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To what extent the lack of trust among Member States influences the EU economic governance: the case of the Stability and Growth Pact

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ABSTRACT

This dissertation investigates for the first time the role of trust, or the lack thereof, in the negotiation processes surrounding EU economic governance, particularly taking as a case study the Stability and Growth Pact. By employing a theoretical framework that integrates liberal intergovernmentalism with trust theories in international relations, this research explores how mistrust among EU Member States has influenced key negotiations of the Pact, particularly those leading to its introduction in 1997 and its subsequent reforms in 2005, 2011, and 2024. The analysis categorizes these negotiations into three scenarios: the implementation of stringent rules, the introduction of flexibility, and a compromise between these two extremes. The study relies on primary sources and interviews with negotiators involved in the most recent 2024 reform, offering a unique perspective on how mistrust has shaped the Stability and Growth Pact, and ultimately the EU economic governance, over time. The findings contribute to the broader understanding of EU governance by highlighting trust as a critical yet underexplored factor in the negotiation processes that determines the Union's fiscal policies.

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INTRODUCTION

The economic governance of the European Union (EU) has been a central issue of debate and analysis since the establishment of the Economic and Monetary Union (EMU). This governance framework, which seeks to balance national fiscal sovereignty with collective oversight, has evolved significantly over time, particularly through key mechanisms such as the Stability and Growth Pact (SGP), introduced in 1997. Indeed, the Stability and Growth Pact has been reformed several times over the years, namely in 2005, 2011 and in 2024, as it was constantly trying to adapt its rules in response to emerging economic challenges. Scholarly debate has focused mainly on assessing the effectiveness of the new rules and their implementation but has not focused as much on their negotiation. Key questions remain: why were these rules agreed upon? What are the main factors influencing the negotiation process?

This dissertation aims at answering this question, by arguing that the central factor influencing EU-level negotiations, and in this case, the negotiation of the Stability and Growth Pact, is the lack of trust among Member States. Indeed, research indicates that negotiations lacking trust are less likely to achieve outcomes where both sides get what they value most, even when such a possibility exists (Schei & Rognes, 2003; Weingart et al. 2007). Therefore, trust is a crucial element in the negotiating process, that however has not received systematic attention within the international relations scholarship (Wrighton, 2022:17). This dissertation aims to fill this gap, by being the first piece of research that employs a theoretical framework combining liberal intergovernmentalism with theories of trust in international relations within the EU economic governance, analysing in particular to what extent trust/mistrust was able to influence the latter. The dissertation will do so by using as a case study the Stability and Growth Pact and analysing the negotiations that led first to its introduction in 1997 and then to its reforms in 2005, 2011 and 2024.

In particular, three distinct scenarios will be taken into account: (a) the case in which more stringent rules are agreed upon (i.e. the introduction of the Pact in 1997 and its reform in 2001); (b) the case in which more flexibility is agreed upon (i.e. the 2005 reform) and (c) the case in which the rules are a compromise between the two instances (i.e. the 2024 reform). This dissertation will show how all these scenarios were characterized by a high mistrust among Member States and how this influenced the negotiations to a large extent. It will do so by analysing the bargaining process among Member States, in particular employing primary sources, such as parliamentary or other hearings, speeches, policy reports, press conference transcripts and so on. Moreover, for the 2024 reform, a further source will be the findings from the interviews that I conducted with some delegates from the Member States and a policy officer who negotiated themselves the revised Pact. This will give even more support to the argument of the dissertation.

The dissertation will proceed as follows. The first chapter will focus on the theoretical approach employed by the dissertation, starting with a comprehensive review on EU economic governance and the Stability and Growth Pact, which analyses the main theoretical approaches employed by scholars, to identify potential gaps in the literature. It will then present the theoretical framework employed in this dissertation, that is the combination of liberal intergovernmentalism – which focuses on inter-state bargaining – and the theories on trust in international relations. The chapter will conclude with the explanation of the research methodology, that is case study research (with the case study being the Stability and Growth Pact), including the types of sources that will be used (primary sources and interviews for the last scenario).

After this theoretical chapter, the following three chapters will be analytical and will focus each of them on one of the three different scenarios mentioned above. In particular, the second chapter will focus on how lack of trust among Member States pushed them to agree on more stringent rules (a). Since two are the cases that belong to this scenario, the chapter will be divided into two parts, with the first part of the chapter (para. 1) focusing on the introduction of the Pact in 1997, which introduced for the first time permanent fiscal rules, and the second (para.2) focusing on the 2011 reform, which required stricter adjustments after the financial crisis. Both will contain an explanation of the new rules (para. 1 and para. 2.3), followed by a detailed analysis of the negotiation process that will show how mistrust among Member States led to stricter rules. In the first case, stricter rules were the result of the fear that other member states would evade the ECB's anti-inflation policy by cutting taxes and increasing spending (para. 1.1). In the second case, it will be shown how stricter rules and harsher sanctions were imposed mainly to avoid that Southern countries' fiscal profligacy could generate another Eurozone crisis (para. 2.4). For this reason, this second paragraph will also contain an explanation of the context pre-crisis (para. 2.1) and of the crisis itself (para. 2.2) to make the reader appreciate more the climate of mistrust that was already there before the reform.

The third chapter will focus on scenario (b), which is the lack of mistrust resulting in more flexible rules, and it will therefore focus on the 2005 reform. In fact, this reform weakened the preventive arm and recognized the economic heterogeneity among countries and their position in the economic cycle. After an explanation of the economic context pre-reform (para. 1) and of the new rules (para. 2), it will be shown how lack of trust was key in achieving this result, by indeed making rules more flexible and more equally enforceable, but always trying to avoid room for discretion among Member States (para. 3).

The fourth and final chapter will focus on scenario (c), that is a hybrid between more stringent and more flexible rules and will therefore focus on the 2024 reform, which sees uniform safeguards for all member states but at the same time more flexibility because of the longer adjustment plans and a slower debt reduction. Here, after usual explanation of the pre-reform context (para. 1) and of the new rules (para.2) it will be shown how the result of the reform was a compromise as Member States, who did not trust each other, dividing themselves in two blocks, with one asking for more flexibility and one asking for more stringent rules. The fact that this was due to a lack of trust can be seen both by the analysis of the bargaining process (para. 3), but also from the findings of the interviews conducted to the negotiators themselves (para. 4). Finally, this chapter will end with an input for further research, that is, whether this mistrust in EU negotiations is not only among Member States but also between the Member States and EU institutions, and in this case namely the European Commission (para. 5). Finally, some concluding remarks will be made.

CHAPTER I

THEORETICAL APPROACH

1. Literature Review

The objective of this literature review is to research what are the key debates and the main theoretical approaches that have been used to analyse the EU economic governance, particularly focusing on the Stability and Growth Pact. The aim is to identify the most appropriate theoretical framework for this dissertation and to highlight potential gaps that this dissertation aims to address.

The economic governance framework of the European Union has been a significant topic of discussion since its inception. In fact, the introduction of the Economic and Monetary Union (EMU) marked a radical departure from the previous practice of exchange rate coordination, culminating in the complete transfer of decision-making authority over monetary policy, which had traditionally been considered as a prerogative of national sovereignty (Puetter, 2012: 167). This transition featured prominently in the debates in 1970 following the Warner Report, in 1977 following the MacDougall report, in 1989 with the Delors report and after the financial crisis (Verdun, 2013: 24). Nevertheless, even though these were the most salient moments, interest in economic governance has remained consistent in the literature, as evidenced by the continuous publication of new articles and books on the subject (see, for instance, Eising & Kohler-Koch, 2003; Molle, 2011; Dermine, 2022). The Stability and Growth Pact, which is one of the key set of rules in the economic governance framework, has been a cornerstone of this debate.

The Stability and Growth Pact has been extensively debated for several reasons, particularly due to its multiple reforms over the years. In fact, as this dissertation will detail, the Pact underwent three major reforms: in 2005, which introduced the consideration of economic cycles in the implementation of fiscal rules; in 2011-13, which imposed stricter rules following the financial crisis; and in 2024, which emphasized public debt sustainability and growth through reforms and investments. Each one of these reforms has been thoroughly analysed by scholars. In fact, after focusing on the introduction of the Pact (Beetsma & Uhlig, 2001), scholars focused on its shortcomings (Feldmann, 2010; De Haan et al, 2004) and suggestions for improvements (Eijffinger, 2003; Fatas et al, 2003; Mathieu & Sterdyniak, 2003). Subsequent literature primarily assessed the 2005 reform (Beetsma & Debrun, 2007; Verde, 2006), with some scholars criticizing it as "too little and too late" (Kostoris Padoa Schioppa, 2006). Soon after, the focus was on the burst of the financial crisis and how it affected the Stability and Growth Pact (Larch et al, 2010), leading to its second reform (Seng & Biesenbender, 2012). Interest in the pact surged again during the Covid-19 pandemic (Hauptmeier & Leiner-Killinger, 2020), when its rules were suspended. Post-pandemic, scholars started debating proposals for further changes (Carrion Alvarez, 2021) and with the new Pact approved in early 2024, preliminary assessments have begun to emerge (Jones, 2024; Pench, 2024).

Beyond this quick overview of scholarly literature on the topic, it is crucial for this dissertation to analyse the theoretical approaches used by scholars in their analysis. This will help determine the most suitable framework for this research and identify any gaps that this dissertation aims to fill.

1.1. **Theoretical approaches**

The primary debate in the literature on EU economic governance revolves around two grand theories of European integration, namely neofunctionalism and intergovernmentalism.

Neofunctionalism, first articulated by Ernst Haas in his 1958 work "The Uniting of Europe: Political, Social and Economic Forces 1950-1957," builds on Mitrany's functionalism. Mitrany posited that men would collaborate in areas where they identified a common need that could only be addressed through cooperative institutions (Mitrany, 1943: 19). Neofunctionalists extend this concept to European integration, arguing that integration in one policy area generates pressure for further integration in other areas by creating closer ties between member states, through a process known as "spillover." In the case of the Stability and Growth Pact, neofunctionalism argues that the decision to adopt a single currency in the Maastricht treaty created a spillover effect into related fields of economic policy (Heipertz & Verdun, 2005: 996). In fact, potential fiscal profligacy by EMU member states could depreciate the euro, leading to higher inflation and interest rates for all member states (ivi: 997). Additionally, asymmetric shocks and divergences between EMU member states necessitated common fiscal rules to prevent economic instability (ibid). Thus, from a neofunctionalist perspective, this justifies the introduction of the Stability and Growth Pact. Regarding its various reforms, neofunctionalism explains the 2011-2013 reform as a response to the Eurozone crisis, emphasizing the need to strengthen the EMU and deepen economic integration among member states (Niemann & Ioannou, 2015: 200), in order to avoid divergence and contagion risks within the Euro-area. While it is early to find comprehensive theoretical analysis on the 2024 reform, a neofunctionalist approach would likely interpret it as a further deepening of the economic integration process, highlighting the increased discretion given to the European Commission as a strengthening of supranational power.

Intergovernmentalism, on the other hand, argues that European integration results from strategies pursued by rational governments acting based on their preferences and power (Moravcsik, 1993: 481). This theory is divided in several branches. For the purpose of this dissertation, the focus will liberal intergovernmentalism, developed by Moravcsik in 1993 to better explain European integration. This theory focuses on national preference formation at domestic level, followed by inter-state bargaining and eventual deeper integration at international level (Moravcsik & Schimmelfenig, 2004). In the case of the EMU and the Stability and Growth Pact, liberal intergovernmentalist scholars argue that it was introduced mainly due to Germany's political leverage (Dyson and Featherstone, 1999; Stark, 2001). The 2005 reform was also influenced by Germany, for which these fiscal rules had become too stringent, as strong domestic groups' pressures on the budget led to a more relaxed fiscal policy (Marzinotto, 2008: 122). As for the second reform, after the Eurozone crisis, it argues that, since all the Eurozone governments were affected by the crisis and a potential disintegration of the Euro area, they all agreed on more integration to address EMU deficiencies (Schimmelfennig, 2018: 1584). However, compared to neofunctionalism, they argue that the depth of integration was not equal among countries, reflecting different preferences at national level. In fact, Northern countries, less affected by the crisis, were more able to shift the major burden of the adjustment to the south, shaping new institutions largely according to their fiscal preferences (ibid). For the 2024 reform, liberal intergovernmentalism would suggest that each member state, during the inter-state bargaining, pushed for their interests based on domestic preferences. In particular, countries from Northern Europe, known as the "frugals" – which have conservative ideas on economic matters, advocated for stricter common thresholds, while countries with a higher public debt pushed for more relaxed fiscal rules.

Beyond these two dominant theories, other approaches have also been proposed. Among the many, it is worth mentioning the "Three-level analysis" proposed by Talani (2008), which explains the reform by emphasizing how three different levels – namely the political one, the economic one and the political economic one – were intertwined and all contributed to the 2003 reform of the Pact. Other authors (Princen & van Esch, 2015: 371) emphasize the role of policy paradigms and policy changes, arguing that Stability and Growth Pact's evolution is not merely the result of diverging interests between member states, but rather of different economic ideologies (i.e. policy paradigms). In particular, some member states, such as Germany and the Netherlands, have promoted a strict Ordoliberal approach, which focuses more on price stability, whereas other states, such as France and Italy, have leaned more towards a Keynesian approach.

1.2. Limitations and gaps in the existing literature

While the theories discussed provide valuable insights into the EU's economic governance, they also exhibit significant limitations. For instance, one of the primary critiques of neofunctionalism is its assumption of a degree of automaticity in the integration process, overlooking the diverse interests and positions of member states and third-party actors and failing to adequately explain interest formation at national level (Eilstrup-Sangiovanni, 2006: 97).

As for liberal intergovernmentalism, Garrett and Tsebelis (2009) affirm that it overestimates the influence of governments with extreme preferences and underestimates the role of more centrist governments. Moreover, they add that it fails to adequately consider the significant roles played by the European Commission and the European Parliament in the legislative processes. Furthermore, I would also add that, liberal intergovernmentalism's emphasis on political leverage and asymmetrical power among member states neglects an important element: trust. In fact, the concept of "trust", which can be defined as the reliability, credibility, predictability, and transparency of state actions (Peter, 2014: 68), is crucial in international relations, to the point that for Hollande and Wolton (2021: 87) "trust is the very foundation of political relations. It is not possible to convince if there is no trust". This is especially vital for cooperation among diverse actors. According to Gambetta (2000: 217-218) when someone is considered trustworthy, this means that the probability that he will perform an action that is beneficial or at least not detrimental to us is high enough for us to consider engaging in some form of co-operation with him. Conversely, a lack of trust leads to precautions to avoid potential harm, which can hinder cooperative efforts (Wrighton, 2022: 14). Research indicates that negotiations lacking trust are less likely to achieve integrative outcomes where both sides get what they value most, even when such a possibility exists given preference structures (Schei & Rognes, 2003; Weingart et al. 2007). Therefore, this becomes relevant also for game theories in international organizations (Degterev & Degterev, 2011). Nevertheless, to my knowledge, trust has never been applied to EU economic governance. In fact, its primary use in international relations so far has focused on security (Wrighton, 2022: 17-18) and the concept has not received systematic attention within the broader international relations scholarship (Haukkala et al, 2018).

2. Theoretical framework and research methodology

Building on the literature review, the theoretical framework that will be used to answer the research question – that is to what extent the lack of trust among member states influences EU economic governance, specifically in the case of the Stability and Growth Pact – is the liberal intergovernmentalism approach with the addition of trust as a missing element to the theory. This means that the analysis will focus on inter-state bargaining and especially the role played by member states in their attempts to achieve their goals. This choice stems from my internship at the Italian Permanent Representation at the European Union, where I have had the chance to witness the importance of bargaining in the policy-making process by participating in it. However, the same experience made me understand the importance of trust among member states during the negotiations – that is, both credibility during bargaining but also the assurance that states will adhere to the agreed-upon rules. In the context of the SGP, the argument is that a lack of trust among member states can lead to stricter rules to prevent free-riding or instability caused by perceived untrustworthy states. This was evident in the second reform following the financial crisis. Alternatively, mistrust can result in complex compromises that make rules more intricate, as seen in the 2024 reform.

As regard to the research methodology, the choice has been to present a case study, that is the Stability and Growth Pact, and chronologically analyse its evolution over time. This chronological approach will help understand whether and how the extent of mistrust among member states has influenced the Stability and Growth Pact over time. Therefore, the Pact will be analysed from its introduction through its reforms in 2005, 2011-2013, and 2024. This method will help identify shifts in trust dynamics and their impact on the SGP's rules and implementation. To substantiate the presence of mistrust, the dissertation will deploy primary sources, such as parliamentary or other hearings, speeches, policy reports, press conference transcripts and so on. These sources will provide direct evidence of the sentiments and positions of member states during key negotiations. Moreover, regarding the latest reform, national experts and a policy officer who negotiated themselves the revised Pact will be personally interviewed. Their perspectives will be integrated into the dissertation, adding depth and firsthand accounts to the analysis.

CHAPTER II

LACK OF TRUST AS A REASON FOR MORE STRINGENT RULES

As affirmed in the previous chapter, a lack of trust among member states can lead to stricter rules to prevent free-riding or instability caused by perceived untrustworthy states. This has been the case for the Stability and Growth Pact on two main occasions: its introduction in 1997 and its reform following the financial crisis, which will be analysed in chronological order in this chapter.

1. Introduction of the Stability and Growth Pact in 1997

The Stability and Growth Pact was first introduced in 1997 with two Council Regulations: one on the strengthening of the surveillance and coordination of budgetary positions (Council of the European Union, 1997a) and the other on speeding up and clarifying the implementation of the excessive deficit procedure (Council of the European Union, 1997b). Its introduction was deemed necessary, particularly after the decision to establish a common currency among member states. In fact, with the establishment of the EMU, monetary policy became fully centralised while fiscal policy remained at the national level (Regling, 2022: 8). Thus, coordinating fiscal policies was essential to ensure sound government finances, which were crucial for maintaining debt sustainability and bolstering the confidence of both citizens and financial markets in the euro (ibid). Although some thresholds, such as the deficit-to-GDP ratio of 3% and the debt-to-GDP ratio of 60%, were already in place, in fact, they needed to be operationalised for effective fiscal coordination (ibid). This is why the Stability and Growth Pact was initially established.

Delving deeper into the content of the Pact, the new rules enhanced surveillance, by requiring member states to submit yearly their stability programmes. The latter had to include, among other elements, the medium-term objective (MTO) and the adjustment path towards this objective, key assumptions about expected economic developments and economic indicators, as well as the economic measures being taken (Council of the European Union, 1997a: art.3 para.2). These plans were to be assessed by the Commission and the Council, especially to assure that the MTO provided a safety margin to prevent excessive deficits, that the economic assumptions on which the programme were based were realistic and that the measures being taken and/or proposed were sufficient to achieve the targeted adjustment path (ivi: art.5). The goal of maintaining a budget close to balance or in surplus was to ensure sustainable fiscal positions in case of unforeseen shifts, making countries more resistant to economic shocks. In case of significant divergences, the Council could send a recommendation to the Member State and request the implementation of corrective measures (ivi: art.6). This constitutes the so-called "preventive arm" of the Pact.

When an excessive deficit exists, the "corrective arm" comes into play. In fact, the Council sets a four-month deadline for the Member States to take effective action and mandates the correction of the excessive deficit within a year. Additionally, the SGP introduced an escape clause ("exceptional circumstances") that allowed larger deficits in the event of severe downturns. If a country fails to comply, the Council can impose sanctions in the form of a non-interest-bearing deposit, consisting of a fixed component of 0.2% of GDP and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP, without exceeding 0.5% of the Member State's GDP. This deposit will convert into a fine if the excessive deficit is not corrected after two years. These procedures will not be activated in case of exceptional circumstances, such as cases in which a country experiences an annual fall in real GDP of at least 2%. In exceptional cases and with supporting evidence the threshold could decrease to 0. 75%.

1.1 Lack of trust as the main driver

The introduction of the Pact itself highlights how the lack of trust was inherent in the project from its very beginning. In fact, the idea that fiscal rules were necessary was not unanimous among all 15 member states, but was rather primarily pushed for by Germany. In fact, Germany believed that the Maastricht criteria alone were insufficient to ensure long-term convergence and stability within the Euro area (Docquiert, 1998). Specifically, these criteria needed to be upheld over time, rather than merely serving as entry-level requirements (Marchat, 2002). Therefore, to reassure Germany, especially on the enforcement of sanctions against countries with excessive debt and/or deficit (Docquiert, 1998; Dinan et al, 2017: 61), the rules outlined in articles 99 to 104 of the Maastricht Treaty were solidified and made permanent, ultimately converging in the Stability and Growth Pact (Marchat, 2002).

This necessity becomes even more evident when analysing the negotiations leading to the Pact's introduction, which was approved at the European Council of Amsterdam in 1997. In fact, even if the issue was discussed at the Madrid European Council in December 1995, in Florence in June 1996 and in Dublin in December 1996, the initiative for common fiscal rules originated from Germany itself (ibid). It all began with a memorandum written by the German Finance Minister Theo Waigel (1995). This memorandum essentially already contained all the rules that would later constitute the Stability and Growth Pact. In fact, Waigel asserted that all the euro-area member states should be "committed to stability from the beginning" and subject to "a strict budgetary discipline" (Waigel, 1995: 2). To achieve this, the criteria to ensure stability needed to be "precisely stated and operationally defined" (ibid). The main features of the proposed Stability Pact included spending discipline and steadiness of the public sector; public-sector control regarding financial markets; reducing the ratio of public sector expenditures, deficits, tax and cost burdens to enhance growth and stability; prioritising government spending for public investments to safeguard Europe's economic future (ibid). These features were introduced by the German minister precisely to ensure that the other participating countries would act conforming to the rules established by Germany and, in particular, to the Maastricht thresholds of 3% and 60%. Moreover, it was in this German memorandum that the idea of sanctions for non-compliance was first proposed. More specifically, Waigel suggested that "if a participant exceeds the deficit limit", it "should make a non-interest-bearing deposit ("stability deposit")" of "0.25% of its GDP for each full or partial percentage point by which the deficit limit is exceeded" (ibid). This stability deposit would be refunded once the member state no longer exceeds the threshold. However, if this did not occur within two years, the stability deposit would become a fine. Additionally, the memorandum allowed for the possibility of introducing further sanctions (ibid).

Following this memorandum, negotiations on fiscal rules began. The proposal was informally discussed both bilaterally and in Ecofin councils for months before being officially tabled at the Madrid European Council in December 1995 (Heipertz & Verdun, 2004: 988). German negotiators aimed to establish numerical parameters, automatic financial sanctions and a short timeframe for the application of the excessive deficit procedure, ultimately seeking to reduce the scope for political discretion within the system (Heipertz & Verdun, 2004: 988).

However, not all countries and institutions agreed with the proposal. For instance, Yves-Thibault de Silguy, European Commissioner for Economic and Financial Affairs, had already affirmed that the Maastricht criteria *per se* were sufficient to ensure sound fiscal management (Docquiert,1998).

The reason why Germany was so insistent on avoiding political discretion was the fear that it could be used by other member states to evade the ECB's anti-inflation policy by cutting taxes and increasing spending. At the Madrid European Council (1995), Germany reiterated its intention to make the euro as strong as the German mark ("wie stark als die Mark"), with the aim of reducing potential risks arising from a lack of strictness in fiscal rules, especially by the so-called "Med Group countries" (Marchat, 2002: 2). This group, although informally established in 2013 by the Foreign Ministers of Cyprus and Spain, included Mediterranean and Southern European Union member states sharing similar economic, social and cultural characteristics. It currently includes 9 member states (Croatia, Cyprus, France, Greece, Italy, Malta, Portugal, Slovenia and Spain), but at the time of the negotiations of the Stability and Growth Pact, it referred to France, Greece, Italy, Portugal and Spain (ibid). This attitude persisted throughout the entire negotiation process, both in bilateral talks and in Ecofin councils, with Germany consistently advocating for stricter rules and other member states wanting either looser definitions or more room for political discretion (Heipertz & Verdun, 2004: 990).

In the end, after months of negotiations and an attitude that some even described as "uncompromising" (Jamet, 2011: para. 1.2), Germany succeeded in several key areas (Heipertz & Verdun, 2004: 991). It achieved the strengthening of the provisions on budgetary deficits foreseen in the Maastricht Treaty, increased the likelihood of sanctions, shortened the timeline to their application and secured a numerical definition of a recession (ibid). The only concessions Germany made were allowing for more political discretion and incorporating the "growth" element (ibid). In fact, the word "growth" was added to the original "Stability pact" proposed by Waigel, especially under the request of French President Chirac (Docquiert, 1998). This ensured that strict fiscal rules would not come at the expense of economic growth (Langenus, 2005: 68).

Overall, this analysis demonstrates how the Stability and Growth Pact was crafted primarily to address German political concerns (Zsolt de Sousa, 2004: 6). In fact, Germany had been reluctant to join a monetary union with other eleven member states that involved also less fiscally credible countries, such as Portugal and Spain (ivi: 5). Additionally, it feared that Mediterranean countries, given their monetary policy, might behave as free riders, generating negative externalities throughout the eurozone. Indeed, a resolution by the German Parliament in 1992 already expressed Germany's intention to resist any attempts to weaken the Maastricht criteria (Deutscher Bundestag, 1992: 2). Thus, the Pact served as a reassurance that all eleven member states would have adhere to the same fiscal discipline regime (ibid), despite the European Economic and Social Committee's opinion that these parameters were mathematical and did not allow for flexibility in interpretation, suggesting that they would need to be revised periodically, especially since some countries were already close to breaching them (EESC, 1997: para.4).

2. **The reform in 2011**

Lack of trust was the main driver not only for the introduction of the Stability and Growth Pact, but also for its strengthening through the 2011 reforms. In fact, following the Eurozone crisis, Germany saw happening what it feared the most: fiscal profligacy carried on by peripheral countries triggered a crisis that nearly led to the collapse of the European Monetary Union (De Grawe, 2010: 2). Therefore, this further eroded trust among member states, especially from the frugal ones towards the peripheral southern ones, and for this reason, stricter rules were eventually introduced. The analysis will begin by examining the pre-crisis context to understand the differing economic situations of member states. It will then explore the crisis itself and the new rules that were introduced in response. The final part of this chapter will focus on the negotiations that led to these new rules, using the adopted theoretical framework to assess to extent to which trust influenced these negotiations.

2.1 Context pre-crisis

Before the Eurozone crisis, substantial divergences in current account positions among Euro member states became evident (European Commission, 2010a: 8; Stockhammer, 2020: 238). More specifically, the Eurozone periphery (mainly Spain, Greece, Portugal and Italy) began to post large and persistent current account deficits[1], while the Eurozone core (chiefly Germany) was registering surpluses (Baldwin et al, 2015: 4) (see Figure 1).

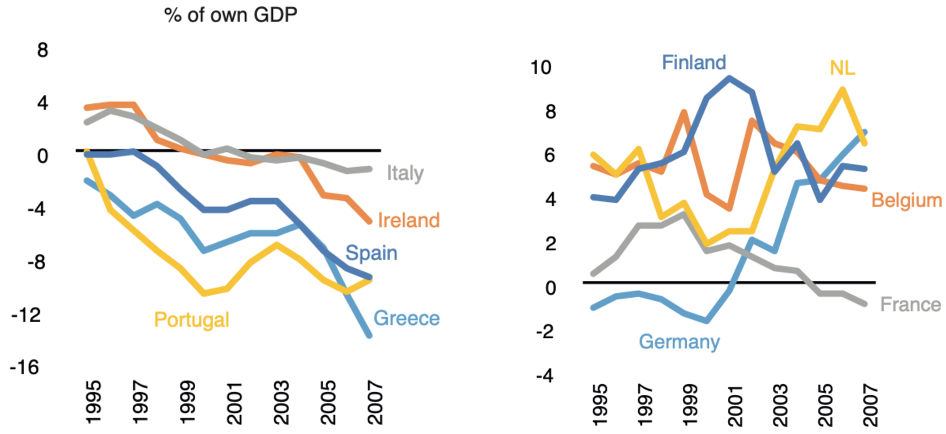

Figure 1. Current account deficits and surplus in the Eurozone (1995-2007). Source: Baldwin et al, 2005.

According to Wyplosz (2013), these trade deficits in the periphery were caused by demand booms, which induced fiscal deficits. Therefore, the primary cause of these external imbalances was the fiscal indiscipline carried on by peripheral member states. For instance, Greece, which was by far the country most severely affected by the crisis, increased its debt from 88% in 1999 to 103% on 2007. This was largely because after the launch of the euro and the deregulation of capital markets, peripheral countries gained access to funding at the same interest rate and under similar conditions as Germany and other core countries (Febrero et al, 2019: 1128). In GIPS countries (Greece, Ireland, Portugal and Spain), this was a very expansive monetary policy that led to strong domestic spending (ibid). For instance, Krugman (2012) analysed the case of Greece, noting that after the establishment of the EMU, Greece started to be considered as a safe country to invest in. This perception led to a significant increase in foreign investments, which led to an economic explosion and rising inflation, while Greece became less and less competitive (ibid). This was coupled with the fact that Greece and the other GIIPS countries, tended to save less and invest more than the average, whereas core Eurozone nations (such as Germany, the Netherland, Belgium and France) tended to save more and invest less (Baldwin et al, 2015: 5). Moreover, in the case of Greece, corruption and fiscal

[1] A nation's current account deficit reflects its net borrowing from abroad. A negative current account indicates net borrowing from foreigners, while a positive current account indicates net lending to foreigners. (Badlwin et al, 1995: 4).

evasion were also major issues (Krugman, 2012). Consequently, when the bubble burst, the crisis began.

Overall, a debt-led consumption pattern was observed in the periphery (Greece, Ireland and Spain), leading to strong GDP growth and rising labour costs due to economic overheating, (Febrero et al, 2019: 1128). These two factors contributed to growing current account deficits whose accumulation led, in turn, to large net international debtor positions (ibid). Increasing asset prices reinforced this vicious circle, especially in the housing market in Ireland and Spain (ibid). Moreover, borrowing often funded non-productive spending (ibid), a situation not mirrored in core countries.

2.2 The crisis

It was under these conditions that the Eurozone was hit by the financial crisis. In fact, the crisis began with the collapse of the subprime mortgage markets in the United States in 2007 and was exacerbated by the Lehman Brothers bankruptcy in 2008. Through the interconnectedness of financial markets, it quickly reached Europe (Hein, 2014: 326). The immediate consequence was a sudden halt in in-cross border lending, causing markets to fear the viability of banks and governments in the countries mentioned above (namely Greece, Ireland, Italy, Portugal and Spain), which were heavily dependent on foreign lending (ibid). This stop in capital flows resulted in decreased growth rate, exacerbating deficits and escalating public debt ratios (ibid). Moreover, governments in these countries often assumed some of their banks' debt, further compounding national debt ratios (ibid).

Greece's case is peculiar, since in 2009 the Greek government, led by George Papandreou, announced that previous governments had masked the size of the budget deficit (Barber, 2010). This revelation led rating agencies to downgrade Greece's rating (FitchRatings, 2009), causing a spike in its risk premium (since investors at that point were not sure that Greece would be able to pay back its debt) and in its spread, which returned to pre-EMU level (Arghyrou & Kontonikas, 2011: 14). Trust further eroded when the European Commission released a forecast at the beginning of 2009 expecting the GDP to contract by 4% in the Euro area in the same year (European Commission, 2009: 1). This triggered a vitious circle where lenders demanded ever-higher interest rates from countries which already had a high level of public debt, making it even more difficult for these countries to repay it. This is why five countries (Greece, Ireland, Portugal, Spain and Cyprus) eventually required sovereign bail out[2] programs to avoid defaulting on their debt (Estella, 2018: 198).

On whether to bail out these countries there was a significant debate among Member States. In fact, according to art.125 of the TFUE, "the Union shall not be liable for o assume the commitments of central governments […] of any Member State". This means that bailouts are forbidden at EU level. This provision aimed to prevent moral hazard: in fact, if countries expected their risks to be ultimately covered by others, they might engage in fiscal profligacy, that is excessive debt and excessive risk-taking (Estella, 2018: 199). Thus, when the Eurozone crisis began, richer countries – such as Germany, the Netherlands and Finland - did not want to bail out the GIIPS, viewing the crisis as a result of the latter's fiscal profligacy (Krugman, 2012; Degner & Leuffen, 2019: 95). Therefore, they insisted on strict austerity measures for GIIPS, to overcome the crisis without overly burdening the rest of the Union (ibid). Indeed, initially the so-called "chain theory" prevailed, suggesting that the Eurozone, viewed as a chain of small circles, could be strengthened by abandoning its weakest circles (starting with Greece). Soon, however, this idea proved problematic: in fact, it had strong political and economic consequences, such as signalling to investors the idea that the euro was a project that could eventually collapse. Consequently, the "domino-theory" gained traction, positing that changes in one country will rapidly affect all the others, through a contagion effect (Eisenhower, 1954). In the economic field, this means that the investors may start wondering which country would be the next to exit the Euro area and start attacking it (see, for instance, Johnson's article (2010) on Portugal; the Financial Times (2010) on the UK; The Guardian (2010) on Spain; the Irish Examiner (2010) on Ireland; the Business Insider (2010) on France). This is why it was ultimately decided to intervene.

Since there were no instruments at the time at European level, the solution was found at international level, with the involvement of the International Monetary Fund (IMF). In fact, the Eurozone and the IMF initially agreed on bilateral loans and later on a bailout package to rescue Greece (Eurogroup, 2010). These packages were also extended to Ireland (Council of the European Union, 2010), Portugal (Council of the European Union, 2011a), Spain (Council of the European Union, 2012) and Cyprus (Council of the European Union, 2013). In exchange

[2] A bail out is a financial assistance intervention program coming from an actor alien to the borrower State (Estella, 2018: 198).

for these financial aids, these countries had to sign the so-called Memoranda of Understanding, which required the implementation of fiscal consolidation and strict reforms (e.g. labour market reforms, tax system reforms, etc.). Whereas the other States' economic conditions started to improve after these bailouts (and in particular, Spain was referred to as a success case), this was not the case for Greece. In fact, Greece required two additional bailout programmes (European Commission, 2012; European Council, 2015). These were coupled with a debt-restructuring and political instability.

However, the crisis was not only an economic one, but also a crisis of lack of trust among member states, which fuelled the economic crisis itself. This was exemplified by the declarations of the former German finance minister Wolfgang Schäuble, who, during a Euro summit, proposed a temporary Grexit, saying that "if Athens does not comply with creditors' demands, the country could be encouraged to take a time out from the euro zone for at least five years" (Spiegel, 2015). This mistrust towards Greece was also shared by other countries, and not only frugal ones: for instance, Lithuania and Latvia were sceptical about providing more financial aid to Greece (Il Post, 2015). Latvia's former finance minister, Reirs, stated that "Latvians do not understand Greeks", whereas Mazuronis, former leader of Lithuania's Labour Party, insisted that "not even a single cent will be given to Greece before some reforms will be approved for real" (ibid). In fact, they argued that if they applied austerity measures, then Greece could also do it (ibid). This pervasive mistrust hindered crisis resolution, signalling to financial markets that the Eurozone was not a safe and stabile investment area. This is also proved by the fact that borrowing costs returned to pre-crisis level only following the "whatever it takes" speech given by the former ECB president Mario Draghi (see Figure 2) (Baldwin et al, 2015).

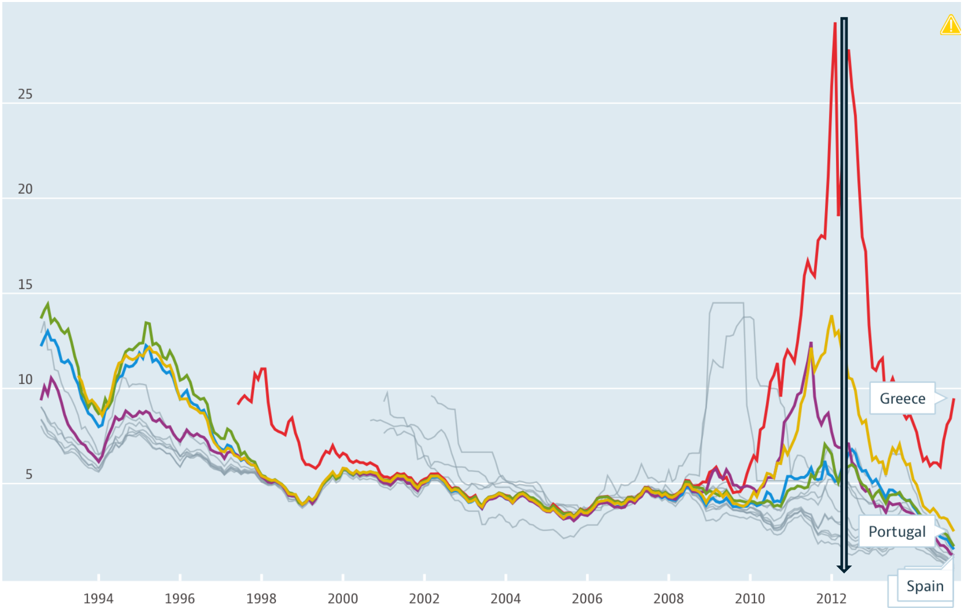

Figure 2. 10-year government bond yields (%) before and after Draghi speech. Source: OECD with author's own elaboration.

In fact, in his speech, Draghi affirmed that the ECB would do "whatever it takes to preserve the euro" and that that would have been enough. This commitment alone played a crucial role in stabilizing the markets by reassuring investors and thereby reducing borrowing costs. This demonstrates once again how trust was a critical factor during the crisis, its management and its resolution.

2.3 The new rules

What became clear after the crisis is that the Stability and Growth Pact had failed to prevent Member States from mismanaging their budgets. As former German finance minister Schäuble (2011) stated "it is an indisputable fact that excessive state spending has led to unsustainable levels of debt and deficits now threaten our economic welfare". This realization prompted the adoption of a new economic governance framework, aimed at enhancing budgetary discipline among member states and broadening the surveillance of their economic policies (Council of the European Union, 2011b). In particular, in 2011 the Six Pack was introduced, comprising five Regulations and one Directive (European Commission, 2011). Three of these Regulations regarded the Stability and Growth Pact, one Directive addressed the budgetary framework, and two Regulations dealt with the Excessive Imbalance Procedure. This framework was further reinforced in 2013 with the "Two Pack", which strengthened the legal basis of the European Semester. Moreover, it enabled the European Commission to gain a clearer view of how Eurozone countries were working to meet the fiscal targets set by the Stability and Growth Pact and establishes clearer procedures for dealing with countries in severe economic difficulties or receiving EU bailouts (European Parliament, 2013).

Regarding the Stability and Growth Pact, both the preventive and the corrective arms were reformed. For the former, a new regulation (Regulation (EU) No. 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies) was introduced. A significant addition was the adoption of the European Semester (section 1-A), which organized the new economic rules into an annual cycle. To this end, member states were required to forward their 'Stability Programmes' (for Euro zone members) and 'Convergence Programmes' (for non-Euro zone members) to the European Commission by mid-April, rather than at the end of the year (Seng & Biesenbender, 2012: 461). These programmes were to include medium-term budgetary strategies, which the Council and Commission would review by mid-July to provide feedback for national budget cycles. Overall, the reformed preventive arm aimed at aligning member states' budgetary and economic policies with the rules agreed at EU level, and particularly at preventing fiscal profligacy, that had been at the basis of the Eurozone crisis, through *ex-ante* guidance.

As for the corrective arm, the Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure was adopted. This reform made it easier to convert sanctions into fines. In fact, a 0.2% of GDP sanction would be imposed as soon as the member state had an excessive deficit, turning into a fine upon Council approval (ibid). Specifically, the European Commission will propose the sanction, which would be considered adopted, unless the Council rejected it by qualified majority within ten days (European Commission, 2010: 6). The size of the non-interest-bearing deposit or the fine could only be reduced or cancelled unanimously by the Council or based on a Commission proposal due to exceptional economic circumstances or following a reasoned request by the Member State concerned (ibid). This change is particularly relevant since before the reform the Council had to approve sanctions by qualified majority, whereas now sanctions are *de facto* already approved and can only be blocked by the latter with the same majority (this is the so-called "reverse qualified majority" voting procedure) (Seng & Biesenbender, 2012: 462). Therefore, this made sanctions more automatic and difficult to block, enhancing their credibility and dissuasive power. Moreover, the reform introduced the “debt reduction rule”, requiring member states with a debt-to-GDP ratio exceeding 60% to reduce it. The novelty of the reform is that a numerical benchmark of 1/20 for this reduction was established, meaning that the gap between a member state’s debt level and the 60% reference must be reduced by 1/20 annually, on average over three years (Council of the European Union, 2011d). Failure to meet this benchmark would result in the country being placed under the excessive deficit procedure, even if its deficit was below 3%. Overall, the reform of the corrective arm aimed at making the enforcement of the rules stricter and more automatic, thereby more dissuasive and credible (European Commission, 2011), to prevent a recurrence of a new wave of fiscal profligacy which could jeopardize the Eurozone.

2.4 Lack of trust in negotiations

As can be seen already from the analysis of the Eurozone crisis, the idea that the Eurozone crisis was caused by the fiscal profligacy of Southern member states was largely spread (Feld et al, 2015) and lack of trust among member states was at its peak. In particular, the prevalent narrative during the crisis was that “hard work, prudent savings, moderate consumption, wage restraint, and fiscal stability (…) were seen as Northern virtues and were juxtaposed to the Southern vices of low competitiveness, meagre savings, undeserved consumption, inflated wages, and fiscal profligacy in the Mediterranean” (Matthijs & McNamara, 2015: 235). This is the so-called “northern saints, southern sinners” narrative (Matthijs & McNamara, 2015), which portrays the former as providing a “sweet life to the latter on credit at the expense of the last solid debtors in Europe” (Frankfurter Allgemeine, 2012). This narrative of mistrust among member states was echoed by political leaders and therefore conditioned the negotiations for the reform of the Pact. Alexander Dobrindt, former secretary general of the Christian Social Union in Bavaria, reflected this narrative by affirming that “prior to any further support for Greece or any other Dolce Vita country, which are characterized by exuberant debt, we need to say: you have to pay your debt yourself” (Die Bild, 2011).

This sentiment set the tone for negotiations for the reform of the Stability and Growth Pact. In fact, richer member States, and especially Germany, now wanted to make up for their concessions on fiscal aid by demanding major reforms of the EU economic governance

(Degner & Leuffen, 2019: 96). In particular, what Germany wished for, in the words of Angela Merkel, then German chancellor, was harsher sanctions for countries violating budget rules (Deutsche Welle, 2010). In fact, according to her, “Greece had shown how vulnerable the EU was to economic mismanagement in a single country” (ibid) and therefore had to “accept its responsibility for the reform” (Matthijs & McNamara, 2015: 236). Thus, she stressed that “Europe could not afford to water down the Stability Pact” (ibid). Moreover, according to the journal Handelsblatt, Merkel, Schäuble and the former economic minister Bruderle also thought about suspending the payment of structural funds to those member States who do not respect their deficit reduction targets, and to suspend for at least one year their voting rights in case of a serious breach of the EMU rules (Le Monde, 2010).

These views converged in the Euro summit which took place on 25th March 2010, where Eurozone leaders underscored the need to strengthen the EU’s fiscal framework to ensure fiscal sustainability and enhance its capacity to act in times of crises (Euro summit, 2010). This had to be done by strengthening “surveillance of economic and budgetary risks and the instruments for their prevention, including the Excessive Deficit Procedure” (ibid). Moreover, “a robust framework for crisis resolution” was needed, but “respecting the principle of member states' own budgetary responsibility” (ibid). This sentence is particularly significant as it means that, after the bailouts, member states wanted to prevent moral hazard. Ultimately, the Euro summit gave the impetus for reform by calling a task force with representatives from member states to work on the new framework (ibid). The role of the Task Force was to prepare for the European Council, by October 2010, a set of recommendations to reform the EU’s economic governance structures (Moloney & Whitaker, 2023: 2). Again, this is a relevant choice: in the area of economic governance, in fact, it is usually the Commission who presents a proposal which is then discussed by the Council and the European Parliament. However, in this case the Commission’s formal role as agenda setter was shared with a Task Force with representatives of the member states, the rotating Presidency, the European Central Bank and presided by the President of the European Council, Van Rompuy (Valle-Flor, 2018: 8). This was a clear signal that member states wanted to have a stronger say in the matter.

Throughout the task force discussions, divisions persisted between northern/eastern and southern countries, with the former advocating for stricter fiscal measures (Moloney & Whitaker, 2023: 16). For instance, among the requests of the former was that of making the financial sanctions automatic (Crespy & Schmidt, 2014: 1093). This was made clear by the joint statement of France and Germany released on 21st July 2010, in which France accepted the German request for tougher sanctions for countries in constant breach of the SGP (Degner & Leuffen, 2019: 97). Moreover, in this letter the two countries asked for the suspension of Council voting rights for countries in breach of the SGP. This idea was reiterated in the Franco-German Deauville Declaration of 18th October 2010 (European Parliament, 2010). Though not all proposals were adopted, scholars found that creditor states' preferences counted more in the negotiations than those with high debt. For instance, Moloney & Whitaker (2023: 16) found that higher current account surpluses in member states were associated with higher levels of bargaining success on issues that mattered most to those member states. Indeed, the final package agreed by the task force, and the Commission proposal later on, proposed a wider range of sanctions, more focus on the debt criterion and sanctions kicking in at an earlier stage (European Council, 2010: 2), which were mainly frugals' wishes.

This is also due to the fact that, as well shown by Morlino & Sottilotta (2019), southern countries were not in a strong negotiating position and had to accept more stringent rules to regain trust from other member states. Their study well explains how the effort to regain trust was central to the entire negotiation of the new economic governance framework, and not just the Stability and Growth Pact. For instance, Greece's commitment to the balanced budget rule was seen as necessary to secure continued financial support and avoid a potential "Grexit" (ivi: 19-20). Similarly, Italy and Spain, sought to recover credibility and also to reassure financial markets through these measures (ibid).

The final agreement on the reforms was reached on 28th September 2011, after a year of negotiations following the Commission's proposal and the approval by the European Parliament and the ECOFIN Council (Council of the European Union, 2011e). In the end, more stringent rules were ultimately approved. This shows how lack of trust and credibility, both towards member states and in the eyes of the market, were crucial in shaping the reforms, by pushing creditor states to ask for reassurance in the form of stricter fiscal rules and debtor member states to accept them to restore trust and stability in the Eurozone.

CHAPTER III

LACK OF TRUST AS A REASON FOR MORE FLEXIBILITY

The previous sections have demonstrated how the lack of trust among member states led to the implementation of more stringent regulations, notably the introduction of the Stability and Growth Pact in 1997 and its subsequent reform in 2011 following the Eurozone crisis. To substantiate this claim, the analysis has primarily focused on the negotiations that culminated in these outcomes, as well as on public statements and interviews with key political figures preceding these developments. This same approach will now be employed to argue that the lack of trust among member states also produced the opposite effect, that is to achieve more flexibility or to reach for a middle way, that is a compromise between flexibility and compromises. The first scenario occurred in 2005, with the initial reform of the Stability and Growth Pact, while the latter scenario unfolded in 2024 with the most recent reform. This chapter is therefore particularly relevant to demonstrate that the lack of trust has consistently been a significant factor at every stage of the Stability and Growth Pact, shaping EU macroeconomic surveillance as one of the primary influences.

1. Economic context pre-2005 reform

Before delving into the explanations of the new rules, the negotiations surrounding the 2005 reform and the role of trust within them, it is necessary to first understand what were the economic conditions prior to the reform, in order to understand why the reform was deemed necessary. Indeed, the Stability and Growth Pact, introduced for the first time in 1997, was intended to be a safeguard against excessive deficits and debts in the Eurozone. However, as shown in Figure 3**,** it became clear that these rules were not fully effective. In fact, between 2000 and 2004, Greece consistently exceeded the allowable deficit and debt levels and Italy, Belgium and Austria always had a higher debt (in the case of Italy, most of the years also a higher deficit). Germany and France, too, ended up breaching the deficit threshold by the end of this period. Overall, in the early 2000s, the Commission initiated EDPs against 13 countries (Auf dem Brinke, 2016: 2). Portugal was the first country to exceed the 3% deficit reference value in 2001, followed by Germany and France in 2002, the Netherlands and Greece in 2003, and Italy in 2004 (González-Páramo, 2005).

Table 1: Growth in real GDP, government deficit as a percentage of GDP, and public debt as a percentage of GDP 2000 – 2004 selected countries.

	2000			2001			2002			2003			2004		
Greece	4.5	-3.7	103.4	4.2	-4.5	103.7	3.4	-4.8	101.7	5.9	-5.6	97.4	4.6	-7.5*	98.6
Portugal	3.9	-2.9	50.5	2	-4.3	52.9	0.7	-2.8	55.6	-0.9	-2.9*	56.9	1.6	-3.4	58.3
Spain	5	-1	59.3	3.6	-0.6	55.5	2.7	-0.5	52.5	3.1	-0.2	48.7	3.3	-0.3	46.2
Ireland	9.4	4.8	37.8	5.7	0.9	35.6	6.5	-0.3	32.2	4.1	0.4	31	4.6	1.4	29.7
Italy	3.7	-0.8	109.2	1.8	-3.1	108.8	0.5	-2.9	105.7	0	-3.5	104.4	1.5	-3.5	103.8
Germany	3.2	1.3	59.7	1.2	-2.8	58.8	0	-3.7	62.9	-0.2	-4*	64.9	1.2	-3.8*	66.4
France	3.9	-1.5	57.3	1.9	-1.5	56.9	1	-3.1	58.8	1.1	-4.1*	62.9	2.5	-3.6*	64.9
Austria	3.7	-1.7	66.5	0.5	0	67.1	1.6	-0.7	66.5	0.8	-1.4	65.5	2.5	-4.4	64.8
Belgium	3.7	0	107.9	0.8	0.4	106.6	1.4	-0.1	103.5	0.8	-0.1	98.5	3.2	-0.3	94.2
Finland	5.3	6.8	43.8	2.3	5	42.5	1.8	4	41.5	2	2.4	44.5	4.1	2.3	44.4
Luxembourg	8.4	6	6.2	2.5	6.1	6.3	4.1	2.1	6.3	1.5	0.5	6.1	4.4	-1.1	6.3
Netherlands	3.9	2	53.8	1.9	-0.2	50.7	0.1	-2.1	50.5	0.3	-3.1	52	2.2	-1.7*	52.4

Notes: The first column for each year is growth in real GDP, the second government deficit as a percentage of GDP, and the final column is public debt as a percentage of GDP. The * represents that the country was in Excessive Deficit Procedure (EDP) that year. The ˜ represents that the EDP procedure was abrogated that same year. Source: Eurostat.

Figure 3*. Source: Filipek & Schreiber, 2010: para.3.1.*

In particular, the turning point that underscored the need for reform was, surprisingly, the loss of credibility of the Stability and Growth Pact following the failure of the EDP against Germany and France (Zsolt de Sousa, 2004: 11). In fact, on 19th November 2002 the Commission initiated an Excessive Deficit Procedure against Germany by adopting a report, in which it stated that the Commission's autumn forecast showed a general government deficit of 3.8% of GDP and a gross debt of 60.9% of GDP for that year (European Commission, 2002). Shortly thereafter, the Commission also began an EDP against France, as Eurostat's initial deficit and debt data for 2002 revealed a general government deficit of 3.1% of GDP (European Commission, 2003a). According to the procedures, this was followed by the second step, which is the Commission recommendation to the Council to decide that the excessive deficit exists (European Commission, 2003b; 2003c). Indeed, the Council recognized the existence of such excessive deficits in both cases (Council of the European Union, 2003a; 2003b). Subsequently, according to the procedure foreseen in the original Stability and Growth Pact, the Council issued a recommendation both to Germany and France outlining the necessary corrective actions and setting a deadline for deficit correction within the following year (Council of the European Union, 2003c; 2003d). However, a year later, the Commission determined that France had failed to implement the required actions (European Commission, 2003d) and Germany's measures were deemed inadequate (European Commission, 2003e). Consequently, the Commission recommended that the Council proceed with the final steps of the EDP, which would involve issuing further notifications to Germany and France to take corrective measures (European Commission, 2003f; 2003g), or potentially imposing sanctions if they did not comply. What happened, however, is that this process was halted due to the lack of a qualified majority in the Council to support these recommendations. Therefore, instead of advancing the procedure, the Council merely issued political conclusions, in which it stated "the Council agrees to hold the Excessive Deficit Procedure for France (and, with the same phrasing, to Germany, NT) in abeyance for the time being" (Council of the European Union, 2003e). In the minutes of the meeting, it is reported that the Commission affirmed its deep regret as "the Council has not followed the spirit and the rules of the Treaty and the Stability and Growth Pact that were agreed unanimously by all Member States" and emphasized that "only a rule-based system can guarantee that commitments are enforced and that all Member States are treated equally" (ibid).

At this point, the issue of ensuring the correct and equal application of the Stability and Growth Pact had become so critical that the Commission decided to escalate the matter to the European Court of Justice. More specifically, the Commission asked the Court to annul Council's decisions not to adopt the formal instruments outlined in the Commission's recommendations, as well as the political conclusions in which the Council stated that the EDP was in abeyance for the time being (European Court of Justice, 2003). Regarding the first claim, the Court ruled it inadmissible, noting that the Council's decision required a qualified majority and therefore could not be adopted under the given circumstances. However, the Court upheld the second claim, leading to the annulment of the Council's conclusions.

Beyond the technical aspects of this procedure, which have just been recalled, this episode shows the severe credibility crisis that the enforcement of the Stability and Growth Pact faced, leading many critics to declare the latter effectively "dead" (Gonzalez-Paramo, 2005). In fact, the first real test of the SGP's rigor ended in failure, as the states subject to the EDP were able to wield their political influence and collude with other Member States to avoid the imposition of sanctions (Schuknecht et al, 2011: 10). This event clearly undermined the credibility and effectiveness of the SGP as a deterrent. Indeed, an analysis of the economic conditions of other EU countries (European Commission, 2004) following this episode and leading up to the 2005 reform, reveals that six additional countries breached the deficit in 2004 and four were projected to do so in 2005 (Coleman, 2004: 4). This clearly shows that adherence to the Pact started to decline even more after this episode, as countries realized they could evade sanctions or strict measures by colluding with others. Ultimately, the original SGP had proven to be ineffective, unequal and lacking in credibility: this is why the Commission proposed its reform (European Commission, 2005a).

2. **The first reform in 2005**

On 27th June 2005, the regulations amending the original Stability and Growth pact officially came into force. More specifically, regarding the preventive arm of the pact, Council Regulation (EC) No 1055/2005 was adopted, amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. For the corrective arm, instead, it was the Council Regulation (EC) No 1056/2005 which amended the Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure. These reforms collectively made the Pact more flexible (Filipek & Schreiber, 2010).

Regarding the preventive arm, several features were revised, ultimately leading to its strengthening (Council of the European Union, 2005c: 28). One of the most significant changes concerned the medium-term budgetary objective (MTO). Previously, the original Stability and Growth Pact required all member states to maintain an MTO that was "close to balance or in surplus" (Council of the European Union, 1997a: 1). This approach was changed in 2005, "in light of the economic and budgetary heterogeneity in the Union[3]" (Council of the European Union, 2005a: 1). Indeed, the new approach introduced country-specific MTOs, tailored to the unique economic and fiscal conditions of each member state. This meant that the MTO could deviate from being strictly balanced or in surplus, as long as it fell within a range between –1% of GDP and balance or surplus, in cyclically adjusted terms (ibid).

Another new element of the reform is that the achievement of the MTO should also consider other factors: this means that, although the benchmark to be reached is 0.5% of GDP annually, the effort towards fiscal consolidation may vary over time. Specifically, the regulation stipulated that greater adjustment efforts should be made economic good times[4], while efforts

[3] It is also important to remember that this reform took place one year after the biggest enlargement in European history, when the Union went from 15 to 25 Member States. Therefore, more heterogeneity from the economic and budgetary point of view was also a consequence of the enlargement itself.

[4] Economic good times are defined as periods where output exceeds its potential level, taking into account tax elasticities (Council of the European Union, 2005c: 30).

could be more limited during economic bad times. Furthermore, when assessing the adjustment path, the Council needs to consider the implementation of “major structural reforms which have direct long-term cost-saving effects, including by raising potential growth, and therefore a verifiable impact on the long- term sustainability of public finances”, with a special attention to pension reforms (ibid). In fact, Member States implementing such reforms should “be allowed to deviate from the adjustment path”, provided that the safety margin to the 3% deficit reference was maintained and that the deficit returned to the MTO within the program period (ibid).

These changes aimed to address a key criticism of the original Pact, which was that the preventive arm overly prioritized short-term formal compliance with rules, neglecting the underlying economic conditions and the medium- to long-term sustainability of public finances (Filipek & Schreiber, 2010).

Finally, the reform also modified the early warning procedure. In fact, the original Stability and Growth Pact established that early warnings were adopted by the Council, upon Commission’s recommendations. In the revised Pact, however, it is the Commission who issues “early policy advice” (Council of the European Union, 2005d: 30) directly to Member States with excessive deficits.

Whereas the preventive arm was strengthened, the corrective arm was made more flexible and almost “weak”, according to some scholars (European Commission, 2005b: 84). Indeed, two key changes involved the concepts of “severe economic downturn” and “other relevant factors”, which serve as exceptions to the rule that an Excessive Deficit Procedure must be initiated whenever a deficit exceeds 3% of GDP. Essentially, a deficit exceeding this threshold is not automatically considered excessive if it can be demonstrated that the breach is “exceptional and temporary”. Although these exceptions were present in the original Pact, their scope was significantly expanded in the 2005 reform.

In fact, regarding the former, the original Pact considered a “severe economic downturn” only an annual decline in real GDP of at least 2 %. Moreover, Member States could not invoke the severe economic downturn if their growth exceeded – 0.75 % (ibid) (see Chapter 1, para.1). With the 2005 reform, however, the definition was broadened considerably. Indeed, an economic downturn can now be deemed “severe” every time the growth rate is negative or if there is an accumulated loss of output during a protracted period of very low growth relative to potential growth (Council of the European Union, 2005b: art.1.1.2). As for “other relevant factors”, the original Pact did not specifically mention what they were or which role they would play in the EDP. On the contrary, in the 2005 reform these factors are highly detailed, and are namely: (a) developments in the medium-term economic position (i.e. potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster research and development and innovation); (b) developments in the medium-term budgetary position (i.e. fiscal consolidation efforts in "good times", debt sustainability, public investment and the overall quality of public finances); (c) any other factors that the concerned Member State deems relevant for a comprehensive qualitative assessment of the excess over the reference value (e.g. budgetary efforts towards increasing, or maintaining at a high level, financial contributions to fostering international solidarity and to achieving European policy goals) (ivi: art.1.1.3). Other aspects recognized as "other relevant factors" are systemic pension reforms involving a multi-pillar pension system. In fact, the deficit of some member states could be excessive because they have just started implementing these new reforms, which are an investment for the future (ivi: art.1.7).

If any of these factors plays a role and if the excess is both temporary and close to the reference value, then the Commission must take them into account when assessing whether the excess is truly excessive (ibid). In fact, if there's an excessive deficit (>3% of GDP), the Commission will have to prepare a report (something that was not required before), examining whether these exceptions apply (ibid). Moreover, if the Council decides that an excessive deficit exists, these factors must be considered in the subsequent steps of the EDP procedure (ivi: art.1.1.4). For instance, while the original Pact required member states to correct an excessive deficit within one year of the Council's decision, the reform introduced more flexibility by allowing the deadline to be extended if these factors are relevant or if the adjustment within a year would significantly harm the economy (ivi: art.1.2b). In fact, the adjustment required is 0.5 % of GDP as a yearly benchmark (ibid).

Additional flexibility can also be seen in the extended timeline: compared to the original Pact, the Council now has six extra months (a total of 16 months) to decide whether to impose sanctions on a Member State, and the steps of the EDP can be repeated (ivi: art.1.5).

3. **Lack of trust as a driver of the reform**

So far, it has been demonstrated that a lack of trust has significantly contributed to the push for stricter rules. This was evident in 1997, when the Stability and Growth Pact was established to reassure member states that countries would adhere to the Maastricht criteria (see para. 1.2), and again in 2011, when stricter sanctions were introduced to prevent another Eurozone crisis (see para. 2.4). However, lack of trust also played a role in the 2005 reform, which ultimately led to greater flexibility, especially in the corrective arm of the Pact. This influence is evident in two key phases preceding the reform: prior to and during the negotiations.

As for the former, mistrust, especially towards Germany and France, was peaking even before the Commission's proposal for a reform. Indeed, the Pact had been enforced rigorously only against two smaller Member States – Ireland and Portugal – but was not applied when France and Germany were into difficulty (Monti, 2005). This unequal application of the rules fuelled discontent among Member States, as reflected in the minutes of the ECOFIN meeting in Stresa. In fact, during this meeting, the Dutch finance Minister dismissed the idea of "invoking particular circumstances" to avoid SGP compliance as "complete nonsense" (Zsolt de Sousa, 2004: 11). Similarly, the Austrian Finance Minister remarked that "all the possible political creativity" would not be enough to see France as a case to justify the invocation of special circumstances (ibid). As Zsolt de Sousa correctly mentioned (ibid), this undermined France's credibility, especially since other countries, like Portugal, had made significant efforts to comply with the 3% budget deficit rule without receiving any special treatment (ibid). This attitude becomes clear when one analyses the documents and alliances formed at that time. For instance, on 17th February 2004, just a day before a meeting between the leaders of France, Germany and the United Kingdom, the leaders of Italy, Spain, Poland, the Netherlands, Portugal and Estonia signed a joint letter that can be considered as a rebuke to Germany and France (Crawford et al, 2004). Indeed, the latter reaffirmed these countries' commitment to sound budgetary policies and to the Stability and Growth Pact itself, which "must be applied consistently and in a non-discriminatory basis" (ibid). Further evidence of this mistrust is found at the start of the negotiations, when the idea of allowing "exceptional circumstances" under which the deficit threshold could be breached was initially rejected by some Member States, particularly those that had recently joined after the 2004 enlargement. These new members had undertaken painful reforms to meet the budget rules, only to see older member states repeatedly breach them (Deutsche Welle, 2005).

Having established that a lack of trust was indeed prevalent among member states during the time of the 2005 reform, it is now important to examine how this mistrust influenced the reform's outcome. The key argument here is that lack of trust significantly impacted on a crucial aspect of the reform that is often overlooked. In fact, flexibility does not necessarily coincide with more discretion. Member states were keen on having more flexible conditions, but they insisted that these conditions be clearly defined within the new Stability and Growth Pact, leaving no room for interpretation or discretionary judgment. This insistence underscores the persistent lack of trust among Member States, with some seeing discretion as an opportunity for free riding, ultimately leading to non-compliance with the rules. This becomes clear when analysing the minutes of the meetings and the ECOFIN council from that period. Notably, the 3% deficit and 60% GDP thresholds – that proved to be challenging targets even for wealthier countries - were never questioned. Furthermore, although the reform ultimately introduced a country-specific MTO, the idea of abandoning the one-size-fits-all approach was never on the table. This is further illustrated by the study conducted by Blavoukos & Pagoulatos (2008), who, in 2003 and 2004, interviewed 77 key participants involved in the national position formation process during the constitutional debate. The results are reported in Figure 4.

Table 1. Stage 1 – National positions on SGP reform

		Deficit criterion: Make SGP more flexible?	
		Yes	No
Debt criterion: Incorporate debt/GDP ratio into SGP?	Yes	HUN MAL SLN	AUS GER LAT SPA
	No	CYP CZR FIN ITA LIT SLK UK	BEL LUX DEN NET EST POL FRA POR GRE SWE IRE

Source: DOSEI Data Set, Questions 20 and 21.

Figure 4. *Source: Blavoukos & Pagoulatos, 2008.*

The table clearly illustrates that most Member States, and particularly those that strongly supported the original introduction of the Pact itself, such as the Netherlands and Austria, did not want a more flexible Pact, fearing the possibility of free riding by other countries. This stance is particularly evident in the case of Portugal, which had successfully reduced its deficit and did not want to see a more flexible Pact that might allow other Member States to bypass similar efforts (ivi: 256). Other countries opposed to increased flexibility included those with deficits already under control, such as Estonia, Latvia, Spain, Belgium, Ireland and Luxemburg (ibid). On the other hand, countries with high debt ratios (Italy, Greece and Belgium) or those about to undertake extensive reforms (Czech Republic, Poland, Slovakia, Lithuania) were more inclined to support flexibility (ibid). Interestingly, the position of France and Germany is quite peculiar, since, considering their excessive deficits and the fact that they had managed to avoid the EDP, one could think that they would ask for more flexibility (ibid). Instead, they did not advocate for it. This reinforces the dissertation's argument: their primary motivation for supporting the Pact and its subsequent reform was not self-interest, but rather a desire to prevent potential instability that could arise from the actions of other Member States.

As can be seen by the EcoFin Council of September 2004, which set the reform agenda, the discussion immediately started from determining the specific conditions under which exceeding the deficit target could be justified, and which types of expenditures might be exempt from the deficit calculation (ivi: 253). Again, the focus of negotiations was on meticulously detailing all exceptions to prevent any room for discretion. Indeed, the debate focused firstly on what was the exact interpretation of the Pact's reference to "exceptional circumstances" under which countries could run excessive deficits (Parker, 2004). Indeed, Austria and the Netherlands, during the informal Ecofin meeting in Scheveningen on 10 September 2004, voiced concerns that the Commission's proposal could undermine fiscal discipline (ibid). The first list of exceptional circumstances proposed by the EU presidency was indeed rejected (Deutsche Welle, 2005), to the point that Jean-Claude Juncker, then president of the Eurogroup, acknowledged that leaders struggled to agree on its definition, even resorting to weekend meetings to expedite the process (ibid). More specifically, two major issues complicated the negotiations. The fist centred around the reference to "all other relevant factors" (Blavoukos & Pagoulatos, 2008: 253). In fact, some States preferred a concise, exhaustive list of exceptions, fearing that allowing additional expenditures could lead to free-riding and undermine the EDP's effectiveness (ibid). This position was particularly supported by Germany, which also wanted to include in the factors the costs of European unification and contributions to the EU budget (ivi: 256). In this way, Germany would have been allowed to insert the costs of German reunification and its contribution to the EU budget, considering that the country is one of the larger net contributors in the European Union (ibid). This is also what other countries began doing, by adding country-specific expenditures (e.g. France and Greece asked for the possibility to insert military expenditures) (ibid). However, this was exactly what Germany was trying to avoid.

The second contentious issue involved another category of exceptions, that of “major structural reforms”. In fact, there was significant debate over what types of expenditures should be classified under this category, slowing down negotiations (ibid). To avoid discretion and due to the lack of trust among Member States, these expenditures had to be clearly defined and agreed upon (ibid). While the Commission was only accepting pension reforms, Member States started to propose to include other expenditures that would benefit them and potentially allow them to exceed the deficit threshold without triggering an EDP. For example, Germany proposed to insert tax and labour market reforms (Benoit & Parker, 2005), France suggested including research & development spending, Italy advocated for tax reforms to reduce the fiscal burden and Greece and Ireland pushed for public investment expenditures, given their respective needs for Olympic preparations and future investment plans (ibid). This approach was seen by the more fiscally conservative Member States as evidence that others were viewing the Pact's reform as an opportunity to free ride (ivi: 261). Indeed, the Deutsche Bundesbank (2005: 20) expressed concern that this could reduce pressure on deficit countries to make necessary adjustments and weaken their commitment to sound fiscal policies. In particular, it noted that government investment and structural reforms are difficult to define, categorise and assess in terms of their impact, leading to a significant risk of manipulations (ivi: 21). This underscores that the lack of trust among Member States persisted even after the reform.

CHAPTER IV

LACK OF TRUST AS A REASON FOR A HYBRID RESULT

So far, it has been demonstrated how the lack of trust among Member States has influenced both the introduction and subsequent reforms of the Stability and Growth Pact, leading to the adoption of either more stringent rules (see Chapter II) or more flexible ones (see Chapter III, para. 1). However, the 2024 reform does not fit neatly into either of these categories. Instead, it appears to be a hybrid, incorporating elements of increased flexibility—such as a reduced required debt reduction for countries exceeding the debt threshold—alongside more stringent measures, like the introduction of safeguards and the strengthening of the Excessive Deficit Procedure (EDP) in cases of excessive debt. This blend of approaches has led many to describe the reform as a compromise (Galbiati, 2024). This characterization is not limited to journalists and scholars but is also echoed by those who were directly involved in crafting the reform. Several Member State delegates have referred to it as a "compromise," with one policy officer even stating that "the compromise seems to be successful since all Member States are somewhat dissatisfied with the content of the reform". This makes the 2024 reform particularly intriguing for the purposes of this study, which aims to assess the extent to which trust influences negotiations at the EU level, using the Stability and Growth Pact as a case study. In fact, this is a scenario that has not yet been considered – a mixture between flexibility and more stringent rules. Could this hybrid outcome also be a result of the lack of trust among Member States during the negotiations? This is the question that the final chapter of the dissertation seeks to answer. Compared to the previous chapters, Chapter IV will not only rely on primary sources but will also incorporate interviews with Member State delegates and policy officers who were directly involved in negotiating the Pact. This was made possible through my internship at the Permanent Representation of Italy to the European Union, where I worked in the Economic and Financial Office and had the opportunity to interact with the delegates and attend their working groups[5].

1. Context pre-2024 reform

[5] For the complete list of interviewees, see Annex 1.

The impetus for the 2024 reform arose from a series of unprecedented events, and most notably the Covid-19 pandemic - a symmetrical shock that severely impacted Europe in 2020-2021 - and the Russian invasion of Ukraine, with the consequent need of a rapid reduction in dependence on Russian resources (Steinberg & Feas, 2024). Both crises had profound economic repercussions across EU countries, creating a need for greater flexibility in managing the fallout. For this reason, the general escape clause foreseen by the Six Pack was activated for the first time on 20th March 2020, allowing for temporary deviations from standard fiscal rules for EU Member States (Council of the European Union, 2020). The deactivation of this clause was originally planned for the end of 2022, but then it was extended by another year due to the ongoing conflict in Ukraine (Banque de France, 2023: 3). However, the European Commission had already indicated that the general escape clause would definitely end by the close of 2023 (European Commission, 2022). During this period, concerns grew among Member States about their ability to meet the fiscal consolidation requirements once the clause was lifted, particularly given the high and persistent levels of public debt (Jones, 2021: 7) (see **Figure 5**). Moreover, the expectation that Member States would reduce their public debt by an average of 1/20th annually became increasingly unrealistic (ivi: 8). These concerns were compounded by widespread criticism from economists and scholars, who argued that the Stability and Growth Pact was overly complex, pro-cyclical, insufficiently transparent, and imposed undue constraints on public investment (Bini Smaghi, 2022: 1).

Public debt in selected euro area Member States

Percent GDP	2019	2020	2021	2022
Austria	70.5	84.2	85.2	85.1
Germany	59.6	71.2	70.1	69.0
Netherlands	48.7	60.0	63.5	65.9
Euro area	***85.9***	***101.7***	***102.3***	***102.6***
Belgium	98.1	117.7	117.8	118.6
France	98.1	115.9	117.8	119.4
Italy	134.7	159.6	159.5	159.1
Spain	95.5	120.3	122.0	123.9
Portugal	117.2	135.1	130.3	127.2
Greece	180.5	207.1	200.7	194.8

Source: Annual Macroeconomic Database of the European Commission (AMECO), *updated 5 November 2020.*

***Figure 5**. Source: Jones, 2021: 8.*

For all of these reasons, the debate on the necessity of reforming the fiscal rules - rather than simply reverting to the pre-existing framework once the general escape clause was deactivated - gained momentum. In June 2022, EU Economic Commissioner Gentiloni announced that the Commission's proposal for a reform of the Stability and Growth Pact would be presented after the summer (Landini, 2022). Indeed, the reform process was finally launched in autumn 2021, with the goal of having new rules in place for the 2023 fiscal year and fully implemented by early 2024 (Banque de France, 2023: 3). Despite some delays, this timeline was ultimately achieved.

2. The new rules

The most recent reform of the Stability and Growth Pact was enacted on 29th April, with the introduction of two key regulations: Regulation (EU) 2024/1263 of the European Parliament and of the Council on the effective coordination of economic policies and on multilateral budgetary surveillance (for the preventive arm) and Council Regulation (EU) 2024/1264 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (for the corrective arm).

Regarding the preventive arm, the main change has been the indicator on which fiscal surveillance is based, which is not anymore how the structural budget balance performs but the annual percentage change of the “nationally financed net primary expenditure” of each Member State, assessing whether it aligns with the agreed-upon, country-specific multi-year net expenditure path (European Commission, 2024). Net expenditure is defined as government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by revenue from Union funds, national expenditure on co-financing of programmes funded by the Union and cyclical elements of unemployment benefit expenditure. This marks the abandonment of the concept of the Medium-Term Objective (MTO).
As for the other elements of the preventive arm, the European Semester has been maintained, with the only difference that Stability and Convergence programmes have been replaced by national medium-term fiscal-structural plans (Council of the European Union, 2024b). Among the other economic indicators, the plan also needs to contain how the Member State will deliver reforms and investments related to EU common priorities, such as fair, green and digital transition, social and economic resilience, energy securities and defence capabilities. This

approach mirrors the logic behind the Recovery and Resilience Facility, indicating a shift in the EU's fiscal framework (Bevilacqua, 2024). The plan will be assessed by the Commission, negotiating the adjustment paths with Member States to reflect their economic conditions. The plans also need to be later endorsed by the Council, which has also the power of rejecting them and ask the Member States to resubmit them (ibid).

If a Member State exceeds either the 3% or the 60% thresholds, the Commission will issue a reference trajectory for the net expenditure (ibid). The adjustment period will have a length of four years and can be extended up to three years (ibid). The extension will be granted if the Member States commits to a relevant set of reforms and investments which must respect certain conditions, among which addressing the common priorities of the Union (ibid). Nevertheless, during the adjustment period (whether 4 or 7 years), the debt-to-GDP ratio has to decrease by a minimum annual average of 1% of GDP, if ratio exceeds 90%, or 0.5% if it is between 60% and 90% (debt sustainability safeguard) (ibid). This is a particularly significant change, since the reduction foreseen before the reform was 1/20 per year. Additionally, a deficit resilience safeguard was also introduced, requiring that government deficits, even after falling below 3% of GDP, should further converge towards a "common resilience margin" of 1.5% of GDP relative to the 3% reference value (ibid). To achieve this, the required annual improvement in the structural primary balance is set at 0.4% of GDP, potentially reduced to 0.25% if the adjustment period is extended (ibid). On the contrary, for Member State that remain within the thresholds, the Commission will only provide, upon request of the former, technical support to ensure that the Member States maintain their fiscal position (ibid). In the event of a severe economic downturn in the euro area or in the Union and/or at national level, in case of exceptional circumstances out of the Member States' control, the rules may be suspended (general escape clause and national escape clause).

Each year, following the approval of the plan, Member States will have to submit to the Commission an annual progress report, detailing their adherence to the net expenditure path and progress on reforms and investments (ibid).

The reform also enhances the role of independent fiscal institutions. Notably, the European Fiscal Board is granted an advisory role in guiding the Commission and Council's functions throughout the process.

Regarding the corrective arm, the process for initiating an EDP for excessive deficit remains largely unchanged from the 2011 reform. In the event of an EDP, the corrective net expenditure path must adhere to a minimum annual structural adjustment of at least 0.5% of

GDP as a benchmark (ibid). However, the EDP for excessive public debt breaches has been strengthened. In fact, when the debt exceeds 60% of GDP and the balance of control accounts surpasses either 0.3% of GDP annually or 0.6% of GDP cumulatively, the Commission will be required to prepare a report. In its report, the Commission should consider factors such as financial contributions for international solidarity and for achieving the common priorities of the Union (ibid). Additionally, unfavourable economic, budgetary and financial developments may also be considered as mitigating factors (ibid). The maximum duration of an EDP has also been extended to seven years, allowing for a slower adjustment path if needed by some Member States (ibid). The penalty system has also been revised: whereas previously fines could reach up to 0.2% of GDP (see para. 2.3.), now they have been reduced to a maximum of 0.05% of GDP. These fines must be paid every six months until the Member State concerned takes effective action, meaning compliance with the net expenditure path (ibid).

3. Lack of trust as the main cause of the compromise

After presenting the new rules and the rationale behind their introduction, it is now time to analyse the role that trust played in shaping the negotiations. The first step is emphasizing that the initial orientation and proposal from the European Commission differed significantly from the final reform (European Commission, 2022b; 2023a; 2023b). This is not unusual, as proposals and orientations are usually the first step of a long negotiation process involving various stakeholders with different interests. However, in this case it is particularly interesting to analyse which elements have been changed and why that is the case. The Commission's initial orientation included a higher degree of discretion, which was notably curtailed during the negotiation process. This shift underscores a recurring theme that has been emphasized during the whole dissertation, that is that Member States tend to favour reducing discretionary in favour of uniform parameters due to a lack of mutual trust. Indeed, the Commission's attempt to transition from a rules-based to a risk-based fiscal framework was met with strong resistance, particularly from countries like Germany, which has a long-standing preference for numerical fiscal rules (Eisl, 2023: 1). Indeed, these countries viewed the initial orientation as "very vague" and as "giving more fiscal leeway to Member States" (ivi: 6). For instance, the Commission's orientation only required debt trajectories to be on a plausibly downward path or remain at prudent levels, without specifying a parameter for the annual-debt reduction – that is, how fast the debt should decrease (European Commission, 2022b). Additionally, the orientation emphasized Member States' ownership and giving the latter more margin of manoeuvre (Gentiloni, 2023). However, this approach was met with significant opposition, especially by frugal countries (mostly, Germany, the Netherlands, Denmark, Austria and Finland), which consistently pushed throughout the negotiations to restrict the extent of country-specific differentiation in fiscal adjustment paths and reintroduce common safeguards (Eisl, 2023: 2). These concerns were so pronounced that even before the Commission presented its formal proposal, Germany submitted a non-paper – i.e. an unofficial paper outlining the government's opinion – urging the Commission to revise its plans and include a minimum debt reduction requirement ("common safeguard") of 1% of GDP per year for highly indebted countries, like Italy, and 0.5% for medium-indebted countries, like Austria (Bruegel, 2023; Packroff, 2023). Indeed, the Commission incorporated some of these requests into its legislative proposal, especially by adding numerical minimum requirements, such as the 0.5% annual deficit reduction (Eisl, 2023: 2). This process demonstrates that the lack of trust among Member States was not only present but was a critical factor in the negotiations, to the point where the Commission had to amend its proposals to include more rigid, uniform parameters to gain acceptance from the Member States. Indeed, as reported by a Commission source, "the central issue in the review of the fiscal rules is the level of trust between member states" (Carretta, 2021).

The relevance of mistrust continued also during the rest of the negotiations which were often described in the media as "exhausting negotiations between frugal and non-frugal countries" (Sky Tg24, 2024). Indeed, Member States were clearly divided between these two groups, with the former asking for rigorous and uniform parameters for all Member States, without making too many concessions and containing the economic risks of an excessive debt, and the latter asking for greater flexibility (Il Post, 2023a). The frugal bloc also expressed concerns that the Commission's proposal was too accommodating toward Southern countries, which typically have the highest debt levels (ibid). Germany, in particular, expected the reform to compel EU member states to reduce their debt levels to create financial buffers for future crises, thereby avoiding the need for additional "recovery funds" financed through common bonds (Płóciennik, 2023). Regarding the deficit threshold, they also asked for a change in the interpretation, stating that 3% deficit-to-GDP should not be seen as a target, but rather as an upper limit (Tamma, 2023a). This is why the former German Finance Minister, Lindner advanced the proposal of a safety margin, to ensure that deficits remained under control (ibid). Furthermore, frugal countries called for a greater role for independent bodies, in assessing the

fiscal health of Member States, reducing the scope for political influence (ibid). This would also reduce the discretion and the bilateralism between each Member State and the Commission (ibid).
On the other hand, non-frugal countries (such as France, Italy, Spain, Greece and Portugal) supported the Commission's initial proposal and did not want to introduce additional fiscal constraints (Tamma, 2023a). Their primary concern during the negotiations was the treatment of investments, and especially those for defence spending and for investments financed by EU loans under the pandemic recovery fund (ibid). This instance was backed mainly by Italy, Poland and the Baltics (ibid). However, this proposal faced criticism from Germany, which viewed it as a way to circumvent fiscal rules by allowing continued spending without accounting for it in debt calculations (Il Post, 2023b).

These divergent positions, that shaped the negotiations, can be encapsulated by statements from the leading political figures representing the two opposing camps: France, speaking for the non-frugal countries, and Germany, representing the frugal nations. Indeed, French Finance Minister Le Maire argued that "the real point of disagreement is whether there should be automatic, uniform rules in the Stability and Growth Pact. Our answer is clearly no, because we believe that this would be an economic mistake and a political one. We tried in the past to have automatic and uniform rules and it led to recession and economic hardship, it led to a loss of production and growth in Europe" (Strupczewski, 2023). In contrast, the German Finance Minister Lindner asserted that "automatic rules are very OK and are needed, we need equal treatment, we need numerical benchmarks and we need a common safeguard and not too much leeway for the Commission to negotiate bilaterally with member states" (ibid). Indeed, this desire for consistent, common rules was expressed in multiple ways during the negotiations, including also an op-ed written by Austria, Bulgaria, Croatia, the Czech Republic, Denmark, Estonia, Germany, Lithuania, Latvia, Luxembourg and Slovenia, and favoured by Finland, Ireland, the Netherlands, Slovakia and Sweden (Tamma, 2023a). The mistrust between these two blocs significantly delayed the negotiations, which dragged on for more than a year, raising concerns that an agreement might not be reached before the end of 2023 - the deadline set by the deactivation of the general escape clause on 31st December 2023.

Ultimately, an agreement was reached within the Council at the eleventh hour, during an informal meeting of the Economic and Financial ministers on 20th December 2023. The outcome was a carefully negotiated compromise between the two positions. Indeed, several media outlets reported that, under “pressing requests of frugal countries”, new safeguards were introduced to bind Member States to a rate of debt reduction which was certain – namely 0.5% for countries with a debt-to-GDP ratio between 60% and 90% and 1% for those exceeding 90% - and to bring the deficit to a common resilience margin of 1.5% to GDP, rather than the 3% foreseen by the Treaties (SkyTg24, 2024). Non-frugal countries, on the other hand, obtained the possibility of spreading the debt reduction over multiple years and to exclude debt interest costs in the period 2025-2027 from debt calculations (Tamma, 2023b). As a result, the Council formally approved a mandate for negotiations with the European Parliament on the preventive arm regulation and reached an agreement in principle with a view to consulting the European Parliament on the corrective arm regulation (Council of the European Union, 2024d). This was followed by the reach of a provisional agreement between the Council and the Parliament on the 10th February 2024 (ibid), which was finally approved by the latter on 26th April 2024 (European Parliament, 2024).

4. **Insights from negotiators: interviews findings on the role of trust**

So far, the analysis of the 2024 reform has followed a similar approach to that used for previous reforms - examining the negotiation process through an intergovernmentalist theoretical lens and assessing the extent to which a lack of trust among parties influenced the outcome. For the 2024 reform, however, I was also able to deepen this analysis by interviewing some of the key negotiators involved. This group included five delegates from Member States (attachés from the Financial Counsellors Committee, the working group that negotiated the reform) and one policy officer. These interviews provided invaluable insights to the dissertation, providing further validity to its argument, that is that lack of trust plays a role in EU negotiations and has played a fundamental role especially in the context of the negotiations of the Stability and Growth Pact.

Indeed, all the interviewees confirmed that trust plays a role in EU negotiations. Although two of them suggested that the terms "trust" or "mistrust" might be too strong, proposing instead that these dynamics could be better understood as diverging national interests among Member States, all of them recognized that it plays a role (some of the answers have been “it definitely does”, “trust influences negotiations to a significant degree”). In particular, one delegate who replied this way explained that the push to reform the treaties by expanding the use of qualified majority voting rather than unanimity is indeed a way to overcome the mistrust of some Member States who tend to block or radically alter reforms. Delving deeper into the economic field, another delegate affirmed that the mistrust in these negotiations is predominantly unilateral, with frugal countries being distrustful of Southern and Eastern European countries, but not vice versa. This distrust can be explained for this delegate as frugal countries are quite sceptical of Southern Member States' ability to manage finances, as they think that the latter spend too much without being careful. As for the Eastern European Countries, distrust is rooted in concerns about the more elevated risk of corruption. Interestingly, this scepticism about corruption is not mentioned in discussions about Southern Europe (the delegate added that this may be because frugals would not mention it directly to Southern European States, even if they thought so, n/a). Within the Southern bloc, mistrust is mainly directed at Italy, Spain and France, while Greece and Portugal have been severely impacted by the Memoranda of Understanding in the past, and therefore no one is going to rage against them.

Focusing now on the reform of the Stability and Growth Pact, the majority of the interviewees acknowledged that lack of trust influenced to a large extent the negotiation process, even though a delegate from a Member State pointed out that this is not spoken openly ("no one will say it in official meetings") and it is something that is implied in the approach taken. In particular, a delegate from Greece who negotiated the Pact emphasized that "the evolution from the presentation of the Commission's proposal to the final agreed outcome can <u>only</u> be explained in terms of intense trust/suspicion, both between the MS and between the institutions". In addition, the policy officer interviewed framed the negotiations as an attempt to create the right incentives for Member States with significant debt sustainability issues. The goal was to build trust among the more fiscally conservative Member States, ensuring that the necessary fiscal adjustments would be made. According to the Greek delegate, "historical perceptions, attitudes, experiences and even stereotypes among the participating actors" influenced the negotiation itself.

As for the negotiation dynamics, a delegate recalled how the Commission's initial orientations were completely "turned upside down", and how Germany started "insisting immediately on the need for more safeguards". In fact, frugal countries viewed numerical benchmarks as essential for ensuring minimum fiscal consolidation and controlling the pace of debt reduction, while the Commission believed it was sufficient to ensure a general downward trajectory. In fact, according to this delegate, the Commission's proposal aimed at "making the frugals understand that it was better to have a less demanding system on paper, but more concrete and effective in reality, as the latter would have really been enforceable". The same delegate argued that "it would have been better to have rules that seemed more lenient but were enforceable than stricter but not enforceable". This perspective was echoed by an EU policy officer involved in the negotiations, who noted that "the Commission wanted a simplification of the rules, because it was clear that one of the reasons why they did not work out before was that they were too complicated and the adjustment targets – e.g. the 1/20 required reduction - were completely unrealistic". The policy officer also said that he/she "did not know why Member States decided to add safeguards to the proposal", but that by doing so "simplification went missing, rules have become more complex than the Commission intended, complicating their implementation as well".

Indeed, it was primarily Germany that insisted on including two safeguards: one on debt and one on deficit. As for the former, a delegate explained that "it made economic sense, because, even if the debt is sustainable, having a high level of debt still means that a lot of resources are "frozen", as investors invest in government bonds, rather than in productive capital". On the contrary, the same delegate criticized the deficit safeguard, describing it as "merely a political game and a mental anchoring" that "nobody wanted and that is part of the German cultural mindset, for which the budget needs to be in balance and that moving from that stance in negotiations is impossible". On the other hand, the EU policy officer, while affirming that the economic logic is not wrong, also recognized that "it is important to avoid making the implementation of the safeguard procyclical".

Therefore, to accommodate Germany, the Commission attempted to integrate some of its demands into the proposal itself, to expedite approval by the Member States. However, this strategy failed, as Germany "kept pushing the limit further every time and making concessions would never be enough, which led to a slowing down of the negotiations". Italy, which had "a weak negotiating position due to its high debt", was not able to "demand much", and focused instead on "limiting the damages, especially because the safeguards were not achievable".

Ultimately, the negotiations ended with bilateral negotiations among Germany, France and Italy, with Germany "bringing the Netherlands along to strengthen its position" and Spain "not being a part of it since it was the President of the Council, making the Southern countries losing a strong ally, as the former only wanted to reach an agreement as soon as possible". This was also confirmed by another delegate, who affirmed that "the rest of the Member States were always waiting for German and France to agree on something and then work on it" and how this led to "fragmentation" and "frustration" within the Council, as "all of the countries are Member States, but not everyone was aware of how things were evolving". The same delegate pointed out that while the original intention was not to "apply a straitjacket" to countries, the final outcome "does not take into account this idea". This was due to the fact, as another delegate recalled, that "Germany did not even want to sit at the table – let alone vote in favour – unless it could dictate the rules". Indeed, the same delegated noted that "even though it was technically possible, approving the reform without Germany on board would have given "a horrible signal to the market" and was ultimately "unthinkable". However, the delegate also added that, as the final text was a compromise between the two instances, "it was a huge effort for Germany to say that they voted in favour".

Finally, when asked whether these dynamics of the negotiation and the resulting agreement were influenced by the lack of trust among Member States, most interviewees agreed that this was indeed the case. The Greek delegate observed that "it is becoming more apparent that the final result accurately captures existing suspicion and lack of confidence without eclipse of the phenomenon" and that "mistrust and mutual suspicion are obvious to the new rules". Another delegate echoed this sentiment, suggesting that the reform can be seen as an effort by fiscally conservative countries to prevent further surprises from those with debt issues. This position was also supported by other delegates, for which "the lack of trust influenced the outcome of the reform to a large extent, and this was especially due to the fact that those who had this higher lack of trust – i.e. the frugals – also had a stronger negotiating position". This confirms the argument of this dissertation, that is that lack of trust played a significant role in shaping the negotiation process of the Stability and Growth Pact.

5. Not only towards member states?

An interesting aspect that emerged from the interviews and that will be inserted here as a starting point for further research, is that lack of trust may not be a feature characterizing only the relationships among Member States, but also among Member States and EU institutions. Indeed, all the delegates from Member States highlighted that the introduction of safeguards was motivated not only by concerns about other Member States, but also by a general mistrust of the Commission. Indeed, a delegate affirmed that safeguards were implemented “to make the rules a bit more automatic, predictable and transparent, giving less power and discretion to the Commission”. This mistrust appears to stem, according to the interviewees, from the fact that “the previous set of rules allowed the Commission to apply the rules in whatever way it desired, sometimes leading to very different outcomes for similar cases” and that “the commission had a very bad track of implementing the rules”. Some delegates felt, for instance, that the Commission “has been too indulgent towards some Member States, e.g. Italy, who has never had an excessive procedure for debt, and the other Mediterranean countries”. Indeed, according to a delegate, “the frugals suffered from never being able to materially influence the process of the European Semester and the fiscal policy, as the power of initiative to decree the existence of an excessive deficit and to present the proposal for the Council decision ultimately belong to the Commission”. Indeed, “the Commission has managed multiple times to avoid arriving to an EDP, the power of the Council is in fact null”. For instance, the Commission never opened a procedure for excessive debt and “has always reached an agreement with the Member State to try to make the latter do a fiscal containment program without opening the procedure”. This was always perceived by frugals as “a secret agreement between the two that cuts out the Council”. For all these reasons, some delegates even suggested that the mistrust towards the Commission might be even greater that than between Member States, since “it was not the Member State’s fault, but the fact that the Commission did not act to put remedy to the high debt”. On this, the EU policy officer commented that “mistrust towards the Commission is not something new” and that “the anxiety of Member States to avoid discretion and make rules as prescriptive as possible has led in past to rules that were so complex that they gave the maximum level of discretion to the Commission itself”.

Indeed, some elements of the new reform seem to aim to limit the power of the Commission in the new governance framework. Besides the safeguards and the uniform parameters to minimize discretion, a lot of emphasis has been put on the fact that the Commission shall apply a replicable, predictable and transparent methodology and make the spreadsheet templates containing the underlying data public (Council of the European Union, 2024b: art.10). Additionally, the involvement of independent bodies like the European Fiscal Board in evaluating the implementation of the Pact further aims to enhance transparency and accountability. Moreover, one negotiator also mentioned how, at the beginning of the negotiations, “some parameters for the Commission to evaluate the plan had been put into an annex that could have changed over time, and the Council instead wanted these parameters to be included in the main act and could only be modified with qualified majority”.

This seems to reflect a general tendency of mistrust towards the Commission that goes beyond the dossier on the Stability and Growth Pact. Some delegates have expressed concerns, for instance, about the fact that the Commission “borrows money on the market without even saying why” and have generally complained over the fact that the Commission “keeps increasing its power and overstepping the Council”. The fear that the Commission may overstep its competences has also been highlighted by many economists, such as De Romanis (2023: 3), who have highlighted how, with this reform, the Commission is trying to replicate the Next Generation EU scheme, by directing Member States’ reforms and investments. However, the latter uses European debt, whereas these new rules would limit the use of national debt, which is however a national competence. As a result, some view the reform as a means for the Commission to extend its reach and influence without explicitly establishing a fiscal union, all while lacking a solid legal foundation for such an integration.

An EU policy officer interviewed for this dissertation has indeed confirmed that the Commission is trying to pursue a similar strategy of the Next Generation EU, by incentivizing Member States to implement specific reforms. However, when asked whether the Commission might be overstepping its competences, the officer replied that “the Commission’s further competences have been assigned to it by the European Council and by the treaties” and regarding investments, “there are the EU common priorities, to which all Member States have committed themselves and therefore all must contribute to common European objectives”. Moreover, the officer said that he/she “understands who is saying that the Commission is going beyond its competencies, but that history is taking the EU in a different direction from the one imagined in 1957”. For instance, “nobody would have ever imagined the possibility of realizing the Ukrainian plan (which imposes conditionalities on a third country)” and affirmed that “the Commission went beyond its competences even in this case”. However, the officer argued that “the European Union is not a static entity, and its evolution is dynamic”. It remains to be seen whether the implementation of the new rules will push the European Union towards another adjustment, by restoring trust in the Commission and getting closer to a supranational fiscal union.

CONCLUSION

In conclusion, this dissertation has provided an in-depth exploration of the central role that trust and mistrust play in the negotiations between EU Member States, particularly within the framework of the Stability and Growth Pact. Through the analysis of three key scenarios - the introduction of more stringent rules, the shift toward more flexible rules, and a compromise between the two approaches - this research has demonstrated how the presence or absence of trust has significantly shaped the negotiation processes and outcomes of the EU economic governance over time.

The case study analysed in this work, namely the Stability and Growth Pact, illustrates how mistrust among Member States has influenced decision-making at critical junctures. In the first scenario, both the creation of the Pact in 1997 and its reinforcement in 2011 were marked by a pervasive lack of trust, leading to the adoption of stricter fiscal rules. This mistrust stemmed from concerns over fiscal discipline, particularly the fear that some Member States after having joined the EMU would abandon fiscal discipline. The 2011 reform, in particular, reflected heightened tensions in the aftermath of the financial crisis, with northern Member States pushing for tougher sanctions to prevent a recurrence of the Eurozone crisis, which they attributed in part to the perceived fiscal irresponsibility of southern countries.

The second scenario, focusing on the 2005 reform, demonstrated a shift toward more flexibility in response to economic heterogeneity within the Eurozone. This reform relaxed certain elements of the SGP to accommodate countries at different stages of the economic cycle. However, this move toward flexibility was not a result of increased trust among Member States, but rather a reflection of ongoing mistrust that forced the negotiation of rules that could be applied uniformly while still accounting for national differences. The flexibility introduced in 2005, therefore, was a pragmatic response to the lack of trust, as it sought to create a system that allowed for economic diversity without opening the door to discretion that could undermine the Pact’s core principles.

The third and final scenario, the 2024 reform, represents a hybrid approach, balancing more stringent rules with greater flexibility. This outcome was the result of highly contentious negotiations between two opposing blocs of Member States: those favouring stricter fiscal oversight and those advocating for more leeway in national budget management. The mistrust between these groups was evident throughout the bargaining process, as detailed in the analysis of the negotiations. The insights gained from interviews with negotiators involved in the 2024 reform confirmed that mistrust was a central factor in the eventual compromise. The reform's outcome—stricter safeguards for fiscal discipline coupled with longer adjustment periods and slower debt reduction—was a direct reflection of the lack of trust between Member States, which prevented either side from fully achieving its objectives.

This dissertation makes a significant contribution to the literature on EU economic governance by offering a new theoretical framework that combines liberal intergovernmentalism with the concept of trust in international relations. By applying this framework to the specific case of the Stability and Growth Pact, this work fills a gap in the literature and opens new avenues for future research on EU negotiations. One of the possible new rooms for further research has been highlighted in the last chapter, and it is that the role of trust may be expanded and studied not only among Member States, but also between Member States and EU institutions. Future research could explore how trust or mistrust between Member States and EU institutions impacts the governance of the Union, particularly in areas such as fiscal surveillance, enforcement mechanisms, and broader economic policy coordination.

Ultimately, the Stability and Growth Pact and its evolution over the years offer a compelling case study for examining how trust - or the lack thereof - shapes the outcomes of negotiations at the EU level. By highlighting the importance of trust in the negotiation process, this research not only advances our understanding of the Stability and Growth Pact but also offers valuable perspectives for addressing future challenges within the EU's governance framework, particularly in times of crisis or divergence among Member States.

ANNEX 1

This appendix contains the list of the interviews conducted for this research. The interviews were carried out with six participants, each providing valuable insights relevant to the study. The following sections present the interviews in the order they were conducted. All the interviewees have requested the use of anonymity, and the titles used to identify them have been mutually agreed upon.

Interview 1: Interviewee A
Role**:** delegate from a Member State who negotiated the reform of the Pact.

Interview 2: Interviewee B
Role: delegate from a Member State who negotiated the reform of the Pact.

Interview 3: interviewee C
Role: delegate from a Member State who negotiated the reform of the Pact

Interview 4: interviewee D
Role: delegate from a Member State who negotiated the reform of the Pact

Interview 5: interviewee E
Role: delegate from Greece who negotiated the reform of the Pact

Interview 6: interviewee F
Role: policy officer

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