



**LEGAL, ECONOMIC AND
FISCAL IMPACT STUDY OF THE
FREE TRADE ZONES
EXECUTIVE SUMMARY**



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INTRODUCTION

In a global environment, the free-trade zones have positioned themselves as the most significant instrument to promote the productive transformation, the insertion in international markets, and to attract investment. As a matter of fact, multiple international experiences in more than 135 countries show that they are the ideal places to promote global value chains, international logistics, as well as added-value services.

The above is manifested in the exponential growth of the number of declared free trade zones, in recent years (since the creation of the WTO until today, 3000 free trade zones have been created in the world, 130 per year on average) and especially in the countries that have adopted them as a development policy.

In Colombia, the first Free Trade Zone was founded in Barranquilla in 1959, and through the Act 1004 of 2005, which repealed the previous Act 109 of 1985, the current free trade regime was created, which enabled the first private free trade zones.

Currently, Colombia has 109 free trade zones that are divided into 34 Permanent Free Trade Zones, which consist of multi-company industrial parks and 71 Special Permanent Free Trade Zones that are single-company and 4 that are in the category of offshore Free Trade Zones, used for exploration and exploitation of mineral-energy based fuels.

The Ministry of Commerce, Industry and Tourism is the entity in charge of authorizing and controlling this mechanism in Colombia. Furthermore, the regulatory framework under which the free trade zones are currently governed is Decree 2147 of 2016, which contains all the provisions regarding their creation, requirements and operation, and the Customs Code (Decree 1165 of 2019), which regulates all customs procedures for entering and exiting the free trade zones.

The Free Trade Zone Regime and its impact on the economic development of the country have been a matter of discussion in recent years, by the academia, some business groups, opinion leaders, even in the National Government and the Congress of the Republic. It may be said that the main discussion points have revolved around the following aspects:

1. Tax inequality between the companies that are beneficiaries of the incentives granted by the Free Trade Regime, concerning other companies and other taxpayers.
2. High fiscal cost for the State, as a result of the tax exemptions granted to companies that are established in the free zone, as opposed to the need to increase public revenues to guarantee public sector investments.
3. A presumed fiscal effort for a regime that benefits a small number of companies, especially at a time when the country needs to substantially reduce the fiscal deficit and maximize the efficiency of public spending.

4. Doubts in the specialized public opinion, regarding the effectiveness of the instrument in terms of its tax cost to contribute in attracting investments and generating formal employment.
5. Concerns regarding the compatibility of the Free Trade Zone Regime and the competition regulations.

To contribute to the national debate, through the presentation of solid and sustained arguments that demonstrate the impact of the Free Trade Regime on the consolidation of employment generation policies, attraction of investments and industrial restructuring, the Chamber of Users of Free Trade Zones developed this study, which evaluates the current status of the Colombian free trade zone regime, from the economic, legal and fiscal perspectives.

The study is divided into three chapters that consider the following subjects: i) the fulfillment of the purposes established in Act 1004 of 2005 by measuring its economic impact; ii) its fiscal impact in terms of the tax benefits granted to the free trade zones within the Colombian tax system; and iii) i) the legality of the regime in the face of current regulations on unfair competition and legal inequity.

I. MEASUREMENT STUDY OF THE ECONOMIC IMPACT AND FULFILMENT OF THE PURPOSES OF THE FREE TRADE ZONES

According to Act 1004 of 2005, the purposes of the Free Trade Zone Regime are:

1. To be an instrument for the creation of employment and to attract new capital investments.
2. To be a development pole that promotes competitiveness in the regions where it is established.
3. Develop highly productive and competitive industrial processes, under the concepts of security, transparency, technology, clean production, and good business practices.
4. Promote the generation of economies of scale.
5. Simplify the procedures of trade in goods and services, to expedite their sale.

In this context, an assessment was made of the indices of employment creation and attraction of new investments by the Colombian Free Trade Zones. Similarly, the performance of the free trade zones as a regional development pole, and the generation of highly productive and competitive industrial processes was analyzed.

Another aspect considered was the adoption of internal policies related to security, transparency, technological restructuring, clean production and good business practices, and the participation of industrial users in the different free trade zones of the country in regional value chains.

Methodology: description of the methodology and sources of information used

For this analysis, the primary source used was the information provided by the Ministry of Commerce, Industry and Tourism, based on the Quarterly Reports, an instrument enshrined in Decree 2147 of 2017 that allows verification for each of the users in the free trade zone, of compliance with investment and employment commitments that led to their qualification as a Free Trade Zone User.

To complement the available information and meet the objectives, a survey was designed and validated by the ANDI and was sent to each of the 984 companies established in the free trade zone, through the ANDI's SUMA platform. From this universe, the complete and comparable information was received from 219 companies, that is to say, information was available for a sample that represents 22% of the universe of companies that are part of the Free Trade Regime in Colombia.

This information was cross-checked against indicators collected through surveys sent to the tabulated databases by the ANDI's Free Trade Zones Chamber, according to official quarterly reports sent by users to the Ministry of Industry, Trade and Tourism, for the 4 quarters of 2018.

Similarly, in order to evaluate the performance of the Colombian free trade zones as a regional development pole, work was carried out with the information published by the National Planning Department in the territorial characterization sheets on economic and tax revenue issues¹.

For the analysis of foreign trade, the information published by the National Administrative Department of Statistics (DANE) was used, specifically the results of foreign trade (imports and exports) and the circulation of goods (coming in and going out), registered by the free trade zones with the rest of the world, the National Customs Territory (by its acronym in Spanish, TAN), other free trade zones and users within the same free trade zone; where a total of 106 free zones are included, between permanent and special. By statistical reserve the information is presented accumulated per free trade zone.

Finally, to measure the participation of the different free zones in the country in regional value chains, the departmental and municipal development plans were used as a basis, as well as the reports of the regional competitiveness commissions and the activities (CIIU Rev 4 A.C) carried out by users in the free zones.

¹ <https://www.dnp.gov.co/programas/.../Fichas-de-Characterizacion-Regional.aspx>

Characterization of the Free Trade Zones

As of December 2018, **940 Colombian companies are qualified as industrial users of free trade zone goods and services. 865 correspond to users established in the 34 Permanent Free Trade Zones, while 71 companies have the qualification of Special Permanent Free Trade Zone and 4 are in the offshore Free Trade Zone category.**

With regards to the Permanent Free Trade Zone users, 34% of the companies, that is to say, 296 are in the small business category, and 30% (256) are micro businesses. In fact, 81% of the companies (700) are part of the MSME group (micro, small and medium enterprises). On the other hand, only 9%, i.e. 77 users, are considered to be large companies. **This means that the Free Trade Zone Regime has mostly benefited the country's small and medium companies.**

At the regional level, the Caribbean, the Central East and the Pacific are the areas of the country with the highest number of free trade zones²:

Furthermore, according to the classification of the ISIC code, **364 companies are engaged in the manufacturing industry (39%), 253 in logistics (27%) and 101 in commerce (11%), and automotive repair.** There are eight types of economic activities in the category labelled as Others.

The manufacturing activities in the free trade zones are diverse. Of the 364 companies, the three activities with the largest number of users are: food processing (46), chemical industry and plastics and rubber, each with 41 companies.

Contribution of the free trade zones to Colombia's economic growth

Colombia's added-value amounted to 835.6 billion pesos in 2017. Of this total, **57% was contributed by the 58 municipalities that feature at least one free trade zone.**

There are four regions whose value-added contributions from free zone municipalities are equal to or greater than the national level: Central Eastern Region (including Bogotá), Pacific Region, Coffee Growing Axis Region, and Caribbean Region.

The South-Central Region case is highlighted, where only the municipality of Palermo (Huila) has a free trade zone and contributes to 43% of the Department's added-value.

² For the purposes of this study, the country was divided into six regions, considering the nine agreements suggested in the Development Plan "Pacto por Colombia, pacto por la equidad 2018 -2022.

³ DANE, base constant prices 2015.

Contribution of the free trade zones to the country's added-value

From the detailed analysis to the regional level, the following is highlighted:

- 58 municipalities with free trade zones contribute to 57% of the national added-value.
- The participation of Central East (including Bogota) and the Pacific stands out, exceeding the national average.
- The Coffee Growing Axis and the Caribbean Region are in a similar range to Colombia's average added-value, contributed by the municipalities with Free Trade Zones.
- In Huila, the municipality of Palermo, with only one free trade zone, contributes 43% of the department's added value.

Contributions of the free trade zones in the trade balance

Colombia's trade balance has been in deficit since 2013, a behavior that has continued in recent years. The opposite is true for the trade balance of all the free trade zones as a whole, given that **in 2017 and 2018 they show a trade surplus. Moreover, between the last two years, exports from the free trade zones have increased by 25%, while imports have decreased by 17%, increasing the surplus by 888 million dollars.**

Assessment of compliance with direct employment commitments

The study found that **at the end of 2018, the free trade zones in Colombia generated 53,450 jobs, of which 32,844 were direct jobs and 20,606 indirect jobs.**

The above also demonstrates that all users located in the free trade zone have exceeded their initial commitments to generate direct employments. In fact, when analyzing the number of active employees in the Permanent Free Trade Zones, it can be seen that **direct employment as of December 2018 was multiplied by six** compared to the commitments made for their qualification (in total the employment commitment is 5,139).

This indicator demonstrates that the mechanism has met the objective of promoting the generation of formal employment.

It should also be noted that the Special Permanent Free Trade Zones participate with more than 60% of the employment generated in the regime and that on average they generate about 267 jobs. In addition, between 70% and 80% of the Free Trade Zones employees are at the technical level, between 17% and 23% are at the administrative level, and between 1% and 6% correspond to the management level.

Similarly, in terms of wages, it is worth noting that the average salary at the technical level, without a transport allowance, as of December 2018 in the companies established in the free trade zone, was double the current minimum wage for the same year.

The surveys made to the free trade zone users also allowed to address issues related to the type and quality of employment offered in the Free Trade Zones. In this sense, in terms of gender equality, **it should be noted that the Special Permanent Free Trade Zones**

employ a higher proportion of women (40%) compared to the Permanent Free Trade Zones (35%).

Assessment of compliance with investment commitments

Free Trade Zones in Colombia are an important source of investment in the country. The study showed that 78% of the investment in the free trade zone is of national origin, compared to the remaining 22% of foreign origin.

It should also be noted that investment in the Permanent Free Trade Zones as of December 2018, amounted to 8.5 billion pesos and were 12 times higher than the commitments made for their qualification.

On the other hand, the Special Permanent Free Trade Zones register as of December 2018, a total investment of 42.3 billion pesos, figures that were multiplied by 3 compared to the commitments initially acquired at the time of their qualification. **In total, the Free Trade Zone Regime generated investments of 50.8 billion pesos as of December 2018.**

As for the average investment generated by each of the users (according to the quarterly reports), it can be seen that the Special Permanent Free Trade Zones average is 604.7 billion pesos, while the average for the Permanent Free Trade Zones is 8.7 billion, that is to say, 69 times greater, **with the Special Free Trade Zones being the largest source of investment compared to the Permanent ones.**

The above shows that the companies established in the free trade zone have fully complied with the investment commitments acquired at the time of their qualification and, in fact, have significantly exceeded the initial investments. Consequently, the purpose established in Act 1004 of 2005 of being an instrument for attracting new capital investments has been fulfilled.

Science, Technology and Innovation (CTel)

In terms of Science and Technology, the survey conducted determined that of the 219 companies that provided information, **15% of the free trade zone users (including Permanent Free Trade Zones, Special Permanent Free Trade Zones and Operating Users) allocate resources to Science, Technology and Innovation in the amount of 11.2 billion pesos.**

The surveyed users of the Permanent Free Trade Zones reported investments in this area for **8 billion pesos in 2018 (71%)**; followed by the Special Permanent Free Trade Zones **with 2.6 billion pesos (23%)**. Operating users represent 6% with 638 million pesos.

Considering that these resources may have multiple purposes, the survey inquired about the objectives of the investment according to the criteria analyzed by the DANE⁴ in its survey corresponding to the business sector.

In this sense, it is defined that the main objective of these investments is **the improvement in the quality of services or goods (21%), followed by the expansion in the portfolio of products and services (15%), increase in productivity (13%), maintaining market share (13%) and improvement in regulatory compliance (11%).**

Business excellence: Quality Certificates

The companies that are part of the regime also seek to certify their processes. **42% of the users surveyed stated that they already have certifications and 8% are in the process of acquiring at least one.**

The certifications are varied, but those of good manufacturing practices and management are highlighted.

More than 50% of the free trade zone users have certified or are in the process of certifying their processes, especially in good manufacturing practices (GMP).

Corporate Social Responsibility (CSR)

The survey conducted to users of free trade zones revealed that **22% of companies in the regime allocate resources to Corporate Social Responsibility programs.** In fact, according to the information provided by the 219 users, it was determined that they invested **122 billion pesos in 2018 in this area.**

96% of the investment in CSR in the free trade zone was carried out by the special free trade zones with 117.5 billion pesos. For the permanent free trade zones, this was 4.5 billion pesos, representing the 3.7%. Operating users have also invested in CSR with a total amount of 229 million pesos.

The action fields are varied. One of the common points between them is to promote the development of their employees and their families; personal and professional development through educational programs, health care and safety at work.

⁴ DANE. «DANE» Survey of Technological Development and Innovation in the Manufacturing Industry 2017 - 2018. November 27th, 2019.
https://www.dane.gov.co/files/investigaciones/boletines/edit/boletin_EDIT_manufacturera_2017_2018.p

Another action point is the environment. Companies are concerned about the impact of their operations and have implemented programs that seek to take advantage of natural resources and reduce waste generation.

Finally, there is a general concern for the well-being of vulnerable communities in their area of influence. In this sense, they have numerous programs in favor of children (education, recreational and artistic activities, sports), the elderly, intervention in community infrastructure and support for small businesses.

The survey shows a trend of resources allocated to CSR programs of 558 million pesos per user

Free Trade Zone Sectors and their alignment with the Regional Productive Commitments

At a regional level, the study divided the country into 6 regions, to identify the effects of the free trade zones in each one of them: Pacific, Caribbean, Central East, Coffee Growing Axis, Orinoco, and South Central.

It was found that there is a correlation between the increase of users and the increase of added-value in the departments of the region with Free Trade Zones. While it is not asserted that the increase in the added-value of the departments is caused solely by the increase in users, it is demonstrated that the flows of investment, employment created and industrial processes, have generated value for the municipalities where the free trade zones operate.

There was also a correlation between the increase in Free Trade Zone users and the increase in municipal tax revenues. Although the parallelism in these variables is not direct, the fact that the arrival of new companies in the Free Trade Zone has not meant a decrease in the tax revenues in the regions is still relevant.

Similarly, in all the regions that were analyzed, it was found that there is a **strong correlation between departmental commitments and the vocation of the companies in the free trade zone.**

For example, in the Pacific Region, the companies established in the region's free trade zones belong to the food processing, clothing and pharmaceutical sectors.

As for the Central-Eastern Region case, there are seven coincidences between Productive Commitments and the activities carried out in the Free Trade Zone in Bogotá D.C. Food, footwear, leather goods, plastics, chemicals, textiles and clothing, and vehicles.

With regards to Cundinamarca, there is a complete alignment between the productive commitments and the Free Trade Zone industries.

The departments of Santander and Norte de Santander prioritize five commitments. In Santander there are three coincidences: Food, base metals and their manufactures and textiles and clothing, while in Norte Santander it coincides with food.

On the other hand, Atlántico has four productive commitments, which coincide with the economic activities of the Free Trade Zones in the territory: Food, chemicals, metal products and pharmaceuticals.

Concerning Bolívar, of the five commitments, four are carried out in the free trade zones: Food, chemicals, plastics and metal products.

The departments of Cesar and Magdalena with food that was developed by the Free Trade Zones in those jurisdictions. Contrary to what happens in Córdoba and La Guajira, which also have prioritized commitments, but are not developed in the Free Trade Zones.

In Antioquia, there are seven coincidences with the activities carried out in the free trade zone. Food, textiles and clothing, electrical machinery, plastics, chemicals and vehicles.

In the three commitments of Risaralda, there is complete alignment with the activities carried out at the Free Trade Zone: food, textiles and electrical machinery.

In Caldas, of the two productive commitments, one is made by the unique Free Trade Zone in the department.

Finally, in the South-Central region there is a complete alignment between Huila's productive commitments (food) and at least one of the activities carried out in the Permanent Free Trade Zone.

Compliance of free trade zones with international standards

The Colombian free trade zones are also in compliance with international regulations and standards, specifically those established by the WTO, the WCO, and the OECD.

Concerning the WTO, Colombia's first free trade zone legislation - Act 109 of 1985 - contained subsidies prohibited by the Agreement on Subsidies and Countervailing Measures. Since it held the benefits of the free trade zone to export results and also did not allow users to sell their products to the domestic market. Colombia corrected all the irregularities of the free trade zone regime with the issuance of the current legislation, Act 1004 of 2005. Therefore, currently Colombia, as far as its free trade zone regime is concerned, complies with the WTO.

For the WCO, the Kyoto Convention contains the Annex D2 with its policy recommendations and regulations for the operation of free trade zones. In Colombia, free trade zones are one of the safest places for international trade because, unlike the rest of the country, they have a strict control and surveillance regime and multiple mechanisms to prevent illegal foreign trade practices.

The authority entitled to carry out the control and surveillance of the free trade zones in the customs, tax and exchange fields is the DIAN. This power is exercised without prejudice to the functions and obligations that correspond to the operating users, according to Article 498 of Decree 1165 of 2019. From the above, it is evident that free trade zones in Colombia have double surveillance and control by two different entities, the DIAN, and the operating users.

In this way, the Colombian free trade zones comply with all the regulatory recommendations of the WCO and also with the recently issued "Code of Conduct for Clean Free Trade Zones" of the OECD.

II. TAX IMPACT OF FREE ZONES

In the world, the free trade zones have been used as an instrument to promote the productive transformation, the insertion in global markets, and to attract investment. Many international experiences show that its use can be highly effective and profitable for the productive and export-oriented development of a country. Nevertheless, some question the instrument because of its alleged negative impact on tax collection in the countries.

Free Trade Zones are typically established to attract foreign direct investment (FDI), serve as pressure valves to alleviate large-scale unemployment, promote exports, and support broader economic reforms aimed at diversifying production⁵. Free Trade Zones have a widespread presence in developing countries, with a history of uneven performance due to the various regulatory distortions they introduce into the market.

In this context, Klemm and Parys ⁶ analyzed whether tax incentives were effective in attracting domestic and foreign investment to countries and regions, and found that lower corporate tax rates and longer tax exemptions are effective in attracting FDI in Latin America and the Caribbean.

Moreover, recent studies in the Dominican Republic and Costa Rica have found that in addition to being a powerful instrument for attracting investment, its multiplying impact in the rest of the sectors in the economy is very positive, so its effect on the economy including employment, income and exports ends up being positive. Estimates show that in these countries, for every peso that is sacrificed in tax collection, more than five are generated. This is easily explained by the taxes paid by the employees and suppliers of these firms, in addition to the additional economic activity generated by the increased consumption and investment derived from the income generation of the Free Trade Regime.⁷ However, none of these studies estimate the net effect on tax collection.

⁵ Farole, T, and G Akinci. «Special Economic Zones: Progress, Emerging Challenges, and Future Directions. » Directions in Development Series. Washington D.C., 2011

⁶ Kleem, A, and S.V. Parys. «Empirical Evidence on the Effects of Tax Incentives» International Tax and Public Finance. Vol 19, Issue 3, 2012: 393-423.

Traditionally, the tax impact of free trade zones has been limited to calculating the difference in tax collection for companies located in free trade zones with the preferential tax rate versus the payment they would face if they were located within the National Customs Territory.

$$IMPACTO\ TRIBUTARIO = \sum_{n=0}^n (Impuestos_{TAN}) - \sum_{n=0}^n (Impuestos_{ZF})$$

- * Tax impact
- * Taxes

Where:

n: Group of companies located within the free trade zone territory

Taxes_{TAN}: Tax collection by applying the tax rate of companies located in the National Customs Territory

Taxes_{ZF}: Tax collection by applying the preferential tax rate of the free trade zones

However, this perspective is limited because it assumes that all companies within the Free Trade Zones would be willing to invest and operate in the National Customs Territory under standard taxation. Furthermore, it is a simplistic view that does not capture the positive externalities associated with Free Trade Zones, and finally, it translates into a biased calculation by definition, since whenever Free Trade Zone taxation is lower than that of the National Customs Territory, the theoretical tax impact will be negative.

Therefore, the traditional approach ignores the rationality that accompanies investment decisions, a key variable that has been incorporated into the methodology used in this study.

Methodology: description of the methodology and sources of information that have been used

The first step in calculating the tax impact of the Free Trade Zones in Colombia properly involves understanding what motivates companies' investment decisions:

⁷ For the Dominican Republic see ADOZONA " Free Trade Zones: Success of a public- private alliance" Analytical November 2015 and for Costa Rica see Procomer "Balance of the Free Trade Zones: Net benefit of the regime for Costa Rica 2011-2015" 2016.

a company is willing to invest and establish itself if the benefits it expects to obtain from its exercise exceed the expenses, that is, if the activity is profitable.

By definition, companies located in Free Trade Zones face a tax burden with a preferential rate, while those located in the National Customs Territory (TAN) are subject to the usual tax rate. This tax difference generates two parallel phenomena: on the one hand, the preferential tax rate of the Free Trade Zone encourages companies, that otherwise would not have found the profitable exercise, to establish themselves, generating employment, favoring international trade, attracting direct foreign investment, etc. On the other hand, some companies whose activity would be profitable even in a regular tax scenario, choose to set up under the Free Trade Zone regime to obtain additional benefits through the preferential rate.

Given this scenario, the question that this document seeks to answer is whether the benefits generated for the government by the companies that exist exclusively under the Free Trade Zone regime, exceed the reduction in tax collection of those companies that, being subject to the Free Trade Zone regime, would have operated equally in the National Customs Territory (TAN).

By crossing the individual ILS of the 14,176 companies with financial information available at the Superintendence of Companies and the list of the 963 companies operating under the Free Trade Zone regime, we find a total of 167 Free Trade Zone companies with financial information reported for the period 2014-2017. Such companies cover a total of 38 four-digit ISIC sectors, have an average equity of 36.383 million pesos, pay an average of 1.322 million pesos in taxes, and have an average net income of 3.542 million pesos.

The current fiscal year is therefore made up of a representative sample of financial information from 14,176 companies, of which 167 belong to Free Trade Zones and 14,009 to the National Customs Territory. To extrapolate the results obtained from the 167 companies in the Free Trade Zones to the total size of the sector, 963 companies, the data from the DANE on the Movement of Goods in Free Trade Zones is used. Additionally, the necessary information about the representative market exchange rate and the discount rate was used from the data provided by Banco de la República (central bank).

To estimate the fiscal impact of the Free Trade Zones, the users of Free Trade Zones registered in the database of the Superintendence of Corporations were separated. In total, 167 registered companies were identified. The period used for the analysis corresponds to the years 2014-2017.

The first step is to identify those companies operating under the Free Trade Zone regime for which the difference between the preferential Free Trade Zone rate and the National Customs Territory tax rate is the decisive element that allows them to operate.

For this purpose, the payment of taxes of a company located in a free trade zone is compared to a similar company, of the same economic sector, installed in the national customs territory. **The objective is to determine which of the 167 companies would have been constituted if they had not had the benefits of the Free Trade Zone regime.**

To carry out this exercise, all the companies registered in the Superintendence of Companies' database are grouped by economic sector, according to the four-digit ISIC classification.

The average tax payment - as a percentage of equity - is then calculated for the companies located in the National Customs Territory for each of these sectors, as well as for the 167 Free Trade Zone users. With this information, the average sectorial taxation of the companies of the National Customs Territory is applied to each user of the free trade zone according to the economic activity to which it belongs. Thus, it seeks to estimate the hypothetical taxation of the free trade zone user with the fees of their sectorial peers located in the national customs territory.

With this hypothetical tax payment, the ROE_{TAN} of each of the 167 Free Zone companies is calculated, in order to estimate the profitability of such companies under a non-preferential tax scenario.

$$ROE_{TAN} = (Utilidad Bruta - Impuestos_{TAN}) / Patrimonio$$

* $ROE_{TAN} = (\text{Gross Profit} - \text{Taxes}_{TAN}) / \text{Equity}$

The assumption applied is that these companies, instead of having received the benefits of the Free Trade Zone, would have paid, since their incorporation, the average taxes of the other companies of their economic sector in the TAN (TAN taxes).

The next step is to determine whether such companies would have been incorporated without the tax benefits. To this end, the ROE_{TAN} of each of the 167 Free Trade Zone companies is compared with the alternative profitability of their investment, i.e., the WACC (Box 3).

In those companies where the ROE_{TAN} is higher than the WACC, it can be concluded that they would have made their investments even without the benefit of the Free Trade Zones. On the other hand, it can be concluded that those companies whose ROE_{TAN} is lower than the WACC exist only and exclusively thanks to the preferential tax treatment of the Free Trade Zones.

To estimate the net tax impact of the Free Trade Zone regime, the following formula is applied:

$$IMPACTO TRIBUTARIO = \sum_{k=0}^k (Impuestos_{ZF}) - \sum_{l=0}^l (Impuestos_{TAN} - Impuestos_{ZF})$$

* TAX IMPACT

* Taxes

Where:

K: Group of companies that, when applying the ROE_{TAN} analysis exercise using the taxation of companies in the same sector in the National Customs Territory, would not have made the investment in the National Customs Territory (ROETAN < WACC)

L: Group of companies that, when applying the ROE_{TAN} analysis exercise using the taxation of companies of the same sector in the TAN, would have also made the investment in the National Customs Territory (ROETAN > WACC)

$\sum_{k=0}^k$ (Taxes ZF): Taxes collected from companies that only exist thanks to the preferential taxation of the Free Trade Zone regime. In aggregate (sum) it represents the additional amount received by the Government associated with the Free Trade Zone regime

$\sum_{l=0}^l$ (Taxes_{TAN} - Taxes_{ZF}): Difference between the taxes that the Government could collect without the Free Trade Zone regime and those that it actually receives from those companies that, even without preferential taxation, would have been incorporated. In aggregate (sum) it represents the amount that the Government associated to the Free Zone regime or the investment of the Government in the regime stops receiving.

Finally, to calculate the tax effect on all free trade zone users - not only for the 167 companies included in the SuperSociedades database - the total value of outflows reported by the DANE for each year was used. With this figure, the weight of all 167 companies is calculated, and the results are prorated.

Thus, based on the financial information available and by simulating the profitability of the Free Trade Zone companies under the National Customs Territory, we can identify those companies that would have been established even in a scenario where there were Free Trade Zones did not exist and those that would not have existed in a scenario without Free Trade Zones, being able to estimate the government's profits and losses resulting from the regime, and calculating the added tax effect.

Results: description of the exercise results

First, the results of the study indicate that the government's investment in the regime, defined as "the amount that the government associated with the preferential taxation of Free Trade Zones ceases to receive from those companies that have also invested in the National Customs Territory " is generally negative. This means that, at least for these companies, the effective taxation of Free Trade Zones is higher than the respective sector average of the companies in the National Customs Territory. In other words, in net terms the government

collects more from companies in the **free trade zones than from those in the TAN which are typically less profitable.**

Once calculated both the investment of the Government and the additional income received from the tax collection of those companies that operate solely and exclusively due to the existence of the Free Trade Zone regime, the results show a positive tax impact for the Government for all levels of WACC considered (12% acid scenario, 14% medium and 16% broad) and for all the years covered by the study (2014 – 2017).

This tax impact averages \$564 billion pesos per year in a 12% WACC scenario and \$709 billion pesos per year on average in a 16% WACC scenario. Although the impact was particularly high in 2014, it shows an increasing trend from 2015 onwards.

At an added level for the entire period of analysis (2014-2017) this tax impact translates into a return for the Government of between 2.3 trillion pesos or 0.25% of the GDP, (associated with a WACC of 12%) and 2.8 trillion pesos or 0.31% of the GDP (associated with a WACC of 16%).

In fact, the Free Trade Zone regime proves to be a fiscally lucrative investment for substantially lower levels of WACC than those observed in practice. This is evidenced by the fact that in recent years the WACC levels from which the net tax impact associated with the regime is positive are substantially low, e.g. 6.5% by 2017.

Additionally, **the tax impact of the Free Trade Zones is particularly important because it has a counter-cyclical effect in a scenario of contraction of the GDP.** Taking into account that the growth prospects of the Colombian economy are not very encouraging in the medium term, with a **current potential growth of only 3.5% it is more important than ever to maintain and preserve incentive instruments for investment, such as the Free Trade Zones, in the context.**

Finally, considering that the most recent quarterly year-on-year growth (third quarter of 2019) is 3.3%, a figure very similar to the country's potential growth, there is concern that, in order to achieve higher growth rates than the current ones, it will be necessary to implement ambitious structural reforms to stimulate the macroeconomic environment.

The need to promote stability in public finances by establishing a tax regime that minimizes distortions and maximizes efficiency is highlighted. It is also vitally important to increase the available stock of production factors and the efficiency of their use, as well as to strengthen the policy of attracting and retaining a foreign direct investment. The free trade zone tool is powerful and useful for the achievement of these objectives.

III. ANALYSIS OF THE FREE TRADE ZONE REGIME FROM THE COMPETITION LAW POINT OF VIEW

The free trade zone regime does not imply in any way an infringement of the General Competition Regime or a transgression of the Unfair Competition Regime. The Free Trade Zones are a figure created and protected by the legislator, which is the reason why their effects could not be catalogued as illegal in the terms of article 7 of Law 256 of 1996.

In other words, it would be wrong to argue a violation of the law (Act 256 of 1996) as a result of the issuance or use of a regime created by the legislator (Law 1004 of 2005, through which the Free Zone regime was created). Thus, it can be concluded that to benefit from a special legal regime under any perspective could constitute a transgression to the legal asset of good commercial faith.

Thus, neither the creation of special regimes in tax matters by the legislator, nor its use by the administered, constitute acts susceptible of being framed in any of the legal prohibitions established in the regime of unfair competition.

As a result, the question is whether this regime can alter the terms of competition and whether there is a justification for it: or in other words, (i) if its rules affect the neutrality and equality principles among competitors and (ii) if that alteration finds any justification in the light of the Colombian legal system.

Power of State intervention in the economy

The starting point for such an analysis is that the legislator and the government, in the exercise of the State's power to intervene in the economy, are able to create incentives to encourage the development of desirable activities as long as the differentiated treatment does not result in discriminatory treatment.

In exercising its power to intervene in the economy, the State may set up regimes that grant special treatment to the agents that use them, in order to encourage or discourage an activity in the market.

The Free Trade Regime establishes tax incentives that aim to achieve objectives in accordance with the general interest, as set out by the legislator in Article 2 of Law 1004 of 2005. To that extent, the differentiated treatment derived from its tax regulations is a reflection of the functional tax principle.

The purpose of establishing less burdensome tax charges to Free Trade Zone users, with respect to agents operating in the National Customs Territory (hereinafter, TAN), is to encourage more economic agents to access it. To that extent, these taxes pursue extrafiscal purposes that justify their existence, even if they imply an alteration in the agents' competition terms.

Now, if (i) the Free Trade Regime is a manifestation of state intervention and (ii) through that power the State can limit or alter competition, then the Free Trade Zone regime may well, legitimately, alter the conditions of competition by establishing a special differentiated treatment for subjects who access the regime; for example, tax obligations of lesser amount than those for agents operating in the National Customs Territory.

Purposes and justification of the free trade zone regime in Colombia

In the specific case, the differential treatment of the free trade zones is fully justified, since the regime pursues purposes that are consistent with the general interest. For that reason, this state intervention, which generates alterations to the conditions of competition, is legally admissible.

In fact, the Superintendency of Industry and Commerce (SIC), has already qualified as justifiable the free trade zone mechanism. In the Official Letter 16-376416, through which the SIC rendered concept of competition advocacy regarding the draft decree "*by which the free trade zone regime is modified and other provisions are dictated*"⁸, that Entity recognized those purposes as legitimate when expressing that they justify this type of differentiated treatment, despite the advantages that they can grant to the companies that are within the free trade zone as opposed to those that operate in the National Customs Territory. On that occasion, the competition authority understood that the economic and social benefits of the regime outweigh its costs, which include potential risks to fair economic competition.

If attracting foreign investment generates positive economic results, and one of the mechanisms to obtain that investment can be the granting of benefits such as those that exist in the free trade zone regime, then the latter can contribute to achieving goals in accordance with the general interest.

Therefore, when studying the purposes and justification of the Free Trade Zone regime in Colombia, one can conclude (i) that this regime is the result of the legitimate power of the State to intervene in the economy, and (iii) that the differentiated treatment generated among its users and agents of the National Customs Territory is fully justified, since the regime pursues purposes that are consistent with the general interest.

⁸ Decree 2147 of 2016

CONCLUSIONS

- The free trade zones are an instrument of high regional development policy. The Congress must ensure its international competitiveness to make it an attractive regime for foreign investment, above its international competitors, to take advantage of the existing situation of foreign trade.
- There is a correlation between the increase of users and the increase of added value in the departments of the region with free trade zones. While it is not asserted that the increase in the added value of the departments is caused solely by the increase in users, it is demonstrated that the flows of investment, employment created and industrial processes, have generated value for the municipalities where the free trade zones operate.
- There is also a correlation between the increase in the number of free trade zone users and the increase in the municipalities' tax revenues. Although the parallelism in these variables is not direct, the fact that the increase in the number of companies in the Free Trade Zone has not meant a decrease in tax revenues is still relevant. It is worth mentioning the case of the industry and commerce tax, which has grown uninterruptedly since 2002.
- Contrary to the claims of some analysts and opinion makers, the free trade zone regime is not for the exclusive use of large companies. The national aggregate shows that the MSMEs group is the most numerous (81%, 700 companies). Only 9% (77) are large companies.
- The companies located in the Free Trade Zone, are generally aligned with the Regional Productive Commitments and the exports from the Free Trade Zone, continue to drive the country's export dynamics.
- The Colombian free trade zone regime complies with the recommendations and regulations of the WCO, the WTO and the OECD on security matters. Colombian free trade zones not only have security regulations that comply with the best international practices, but even exceed them, since they have two control and surveillance entities, the DIAN and the user operator who is responsible with his assets for any customs infraction of a user under his surveillance.
- Traditional measurements have contributed to skewing the perception of the regime's impact on public finances. It is necessary to incorporate the rationality of investment decisions in order to make an adequate measurement of the fiscal impact.
- In an acid scenario (WACC 12%), 62% of the companies located in the free Trade Zone would not have invested in the TAN at all if the regime did not exist.

- The companies that are currently located in the free trade zone, due to their higher profitability, pay more taxes to the State than the companies in the TAN.
- The model estimates a net positive fiscal impact of the Free Trade Zones during the 2014-2017 period with an added value of 2.3 billion pesos (0.25% of GDP). Other scenarios (WACC 14% and 16%) reveal an even greater net positive fiscal impact (0.27% and 0.31% of GDP). In fact, the regime is profitable for the government as long as the WACC is higher than 6.5%.
- The Regime has a counter-cyclical effect that becomes particularly relevant in a scenario of reductions in the rate of long-term GDP growth, such as the one Colombia is currently experiencing.
- Tax incentives, although they break the neutrality, are justified as a Public Policy instrument.
- By constitutional mandate, free and fair economic competition is not an absolute right, but it admits limitations made by the law, of course, as long as these are justified by the prevalence of the general interest or by the State's power to intervene and regulate.
- The benefits derived from the Free Trade Zone regime fully justify its existence, even though this implies a differentiated tax and customs treatment. These benefits also bring a pro-competitive advantage in attracting foreign investment in a competitive context with other countries in the region.
- Notwithstanding the above, the regime can be improved in order to guarantee access to the regime under equal circumstances for existing legal entities versus new legal entities.