VIVEKANANDA COLLEGE
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NAAC ACCREDITED 'A' GRADE

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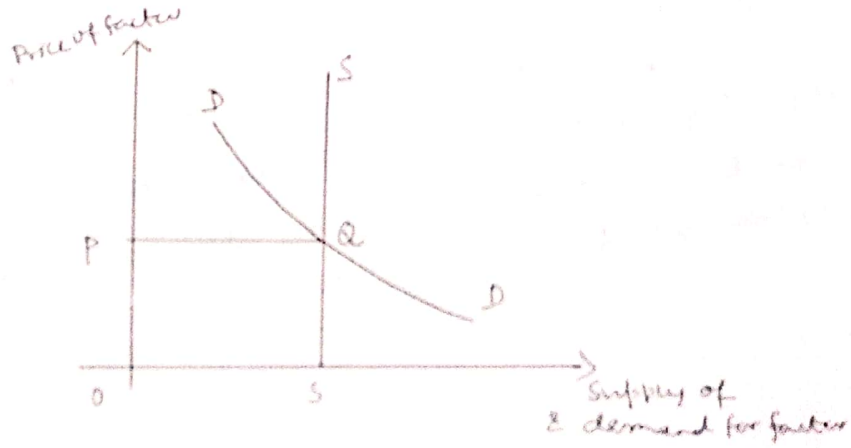
MODERN THEORY OF RENT

In the classical theory, rent is the price paid for the use those factors of production which are perfectly inelastic in supply. Hence in the classical theory rent is the reward for the use of land and other natural resources which are free gifts of nature.

But modern theory defines rent in another way. It is however clear that rent of a factor arises due to inelasticity of supply of a factor. For almost all the factors, supply is more or less elastic. Here according to the modern theory any factor of production whose supply elasticity varies from zero to + ∞ may be rent. The modern theory defines rent in this way : rent is the difference between market price and supply price of a factor. The market price is determined by the intersection of demand and supply of factor. Again supply is the price which is to be paid a unit of a factor in order to make it available. From the stand point of the elasticity of supply of the factor, there are three types of —

1) Perfectly inelastic in supply
2) Supply elasticity varies from 0 to ∞
3) Perfectly elastic in supply.

Case I Perfectly inelastic in supply i.e. $e_s = 0$.

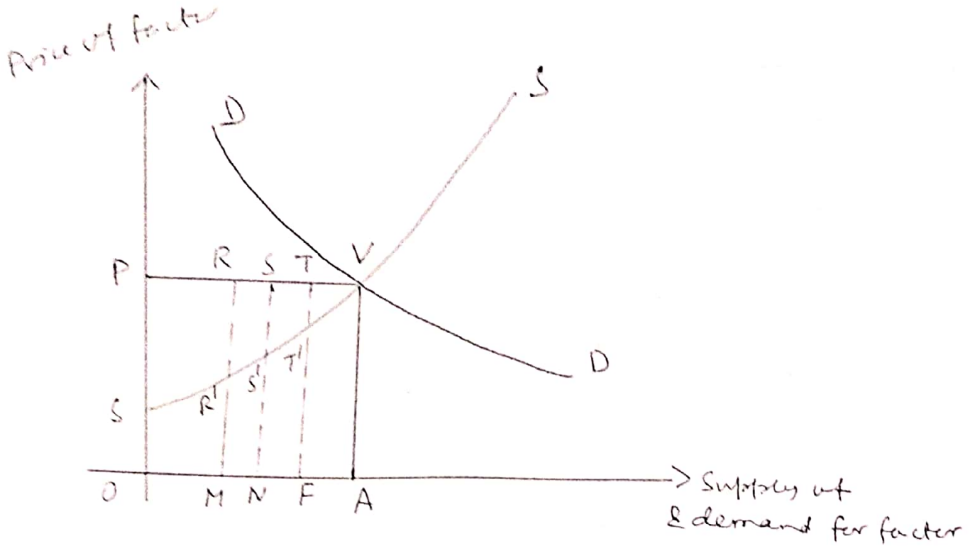


DD is the demand curve and SS is the supply curve. The intersection of the two curves determine

OP as the market price for a unit of the factor. But supply price in this case is zero. Because whatever may be the price of the factor supply is OS. Hence for each unit of the factor, rent is same. So the total rent of the factor is □OPQS. An upward shifts in the demand curve of the factor (i.e. falling portion of the MRP - Marginal Revenue Product which lies below the maximum point ARP) leads to further increase in rent.

Here we have determined rent of the factor whose supply is perfectly inelastic. According to the classical economists, the factor land is perfectly inelastic in supply. This is so because classical economists consider land from the view point of the society as a whole and assumes that land is used for growing a single crop. But the modern economists do not consider land from the view of the society as a whole and reject the classical assumption that land is used for growing a single crop. According to them supply of land is not perfectly inelastic from the point of view of a particular use or industry. The explained rent is in terms of transfer earnings. By transfer earnings we mean the minimum earnings which must be paid inorder to induce a given units of factor to remain in a particular use ~~of~~ of industry. The transfer earnings of a unit of a factor may be defined as the amount of earnings which it can obtain in the next best alternative use. The modern economists think that the supply curve of a factor is rising from left to right since by offering more the supply of the factor can be increased.

Case II Supply elasticity varies from 0 to ∞

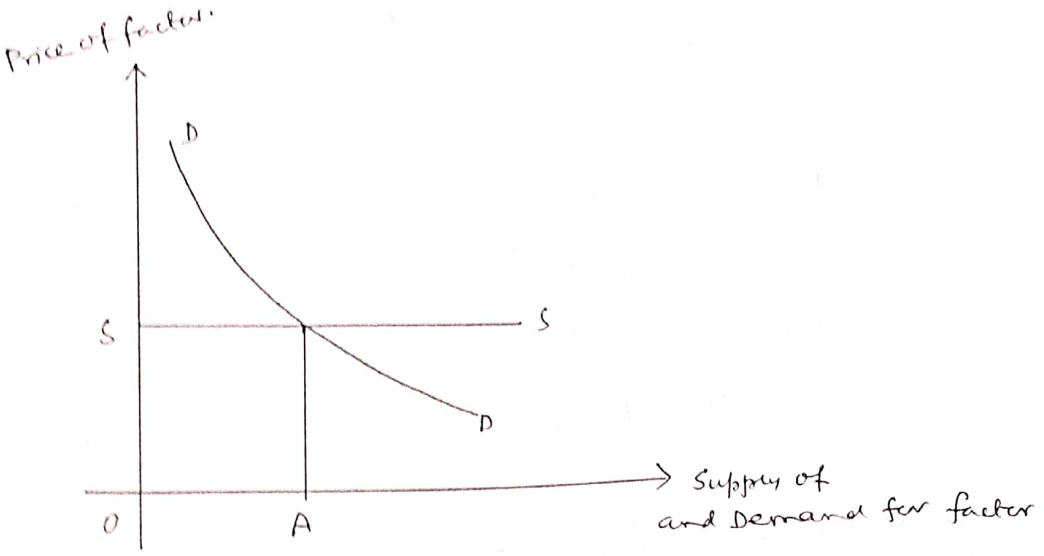


Here the market price for each unit of the factor is OP. But the supply price is not same for each unit of the factor. Hence rent is not same for each unit. As for example for (OM)th unit, the supply price is MR' and the market price is OP. and hence the rent is (OP - MR') = RR'

For (ON)th unit the supply price or the transfer earnings is NS' and hence the rent is SS'. For (OA)th unit rent is zero. Since both the market price and the supply price are equal to OP. So the total rent earned = area PVS.

The factors which are capable of earning rent is called the intra-marginal factor. In this sense, OMth factor, ONth factor are intra-marginal factor. But the OAth factor which earns no rent is called marginal factor.

Case III Perfectly elastic in Supply i.e. $e_s = \infty$



Consider a factor which is perfectly elastic in Supply. In that case, supply is same (OS) for all units of land. But the market price for each unit of land is OS. Hence rent is zero for each unit of the factor. Therefore the total rent is zero.

In the Ricardian theory rent does not enter into