

# **Establishing Suitable Strategies to Improve Sustainable Development in the Portuguese Ultraperipheral Regions of Madeira and the Azores**

**Peter Ludlow  
Vitor Martins  
and Jorge Núñez Ferrer**

## **Abstract**

*This document is a report prepared for the Portuguese Secretary of State for European Affairs to help the ultraperipheral regions to interpret the potential benefits and obligations for the ultraperipheral regions of Azores and Madeira of the new Art. 299.2 in the Treaty of the European Union. It analyses the economic situation and special ultraperipheral needs of the archipelagos and discusses approaches to improve their level of development. It proposes to use the new article as the basis for the creation of a new contract with the EU, in which the ultraperipheral regions guarantee their commitment to move towards self-sustainability in exchange for financial assistance and derogations from Community law.*

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Peter Ludlow, is Director of the Centre for European Policy Studies; Vitor Martins is Associate Senior Research Fellow at CEPS and Jorge Núñez Ferrer is a CEPS Research Fellow. This report was prepared for the Secretary of State for European Affairs of the Portuguese Ministry of Foreign Affairs in Lisbon.

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Centre for European Policy Studies  
Place du Congrès 1, B-1000 Brussels  
Tel: (32.2) 229.39.11 Fax: (32.2) 219.41.51  
e-mail: [info@ceps.be](mailto:info@ceps.be)  
internet: <http://www.ceps.be>

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## **Preface**

The present Report examines the implications of the new Article 299.2 in the Treaty of Amsterdam for the Azores and Madeira. It is divided into two sections.

Part A provides an analysis of the issues at stake. It explains the origins and significance of Article 299.2 and examines in some detail aspects of the economies of the Azores and Madeira which are relevant to a discussion of the implementation of the new Treaty Article.

Part B consists of recommendations. These themselves are divided into three sections, the first dealing with improvements of a horizontal character which are relevant to the needs of both groups of islands, the second with the Azores and the third with Madeira.

As with all CEPS studies, the views expressed in this Report are those of the authors alone and do not commit CEPS as an Institution or any other persons or groups of persons. We are nevertheless grateful for the help that we have received from the authorities in the Azores and Madeira, from officials in the Portuguese government and, by no means least, from many who are concerned with the issues under discussion in the EU institutions.

Peter Ludlow, 3 November 1999

## **Introduction: The origins and significance of Article 299.2**

The special status of what are now described as the ultraperipheral regions of the EU was recognised in Article 227.2 of the Treaty of Rome of 1957. The article arose out of French concern for its overseas departments, French Guyana, Guadeloupe, Martinique and Reunion (DOM). It laid down that even though these regions were to be regarded as an integral part of the European Community, special policies would be devised to deal with their specific problems.

It took a long time for the promises contained in Article 227.2 to bear practical fruit. The principal concern indeed of the DOM during the first decades of the European Community was to safeguard their position as an integral component of the European Community. The issue came to a head in a case that went to the European Court of Justice following a German decision in 1977 to treat the DOM as to all intents and purposes a non-EU country, by imposing taxes above the EC rate on imports of rum. A Court of Justice ruling in 1978 declared this action illegal and defined the DOM as an integral part of the European Community with the same rights and obligations as any other regions. It also ruled that specific measures could be allowed to compensate them for disadvantages that they might have vis-à-vis other EC regions.

The accession of Portugal and Spain to the EC in 1986 gave a powerful new impetus to the policy debate. As a result, an inter-services group was established in Brussels in 1986 to develop a coordinated programme vis-à-vis the DOM and the overseas regions of Portugal and Spain. It was also given responsibility for organising the Community's policy towards other overseas countries and territories which, though not an integral part of the EC, were dependent on an EC member state. These latter included the Falkland islands, Saint Helena and Macau. Two years later, the European Council meeting in Rhodes in December 1988 called for new policies for the regions concerned.

In the years that followed, the European Community transformed promises into practice. The POSEIDOM programme dealing with the French departments was launched in 1989 and was followed in 1991 by POSEICAN (the Canary Islands) and POSEIMA (Madeira and the Azores). These programmes allowed for two types of action in favour of the target regions: modification of common policies and enhanced assistance through the Structural Funds.

The impact of the programmes, particularly in the early years, was highly positive. Direct assistance was given to various sectors, including for example cottage industries, fisheries and, it need hardly be said, agriculture. The fact furthermore that France, Portugal and Spain were also able to persuade other member states to approve a Declaration on the outermost regions in the framework of the Treaty of Maastricht suggested that the Union was indeed ready to give the ultraperiphery the special regard that it merited.

This initial momentum was not, however, uniformly maintained. On the contrary, particularly in the period following a programme review in 1994, the Portuguese (and others) formed the impression that the Commission in particular and the EU institutions in general were at best lukewarm and at worst indifferent. Important elements in the programme were allowed to drop. New ideas were not taken up.

Against this background, the countries concerned decided to press for a revision of the Treaties. It was not an easy negotiation, but eventually the intergovernmental conference at Amsterdam in June 1997 accepted the amendment which is now incorporated in Art. 299.2.

The article states:

*The provisions of this Treaty shall apply to the French Overseas Departments, the Azores, Madeira and the Canary Islands.*

*However, taking account of the structural social and economic situation of the French overseas departments, the Azores, Madeira and the Canary Islands, which is compounded by their remoteness, insularity, small size, difficult topography and climate, economic dependence on a few products, the permanence and combination of which severely restrain their development, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, shall adopt specific measures aimed, in particular, at laying down the conditions of application of the present Treaty to those regions, including common policies.*

*The Council shall, when adopting the relevant measures referred to in the second subparagraph, take into account areas such as customs and trade policies, fiscal policy, free zones, agriculture and fisheries policies, conditions for supply of raw materials and essential consumer goods, State aids and conditions of access to structural funds and to horizontal Community programmes.*

*The Council shall adopt the measures referred to in the second subparagraph taking into account the special characteristics and constraints of the outermost regions without undermining the integrity and the coherence of the Community legal order, including the internal market and common policies.*

The new article is a considerable advance on both the Maastricht Declaration and the political declarations that accompanied the establishment of the POSEIMA and other similar programmes a decade ago.

Four features are particularly worth emphasising. Firstly, the new Treaty emphasises the political commitment of the Union to find solutions to the problems of the ultraperipheral regions. Secondly, as an article in the Treaty and not a Declaration, it provides a legal base for concrete action. Thirdly, it specifies methods by which the European Union can help. Finally, and by no means least, it provides for decisions by qualified majority rather than unanimity. As the three member states directly implicated did not ask for this last concession in the paper that they submitted to the intergovernmental conference, the fact that it was made was highly positive.

The present Report needs to be seen against this background. It is based on the assumption that the commitment on the part of the European Union is serious and that there is therefore a real possibility to establish what can be best described as a New Contract between the EU and the ultraperipheral regions.

In return for a clear commitment by the authorities in the regions, endorsed by the Portuguese government, that the fundamental objective of their policies is to enable the regions concerned to move as rapidly as possible towards self-sustainability, the EU should agree to a comprehensive programme of assistance using a mix of direct financial transfers, tax concessions and other instruments, to help the regions towards this goal. The programme should be as concrete as possible, with targets and dates.



## Part A: Analysis

The Azores and Madeira are best treated separately. They share, it is true, several common features, including in particular insularity, remoteness and an often hostile natural environment. They also have amongst the lowest levels of GDP per capita anywhere in the Union. They are nevertheless quite different in many significant respects. The recommendations that we make in the second part of this Report take account of these differences.

### 1. The Azores

The Azores is the ultraperipheral region **par excellence**. It is 1500 kilometres from the mainland and its nine islands are dispersed over a tract of sea 600 kilometres wide. As if that were not enough they are frequently exposed to hurricane force winds, volcanic eruptions and earthquakes which have in their turn provoked emigration on an impressive scale.

The key statistics are reproduced in Appendix A. With GDP per capita of approximately 50 % of the EU average, the Azores are the fifth poorest region in the whole of the EU. Despite superficial similarities, the structure of the economy is in fact strikingly different from most of mainland Europe. 21% of the work force is engaged in agriculture and fisheries, while more than 60 % of the employed population work in the public sector. The low unemployment rate, which is approximately half the EU average, is due more to the peculiarities of Portugal's labour market than to the strengths of the economy<sup>1</sup>

The Azores are therefore entitled a special treatment under this article by almost any reckoning. It is, however, important to stress at the very beginning of this analysis that we are convinced that the islands are nevertheless full of development potential.

#### 1.1 Transport

High transport costs are common to all ultraperipheral regions. In the case of the Azores, however, the problems posed by distance from the main land are compounded by difficulties arising from the widely dispersed character of the island group itself.

#### Maritime transport to and from the main land

The economy of the Azores depends on the maritime link with the main land. It is, however, a source of considerable extra cost for at least three reasons:

- Distance.
- A negative trade balance.
- An exclusive operating agreement between the Portuguese government and one company.

The significance of the **distance** of the island group from the main land should require no comment. The impact on prices of their reliance on maritime transport is however exacerbated by the Azores **negative trade balance** (see Table 1). The Azores import

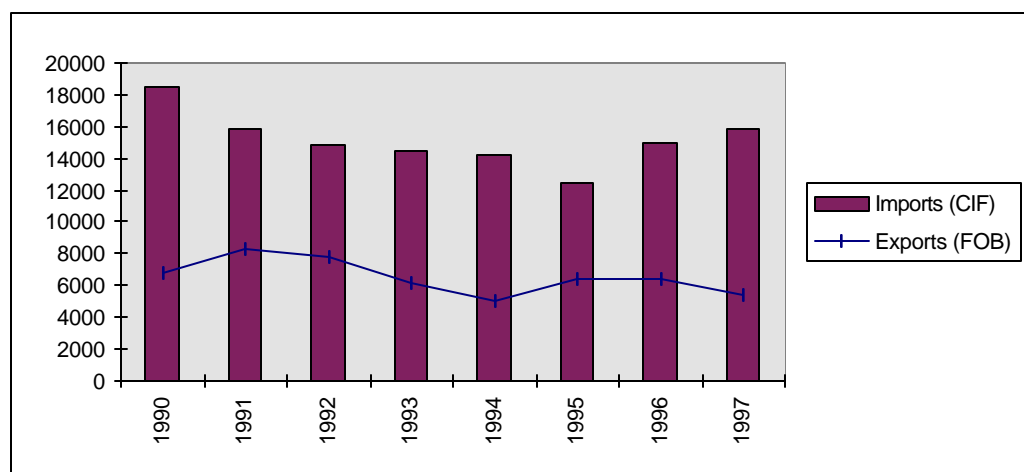
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<sup>1</sup> Cf. M. Emerson and D. Gros, 'Interactions between EU Enlargement, Agenda 2000 and EMU – the Case of Portugal'

significantly more than they export which means that they have to pay for half empty ships returning to the main land.

**Table 1: Trade balance of the Azores (1000 \$)**

	1990	1991	1992	1993	1994	1995	1996	1997
<b>Imports (CIF)</b>	18511	15852,3	14824,4	14417	14172,9	12432,5	14947,8	15887,4
<b>Exports (FOB)</b>	6799	8354,3	7802,6	6120,1	5064,5	6389,3	6433,9	5372,3
<b>Difference</b>	-11712	-7498	-7021,8	-8296,9	-9108,4	-6043,2	-8513,9	-10515,1
<b>exports/total</b>	0,37	0,53	0,53	0,42	0,36	0,51	0,43	0,34



The situation has in our view been made still worse by the decision of the Portuguese government to award a **single operator**, admittedly, through a tender process, sole rights to provide transport of goods to the islands. The rationale for this policy is closely linked with the need to guarantee basic services to all the islands. By coupling issues that could, however, equally easily have been kept apart, the Portuguese government has arguably encouraged higher prices than could normally be justified on economic grounds for maritime transport between the main land and the Azores. Competition on these routes would we believe drive prices down. We shall return to this point in Part B.

The cumulative impact of transport costs and port duties on the Azores economy is discussed further in Appendix B. Suffice to say, the Azores has the highest average price level in Portugal, 12 % higher than in the Portuguese regions and higher than Lisbon or Madeira.

### Internal maritime transport

The importance and complexity of ensuring adequate maritime transport between the islands add a further twist to the story. Goods imported from the main land to San Miguel are by definition more expensive by the time they arrive in Flores. Several policy measures have been introduced in an effort to reduce the impact of these extra costs including, for example, lower VAT rates and a monopoly license to a single operator who in return guarantees regular services from island to island at a single price. Prices in the remoter islands nevertheless remain higher. Transport is doubtless not the only explanation. The lack of competition between retailers in these smaller centres is also important. Transport is, however, a vital element in the equation.

## Air transport

The problems in the aviation sector are in many respects similar to those concerning maritime transport. Following a competitive tender, routes from Lisbon and Porto to San Miguel, Terceira and Faial were awarded to TAP and SATA. The operators concerned have exclusive rights for five years on each of their routes in exchange for a guaranteed number of flights. Other companies can fly from other locations to the Azores.

Internal flights are the prerogative of SATA alone. In exchange for its monopoly position, it is obliged to provide regular services to and from all the islands except Corvo. These flights are subsidised.

The need for regular flights to and from destinations which cannot be serviced without subsidies is obvious. The economy of the islands could not function without them. Nor too could the inhabitants of the remoter islands otherwise have guaranteed access to hospital treatment on the bigger islands or on the main land.

The present system nevertheless suffers from several defects. We would highlight three in particular:

- The distinction between flights to and from the main land and internal flights is arbitrary and its effects are perverse. A better division would be between routes which are quite definitely uneconomical and those, internal as well as external, where competitive carriers could expect to generate profits.
- The use of “normal” services to handle urgent medical cases reduces transparency in accounting terms and is also inappropriate from the point of view of the patients. This latter consideration applies particularly to the remoter islands such as Corvo and Flores where the planes used for scheduled services cannot be used in very bad weather. Rescue helicopters could by contrast be deployed for this purpose even in inclement conditions.
- The scale of the subsidies. The Portuguese government subsidises internal flights. It does so, however, at a lower level than it applies in the Madeiran archipelago. A trip between Madeira and Porto Santo costs a third of the price charged for a journey of similar length in the Azores.

## 1.2 Other infrastructures

### Harbours and airports

The islands now have an established network of viable harbours and airports. Maintenance costs are, however, very high due to two factors. The first is the weather. The second is their sheer number. With nine islands and a population roughly comparable to that of Madeira, the Azoreans have to maintain many more facilities than their counterparts further south.

### Energy

Energy costs in the Azores are significantly higher than in main land Portugal. This is due to the costs of importing and transporting fuel between the islands, and the difficulty of

generating electricity in the islands themselves. As Portugal, unlike France and Spain, does not guarantee a unitary price for energy throughout its territories, this means that the extra costs fall directly on Azorean producers and consumers.

The costs associated with **importing fuel** from the main land and transporting it amongst the islands are a further illustration of the issues already discussed in the section on Transport. The POSEIMA programme previously compensated the islands for some of the costs. The programme has, however, been discontinued. As a result, all the costs fall on the region itself.

The problems associated with **electricity generation** include:

- Isolation from the main land. Given the distance between the Azores and the main land, none of the islands can be linked to large continental generators.
- Distance between the islands themselves. Every island has to produce its own electricity. This means that there are 29 generators, some of them very small, but all of them requiring maintenance. Labour costs account for approximately 40 % of the costs of generating electricity in the Azores compared with 15 % on the main land.

Substantial investment could overcome some of these problems, particularly in the central group of islands, Terceira, San Jorge, Pico and Graciosa. Two schemes are currently in the public domain.

The first would involve the construction of a geothermal energy generator in Terceira, comparable to the highly successful generator on San Miguel, which is expected within the near future to cover almost half the energy requirements of that island. The Terceira generator could, however, have an even greater impact, if, as is planned, submarine power cables were installed linking Terceira with the other islands in the central group. The investment costs needed to implement this plan are however heavy and it is difficult to see how they can be met without significant EU assistance.

The other scheme involves eolic power. This could not be a substitute for fuel powered electricity plants, since wind levels are not constant throughout the year. Installation of eolic power plants could nevertheless help towards reducing costs particularly in the remoter islands.

Unless and until these or other solutions are implemented the Azores will be condemned to suffer high energy costs. Just how high can be seen in Tables 2 and 3.

**Table 2: Costs of energy production in the single islands of the Azores esc/kWh 1995**

	Cost of energy esc/kWh	Difference mainland Islands	Percentage difference to mainland
<b>Sta. Maria</b>	50,70	32,80	283
<b>S. Miguel</b>	29,33	11,43	164
<b>Terceira</b>	30,67	12,77	171
<b>Graciosa</b>	62,12	44,22	347
<b>S. Jorge</b>	54,06	36,16	302
<b>Pico</b>	57,77	39,86	323
<b>Faial</b>	35,52	17,62	198
<b>Flores</b>	46,02	28,12	257
<b>Corvo</b>	85,50	67,60	478
<b>Azores average</b>	34,00	16,10	190
<b>Mainland Portugal</b>	17,90	-	-

Source: EDA

**Table 3: Electric power prices, January 1997**

Region	Price ECU/100 kWh Industrial sector	PdP <sup>1</sup>	PdEU <sup>2</sup>	Price ECU/100 kWh Private sector	PdP <sup>1</sup>	PdEU <sup>2</sup>
Portugal mainland	8.88	-	-6	15.5	-	-7
Azores	13.73	55	45	19.03	23	19

1. Percentage difference to mainland price (excluding Azores and Madeira)

2. Percentage difference to EU average (excluding Azores and Madeira)

## Health services

Leaving aside Corvo, the other eight islands, separated by often hostile seas, require in effect eight distinct health services. The strains imposed by this requirement are apparent from Tables 4 and 5.

- Fixed installations, including beds, are more numerous than would be the case for a population of this size on the main land. As a result, both capital investment and running costs are significantly higher. In the case of the former, the figure for the Azores is seven times that of the comparable figure on the main land. Even running costs are one third higher.
- Trained personnel are in short supply. For the Azores as a whole, the number of doctors per 1000 inhabitants is only a little more than half the Portuguese average.
- The combination of scarce resources distributed over eight islands results in a medical service which is, despite the efforts of all concerned, seriously deficient in certain important respects by comparison with main land standards. It is difficult to cite statistics which demonstrate this “quality gap”, but the fact that infant mortality rates averaged 11.55 per 1000 inhabitants between 1991 to 1995 compared to 8.92 in the whole of Portugal cannot be without significance.

**Table 4: Health services in the Azores 1997 per 1000 inhabitants**

	Santa Maria	Sao Miguel	Terceira	Graciosa	Sao Jorge	Pico	Faial	Flores	AZORES TOTAL	Portugal average
<b>Hospitals</b>										
Number <sup>1</sup>		1	1				1		3	
Beds		2.52	4.16				8.95		2.87	
Doctors		1.11	1.23				1.97		1.00	
Nurses		2.08	2.95				5.15		2.12	
<b>Clinics</b>										
number <sup>1</sup>		3	2						5	
beds		3.23	6.14						3.17	
doctors		0.14	0.23						0.13	
nurses		0.4	0.51						0.34	
<b>Health Centres with out-patient facilities only</b>										
number <sup>1</sup>		2	1				1	1	4	
doctors		0.24	0.25				0.81		0.24	
nurses		0.53	0.79				0.88		0.52	
<b>Health centres with in-patient facilities</b>										
number <sup>1</sup>	1	4	1	1	2	3		1	13	
beds	3.29	1.30	0.35	4.69	6.03	3.36		7.62	1.56	
doctors	0.49	0.17	0.18	0.82	0.87	0.60		0.90	0.25	
nurses	1.98	0.70	0.47	1.63	1.75	1.61		2.02	0.78	
<b>TOTAL of beds and medical staff</b>										
beds	3.29	7.05	10.64	4.69	6.03	3.36	8.95	7.62	7.61	4.63
doctors	0.49	1.66	1.88	0.82	0.87	0.60	2.78	0.90	1.62	2.96
nurses	1.98	3.72	4.72	1.63	1.75	1.61	6.03	2.02	3.76	n.a

1. actual number

Data source: SREA

**Table 5: Average costs in euros for the provision of health services per inhabitant, 1995**

	Continent	Azores	% difference
<b>Current Expenses</b>	349	464	33
<b>Capital Expenses</b>	12	82	709
<b>Total</b>	360	546	52

Data Source: SDM

## Education

A similar situation obtains with regard to education. Every island, including Corvo, with its population of little over 300, provides primary and secondary education. The costs of maintaining this system are, as Table 6 shows, 50 % higher per capita than in main land Portugal.

**Table 6: Total costs of school education 'per capita' in euros, 1995/96**

Azores	Continent	% difference
279	190	147

Data Source: SDM

This higher expenditure does not, however, result in higher quality. On the contrary, there is a serious shortage of trained teachers. 40 % of teaching staff in primary and secondary schools do not have formal training.

As a result of local endeavour, and with help from the European Social Fund, standards have risen during the last 20 years. In 1981, 23 % of the inhabitants of the islands were still functionally illiterate. By 1991, this figure had fallen to 14 %, and the situation has continued to improve since then.

This victory against illiteracy, though welcome, is however, only a small step in relation to the challenges and opportunities implied by new technologies for a community as remote as the Azores. The priority now has to be to develop an educational system which guarantees a constant supply of highly skilled personnel.

This will require investment. It will also involve innovation in school and university syllabuses. In the latter case, for example, the Azores ought to be exploiting its comparative advantages as a potential centre of excellence for advanced work on marine biology and environmental studies.

### 1.3 Agriculture and rural development

Agriculture is central to the economy of the Azores. The sector employed 16 % of the total work force and accounted for 12 % of Gross Value Added in 1995. There are 130 000 hectares of usable land and 22 000 farm units with an average size of 5.7 hectares per farm. Meat and dairy products predominate, but there is also some production of fruit, tobacco, sugar beet and tea.

Conditions for agricultural production on the islands are generally good. There are also some flourishing businesses in the meat and dairy sectors. There are however grounds for anxiety. The sugar and tobacco industries are struggling and it is not easy to see how they can emerge from their difficult situation. Still more important, however, is the growing, negative environmental impact of cattle farming. There are limits to the numbers of cattle that the Azores can sustain without damage to the environment, and more particularly pollution of rivers and lakes. The situation is not, however, easy to control, since the CAP as currently constituted encourages farmers to increase their herds of cattle and thereby enhance the risk to the environment. What is needed in other words is a more broadly conceived strategy for land use which encourages farmers to develop other types of activity as well as cattle rearing.

### 1.4 Fisheries

Fishing has long been a mainstay of the Azorean economy. It is important in itself. It is also important, however, as the source of raw materials for the food processing industry. The fact that the fishery sector is fragile is therefore a matter of considerable significance.

Its fragility stems from:

- A limited number of species in this part of the Atlantic.
- Overfishing and the employment in certain cases of forbidden methods.
- Inadequate quality control. The Azores are currently failing to take advantage of high world market prices, due to a lack of quality control and the failure to weed out those parts of the catch that are not so valuable. This in turn reflects a shortage of properly trained personnel.
- High costs in processing and marketing due to a need to import essential equipment and the additional costs caused by the need to ship the end product to the main land.

The European Union has already acknowledged the vulnerability of the sector through successive provisions under the POSEIMA programme. The most important measures involve subsidies towards marketing. The programme was furthermore renewed for three years in 1998. This is all to the good. The EU's commitment is still, however, provisional rather than permanent. To encourage long-term investment in the sector, the EU should make the programme of unlimited duration. The Commission has already acknowledged the need for permanence. The Council has so far, however, refused to concede the point. It is to be hoped that it will change its position in the light of the new Treaty of Amsterdam article.

## 1.5 The Environment

The quality of the Azores environment is of critical importance to its economic welfare, since any long-term strategy for the islands must accord eco- and agro-tourism a very high priority.

There are at the moment two principal sources of trouble: pollution resulting from a large and growing population of cattle and inadequate waste disposal facilities.

The first point has been dealt with in the paragraphs on agriculture. As far as the waste management issue is concerned, there are no recycling facilities and space is very limited for landfills. Glass bottles, for example, which are practically all imported from the main land are not currently recycled and do not usually get sent back to where they came from.

As and when tourism increases and economic development picks up, the inadequacies of the present waste disposal system will be highlighted still further.

## 1.6 Industry, services and business development

High transport, communication and energy costs put Azorean businesses at a disadvantage. So too do a scattered local market and isolation. Finally, there is a serious shortage of capital.

### Industry

The principal industrial sector, after the construction industry, is food and beverages. It is a very varied sector and generalisations are therefore difficult. Most of it is however heavily subsidised by the EU, either through the CAP or through direct compensation of the kind that the POSEIMA programme makes available to the fish processing industries.

Although in certain cases, such as the sugar industry, which can only operate with a higher quota than the one that is currently permitted, there appears to be little that even the EU can do to prop up production indefinitely, pessimism is not justified across the sector as a whole. On the contrary, a mixture of investment and assistance with marketing and transport costs could enable the businesses concerned to compete effectively.

In the absence of a Free Trade Zone similar to the one that Madeira has established, the Azores' only other industrial sector which could have serious potential in the future is its traditional cottage industry. If, however, it is to achieve this potential, those involved will have to reverse a long and continuous process of decline which has been exacerbated in recent years by the EU's decision to abandon its 1993 programme for cottage industries.



Given the potential importance of handicrafts if tourism expands as it ought to, this EU decision is highly regrettable.

## Services

Over 60 % of the total work force are employed in services. Most of those involved work in the public sector. This is to some extent an inevitable result of the dispersion of a small population over nine islands, each of which requires a public service infrastructure. The public sector's share of employment does nevertheless seem excessive.

Looking to the future, tourism is the most promising growth sector. The present situation is not, however, particularly impressive. The figures in Annex C showing the number of beds available in the Azores and Madeira and total revenues from tourism indicate just how far behind Madeira the Azores still is. The Azores has almost one third of the number of visitors per annum that Madeira has. The revenues generated from these tourists are, however, less than 10 % of the Madeiran figure.

Various explanations can be found for this unimpressive performance. The one that is most commonly cited is inclement weather during the long winter months and, as a result, a much shorter "season" than Madeira's where there are often more tourists on the islands in January than in July.

Explanations along this line are, however, only partially convincing. Eco- and agro- tourists of the kind that the Azores ought to be attracting are less deterred by wild weather than more conventional visitors. For Northern Europeans who delight in long hikes across rough terrain in weather which is both wild and cold, the Azores should hold few terrors.

The impression that more could be done is confirmed by a few highly successful pilot projects. Take for example the Cuada development in the island of Flores. In this case, a tiny, deserted village in one of the wildest and remotest islands has been transformed into an extremely attractive destination for tourists who want peace and quiet in an undisturbed and beautiful environment. It would be difficult indeed to find many better examples of agro-tourism anywhere in Europe. The initiative of those who set up the project is furthermore being rewarded. Occupancy rates are excellent and are by no means restricted to high season..

Cuada has unique properties. It can, however, serve as an illustration of the kind of project which should surely figure large in any vision of the Azores future as a tourist centre.

## IT and telecommunications

The current situation regarding both is far from optimal in the Azores. Within the near future, however, the Azores will be connected to the fibre glass intercontinental cable linking North America and the European Union. This is a development of immense potential significance both socially and economically. By itself, it could go a long way to mitigating the effects of isolation. The Azores will be more than ever on the map and accessible. For those seeking to market anything from organic foods to tourism in either North America or the EU, it will also be a major new instrument. Last, but by no means least, it could provide a focus for indigenous business development.

If the Azores is to seize the potential offered by this development, however, and more particularly to respond to the possibilities that it offers over time, urgent steps will have to be taken to rectify a considerable shortage of highly skilled labour, due in the final analysis to the shortcomings of the educational system.

## **Conclusions**

Previous pages should have demonstrated that the Azores do indeed suffer from significant handicaps stemming from their ultraperipheral location. If they are to be able to compete on more or less equal terms on a level playing field, they will therefore need countervailing help from the EU. The philosophy behind Article 299.2 is thus entirely appropriate to this case.

A systematic effort by the EU to come to terms with the specific problems of the Azores will only stand a chance of success, however, if the authorities on the Azores themselves seize the opportunity offered by the new Treaty Article to carry out a thorough going review of their own policies and strategy. The Azores structural problems are an important part of any explanation of its lopsided and inadequate economic development. They have however been compounded by failures of public policy. The fact that the Azores has never taken advantage of concessions regarding trade zones, which Madeira has used to such obvious benefit, is a case in point. The authorities have also been insufficiently proactive with regard to the islands tourist potential.

It is for this reason that we lay such stress in our recommendations on the need for a bold and comprehensive development strategy as the Azorean authorities quid pro quo in the New Contract. The Azores will always be an ultraperipheral region. This does not however mean that they are for ever condemned to lag behind the rest of the EU, let alone Madeira or the rest of Portugal. New policies devised and implemented within the context of the new Treaty could be decisive in transforming the Azores' prospects.

## 2. Madeira

The two inhabited islands of the Madeira archipelago, Madeira and Porto Santo are undoubtedly ultraperipheral. They are islands. They are remote: Funchal is almost a thousand kilometres from Lisbon. They are small. Their topography is difficult: much of the island of Madeira is uninhabitable, with the result that population density on the usable land is more than 500 inhabitants per kilometre, which is five times the EU average. Although the Madeiran climate is remarkable and a major element of its attractiveness to tourists, Porto Santo suffers from serious water shortages. Finally, the archipelago's economic development has hitherto depended on too few products.

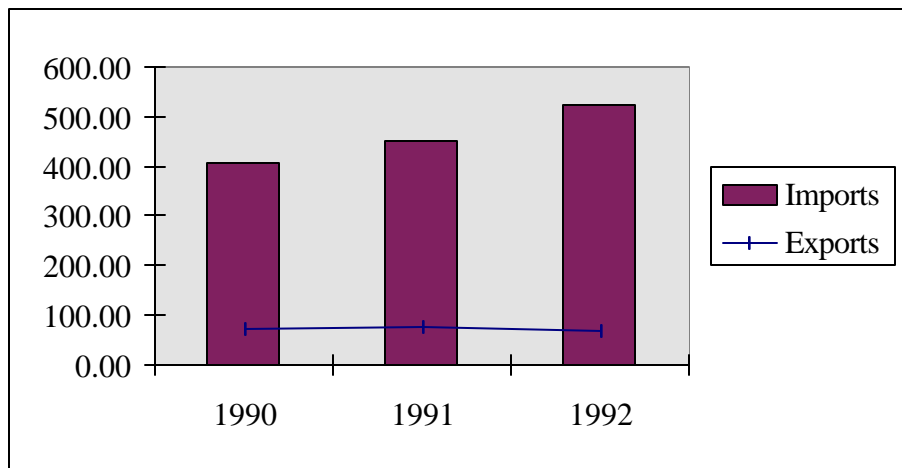
The archipelago therefore fits the profile of an ultraperipheral region very well. There are, however, important offsetting features of the Madeira story which must be stressed throughout this Report. Despite their handicaps, the islands' basic infrastructure is more advanced than is the case in the Azores. Its tourism is also better developed. Last, but by no means least, the regional authority has established a medium to long term strategy aimed at developing other business activities alongside tourism under the aegis of Madeira's International Business Centre (MIBC). The ultimate objective, already stated and palpably realistic, is to set Madeira on a path of self-sustainable prosperity and growth.

### 2.1 Transport

Like the Azores and all other ultraperipheral regions, Madeira suffers from heavy additional transport costs, linked to both its insularity and its negative trade balance (see Table 7). As there are no subsidies to maritime operators, the inhabitants of the islands themselves have to pay for the additional expense involved in importing and exporting. This in turn has a significant impact on price levels which, as Annex B shows, are higher than on the Portuguese main land.

*Table 7: Trade balance of Madeira, (m euro)*

	1990		1991		1992	
Commercial Trade	Value	%	Value	%	Value	%
<b>Abroad</b>						
Imports	64.88	15.97	65.31	14.42	109.85	21.03
Exports	25.06	34.74	25.03	32.95	25.23	37.15
<b>Mainland + Azores</b>						
Imports	341.38	84.03	387.53	85.58	412.54	78.97
Exports	47.07	65.26	50.94	67.05	42.68	62.85
<b>Total</b>						
Imports	406.26	100	452.84	100	522.39	100
Exports	72.13	100	75.97	100	67.91	100
<b>% Coverage with</b>						
Abroad	38.63		38.33		22.97	
mainland and Azores	13.79		13.15		10.5	
Global	17.75		16.78		13.00	



Data Source: DREM

Air traffic to and from Madeira is heavy because it is such a popular tourist destination. Scheduled flights to and from Lisbon are nevertheless reserved to TAP. The Portuguese government tried to attract bids for rights to the route on the understanding that there would be no subsidies. The offer was not, however, popular and had to be revised to include subsidies from the Portuguese government to passengers who were inhabitants of Madeira itself. TAP won this contract which will last three years. Other companies can fly from other destinations to Madeira without restrictions.

## 2.2 Other infrastructures

### Harbours, airports and roads

Although the Madeiran archipelago does not have as many airports and harbours as the nine Azorean islands, the costs involved in developing appropriate facilities have been and are enormous as a result of Madeira's very distinctive topography. Madeira's road building programme has suffered from the same problem. Construction costs are reckoned to be four times higher than on the main land even without tunnels and bridges which, as they are numerous, add significantly to the end price.

It is a tribute to the energy and initiative of the regional authority that, drawing on substantial support by the Structural Funds, a great deal of the basic infrastructure is already in place. There is still, however, much to be done and the costs will continue to be more than the Madeirans can be reasonably expected to carry on their own.

### Energy

With only two inhabited islands, Madeira does not face some of the most serious problems confronted by the Azores. There are nevertheless important limitations on Madeira's ability to produce its own energy. The hydroelectric plants that exist are small and sites for wind generators are limited both on account of the topography and, still more, because of the negative impact that any major development might have on the beauty and therefore the tourist appeal of the island.

As to oil, Madeira is heavily dependent on imports. As furthermore it has no refining capacity, these imports are of refined petroleum products.

Table 8 gives some indication of the cumulative impact of these various disadvantages on the Madeiran economy. The price of energy for domestic consumption is 10 % higher than on the mainland. In the case of the services sector it is 35 % higher.

**Table 8: Consumer prices for energy in the archipelago of the Madeira Euro/100kWh**

1999	Cost of energy euro/100kWh	Mainland Portugal	Difference	% difference
<b>Domestic consumption</b>	14,5	13	1,5	10
<b>Services</b>	12,5	8,1	4,4	35
<b>Commerce et al.</b>	10,7	7,1	3,6	36
<b>Industry, agriculture and Fisheries</b>	8,3	8,1	0,2	2
	7,7	7,1	0,6	8

### Health services

Madeira's problems here are comparable to those on the Azores. The provision of beds is significantly higher than on the main land. The availability of qualified personnel, and more particularly doctors, is by contrast much more restricted. There are also special problems on the island of Porto Santo, where any reasonably serious medical problem necessitates a transfer by air or sea to Madeira or possibly even the main land.

**Table 9: Provision of health services per 1000 inhabitants 1995**

	Madeira	Portugal
<b>Beds</b>	7.69	4.63
<b>Doctors</b>	1.49*	2.96
<b>Nurses</b>	4.9*	n.a.

\*1998

\*\* 1991/95

The figures for infant mortality are almost identical with those of the Azores.

### Education

Madeira's school system has improved considerably, thanks not least to support from the European Social Fund which has increased the supply of teachers and school places. The overall aim has been to combat illiteracy and to change the expectations for the population regarding education. There are clear signs of success on both fronts. It is nevertheless still the case that over 70 % of parents have no more than 4 years of schooling. As requirements for highly skilled personnel increase, with the growing success of the MIBC initiative and the imminent arrival of fibre glass cables, Madeira is likely to face serious constraints. Ensuring that they do not hold up development is therefore a priority of public policy.

### 2.3 Agriculture

Most of Madeira's agricultural production is uneconomical in strict market terms. This is in large measure due to the extraordinary topography of the island. Its steep hills require terraced agricultural production on small plots of land where machines are virtually irrelevant. 95 % of the farms are less than half a hectare in size and farmers are amongst the poorest inhabitants.

Farming is nevertheless crucial to the local economy. To take only the two most obvious examples: terraces and bananas.

One of the outstanding features of the Madeiran landscape is the sheer number of terraces. All manner of products are grown on them. They are also very picturesque. Madeira, as a tourist resort, would not in fact be the same if these terraces were left untended. Still more to the point, neglect of the terraces would in time lead to serious erosion with all that that might entail. Viewed in a broader perspective in other words, the cultivation of crops on Madeira's terraces is a public good.

Much the same can be said of bananas. Production costs are high and local producers will never be able to compete on the world markets. If Madeira was exposed therefore to the full consequences of the WTO ruling, its banana production would be wiped out.

Madeira without bananas would, however, not be Madeira. They are, along with the extraordinary variety of exotic flowers, the clearest evidence to tourists that Madeira is a sub-tropical island. Once again, therefore, there is a broader argument for maintaining production. Some mileage might be made out of a more systematic and authoritative certification system. The survival of Madeira's banana production can and will however only be assured if the EU acknowledges, and in due course persuades its global partners to accept, the broader social, environmental and ornamental importance of this product.

## 2.4 Fisheries

Here too Madeira's problems are similar to those of the Azores. Resources are limited and there is little scope for diversification. Over 84 % of the fish caught by the local industry in 1994 were either tuna or sword fish. The catch is often plentiful. The supply is not unlimited and needs careful husbanding.

There are also, once again, additional costs associated with importing material to process the fish and to export both the fish and the processed products. As in the Azores, there is still a POSEIMA financed scheme in place to compensate producers. It is not, however, permanent, even though the need is clearly not going to go away.

## 2.5 Environment

As with the Azores, Madeira's environment is its single greatest asset. It is however under threat, because of the exceptionally high density of the population, structural difficulties with waste management and, by no means least, the adverse consequences of success, particularly with tourism. It could also be threatened if supports were withdrawn from the farming community who work the terraces and produce bananas.

The menace represented by population density and an expanding tourist industry can only be dealt with by the Madeiran authorities themselves through rigorous controls on building development. The lack of an adequate waste management system is, by contrast, amenable to outside help. With limited space available to dispose of waste, the authorities do not have anything resembling a modern waste disposal system, let alone recycling facilities. To the extent that waste is removed, it has to be shipped to the main land at considerable cost. The development of local facilities is therefore a priority of the highest order.

## 2.6 Industry, services and business development

### Industry

In 1996, 29 % of the population was employed in the industrial sector. 90 % of those involved were, however, engaged in companies employing less than 20 people. Only 1 % of the companies had more than a hundred employees.

Most companies operated in the traditional handicrafts sector (embroidery, tapestry and wickerwork). In the past, output in this sector was aimed primarily at the export market. It is a reflection of the declining competitiveness of the firms involved, however, that the tourist market is now increasingly important.

The POSEIMA programme incorporated a series of measures designed to support traditional cottage industry, through assistance to vocational training, facilitation of access to and use of new technologies and subsidies towards marketing costs. In due course, these programmes were taken up in Regis II. In the last few years, however, this support too has dried up and there is at the moment no programme in place.

The travails of the traditional handicraft sector are made all the more important by the rather disappointing results in the industrial programme sponsored by the Madeira International Business Centre (MIBC). There has been some industrial development in and around the free port, but it is on a small scale and has only marginal significance in the overall Madeiran economy.

### Services

Almost 54 % of the employed population worked in the services sector in 1998. Its contribution to the Gross Value Added of the economy as a whole was approximately 75 %.

**Tourism** is by far the most important single source of revenue in the Madeiran economy. As the figures in Appendix C confirm, tourism is incomparably more important in Madeira than it is in the Azores. The number of visitors is much larger. The length of stay is longer. Last but by no means least, up-market visitors are the norm rather than the exception. In 1997, there were almost 7500 beds in four and five star hotels. If to this one adds other "luxury accommodation" in apartments, guest houses and agro-tourism developments, the luxury market accounted for 64 % of the islands' overall provision for tourists.

Tourism is, however, a volatile industry. Economic slow down can halt a seemingly regular supply of visitors. So too can changing fashions. During the past decade alone, overall occupancy in the island, which has tended to fluctuate around 63 % for most of the years in question, fell as low as 49.5 % in 1993. Against this background, the regional authorities have rightly laid great stress on the need to reduce the overall economy's dependence on the tourist sector. Hence the MIBC initiative.

## Business development

The principal instrument of diversification in the last two decades has been the Madeira International Business Centre (MIBC). The initiative was conceived in the 1970's and launched in 1980 with the creation of a Free Trade Zone. Responsibility for developing the zone was entrusted to the SDM (the Madeira Development Company), which later became the Madeira International Business Centre (MIBC).

The MIBC operates in four principal areas: the industrial Free Trade Zone, financial services, international services and the international shipping register. Its main objectives are:

- To stimulate GDP growth through the reorientation of the productive structure of the island's goods and services.
- To reduce inefficiencies and other sources of weakness in the economy.
- To help the island to prove its competitive capacity in external markets
- To improve opportunities for professional training and employment for young people and to provide highly qualified jobs for Madeirans who return home with enhanced qualifications.

The MIBC operates in different ways. A crucial factor in its development has however been its capacity to offer tax incentives to Madeiran and non-Madeiran companies. These incentives involve reductions or exemptions on income, corporate and stamp taxes.

Madeira's special regime figured prominently in Portugal's negotiations to join the European Community. As a result, Portugal was allowed to maintain the regime until the end of 2011. The Commission was, however, authorised to review the arrangement before that date. As a result, **new** concessions could be banned as early as December 2000. Given the much greater interest now being shown by the EU in special tax regimes which allegedly constitute "unfair competition", this review date has understandably assumed considerable significance in the Madeiran policy debate.

Three questions are clearly pertinent. Firstly, is the regime "unfair" judged by the criteria normally applied to "offshore" centres and those developed more recently in the context of the EU's Task Force on unfair tax competition? Secondly, has the regime benefited the Madeiran economy? Thirdly, what further advantages can be expected to accrue if it is allowed to continue?

As far as the first question is concerned, the answer is clear. The Madeiran regime is not a classic "offshore" system. Nor does it offend against the principal criteria laid down in the mandate to the EU's new Task Force. A previous Commissioner, Raniero Vanni d'Archirafi was quite explicit regarding the first point when, on 13 December 1993, he declared that it would be misleading to describe the Madeiran regime as "offshore" or "extraterritorial". It is easy to see why he came to this conclusion. The regime is in fact subject to rather strict rules.

- Incentives have to be time limited and justified by clearly defined goals.
- The companies that operate in Madeira have to be resident in Portugal and subject to supervision by the Portuguese authorities. This means, for example, that they have to comply with all the reporting requirements that the Portuguese government lays down for tax-payers in general.



- The regime does not discriminate between residents and non-residents. On the contrary, the MIBC is required to treat companies resident in Portugal on the same basis as non-residents.

As to the new Code of Conduct agreed at Luxembourg in December 1997, here too the Madeiran regime seems to us to pose no problems. The two most important criteria are firstly, that tax concessions to businesses should not harm the working of the internal market and secondly, that they should be “in proportion to and targeted at the aims sought”.

It would be hard to argue that the Madeiran system currently constitutes or is likely to constitute a threat to the operation of the internal market. Even if it grows, as it should, it will remain a very small affair. In terms, however, of Madeira’s overall development objectives, it is entirely appropriate and “in proportion”. The regime corresponds to Madeira’s need not only to develop but still more to ensure that this development is broadly based. It also serves the EU’s own interest, since, as is entirely possible, the benefits that it brings to Madeira are sufficiently important to set the island on a self-sustaining course, the European Union will eventually be the beneficiary, as its contributions to the Madeiran economy are scaled back.

The second question concern the effectiveness of the regime. Here too the answer is positive. There have, it is true, been disappointments regarding the industrial Free Trade Zone. In the international services and financial services sectors, however, the growth in business activity has been impressive. Table 10 conveys the picture well.

**Table 10: Companies licensed in MIBC on the 31st of December**

Years	Total		
	No	Accumulated	Growth
1988	7	7	
1989	50	57	714.29
1990	152	209	266.67
1991	230	439	110.05
1992	378	817	86.10
1993	314	1131	38.43
1994	346	1477	30.59
1995	197	1674	13.34
1996	464	2138	27.72
1997	434	2572	20.30
1998	659	3231	25.62

Source: SDM - Madeira Development Company

The growth in the number of businesses has been matched by a growth in employment. Over 2000 jobs depended directly or indirectly on these new businesses in 1998.

This leads on to the third issue: the further potential of the scheme. Here again, the evidence is highly encouraging. As Table 10 itself shows, the growth in business creation has tended to accelerate. This is very much in line with the experience of other island economies that have operated schemes with similar goals, namely Man, Guernsey and Jersey. Table 11 shows how long it has taken the isle of Man’s Business Centre to become a major source of employment in the island. The MIBC which operates, it must be stressed, in a much more stringent regulatory environment than its counterpart in the isle of Man, seems to be on a similar trend.

**Table 11: The changing structure of employment in the isle of Man**

	1951	1961	1971	1981	1991	1996
Employment	1.54	1.95	3.43	5.86	13.68	17.69
relative position*	10	10	9	8	3	2

\* The study by SDM subdivides the economy in 11 areas. The relative position shows how the sector ranks as employment creator

If this is indeed the case, it is good news for everybody, including by no means least the European Union. Table 12 which brings together key indicators concerning all three island economies shows why. Financial services and more generally international services may never become quite as important in Madeira as they are on the other three islands, partly because Madeira has such a successful up-market tourist industry. Even partial success would, however, hasten the day when the Madeiran economy becomes self-sustaining and therefore largely independent of financial transfers from the rest of the European Union.

**Table 12: Indicators concerning financial and international services in the islands of Man, Guernsey and Jersey**

Contribution of the sector	Isle of Man (96/97)	Guernsey (96)	Jersey (97)
GDP	36%	59%	55%
Employment	18%	26%	20%
Position relative to GDP of the UK (96)	82%	158%	146%

Source: SDM

## IT and telecommunications

Madeira is at a junction in the fibre glass communication network linking North America, Africa and Europe. The island has in fact already been used as an experimental centre for cable and satellite communication systems.

This augurs well for the future. The Technopolo Centre is already engaged in trying to create a Science Park. With the improvements that are anticipated in telecommunications infrastructure, this scheme should become more attractive to investors. If it does, Madeira could exploit its advantages as a base for advanced research into marine biology, astronomy and ecology.

A precondition of success is, however, the acceleration of improvements in the educational system that are already under way. Otherwise, Madeira, like the Azores, could be held back by an acute shortage of highly skilled labour.

## 2.7 Porto Santo

Porto Santo is a small island, fifty kilometres north of Madeira. It has approximately 5000 inhabitants in an area of 42 kilometres. The island is topographically quite different from Madeira. There is, it is true, one high peak, but the principal features of the island are a relatively low coast line, including several small villages, and a long sandy beach.

Under inhabited, Porto Santo might at first sight appear to be something of a paradise. In reality, however, it is the poor cousin of the archipelago. Unemployment is more than double that on Madeira. Income is lower. Prices are significantly higher.

**Table 13: Price differentials between Madeira and Porto Santo, Portuguese escudos**

Products	Nº Prod.	Porto Santo	Madeira	Difference	
				Absolute	%
Food and drinks	92	42856.83	40816.56	2040.27	5.00
Household and cleaning products	29	9026.17	8734.24	291.93	3.34
Cosmetics and personal hygiene	16	8095.83	7795.23	300.61	3.86
Baby products	5	2324.67	2330.17	-5.50	-0.24
<b>Total</b>	<b>142</b>	<b>62303.5</b>	<b>59676.2</b>	<b>2627.3</b>	<b>4.40</b>

Data from January 1999

The island's principal source of earnings is its tourism. The latter is, however, quite different from tourism on the main Madeira island. It is in the first place distinctly seasonal. Whereas the island of Madeira attracts tourists mainly in the European winter and spring, visitors to Porto Santo come almost exclusively in the high summer months. When they get there, they do quite different things. The beach is the principal attraction. The accommodation they use is down-market. The facilities in general are inferior. Efforts to build hotels of some kind of international standing in Porto Santo have not been successful as the abandoned betton complex shows.

Porto Santo's future clearly lies in tourism. With a large and underused airport and a magnificent beach, it should be able to do better. The key, however, almost certainly lies through greater coordination with the principal island. Better services and air connections plus better marketing could encourage up-market tourists on the main land to devote a day or two to visiting the smaller island. This would in turn break down the seasonality of Porto Santo tourism and generate revenues which could be used to upgrade hotel, restaurant and other facilities.

One other aspect of the Porto Santo is worth highlighting, namely the lack of fresh water. The present desalinisation plant in the middle of the beach is neither adequate nor elegant.

## **Part B: Recommendations**

The diagnosis in Part A of this report has drawn attention to the considerable differences between the Azores and Madeira and within the Madeira archipelago between the main island and Porto Santo. Most of the prescriptions that follow are therefore specific to each of the island groups. We begin, however, with some general proposals.

### **1. General proposals concerning both Azores and Madeira**

The proposals that follow are not simply an attempt to revive POSEIMA. This programme had its virtues. It is however a thing of the past.

What is needed now is a New Contract, incorporating more dynamic and better targeted programmes, aimed at encouraging the development of sectors and activities that can become self-sustaining, and providing enduring support for those which, because of the islands' ultraperipheral situation, will otherwise remain vulnerable.

We believe that the negotiation of a Contract of this nature should be the highest priority of the regional authorities, the Portuguese government and the EU institutions in the first half of the year 2000.

#### **1.1 Adapting the Structural Funds to the realities of the ultraperiphery**

The Azores and Madeira are already the highest recipients of Structural Funds in Portugal. They will presumably remain so in the future. There are nevertheless a number of recent developments in the administration of the Structural Funds which give rise for concern and should prompt specific, countervailing action on the part of the Union in favour of the ultraperipheral regions.

All these problems are in one way or another tied up with new guidelines concerning co-financing. We believe that these guidelines are inappropriate in the context of the ultraperiphery and should be modified in accordance with the letter and spirit of Article 299.2. More specifically, we propose that:

- The ceiling on EU co-financing of ultraperipheral infrastructural projects should be maintained at 85 % of eligible costs.
- EU participation in investments in business start-ups in the ultraperiphery should be allowed to exceed even the upper limit of 45 % allowed to small and medium sized enterprises under the general guidelines.
- The ceiling for advanced payments should be maintained at 50 % and not cut to 10 % as currently envisaged.
- Greater flexibility should be allowed in the ultraperipheral regions concerning the possibility of rolling over grants beyond two years.

#### **1.2 Research and Development**

Given the isolation of both the Azores and Madeira, we believe that it would be in line with the spirit of Article 299.2 if the EU were to give proactive help in the form of additional

finance to encourage exchanges between research institutions on the islands and elsewhere and to facilitate student participation in the Erasmus programme.

### 1.3 Permanent support for permanent handicaps

The Council's refusal to countenance any permanent concessions under the POSEIMA programme except with regard to agriculture is regrettable and should be reversed. The handicaps faced by key industries such as fisheries are structural and permanent. EU assistance should acknowledge this fact.

### 1.4 Cabotage

The EU should subsidise transport between the islands just as much as if not more than travel between the main land and the islands.

### 1.5 Institutional issues

We believe that with the coming into force of Article 299.2 both the EU institutions and the ultraperipheral regions should take steps to strengthen the institutional underpinnings of their cooperation. Specifically we recommend:

- A strengthening of the Inter-Services Group in the Commission. As matters stand, the group appears to have less significance now than it did in the days of POSEIMA. One possible solution would be the creation of a Task Force for the Ultraperiphery in the General Secretariat of the Commission, reporting through the Secretary General to the President. This would enhance the political profile of the regions and facilitate internal coordination.
- The establishment within the Council Secretariat of a small unit dedicated to the problems of the ultraperipheral regions.
- The General Affairs Council should undertake to review progress on the implementation of Article 299.2 at least once during each Presidency.
- The ultraperipheral regions themselves should consider creating a combined office in Brussels to argue their case more effectively.
- Consideration should be given by both sides to the creation of a forum which would meet once or twice a year in Brussels or in the regions themselves to review the implementation of Article 299.2. The forum should bring together representatives of the regional authorities, the Portuguese government, the EU institutions, the social partners, and university and other experts.

## 2. The Azores

### Introduction: the need for a comprehensive strategy

Our analysis of the present situation in the Azores in Part A should have highlighted both the objective needs of the islands and what we believe to be a serious lack of an overall development strategy. Our recommendations for the Azores are correspondingly more far-reaching and radical than those for Madeira.

Most of the proposals in the following paragraphs concern specific policy areas. The validity of these recommendations and of others that may emerge in due course can, however, only be tested if they are considered within the framework of a general development plan. Our first and most important recommendation is therefore that the authorities in the Azores should seize the opportunity offered by the new Treaty to reformulate their ambitions in a comprehensive strategic document which could constitute in due course their contribution to the proposed Contract. The overall aim of the strategy should be to enhance the development of the islands and their integration with the European Union economy with the long-term objective of self-sustainability.

### 2.1. Transport

We believe that the Azores should combine their justified request for greater subsidies with liberalisation of both maritime and air transport. The present system sanctions monopolies in return for guaranteed services to all islands, regardless of the economic viability of the routes concerned.

We are convinced that if routes to and from the main land and amongst the principal islands were open to any qualified operators, costs would be greatly reduced and the volume of traffic would increase. Subsidies could then be concentrated on non-commercial routes and on specific social service requirements, including in particular a stand-by emergency service to transfer patients to bigger hospitals in the islands or on the main land.

In return for a commitment to liberalisation along these lines, the Commission should, as its part of the Contract, lift its refusal to subsidise transport between the islands. The present system, whereby the Commission subsidises routes which are basically viable and refuses assistance towards routes which are not, is perverse and contrary to both the spirit and the letter of Article 299.2.

### 2.2. Other Infrastructures

#### Ports and airports

Given the high maintenance costs of sea and airports due to both the number of ports involved and adverse weather conditions, we urge that the Commission should invoke Article 299.2 to abandon the distinction between investment projects and maintenance costs. Both should be eligible for EU grants.

## Energy

Given the difficulties outlined in Part A, we recommend:

- The introduction of a unified energy price for the whole of Portugal, along the lines of the regime operated by the Spanish government in the Canary islands.
- 85 % co-financing by the EU to construct the geothermal plant in Terceira and the cable links to other islands.
- Reintroduction of the POSEIMA scheme to offset the extra costs involved in shipping petroleum products from the main land to Azores

## Education and Research

The Azores have an important educational deficit which can in some measure at any rate be attributed to their ultraperipheral location. New technologies could reduce some of the more important structural disadvantages that the local population has faced hitherto. If this is to happen, however, the islands will have to be able to mobilise much more skilled labour than they currently possess. A comprehensive programme aimed at upgrading educational attainment and skills could be used to justify enhanced funding from the European Social Fund in the spirit of Article 299.2.

In terms of higher education, the Azores should give priority to encouraging research in marine biology and environmental studies where it has manifest advantages. EU funding could once again be important.

### 2.3 Agriculture and Rural Development

The POSEIMA programme, which is still in place, concentrates on specific market measures and exemptions from CAP regulations. A new programme should focus on:

- Environmental sustainability.
- Rural development.
- The food industry.

A reorientation of policy in this way is in line with the new philosophy behind the EU's Common Agricultural Policy. It is also appropriate to islands where the present CAP has contributed to a heavy and potentially damaging concentration on cattle farming.

Specifically, we suggest that:

- The link between the level of payments from the CAP and the number of cattle should be replaced in favour of direct payments to farmers. Initial payments could be calculated on the basis of present allocations.
- The role of farmers in the local economy should be reassessed within the context of a more ambitious programme to protect the environment and to develop the countryside. This programme could and should foster agro-tourism.
- Measures should be taken to consolidate and exploit the fact that most of the Azores agricultural production is "organic". Stronger local controls, certification and labelling could give Azores products an important competitive edge.

## 2.4 Fisheries

The Azores are currently failing to take advantage of high world market prices for tuna and other fish in this part of the Atlantic. This is due to a lack of quality control. Responsibility for improving the situation must lie in the final analysis with the authorities in the Azores. The EU could, however, help to improve training in marine resource management and fish marketing through the European Social Fund.

The POSEIMA programme acknowledged that the Azores face higher costs in marketing fish products because of their ultraperipheral situation. The Council has nevertheless opposed making the assistance offered under this programme permanent. Against the background of Article 299.2, it is to be hoped that the Council will lift its opposition, since the problems that the Azores faces are structural and uncertainty inhibits investment.

## 2.5 The Environment

The Azorean authorities are rightly greatly concerned about potential damage to the environment caused by waste and agricultural pollution. As all the more significant difficulties involved are directly linked with the island's ultraperipheral position, appeal could be made to Article 299.2.

Specifically, we would suggest that EU help should be requested:

- To develop a waste management system.
- To establish a waste treatment and recycling plant complete with recycling capability.
- To contribute towards the costs of the shipment of the remaining waste and glass to the main land.

## 2.6 Industry, Services and Business Development

### Industry

We recommend that the Azores should concentrate in its dialogue with the EU institutions on two sectors which are actually or potentially promising.

- **The food industry.** The potential market for "organic" products is growing exponentially. There is also a strong "nostalgia market" amongst the Azorean Diaspora in the United States. As already indicated, everything possible should be done to consolidate and exploit this quality advantage. One concrete way in which the EU could help would be to co-finance the establishment of an E-commerce unit to target the "nostalgia market".

Assistance should also be requested from the EU under the Structural Funds for the development of processing facilities in the islands themselves. If the more advantageous co-financing arrangements urged in section 1 are sanctioned, it should be possible for the Azores to increase processing capacity significantly.

Finally, the Azores should also press for EU assistance in meeting the above average



marketing costs which Azorean producers face, along the lines of the compensation already available for the marketing of certain fish products. (Council Regulation (EC) N° 1585-98 of July 1998). Given the structural nature of the problems, this aid should in principle be permanent.

- **Traditional handicraft industries.** Azores traditional handicraft industries are in danger of extinction. The reintroduction of the programme for cottage industries embodied in Commission decision number EC (93) 3767 of December 1993, linked with an imaginative and comprehensive plan for the development of tourism, could be very beneficial.

## Services

The services sector in the Azores is currently dominated by the public sector. Given the dispersion of a small population over nine islands, a bigger than average public sector is inevitable. The Azorean authorities should nevertheless give higher priority to tourism and IT and telecommunications.

- **Tourism** Tourism in the Azores has considerable potential and is currently seriously underdeveloped. Comparisons with Madeira are striking. EU assistance could and should be sought in the development of initiatives which exploit and at the same time protect the Azores comparative advantage as a largely unspoiled and quite distinctive environment. Help with the start-up of projects modelled on the Cuada development in Flores is just one example of the way in which the regional authority might be able to tap into EU funds.
- **IT and telecommunications.** The islands will soon be connected to transatlantic fibre glass communication cables. These will at one stroke significantly diminish some of the disadvantages of isolation. The Azores could exploit the opportunities that they offer both in relation to the development of locally based information technology and efforts to market their products across Europe and the United States including, for example, the E-commerce unit referred to above. If the Azores are to respond effectively to these challenges, however, high priority will have to be given to education, including adult education, and networking.

Given the positive impact that a stronger IT sector could have in offsetting the islands' isolation, it would seem entirely appropriate for the Azorean authorities to invoke Article 299.2 in the context of both Structural Fund programmes designed to enhance training and skills and the Fifth Framework Programme.

## Business development

Given the current mood in the EU concerning concessionary regimes of the kind that Madeira has operated with great success, we do not believe that the Azores stands any real chance of obtaining special treatment of this kind. This particular train has in other words left the station and is not worth pursuing.

## 3. Madeira

### Introduction: Reinforcing success

As the analysis in Part A of this report should have demonstrated, Madeira has an overall development plan which is in process of being implemented. The key elements have been the development of infrastructures, the encouragement of tourism and the establishment of the Madeiran International Business Centre.

As the islands are undoubtedly ultraperipheral, the Regional Authority can and should appeal for EU help under Article 299.2 to offset the structural handicaps that this status implies. The principal element in Madeira's case for special assistance from the EU should nevertheless be the fact that this is a success story in the making which, if it is encouraged to mature, will mean that, sooner rather than later, the islands should settle into a pattern of self-sustainable growth. This in turn will mean that the EU can expect to see a gradual but real reduction in the levels of its support.

Both sides are therefore potentially in a win-win situation. The object of each in the forthcoming discussions about the implications of Article 299.2 should be to ensure that they both achieve the success which is in their grasp.

### 3.1 Transport

Our recommendations in this sector as in so many others are less far-reaching than in the case of the Azores because the needs are less. We do however propose:

- The reintroduction of EU assistance to offset the costs of importing fuel on the understanding that 50 % of these funds should be used to enhance local production including in particular eolic power.
- 85 % EU co-financing of private sector investment in the maritime ferry link between Madeira and Porto Santo. An all year round service would have important knock-on effects in terms of enabling Porto Santo to benefit from up-market winter and spring tourists in Madeira.

### 3.2 Other infrastructures

#### Energy

Madeira's options are limited. The reintroduction of the POSEIMA contribution towards the costs of importing fuels on terms indicated above would, however, enable the islands to enhance the efficiency of their hydraulic and eolic power generators.

As already indicated in the report on the Azores, we also believe that the Portuguese authorities should consider applying a unified price system for both the main land and the islands along the lines of the regime that the Spanish authorities have established for the Canaries. EU help might be sought at least initially to offset any loss in revenues.

## Education

Madeiran education has already made great strides thanks not least to support from the European Social Fund. We recommend that this support should continue and that greater emphasis should be laid on flexibility. The needs for skilled labour will grow **pari passu** with the successful development of the various programmes sponsored by the MIBC (see below). As in the Azores, there are also important opportunities for the islands in the development of modern technologies and more particularly Information Technology.

### 3.3 Agriculture

Madeira's agriculture production falls into two distinct categories: competitive and uncompetitive. Unfortunately for Madeira, the only products in the first category are wine and flowers. Recommendations regarding the rest of the agricultural sector require therefore a different justification.

As far as wine is concerned, EU assistance could be sought to cover some if not all of the additional costs to the producers involved in importing bottles and exporting the product itself. In the case of flowers, little more can be done that is not already being done.

In the non-competitive sector, the need for subsidies can be justified principally on the grounds of environment, rural development and tourism. An appeal to broader considerations such as these is in keeping with the new philosophy of the CAP.

This is particularly relevant in the case of Madeira's banana production. It is a crucially important part of the local economy, both as a source of income for those concerned and as a feature of the Madeira landscape which is significant both in ecological terms and as part of Madeira's tourist appeal. As furthermore production levels are not sufficiently large to threaten any producers on the world markets, it should be possible for the EU to argue both prior to and subsequently in the context of the new Millennium round for general acceptance of measures aimed at maintaining production.

### 3.4 Fisheries

The provisions contained in Council Regulation (EC) n°1585/98 of July 1998 regarding compensation for the additional costs of marketing fishery products should be made permanent.

### 3.5 Environment

Assistance towards the protection of Madeira's environment, which is its single most important asset and which is also under threat from pressures arising from population density and the successful development of tourism, is of the highest priority. We recommend:

- Adaptation of the CAP to enable farmers to maintain uneconomical, terraced plots and therefore, **inter alia**, prevent erosion. Measures to ensure the survival of Madeira's non-competitive banana producers, given their importance in preserving Madeira's distinctive landscape and therefore an important part of its tourist appeal, have already been

discussed above.

- Assistance regarding waste disposal along the lines already indicated in the corresponding section of the report on the Azores.

### 3.6 Industry, Services and Business development

By far the single most important issue under this heading is the future of the MIBC. Concerning other questions we would recommend:

- The reintroduction of assistance to cottage industries.
- Further development of agro-tourism as a counterpart to and enhancement of Madeira's highly successful up-market hotel tourism.
- The application of Structural Funds to upgrading tourist facilities and infrastructure in Porto Santo.

The most important issue at stake is, however, the future of the MIBC. Madeira is widely believed within the European Union to be operating an "offshore regime". As a result, the concessions that apply to those who invest in Madeira are under scrutiny by the Council's Task Force charged with reducing "unfair tax competition". The situation in Madeira is particularly acute, because no **new** concessions may be granted from December 2000 onwards unless the Commission gives specific approval to the contrary.

We believe that it is of paramount importance to Madeira, and furthermore in the interests of the EU itself, that Madeira should be allowed to maintain its regime in full until 2011 and possibly even beyond.

We justify our belief on the grounds set out at some length in Part A section 2.6:

- The Madeira regime is not "offshore" in the normal sense of the term. Concessions are subject to strict rules. The companies that operate in Madeira have to be resident in Portugal and subject to Portuguese official supervision, and residents are treated on the same basis as non-residents.
- The regime also meets the criteria set out in the ECOFIN Code of Conduct of December 1997. More particularly, the concessions do not harm the functioning of the Single Market nor, secondly, are they out of proportion to the aims sought, which in this case are business diversification in the context of a development policy for a backward region.
- There is every prospect that within the next ten to twenty years, as a result of these concessions, Madeira, like Guernsey, can achieve its growth, diversification and employment goals and begin to phase out its preferential regime. If it did so, the EU would be a beneficiary in the form of drastically reduced subsidies.

The issues raised by the MIBC typify the challenge that Madeira presents to EU and Portuguese policy-makers alike. It is a success story which should be allowed to run its course. As and when it does, Madeira should be in a position to sustain itself and therefore to drastically reduce dependence on EU subsidies.

## Appendix A. General data concerning the Azores and Madeira

*Table A.1 Basic Statistics*

	Area (km <sup>2</sup> )	Population 1996 (‘000s)	Population density, 1996 (nos./ km <sup>2</sup> )	GDP per head in PPS, 1997 (EU15=100)	Unemployment Rate (%), 1997	Employment by sector (% of total), 1996		
						Agriculture	Industry	Services
<b>Azores</b>	2333	242	104	50	5,4	16,0	21,2	62,9
<b>Madeira</b>	797	258	331	54	5,4	12,5	27,6	59,8
<b>Portugal</b>	92000	9927	108	70,5	6,7	13,3	31,0	55,7
<b>EU</b>	3191120	373607	117	100	10,8	5	29	66

Source: Eurostat

*Table A.2 GDP per head for the poorest 10 regions of the EU, 1996*

Region	GDP per head in PPS (EU15=100)	Rank
<b>Guadeloupe (F)</b>	40	1
<b>Ipeiros (EL)</b>	44	2
<b>Reunion (F)</b>	46	3
<b>Guyane (F)</b>	48	4
<b>Azores (P)</b>	<b>50</b>	<b>5</b>
<b>Voreio Aigaio (EL)</b>	52	6
<b>Martinique (F)</b>	54	7
<b>Madeira (P)</b>	<b>54</b>	<b>8</b>
<b>Extremadura (E)</b>	55	9
<b>Dessau (D)</b>	55	10

Source: Eurostat

Note that 6 of the seven ultraperipheral regions are in the list

**Table A.3 GDP per head in the Ultraperipheral Regions, 1996**

Region	GDP per head in PPS (EU15=100)
Azores (P)	<b>50</b>
Canary Islands (E)	74
Guadeloupe (F)	40
Guyane (F)	48
Madeira (P)	<b>54</b>
Martinique (F)	54
Reunion (F)	46

Source: Eurostat

**Table A.4 GDP per head (in PPS) Portugal, 1996 (EU15 = 100)**

Region	GDP per head (%)
Norte	62
Centro	61
Lisboa e Vale do Tejo	89
Alentejo	60
Algarve	71
Azores	50
Madeira	54
<b>Portugal</b>	<b>70</b>

Source: Eurostat

**Table A.5 Productivity in Portugal, 1996 (EU15 = 100)**

Region	GDP/employed (%)
Norte	59
Centro	57
Lisboa e Vale do Tejo	77
Alentejo	66
Algarve	64
Azores	57
Madeira	57
<b>Portugal</b>	<b>66</b>

Source: Eurostat

**Table A.6 Educational attainment of 25 - 59 year olds (% of total), 1997**

Region	Low	Medium	High
Norte	80	10	10
Centro	81	9	10
Lisboa e Vale do Tejo	68	17	16
Alentejo	82	9	8
Algarve	83	11	5
Azores	84	9	6
Madeira	85	10	5
<b>Portugal</b>	<b>76</b>	<b>12</b>	<b>12</b>
<b>EU15</b>	<b>41</b>	<b>40</b>	<b>20</b>

Source: Eurostat

## Appendix B. Effects of transport costs and port duties on consumer goods

A study published by the Bulletin for Common Consumer Goods from the Division on Competition and Prices of the Regional Secretariat for Economics and External Co-operation of Madeira shows the extent to which prices differ in the ultraperiphery compared to the main land. The price data were collected in January 1999 from hyper- and supermarkets as well as from small retailers. The study divides the products into four categories: food and drink, household cleaning products, cosmetics and personal hygiene, and baby products.

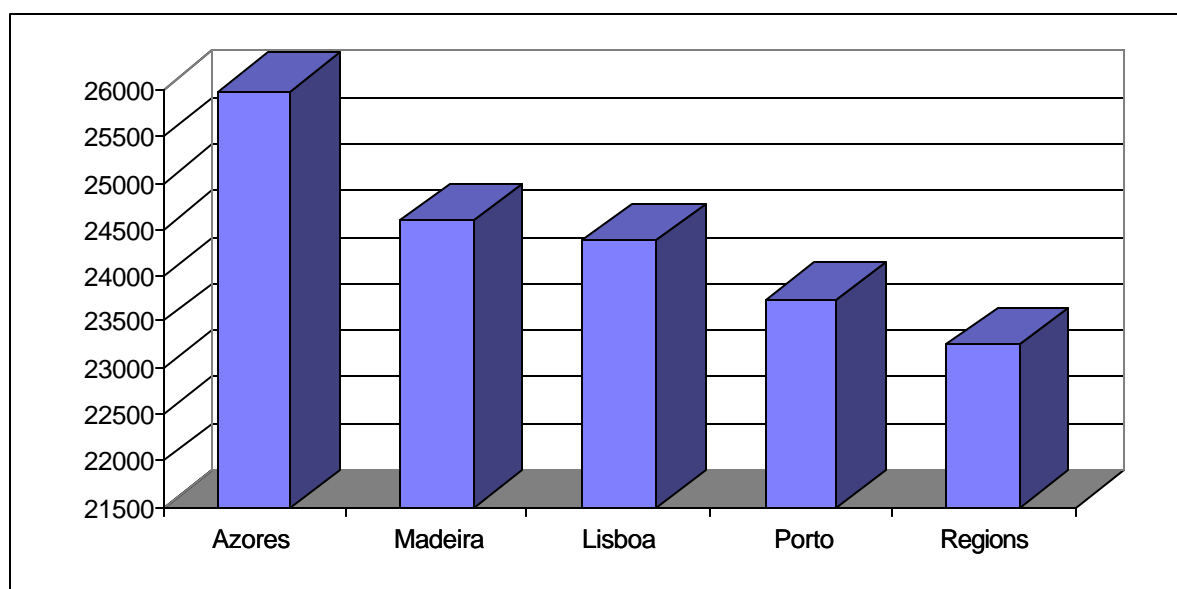
A cost of a representative bundle of goods was used to assess the price level differences between the Azores, Madeira, Lisbon, Porto and the remaining regions of Portugal. The results show that prices are higher in the ultraperiphery, with the Azores in the lead. The gap is particularly notable between the regions of Portugal and the two ultraperipheral archipelagos. Prices in the Azores are 12% higher than the average prices in the regions of Portugal; for Madeira the figure is 6%.

**Table B.1 Prices of Consumer Products in Escudos, January 1999**

Product group	No of products	Azores	Madeira	Lisbon	Porto	Regions*
Food and drink	34	12843.3	12185.48	11973.1	11579.8	11465
Household cleaning products	20	5438.41	5185.33	5140.3	4931.6	4956.1
Cosmetics and personal hygiene	11	5085.76	4780.43	4731	4904.5	4550.5
Baby products	6	2615.68	2431.73	2520.5	2319.5	2290.1
<b>Total</b>	<b>71</b>	<b>25983.15</b>	<b>24582.97</b>	<b>24364.9</b>	<b>23735.4</b>	<b>23261.7</b>

\* Data to represent the regions have been collected in Aveiro, Braga, Coimbra, Leira, Setúbal and Viseu

**Figure B.1 Prices of Consumer Products in Escudos**



## Appendix C. Tourist accommodation in Madeira and Azores

	Establishments	Beds Total	Visitors		No. of nights		Average stay nights	Revenues euro m
			Portuguese	Foreign	Portuguese	Foreign		
<b>Azores, 1997</b>	69	3660	118098	42534	n/a		2,4 2,9	14,14
<b>Madeira, 1996 (1)</b>	150	18151	545430		500459	3600782	7,5 (1)	150,73

- (1) The number of Portuguese visitors to Madeira is not available. However, if the number of nights spent in tourist accommodation is used as a *proxy*, the figure is only 14%.



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Centre for European Policy Studies  
1 Place du Congrès  
1000 Brussels, Belgium  
Tel: 32(0)2.229.39.11 Fax: 32(0)2.219.41.51  
E-mail: [info@ceps.be](mailto:info@ceps.be) Website: <http://www.ceps.be>