

POLICY BRIEF

MINIMUM ROOM RATES

1. Introduction

The tourism industry stands as a pillar of Sri Lanka's economy, drawing visitors from across the globe to experience the country's rich cultural heritage, pristine beaches, and captivating landscapes. It is the third largest export earner after remittances and textiles/garments, attracting 767,913 tourists and earning a revenue of USD 1.09 Bn between January and July of 2023¹.

In recent years, the tourism landscape in Sri Lanka has evolved, markedly by a diverse array of options for accommodation catering to an equally diverse range of travelers. Recently, the idea of implementing minimum room rates for hotels in the city of Colombo has garnered attention as a potential strategy to ensure fair competition by limiting alleged price undercutting by higher end hotels, to reposition the country as a high-end holiday destination and boost foreign earnings.

The proposed minimum room rates seek to place a rate of USD 100 on 5 star hotels, USD 75 for 4 star hotels, USD 50 for 3 star hotels, USD 35 for 2 star hotels, and USD 20 for 1 star hotels within the city of Colombo, effective from October 1st, 2023. These rates exclude service charges and other applicable taxes, fees or charges. If the service fee and taxes were included, a double room with bread and breakfast in a 5 star hotel will amount to USD 156.30 at a minimum. With the VAT increase starting, 1st January 2024 to 18%, this will increase to USD 162.

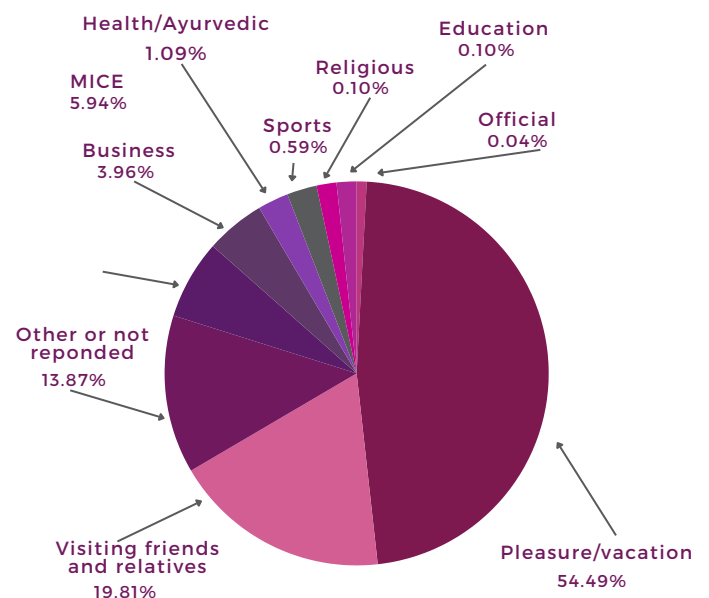
This will, in effect, act as a price control, ensuring that hotels within these star classifications located within the city of Colombo cannot price their rooms at rates lower than those prescribed by the government. This policy brief will explore the dynamics of the hotel industry and provide a critical analysis of the potential consequences and challenges of implementing this scheme.

By critically evaluating these effects, we aim to provide policymakers and stakeholders with a holistic perspective to inform their decisions.

2. Overview of the tourism industry

An analysis of Sri Lanka's inbound tourism shows the diversity of tourists the country attracts, not just in their country of origin but also with the reasons governing their travel into the country. While a majority of tourists arrive to vacation and visit with loved ones, there are others that arrive for business, religious purposes, and MICE (Meetings, Incentives, Conferences and Exhibitions) events among others. According to the Sri Lanka Tourism Authority's data from December 2022, the breakdown of tourist arrivals by purpose of visit is given in Figure 1.

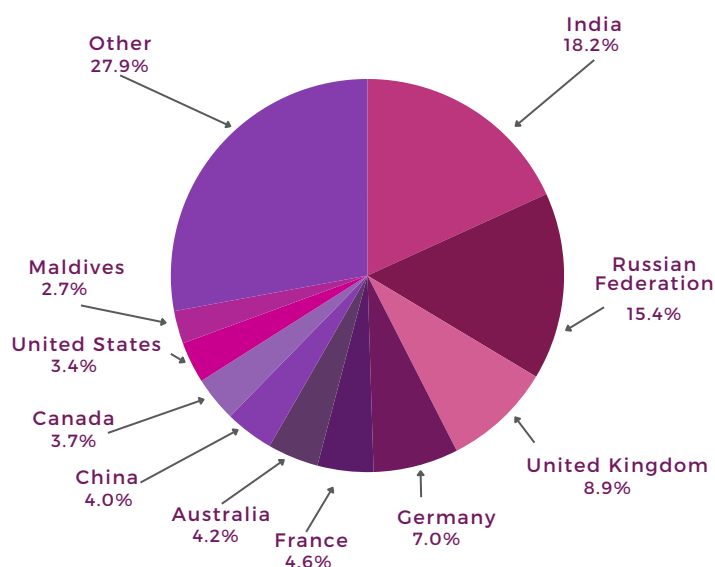
Figure 1: Breakdown of tourist arrivals by purpose of visit during December 2022.



Source: Monthly Tourist Arrivals Report: A Monthly Snapshot of International Arrivals to Sri Lanka from Immigration Statistics December 2022, Sri Lanka Tourism Development Authority

Further, the largest in-bound tourism source market for Sri Lanka is India, closely followed by the Russian Federation, and the United Kingdom. According to the Sri Lanka Tourism Development Authority, the largest source markets for the country from January to July 2023 are given in Figure 2:

Figure 2: The largest source markets for Sri Lanka from January to July 2023



Source: Year in Review August 2023, Sri Lanka Tourism Development Authority

3. Issues with the policy proposed by the government

Government intervention can only be justified in the presence of abject market failure. Market failure is categorized as when the market does not reflect the economic realities of a market, broadly categorized under three areas; existence of a monopoly, information asymmetry, and externalities. It is clear that the hotel industry does not exist as a monopoly owing to the plethora of players in the market. Therefore it is prudent to explore the other two possibilities of market failure that would warrant government intervention.

In brief summary, information asymmetry speaks to a situation in which either the producer or the consumer is not aware of, completely or correctly, the circumstances the market faces. A vital condition for the success of a market is the availability of complete information as well as free access to it. The alleged price undercutting that forced the government to step in did not result in substantial or tangible harm to either the hotel sector nor the consumer.

There was no indication of an artificial drop or rise in demand/supply. In the hotel industry in particular, given the widespread use of online booking platforms, price discovery happens in real time.

Externalities present themselves in two forms; positive and negative. Negative externalities are ones that give way to third party harm. In short it must be proved that by the purported price undercutting, there existed harm to either the consumer, the industry itself, or some aspect of society.

In the absence of the above, government intervention is not in any way warranted. Notwithstanding the need for intervention, price controls especially in a market sector that is price sensitive is not the overarching solution.

Price controls exist primarily in two dimensions; price ceilings and price floors. A price ceiling is introduced with the aim of protecting the customer from asymmetric information that prevents them from participating in a fair market. A price floor is used to protect the supplier in a market where the market price does not reflect the costs of production and the bargaining power is tilted in favour of the buyer due to a fragmented supply and concentrated demand. The price control system utilized in the hotel industry, is one of a price floor. The rates place a binding on the lowest rate a hotel can price their rooms at. However, the bargaining power imbalance favouring the consumers is not observed in this industry as the suppliers covered by this policy are large.

The fundamental problem with a policy imposing price controls is that it distorts the hidden hand of the market: pricing. Prices are not only a measure of value but also provides incentives and acts as a signal in a market economy.² They signal to the buyers and sellers the perceived quality and relative scarcity of a good or service through shortages and surpluses, and assists hotels to respond to changing market conditions. This is observed during off peak seasons, when hotels offer discounts, promotional packages, and other incentives to induce demand. In tandem, they play a role in achieving allocative efficiency³ by determining the equilibrium between supply and demand for a given product and setting the price accordingly.

In addition, pricing is a key component of a firm's marketing strategy. It serves as an important tool a hotel can utilize to distinguish itself from competitors. Consequently, any interference with their pricing strategy disrupts their ability to effectively market themselves and target different customer demographics.

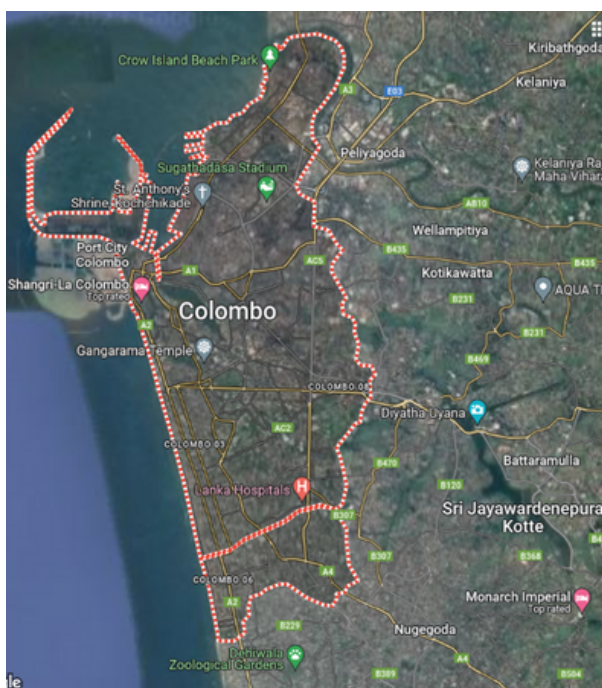
Therefore, the implementation of this policy artificially distorts prices and thereby, market equilibrium. This creates surpluses and shortages, thereby preventing allocative efficiency from being achieved. Further, this eliminates the incentive for hotels to optimize efficiency and maintain cost-effectiveness.

In addition to the fundamental problem, an analysis of the proposed policy uncovers the following shortcomings:

3.1. Geographical scope of the policy

The implementation of this policy is restricted to Colombo city limits. This implies that hotels located outside this region will have a competitive edge at the expense of Colombo hotels. In short, while trying to fix a problem that didn't exist in the first place, it creates another, discriminating against hotels within Colombo city limits for no reason other than arbitrary delineation.

Figure 3: Colombo City Limits



Hotels situated outside the jurisdiction of this proposed policy are in a position to offer accommodation at cheaper rates than their Colombo rivals, then resulting in a substantial loss of revenue for hotels in Colombo. Another consideration that needs to be taken into account, is that this policy is applicable exclusively to hotels and not to alternative forms of accommodation like Airbnbs, HomeExchange, holiday homes, and bungalows.

Moreover, this policy is likely to disproportionately hinder certain sectors of tourism such as the MICE (Meetings, Incentives, Conventions, and Exhibitions) industry. This industry, one of the tourism industry's fastest growing sectors, refers to a specialized niche group of tourism dedicated to planning, booking, and facilitating conferences, seminars, and other events. In October 2023, MICE tourism accounted for 5% of inbound tourism. MICE tourism is concentrated in cities owing to the larger prevalence of infrastructure supporting this sector, with Singapore, Bangkok, Kuala Lumpur, and Mumbai being the leading destinations for Asia. Further, a key factor influencing a destination's appeal in this industry is the cost of accommodation, given that bookings are made in bulk. The letter by the SLTDA imposes a maximum complimentary room allocation as well. Therefore, the implementation of minimum room rates will not only impact hotels in Colombo but will also make Sri Lanka, as a destination, more expensive for this category of tourism. The impact of this is amplified by Sri Lanka's geographic access to key MICE markets in Asia. Hotel rooms, especially in this category of tourism, are tradeable goods, as a hotel room in Colombo can be readily substituted with one in other parts of the country or even regionally.

3.2. Seasonality of demand

It is imperative to recognise the demand patterns within the hotel industry exhibit traits of seasonality. A study of tourist arrivals to Sri Lanka over the period 2010-2018 reveals that, on average, tourist arrivals peak in December and slumps in May and June (Appendix 1).⁴

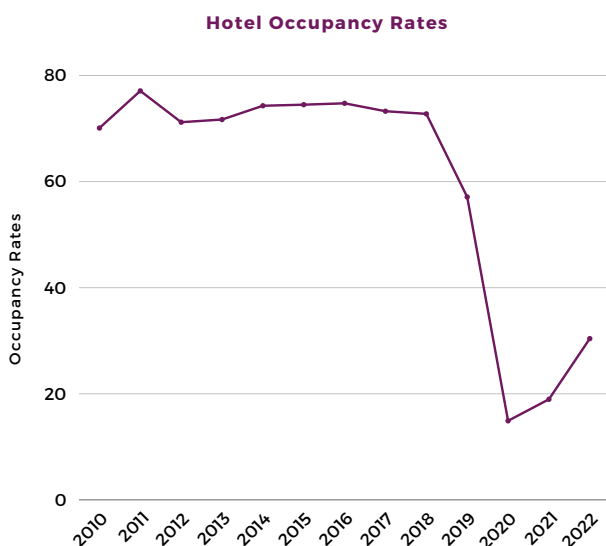
Essentially, permitting hotels to determine their pricing strategies in accordance with these seasonal demand patterns enables them to optimize their revenue. Infringing on the autonomy of hoteliers to determine room rates undermines their ability to devise their own marketing strategy as well as interfering with the day-to day operations of the hotel.

3.2.1. Hotel occupancy rates

Hotel occupancy rates constitute a vital Key Performance Indicator (KPI) that is employed by hoteliers in order to determine the success rate of their hotels. An ideal hotel occupancy rate falls within the range of approximately 70-95%.⁵ This KPI is calculated by dividing the number of rooms sold by the total number of rooms in the hotel.

Sri Lanka's hotel occupancy rates exhibited an average of 70% from 2010 to 2018, thereby falling into the acceptable range as given in Figure 3. However, following the 2019 Easter bombings, this value plunged to 57% and this downward spiral continued with the Covid-19 pandemic, and the economic and political crisis Sri Lanka experienced in 2022. Since 2020, this KPI has not surpassed the 30% mark.

Figure 4: Hotel occupancy rates for Sri Lanka 2010-2022.



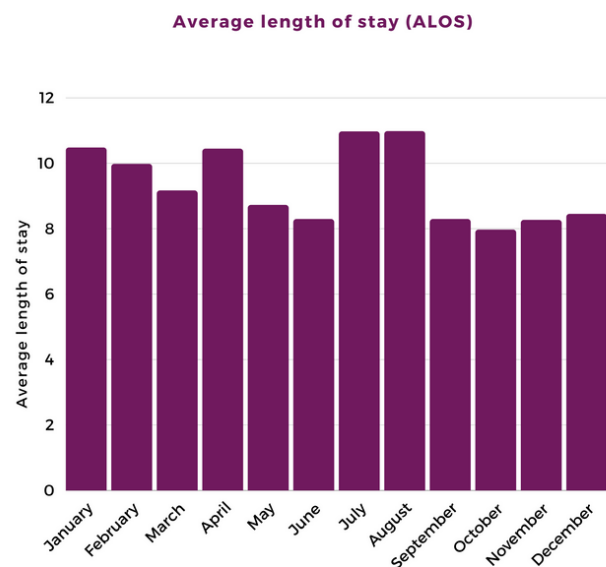
Source - Tourism Growth Trends - 1985 to 2022, Sri Lanka Tourism Development Authority

3.2.2. Average length of stay

Another critical KPI adopted by hoteliers is the Average Length of Stay (ALOS), calculated by dividing the number of occupied room nights by the total number of bookings. The ideal value for this particular indicator differs significantly from country to country.

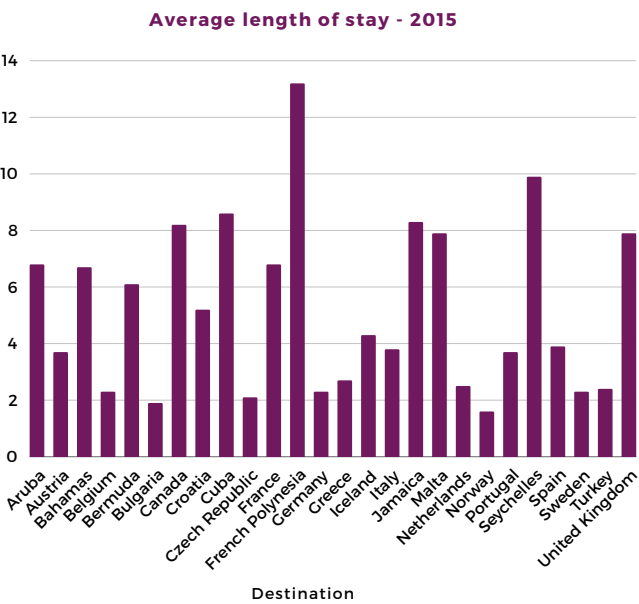
Several factors contribute to the determination of ALOS, including the socio-economic traits of the target demographic and destination attributes. Although hoteliers wield limited control over the first two factors, they can exert some influence on expenditure. Since expenditure and ALOS have an inverse relationship, maintaining low room rates will increase this indicator.⁶ Improving hotel occupancy rates as well as average length of stay (ALOS) is dependent on the employment of a sound marketing strategy. The ALOS for Sri Lanka and other countries is given in Figure 5 and 6 respectively.

Figure 5: Average Length of Stay for Sri Lanka Hotels in 2022.



Source - Year In Review 2022, Sri Lanka Tourism Development Authority

Figure 6: International Comparison for Average Length of Stay, 2015



Source - Global Trends in Length of Stay: Implications for Destination Management and Climate Change, 2018, Journal of Sustainable Tourism

3.3. Star classifications

Hotel star ratings within Sri Lanka predominantly rely on tangible features such as furnishings instead of service quality.⁷ These requirements are all quantitative in nature and centered around the availability of certain equipment and facilities, rather than the quality of service. This framework places hotels that prioritize qualitative measures such as superior service, excellent cuisine, or ambience to distinguish itself from competitors at a marked disadvantage. This predicament applies specifically to smaller hotels that may be financially constrained and therefore unable to acquire all the fixtures and fittings of a larger hotel. If these requirements were amended to reflect quality of service, these smaller hotels which typically focus more on customer service, could attain a higher ranking. Accordingly the hotels must also pay a licensing and a registration fee stipulated by this new policy

Table 1: Licencing and registration fees according to the gazette

SCHEDULE II

The fees payable for re-registration and licensing, in ruppes (Rs) shall be as follows :-

Category	Re-Registration fee (Rs)	Licensing fee(Rs)
five- star tourist hotels	3,000,000	2,000,000
four- star tourist hotels	1,500,000	2,300,000
three- star tourist hotels	1,850,000	1,200,000
two- star tourist hotels	1,500,000	1,000,000
One- star tourist hotels	1,100,000	750,000

The absence of a universally accepted international hotel accreditation standard results in countries having full discretion when it comes to determining their classification systems. Consequently, these star ratings may not align with international standards, thereby presenting serious challenges when it comes to making cross-country comparisons in this regard.

These regulations only exist for SLTDA approved hotels, allowing for other hotels within Colombo city limits to provide rooms for below price controlled amounts.

TThe policy carries the assumption that all hotels within a classification are equal in their services offered and fails to account for differences that hotels utilize to distinguish themselves from competitors.

Even within a specific category, such as the 5-star classification, there exist significant differences in the quality of service offered owing to differences in amenities and overall service. These distinctions are often reflected in the wide range of prices charged by hotels, even within a specific star category. The imposition of a standardized price, without allowing hotels to set prices reflective of their unique quality of service will pose a challenge, as hotels within the same star category may face a disadvantage as they are constrained to a mandated rate, potentially losing to competitors who can deliver better value for the rate set by the government.

3.5. Enforcement issues

Another challenge arising from the implementation of this policy lies in its enforcement. Notably, this is not Sri Lanka's first attempt to implement minimum room rates. A previous attempt at introducing such rates took place from 2009 to 2019, to very limited success, driven by lobbying efforts from 4-star hotels. These establishments alleged that 5-star hotels engaged in price undercutting, prompting the policy's implementation. The limited success was driven by hotels that found ways to circumvent the minimum rate. What assurance can or will be made to prove that this time will be different? The effective enforcement of this policy necessitates the establishment of a mechanism that will ensure that the policy isn't violated, which requires a large investment of resources.

Perusal of the letter guiding Colombo City hotels by the Sri Lanka Tourism Development Authority indicates the purported solution to a lack of resources that may arise in enforcement is putting the onus of proving adherence to the policy on the hotels themselves.

The sections concerning adherences reads as follows:

"Three Internationally reputed audit companies will be appointed to audit adherence/compliance to the above-mentioned Gazette notification.

The auditors will be given the names and contact numbers of each hotel General Manager. Prior notice will be given for the general audits.

Three main meals and soft beverages are to be provided by the respective hotel for the auditors. (Maximum 4 persons).

The payment for the audits will have to be borne by the respective hotel."

According to these guidelines, not only do the hotels have to be subject to general audits by "three internationally reputed audit companies" but have to bear all costs involved. This adds further cost to city hotels whose bottom line will be impacted heavily by price controls.

Conclusion

In addition to the primary concerns associated with government intervention through price controls on the hotel industry, namely price distortions and allocative inefficiency, significant issues arise with regards to the effective implementation of this policy. In light of the recent turbulent years endured by the Sri Lankan tourism industry, this policy is the worst course of action that can be taken by the government. It places the industry at a considerable disadvantage against regional and global competitors, at a time when a global slowdown looms large on the horizon, and positioning itself as a cost-effective alternative to other destinations is crucial to redeem the tourist industry. Rather than pursuing this policy, the government should focus their attention on increasing inbound tourism through public relations campaigns, promoting tourism, and investing in developing existing bottlenecked infrastructure, such as airports.

Appendix 1: In-bound tourist arrivals into Sri Lanka for the period 2010-2018

Months	Number of tourists								
	2010	2011	2012	2013	2014	2015	2016	2017	2018
January	50,757	74,197	85,874	110,543	146,575	156,246	194,280	219,360	238,924
February	57,300	65,797	83,549	113,968	141,878	165,541	197,697	197,517	235,618
March	52,352	75,130	91,102	113,208	133,048	157,051	192,841	188,076	233,382
April	38,300	63,835	69,591	80,737	112,631	122,217	136,367	160,249	180,429
May	35,213	48,943	57,506	74,838	90,046	113,529	125,044	121,891	129,466
June	44,730	53,636	65,245	90,279	103,175	115,467	118,038	123,351	146,828
July	63,339	83,786	90,338	107,016	133,971	175,804	209,351	205,482	217,829
August	55,898	72,463	79,456	123,269	140,319	166,610	186,288	190,928	200,359
September	47,339	60,219	71,111	90,339	105,535	143,374	148,499	145,077	149,087
October	52,370	69,563	80,379	107,058	121,576	132,280	150,419	152,429	153,123
November	72,251	90,889	109,202	109,420	119,727	144,147	167,217	167,511	195,582
December	84,627	97,517	122,252	153,918	178,672	206,114	224,791	244,536	253,169

Appendix 2: Minimum requirements for star classifications

2.1 Mandatory requirements for 1 and 2 star hotels

Items	Facilities
Bed Rooms	<ul style="list-style-type: none">Centrally located safe deposit facilities or individual safe deposit lockers shall be available
Restaurants and bars	<ul style="list-style-type: none">Suitable glass washing facilities with running hot and cold water with a mixer tap Bars shall be available in the bar
Kitchens	<ul style="list-style-type: none">Where dishwashers are not available, three sinks with hot & cold water with mixer taps shall be available exclusively to be used for dish washing purposes.

2.2 Mandatory requirements for 3,4 and 5 star hotels

Items	Facilities
Hotel Building	<ul style="list-style-type: none">5 star Hotels shall have a minimum of 30 rooms including 3 suites. The minimum area of the suite shall be not less than 65sq.m. Each suite shall consist of a bed room with attached toilet, living and dining area with a pantry.4 star Hotels shall have a minimum of 30 rooms including 2 suites. The minimum area of the suite shall be not less than 45 sq.m. Each suite shall consist of a bed room with attached toilet, living and dining area with pantry.3 star Hotels shall have a minimum of 30 rooms including 1 suite. The minimum area of the suite shall be not less than 45sq.m. Each suite shall consist of a bed room with attached toilet, living and dining area.
Main Services	<ul style="list-style-type: none">A generator capable of providing 100% back up power supply shall be available in case of failure of main power supply.Adequate number of service elevator/s shall be available for hotels/ buildings with more than three floors including the ground floor.
Bed Rooms	<ul style="list-style-type: none">The main door lock shall be on a master key/card system and shall have a double locking facility from within, which shall open from outside only . with an emergency master key/card.Keyless safety deposit locker of adequate size shall be provided in each bedroom.

Restaurants and Bars	<ul style="list-style-type: none"> • An additional bar maintaining comfort conditions with either cooling or heating shall be available. • A glass washing machine shall be available in the bar. • An ice cube-making machine connected to a sterilized potable water supply shall be available in the bar. • A room service facility with a wide variety of food and beverage shall be available. • Five and Four star hotels shall have a coffee shop or in-room dining facility operating for 24 hours.
Kitchen	<ul style="list-style-type: none"> • Kitchen floor shall be of impervious materials conducive for easy cleaning and shall not be slippery. • There shall be a dish washing machine with a pre-wash sink and dishwasher crates for all items of cutlery, crockery and glassware. • There shall be a separate Glass Washing machine. • All cooking appliances shall be provided with an Exhaust Hood Canopy equipped with Grease Filters to extract hot air and odours effectively. • The pot wash shall be separated and shall have a stainless steel sink with hot and cold water through a mixer tap
Stores	<ul style="list-style-type: none"> • Meat, sea food, processed food and dairy products shall be stored separately at correct temperatures suitable for the intended period of storage
Sanitary Requirements	<ul style="list-style-type: none"> • Wet garbage shall be stored in a temperature controlled space, with finishes conducive for easy cleaning until disposed of. • Kitchen wastewater shall be directed to a Grease Trap where accumulated grease is removed and disposed of regularly.
Facilities for Drivers	<ul style="list-style-type: none"> • Separate adequate toilet facilities shall be available for the use of drivers.
Staff	<ul style="list-style-type: none"> • There shall be two or more staff speaking foreign languages other than English, if necessary. The front office staff including the Guest Relations Officers shall have a good knowledge of English.

Endnotes

- (1). [Year-in-Review-2023 -August-Final-2023.10.04.pdf \(sltda.gov.lk\)](#)
- (2). [price | Demand, Supply & Market Equilibrium Definition | Britannica Money](#)
- (3). Allocative efficiency ensures that production is aligned with consumer preferences
- (4) For the purpose of this analysis, tourist arrivals are utilized as a proxy for hotel occupancy, with the caveat that the years 2019 - 2022 have been omitted due to external shocks such as the Easter bombings, Covid-19 and economic and political crisis.
- (5) [https://ratetiger.com/what-is-a-good-hotel-occupancy-rate/](#)
- (6) [https://www.researchgate.net/publication/248500860_The_length_of_stay_in_tourism](#)
- (7) In Sri Lanka, the classification of hotels into distinct categories is presented in a gazette published in 2016. According to this gazette, certain mandatory requirements have to be met in order for a hotel to be classified as a 1,2,3,4 or 5 star hotel (Appendix 2). In addition to these criteria, there are several non-mandatory requirements outlined, each with marks attached to each standard that is met. The cumulative total of these marks helps determine the classification. In accordance with this gazette, a star class hotel is subject to reclassification every three years.