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The Eurozone's Achilles heel: Reassessing Italy's long decline in the context of European integration and globalization

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Abstract

This paper analyzes how Italy's decades-long decline turned the country into the Eurozone's Achilles heel, the most vulnerable spot of the common currency. We use a new structuralist framework to synthesize different (competing) supply-side and demand-side explanations. 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 globalization and European integration to exacerbate Italy's decline vis-à-vis its large Eurozone peers.

Keywords: Italy, decline, Eurozone, crisis.

1. Introduction

The Eurozone'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 its 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 in 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 Eurozone'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 new 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 globalization and European economic integration to exacerbate Italy's decline vis-à-vis its large Eurozone 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, sheeding new light on how Italy became the Eurozone's Achilles heel is of major importance for researchers and policy-makers.

Several stylized facts point to the vulnerability of Italy: a long-lasting stagnation in labor productivity; a high public debt burden that makes the country 'too big to fail' in the Eurozone context; fragility to periodic increases in interest rates spreads endangering domestic debt sustainability but also European financial stability; unemployment persistently above the EU average. There is a voluminous literature on the Italian decline and its economic position in Europe (e.g., Krahé, 2023; Notermans and Piattoni, 2021). Competing explanations stress different historical (cronyism, familism, too much state interventionism in market processes, as in Toniolo 2013), supply-side (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., Baccaro and Bulfone, 2022; Kohler and Stockhammer, 2022) by identifying fundamental discontinuities in the 'Italian model'; we use our structuralist framework to highlight links between domestic institutional factors and their feedback effects with international factors.

The rest of the paper is structured as follows. Section 2 sets out major stylized facts on Italy's decline and why the country can be seen as the Eurozone's Achilles heel. Section 3 illustrates the analytical framework identifying the major drivers of the decline in the context of globalization 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 globalization locked Italy onto a path of decline. Section 5 concludes.

2. Italy as the Eurozone's Achilles heel

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

2.1 Economic domain

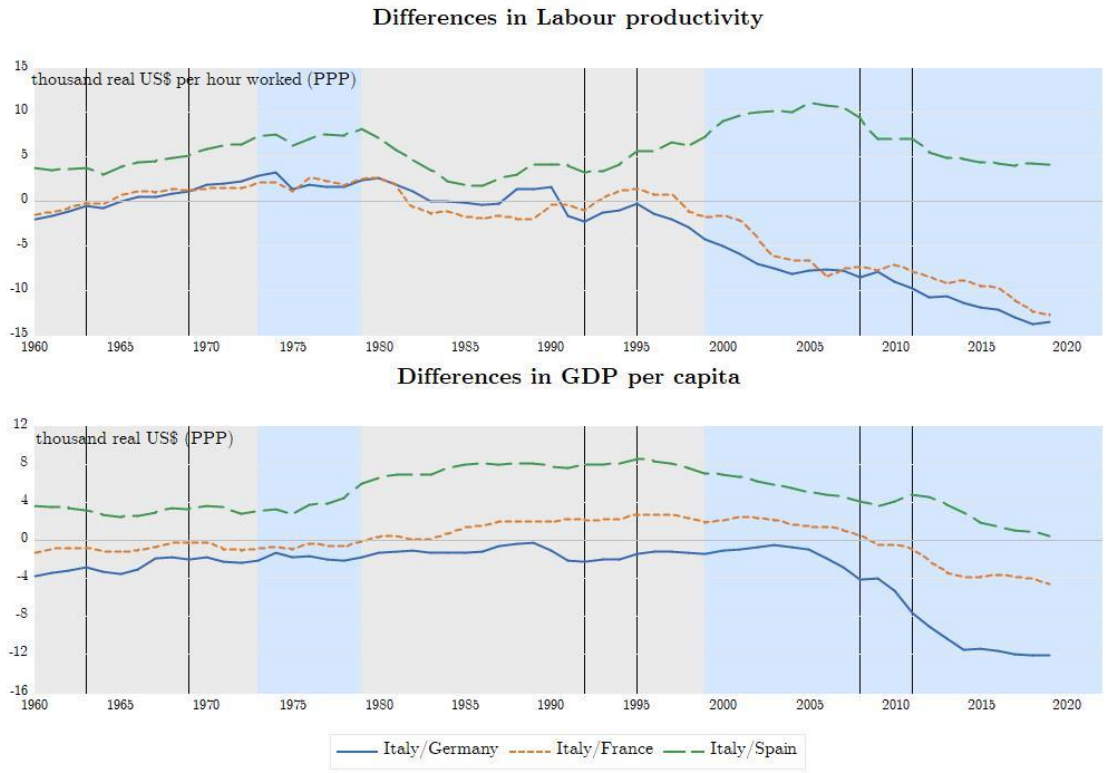
In the economic domain, size is a big deal. Despite its decades-long stagnation, Italy remains the third largest Eurozone economy in terms of economic output.[1] Beyond its sheer size, the connectedness through trade links is also relevant, as Italy's Northern regions are tightly linked with Europe's 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 the lockdowns interfered in 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, GVCs disruption and trade rationing exposed the impoverishment of Italy's productive structure after decades of offshoring and declining investments (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 Eurozone as a whole. Its persistent economic problems are manifest when

[1] In 2021, Italy's real Gross Domestic Product stood at €1678 billion, which accounts for 14.9% of the Eurozone's whole output. Only Germany (28.4% of the Eurozone) and France (20.7%) surpass Italy in terms of economic size.

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, the underperformance of productivity rapidly gathered pace in the 1980s and accelerated further after Italy joined the Eurozone 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 Eurozone peers.

Figure 1. Performance of Italy compared to the other large Eurozone peers (labour productivity, GDP per capita)



Source: Long Term Productivity Database; own calculations. Notes: values in thousands constant (2010) U.S. $, 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 unions' uprising (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).

Over the course of a 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 a lacklustre industrial performance have culminated in substantial losses in relative living standards. Up to 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).

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 Eurozone from a financial point of view. Among the Eurozone's largest member countries, Italy now by far exhibits 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 Eurozone 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).

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 Eurozone membership would reduce the risks associated with Italian bonds to the risk levels of Germany and other Eurozone countries. With the emergence of the Euro Crisis, Italy's interest rate spread vis-à-vis Germany and France again 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 summer 2012 that it would backstop the Eurozone's government bond markets (e.g., Saka et al., 2015). However, Italy's public-debt-to-GDP ratio relative to Germany increased strongly over the years of the Euro Crisis as Italy's growth performance was worse than in other Eurozone countries. This further increased the financial fragility of the Eurozone's third-largest economy to future economic shocks by reducing the Italian

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

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

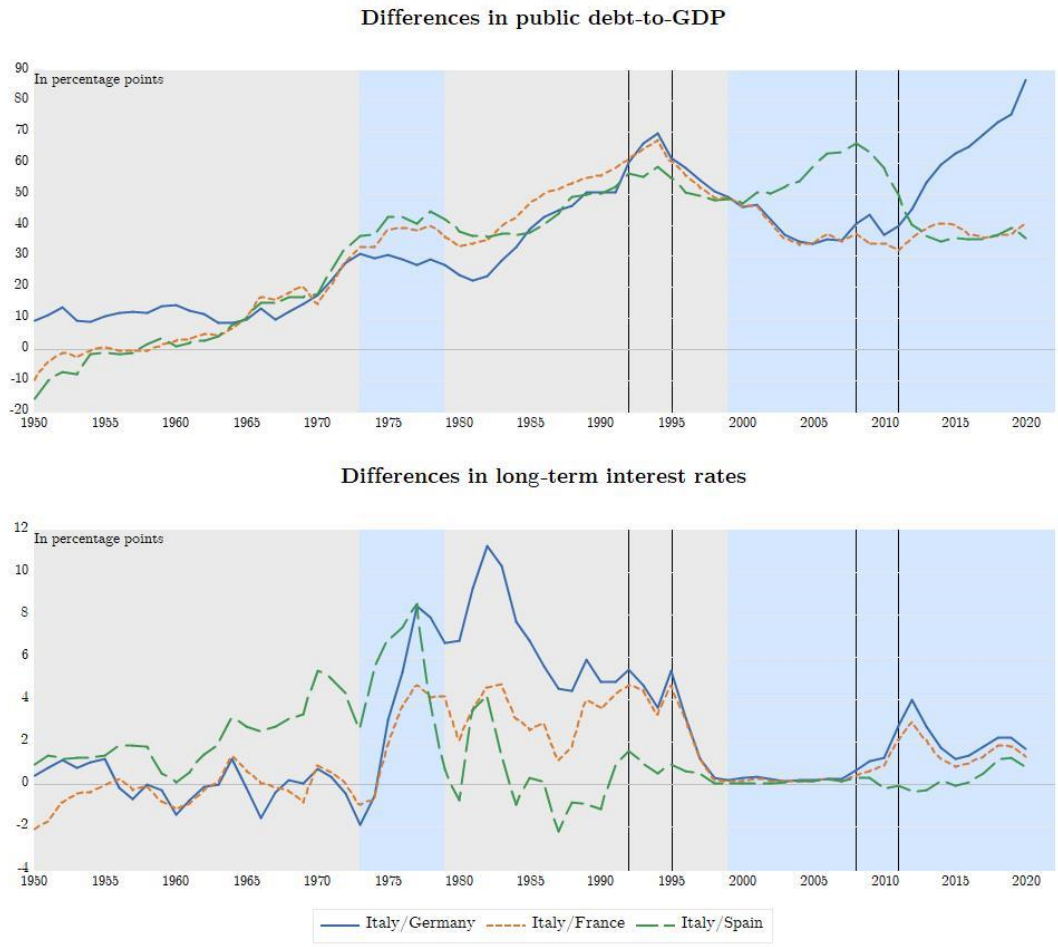
policy-makers' fiscal space, which became apparent during the early stages of the Covid-19 crisis (e.g., Gräbner et al., 2020a; Storm, 2021).

Italy's large public debt stock in relation to other Eurozone countries[4] combined with its long economic decline matters in the context of Europe's financial plumbing. Europe's largest money market is the €9 trillion 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 the Eurozone 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 Eurozone'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 financial crisis, Euro Crisis and 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 that can lead 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, Italy's large economic size and investor concerns about its future debt and economic trajectory make Italy into 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 Eurozone via contagion effects (e.g., De Grauwe and Ji, 2013).

Italy's economic decline and its worsened fiscal outlook through the crises of the past two decades have contributed to the intensification of major political conflicts concerning the resolution of the economic and political problems in Italy and the Eurozone (e.g., Frieden and Walter, 2017). Despite Italy's problems, a majority of Italians so far continues to be in favour of EU and Eurozone membership. However, support for European integration has declined over time (e.g., Baccaro et al., 2021). A political push for an Italian exit from the Eurozone 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 €2678 billion, which was even higher than Germany's at €2476 billion.

Figure 2. Performance of Italy compared to the other large Eurozone peers (Public-debt-to-GDP, long-term interest rates on government bonds)



Source: Macrohistory database; own calculations.

Section 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), identifying fundamental discontinuities and underlining how Italy became a 'failed growth model' (Baccaro and Bulfone, 2022). We then provide our framework for a structuralist synthesis in bringing together the 'pieces of the puzzle' – i.e., seemingly competing supply-side and demand-side explanations and highlighting the linkages connecting them. To this end, we adopt a long-run perspective showing how original sins changed their shape and became more binding as a consequence of globalization and European integration.

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 (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 Eurozone has 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, such as property prices, private debt, the fiscal stance, and export complexity.

Using growth decomposition to identify growth models[5], 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.

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 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 the increase in the fiscal deficit. With the entry in the EMS, as Italy started to fight inflation, and tried to avoid currency realignments, the 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 the early

[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.

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 globalization and European integration to exacerbate Italy's decline from the 1990s onwards. We thereby combine the growth model approach with a structuralist framework.

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.

3.2 A structuralist framework for explaining Italy's decline

We argue that Italy's long decline compared to its Eurozone 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 globalization 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.

We conceptualize globalization and European integration as processes that have led to tighter constraints on domestic economic policy in Italy. We understand economic globalization 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 globalization makes it harder for governments to prevent mobile capital from leaving a country if business leaders find tax law or regulations in other countries more attractive. This may put pressure on tax policies and welfare states, as tighter financial integration penalizes deficit spending (e.g., Garrett, 1998; Streeck, 2014).

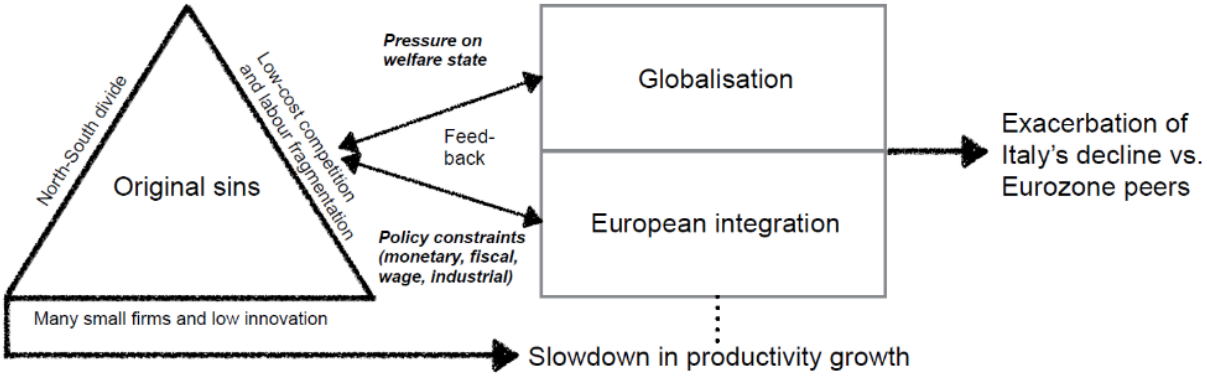
European economic integration, which culminated in member states sharing the same currency, has substantially affected domestic economic policy options. As Italy entered the Eurozone, it lost the option to devalue its currency vis-à-vis Germany and other member countries, although it had regularly used devaluations in the past to ensure export competitiveness (e.g., Bagnai, 2016). As Eurozone 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., Buiter et al., 1993; Zezza, 2020). The convergence criteria for joining the Eurozone concerning price stability, low fiscal deficits and exchange rate stability already put pressure on Italian economic policy throughout the 1990s. Furthermore, European integration has affected industrial policy, as the single market has led to the liberalization of trade, tougher competition between firms across borders and the harmonization 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 technocrats and politicians actively used the "external constraints" strategy to push the agenda for liberalizing 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 modernization, 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.

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 labor fragmentation; small firms and low innovation; and a deep territorial divide. All major components of aggregate demand in Italy slowed down over time, which did not happen in the other large Eurozone countries. In what follows, we highlight how our framework contributes to explaining the Italian decline. Exporting became more difficult as the real exchange rate appreciated when Italy entered the Eurozone. 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 the 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.

Figure 3. A framework for explaining Italy's decline



Source: own elaboration

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 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 Mezzogiorno (Daniele and Malanima, 2011); excessive state interventionism (Amatori, 2003); a bank-centred financial sector favouring capital misallocation (Battilossi et al., 2013); familism and corruption (Ghezzi, 2016; Toniolo, 2013).

For some of the explanations, 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; Krahé 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 privatisations (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 Eurozone peers over time. In particular, the territorial divide is 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 emphasizing 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 centralized wage bargaining system, excessive presence of state-owned enterprises (SOEs), administrative control on banks and constraints on international capital flows.

Such a view, however, clashes with the persistence shown by Italian governments in deregulating and introducing structural reforms. Table A1 in the appendix displays how Italy outperformed its European peers as it liberalised more in several relevant dimensions:

Privatization. In the 1990s, privatization 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 belonging to IRI, to private companies. Second, most SOEs were listed on the stock market being subject to commercial law rules although the State retained a controlling stake (Gasperin et al., 2021). Privatizations were expected to help bring down public debt by providing one-off revenue, increase efficiency of the production system and, more broadly, jumpstart productivity growth. In 1986, the IRI still employed over half-a-million workers (75,000 employed in 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 [Institute for Industrial Reconstruction] 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)" (Gasperin, 2022, p. 600). But the joint action of a generalised push for privatization, financial distress faced by some IRI-controlled companies, the constraints on government recapitalization and the 'Clean Hands' scandal, paved the way for its dismantling.[6]

Product market liberalization. As Italy's product market was among the more strictly regulated until the 1990s, the country experienced the deepest deregulation process among European countries with a strong acceleration during the first five years after the Euro

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

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 such as Germany, France and Spain (Lanau and Topalova, 2019). Relevant liberalization measures – i.e., the 2006 and 2007 'Bersani Laws' – were introduced in professional and service sectors (e.g., pharmacies, architecture, law, accounting, insurance brokerage) to reduce entry barriers.

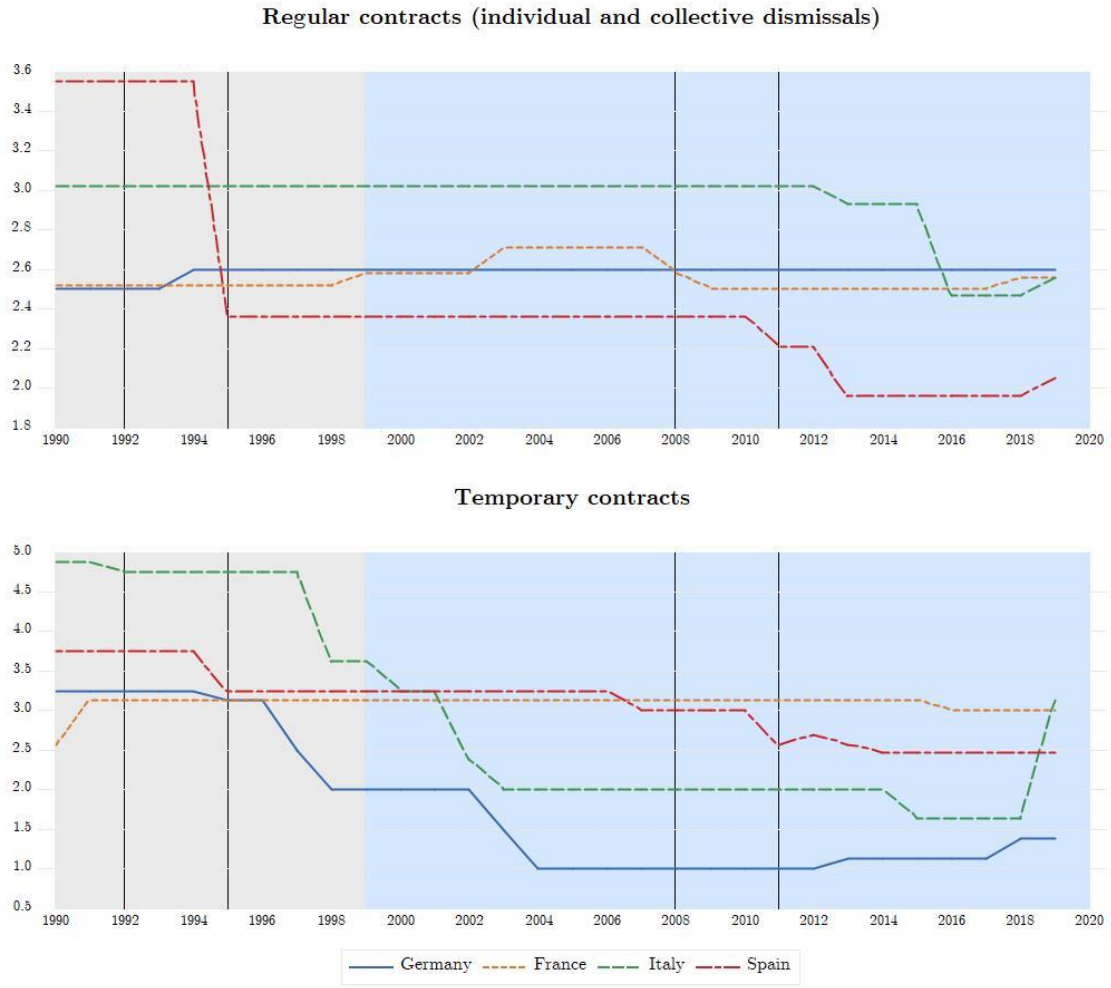
Labour market flexibilization. Since the mid-1990s, labour market flexibilization has been at the centre of the Italian political agenda, notwithstanding the orientation of the governments in charge.[7] Figure 4 plots the Employment Protection Legislation index for both temporary and permanent contracts. Italy's score for regular contracts was marginally stricter than in Germany and France in the 1990s, but it declined 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 the 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, replaced by a new regulation based on the second European Banking Directive, thereby kickstarting the privatization of public banks. After more than 20 years of deregulation and massive concentration, with some key Italian banks being included among the Europe's largest financial institutions (e.g., Unicredit and Intesa San Paolo), another relevant push was provided by the 2015 reforms of the Renzi government.[8]

[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 decentralized 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 Statue, 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 a monetary compensation. Only in 2018 and 2019 there has been somewhat 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 has been very short-lived, as the new government in 2022 was already planning a counter-reform, again in the direction of further flexibilization, and lowering unemployment benefits and their duration.

[8] Reforms include measures aimed at: favouring consolidation – with the reform of Popular Banks and Mutual Banks; introducing barriers to State recapitalization (e.g., the so-called "*bail-in*"); speeding up debt recollections – with the introduction of the Guarantee Mechanism on the Securitization of NPLs (GACS).

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 the Italian decline accelerated in the 1980s and 1990s with the process of European integration and globalization when some of the abovementioned weaknesses stabilized 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 globalization and European integration.

4.2 Low-cost competition and labor fragmentation

Before WWII, Italy was specialized in traditional and unsophisticated manufactures (with the only exception of motor vehicles) and had "an advantage in less technology-intense supplier-dominated and scale-intensive industries, while it had a general disadvantage in the more technology-intense specialised-suppliers sectors" (Domini, 2016, p. 148). This specialization

pattern is the result of the country's abundance of cheap unskilled labour[9] and the relative scarcity of natural resources hampering the development of heavy industries (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 labor supply, allowing Italy to combine high output and employment growth rates with strategies aimed at wage containment to achieve external competitiveness. The social conflicts in the 1970s resulted in a historical defeat of the labor movement leading to the rapid downsizing of manufacturing employment. The weakening of trade unions and organized labor in manufacturing, in turn, paved the way for a process of further flexibilization and liberalization when European integration intensified, which eventually led to the precarization of labor markets from the 1990s onwards (Tassinari, 2022).

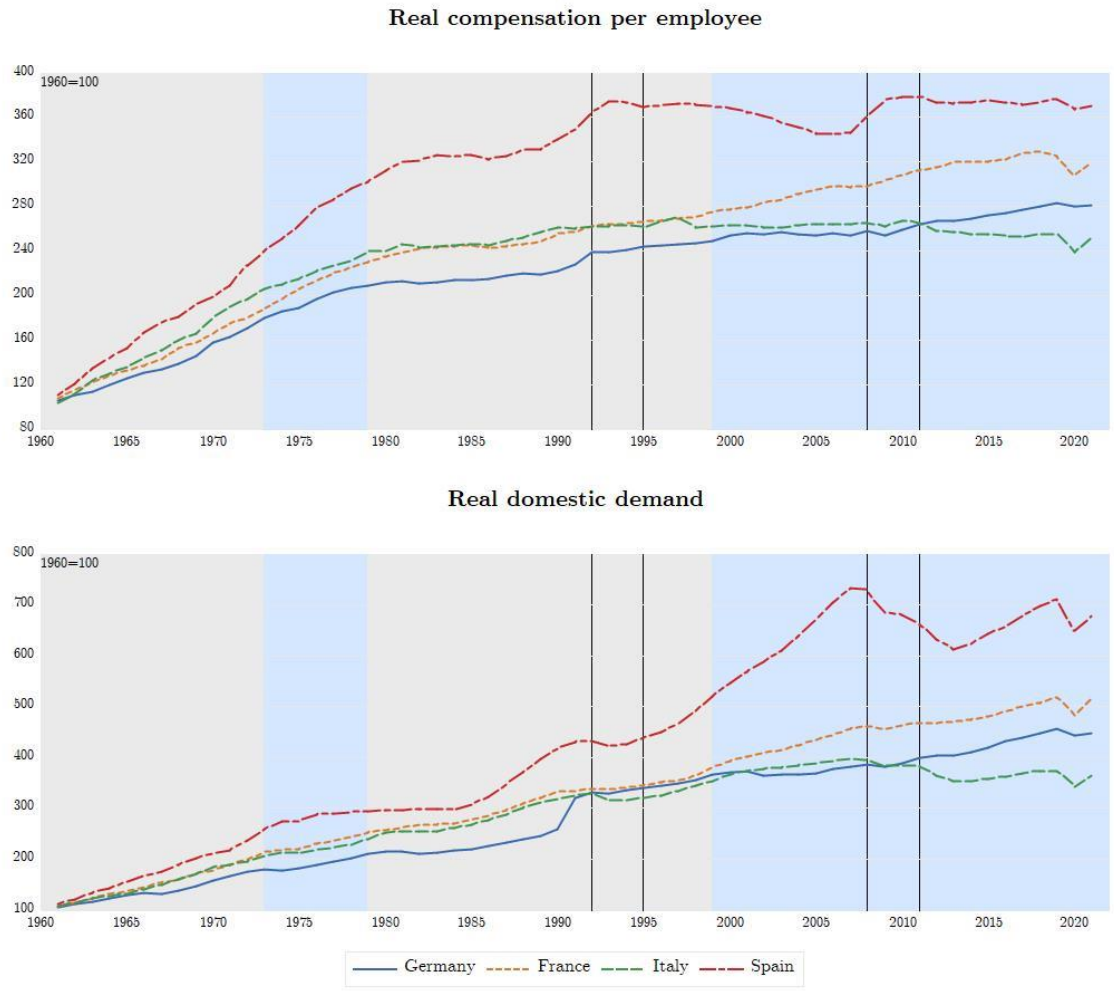
The structural weakness of labor is important for understanding the Italian decline in two major ways. First, wage repression negatively affected growth dynamics by weakening the linkage between aggregate demand and the 'Kaldorian' processes of learning, innovation, and industrial renewal (Antonelli and Barbiellini Amidei, 2007). Second, the persistent availability of cheap labor 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 specialization path preventing it from playing a significant role in the development of frontier sectors and technologies (Ciocca, 2020). This was a particular problem when globalization intensified in the 1980s and 1990s, as exporting firms in medium-technology specializations had problems in 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 Eurozone 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 cost competitiveness of Italian firms, thereby allowing them to gain export market shares as they came under increasing pressure from competition in China and other emerging market economies while the option of currency devaluations was no longer available. Labor market reforms indeed contributed to reducing inflation and real wage growth. But cheap labour also increased the labour-intensity of production, as an increasing share of temporary employment contributed to reducing the 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 investment. This counteracted improvements in competitiveness in terms of unit labour costs (Krahé 2023). The original sin related to low-

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

cost competition and labour fragmentation, therefore, interacted with policy constraints that intensified with globalisation and European integration to exacerbate Italy's problems of deteriorations in the domestic demand for goods and services compared to its Eurozone peers: there were first signs of a stagnation in real compensation per employee 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).

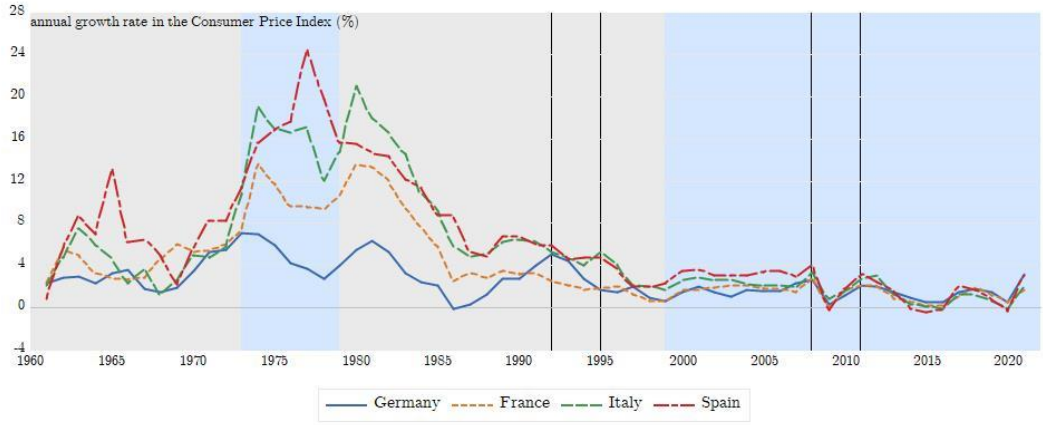
Figure 5: Real wages and domestic demand in Italy, Germany, France and Spain



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)



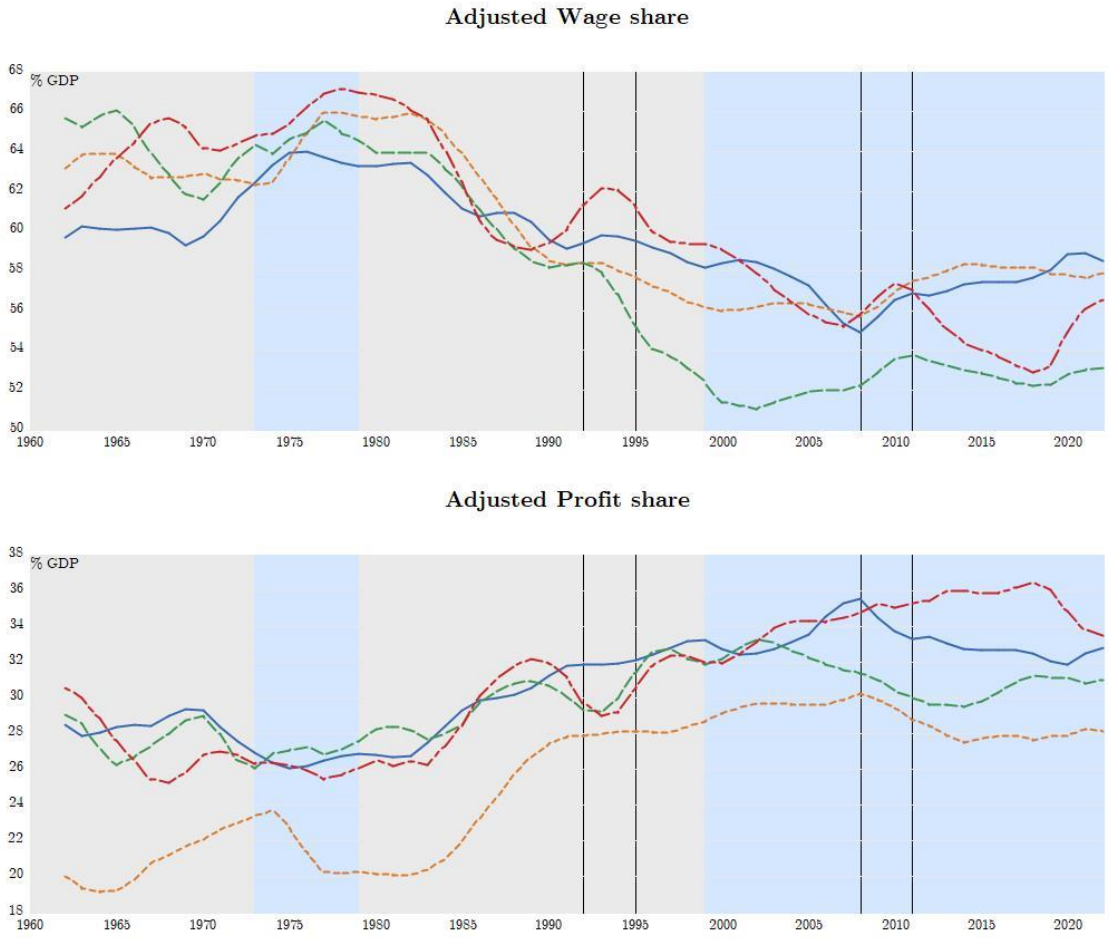
Source: Macrohistory database; own calculations.

Up to 1992, the Italian policy strategy was rather incoherent: restrictive monetary and exchange rate policies to keep inflation under control, on the one hand, deficit spending to sustain domestic demand and flatter electorates on the other hand. In fact, this proved ineffective in sustaining growth due to higher inflation, losses of external competitiveness, 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 allows rebalancing of the current account.

Wage indexation was abolished to restore external competitiveness. Fiscal policy became restrictive and there is an acceleration on privatisation. 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 privatization rapidly became synonyms for modernization or 'Europeanization' (Celi et al., 2018). As the external constraint tightened, market forces are 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 investments, further weakening productivity and growth dynamics. The labor market reforms killed a flock of birds with one stone. First, they helped bringing down inflation (see Figure 6); second, they increased labour intensity by making labour cheaper, thereby initially reducing unemployment;[10] third, they led to a significant increase in the 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 retirements for millions of workers (Brandolini et al., 2018).

Figure 7. Functional Distribution. 1960-2022



Source: AMECO; own calculation. Notes: the (adjusted) wage share is the compensation per employee as percentage of GDP at market prices per person employed; the 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 characterized by low productivity growth is the second structural domestic factor important for understanding the puzzle, which 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 keep up the pace of capital intensive investments and R&D, SMEs, particularly those organized in Industrial Districts (Rabellotti et al., 2009), benefited from knowledge spillovers providing a significant contribution to productivity and GDP growth. A virtuous circle that got interrupted, though, as global competition became harsher and industrial policy was partly abandoned (Becattini and Coltorti, 2004; McCaffrey, 2013).

On the supply-side, a key constraint on Italy's development is 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 experienced a flat trend since the early 2000s being, in 2020, barely above the level recorded in 1980. The data also reveals how besides the gap vis-a-vis France and Germany, the North-South divide widened too. 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); the 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							
	1970	1980	1990	2000	2010	2020	Var.*
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*	*06*	*+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							
	1970	1980	1990	2000	2010	2020	Var.*
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 the European competition policies, privatizations were seen as a quick way of providing one-off revenue and modernizing the economy. As discussed above, the 1990s were characterised by a series of privatizations 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 the levels of investment of previously SOEs (e.g., Baccaro and D'Antoni, 2022). Italy's lack of large companies with high levels of technological sophistication is then an important factor contributing to the slowdown in Italian productivity growth compared to the Eurozone 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 yet holding an outstanding reputation as public manager - to save healthy (and technologically strategic) companies by placing them within a dedicated state-owned holding: the IRI. From WWII up to the 1980s, IRI grew considerably, some scholars argue too much (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 the national motorways and other large infrastructural projects (Gasperin, 2022). In the 1960s, IRI contributed to the industrialization of Mezzogiorno investing heavily in capital-intensive sectors and R&D.[11] However, as the Oil shock hit the Italian economy, IRI's growth started to slow down. Investments aimed at promoting regional convergence reached their peak while diversification didn't manage to stop the decline in productivity. IRI epitomizes 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 interventions have 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 on fiscal and industrial policies (e.g., Scharpf, 1999).

In 2019, Italy's share of micro firms amounted to about the 94.4% of the total – a number which is close to Spain (94.2%) and France (94.7%), but far higher than for 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 than Germany, at 18.7%, and followed at a distance by Spain, at 35.8%) and, most importantly, are the least productive among the big-4.[12]

[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 characterized by low wages.

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.

Why are there so many small firms and why should this matter to explain Italy's decline? Concerning the why, some authors emphasize the role of institutions and 'dedicated' regulations (applying for firms with less than 15 employees) providing incentives to stay small: 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 mis-allocation (Calligaris et al., 2016). Even the small firms' explanation may be considered controversial, though. When the large SOEs started to show a smaller contribution to growth, partly due to the dismantling of the IRI and subsequent privatizations, 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 represent 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, such enthusiasm, however, faded away and the weakness of a system where large innovative companies are in short supply became difficult to dispute. Yet, 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 p.p. 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% manufacturing firms has been increasing steadily between 2005 and 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.

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 characterized by three distinct phases, heterogeneous in terms of convergence/divergence dynamics, paces of industrialization and structural change (Iuzzolino et al., 2013).

From the unification until 1950, the Italian economy experienced an intensive sectoral shift from agriculture to manufacturing (textiles, engineering, steel, chemicals, automotive). This process regards mainly the country's north-west and, in particular, the areas around the cities of Milan, Turin, and Genoa – i.e., the 'Industrial Triangle'. As a result, the gap between the industrialized 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 to a large extent driven by fiscal and industrial policies. 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 investments, 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 industrialization process, hampering further convergence (Fanti et al., 2022). The third phase – starting with the oil crisis of the 1970s – brought a complete halt in the convergence process, followed by a long period of growing divergence in both income 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

[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, fostered also by Government policies. Internal and external migration were blocked, while industrial production was ever concentrated in the North to sustain the 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 was already losing effectiveness as an industrial policy tool due to mounting political pressures and related misallocation of public resources (Del Monte and Papagni, 2007).

started going out of steam with an increasing amount of resources absorbed by rising interest rates on 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 globalization of markets further penalizing 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 administrations are peculiar characteristics of the South, which has been lagging behind the rest of the country since the Unitarian era. Representing an inexhaustible source of cheap labor, Mezzogiorno's regions are instrumental to the cost-competitiveness strategies of the northern export-led growth strategy (e.g., Di Carlo et al., 2023). Furthermore, the North-South divide led to a continuous depletion of material and human resources, ballasting Italy's structural upgrading prospects. Nonetheless, 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; 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 parts; business investment, household consumption, and public expenditure in the South also fell significantly more, which further increased the deep territorial divide.[15] Increased North-south polarization is even visibly in areas such as banking, where a broad process of centralization 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 to most renowned) were followed by judicial investigations. But financial deregulation did contribute to a decline in credit to Southern firms, thereby putting further pressure on the shadow economy.[18]

[15] Manufacturing value added declined by 33.1% in the South between 2008 and 2014, while it fell by are 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 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 from 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 declines after M&As – which primarily involved acquisitions of southern banks from northern institutions – severely affecting southern firms (Del Prete et al., 2022).

[17] Studying the effect of bank reforms in Italy, Guiso et al (2006) find that in provinces characterized by tougher restrictions to 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.

[18] A recent study from 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 declines after M&As – which primarily involved acquisitions of southern banks from northern institutions – severely affecting southern firms (Del Prete et al., 2022).

5. Conclusions

We have analyzed how Italy's decades-long decline turned the country into the Eurozone's Achilles heel. Using a structuralist framework has proven helpful in synthesizing different supply-side and demand-side explanations. 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 globalization and European integration to exacerbate Italy's decline vis-à-vis its large Eurozone peers Germany, France and Spain. The interaction of "original sins" has constrained Italy's development. Until the 1980s, public demand, vertical and selective industrial policies operated through import substitution, 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 the globalization and the European integration process accelerated the room for maneuver for domestic monetary and fiscal policymakers was reduced, thereby making the demand-side constraint due to downward pressure on wages even more severe. 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 penalizing labor, wages, and thus aggregate demand. The interaction between original sins and external policy constraints exacerbated the negative impact on productivity growth, making the Italian economy increasingly weak vis-à-vis its large Eurozone peers.

From a structural point of view, Eurozone membership did not result in modernization and convergence towards higher living standards as those experienced in Europe's best performing countries (e.g., Germany). On the contrary, a fault line opened between the core – centred around Germany's exporters – 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 tertiarization' (Blyth et al., 2022; Bürgisser and Di Carlo, 2023; Cirillo et al., 2017). Productive and technological capabilities declined while low-tech-low-wage service sectors increased their relative importance.

Doubling down on the recipes from the Euro Crisis, when European policymakers increased the pressure on Italian governments to pursue stricter fiscal consolidation and structural reforms from the market liberal playbook may further push Italy down its path of decline. This would neither address instability of the Eurozone, which can only be solved by institutional reforms at the European level, nor tackle the complex domestic structural problems in Italy that have made it difficult to develop a coherent economic policy strategy.

If Italian policymakers are to develop a credible approach on opening up a positive long-term development perspective beyond sticking to the National Recovery and Resilience Plan in the context of Next Generation EU, they will need collaboration with EU policymakers. First, a serious conversation about biased or incomplete views on how Italy ended up in long-term economic decline is needed. If persistently tight fiscal policies and market-liberal reforms have failed to move the country forward in interaction with globalisation and European

integration, then 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 penalizing 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-years long strategy based on flexibilizing labor and pushing wages downward has ballasted productivity, further accelerating the decline. Summing up, European policymakers need to support a 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 literature in multiple directions. First, our framework should be taken to the data: the original sins driving Italy's decline need to be quantitatively identified, and their relationships with other growth drivers and external constraints empirically tested. Second, 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 Eurozone.

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Appendix

Table A1. 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
Privatization or nationalization (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 liberalization (e.g., variables recorded with 1 in the lib_delib dummy, see the annexed Codebook for further details).

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