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978-1-107-00864-9 - Regulating Trade in Services in the Eu and the WTO: Trust, Distrust and Economic Integration

Edited by Ioannis Lianos and Okeoghene Odudu

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## Introduction

IOANNIS LIANOS AND OKEOGHENE ODUDU

Trade in services is of significant importance for the global economy: in the European Union, ‘services constitute the engine of economic growth and account for 70% of GDP and employment in most Member States’.<sup>1</sup> The liberalization of trade in services, at both the European level and more generally, has been and continues to be beset with difficulties. The difficulties arise not only from the specific characteristics of the different economic sectors in which services are provided, but also from the interaction of inter-State trade in services with diverse regulatory regimes that States have adopted either in order to promote the social welfare of their citizens or following pressure from specific domestic interests.

The tension between the logic of free trade and regulatory competition on the one hand and fair trade and harmonization on the other has long provided the conceptual framework within which several battles have taken place between the proponents of liberalization and market integration and the proponents of regulatory diversity and the defence of the ‘social sphere’. At the international level, these tensions are often inherent in the debates between proponents of ‘free trade’ and proponents of ‘fair’ trade<sup>2</sup> – debates between those that highlight the benefits of ‘trade’ and those that focus on ‘non-trade’ elements such as the effects of trade liberalization on social and environmental development. Instances of deeper regional integration, as the European Union example illustrates,

<sup>1</sup> Directive 2006/123/EC of the European Parliament and of the Council on services in the Internal Market, OJ 2006 L376/76.

<sup>2</sup> J. Bhagwati and R. E. Hudec (eds.), *Fair Trade and Harmonization*, Vol. 1, *Economic Analysis* (Cambridge, MA: MIT Press, 1996); J. Bhagwati and R. E. Hudec, *Fair Trade and Harmonization*, Vol. 2, *Legal Analysis* (Cambridge, MA: MIT Press, 1996).

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have resulted in calls for a more ‘social Europe’<sup>3</sup> and, less abstractly, for the ‘integration’<sup>4</sup> of various social clauses in the trade regime.

The conception of the ‘economic’ and the ‘social’ spheres as separate and antagonistic is the product of a specific view of the nature and aims of international or regional integration. Separation is thought of as a mechanism to promote greater convergence and similarity between the different units to be integrated: separation allows trade liberalization to be seen as a technical exercise, since social or distributive consequences are left outside the realm of economic integration. Social or political integration may follow separately, as the expected ‘counter-movement’ to the expansion of the market sphere.<sup>5</sup> The separation of the economic from the social has also been justified by a conceptualization of integration linked to expertise – authors of trading regimes have greater claims to expertise in efficiency than to that of equality, if one perceives these concepts as being in conflict.<sup>6</sup> At the international level, one might think of the functionalists’ construction of different spheres and subsequently the substantive fragmentation of international law as an epiphenomenon of the transposition of the logical positivist’s anxieties to the legal sphere. In the field of economic integration, the economist’s rejection of distributive justice, perceived as a value external to economic expertise, can again be explained by the logical positivist connection, as it is illustrated by the two welfare theorems of economics,<sup>7</sup> following which the ‘ethical foundations’ of economics ‘are now regarded to be a settled matter’.<sup>8</sup>

As contributors to this volume ably demonstrate, the separation thesis, and its positivistic and functionalist assumptions, underestimate the entanglement of the economic and the social. Tenants of the ‘embedded liberalism’<sup>9</sup> thesis as well as their neo-liberal opponents would agree that

<sup>3</sup> A. Giddens, P. Diamond and R. Liddle, *Global Europe: Social Europe* (Cambridge: Polity Press, 2006).

<sup>4</sup> See Title 3 of the TEU, Articles 7, 9, 11 and 13.

<sup>5</sup> K. Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (New York: Farrar and Rinehart, 1944).

<sup>6</sup> A. M. Okun, *Equality and Efficiency: The Big Trade Off* (Washington DC: Brookings Institution, 1975).

<sup>7</sup> M. Blaug, ‘The Fundamental Theorems of Modern Welfare Economics, Historically Contemplated’, *History of Political Economy* 39(2) (2007) 185–207.

<sup>8</sup> P. Dasgupta, ‘What Do Economists Analyze and Why: Values or Facts?’, *Economics and Philosophy* 21 (2005) 221–78, at 222. See also the criticism by H. Putnam and V. Walsh, ‘A Response to Dasgupta’, *Economics and Philosophy* 23 (2007) 359–64.

<sup>9</sup> J. G. Ruggie, ‘International Regimes, Transactions, and Change: Embedded Liberalism in the Post-War Economic Order’, *International Organization* 36(2) (1982) 379–415.

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the process of European economic integration is re-embedding national considerations of the social sphere within the unified supranational institutional structures. At a time when the European Union declares the Charter of Fundamental Rights – containing a number of social rights – binding, progressively extends its aims and competence to cover areas of social regulation (i.e., social protection and environmental protection), and multiplies horizontal ‘integration clauses’, thus enabling the consideration of environmental concerns, sustainable development and social protection in all of the European Union’s policies and activities,<sup>10</sup> it seems possible to abandon the decoupled/distinct spheres thesis in favour of one embracing ‘holistic’ theory of integration.<sup>11</sup>

Despite its certain political appeal, the concept of ‘holistic integration’ might nevertheless prove to be a slogan without content, if the dependent variable of integration is not reconceived to reflect the ‘complex and multidimensional process of societal change’ in the governance of the relationships between public and private actors at the national, international and supranational level that this concept of integration entails.<sup>12</sup> This volume suggests a new reading of the dependent variable of integration, relying on the concept of ‘trust’.

The reference to the concept of ‘trust’ as consubstantial to that of integration may follow naturally from the emphasis recently put on managed mutual recognition as the cornerstone of economic integration.<sup>13</sup> Some scholars have noted the significance of ‘mutual trust’ in the process of harmonization, where, despite the efforts of establishing uniform rules, uncertainty remains as to the effective enforcement of these rules by the authorities of other Member States<sup>14</sup> (trust between Member States). Others emphasize the importance of trust in government, but also the need to institutionalize distrust at moments of major political

<sup>10</sup> See, e.g., Article 9 (social policy) and Article 11 (environment).

<sup>11</sup> I. Lianos, ‘Shifting Narratives in the European Internal Market: Efficient Restrictions of Trade and the Nature of “Economic” Integration’, *European Business Law Review* (2010) 705–60.

<sup>12</sup> P. de Lombaerde, E. Dorrucchi, G. Genna and Francesco P. Mongelli, ‘Quantitative Monitoring and Comparison of Regional Integration Processes: Steps Toward Good Practice’, in A. Kössler and M. Zimmek (eds.), *Elements of Regional Integration* (Baden-Baden: Nomos, 2008), 149–79, at 149.

<sup>13</sup> K. Nicolaïdis and G. Shaffer, ‘Transnational Mutual Recognition Regimes: Governance without Global Government’, *Law and Contemporary Problems* 68 (2005) 263–317.

<sup>14</sup> C. Barnard, *The Substantive Law of the EU* (Oxford: Oxford University Press: 2010), 189–90.

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and legal change, as a way to reinforce the legitimacy of the political system<sup>15</sup> (trust of the citizens in the Union). The remit of this volume is broader, as it recognizes that the concept of trust is multidimensional and might refer to the existence of various trust relationships: between States, between States and the international/supranational level, between the private actors and the government (States or supranational level), and transborder relations between private actors. Trust can also take different forms: it can be inter-personal, as it relates to specific characteristics/similarities/familiarity between the different trust partners, or it can be ‘system trust’, when trust is provided to a third party and is based on factors other than similarity and familiarity. The hypothesis to be examined in this volume is the following: can the concept of integration be understood as related to that of increased levels of trust between different actors? Such an approach rejects the functionalist distinction between various spheres of integration – social, economic, political – but it also liberates the concept of integration from its usual analogy to centralism and uniformity. It thus breaks with the focus of integration studies on trade liberalization to the point that the removal of inter-State trade barriers is considered as one of the principal indicators of the success of the process of integration.

The questions arising from this new conceptualization of integration were examined by a number of scholars, lawyers, economists and political scientists, in a workshop at the Faculty of Laws, University College London, and at Emmanuel College, University of Cambridge, on 1 and 2 June 2009. This volume is the result of the participants’ efforts to reflect on the topic of ‘trust, distrust and economic integration’. Our aim was to test the ‘trust theory of integration’ in the most difficult area of trade in services, at both the European Union and the World Trade Organization (WTO) levels. Some of the contributions to this volume engage fully with the new conceptualization of economic integration and find that it provides a useful framework to analyze developments in the specific sector of services trade they examine. Others take a more sceptical position and refer to other theories explaining the evolution of trade regulation. In the end, any effort to theorize such complex phenomena as the regulation of trade in services and the emergence of multilateral or regional remedies relies on large cognitive structures, which are linked to the development of narratives (‘embedded liberalism’), stories (‘mutual

<sup>15</sup> I. Maher, ‘Trust and EU Law and Governance’, *Cambridge Yearbook of European Legal Studies* 12 (2010) 283–312.

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recognition') and global accounts (functionalism, neo-functionalism). Choosing among competing explanations or global accounts depends on the relative plausibility of each narrative/story as measured by reference to a number of criteria: the portion of the facts that can be explained through that account; its consilience; and its internal coherence. This volume attempts to test the 'trust theory of integration' compared to other theoretical accounts and to develop a theoretical framework that could be later expanded to fit different processes of integration.

Part I of the volume introduces the 'trust theory of integration' and situates it with regard to competing accounts. In Chapter 1, Ioannis Lianos and Johannes Le Blanc examine the various theories of integration and discuss how the concept of integration, the dependent variable of this study, has received different interpretations by lawyers, political scientists and economists. Lianos and Le Blanc argue that the concept of economic integration owes a lot to functionalist theories. Based on this approach, neo-functionalism was able to construct a theory of regional integration employing the model of European integration as the archetypical paradigm of the concept. It follows that the functionalist approach and the concept of integration are profoundly linked: without the functionalist emphasis on the existence of separate functions, where national authority can be transferred to supranational institutions, there can be no integration. The chapter by Lianos and Le Blanc challenges the neo-functionalist view and seeks to show that the separate spheres approach – the distinctive characteristic of functionalism and of its neo-functionalist progeny – does not hold in the current state of the European integration process. Once the limits of the functionalist logic are displayed, the competing theories of international relations fail to conceptualize the dependent variable of 'integration'. Having recognized the need for a new approach to the concept of integration, Lianos and Le Blanc explore two alternatives. The first one – economic integration as efficient organizational creation – perfects the dependent variable suggested by functionalism. The second one – the 'trust theory of integration' – chooses instead to abandon the definition of the dependent variable suggested by functionalism and to focus on a different dimension that would represent the turn towards a holistic, as opposed to a functionalist, approach to integration, where the social, economic and political dimensions are embedded in each other. For Lianos and Le Blanc, the trust theory of integration provides a promising platform for reflection, not only for the European project of integration but also for all other projects of integration.

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Part II of the volume aims to deconstruct the current narrative of economic integration, in particular in Europe, and to introduce a new approach that would engage with the concept of trust. Economic integration has long been associated with the concept of market access in order to bring within the scope of 'negative integration' important areas of economic and social activity and to subject them to the Procrustean logic of barriers to trade. Equivalence and mutual recognition (MR), in its judicial or regulatory variety, have also been thought of as complementary tools to negative integration and as an alternative to the paradigm of exhaustive or complete harmonization, the archetypical examples of 'positive integration'. The concept of trust having been long associated with mutual recognition, it is important to examine more closely this complex phenomenon, before extending the trust theory of integration to other dimensions of the integration process.

A comparison of the approach followed in the regulation of trade in services with that followed in other areas of free movement illustrates the operation of mutual recognition and its relation with the concept of trust. In Chapter 2, Vassilis Hatzopoulos examines why services present different challenges than the area of the free movement of goods for the principle of mutual recognition. He notes the decentralized and non-State origins of the measures; the important role of the recipient of services, which complicates any effort to regulate their content, services regulation being merely about process; the impossibility of a prior notification system for rules on services; the absence of extensive standardization; and, last but not least, the sensitive political stakes involved in the regulation of services. Hatzopoulos then proceeds to a detailed analysis of mutual recognition typology and of the practical implementation of the principle for a variety of State measures. He concludes that the 'proceduralization' of European governance and the experimentation with new modes of governance have transformed mutual recognition to the 'most far-reaching regulatory technique for the completion of the internal market', the concept being flexible and/or binding enough as each case requires. We are away from the sterile opposition between mutual recognition and harmonization or between mutual recognition and other new forms of soft law governance.

The Services Directive constitutes an excellent example of this mutation of the principle of mutual recognition, from a merely judicial instrument to a far-reaching regulatory tool. It is suggested that the concept of trust may serve as the common reference for the different forms of mutual recognition.

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In Chapter 3, Gareth Davies explores the Services Directive as an example of market-making legislation, which works by indirect rather than direct means. Rather than adding significantly to the rules on free movement, Davies notes that the Services Directive develops communication and transparency mechanisms which will add to trust between Member States. Using ideas of oligopoly, regulatory competition and reflexive harmonization, he suggests that such transparency will lead to voluntary convergence of regulation, with a resulting increased tolerance for mutual recognition. This system is, however, likely to be unstable, given the fragmented and rapidly developing nature of services markets. The likely impact of the Directive on the services market demonstrates the dynamic interdependence between trust, mutual recognition and centralizing legislation.

The topic of mutual recognition is further explored in Chapter 4. Wolfgang Kerber and Roger van den Bergh critically assess the prevailing view that the principle of mutual recognition leads simultaneously to the removal of non-tariff barriers to trade and the implementation of an integrated market, the enabling of regulatory (institutional) competition, and the protection against a centralization of competences in a multi-level system of jurisdictions. They argue instead that the principle of mutual recognition leads to a number of serious (and so far not well-recognized) inconsistencies and problems, which are linked to a basic misunderstanding of its function with regard to the removal of trade barriers. According to them, the introduction of the rule of mutual recognition cannot be understood as an appropriate rule for the enabling of effective regulatory competition nor is it a suitable instrument for avoiding harmonization and centralization. Its introduction triggers a dynamic process of reallocation of regulatory powers between different regulatory levels in a multi-level system of regulation, and therefore has consequences for the vertical allocation of competences. In other words, it can be interpreted more as a test, whether the regulatory powers on the national level are still defensible or whether another solution for the allocation of regulatory powers seems to be superior, as, for example, centralization/full harmonization or the transition to a fully competitive system of regulations (with free choice of law). They conclude that mutual recognition seems to be more an alternative indirect path to harmonization and centralization, instead of offering a solution for the removal of barriers that simultaneously maintain the decentralized structure of competences. Since the introduction of mutual recognition also influences the vertical allocation of competences within a multi-level



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system of governance, they argue that the advantages of the removal of trade and mobility barriers also have to be balanced against the foregone manifold advantages of decentralization – leading to a much more ambivalent assessment of the long-term consequences of mutual recognition. On a theoretical level, this implies that the theory of international trade is relevant for the assessment not only of mutual recognition but also of the economic theory of federalism with its comprehensive analysis of all advantages and disadvantages of centralized and decentralized competences in a federal multi-level system of jurisdictions.

Chris Bovis' contribution in Chapter 5 examines the process of harmonization in the area of public procurement and public services and its interaction with the negative integration provisions of the Treaties. Bovis notes the wide margin of discretion the Member States enjoy in introducing public policy considerations with regard to public services, thus demonstrating that harmonization does not always lead to a lack of regulatory diversity.

The main components of the current paradigm of economic integration deconstructed, it is important to understand how the process of integration may accommodate regulatory pluralism. We start from the assumption that the main problem faced by economic integration regimes in services is not the existence of regulation – which is necessary either in order to address the risk of market failure in network industries or to promote efficient trade for credence goods, such as professional services and services where there is an important information asymmetry – but rather the distrust between national regulators and the risk of opportunistic behaviour. By providing for a process of administrative cooperation and exchange of information, the Services Directive facilitates trust-building between national actors (regulators or consumers). Harmonization and negative integration are not the only options on the table. This leaves enough room for diversity and regulatory pluralism that need to be managed, the topic of Part III, which considers the interaction between pluralism, trust and economic integration.

In Chapter 6, Ioannis Lianos and Damien Gerard examine how the trust theory of integration accommodates claims of regulatory pluralism. They start by describing the evolution of the case law of the Court of Justice of the European Union in assessing the existence of a State restriction of trade and the proportionality of the restriction(s) at stake in light of the alleged public interest to be safeguarded (the Internal Market test). They note that both the case law of the Court and the Internal Market policies of the European Commission increasingly take



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into account pluralistic concerns and regulatory diversity, each Member State embodying a specific political compact reflecting particular social choices and cultural traditions. This part of the volume builds on the dominant conception of economic integration as characterized by the absence of barriers and increased intra-area harmonization, which is, in essence, paradoxical to claims of pluralism. While the first section of the chapter highlights an evolution in the application of the Internal Market test revealing an emerging praxis of pluralism, the second reconceptualizes economic integration from the perspective of trust theory, in order to test if and how such an approach could accommodate regulatory pluralism. Lianos and Gerard consider that States put in place different mechanisms to govern the risk of cooperation with other States. Their focus on discrete governance mechanisms as risk management techniques displaces the unidimensional focus of integration theory on the erosion of barriers to exchange and regulatory sameness. Their analysis of the different governance mechanisms, put in place in various sectors of trade in services, illustrates the adjustments made in order to accommodate regulatory diversity and the porosity of the tripartite distinction between the market access/national treatment rule, the principle of equivalence and that of harmonization as discrete governance mechanisms. Building on the trust theory of integration, Lianos and Gerard note that, if the main problem faced by economic integration regimes is the distrust between national regulators, the different governance mechanisms cannot be thought of as constituting the different stages of a process of integration that leads ultimately to 'convergence' of regulatory systems, or any form of centralized control (EU regulation or the 'single' market's forces of supply and demand). The emphasis is on the establishment of institutions, formal and informal, with the aim to manage the risks of cooperation between diverse regulatory systems. Regulatory sameness is thus not the only desirable outcome but a possible outcome among others. What counts is the potential of these governance arrangements in generating inter-organizational system trust. The centrality of the mutual recognition principle in the process of European integration further illustrates the shift towards a trust-based conception of integration, focusing on regulatory interoperability. By disentangling the focus of integration from managing or suppressing conflicts from regulatory diversity establishing system trust between the different stakeholders, the trust theory of integration offers a real chance for regulatory pluralism.

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The theme of regulatory pluralism is brilliantly explored by Kalypso Nicolaïdis in Chapter 7, in which she revisits the regulatory wars that marked the adoption of the Services Directive and the struggles surrounding mutual recognition in the EU. These conflicts struck a painful chord across European societies which had not yet come to terms with the tensions associated with enlargement and the gap between old and new Member States. They show that claims of regulatory pluralism are embedded in broader conflicts of identity. Nicolaïdis advocates the need for a regulatory peace theory, that is, a stable state of cooperation among regulators (broadly conceived) from different jurisdictions. A stable state of cooperation does not necessarily mean harmony, but rather the existence of mechanisms to manage the unavoidable mix of convergent and divergent interests and values between these actors, allowing them to pursue the public good in their own jurisdiction while minimizing negative externalities for outsiders. Building on ‘democratic peace theory’, she explores factors that make regulatory peace more likely both as characteristics of individual jurisdictions and as attributes of the interactions between them. Differences ought to be considered legitimate until proven otherwise. Managing differences does not necessarily require engineering convergence.

Establishing higher levels of trust between national regulators, between national regulators and international institutions and between citizens/consumers and national regulators or integration institutions thus becomes the principal aim of regimes of economic integration. However, in many instances, private parties intervene in the process of economic integration in various ways, such as delegation, self-regulation and standard-setting activity. The intervention of private parties in the economic integration process may render more complex the dynamics of the trust-building game. This is an additional challenge explored by two studies in Part IV of the volume.

In Chapter 8, Harm Schepel examines the (direct or indirect) horizontal application of the negative integration provisions to private parties, that is, the idea that private parties are directly bound by the free movement provisions of the EU Treaties. He notes that the full direct horizontal effect of the regimes of the free movement of workers, the freedom to provide services and the freedom of establishment – what he calls ‘total market’ – is the inescapable consequence of the Court’s case law. He further notes that, if the Court persists in its case law on the horizontal scope of the prohibitions of the free movement provisions, it seems inevitable that it will have to expand the justification regime to the