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Can Economics Explain Where All-Inclusive Deals are Offered?

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Can Economics Explain Where All-Inclusive Deals are Offered?

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Abstract: This paper investigates why all-inclusive travel packages are offered at some hotels but not at others. By using the theory of transaction cost, it is argued that all-inclusive contracts mitigate a hold-up problem and that the severity of this problem varies with regards to the hotel's distance to the resort center. This hypothesis is tested empirically against data from 3798 hotel offers and is strongly supported. Additionally, some country-specific mechanisms related to the general price level and the degree of corruption are analyzed. Countries with all inclusive offers are characterized by a low price level and high corruption.

Keywords: All-inclusive, contracts, hold-up, transaction cost, tourism.

JEL-codes: D23; D86; L14; L83.

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1. INTRODUCTION

In recent decades, the growth of tourism in the world has clearly outpaced the world's GDP growth, and the number of yearly tourist arrivals is rapidly approaching one billion, according to the United Nations World Tourism Organization.¹ It is thus of increasing economic importance to understand this sector properly. The purpose of this paper is to use economic theory to investigate an important contractual form in this sector: namely, the all-inclusive contract.²

The supply of all-inclusive vacation packages is something of a mystery to an economist. The idea of setting the price of services, drinks and food in a hotel equal to zero seems odd from a theoretical perspective because it disrupts the price mechanism and promotes consumption of a good that consumers value as lower than its marginal cost. Furthermore, as an allocation system, all-inclusive allocation comes rather close to a command economy at the micro-level, which has been shown to be severely unsuccessful, at least on a larger scale. In spite of this, all-inclusive vacation packages are offered to tourists in many parts of the world, and consumer research efforts in the study of tourism have tried to identify some factors affecting the buyers' choice of such packages in survey studies (see, e.g., Wong and Kwong, 2004). However, the offering of an all-inclusive contract involves at least two parties, namely the hotel (which may be owned by or have a contract with a travel agency) and the buyer. Thus, this can be seen as a contractual or institutional solution, which not only reflects consumer preferences, but also both parties' deeper strategic considerations. In this paper, we suggest that all-inclusive contracts mitigate hold-up problems, and we test this mechanism with data on the actual contracts offered. In particular, we test

¹ See www.unwto.org.

² All-inclusive travel packages are vacations where almost everything is included in a pre-paid price, from ground transfers, baggage handling, government taxes, room, meals, snacks, drinks, and the use of facilities in a hotel (see Tourism Intelligence International, 2000).

whether hold-up considerations may explain why some hotels offer all-inclusive packages and others do not.

We also take the opportunity to explore some country-specific factors that may be indirectly connected to the choice of contractual form. It should be emphasized that these indirect country-specific causes have weaker theoretical support and are more difficult to test. However, because the collected data and the question posed appear to be new, we think it is worthwhile to provide theoretical and empirical arguments for two such mechanisms. Hence, we investigate whether the price level and the degree of corruption in a country may be associated with the occurrence of all-inclusive contracts.

It should be emphasized that we know of no prior study that has investigated this phenomenon from a theoretical economic perspective. There are a number of descriptive studies in the economics of tourism, but these do not apply stringent mechanisms derived from economic theory.³ This paper should, therefore, be seen as a first attempt to see if economic theory can act as a complement to this earlier research. We claim that this is, indeed, the case and that our result nicely illustrates some economic factors that are driving a common contractual form in a fast growing global industry. At the same time, we want to stress that a comprehensive economic analysis of all-inclusive contracts, needs to incorporate more variables than the ones included in the present study.

³ Much of this research focuses on understanding the tourists' preferences (see e.g., Goodrich, 1977, Stevens, 1992, and Wong and Kwong, 2004) or the determinants of tourist expenditure (see e.g., Kozak et al., 2008), which obviously is of great interest to the industry.

2. THEORY

There are many conceivable economic explanations for all inclusive packages. One uncomplicated explanation is simply that consumers have a preference for buying the right to get everything for free (e.g., to avoid the hassle or inconvenience of having to pay for everything). While it is, indeed, a necessary condition that consumers value and thus, are willing to pay for such contracts, preference for this contract type could be applied universally and does not help much in understanding why they are offered by some hotels and not by others. To explain this variation, we suggest that there exists a hotel-specific hold-up problem between the hotel and the buyer of a travel package. Subsequently, using a theoretical framework, we also analyze why two country-specific macro phenomena may provide fertile ground for all-inclusive contracts.

2.1. Hold-up

A hold-up problem is characterized by a situation where i) at least one party makes a (non-contractible) specific investment before further transactions, and ii) the optimal form of future transactions (in terms of e.g., quantity and quality) is not known before the specific investment is made (see Klein, Crawford and Alchain, 1978, and Williamson, 1975). Travelers who have pre-paid for a one or two week's stay at a hotel have made a specific investment and cannot know important details beforehand about consumption of local services, e.g., food and beverages at the hotel. The traveler can, therefore, easily fall prey to hold-up pricing of these local services.⁴ This potential hold-up problem would make the buyers value the travel packages (including hotel) less. Consequently, the seller of the package would need some type

⁴ To keep the presentation simple, we present the hold-up problem in terms of pricing, but in reality the hold-up is likely to concern both price and quality.

of device that would make it credible to the traveler that they would not fall prey to such a hold-up. All-inclusive fills this function because the travelers pre-pay a certain amount and then get rather detailed pre-specified consumption rights without having to worry about the price.⁵ However, to reach a coherent explanation of the variation in all inclusive offers, the hold-up mechanism needs to be combined with the following insight: there is only a severe hold-up problem when there are no or few alternatives to the local services included in the package offered by the hotel (such as restaurant, food, and bar services). To put it more concretely, if there are plenty of competing restaurants and bars close to the hotel, the travelers can easily substitute to these if the prices at the hotel are unjustifiably high. Hence, we should expect that the all-inclusive contract more effectively mitigates hold-up and, therefore, is more likely to be offered the more market power the hotel has on its local markets for services. As a proxy for market power on these services, we use the distance from the hotel to the center of the resort or city.⁶

To provide a simple, but more structured, account of this argument, assume that customer i demands one unit of a composite local service, of which she has a reservation price of V_i . Suppose that the only alternative to the hotel's services is located in the resort center and that the customer's total cost (including the inconvenience) to get from the hotel to the center is given by the function $t_i(d)$, which is increasing in the distance d between the hotel and the center. Furthermore, the service (due to competition) is priced according to its marginal cost c in the center

⁵ It can be noted that expressions such as "you don't need to think about the bill" are very frequent in travel companies' marketing of all-inclusive packages. It should also be noted that many aspects of the quality of the services included in the package is pre-specified, like the opening hours for the bar, dinner services, and the type of drinks (e.g., domestic or foreign brands), etc... This also reduces the scope for hold-up in the quality dimension.

⁶ The idea to use physical distance between the contracting parties' relevant activities as a proxy of site specificity and thus the severity of the hold-up problem has been used earlier by e.g., Joskow (1987) to explain contract lengths.

and according to p at the hotel. To attract customers, the hotel's price must satisfy $V_i - p \geq V_i - t_i(d) - c \rightarrow p \leq t_i(d) + c$.⁷ From this formula, it should be obvious that as the d value increases, the hotel owner is less restricted when it comes to pricing decisions, and thus, the hold-up problem increases as well. Hence, our hypothesis can be stated as follows:

Hypothesis: All-inclusive contracts are more likely to be offered the farther away the hotel is located from the resort center.

2.2. Country specific factors: Price Level and Corruption

Countries differ in culture, economy, bureaucracy, and legislation. It is, therefore, quite likely that different contractual forms are better suited for some countries than for others. A general theoretical problem for investigating how variables that characterize a whole country are related to a micro phenomenon is that these variables are highly aggregated, which means that they are affected by a multitude of underlying factors. These factors can seldom be controlled for and can usually only be indirectly linked to the micro phenomenon through a battery of auxiliary assumptions. In addition, such empirical investigations are usually also plagued by the limited number of country observations that are available and that the observations used as independent variables are often strongly correlated. Hence, we do not want to hide the fact that the mechanisms in this section are substantially less convincing to us than those of the previous section. Nevertheless, country-specific factors may be important, and if the reasoning and results are interpreted with care, we believe they are worth exploring in a first study like the present one.

⁷ Needless to say this is only a necessary condition, sufficiency also requires $V_i - p \geq 0$.

The Price Level: A country-specific factor that may be connected to the occurrence of all-inclusive contracts is the price level in the country. To understand this relationship, it is best to start at the micro level where all inclusive contracts can be seen as a form of bundling. The idea behind bundling is that consumers' valuations of the components in the bundle vary. If the marginal costs of the components are sufficiently small, the seller may be able to extract more consumer surplus by selling all of these as a package, compared to selling them separately (see Adams and Yellen, 1976). For instance, while some travelers value free food and drinks highly, but not normal hotel services, other travelers may have the opposite valuation. If this is the case and the marginal costs of the services are sufficiently small, it is easy to construct examples where it is optimal for the hotel owner to sell these services in a bundle. We therefore hypothesize that all-inclusive is more common where the cost of the included components are low.

All-inclusive components typically incur costs in terms of labor, food (mainly domestic), and both alcoholic and non-alcoholic drinks (domestic). Hence, the cost of all-inclusive components mainly consists of domestic goods and labor costs, which do not differ much between hotels in the same country.⁸ It is therefore reasonable to use a country-specific proxy of these costs, and we suggest the purchasing power exchange rate, with the conjecture that a country's purchasing power exchange rate is negatively associated with the prevalence of all-inclusive offers.

Corruption: The second mechanism relates to the relative benefits and costs of removing transactions between the traveler and the hotel, which we conjecture may be indirectly linked to the corruption level in a country. It is obvious that all-inclusive

reduces transactions involving money. This simplifies things in many ways and reduces the time the staff needs to spend on calculating bills and making change. However, many of these aspects will apply universally and do not give any cutting-edge in explaining the variation in all-inclusive offers. One detail that may differ between countries is the degree to which the hotel owner can trust his staff not to take personal advantage of the money transaction between the guests and the hotel. There are many ways in which a staff member can exploit this middleman position (e.g., by only giving good service to tipping customers or by not registering some drinks and then putting the money in his own pocket). By taking away the money in the transaction by offering all-inclusive deals, many of these opportunities vanish. It is quite conceivable that the staff in different countries vary in their “culture” of exploiting such a middleman position. There is, of course, no direct measure of this inclination among hotel staff, but we think that the country’s corruption perception index (CPI) can be used as a reasonably good proxy.⁹ In addition, the corruption index also captures some differences between countries in the predictability and the cost of using the legal system. Adding a monetary transaction between the hotel and the guest is likely to increase the likelihood that the parties in some situations would need the legal system to enforce contracts and to solve disputes between guests and the hotel. This means that it would be more beneficial to avoid such disputes in more corrupt countries. Thus, our second conjecture in this section is that the more corrupt a country is, the more likely it is that all-inclusive contracts are offered.

⁸ Clearly, we cannot disregard from the fact that hotels in different countries may have different ratios of imported goods in their all-inclusive components. However, since we do not have data on these ratios we cannot control for this effect.

⁹ This index mainly measures corruption in public and political sectors. However, it is reasonable that the “culture” in these sectors may reflect a more widespread culture in the whole society or that it spills over into the rest of the population (see Rothstein, 2005).

3. RESULTS

To determine whether the suggested mechanisms can explain the presence of all-inclusive contracts, data were collected from the homepages of the three largest travel agencies in Sweden in April, 2010. These three agencies are Apollo, Fritidsresor, and Ving, with market shares of 20, 30 and 32 percents respectively (see Swedwatch, 2008: 61-65). The collected offers cover more than 80 percent of the packaged travel market in Sweden, which means that selection problems should be of minor importance. Altogether, data from 3,798 hotels from 46 countries were collected. For each hotel, the travel company offers some information. First, the data on whether the hotel offered “all-inclusive” were collected; they will be used as the dependent binary variable. If the hotel did not offer all-inclusive, it typically offered a more limited package of services in addition to the stay (e.g., some included breakfast and some did not). The travel companies also provide information on the distance to the center of each hotel, which is the proxy on the competition around the hotel and thus, an indication of the severity of the hold-up problem. The country-specific data on price levels was obtained from the World Bank.¹⁰ Data on corruption was obtained from Transparency International Corruption Perceptions Result Report 2010.¹¹ The descriptive statistics are given in Table 1. It is important to note that a low value of the corruption index means that corruption is high.

TABLE 1

¹⁰ The purchasing power exchange rate is obtained by the ratio between the per capita GDP (according to the Atlas method) and the per capita GDP (based on purchasing power parity). The GDP figures refer to year 2008.

¹¹ Figures are available at <http://www.transparency.org>.

3.1. Mitigating Hold-ups

In the data set, 582 hotels offered all-inclusive packages, and 3,216 did not. The average distance from the center of the resort is 1,364 meters in the former group and more than three times higher in the latter group (4,767 meters), which clearly lends support to our hypothesis. In Table 2, we run a logistic regression first, without country dummies, and then with dummies for countries that have at least one hotel that offers all-inclusive.¹² Without controls, distance is highly significant (p-value =0.000, N=3798). By including country dummies, we control for factors that are specific to each country (e.g., geography, economy, “culture” and regulations).¹³ Distance is also highly significant with controls (p-value=0.000, N=3323). It can also be noted that countries differ in their likelihood of having all-inclusive hotels. Countries like the Dominican Republic, Egypt, Mexico, Tunisia and Turkey are significantly more likely to have hotels with all inclusive offers as opposed to Spain, which is the baseline country in the regression. Hotels in Thailand (with only one all-inclusive hotel), Portugal and Greece are significantly less likely to offer all-inclusive contracts.

TABLE 2

3.2. Country-specific factors

There are different ways to empirically test whether the country-specific factors are statistically associated with all-inclusive offers. Because the number of countries is limited and the study of these variables is exploratory, we have chosen a simple and

¹² Trinidad Tobago is also excluded since 100 percent of the hotels offer all-inclusive.

¹³ Since countries without any all inclusive is excluded, countries that mainly offers city vacations like e.g., UK (London), Czech Republic (Prague) and Denmark (Copenhagen) are excluded and can thus not drive the results.

straightforward method that does not involve many hidden assumptions. We therefore first test whether the distribution of country-specific variables in countries with at least one hotel offering all-inclusive differs from that of countries without any all-inclusive hotel offers. We then inspect the correlation between the country-specific variable and the percentage of all-inclusive hotels in countries where all-inclusive contracts exists.

To start with the price level, it can be noted that mean price level in the countries without all-inclusive is 0.86, while it is 0.64 in the countries with all-inclusive offers. These figures are consistent with the suggested mechanism that a low price level makes all-inclusive more attractive. The Wilcoxon rank-sum test rejects that the price levels for countries with at least one all-inclusive hotel are from the same underlying distribution as the price levels for countries without all-inclusive offers ($p=0.041$, $N=44$, two-sided test).¹⁴ The price level for countries with all-inclusive is also, as expected, negatively correlated with the percentage of all-inclusive contracts. The correlation coefficient is -0.28 , but is not statistically significant ($p=0.17$, $N=25$).

If we perform the corresponding analysis for the corruption index, it can be noted that this index in countries without any hotels offering all-inclusive in general is higher than the corruption index for countries with all inclusive. This is consistent with the suggested mechanism that a high degree of corruption makes all-inclusive more beneficial. The mean corruption index in the 21 countries without all-inclusive is 6.00 while it is 3.94 in the 25 countries with all-inclusive offers. A Wilcoxon rank-sum test strongly rejects that the corruption indices for countries with at least one all-inclusive hotel are from the same distribution as for countries without all-inclusive

¹⁴ We use a non-parametric test to avoid making unnecessary assumptions about the distributions. Note, that price levels from Cuba and the United Arab Emirates were not available.

offers ($p=0.000$, $N=46$, two-sided test).¹⁵ However, it should also be mentioned that the corruption index does not satisfactorily explain the variation in the proportion of all-inclusive contracts offered in the 21 countries with at least one all-inclusive offer. The sign of the correlation coefficient is the expected one (i.e., negative), but its magnitude is moderate (-0.14) and not significant.

The conclusion must be that it is too early to conclude that the price level and corruption are connected to the choice of contractual form. However, the fact that the effects are in the expected direction and that some statistically significant results can be observed suggest that both mechanisms should be kept as possibilities for future research. Of particular interest is the search for an underlying factor that is associated with both these relationships. The very high positive correlation coefficient between these two variables (0.87) suggests that such an effort may be rewarding.

4. CONCLUDING REMARKS

All-inclusive contracts give the traveler a bundle of consumption rights at the hotel. The purpose of this paper is to investigate why some hotels offer such contracts but not others. By using the theory of transaction cost developed by, among others, the 2009 Nobel Laureate Oliver Williamson, it is argued that all-inclusive contracts mitigate a hold-up problem and that the severity of this problem varies with the hotel's market power in the surrounding local market for those services that are included in the contract. The market power is approximated by the distance to the resort center, where competing service providers are located. The prediction is that the higher the market power of the hotel (i.e., the longer the distance to service competitors) the more likely it is that an all-inclusive contract is offered. This

¹⁵ A non-parametric test is preferable since the corruption perception index can be considered to be an ordinal variable.

hypothesis is tested empirically against data from 3798 hotel offers (covering approximately 80 percent of the Swedish travel package market) and gets strong empirical support.

We also explore some country-specific mechanisms related to the price level and the degree of corruption. Our preliminary results indicate that countries with all-inclusive offers are characterized by a low general price level and a high degree of corruption. These country-specific results are interesting but need to be investigated further before any definite conclusion can be drawn.

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Country	Observations	% All Inclusive	Mean distance to center (km)	Price Level	Corruption Index
Austria	11	0	145	1.23	7.9
Bulgaria	114	23	1023	0.46	3.6
Cambodia	14	0	1831	0.33	2.1
Cape Verde	22	18	1642	0.91	5.1
Czech Rep.	13	0	0	0.73	4.6
Chile	9	0	155	0.71	7.2
Croatia	26	15	1072	0.74	4.1
Cuba	12	50	4000	-	3.7
Cyprus	50	26	1902	0.95	6.3
Denmark	10	0	0	1.59	9.3
Dom. Rep.	36	86	4706	0.56	3.0
Egypt	148	42	6596	0.33	3.1
Estonia	6	0	0	0.74	6.5
France	40	0	611	1.23	6.8
Gambia	13	8	1951	0.30	3.2
Germany	15	0	0	1.18	7.9
Greece	847	9	1048	1.01	3.5
Hungary	20	0	90	0.72	4.7
India	36	8	1725	0.36	3.3
Indonesia	26	8	2187	0.52	2.8
Ireland	10	0	0	1.33	8.0
Israel	13	15	746	0.90	6.1
Italy	182	2	704	1.16	3.9
Jordan	14	0	3364	0.60	4.7
Kenya	8	38	5625	0.49	2.1
Lithuania	4	0	0	0.71	5.0
Malaysia	15	0	6903	0.51	4.4
Maldives	7	71	63286	0.69	2.3
Mauritius	37	51	6692	0.51	5.4
Mexico	34	65	1599	0.70	3.1
Morocco	44	16	658	0.60	3.4
Netherlands	13	0	0	1.20	8.8
Portugal	70	3	870	0.93	6.0
Slovenia	4	0	0	0.89	6.4
South Africa	22	0	4425	0.60	4.5
Spain	767	13	703	1.03	6.1
Sri Lanka	22	41	2495	0.40	3.2
Tanzania	2	0	30000	0.35	2.7
Thailand	449	0	2979	0.47	3.5
Trin. Tobago	2	100	8000	0.69	3.6
Tunisia	103	56	3454	0.47	4.3
Turkey	257	46	2188	0.68	4.4
Un Arab Em	26	0	3954	-	6.3
Un Kingdom	33	0	0	1.26	7.6
Un States	116	0	1338	1.01	7.1
Vietnam	68	0	1818	0.33	2.7

Table 1. Descriptive statistics. Price level is measured by the country's purchasing power exchange rate.

	Equation 1	Equation 2
Explanatory Variables		
Intercept	-1.953 (.000)	-2.009 (.000)
Distance	.107 (.000)	.155 (.000)
<i>Bulgaria</i>		.704 (.013)
<i>Cape Verde</i>		.178 (0.759)
<i>Croatia</i>		.113 (.839)
<i>Cuba</i>		1.478 (.022)
<i>Cyprus</i>		.705(.041)
<i>Dominican R.</i>		3.349 (.000)
<i>Egypt</i>		.879 (.000)
<i>Gambia</i>		-.692 (.511)
<i>Greece</i>		-.502 (.002)
<i>India</i>		-.724 (.242)
<i>Indonesia</i>		-1.020 (.189)
<i>Israel</i>		.160 (.838)
<i>Italy</i>		-2.227 (.000)
<i>Kenya</i>		.580 (.459)
<i>Maldives</i>		-1.078 (.642)
<i>Mauritius</i>		1.200 (.002)
<i>Mexico</i>		2.396 (.000)
<i>Morocco</i>		.234 (.584)
<i>Portugal</i>		-1.713 (.019)
<i>Sri Lanka</i>		1.248 (.006)
<i>Thailand</i>		-4.979 (.000)
<i>Tunisia</i>		1.771 (.000)
<i>Turkey</i>		1.502 (.000)
Pseudo R ²	.0484	.2619
Significance of the model P-value (Prob<chi2)	.000	.000
Number of obs.	3798	3323

Table 2. Logistic regressions. Dependent variable: All inclusive (No =0, Yes=1). P-values are in parentheses. Spain is used as the baseline country in Equation 2.