Lecture 17: Economic Rents and Rent Seeking

Clicker Question
Clarification: The Short Run

- The short run is often defined as a period of time during which the quantities of some inputs cannot be changed.
  - The size of a supermarket.
  - The number of check-out lanes.

- The long run is defined as the time when all input levels can be changed.

- In the short run, the costs of the unchangeable inputs are unavoidable (sunk). Why?

- That was the starting point of our analysis in the previous two lectures.

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.*

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Example: Cristiano Ronaldo

- Cristiano Ronaldo, a superstar soccer player, provides a critical input for Real Madrid, his team.

- In 2015 Ronaldo will earn **$79.5 million**.*
  

- He loves soccer, and would have been willing to play for only **$30,000 / year**, his **reservation price**.

- His reservation price is **compensation** for the hard work and difficult training that any great athlete must endure.

- He is earning an economic rent of **$79,500,000−$30,000 = $79,470,000** per year.

- 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:

- a special talent
- better technology
- market power (the ability to raise prices without losing all of your customers)

Sometimes rent-creating inputs are naturally **scarce**, …

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

- talent in a sport
- mathematical ability
- high-quality land
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 “what the market will bear,” in this case, the competitive 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: Cristiano Ronaldo

- 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

- BU students are far more intelligent than average.
- On average, after you graduate, you will earn more money than most other people.
  - compensation for academic achievements
  - economic rents to your intelligence
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 or subject to a ceiling.

¡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
Rent-Seeking

- Economic rents are often generated by the productive use of naturally scarce inputs…
  - Ronaldo uses his talent to entertain millions of Madrid supporters (and others).
  - BU students use their intelligence to be productive in their jobs.
- But sometimes people obtain rents by means of costly nonproductive activities:
  - creating artificial scarcities
  - manipulating their economic environment
- 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.

- 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:

- complete time-consuming applications,
- negotiate with politicians or civil servants (or even pay bribes),
- deal with competing owners who try to block the license,
- hire lawyers at great expense.

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.

- Consumers must pay the higher prices that create economic rents for the owners (and possibly for politicians who take bribes).
- The high prices reduce their consumption of restaurant food and drink below the competitive equilibrium level.
- Consumers must choose from a smaller number of bars and restaurants.

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?

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**Rent-Seeking by Manipulating the Economic Environment**

- **Example:** Jorge stays in his office until 9:00 pm every night.
  - He spends his time reading comic books,…
  - but his boss thinks he is working.
  - Jorge flatters his boss at every opportunity.
  - He is hoping for a large salary increase.
Jorge’s behavior is a classic example of *rent-seeking*.

- Jorge expends a lot of time and energy trying to get a raise,…
- not by doing anything productive,…
- but by manipulating his economic environment (in this case, his boss).

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.
- She enjoys her work and doesn’t mind working late.
- Her teaching evaluations are excellent.
- 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.
Clicker Question

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