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REPORT FROM THE COMMISSION TO THE COUNCIL

**on the application of the special arrangements concerning the AIEM tax applicable in
the Canary Islands**

(presented by the Commission)

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1. BACKGROUND

The provisions of the EC Treaty, which apply to outermost regions of the Community, such as the Canary Islands, in principle do not permit differences in taxation between local products and products sold from one Member State to another. Article 299 (2) of the EC Treaty however envisages the possibility of introducing special measures to those regions because of the existence of permanent handicaps affecting the social and economic situation of those regions.

In the Council Decision of 20 June 2002 (2002/546/EC), taken on the basis of Article 299(2) of the EC Treaty, the Kingdom of Spain was authorised from 1 January 2002 until 31 December 2011 to exempt or reduce partially from the AIEM tax ("Arbitrio sobre las Importaciones y Entregas de Mercancías en las islas Canarias") some products produced locally in the Canary Islands. The AIEM tax is generally imposed on products imported into or obtained in the Canary Islands. In the annex to the Council Decision is the list of products to which the above mentioned special measure applies. The difference in taxation between goods taxed on a regular basis and those to which is applied an exemption or partial reduction cannot be higher than 5%, 15% or 25% depending on the product.

In the Council Decision of 20 June 2002 the reasons underlying the adoption of the special arrangements were presented. The main sources of the problems faced by the Canary Islands are isolation and fragmentation of the market. This causes various difficulties mainly connected with higher production costs (transport, energy, supplies of raw materials, treatment of waste, etc). It also contributes to the low diversification of the economy which is weaker and more susceptible to negative changes than European and global markets.

In other words the special measures were introduced to counter disadvantages faced by the Canary Islands and thereby allowing the economy of the Islands to develop. They were especially targeted at strengthening domestic industry by increasing its competitive position, which is disadvantaged because of the location, structure and size of the market.

Article 2 of the Council Decision of 20 June 2002 mentioned above, obliges the Spanish authorities to present to the Commission at the latest by 31 December 2005 a report on the application of the arrangements concerning the AIEM tax. This is necessary in order to assess the impact of the measures taken and their contribution to the promotion or maintenance of local economic activities with account being taken of the handicaps affecting the outermost regions. This report, submitted to the Commission in the first days of January 2006, is annexed to the present report (Annex 1). A summary of this report, in English, is annexed as well (Annex 2).

In addition, Article 2 of the mentioned Council Decision requires the Commission to present a report to Council comprising an analysis of the economic and social aspects of the application of those special arrangements concerning the AIEM tax and where appropriate a proposal for adapting the provisions of this Decision.

2. SUMMARY

The purpose of this report is to check the impact of the measures taken under the Council Decision of 20 June 2002 (2002/546/EC) and to assess their contribution to the promotion or maintenance of local economic activities with account being taken of the handicaps faced by the Region.

The greatest handicaps faced by the Region are connected with isolation, the small size of the market and its fragmentation. The Islands, because of those limitations, have a higher cost of

production and transport, and higher environmental costs. Also, they are unable to benefit from globalisation. The AIEM aims at reducing those disadvantages of the market of the Canary Islands. Data provided by the Spanish Government shows that positive effects were observed after the special measures were introduced, however the problems underlying the special tax scheme continue to exist. Therefore continuation of special measures is justified.

The analysis in the report takes into account the special characteristics and constraints of the region and the objective not to undermine the integrity and coherence of the community legal order, including the internal market and common policies.

The Commission concludes that, given the data provided by the Spanish authorities and the absence of any significant complaints from the stakeholders, the AIEM is functioning in a satisfactory manner. Therefore, the current rules can remain in force, without any necessity to amend the provisions of this Decision.

3. ANALYSIS

This analysis is based on the data provided by the Spanish Authority in its report presented in accordance with Article 2. The report describes variable factors, and among them indicates changes that took place after the introduction of special measures for the AIEM tax.

3.1. Economic growth - activity and employment variables

During the analysed period, when special arrangements for the AIEM tax were in force, many positive tendencies were observed.

Firstly, the growth in the Canaries' economy has been noted. The industrial sector in the Canaries has grown faster (especially in the construction sector) than in the rest of Spain and this has produced an increase in the importance of the Canaries' industry in the Spanish industrial sector. Examination of business activity shows that the number of AIEM businesses (covered by special measures introduced under the Council Decision of 20 June 2002) gradually increased in the period 2001-03 to involving nearly 60% of all manufacturers. It should be underlined that the increase in number of these AIEM businesses was more important than that of other manufacturing firms in the Canaries. In years 2001 to 2003 the number of enterprises manufacturing products taxed only on imports increased by 12,5 %. This increase was larger than that of the manufacturing industry, that in the same period increased only by 2,6 %.

With regard to turnover, the net amount for AIEM businesses showed a tendency to increase more, especially in the year 2004, than in other manufacturing activities.

Certain diversification of industry in the manufacturing sector was observed after the introduction of the AIEM. Several new production lines were installed in production sites in the Canary Islands. Also some new products and brands were introduced such as new beverages and tobacco brands, bottled water and packaging materials.

As for the investment rate, for the AIEM companies it increased 13,7% during the years 2001 to 2003 (Net investment of AIEM businesses in million euro: in 2001 – 114,44; in 2002 – 125,28; in 2003 – 130,14). Net investment in all manufacturing industries increased greatly in 2002 but fell in 2003 (Net investment of all manufacturing businesses in million euro: in 2001 – 209,58; in 2002 – 260,29; in 2003 – 238,86).

AIEM had also an impact on employment. In the years 2002 and 2003, the number of jobs created in AIEM activities increased at a higher rate than in the rest of the manufacturing industry. The AIEM employment constituted almost 63% of total manufacturing employment (Number of AIEM jobs: in 2001 – 22 618; in 2002 – 23 721; in 2003 – 24 561 / Number of all

manufacturing jobs: in 2001 – 37 112; in 2002 – 38 571; in 2003 – 39 107). During those years the ratio of AIEM turnover to all manufacturing industry turnover stayed at similar level of around 51,5 % (in 2001 – 51,8 %, in 2002 – 51,5%, in 2003 – 51,3 %). The preliminary results for the year 2004 suggested a fall in employment in AIEM activities, but this fall was less marked than the decrease generally observed in the Canary Islands.

In general terms, the evolution of the consumption price index (CPI) has been more favourable in the Canary Islands than in the rest of the Spain. The inflation differential in 2004 was of 0.7%. Regarding the evolution of the CPI in the Canary Islands in comparison to the CPI of the AIEM product basket, the AIEM items showed a better evolution. While the CPI increased by 2.5% in the period 2001-2004, it increased only by 1.8% for AIEM products. Within AIEM products, Food and beverages and tobacco experienced particularly low inflation rates

The AIEM tax revenue is to be incorporated into the Canary Islands' economy and used for an economic and social development strategy involving the promotion of local activities (recital No 23 of the Council Decision 2002/546/EC). The Spanish report demonstrates that the actual expenditures of the Canaries' public bodies for the promotion of local activities exceed the revenues generated by the AIEM.

The above described trends indicate that there have been positive changes in the Canaries' economy, after introducing special measures for the AIEM tax under the Council Decision of 20 June 2002. In many respects (overall growth, turnover, diversification, investments, employment) the situation of businesses to which exemption or partial reduction from the AIEM tax for goods produced locally is applied, has improved. This is especially true when compared with businesses not affected by the application of special measures for the AIEM tax.

The evidence presented thus indicates that the Council Decision of 20 June 2002 fulfils its purpose.

However, the situation for businesses operating on the local market remains at a disadvantage and there is still a need for this specific and targeted measure. This aspect will be analysed in the subsection immediately below.

3.2. Remaining handicaps justifying the continued application of the special arrangements concerning AIEM

The local industry remains in a disadvantaged position.

There are certain permanent handicaps of the Region which hinder the economic development of the Canary Islands: geographic isolation, fragmentation and the small size of the market. Those circumstances affect many important aspects connected with the economic development of the area.

One of the main handicaps is the limitation of the means of transport (only by air or sea). Consequently the cost of transport is much higher than the average cost in Spain. This is especially true in relation to transport of freight and to a lesser extent when it concerns passenger transport. The transport of goods has in practice many restrictions connected with weak price competition and delays in deliveries. Therefore additional costs for the Canaries' business connected with transport can be expressed both in money and time. Such a restriction leads to a lower efficiency and higher costs of production in the Canaries.

Other aspects connected with the production process also lead to higher costs. Companies depend mostly on imported raw materials and energy (more than 70 % of their inputs are from outside the Islands, whereas in the rest of Spain such imports do not exceed 40 %). In practice

they must build up additional stocks and quite often are faced with overstocking. As a result some raw materials have higher costs. For example, for water the total average cost per cubic meter is 1,68 Euro. This price is the most expensive in Spain where the average cost for the whole country is 0,86 Euro.

Extra costs for companies are also connected with such factors as specialised maintenance services, training for managers and technicians, or promotion of the business. As the market is small, specialists must be brought from further distances. The same applies when staff need to attend training, attend a business fair or conference, or undertake a business trip in order to promote goods or sign a new contract.

Furthermore, costs connected with the disposal of industrial waste are also high. Many kinds of waste (including toxic waste) cannot be treated in the Canary Islands because there are a limited number of specialised recycling plants. Therefore very often waste has to be transported outside of the Islands.

The analysis of price levels shows that for certain groups of AIEM products (food, medicines and perfume) price levels are generally higher in the Canaries than in the rest of Spain. The higher prices reflect the additional burden on industrial activity in the Canaries. This means that the reduction or elimination of this protection would reduce the competitiveness of Canaries' industrial production vis-à-vis imported products even further, and thus the profitability of this production, and the continued existence of at least some of the activities concerned may directly be put at risk.

Given the geographical constraints, the market of the Canaries remains very limited in its nature. The contribution of exports to total GDP is the lowest of all the Autonomous Communities of Spain. The Canaries, in comparison to the rest of Spain, have the smallest number of firms involved in the export activity. Additionally local firms are very interdependent: closing one firm has a negative effect on others businesses. Moreover, the average size of the Canaries' industrial businesses in terms of employees tends to be lower than for the whole country.

Constraints experienced by the Canarias market cause low diversification of the whole economy. This means that for the market there is no balance between different sectors of industry. The predominance of the service sector (especially tourism) remains at a similar level and has almost not changed over the last few years. In 2001 the contributions of the service sector to the total Gross Value Added was 79% and in 2004 it was 78%. In Spain, for both periods, it remained at 66%.

Such a bias puts the market in a weaker position.

3.3. Integrity and coherence of the Community legal order

Data presented in the analysis of the report shows that the scheme in question also fulfils the requirement whereby Council measures under Article 299(2) of the Treaty shall not undermine the integrity and coherence of the Community legal order.

Measures applied in accordance with the Council Decision of 20 June 2002 (2002/546/EC) are necessary and proportionate to the objectives set by this decision.

From the start measures adopted in the framework the Council Decision were targeted and aimed at the most vulnerable industrial products only. Figures presented by the Spanish government show that additional costs faced by this outermost region are not overcompensated by the application of allowed exemptions to specified AIEM products. The

measures in place are thus proportionate to the objectives set. Details have been set out in the Commission decision of 16 April 2008 relating to the State aid aspect of this file¹.

Moreover, it results from the additional study presented by the Spanish government (IMPACTO DE LOS APE EN CANARIAS of 26 September 2006) that trade relations between the Canary Islands and ACP countries are of a negligible nature and therefore special arrangements for the AIEM tax cannot be seen as an obstacle in the context of the European Partnership Agreement under negotiation between the EU and West Africa and intended to increase trade and investment between them.

In addition, the Commission did not receive any significant complaints on a possible negative impact of the AIEM on the functioning of the internal market. In particular, the Commission did not receive any information indicating that the application of the AIEM overcompensate costs connected with the permanent handicaps affecting the Canary Islands.

In conclusion to the above findings it appears that the current arrangements work properly and should be kept in force in order to compensate appropriately the difficult position of the Canary Islands.

4. GENERAL CONCLUSION

The special measures introduced by the Council Decision of 20 June 2002 (2002/546/EC) have had positive effects on the economic and social environment of the Islands. The analysis of trends of the given indicators shows that the objective of promotion or maintenance of local economic activities has been fulfilled.

Given the handicaps connected with the specific situation of the Canary Islands, the continuation of these measures is still justified. In particular, it appears that their situation is still disadvantaged in many ways, despite positive tendencies.

The information available confirms that the integrity and coherence of the community legal system is not undermined by the special arrangements for the AIEM tax. The measures are well targeted (only at the most sensitive products) and limited to what is necessary to achieve the objectives set (compensation for the handicaps of the region such as remoteness, small size and fragmentation of the market). All the stakeholders are satisfied by the current arrangements, which do not disturb the proper functioning of the Internal Market. On the other hand, the reduction or elimination of this protection would reduce dramatically the profitability of manufacturing in the Canaries in industrial products. In some cases it might even provoke the cessation of some domestic production.

The Commission concludes that the AIEM tax, as introduced under the Council Decision of 20 June 2002, is still justified in its present form. Therefore, no proposal from the Commission for adapting the existing provisions of this Council Decision is required.

¹ Case NN 22/2008