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Unmasking Mutual Recognition: Current Inconsistencies and Future Chances

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The principle of 'mutual recognition' is almost universally acclaimed for removing barriers to trade (e.g., within the EU), for enabling regulatory competition, and for preserving scope for regulatory autonomy instead of embarking on a path to harmonisation and centralisation. Through the analysis of the application of 'mutual recognition' within the EU (by using economic theories of legal federalism and regulatory competition), we show that this principle leads to a number of serious inconsistencies and problems, which question its suitability as a conflict of law rule that leads to a stable allocation of regulatory powers within a two-level system of regulations. 'Mutual recognition' should be understood more as a dynamic principle, which triggers a reshuffling of regulatory powers between different jurisdictional levels. It leads either back to the country of destination principle, to a free (internal) market for regulations, or to harmonisation and centralisation. In particular, the European experiences suggest that the introduction of a regime of 'mutual recognition' seems to be primarily another path to convergence and harmonisation instead of being an instrument that preserves decentralised regulatory powers or even regulatory competition.

1. Introduction

Since the *Cassis de Dijon* judgement of the European Court of Justice (ECJ)[1], the application of the principle of mutual recognition has been one of the most important strategies for overcoming manifold barriers to the fundamental economic freedoms in the European Union. National regulations, such as rules on safety, health, environment and consumer protection, have been qualified as non-tariff barriers to trade and, therefore, may be declared contrary to the principles of free movement of goods, freedom of establishment and free movement of services enshrined in the EC Treaty. However, national rules may be justified if they satisfy four conditions: i) foreign firms and domestic firms must be treated equally; ii) the rules must be justified by reasons of public interest; iii) the rules must be necessary to attain the public interest goal aimed at; and iv) they must be proportionate to that objective.[2] In many cases, public interest goals are thought to be adequately protected by the regulations of the export state and hinder the import state from imposing stricter standards. This principle of mutual recognition has meanwhile expanded from the area of free movement of goods into the areas of right of establishment, freedom to provide services, and even to safety and security.[3] Mutual recognition has also been discussed as a promising strategy to overcome trade barriers outside the

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[1] Case 120/78, *Rewe-Zentrale AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649. The country of origin principle was more explicitly developed in case 113/80, *Commission* v *Ireland* [1981] ECR 1625.

[2] Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165.

[3] In its *Gözütok and Brügge* judgement, the ECJ concluded that every Member State should accept the application of the criminal law of another Member State, even if its own criminal law would lead to a different outcome (Joint cases C-187/01 and C-385 /01, *Gözütok and Brügge* [2003] ECR I-1345).

EU, e.g., on the global level (WTO) or bilaterally between the USA and the EU (Weiler 2005, pp. 58-59; Nicolaidis/Shaffer 2005).

The rapid expansion of the principle of mutual recognition principle has not been without its critics. Despite the almost universal acclaim that mutual recognition has received, the principle has contributed only modestly to the actual achievement of free movement in the internal market. Businesses have deplored the large degree of uncertainty in its application resulting in high transaction costs (Pelkmans 2005). The precise content of the principle of mutual recognition is often only decided in the case law of the ECJ, which has not developed rapidly and smoothly enough. This has led to proposals favouring harmonisation measures. Recently, the proposal of the Services Directive[4], which intends to eliminate the remaining barriers that prevent service providers from extending their operations beyond their national borders, faced strong opposition. Many concerns were voiced regarding the social repercussions of mutual recognition of national regulations, such as its consequences in the area of health services. These criticisms have led to a highly attenuated version. This debate shows that a major challenge for the future of the European Union is the question how the increasing tension can be solved between market integration and the preservation of regulatory autonomy of Member States, allowing them to independently develop economic and social policies.

In the Law and Economics literature, it is widely acknowledged that the introduction of the rule of mutual recognition is a very important device for enabling regulatory competition. There is still much controversy whether such regulatory competition is to be evaluated positively as a 'race to the top', or rather negatively due to potential 'race to the bottom' problems. Another discussion concerns the question to what extent the introduction of mutual recognition is sufficient to trigger a dynamic process of regulatory competition. There is a broad consensus, however, that mutual recognition is an appropriate, but perhaps not sufficient, institutional precondition for regulatory competition.[5] Particularly, the proponents of regulatory competition have assessed the introduction of the principle of mutual recognition very positively. They view mutual recognition as an important measure for triggering beneficial competition among regulations, leading to more innovative and efficient rules and less regulatory capture. Mutual recognition is also positively evaluated as a strategy that overcomes non-tariff barriers to trade without having to embark on a pathway to harmonisation, and that protects the regulatory competences of the Member States against centralisation (e.g., Siebert/ Koop 1990; Pelkmans 2005).

This paper takes a more critical view on the principle of mutual recognition. We do not deny that the strategy of applying mutual recognition was very helpful to overcome the traditional structure of national regulations with its many barriers to trade within the EU. We also acknowledge that the principle of mutual recognition can contribute significantly to the removal of barriers to trade in other regional areas and on the global level. However, we will show that the rule of mutual recognition is neither an appropriate rule for enabling a sustainable process of regulatory competition nor an effective device for impeding processes of harmonisation and centralisation. The serious inconsistencies and problems that ensue from the application of the rule of mutual recognition leads to the conclusion that this principle does not ensure a stable allocation of regulatory powers in the European two-level system of regulations. On the

[4] It is also called Bolkestein Directive, named after the former Commissioner for Internal Market Affairs. The final text is Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on services in the internal market, OJ 27.12.2006, L 376/36.

[5] See, e.g., Sun/Pelkmans (1995), Streit/Mussler (1995), Van den Bergh (2000), Pelkmans (2005, 2006, pp. 65-68), and the contributions in Esty/Gerardin (2001) and Marciano/Josselin (2002).

contrary, the introduction of mutual recognition seems to initiate a dynamic process of reshuffling regulatory powers, either (1) back to the Member States (country of destination principle), or (2) to harmonisation and centralisation, or (3) towards a free market for regulations (free choice of law). The experience within the EU suggests that the introduction of mutual recognition has mostly led to a process of harmonisation and centralisation of regulatory powers. An appropriate assessment of the principle of mutual recognition must also take into account the potentially large costs through the loss of decentralised regulatory powers. From an economic perspective, only a comprehensive analysis of all advantages and disadvantages of centralisation and decentralisation may show how the trade off between the advantages of an internal market and the advantages of regulatory autonomy should be dealt with.

The structure of the paper is as follows. Section 2 briefly depicts the introduction and evolution of the rule of mutual recognition in the case law of the ECJ and in European Regulations and Directives. Section 3 analyses the main inconsistencies and problems of the rule of mutual recognition, which impede its suitability as a rule for regulatory competition and for governing the allocation of regulatory powers. For explaining these criticisms a theoretical framework of a two-level system of regulations is used, and a number of examples taken from the field of consumer protection laws and the regulation of health care are analysed. The most important conclusions can be found in section 4.

2. Mutual recognition in European law

The EC Treaty sets out the basic principles of free movement of goods, persons, services and capital in broad terms, which receive more concrete contents in judgements of the ECJ. National legislative measures contrary to these four economic freedoms may be declared non-applicable to transactions in interstate trade. Besides this so-called ‘negative integration’, initiatives may be taken to harmonise diverging national laws in order to achieve ‘positive integration’. The principle of mutual recognition has its foundations both in this case law and in a non-judicial phase of legal evolution consisting of, *inter alia*, the White Paper of the European Commission and the so-called new approach to harmonisation.

2.1. Free movement of goods

With respect to free movement of goods, the EC Treaty contains a prohibition of quantitative import restrictions and measures of equivalent effect (Art. 28 EC) and an exhaustive list of derogations (Art. 30 EC). The degree of liberalisation brought about by the prohibition crucially depends on the interpretation of the notions in Articles 28 and 30 EC. On the one hand, the ECJ has given a broad, economically inspired, interpretation to the notion of 'measures of equivalent effect'. On the other hand, the ECJ has expanded the list of exceptions which may justify restrictive national regulations.

In the *Dassonville* case (1974), the ECJ clarifies that the notion of 'measures of equivalent effect' covers all non-tariff trade barriers or regulatory barriers, by providing the following definition: "all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade".[6] For example, national measures of consumer protection, such as rules on the composition of foodstuffs, information duties,

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

rules on advertising and prohibitions of unfair trade practices, can be seen as 'measures having equivalent effect' to quantitative restrictions. The *Dassonville* jurisprudence considerably expanded the number and type of cases in which a Member State is required to justify its regulations (Weiler 2005, p. 42). Given the exhaustive list of derogations (Art. 30 EC) this implied a dramatic reduction of the scope of Member States' regulatory autonomy.

However, in the *Cassis de Dijon* judgement (1979), the ECJ has created scope for additional exceptions to the principle of free movement by introducing a 'rule of reason' approach. In addition to the list of explicit derogations provided for by Art. 30 EC Treaty, the ECJ has created an open list of so-called mandatory requirements which may justify non-discriminatory measures of equivalent effect to quantitative restrictions: "Obstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the products in question must be accepted in so far as those provisions may be recognised as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer."[7] In later judgements, the list of mandatory requirements of general interest has been substantially expanded[8] and more exceptions to the principle of free movement may be added in the future.

In the *Cassis de Dijon* case, the ECJ famously preaches the rhetoric of mutual recognition: "There is (…) no valid reason why, provided that they have been lawfully produced and marketed in one of the Member States, (products) should not be introduced into any other Member State". At first sight, this seems to imply that goods which are offered in accordance with the regulations of the country of origin can circulate entirely freely in the European internal market. Economists have often misunderstood mutual recognition in this way. However, the real meaning of the country of origin principle in the early case law of the ECJ is that Member States cannot apply certain specific details of national regulations to interstate trade, if the objectives or effects of the relevant law in other Member States are equivalent to that of the importing country. The principle starts from the idea that all Member States care for their citizens and protect their citizens from unhealthy or unsafe products. If the regulatory objectives are equivalent, harmonisation is no longer necessary and free movement of goods may prevail, despite different technical specifications. Consequently, the principle of mutual recognition should play a pivotal role in the achievement of the internal market. However, in its case law the ECJ has referred to equivalence of "objectives or *effects*" (italics added). Although the interpretation of objectives may cause difficulties occasionally, the required equivalence of effects introduces a grey area, which substantially raises the information, transaction and compliance costs of the principle of mutual recognition (Pelkmans 2005, pp. 103-105).

After its continuous expansion in the 1980s, the scope of the mutual recognition principle has been reduced in the 1990s. In the *Keck* case (1993) the ECJ limited the application of the *Dassonville* ruling: "… contrary to what has previously been decided, the application to products from other Member States of national provisions restricting or prohibiting certain selling arrangements is not such as to hinder directly or indirectly, actually or potentially, trade between Member States within the meaning of the Dassonville judgement (case 8/74 [1974] ECR 837), so long as those provisions apply to all relevant traders operating within the national territory and so long as they affect in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States." [9] Consequently, a distinction

[7] Case 120/78, *Rewe-Zentrale AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.
[8] See the long list in Art. 4(8) of the Services Directive (fn. 4).
[9] Cases C-267 & 268/91, *Keck and Mithouard* [1993] ECR I-6126.

has been introduced between product requirements, where the principle of free movement of goods must be applied, and regulations concerning selling arrangements, which fall outside the scope of Article 28 EC. In the case at hand, it was decided that the French prohibition of sales at loss prices falls outside the scope of Article 28 EC. The *Keck* rule also applies to other national regulations on sales arrangements, such as opening hours of shops or the prohibition of joint offers at reduced prices or free gifts. Unfortunately, the *Keck* rule is not a clear-cut distinction and its application has initiated a lively debate among lawyers (Weatherill 1996, Barnard 2001). The *Keck* ruling created more scope for decentralisation and application of the country of destination principle. However, this tendency has been countered by European legislation: the recent Directive on unfair business-to-consumer practices[10] aims at full harmonisation (see section 3.3.2).

Besides the case law of the ECJ, the principle of mutual recognition has also been embraced in policy documents leading to a new approach to harmonisation. In its White Paper on the Completion of the Internal Market (1985), the European Commission adopted the principle of mutual recognition as its main strategy to achieve the internal market and proclaimed its intention to concentrate the harmonisation efforts in areas where trade barriers can be justified according to the criteria determined by the ECJ. In the 1960s and 1970s, EC Directives defined the technical or qualitative characteristics of products. The promulgation of these legislative acts, which were known as 'vertical' directives, turned out to be a very burdensome process since Member States had to reach unanimous agreement on a lot of technical details.[11] After the *Cassis de Dijon* judgement, a new approach to harmonisation has emerged. In the area of product regulation, the relevant EC Directives no longer contain detailed technical standards or specifications but are confined to identifying the objectives in terms of health and safety, leaving the task of devising the necessary technical solutions to standard-setting bodies within the Member States (Mattera 2005, p. 14). In addition, changes of the EC Treaty have made it possible to have new Directives approved by a qualified majority (Art. 94-95 EC). In this way, approximation and harmonisation of the diverging regulations of the Member States has been facilitated.

In the *Foie Gras* case[12], the ECJ endorsed the new approach of the European Commission by requiring the Member States to include in their technical regulations a mutual recognition clause, according to which Member States must allow the import into their territory of products which are in conformity with the legislation of another Member State. The Information Directive (1998) institutionalises the new approach by imposing a duty on Member States to inform the European Union about drafts of new legislation having an actual or potential bearing on regulatory barriers in goods markets.[13] This information duty allows the European Union to prevent the erection of new regulatory barriers at an early stage. A special Committee investigates all national draft laws in areas such as regulation of safety, health and consumer protection. This examination takes place before the drafts reach national parliaments (and with a standstill of several months).

[10] Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market, OJ 11.6.2005, L 149/22

[11] The requirement of unanimity has been abolished by the Maastricht Treaty, which introduced the decision rule of qualified majority.

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

[13] Directive 98/34 of the European Parliament and of the Council of 22 June 1998 laying down a procedure for the provision of information in the field of technical standards and regulations, OJ 21.7.1998, L 204/37.

2.2. Right of establishment and freedom to provide services

The process of gradually increasing market integration scrutiny of national regulations – and the concomitant scope of the mutual recognition principle – from the area of free movement of goods into the areas of right of establishment and freedom to provide services has reached its apogee in the ECJ's judgement of the *Gebhard* case (relating to the right of a German lawyer to practise in Italy). National rules which limit the freedom of establishment (e.g., by requiring an authorisation to practice a certain profession) or the free movement of services (e.g., by subjecting the provision of services to rules of professional ethics) can only be accepted, if four conditions are satisfied: (1) Foreign firms and domestic firms must be treated equally (no discrimination on grounds of nationality); (2) the rules must be justified by the need to protect consumers; (3) the rules must be necessary to attain the latter goal (principle of necessity), and (4) they should not go further than necessary to attain this goal of consumer protection (principle of proportionality). The requirement of proportionality opens the door to an application of the mutual recognition principle also in the areas of the right of establishment and free provision of services. However, developments at the legislative level have again limited its scope.

At the legislative level, in the area of services, the vertical approach aimed at harmonising the conditions for practicing certain professions has been replaced by a horizontal approach embedded in the so-called General System Directives. These Directives – one dealing with higher-level diplomas corresponding to three or more years of study, the other dealing with less than three years – address the issue of equivalence by asking applicants to opt directly for a specific profession rather than selecting the university diploma that they consider equivalent to their own (Nicolaïdis 2005, p. 137). In these Directives, the principle of mutual recognition has not been accepted unconditionally. Host Member States may still impose additional compensatory requirements on migrants, for example when studies have a different duration or content (as is the case in the legal profession). The recent Services Directive contains several measures to facilitate the provision of services across interstate borders (such as the facilitation of administrative requirements) but equally contains a very long list of derogations.[14]

3. The mutual recognition principle as an inconsistent rule in the European two-level system of regulations

Before analysing the inconsistencies and instability of the structure of regulatory powers, which ensue through the application of the principle of mutual recognition (sections 3.2 - 3.5), we will present a theoretical framework of a two-level structure of regulations (section 3.1). Economic theories of federalism and regulatory competition can be used to analyse whether the country of destination principle, the mutual recognition rule, harmonisation of laws, or other rules might be the most appropriate solution for allocating and delineating the regulatory powers within a two-level system of regulations. The advantage of this approach is that mutual recognition is not only analysed in regard to its impact on the aim of achieving the internal market but in regard to all welfare effects of the ensuing allocation of regulatory powers between the EU level and the Member States.

[14] Articles 2(2) and 17 Directive 2006/123 (fn. 4) contain a list of no less than 27 exceptions.

3.1. Regulatory powers and regulatory competition in a two-level system of regulations: a theoretical framework

In a two-level system of jurisdictions as within the EU, regulatory powers can be allocated to the level of the EU or the level of the Member States. If all regulatory powers are assigned to the EU, Member States cannot enact their own regulations. This excludes the possibility of any kind of regulatory competition; fully centralised regulatory powers imply uniform regulation throughout the EU. If the regulatory powers are decentralised and allocated to the Member States, the States can enact different regulations. Diverging national rules may reflect different policy objectives, different factual conditions, or different opinions about appropriate policies. Except for the extreme case that all regulatory powers are allocated to the central level, it is necessary to have 'conflict of law rules' to delineating the regulatory powers of jurisdictions within a two-level system of regulations. Such rules are needed for solving conflicts both vertically between the two jurisdictional levels and horizontally between the lower-level jurisdictions (i.e., the Member States).

The country of destination principle and the mutual recognition principle can be seen as conflict of law rules. The country of destination principle solves the conflict of laws problem by stipulating that all firms selling in a particular country must comply with the regulations of that country. This leads to the well-known problem of non-tariff barriers to trade, since firms must incur additional costs to adapt to those regulations. The mutual recognition rule (also called 'country of origin principle') deals with this problem by allowing foreign firms to 'export' the regulations from their home country to other states. This conflict of law rule restricts the extent of the regulatory power of the Member States severely, because they have lost their power to regulate the sale of products or services within their territory; their regulatory power remains restricted to domestic producers and service providers. However, the mutual recognition rule established by the ECJ is a conditional rule: it only applies as far as the objectives or effects of diverging national regulations are equivalent. Another conflict of law rule is free choice of law. This rule implies that firms can decide for themselves which regulations they want to comply with.

Depending on the applied conflict of law rule, different forms of two-level systems of decentralised regulatory regimes emerge, which also entail different types of regulatory competition (Heine/Kerber 2002; Kerber/Budzinski 2004). The most intensive type of regulatory competition can materialise through the free choice of law rule, because in this case the firms can choose between all national regulations without having to move their location. This is the type of regulatory competition which is well known from the US discussion on competition of corporate laws. It is now also discussed in Europe in the aftermath of several judgements of the ECJ on the freedom of the right of establishment.[15] The rule of mutual recognition, as introduced by the *Cassis* judgment, leads to a type of regulatory competition, in which the consumers but not the producers can choose between regulations. Regulatory competition can also be a part of interjurisdictional competition, i.e. by moving to other jurisdictions firms can choose between different regulations as part of the overall package of public goods, taxes, and legal rules that the jurisdictions offer. Also the country of destination principle allows firms to choose between different national regulations through relocating their business. However,

[15] Case C-212/97 *Centros Ltd* v *Erhvers-og Selskabsstyrelsen* [1999] ECR I- 1459, case C-208/00 *Uberseering B.V.* v *Nordic Construction Company Baumanagement GmbH* [2002] ECR I-9919; Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam* v *Inspire Art Ltd* [2003] ECR I-10155. See for the American discussion: Romano 1993; for the European discussion, see Heine (2003).

they cannot use these national regulations for exports to other Member States. Therefore, the country of destination principle combines strong decentralisation with a rather weak form of regulatory competition. In all cases (even in the last one), there can be regulatory competition in the form of yardstick competition, which at least allows parallel experimentation with different regulations enabling mutual learning processes for the Member States involved. Full harmonisation would eliminate even this reduced form of regulatory competition.[16]

Which allocation of regulatory powers within the European two-level system of regulations is optimal? This encompasses not only the optimal extent of centralisation or decentralisation, but also questions concerning the optimal conflict of law rule, and therefore, the appropriate extent and type of regulatory competition.[17] Using economic theories of (legal) federalism and regulatory competition,[18] a number of assessment criteria can be derived.[19] In most cases, several kinds of costs (static economies of scale, information and transaction costs, externalities, etc.) favour centralised and uniform regulations. This is also true of the costs caused by barriers to trade. Heterogeneity of preferences and problems as well as the advantages of local knowledge and decentralised experimentation (allowing more innovations and greater adaptability) are well-founded arguments for a more decentralised allocation of regulatory powers. Also, in several cases rent-seeking problems can be better solved through decentralised solutions. Due to 'path dependency' effects (dynamic economies of scale, lock-in effects) the history of legal evolution can also be consequential. Another crucial question is whether the positive effects of regulatory competition that might emerge from a decentralised system (e.g., more cost-efficient regulations, more innovativeness, and less rent seeking) dominate, rather than that its potential problems (in particular, 'race to the bottom' problems).

The application of this theoretical framework shows that in most cases there are positive and negative welfare effects of both centralised and decentralised solutions. Beyond the above criteria other decisive factors, such as distributional justice and the effects on private autonomy, can be included. In real-life policy making, these effects usually differ regarding the kind of regulation and the type of regulatory competition. Consequently, a potentially large number of complex trade-off problems emerge, leading to differentiated results. With regard to some regulations a centralised solution (harmonisation) might be advisable, whereas in other cases decentralised solutions (free choice of law or country of destination principle) might be superior. From this theoretical perspective, the trade-off between the advantages of removing non-tariff barriers to trade and the advantages of decentralised regulatory powers is only one aspect of the very complex analysis of the positive and negative effects of varying degrees of centralisation and different types of regulatory competition.

[16] For learning from parallel experimentation, yardstick competition, and laboratory federalism, see Hayek (1978), Salmon (1987), Vanberg/Kerber (1994), Oates (1999), and Kerber (2005).
[17] For the necessity of an institutional framework for a multi-level legal system and regulatory competition, see Kerber (2000) and Van den Bergh (2000); for the regulatory function of choice of law / conflict of law rules, see Muir Watt (2003).
[18] See Siebert/Koop (1990), Bratton/McCahery (1997), Oates (1999), Ogus (1999), Frey/Eichenberger (1999), Van den Bergh (2000), Trachtman (2000), Esty/Geradin (2001), Kerber/Heine (2002); in Feld/Kerber (2006) a broad overview on recent theoretical and empirical literature on federalism and multi-level systems of jurisdictions can be found.
[19] See for an overview on these criteria Van den Bergh (1996, 2000, 2007), Kerber/Heine (2002), and Kerber/Grundmann (2006, 220-223).

3.2. High transaction costs of mutual recognition

Since the principle of mutual recognition is mostly defended due to its pragmatic advantages for removing barriers to trade, the fact that the application of mutual recognition often incurs high transaction costs is a severe problem. The broad interpretation of the notion ‘measures of equivalent effect’ in the *Dassonville* judgement has had the consequence of bringing the entire variety of trading rules within the scope of the prohibition of Article 28 EC. This caused great uncertainty about the conformity with European law of a wide gamut of national regulations, including *inter alia* rules fixing opening hours of shops, prohibitions of Sunday trading, bans on smoking in public places, bans on selling cigarettes to children, prohibitions of sales at loss prices, bans of certain commercial practices (free gifts, joint offers at reduced prices), and limitations on the content and form of advertising (in particular rules on advertising addressed to children and prohibition of telephone advertising). It has been argued in the literature that the application of the principle of mutual recognition in the EU turns out to have "fairly high information, transaction and compliance costs" (Pelkmans 2005, p. 103). Our analysis in section 2 confirms this view. The following vague concepts cause legal uncertainty and high transaction costs: the increasing scope of the 'mandatory requirements’ exception developed in the judgements of the ECJ; the appreciation of the necessity of national protective measures; the assessment whether the proportionality criterion is satisfied; the possibility for Member States to show that mutual recognition cannot apply since the objectives or effects of diverging national regulations are not equivalent; the distinction between product requirements and prohibitions of certain selling arrangements (*Keck* judgement).

To reduce the high transaction costs resulting from the ensuing legal uncertainty, producers and traders have only two options: (1) invoke the ‘euro-defence’ (*i.e.* argue that the national rule is contrary to Art. 28 EC) and wait for a clarification from the ECJ, or (2) lobby for harmonisation and try to impose domestic rules also on foreign firms in order to achieve a competitive advantage (rent-seeking). Given the complexity of current European law and the fact that judicial review by the ECJ is slow, it is unsurprising that there exists support for more pro-active measures designed to achieve market integration. The most obvious of these measures is harmonisation of laws. Therefore the huge transaction costs of the application of the rule of mutual recognition suggest a reallocation of regulatory powers towards a greater degree of harmonisation and centralisation.

3.3. The impossibility to satisfy divergent preferences

3.3.1 The loss of regulatory autonomy under a mutual recognition rule

A second major flaw of the principle of mutual recognition is that it does not easily allow the fulfilment of different preferences with respect to the contents of mandatory regulations. Diverging national regulations may take full account of the specificity of regional problems, preferences and differences in income levels. On the one hand, it is widely acknowledged that mutual recognition implies a limitation of the regulatory autonomy of the Member States. On the other hand, the principle is also defended on the grounds that Member States retain much of their regulatory autonomy, since mutual recognition allows them to enact stricter regulations. However, the latter interpretation is grossly misleading. Under a mutual recognition rule, the Member States lose their power to enact mandatory regulations for domestic markets. They are only able to enact mandatory regulations for domestic producers who are then

bound to obey the stricter domestic standards. As will be further explained in section 3.5, the principle of mutual recognition turns a market regulation into a mere regulation for domestic producers. Therefore, the regulatory autonomy of a state over its domestic market is not only limited - it is lost. If the Member States should have the right to regulate certain types of business behaviour on their domestic markets according to their own preferences, then the domestic laws have to be mandatory for all market participants (country of destination principle).

At first sight, it may seem that the rule of mutual recognition developed by the ECJ still enables Member States to satisfy divergent preferences, because regulations of other Member States only have to be recognised, "if the objectives or effects are equivalent". However, this result is a consequence of *limiting* the application of mutual recognition by way of this additional precondition. Hence, the qualification of equivalent objectives or effects leads back to the country of destination principle. This does not imply, however, that divergent national preferences can be more easily satisfied. On the contrary, the rule of mutual recognition often initiates a process of harmonisation. Since equivalent objectives and effects are a precondition for mutual recognition, a number of rules and procedures have been developed to prevent Member States from enacting regulations, which exclude the application of the mutual recognition principle. These include the requirement imposed on Member States to include a mutual recognition clause in their technical regulations (*Foie Gras* rule), the duty to inform the EU about drafts of regulations (Information Directive) as well as the establishment of a special Committee that pre-checks drafts of national regulations. The overall effect of these measures is that the factual scope for national regulations, which can fulfil divergent preferences -because the principle of mutual recognition need not be applied - is severely restricted (Pelkmans 2005). Beyond that, there is always the possibility of an approximation of laws according to Articles 94 - 95 EC (qualified majority voting). As a consequence, the rule of mutual recognition in combination with the described measures and rules leads to a process of de facto harmonisation of national regulations.

In the following, regulations of consumer protection and health care services are used as examples for such harmonisation processes as well as the danger of an inappropriate dealing with the trade off between the advantages of the internal market and the disadvantages resulting from the impossibility to fulfil divergent preferences.

3.3.2 Different preferences on consumer protection

Opinions on the need of consumer protection and its precise content may differ significantly across EU Member States. Neither the ECJ nor the European Commission demonstrated sufficient sensitivity to the problem of different preferences in the field of consumer protection laws. Let us take a look at three examples to see how European law deals with these issues. First, some Member States may wish to provide incentives which cause consumers to think twice before they buy products and services, whereas other Member States may prefer a more paternalistic approach which also protects the less diligent consumers. These different views will have an impact on the choice between information remedies and more interventionist measures, such as direct regulation of quality. With respect to information remedies, the rule of mutual recognition does not leave Member States regulatory autonomy to decide how much risk they are willing to take (Weiler 2005, p. 49). In the leading *Cassis de Dijon* case, the ECJ made clear that consumers can be appropriately protected by information measures. However, the communicative effect of labels is notoriously quite limited. Under the principle of mutual recognition, Member States preferring a zero-tolerance approach to any consumer

confusion are not allowed to take more restrictive measures, such as rules on product composition.

Second, views on aggressive trade practices may differ across Member States. With respect to aggressive trade practices, the European Commission seems to be aware of diverging preferences but does not accept the problem up to its full consequences. In the recitals of the recent Directive on unfair business-to-consumer commercial practices, the Commission acknowledges the fact that there may be large differences related to taste and decency which explain differences across national legal systems (recital 7). Nevertheless the Directive outlaws, *inter alia*, persistent and unwanted solicitations by telephone, fax, e-mail or other remote media, as well as advertisements which persuade parents or other adults to buy advertised products for children (Annex 1). It may be doubted whether these practices are uniformly disapproved by the consumers of all EU Member States.

Third, preferences may also differ on the scope of a prohibition of misleading advertising. Traditionally, German judges have taken a much stricter attitude than their European counterparts. In several European countries some types of misleading advertising (in particular puffery) were usually accepted, since judges thought that 'average' consumers were able to recognise the lies. By contrast, German judges banned untrue advertising, in order to protect also the weakest consumers. In a number of 'negative integration' cases[20], the ECJ examined conformity with the principle of free movement of goods of a number of national rules prohibiting particular forms of price reductions and other potentially misleading commercial statements. The ECJ decided that in order to determine whether a particular statement is misleading, "it is necessary to take into account the presumed expectations of an average consumer, who is reasonably well informed and reasonably observant and circumspect."[21] The recent Directive on unfair business-to-consumer commercial practices has endorsed this notion of the 'average consumer' (recital 18) and has laid it down explicitly in the prohibitions on misleading actions (Article 6) and misleading omissions (Article 7). As a consequence of the full harmonisation approach adopted in this Directive, it will be impossible for EC Member States to adopt a stricter approach in general assessments of deception by also taking account of the way in which the most vulnerable consumers interpret statements in advertising. The case law of the ECJ has been criticised for sacrificing the interests of vulnerable consumers to the interests of self-reliant consumers, in spite of rather important differences in expectations between consumers in the different EU Member States (Howells and Wilhelmsson 2003, pp. 378-379).

It is remarkable that current European law is moving towards the harmonisation of rules on aggressive and misleading trade practices. It must be recalled that the *Keck* judgement introduced a distinction between product regulations and rules on selling arrangements. Consequently, diverging national rules inspired by historical, cultural and social reasons, such as a prohibition of Sunday trading, may remain outside the scope of Article 28 and thus also beyond the reach of the European legislator. However, in the field of consumer protection there is an independent legal basis for harmonisation measures (Article 153 EC). Contrary to earlier consumer protection Directives, the recent Directive on unfair business-to-consumer commer-

[20] Case C-373/90, *Procureur de la Republique* v. *X* [1992] ECR I-131; Case C-126/91, *Schutzverband gegen Unwesen in der Wirtschaft* v. *Y. Rocher GmbH* [1993] ECR I-2361; Case C-1315/92, *Verband Sozialer Wettbewerb eV* v. *Clinique Laboratoires SNC* [1994] ECR I-317.
[21] Case C-210/96, *Gut Springenheide GmbH and Rudolf Tusky* v. *Oberkreisdirektor des Kreises Steinfurt – Amt für Lebensmittelüberwachung* [1998] ECR I-4657, at paragraphs 31-32.

cial practices[22] adopts a full harmonisation approach. In the area of consumer protection the European legislator tries to eradicate barriers to trade flowing from rules on selling arrangements, even though they may be based on different preferences regarding the level of consumer protection.

3.3.3 Regulation of health care services

In regard to the recent discussion on the Bolkestein Directive, the criticisms on an unlimited application of the principle of mutual recognition in services markets are easily understandable. Compared to goods markets, services markets are more heterogenous. For this reason, an unqualified transplantation of the principle of mutual recognition from goods markets into services markets seems inappropriate. National regulations on health care constitute a clear case. Preferences concerning the ways in which health care is financed are very strong. The citizens of different Member States may disagree strongly on the desirability of introducing competition in health care services. Competition in the health care sector may lead to suboptimal outcomes because of market imperfections (information asymmetries) and distributional considerations (social corrections). For example, the current Dutch health care regime, which heavily relies on competition between health insurers (several buyers of health care) to increase the macro-affordability of the health care system, contrasts sharply with health care systems in other Member States, which are based on a single buyer of health services (the state) financed by taxes. For this reason, mutual recognition might prove counterproductive in the field of health care law. It was feared that the Services Directive would interfere with the right of Member States to organise their own health care system and, for this reason, health services have been included in the list of derogations.[23]

As a consequence of the free movement of workers, individuals from Member State A are entitled to medical support in Member State B on the same basis as nationals in the latter state if authorised by the competent institution (national health service, sickness funds, health insurers) in their home State. Therefore, the country of destination principle is enforced, since the individuals are treated according to the conditions and tariffs of the destination state. However, in the *Kohll and Decker* judgement (1998) the ECJ awarded two Luxembourg citizens the right to obtain reimbursement for healthcare services provided in another Member State on the basis of the reimbursement tariff applicable in their home country.[24] This judgement opened the door for the introduction of the principle of mutual recognition in the field of health services, since patients are not integrated in the health care system of the country of destination but treated abroad following the modalities and tariffs of the country of origin. Later judgements of the ECJ have challenged the conformity with European law of additional aspects of national health services regulation and have thus increased the scope for free movement of services. Obviously, this case law has also created a great deal of legal uncertainty which has led to pleas in favour of harmonised rules (Kostoris Padoa Schioppa 2005, p. 200). The debate about the Services Directive revealed a clear tension between the goal of

[22] Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market, OJ 11.6.2005, L 149/22.
[23] The amended version of the Directive contains a long list of derogations, among which "healthcare services whether or not they are provided via healthcare facilities, and regardless of the ways in which they are organised and financed at national level or whether they are public or private" (Art. 2 cc).
[24] In another judgement, the ECJ decided that granting authorisation should not be the exception but the rule; 'normal' medical treatment may only be refused if the health service of the country of origin can provide the same service without undue delay (no lengthy waiting lists). See: Case 157/99 *Smits/ Peerbooms* [2001] ECR I-05473.

market integration and the wishes of Member States to pursue their own economic and social policies. Due to the strong diversity of preferences, the application of mutual recognition has been excluded in regard to health care services, thus leading back to the country of destination principle.

3.4 Race to the bottom, mutual recognition, and harmonisation

The most important concern about the introduction of the rule of mutual recognition has always been that ensuing processes of regulatory competition can lead to a 'race to the bottom'. Inefficiently low regulatory standards would result. In the aftermath of the *Cassis* judgment of the ECJ, it was argued that competition between product regulations may incite domestic firms which lose market shares to firms of other Member States with 'superior' regulations to lobby their Member State for 'more competitive' regulations (Sun/Pelkmans 1995). Depending on the effects provoked by regulatory competition, such lobbying processes can lead to either better or worse regulations from the perspective of social welfare ('race to the top' vs. 'race to the bottom'). Also in the discussion on the Bolkestein Directive, the argument of a downward spiral of ever decreasing levels of consumer protection was a crucial issue. Under a rule of mutual recognition, service providers might get an incentive to move to a less regulated country or to lobby for less restrictive domestic rules, in order to be able to compete successfully on the relevant market for services. This might increase pressure on highly regulated Member States to adapt their rules to those of less regulated Member States.

A large number of theoretical and empirical studies have examined the effects of regulatory competition.[25] These studies cannot be reviewed within the scope of this paper, but for the purposes of our argument a summary of the most important conclusions follows. Depending on the specific assumptions made, theoretical models have derived both 'race to the top' and 'race to the bottom effects'. [26] However, it is interesting that empirical studies could not confirm the fears about 'race to the bottom' effects, even in cases in which theoretical reasoning would have suggested such outcomes. Different reasons have been put forward for this surprising result. One hypothesis states that mutual recognition might not trigger a dynamic process of regulatory competition at all (Sun/Pelkmans 1995) or that detrimental effects of regulatory competition are impeded through complementary legal rules, which are harmonised and therefore remain outside of the domain of regulatory competition. Although it seems that the concerns about 'race to the bottom' problems may have been overblown,[27] the emergence of such effects cannot be totally excluded. The most important lesson to be learned from the theoretical and empirical literature is that it depends on the specific regulations and the particular conditions, whether regulatory competition may lead to a 'race to the bottom' or not.

An analysis of competition among consumer protection regulations under a rule of mutual recognition must take into account the justifications for these regulations. The main arguments in favour of mandatory consumer protection regulations are based upon information

[25] Please note that a high quality of consumer regulation does not correspond to a high level of consumer protection in the traditional meaning. 'Race to the top' means the search for rules that lead to the best fulfillment of the preferences of the consumers, taking the benefits and costs of a certain level of protection into account. In the case of overregulation, the improvement of consumer regulations implies processes of deregulation, i.e. a reduction of traditional consumer protection.

[26] See, e.g., for overviews Van Cayseele/Heremans (1991), Apolte (2002), Wagener/Eger/Fritz (2006), pp. 234-236.

[27] See, e.g., Vogel (1995), Sun/Pelkmans (1995), Van Beers/Van den Bergh (1999), Holzinger (2007).

asymmetries between producers and consumers, which might lead to market failures (adverse selection and moral hazard problems). Although a number of market solutions exist, as e.g. the reputation mechanism or information intermediaries, mandatory consumer regulations might be appropriate if these market solutions fail.[28] Under the rule of mutual recognition used in the EU, European consumers can choose between products and services, supplied under the different regulations of the home countries of the producers and service providers. It has been argued that if consumer regulations should be mandatory because of information asymmetries and the inadequacy of market solutions, then also regulatory competition between consumer regulations will fail, because the adverse selection problem will re-emerge on the market for consumer regulations (Sinn 1997). However, here the market failure problem through information asymmetries is a different one, because consumers need only be able to assess the quality of a limited number of consumer regulations. In addition to that, the state agencies which decide on the content of regulations are also accountable to political and judicial bodies and the public at large. Although the potential market failure problems of competition among consumer regulations differ significantly from the initial market failure problems that led to these consumer regulations in the first place, whether consumers are sufficiently capable of comparing the quality of the consumer regulations from different Member States is still open for debate.

We do not want to answer this question. Instead we want to demonstrate the inconsistency of a rule of mutual recognition. If there are well-founded concerns that a significant number of consumers are not able to assess the consumer regulations of Member States appropriately, then the rule of mutual recognition can lead to considerable market failures, either through potential 'race to the bottom' problems or simply through bad choices by consumers. In these cases, either harmonisation or the traditional country of destination principle are superior solutions. Intensive efforts to achieve minimum or full harmonisation can also be interpreted as a response to the fear of 'race to the bottom' problems resulting from mutual recognition. Also the precondition of "equivalence of objectives or effects" for the application of mutual recognition formulated by the ECJ can be seen as a device for impeding any kind of 'race to the bottom'. As shown above (3.3.3), in the area of services the fear of 'race to the bottom' processes strengthens the traditional solution of the country of destination principle. However, as already mentioned, the fear of 'race to the bottom' is often exaggerated. In the following section we assume that consumers are sufficiently capable of assessing the consumer regulations of the Member States, i.e., that the rule of mutual recognition does not face a market failure problem from the demand side. For this case, however, we will show that a free choice of law rule (and therefore a free internal market for regulations) is superior to the rule of mutual recognition.

3.5. Reverse discrimination, industrial policy, and a free internal market for regulations

3.5.1 Reverse discrimination

One of the most puzzling implications of a mutual recognition rule is the ensuing problem of 'reverse discrimination'. Whereas consumers are allowed to choose between goods from all Member States produced according to diverging regulations, producers remain bound to their domestic regulations. This has been called ‘reverse discrimination’, because the discrimina-

[28] See, e.g., Akerlof (1970), Kreps/Wilson (1982), Shapiro (1983), and Hadfield/ Trebilcock (1998).

tion of foreign firms that results because they are forced to obey rules of the import countries (the country of destination principle)[29] is superseded by the discrimination suffered by domestic firms, which are not allowed to produce goods according to regulations used by their competitors. Also in the area of the right of establishment and the provision of services, unconditional mutual recognition implies that domestic providers of services need diplomas and qualifications from their home country, whereas foreign providers of services are allowed to practice in host countries, even if they do not have the diplomas and qualifications required by the latter. In the following, we discuss the resulting problems of reverse discrimination in the areas of free movement of goods and services.

3.5.2 Consumer regulations, producer regulations, and industrial policy

Application of the principle of mutual recognition to consumer regulations implies that these regulations lose their mandatory character because consumers can choose between them. Moreover, another consequence –which has not yet been sufficiently recognised– is that consumer regulations change into a very different type of regulation. Under a rule of mutual recognition only domestic producers are bound to obey mandatory consumer regulations and, as a consequence, these rules have in fact changed into mandatory regulations for domestic producers and service providers (Kerber 2000, pp. 239-244). It is difficult to imagine how this type of producer regulations can be defended economically. Under the country of destination principle, producer regulation was an instrument used to achieve the goal of consumer protection. However, if consumers are deemed capable of choosing between different consumer regulations, as assumed by mutual recognition, this justification disappears. For example, if French firms are allowed to sell in Germany products containing ingredients that are not allowed for products of German firms, the German regulations can no longer be defended by the aim of protecting German consumers. If the French and German regulations are assessed under the principle of mutual recognition as being equivalent for the consumers, why should domestic producers remain obliged to obey specific national rules? Why should domestic producers under a rule of mutual recognition not be allowed to produce according to regulations of other Member States and sell these products - appropriately labelled - on the domestic markets?

One might try to defend regulations imposing product specifications only on national producers with industrial policy arguments. If one assumes that a Member State has superior knowledge about the design, composition or other characteristics of the products which are particularly competitive on the European markets, mandatory product regulations might help the firms in this Member State to compete successfully in the internal market. However, both the theoretical and the empirical literature on industrial policy shows in a very convincing way that, in general, firms know much better than the state what kind of products and services might be successful (Holmes/Seabright 2000, Monopolkommission 2005, pp. 75-85). Therefore use of these regulations to improve the competitiveness of domestic firms on the internal market leads to the manifold, well-known industrial policy problems.

However, there is a potential economic justification for reverse discrimination that is aligned with the economics of geographical indications. Haucap, Wey and Barmbold (1997) argue that location choice can act as a signalling device for product quality, e.g., that high country-

[29] It should be noted, however, that already the country of destination principle implied a prohibition of 'non-discrimination', because both foreign and domestic firms have to fulfill the same domestic regulations (principle of national treatment).

specific costs signal high quality products. In their analysis they defend regulations protecting geographical denominations, because they can provide valuable signals about the quality of products. Their argument is primarily based upon high labour costs, which forces the firms to produce high product quality. An additional step is made, if these geographical denominations are connected with very strict mandatory product regulations, as, e.g., in the case of French wine. Thanks to strict mandatory regulations national (or regional) producers can build up a specific reputation. The mandatory character of these regulations may then be defended on grounds of impeding free-riding of other firms on this reputation. However, only in very particular cases (as in the case of regionally typical food, in which the country of origin might be a very strong indicator for a specific form of quality or taste), mandatory producer regulations (beyond labels indicating the country of origin) might be defended from an economic point of view. For most goods and services, however, such producer regulations will not be efficient. Such a strategy would suppose that the same set of production standards would be optimal for all firms of a particular Member State; but usually firms have different strategies, and produce and sell goods with different qualities and prices. With the rare exceptions mentioned above, imposing a strict regulatory standard to all domestic producers will not improve their competitiveness. In addition to that, most of these reputation effects can also be achieved with the less restrictive instruments of certification and labelling.

The above arguments with respect to problematic industrial policy effects of reverse discrimination apply also to services. First, it is unlikely that Member States have superior knowledge about the characteristics of services which are decisive for their performance and competitive position on European markets. Typically, service providers will know better than a public regulator which quality must be provided to satisfy consumers. Public authorities cannot gather the necessary information to regulate the quality of a broad array of heterogeneous services provided by various skilled people, such as technical craftsmen and practitioners of a liberal profession. Second, the question arises as to whether it really pays off for a country to impose costly additional training requirements upon service providers. To signal high quality of local service providers, title protection may be sufficient. Contrary to licensing systems, which do not allow foreign providers unless they satisfy all educational requirements of the host country, different titles allow competition between service providers from different EU Member States. Title protection is a less restrictive means to cure information symmetry in markets and may allow beneficial regulatory competition between different providers. Interestingly, the use of professional titles as signalling devices was introduced in the EC Directives on the medical profession. Host states were allowed to require use of the home state title followed by the name and location of the establishment or examining board which awarded it (Nicolaïdis 2005, 187, note 48). In the legal profession, the relevant EC Directive allows lawyers to practice abroad under their home title, whereas an aptitude test is required before the title of the host country can be used.[30] In this way, there is no mutual recognition of titles and foreign providers of legal services may compete under the condition that they disclose their different education.

[30] Directive 98/5 of the European Parliament and of the Council of 16 February 1998 to facilitate the practice of the profession of lawyer on a permanent basis in a Member State other than that in which the qualification was obtained, OJ 14.3.1998, L 77/36.

3.5.3 Towards a free internal market for regulations

The manifold problems of reverse discrimination can be avoided, if both consumers and producers have the right to choose freely between the regulations of all Member States. Then the rule of mutual recognition is replaced by the rule of free choice of law as the applicable conflict of law rule. In this case a free market for consumer regulations emerges within the EU (Kerber 2000, pp. 242-244; Muir Watt 2003, p. 394). Since consumers are assumed capable of assessing the quality of the consumer regulations of the Member States, allowing free choice of law to the producers would not provide any problems in regard to consumer protection. The only requirement would be the appropriate labelling of the products. We know from the economic theory of regulatory competition that free choice of law allows for the most intensive form of regulatory competition. Neither the consumers nor the producers need migrate to other Member States to choose those regulations, which they deem as most appropriate to their needs and preferences. Economically, these consumer regulations would work as certifications (labelled with a brand name), and their quality would be safeguarded by the reputation mechanism. Member States would invest into the reputation of their consumer regulations in order to build up trust both with the consumers and the producers. The ensuing internal market for consumer regulations would be a competitive market for certifications.

What are the advantages of this solution? Such a regulatory competition would enable a much richer differentiation of regulatory standards, e.g., in regard to criteria of costs, quality, health, environment or even moral standards.[31] This would allow Member States to develop more specialised regulatory standards, because not all domestic firms would have to comply with these regulations. This greater differentiation can better fulfil the heterogeneous preferences of consumers and would allow producers and service providers a wider scope of business strategies. Furthermore, free choice of consumer regulations can improve the signalling of superior regulations, because the existence of a separating equilibrium between different qualities of consumer protection regulations (in contrast to a pooling equilibrium) becomes more probable.[32] The innovativeness and adaptability of regulations would be enhanced, because more parallel experimentation with different kinds of regulations can take place. The problems of reverse discrimination would be avoided, both in regard to problematic industrial policy implications and the saving of migration costs of domestic producers to other Member States.

Which are the institutional preconditions for such a solution? As far as the greater variety of regulations leads to larger information problems for consumers, with the ensuing danger of a 'race to the bottom' , some kind of minimum harmonisation might be appropriate. However, as in consumer law generally, mandatory information duties about the content of the applied consumer regulations might be sufficient (e.g., duty to disclose the regulations complied with). One counter-argument is that there might be problems in monitoring firm compliance. For example, how can the compliance of a Finnish firm to Dutch regulations be ensured?[33] Another problem is whether the Member States will have sufficient incentives to provide effi-

[31] It is one of the shortcomings of the discussion on regulatory competition that the multidimensionality of regulatory standards is ignored; the race to the top vs. race to the bottom discussion falsely suggests a one-dimensionality of the problem in form of high or low standards.

[32] This argument was developed in regard to free choice of corporate laws in Iacobucci (2004) and Heine/Röpke (2006).

[33] This problem must be distinguished from applying national law in cross-border cases, where enforcement authorities of both countries already have to cooperate (Regulation 2006/2004 of 27 October 2004 on cooperation between national authorities responsible for the enforcement of consumer protection laws, OJ, 9.12.2004, L 364/ 1).

cient consumer regulations, given that the lobbying interests of the domestic firms will be considerably reduced due to the possibility of opting for another regulation. In the US case of competition among corporate laws, this problem is solved by a franchise tax which the states levy on incorporated firms. Hence, also in the field of consumer laws, a kind of franchise fee that all firms have to pay for using national consumer protection regulations should be considered. Such a fee could also be used to finance compliance monitoring.[34]

4. Conclusions

The introduction of the principle of mutual recognition has been widely acclaimed as a very suitable strategy for reducing non-tariff barriers to trade in the EU without embarking on a pathway to harmonisation and centralisation. However, there is also much disillusionment about the practical working of the rule of mutual recognition, partly due to the limited effectiveness in removing trade barriers and partly due to fears of a too large loss of regulatory autonomy amongst the Member States. These disappointments should not come as a surprise. Mutual recognition is not an easy answer for avoiding difficult trade off problems. In the academic and legal discussion on European integration, the merits and problems of harmonisation, mutual recognition, and country of destination principle are only discussed from an internal market perspective. However, the welfare effects of their impact on the allocation of regulatory powers within the European two-level system of regulations are complex and manifold. The principle of mutual recognition does not simultaneously solve the problem of non-tariff barriers to trade and of impeding tendencies to harmonisation and centralisation by protecting the regulatory powers of the Member States. To reach stable and satisfactory solutions, one needs a much clearer understanding of the long-term effects of the strategy of mutual recognition, especially in regard to the remaining scope for regulatory powers of the Member States and for regulatory competition.

We have demonstrated that the rule of mutual recognition leads to an extensive loss of the regulatory autonomy of the Member States. The fulfilment of the different preferences of the citizens in the Member States in regard to the regulation of consumer protection and business practices, as well as health care and other services, is impeded by the rule of mutual recognition. This can lead to significant welfare losses. The remaining option for Member States, enactment of stricter regulatory standards, is no solution, because only domestic producers and service providers are bound by stricter national rules. Beyond that, in the EU a number of mechanisms have been established in order to prevent Member States from enacting national regulations which do not fulfil the conditions for mutual recognition ("equivalent objectives or effects"). Consequently, the principle of mutual recognition has not protected the regulatory powers of the Member States. On the contrary, extensive direct and indirect processes of harmonisation have followed this strategy. This is aggravated by the high information and transaction costs of the rule of mutual recognition that suggest harmonisation as a less cumbersome way for the intended removal of trade barriers. Divergent preferences for mandatory regulations can be fulfilled only under the country of destination principle. The solution of the relevant trade off problems requires a much more extensive analysis of all the advantages and disadvantages of centralisation and decentralisation. Otherwise the advantages of more decen-

[34] It could be asked whether an internal market for national product regulations under a free choice of law rule would not be a first step towards privatisation of these regulations. Why should certifications be offered only by the Member States? It is beyond the scope of this article to discuss under what conditions also the next step to a market which also allows private regulations (offered by private agencies) might be appropriate.

tralised solutions (e.g., fulfilling divergent preferences and more innovative experimentation) are in danger of being ignored.

The principle of mutual recognition is also not an appropriate rule for regulatory competition. If, e.g., consumers have problems in assessing properly the quality of the consumer regulations of different countries, then its introduction can initiate (minimum or full) harmonisation in response to the fear of 'race to the bottom' problems, or lead back to the country of destination principle. If, however, consumers are able to cope with the different regulations they face on the market, then the rule of free choice of law by consumers and producers is superior in comparison to the rule of mutual recognition with its implication of an economically non-defensible regulation of the domestic producers. Moreover, 'reverse discrimination' can lead to serious industrial policy problems. Also, the qualified rule of mutual recognition limited to regulations having 'equivalent objectives and effects' does not seem to be appropriate for regulatory competition. What is the scope of meaningful regulatory competition, if the competing regulations must have the same objectives and effects? Only the dimension of reducing the costs for the regulations would be left for regulatory competition, whereas the qualitative properties of the regulations are de facto harmonised. Hence, discovery of superior legal rules as one of the main functions of regulatory competition is significantly impeded by the rule of mutual recognition.

The rule of mutual recognition does not lead to a stable allocation of regulatory powers. It either leads to direct or indirect processes of harmonisation and centralisation, or back to the country of destination principle, or to a free internal market for regulations. This is also a consequence of the fact that within a two-level system of regulations only three consistent main options for allocating regulatory powers exist, namely (1) harmonisation, (2) decentralisation of mandatory regulations coupled with the country of destination principle, and (3) decentralisation enabling a free market for regulations with free choice of law as conflict of law rule. These three main solutions can also be combined with each other, as, e.g., minimum harmonisation with a free market for regulations or with stricter standards under the country of destination principle. The rule of mutual recognition does not lead to a consistent solution. However, it cannot be denied that the rule of mutual recognition has played and still plays a very important role in the process of European integration. The recent discussion on the Services Directive emphasises the eminent role of this principle. What kind of role is this?

The strategy of 'mutual recognition' can be better understood as the application of a test which breaks up the traditional solution of the sovereign nation state (national regulations combined with the country of destination principle), in order to activate a dynamic process of searching for a superior allocation of regulatory powers. Whereas at the beginning of the European integration process, national regulations only reflected the costs and benefits for the Member States involved, the integration process implies that costs and benefits for the entire population of the EU must be taken into account. Therefore, a new allocation of regulatory powers within the integrated European two-level system of regulations has become necessary. This new solution should solve better the trade off problems between benefits and costs for a single Member State and the costs and benefits for the whole European two-level legal system. Since on the EU level it is difficult to agree to a solution, the strategy of mutual recognition can be used as a pragmatic institutional device to break up the hitherto existing structure of regulatory powers and subject it to a systematic test. In some cases, the continued existence of national regulations ‘protected’ by the country of destination principle could be defended, but often other solutions have been deemed superior. A reshuffling of regulatory powers within the European two-level system of regulations is ongoing. Testing for mutual recognition leads

to decisions about the proper allocation ofcompetences, in other words whether there should be harmonisation or a decentralised solution (coupled with the country of destination principle) or a market solution enabling full regulatory competition (or a combination of them). In our view, the main rationale for the strategy of the application of mutual recognition is that it activates such a dynamic process of reallocation of regulatory powers. In this way, the principle of mutual recognition can play an important role also in the future, e.g., in other regional integration projects and on the global level.

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