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Mutual Recognition Revisited: Misunderstandings, Inconsistencies, and a Suggested Reinterpretation

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I. INTRODUCTION

In the literature on trade policy and economic integration, the principle of mutual recognition is seen as an ingenious institutional innovation for the removal of barriers to trade and the achievement of integrated markets (Weiler 2005, Pelkmans 2005). Since the *Cassis de Dijon* judgement of the European Court of Justice (ECJ), its application in regard to regulations of the EU Member States has been the most important strategy for overcoming manifold barriers to the fundamental economic freedoms. Also on the global level, the principle of mutual recognition is deemed to be a promising strategy for reducing barriers to trade (Nicolaidis and Shaffer 2005, Trachtman 2006). In the Law and Economics literature, the principle of mutual recognition is widely appreciated as an instrument for enabling regulatory competition and impeding the centralisation of regulatory powers. Therefore, mutual recognition is often recommended as a nearly ideal solution for removing obstacles to free trade without embarking on a pathway to harmonisation. Although it is acknowledged that the implementation of the principle of mutual recognition occasionally may lead to considerable practical problems, this has not changed the overall positive assessment (Pelkmans 2007).

This paper takes a more critical view on the principle of mutual recognition. We do not deny that the strategy of introducing mutual recognition contributed substantially to the removal of barriers to trade within the EU, and that the application of this principle might have similar effects on the global level. However, we claim that applying mutual recognition leads to serious inconsistencies and that the role of the principle of mutual recognition has been largely misinterpreted. We argue that mutual recognition is neither an appropriate rule for enabling a sustainable process of regulatory competition

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nor an effective device for preventing harmonisation and centralisation. We suggest that the principle of mutual recognition does not ensure a stable allocation of regulatory powers in a two-level system of regulations. Mutual recognition primarily initiates a dynamic process of reallocating regulatory powers between different regulatory levels. It should be seen as a test whether the traditional national regulatory autonomy is still defensible. Only if this is not the case, decentralisation should be replaced by another allocation of regulatory powers. This may be either a form of centralisation (including measures of harmonisation) or a free market for regulations (free choice of law). Our critical assessment of mutual recognition is mostly based upon the insight that not only the positive effects of the removal of regulatory barriers but also its implications for the vertical allocation of regulatory powers must be taken into account. We believe that the one-sided focus on the problem of barriers to trade and the ensuing neglect of the positive effects of decentralised regulatory powers might have contributed to the tendency of too much harmonisation within the EU.

The structure of the paper is as follows. Section II briefly summarizes the current positive assessment of the principle of mutual recognition in the literature. The main section III analyzes the misunderstandings, inconsistencies and problems of mutual recognition by using a theoretical framework for the optimal vertical allocation of regulatory powers based upon economic theories of legal federalism and regulatory competition. Section IV presents our reinterpretation of mutual recognition as a dynamic principle for the reallocation of regulatory powers within a two-level system of regulations. Section V concludes.

II. THE PRINCIPLE OF MUTUAL RECOGNITION: THE 'STATE OF THE ART'

The principle of mutual recognition has its foundations in the case law of the European Court of Justice (ECJ) and the decision practice of the European Commission. Its purpose has always been the removal of unnecessary and disproportionate trade barriers. Article 28 EC Treaty prohibits quantitative import restrictions for goods and 'measures of equivalent effect'. In the *Dassonville* case (1974), the ECJ limited the regulatory autonomy of the Member States by clarifying that the notion of 'measures of equivalent effect' covers 'all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade'.[1] Given the exhaustive list of derogations (Art. 30 EC), this broad

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

interpretation implied a dramatic reduction of the scope of EU Member States' regulatory autonomy with respect to product requirements that could hinder the free movement of goods. However, in the *Cassis de Dijon* case[2] and in later cases on the other fundamental freedoms, the ECJ has created scope for additional exceptions to the principle of free movement by introducing a 'rule of reason' approach. The ECJ has created an open list of so-called mandatory requirements (including, among others, safety, health, environment and consumer protection) which may justify the application of national regulations, if they satisfy four conditions: i) foreign firms and domestic firms must be treated equally; ii) the rules must be justified by reasons of public interest; iii) the rules must be necessary to attain the public interest goal aimed at; and iv) they must be proportionate to that objective.[3]

In the *Cassis de Dijon* case, the ECJ also famously preaches the rhetoric of mutual recognition: 'There is (…) no valid reason why, provided that they have been lawfully produced and marketed in one of the Member States, (products) should not be introduced into any other Member State'.[4] At first sight, this seems to imply that goods which are offered in accordance with the regulations of the country of origin can circulate entirely freely in the European internal market. Economists have often misunderstood mutual recognition in this way. However, the real meaning of the 'country of origin' principle (now referred at as mutual recognition) in the early case law of the ECJ is that Member States cannot apply certain specific details of national regulations to interstate trade, if the objectives or effects of the relevant law in other Member States are equivalent to that of the importing country. The criterion of the 'equivalence of objectives or effects' is the guiding principle to judge whether public interest goals are adequately protected by the regulations of the export state and hinder the import state from imposing stricter standards. The principle of mutual recognition has meanwhile expanded from the area of free movement of goods into the areas of right of establishment, freedom to provide services, and even to safety and security.[5]

Besides 'judicial mutual recognition' through the case law of the ECJ (Weiler 2005), also the European Commission has used mutual recognition as its main strategy to achieve the internal market ('regulatory mutual recognition', Pelkmans 2005, p. 96; or: 'political mutual recognition', Weiler 2005, p. 50).

2. Case 120/78, *Rewe-Zentrale AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.
3. See case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165.
4. Case 120/78, *Rewe-Zentrale AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649, at para 14.
5. In its *Gözütok and Brügge* judgement, the ECJ concluded that every Member State should accept the application of the criminal law of another Member State, even if its own criminal law would lead to a different outcome (Joint cases C-187/01 and C-385 /01, *Gözütok and Brügge* [2003] ECR I-1345).

After the failure of the 'old approach' of removing barriers to trade through a full harmonisation strategy, the relevant EC Directives (e.g., in regard to product regulation) no longer contain detailed technical standards or specifications. They are confined to identifying the objectives in terms of health and safety, leaving the task of devising the necessary technical solutions to standard-setting bodies within the Member States (Pelkmans 2007, p. 706). In the *Foie Gras* case[6], the ECJ endorsed this 'new approach' of the European Commission by requiring the Member States to include in their technical regulations a mutual recognition clause, according to which Member States must allow the import of products which are in conformity with the legislation of another Member State. This was complemented by the Information Directive[7] which imposes a duty on Member States to inform the European Union about drafts of new legislation having an actual or potential bearing on regulatory barriers in goods markets.

In the literature on European integration the principle of mutual recognition is widely applauded 'as an ingenious innovation by economists, lawyers and political scientists alike' (Pelkmans 2007, p. 699). The following assessment of Pelkmans (2005, p. 89) is shared by many scholars: '… the principle of mutual recognition plays a pivotal role in the internal market since it ensures free movement of goods (and services) *without* making it necessary to approximate/harmonize national legislation'. Pelkmans (2005), however, also demonstrated that judicial mutual recognition can have 'fairly high information, transaction and compliance costs' (p. 103), because the criteria of necessity, proportionality, and equivalence are vague concepts that can cause legal uncertainty. Especially the regulatory variant of mutual recognition is broadly viewed as an important device for impeding the erection of new regulatory barriers by the Member States (Pelkmans 2007).

In the Law and Economics literature, the principle of mutual recognition has become an important topic in the debate about regulatory competition. Before the 1990s, regulatory competition was discussed mainly in the US, particularly in regard to competition between US corporate laws ('Delaware effect'; see Romano 1993). The application of mutual recognition within the EU also initiated a discussion about regulatory competition between national regulations in Europe (Siebert and Koop 1990; Sun and Pelkmans 1995). Another discussion emerged because of the increasing relevance of choice of law for international transactions (Parisi and Ribstein 1998). All these discussions have been dominated by the question, whether regulatory competition would lead to a 'race to the bottom' or a 'race to the top'. The adherents of regulatory competition expect that competition between legal rules will improve the

6. Case C-184/96, *Commission v France (Foie Gras)* [1998] ECR I-6197.
7. Directive 98/34 of 22 June 1998, OJ 21.7.1998, L 204/37.

efficiency of regulations, trigger innovative improvements, and help to solve rent seeking problems. The opponents emphasize the danger that regulatory competition may lead to an inefficient low level of regulatory standards, and cause high transaction and information costs. More recently, the question was raised whether the introduction of mutual recognition is sufficient for triggering a dynamic process of regulatory competition, because often the introduction of mutual competition did not seem to initiate a dynamic competitive process at all (Sun and Pelkmans 1995). In the meantime, the results of theoretical and empirical studies have led to a highly differentiated assessment, which emphasises that it depends on the kind of regulations, the specific institutional structure, and other circumstances whether the advantages outbalance the potential problems of regulatory competition.[8]

III. EFFECTS OF MUTUAL RECOGNITION: MISUNDERSTANDINGS AND INCONSISTENCIES

1. A Broader Perspective: Mutual Recognition As a Conflict of Law Rule Within a Two-Level System of Regulations

So far the merits and problems of mutual recognition have been discussed mainly from the perspective of the theory of economic integration, which primarily is based upon trade theory. Moreover, in the theoretical Law and Economics discussion, the rule of mutual recognition has been seen as a necessary precondition for enabling regulatory competition. Whereas the proponents of regulatory competition therefore strongly recommend mutual recognition, the opponents usually object to mutual recognition for impeding 'race to the bottom' processes. A broad consensus exists that it is a crucial advantage of the principle of mutual recognition that it is capable of removing barriers to mobility without leading to centralisation and harmonisation. We claim that mutual recognition can only be assessed properly within a theoretical framework that takes into account both the effects of non-tariff barriers to trade through regulations and the impact of mutual recognition on the vertical allocation of regulatory powers. Hence, also the insights from the economic theories of federalism and regulatory competition must be taken into account.[9]

In a two-level system of jurisdictions, as it exists within the EU, regulatory powers can be allocated either to the central level or the level of the Member

8. See, among others, Siebert and Koop (1990), Vanberg and Kerber (1994), Van den Bergh (2000, 2007), Sinn (1997), Esty and Geradin (2001), Marciano and Josselin (2003), Trachtman (2000), Kerber and Grundmann (2006).
9. See Oates (1999), Frey and Eichenberger (1999) and the references in fn.8.

States. If all regulatory powers are assigned to the EU, Member States cannot enact their own regulations, which excludes regulatory competition and usually implies uniform regulation. Decentralised regulatory powers allow different national rules that may reflect different policy objectives, different factual conditions, or different opinions about appropriate policies. Within such a two-level system of regulations 'conflict of law rules' are necessary to delineate the regulatory powers of jurisdictions. They help to solve conflicts both vertically between the two jurisdictional levels and horizontally between the lower-level jurisdictions (i.e., the Member States). Conflict of law rules allow to decide which rule is applicable to a particular behaviour or transaction in a cross-border context (extraterritoriality).[10]

From the legal perspective, the principle of mutual recognition is a conflict of law rule, because it stipulates that for cross-border transactions it is sufficient that the goods or services comply with the regulations of the home country. Two basic types of mutual recognition must be distinguished: unconditional mutual recognition (which is often assumed in the theoretical literature, meaning that mutual recognition applies without specific requirements) and conditional mutual recognition (see also Trachtman 2006, Nicolaidis and Shaffer 2005). The mutual recognition rule established by the ECJ is a conditional rule: it applies only if the objectives or effects of diverging national regulations are equivalent (Weiler 2005: 'functional equivalence/parallelism'). Other relevant conflict of law rules are: the country of destination principle and the rule of free choice of law. The first principle implies that all firms selling in a particular state must comply with its domestic regulations. Free choice of law solves the conflict of laws problem by giving private parties the authority to choose which legal rules (and which forum) should govern their behaviour or transactions (Parisi and Ribstein 1998).

The different conflict of law rules lead to different types of regulatory competition within a two-level system of regulations (Heine and Kerber 2002; Kerber and Budzinski 2003). The most intensive type of regulatory competition can emerge under a regime of free choice of law. Under this scheme, firms can choose between national regulations without having to move their location. Regulatory competition initiated by mutual recognition is of a different type, since only the consumers (in the import country), but not the producers, can choose between diverging regulations. The country of destination rule does not allow direct regulatory competition between product regulations, because even a relocation of firms does not change the requirement of compliance with the domestic regulations of the import countries. However, in all cases (even in the last one), there can be regulatory competition in the form of 'yardstick competition', which allows parallel experimentation with

10. See Muir Watt (2003) with many references to relevant legal literature.

different regulations and mutual learning about better regulations. Full harmonisation would eliminate even this reduced form of regulatory competition.[11] The questions of the optimal vertical allocation of regulatory powers in a two-level system of regulations, the optimal extent and type of regulatory competition, and, therefore, the appropriate conflict of law rules are mutually interdependent and require a simultaneous and integrated solution.

Beyond the merits and problems of regulatory competition, a number of other assessment criteria for the optimal vertical allocation of regulatory powers have been derived from economic theories of (legal) federalism.[12] For example, several kinds of costs (static economies of scale, information and transaction costs, externalities) favour centralised and uniform regulations. This is also true of the costs caused by barriers to trade. Conversely, heterogeneity of preferences and problems as well as the advantages of local knowledge and decentralised experimentation (allowing more innovations and greater adaptability) are well-founded arguments for a more decentralised allocation of regulatory powers. Also, the risk of rent-seeking problems might be better overcome through decentralised solutions. So far the theoretical analyses and experiences in different fields of regulations demonstrate that often there are both many positive and negative effects of centralisation or decentralisation, as well as merits and problems of regulatory competition. Therefore a (potentially large) number of trade-off problems can emerge, leading to highly differentiated results. With regard to some regulations a centralised solution (harmonisation) might be advisable, whereas in other cases decentralised solutions with more or less regulatory competition (free choice of law or country of destination principle) might be superior (Kerber and Grundmann 2006).

2. Mutual Recognition and Regulatory Autonomy: A Fundamental Misunderstanding

One of the most praised advantages of mutual recognition is that it would remove barriers to trade without depriving the states of their regulatory powers to maintain or enact stricter domestic regulations. This interpretation of the principle of mutual recognition shows a fundamental misunderstanding. Under a mutual recognition rule, the Member States lose their power to enact

11. For policy innovation and learning from parallel experimentation, yardstick competition, and laboratory federalism, see Salmon (1987), Vanberg and Kerber (1994), Oates (1999) and Van den Bergh (2000).
12. See for these criteria in more detail Van den Bergh (2000) and Kerber and Heine (2002). Beyond welfare also other normative criteria, such as distributional justice and the effects on private autonomy, can be included.

mandatory regulations for *domestic markets*. They are only able to enact mandatory regulations for *domestic producers*, who still have to comply with domestic regulations. The puzzling point is that the introduction of mutual recognition turns a former regulation for the domestic market into a regulation applying only to domestic producers. Consequently, under mutual recognition the regulatory autonomy of a state over its domestic market is lost.

The main effect of this loss of regulatory powers over the domestic market is that different preferences of the citizens in regard to regulations can no longer be satisfied. It is easy to show that, for example in regard to consumer protection or to health services, different preferences exist within the EU (Van den Bergh 2007). Under mutual recognition, the citizens in one country have to accept foreign regulations, based upon different values and preferences of the citizens of other countries. Some authors, who defend mutual recognition, acknowledge that it can also lead to considerable welfare losses, if the preferences in the countries are different (Pelkmans 2005, p. 97; Weiler 2005, p. 49). However, in most of the literature on mutual recognition this problem is entirely ignored. Different regulations can also be optimal because of different wealth conditions in the countries, e.g. different income levels. Also in these cases welfare losses will occur through mutual recognition. One counter-argument might be that mutual recognition in the EU does not hinder the Member States to satisfy heterogeneous preferences, because regulations of other Member States only have to be recognised, 'if the objectives or effects are equivalent'. However, this is a consequence of *limiting* mutual recognition (conditional mutual recognition). If this condition is not fulfilled, the country of destination principle will apply again, and different preferences in the Member States can be satisfied.

Experience in the EU demonstrates that the precondition of 'equivalence of objectives or effects' can lead also to the opposite effect of an increased tendency to harmonisation. A number of rules and procedures have been developed to prevent Member States from enacting new regulations that lead to new barriers to trade within the EU. These entail the requirement imposed on Member States to include a mutual recognition clause in their technical regulations (*Foie Gras* rule), the duty to inform the EU about drafts of regulations (Information Directive) as well as the establishment of a special committee that pre-checks drafts of national regulations.[13] The result is that: 'The large majority of national draft laws passing the 98/34 committee either contain equivalence clauses by now or have been adjusted after insistence by the committee' (Pelkmans 2007, p. 706). The overall effect of this regulatory

13. Also European technical standard-setting committees, such as the European Committee for Standardisation (CEN) and the European Committee for Electrotechnical Standardisation (CENELEC) play an important role.

mutual recognition is that the factual scope for national regulations (with different objectives or effects), which may fulfil divergent preferences, is severely restricted. This 'pre-emption machinery' is defended with the argument that otherwise hundreds or thousands of new national regulations with potentially new regulatory barriers would be enacted (Pelkmans 2007, p. 707).

In the current state of things, regulatory mutual recognition leads to a de facto harmonisation of regulations in those areas of law, which so far have not been harmonised. This result is in line with the explicitly stated (and also widely recommended) policy that in many realms, where mutual recognition cannot be applied due to different objectives, a direct harmonisation approach should be attempted (Weiler 2005, p. 50). From this perspective, Trachtman (2006) might be right in his analysis that mutual recognition requires 'essential harmonisation'. The rules for the approximation of laws for the accomplishment of the internal market (Articles 94 – 95 EC) can be used to harmonise national regulations, even if the Member States pursue different regulatory objectives (with a slightly modified qualified majority voting rule). The crucial problem then is that the advantages of market integration tend to be overstated, while the advantages of decentralisation, regulatory autonomy, and regulatory competition are largely ignored.

3. Reverse Discrimination, Producer Regulations, and Industrial Policy Implications

Another implication of mutual recognition is the problem of 'reverse discrimination'. Although consumers are allowed to choose between different regulations from all Member States, producers remain bound to their domestic regulations. This has been called 'reverse discrimination', because the discrimination of foreign firms through their obligation to comply with the rules of the import countries (country of destination principle)[14] is replaced by the discrimination of domestic firms, which are not allowed to produce goods according to regulations used by their competitors on the same market. This leads to the puzzling insight that mutual recognition can change the character of a regulation. For example, if French firms are allowed to sell in Germany products containing ingredients that are not allowed for products of German firms, these specific German regulations can no longer be defended by the aim of protecting German consumers. Under the country of destination principle, this producer regulation was a policy instrument used to achieve the goal of

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

consumer protection. However, if under the mutual recognition rule consumers are allowed to choose between different regulations, why is it prohibited that also domestic firms produce according to regulations of other Member States and sell these products – appropriately labelled – on the domestic markets?

One approach for defending this kind of producer regulation may be based on the economics of geographical indications (origin labelling; see e.g., Falvey 1989). Haucap, Wey and Barmbold (1997) argue that location choice can act as a signalling device for product quality, e.g., that high country-specific costs signal high quality products. In their analysis, they defend regulations protecting geographical indications, because they can provide valuable signals about the quality of products. Their argument is primarily based upon high labour costs, which forces the firms to produce high product quality. An additional step is made, if these geographical indications are connected with strict mandatory product regulations, as, e.g., in the case of French wine. Thanks to strict mandatory regulations national (or regional) producers can build up a specific reputation. The mandatory character of these regulations may then be defended on grounds of impeding free-riding by other firms on this reputation. However, only in very particular circumstances (as in the case of regionally typical food, in which the country of origin might be a strong indicator for a specific form of quality or taste) can mandatory producer regulations (beyond labels indicating the country of origin) be defended from an economic point of view. For most goods and services such mandatory producer regulations cannot be justified as a signalling strategy.

Such producer regulations might also be defended with industrial policy arguments. If it is assumed that the state has superior knowledge about the design, composition or other characteristics of particularly competitive products, domestic mandatory product regulations might help the firms to compete successfully in the internal market. However, both the theoretical and the empirical literature on industrial policy shows in a very convincing way that, in general, firms know much better than the state what kind of products and services might be successful. Beyond that, there is an abundance of literature on the manifold problematic consequences of industrial policies, including, among others, indirect forms of 'subsidisation' due to rent seeking activities (Holmes and Seabright 2000). Theoretical models developed in the literature on international trade show that under a mutual recognition regime national regulations may be used strategically in markets with imperfect competition (Lutz 2000, Pelkmans 2005, pp. 97–102). These problems raise serious concerns about the specific type of regulatory competition that might ensue under mutual recognition within the EU. The disadvantages domestic firms suffer through 'reverse discrimination' provide incentives to lobby for 'better' regulations. These lobbying efforts will focus entirely on the

competitiveness of the domestic firms and may lead to quality deterioration to the detriment of consumers, if the latter cannot choose properly between different consumer regulations. Theoretically, also this type of regulatory competition can lead to positive effects, such as more innovative regulatory solutions. However, under the conditional rule of mutual recognition in the EU, not much scope for innovative experimentation remains, because the objectives and the effects of the regulations must be 'equivalent'. Although there might still be some scope for achieving the same regulatory output at lower cost, the scope for diversity and regulatory competition is so small that it is doubtful whether it can still be called regulatory competition in a meaningful way.

4. Race to the Bottom, Mutual Recognition, and Free Choice of Regulations

The most important concern about the rule of mutual recognition has always been that it might lead to inefficiently low regulatory standards through a 'race to the bottom'. A large number of theoretical and empirical studies has examined the issue whether regulatory competition may lead to either a 'race to the bottom' or a 'race to the top'. Under specific assumptions, theoretical models could derive the possibility of both outcomes.[15] However, empirical studies could not confirm the fears about widespread race to the bottom effects, even in cases in which theoretical reasoning would have suggested such outcomes. Different reasons have been put forward for this surprising result. One thesis is that mutual recognition might not trigger a dynamic process of regulatory competition at all (Sun and Pelkmans 1995); another view is that detrimental effects of regulatory competition are impeded through complementary legal rules, which are harmonised and therefore remain outside of the domain of regulatory competition. Although the concerns about race to the bottom problems seem to be exaggerated, their existence cannot be excluded. The most important lesson to be learned from the theoretical and empirical literature is that the outcome depends on the specific kind of regulation and the particular conditions. In the following, we distinguish two potential scenarios and argue that in both cases mutual recognition is not the best conflict of law rule in comparison to other rules.

An analysis of regulatory competition must take account of the justification for these regulations. Mandatory consumer protection regulations are based upon potential market failures (adverse selection) due to information asymmetries between producers and consumers, which might not be remedied

15. See for overviews, e.g. Van Cayseele and Heremans (1991), Wagener, Eger and Fritz (2006), pp. 234–236, and the references in fn.8.

sufficiently through market solutions, such as the reputation mechanism or information intermediaries (Hadfield and Trebilcock 1998). Under mutual recognition, the question must be raised, whether there are well-founded concerns that consumers are not able to assess the quality of diverging regulations of different Member States. If such an information problem exists, then mutual recognition can lead to market failures, either through a race to the bottom or simply because consumers make wrong choices. In these cases, (minimum) harmonisation or the traditional country of destination principle are superior solutions, since they both avoid harmful regulatory competition. The precondition of 'equivalence of objectives or effects' for the application of mutual recognition can be seen as an explicit device for impeding race to the bottom problems. However, the usual response in the EU to race to the bottom concerns has been minimum or full harmonisation (including the indirect method of regulatory mutual recognition).

Under the second scenario, consumers are sufficiently able to assess different consumer regulations. Hence, regulatory competition that might be initiated by mutual recognition will not lead to significant race to the bottom effects. However, in this case a free choice of law rule enabling both consumers and producers to choose the law applying to their transactions would be a superior conflict of law rule. The transition from mutual recognition to a free choice of law rule for national regulations would establish a free market for consumer regulations within the EU (Muir Watt 2003, p. 394). Consumer regulations would then have a function similar to voluntary certifications, implying that certain products or services are produced or sold according to particular national consumer regulations. The ensuing internal market for consumer regulations would be a competitive market for certifications, and their quality would be safeguarded by the reputation mechanism. Member States could invest into the reputation of their consumer regulations in order to build up trust both with the consumers and the producers. This solution does not require detailed knowledge about the regulations by the consumers, because the reputation mechanism may overcome information asymmetry problems in the market for regulations.[16]

What are the advantages of a free market for regulations? Free choice of law allows for the most intensive form of regulatory competition. Neither the consumers nor the producers need to migrate to other countries in order to choose the regulations they deem most appropriate to their needs and preferences. Free choice of law avoids all the above-mentioned problems of reverse discrimination with its ensuing industrial policy implications. Such a

16. The argument of Sinn (1997) that the same adverse selection problem that leads to the necessity of consumer regulations will re-emerge again, if consumers can choose between consumer regulations, is not convincing. The information problems in these two cases are very different, because the consumers need only assess a much smaller number of consumer regulations than products of firms.

regulatory competition enables also a much richer differentiation of regulatory standards. The discussion on the race to the bottom versus the race to the bottom is misleading, because it falsely suggests that only vertical differentiation of regulations (high versus low standards) is relevant. However, consumers can have different preferences about the relevant assessment criteria in regard to consumer regulation, as, e.g., costs, product quality, health risks, environmental concerns or even moral standards. A free market for consumer regulations can lead to much more specialised regulatory standards of the Member States, which would enable a better fulfilment of heterogeneous preferences of consumers. Free choice of consumer regulations can also improve the signalling of superior regulations, because the existence of a separating equilibrium between different qualities of consumer regulations (in contrast to a pooling equilibrium) becomes more probable (for corporate laws, see Iacobucci 2004). Additionally, the innovativeness and adaptability of regulations would be enhanced, because more parallel experimentation with different kinds of regulations can take place.

What might be the problems and the institutional preconditions of a free market for consumer regulations? The greater variety of regulations can lead to larger information costs for the consumers. However, mandatory information duties about the content of the applied consumer regulations might be sufficient. Particularly important might be a duty to label properly according to which regulations the products and services are produced and sold. If despite these measures serious concerns about the capability of consumers to choose properly between regulations remain, this market of regulations can be combined with minimum harmonisation. A serious problem can be the monitoring of the compliance of the firms with the regulations, if they can choose between the regulations of all Member States (Koenig, Braun and Capito 1999). For example, how can the compliance of a Finnish firm to Dutch regulations be ensured? Another problem is whether the Member States will have sufficient incentives to provide efficient consumer regulations, given that the lobbying interests of the domestic firms will be considerably reduced, because they can opt for other regulations. In the US case of a market for corporate laws, this problem is solved by a franchise tax which the states levy on incorporated firms. Hence, also in the field of consumer regulations, a kind of franchise fee that all firms have to pay for using national consumer protection regulations might be considered. Such a fee could also be used to finance compliance monitoring.[17]

17. It can be asked whether an internal market for national product regulations under a free choice of law rule would not be a first step towards privatisation of these regulations (private regulations). Why should these certifications be provided only by the Member States? This important issue cannot be discussed in this article.

IV. A SUGGESTED REINTERPRETATION: MUTUAL RECOGNITION AS A DYNAMIC PRINCIPLE FOR REALLOCATING REGULATORY POWERS

Despite our critical assessment above, we do not deny the huge positive effects of the introduction of the principle of mutual recognition within the EU as a tool to remove unnecessary barriers to trade. Even though the principle of mutual recognition can play a very important role for economic integration, we claim that so far this role has not been understood properly. Our suggestion is that mutual recognition should not be viewed primarily as a static conflict of law rule that delineates the scope of regulatory powers. Rather it should be understood as a dynamic principle that leads to a process of reallocating the regulatory powers within a two-level system of regulations. This dynamic evolution can be described as follows. The beginning of an integration process is characterised by regulatory sovereignty of the states. In regard to their regulatory decisions, the states only take into account their own benefits and costs and they neglect the negative effects on other countries. The move towards economic integration is an attempt to increase the overall welfare of the member states by internalising the external effects of regulatory decisions. This requires a transition to a new allocation of regulatory powers within the broader geographic area of economic integration.

In the EU, the first direct attempts to reallocate regulatory powers through harmonisation measures in the 1970s ('old approach') were not successful. At a time when the harmonisation process had stalled – due to the requirement of unanimous consent for adopting the necessary regulations and directives –, the ECJ introduced the principle of mutual recognition in its case law as an alternative way to further the market integration process. Mutual recognition can be understood as a test whether the old allocation of regulatory powers is still optimal. In a first step, the application of the principle requires an investigation of the equivalence of the foreign regulation with the domestic one. If both rules are equivalent, there are no serious negative effects for the importing country, and therefore the old allocation of regulatory powers (combined with the country of destination principle) cannot be defended. If the regulations are not equivalent, because a state pursues different regulatory objectives, then the appropriate reallocation of regulatory powers depends on the solution of the trade-off problems between the advantages of removing trade barriers through the recognition of the foreign regulation and the negative effects of restricting the regulatory autonomy of the importing state. The four requirements formulated by the ECJ to put aside the principle of free movement because of 'mandatory requirements of general interest' can be seen as guidelines to solve the emerging trade-off problems. In particular, the conditions of 'necessity' and 'proportionality' of the national regulations for achieving the specific regulatory objectives of the importing state can be

interpreted from the perspective of reallocation of regulatory powers, because they represent an optimisation in regard to these trade-offs.

A proper reallocation of regulatory powers cannot be achieved only by judicial mutual recognition. It can neither lead to (sometimes necessary) centralisation (full harmonisation) or minimum harmonisation (Weiler 2005, p. 50), nor can it consider sufficiently the advantages and problems of regulatory competition. Therefore, the transition from the country of destination principle to mutual recognition cannot be the proper general solution. It is thus not surprising that in the EU, together with the adoption of the principle of mutual recognition, also the direct approach of changing regulatory powers through harmonisation was strengthened. Approximation of laws has been made possible with a qualified majority rule (Art. 94–95 EC as changed by the Maastricht Treaty). Also the regulatory variant of mutual recognition can be seen as a direct response to the problem that judicial mutual recognition is not well suited for preventing the erection of new barriers to mobility through new national regulations, because it can only be used ex post.

The main effect of the introduction of the principle of mutual recognition was that it broke up the stalemate situation that on the political level the EU Member States were not able to agree otherwise on a reallocation of regulatory powers for removing obstacles to the fundamental freedoms. The *Cassis de Dijon* judgement is a clear example of judicial rule-making, which shows that judges become active as policy makers if regular legislative processes are paralysed. The introduction of mutual recognition may be seen as an instrument of last resort for enforcing the fundamental freedoms after other approaches had failed. In this way, the ECJ urged the European Commission and the EU Member States either to accept its decision on the reallocation of regulatory powers or to come forward with own proposals how the regulatory powers should be changed. After the *Cassis de Dijon* judgement, several processes of reallocating regulatory powers within the EU got started. In a number of areas, directives were adopted favouring the solutions of partial or full harmonisation. For example, the directive on product liability[18] has opted in favour of partial harmonisation, whereas the more recent directive on unfair business-to-consumer commercial practices[19] has chosen to pursue full harmonisation. As a consequence of the restriction of the scope of Article 28 EC in the *Keck* decision[20], the country of destination principle now applies again with respect to regulations governing sales practices that do not come within the scope of harmonisation directives. Conversely, in the area of general contract law, free choice of law is currently favoured by the development of a common frame of reference (Röttinger 2006) and offering European law as an additional choice.

18. Directive 85/374 of 25 July 1985, OJ 07.08.85, L 210/29.
19. Directive 2005/29 of 11 May 2005, OJ 11.6.2005, L 149/22.
20. Cases C-267 & 268/91, *Keck and Mithouard* [1993] ECR I-6126.

These examples show that mutual recognition is not a stable rule for the vertical allocation of powers within the EU; it merely initiates dynamic processes to either: i) harmonisation, ii) back to the country of destination principle, or iii) free choice of law.

An entirely different question is whether these dynamic processes of reallocating regulatory powers through the principle of mutual recognition during an integration process ultimately lead to an appropriate allocation of regulatory powers. The answer to this question requires a detailed and sophisticated analysis. Hence, the problem whether particular rules of consumer law or environmental law should be decided at the Member State level, rather than by the EU, and what would be the most appropriate conflict of law rule in cases of extraterritorial application of these rules cannot be discussed within the confines of this article. Here, it suffices to recall that it is often argued that the European integration process has led to too much centralisation and harmonisation of legal rules. A number of political economy explanations have been offered for the strong centralist tendencies (e.g., Bernholz et al. 2004, and Feld 2007 with many references).

We suggest that the misunderstandings about the effects of mutual recognition might have contributed to the tendency of too much harmonisation. Up until now, the principle of mutual recognition is viewed only as a suitable device for removing barriers to trade and free movement without sufficiently taking into account its long-term effects of de facto harmonisation and centralisation of regulatory powers. The main reason for this one-sided view is that the effects of mutual recognition are analysed only from the perspective of trade theory and not from the perspective of federalism theory. The latter approach would allow also for the consideration of the positive welfare effects of decentralised regulatory powers. Therefore, the trade offs between the advantages of harmonisation/centralisation and decentralised regulatory powers tend to be not taken into account properly. The experiences in the EU demonstrate that mutual recognition is less an alternative to harmonisation (as most of the literature contends) but more an alternative pathway how to achieve (de facto) harmonisation, if directly agreeing on harmonised rules turns out to be too difficult.

V. CONCLUSIONS

In the literature on economic integration, the principle of mutual recognition is universally acclaimed as a creative device for eliminating barriers to trade. In the Law and Economics literature, proponents of regulatory competition support mutual recognition as a tool enabling such competition. It is generally agreed that mutual recognition is capable of removing barriers to mobility without leading to harmonisation and centralisation.

This paper takes a more critical approach by analysing the rule of mutual recognition as a conflict of law rule within a two-level system of regulations. This analysis demonstrates a number of problems, misunderstandings and severe inconsistencies. Mutual recognition does not help to preserve decentralised regulatory powers, because the states lose the regulatory autonomy over their domestic markets and retain regulatory power only over domestic firms. In this way, existing regulations for domestic markets are transformed into hardly defensible regulations for domestic producers. Complaints about 'reverse discrimination' may lead to problematic industrial policy efforts for improving the international competitiveness of domestic firms. If the conditional rule of mutual recognition ('equivalent objectives and effects') is used, almost no scope is left for a meaningful form of regulatory competition in the EU. In the case of an unconditional rule of mutual recognition, another problem may emerge. If there is a serious risk of a race to the bottom, mutual recognition tends to be an inferior rule, compared to (minimum) harmonisation or the country of destination principle. In the opposite case, a free choice of law rule, which creates a free market for regulations and the highest possible degree of regulatory competition, will be superior to mutual recognition. Consequently, the rule of mutual recognition does not seem to be a stable conflict of law rule in a two-level system of regulations. Its inconsistencies and problems suggest that it will initiate a process leading to (de facto) harmonisation, back to the country of destination principle, or to a free choice of law rule.

In the literature on mutual recognition, trade policy arguments have been dominant and the impact of mutual recognition on the vertical allocation of regulatory powers within the EU has been largely neglected. This has caused much confusion and wrong analogies. Mutual recognition is a conflict of law rule, which has complex effects on the degree of (de)centralisation in two-level jurisdictions and the ensuing type of regulatory competition. The positive welfare effects of mutual recognition through the removal of barriers to trade can be outweighed by the negative welfare effects through other consequences of its application (such as the impossibility to satisfy diverging preferences in different areas of law). In sum, an in-depth analysis focussing on the total welfare effects is necessary to fully assess the long-term consequences of the principle of mutual recognition.

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SUMMARY

The principle of mutual recognition is almost universally acclaimed for removing barriers to trade, for enabling regulatory competition, and for preserving scope for regulatory autonomy instead of embarking on a path to harmonisation and centralisation. By using economic theories of legal federalism and regulatory competition, this paper shows that mutual recognition leads to a number of inconsistencies, which question its suitability as a conflict of law rule that guarantees a stable allocation of regulatory powers within a two-level system of regulations. Mutual recognition should be understood more as a dynamic principle, which triggers a reallocation of regulatory powers between different jurisdictional levels. It leads either back to the country of destination principle, to a free market for regulations, or to harmonisation. The European experience suggests that a regime of mutual recognition is primarily another path to convergence and harmonisation, instead of being an instrument that preserves decentralised regulatory powers or even regulatory competition. The welfare gains from achieving market integration should be balanced against the welfare losses of an inefficient allocation of regulatory powers.

