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Delegations will find attached document SWD(2020) 154 final.

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**COMMISSION STAFF WORKING DOCUMENT**

**Tax relief for Canary islands on certain local products (review)**

*Accompanying the document*

**Proposal for a Council Decision**

**on the AIEM tax applicable in the Canary Islands**

{COM(2020) 355 final}

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## Glossary

<i>Term or acronym</i>	<i>Meaning or definition</i>
AIEM	Arbitrio sobre las Importaciones y Entregas de Mercancías
CN	Combined Nomenclature
EU	European Union
EUR	Euro
GRP	Gross Regional Product
GDP	Gross Domestic Product
ISSG	InterService Steering Group
OR	Outermost Region
REF	Régimen Económico Fiscal
SMEs	Small and medium Enterprises
TFEU	Treaty on the Functioning of the European Union

## 1. INTRODUCTION: POLITICAL AND LEGAL CONTEXT

### 1.1. Introduction: Outermost Regions

Several regions of the European Union (EU), known as the outermost regions, are located in areas that are remote from Europe. These are the French regions of Guadeloupe, French Guiana, Réunion, Martinique, Mayotte and Saint-Martin; the Portuguese Madeira and the Azores; and the Spanish Canary Islands. These regions are an integral part of the EU and therefore need to comply with EU legislation. At the same time and unlike the rest of the EU territory, they have to deal with a number of difficulties related to their characteristics, in particular to remoteness, insularity, small size, difficult topography and climate, and economic dependence on a limited number of products.

Figure 1. Geographical distribution of EU outermost regions



The special situation of these regions is recognised under Article 349 of the Treaty on the Functioning of the EU (TFEU). This article allows for specific measures for these regions to be taken as it acknowledges that the permanent and combined constraints affect their economic and social situation and severely restrain their development. It permits such measures provided that they do not undermine the integrity and the coherence of the Union legal order, including the internal market and common policies. Such measures concern various policies, including taxation, support to create jobs, boosting competitiveness, and preserving the environment.

### 1.2. Spanish outermost region

This report concerns the outermost region (OR) of Spain: the Canary Islands, which is a Spanish autonomous community comprising the provinces of Las Palmas and Santa Cruz

de Tenerife, as well as seven insular councils. The archipelago is formed by eight main islands and various islets located in the Atlantic Ocean, at a distance of about 1,800 km from the capital of Spain. The Canary Islands have a population of almost 2.1 million inhabitants, mostly concentrated in the two capital islands: Gran Canaria (40%) and Tenerife (43%).

The Canary Islands are the 8th largest regional economy in Spain by nominal GDP, worth EUR 46 billion in 2018 (corresponding to a GDP per capita of EUR 21,000). The service sector accounts for the greatest share of the economy, namely 85% of total value added. In particular, the regional economy is largely based on tourism, which in 2018 totalled some 15.5 million visitors (of which 89% were internationals), and accounts for 30% of total employment. However, data from 2018 register a decline in the arrivals. As regards the secondary sector, construction makes up 6.2% of the value added and 5% of total employment, while manufacturing industries account for 3.8% of value added and 4% of total employment. The primary sector contributes only 1.2% of the GDP. The main agricultural products are bananas and tomatoes, which are grown for dispatch/export to Europe and the Americas. Overall, the productive sectors addressed by AIEM represent some 8% of the total GDP of the Canary Islands.

The private sector of the Canary Islands comprises some 117,000 enterprises (excluding agriculture and financial services). Trade and business services account for nearly 28% and 24% of the business population. Food and accommodation services and construction are other important economic activities, each accounting 14% of all firms. Manufacturing accounts for nearly 4% of the total.

The economy of the Canary Islands is heavily dependent on trade of goods with mainland Spain, which accounts for 68% of the total value of Canarian external trade. Excluding oil and petroleum products, the Canarian imports totalled some EUR 14.06 billion in 2018 (30.5% of GDP), largely driven by vehicles (18% of total), machinery and electrical equipment (14%), and agri-food products. Canarian exports of goods (excluding fuels) reached some EUR 2.79 billion in 2018, including machineries and equipment (10%), vehicles (5.6%), boats (3.7%), fruits (5.5%), tobacco (5.2%), fish (4.4%), oils and cosmetics (3.5%).

In 2018, the unemployment rate in the Canary Islands amounted to 20% of the active population, with particularly high incidence among young people (ca. 37% in the 20-24 years cohort). Unemployment soared in 2009 (+9% points), in connection with the global financial crisis which severely hit the local economy. In 2013, unemployment reached its peak at nearly 34% (more than 60% in the 20-24 years group), then it started declining in line with the economic recovery trend and the positive growth rates registered in the 2014-18 period.

Table 1 – Canary Islands: Key socio-economic data (2018)

Indicator		Sector	# of firms
Distance from Spanish mainland (Madrid, km – average of all the islands)	1,800	Mining	50
Population (000' people)	2,127	Manufacturing	4,808
Unemployment (% of labour force 15-74)	20.1%	Construction	15,938
GDP (billion EUR)	46.0	Trade	33,196
GDP per capita (in 000' EUR)	21.0	Transport	9,110
Primary (% of value added)	1.4%	Food and accommodation	16,558
Industry and Construction (% of value added)	13.9%	Professional and administrative services	27,756
Service (% of value added)	84.7%	IT	2,570
Import of goods (million EUR)	17,375*	Real Estate	7,044
Export of goods (million EUR)	3,711*	<b>Total</b>	<b>117,030</b>
Number of tourists (000' visitors)	15,560		

**Sources:** ISTAC and Eurostat; \*provisional figures.

### 1.3. Specific measure for the Spanish outermost region

This report focuses on analysing the effects of the existing derogation for the AIEM ('Arbitrio sobre las Importaciones y Entregas de Mercancías') tax to certain products produced locally in the Canary Islands, which expires on 31 December 2020.

The AIEM is an indirect tax levied on the production in and import of certain goods into the Canary Islands. The AIEM tax is one of the components of the Economic and Fiscal Regime of Canary Islands (Régimen Económico Fiscal – REF), which encompasses the various special measures in place to promote the social and economic development of the region and to cope with its structural constraints. The origins of REF date back to the XIX century, but its modern version was defined in the legislation adopted in the early 90s<sup>1</sup>.

Council Decision No 377/2014/EU of 12 June 2014<sup>2</sup> on the AIEM tax applicable in the Canary Islands authorises Spain to apply, until 31 December 2020, exemptions from or reductions in the AIEM tax to certain products produced locally in the Canary Islands. The difference between the taxation of locally manufactured products and the taxation of products manufactured outside the Canary Islands may not exceed 5, 10, 15 or 25 percentage points, depending on the product.

The objective of the existing Council Decision is to support local production of the Spanish outermost region by reducing the competitiveness gap of local products against third country imports and products from 'mainland' Spain and the EU that is caused by additional production costs.

The objective of this report is to evaluate the current regime and analyse possible future options upon the expiry of the current measure on 31 December 2020. This report is based on an external study by Economisti Associati<sup>3</sup> ("the study") commissioned by the European Commission.

<sup>1</sup> Ley 20/1991, de 7 de Junio, de Modificación de los Aspectos Fiscales del Régimen Económico Fiscal de Canarias, followed by ley 19/1994, more recently modified by Ley 8/2018.

<sup>2</sup> OJ L 182, 21.6.2014, p. 4-8

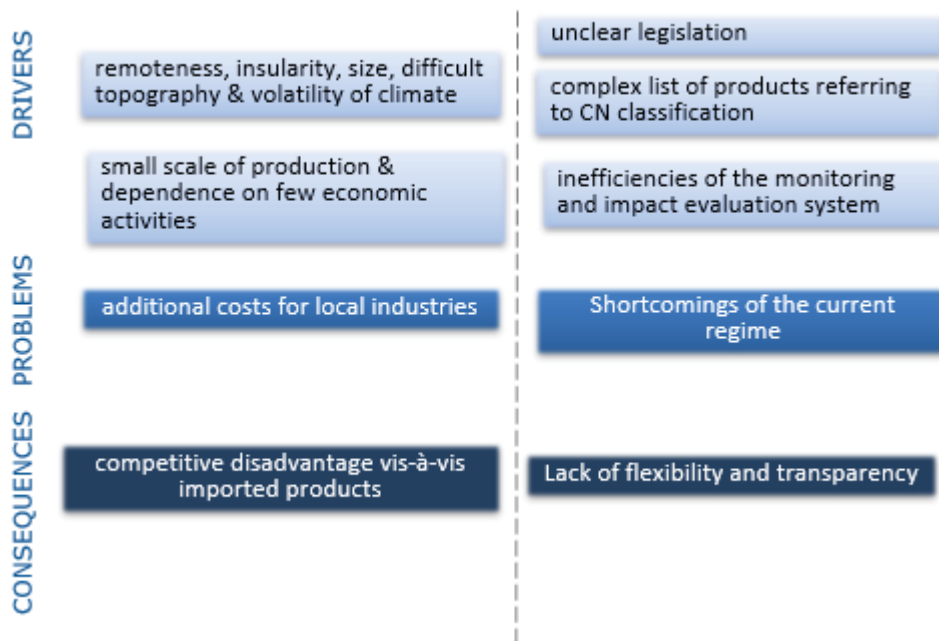
<sup>3</sup> Study on specific tax regimes for outermost regions belonging to France and Spain, Economisti Associati



## 2. PROBLEM DEFINITION

The constraints noted in Article 349 TFEU result in several problems for local producers in the Spanish outermost region. The following problem tree outlines the problems, the drivers and their consequences.

Figure 2. Problem tree



### 2.1. Problem 1: Additional costs for local industries

Quantitative assessments of additional costs incurred by local industries in the Canary Islands are carried out periodically<sup>4</sup>. The latest assessment was completed in 2019 and estimated the total additional costs of the private sector in Canary Islands at EUR 5.23 billion, of which EUR 1.04 billion is attributable to the AIEM supported sectors (manufacturing and primary sector). The freight cost of inputs is the major source of additional costs, with an incidence of 4.4% on the aggregated turnover of local producers, followed by the effects of idle production capacity and the related diseconomies of scale, which account for ca. 1% of their turnover. The estimated additional costs vary by industrial branch, ranging from the 36% of the food industry to 7.3% of the mining sector<sup>5</sup>.

The incidence of additional costs varies across islands: the most affected are the western islands, where additional costs reach 10% of the total turnover (especially because of freight costs), whereas in capital islands the estimated incidence is 6.4%. The gap between capital and non-capital islands has reportedly reduced by 0.9% points between

et al, 2020

<sup>4</sup> Despite the efforts deployed, the exercise remains subject to intrinsic methodological limitations, so estimates have to be taken with due caution.

<sup>5</sup> The low degree of granularity of the analysis means there are uncertainties in the attribution of costs to specific CN categories of product

2008 and 2016. Similarly, the incidence is inversely proportional to firm size: for micro-enterprises with less than 10 employees the additional costs account for 11.3% of the turnover, while for enterprises with more than 250 employees their incidence is ‘only’ 4.8%.

Table 2. Evolution of the estimated additional costs for Canary Islands, by cost factor

Cost Factor	2016		2008	1999*	western islands	1-9 employees
	€ million (2016)	% of turnover	% of turnover	% of turnover	% of turnover	% of turnover
Freight costs	2,860	4.4%	3.7%	1.5%	6.8%	6.9%
Keeping stocks	347	0.5%	0.7%	0.8%	0.8%	1.0%
Business travels	326	0.5%	0.3%	0.1%	0.5%	1.3%
Idle production capacity	631	1.0%	1.1%	n/a	1.1%	1.1%
Water	48	0.07%	0.1%	n/a	0.12%	0.1%
Energy	344	0.5%	1.0%	n/a	0.4%	0.6%
Multiple establishments	575	0.9%	0.3%	0.1%	n/a	0.1%
Financial costs	98	0.1%	0.3%	0.8%	0.12%	0.2%
				1.3% (human resources) 0.5% (marketing)		
<b>TOTAL</b>	<b>5,228</b>	<b>8.0%</b>	<b>7.6%</b>	<b>5.1%</b>	<b>10.0%</b>	<b>11.3%</b>

**Source:** UTE Eco-CoRe 2018; CEET 2002, 2010.

**Note:** (\*) the structure of costs in the 2002 study differ from the following. Overall, 1999 data are not fully comparable with later estimates, for methodological differences.

## What are the drivers of the additional costs for local industries?

*Remoteness, insularity, size, difficult topography and volatility of climate (exogenous to the economy)*

The remoteness of the Canary Islands and their distance to the European continent and Spain, the main supply market, affects the economy of the outermost region. The Canary Islands form an archipelago 2,000 km from mainland Spain. Within the Canary Islands, which comprise eight islands, the distance between the two most remote islands, El Hierro and Lanzarote, is 460 km. As far as the archipelagos are concerned, there is the additional problem of land fragmentation. With a total area of 7,249 km<sup>2</sup>, the Canary Islands remain a small territory.

Moreover, the outermost region is marked by a complex and fragmented territorial topography that limits internal accessibility and constrains the development and economic development of the territories. These are mostly high mountain areas of volcanic origin, where steep slopes, collapse zones and gullies are significant. Coastal coasts are often rugged and inhospitable. The Canary Islands, with the exception of the two low-lying islands of Fuerteventura and Lanzarote, have a very rugged terrain, consisting of cones, calderas, peaks of more than 2000 meters and steep cliffs. The highest point of the archipelago is the peak of Teide (3,718 m), a volcano in Tenerife which is also the highest peak of Spain. Nearly 80% of the archipelago's area has an average slope of more than 20%, which poses problems in terms of soil erosion.

Adverse climate conditions are also a strong feature of the outermost region constraining its development. In the Canary Islands, there is great variability between the islands and

within the islands. The climate varies between a dry subtropical and dry or humid tropical climate depending on the island and the location. For example, in some parts of Tenerife, rainfall does not reach 100 millimetres per year, whereas a few kilometres away, it can exceed 2 metres per year. This precipitation may even increase due to fog. The easternmost islands, Lanzarote and Fuerteventura, are almost desert because they have a lower land surface. Water scarcity is one of the most significant problems in the Canary Islands.

It should also be mentioned that the outermost region is highly exposed to natural seismic hazards that regularly cause significant damage and require continuous vigilance. The last volcanic eruptions took place in Tenerife in 1909 and on the island of La Palma in 1949 and 1971. Volcanic activity is also visible in the sulphuric emissions of the Teide Crater and Lanzarote, where a chain of volcanoes continues to emit heat today after an eruption, which lasted 6 years, in the 18th century.

These natural factors lead to higher operating costs and less competitiveness.

*Small scale of production and dependence on few economic activities (endogenous to the economy)*

The concept of endogenous handicaps of the outermost regions was developed by LL&A 2006<sup>6</sup> with reference to a set of socio-economic features that constrains local development and drives up production costs in the outermost regions. These constraints may derive directly from structural features (or a combination thereof) or stem from other specificities of local economies.

One of these constraints is the economic reliance on a limited number of activities (or limited diversification of the economy), and in particular on the service sector, both commercial (especially trade and tourism) and non-commercial (public service), which makes the outermost regions more exposed to the adverse effects of shocks. In the Canary Islands, the service sector accounts for approximately 85% of the economy and tourism accounts for 30% of employment.

In addition, the outermost region is marked by the small size of the local market, as a consequence of its structural and geographic features. The local demand is weak because of both a small population and limited purchasing power, which is on average lower than in the EU.

The supply side is also weak and atomised. The vast majority of firms in the Canary Islands are either individual businesses (55% have no employees) or micro undertakings (41% have between 1 and 9 employees). Small firms (with 10 to 49 employees) and medium-large companies (with more than 50 employees) account for 4% and 1% of the total business population, respectively.

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<sup>6</sup> LL&A et al., Etude sur l'identification et l'estimation des effets quantifiables des handicaps spécifiques propres aux régions ultrapériphériques ainsi que des mesures applicables pour réduire ces handicaps, 2006 (for the European Commission).

SMEs in general face significant obstacles in terms of development. SMEs in the Canary Islands are further hampered and the main cause of the competitiveness ‘gap’ is linked to the absence of economies of scale: while, on the continent, industries grow in size and degree of specialisation, with falling unit production costs, in the Canary Islands, the growth is further constrained by the need to produce a larger variety of products with the same production lines. This has a significant impact on costs including higher maintenance and depreciation costs. The lower degree of specialisation reduces productivity of labour and requires larger stocks. This requires extra storage capacity. Increased financial costs can also be also noted as a result of this.

## **2.2. Problem 2: Certain shortcomings of the current regime**

The most critical implementation concerns of the AIEM special tax regime are linked to the eligibility of products to differentiated AIEM rates. In the Council Decision No 377/2014 such criteria are not explicitly mentioned but, as confirmed by the competent authorities, they are based on the existence of a substantial local production that is threatened by imports which are not constrained by the same additional operating costs faced by local producers. The key indicator is the ‘market share’ of local production, but no specific threshold for the triggering of the exemption has been established. Analogously, the special treatment is justified by additional costs which have always been estimated at sectoral / branch level but never at the level of individual product.

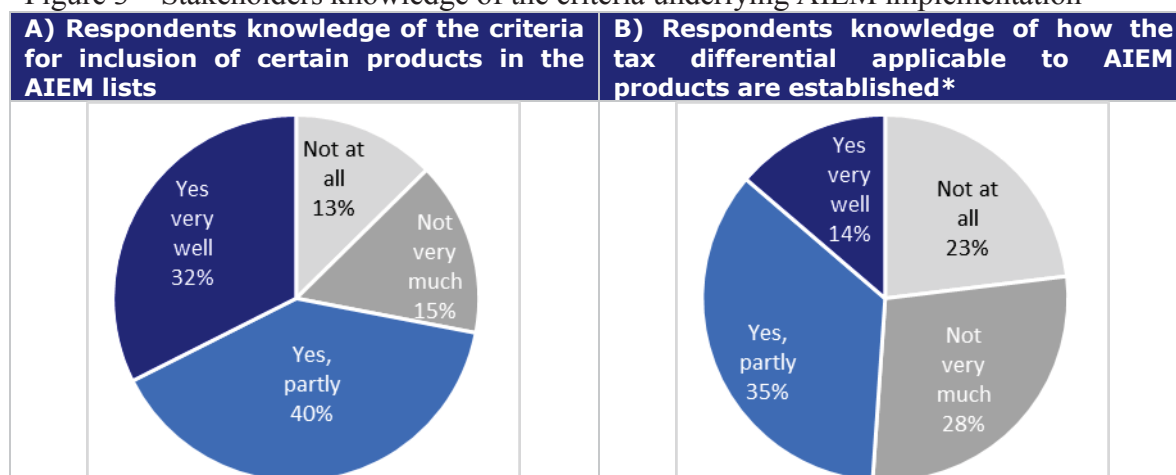
Stakeholders note that the policy process leading to the selection of products and the application of tax differentials is not fully transparent<sup>7</sup> and there appears to be a disparity of treatment. This creates legal uncertainty for stakeholders and is a potential cause of disputes. This is a recurrent criticism raised by enterprises (both importers and local producers) against the special tax regime.

It is therefore not surprising that a significant share of both local producers (20%) and trade and service businesses (40%) expressed limited or no knowledge of the criteria for inclusion of certain products in the AIEM lists, and more than half of the respondents admitted a poor knowledge of the methods used to establish the tax differential applicable to AIEM products (see Figure 3). Moreover, the lack of transparency is possibly fuelling the mistrust towards the AIEM regime.

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<sup>7</sup> The absence of more articulated criteria to determine the eligibility emerged also from an official response of the competent service of the local administration to a recent parliamentary request (October 2018). To a series of questions concerning the selection criteria and the establishment of the appropriate tax rates, the answer was that reference is made to local production level and of imports, but no further explanation was provided on the benchmarks triggering the application of the special regime. Source: Stakeholder consultation

Figure 3 – Stakeholders knowledge of the criteria underlying AIEM implementation



**Source:** Business survey of the Study.

**Note:** the question did not refer to specific official guidelines that are not publicly available in Canary Islands, but more generally to the process that lead to the establishment of a tax differential, e.g. from the additional costs assessment (many enterprises participate to the periodical surveys conducted in this respect), to the policy decision and negotiations at EU level.

Furthermore, the current policy arrangements and the governance system are overly complex or rigid, causing unnecessary burden for the European Commission and the national authorities. One such aspect is the impossibility to revise the list of products<sup>8</sup> which benefit from the regime and the exemptions extended to specific products without a legal amendment of the Council Decision, triggering a full special legislative procedure according to Article 349 TFEU. This hampers a smooth adaptation of the regime to the evolving market and sectoral needs in the Canary Islands, reducing its effectiveness and imposing administrative burden on the authorities and the stakeholders involved. Finally, the current monitoring requirements involve significant efforts from competent authorities, but the lack of a proper, harmonised monitoring framework and the poor timing of the monitoring reports affect their informative value and utility for the policy process.

### What is affecting the smooth functioning of the regime?

#### *Complex list of products referring to CN classification (8 – 10 digits) (lack of flexibility)*

The eligible products for reduction or exemption to the tax are fixed for a seven year period and some of them are listed in the Annex to the Decision using 8 – 10 digit Combined Nomenclature codes (hereinafter ‘CN codes’)<sup>9</sup>, which are very specific. This list covers products such as building materials, chemicals, beverages, food, textiles, paper or agricultural and fishery products.

Table 3. Example of products which benefit from the regime related to the metal-working industries sector.

CN codes	% applicable	Description
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<sup>8</sup> The list of products is in the annex of the Council Decision No 377/2014/EU

<sup>9</sup> CN codes are a tool for classifying goods. CN codes can be divided into 4, 6, and 8 digits. TARIC classification contains 10 digits. 4 digit CN codes are used for products of a kind, whereas each specific product has an 8 digit CN code.

7309 00	10	Reservoirs, tanks, vats and similar containers for any material (other than compressed or liquefied gas), of iron or steel, of a capacity exceeding 300 l
7604	5	Aluminium bars, rods and profiles
7608	5	Aluminium tubes and pipes
7610 10 00 00	10	Doors, windows and their frames and thresholds for doors
9403 20 80 90	10	Other metal furniture

The legislation for CN codes is amended periodically and as a result specific products that were included originally in the Decision may unintentionally ‘fall’ off the list. Due to the use of 8 – 10 digits CN and TARIC codes respectively, new emerging local productions that were not in place when the Decision was adopted are not covered. Changes in the level of compensation extended to certain industries to cope with changed conditions of competition (e.g. to cope with aggressive importation) cannot be addressed and removal of products no longer relevant (i.e. no longer produced locally) is not possible.

#### *Unclear legislation (lack of transparency)*

The Council Decision No 377/2014 provides no information on which criteria are used for including the products on the list. It is therefore not surprising that a significant share of both local producers and trade and service businesses expressed limited or no knowledge of the criteria for inclusion of certain products in the AIEM lists, and more than half of the respondents admitted a poor knowledge of the methods used to establish the tax differential applicable to AIEM products. This lack of transparency may fuel the perception of subjectivity and disparities of treatment.

#### *Inefficiencies of the monitoring and impact evaluation system*

The Council Decision No 377/2014 contains specific provisions requiring Spain to submit periodical reports to the Commission on the implementation of the AIEM regime and its impacts on local economic activities. These ‘mid-term’ reports are the basis of Commission’s reports to the Council.

The monitoring and evaluation arrangements of the regime are very burdensome both for the economic actors and for the administrations. Considering the number of products at stake, the efforts deployed to implement these reviews have been significant, but despite the general adequacy of the approach and methodology used, the results should be taken with caution, because of various limitations and constraints.

The monitoring and evaluation arrangements are not always in line with the information needs, as concerns timeliness, quantification and scope. The information provided did not give a complete picture of the economic and social impact on local production in the Canary Islands of the AIEM regime.

Overall, a picture emerges where approximations, uncertainties and theoretical assumptions are abundant. In most cases, these cannot be removed or huge efforts would be required to obtain marginal improvements in the reliability of the assessment.



### 2.3.How will the problems evolve?

In the 2017 Commission Communication “A stronger and renewed strategic partnership with the EU's outermost regions”<sup>10</sup>, the Commission notes that despite progress made over the years, the outermost regions continue to face serious constraints, many of which are permanent. Furthermore, globalisation and climate change are amplifying these constraints. Diversification opportunities are limited due to the few resources at their disposal and the geographical and natural characteristics specific to their remoteness. Consequently, economies of the outermost regions are fragile and any sustainable economic growth or desirable structural changes insecure. Economic crises are bound to affect the economies of the outermost regions to a greater extent than of mainland Europe, and recovery is slower. Any such effect and developments are however difficult to determine as regional statistical data are not always available and if available, not always reliable.

The Communication stresses the need to build on the assets of the ORs, identifying new sectors to enable growth and job creation.

While this approach is important to address the numerous threats and constraints for the ORs, the traditional activities are also vital to the development of the regions as any sustainable structural changes to the economies of the ORs will take time to materialise.

The costs faced by producers in the regions are higher than the costs faced by the mainland producers and they are attributable to the factors identified in Article 349 TFEU. Overall, the derogation has increased production levels, and as such, supported employment in the regions.

As many of the underlying drivers, such as remoteness, insularity or climate, are of permanent nature, they will always act to the ORs' disadvantage. There are no grounds to consider that they would diminish significantly in the near future as they are inherent to small insular economies in general. On the contrary, with global trade growing increasingly competitive, the ‘gap’ of outermost regions might become even more difficult to bridge overtime. Numerous cases were reported of imported goods sold at retail at a price (tax included) lower than the production cost of the same good locally-made. Hence, the AIEM is generally viewed by enterprises as tools to help mitigating / slowing down the inevitable loss of competitiveness of local production rather than as a development tool.

Transport infrastructures have been steadily built and a mildly positive trend in the maritime and air transport of freight could be observed in the last decades in the ORs but accessibility issues will always affect the trade and exchanges of the ORs with the EU as and within their geographic areas alike.

What we can carefully conclude from the nature of the costs is that they can fluctuate but will never disappear altogether.

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<sup>10</sup> COM(2017) 623 final

## **2.4. Why should the EU act?**

On the basis of Article 349 TFEU, the Council can adopt specific measures in favour of the EU outermost regions to adjust the application of the Treaties to those regions, including the common policies, because of the permanent constraints which affect the economic and social conditions of the outermost regions. In its judgement of 15 December 2015<sup>11</sup>, the European Court of Justice clarifies the scope of the application of Article 349 TFEU on the basis of which the Council is entitled to adopt specific measures for the EU outermost regions.

The EU has been building a strong partnership with its outermost regions. In 2004, the Commission presented its first strategy for the regions, which was renewed in 2008, in 2012 when the strategy was aligned with the Europe 2020 goals of sustainable growth, social development and creation of jobs; and in 2017, when the Commission strengthened and renewed its strategic partnership with these regions. Access to the EU single market is vital for the continued development of the ORs as underlined in the 2017 Commission Communication “A stronger and renewed strategic partnership with the EU's outermost region”<sup>12</sup>.

Maximising the potential of each outermost region can only benefit both the outermost regions and the EU as a whole.

## **3. OBJECTIVES: WHAT IS TO BE ACHIEVED?**

### **3.1. General objectives**

The situation of the outermost regions is recognised in Article 349 TFEU, which envisages specific measures for these regions to take account of the structural, social and economic situation of these regions. Measures adopted must mitigate the constraints of the regions and promote regional development without undermining the integrity and the coherence of the Union legal order, including the internal market and common policies.

### **3.2. Specific objectives**

The AIEM special regime is part of the overall EU policy approach for the Canary Islands as an EU Outermost Region, and in this sense its coherence is ensured by the substantial alignment of its objectives with the broad strategic framework.

In particular, the objectives of the AIEM are to promote and sustain local production activities, which, in turn, contribute to attracting investments, building capacity and skills, and reducing the dependency from the Spanish ‘mainland’.

Moreover, another objective of the AIEM in the Canary Islands is to support industrial activities, which in turn promote the development and diversification of local economy and, in particular, foster activities with high value-added and job creation potential.

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<sup>11</sup> Joined Cases C-132/14 to C-136/14

<sup>12</sup> [COM\(2017\) 623 final](#)



## 4. WHAT ARE THE AVAILABLE POLICY OPTIONS?

### 4.1. What is the baseline from which options are assessed?

For the purposes of this report, there is a difference between ‘no action’ and the ‘status quo’. Given that the Council Decision authorising the reduced excise duties expires in 2020, a ‘no action’ scenario would imply that the current system of reduced rates expires in 2020 with no other regime put in place. This is, however, not considered to be a realistic baseline scenario.

As such, we assess non-renewal of the regime as a ‘new policy option’, whereas the baseline option for this regime is defined as a ‘business as usual’ scenario, in which the derogation is renewed for a further seven years. The baseline assumes that the current products listed in the Annex of the Council Decision produced locally in the Canary Islands continue benefiting from total exemptions or partial reductions of the AIEM after 2020.

### 4.2. Description of the policy options

#### *Option 1 – Termination of the OR specific support*

Under this policy option, the existing regime of reduced rates or exemptions of the AIEM for local products in the Spanish outermost region would not be renewed and would therefore expire on 31 December 2020. All products would be subject to the AIEM.

This option would mean no further specific relief would be provided after 31 December 2020 to the OR local producers to mitigate the additional costs they face due to their location.

#### *Option 2 – Revision of the current regime*

This option involves prolonging the current regime introducing a series of revisions to the policy and its implementation arrangements. The proposed changes regard three main aspects, described in the following paragraphs. The proposed changes are not mutually exclusive and are technically independent of each other, although in some duly highlighted cases there are interconnections.

#### *Option 2A – Revision of criteria for the identification of eligible products and updates*

The proposed option envisages a shift in the method used for the identification of the products supported through the special tax regime, namely from the current approach where each specific product is explicitly identified in the Decision (based on a coding ranging from CN4 to TARIC10) to a system where the Decision indicates only the eligible product categories (CN4) while specific products (CN8 or higher) are detailed by national authorities in their legal and administrative frameworks.

This measure would allow for a more flexible management of the regime by competent authorities removing the needs for EU-level legal amendments for ordinary revisions and updates of product lists. Secondly, it is proposed to adopt clearer and verifiable criteria for the selection of products benefitting from the AIEM support. In line with the current

practice such criteria should take into consideration inter alia the market share of the product, and in the case of products in residual or largely dominant position on the local market a proper justification for support should be transparently provided. Overall, this provision would prevent the risks that a greater flexibility in the management of lists translates into unwarranted extension of the scope of the policy, and would respond to the demand of greater clarity and objectivity expressed by most of AIEM opponents.

The proposed option would respond to one of the main comments expressed by competent authorities and private sector stakeholders in order to allow for a more flexible modification and updating of product lists since, at present, any change would require a legal amendment of the Council Decision.

#### *Option 2B – Revision of mechanisms to establish the maximum permitted differential*

This proposed option is articulated into three specific measures. The first intends to simplify the arrangements regarding the establishment of tax differentials, replacing the current four different product lists with only one list with a single maximum permitted threshold of 15% as the maximum permitted differential for all the products listed in the Annex of the new Decision. The Spanish authorities, in line with the principle of subsidiarity, will decide the specific percentage applicable to each product, ensuring that the specific percentage equals or is less than the additional costs associated with producing the product in the outermost regions. This will facilitate amendments by the Spanish authorities without the need for a legislation amendment to the Decision.

The benefits of this measure would consist in a more flexible management of the differential rates applied by the competent authorities, allowing revisions without a formal amendments of the Council Decision. To prevent the risk that this measure enables an unwarranted greater intensity of the support and, at the same time, to facilitate the coordination with other support schemes avoiding an excessive cumulation of aid, the second proposed measure consists of introducing in the policy a global reference value, i.e. a monetary ceiling referred to the estimated ‘foregone tax revenue’ that competent authorities shall respect. The third proposed measure aims at improving the utility, for policy purposes, of additional cost assessments, disaggregating the estimates at the level of CN4 product categories, and ensuring that the tax differentials applied do not exceed such estimates (account taken of the other compensations addressing the same additional costs).

#### *Option 2C – Revised monitoring arrangements*

The proposed revision has the parallel objectives of reducing the burden of unnecessarily frequent re-assessment and renewal of the policy and enhancing the utility and effectiveness of monitoring and evaluation activities. As regards monitoring, the proposed revision consists of the adoption of a standardised structure for reporting based on a harmonised set of indicators common to all EU outermost regions benefitting from a special tax regime, and deemed sufficient to properly assess the impact of the regime.

Additionally, the timing of submission of monitoring report could be moved back to the fifth year since the adoption of the policy, in order to ensure (a) a greater availability of monitoring data, and (b) a closer alignment with the needs of the policy renewal process. The current monitoring system can be made more effective and informative moving the timing of the mid-term report to Y+5 (where ‘Y’ stands for the first year of application of the Council Decision). In practice, for the period 2021-27, the report would have to be submitted by the end of 2025 and spanning, ideally, the period 2019-24.

#### **4.3. Options discarded at an early stage**

##### *Replace with other EU measures*

Under this alternative, the regime would be replaced with another EU measure to the same effect. This approach can be further specified considering two main aspects: (a) the fiscal or non-fiscal nature of the replacement measure; and (b) the type of funding envisaged. In fact, the current AIEM regime is a fiscal measure entailing no expenditure of EU funds and replacing it with a different kind of measure is not a suitable option for two main reasons:

- Replacing the current regime with a non-fiscal equivalent measure would *de facto* entail extending the support through one of the existing EU schemes for the ORs (i.e. the regional development policies and/or the other schemes mapped in Annex D), increasing the allocations and possibly creating *ad hoc* lines for the compensation of local production costs (to ensure the equivalence of the effects with the current regimes). This would have implication both at the level of EU-level policy design as well as specific programming and implementation of the aid. The responsibility for it would fall outside of the remit of the fiscal services of the Commission and would involve the other line services responsible for the regional development and cohesion policy. This option would add unnecessary complexity to the regime with poor feasibility.
- Currently, the estimated budget for the AIEM special regime (measured in terms of non-collected taxes) according to the corresponding State aid fiche amounts to € 80 million / year.<sup>13</sup> At present, the measure is implemented at no cost for the EU budget as it consists of ‘non-collected’ taxes. Replacing it with an expenditure scheme of equivalent impact, would therefore require additional monetary transfers of up to € 560 million for the next EU programming period (2021-27). This approach would evidently be very cost-inefficient and is therefore discarded.

Based on the above considerations, this option is discarded.

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<sup>13</sup> SA.40255 (2014/X) - HAC - Arbitrio sobre importaciones y entregas de mercancías en las Islas Canarias

## **5. WHAT ARE THE IMPACTS OF THE POLICY OPTIONS?**

### **5.1. Methodology**

The impacts of the policy options have been assessed mainly on the basis of “the study”, which was based on a combination of primary research, that is, on data gathered from all relevant stakeholders and independent research to triangulate findings, review of the existing literature and data, and economic and policy analysis.

Appropriate, but limited, adjustments were made on specific points where this was warranted by newer information becoming available or by fine-tuning of the policy option. For the quantitative estimates, the impacts are measured as the deviation of the variable assessed from the baseline, at the conventional date of 2027. This is sufficiently distant to allow short-term effects play out with the exception of the emerging effects of COVID 19. Full details on the methodology are provided in Annex 3.

#### *Effects of the COVID-19 pandemic on the projections underlying the assessment*

It should be noted that the baseline scenario as well as the impacts from the various options have been assessed on the basis of the study carried out in late 2019-early 2020. As such, the effects of the COVID-19 pandemic are not taken into account. The Coronavirus pandemic will certainly reduce tourists to the outermost regions and demand for spirits in the first half of 2020. At the time of writing, it is too early to assess whether the impact on the tourism and the demand for spirits will be limited to 2020 or will stretch into the future. While in the first case the projected baseline may not be affected to a large extent, in the second case, the baseline scenario may overstate growth. The impacts of the options, however, are calculated on the basis of long-term elasticities and should, as a result, be less affected than the baseline.

### **5.2. Baseline**

In this context, the ‘no change’ scenario consists of the renewal of the special regime without any significant modification. In this sense, this scenario corresponds to the baseline situation.

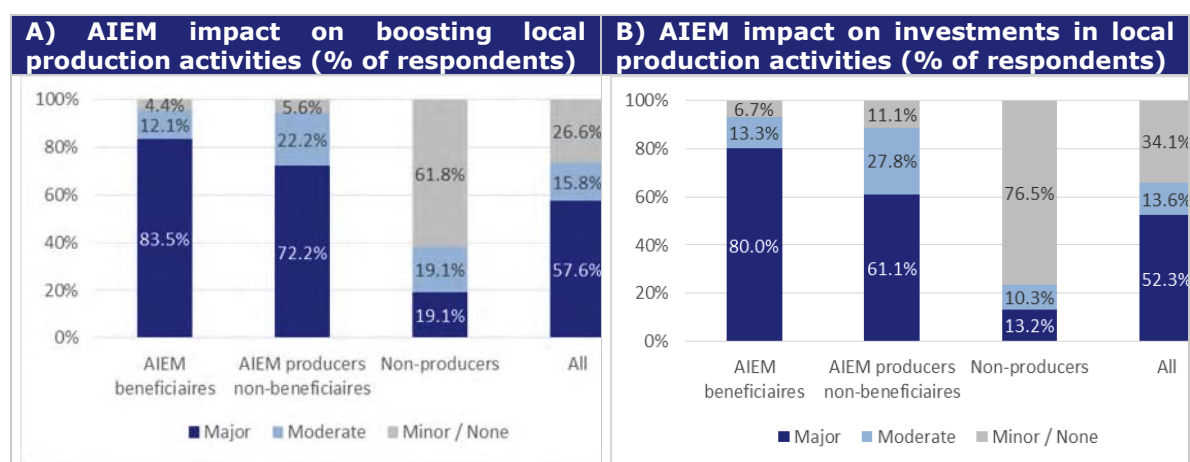
The current AIEM regime compensates only a portion of the estimated additional cost. On average, tax differentials address about one-fourth of additional costs, but in monetary terms the total compensation - measured in relation to the total tax charged on imports – accounts for only 14% of the overall additional costs. This limited incidence combined with fairly irregular compensation patterns at product level make the impact on the competitiveness gap rather uncertain: according to the majority of beneficiaries the AIEM support has been essential to sustain the competitiveness of local products, but the data suggest that such competitiveness has nonetheless slightly declined overtime. In this sense, and as confirmed by statistics, the AIEM emerges as primarily effective in mitigating such decline rather than for development and growth: the value-added of AIEM-supported industries since 2008 has remained substantially stable, but since the value of imports has been growing at a faster pace, the market share of AIEM-supported industries has fallen by ca. 1% point over the past decade.

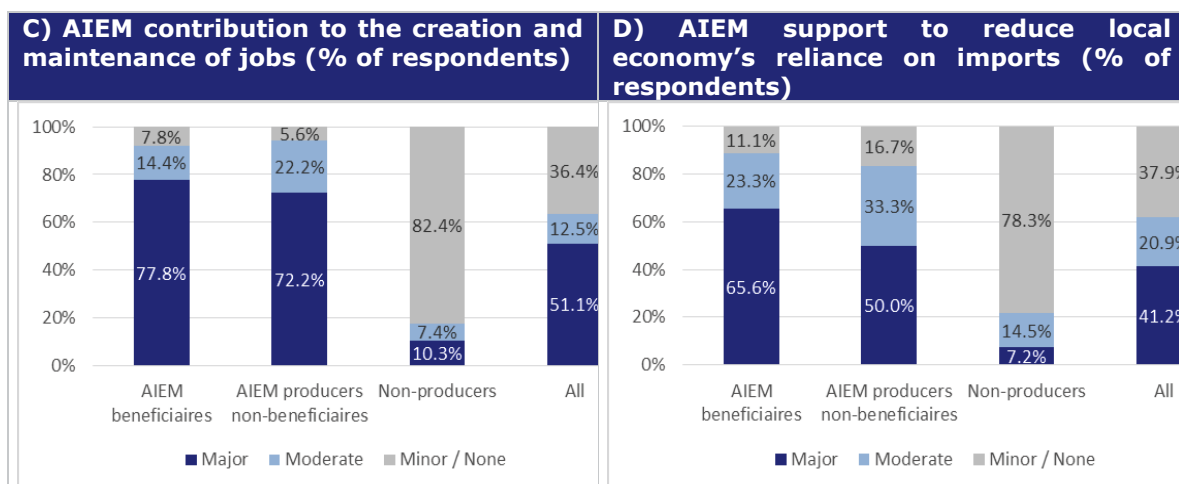
The results of the survey of the study suggest that, in the absence of the AIEM support, the performance of the local production sectors would have been significantly worse. About one third of the value of AIEM-supported products (ca. EUR 570 million) was theoretically enabled by the tax differential mechanism, with positive repercussions also on employment - which registered an increase of nearly 2,000 units in the AIEM sectors since 2014 – and on the number of active enterprises, which has grown by ca. 300 units in the same period. There is instead no evidence on the benefits in terms of the total value of investments and on the diversification of productions.

Overall, the impact of the AIEM is regarded as more significant in terms of support to the local production, investment and employment, while respondents are less persuaded of the AIEM positive effects in terms of local market share. In particular, as summarised in Figure 4:

- almost three fourths of the respondents maintained that the AIEM had a moderate to major impact in boosting local production activities in the Canary Islands. This share includes 83% of the tax beneficiaries, assessing the impact as ‘major’, but also about 40% of the enterprises active in sectors other than manufacturing;
- the perceived influence of the AIEM in supporting employment and investments in local production activities is comparatively more controversial. The vast majority of local producers (about or over 90%) believe that by supporting the viability of their business the AIEM is also helping maintaining and possibly creating jobs, as well as fostering investments. Such an opinion, however, is not shared by non-producers, considering the impact of the tax as minor or absent;
- the replies on the AIEM impact on reducing the local economy reliance on imports are the least enthusiastic, even among local producers, which are conscious that other factors influencing competitive dynamics are at play. Less than one third of the tax beneficiaries assessed this impact as ‘major’, and this share declined to 50% in the case of producers not directly benefitting from the tax.

Figure 4. Business perception of AIEM impacts on economic performance

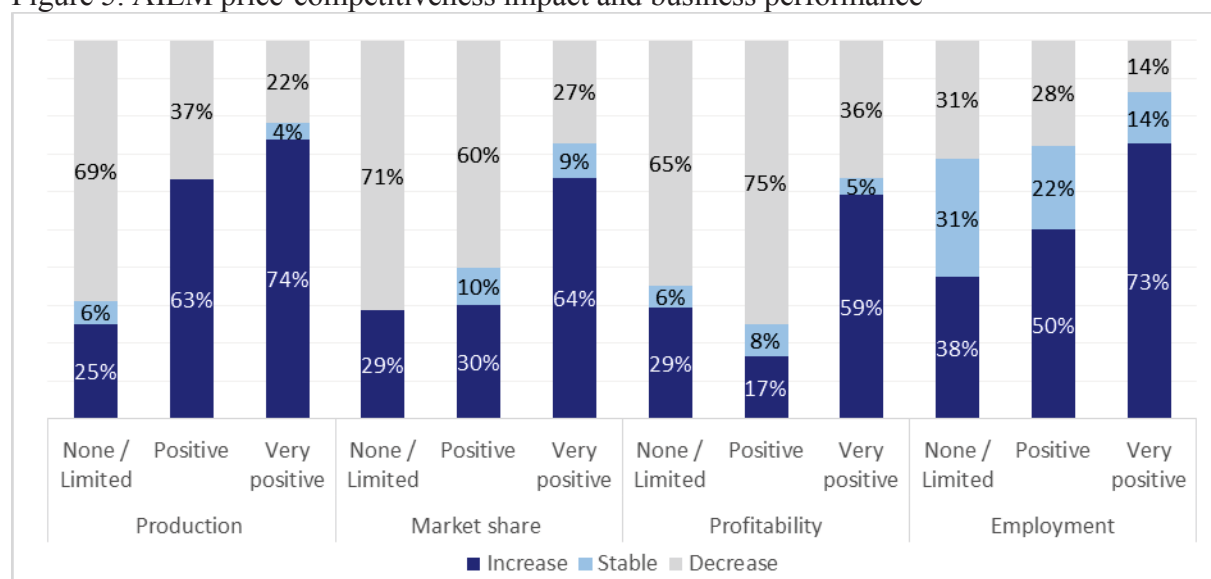




**Source:** Business survey of the Study.

Additional indications on the extent to which the AIEM contributed to promoting local economic activities were drawn by comparing the tax impact on price-competitiveness with firms' past performance. As shown by Figure 5 below, the strength of the AIEM price-competitiveness impact features a positive linkage with other dimensions of the firms' performance. Consistently with the self-reported assessments presented above, this seems to be especially true in the case of production and employment: a 'very positive' tax impact in terms of price-competitiveness is associated with almost three-fourth of firms reporting a positive past trend. On the contrary, the majority of the firms reporting a lacking/small price competitiveness impact recorded a negative performance. In the case of market share and profitability, the importance of other factors at play is also confirmed: although a positive relationship is detected in the case of firms experiencing a 'very positive' price-competitiveness impact, the majority of firms with a positive impact recorded a negative performance.

Figure 5. AIEM price-competitiveness impact and business performance



**Source:** Business survey of the Study.



### 5.3. Option 1 - Termination of the OR specific support

The ‘do nothing’ scenario entails that the current EU Decision for AIEM is not renewed after its expiration in 2020, and is not replaced by other EU support mechanisms. This would lead to the removal of tax differential system based on the origin of products, although not necessarily to the withdrawal of the AIEM as a ‘budgetary’ measure.

The estimated impact of the existing regime is globally positive, so its plain withdrawal would predictably not lead to an improvement but rather to a worsening of the current situation.

First and foremost, the removal of AIEM tax differentials would severely affect the competitiveness of local firms engaged in production activities – manufacturing activities in the first place, then enterprises in the agriculture and fisheries sectors. The overwhelming majority of the affected firms would be SMEs. It has been estimated that the AIEM special regime compensate some 14% of the additional costs of local producers (EUR 125 million), which is tantamount to assume that *ceteris paribus* local products would become some 5% more expensive than imports.

The loss of competitiveness would evidently have repercussions on sales and market share of local products, whose extent depends on the characteristics of the demand for each specific product affected. Assuming – for analytical purposes – a proportional and linear elasticity of the demand, the demand for local products would decrease by 5% and the average market share would decline by 2.7%, on average.<sup>14</sup> Eventually, several local producers would be no longer competitive and would interrupt activities. According to the results of the survey of the study, this may happen to some 54% of the currently supported enterprises (self-employed excluded). As a consequence, the competition would reduce and the market would become more oligopolistic, with possible long-term boosting effects on retail prices and a worsening of consumer welfare.

For the macroeconomic indicators of regional economy, the following impacts can be expected:

- Reduction in the production value, largely proportional to the 5% reduction of sales anticipated (i.e. EUR 107 million). The contribution of industrial sector to the local economy would be reduced, increasing the dependence on the service sector.
- Similarly, a parallel decrease in the number of employees engaged in the industrial sector, as well as in the level of investment mobilised can be expected.
- The trade balance of Canary Islands would further worsen, as the loss of local production shall be substituted by imported goods.

The budgetary effects of this policy change are rather unpredictable as they depend on the actual policies deployed by competent authorities in response to the discontinuation of the special regime. In essence, if the removal of differentiated rates translates into an increase of internal rates to the same level of external AIEM rates, the tax revenues

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<sup>14</sup> Note: the market share in value terms would actually not change, but it would change in volumetric terms.

collected would evidently increase – and precisely by the current amount of the tax not collected because of exemptions (assuming the demand stable). If, conversely, the AIEM is removed altogether on internal and external delivery a loss of tax revenue is expected, equal to the AIEM receipts currently collected (EUR 160 million). The first approach is unrealistic as it would lead to a price level increase hardly acceptable by consumers. On the other hand, the second approach would deprive the regional administration of part of its budget (some 5% of total indirect tax receipts), which could be nonetheless compensated by an increase of IGIC or other local taxes. A ‘halfway’ solution seems also possible, i.e. at the same time decreasing external rates and increasing internal rates until reaching the point of equilibrium that would offset any budgetary impact.

For the same reasons, the impact of the discontinuation scenario on price levels is unpredictable, as it depends on the approach chosen by competent authorities to eliminate AIEM tax differentials. In the extreme case of bringing internal rates to the level of external rates, the cost for consumers would be equal to the extra tax receipts levied (EUR 166 million) and would increase household expenditure by 0.8%.<sup>15</sup> In the event of a complete removal of AIEM (offset by an increase of IGIC) or of an adjustment of rates to equal the current burden, no marginal aggregated effects would be registered on price levels.

Table 4. Summary and rating of expected impacts of option 1

Impact area	Impact	Subject	Rating and magnitude	Notes
<b>Operating costs/ competitiveness of business</b>	<b>Severe reduction of competitiveness</b> of local products vis-à-vis import	Beneficiary firms	<b>-2</b>	
<b>Budgetary effects</b>	<b>Unpredictable</b> , but potentially significant depending on authorities' decisions	MS authorities	<b>-1/+1</b>	From (+1) if harmonised on external rates to (-1) if removed (and not compensated)
<b>Functioning of the market and competition</b>	<b>Major changes in the market structure</b> (increase of import) and reduced competition	All economic operators	<b>-2</b>	
<b>Macroeconomic impacts</b>	<b>Worsening of trade balance</b> , and possible negative effects on <b>employment, investments</b> .	MS authorities	<b>-1</b>	Effects on consumer prices would depend on the policy adopted

**Legend:** rating scale: +2 major positive impact; +1 minor positive impact; 0 neutral impact; -1 minor negative impact; -2 major negative impact.

**Source:** Analysis of the Study.

## 5.4.Option 2 - Revision of the current regime

### 2A – Revision of criteria for the identification of eligible products and updates

<sup>15</sup> Based on an estimated total household expenditure of EUR 19,875 million (2017). Source: *Informe Anual del CES, 2019*.



One of the most tangible impacts of this proposed sub option is the removal of the need for legal amendments to modify product lists and of the regulatory burden connected to it. A reduction of the private sector's regulatory burden is also envisaged, but on a smaller scale. These benefits would stem from the timelier fixing of any issue deriving from the periodical revision of the CN customs classification. For a rough appreciation of the magnitude of benefits it should be considered that 37% of the enterprises surveyed in the Study reported a change of CN code for at least one of the AIEM products in their portfolio, and for nearly 20% of respondents the time spent on identifying the correct coding is a source of 'major burden'.

For the concerned products, the advantage of greater flexibility is clear and direct: a timelier adoption of the special regime, and therefore an enhanced impact on competitiveness and, possibly, growth. More specifically, compared to the current situation, new products might have access to special treatment a few years before the next policy renewal (up to 7 years). Assuming that local enterprises would schedule the launch of new production activities taking into consideration the entry into force of the special regime, the proposed option might reduce the time-to-market of new products by 3-4 years, on average. Similarly, competent authorities would also be able to remove products no longer relevant from the list, but no marginal impact is expected in this case because also in the present situation authorities may at any moment set the AIEM rate and/or the differential at 0% for products that no longer require support.

The general functioning of the market would also benefit, in principle, from more timely and flexible updates of product lists. In particular, facilitating the development of new productions, which would contribute to the diversification of the local economy; where this translates into greater market competition, an improvement of consumer welfare is assumed.

Whether the abovementioned benefits would lead to tangible macro-impacts, such as on the growth of industrial value-added or employment is difficult to say, but based on the results of the retrospective evaluation it seems unlikely. The proposed option would regard only a small fraction of the supported products and with low magnitude effects. Nevertheless, it can occasionally lead to non-negligible sectoral impact, especially in emerging economic sectors for which there are currently no activities in the Canary Islands.

The adoption of well-calibrated and verifiable criteria would be beneficial for all public and private sector stakeholders, as follows:

- EU authorities. The establishment of binding criteria provides a safeguard against possible distortive uses of the policy, at the same time facilitating the supervision tasks.
- Competent authorities. The proposed criteria are coherent with the existing policy so they would not cause any friction at administrative level. In fact, they would help competent authorities to cope with the possible increased pressure from private sectors that might accompany the proposed greater flexibility of implementation. The option may also lead to removing the special treatment on products for which there is no or negligible local production, thus addressing the concerns frequently raised by

importers and possibly reducing / eliminating one of the major causes of complaints and disputes.

- Economic operators. The adoption of objectively-verifiable criteria would respond to the need for transparency and accountability emerged from field work interviews with private sector stakeholders from both productive sectors (i.e. the beneficiaries of the regime) and trade sectors (i.e. the ‘taxpayers’). In this sense, this option would improve the implementation of the policy, preventing/removing the application of the special regime to products that do not arguably meet the required conditions, and ultimately contributing to eliminate competition distortions and to the proper functioning of the market.

As concerns the impact on the competitiveness of local firms, the proposed option is in principle neutral, in the sense that it does not intend to modify the current scope of the special regime and the tax treatment of any particular products. If some currently supported product loses the requisites for the support, the option implies its removal from the list, but this is already envisaged by the current provisions, so the option would not have different or additional effects. Still, making the justification of support more transparent and verifiable could lead to an improved assessment of the real needs of producers and a timelier detection and fixing of possible incongruences in the product lists. The ensuing benefits of removing from the list products that do not meet the eligibility criteria would regard, again, the general proper functioning of the market but the impact on the competitiveness of local enterprises would be negligible, since the market share of the excluded products would be either not significant or so large that arguably no support for competitiveness is required.<sup>16</sup>

Table 5. Summary and rating of expected impacts of option 2A

Impact area	Impact	Subject	Rating and magnitude	Notes
<b>Governance and good administration</b>	<b>Enhanced transparency and accountability</b> in the selection of supported products	EU / MS authorities	<b>+1</b>	Delegating the establishment of thresholds to MS authorities enhances subsidiarity but possibly fuels disparities
<b>Regulatory costs and savings for public authorities</b>	<b>Increased burden</b> , related to the required <i>ad hoc</i> justification for special cases	MS authorities	<b>-1</b>	
<b>Operating costs/ competitiveness of business</b>	<b>Neutrality of effects</b> on the current state of play should be ensured	Beneficiary firms	<b>0</b>	Except for non-eligible products, which have to be removed anyway
<b>Functioning of the market and competition</b>	<b>Reduced complaints</b> and disputes over unjustified disparities of treatment and unduly distortion	All economic operators	<b>+1</b>	

<sup>16</sup> It is important to remind that, according to the proposed option, the compliance with the prescribed market share window can still be derogated, if duly justified, so products falling above or below the established thresholds would not be automatically excluded.

**Legend:** rating scale: +2 major positive impact; +1 minor positive impact; 0 neutral impact; -1 minor negative impact; -2 major negative impact.

**Source:** Analysis of the Study.

## 2B – Revision of mechanisms to establish the maximum permitted differential

The budgetary impact of the proposed option would be neutral ‘by design’: the option has not the objective of increasing tax differentials and, in general, of modifying the intensity of the aid but to allow revisions – where needed - without a legal amendment procedure. In this sense, the amount of tax levied would not be affected by the option. In practice, to prevent the risk of a generalised increase of tax differentials, this option should be accompanied by the establishment of a global ceiling for the cost compensation.

For the competitiveness of individual local production, the proposed option could be beneficial as it would enable timelier modification of the differential applied, i.e. without the restriction of periodical renewal or interim legal amendments. However, this typically regards a limited number of products (i.e. only 8 products were moved to a higher list in the 2014 renewal of the policy) and an improved timeliness of 3-4 years compared to the present situation, so from a general market perspective and in aggregated terms (including macro-economic aspects) the expected impacts would be hardly noticeable.

This option is also aimed at simplification and greater flexibility in the implementation of the policy. Importantly, it does not intend to modify the intensity of the support extended to the products benefitting from tax differentials but only to facilitate those revisions that currently imply moving a product from a list to another one with a higher permitted differential. In fact, the proposed option regards essentially procedural aspects and therefore its fundamental impacts fall in the category of governance and good administration.

The current subdivision into four distinct lists does not add value to the efficacy or the relevance of the policy and constitutes an unnecessary complexity that can be removed and replaced with a single list with a single maximum permitted differential. The maximum permitted differential applicable to the single list would be 15%, which is the currently highest differential actually applied under the AIEM regime.<sup>17</sup>

In practical terms, the option would eliminate the need for any administrative action to move products across lists and the related burden. On the other hand, this option can result advantageous for competent authorities only if there are effective administrative rules and procedures in place to cope with the possible increase of pressures from private sector.

Table 6. Summary and rating of expected impacts of option 2B

Impact area	Impact	Subject	Rating and magnitude	Notes
<b>Governance and</b>	<i>Improved alignment with</i>	EU / MS	<b>+1/-1</b>	depending on

<sup>17</sup> The ‘List D’ would allow a differential of up to 25% but since 2015 the only product in this list, manufacturing tobacco, has a tax differential of 15%.

<b>good administration</b>	<i>needs</i> , but enhance risk of increased pressures	authorities		ORs rules of procedure
<b>Regulatory costs and savings for public authorities</b>	<i>Reduced burden</i> , for revising the differentials applied straightforwardly	MS authorities	<b>+1</b>	
<b>Operating costs/ competitiveness of business</b>	<i>More timely revision of support</i> for specific products requiring higher differentials	Beneficiary firms	<b>0/+1</b>	greater magnitude (+1) for the few specific products concerned

**Legend:** rating scale: +2 major positive impact; +1 minor positive impact; 0 neutral impact; -1 minor negative impact; -2 major negative impact.

**Source:** Analysis of the Study.

## 2C – Revised monitoring arrangements

The heterogeneous content of the interim implementation report submitted by the national competent authorities to the Commission creates difficulties for the data analysis. For this reason, option 2C proposes to harmonise the structure and the indicators provided in those reports in order to: (a) enhance their consistency overtime; and (b) prevent and address the information ‘gaps’ characterising some of the past reports. All these outcomes would contribute to a better design and administration of the policy, providing the EU and the Spanish authorities with more robust evidence on the effects of the special regime on the local socio-economic structure (including in the medium/long-term). This would include dimensions poorly investigated so far due to insufficient data, such as the impact on market structure, on trade flows, on price levels and other macroeconomic indicators. To ensure compliance, the harmonised structure and the indicators for the report should be annexed to the Council Decision.

The benefits of the improved arrangements would go beyond institutional oversight. The mainstreaming of more robust and comprehensive impact evidence into the policy design, can eventually improve its efficiency and help competent authorities to correct possible distortions in the market, thus responding to the concerns raised by various stakeholders and preventing the emergence of disputes. The ‘knowledge’ areas that might particularly benefit from the proposed overhaul of the system include: (a) the specific impact of the AIEM special regime on sectoral value-added (and employment); (b) the impact of the tax differentials on price levels; and (iii) the assessment of the intensity of the aid, taking into account the other support measures.

The costs of this proposed option are those imposed on the competent authorities for the collection and processing of data and the preparation and transmission of the revised interim report. However, as monitoring obligations already exist in the current framework, the actual burden would be limited to the additional information requirements introduced with the revision. More specifically, the additional burden would consist of two activities:

- the ‘one-time’ familiarisation with the harmonised structure and the indicators requested;
- the recurrent collection and elaboration of data that are not currently included in the periodical monitoring reports.

To minimise the additional burden, the proposed indicators have been selected considering the information that is already collected and reported by Spanish authorities - or easily available, such as customs data - and introducing modifications only where deemed important.

No additional burden for enterprises is expected. All the indicators listed derive from information collected by public authorities or statistical data. Some data do require the consultation of enterprises (e.g. the estimation of additional production costs) but this is information that is being collected anyway and not an obligation introduced by the policy option.

Table 7. Summary and rating of expected impacts of option 2C

Impact area	Impact	Subject	Rating and magnitude	Notes
<b>Governance and good administration</b>	<b>More informative monitoring</b> , and better stock-taking of impacts also in comparative terms	EU/MS authorities	<b>+2</b>	
<b>Regulatory costs and savings for public authorities</b>	<b>Increased burden</b> , for filling information gaps and elaborating few new indicators	EU authorities	<b>-1</b>	
<b>Functioning of the market and competition</b>	<b>Improved policy design and implementation</b> , preventing market distortions, and the risk of overcompensation	All economic operators	<b>+1</b>	assuming the results of the analysis are fed back into policy design

**Legend:** rating scale: +2 major positive impact; +1 minor positive impact; 0 neutral impact; -1 minor negative impact; -2 major negative impact.

**Source:** Analysis of the Study

## 6. HOW DO THE OPTIONS COMPARE?

For the purposes of this analytical report, all options have been assessed whether they have a positive, negative or neutral effect relative to the baseline for effectiveness, efficiency and coherence.

### Effectiveness

Overall, the policy aims at enhancing the competitiveness of local industries and production activities mitigating the constraints caused by the outermost status of the regions concerned. The proposed options 2A and 2B, and especially the measures aimed at facilitating the updating of the special regime to the evolving needs, could prove beneficial in this respect, in particular as concerns the support to emerging activities. The majority of beneficiaries of special regimes are SMEs, so the benefits would be apparent especially in that segment. Conversely, the discontinuation of the policy (option 1) would have, by definition, severe adverse effects on the competitiveness of local producers.

The proposed policy revisions (options 2A, 2B and 2C) are also expected to improve the functioning of the market, mitigating the risk of unduly distortions of competition, which is the second overall objective of the policy. This result would be achieved by a series of specific measures concerning the selection of eligible products, the application of tax

differentials in line with needs, the prevention of overcompensation risks, and the effective monitoring of the regime. Individually, all proposed measures would have moderate effects, but altogether they might effectively respond to various concerns raised by trade and service sectors over the fairness and proportionality of the special regime. Also in this case, the effects of a discontinuation of the regime (option 1) would be markedly negative: various local producers would no longer be able to compete, and the market would become even more oligopolistic, with adverse effects also for consumers.

Ultimately, the policy aims at contributing to the social and economic development of the Canary Islands. The proposed revisions of the current system would have limited effect in this area, first and foremost because they do not intend to modify the current scope and intensity of the support extended through the special regime. The improvements described above might have beneficial effects in few specific product areas – e.g. improving the alignment with needs or redressing existing distortions – but at the macro-economic level these effects would be hardly noticeable. Instead, the negative impacts of discontinuation would be probably visible on the industrial value-added indicators and, possibly, on investments and employment.

## **Efficiency**

The policy options examined do not envisage modifications that might affect the amount of tax revenues collected and, therefore, the budget of the regional administrations concerned. The budgetary effects of the proposed options would be either neutral, by design, or ambivalent and unpredictable since they would depend on the policy decisions taken at local level.

In terms of regulatory burden for EU and MS authorities, the specific measures proposed for the revision of the policy are expected to have differentiated effects. Compared to the baseline situation, the impact of option 2A would contribute to the reduction of the current burden - especially because of the simplification and the greater flexibility introduced in the system. Conversely, certain aspects of options 2B and 2C such as the establishment of a global reference value for the policy, the revised mechanisms for additional costs estimation, and the improvement of the monitoring system, could imply an increase of the efforts required. At any rates, the additional burden anticipated would remain limited and largely offset by the benefits of the proposed revisions.

The regulatory burden imposed on enterprises would possibly decrease - although moderately - under option 2A and primarily as a consequence of the shifting of the policy focus from specific products to broader categories, facilitating and alleviating the efforts for additional cost assessments and the justification for the application of tax differentials.

## **Coherence**

For the coherence of the proposed options with the EU policy, the primary reference is the impact on governance and good administration. This included – where relevant – also



the coherence with the parallel State aid policy on AIEM and its possible evolution. As most of the proposed revisions explicitly address policy governance and implementation arrangements, a generalised improvement can be expected under this scenario. In particular, they would enhance the subsidiarity in the implementation of the policy, while reinforcing the monitoring and making rules and conditions clearer and easily verifiable.

Table 8. Summary of estimated impacts for each of the options considered (see key below)

Option theme	Effective	Efficient	Coherent
Baseline: The derogation is renewed with no further policy changes	0	0	0
Option 1: Policy discontinuation	-	-	--
Option 2A: Revision of criteria for the identification of eligible products and updates	+	+	++
Option 2B: Revision of mechanisms to establish the maximum permitted differential	+	+	+
Option 2C: Revised monitoring arrangements	+	-	+

Legend: ++ positive effect expected; + moderate positive effect expected; 0 no effect or neutral impact expected; - moderate negative effect expected; -- negative effect expected; (all relative to baseline)

Source: Analysis of the Study

## 7. PREFERRED OPTION

Option 2 which entails a combination of sub options 2A+2B+2C, which renews and revises the current regime is the preferred option. This would renew the special rules beyond 2020 with the following modifications:

- The establishment of criteria for the identification of eligible products and updating of product lists.
- The revision of the mechanisms for establishing the maximum permitted tax differential.
- The revision of the duration of the policy and of monitoring arrangements.

The three sub options are not mutually exclusive and are technically independent of each other. Each sub option addresses a specific problem effectively and efficiently. Nevertheless implementing all sub options together, rather than in isolation, has overall a greater positive impact. These options enable the Spanish authorities to manage the regime effectively at Member State level to amend the regime in line with the set criteria. In comparison, option 1 is ineffective as the termination of the regime would mean that the objectives of the regime would not be achieved and could lead to economic and social instability in the Canary Islands.

Legal certainty would be increased for all stakeholders and the monitoring of the regime would be greatly enhanced by this option. Finally all sub options of option 2 would be more coherent with other EU policy, whereas option 1 would be incoherent with EU policy for the outermost regions.

## **8. HOW WILL ACTUAL IMPACTS BE MONITORED AND EVALUATED?**

The monitoring of the implementation and functioning of the derogation will be the role of the Spanish authorities and the Commission, as it has been to date.

In accordance with Article 4 of the current Decision, the Spanish authorities were required to submit a report, halfway through the life of the Decision to the Commission. This report was to enable the Commission to assess whether the reasons justifying the derogation still existed.

It is important that the Spanish authorities continue preparing a monitoring report as they are best placed to gather the precise information from the impacted stakeholders. Spain will be asked to submit a report by 30 September 2025 for the period from 2019 to 2024<sup>18</sup>. This report will include any relevant information as regards the additional costs involved in the local production, economic distortions and market impacts. This report will contain the necessary information for the evaluation of the effectiveness, efficiency, coherence with other EU policies, continued relevance and EU added value of the new legislation. The evaluation should also seek to collect input from all relevant stakeholders as regards the level and evolution of their additional production costs, compliance costs and any instances of market distortions.

To make sure that the information collected by the Spanish authorities and analysed in the report contains the necessary data that the Commission must know to take an informed decision on the validity and viability of the scheme in the future, the Commission will draw up specific guidelines on the required information. Such guidelines will be setup on the same principles as those for other similar schemes in the EU's outermost regions, where they are governed by similar legislation.

This will enable the Commission to assess whether the reasons justifying the derogation will still exist, whether the fiscal advantage granted by Spain will still be proportionate and whether alternative measures to a tax derogation system which will also be sufficient to support a competitive industries can be envisaged, taking into account their international dimension.

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<sup>18</sup> The report should include 2019 data so that a baseline is established and that the Commission is able to review the impact of the derogation covering the period post 2020. The report should contain the most up to date data up to and including 2024, where possible.



## **ANNEX 1: PROCEDURAL INFORMATION**

### **1. Lead DG, Decide Planning/CWP references**

The lead Commission service for this file is the Directorate General for Taxation and the Customs Union (DG TAXUD).

This initiative got the following political agreements:

- Agenda Planning and roadmap: Proposal for a Council Decision authorising Spain to apply a reduced rate of the AIEM tax on some locally produced products in the Canary Islands (PLAN/2019/5284)

Due to its limited impacts, the file was not included in the Commission Work Programme.

### **2. Organisation**

The following Commission services were invited to the Inter-Service Steering Group: AGRI, BUDG, CLIMA, COMP, DEVCO EMPL, ENV, GROW, HOME, JRC, MOVE, REGIO, SANTE, SG, SJ, TRADE, MARE.

A consortium led by Economisti Associati, (hereinafter collectively referred to as “the Consultant”) undertook the assignment titled “Study on specific tax regimes for outermost regions belonging to France and Spain” (“the Study”).

The Study has established the basis for a so-called back-to-back exercise with evaluation and impact assessment carried out simultaneously in accordance with Better Regulation Guidelines.

The objectives of the Study were to analyse how these regimes contributing to the analysis of the policy scenarios available for the way forward, or more specifically: a) to collect and elaborate evidence on the past performance of these special tax regimes in the regions concerned; b) to identify and assess possible revisions of the current policy, and c) to provide conclusions and recommendations on the different policy scenarios available.

The Study assessed the evolution of the problems if the current regime and the impacts of the possible options to address the problems identified.

## ANNEX 2: STAKEHOLDER CONSULTATION

### 1. Overview of consultation activities

The stakeholder consultation strategy has been developed to ensure a wide and balanced coverage of the different entities involved in, subject to, or concerned by the design and implementation of the special tax regime, by means of tailored tools and questionnaires. The perspectives and positions on the AIEM were expected to vary significantly (a) across the groups of stakeholders considered – i.e. policy-makers, tax and customs administrations, enterprises, professionals, etc.; (b) geographically – i.e. ‘mainland’ or Canary Islands residents; and (c) in the case of the private sector stakeholders, between the local producers benefitting from the regime, the enterprises that are instead subject to direct tax charges (e.g. importers), and the enterprises that are indirectly affected (e.g. local manufacturers using production inputs falling inside or outside the tax differential regime).

To address all different perspectives and positions comprehensively, the stakeholder consultation consisted of the following two main pillars:

- ***targeted interview programme, involving field visits.*** In-depth interviews were conducted with selected stakeholders, including EU institutions, Spanish government authorities at national and local level, and economic operators and trade organisations representing both the local productive sectors - i.e. the beneficiaries of the special regime - and the trade and service sectors, which are directly or indirectly affected. A total of 58 stakeholders were interviewed, of which 38 in the Canary Islands;
- ***focussed online survey of economic operators active in the Canary Islands.*** A web-based survey of the economic operators located in the Canary Islands was carried out between November 11 and December 20, 2019. The survey enabled to collect firms’ views on the key features of the AIEM, i.e. positive impacts, side effects, changes needed, etc., and to gather structured information on the conduct and performance of local businesses which are affected by the special tax regime to different degrees. The survey questionnaire was available in English and Spanish, and customised to reflect the different effects of and views on the special tax regime based on the different groups of local businesses involved, namely: (i) local producers, and (ii) importers and distributors. A total of 182 valid replies were received from the Canary Islands. Table 2.1 provides a summary of the responses to the survey by size of the firm and respondent economic activity.

Table 2.1 – Response summary to the business survey

Firm size	Number of respondents	Main economic activity	Number of respondents
Between 1 and 9 employees - firms (micro enterprise)	28	Productive activities	112
Between 10 to 49 employees (small enterprise)	81	<i>Of which beneficiaries of the AIEM regime</i>	70
Between 50 to 249	50	Non-productive activities	70

employees (medium-sized enterprise)	
More than 250 employees (large enterprise)	20
No answer	3
<b>Total</b>	<b>182</b>

<i>Of which traders / importers</i>	40
<b>Total</b>	<b>182</b>

Altogether, the consultation allowed to gather three main kinds of information:

- (1) factual information on the legal and administrative arrangements for the special tax regime in the Canary Islands;
- (2) evidence on the performance of the tax regime, including the benefits delivered, the contribution to the local development, and any possible issue or unintended effect registered;
- (3) the stakeholders' expectations and views on possible policy scenarios for the future – including the revision of the current regime, and their forecasts concerning the effects of different possible EU actions.

## 2. Overall evaluation of the AIEM regime

### ➤ ON THE COHERENCE AND RELEVANCE OF THE REGIME

The results of the study indicate that the scope of the AIEM regime is fairly comprehensive, satisfactorily addressing the needs of the economic operators concerned. This was confirmed by the majority of the key stakeholders consulted, even though private sector representatives reported some gaps. About half the local producers involved in the survey maintained that some products should be added to the AIEM list. In this regard, the main problem lamented by stakeholders was the system's slowness to respond to the emerging needs of the local economy and to correct errors and omissions, when relevant. The lack of flexibility is due to the fact that the list of products with a tax differentiated rate is laid down in the Council Decision, and, hence, any revision – e.g. the inclusion of a new emerging production or the modification of the extent of the tax support – requires a burdensome legal amendment process or its postponement to the next renewal of the policy.

Another main issue with reference to the AIEM scope was typically voiced by traders' representatives and concerned the application of tax differentials to products for which there was no 'equivalent' local production in strict terms. In some cases, CN categories included in the AIEM list cover heterogeneous products, some of which are not produced locally. The results of the business survey confirm the existence of this issue: the majority of the respondents (60%), including a relevant share of local producers (38%), reported the existence of products with negligible production in the Canary Islands that should be removed from the list.

The criteria adopted by competent authorities to establish the list of products benefitting from fiscal advantages and determine the level of support are not articulated in a clear and very detailed manner. Consistently, about one fifth of the local producers and some 40% of the firms active in other sectors reported limited or no familiarity with the criteria

for the inclusion of certain products in the AIEM lists. As for the methods used to establish the tax differential applicable to AIEM products, respondents are even less knowledgeable: over 60% of the non-producer firms and 44% of the local producers declared to have little/no information about these methods.

Table 2.2 – Stakeholders knowledge of the criteria underlying AIEM implementation

	Total	Non producer s	Producer s
Share of respondents with no/limited knowledge of the criteria for inclusion of certain products in the AIEM lists	<b>28%</b>	40%	21%
Share of respondents with no/limited knowledge of the methods used to establish the tax differential applicable to AIEM products	<b>51%</b>	63%	44%

**Source:** Business Survey.

### ➤ IMPACT OF THE AIEM ON PRICE-COMPETITIVENESS

The importance of the AIEM regime in redressing the price-competitiveness of local productions was widely acknowledged by representatives of the relevant private sector associations and manufacturing firms met during fieldwork, even though the price gap between locally-produced goods and imported ones was not fully closed.

The local producers involved in the survey attributed great importance to the AIEM in shaping the conditions for competition: the majority (54%) of the relevant respondents qualified the tax role as ‘essential’, adding that without the AIEM they could not compete, and another 42% assessed the impact of the AIEM as ‘moderate’. Likewise, the majority (57%) of the importers maintained that the AIEM affected ‘significantly’ the competitiveness of their imported products with AIEM differential rate.

Table 2.3 – Stakeholders assessment of AIEM impact on price-competitiveness

	% of local producers		% of importers
Essential, without AIEM we could not compete with imported goods	54%	Significantly, AIEM makes our main imported product much less competitive	57%
Moderate, AIEM helps us being competitive but there are other factors	42%	Moderately, AIEM does affect competitiveness but there are other factors at play	32%
Limited, AIEM is only a minor factor in the dynamic of price	4%	Limitedly, AIEM is only a minor factor in the dynamic of price	11%

**Source:** Business Survey (excluding ‘don’t know’ answers).

### ➤ PERCEIVED ADVANTAGES OF THE AIEM REGIME

The business survey investigated the respondents’ views on the potential positive impacts of the AIEM regime on the local economy, in general, and on production activities, specifically. Views substantially differed between enterprises engaged in the production of goods with AIEM differential rate and businesses operating in non-productive sectors:

the former are inevitably much keener to assess the importance of the AIEM as critical, while the latter are much more sceptical. More specifically:

- almost three fourths of the respondents maintained that the AIEM had a moderate / major impact in boosting local production activities in the Canary Islands. This share includes almost all local producers of AIEM goods (96%), but also a relevant share (38%) of the firms active in other sectors;
- the opinions concerning the impact of the AIEM in terms of supporting employment, increasing investments in local production activities and reducing the local economy reliance on imports are more polarized. About 90% of the local producers attributed a positive role of the AIEM regime to these ends, while such an opinion was shared by a tiny minority of non-producers;
- the effects of the AIEM on the expansion of the range of products available locally and the promotion of R&D and innovation in the local industry were those assessed as least positively.

Table 2.4 illustrates the share of respondents assessing the positive impacts of the AIEM regime as ‘moderate’ or ‘major’.

Table 2.4 – Stakeholders perception of the positive impacts of the AIEM

Positive Impact	% of respondents assessing impact as moderate or major		
	Total	Non producers	Producers of AIEM goods
Boosting local production activities	<b>73%</b>	38%	96%
Encouraging the diversification of local production activities	<b>66%</b>	24%	92%
Reducing the local economy's reliance on imports	<b>62%</b>	22%	89%
Contribution to the creation and maintenance of jobs	<b>64%</b>	18%	92%
Fostering investments in local production activities	<b>66%</b>	24%	93%
Expanding the range of products available in the local market	<b>58%</b>	13%	88%
Fostering research and development and innovation in the local industry	<b>56%</b>	11%	85%

**Source:** Business Survey (excluding 'don't know' answers).

#### ➤ PERCEIVED ADVERSE EFFECTS OF THE AIEM REGIME

The business survey also investigated the respondents' views on the potential negative effects of the AIEM regime on the local economy, market competition, regional trade, local consumption, and price level. As shown by Table 2.5 below, also in this case views largely differed between enterprises engaged in the production of AIEM goods and businesses operating in all other sectors, but in a reverse order. In particular, the table illustrates the share of respondents within each group assessing negative impacts as ‘moderate’ or ‘major’.

The salient results can be summarised as follows:

- the majority of non-producer firms, ranging between 51% and 83%, assessed all the negative impacts as significant. Oppositely, only a tiny minority of the local producers (barely exceeding 10%) provided a similar assessment of the different impacts of the AIEM regime. Overall, the inflationist effect exerted by the tax and its negative impact on trade between the Canary Islands and neighbouring countries attracted the highest degree of consensus;
- the polarisation of the stakeholder views on the AIEM distortive effects on competition is comparatively more marked: for over 80% of trade and service businesses the cumulation of the AIEM with other aids caused a ‘moderate’ to ‘major’ distortion of competition, whereas only 7% of local producers held a similar opinion. Similar shares of respondents within the two groups lamented the negative effects exerted by the tax on local economic activities importing raw materials and supplies on which the AIEM is levied;
- a smaller share of non-producer firms assessed as significant the potential negative effects of the tax concerning the efficiency of local producers, which might be discouraged to make efforts to boost productivity, and the fact that the AIEM tended to draw resources towards existing ‘supported’ sectors, hampering the development of new ones.

Table 2.5 – Stakeholders perception of the negative impacts of the AIEM

Negative Impact	% of respondents assessing impact as moderate or major		
	Total	Non producer s	Producers of AIEM goods
Because of AIEM support, local firms are not encouraged to boost efficiency and productivity	<b>34%</b>	69%	9%
The AIEM drives most of investments and human resources to the ‘supported’ sectors, thus hampering the emergence of new activities in ‘non-supported’ sectors	<b>29%</b>	58%	9%
The AIEM influences the demand, switching consumption from more taxed products to substitute products	<b>35%</b>	51%	22%
The addition of AIEM and other aids to local production produces an excessive distortion of competition	<b>37%</b>	82%	7%
By taxing certain raw materials and supplies, the AIEM indirectly affects local production activities and services (such as tourism etc.)	<b>36%</b>	76%	8%
The AIEM translates into higher prices for consumers	<b>39%</b>	79%	12%
The AIEM hampers trade with neighbouring countries (e.g. Portuguese islands and West Africa)	<b>40%</b>	83%	11%

**Source:** Business Survey (excluding ‘don’t know’ answers).

## ➤ EFFICIENCY OF THE AIEM REGIME

The AIEM regime does not create major problems in terms of implementation or major administrative burdens on competent authorities. Coherently, public authorities generally agree that the tax enforcement burden arising from activities concerning products with AIEM differentials can be considered as acceptable and justified by the benefits produced. On the other hand, at a broader level, the revision of the list and the exemptions extended to specific products through a legal amendment of the Council Decision is



regarded as overly complex, thus causing unnecessary burdens to EU and national authorities. Likewise, national competent authorities reported that the current monitoring requirements require significant efforts, possibly disproportionate compared to their informative value and utility for the policy process.

The administrative and compliance costs of the AIEM regime are considered as rather limited by private sector representatives. The majority of the importers involved in the survey assessed compliance with AIEM-related obligations as not particularly burdensome. In this context, the most burdensome task is considered the identification of the applicable customs codes and the corresponding AIEM rates, sometimes uncertain and potentially a cause of disputes and disparity of treatment. In particular, this task was assessed as a major burden by about one about three fourths of the relevant respondents.

The negative assessment concerning the customs classification of imported raw materials/supplies subject to the AIEM was confirmed by the feedbacks provided by local firms operating in the manufacturing industry as well as in other sectors that import part of the raw materials and supplies used in their business activity. About half of these firms reported at least one change in the customs code and/or definition of the raw materials/supplies usually imported.

### **3. Stakeholder views on future policy scenarios**

#### **➤ ATTITUDE TOWARDS THE RENEWAL OF THE AIEM REGIME**

The consultation of the public authorities gave a clear picture with regard to the future of the current tax regime. On the one hand, with the AIEM considered as important both for the public budget of the Canary Islands and to support local production activities, the renewal of the regime enjoys a widespread consensus. On the other hand, the local competent authorities consulted highlighted the need for greater flexibility and a less cumbersome procedure to update the supported products list and the tax differentials applied.

The views of the private sector with regard to the renewal of the AIEM regime are strongly polarized, depending on the business activity and the different effects of the AIEM on this activity. As expected, respondents engaged in production activities, typically benefitting from tax differentials, largely supported the renewal of the policy (95%). Still, the majority of them (75%) deemed that the current mechanism needed some change.

Conversely, the majority (70%) of the businesses operating in other sectors (i.e. different from production activities) would prefer the current policy to be discontinued. In particular, one third of the respondents would like the policy to be replaced with different forms of support for local production activities. Interestingly, opponents to the renewal of the AIEM regime are more common in the tourism sector than among traders. This substantiates a point frequently made during field interviews: the main problem with the

AIEM regime concerns its impact on the ‘inputs’ for which there is no or insufficient (for quantity or quality) local production.

Table 2.6 – Stakeholders attitude toward the renewal of the AIEM regime

Scenarios	% of respondents		
	Total	Non producer s	Producer s
Renew the Decision without major changes	<b>16%</b>	6%	22%
Renew the Decision, introducing some revisions	<b>55%</b>	24%	73%
Not renew the Decision, and introduce alternative support mechanisms	<b>14%</b>	33%	3%
Not renew the Decision	<b>15%</b>	37%	2%

**Source:** Business Survey (excluding ‘don’t know’ answers).

### ➤ STAKEHOLDER VIEWS ON POSSIBLE POLICY REVISIONS

Revisions to the current policy and its implementation arrangements were discussed with different stakeholders. The business survey also investigated the respondents’ positions on the possible areas for improvement. The Table 2.7 below shows the share of respondents fully or partly agreeing with a set of proposed areas for revision of the policy, distinguishing between enterprises engaged in production activities and all other sectors.

The salient results can be summarised as follows:

- all the proposed revisions were assessed positively by a majority of the respondents, irrespective of the sector of activity. The ‘producers’ group generally expressed more favourable feedbacks but, for most of the proposed options, differences between the two groups are limited;
- local producers are more interested in improving the flexibility of the system, making modifications of the tax-supported products lists and the tax differentials applied more frequent and easier. In this regard, several enterprises specified that this flexibility was needed to better align with evolving needs but should not translate into too frequent changes of the rates by local authorities, which would undermine the stability and the predictability of the markets;
- conversely, non-producers expressed a more favourable view compared to producers on the possibility to adopt measures aimed at mitigating the impact of the AIEM on imported production inputs (raw materials, supplies etc.);
- the improvement of the monitoring system on the whole and the price levels specifically encountered a large degree of support in both groups (and especially among local producers);
- likewise, both groups substantially agree on the need for more transparent and clear criteria for both selecting the supported products and establishing the applicable rates. From the perspective of non-producers, improved and transparent criteria should ensure that products for which no local production exists are excluded from the special regime.



Table 2.7 – Stakeholders attitude toward proposed revisions of the AIEM regime

Purposed Revisions	% of respondents agreeing with		
	Total	Non producers	Producers
It should be possible to amend the list of supported products more frequently and easily	<b>80%</b>	69%	88%
It should be possible to modify the tax rates applied more frequently and easily	<b>76%</b>	70%	79%
The criteria for updating the list of supported products should be clearly and precisely laid down in the EU policy	<b>75%</b>	74%	76%
The criteria for modifying the differentiated tax rates applied to AIEM products should be clearly and precisely laid down in the EU policy	<b>75%</b>	71%	77%
The AIEM monitoring system should be improved, with the regular collection of market data on local production, import, employment etc.	<b>82%</b>	74%	88%
The price levels of AIEM products imported and locally-produced should be periodically monitored	<b>73%</b>	71%	74%
Mechanisms to reduce the impact of AIEM on the import of production inputs (e.g. raw materials and supplies) should be considered	<b>73%</b>	80%	68%

**Source:** Business Survey.

Additional suggestions were occasionally made by stakeholders: (a) to improve the enforcement of product classification to avoid the practice of incorrect coding for tax circumvention; (b) to exclude freight costs from the tax base of imported products; and (c) to consider mechanism to ensure benefits are extended primarily to small companies.

### ANNEX 3: ANALYTICAL METHODS

The sources of evidence used in the Study are of three main types:

1. **desk research** and review of documentary sources;
2. **stakeholder consultation** activities, consisting of in-depth qualitative interviews and of questionnaire surveys;
3. **quantitative data analysis**, based on existing datasets and statistics elaborated with appropriate analytical tools in order to produce quantitative evidence.

#### 1. Desk Research

The variety of the analytical objectives of the Study and the multiple geographical region covered by the policies required a comprehensive mapping and review of documentary sources, which was conducted especially in the structuring phase of the Assignment. A total of +300 documents<sup>19</sup> in English, French and Spanish language have been retrieved in the course of the Study including to a large extent non-published administrative and implementation documents provided by the competent authorities as well as market analyses and other reports and papers provided by private sector stakeholders.

For classificatory purposes, the various types of documentary sources can be gathered in four main groups, as described below.

- The first category of documents included **EU policy for special tax regimes** and related documents.
- The second group regards the **broader EU policy framework for ORs**, including the overall EU strategic approach to the ORs as enshrined in a 2017 Commission Communication on a stronger and renewed strategic partnership with the EU outermost regions, and sectoral / thematic policies, including
- The third group concerns specific **national and regional documents on the special tax regime**
- The fourth group includes a variety of relevant **academic and ‘grey’ literature** published by several scholars, ‘think-tanks’ or private sector bodies.

#### 2. Stakeholder consultation

Overall, some 120 stakeholders were interviewed in the framework of the Assignment, largely exceeding the initial minimum target of 70. The interview programme was partly conducted in the initial structuring phase of the Study – involving the relevant Commission services and the representatives of the Spain - and partly through on-site visits in the Canary Islands.

The second pillar of the stakeholder consultation strategy consisted of a targeted online survey of economic operators in the ORs. The targeted survey responded to the need for structured and homogeneous information on firms’ conducts and performance, allowing to connect the outcomes of qualitative stories collected via interview, with the

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<sup>19</sup> Conservative estimate not inclusive of the several EU policy documents, Operational Programmes, implementation reports, State aid decisions etc. regarding other supports for ORs, and not including OR-level administrative and informative documents on the tax rates applied.

quantitative statistical data gathered. Full details of the stakeholder consultation are available in Annex 2,

### 3. Quantitative data analysis

#### ➤ DATASETS

The Study required a robust foundation of quantitative data and statistics, and several datasets have been collected and gathered from a variety of sources. Publicly-available data regarding specifically the ORs and the sectors benefitting from special regimes were limited, so to a large extent the raw data used in the Study have been provided directly by the competent authorities (i.e. customs and tax administrations, statistical institutes, local governments etc.) and by the Commission.

Despite efforts, several data gaps and inconsistencies remained, inevitably affecting the significance of the quantitative analysis. Such limitations regarded, in particular: (a) the limited availability of local production data (at the level of disaggregation required); (b) the difficult matching between product data based on customs classification and on NACE classification; (c) the limited availability of monitoring data on the other aid measures implemented in the ORs; and (d) the unavailability of cost-price data. The data gaps regarded primarily the early period of implementation of the special regime, while in recent years the amount and the quality of the data collected at local level have largely improved. The type of data collected for the Study are summarised in Table 3.1 below.

Table 3.1 – Datasets collected for the Study

Analytical areas	Datasets
<b>Policy implementation</b>	<ul style="list-style-type: none"> <li>• Data on permitted AIEM differentials</li> <li>• Data on actual AIEM differentials</li> <li>• Data on fiscal revenues</li> </ul>
<b>Additional costs</b>	<ul style="list-style-type: none"> <li>• Input-output data at ORs and mainland level</li> <li>• Micro-data from regional level estimates</li> </ul>
<b>Trade and market impacts</b>	<ul style="list-style-type: none"> <li>• Data on imports, by product / origin</li> <li>• Data on local production, by product / sector</li> <li>• Other 'control' data for gravity modelling (distance etc.)</li> </ul>
<b>Macroeconomic impacts</b>	<ul style="list-style-type: none"> <li>• Macroeconomic data on employment</li> <li>• Macroeconomic data on industrial added-Value</li> <li>• Data on price levels</li> </ul>

**Source:** Author's Study elaboration

#### ➤ QUANTITATIVE DATA METHODS

A summary of the approach adopted for the quantitative analysis is provided here below.

**Review of policy implementation.** The analysis focused on collected AIEM tax revenues, broken down by external (on imports) and internal (on local production) tax receipts, as well as on the estimation of the 'foregone' AIEM revenue (i.e. the tax not collected due to exemptions/reductions).

- The collected revenues data were provided for most of products/years by customs authorities or other competent authorities. When not available, the revenues have

been estimated applying the relevant tax rate to the tax base, i.e. the value of imports or local production.

- For the foregone AIEM revenue the official estimates have been triangulated calculating the amount of exemptions at product level (multiplying the value of local production by the corresponding tax differential applied) and aggregating the results.

***Analysis of additional costs and competitiveness.*** Additional costs provided at the micro-level (i.e. in product *fiches* or reports) have been at first triangulated using input/output tables available for the ORs.<sup>20</sup> The matching allowed showing disparities both in the total additional costs for a given sector but also on the distribution of the cost factors (i.e. transports, labour, energy, etc.). Secondly, the compiled and systematised micro-data have been used to assess how much of these costs were compensated by AIEM differential rates (with reference to the value of ‘foregone revenues’). This analysis was done at the product level as well as the aggregated level.

***Analysis of trade and market impact.*** Using two separate models, imports and local production have been modelled as a function of the actual AIEM differentials rates and of the internal AIEM rates. The main difficulty consisted in the comparability of value of local production and imports for different products. To overcome this difficulty, three measures were adopted: (i) using the logarithm of variables so that impact of AIEM differential was expressed in percentage terms, (ii) aggregating the products (dependent variable) at the 4-digit CN level, (iii) applying individual fixed effects for each 4-Digit CN level products.

- The impact on trade is estimated based on gravity modelling of imports of products (CN4 level) between ORs and other countries (including mainland). In addition to AIEM rates, other variables including economic weight and distance of the trading partners are used as explanatory variables to predict trade flows.
- The impact on local production was estimated based on data panel modelling. To overcome the data gaps, only products (CN4 level) for which comprehensive data on local production were considered.

***Analysis of macroeconomic impacts.*** The impact on added-value and employment of AIEM differential rates have been estimated by extrapolation of the impact on local production. For each economic branch, ratios of added-value over local production and employment over local production are estimated using data from economic accounts. The impact on added value and employment are then derived from the impact on local production assuming that these ratio are constant. Finally, to estimate the impact of AIEM on retail prices, it was assumed that the tax paid was fully passed onto consumers. Then, the tax receipts - increased by retailer margins - were related to household expenditure to derive an index of the maximum additional price borne by final

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<sup>20</sup> In input-output tables, payments made by a sector to other sectors (for example: agricultural products, energy, water, transportation) and to production factors (for example: labour, capital, land) are valued for a given year, in effect providing its cost structure. The resulting estimates of additional costs for each sector can therefore be compared with estimated additional costs based direct micro-level estimates used for the Canary Islands.

consumers. The results were triangulated with the official statistics on price index in the ORs elaborated by national statistical institutes as well as with other literature sources.



## ANNEX 4: EVALUATION

The scope of the evaluation is a retrospective assessment of the derogation during the period 2014 to 2019. The evaluation assesses the performance of the Directive against the basic evaluation criteria of relevance, effectiveness, efficiency, coherence and EU added value, in line with the Better Regulation Guidelines. The evaluation is based on the external ‘back to back’ study with an evaluation and forward-looking assessment of the Decision carried out simultaneously in accordance with Better Regulation Guidelines.

### 1. Coherence

The AIEM special regime is part of the overall **EU policy approach for the Canary Islands as an EU Outermost Region**, and its coherence is ensured *prima facie* by the substantial alignment of its objectives with the broad strategic framework. In particular, the AIEM special regime addresses two interrelated objectives of the 2017 Communication as follows:

- ‘Building on the ORs’ assets’: The AIEM concurs to this objective by promoting and sustaining local production activities, which, in turn, contributes to attracting investments, building capacity and skills, and reducing the dependency from the ‘mainland’.
- ‘Enabling growth and job creation’: The AIEM aims at promoting the diversification of local economy and, in particular, fostering activities with high value-added and job creation potential.

The third pillar of the EU strategy consists of scaling up ORs’ cooperation with their neighbourhood, through policy dialogue, territorial cooperation programmes, trade agreements etc. The AIEM special regime is not contributing to this goal, conversely – as regards regional trade – it may even constitute an obstacle to a greater integration. But this is an inevitable effect due to the nature of the scheme and to its underlying rationale.

EU policy includes a number of **other measures for ORs** – financed under the European structural and investment funds (ESIF) and/or through a series of specific regional State aid measures. The study notes that various other measures address the same targets of the AIEM regime. At a general level, these measures are coherent with the objective of AIEM of strengthening the competitiveness of local producers in the manufacturing sector as well as agriculture and fisheries. Overlap is minimised and overcompensation is limited, if any.

The AIEM regime constitutes a derogation from the **EU general policy on internal market and competition** but its legal basis is firmly anchored to Article 349 TFEU. The differentiated rates regime constitutes **regional State aid** and is, therefore, subject to the relevant EU legislation and controls. In 2017, the General Block Exemption Regulation



(GBER) <sup>21</sup> was amended, and the permitted cumulated aid per beneficiary moved from 10% in 2014 to 30% of the turnover, making the highest tax differentials of the AIEM regime compatible with the GBER thresholds. The compliance is controlled by the competent tax authority.

The study notes the current mechanisms allow for verification the compliance with the State aid proportionality rule. Furthermore the study found that, the extent of AIEM tax differentials, which in most of cases is limited to 5%, appeared well below the estimated additional costs of production in Canary Islands – i.e. 30% on average - so the risk of product-level ‘overcompensation’ was, in practice, very limited.

## 2. Relevance

This section evaluates whether the criteria used to select the product for reductions or exemptions to AIEM are still relevant compared to the general needs of all stakeholders.

The study found that:

- the AIEM regime covered almost evenly local productions holding the majority and the minority of market shares;
- there was no substantial change overtime in the structure of the distribution; minor changes could be attributed to margins of error in the measurement;
- local products with less than 20% of market share accounted for some 30% of the AIEM list, while local products with less than 5% of the market accounted for ca. 15% (slightly decreasing overtime);
- less than 20% of products in the AIEM list held more than 85% of the respective markets; for some 10% the market share exceeded 95%.

The above data indicates that there are cases where the market share criteria may not be sufficient to justify the inclusion of certain products in the AIEM list where the local production level is marginal or, conversely, where local producers are in a largely dominant position. The results of the stakeholder consultation also suggest that there are some gaps in the scope of the AIEM, with half of the local producers involved in the survey maintaining that there are products that should be added to the AIEM list. This is due to the lack of flexibility in the process of revision of the lists, which makes it difficult to timely respond to emerging needs of local economy and – where relevant – to correct errors and omissions.

However regarding the overall relevance of the scope of the AIEM, the main reported issue with regard to the application of tax differentials to products is that certain CN categories of the AIEM list include heterogeneous products of which only some are produced locally. This issue is somewhat mitigated by the competent authorities, who have added further

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<sup>21</sup> The GBER (Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty) is the EU legal base on which the AIEM State aid scheme is allowed under EU rules.

specifications to the standard definition to better distinguish between products falling in the same category but requiring a different tax treatment.

Furthermore the AIEM regime does not envisage exemptions for the import of ‘inputs’ used in other production activities, i.e. raw materials, packaging and/or other supplies. There are only few cases where an AIEM tax refund (*‘devolución’*) is permitted and regard the categories of AIEM products that are subject to the ‘internal tax’. But these remain rather sporadic events. The approach adopted in Canary Islands to mitigate the lack of exemptions for imports of ‘inputs’ on production costs is to add *ad hoc* specifications to the CN definitions to distinguish products for retail sales from products sold in bulk and exempt the latter. This approach is, in certain respects, more straightforward for businesses, who do not have to carry out any additional administrative activity to demand exemption or refund of the AIEM paid. On the other hand, it makes product identification more complex and requires a constant revision of the definitions by the competent authorities.

### 3. Effectiveness

The effectiveness of AIEM was evaluated by assessing the extent to which the regime supported industry.

The establishment and the periodical renewal of the AIEM regime have been underpinned by a series of external studies **estimating the nature and the extent of the additional costs** caused by Canary Islands’ structural constraints.<sup>22</sup> Overtime, the catalogue of cost factors possibly affected by ‘outermost-ness’ has remained substantially stable.

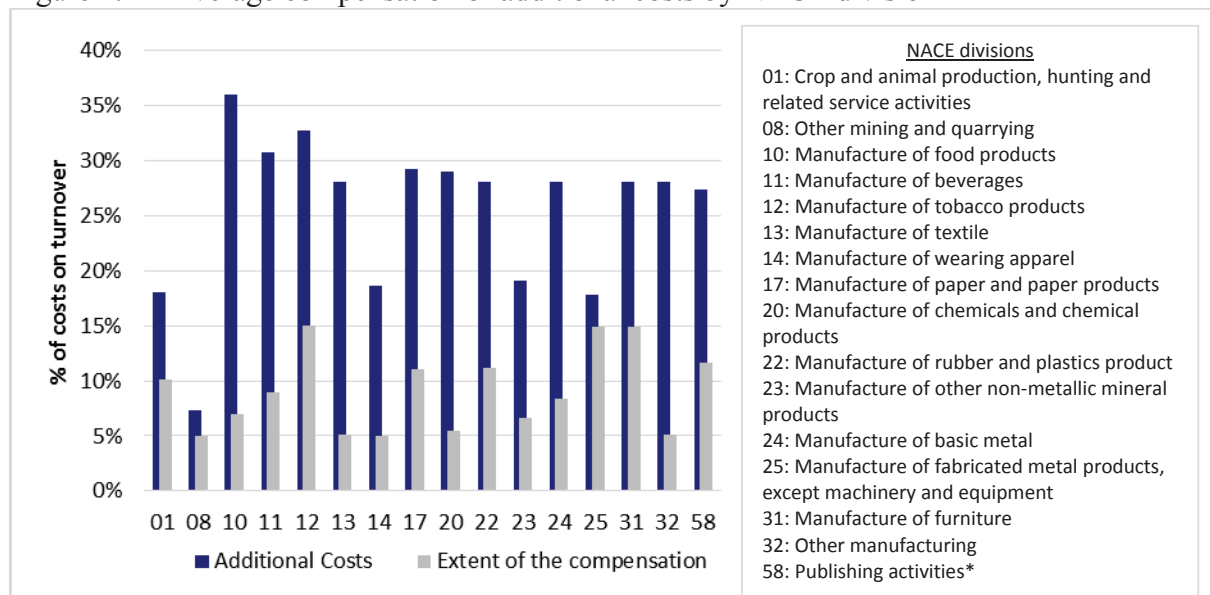
Freight costs have remained the major source of additional costs. They are followed by the ‘idle production capacity’, that is fairly stable around 1% of the total turnover. Overall, the impact of additional costs has seemingly grown overtime. In monetary terms, the total impact of outermost-ness on private sector is worth some EUR 5.23 billion (2016). However, there are significant differences between islands, firm size, economic sectors and specific branches. The results of the latest external study (2018) indicate that the bulk of the additional costs are borne by productive sectors, namely industry (29.7% of sectoral turnover, i.e. EUR 889 million) and the primary sector (18%, EUR 148 million).

The final part of the answer to this evaluation question examines the extent to which the additional costs faced by local producers are ‘compensated’ by the AIEM special regime. The extent of the compensation does not correlate with the extent of the additional costs, so some productions are compensated for more than 50% of the estimated costs while others less than 15%, as seen in Figure 4.1 below.

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<sup>22</sup> Centro de Estudios Económicos Tomillo, “Los costes de ultraperiferia de la economía canaria”, 2002; Centro de Estudios Económicos Tomillo, “Los costes de la ultraperiferia en la economía canaria”, 2010; and UTE Eco-CoRe (consortium), “El coste privado de la ultraperiferia y la doble insularidad en Canarias”, 2018

Figure 4.1 – Average compensation of additional costs by NACE division<sup>23</sup>



**Source:** Author's Study elaboration.

*Note: (\*) depending on the CN: NACE conversion table used, these products may be classified under NACE division 18: Printing and reproduction of recorded media*

The extent of the compensation roughly corresponds to the amount of tax revenue collected, i.e. EUR 160 million in 2018 or – more accurately – ca. EUR 125 million, deducting the receipts collected from AIEM products with no differential rate. So, considering global additional costs of EUR 889 million for AIEM sectors altogether – in line with the ad hoc study completed in 2018<sup>24</sup> - the overall extent of the compensation of additional cost would amount to ca. 14%. This figure is correlated with the value of local productions and imports, which influence respectively the extent of additional costs (which is function of enterprise's turnover) and the tax collected.

#### Impact of AIEM on competitiveness

The analysis of market data did not return conclusive evidence on the effects of the special regime on the competitiveness of local production. The business survey provides some additional evidence on the effectiveness of the AIEM regime in redressing the competitiveness gap affecting local producers. A 'positive' or 'very positive' impact of the AIEM can be assumed for two-thirds of respondents. Still, in most of the cases (58%), the price-competitiveness is restored only partially, as the retail price of imported products remains lower than that of local ones.

The AIEM impact on competitiveness differs for products with a higher tax differential compared to products with lower tax differentials and also for economic operators of different sizes.

<sup>23</sup> The figure illustrates the disparities in the extent of the compensation by NACE sector. The analysis is done by NACE sector for consistency with the approach used for additional costs estimation.

<sup>24</sup> Source: UTE Eco-CoRe, 2018, unpublished. The reconstructed additional costs estimated in this Study are only moderately higher, i.e. EUR 967 million in 2017.

### *Local production activities*

In the sectors benefitting from the AIEM the downward growth trend has been milder and, based on provisional data, a positive growth was possibly registered in recent years. In 2018, some additional 200 firms were recorded in the AIEM industries, mainly in the food & beverage, manufacture of structural metal products and printing sectors. As a result, the total number of active firms reached 3,260. According to regional statistics, the estimated total number of employees in AIEM industries has remained comprised between 20,000 and 25,000 units since the introduction of the special regime, representing ca. 60% of the employment in the manufacturing and mining sectors. The average number of employees in AIEM industries increased from 5.7 units in 2008 to 7.2 units in 2017.

Almost three quarters of the respondents maintained that the AIEM had a moderate to major impact in boosting local production activities in the Canary Islands. The vast majority of local producers believe that by supporting the viability of their business the AIEM is also helping maintaining and possibly creating jobs, as well as fostering investments. About 70% of the AIEM beneficiaries that recorded an increase in the production volume also reported an improvement in their profitability.

The possible influence of the AIEM regime on the diversification of productive activities is controversial. By its nature, the scheme is fairly conservative: the existence of a non-negligible local production is a pre-condition for the application of tax differentials and amending the list to insert new products requires a lengthy and burdensome process. However, tax beneficiaries were not concerned by the ‘rigidity’ of the mechanism: over 90% of local producers of AIEM goods did not consider this tax as an obstacle to the emergence of new activities, and a similar share even attributed to the AIEM a positive effect in terms of diversifying productions.

Overall, however, the performance of AIEM producers in terms of profitability looks rather modest. The local production has been exposed to increasing competition from imports in the past years: the value of imports of products subject to the AIEM differential regime increased by ca. 50% in 8 years (between 2009 and 2017) while in the same period the local production has grown by only 24%. Based on the respondents’ feedback – and as largely confirmed by direct interviews – the contraction of the profitability is the result of the increased competitive pressure registered in the last years.

The efforts made by local producers to bridge the competitiveness gap with imported products and remain profitable are also witnessed by the fact that the vast majority of the surveyed businesses purchased some fixed assets, such as machinery or equipment, in the past five years, and some 30% set up new establishments. The statistical data suggest that investments in AIEM industries have not recovered at the same pace as in other industry. Before the crisis, AIEM industries used to account for more than 60% of the investments, while in the past few years their share remained well below 40%.

### **4. EU Added-value**

### ***The benefits for local economy***

The baseline assumption made by the majority of local producers consulted is that without AIEM it would not be possible to maintain industrial activities in Canary Islands able to compete with external products.

The AIEM regime is mainly viewed as a tool for preventing and mitigating the decline and disappearance of local industry rather than a development tool. The industry sector – which is to a large extent formed by AIEM supported enterprises – performed better than other sectors in terms of sectoral GDP growth, especially in the past three years, whereas in terms of employment it witnessed a decline but not as marked as other sectors.

The quantitative model suggests that an increase of 1% point of tax differential is correlated with an increase of 4.6% of production value. The compensation ‘gap’ - i.e. the part of the additional costs not covered by AIEM differential – is negatively correlated with the production value – as predicted – but with effects of very limited magnitude, possibly explained by the fact that additional costs estimates present a significant degree of approximation.

If the above estimate is applied to the overall value of production of concerned goods, the ‘virtual’ effects of AIEM can be associated to nearly one-third of the value of local production of the supported goods, i.e. ca. EUR 570 million.

### ***Impact on import substitution***

In accordance with the State aid policy, one criterion to measure is the impact on imports and the extent of their substitution with locally-manufactured products.

The total value of import in the Canary Islands had recovered quickly from the 2009 drop and, in the 2010-16 period, has remained fairly stable. In the same period, the import of AIEM products (i.e. some 10-12% of total imports) recovered at a slower but steadier pace, and, in 2016, it was well-above the pre-crisis levels. In other words, despite the charging of the tax, import of AIEM products has kept growing, suggesting that the special regime did not have dramatic impacts in terms of import substitution.

Coherently, the market share of local AIEM products vis-à-vis imported ones has slightly reduced overtime, on average, although the situation varies significantly across products: some 30% of local products have lost more than 10% of their market share, nearly 20% have instead acquired more than 10% points, while for the majority of products no significant change has occurred.

Overall, the results indicate that tax differentials do affect imports and, specifically, 1% point increase of tax differential is associated with a 0.41% decrease of import, but the explanatory power of the model is fairly low, so other factors are at play. Based on this

estimate, in the hypothetical scenario of removal of AIEM differentials, the value of import of AIEM products could be some 2.5% point greater than today (i.e. ca. EUR 50 million).

### ***Integration in the EU and in the regional market***

The statistics on external trade of Canary Islands show a trade balance worsening overtime, especially in the exchanges with mainland Spain and, to a lesser extent, with the EU. In 2018, the import from mainland Spain accounted for 87% of total import, i.e. 15% points more than ten years before. Globally, the exchange with EU countries (including Spain) exceeds EUR 16 billion, which is some EUR 2.5 billion more than 2008 and nearly EUR 5 billion more than 2012. As the incidence of AIEM tax differentials has remained substantially stable in the period, it seems that the special regime is not creating significant obstacles to the participation of Canary Islands to the EU internal market.

Conversely, the commercial exchanges in the geographical region remains limited. The imports from Africa has fallen in 10 years from some EUR 1.7 billion (primarily fuels) to nil, while exports remain below EUR 100 million (mainly to Morocco, Cape Verde and Mauritania).

By far, the main reason for importing inputs is the unavailability of the required inputs on the local market in sufficient quantity, indicated by almost 85% of the respondents. The unsuitable quality of the locally-produced goods and – despite AIEM – the lower price of imported goods were indicated as main reasons for buying imported goods by only 27% and 22% of the relevant local firms, respectively.

## **5. Efficiency**

### ***Administration and enforcement burden***

The administrative arrangements for the implementation of the AIEM regime are fairly straightforward and do not impose particularly complex or burdensome procedures to competent authorities and firms alike. The most critical aspects are linked to the classification of products, which is sometimes uncertain and a potential cause of disputes and disparity of treatment. The ***burden for local authorities*** to deal with this system can be estimated as follows:

- Two full-time staff within the competent service of Canarian administration, primarily responsible for identification and classification of AIEM products.
- The Canarian tax authorities have some 90-100 staff in the indirect tax sector. Using a pro-quota distribution based on revenues, some 5% of them can be virtually attributed to the administration of AIEM.

As regards the administrative burden for private sector, less than half of importers surveyed qualified the compliance with AIEM requirements as a ‘major burden’. Still, the identification of the applicable customs codes and the corresponding AIEM rates is



regarded as a more burdensome task, representing a moderate or major burden for about three quarters of the relevant respondents.

As regards the quantification of the administrative burden for the importers, the estimated staff time spent by these firms to deal with the management of the AIEM varies greatly, from one-two working days per year to a full-time staff year-round. The working time required to comply with the AIEM-related declaration and accounting obligations has been converted in monetary values based on the gross salary paid to salaried staff in the Canary Islands.<sup>25</sup> Additionally, 40% of the respondents reported having incurred external costs related to AIEM, i.e. the fees paid to external service providers to which compliance is delegated in full or in part. The amount paid typically ranges between 0.1% and 0.7% of the firm's turnover. Based on these figures, the total incidence of administrative and compliance burden on the turnover of importers can be roughly estimated at 0.3%, on average. Still, this estimate seems excessive, and possibly inflated by attributing to AIEM also administrative activities that would be incurred anyway, such as customs clearances procedures, filling of quarterly tax declarations etc. In this sense, the 'extra' activities performed exclusively because of the AIEM tax are probably limited to the calculation and payment of the tax due.

### ***The monitoring arrangements***

In addition to the ordinary administration and enforcement duties, the competent national authorities are periodically required to submit to the Commission monitoring reports on the implementation of the AIEM regime, its impact and contribution to the promotion or maintenance of local economic activities.<sup>26</sup> Since 2002, three Mid-term Reports (*Informe Intermedio*) have been submitted, namely in 2005, in 2010 and in 2017. The Mid-term Reports constitute, at the same time, monitoring documents and evaluation documents, as they contain:

- an update review of the applicable legal framework;
- a product-by-product review of the relevant tax rates and their evolution during the monitoring period, considering also the changes occurred in the CN classification;
- a review of the evolution of the economic context;
- an assessment of the degree of achievement of the objectives of the measure, as concerns: enterprise demography, production levels, market shares, investment and employment generated and price trends;
- an assessment of the constraints affecting local production, their evolution and persistence.

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<sup>25</sup> Data on the gross monthly salary paid to a full-time employee in year 2018 are provided by the INE (see, Insee, *Encuesta de Población Activa*, 2019). The monthly value of EUR 1,820 reported by the INE has been incremented to include 25% overheads, in line with the SCM methodology.

<sup>26</sup> Art. 2 of Council Decision No 377/2014/EU.



While the first part of the Mid-term Reports deal with monitoring information, the parallel evaluative nature of the documents emerges clearly in the second part. In this sense, the Mid-term Reports appear more articulated and burdensome than a standard monitoring document, but also lighter and less rigorous than a fully-fledged impact assessment.

The estimated additional costs caused by regional structural constraints are not in the scope of the Mid-term Reports because they are the subject of separate, external studies. In particular, since the establishment of the AIEM, three studies measuring the additional costs have been implemented: in 2002, 2010, and 2018, as noted above. A monetary quantification of the burden of monitoring is not feasible, but the double nature of the Mid-term Report may not be the most cost-efficient approach:

- As a monitoring document, the Mid-term Report lacks: (1) detail (e.g. product-level data on volume, value and market share of product by origin, the number of active players, the estimated forgone revenues etc.); and (2) timeliness, as up to 7 years may pass from one report to the next (and delays in the delivery reportedly occurred).
- As an evaluation document, the Mid-term Report lacks of (1) robustness (the conclusions are based mainly on descriptive statistics, no quantitative analysis is carried out); and (2) focus (no ad hoc primary data collection is carried out).

However, the main limitation of the current monitoring system is the lack of background data on various aspects of the implementation. Only recently (November 2019), the regional statistical office (ISTAC) was able to complete and publish the results of the first Survey of Industry in Canary Islands (*Encuesta de la Industria en Canarias – EICAN*), which specifically aimed at measuring the impact of special regimes on the market structure of AIEM products. The published data refer to the 2015-17 period, and there are plans to conduct this exercise periodically, so the problem of ‘data gaps’ will be reasonably addressed in the future.

### ***The amendment of AIEM lists***

The process for updating the lists is far from straightforward, as any revision requires a legal amendment of the Council Decision. The process shall follow the ordinary rules of procedure, with a significant investment of time and resources from national and EU administrations. The AIEM regime has never undergone an interim revision because, reportedly, the complexity of the procedure and the efforts required were not worth the few changes that local authorities wanted to introduce. In this sense, the burden of the legal amendment process acted as a deterrent preventing authorities to demand for such changes. The direct consequence was that AIEM has progressively lost part of its relevance, not being able to keep pace with the evolving needs of the local context. Lighter and more flexible mechanisms for the revision of lists constitute the main request for policy revision expressed by local competent authorities.

### ***The budgetary impacts of AIEM***

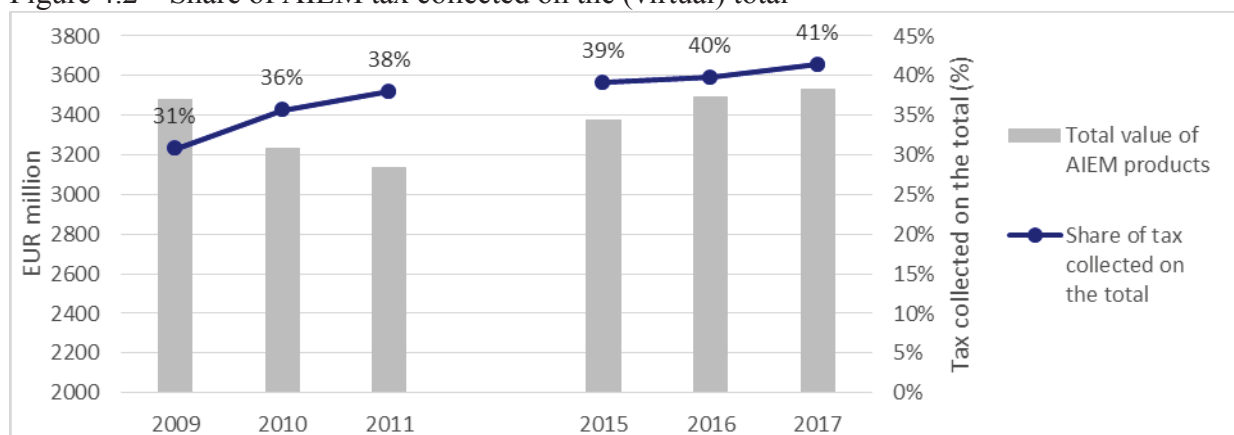
The amount of forgone revenue is difficult to calculate precisely. An accurate estimation would require data on the market value of locally-produced goods delivered internally (i.e. not exported), for all the products subject to a differentiated regime.

The analysis covers two time periods (2009-11) and (2015-17), whose datasets are not fully comparable because of disparities in the methodology and different scope (changes in the AIEM lists). In various instances, the market value of local production had to be inferred triangulating market share data with tax authority's data on the import value of AIEM products. The outcomes of the analysis can be summarised as follows:

- The amount of tax collected on the import of AIEM product has been steadily increasing overtime. However, its average incidence on the value of import has possibly declined of 0.5% point, so it can be assumed that the upward trend of receipts has been primarily driven by the growth of imports and not by a greater tax charge.
- The amount of foregone revenues from AIEM products has remained fairly stable in the range of EUR 155-165 million/year. The figure is possibly inflated by the inclusion of exports in the amount, especially in the case of tobacco, whose export accounts for ca. 40% of the total. Another major source of foregone revenue is the production of beer that benefits from a virtual AIEM compensation of ca. EUR 23 million/year (2015-2017 average).
- The ratio between foregone revenues and the value of local production has seemingly increased overtime from ca. 7.5% in the 2009-11 period to more than 8.5% in the 2015-17 period. The underlying cause seems the decline in the value of production registered with several products.

Another way to look at the budgetary efficiency of the AIEM regime consists in assessing what share of the overall tax applicable to the concerned products is actually collected. In practice, the indicator reflects the ratio between the tax receipts and the overall amount due if tax differentials were not in place. The results are shown in Figure 4.2 below and indicate that overtime the balance between tax collected and not collected has progressively moved towards the former (albeit the latter still account for the majority of the virtual tax revenue). As the average level of taxation has not changed significantly, this trend seems again a consequence of the loss of market share value of local production.

Figure 4.2 – Share of AIEM tax collected on the (virtual) total



Source: Author's Study elaboration based on GoC, ATC and ISTAC data.

**Notes:** The comparison between the two periods displayed (2009-11) and (2015-17) requires caution because of disparities in the collection methods. Differences are also due to changes in the composition of the AIEM list across the two periods.

### ***The efficiency of AIEM***

How well the budgetary effects of the AIEM regime has converted into benefits remains very complex to quantify, due to the data validity limitations reported, and the absence of a clear baseline for a counterfactual analysis. Still, the results of the analysis conducted in the previous section allow the elaboration of a general efficiency index for the AIEM special regime. The index is calculated as the ratio between the additional production virtually enabled by tax differentials and the cost of the special regime in terms of foregone tax revenues. As shown in Table 4.1 below, such ratio is of 1 : 2.9 – that is one Euro of foregone revenue can be roughly associated with nearly 3 Euro of local production.

Similarly, it is possible to estimate the efficiency in terms of employment, by estimating the extent of foregone revenue associated to the number of jobs hypothetically enabled by AIEM (i.e. based on the additional value-added generated). As table 4.1 shows the efficiency of the scheme can be roughly estimated at less than EUR 30,000 per job.

Table 4.1 – Efficiency indexes of the AIEM regime

<b>AIEM foregone revenues</b>	<b>Production value associated to AIEM</b>	<b>Associated jobs</b>	<b>Monetary Ratio (efficiency index)</b>	<b>EUR per job</b>
EUR 165 million	EUR 570 million	5,522	<b>1 : 2.9</b>	<b>29,880</b>

**Source:** Author's Study elaboration

One of the possible ‘externalities’ of the AIEM regime concerns its repercussion on retail price of consumer goods and, therefore, on the cost of living in Canary Islands and the purchasing power of residents. According to survey results, almost 80% of non-producer firms maintained that the AIEM translated into higher consumer prices. On the contrary, the large majority (84%) of local producers denied the existence of a similar inflationist effect of the tax or assessed it as minimal. These opposed views require a more factual assessment. The first element to consider is the actual incidence of the tax on imported products:

- The majority of AIEM receipts (53%, in 2016) come from products in List A, i.e. with a tax rate on import of 5%. The weighted average rate, as estimated by the competent authorities, has been fluctuating between 7.0% and 7.3%, with minimal changes overtime.
- The AIEM products account for approximately some 10%-12% of total import, which means that the tax charge accounts for some 0.7%-0.9% of the total value of imports.
- Assuming that imports represent some 75%-85% of the sales of consumer goods, the total incidence of the tax would further reduce to 0.5%-0.75%. However, some local producers are subject to the payment of the tax on certain production inputs. The most realistic estimates collected indicate that the tax represents some 0.5%-1.5% of firms’ turnover (evidently only of companies purchasing inputs subject to AIEM).

- So, the order of magnitude of the possible impact of AIEM on retail prices remains roughly comprised between 0.5% and 1.0% - assuming that 100% of the tax paid is entirely passed-on to the consumer.

The analysis of consumer price index, elaborated by the national statistical institute (INE) does not show any relevant disparity between the Canarian trend and the overall Spanish trend, and this applies to both the general index and the indexes of goods mostly affected by AIEM, namely industrial goods, and specifically the food, beverage and tobacco macro-category. Actually, in various instances the price increases registered on mainland appear higher than in the Canary Islands.