

Michaelis, Jochen

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Jochen Michaelis*

Mutual Recognition of National Regulations in the EC

The principle of the mutual recognition of national regulations is often seen as the best course towards the realization of the EC single market, but there still remains great uncertainty concerning the interpretation of this principle. Which companies must observe which regulations? Will there be changes affecting current competitive conditions?

Up to the beginning of the 1980s the EC Commission pursued the concept of harmonization of the law. Divergences in national regulations were regarded as non-tariff trade barriers, and the idea was to eliminate these by establishing a common, harmonized code of regulations. When the attempt to set up that common basis became mired in countless technical details, the Commission was forced to find a way out of this dead end. It developed its "new strategy", which was presented in a White Paper and consisted essentially of two elements:

- ☐ confinement of harmonization to the fixing of obligatory health and safety requirements (minimal harmonization); and
- ☐ mutual recognition of each other's national regulations.

In putting forward the idea of mutual recognition, the Commission was taking up the principles underlying the Cassis de Dijon judgement of the European Court of Justice: any product which is legally produced and brought on to the market in one member country is fundamentally also allowed to be marketed in the other member countries. The Cassis formula implies the removal of import restrictions – national law may not be applied to imported goods. On the other hand, national regulations continue to apply to domestic goods.¹ For example, all goods produced in Federal Germany and intended for the German market must also continue to satisfy German regulations in the single market. This applies equally to German producers, to German subsidiaries and to local branches of foreign companies.

The changes in the legal situation will only affect exported goods, which up to the present have had to

conform to the regulations of the country of destination. The principle of mutual recognition is equivalent to a conversion to the country-of-origin principle, i.e. in intra-Community trade in goods, the law as it stands in the country of origin always takes precedence. Thus a manufacturer in any given country is now permitted to distribute products produced in accordance with domestic laws throughout the EC; whereas in the past he would have had to observe twelve different national regulatory codes in order to market his goods EC-wide, it is now sufficient for him to comply with those of the country of origin.

An exporter is allowed, but not compelled, to change to conformity with the regulations of his own country, or may choose, if he wishes, to comply with the regulations of the country of destination. This position is different from the one which applies to services, which will be discussed later, and as such it is worth illustrating more closely. Nearly all national laws contain a clause waiving the applicability of their own regulations to production for export. It is only by dint of such a clause, for example, that a German manufacturer is permitted to export a product to Denmark which is prohibited in Germany but allowed in Denmark. In the absence of such a clause, the exporter would be strictly held to his own domestic regulations. One example of this is Sec. 36 of the German Milk Act, which not only prohibits the marketing, but also the production and hence also the export of imitation milk products. Surprisingly, it has still not been clarified whether such a prohibition does not in fact violate Article 34 of the EEC treaty, which prohibits export quotas, or any measures having the same effect, between the member countries.

¹ This was explicitly confirmed by the European Court in the fruit vinegar judgement of 26th June 1980 (Case 788/79). Cf. also Ulrich Everling: Die rechtliche Ausgestaltung des EG-Binnenmarktes, in: Die Verwirklichung des EG-Binnenmarktes, Beihefte der Konjunkturpolitik, No. 36, 1990, pp. 75-91.

* University of Freiburg, West Germany.

Is the observance of any one of the twelve national regulatory codes sufficient to gain market access throughout the EC? Would it be possible in the single market, for example, for a German manufacturer to produce something prohibited in Germany but allowed in Denmark and export it not only to Denmark, but also to France? In this case, the position in the single market will be just the same as it is today: if the product satisfies not only the Danish, but also the French regulations, the answer to the question is yes (the regulations of the country of destination are adhered to); otherwise the answer is no.

The Commission interpreted the Cassis judgement² to the effect that a product can only lay claim to unrestricted EC marketability if it is produced in accordance with the domestic regulations of the export country, and is brought on to the market *in that country*. In the foregoing example, the second criterion is not fulfilled, and consequently France does not have to allow the import of this product within the context of the single market. In the absence of any border controls, however, the question of feasibility arises along with that of the reasonableness of such import restrictions. As with national import quotas (e.g. those for automobiles) the *de facto* implementation of such regulations is impossible. Apart from that, it is contrary to the spirit of the single market if, as in the above example, a product which is "made in Denmark" can be sold in France, while exactly the same product which is "made in Germany" cannot. From the economist's point of view, therefore, it must be demanded that companies be not only free to choose between the regulations of the country of origin and those of the country of destination, but be allowed to opt for the regulations of any member country they prefer. Moreover, this is the only way in which it can be avoided that EC companies are put at a disadvantage vis-à-vis competitors from third countries.

In accordance with Article 9 of the EEC treaty, goods from third countries which are freely marketed in the EC are put on a par with goods originating in the EC. A company from a third country therefore benefits considerably from the single market, as it only has to observe the regulations of one of the twelve member countries to market its product throughout the Community. The only aspect which might give rise to problems is the initial importation into the EC, as the product concerned has to be imported via a member country in which it is legally marketable. Take as an example a Swiss manufacturer who wants to market a product in Germany which is allowed in Denmark but forbidden in Germany. The manufacturer is barred from direct export to Germany because national regulations

can be applied at the so-called third country border.³ A strict application of this fundamental principle, however, inevitably gives rise to pure nonsense: how should the Swiss product be transported from Switzerland to Germany if it violates not only the German but also the French regulations and cannot be imported via France either? Here again the Commission is challenged with the task of ensuring that a product can be imported via any third country border into the EC, insofar as it can be shown that this product meets at least one of the twelve member countries' regulations.

There are, of course, no rules without exceptions: Article 36 of the EEC treaty, as well as the decisions by the European Court of Justice, defines various goals including health protection, consumer protection and environmental protection, which are superordinate to the free movement of goods, and which therefore might serve as a justification for impediments to trade. Any import restriction derived from these objectives must, however, also fulfil the law of commensurability. In other words, the objectives should be met by means which do the least injury to trade. The European Court of Justice applies very stringent requirements concerning these criteria. Even in such a sensitive area as that of foodstuffs, the European Court has to date ruled that – save one exception – all import bans based on health or consumer protection are violations of the EEC treaty. The most spectacular cases involved the German beer purity law, the German imitation milk product ban and the Italian pasta purity law. In each of these cases the European Court considered the above objectives to be fulfilled if the products were plainly labelled, indicating their type and ingredients.

Banking Services

The EC Commission is less consistent in its treatment of mutual recognition in the services sector than in the real goods market. Financial services offered by banks and insurance companies serve as a good example. In the area of banking, steps towards bringing the single market into operation are relatively advanced. It is already possible, based on the country-of-origin principle, for any EC bank to offer its services in all the member countries, without being required to have branches there (free trade in services). The remaining

² EC Commission: Communication of the Commission on the effects of the judgement of the European Court of Justice dated 20th February 1979 on Case 120/78 ("Cassis de Dijon"), Official Bulletin No. C 256 of 3rd October 1980.

³ It was decided by the German Federal Court of Justice in the "cocktail judgement" of 28th May 1985 that a German importer of a US liquor prohibited in Germany should be barred from direct import, whereas importation through the Netherlands, where this product was legally marketable, should be allowed.

restrictions on the movement of capital which still impeded the free development of banking services were lifted on 1st July 1990.

Mutual recognition particularly bears on the subject of freedom to set up foreign operations. Although the First Banking Directive of 1977 (COM 77/780/EEC) provides for the unrestricted opportunity to establish operations in any EC country, each such foreign operation – whether a subsidiary or a branch office – is still subject to the admission procedures and the supervisory system of its host country.

This directive did no more than to grant open access to foreign regulatory systems. For branch offices, although not for subsidiaries, the transition to the country-of-origin or home-country principle was ratified in the Second Banking Directive of 15th December 1989 (COM 89/646/EEC). In the single market every EC bank will be entitled to establish a branch in any other member country on the basis of its own domestic licence and, through this branch, may offer financial services in keeping with the regulations of its home country. Responsibility for monitoring the financial soundness and the solvency of such a branch office as well as its activities in general will in future be the responsibility of the authorities in the home country. Meanwhile, the authorities of the host country retain their responsibilities for supervising liquidity ratios and monetary policy. The host country can only deny a branch office permission to operate if it is guilty of a serious infringement of public interest.

Before subsidiaries of banks from third countries can enjoy the benefits of an EC banking licence they must jump the hurdle of "reciprocity". This involves a review by the Commission to determine whether the treatment of EC banks in the third country is comparable to that granted to the third country banks within the Community. If the Commission ascertains unequal treatment, it directs the member countries to suspend the decision on the admission of the third country bank. This ruling has often aroused the suspicion that it is in fact a massive cornerstone for Fortress Europe.⁴

It was not least due to this criticism that more moderate formulations were chosen in the Second Bank Directive. This directive states that if EC banks in a third

country are treated identically to domestic banks, this is sufficient for third country banks to receive the green light for EC entry from the Commission. The subsidiary of the third country bank is placed on an equal basis with the financial institutions of the host country, that is, it falls under the supervisory regulations of the host country, and it can offer its products throughout the Community via the free traffic in services or by setting up branch offices. On the other hand, mere branches of third country banks which do not have a subsidiary company "interposed" will remain excluded from the free intra-Community traffic in services, even in the single market. They are allowed to offer their services solely in the member country where they are registered.

Insurance Services

In the insurance sector, no equivalent yet exists to the EC banking licence. The Commission and the European Court consider insurance services an especially sensitive area, to which the principles of mutual recognition can be applied only to a limited extent. The decisions of the European Court follow the line that the retention of the currently practised country-of-operation principle is usually justified for the protection of the insured parties. It is solely in exceptional cases where, due to the uniqueness of the risk or of the insured party, no special need for protection exists, that a change to the country-of-origin principle is thought appropriate.

This European Court principle was made concrete in the Second Indemnity Directive (COM 88/357/EEC).⁵ Insurance contracts with private customers as well as with small businesses (mass risks) continue to be subject to the laws of the country of the insured party. This is true whether or not the contract is made with a domestic insurer, with the domestic subsidiary of a foreign insurer or with an insurer which has no subsidiaries in the country. In the last case permission from the domestic authorities must be obtained. The non-application of mutual recognition makes it impossible for private individuals or small businesses to exercise a preference for foreign regulatory systems. From the economist's point of view, these restrictions should be removed as quickly as possible. Why should indemnity insurance in particular be governed by the maxim that the customer has to be protected and that he should not, for example, be free to purchase a foreign fire insurance policy?

For the commercial insurance purchaser who exceeds a certain sales volume (large risks), the country-of-origin principle and free traffic in services is a reality. In the single market such customers will be able to choose freely among all the various forms of insurance offered in the Community as well as to choose

⁴ Cf., e.g., Horst G. Krenzler: Zwischen Protektionismus und Liberalismus – Europäischer Binnenmarkt und Drittlandsbeziehungen, in: Europa-Archiv, No. 9, 1988, pp. 241-248; Willy de Clercq: 1992: The Impact on the Outside World, Alpbach European Forum, Economic Symposium, 29th August 1988.

⁵ On the following, cf. Michael Krakowski: Versicherungsmärkte, in: Otto G. Mayer, Hans-Eckart Scharrer, Hans-Jürgen Schmahl (eds.): Der Europäische Binnenmarkt – Perspektiven und Probleme, Hamburg 1989, pp. 151-173.

any insurer they wish. Such insurance policies can either be purchased directly from the foreign country, or through the domestic branch of the foreign insurance company. In the Second Indemnity Directive there is no mention of regulations for third country insurance companies; if any such company is seeking a licence for a subsidiary in the EC, the procedure will be unaffected by how EC insurance companies are treated in the company's own country.

Mutual recognition was outlined only in rudimentary form in the Commission's proposals for the Second Life Insurance Directive (COM (88) 729 final). In order to protect the consumer, individual life insurance should continue to be subject to the law of the country in which the policy holder resides. A foreign insurance company which offers its services through a subsidiary must still follow the regulations of the host country. New is the fact that a client may directly consult a foreign insurance company and sign a contract which is then subject to the applicable regulations of the country of the insurer. Such a contract may not, however, be drawn up through the domestic subsidiary of the insurer, if the contract involves a branch of insurance also covered by that subsidiary. For example, if a British life insurance company offers term life insurance in the United Kingdom as well as through a subsidiary in Germany, the German customer may not obtain insurance through the subsidiary if he/she desires an insurance policy based on British law. The customer, however, is allowed to employ the services of an insurance broker. Where access by third countries is concerned, life insurance will be treated exactly as are financial institutions under the Second Banking Directive.

The Commission's proposal, which is supposedly founded on the need for consumer protection, can be seen at a glance to be in need of reform. The proposal should be welcomed, however, as long as it is understood not as the ultimate goal, but rather as the first step towards establishing a country-of-origin principle, to which individual member countries are still putting up heavy resistance.

The principle of mutual recognition is a giant step in the right direction as it drastically reduces the number of EC harmonization procedures and, in combination with the introduction of qualified majority voting, has greatly accelerated the realization of the single market. It would therefore be positive if this principle were extended to include those areas regulated at present – albeit

incompletely – by the Community. There are, however, no signs of this at present. On the contrary, the Commission intends to maintain the already existing directives of specific products.

When such directives are adopted in national legislation there occasionally exist certain areas of flexibility which could result in divergences in national legislation. Non-tariff trade barriers arise here, which will not be made obsolete by the principle of mutual recognition.⁶ It is not at all clear why, for example, a British producer of vegetable-fat chocolate – which is clearly not a health risk – is not allowed to export the product to France simply because this prohibition is backed up by a directive (COM 73/241/EEC). Quite apart from that, there remains the question of how well such a prohibition is enforceable without border controls. This reveals a potential for deregulation which could be utilised through mutual recognition.

Reverse Discrimination

According to the country-of-origin principle, products from other EC countries need not conform to domestic regulations. Yet domestic producers themselves continue to be subject to domestic standards which are on occasion stricter. The result is a competitive advantage for foreign producers and discrimination against domestic producers.

Reverse discrimination can take quite farcical forms. For example, while foreign and domestic producers may well sell equivalent foodstuffs on the same market, they may not be allowed to use the same labelling. Thus German regulations define in detail what characteristics a product must have before it can be labelled "remoulade". A foreign producer whose product fits the foreign definition of remoulade but not the German one is allowed to sell this product as remoulade in Germany. On the other hand, a German producer would be forced to find a description for the same product which did not mention the word remoulade.

Because of reverse discrimination, the competition between regulatory systems is necessarily accompanied by distortions in competition. New domestic markets and product differentiations arise which are reserved for foreign producers. An illustrative example is the German market for imitation milk products. If the German production and marketing prohibition (Sec. 36 of the Milk Act) is not removed, German producers will not only be barred from taking advantage of this lucrative market – in the rest of Europe as well as in the USA imitation milk products represent up to 30% of all milk products sold – but they must also accept loss of profit due to the shift in consumer

⁶ This assessment was explicitly confirmed by the Commission in answer to a written question in the European Parliament from Beyer de Ryke, MEP; cf. Official Bulletin, No. C 92, 13th April 1982.

demand. The positive aspects of an increase in the range of goods available will be accompanied by negative effects on domestic income and employment.

In view of these implications, the demand for new regulations in certain areas on the part of domestic producers will sink drastically. National standards are no longer appropriate to prevent competition by reducing the opportunities for substitution. In the single market they are not only ineffective, but indeed turn into a competitive disadvantage for the domestic producer. This will result in forceful pressure on domestic law-makers (in all member countries), as only they can counteract the prejudicial regulations affecting domestic producers by harmonizing the rules. A tendency for legislation to match that of other member countries is the result. At the end of this process, as a theoretical extreme case, is complete harmonization as the crowning touch on the concept of a single market rather than the precondition for it, as was claimed by the Commission up to the time of the White Paper.

Lowered Standards of Quality?

Mutual recognition frequently engenders anxiety that quality standards may be lowered. Such a hypothesis can be divided into two arguments, one of which is primarily technical, the other of which is primarily economic. Addressing first the technical argument, under the single market control by domestic supervisory authorities over imported goods will be made much more difficult. German authorities, for example, will have to check whether a Greek product sold in Germany meets domestic Greek regulations, whether a Spanish product meets domestic Spanish regulations, and so on.⁷ Virtually insurmountable problems involving access to information suggest there will be a shifting of control from the country of destination to the country from which goods originate. Those countries which uphold "high standards" harbour a definite mistrust regarding the quantity and the quality of control elsewhere, particularly in the peripheral EC countries. The Commission has now recognized this problem and is attempting to solve it by creating data banks and setting up training programmes.

A more serious matter is the economic argument: that high quality domestic goods will be driven from the market by shoddy goods imported from countries with "low standards". However, even the initial hypothesis – that foreign products are of lower quality – cannot be sustained in this over-generalized form. Products

deviating from domestic standards of quality are not *per se* better or worse, but rather it is often simply a case of differing product definitions.

Yet even if one accepts the hypothesis in general, one is left with the problem of how to view it in normative terms. One undeniable fact is that demand can then spread over a broader spectrum of price and quality. If a range of products previously restricted to a certain minimum quality level by national standards did not conform with consumer preferences, at least a portion of consumer demand will shift to lower-priced products which are also of lower quality. The resultant decrease in the average quality of goods should, however, not be interpreted negatively, but rather positively, as it is based on consumer preference.⁸

Minimal Harmonization

In the single market, the Commission is reducing its harmonization efforts to the fixing of minimal standards, to be binding EC-wide. The reasons it gives for continuing this form of harmonization are, however, not free of inconsistencies. If all national legal systems pursue in principle the same goals, e.g. health and environmental protection, and if all national regulations are classified as essentially equal, then the necessity for minimal harmonization disappears. Consequently, minimal harmonization can be interpreted as an expression of mistrust on the part of the "high standard countries" vis-à-vis the requirements made by other individual national legislation. On the other hand it was the continuance of minimal harmonization which paved the way for their agreeing to mutual recognition at all.

Also participating in the competition between national regulatory systems sketched out above are the EC's own regulations. Domestic law-makers will be motivated to elude the changes necessary to eliminate reverse discrimination resulting from their own national legislation by lobbying for their own national standards to be adopted as future EC minimal standards. Demand for EC harmonization is therefore also present in the single market, and the Brussels bureaucracy can surely be depended upon to meet that demand.⁹ The danger is that over time, the net of harmonization will again be woven with too tight a mesh.

⁸ It is assumed here that the consumer is familiar with the characteristics of the product and that there are not considered to be any negative external effects from the consumption of the product. Cf. on this Hans Günther Oberlack: *Handelshemmnisse durch Produktstandards – ökonomische Aspekte ihrer Beseitigung*, Hamburg 1990.

⁹ A typical example are the EC plans to determine how much of each additive can legally be contained in which foodstuff. The justification given for this is that if mutual recognition were also to apply to additives, a potential health danger could arise from the cumulative ingestion of additives, due to the differing consumer habits from country to country.

⁷ There can be no denying that the problem of control will be multiplied if the proposal being promoted here – that a company must only conform to any one national legislation – does become a reality.