 1967.[2] The expression *rent-seeking* was coined in 1974 by Anne Krueger.[3] The word "rent" does not as a rule refer here to payment on a lease but stems instead from Adam Smith's division of incomes into profit, wage, and rent.[4] The origin of the term refers to gaining control of land or other natural resources.

Georgist economic theory describes rent-seeking in terms of land rent, where the value of land largely comes from government infrastructure and services (e.g. roads, public schools, maintenance of peace and order, etc.) and the community in general, rather than from the actions of any given landowner, in their role as mere titleholder. This role must be separated from the role of a property developer, which need not be the same person.

Rent-seeking is an attempt to obtain economic rent (i.e., the portion of income paid to a factor of production in excess of what is needed to keep it employed in its current use) by manipulating the social or political environment in which economic activities occur, rather than by creating new wealth. Rent-seeking implies extraction of uncompensated value from others without making any contribution to productivity. The classic example of rent-seeking, according to Robert Shiller, is that of a feudal lord who installs a chain across a river that flows through his land and then hires a collector to charge passing boats a fee (or rent of the section of the river for a few minutes) to lower the chain. There is nothing productive about the chain or the collector. The lord has made no improvements to the river and is helping nobody in any way, directly or indirectly, except himself. All he is doing is finding a way to make money from something that used to be free.[5]

In many market-driven economies, much of the competition for rents is legal, regardless of harm it may do to an economy. However, some rent-seeking competition is illegal – such as bribery or corruption.

Rent-seeking is distinguished in theory from profit-seeking, in which entities seek to extract value by engaging in mutually beneficial transactions.[6] Profit-seeking in this sense is the creation of wealth, while rent-seeking is "profiteering" by using social institutions, such as the power of the state, to redistribute wealth among different groups without creating new wealth.[7] In a practical context, income obtained through rent-seeking may contribute to profits in the standard, accounting sense of the word.

Tullock paradox

Tullock paradox refers to the apparent paradox, described by Tullock, on the low costs of rent-seeking relative to the gains from rent-seeking.[8][9][10]

The paradox is that rent-seekers wanting political favors can bribe politicians at a cost much lower than the value of the favor to the rent-seeker. For instance, a rent seeker who hopes to gain a billion dollars from a particular political policy may need to bribe politicians only to the tune of ten million dollars, which is about 1% of the gain to the rent-seeker. Luigi Zingales frames it by asking, "Why is there so little money in politics?" because a naive model of political bribery and/or campaign spending should result in beneficiaries of government subsidies being willing to spend an amount up to the value of the subsidies themselves, when in fact only a small fraction of that is spent.

Possible explanations

Several possible explanations have been offered for the Tullock paradox:[11]

1. Voters may punish politicians who take large bribes, or live lavish lifestyles. This makes it hard for politicians to demand large bribes from rent-seekers.
2. Competition between different politicians eager to offer favors to rent-seekers may bid down the cost of rent-seeking.
3. Lack of trust between the rent-seekers and the politicians, due to the inherently underhanded nature of the deal and the unavailability of both legal recourse and reputational incentives to enforce compliance, pushes down the price that politicians can demand for favors.

Examples

An example of rent-seeking in a modern economy is spending money on lobbying for government subsidies in order to be given wealth that has already been created, or to impose regulations on competitors, in order to increase market share.[12] Another example of rent-seeking is the limiting of access to lucrative occupations, as by medieval guilds or modern state certifications and licensures. Taxi licensing is a textbook example of rent-seeking.[13] To the extent that the issuing of licenses constrains overall supply of taxi services (rather than ensuring competence or quality), forbidding competition by livery vehicles, unregulated taxis and/or illegal taxis renders the (otherwise consensual) transaction of taxi service a forced transfer of part of the fee, from customers to taxi business proprietors.

The concept of rent-seeking would also apply to corruption of bureaucrats who solicit and extract ‘bribe’ or ‘rent’ for applying their legal but discretionary authority for awarding legitimate or illegitimate benefits to clients.[14] For example, tax officials may take bribes for lessening the tax burden of the tax payers.

Regulatory capture is a related term for the collusion between firms and the government agencies assigned to regulate them, which is seen as enabling extensive rent-seeking behavior, especially when the government agency must rely on the firms for knowledge about the market. Studies of rent-seeking focus on efforts to capture special monopoly privileges such as manipulating government regulation of free enterprise competition.[15] The term *monopoly privilege rent-seeking* is an often-used label for this particular type of rent-seeking. Often-cited examples include a lobby that seeks economic regulations such as tariff protection, quotas, subsidies,[16] or extension of copyright law.[17] Anne Krueger concludes that, “empirical evidence suggests that the value of rents associated with import licenses can be relatively large, and it has been shown that the welfare cost of quantitative restrictions equals that of their tariff equivalents plus the value of the rents”.[18]

Economists such as the chair of British financial regulator the Financial Services Authority Lord Adair Turner have argued that innovation in the financial industry is often a form of rent-seeking.[19][20]

Development of theory

The phenomenon of rent-seeking in connection with monopolies was first formally identified in 1967 by Gordon Tullock.[21]

Recent studies have shown that the incentives for policy-makers to engage in rent-provision is conditional on the institutional incentives they face, with elected officials in stable high-income democracies the least likely to indulge in such activities vis-à-vis entrenched bureaucrats and/or their counterparts in young and quasi-democracies.[22]

Criticism

Critics of the concept point out that, in practice, there may be difficulties distinguishing between beneficial profit-seeking and detrimental rent-seeking.[23]

Often a further distinction is drawn between rents obtained legally through political power and the proceeds of private common-law crimes such as fraud, embezzlement and theft. This viewpoint sees "profit" as obtained consensually, through a mutually agreeable transaction between two entities (buyer and seller), and the proceeds of common-law crime non-consensually, by force or fraud inflicted on one party by another. Rent, by contrast with these two, is obtained when a third party deprives one party of access to otherwise accessible transaction opportunities, making nominally "consensual" transactions a rent-collection opportunity for the third party. The high profits of the illegal drug trade are considered rents by this definition, as they are neither legal profits nor the proceeds of common-law crimes.

People accused of rent-seeking typically argue that they are indeed creating new wealth (or preventing the reduction of old wealth) by improving quality controls, guaranteeing that charlatans do not prey on a gullible public, and preventing bubbles.

Possible consequences

From a theoretical standpoint, the moral hazard of rent-seeking can be considerable. If "buying" a favorable regulatory environment seems cheaper than building more efficient production, a firm may choose the former option, reaping incomes entirely unrelated to any contribution to total wealth or well-being. This results in a sub-optimal allocation of resources – money spent on lobbyists and counter-lobbyists rather than on research and development, on improved business practices, on employee training, or on additional capital goods – which retards economic growth. Claims that a firm is rent-seeking therefore often accompany allegations of government corruption, or the undue influence of special interests.[24]

Rent-seeking can prove costly to economic growth; high rent-seeking activity makes more rent-seeking attractive because of the natural and growing returns that one sees as a result of rent-seeking. Thus organizations value rent-seeking over productivity. In this case there are very high levels of rent-seeking with very low levels of output. Rent-seeking may grow at the cost of economic growth because rent-seeking by the state can easily hurt innovation. Ultimately, public rent-seeking hurts the economy the most because innovation drives economic growth.[25]

Government agents may initiate rent-seeking – such agents soliciting bribes or other favors from the individuals or firms that stand to gain from having special economic privileges, which opens up the possibility of exploitation of the consumer.[26] It has been shown that rent-seeking by bureaucracy can push up the cost of production of public goods.[27] It has also been shown that rent-seeking by tax officials may cause loss in revenue to the public exchequer.[14]

Mancur Olson traced the historic consequences of rent seeking in *The Rise and Decline of Nations*. As a country becomes increasingly dominated by organized interest groups, it loses economic vitality and falls into decline. Olson argued that countries that have a collapse of the political regime and the interest groups that have coalesced around it can radically improve productivity and

increase national income because they start with a clean slate in the aftermath of the collapse. An example of this is Japan after World War Two. But new coalitions form over time, once again shackling society in order to redistribute wealth and income to themselves. However, social and technological changes have allowed new enterprises and groups to emerge in the past.[28]

A study by Laband and John Sophocleus in 1988[29] estimated that rent-seeking had decreased total income in the USA by 45 percent. Both Dougan and Tullock affirm the difficulty of finding the cost of rent-seeking. Rent-seekers of government-provided benefits will in turn spend up to that amount of benefit in order to gain those benefits, in the absence of, for example, the collective-action constraints highlighted by Olson. Similarly, taxpayers lobby for loopholes and will spend the value of those loopholes, again, to obtain those loopholes (again absent collective-action constraints). The total of wastes from rent-seeking is then the total amount from the government-provided benefits and instances of tax avoidance (valuing benefits and avoided taxes at zero). Dougan says that the "total rent-seeking costs equal the sum of aggregate current income plus the net deficit of the public sector".[30]

Mark Gradstein writes about rent-seeking in relation to public goods provision, and says that public goods are determined by rent seeking or lobbying activities. But the question is whether private provision with free-riding incentives or public provision with rent-seeking incentives is more inefficient in its allocation.[31]

The economist Joseph Stiglitz has argued that rent-seeking contributes significantly to income inequality in the United States through lobbying for government policies that let the wealthy and powerful get income, not as a reward for creating wealth, but by grabbing a larger share of the wealth that would otherwise have been produced without their effort.[32][33] Piketty, Saez, and Stantcheva have analyzed international economies and their changes in tax rates to conclude that much of income inequality is a result of rent-seeking among wealthy tax payers.[34]

See also

- Cartel
- Client politics
- Competition law
- Crony capitalism
- Cybersquatting
- Elasticity of supply
- Geolibertarianism
- Intellectual property
- Landed gentry
- Land monopoly
- Land value tax
- Law of rent (Ricardo)
- Legal plunder
- *The Logic of Collective Action*
- Manorialism
- Occupational licensing
- Patent troll
- Rentier state
- Royalty payment
- Software patent
- Tragedy of the anticommons
- Unearned income
- Value capture

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