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Intermediaries as quality assessors: Tour operators in the travel industry ☆

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Abstract

Intermediaries often arise in order to facilitate trade in markets characterized by asymmetric information. In the travel industry, policymakers have tried to address information asymmetries by providing hotel ratings. We show that those ratings are noisy indicators of quality because of the use of nonuniform standards across countries and limited information available to policymakers. Tour operators use their specialized knowledge to produce better ratings which are useful for comparing hotels within a country, as well as across countries. Intermediation by tour operators provides a better matching of quality with price and leads to a more efficient market outcome.

JEL classification: L15; L83

Keywords: Intermediaries; Middlemen; Information provision; Tourism and travel industry

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1. Introduction

Imperfect information is an important feature of many markets. Its simplest and most widely-studied form is the asymmetric information case where the seller of an object knows its true value while potential buyers do not. Akerlof (1970) pointed out how this informational asymmetry can hinder the proper functioning of markets and lead to suboptimal levels of exchange. In extreme cases, the buyer's inability to assess quality can kill markets for high quality goods. This gloomy prediction is often overcome in practice through various mechanisms such as the provision of warranties and the buildup of reputations. Additionally, in some markets information asymmetries give rise to a new class of agents whose function is to determine the quality of an object and make that information available to potential buyers. By providing that service the intermediary, or middleman, mitigates the information problem and facilitates trade. Both buyers and sellers can benefit from the presence of an intermediary and are willing to pay for its services. Thus the intermediary has an incentive to invest resources in acquiring the skills that enable it to assess quality. Well-known intermediaries include firms like Moody's and Standard & Poor's, whose rating services play a crucial role in the proper functioning of financial markets. Other agencies rate consumer products or services: *Consumer Reports* evaluates consumer products, *Zagat* rates restaurants and the *American Automobile Association* rates hotels.

Governments are also active information providers. Intervention by public agencies typically comes in the guise of minimum quality standards. For example, educational institutions need to satisfy certain criteria in order to have their degrees recognized; airlines must abide by safety rules; eating establishments must follow hygiene standards. Attainment of a minimum standard is often required in order for an establishment to be allowed to operate. Alternatively, the standard may be optional and firms decide whether to conform to it or not depending on the expected response by consumers. In such markets public and private information providers often coexist and provide complementary services. The task of public agencies is limited to determining whether a product or service meets an objectively defined minimum standard. It is then up to private intermediaries to assess the relative quality of the products and services that pass the minimum standard criterion.

In this paper we study a rare example of a market where both public and private intermediaries provide quality ratings. The travel and tourism industry is characterized by a large degree of asymmetric information. Prospective tourists typically need to transact with agents such as hotels and car rental agencies who are located in faraway destinations, often in foreign countries. The quality of the accommodation and the surrounding locality is difficult to assess without first-hand experience. Recognizing this problem, most countries have established national rating agencies whose task is to assess the quality of hotels in their jurisdiction and rate them according to a five-point star system. At the same time, private intermediaries such as tour operators play a prominent role in this market. Tour operators are firms that sell complete vacation packages. Their mode of operation entails three vital intermediary functions. First, they collect objective information about alternative destinations and make it available on the internet or in brochures suitable for comparison shopping. Second, they provide subjective ratings of the different destinations based on both customer feedback and their own assessment of the facility. Third, they bundle together transportation, accommodation and other services and sell them to consumers as a complete vacation package. Bundling minimizes transaction costs, while pooling together tourists headed to the same destination exploits scale economies.[1]

[1] The first two tasks are also performed by other entities, such as travel magazines, but on a much smaller scale.