



THE TOURISM MARKETS

Candela and Figini (2012): The Economics of tourism Destinations



?

Information Asymmetry in Tourism Market

- Parties involved in market transaction do not have same set of information
- An agent has some private info relevant to exchange that other party does not have
- Person selling used car knows state of vehicle better than buyer: seller has private info on quality of the car
- Individual who buys health insurance knows her health status better than insurance agent: buyer has private info
- Two types of asymmetric information: 1. moral hazard, 2. adverse selection

Moral Hazard

- Parties have identical ex-ante info about every relevant aspect of contract, while info asymmetry occurs ex-post once contract signed.
- (a) if one party is able to perform actions that are not observable by other party (hidden action): contractor of insurance policy that undergoes reckless action after signing, insurer cannot control
- (b) if one party, after signing, owns detailed info that the other party cannot access (hidden information): relationship between owner of company and its finance manager, who decides based on conditions about which owner is not informed.
- Primary economic concern for uninformed agent: provide incentive for other party to act in its interest, or control agent's behavior.

Adverse Selection

- Requires that asymmetry occurs when one party has ex-ante private information, i.e., before signing the contract.
- Insurance company faces adverse selection problem when it offers life insurance to a customer without knowing his true health condition
- A firm faces same problem when selling good to another company without knowing the close-to-bankruptcy condition of the latter.
- Primary economic concern for uninformed agent: provide incentive for the informed party to reveal it or to implement mechanisms to get as much info as possible.

Adverse Selection & the Decline of Destination

- Two types of hotels: L (low-quality) and H (high-quality) hotels
- Managers of L set price of room at 100, of hotel H set price at 200
- From demand, we assume tourists who prefer low-quality hotels L willing to pay up to 120, those looking for H willing to pay up to 240
- Should quality of hotel be known to everyone, then market works perfectly, overnight stays sold in both L (price range 100-120) and H (price range 200-240), mutual satisfaction of hotels and tourists
- If only hotel managers know quality of their hotels while tourists cannot observe (book from home, no access to info on quality)
- Asymmetric information on quality of the service
- Suppose tourists assume equal probability to meet any hotel type

Adverse Selection & the Decline of Destination

- Average price tourist would pay in this uncertain market condition is equal to 180 ($=120 \times 0.5 + 240 \times 0.5$): this is average price of hotels of different quality weighted by probability of meeting each hotel type
- Problem is such price attractive only to managers of hotels L, since minimum price required by managers of hotel H is 200.
- If tourists were to know such consequence of info asymmetry, they would be sure that at price of 180 only rooms of L-type hotels are offered, thus not willing to pay 180, since they know price of such hotels should be between 100-120.
- If price was included in this range, only rooms in L type would be on the market and tourists would be sure to only meet low quality

Adverse Selection & the Decline of Destination

- Type H would not appear in market, despite willingness to pay of tourists for high-quality (240) > evaluation of manager (200)
- Market badly selects quality of product and service under info asymmetry, tourists stay away from destination that presents large variability and uncertainty about quality of accommodation sector
- Signaling: worker well aware of her skills faces problem of how to report professional quality to potential employers, also employer pleased to get high-quality info to identify high value candidate: CV
- Managers of H hotel want customer to be aware of qualitative characteristic of their hotel, also tourists delighted to know: star-based classification

Adverse Selection & the Decline of Destination

- Win-win for buyers and sellers exists, incentive to fully share info before purchase.
- But interest for revealing private info only for high-quality operator
- Low quality product incentive to create confusion in consumers
- Main problem related to signaling is that effectiveness depends on degree of credibility of revealed info
- Reputation is then mechanism by which credibility guaranteed, at least in long-run
- Example: membership of hotel to renowned chain credible signal of adherence to quality standards.

Tourism Markets with Signalling

- If signal properly interpreted by tourist, reveals info.
- Introduce assumption on emission cost of signal. Less expensive for H hotel than L: H pays for each unit of signal $\frac{1}{2}$ of L
- If «s» is signal, then cost for L is «s» and for H is «s/2»
- Suppose if signal $< s^*$, hotel certainly of type L and if $\geq s^*$ of type H
- Tourist willing to pay 120 for hotels signalling $s < s^*$ and 240 for $s \geq s^*$
- How do hotels respond to such tourists' attitude?
- If hotel decides not to emit signal, optimal decision would be $s=0$, since all values of $0 < s < s^*$ would be more expensive but ineffective
- If hotel decides to emit signal, optimal decision would be $s=s^*$, since sufficient to convince tourist, any $s > s^*$ unnecessarily expensive

Tourism Markets with Signalling

- Given alternatives $s=0$ and $s=s^*$ determine which hotels signal
- Hotel's expected price: competition leads hotels to take minimum price 100 for L and 200 for H
- L hotels find it convenient to be perceived as H hotels, so to obtain benefit up to 100 ($=200-100$) only if $s^* < 100$, while decide to not invest in signal if $s^* > 100$.
- H hotels have lower cost $s^*/2$ for identical benefit ($=100$), so they do not invest when $s^* > 200$ while invest if $s^* \leq 200$
- To be credible signal implies that only high-quality hotel should find it convenient to emit signal: best hotels make effort to reveal quality only if separating signal falls within $100 < s^* \leq 200$

Tourism Markets with Signalling

- Above is separating equilibrium.
- If $s^* \leq 100$ then both hotels find profitable to choose $s=s^*$ and they are indistinguishable in eyes of tourist.
- This is pooling equilibrium.
- Separating Eq efficiently segments market for accommodation by distinguishing H and L hotels through signal, pooling Eq reproduces condition of uncertainty, uninformed tourist not willing to pay >180
- Concept of signalling used: advertising new product, certification of quality, the warranty, price refund scheme.
- Reputation is the other way in which quality is assessed by tourists on basis of info and experience built in the past.