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The Rise and Fall of the Country of Origin Principle in the EU's Services Directive - Uncovering the Principle's Premises and Potential Implications

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The Rise and Fall of the Country of Origin Principle in the EU's Services Directive

– Uncovering the Principle's Premises and Potential Implications –

By

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CONTENT

A. Introduction

In January 2004 the European Commission proposed a directive on "services in the internal market", which contained the so-called "country of origin principle" (COP) as its most important provision regulating the free movement of cross-border services in the EU.[1] This principle essentially lays out the general rule that Member States must "ensure that [service] providers are subject only to the national provisions of their Member State of origin."[2]

The COP played the most prominent role in the political controversy that aroused in the context of the legislative proceedings. The debate has been centred around the slogans of social dumping and a race to the bottom for social standards on the one hand, and the potential for growth and greater competitiveness on the other. The way this debate was taken up by the media and politicians, it has been marked by a considerable degree of blurred beliefs and unsubstantiated assumptions. It therefore demands demystification and a clear identification of the underlying normative choices for European integration.

In the meantime, the legislative process has advanced: The European Council concluded in 2005 that the Commission's proposal did not sufficiently preserve the European social model. The European Parliament's committees were faced with more than 1.000 amendments to the proposal. Finally, on 16 February 2006 the plenary adopted at its first reading a legislative resolution demanding major amendments to the draft proposal.[3] The Commission subsequently presented an amended proposal on 4 April 2006 which considerably changes the provisions regarding the free provision of cross-border services deleting the notion of the COP.[4]

However, the Member States that now carry the task of finding a common position appear far from unanimous on the question of country of origin principle. While Germany and France favour the amended version of the directive, Great Britain and the new Eastern European Member States remain supportive of the COP.[5] A final solution regarding the political desirability of the COP is not in sight.

In this state of uncertainty it therefore still appears warranted to take the original formulation of the country of origin principle as a basis for further academic legal analysis in order to shed light on some of its most important premises and implications. Such is the objective of this article. The background will be provided in chapter B which discusses the specific nature of services and their regulation and the economic argument underlying the services directive in order to then put the content of the

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1 Proposal for a Directive of the European Parliament and of the Council on Services in the Internal Market, COM (2004) 2 final, 05 March 2004, (hereafter European Commission (2004)).

2 *Ibid.*, Art. 16 (1).

3 European Parliament legislative resolution on the proposal for a directive of the European Parliament and of the Council on services in the internal market, provisional edition, P6_TA-PROV(2006)0061, 16 February 2006.

4 European Commission, Amended proposal for a Directive of the European Parliament and of the Council on Services in the Internal Market, COM (2006) 160, (hereafter European Commission (2006)).

5 This informal information to the press is documented e.g. in Handelsblatt, 14 March 2006, 6.

COP in its policy context. Chapter C seeks to locate the COP in existing EU law, particularly with regard to the EC Treaty, secondary legislation and the case law of the Court of Justice. Is the COP a mere restatement of existing law? Or does it go beyond the case law concept of "mutual recognition"? Chapter D then places the principle in the broader systemic context of the European economic constitution. In particular, the relationship between the COP and harmonisation will be evaluated: Does the new principle promote harmonisation or deflect from it? Further, the impact on regulatory competition will be assessed: Does the COP foster a race to the bottom in regulatory standards of protection? Chapter E subsequently adopts a more practical perspective enquiring into the workability of the principle on the enforcement level. Its merits will particularly be questioned in the light of tactics of circumvention or abuse that the COP might facilitate. Chapter F will then briefly deal with the most recent developments presenting the relevant parts of the amended proposal for the services directive. It will particularly analyse whether the new approach to promoting the freedom to provide services effectively addresses the criticism developed in this article.

Due to constraints of time and space, this article has to focus on a limited number of issues. Other issues of interest, e.g. the scope of the principle or the interaction with other directives, have to be omitted. The added value of this research can rather be found in a deeper insight into the legal value of the country of origin principle within the broader context of economic integration.

B. The Proposed Services Directive: Prescribing the Country of Origin Principle

The present chapter will present the background to the subsequent discussion of the country of origin principle. Before outlining the content and scope of the principle as proposed by the 2004 draft services directive, a brief account will be given of the specific nature of services and their regulation. Moreover, the economic argument supporting the proposed directive will be rehearsed in order to put the principle in its policy context.

I. The Nature of a "Service" and its Regulation

Searching for the content of the term "service", the EC Treaty provides only for limited clarification: "Services" within the meaning of the Treaty are "normally provided for remuneration".[6] Moreover, the free movement of services must be distinguished from the freedom of establishment: Unlike establishments, services are considered to be "temporary"[7] activities.[8] The classification of services into four different "modes of supply" suitably illustrates the scope of services in a cross-border context:[9]

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6 Art. 50 (1) Treaty of the European Community (hereafter: EC); the service, however, need not be paid for by those benefiting from it, see e.g. ECJ, Case 352/85 *Bond van Adverteerders*, [1988], ECR 2085, para. 16.

7 Art. 50 (2) EC.

8 For further detail, see below section E.I.

9 See *Barnard*, Substantive Law, 331, *Snell/Andenas,* in: Andenas/Roth (eds.), Services and Free Movement, 69 (71) and *Woods*, Free Movement, 161.

(1) The service provider temporarily moves to the country of the recipient.
(2) The recipient travels to the country of the service provider.
(3) Both service provider and recipient travel to another country.
(4) Neither provider nor recipient travels, but the service itself moves.

The first category reflects the situation originally envisaged by the Treaty's freedom to provide services, e.g. a construction company fulfilling a contract in another Member State.[10] The second category was developed as a "necessary corollary", e.g. allowing tourists access to medical treatment in other Member States.[11] The third category applies to situations like tourism, where tourists guide and tourists both travel to a third country. The forth category involves cross-border supply of a service by means of telecommunication or broadcasting.[12]

While the provision of services is far more complex and multi-faceted than that of goods, services are also generally more heavily regulated:[13] Rather than just the service, the qualifications of the provider and its staff and the quality of their equipment are often subject to rules.

II. The Economic Case for the Services Directive

In March 2000 the Lisbon European Council set an ambitious objective for the European Union: "to become the most competitive and dynamic knowledge-based economy in the world" by 2010.[14] To this end, it called for rapid reforms for a "complete and fully operational internal market" and asked the Commission to set out a strategy for the removal of barriers to services.[15]

The Commission subsequently announced its "Internal Market Strategy for Services".[16] In 2002, it presented the results of a comprehensive survey and analysis of existing barriers.[17] Finally, this process lead to the Commission's legislative proposal, the draft services directive.

The Commission has repeatedly stressed that a competitive services industry is an indispensable precondition to meeting the Lisbon objectives:[18] Services have come to play a key role in today's EU economy, representing almost 70% of jobs and GDP in most Member States.[19] Trade in services, however, has not developed accordingly.[20] In

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10 See Art. 49 EC.
11 ECJ, Joined Cases C-286/82 and 26/83 *Luisi and Carbone*, [1984] ECR 377, para. 10.
12 See e.g. ECJ, Case 352/85 *Bond van Adverteerders*, [1988], ECR 2085, para. 14-15.
13 See e.g. *Snell/Andenas,* in: Andenas/Roth (eds.), Services and Free Movement, 69 (73).
14 Lisbon European Council, Presidency Conclusions, 23-24 March 2000, para. 5.
15 *Ibid.*, para. 16 and 17.
16 COM (2000) 888 final, 29 December 2000 (hereafter European Commission (2000)).
17 Report from the Commission to the Council and the European Parliament on the State of the Internal Market for Services, COM (2002) 441 final, 30 July 2002 (hereafter European Commission (2002)).
18 Econometric studies estimate an increase in intra-EU services trade and a subsequent net creation of jobs and output, if trade barriers were significantly reduced; see e.g. Copenhagen Economics, Economic Assessment of the Barriers to the Internal Market for Services, Final Report, 1/2005, available on the internet: <http://www.europa.eu.int/comm/internal_market/services/docs/services-dir/studies/2005-01-cph-study_en.pdf> (visited on 26 April 2006), 7.
19 European Commission (2002), 55.

order to promote competition and allow service providers to reap the benefits of larger geographical markets and resulting economies of scale, the Commission advocates a comprehensive removal of existing barriers to trade aiming to make the provision of services across borders "as easy as acting within a Member State".[21]

The Commission has consistently argued that the main barriers to services trade are of a legal nature: Rather than straightforward discrimination or physical barriers, it is the mere existence of divergent regulatory systems that creates the greatest burden for cross-border services.[22] The host state's failure to take sufficiently into account conditions already met by the service provider in its home state, may lead to a costly duplication of requirements.[23] As a result, these barriers create compliance costs on cross-border service provision, which may be prohibitively high for small firms.[24] The Commission attributes these legal barriers mainly to a lack of mutual trust between Member States: Host state authorities that lack trust in the quality of the home state's legal system prefer to apply their own rules.[25]

III. The Services Directive and the Country of Origin Principle

The services directive aims to "provide a legal framework that will eliminate the obstacles to the freedom of establishment for service providers and the free movement of services between Member States, giving both the providers and the recipients of services the legal certainty they need".[26] The scope of services covered by the directive is broad and subject only to limited sectoral derogations. This horizontal approach is thus markedly different from previous approaches that dealt with specific sectors only.

The original draft of the directive first addresses the freedom of establishment. It sets out far-reaching provisions on administrative simplification,[27] restricts the authorities' margin of appreciation for the granting of authorisations,[28] prohibits a number of legal requirements on establishment and subjects others to evaluation.[29]

The chapter on the free movement of services contains the country of origin principle (COP) as its main provision. Article 16(1) reads:

> *Member States shall ensure that providers are subject only to the national provisions of their Member State of origin which fall within the coordinated field.*
>
> *Paragraph 1 shall cover national provisions relating to access to and the exercise of a service activity, in particular those requirements governing the behaviour of*

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20 *Ibid.*, 56; the share of services in overall trade has even decreased from 22.8% in 1992 to 21.6% in 1999.

21 European Commission (2000), 3 and 7.

22 European Commission (2002), 45.

23 *Ibid.*, 17.

24 *Ibid.*, 61.

25 *Ibid.*, 53.

26 European Commission (2004), Explanatory Memorandum, 3.

27 *Ibid.*, Art. 5-8.

28 *Ibid.*, Art. 9-13.

29 *Ibid.*, Art. 14-15.

> *the provider, the quality or content of the service, advertising, contracts and the provider's liability.*

This determination of the exclusive applicability of the home state's law is complemented by a comprehensive duty of supervision of the home state in Article 16(2):

> *The Member State of origin shall be responsible for supervising the provider and the services provided by him, including services provided by him in another Member State.*

As a corollary, the host state is generally precluded from regulatory intervention. Article 16:3 states:

> *Member States may not, for reasons falling within the coordinated field, restrict the freedom to provide services in the case of a provider established in another Member State …*

In particular, a host state must not impose obligations on the provider to have an establishment in the host state, to notify or register its services or to comply with requirements relating to the exercise of an activity that apply in the host state.

The Commission thus seeks to promote the free movement of services by giving service providers the legal certainty only to be bound by one set of regulations – normally that of their home state.[30] It also claims that supervision could best be effectuated "at source"[31], i.e. by the home country authorities. Authorities of the host state may participate in the supervision at the request of the country of origin. On their own initiative, they may only conduct checks, inspections and investigations, if those are non-discriminatory, objectively justified by a public interest reason, proportionate and consisting exclusively in the establishment of facts, not giving rise to any other measure against the provider.[32]

Further measures may only be taken where derogations to the COP are permitted. Articles 17 provides for general derogations, which are designed not to contradict Community instruments that prescribe the country of destination principle, i.e. the applicability of the host country's legislation to certain aspects of cross-border service provision.[33] These derogations also reflect areas where the level of disparity between national regimes is considered too wide and cannot yet sufficiently be narrowed by cooperation or harmonisation.

Importantly, Article 19 provides for case-by-case derogations. It sets out conditions according to which a Member State may, "in exceptional circumstances only", take measures against a service provider from another Member State. Essentially, such measures must be proportionate and motivated exclusively by reasons related to the safety of a service, the exercise of a health profession or public policy, and only to the extent that national provisions have not been harmonised in the respective field. In

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30 *Ibid.*, Recital 37.

31 *Ibid.*, Recital 38.

32 *Ibid.*, Art. 36.

33 E.g. the Posting of Workers Directive 96/71/EC, OJ L 18/1 of 21 January 1997.

addition, the Member State must comply with a mutual assistance procedure:[34] First, it is obliged to refer the case to the authorities of the home state; if the matter remains unresolved it must then – except in cases of urgency – notify the home state and the Commission before taking any measures.

Derogations are thus designed to be of very limited scope. Where openly worded, they are made subject to justification and even scrutiny by the Commission. As a consequence, the country of origin principle as prescribed by the original draft services directive appears very robust. With its introduction, the host state's prospects of applying its own rules would be considerably curtailed.

C. The Country of Origin Principle: Breaking New Ground?

Even the comparatively simple question whether the country of origin principle breaks new ground, i.e. goes beyond existing EU law, is subject to controversy. A frequently heard argument is that "the country of origin principle as a basic rule is part and parcel of European law regarding the provision of services as it stands today."[35] In the present chapter, this assumption will be tested. It will be examined with regard to the Treaty, secondary legislation, and most importantly, the case law of the Court of Justice. The chapter concludes by working out the differences between the judicially created concept of mutual recognition and the COP of the original draft services directive.

I. The Country of Origin Principle as a Treaty Principle?

There is no express mention of the COP in the EC Treaty. While Article 49 prohibits "restrictions on freedom to provide services", Article 50(3) seems to stress an obligation of national treatment, stating that a person may provide a service in another Member State "under the same conditions as are imposed by that State on its own nationals".

The view that a COP cannot be read into these provisions was confirmed by the Court of Justice in *Germany v. Parliament and Council.* It found that an alleged Community principle of home state control was "not a principle laid down by the Treaty".[36] Therefore, it could be departed from by the legislature.

II. The Country of Origin Principle in Secondary Legislation

In the absence of a specific Treaty mandate, Community legislation has been diverse: While some internal market directives have prescribed the COP, or principle of home state control, others have prescribed the opposite, i.e. a system of host state control.

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[34] Commission Proposal, Art. 37.

[35] *Brouwer*, Country of Origin Principle, 55, see also *Kluth/Rieger*, Gewerbe Archiv 52 (2006), 1 (1), who describe the COP as a "product" of the ECJ's jurisprudence.

[36] ECJ, Case C-233/94, *Germany v. Parliament and Council,* [1997] ECR I-2405, para. 64.

The language of the "home country control principle" prominently entered the realm of Community legislation with the Commission's 1985 "White Paper on Completing the Internal Market".[37] A number of subsequent directives in the field of financial services then incorporated the principle along with comprehensive measures of harmonisation.[38]

Another early example for the application of the COP is the broadcasting directive.[39] It ensures that the transmission of transfrontier broadcasts is generally only regulated by the home state of the broadcaster, the so-called transmission state. The receiving state must not hinder retransmission except under a few very narrowly defined conditions.[40] The transmission state, on the other hand, is obliged to ensure that all broadcasters under its jurisdiction comply with its national laws and particularly with the minimum standards laid out in the remainder of the directive.[41]

A recent legislation that resembles the approach and language of the draft services directive is the "electronic commerce directive".[42] It provides that online service providers are bound only by the laws of their Member State of establishment.[43] The directive only allows for case-by-case derogations from the COP, which must serve one of the strictly circumscribed general interests, be proportionate and be notified to the home state and the Commission. A special feature of the e-commerce directive is that the COP broadly applies across all sectors and not just to the few areas subject to harmonisation.

While the previous examples have shown various realisations of the country of origin principle, the "posting of workers directive" implements what may be called a country of destination principle.[44] This directive applies to service providers established in a Member State which post their employees to the territory of another Member State in order to temporarily provide services there.[45] It basically requires the host state to apply to posted workers certain core standards of its own labour law.[46] Rather than harmonising national rules the directive thus simply identifies those em-

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37 COM (85) 310, 14 June 1985, (hereafter European Commission (1985)), para. 102-103.

38 Particularly the Second Banking Coordination Directive 89/646/EEC, OJ L 386/1 of 30 December 1989, the Third Generation Insurance Directives 92/49/EEC, OJ L 228/1, and 92/96/EEC, OJ L 360/1 of 09 December 1992, and the Investment Services Directive 93/22/EEC, OJ L 141/27 of 11 June 1993, all amended by Directive 95/26/EC, OJ L 186/7 of 18 July 1995; for further information, see *Lomnicka*, in: Andenas/Roth (eds.), Services and Free Movement, 295 (298).

39 Directive 89/552/EEC, OJ L 298/23 of 17 October 1989 as amended by Directive 97/36/EC; OJ L 202/60 of 30 July 1997; for a discussion of the "transmission state principle", see in particular *Katsirea*, Cambridge Yearbook of European Legal Studies 6 (2005), 105.

40 *Ibid.*, Art. 2a; it may, however, apply its own law in areas not "coordinated" by the directive, see ECJ, Joined Cases C-34-36/95 *De Agostini*, [1997] ECR I-3843.

41 Art. 2 (1) and 3 (2).

42 Directive 2000/31/EC, OJ L 178/1 of 17 July 2000; for further discussion on the directive and its version of the COP see *Hörnle,* INTJLIT 12 (2004), 333 and *Knightlinger*, MIJIL 24 (2003), 719.

43 *Ibid.*, Art. 3.

44 Directive 96/71/EC, OJ L 18/1 of 21 January 1997; see generally *Barnard*, EC Employment Law, 172; for a critique of the directive in the light of the services case law, see *Davies*, INDUSLJ 31 (2002), 298.

45 *Ibid.*, Art. 1.

46 *Ibid.*, Art. 3 (1).

ployment conditions applicable in the host state that the foreign service provider must respect when posting its workers there.[47]

A recent example for a COP being considerably mitigated during the legislative process is offered by the directive on unfair commercial practices. While the Commission's proposal prescribes the COP,[48] the version finally adopted by Council and Parliament merely contains the obligation on Member States not to restrict the free movement of goods and services for reasons falling within the harmonised fields.[49]

These examples show that Member States have been relatively free to choose whether to incorporate a country of origin or a country of destination principle in secondary legislation. Trying to make sense of their respective choices one should look at the nature of the service being provided: The directives implementing the COP tend to regulate situations, where the service itself travelled and not the service provider (broadcasting signals or internet downloads). The country of destination principle, however, was preferred in a situation, where not just the service provider, but also its staff travelled to the host state.

Moreover, as illustrated above, the COP used to be generally accompanied by (minimum) harmonisation of national laws.[50] The e-commerce directive and the services directive, however, represent a new generation of legislation that organise the allocation or regulatory competence, e.g. by means of the COP, without placing much emphasis on corresponding harmonisation of the content of national laws.[51]

III. The Country of Origin Principle and Mutual Recognition

Before enquiring into the extent to which a country of origin principle may exist in the services case law, the landmark decision of *Cassis de Dijon* in the field of free movement of goods will provide an appropriate starting point.[52] The central issue underlying the *Cassis de Dijon* case closely resembles the main problem identified to restrict the free movement of services today - the divergence of national regulatory systems. The point at issue in *Cassis* was a German product requirement on alcoholic beverages that was indistinctly applicable to domestic and foreign producers. The Court considered that:

> *Obstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the products in question*

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47 The conformity of the country of destination principle in this field with the Treaty's rules on the free movement of services was confirmed by the ECJ, Case C-113/89 *Rush Portugesa*, [1990] ECR I-1417, para. 18.

48 COM (2003) 356 final, 18 June 2003, Art. 4 (1), which is named "internal market clause".

49 Directive 2005/29/EC, OJ L 149/22 of 11 June 2005, Art. 4.

50 Apart from the above examples, see e.g. the Data Protection Directive 95/46/EC, OJ L 281/31 of 23 November 1995 or the Electronic Signature Directive 99/93/EC, OJ L 13/12 of 19 January 2000.

51 See *Hatzopoulos*, Principe d'Equivalence, 389 et seq., for a generational model of the relationship between mutual recognition and harmonisation.

52 ECJ, Case 120/78 *Rewe-Zentrale AG v. Bundesmonopolverwaltung für Branntwein,* [1979] ECR 649; for two good discussions, see *Weatherill/Beaumont*, EU Law, 565 or *Barnard*, Substantive Law, 104.

> *must be accepted in so far as those provisions may be recognised as being necessary in order to satisfy mandatory requirements…"*[53]

The Court thus subjected the trade-restricting application of the importing state's laws to its own scrutiny laying out requirements for their justification: The importing state's laws need to serve a legitimate public interest i.e. be a mandatory requirement, and be proportionate, i.e. suitable and necessary to achieve this objective of public interest. The Court thus introduced a "rule of reason" to examine indistinctly applicable impositions of the importing state's laws. The German government's justification for imposing its product requirement at issue failed to meet this test.

Even so, the Court complemented its judgement by a dictum soon to become famous:

> *There is therefore no valid reason why, provided that they have been lawfully produced and marketed in one of the Member States, alcoholic beverages should not be introduced into any other Member State.*[54]

This proposition became widely regarded as the "principle of mutual recognition" or alternatively the "principle of equivalence". Its consequences were far-reaching: As one observer notes, "the decision comes close to establishing a presumption in favour of free trade throughout the Community in goods that are lawfully available in a Member State."[55] How closely exactly it comes to removing all restrictions to trade based on disparate national laws, however, is a matter of controversy.[56]

The Commission was quick to come up with its own interpretation advocating a far-reaching principle of mutual recognition. It claimed that "any product lawfully produced and marketed in one Member State must, in principle, be admitted to the market of any other Member State".[57] Proponents of such a broad reading have since interpreted the principle of mutual recognition as a "mechanism of allocation of regulatory competence to the country of origin, designed to avoid goods being subject to a dual burden of regulation by home and host country."[58] Interpreted as such, mutual recognition would be little different from the country of origin principle proposed by the draft services directive.

However, this broad understanding of mutual recognition did not remain unchallenged. As *Weiler* contends, "the Court famously preaches the rhetoric of mutual recognition but practices functional parallelism." And instead of being a radical departure, the Court's proposition is just a "fully justified application of the principle of proportionality."[59] The concept of functional equivalence illustrates this point: In a

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53 *Ibid.*, para. 8.

54 *Ibid.*, para. 14.

55 *Weatherill and Beaumont*, EU Law, 569.

56 *Alter/Meuner-Aitsahalia*, Comparative Political Studies 26 (1994), 535 give an account of the political reverberations of the *Cassis* decision.

57 Commission Communication of 3 October 1980, [1980] OJ C256/2; the Commission has frequently repeated this statement, e.g. in its Communication to the European Parliament and Council, Mutual Recognition in the Context of the Follow-up to the Action Plan for the Single Market, COM (1999) 299, 16 June 1999, (hereafter European Commission (1999)), 3.

58 *Bernard*, in: Barnard/Scott (eds.) Law of the Single European Market, 101 (105).

59 *Weiler*, in: Craig/De Búrca (eds.), Evolution of EU Law, 366.

case regarding the applicability of French safety requirements to imported woodworking machines lawfully produced and marketed in Germany, the Court held that

> *[a Member State] is not entitled to prevent the marketing of a product originating in another Member State which provides a level of protection of the health and life of humans equivalent to that which the national rules are intended to ensure or establish.*[60]

This decision illustrates a narrower understanding of mutual recognition. Thus conceived, mutual recognition requires a "comparison of home and host state measures in order to determine whether there is functional equivalence."[61] Its purpose then lies in the avoidance of duplication of similar requirements by home and host state.[62] It can be inferred that if the home state's requirements are not functionally equivalent, i.e. do not sufficiently achieve the public interest purpose of the host state, the host state is entitled to apply its own law. This enquiry generally forms part of the assessment of the proportionality of host state measures. Indeed, a host state can hardly justify that a measure is necessary to serve a legitimate objective, if that objective is already sufficiently achieved by similar home state measures. While the application of home state law may therefore be the outcome of a mutual recognition analysis, *Armstrong* claims that mutual recognition must be understood as "based on the enduring regulatory responsibility of host state regulators in the absence of harmonisation rather than one premised on a pure model of home state control."[63]

There is thus disagreement as to whether mutual recognition amounts to a country of origin principle. However, the latter view, stressing the considerable differences between the two concepts, appears more convincing. In fact, a more proactive role of the host state is a better description of the legal reality. In practice, mutual recognition is not an automatic principle. Its operation largely relies on the discretionary powers of host state authorities assessing functional equivalence on a case-by-case basis.[64] Indeed, the very shortcomings of the mutual recognition approach to free movement have lead to the perceived need for a country of origin principle.[65]

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60 ECJ, Case 188/84 *Commission v. France (Woodworking Machines)*, [1986] ECR 419, para. 16, emphasis added; as the German machinery presumed a higher level of worker training as was common in France, France was allowed to apply its own law.

61 *Armstrong*, in: Barnard/Scott (eds.), Law of the Single European Market, 225 (235).

62 *Hatzopoulos*, Principe d'Equivalence, 86.

63 *Armstrong*, in: Barnard/Scott (eds.), Law of the Single European Market, 225 (234); *Albath/Giesler*, EuZW, 2/2006, 38 (38), come to the same conclusion.

64 Report from the Commission to the Council, the European Parliament and the Economic and Social Committee, Second Biennial Report on the Application of the Principle of Mutual Recognition in the Single Market, COM (2002) 419 final, 23 July 2002, 5.

65 See European Commission (1999), 5, and *Craig*, in: Barnard/Scott (eds.), Law of the Single European Market, 36 on the shortcomings and European Commission (2002), 52, on the subsequent need for reform.

IV. The Country of Origin Principle and the Case Law on Services

The same principle of mutual recognition discussed above also applies to the free movement of services.[66] The way the Court has dealt with the problem of disparate national laws can best be exemplified by the 1991 case of *Säger:*[67] A German law required those monitoring patents to possess a license which was available subject to certain qualification requirements. The point at issue was whether this law could be applied to a British undertaking providing patent monitoring services in Germany. As the Advocate General (AG) pointed out, the British company was receiving exactly the same treatment as a company established in Germany.[68] Departing from its previous emphasis on national treatment,[69] the Court laid out a new formula of what constitutes a "restriction" to the free movement of services, which subsequently became a standard template for services cases:

> *Article [49] of the Treaty requires not only the elimination of all discrimination against a person providing services on the ground of his nationality <u>but also</u> the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, when it is liable to prohibit or otherwise impede the activities of a provider of services established in another Member State where he lawfully provides similar services.*[70]

The Court thus significantly enlarged the scope of what could constitute a restriction: Rather than discriminatory obstacles, the Court includes *any* substantial obstacle to free movement in its definition. The simple application of host state law to foreign service providers is now likely to be considered a restriction and prima facie violation of Article 49. This can be explained by the concept of dual burden: After all, compliance with an additional set of laws might render the provision of cross-border services more costly.[71]

With the scope of restrictions thus considerably enlarged, the emphasis shifts to the Court's scrutiny of host state measures at the stage of justification.[72] Here, the public interest requirements proposed by the Member States have mainly been accepted without much questioning by the Court as long as they were of a non-

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66 The Commission regularly stresses this, e.g. in European Commission (1999), 4; see generally *Hatzopoulos*, Principe d'Equivalence.

67 ECJ, Case C-76/90 *Säger v. Dennemeyer,* [1991] ECR I-4221; interpretations of the case law on services have come to receive greater attention in the literature, see e.g. *Barnard*, Substantive Law, *Roth*, in: Andenas/Roth (eds.), Services and Free Movement, 1, *O'Leary/Fernández-Martín*, in: Andenas/Roth (eds.), Services and Free Movement, 163, *Snell*, Goods and Services in EC Law, and *Woods*, Free Movement.

68 *Ibid.*, Opinion of the AG, para. 18; see para. 59 for what can be read as an early pleading in favour of the COP.

69 See in particular ECJ, Case 33/74 *Van Binsbergen*, [1974] ECR 1299, para. 10; see cases 279/80 *Webb*, [1981] ECR 3305, and 205/84 *Commission v. Germany (Insurance Services)*, [1986] ECR 3755, for an intermediary position denying the full applicability of host state law by reference to the concept of functional equivalence.

70 Case C-76/90 *Säger*, [1991] ECR I-4221, para. 12, emphasis added.

71 *Roth*, in: Andenas/Roth (eds.), Services and Free Movement, 1 (19).

72 The approach to justification remained essentially unchanged by *Säger.*

economic nature.[73] The list of possible good reasons to impose host state law has remained open.[74]

The ensuing analysis of proportionality represents a far greater hurdle to Member States.[75] The Court's approach can be exemplified by the recent case of *Commission v. Netherlands.* Having readily accepted the public interest of protecting population and clients by ensuring the trustworthiness of private security firms, AG *Kokott* questioned the necessity of an authorisation requirement in Dutch law:

> *According to settled case-law the public interest objective may not be pursued in so far as this is already taken into account by the rules to which the provider of such a service is subject in the Member State where he is established. That case-law is in fact an expression of the principle of the State of origin, according to which the principle of mutual recognition applies between the Member States.*[76]

The Court agreed, holding that the host state must take into account requirements already satisfied in the home state.[77] AG *Kokott*'s language is consistent with the narrow definition of mutual recognition set out in the previous section. Interestingly, she seems to equate mutual recognition to what she calls state of origin principle. It is submitted that she did not refer to the COP as formulated in the draft services directive.

After all, important differences persist between the principles of mutual recognition and country of origin. They can be condensed as follows: Under mutual recognition, the existence of functionally equivalent regulation in the country of origin makes it more difficult for the host state to justify the proportionality of its measure. Under the COP, the host state's regulation is pre-empted as a general rule regardless of what is or is not regulated by the home state. A comparison between the home and host state's laws is not foreseen, the only requirement is the lawfulness of the product in the home state. While mutual recognition is thus a principle structuring the behaviour of the host state, imposing on it what may be called a rebuttable presumption of equivalence of home state law, the COP is a rule of competence generally prescribing the inapplicability of host state law. This distinction has important implications: The presumption of equivalence can be rebutted by the host state showing that the imposition of its own rules is necessary in order to achieve one of the openly-defined overriding requirements of public interest that could not be achieved by functionally equivalent rules of the home state. The COP, on the other hand, can only be derogated from under procedural and substantive conditions strictly circumscribed by legislature. In particular, the grounds of general interest are limited to the ones listed in the draft

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[73] See *Hatzopoulos*, CMLR 37 (2000), 43 (77).

[74] For an update, see *O'Leary/Fernández-Martín*, in: Andenas/Roth, Services and Free Movement, 163 (170). For an early list of "mandatory requirements", see ECJ, Case C-288/89 *Gouda*, [1991] ECR I-4007, para. 14.

[75] *Ibid.*, 174 et seq., provide a survey on the intensity of scrutiny.

[76] ECJ, Case C-189/03*, Commission v. Netherlands*, Opinion of the AG, [2004] ECR I-9289, para. 35.

[77] *Ibid.*, Judgement, para. 20; for another good example of the interplay of functional equivalence and proportionality in the case law of services, see ECJ, Joined Cases C-369 & 376/96 *Arblade*, [1999] ECR I-8453.

directive.[78] Procedurally, case-by-case derogations from the COP are generally subject to ex-ante approval by the Commission. Under current case law, host states are only subject to ex-post judicial review if they impose their own law on foreign service providers.

As the foregoing analysis has shown, it cannot be said that the draft services directive simply restates existing Community law. To the contrary, it incorporates important changes regarding the way service providers are or are not regulated. An evaluation of these changes will be the subject of the next two chapters.

D. A Systemic Impact Analysis: Altering the European Economic Constitution?

In the present chapter, a broader, systemic perspective will be adopted for an assessment of the impact of the COP: an economic constitutional view of the European Union. The analytical framework of competing models of economic integration will prove valuable to uncover the premises of the COP and to locate the contributions to its debate in a broader political context. Against this background, the controversial relationship between harmonisation and the COP will be discussed. The chapter concludes with an assessment of one of the most hotly debated arguments, the potential promotion by the COP of regulatory competition leading to a "race to the bottom".

I. Three Models of Economic Integration

Adapting a classification developed by *Maduro* the different institutional alternatives to European market regulation can be related to three competing economic constitutional models.[79] These ideal-type models reflect mainly the allocation of regulatory competence to the host state, the home state or the Community. They are linked to competing visions and forms of legitimation of the European economic constitution. Many disputes over European regulation, including the present one on the draft services directive can be seen as expressions of underlying disputes over the basic constitutional models.

Under the host state model the competence to regulate transfrontier economic activity is attributed exclusively to the host state, or the state of destination.[80] All incoming products need to satisfy local rules. The goal of curbing protectionism is served only by an obligation on the host state not to discriminate against foreign products and persons in the application of its laws. Competition subsequently occurs among different markets, each equipped with its own set of regulations. Underlying this is the view that the highest source of democratic legitimacy is the nation state, which is considered closer to and more directly legitimised by the subjects of its laws. The problem

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[78] Recall that case-by-case derogations from the COP may be motivated exclusively by reasons relating to the safety of a service, the exercise of a health profession or the protection of public policy, notably the protection of minors; see European Commission (2004), Art. 17 (1).

[79] *Maduro*, We, the Court.

[80] *Ibid.*, 143, where this is referred to as the decentralised model.

associated with this approach is, however, that many barriers to trade still persist, especially those arising out of dual regulation.[81]

The home state model addresses this problem by occupying the other extreme, absolute home state control.[82] The host state's competence to regulate imports or foreign service providers is wholly excluded or pre-empted.[83] Conformity with the home state's regulations is considered sufficient for EU-wide operations. Local regulation still applies to locally established firms, giving rise to the application of different rules to local and foreign companies within the same market.[84] Mobile firms can choose among the different national laws the set of regulations that suits them best. Consumers, on the other hand, have a choice among goods and services corresponding to different national regulations. As a consequence, not just the products, but also national regulations compete with each other. It is the sum of individual choices, the market, which determines the "best" regulation, i.e. the outcome of what is called "regulatory competition". Accordingly, the legitimacy of this model is derived from individual market choices rather than from democratic processes on a national or European level. One problem associated with this approach is excessive deregulation: The outcome of regulatory competition is feared to be a race to the bottom in regulatory standards.

Finally, the harmonisation model seeks to replace the different national laws by Community legislation.[85] As a result of market-opening, so-called "negative integration", the nation state's regulatory power has eroded. As compensation, "positive integration" must follow through the adoption of harmonisation measures at Community level. It is assumed that political control over the economic sphere is necessary and achievable only at EU-level. The centralised approach allows for market integration and economies of scale as it replaces 25 different national rules with one Community rule guaranteeing equal treatment for all.[86] Its legitimation is sought through improved democratic processes in the EU. Here, however, lies the main problem with this model: The EU legislative process appears neither able nor sufficiently legitimate to produce such legislation. Moreover, problems of subsidiarity, national diversity and flexibility remain. After all, it may not be desirable to impose one rule on all 25 Member States.[87]

The European Economic Constitution as it stands today represents a mixture of these models.[88] The fundamental freedoms coupled with the principle of mutual recognition create a presumption in favour of the home state model. On the other hand, the express derogations thereof or the justifications under the rule of reason reflect the

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[81] See above: the Commission uses this perceived insufficiency of the host state model as a rationale for its proposal.

[82] *Ibid.*, 126, Maduro calls this the competitive model.

[83] *Weatherill*, in: Barnard/Scott (eds.), Law of the Single European Market, 41 (54).

[84] The resulting stricter treatment of nationals, usually referred to as "reverse discrimination", is in general compatible with EC law, see ECJ, Case 115/78 *Knoors*, [1979] ECR 399, para. 24.

[85] *Maduro*, We, the Court, 110, calls this the centralised model.

[86] See also *Barnard*, Substantive Law, 21; it may also be more suitable to counter circumvention of domestic laws, see chapter E for further discussion.

[87] For an argument on the advantages of decentralisation, see *Snell/Andenas*, in: Andenas/Roth (eds.), Services and Free Movement, 69 (86).

[88] *Maduro*, We, the Court, 109.

host state model. The harmonisation approach is present in a large amount of secondary legislation.[89]

As described in chapter C, EC law on the free movement of services represents a "balance" of all three approaches. The proposed services directive could alter this balance in favour of the home state model. After all, the COP is closely associated with home state control and, as shown above, goes considerably beyond current case law. Raising the debate on the COP to a general, systemic level, it is submitted that two main lines of conflict exist: The first reflects the conflict between the home state and the harmonisation model; the second is an expression of the antagonism between the host state and the home state model reflected in the debate on regulatory competition. Both relationships will be assessed in the following.

II. The Country of Origin Principle and Harmonisation

One of the major strands of criticism facing the original draft services directive in the European Parliament is its insufficient connection to harmonisation. The proposed COP broadly applies to what is termed the "coordinated field", consisting of "national provisions relating to access to and the exercise of a service activity."[90] However, the field actually coordinated in the sense of setting common minimum standards is considerably smaller than this: Actual coordination extends to the provision of information on service providers,[91] professional insurance,[92] after-sales guarantees[93] and settlement of disputes.[94] Apart from this, industries are to be encouraged to draw up codes-of conduct[95] and the Commission is asked to assess the need for additional harmonisation in certain limited areas, mainly those not covered by the COP.[96] The Commission thus seems to view COP and harmonisation as two instruments that need not necessarily go together. Harmonisation merely becomes an alternative necessary only where the COP does not apply properly.

This approach clashes with the counter position that "a precondition of the country of origin principle is a minimum level of harmonisation at EU level or, at least, the presence of comparable rules within the Member States" and that the scope of the COP should therefore be limited to the harmonised fields.[97]

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89 See *Barnard*, Substantive Law, 534, on the combination of central and de-central regulation in today's European multi-level governance.

90 European Commission (2004), Art. 16 (1).

91 *Ibid.*, Art. 26.

92 *Ibid.*, Art. 27.

93 *Ibid.*, Art. 28.

94 *Ibid.*, Art. 32.

95 *Ibid.*, Art. 39.

96 *Ibid.*, Art. 40; these areas mainly cover the fields transitionally exempted from the COP and matters having become frequent subject of case-by-case derogations.

97 European Parliament, Opinion of the Committee on Employment and Social Affairs, PE 357.591, 19 July 2005, justification to amendment 110, by Rapporteur *van Lancker*, who suggests in a Working Document, PE 353.365, 11 January 2005, 2, further harmonisation in the fields of minimum quality norms, the protection of public order, minimum vocational training and qualification requirements for service professions as well as harmonised mechanisms to supervise these minimum norms; similarly, see rapporteur *Gebhardt* in her Working Document, PE 353.297, 21 December 2004 (hereafter "Working Document"), 4.

This argument mirrors the debate regarding the free movement of goods following the arrival of mutual recognition and the so-called "new approach to harmonisation" in the 1980s. Rather than pursuing the burdensome task of harmonising broad areas of divergent national laws, the new approach distinguished between what was essential to harmonise and what could be left to mutual recognition. Harmonisation was to cover only essential health and safety requirements, providing for obligatory compliance and subsequent free circulation.[98] Legislative harmonisation has thus come to be regarded an alternative to mutual recognition, its role being reduced to those instances where the host state could still justify the imposition of its laws.[99]

However, as shown above, the principle of mutual recognition requires a comparison of functional equivalence between home and host state law. In this sense, it is not alternative but complementary to the existence of *de iure* or *de facto* harmonisation. Indeed, the practical implementation of mutual recognition does not function independently of the content of the respective regulation. It depends on how close home and host state law are to each other and whether it is possible to ascertain functional equivalence. It has been pointed out that "where the regulatory stakes are high and the differentials in regulatory policies between the Member States substantial, mutual recognition is unlikely to work."[100] A certain degree of prior harmonisation may therefore be necessary for the effective functioning of mutual recognition.[101]

The very barriers to mutual recognition created by too great divergence of national laws would be eliminated by the imposition of the COP. As demonstrated above, the COP differs from mutual recognition in that it pre-empts host state regulation regardless of functional equivalence. The quality of the relationship between home state control and harmonisation would thus change dramatically diminishing the need for harmonisation that still exists under the mutual recognition case law.[102] Indeed, in systemic terms the institutional balance of the Community would be tilted towards the home state model at the cost of the harmonisation model if the proposed COP were introduced.[103]

A compromise solution between unqualified home state control and total harmonisation could be found in the concept of minimum harmonisation coupled with home state control:[104] The Community lays down minimum standards that all Mem-

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98 See European Commission (1985), para. 65; for further information, see *Craig*, in: Barnard/Scott (eds.), Law of the Single European Market, 1 (24); the new approach also promoted European standardisation, comparable to the encouragement of codes of conduct in the draft services directive.

99 *Weatherill*, in: Barnard/Scott (eds.), Law of the Single European Market, 41 (51).

100 *Bernard*, in: Barnard/Scott (eds.), Law of the Single European Market, 101 (108).

101 *Hatzopoulos*, Principe d'Equivalence 127, 149; similarly *Armstrong*, in: Barnard/Scott (eds.), Law of the Single European Market, 225 (249), and *Weiler*, in: Craig/De Búrca (eds.) Evolution of EU Law, 349 (368).

102 See also *Hatzopoulos*, Principe d'Equivalence, 155; this view is also held by *Gebhardt*, Working Document, 4, who fears that "introducing the country of origin principle would even endanger progress towards harmonising European legislation…".

103 The COP would also alter the rationale and the bargaining positions with regard to the content of harmonisation, see *Bruun*, Employment Issues, 87, who claims that the minimum standard of employment protection offered by the Posting of Workers directive is turned into a maximum standard if coupled with a COP.

104 See *Dougan*, CMLR 37 (2000), 853 on this concept, see also *Barnard*, Substantive Law, 515.

ber State legislations need to comply with. Over and above this "floor" Member States are free to apply higher standards to domestic undertakings. Foreign service providers, however, normally have to be admitted if they comply with the minimum requirements.

However, comprehensive harmonisation, even of the minimum standards type, is not perceived as an attractive and realisable option in the enlarged Union.[105] Other possibilities for reforming the COP should therefore be considered and will be discussed below.

III. The Country of Origin Principle and Regulatory Competition

One of the most prominent arguments put forward against the introduction of the COP is that it would induce Member States to lower their protection standards in order to attract or retain businesses. This would then lead to harmful competition between the Member State's regulatory systems eventually resulting in a lower level of consumer protection throughout the Community.[106]

Concerns about this possibility, which is referred to as "race to the bottom",[107] exist within the EC for at least as long as the principle of mutual recognition.[108] However, while the theory of regulatory competition appears well-explored, its practical occurrence has lacked comprehensive description.[109] According to the theory, two key elements need to be present for regulatory competition to take place: free movement and mutual recognition.[110] Free movement needs to be guaranteed by a central authority (i.e. the EC) in order to ensure effective exit out of one and entry into another jurisdiction by capital or workers. Mutual recognition, on the other hand, brings about the presence on the same market of a variety of products conforming to different decentrally (i.e. nationally) determined sets of regulations. Consumers then effectively choose not only between different products, but also between sets of regulations, that are themselves thrown into competition with each other. Companies that consider themselves disadvantaged by "their" regulations could then either lobby their government to lower the standards or relocate to another jurisdiction. In both cases, the government receives powerful signals pushing for a change of law. If governments react

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105 *Drijber*, Country of Origin Principle, 50.

106 See e.g. *Guillaume*, Country of Origin Principle, 47; or the representative of the European Trade Union Confederation claiming that the COP "would openly invite Member States to enter into 'regime-competition', with workers, consumers and the environment being the big loosers." Committee on the Internal Market and Consumer Protection, Public Hearing of 11 November 2004, Consolidated Proceedings, available on the internet: <http://www.europarl.eu.int/comparl/imco/services_directive/050303_consolidatedproceedings_en.pdf> (visited on 26 April 2006) (hereafter Hearing), 105.

107 See e.g. *Barnard*, EURLR 25 (2000), 57 (57).

108 Indeed, this argument was raised as a defence by the German government in Case 120/78 *Cassis de Dijon*, [1979] ECR 649, para. 12.

109 For detailed coverage of the academic debate in the US and Europe see the essays collected in *Esty/Geradin*, Regulatory Competition.

110 *Sun/Pelkmans*, Journal of Common Market Studies 33 (1995), 67 (69, 76); *Barnard/Deakin*, in: Barnard/Scott (eds.), Law of the Single European Market, 197 (202).

by adapting the standards, a mutually reinforcing process of competition between governments may ensue, possibly leading to a race to the bottom.[111]

Outside the realm of economic theory, however, it is far from certain, whether regulatory competition actually takes place. It is contended that important presumptions to the economic model do not match the reality of the EC: Full mobility, especially of workers, and full knowledge of laws of other jurisdictions for example, cannot be presupposed.[112] It is widely suggested that there is no compelling empirical evidence that the lowering of standards is used as a tool of competition between Member States.[113]

While the academic debate on the current extent of regulatory competition in the EC thus remains inconclusive, it has not been lead with regard to the COP. Any such discussion must necessarily remain speculative at this stage. However, the impact of the largely similar "transmission state principle" set out in the broadcasting directive on regulatory competition has recently been assessed. The case study shows that while Member States may not necessarily follow the textbook-process of regulatory competition, the COP may provide incentives for company relocation to the detriment of high-standard countries.[114]

The likelihood of a race to the bottom might increase as a consequence of the replacement of mutual recognition by the COP. Under current case law in services the public interest requirements provide for some residual regulatory space of the host state regarding essential policy objectives. The host state sets certain limits to the competitive process, or in other words "places a brake" on the race to the bottom.[115] The allocation of competences between host state and home state thus determines which elements of national regulation are subjected to regulatory competition. As shown above, the COP allocates considerably more regulatory power to the home state than current case law: It is subject to less derogation than foreseen by the public interest requirements and ignores the test of functional equivalence inherent in the principle of mutual recognition. As a consequence, the brakes on the race to the bottom may increasingly fail to work.[116] It has been suggested that all the public interest

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[111] Others would view this as a race to efficient regulation, e.g. *Snell/Andenas*, in: Andenas/Roth (eds.): Services and Free Movement, 69 (90).

[112] For a more comprehensive list of necessary preconditions to regulatory competition see *Barnard*, EURLR 25 (2000), 57 (65); the divergence in mobility between capital and workers is seen as a major distorting factor, see *Barnard*, Substantive Law, 21.

[113] *Barnard*, EURLR 25 (2000), 57 (70); similarly *Weatherill*, in: Barnard/Scott (eds.), Law of the Single European Market, 41 (55); *Scharpf*, Journal of European Public Policy 4 (1997), 520 (526), however, proposes that the deregulatory pressure varies from one policy area to another: while environmental or social process regulations are affected by downward pressures, national product regulations may under certain conditions even be adapted upwards if high standards come to be considered as certificates of superior quality.

[114] *Harcourt*, EUI Working Paper, RSCIS 2004/44, finds that only the UK and Luxembourg voluntarily deregulated their broadcasting regime. This deregulation, however, proved successful in attracting media investment from other Member States with a high number of broadcasting companies relocating to these two States.

[115] *Barnard*, Substantive Law (2004), 106.

[116] *Barnard/Deakin*, in: Barnard/Scott (eds.), Law of the Single European Market, 203 (204), warn that, "if applied without any qualification, there is a danger that mutual recognition would lead to a race to the bottom and to a deregulation of standards." The draft services directive also facilitates

requirements derived from the case law should be recognised as exceptions to the COP.[117] Such a solution appears likely to preserve the balance between home and host state approach and therefore to keep the "brakes to the race to the bottom" working.

E. Practical Impact Analysis: Problems of Enforcement and Circumvention

This chapter is devoted to two of the most controversial implications of the COP, the issues of enforcement and circumvention. It will first discuss to what extent the COP entails a structural enforcement deficit. In the second section, it will then enquire into how this deficit is likely to be further exploited by possibilities for the circumvention of domestic laws.

I. Enforcement by the Country of Origin: A Race to Laxity?

A key feature of the original draft services directive is that supervision of service activities is carried out "at source", i.e. by the home state, while host state authorities are precluded from performing measures of law enforcement save upon request of the home state.[118] According to the Commission, this approach is necessary and justified, as "the competent authorities of the country of origin are best placed to ensure the effectiveness and continuity of supervision of the provider and to provide protection for recipients, not only in their own Member State but also elsewhere in the Community."[119]

This belief has been seriously questioned. The European Parliament's rapporteur for example stated that "on the basis of Member States' previous experiences of administrative cooperation, it must be feared that there will be no efficient supervision" of cross-border services.[120]

This scepticism can be supported by an assessment of the incentive structure of home and host states. As identified by *Weatherill*, the allocation of competences followed in the draft services directive brings with it a "serious risk of an enforcement deficit".[121] In return for the pre-emption of the host state's competence to enforce its

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cross-border mobility of firms (particularly Art. 14, 15) and may thus further promote regulatory competition by strengthening its second key element.

117 *Drijber*, Country of Origin Principle, 50.

118 See chapter B for further details.

119 European Commission (2004), Recital 38.

120 European Parliament, rapporteur *Gebhardt*, Working Document, 4; this view is shared e.g. by the pan-European employer's association UNICE, which states that "the host country must remain able to control the quality or content of a service", UNICE Comments on the European Commission's Proposal for a Directive on Services in the Internal Market, 05 October 2004, available on the internet: <http://212.3.246.117/1/CJLJJKLAKFCMLHGMJMFNPPFJPDB19DBKT39LI71KM/UNICE/docs/DLS/2005-00477-EN.pdf> (visited on 19 May 2005), and the European Trade Union Confederation, Position Paper, 18 March 2004, available on the internet: <http://www.etuc.org/a/243> (visited on 26 April 2006); similarly, *Kluth/Rieger*, Gewerbe Archiv 52 (2006), 1 (6).

121 *Weatherill*, in: Barnard/Scott (eds.), Law of the Single European Market, 41 (42), refers to the enforcement of harmonised rules, but his assessment of incentive structures is equally applicable to the application of non-harmonised home state law.

own rules, the home state agrees to "work as a law enforcement agency" on behalf of consumers in the host state.[122] In reality, however, "in so far as a home state is expected to apply rules against its corporate citizens in favour of citizens of host states one may assume that the very basis of representative democracy will militate against effective enforcement."[123] Indeed, it is highly questionable that a home state will spend scarce resources to carry out costly controls that may harm home-based business while only benefiting foreign consumers. After all, the EU needs to rely on national mechanisms of enforcement that are necessarily shaped by a national political mandate. The interests of out-of state consumers are thus not represented at enforcement level.

While incentives to cheat are evident, incentives to comply remain weak: Technically, affected Member States or the Commission may react by bringing infringement proceedings against the home state for failure to fulfil the obligation to effectively enforce its laws on service providers abroad. Likewise, private parties adversely affected by such under-enforcement could seek litigation before domestic courts. Such counter-incentives are, however, unlikely to realise: European litigation can be burdensome and lengthy, the obligation to effectively enforce positive regulation is difficult to monitor and even a judgement finding a breach of this obligation would be of limited effect.[124]

As a consequence of this set of incentives, *Weatherill* predicts a spiral of inter-state competitive under-enforcement.[125] This finding has been supported by empirical evidence in the broadcasting sector which is also governed by a COP.[126]

The regulation of the internal market is thus caught in a dilemma: On the one hand, the current system of mutual recognition is said to allow for too much protectionism due to the lack of Member State's mutual trust in the quality of each other's legal systems.[127] On the other hand, that same mutual trust in the effective enforcement of rules by the other Member States is unrealistically presumed by the Commission when proposing the COP. While the lack of mutual trust presents problems in both instances, it appears reasonable to expect a host state to be marginally more motivated to screen the home state's law for equivalence than the home state to effectively control its companies operating abroad. The host state should therefore be entrusted the task of supervision, possibly complemented by a procedure of administrative cooperation wherever it seeks to impose its own law giving rise to dual regulation.

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122 *Ibid.*, 67.

123 *Ibid.*, 41.

124 *Ibid.*, 70; Weatherill also points out that private litigants are unlikely to appear as affected interests (e.g. consumer and environmental protection) are diffuse.

125 *Ibid.*, 69.

126 *Harcourt*, EUI Working Paper, RSCIS 2004/44,14, finds that the enforcement by the country of origin of its own laws, or even Community minimum standards, proves highly deficient when it comes to regulating "domestic" broadcasters that only operate in foreign markets. Similarly, *Katsirea*, Cambridge Yearbook of European Legal Studies 6 (2005), 134, reports concerns regarding the effective enforcement of the rules on the protection of minors and public order.

127 European Commission (2002), 53.

II. The Country of Origin Principle: Facilitating Circumvention?

The structural enforcement deficit outlined above may be aggravated by the absence of effective means to tackle circumvention. If circumvention is possible, not only genuinely foreign service providers will reap the benefits of the COP, but also those, that deliberately place themselves under the jurisdiction of another Member State in order to evade the laws of the state where the service is provided.[128] Two elements can be discerned in this respect: The first one can be referred to as "home state shopping", i.e. the choice by service providers of their country of origin and thereby the most favourable law applicable to them. The second one can be called "disguised establishment" and refers to economic activities that fall under the rules on provision of services, even though they should be governed by the rules on establishment. Taken to a hypothetical extreme, a combination of these possibilities of circumvention could present a company, established with a mere letter box in Malta where legislation is most favourable, directing almost all its commercial activities towards Germany while claiming that it should not be bound by German law as it only engages in the provision of cross-border services.

The proposed services directive is likely to increase the incentive to pursue tactics of circumvention as the perceived rewards may be greater under the COP than under the current system of mutual recognition. At the same time, the provisions of the draft directive may not be sufficiently apt to prevent such circumvention. In any event, their countervailing force depends on how the country of origin is determined and how the dividing line between establishment and the provision of services is drawn.

The draft directive defines the country of origin as "the Member State in whose territory the provider of the service concerned is established".[129] Establishment, in turn, "means the pursuit of an economic activity, as referred to in Article 43 of the Treaty, through a fixed establishment of the provider for an indefinite period".[130] Services, on the other hand, are essentially defined by reference to the Treaty and – by implication – the corresponding case law of the Court.[131]

The definition of establishment at first sight creates the impression that a host State could treat as established in its own territory any company registered abroad that disposes of a fixed and somewhat permanent infrastructure within its territory.[132] A contextual reading, however, reveals that this definition is far from clear.[133] If the above interpretation were correct, the corresponding far-reaching powers of the host state would need to be acknowledged elsewhere in the directive. To the contrary, however, Article 16(3) precludes the host state from imposing a "ban on the provider

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[128] For a definition of forms of circumvention or abuse, see *Kjellgren*, in: Andenas/Roth, Services and Free Movement, 245 (246); for an identification of the problem by the Court, see Opinion of AG *Léger* in ECJ, Case C-55/94 *Gebhard*, [1995] ECR I-4165, para. 25.

[129] European Commission (2004), Art. 4 (4).

[130] *Ibid.*, Art. 4 (5).

[131] *Ibid.*, Art. 4 (1), see above section 2.1.

[132] Such an interpretation was put forward by the Commission's representative Fröhlinger at the hearing, 61, claiming that "every fixed installation, and fixed infrastructure, through which a service is provided, is considered to be an establishment within the meaning of the services directive."

[133] See e.g. *Bruun*, Employment Issues, 101.

setting up a certain infrastructure in their territory." Moreover, recital 19 recalls the case law of the Court on the difference between establishment and services stating that

> *the temporary nature of the activities in question must be determined in the light not only of the duration of the provision of the service, but also of its regularity, periodical nature or continuity. In any case, the fact that the activity is temporary does not mean that the service provider may not equip himself with some forms of infrastructure in the host Member State, such as an office, chambers or consulting rooms, in so far as such infrastructure is necessary for the purposes of providing the service in question.*[134]

The express provisions of the draft directive thus lack workable criteria for distinguishing the temporary provision of services from the on-going nature of an establishment. Nor does the case law, which the directive refers to in the recitals as well as by means of reference to the Treaty provisions, provide for additional clarification. Indeed, the Court recently conceded in *Schnitzer* that "no provision of the Treaty affords a means of determining, in an abstract manner, the duration or frequency beyond which the supply of a service (…) in another Member State can no longer be regarded as the provision of services within the meaning of the Treaty."[135]

As a consequence, a "temporary" service provider could avoid host state legislation for potentially long periods before being treated as an established, i.e. domestic, undertaking.[136] Moreover, no clearly qualified minimum presence by the service provider in its home state is required. Nor is a maximum presence in the host state spelled out. Instead, host state authorities are faced with the legal uncertainty that they may treat a "fixed establishment" for an "indefinite time" as an establishment but must accept "a certain infrastructure" as a provision of services. This distinction appears unworkable.

The absence of clear criteria could possibly be mitigated by a general principle of circumvention or abuse of rights which could intervene in such cases and enable a host state to treat a "false" service provider as domestic.[137] The classic statement establishing the principle that EC law cannot be relied on for abusive ends was issued in the *Van Binsbergen* case:[138]

> *…a Member State cannot be denied the right to take measures to prevent the exercise by a person providing services whose activity is entirely or principally directed towards its territory of the freedom guaranteed by Article [49] for the purpose of avoiding the professional rules of conduct which would be applicable to him if he were established within that State; such a situation may be subject to judicial control under the provisions of the chapter relating to the right of establishment and not of that on the provision of services.*

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[134] This statement draws from ECJ, Case C-55/94 *Gebhard*, [1995] ECR I-4165, para. 27, emphasis added.

[135] ECJ, Case C-215/01 *Schnitzer*, [2003] ECR I-14847, para. 31.

[136] This concern was expressed by *Bruun*, Employment Issues, 98.

[137] See *Kjellgren*, in: Andenas/Roth (eds.), Services and Free Movement, 245, and *Brown*, in: Curtin/Heukels (eds.), Institutional Dynamics, 511.

[138] ECJ, Case 33/74 *Van Binsbergen*, [1974] ECR 1299, para. 13, emphasis added; see also ECJ, Case 205/84 *Commission v. Germany (Insurance Services)*, [1986] ECR 3755, para. 22.

The Court thus set out two main criteria for the invocation of the circumvention principle: First, the service activity must be entirely or principally directed towards the territory of the host state; second, the foreign establishment must have been chosen with the purpose of avoiding host state legislation.[139]

However, as a result of recent Court decisions, the circumvention principle has been diluted beyond recognition. In the case of *VT4* the Court said

> *that the mere fact that all the broadcasts and advertisements are aimed exclusively at the Flemish public does not (…) demonstrate that VT4 cannot be regarded as being established in the United Kingdom. The Treaty does not prohibit an undertaking from exercising the freedom to provide services if it does not offer services in the Member State in which it is established.*[140]

The Belgian authorities were thus prohibited from "lifting the disguise" and treating VT4 as a domestically established company. This case dealt with the interpretation of establishment under the broadcasting directive and can therefore be regarded as providing useful directions for possible interpretations of the largely similar services directive. Host state measures to curb circumvention were further curtailed by the decision in *Centros* which for the first time comprehensively addressed the issue:[141] According to the court, anti-circumvention measures can only be taken by the judiciary, on a case-by-case basis and not on the basis of abusive intention but merely of objective criteria of abuse.[142] It is unclear, however, on what criteria abusive circumvention could be established, as neither the opportunistic choice of the state of establishment nor the fact that the company does not conduct any business there qualifies as such.[143] In other words: There is nothing abusive about simply taking advantage of the Treaty freedoms.[144]

Apart from facilitating the tactic of disguised establishment, this case also highlights the absence of any required minimum degree of economic activity in the "home state".[145] The vehicle of so-called letter box companies therefore becomes readily available for companies wanting to engage in "home state shopping" for the most favourable legislation. Such a development would be further promoted by future proposals facilitating the change of the registered seat of companies within the EU.[146]

The case law therefore cannot be regarded as helpful in combating circumvention under the proposed services directive. To the contrary, the absence of specific safe-

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139 For later decisions regarding the permissibility of legislative measures against circumvention of the restrictive Dutch broadcasting laws see ECJ, Case C-148/91 *Veronica*, [1993] ECR I-487, para. 13 and ECJ, Case C-23/93 *TV10*, [1994] ECR I-4795, para. 26; for a comprehensive discussion, see *Hansen*, LIEI (1998), 111.

140 ECJ, Case C-56/96 *VT4*, [1997] ECR I-3143, para. 22.

141 ECJ, Case C-212/97 *Centros*, [1999] ECR I-1459, although this case concerns the right to a secondary establishment its ruling on circumvention appear equally applicable to the free movement of services, see also *Barnard*, Substantive Law, 320, *Hatzopoulos*, Principe d'Equivalence, 64, and *Cabral/Cunha*, EURLR 25 (2000), 157, for a case comment.

142 *Ibid.*, para. 25.

143 *Ibid.*, para. 27 and 29.

144 *Kjellgren*, in: Andenas/Roth (eds.), Services and Free Movement, 245 (273).

145 This was recently confirmed in Case C-167/01 *Inspire* Art, [2003] ECR I-10155, para. 95 and 96.

146 On the current state of the law see *Wymeersch*, CMLR 40 (2003), 661 and *Winter*, LIEI (2004), 97.

guards in the proposal appears incompatible with the case law. While circumvention certainly exists already under the current services regime, the introduction of the COP in connection with provisions facilitating establishment[147] and hampering supervision[148] clearly renders this practice more attractive and more difficult to tackle.

The COP should thus be complemented by additional safeguards. Three proposals will be made in the following:

First, a circumvention principle could be introduced by legislative means. An example of this can be found in recital 14 of directive 97/36 amending the broadcasting directive:

> *Whereas the Court of Justice has constantly held that a Member State retains the right to take measures against a television broadcasting organization that is established in another Member State but directs all or most of its activity to the territory of the first Member State if the choice of establishment was made with a view to evading the legislation that would have applied to the organization had it been established on the territory of the first Member State.*

A similar statement could be included in the recitals to the services directive. However, it should be considered whether the reference to the Court's jurisprudence still reflects the objective of curbing circumvention. Moreover, a deletion of the part of the *Van Binsbergen* statement concerning the intention to circumvent ("for the purpose of avoiding", or here "with a view to evading") could provide for further clarity.[149]

Second, the concept of "services" could be equipped with a more workable definition in order to counter disguised establishment. On the time scale, a presumption of, say, a maximum of 16 weeks a year could workably differentiate between real service providers and those that would more appropriately be covered by the provisions on establishment. Such a distinction would not be new. Indeed, the Commission's proposal for a directive on the recognition of professional qualifications provides in Article 5(2):

> *For the purposes of this Directive, where the service provider moves to the territory of the host Member State, the pursuit of a professional activity for a period of not more than sixteen weeks per year in a Member State by a professional established in another Member State shall be presumed to constitute a "provision of services". The presumption referred to in the previous paragraph shall not preclude assessment on a case-by-case basis, for example, in the light of the duration of the provision, its frequency, regularity and continuity.*[150]

The Commission deemed such a clarification necessary "in view of the relaxation of requirements with regard to the provision of services, as compared with establish-

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147 European Commission (2004), Art. 14 and 15.

148 See e.g. *ibid.*, Art. 9, which essentially forbids Member States to require a prior authorisation.

149 The difficulty of attributing subjective intentions to legal persons has been highlighted by AG *Lenz* in Case C-23/93 *TV10*, [1994] ECR I-4795, para. 60-61 of the opinion.

150 COM (2002) 119 final, 07 March 2002, Art. 5 (2); the adopted version of Directive 2005/36/EC, OJ L 255 of 30 September 2005, does not contain this presumption. The new Art. 5 (2) merely speaks of "the temporary and occasional nature of the provision of services", which "shall be assessed case by case."

ment, and in order to avoid those rules being invoked in cases which in fact concern establishment rather than the provision of services."[151] It is surprising that the relaxation of requirements brought about by the draft services directive did not call for similar clarification.

Third, the determination of the "country of origin" could be prescribed more clearly while increasing the threshold. An obvious way would be to add a requirement to the definition of establishment demanding that the service in question must effectively be carried out in the Member State of establishment already.[152] An example for such a provision can be found in the amended "Television without Frontiers" directive, which spells out in detail under what circumstances a broadcaster shall be deemed to be established in a Member State.[153] This way, "home state shopping" by means of setting up mere letter box companies could be curbed. Moreover, in cases where a service provider disposes of more than one establishment, clarification is needed for legal certainty. For such cases, it could then be provided that the place of establishment is the place from which the service concerned is provided.[154]

In conclusion, examples for safeguards exist and are fairly easy to incorporate. While the structural enforcement deficit inherent in the division of competences proposed by the COP would remain, such safeguards would help to avoid much of the aggravation caused by the circumventive tactics of home state shopping and disguised establishment.

F. The Amended Proposal: A Compromise Solution?

I. The new provisions: Still breaking new ground?

Reacting to the vast amount of criticism and the demands of the European Parliament concerning the country of origin principle, the Commission's amended proposal for a services directive of April 2006 considerably changed the approach to the cross-border provision of services.[155] This section will first analyse the major differences between the original and the amended draft in this respect. It will then ask whether the new approach still breaks new ground, i.e. goes further than existing case law.

The changes in the directive are best reflected by the new title: "Freedom to provide services" has come to replace the "country of origin principle" as the header of the respective chapter.

The newly drafted Article 16(1) now reads:

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[151] *Ibid.*, Explanatory Memorandum, 10.

[152] Such a solution is chosen in the Opinion of the Committee on Employment and Consumer Affairs, PE 357.591, 19 July 2005, Amendment 68 to Art. 4 (5); the draft report by the rapporteur of the Committee on the Internal Market and Consumer Protection, *Evelyne Gebhardt*, PE 355.744, 25 May 2005 (hereafter "IMCO Draft Report"), seeks to achieve the same objective by adding an interpretative recital 19a stating inter alia that "a mere letter box does not constitute an establishment".

[153] Directive 89/552/EEC as amended by Directive 97/36/EC, OJ L 202/60 of 30 July 1997, Art. 2 (3).

[154] IMCO Draft Report, Amendment 18 to Recital 19a (new).

[155] European Commission (2006), Art. 16.

Member States shall respect the right of service providers to provide services in a Member State other than that in which they are established.
The Member State in which the service is provided shall ensure free access to and free exercise of a service within its territory.
Member States shall not make access to or exercise of a service activity in their territory subject to compliance with any requirements which do not respect the following principles:

(a) non-discrimination: the requirement may be neither directly nor indirectly discriminatory with regard to nationality or, in the case of legal persons, with regard to the Member State in which they are established,
(b) necessity: the requirement must be justified for reasons of public policy, public security, public health or the protection of the environment,
(c) proportionality: the requirement must be suitable for securing the attainment of the objective pursued, and must not go beyond what is necessary to attain the objective

The Commission interprets this new provision as follows: The Member State where the service is provided cannot apply its own national requirements to service providers established in another Member State unless these requirements fulfil the conditions of non-discrimination, necessity and proportionality.[156] By contrast, Member States that respect these conditions may not be prevented from imposing their own rules. This is again confirmed in the new Article 16(3) which adds, for clarification, that Member States may also apply their rules on employment conditions. Article 16 is complemented by a – now exhaustive – list of prohibited requirements that roughly resembles the old illustrative list.[157]

The major alteration to the original draft lies in the role accorded to the host state. While the COP pre-empted its competence as a general rule, the "freedom to provide services" clause merely creates a presumption against the application of host state law. This presumption is, however, rebuttable: The host state may apply its own law in a non-discriminatory manner, if this is suitable and as long as this is necessary to achieve objectives of public policy, public security, public health or the protection of the environment. The decision to invoke one of these grounds and apply its own law remains at the discretion of the host state and is subject only to ex-post judicial review. Different from the COP, the new rule thus resembles the concept of mutual recognition as it merely structures the behaviour of the host state.

However, the discretion of the host state only extends to the – admittedly important – areas of public policy, security, health and the environment. Other policy objectives remain unmentioned and do therefore not constitute legitimate reasons to apply host state regulations. Measures relating to the safety of a service may be applied to foreign service providers only if the mutual assistance procedure is complied with.[158] The strict procedural conditions for case-by-case derogations, amounting to an ex-

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[156] *Ibid.*, Explanatory Memorandum, 10.

[157] *Ibid.*, Art. 16 (2), however, the very general wording of the old Art. 16 (3) (c), prohibiting Member States to oblige a „provider to comply with requirements, relating to the exercise of a service activity, applicable in their territory" has been deleted.

[158] *Ibid.*, Art. 19.

ante monitoring by the Commission, thus remain part of the directive.[159] Their scope, however, is reduced to safety measures.

The new provisions are thus markedly different from the original ones. The question remains, however, whether they break new ground with regard to the current case law or merely restate the status quo. Recalling the *Säger* case law of the ECJ, any application of host state law is likely to be considered a prima facie violation of Article 49 of the Treaty which must then be justified by the host state with regard to legitimate objectives and proportionality.[160] This is in line with the approach chosen by the amended directive. Comparing the conditions for justification set out in the new Article 16 of the draft directive with the existing law, a number of observations can be made: The condition of non-discrimination merely reflects the obligation already laid out in Article 50(3) of the Treaty. The condition of proportionality restates the existing case law. The condition of necessity, however, differs from the status quo, not with regard to the notion of necessity itself, but with regard to the acceptable reasons for intervention. While the Court has traditionally been quite receptive to the public interest justifications put forward by Member States, leaving the list of possible good reasons open, the new version of the directive limits these grounds to a mere number of four.[161]

It can thus be said that the amended proposal reflects a compromise solution: On the one hand, it preserves the host state's competence to apply its own law under certain conditions and in those areas only where its interests are likely to be most affected. On the other hand it prevents host states from justifying intervention in other areas. Overall, the new approach rather resembles the case law than the clear-cut preemption of competences found in the COP. As a consequence, it will still be left to the Courts to fill the conditions of necessity and proportionality with concrete meaning.

II. The new provisions: Addressing the imbalances?

This section will analyse to what extent the new provisions contained in the amended proposal alter the conclusions derived from the impact assessments carried out in chapters D and E.

Chapter D identified a balance between the approaches of host state control, home state control and harmonisation inherent in the European economic constitution as it stands today. While the introduction of the COP would significantly alter this balance in favour of the home state model, the new rule is likely to have a considerably smaller impact on this balance. This is due to the retention of the public interest requirements of public policy, security, health and the protection of the environment. As the invocation of these public interest requirements by the host state involves a comparison between home state law and host state law at the proportionality stage of justification, the need for de iure or de facto harmonisation inherent in the concept of functional equivalence continues to be a driving force in the European

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[159] *Ibid.*, Art. 37, see section B. III.

[160] See section C.IV.

[161] See above, this excludes e.g. consumer protection.

economic constitution. This residual regulatory space of the host state with regard to essential policy objectives also seems suitable to place a brake on a potential race to the bottom in the respective policy areas.

Overall, the new rules seem to introduce a three-tiered-system of competence distribution for the regulation of cross-border services: first, the continuing possibility for the host state to justify measures designed to achieve objectives of public policy, security, health and the protection of the environment reflect the host state model; second, the exclusion of other policy objectives as legitimate grounds for intervention reflects the model of home state control; third, the mutual assistance procedure introduced for safety measures reflects a mixture of the two as it makes host state intervention subject to ex-ante approval by the Commission. The concrete practice and the level of scrutiny remain to be developed by the Member States and the Commission.

The provisions on enforcement presented by the original draft met with strong resistance in the political process.[162] The amended version has therefore reorganised the chapter on supervision which is renamed into "administrative cooperation."[163] It introduces a new Article 35 which follows the logic of the new provisions replacing the country of origin principle: Regarding those requirements that the host state may impose pursuant to one of the derogations to the "freedom to provide services", the host state is responsible for the supervision of foreign service providers. However, with respect to other requirements, the host state may only participate in the supervision: either at the request of the home state, or on its own initiative as long as its intervention is limited to mere fact-finding which is non-discriminatory and proportionate. This distribution of supervisory competences is supplemented by an obligation on the home state not to "refrain from supervisory or enforcement measures in its territory on the grounds that the service has been provided or caused damage in another Member State."[164]

The amended proposal thus partly retains the approach chosen in the original draft. While it attempts to address the problem of under-enforcement through improved information channels coupled with legally binding obligations to cooperate, the incentive structure identified in chapter E is likely to continue hampering any effective cross-border supervision.

Section E.II. identified certain loopholes in the original draft proposal that could help service providers circumvent the regulations that would otherwise be applicable to them by means of "home state shopping" or "disguised establishment". It subsequently suggested a number of safeguards in order to curb circumvention and draw a clearer line between the concepts of service and establishment.

First, it was suggested to introduce a circumvention principle by legislative means. The amended directive contains a new recital 37a, which states:

> *The Court of Justice has consistently held that a Member State retains the right to take measures in order to prevent service providers from abusively taking advantage of the Internal Market principles. Abuse by a provider must be established on a case by case basis.*

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[162] See above section E.I.

[163] European Commission (2006).

[164] *Ibid.*, Art. 34 (2).

While it was shown above that the reference to a consistent jurisprudence by the ECJ appears questionable, the spirit of this recital appears suitable to enable Member States to curb circumvention of their regulations. It remains to be seen, however, to what extent such anti-abusive measures would be accepted by the Court.

Second, it was suggested to equip the concept of "services" with a more workable definition introducing a presumption on the time scale. The amended proposal, however, merely attempts to clarify the definition of "services" by contrasting it to the similarly vague concept of "establishment".[165]

Third, it was suggested to prescribe a clearer and higher threshold for the determination of the home country in order to avoid "home state shopping." The amended proposal meets this concern by means of a newly drafted definition of "establishment" which in turn determines the country of establishment, or home state:

> *"Establishment" means the actual pursuit of an economic activity as referred to in Article 43 of the Treaty, by the provider for an indefinite period of time and through a stable infrastructure from where the business of providing services is actually carried out.*[166]

The new recital 18a further illustrates this definition. It is clarified that the requirement of "actual pursuit" excludes mere letter boxes from being "establishments". The recital also clarifies that "where a provider has several places of establishment it is important to determine from which place of establishment the actual service concerned is provided."

The amended proposal is thus likely to better enable Member States to counteract tactics of circumvention than the original draft proposal.

G. Conclusion

This paper has uncovered some of the most important premises and implications of the country of origin principle as proposed by the draft services directive. To summarise: The services directive seeks to eliminate the dual burden on cross-border service providers resulting from the regulatory diversity between different Member States by embracing the country of origin principle. This principle prescribes that service providers are generally bound only by the laws of their home state, even when providing services in other Member States. The host state is – subject to very limited derogations - generally precluded from regulatory intervention.

As the COP is not a Treaty principle, the legislature is free to depart from it. Indeed, examples of past directives show that both country of origin and country of destination principles have been adopted. Where the COP was adopted, it was generally accompanied by provisions harmonising the content of the coordinated laws. The original draft services directive marks a new approach in combining a broad scope of application of the COP with very limited and superficial harmonisation. The COP also breaks new ground compared to the current case law on the free movement of services. Under the judicially created principle of mutual recognition, the host state

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[165] *Ibid.*, Recital 36b.

[166] *Ibid.*, Art. 4 (5).

may not duplicate functionally equivalent measures of the home state. While home state law is presumed to be equivalent, this presumption can be rebutted by the host state showing that the imposition of its own law is necessary to achieve one of the openly defined public interest objectives that could not be achieved by functionally equivalent rules of the home state. The COP, by contrast, pre-empts the host state's regulation regardless of what is or is not regulated by the home state, only allowing for derogations under strictly circumscribed procedural and substantive conditions.

The introduction of the COP would thus entail major implications. On a systemic level, the relationship between the models of home state control and harmonisation would be altered dramatically. Under the mutual recognition case law, harmonisation is still needed for the creation of the internal market as too great divergence between the national laws acts as a barrier to the effective functioning of mutual recognition. Under the COP, this need for harmonisation would disappear along with the concept of functional equivalence. Harmonisation would be limited to those instances where the COP does not apply properly.

The shift in emphasis from host state to home state control could also lead to greater regulatory competition possibly resulting in a race to the bottom in standards of consumer, environmental or social protection. Brakes to that race could be placed by retaining the host state's right to invoke the public interest justifications of the case law as exceptions to the COP.

Rather than a fully-fledged race to the bottom of legislative standards, however, one should expect a structural enforcement deficit as a consequence of the COP. After all, host states are generally precluded from taking enforcement measures on their own initiative, and home states have major incentives not to supervise effectively "their" service providers when operating abroad. In addition, the COP is prone to the circumventive tactics of "disguised establishment" or "home state shopping" unless proper safeguards are put in place.

A number of recommendations can be put forward: The balance between home state control, host state control and harmonisation could be preserved by retaining the public interest requirements developed by the Court. If host states have good reasons to impose proportionate measures, they should be allowed to do so. Apart from placing brakes on a possible race to the bottom, this would preserve the need for harmonisation in those areas where dual regulation would subsequently persist. Enforcement should realistically remain with the authorities of the host state. Such a rule could be complemented by a procedure of administrative cooperation wherever the host state imposes its own rules giving rise to dual regulation. Safeguards against circumvention should be put in place to compensate for a case law that is incompatible with the proposed COP: A circumvention principle could be included in the directive and the dividing line between the provision of services and establishment must be drawn clearer by means of better and more workable definitions.

Such changes to the proposed COP can be justified by recourse to the underlying economic rationale of the services directive. The directive seeks to replace dual regulation of cross-border service providers by single regulation. If, however, that single regulation is not effectively enforced in the host state, the outcome may well be no regulation. Such an outcome appears undesirable in the light of the public interest objectives that proportionate regulatory measures aim to serve.

The amended proposal addresses several of the shortcomings identified in this paper. By introducing a limited list of public interest requirements as justifications for host state intervention it brings the proposal closer to the existing case law. It thereby places a conditioned brake on a potential race to the bottom in standards regarding public policy, security, health and the protection of the environment. It also leaves Member States with more effective means to tackle abusive practices by economic operators, in order to better target the benefits of the freedom to provide services to those companies that actually create economies of scale through their cross-border operations. It can therefore be concluded that the amended proposal reflects a suitable compromise between the demands of a functional internal market and the legitimate policy objectives of the Member States.

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