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**Dismantling the *Ancien Régime*:
Public Service Liberalization in the EU and the Vulnerability of Sector Regimes**

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Abstract

How was it possible for public services to be liberalized in the EU despite a history of strong government control? Much of the literature on this issue has developed around the argument over the impact of EU institutions on the liberalization process. But the fact that liberalization is not an EU-only phenomenon poses problem: did EU institutions really matter? The paper tries to assess the relative impact of EU institutions and non-EU factors, especially the role of institutions at the sectoral level which has largely been ignored. Liberalization of public services involves the difficult task of dismantling an *ancien régime* which justified and supported monopolization, and of setting up a new one. Thus, it is highly likely that the vulnerability or strength of the former regime will affect the prospects of liberalization at the EU level.

Against this backdrop, the paper focuses on “sector regimes” that governed service provision in each sector. Introducing the framework of sector regimes has several advantages. First, it allows us to trace and explain the agenda-setting process and preference change of member states in a dynamic way. Secondly, it helps us predict how likely member states' preferences are to converge. Thirdly, it allows us to see that the nature of relationship between member states and EU institutions is not a uniform one, but that it is in fact shaped by the vulnerability of sector regimes. The paper examines two cases, the liberalization of air transport and telecommunications services. The case studies show that liberalization of the two services was brought by the subsequent weakening of national sector regimes, and find that the impact of EU institutions was greater in the telecommunications sector than in the air transport sector due to the difference in vulnerability of the sector regimes.

Introduction

Provision of public services was one of the major socio-economic policies of West European governments in the twentieth century. The government provided a wide range of services such as water, gas, electricity, post, railway, telecommunications, and air transport that contributed to people's well-being, economic development, and the creation of employment. Since government intervention was legitimized by economic theories, that of natural monopoly in particular, there was little room for criticism against public monopolies. For most of the post-war period, governments regarded the provision of basic services that are essential for citizens and economic activity as part of their responsibility.

However, the situation changed slowly but substantially from the mid 1980s, with the adoption of the White Paper on completing the internal market and the signing of the Single European Act. The public services that the member states provided became targets of liberalization at the Community level one after another, starting with air transport, and quickly spilled over to telecommunications, electricity, gas, and postal services in the 1990s. Many of the service providers have been either fully or partly privatized, leaving less room for government control. How was it possible for a policy area which was subject to strong member state control to be liberalized in the European Union (EU)?

Much of the literature on this issue has developed around the argument over the impact of EU institutions on the liberalization process.¹ Among them, Sandholtz and Stone Sweet give the most "supranationalist" account, arguing that liberalization was driven by a coalition of the European Commission and transnational interest groups which pressured member states into changing their policy towards public service regulation. During the liberalization process, the Commission upheld judgments by the European Court of Justice (ECJ) and Article 86(3) (ex Art. 90 (3) EEC) of the Treaty to press governments for liberalization. Thus, the supranational authority of EU institutions has been referred to as a major explanatory variable for public service liberalization in the EU.²

However, liberalization of public services did not occur exclusively in the EU, but in other advanced industrialized countries as well. This poses a serious question: if liberalization occurred in other countries, did EU institutions really matter?; were they decisive in bringing about change? For example, Schmidt insists that it was because of government support that the Commission was

¹ See, for example, Wayne Sandholtz and Alec Stone Sweet eds., *European Integration and Supranational Governance* (Oxford: Oxford University Press, 1998); Rainer Eising and Nicolas Jabko, 'Moving Targets: National Interests and Electricity Liberalization in the European Union' in *Comparative Political Studies* 34 (7) September (2001): 742-67; Mitchell P. Smith, *States of Liberalization: Redefining the Public Sector in the Integrated Europe* (Albany: State University of New York Press, 2005); Joseph Goodman, *Telecommunications Policy-Making in the European Union* (Cheltenham, U.K. and Northampton, MA: Edward Elgar, 2006).

² Sandholtz and Stone Sweet, op. cit.

able to make use of its supranational authority.³ Moreover, Levi-Faur argues that liberalization would have diffused to most member states even without the EU.⁴

Thus, the objective of the present paper is twofold: first, to answer why EU member states agreed to liberalize public services; and second, to assess the relative impact of EU institutions and other factors that are not derived exclusively from the EU. To achieve this, the paper focuses on the politico-economic structures and institutions at the sectoral level, or “sector regimes,” that managed and regulated service provision in each sector. Liberalization involves the difficult task of dismantling these *ancien régimes* that justified and supported monopolization, and of setting up new ones. Therefore, it is highly likely that the vulnerability or strength of the former regimes will affect the liberalization process. As the following argument will show, the framework of sector regimes allows us to trace and explain the agenda-setting process and the change in member-state preferences in a dynamic way. Moreover, it enhances our understanding of the relationship between member states and EU institutions. Specifically, when a sector regime is vulnerable, supranational institutions and actors are likely to play the role of a facilitator of negotiations at the Council rather than to shape the preferences of member-states per se, since member-state preferences will have already changed due to the breakdown of sector regimes which was caused by forces other than those derived from EU institutions.

The rest of the article proceeds as follows. Section one outlines the basic structure of “sector regimes” and the conditions that make a regime more vulnerable, thus inducing liberalization. In doing so, it identifies two distinct types of sector regimes: one that is based primarily on national institutions, and the other on international institutions. The latter is presumed to be more vulnerable and thus, be liberalized with less impact from EU institutions. In sections two and three, the liberalization process of international air transport and telecommunications services in the EU will be analyzed. These two services were chosen as case studies because: (1) they represent the two different types of sector regimes; (2) they can be considered as “hard cases” that have been explained by “supranational” governance; and (3) they are less susceptible to the influence of previous liberalizations since they were the first to be liberalized. The article will analyze the liberalization process by focusing on the vulnerability of sector regimes, how it affected member states’ preferences, and its relations with EU institutions. The case studies that follow will analyze the policy-making process up to the most critical decisions made in each sector: the adoption of the First Package in 1987 for air transport services; and the Council’s decision to liberalize voice telephony in 1993 for telecommunications services.

³ Susanne Schmidt, ‘Commission activism: subsuming telecommunications and electricity under European competition law’ in *Journal of European Public Policy* 5 (1) March (1998): 169-84.

⁴ David Levi-Faur, ‘On the “Net Impact” of Europeanization: The EU’s Telecoms and Electricity Regimes between the Global and the National’ in *Comparative Political Studies* 37 (1) February (2004): 3-29.

Structure and Vulnerability of “Sector Regimes”

A “sector regime” is a configuration of institutions and structures that governs the provision of services in a sector. In general, public service sector regimes are constituted of: (1) a logic that legitimizes monopolization of a service; (2) a formal institution that stipulates or enhances monopolization; and (3) interdependence among actors who benefit from monopolization.⁵ The theory of natural monopoly played an important role as a legitimizing logic of monopolization and public ownership of transport services and utilities. For example, air transport services were exempted from the application of anti-trust law because it was deeply related with national security concerns, and because it was regarded as a natural monopoly. Since the basic principles of the international air transport regime was drawn up before and after the Second World War, governments were reluctant to grant each other free traffic rights over their territories. Also, despite the fact that air transport services required massive amount of investment, there was limited demand in the wake of the post-war period. Thus, governments had to restrict competition so as to make air transport services profitable. The same logic could be applied to telecommunications services. Since network construction required an enormous amount of investment, it was necessary for service operators to minimize their production costs by expanding their network as much as possible. The conventional wisdom was that there should be a single service operator so that services could be efficient, and be provided at the minimum price. The fact that services were limited to telegrams and voice telephony at the time reduced chances for competition to take place, and this strengthened the logic for monopolization. As a result, international and national institutions were set up to authorize monopoly status for service operators or administrations which provided these services.

In international air transport services, the Convention on International Civil Aviation and bilateral aviation agreements regulated the provision of services. These international agreements provided for state sovereignty over the airspace above their territories, equal opportunity to participate in international air transport services, and at times, measures to enhance equality of outcome as well. The bilateral agreements stipulated terms on airfare, the number of flights, capacity sharing, and traffic rights so that contracting states would be able to share equal capacity of flights and reduce competition between national flag carriers. In principle, a single airfare was set for each route through negotiations among airline companies at the International Air Transport Association. Furthermore, the Convention Relating to the Regulation of Aerial Navigation in 1919

⁵ Studies on the liberalization of public services often use the concept of rent-seeking coalitions. In developing the concept of “sector regimes,” I especially drew on the work of Hulsink. cf., Willem Hulsink, *Privatisation and Liberalisation in the European Telecommunications: Comparing Britain, the Netherlands and France* (London and New York: Routledge, 1999). See, also, Yuko Suda, *The Politics of Globalization in Telecommunications: “External Pressure” on Japanese Policies (Tsushin Gurobaruka no Seijigaku: “Gaiatsu” to Nihon no Denki-tsushin Seisaku)* (Tokyo: Yushindo-kobunsha, 2005): 46-9.

authorized national governments to restrict domestic air transport services (cabotage) to national airlines. In the case of telecommunications, the International Telecommunications Union set interconnection standards, and restricted the provision of international services to those operators who had monopoly status in their domestic market. Service operators, which were generally administrative bodies, were authorized by law to provide services and construct infrastructure exclusively. In addition, they could decide which terminals were allowed to connect to the network, set standards of the terminals, as well as prohibit resale of networks by private companies. In this way, air transport and telecommunications services were exempted from anti-trust law, and were governed instead by international and national institutions that formally excluded competition among service providers.

Actors who benefited from the legitimizing logic and formal institutions were public service providers, administrative bodies, hardware manufacturers and politicians. Public service providers and administrations profited from the monopoly over service provision, and possessed the authority to regulate the market. Hardware manufacturers were able to benefit from a less competitive procurement system and a monopsony with a demand side (i.e., usually the government) which was less concerned with cost-effectiveness. Thus, politicians were able to gain support of public officials, manufacturers and constituencies in rural areas. This, in turn was reflected in choices of government policies. The three elements noted above—logic, institution and interdependence among actors—formed a robust regime that supported the existence of public service monopolies.

Thus, it is possible to hypothesize that the weaker the sector regime becomes, the easier the liberalization process. But what makes a sector regime in one service weaker? Sector regimes lose their robustness when their legitimizing logic, for example the theory of natural monopoly, turns out to be less credible, and/or when actors who had benefited from the regime have to pay higher opportunity cost to maintain it. Also, regimes tend to be more vulnerable when they are based primarily on international institutions. This is because when two or more of the parties liberalize the sector, it enhances competition and brings down prices, thereby diverting demand to that country when there are no trade barriers. Public monopolies in neighboring countries will have to pay the cost of maintaining a regulated market by losing domestic users to foreign operators. In this way, liberalization in one country elevates opportunity cost for actors in another country to maintain monopoly, thereby enhancing the spillover of liberalization processes internationally. On the other hand, liberalization of services that are constituted of national institutions does not generate similar spillover effects, and liberalization tends to stop at the domestic level. This implies that member state-preferences are likely to converge in sectors with regimes based primarily on international institutions even without the impact of EU institutions. On the other hand, member-state preferences are likely to remain diverged in sectors with regimes based

primarily on national institutions, and EU institutions are likely to play a more important role in the liberalization process. The following sections analyze how and why regimes in both air transport and telecommunications services weakened, and led to liberalization.

Liberalization of Air Transport Services

Breakdown of the sector regime in the U.S. and its impact on the EC (1978-1984)

The regime that regulated air transport services began to weaken in the U.S., starting in the 1970s. As was mentioned above, it was the lack of demand and economies of scale that legitimized the regulation of air transport services. These problems were gradually resolved after demand started to grow in the 1950s, and transport cost decreased thanks to the development of jet airplanes. By the 1970s, it was deemed possible for small-scale, low-cost companies to survive in the market. In spite of these developments, major airline companies struggled for stable revenue, asking the Civil Aeronautics Board (CAB) for tighter regulation.⁶ This went completely against the deregulation argument which was gaining ground at the time, and contrary to the hopes of the major airlines, only worked to speed up the breakdown of the existing regime.

Calls for tighter regulation from airline companies were refuted by the theory of contested markets which was recently introduced in the field of economics.⁷ According to this new theory, if entry to and exit from the market were relatively easy, new entrants would be able to challenge the monopoly with lower prices. Therefore, government regulation is no longer necessary even in sectors with characteristics of a natural monopoly. As the theory of natural monopoly was rejected in this way, interdependence among the actors that supported the existing regime began to loosen. President Carter enthusiastically supported deregulation, thinking that it would raise support from the public who were users of air transport. In October 1978, a law was passed that stipulated the deregulation of market access and airfares in domestic routes by 1982 and abolition of the CAB by 1984.

Developments in the U.S. greatly influenced the policy proposal of the Working Party on Air Transport which had just been set up under the Committee of Permanent Representatives a year before in 1977.⁸ In May 1979 the European Commission issued a Memorandum (hereinafter,

⁶ Takao Akiyoshi, *Transformation of Public Policy and Policy Science: Regulatory Reforms in the Air Transport Industry in Japan and the U.S. (Kokyo-seisaku no henyo to seisaku-kagaku: Nichibeï kokuyuso-sangyo niokeru hutatsu no kisei-kaikaku)* (Tokyo: Yuhikaku, 2007): 82-4, 93.

⁷ Ibid: 96-8. There are many counterarguments questioning the proposition that the air transport market is contestable.

⁸ Commission of the European Communities (CEC), Air transport: a Community approach. Memorandum of the Commission, *Bulletin of the European Communities. Supplement 5/79* (1979): 7-8. It is not clear why the working party was established, but according to an interview by O'Reilly, a Commission official has commented on the need to react to the ECJ judgment in 1974, which is considered to have opened prospects for liberalization in the air transport sector (Dolores O'Reilly and Alec Stone Sweet, 'The Liberalization and European Regulation of Air Transport,' Sandholtz and Stone Sweet, op. cit.: 167).

“First Memorandum”) which, referring to the air transport policy in the U.S., proposed new goals and policy measures for the Community.⁹ The Commission claimed that monopoly of the sector for reasons of economies of scale “is not necessarily true,”¹⁰ and that competition rules should be applied.¹¹ The Commission’s neoliberal understanding of the problem, and its strong will to counter the *ancien régime* were reflected in the text.

However, the Council ignored most of the Commission’s proposals. Restricting the emission of nuisances and simplification of freight transport procedures were what concerned many member states at the time, and liberalization was a not a priority for most of them.¹² The fact that the Commission proposed revolutionary measures in order to provoke discussion¹³ did not help the negotiation either.

Nevertheless, the Commission proceeded with the consultation procedure and was encouraged by the European Parliament, airline companies and user associations who supported liberalization.¹⁴ This motivated the Commission to complete another Memorandum (hereinafter, “Second Memorandum”) in March 1984. The Second Memorandum was a more concrete, detailed policy proposal than the first, which recommended a gradual, partial liberalization. In response, the Council set up a High Level Working Group constituted of national flag carriers and regulatory agencies. The Working Group met eight times in late 1984, and submitted a report which showed changes in member states’ preferences toward liberalization. Member states who strongly supported the Commission’s proposal were representatives from the U.K., the Netherlands and Luxembourg, but the rest also agreed that a gradual, limited liberalization was necessary.¹⁵ The fact the all member states agreed to examine the prospects of liberalization, albeit cautiously, was a significant change, which reflected the weakening of the air transport sector regime in these states.

Breakdown of the sector regime in Europe (1978-1985)

The Netherlands was the first member state in the Community to conclude a liberal bilateral agreement with the U.S. The Netherlands supported the U.S. at the Chicago Conference in 1944 and had traditionally supported a liberal air transport regime. Its national flag carrier, KLM, was known for its efficient management which concentrated on international services, and was seeking to gain greater access to the U.S. market. In order to support KLM, the Dutch government not

⁹ CEC, op. cit.: 28-30.

¹⁰ Ibid.: 13.

¹¹ Ibid.: 19.

¹² Ibid.: 24.

¹³ Ibid.: 3.

¹⁴ CEC, *Civil Aviation Memorandum No 2. Progress Towards the Development of a Community Air Transport Policy*. COM (84) 72 final. Brussels: 15 march 1984: 3,7.

¹⁵ Stephen Wheatcroft and Geoffrey Lipman, *Air Transport in a Competitive European Market: Problems, Prospects and Strategies* (London: The Economist Intelligence Unit, 1986): 54-5.

only concluded a new bilateral agreement with the U.S., but was promoting a liberal plurilateral agreement as well.¹⁶ The U.S.-Dutch agreement in 1978 became a threat for neighboring countries that were still harboring protectionist agreements, and led the Belgian, West German and British governments to revise their bilateral agreements with the U.S.

Liberalization in the North Atlantic routes spilled over to European routes after 1984. This time, it was the U.K. who set the process in motion. Having completed the restructuring of British Airways, the Thatcher administration began to promote the revision of bilateral agreements with other EC member states. The first one was with the Dutch which was concluded in 1984. At the end of the same year, West Germany also responded to calls of the British. These developments led to a watershed year in 1985 when Luxembourg, France and Belgium also concluded new agreements with the U.K., thus creating a wave of liberalization in Western Europe.¹⁷

What made such a spillover of liberal bilateral agreements possible? This was due to the market structure of the air transport sector which enhanced transport diversion from countries with protectionist regimes to those with liberal ones. For example, if transport capacity and airfares were to be liberalized through a liberal bilateral agreement between the Dutch and the U.S., national flag carriers will have to compete with each other, thus bringing down airfares in the Amsterdam-New York route. This may make it cheaper for users in neighboring countries such as West Germany or Belgium to travel via Amsterdam instead of flying from their own country to New York. Consequently, airline companies in these countries will lose customers to KLM.¹⁸ The fact that European airlines had a greater dependency on international services¹⁹ made them extremely vulnerable to the threat of transport diversion.²⁰ In fact, between 1978 and 1981, countries such as Belgium, the Netherlands and West Germany who had concluded liberal bilateral regimes with the U.S. saw a rise in the number of passengers in the North Atlantic route by 30.9 percent, while in countries such as France, Spain and Italy, who maintained their protectionist agreements, the number increased by only 12 percent²¹. In other words, in countries where the government had maintained their protectionist regimes, national flag carriers were paying an enormous amount of opportunity cost. The same logic can be applied to explain the rise

¹⁶ Daniel M. Kasper, *Deregulation and Globalization: Liberalizing International Trade in Air Services* (Cambridge: Ballinger, 1988): 56-7.

¹⁷ It is important to note that the French and Belgian decisions in fall 1985 to conclude a new agreement with the U.K. were made against the backdrop of the White Paper on Completing the Internal Market, which was adopted just a few months before, in June.

¹⁸ Higher reduction of airfares and growth in passenger traffic were seen in early liberalizing countries. For example, leisure airfares between Amsterdam and the U.K. were reduced by 20%, and passenger traffic increased by 63% between 1982 and 1987, while airfares rose by 18% and passenger traffic increased only by 25% in routes connecting Paris and the U.K. (Kim Abbot and David Thompson, 'De-regulating European aviation: The impact of bilateral liberalisation' in *International Journal of Industrial Organization* 9 (1991): 131).

¹⁹ Civil Aviation Authority, *Airline Competition in the Single European Market* (London: Civil Aviation Authority, 1993): 75.

²⁰ Kasper, op. cit.: 78.

²¹ Jose A. Gomez-Ibanez and Ivor P. Morgan, 'Deregulating International Markets: The Examples of Aviation and Ocean Shipping' in *Yale Journal on Regulation* 2 (1) (1984): 115.

of liberal bilateral agreements in European routes.

In the bilateral agreements concluded between the U.K. and the Netherlands, Luxembourg, and Belgium, regulations on market access, transport capacity, and airfares were liberalized to a great degree, showing the governments' strong preferences for a liberal air transport regime. On the other hand, agreements between the U.K. and West Germany and France were much more limited. For example, they maintained limits on capacity sharing: the former left room for consultation, and the latter set a sharing ratio of 55:45 instead of the previous 50:50.²² By examining the content of the bilateral agreements noted above and policy stances of each country, it is possible to identify three groups of countries with different preferences.²³ The first group includes the U.K., the Netherlands, Luxembourg, Belgium, and Ireland. This group supports rapid deregulation. The second includes West Germany, France, and Denmark. These countries prefer a gradual, partial reform of the sector and support the adoption of decisions made at the European Civil Aviation Conference by the Community. The rest, including Italy, Spain, Portugal, and Greece were less enthusiastic about regulatory reform. Considering the fact that the Council showed little interest in the First Memorandum, this shows that many member states had changed their preferences toward liberalization in just five to six years. At the same time, this indicates that the key to successful negotiation at the Council depended on how far the member states in the first group and those in the third group could compromise on the issue.

The Single Market Project and the adoption of the First Package (1985-1987)

As the sector regimes in many member states were beginning to weaken, the European Council adopted the White Paper on completing the internal market (hereafter, "White Paper") in June 1985. The White Paper stated that the Council of Ministers was supposed to decide on a common policy for bilateral air transport agreements according to the following schedule.²⁴ First, Council will decide on the procedure of setting airfares by December that year, then change the ratio of capacity sharing from 50:50 to 75:25 by June 1986, and finally, adopt a common policy regarding the application of Article 81 (ex Art. 85 EEC) by 1987. In addition, the White Paper noted that the Commission would use its powers designated in Article 85 (ex Art. 89 EEC) to examine violations of airline companies and demand member state governments to take the necessary measures if the Council did not show progress according to schedule.²⁵

However, negotiations in the Council did not proceed as scheduled. Instead, it was the judgment of the ECJ in April 1986 that gave an impulse to the negotiation process. The ECJ concluded that competition rules of the Treaty applied to bilateral agreements on air transport services, and until

²² Wheatcroft and Lipman, op. cit.: 213.

²³ Ibid.: 61.

²⁴ CEC, Completing the Internal Market. *White Paper from the Commission to the European Council* (Milan, 28-29 June 1985). COM (85) 310 final: 30, Annex: 27; CEC (1984).

²⁵ Ibid.: 30.

the application procedures are decided in accordance with Article 83 (ex Art. 87 EEC), the member states or the Commission are to take the necessary measures according to Articles 84 (ex Art. 88 EEC) and 85 respectively.²⁶ Encouraged by the ECJ judgment, the Commission and the Dutch presidency decided to add pressure on the member states who were less enthusiastic about liberalization.

On June 18, the Commission held a press conference, calling on member states to respect the schedule stipulated in the White Paper and to take measures to liberalize airfares and capacity sharing at the Council meeting scheduled at the end of the month.²⁷ The Dutch presidency, who was also frustrated with the slow reaction of the Council, decided to make use of its status as presidency to refer to the problem at the coming European Council in the Hague. The Dutch presidency successfully included a paragraph in the Presidency Conclusion which referred to the ECJ judgment and encouraged the Council of Ministers to adopt the appropriate decisions “without delay.”²⁸ This turned out to be a turning point for the creation of a common air transport policy. A week later, the Council of Ministers set for itself a goal for the first time to complete the internal market by 1992.²⁹

For the Commission, though, the Council’s statement was insufficient since it did not guarantee the fulfillment of the schedule stated in the White Paper. Soon after the Council, the Commission notified the national flag carriers to correct or abandon all cartel-like measures that impede Article 81 within two months, showing its adherence to the White Paper.³⁰

These developments coincided with the formation of a conservative government in France and the rotation of the presidency from the Netherlands to the U.K. that helped accelerate discussions in the Council after November. As was mentioned above, France had still maintained a cautious stance towards liberalization when she concluded a new agreement with the U.K. However, the conservative government formed in March 1986 was enthusiastic about liberalizing the economy, and at the Council in November, France began to propose deals so as to reach a compromise.³¹ The fact that the U.K. held the presidency helped the negotiation proceed as well, since the U.K. was now responsible for hammering out a compromise rather than demanding radical reforms.

As a result, most of the member states agreed on the terms of capacity sharing and multiple

²⁶ European Court of Justice, Judgment of the Court of 30 April 1986. Criminal proceedings against Lucas Asjes and others, Andrew Gray and others, Jacques maillot and others and Leo Ludwig and others. References for a preliminary ruling: Tribunal de police de Paris France. Fixing of air tariffs. Applicability of the competition rules in the EEC Treaty. Joined cases 209 to 213/84 in *European Court Reports* (1986): 1425.

²⁷ Stephen Wheatcroft and Geoffrey Lipman, *European Liberalisation and World Air Transport: Towards a Transnational Industry* (London: The Economist Intelligence Unit, 1990): 60.

²⁸ European Council, Presidency Conclusions. 26 and 27 June 1986 in *Bulletin of the European Parliament. Special Edition* 4 July 1986: 5.

²⁹ Council of the European Communities General Secretariat, Continuation of the 1090th Council meeting Transport Luxembourg, 30 June 1986, 7883/86 (Presse 104): 8.

³⁰ Wheatcroft and Lipman (1986): 60.

³¹ Tim Dickson, ‘Bitter Blow for Britain as Hope of Airfares Compromise Fades’ in *Financial Times*, 12 Nov. 1986: I-3.

designation at the Council meetings in November and December, thereby progressing towards the first stage of liberalization. Although the Council in December saw “significant progress”³² on the terms of airfares, the policy stances of the member states mentioned above did not fully converge. Six countries, including the Netherlands and West Germany, agreed to the presidency’s proposal, but four countries such as France and Southern European countries demanded conditions on discount fares.³³ The confrontation between the two groups reflected the differences in geographic conditions and the competitiveness of their national flag carriers.³⁴ Similar confrontation reappeared in issues such as fifth freedom and opening up of access to regional airports.³⁵

Despite such confrontation, it is highly likely that both the member states who preferred full liberalization and those who demanded tighter conditions held incentives for an agreement at the Community level. Countries that preferred full liberalization, such as the U.K. and the Netherlands, had better chances to open up Southern European markets by negotiating at the Community level rather than the bilateral level. This was because the financial status of the airlines of Southern European states were so unstable and fragile that it was deemed extremely difficult to open up their markets if the negotiations were left to bilateral ones. For the liberals, it was important that these countries were firmly set on the road towards full liberalization, even if it progressed in small steps. On the other hand, the Southern European states had to face increasing transport diversion if they were to be left behind in the liberalization process. Thus, it was also in the interest of these states to participate in the negotiations at the EC level, thereby slowing down the liberalization process. The countries’ strategic positions were reflected in the outcome of the First Package which was agreed in June 1987: i.e., the negotiation ended with the U.K. and the Netherlands compromising with the demands of the Southern European countries.³⁶

The First Package functioned as a spring board for successive legislations to liberalize air transport services and led to the dismantlement of the monopolist regime which had governed international civil air transport. As soon as the second stage of liberalization began in late 1989, the member states reaffirmed their commitment to complete the internal market by January 1993.³⁷ As a result, member states agreed to a greater degree of liberalization than the White

³² Council of the European Communities General Secretariat, Corrigendum to the 1133rd meeting of the Council Transport Brussels, 15/16 December 1986, 11296/86 (Presse 203) COR 1(e): 4.

³³ *Ibid.*: 4-5; ‘UK Gives Up Hope of Air Route Reform’ in *Financial Times*, 15 Dec. 1986: I-2.

³⁴ Member states that demanded conditions (e.g., the length of stay) on discount fares were southern European states that attracted numerous tourists during the vacation period. The national flag carriers in these countries were less profitable than those in the U.K. or the Netherlands. For example, Spanish and Greek airlines were recording consecutive losses (Wheatcroft and Lipman, *op. cit.*: 34).

³⁵ Tim Dickson, ‘EC Ministers in Air Transport Reform Talks’ in *Financial Times*, 23 June 1987: I-2; O’Reilly and Stone Sweet, *op. cit.*: 179-81.

³⁶ Council of the European Communities, Council Directive 87/601/EEC of 14 December 1987 on fares for scheduled air services between Member States in *Official Journal L 374*, 31. 12. 1987: 12-8.

³⁷ Council of the European Communities General Secretariat, 1373rd meeting of the Council Transport Brussels, 4/5 December 1989, 10311/89 (Presse 230): 15.

Paper had designated by July 1992, when the Third Package was adopted. With the liberalization of cabotage in April 1997, the problem has now shifted towards slot allocation in congested airports and agreements with third countries.

As O'Reilly and Stone Sweet have pointed out, the role played by the Commission in the liberalization process cannot be neglected³⁸. In the first half of the 1980s, the Commission drafted legislation and supported the creation of user associations despite the reluctance of a majority of member states. After the adoption of the White Paper, it used its legal powers enshrined in the Treaty to pressure member states into complying with the schedule and influenced the policy-making of member states, to a certain degree, by setting goals for further liberalization.

However, the analysis so far has also shown that the preferences of member states had changed substantially even before the Commission started to wield its legal powers, namely Article 86 (ex Art. 90 EEC), and that we need to look further into the process of preference formation. The reason why member states other than those of Southern Europe shifted their preferences towards liberalization, albeit difference in degree, was because the Dutch-British bilateral agreement spread fear of transport diversion among national airlines of neighboring states, thereby weakening the sector regimes in these countries. As a result, the question that the Council faced after the adoption of the White Paper was not so much about liberalization per se, but about the appropriate pace and extent of liberalization. The outcome of the negotiation was up to the countries that demanded full liberalization and those that demanded the maintenance of regulation to compromise on an appropriate level of regulatory reform. In that sense, the fact that the U.K. held the presidency at the latter half of 1986 and was left in charge of reaching a compromise, and that a conservative government was formed in France were important coincidences. In these kinds of circumstances, the Commission did not so much shape the preferences of member states, but facilitated negotiations in the Council. The role of the Commission though, grew in importance in the telecommunications services, which will be analyzed with in the next section.

Liberalization of Telecommunications Services

Breakdown of national sector regimes and their impact on the EC

As in the air transport sector, it was liberalization in the U.S. that triggered reform in the EC (European Communities). In the U.S., the consent decree of 1956 precluded AT&T from engaging in any business other than the provision of common carrier communications services. But the growth of the computer industry from the 1960s led to the development of new specialized services and equipment for businesses by companies other than the AT&T. The 1970s saw the Federal Oversight Board and the court granting new entrants authority to provide specialized

³⁸ O'Reilly and Stone Sweet, op. cit.

services and allowing them to connect their terminals to AT&T's network. Hence, it was not long before the monopoly status of AT&T was called into question. In November 1974, the Department of Justice filed an antitrust lawsuit against AT&T. After a hard-fought battle, the two sides reached a settlement in 1982, in which AT&T would divest itself and cease to provide local telecommunications services, but be allowed to compete in the provision of value-added services (VAS) instead.

Following developments in the U.S., the British government also began liberalizing telecommunications services. The idea to liberalize telecommunications services had a great potential to be welcomed by the financial sector which had long demanded for better services, and the public who had become weary of inefficient services and strikes of labor unions at British Telecom.

In this way, the provision of VAS, voice telephony, and infrastructure were liberalized in the U.S. and U.K. by the mid-1980s. But developments in the two countries did not simply spillover to their neighbors, as was seen in the case of air transport services. This was primarily because in the telecommunications sector, most of the services were directed toward domestic users, and users were unable to switch providers due to regulations on international services. The telecommunications sector was based on a regime that allowed a much smaller scope for the convergence of member state preferences than that of the air transport sector.

In the EC, Commissioner for Internal Market Etienne Davignon noticed the rapid development in information and transmission technologies and their potential impact on the European socio-economy. Davignon was also familiar with the fact that new services such as electronic mail and videotext were being developed, and that they could bring down the cost of transmission. However, this knowledge did not lead to the proposal for the liberalization of services and infrastructure, but were directed towards the liberalization of the provision of hardware to enhance the development of technology. Hence, liberalization of telecommunications services was never proposed as a major agenda in the EC until the mid-1980s.³⁹ In fact, it was not so much initiative of the Commission, but developments in the General Agreement on Tariffs and Trade (GATT) that shaped the liberalization process in the EC.

The Uruguay Round and the liberalization of VAS (1985-1990)

In autumn 1982, the contracting states to the GATT agreed to examine a proposal to start negotiations on the liberalization of trade in services which was put forward by the U.S. The ever stronger integration of the computer and telecommunications industries enhanced the development

³⁹ In 1983 the Commission proposed a policy to establish a framework to support the development of advanced services in the private sector, but the Council did not regard it as a priority issue, and declined to adopt it. Thereafter, policy proposals concerning the liberalization of services were not put forward until 1985, when the White Paper on Completing the Internal Market was published.

of VAS, which in turn created a new notion of trade: “trade in services.” Technological development in both industries led to the increase in international transactions, the emergence of multinational enterprises and outsourcing of business activities, thereby increasing the importance of information processing via international networks. It was therefore deemed inevitable that liberalization of telecommunications services, especially VAS, which was highly internationalized and did not fit into the theory of natural monopoly, would be placed on the agenda. Behind the U.S. proposal were ambitions of the AT&T to enter into the international VAS market.

Although the U.S. was well aware of the potentials of liberalizing trade in services and its ramifications to the telecommunications sector, it was not the case for the Commission and the member states of the EC. Following the U.S. proposal, the Commission and several member states conducted a comprehensive review of the service sector for the first time. The report showed the link between trade in services and telecommunications, its potential growth, and the fact that the EC was one of the greatest exporters of services in the world. Among the member states, the U.K., France, West Germany, and the Netherlands were found to be the leading exporters.⁴⁰ In March 1985, the Council decided to support negotiations for services trade under the GATT along with the U.S. The Uruguay Round negotiations began in 1986, and in parallel with the negotiations, the issue of service liberalization finally came to the fore in the EC.

In February 1988, the Commission presented an action plan to liberalize telecommunications services. The aim of the Commission was to swiftly liberalize the services market so that member states could decide on a common position for the new round and also to complete the creation of the internal market for telecommunications by the end of 1992. The Commission proposed two directives: (1) an Article 86 Directive to liberalize services that did not share the characteristics of a natural monopoly, that is, VAS; and (2) a Council Directive to ensure open interconnection between member states, i.e., the Open Network Provision (ONP). As no Article 86 Directive had ever been drafted before, the Commission’s stance caught the member states by surprise.⁴¹

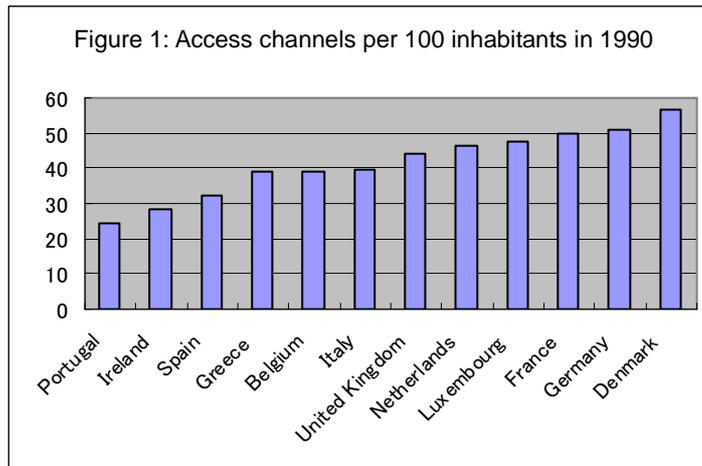
By the mid-1980s, VAS had been liberalized or its liberalization had been at least examined not only in Britain but also in France, Belgium, Denmark, West Germany, and Italy. Since businesses were the primary users of VAS, liberalization was a convenient way for conservative governments to gain support from them. But only the governments in the U.K. and West Germany went so far as to support the liberalization of voice telephony.⁴² Moreover, the rest of the member states had

⁴⁰ William J. Drake and Kalypso Nicolaidis, ‘Ideas, Interest, and Institutionalization: Trade in Services and the Uruguay Round’ in *International Organization* 46 (1) Winter (1992): 52, 57; R. Brian Woodrow and Pierre Sauvé, ‘Trade in Telecommunications Services: The European Community and the Uruguay Round Services Trade Negotiations’ in Charles Steinfield, Johannes M. Bauer and Laurence Caby eds., *Telecommunications in Transition: Policies, Services and Technologies in the European Community* (Thousand Oaks: Sage Publications, 1994): 100; CEC (1985): 26-7.

⁴¹ CEC, *Towards a Competitive Community-wide Telecommunications Market in 1992. Implementing the Green Paper on the Development of the Common Market for Telecommunications and Equipment*. COM (88) 48 final. Brussels: 9 February 1988: 22.

⁴² The reform proposal submitted to the Cole government of West Germany recommended the liberalization the

not even considered the issue of liberalization at that point. Telecommunications services in Southern Europe were not sufficiently developed to adapt to the developments experienced in the U.K. or West Germany. For example, the number of access channels in Portugal was only half of that in Denmark (see Figure 1). This diversity among member states was bound to make the negotiations difficult, and the Article 86 Directive was a convenient way to circumvent delays in the liberalization process.



Source: OECD Telecommunications Online Database.

In December 1988, the Commission announced it will adopt the Article 86 Directive to liberalize VAS. Since only the Council could adopt the ONP Directive, the Council responded by using the ONP Directive to seek concessions on the terms of the Services Directive. The preferences of member states clashed over the appropriate level of liberalization. While the U.K., the Netherlands, Denmark, and West Germany demanded full liberalization of VAS, France, who was accompanied by Southern European states and Luxembourg, wanted basic data transmission services to be exempted from liberalization. In this context, the Uruguay Round negotiations and the active trade policy of the U.S. enhanced decision-making in the Council.

Negotiations concerning the liberalization of telecommunications services started in June 1989 at the Uruguay Round, and it was highly likely that VAS would be the first type of service to be liberalized. In addition, the U.S. expanded its target for liberalization beyond the domestic market from 1988, demanding the EC to open up its market.⁴³ Faced with mounting international pressure, the member state representatives at the December 1989 Council recognized the need to decide on a common position and to liberalize the internal market.

public telecommunications network if it were to impede the development of private operators (Eberhard Witte, 'A history of recent German telecommunications policy' in Harvey M. Sapolsky et al., *The telecommunications revolution: past, present, and future* [London: Routledge, 1992]: 98-101).

⁴³ Woodrow and Sauv , op. cit.: 110.

As a result, the Council and the Commission agreed on a compromise to delay the liberalization of basic data transmission services until January 1993, to allow member states like the U.K. to proceed with early liberalization, while granting countries with low levels of development to defer the implementation of the directive. As has been discussed, many national telecommunications regimes were left relatively immune from liberalization in other countries because sector regimes lacked the spillover mechanism which worked through the market. Instead, the Article 86 Directive, which was legitimized by ECJ judgments in 1991 and 1992, and international pressures acted as a driving force for common policy. The “*deux-vitesses* (two-speed)” approach, which became common in subsequent directives, was a response to such exogenous pressure and the rift among member states preferences.

The GATS negotiations and the liberalization of voice telephony (1990-1993)

During the negotiations of the Services and ONP Directives, member states and the Commission were in agreement not to apply competition rules to voice telephony and construction and operation of infrastructure for the time being. However, the very notion of telecommunications as a natural monopoly was losing ground because of technological development and fundamental reforms in the U.S., U.K., and Japan. Furthermore, the U.S. proposed in December 1991 to liberalize long-distance basic telecommunications services in the Uruguay Round.⁴⁴ Met with fierce opposition from the EC and other countries, the U.S. backed down the proposal. But by that time, the EC had already agreed to include an article in the General Agreement on Services in Trade (GATS) that promised to continue negotiations for further liberalization in the future.⁴⁵ Faced with these developments, it seemed inevitable for member states, albeit reluctantly, to liberalize voice telephony and infrastructure in the near future.⁴⁶

The fact that France Télécom (FT) and the French government became enthusiastic about liberalization was another blow to the states of Southern Europe who were opposed to rapid liberalization. The FT had become a public enterprise with an independent accounting system in January 1991 and was developing joint ventures with Deutsche Telekom to provide international services.⁴⁷ The change in French preference reflected the development in technology. The various technological developments that had been in the R&D or testing stage were now ready for commercialization, and telecommunication services were shifting from fixed voice telephony to

⁴⁴ H. G. Braodman and C. Balassa, ‘Liberalizing International Trade in Telecommunications Services’ in *The Columbia Journal of World Business* 28 (4) (1993): 33-4 cited in Markus Fredebeul-Krein and Andreas Freytag, ‘Telecommunications and WTO Discipline: an assessment of the WTO agreement on telecommunication services’ in *Telecommunications Policy* 21 (6) (1997): 483.

⁴⁵ Woodrow and Sauvé, op. cit.: 102-3.

⁴⁶ CEC, *Communication to the Council and the European Parliament on the Consultation on the Review of the Situation in the Telecom Services Sector*. COM (93) 159 final. Brussels: 28 April 1993: 14-5; Goodman, op. cit.: 177.

⁴⁷ France Télécom and Deutsche Telekom started a joint venture in VAS in October 1991 called Eucom, then decided to establish a company to provide telecommunications network and services to multinational enterprises in March 1993.

mobile telecommunications and from single-function networks to multi-function networks. Mobile telecommunication services had been in service since the 1980s, but the adoption of a new standard, Groupe Spéciale Mobile (GSM), showed prospects for growth of a European-wide market. As for the fixed network, an optic wire was laid down across the Atlantic in 1988, and the introduction of ISDN (Integrated Services Digital Network) by 1992 was agreed in the EC, raising expectations for an emerging market for international data services for multinational enterprises. Surrounded by such environmental change, the objective of France in the GATS negotiations was similar to that of the U.K. and other countries that preferred full liberalization: to gain access to American, Japanese, and Canadian markets even if that required opening up their home market.⁴⁸

Until then, countries such as Spain, Portugal, Greece, Italy, Belgium and Luxembourg⁴⁹ were able to cooperate with the French to lessen the speed of liberalization. But with the French shifting her attitude, albeit less so than the British, it was evident that it would be much more difficult to impede liberalization. The new French government, formed in May 1995, had manifested for liberalization and privatization of the economy. This fueled enthusiasm within the FT for reform, and enhanced the negotiation process in the Council.

After the Denmark Shock in June 1992, the Commission acted less authoritatively, becoming more of a coordinator and mediator, and was more discreet about adopting Article 86 Directives.⁵⁰ But the Commission's discretion was also due to the fact that a consensus towards liberalization in the medium term was formed through negotiations and consultation among the member states and public service operators. Greece, Italy, Portugal, Spain and Ireland have responded that they would agree to the Commission's proposal for full market liberalization by 1998 if they were granted financial assistance from the Structural Fund to develop their networks,⁵¹ which paved the way for concession. As a result, the June 1993 Council adopted a resolution that stated the member states' commitment to liberalize voice telephony by 1998, while allowing countries with lower level of development and small networks to defer the process.⁵²

In this way, the liberalization process of telecommunications services was quite different from

⁴⁸ Alasdair R. Young, *Extending European Cooperation: The European Union and the new international trade agenda* (Manchester: Manchester University Press, 2002): 71.

⁴⁹ These countries are said to have been the most reluctant towards liberalization (Analysys Consultants, *Network Europe: Telecoms Policy to 2000*. Briefing Report Series. European Telecommunications 9. [Cambridge: Analysys Publications, 1994] cited in Goodman, op. cit.: 175-6.

⁵⁰ Goodman, op. cit.: 171-3. In the wake of the Denmark Shock, Competition Commissioner Brittan gave a speech that emphasized the principle of subsidiarity in European integration (Extract from a Speech by Sir Leon Brittan to the European University Institute-Florence, 11 June 1992: Subsidiarity in the Constitution of the EC. IP/92/477). The turbulence within the Commission was also reflected in the review report which was published in October 1992. Although the Commission pointed out the positive economic effect liberalization of voice telephony would bring, it proposed to open up only international calls within the EC for the time being, taking into account the ramifications it would bring to public service operators.

⁵¹ *Tech Europe*. 1 April 1993.

⁵² The resolution stated in principle that markets will be opened by 1998, but also confirmed that countries such as Spain, Ireland, Greece and Portugal, in which network capacity and development was limited and countries with extremely small networks, namely Luxembourg, will be allowed moratorium of up to five years and two years respectively.

that of air transport. Since telecommunications services were mainly directed towards the home market, and access to the network was restricted by regulation, liberalization policies tended to stop at the national level. In countries where telecommunications networks were developed and where they experienced technological development, national sector regimes weakened, but independently. Denmark, West Germany, France, and the Netherlands are an example. But in Southern European countries with underdeveloped networks and countries like Luxembourg with extremely small national networks, national sector regimes were still prevalent. These structural differences created serious rifts within the EC, and often made it difficult to pass directives even by qualified majority voting. The reason why the Commission was able to employ its supranational authority by adopting Article 86 Directives was because there was consistent demand for accelerated liberalization by some member states,⁵³ and because member states recognized the need to adopt a common position for the GATS negotiations.

Conclusion

In order to understand why public services have been liberalized in the EU, the paper investigated how the gradual weakening of national sector regimes led to the liberalization of air transport and telecommunications services at the EU level. Sector regimes of the two services weakened because of technological, theoretical, and economic development that made the former legitimizing logic obsolete and consequently raised the opportunity cost for key actors—incumbent service operators and politicians in particular—to maintain the regime.

But the way liberalization took place in the EU was different according to the vulnerability of the sector regime. In the air transport sector, national sector regimes were based primarily on international agreements and thus, were more vulnerable to policy developments in other countries. When the Dutch and the U.S. governments embarked on liberalization, the policy change spilled over to their neighbors and created a wave of liberalization. This was because the threat of transport diversion raised the opportunity cost for actors in neighboring countries to maintain the regime, thus making liberalization in the EU more attractive for both member states seeking full liberalization and those feeling more reluctant. Since member-state preferences converged in this way, EU institutions did not so much shape the preferences of member states *per se*, but functioned as a facilitator of negotiations at the Council.

On the other hand, liberalization of telecommunications in the U.S. and U.K. did not weaken sector regimes in other countries because sector regimes were based primarily on national

⁵³ After the decision to liberalize voice telephony was made, the Commission adopted three Directives in less than three years, concerning the liberalization of alternative infrastructure, mobile and personal communications and all of infrastructure. The adoption of Commission Directives was strongly supported by Italy, Denmark, the U.K., and Finland who wanted to speed up the liberalization process (Goodman, *op. cit.*: 205-7).

institutions. This expanded the divergence in preferences especially between the more advanced and the less developed member states, hampering liberalization in the EU. In this context, there was increasing role to be played by EU institutions, but with differential impact on the member states. By the early 1990s, there emerged strong demand from several member states, mostly advanced countries, as well as strong international pressure at the GATS negotiations to speed up the liberalization process. Member states seeking accelerated liberalization formed a coalition with the European Commission and employed EU institutions to press liberalization forward, despite the reluctance of member states mostly of Southern Europe. In this case, EU institutions are likely to have pressured the less developed member states into agreeing to liberalization in exchange for financial assistance to develop their telecommunications infrastructure.

Thus, it is plausible to say that EU institutions had a stronger impact on the liberalization of telecommunications services than on air transport. This is because in the case of the latter, the vulnerability of the sector regime accounted for the convergence in member-state preferences. In this way, the paper has shown the relative impact of sector regimes and EU institutions on the liberalization of public services.

In conclusion, the framework of sector regimes allows us to trace and explain the agenda-setting process and preference change of member states in a more dynamic way, and enhances our understanding of the relations between member states and EU institutions. The present analysis opens up a prospect of creating typologies of various liberalization processes and relations between member states and EU institutions that can be tested and refined through additional case studies of liberalization.