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## BREAKING WITH TRADITION:

### SERVICE TRADE LIBERALIZATION IN THE EU AND GERMANY

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#### *Abstract*

This chapter asks why and how services that were not previously thought of as tradable have increasingly been opened up to international competition in EU member states including even in Germany. The chapter contrasts an explanation that focuses on the impact of economic interests with an explanation that focuses on the impact of EU membership. The chapter argues that lobbying by producers or users of services cannot fully explain reform nor does EU membership simply constrain reluctant member state governments to adopt new legislation. Instead the chapter argues that in important service sectors the German government has promoted trade reform even sometimes in the face of strong opposition from providers, consumers, and unions. The chapter maintains that a crucial key to liberalisation is the emergence of a break in government opposition. In particular, the ability of the government to re-interpret services as regular tradable products combined with new regulation to "shelter" exposed groups such as consumers and workers against potential harm. Implications of this claim for future service sector liberalisation are subsequently discussed.

*Trade liberalisation can be likened to the draining of a swamp: as the water level (average tariff level) fell due to successful pumping efforts, rocks, stumps and all manner of other obstacles (non-tariff) barriers emerged (Robert E. Baldwin 1970).*

## INTRODUCTION

Traditionally domestic service sector regulations have been exempted from international oversight. At least five reasons explain why services have not been part of international trade regimes: 1) most traditional services had to be produced in the country where they were consumed; 2) many service sectors are large-scale employers and hence employees have substantial political clout; 3) service trade often requires establishment in the “importing” country which is costly; 4) barriers to service trade are frequently part of domestic institutions which are difficult to change; and, 5) many services have provided an employment shield against economic fluctuations.

What has now changed is that many services --telecoms for example-- are increasingly perceived as exportable. Subsequently services are becoming important for international trade negotiations. Although services make up less than 25 percent of the volume of international trade, their growth rate is already twice that of trade in manufactured goods (Paemen and Bensch 1995). Services have changed in at least five ways. First, for example a German businessman who wishes to send mail for advertising purposes within Germany now has more options than using the incumbent provider. Private postal operators pick up the mail in Germany and drive it to Holland in order to take advantage of the cheaper Dutch postal rates. The mail is then returned to Germany and distributed there by the incumbent postal administration. Thus, postal services no longer have to be produced in Germany even though they are consumed there.

Secondly, although many service sectors remain large employers their political clout has been reduced. In telecoms for example services have become increasingly diversified branching into multi-media services, mobile services, internet services, etc. Subsequently, the political interests of employees in telecoms have also diversified. In Deutsche Telekom many employees still see the traditional union Deutsche Postgewerkschaft (DPG) as representing their interests. In contrast employees in new multimedia and internet firms frequently see themselves as having more in common with media people or designers and hence prefer to join other unions such as IG Medien. Furthermore, many employees in these new services are not interested in union membership because they see unions as having an inflexible view of working time, salary, job protection, etc.

Thirdly, with the adoption of the principle of the single license and home country rule, establishment abroad has become easier and less costly. For example in insurance services, the principle of a single license has been adopted throughout the EU in both business and mass insurance services. This means that non-German insurers who have already obtained a license to sell insurance in another EU member state are also allowed to sell insurance in Germany<sup>1</sup>. Fourthly, although many service sectors such as telecommunications traditionally have been part of an intricate domestic institutional set-up, these institutional structures have now been changed. For example provisioning of telecoms services has changed completely. Today foreign telecoms providers --German as well as non-German-- are allowed to offer services in Germany. Finally, the German telecoms monopoly was previously used as an employment shield against economic fluctuations. For example during economic recessions, investment in telecoms

infrastructure was typically increased and directed to German regions which were particularly hard hit (Noam 1992). Today in contrast Deutsche Telekom is a private enterprise and operates on regular market terms and therefore is neither required to nor interested in safeguarding employment as a social goal.

This chapter asks why and how EU countries have increasingly come to support an opening of their borders to international service sector competition. Germany's support is especially surprising because Germany has traditionally been a "service desert" (Dienstleistungswueste) where high quality services were as rare as water in the desert. Services constitute a lower share of employment in Germany compared to most EU countries and in particular the UK. For example in the 1985-89 period service employment was 29 percent in Germany and 41 percent in the UK (Iversen and Wren 1998, table 2). ~~Need new figures.~~ Furthermore, Germany's trade balance in services has been consistently negative. For example from 1976 to 1994 every single year Germany's trade balance in services was negative while during the same period the UK consistently enjoyed a positive trade balance (International Monetary Fund 1995: 388-389 and 774-775. The IMF refers to values of international service transactions). Today, however, Germany welcomes competition in previously closed sectors such as telecoms, insurance and to some extent the post.

It could perhaps be argued that since Germany is lagging in service sector employment then Germany should be particularly interested in regulatory reform. A reduction in regulations could possibly spur service sector growth and hence employment. However, the sectors considered here which include telecoms, postal and insurance services contain major institutional barriers to reform. For example

privatisation of telecommunications and postal services required a two-third majority in the Bundestag and the Bundesrat according to the German Basic Law. In insurance services prices and conditions were strictly determined by a regulatory authority.

Germany's institutional structure to some extent has been a barrier to reform. For example privatisation of telecommunications and postal services required a two-third majority in the Bundestag and the Bundesrat according to the German Basic Law. In insurance services prices and conditions were strictly determined by a regulatory authority.

The chapter is divided into three parts. Part I presents two theoretical perspectives on service trade liberalisation: an interest-based perspective and an EU-based perspective. In order to explain the policy change from protectionism to international competition in services, the chapter traces the process of enacting reform. Part II presents evidence from the German telecommunications, insurance and postal sectors. Finally, part III asks what are the implications of the German service sector experience for future service sector reform in Germany and the EU.

## I THEORETICAL PERSPECTIVES ON SERVICE TRADE LIBERALIZATION

In order to explain trade liberalisation in Germany the chapter starts out by contrasting an interest-based perspective with a perspective on the impact of EU membership. The purpose is not to prove one theory entirely correct or entirely dismiss it but to assess the relative importance of economic interests and EU membership.

### 1.1 Interest-based explanations

Interest-based explanations stress primarily the political pressure through legislatures from domestic social groups such as producer and labour groups (Alt and Gilligan 1994; Olson 1965; McKeown 1984). These explanations mainly view economic policies as a response to coalitions which represent distinctive economic sectors and which form and reform in response to changes in the international economy that shift the underlying interests of their members (Hall 1999). These works can be roughly divided into two categories<sup>2</sup> which emphasise different explanatory factors but which are mutually compatible: a sector-based explanation and a firm-based explanation (Frieden and Rogowski 1996). Frieden argues that changes in international financial regimes also affect the interests of key economic sectors (Frieden 1988 and 1991). Milner in turn explores how growing economic internationalisation changes the trade interests of firms from support for protection to support for liberalisation (Milner 1988a and 1988b).

Frieden for example uses the specific-factors model to assess the distributional effects of increased capital mobility and to determine the impact of these distributional effects on lobbying for policy (Frieden 1991). In contrast to the Stolper-Samuelson perspective, the specific factors model assumes that factors of production are specific to a particular industry. If that industry declines, factors of production cannot move into new industries –at least not for a very long time. Such factors as geographical location, human resources and skills, etc. are important characteristics that determine the ease with which factors of production can be re-deployed. The effects of trade liberalisation depend on the specificity of the relevant actors' characteristics and their degree of international competitiveness (Frieden and Rogowski 1996). If a sector is internationally

competitive, producers and labour will favour free trade while they prefer protection if it is not competitive. The interests of export and import sectors are therefore diametrically opposed. Rather than creating battle lines between capital and labour, trade liberalisation leads to greater conflict between industries uniting workers and producers alike behind sectional demands. In short, the key focus of the specific factors model is on specifying the economic preferences of societal actors, in particular the preferences of economic sectors.

Milner focuses specifically on the interests of firms. She finds that growing economic internationalisation measured as export dependence and multi-nationality fosters *anti*-protectionist interests, even in sectors facing economic pressures due to growing import penetration (Milner 1988a and 1988b). In other words, within a sector that enjoys protection, firms with links to the international economy are less protectionist than domestically oriented firms, even when faced with severe economic distress. The former will view protection as undesirable since it will be more costly for them than the latter (Milner 1988a). Milner argues that owners of sector-specific assets have incentives to lobby for liberalisation if faced with export opportunities. For example if a sector consists of many firms which are already engaged in international transactions and/or is characterised by economies of scale which may be an advantage in certain sectors for penetrating international markets, then that sector will lobby for liberalisation. In short, according to Milner, increasing economic interdependence strengthens the political influence of trade liberalising firms vis-à-vis protectionist groups. In sum, according to an interest-based explanation, trade liberalisation is more likely to take place when groups in favour of free trade become politically stronger than protectionist groups.

In order to evaluate the explanatory power of an interest-based argument, more specific hypotheses concerning trade preferences are presented below for the telecoms, insurance and postal services sectors derived from sectoral studies, reports, etc<sup>3</sup>. Services are divided into value-added services, which are of main interest to businesses, and basic services, which are of particular interest to consumers. This division is helpful because whole sectors are typically not liberalised at once.

An outline of the expected preferences of service providers and users for open or closed trade in the business segments and in the basic (or private) service segments of the telecommunications, insurance and postal sectors is given in table 1 below.



Table 1  
 PREDICTIONS: initial demands for reform (+ for reform; - against reform)

Explanations	General prediction	Specific predictions (business services)	Specific predictions (basic services)
<u>Expected interests of service sectors</u>	<p><b>Sector-based approach:</b>            Internationally competitive sectors favour liberalisation and non-competitive sectors oppose liberalisation, uniting workers and managers alike behind sectoral demands</p> <p><b>Firm-based approach:</b>            Support for liberalisation increases with firm size and international experience measured as export dependence and multi-nationality of production</p>		
Telecoms services		The telecoms operator is not export dependent and does not engage in multi-national production and hence initially favours protection. Workers oppose liberalisation because they do not know ex ante if the sector will be competitive. (-)	The telecoms operator is likely to oppose liberalisation for the same reasons cited under business to business telecoms services. (-)
Telecoms equipment		Producers oppose reform if they are not internationally competitive. (-)	Producers oppose reform if they are not internationally competitive. (-).
Insurance		Large insurance firms have international experience and economic capability to move abroad and favour liberalisation. Employees in these firms favour liberalisation because the firms are competitive. Domestically oriented firms are opposed due to a lack of economic means to expand abroad. (+/-)	Domestically oriented firms mainly service private customers. They do not have the international experience or clout to expand abroad and are likely to oppose liberalisation. (-)
Postal services		Express and parcel services favour reform. Workers in express and parcel services are expected to favour liberalisation because they are competitive. (+)	The postal operator opposes reform because of benefits of domestic market. Workers oppose liberalisation because they do not know if the post will be competitive. (-)
<u>Expected interests of users of service sectors</u>	Those who consume services that are internationally traded favour liberalisation (shadow price argument).		
Telecoms services		Telecoms users favour liberalisation in order to obtain cheaper and more efficient services. (+)	Consumers oppose reform because local and national services are subsidised. Consumers: uniform service at affordable price. (+/-)
Telecoms equipment		Business users favour liberalisation as a way to reduce production costs. (+)	Consumers expect lower prices. They may also fear reduced protection. (+/-)
Insurance		Insurance users (business users) favour liberalisation as a way to reduce production costs. (+)	Consumers could be opposed as they might fear less customer protection (but they favour cheaper services). (+/-)
Postal services		Most business users favour reform because they expect reform to improve services. (+)	Consumers favour reform to improve services. But reform could end subsidisation and result in higher prices. (+/-)

## 1.2 Strengths and Weaknesses of Interest-Based Theories

The strength of interest-based theories is their ability to specify how policies change. For example these theories can well account for how changes in the constellation of preferences will be reflected in changes in public processes. Certainly interest-based theories also recognise the importance of political processes for the adoption of economic policies. For example Frieden and Rogowski point out that although exogenous easing of trade improves a country's aggregate economic performance, "it is a commonplace of political economy that what is good for national welfare may bear little relation to the policies actually adopted" (Frieden and Rogowski 1996: 36). Furthermore, according to Frieden and Rogowski, "whether expected economic pressures lead to actual changes in policy is a function of complicated coalitional and institutional conditions" (Frieden and Rogowski 1996: 42).

However, Frieden and Rogowski only propose a very general model of politics. They argue that under an exogenous easing of trade a country will be more likely to liberalise under three conditions: 1) the longer the average life of a cabinet in a given country; 2) the more stable is a cabinet's majority or more fixed its terms of office; 3) the more influential are agencies relatively independent from direct political pressures in the making of international economic policy. Certainly this model can explain for example why service sector liberalisation in the UK took place much faster than in Germany (the UK has a more stable majority and agencies are more independent from political pressure).

Yet, such a sketchy model is not helpful for explaining service sector reform in Germany. For example the case studies presented below illustrate that liberalisation has

taken place even in services where both users and providers were opposed to reform. One example is liberalisation of trade in personal insurance services. Furthermore, although many new providers of value added telecoms services supported liberalisation of basic telecoms because they wished to expand their business opportunities, mass consumers, the union, and to some extent Deutsche Telekom opposed liberalisation. Furthermore, the SPD also opposed reform. Social democratic opposition was important since privatisation of Deutsche Telekom –which was a precursor to full liberalisation— required a change of the German Basic Law (Grundgesetz). Such a change could only take place if the SPD decided to support privatisation because a change of the Basic Law requires a two-thirds majority in the Bundestag.

Given this substantial opposition to service sector reform, liberalisation was not a given outcome. In order to explain liberalisation it is therefore necessary to explain how opposition to reform was overcome. A more fine-grained analysis of the impact of public institutions and political processes on policy outcomes is required. Furthermore, legislation to liberalise services trade is not just adopted in member states such as Germany but in the EU as well (and lately also within the context of the WTO). The relative impact of EU and domestic political factors therefore first needs to be clarified.

### 1.3 The Impact of EU Membership

This section examines the impact of EU membership on German service sector liberalisation. Germany's liberalisation of telecommunications services, insurance services and postal services might be a result of skilful political entrepreneurship by the EU Commission. It might be the Commission that promotes reform of insurance services

as guardian of the Treaty of Rome or does the Commission use its powers to break up monopolies in order to open up telecoms and postal services to competition even in the face of domestic opposition? Furthermore, is liberalisation a result of rulings made by the ECJ seeking to transform the Treaty of Rome into a kind of constitution for the European Union and in so doing pushing open borders in services?

Questions such as these are addressed by the debate between state-centric (liberal intergovernmentalism) theorists and theorists who focus on other political actors than the state such as EU institutions or even regional actors including neo-functionalists and multi-level governance theorists (Moravcsik 1994; Moravcsik 1999; Hoffmann 1966; Milward 1992) and the multi-level governance approaches (Sandholtz 1993; Marks Hooghe and Blank 1996; Sbragia 1992; Pierson 1996. An overview of this line of reasoning is provided in Caporaso and Keeler, 1993). This broad debate is briefly presented and predictions are derived concerning how to detect and measure an EU effect as distinct from the effect of changing government preferences on liberalisation of service trade. Was service trade reform in Germany mainly a result of EU pressure or did the German government's position on service trade reform change prior to EU reforms? Secondly, to what extent did reforms at the EU level interact with policy reforms in Germany?

The point is only to show that although EU membership certainly is important for domestic policymaking, its impact should not be overstated. Tracing the process of reform shows that domestic policy processes played a key role in shaping reform of services in Germany and these processes need to be understood in order to explain why and how services were opened to international competition.

### The state-centric perspective

Moravcsik proposes that European integration can best be explained with a “liberal intergovernmentalist” framework. At the core of liberal intergovernmentalism are an assumption of rational state behaviour, a liberal theory of national preference formation, and an intergovernmentalist analysis of inter-state negotiation. Moravcsik’s central claim is that “the broad lines of European integration since 1955 reflect three broad factors: patterns of commercial advantage, the relative bargaining power of important governments, and the incentives to enhance the credibility of interstate commitments” (Moravcsik 1998, p 3). First, following liberal theories of international relations which focus on state-society relations, the foreign policy goals of domestic governments are seen as varying in response to shifting pressures from domestic social groups whose preferences are aggregated through political institutions. National preferences for integration emerge from a process of domestic political conflict in which sectoral interests, adjustment costs, and sometimes geopolitical concerns played an important role.

Secondly, once governments have defined a set of interests (governments shape the demand function for international cooperation) they then bargain among themselves in order to realise those interests (governments shape the supply function for international cooperation). Intergovernmentalist theory seeks to analyse the EU as a result of strategies pursued by rational governments acting on the basis of their preferences and power. Moravcsik argues that key member state governments such as Germany, the UK

and France broadly determine policy outcomes at the EU level. In short, bargaining outcomes are said to reflect the relative power of member states.

Finally, Moravcsik argues that member states have enhanced the credibility of interstate commitments by delegating and pooling sovereignty in international institutions for the purpose of committing one another to cooperate. Concerning the political impact of EU institutions, Moravcsik argues specifically that supranational influence is only possible when two conditions are met: national governments face high ex-ante transaction costs and significant informational (or ideational) asymmetries favour supranational entrepreneurs (Moravcsik 1999). In sum, the following hypothesis follows from the state-centric perspective:

Hypothesis: Decisions to liberalise services in the EU reflect the relative bargaining power of important governments in pursuit of commercial interests. It is unlikely that services would be liberalised against the wishes of the German government unless the German government is able to secure other desirable bargaining outcomes in return.

#### The multi-level governance perspective

According to the multi-level governance perspective, the state no longer monopolises European level policy-making. According to Marks, Hooghe and Blank for example, decision-making is shared by actors at different levels rather than monopolised by state executives. In addition, collective decision-making involves a significant loss of control for individual state executives. Finally, political arenas are inter-connected rather than nested. This means that subnational actors operate in both national and supranational

arenas creating transnational associations in the process (Marks, Hooghe and Blank 1996).

Stone Sweet and Sandholtz attempt to move beyond the multi-level governance perspective which takes a certain amount of supranational governance for granted and seek to explain how EU institutions develop<sup>4</sup>. According to Stone Sweet and Sandholtz the assumption is that EU rules are adopted by EU institutions in response to the demands of transnational society and this implies that member states do not drive the process nor do they fully control it. Stone Sweet and Sandholtz propose that governments are reactive, constantly adjusting to the integration that is going on all around them.

The argument is that as transnational activity rises so do the costs for governments of maintaining disparate national rules. In short, transnational activity such as trade, investment and the development of Euro-groups, networks and associations has been the catalyst of European integration. Transnational exchange pressures EU organisations to construct new policies which favour those individuals, groups and firms who transact across borders. Generally, EU organisations such as the Commission and the ECJ respond to this pressure by working to extend the domain of EU rules in order to achieve collective (transnational) gains and to accomplish the purposes of the Treaties, broadly interpreted. In sum, the following hypothesis follows from the multi-level governance perspective:

Hypothesis: EU institutions play a key role in defining the nature and scope of EU governance. If EU level actors and rules shape EU legislation and subsequently

legislation in EU member states, then legislation should reflect pressure from the European Commission and the ECJ.

Part II of this chapter examines the explanatory power of an interest-based explanation as well as an EU-based explanation concerning the decisions in Germany to liberalise telecommunication and insurance services as well as part of the postal sector. The chapter concludes that liberalisation has sometimes taken place even in services where producers and users opposed reform. Furthermore, EU membership does not necessarily result in liberalisation in the face of strong domestic political opposition. Instead a key factor driving reform was a shift in the German government's perception of services from products in need of special protection from international competition to products that could be treated as regular tradable goods.

## PART II EVIDENCE

### 2.1 Telecommunications

In 1986 referring to telecommunications, Morgan and Webber claimed that “with the exception of defence and agriculture, no other sector has been so politicised and so protected” (Morgan and Webber 1986: 56). According to Morgan and Webber, the telecommunications regime in Germany (the legal and institutional framework within which telecommunications policy is formulated and implemented) was “an island of stability” (Morgan and Webber 1986).

However, since 1986 Germany's telecommunications sector has undergone a major transformation (Schmidt 1991; Werle 1998). In 1988 terminal equipment was



liberalised and in 1990 value-added services were opened up to international competition. In particular, the 1996 Telecommunications Act created the framework for today's open borders introducing competition in all telecommunications services including basic services and removing the public monopoly of the cable-based telecommunications network (see tables 2 and 3 below for an overview of telecoms reform in Germany and the EU).

Table 2  
Regulatory changes in the German telecommunications sector

German reforms	Regulatory changes
1989 Postal Reform (I)	<ol style="list-style-type: none"> <li>1) Liberalisation of terminal equipment and value added services in line with the recommendations of the European Commission's 1987 Green Paper</li> <li>2) Separation of the regulatory body (the Ministry for Post and Telecommunications) from the operator (the Deutsche Bundespost)</li> <li>3) Division of the Deutsche Bundespost into three regulatory bodies for postal services (Deutsche Post), telecommunications (Deutsche Telekom), and banking (Deutsche Post Bank)</li> </ol>
1994 Postal Reform (II)	<ol style="list-style-type: none"> <li>1) Privatisation of Deutsche Telekom (establishment of a joint-stock company, Deutsche Telekom AG)<sup>5</sup></li> </ol>
1996 Postal Reform (III)	<ol style="list-style-type: none"> <li>1) Removal of the public monopoly of the cable-based telecommunications network and the telephone service effective on January 1, 1998</li> <li>2) Creation of a new independent telecommunications regulator, the National Regulatory Authority (Regulierungsbehoerde)</li> </ol>

Table 3  
Regulatory changes in EU telecommunications services

Directive	Regulatory changes
Commission Directive on telecommunications terminal equipment (88/301/EEC)	Elimination of all special or exclusive rights for importing, marketing or maintaining terminal equipment
Commission Directive on telecommunications services except voice telephony (90/388/EEC)	Free competition in all telecommunications services except voice telephony
ONP Council Directive (90/387/EEC)	Council of Ministers must adopt directives establishing open network provision conditions
1993 Council Resolution following a review of the situation in the telecommunications sector in the EU.	Free competition in all telecommunications services Removal of the public monopoly of the cable-based telecommunications network

#### An interest-based explanation

In the 1980s opposition to telecoms reform was strong in Germany from producers of telecoms equipment and the monopoly service provider as well as from some users<sup>6</sup>. Producers of computer equipment favoured reform but they were not well organised within the industry associations such as the BDI (Bundesverband der Deutschen Industrie, the Association of German Industry) and the DITH (Deutsche Industrie und Handelstag, the German Chamber of Industry and Commerce) (Morgan and Webber 1986; Grande 1989). Hence computer equipment producers did not constitute a strong voice in favour of reform. Telecoms equipment producers opposed reform because they

had traditionally enjoyed a close supplier relationship with the incumbent operator guaranteeing demand and high prices. Furthermore, telecoms equipment producers were also members of the BDI and the DITH and telecoms equipment producers opposed reform. Given the divergence of interests of computer equipment producers and telecoms equipment producers concerning trade liberalisation, the BDI and the DITH could not organise strong support for reform.

In addition to opposition from telecoms equipment producers, users of postal services including newspaper deliveries, publishing houses and mail order firms also opposed reform. The reason was that these firms traditionally benefited from cross-subsidisation of letter services by telephony (Morgan and Webber 1986; Grande 1989). The financial sector was interested in faster data transfer and favoured reform but the opposition from newspaper deliveries, publishing houses, etc. muted their support.

Furthermore, the union for post and telecommunications workers (Deutsche Postgewerkschaft, the DPG) took upon itself the job of representing consumer interests and collected more than 1.4 million signatures against the first postal reform. The union feared that a separation of the postal and telecommunications branches of the Post Office would lead to a massive rationalisation of the loss-making postal division and result in a decline in employment and working conditions (Morgan and Webber 1986).

The incumbent telecoms operator also opposed liberalisation of value-added services. It argued that liberalisation of value-added services could be the first step towards an end to universal service provisioning at affordable cost (Vogel 1996). The incumbent operator enjoyed monopoly rents and did not want to give up this special status. Furthermore, in 1989 firms such as Mannesmann which later successfully

diversified into telecommunications did not lobby for reform (interview, Mr. Durwen, Director of Business Development, Mannesmann Mobilfunk GmbH, February 24, 1998; interview, Mr. Arne Boernsen, Vice President of the Regulatory Authority, April 6, 1998; Vogel, 1996).

In sum, the big industrial associations in Germany such as the BDI and the DITH did not promote reform because interests diverged in the telecommunications and computer equipment industries. Furthermore, interests diverged between the winners (i.e. banks) and losers (i.e., mail order houses and newspapers) from the traditional cross-subsidisation of letter services by telephony. Consumers and the incumbent telecoms provider also opposed reform. In the very least opposition to reform was so significant that pressure from users and providers in favour of liberalisation was not strong enough to bring about reform in Germany.

### The impact of EU membership

The European Commission released directives to open up the terminal equipment market (in 1988) and the value-added services market (in 1990) based on Article 90(3) <sup>7</sup> of the Treaty of Rome. This article allows the Commission to issue directives without the cooperation of other bodies such as the Council of Ministers or the European Parliament. Specifically, the Commission can establish competition in monopolies that are found not to be operating in the public interest. The Commission's recourse led to complaints from member states. France with support from Italy, Germany and Greece turned to the ECJ regarding the 1988 terminal equipment directive. The complaint concerned the procedure. France argued that because the Commission issued its own directive and not a

directive approved by the Council of Ministers, then the Commission established a regulatory power, which went beyond its normal supervisory competencies. The member states saw the use of Article 90(3) (Article 86(3)) as a “legal trick” aimed at undermining the Council’s position in defining telecommunications policy (Schmidt 1996). However, the decision of the ECJ issued in March 1991 upheld the Commission’s right to liberalise equipment based on Article 90(3) (Article 86(3)) vis-à-vis the member states.

Concerning value-added services, the Commission struck a compromise with the Council of Ministers and issued its services directive (Commission Directive 90/388/EEC) with a Council directive on open network provision (Council Directive 90/387/EEC). This way a compromise was reached between the Council and the Commission. Spain challenged the 1990 service directive before the ECJ but the ECJ upheld it in 1992.

However, as Susanne Schmidt has shown focusing on telecoms and electricity reform in the EU, the Commission has held back from pursuing reform of the electricity sector by issuing directives based on Article 90(3) (Article 86(3)). Similarly, the Commission has not issued directives to open up the postal sector based on Article 90(3) (Article 86(3)) either. In fact, the Commission has only issued a directive based on Article 90(3) (Article 86(3)) this one time. Susanne Schmidt concludes that domestic political sensitivity –which was higher in electricity and postal services than in telecoms services-- is a key constraint on the Commission’s ability to pursue reform (Schmidt 1998).

In sum, the political influence of the European Commission is constrained by domestic politics. Is this also the case with the impact of the ECJ on reform? Next, this

chapter considers the impact of the ECJ on telecoms reform. The founding treaties of the European Union do not contain an explicit mandate for undertaking common policies in telecommunications. However, the Commission used a 1985 decision by the ECJ –“the British Telecom case” as an indication that the competition rules of the Treaty apply to telecommunication administrations.

In 1978 the British Post Office prohibited telex agencies from providing international services for their customers when messages were in data form (from computer to computer) and were received through the telephone lines and then converted to telex, fax or other visual form (Noam 1992). In 1979 this requirement led one of the telex agencies to lodge a complaint with the European Commission.

In December 1982 the European Commission concluded that British Telecom’s rules were in violation of Article 86 (Article 82) of the Treaty of Rome (*Official Journal*, L360, 1982, p 36). The Commission announced that restraints upon telecommunications services were in violation of the European anti-trust provisions. The British government was by then firmly embarked on a course of liberalisation and British Telecoms did not appeal the decision. However, the Italian government subsequently challenged the European Commission decision before the European Court of Justice. Italy argued that the Community’s competition rules did not apply to monopoly telecommunications services authorities and that regulatory activities of public companies should not be considered as an activity of an undertaking within the meaning of Article 86<sup>8</sup>. The European Court of Justice announced its decision in March 1985, in which it rejected Italy’s claims and confirmed that the European Community competition rules applied also to telecommunications.

As Fritz Scharpf has argued, ECJ decisions are also politically constrained (Scharpf 1997). In general, the ECJ refrains from adopting rulings that would be very unpopular politically. Certainly the ruling was unpopular in Italy. However, the UK accepted the ruling because it had already begun to liberalise its telecoms sector under the Thatcher government. Furthermore, the CDU/CSU-FDP government, which came to power in Germany in 1982, had also begun to contemplate the possibility of telecoms reform. The ECJ decision that competition rules apply to the telecoms sector was welcomed by key political actors in favour of reform in Germany including the government and the Economics Ministry (Baggehufvudt 1993).

In short, liberalisation did not mainly reflect user or producer pressure. Secondly, reform in Germany was not due primarily to political pressure from the EU forcing reform down the throat of a reluctant Germany. In order for major reforms to be adopted in Brussels domestic governments must support reform.

A break in government opposition to reform

*Liberalisation of terminal equipment and value-added services.*

According to Grande, the first really serious criticism of the Post Office surfaced in 1978. Large data communications companies such as Nixdorf began to launch complaints that the development and use of new forms of telecommunications did not follow pressure from market forces but instead the organisational and technical plans of the Post Office. This was problematic because it slowed down the development of efficient and up-to-date telecoms services in Germany (Grande 1989). The Economics Ministry agreed and proposed that the Ministry for Post and Telecommunications should no longer be allowed to sell private telecoms equipment.

Furthermore, in 1979 the Monopoly Commission<sup>9</sup> launched a special investigation concerning the role of the Post Office in telecoms services titled *Die Rolle der Deutschen Bundespost in Fernmeldewesen* (The role of the German Post Office in telecommunications). The report was published in 1981 and advocated full liberalisation of services although the Monopoly Commission accepted that the network should remain a monopoly “for the time being”. The Monopoly Commission also proposed that with the exception of simple telephones, the equipment market should be opened up to competition and the Post Office should be excluded from the market.

Traditionally, the CDU/CSU had been cautious of liberalisation measures that might result in further unemployment in the Post Office and the equipment manufacturing industry. Furthermore, the CDU/CSU feared that a more cost-oriented structure of changes could lead to increased rates for local calls whose price covered only about 50% of the costs, and price increases would be unpopular with voters. Party strongholds also



included the countryside and sparsely populated regions in Germany, and the CDU/CSU therefore worried that liberalisation could end to the principle of uniform services at affordable cost, possibly resulting in higher charges and a deterioration of services in rural areas. Finally, the CDU/CSU is the traditional party for civil servants and the postal and telecommunications sector has traditionally been dominated by civil servants.

Reform discussions gained momentum with the coming to power in 1982 of the conservative coalition government. The government wanted to improve the framework conditions of the German economy. The fundamental assumption of the federal government was that the “social market economy as well as free and open international trade” was the only economic system suitable for guaranteeing equal opportunities, property, prosperity, and social progress for all citizens. Such a market economy could only be realised in “an environment of dynamic competition (Federal Minister of Posts and Telecommunications 1988, p 16). The government favoured telecommunications reform and appointed a dedicated supported of telecoms reform, Dr. Schwarz-Schilling of the CDU/CSU, as the minister for post and telecommunications. The belief was that deregulation was required in order to fully utilise the growth potential in information and communications technologies.

The election of March 6, 1983 was a victory for the CDU/CSU-FDP government. According to the government statement (Regierungserklaerung) from May 4, 1983, the government intended to present an extensive program to strengthen the development of microelectronics and information and communications services (Grande 1989, p 207). The key goal was to improve the framework conditions for production of German information technology.

Schwarz-Schilling set up a twelve-person government commission for telecommunications in 1985, chaired by Dr. Witte, an economics professor from Munich. The Witte Commission included representatives from the unions, the CDU, the SPD, state governments and the media as well as representatives from the sectoral policy network, which was established within the ministry for post and telecommunications. In 1988 the Witte Committee finished its report (Government Commission for Telecommunications 1988). The report's recommendations were closely in line with the recommendations in the European Commission's 1987 Green Paper on telecommunications. The European Commission and the Witte Committee in fact worked closely together (interview, Dr. Witte, March 27, 1998). The Witte Committee's recommendations were somewhat modest, suggesting only liberalisation of value added services and telecommunications equipment while arguing that a monopoly for basic services and the network should be maintained. Nonetheless, the SPD and DPG members of the Witte Committee issued separate statements denouncing the Witte report as too liberal. In sum, the Committee report was very important because the German government based its legislative draft for the 1989 reform on this report.

In short, domestic opposition to reform had begun to weaken already prior to the coming to power of the CDU/CSU-FDP government. The new government strongly supported reform following a new understanding in the government, advocated by people such as Schwarz-Schilling and Lambsdorff, that telecoms reform of value-added services and equipment did not prevent universal service provisioning.

*Liberalisation of basic telecoms services and the network.*

Only a few years after the government had promised that only value-added services would be opened up to competition while basic services and the network would remain a public monopoly, the government promoted privatisation of the incumbent telecoms operator and complete liberalisation of basic services and the network. The government's proposal was supported by Social Democrats, who had previously adamantly opposed such reforms. How was domestic opposition to reform broken?

The government came to support privatisation of Bundespost Telekom because with unification the government needed to finance costly infrastructure developments in the former East Germany. Privatisation would enable Deutsche Telekom to raise much needed capital. The government also came to support liberalisation of basic telephone services and the network. Liberalisation of value-added services had resulted in the development of a range of new services and the government expected liberalisation of basic services to result in a massive growth in new and improved services. Deutsche Telekom gradually came to support this position. The organisational separation of telecoms services from postal services had begun to result in a more market-oriented outlook. The sheer size of Deutsche Telekom in combination with its fairly high-level technical skills and services meant that Deutsche Telekom gradually came to favour an international strategy and hence to support international liberalisation.

In order to win the support of consumers, the government argued that international trade in telecoms services could be combined with sheltering of German consumers. In particular, the government argued that universal service provisioning at

affordable cost could be guaranteed by adopting domestic regulation to protect consumers (*Sueddeutsche Zeitung*, March 23, 1992)<sup>10</sup>.

Within the Social Democratic Party key members gradually began to favour additional reform of the post and telecoms sector. One such key member was Arne Boernsen<sup>11</sup>. In 1994 Arne Boernsen had been appointed by the Social Democratic Party as head of the post and telecommunications committee in the German Bundestag<sup>12</sup>. Mr. Boernsen was known as the social democratic motor of the Bundestag committee on post and telecommunications. In his capacity as spokesman, Boernsen had had many disagreements with Mr. Paterna. In Boernsen's opinion telecoms reforms in the UK and the US had been useful resulting in improved service and lower prices (interview with Mr. Boernsen April 8, 1998; interview with Mr. Cloes, secretary for the Bundestag committee on post and telecommunications, November 20, 1997).

Boernsen was known for being two steps ahead of his party on post and telecoms issues (*Frankfurter Allgemeine Zeitung*, November 28, 1999, p 18). For example in 1991 Boernsen for the first time discussed the pros and cons of privatisation with Bundespost Telekom. Boernsen inquired whether Bundespost Telekom would be able to engage in widespread and international competition without constitutional reform, which would allow privatisation in Germany. The reply from Bundespost Telekom was that it wished to expand its business operations abroad and improve the infrastructure in the former East Germany. Therefore privatisation was required in order to raise capital (interview with Mr. Arne Boernsen, April 7, 1998).

In the end the Social Democratic Party agreed to fully liberalise the telecoms sector. The Social Democrats felt "morally" justified in agreeing to liberalise telecoms

because of the adoption of early retirement plans for postal and telecoms employees, the promise not to lay-off employees, the creation of generous pension schemes, etc.

(interview, Mr. Boernsen, April 7, 1998; interview, Mr. Cloes, November 20, 1997; interview, Dr. Witte, March 27, 1998).

## 2.2 Insurance Reform

Since the 1980s Germany's regulatory framework for insurance has changed substantially<sup>13</sup>. Previously, insurance prices and conditions were extensively controlled, but today the German government favours liberalisation of insurance services and has implemented a new legal framework based on the principle of home state rule in non-life business insurance. Surprisingly, the German government has even liberalised personal insurance, which has traditionally been extensively regulated in Germany. Why has the German government agreed to open up its traditionally protected insurance sector, including even personal insurance, to competition within the EU and how has liberalisation of insurance services come about?

Government preferences concerning liberalisation of insurance trade, including insurance services, have changed substantially within the German government from opposition to support. This change in government position came about following the coming to power of the conservative coalition government in 1982, which supported a new more liberal economic policy agenda ("die Wende" or turnabout). Die Wende was Kohl's promise to take a new, more market-oriented direction concerning a range of economic and social policies (Smith et al. 1992). "Ordnungspolitik" was a component of die Wende and entailed the creation by the state of favourable conditions for economic

activity while relying on the market to act as the motive force (Padget 1992).

Competitive insurance services –especially business insurance services-- were seen as an important component of Ordnungspolitik. The government set up committees to study the potential for service liberalisation. Insurance services should no longer be exempted from the German Act Against Restraints of Competition (Gesetz gegen Wettbewerbsbeschränkungen).

Furthermore, the German government decided that international market opening could be combined with domestic sheltering of consumers in the form of new domestic regulation. This regulation included the setting aside of emergency funds in the case of insurance firm bankruptcy, the formulation of standard contracts and supervision of the financial soundness of insurance firms.

Business insurance services were liberalised in 1990 while personal insurance services were opened up to competition in 1994. Table 5 below lists regulatory changes in insurance services in Germany and the EU.

Table 5  
Regulatory changes in the EU and German insurance

Directive	Year of adoption	Year of implementation <sup>14</sup>	Regulatory changes
First Non-Life Directive (73/239/EEC) First proposed in 1966	24 July 1973	Erstes Durchfuehrungsgesetz/ EWG zum Versicherungsaufsichts gesetz (31 January, 1975)	Elimination of divergences which existed between national supervisory legislations (i.e. harmonisation of prudential control). Insurance undertakings wishing to operate outside their home countries had to obtain authorisation in both member states (under comparable legal and financial conditions and according to a uniform procedure)
Second Non-Life Directive (88/357/EEC) First proposed in 1975	22 June 1988	Zweites Durchfuehrungsgesetz/ EWG zum Versicherungsaufsichts gesetz 1 July 1990	For large risks <sup>15</sup> an internal market providing free services was created based on the principle of home state rule
Third Non-Life Directive (92/96/EEC) First proposed in 1990	18 June 1992	Drittes Durchfuehrungsgesetz/ EWG zum Versicherungsaufsichts gesetz 1 January 1994	In personal insurance the principle of a single license, home country rule, and abolition of prior control of premiums and policy conditions for <u>all</u> insurance risks and all policy-holders applies within the European Economic Area

#### An interest-based explanation

While liberalisation of business insurance can be partly accounted for by an interest-based explanation, this is not the case for liberalisation of the mass insurance market.

Concerning providers, in the 1980s the Association of German Insurers (Gesamtverband der Deutschen Versicherungswirtschaft, or GDV) argued in favour of liberalisation of

business insurance (GDV, Annual Report 1983; interview, GDV, May 20, 1998). A key reason for GDV's support was that demand for business insurance was changing. Large international manufacturing firms increasingly demanded that insurance firms provide for all their risks abroad (Boissier 1986). Also, large insurance firms expected that the implementation of the single European market would lead to an increase in the international operations of large firms and hence increase demand for large-scale insurance services.

In contrast German insurance providers strongly opposed opening up Germany's personal insurance market to foreign competition. They argued that liberalisation would end transparency and hence erode consumer protection (*Lloyds List*, 27, August 1988, p 8; Monopoly Commission 1988). Dr. Biagosch, CEO of Germany's third largest insurance company Colonia and President of the Committee for international operations in the GDV, claimed that "...even I –and I think the case is the same for colleagues— sometimes find it difficult to compare the conditions of non-German insurance companies with the conditions of German insurance companies even in the relatively simple area of personal insurance" (Biagosch 1990).

A reason why insurance providers opposed liberalisation of personal insurance was that personal insurance traditionally has been more profitable than business insurance (Farny cited in Finance Committee hearing, 25 April, 1990: 74/12 and 74/6 – 74/32). Personal insurance providers were known to extract rents over-calculating premiums for personal insurance in relation to risk.

Furthermore, most consumers opposed liberalisation of personal insurance such as motor vehicle insurance. For example during the hearing in the Finance Committee



concerning the implementation of the Second Non-Life Insurance Directive, consumer organisations such as Arbeitsgemeinschaft der Verbraucherverbände and Bund der Versicherten argued that liberalisation of insurance services should only include business insurance. Personal insurance should remain closed to competition in order to ensure consumer protection (Finance Committee hearing, 25 April, 1990: 130). While consumer organisations favoured the possibility of lower prices, they feared even more that liberalisation would reduce transparency thereby making it impossible for customers to compare prices and insurance conditions. Hence consumers could then easily end up buying too much and too expensive insurance products or might find themselves inadequately covered (interview with the German Federal Insurance Supervisory Office, June 26, 1998). In sum, personal insurance customers were satisfied with the available insurance products. Otto Graf Lambsdorff had to admit that consumers did not favour reform even though he as a prominent FDP member and Minister of Economics during 1977-82 and 1982-84 had strongly criticised German insurance regulation for being excessive (Lambsdorff cited in Hopp and Mehl 1991).

In conclusion, demand driven explanations can account for reform of business insurance but not personal insurance as both providers and users opposed personal insurance reform.

### The impact of EU membership

European Commission initiatives in insurance services were severely constrained by member state opposition. Already in 1973 the European Commission proposed the first insurance directive --which only entailed limited liberalisation measures. However, the directive encountered substantial opposition from the Council of Ministers and the directive was not adopted until 13 years later. Furthermore, the Commission did not propose the second non-life insurance directive until the Council of Ministers had adopted the Single European Act and set the deadline of January 1, 1993 for liberalisation of services including insurance services.

Concerning business insurance, the ECJ ruled in 1986 that if the principle of free provision of services as defined in Article 59 (now Article 49) meant anything then people from member state A who were not established in member state B should be allowed to offer their services in member state B (Dehousse 1998: 89-90)<sup>16</sup>. Thus, the ECJ allowed for a greater utilisation of the concept of free provision of services. In personal insurance on the other hand, the ECJ noted that in the absence of Community rules regarding the conditions of operations of insurance companies, member states had the right to require and to control respect for their own rules concerning services offered in their country (Dehousse 1998). Given the need to ensure consumer protection the ECJ also conceded the legitimacy of authorisation procedures according to which national authorities can make sure that in personal insurance an insurance firm fulfils the regulatory conditions. Thus, the ECJ established as a principle the freedom to provide services in business insurance but allowed room for national exceptions in order to provide consumer protection in personal insurance (Farny cited in Finance Committee

hearing, 25 April 1990, 74/11). In other words, the ECJ was careful not to push liberalisation substantially beyond what member states wanted. In sum, EU proposals relied extensively on member state support.

#### Changes in German government preferences

The German government initially only supported liberalisation of commercial insurance and transport insurance and argued that the consumer market should be left alone (*Financial Times* 1984: 2). The government believed that the large size of some of Germany's key insurance firms such as Allianz constituted an advantage in a liberalised market because financing of operations abroad would be relatively easy. However, when in the late 1980s and early 1990 both the Monopoly Commission and the Deregulation Commission<sup>17</sup> argued that liberalisation of the mass insurance market could be undertaken without putting the consumer at risk, the German government increasingly came to favour liberalisation of mass insurance as well.

The Monopoly Commission, which was established in 1986, presented concrete proposals in 1988 concerning insurance services and these proposals provide key insights into the economic program advocated by the German government. Economics Minister Lambsdorff in 1982 had proposed liberalising personal auto insurance but failed to win support for his proposal. However, Lambsdorff's ideas gained support after the Monopoly Commission (and the Deregulation Commission) had argued that liberalisation of personal insurance would lead to cheaper and better products for the consumer. They also argued that the consumer could be guaranteed protection (see for example the hearings concerning the third EU non-life insurance directive in the finance committee).

The Deregulation Commission published a report in 1991 titled *Marktoeffnung und Wettbewerb* (Market Opening and Competition), which strongly reflected the economic program of the German government concerning insurance services. As Farny points out, reports from the Monopoly Commission and the Deregulation Commission show that pressure for reform was strong within the German government and supplemented pressure for reform in the EU (Farny 1991: 287). Both reports pointed out that the insurance sector was growing but was suffering from market inefficiencies due to restrictive national regulations and both reports argued that liberalisation would be a useful tool for making the sector more efficient.

Studies by the Monopoly Commission and the Deregulation Commission were significant because they constituted the first massive criticism of insurance regulation (Lambsdorff 1991: Kartte 1991). Both the Monopoly Commission and the Deregulation Commission suggested an end to the setting of uniform insurance conditions as well as price regulation. Furthermore, in order to protect insurance customers against bankruptcies both reports proposed setting up a guarantee fund as well as the undertaking of regular solvency checks. Professor Ernst Starke in his (critical) evaluation of the proposals made by the Monopoly Commission argued that the reports signalled a radical change in the government's thinking about services exactly because the Monopoly Commission viewed insurance as a product which could be sold as a regular good while new regulation could protect consumers (Starke 1988a)<sup>18</sup>.

Starke's interpretation may hold the key to how reform came about and may also point to how far reform is likely to go. The key is redefining protected services as regular tradable products while at the same time adopting new regulation to ensure that

consumers and workers are sheltered against negative side effects of liberalisation. If such a redefinition is not possible then liberalisation becomes extremely difficult.

### 2.3 Postal Reform

When telecommunications services were opened up to competition in Germany, it was firmly believed that the postal side of the traditional Post, Telegraph and Telephone administration would remain a public monopoly<sup>19</sup> (see for example the Federal Minister for Post and Telecommunications 1988 and the Government Commission for Telecommunications 1988). The reasons for this expectation were threefold. First, it was assumed that the provision of reasonably priced universal postal services could only be guaranteed by a postal monopoly. Secondly, the postal sector had not experienced major technological developments that warranted reform (Price Waterhouse 1997). Finally, the postal sector is one of the largest employers in Europe. Privately employed postal workers typically work longer hours and for less pay than publicly employed postal workers. Political opposition to reform was therefore likely to be massive. However, in spite of these obstacles it became increasingly clear that the organisation of the German postal sector resulted in a low product innovation rate, a small letter mail volume per inhabitant, below average labour productivity and high letter prices.

Postal services can be divided into reserved services and non-reserved services. Reserved services are typically allocated to one or more operators who provide this particular service universally. In reserved services Deutsche Post AG is the only operator allowed to collect, sort, transport and deliver mail. In non-reserved services competition is open to German as well as non-German providers and operators are allowed to

establish a base of operations in Germany from which they can offer services. Prior to the 1997 reform reserved services included letters under 1 kilo and priced under 10 DM while bulk mail was reserved under 100 g (Deutsche Post AG, Bundestag committee for Post and Telecommunications, 24 September, 1997: 977). All other services were open to competition. Following the 1997 reform which took effect on January 1, 1998, the reserved services segment was reduced to letters and addressed catalogues (direct mail) under 200 grams or costing less than 5,50 DM as well as bulk mail above 50 grams. Letters between 200 grams and 1 kilo were opened up to competition but required a license.

Tables 7, 8a, 8b and 9 provide an overview of regulatory changes.

Table 7

Regulatory changes in the German postal sector (see also table 2)

German reforms	Regulatory changes <sup>20</sup>
1997 Postal Reform	Liberalisation of: <ol style="list-style-type: none"> <li data-bbox="663 1234 1044 1379">1. Letters and addressed catalogues weighing more than 200 grams or costing more than DM 5,50</li> <li data-bbox="663 1384 1083 1527">2. Bulk mail (Massendrucksache) (at least 50 pieces) weighing more than 50 grams</li> </ol>

Table 8a

German reserved postal services before 1997

<i>Non-reserved services</i> <ul style="list-style-type: none"><li>• Express and parcel services</li></ul>
<i>Reserved services</i> <ul style="list-style-type: none"><li>• Letters and direct mail under 1 kilo</li><li>• Price under 10 DM</li><li>• Bulk mail</li></ul>

Table 8b  
 German reserved services after 1997

<i>Non-reserved services and NO license</i>
<ul style="list-style-type: none"> <li>• Express and parcel services for example</li> </ul>
<i>Non-reserved services AND license</i>
<ul style="list-style-type: none"> <li>• Letters under 1 kilo and more than 200 g</li> </ul>
<u>Reserved services</u>
<ul style="list-style-type: none"> <li>• Letters and direct mail under 200 g</li> <li>• Price under 5,50 DM</li> <li>• Bulk mail under 50 g</li> </ul>

Table 9  
 EU level postal reform

Directive	Regulatory changes
Council Directive <sup>21</sup> 97/67/EC (“Council Directive of the European Parliament and of the Council of 15 December, 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service” (in force February 1, 1999))	EU directive opens up competition in the clearance, sorting, transport and delivery of letters, postcards and direct mail (addressed advertising and marketing material) weighing more than 350 grams or costing more than five times the price of a standard letter

An interest-based explanation

The interests of business users diverged initially. Supporters of reform included advertising and mail order firms as well as employer associations. However, the largest user group of postal services was newspaper producers who opposed reform because they feared that it would jeopardise universal service provisioning. Deutsche Post AG



favoured the status quo because it obtained most of its revenue from the reserved letter services segment. Privately owned express and parcel service providers were interested in breaking into the mail business market and supported reform. Consumer organisations as well as the union found that reform proposals went too far because they feared that liberalisation would end the principle of universal service provision at affordable cost and lead to an increase in unemployment. In sum, although business users and private providers largely favoured reform, substantial opposition to reform existed among consumers, the union and the incumbent provider. It therefore needs to be explained how opposition to reform was overcome in order to understand why and how part of the letter market was slowly opened up to competition.

#### The impact of EU membership

EU proposals for liberalisation were severely constrained by domestic politics. First, the Commission had long attempted to push reform of postal services on the agenda but refrained from using Article 90(3) (Article 86(3)) to create competition<sup>22</sup>. Secondly, the ECJ determined that competition rules apply to postal services but on the other hand the ECJ also ruled that member states could protect postal providers operating in the “general interest”. The ECJ left it up to national courts to determine which services meet such criteria<sup>23</sup>. Recently on February 10, 2000 the ECJ also ruled that remailing requires full reimbursement. Thus, Deutsche Post has a right to the full tariff when it delivers letters that have made a detour via cheaper countries such as the Netherlands. In sum, in order for major reform of the postal sector to be undertaken in the EU, key member states had to support such changes. How then did the German government change its views on

postal sector reform from opposition to support?

### The break in German government opposition

The economic success of Deutsche Post AG following the initial postal reform in 1989 constituted a key reason for why the German government sought to open up postal services to competition (statement by Mr. Boetsch, Minister for Post and Telecommunications, Bundestag committee for post and telecommunications, 24 September 1997, p 143). However, it was very difficult for the government to devise a proposal for postal reform, which would be accepted in the Bundesrat by the social democrats as well as the federal states.

The key issue for the CDU/CSU was whether postal liberalisation could be combined with universal service provision. The CDU/CSU feared that if letter services were opened up to competition then postal operators would only be interested in providing services in the most profitable areas such as city centres whereas they would not be interested in offering services in rural areas. However, during the hearings about the new postal reform, studies were presented which proposed solutions on how to maintain the principle of universal service provisioning. One solution entailed the establishment of an equalisation foundation (Ausgleichsfond) paid for by license holders (see for example the testimony in the Bundestag committee for post and telecommunications by Mr. Stumpf from the Wissenschaftliches Institut fuer Kommunikationsdienste (WIK, the Research Institute for Communication Services), September 24, 1999). This solution formed the crux of the CDU/CSU reform proposal. By setting up such a license system CDU/CSU core constituents in rural areas would be

sheltered from potentially negative side effects of market reform.

Legislative proposals must go through three readings in both the Bundestag and in the Bundesrat. The SPD had the majority in the Bundesrat and on May 16, 1997, the Bundesrat turned down the government's proposal. The SPD feared that postal jobs in the private sector would be less well paid and more stressful. The SPD therefore demanded that a social clause should be inserted in the new postal legislation. This clause should ensure that jobs in the privately owned postal operators were "equal" to jobs in the Deutsche Post AG (SPD statement, Bundestag Committee for Post and Telecommunications (Bundestag committee for post and telecommunications), October 7, 1997: 93-94).

However, the Bundesrat rejection was not only due to SPD opposition. The federal states more broadly wished to ensure that the principle of universal services at affordable prices was upheld. Many federal states feared that lower prices and service improvements in the metropolitan areas would result in a decline in service and higher prices in rural areas (*Frankfurter Allgemeine Zeitung*, May 17, 1997, no author: 14).

Because of substantial opposition in the Bundesrat the legislative proposal was submitted to the Vermittlungsausschuss (conciliation committee) to be discussed on December 11, 1997. A compromise was found which allowed a continuation of part of the DPG monopoly. Universal service provision was guaranteed by creating a license system, which required licensees to fund universal services. The proposal satisfied the SPD and the Bundesrat. The compromise included the following four issues. First, Deutsche Post maintained its monopoly until January 1, 2003 for letters until 200 grams. Secondly, bulk mail up to 50 grams was reserved until January 1, 2003. Thirdly, every

two years the Regulatory Authority must write a report to evaluate if reserved services should be opened up to competition. Finally, concerning social protection, chapter 1 paragraph 2 (5) of the Postal Act states that the aim of postal regulation is to meet social requirements. Furthermore, chapter 2, paragraph 6 states that a license can be denied if an applicant for a license “fails to a not inconsiderable extent to meet the basic working conditions common in the licensed sector”.

In sum, in postal services substantial reform has taken place even beyond what was expected only a few years back. The government convinced the opposition that sheltering of jobs and service provisioning would be guaranteed. However, extensive opposition to full reform both in Germany and in the EU prevented complete liberalisation of postal services at the moment.

### **III IMPLICATIONS FOR FURTHER LIBERALIZATION OF SERVICES**

While pressure from economic interests as well as from EU institutions are important for reform, in key service sectors the position of member state governments in favour of reform was crucial for the adoption of new policies. In Germany the government supported by liberal ministries such as the economics ministry and the finance ministry came to favor liberalization of value-added telecoms services and personal insurance services in order to increase economic efficiency. In the process of considering reform proposals a learning process took place whereby the government decided that services could be traded internationally as regular products while consumers and workers could be sheltered from harm by adoption of new regulations. In short, the success of EU proposals to liberalise services depends to a large extent on domestic government support

and the ability of governments to shelter workers and consumers from harm.

It could perhaps be argued that Germany did not have a choice but to open up protected services to international competition given ongoing market changes. Technology was developing at a rapid pace in telecommunications and US and UK deregulation was possibly forcing Germany to follow along the same path. If US and UK deregulation resulted in better and cheaper products eventually the German governments would be faced with demands from users for reform as well. Finally, recently telecommunications and financial services were liberalized within the WTO framework. The point here is not that liberalization in Germany could have been prevented –it probably could not have been. Instead the claim is that domestic governments play a key role in shaping the pace and extent of regulation as well as shaping new regulation to protect against harm.

In addition, the impact of market constraints should not be overstated. For example Germany has more than 11 million unemployed as well as Europe's slowest growth in service sector employment. In economic terms this situation represents an inefficient allocation of resources. All things equal creation of service sector jobs could reduce tax burdens on German firms as the need to finance unemployment benefits was reduced. This in turn could increase the international competitiveness of German firms. However, so far Germany has not managed to increase employment growth in services. Recent proposals by the Red-Green coalition to spur job growth by lowering wages along with social contributions and taxes in services were rejected outright by the unions including IG Metall. In short, service sector liberalization has been possible for services, which can be reinterpreted as tradable products on a par with manufacturing goods.

However, reform of non-exposed services that creates a legislative “wedge” between goods and services have so far not been possible.

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<sup>1</sup> On the impact of insurance reform see Schmidt, 2001.

<sup>2</sup> The factor model argues that trade liberalization shifts the comparative advantage of a nation, in familiar Stolper-Samuelson fashion, in order to favor the most plentiful factor among land, labor and capital. However, this model is not considered here. The factor model is too parsimonious focusing on the very broad factors of land, labor and capital. Furthermore, a focus on land, labor and capital does not include voice telephony or email transmissions across borders as tradable products. The movement of letters and parcels also does not count as a vendible commodity and neither does the purchase of an insurance policy.

<sup>3</sup> See for example Noam, 1992; Morgan and Webber, 1986; Farny, 1991; Huebner, 1987; Grande, 1989; Price Waterhouse, 1997.

<sup>4</sup> For a critique of Stone Sweet and Sandholtz see Branch and Ohrgaard, 1999. In particular, Branch and Ohrgaard criticize Stone Sweet and Sandholtz for an ambiguous account of the role of government. If governments adapt their preferences, strategies and behavior to new rules, then it is important to determine how this happens (Branch and Ohrgaard, 1999, pp. 132-133). See also Sandholtz and Stone Sweet, 1999.

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5 Deutsche Telekom AG went on the stock exchange for the first time in November, 1996.

6 A key source of information concerning the preferences of users and providers of telecommunications services is provided by the detailed stenographic protocols from the hearings held in the German Bundestag's committees such as the committee for post and telecommunications. Another key source consists of the extensive written statements provided by the various actors prior to the hearings. Academic articles, interviews with key actors involved in the reforms, business and government studies and reports, newspapers, etc., also constituted useful sources.

<sup>7</sup> With the entry into force of the Treaty of Amsterdam on May 1, 1999 Article 90(3) changed to Article 86(3). This article refers to the numbering system prior to the Treaty of Amsterdam first and with the new Article numbers in parentheses.

<sup>8</sup> With the entry into force of the Treaty of Amsterdam on May 1, 1999 Article 86 became Article 82.

9 Following a mandate from the German Act against restraints on competition, a so-called independent Monopoly Commission (Monopol Kommission) regularly produces a report on the state of competition in the German economy.

10 Mr. Boetsch replaced Dr. Schwarz-Schilling as minister for post and telecommunications in 1993 after Dr. Schwarz-Schilling retired on December 13, 1992 following a disagreement between Dr. Schwarz-Schilling and Chancellor Helmut Kohl over Germany's foreign policy. Mr. Boetsch also favored reform of telecommunications.

11 On January 1, 1998 Mr. Boernsen was appointed as one of two vice presidents for the new Regulatory Authority in Bonn (the Regulierungsbehörde) which oversees competition in the German telecom market. Towards the end of 1999 Arne Boensen surprisingly handed in his resignation. The reason was apparently growing disagreement with Mr. Scheurle, the President of the Regulatory Authority, on the pace of reform. According to Mr. Boernsen, the pace of reform was moving too slowly (*Frankfurter Allgemeine Zeitung*, November 28, 1999, p 18).

12 The committee had 17 members. Eight were from the CDU/CSU, six were from the SPD, one was from the Green Party, one was from the FDP and one was from the Socialists. Following liberalization of telecommunications services on January 1, 1998 this committee was subsequently abolished. Issues relating to post and telecommunications are now dealt with in the Wirtschaftsausschuss (committee for economic issues).

<sup>13</sup> Concerning the impact of this reform see Susanne Schmidt, 2001.

14 The European Commission, *The Single Market Review: Impact on Services*. Insurance, 1998.

15 The directive excluded certain classes of insurance including third-party motor vehicle insurance, builders' risk insurance, and nuclear liability insurance.

16 Case 205/84 Commission v Federal Republic of Germany [1986]; Case 206/84 Commission v Ireland [1986]; Case 220/83 Commission v France [1986]; Case 252/83 v Denmark [1986]. See Pool, 1990 and Dehousse, 1998 for more information on ECJ rulings in insurance services.

17 The government in 1987 set up a Deregulation Commission (Deregulierungskommission) to estimate the cost of existing regulations in the German economy as well as to develop proposals for reform concerning how regulations could be removed.

18 Starke argued that the perception of insurance as a regular tradable product was false. In insurance the product is the promise to take over the risk for others. The only way to guarantee that such a promise will be kept is to adopt a set of complex insurance regulations (Starke, 1988b).

19 Parcel and express postal services have long been opened up to international competition in Germany and most EU member states while letter services have been closed to competition.

20 Universal services include the clearance, sorting, transportation and distribution of parcels up to 20 kilograms, as well as letters. Furthermore, the conveyance of books, catalogues, newspapers and magazines is included insofar as conveyance is undertaken by companies providing postal services either in the form of letters or in the form of addressed parcels weighing not more than 20 kilograms (German government, 1997 Postal Act, paragraph 11).

21 The Directive published by the EC posts and telecommunications directorate called for retention of a universal postal service defined as the availability of standard mail services at economic and uniform prices for everyone within the EU.

22 In May 2000 the European Commission has drawn up controversial plans to open up the EU mail market to further competition. The Commission wants to introduce competition for letters weighing more than 50 grams. This move would free up 16 percent of the revenue of the existing monopolies. It also

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wants to liberalize direct mail. However, the debate quickly became highly politicized as many national postal services and governments oppose reform. Mr. Romano Prodi, European Commission president, is believed to have intervened in the plan and asked internal market commissioner Frits Bolkestein, to postpone setting a date for full competition because the issue is so sensitive (*Financial Times*, May 10, 2000, p 3).

<sup>23</sup> Case C320/91 Procureur du Roi v Paul Corbeau.