Chapter 14: Rent, Interest, and Profit

Because wages account for about 70% of the income paid to resource providers, labor is the focus of the resource market discussion. We now turn to the other resources and the returns paid for their use. Chapter 14 discusses land, capital, and entrepreneurial resources and the rent, interest, and profit that accrue to them.

In the market for land, supply is fixed, represented by a perfectly inelastic supply curve. Therefore the demand for land determines the rent paid for the fixed resource. Just as for labor, the demand for land is derived from demand for the final product. Demand slopes downward due to diminishing returns and is based on the product price, the productivity of the land, and the cost of related resources.

Interest is the price paid to borrow money. In resource markets, firms typically borrow money from households (through bonds or banks) in order to buy capital. In the loanable funds market, demand is downward sloping because the firm will only borrow funds if the return on the capital is greater than or equal to the cost to buy it. At higher interest rates, firms are less willing to borrow; at lower interest rates, firms borrow more. The supply of loanable funds is upward sloping, because households must choose between spending and saving. At a higher interest rate, households enjoy a greater return on their savings and are more willing to save than spend. The equilibrium point determines the interest rate. The nominal interest rate is expressed in the current value of dollars, while the real interest rate takes inflation into account.

Economic profit is the difference between the firm's total revenue and economic cost (including normal profit), paid to entrepreneurs. Firms can increase and maintain economic profit by creating popular new products, reducing production costs, and erecting barriers to entry of competitors into the industry.

Material from Chapter 14 appears in a question or two on the multiple-choice portion of the AP Microeconomics Exam. A question or two about the loanable funds market, the effects of changes in interest rates, and the distribution of national income also appear on both the multiple-choice and free-response portions of the AP Macroeconomics Exam. The land and interest market graphs are the most important concepts from this chapter.