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**For the Students of B.Com. IInd semester**

## **THEORY OF RENT**

### **THEORY OF RENT RICARDIAN**

David Ricardo, a classical economist developed a theory in 1817 to explain the origin and nature of economic rent. Rent is the payment made to landlord for the use of land. Ricardo was of the view that rent is paid for the fertility of land. Ricardo stated "Rent is the portion of the produce of the earth which is paid to landlord for the use of the original and indestructible powers of the soil"

### **ASSUMPTIONS-**

1. Rent of land arises due to the differences in the fertility of the soil.
2. Law of diminishing marginal returns. As the different plots of land differ in fertility, the produce from the inferior plots of land diminishes though the total cost of production in each plot of land is the same.
3. Rent accrues only to land i.e. none of the other factors of production earn rent. However later on Modern economists disagreed on it.
4. There is tendency to move from most fertile land to the less fertile one.
5. Land on which no rent is earned is known as marginal land.
6. Total cost spent on each piece of land is same.

According to Ricardo rent arises as the difference between production of Marginal land (On which zero rent accrues) and superior land. As there is general tendency to move from most fertile land (Attracts highest rent) to the less fertile land, a point comes where no rent accrues to what is called a Marginal land. So in this way Ricardo classified land into various grades according to their fertility. The most fertile land will attract highest rent and Marginal land will attract no rent indicating the land to be the infertile one.

### EXAMPLE

There are 6 grades of land ó I, II, III, IV, V, VI. The classification is on the basis of fertility. A is most fertile. The fertility of soil is known by its production. Most fertile soil will have more production and consequently more value of output. So the column of value of output is indicator of fertility of the soil. As mentioned in assumption total cost remains same. Say here total cost = 1000.

### RENT EARNED

GRADES OF LAND	AMOUNT SPENT (Rs.) (cost)	VALUE OF OUTPUT (Rs.)	RENT ( VALUE OF OUTPUT- AMOUNT SPENT)
I	1000	5000	5000-1000=4000
II	1000	4000	4000-1000=3000
III	1000	3000	3000-1000=2000
IV	1000	2000	2000-1000=1000
V	1000	1000	1000-1000=0
VI	1000	NIL	-

As can be seen that Grade I is the most superior land producing maximum output of 5000 on which Rent earned is 4000. Similarly Grade II land earns 3000 and so on. This shows direct relation between the value of output and rent earned thereof keeping the amount spent on land same on every piece of land . On Grade V land Amount spend = Value of output i.e. Total rent is 0. This is Marginal land. Grade VI land will never be cultivated as the Value of Output is NIL.

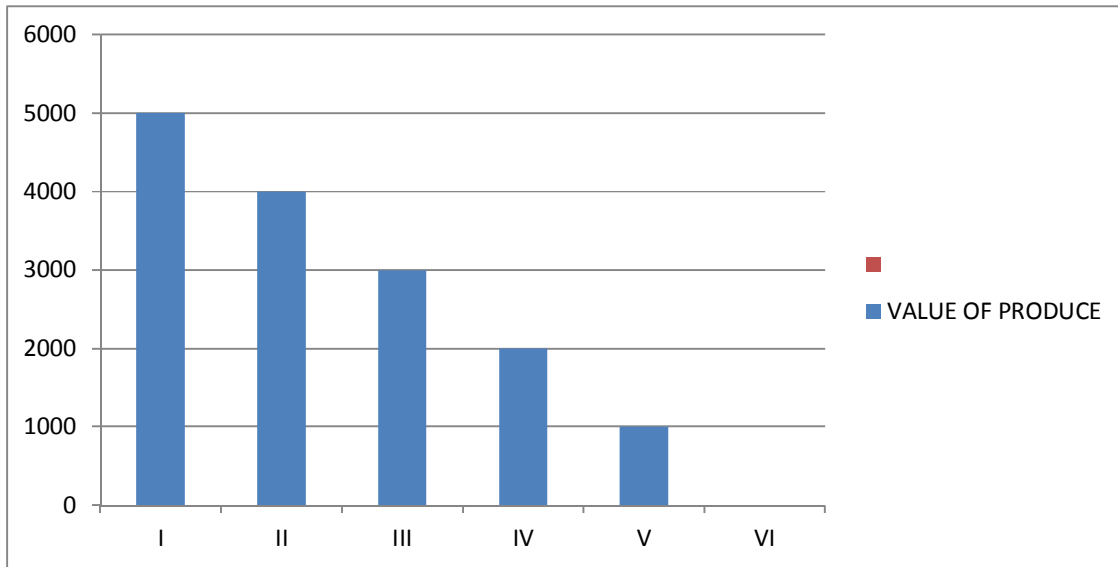
Highest Rent = On Grade I land i.e. Most superior piece of land

Marginal land = Grade V land where Amount spend and Value of Output is Equal i.e. ZERO RENT

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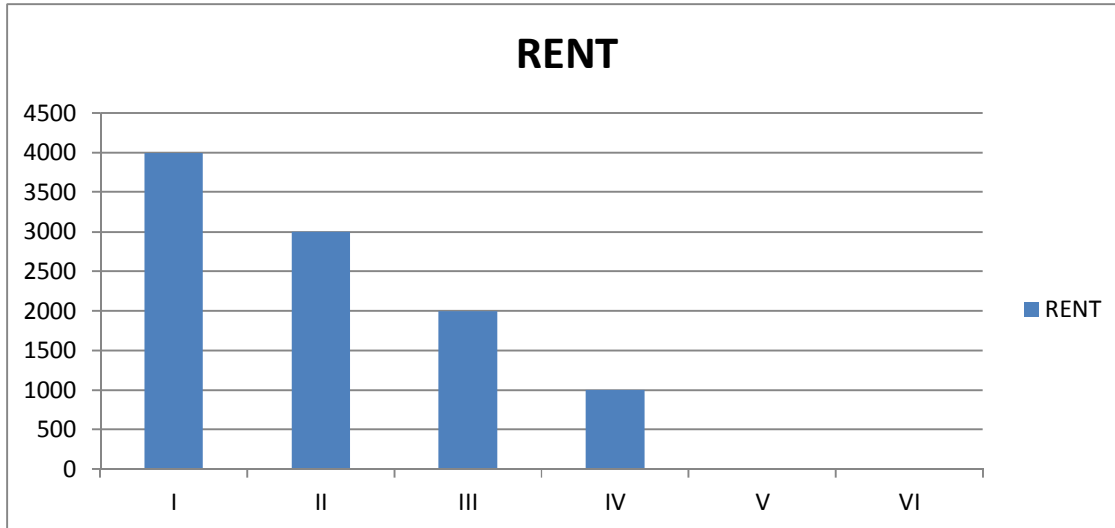
Land left uncultivated = Grade VI land as the value of output is nil and Amount spent is 1000 so it is irrational to cultivate it.

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Most Fertile land = I Grade land

Grade VI = Infertile



Grade V Land = MARGINAL LAND = Rent = 0

Grade VI land will not be cultivated

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Ricardo further said that arising of rent is not static but dynamic i.e. it can change according to time and circumstances. Say in above example if the value of output changes then Marginal land, Rent etc. will change

GRADES OF LAND	AMOUNT SPENT (cost) (Rs.)	VALUE OF OUTPUT (Rs.)	RENT ( VALUE OF OUTPUT- AMOUNT SPENT)
I	1000	6000	6000-1000=5000
II	1000	5000	5000-1000=4000
III	1000	4000	4000-1000=3000
IV	1000	3000	3000-1000=2000
V	1000	2000	2000-1000=1000
VI	1000	1000	1000-1000=0

As can be seen now Grade VI land is Marginal land as now in this land no rent is accruing.

Ricardo said that  $\bar{C}$ orn is high not because rent is high but rent is high because corn is high. He changed popular belief that rent does not affect the price of product but is affected by it. If price remains high, cost will also remain high resulting in high residual income and increase in price.

However Ricardian theory of rent was criticized on many grounds. Some economists believe that Ricardo had taken some unrealistic assumptions. They questioned why to use most fertile land first, and not the less fertile land. Moreover Modern economists believe that rent can also accrue on other factors of production and it arises due to scarcity of a factor rather than its fertility. Also the cost is different on different plots whereas Ricardo assumed it to be the same.

## MODERN THEORY OF RENT

Economists like Alfred Marshall, Joan Robinson criticized Ricardian theory of Rent and put forward a new approach. They believed that rent does not arise due to fertility of the land rather it arises due to Scarcity of a factor. Although land is free gift of nature but it is not free for a firm or enterprise. They have to pay for its usage and the price is decided by the scarcity i.e. more scarce the factor more price for it. So the availability of the factor affects its price. Here the concept of opportunity cost comes in play. Opportunity cost is the value of next best available alternative. A Factor needs to be paid minimum amount equal to its opportunity cost. Remember it is the minimum amount i.e. the lowest limit, actual amount may be much higher.

The actual amount to be paid depends on the scarcity and availability of that factor. If the factor is scarce i.e. less available then the buyer has to pay more amount (Price) for that factor than its opportunity cost. This extra payment is nothing but **Rent** which depends on scarcity of a factor. Similarly for less scarce factor buyer may pay an amount equal or slightly higher than its opportunity cost.

**So rent is the extra payment over the opportunity cost (Minimum cost which has to be incurred).** The scarce factor attracts more rent as the difference in the opportunity cost and actual rent paid is more.

Ricardo in his theory assumed that rent arises only on land but the advocates of Modern theory of rent believed that rent can arise on any factor of production.

## EXPLANATION WITH THE HELP OF EXAMPLE

Suppose an IT professional is working in firm A for a monthly package of Rs. one lakh. With the growing IT sector, the demand for IT professionals will increase. Now firm B offers him a monthly package of Rs. two lakh and he accepts the same.

Opportunity cost in above example = 1,00,000

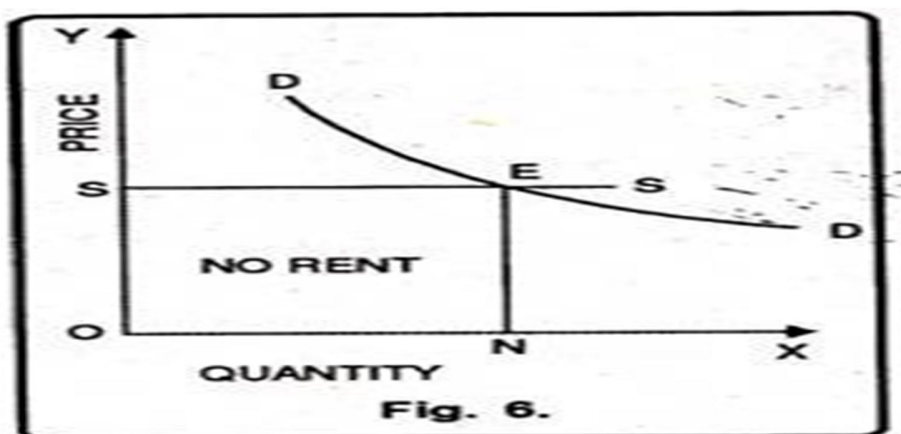
Actual earning of factor = 2,00,000

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Rent= Actual earning- Opportunity cost i.e. 200000-100000=100000

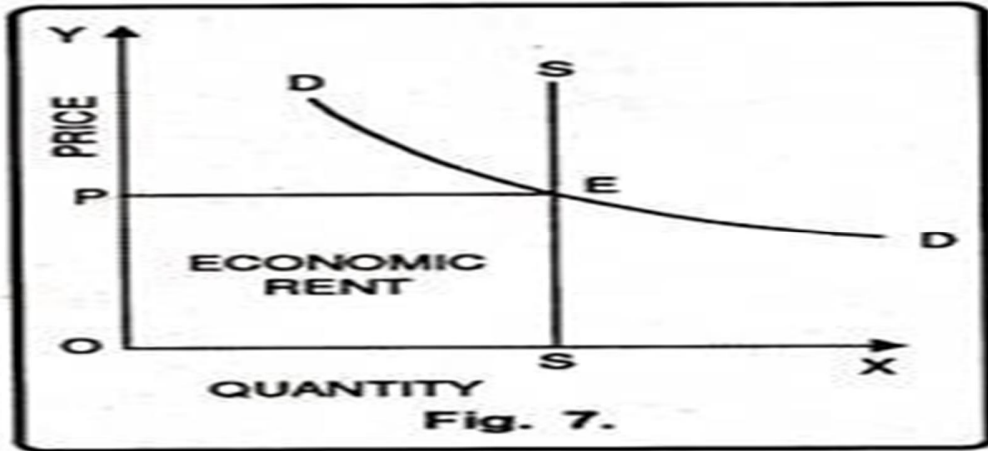
The rent of one lakh is result of scarcity of IT professionals i.e. demand of IT professionals are more than its supply as a result their price increases.

The scarcity of factor can be shown with the help of its Supply curve. If the factor is highly scarce its supply curve will be vertical to the X axis or perfectly inelastic showing zero opportunity cost and whole amount as rent. On the other hand if the factor is not scarce at all supply curve will be horizontal to the X axis or perfectly elastic one showing that the opportunity cost is equal to actual amount and hence Zero rent. So the shape of supply curve is the indicator of scarcity of the factor.

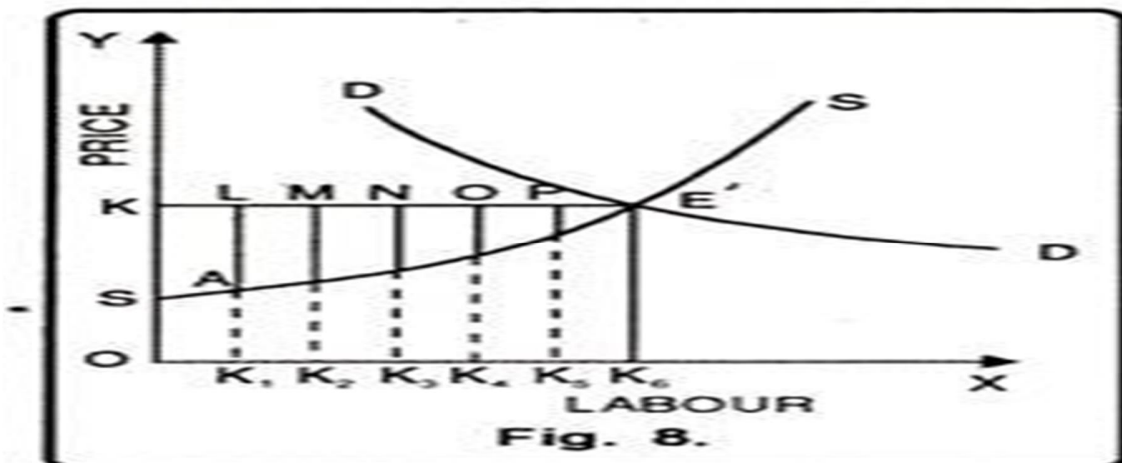


The above diagram shows the situation of no Rent. As you can see the supply curve is perfectly elastic indicating that the factor is not scarce at all. Here the opportunity cost is same as the actual amount spent i.e. the minimum amount of opportunity cost is equal to the actual earning of the factor.

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The above diagram shows the case of completely scarce factor in which the whole earning is the amount of rent. Here the opportunity cost is zero and supply curve is perfectly inelastic. So whatever the demand for the factor determine its price and the whole amount represents the rent which is  $OPSE$  in the above diagram.



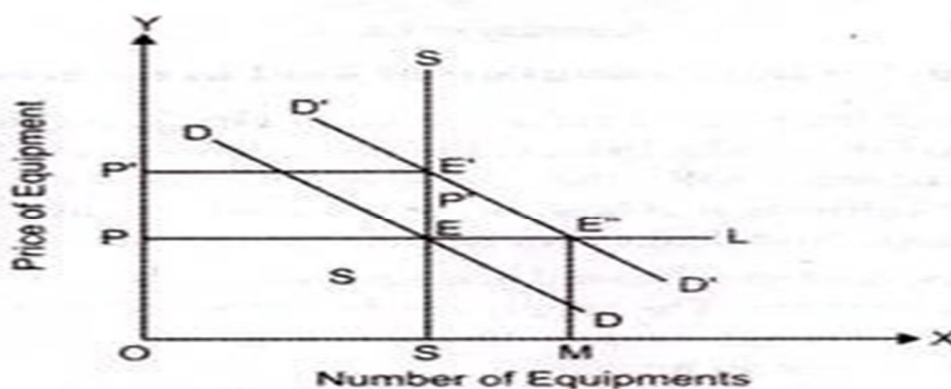
The above diagram shows that point  $E'$  is the point of intersection of demand and supply curve on which  $K$  price is decided.  $OSE'K_6$  is the opportunity cost. On the other hand  $OKE'K_6$  is the actual amount spend.  $KSE'$  represents the amount of rent which is due to the scarcity of factor.



## QUASI RENT

The concept of Quasi Rent was given by Alfred Marshall. He defined quasi rent as the rent like income which arises due to fixed supply of a factor. It may arise on plant and machinery, building etc. The reason behind the income of quasi rent is fixed supply of the factor. However it is mainly a short run phenomenon and disappears as the supply becomes flexible in the long run.

Although he mentioned rent arises due to fixed supply of land. Similarly if man made things starts earning extra income due to its fixed supply it is known as **Quasi Rent**. Now the question arises how the plant and machinery start earning more. As the supply is fixed any rise in demand will not be accompanied by increase in supply as it is fixed, the only outcome will be the rise in price. So the same machinery will earn more income due to fixed supply. If supply would not be fixed then price won't rise and no extra income could be earned.



**Figure-16: Quasi-Rent**

The above diagram shows that supply curve  $SS$  is perfectly inelastic showing that it can be increased in the short run. If demand increases and demand curve rises from  $DD$  to  $D'D'$  then the extra earning due to fixed supply curve i.e.  $PEP'E'$  is the amount of quasi rent as it arises due to inelastic or fixed supply curve.