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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
(submitted by the Commission in accordance with Article 2 of the Council Decision 377/2014/EU of 12 June 2014)

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A. Background

The AIEM ('Arbitrio sobre las Importaciones y Entregas de Mercancías en las islas Canarias') is a tax imposed on products imported into or obtained in the Canary Islands. Given the numerous obstacles that the Canary Islands face, Council Decision 377/2014/EU[1] of 12 June 2014 on the AIEM tax applicable in the Canary Islands provides for special tax arrangements. In particular, it authorises the Kingdom of Spain to exempt or reduce partially from the AIEM tax certain products produced in the Canary Islands that are listed in the annex to the Decision. This authorisation applies from 1 July 2014 to 31 December 2020. The difference in taxation between products taxed on a regular basis and those to which an exemption or partial reduction is applied cannot be higher than 5%, 10%, 15% or 25% depending on the product.

That Decision replaced Council Decision 2002/546/EC[2] of 20 June 2002, which is based on Article 349 of the Treaty on the Functioning of the European Union, which confers the status of EU outermost region to the Canary Islands. This article recognises the permanent constraints faced by the outermost regions - remoteness, insularity, small size, difficult topography and climate, and economic dependence on a few products – and enables the adoption of specific measures tailor-made to these regions. The reasons underlying the adoption of the special arrangements are the problems faced by the Canary Islands by their isolation and the fragmentation of the local market. This causes various difficulties mainly connected with higher production costs (transport, energy, supplies of raw materials, treatment of waste, etc.) and 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 the handicaps faced by the Canary Islands and thereby allowing the economy of the Islands to develop. The measures are 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 Council Decision 377/2014/EU, requires the Spanish authorities to present to the Commission by 30 September 2017 a report on the application of the arrangements concerning the AIEM tax. The purpose of the report is to assess the impact of the measures taken and their contribution to the promotion or maintenance of local economic activities, taking into account the disadvantages affecting the Canary Islands. Spain has submitted the interim report to the Commission in October 2017 (Annex 1). A translation of the Report, in English, is also annexed (Annex 2). The Commission was conducting additional analysis and had to conduct additional exchanges with Spanish authorities during the year of 2018 in order to finalise the assessment.

In addition, Article 2 of the Council Decision 377/2014/EU requires the Commission to present a report to the 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.

[1] Council Decision 377/2014/EU of June 2014 on the AIEM tax applicable in the Canary Islands, OJ L 182, 21.6.2014, p. 4.

[2] Council Decision 2002/546/EC of 20 June 2002 on the AIEM tax applicable in the Canary Islands, OJ L 179, 9.7.2002, p. 22.

B. Summary

The purpose of this report is to examine the impact of the measures taken under the Decision, for the period from 1 July 2014 to the end of 2016, and to assess their contribution to the promotion or maintenance of local economic activities. Duly account is taken of the obstacles faced by the Canary Islands.

In general, it would appear that between 2014 and 2016 the measures in place have contributed to the economic recovery of the outermost region concerned. There are visible positive trends generated by the exemptions from AIEM, such as the Gross Domestic Product (GDP) growth and the positive increase in the number of companies and jobs created. In the same period, income from AIEM tax rose. The imports of products subject to the AIEM also rose between 2014 and 2016. The comparison of local products, who have benefitted and continue to benefit from the special measures in question with comparable imported products subject to AIEM have not revealed measurable negative effects for imported products in the categories of goods concerned.

C. Analysis

This analysis is based on the data provided by the Spanish authorities in their interim report for the period from 1 July 2014 to the end of 2016 submitted to the Commission in accordance with Article 2 of the Decision. The report describes various factors, including changes that took place after the entry into force of the Decision in 2014.

1. Economic growth – activity and employment variables

During the period analysed, when special arrangements for the AIEM tax were applicable, many positive tendencies have been observed. A number of examples are provided to evidence the impact of the AIEM-related measures and their contribution to the maintenance or development of domestic economic activities. It is made clear, though, that industrial activity is influenced by a multitude of factors such as the economic context, the framework of other taxes and costs that affect operations, as well as the changing conditions in the market and distribution systems. Hence, isolating the direct impacts of the AIEM on industrial activity in the Canary Islands is a complex exercise.

In general terms, the economic environment since 2014 has experienced a period of stable global growth worldwide and economic recovery at both national and European level. From 2014 onwards, the Canary Islands' economy has started to recover and has continued to expand up to the present date, with real GDP growth accelerated to reach 3.5 % in 2016. This rate exceeds that of Spain, the EU-28 and the world average for the same year. Moreover, the number of enterprises in the manufacturing, mining and quarrying sectors which benefit from the AIEM ('AIEM industry' which represent 67.3% of the total amount of enterprises) increased between 2014 and 2016, whereas the enterprises not benefiting from the AIEM ('non-AIEM industry') decreased between 2014 and 2016. In quantitative terms, there were 14 more enterprises in AIEM industry in 2015 than the previous year, and in 2016 there were further 41 new enterprises.

As regards employment in the AIEM industry, the data provided in the Report demonstrate a successive annual growth of registered employees over the period 2014-2016. In quantitative terms, the number of employments in the AIEM industry had increased from 20,050 registered in 2013 to 21,541 in 2016. The only sectors that suffered a decrease were the following: *Other mining and quarrying, Manufacture of beverages, Manufacture of tobacco products, Manufacture of pulp, paper and paper products*, and lastly *Manufacture of rubber and plastic products*. Intra-sectoral analysis reveals the significant relative weight of employment of the *Manufacture of food products* within the overall AIEM industry. It is followed by the *Manufacture of metal products, except machinery and equipment*, and the *Manufacture of beverages*.

Analysing different sectors, the Spanish data shows that the services sector, which accounts for the greatest share of the Canary Islands' economy, has performed favourably from 2014 onwards. Tourism, which contributes nearly 32% of regional GDP, has recovered strongly in recent years and, following a small decline in 2015, even achieved record figures in 2016, assisted by a context of political uncertainty in several North African and Middle Eastern Mediterranean countries. The dynamism of the tourist sector continues to date; it has resulted in an increase of its share in terms of contribution to Gross Value Added and employment in the Canary Islands' overall economy. We can assume that the AIEM measures for promotion of local activities have had a positive effect in the sense that local enterprises are prepared to offer better quality service, which guarantee a sustained growth of the tourism in this region. The Report demonstrates that local enterprises have been consolidating deployment of quality management systems to ensure that the products and services they offer meet standards that instil confidence in consumers. This reflects the commitment of domestic enterprises to production efficiency and competitiveness. The trend is especially true as regards enterprises operating in the food and packaging sectors, of which more than 41.9 % hold external food safety certification and a further 9.3 % were in the process of obtaining it in 2017.

The average rates applied to imports of products subject to the AIEM, with the exception of tobacco products, are approximately 7 % (7.1 % in 2016). This indicates that the average rates in the new period during which the AIEM is in force are, in general, similar to the average rates of the previous period (7.2%), and therefore there is no change in the burden imposed by this charge.

Further analysis by sectors and imports of products subject to the AIEM reveals that the majority of industries saw increases in imports after 2014, with the exception of three sectors. The imports of *Chemical products* decreased steadily between 2014 and 2016; *Building materials* decreased significantly in 2015 to increase again in 2016, albeit remaining to lower levels than in 2014; and *Manufacture of food products* fluctuated downwards in 2015 before increasing in 2016. In general, the imports of products subject to the AIEM rose between 2014 and 2016, despite a slowdown in 2015.

The evidence presented thus indicates that the Council Decision of 12 June 2014 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 3.

2. Proposal of technical adjustments

The Spanish authorities mentioned in the mid-term report a limited number of modifications to tax rates and tariff codes with regard to the AIEM products specified in the Annex.

To be able to resolve problems that arise from modifications in the tariff classification of products, Spain requests the establishment of an agile mechanism that allows for relatively easy updating of the list of products for which a tax differential is permitted.

The necessary amendments to the lists of tax rates and tariff codes as well an agile mechanism to amend them, could be considered at a later stage during the renewal of the Decision.

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

The Canary Islands continue to suffer a series of severe handicaps. For this reason, their local industry remains highly vulnerable and requires measures to safeguard a sector that is highly strategic, generates wealth and stability and has the capacity to ensure the supply of goods to the market in the event of problems with external supply. In this regard, according to the Report, the structural constraints indicated in the recitals of the Council Decision persist.

There are certain permanent obstacles of the Canary Islands, which hinder the economic development of the region: 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 obstacle in the Canary Islands' economy continues to be highly specialised in services (over 85 % of GVA) a figure well above the national average in Spain (74 % of GVA). Within this sector, the predominant activity in the archipelago remains tourism. Its contribution to GDP, when both direct and indirect effects are taken into account, has risen to over 34 % in comparison with a national average of just above 11 %. The number of jobs linked directly or indirectly to tourism in the Canary Islands is equivalent to around 40 % of the total compared with a national average of 13 %.

Also, account must be taken of the limitation of the means of transport of the Canaries that restricts the movement of goods, particularly between islands (only by air or sea). According to the Report, inter-island shipping costs remain high in comparison to freight between the islands and the continent. That constraint is even greater as regards routes to the islands that are not home to provincial capitals as their freight costs are higher than between islands with provincial capitals. The cost of freight between capital islands and non-capital islands can be higher than the cost of freight between the Canary Islands and Spanish mainland. This reoccurs in the cost of supply of raw materials for which, in general, and with some exceptions on certain routes, the cost of supply is greater than that of shipping goods abroad. Such a restriction leads to a lower efficiency and higher cost of production in the Region.

The Canary Islands' enterprises bear high environmental costs. As a result of the relatively more limited availability of water resources, businesses in the Canary Islands bear a unit cost of water that is significantly higher than the average for Spain as a whole. In addition, the disposal of industrial waste and the treatment of toxic waste continue to give rise to high environmental costs in the Canary Islands. There are still no recycling plants, other than for certain products (which include management of waste electrical and electronic equipment), and waste still has to be transported to the mainland and toxic waste still has to be treated outside the Canary Islands. According to 2017 data provided in the Report, the unit costs of the various forms of waste are higher in the Canary Islands than in mainland Spain and the difference is generally in excess of 50 %. In addition, in some cases, such as those of alkaline batteries, computer hardware and electronic equipment and sludge, the management costs are over 20 times higher in the Canary Islands than in mainland Spain. These higher costs incurred by the Canary Islands' enterprises compared with their competitors on the European continent, which are able to use recycled raw materials, results in a loss of competitiveness for industry in the Canary Islands.

D. Conclusions

The special measures introduced by Council Decision 377/2014/EU of 12 June 2014 have positive effects on the economic and social environment of the Islands. The AIEM measures applied in the Canary Islands are necessary and proportionate to the objectives set by the Decision. The handicaps affecting the archipelago (notably remoteness, small size and fragmentation of the local market) are still present and result in additional costs, which are not overcompensated by the application of the allowed exemptions to specified AIEM products.

Despite the economic slowdown due to the financial crisis, it appears that the domestic economy started to recover as from 2014, also thanks to the positive effects of the AIEM measures. However, given the handicaps connected with the specific situation of the Canary Islands, the continuation of theses measure is still justified. In particular, it appears that their situation is still disadvantaged in many ways, despite positive tendencies.

However, data presented in the mid-term report of the Canary Island is not sufficient to do a full analysis of the economic and social aspects, so the conclusion is partially based on the statements of the report, which cannot always be verified.

The Commission has not received any complaint on a possible negative impact of the AIEM measures on the functioning of the Internal Market. A possible reduction or elimination of the protection granted through the AIEM scheme could prove detrimental for the local industry and in general the economic and social development of the Canaries.

In the light of the above, the Commission concludes that the AIEM measures currently in place, in accordance with Council Decision 377/2014/EU of 12 June 2014, are still justified and proportionate. Furthermore, the Commission believes that no proposal to adapt the existing provisions of the Decision is required.