Reasoned Opinion of the Parliamentary Committee of Foreign & European Affairs of the House of Representatives of the Republic of Cyprus

Sent to the Presidents of the European Parliament, the Council and the Commission pursuant to Article 6 of Protocol (No 2) to the Treaty on European Union, on the Application of the Principles of Subsidiarity and Proportionality

Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC [COM (2011) 594].

1. The Treaty framework concerning the application of the principles of subsidiarity and proportionality

1.1. Article 5(3) of the Treaty provides that:

> "Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Community shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.
>
> The institutions of the Union shall apply the principle of subsidiarity as laid down in the Protocol on the application of the principles of subsidiarity and proportionality. National parliaments ensure compliance with the principle of subsidiarity in accordance with the procedure set out in the Protocol".

1.2. Likewise, Article 2 of the Protocol (No 2) to the Treaty provides that the European Commission shall consult widely before proposing legislative acts and that these consultations shall, where appropriate, take into account the regional and local dimension of the action envisaged.

1.3. Article 5 of the Protocol (No 2) to the Treaty provides that:

“Draft European legislative acts shall be justified with regard to the principles of subsidiarity and proportionality. Any draft European legislative act should contain a detailed statement making it possible to appraise compliance with the principles of subsidiarity and proportionality. This statement should contain some assessment of the proposal's financial impact and, in the case of a European framework law, of its implications for the rules to be put in place by Member States, including, where necessary, the regional legislation. The reasons for concluding that a Union objective can be better achieved at Union level shall be substantiated by qualitative and, wherever possible, quantitative indicators. Draft European legislative acts shall take account of the need for any burden, whether financial or administrative, falling upon the Union, national governments, regional or local authorities, economic operators and citizens, to be minimised and commensurate with the objective to be achieved”.

1.4. Finally, as laid down in Articles 5(3) and 12(b) of the Treaty, national parliaments ensure compliance with the principle of subsidiarity in accordance with the procedure set out in the Protocol (No 2), that is, sending a reasoned opinion within eight weeks from the date of transmission of a draft European legislative act in all the official languages of the European Union

1.5. The guidelines for the application of the principle of subsidiarity were laid down in the Treaty of Amsterdam and specified in the Protocol on the application of the principles of subsidiarity and proportionality. It should be noted that these guidelines continue to be useful tools for exercising the control in question.

Concretely, the guidelines concern:

- whether there are supranational aspects to the matter under consideration, which cannot be effectively addressed by action taken at national level,
- whether action taken at national level or lack of action at Union level conflicts with

the requirements of the Treaties of the European Union or is contrary to the interests of the Member States, and

- whether there are clear advantages to action at Union level compared to action at national level, by reason of the scale or effects of the proposed action.

Further, for an action at Union level to be compatible with the principle of proportionality:

- the means used to achieve it must be appropriate, and
- these means must not exceed what is necessary to achieve its objectives.

The relevant Protocols, both of Amsterdam and of Lisbon, impose certain restrictions on the European Union in relation to the requirement to apply the principle of proportionality:

- the form of the action taken by the Union must be as simple as possible, and the European legislation should preferably be enacted in the form of Directives rather than Regulations;
- account must be taken of the need to minimise any burden, whether financial or administrative, falling upon national governments, economic operators and citizens; and
- European action must allow as wide as possible a field for national action (this third restriction is essentially covered by the clauses on the application of the principle of subsidiarity).

2. <u>The proposal for a Directive on a common system of financial transaction tax</u>

2.1. The aim of the proposed Directive is to establish a common system of financial transaction tax (FTT). If approved, the Directive would apply to all financial transactions, insofar as at least one party to the transaction is established in a Member State of the European Union and insofar as a financial institution established in the territory of an EU Member State is involved in the transaction, acting either for its own account or for the account of another person or acting in the name of a party to the transaction. According to the European Commission, the reason for this Directive is to ensure the smooth

functioning of the European internal market and to avoid distortion of competition, with the objective of removing incentives for tax arbitrage within the Union as well as possibilities for double or non-taxation.

2.2. More specifically, the stated objectives of the Directive proposed by the European Commission are:

- to generate revenue and secure a fair contribution from the financial sector on tax revenues (identifying new sources of revenue, recovering the costs of the recent financial crisis, covering the budgetary costs of potential future crises and compensating for the VAT exemption of financial services),
- to stabilise the market (dis-incentivise excessively risky activities, address the particular risks associated with automated trading), and
- to ensure the proper functioning of the internal market (avoid double taxation and distortion of competition).

2.3. The scope of the proposed Directive covers financial instruments that are negotiable on the capital market, money-market instruments (with the exception of means of payment), units or shares in collective investment undertakings (which include UCITS and alternative investment funds) and derivatives agreements. The proposed legislation also covers the over-the-counter trade. Moreover, the proposed Directive contains harmonisation provisions relating to chargeability, taxable amount and rates. The tax would be chargeable on every financial transaction at the moment it occurs.

3. <u>The position of the executive authority</u>

The Cypriot government, via the competent Ministry of Finance, stated its views during the Parliamentary Committee of Foreign & European Affairs' scrutiny of the proposed Directive. Specifically, it noted that the proposed tax is expected to have a negative impact on the Cypriot economy and on the economies of other Member States and formulated the opinion that such a piece of legislation on the part of the Union would lead to the phenomenon of relocation of financial activities outside the European Union

to the benefit of other centres. This is expected to have a knock-on effect on employment, on VAT, on GDP and on tax revenues. According to representatives of the competent Ministry, the situation would be different if the tax in question could be applied worldwide. The government further expressed the view that, while insurance transactions are not directly affected by the proposal, the insurance sector would nonetheless be adversely affected because the financial transactions affected would affect insurance products, a severe blow that would be borne by the consumer.

4. Aspects of the proposed Directive that are incompatible with the principle of subsidiarity

4.1. Following its scrutiny of the proposed Directive, the Parliamentary Committee of Foreign & European Affairs came to the conclusion that the proposed legislation was not in harmony with the principle of subsidiarity. More specifically, the said Parliamentary Committee found insufficient substantiation of the need to take action at European Union level, contravening the principles of subsidiarity and proportionality.

4.2. ***Justification***

4.2.1. Paragraph 7.8 of the European Commission's "*Executive Summary of the Impact Assessment*" says, with regard to the question of relocation, that:

"The introduction of additional taxes bears the intrinsic risk of agents relocating their activities to reduce the fiscal burden. Relocation might take place by moving the relevant activities to jurisdictions where they are taxed less, or by shifting to products/suppliers outside the scope of taxation within the same jurisdiction. Obviously, the risk of physical relocation of markets/market players and migration to non-taxed products decreases the more widespread is the adoption of the taxes and the broader is their scope".

This extract from a European Commission document confirms the validity of the view that the proposed regulation would be effective if it were applied worldwide, given the visible risk of activities being relocated outside the EU if the measure were to be applied solely within the territory of the European Union.

4.2.2. Likewise, the same paragraph of the document cited goes on to say, with regard to the question of macroeconomic impacts and employment, that:

> "A limitation of the model is that it only takes into account the effects of an FTT on one source of financing, namely the issuance of equity. The effects on the costs of debt financing are not taken into account. Due to this limitation the model could overestimate the negative GDP effects of the tax. Also, there is no available model to assess the proposed mitigating effects from the design of the proposal (e.g. exclusion of primary markets, excluding most transactions that do not involve at least one financial institution, etc.) and the channels through which they impact macroeconomic variables. The only available approach is therefore to proxy the effects with the large caveats and uncertainties that such an exercise may carry ".

4.2.3. In addition, the sub-paragraph entitled "*Risk-taking and behavioural effects*" states that:

> "While the economic literature concludes that the effects of the FTT on volatility is largely inconclusive and depends on market structure, it would be a very effective tool to curb automated high-frequency trading and highly leveraged derivatives".

These two excerpts show that it is uncertain how far the imposition of a common financial transactions tax would produce the desired results, given on the one hand that volatile factors can affect those results adversely and on the other that many of these factors depend on market structure. This makes it extremely difficult, if not impossible,

to give a precise assessment of its effects. This runs counter to the requirement of Article 5 of the Protocol (No 2) to the Treaty, which stipulates a detailed statement containing an assessment of the financial impact of any action and its implications for the rules to be put in place by the Member States. The reasons for concluding that a Union objective can be better achieved at Union level are to be substantiated, according to Article 5 of the said Protocol, by qualitative and, whenever possible, quantitative indicators. In the present case, the Parliamentary Committee of Foreign & European Affairs does not think that there is sufficient substantiation, especially quantitative indicators, to make it evident that the matter needs to be regulated at EU level. Moreover, it is open to question whether the impact assessment model upon which the proposed legislation is based implies a minimal and proportional burden on national governments, economic operators and citizens, as required by Article 5 of the said Protocol. Consequently, the express rule that decisions must be taken as closely as possible to the citizens of the Union, which is entrenched in the said Protocol, presupposes that there must be a clear and detailed justification of the necessity for regulating a matter at EU level.

4.2.4. Further, there is some doubt as to the legal basis cited by the European Commission for the proposed Directive. As has been said, the right of the European Commission to legislate in this matter would be based on Article 113 of the TFEU, concerning the harmonisation of national legislation for the purpose of ensuring the proper functioning of the internal market and avoiding distortions to competition. This does not, however, appear to be the primary purpose of the proposed Directive. The objectives of the proposed Directive, as noted above, are ranked by the EU as follows:

- to generate revenue and secure a fair contribution from the financial sector on tax revenues (identifying new sources of revenue, recovering the costs of the recent financial crisis, covering the budgetary costs of potential future crises and compensate for VAT exemption of financial services),
- to stabilise the market (dis-incentivise excessively risky activities, address the particular risks associated with automated trading), and

- to ensure the proper functioning of the internal market (avoid double taxation and distortion of competition).

Given the above objectives and the related statements in the EU's rationale for the Directive, it is clear that ensuring the proper functioning of the internal market is not its primary aim. Consequently, this casts doubt on the legal basis for the proposed legislation (Article 113 of the TFEU). It should be noted, in this connection, that the European Court of Justice (ECJ) has ruled that when a regulatory measure instituted by the EU has more than one object, then the predominant aim or component must be identified and there must be a legal basis for it.[1] In the present case, although the Article concerning the internal market is referenced, the proposed legislation is manifestly aimed chiefly at other objectives, for which no legal basis is offered, let alone one which is compatible with the existing one.[2]

4.2.5. Furthermore, the other objectives of this proposed legislation (avoidance of double or non taxation, adequate contribution from the financial sector to financing the crisis, compensation for the exemption of the financial sector from VAT) are objects that can be adequately regulated by the Member States at national level and that belong to the sphere of their national economic sovereignty. Whatever supranational aspects there may be to the matter in question, it does not necessarily follow that they cannot be dealt with at national level, either through regulatory measures or by agreement. This fact is reinforced by the imprecise and uncertain assessment of the impact of regulation at EU level, as mentioned above. There is insufficient evidence that action at Union level, as opposed to action on the part of the Member States, would offer *clear* advantages by reason of its scale or effects.

[1] Case C-155/07, par.35., European Parliament v Council.

[2] As above, paragraphs 36 and 37.

4.3. In the light of the above, the Parliamentary Committee of Foreign & European Affairs concludes that the proposed Directive under consideration does not comply with the principle of subsidiarity and that the criteria justifying the necessity for regulatory action on the part of the Union are not adequately met.