Special Economic Zones: Revisiting the Policy Debate

A discussion of the pros and cons of the controversial SEZ policy.

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Export Processing Zones (EPZs) are an international phenomenon influencing increasing share of trade flows and employing a growing number of workers. In 1986, there were 176 zones across 47 countries; by 2003, the number had increased to over 3,000 across 116 countries.

Over the past few years, the policy of promoting zones has found favour with the government of India as well. In 2000, the government replaced the old EPZ regime by a new scheme of "Special Economic Zones" (SEZs) with several lucrative incentives/benefits that were not available in the earlier scheme. In 2005, it enacted the SEZ Act and the SEZ Rules were notified in February 2006. The policy is expected to give a big push to exports, employment and investment in SEZs. The ministry of commerce claims that these zones are expected to attract investment of about Rs 1,00,000 crore including FDI of Rs 25,000 crore and create additional 5,00,000 direct jobs, by December 2007.

These claims notwithstanding, the policy has come under heavy criticism. Dissenters contend that the policy would be misused for real estate development rather than for generating exports. Concerns have also been expressed on the displacement of farmers by land acquisition, loss of fertile agricultural land, a huge revenue loss to the exchequer and adverse consequences of uneven growth.

This article revisits the debate. It describes the economic rationale for SEZs; examines India's experience with EPZs/SEZs; discusses the context in which SEZ policy is being promoted in the country; reviews the arguments for and against SEZs; analyses what went wrong, from the perspective of the promoters of the scheme; and finally, draws lessons.

The promotion of SEZs is an attempt to deal with infrastructural deficiencies, procedural complexities, bureaucratic hassles and barriers raised by monetary, trade, fiscal, taxation, tariff and labour policies. These structural bottlenecks affect the investment climate adversely by increasing production and transaction costs. Since country-wide development of infrastructure is expensive and implementation of structural reforms would require time, due to given socio-economic and political institutions, the establishment of industrial enclaves (SEZs/EPZs) is seen as an important strategic tool for expediting the process of industrialisation in these countries. The zones offer numerous benefits such as, (i) tax incentives, (ii) provision of standard factories/plots at low rents with extended lease period, (iii) provision of infrastructure and utilities, (iv) single window clearance, (v) simplified procedures, and (vi) exemptions from various restrictions that characterise the investment climate in the domestic economy.

These benefits foster a conducive business environment to attract local and foreign investment, which would not otherwise have been forthcoming. The competitive advantages of zones may also be explained within the framework of the "cluster approach". Zones are industrial clusters where external economies of scale and other advantages help the operating firms in reducing costs, developing competitive production systems and attracting investment, in particular, FDI. As a result of these benefits, many developing countries have been promoting zones with the expectation that they will provide the engine of growth to propel industrialisation.

There is, however, no conclusive evidence regarding the role of the zones in the development process of a country. The literature review indicates that while some countries have been able to capture the dynamic and static gains from zone operations, many others have not [Aggarwal 2006a]. In that context, it is important to analyse the Indian experience.

Indian Experience

A micro level analysis of the zones' contribution to industrialisation efforts in India reveals that EPZs have had a catalytic effect in promoting new production sectors, exporting new products and in building up the country's image in certain products in international markets [Aggarwal 2006b]. The foundation of the modern jewellery industry in India, for instance, was laid in SEEPZ in Mumbai in 1987-88. It was there that the "wax setting technique" was introduced in jewellery production, which made mass scale production possible and dramatically transformed the labour-intensive jewellery industry from its cottage industry status into a highly mechanised modern industry. SEZs accounted for over 55 per cent of total Indian jewellery exports in 2002-03. Zones have also been instrumental in creating the base for the growth of the electronics industry through technology transfers, spillovers and demonstration effects. Until the early 1980s, electronic hardware exports were primarily originating from EPZs. Even during 2000-02, the share of SEZs in total hardware exports was as much as 26 per cent. The Indian software saga also really began in SEEPZ, Mumbai [Heeks 1996]. The first major breakthrough in India's software exports came in 1977 when the Tatas established a unit in SEEPZ in partnership with Burroughs, an American company, to export software and peripherals. A further breakthrough in the progress of the industry occurred when, in 1985, Citibank established a 100 per cent foreign-owned, export-oriented, offshore software company in SEEPZ. This company drew attention to the possibilities available for offshore software development in India. Soon after, Texas Instruments and Hewlett-Packard established subsidiaries in Bangalore, in 1986 and 1989, respectively and the rest is history.

The success stories notwithstanding, the economic contribution of SEZs remained minuscule at the national level. Though India was the first Asian country to take the free zone initiative and set up the first zone in Kandla as early as in 1965, the share of SEZs in exports was a mere 5 per cent in 2004-05. Furthermore, they accounted for only 1 per cent of factory sector employment and 0.32 per cent of factory investment in the same year [Aggarwal 2006b]. Their contribution to regional economies has also been limited. Although they have had a positive impact on regional employment and human development by creating economic opportunities, especially for those without high levels of schooling, their potential in contributing to human development has not been fully exploited due to their failure in attracting investment and promoting economic activities in the region [Aggarwal 2006c].

SEZ Regime: Indian Context

The 1991 reforms did not result in a sustainable growth in manufacturing, there was a significant slowdown in the second-half of the 1990s. Bureaucratic red tape, administrative procedures, rigid labour laws and poor infrastructure are believed to have affected the investment climate adversely in the manufacturing sector [Acharya 2006]. To address these issues, the government reverted to EPZs with the expectation that if they could effectively be separated from the rest of the economy then they could provide the “engine of growth” to propel the manufacturing sector. It was argued that the existing zones could not succeed in attracting investment because of the lack of government commitment to the programme, piecemeal reforms, policy reversals, poor site selection, failure to provide word class infrastructure, weak incentives and poor regulation of the zones. In a major initiative to boost export-led growth and motivated by the success of Chinese SEZs, the government replaced the EPZ scheme with the “SEZ scheme” in 2000. The main difference between an SEZ and EPZ is that the former is an integrated township with fully developed infrastructure whereas an EPZ is just an industrial enclave. Under the new scheme, all existing zones were converted into SEZs and three greenfield SEZs became operational by 2004. However, the impact of SEZs remained far removed from expectations. In order to provide a significant thrust to the policy, the government enacted the SEZ Act 2005. The act became operative in February 2006 after the SEZ rules were framed and notified. In addition, state governments also enacted their own SEZ laws, primarily to cover state subjects. The salient features of the SEZ Act are as follows.

Governance: An important feature of the Act is that it provides a comprehensive SEZ policy framework to satisfy the requirements of all principal stakeholders in an SEZ – the developer and operator, occupant enterprise, out zone supplier and residents. Earlier, the policy relating to the EPZs/SEZs was contained in the Foreign Trade Policy while incentives and other facilities offered to the SEZ developer and units were implemented through various notifications and circulars issued by the concerned ministries/departments. This system did not give confidence to investors to commit substantial funds for development of infrastructure and for setting up units.

Another major feature of the Act is that it claims to provide expeditious and single window clearance mechanisms. The responsibility for promoting and ensuring orderly development of SEZs is assigned to the board of approval. It is to be constituted by the central government. While the central government may suo motu set up a zone, proposals of the state governments and private developers are to be screened and approved by the board. At the zone level, approval committees are constituted to approve/reject/modify proposals for setting up SEZ units. In addition, the Development Commissioner (DC) and his/her office is responsible for exercising administrative control over a zone. The labour commissioner’s powers are also delegated to the DC. Finally, clause 23 requires that designated courts will be set up by the state governments to try all suits of a civil nature and notified offences committed in the SEZs. Affected parties may appeal to high courts against the orders of the designated courts.

Incentives: The Act offers a highly attractive fiscal incentive package, which ensures (i) exemption from custom duties, central excise duties, service tax, central sales taxes and securities transaction tax to both the developers and the units; (ii) tax holidays for 15 years (currently the units enjoy a seven year tax holiday), i e, 100 per cent tax exemption for 5 years, 50 per cent for the next five years, and 50 per cent of the ploughed back export profits for the next five years[1]; and (iii) 100 per cent income tax exemption for 10 years in a block period of 15 years for SEZ developers.

Infrastructure: Provisions have been made for (i) the establishment of free trade and warehousing zones to create world class trade-related infrastructure to facilitate import and export of goods aimed at making India a global trading hub; (ii) the setting up of offshore banking units and units in an international financial service centre in SEZs; and (iii) the public private participation in infrastructure development; and (iv) the setting up of a "SEZ authority" in each central government SEZ for developing new infrastructure and strengthening the existing one.

There has been a tremendous rush to set up SEZs since the Act came into effect in February 2006. The total number of approvals and in-principle approvals across 21 states as on October 27, 2006, was 212 and 152, respectively. As on date, 34 SEZs out of these approvals have been notified. Table 1 shows the current status of the upcoming SEZs.

Table 1: Current Status of Upcoming SEZs

SEZ	Status	Investment	Employment (No)
Nokia, Tamil Nadu:	Commenced commercial production	US$ 100 Million	Direct : 2800 Indirect : 10000
Quark City, Chandigarh:	Inaugurated	$ 0.5 billion FDI*	35000* by May 2007
Flextronix in Tamil Nadu	Commences operation in November 2006	$100 million	3000* (2500 under training)
Motorola and Foxconn, Tamil Nadu	Units being set up	$200 million*	5000* by December 2007
Apache SEZ (Adidas Group), Andhra Pradesh	Construction started	$50 million*	25,000*
Divvy's Labs, Andhra Pradesh	Commenced operations	NA	8000* by April 2007
Rajiv Gandhi Technology Park, Chandigarh	Construction started	NA	5000* by June 2007 (500 under training)
Brandix Apparel SEZ, Andhra Pradesh	Construction started	$100 million*	26000* by March 2007

*Expected.

The Debate

The SEZ policy has become one of the most hotly debated issues in recent years. Huge protests are being organised by those who stand to lose their land. There has been a scathing campaign against SEZs by politicians, scholars, media and civil society. Of much more concern however is the fact that there are differences within the government too. The Congress president Sonia Gandhi has also expressed her reservations over the impact of SEZ policy on displaced farmers and the Reserve Bank of India has asked the banks to treat SEZ lending as real estate business and not infrastructure. The advocates of the policy led by the ministry of commerce have however strongly defended the policy. Table 2 summarises some of the major concerns and counter arguments.

Table 2: Arguments For and Against SEZs

Issue	Argument against SEZs	Counter Arguments for SEZs
Relocation	– Companies will simply relocate to SEZs to take advantage of the tax concessions being offered and little net activity will be generated.	– Special provisions have been made in the act under which tax exemptions are applicable only if the unit is not formed by splitting up, or the reconstruction, of a business already in existence and it is not formed by the transfer to a new business of machinery or plant previously used for any purpose. – Relocation of units to SEZs would involve cost and loss of efficiency. – There is little incentive to relocate due to the continuation of various export promotion schemes such as the duty drawback scheme for outside units and other business practices prevalent outside the zones.
Revenue loss	– The policy would cause a revenue loss of Rs 9,39,000 million over the next four years. If an annual average of this four-year figure is drawn, it comes out to be Rs 23,475 million, which is about 6.7 per cent of the central government's total revenue receipts during 2005-06.	– Revenue loss is notional as without the SEZ Act, there would not be much investment in the zones. – SEZs would bring a net revenue gain of Rs 4,40,000 million on account of additional investment activities.
Land acquisition	– The act will lead to a large-scale land acquisition by developers, displacement of farmers, meagre compensation and no alternative livelihood for them.	– The land requirement of all SEZs (including those under consideration) is 1,00,000 hectare, which is less than 0.1 per cent of total cultivable land in India. – The total land area in 212 formal approvals granted till date is 33,761 hectares out of which 50 approvals are for state industrial development corporations/state government ventures, which account for 17,800 hectares approximately. No fresh land acquisition took place for any of these cases. – Different states have their own land acquisition laws. Some states also have special land acquisition laws for SEZs. The onus is on state governments to put in place reasonable and transparent land acquisition laws for SEZs and implement them effectively. – SEZ developers are required to provide for an adequate relief and rehabilitation package for the affected.

(Contd)

Though the ministry of commerce has attempted to dispel the criticism of the SEZ policy, the fact remains that the SEZ Act was framed without giving adequate thought to most of the ancilliary issues. No exercise was undertaken to ensure that legal institutions are in place for massive land acquisition. No long-term strategy was drawn to counter the socio-economic consequences of the scheme. Even amid heavy criticism of the policy, no serious research has been conducted

Table 2: Arguments For and Against SEZs *(Contd)*

Issue	Argument against SEZs	Counter Arguments for SEZs
		– In Maharashtra, MIDC has come out with a R&R package which includes assured employment for members of the displaced families and land at concessional rates for them in the developed area.
Loss of agricultural land	– SEZ will be built on prime agricultural land with serious implication for food security.	– The general consensus in the board of approval and state governments is that mainly waste and barren land and, if necessary, single crop agricultural land alone should be acquired for the SEZs. If perforce a portion of double cropped agricultural land has to be acquired to meet the minimum area requirements, the same should not exceed 10 per cent of the total land required for the SEZs.
Misuse of land for real estate	– Promoters will get land cheaply and will make their fortune out of real estate development and speculation indiscriminately. The minimum required processing area is 35 per cent. The rest will be for residential, recreational facilities.	– To regulate usage of the SEZ area by the developers, the SEZ board of approvals will assess the size requirement of infrastructural facilities like housing, commercial spaces, recreational amenities, etc, based on the employment generation potential of the SEZ. In the first phase it is proposed to allow only a maximum of 25 per cent of the approved housing while the other approved infrastructure will be allowed to be created as per the developer's plans and as approved in the Master Plan. The balance housing shall be allowed to be established by the approval committee in three phases depending upon the progress in allotment/occupancy of units in the processing area.
Uneven growth	– There is a strong possibility that SEZs will be set up in states where there is already a strong tradition of manufacturing and exports. This will aggravate regional disparities. – The trend is already seen in the initial approvals. The share of the four most industrialised states (TN, Karnataka, Gujarat and Maharashtra) in total approvals is 49.5 per cent. Andhra Pradesh, Kerala and Haryana account for another 31.1 per cent of total approvals. Thus seven states account for 80.6 per cent of approvals. Their share of in-principle approvals is 63.8 per cent. On the other hand, industrially backward states of Bihar, north-east and J and K do not have a single approval.	– Almost every state will have SEZs under the policy. This will promote infrastructure development and industrialisation in states such as UP, Orissa, West Bengal
Inequities	– The incentives dished out to SEZs will create a tilted playing field between SEZ and non-SEZ investors.	– EOUs have the freedom of setting up their businesses anywhere in the country and are enjoying the benefit of DTA sales, which is not available to zone units.

on how SEZs will affect the regional economy, how much fertile land will actually be lost, how many farmers will be affected and what the tax implications of SEZs will be. Most arguments are based on the perception of officials. There is therefore an urgent need to institute a study on the socio-economic effects of SEZs under consideration.

A Note of Caution

The sectoral break of SEZ approvals shows that the largest number of approvals (61 per cent) has been in the IT sector. The manufacturing sector accounts for only one-third of total approvals. This pattern is worrisome. In view of the declining competitiveness of the manufacturing sector, the focus of the SEZ policy needs to be on making India a preferred destination for manufacturing. It is however encouraging to note that the share of manufacturing SEZs in approvals-in-principle is 69 per cent.

Furthermore, it is instructive to note that SEZs do not embody dynamic forces that can point towards sustainable development. In the long run the competitiveness of SEZs can be sustained only if economy-wide investment climate is improved. This is because zones cannot be insulated from the broader institutional and economic context of the country. The key to successful industrialisation in the long run thus lies in shaping the existing institutions such that they drive firms towards an outward orientation and technological upgradation; the creation of zones which offer the easy option of competing on the basis of cost minimisation should only be treated as a transitory policy arrangement. Zones should not be considered the best policy option for long-run industrial development. Thus, the establishment of EPZs should not be regarded as a substitute for pursuing institutional and infrastructural improvements. EPW

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Note

1 This is applicable to SEZ units who begin their operations during the previous year relevant to any assessment year commencing on or after April 1, 2006.

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