The zero-fee tour: price competition and network downgrading in Chinese tourism

Dev Nathan,¹ Yang Fuquan² and Yu Yin³

March 2013

Working Paper 28

¹ Institute for Human Development, New Delhi, India, and Duke University, US
Email: nathandev@hotmail.com

² Yunnan Academy of Social Sciences, Kunming, China
Email: fuquany@vip.sina.com

³ Kunming, China
Email: yuyin98@yahoo.com

Capturing the Gains 2013

Abstract
This paper deals with the impact of competition on the tourism network in China. It identifies the supply and demand conditions among service providers, tour operators and tourists that have led to the zero-fee tour and then deals with the impact of this intense price competition in terms of the reduction in product quality and degrading of the whole network. The paper also deals with various attempts by local governments and others to curb the zero-fee tour. It points out that price restrictions have worked in a destination that has established a brand value and, thus, has become a differentiated product. In concluding, the paper deals with the supply reductions that are needed to reduce price competition in various segments of the tourism network.

Keywords: China, tourism, price competition, product quality, network downgrading

Authors
Dev Nathan is Visiting Professor at the Institute for Human Development, New Delhi, and Visiting Research Fellow at the Center on Globalization, Governance and Competitiveness, Duke University, US.

Yang Fuquan is Vice-President, Yunnan Academy of Social Sciences, Kunming, China.

Yu Yin is an independent researcher, Kunming, China.

Acknowledgements
Miao Yun was an able field assistant in 2011 and 2012. Thanks also go to Atul Sarma for some clarifying discussions.

This document is an output from a project funded by the UK Department for International Development (DFID), the Sustainable Consumption Institute (SCI), the Chronic Poverty Research Centre (CPRC) and the Economic and Social Research Council (ESRC). However, the views expressed and information contained in it are not necessarily those of or endorsed by the funding organizations, which can accept no responsibility for such views or information or for any reliance placed on them.
Abbreviations

CPRC Chronic Poverty Research Centre
DFID Department for International Development
DM Destination Manager
ESRC Economic and Social Research Council
GPN Global Production Network
LO Local Operator
NGO Non-Governmental Organization
OTO Outbound Tour Operator
PTO Principal Tour Operator
SCI Sustainable Consumption Institute
TO Tour Operator
UK United Kingdom
US United States
WTTC World Travel and Tourism Commission
Introduction

One of the notable features of tourism in China has been the rise of the zero-fee tour, or, even more extreme, the buying of tourists, whereby service providers pay the outbound tour operator (OTO) for the tourists provided. Who then pays for the service providers and how is this done? These questions need to be answered if we are to understand this phenomenon. More important, however, is understanding the factors that have led to the rise of this phenomenon, its possible negative or downgrading effects on the tourism services’ network and ways of dealing with it. This paper takes up these questions.¹

We start by laying out the basic structure of the tourism services’ production network, along with its associated cash flow system, and then go on to consider how the zero-fee mode changes the usual cash flow system. This is followed by an analysis of both supply- and demand-side factors and the way they work through the production structure.

The fieldwork for this study was done in Lijiang and Shangri-la in Yunnan province and at the Great Wall at Badaling. These areas were chosen as representing indigenous, or minority, and mainstream or mass tourism, respectively. However, Yunnan, although an indigenous or minority area, is also an area of mass tourism: the township of Lijiang, with a population of just 300,000, receives about 10 million visitors in a year.

Initially, our investigations in these areas were of the impact of tourism on poverty reduction, of which we found substantial evidence, as analysed in Nathan et al. (2013). But it was also clear that the zero-fee tour was widely prevalent in these areas, albeit less so in Lijiang than in Shangri-la or Badaling. Discussions with scholars who had studied Dali (Bai 2010) showed that the zero-fee tour was widespread in Dali, which also falls within Yunnan province. In fact, Dali is historically more famous than Lijiang, having been an important post on the Southern Silk Route to Tibet and India. But, as we point out later in the paper, overcrowding and poor environmental management had reduced its attraction as a tourist destination. Our field investigations in Lijiang, Shangri-la and Badaling are supplemented by published material on Dali, Hong Kong and other tourist destinations in China, along with various analyses and accounts of zero-fee tours.

Structure of the Chinese tourism global production network

The tourism global production network (GPN) is what connects the customers (tourists) with the service providers (travel, accommodation, food and beverages, excursions and entertainment and shopping), all of which together provide the tourist experience (see Figure 1). There are usually two levels of intermediation between the tourist and the experience – the OTO and the local operator (LO), who can also be called the destination manager (DM). The intermediaries perform two key functions. The first is that of integration: putting together or bundling all the services

¹ The paper is based on our investigations of tourism in Lijiang, Shangri-la and Kunming of Yunnan province, supplemented by material from Dali, also in Yunnan province. The first Chinese author is a member of the Yunnan provincial cultural tourism advisory body. The second Chinese author has also closely observed the development of tourism in Yunnan. The non-Chinese author has visited and carried out fieldwork, often with one or the other of the Chinese authors, over 20 years and about 10 visits to Kunming, Lijiang, Lugu Lake, Shangri-la and other parts of Yunnan. In a more systematic manner, the authors, jointly and separately, conducted interviews with more than 50 persons involved with tourism, including tourism department and local government officials, staff of tour agencies, staff of non-governmental organizations (NGOs), operators of guesthouses and restaurants, tour guides, drivers and taxi operators and providers of horse rides and other village services. The interviews were conducted over three weeks each in March-April 2011 and June 2012.
mentioned above into one package. The second is that of aggregation: accumulating large numbers of tourists so as to secure discounts from service providers (see Paraskevas 2005).

A third function that intermediaries have traditionally performed is that of providing information about destination services. But now the information gap is being reduced through the development of the Internet and the mobile phone, which together make it increasingly possible for individual tourists to acquire the requisite information about destinations and services provided.

Acquiring information about destination services does not fully fulfil tourists’ requirements, however. There is also a trust factor to be covered. Will destination services be of the quality purchased? This is somewhat of an unknown. Earlier, besides tour operators’ (TOs’) own contracts, word of mouth used to be important in learning about the quality of services and their reliability. But here again the Internet is making a difference. Word of mouth is being replaced by customer reviews on various social networking sites. However, it is the younger tourists who tend to use these information access technologies; older tourists tend to rely more on traditional TOs for both information and trust. What also counts in the use of TOs is that this takes away all the supply chain management hassles. Tourists do not have to individually contract each service, but can just buy an appropriate package.

There are then four sets of agents in the tourism GPN: 1) tourists; 2) TOs, who can be sub-divided into OTOs; 3) LOs; and 4) tourism service providers. The business relationships between different segments of service providers (OTOs, LOs and destination service providers) are usually contracted, which is what justifies the use of the term ‘GPN’ for tourism. The lead firm in the tourism GPN is the OTO, who controls and provides the tourists for the LOs and service providers. The OTO, on the basis of customers’ requirements, decides on the quality requirements of the tour package.

In the case of China, these four agents need to be supplemented by one more – provincial and local governments. In most countries, governments play an enabling role in providing infrastructure and an overall policy framework. But in the case of China, governments, both provincial and, in particular, local, play not only supervisory but also substantial direct roles. Besides licensing various types of operators, they also own key LOs that directly operate in the market. For instance, the tourism corporation owned by the Shangri-la Tourism Department purchases all hotel rooms and then resells them to LOs, some of which are also subsidiaries of the department’s holding company.

The tourism GPN can be simplified into the following four stages, shown in Figure 1 below. In the case of inbound international tourists, there may be yet one more layer, that of national or principal tour operators (PTOs), who are intermediaries between the OTOs and the LOs. In China, most PTOs are in Beijing, Shanghai or Guangzhou; these then subcontract to LOs, in Kunming or Lijiang or elsewhere. But any TO that has the financial capacity and the permission to secure international tourists can become a PTO. The most usual entry points of foreign tourists, however, are still Beijing, Shanghai and Guangzhou. More recently, with the development of Yunnan destinations, Kunming has also become a point of entry for foreign tourists, albeit to a limited extent. TOs in Kunming do put together all-China packages for foreign tourists.
We use the term GPN in the general sense of a production network, recognizing that this production network need not be global but also can be regional or even just domestic. In fact, one of the features of Chinese tourism (see Christian and Nathan 2013 for details) is that domestic tourism far outweighs international tourism in the Chinese tourism market. As seen in Table 1, about 88 percent of total travel and tour expenditure in China is domestic and not foreign.

Table 1: Share of domestic visitor spending in tourism and travel, 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of foreign visitor spending in tourism and travel (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>88.1</td>
</tr>
<tr>
<td>India</td>
<td>82.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>79.1</td>
</tr>
<tr>
<td>Kenya</td>
<td>39.8</td>
</tr>
<tr>
<td>South Africa</td>
<td>56</td>
</tr>
<tr>
<td>Uganda</td>
<td>29</td>
</tr>
</tbody>
</table>


The increase in Chinese income per capita means people have more money and leisure time, and tourism, both domestic and international, has become increasingly popular. In 2000, urban residents’ annual discretionary income per capita was RMB 6,280 (equivalent to US$1,047). In 2011, annual discretionary income per capita had risen over threefold to RMB 21,810 (equivalent to US$3,635). Correspondingly, the total number of domestic tourists increased over threefold from 744 million in 2000 to 2,641 million in 2011. Travel and tourism spending has also increased over threefold, from RMB 317.6 billion to RMB 1,018.4 billion (about US$170 billion). And average travel and tourism spending per capita has also increased, from RMB 426.6 to RMB 731.²

The zero-fee tour\textsuperscript{3}

A tourist or a tourist group usually approaches an OTO, who makes a package, which includes the cost of transport, accommodation, food and (non-alcoholic) beverages and excursions, along with a fee for itself and for the LO, also sometimes called the DM. The zero-fee tour is a tourism package that just about covers the above costs, minus the LO’s fees. At times, the package may even be below the above costs. In either case, the LO then recovers its fees through tour guides, who get tourists to carry out shopping at designated shops or participate in entertainment, both of which give a commission to the tour guides and the LO. At times, there may even be a ‘negative commission’ package, whereby the LO pays the OTO for each tourist supplied.

In China, the relationship between the tour agency and tour guides is often not an employment relationship. Tour guides are more like freelance agents who obtain short contracts from tour agencies. Hence, most tour guides are not paid salaries when they deal with Chinese tourists. Salaries of about RMB 300 per day (US$50) are paid only when guides deal with foreign tourists. Tour guides for domestic tourists are in any case expected to earn their fees through shopping and related commissions. The shopping commissions for tour guides are about 10 percent, which they have to share with other staff, such as drivers.

In the zero-fee tour, the tour guides have to earn not just for themselves but also for the LOs. The shopping commissions for LOs in the zero-fee tour go up to 60 percent, as against the normal 30 percent. The shopping is done in designated shops, with which there are prior arrangements.

These designated shops were designed to protect tourists from being sold fake or poor quality products. Initially, they needed to get approval from the local tourism authority in order to cater to tourists. However, these days, they need no such approval. The shops are located either in the suburbs along travel routes or inside scenic spots to facilitate shopping. Most products are jewellery, herbal medicines, amulets etc. The products have one common characteristic – that sellers decide the price and customers lack the knowledge to value them. Hence, customers are easily induced by sellers to pay a high price. This information asymmetry between seller and buyer in tourist shopping is a key factor in the operations of the zero-fee tour, as also argued in Zhou and Chan (2012).

The stress of meeting local costs, including normal income, in the zero-fee tour is passed on to the tour guides and shopping by tourists. Shopping stops are marked out and tourists are cajoled or even forced to spend a certain amount of time in designated shops.

A zero-fee tour is risky, since it depends on the extent of shopping tourists carry out. Sometimes, the LOs further shift the risk on to tour guides, by making them ‘buy’ the tour. It is then up to the tour guides to recover their costs. One guide who had ‘bought’ such a group reported making a loss of RMB 1,000 (about US$160).

A GPN as a production relationship is also a cash flow relationship. In tourism, the normal cash flow along the GPN is as given below in Figure 2. The zero-fee tour reverses part of the usual cash flow along the tourism production network, as shown in Figure 3. Instead of the OTO paying a commission to the LO, the LO secures a share of shopping commissions, through the tour guides. In the case where the LO pays the OTO for the tourists sent, some of the LO’s shopping commissions may be passed on to the OTO.

\textsuperscript{3} Some of the analyses of the zero-fee tour phenomenon are, in English, Dai et al. 2011; Zhang and Qi 2009; Zhang et al. 2009; and Zhou and Chan 2012; and, in Chinese, Zhang 2006; and Zhoumin and Liang 2005.
The zero-fee tour seems to have first emerged in the case of Chinese outbound international tourism immediately after the 2003 SARS epidemic (Lu 2006; Zhou and Chan 2012a),\(^4\) when Chinese tourist numbers declined substantially. Chinese law requires all Chinese tourists to travel abroad only as part of groups (Zhang et al. 2009). When there was a sharp contraction in the market, LOs in Hong Kong, Singapore etc. did not charge their Chinese business partners the usual commissions, but instituted high shopping commissions to secure their own incomes. Over time, this practice has spread over Chinese domestic tourism, where there is no legal requirement to undertake tours only as part of organized groups. But local governments prefer group tours, since it is easier both to regulate and provide services for groups than for individual tourists.

The analysis of Zhang et al. links this system with ‘group travel as the only permitted travel mode’ (2009: 369) as one of nine key factors in this mechanism. The appearance and continuation of zero-fee tours in Chinese domestic tourism means this analysis is inadequate and there must be other features of the tourism market and its organization that account for the zero-fee tour. Group travel may promote the zero-fee tour, but it is not a necessary condition for its appearance.

What, then, are the factors in Chinese tourism that have led to the appearance and persistence of the zero-fee tour?

**Increased competition among tourism service providers**

First is the existence of over-capacity in key parts of the tourist service supply network: accommodation, guides, drivers etc. In the townships of Lijiang and Shangri-la, there is over-capacity in hotels, as admitted by local government and tourist officials in both places. Some of this

\(^4\) In Zhou and Chan (2012), the origin of the zero-fee tour is traced even earlier, back to Thailand.
over-capacity may owe to the usual overinvestment in a period of expansion, when every entrepreneur thinks she has a good business opportunity. But a contributing factor is non-commercial investment by government departments. In Lijiang, for instance, customs, forest and other government departments all have invested in hotels, having both land and a surplus of investible capital. The managements of these hotels are under no compulsion to even cover costs. As one official is reported to have pointed out, ‘It is unnecessary for hotel managers who are also government officials to worry about the revenue of the hotel, because they do not need to be responsible for the deficits of the business’ (quoted in Wang and Ap 2013). But, leaving aside amortization of capital, there is not even a requirement to recover staff costs. So such government department-run hotels can indulge in price competition.

Besides non-commercial hotels run by various government departments, there is another factor in over-capacity in tourist accommodation. This is the proliferation of guesthouses that are converted residences. In the old town of Dayan in Lijiang, the number of guesthouses keeps increasing. Similarly, along the shore of Lugu Lake, all residences have given way to guesthouses or larger hotels. These have even spread to interior parts of the villages that are not on the lake shore.

Commercial tourism service organizations, government department-run non-commercial hotels and numerous family-owned guesthouses then all vie for space in the tourism business. With the township of Lijiang itself receiving 10 million visitors in 2011, there are still shortages during the peak tourist seasons of spring and summer. But the real problem is in winter, when discounts of more than 50 percent are normal.

The number of tour agencies of various types has also grown. The number of travel agencies in China more than doubled from 8,993 in 2000 to 22,784 in 2010 (National Bureau of Statistics 2013; Zhou and Chan 2012). Tour agencies carried out price competition with their own respective customers – LOs reduced or eliminated their charges from OTOs, while OTOs reduced prices charged to tourists.

Owing to local protectionism, tour agencies generally cannot operate alone across provinces, and need local tour agencies to provide tourism services. This restricts the growth of tour agencies on a corporate scale. Hence, most tour agencies are small scale and scattered, weak in management and poor in service quality. In order for most tour agencies to survive, they try to reduce costs to attract customers, as they know the demand for tourism is highly price elastic.

Other tourism services are also over-supplied. This is so for shops, restaurants and bars. With an agglomeration effect, whole streets in the town of Dayan and the neighbouring old town are covered with bars, while others streets are almost entirely shops. Surrounding villages compete to supply horse rides and other entertainment services. Educated youth (and all youth are educated at least through middle school) from all over the township have flocked into Dayan town as tour guides and to work in various tourism-related businesses. Discussions and observations all over the region point to the villages being emptied of youth, who have all taken to tourism-related work.

Being a domestic tour guide is an occupation that almost any Chinese youth could enter, but the investment required to acquire some proficiency in foreign languages restricts the supply of such tour guides. The differences in the investment required for the two types of guides leads to differences in their supply, with domestic guides over-supplied and foreign guides in short supply. Remuneration systems are also quite different for the two types of tourist guides. Foreign tour

---

5 Data from Tourist Department, Lijiang and Kunming. The population of the township of Lijiang was less than 400,000 in 2011.
guides get a salary, which they can supplement with tips and regular shopping commissions. Domestic tour guides do not get a salary, but have to manage with tips and shopping commissions.

Two factors promote the over-supply of tourism services in the informal sector of small-scale providers. One is the ease of entry into segments of tourism service provision. Not much capital or education is required to provide these services. To be in the horse riding business, a rural family needs a set of two or three horses. For tour guides, middle school education, which all youth have, is sufficient, along with some easily acquired knowledge of local culture and history. As a result, besides accredited guides there are numerous unofficial guides, offering services at reduced prices.

This ease of entry is compounded by the absence of other non-agricultural employment in upland areas. As discussed in more detail in our study of tourism and poverty reduction in upland areas (Nathan et al. 2013), the upland areas of China and India have little manufacturing, which is the traditional route for absorbing surplus rural labour. Tourism has been the only non-farm sector that has developed in these upland regions. It has lifted not only the urban but also the rural population out of poverty, while some villages, such as Lashe on Lugu Lake, have even become one of the 10 richest villages in the province. But the absence of other non-farm employment avenues means entrants into tourism are, in a sense, trapped in it, and are not able to shift into other sectors. This works to retain over-supply and thus reduce supply price.

So far, we have dealt with service suppliers within a region. But there is an additional aspect of over-supply, which is that of the proliferation of tourist destinations. Yunnan province has airports in Kunming, Lijiang, Dali and Jing Hong. A new airport is due near Lugu Lake. Railways and expressways also connect these major centres. This is all only within Yunnan province. Other provinces in the poorer west of China, such as Sichuan and Guizhou, have also developed their own tourist centres. These are not as well established on the tourist circuit as Yunnan but they add to the supply of ‘me-too’ tourist centres.

As with sun and sand centres in South-east Asia, there is homogeneity of minority or indigenous tourist offerings in the west of China. Even if they try to differentiate themselves, which, as we see later, is an important strategy in trying to reduce competition and increase returns, most tourist offerings are forms of recreational tourism with a minority or indigenous cultural angle. Homogenization of destinations is a factor in increasing competition. A differentiated product is possible only for a few cases. But it should be noted that the zero-fee tour operates even in unique products, such as the Great Wall and the Xian terracotta armies.

**Technological factors in increased competition**

Ease of entry, absence of other non-farm employment avenues, non-commercial investment and homogenization of destinations have all been identified as factors leading to an increase in the retail suppliers of tourism services and thus increased competition among them. Technological factors also come into the picture. The Internet and the mobile phone have both had numerous impacts on tourism, chiefly in terms of reducing information gaps and enabling direct links between suppliers and customers.

LOs have traditionally played an important role in providing information and overcoming trust deficits in tourism services. Where tourists did not have much information about destination service providers, they had to rely on LOs to make packages. But destination service providers, such as hotels, guesthouses and transport operators, increasingly have web sites. Even if they do not have facilities for online payment, when supplemented by phones and credit cards bookings can be
carried out. Airlines, railways and transport operators can be accessed and booked through the Internet.

Individual service providers, such as guides and drivers, can also be contacted by mobile phone. In addition, they can also put together local packages, with accommodation, transport and excursions all taken care of. As they have gained experience of the various dimensions of tourism packages, providers of a single service have begun to operate as small-scale LOs.

The Internet and the mobile phone are together reducing, if not eliminating, the factor of ‘incomplete knowledge of the destination held by tourists before departure’, which Zhang et al (2009: 370) identify as one of the factors in the rise of the zero-fee tour in China.

Zhou and Chan (2012) too identify information asymmetry as a key factor promoting the zero-fee tour. The information asymmetry is not about tourist destination services but about prices in retail shops. Particularly in the case of jade, where there are not standard prices, tourists are unlikely to be aware of the extent of mark-up in the retail shops. But for this information asymmetry to be a factor in the zero-fee tour, shopping must be an essential component of the tourist experience. This is quite likely to be true with regard to destinations like Hong Kong or Singapore, which are well known for electronic and such items being cheaper than in China. But in the domestic destinations, such shopping is not a key factor in tourists’ choices. Shopping for mementos and gifts are part of tourism, but they may not be very expensive.

Overall, the Internet and mobile phone together reduce the information gap that was an important part of the reason for services provided by intermediaries, OTOs and LOs. As Porter wrote about the impact on the Internet on strategy, ‘Its greatest impact has been to enable the reconfiguration of existing industries that had been constrained by high costs for communicating, gathering information, or accomplishing transactions’ (2011: 66). The tourism production network, with the important role of intermediaries in providing information and managing transactions, is being reorganized by the Internet. The proportion of tourists traveling on their own, without OTOs or even LOs, is increasing. In addition, new intermediaries, the web-based agencies, such as Expedia.com, are making a new space as web-based intermediaries. For the purposes of this paper, we just note that the Internet has reduced the information gap, and that this promotes increased competition.

**Competition among lead firms**

Tourists in China, even domestic tourists, largely travel in groups. Only younger tourists and the famous ‘singles’ that throng Lijiang travel as individual families or singly. In the case of international destinations, Chinese tourists are only permitted to travel in groups. This could lead to a kind of cartelization. The OTOs could push down LOs’ supply prices, but not pass on the benefits to consumers. In this case, it would be a zero fee for the OTOs, but not for tourists. But the fact that tourists were also passed on the price benefits shows there was competition among OTOs, in both international (outbound) and domestic tourist markets.

With tourist numbers increasing every year, why was there competition among oligopolistic OTOs for tourist customers? When an economy has been consistently growing at above 8 percent a year, businesses are likely to make their annual plans on the basis of such growth. When that growth does not occur, then the effect could be like that of an actual decline in the market in the case of a slow-growing economy. When business growth is below expectations, it could spark off a price war for customers. The struggle for market share becomes a price war in a stagnant or declining market. The key periods when a decline in tourist numbers sparked off price wars are those of the 2003 SARS decline and the post-2008 global recession.
Table 2 shows that the growth rates of domestic tourism varied from over 11 percent in 2006 to just 1 percent in 2008. Such variation in rates of growth in an economy growing at above 8 percent would upset business plans and could trigger competition. Some of the impact of the variation in rates of growth is possibly reflected in a sharp fall in employment (see Row 3 of Table 2) of as much as 6.4 percent in 2008.

Table 2: China tourism growth (%)

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Tourism exports</td>
<td>9.5</td>
<td>-1.6</td>
<td>-9.3</td>
<td>-4.3</td>
<td>9.5</td>
<td>-6.3</td>
<td>7.4</td>
</tr>
<tr>
<td>2. Domestic tourism</td>
<td>11.6</td>
<td>7.6</td>
<td>1.0</td>
<td>6.7</td>
<td>2.8</td>
<td>7.7</td>
<td>9.9</td>
</tr>
<tr>
<td>3.Employment</td>
<td>3.6</td>
<td>-3.6</td>
<td>-6.4</td>
<td>0.3</td>
<td>5.0</td>
<td>1.7</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Source: WTTC (2012).

Why the zero-fee tour?

The following factors then seem to lead to price discounts leading to the zero-fee tour:

1. Competition among service providers, because of over-supply owing to:
   a. Proliferation of homogenized destinations;
   b. Non-commercial investment in accommodation and other facilities;
   c. Ease of entry at lower service levels, exacerbated in upland areas by absence of other non-farm employment avenues;
2. Competition among OTOs for customers: fluctuations in the market lead to a business strategy of struggle for volume through price competition.

Proliferation of homogenized destinations affects both supply- and demand-side conditions. Suppliers of a homogenized product cannot ask for prices higher than those prevailing elsewhere; they cannot be price makers. On the demand side, the final customers, the tourists, would not pay more for one destination that is similar to another. Homogenization of products is key to what has been identified as the ‘Chinese culture of consumption, which has traditionally emphasized the priority of low prices’ (Zhang et al. 2009: 370). When products are similar, they may be distinguished only by price. In addition, most middle-aged tourists travel with the idea of taking pictures to show they ‘have visited this place’; hence the tour cost becomes their prime consideration.

Competition among suppliers with a lead firm as monopolist buyer on the other side, classical monopsony, would enable the lead firm to corner all the benefit of supplier competition. But the situation of competition for customers among lead firms too would force the lead firms to pass on some of the benefits of low supplier prices through the zero-fee tour. With competition among both suppliers and buyers, we have the textbook case of perfect competition. Any surpluses in the GPN are passed on to consumers, the tourists, though low tour prices. But, as we see later, the effect of this dissipation of surpluses as consumer surplus is to seriously undermine and degrade the value chain or the production network.

Zhang et al. (2009: 169-170) identify a set of nine factors as the key components of the zero-fee tour mechanism in Chinese outbound international tourism:

1. Group travel as the only permitted travel mode;
2. Restrictions on local operators with regard to direct business in the source market;
3. Homogeneity in outbound tourism products;
4. Transfer of the financial burden to the local guide by the LO;
5. Incomplete knowledge of the destination by tourists before departure;
6. Misleading information from the OTO and ambiguous clauses in the tour contract;
7. Deceptive and bullying language and behaviour by the guide that encourages tourists to spend additional money during the tour;
8. Poor quality and exorbitant prices of items purchased; and
9. Ineffective post-tour complaint-handling mechanisms at origin.

Our analysis relates to both international and domestic tourism and thus does not have the factor of 'group travel as the only permitted mode of travel'. Rather, we find that group travel is the preferred mode of travel. But, whether as legal requirement or as preferred form of travel, group travel is important in giving OTOs their power in fashioning the whole production network. Groups approach OTOs, whereas individuals are much more likely to use the Internet or other direct methods of organizing their tour.

The behaviour of guides in forcing shopping (No. 7 above) is a result of the zero-fee tour, not a factor that results in the zero-fee tour. This, along with poor quality goods sold at high prices, is a component of the zero-price tour. But these may not be the reasons why such a phenomenon has come about. Rather, these practices result from or have been exacerbated by the zero-fee tour.

Our analysis of the factors leading to the rise of zero-fee tour groups subdivides these into two sets: those affecting the supply side, leading to a high level of competition among suppliers; and those affecting the demand side, leading to competition among lead firms to secure tourist numbers.

What has eroded the power of tourism service suppliers? Over-supply of facilities, ease of entry and the rise of substitute products (ever more destinations offering similar services and recreation facilities). These are standard factors in eroding supplier power in networked transactions.

More interesting is to look at the factors that have eroded the power of the lead firms, the wholesale buyers who retail packages to tourists. The major factor that seems to have eroded the power of lead firms is information. Tourists now have information about destinations, services provided and even price ranges of different qualities of service. When discounts are offered, information spreads quickly, either on the Internet or through printed pamphlets. For instance, travellers coming from Kunming Airport have leaflets thrown through car windows advertising various cut-price tours. In one way or another, information about destination attractions, price ranges and discounts spreads very quickly. This information spread only strengthens the tendency for price competition, which transfers surpluses from the lead firms to the buyers, the tourists.

**Nature of price competition**

In a perfectly competitive market, neither buyers nor sellers are price makers. Market price tends to settle at a level where costs plus normal profits are returned to the firms. Where there is a monopolist buyer or lead firm, that is, in turn, also a monopolist seller of the product, then there would be a competitive price for suppliers, but the lead firm would be able to secure all the gains from competitive suppliers. The lead firm would not be forced to pass on any of its surplus to the consumers, the tourists. In a production network with oligopolistic competition among lead firms, the price to the consumer would settle somewhere between the competitive and monopoly prices.
In the zero-fee tour, however, prices fall below the level of costs plus normal profits. What would be operating costs provided through the price mechanism are eliminated and replaced by shopping commissions. If shopping commissions are lower than normal profits all through the network, then there would be losses somewhere in the network.

To the extent that shopping commissions fully replace the money lost to tourists then normal profits could prevail in the network. But even if the network as a whole secures normal profits, it would not be distributed evenly on the basis of capital invested, in the whole network. Some service segments that are easy to enter, such as guides or drivers, may not obtain an income equal to that in an alternative occupation. This would be particularly so in upland areas, where the prospects of non-tourism employment are limited.

While perfect competition yields normal profits, the zero-fee tour yields less than normal profits. Such a situation is usually one of transition, or dis-equilibrium, as economists would put it. Some firms would go out of business, as would some own account enterprises. Employment in the network would shrink, until a situation of normal competitive prices and returns is restored. In addition, some firms would buy up others, leading to consolidation in the industry. Or, demand would rise to utilize existing capacity.

Data (Table 2) show there are substantial fluctuations in year-to-year employment in tourism in China. This is a form of adjustment. But the adjustment is being delayed by three factors. The first is the presence of non-commercial organizations (hotels run by government departments); the second is local protectionism that keeps loss-making enterprises in the business; and the third is the paucity of alternate employment in upland economies.

We next deal with the impact of the zero-fee tour on different segments of the tourism GPN.

**Effects of price competition on tourism production network**

With competition among suppliers, LOs often give discounts of up to 70 percent to the lead buyers, the OTOs. The OTOs in turn pass on some of this discount to tourists. Having given these discounts, LOs then put pressure on tour guides to retrieve the lost income through shopping commissions. Tour guides for their part increase pressure, in various ways, on tourists to spend more time and money shopping.

This system of recouping tourism chain incomes, not through straightforward additions of commissions to tour costs but through shopping commissions, affects the whole chain in a number of ways.

Commissions in normal shopping by tourists are around 30 percent. But in the zero-fee tour, shops give commissions of 50-60 percent, although tour guides and drivers together get only 5-8 percent. The high commissions in ‘zero-fee’ shopping destinations show the extent to which prices are inflated. Along with price inflation in retail shops, there is also outright cheating. Artificial gems and diamonds are sold as natural, with the cheating covered up by extra-fine print text stating that the stones were made artificially (Zhou and Chan 2012).

For tourists, with the over-emphasis on shopping there is a deterioration of the tourism experience, key components of which are relaxation and experiencing novel places. As would be expected, this shopping is also for cheap goods at highly inflated prices. While the price of the tour may be low, the tourists lose both in the quality of the experience and in the forced and high-priced shopping. In
an important manner, the quality of the tourist product is downgraded. As Zhang and Qi put it, there is a ‘dissatisfying and even disastrous travel experience of the tourists’ (2009: 21).

Various reports in Chinese newspapers\(^6\) have highlighted the abusive behaviour of tour guides when tourists do not do the expected shopping. In more than one instance, tour guides have abandoned the tourist party and left them to fend for themselves. In a survey of 2,000 tourists in six Chinese cities, some 68.5 percent reported unpleasant experiences (Lu 2006). These frequent incidents show the deleterious effects of the pressure on tour guides to earn commissions for themselves, the drivers and the LOs.

Sometime, the LOs ‘sell’ the tour party to the tour guide. Tour guides may pay about RMB 6 (US$1) or more per tourist to get a group. The LO recovers some part of its fees in this manner, and transfers the risk of the tour to the guide. The guide will then bear any loss in case the group fails to buy enough to make up for the amount paid to ‘buy’ the group. One guide who had to pay for a tourist group reported losing HK$1,000 on a tour group (Lu 2006). Desperate competition to get tourists to buy enough for guides to make a living resulted in strikes by tour guides in both Sichuan and Yunnan provinces (ibid.).

In an integrated tourist agency where the agency provides all the services, including that of guides, drivers etc., the impact of a zero-fee situation would be felt by the agency as a whole. In a production network, however, one would expect the burden of losses or of reductions in profit to fall unevenly on different segments, based on their bargaining power within the network. The production segment, where entry is easy and neither high capabilities nor large amounts of capital are required, such as with tour guides – that would be the weakest portion of the production network. They are the ones who get no salary at all but have to entirely depend on commissions. Further, they have to make sure they secure this commission not only for themselves but also for other service providers, such as the LOs. As the buying of tour groups shows, they may end up bearing most of the business risks (Zhou and Chan 2012).

The need to pay commissions to tour guides and through them to the LOs affects quality in other segments of the tourism GPN as well. For instance, restaurants are forced to give commissions to tour guides who bring them customers. The result could be that the restaurant gets an effective price of, say, RMB 6 per person for a set meal, while RMB 4 of the customer price of RMB 10 goes to the tour guide and the LO (Dai et al. 2011). With restaurant profit margins cut in this manner, there is bound to be deterioration in food quality.

Hotels and other providers of accommodation also have their margins cut by the commissions they have to pay. Competition does not allow them to raise prices; rather, margins have to be cut. This will affect both the quality of care and the ability of the hotel or guesthouse owners to recoup their investments and earn normal profits. Besides a fall in the quality of hotel care, there will be a fall in surpluses available for reinvestment, essential to maintaining quality.

What the above points show is that profits all along the chain are likely to fall below normal levels. This could also end with the local tour industry in a debt chain, as tour agencies are unable to pay for the hotel, the tour bus and restaurants, leading to further deterioration in tour services. This will affect the quality of service and products and of the whole tourism experience, as tourists are forced to increase their time shopping. In effect, there will be a downgrading of the whole network.

\(^6\) We refer to a few of the reports easily available in the English language press, e.g. Asia Times Online (2007) and China Daily (2011).
Price wars will affect ability to carry out renovations, let alone improvements and upgrading. The economic results will affect reinvestment and the sustainability of the tourism network.

The effects of this downgrading on the quality of the tourist experience are clear from the reports mentioned above. But their inevitable impact on earnings along the value chain was not so obvious in our field investigations, which were in Lijiang township and its villages, including Lugu Lake. As mentioned below, Lijiang has managed to control the zero-fee tour owing to the success of its branding. As such, the negative impacts of the zero-fee tour on the incomes of various actors along the network did not show up. But analysis of Dali (Dai et al. 2011) and discussions in Shangri-la and Kunming did bring out the negative impacts on incomes along the network.

Table 2 shows the impact on employment in tourism and travel. Employment fell by as much as 6.4 percent in 2006. Such an impact is likely to have been less in the mountain areas, where alternative employment is less available. In such areas, those working in tourism would have stayed on and accepted a decline in income. Discussions with tour guides in Shangri-la pointed to such declines in income, while employment did not change.

The share of zero-fee tours in total tours seems to be rising. For Hong Kong, an estimated 60 percent of LOs operated zero-fee tours in 2006, and this went up to 90 percent in 2008 after the global recession set in (Zhou and Chan 2012). The Hong Kong Tourism Board estimates the proportion of tour groups under the zero-fee system to take 85 percent of all Chinese tourists. This means just 15 percent of Chinese tourists to Hong Kong pay for high-quality regular tours (ibid.). This would clearly mean serious degradation of the tourism production network.

Deterioration in quality of services, decline in the incomes of service providers and, most importantly, erosion of the ability to reinvest in providing quality services – all these are bound to degrade the network. Destinations that are able to brand themselves and secure some rent may, however, be able to escape such degradation. In addition, there are quality-conscious tourists, who want better service and will pay higher rates. The higher-quality segment would be better maintained, while the zero-fee segment would be degraded.

While there are two different segments of tours, full-cost and zero-fee tours, TOs, whether OTOs or LOs, are not differentiated by the type of service they provide. Both full-cost and zero-fee tours are provided by all operators. There is a difference in TOs by tourism segment only in the case of foreign tourists. Only those TOs registered to deal with foreign tourists are allowed to receive them. And, as pointed out earlier, at the level of tour guides, there is a difference between those who deal with foreign and domestic tourists. The former get a salary plus commissions, the latter only commissions. A higher-quality product is related to better employment conditions for tour guides.

Our analysis leads to the hypothesis that high levels of competition at both service provider ends, origin and destination, have eroded the overall profitability of the tourism network. To the extent that some profits are retained, this depends on shopping or the limited high-quality segment.

At an analytical level, the role of shopping commissions as key to earnings in the tourism production network shows that shopping must be included as part of the tourism network, not as something outside it. Souvenirs and gifts for family and friends are part of the tourism experience. Besides high-end shopping for jewellery, local handicrafts and clothes often play a part. The share of shopping in total expenditures varies from 10 to 40 percent in China. At one level, budget tourists may well prefer to minimize expenditure on services and maximize expenditure on shopping. The latter provides some goods the tourists can take back; the former is spent just on
services, with nothing to show afterwards. The share of shopping expenditure in overall tourist expenditure in different price segments would be an interesting issue to investigate.

**Dealing with the zero-fee tour**

Alarmed by the negative effects of the high level of price competition and the spread of zero-fee tours, local governments have taken many steps to try to control competition and sustain prices. The main steps have been to reduce supply through administrative measures.

To regulate tourism prices and make the tourism market more orderly, the State Development Planning Commission and Tourism Administration Department in Yunnan issued regulations such as ‘On strengthening tourism prices management consolidation order notice’ and ‘The scenic spots’ tickets price management measures’. But governments are still weak in regulating the intense price competition among tour agencies.

In Shangri-la township, the local government, through its fully owned tourist corporation, bought up all hotel rooms and then resold them to tour operators. This was an attempt to maintain a price level and not allow discounts. In Lijiang, the local government forced hotels to close by rotation in the off-season, which was the period of the deepest discounts. In Dali too, the local government took similar measures to reduce competition in the market for hotel rooms.

In Shangri-la, competition took on an ethnic character of Han–Tibetan conflict: Han hotel operators, with higher financial staying power, were able to out-compete Tibetan operators. Because of this potential for ethnic conflict, the local government was very strict in not allowing formal hotel room prices to fall. But this does not mean hotels may not have been returning commissions in cash. With regard to a similar situation of local government price regulation of accommodation and catering in Dali, ‘these establishments still provided cash commissions to tour guides in order to increase their share of the available tourists’ (Dai et al. 2011: 157). Our discussions in Shangri-la also revealed cash commissions being paid to circumvent government controls on prices.

Further, while local governments could to some extent regulate the formal sector, they have not been able to do much about the informal sector. Small guesthouses and small-scale LOs have proliferated in a growing informal sector. These are outside the purview of government regulation and could continue to keep down prices.

At times, OTOs, LOs and informal service providers have colluded to circumvent government regulations. In Dali, when the local government tried to keep hotel prices high, an alliance of these actors set up a half-day sightseeing itinerary and then took the group to Lijiang, skipping any overnight stay in Dali (Dai et al. 2011). This led to the government organizations incurring losses.

Local government regulation of accommodation seems to have been more successful in Lijiang than in either Dali or Shangri-la. There seem to have been two interrelated reasons for this. The first was that Lijiang had established itself as a differentiated product in a generally homogenized market. It was the preferred Spring Festival destination in China, with its quasi-matrilineral status being a special attraction. Established brand status meant Lijiang could keep its prices higher than, say, Dali or other destinations in Yunnan.

Related to its established brand status was the fact that its surplus of rooms was basically a seasonal phenomenon. In spring and summer, and in fact right till winter, rooms remain in short supply. As mentioned earlier, Lijiang received a total of 10 million visitors in 2011. It is only in
winter that rooms are in surplus. Consequently, the rationing of rooms is not a year-long but only a winter matter, making it easier to implement than if it had been a year-long problem.

A third possible factor is the growing importance of young, single men and women in Lijiang tourism. This increases the proportion of tourists who make their own, direct arrangements through the Internet and by mobile phone.

The main factor in Lijiang being able to withstand competitive pressures better than Dali or Shangri-la is its brand status. Establishing a differentiated product, which need not force its LOs into price competition, was the main strategy to counter intense competition. The differentiated product allows service suppliers to command a higher price. Rents earned in this manner enabled better income conditions all along the network, compared with destinations that were forced into competitive price-cutting.

Even with a homogenized product, at a local, that is, village level, it was possible to establish some control over supply. Villages in Lijiang that provided horse rides and similar rural experiences initially started providing such services on an individual, or household, basis. But this led to intravillage competition to secure more tourists, which soon degenerated into competitive price-cutting, which hurt all operators. Given the villages’ history of party organized cooperation, it was not long before the villages set up cooperative rotational systems of accessing tourists. This eliminated individual attempts to secure more tourists by cutting prices. Such collective village actions spread through Lijiang. And 10 million tourists in 2011 kept up the overall demand for excursions by urban tourists eager for a rural or mountain experience.

In the villages around Lugu Lake, village governments set up similar cooperative rotational access to tourists for those providing horse or boat rides. In the first place, only those families that did not have guesthouses were allowed to provide these lower-income excursion facilities. That itself limited supply of such tourist services. Those who invested in providing these services were then required to follow a strict rotational system.

Given that these village excursion service providers were individual-based and small-scale, why was there not the type of competition noticed in Dali and Lijiang? Why did rotational access to tourists work? The reason must be the close and intense nature of village interaction. In close-knit communities, violations of cooperative rules would immediately be noticed and could be punished by the village government. In urban centres, however, service providers are both more numerous and not so well known to each other. As the literature of cooperation, starting with Axelrod (1984), suggests, cooperation is more likely to be successful in small-scale societies, such as villages, than in larger-scale societies, such as cities.

Controlling supply on the market and thus propping up supply price was thus key to combating the zero-price tour. At the destination level, whether in Lijiang, Dali or Shangri-la, the ability to implement a policy of controlling supply depended on the ability to develop and maintain a differentiated product, a brand that could earn some rents through premium prices on the market. Earning higher returns through branding could control the struggle to secure volume through competitive price-cutting. In a sense, higher-value products, giving higher returns per tourist, could control the struggle to secure higher volume, trying to compensate for lower returns per tourist through increasing market share.

But in destinations that are not able to break out of the pack of homogenized products, there will have to be some reduction of supply. Administrative arrangements to restrain completion without reducing supply are not likely to be successful. As the experiences mentioned above show, such
administrative measures are likely to work temporarily but will inevitably be subverted by the various agencies in the network.

**Conclusion**

This paper has argued that a combination of competition among service providers and simultaneous competition among lead firms for tourist customers could lead to product prices falling below full cost levels, as reflected in the phenomenon of the zero-fee tour. Rather than different agents in the production network securing and sharing profits produced in the network, these profits are distributed away from producers in the network and, through lower prices of the products, end up as consumer surpluses. Over time, such a dissipation of producer surpluses as consumer surpluses is bound to lead to deterioration in the quality of production in the network. There could be a painful process of adjustment as excess capacity is reduced. Given the ease of entry of small-scale service providers in the informal sector, a reduction of capacity will very much depend on the growth of alternate employment opportunities.

This is an extreme form of the Prebisch-Singer thesis, as extended by Kaplinsky (2005) to manufacturing in global value chains. In Kaplinsky’s analysis, the negative effects were felt by the commoditized manufacturers in the commoditized segment, e.g. cut-make-trim garment work. In the zero-fee tour case, the negative effect is felt not only in the lowest segment, namely, tour guides, but also all along the network. There is degradation of the network itself, or at least of a major part of it, the low-price segment. Network degradation or downgrading is likely to be more with single-service providers than with multiple-service providers.

What leads to this network degradation effect is the existence of high competition among lead firms too, resulting in at least some of the surpluses being transferred out of the production network to consumers. This degrades the quality of the service.

The major interventions in combating the zero-fee tour have been in terms of controlling supply. Sometimes supply is restricted, so that the supply price does not fall. At other times, supply is restricted and, simultaneously, prices are controlled. But we have seen that supply restriction is effective in increasing prices only when it is combined with brand building, which helps gain higher prices. These higher prices leading to higher returns can restrict or even eliminate the competitive search for market share.

In addition, supply is affected by the ease with which small-scale suppliers can enter the market. This limits the effectiveness of supply restrictions, which work through the formal organizational structure. Over-crowding at the lower end of the supply chain is a feature of economic regions, viz. the uplands, where there are no alternative, non-farm occupations available. Tourism tends to be the residual sector, absorbing all those who are getting out of agriculture. This problem can be taken care of by the development of other, non-tourist occupations. At some point, a reduction of supply or capacity is needed to reduce price competition.

Supply-side restrictions are difficult to implement, and that too for a long period, when there is already over-capacity and entry is not too difficult, particularly at the lower end of small-scale service delivery and where some units in the market are not commercial, or receive local government support to remain in business. Reductions of capacity and brand building are then two ways to deal with the intense competition that has become a ubiquitous feature of the tourism production network in China.
References


Capturing the Gains brings together an international network of experts from North and South. The research programme is designed to engage and influence actors in the private sector, civil society, government and multi-lateral organizations. It aims to promote strategies for decent work in global production networks and for fairer international trade.