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# MUTUAL RECOGNITION IN GOODS AND SERVICES:

## AN ECONOMIC PERSPECTIVE

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**ABSTRACT**

Mutual recognition is a remarkable innovation facilitating economic intercourse across borders. In the EU's internal goods market it has been helpful in tackling or avoiding the remaining obstacles, namely, regulatory barriers between member states. However, there is a curious paradox. Despite the almost universal acclaim of the great merits of mutual recognition, the principle has, in and by itself, contributed only modestly to the actual realisation of free movement in the single market. It is also surprising that economists have not or hardly underpinned their widespread appreciation for the principle by providing rigorous analysis which could substantiate the case for mutual recognition for policy-makers. Business in Europe has shown a sense of disenchantment with the principle because of the many costs and uncertainties in its application in actual practice.

The purpose of the present paper is to provide the economic and strategic arguments for employing mutual recognition much more systematically in the single market for goods and services. The strategic and the 'welfare' gains are analysed and a detailed exposition of the fairly high information, transaction and compliance costs is provided. The information costs derive from the fact that mutual recognition remains a distant abstraction for day-to-day business life. Understandably, verifying the 'equivalence' of objectives of health and safety between member states is perceived as difficult and uncertain. This sentiment is exacerbated by the complications of interpreting the equivalence of 'effects'. In actual practice, these abstractions are expected to override clear and specific national product or services rules, which local inspectors or traders may find problematic without guidance. The paper enumerates several other costs including, inter alia, the absence of sectoral rule books and the next-to-prohibitive costs of monitoring the application of the principle. The basic problems in applying mutual recognition in the entire array of services are inspected, showing why the principle can only be used in a limited number of services markets and even there it may contribute only modestly to genuine free movement and competitive exposure. A special section is devoted to a range of practical illustrations of the difficulties that business experiences when relying on mutual recognition. Finally, the corollary of mutual recognition – regulatory competition – is discussed in terms of a cost/benefits analysis compared to what is often said to be the alternative, that is 'harmonisation', in EU parlance the 'new approach' to approximation.

The conclusion is that the manifold benefits of mutual recognition for Europe are too great to allow the present ambiguities to continue. The Union needs much more pro-active approaches to reduce the costs of mutual recognition as well as permanent monitoring structures for its application to services ( analogous to those already successfully functioning in goods markets). Above all, what is required is a 'mutual recognition culture' so that the EU can better enjoy the fruits of its own regulatory ingenuity.

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# MUTUAL RECOGNITION IN GOODS AND SERVICES: AN ECONOMIC PERSPECTIVE

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## Introduction

Mutual recognition is a remarkable innovation facilitating economic intercourse across borders. In the EU's internal goods market it has been helpful in tackling or avoiding the remaining obstacles, namely, regulatory barriers between member states. Mutual recognition (MR) is widely appreciated for the original and simple fashion in which it can solve what seemed to be a long and intractable and infinite steeple chase of overcoming obstacles for thousands of products. It also underlies ingenious ways to facilitate the free movement of services. This general appreciation has spread beyond the Union to other continents and the WTO. The notion of MR has travelled beyond disciplines, too, from European law and the domain of regulatory specialists to economists worldwide.

However, there is a curious paradox. It has turned out to be difficult to get MR accepted with all its consequences, despite the almost universal acclaim of its great merits. The widespread recognition on its own has neither led to a sweeping liberalisation of the internal market, whether in goods or services, nor to much of a deeper analytical economic understanding. Not surprisingly, this has frustrated its initial supporters in policy circuits. During the mid-1990s, the disenchantment with MR was so strong that UNICE (the European confederation of industry) recommended a return to harmonisation as a superior option. In services it has turned out that MR is not so easy to apply. As to analysis, economic work on MR is scant. Economic literature on trade or the internal market often mentions MR but usually merely in passing or with just a few telling cases (like the German beer case).

This disenchantment and neglect is most regrettable. Mutual recognition opens up many and great opportunities. It deserves better recognition in economics and more widespread application in Union practices. The purpose of the present paper is to provide the economic and strategic arguments for such recognition and application, especially for the goods and services markets. In the process I also hope to clarify why MR, simple as it would appear to be at first sight, nevertheless entails considerable complications. These complications can lead to high transaction costs, and lowering those is a painstaking and involving process. The Union is developing this process (as I shall set out) and thereby gradually rendering MR more attractive. Indeed, the paper argues for a '*mutual recognition culture*', especially at the level of national authorities, which would stimulate permanent exposure to healthy competition throughout the single market, without in the least sacrificing justified concerns of health, safety and consumer protection.

The structure of the paper is as follows. Section 1 defines MR and its place in the internal goods market. The legal and regulatory detail is minimised so that the essence becomes clearer for the economic reader. MR cannot be understood in isolation; it can be indispensable for free movement (liberalisation) and substitutes for or complements harmonisation. Section 2 sets out the strategic economic advantages of MR in the new regulatory strategy of the Union. In allowing a much less costly regulatory system to emerge, these strategic advantages probably far outweigh the direct economic benefits of applying the principle. A microeconomic analysis of the direct (welfare) benefits is provided in section 3, showing its pro-competitive nature unless strategic games are played on quality. Section 4 deals with the drawbacks of MR. It is little known or understood that the proper application of MR implies

large and ‘deep rooted’ transactions costs. These costs are spelled out in some detail and illustrated. Section 5 discusses MR in services. MR or the related ‘home country control’ principle has clearly yielded strategic as well as direct benefits in some service sectors like transport and financial services. Yet in other sectors the gains are spurious or MR is largely irrelevant.

The discussion then turns to regulatory competition and its (de)merits. The case for regulatory competition is conditional and indeed more problematic than MR, its prerequisite. Casual empiricism suggests that it is not widely practiced in Europe despite many fears. This brings us to the ambivalent attitude of European business to MR which is explored in section 7. Section 8 concludes.

## 1. Mutual Recognition in the internal goods market

After decades of experience with ‘deep’ market integration in Europe, the concept and place of mutual recognition can be clearly defined. There are basically three ways of realising free movement (here, of goods) in the internal market: liberalisation, approximation and mutual recognition. All three have limitations and no single method can suffice for all cases. In that sense they are complements. Liberalisation amounts to the imposition of free movement by prohibitions for member states to intervene in cross-border trade in direct or even indirect ways. These prohibitions derive either straight from the Treaty and the European Court of Justice (ECJ) jurisprudence or from EC regulations or directives building on such provisions. Approximation is the adaptation of national laws in such a way and to such a degree that cross-border trade is no longer hindered in a direct or indirect way. This approximation avoids, therefore, centralised rules but aims to bring national laws into ‘harmony’ (hence, the French wording ‘harmonisation’ in Arts. 94 and 95, EC where the English text speaks of ‘approximation’). Approximation can be justified as a complement to liberalisation where market failures have to be overcome by regulation. In extreme cases of very high risk where uncertainty or discretion could have unacceptable consequences, such market failures might be addressed by centralised rules, but otherwise, hence in the overwhelming majority of regulatory issues, approximation will suffice. The goal must then be commonly defined (because the purpose of directives is to remove or overcome the market failure throughout the EU) and the instruments (that is, the detailed technical provisions) only insofar as they might hinder, directly or indirectly, intra-EC trade.

Mutual recognition starts from the idea that member states have equivalent regulatory objectives in safety, health, environment and consumer protection (SHEC) which, in actual practice in Europe, is very often correct. But if and when objectives are equivalent and thus the market failure is addressed, approximation should no longer be necessary and free movement could prevail. The notion of mutual recognition refers to the implication for national customs or inspectors or regulatory agencies or policy-makers that a good entering one member state from another EU country must be allowed unhindered access, even if the detailed specifications in the relevant domestic regulation differ from those in the country of origin, as long as the regulatory objectives are equivalent: from a narrow regulatory point of view, it would thus seem as if the importing country ‘recognises’ the regulatory regime of the exporting country. Because the principle has general application for the internal market, this ‘recognition’ is ‘mutual’.

Before explaining MR a little more precisely in the EU context, it is crucial to appreciate a few properties. First, mutual recognition must always be understood as an alternative or complement to liberalisation and/or approximation. Therefore, when EU authorities say that MR is a leading principle of the internal market this should not be interpreted – as some ill-

informed economists have done – as meaning that it is the sole or overriding principle. Economists ought to analyse the economics of MR in the proper regulatory context. Second, the reliance on MR in the EU is greatly facilitated by the forceful treaty principle of free movement, a principle that does not exist and cannot be expected in international trade law or in economic regionalism elsewhere (whether NAFTA, the ASEAN free trade area, Mercosur, etc.). Free movement goes much beyond free trade in that the former implies a *right* to enter national markets. National discretion to intervene only exists when there is an explicit derogation in the treaty. Thus, when the derogation does not apply or when it is narrowly interpreted by the ECJ (which has typically happened in the EU), free movement prevails automatically. And when derogations do apply, the objectives and key aspects can be approximated by common decision-making. The originality of 'mutual recognition' was that, before rushing into thousands of approximation exercises, one should first ask the question whether the objectives of national regulation, falling under the derogation, are not equivalent to begin with. If so, MR applies because the purpose (i.e. overcoming the internal market failure) is then fulfilled and free movement should prevail, irrespective of the details that might differ between those national rules. Third, a supranational ECJ is neither present in the WTO regime nor in other regional trade regimes. It is the combination of these last two aspects (i.e. the principle of free movement rather than free trade, and a 'supreme' court) that makes it doubtful whether MR, with all its profound consequences, can be exported to world trade or other trade blocs. (see also Pelkmans, 1995).

The remainder of this section endeavours to set out more precisely the mutual recognition regime of the Union in its regulatory context. The aim is to have the reader understand that MR can only flourish in a well defined and hierarchical legal regime. As section 4 will show. Even this is only a necessary, not a sufficient condition for a smooth application in the internal market, genuinely lowering transaction costs of intra-EU economic intercourse.

The principle of mutual recognition has been developed by the ECJ in its case law. In its famous *Cassis de Dijon* case, the ECJ held that, in principle, a member state must allow a product lawfully produced and marketed in another member state into its own market, unless a prohibition of this product is justified by mandatory requirements, such as health and safety protection (see below).[1] This means that member states cannot apply certain specific details of national regulation to intra-EC imports of goods, if the *objective or effect* of the relevant law in other member states is *equivalent* to that of the importing country. The idea behind mutual recognition is that all member states care for their citizens and cannot be assumed to produce for instance unsafe or unhealthy products, merely because technical specifications differ. Hence the principle of mutual recognition plays a pivotal role in the internal market since it ensures free movement of goods (and services) *without* making it necessary to approximate/harmonise national legislation. Since free movement of goods is essential to the internal market, it is not surprising that the burden of proof of 'non-equivalence' of objectives is on the member state which is unwilling to allow the import of the products concerned. Where the regulatory objective or effect are *not* equivalent, free movement can be impeded. In such cases, however, the Treaty offers a remedy to the free movement by allowing for the approximation of precisely those objectives or effects under Art. 95 EC (ex Art. 100a EC), under qualified majority voting.

[1] Case 120/78, *Rewe-Zentrale AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649, although this principle was only explicitly developed in Case 113/80, *Commission* v *Ireland* [1981] ECR 1625.

*Table 1. Interaction between liberalisation, mutual recognition and approximation*

| | Article | Nature | Main features |
|---|---|---|---|
| 1. | 28 EC<br>(ex 30 EC) | Liberalisation<br><br>Extended:<br>(ground work for mutual recognition) | Prohibition of quantitative restrictions on imports or measures having an equivalent effect<br>(regulatory barriers)<br><br>*Dassonville* Ruling of 1974: widening of prohibition to all regulatory barriers:<br>'[a]ll trading rules enacted by member states which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an effect equivalent to quantitative restrictions'<br>Enhances liberalisation |
| 2. | 28 EC<br>(ex 30 EC) | Mutual recognition | *Cassis de Dijon* Ruling of 1979: further refinement of the principle of equivalence:<br>member states must allow a product lawfully produced and marketed in another member state into their own market, unless a prohibition of this product is justified by mandatory requirements (see point 3)<br>if regulatory objectives or effects such as Safety, Health, Environment and Consumer protection (SHEC) are equivalent, member states must mutually recognise each other's legislation<br>obligation to include a mutual recognition clause in national legislation (*Foie Gras* Ruling and Dir. 98/34)<br>if not equivalent, then approximate (see point 4, below)<br>enhances liberalisation even more |
| 3. | 30 EC<br>(ex 36 EC)<br><br>and<br><br>28 EC<br>(ex 30 EC) | Derogations to liberalisation<br><br>and<br><br>mutual recognition | all grounds in mentioned in Art. 30 EC, which are restrictively interpreted<br><br>and<br><br>other 'mandatory requirements' developed in the ECJ's case-law, notably the *Cassis de Dijon* Ruling ('rule of reason')<br>all derogations are subject to a proportionality test |
| 4. | 95 EC<br>(ex 100a EC) | Approximation<br><br>'New Approach'<br>(broad and/or horizontal) | where national (SHEC) objectives are not equivalent, approximation unifies those objectives<br>wide sectors covered (e.g. machines)<br>or horizontal issues covered (e.g. directives on food additives or general product safety) |
| 5. | 95 EC<br>(ex 100a EC)<br>only if not applicable:<br>94 EC<br>(ex 100 EC) | Approximation<br><br>'Old Approach'<br>(specific and/or vertical) | all other (product) approximation: for instance:<br>involving high risk (chemicals, cars)<br>precision in rules required (measuring instruments)<br>specifying certain product compositions, such as jam and marmalade and cocoa and chocolate) |

*Source*: Pelkmans, Vos & di Mauro (2000).

In order to grasp fully the role and significance of mutual recognition, one needs to understand how liberalisation, mutual recognition and approximation work together to ensure free movement. This interrelationship is summarised in Table 1. Art. 28 EC gives expression to the general principle of free movement of goods by prohibiting the member states from imposing quantitative restrictions on imports or measures having an equivalent effect. The treaty language is a misnomer, probably drafted by trade diplomats. The phrase should be: 'regulatory barriers', as the Court acknowledged in Dassonville (1974). In *Dassonville*, the ECJ removed all uncertainties about the interpretation of the concept of 'measures having equivalent effect' by declaring that also trading rules enacted by member states which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an effect equivalent to quantitative restrictions.[2] This economic interpretation paved the way for a very broad interpretation of measures of equivalent effect.[3] In its famous *Cassis de Dijon* ruling, the ECJ further refined the principle of equivalence and ruled that products lawfully produced and marketed in one member state must be admitted by another member state, save where refusal is justified by virtue of mandatory requirements.[4] In its 1985 White Paper on the Completion of the Internal Market, the Commission adopted the principle of mutual recognition as its main strategy to achieve the internal market, with far-reaching consequences.[5] In addition, it proclaimed its intention to concentrate its approximation activities mainly in areas where trade barriers were justified according to the criteria determined by the Court.

The principle of mutual recognition thus implies that member states, when drawing up commercial or technical rules liable to affect the free movement of goods, may *not* take an exclusively national viewpoint and take account only of requirements confined to domestic products. In this way, the mutual recognition case law boils down to *regulatory reform* because exposure to competition from elsewhere in the Union is enhanced, without compromising the purpose of regulation, namely, overcoming the SHEC-type market failures. According to the ECJ's case law, member states are moreover required to include in their national legislation a so-called *mutual recognition clause*, in order to allow the acceptance on their territory products which are in conformity with the legislation of another member state.[6] This requirement stems from the implementation of the notification procedure laid down in the Information Directive (Directive 98/34/EC) (see below).

In emphasising the objective(s), rather than the detailed specifications, in a national product law or decree, the national regulation as well as the regulation of member states where the imported product comes from are *forced to concentrate on overcoming the market failure*. This will tend to make regulatory failure unattractive. A widespread instance of regulatory failure in Europe was over-regulation in the sense that national product laws would extend to aspects that had nothing to do with the market failure. At the same time, however, it assumes that the grounds in Art. 30 EC (ex Art. 36 EC, referring mainly to health and safety) represent market failures. If one includes the so-called 'rule of reason' interpretation of the ECJ of Art.

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[2] Case 8/74, *Procureur du Roi* v *Dassonville* [1974] ECR 837.

[3] See, more recently, for instance, Cases C-238/89, *Pall-Dahlhausen* [1990] ECR I-4827; C-362/88, *GB-INNO-BM* v *Confédération du Commerce Luxembourgeois* [1990] ECR I-667, C-126/91, *Schutzverband gegen Unwesen in der Wirtschaft* v *Yves Rocher* [1993] ECR I-2361. See however the ECJ's more restrictive approach in the Court's Cases C-267 & 268/91, *Keck and Mithouard* [1993] ECR I-6126.

[4] Case 120/78, *Rewe-Zentrale AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

[5] White Paper, Completing the Internal Market, 13 June 1985 (COM (85)314).

[6] See Case C-184/96 *Commission* v *France (Foie Gras)* [1998] ECR I-6197.

28 EC (ex Art. 30 EC), which justifies national regulation involving environment and consumer protection, and observes that almost all the relevant product regulation, related to Art. 30 EC (ex Art. 36 EC) is about health and safety protection, this assumption is broadly correct. Those four combine to SHEC which covers practically all relevant market failures for goods.

Where mutual recognition fails because of non-equivalence the EU can decide to take up regulation approximating national legislative provisions in order to ensure the free movement of goods. In an attempt to overcome the drawbacks of the 'old approach' to the abolition of technical barriers to trade followed by the Council since 1969,[7] the Commission launched in 1985 its 'New Approach to Harmonisation and Technical Standards'. The new approach restricts approximation to stipulating *essential* health and safety requirements, whilst the specification of these requirements in technical standards is left to the European standardisation bodies (CEN, CENELEC and ETSI). The distinction between the essential SHEC requirements (the regulatory objectives) and technical specifications constitutes the main characteristic of the new approach. This new approach is often denoted as 'minimum harmonisation': what this refers to is not that regulation is somehow (too?) minimalistic but that all that is to be approximated are the objectives and their essential links with voluntary, preferably common standards, but no more than that. Once these objectives are approximated, the rest is subject to mutual recognition. Common – though voluntary – standards are then desirable instruments to drastically lower information costs and uncertainty for business and technical designers in clarifying what critical specifications are presumed to be in compliance with these (often quite general) SHEC objectives. However, innovation is not throttled because new solutions may be tested and certified as well, as long as they comply with these objectives. The new approach, with much lower costs and far fewer blockages in the Council, has thus been greatly facilitated by the emergence of mutual recognition.

The new approach is far superior to the old, rigid harmonisation approach the Community applied before 1985. But would regulatory competition, as a logical corollary of MR and precisely because it might overcome market failures at least cost, not be still better than approximation? Approximation suggests that there is no prior equivalence between objectives of national regulation, otherwise mutual recognition should apply. A lack of equivalence could be due to the fact that some member states have barrier-prone regulation and others do not, or, that objectives of all existing national regulation of a product differ 'too much'. Under the 'new approach', approximation can be viewed as a written agreement in Council on equivalence. In actual practice, it turns out to be far more complex, because the new approach defines the objectives over wide product groups. As soon as the objectives have to be operationalised in mandates for European standardisation, great differentiation and some precision is often required, hence directives (have to) go further than just equivalence of objectives. Indeed, the ECJ speaks about objectives *or effects*. Some economists have attempted to show that regulatory competition between member states, driven by free movement under mutual recognition, can be (economically) superior to approximation. Given the equivalence of objectives, 'the market' (rather than civil servants and ministers) would reveal consumer and user preferences, and in this way the desired specifications could be 'discovered', which can then be codified in directives to facilitate trade. Although this might possibly be correct in comparison with the 'old' approach, it is unlikely to be superior to the 'new approach' (Sun & Pelkmans, 1995). In any event, where the new approach fails because no qualified majority on objectives (or effects) can be found, regulatory competition fails as

[7] Adopted on 28 May 1969, (1969) OJ C 76/1. For the drawbacks, see Pelkmans (1987).

well, because free movement would be blocked. The issue of regulatory competition will be addressed below.

As Table 1 shows, liberalisation, MR and approximation cannot be understood in isolation but only within the notion of a regulatory strategy. MR and (new approach) approximation can be substitutes or complements, and they may well serve different needs.

## 2. The strategic advantages of mutual recognition

The advantages of MR are of two types, strategic for the overall realisation of the internal market and the manifold benefits this implies, and direct (net) welfare benefits of the application in specific cases. The latter are dealt with in Section 3. It would be a serious mistake to narrow down the economic analysis of MR to the comparative statics of applying MR to a particular traded good as the strategic gains almost certainly outweigh the direct benefits greatly.

There are four strategic economic advantages of mutual recognition in goods markets. First, the internal goods market can be (and indeed has been) established far more easily and more quickly than would have been possible with old and new approaches of approximation combined with technical and unsatisfactory judicial review. Second, the propensity to over-regulate for vested interests or bureaucratic reasons is severely constrained both as to EC directives and at the national level. Third, even if regulatory competition does not seem to be pursued actively in the EU, mutual recognition creates the prerequisites for it; this potential for regulatory competition exercises an additional disciplinary effect on national regulators. Fourth, the interaction between MR and approximation under the new approach (under qualified majority voting) forces member states to rethink their national regulatory solutions and focus on what is essential (the objectives) and what can usefully be subject to common (but voluntary) standards; in so doing, time and again, regulators have to think in terms of mutual recognition (for all that is not 'essential'). This prompts a process of learning among member states about 'best-practice' regulation and reinforces the incentives to raise the quality of regulation at both levels in the European public interest.

These strategic advantages stem from the systemic implications of the notion of mutual recognition, not from the pure judicial application by the ECJ itself. It is important to see that a mere judicial application of MR (à la Cassis de Dijon) would have been no more than a welcome handmaiden to the promotion of free movement in some selected product sectors. Its main application would have been limited to food products, with a few scattered instances in other markets as well. Only once one begins to understand its influence on the design of the new regulatory strategy of the Union (after the White Paper of 1985 and the Single European Act) and its crucial role in that strategy, is it possible to discern and appreciate the strategic economic meaning of the principle.

The strategy consists of a triptych of a political, a judicial and a regulatory panel (see Table 2). The regulatory panel, in turn, is made up of a quintet. With due account of the political and judicial panels, this *regulatory quintet* is central to the establishment and proper functioning of the single market, the economic hard core of the Union.

The Single Act removed the veto obstacle. For most internal market matters qualified majority voting (QMV) was de jure and de facto introduced. This altered the conduct of member states representatives in Coreper and Council. No longer could every detail and every deviation with other member states be imposed on the Community: compromises were either needed to obtain some concessions from others or they were indispensable to form a blocking

minority. QMV thereby reduced the costs of 'how' the EU regulated, while significantly lowering the probability of deadlock, so that the internal market could be built much faster.

*Table 2. The Union's new regulatory strategy*

| Political | Judicial | Regulatory |
|---|---|---|
| Qualified majority voting (with a few exceptions) | Judicial mutual recognition (given equivalent objectives or if Art 30 does not apply) | → Free movement<br>→ No internal frontiers<br>→ Subsidiarity<br>→ Minimum approximation / harmonisation<br>→ Regulatory mutual recognition |
| | Proportionality (member states) | Proportionality (EC level) |

*Source:* Pelkmans (2001a, p. 59).

The judicial panel has its roots in the 1970s, albeit only for goods markets, in the Dassonville and Cassis de Dijon cases. This *judicial form of mutual recognition* is remarkable because in effect, it undermines the regulatory autonomy of a member state with respect to intra-EU imports.

Judicial mutual recognition proved capable of declaring inapplicable to intra-EU imports a very large number of regulatory specifications in food laws, and some in machine safety regulations, construction products, etc. In and by itself, it made superfluous a lot of tedious approximation that was deadlocked on the technical specifications, *not* on the regulatory objectives sought. Just as qualified majority voting did after the Single Act, judicial mutual recognition altered the behaviour of member states. First, it came to be understood that the 'need to act in common' (a required step of the subsidiarity test) at EU level often did not apply where health, (etc.) objectives were the same. This had the practical effect of *reducing the EU regulatory burden* (that is, less approximation) while exposing national overregulation (with technical specifications) by free movement. In one stroke, therefore, *the probability of costly regulatory failure diminished greatly* at both levels of government. Or, to put it in a less abstract way, the potential total number of products waiting for EU regulation before free movement would become a reality for business and consumers was drastically curtailed. Moreover, existing, often detailed national regulation as well as possible future refinements became unenforceable vis-à-vis intra-EU imports.

Second, it led to a re-think of how approximation could best be tackled whenever there was doubt about the equivalence of regulatory objectives. Approximation was minimised to the 'essential requirements' of health, safety, environmental or consumer protection. Beyond these regulatory objectives, member states were free to regulate more strictly, but mutual recognition (and thus free movement) would apply. This *regulatory mutual recognition* solved the problem of (business) uncertainty about 'equivalence' by defining common minimum requirements in rather general terms, while imposing free movement and mutual recognition 'beyond' those requirements. This had the great advantage that agreement in the Council would be far easier to achieve as, in Europe, regulatory objectives hardly diverge in the large majority of cases. It meant that the establishment of the internal market became politically feasible.

The Court also introduced another principle, that of 'proportionality'. Because judicial mutual recognition may confuse consumers, as they are confronted with products from different regulatory regimes, it did accept labelling requirements as a 'least restrictive' measure to protect the consumer. Previous very costly measures such as complete import bans (e.g. beer into Germany; pasta not fully made from durum wheat into Italy, etc.) had to be removed. Thus asymmetric information can be solved at very little cost and without impeding free movement.

The regulatory panel of Table 2 emerged from this evolution. With the Single Act's removal of internal frontiers and the Maastricht Treaty's adoption of subsidiarity, the quintet was complete. It is hard to overrate the economic significance of the regulatory quintet. The combination of free movement, no internal frontiers and mutual recognition as well as proportionality at the member states' level have led to a far greater and more intense competitive exposure of national goods markets than before the Single Act. Should common regulatory action be necessary, it is nevertheless still bound by the combination of subsidiarity (as in the Treaty, Art. 5-EC), minimum approximation and EU-level proportionality.

There is one caveat. Establishing the internal market while overcoming market failures and minimising regulatory failures should improve economic welfare, as a rule. But this conclusion cannot be fully generalised. Consider the case of EU countries having very large differences in preferences: in some health, safety or environmental objectives they diverge sharply. An inconsiderate application of free movement would pre-empt the satisfaction of the strictest local preferences (in say, environmental regulation). Art 30, EC should prevent this from happening. But approximation may similarly suppress such preferences if QMV overrules the relevant member state(s). This might mean that common regulation to overcome market failure would *lower* welfare in some member states. Assuming that the overruled preferences expressed in Council are widely held by the voters in these countries and do not merely reflect overt protectionism, this would be a serious drawback.

There are two possible responses to this problem. First, in Art. 95, sub 4 an escape clause is formulated, under strict conditions, allowing a member state to maintain stricter legislation *without* mutual recognition. This clause has hardly been invoked thus far showing that it is not a pressing problem in actual practice. Second, a member state may maintain or enact stricter legislation, but of course subject to mutual recognition. In economic terms, the effect will be that *the regulatory costs will fall on the suppliers in the member state itself*. If such preferences are truly wide-spread in the country, the satisfaction of these preferences may well offset the regulatory costs.

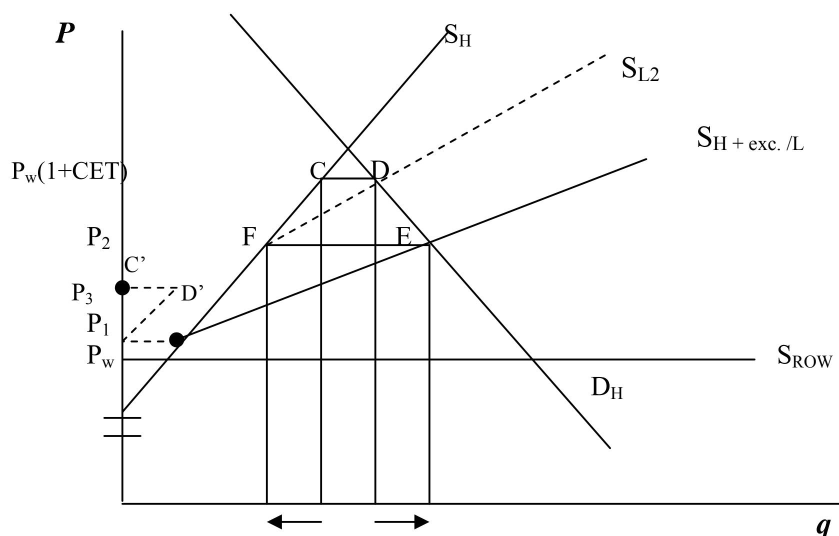
## 3. The economic welfare analysis of mutual recognition

The direct benefits of MR can be clarified with the help of rigorous welfare analysis, be it under somewhat restrictive assumptions. Realising that regulatory barriers are very different from tariff barriers or quotas, there are essentially two (different) ways of approaching the direct economic effect of MR. First, one can regard national standards and regulations as *cost-increasing entry barriers* and MR will then alter the competitive exposure of domestic firms, hitherto operating in fairly sheltered national markets. Second, one can regard national SHEC rules or voluntary standards and (tough) conformity assessment as *quality signalling*. In such a setting, the cost differential may simply reflect quality competition and a need to invest in reputation-building. These two contrasting perspectives can both be relevant, dependent on the nature of the goods market. With the steady Europeanisation of standards, whether linked to directives or not (hence, MR), the problem could be expected to fade away in another one

or two decades (except perhaps in building products where also the US continues to have perennial barriers in its internal market).

First, the analysis will focus on a simple three-countries/one-good model, with constant costs for the rest of the world (= ROW) and increasing costs for the two EU countries, *L* and *H*. Consider Figure 1[8] showing the market in *H*. The good is homogenous between *ROW, L* and *H* (no quality differences), but regulations between *L* and *H* differ, causing adjustment costs.

*Figure 1. Mutual recognition and homogenous goods*




The high-cost country *H* is not fully protected by the Union's common external tariff (CET) and *CD* of imports from *ROW* enter. The low-cost country *L* could easily export to *H* over its excess-supply curve (as drawn in the *H* market) $S_{H + exc. / L}$. [9] Its potential exports to *H* would be *FE*; if so, *ROW* would be squeezed out of the market as in simple customs union theory. However, with non-harmonised and non-recognised national technical regulations, *L* incurs an adjustment cost, in Figure 1 assumed to be the vertical difference between $S_{H + exc. / L}$ and $S_{L2}$, hence, a given percentage of the cost price. It is (arbitrarily) drawn such that it goes through *D* and leaves enough exports into *H* so as to squeeze out *ROW* at the price $P_w(1 + CET)$. If the adjustment were a little higher, *L* firms would refrain from exporting to *H*. Thus, in the internal market for homogenous goods, still characterised by regulatory barriers, we find that:

(a) Trade diversion may still occur, but, dependent on the (cost-increasing) barriers, it may also be reduced or absent; it also depends on whether the world price does or does not include similar adjustment costs as L experiences when entering H.

[8] Figure 1 extends the notion of 'cost increasing trade barriers' ( emphasised by Pelkmans & Winters, 1988, pp. 18-20, as distinct from tariffs which are revenue generating, and this property is crucial in customs union theory) to mutual recognition. Figure 1 is adapted from Abraham (1991, pp. 6-15).

[9] Beyond the market clearance price $P_L{}^1$, its excess supply is horizontally added to *H*'s domestic supply schedule.

(b) Both *L* and *H* keep very high domestic market shares when regulatory barriers are not tackled; indeed, dependent on the cost of adjustment to the regulation in *H*, the internal market may well remain segmented.

(c) The consequence of partial or complete segmentation is price disparities in the EU, despite tariff-free trade in the EU and the homogeneity of the good; if $S_{L2}$ were relevant, or if it were situated even higher, the price prevailing in *H* would be $P_w$ ( 1 + CET) ; in L the domestic market clearing price would be P 1 and adding excess supply CD ( = C' D') would increase it to P 3; hence a considerable price disparity would arise.

Note that 'old-approach' type of harmonisation (as distinct from mutual recognition or, as in Figure 1, from cost-increasing barriers only for exports to H, yet not domestically) would, due to vetoes and technical specificities, probably lead to 'maximum' requirements for standards and/or testing, in other words, close to or identical with those of *H*. The effect of this is not visible in the graph as nothing would alter in *H* but in *L* it would cause a price-hike. It would wipe out the competitive advantages of *L*, clearly something companies will fiercely resist. This simple analysis shows one major drawback of the 'old approach': it provides power to *protect* a high-cost industry, protected by regulatory barriers,[10] *rather than a 'liberalisation'* of the internal market. The seductive plea for a 'level-playing field' may be very costly and throttle (potential) intra-EU trade.

The introduction of 'mutual recognition' (assuming that 'equivalence' is not a problem) drastically alters the picture. In Figure 1, *L* no longer incurs an adjustment cost and will export *FE* to *H*. The market share of domestic *H* producers is more or less halved (an absolute decline of sales, for a larger total quantity) which will prompt rationalisation and restructuring. Consumers in *H* gain with the price fall, but consumers in *L* lose as the EU will now enjoy one price ($P_2$). Note that, if the restructuring of *H*-based firms does not lead $S_H$ to shift down considerably (an improvement of technical efficiency), these firms cannot exploit mutual recognition by exporting to *L*. Trade diversion would now be certain in Figure 1.[11]

In this simple analysis, therefore, mutual recognition boils down to a *pro-competitive* regulatory regime.

Second, the analysis will stylise a case where SHEC regulations can be considered as quality signalling. Let us assume that domestic regulations refer to national standards which reflect quality; different national standards reflect quality differentials. The distinction between regulations and standards is crucial – without mutual recognition, the regulations constitute barriers, but with mutual recognition (hence, equivalence as to the 'essential requirements') only the voluntary quality standards remain, and hence the price/quality combinations are determined by consumers and users. So, quality refers to 'non-SHEC requirements' like solidity, guarantees, materials, ingredients (including 'recipes' in the case of food products), technical sophistication, durability, design or after-sales service. Now consider Figure 2 which links (cost) prices to levels of quality in *L* and *H* (*ROW* is ignored).[12] Both countries

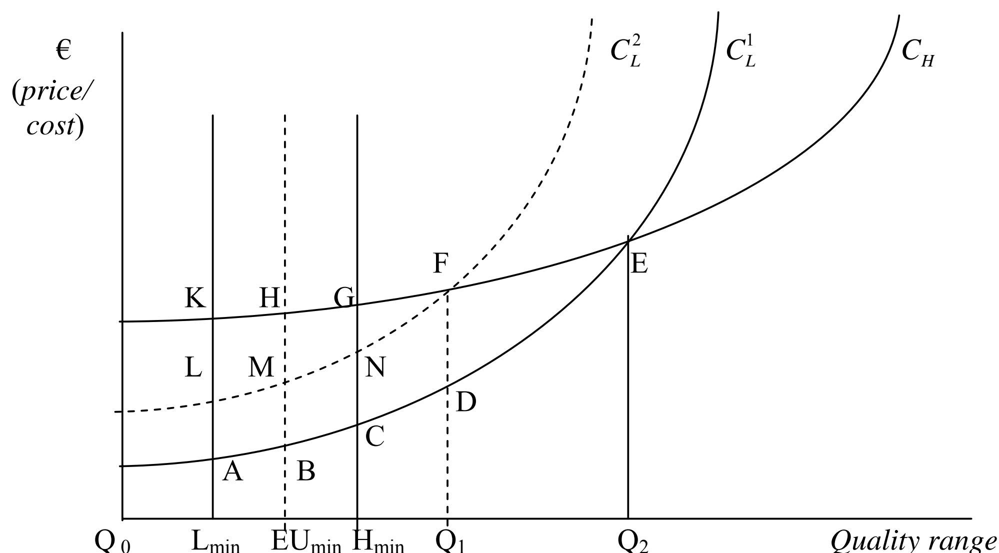
[10] Not seldomly, the barrier may have relaxed the cost minimisation discipline of external competition (so the stakes to keep it become more entrenched over time), or, indeed the barrier is fully endogenous, in the sense that regulators have been captured to 'tailor' the barrier so as to protect sufficiently.

[11] Clearly this was one fear behind the 'fortress Europe' campaign of the US in the late 1980s. In actual practice, one has to be careful to draw this conclusion. The ECJ has been quite liberal here: thus if *ROW* would obtain acceptance of its product in any member state of the EU, mutual recognition would apply in full throughout the internal market.

[12] Figure 2 (as adapted) draws from Abraham (1991) and Falvey (1989). Note that there is no volume in this graph.

have (different) minimum qualities $L_{min}$ and $H_{min}$. The price/quality curves are convex, expressing the idea that ever higher quality becomes increasingly expensive. However, it is dependent on soft and hard infrastructure as well as experience, given domestic preferences (themselves a function of per capita income levels), *H* is a typical high-cost producer in the low-qualities range (between $L_{\min}$ and $Q_2$) and *L* in the high-qualities range (beyond $Q_2$ or *E*).[13]

*Figure 2. Mutual recognition and quality signalling*




With intra-EU trade opened up, under regulatory barriers, *L* can sell in *H* only beyond $H_{\min}$ up to $Q_2$ (i.e. over *CE*) and *H* can sell in *L* only beyond $Q_2$ (or E). This squares with the notion that differentiated goods will generally sell in both markets.

Now mutual recognition is introduced. For simplicity we take this to mean that all qualities at or beyond $L_{min}$ can be sold in the internal market. For *L* producers, the extra business opportunity is to sell now in *H* in the $L_{min}$ – $H_{\min}$ (AC) range. Seizing this opportunity depends, however, on the effectiveness of the quality signal. Consumers in *H* may mistrust the lower price of the *L* product for lower quality compared to *H* products in the same range. This lack of confidence is caused by the disappearance of the *H*-testing mark or certificate, so that consumers have an information problem. Beyond $H_{min}$ this is less of a problem because *H* quality traditions are adhered to; still, convincing consumers of this very fact might require extra effort (for example, voluntary certification). In other words, *L* will need to invest in reputation-building or it would systematically ensure that its products are tested and certified to compliance with *H* standards.[14]

These efforts shift the $C_L^1$ curve to $C_L^2$. *L* producers will now sell in *H* any quality between $L_{\min}$ up to $Q_1$ (over LF) but lose competitiveness vis-à-vis *H* firms in the range *FE*. Another interesting effect has to do with the fear of a 'race to the bottom'. In Figure 2, the opposite

[13] Note that, compared to Figure 1, no (further) adjustment costs are assumed.

[14] Note that, here, there is no CE marking since this only applies to an EC directive. CE marking is completely independent from the (EU) country of testing & certification.

occurs – it leads to what David Vogel (1995) has called, 'trading up', a convergence to higher quality levels.

If, in contrast to the earlier assumption, we assume that SHEC objectives play a role to set a minimum quality (say, of safety; or an emission ceiling), then one obtains a combination of minimum harmonisation, and mutual recognition beyond it, based on quality. This could represent a stylised 'new approach'. In Figure 2, $EU_{min}$ represents the regulatory minimum, in the light of SHEC objectives, but this (often) says relatively little about the overall quality properties of machines, toys, etc. As shown, this could lead to the exit of producers in the very low-quality range between $L_{min}$ and $EU_{min}$. Whether this is a welfare loss depends on whether $L_{min}$ did or did not fully overcome the market failure.[15]

Analytical work in more sophisticated models is still scant and the results are not comparable because of disparate approaches. Box 1 provides a flavour of this kind of economic research.

The conclusion is that mutual recognition in homogeneous goods markets tends to be strongly pro-competitive whereas in differentiated goods markets there are likely to be forceful incentives for 'trading up', the opposite of a race-to-the-bottom. However, in models of imperfect competition (and given that mutual recognition requires equivalent objectives of domestic regulation, including reliable conformity assessment), there is scope for strategic quality games. In such games the competitiveness of low-cost, lower-quality suppliers might sometimes be affected.

*Box 1. Mutual recognition and imperfect competition*

Advanced economic analysis has ignored mutual recognition, with a few exceptions. In Lutz (1996) harmonisation and mutual recognition are compared in a model of vertical product differentiation, which builds on work by Shaked & Sutton (1982) and Ronnen (1991), for the two-countries case. Duopolistic firms face quality-dependent fixed costs and compete in quality and price in two segmented markets. When firms have identical cost functions, the introduction of mutual recognition yields the maximal sum of regional welfares, compared to harmonisation or 'no regulation'. A harmonised regulation, maximising the sum of national welfares, will lead to a reduction of welfare in *H*. But when costs of the *L* firms increase (and indeed increasing with higher quality, as in Figure 2), these results are partially reversed. Indeed, with a high enough cost differential, harmonisation with only one firm in the market is superior in welfare. The exit of *L* firms is in the overall (welfare) interest of the country. Lutz is capable of showing, be it in a highly stylised fashion, that entry deterrence by strategically choosing quality is possible (see also Herguera & Lutz, 1998).

A somewhat different two-stage game, with Cournot duopoly and two countries, is presented by Suwa-Eisenmann & Verdier (2002). It is an extension of the well known Brander & Spencer model (1985) and introduces a political support function (i.e. the government only looks at producers' interest). Mutual recognition is interesting once the 'institutional capacity' of *L* and *H* differs in supporting all that such recognition takes (in quality & conformance infrastructure) at low costs. This would tend to move implicit regulatory protection towards an asymmetric increase in the cost of *L* producers exporting to *H*. In other words, it favours *H* as if it were a tariff.)

[15] The problem with market failures, such as safety and health objectives, is that they are not independent from local preferences and income levels; hence, the risk/price preferences matter to some degree.

## 4. The costs of mutual recognition

After two decades of judicial MR and one and a half decades of a regulatory application of the principle in goods market, the picture emerging is one of great ambiguity.

On the one hand, there can be no denying of the great merits of introducing this innovative principle. Many instances of silly and de facto protectionist import bans have been removed. An entirely new approach to food law has been developed at EU level which is solely focused on SHEC objectives or effects, without – as a rule – specifying the individual products concerned. When the *quality* of goods – beyond 'essential' issues of SHEC – is concerned, the consumer disposes, based on mere labelling requirements (so as to remove asymmetries of information). Beyond food and beverages, it is possible to identify a range of goods market where MR applies. Based on the Atkins report for the Single Market Review (Atkins, 1998), it is estimated that nearly 50% of intra-EU goods trade are subject to MR and the rest is covered by the old and new approaches. Of the 50% covered by MR, some 20% refers to unregulated goods (say, teaspoons) and another 30% to nationally regulated ones (say, beer, pasta, carpets, etc.).

Yet, one has to answer the questions whether this figure means that 1) without MR these markets would not enjoy free movement?; or 2) with MR, do they enjoy unhindered market access? Both questions should be answered with a qualified 'no'. The completely unregulated markets would probably enjoy free movement without any problems. But the nationally regulated ones would cause higher costs of intra-EU trade or force local establishments or block trade. So, the identifiable gains should be looked for only in those markets. However, when question 2 is considered, it turns out that there are numerous practical problems in enjoying market access, even when MR should formally apply. These problems can cause a great deal of anxiety and uncertainty, and have indeed engendered a sense of disenchantment with the principle. We shall discuss the generic 'costs' of mutual recognition and what to do about them in the present section; a brief review of the belated strategy at EU level to reduce these costs is included as well. In section 7 the more specific costs that tend to fall on business are set out, with some examples from goods markets. There is also evidence that MR in those services markets where the principle could matter is little exploited by business.

Mutual recognition turns out to have fairly high information, transaction and compliance costs. Apart from some specific costs to business (see section 7), there are six reasons for these costs to be high. First, MR is not 'visible'. For a particular tradeable good in markets, MR is a distant abstraction. What makes it even more difficult is that the national rules in a country are usually well known and can be easily verified, yet they are overridden by this abstraction. It is obvious that in many cases such a configuration cannot be expected to lead to the required degree of legal certainty in day-to-day business throughout a big internal market trading many tens of thousands of goods. Perhaps one could best regard MR as a 'regulatory' principle with several layers: whereas the general principle will necessarily remain abstract, if only for its applicability in a wide variety of cases, the sufficient conditions for low-cost applicability amount to several layers of much more practical guidelines which should be easily verifiable. This is confirmed by the other five reasons for the generic costs of MR.

Second, there is no rule book for MR; indeed, if anything, MR applies the negative of a rule book. Clearly, for inspectors, certifiers and especially for traders themselves, this can be a drawback when one realises how fast modern markets and exchanges work. The EU authorities and possibly national ones as well could undoubtedly be pro-active at this 'lower' layer of MR. As we shall see, this has finally been realised by the Union during the last few years. Third, one important reason for the gap between the principle and its application in

day-to-day business is the lack of clarity about the equivalence of *effects*. The ECJ has always spoken about equivalence of 'objectives or effects'. Although objectives can cause difficulties occasionally, even when the leap to approximation is not taken, the interpretation of effects risks to (re-)introduce a good deal of the regulatory specifications that should be of little or no significance under MR. Hence, the importance of the new approach where voluntary standards deal with the effects in a useful but not restrictive manner. But where MR applies in the presence of some national regulation, the 'effects' clause creates a grey area which raises the costs of MR. Again, these costs can be reduced by pro-active policies. Fourth, the costs of monitoring are very high. It is out of the question to monitor each and every individual case of MR. The high costs of monitoring may even prompt strategic behaviour on the part of some authorities in some specific cases, not least when viewed in combination with the next drawback. Fifth, judicial review in the EU is slow because of the overload of the ECJ and the huge increase in the requested 'preliminary rulings' (not uncommon in MR cases). Of course, this drawback is not specific to MR, but the application and indeed the conduct of national regulatory authorities and testing/certification institutes are likely to be directly affected by it. Sixth, the application of MR has turned out to be much more complex than originally envisaged. The more complicated its interpretation and the more 'grey areas' and special cases, the more it approaches an EU-based regulatory system, whereas the idea is precisely to avoid EU rules and allow diversity to be combined with free movement. Once again, the complexity calls for a pro-active policy of information and lowering of transaction costs.

In discussing what the Union has done in order to lower the costs of MR, one should distinguish the activities and debates about *existing* regulatory barriers and the EU infrastructure about *newly emerging* regulatory barriers due to new legislation in member states.

As to the existing regulatory barriers, the doubts about the effectiveness of MR in goods markets began after the EC-1992 programme was completed. Following regular complaints from European business and an ad-hoc conference in Copenhagen between the Commission and European business on a Danish list of no less than 400 instances where MR had allegedly failed, two initiatives were taken to address the issues. The Molitor (1995) report on simplification of European regulation recommended that the actual benefits of MR were often outweighed by the costs of uncertainty, hence, approximation would often be better. The 1995 UNICE report took a similar stance. The Atkins report on technical barriers (1998) in the Single Market Review documents both deep scepticism amongst economic agents in markets about MR and analyses, in 7 case studies, how rarely MR works out the way (naive?) economists might be led to believe (see also section 7). A 1999 Commission report[16] finally acknowledges that MR requires a far wider, deeper and pro-active infrastructure in the single goods market to make it work. One can also infer from this paper that there is no, what I call, '*MR culture'* yet in the Union.

Such a culture would comprise at least three 'soft' but critical ingredients which are nowadays still lacking: 1) economic agents who are well-informed about the 'rights' MR implies for their business, trade or consumptive activities; 2) confidence between member states, and more specifically their various regulatory, inspection and/or certification agencies, about specifications and actual enforcement; and 3) incentives for whatever national bodies having a direct or indirect impact on free movement (under MR) to think and act 'European' rather than national – the point here is that the incentive structure is tilted the other way around. The

[16] COM (1999) 299 of 16 June 1999, Mutual recognition in the context of the follow-up to the Action Plan for the Single Market.

*information-confidence-Union-mindset* combination could do much to render MR far more effective. However, this requires deep and permanent investments and possibly some restructuring.

The Barcelona European Council (15/16 March 2002) asked the Commission to report (once again!) on technical barriers to trade. This signals a persistent concern about MR when it comes to the day-to-day enforcement in the single market. The Commission has opened the SOLVIT initiative in 2002 for infringement cases where the reason seems to be 'misapplication' of EC law in goods and services – often, a matter of MR. In May 2002, such cases numbered no less than 681![17] This is likely to be only the well known tip of an iceberg of unreported frustrations of free movement.

More specifically, the second Commission report on MR[18] comprises for the first time a much more pro-active approach with activities such as regular conferences and round tables, the publication of guides and guidelines and detailed case studies as the basis for common interpretation. At the same time this report testifies to the complications of MR in all areas. Nevertheless, the Commission is more adamant than ever to ensure better and more widespread compliance with MR, for the better functioning of the internal market.

The EU has done much better in permanently *preventing new regulatory barriers* from arising year after year. The infrastructure consists of a little known yet crucial committee, backed up by exceptionally strong information powers as well as strict obligations of member states to accept EU priorities in their national legislative processes. The 98/34 Committee (formerly known as 83/189 Committee) deals with all national draft laws having a bearing, actual or potential, on regulatory barriers in goods markets. The Committee does this *before* these drafts reach national parliaments and under automatic or discretionary 'standstills' (of the national legislation process) of anything between 3 and 18 months! Member states and the Commission give 'detailed opinions' if regulatory barriers are suspected or expected and, in any event, 'equivalence' and/or MR clauses have to be incorporated in every such law. In doing so, new regulatory barriers are nipped in the bud and MR is not only allowed to work, it is encouraged by explicit references to equivalence. In effect, therefore, the 98/34 Committee protects MR for all new laws of member states. Only in very rare cases where no equivalence exists will the Commission propose an approximation directive. With hindsight it is clear that this committee has rescued the functioning of the internal goods market. Without this infrastructure a singular focus on the existing barriers, even with MR, would have been hopelessly ineffective given the extremely high rate at which member states add new sources of barriers where MR could lead to uncertainties. The work of this committee also shows that a pro-active approach, based on firm powers, is the only way to render MR effective and (via equivalence clauses in national law) transparent.

The functioning of this low-key but critical committee has revealed to what extent member states have turned into 'regulatory machines' (see also Pelkmans, Vos & di Mauro, 2000, for detailed analysis). In recent years, the 15 member states have produced, year after year, some 650-700 laws and decrees (or non-trivial amendments of them), which have to pass the Committee. If that number is not sufficient reason to pause and wonder whether market functioning is genuinely improved by such a regulatory 'turnover', one ought to realise that (a) this only refers to goods markets,[19] and (b) member states are not allowed to draft laws in

[17] Internal Market Scoreboard, no. 10, May 2002, p. 10.

[18] COM (2002) 419 of 23 July 2002, Second biannual report on the Application of the Principle of Mutual Recognition in the Single Market.

[19] And a small category of 'information services'.

'approximated' markets, other than implementation of the directives.[20] So these 700-odd laws or decrees only deal with MR-type markets, covering a mere 30% of intra-EU goods trade! After 18 years of the operation, of this committee the beginnings of an 'MR culture' can be discerned. However, national instincts and incentives to come up with a lot of new regulation, year after year, remain forceful. It is also unclear whether the incipient MR culture in the committee spills over to the tackling of existing barriers where MR should apply. Fortunately, to the extent that the committee is a success, the area of existing barriers should no longer grow and a pro-active MR policy by the EU might become effective in lowering the generic costs of MR in those goods.

## 5. Mutual recognition in services markets

It took some time before mutual recognition came to be applied to services in the internal market. In 1979 – the year of the Cassis de Dijon ruling – the liberalisation of cross-border services had hardly begun and was therefore far behind the progress in goods markets. By the time the EC-1992 programme was designed, services had become more prominent and the question was rather how to tackle the many services markets that were regulated, and indeed differently regulated in different types of services markets.

The basics in the treaty looked like those in goods in that there is a clear obligation to remove restrictions on the free movement of services (Art. 49, EC; then Art. 59) and that non-discrimination is the rule. Like in goods there are derogations from non-discrimination (Art. 46, then Art. 56) and these tend to be narrowly interpreted by the ECJ. The analogy with goods also extends to the judicial approach to restrictions of a non-discriminatory kind in the 1991 Saeger case,[21] just like the famous Dassonville ruling of 1974 in goods. Hence, these restrictions should be judged from an economic perspective: restrictions "…liable to prohibit or otherwise impede cross-border services of the 'temporary' type" are not allowed. This economic approach covers measures affecting the ability to provide, those increasing the costs of the relevant service (a very wide-ranging prohibition, like in Dassonville), those discouraging its provision and those preventing consumers from receiving the service.

It is then a small step to introduce the Cassis de Dijon analogy, that is, the notion of judicial mutual recognition.[22] A member state cannot normally prohibit the provision, in its own territory, of a service lawfully provided in another member state, even if the conditions in which it is provided are different in the country where the service provider is established. As with goods this mutual recognition even applies in case of derogations as long as the legitimate objectives pursued in different member states are equivalent.

Nevertheless, it would seem that the practical economic significance of judicial MR in services is fairly limited. The wide derogations of Art. 46, EC and a host of other objectives (often under the 'general good' doctrine, a kind of rule-of-reason approach, developed by the ECJ) can be legally compatible with the treaty, even though free movement of services is thereby severely curtailed. The ECJ will verify this compatibility using three tests: a restrictive justification test (overriding reasons of public interests), a non-duplication test (for statutory conditions, if equivalent, already satisfied in the home country) and the proportionality test (barriers should be indispensable and least-restrictive). The ECJ approach

[20] Anyway, these are not notified to this Committee.

[21] Case C-76/90.

[22] The following paragraphs are based on an interpretative communication by the European Commission on the free movement of services, Official Journal EC, C 334 of 9 December 1993.

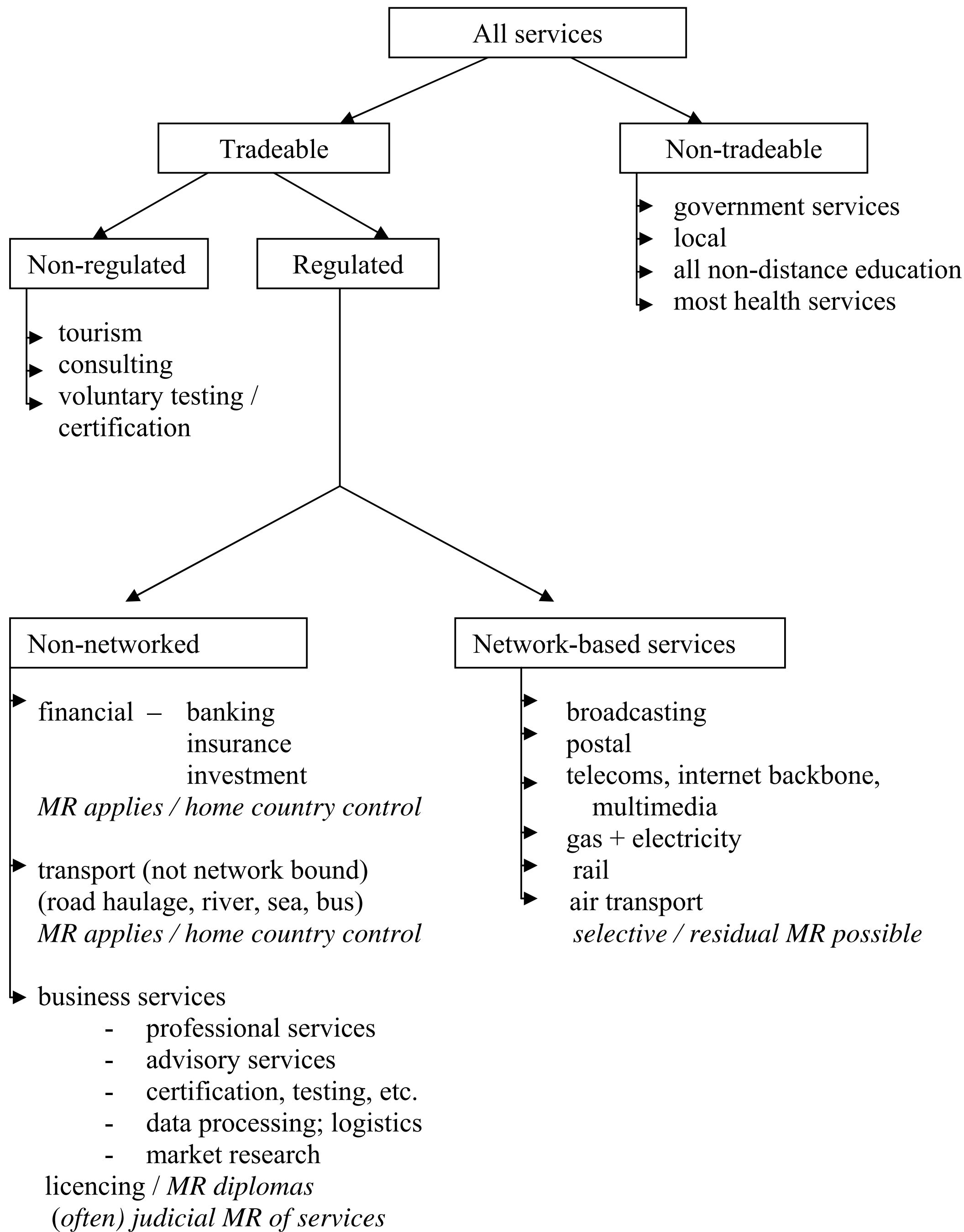
has helped to remove all kinds of arbitrary protectionism or overregulation. In and by itself, however, judicial MR and the compatibility tests of derogations have not resulted in truly free movement of services in most markets.

To understand why this is so, three crucial properties of services provision in the internal market should be considered. First, many services markets are regulated. Although judicial MR might sometimes suffice to obtain free movement, the information, confidence and transaction costs of MR are likely to be much higher in the case of services than for goods. Services are not storable and are also intangible, which renders it difficult to assess quality. Services are typically not search goods (the buyer can verify quality before consumption, as in goods markets) but either experience goods (evaluation of quality only possible after consumption) or credence goods (quality cannot even be assessed after consumption). Such markets tend to suffer from asymmetries of information and this can lead to a range of inefficiences (including moral hazard and adverse selection). Suitable regulation ought to ensure a proper functioning of such markets. The gradual establishment of the internal market for services in the EU has shown that the reduction of these costs of MR may require a regulatory approach to MR, that is, directives specifying the objectives and (main) effects, beyond which MR applies.

Second, most of the larger (non-governmental) services markets fall under special regimes in the treaty which assume priority before free movement of services (Art. 49, EC) applies. This renders services incomparable to goods trade in economic terms. Financial services, transport services (all six modes) and all services in network industries (including telecoms, broadcasting, postal and the distribution services of gas and electricity) have special articles or chapters in the EC treaty. All of these tend to be heavily regulated (both for services and for establishment) and a judicial form of MR cannot easily be expected to be workable. The internal market will require either far-reaching approximation of rules and supervision or regulatory MR or some combination of the two.

Third, the economics of services provision, such as the simultaneity of production and consumption of services (in many cases), the frequently inevitable proximity of supplier to the customer (both in B2B and B2C) and the importance of reputation and confidence, strongly suggests that the determinants of the volume and nature of cross-border services are not comparable to those of goods trade. Simply put, the formal removal of regulatory barriers may well prompt a much greater response in goods trade than in services trade, even if everything else were equal. But everything else is not equal in at least two respects: many services submarkets are characterised by some degree of market power (for reasons such as product differentiation, reputation, consumer loyalty, existing networks, etc.) and this is probably a greater obstacle to market penetration than in goods markets in a number of instances, and the incentives to substitute service provision through local establishment for cross-border provision is far stronger than in goods trade precisely because of proximity and confidence reasons.

*Figure 3. Services trade and mutual recognition*




Like in goods, mutual recognition applies only to a limited number of cases. However, in services there is no such thing as the 'old' approach of total and detailed harmonisation. It is true that, for a long time, the Transport Council was split on how much (intrusive) harmonisation would be required before free movement of transport services would apply but no decisions of the 'old' approach kind were actually taken. Once the Council had been convicted (!) by the ECJ in 1985 (on request of the European Parliament, *nota bene*) for its

failure to establish a common transport policy, as the treaty clearly prescribed, the EC pursued a 'new approach' with minimum approximation and mutual recognition (see below). Compared to the categorisation of goods trade falling under either judicial MR (unregulated or equivalence) or old approach (no scope for any MR due to uniformity) or the new approach (approximation only of 'objectives' and key issues of 'effects' if any; mutual recognition beyond it), a somewhat different categorisation is best used in services as Figure 3 sets out.

Whereas most goods are tradeable, there exists a large category of services which are not, including pure governmental services, local private services (e.g. a haircut, etc.), all non-distance education (a major sector) and a very large part of health services. The tradeable services have to be split into non-regulated services where MR is not necessary (such as tourism, the service sector with the biggest turnover in Europe, and business services such as consulting and voluntary conformance services), and regulated services. Regulated services, in turn, can be divided into network industries and non-networked services. The former services depend critically on physical or logistical networks with enormous sunk costs and are typically subject to public (or universal) service obligations. The liberalisation and proper pursuit of competitive cross-border services in network industries are complex processes and require sophisticated combinations of approximation, supervision (by 'regulators') and competition policy (see European Commission, 1999, 2000; Pelkmans, 2001b). Within strict limits, selective and /or residual instances of MR (e.g. of licensing) remain possible.

It is in the realm of non-networked regulated services that mutual recognition has regulatory and economic significance. Two distinct approaches are employed. In financial services and (non-networked) transport services, a regulatory form of MR, based on approximation of 'essential requirements', coupled with 'home country control' has been opted for. Home country control adds another innovative twist to the originality of mutual recognition. In financial services the EU has chosen to differentiate between the institutions supplying services (that is, banks, insurance companies and merchant banks and the like) and the services themselves. Knowing that approximation of the essential requirements of the services themselves might be very difficult and slow (indeed, a 'new approach' might be infeasible, as it certainly was in the mid-1980s, before the wave of financial innovation and large-scale application of IT to financial services), the financial soundness of institutions was tackled as follows. Approximation of the key rules for financial soundness and the obligations of national supervisors to verify this on a permanent basis were achieved (think of minimum capital, solvency, large (risk) exposure, etc.) and far-reaching cooperation about automatic access to detailed information between the national supervisors established, which provided a solid basis to allow these sound financial institutions to do cross-border business anywhere in the internal market (at a distance or via simple branches or support offices in the host country). No authorisation in the host country is necessary unless one changes to full subsidiaries. Thus, the bank or insurance licence in one member state becomes a 'passport' to do business all over the Union. The mutual recognition refers to the authorisation/supervision regimes amongst the member states so that confidence in country B in a financial institution offering services there but originating from country A can be based on the 'home country control' (under common rules, to be sure) in A. Close cooperation and information exchange among regulators iron out any remaining problems. Since the services are not approximated (except a part of consumer credits), one might ask whether judicial MR in the services themselves could not yield substantial cross-border business and, eventually, perhaps a process of regulatory competition facilitating a 'new approach' or market-driven convergence. The answer here is that the ECJ itself has made this very difficult by developing the 'general good doctrine' protecting a host of regulatory interventions by member states from free

movement.[23] Although this doctrine is now increasingly confined to B2C transactions – as asymmetries of information are much more serious there – the application of judicial MR to the services themselves has had little practical impact thus far.[24]

In road haulage as the dominant mode of non-networked transport services, the so-called common transport policy now realised consists of mutual recognition of the licensing based on approximation (hence, home country control as well) and approximation of the safety and environmental requirements of the vehicles (i.e. goods) and the driving times of the drivers. Free movement has turned out to be easy and indeed has been aggressively exploited, with steady growth of cross-border trucking ever since EC-1992. The major issue in road haulage is the appropriate allocation of user costs of infrastructure in countries refusing to have toll roads, which has nothing to do with MR.

In business services regulation is uneven, and generalisations are dangerous.[25] The present paper is not the place to analyse the problems. For the sake of comparison, however, one might say that the application of judicial MR is the rule, yet it has turned out to be exceedingly difficult in actual practice. Where licensing plays a role in these markets, mutual recognition tends to be of a different nature, namely based on MR of diplomas. There is an old and a new approach in diploma recognition but it is doubtful that either of them really facilitates cross-border provision, especially but not only in professional services.[26]

In conclusion, mutual recognition has been applied to services with ingenuity, based on analogous case law (as in goods) and the notion of 'home country control'. The sector where this has worked best is least known for MR, namely road haulage. The reason is presumably that regulation of services and firms in road haulage is relatively light, whereas truck regulation falls under goods rules. In financial services MR of 'home country control' has undoubtedly been a clever regulatory innovation, but it has served as little more than a necessary, not a sufficient condition to boost cross-border services provision. That 'deeper' regulatory commitments were required was recognised by all the EU players and lawmakers when the Financial Services Action Plan was adopted in 2000, for completion in 2005. As far as MR of financial services themselves are concerned, the 'general good' doctrine has been a far too-wide and almost open-ended inhibition of cross-border service provision. The limitation of the doctrine to B2C transactions is an improvement but the doctrine itself should be reconsidered. A third reason why MR in financial services is of limited economic significance has to do with the relatively great need for proximity to customers for reasons of trust, consumer loyalty and service quality. The link between FDI and service provision is therefore very strong.

This is also the case in business services. Nevertheless, in business services there are numerous opportunities for irregular cross-border services trade without FDI but the practical problems are still considerable. The link with diploma recognition for all professional services and some other ones as well, an array of local regulations, problems with FDI and a litany of obstacles about contracts for 'posted' workers (essential for occasional contracting), not to mention the reluctance of SMEs to complain, are amongst the more important issues.

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[23] See, for a revealing analysis two communications by the Commission in Official Journal EC C 209 of 10 July 1997 and *idem* C 43 of 16 February 2000.

[24] The reader is referred to the contribution by Piergaetano Marchetti in this volume as well as Hertig (2001).

[25] For a detailed analysis of barriers to cross-border trade see COM (2002) 441 of 30 July 2002 on the state of the internal market for services.

[26] See the chapter by Kalypso Nicolaides in Padoa Schioppa (2002).

Altogether, in services even more than in goods MR requires pro-active policies. It should be realised that there is no committee like 98/34 in goods and, until recently, the European Commission did not pay systematic attention to cross-border services problems. The member states, the regions and local authorities hardly display anything like a 'MR culture'. The underutilisation of MR and the lack of competitive challenge across borders is not particularly helpful for Europe's dynamism in services. Pro-active policies, embedded in an EU-driven infrastructure to follow this systematically, are badly needed.

## 6. Assessing regulatory competition

Regulatory competition between member states would seem to be a natural consequence of mutual recognition, under free movement obligations. MR will expose national regulation to the forces of arbitrage: consumers may choose between domestic regulation and that of any other member state by importing the relevant *goods or services*. To the extent that even production factors find it profitable to respond to regulatory differences, mutual recognition and free movement may induce cross-border *factor* flows. All this should improve welfare on account of greater variety and additional output in the EU. But, since mutual recognition is a static notion, no more than a one-time adjustment would take place.

Regulatory competition is dynamic and takes this process further. It is defined as changes in national regulation in response to the actual or expected impact of cross-border mobility of goods or services on national economic activity, itself prompted by MR (Sun & Pelkmans, 1995). Behind this alteration of national rules one may find complex business-government interactions. Jurisdictions with costly regulations may find businesses pressing for reductions in their regulatory burden when faced with import competition from jurisdictions with 'light' regimes. Alternatively, local businesses and governments may agree on strategic de-regulation with the aim of boosting certain activities in the internal market. Since this may also be practised, or responded to, by other member states, iterative processes of regulatory competition may develop. Where member states would *maintain* ambitious regulation, the costs will fall on that member state's economy; this can be interpreted as meaning that the local benefits of satisfying these preferences are more than worth the local costs. Quality or other non-price determinants induced by this regulation would make products from other jurisdictions poor substitutes, and hence would protect local business from suffering too much from import competition. When factor mobility is at issue, location benefits (after taking account of sunk costs of establishment) would apparently outweigh the benefits of relocation at the margin. The notion of regulatory competition implies that the maintenance of regulatory differences despite exposure to arbitrage would be economically justified in view of disparate preferences.

As a rule, however, one would expect a process of regulatory competition to induce 'market-driven' regulatory convergence in the EC. The condition for optimality is that this should *not* be allowed where negative externalities produce the relevant market failure as this would lead to fragmentation of the internal market or too low regulation (exposing the environment, for example, or failing to deal with discriminatory measures), but it would be suitable if information asymmetries or other 'internalities' are the problem. At the end of a process of regulatory competition, the market-driven convergence could be codified in essential requirements in EC approximation. This economic 'model' of regulatory competition can be shown to be of some but not great practical relevance in the EU (with respect, for example, to equivalence). There is also little empirical evidence that intra-EC regulatory competition does take place (e.g. Neven, 1996).

Initial fears in the Community that regulatory competition would create a 'regulatory gap' (Bourgoignie, 1987, pp. 171-172) or a race to the bottom have not been borne out. This is indeed what proper understanding of mutual recognition – the prerequisite of regulatory competition – would lead one to expect. After all, mutual recognition only applies if the objectives or effects of regulations in different member states are equivalent. A race to the bottom, removing regulation justified by market failure would clearly violate the equivalence test. Perhaps it may well work the other way, at times, as Vogel (1995, 1997) and Genschel and Pluemper (1997) attempt to show, namely pushing regulation 'upwards', especially in environment and food law. This 'trading up' prompts the question whether it indicates a regulatory failure, ex-post, or a failure to tackle a market failure, ex ante. If the political economy is not disciplined by regulatory quality requirements, there is a risk that regulatory failure may occur, that is, overregulation beyond what is needed to overcome the market failure.

A cost/benefit analysis of regulatory competition in the internal market is best made in comparison with that of EU regulation (here, approximation). However, it is crucial, in such a comparison, to compare regulatory competition *not* with the 'old approach' (and easily declare victory) but with the new approach.

Table 3 summarises the main costs and benefits of EU regulation and of regulatory competition (cf. Sun & Pelkmans, 1995).

The three benefits of regulatory competition are often mentioned and presumably require little elaboration. The third one, inspired by a Hayekian view of competition, is difficult to evaluate. I would submit that its empirical significance is so unclear that it leads to extremely difficult policy dilemmas. Its appeal is perhaps more relative than absolute, that is, in cases where the costs of regulatory rigidity (e.g. product harmonisation before 1985 in the EU) are evidently very high, or where radical reform is going to prompt upheavals and far-reaching adjustment anyway (e.g. EU telecoms before 1998), risky experiments and liberal processes of 'discovery' tend to become more acceptable.

*Table 3. EU regulation and regulatory competition: Costs and benefits*

| Costs | Benefits |
|---|---|
| **Regulatory competition** | |
| 1. Open-ended and distortive<br>2. Sub-optimal regulation (too little, or, too much)<br>3. National regulatory drift | 1. Greater choice of regulation<br>2. 'Disciplining effect' on national regulatory systems<br>3. Strategy for discovery, experimentation and innovation |
| **EU regulation*** | |
| 1. Regulation disproportionate to market failure<br>2. Rigidity, once in place (esp. before EC-92) | 1. Removal of distortions, with (more) certainty for business<br>2. Flexibility (with EC-92), through various modes, intensities and differential scope |

* Used here to mean approximation.

The costs of regulatory competition may well be considerable. Sun & Pelkmans (1995) show by means of a detailed decomposition of the process in the EU as well as illustrative case studies (one for goods, one for services) that regulatory competition may well be open-ended

and distortive. Also, the well known argument that too little regulation may result should not be dismissed, in contrast to the conclusions of Siebert & Koop (1990) and Oates & Schwab (1988). The point is that regulatory competition is not the same as fiscal competition where a 'race to the bottom' might never occur under 'fiscal equivalence'. Insufficient regulation will allow the re-emergence of the market failure which regulation was originally designed to overcome. Similarly, too much regulation may occur as Peltzman (1976) has shown.[27] Finally, alteration of laws as a means of discovery has a price, quite apart from possible distortions, namely national regulatory drift. An extreme example is the drift in US state liability laws in the 1980s and early 1990s where hundreds of changes created great uncertainty, so much so that some markets failed or collapsed.

Shifting to the costs and benefits of EU regulation, it should first be noted that the picture here has changed quite radically since the mid-1980s. The *relative* attraction of regulatory competition has decreased since the new regulatory strategy of the EU has come to be accepted. The strategy has no doubt reduced the two types of costs in Figure 3: the highly detailed and otherwise excessive regulation, often disproportionate to the market failure (but pre-1985, under unanimity, inevitable for the free movement in such products), and the rigidity, once EC directives were in place).[28] With minimum approximation, only of objectives ('essential requirements'), reference to voluntary standards [29] and options to comply even with the help of other standards, the dated anecdotes about the jam or chocolate directives or the hill-farming tractor directive no longer form the benchmark to compare regulatory competition with.

On the benefit side, the first one (removal of distortions) has probably not changed in nature, yet drastically in scope. Beginning with the long delayed, proper implementation of the 1973 low-voltage directive in the early 1980s, EC-1992 has enormously widened the range of products benefiting from free movement with often fairly 'light' and flexible directives. This change was a function of the wide product scope of crucial EC-1992 directives (e.g. toys, machines, electro-magnetic compatibility) and some horizontal ones (e.g. product liability), as well as the sheer number of industrial and agricultural product directives (some 160). Also, the flexibility of EU regulation has greatly improved, after the bitter and costly lessons from the past had been learned. In fact, a conscious differentiation has taken place amongst a wider range of partial or complete alternatives, such as a greater reliance on framework directives, sunset legislation, Council recommendations with a call for (constrained) self-regulation, etc. In regulations (unlike a directive, an EC regulation has direct effect throughout the Union and is, in that sense, 'centralist'), regional or national differentiation has also been introduced to a greater extent.

The most interesting aspect is perhaps that regulatory competition and EU regulation act as *complements* in all cases where SHEC objectives justify regulation. So, the upper and lower panels of Table 3 are no longer independent in a large number of cases of products and services. To understand this, remember that, beyond the 'essential requirements' in EC directives, regulatory competition is allowed, if not implicitly encouraged. Unless a blocking minority insists on detailed specifications of 'essential requirements' (which has become rare,

[27] For example, US state regulation of registered nurses. However, these state rules were affecting inter-state free movement, which is not in keeping with the MR principle in the EU. Perhaps a comparable example consists of the packaging law in EU countries.

[28] This rigidity was a result of the excessive detail in the directives, and the heavy procedural obstacles to non-trivial changes (see Pelkmans, 1990, for elaboration).

[29] And a widespread shift from design to performance standards.

except in the environmental field), *the threat of regulatory competition exercises a disciplinary effect* on national regulators. Qualified majority voting and the no-frontiers accomplishment make this threat credible. This permanent discipline has been identified as a great strategic advantage in section 2.

## 7. Business' ambivalence about mutual recognition

It is well known that business has a Janus face when it comes to regulation and protectionism. Particular barriers protecting narrowly defined product markets may be strongly preferred by specific interests whilst, at the same time, joining the overall lobbying against 'overregulation' and barriers in the internal market. In this sense one can almost never speak of one consistent business view. Even when this caveat is taken into account, however, it would seem entirely appropriate to call attention to the deep ambivalence business in Europe has developed about mutual recognition. With analogies of peeling an artichoke or sailing to the horizon on a big ocean, business expresses the sentiment that mutual recognition appears to be a promise which materializes in actual practice only very slowly. It is often suggested that MR has to be 'conquered', almost case by case, and is therefore not so radically different from approximation. Such utterances tend to be heavily biased towards the remaining problems since, where MR functions or approximation is satisfactory, nothing is heard. Given the practical difficulties of measuring the progress in applying the principle in so many submarkets in goods and services, the voices of frustrating are not put into perspective by a clear overall picture. Nevertheless, the problems business still encounters on a daily basis are simply too serious to be ignored or belittled. It is also narrow-minded, indeed costly, to have a mythical confidence in the judicial and enforcement system of the EU as the sole source of removal of the many barriers as the Internal Market Scoreboards and a range of legal sources testify.[30] Much more cost-effective would seem to be the regular 'package meetings' the Commission holds with each one of the member states where numerous instances of non-application of MR can be resolved.

This section aims to illustrate the market realities of MR for business. After a few short examples from the Atkins report, (Box 2), three cases in goods markets will be presented with a little more detail, followed by illustrations from the markets for business services. These illustrations help to understand the sharp contrast between the praise for an innovative principle and the scorn from business in Europe when entering markets.

The case studies summarised from the Atkins (1998) report in Box 2 give some impression of the uphill struggle one faces if one would insist on the right of free movement and market access. Zooming in on three other examples only confirms the complexity of MR application and helps one to appreciate the scepticism in business circles. All three are markets with considerable turnover and anything but marginal or exceptional.

[30] For a survey and trends of infringements, other compliance problems and financial sanctions by the ECJ, see Pelkmans, Gros and Nuñez Ferrer (2000, Chapter 3).

*Box 2. Case studies of mutual recognition in the EU*

| | |
|---|---|
| Electric cables | No formal barriers, but a private mutual recognition agreement between selected certification bodies having a 'monopoly' in each of the 16 member countries (so, not the Global Approach for conformity assessment accompanying the 'new approach' of approximation, and presumably anti-competitive, the main motive being quality, but this could "raise rivals' costs" unduly). |
| Cement | Little cross-border trade because of regulatory and non-regulatory barriers (hence, complex infringement cases, one by one) and a cartel severely limiting cross-border trade discovered in 1998; solutions to be found under the Construction Product Directive which moves very slow because of building codes (etc.); it implies that MR is partly substituted by approximation and common standards. |
| Pesticides | Strong technical barriers; high costs of compliance; MR does not work and neither does approximation (in 1996/97). MR here is legal fantasy. The only reason that goods are not approximated is disagreement among member states precisely about 'essential requirements'. |
| Carpets | Regulatory (fire-testing) and non-regulatory barriers; high compliance costs; MR does not work but embryonic private MR agreement now exists. |

*Source*: Atkins (1998).

The first case is 'fortified food or drinks'.[31] Typically these products claim to provide extra energy (e.g. for sports) or vitamins or otherwise to be good for health. The central problem here is 'non-equivalence' of objectives or effects (mainly the latter) between member states. So MR cannot work fully. Approximation had failed at least up to 1998. The elegant triptich of the EU's regulatory system (free movement through prohibitions to member states; mutual recognition; approximation) breaks down and a seemingly chaotic battery of restrictions fragments the internal market. Non-equivalence is hard to tackle via the ECJ because the scientific evidence of 'effects' is unclear and in such cases the ECJ gives the benefits of the doubt to the country imposing restrictions. The inconsistencies are many. Take margarine: whereas France applies a ban to fortification, it is compulsory in the Netherlands! In many product categories there are labelling problems since the claims about health or other effects are often hard to substantiate. Member states differ in drawing the line between permissible claims and misleading ones. Parallel imports are usually not tightly controlled – giving the impression that MR does work – but this can prompt liability claims. Yet another inconsistency is that some member states employ positive lists and other ones negative lists.

Bicycles is a second case.[32] Until recently the internal market for bicycles did not function properly. Unlike cars, there is no technical approximation (neither 'old' approach like in cars nor 'new' approach) for bicycles. But MR was not allowed to work well either. The greatest problem is that national standards (which are, by definition, voluntary) in France and the UK

[31] Drawn from Atkins (1998).

[32] The Internal Market Scoreboard no. 10, May 2002, pp. 21-23.

have been referred to in domestic laws as compulsory. In Germany, with greater subtlety, exactly the same effect resulted because product liability insurance requires retailers to provide a 'voluntary' certificate of compliance with the DIN standard. The Danish concerns about theft go so far as to impose an obligation for an indelible mark/stamp for purposes of traceability. Since this creates problems for the import of painted bikes (it is costly to paint separately on location of sales), it serves as a regulatory barrier and would be convicted by the ECJ. After several decades of growth, partly as a result of innovation (mountain bikes, etc.), demand is stagnating and the threat of import competition from East Asia has increased. In the second half of the 1990s, the EU imposed anti-dumping duties. Some trade diversion was captured by EU producers behind these duties and a (high) tariff of 15%. It would seem that the mounting evidence of weak competitiveness of the Union's bicycle industry and an awareness that some barriers might not be enforceable once tested before the ECJ have finally prompted action, driven by the largest intra-EU exporter, Italy. A consistent application of MR would lower the cost for the industry and thereby enhance competitiveness. The approach taken is interesting. While avoiding approximation, mutual recognition will be based on the withdrawal of national standards but only once a European (CEN) standard is agreed (which is expected). This standard is given legal force by publishing it under a general directive for safety which serves as a fallback for instances where there is no product-specific directive.[33]

The third example is about the Danish beer fortress. In the internal market for beer, MR might be believed to have prevailed ever since the famous 1987 case against Germany (and, little known, Greece as well). Not only is MR merely a necessary, yet far from sufficient condition to penetrate national beer markets (because of anti-competitive structures due to ownership or tied-finance-and-exclusive-distribution of beerhouses contracts as well as numerous anti-competitive conduct cases and problematic mergers), dubious restrictions have long remained in place that make a mockery of mutual recognition. The celebrated case is what can be denoted as the Danish beer fortress. Ever since Denmark became an EC member state (1973), several laws have been introduced creating cost-raising barriers for beer exporters from other Union countries. The Commissions' vigilance prevented these measures from taking effect or ensured their withdrawal. The measures were also seen as suspect because in those days Denmark had a tight duopoly of Tuborg and Carlsberg with a joint market share at home of over 90%. The ingenious attempt to create a new regulatory barrier in 1981 proved harder to fight because it was tied up with an environmental cause: beer (and some other beverages) could only be sold (hence, also imported) in reusable bottles, thereby blocking all canned beer imports and significantly raising costs for importers of bottled beers. It would go too far for the present illustration to enter the details of this case. The crux of the matter was whether environmental objectives could serve as a derogation of free movement (based on MR). But three circumstances spoke strongly against this: the clear protectionist intent (shown by this law being another attempt in a series), the fact that it was not least-restrictive (violating proportionality) and, worst of all, shielding a tight domestic duopoly (soon to alter into a monopoly due to a merger). Also, the distortive effect was demonstrated when the duopoly continued to produce huge exports of canned beer for the internal market while its competitors could not sell canned beer in their Danish home market. The ECJ, in a stunning ruling, allowed the derogation in 1988 despite strong evidence in the Cecchini report (published five months before the ruling!) of the import blocking effect of the law.[34] The protectionist intent was moreover proven by the lifting of the law during a long strike at both

[33] The General Safety directive 92/59 (Official Journal EC L 228 of 11 August 1992, as amended (see proposal in COM (2001) 63 of 2 February 2001).

[34] See MAC (1988), esp. pp. 368-394.

Tuborg and Carlsberg in 1985/6 when imports dramatically increased, only to reduce to close to zero once the strike was over and the law restored. Was the environmental objective no longer valid during the strike? It was only in 2002 that Denmark finally agreed to accept imported beer not packaged in reusable bottles. This case shows clearly that MR requires extreme vigilance by the EU authorities and does not preclude clever instances of regulatory capture.

Mutual recognition in services equally requires deep supervisory investment and vigilance. In the Commission's view services 'are much more prone to Internal Market barriers than goods and are harder hit'.[35] A compact but incomplete explanation is insightful: 'Because of the complex and intangible nature of services and the importance of the know-how and the qualifications of the service provider, the provision of services is often subject to much more complex rules covering the entire service activity than is the case for goods. Furthermore, while some services can be provided at a distance, many still require the permanent or temporary presence of the service provider in the member state where the service is delivered. Whereas with goods only the goods themselves are exported, in the case of service provision it is often the provider himself, his staff, his equipment and material that cross national borders. As a result some or all of the stages of the business process may take place in the member state where the service is provided and be subject to requirements differing from those in the Member State of origin. This also means that barriers at a single stage of the business process cannot be looked at in isolation; their cumulative impact throughout the service activity must be considered' (*idem*). Note that this worrying conclusion refers mainly to business services, the category at the bottom of Figure 3 where the application of MR should be expected to work.

The present paper is not the appropriate place to delve deeply into the maze of restrictions and the scope, actual or potential, for effective application of MR to business services. An arbitrary selection of examples might hammer home the point that much remains to be done to exploit MR.[36] At the same time it also means that the permanent welfare gains to be had from exposure to greater competitive pressure from cross-border origins should be quite significant.

Although monopolies are (now) rare in business services, all kinds of sweeping restrictions remain with analogous effects such as numerus-clausus rules for geographical areas, territorial restrictions or even a single-establishment obligation (medical laboratories in a member state) which implies the giving up of an establishment in the member state of origin! Authorisations and registration requirements tend to be annoying, unnecessarily costly or next to prohibitive. Duplication (hence, going against the ECJ jurisprudence, see section 5), multiplicity (bakeries in one country tend to become a 'collector' of licences because licences do not refer to the nature of the business but to many individual products), long duration, too much discretion of the part of local authorities and recommendations from bodies made up of local competitors (!) are amongst these barriers and would appear to express the very opposite of a 'mutual recognition culture' that the internal market for services requires. Because of the need to employ local establishment the very considerable fiscal problems of cross-border business, precisely for SMEs without professional fiscal departments, should not be underestimated.[37]

[35] Quoted from COM (2002) 441 of 30 July 2002, p. 6.

[36] All examples taken from the paper quoted in preceding footnote.

[37] See, for a detailed analysis, SEC (2001) 1681 of 23 October 2001, a special Annex on Company taxation in the internal market, of COM (2001) 582 on the strategy paper 'Towards an internal market without obstacles' of the same date.

Similarly, because cross-border services by nature often involve temporary work across borders, the actual profitability of a contract is more often than not dependent on the extremely restrictive treatment of 'posted workers' where disproportionate requirements and duplication seem to be viewed as legitimate. If, in addition, companies make use of workers from employment agencies, additional difficulties may arise.

Insofar as professional services are concerned, not only the cumbersome MR of diplomas amounts to a severe obstacle but frequently a range of additional, often subtle barriers flowing from codes of conduct (self regulation of an anti-competitive nature) as well.

The consequences of these practices fall disproportionately on SMEs and on users who (rightly) take free movement serious. Practices are resistant to change because companies, especially SMEs, shy away from litigation against local authorities. This leads to what the Commission calls 'arrangement practices' (not seldom with local competitors) or evasion ('black market strategies'). It goes without saying that a lot of cross-border business simply gets discouraged by the number and arbitrariness of the barriers.

All the illustrations, even if selective, feed the ambivalence of business about mutual recognition. Much as they would like to compete across borders and deepen the economic meaning of the single market, firms find themselves unwillingly appointed as the guardian of the treaty (here, free movement under MR), chasing violations at their own costs. For business the legal access to national markets represents only one among several possible costs of gaining market share, besides different tastes, other marketing strategies and perhaps different pre- and after-sales service. Given the costs and uncertainties of MR in some goods and many services markets, the risks of testing MR are simply not assumed and what ought to be a single market remains too often fragmented.

## 8. Conclusions

Mutual recognition has taken root in EU law, policies, enforcement and, at least for goods, infrastructure. The introduction of mutual recognition has induced a focus on essential requirements, thereby reducing the intrusiveness of approximation or avoiding any EC directive altogether in thousands of cases. Indeed, as section 2 shows, the great strategic advantages of MR can be found in the systemic upheaval it prompted in the regulatory system of the EU. These strategic advantages are worth spelling out once again: a much more rapid realisation of the internal market, severe constraints to overregulation by member states, additional disciplines on national regulators by the further option of regulatory competition and a search for 'best practice' regulation among member states, whether for national purposes or for directives. In addition, the direct 'welfare' benefits are likely to be considerable as MR is pro-competitive, without sacrificing essential regulatory objectives such as health, safety, environment and consumer protection. Only in cases where quality is extremely demanding, a risk might exist that the needed investment in reputation is so costly that entry barriers are even strengthened in the internal market. The conclusion is that mutual recognition is highly beneficial and many of the gains are permanent.

Nevertheless, the application of MR in the internal market for goods and services is not an unambiguous success story. Applying the principle turns out to have fairly high information, transaction and compliance costs. We identify six cost elements including, among other things, the abstract nature of MR when inspectors or indeed business itself are confronted with well specified national law which might be overridden by this 'invisible' notion, the absence of a 'rule book' for MR for market participants, the lack of clarity about the 'effects' (much more than 'objectives'), the very high costs of monitoring, the low speed of EC judicial review (which invites strategic or opportunistic behaviour) and the increasing

complications in MR interpretation, especially in services. Focusing on existing barriers, lowering these costs has not been aggressively pursued by the EU until very recently. When it comes to the prevention of new regulatory barriers, the picture in goods is completely different: for 18 years now and with increasing effectiveness, a low-key committee stops member states from further fragmenting the internal market. This highly valuable piece of infrastructure does not exist for services.

Mutual recognition covers about one-half of intra-EC industrial trade, but it only matters for the 30% of intra-EC trade for which national regulations exist. A selection of examples, some with considerable detail, illustrates the practical problems for business when relying on the MR principle. Business in Europe is disenchanted about MR as it works out in actual practice. Firms find themselves unwillingly appointed as the guardian, or at least front soldiers, of the treaty, chasing violations at their own costs. Although hard overall figures are not available, the situation in services is probably graver. As Figure 3 clarifies, there are many tradeable services where MR is pointless or of very limited significance. In financial and business services, it applies but leaves much to be desired for reasons of information, compliance and the crucial meaning of a link with FDI in services. In road transport, MR works well and is exploited dynamically. The analysis also explores the role regulatory competition could play, as a dynamic complement to MR. Compared with the 'new approach', expectations should not be set high because regulatory competition may well be distortive and because in actual practice, it cannot fully substitute for approximation (due to the lack of 'equivalence').

The manifold benefits of MR for Europe are too great to allow the present ambiguities to continue. The EU needs much more pro-active approaches as proposed in recent Commission documents and should create permanent monitoring infrastructures for MR in services. Above all, what is required can be called the development of a 'mutual recognition culture'. Such a culture would have to improve and deepen the triptich of *information-confidence-Union mindset* for national policy-makers and compliance officers. It is in that spirit that the new Commission and other initiatives should be assessed so that the Union can better enjoy the fruits of its own regulatory ingenuity.

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