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The euro area's Achilles heel: Reassessing Italy's long decline in the context of European integration and globalisation

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The Euro Area's Achilles Heel:

Reassessing Italy's Long Decline in the Context of European Integration and Globalisation

Dario Guarascio, Philipp Heimberger and Francesco Zezza



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Abstract

This paper analyses how Italy's decades-long decline turned the country into the euro area's Achilles heel, the most vulnerable spot in the common currency. We use a structuralist framework to synthesise different (competing) supply-side and demand-side explanations, accounting for long-term processes and sectoral interdependencies. We argue that structural domestic factors that were already present in the decades after World War II ('original sins') – low-cost competition and labour fragmentation, many small firms linked to low innovation, and a deep territorial divide – interacted with the policy constraints brought about by globalisation and European integration to exacerbate Italy's decline vis-à-vis its euro area peers.

Keywords: Italy, decline, euro area, crisis

JEL classification: E65; P16; F45; F62

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1. Introduction

The euro area's imminent breakup has been predicted countless times. Despite major economic and political crises over the past two decades, Europe's economic and monetary union has so far avoided a premature death, although it remains fragile given its incomplete institutional architecture, in combination with macroeconomic and structural divergence between (and within) its member countries (Gräbner et al., 2020a; De Grauwe and Ji, 2022). In Greek mythology, Achilles faces the prediction of dying at a young age. As the story goes, his mother dips baby Achilles into the River Styx while holding him by his heel in order to render him immortal. Growing up as a man surrounded by war, Achilles goes on to survive as a warrior in many battles. In the myths surrounding the Trojan War, however, the prediction finally comes true as Achilles dies from a wound to his heel.

This article argues that Italy is the euro area's Achilles heel - i.e., its most vulnerable spot. We contribute to the literature on the sources of Italy's economic decline over recent decades (e.g., Baccaro and D'Antoni, 2022; Storm, 2019; Toniolo, 2013) by providing a structuralist framework that allows us to synthesise how structural domestic factors that were already present in the decades after World War II ('original sins') interacted with the policy constraints brought about by globalisation and European economic integration to exacerbate Italy's decline vis-à-vis its large euro area peers Germany, France and Spain. Italy has been at the centre of international debates over European vulnerabilities with regard to handling the fallout from the Euro crisis and the Covid-19 crisis, the future of the EU's fiscal rules and the ECB's bond-purchase programs. Hence, shedding new light on how Italy became the euro area's Achilles heel is of major importance for researchers and policy-makers.

Several stylised facts point to Italy's vulnerability: the long-lasting stagnation of labour productivity; a high public debt burden that makes the country 'too big to fail' in the euro area context; fragility due to periodic increases in interest rate spreads endangering domestic debt sustainability but also international financial stability; and unemployment persistently above the EU average. There is a voluminous literature on Italy's decline and its position in Europe (e.g., Krahé, 2023; Notermans and Piattoni, 2021). Competing explanations stress different historical factors (cronyism, familism, too much state interventionism in market processes, as in Toniolo 2013), supply-side factors (e.g., institutional inefficiencies and market rigidities, as in Alesina and Giavazzi, 2006; Bassanetti et al., 2014), and demand-side factors (e.g., persistent downward pressure on wages and fiscal consolidation as in Storm, 2019 or Baccaro and D'Antoni, 2022) as drivers of the decline. We contribute to the recent comparative political economy (CPE) and growth model literature (e.g., Kohler and Stockhammer, 2022) by identifying fundamental discontinuities in the 'Italian model'. To analyse the drivers of Italy's growth regime over the last sixty years, we use the growth model approach (e.g., Baccaro and Bulfone, 2022) to identify important developments and breaks. Our contribution complements the existing literature with a structuralist framework that synthesises supply-side and demand-side explanations of Italy's decline. Our approach is structuralist (e.g., Cimoli et al., 2009) in the sense that we emphasise the long-term perspective (e.g., Cipolla, 1952), account for the role of institutions (e.g., Amable and Palombarini, 2008) and the sectoral composition of the economy, while also highlighting domestic and international interdependencies (e.g., Andreoni and Scazzieri, 2014).

The rest of the paper is structured as follows. Section 2 sets out major stylised facts regarding Italy's decline and why the country can be seen as the euro area's Achilles heel. Section 3 illustrates the analytical framework identifying the major drivers of the decline in the context of globalisation and European integration. Section 4 discusses how major 'original sins' are linked, and how feedback effects with tightened constraints on monetary, fiscal and industrial policy in the context of European integration and globalisation have locked Italy into a path of decline. Section 5 concludes.

2. Italy as the Euro area's Achilles heel

In what follows, we discuss important sources of Italy's status as the euro area's Achilles heel in the economic and financial domain.

2.1. ECONOMIC DOMAIN

In the economic domain, size is a big deal. Despite its decades-long stagnation, Italy remains the third largest euro area economy in terms of economic output.¹ Beyond its sheer size, its connectedness through trade links is also relevant, as Italy's northern regions are tightly linked with Europe's industrial core via long and complex global value chains (GVCs, hereafter) (e.g., Stöllinger, 2016). This interconnectedness became particularly evident during the early phases of the Covid-19 crisis: when lockdowns interfered with Italy's exports of (intermediate) goods, manufacturing production in factories located in Germany and the Visegrad countries had to be reduced or even halted. By the same token, the disruption of GVCs and trade rationing exposed the impoverishment of Italy's productive structure after decades of offshoring and declining investment (e.g., Celi et al., 2020).

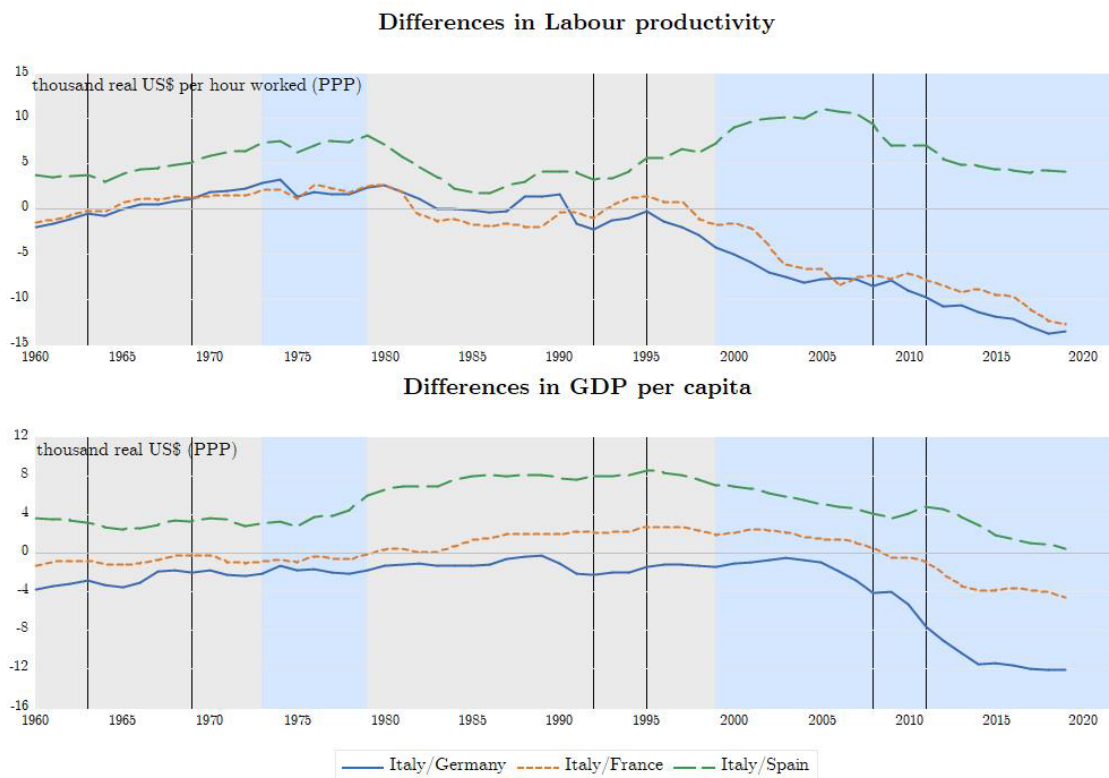
For these reasons, Italy's long economic decline is not only a domestic policy concern; it is a major issue for the euro area as a whole. Its persistent economic problems are manifest when looking at the weak dynamics of labour productivity (measured in terms of GDP per hour worked), which is a major hindrance to long-run economic growth (e.g., Lucidi and Kleinknecht, 2010). As the upper panel of Figure 1 shows, labour productivity in Italy during the 1970s was higher than in Germany, France, and Spain. However, underperformance in productivity rapidly gathered pace in the 1980s and accelerated further after Italy joined the euro area in the late 1990s. Over the period 1980-2021 Italy experienced the emergence of a massive cumulative labour productivity gap compared with the other large euro area peers.

Over the course of strong economic expansion after the Second World War, the 1950s and 1960s saw Italy turn into one of the world's most dynamic industrial powerhouses (e.g., Graziani, 1998). Although Italy remains the EU's second-largest industrial location (e.g., Heimberger and Kowall, 2020),² its industrial base has deteriorated over recent decades. Long-standing labour productivity issues and lacklustre industrial performance have culminated in substantial losses in relative living standards. Up until the mid-2000s, Italy's income per capita was higher than France and close to Germany. However, a large gap has opened up over the last two decades, so that Italy's GDP per capita before the pandemic was only slightly higher than the level observed in Spain. The financial crisis of 2007/2008 and the euro crisis from 2010 onwards further accelerated Italy's relative decline in average living standards, in particular in comparison with Germany; this divergence can be seen as a major driver of economic polarisation within the European economic and monetary union (e.g., Celi et al., 2018; Gräbner et al., 2020b).

¹ In 2021, Italy's real gross domestic product stood at EUR 1,678 bn, which accounts for 14.9% of the euro area's entire output. Only Germany (28.4% of the euro area) and France (20.7%) surpass Italy in terms of economic size.

² In 2021 Italy's share of the EU's total value of sold industrial production stood at 16%, which is significantly lower than Germany's 27%, the EU's largest industrial location, but still well ahead of France's 11%, the country with the third-largest share.

Figure 1 / Italy's performance compared to the other large euro area peers (labour productivity, GDP per capita)



Notes: values in thousands constant (2010) USD, expressed in PPP; shaded areas correspond to: the golden age (1960-1973), the oil shocks (1973-1979), the EMS (1979-1999), the euro (1999-2022); vertical lines correspond to: the two union uprisings (1963 and 1969), the currency crisis (1992), the start of the convergence process towards euro membership (1995), the global financial crisis (2008), the sovereign debt crisis (2011).

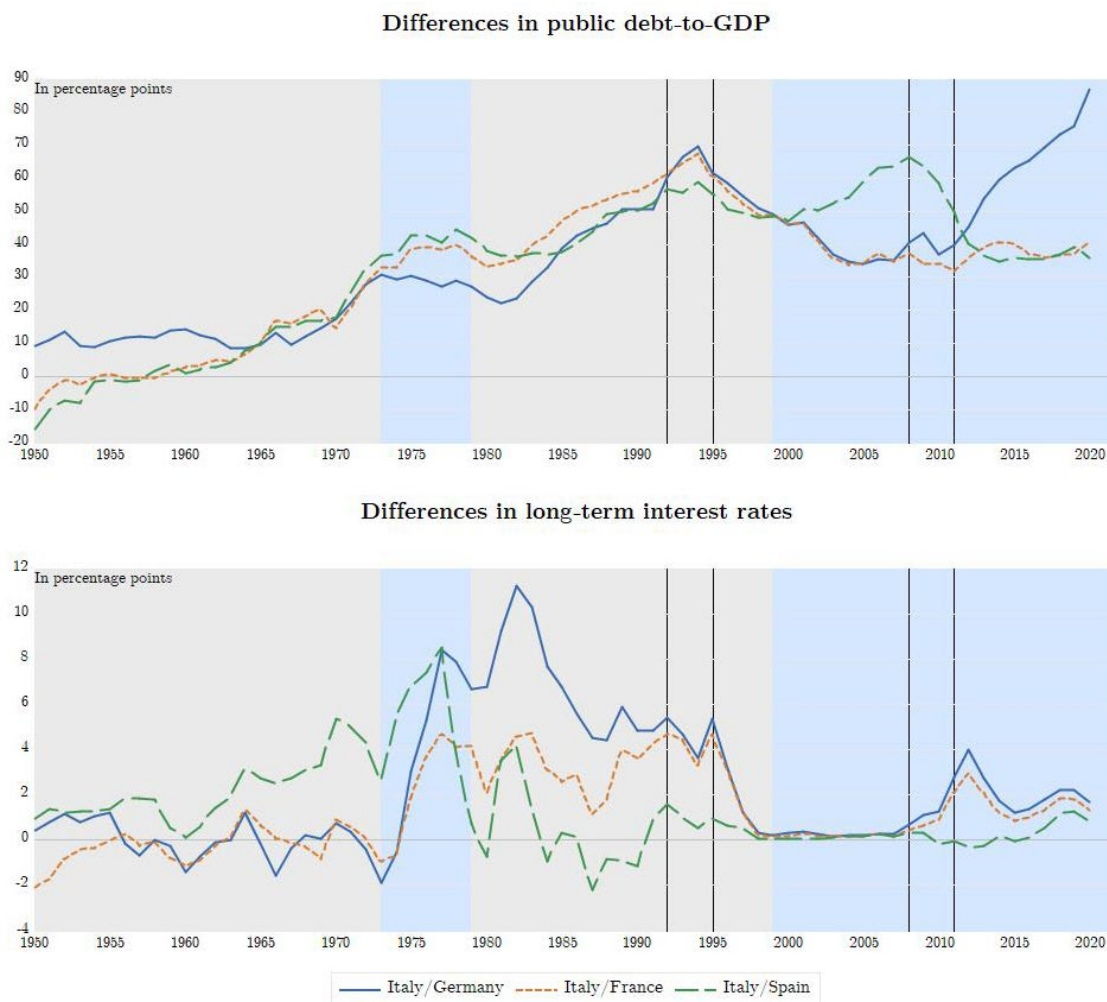
Source: Long Term Productivity Database; own calculations.

2.2. FINANCIAL DOMAIN

Italy's size, interconnectedness and decline do not only matter in the economic domain; these factors are also important when looking at the country's position in the euro area from a financial point of view. Among the euro area's largest member countries, Italy now exhibits by far the highest public debt level.³ As the upper panel of Figure 2 shows, Italy's public-debt-to-GDP ratio only started to diverge strongly from Germany, France and other euro area peers during the 1980s. Italy's public debt ratio nearly doubled from 54.0% in 1980 to more than 100% in 1992, when a currency crisis finally drove Italy out of the European monetary system after Italian policymakers had tried to fix the nominal exchange rate. The early 1980s were marked by the 'divorce' between the Banca d'Italia and the treasury, as the central bank stopped directly supporting the government in financing its fiscal deficits to enhance its credibility (e.g., Tabellini, 1987). This was followed by a surge in Italy's long-term interest rates vis-à-vis its European peers, which heavily increased government financing costs (e.g., Celi and Guarascio, 2019; Cesaratto and Zezza, 2019).

³ Greece was the only euro area country to exhibit a higher public-debt-to-GDP ratio than Italy in 2021 (193.3% compared to 150.8%).

Figure 2 / Italy's performance compared to the other large euro area peers (public-debt-to-GDP, long-term interest rates on government bonds)



Source: Macrohistory database; own calculations.

The interest rate spread to Germany increased to more than 10% in the early 1980s; it then declined rapidly from the mid-1990s onwards as investors initially bet that Italy's euro area membership would reduce the risks associated with Italian bonds to the levels of Germany and other euro area countries. With the euro crisis, Italy's interest rate spread vis-à-vis Germany and France increased substantially as investors sold Italian government bonds, threatening a debt default or the need for a bailout package (e.g., Baldwin et al., 2015). Spreads only came down again after the ECB credibly signalled, at the climax of the euro crisis in the summer of 2012, that it would backstop the euro area's government bond markets (e.g., Saka et al., 2015). However, Italy's public-debt-to-GDP ratio relative to Germany grew significantly over the years of the crisis as Italy's growth performance was worse than in other euro area countries. This further increased the financial fragility of the euro area's third-largest economy in relation to future economic shocks by reducing Italian policy-makers' fiscal space, which became apparent during the early stages of the Covid-19 crisis (e.g., Gräbner et al., 2020a; Storm, 2021).

Italy's large public debt stock in relation to other euro area countries⁴ combined with its long economic decline matters in the context of Europe's financial plumbing. Europe's largest money market is the EUR 9 tn repo market, which has more than quadrupled in size since 2001, thereby becoming structurally important for public and private finance (ICMA, 2021). This repo market is strongly intertwined with euro area government bond markets, because two thirds of all the money lent by banks and institutional investors is based on sovereign bond collateral (Gabor, 2021). In essence, a 'repurchase agreement' (repo) is about one financial institution (the lender) agreeing to buy an asset (i.e., an existing government bond) from another institution (the borrower) and selling the asset back at a pre-agreed price later on with the lender receiving a fee. Private credit creation through the repo market fundamentally relies on what is happening in the euro area's sovereign bond markets, which provides most of the collateral for the heavily collateral-dependent financial system. (Shadow) banks whose short-term funding is reliant on collateral are strongly exposed to an increase in government bond yields and an increase in spreads between Italy and other countries, because this leads to daily changes in the market values of their sovereign bonds. Large increases in spreads, as during the 2011 and the Covid-19 crisis are, therefore, an immediate threat to financial stability, as repo collateral revaluation in times of stress implies a drying up of market liquidity leading to major funding problems not only for governments but also for private institutions. In June 2008, Italy alone accounted for around 11% of collateral in European repos (Gabor and Ban, 2016). Stress in Italian sovereign debt markets due to concerns over Italy's economic trajectory and debt sustainability contributes to contagion and broader problems for the European financial system. This was particularly apparent in the early stages of the pandemic, when the ECB was forced to intervene with a pandemic emergency bond purchase program after Italy's government financing costs vis-à-vis Germany had started to increase sharply (e.g., van 't Klooster, 2022). In essence, its large economic size and investor concerns about its future debt and economic trajectory make Italy the prime candidate for panic-induced selling and speculation-induced shorting of government bonds, which can amplify into major financing problems for large parts of the euro area via contagion effects (e.g., De Grauwe and Ji, 2013).

Italy's economic decline and its worsened fiscal outlook have contributed to the intensification of political conflicts concerning the causes of the decline and the appropriate recipes for addressing it (e.g., Frieden and Walter, 2017). Despite Italy's problems, the majority of Italians so far continues to be in favour of EU and euro area membership. However, support for European integration has declined over time (e.g., Baccaro et al., 2021). Clearly, a political push for an Italian exit from the euro area, given a perceived lack of positive development prospects and growing democratic discontent, is a major risk factor for European disintegration.

⁴ In absolute numbers, Italy's gross public debt at the end of 2021 amounted to EUR 2,678 bn, which was even higher than Germany's at EUR 2,476 bn.

3. Putting the pieces of the puzzle together: A framework for explaining Italy's decline

In what follows, we situate our contribution in the comparative political economy literature (CPE, hereafter), identify fundamental discontinuities and analyse how Italy became a 'failed growth model' (Amable and Palombarini, 2014; Baccaro and Bulfone, 2022; Trigilia and Burroni, 2009). We then provide our framework for a structuralist synthesis in bringing together the 'pieces of the puzzle' – seemingly competing supply-side and demand-side explanations that are connected with each other.

3.1. ITALY'S DECLINE THROUGH A COMPARATIVE POLITICAL ECONOMY LENS

The last decade witnessed a shift in the CPE literature from the varieties of capitalism (VoC) approach (Hall, 2018; Hall and Soskice, 2001; Soskice, 2007) toward the growth model approach (GMA, hereafter) (Baccaro and Pontusson, 2016; Blyth et al., 2022). The VoC literature was predominantly rooted in neoclassical economics and static institutional equilibria, differentiating countries between liberal market economies, coordinated market economies, and mixed market economies. In contrast, the GMA is rooted in post-Keynesian/Kaleckian demand-led growth and distribution models (e.g., Hein, 2023). The latter showed how the coexistence of different growth models in the euro area generated severe imbalances prior to the financial crisis, due to the instability of export-led and debt-led models via rising export-dependence and financial fragility (Hein, 2019; Onaran and Galanis, 2014; Stockhammer, 2016). Even though growth was still demand-led, other growth drivers took stage: asset price inflation, private debt, and inequality (Lavoie and Stockhammer, 2013). It is thus essential to analyse the drivers of the growth regimes in particular periods, including property prices, private debt, the fiscal stance, and export complexity.

Using growth decomposition to identify growth models⁵, Baccaro and Pontusson (2016) argue that most countries were wage-led during the golden age and turned into different forms of profit-led regimes in the neoliberal era – export-led (Germany), consumption-led (UK), and a 'failed model' (Italy). Building on that, Hein et al. (2021) add a financial dimension, combining growth accounting with the sectoral balances approach, which provides insights into how expenditures are financed, and how they affect wealth accumulation. They report that Italy was domestic demand-led before the GFC, and weakly export-led thereafter.

Table 1 reports the demand contributions to real GDP growth, the sectoral balances – with the decomposition of the private sector balance between households and corporations –, along with growth drivers and other structural variables for Italy over the period 1960-2022. This helps us to assess the development strategies adopted by Italy over the last sixty years.

⁵ Starting from the aggregate demand identity, $Y = C + I + G + X - M$, the individual contribution to the aggregate rate of growth is computed by multiplying the share of each component of demand in GDP by its growth rate.

Table 1 / Contributing factors to Italy's real GDP growth, 1960-2022

	Golden Age	Oil Shocks	EMS	Euro pre-GFC	Euro post-GFC	Pandemic	1960-2022
Real GDP growth	5.45	3.30	2.04	1.44	-0.34	0.02	2.18
Demand contribution to real GDP growth							
Consumption	3.39	1.71	1.44	0.77	-0.09	-0.37	1.36
Investment	1.40	0.11	0.29	0.55	-0.36	1.14	0.44
Change in inventories	0.03	0.02	0.13	0.04	-0.03	0.04	0.05
Gov. Expenditures	0.84	0.66	0.34	0.28	-0.07	0.10	0.37
Net Export	0.03	0.02	0.13	0.04	-0.03	0.04	0.05
- Import	-1.44	-0.41	-0.92	-1.06	-0.10	-1.49	-0.86
- Export	1.58	1.43	0.81	0.90	0.36	1.08	0.96
Sectoral Balances (% GDP)							
Net Acquisition of Financial Assets	3.03	6.58	8.91	2.48	3.37	11.80	5.54
- Households	..	..	12.36	2.66	1.39	5.85	6.84
- Corporations	..	..	-3.35	-0.18	1.98	5.95	-0.70
Gov. Deficit	-2.19	-7.33	-9.04	-2.89	-2.94	-8.36	-5.34
Current Account Balance	0.84	-0.75	0.00	-0.41	0.42	3.43	0.24
Demand Drivers							
Wage share (% GDP)	64.26	64.74	58.88	51.61	52.90	53.12	58.10
Wage growth (%)	12.08	12.28	6.45	4.24	0.54	5.87	6.70
Real ULC (growth rate)	-0.39	0.02	-1.05	0.23	0.11	-0.60	-0.39
Unemployment rate (%)	5.0	6.1	9.4	8.8	10.3	9.0	8.2
Primary Deficit/surplus (% GDP)	-0.39	0.02	-1.05	0.23	0.11	-0.60	-0.39
REER (1964m1=100)	-1.20	-4.47	-0.54	2.36	1.35	-7.26	-0.38
Long-run real interest rate	1.01	-4.94	3.60	2.07	2.18	-0.08	1.62
House prices (growth rate)	1.26	5.49	1.85	3.60	-2.65	1.35	1.45
Debt (% GDP)							
Government Debt	34.12	54.01	90.32	107.26	127.47	149.94	87.60
Private sector debt	62.01	64.18	56.21	91.44	119.39	119.27	77.57
- Households	6.09	7.70	11.83	28.59	41.95	44.29	19.54
- Corporations	55.92	56.48	44.38	62.85	77.43	74.97	58.04

Legend: Golden Age (1960-1972); Oil shocks (1973-1978); EMS (1979-1998); Euro pre-GFC (1999-2007); Euro post-GFC (2008-2019); Pandemic (2020-2022). Source: AMECO, World Bank, IMF, Osservatorio CPI, Bank of Italy, FRED.

Notes: table shows average values over the periods.

The 1960s were a period of growth and stability (with real GDP growth averaging 5.45%): stable sectoral balances-to-GDP ratios (which imply there are no major processes of debt accumulation), a large contribution of consumption and investment, relatively high wage share and sustained wage growth (but falling real unit labour costs (ULC)), balanced trade and low real interest rates. The condition changed with the oil crisis. The large public deficit in the 1970s allowed the private sector to accumulate net financial assets (which were mainly the liabilities of the public sector, i.e., government debt), while the current account balance was readjusted by large exchange rate movements; however, the contribution of investment dropped substantially, only partially counterbalanced by an increase in the fiscal deficit. With entry into the EMS, as Italy started to fight inflation, and tried to avoid currency realignments, real interest rose above the growth rate, so that the public-debt-to-GDP ratio increased markedly. The current account started to deteriorate in the run-up to the large currency devaluation of 1992, and the decline in the government deficit relative to GDP from early 1990 onwards implied a drop in the ability of the private sector – particularly households – to accumulate financial assets, with external debt rising substantially.

The literature on growth models highlights that what is special about Italy's experience over the past decades is that all components of aggregate demand for goods and services slowed down (Baccaro and Bulfone, 2022). In what follows, we sketch out our framework, which highlights that this was only possible because domestic structural factors that were already present during the golden age after the Second World War interacted with policy constraints brought about by globalisation and European integration to exacerbate Italy's decline from the 1990s onwards. We thereby combine the growth model approach with a structuralist framework.

3.2. A STRUCTURALIST FRAMEWORK FOR EXPLAINING ITALY'S DECLINE

We argue that Italy's long decline compared to its euro area peers, as illustrated in section 2, cannot be explained by looking at specific factors highlighted by the existing literature in isolation, but only by considering how crucial domestic factors interacted with policy constraints brought about by globalisation and European integration, which further pushed the Italian economy down its path of decline, the tracks of which were already visible well before the 1990s. In tune with the structuralist tradition (e.g., Cimoli et al., 2009) and, more specifically, with those contributions applying their key theoretical insights to the analysis of intra-EU core-periphery divides (e.g., Celi et al., 2018, 2022; Guarascio et al., 2023), our framework is based on four main analytical pillars: a long-term perspective (e.g., Cipolla, 1952), the sectoral composition of the economy and interdependencies (both domestic and international; e.g., Andreoni and Scazzieri, 2014), interaction between supply and demand-side drivers/constraints and the prevalence of disequilibrium conditions in markets (e.g., Kaldor, 1981), and the key role of institutions (e.g., Amable and Palombarini, 2008). In the Italian case, this means highlighting the importance of the following factors in making Italy the euro area Achille's heel: long-term processes sedimenting since unification (e.g., the north-south divide); changes in the conditions of accumulation and industrial specialisation (i.e. from fast technological catching-up mostly guided by large SOEs during the 'golden age' to the dynamics of 'poor tertiarisation' driven by the combination of financialisation and privatisation); demand-side constraints (both domestic, as in those related to wage repression as the prevalent competitive strategy; see Cirillo and Guarascio, 2015); and external constraints, connected to membership in the euro area and the requirements of EU fiscal rules.

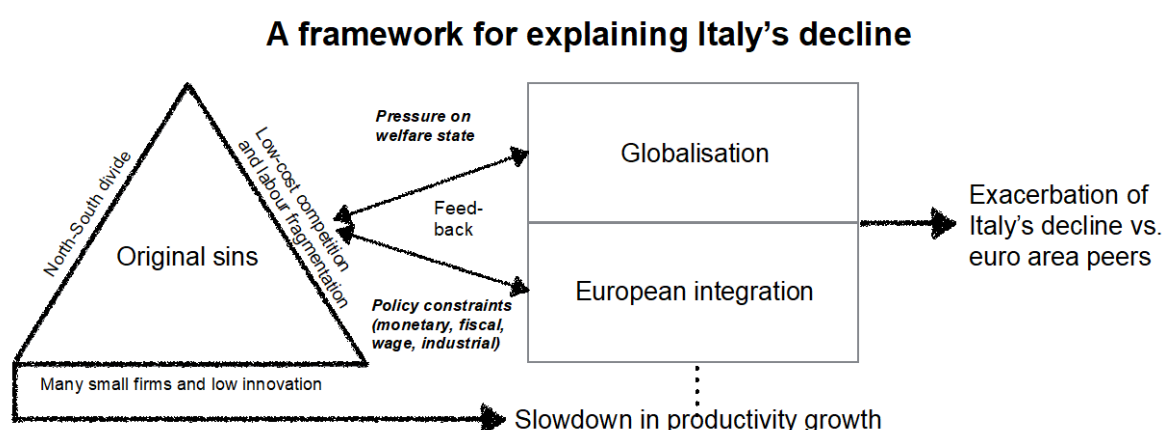
We conceptualise globalisation and European integration as processes that have led to tighter constraints on domestic economic policy in Italy. We understand economic globalisation as the 'degree to which non-domestic actors can or do participate in a domestic economy' (Gräbner et al., 2021, p. 87) – a process that intensified in the 1980s and 1990s (Gygli et al., 2019). The literature points out that economic globalisation makes it harder for governments to prevent mobile capital from leaving a country if business leaders find tax laws or regulations in other countries more attractive. This may put pressure on tax policies and welfare states, as tighter financial integration penalises deficit spending (e.g., Garrett, 1998; Streeck, 2014).

European economic integration, which culminated in member states sharing the same currency, has substantially affected domestic economic policy options. As Italy entered the euro area, it lost the option of devaluing its currency vis-à-vis Germany and other member countries, although it had regularly used devaluations in the past to ensure export competitiveness (e.g., Bagnai, 2016). As euro area member states share the same currency and economic policy outcomes in one country can spill over to other countries, the idea of the European regulatory framework was to avoid excessive public deficits and debt

that could trigger inflation and negative cross-border effects. European fiscal rules, with their emphasis on limiting fiscal deficits and public debt levels, are meant to restrict the room for maneuver of domestic fiscal policy-makers (e.g., Buiters et al., 1993; Zezza, 2020). Indeed, the convergence criteria for joining the euro area, concerning price and exchange rate stability and low fiscal deficits, had already put pressure on Italian economic policy throughout the 1990s. By strangling domestic demand, this external constraint inhibited Italy's growth prospects (e.g., Storm, 2019) with negative implications also in terms of productivity, as the 'Kaldorian' engine linking demand flows to investments, innovation and learning processes has been gradually weakened (e.g., Kaldor, 1981). Furthermore, Italy's productive and technological capabilities have been impoverished by the partial abandonment of industrial policy, as the single market led to the liberalisation of trade, tougher competition between firms across borders and the harmonisation of industrial policies in the direction of fewer targeted interventions, which has made it more difficult to protect and support industries (e.g., Guarascio and Simonazzi, 2016).

The emphasis on policy constraints is not to deny the agency of Italian policymakers. It is well-documented that Italian politicians actively used the 'external constraints' strategy to push the agenda for liberalising major parts of the Italian economy (e.g., Baccaro and D'Antoni, 2022; Ferrera and Gualmini, 1999). The idea of those who welcomed and promoted tighter external constraints was that a reduction in the country's discretion in policy-making would facilitate economic modernisation, breaking the negative trend in productivity growth; it would discipline trade unions due to the need to retain external competitiveness by keeping wage growth low, as the option of currency devaluation was no longer available; and it would discipline government expenditures, thereby making Italy more attractive for financial investors. What those advocating for stricter external constraints failed to see, however, was that this would put the brakes on important drivers in the Italian growth model that used to compensate for the restraining impact of structural domestic factors that had already been present for decades.

Figure 3 / A framework for explaining Italy's decline



Source: own elaboration.

In this context, we identify three 'original sins' as the key long-term drivers of Italy's decline (see Figure 3): low cost competition and labour fragmentation; small firms and low innovation; and a deep

territorial divide. Their contribution to the decline has been further accentuated by the fact that all major components of aggregate demand in Italy have slowed down over time, which did not happen in the other large euro area countries. Exporting became more difficult as the real exchange rate appreciated when Italy entered the euro area. Downward pressure on real wage growth due to intensified cost competitiveness strategies dampened household consumption. Investment declined as the economic outlook deteriorated and as privatisation promoted a decline in the number of large firms in crucial sectors from the 1990s onwards. And constraints on fiscal policy led to a decline in the growth contribution of public expenditures, as Italy was forced to run primary fiscal surpluses to meet the European fiscal rules and appease investors.

4. Explaining Italy's decline

4.1. THE ROOTS OF ITALY'S DECLINE: SUPPLY-SIDE EXPLANATIONS AND REFORMS

Economic historians trace the deep roots of the Italian decline back to the early stages of the unification process (e.g., Federico et al., 2019; Toniolo, 2013). A number of 'original sins' are found to be guilty: the prevalence of small firms and low education levels, constraining innovation and capability accumulation (Felice and Vasta, 2015; Nuvolari and Vasta, 2015); a long-lasting territorial divide between the advanced centre-north and the Mezzogiorno (Daniele and Malanima, 2011); excessive state interventionism (Amatori, 2003); a bank-centred financial sector favouring capital misallocation (Battilossi et al., 2013); and familism and corruption (Ghezzi, 2016; Toniolo, 2013).

For some of the explanations, the timing is off. Corruption was under control during the 1950s and 1960s, accelerated in the mid-1970s, reached its acme with the Tangentopoli ('Bribe City') scandal in 1992 and declined thereafter (Del Monte and Papagni, 2007; Newell and Bull, 2003; Krahe 2023), so that it is an implausible causal factor of decline. Similarly, state interventionism declined markedly from the 1990s onwards, as Italian policymakers acted under tightened policy constraints on industrial policy and fiscal policy and followed an agenda of privatisation (e.g., Celi et al., 2018). Furthermore, several of the most important supply-side explanations fail to account for the acceleration of Italy's decline versus the other large euro area peers over time. In particular, the territorial divide has been an issue since the late 19th century, when the 'southern question' (Questione Meridionale) – i.e., the intellectual debate on the origins and determinants of the Mezzogiorno's underdevelopment – became prominent (Daniele and Malanima, 2011).

There is a strong connection between the explanations proposed by historians and those provided by economists highlighting the role of supply-side factors. This group of explanations can be divided between those focusing on structural elements related to firm size, innovation and skills; and the ones emphasising the excessive rigidity of markets and the lack of structural reforms (Alesina and Giavazzi, 2006; Bassanetti et al., 2014; IMF, 2016; OECD, 2009, 2021a, 2021b), particularly in labour markets (Boeri et al., 2021; Daveri and Tabellini, 2000; Hijzen et al., 2017; Kangur, 2018; Tokarsky, 2019), as the major cause of the decline. According to this view, Italy's growth has been hindered by market 'rigidities' related to insiders' protection in the labour market, the centralised wage bargaining system, the excessive presence of state-owned enterprises (SOEs), administrative control of banks and constraints on international capital flows. Such a view, however, clashes with the persistence shown by Italian governments to deregulate and introduce structural reforms. Table A1 in the appendix displays how Italy outperformed its European peers as it liberalised more in several relevant dimensions:

Privatisation. In the 1990s, privatisation was more intense and widespread in Italy than anywhere else. There were two main processes. First, the transfer of public assets, a significant share of which belonged to the Institute for Industrial Reconstruction (IRI), to private companies. Second, most SOEs were listed on the stock market and were subject to commercial law rules, although the state retained a controlling stake (Gasperin et al., 2021). Privatisation was expected to help bring down the public debt

by providing one-off revenue, increasing the efficiency of the production system and, more broadly, jumpstarting productivity growth. In 1986, IRI still employed over half-a-million workers (75,000 employed in the Mezzogiorno, representing the majoritarian share of manufacturing employment), and accounted for almost 4% of the country's total value added as well as 15% of total R&D investment (Ciocca, 2015). In 1992, 'IRI was the world's tenth largest industrial group in terms of sales (third in Europe), the fourth largest in terms of assets (first in Europe) and the fifth largest industrial employer (third in Europe)' (Gasparin, 2022, p. 600). But the joint action of a generalised push for privatisation, financial distress faced by some IRI-controlled companies, the constraints on government recapitalisation and the 'Clean Hands' scandal, paved the way for its dismantling.⁶

Product market liberalisation. As Italy's product market was among the more strictly regulated up until the 1990s, the country experienced the deepest deregulation process among European countries with a strong acceleration during the first five years after euro adoption (Alesina et al., 2010). Alongside privatisations, utilities (electricity and communications) and transport markets were deregulated, and a new competition law was adopted in 1990. The OECD Product Market Regulation indicator reflects these developments: between 2003 and 2013, Italy outperformed its major EU peers, including Germany, France and Spain (Lanau and Topalova, 2019). Important liberalisation measures – i.e., the 2006 and 2007 'Bersani Laws' – were introduced in the professional and service sectors (e.g., pharmacies, architecture, law, accounting, and insurance brokerage) to reduce entry barriers.

Labour market flexibilisation. Since the mid-1990s, labour market flexibilisation has been at the centre of the Italian political agenda, notwithstanding the orientation of the governments in charge.⁷ Figure 4 plots the employment protection legislation (EPL) index for both temporary and permanent contracts. Italy's score for regular contracts was marginally stricter than in Germany and France in the 1990s, but it declined to below German levels by 2019. When it comes to temporary contracts, the Italian EPL index dropped below the level observed in France and Spain to slightly rebound in 2018 due to the introduction of the 'Dignity Decree' (Tassinari, 2022).

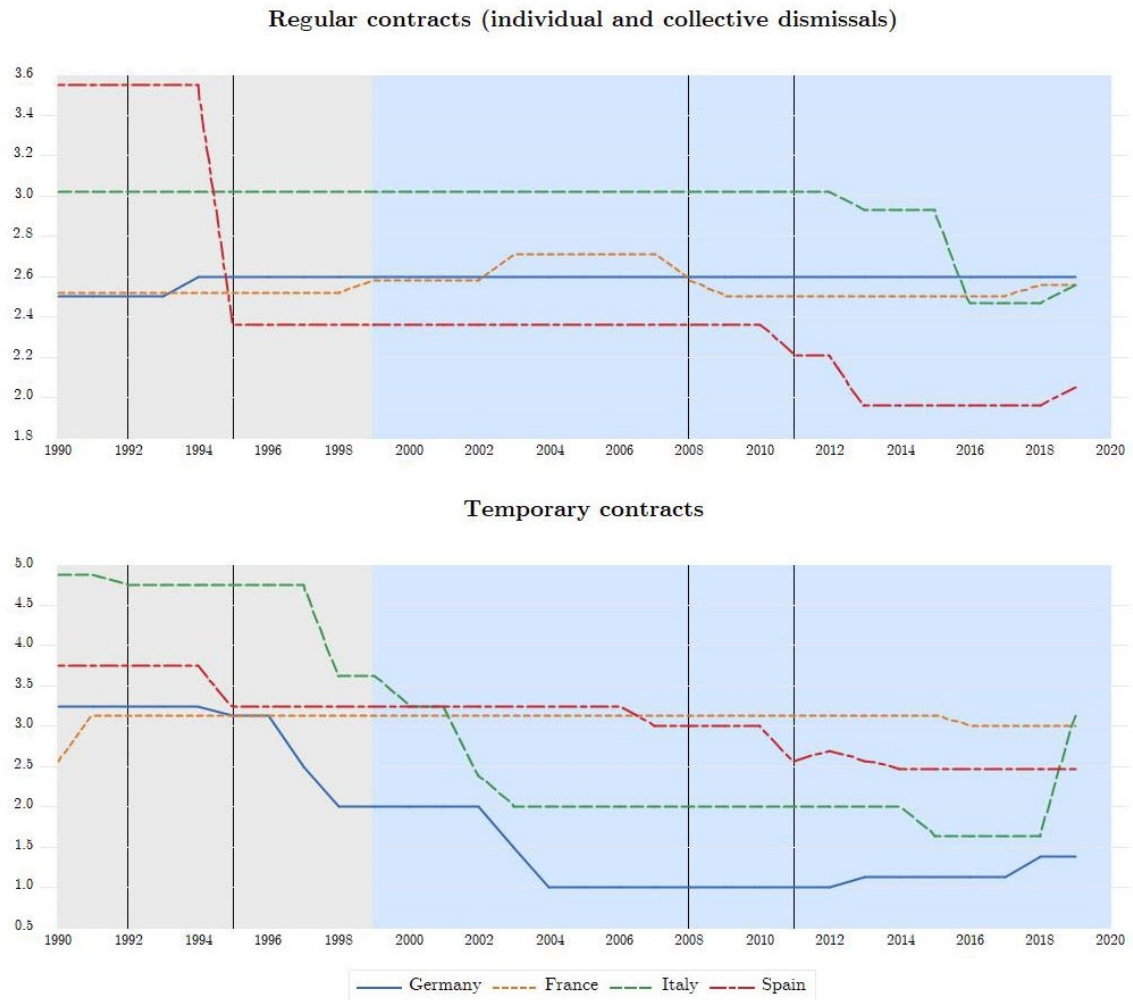
Financial deregulation. In the early 1980s, Italy started to deregulate its financial sector. In 1981, central bank governor Ciampi succeeded in 'divorcing' from the treasury, removing the Bank of Italy's obligation to meet public sector borrowing requirements. Most capital controls were removed, starting from the credit ceilings in 1982, to the adoption of the first European Banking Directive in 1985, which introduced the concept of banks as profit-making institutions, overcoming the previous concept of 'public interest' (Piluso, 2021). The Banking Law of 1936 was eventually abolished in 1990 and replaced by a new regulation based on the second European Banking Directive, thereby kickstarting the privatisation of public banks. After more than 20 years of deregulation and massive concentration, with some key Italian

⁶ The liquidation of IRI took place between 1992 and 2002.

⁷ In 1992, just before the lira devaluation, the 'scala mobile' (i.e., indexation of wages to inflation) was suspended. In 1993, a 'tripartite agreement' between the government, the main unions and Confindustria decentralised the wage bargaining system (with a clear wage-moderation objective) in exchange for new investment in innovation, where the latter did not materialise. In 1997 and 2003 the 'treu package' and the 'Biagi law' introduced and extended temporary contracts. During the technocratic Monti government, in 2012 the 'Fornero law' amended the worker's statute, allowing for the possibility of firing permanent workers for economic reasons. In 2015 the 'Jobs act' further reformed permanent contracts and introduced the possibility of firing workers 'without just cause', in exchange for monetary compensation. Only in 2018 and 2019 was there somewhat of a reversal, with the introduction of the 'Dignity Decree' – which reduced the margins of applications of temporary contracts – and the introduction of universal unemployment insurance. However, this reversal was very short-lived, as the new government in 2022 was already planning a counter-reform, again in the direction of further flexibilisation, also lowering unemployment benefits and their duration.

banks included among Europe's largest financial institutions (e.g., Unicredit and Intesa San Paolo), another significant push was provided by the 2015 reforms of the Renzi government.⁸

Figure 4 / Employment Protection Legislation Index 1990-2019



Source: OECD. Notes: the Employment Protection Legislation index ranges from 0 (unprotected) to 6.

The analyses of historians and economists focused on supply-side factors have the merit of grasping the persistence of factors that have been present in Italy's development since unification. But Italy's decline accelerated in the 1980s and 1990s with the process of European integration and globalisation, when some of the abovementioned weaknesses stabilised or even entered a more positive path. In what follows, we analyse the most important structural domestic factors in turn and pay specific attention to feedback effects with policy constraints brought about by globalisation and European integration.

⁸ Reforms include measures aimed at: favouring consolidation – with the reform of popular banks and mutual banks; introducing barriers to state recapitalisation (e.g., the so-called '*bail-in*'); speeding up debt recollection – with the introduction of the guarantee mechanism on the securitisation of NPLs (GACS).

4.2. LOW-COST COMPETITION AND LABOUR FRAGMENTATION

Before WWII, Italy was specialised in traditional and unsophisticated manufactures (with the sole exception of motor vehicles) and had 'an advantage in less technology-intensive supplier-dominated and scale-intensive industries, while it had a general disadvantage in the more technology-intensive specialised-suppliers sectors' (Domini, 2016, p. 148). This specialisation pattern is the result of the country's abundance of cheap unskilled labour⁹ and the relative scarcity of natural resources, hampering the development of heavy industry (Nuvolari and Vasta 2015).

During the golden age, the sectoral shift from agriculture to manufacturing – along with large internal migration from south to north – determined an excess labour supply, allowing Italy to combine high output and employment growth rates with strategies aimed at wage containment to achieve external competitiveness. The social conflicts of the 1970s resulted in an historical defeat of the labour movement, leading to the rapid downsizing of manufacturing employment. The weakening of trade unions and organised labour in manufacturing, in turn, paved the way for a process of further flexibilisation and liberalisation when European integration intensified, which eventually led to the precarisation of labour markets from the 1990s onwards (Tassinari, 2022).

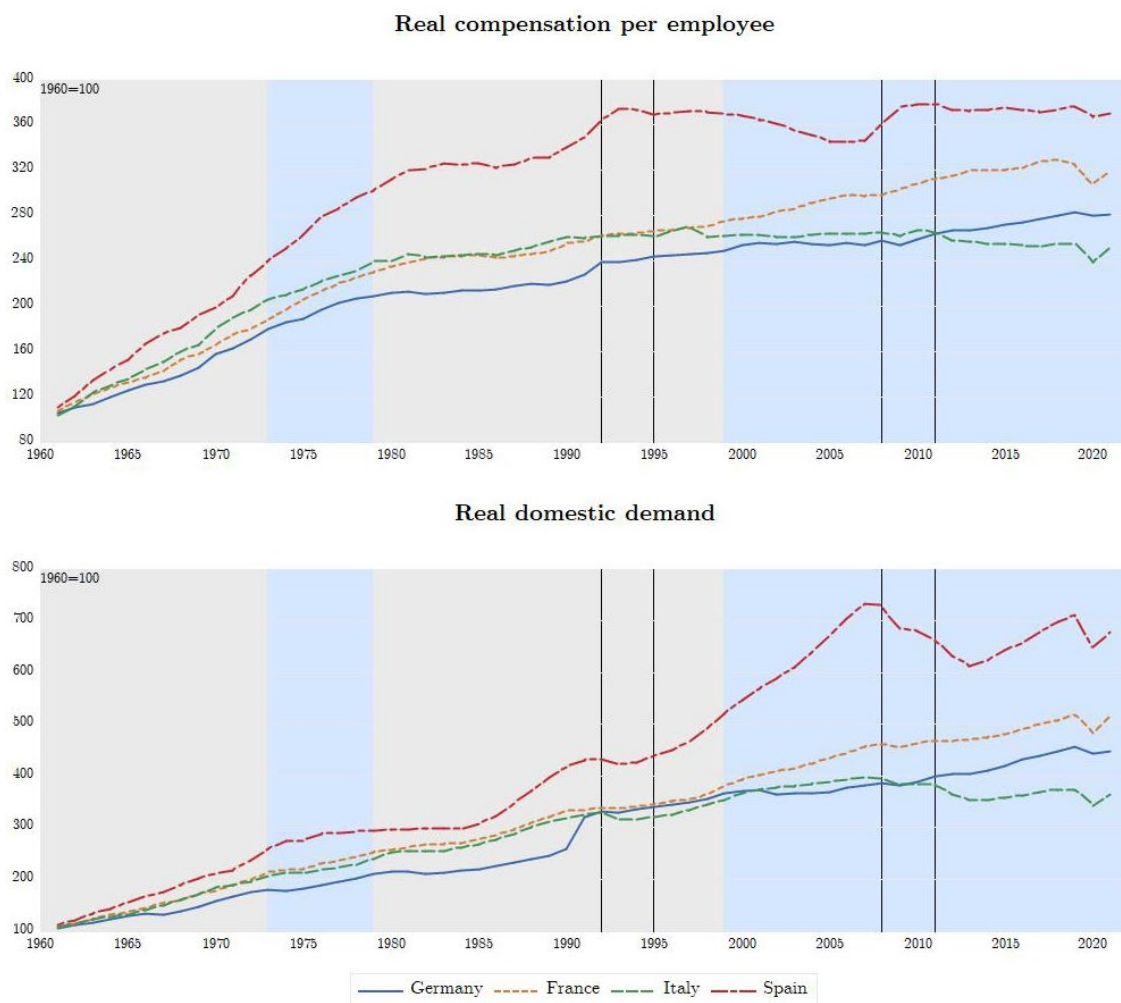
The structural weakness of labour is important for understanding Italy's decline in two major ways. First, wage repression negatively affected growth dynamics by weakening the linkage between aggregate demand and the 'Kaldorian' processes of learning, innovation, and industrial renewal (Antonelli and Barbiellini Amidei, 2007). Second, the persistent availability of cheap labour encouraged the spread of low-cost competitive strategies, which in turn discouraged alternatives based on investment, innovation and training. Cost competitiveness strategies contributed to locking in the Italian economy along a medium-technology specialisation path, preventing it from playing a significant role in the development of frontier sectors and technologies (Ciocca, 2020). This was a particular problem when globalisation intensified in the 1980s and 1990s, as exporting firms in medium-technology specialisations had problems meeting the challenge of increased global competition for export market shares (Daveri and Parisi, 2015). Italy's technological competitiveness trended downwards as it was confronted with more competition from China and other emerging market economies (e.g., Gräbner et al., 2020b).

Entering the euro area took away the option of currency devaluation to regain price competitiveness. 'Internal devaluation', the attempt to improve cost competitiveness by domestically putting downward pressure on wages, gained importance (e.g., Armingeon and Baccaro, 2012; Rathgeb and Tassinari, 2022). Italian governments reformed the labour market in several rounds from the early 1990s onwards. In theory, this was supposed to increase the cost competitiveness of Italian firms, thereby allowing them to gain export market share as they came under increasing pressure from competition in China and other emerging market economies, while the option of currency devaluation was no longer available. Labour market reforms indeed contributed to reducing inflation and real wage growth. But cheap labour also increased the labour-intensity of production, as a growing share of temporary employment contributed to reducing incentives for innovation (Tridico, 2015). Private investment is key to rising productivity and particularly important in high-tech sectors (Kleinknecht, 2020), but the intensification of low-cost business strategies in a more flexible labour market took away incentives for private

⁹ Between the 1880s and WWII, only Spain had a lower per-capita number of patents than Italy among major European countries (Nuvolari et al., 2019). Moreover, spending on education was low with respect to other major European countries.

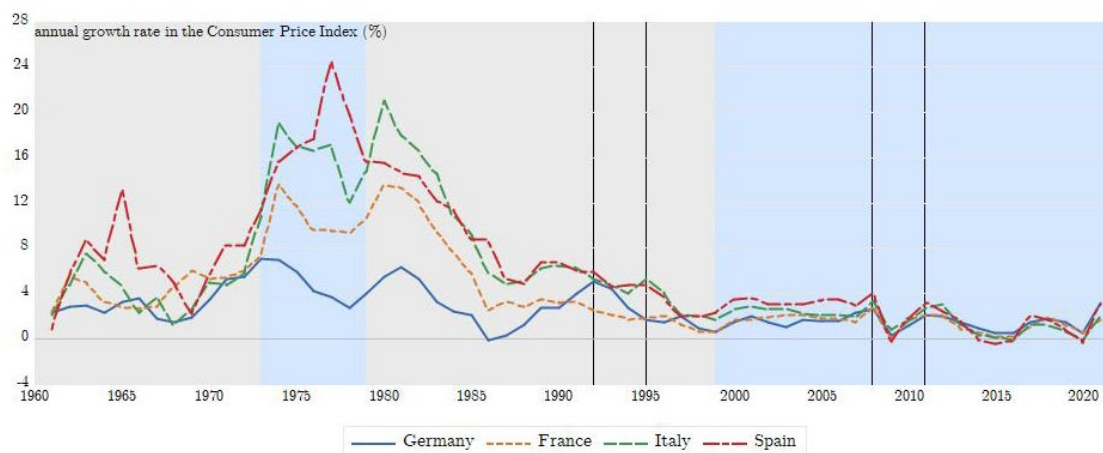
investment. This counteracted improvements in competitiveness in terms of unit labour costs (Krahé, 2023). The original sin related to low-cost competition and labour fragmentation, therefore, interacted with policy constraints that intensified with globalisation and European integration to exacerbate Italy's problems of deteriorating domestic demand for goods and services compared to its euro area peers: the first signs of stagnation in real compensation per employee appeared in the late 1970s, but from the 1990s onwards, real wages first flat-lined and then developed into a negative trend; in 2021, the level in Italy was lower than in 1990. Such dynamics contributed to the stagnation of domestic demand, which is observable from the late 1990s onwards (see Figure 5).

Figure 5 / Real wages and domestic demand in Italy, Germany, France and Spain



Source: AMECO; own calculations.

A large literature focuses on the weakness of aggregate demand as the main explanation for Italy's decline. The theoretical premise runs as follows: economic growth is primarily determined by aggregate demand via Keynesian mechanisms (i.e., uncertainty reduction driving firms' investments), Kaldorian learning-by-doing dynamics and efficiency-wage effects stimulating companies' productivity (Hein, 2023; Lavoie, 2022).

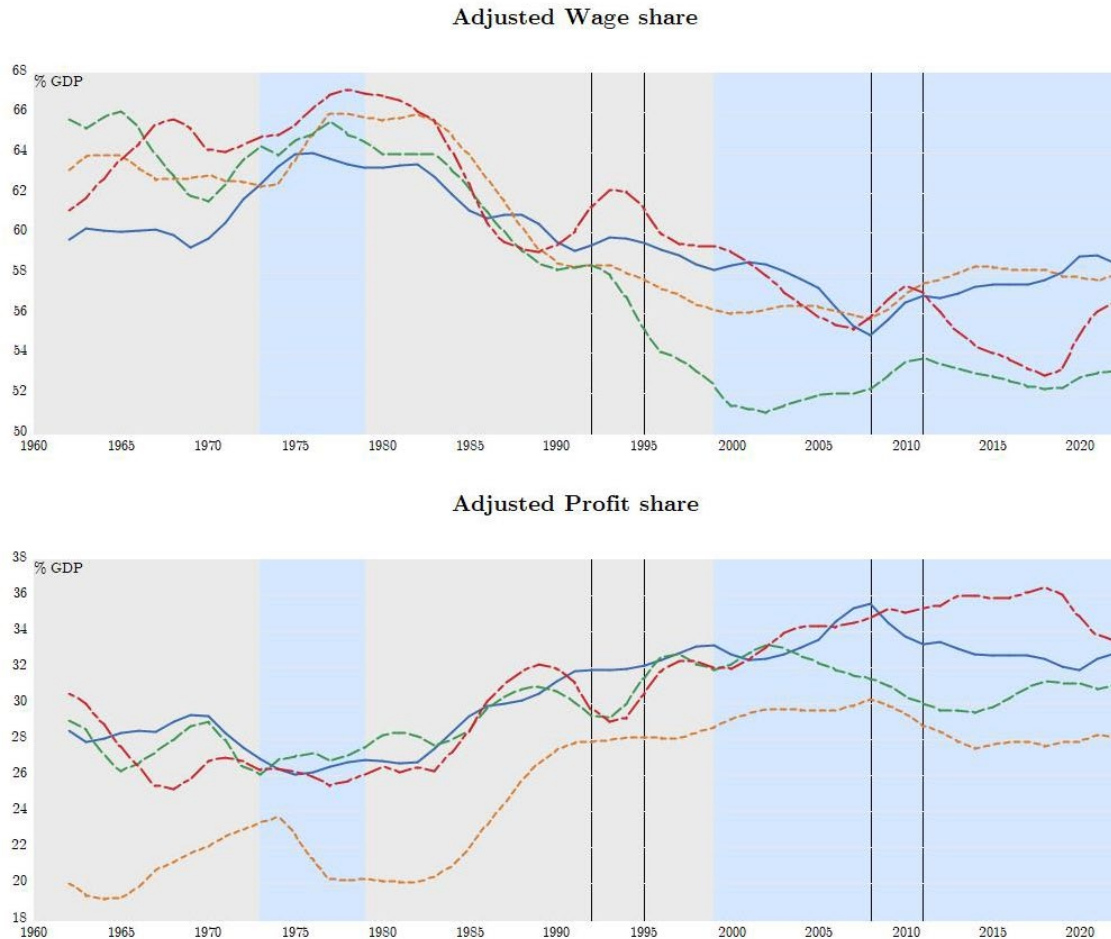
Figure 6 / Inflation rates in Italy, Germany, France, and Spain (1950-2020)

Source: Macrobistory database; own calculations.

Up until 1992 Italy's policy strategy was rather incoherent: restrictive monetary and exchange rate policies to keep inflation under control, on the one hand, and deficit spending to sustain domestic demand and flatter electorates, on the other. In fact, this proved ineffective in sustaining growth due to higher inflation, the loss of external competitiveness, and growing external and public debt (Graziani, 1998). Growing imbalances culminated in the 1992 currency crisis with the Bank of Italy nearly running out of foreign reserves. The 1992 crisis was a watershed. Italy was forced to exit the EMS, leading to a devaluation of the lira that allowed for rebalancing the current account.

Wage indexation was abolished to restore external competitiveness. Fiscal policy became restrictive and privatisation was accelerated. In this way, the shift to an economic policy paradigm characterised by wage repression, state retrenchment, and restrictive fiscal and monetary policies was initiated (Costantini, 2017). To avoid being excluded from the common currency project, Italy outperformed the other candidates to meet euro-membership conditionalities. Large primary surpluses, structural reforms for market liberalisation, wage moderation and privatisation rapidly became synonyms for modernisation or 'Europeanisation' (Celi et al., 2018). As the external constraint tightened, market forces were expected to reach their full potential, turning Italy into a truly European economy, finally free from its 'original sins'. But the increasing pressure on wages penalised aggregate demand, including investment, further weakening productivity and growth dynamics. The labour market reforms killed a flock of birds with one stone. First, they helped bring down inflation (see Figure 6); second, they increased labour intensity by making labour cheaper, thereby initially reducing unemployment;¹⁰ and third, they led to a significant increase in profit share, which converged to Germany's level (Figure 7). However, this backfired in terms of aggregate demand, productivity and, ultimately, growth.

¹⁰ It is worth noting, however, that the reduction in unemployment was partly due to pension reforms, which allowed early retirement for millions of workers (Brandolini et al., 2018).

Figure 7 / Functional Distribution. 1960-2022

Source: AMECO; own calculation. Notes: (adjusted) wage share is the compensation per employee as percentage of GDP at market prices per person employed; profit share is gross operating surplus adjusted for imputed compensation of self-employed.

4.3. MANY SMALL FIRMS AND LOW INNOVATION

The existence of a large number of small firms characterised by low productivity growth is the second domestic structural factor that is important for understanding the puzzle, and has contributed to Italy falling further behind its European peers in recent decades (i.e., Germany, France as well as the Scandinavian countries) with respect to innovation indicators such as R&D and patents (Dosi et al., 2012, 2021). Small and micro enterprises have always been the dominant type of firm in Italy. This, however, has not always been an obstacle to development. As long as industrial policy, mostly channeled through large SOEs, contributed to keeping up the pace of capital intensive investment and R&D, SMEs, particularly those organised in industrial districts (Rabellotti et al., 2009), benefited from knowledge spillovers, providing a significant contribution to productivity and GDP growth. This was a virtuous cycle that was interrupted, however, as global competition became harsher and industrial policy was partially abandoned (Becattini and Coltorti, 2004; McCaffrey, 2013).

On the supply-side, a key constraint to Italy's development has been the chronic lack of R&D and education spending. From 1970 onwards, Italy has persistently lagged behind France and Germany (Table 2). Concerning education spending, Italy has experienced a flat trend since the early 2000s, and in 2020 was barely above the level recorded in 1980. The data also reveals how in addition to the gap vis-a-vis France and Germany, the north-south divide also widened. This is consistent with the historical evidence reported above and can be explained by the prevalence of small firms and competitive strategies based on cost containment rather than innovation in the south (De Cecco, 1971; Celi and Guarascio, 2019); relatively slow growth in the supply of public goods; and the large share of the population excluded from the labour market as well as from education and training activities (this phenomenon is particularly relevant with regard to women), especially in the Mezzogiorno.

Table 2 / R&D and Education Expenditure (% of GDP)

	R&D						Var.*
	1970	1980	1990	2000	2010	2020	
France	1.8	1.7	2.3	2.1	2.2	2.4	+0.6
Germany	2	2.4	2.6	2.4	2.7	3.1	+1.1
Spain	0.2	0.4	0.8	0.9	1.4	1.4	+1.2
Italy	0.9	0.8	1.3	1.0	1.2	1.5	+0.6
- Pub. Admin.	0.4	0.3	0.5	0.5	0.5	0.6	+0.2
- Corporations	0.4	0.5	0.8	0.5	0.7	0.9	+0.4
- of which: SOEs	0.1	0.2	0.3	...	...	...	...
- Centre-North [°]	1.1	1.3	1.7	+0.6
--- Pub. Admin. [°]	0.5	0.5	0.6	+0.1
--- Corporations [°]	0.6	0.8	1.1	+0.5
- Mezzogiorno [°]	0.7	0.8	1.0	+0.3
--- Pub. Admin. [°]	0.5	0.6	0.6	+0.1
--- Corporations [°]	0.2	0.2	0.4	+0.2

	Education						Var.*
	1970	1980	1990	2000	2010	2020	
France	3.4	4.3	4.5	5.7	5.7	5.5	+2.1
Germany	...	...	4.4	4.5	4.9	4.7	+0.3
Spain	1.8	2.3	3.6	4.2	4.9	4.6	+2.8
Italy	3.4	4.2	4.6	3.9	3.8	3.7	+0.3
- Centre-North [°]	3.0	3.1	3.7	+0.7
- Mezzogiorno [°]	6.8	6.3	5.9	-0.9

Source: World Bank, Antonelli and Barbiellini Amidei (2007), Istat; own calculations. Notes: (*) variation from first available data; (°) share in local GDP.

Under political pressure to comply with the Maastricht criteria and European competition policies, privatisation was seen as a quick way to provide one-off revenue and modernise the economy. As discussed above, the 1990s were characterised by a series of privatisations of SOEs, market deregulation, and service liberalisations. These reduced the number of large companies in mature sectors of the economy, and contributed to a decline in investment as private owners were unable or unwilling to keep up previous levels of investment in the former SOEs (e.g., Baccaro and D'Antoni, 2022). Italy's lack of large companies with high levels of technological sophistication has thus been an important factor contributing to the slowdown in Italian productivity growth compared to euro area peers with more large-sized firms.

Like the other original sins, state interventionism plays an ambivalent role in explaining Italy's decline. In the early 1930s, the country was on the brink of collapse: large private companies were going bankrupt, banks were at risk of insolvency and the Bank of Italy was in financial distress. The fascist regime entrusted a technocrat, Alberto Beneduce – a socialist and antifascist with an outstanding reputation as a public manager - to save healthy (and technologically strategic) companies by placing them within a dedicated state-owned holding: IRI (see above). From WWII up until the 1980s, IRI grew considerably, some scholars argue excessively (Amatori, 2003; Amatori and Toninelli, 2011). The holding played a crucial role during the golden age, being actively involved in steelmaking, mechanical-shipbuilding and telecommunications as well as in the construction of national motorways and other large infrastructural projects (Gasperin, 2022). In the 1960s, IRI contributed to the industrialisation of the Mezzogiorno by investing heavily in capital-intensive sectors and R&D.¹¹ However, when the oil shock hit the Italian economy, IRI's growth started to slow down. Investment aimed at promoting regional convergence reached its peak, while diversification did not manage to stop the decline in productivity. IRI epitomises the ambivalent role of state interventionism: it was a fundamental driver of growth and convergence until the 1970s, but a source of inefficiency and cronyism when the global competitive environment changed and the dominant economic policy framework moved from Keynesianism to monetarism and financial deregulation. State intervention has played a larger role in Italy than in other growth models. Hence, Italy was arguably penalised more than others by the restrictions brought about by the European regulatory framework for fiscal and industrial policy (e.g., Scharpf, 1999).

In 2019, Italy's share of micro firms amounted to about 94.4% of the total – a number which is close to Spain (94.2%) and France (94.7%), but far higher than Germany (83.3%) (Table 3). The difference though, is that Italian micro firms contribute to over one-fourth of total value-added (against a mere 13.1% for Germany, and 22.4 and 17.3 for Spain and France, respectively), employ over 6.4 million workers (41.9%, more than twice that of Germany, at 18.7%, and followed at a distance by Spain, at 35.8%) and, most importantly, are the least productive of the big-4.¹²

Why are there so many small firms and why should this matter in explaining Italy's decline? Concerning the why, some authors emphasise the role of institutions and 'dedicated' regulations (applying to firms with less than 15 employees) providing incentives to stay small: the availability of more flexible labour contracts, access to tax breaks, and fewer constraints on governance as compared to larger companies (Bugamelli and Lotti, 2018; Lotti and Sette, 2019). On the other hand, firms' dwarfism is related to elements that are often linked to Italy's poor productivity performance, such as family-based governance structures leading to poor managerial practices (Bloom et al., 2012; Damiani et al., 2018; Pellegrino and Zingales, 2017; Schivardi and Schmitz, 2020), lower propensity to innovate, and capital misallocation (Calligaris et al., 2016). Even small firms' explanation may be considered controversial, however. When the large SOEs started to show a smaller contribution to growth, partly due to the dismantling of IRI and subsequent privatisations, industrial districts populated by networks of SMEs operating mainly in the medium- and medium-high-tech industrial districts of Emilia-Romagna and Veneto became a key asset, particularly in the manufacturing sector. In this period, some scholars argue that their dynamism and adaptability may have represented a role model, opening the way for a new season of Italy's competitiveness (e.g. Rabellotti et al., 2009). As the decline accelerated during the 1990s, however, this enthusiasm faded and the weakness of a system where large innovative companies were in short supply

¹¹ Attracting the attention of many international scholars (e.g. Holland, 1972; Posner and Woolf, 1967).

¹² This is due to the high share of self-employed in the workforce, which are in fact 1-person firms, often employed in services, and characterised by low wages.

became difficult to dispute. Still, a closer inspection of Italy's industrial structure (see Table 3) shows that large firms (over 250 employees) have productivity levels comparable to German ones, while firms with 50-249 employees have the highest productivity among European peers (4.3, 8.7, and 13.4 pp higher than France, Germany, and Spain, respectively). However, these two groups, representing the bulk of Italian manufacturing companies, amount to only the 37.2% of total employment (5.7 million), lower than the figures for France (61.6%), Germany (59.2%), and Spain (44.4%). This is in line with the findings of Bugamelli and Lotti (2018), who report that productivity in the top 10% of manufacturing firms increased steadily from 2005 to 2014. Furthermore, Giordano and Zollino (2021) show that the Italian decline is mostly driven by the now-dominant service sector, where SMEs tend to be concentrated.

Table 3 / Firms' statistics by size, 2019

	Country	0-9	10-49	50-249	250+	Total
Number (%)	Germany	83.3	14.1	2.2	0.5	100
	Spain	94.2	5.04	0.6	0.1	100
	France	94.7	4.48	0.7	0.2	100
	Italy	94.4	4.92	0.6	0.1	100
	- Centre North	94.3	4.97	0.7	0.1	100
	- Mezzogiorno	96.1	3.51	0.3	0.04	100
Value Added (%)	Germany	13.1	17.0	16.8	53.1	100
	Spain	22.4	18.6	16.1	42.9	100
	France	17.2	13.1	12.5	57.2	100
	Italy	25.3	20.7	17.8	36.2	100
Employment (%)	Germany	18.7	22.1	17.2	42.0	100
	Spain	35.7	19.9	12.8	31.6	100
	France	22.5	15.9	12.9	48.7	100
	Italy	41.9	20.9	13.3	23.9	100
	- Centre North	43.9	24.9	18.9	12.3	100
	- Mezzogiorno	57.5	22.5	12.4	7.6	100
Productivity (%)	Germany	42.5	46.3	59.2	76.6	60.6
	Spain	27.3	40.3	54.5	59.0	43.4
	France	50.4	54.1	63.6	77.2	65.8
	Italy	30.7	50.5	67.9	76.8	50.7

Source: Eurostat; own calculations. Notes: Table displays values relative to all business activities.

4.4. DEEP TERRITORIAL DIVIDE

The north-south divide has constrained Italy's development since the late 19th century, when the 'southern question' became prominent in the political arena (Daniele and Malanima, 2011). Despite its persistence, the evolution of the north-south divide has been uneven. It is characterised by three distinct phases, heterogeneous in terms of convergence/divergence dynamics, paces of industrialisation and structural change (Iuzzolino et al., 2013).

From unification up until 1950, the Italian economy experienced an intensive sectoral shift from agriculture to manufacturing (textiles, engineering, steel, chemicals, and automotive). This process regarded mainly the country's north-west and specifically the areas around the cities of Milan, Turin, and Genoa – i.e., the 'industrial triangle'. As a result, the gap between the industrialised north and the

Mezzogiorno, with notable exceptions such as the Naples area, started to widen.¹³ The second phase corresponds to the golden age (1950-1973), when the Mezzogiorno displayed one of the highest growth rates globally – driven by rising productivity growth – and the internal divide declined considerably (Daniele and Malanima, 2011; Felice, 2018). Convergence was driven to a large extent by fiscal and industrial policy. A pivotal role was played by the Southern Italy Development Fund (SIDF, 'Cassa per il Mezzogiorno'), a state-owned agency focusing – in the 1950s – on infrastructural and agricultural investment, and later – in the 1960s and early 1970s – on the promotion of capital-intensive industries (Felice and Lepore, 2017; Papagni et al., 2021). In the meantime, the gradual build-up of the Italian welfare system opened the way for large fiscal transfers from north to south, alongside growing interregional trade. Nevertheless, the prevalence of SMEs concentrated around the so-called 'cathedrals in the desert' – i.e. large SOEs with poor competitiveness and unable to stimulate the growth of adequate supply chains around them – slowed down the Mezzogiorno's industrialisation process, hampering further convergence (Fanti et al., 2022). The third phase – starting with the oil crisis of the 1970s – led to a complete halt of the convergence process, followed by a long period of growing divergence in both incomes and employment. Many dynamics were at work. First, the setback of industrial policy, as the SIDF was gradually downsized and, in 1984, finally terminated.¹⁴ Second, fiscal redistribution started running out of steam, with an increasing amount of resources absorbed by rising interest rates on the public debt and political priorities, moving from full employment and structural convergence to containing inflation in the context of the accession process for deeper European integration (Daniele and Malanima, 2011). Third, the more fragile industrial structure of the south proved less resilient to the increasing competition brought about by the globalisation of markets, further penalising its competitiveness vis-à-vis the north.

The north-south divide is Italy's third original sin. Higher unemployment rates, low-paid jobs, poor innovation, and inefficient public administration are unique characteristics of the south, which has lagged behind the rest of the country since the Unitarian era. Even in this case, there is ambivalence. Representing an inexhaustible source of cheap labour, the Mezzogiorno's regions are instrumental to the cost-competitiveness strategies of the northern export-led growth strategy (De Cecco, 1971). On the other hand, the north-south divide has led to a continuous depletion of material and human resources, impeding Italy's structural upgrading prospects. Nonetheless, up until the acceleration of the European integration process in the 1990s, fiscal and industrial policies mitigated the divide and, in some phases (1950-1970), ensured some convergence. However, the European regulatory framework made the use of industrial policy interventions much more difficult (e.g., Guarascio and Simonazzi, 2016) while fiscal policy turned restrictive. During the euro crisis Italy lost about 25% of its industrial production; the reconstruction of Italian industries was limited by restrictions on fiscal and industrial policies (Lucchese et al., 2016). Importantly, the south of Italy experienced a much larger contraction in manufacturing value added than the northern regions; business investment, household consumption, and public expenditure in the south also fell significantly more, which further increased the deep territorial divide.¹⁵

¹³ Nevertheless, by the end of the century productivity in the south was equal to northern regions (Federico, 2007). During the Fascist regime, however, the gap increased, also fostered by government policies. Internal and external migration was blocked, while industrial production was ever more concentrated in the north to sustain growing defense needs. During WWII the south of Italy was bombed more massively than the north, while the latter absorbed most of the resources devoted to reconstruction.

¹⁴ Before, the SIDF had already been losing effectiveness as an industrial policy tool due to mounting political pressure and related misallocation of public resources (Del Monte and Papagni, 2007).

¹⁵ Manufacturing value added declined by 33.1% in the south between 2008 and 2014, while it fell by a more modest 14.2% in the north. Household consumption in the south slumped by 13.2% vs. 5.5% in the centre-north. Gross fixed

Increased north-south polarisation is even visible in areas such as banking, where a broad process of centralisation and desertification of banking activity in the south has taken place.¹⁶ The financial deregulation measures discussed in section 4.1 did not improve the performance of the Italian banking system: allocative efficiency did not increase,¹⁷ scandals and opaque mergers and acquisitions (Monte dei Paschi-Antonveneta being the most renowned) were followed by judicial investigations. Moreover, financial deregulation contributed to a decline in credit to southern firms, thereby putting further pressure on the shadow economy.

investment in the south and in the rest of Italy declined by 38.1% and 27.1%, respectively (Guarascio and Simonazzi, 2016, p. 316).

¹⁶ A recent study by the Bank of Italy showed that between 1995 and 2019 the share of banks in the south headquartered in the area declined from 88.2 to 68.6%. Moreover, in the short-to-medium run, bank credit to firms declined after M&As – which primarily involved acquisitions of southern banks by northern institutions – severely affected southern firms (Del Prete et al., 2022).

¹⁷ Studying the effect of bank reforms in Italy, Guiso et al (2006) find that provinces characterised by tougher restrictions on bank competition had higher access to credit (though at higher interest rates) and a lower proportion of bad loans, which however increased severely after deregulation.

5. Conclusions

We have analysed how Italy's decades-long decline has turned the country into the euro area's Achilles heel. We borrow from the existing growth model literature (e.g., Baccaro and Bulfone, 2022) by analysing the drivers of Italy's growth regime over the last decades, allowing us to identify important developments and breaks. However, we go beyond the existing literature to develop a structuralist framework that allows us to synthesise different supply-side and demand-side explanations in a long-term perspective (e.g., Cipolla, 1952). In so doing, we account for the role of institutions (e.g., Amable and Palombarini, 2008; Simoni, 2020), the sectoral composition of the economy, and domestic and international interdependencies (e.g., Andreoni and Scazzieri, 2014).

We argue that structural domestic factors that were already present in the decades after World War II ('original sins') – in particular low-cost competition and labour fragmentation, many small firms and low innovation, and the north-south divide – interacted with the policy constraints brought about by globalisation and European integration to exacerbate Italy's decline vis-à-vis its large euro area peers, Germany, France and Spain. The interaction of 'original sins' has constrained Italy's development. Up until the 1980s, public demand, vertical and selective industrial policies operated through import substitution, and the actions of SOEs operating in technologically strategic sectors, together with the Cassa del Mezzogiorno's programs partly offset the negative impact of the structural flaws. As globalisation and the European integration process accelerated, the room for maneuver for domestic monetary and fiscal policymakers was reduced, thereby making even more severe the demand-side constraint due to downward pressure on wages. The rapid opening to capital movements, the abandonment of interventionist industrial policies, and the dismantling of many SOEs interrupted the process of structural strengthening and further widened the north-south divide. At the same time, structural reforms weakened the welfare state by further penalising labour, wages, and thus aggregate demand. The interaction between original sins and external policy constraints exacerbated the negative impact on productivity growth, increasingly weakening the Italian economy vis-à-vis its large euro area peers.

Our results suggest that Italy is a failed case of modernisation brought on by external constraints. Euro area membership did not result in modernisation and convergence towards higher living standards such as those experienced in Europe's best performing countries. On the contrary, a fault line opened up between the core – centred around Germany's industrial export hub – and the southern periphery, including Italy (Celi et al., 2018). As the core strengthened its industrial base, accumulating large trade surpluses, Italy (and to a certain extent, other parts of the southern periphery) experienced a process of structural weakening or 'poor tertiarisation' (Blyth et al., 2022; Bürgisser and Di Carlo, 2023; Cirillo et al., 2017). Productive and technological capabilities declined while the relative importance of low-tech-low-wage service sectors increased.

While persistently tight fiscal policies and market-liberal reforms have failed to move the country forward in interaction with globalisation and European integration, a coherent long-run investment strategy may help boost Italy's economy. This of course cannot happen if the EU fiscal framework remains deflationary and self-defeating by strangulating growth and structurally penalising the most financially

vulnerable member states (e.g., Heimberger and Kapeller, 2017). By the same token, industrial policy must again become a driver of development and an engine of growth, not only to promote specific sectors and technologies but also to ensure structural convergence within the Union. Second, rethinking labour policies is also sorely needed, starting from the acknowledgement that the 20-year-long strategy based on flexibilising labour and pushing wages downward has damaged productivity, further accelerating the decline. Summing up, European policymakers need to support the proper coordination of wage, industrial, and fiscal policy by rethinking the rules of the game.

Our work paves the way for further research in comparative and international political economy in multiple directions. First, we hope to stimulate work on biased or incomplete views of how Italy ended up in long-term economic decline, including the role of media outlets and policy elites in framing Italy's decline. Second, our framework should be further taken to the data: future research can aim at quantitatively testing the original sins driving Italy's decline. Third, as some of those factors may be relevant in explaining the evolution of other European economies, an analogous structuralist synthesis may be applied to understand the broader process of core-periphery divergence which has plagued the euro area. Fourth, given the interconnectedness of the euro area with the global financial and economic system (e.g., Tooze, 2018), more international political economy research is needed to compare Italy's failed case of modernisation by external constraint with other cases inside and outside Europe. Finally, if Italy is the euro area's Achilles heel, the protection of Italian public debt has systemic importance in a world of collateral-based shadow banking (e.g., Gabor, 2016, 2021), so that future constraints on ECB interventions to backstop government bond markets must be expected to create stress in the European and global financial system. Further research is needed to understand the international political economy of the role played by a fragile, systemically important country in domestic and international economic policy decisions and how underlying political conflicts play out behind closed doors (e.g., Moschella and Diodati, 2020).

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Appendix

Table A.1 / Structural Reforms 1973-2013

	France	Germany	Italy	Spain
Active labour market policies (excluding vocational training)	10	52	42	7
Competition and product market regulation (excluding finance)	21	23	73	53
Education (excluding vocational training)	4	6	10	0
Employment protection legislation	35	27	65	57
Financial sector regulations	13	9	19	7
Corporate governance	3	1	0	0
Healthcare policies	11	22	27	10
Industrial relations	26	5	25	28
Non-employment benefits	37	34	16	24
Pension policies	35	24	39	27
Privatisation or nationalisation (excluding healthcare and education facilities)	21	16	46	17
Personal or corporate income taxes	36	41	37	35
Vocational training	0	0	2	4
Total	252	260	401	269

Source: Armingeon et al. (2019). Notes: table only reports reforms which have increased market liberalisation (e.g., variables recorded with 1 in the lib_delib dummy, see the annexed Codebook for further details).

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