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Letter-box companies and abuse of the posting rules: how the primacy of economic freedoms and weak enforcement give rise to social dumping

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Policy recommendations

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The Internal Market legislation that underpins the economic freedoms in the European Union interferes directly with national regulatory frames in the fields of social security, (income) taxation and labour law. In many sectors – including international road transport and construction which are examined in this policy brief – rules are circumvented through the establishment of letter-box companies, while additional risks of social dumping have been created by recent ECJ judgements. All in all, the primacy accorded to the freedom to provide services and the freedom of establishment actually encourages social dumping. Moreover, the ambiguity in terms of which law applies impedes controls and efficient rule enforcement. There is, accordingly, an urgent need for clear, transparent regulation that would enable tighter control of undertakings operating in cross-border contexts, and for closer cooperation between national law-enforcing authorities.

Introduction

The White Paper 'Growth, competitiveness, employment: the challenges and ways forward into the 21st century', issued by the European Commission in 1993, was written as the Commission's answer to economic difficulties faced by EU member states in the wake of creation of the Internal Market. The Commission presented this paper as a blueprint for a medium-term agenda for growth, competitiveness and employment. Having been formulated with the best of intentions, this strategy of promoting economic efficiency and social cohesion was subsequently watered down as a result of poor implementation, lack of enforcement, and the EU institutions' insistence on the primacy of economic freedoms.

This policy brief shows how, given the negative tendencies outlined above, EU Internal Market legislation might represent a threat to national labour and employment standards and could serve to encourage social dumping which is taken here to mean 'the practice (...) of undermining or evading existing social regulations with the aim of gaining a competitive advantage' (Bernaciak 2014).

More specifically, the paper demonstrates how the emphasis on the primacy of economic freedoms has negatively affected the application of EU social security rules and the working conditions of posted workers. The second part of the policy brief discusses the legal ambiguities accompanying the notion of 'genuine undertakings' and some recent cases of abuse of the freedom of establishment through the spread of letter-box companies.

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Social security and working conditions in a cross-border context

The coordination of different national social security systems in cross-border situations has been subject to a dynamic process of legislation and legislative amendment. The coordination was – and still is – based on the so-called *lex loci laboris* principle according to which persons moving within the EU are subject to the social security scheme of one EU member state only, specifically that of the country in which the work is pursued. In accordance with this principle, workers from abroad have the right to be treated as if they were citizens of the host state. An exception to the principle, however, is the so-called 'posting of workers' in the framework of the free provision of services, where workers temporarily stay in another member EU state in order to provide services, but remain subordinate, as employees, to the posting company in their home country. Applicability to posted workers of the coordination principles for social security is assured in the sense that they stay under the home-country rather than the host-country regime; here again, only one country legislation applies.

For pay and conditions of employment in the case of migration for work, the country of employment principle applies; discrimination on grounds of nationality is prohibited. In principle, this means that workers who come to work in a country other than their country of origin on their own initiative have the same rights as host-country citizens and the same possibilities to derive these rights, whether through union membership or any other path to justice. Over time, however, different forms of cross-border recruitment and temporary work abroad have been introduced. In some areas EU legislation has been amended, notably with regard to seasonal and third-country workers, and for daily cross-border commuters a mixture of case law and legislation has been established.

Given the notion that workers posted in the context of temporary services provision abroad are not supposed to seek permanent access to the host country's labour market, their position with regard to the wages applicable for their labour was ambiguous. The legal machinery for making the country-of-employment principle apply across Europe was lacking until enactment of the Posted Workers Directive (Directive 96/71, PWD hereafter). At the time when this directive was issued, the starting point was respect for national social policy frames. There was a hard core of minimum prescriptions. Additionally, EU member states could decide on general mandatory rules or public policy provisions applicable within their territory, as long as these rules did not lead to discrimination or protection of their market. Two court cases in the 1990s – *Rush Portuguesa* and *Arblade* – were seen as the confirmation of EU member states' competence to define the regulatory framework for the protection of all workers who pursue their activities on the country's territory. The PWD thus seemed to provide a possibility to apply, in a non-discriminatory manner, employment conditions that can be seen as public policy provisions in the host country.

Mandatory social provisions no longer under host-state control

However, the relationship between the working conditions of workers involved in temporary cross-border activities and the freedom to provide services soon proved problematic. According to the European Court of Justice (ECJ), backed up by the Commission, it was not up to EU member states to define unilaterally the notion of public policy or to impose all mandatory provisions of their employment law on suppliers of services established in another country. Referring to Council Declaration no. 10 on Directive 96/71T, the ECJ stated in the *Luxembourg* case that rules and requirements that are not specified in the exhaustive list contained in the PWD have to be judged within the limits of the legislator's definition of mandatory rules (Cremers 2010). According to this interpretation, EU member states no longer had the unilateral right to decide on the mandatory rules applicable within their territory, even if these mandatory rules would guarantee better provisions for the workers concerned, and the guiding principles of the PWD were thus no longer effective. The ECJ created a situation whereby foreign service-providers are not required to comply with mandatory rules that are imperative provisions of national law and that, as such, have to be respected by domestic service providers. In this situation Europe 'is no longer a unity of Member States with open markets combined with well-defined national social policy systems (a unity in diversity), but a unified economic bloc with a clear hierarchy: the radical ECJ interpretation of article 49 of the Treaty (now article 56 of the Lisbon Treaty) makes every national host-country mandatory provision in principle a restriction to the free provision of services' (Cremers 2011). The Internal Market directly interferes with national regulatory frames and the *lex loci laboris* principle becomes subject to social dumping pressures.

The abuse of posting regulations

The legal uncertainties outlined above translated into concrete problems of enforcement and abuse. An early assessment of the implementation of the PWD (Cremers and Donders 2004) concluded that the national measures to ensure compliance with the posting rules were not sufficiently well developed. Checking up on whether or not labour regulations were being applied was no straightforward matter; ascertaining whether the undertaking in the home country was a genuine undertaking pursuing economic operations on a stable basis proved very difficult. In practice, it was hard to control in the host country whether the posting was nothing more than the supply of labour or was indeed based on a contract for the provision of genuine services. Host countries had to rely entirely on information from the home country and the crucial cooperation and mutual exchange were absent.

In 2010 a team of experts conducted a new investigation of the operation of the posting rules and identified even greater divergence, compared to the 2003 results, in transposition and application (Cremers 2011). Use of the posting mechanism ranged from perfectly normal and acceptably long-established

partnerships between contracting parties to completely fake letter-box practices consisting of labour-only recruitment. The study found that problems arise as soon as cross-border labour-only subcontracting is presented as the provision of services. Groups of workers are in this way recruited via agencies, gang masters and letter-box companies, advertising and informal networking. Posting has become one of the channels for a cross-border recruitment of 'cheap' labour without reference to the rights that can be derived from the EU law pertaining to genuine labour migration. The resulting concentration of posted workers in the lower echelons of the labour markets entails serious risks, such as the distortion of competition, the erosion of workers' rights and the evasion of mandatory rules. Employment conditions, in particular wages offered to posted workers, if not subject to proper monitoring and enforcement, may undercut the minimum conditions established by the host country's law or negotiated under generally applicable collective agreements and undermine the organisation and functioning of local labour markets.

The notion of a 'genuine' undertaking versus freedom of establishment

One key element for the determination of the applicable rules in cases of free provision of services with temporary posted workers is whether the companies are genuine undertakings. The question remains whether the social security institution in one country has the capacity and the competence to judge the bona fide standing of a company that has a registered office or place of business in another country. EU rules in the field of the social security coordination give some guidance as these refer to an undertaking that ordinarily performs 'substantial activities, other than purely internal management activities, in the territory of the Member State in which it is established, taking account of all criteria characterizing the activities carried out by the undertaking in question' (article 14.2 Regulation 987/2009). If the undertaking's activities are confined to internal management, it will not be regarded as normally carrying out its activities in that EU member state. Moreover, account must be taken of several other criteria characterizing the activities carried out by the undertaking in question. For the transport sector this was further specified in Regulation 1071/2009 and in a practical guide issued by the Commission in 2012.

These notions, however, do not seem to have a serious impact on the policy related to the freedom of establishment developed by other Commission services, notably by DG Internal Market and DG Competition. The latter two are firm promoters of free establishment with limited possibilities for countries other than the country of establishment to control the genuine character of undertakings. The dominant policy of the Commission is thus to ease the provisions governing the establishment of service providers at home or abroad; restrictions of the freedom of establishment have to be objectively justified in accordance with ECJ case law. In the *Laval* and *Luxembourg* rulings, the application and control of the host country labour standards are qualified 'restrictions to the free provision of services';

additional administrative domestic rules should not hinder this free provision. As a consequence, countries are hindered and discouraged from controlling foreign undertakings and there is no strict guidance on how to deal with violations. At the same time, the Commission is very active with infringement procedures every time a country creates 'barriers for the free provision of services'.

On the basis of EU legislation and ECJ jurisprudence, the freedom of establishment makes it possible for firms to be founded in accordance with the law of one EU member state, and to have their registered office, central administration or principal place of business in another EU member state. The relevant legislation in this area does not provide direct effective instruments to enforce such provisions and to facilitate the fight against abusive practices. As a result, there is hardly any effective control of whether an established subsidiary pursues activities or is involved in no real activity. Companies can install a considerable part of their legal frameworks in other EU member states without pursuing any activities there. This can be seen as a by-product of legislative interest in allowing companies the benefit of freedom of establishment by way of Article 49 of the Treaty. Concrete instances of this type of abuse are presented below.

Social dumping in action: international road transport

In 2011 several transport companies in the Benelux countries received the offer to transfer their workforces to intermediate companies located in Cyprus and Liechtenstein, and to hire the staff through these intermediate service suppliers. With reference to the changes in the coordination of social security as a result of Regulations 883/2004 and 987/2009, the intermediaries offered to act as employers for the workforce. The original employer of the truck drivers would become the 'client' and would receive an invoice for supply of services, whilst the truck drivers would continue to work de facto for the original employer. By opening an office abroad – for instance in Cyprus – the intermediaries claimed that it was justifiable to offer a Cypriot employment contract to the truckers, even though they did not live there and never visited the island.

The use of such go-betweens constitutes a clear instance of social dumping: it is an ideal way to save money, as it allows lowering of social security costs and avoidance of taxes. It means no employer costs for the original employer, no health and safety services, no wage indexation, the denial of a labour relation between client and driver, and no trade union involvement. Hence, the freedom of establishment makes it possible to open in another country a company that has no staff and no activities in the country of registration, consisting of an office that is nothing more than a letter box.

Similar examples abound. In a 2012 court case, the Dutch transport union accused a company of letter-box practices. The drivers, mainly Hungarians, were directly engaged by the Dutch headquarters. However, they were on the payroll

of a Hungarian subsidiary based in one of the premises of PricewaterhouseCoopers in Budapest that had one half-time administrative employee on parental leave, with all formalities handled by PWC. There were no trucks stationed in Hungary, but the truckers were subjected to constant pressure because the 'Hungarian way' was cheaper. In yet another case, the German-Latvian agency Dinotrans recruited workers from the Philippines, in fact third-country workers not entitled to enter the EU. However, they were recruited using the argument of 'a shortage of skilled labour for international trucking' in Latvia, this being one of the reasons on the basis of which permission for such workers to enter the EU may be granted. As soon as they entered Latvia the drivers in question were hired out to other undertakings in Europe. The company's own financial statements recorded that the haulage contractor was paying these drivers approximately €2.36 per hour, making this practice tantamount to slave labour.

Apart from tax evasion, the abuses discussed here are related to denial of the labour contract and circumvention of statutory social security contributions. Recruitment of 'cheap' labour has thus become a new business practice and the creation of a maze of such companies all over Europe is one of the best ways to circumvent national standards and regulations. Freedom of establishment and the deregulation of company law, in particular easy registration and the lowering of other statutory obligations, have opened doors for these fraudulent intermediaries. The labour contract is based on the 'official' address in the registered office of the intermediary, in other words, a fictitious firm in an obscure office in a country with neither activity nor turnover; meanwhile, the risk of inspection is almost zero.

In the cases listed, the fact that the labour relation with the original employer is maintained is often patently obvious. This does not mean, however, that it is easy for a worker to derive his employment rights based on the *lex loci laboris* principle. In one case a truck driver was fired by the old employer (referred to as the 'client'); a week later, he received a confirmation from the Cypriot intermediary that he was no longer needed. The confirmation letter was typed on stationery of another letter-box company based in Luxembourg, posted with a Dutch stamp, using a Belgian standard form to notify dismissal. How can a worker possibly stand up for his interests within such a maze of clashing constituencies?

Conclusions

EU labour mobility has prompted a series of debates about the application of home- versus host-country legislation, especially regarding the treatment of persons who temporarily pursue activities in one or more EU member states other than their country of origin. The freedom of establishment has created an industry of incubators able to deliver ready-made companies whose sole purpose is to circumvent national regulations, labour standards and social security obligations. The first indications of bypassing of the applicable rules through the establishment of letter-box companies gave rise to question marks about the

role of cross-border labour recruitment and the possibility of upholding the *lex loci laboris* principle in the field of labour law and pay. Non-compliance, the lack of cross-border cooperation, the difficulty of monitoring cross-border labour posting and recruitment and of identifying cases of circumvention in cross-border situations, alongside the weakness of the existing sanctioning mechanism, lead to frustration on the part of rule-enforcing institutions and other stakeholders.

In theory, the EU has started to tackle this problem. However, workers who are exploited in a foreign constituency live and work at a far remove from such theoretical action. Their possibilities of deriving rights from highly abstract judicial deliberations are neither ready-to-hand nor easily obtainable. As such, prevention and anticipation need to come from labour-market-oriented instruments constructed by the institutions and bodies that have built up the conventional and legislative framework governing working conditions. It is important to be able to verify, in both law and practice, whether a worker is being correctly treated, and to decide about liability in cases of fake self-employment and/or fake posting. It is necessary to create firm regulations that define the real and genuine undertaking and to implement liability schemes in case of fake posting by letter-box companies or bogus self-employment. A more effective execution of sanctions in cross-border situations and closer co-operation among labour inspectorates is needed. In order to establish a level-playing field for service providers and to avoid social dumping and distortion of competition for domestic service providers, the EU needs an ambitious social agenda, including the prevention of fraud and abusive practices. The primacy of the economic freedoms, notably the freedom of establishment and the freedom to provide services, has so far obstructed the political proposals required to this end.

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