Different reasons for high rent

Do you care if you get ripped off?

I do. A lot of things in this life are expensive. Of course, sometimes that expense is a natural outcome of the power of scarcity. For instance, there are not many apartments overlooking Central Park in New York or Hyde Park in London. Because so many people want them, those apartments are expensive, and a lot of people end up being disappointed. There is nothing sinister about that. But it's not nearly so obvious why popcorn is so expensive at the movies—there was no popcorn shortage last time I checked. So the first thing we might want to do is to distinguish between different reasons for things being expensive.

In Ricardo's terms, we would like to know the different causes of high rents. Knowing this about meadows is only mildly interesting (unless you are a farmer) but takes on a sudden significance when applied to the question of why your apartment rent seems so extortionate, or whether banks are ripping us off. But we can start with meadows and apply what we learn more widely.

We know that rents on the best land are determined by the difference in fertility between the best land and the marginal land. So the obvious reason that rents might be high is that the best land produces very valuable crops relative to the marginal land. As mentioned a couple of pages ago, five bushels of grain is a five-dollar rent at a dollar a bushel, but at two hundred thousand dollars a bushel, five bushels of grain is a million-dollar rent. If grain is expensive, it's only natural that the scarce meadows that produce it will also be expensive.

But there's another way to drive rent on meadows up, and it is not nearly so natural. Let's say landlords get together and manage to persuade the local sheriff that there should be what in England they call a "green belt," a broad area of land around the city on which property development is very strongly discouraged by tough planning regulations. The landlords claim that it would be a shame to cover beautiful wild land with farms, and so farming on the land should be made illegal.

The landlords stand to benefit hugely from such a ban, because it would drive up the rents on all legal land. Remember that rents on meadowland are set by the difference between the productivity of meadowland and the productivity of the marginal land. Ban farming on that marginal land, and the rent on meadows will jump; where once the alternative to paying rent and farming on meadows was to farm on grassland rent-free, now there is no alternative. Farmers are much more eager to farm on meadows now that farming on the grassland is illegal, and the rent they're willing to pay is much higher too.

So we've found two reasons why rents might be high. The first is that it's worth paying a lot for good land, because the grain

that good land produces is so valuable. The second is that it's worth paying a lot for good land because the alternatives that should be available are not.

Those readers currently renting property in London may have furrowed brows at this point. London is surrounded by the original "Green Belt," created in the 1930s. Is that why property in London is so expensive to rent or buy—not because it's so much better than the alternative, but because the alternative has been made illegal?

It is a combination of both: it is certainly true that London is unique, and a better place to put plush apartments or office buildings than Siberia, Kansas City, or even Paris. Rents are high, in part, for that reason. But another reason why property in London is expensive is because of the Green Belt. One effect is to keep London from sprawling out across the surrounding region—which many people think is a good idea. The other effect is to transfer a massive amount of money from London tenants to London landlords: the Green Belt keeps rents and house prices in London much higher than they would be, in exactly the same way as a ban on grassland farming keeps rents on meadow and scrub much higher than they would otherwise be.

This is not an argument against the Green Belt. There are lots of benefits in having London's population capped at around six million people, instead of sixteen million or twenty-six million. But it is important that when we are weighing the pros and cons of legislation like the Green Belt, we understand that its effects are more than simply to preserve the environment. Office rents in London's West End are higher than in Manhattan or central Tokyo—in fact, the West End is the most expensive place in the world to rent an office, and it also holds the world record for the most expensive home, at £70m (about 130 million dollars). The Green Belt has made property in London scarce relative to the people who want to use it, and of course, strength comes from scarcity.

Now it's time for your first economics test. Why would improvements in the quality and price of the commuter train services that bring people into New York's Penn Station from the surrounding suburbs please anyone who rents a property in Manhattan? And why might New York landlords be less enthusiastic about such improvements?

The answer is that improved public transportation increases the alternatives to renting a place in the city. When a two-hour commute becomes a one-hour commute, and people are able to get a seat on the train instead of standing, some decide they'd rather save money and move out of Manhattan. Vacant apartments then appear on the market. Scarcity lessens, and rents fall. Improving commuter services wouldn't just affect commuters; it would affect everyone involved in New York's property market.

Are we being ripped off?

One of the problems with being an undercover economist is that you start to see "green belts" of one kind or another all over the place. How can we tell the difference between things that are expensive because they are naturally scarce, and things that are expensive because of artificial means—legislation, regulation, or foul play?

Ricardo's model can help here, too. We need to appreciate a hidden parallel between natural resources, like fields or busy locations, and companies. Fields are ways of turning stuff into different stuff: manure and seed into grain. Companies are the same. A car manufacturer turns steel, electricity, and other ingredients into cars. A gas station turns pumps, big tanks of fuel, and land into gasoline in your tank. A bank turns computers, advanced accounting systems, and cash into banking services. Without perpetrating too much intellectual violence, we can replace "rent" with "profit" throughout Ricardo's model. Rent is the return landlords receive from their property; profit is the return company owners earn from *their* property.

Let's use banking as an example. Imagine that one bank is very good at producing banking services—it has a fantastic corporate culture, strong brand, and has developed the best specialized banking software. Good people work there and other good people join just to learn from them. All this adds up to what economist John Kay (who explicitly invokes Ricardo's model) calls a "sustainable competitive advantage," meaning the sort of edge over the competition that will produce profits year in and year out.

Let's call this uberbank Axel Banking Corporation. A second bank, Bob's Credit and Debt, is not quite so competent: the brand is less trusted, the corporate culture is so-so. It's not bad, but it's not great either. A third bank, Cornelius's Deposit Enterprises, is extremely inefficient: it has a terrible reputation, the tellers are rude to the customers, and control of expenses is nonexistent. Cornelius's bank is less efficient than Bob's outfit and grossly incompetent compared with Axel's Banking Corporation. All this should remind us of the three types of land: meadowland, which is very efficient at producing grain; scrub, which is less efficient; and grassland, which is even less efficient.

Axel's bank, Bob's bank, and Cornelius's bank compete to sell banking services by persuading people to open accounts or take out loans. But Axel's bank is so effective that it can either produce banking services more cheaply or produce better quality services for the same cost. At the end of each year, Axel's bank will earn large profits, and Bob's bank, which serves its customers with less ease, will make something rather more modest, and Cornelius's bank will just break even. If the banking market was tougher, Cornelius's bank would go out of business. If the banking market started to get more attractive, Cornelius's bank would start to make a profit, and a new bank, even less efficient than Cornelius's, would enter the business. The new bank would be the marginal bank, just breaking even.

Without repeating every step of the analysis, we can remind ourselves that the rent on meadowland was set by comparison with the productivity of meadows to that of the marginal grassland. In the same way, Axel's profits are set in comparison with

Cornelius's bank, the marginal bank, which we know should expect to make little or no profits: company profits, like rents, are determined by the alternatives. A company with stiff competition will be less profitable than a company with incompetent rivals.

You are probably thinking of a flaw in the analogy: the acreage of meadows is fixed, but companies can grow. But that's only partly true; companies cannot grow overnight without diluting their reputation and the other capabilities that made them successful. On the other hand, while acreage cannot change, the distinctions between different types of land will shift over time as irrigation, pest control, or fertilizer technology develops. Ricardo's model, which ignores these changes over time, will explain trends in agricultural prices over decades but not over centuries, while it will explain corporate profitability over years, but not decades. As with many economic models, the analysis will work well for a certain time scale—in this case, the short and medium term. For other time scales, different models are needed.

This is all very well . . . but what does it have to do with corporate profiteering?

The newspapers often point to high corporate profits as a sign that the consumer is being screwed. Are they right? Only sometimes. Ricardo's analysis suggests that there are two reasons why average profits of an industry like banking might be high. If customers really value great service and reputation, both Axel and Bob will make a lot of money (Cornelius's bank is the marginal bank and can expect very little). Newspaper hacks will be able to complain about excessive profits. If customers place only a small value on great service, Axel and Bob will be only moderately more profitable than Cornelius (still the marginal bank, still making very little), and average profits should be low. The commentators will be silent. But the motives and strategies used by the industry haven't changed—the only thing that changed was that customers put a premium on great service. Nobody is ripping anybody off; instead, Axel and Bob are being rewarded because they are offering something both scarce and highly valued.

But high profits are not always earned so fairly; sometimes the newspaper outrage is justified. There's a second explanation for high corporate profits. What if a kind of banking "green belt" completely excluded Cornelius's bank from the market? In the real world there are lots of reasons why potential new companies cannot enter a market and compete. At times the consumers have only themselves to blame: new firms struggle to enter the market because customers will deal only with established companies. John Kay shows that certain "embarrassing" products, including condoms and tampons, are highly profitable because new entrants find it hard to create a buzz about their products. More frequently, the firms themselves lobby their governments asking to be protected from competition, and many governments around the world grant monopoly licenses, or are highly restrictive of entry into "sensitive" industries like banking, farming, or telecommunications. Whatever the reason, the effect is the same: established companies, free of competition, enjoy high profits. In fact, because of the similarity between the rents that can be charged on land with few substitutes and the profits enjoyed by a firm with few competitors, economists often call those profits "monopoly rents." It may be a confusing term, but you can blame David Ricardo's model and the lack of imagination shown by economists ever since.

If I want to know whether I am being ripped off by supermarkets, banks, or drug companies, I can find out how profitable those industries are. If they are making high profits, then initially I am suspicious. But if it seems that it is fairly easy to set up a new company and compete, I become less suspicious. It means that the high profits are caused by a natural scarcity: there are not many really good banking organizations in the world, and good banking organizations are much more efficient than bad ones.

Resource "rents"

Landlords and executives are not the only people who like to avoid competition and who like to enjoy monopoly rents. Trade

unions, lobby groups, people studying for a professional qualification, and even national governments like them too. Every day people all around us are trying to avoid competition or reap the rewards of others who have succeeded in doing so. Economists call this type of behavior "creating rents" and "rent-seeking."

It's not easy to do this. It turns out that the world is a naturally competitive place, and it is no simple matter to steer clear of competition. This is fortunate, because although competition is uncomfortable if you are on the wrong end of it, it is pleasant to be on the right end, as the customer. We all benefit when we are interacting with people who are competing to offer us jobs, newspapers, or vacations in the sun, just as our mythical landlords benefited from competition between Bob and Axel.

One way of preventing competition is by controlling a natural resource such as farmland. There is only so much good farmland in the world, and only revolutions in agricultural techniques can change that. But farmland is not the only finite natural resource in the world. Another example is oil. Some parts of the world can produce oil cheaply, most notably Saudi Arabia, Kuwait, Iraq, and other Gulf states. Other parts of the world can produce oil more expensively—Alaska, Nigeria, Siberia, and Alberta. And there are many parts of the world that have oil that is so expensive to extract that nobody is even thinking of doing so. At the moment, places like Alberta produce the marginal oil.

The history of the oil industry is a case study in Ricardo's theory of rents. Until 1973, the world's oil supply was produced by "oil meadows," largely in the Middle East. Despite the incredible value of oil to the industrialized economies, the price of oil was very low—less than ten dollars a barrel in today's money, because there was plenty of it available at very low costs. The Organization of the Petroleum Exporting Countries, OPEC, which was sitting on most of the oil meadows, decided in 1973 to take some of its own meadows out of commission, by ordering each member country to restrict oil production. Oil prices leapt to forty dollars a barrel, and then to eighty dollars, in today's money. They stayed high for years, because in the short run there were few alterna-

tive sources of oil. (The equivalent in Ricardo's world would have been to abruptly halt the cultivation of meadowland, leaving a delay before grassland could be cleared and plowed, thereby causing a temporary grain shortage, raising rents.)

At eighty dollars a barrel, plenty of alternatives looked cheap and were adopted over the years: producing electricity using coal instead of oil; building cars that got better gas mileage; and exploring for oil in places like Alberta and Alaska. More and more "energy scrubland" and "energy grassland" was being cultivated. To keep prices high, OPEC was forced to accept a smaller and smaller share of the world oil market. Eventually Saudi Arabia broke ranks in 1985 and expanded production. Prices collapsed in 1986, and until just a couple of years ago the price of oil has roughly tracked the cost of production from marginal fields in places like Alberta—around fifteen to twenty dollars a barrel. In the last couple of years we have been tripped up by a combination of unexpectedly high demand in China with disruptions in Saudi Arabia, Iraq, Nigeria, and Venezuela, all of which have caused oil prices to rise to more than fifty dollars a barrel. Yet even at the lower prices prevailing in the 1990s, the oil produced from the cheapest fields in Saudi Arabia and Kuwait, at a cost of a couple of dollars a barrel, was almost pure profit.

When does crime pay?

A lot of the world's economy isn't closely linked to limited natural resources. That means that people have to find other ways to prevent competition.

One popular method is through violence, which is particularly popular in the drug trade and other organized crime. Drug dealers prefer not to have competitors driving down the price of drugs. Conceivably, by shooting or beating up enough people, a criminal gang could discourage rival gangs from entering the market and thus enjoy large profits. This is illegal, of course, but so is dealing in drugs; if you're risking prison anyway, there is little point in using half measures. If drug dealers want to enjoy strength

from scarcity, they have to go to some lengths to make the competition scarce. Meanwhile, their customers are hardly likely to complain to the police about being ripped off.

Unfortunately for your average drug gang, even violence may not be enough to earn profits. The difficulty is that guns and aggressive young men are both in plentiful supply. Any gang making good money is tempting other gangs to muscle in on its territory—and there will be plenty of contenders. Economist Steven Levitt and sociologist Sudhir Venkatesh managed to get hold of the accounts of one American street gang. It turns out that the "foot-soldiers" sometimes take home as little as $1.70 an hour. Promotion prospects are good, considering the rapid turnover of gang membership (people leave, or get killed, quite often); but even considering these prospects, the average wage is less than ten dollars an hour. This is not much given that over a four-year period, the typical gang member can expect to be shot twice, arrested six times, and has a one-in-four chance of being killed.

Some criminal enterprises are more successful. Mafia groups often get involved in legitimate businesses, such as wholesale laundry, which can make big profits only if entry is deterred. One way to deter entry is to threaten rivals. This is fairly easy, since laundry trucks and laundries themselves are much easier to find and damage than a bag of cocaine. It's even easier to threaten customers. Fans of *The Sopranos* know that the Mafia provides overpriced laundry services to restaurants as a way of extorting money. The reasons are clear enough: restaurants are particularly vulnerable to extortion because it doesn't take much disruption to put off customers, while collecting the extorted cash by providing an expensive service makes the protection money tax deductible. Profitable businesses usually attract competition, but in this case the competition reckon that there must be a safer way to make a living.

This suggests that it isn't violence as such that creates barriers to entry and sustainable profits—it's the effectiveness of an organ-

ization. Axel's bank had it and Cornelius's didn't; the typical street gang lacks it, the Mafia seems to have it in spades.

"Conspiracies against the laity"

Luckily, in genteel corners of the developed world we are usually sheltered from people who use violence to keep out competition. But it does not mean that people have not worked out other ways to keep competitors at bay.

Trade unions are an obvious example. The purpose of a union is to prevent workers from competing with each other for jobs, driving down wages and conditions. If there is a lot of demand for electricians and few people who can do the job, then the electricians have strength from scarcity and should have excellent pay and conditions, with or without a union. If more and more electricians set up shop, this strength is sapped. The new electricians play the role of Bob the farmer. The trade union is designed partly to bargain collectively, but partly to block too much entry into the profession.

As mass-mechanization spread in the nineteenth century, the incentive to unionize was considerable. Workers were a plentiful commodity: all gathered together in urban concentrations, easily substitutable for each other. Without unionization, wages could be kept very low. With it, competition could be excluded and wages would rise—for the lucky ones inside the union. In the United States, trade unions were kept at bay by the law: antitrust laws designed to prevent collusion between large companies were also directed against unions. But as the political climate changed, these laws were ruled inapplicable and trade unions grew in strength.

If trade unions were especially successful, then we might expect unionized industries to enjoy enormous salaries, and there have been times and places—such as the American auto industry in the 1960s and 1970s—when this has been true. But trade unions face several obstacles to this kind of success. When unions are perceived as making unreasonable demands, causing prices to rise

to a level that's deemed unacceptable by a large portion of the public, the public in turn puts pressure on politicians to regulate the unions. Sometimes the unions have their scarcity challenged by international competition, as in the case of American auto workers, who enjoyed excellent wages and job security until the Japanese car industry used more efficient methods and started putting American manufacturers under pressure.

In the case of shrinking industries like the British shipwrights or the car industry in the United States, available jobs are disappearing at such a rate that trade unions have great trouble maintaining their scarcity value; the union can never threaten to cut off the supply of workers fast enough to keep pace with a vanishing demand.

In other industries it is not shrinking demand but powerful employers that curtail the power of the unions. In the United States, Wal-Mart has tremendous bargaining power: there were only two unionized Wal-Marts in North America in the spring of 2004, when Wal-Mart announced that one of them, a branch in Quebec, would be closed because the union was damaging its business model. In the United Kingdom, teachers' wages are low in spite of the fact that there is a shortage of qualified teachers. This is because the government, the single employer, has massive bargaining power. Ordinarily, when there is a shortage of workers, competition between employers would bid up wages. Only a monopoly employer could possibly maintain a situation where there is a serious shortfall of teachers but salaries do not rise to respond. The teachers have some strength from scarcity, but in this case the government has more.

Other professionals, like doctors, actuaries, accountants, and lawyers manage to maintain high wages through other means than unionization, erecting virtual "green belts" to make it hard for potential competitors to set up shop. Typical virtual green belts will include very long qualification periods and professional bodies that give their approval only to a certain number of candidates per year. Many of the organizations that are put forth to

protect us from "unqualified" professionals in fact serve to maintain the high rates of the "qualified" to whom we are directed. In fact, many of us, informally, are happy to seek legal advice from experienced professionals who lack the formal qualification—even medical advice from medical students, foreign doctors, or alternative therapists. But the legal and medical professions do their best to limit the supply of fully qualified professionals and outlaw any low-cost substitutes: if you can't afford the rent on meadow, the scrub and the grassland are forbidden. Small wonder that George Bernard Shaw said that the professions were "all conspiracies against the laity."

And now for something controversial

Immigration has always been an emotive issue for America, and although national security has recently become a concern, the debate continues to revolve around an old question: do immigrants steal our jobs? They may steal your job, but they certainly haven't stolen mine.

Well-educated workers with jobs requiring skill and training, along with businessmen in need of cheap labor, tend to welcome immigration as part of an enriching process, which adds to each nation's economic and cultural life, while poorly educated workers tend to reject any further immigration by unskilled immigrants on the grounds that "they steal our jobs." Perhaps that's too much of a caricature, but it makes sense from a self-interested viewpoint.

As one of those skilled workers I dislike resistance to immigrants and would like to see more immigration. But then, I would, wouldn't I? If you need skilled and unskilled labor together to get useful work done, then it is in my direct interests to see more unskilled workers come to the country, and directly against the interests of the unskilled workers who are already here.

Imagine me and my fellow well-educated citizens as landowners, but instead of "meadow" read "degree." My skills and qualifications are a resource, just as a meadow is a resource. But are

my skills a *scarce* resource? Imagine that I go to work for Wal-Mart's management team. When my skills (let's not be too specific about what they are supposed to be) are combined with the hard work of store assistants and shelf-stackers, we're a productive team. Who gets to enjoy the proceeds depends on whose abilities are scarce. If the country is short of unskilled shelf-stackers, their wages will have to rise to attract people into the job. But if the country is short of skilled managers and full of unskilled shelf-stackers, I'll be paid well for my scarcity value, just as landlords were paid well for scarce land once enough farmers showed up.

Some blame working-class resistance to immigration on racism. An alternative, and more convincing, theory suggests that everybody is acting in his own self interest. New workers are good for people who have assets that become relatively scarcer, whether those assets are meadows or degrees; but it is understandable if new workers are loathed by established ones. In fact, the people who are most harmed by new immigration are the previous group of immigrants, who find their wages nailed to the floor.

The facts support the application of Ricardo's theory to immigration. Skilled immigrants lower the wages of skilled natives, and unskilled immigrants lower the wages of unskilled natives. In the UK, the salaries of nurses in the National Health Service have been kept low by the influx of thirty thousand foreign nurses; immigrants in the UK are nearly 50 percent more likely than natives to have a university degree. In contrast, in the United States, which takes in a far higher percentage of low-skilled immigrants than the UK does, it is unskilled wages that have stayed low: the income of unskilled workers has not improved in thirty years.