



PRODUCTION IN TOURISM

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

Market Relationship vs. Firm Organization

- Example: car industry. Should a car producer manufacture the engine, the battery, the cockpit, etc. or should these components be supplied by other companies and then bought and assembled by car producer?
- Should car producer set up internal IT dept to manage company's info system or consult external IT company?
- Rely on in-house production or outsourcing its activities?
- Tourism sector: should tour operator be also owner of hotel, carriers, restaurant, booking center, used by tourists or should they leave these services to other independent companies from which it buys services?
- Should they use service of professionally trained staff or rely on market relationships with independent consultant and external firms?
- Tour operator has to choose between in-house and outsourcing

Market Relationship vs. Firm Organization

- Organization of production ranges between two systems:
- 1. the market, which consists of set of decentralized relationships between independent economic agents governed by info mechanism called price
- 2. the authority, transferring right of choice on some decision sets from one economic agent to another, as in firms. Confers to another right of choosing what action to take on its behalf
- Choice depends on benefit-cost analysis
- Both build upon contracts, legally binding. Choose market or authority contacts in producing tourism services?
- Firms is an institution where production factors purchased, production process made by selecting techniques, aim to maximize profits

Market Relationship vs. Firm Organization



Market Relationship vs. Firm Organization

- In tourism creation of final output (package holiday for tour operator) by combining overnight stays, meals, services, not same as producing car by assembling components.
- In case of tourism useful to consider firm as set of contracts, to support idea of tourism idea of tourism as uncommon.
- Transaction cost: cost of stipulation, execution, control of contract
- When maintaining market relationship with other independent firm is too expensive or too complicated (too difficult to define complete contract) firm created as team production to overcome info problems
- Authority outperforms market solution, agent formerly being a supplier hired by newly born firm, becomes a dependent worker

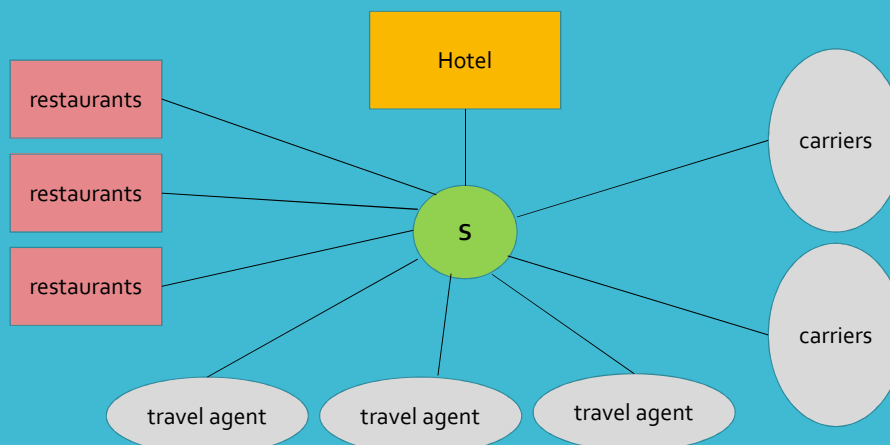
Market Relationship vs. Firm Organization

- Relationship between employer and employee regulated by incomplete contract: does not specify what employee has to do but leaves in hands of employer right of deciding tasks and performance of employee at each particular circumstance.
- Example: individual wants to produce and sell package holiday
- Agent requires contribution of other agents (hotels, rest., promoter)
- Three alternative types of contracts to reach goal of producing tourism product

1. Rely on Market Relationship

- An office, telephone, computer will suffice, contact hotel and restaurant managers, travel agents, stipulate specific contracts
- Any person **S** with skills can undertake activity of tourism production by completely relying on market relationships
- Agree precise performance with providers and pay them what is established in the contract
- Difficulties: once contract has been executed, necessary to check if quantity and quality of performance corresponds to what was established, if timing of execution respected, in case does not meet standards verify whether fault of contractor or external events.

Production as a Network of Contracts



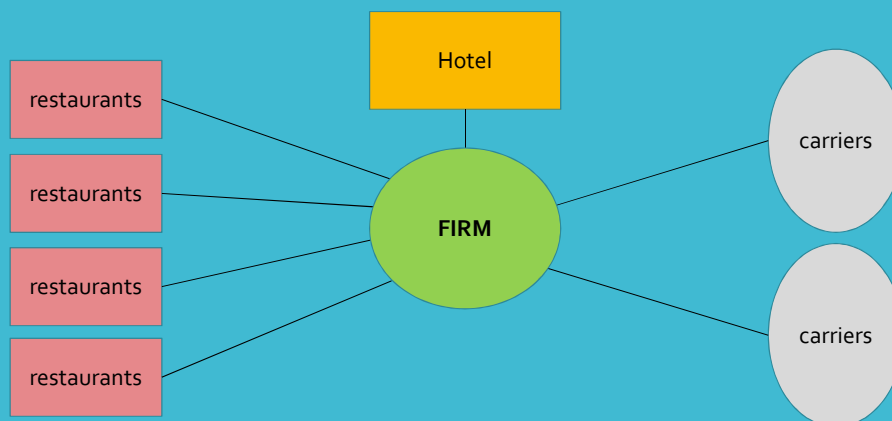
2. Production as a Team project

- Coordination and control must be carried out by **S**
- Output obtained through combined contribution (subsequent or simultaneous) of several agents.
- Only result that matters is aggregate output, individual contribution may not be directly observable (principal-agent problem)
- Remuneration based on aggregate performance
- such incentive scheme works poorly
- Member of team contributes to increase aggregate value of production, but benefits shared equally with all other members
- Not being able to closely observe activity of other subjects implies that one leader checks individual performance to allocate incentives
- Centralized, to overcome opportunistic behaviors

3. Hierarchic Organization

- Hire through job contract agents whose contribution needed for production of tourism product (example: hire travel agent)
- Carry out tasks under employer supervision.
- Number of market relationships diminish
- Promotion and distribution agents internalized and a firm for production of holiday has been introduced.
- For firm to be an efficient solution to production process, necessary that supervision, organization, coordination costs under firm's authority less than the transaction costs associated to contracts stipulated through market mechanism
- Assume hierarchical organization

Production as a Hierarchic Organization



Transaction Costs

- 1. Ex ante transaction costs: costs agent faces when defining features of contract
- 2. Ex post transaction costs: costs agent faces after having defined contract and during time of execution
- Firm arise when costs are less than respective costs borne through market relationships.
- Transaction costs also provide explanation for firm's size

Why Transaction Costs Arise?

- 1. Information asymmetry: seller more info than buyer about characteristic and quality (food ingredient in restaurant)
- 2. Specificity of transaction: value higher inside than outside relation, if marketing develops brand or logo for tourism destination, investment worthless outside relation with destination (same logo cannot be sold to other destinations. Once investment carried out, corresponding costs cannot be recovered outside specific relation)

Why Transaction Costs Arise?

- 3. uncertainty and complexity of transaction: time of delivery, destination, nature. Uncertainty makes outcome of tourism contract more imprecise than car sale (skiing week depends on weather)
- 4. Difficulty of measuring performance: when quality of agent performance hard to assess, firm takes over to reduce control cost. if tour operator sees low sales, not sure if due to low effort in promoter sale activity or due to low appealing of the destination itself

Production and Sale of the Holiday

- To tackle organization issues, there are
- (i) tour operators: firms specialized in production and sale of whole tourism product
- (ii) travel agencies: firms aimed at promotion and distribution of package holiday and at sale of individual or assembled services
- (iii) suppliers of single services (hotels, attractions, carriers) that can both sell to travel agencies and tour operators, and directly to tourists
- Travel agents link producers and final consumers
- Tour operator as wholesale level, travel agencies at retail level
- Supplier → tourist & supplier → travel agency/tour operator → tourist
- Supplier → tour operator → travel agency → tourists
- intermediaries in tourism benefit firm, tourists, destinations