

MONASH UNIVERSITY
DEPARTMENT OF ECONOMICS

DEFINITION OF RENT

The following two definitions of rent are contradictory.

"Any price unnecessary to keeping the good in **existence**, but necessary for **allocation** to highest-valuing uses, is called **economic rent**: economic to emphasize that it serves an allocative function, and rent to indicate that it does not affect the supply."

Alchian & Allen, *Exchange and Production: Competition, Coordination and Control*, 3rd ed, p.75.

"Economic rent ... is defined as a payment of the resource owner in excess of that resource's opportunity cost."

M.J. Brennan, *Theory of Economic Statics*, 1st ed., 1965.

Discussion:

The classical economists (especially Ricardo) noted that agricultural land was fixed in supply and was a gift of nature, whereas labour and capital had to be produced, at a cost, and could decline through death and lack of reproduction, or depreciation. If wages fell below subsistence level, population would decline, and similarly if the return on capital discouraged investment, the capital stock would deteriorate. However, no matter how much the return on land fell, it would still be there and available for use, and however high the return, the quantity of land could not be augmented. Hence the return on land, rent, was not needed to call forth the supply and in this respect rent differed from the other factor returns.

Later, the idea of economic rent was generalised to mean any payment to a resource over and above the amount needed to keep it in its present use. This latter amount is presumably the payment the resource could get in its next-best type of employment; hence rent came to be defined as any payment to a resource in excess of its opportunity cost. This customary definition is exemplified in the quote from Brennan.

A problem associated with the customary definition is the ambiguity of the phrase, "its present use". Frequently this is taken to mean industry, but industries can be defined widely or narrowly, and the rent component of earnings will vary according to the width of the definition. It is also possible to define present use as employment by a particular firm in a particular place; or, at the opposite extreme, and with regard to labour, as employment in the workforce, as distinct from being unemployed.

As a consequence of this ambiguity of definition, the term "economic rent" is itself quite ambiguous, its magnitude varying widely depending on what is considered to be the relevant alternative use. This need not matter, provided the relevant alternatives (in practice, the degree of aggregation or "level of analysis") are made quite explicit. But in practice it can give rise to confusion and faulty analysis.¹

¹ An egregious example of such confusion is provided by the recommendation of the Commission of Inquiry into Land Tenures.

In 1976 a Commission of Inquiry into Land Tenures argued that increases in the value of land resulting from urban growth and development, and from changes in the zoning of land by planning authorities, were "unearned" by the owners of the land, and as such were suitable objects for appropriation by the state. With respect to residential land it contented itself with the proposal to appropriate only those value increments associated with changes in the designated use of the land (i.e., with rezoning). It distinguished between the land's development value (i.e., the capital value of the expected net benefits arising from any future changes in the use of the land) and its use value (i.e., the present value of expected future net returns associated with the land's continued use for its present purpose; or its most intensive lawful use according to existing planning restrictions). It proposed that when urban land was rezoned to permit more intensive use, the development value should be appropriated by the state. This proposal has a number of serious disadvantages:

- (i) Whether a change affecting the value of land is a development or a continuation of an existing use depends on how widely or narrowly use categories are defined for planning purposes. Hence it would be within the power of a planning authority to appropriate anything from a very small to a very large proportion of all capital gains, depending on the fineness of the classification it chose to adopt.
- (ii) the magnitude of the capital gain associated with a rezoning of land depends on the "economic ripeness" of the land for redevelopment. As a result: (a) inequities would arise in the treatment accorded to different landowners, with those whose properties were rezoned when over-ripe for development paying much larger imposts than those whose properties were rezoned anticipatively; and (b) planning authorities would have a monopolist's incentive to restrict the supply of development rights, so as to maximise revenues received from their sale.
- (iii) Rezoning of land to a more intensive use increases its value but, since the rezoning increases the effective supply of urban land, it also tends to depress the value of other urban land. Consistent application of the principle espoused by the Commission, that gains or losses in land value resulting from "community" decisions should flow back to the community, could therefore result in net compensation being paid to landowners whenever land was rezoned for more intensive use. Such a policy would be impracticable and absurd. The Commission's ethical

Thus if $W_1, W_2 \dots W_\eta$ are the wages, arranged in descending order, that a person might receive in various firms in industry A, and $W_{\eta+1}$ the highest wage he could obtain in industry B, with $W_{\eta+1} < W_\eta$, then $W_{\eta+1}$ is the opportunity cost of employing him in A. If he is employed in firm 1, $(W_1 - W_{\eta+1})$ is the economic rent attributable to his employment in firm 1, industry A, rather than industry B. But the economic rent associated with his employment in Firm 1 rather than Firm 2 is $(W_1 - W_2)$. In order to secure his services, firm 1 has to at least match the wage offered by firm 2. Hence the greater part of economic rent as defined at the industry level of analysis is opportunity cost at the firm level.

From the point of view of efficiency, it may be just as important that the person be employed in firm 1 rather than firm 2, both in industry A, as that he be employed in firm η , industry A, rather than firm $\eta+1$, industry B. That is, allocation within an industry may be just as important as allocation between industries. And, as mentioned above, industry can be defined widely or narrowly.

The Alchian and Allen definition constitutes a reversion to the classical view, in that it is any payment in excess of the amount needed to keep the factor in existence that is called economic rent. At the same time, by saying that economic rents are necessary for allocating the resource to its highest-valued use, they stress the allocative role of these payments, a role that the ordinary definition explicitly rules out (but implicitly accommodates, through variation in the "level of analysis").

The Alchian and Allen definition relates to economic rent in the broadest sense, i.e., any payment unnecessary to keep the factor in existence. However, much of the economic rent so defined would constitute opportunity cost, i.e., be necessary to keep the resource in its present use, however narrowly or broadly that would be defined. But the same is true of the ordinary definition, except when applied in the narrowest possible way, i.e., when "present use" means employment in a particular firm at a particular place.

rationalization for the State's appropriation of development value must therefore be abandoned.

- (iv) The two components of total land value -- "use value" and "development value" -- are not observable quantities, but can be estimated only on the basis of certain assumptions and "expert opinion". Disputes between landowners and planning authorities would be frequent, to the enrichment of lawyers and land valuers. The Commission apparently believed that, after a time, market value would come to reflect use value only. This belief is unfounded.

(For a full analysis, see, Ross Parish, "The Commission of Inquiry into Land Tenures", *Australian Journal of Management*, Vol.2, No.1, April 1977, pp.35-52.)