

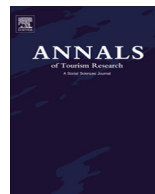


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Measuring price elasticities of demand for outbound tourism using competitiveness indices



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ABSTRACT

The real exchange rate (REX) has long been used as the proxy for prices in tourism demand models. However it has limitations, particularly when it comes to models of outbound tourism. As an alternative, a price competitiveness index (PCI) is developed and used as a proxy for prices in a model of outbound tourism from Australia. Results obtained show that while REX is statistically insignificant and yields a price elasticity of -0.002 , PCI is significant and generates a price elasticity of -1.07 . The results obtained show that PCI outperforms REX as the preferred price variable in modelling outbound demand on both theoretic and empirical grounds. Furthermore, this index can be used to monitor the inter-temporal competitiveness of a destination.

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Introduction

The notion of price elasticity of demand was developed by Alfred Marshall in his seminal work, the *Principles of Economics* in 1890. Today, the concept is central to microeconomic analysis of consumer demand. It is an essential tool in the analysis of demand for goods and services and the understanding

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of decision making processes related to pricing, investment and planning. Price elasticities of demand are essential to policy makers in their assessment of the impacts of existing and potential new fiscal and monetary policies on the consumption habits of households. In the case of tourism demand, price elasticities are used by destination managers to measure the effects of changes in prices on number of arrivals, expenditure per capita of travellers and number of nights spent at a destination. Such information is crucial for developing strategies and plans for the tourism industry. Price elasticities of demand are also the basis for calibrating economic models which appraise the likely consequences of demand and supply shocks on the economic contribution of tourism to a destination. They are fundamental to forecasting exercises as they indicate to the industry the potential effect of changes in prices on sales revenue.

The above may explain the relatively high volume of research which has been devoted to the development of tourism demand models and the estimation of price elasticities of demand. According to a study by [Song and Li \(2008\)](#), there were 420 published articles on these topics from 1960 to 2002. Since then, over a hundred more may be added to this list. Researchers, however, face considerable difficulties in deciding on an adequate measure of price in their demand models ([Crouch, 1992, 1994](#)). Tourism prices may be decomposed into two main components: the transportation cost and the prices of goods and services consumed at the destination. Researchers typically separate these two types of prices in their modelling. The transportation cost for international tourism is more often than not measured by the price of an air ticket to the destination, and its coefficient yields the transport price elasticity of demand.

Finding a measure for the prices of goods and services at the destination is a more complex procedure. Ideally, the tourism price will include the prices of a bundle of goods and services consumed by the representative tourist at the destination. The resulting set of prices, if included separately, will result in an 'intractable' model ([Crouch, 1994](#)). As a consequence, composite prices in the form of ratios of prices at the destination to those of the home countries are constructed and used ([Li, Song, & Witt, 2005](#)). The underlying assumption is that the potential traveller will compare these prices in local currency and prices prevailing in the home country when making the travel decision. The relative prices converted to the home country currency are referred to as the tourism price index. The construction of tourism price indices are often hampered by lack of data on the actual good and services consumed by tourists and their prices ([Dwyer & Forsyth, 2011](#); [Dwyer, Forsyth, & Rao, 2000](#); [Forsyth & Dwyer, 2009](#)). The real exchange rate (REX) has been put forward as an adequate approximation to changes in the relative prices that tourists face. REX is the most commonly used proxy for prices in tourism demand models ([Song & Li, 2008](#)).

Objections to using REX

In spite of its widespread use, there are important objections to using the REX as a price proxy.

The conceptual limitation to using the REX as a price proxy is that it must be capable of measuring how costly destinations are to visit. It cannot do this- the REX can measure the *change* in prices over a period, but not the *absolute level* of prices. It does not measure the relative prices of goods and services in different countries as it does not go beyond changes in prices, and does not determine whether a country is more or less price competitive than another at a particular point of time. However, to estimate demand elasticities, it is necessary to measure the absolute level, not just the change. This is a fundamental requirement when estimating demand functions. The REX cannot tell us, for example, whether prices in Norway are different from prices in India, at a point of time. To measure the level, as opposed to simply *trends* in tourism prices, cross-sectional studies using the prices paid by tourists in different countries are needed ([Dwyer et al., 2000](#)).

This problem shows up in empirical work. Studies such as [Song, Romilly, and Liu \(2000\)](#), [Halicioglu \(2010\)](#) and [Seo, Park, and Yu \(2009\)](#) provide the evidence of a strong cointegrating relationship between outbound tourism and REX and [Seetaram, Song, and Page \(2014\)](#) found significant price elasticities in five out of ten destinations for UK outbound travellers using real exchange rate. This variable has nevertheless not always performed satisfactorily as a proxy for prices in demand models for outbound tourism. This is illustrated, for example, in studies of demand from Australia, such as those of the [Bureau of Transport and Communication Economics \(BTCE\) \(1995\)](#), [Smith and Toms \(1978\)](#),

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