The Impact of Legislation and Regulation on the Freedom of Movement of Capital in Estonia, Poland and Latvia

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By

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To my family, especially my mother, for loyalty and support
in the preparation for and writing of this work.

Europe stands on the threshold of a new millennium. We face the challenge of integrating the continent's various countries and regions, and of modernising our societies.
—Dr. Vaira Vīķe-Freiberga, 6th President of Latvia 1999-2007

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PREFACE

The idea behind the research described in this book represents a convergence of two professional subject interests – the laws describing the Internal Market of the European Union and the economic development of countries. The following paragraphs show how this confluence occurred.

One of the fundamental freedoms of the Internal Market is the free movement of capital. According to Article 56 of the Treaty Establishing the European Communities, (which has recently been recategorised as Article 63 of the Treaty on the Functioning of the European Union), restrictions on the movement of capital and payments between European Union Member States and between these countries and those outside the European Union shall be prohibited, subject to certain exceptions. This inspired piece of legislation should, in theory at least, improve conditions for cross-border business to take place, both within the Union and between the Union and countries outside it. But does it do so in practice?

A method for considering this issue is to relate the removal of national restrictions to the free movement of capital to the cross-border capital flows to and from selected Member States of the European Union. Countries that are advanced in terms of economic development tend to have higher cross-border capital flows per person than those that are less industrialised, other things being the same. The countries of the former Soviet Union and Warsaw Pact have been, and are still in some instances, transition economies from a less-developed command system to a more-developed free market system. Several of these countries have recently joined the European Union, including the three Member States that are the subject of this book.

The study of the movement of capital to and from Estonia, Latvia and Poland in this context provides the link being sought – between the Internal Market and economic development. First, ascertain the precise details of the European Union Law governing the free movement of capital. Second, develop a method to compare these provisions with the national laws limiting such movement. Third, identify the Estonian, Polish and Latvian laws restricting it. Fourth, develop a method to compare the national laws. Fifth, make this comparison, and from it, construct a legal index that measures national legal restrictions to cross-border capital movement. This index can then be compared with the capital flows to and from the three Member States. Some other factors affecting these flows are identified, too, and a reasonable explanation is given as to the role that the removal of national restrictions might have had on cross-border flows in the period 1998-2007.

This is exciting new ground, which is potentially extendible to other European Union Member States, and provides a framework for concentrated study of some of the business sectors in which the restrictions to the free movement of capital were identified. One senior professor of economics at the School of Oriental and African Studies, University of London, at which the research was conducted, was sceptical of this cross-disciplinary approach. His main objection was that a rigorous econometric analysis with panel data should have been undertaken, and, therefore, in the absence of such a method, the conclusions did not have the generality claimed.

This type of comment, whilst valid in itself, misses the whole point of the exercise. The research is exploratory, and connects two related items but in different orders. The first is the literal concept of deviation in the national legislation and regulations of Member States from the free movement of capital provisions of European Union Law. The second is the numerical concept of cross-border capital flows. The common theme is that both concepts relate to the same subject matter – the cross-border movement of capital. The research described does indeed explore the relationship between these concepts in some depth, and, by doing so, adds a considerable input to the research base in this developing area.

Econometric studies have been performed to measure the impact of laws on economic variables. Some of these by Dr. Raphael La Porta and his colleagues, leading proponents of this approach, are included in Appendix F. There are some technical shortcomings in the methodology, which are outlined there. Consequently, one would hesitate to follow it before a more thorough approach has been conceived, tested and applied.

Please feel free to come to a view on the value of this research, both in its methodology and in its findings. Improvements can always be made. If there are any specific issues which the reader wishes to raise concerning the work, then I am available at gb23@soas.ac.uk. In the meantime, I hope that the contents of this book at least equal, and even exceed, your expectations.

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LIST OF ABBREVIATIONS

Annex I	Annex I to Directive 88/361/EEC
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
ECJ	European Court of Justice
ECR	European Court Reports
EC Treaty	Treaty Establishing the European Communities
EEA	European Economic Area, comprising the European Union, Iceland, Liechtenstein and Norway
ELLC	Estonian Legal Language Centre
EU	European Union
FCMC	Latvian Financial and Capital Market Commission
FDI	Foreign Direct Investment
FSA	Estonian Financial Supervision Authority
FSC	Polish Financial Supervision Commission / Authority
GDP	Gross Domestic Product
IMF	International Monetary Fund
LTTC	Latvian Translation and Terminology Centre
Member State	Member State of the European Union
MNCs	Multinational corporations
NEER	Nominal Effective Exchange Rate
OECD	Organisation for Economic Cooperation and Development
PAAS	Prior Administrative Authorisation Scheme
PPP	Purchasing Power Parity
Third countries	Countries outside the European Economic Area
VLTL	Vorarlberg Land Transfer Law
WTO	World Trade Organisation

Abbreviations for Estonian legislation and regulations

Chapter 3 and section 8.2.1

CIA	Credit Institutions Act 1999
IAA	Insurance Activities Act 2004
IFA	Investment Funds Act 2004
ITA	Income Tax Act 1999
LPA	Law of Property Act 1993
PILA	Private International Law Act 2002
Regulation No.73	Regulation No.73 of the Minister of Finance of 19 November 1997
SMA	Securities Market Act 2001

Sections 1.3.2, 4.1.7, 4.3.3, 5.1.8, 5.3.3 and 7.2.2

ECIA	Credit Institutions Act 1999
EIAA	Insurance Activities Act 2004
EIFA	Investment Funds Act 2004
EITA	Income Tax Act 1999
ESMA	Securities Market Act 2001

Abbreviations for Polish legislation and regulations

Sections 2.5.2 and 8.2.2, and chapter 4, excluding section 4.1.7

AIPFPA	Act of 24 March 1920 on the Acquisition of Immovable Properties by Foreign Persons
BL	Act of 29 August 1997: Banking Law
FEAA	Act of 28 February 2004 on Freedom of Economic Activity
FEL	Act of 27 July 2002: Foreign Exchange Law
IAA	Act of 22 May 2003 on Insurance Activity
IFA	Act of 27 May 2004 on Investment Funds
IMA	Act of 22 May 2003 on Insurance Mediation
LPITA	Act of 15 February 1992 on Legal Persons' Income Tax
NPITA	Act of 26 July 1991 on Natural Persons' Income Tax
POA	Act of 29 July 2005 on Public Offers and the Conditions for Introducing Financial Instruments to the Organised Trading System, and on Public Companies
RGFEP	Regulation of the Minister of Finance of 3 September 2002 on General Foreign Exchange Permits

TFIA	Act of 29 July 2005 on Trading in Financial Instruments

Sections 1.3.2, 4.1.7, 5.1.8, 5.3.3, 5.4.6, 6.2.1 and 7.1.4

PAIPFPA	Act of 24 March 1920 on the Acquisition of Immovable Properties by Foreign Persons
PBL	Act of 29 August 1997: Banking Law
PIAA	Act of 22 May 2003 on Insurance Activity
PIFA	Act of 27 May 2004 on Investment Funds
PIMA	Act of 22 May 2003 on Insurance Mediation
PLPITA	Act of 15 February 1992 on Legal Persons' Income Tax
PNPITA	Act of 26 July 1991 on Natural Persons' Income Tax
PPOA	Act of 29 July 2005 on Public Offers and the Conditions for Introducing Financial Instruments to the Organised Trading System, and on Public Companies
PTFIA	Act of 29 July 2005 on Trading in Financial Instruments

Abbreviations for Latvian legislation and regulations

Section 8.2.3 and chapter 5, excluding sections 5.1.8 and 5.3.3

AIRIL	Activities of Insurance and Reinsurance Intermediaries Law 2005
CIL	Credit Institution Law 1995
FIML	Financial Instrument Markets Law 2003
FPRL	The Free Port of Riga Law 2000
FPVL	The Free Port of Ventspils Law 1996
LEIT	Law on Enterprise Income Tax 1995
LIC	Law on Investment Companies 1997
LICST	Law on Insurance Companies and Supervision Thereof 1998
LLRCRL	Law on Land Reform in the Cities of the Republic of Latvia 1991
LPIT	Law on Personal Income Tax 1993
LPLRA	Law on Privatization of Land in Rural Areas 1992
LPPF	Law on Private Pension Funds 1997
LSFP	Law on State Funded Pensions 2000
RICIOL	2002-08-15 Regulations on the Issue of Credit Institution and Credit Union Operating Licences

Sections 5.1.8 and 5.3.3

LAIRIL	Activities of Insurance and Reinsurance Intermediaries Law 2005
LCIL	Credit Institution Law 1995
LFIML	Financial Instrument Market Law 2003
LLEIT	Law on Enterprise Income Tax 1995
LLIC	Law on Investment Companies 1997
LLICST	Law on Insurance Companies and Supervision Thereof 1998
LLPIT	Law on Personal Income Tax 1993
LRICIOL	2002-08-15 Regulations on the Issue of Credit Institution and Credit Union Operating Licences

Legal subsidiary indices in chapter 7 and appendix A

D:I	legal restrictions on capital inflows
D:O	legal restrictions on capital outflows
L:EEA	legal restrictions on intra-EEA capital flows
L:TC	legal restrictions on capital flows to/from third countries
S:InvF	legal restrictions on investment funds' capital flows
S:InvS	legal restrictions on capital flows concerning investment services
S:CI	legal restrictions on credit institutions' capital flows
S:InsS	legal restrictions on capital flows concerning insurance services
S:InsM	legal restrictions on capital flows concerning insurance mediation
S:T	legal restrictions on capital flows concerning taxation
S:L	legal restrictions on capital flows concerning real property transfers

Abbreviations used only in appendix F

F,G&S	French origin, German origin and Scandinavian origin regression variables
GNP	Gross National Product
IPO	Initial Public Offering of equity shares
LP1	La Porta et al. (2003a)
LP2	La Porta et al. (2003b)
LP3	La Porta, Lopez-de-Silanes, and Schleifer (2006)
OLS	Ordinary Least Squares regression
2SLS	2-Stage Least Squares regression

CHAPTER ONE

ISSUES CONCERNING THE EFFECT OF LAWS ON CAPITAL FLOWS

1.1 What is the purpose of the research?

On 1st May 2004, ten new Member States joined the EU. The majority of these countries were members of the Warsaw Pact until its abolition in 1990, and three were part of the Soviet Union.

In 1998, the EU entered into accession talks with these countries for membership. The main condition for membership was acceptance and implementation of the 'acquis communautaire' – the substantial body of Treaty provisions, Regulations, Decisions and Directives and case law already in force in the EU.[1]

One substantial part of the acquis communautaire consists of the legislation to create the Internal Market, which is characterised by the removal of barriers to the free movement of goods, persons, services and capital between Member States.[2] This book concerns the free movement of capital legislation (Articles 56–60) of the EC Treaty.

I selected three from the ten accession countries of 2004 to study the national legislation and regulations, identify differences between the EU and national laws, and compare those differences with the capital flows into and out of these countries. I chose Poland because it is the largest economy in Central and Eastern Europe,[3] Estonia because it is the most advanced country in the former Soviet Union,[4] and Latvia because it completes a triad of north-eastern European countries.

The national financial services legislation must comply with the corresponding Directives – 2004/39/EC for investment firms, 2006/48/EC

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[1] See section 1.3.1.
[2] See section 1.2.3.
[3] This excludes Germany, since the reunified Germany's economy remains largely driven by the western region.
[4] Estonian gross domestic product per capita was US$ 9,598 in 2005, highest of the former Soviet republics (United Nations Statistics Division, 21 June 2007).

for credit institutions, and 73/239/EEC, 88/357/EEC, 2002/83/EC and 2002/92/EC for insurance companies.[5] As I analyse such legislation and its related regulations in chapters 3, 4 and 5 for barriers to the free movement of capital, it is but a step further to comment on compliance with these Directives. Both are important contributions to the alignment of national laws with the acquis communautaire, which, by joining the EU, constituent Member States are obliged to implement.[6]

The book compares the cross-border capital movement restrictions in Estonia, Poland and Latvia, and analyses the effect of the limitations on capital flows to and from these countries. As there are other determinants of such capital flows,[7] the effect of legal barriers is difficult to establish in practice. Nonetheless, it is interesting to investigate for the EU and, potentially for other regional trade blocks, whether free movement of capital laws increase cross-border flows. This research makes an initial attempt to do just that.

1.2 Why legislate to remove cross-border capital restrictions?

It must first be established whether, on balance, it is beneficial for a country or trade block to lift its barriers to cross-border capital flows. Since the free movement of capital is part of the Internal Market, Member States have an additional powerful incentive to remove restrictions to these flows.

1.2.1 Reasons in favour of the free movement of capital

The free movement of capital stimulates cross-border trade and investment, which may increase the rate of economic growth.[8] Investment

[5] These are described in section 2.4.

[6] If an Article of a Directive limits the free movement of capital, Member States tend to follow the Article. Conflict between the EC Treaty and Directives was discussed at the United Kingdom Association for European Law conference on 28 April 2007, but there were no firm conclusions to this debate. Section 8.2.4 discusses alternative solutions to a situation in which a provision of a Directive restricts the free movement of capital.

[7] See Appendix E.

[8] The Harrod-Domar and two-gap models incorporate the positive effect of capital inflows on growth, and the Solow growth model has been applied to international capital movements. There are also two groups of optimization models: the representative consumer approach in which the economy is treated as a single unit

may also fund training and/or raise the level of exports in the sector concerned, although the latter may cause the terms of trade to deteriorate.[9] Free capital movement across the EU also encourages the formation of companies with subsidiaries and branches in other Member States,[10] and lowers the cost of investment for financial asset providers in such States.[11]

Cardoso and Dornbusch describe the following effects of capital inflows.[12] Firstly, such inflows raise the economy's productive capacity, thereby potentially increasing welfare.[13] There is an increase in national income, whose size is quadratically related to the share of capital in the income accruing to domestic factors of production, and inversely correlated with the elasticity of substitution between capital and other such factors.[14]

Secondly, capital inflows may smooth consumption in two contexts. 1) Cyclical fluctuations: one can borrow when disposable income is lower than consumption, and repay when income rises. 2) Growth in per capita income: foreign loans can finance investment so that income exceeds consumption and domestic savings increase; later, such savings fund investment and the loans are repaid.

Thirdly, capital inflows lower the scarcity of capital, thereby raising the factor productivity for domestic factors as a whole. Where such inflows are accompanied by immigration, returns to land increase whilst the income of local capital and labour tend to fall – the effect on factor prices depends on technology and on the relative change in the domestic capital stock and labour supply.

Fourthly, if there is a foreign exchange gap, foreign capital goods are too expensive to be purchased by exports and the real exchange rate must depreciate. Capital inflows may alleviate real price rigidity and/or costly adjustments to relative prices, by providing foreign exchange and raising investment for economic growth. In the two-gap model, the capital inflow

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over time, and the life-cycle approach in which 'younger' consumers earn and save and 'older' consumers do not.

[9] See section 1.2.2.

[10] The free movement of capital therefore complements the freedom of establishment.

[11] The cost of investment includes taxes and administration expenses.

[12] *Handbook of Development Economics*, Volume II, 1989, 1404–1419.

[13] Capital inflows may lower welfare: see section 1.2.2.

[14] The domestic gain is the following fraction of national income: $(1 - \alpha)\ \alpha x^2 / 2\sigma$, where x is the proportionate rise in the capital stock, α is the share of capital in income to domestic factors, and σ is elasticity of substitution. This neoclassical model also predicts a gain to foreign investors.

moves the foreign exchange constraint to the right, thereby raising the growth rate and the ratio of domestic to foreign prices.[15]

1.2.2 Reasons for retaining barriers to capital flows

Capital flows may destabilize macroeconomic conditions within a country. An example is Chile, which implemented a financial liberalization program in the 1970s–1980s. After a period of high growth, the capital account of the balance of payments was opened to medium and long-term international capital movements. There was a large capital inflow, causing the exchange rate to appreciate. Expenditure on imports rose, creating a current account deficit. As the rate of capital inflow declined, a real devaluation of the peso was required to raise the competitiveness of the export sector. Since the nominal exchange rate was pegged to the strong dollar, and since Chile had a law which prevented reduction in real wages, there was initially no devaluation, and output declined rather than prices. The next year, the government devalued the peso, causing a loss of international reserves and lower capital inflows. As inflation was relatively low, there was a real devaluation and competitiveness was regained.[16]

One factor present in Chile's experience is deterioration in the terms of trade, since the exchange rate appreciation made exports and import-competing products more expensive relative to imports.[17] Drs. Raúl Prebisch and Hans Singer believed that the terms of trade had moved against primary products during the early 20th century, a trend which continued into the latter half of the century.[18] A rise in capital inflows to a developing country in these circumstances is counterproductive, stimulating the purchase of imports with the additional burden of debt repayment.

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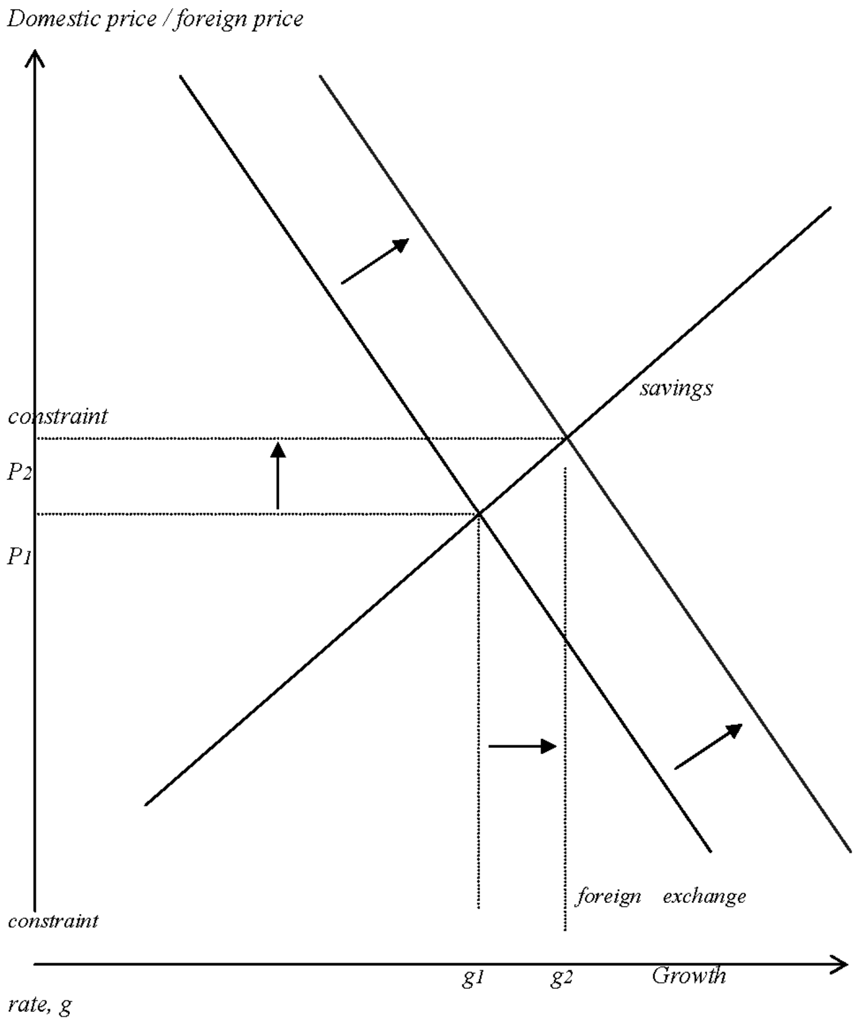
[15] Fig. 1-1 is adapted from Cardoso and Dornbusch, *Handbook of Development Economics*, figure 26.6, 1418.
[16] Edwards (1985), *Economic Development and Cultural Change*, 33, 223–254.
[17] The terms of trade are the price of exports divided by the price of imports.
[18] Cypher and Dietz (2004), *The Process of Economic Development*, 162–169. Many developing countries have traditionally been net exporters of agricultural products, a trend which changed to some extent with the introduction of import substitution industrialization (ISI). ISI has been partially but not totally successful.

Fig. 1-1: The two-gap model: a capital inflow shifts the foreign exchange constraint to the right.



Cardoso and Dornbusch state two cases in which capital inflows reduce welfare.[19] 1) If capital inflows enable the expansion of an industry with monopoly power in the export sector, the terms of trade deterioration due to the rise in the price of exports may, in the absence of an optimum tariff, reduce national income. 2) Tariff or tax distortions may, through general equilibrium effects, cause capital inflows to contract an industry that is already underproductive. These welfare-reducing cases are an exception to the general principle that capital inflows tend to raise national income.[20]

Capital flight–the mass transfer of investment from domestic to foreign assets[21]–is a potential problem for countries in financial distress. The main determinants of capital flight are real exchange rate appreciation and/or currency overvaluation, a high and/or rising inflation rate, the expectation of currency devaluation, and a low domestic interest rate relative to the world interest rate.[22] Controls on capital outflows are essential for countries with these characteristics.[23] Investors may move their assets abroad in response to high domestic taxation or political risk (of expropriation, for instance),[24] or because local financial markets are volatile.

There are also difficulties with debt and FDI. Debtor countries may be unable to make debt repayments, especially after adverse economic shocks. The debt crisis of the 1980s was precipitated by the oil price rises

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[19] *Handbook of Development Economics*, 1407–1408.

[20] See section 1.2.1.

[21] 'Capital flight' may be narrowly defined as short term capital outflows or broadly defined as the gross value of all capital outflows. The broad definition more accurately describes capital flight because many outflows are long term; for instance, some white South African residents invested abroad after termination of the apartheid regime to safeguard their assets. In estimating capital flight from selected countries from 1979–1982, the World Bank uses a broad definition: gross capital inflows plus the current account deficit less increases in official foreign reserves (Eaton (1989), *Handbook of Development Economics*, Volume II, 1353), leaving gross capital outflows as the residual term. The definition of 'capital flight' used by Cuddington (1986), *Princeton Studies in International Finance*, No. 58, 1–40 is more specific and his investigation covers 1974–1982, but both studies conclude that Argentina, Mexico and Venezuela displayed the highest levels of capital flight.

[22] Cuddington, *Princeton Studies*.

[23] Brazil, Chile and Peru retained some capital controls during 1974–1982, which prevented more extensive capital flight, given their inflation and exchange rate movements in this period (Cuddington, *Princeton Studies*).

[24] Cardoso and Dornbusch, *Handbook of Development Economics*, 1423.

of the 1970s and the worldwide economic recession of the early 1980s. In non-oil producing developing countries, export volumes and prices declined and the current account balance worsened. Real appreciation of the dollar raised the real value of developing countries' debt repayments, since their currencies were pegged to the dollar or to a basket of currencies. In Latin America, repayment problems were so severe that debt restructuring and forgiveness from the commercial lenders under the guidance of the Brady plan and market reforms supervised by the International Monetary Fund were required to restore economic health.[25]

Governments may incur problems by permitting FDI from MNCs. MNCs may 1) lower domestic savings and investment by smothering competition, extracting profits and providing income for people with a low propensity to save but a high propensity to import; 2) reduce foreign exchange earnings by importing intermediate and capital goods, and by repatriating profits, interest, royalties and management fees; 3) increase income inequalities by widening wage differentials, manufacturing advanced products for the local elites and operating in urban areas; 4) introduce inappropriate products and technologies and 5) use non-arm's length transfer prices in intra-firm transactions.[26]

1.2.3 The Internal Market

The free movement of capital is one of the four fundamental freedoms provided by the EC Treaty, the others being the free movement of goods, persons and services. These freedoms are part of the EU's Internal Market, whose completion by December 1992 also required the removal of internal frontier controls and the approximation of indirect tax rates.[27] Initially the free movement of capital was not intended to apply directly, but to facilitate, by way of Directives, the formation of a common market in financial services.[28] Today, the free movement of capital is stated by

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[25] Pilbeam (2006), *International Finance*, 377–407. Although their export levels and inflation rates have recovered from the debt crisis, the total external debt in each of the four biggest debtor countries (Argentina, Brazil, Mexico and Venezuela) was higher in 2002 than it was in 1982, when the crisis began.

[26] Cardoso and Dornbusch, *Handbook of Development Economics*, 1413–1414. FDI may provide superior technology to local firms and economies of scale in marketing, and increase competition (ibid., 1407). The benefits and drawbacks are specific to each case.

[27] EC Commission (1985), 'Completing the Internal Market', COM(85) 310 final, 1–2, 9 and 51–54.

[28] Ibid., 32–33. This freedom was referred to as a 'secondary freedom'.

Article 63 of the Treaty on the Functioning of the European Union,[29] and stands on an equal footing with the other freedoms.

Comment

The requirement for Member States to remove barriers to capital flows to and from other States and third countries as part of implementing the Internal Market (with certain exceptions),[30] renders academic the question as to whether States should retain them. Nonetheless, the arguments in section 1.2.2 are persuasive for countries that wish to borrow to fund investment and which have, or expect to have, high or rising inflation rates and/or real exchange rates. Estonia, Poland and Latvia have not yet joined the Euro, so these conditions can still occur.[31]

1.3 The comparison of national law with European Law

1.3.1 Implementing the acquis communautaire

All aspiring EU Member States must implement the body of Treaty provisions, Regulations, Directives and case law that exists at the time of their accession to Membership – 1st May 2004 for Estonia, Poland and Latvia. This is a legal transplantation of EU law onto national law, and has implications of harmonisation of national law with that of other Member States. These issues are discussed below.

Legal transplants

Before the Enlightenment, European laws moved geographically, though usually with peoples – Germans into Poland, Normans into

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[29] Until the recent implementation of the Lisbon Treaty, the relevant provision was Article 56 of the EC Treaty, which was identical to the new Article 63. Since all of the research for this book was undertaken before introduction of the Lisbon Treaty into EU law, this measure is referred to as 'Article 56, EC Treaty' throughout.

[30] See section 2.1.3.

[31] High Latvian inflation (8.5% annually to March 2007) may prevent Latvia from joining the Euro before 2011 (EUbusiness.com, 28 June 2007). Estonia's high inflation rate has caused it to postpone adoption of the Euro to beyond 2009 (Bank of Estonia (2007), 'Report on the Adoption of the Euro', 6). A recent Communication from the Commission of the European Communities confirms that Latvia and Poland have no target date for adopting the Euro, and that Estonia is aiming to join on 1 January 2011 (COM/2009/692 final, 3, 4 and 6).

England, English into Ireland, and all of these peoples into foreign territories as part of colonisation. However, this spatial movement of law was perceived by the participants as a growing area of influence rather than as a transplant. Legal rules were considered to be models that could be used or not in specific cases.[32]

Alan Watson considers that the growth of law is primarily to be explained by the transplantation of legal rules. Watson investigates the spread of Roman law across Europe, noting the persistence of Roman legal rules into the present time. He states that the rules of Roman law have been transplanted in bulk into most continental European countries and are the foundation of their legal systems.[33] Watson argues that legal transplants are the main method for legal change in Western countries because the law is conservative and backward-looking. The law is such because the legal profession tends to treat legal rules as ends in themselves, with the sources of law being regarded as given, almost sacrosanct.[34]

William Twining states that most literature on legal transplants is in the ‘Country and Western Tradition’ of comparative law,[35] and that a broader perspective is required. He perceptively observes that legal diffusion studies have shared origins with 19th century sociology and anthropology, but that such studies have lost touch with literature in other social sciences concerning the diffusion of innovations, language, music, religion and sport, which may enlighten enquiries into legal diffusion. Twining recommends adoption of a global view and a broad notion of law, covering different levels of ordering and relations.[36]

Twining’s perspective of different levels is applicable to the implementation of EU law in Member States, for such law is of a higher level than the national rules of Member States, since these rules must

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[32] Glenn (2006), *Journal of Comparative Law*, 1, 124–130.

[33] Watson (1974, 2nd edition 1993), *Transplants: An Approach to Comparative Law,* cited in Ewald (1995), *American Journal of Comparative Law*, 43, 489–510. These countries are ‘civil law’ families, a distinction used in contrast to ‘common law’ families by La Porta et al. in their leximetric studies – see Appendix F.

[34] Watson (1985), *The Evolution of Law,* cited in Ewald, *American Journal.*

[35] This tradition concerns positive laws and national legal systems, focuses on Western capitalist societies, is primarily concerned with common law / civil law differences, legal doctrine and private law, and involves description and analysis in preference to evaluation and prescription.

[36] Twining (2006), *Journal of Comparative Law,* 1, 3–26. Such different levels include, for example, the adoption of international norms into national law, such as the incorporation of the European Convention on Human Rights into the United Kingdom Human Rights Act 1998.

comply with it.[37] In as far as EU law has direct effect,[38] there is no change in the national law of Member States other than repealing incompatible provisions.

However, a more interactive legal transplantation occurs for Directives than for EU Treaty provisions and Regulations both because Directives must be transposed into national law and because of the principle of indirect effect.[39] Although the resulting national law must comply with EU law, it is in the context of the Member State's legal system, which may affect what form the domestic law takes – i.e. the transposed Directive may be transformed in the local environment.[40]

Harmonisation

The EC Treaty does not refer exclusively to 'harmonisation' of laws. Articles 94 and 95(1) use 'approximation' of laws instead, which conveys a lesser degree of uniformity than harmonisation. Confusion is caused, however, by the use of the term "harmonisation measure" in Articles 95(4) and 95(5), which refer to a measure adopted under Article 95(1).

Article 94 empowers the Council to issue Directives to approximate the laws, regulations or administrative provisions of Member States that "directly affect the establishment or functioning of the common market". The Council must act unanimously on a Commission proposal. By contrast, Article 95(1) authorises the Council acting by qualified majority on a Commission proposal (under the co-decision procedure)[41] to adopt

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[37] In *Amministrazione delle Finanze dello Stato v Simmenthal SpA (No.2)* [1978] ECR 629, the ECJ stated that a national court must set aside a legal rule that conflicts with a provision of Community law.

[38] To have direct effect, an EU provision must 1) be clear and unambiguous, enabling the national court to identify the rights and obligations of individuals, 2) be unconditional, and 3) require no further action from EU and national authorities (*Van Gend en Loos v Nederlandse Tariefcommissie* [1963] ECR 1). The ECJ has extended the principal of vertical direct effect (i.e. rights conferred on individuals against national institutions) to Directives (*Van Duyn v Home Office* [1975] ECR 1337).

[39] The principle of indirect effect states that national courts are required to interpret their national law in the light of the purpose and wording of the Directive, especially if that law is specifically enacted to implement the Directive (*Von Colson v Land Nordrhein-Westfahlen* [1984] ECR 1891).

[40] The countries studied tend to transpose the financial regulation Directives (see section 2.4) into national law almost word for word (see sections 3.1, 4.1 and 5.1); i.e. there is little transformation of the Directives' content on placement in the national legal systems.

[41] Article 251, EC Treaty.