

# Tourism Cluster in Italy

Microeconomics of Competitiveness Final Report

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## Executive Summary

Italy is Europe's 4th largest economy and the 7th largest economy in the world with a GDP per capita of \$30 700<sup>i</sup>. Despite a turbulent political history, modern Italy, founded in 1861, has been at the forefront of European economic and political unification. In spite of its prosperity and GDP CAGR of 4.4% (1980-2009), growth has been slower than other major countries. In addition, persistent regional inequality has left the Southern regions lagging behind the North in terms of development.

The Italian economy has benefitted from its membership of the EU resulting in macroeconomic stability and its strategic location in Europe and the Mediterranean which facilitates access to a large sophisticated market. However social infrastructure is relatively weak. Our analysis highlights strengths in related and supporting industries, largely driven by the 'infrastructure' that has developed around clusters in its industrial North. On the other hand, we find major challenges in the context for firm rivalry and strategy where the structure of the SMEs that have been the backbone of its industrial clusters have not adapted to international trends in labor, innovation and management practices. Our overarching proposal for Italy is to address chronic weaknesses in physical and social infrastructure, especially in the South; facilitate innovation activity and coordination and leverage its position in Europe to boost competitiveness.

The Italian tourism cluster is growing as a share of world exports and currently represents its third largest source of foreign income. We find that despite a wealth of cultural and natural endowments and strong demand conditions and related and supporting industries, the context for firm rivalry and strategy remains challenging. We believe a national tourism strategy focusing on competitiveness by improving research, education and innovation, and collaboration between IFCS would enable Italy to reposition itself for increased growth.

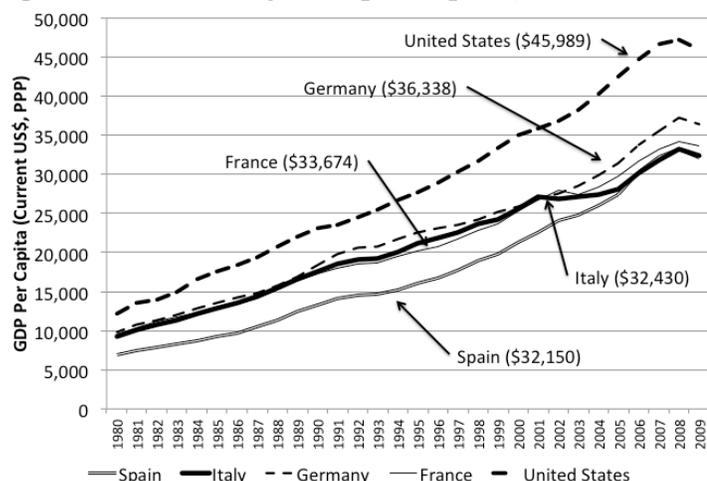
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## 1. Introduction

Italy is a highly diversified and industrial advanced economy with an educated and entrepreneurial population. Although it has achieved 4.69% CAGR in GDP per capita over the past 30 years, growth has been sluggish compared to other developed countries.

**Figure 1-1: Growth of GDP per Capita (Current US dollar, PPP)**



	In 2009	CAGR (1980-2009)
United States	\$45,989	4.69%
Germany	\$36,338	4.63%
France	\$33,674	4.46%
Italy	\$32,430	4.44%
Spain	\$32,150	5.48%

*Source: The World Bank*

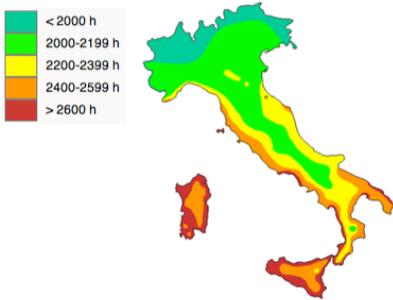
This is partly attributable to years of political instability which have strangled reform efforts; corruption that has discouraged business and investment; a drag by a southern economy that is saddled with organized crime, low income, low technical standards and low productivity which pre-existed modern Italy and a substantial shadow economy that places a drain on the public finances.

## 2. Endowments

Italy is rich in endowments. Although Italy lacks natural resources for industrial use, it has very rich endowments in terms of geography, climate, location and culture. Its diversified geography and moderate climate are advantageous for tourism and agriculture. Italy has the mountainous region of the Alps in the North as well as islands such as Sicilia in the Mediterranean Sea in the South. Such a diversity in geography resulted in variety of climate conditions that enable a variety of year round leisure and agricultural activities. Especially,

the southern part of Italy has the most moderate climate in Italy: annual sunshine duration in the region exceeds 2,600 hours per year.

**Figure 2-1: Annual Sunshine Duration in Italy**



Source: *Current Results* (<http://www.currentresults.com/>)

Proximity to neighboring rich countries enabled Italy to become a center of the Western civilization for a long time. As said as “all roads lead to Rome,” Italy is directly connected not only with France, Switzerland, and Austria in the north, but also with the Mediterranean countries through sea transportations. This advantage in location provided an easy access to continental Europe, Eastern Europe, Africa, and Asia. As a result, almost all major landmarks in the Western history are from Italy: the Roman Empire; the Roman Catholic Church; and the Renaissance. These historic heritages are also important as Italy’s cultural endowments.

Italy with 60 million inhabitants, is a peninsula located in the south of continental Europe, with an area of area of 301 263 square kilometers<sup>ii</sup>, bordered in the alpine north by Austria, France, Switzerland and Slovenia and extending into the Mediterranean Sea, northeast of Tunisia<sup>iii</sup>. Italy also encompasses the independent states of the Vatican and San Marino. Although a predominantly mountainous country boasting some world famous mountains such as Mont Blanc de Courmayeur, its highest peak at 4748 metres, Italy has some plains and coastal lowlands and includes over 70 islands including the larger islands of Sardinia, Sicily and Elba<sup>iv</sup> – endowing it with about 7600 km of coastline<sup>v</sup>.



SOURCE: CIA World Factbook-<https://www.cia.gov/library/publications/the-world-factbook/geos/it.html>

### 3. Macroeconomic Competitiveness

#### 3-1. Social Infrastructure and Political Institutions

Italy has good records in its social infrastructure while there are some areas for improvement such as higher education. Italy's most significant advantage is its integration in the EU neighborhood where free flow of people, goods, and capital are the essential for economic development. On the other hand, Italy has been burdened by political instability and the prevalence of organized crime, 'the Mafia'. Patronage systems are prevalent in politics and public life. In the old system of *lottizzazione*, thousands of other public appointments were dished out according to party labels. Much of this system lingers. Italy is "still dominated by invisible networks"<sup>vi</sup>.

Another impediment to Italy's competitiveness is its ageing population. According to a McKinsey report, "demographic pressure is expected to continue to drive down Italian household savings flows, further slowing the growth rate of household net financial wealth accumulation, with potentially significant implications for economic growth in Italy." In 2030, the population of Italy will reach 62.5 million, an increase of just 3.4% from 2010, mainly as the result of a large jump in the number of those aged 55 and over.<sup>vii</sup> The population of this particular group will rise by 33.7% in 2010-30. Falling birth rates have caused the population growth to decline (9.18 births/1000 people, 2010).<sup>viii</sup> The decline in population will have a direct incidence on the growth

rate of household formation from a historical 0.7% to 0.5% in the next 20 years. Lower rates of household formation will constrain aggregate wealth accumulation since there will be fewer households generating savings.

Although Italy had problems, including a revival of the Mafia and a succession of weak governments as well as weak institutions, 50 years of rapid growth have made it a rich country. Its big concern now is the struggle to stay rich—something that years of economic stagnation under Mr. Berlusconi, Italy's longest serving prime minister since the war, makes far harder. Despite being a full democracy, government functioning is seen as a problem in Italy, ranked 29 out of 31 full democracies and behind all western European countries except Turkey and Cyprus in the Economist Intelligence Unit's democracy index<sup>ix</sup>. The executive in Italy is deemed to be weaker than in other western countries – partly because of a legacy of fragmented party system and a move back to full proportional representation that disproportionately strengthened the influence of smaller parties and led to fragile governing coalitions that lasted in some cases, a mere six months. There is a general dissatisfaction with the ineptitude of the political class in general and the inefficiency of state administration, while the judicial system is viewed as extremely weak. An important aspect of the country leader is that Mr. Berlusconi himself is not a true believer in free markets either. His own business success was built on the creation of near-monopolies that, far from being attacked by antitrust authorities, benefited from political friendships. The most notorious example is his Mediaset television empire, which needed the strong support of a Socialist leader, Mr. Craxi. This proves a serious handicap for Italy's competitiveness agenda as such an agenda needs the strong backing of the country's leader.

### **3-2. Macroeconomic Policies**

The adoption of the euro contributed to break Italy's habit of frequent devaluation of the lira and forced the country to rethink its entire economic model. Instead of relying on high inflation, high budget deficits and currency devaluations, agreements such as the Maastricht Treaty of 1992 have forced Italy to learn to maintain low inflation and a fixed exchange rate. Such a massive adjustment has been painful but it resulted in a lower

inflation rate for Italy as the monetary policy of the country became the responsibility of the European Central Bank. However, Italy has had poor records in macroeconomic policies in general compared to other developed economies. Although EU membership instilled some discipline in its economic policies, Italy still suffers from high public debt and weak growth rate.

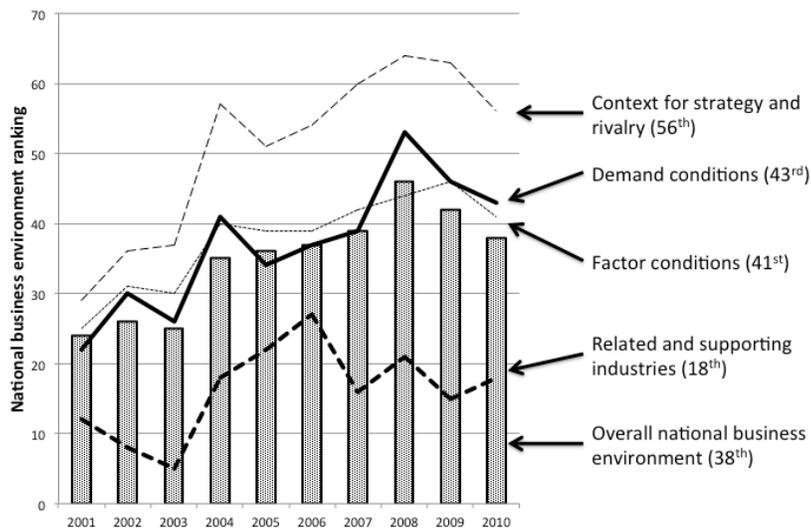
Historically, the Italian government has had loose control over the macroeconomic environment. Macroeconomic stability has been persistently hampered by high inflation rate, high budget deficit and unstable exchange rate. During 1970s, Italy suffered from high inflation rate, which hit its peak of 21.4% in 1980. Fiscal policy has also been a challenge for Italy. The government debt to GDP ratio is now at 121%.<sup>x</sup> In addition to a loose macroeconomic policy, the existence of a huge informal economy limits tax revenue. In addition, the exchange rate had been fluctuating widely since 1970s. Nevertheless, there were also some positive factors. Unemployment rate in Italy (8.4%) is now not as high as in some European countries. However, government debt/GDP ratio of 121% is the highest among OECD countries.<sup>xi</sup> Although 57.3% of the total debt is held domestically, this significant amount of debt is risky for the macroeconomic environment. Secondly, although adoption of the euro stabilized exchange rate with neighboring countries, Italy started to face appreciation of the euro against US dollar in the recent years. Between 2001 and 2008, the euro persistently appreciated against the US dollar by 38.9%.<sup>xii</sup> Even though currency appreciation is not necessarily bad for the prosperity of countries, it may threaten the competitiveness of industries competing against foreign firms.

## **4. Microeconomic Competitiveness (Country Level)**

### **4-1. Quality of the National Business Environment (The Diamond)**

Overall quality of the national business environment has been worsening in the past decade with little recovery in 2009 and 2010. Italy ranks 38<sup>th</sup> in the national business environment index, which is lower than its GDP per capita (PPP, 27<sup>th</sup>). Amongst the four components of the national diamond, Italy ranks better in the ‘related and supporting industries’ category but ranks lower in the ‘context for firm strategy and rivalry’ category.

**Figure 4-1: Ranking of the National Business Environment (2001-2010)**



Source: Institute for Strategy and Competitiveness (Version: 2010 Nov 23e, v. 74 countries)

**Figure 4-2: Strength and Challenges of the National Business Environment**

	Strengths	Challenges
Factor Conditions	Central location in the Mediterranean Sea Good climate	Infrastructure Higher education Access to capital market Inflexible labor market
Demand Conditions	Sophisticated demand Industrial buyers	Foreign Low cost competition
Related and Supporting Industries	Geographic concentration Established culture of Cluster	Low vertical integration
Firm Strategy and Rivalry	Intense rivalry between SMEs SMES specialization	SMES sold to multinationals Demographics

Figure 4-2 summarizes the state of each element of the national diamond. Italy faces a number of challenges especially in terms of factor conditions and firm strategy and rivalry. Also, it should be highlighted that benefits from the European Union (EU) is limited: Although tariff rate is low, foreign direct investment and technology transfer are small. Also, there is a prevalence of trade barrier.

#### 4-1-1. Factor Conditions

Because of its lack of natural resources, Italy suffers from local disadvantages in factors of production, which forced the country to move towards an innovation-driven path to generate productivity gains. Italy has been able

to leverage its disadvantages in factor conditions and make some critical moves up the value chain into higher-value-added economic activities.

The first stage of the Italian economic development occurred after World War II, more precisely in the 1950s and 1960s. Italian firms were competing on the cost of inputs such as cheap labor. Following mass strikes and demonstrations in 1968 and 1969, a statute of workers' rights became law in 1970, thus ensuring security of employment in larger firms.<sup>xiii</sup> As a result, the cost of labor dramatically increased with the enactment of a wage indexing system guaranteeing that salaries would rise in line with annual inflation; common job classifications, which introduced standardized salaries throughout Italy for specific categories of work; paid maternity leave and an increase in the number of paid holidays. This legislative reform constituted the catalyst that forced Italian companies to move into sophisticated and higher value-added industry segments. Technology and automation were instrumental in upgrading the production process as well as a decreasing reliance on the devaluation of the lira, a process commonly used by successive Italian governments to artificially boost exports. The upgrading of the Italian economy accelerated in the 1980's. It happened because Italian firms generated productivity gains as Italy's disadvantages in factor conditions were offset by the presence of favorable elements of the diamond such as sophisticated demand and intense rivalry in the domestic market.

We have identified four challenges that Italy should address in the near future: declining infrastructure, weak higher education system, unsophisticated capital markets, and rigid labor market.

### ***Challenges 1: Declining Infrastructure***

Infrastructure in Italy is of unequal quality throughout the country (Italy is ranked 73<sup>rd</sup> for the overall quality of its infrastructure in the Global Competitiveness Index). While the road and rail networks are plentiful and efficient in the north and the center of Italy, the southern infrastructure is poor and is in need of serious upgrading. Northern Italy's higher economic growth and geographical proximity to the heart of Europe made it a key commercial area where the infrastructure was developed accordingly. By contrast, the geographical isolation and poor economic development of Southern Italy meant that infrastructure was never a government priority except for seaports. As such, there are 6,460 kilometers of expressway, mostly in the northern and central regions and the system overall is comprised of 654,676 kilometers of paved roads.<sup>xiv</sup> While the linkage

with the rest of Europe is quite good, Italy's extensive and sophisticated road network is now barely able to cope with the steadily increasing traffic. The country rail system traverses a distance of 19,394 kilometers and represents an alternative to many commuters and tourists who wish to avoid congested roads and urban areas. However, it needs a serious upgrade as it is lacking high-speed trains like the French TGV.<sup>xv</sup> Italy has 136 airports that concentrate on different user segments (intercontinental passengers, local passengers, air cargo traffic etc.). Three-quarters of Italy's international air traffic is generated in northern Italy, with Milan alone responsible for one-third. Seaports used to be a key element of the Italian transport system as they handled a substantial percentage of cargo until the mid-1970s. Because of the increased competition from neighboring ports in Europe (Marseille) and the development of alternative ways of transporting goods and people, the traffic in the main ports (Trieste, Genoa, Naples...) has declined somewhat. The country has 1,500 miles of waterways that are used for commercial purposes but this system is relatively undeveloped.<sup>xvi</sup>

### ***Challenges 2: Weak Higher Education System***

With a 98% literacy rate that highlights the presence of a somewhat educated workforce, only a few university departments such as *Instituto Politecnico di Milano* or *SDA Bocconi School of Management* are able to maintain a decent level of innovation and management that give Italy a competitive edge in niche areas.<sup>xvii</sup> While some valuable research is done in Italian universities, the more common pattern is of a uniform mediocrity. Not one Italian institution is in the top 100 of the 2010-2011 Times Higher Education world university rankings. There is a pressing need for change because the system as a whole is a brake on Italy's competitiveness. Only 17% of Italians between 25 and 34 have a tertiary qualification, compared with an OECD average of 33%. The main reason is a shocking dropout rate of 55%, the highest in the developed world.<sup>xviii</sup>

### ***Challenges 3: Unsophisticated Capital Market***

Capital has also been a constant factor disadvantage in Italy for many years. The main cause for concern is the level of the public debt, which represents 121% of GDP and weakens the government's ability to invest in the Italian economy. However, much of this debt is held within the country (57.3%). Private sector debt is low, while the national household savings rate is high (7.7% in 2010).<sup>xix</sup> Private capital in Italy is not allocated efficiently because only a minority of individuals has access to it and deploys it to create large groups of

companies with locked ownership structures, which contributes to distorting competition. Italy could also face sovereign debt problems if the government is unable to find policies to address the underlying constraints for Italy's competitiveness: poor administrative and judicial infrastructure, inadequate communication systems, over-extended welfare, poor higher education systems and costly pension arrangements. Italy's stock market is tiny in relation to the size of the economy, with fewer than 300 quoted companies.<sup>xx</sup> Allocation of capital is inefficient because of the absence of a special second market to fund smaller enterprises. Further we must stress that many owners of such firms resist any loss of control, dislike relying on external finance, even more so, when public confidence in the market has been hardly hit by scandals such as the demise of Parmalat, one of Italy's biggest food groups, in December 2003 and the 2008 financial crises.

#### ***Challenge 4: Rigid Labor Market***

However, Italy has been more aggressive than its European peers in undertaking the necessary reforms of its rigid labor market. The 'Biagi' law was a landmark legislation that has led to an increase in temporary and part-time jobs by exempting many new jobs from rules that required most work to be full-time and permanent. The privatization of labor exchanges and changes to apprenticeship contracts contributed to inject more flexibility into the Italian labor market. Although unemployment for Italy as a whole, now at 8.4% (Eurostat), is lower than that of the euro area (9.9%), it remains high among the young (almost 23%), women (9.3%), seniors and the southern population.<sup>xxi</sup> But Italy's strong employment record has a downside: negative productivity growth as more marginal and less productive workers have been brought into the workforce. It is the combination of poor productivity growth and rising wages that has caused Italy's unit labor costs to rise so much faster than those in other euro members since the euro started.

#### **4-1-2. Demand Conditions**

Italy has strong demand conditions that result from sophisticated buyers and industrial demands.

#### ***Strengths 1: Sophisticated Buyers***

Italians' natural flair, inventiveness and creativity are the drivers of the country's ability to spot new trends and the capacity of small Italian firms to move quickly into new designs and features for their products. In industries

such as footwear or sportswear, Italians are among the most sophisticated buyers in the world, a fact reinforced by the presence of sophisticated distribution channels for these products. As such, the local market acts as an advanced trend-setting laboratory, which in turn helps local firms anticipate global trends. The country's plethora of small firms is an advantage vis-à-vis foreign retailers because of their high degree of specialization in particular products (textile machinery, tiles...) providing flexibility to cope with change.

### ***Strength 2: Industrial Buyers***

Italian firms are very efficient in producing specific industrial products such as machine-tools and selling these products to the Italian consumer and retail industry. This highlights the depth of Italian clusters (footwear parts, fabrics and textile machinery...). In his article, Prof. Michael Porter argues that “Italian end-product firms play the role of advanced and highly demanding buyers for other Italian firms. They compete on the basis of frequent product changes and want to stay on the cutting edge of style and technology.”<sup>xxii</sup> As such, Italian innovation and creativity constituted a boost for Italian exports thanks to the “internationalization of local style and taste”<sup>xxiii</sup> that was made possible by renowned design and fashion magazines. Tourism can be considered a driver for the internationalization of demand because many visitors to Italy are exposed to Italian products during vacation time.

### **4-1-3. Related and Supporting Industries**

The Italian economy is characterized by deep clusters of related and supporting industries. Italian firms organized early into clusters, a move that provided them with necessary protection from low-cost foreign rivals. As argued by Prof. Michael Porter in his book *On Competition*, grouping together in the same place is supposed to help small firms remain competitive, since they can tap the deep local pools of skilled workers and have better access to capital.<sup>xxiv</sup> Additionally, the geographic concentration of so many firms working in the same industry is deemed to spark creative ferment. All this is characteristic of Italy, where firms are generally makers of traditional consumer goods, small or medium-sized, family-owned, dependent on exports and, for reasons of geography and history, cluster together.

According to the Business Environment Index of 2010, Italy is ranked 20<sup>th</sup> among 139 countries. This good showing is a testament of the development of variant domestic clusters, a positive interaction with other European clusters, a productive collaboration within clusters, and numerous good local suppliers. There is a high fluidity of exchange within Italian clusters that is “facilitated by proximity, strong family ties that connect many Italian firms with their suppliers and related firms and by community spirit” (Michael Porter).<sup>xxv</sup> Italy is ranked first in the “state of cluster development” category of the Global Competitiveness Index 2011. This good performance can be explained by the ease of coordination across firms and the diffusion of best practices allowed by Italian clusters. Because of low vertical integration among firms, these small firms specialize in a few activities along the value chain and contract out to neighboring firms, which allows them to reap economies of scale and puts them in a better position to perceive innovation opportunities.<sup>xxvi</sup>

The survival of these SMEs depends on the ability of Italy’s clusters to transform themselves into districts where new ideas are dreamed up, designs developed and goods finished, with most production taking place in cheaper spots abroad. In the recent economic downturn, traditional industries such as tourism have been badly affected. Being technologically advanced and well diversified in export markets is a strong defense. Italian firms that have embraced such ideas have indeed been better able to fend off competition from low-cost foreign producers. Benetton, whose headquarters and design centre are located amidst a clothing cluster in the Veneto region, has long ago outsourced most of its manufacturing activities.

#### **4-1-4. Context for Firm Strategy and Rivalry**

Intense rivalry has traditionally been the recipe for success for many Italian firms. Most of the successful Italian industries at the international level are competing against many local competitors in the same niche segment and often in the same region. Rivalry is fueled by the particularity of Italian businesses centered on a family structure. The family firm has been the backbone of the Italian economy. In a way, it had the positive effect of fueling this wave of constant innovation and specialization that intensified the degree of local rivalry and benefited the Italian economy as a whole.<sup>xxvii</sup> Well-known names such as Agnelli, Pirelli, and De Benedetti have long controlled large parts of Italy’s industry. Lesser-known families own the small and medium-sized

exporters upon which Italy's post-war prosperity was founded. Yet Italy's business culture is moving away from the family as firms struggle to adapt to changing technologies and financial markets. We can view this either as a threat or as a chance for Italian firms to attain the scale denied to them by a shortage of capital and good managers.

The large private firms are generally local market leaders with a few groups such as Fiat or Pirelli having international outreach. However, these large groups are not global leaders. In contrast, Italian industries composed of many medium-sized and small firms are often world leaders in their niche markets. This disparity in competitiveness can be attributed to the absence of well-developed capital markets and a management style and an organizational structure inherent to Italian firms. According to a recent report from Cofindustria, Italian firms are generally run by the founder who tends to operate in a top-down manner.<sup>xxviii</sup>

**Figure 4-3: The Role of Small and Medium Enterprises in Italian Economy**

	Number of enterprises			Number of persons employed			Value added (MEUR)		
	Value	%	EU-26 average	Value	%	EU-24 average	Value	%	EU-26 average
Micro	3.615.729	94,6%	91,8%	7.066.111	47,1%	29,6%	188.012	31,8%	21,1%
Small	183.662	4,8%	6,9%	3.257.900	21,7%	20,6%	137.145	23,2%	19,0%
Medium	19.354	0,5%	1,1%	1.858.001	12,4%	16,8%	94.756	16,0%	17,8%
<b>SMEs</b>	<b>3.818.745</b>	<b>99,9%</b>	<b>99,8%</b>	<b>12.182.012</b>	<b>81,3%</b>	<b>67,1%</b>	<b>419.913</b>	<b>70,9%</b>	<b>57,9%</b>
Large	2.943	0,1%	0,2%	2.804.688	18,7%	32,9%	172.234	29,1%	42,1%

Source: Eurostat SBS data base, 2004 and 2005 data.

Italian industry is dominated by small firms. According to Eurostat, 81.3% of Italian workers work for firms that have fewer than 100 employees. In France, the share is 30%; in Germany and America, it is around 20%. More than half of Italian manufacturing companies have fewer than 20 workers, according to the Bank of Italy.<sup>xxix</sup> Despite all its obvious drawbacks, the system has produced a highly successful manufacturing economy. Northern Italy is one of the richest parts of Europe. The region is home to hundreds of world-class firms that dominate their niche, such as cigarette-making machines, buttons or surgical tools. Because managers and owners tend to be one and the same, the best Italian firms are hard-working and run for the long term. The north-east of the country, between Milan and Venice, produces an astonishing range of items that sell on design, quality and marketing, from air-conditioners to jewelry and sportswear, and an array of engineering products that go into making motor vehicles, televisions and fridges.

Italy is a case study of a country forced to constantly innovate in order to create its own factors. As such, the most successful industries are characterized by a dense network of small and medium enterprises where highly specialized knowledge and skills are passed within families from generation to generation. But what was seen as strength is now a structural weakness because direct family involvement in the business sphere is responsible for the fact that most Italian companies are small and privately owned; it has contributed to a low female participation rate in the workforce; and it is at least partly to blame for low social and labor mobility.<sup>xxx</sup>

However, family control is coming under attack on several fronts. One, inevitably, is the Internet, something that Italian business needs to embrace more quickly. As well as setting up websites and web-based operations, traditional firms are realizing that they need to be able to raise capital rapidly if they are to have efficient online capabilities that necessitate high upfront fixed costs. Demographics are important too and constitute the second front. Many of the more successful family firms started in the 1950s and 1960s. Their founders, if still alive, are at retirement age. A few families have had the good fortune to produce second- and even third-generation talent, but most have now to sell the business or bring in professional managers. The recent announcement of a €4.3 billion (\$6 billion) takeover of Bulgari, a jeweler, by LVMH, a French luxury-goods giant, was an example of one of Italy's many successful family firms selling out to foreign multinationals. Many of the big family firms were born during Italy's economic miracle of the 1950s and 1960s. They have weathered recessions, oil shocks and currency turmoil because of their agility and ability to anticipate consumer demand. Now, these firms are up for sale to offset the threats they face from within, while facing stronger competition from abroad. This phenomenon represents a serious threat to Italy's competitiveness. The continuity of the small Italian firms, which represented the growth engine of the Italian economy, is now put into question.<sup>xxxi</sup>

#### **4-2. Recommendations**

Italy's business environment needs to be improved as there are key weaknesses including corruption, declining physical infrastructure, insufficient skill base, unsophisticated financial markets, technological challenges that handicap Italy's competitiveness.

**Figure 4-4: Summary of Recommendations**

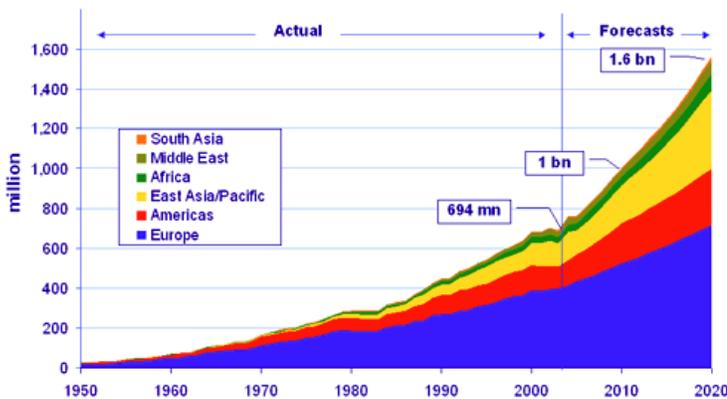
<b><u>I</u></b> <b><u>Addressing some chronic weaknesses</u></b>	<b><u>II</u></b> <b><u>Increasing the intensity of innovation in Italian economy</u></b>	<b><u>III</u></b> <b><u>Repositioning Italy as a central economic player in Europe</u></b>
<ul style="list-style-type: none"> <li>• Improve physical infrastructure via public-private partnerships and more efficient allocation of European Structural Funds</li> <li>• Upgrade domestic financial markets by accelerating integration with other European stock markets</li> <li>• Increase transparency, openness and legal accountability standards in administrative infrastructure (permit process, M&amp;A regulatory hurdles...)</li> <li>• Leverage different levels of geography               <ul style="list-style-type: none"> <li>– Regions within Italy</li> <li>– European neighborhood</li> <li>– Asia and Middle East</li> </ul> </li> <li>• Continue to liberalize Italian economy by leveraging Italy's EU membership</li> <li>• Loosen up a still rigid labor market</li> <li>• Overhaul Italian welfare system by raising the retirement age</li> <li>• Reconnect the south, not with handouts but by continuing to devolve powers to the regions (decentralization)</li> <li>• Bring in constitutional and electoral reforms that will move Italy towards a bipolar system to produce more stable governments</li> <li>• Clean up what is still the European Union's most corrupt country. Adopt zero-tolerance policy against corruption.</li> </ul>	<ul style="list-style-type: none"> <li>• Boost the efficiency of domestic industries by increasing public and private spending on R&amp;D</li> <li>• Improve coordination between regional and national governments in the allocation of resources and during the implementation phase of the economic strategy</li> <li>• Upgrade Italy's scientific and technological capacity by encouraging private sector to take a bigger leadership role in funding innovation initiatives</li> <li>• Upgrade the quality of human capital by reinforcing linkages university-government-private sector</li> <li>• Create advanced demand conditions by adopting fair and progressive regulatory standards (Charter for Environment with strict compliance to European green standards)</li> <li>• Put in place an incentive program to increase the pool of Italy's scientists, engineers and managers</li> <li>• Increase the size and availability of R&amp;D tax credits</li> <li>• Widen the base of major clusters in the Italian economy</li> </ul>	<ul style="list-style-type: none"> <li>• Italy should be at the forefront in the design of a Strategic European Economic Agenda that will boost the region's competitive agenda</li> <li>• Italy needs to define a unique role for itself in its European neighborhood that:               <ul style="list-style-type: none"> <li>– Builds on its distinctive strengths</li> <li>– Offsets EU's weaknesses and rigidities</li> <li>– Puts Italy at the forefront of best environmental practices</li> </ul> </li> </ul>

Source: Authors

## 5. Tourism Cluster Analysis

Despite its troubles, Italy is a significant economic player in Europe. Developing the tourism cluster can enable Italy to accelerate the upgrading of its economy because this cluster is naturally linked to the other tourism clusters in Europe, such as France, Spain and Switzerland. Because of the South's troubled economy, our economic strategy for Italy will include a cluster positioning across two geo-economic dimensions that will also leverage the global trend in the tourism industry showing that Europe will be the most visited continent in the next ten years.

**Figure 5-1: Growth of Tourism in the World**



Source: WTO – Tourism Vision 2020 Report

### 5-1. Global Tourism Industry

Tourism is one of the fastest growing economic sectors worldwide with an average annual growth rate of 6.5% since 1950. According to the United Nations World Tourism Organization (UNWTO), as an internationally traded service, inbound tourism has become a major source of revenue. The UNWTO estimated that ‘the overall export income generated by inbound tourism, including passengers transport, exceeded US\$ 1 trillion in 2009, or close to US\$ 3 billion a day’. Global tourism exports represents about 6% of overall exports of goods and services, while the contribution of tourism to economic activity worldwide is estimated at some 5% and it represents 6-7% of the overall number of jobs worldwide (direct and indirect)<sup>xxxiii</sup>. Competition among multiple global destinations has spurred investment in tourism development. As a result, this has spurred job

creation, infrastructure development and increased foreign currency earnings making tourism a key driver for socio-economic progress.

In terms of global trends, a 2010 OECD Report<sup>xxxiii</sup> points out a number of trends that will pose challenges for the industry. They include the increased use of information and communication technologies in tourism; the emergence of new international customers; increased role for domestic tourism; shifting travel trends to the Southern Hemisphere and the increase trend towards shorter holidays.

## 5-2 Market Segments

A recent BCG study classified travelers in three categories: inexperienced travelers, experienced mass market travelers and experienced affluent travelers. It estimates that experienced travelers will represent 41% of the share of total travel spending by 2020. It defines the aspirations of this segment of travelers as principally geared towards ‘relaxation and stress relief’ with a high potential for repeat business. Their primary travel activities are shopping, entertainment and they require luxury accommodations rather than overscheduled sightseeing.

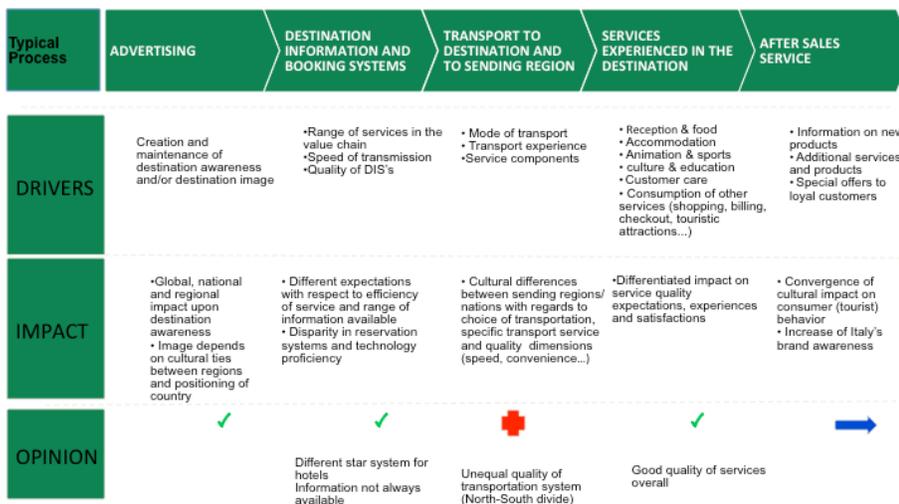


Figure 5-2: The Value Chain of the Tourism Industry –

Source: Authors

According to this BCG travel study, their travel planning is done primarily via websites and premium theme-based tour packages. To compete for these high-end customers, Italy has to perform a diagnosis of its capabilities on the value chain. Based on the value chain in Figure 5.2, we believe that advertising and transportation are the biggest challenges for Italy in attracting these high value customers.

### 5-3. European Tourism Industry

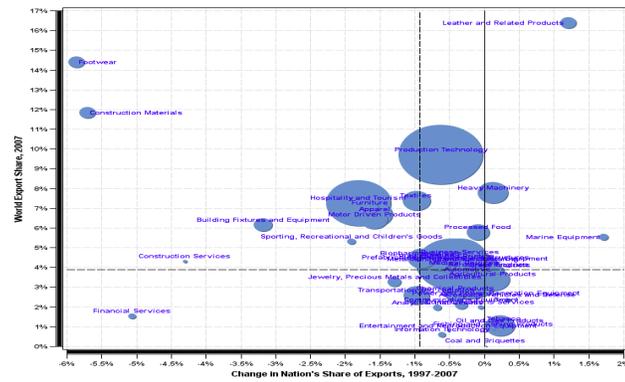
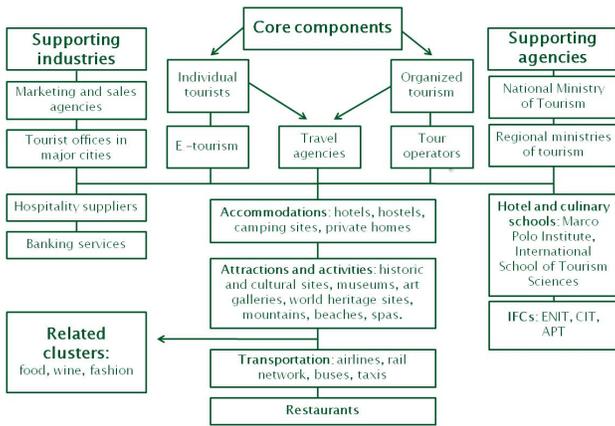
Europe is the world's largest and most mature tourism sector. In 2009, despite being the hardest hit region by the global economic crisis, it accounted for 52% of global tourism arrivals and 48% of global tourism receipts<sup>xxxiv</sup>. Its success is mainly due to the developed neighborhood of countries that generates a very competitive environment; while there are some countries that have a slightly bigger share of the market, almost all are players and benefit from the industry. In 2009, the main European destinations by share of the market were France (16.1%), Spain (11.4%), Italy (9.4%), UK (6.1%), and Turkey (5.5%)<sup>xxxv</sup>.

### 5-4. The Italian Tourism Cluster

#### 5-4-1. Positioning

There has always been an implicit differentiation of the destination "Italy" through art. Its confection of man-made and natural beauty, cultural heritage and clement climate are exhibited in historic cities such as Venice that marked the Italian Renaissance. We propose positioning the North by building on its core artistic and historical strength: an 'intellectual tourism' that builds on the branding of Italian cities such as Rome and Venice. Although the South needs to catch up economically with the North and has many competitive factor advantages such as climate, we have decided to leverage the national and European trend of an ageing population and position the tourism cluster in the South around Health and Wellness. As Italian households above 55 have the highest purchasing power, there is the potential to lure this segment of "experienced affluent travelers" at the local and European level. A recent BCG survey suggests that these customers are willing to pay a premium for a vacation package and forecasts that by 2020 "travel for relaxation will become more popular than sightseeing."<sup>xxxvi</sup>

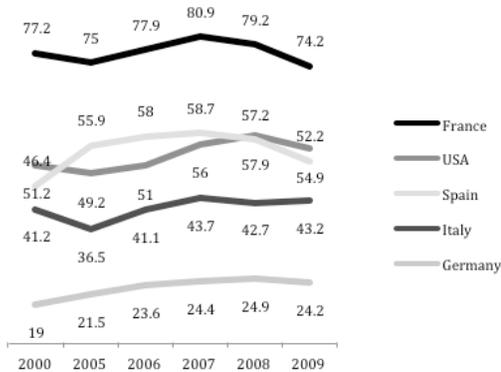
*Figure 5-3: Cluster Map for Italian Tourism Industry & Export Portfolio by Cluster Share*



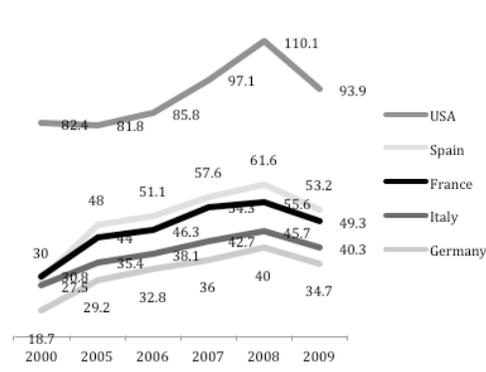
Source: Map – Authors; Graph - Institute for Strategy & Competitiveness, HBS

### 5-4-2. Italian Tourism Performance

In terms of its performance, Italy ranks 5<sup>th</sup> worldwide by the number of international tourist arrivals and 4<sup>th</sup> worldwide by the amount of international tourism receipts<sup>xxxvii</sup>. However, as the 28<sup>th</sup> ranked country in the World Economic Council’s Travel & Tourism Competitiveness Index of 2010<sup>xxxviii</sup> it faces many challenges, including the pressure from its regional competitors among which it is ranked 21<sup>st</sup>. Against its main regional competitors, Italy has been able to extract more value per visitor. While France and Spain receive more international tourist arrivals (Figure 5-4), Italy captures more receipts per tourist (Figure 5-5). On average, each person that visits Italy spends \$1,141 USD, while in France the average is \$664 and \$1,019 in Spain.



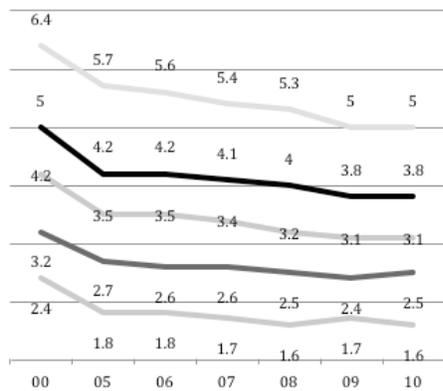
**International Tourist Arrivals (millions)**  
Source: UNWTO  
**Figure 5-4**



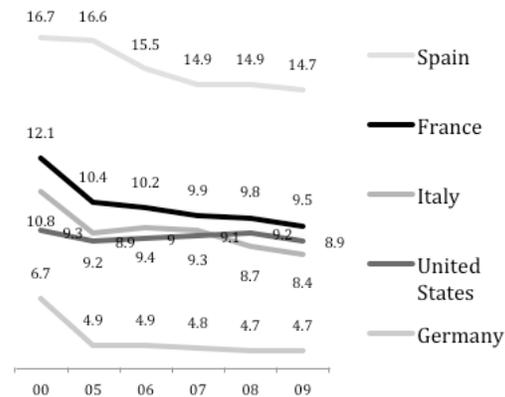
**International Tourist Receipts (USD billions)**  
Source: UNWTO  
**Figure 5-5**

Finally, in relation to the direct contribution of tourism as a percentage of the country’s GDP, Italy’s tourism industry represents less than that of Spain’s and France’s (Figure 5-6). And as a total contributor to GDP

(Figure 5-7) the industry in Italy has been less effective than them at sustaining the spillover effect with bigger drop in recent years than Spain and France.



**Direct contribution of tourism to GDP (%)**  
Source: World Travel and Tourism Council  
**Figure: 5-6**



**Total contribution of tourism to GDP (%)**  
Source: World Travel and Tourism Council  
**Figure: 5-7**

### 5-5. Quality of the National Business Environment (The Diamond)

The following figure summarizes states of the Italian tourism cluster and its “Diamond.”

**Figure 5-8: Strengths and Challenges of the Italian Tourism Cluster**

	Strengths	Challenges
Factor Conditions	Natural endowments Rich cultural heritage	Unskilled human resource Tourism infrastructure
Demand Conditions	Appeals to diverse range of customers - sophisticated and low budget	Seasonality
Related and Supporting Industries	Food cluster Wine cluster Fashion	Declining quality of transport infrastructure Unsophisticated capital markets
Firm Strategy and Rivalry	Intense rivalry between SMEs SMES specialization	Inconsistent quality standards Fragmentation of IFCs Inefficient IFCs

Source: Authors

#### 5-5-1. Factor Conditions

Italy’s natural beauty offer magnificent beaches with 7,600 miles of coastlines and stunning views, exceptional trekking trails, and more than 1,800 miles of ski runs in its beautiful mountains like the Alps in the North and Apennine mountains that cut down the center of Italy dividing the East and West coasts. Its long history, including its status as the center of the Roman Empire, endows it with a myriad of cultural landmarks. These

include 45 United Nations World Heritage sites, the most in the world, as the Coliseum in Rome, the Costiera Amalfitana in the South, and historic centers of cities like Rome, Florence, Pisa, Naples, and Venice. Its history also bestows 393 archeological sites, like Pompeii, the Roman Forum, and the Greek ruins in Agrigento and being the center of the Roman Catholic Church, it offers visitors almost 7,300 churches, of which 750 are in Rome. Additionally Italy has 4,100 museums, 12 of which are included in the 100 most visited museums in the world<sup>xxxixxi</sup>. Additionally, its climate offers visitors an average of more than 282 days of sun per year, and 60 degrees Fahrenheit average temperature.

The human capital in tourism services is generally low skilled. Despite the offering of several high education programs in tourism, the percentage of people with higher education employed in the tourism sector is 0.8% in Italy while the European Union average is just below 6%<sup>xli</sup>. Whilst levels of knowledge of a foreign is improving, it still lags behind other advanced European countries. Currently around 65% of the population between 18 and 34 years of age understands a foreign language (this percentage is higher in the north of Italy and lower in the South) while only 35% of the population over 45 speaks a foreign language<sup>xlii</sup>.

Italy has very well developed tourism infrastructure that includes the second biggest hotel offering in the world with over 36,000 hotels and 1.7 million beds; camping sites, religious institutions, agri-tourism sites, and private homes bring total accommodations up to 3.8 million beds.

Logistical infrastructure in relation to tourism it compares poorly to its main European competitors. The World Economic Forum Travel and Tourism Competitiveness Report of 2009 ranked its quality of air transport infrastructure 78th out of a 133 countries, compared to France's 5th and Spain's 34th; in terms of international air transport network it ranked 89th (France 6th, Spain 41st). In regards to ground transportation infrastructure, despite having a high density of roads, the quality of its network was ranked 99th (France 5th, Spain 20th); this result is largely affected by the extremely low quality of infrastructure in the South of Italy.

### **5-5-2. Demand Conditions**

Italy manages to attract many different types of tourists: from backpackers to sophisticated elderly groups but seems to have problems in attracting national tourist. Compared to French or Spanish, Italians spend less time

traveling in their own country (the total number of domestic trips is just over 100,000 in Italy, compared to the 120,000 of France and the 100,000 of Spain – but with smaller population than Italy). In particular in the last years, due to the economic crisis, Italian tourists have paid particular attention to the value for money and more than ever have decided to spend abroad their vacations. In particular European capitals and coastal destinations in the Mediterranean are among the most visited locations and even adding the transportation costs are perceived if not cheaper, at least more exotic and therefore more attracting than domestic destinations. This is in part related to the ability of the Italian touristic sector in extracting values from tourists; interestingly enough, contrarily to what Italians do, foreign tourists consider Italy a premium location and are therefore ready to spend more money for visiting it. In order to reverse the trend and increase the number of domestic tourists, the Italian Government has implemented several programs in the last years. During the economic crisis it was decided to incentivize vacations of lower income families by providing vacation vouchers to be used domestically, while the recently established Ministry of Tourism has launched a domestic media campaign featuring President Berlusconi promoting the “thousands and more wonders Italy has to offer”.

### **5-5-3. Context for Firm Strategy and Rivalry**

Despite being one of the first adopters of cluster philosophy, Italy has still a weak context for firm strategy and rivalry. The Italian hotel market is the second biggest in the world after the United States, nevertheless it appears extremely fragmented – with over 93% of hotels being independently owned – and relatively low quality – almost 50% of the 36,000 hotels are low quality (1 or 2 stars).

Fragmentation and low quality that explain the high exposure to seasonality of demand that is reflected in the low average occupancy rate of 40%, compared to the average hotel chain occupancy rate of 68 – 70%<sup>xliii</sup>. These large differences in performances can be also explained by the prevalent locations of independent hotels that are traditionally located on the coast, and that therefore are operating only in the summer. Another problem that was affecting the Italian hotel market was the relatively inconsistency of quality and standards classification of lodging facilities that created problems for travelers defrauded by over-ambitious claims of entrepreneurial hotel owners who have only their conscience to govern how many stars they give themselves. The newly established

Ministry of Tourism has then, on February 2009, published a decree setting minimum standards that hotels must meet within the Italian territory. The intended purpose of the decree is to provide to hotel guests better and more competitive services while at the same time incentivizing owners to renovate their hotels.

In order to meet new quality standards and increase their occupancy rate, most of these independent hotels – that are 30 or 40 years old – would need to be refurnished and modernized. Nevertheless the difficulties in accessing capital (Italy is ranked 89<sup>th</sup> out of 183 countries in access to credit by The World Bank, Doing Business report of 2011) and the uncertain perspectives of Italian touristic trends are holding these investments from happening, therefore reducing the ability of those independently owned hotels to reach a new segment of tourists other than their classic costumers base (usually consisting of families spending weeks in the same locations during the summer time). In terms of international competition, a other disadvantage of Italian firms compared to their main competitors is the high taxation rate and social security burdens: with a total tax rate of profits of 68% Italy has a tax rate comparable to France and 10 points higher than Spain and 20 points higher than the US (respectively 57% and 46%).

We have already briefly spoken about Governments programs to incentivize domestic tourism, and we have mentioned that the Ministry of Tourism has been recently created. In fact, Italy has a quite confused institutional framework for dealing with tourism policy with responsibilities that lie on the Regional administration and since the Constitutional reform of 2001 the central government has lost any coordination power of the different policies to market and brand the Italian touristic offer. According to the WEF – Travel & Tourism Competitiveness Index 2009, Italy prioritization of the tourism and travel sector is astonishing low considering the potential of such cluster in the country. In terms of Government prioritization Italy ranks 107<sup>th</sup> out of 133 countries and ranks 108<sup>th</sup> regarding its effectiveness in marketing and branding.

In terms of Institution for Collaborations (IFCs), Italy doesn't perform any better: the association that represents the private sector actors, FederAlberghi, has mainly a lobbying role and lacks a clear strategy on how to move the Italian touristic cluster to more competitive positioning. Also, ENIT, the Italian National Tourism Organization, despite having the mission of promoting the tourism sector has been so far able only to participate

in international fairs and events on tourism, but not in promoting a serious discussion between public and private actors on how to increase the quality of the services to domestic and international tourists.

#### 5-5-4. Related and Supporting Industries

Italy's relating and supporting industries represent, together with the natural and cultural endowment, its major strength. Numerous industries support the tourism cluster and create additional incentives to visit Italy. The main supporting cluster is indubitably the food cluster. Italian cuisine is world class and recognized as one of the best internationally. Italy has the second highest number of Michelin rated restaurants in the world just after France where the Michelin Guide is published (over 2,300 restaurants in Italy compared to the 3,400 in France). Also, Italian cuisine is famous for its regional variations and influx from the different culture that have been present in Italy since few decades ago. It is therefore easy to find Arabic and Spanish influx in Sicilian cuisine as well as French in the north.

Coupled with the Food industry there is the wine cluster. Italy is the world's largest producer of wine producing over 4.5 million tons<sup>xliv</sup> and cultivating over 500 different varieties of grapes, developed since the II century BC. Italy has over 300 zones officially classified as DOC or DOCG (national higher quality standard labels). In addition to increasing the positive perception of Italy, both the cuisine and wine cluster are gaining increasing importance in directly attracting tourist. New agricultural and enogastronomic tours are expanding rapidly in several areas of Italy with Tuscany being a prime destination for such kind of tourism however the south of Italy is increasingly trying to get into this niche market. Of particular interest in this sense is the experience of Apulia and Abruzzi where, through enogastronomic and agricultural tourism, they have restored several rural towns, transforming them into *alberghi diffusi* whereby entire towns have in effect become extended hotels.

Italy could also leverage other supporting industries to increase its ability of attracting new tourist such the wellness and health cluster especially in the south. Regions like Tuscany are famous for their spa – complex and wellness centers and other regions especially in the South could leverage their endowments in terms of climate and natural resources and develop a new wellness cluster, considering the high quality of life, the high life

expectancy (ranked 5<sup>th</sup> in the world) and the large quantity and high quality of physicians available in the country (Italy has 530 medical doctors per 10,000 inhabitants, France 337 and Spain 330). Other supporting industries include the fashion and luxury apparels in the North (including yacht and sportive cars) as well as cultural events industry that is particularly active in the south. Also, according to the World Economic Forum Travel and Tourism report of 2009, Italy performs well in terms of services relating to tourism (category that includes presence of car rental companies, information points for tourists in the major cities and historic landmarks) and in the number of international fairs and exhibitions organized.

Nevertheless, some of Italy's relating and supporting industries represent a burden to the growth of the touristic sector. The first example of poor support is related to the capital market and its poor performance and structure that creates difficulties to small entrepreneurs in getting access to credit. This is preventing necessary investments especially for independently owned hotels and stops them from repositioning in more profitable areas of the tourism market.

Another weakness is related to the relative inefficiency of the airline industry that appears especially negative regarding the domestic routes. While Italy is a member of the "open skies" agreement that allows foreign airlines to travel freely in a third country, the government has, in recent years, protected the former publicly owned company Alitalia, by facilitating a quasi-monopoly on domestic routes. Despite these issues, Italy takes advantage of its neighborhood, and it is well connected to the rest of the world through the national airlines of other EU countries in particular Germany and France.

## 5-6. Recommendations

<b><u>I</u></b> <b><u>Addressing some chronic weaknesses</u></b>	<b><u>II</u></b> <b><u>Increasing collaboration in Italian Tourism Cluster</u></b>	<b><u>III</u></b> <b><u>Repositioning Italy's Tourism Cluster</u></b>
<ul style="list-style-type: none"> <li>• Upgrade the quality of human capital by:               <ol style="list-style-type: none"> <li>1. Reinforcing linkages university – government - private sector;</li> <li>2. Strengthening the vocational training offered in tourism services</li> <li>3. Continuing focusing on teaching foreign language</li> </ol> </li> <li>• Develop public–private partnerships for the restoration and maintenance of archeological sites and landmarks</li> <li>• Increase access to capital for touristic small and medium enterprises</li> <li>• Promote consolidation of hotel industry (without losing authenticity of offering)</li> <li>• Increase competition in the airlines industry by promoting access of new players in the national market</li> </ul>	<ul style="list-style-type: none"> <li>• Strengthen quality standards and certification and ensure enforcement</li> <li>• Continue promoting domestic tourism destinations by increasing likeability of brand and perception of value for money</li> <li>• Increase coordination of different administrative bodies (both at national and local level) with responsibilities over tourism</li> <li>• Promote enhanced collaboration among public and private sectors actors through IFCs</li> <li>• Develop an integrated national tourism strategy that includes a aggressive national and international marketing campaign in collaboration with all relevant stakeholders</li> <li>• Reorganize the National Observatory of Tourism, to enhance the reliability of data collected</li> </ul>	<ul style="list-style-type: none"> <li>• Take advantage of current trends and develop new touristic offerings linking them to related industries:               <ol style="list-style-type: none"> <li>1. Art and cultural tourism</li> <li>2. Health and wellness tourism</li> <li>3. Eno-gastronomic tourism</li> </ol> </li> <li>• sign strategic agreements with key international tour operators</li> </ul>

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<sup>xxxix</sup> Exhibition and Museum

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<sup>xliiii</sup> Euromonitor

<sup>xliiv</sup> In 2008 according to the Food and Agriculture Organization of the UN, compared to the 4.1M ton of France and the 3.5 M ton of Spain