



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 structuralist-evolutionary framework to synthesize supply-side and demand-side explanations, accounting for long-term processes and sectoral interdependences. We argue that Italy is a failed case of modernization by external constraint. Structural domestic factors—low-cost competition and labour fragmentation, many small firms, and the North–South divide—which proved instrumental to Italy's development after WWII later interacted with the policy constraints brought about by globalization and European integration, exacerbating Italy's decline vis-à-vis its Eurozone peers. Our analysis underscores the need to reconcile fiscal, industrial and labor market policies, both at the national and at the EU level replacing: fiscal austerity with a broad and lasting public investment program; subsidies and horizontal policies with selective and strategic interventions; flexibilization of labor with the promotion of stable, high-quality and high-wage employment.

Keywords Italy · Decline · Eurozone · Crisis

JEL Classification B50 · B52 · 052 · P51 · P52

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1 Introduction

In Greek mythology, Achilles faces the prophecy of an early death. His mother, seeking to protect him, dips him in the River Styx, holding him by his heel, rendering him nearly invulnerable except for that single, unprotected spot. Growing up as a man surrounded by war, Achilles survives numerous battles but eventually succumbs to a fatal wound to his heel.

This article posits that Italy symbolizes a critical vulnerability within the Eurozone (EZ), much like Achilles' heel in Greek mythology—a point of weakness that, while not necessarily fatal, exposes deeper systemic challenges. Rather than suggesting that Italy's economic decline will inevitably bring down the Eurozone, we explore how Italy's trajectory reveals underlying tensions in the integration process, particularly the widening disparities between core and peripheral regions (Celi et al. 2018).

Italy's persistent economic challenges—such as stagnation in productivity, high public debt, and structural unemployment—serve as a microcosm of broader issues that could undermine the EZ's cohesion and resilience. Indeed, peripheral countries such as Spain, Greece, and Portugal have similarly struggled with structural weaknesses—ranging from high public debt to stagnant productivity—that have been exacerbated by the policy constraints of European integration. These nations have also faced intensified economic pressures under the EU's fiscal framework, highlighting systemic vulnerabilities that contribute to persistent core-periphery disparities. Italy's experience, therefore, offers valuable insights into the wider dynamics at play within the Eurozone, underscoring the need for a more integrated and flexible approach to economic policy across member states.

The existing literature offers a range of explanations for Italy's economic decline, attributing it to various historical factors (cronyism, familism, too much state interventionism in market processes, as in Toniolo 2013), supply-side issues (including institutional inefficiencies and market rigidities, as in Bassanetti et al. 2014), and demand-side constraints [persistent wage suppression and fiscal austerity, as discussed by Storm (2019) and Baccaro and D'Antoni (2022)]. Despite the abundance of research, there remains a need for a comprehensive framework that integrates these diverse perspectives and aligns them with long-term empirical trends.

This paper addresses this gap by introducing a structuralist-evolutionary framework. Taking a long-term view (Cipolla 1952), we examine how domestic characteristics that once propelled Italy's post-war development—such as the north-south divide, low-wage competition, the prevalence of small firms—have been compounded by the constraints imposed by globalization and European integration, leading to an accelerated decline. Our contribution lies in synthesizing evolutionary (Cimoli and Porcile 2009) and structuralist approaches (Lucarelli and Romano 2016; Celi et al. 2018) to explore the interplay between supply-side factors (sectoral composition, technological specialization, value chain positioning, and external relationships, as per Andreoni and Scazzieri 2014), demand-side factors (aggregate demand flows and external constraints, as highlighted by Baccaro and D'Antoni 2022), and institutional dynamics (market regulation, structural reforms, labor market characteristics, and shifts in fiscal, monetary, and industrial policies, following Amable and Palombarini 2008). We also contribute to Comparative Political Economy (CPE) and growth model literature (Hein

and Martschin 2021; Stockhammer and Kohler 2022; Blyth et al. 2022) by identifying key discontinuities in Italy's economic evolution and assessing the impact of policy shifts.

The structure of the paper is the following: Sect. 2 elaborates on why Italy is considered the Eurozone's Achilles heel. Section 3 reviews competing explanations for Italy's decline. Section 4 presents our structuralist-evolutionary framework, demonstrating how domestic structural factors and external policy constraints have deepened Italy's economic downturn. Section 5 concludes with reflections on the broader implications of our findings.

2 Italy as the Eurozone's Achilles Heel

Despite its decades-long stagnation, Italy remains the third largest Eurozone economy. Beyond its sheer size, the connectedness through trade links is also relevant, as its Northern regions are tightly linked with Europe's industrial core (Stöckinger 2016). This interconnectedness became particularly evident during the early phases of the Covid-19 crisis: when the lockdowns interfered with Italy's exports of (intermediate) goods, manufacturing production in factories located in Germany had to be reduced or even halted (Celi et al. 2020).

For these reasons, Italy's decline is not only a domestic policy concern; it is a major issue for the EZ as a whole. Italy's persistent economic problems are manifest when looking at labour productivity. As Fig. 1 shows, during the 1970s Italy performed better than Germany, France and Spain. However, the situation worsened in recent decades. Between 1980 and 2021, Italy experienced a massive productivity gap vis-à-vis its largest EZ peers.

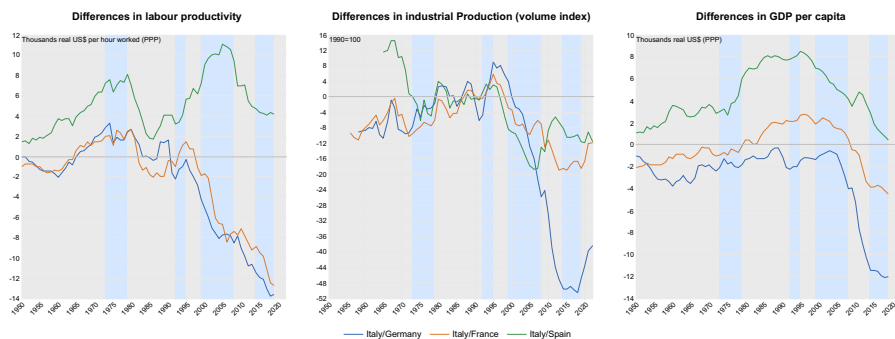


Fig. 1 Performance of Italy compared to the other large Eurozone peers (labour productivity, industrial production, GDP per capita). 1950–2022. *Source* Long Term Productivity Database; OECD; own calculations. *Notes* Labour productivity and GDP per capita are expressed in thousands constant (2010) U.S.\$, in PPP. Industrial production refers to industry (except Construction), Index 1990 = 100, Quarterly, Seasonally Adjusted. Shaded areas correspond to: the Golden Age (1960–1973), the Oil shocks (1973–1979), the first phase of the EMS (1979–1991), the currency crisis (1992–1994), the second phase of the EMS (1995–1998), the first decade of the Euro membership prior to the financial crisis (1999–2007), the financial crisis (2008–2013), the recovery (2014–2019), and the pandemic (2020–2022)

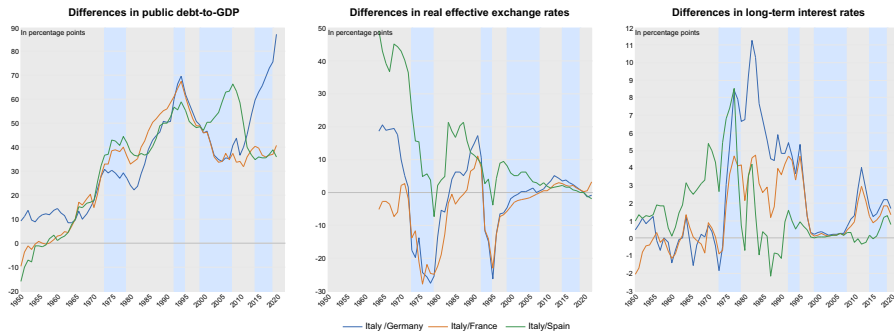


Fig. 2 Performance of Italy compared to the other large Eurozone peers (Public-debt-to-GDP, real exchange rate, and long-term interest rates on government bonds). 1950–2022. *Source* Macrohistory database; World Bank; own calculations

In the 1950s and 1960s, Italy became one of the world's most dynamic industrial powerhouses (Graziani 1998). Yet, although the country remains the EU's second-largest industrial location, its productive base has deteriorated over time (Fig. 1, central panel). Concerning living standards, up to the mid-2000s Italy's income per capita was higher than in France and close to the German level (Fig. 1, right panel). Nonetheless, falling labour productivity and a lacklustre industrial performance culminated in substantial losses, exacerbated by the Euro Crisis.

Among the largest EZ's member countries, Italy now exhibits the highest public debt level.¹ As Fig. 2 shows, Italy's public-debt-to-GDP started diverging during the 1980s, when it nearly doubled from 54% in 1980 to more than 100% in 1992, when a currency crisis drove Italy out of the European Monetary System (EMS). The early 1980s were marked by the “divorce” between the Banca d'Italia and the Treasury, as the former stopped supporting the government in financing its fiscal deficits (Tabellini 1987). This was followed by a surge in long-term interest rates, which increased government financing costs (Cesaratto and Zezza 2019).

The interest rate spread to Germany increased to more than 10 percentage points; it then declined rapidly from the mid-1990s as investors initially bet that Italy's EZ membership would reduce country-specific risks (Fig. 2, central and right panel). With the Euro Crisis, interest rate spreads increased substantially, threatening a debt default or the need for a bailout package (Baldwin et al. 2015). Spreads only came down again after the ECB credibly signalled, at the climax of the crisis in summer 2012, that it would backstop the Eurozone's government bond market (Saka et al. 2015).

Italy's economic decline and its worsened fiscal outlook have contributed to the intensification of political conflicts. On one side, those blaming Italy's internal and long-lasting inefficiencies asking for more external (EU-based) constraints to tie politicians' hands, on the other, those pointing to the EU as the major cause of the Italian decline (Frieden and Walter 2017). From an empirical point of view, a majority of

¹ It is worth noting that private debt in Italy was in 2022 the *lowest* among the big-four, at 161.3% of GDP against 280.87%, 185.6% and 177.24% for France, Spain and Germany respectively. Looking at total debt/GDP figures, Italy ranks third (266% of GDP), behind France (345%), and Spain (279%).

Italians so far continues to be in favour of EU and Eurozone membership. However, support for European integration has declined over time and remains relatively volatile (Baccaro et al. 2021).

The role of the Euro and the loss of an autonomous exchange rate policy—in particular the possibility to rely on periodic nominal Lira devaluations—are also key to explain Italy's decline. Building on an historical database spanning from unification to the early 2010s, Di Nino et al. (2013) report that in the periods of highest (1950–1973) and sustained growth (1970s and 1980s), Italy benefited from an undervalued currency. Conversely, from the mid 1990s onwards—when the decline begins to accelerate—Italy's currency was largely overvalued, resulting in a drag on growth in the order of -0.1% per year. This is further corroborated by Bagnai et al. (2016, 2018) documenting a sizeable and significant “scale effect”—i.e., in the presence of economies of scale, an overvalued currency, by repressing external demand, may reduce the scale of production and hence productivity—which contributed to the productivity slowdown in the southern periphery. Relatedly, a recent strand of literature, based on synthetic controls, tried to answer the question of what would Eurozone member's income per capita levels be, if they had not joined the Euro. Italy is consistently found to be a net loser from adopting the common currency while results for France, Germany and Spain are mixed and change over subperiods (Dreuw 2023; Gabriel and Pessoa 2024).

Finally, it is worth underlining that some of the problems characterizing Italy's evolutionary trajectory are shared by the rest of the Southern periphery. Although at different rates and starting from heterogeneous initial conditions (Celi et al. 2018), Portugal and Spain have experienced a similar process of structural and technological weakening vis-à-vis the core (i.e., Germany). Also in those economies, as in Greece, fiscal austerity has exacerbated such weaknesses, increasing their vulnerability in the face of the financial crises that have repeatedly hit the European economy. Differences are also in order, though. Compared with other peripheral economies, especially Portugal and Spain, Italy has been particularly stubborn in pursuing wage repression and public spending restraint policies. This impoverished its industrial structure in a particularly significant way (Celi et al. 2024). On the other hand, the financial bubbles characterizing the Spanish economy—in particular its construction and real estate sectors—that opened the way to the painful memorandum (bail-out plans) imposed by the EU after the 2008 crisis have been less relevant in the Italian case. This may explain why, during the subsequent sovereign debt crisis, the banking crises in Greece and Spain contributed more intensely to the general instability affecting the European economy (Zezza 2020).

3 Explaining Italy's Decline: Competing Explanations

3.1 The Roots of Italy's Decline: Supply-Side Explanations and Reforms

Economic historians trace the roots of the Italian decline back to the unification process (Federico et al. 2019; Toniolo 2013). Several “original sins” are found guilty: the prevalence of small firms and low education levels constraining innovation (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, corruption, and a large informal sector² (Toniolo 2013; Ghezzi 2016).

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), so that it is an implausible causal factor of decline. Similarly, state interventionism declined markedly from the 1990s, as policymakers acted under tightened constraints on industrial and fiscal policy, following an agenda of privatisations (Celi et al. 2018). In the same vein, while still the largest among advanced EU countries, the informal sector in Italy has been shrinking in the last thirty years. Data from the World Bank Informal Economy Database shows that, if anything, informality has been declining up to the financial crisis, and then either rose (or ceased to decline) during the austerity phase up to late 2014 (on this point, see also Mantegazza et al. 2012).³

Finally, several of the most important supply-side explanations fail to account for the acceleration of Italy's decline versus the other large EZ peers.

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, particularly in labour markets, as the major cause of the decline (Bassanetti et al. 2014; IMF 2016; Hijzen et al. 2017; OECD 2021; Boeri et al. 2021). According to this view, Italy's growth has been hindered by market 'rigidities' related to insiders' protection in labour markets, 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 compared to its peers, as detailed in Table 1. Online Appendix 2 further explores structural reforms adopted in Italy, detailing the actions undertaken in four areas, related to: (i) privatizations, (ii) product market liberalization, (iii) labor market reforms, and (iv) financial deregulation.

The analyses of historians and economists focusing on supply-side factors have the merit of grasping the persistence of elements that have been present in Italy's development since unification. Yet, the Italian decline accelerated in the 1980s and 1990s alongside the process of European integration and globalization when some of the abovementioned negative factors stabilized or even improved.

² See Dell'Anno (2022) for a recent survey on theories and definitions of the informal economy.

³ Italy's larger informal sector, relative to core EU economies, has multifaceted implications for productivity and fiscal capacity. On one hand, the presence of informal firms may lead to underreported revenues, creating a downward bias in measured productivity levels and masking the true economic contributions of these enterprises. On the other hand, the informal sector undermines fiscal state capacity through tax evasion, limiting the resources available for public investment and social policies. These dynamics reinforce wage compression, as informal employment tends to offer lower and more precarious wages, which exerts downward pressure on formal sector wages as well.

Table 1 Structural reforms 1973–2013. Source Armingeon et al. (2019); own calculations

	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

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)

3.2 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) (Soskice 2007; Hall 2018) toward the Growth Model approach (GMA, hereafter) (Baccaro and Pontusson 2016; Blyth et al. 2022). For both, the Italian case is difficult to classify.

The VoC literature was predominantly rooted in neoclassical economics and static institutional equilibria, differentiating countries between Liberal-, Coordinated- and Mixed-Market Economies. Due to incoherence and lack of complementarity among institutions, Italy has been defined as a case of a mixed market economy (Molina and Rhodes 2007). While the country tried to mimic elements of a coordinated market economy during the Golden Age, it chose to adopt more liberal features as the process of Europeanization proceeded (Della Sala 2004). However, both attempts failed, and Italy became stuck in between the two fundamental models, thus underperforming with respect to countries that better fit one of the two.

Using growth decomposition, Baccaro and Pontusson (2016) argue that most countries 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 shifted from a domestic

demand-led regime in the first years of monetary union to an export-led one after the financial crisis, due to an overly-restrictive macroeconomic policy regime (Hein et al. 2021; Hein and Martschin 2021). Similarly, Bramucci (2024) explains Italy's post-crisis regime with the failed attempt to adopt an export-led recovery strategy, due to the (common) misconception that Germany's post-crisis performance was the result of previous wage-compression strategies, structural reforms and restrictive fiscal policies, whereas its true success came from non-price factors, such as the technological improvement of exported products and the reorganisation of outlet markets (Simonazzi et al. 2013).

Table 2 reports the demand contributions to real GDP growth along with growth drivers and other structural variables for Italy over the period 1960–2022.⁴ This is complemented with Fig. 3, showing the medium- to long-run evolution of sectoral balances for Italy, Germany, France and Spain, which can be used to synthesize a country's position and its growth path (e.g., Zezza 2009; see Zezza and Zezza 2019, Online Appendix 1 on the derivation of sectoral net lending/borrowing positions using national accounts data).

The 1960s were a period of growth and stability: stable sectoral balances-to-GDP ratios, a large contribution of consumption and investment, relatively high wage share and sustained wage growth, balanced trade and low real interest rates. The condition changed with the oil crisis. In Italy, the large public deficit in the 1970s allowed the private sector to accumulate net financial assets (mainly government bonds), 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. While Germany managed to maintain its external competitiveness through the restructuring of its industrial sector (Simonazzi et al. 2013), Spain registered large current account deficits that, coupled with a restrictive fiscal policy, implied a surge in private sector borrowing (i.e., negative NAFA).

With the entry in the EMS, large currency realignments were no longer possible, and most participants started to lose ground with respect to Germany. In Italy, the combination of restrictive monetary and expansionary fiscal policy led to a large increase in real interest rates. At the same time, the current account started to deteriorate, up to the large currency devaluation of 1992. After a short-lived recovery following the break-up of the EMS, the Maastricht rules kicked-in, igniting a new wave of core-periphery polarization. In Italy, the year 1995 marked the start of a new (restrictive) macroeconomic policy regime. The decline in the government deficit relative to GDP implied a drop in the ability of the private sector—particularly households—to accumulate financial assets, with external debt rising substantially. The first years of the Euro seemed to be a success, with GDP growth in peripheral countries outpacing Germany. However, this masked the build-up of large imbalances.

After the crisis, core-periphery capital flows halted and peripheral countries embarked on an austerity agenda (De Grauwe and Ji 2013). While Italy and Spain managed to restore their current account balance (though, as we will discuss later, at the cost of compressing wages even more and, in the Italian case, losing further ground

⁴ Table A1 extends the analysis for Germany, France and Spain.

Table 2 Contributing factors to Italy's real GDP growth, 1960–2022. *Source* AMECO, World Bank, IMF, BIS; own calculations

Italy										
	1960–1972	1973–1978	1979–1991	1992–1994	1995–1998	1999–2007	2008–2013	2014–2019	2020–2022	
Real GDP growth	5.8	3.5	2.5	0.7	1.9	1.5	– 1.4	0.9	0.5	
Contribution to GDP growth										
Consumption	3.3	1.7	1.8	0.0	1.4	0.8	– 0.8	0.6	– 0.4	
Gov. expenditures	1.0	0.8	0.6	– 0.1	– 0.1	0.3	– 0.1	0.0	0.1	
Investment	1.5	0.1	0.4	– 0.9	0.7	0.6	– 1.0	0.3	1.2	
Construction	1.0	0.0	0.2	– 0.5	0.1	0.3	– 0.7	0.0	0.8	
Equipment and other investment	0.5	0.1	0.2	– 0.3	0.5	0.2	– 0.3	0.4	0.4	
Net export	0.0	0.7	– 0.3	1.3	– 0.1	– 0.2	0.6	– 0.1	– 0.5	
Import	1.0	0.3	0.7	0.0	1.2	1.0	– 0.7	1.0	1.6	
Export	1.0	1.0	0.4	1.3	1.1	0.9	– 0.1	0.9	1.1	
Change in inventories	– 0.1	0.3	0.0	0.3	0.0	0.0	– 0.1	0.1	0.1	
Financial balances (% of GDP at current prices)										
Net acquisition of financial assets	3.0	6.6	9.3	9.3	7.4	2.5	1.9	4.8	11.8	
Households	n.a.	n.a.	14.5	10.9	7.1	2.7	1.1	1.7	5.8	
Corporations	n.a.	n.a.	– 5.0	– 1.5	0.2	– 0.2	0.9	3.1	6.0	
Gov. Deficit	2.2	7.3	10.2	9.4	4.9	2.9	3.6	2.3	8.4	
Current account balance	0.8	– 0.7	– 0.9	– 0.1	2.4	– 0.4	– 1.6	2.5	3.4	

Table 2 (continued)

Italy	1960–1972	1973–1978	1979–1991	1992–1994	1995–1998	1999–2007	2008–2013	2014–2019	2020–2022
Demand drivers									
Adjusted wage share (% GDP)	64.3	64.7	61.1	56.8	53.1	51.6	53.4	52.4	53.1
Real wage (growth rate)	5.8	2.7	0.9	0.4	− 0.2	0.1	− 0.4	− 0.1	− 0.5
Real ULC (growth rate)	1.6	− 0.3	− 0.1	− 1.4	− 1.1	0.3	− 0.2	0.0	0.6
Unemployment rate (%)	5.0	6.1	8.5	10.0	11.9	8.8	9.2	11.4	9.0
Inflation (%)	4.0	15.5	10.7	4.6	3.3	2.2	2.1	1.3	3.3
Union density	32.0	47.7	43.5	38.6	36.5	34.1	35.1	33.6	n.a.
Government primary balance (% GDP)	− 1.3	− 4.7	− 3.0	2.3	5.1	2.6	1.1	1.6	− 5.1
REER (1964m1 = 100)	− 4.6	− 21.9	16.6	− 22.0	7.3	4.9	− 0.7	− 6.3	1.9
Long-run real interest rate (%)	6.8	11.7	14.5	11.7	8.3	4.6	4.7	2.1	1.2
Real house prices (growth rate)	4.3	27.3	13.7	0.2	− 0.9	7.9	− 2.5	− 1.7	1.9
Debt (% of GDP at current prices)									

Table 2 (continued)

	Italy									
	1960–1972	1973–1978	1979–1991	1992–1994	1995–1998	1999–2007	2008–2013	2014–2019	2020–2022	
Total Debt (Public + Private)	96.5	120.2	128.2	177.9	185.9	198.7	244.0	249.5	266.2	
Government debt	34.0	55.6	77.0	114.3	117.3	107.3	120.1	134.7	149.7	
Private sector debt	62.5	64.7	51.2	63.6	68.5	91.4	123.9	114.8	116.5	
Households	6.1	7.8	8.7	17.7	17.9	28.6	42.5	41.4	43.3	
Corporations	56.3	56.9	42.5	45.9	50.6	62.9	81.4	73.5	73.2	

Table shows average values over the periods

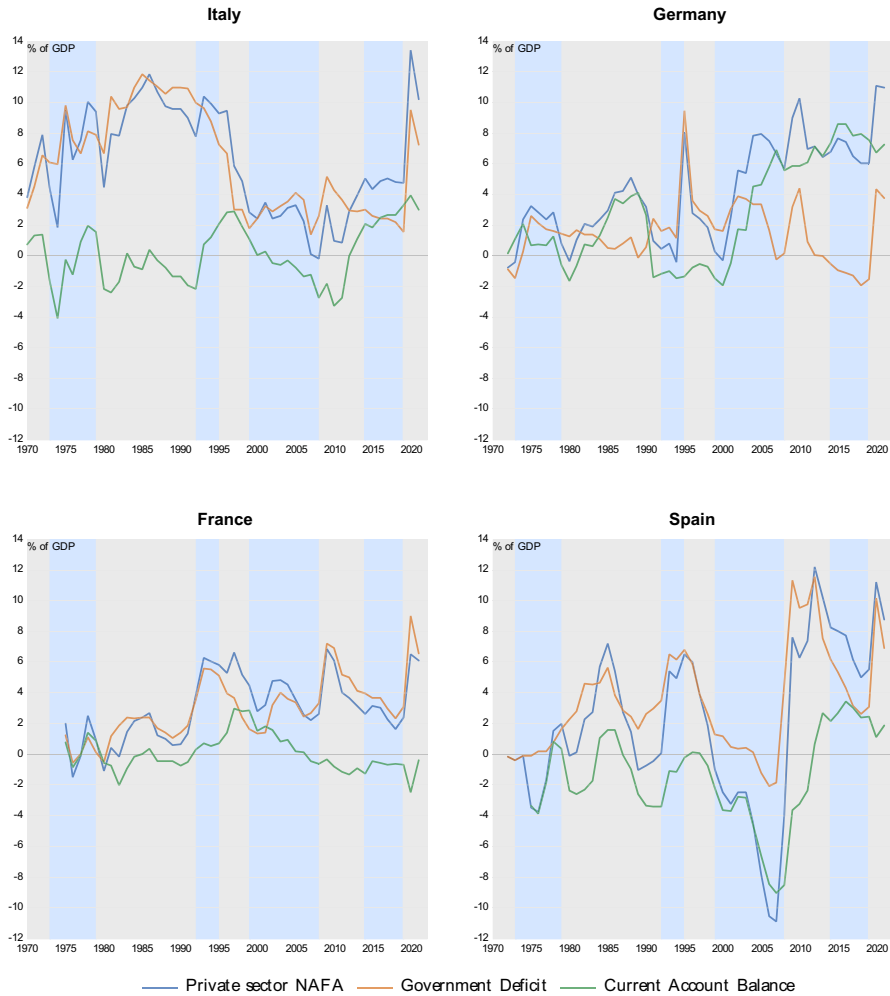


Fig. 3 Evolution of Sectoral Balances in Italy, Germany, France and Spain. 1970–2022. *Source* AMECO, Eurostat; own calculations. *Notes* Figure shows evolution of Sectoral Balances, i.e., net lending/borrowing (NL) position of private (households, financial and non-financial corporations), public, and foreign sector, as percent of GDP. NL data for all sectors are available on Eurostat for the period 1995–2022. For the period 1970–1994, we estimate private sector NL using Current Account Balance and Government deficit data. See Zezza and Zezza (2019) Online Appendix 1 on the derivation of NL position using national accounts data

with respect to Germany in terms of productivity), France did not, and is still today in a deficit position.

The literature highlights that what is special about Italy's experience is that all components of aggregate demand slowed down (Baccaro and Bulfone 2022). In what follows, we sketch out our framework, highlighting that this was only possible due to

the interaction of domestic structural factors with policy constraints brought about by globalization and European integration.

4 A Structuralist-Evolutionary Framework for Explaining Italy's Decline

We now illustrate our structuralist-evolutionary framework bringing together the 'pieces of the puzzle'—seemingly competing supply- and demand-side explanations that are indeed connected with each other when considering long-run processes. In tune with the structuralist tradition (Cimoli et al. 2009), our framework is based on four main analytical pillars: long-term perspective (Cipolla 1952); sectoral composition of the economy and interdependencies (Andreoni and Scazzieri 2014); interaction between supply and demand-side drivers/constraints and prevalence of disequilibrium conditions in markets (Kaldor 1981); and key role of institutions (Amable and Palombarini 2008). In the Italian case, this means highlighting the importance of: long-term processes sedimenting since unification (the North–South divide); changes in industrial specialization (i.e. from a fast technological catching-up during the 'Golden Age' to a dynamics of 'poor tertiarization'); demand-side and external constraints, connected to the EZ fiscal rules.

As Italy entered the EZ, it lost the option to devalue its currency to ensure export competitiveness. European fiscal rules, with their emphasis on limiting deficits and debt levels, are meant to restrict the room for maneuver of domestic policy-makers (Buiter et al. 1993). Indeed, the convergence criteria for joining the Eurozone, concerning price and exchange rate stability and low fiscal deficits, already put pressure on Italian economic policy throughout the 1990s. By strangling domestic demand, the external constraint ballasted Italy's growth prospects (Bagnai 2016; 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 (Kaldor 1981). Furthermore, Italy was dragged down by the partial abandonment of industrial policy, as the single market 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 (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 liberalizing major parts of the economy (Baccaro and D'Antoni 2022; Ferrera and Gualmini 1999). The idea 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 moderating wage growth; and it would avoid indiscriminate use of public finances, 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 growth drivers.

In this context, we identify three key long-term drivers of Italy's decline (see Fig. 4): low cost competition and labor fragmentation; small firms and low innovation; and

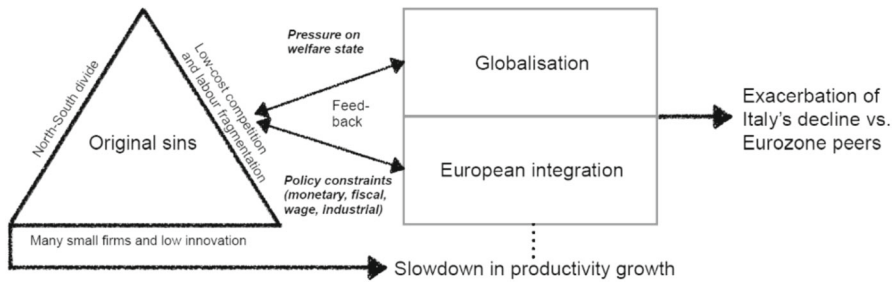


Fig. 4 A framework for explaining Italy's decline. *Source* Own elaboration

a deep territorial divide. Their contribution to the decline is further accentuated by the fact that all major components of aggregate demand slowed down (see Table A1 in the Online Appendix). Exporting became more difficult as the real exchange rate appreciated. 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. Finally, the constraints on fiscal policy led to a decline in the growth contribution of public expenditures, as Italy was forced to run primary surpluses to meet EZ's rules and appease investors.

4.1 Low-Cost Competition and Labor Fragmentation

Before WWII, Italy was specialized in traditional manufactures (with the only 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 specialization was the result of the country's abundance of cheap unskilled labour 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 massive south-to-north migration—determined an excess labor supply, allowing Italy to combine high output and employment growth rates with cost-containment strategies aimed at achieving 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 in manufacturing, in turn, paved the way for a process of further flexibilization 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 fundamental for understanding the Italian decline. 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, discouraging alternatives based on innovation and training. Italy thus locked itself into a medium-technology specialization path preventing it from playing a significant role in frontier sectors and technologies (Ciocca 2020). This became particularly problematic when globalization intensified, as exporting firms in medium-technology specializations had problems in meeting the challenge of increased global competition (Daveri and Parisi 2015). Italy's technological competitiveness trended downwards as it was confronted with more competition from China and other emerging market economies (Gräbner et al. 2020).

With the common currency, absent the option of currency devaluation, “internal devaluation”—the attempt to improve cost competitiveness by domestically putting downward pressure on wages—gained importance (Armingeon and Baccaro 2012; Rathgeb and Tassinari 2022). Italian governments reformed the labour market in several rounds since the early 1990s. 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. 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 (Fig. 5, right panel). The dynamics of equipment investment is particularly relevant to explain productivity, especially when assessed together with R&D, since it allows to ascertain “to what extent the investment dynamics is correlated to the structural dynamics of the productive system as a function of the level of specialization in branches at high intensity of research” (Lucarelli and Romano 2016, p. 21). Italy performed rather unfavorably in this respect in the last two decades, especially when compared to Germany, making the technology constraint more binding, since technological and organizational improvements by Italian firms led to higher imports of high-tech investment goods from Germany—whose productivity was thus further stimulated, thereby making the productivity gap larger. This counteracted improvements in competitiveness in terms of unit labour costs.

Low-cost competition and labour fragmentation, therefore, interacted with external constraints exacerbating Italy's problems: 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 (Fig. 5, left panel); in 2021, Italian real wages were lower than in 1990. Such dynamics contributed to the stagnation of domestic demand, which is observable from the late 1990s onwards.

A large literature focuses on the weakness of aggregate demand as the main explanation for Italy's decline (Cesaratto and Zezza 2019; Storm 2019; Baccaro and D'Antoni 2022). 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.

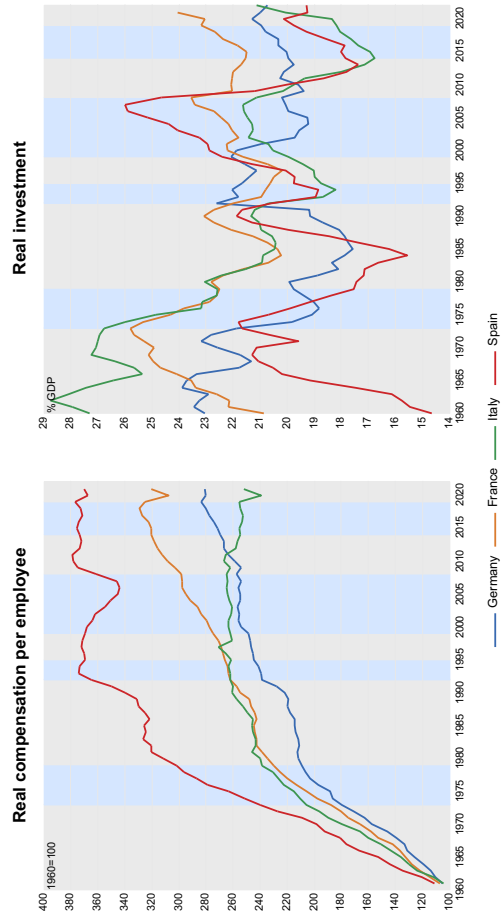


Fig. 5 Real wages and investment in Italy, Germany, France, and Spain. 1960–2022. *Source* AMECO; own calculations

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, on the other hand. This strategy proved ineffective in sustaining growth due to high 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. Italy was forced to exit the EMS, leading to a devaluation of the Lira that restored the current account.

Wage indexation was abolished to restore external competitiveness. Fiscal policy became restrictive and there was an acceleration in 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 were expected to turn Italy into a truly European economy, finally free from its structural domestic weaknesses. But the increasing pressure on wages penalised aggregate demand, including investments, further weakening productivity and growth. The labor market reforms killed a flock of birds with one stone. First, they helped bring down inflation; second, they increased labour intensity by making labour cheaper⁵; third, they led to a significant increase in the profit share, which converged to Germany's level. However, this backfired in terms of aggregate demand, productivity and, ultimately, growth.

4.2 Many Small Firms and Low Innovation

The existence of a large number of small firms is the second structural domestic factor important for solving the puzzle (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 investments and R&D, Small and Medium Enterprises, particularly those organized in Industrial Districts, benefited from knowledge spillovers providing a significant contribution to productivity and growth (Rabellotti et al. 2009). A virtuous circle that got interrupted, though, as global competition became harsher and industrial policy was partly abandoned following EU regulations (Becattini and Coltorti 2004; McCaffrey 2013).

On the supply-side, a key constraint is the chronic lack of R&D and education spending. Since 1970, Italy has persistently lagged behind France and Germany (Table 3).

⁵ 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). Quantitative surveys of the empirical evidence of whether labor market deregulation reduces unemployment suggest that the effects are, at best, very weak (Brancaccio et al. 2020; Heimberger 2021).

Table 3 R&D and education expenditure (% of GDP). *Source* World Bank, Antonelli and Barbiellini Amidei (2007), Istat; own calculations

	1970	1980	1990	2000	2010	2020	Var.*
R&D							
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	n.a	n.a	n.a	n.a
Centre-North [°]	n.a	n.a	n.a	1.1	1.3	1.7	+ 0.6
Pub. Admin. [°]	n.a	n.a	n.a	0.5	0.5	0.6	+ 0.1
Corporations [°]	n.a	n.a	n.a	0.6	0.8	1.1	+ 0.5
Mezzogiorno [°]	n.a	n.a	n.a	0.7	0.8	1.0	+ 0.3
Pub. Admin. [°]	n.a	n.a	n.a	0.5	0.6	0.6	+ 0.1
Corporations [°]	n.a	n.a	n.a	0.2	0.2	0.4	+ 0.2
Education							
France	3.4	4.3	4.5	5.7	5.7	5.5	+ 2.1
Germany	n.a	n.a	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 [°]	n.a	n.a	n.a	3.0	3.1	3.7	+ 0.7
Mezzogiorno [°]	n.a	n.a	n.a	6.8	6.3	5.9	− 0.9

(*) variation from first available data; (°) share in local GDP

Concerning education, Italy experienced a flat trend since the early 2000s, with spending in 2020 barely above the level recorded in 1980. At the same time, the North–South divide has widened. This can be explained by the prevalence of small firms and competitive strategies based on cost containment rather than innovation, particularly 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 (this phenomenon is particularly relevant for women).

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, market deregulation, and service liberalisations. These reduced the number of large companies in mature sectors, and contributed to a decline in investment as private owners of former SOEs were unable to keep up their level of investments (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 of productivity compared to its EZ peers.

Like the other key structural deficiencies, also state interventionism plays an ambivalent role. In the early 1930s, the country was on the brink of collapse: large private companies were going bankrupt, with banks at risk of insolvency and the Bank of Italy in financial distress. The fascist regime entrusted a technocrat, Alberto Beneduce, to save healthy companies by placing them within a dedicated state-owned holding: the IRI (see above). From WWII up to the 1980s, IRI grew considerably, some 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 large infrastructural projects (Gasperin 2022). In the 1960s, IRI contributed to the industrialization of Mezzogiorno investing heavily in capital-intensive sectors and R&D. 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: 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 played a larger role in Italy than in other growth models. Hence, Italy was penalised more than others by the restrictions brought about by the European regulatory framework on fiscal and industrial policies (Scharpf 1999).

In 2019, the Italian 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 4). The difference, though, is that Italian micro firms contribute to over one-fourth of total value-added, employ over 6.4 million workers (41.9% of the total) and, most importantly, are the least productive among the four EU largest economies.⁶

Thus, why are there so many small firms and why should this matter in explaining 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' small size is related to elements that are often linked to Italy's weak productivity performance, such as family-based governance structures leading to poor managerial practices (Pellegrino and Zingales 2017; Damiani et al. 2018; 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 small- and medium-sized enterprise (SMEs)—operating mainly in the

⁶ 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 4 Firms' statistics by size, 2019. *Source* Eurostat; own calculations

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

Table displays values relative to all business activities

medium- and medium-high-tech industrial districts of Emilia-Romagna and Veneto—became a key asset. In this period, some scholars argue that their dynamism 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, such enthusiasm faded, 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 4) 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. However, these two groups, representing the bulk of Italian manufacturing companies, amount to only 37.2% of total employment (5.7 million), lower than the figures for France (61.6%), Germany (59.2%), and Spain (44.4%). Bugamelli and Lotti (2018) report that productivity in the top 10% manufacturing firms has been increasing steadily between 2005 and 2014. Likewise, Giordano and Zollino (2021)

show that the decline in Italian productivity is mostly driven by the now-dominant service sector, where SMEs tend to be concentrated.

4.3 Deep Territorial Divide

The North–South divide—or the ‘Southern Question’—has characterised Italy’s development since the late nineteenth century (Daniele and Malanima 2011). Despite its persistence, the evolution of the North–South divide has been uneven. It is characterized by distinct phases, heterogeneous in terms of convergence/divergence dynamics, paces of industrialization and structural change (Iuzzolino et al. 2013; Bürgisser and Di Carlo 2022).

From the unification until 1950, the Italian economy experienced a 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. During the Golden Age (1950–1973), the Mezzogiorno displayed one of the highest growth rates globally and the internal divide declined considerably (Daniele and Malanima 2011). Convergence was to a large extent driven by fiscal and industrial policies: Fig. 6 displays the contribution of demand components to real GDP growth in the two Italian macro areas, showing how public demand has been indeed among the largest contributors to the development of the Mezzogiorno.

A pivotal role was played by the Southern Italy Development Fund (SIDF, ‘Cassa per il Mezzogiorno’), a public agency focusing—in the 1950s—on infrastructural and agricultural investments, and later—in the 1960s and early 1970s—on the promotion

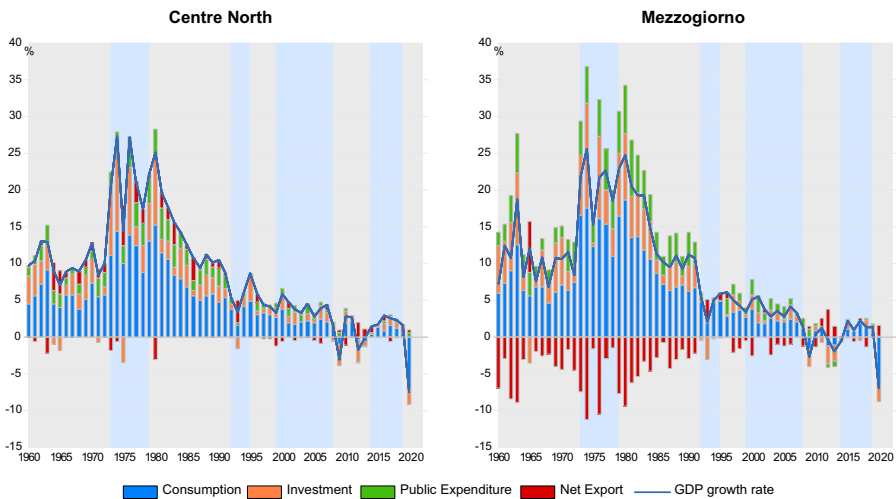


Fig. 6 Demand contribution to GDP growth. Centre-North and Mezzogiorno, 1960–2021. *Source* SVIMEZ; own calculations

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. However, by the end of the 1970s, the country was split into “three Italies”: the industrialized North, few industrial districts centred around large SOEs in the South, and the rest of Mezzogiorno, characterized by very low competitiveness (Fanti et al. 2022).

The third phase—starting with the oil crisis of the 1970s—determined 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.⁷ Second, fiscal redistribution increasingly losing 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 (Daniele and Malanima 2011). Finally, the more fragile industrial structure of the south proved less resilient to the increasing competition brought about by globalization further penalizing its competitiveness vis-à-vis the north.

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. Even in this case, there is ambivalence. Representing an inexhaustible source of cheap labor, Mezzogiorno's regions are instrumental to the cost-competitiveness strategies of the northern exporters (De Cecco 1971). On the other hand, 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, ensured some convergence.

The European regulatory framework made the use of industrial policy much more difficult 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 experienced a much larger contraction in manufacturing value added than the North; business investment, household consumption, and public expenditure in the South also fell significantly more, which further increased the deep territorial divide (Guarascio and Simonazzi 2016). Increasing polarization is also visible in areas such as banking, where a broad process of centralization and desertification of banking activity in the South has taken place (Del Prete et al. 2022). The financial deregulation measures discussed in Sect. 3.1 did not improve the performance of the Italian banking system: allocative efficiency did not increase,⁸ with scandals and opaque mergers

⁷ 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).

⁸ Guiso et al (2006) show that 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 increased severely after deregulation.

and acquisitions followed by judicial investigations. But financial deregulation did contribute to a decline in credit to firms located in the Mezzogiorno.⁹

5 Conclusions

We have analyzed how Italy's decades-long decline has rendered the country a critical vulnerability within the Eurozone. By drawing on the existing growth model literature (e.g. Baccaro and Bulfone 2022; Blyth et al. 2022), we have identified key developments and discontinuities in Italy's growth regime. However, we extend the literature by developing a structuralist-evolutionary framework that synthesizes various supply- and demand-side explanations in a long-term perspective (Cipolla 1952), considering the roles of institutions (Amable and Palombarini 2014), the sectoral composition of the economy, and domestic and international interdependencies (Andreoni and Scazzieri 2014).

We argue that structural domestic factors—low-cost competition and labour fragmentation, many small firms, and the North–South divide—which proved instrumental to Italy's development after World War II later interacted with the policy constraints brought about by globalization and European integration, exacerbating Italy's decline vis-à-vis its Eurozone peers. Initially mitigated by public demand and 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—these structural weaknesses were amplified in the 1980s as globalization and European integration intensified. The erosion of policy autonomy, particularly in monetary and fiscal spheres, exacerbated demand-side constraints and widened the North–South divide. This process was further aggravated by structural reforms that weakened labor and welfare institutions, thereby suppressing aggregate demand and productivity. The interaction between the structural domestic factors and external constraints exacerbated the negative impact on productivity, making the Italian economy increasingly weak vis-à-vis its main EZ peers.

Our findings indicate that Italy represents a failed attempt at modernization under external constraints. Eurozone membership did not result in modernization and convergence towards higher living standards. On the contrary, a fault line opened 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 tertiarization' (Blyth et al. 2022; Bürgisser and Di Carlo 2022; Cirillo et al. 2017). Productive and technological capabilities declined while low-tech-low-wage service sectors increased their relative importance.

Identifying the causes of Italy's long decline could prove relevant to understand the evolution, positioning, and challenges faced, in the new global context, by the

⁹ Between 1995 and 2019, the share of banks in the South headquartered in the area declined from 88.2 to 68.6%. 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).

broader European periphery. As in the Italian case, the experience of other peripheral countries such as Spain, Greece, and Portugal highlights how external constraints may exacerbate domestic weaknesses, impoverishing productive and technological capabilities, ballasting productivity and increasing dependency on foreign capital and goods. From a policy perspective, The lessons from Italy suggest that fostering sustainable growth requires not only flexibility in fiscal policies but also a coordinated approach that integrates industrial policy, investment in innovation, and support for regional development. By learning from Italy's experience, Eurozone policymakers can design strategies that better balance national economic needs with collective European goals, ultimately enhancing the stability and inclusiveness of the Eurozone as a whole.

Yet, if persistently tight fiscal policies and market-liberal reforms have failed to move the country forward, then an alternative, 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 (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. Furthermore, labour policies need to be redesigned, 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.

Addressing these challenges requires a fundamental rethinking of EU policies. First, persistently tight fiscal policies have proven deflationary and counterproductive, particularly for financially vulnerable member states (Heimberger and Kapeller 2017). A long-term investment strategy could provide the necessary conditions for economic recovery and convergence, as well as achieving the targets for digital and green transitions. Given that the new SGP reduces the fiscal space for highly indebted countries as Italy, to implement such an investment program would primarily involve leveraging the available tools to allow greater flexibility to pursue investment-led growth, particularly in sectors with high productivity potential. These include European Investment Bank (EIB) loans for infrastructure and innovation projects, Structural and Cohesion Funds for regional development, as well as programs targeted at the Green Transition, such as the Just Transition Mechanism. This strategy, if well-tailored to consider peculiar needs and structural characteristics of different Member States, should be pursued all across the EU's periphery in an effort to narrow the gap vis-à-vis the core and, in so doing, increase the resilience of the entire Union (Guarascio et al. 2025a; b).

Moreover, reconciling national-level industrial policies with EU-level constraints necessitates innovative policy coordination. One potential pathway could be the development of a European-level industrial policy that complements national efforts favoring synergies and ensuring coherence among them. Such a framework could prioritize strategic sectors and technologies while ensuring structural convergence across

member states. Furthermore, the EU could consider revising state aid rules to permit targeted support for industries crucial to national development, thereby fostering regional and sectoral resilience.

Labour policies also require recalibration. The current focus on labor market flexibility and wage suppression has hindered productivity growth and deepened economic decline. A shift towards policies that support wage growth, enhance job security, and promote skills development could stimulate aggregate demand and productivity. This would necessitate a coordinated approach to wage-setting and labor market regulations at both national and EU levels.

In conclusion, the European policy framework needs a comprehensive overhaul to better integrate industrial, fiscal, and labor policies, with an emphasis on sustainable growth and structural convergence. Our work paves the way for further research along multiple directions. First, we hope to stimulate work on biased or incomplete views on how Italy ended up in long-term economic decline, including the role of media outlets and policy elites in framing the decline. Second, our framework should be further taken to the data: additional research can aim at quantitatively testing the structural domestic factors 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 Eurozone. Fourth, given the interconnectedness of the Eurozone with the global financial and economic system (Tooze 2018), more international political economy research is needed to compare Italy's failed case of modernization by external constraint with other cases inside and outside of Europe.

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Declarations

Conflict of interest We have no conflict of interest to disclose.

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