The Free Movement of Capital and Financial Services

The Free Movement of Capital and Financial Services: An Exposition?

By

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

[I]n examining the cross-border out-shopping phenomenon, we postulate that those consumers who engage in international (cross-border) out-shopping exhibit low levels of economic patriotism.

—Dmitrovic, T. and Vida, I. (2007), 'An examination of cross-border shopping behaviour in South-East Europe', *European Journal of Marketing*, 41(3/4), 382-395, 386.

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PREFACE

The time has come to review the laws that relate to cross-border capital flows within the European Economic Area. There have been changes in European Law, as a result of the introduction of the Treaty on the Functioning of the European Union. Furthermore, the structure of the Union has developed since the book 'The Impact of Legislation and Regulation on the Freedom of Movement of Capital in Estonia, Poland and Latvia' was published by Cambridge Scholars Publishing in June 2010.

Article 64(3) of the Treaty on the Functioning of the European Union supersedes Article 57(2) of the Treaty Establishing the European Community in providing for the Council to act unanimously, after consulting the European Parliament, in order to reverse the liberalisation of capital movements to or from countries outside the European Economic Area. In the absence of Council action under Article 64(3), Article 65(4) of the Treaty on the Functioning of the European Union permits the Council to unanimously take a decision that declares the restrictive tax measures adopted by a Member State concerning states outside the European Economic Area compatible with the European Union Treaties.

Regulations 1092, 1093, 1094 and 1095 of 24 November 2010 promptly established a European Systemic Risk Board, a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities and Markets Authority, respectively. These organisations are an integral part of the legislative process in European Union financial services law.

The judgment in Case C-101/05 *Skatterverket v A.* [2007] ECR I-11531 provides guidance as to the application of the European Union's free movement of capital rules to countries outside the European Economic Area. In paragraph 37 of this case, the Court of Justice of the European Union held that the taxation by a Member State of cross-border economic activities within the European Union is not always comparable to such taxation if the activities are between Member States and third countries. It will be interesting to watch how the Court develops this principle.

There is increasing convergence of legal standards in financial markets. Some of this is a result of international initiatives, such as that of the G-20 relating to over-the-counter derivative contracts. As a result, capital must, in practice, be able to cross borders as free from restrictions as is reasonably possible. In other words, the issue is larger than the completion of the European Union's internal market – important though this objective is. It involves integration of the financial sector globally.

As there have been developments in European Union and national financial services law since the earlier book, I decided to concentrate this time on this area of the law in particular. Consequently, material that relates to taxation and real property in chapters 2-5 of that publication, and the economic analysis in chapters 6 and 7, have been removed. In addition to Estonia, Poland and Latvia, I have included an examination of an extract of the financial services legislation of Germany and Croatia for compliance with the European Union's free movement of capital rules.

The Federal Republic of Germany joined the European Economic Community on 1st January 1958, at its formation. The European Economic Community was renamed the European Community when the Treaty on European Union came into force, on 1st November 1993. Estonia, Poland and Latvia joined the European Community on 1st January 2004. The European Community became the European Union when the Lisbon Treaty came into effect, on 1st November 2009. Croatia joined the European Union on 1st July 2013. Hence, this book analysis the laws of countries that have been Member States for various lengths of time.

Please feel free to comment on the analysis and comments made in the book. I can be contacted at GraemeBaber@bpp.com, and look forward to receiving your suggestions and feedback.

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Elsevier Science Publications B.V. and the Copyright Clearance Center's Rightslink service for: Cardoso and Dornbusch (1989), 'Foreign Private Capital Inflows', figure 26.6, page 1418, *in* Chenery, H. And Srinivasan, T. N. *eds*., *Handbook of Development Economics, Volume II* (Amsterdam: Elsevier Science Publications B.V.), which is adapted to become Fig. 1-1.

LIST OF ABBREVIATIONS

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
Annex I	Annex I to Directive 88/361/EEC
BaFin	German Federal Supervisory Authority
CFSSA	Croatian Financial Services Supervisory Authority
CJEU	Court of Justice of the European Union
ECR	European Court Reports
EEA	European Economic Area, comprising the European Union, Iceland, Liechtenstein and Norway
EFSA	Estonian Financial Supervision Authority
ELLC	Estonian Legal Language Centre
EU	European Union
EUR	Euros
EURATOM	European Atomic Energy Community
FDI	Foreign Direct Investment
IMF	International Monetary Fund
LFCMC	Latvian Financial and Capital Market Commission
LTTC	Latvian Translation and Terminology Centre
Member State	Member State of the European Union
MNCs	Multinational corporations
OECD	Organisation for Economic Co-operation and Development
PAAS	Prior Administrative Authorisation Scheme
PFSA	Polish Financial Supervision Authority
TFEU	Treaty on the Functioning of the European Union
Third countries	Countries outside the European Economic Area
UCITS	Undertakings for Collective Investment in Transferable Securities
WTO	World Trade Organization

Abbreviations for Estonian legislation and regulations

Chapter 3

CIA	Credit Institutions Act 1999
IAA	Insurance Activities Act 2004
IFA	Investment Funds Act 2004
PIA	Payment Institutions and E-money Institutions Act 2009
Regulation No. 19	Regulation No. 19 of the President of the Bank of Estonia of 6 July 1999
SMA	Securities Market Act 2001

Section 4.1

EIFA	Investment Funds Act 2004

Section 5.3.3

EIAA	Insurance Activities Act 2004

Abbreviations for Polish legislation and regulations

Chapter 4

BL	Act of 29 August 1997: Banking 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
IPFSA	Act of 22 May 2003 on Insurance and Pension Funds Supervision and on Insurance Ombudsman
LPF	Act of 28 August 1997 Law on the Organisation and Operation of Pension Funds
OPSA	Act of 20 April 2004 on Occupational Pension Schemes
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
PSA	Act of 19 August 2011 on Payment Services
RIM	Regulation of the Minister of Finance of July 6th 2007 on Detailed Conditions to be Met by the Information Memorandum Referred to in Articles 39(1) and 42(1) of the

	Act on Public Offers, and the Conditions for Introducing Financial Instruments to the Organised Trading System, and on Public Companies
RLDAIP	Resolution No. 389/2008 of the Polish Financial Supervision Authority of 17 December 2008 concerning the list of documents attached to the application to the Polish Financial Supervision Authority on issuing a permit to establish a bank, consent to appoint the members of the bank's Management Board and information about the composition of the board presented to the Polish Financial Supervision Authority by the Supervisory Board of the Bank
RLDEFE	Resolution No. 359/2012 of the Polish Financial Supervision Authority of 20 December 2012 on the list of documents relating to business activity of entrepreneurs or foreign entrepreneurs enclosed with requests for authorisation referred to in Articles 6a(1)(1)(m) and 6d(1) of the Banking Law
RMESBA	Resolution No. 312/2012 of the Polish Financial Supervision Authority of 27 November 2012 on the Mode of Exercising Supervision over Banking Activity
TFIA	Act of 29 July 2005 on Trading in Financial Instruments

Abbreviations for Latvian legislation

Chapter 5

CIL	Credit Institutions Law 1995

Abbreviations for German legislation

Chapter 5

PSSA	Payment Services Supervision Act 2009

Abbreviations for Croatian legislation

Chapter 5

IA	Insurance Act 2006

CHAPTER ONE

BACKGROUND AND METHODOLOGY

1.1 What is the purpose of the research?

On 1st May 2004, ten new Member States joined the EU.[1] The majority of these countries were members of the Warsaw Pact until its abolition in 1990,[2] and three were part of the Soviet Union.[3]

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.[4]

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.[5] This book concerns the free movement of capital legislation (Articles 63–66) of the Treaty on the Functioning of the European Union (TFEU).

The book investigates the compliance of the financial services laws of Estonia (in depth) and Poland (comprehensively and concisely) with the EU's free movement of capital laws. The conclusions from these studies are then compared with the findings from selected financial services provisions of Latvia, Germany and Croatia. From this analysis, broader conclusions are reached, and their implications for the provision of financial services investigated. This methodology is grounded theory, in so

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[1] These countries are Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

[2] The countries from these ten states that were members of the Warsaw Pact are Czech Republic and Slovakia (as Czechoslovakia), Estonia, Latvia and Lithuania (as part of the former Soviet Union), Hungary and Poland.

[3] The countries from these ten states that were part of the Soviet Union are Estonia, Latvia and Lithuania.

[4] See section 1.3.1.

[5] See section 1.2.3.

far as the analysis of the Estonian and Polish financial services legislation and regulations provides observations that are tested on the other three countries, from which general conclusions are made.

Although the author approached this research already familiar with the study of the compliance of national legislation and regulations in Estonia, Poland and Latvia with the EU's rules on the free movement of capital,[6] almost all of the commentary on these three countries is new, due to changes made in the law and to the need for detailed reportage and analysis. The selection of Germany and Croatia was based upon the need to extend the temporal reach of the analysis from countries that acceded to Membership of the EU in 2004.[7] West Germany was one of the founding states of the European Economic Community, whose Treaty was signed on 25th March 1957, and which came into operation on 1st January 1958. East Germany 'joined' the European Economic Community on 3rd October 1990, the date on which it reunited with West Germany to form Germany.[8] Croatia acceded to Membership of the EU on 1st July 2013. At the time of writing, no country has subsequently acceded. Thus, in choosing to analyse the financial services laws of these countries, the whole period of the Community's existence is considered.[9]

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

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6 See Baber (2010), *The Impact of Legislation and Regulation on the Freedom of Movement of Capital*.

7 See note 1, for a list of the countries that acceded to EU Membership in 2004.

8 West Germany (the Federal Republic of Germany) absorbed East Germany (the Democratic Republic of Germany) as five new Federal States, with a reunited Berlin as a Federal City-State. Thus, the Treaties of West Germany, including Membership of the European Communities, were extended over the whole German territory from the reunification date (3rd October 1990).

9 The financial legislation of (West) Germany has changed since 1958, in accordance with EU Directives. Furthermore, the Community project started before this, with the signing of the Treaty Establishing the European Coal and Steel Community on 18th April 1951, and the consequent foundation of the European Coal and Steel Community amongst Belgium, France, Italy, Luxembourg, Netherlands and West Germany on 23rd July 1952. This Treaty expired on 23rd July 2002.

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.[10] Investment 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.[11] Free capital movement across the EU also encourages the formation of companies with subsidiaries and branches in other Member States,[12] and lowers the cost of investment for financial asset providers in such States.[13]

Cardoso and Dornbusch describe the following effects of capital inflows.[14] First, such inflows raise the economy's productive capacity, thereby potentially increasing welfare.[15] 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.[16]

Second, 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.

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

[11] See section 1.2.2.

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

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

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

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

[16] 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.

Third, 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.

Fourth, 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 moves the foreign exchange constraint to the right, thereby raising the growth rate and the ratio of domestic to foreign prices.[17]

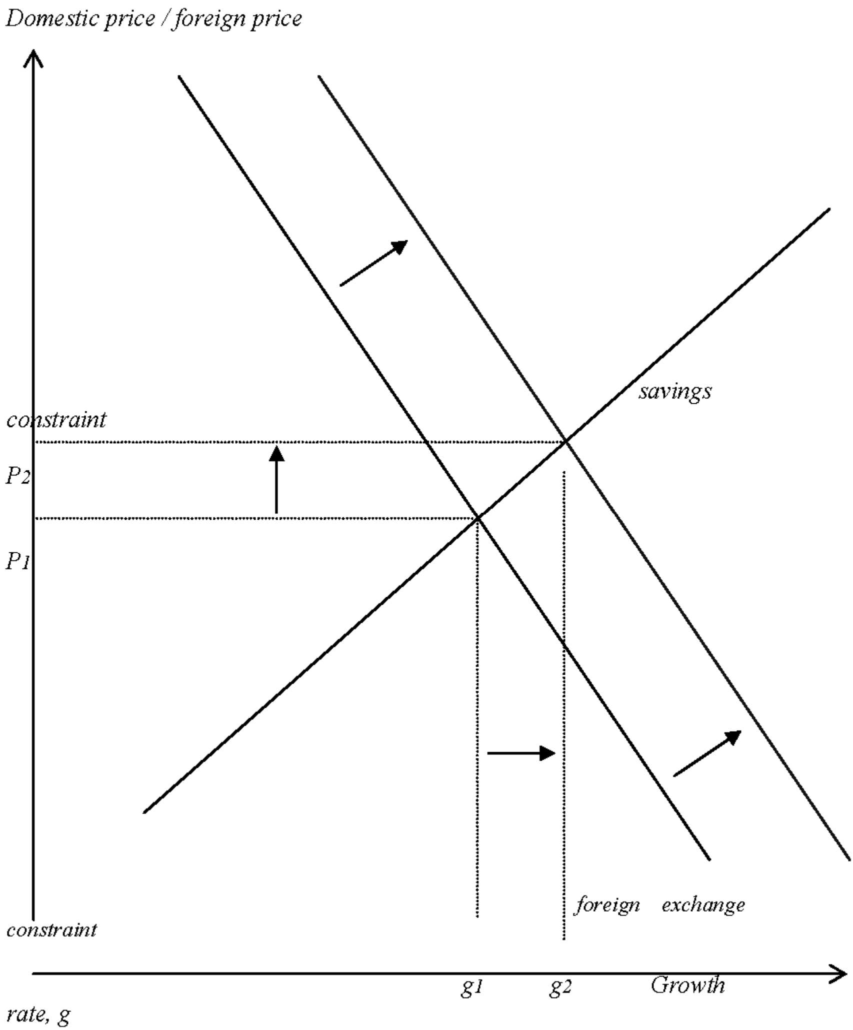
1.2.2 Reasons for retaining barriers to capital flows

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.[18]

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.[19] 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

[17] Fig. 1-1 is adapted from Cardoso and Dornbusch, *Handbook of Development Economics*, figure 26.6, 1418.
[18] Edwards (1985), *Economic Development and Cultural Change*, 33, 223–254.
[19] The terms of trade are the price of exports divided by the price of imports.

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



continued into the latter half of the century.[20] 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.

Cardoso and Dornbusch state two cases in which capital inflows reduce welfare.[21] 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.[22]

Capital flight–the mass transfer of investment from domestic to foreign assets[23]–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.[24] Controls on capital outflows are essential for countries with these characteristics.[25] Investors may move their assets abroad in

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[20] 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.

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

[22] See section 1.2.1.

[23] '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.

[24] Cuddington, *Princeton Studies*.

[25] 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*).

response to high domestic taxation or political risk (of expropriation, for instance),[26] 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 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 IMF were required to restore economic health.[27]

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.[28]

1.2.3 The internal market

The free movement of capital is one of the four fundamental freedoms provided by the TFEU, 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

[26] Cardoso and Dornbusch, *Handbook of Development Economics*, 1423.
[27] 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.
[28] 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.

frontier controls and the approximation of indirect tax rates.[29] 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.[30] Today, the free movement of capital is stated by Article 63 of the TFEU,[31] 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),[32] 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. As Poland and Croatia have not yet joined the Euro,[33] they can still experience these conditions.[34]

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, and 1st July 2013 for Croatia. 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.

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

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

[31] Before 1st December 2009, the relevant provision was Article 56 of the Treaty Establishing the European Community, which was identical to the Article 63 of the TFEU.

[32] See section 2.1.3.

[33] Germany was one of the founder Members of the Eurozone, which introduced the Euro as legal tender on 1st January 1999. Estonia and Latvia adopted the Euro on 1st January 2011 and 1st January 2014, respectively. Poland and Croatia have no target date for joining the Euro.

[34] The European Central Bank sets the monetary policy of the countries that have adopted the Euro as their currency.

Legal transplants

Before the Enlightenment, European laws moved geographically, though usually with peoples – Germans into Poland, Normans into 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.[35]

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.[36] 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.[37]

William Twining states that most literature on legal transplants is in the 'Country and Western Tradition' of comparative law,[38] 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.[39]

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35 Glenn (2006), *Journal of Comparative Law*, 1, 124–130.

36 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.

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

38 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.

39 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.

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 comply with it.[40] In as far as EU law has direct effect,[41] 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.[42] 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 the form that the domestic law takes – i.e. the transposed Directive may be transformed in the local environment.

Harmonisation

The TFEU does not refer exclusively to 'harmonisation' of laws. Articles 114(1) and 115 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 114(4) and 114(5), which refer to a measure adopted under Article 114(1).

Article 115 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 114(1) authorises the Council acting by qualified majority on a Commission proposal (under the ordinary legislative procedure)[43] to adopt measures to approximate the laws, regulations or administrative

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

[41] 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 CJEU 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).

[42] 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).

[43] Article 294, TFEU.

provisions of Member States that "have as their object the establishment and functioning of the internal market".

Article 114(2) does not apply to fiscal provisions, which therefore require unanimity in the Council to be ratified.[44] Since unanimity is difficult to achieve, especially in relation to tax matters, the Council has passed few direct tax harmonisation measures.[45] Consequently EU developments in direct taxation have been by CJEU case law.[46]

Weatherill and Beaumont state that it would "likely to be fruitless" to introduce a single harmonised system, due to the diversity across the Community.[47] They express that replacing national rules by one Community rule is "a discredited option in most circumstances" because the accompanying "elimination" of the Member States' diversity would "stifle tradition and … ossify existing practice, thereby deterring innovation by business".[48] The alternative taken is "to adopt different traditions within a flexible Community framework" and to emphasize "administrative cooperation".[49] Sometimes the Community may use a "minimum standard", which Member States can choose to exceed.[50] This differentiated pace of integration may be "inevitable and desirable" in a heterogeneous Community.[51]

Dashwood, Dougan, Rodger, Spaventa and Wyatt consider whether harmonisation facilitates the working of the internal market,[52] in particular company law and direct tax measures. The rationale of company law harmonisation is that it enables freedom of establishment.[53] Article 50(2)(g) of the TFEU supplies the legal basis for such harmonisation,[54] stating that the European Parliament, the Council and the Commission may "carry out the duties devolving upon them under the preceding

[44] Article 114(2), TFEU. Unanimity is required for the "harmonisation" (not approximation) of indirect taxes (Article 113, TFEU).
[45] Directives 90/434/EEC (the Mergers Directive) and 90/435/EEC (the Parent/Subsidiary Directive) are examples.
[46] See Baber, *The Impact of Legislation and Regulation*, section 2.3, 50–58, for a synopsis of these developments. There have been several more recent CJEU judgments on national direct tax provisions that contravene the free movement of capital, which are not reported there.
[47] (1999), *EU Law*, 556.
[48] Ibid.
[49] Ibid., 556–557.
[50] Ibid., 557.
[51] Ibid.
[52] (2011), *Wyatt and Dashwood's European Union Law*, chapter 21.
[53] Ibid., 677.
[54] Ibid.

provisions [the right of establishment] by coordinating ... the safeguards which ... are required by Member States of companies or firms ... with a view to making such safeguards equivalent throughout the Union."

Dashwood et al. explain that the company law harmonisation measures address the following issues: 1) differences between national rules that cause economic entities to be unfamiliar with those in another Member State, 2) differences between national rules that cause varying requirements for establishment, and 3) national rules or practices inhibiting cross-border establishment.[55] They conclude, as follows.

> "The Commission's approach to company law harmonisation has, however, changed – perhaps more than that of the European Parliament and the Member States. The Commission has sought to utilise company law harmonisation as a means of promoting cross-border business activity to a greater extent than in the past, which accords with the logic of the Treaty basis for harmonisation being the chapter on establishment."[56]

Thus, the Commission may be leading a reversal of the move away from harmonisation that Weatherill and Beaumont observe.[57]

Comment

EU law has been superimposed on the national legal systems of Member States rather than transplanted. This is particularly true for the thirteen States that joined the EU since 2000,[58] because they were required to implement an *acquis communautaire* developed over more than forty years by other decision-makers. In addition, most of these countries have legal systems that were shaped by communist rule during many of these years. By contrast, there was no communist input to the early development of EU law.

Wade Channell states that there are three core problems for post-communist countries in implementing law that support the free market and democratic government:

1. *Lack of Ownership*. Foreign laws are often translated without sufficient attempt to adapt them to the local legal and commercial

[55] Ibid., 679. Discussion of the Company Law Directives is outside the scope of this section, which considers the harmonisation of laws within the EU in general terms.
[56] Ibid., 700.
[57] See above in this subsection.
[58] Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia.