Ricardian Rent Theory Revisited: A Modern Application and Extension

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ABSTRACT

"Ricardian Rent Theory Revisited -- A Modern Application and Extension"

In the early 19th century, David Ricardo argued that owners of high quality land would be able to extract the differential gain, or rent, from using higher instead of lower quality land by simply sitting back and letting the farmers bid amongst each other for the higher quality land. Competition would make every farmer's profits identical; the productivity differential, however, would remain and accrue to the holders of higher than marginal quality lands.

This simple idea is the driving force behind a revolution in the hair care industry. The "conventional" firm (i.e., employer pays employee salary and/or commission) is being challenged by a different organizational form called "booth rental." Here the stylist rents the "capital" (the space in the salon and the chair itself) and becomes an individual firm. This has caused an uproar among salon industry professionals and attracted attention from the Internal Revenue Service.

But why did this happen? The answer here is Ricardian Rent Theory. Stylists are NOT perfect substitutes -- they develop long, established, loyal clienteles. The analogy is clear: landowner is to stylist as farmer is to salon owner. Both landowners and stylists own a resource that comes in different qualities and yields, naturally, different revenues; farmers and salon owners hire that resource. Just as Ricardian farmers bid up the price of high quality land, so do modern-day salon owners bid up the price of higher quality stylists. In a final attempt to keep or lure a high quality stylist, the salon owner offers booth rental -- a system where the owner relinquishes the residual profit.

This leads directly to the "extension" of Ricardian Rent Theory. In Ricardo's day, it was the politically powerful landlord who benefitted from the competition; but, today, the politically powerful, organized salon owner is being forced to compete to the benefit of the stylist. The response has been quite predictable -- an all out attempt to prevent competition among salon owners, including: scaring potential booth renters with threats of IRS audits and penalties; legislation to prevent booth renting; and, perhaps most interesting, franchising (in which the firm tries to convince the consumer that all stylists are alike by quite ingenious methods).

Competition, in the Ricardian sense, is caused by clearly identified productivity differentials. In farming, it's the quality of land; in hair care, it's the quality of stylist. In either case, the users of the resource will compete for the higher qualities resulting in equal profits for the users and rent for the resource owners. Since Ricardo only saw the powerful as beneficiaries of this competition, he never considered what would happen if the powerful happened to be on the other end of the stick. In the hair care industry, as in any other case, the result is quite predictable -- an attempt to block competition.

I. Introduction

When asked to review a book on the history of economic thought, Arthur C. Pigou is said to have replied:

> These antiquarian researches have no great attraction for one who finds it difficult enough to read what is now thought on economic problems, without spending time in studying confessedly inadequate solutions that were offered centuries ago.[1]

This paper directly refutes Pigou's claim regarding past theories as "confessedly inadequate solutions" by applying Ricardian Rent Theory to explain a modern phenomenon. For Ricardo, the issue at hand was the shares received by landlord and capitalist. Thus, he developed a theory specifically designed to show how rents and profits were determined. However, the heart of the resulting theory is much more universal than Ricardo imagined.

In this paper, Ricardian Rent Theory will be used to explain recent organizational changes in the hair care industry and the resulting power struggle that is currently underway. As in Ricardo's day, we will see how competition for higher quality inputs generates "rent" for the higher quality resource owner. In addition, this paper will extend Ricardo's theory by explaining the cause behind a heated debate in the industry: because the politically powerful are the competitors themselves and not the resource owners (as in Ricardo's time), a series of moves designed to prevent competition have been devised. Not surprisingly, when competitive pressures are blocked by obstacles, disagreement and dissatisfaction results.

The organization of this paper is straightforward. The next section reviews Ricardian Rent Theory in its initial garb -- i.e., as an explanation of differing land rents. This is followed by the application of the theory to today's hair care industry. The final section extends Ricardo's theory by explaining some of the recent changes in the hair care industry as a desire to limit competition.

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[1] Blaug [1978], p. 1.

II. Ricardian Rent Theory

David Ricardo is well known to economists as a "free trader" who developed the notion of comparative advantage. Others know him for his celebrated, long running debate with Parson Thomas Malthus or through his work in public finance. Always active in political debate, Ricardo developed his theory of rent as a means of convincing the public of the harmful effects of the Corn Laws (import restrictions on grain). He accomplished this by building a highly abstract and simplified model from which he showed the negative effects of protectionism.[2]

Ricardo held that total output was divided into three shares. From gross revenue, the farmer (or capitalist) paid the landowner rent and the workers their wages; the rest belonged to the farmer as his profits. Ricardo carefully defined rent as "that compensation, which is paid to the owner of land for the use of its original and indestructible powers."[3] Although fences, buildings, and fertilizer might raise the total remuneration received by a landowner for a given plot, its rent would remain unchanged.

The next question, naturally, concerned the size of each agent's share. Ricardo argued that the wage was determined exogenously by the worker's subsistence requirements. The rent and profits were determined by a competitive process in which farmers bid for land. Higher quality land, by virtue of its greater productivity, received a higher bid than its lowest quality counterpart. This differential Ricardo called "rent." For Ricardo, differential land quality and competition that equalizes profit meant that any profit greater than the lowest profit level will accrue to the landowner as rent.

To see how competition generates rent and, therefore, determines the magnitudes of the two remaining shares, we follow Ricardo's original logic and example. He began by noting that if land is not scarce, then it generates no rent.

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[2]For this he has been called both the father of modern economic theory and, as Joseph Schumpete charged, the creator of the "Ricardian Vice."

[3] Ricardo [1821], p. 69.

> If all land had the same properties, if it were unlimited in quantity, and uniform in quality, no charge could be made for its use.[4]

But, of course, land is scarce and of differing qualities. Ricardo supposed that there were three qualities of land (No. 1, 2, and 3) that generated (*ceteris paribus*) a profit (total revenue - wages) of 100, 90, and 80 units of corn, respectively. As long as there is an abundance of fertile land relative to the population, farmers need cultivate only the highest quality land. In this case, there is no rent. As population increases and it becomes necessary to cultivate No. 2 quality land, a rent of 10 units would commence on the highest quality land.

Using the exact same materials and labor, the farmer on No. 1 quality land would generate a profit of 100 units of corn, while his No. 2 quality land counterpart would have only 90 units. Figure 1 shows the resulting distribution of product across land quality in this case:

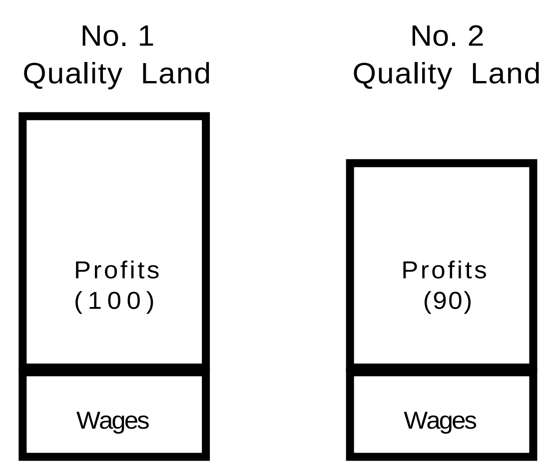

Figure 1: Initial Distribution

[4] Ricardo [1821], p. 70.

This situation, however, is unlikely to remain unchanged given competition among farmers. Obviously, the farmer on the lower quality land would bid up to 10 units in order to farm on No. 1 quality land. As Ricardo tells the story, the landowner of the higher quality land would insist on a 10 unit rent "and if the original tenant refused, some other person would be found willing to give all which exceeded that rate of profit to the owner of the land from which he derived it."[5]

In equilibrium, after competition among farmers has forced profits to be equal once again, the total product would be distributed as shown in Figure 2:

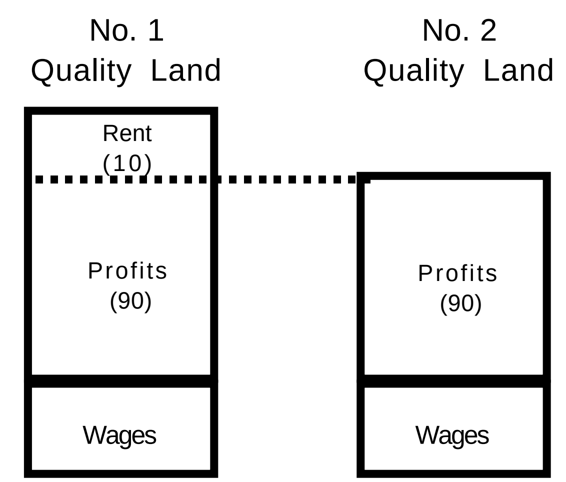

Figure 2: Equilibrium Distribution

As population increased and inferior land was cultivated, the rent would always be calculated as any difference in profits between a higher quality land and the lowest quality land in cultivation. Clearly, farmers earning the lowest profits on the lowest quality land would be willing to bid the difference in profits between a higher quality land and their low quality variety. Thus, bringing No. 3 quality land into cultivation would mean a rent

[5]Ricardo [1821], p. 72.

of 20 units on No. 1 quality land and 10 units on No. 2 quality land for the profits would be equalized at 80 units (the profit generated by the lowest quality, No. 3 land).

With this simple model, Ricardo could explain how the two remaining shares, rent and profits, were determined. The logic is crystal clear:

(1) A given population requires a certain amount of food.

(2) The lowest quality land called into cultivation generates some profit (total revenue - wages).

(3) This profit becomes the prevailing profit through competition among farmers -- any difference between the profit generated by higher quality land and the profit generated by the lowest quality land accrues to the landowner as rent.

For purposes of completeness regarding the story on Ricardo and his opposition to the Corn Laws, the reader need only realize that protectionist grain policies would require England to grow more of its own food. Ricardo argued such policies would simply raise rents (enriching landlords) and lower profits (impoverishing capitalists) as lower and lower quality land was called into cultivation. Furthermore, since capitalists powered economic growth by systematically reinvesting their profits, lower profits implied slower growth.[6] In turn, this meant the quicker arrival of the "stationary state." For Ricardo, the Corn Laws quickened the inevitable economic stagnation that would occur when profits were driven to their lowest point.

Ricardian Rent Theory is built on the simple, yet powerful, notion of competition. Competition among farmers equalizes profits and generates rent on higher than lowest quality land. Ricardo believed that land was special, "singular," in this respect:

[6]Landowners, Ricardo believed, lacked the ambition to reinvest aggressively; they spent their monies o luxuryconsumptiongoods.

> If air, water, the elasticity of steam, and the pressure of the atmosphere were of various qualities; if they could be appropriated, and each quality existed only in moderate abundance, they, as well as the land, would afford a rent, as the successive qualities were brought into use."[7]

But Ricardo was wrong in this instance -- land is not unique as an input with quality differentials. The question then becomes, "Does Ricardian Rent Theory hold for any input of varying quality?" To a modern day application and extension of Ricardo's theory, we now turn.

III. Ricardian Rent Theory and Booth Rental

The application of Ricardian Rent Theory to the hair care industry concerns the new, and some say troublesome, practice of "booth rental." In this section, a review of alternative organizational arrangements in the modern beauty salon is presented in order to provide necessary background information. Ricardian Rent Theory is then used to explain why booth rental has arisen, why it spreads unevenly, and why it seems to be gaining strength in spite of strong opposition.

A. Current Organizational Forms in The Modern Beauty Salon

Over the past two decades, there have been tremendous product, employment, and organizational changes in the hair care industry. Men have moved from barber shops to "unisex" hair styling salons; franchises (such as Fantastic Sam's® and SuperCuts®) have exploded on the scene; and the industry has grown rapidly. One change that has occurred

[7] Ricardo [1821], p. 75.

more quietly is the transformation, in many salons, of the stylist-salon owner relationship.

Traditionally, stylists have been employed by the salon owner (who is often a stylist herself) and paid hourly wages, a salary, a commission, or some combination of the three. Novice stylists, recently graduated from cosmetology school, often prefer to be paid on a non-commission basis since they are unlikely to generate much income. Experienced stylists, with a long list of loyal customers, can often command up to 60-70% commissions -- the salon owner taking the remaining share.

However, another organizational choice is possible. Some firms are moving from a wage or commission compensation scheme to booth rental -- the practice of renting out space (or a booth) for a fixed fee to each stylist. Such a system is radically different from "conventional" payment schemes. Importantly, the owner of the firm is no longer an employer and the stylist an employee; instead, the owner becomes a landlord and each stylist her own individual firm. This independent contracting scheme is the topic of hot debate within the hair care industry.

The actual day-to-day operation of a booth rented salon is interesting in and of itself. In actual practice, a booth rented salon is almost indistinguishable (certainly to the consumer) from a conventional (i.e., employer-employee) salon. Bob Linehan, Sr.[8] notes that stylists who booth rent put money into a pool every week for the non-styling aspects of the operation ($10 for the receptionist, $5 for clean-up, $5 to run the dispensary). Established clients, of course, go to their regular stylist, while walk-ins are allocated in a rotating order. The "tools of the trade," such as combs and dryers, are provided by each stylist and they are free to set their own hours, work pace, and prices. All revenues over costs (including the booth rental fee) are kept by the stylist and, similarly, all costs over revenue are absorbed by the stylist.

The booth renting salon owner need not booth rent all of her stations in the salon. The same salon could have any combination of booth renters, wage workers, and

[8] A distributor of hair care products and owner of Standard Beauty Supply, Inc. of Omaha, Nebraska.

commissioned stylists. A 1988 survey showed that 26 out of 109 salons sampled across the United States booth rent at least one chair and that the average fee was $157 per week.[9]

But surely this brief presentation of alternative beauty salon compensation schemes begs the question, "Why do these different forms exist?" Ricardian Rent Theory provides an interesting, plausible explanation.

B. Booth Rental as Ricardian Competition

The Ricardian explanation of booth rental, like the determination of profit and land rent, is really quite simple. Using Ricardo's original participants and those in our case, the analogy would be: LANDOWNER is to FARMER as STYLIST is to SALON OWNER.

The reader should recall that the Ricardian landowner possessed a scarce input of varying quality. The input quality differences and competition among farmers for the right to cultivate higher quality land led to the creation of rent. These same characteristics hold true in today's hair care industry.

The factor of production under review here is the hair stylist. The quality differential arises because the superior stylist develops a long, established clientele; while the mediocre stylist does not. Importantly, stylists are neither all alike nor easily substitutable -- some have established clienteles, while others don't; some generate a great deal of revenue for the firm, while others don't.

Obviously, this type of human quality differential may arise whenever there is a personal relationship between buyer and seller. Medical care (e.g., doctors and dentists), financial aid (e.g., accountants and brokers), and legal services (e.g., lawyers and negotiators) would, to differing degrees, seem to fall in this category.[10] However, hair stylists have two particular attributes that tie the client to the stylist more tightly than in most other cases. First, hair care requires constant, repetitive attention. Most people use

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[9] Barreto [1988], Table 2: Descriptive Statistics, p. 13.

[10] The list gets long, in different directions, very quickly -- realtors, auto mechanics, and trav agents come to mind.

accountants, for example, once a year, but those who frequent beauty salons get their hair styled many times during the course of a year. Secondly, the consumer can easily judge the quality of hair care. It is usually impossible to determine if a doctor, for instance, has treated you poorly or excellently -- after all, the correlation between medical care and recovery is not perfect. The consumer simply does not have the information necessary, in most cases, to correctly assess the quality of many personal services. For this reason, the customer lacks confidence in making such judgments. Hair care, however, is one service in which the consumer routinely does appraise the provider's performance and feels perfectly justified in doing so. For these two reasons, frequency and the consumer's power to judge the outcome, the tie between stylist and client is especially strong. Once a stylist is found, many consumers will often loyally follow her as the stylist moves from one salon to another.

Given the fact that there are strong quality (and, hence, income producing) differentials among stylists and that many consumers are strongly tied to their stylist, it is clear that a salon owner could increase her profits by acquiring high quality stylists. At the same time, however, this is true for all salon owners. Thus, the resulting competition will generate rent for the higher than lowest quality stylists and lower profits for the salon owners.

As in Ricardo's original case, at any given time, consumer demand will require a given quantity of hair care. The lowest quality stylists will generate a certain profit for their salon owner. Salon owners with higher quality stylists will generate higher profits just like farmers on higher quality land, initially, earned higher profits (Figure 1). Ricardo would predict that this will lead salon owners with low quality stylists and, hence, low profits to bid for the higher quality stylists in order to increase their profits. Competition will equalize profits at the level of the lowest profit salon owner and all remaining differentials will accrue to the higher than lowest quality stylists as rent. (See Figure 2).

Ricardo saw competition as meaning that farmers would pay higher prices for the right to cultivate higher quality land. Interestingly, in the beauty salon case, the bidding for high quality stylists has surpassed the monetary realm and entered a whole new area. Salon owners, needing high revenue producing stylists or threatened by the loss of a high quality stylist, have upped the ante to include a more attractive business relationship -- booth rental.

Under such a scheme, the high quality, high revenue producing stylist maximizes her returns. In effect, she becomes the residual profit claimant, taking *all* earnings over costs. Under conventional payment schemes, the salon owner takes these gains if the stylist is paid a flat wage or shares these gains if working under a commission scheme. Booth rental is the final step in acquiring control over residual earnings. Michael Seid, of Growth Decisions, Inc. in Dallas, says that often a stylist who is doing well (i.e., has many clients) will insist on booth rental and the salon owner, faced with the loss of the stylist *and* her clients to a competitor, is forced to agree. Clearly, booth rental is the final step in the bidding war for high quality stylists.

Today, booth renting is becoming more prevalent. In accordance with Ricardian Rent Theory, it is spreading, not gradually and systematically, but quickly in certain areas and not at all in others.[11] In talking with industry representatives, it became clear that several places were considered "hotbeds" for booth rental, including, for example: Oklahoma City, Indianapolis, Cincinnati and parts of California. Other sections of the country had little, if any booth rental, including: New Jersey, Pennsylvania, New York and Texas.

This is Ricardian Rent Theory in action -- if someone booth rents near the conventional salon owner, she will feel pressure from her stylists to offer booth renting. A salon owner with high quality stylists in an area without booth rental need not make a booth rental offer to keep her stylists. More to the point, any threat of booth rental by a stylist is not credible if there are no booth renting salons available. As soon as booth rental enters an area, however, the situation changes. Booth rental immediately becomes part of the range of plausible bids and spreads throughout the region. This leads to statements like the following from a booth renting salon owner in Oklahoma City, "Sure I could make more money paying wage and commission, but I couldn't keep my stylists."

The industry is in the process of moving toward an equalized profit equilibrium, but has not yet attained such a state. Given the reluctance of conventional salon owners

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[11] Barreto [1988], pp. 20-22.

to readily acquiesce to booth rental, it is not surprising that this new organizational scheme would spread unevenly; but, it is noteworthy that Ricardian Rent Theory easily explains the uneven pattern of expansion.

But surely quality differentials among stylists have always existed, yet why hasn't booth rental always existed? In fact, it has, but only in very limited amounts. Ricardian Rent Theory can be used to explain this observation if one remembers the effect of increasing demand on rents and profits. As population increased and lower quality land was tilled, rents rose and profits fell because the lowest quality land sets the profit level. In the hair care industry case, the revolution in men's hair care devastated the old-time barbershop and created a tremendous new demand for hair stylists. The result was easily predictable. Since the new stylists were lower quality, profits initially fell for new salon owners using such stylists. These owners responded by raising their offers to the experienced, high quality, high revenue producing stylists. These offers first take the form of higher wages, a move from a wage to a commission payment scheme, or higher commissions. Eventually, the bidding escalates to a booth rental offer. Thus, booth rental was not observed in widespread use until the profits made by the marginal salon owner were low enough to generate rents for the high quality stylists high enough such that booth rental would be offered.

C. Conclusion

In this section, Ricardian Rent Theory was applied to the modern day beauty salon. Today, stylists can be paid "conventionally" -- i.e., a wage, salary, or commission -- or they can rent a booth. The latter means that salon owner and stylist are no longer employer and employee, but landlord and tenant.

Ricardian Rent Theory answers three important questions concerning booth rental: (1) Why does it arise? (2) Why does it spread unevenly? and (3) Why has it recently been spreading? As to the first question, the evolution of booth rental is explained here as a further step in the competition for high quality stylists. Stylists are not uniform in quality; nor universally abundant -- the two characteristics that Ricardo identified as requisite for the creation of rent for land. Furthermore, the frequency of use and the consumer's power to judge the results makes for a strong stylist-customer bond. In their efforts to get high quality, high revenue producing stylists, salon owners have competed amongst each other by offering a more favorable employment relationship -- booth rental. Thus, in this analysis, booth rental can be seen as simply a manifestation of Ricardian rent. Secondly, the theory explains the uneven spread of booth rental by noting that those salons exposed to competition will be much more likely to booth rent. Booth rental is an offer made because of the presence of competitive pressure. Absent such pressure, no conventional salon owner will readily forego her status as residual claimant. Finally, the recent increase in booth rental is explained as a consequence of the increased demand for stylists. As Ricardo argued, such a change leads to lower profits (as lower quality inputs are called on line) and, therefore, higher rents (as the bidding increases for higher quality inputs). In the hair industry case, higher rents mean booth rental.

IV. Extending Ricardian Rent Theory

Up to this point, Ricardian Rent Theory has been straightforwardly applied to the hair care industry. It seems to handle the observed phenomena fairly well, giving plausible explanations for the evolution of booth rental, its uneven spread, and its recent expansion.

There is another area, however, in which the theory can be made to do work -- an area with which Ricardo was completely ignorant. In this section, Ricardian Rent Theory is used to explain the series of moves designed to prevent the competition among salon owners from escalating to the point were booth rental results.

In Ricardo's case, the competitors were the farmers and those who received the rent, the fruits of competition, were the landlords. Remembering the analogy to the hair industry, it is the salon owners who compete, generating rents for the stylists. Of course, the politically powerful and relatively few landlords were much in favor of competition among the disorganized, many farmers. Thus, it is not surprising that Ricardo never considered possible strategies for preventing or limiting competition.

In the hair industry case, however, the roles are reversed. The politically powerful are the salon owners and they are very much opposed to a competitive process that lowers profits and generates rent for the owners of a factor of production. In addition, it is the stylists who are politically weak, disorganized, and many in number. Thus, it is not surprising that changes are occurring in the industry designed, from a Ricardian Rent Theory perspective, to mitigate the effects of salon owner competition.

Faced with the prospect of inexorable competition for established stylists continually eroding their status as residual claimants, owners have responded in two very different, but increasingly effective ways. As soon as the stylist establishes a loyal clientele, she can bargain for higher remuneration -- culminating, if she is good enough, in booth rental. Thus, (1) a pool of stylists of varying quality and (2) competition from salon owners seeking to increase their profits are the two key conditions that must be met in order for rent to be generated. Removal of either one will stop the flow of profits toward the stylist. Naturally, both are tried; owners have (1) attempted to prevent the stylist from ever establishing a clientele and (2) sought government barriers to competition. From the salon owners' perspective, the former is an attempt to never let the "problem" -- input quality differentials -- from arising in the first place; while the latter makes quality differentials irrelevant by calling in outside forces to thwart competition -- a time-honored means of maintaining the status quo.

A. The "Nip It in the Bud" Strategy

If the stylist is unable to generate a loyal clientele, she will be unable to bargain for booth rental since the threat of leaving will not be credible. After all, other salon owners will not bid for her services if her revenue producing ability is not transferable. Similarly, if quality differentials are somehow removed, the possibility of booth rental will be eliminated since all stylists would be substitutable for each other.

Hair care franchisors have combined these two tactics into a "nip it in the bud" solution to the problem of competitive pressure. A successful franchise operation, of course, is built on product standardization. The customer must believe the good or service to be identical no matter where it is distributed.

Through a series of sometimes ingenious moves, hair care franchisors attempt to convince the consumer that *all* stylists in their salons are the same. Fantastic Sam's®, the nation's leading hair care franchise, does not allow its stylists to use their own names; instead, they must accept standardized nicknames (such as Bubbles or Peaches). Every Fantastic Sam's® outlet has a Bubbles and the consumer can get his hair cut by Bubbles in Los Angeles or in New York. Even the stylist's business card must carry the standardized nickname and not her real name. Franchisees are encouraged to hire stylists fresh out of cosmetology school instead of more experienced stylists. Newly hired stylists are trained to cut hair a particular, standardized way. Continuing education classes are given to maintain uniformity across stylists. A customer is never totally cared for by a single person -- a hostess greets her, the stylist cuts her hair, and other stylists stop by the chair to see how things are going. The Fantastic Sam's® "Franchise Information and Confidential Evaluation Form" informs prospective franchisees that "All personnel are required to wear career apparel [the Fantastic Sam's® uniform] at all times . . . to reinforce our already strong brand image." Another franchisor, SuperCuts®, penalizes the stylist if too many customers ask for her; they also penalize the customer by charging a $1.00 premium for getting a particular stylist. A major chain responds to the loss of a stylist by writing all of her clients and offering them a substantial discount for a visit.

These are but a few of the many strategies designed to prevent the stylist from ever acquiring the power that comes from tying clients to herself. All of these strategies emphasize standardization and team symbols so that the consumer thinks it is, for example, Fantastic Sam's® -- and not any particular stylist -- who is responsible for her hair care.

Ricardian Rent Theory explains the franchise approach to hair care by viewing its growth as an attempt to mitigate competition. Franchisors would never booth rent because the control that is so necessary for the franchise (or chain) scheme to work runs directly counter to the variation and independence that is the essence of booth rental. The franchisor is trying to prevent quality differentials from ever arising. If successful, the franchise owner avoids the ensuing competition for high quality stylists.

If market success is any indicator, then the franchise or "nip it in the bud" solution may have some merit. Franchisors have made remarkable gains in the last ten years.

Started in 1976, Fantastic Sam's® has 1400 locations in the US and averages 30 new store openings a month.[12]. Furthermore, most industry experts predict hair care franchises will increasingly dominate the industry.

B. The Government Intervention Strategy

Instead of preventing stylists from ever establishing quality differentials, the second approach to stopping the spread of the booth rental independent contracting scheme relies on government sanctions to prevent salon owners from offering booth rental as the bidding for high quality stylists escalates. Given the basic instability of a cartel, it is highly unlikely that any agreement among salon owners to not offer booth rental will last. An obvious alternative, then, is to use the state as a means of controlling the competitive pressure felt by salon owners.

This solution is powered by a coalition of powerful interests. First, non-booth renting salon owners need a way to ensure that their poorer, weaker or greedier salon owning brethren don't succumb to the competitive forces. Secondly, distributors, who have to sell their retail products to each individual booth renter instead of a single owner, strongly oppose booth renting. Finally, industry leaders (e.g., Richard B. Levac, president of the National Hairdressers and Cosmetologists Association, and Mike Ross, publisher of <u>Modern Salon</u>, a major industry trade publication) resist booth renting because of the shift in control from salon owner to stylist.

The government sanction approach has taken two roads: (1) direct legislation and (2) tax strategies. Unlike the method above, designed to never allow the conditions for booth rental to occur, the government intervention strategies take those conditions as already in existence and try to prevent the salon owners from competing with each other.

With regard to direct legislation, conventional salon owners have managed, in at least two states (New Jersey and Pennsylvania), to effectively bar booth renting by passing appropriate legislation. It is difficult to determine whether a state allows booth renting because it is not prohibited explicitly by statute. Instead, a law is passed stating that "a

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[12] 1986 Franchise 500®, <u>Entrepreneur</u>, [1986]

salon license doesn't license those booths in the salon rented out."[13] This effectively prevents booth rental because it is highly improbable that a single worker firm can generate enough revenue to cover the cost of a salon license. New Jersey recently passed its law against booth rental and Texas appears to be near passing a similar statute. One industry trade magazine writes, "In the future, one state after another will probably . . . pass a law making booth rental illegal."[14]

The second method utilizing the government involves bringing Internal Revenue Service pressure to bear on booth renters and, more importantly, those thinking of switching to the booth renting organizational form. The IRS, understandably, is concerned about the possibility of a salon owner unilaterally declaring that her employees are, in fact, independent contractors and, therefore, not paying FICA or unemployment compensation taxes and not withholding income taxes.[15] Furthermore, it is clear that many booth renting stylists are not aware of the special tax considerations pertaining to self-employed workers and are failing to report or pay the proper taxes.

Rumors are rampant within the industry that the IRS is about to launch a major investigation of booth rental and will selectively audit booth renting salons. While conducting a 1988 survey, several respondents asked if the surveyors were from the IRS; while others claimed, incorrectly, that the IRS had outlawed booth rental.[16] An advertisement for the 2nd Salon Marketing/Management Symposium (which includes a session by Gerald Stefanick on "The Salon and the Law") says:

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[13]Salon Today [1987], p. 14.

[14]Salon Today, [1987], p. 14.

[15]The IRS has devised several tests that are used to determine whether or not a stylist is in fact employee, including: whether or not she sets her own hours, keeps her own books and has her own key to place of business. Of course, the employee versus independent contractor issue has not been and is not n clear cut and the large resulting gray area will undoubtedly continue to be the source of substantial litig

[16]Barreto [1988], p. 24.

> Mr. Stefanick spent ten years as an investigator with the US Department of Labor. "I have yet to see a chair rental salon which is not in violation of some of the IRS regulations for that type of operation. . . Besides basic issues like compensable time, wage and hour exemption and commission versus salary concerns, I will be presenting the critical issues as they pertain to the volatile chair rental problem in the salon industry.

Proponents of the capture theory of regulation would not be surprised by the use of government by a particular special interest to prevent competition and to keep such means from an unsuspecting general public. The process by which the legislation was passed would be interesting and informative on several counts. Here, however, we merely point out, once again, that the root cause of the "problem" and the source of the "volatility" in the hair care industry can be explained by a simple extension of Ricardian Rent Theory: quality differentials among stylists leads to competition and, this, in turn, leads to efforts to prevent such competition.

In the previous section, it was shown how Ricardian Rent Theory provides a simple, but instructive model of competition among salon owners for a factor of production with quality differentials, hair stylists. In this section, a natural extension of rent theory shows how two alternative means have been developed to combat the problem: (1) prevent the stylist from ever establishing a quality differential and (2) enlist the aid of government to prevent competition among salon owners for the highly sought after stylist. This has taken the form of direct legislation and the threat of tax difficulties. Importantly, Ricardian Rent Theory accounts for these steps as a natural attempt by salon owners to prevent and limit competition.

V. Summary and Conclusion

In this paper, Ricardian Rent Theory has been used to explain a series of observed phenomena in the hair care industry. After briefly presenting Ricardo's own simple model of the distribution of output into its wage, profit, and rent components, the theory was applied to today's changing stylist-salon owner relationship. In both cases, input quality differentials lead to competition among firm owners for higher than lowest quality inputs. Competition ensures that profits will be equalized at the lowest profit level and that any excess funds will accrue to the higher than lowest quality resource owners as rent.

Applying this simple model to today's hair care industry explains three empirical observations. The practice of booth rental, in which a stylist rents space and becomes her own individual firm, is seen to be the culmination of the competitive process for high quality, high revenue generating stylists. Furthermore, the theory easily accounts for the uneven spread of booth rental across the country (including the pockets of highly concentrated booth rental activity) as a natural consequence of the competitive process. Finally, its recent expansion is attributed to the increased demand for stylists -- such a change leads to higher rents which, in this case, means booth rental.

Ricardo's original theory was then extended by noting that when the competitors are a powerful group, they may be able to limit what Ricardo believed to be an inexorable competitive process. Thus, by extending Ricardian Rent Theory, the growth of hair care franchises, legislative attempts to stop booth rental, and rumors within the industry concerning IRS plans can all be understood. Franchises are applications of the first strategy, never let the problem arise by never allowing the stylist to establish a bond with a client and by presenting all stylists as identical. Legislation and tax strategies are designed to prevent non-booth renting salon owners from upping the bid to booth rental.

In conclusion, we have distributor Ken Maly's views on the issue:

> There seems to be no good reason for booth rental. Maly sums up the problem well: "Nobody really likes booth rental. It's usually either something people have done out of habit, or a short-term solution to a long-term problem. . . We have found it concentrated in pockets throughout the country; Indianapolis and Oklahoma City are, for example, notorious booth rental areas. . ."

"Ultimately," says Maly, "booth rental will destroy itself. As far as I'm concerned, booth renters are doomed."[17]

Distributor Bob Linehan concurs, stating that, "Home beauty shops were legislated out of existence forty years ago and the same thing is going to happen to booth rental."

The depth of the emotion and animosity involved is not surprising when one considers some of the elements involved. First, the stakes over which the battle is being fought, money and control, are quite high. Secondly, the directly conflicting interests of the salon owner and stylists, the zero sum nature of the game, guarantees bitterness because there will be losers and winners. Finally, the meeting of an irresistible force, competition, and a series of obstacles ensures conflict and disagreement.

This leads to consideration of a final question: Who will win? Ricardo is little help here for farmers never attempted to thwart the competitive process. Ricardian Rent Theory itself is, likewise, silent on this question. It can explain how booth rental appears and how its opponents can block its spread, but it doesn't provide any guidance concerning the issue of the relative strength of competition and its obstacles. Thus, we are left with a series of observations within the hair care industry that can be explained by a theory first presented by David Ricardo in the early 19th century—a tiny bit of evidence that “antiquarian researches” may be helpful in understanding present-day phenomena.

[17] Friedman [1987], p. 38-A.

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