Thursday, Nov 4, Lecture 17
Economic Rents

This lecture will not be covered in Midterm 2, but it will be included in the Final Exam

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**Economic Rent: Example**

- Manove has been contacted by a publisher who wants to buy his animated 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 “rents” or “rentals” that you pay when you rent an apartment or a car. Do not confuse them.

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 not willing 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, a superstar soccer player, provided a critical input for Juventus, his former team. (This August, he moved back to Manchester United.)

- His salary with Juventus was only $70,000,000/year, but his total earnings were about $117,000,000/year.

Cristiano Ronaldo

[This is Fiction]

- Ronaldo loves soccer, and he 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. (*it compensates for his opportunity cost)

  - But his economic rent arises from competition for his prodigious talent, which he can use without sacrifice.

  - He was earning an economic rent of $117,000,000$–$30,000 = $116,970,000 per year.
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

*Sometimes the scarcity is intentionally created—discussed below
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

- 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
**Clicker Survey**

In your opinion, do smart people *deserve* to earn more than stupid people? (Is it equitable to pay smart people more?)

a. Yes
b. No

Both answers are correct.

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**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,…

- FIFA would limit the salary of all soccer players to $50,000.

- Ronaldo now plays for Manchester United, 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 leave Man U and go to Madeira, a small Portuguese island 600 miles out to sea.
  
  - Madeira is famous for its fortified wine.
  
  - Ronaldo played soccer there when he was younger.

- Anything wrong with that?

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Clicker Question

It would not be efficient for Ronaldo to play for a team on a small island, mainly because…

a. he would enjoy life in an Italian city more than on a small island.

b. Man Utd would pay him more.

c. cities usually have better teams than small islands do.

d. he would entertain more supporters in a city.
An Important Function of Rents

- The *payment* of economic rents helps guide resources to their most valued use; for example,
  - to expose the best soccer players to the most soccer fans, and…
  - to 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 then taxing them, might increase equity without reducing efficiency as much.

Economic Rents and Social Surplus

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

- For inputs that a firm *owns*, *economic rents* are included in *producer surplus*.

- For inputs that a firm *buys*, *economic rents* are part of the firm’s cost,…

- …but they are included in the *producer surplus* of the market for the input.

- The social surplus generated by *all economic activity in the entire economy* is the sum of
  - consumer surplus for all outputs, and
  - *economic rents* for all inputs.
Rent-Seeking

A Nonproductive Effort to Obtain Economic Rents

- Economic rents are often generated by the productive use of naturally scarce inputs...
  - Ronaldo was using his talent to entertain millions of Juve 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 creating 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 *cost* of the rent-seeking activities reduces 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 in the USA) bars and restaurants must obtain liquor licenses from the state government.

- The liquor licenses are used as a scarce rent-producing input,…
  - …although some people may view 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 \textit{artificial scarcity}
of restaurants that can serve alcoholic drinks,…

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

…and for the politicians 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 even pay bribes),
- deal with competing owners who try to block the license,
- hire expensive lawyers.

The opportunity cost of such activities is the \textit{cost of rent seeking}.
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 limited number of restaurants and 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 reduced social surplus.

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 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 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.
- Professor Suárez 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**

Would economic efficiency increase if regulations prevented the payment of economic rents?

a. Yes, because many people would work for lower pay.

b. Yes, because only the rich have the ability to pay them.

c. No, because people who get rents would not work without them.

d. No, because rents guide inputs to the producer that values them most.
End of Lecture 17