

Internal or External-Deep-rooted Reasons for Italy's Economic Decline After the 1990s

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Abstract: The economic decline of Italy after the 1990s is a topic that many researchers look into. However, most of the existing works focused on a singular factor attributed to the problem. Different from previous works, this study looks into the problem of the Italian economy through various determinants, aiming to answer the question: Are external and internal factors equally important for the decline of the Italian economy, or is one of them more significant? Based on the review of literatures and theories, we identified a few essential internal and external factors that affected the Italian economy and analysed them individually. We then evaluated the precedence of these factors to indicate which factor has a more significant influence on the Italian economy, and concluded that short-term (external) triggers are symptomatic of long-term (internal) problems. Ultimately, the failure to rectify deep-rooted deficiencies in its economic and political structure rendered Italy uncompetitive in the modern era. Although this paper has not delved deep enough on some specific issues, this study will still provide some information and further insights for European and Italian Economic Research.

1. Introduction

Italy emerged with a burgeoning economy during the years of 'economic miracle': during the postwar period, its GDP growth rate ranked among the top of Europe. At one point, its GDP per capita even exceeded Britain in terms of relative prosperity [1]. Nevertheless, sustained economic growth ended abruptly in the early 1990s, and the country entered a slow yet irreversible phase of economic decline. The once economic leader of Europe became a laggard in terms of GDP growth rate, industrial productivity, and technological innovation. At the start of the 21st century, Italy's GDP growth rate ranked as the last in Europe, and by 2014 its level of real GDP per capita was reversed, backed to its level in 1997 [1]. Many explanations have attributed this sudden reversal in economic trends to only one aspect of the Italian economy. Yet, there appears to be no single explanation but a concatenation of trigger events and deep-rooted weaknesses that eventually culminated into an economic debacle.

Both internal and external factors contributed to the economic decline of Italy after 1990, yet the difficulty lies in a precise assessment of their relative importance. The internal setup of the economy is indispensable as the Italian economy specialised in a small-scale family business. Corporate management relied extensively on cronyism and patronage and neglected spending on research and technology. Meanwhile, export competitiveness during the years of 'economic miracle' (the 1950s-1970s) was maintained by a continuously devaluated currency rather than comparative productiveness. Coupled with a tendency to maintain an unsustainably high level of spending, the government was burdened by persistent budget deficits and ever-rising public debts. These inherent problems were accentuated by the external environment, as the convergence of European economies further limited fiscal independence, and the European Fiscal Compact further curbed economic development. The advent of globalisation also gave rise to the economic rivalry of Asian countries,

undermining Italy's comparative advantage and accelerated the rate of domestic de-industrialisation. After examining the importance and impact of each factor, their interrelation will be investigated under four key questions:

(1) Whether internal and external factors are jointly significant in triggering the economic decline of Italy?

(2) Should economic stagnation be attributed to insufficient technological investment and productive inefficiency, or globalisation?

(3) Did labour market inflexibility play a more paramount role than European economic convergence?

(4) Was the 2012 Eurozone crisis a reactionary event to the long-standing problem of domestic fiscal mismanagement?

Existing knowledge in the field would enable a holistic investigation of questions 1, 2, 3, and 4, and our research would resolve some of these ongoing dichotomies. Question 1 summarises our approach on justifying the importance of the internal culprits of decline. Question 2 would settle whether technological stagnation was the most important reason for economic decline after 1990. Question 3 focuses extensively on the importance of labour market constraint to growth, in relation to the external event of convergence in European market. While prior investigation on European monetary and political integration followed a Eurocentric approach, in Question 4, we attempt to trace the root of the 2012 Eurozone crisis from inside.

2. Literature Review

2.1. Special interest groups as the liability

Many have documented the economic decline of Italy [2][3], and the interpretation of the roots behind Italy's economic failure also varied. One possible theory for explaining this situation is the classic hypothesis of Olson [4], using the increasing monopolistic power of unions as a source of increasing burden on public finance, and positing economic performances as a consequence of entrenched special interest groups imposing deadweight costs on the society [5]. It appears that the slow and progressive decline of the Italian economy might have followed from this pattern, which matches up with Olson's interpretation. However, one problem of this theory is that, in contrary to Olson's expectation, during the period of economic decline Italian interest groups grew weaker instead of stronger. The density of unions demonstrated a tendency of decline since 1976 when they reached 50.5 per cent [6], which was then dropped to 40 per cent in 1987 and declined to 33.4 per cent in the the year 2008. This decline in unionisation rates could not explain the increase of the monopolistic power of unions. Thus, the hypothesis of Olson might not be a persuasive explanation for the decline of the Italian economy after the 1990s [3].

2.2. Globalisation of the economy

The second common explanation of Italy's economic failure is the advent of globalisation [7, 8]. Concurrently, internal restructuring of the Italian economy overlapped with rapid changes in economic convergence on the international leve [8]. In this pivotal phase of transition Italy failed to adopt effective reforms to reap the benefits of global economic integration. This factor will be further discussed in the following section. One controversy for this explanation stems from Italy's traditional North-South divide. Northern Italy has been more prosperous than the southern areas since the 19th centur [9]. Suppose the leading cause of Italian economic decline is the absence of liberalisation reforms during a phase of increased global competition. In that case, the decline in the south part of the country should be more profound than in the north area. However, the reality is that southern households' income during the same period constantly grew above the national average. During 1995-2007, the annual growth of GDP per capita in the south of Italy was 1.4 percent, whereas the north was merely 0.7 percent [10], which proves to be inconsistent with the globalisation explanation.

2.3. Key factors investigated

Italy's economic stagnation could then be attributed to other aspects, such as political fragmentation, technological stagnation, and relative uncompetitiveness in productivity. Prevailing opinions called attention to the failure to catch up with the technology race in ICT and R&D and relative unproductiveness indicated by falling TFP to explain Italy's economic stagnation [1, 11]. Politically, Calingaret traced the importance of the political roots of the country and highlighted the role of persistent political instability: weak political system, mercurial voting system, and unstable government might also dwarf the Italian economy [12]. The unhealthy levels of public debt originated from an unbalanced demographic structure and political incompetence of coalition governments. At the same time, over-regulation and lack of competition in the labour and product market created a barrier to innovation and entrepreneurship. The deepening of European financial and political integration further testified to fiscal mismanagement and a splintered political landscape [12, 13], resulting in divergence rather than convergence in economic growth. Albeit less central to the discussion, the effect of EMU policies such as the Maastricht criteria, the Stability Pact, implementation of the Common Currency was also substantiated by Talani and Bull [13, 14], respectively.

Synthesising the study of Zotti [1], Felice and Vecchi [15,16], and Pellegrino and Zingales [11] enables us to establish technological stagnation - slow adoption of ICT and lack of investment in R&D - as inseparable factors of decline, while incorporating other political and institutional constraints. Since successful development of ICT and R&D required an efficient and transparent fiscal and financial framework, an educated and expanding labour workforce, and political stability. Yet all of these required inputs are missing in contemporary and modern Italy. This unique starting point enables us to explain why the Italian economy suffered disproportionately in the era of technological innovation aside from industrial and managerial inefficiency. Changes in the external environment might have damaged the previously optimistic growth outlook, as Italy was forced to synchronise its domestic policies with ongoing economic and political integration in Europe. But decline originated from the inherent weaknesses of the Italian government, economy and population were accentuated by external forces.

Our research begins by quantifying the impact of external and internal factors on Italy's economy after the 1990s. For external factors, we highlight the importance of globalisation and the influence of European Union policies such as the Maastricht Treaty and Fiscal Compact by combining the research of Zotti [1], Felice and Vecchi [15,16], and Bull [14]. Three predominant areas are investigated concerning internal elements, on domestic economic landscape, macroeconomic policy making and Italy's political and institutional environment. Unlike Calingaret [12], we attribute problems in public finance to political causes because a deeply fragmented political arena limited the ability of political leaders to rationalise public deficit and debt, which subjected Italy to a more stringent austerity policy after European economic convergence. To further advance the importance of domestic factors, a comparative account of investment in R&D compared to prospering European countries will be offered to examine why Italy alone diverged from the upward trend of economic growth after the intensification of European integration.

3. Investigation of External Factors

3.1. Globalisation

Italy failed to capitalise on the prosperity conferred by globalisation for two primary reasons: 1) the emergence of Asian economies; 2) the failure to develop its own specialisation. Emerging Asian economies as cheaper manufacturers in the world market gave rise to the practice of foreign outsourcing as OECD countries shifted their manufacturing units to low-cost countries and began to focus on developing a high value-added economy (i.e., by producing goods with a relatively high profit margin due to R&D and complexities in design). Italy, in contrast, relied extensively on low-innovation and labour-intensive industries, while globalisation and the emergence of new suppliers

accelerated the pace of domestic deindustrialisation. Another determinant for Italy's economic stagnation during globalisation was the deficient specialisation pattern of the economy. While stagnation in relative productivity could be attributed to regional and sectoral disparities in R&D spending, the failure of state-owned enterprises in the 1980s and the subsequent abandonment of industrial districts also shed a light on how managerial inefficiency and misconduct impeded enhancement in productivity and development in ICT and R&D, especially in Northern Italian regions.

3.2. EMU

The second focus of external influences is the process of economic and political integration in Europe. European Monetary Union (EMU) signified shifting political and economic focus to the centre of Europe in achieving policy and economic harmony, with the creation of the European Central Bank supervising the fiscal and monetary policies in 15 member states. Although Italy retained control of its foreign currency rate until 2002, the Maastricht criteria altered the macro-economic regulatory framework, and EU financial regulations superseded the original market constraints [14]. Before the 1990s, the Italian economy followed an export-led growth model, using devaluation of the lira to boost export competitiveness [12]. Entrance to the EMU created a single currency (the euro), which fixed the exchange rate, stripped away monetary independence at national and super-national levels, and led to adverse phenomena such as exchange rate risk[12].

3.3. European Union

The impact of the EU on Italy can also be analysed through the lens of 2012 Eurozone crisis and the implementation of the Fiscal Compact. Although other countries also underwent a recession, Italy was at the centre of the crisis. The export of Italy was in penultimate place from 2008 to 2017, and the long-term unemployment rate was higher than all other European member states except Greece and the Slovak Republic. Prior to the crisis, Italy also suffered from negative and ever-exacerbating GDP growth rates (see Figure 1). This crisis caused higher public debt and public deficit in Italy, which further impeded the economic development of this country. In response to the crisis, the Fiscal Compact limited national budget sovereignty, resulting in around 2% of GDP in Italy being cut every year [14], which was also a heavy blow to the nation's public finance.

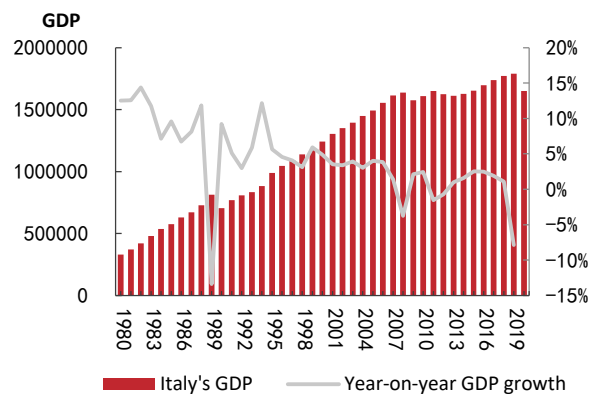


Figure 1. GDP Growth of Italy, 1980-2020

4. Investigation of Internal Factors

4.1. Demographic Structure

Italy has a declining and ageing population with a low birth rate and high life expectancy. This meant that a relatively small workforce was forced to share the burden of rising pension contribution. The current ratio of the working population versus the non-working population in Italy is 100:135, which is projected to rise to 100:200 in 2050 [12]. A low birth rate also translates into a low

participation rate of 63%, compared to an average of 71% in Europe. As a result, the population of Italy is estimated to fall by 12% in the year 2030, while the number of EU is 8%, which indicates a labour shortage and higher cost of human capital in Italy. Moreover, Italians also have an earlier retirement age due to the incentivising effect of pension scheme and disincentivising effect of "implicit tax" (50% after 50), which aggravated labour market inflexibility.

4.2. Political determinants

Italy's political and institutional environment offered a multifaceted explanation for the economic decline: political fragmentation, fiscal incompetence, and institutional inflexibility together stifle the channels for reform and innovation. Italy's political structure was inherently problematic: the 1946 Constitution guaranteed the supreme powers of the two Houses and the relative weakness of political leaders, while the reliance on the Proportional Representation system created a deeply divided political constellation [12]. Thus, successive coalition governments such as central-left and central-right failed to keep recalcitrants under control [12]. Internal divisions also limited the efficaciousness of public administration and made it challenging to implement coherent policies. As a result, the Prodi government failed to streamline pension payments under the pressure of left-wing unionists. Liberalisation reforms aiming to deregulate tax licenses and reduce bureaucracy also failed to be implemented due to internal pressure. Finally, political factions were further accentuated by the influx of immigrants, fuelling xenophobia: the Pew Global Attitudes Projects reveals Italy as one of the most xenophobic countries out of 47 [12].

4.3. Problem in Public Finance

Italy suffered from a persistent and ever-rising budget deficit since the 1980s (as illustrated in Figure 2). Exacerbated by the increasing number of unemployment, Italy's public debt was 120 percent of GDP in the 1990s and remained over 100% in the following decades [12]. This situation was primarily triggered by the problem of tax evasion and difficulty to implement an austerity policy. According to Calingaret [12], one obstacle in the way of Italy's budget cut is the prevalence of unionists, reflected in their slogan of "Don't touch pensions". A higher percentage of the elderly population also necessitates a higher ratio of pension expenditure: Italy has the highest ratio of pension expenditure to GDP in Europe, currently takes up to 14 per cent of total expenditure allowance, which is projected to rise to 17 per cent in 2035. By then Italy will have an even more imbalanced demographic structure, which will place further burden on its public finance.

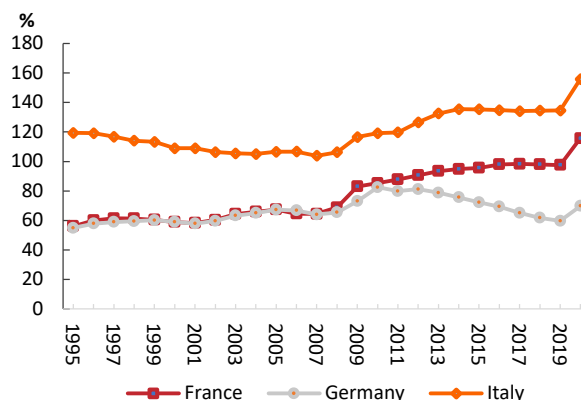


Figure 2. Gross government debt as a percentage of GDP, 1995-2020

4.4. ICT and R&D

The importance of the domestic economic landscape is examined through the lens of technology and modern management: Information and Communication Technologies (ICT), Research and Development (R&D), and Total Factor Productivity (TFP). Stagnation in ICT could be attributed to traditions of family businesses supplying a niche market, inclination towards low-tech instead of

capital-intensive productions, and decline in the proportion of large enterprises. Indeed, Italy's negligence in ICT adoption became more conspicuous as emerging countries supplanted Italian manufacturers with lower prices and greater affordability [1]. Insufficient R&D development also reinforced our predictions: funding for scientific research and education in Italy were curtailed under a policy to streamline public expenditure (as demonstrated in Figure 3), which limited human capital development as the level of schooling and human capital remained below OECD averages and of standards in the modern knowledge economy. Aside from technology, managerial inefficiency was also exacerbated by the prevalence of cronyism and patronage, which inhibited the expansion of meritocratic and scientific management [11].

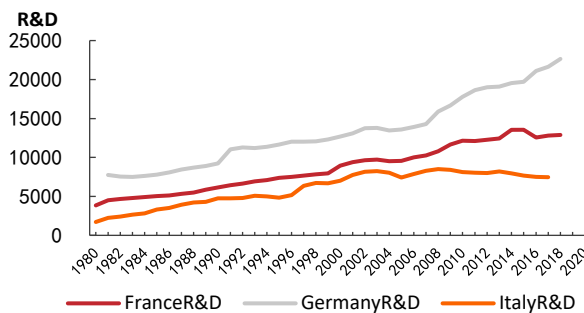


Figure 3. R&D comparison among France, Germany, and Italy, 1980-2019

5. Discussion and Evaluation

5.1. Joint significance of internal & external factors

The interconnections between internal and external culprits of decline are explored in several facets, such as success in the global technology competition, the effectiveness of political institutions on improving labour market flexibility, and the efficacy of macroeconomic policies. European integration, in essence, is a form of economic and political liberalisation at the federal-state level. The outcome of integration is already symptomatic of some of the underlying production and distribution patterns between member countries. In light of globalisation, Zotti also demonstrated in a Cournot-oligopoly model [1] that concurrent liberalisation of global and domestic markets works counter-productively to economic expansion. Yet an apparent caveat here is that these explanations have not placed enough emphasis on the fundamental economic engines of growth - R&D investment and ICT development - as demonstrated by the most economically successful OECD countries. The failure of macroeconomic and labour market management could also be attributed to apparent flaws in Economic institutions and political competence at the European state-level. Nonetheless, failure of internal management preceded external factors. The persistence of internal deficiencies in public finance, monetary and fiscal policies and labour market remains as the root cause for the sovereign debt crisis and failures in the labour market reforms.

5.2. Does globalisation outweigh internal technological development?

When thinking about globalisation among EU countries, undoubtedly Germany has successfully taken advantage of globalisation in contrary to Italy. According to Sprinch, exports of goods and services in Germany weigh for about 50 per cent of the country's added values, and one in four jobs are related to exports, with the number higher in the manufacturing industry [17]. Imbalances between EU country productions subsequently led to the emergence of a German-centric production system, where neighbouring countries increasingly participated as subcontractors, including northern Italy. Hence shifting the international production system towards a more hierarchical and centralized structure, resulting in a drastic increase in the oligopoly market power of multinational companies to control a wider network of outsourcing and offshore activities at the European level.

It might have appeared that European integration favoured some countries disproportionately. Still, arguably economic liberalisation at supranational levels more likely created a level playing field

that testified to each member country's productive capacities and efficiency. Whilst relying heavily on low-innovation and labour-intensive industries, Italy also has a very limited number of multinational companies and many existing ones were lost to foreign acquisition (such as Telecom, Pirelli, Italcementi), whose interest in maintaining production, employment, R&D in Italy is at best uncertain [17]. Therefore, high-technology industries in Italy are seriously damaged both by globalisation and lack of investment expenditure in R&D and innovation. The relative stagnation in R&D could be inferred from the comparison between Italian's share of GDP as R&D expenditure, and concentration of R&D spending in the private sector to European averages. Istat stated that in 2013, the ratio of Italy's R&D to GDP was 1.30%, which is far below the 1.53% target reached by Europe in 2020; this gap could only be filled with additional 4 billion euros. Due to the under-performance of Italy in many indicators (which is far below the average of EU28), it was listed as a "moderate innovator" by the Innovation Union Scoreboard in 2014. The Italian Innovation Survey shows that during the 2010-2012 crisis, only 35.5% of companies introduced at least one process or product innovation, which is far lower than European averages. Furthermore, only 12.5% of innovative companies reported cooperation with the public sectors and/or universities, while the EU average was 31.3% [18,19].

5.3. Labour market inflexibility vs. European convergence?

As discussed before [12], political instability was a liability to the Italian economy. Concurrently, labour market instability and rigidity also created a barrier to innovation and entrepreneurship. In this section, we will discuss these factors in more details.

The creation of a European common market created "four freedoms": freedom of movement for goods, services, capital and labour in all member countries. Yet in the context of greater cross-regional mobility Italy failed to catch up with other European counterparts in terms of labour market flexibility and stability. It is true that the single market gave rise to "agglomeration effects": given the free-flowing property of capital, productive resources will be attracted towards its most efficient use in the European market, subsequently exacerbating regional and national inequalities [23]. Yet labour market mobility is more closely linked to employment flexibility in a certain region hence more considerations should be given to the internal aspects of the Italian labour market [28].

As for the internal factors, the government proposed reforms to reduce labour inflexibility, assure the efficient allocation of labour resources, and increase labour mobility in modes and forms of utilisation [24]. Such action is laudable, yet the results were less satisfactory: started from the Treu Reform in 1997, proposed by the Labour Ministry of the Prodi government [25], which focused on apprenticeship and the free hiring of individuals on a temporary work contracts [21]. Researchers [26] find that while the reform positively influenced the probability of getting hired temporary at the first employment spell, the proportion of individuals obtaining a stable job three years after they entering the labour market was lower than before the reform. Additionally, although reforms reduced the labour cost of enterprises, it was done at the cost of exacerbating labour market instability and outsourcing of employment. In the long term this led to stagnation of Italian productivity and widened the competitiveness gap with other EU countries [27].

5.4. Fiscal and monetary mismanagement: EMU and EU

Undeniably, the creation of EMU limited both national and supranational monetary policy flexibility, while member favoritism also created unequal conditions for growth [13]. The implementation of Maastricht criteria and the Stability Pact limited fiscal autonomy of member countries and their ability to tackle asymmetric shocks without providing an alternative mechanism for European fiscal policy-making, leaving little room for maneuver in the advent of future crises. The absence of fiscal consensus and cooperation left European fiscal policy making in an inchoate state, forcing countries to rely on liberalisation of labour market and freedom of movement as a partial engine of growth. While EMU banned the use of devaluation policy in member countries, the values at which EMU exchange rates were set equaled a currency devaluation for Germany, which arguably

boosted growth and expansion in its exporting sector [13]. Hence it would not be nonsensical to state that the discrepancy of growth in Europe was emboldened after the creation of EMU.

Yet, although fiscal and monetary rigidity at the European level resulted from the creation of EMU, the problem of ineffective domestic macroeconomic regulation emerged at a much earlier date [20]. As early as in the 1980s, policymakers in Italy failed to capture the shift in the Italian growth paradigm, trapping domestic monetary policy in a contradictory framework as domestic policies of short-term credit controls contravened with European economic convergence. The decision to shift from an anti-cyclical to pro-cyclical framework debilitated the effectiveness of central bank policies on soothing business cycles, while continued reliance on traditional fiscal and monetary stimulus only exacerbated budgetary imbalances and domestic inflation [20]. On the other side of the coin, monetary policies is most effective only when it functions with a liberal labour market, innovative product market, and an optimistic-looking technology sector. Without the much-needed institutional liberalisation and labour market reforms, Italy failed in competition on intangible assets and human capital, which would lessen the impact of all macroeconomic policies regardless of their effectiveness.

5.5. Was the Eurozone crisis 2012 a reactionary event to deep-rooted domestic problems?

Evidently, much of the blame for the 2012 Eurozone crisis is attributed to the failure of EU management and European integration. The fact that a divergence rather than convergence of growth resulted from the process of economic integration reflected the failure of EU macroeconomic management and policy-making. The EU was also accused of lacking fiscal prudence in failing to regulate the reckless lending of Eurozone banks and to rectify the weaknesses of ill-designed fiscal policies after the crisis [21]. The implementation of austerity policies was mandatory but not inevitable (the worst debtor nation's deficit to GDP ratio was only 4.3% higher than EU averages). Still, the decision of full debt repayment for debtor countries opened up a debtor-creditor divide and curbed economic growth in all member countries [13]. The intensity of austerity programs imposed in Southern nations also resulted in a structural asymmetry - in terms of real GDP, employment, and relative labour unit cost - leading to wage cuts and "internal devaluations" compared to Northern nations [21]. But despite the inexorability of EU policy-making and macroeconomic regulations, the trigger of the crisis still lay within the domestic finance of PIGS (Portugal, Italy, Greece, Spain). Italy's infamy of having a severely imbalanced debt-to-GDP ratio and failure to keep its own sovereign debt in control since the 1980s meant that the EU measures were more than precautionary: Italy's level of public debt remained among the highest of Europe (around 120% of GDP and ever-increasing since 2007), which is a reflection of its weak fiscal regulatory regime, widespread tax evasion and deficient public finance [22]. Clearly, the sluggish pace of productivity growth since the 1990s also played a role in slowing down economic expansion and intensifying debt burden, which ultimately led to the imposition of more stringent fiscal controls. These deep-rooted national weaknesses were undeniably more important in keeping Italy in a state of fiscal incompetence and in culminating in the eventual European-wide debt crisis.

6. Conclusion

Based on the analysis provided, it is safe to conclude that short-term triggers exacerbated long-term problems. Changes in the external environment damaged future prospected on growth and forced Italy to synchronise its domestic policies with global economic and political integration. However, economic decline originated from the inherent weaknesses of Italian political regime, economy and population. With a fractured political landscape limiting the scope for economic reforms, an imbalanced demographic structure causing persistent deficit and debt, and failure in macroeconomic and labour market management, Italy arrived at a disadvantaged position in the EU and EMU. These pre-existing constraints became more conspicuous when specialisation, technology, and continental unions began to dominate the world economy. Failure to rectify these deep-rooted deficiencies rendered Italy uncompetitive in the modern era.

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