UNIT 3: RENT

UNIT STRUCTURE

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3.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss some of the basic concepts in Rent, viz., its meaning, differences between economic rent and contract rent and rent as a surplus,
- explain the Ricardian Theory of Rent,
- discuss the Marshallian concept of producer's surplus,
- define what is Quasi-Rent and its importance, and
- discuss the relation between rent & price.

3.2 INTRODUCTION

This unit discusses rent, i.e., the reward that is accrued to land. In general, the term ‘rent’ is used in a wide sense - to mean a hiring charge. Thus, we use this term to denote the rent for a house, for a machine etc. But in Economics, the term ‘rent’ has a special use. In Economics, the term has been widely used in the sense of a surplus.

This unit discusses in detail such basic concepts of rent. Apart from these, the unit also discusses the Ricardian Theory of Rent. At the end of this unit, you will be able to discuss the concepts of Quasi-Rent and the relation between rent and price as well.

3.3 BASIC CONCEPTS OF RENT

Before we discuss rent in detail, it will be helpful for us to discuss the meaning of rent and other relevant basic concepts.

We have already said that, in general, the term 'rent' is used in a wide sense - to mean a hiring charge. Thus, we use this term to denote the rent for a house, for a machine etc. But in Economics, the term 'rent' has a special use. Originally, the term was used to mean the price paid to land for its use. But now, the term is also used for the surplus earnings of any factor of production in excess of the cost incurred to obtain its service. In the modern economic theory, the term rent is used in the following senses:

- *First,* the term refers to the rental made for the use of fixed factors of production whose existence is not dependent on any human effort or sacrifice. We know that land is one such factor, because land is a free gift of nature and its supply can not be increased. Hence, modern economics includes land rent as a part of rent.
- The *second* type of rent relates to economic rent. Economic rent means the surplus earned by a unit of factor of production over and above the minimum earnings necessary to induce it to stay in the present use, industry or occupation.
- *Third*, Marshall used the concept of rent to cover the short-run earnings (net of depreciation and interest charges) of fixed capital equipment. This is because, just like land, supply of fixed capital equipment is also inelastic during the short-run. However, since the captial equipment is not permanently in fixed supply like land, and as their supply is elastic in the long-run (which is not the case with land), hence Marshall preferred to call the short-run earnings from fixed capital equipment

as Quasi Rent rather than rent. (We shall later discuss about Quasi Rent in section 3.6 of this unit).

3.4 THE RICARDIAN THEORY OF RENT

David Ricardo's theory of rent known as "Ricardian Theory of Rent" occupies a distinct place in economic theory. Ricardo said that rent is a 'surplus' which accrues to the owner of the land by virtue of relative advantages of fertility or situation or both which a particular plot of land enjoys over less productive plots. He has defined rent in these words: *"Rent is that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil'*. Thus, rent is the price for the use of land.

From the above discussion, we can say that rent arises due to two factors:

- differences in the productivity of various plots of lands and
- situational differences

Assumptions of the Theory: The Ricardian Theory of Rent rests on the following assumptions:

- **Fixed supply of land:** Ricardo assumes that the supply of land is fixed; it can neither be increased nor decreased. Thus, it is a free, fixed gift of nature.
- **Original Powers:** Ricardo also assumes that the fertility quality of the soil is original. It means that the fertility of land is gifted by God, it cannot be affected by human effort.
- **Indestructible Powers:** Further, the theory assumes that the original fertility quality of land is indestructible. This means that the original fertility quality of a plot of land will remain intact forever, it will never diminish.
- **Cultivation in Order of Fertility:** It is also assumed that the different plots of lands are utilized according to their grade of quality. Thus, higher grade of land is utilized prior the lower grade of lands.
- **Law of Diminishing Returns:** Ricardo also assumes that the law of diminishing returns or increasing costs operates in agricultural field.

- **Differences in Fertility:** Another assumption of the theory is that different plots of land have differences in their fertility. Thus, some plots are more fertile than others.
- **Free Gift:** Land is a free gift of nature. It does not have any supply price.
- **Perfect Competition:** There is perfect competition in the market.
- **Long-run:** The theory is applicable in the long-run as well.
- **Marginal Land:** According to Ricardo, there is a 'no-rent land'. This is the lowest grade of land and the return from this plot of land just covers its cost. This plot of land is also called 'marginal land'.
- **Different Situations:** Different plots of land exist in different conditions. Some are nearer a market place, while others are distant from a market place. Thus, the producer nearer a market can save a lot of transport costs.

Explanation of the Theory: Ricardo explained his theory with the help of an example of colonization. Let us assume that there are three grades of land in a deserted colony. If some people go and settle down in that colony, first they will cultivate the best lands. If more people go and settle down, the demand for land will increase and they will cultivate the second-grade lands. As a result, the cost of production will go up. So the price of grain in the market must cover the cost of cultivation. In this case, the first grade land will get rent. After some time, if there is increase in population, even third grade lands will be cultivated. Now, even second grade lands will get rent and first grade lands will get more rent but the third grade land will not get any rent.

The theory has been explained with the help of Table 3.1

Table 3.1: Rent

Grades of land	Production (Quintal per acre)	Rent or Surplus Production (Quintal per acre)
A	24	24 – 14 = 10
B	19	19 – 14 = 5
C	14	14 – 14 = 0

From Table 3.1 it can be seen that at the first stage, when the first

batch of people migrated to the new colony, they fulfilled their demand of food production while utilizing in the best grade land. Thus, in A grade land, they were able to get a production of 24 quintals of rice per acre of land. In this situation, the A grade land would command no rent. It would be like a free gift of nature.

Now, suppose population in the colony increases (owing to migration or internal increase in population). This will necessitate increasing the area under cultivation. Thus, in addition to the A grade land, the second quality land (B grade land) is also used. This B grade land yields 19 quintal of rice per acre of land. Now, the A grade land will yield a rent equivalent to the difference in the production of the B grade land. Thus, the rent earned by A grade land at this stage is 5 (24 – 19) quintals of rice per acre of land. The B grade land being the marginal land in this case, does not earn any rent.

But the population continues to increase further. This will necessitate utilizing the remaining lowest grade (grade C) land as well. The C grade land yields 14 quintals of rice per acre of land. In this situation, both the A grade and the B grade lands will earn rent equal to the respective differences with this C grade land. Thus, A grade will earn 10 (24 – 14) quintals of rice as rent per acre of land. Similarly, B grade land will earn 5 (19-14) quintals of rice as rent per acre of land. It is to be noted that the grade C land does not get rent and hence is termed as marginal land or no-rent land.

Diagrammatic Explanation of Ricardian Theory of Rent: The Ricardian Theory of Rent has been presented with the help of Figure 3.1:

Figure 3.1: Diagrammatic representation of the Ricardian Theory of Rent

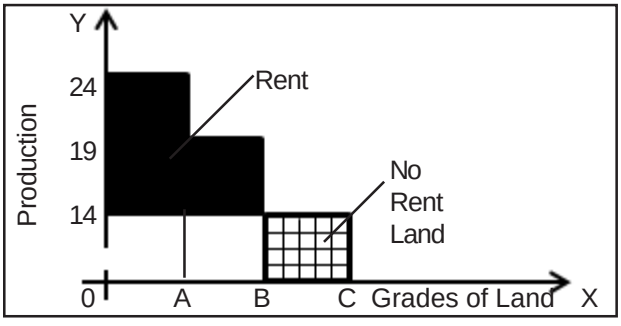


Table 3.1 has been represented with the help of Figure 3.1. You will notice from the figure that A grade land being of higher quality earns more revenue than B grade land. C grade land does not earn any rent.

Criticisms of the Ricardian Theory of Rent: Ricardian Theory of Rent has been criticized on the following grounds:

- Ricardo tells that only the best lands are cultivated first. There is no historical proof for this.
- According to Ricardo, land has "original and indestructible powers". But the fertility of land may decline after some time because of continuous cultivation.
- Ricardo believed that rent is peculiar to land alone. But many modern economists argue that the rent aspect can be seen in other factors like labour and capital. Rent arises whenever the supply of a factor is inelastic in relation to the demand for it.
- Ricardo is of the view that rent does not enter the price of the commodity produced in it. But rent enters the price from the point of view of a single firm.
- Ricardian theory does not take note of scarcity rent.
- It is based on perfect competition. Only under perfect competition, will there be one price for a good. But in the real world, we have imperfect competition.
- Though there are some criticisms against the Ricardian theory, we may note that it tells us that because of increasing pressure on land, we have to cultivate inferior lands.



CHECK YOUR PROGRESS

Q 1: State whether the following statements are true (T) or false (F).

(a) The Ricardian Theory of Rent is applicable in imperfect competition as well. (T/F)

(b) Ricardo acknowledged that fertility of land may decline over time. (T/F)

Q 2 : What is no-rent land, according to Ricardo? (Answer in about 50 words)

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3.5 MARSHALLIAN CONCEPT OF PRODUCER'S SURPLUS

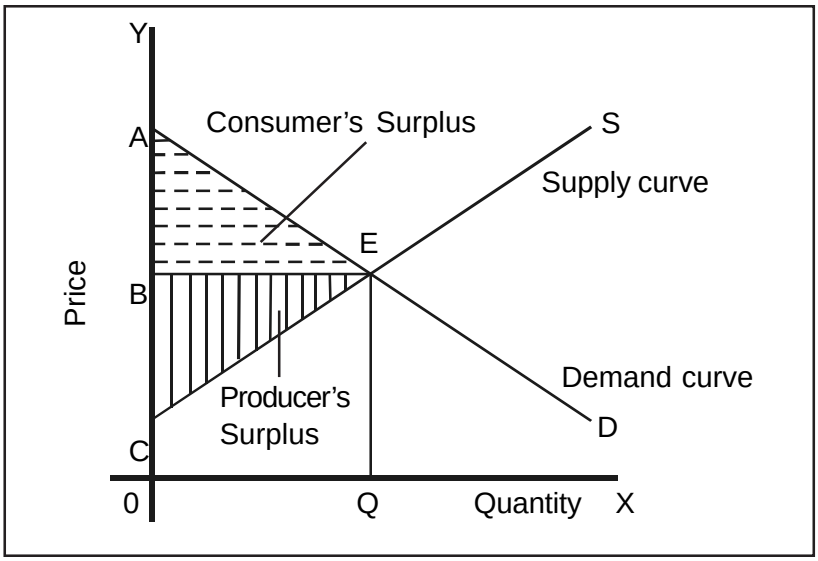
The concept of producer's surplus as well as consumer's surplus was introduced by Alfred Marshall. We have already discussed the concept of consumer's surplus in Unit 4 of the first semester course. In that context, we discussed that consumer's surplus is the amount that consumers benefit by being able to purchase a product for a price that is less than what they would be willing to pay. Let us now discuss the concept of producer's surplus.

Producer's Surplus: The producer's surplus is the amount that producers benefit by selling at a rnarket price that is higher than what they would be willing to sell for that quantity of goods. It is to be noted here that producers surplus flows through to the owners of the factors of production, unlike economic profit which is zero under perfect competition. If the markets for factors are perfectly competitive as well, producer's surplus ultimately ends up as economic rent to the owners of scarce inputs such as land. A surplus accruing to the owners of factors of production owing to an individual generally receiving something which has greater direct or indirect utility to him than the utility of what he gives up. The traditional measure of Producer's surplus is the area above the product supply curve and below the price as shown in Figure 3.2.

Marshall used the concept of of producer's surplus to measure the change in well-being from government policies, such as taxation. Now, if the government intervenes by implementing, for example, a ***tax*** or a ***subsidy***

then the graph of supply and demand becomes more complicated and will also include an area that represents government surplus. In Figure 3.2, we have not considered government surplus.

Figure 3.2: Consumer's Surplus & Producer's Surplus



The consumer's surplus, the producer surplus, and the governmert surplus (if present) when combined together make up the social surplus or the total surplus.

Total surplus is the primary measure used in ***Welfare Economics*** to evaluate the efficiency of a proposed policy. Now, In the above Figure 3.2, AD represents the demand curve, CS represents the supply curve. The equilibrium price is OB or QE. In the figure, portion ABE represents consumer's surplus, while protion BEC represents the producer's surplus. It is to be noted that ABE is the consumer's surplus because, the consumer is ready to pay OAEQ for OQ amount of quantities at OB price; but he actually pays OBEQ. Thus, ABE (OAEQ – OBEQ) is the consumer's surplus. Similarly, the producer is paying OCEQ, while he is getting OBEQ. Thus, he gets an excess of BEC (OBEQ–OCEQ). BEC represents producer's surplus.

3.6 QUASI-RENT

Marshall introduced the concept of 'Quasi-rent' in Economics.

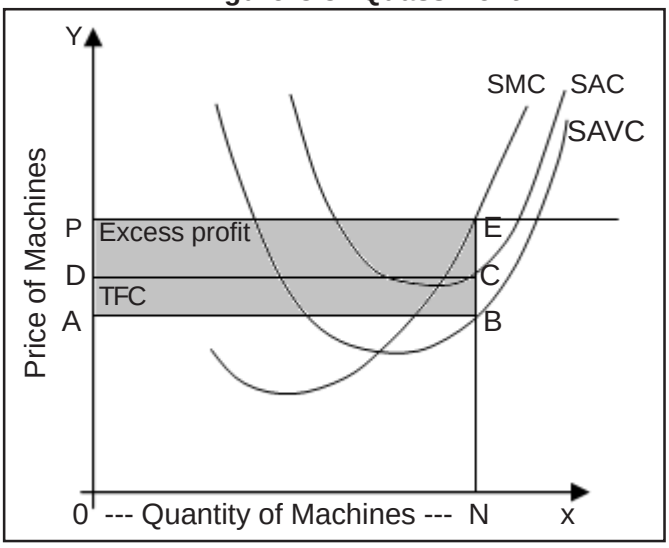
According to Marshall, '*Quasi-rent is the income derived from machines and other appliances for production by man*". There are some machines and other man-made appliances (e.g. boats) whose supply may be inelastic in the short run in relation to the demand for them. For example, when there is large increase in demand for fish during a season, the demand for boats will increase. But they can not be supplied over night. So they will earn some extra income over and above the normal income they receive. Marshall has termed this as 'Quasi-rent'. Quasi-rent will disappear, when the supply of boats increases.

Quasi-rent has also been defined as the excess of total revenue earned in the short-run over and above the total variable costs. Thus,

Quasi-rent = Total Revenue – Total Variable Cost

The concept of Quasi-rent has been explained with the help of Figure 3.3.

Figure 3.3: Quassi-rent



In the figure, P represents price. The firm maximises profit while it produces ON unit of output with 0PEN amount of total revenue. Now, the firm pays 0NBA amount of variable cost to the variable factor. This means that the residual of the total income, i.e., ABEP is the quasi-rent which goes to the fixed factor.

It is to be noted that the theory assumes that the firm operates under perfect competition. The quassi-rent can be divided into two parts. This has been shown with the help of Figure 3.3. In the figure, the area

ABCD represents the total fixed cost, while PECD represents the excess (or pure) profit.

Thus,

Quasi-rent = TFC + excess profit.

Or, Excess profit = Quasi-rent - TFC.

In the long run, as supply increases, Quasi-rent becomes zero and the firm is in equilibrium, earning just normal profit.



CHECK YOUR PROGRESS

Q 3 : State whether the following statements are true (T) or false (F).

(a) Quasi-rent is not same as profit. (T/F).

(b) Quasi-rent applies both in the short-run and in the long-run. (T/F)

Q 2 : What do you mean by Quasi-rent? (Answer in about 50 words)

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Q 3 : Why is it said that Quasi-rent appears in the short-run only and it disappears in the long-run? (Answer in about 50 words).

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3.7 RELATION BETWEEN RENT AND PRICE

Rent is price determined: Ricardian View: According to Ricardo, rent is price determined and not price determining. This means, according

to him, rent is not included in price. The modern theory of rent, however, differs from that of Ricardo. Ricardo argued that rent did not enter into the cost of production of the produce and hence is not included into its price. Rent rises because of the rise in price and not the vice versa.

While discussing the Ricardian theory of Rent, we have discussed that rent is surplus over cost. Price is determined by the margin where there is no rent. Hence, rent does not enter into price.

It is true that the differential aspect of land is not a cause of price. Say, there are two plots of land A and B. If land A gives more valuable service than land B, the extra payment yielded by land A would not affect the price of the produce.

Another argument for rent not being a part of price is that land is a free gift of nature. No payment is necessary to maintain the total supply of land. In this sense, rent is not a part of the supply price of land and consequently of the products of land. Since the supply of land is inelastic, it will always work for whatever it fetches under competition value (.i.e, price) of the product, and not vice versa.

Again, it may also happen that land is specific and it can be put to only one use and to none else. A particular area of land has been allotted for specific use/industry. This means, that particular area of land can not be used in any other purpose. It is thus, a case of inelastic supply to that particular industry. So, it is immaterial regarding the price of land; it will work for whatever it gets. Thus, in this case as well, rent will be price-determined and not price determining.

Rent is price determining: Modern View: Modern economists differ with Ricardian theory. According to them, in certain cases, rent does enter into price. These cases are:

- **When land is under control**: Under perfect competition, rent does not enter into price. But if land is owned and controlled by a few landlords, they may compel the farmers to pay rent even on 'marginal land'. In such cases, the farmers add rent (as a cost) to the price of the produce.
- **Over dependence on land**: In situations where over dependence on

land leads to its over demand, the owners of land may take advantage of the situation. Thus, they may increase rents. In such cases, actual rent is higher than the economic rent; and rent enters into price.

- **Different productivity in different uses**: In some cases, productivity may vary with respect to varieties of crops. For example, it may happen that a particular plot of land yields better produce of rice than jute. Thus, certain surplus is earned while cultivating rice on that plot of land. But if the land is used in the cultivation of jute, it will yield less, but farmer will have to pay rent as applicable to rice. Hence, rent as a surplus will be included in the cost of jute. So, rent enters into price.
- **Scarcity of Fertile Land**: Fertile land is scarce. When a particular plot of land is used for some particular purpose, its availability for alternative uses is negated. Therefore, the relative scarcity of the prime land determines its price. In fact, in such situations, the rent paid by the users of prime land affects its price. Hence, indirectly, rent affects price.



CHECK YOUR PROGRESS

Q 6: State whether the following statements are true (T) or false (F).

(a) Ricardo accepted the view that rent enter into price. (T/F).

(b) According to Ricardo, rent is a part of cost of production. (T/F)

(c) According to modern economists, variability in production may result in the emergence of rent. (T/F)

Q 7: Mention any two arguments in favour of rent affecting the price of land. (Answer in about 50 words)

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3.8 LET US SUM UP

- The term 'rent' was originally used to mean the price paid to land for its use. But now, the term is also used for the surplus earnings of any factor of production in excess of the cost incurred to obtain its service.
- According to the Ricardian Theory Rent, rent is a 'surplus' which accrues to the owner of the land by virtue of relative advantages of fertility or situation or both which a particular plot of land enjoys over less productive plots.
- Ricardian Theory of Rent has been criticized on various grounds.
- The concept of Quasi-rent was introduced by Marshall.

  The concept is applicable only in the short-run.

  Quasi-rent disappears in the long-run.

  Quasi-rent is calculated as: Quasi-rent = Total Revenue – Total Variable Cost.

  The firm may earn Quasi-rent while earning profit or incurring losses.
- According to Ricardo, rent is price determined and not price determining. This means, according to him, rent is not included in price.
- Price is determined by the margin where there is no rent. Hence, rent does not enter into price.
- Land is a free gift of nature. No payment is necessary to maintain the total supply of land.
- Again in cases, where land is specific and it can be put to only one use and to none else a particular area of land has been allotted for specific use/industry, rent does not enter into price.
- According to the modern economists, in certain cases, rent does enter into price.
- When there is absence of perfect competition and land is owned and controlled by a few landlords, they may compel the farmers to pay rent even on 'marginal land'. Hence, rent enters into price.
- In situations where over dependence on land leads to its over demand,

the owners of land may take advantage of the situation. Rent may enter into price of land in such case as well.

- In some cases, productivity may vary with respect to varieties of crops. This may result in the emergence of rent and rent may be included as a cost in the price of the lower productive use.
- The relative scarcity of the prime land determines its price. In fact, in such situations, the rent paid by the users of prime land affects its price.



3.9 FURTHER READING

1) Ahuja, H. L. (2007). *Advanced Economic Theory: Microeconomic Analysis*. New Delhi: S.Chand & Company Ltd.
2) Chopra, P. N. (2008). *Micro Economics*. Ludhiana: Kalyani Publishers.
3) Dewett, K. K. (2005). *Modern Economic Theory*. New Delhi: S.Chand & Sons.

3.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No. 1: (a) False (b) False

Ans to Q No. 2: According to Ricardo, rent arises due to difference in the productivity of different grades of land. Thus, a high grade (quality) of land will yield more produce that a low grade land. Rent arises in the higher grade land. The marginal (the lowest quality) plot of land will thus, yield no rent, and hence has been termed as 'no rent' land by Ricardo.

Ans to Q No. 3: (a) True (b) False

Ans to Q No. 4: If there is large increase in demand for fish during a season, the demand for boats will increase. But they can not be supplied over night. So they will earn some extra income over and above the normal income they receive. Marshall has termed this as 'Quasi-rent'.

Ans to Q No. 5: Quasi-rent appears only in the short-run as a result of

sudden rise in demand for a machinery, supply of which can not be fulfilled over night. Due to shortage in supply, the existing machineries earn extra income. This is the Quasi-rent. But, such earning will disappear in the long-run, when supply of that machinery increases.

Ans to Q No. 6: (a) False (b) False (c) True

Ans to Q No. 7: Rent may enter into price in situations like:

- Over dependence on land leads to its over demand, the owners of land may take advantage of the situation. Rent may enter into price of land in such case, and secondly,
- The relative scarcity of the prime land determines its price. In fact, in such situations as well, the rent paid by the users of prime land affects its price.



3.11 MODEL QUESTIONS

A) Short questions (Answer each question in about 150 words)

Q 1: Write short notes on:

(a) Rent in modern economic theory (b) Quasi-rent

Q 2: Show the differences between Rent and Quasi-rent.

Q 3: Mention similarities between Rent and Quasi-rent.

B) Long Questions (Answer each question in about 300-500 words)

Q 1: Critically discuss the Ricardian Theory of Rent.

Q 2: Explain the concept of Quasi-rent. *'A firm can earn Quasi-rent regardless of earning of profit or incurring of losses.'* Explain the above statement.

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