



## Quality deterioration in package tours: The interplay of asymmetric information and reputation

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### H I G H L I G H T S

- ▶ Quality deterioration of package tours is caused by asymmetric information.
- ▶ Quality deterioration of package tours can be alleviated by reputation.
- ▶ Tourists' information of effort helps to slightly improve service quality.
- ▶ Reputation dramatically improves service quality.
- ▶ Increasing tourists' information of effort leads to perception of high reputation.

### A R T I C L E I N F O

#### Article history:

Received 8 March 2012

Accepted 17 February 2013

#### Keywords:

Quality deterioration  
Asymmetric information  
Reputation  
Package tours  
China

### A B S T R A C T

Asymmetric information in the tourism industry has been regarded as a fundamental cause of quality deterioration of travel services. This study aims to explain such quality deterioration by modeling the interplay of asymmetric information and reputation in package tours. This model is composed of eight hypotheses which regard asymmetric information of product knowledge and effort as a cause on the one hand and tour operators' reputation as a mediator in alleviating quality deterioration on the other. By applying this model to China's outbound tourism market with a cross-sectional survey from December 2010 to June 2011, six hypotheses of the model are supported. The results have shown that asymmetric information measured by tourists' perception of effort results in low service quality at the destination and that tour operators' reputation has a significant role to play in mitigating tourists' price sensitivity in the source market and improving service quality at the destination.

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### 1. Introduction

The tourism industry has been characterized by asymmetric information, which leads to quality deterioration of travel services in various forms (Caserta & Russo, 2002; Darby & Karni, 1973; Keane, 1996, 1997; Reece, 2009). In the most fundamental sense, asymmetric information associated with tourism can be attributed to the fragmented nature of the tourism industry, which involves a variety of service sectors interconnected somewhat loosely with each other. Of particular importance is that tourism inherently involves the displacement of tourists and, hence, a separation of tourism businesses into the source market and the destination. The

business of package tours, in particular, seems to have impeded information transmission within the tourism industry, for it is operated separately by outbound tour operators (OTOs) in the source market and inbound tour operators (ITOs) at the destination. As a consequence, obtaining information is difficult and costly on the tourist's side. Economic theories have concluded that the market size of high quality is likely to shrink as the distance between two traders expands to the extent where information transmission is sufficiently difficult (Dixit, 2003). In terms of the operation of package tours, this conclusion implies that inferior quality of package tours could probably occur when OTOs and ITOs are separated in different geographical locations, especially when the source market is far from the destination.

As a bundle of travel services, package tours are characterized by intangibility, heterogeneity, and the inseparability of production and consumption, each of which may cause ambiguity and uncertainty for tourists to discern quality (Keane, 1996, 1997; Nicolau &

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Sellers, 2010; Schwartz, 2006). This has to a large extent explained why the tourism industry encountered a number of inferior quality incidents, ranging from tour operators' misrepresentation of information in the source market to cheating tourists at the destination (Arlt, 2006; Atherton, 1994; Dwyer, King, & Prideaux, 2007; Elton, 1984; Grant, 1996; Keating, 2009; Prideaux, King, Dwyer, & Hobson, 2006; Reece, 2009; Sheldon, 1986). As one of the largest source markets, China has for the past decade severely suffered from inferior quality, particularly in the form of "zero-fare" group tours (Chen, 2012; Chen, Mak, & Guo, 2011; Zhang, Heung, & Yan, 2009; Zhang, Yan, & Li, 2009). The business of "zero-fare" group tours is a complex of inferior quality, which incorporates not only inferior quality of travel services but also of information in package tours (Chen, 2012; Chen et al., 2011). This business may have undermined China's outbound tourism market at large (Chen, 2012; Chen et al., 2011). This consequence is perhaps not surprising as economic theories have suggested that asymmetric information may not only lead to quality deterioration for a particular business but also result in market failure as a whole (Akerlof, 1970; Hörner, 2002; Stiglitz, 1989).

Yet evidence on the contrary has shown a relatively optimistic prospect on China's outbound tourism market. Over the past decade, the Chinese outbound departures increased from 5.3 million in 1997 to 57.4 million by 2010 with an average annual growth of 10% projected in the next ten years (CNTA, 2011; NBS, 1998; UNWTO, 2011a). China has also undergone by far the fastest growth with regard to tourist overseas expenditure since 2000 and by 2010 had been the third largest spender with up to US\$54.9 billion on international tourism (UNWTO, 2011b). These facts seem contradictory to what asymmetric information has predicted about market failure for China's outbound tourism. In fact, in addition to asymmetric information as a fundamental cause of quality deterioration, there are a variety of mechanisms that can assure quality by mitigating the effect of asymmetric information (Hörner, 2002; Klein & Leffler, 1981; Leland, 1979; Stiglitz, 1989). One of these mechanisms is reputation, which can fundamentally assure quality provision by reducing asymmetric information in the market (Allen, 1984; Klein & Leffler, 1981; List, 2006; Shapiro, 1982, 1983; Stiglitz, 1989). Since quality in package tours can be under provided on the one hand and the market may deviate from failure on the other, the present study aims to explain why and to what extent inferior quality in package tours can be accounted for by both asymmetric information and reputation.

## 2. Literature review and hypotheses

### 2.1. Asymmetric information, reputation, and quality

The notion of information asymmetry generally suggests that one party is better informed than its counterpart of characteristics of a product or a transaction, leading to information being asymmetrically distributed between two parties (Akerlof, 1970; Stiglitz, 1989, 2002). Such an information asymmetry is regarded as the paramount cause of quality deterioration and market failure (Akerlof, 1970; Darby & Karni, 1973; Shapiro, 1982, 1983). Despite having acknowledged various dimensions of asymmetric information in the market, of particular concern is information of quality (Nelson, 1970; Parker, 1995; Smallwood & Conlisk, 1979). This is because for consumers quality information is more difficult and costly to obtain than other information (Nelson, 1970). Research on quality deterioration has illustrated the mechanism of asymmetric information, whereby quality can be deteriorated either in production or in transaction (Arnott & Stiglitz, 1988; Fama, 1980; Holmström, 1979; Rothschild & Stiglitz, 1976). Akerlof's (1970) Lemons principle modeled this mechanism as adverse selection

in the United States' used automobile market. The literature has shown that quality deterioration is indeed a widespread phenomenon in various markets with asymmetric information, including those for professional services, labors, and insurances (Chou, 2002; Cohen & Siegelman, 2010; Edelman, 2009; Foster & Rosenzweig, 1994; Hubbard, 1998, 2002).

While asymmetric information has been viewed as the fundamental force in determining quality deterioration and market failure, information economics suggests that the market may not necessarily fail to function or simply collapse (Klein & Leffler, 1981; Stiglitz, 1989). In other words, quality could be deteriorated to the extent that the market still functions though somewhat inefficiently (Stiglitz, 1989). Underlying this argument is the second fundamental force known as reputation, a market-based mechanism that can assure quality through mitigating asymmetric information (Allen, 1984; Hörner, 2002; Klein & Leffler, 1981; Rogerson, 1983; Shapiro, 1982, 1983; Stiglitz, 1989). The role of reputation in alleviating quality deterioration was modeled in early works as a repeat-purchase mechanism between two sides of market participants in the long run (Heal, 1976; Kreps & Wilson, 1982; Telser, 1980). This mechanism was explicitly illustrated by Klein and Leffler (1981) and Stiglitz (1989), revealing that firms establish reputation for supplying high quality because the payoffs from reputation outweigh temporary benefits from supplying low quality. This also means that firms may lose their reputation and future benefits if they supply low quality.

The mechanism of reputation specifically suggests two functions, namely its signaling and incentive effects (Allen, 1984; Klein & Leffler, 1981; Rogerson, 1983; Shapiro, 1982, 1983). The signaling effect was modeled by Shapiro (1982, 1983) who asserted that firms build reputation through disseminating quality information to consumers. This effect has been exemplified by treating reputation as an asset of firms, such as brand names and trademarks, which helps consumers to identify reputable firms (Mailath & Samuelson, 2001; Marvel & Ye, 2008; Tadelis, 1999, 2002, 2003). On the other hand, reputation can return an incentive in the form of price premium to firms which produce high quality (Klein & Leffler, 1981). This effect has been extensively investigated in the internet-based trading systems, such as Amazon, Yahoo!, and eBay (Houser & Wooders, 2006; Melnik & Alm, 2002). It was found that firms with reputation normally charge a relatively high price—price premium—for an identical product compared to their counterparts without reputation (Dewan & Hsu, 2004; Houser & Wooders, 2006; Melnik & Alm, 2002; Resnick, Zeckhauser, Swanson, & Lockwood, 2006). In other words, reputation lowers consumers' price sensitivity and hence increases their willingness to pay—a proxy of price premium presented on the demand side (Melnik & Alm, 2002; Resnick et al., 2006).

### 2.2. Hypotheses

The economic literature lays out the theoretical foundation to conceptualize the interplay of asymmetric information and reputation in determining quality deterioration in package tours. Applying the theories of asymmetric information and reputation requires researchers to operationalize the key constructs in a way that not only represents the theories themselves but can also be tested in the paradigm of consumer behavior research with package tours as a context. In view of this, four interconnected constructs that underlie the economic studies are drawn to develop the theoretical model of the present study (Fig. 1). They are asymmetric information, reputation, price premium, and quality. Drawing upon the applications of these theories in management and marketing, eight hypotheses are proposed in the context for package tours below, suggesting that asymmetric information is the cause of

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