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'When efficiency results in redistribution: the conflict over the single services market' [1]

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Abstract: The discussion of the Services Directive from 2004 onwards showed an unprecedented extent of politicization of a single-market issue. Coinciding with the 2004 Eastern Enlargement round, the easing of the services freedom through the directive raised significant redistributive issues, given the differences in labour costs. The article analyzes why mutual recognition is so controversial in services, arguing that the relationship among member states, between governments and their citizens, and among differently regulated EU citizens matters. Partly, the directive lessens the risk of redistribution through the institutionalization of administrative cooperation between the home and the host member state. Partly, the directive fails, as member states may be forced to discriminate against their population in the name of the internal market.

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1 Introduction

The discussion of the Services Directive from 2004 onwards showed an unprecedented extent of politicization of an internal market issue. Until then, internal market policies had gone mainly unnoticed, but this time protest soared. In the course of this discussion, the French and the Dutch even voted down the Constitutional Treaty (Howarth, 2007: 94). With the Services Directive, politicization hit the internal market.

With its proposal, the Commission wanted to strengthen the internal market for services, which does not reflect the importance of services in national GDP. Though services had been included in the internal market programme of 1992, only very few sector-specific directives resulted (such as for insurance services) from a very long and cumbersome process. As a horizontal directive, the draft targeted all services, realizing the internal market by following strictly the home-country responsibility for regulation. While home-country regulation, implying the mutual recognition among member states of each others' regulations, (← **p. 847**) never roused such widespread political attention for goods markets, for services the Commission was told differently.

By integrating segmented national markets, internal market legislation significantly enhances efficiency. Companies no longer need to adapt their goods or services to the different domestic regulations of member states. Instead, there are either common harmonized rules, or there is mutual recognition. This lifting of market segmentation allows companies to exploit economies of scale, while customers may enjoy greater product variety. Internal market policies are thus classic examples of measures increasing Pareto-efficiency (Majone, 1989: 166-168, Majone, 1992).

This article analyzes why the realization of the internal market for services was nevertheless perceived as a highly redistributive exercise. The explanation builds on

the difference of services vis-à-vis trade in goods, the specifics of governance through mutual recognition, and the increased heterogeneity among member states after enlargement. Integrating markets via mutual recognition has implications for three relationships, I argue: For the relationship among EU governments, who implicitly delegate regulatory authority among each other; for the relationship of governments, being politically responsible for market regulation to their citizens; and finally among different EU citizens being subject to the different regulations of their home countries while engaging in the same activities.

For mutual recognition to work in services, member states have to perceive themselves as cooperating rather than competing entities. Integration becomes acceptable only if rules are being set and controlled according to domestic criteria, and not simply with a view to outcompeting other member states. If integrating markets via mutual recognition invites forum-shopping, redistributive issues are in the forefront. The member state which manages to adapt its rules in the most market-friendly sense gains most. For redistributive issues, the Union has insufficient input-legitimation (Scharpf, 2004). Even if liberalizing services markets strengthens general welfare, given that it has highly redistributive effects this is unlikely to be perceived as legitimate, due to the lack of a common demos showing sufficient solidarity for significant redistribution.

The article starts by analyzing the original proposal of the directive. Then it approaches the issue of why mutual recognition proved so contentious with services by focusing on the regulation of services trade in the EU. A discussion of the German experience with mutual recognition in services exemplifies the resulting redistribution, leading to an analysis of the limits of mutual recognition in services. Finally, it shows how member states have tried to contain redistributive issues in services trade, focusing on the unilateral and bilateral German responses as well as the compromise on the

Services Directive. Paradoxically, in services the choice of mutual recognition over the harmonization of rules seems to imply that member states will need to follow common administrative procedures in implementation to lessen redistributive consequences. However, the inequality that (← **p. 848**) mutual recognition in services imposes on citizens cannot be fully contained in this way and makes its application contentious.

2 The Bolkestein Directive

Launched in early 2004, the draft directive aimed at realizing the internal market for services in all those areas where specific legislative measures had not yet been taken (as in the case of financial services, for instance). Due to the importance of services, the Commission targeted about 50% of all economic activities of member states with this single directive.[2] The directive aimed at realizing both the freedom of establishment and the freedom of services, *exempting* only lotteries and all genuinely public services with no profit interest (e.g. education, cultural activities). Health and social services were included. In order to achieve its ambitious goal, the draft directive relied on the principle of home-country control. Member states were required to mutually recognize services regulated in other member states as equivalent to domestically regulated services and to abolish excessive regulatory requirements.[3] In order to support the necessary cooperation between home- and host-country authorities, the directive

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[2] See the report of the European industrial relations observatory on-line: **http://www.eurofound.europa.eu/eiro/2004/07/feature/eu0407206f.html** [accessed June 2nd, 2008]

[3] Davies (2007a: 241f) critically discusses the fact that the directive combines transborder and domestic administrative reforms, even though the Treaty does not give the competence to regulate purely internal matters. This problem remains with the adopted directive but its discussion is outside the scope of this article.

obliged *national authorities to cooperate* with each other. Thus, the possibilities of host-country authorities to obtain information from home-country authorities as to the legality of companies posting workers would be greatly improved.

Given the highly regulated nature of most services, the deregulatory potential of the directive was considerable, as was aptly described by the former Commissioner Bolkestein:

> "We cannot expect European businesses to set the global competitiveness standard or to give their customers the quality and choice they deserve while they still have their hands tied behind their backs by national red tape, eleven years after the 1993 deadline for creating a real Internal Market. Some of the national restrictions are archaic, overly burdensome and break EU law. Those have simply got to go. A much longer list of differing national rules needs sweeping regulatory reform."[4]

Since sector-specific attempts at building the internal market for services had already proven cumbersome, the directive was bound to be controversial. With its broad scope, it was hardly possible to assess all the implications of the directive. Moreover, the Services Directive explicitly complemented existing services law, with uncertain implications resulting from the interaction. This overlap concerned in particular the *posted-workers directive* (96/71/EC) of 1996, for which the services draft foresaw the easing of some restrictions on posted workers, like the need to carry papers for local controls in the host country and the obligation to appoint a national representative, making controls of the host country more difficult. (← **p. 849**)

While the Commission tried to advertise the services proposal as a measure simply enhancing efficiency in a Pareto-optimizing sense, the reactions to the draft

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[4] Rapid press release IP/04/37, 13.1.2004.

emphasized its redistributive consequences. Why the liberalization of services trade is more closely linked to redistribution than to Pareto-efficiency will be discussed below.

3 The puzzle: Why do services pose different problems than goods?

Why, then, was the transfer of a principle well established in goods trade to services so controversial? To approach this question, it is necessary to discuss both the nature of mutual recognition and of services regulation and trade. I will then turn to the German experience with mutual recognition in services to illustrate the problems of redistribution. The section closes with a discussion of the limits of mutual recognition in services.

3.1 Mutual recognition and the regulation of services trade in the EU

While mutual recognition was already considered by the Commission in the 1960s as a way to integrate tax policy (Genschel, 2007), noticeably it entered the scene only in 1979, with the Cassis ruling (C-120/78) of the European Court of Justice. Drawing on Dassonville (C-8/74), the ECJ gave a broad meaning to the freedom of goods (Art. 28), implying that goods legally marketed in one member state, can also be marketed in all other member states. This is the obligation to *mutually recognize* goods from other member states, if they conform to the rules of their home country. However, by broadening the reach of the market freedoms under the Cassis-de-Dijon case law, the ECJ simultaneously enhanced the possibilities of member states to claim exceptions beyond those already foreseen in the Treaty by Art. 30. Member states in principle retain the right to regulate their domestic markets in sensitive areas, by invoking

mandatory requirements goods have to adhere to (this is called the "rule of reason"). As regulation needs to be proportionate, and the Court takes a very strict view of proportionality, the scope is however quite circumscribed (Hatzopoulos and Do, 2006: 965f).

As is well-known, the Commission readily took up the idea of mutual recognition and launched the internal market initiative around it. While the idea raised some discussion in the legal profession that goods according to foreign rules would have to be mutually recognized (Alter and Meunier-Aitsahalia, 1994), the issue did not become similarly politicized as in services.

Integrating markets with mutual recognition evades the difficulty of agreeing on harmonization. However, compared to harmonized rules, mutual recognition is much more difficult to implement. Companies may believe that their goods and services are regulated in an equivalent way and therefore qualify for mutual recognition—it may also happen, however, that national authorities are of a different opinion (Pelkmans, 2007). As the (← **p. 850**) local authorities responsible for the control of market regulations have to decide whether the rules of the 26 other member states are equivalent or not, mutual recognition entails significant transaction costs. The solution of conflicts is thus shifted from the decision-making to the implementation stage (Héritier, 1999: 16-19, 23). Normatively, mutual recognition also has specific advantages. Joerges makes the important argument that by having to honour the regulations of the other member states, mutual recognition manages to lessen the legitimatory deficits of national policy-making. These deficits arise as national legislation focuses only on the domestic situation despite having significant externalities for other member states in an integrated market (Joerges, 2006: 790).

Following a similar logic to the one of the internal market, the European Council in Tampere decided in the late 1990s to transfer mutual recognition to the area of justice and home affairs (JHA). Again, there was a perceived need for cooperation, but an inability to agree on harmonization (Lavenex, 2007). Thus, even for rules which normally fall under parliamentary prerogative, mutual recognition may be acceptable. If mutual recognition in services appears to be more difficult than for goods it is therefore unlikely to be simply due to the fact that services regulation is politically too sensitive to be mutually recognized.

To sum up, mutual recognition can act as an alternative to harmonization if member states differ in their—equivalent—regulations. Then they could accept each others' rules instead of bothering to agree on common ones. Key to the acceptability of the principle is the question of what is regarded as "equivalent". If rules have to attain the same qualitative degree of regulation, the deregulatory push following from mutual recognition is much less than when merely "adequate" regulation has to be recognized, mirroring only essential requirements. Even though the ECJ largely follows this latter view, it was only with services that the issue became broadly politicized. To further the understanding of why the question of equivalence versus adequacy was so much more contentions in services, it is necessary to proceed by looking at the specifics of services trade, regulation, and the legal provisions for the freedom of services.

Different to goods, only a few services can travel borders independent of their production. It is only for these *correspondence services* (for instance financial services, telecommunications) that services trade resembles largely goods trade. For most services, the delivery coincides with consumption, meaning that either the service provider (*active* freedom of services) or the service consumer (*passive* freedom of

services) has to move for services trade (Hailbronner and Nachbaur, 1992: 108). It is on the problems of the active freedom of services that this article focuses.

Services are in a certain sense invisible, which is why it is often difficult to separate their production from their consumption. This makes regulation much more constitutive for services than for goods. It can concern market access (e.g. certain training requirements), operation (e.g. certain solvency (← **p. 851**) requirements, speed limits), the products themselves, and their distribution (cf. Roth, 2002: 16). Different to goods, the regulation of services relies heavily on what one can compare to process standards (cf. Troberg, 1997: 1472f). "… there is a closer connection between services regulation and labour market regulation than in the case of goods" (Pelkmans and Kessel, 2007: 7).

We know from goods trade that product and process standards are subject to different kinds of competitive pressures (Scharpf, 1999). While consumer demand for high- quality products may keep product standards up, process standards are much more subject to competitive pressures. Since process standards are more relevant for services than for goods, a strategic choice of the home country simply for ease of regulation, so- called forum shopping, is much more likely. This is facilitated by the fact that compared to goods the investment and commitment to a location is often lower in services.

To what extent does EC law prescribe the home-country rule to services provision? It is necessary to ask this question to know whether the services directive merely codified the case law of the Court or expanded on it. The services freedom aims at the remunerated, temporary services delivery across borders (Roth, 1988: 41). It has to be distinguished from the free movement of labour and of establishment. If someone

occasionally works in another country, they will probably profit from the freedom of services; if they do it on a continuous basis with some sort of establishment, it is the freedom of establishment that matters. If an EU-foreigner is part of the national labour market, it will be the free movement of labour. Important is the difference in regulation: with the freedom of establishment and of labour, companies resp. persons are regulated on a par with nationals in the country where the services are provided. But if services freedom is evoked, regulations of the country of establishment (i. e. the home country) and not so much of service provision (i. e. the host country) are applicable. However, host countries can apply rules that are covered by the general interest—provided such rules have not already been observed in the home country (Hailbronner and Nachbaur, 1992: 112).

Different to the freedom of goods, for a long time the ECJ interpreted the *freedom of services* in quite a restrictive way, not covering c*ontinuous*, *regular activities* (Hatzopoulos, 2000: 63f, Roth, 2002: 20, Davies, 2007b: 14). Article 50 even clearly prescribes the host-country rule for services trade and restricts it to temporary activities as exemplified by the case law on the posting of workers, where the ECJ allowed France in the Rush Portuguesa Case (C-113/89) to apply its minimum wages also to workers temporarily posted from Portugal. This ruling led to the posted workers directive. More recently, however, the ECJ pursues a more liberal approach with regard to services, emphasizing the need to eliminate hindrances to services trade more than the right of the host country to impose its regulations. At the (← **p. 852**) same time, the number of Court cases concerning the freedom of services is increasing, showing its growing relevance (Hatzopoulos and Do, 2006: 923). Thus, in 2003 the ECJ did not stress the temporary nature of services in the case Schnitzer (C-215/01), loosening the relationship with the freedom of establishment. In a later case, the ECJ

went so far as to state that "*all* services that are *not* offered on a stable and continuous basis from an established professional base in the Member State of destination constitute provision of services within the meaning of Article 49 EC" (Hatzopoulos and Do, 2006: 929, original emphasis). This interpretation enhances the scope for mutual recognition by emphasizing the right of companies to forum-shopping, thereby increasing competitive pressure based on services regulation. The proposal for a Services Directive took up this incipient change of the case law, seeking to codify it in a radical way (Witte, 2007: 9f). The resulting redistributive consequences can be illustrated well by taking the German case.

3.2 Redistributive concerns: the contention about the draft directive illustrated with the German case

Given that services were part of the internal market initiative of the late 1980s, the Services Directive was long overdue. With services' growing relevance, the failure to establish the internal market implied significant efficiency losses.[5] As we just saw, however, the Treaty's text and its interpretation meant that member states had a good legal basis to object to the radicalized home-country principle of the directive. Why did redistributive worries largely manage to overshadow efficiency concerns? Important was the particular timing of the draft directive in early 2004. Within a few months of the proposal, Eastern Enlargement increased significantly the heterogeneity in the EU. This fundamentally altered the basis of a regime built on home-country rule.

Governance based on mutual recognition requires equivalent rules and a functioning

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[5] Several economic studies make the point, see the webpage of the Commission: **http://ec.europa.eu/internal_market/services/services-dir/studies_en.htm** [accessed June 2nd, 2008].

administrative cooperation. While already in the EU-15 mutual recognition was ridden with prerequisites (Pelkmans, 2007), in the EU-25 (27 to be) it could only become harder. Redistributive effects arise on the one hand due to the labour-intensive nature of most services. Eastern Enlargement implied that the lower wages of these countries immediately exert pressures—most of all in those countries relying on collective wage agreements instead of minimum wages, as these are not automatically binding for service providers from other member states.

The German case illustrates well how redistributive issues overshadowed the promise of efficiency gains. Germany had joined most other member states (with the exception of the UK, Ireland and Sweden) in using the transitory arrangement (2+3+2) restricting the freedom of labour for the East European new member states. In addition, Germany negotiated a transitory regime for the freedom of services for some sectors. The German public was therefore surprised when some months after enlargement East Europeans nevertheless put significant pressure on the (← **p. 853**) national job market—simply by using the services freedom. Important is that Germany does not have a generalized minimum wage it can impose (Christen, 2004, Temming, 2005).[6] Under the services freedom, workers can come in temporarily—which is interpreted as up to one year—and replace German workers for the wages of their home country.

Most noted in the press was the case of the slaughterhouses, where Germans were laid off on a large scale as East European service providers were brought in, working for

[6] At the time, a minimum wage existed only for the construction industry and sea transport.

little money under deplorable working conditions. As a result of this experience, it was feared that the Services Directive would bring similar pressure to other sectors.[7]

The situation was complicated as East Europeans could work in Germany under different legal provisions, either relying on the freedom of establishment or of services, added to which were illegal activities.[8] Under the *freedom of establishment,* East Europeans face no restrictions but they have to comply with German laws. No specific wage and social security obligations exist for establishments, inviting social security fraud, for instance through mock self-employment.

Under the *freedom of services*, East Europeans can be posted from an Eastern European company for temporary service deliveries in Germany, except in the exempted sectors (construction, cleaning, and internal decoration) (Temming, 2005: 188). Following the posted-workers directive, German labour conditions apply for all branches, but with no general minimum wage, there are no restrictions on what posted workers have to be paid. The posting company has to discharge social security expenses in the home country, where it also has to be active—mere mailbox companies are illegal as are posted workers that are fully integrated in the German company's work process (Fleischwirtschaft 12.5.2005, p. 10). A host of different possibilities result for illegal activities from these requirements. But violations are difficult to detect by the host country, whose authorities have to trust the controls of the home country. Moreover, there are tricky legal questions: it is probably insufficient if a company employs one person for recruitment and control purposes in, say, Poland, and posts 99 workers into

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[7] FTD 9.2.2005, p.27. Der Spiegel 7/2005, Der Osten kommt, p. 32-35. Hamburger Abendblatt 26.2.2005, p. 23.

[8] I omit the freedom of labour given the transitory regime.

Germany. But how many persons have to be employed in Poland? Which part of the annual turnover has to be achieved in the home country in order to be seen as a company active in the home country (FR 23.7.2005, p. 12)? A Commission "practical guide" for the posting of workers suggests that companies should achieve a minimum of 25% of total turnover in the posting state, where they should have been established for at least four months, with other cases requiring "individual attention".[9] With high unemployment rates in many new member states, old member states distrust whether new member states abide by the rules.

The German situation was particularly difficult due to not having a minimum wage, which is also the case in a few other member states (Denmark, Finland, Italy and Sweden). Nevertheless, the lesson told by the German case is a more general one. It shows the problems of applying home-country control to services trade, of which the ample opportunities (← **p. 854**) for illegal activities are one important part. With the significant wage differentials in the EU after enlargement, a greater emphasis on home- country regulations for services has a significant deregulatory potential—which, after all, was partly wanted, as is evident in the citation from Commissioner Bolkestein, noted above. The contentious ECJ decisions in Laval and Viking, at the end of 2007, have emphasized the competitive pressure (Joerges and Rödl, 2008), as have the cases Rüffert and Luxembourg in 2008.

[9] Practical Guide for the Posting of Workers in the Member States of the European Union and the European Economic Area and in Switzerland, p. 4. **http://ec.europa.eu/employment_social/social_security_schemes/docs/posting_en.pdf** [Accessed June 2nd, 2008.]

3.3 The limits of mutual recognition in services

Why, then, is mutual recognition for goods regarded as efficiency enhancing while for services it is perceived as a redistributive issue? After all, the rationale for trading both goods and services lies in exploiting comparative advantages. This section analyzes why mutual recognition is more difficult to accept for services than for goods. Most services differ from goods, we saw, in that provision and consumption coincides, making it necessary that the service provider travels along. If the service provider has to become active in the host country, what does this imply for mutual recognition and home-country control?

Mutual recognition relies on the assumption that member states regulate markets differently, but in functionally equivalent ways. It implies that member states' governments accept regulations on their territory for their population that were decided and legitimated in other member states (Schmidt, 2007). Mutual recognition thus fundamentally concerns *three interdependent relationships*: The relationship among member states' governments, the relationship of governments to their population, and the relationship between EU citizens being subject to different regulations. If mutual recognition becomes problematic, as happens with services, we have to enquire into these three relationships.

Governments only accept regulations that are equivalent because they remain politically responsible to their population for the regulation of their markets. If rules are not equivalent, host-country rules apply, fragmenting the market, so that harmonization is needed. Given their political responsibility, governments therefore have to trust each other as to their equivalence of setting and controlling regulations when agreeing to mutual recognition. It is here that the difference in the regulation of

services compared to goods becomes relevant. For goods, in general, governments only have to trust each other in maintaining sufficient regulation and control of product standards. There is the interest of governments in the well-being of their own population, and the interest of manufacturers in their reputation, also in the case of exported goods. In the case of services, however, process standards have to be controlled which only in part impact the service quality. Where services are being exported using the competitive advantage of lower wages this requires a higher (← **p. 855**) degree of trust. Governments have to trust that their counterparts behave altruistically and control service providers simply for the sake of other member states (cf. Scharpf, 1997: Ch. 4). By contrast, with respect to goods there is a self-interest in effective controls. The amount of fraud occurring with services trade shows how demanding controls are, and that governments have good reason to be sceptical towards mutual recognition in services.

Secondly, for the relationship of the government to its citizens it is relevant that the increased legal certainty under home-country control for service providers comes at the cost of significant legal uncertainty for the host countries. Mutual recognition implies that they cannot be aware anymore under which rules services are provided temporarily in their country. Related were fears of competitive pressures on domestic regulations, as well as insecurity for final consumers not knowing which rules service providers would have to abide by and which rights they would have themselves as consumers (Nicolaïdis and Schmidt, 2007). More important yet, governments cannot guarantee equal treatment any longer to their citizens, as becomes apparent when turning to the (third) relationship between EU citizens.

As service providers travel along with the traded services, it follows that very differently regulated service providers might work side-by-side simultaneously, raising important issues of equality. Davies puts the problems succinctly:

> "The presumption is that service providers are exempt, above the law of the territory where they operate, and the rebuttal of that presumption is hard. The situation where competing service providers on a territory are subject to different legal regimes – that they essentially bring their own legal regime with them – becomes the usual one, with all the associated challenges to equality and competition norms (…)"(Davies, 2007b: 8).

Davies therefore argues that home-country control for services violates the prohibition of nationality discrimination of Art. 12 of the Treaty, as nationals of the host state are being discriminated against. Host-country control, in contrast, would generally lead to less inequality (Davies, 2007b: 8).

> "An individual who is present in the jurisdiction but not subject to its regulation, and operating under a more beneficial regime, is a direct challenge to the content of citizenship – national or European – and its associated guarantees of equality and privilege. His domestic competitor sees his most privileged position as a national citizen undermined, while the two competitors, working side by side, operate under different legal regimes with different rights, despite a shared EU citizenship" (Davies, 2007b: 7).

To sum up: Services are particularly rule-dependent, and normally cannot be traded without their providers. If mutual recognition is applied, this can give (← **p. 856**) much greater scope for forum shopping. Mutual recognition in services is problematic with regard to three relationships. Among governments, it requires trust in an altruistic orientation, as service providers are controlled by a different jurisdiction than the one where they operate, facilitating illegal activities. In the relationship of governments to their population, governments might have to discriminate against their own citizens.

Among EU citizens, mutual recognition raises issues of equality, as in the same situation EU citizens are simultaneously subject to different rules.

Mutual recognition for services, we can conclude, cannot be treated merely in parallel to goods. To accept mutual recognition in services, member states need to be assured among themselves that the delegation of competence inherent in mutual recognition is taken up responsibly. Since mutual recognition implies that differently regulated EU citizens work side-by-side, the duty to take into account the interests of other member states, moreover, demands from member states to discriminate against their own citizens. To balance both (domestic and EU) interests by drawing appropriate borders as to the necessary extent of mutual recognition is inherently difficult for services.

4 Containing redistributive conflicts in services trade

Member states reacted to the redistributive effects of applying mutual recognition to service trade not only in the negotiations of the Services Directive. Being particularly vulnerable, Germany has also responded autonomously.

4.1 German reactions

One notable result of the services freedom has been the heightened discussion on minimum wages in Germany, which started with the red-green coalition's agreement in May 2005 on extending the German posted workers law to all sectors of the

economy.[10] This discussion has been continuing ever since. Since the state traditionally leaves wage agreements to the unions and employers' associations, a state-set minimum wage implies a significant institutional rupture. But it would be the easiest way to handle some of the redistributive issues arising from the services freedom, next to responding to the general erosion of the German wage system. The discussion on minimum wages, which is ongoing, is therefore an interesting example of an Europeanization effect (Schmidt et al. 2008).

Moreover, Germany has attempted to fight illegal activities and engaged in bilateral talks with its neighbours about the interpretation of the freedom of services.[11] Both reactions have been part of the mandate of the 'Task (← **p. 857**) Force zur Bekämpfung des Missbrauchs der Dienstleistungs- und Niederlassungsfreiheit'[12], which was created in March 2005 to combat the adverse effects of the freedom of services and establishment after enlargement. Germany requires a postal address of the posting company as well as a translation of relevant documents concerning working contract, working times and pay into German (TAZ 14.06.2007). The facilitations foreseen in the draft Services Directive for the posted-workers directive clearly ran counter to these control efforts. In its attempt to ease the posting of workers, the Commission started an infringement procedure in late 2004 against Germany for restricting the services freedom disproportionately. But in its judgement of July 2007, the ECJ assessed the German interest in workable controls by requiring translated documents as not

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[10] 'Für Fairness am Arbeitsmarkt – Kabinett beschließt Änderung des Arbeitnehmer-Entsendegesetzes'. Bundesministerium für Wirtschaft und Arbeit, 11.05.2005.

[11] In the following, I partly draw on unpublished work and interviews done by Wendelmoet van den Nouland in the context of our NewGov project "The Domestic Impact of European Law".

[12] Task Force to fight the abuse of the freedom of services and of establishment.

interfering with the services freedom (C-490/04). It remains to be seen whether this will lead the European Commission to back down from its criticism on how Germany, and other member states, have implemented the posted workers directive, and to refrain from further liberalization. Only in June 2007 the Commission had published a communication on the directive, criticising member states for overly controlling the use of the services freedom.[13]

Moreover, since April 2006 Germany compels other member states to send a copy of all E 101-forms (documenting social-security contributions in the home country) of workers posted to Germany to the Deutsche Rentenversicherung in Würzburg.[14] Previously, Germany suffered a serious set-back in its activities to combat fraud when the ECJ ruled in early 2006 that member states have to accept existing E 101-forms, even when they are obviously improperly issued (C-2/05, 26.1.2006). In cases of suspicion, member states have to contact the issuing authority of the concerned member state or start an infringement procedure (Art. 227 EC Treaty) against each other. But national courts may not unilaterally reject administrative acts of other member states. This left Germany relatively helpless in a case where Germans had

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[13] Communication from the Commission: Posting of workers in the framework of the provision of services – maximising its benefits and potential while guaranteeing the protection of workers. See: **http://ec.europa.eu/employment_social/news/2007/jun/communication_en.pdf** [accessed June 2nd, 2008]

[14] Deutscher Bundestag, Drucksache 16/5098, 25. April 2007. Deutscher Bundestag, 27 May 2005, 'Dienstleistungsfreiheit nach der EU-Osterweiterung', p. 18. **http://dip.bundestag.de/btd/15/055/1505546.pdf** [accessed June 2nd, 2008]

employed Portuguese workers on a permanent basis, pretending that they were being posted from Portugal, thus evading social security payments in Germany.[15]

Aiming at a 'common understanding' of the freedom of services, Germany conducts bilateral talks with other member states, both old (e.g. Denmark, the Netherlands, Austria) and new (Poland and Hungary) on a regular basis (BMF/BMAS 2006: 4-6). At issue are the criteria of according the status 'posted worker' and the conditions of giving out E 101-certificates, including the required economic activity in the country of origin (combating mailbox companies), and the distinction between real and mock self- employment.[16] Moreover, the bilateral talks allow the investigation of specific problems, such as the situation in German slaughterhouses.[17] The talks explicitly aim to strengthen mutual trust (BMF/BMAS 2006: 4) and seek the signing of administrative cooperation agreements between Germany and the new member states (which exist already between Germany and France, between France and (← **p. 858**) Belgium, and between Britain and the Netherlands) in order to improve cross-border controls and cooperation between the respective authorities.[18]

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[15] Bundesgerichtshof, Pressestelle, N. 143/2006; Keine Strafbarkeit wegen Nichtabführung von Sozialversicherungsbeiträgen bei Vorlage einer durch einen Mitgliedstaat ausgestellten „E 101- Bescheinigung". Urteil vom 24.10.2006, 1 StR 44/06.

[16] Interview BMAS 29.3.2006; Interview BMWi 29.3.2006. Die Welt, 12 April 2005, 'Lohndumping: Regierung verhandelt mit Polen'; Financial Times Deutschland, 26 April 2005, 'Rüge aus Polen; Dienstleistungen'

[17] Interview BMWi 29.3.2006.

[18] Interview Zoll- FKS 17.3.2006; 'Gemeinsam für Deutschland. Mit Mut und Menschlichkeit'. Koalitionsvertrag von CDU, CSU und SPD, 11 November 2005, p. 39.

http://www.bundesregierung.de/nsc_true/Content/DE/__Anlagen/koalitionsvertrag,templateId=raw,property=publicationFile.pdf/koalitionsvertrag [accessed June 2nd, 2008]

4.2 The fate of the Bolkestein Directive

Redistributive rather than efficiency issues also dominated the negotiations of the Services Directive. The compromise which was reached in the European Parliament between the Social Democrats and Christian Democrats abolished all references to the contentious home-country principle, speaking only of the obligation to enable the freedom of services.[19] However, a list of measures is included which member states may not impose, such as special duties to register in the host country or ex-ante certification as well as prescriptions as to materials and tools used. So in all these cases, home-country rules apply, albeit the directive refrained from saying so openly (Nicolaïdis and Schmidt, 2007). Importantly, the list of justifications for host-country requirements in Art. 16 III is much narrower than the ECJ case law, implying a "deregulatory shift" (Witte 2007: 12; Davies 2007b: 12, 18).

The final directive is more restricted in scope than the draft, exempting health services, utilities, public transport, social, and security services, temporary workers, gambling and lotteries, waste, audiovisual services, electronic communication, financial and legal services. With regard to consumer protection, the directive applies host-country rules (Art. 3 II). Also, the facilitations foreseen for the posted-workers directive were deleted, much to the displeasure of the East European member states. Here, the Commission promised a separate follow-up on the workings of the posted-workers directive, as mentioned above. It remains to be seen whether the recent ECJ judgment concerning the German controls stops the Commission's attempts to liberalize the posted workers regime.

[19] Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on services in the internal market, see: **http://eur- lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32006L0123:EN:NOT** [accessed June 2nd,2008]

Other provisions remained more or less untouched. Thus, member states have to establish points of single contact for service providers in their administration, to abolish disproportionate regulatory burdens, and to allow service providers to do all formalities electronically. Importantly, the directive includes far-reaching provisions on administrative co-operation (Chapter VI; Articles 28-36), detailing the responsibilities of the administrations in the home and the host country. In contrast to the original version, host-country authorities will now be responsible for controlling those rules which they impose themselves (Art. 31). But generally, home-country authorities are the ones legally responsible for oversight. Both authorities cooperate closely, since home-country authorities cannot become active in the host country, having to request the host authorities to act. Notably, the directive establishes a duty to cooperate among the member states' administrations. This has not existed before to such an extent.[20] Thus, Art. 28 (8) foresees that the Commission will start an infringement procedure if member states fail to comply with their duties of (← p. 859)"mutual assistance". In order to facilitate cooperation across the language barriers, the Commission is promoting an information system providing for automatic translation of specific standardized paragraphs.

Thus, the Services Directive lays the root for transnationally operating administrations. Instead of simply following the instructions given in their national hierarchy of command, with the Minister on top being ultimately politically responsible (Döhler, 2001), administrations now also have to comply with horizontal demands, originating in other member states' administrations.

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[20] Interview European Commission, DG Internal Market 27.9.2005.

In the negotiations on the directive, the administrative changes required by the directive received relatively little attention. They impose, however, major institutional changes. "… the real importance of the Directive is elsewhere. Its proper title should perhaps be "the Directive on harmonisation and modernisation of public administration"" (Davies, 2007a: 239). Yet the requirement to provide for points of single contact implies a "paradigmatic" change for administrations, as these now have to be thought of from the point of view of the citizen accessing the administration rather than from the point of view of state organization and lines of inner- administrative accountability and responsibility (Schliesky, 2005: 891). The obligation of administrative assistance among member states intensifies these changes, and raises questions as to which administration acts under what kind of law. Thus, if the host- country administration acts on behalf of the home-country administration, it would have to do so on the legal basis of the home country. But how would legal protection against these acts be organized, which court would subject the administration under what kind of law? Would the home-country court, say in Estonia, order the administration, say in the UK, to postpone or alter its acts? How would different data protection laws be handled? It is likely, that the duty to cooperate will lead to further harmonization of administrative laws of member states, as national laws have to be adapted to the new requirements (Schliesky, 2008: 223-228). Thus, the directive presents a significant break from the past principle that member states are free to implement European directives with the European Union not interfering with member states' administrative organization (Schliesky, 2005: 893f).

To sum up, redistributive concerns were appeased by reducing the scope of the directive and by abolishing the home-country principle, at least officially. By the back door, however, mutual recognition and home-country control remain. The directive

does not provide an answer to the resulting issues of equality of service providers working side-by-side under different regulations and the obligation of member states to possibly discriminate against their own population. For the problem of home- country control of service providers active in another member state the directive introduces an obligation of cooperation. The centrality of administrative cooperation becomes also apparent in the bilateral attempts of the German government. In the case of services, regulation matters so much (← **p. 860**) for competitive performance that incentives are high to engage in regulatory arbitrage or even fraud. The harmonization of administrative procedures to contain these redistributive issues logically follows.

5 Conclusions

Mutual recognition is an alternative to integrating markets via harmonization. For services markets it poses particular challenges. While integrated markets can further Pareto-efficiency, the specific rule dependence of services, whose production generally cannot be separated from consumption, implies significant redistributive consequences. Often little investment and long-term commitment is needed for services trade, making forum-shopping quite easy. I have argued that to understand why mutual recognition in services proves so contentious, three interdependent relationships have to be taken into account: among member states, between governments and their citizens, and among differently regulated EU citizens.

With mutual recognition, governments effectively delegate the regulation of services among each other. For services, member states have to trust each other to control sufficiently—even when just for the sake of customers abroad. Different to goods, in the control of services it is often possible to distinguish whether the beneficiaries of

controls are domestic customers or those of another member state. Particularly in view of high unemployment figures in new member states, old member states are sceptical whether the administrations of new member states act altruistically to take decisions favouring old member states at the expense of their own population. Because of the difficulty of controlling service providers under home-country rule, mutual recognition in services favours illegal activities.

In order to ameliorate such concerns of not playing by the rules, and thereby raising redistributive issues, the Services Directive strengthens administrative cooperation. As we saw, this is also what Germany attempted in bilateral talks. Interestingly, mutual recognition thus leads to a beginning harmonization of state organization.
Traditionally, it is up to member states how they implement the law of the European Union. While mutual recognition allows 'unity in diversity' when it comes to regulation (Joerges, 2006: 790); paradoxically, in implementation it leads to a new form of harmonization in the case of services. In terms of institution building, this is a significant development. Possibly, it lays the root for a network of nationally-based administrations pursuing European aims, rather than segmented national authorities pursuing domestic goals (cf. Egeberg, 2008). It remains to be seen to what extent the redistributive conflicts inherent in services trade can be mediated successfully on this level.

While administrative cooperation may strengthen trust among governments, the problems mutual recognition in services raises in the relationship of governments to their citizens and among EU citizens are much more difficult to solve. As home- country rules are being taken along (← **p. 861**) with services provision, these rules take effect outside the territory where they were legitimately enacted. Thus, service providers simultaneously work side-by-side under different rules and member states

may be forced to discriminate against their own citizens with their domestic regulation. This is a consequence difficult to accept, and the directive does not provide any answer to this problem of equality.

As Joerges argues, mutual recognition has the normative benefit of forcing member states to take into account their respective interests, given that economic decisions of one member state very likely have externalities in the single market. Mutual recognition works under the assumption that regulations are equivalent. Often, there are different ways of achieving the same regulatory objectives. By agreeing to mutual recognition, member states implicitly accept that the efficiency gains of a larger market come at the cost of some discrimination of their own citizens. This is the case whenever mutual recognition is applied. The example of services trade shows that it is not so much the kind of rules that are recognized, but the ocurrence of very open inequality between different EU citizens that makes mutual recognition politically so contentious. With goods, and also with mutual recognition in JHA, EU citizens subject to different home-country rules do not find themselves in the same place at the same time, noticing directly their different treatment. For services this is the case. It follows that while member states have to take account of the regulatory situation in other member states to lessen their legitimatory deficit, it is politically difficult for the Union to demand from member states to openly discriminate against their own citizens. Consequently, in those areas where mutual recognition leads to a direct comparison of EU citizens being subjected to different home-country rules, mutual recognition is bound to be contentious. (← **p. 862**)

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