

The Standard Economic Theory of Rent is Immoral and Unjustifiable Ideological Fiction



Ron Baiman
Benedictine University
Lisle, Illinois
rbaiman@ben.edu

Abstract: In this paper I will demonstrate: A) that the standard economic theory of rent (and most of the rest of mainstream economics) is ideological fiction, and offer a more realistic alternative analytical framework for understanding rent, and B) why rent payments to landlords (and “rentiers” more broadly for finance, insurance and monopoly products) are mostly property-based extractions without moral or economic justification.

Keywords: Rent; Rentierism; Supply and Demand; Demand and Cost; Introductory Economics Teaching; Neoclassical Economics; Unequal Exchange; Economic Memes.

Introduction

In this paper I will demonstrate: A) that the standard economics theory of rent (and most of the rest of mainstream economics) is ideological fiction, and offer a more realistic alternative analytical framework for understanding rent, and B) why rent payments to landlords (and “rentiers” more broadly for finance, insurance and monopoly products) are mostly property-based extractions without moral or economic justification.

A) The Standard Economic Theory of Rent is Ideological Fiction

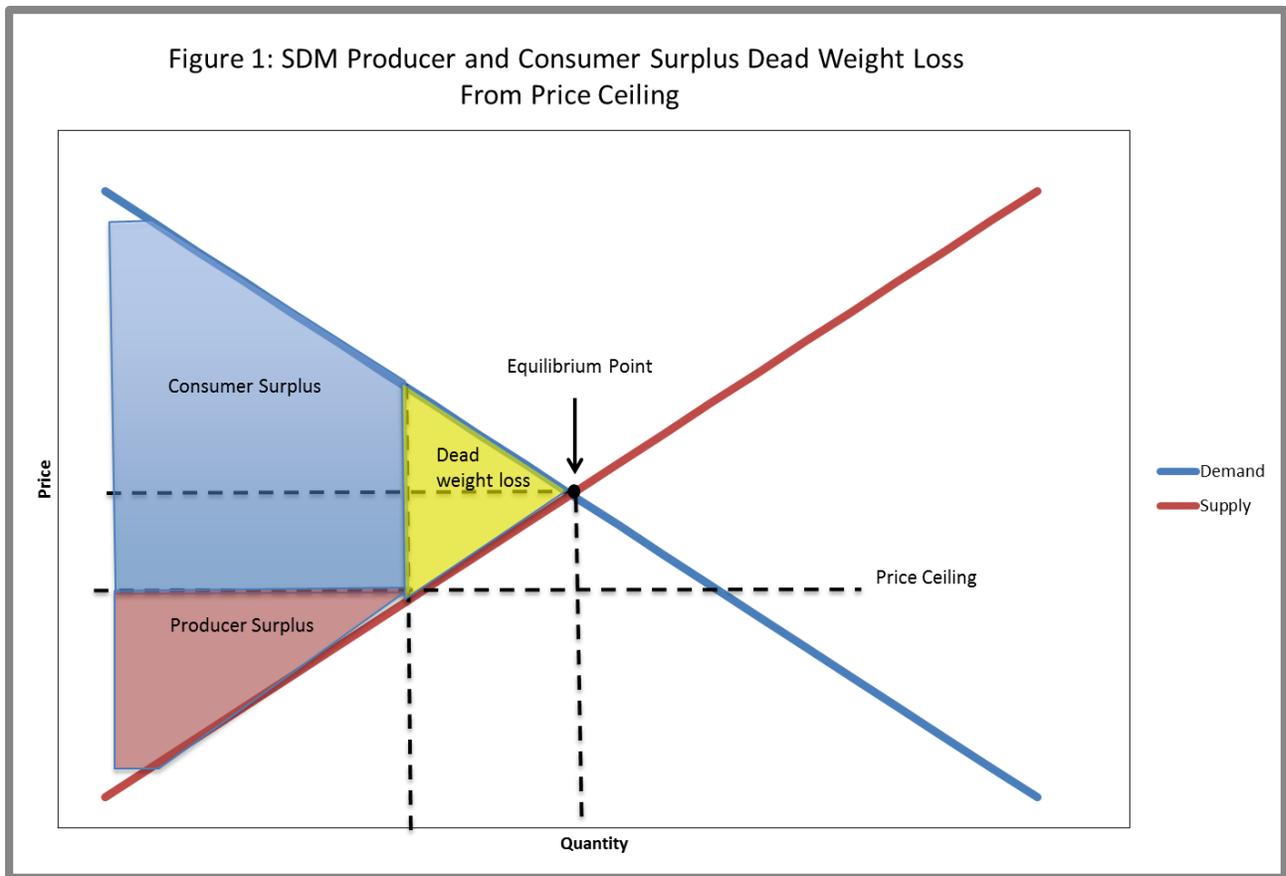
The standard intro economics story on rent control is presented as an application of the Supply and Demand Model (SDM) that is a core part, with [the “Ricardian Comparative Advantage” parable for international trade](#), of the “free market” indoctrination that forms most of [the substance of the “Neoclassical” \(NC\) economics curriculum](#). But the SDM story is [fictional](#) for most of the production economy as the “Supply Curve” (SC) part of the SDM does not generally exist. This is easy to demonstrate. If you’re asked to manage a pizza shop and don’t know anything about the normal demand for pizzas from that shop, you will have no ability to offer an estimate of how many pizzas to make at any given price. For example, you will not be able to estimate how much pizza to produce at \$15 a pie. But the hypothetical SC of the SDM is premised on the assumption that producers *can* estimate a hypothetical “quantity supplied” amount to produce at any given price. In other words, the SDM assumes that you will be able to determine how many pizzas you will make at \$15 a pie, *independent of, or without any knowledge of, demand conditions. Because, in almost all cases, producers cannot do this, SC’s are ghost curves that do not exist in most of the production economy.*

Moreover, the “Supply and Demand Model” (SDM) sleight of hand is [profoundly ideological](#). The SDM is ideological as it provides pseudo “scientific” legitimation by means of a simple analytical, or formal mathematical, parable, dressed up in graphs (and sometimes equations), for: a) objective “market forces” determining a unique, b) stable, or self-adjusting, equilibrium, that is also c) socially optimal. These points are highlighted in introductory economic courses, the only economics classes taken by most people, so that the SDM meme of objective, self-regulating and socially beneficial, market forces is firmly inculcated into the minds of students and the general public, where it is indeed pervasive in politics, law, regulation, business theory, and in the general popular understanding of economics. For example, at the start of my MBA economics classes, I often ask my students what is the most important thing that they remember from prior economics courses that they may have taken. The almost universal answer is “supply and demand”.

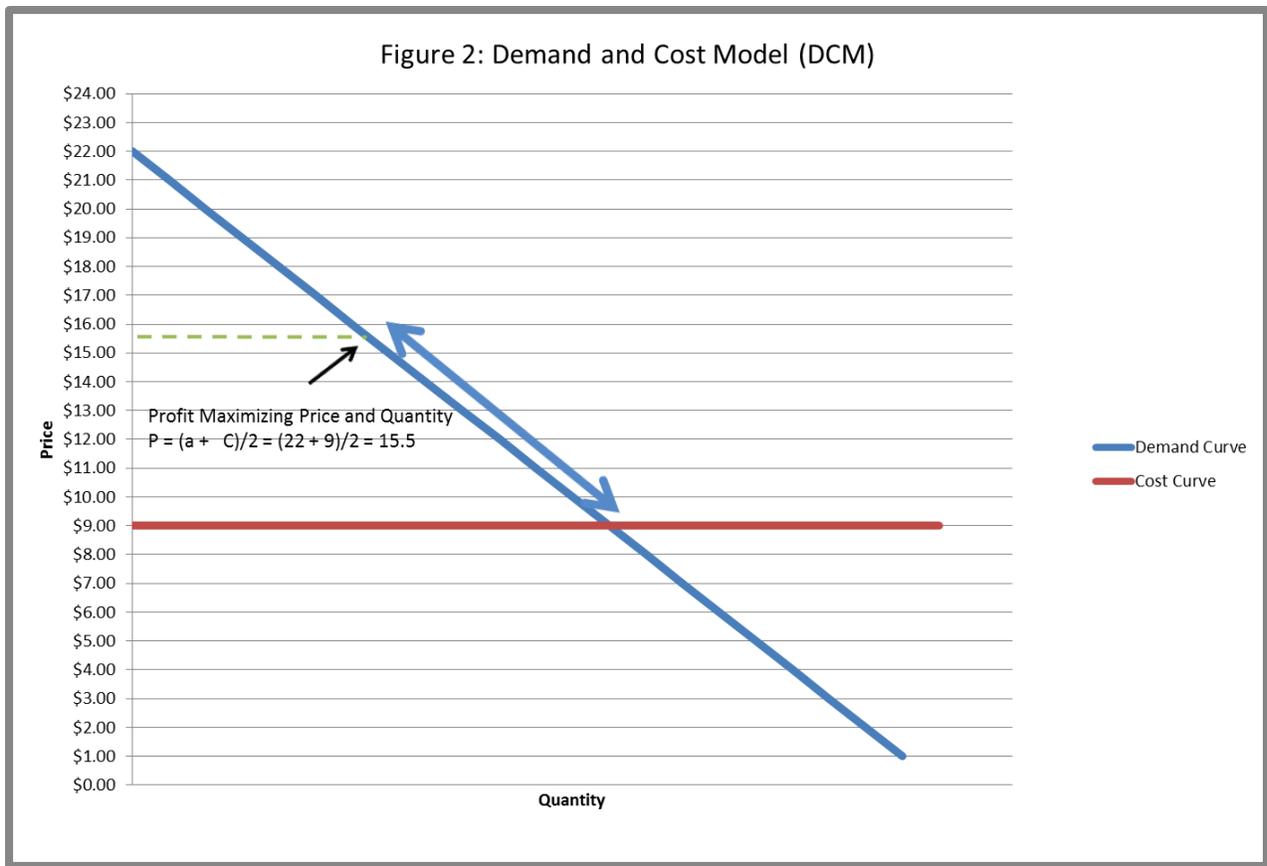
An example of the standard NC SDM theory of rent from Gregory Mankiw’s very popular introductory economy textbook is provided in the Appendix. Mankiw posits a short-run SDM of rent with a vertical supply curve (Figure A1 Panel A), and a long-run SDM of rent with an upward sloping supply curve (Figure A1 Panel B). The major conclusion of his story is that while rent control can make housing more affordable in the short-run it will reduce the production of

new housing and cause shortages that will unfairly prevent new residents from finding housing in the long-run.

The Mankiw story, that is similar to that in almost every other introductory text, thus reinforces the overarching message that is at the core of the standard NC economics curriculum. “Soft hearted” interference with markets to produce beneficial social outcomes will likely backfire and have negative unintended consequences. More generally the standard view presents the “market equilibrium” point where the supply and demand curves of the SDM cross, as a socially efficient outcome towards which free markets will gravitate. In this standard NC economic view, the SDM equilibrium point is a *fair and efficient* point of “equal exchange” where incremental costs for suppliers and incremental benefits for renters are equal. As shown in Figure 1 below, it is also an *optimal* point that [maximizes social welfare as measured by the sum of producer and consumer surplus](#).



All of this breaks down in the more realistic “Demand and Cost Model” (DCM) with a real “Cost Curve” (CC) replacing the ghost SC curve. The DCM is presented in Figure 2 below.



The blue “Demand Curve” shows hypothetical “quantities demanded” of apartment units on the horizontal “Quantity” axis in a given locality at different possible rents or “Price” on the vertical axis. The red “Cost Curve” shows hypothetical average costs per unit for landlords in this location. Like the SDM, the DCM presents a hypothetical picture at one point in time. If rents are lower, there will be more demand from renters for units but average costs per unit will remain the same. Landlord profit per unit will equal the “mark-up”, or difference between cost and rent per unit.

If there is only one monopoly landlord who wants to maximize his/her profit on existing units, he or she can maximize their profit in this simplified linear downward sloping demand curve and flat horizontal average cost curve model, by charging a rent of \$15.50, or by setting a price that is halfway between constant average cost (\$9.00) and the vertical intercept of the demand curve (\$22.00). This is a consequence of housing unit quantity demanded falling as rents go up, so that there is an optimal rent increase beyond which the loss of profit due to fewer units being rented will be greater than the increase in profit from higher rents (for a mathematical derivation see [this](#)). Generally however there will be more than one landlord, and competition will prevent landlords from maximizing their short-run profit, so that rents will, depending on

landlord strategies, cluster in the heavily shaded blue region of the demand curve between the two arrows, above the cost curve (\$9.00) and below profit maximizing rent (\$15.50).

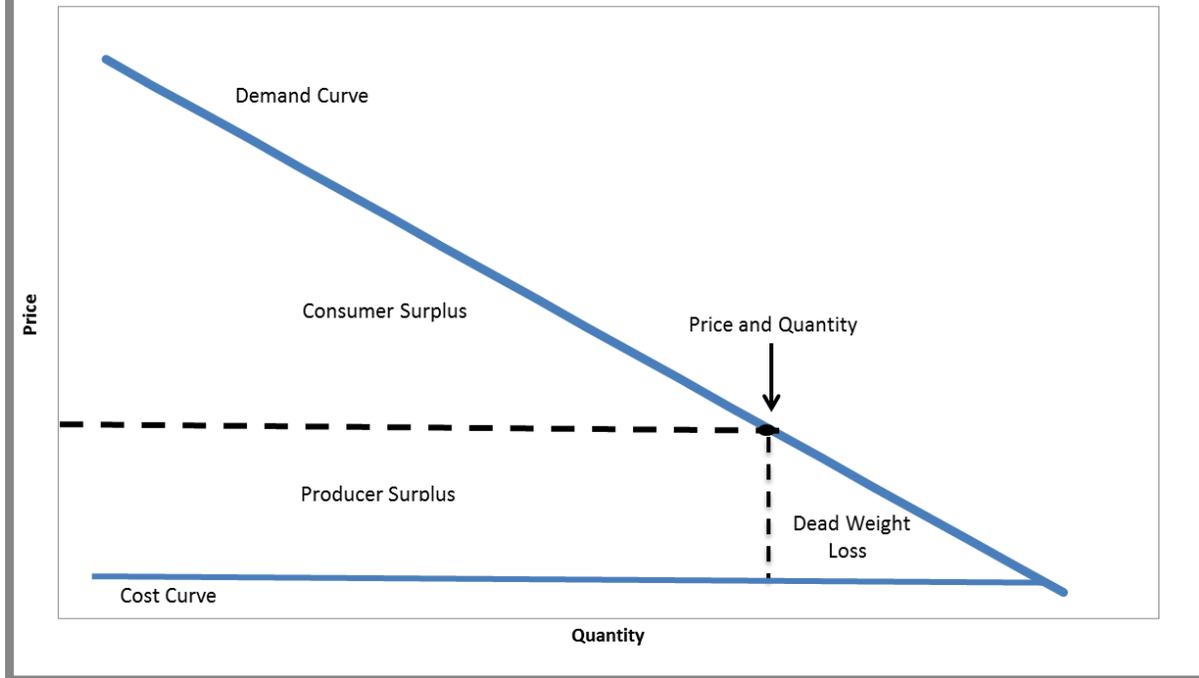
In the *short-run*, when demand for units in this location goes up, the supply of units will be restricted by the supply of existing open units available, with some flexibility from landlords offering more units due to the possibility of finding tenants willing to pay higher rents. Increased demand will be depicted by a demand curve shifting up and to the right representing a hypothetical demand schedule with higher rents for any given number of units supplied. The outcome in this case will thus be similar to that depicted in Figure A1 Panel A, though with no SC, and a narrow range of outcomes on the demand curve rather than a single point. This cluster of outcomes would represent landlord offers of a limited number of new units, without the production of new apartments, due to the inducements of tenant demand for units at higher rents. In this situation landlords will enjoy windfall increases in profit from higher rents but the number of units available for rent will not increase very much.

In the *long-run*, if developers and landlords expect the demand curve to continue to shift up and to the right, they will construct new units. The upward shifting demand curve will drive up rents, and demand by developers and landlords will drive up costs for new choice locations that can be developed or redeveloped, driving up the average cost curve. At any given point in time depending on competition and costs, the range of outcomes will again be represented by a cluster of points along the bold part of the blue demand curve in Figure 2.

If expectations are correct, all of these possible outcomes will be “market clearing” in the sense that the supply of new units will equal the demand for new units, *but there will be nothing inherently optimal about the level of rent, or the supply of new units, resulting from any of these possible market outcomes.* To the contrary, in a location where demand for units is rapidly going up, rents will go up, apartments will be rationed by ability to pay, and landlords and developers will make windfall profits until the boom ends, or until costs and rents become unfinance-able for developers or unaffordable for renters.

Instead of the socially optimal market outcome depicted in Figure 1 above that shows that the sum of consumer and producer surplus is maximized at market equilibrium price and quantity where the demand and supply curves cross (more on the definitions of “consumer surplus” and “producer surplus” and why the sum of these is considered an approximate measure of “consumer welfare” in NC economics [here](#)), when the ghost supply curve is removed and replaced by an average cost curve, the consumer and producer surplus outcome at any given point in time will be as represented in Figure 3 below.

Figure 3: DCM Consumer and Producer Surplus and Dead Weight Loss



In this picture the sum of consumer and producer surplus, or NC social welfare, is not maximized, and “dead weight loss” does not disappear at some hypothetical and non-existent market equilibrium, but rather consumer surplus ([a more appropriate non-NC static measure of social welfare](#)) is maximized to the extent that that mark-ups or landlord profits are reduced, i.e. given the supply of units, mark-ups or rents should be constrained so that housing is affordable.

B) Rent is Mostly Property-Based Exploitation Without Moral or Economic Justification

Markets can be useful and powerful tools for progress when the incentives that they create align with just, efficient, and sustainable, economic growth and allocation. This usually means that they have to be [constrained and regulated through democratic social choice](#). Property-based extraction of income, the political economic definition of “rent”, has long been reviled in classical political economy at least as far back as [David Ricardo](#) who made a fortune in bond trading but focused on land rent, [and in modern political economy](#), as parasitical and unproductive. Land rent, or “real estate” rents are a classical example of property-based income extraction that has been recognized as unjustifiable and inefficient since the primary driver of the value of land and property is location, and the unique incremental value of a particular location is largely a result of nature or society, that is only marginally, if at all, related to the efforts and investments of individual owners.

In recent history [Henry George](#) was perhaps the most well-known advocate of taxing away the windfall profits of landlords that accrues from the rising value of real estate property that is largely the result of general economic growth and social and community development, but contemporary radical political economists like [Hyman Minsky](#), [Michael Hudson](#), [Steve Keen](#), and [Ron Baiman](#) have expanded this “rentierist” perspective to the general “Finance, Insurance, and Real Estate” (FIRE), as well as tech platform and other monopoly, sectors of the economy. As pointed out originally by Minsky, capitalist economies are prone to financial crisis from self-perpetuating bubbles of exuberance, from private bank lending creating credit that drives up the price of housing, that increases the value of collateral for more lending, in a feed-back loop that drives up credit creation, capital appreciation, rents, interest payments, profits and fees, until prices stop rising and a collapse ensues. Hudson has shown that rentierism has been a primary cause of civilization collapse throughout antiquity. Keen has focused on the private debt overhang that persists when financiers/rentiers are bailed out (as in 2008) causing long-term stagnation and economic polarization.

And Hudson, Keen, and Baiman have urged that democratic socialists expand the classic Marxian capital-labor class struggle paradigm to a three-way “rentiers, capital, labor” analysis of the contradictions, conflicts, and possible imminent collapse of modern capitalism from unbridled rentierist exploitation of people and planet. In fact, as [John E. Roemer](#) and the Analytical Marxists have pointed out, capitalists could be considered to be a particular type of rentiers [who use their monopoly ownership power over the means of production to exploit workers](#). The key difference between such classical “capitalist-rentiers” and modern “rentierist-rentiers” being that the former group exploit labor through capitalist “equal-exchange” and the creation of surplus value in real production, whereas the later exploit both labor and capital through “unequal-exchange” without necessarily producing any real new goods or services.

The DCM model lifts [the bourgeois equal-exchange ideological veil of the SDM model](#) by demonstrating the arbitrary nature of rent mark-ups based on market power that are unrelated to costs of production or investment ([or current or past labor](#)). In a more equal society it might make sense to allocate housing based on how much households are willing to spend of their income and wealth for desirable housing as opposed to other goods or services. However in the vastly and increasingly unequal and rentierist modern capitalist societies of today, it makes little sense to allocate housing purely on the basis of ability and willingness to pay, especially as housing is widely recognized as a basic human right. There are numerous reasons why housing should be affordable, and as much as possible, widely available across communities and regions. Affordable housing is vitally important for basic human and family welfare, for maintaining and enhancing community diversity and democracy, and to prevent geographic, economic and social polarization. It makes little sense to tie housing development to for-profit “market signals”. Rather large scale investment in public and not-for profit public housing, as well as rent control and other measures, should be the primary drivers that ensure an adequate and geographically diverse supply of affordable housing, and this goal should be the guiding principle of housing “markets”.

Appendix

From Mankiw *Principles of Macroeconomics* 8th ed.

Rent Control in the Short Run and in the Long Run

Figure A1 Panel A, below, shows the short-run effects of rent control: Because the supply and demand curves for apartments are relatively inelastic, the price ceiling imposed by a rent-control law causes only a small shortage of housing. Figure A2, Panel B, below, shows the long-run effects of rent control: Because the supply and demand curves for apartments are more elastic, rent control causes a large shortage.



The long-run story is very different because the buyers and sellers of rental housing respond more to market conditions as time passes. On the supply side, landlords respond to low rents by not building new apartments and by failing to maintain existing ones. On the demand side, low rents encourage people to find their own apartments (rather than living with their parents or sharing apartments with roommates) and induce more people to move into the city. Therefore, both supply and demand are more elastic in the long run.

FIGURE A1 PANELS A AND B

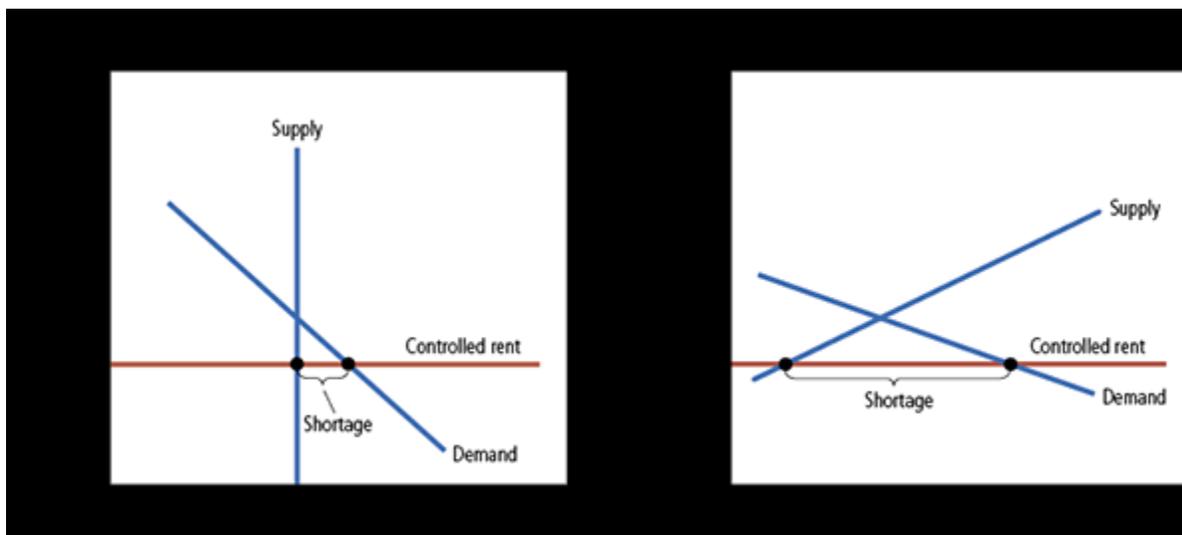


Figure A1 Panel B illustrates the housing market in the long run. When rent control depresses rents below the equilibrium level, the quantity of apartments supplied falls substantially and the quantity of apartments demanded rises substantially. The result is a large shortage of housing.

In cities with rent control, landlords use various mechanisms to ration housing. Some landlords keep long waiting lists. Others give preference to tenants without children. Still others discriminate on the basis of race. Sometimes apartments are allocated to those willing to offer under-the-table payments to building superintendents. In essence, these bribes bring the total price of an apartment closer to the equilibrium price.

To understand fully the effects of rent control, we have to remember one of the *Ten Principles of Economics* from Chapter 1: People respond to incentives. In free markets, landlords try to keep their buildings clean and safe because desirable apartments command higher prices. By contrast, when rent control creates shortages and waiting lists, landlords lose their incentive to respond to tenants' concerns. Why should a landlord spend money to maintain and improve the property when people are waiting to move in as it is? In the end, tenants get lower rents, but they also get lower-quality housing.

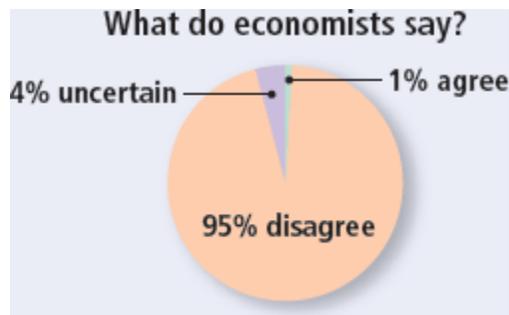
Policymakers often react to the effects of rent control by imposing additional regulations. For example, various laws make racial discrimination in housing illegal and require landlords to provide minimally adequate living conditions. These laws, however, are difficult and costly to enforce. By contrast, when rent control is eliminated and a market for housing is regulated by the forces of competition, such laws are less necessary. In a free market, the price of housing adjusts to eliminate the shortages that give rise to undesirable landlord behavior.

Ask the Experts

Rent Control

“Local ordinances that limit rent increases for some rental housing units, such as in New York and San Francisco, have had a positive impact over the past three decades on the amount and quality of broadly affordable rental housing in cities that have used them.”

FIGURE A2



Source: IGM Economic Experts Panel, February 7, 2012.

Biographical Note: Ron Baiman teaches Economics in the MBA program at Benedictine University in Lisle, IL outside of Chicago. He is the author of two recent books: *The Global Free Trade Error: The Infeasibility of Ricardo's Comparative Advantage Theory* (Routledge, 2017), and *The Morality of Radical Economics: Ghost Curve Ideology and the Value Neutral Aspect of Neoclassical Economics* (Palgrave Macmillan, 2016); and co-author of *Political Economy and Contemporary Capitalism* (M.E. Sharpe, 2000). He has published theoretical and policy papers on international, national, and local political economy in numerous heterodox and neoclassical journals; has been a member of the Editorial Board of the *Review of Radical Political Economics* for many years, and is a founding member of the Chicago Political Economy Group (CPEG) (www.cpegonline.org) where many of his policy analyses and blog postings can be found.