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THE STUDY OF CLASSICAL ECONOMISTS' HYPOTHESIS ON THE RELATIONSHIP BETWEEN THE RENT AND THE PRODUCT PRICE

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ABSTRACT

This paper investigates the short- and long-run causality relationships between rent and the product price. The main goal of this paper is to examine the classical economists' hypothesis concerning the idea that an increase in the product price leads to an increase in the rent and not vice versa. In order to consider this hypothesis in Iran, we have used the time-series data covering the period 1971-2008 for rent (net income) and the wheat price. After the necessary examinations such as unit root, co-integration, and Granger- causality tests were carried out, we came to the conclusion that the rent and the wheat price have short and long-run bidirectional causality relationship, and then the classical economists' hypothesis is to be rejected.

KEYWORDS

Rent, wheat price, causality test, co-integration.

INTRODUCTION

In terms of national accounts, Iran's economy is divided into four categories: Mine and Industry, Agriculture, Oil and the Services, i.e. we can say that agriculture is one of the main categories of economy in Iran. Among the agricultural products, wheat is a strategic one and self-sufficiency of Iran in yielding the wheat it needs is one of the most important aims followed by Iranian government. Like any other product, the main goal of any producer is to gain the profit maximum (or net income). The net income in classical economics is the rent of the land or the proprietary interest and it generally has a relationship with the product price since the product price is included in the gross income (TR=p.q). The rent is the result of the high income obtained from the high-quality land in comparison with the low-quality one (Ricardo 1817). Marxists accept the rent and consider it as the excess value of the production in agriculture which is divided between the landlord and tenant. Since Marx was sensitive to the relationship between the laborer and the proprietor, he considered it as the factor which leads to waste and the lack of land efficiency. On the other hand, the classical economists believe that an increase in prices is the cause of the rent and not vice versa. Therefore, this article tries to answer the question whether an increase in the product price is the cause of rent according to the classical economists' hypothesis.

A lot of examinations have been conducted in the field of causality relationship between the economic variables such as the causality relationship between GDP and the money growth or GDP and energy, etc. Here, we study this relationship between wheat price and rent. A lot of studies have been done on rent. Burger (1998) has considered the effect of land privatization on the rent of land and the prices in Hungary and has shown that high demand for the lands increases the rent of the land. Tratnik, Franic, Svrznjak, Basic (2008) have considered the regionalization of the agricultural economics according to the concept of differential rent of the land for the wheat. Dekle and Eaton (1999) have used the data related to wage and rent in Japan in order to estimate the greatness of agglomeration effect in industry and in financial services. Kahn and Reback (1995) have used the local wages and the rent of land in order to estimate the local welfare in the United States.

This article includes the following parts in order to consider the causality relationship: 1.The theoretical basics, 2. Methodology, 3. Data and results, 4. Conclusion.

1. RICARDIAN RENT AND HOTELLING RENT

In a classification, the rent of the natural resources can be classified under two categories: Ricardian rent and Hotelling rent.

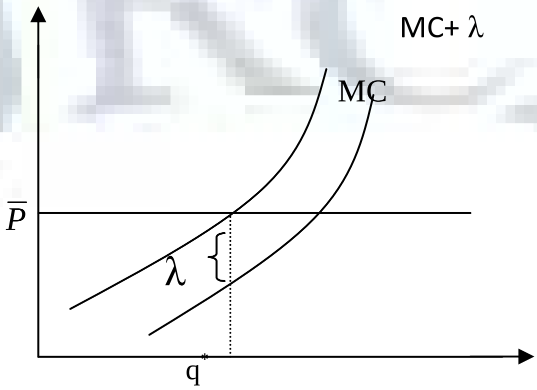
HOTELLING RENT (SCARCITY RENT)

This kind of rent is also known as the opportunity cost, the shadow price and the imputed price. If we extract and consume a non-renewable natural resource such as oil or iron, this oil and iron will not have any value for us in the next period; therefore, the extraction of these recourses in one period means to ignore their consumption in the future. The extraction of one unit of non-renewable natural resource, other than the extraction cost entails other costs called user cost or opportunity cost. This kind of cost is called the scarcity rent or Hotelling rent. This type of rent indicates the scarcity nature of the resources and shows the scarcity value of the resources resulted from their present consumption (Ahmadian 1991).

$P = MC + \lambda \quad \Rightarrow \quad \lambda = P - MC$

λ is the scarcity rent. If $\lambda = 0$, we reach the complete competition conditions in the production firm.

GRAPH 1: HOTELLING RENT

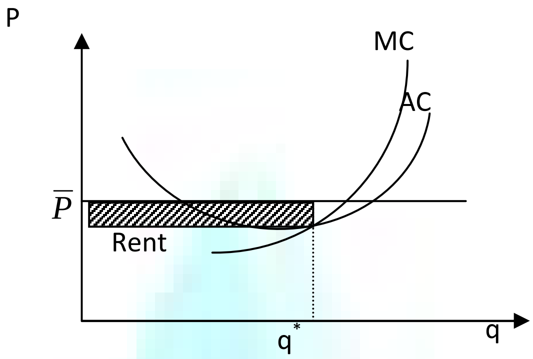


RICARDIAN RENT (DIFFERENTIAL RENT)

The rent is the net income of the land in the firm of complete competition. If a surplus value remains after the payment of the production factors' shares and the opportunity cost, it is the Ricardian rent or differential rent. This extra amount results from the fertility value of the land. Ricardo expresses that more fertile

lands have more economic profit, as compared with undesirable ones, because of less costs, i.e. the difference between the fertility is achieved by application of equal amounts of labor and capital in the heterogeneous lands. This rent results from the quality of the resource.
The difference between the price and the average cost is called the differential rent (R=P-AC). Therefore, the product price and the production cost are the factors effective on rent. Generally, according to the classical economists' hypothesis an increase in the product price is the cause of rent and not otherwise. So, this article intends to estimate the causality relationship between the rent and the price of the product.

GRAPH 2: RICARDIAN RENT



2. METHODOLOGY

In order to test the causality relationship between the rent and the product price we use Granger causality test. But before this test, the stationarity, co-integration and the structural break should be taken into consideration.

STATIONARITY

In order to perform Granger test, the time series variables should be stationary because the application of the non-stationary data leads us to a spurious regression. One of the applied tests for considering stationarity is the unit root test. Equation (1) is a first-order autoregressive equation. If the coefficient of y_{t-1} is equal to 1, we face the problem of unit root. In the time series variables if ρ =1, the concerned variable will be non-stationary (Gujarati 1995).

$$Y_t = \rho\, y_{t-1} + u_t \quad (1)$$

Equation (2) which is a model of Augmented Dickey Fuller can be used in unit root test.

$$\Delta y_t = \beta_1 + \delta y_{t-1} + \sum_{i=1}^{m} \alpha_i \Delta y_{t-i} + \varepsilon_t \quad (2)$$

CO-INTEGRATION

Upon confirmation of stationarity, the long-run relationship or Co-integration of the two variables of price and rent should be studied. Engle and Granger (1987) proved that if y and x are non-stationary but are I (1), the linear combination of these two variables might be stationary: Z = x – by. If the linear combination of x and y is integrated with I (0), then x and y would be co-integrated, too. Johansen and Juselius (1990) explain a vector autoregressive model with Gauss errors as follow:

$$Y_t = A_1 y_{t-1} + A_2 y_{t-2} + \ldots + A_k y_{t-k} + \mu_t\, \varepsilon_t \quad (t = 1,2,\ldots,T) \quad (3)$$

where y_t indicates the product price and rent.

CAUSALITY TEST

In 1969, Granger studied the concept of causality: Granger causality test assumes that the information relevant to the prediction of respective variables, y_t and x_t, is contained solely in the time series data on these variables (Gujarati 1995). If y_t and x_t are stationary, we will have a VAR (P) model as follows:

$$\begin{bmatrix} X_t \\ Y_t \end{bmatrix} = \begin{bmatrix} \alpha_\circ \\ \beta_\circ \end{bmatrix} + \begin{bmatrix} \alpha_1^1 & \beta_1^1 \\ \alpha_1^2 & \beta_1^2 \end{bmatrix} \begin{bmatrix} X_{t-1} \\ Y_{t-1} \end{bmatrix} + \begin{bmatrix} \alpha_2^1 & \beta_2^1 \\ \alpha_2^2 & \beta_2^2 \end{bmatrix} \begin{bmatrix} X_{t-2} \\ Y_{t-2} \end{bmatrix} + \ldots + \begin{bmatrix} \alpha_p^1 & \beta_p^1 \\ \alpha_p^2 & \beta_p^2 \end{bmatrix} \begin{bmatrix} X_{t-p} \\ Y_{t-p} \end{bmatrix} + \begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \end{bmatrix} \quad (4)$$

If the hypothesis H_0 under $\beta^1_1 = \beta^1_2 = \beta^1_p = 0$ is not rejected, y_t is not the cause of x_t.
If the hypothesis H_0 under $\alpha^2_1 = \alpha^2_2 = \alpha^2_p = 0$ is not rejected, x_t is not the cause of y_t.
If we accept that x_t is the cause of y_t and y_t is the cause of x_t, we are discussing about feedback effect.
If there is a long-run relationship between two variables, we use Granger causality under ECM instead of standard Granger which indicates the long- and short-run causality relationship between Rent and Price with ECT.

3. DATA AND RESULTS

DATA

In order to consider the relationship between the wheat price and the wheat rent, i.e. the classical economists' hypothesis test in Iran, the time series data from 1971 to 2008 have been used. The data being used were annual time series. We have used the wheat price logarithm (P) for price variable and the wheat net income logarithm (R) for rent variable during the said period. The statistical resources are the website of the ministry of agricultural Jihad and the statistical calendar of different years.

EMPIRICAL EVIDENCE

In order to avoid the spurious regression before the Granger causality and the co-integration tests, we consider the series stationary. The Augmented Dicky Fuller and Phillips Perron test results for stationarity at the levels and the first differences have been shown in table (1). Regarding both tests, R and P variables are stationary at the first differences but not at levels. Since both of the variables are stationary, the spurious regression problem is removed. (Granger and Newblad 1974)

TABLE (1): RESULTS OF PHILLIPS PERRON (PP) AND DICKY FULLER UNIT ROOT TESTS

Variables	DFA values	PP values		
	Level	Level		
	[b]	-1.2[6] [b]	P	2.43[3]
	[b]	-2.12[4] [b]	R	-2.14 [3]
	First differences	First differences		
D(P)	-3.564[6][a]	4.162[2][a]		
D(R)	3.962[6][a]	-1.799[3][a]		

Note: the numbers inside the brackets are the optimum lag lengths determined using Akaike's information criterion.

[a] represents the rejection of the null hypothesis at 5% level of significance. [b] represents the non rejection of the of the null hypothesis at 10% level of significance.

Sometimes, lack of a unit root is due to structural break. According to this fact, the CUSUM test has been used to test the parameters' stability. As it is indicated by Graph 3, the parameters are stable in pattern. The null hypothesis is that the coefficients are the same in every period, i.e. there is no structural break. Graph 3 shows that the null hypothesis of absence of structural break cannot be rejected at 5% level of significance. Therefore, the models are stable over time. It means that using Granger-causality tests based on the ECMs described in the equations does not suffer from any problem caused by a structural break.

To determine the co-integration, the optimum lag length in VAR model have been determined using Akaiko Information Criterion (AIC) and Schwarz Bayesian Criterion (SBC) both of which determine the optimum lag length to be 5.

GRAPH 3: CUSUM

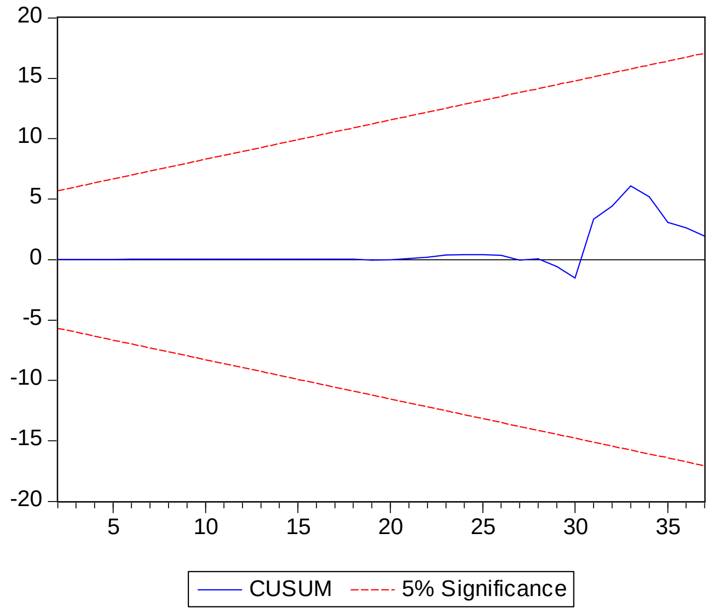


TABLE 2: RESULTS OF JOHANSEN CO-INTEGRATION TESTS

	Max-Eigen Statistic	Trace Statistic
The number of co-integrating equation is zero (R=0)	46.917 (12.320)	47.787 (12.320)
The number of co-integrating equation is at most one (R≤1)	0.869 (4.129)	0.869 (4.129)

The numbers written inside parentheses are the critical values at 5% level

According to the results of Johansen test, it can be concluded that the two variables are co-integrated and a long-run relationship is established between them. When the variables are co-integrated in the first differences, there is a long run relationship between the variables. The table 1 show that the variables are stationary in the first differences and Johansen Co-integration indicate that there is minimum one co-integrated vector because statistic values in the null hypotheses r=0 are greater than critical values. The null hypothesis for co-integration is: there is any co-integrated equation.

GRANGER CAUSALITY TEST

Due to the long-run relationship between rent and price of wheat, Granger causality model can be used in ECM. The results have been presented in table 3.

TABLE 3: RESULTS OF CAUSALITY TESTS BASED ON THE ERROR CORRECTION MODEL

Null hypotheses	Source of Causation		
	Short-run		Long-run
	ΔR	ΔP	ECT
	F-statistics		T-statistics
R does not Granger Cause P	2.841[a] (0.041)	….	- 0.00072[a][-7.370]
P does not Granger Cause R	….	9.036[a] (0.0001)	– 2.321[a][-2.536]

[a] denotes the rejection of the null hypotheses at 5% level of significance.

The numbers inside parentheses are P-values and those inside brackets are t statistic.

As stated above, if the series of two variables are non- stationary and the linear combination of these two variables is stationary, then the error-correction modeling rather than the standard Granger-causality test should be employed. Therefore, an ECM was set up to investigate both short-run and long-run causality. In the ECM, first-difference of each endogenous variable (R and P) was regressed on a period lag of the co-integrating equation and lagged first-differences of all the endogenous variables in the system, as shown in causality equation.

For Granger test, 5% significance level has been used. A short-run causality relationship from wheat rent to wheat price and a short-run causality relationship from wheat price to white rent have been observed. It means that there is a bidirectional causality relationship between P and R. The coefficients of the ECT are found to be significant in two equations. ECT coefficient is significant for both variables and indicates that a bidirectional relationship is established between P and R in long run, too.

As it can be observed, the classical economists' hypothesis in regard to the relationship between rent and wheat is rejected at least in Iran. It indicates that in Iran, increase of wheat price would increase the rent, and the increase of rent, also, would be followed by increase of wheat price.

4. CONCLUDING REMARKS

The aim of this research is to consider the classical economists' hypothesis on the causality relationship between the rent and the price of wheat product; i.e. to examine whether the rent is the effect of an increase in the product price. This study has been carried out on time series from 1971 to 2008 for Iran. For this purpose, firstly we considered the stationarity of the data and came to the conclusion that the variables were stationary and we could say there has been no spurious-regression problem. Regarding the Johansen test, the long-run relationship between these two variables is proved and as a result the Granger causality based on ECM is preferred to the standard Granger causality.

The results of these studies indicate that in long- and short-run there is a bidirectional causality relationship between the wheat rent and the wheat price in Iran; i.e. a feedback effect. Therefore, the higher the wheat price is, the higher the rent will be; also, the higher the rent is, the higher the price will be. We can say that the classical economists' hypothesis asserting the causality relationship from the product price to the rent in a short-run relationship, and the long-run is rejected at least for the wheat product in Iran.

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In this age of Commerce, Economics, Computer, I.T. & Management and cut throat competition, a group of intellectuals felt the need to have some platform, where young and budding managers and academicians could express their views and discuss the problems among their peers. This journal was conceived with this noble intention in view. This journal has been introduced to give an opportunity for expressing refined and innovative ideas in this field. It is our humble endeavour to provide a springboard to the upcoming specialists and give a chance to know about the latest in the sphere of research and knowledge. We have taken a small step and we hope that with the active co-operation of like-minded scholars, we shall be able to serve the society with our humble efforts.

Our Other Journals