Special Economic Zones:
Are They Good for the Country?

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Executive Summary

India over the past decade has progressively opened up its economy to effectively face new challenges and opportunities of the 21st Century. To compete in the global market, the Government of India (GoI) has liberalized export policies & licensing of technology and implemented tax reforms providing various incentives. Special Economic Zone (SEZ) policy is also one of the steps India has taken to boost economic growth through outward looking approach. Special economic zone is a specifically duty fee enclave and shall be deemed to be foreign territory for the purpose of trade operations and duties and tariffs. When SEZ policy was introduced in the country, it made headlines and people started considering it as a policy to create a hassle free and investment friendly environment.

The main objective of this research paper is to analyze SEZ policy in terms of export performance, FDI inflow, employment generation and overall physical and financial infrastructure building. This research paper tries to investigate whether having these policies are good for the country or not. SEZs are a larger variant of Export Processing Zone (EPZ), thus performance of EPZ has also been discussed briefly. It has been five years now since all then existing EPZs have been converted into SEZs. Section –II has been devoted to performance analysis of these zones.

After the failure of EPZs, a significant change has been made in the rules/regulations and a new package of fiscal and non- fiscal incentives is also being offered to developers and units. According to Finance Msinistry, the government has to forego about Rs. 90,000 crore in direct and indirect taxes over the next four years on account of SEZs. Despite so many incentives, performance of these privileged enclaves over the last five years indicates the failure of this scheme.

For instance, the share of exports from SEZs in the total exports of the country has only increased from 4.2% in 2000-01 to 5.1% in 2004-05. Some economic experts are also seeing it as a corporate welfare scheme and the possibility of a sharp decline in investments in SEZs can't be ruled out as tax benefits are only for 10 years. Other issues of concern like the heavy economic cost, real estate scam and labour policies are also discussed in the last section of the paper. Data are mostly secondary but the opinion of different economists and the Development Commissioners (SEZ) has also been taken into account.

The zones cannot be insulated from the broader institutional and economic context of the country and be treated as an economy within the economy. Zones are a part of the economy and require overall improvement in the investment climate to ensure success in the long run. They should not, therefore, be viewed as an alternative to the overall development model. This is perhaps the reason why SEZs failed to fulfill the role of engines of economic growth in most countries on a sustainable basis.

Major Findings

- The union Govt has foregone a whopping Rs 39,704 crore of duty under export promotion schemes during 2003-2004 accounting for 82% of customs duty collected in that year.
- The foreign exchange earned by all the 811 units in the 8 zones put together came to only Rs. 18,309 crores, a mere 5% of India's exports during the fiscal year 2004-05.
- During 1966-1980 average annual export growth rates of EPZs was over 77%, whereas during the post 2000 period (2001-03) it came down to 7%.
- Total share of FDI investment in Noida SEZ in 1997 was 12.3% and it went up by a mere 0.4% in the six years. Total FDI share in 2003 was 12.7%.
- A slew of tax exemption planned for SEZ to boost exports will erode Rs. 93,900 ($ 20.62 billion) in government revenue over the next four years.
- Haryana Govt has offered over 1700 acres of land near Gurgaon to RIL (Reliance) for about Rs.360 crore while it is estimated that the land was worth 5000 crore and HSIDC had acquired this land by paying Rs. 300 crore in compensation to the farmers.

Section – 1

SEZ Policy: An Overview

1.1 Introduction

A Special Economic Zone (SEZ) is defined as a deemed foreign territory within a country with special rules for facilitating FDI for export-oriented production, and for purposes of trade and customs duties. These Zones (SEZs) are geographical region that have economic laws different from a country's typical economic laws. Different economic institution and government departments have defined it in different ways. As per Ministry of Commerce and Industry they are defined as:

Special economic zone is a specifically duty fee enclave and shall be deemed to be foreign territory for the purpose of trade operations and duties and tariffs.

SEZs have been established in several countries, including the People's Republic of China, India, Jordan, Poland, Kazakhstan, the Philippines and Russia. The concept of having free trade zones, export oriented zones and SEZs dates back to 1970. In 1979-80, China opened up its economy to foreign investment with the establishment of Shenzhen SEZ. Situated close to the Hong Kong port, this small fishing hamlet has today acquired the distinction of being the manufacturing hub of the world with a GDP of $20 billion and an annual foreign trade of nearly $50 billion. Inspired by the success of Chinese SEZs our policy makers also tried to experiment with SEZs in India. Despite the failure of Export Processing Zones (EPZs) Murasoli Maran after visiting China in the year 2000 introduced the SEZ policy very same year considering the need to enhance foreign investment and promote exports from the country. The SEZ bill was passed by parliament in 2005 and the Commerce Ministry notified the Special Economic Zones law on February 9, 2006 and the rule came into effect from February 10, 2006 but the rush of proposals for setting up SEZs had begun much earlier and by November 2005 some 61 SEZs were already approved. According to reports, so far, the Government has cleared around 150 SEZ proposals out of around 200 received.

The policy provides for setting up of SEZs in the public, private, joint sector or by State Governments. It was also envisaged that some of the existing EPZs would be converted into SEZ. Accordingly, the Government has converted all eight EPZs into SEZs. Table 1.1.1 below shows all the EPZs which has been coveted to SEZs with their size

Table 1.1.1 List of all the EPZs converted into SEZs with their size

Location	Size (Sq.KM)
Kandla (Gujarat)	2.99
SEEPZ (Mumbai)	0.38
Cochin (Kerala)	0.40
Surat (Gujarat)	NA
NOIDA (UP)	1.22
Chennai (TN)	1.04
Vizag (AP)	1.43
Falta (WB)	1.12

Source: Export Promotion Council. Ministry of Commerce, Government of India

1.2 Evolution of EPZs/SEZs in India

The economic policy of 1960's which were geared towards selective import liberalization and export promotion, marked the development of EPZ's in the country. The first EPZ in India which was also the first in Asia was set up at Kandla in 1965.The proposal for setting up the Kandla free trade zone was mooted in 1961, with the objective of facilitating the development of the Kutch region, to ensure greater utilization of Kandla port and to create employment opportunities in the Kandla.

The second EPZ in the country, the Santa Cruz Electronics Export Processing Zone (SEEPZ), was set up at Mumbai in 1974. This EPZ was developed specifically for processing electronics goods and was expected to generate employment opportunities and facilitate the technology transfer. SEEPZ was initially planed as single product zone for processing electronics goods but by 1986 it was made a two product zone providing for gems and jewellery complex as well.

Four more zones were set up in the mid-eighties at Noida (NEPZ), Chennai (MEPZ), Cochin (CEPZ, Kerala), and Falta (FEPZ, West Bengal) and the seventh EPZ in the country was commissioned at Vishakhapatnam (VEPZ, Andhra Pradesh) in 1994.

Initially the Central Government was solely responsible for establishing EPZ, but this policy was amended in 1994 to enable state governments, autonomous agencies and the private sectors to participate in the development agencies and operation of EPZs. Following the implementation of this policy, one EPZ was developed by private sector in Surat. A joint sector EPZ (now SEZ) has been approved for Greater Noida (UP). In terms of export performance, employment generation and FDI inflow EPZs failed in India but considering the need of better export performance and infrastructure building, central government came up with SEZ policy in 2000. Section II of this research paper has been devoted to analysis of the failure of EPZs in India. Without understanding the key difference between these two similar policies it would not be fair to comment upon the future of SEZ scheme.

1.3 How SEZs are different from EPZs ?

SEZs are a larger variant of EPZs. Both have a delineated area and permit duty free import of capital goods and raw materials; both aim to attract foreign investment for setting up export-oriented units by providing developed infrastructure, conducive operating environment and a package of fiscal incentives. However, the objective of SEZs is much larger than mere promotion of export processing activities. While EPZs are industrial estates, SEZs are virtually industrial townships that provide supportive infrastructure such as housing, roads, ports and telecommunications hospitals, hotels, educational institutions, leisure and entertainment units, residential/industrial/commercial complexes, water supply sanitation and sewerage system and any other facility required for development of the zone.

The scope of activities that can be undertaken in the SEZs is much wider and their linkages with the domestic economy are stronger. Resultantly they have a diversified industrial base. Their role is not transient like the EPZs, as they are intended to be instruments of regional development as well as export promotion. Although the objectives of SEZ policy are quite similar to the objectives envisaged by central government through EPZ policy in early eighties but there is significant difference between these two policies in terms of tax benefits and rules and regulations. The table 1.3.1 below summarizes the difference between these two:

Table 1.3.1 Comparison between SEZ and EPZ

	India's SEZ	**India's EPZ**	**SEZ vs. EPZ**
Restriction on sectors	Open to manufacturing, services and trading activities	Open to manufacturing and trading activities. Services may also be considered	While SEZs are generally open to all activities, EPZs appear to focus more on manufacturing and trading
Tax exemption	Companies in SEZs enjoy a 5 year corporate tax holiday, followed by 50% exemption for 2 more years	Companies in EPZs were exempted from corporate tax for a block of 5 years in first 8 years of operations. However, under section 10a of the income tax act, the concession was to be phased out by 2009	SEZs offer more attractive tax benefits than EPZs
Retention of foreign exchange earnings	Retain 100% foreign exchange earnings in Exchange Earner	Retain 70% foreign exchange earnings in Exchange Earner Foreign Currency	Companies in SEZs would have better control over foreign

	Foreign Currency Account (EEFC).	Account (EEFC).	currency in relation to purchase of imported inputs.
Export performance (EP) & Net Foreign Exchange Earning as % of exports (NFEP) requirements	No minimum EP required. Positive NFEP required (varies across industries and states)	Minimum EP and NFEP required. (varies across industries and states)	Companies in SEZ enjoy more leeway in meeting export performance requirements.
Duty recovery in case of failure to achieve positive NFEP	Duty recovery is in proportion to shortfall	Full duty recovery is imposed	Lesser penalty for SEZs failing to achieve positive NFEP
DTA* sales	Unlimited DTA sales on full duty	Only 50% of exports qualify for DTA sales	SEZs enjoy greater access to domestic market
Duty free imported raw material	Allowed. These duty free materials are to be utilized over 5 years	Allowed, but duty free materials are to be utilized over 1 year.	More flexibility in production and inventory planning for companies in SEZs.
Certifications of imports	Imports on self-certification basis	Imports require attestation of Development Commissioner	Simplified customs procedures facilitate movement of

			imports into SEZs
Customs inspection	No routine examination of import/export cargo by Cusoms	Routine customs inspections of import/export cargo	Expedited movement of goods in an out of SEZs
FDI approval process	100% FDI investment through automatic route available for manufacturing companies	Foreign investment promotion board approval is required for FDI	Easier and quicker FDI flows into SEZs for manufacturing companies.

Source: SEZ Authority, Ministry of Commerce and Industry, Government of India _Available at sezindia.nic.in. Accessed on June 5, 2006

1.4 Objectives of SEZ envisaged by the Government of India

The main objective of the SEZ scheme according to the finance and commerce ministries is to create delineated, duty –free zones with world class infrastructure, internationally competitive production environment and fast track clearance system for attracting private investments, especially foreign direct investment (FDI) for setting up export oriented unit. The broad objectives of the SEZ policy are:

- Attract Foreign Direct Investment (FDI)
- Earn foreign exchange and contribute to exchange rate stability
- Boost the export sector, particularly non traditional exports
- Create jobs and raise standard of living
- Transfer new skills and expertise to local human resources
- Create backward & forward linkages to increase the output and raise the standard of local enterprise that supply goods and services to the zone
- Introduce new technology

- Develop backward regions by locating such zones in these areas and attracting industries
- Provide a stimulus to the economy
- Test key policy reforms in these ‘pilot areas’

According to the Commerce Ministry, investment of the order of Rs.100,000 crore over the next 3 years with an employment potential of over 5 lakh is expected from the new SEZs apart from indirect employment during the construction period of the SEZs. Heavy investments are expected in sectors like IT, pharma, bio-technology, textiles, petro-chemicals, auto-components etc. With the Act and Rules in place, it is expected that many large format, multi-product SEZs that have so far been unable to achieve financial closure will now quickly move towards such closure. It is anticipated that this will trigger a large flow of foreign and domestic investment in SEZs, in infrastructure and productive capacity, leading to generation of additional economic activity and creation of employment opportunities. Fiscal and other incentives are being offered to woo investors and SEZ developers. Incentives like tax benefits, single window clearance, flexibility in export and import rules and regulations has made SEZs an important and most sought after destination for setting up the business empire. Unlike most of the international instances where zones are primarily developed by Governments, the Indian SEZ policy provides for development of these zones by the government, private or joint sector.

1.5 Establishing SEZs : Procedures and Requirements

According to Commerce Ministry and SEZ authority SEZs may be developed and managed in the private sector or jointly by state government and a private agency or exclusively by the State Government or their agencies. In the case of privately developed zones, the investors could be either Indian individuals, NRIs, Indian or foreign companies. New infrastructural development works such as construction of Standard Design Factory Building, operation and maintenance of infrastructure in the Zones may also be undertaken through private/joint/state sector in the Export Processing Zones, now converted into Special Economic Zones. Any person, who intends to set up a SEZ, may, after identifying the area can make a proposal to the Board of Approval (BOA) but will also have to obtain the concurrence of the State Government. SEZ developer will have to get a no-dispute certificate for that area where he wants to establish SEZ from the Chief Secretary of that state. After getting clearance from the state government BOA considers that proposal and if the proposal is within the purview of SEZ act BOA can approve the proposal. However if a state government wants to set up a special economic zone, after identifying the area can make a proposal directly to the board. The central government has prescribed the minimum area requirement for setting up SEZs. Table 1.5.1 shows the minimum requirement of area for various sectors.

Table 1.5.1 Minimum area requirement for various sectors

Sector	Minimum area required (in hectare)
Multi Product	1000
Green field	1000
Service sector	100
Bio-Technology	10
Information-Technology	10
Gems & Jewellery	10
All other sectors	100

Source: SEZ authority, Ministry of Commerce & Industry. Government of India. Available at sezindia.nic.in. Accessed on June 15, 2006

The area requirement for multi-product SEZs has been relaxed to 200 hectares and for sector specific SEZs to 50 hectares, for certain States (Assam, Meghalaya, Nagaland, Arunachal Pradesh, Mizoram, Manipur, Tripura Himachal Pradesh, Uttaranchal, Sikkim, Jammu & Kashmir, Goa) and Union Territories, keeping in view the difficulty in finding large tracts of contiguous land in such states/union territories. According to the SEZ Act at least 25 % area of the SEZ shall be used for developing industrial area for setting up of such units and the remaining 75% can be used for building infrastructures like roads, hotels, power generation station, educational institution and other facilities.

1.6 Setting up Units

Any person who wants to set up a unit for operating in a SEZ will have to submit a proposal to the development commissioner of that SEZ. Development commissioner submits the application to the Approval Committee and the Approval Committee may, either approve the proposal without modification, or approve the proposal with modification. A modification suggested by Approval Committee will be well within the purview of SEZ Act.

1.7 Important Features of SEZ Policy and Incentives given to SEZ

In India SEZs are deemed foreign territory within the country with special rules for facilitating FDI for export-oriented production, and for purposes of trade and customs duties. The key implication of being a deemed foreign territory is that individual units within the SEZ are allowed operational freedom in routine activities and not supervised by the customs authorities. Units may be set up in SEZ for manufacture of goods and rendering of services.

To woo the investors to the zones, the Central Government has been offering a number of fiscal incentives and concessions. For instance, the zones are deemed as foreign territories as far as trade operation, duties and tariffs are concerned. The units (100% export oriented) also have full flexibility in operations. They are exempt from all direct and indirect taxes. No export and import duties, no excise duties, no central or state sales tax and no service tax. The units don't require license for importing capital goods and raw material. According to SEZ Act 2005, the firms are eligible for getting an extended Income Tax holiday for 15 years. Income tax exemption for 15 years is available for SEZ units as detailed below:-

a) 100% of profits and gains from exports for the first 5 years

b) 50% of profits and gains from exports for the next 5 years

c) Amount not exceeding 50% which is credited to a reserve account 'Special Economic Zone Re-investment Reserve Account' and utilized for business for the next 5 years.

The only condition imposed on the firms is that they must have positive net foreign earning (NFE). The important fiscal and non-fiscal incentives given to SEZ developers and firms are as follows:

- 100% FDI in the manufacturing sector permitted through automatic route[1] except arms and ammunition, explosives, atomic substance, narcotics and hazardous chemicals, distillation and brewing of alcoholic drinks and cigarettes, cigars and manufactured tobacco substitutes.
- External commercial borrowings by SEZ units upto US$500 million in a year without any maturity restrictions through recognized banking channels.
- Facility to retain 100% foreign exchange receipts in Exchange Earners' Foreign Currency Account.
- Exemption from Central Sales Tax and Service Tax
- Facilities to set up off-shore banking units in SEZs.
- Exemption from duties on import /procurement of goods for the development, operation and maintenance of SEZ.
- FDI to develop townships within SEZs with residential, educational, health care and recreational facilities permitted on a case-to-case basis.

The full list of all the fiscal and non-fiscal incentives being offered to SEZ developers and units has been given in the (*appendix-i*). Apart from getting tax benefits from central government these zones are also getting tax benefits from state governments. TABLE 1.7.1 shows the list of tax benefits given by state governments to all the EPZs which has been converted into SEZs.

Table: 1.7.1 Exemption From The State Level Taxes By Zone

	Falta	Cochin	Chennai	Noida	Vizag	Kandla

Sales tax	Yes	Yes	Yes	Yes	Yes	Yes
Contract tax	No	n.a.	n.a.	No	n.a.	Yes
Purchase tax	Yes	n.a.	n.a.	Yes	Yes	Yes
VAT	Yes	n.a.	n.a.	n.a.	n.a.	
State entry tax	Yes	Yes	n.a.	Yes	No	Yes
Octroi tax	No	n.a.	n.a.	Yes	No	Yes
CESS	No	No	n.a.	Yes	No	Yes
Luxury tax	No	n.a.	No	No	Yes	Yes
Entertainment tax	No	n.a.	No	No	Yes	Yes
Stamp duty and registration chages on land transfers	No	Yes	No	No	Yes	Yes
Stamp duty and registration charges on loan agreements/credit deeds	No	No	No	No	Yes	Yes

Source: Agrawal,2004

Units within the SEZ and EPZ also get subsidies sometimes on land rents and built up areas are also provided on lower rental rate. In some countries utility services such as electricity, water, and telecommunication are also subsidized. Table 1.7.2 shows the list of subsidies being given to zone units in six EPZs (now SEZs):

Table: 1.7.2 Provision of subsidies by Zone

	Falta	**Cochin**	**Chennai**	**Noida**	**Vizag**	**Kandla**
On land rent	Yes	Yes	Yes	Yes	Yes	Yes
Factory rent	Yes	Yes	Yes	Yes	Yes	Yes
On purchase on capital goods	Yes	No	No	No	Yes	No
On capital investments	Yes	No	No	No	Yes	No
Interest rate subsidies	Yes	No	No	No	No	No
Concessional finance	Yes	No	No	No	No	No
Any other	No	No	No	No	No	No

Source: Agrawal,2004

In terms of fiscal and other benefits we are ahead of China but the record of the Indian EPZs stands in contrast even to the performance of the general economy. Unlike other countries, in India, SEZs are being developed by the private sectors as well and to attract the private and foreign investment a package of incentives is being offered by both state as well as central government. Later in the research paper an investigation has also been made to analyse the worth of these benefits.

Section – II

Performance Analysis of EPZs & SEZs

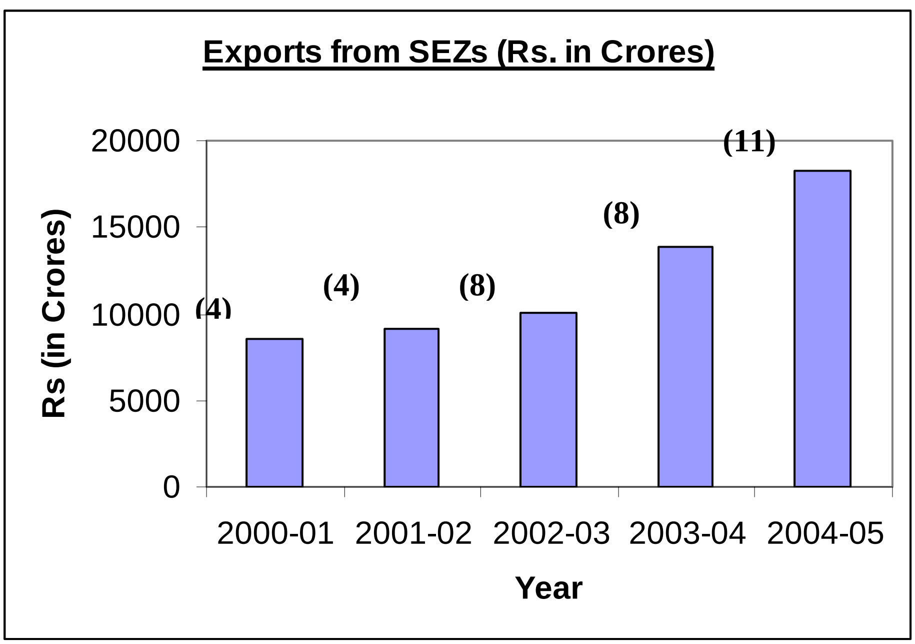
Introduction

What is a successful SEZ? Is it the one that contributes to the host economy, one that generates profit for its own owners/managers? SEZs are extensions of EPZs and taking this into consideration, an attempt has been made to analyze the success of both EPZs and SEZs in India. It has been just five years since the introduction of the SEZ policy in India. Some economists believe that it's too early to comment upon its potential or chances of its failure. A significant change has been made in the rules and regulations but by and large the objectives of SEZs and EPZs are similar. Taking this into account this section has been devoted to explain the experience India had with EPZ policy in terms of export performance, employment generation, FDI inflow and infrastructure development. SEZs have been viewed as a tool to attract FDI and boost the export sector, which will further create employment. It might be argued that policies like SEZ which has been introduced very recently can not be categorized as a good or a bad policy by looking at the performance analysis of five years but it definitely gives an insight into its potential success or failure.

2.1 Share in Total Exports: Aggregate Analysis

Exports from SEZs grew by 16.4% from 2000-01 to 2004-05. In the same period, total exports in India grew by 12.1%. This clearly indicates that despite getting special treatment, performance of SEZs in India is not satisfactory. Even, the share of exports from SEZs in the total exports of the country has only increased from 4.2% in 2000-01 to 5.1% in 2004-05. It's quite apparent from the diagram that Domestic Tariff Area is also more or less witnessing the same rate of growth. Exports from SEZ touched the figure of 18,309 crore in 2004-2005 which is just a mere 5% of the total exports from India.

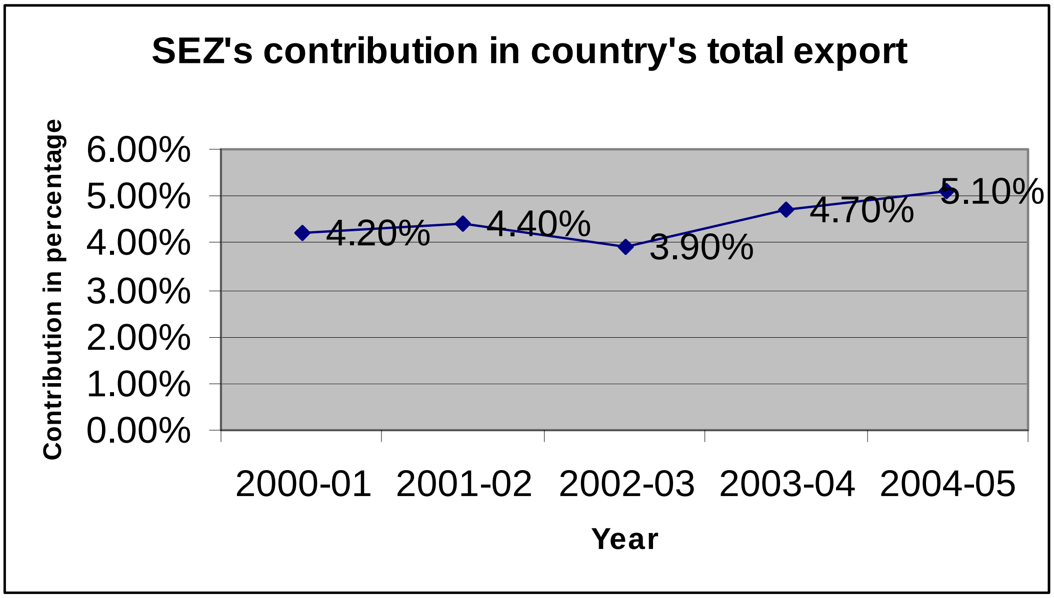
Figure: 2.1.1 Trend in export performance of SEZs



Source: Export Promotion Council, Ministry of Commerce & Industry, Government of India

Note: figures in parenthesis shows the No. of functional SEZs

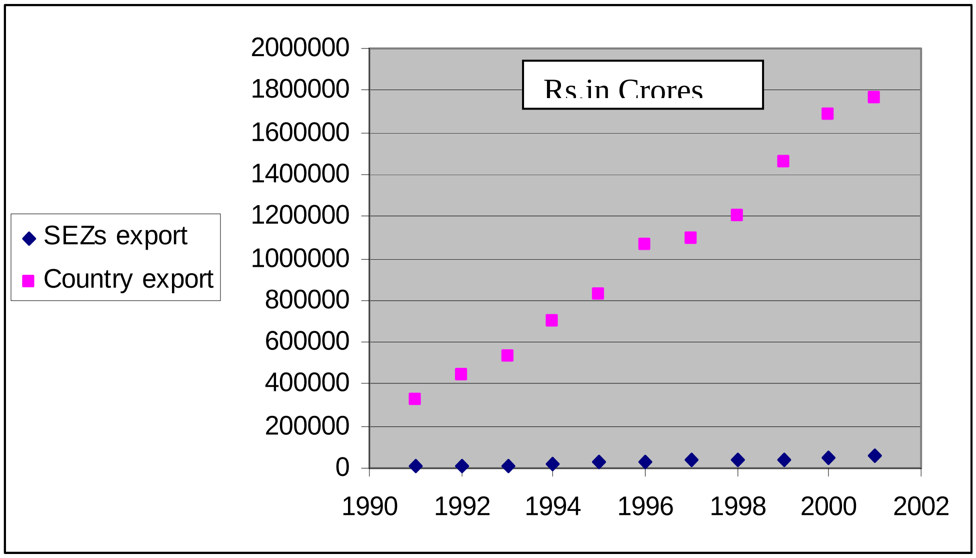
Figure: 2.1.2 Contribution of SEZs in country's total Export



Source: CII report, 2005

Study shows that initially EPZs also witnessed high growth but gradually it started declining. In the early seventies, the growth rate of EPZs touched 77% but gradually it started coming down (Agrawal, 2004) and declined to 7% in 1999-00. Figure 2.1.3 indicates that the SEZs are failing to induce dynamism in the overall export performance of the economy. As the figure shows, despite a high growth of overall exports, SEZ contribution has remained constant over the years despite various other benefits. However, this may be counter argued by saying that apart from exports government has other objectives like employment generation and attracting FDI but our analysis shows that SEZ scheme is also failing like EPZs in attracting FDI.

Figure: 2.1.3 Growth Trend of SEZ and Country Export



Source: sezindia.nic.in, Ministry of Commerce & Industry. Government of India

2.2 FDI inflow and Employment

India had a very slow expansion in the initial phases of EPZ policy. Expansion in the zones started picking up in the 1980s in terms of employment but total investment remained abysmally low till the late 1980s[8]. In the 1990s, investment also started increasing. Growth rates in employment slowed down considerably in the late 1990s but in terms of investment EPZs in India continue to be dominated by domestic investment. This was despite its edge in terms of labour costs, availability of trained manpower and a stable macroeconomic environment. The share of FDI in total investment increased slowly from 12% in 1989 to slightly over 18% in 2000 (Agrawal, 2004). During 2000-03, however, FDI inflows increased faster. Table 2.2.1 below shows the share of FDI in EPZ/SEZ investment. In 2000, all the EPZs were converted into SEZs, and with new rules and incentives it was expected that FDI will pour in but a more detailed study of Noida SEZ shows a mere 0.4% growth in FDI investment in six years while in Chennai it just went up by 2.3%. Despite this, new SEZs are becoming the most sought after destinations for foreign investors, however the chances of decline in FDI in SEZs can't be ruled out as once the tax benefit period gets over and there would not be much incentives for investors to invest in SEZs.

TABLE: 2.2.1 Share of FDI in total EPZ/SEZ investment (%)

Zone	1997	2003
Kandla	1.3	4.9
Santacruz	8.4	9.2
Noida	12.3	12.7
Chennai	28.4	30.7
Cochin	9.6	13.7
Falta	3.1	4
Vizag		38.8

Source: Ministry of Commerce & Industry. Government of India

Unlike other countries, in India SEZs are being developed largely by private sectors and to avail the tax and other benefits private players are rushing in but it would be interesting to see if Govt doesn't extend the benefits again once the period gets over , will they be still interested in investing and building infrastructure. Employment creation is one of the important goals which Indian government wants to achieve through SEZs but previous experiences with EPZ and other free trade zones doesn't give us any rosy picture. EPZ had a share of near about 1% in organized employment (Agrawal, 2004) and till now all eight functional SEZs has created 1 lac employment and it is being expected that in next five years it will cross the figure of 5 lac. Table 2.2.2 shows the employment generated by different zones and the amount of Government and private investment in these zones.

Table: 2.2.2 Zone wise employment and Investment upto 31.03.2005

Zone	No of units	Employment as on 31.03.2005	Govt investment upto 31.03.2005	Private investment upto 31.03.2005
KSEZ	123	9821	26.93	134
SEEPZ	176	42150	57.39	279.49
NSEZ	151	19857	78.04	650
MSEZ	105	16107	74.83	223.96
CSEZ	74	4712	87.53	92.79

FSEZ	83	2753	82.83	263.85
VSEZ	28	2500	39.3	311.58
Surat	62	2250	32.46	5.07
Manikan chan	5	300		4
Jaipur	2	50		1
Indore	2	150		3

Source: Export Promotion Council, Ministry of Commerce & Industry. Government of India

SEZ or any other free trade zone should not be viewed as a tool to generate employment. Studies show that even small countries like Philippines has created 1.1 million jobs through these economic zones (KPMG Report, 2004) but despite being the first country to have EPZ in Asia, India failed to achieve a high employment rate. Dysfunctional policies, regulations, lack of single window clearance facilities, poor attitude of the officials, centralized governance, stringent labour laws, poor physical and financial infrastructure, all accounted for an undesirable investment climate and thus EPZ failed to create employment. SEZ should have witnessed much higher growth in exports and employment but it is not happening either. If SEZ policy is really an example of decentralized governance, is it capable to strengthen our physical and financial infrastructure and if single window clearance facilities are no longer a dream, all these issues and concerns have been emphasized in the last section.

Generally, it is argued that the SEZ concept is attractive because it is much easier to resolve the problems of infrastructure and governance on a limited geographical area than it is to resolve them countrywide. On the contrary, the performance over the last five years of these privileged enclaves indicates the failure of this scheme. The zones cannot be insulated from the broader institutional and economic context of the country and be treated as an economy within the economy. Zones are a part of the economy and require overall improvement in the investment climate to ensure success in the long run. They should not, therefore, be viewed as an alternative to the overall development model. This is perhaps the reason why SEZs failed to fulfill the role of engines of economic growth in most countries on a sustainable basis.

Section – III

A comparative study of Chinese SEZ policy

3.1 SEZs in China

The development of Special Economic Zones is one of the highlights of remarkable Chinese economic achievements. The Development of Chinese Special Economic Zones dates back to 1980's. It is different from Indian practice: SEZ in China is classified in two levels by their scales. SEZ is the whole city even whole province opened to special financial, investment and trade policy, while Economic and Technological Development Zones **(ETDZ)** is a relatively small piece of land earmarked in coastal and other open cities for industry and trade development.

As early as 1980, under the opening-up and reform policy, the Chinese Government set up the first group of Special Economic Zones in Shen Zhen, Zhu Hai, Shan Tou and Xia Men, all of which are located in costal areas of Southeast China, followed by other 10 costal cities, Hai Nan Province and Pu Dong area in Shanghai as the second group. To further open to the outside world and to spread successful experiences of SEZs, at the beginning of 1984, the government decided to establish ETDZs along coastal line on the basis of successful experiences of and favorable policies granted to the SEZs in the previous period. Consequently, China's first group of 14 National Economic and Technological Development Zones (NETDZ) were established from 1984 to 1988 successively. The distinguishing features of Chinese SEZs are their large size, investment friendly customs regime, flexible labour laws, liberal policy for DTA access, attractive package of incentives and delegation of powers in favour of provinces and local authorities for managing the zones.

3.2 Comparing Chinese SEZ policy with India

In spite of the fact that India was a pioneer in creating one of the worlds's first export processing zones at Kandla in 1965, EPZs have never had much impact on India's export performance. Tariff exemption schemes have tended to be excessively complex and encourage a 'licence raj' mentality at the operational level. Both economies are large emerging markets that had rather similar profiles in 1978. Today, China ranks number one as the world's preferred foreign investment destination. Closer examination of the FDI statistics suggests that India's performance has been abysmal in comparison to China. India lags behind for a number of reasons. These include a high tariff regime, poor infrastructure (power, ports, roads and railways), and a regulatory system that is too often not business-friendly and inflexible labour laws. In this section a comparison has been done between Chinese and Indian SEZ policy on different parameters like tax incentives, labor laws, FDI inflow, employment and export performance.

First, consider the size of the proposed SEZs. Chinese SEZs are like townships. India has not gone that far, but according to the SEZ guidelines, the area of an SEZ should be 1000 hectares. It is being argued that large sized SEZs can perform better as they will have a larger scale of economy but on contrary to that the best performing SEZ in Mumbai has an area of 93 acres only. It is being considered that one of the china's success factors was large size of SEZs. For instance, entire Hai Nan Island has been declared as SEZ with an area of 34,000 Sq. km. Table 3.2.1 below shows the size of all five existing SEZs in china.

Table: 3.2.1 Size of Chinese SEZs

SEZ	**Area (Sq. KM)**
1) Shenzhen	327
2) Zhuhai	121
3) Xiamen	131
4) Hainan	34000
5) Shantou	234

Source: Kumar, 2003

There is no doubt that SEZs have an edge over rest of the economy in terms of investment friendly environment and it's quite obvious that if we have an investment friendly environment in a larger area, economy would do well. Rather than applying the theory of having larger scale of economy we should focus on an overall hassle free environment for export and this can be done only by extending the SEZ policy to whole country where every small and big export oriented manufacturers will have the access to business friendly environment. One counter argument to this proposal might be that SEZ policy in India is being implemented on a pilot basis, and government can extend this policy to whole country if SEZ works as a tool to bring economic reform. But unfortunately SEZ policy nowhere talks about extending the same hassle free system to rest of the country. It means that carrying out businesses in hassle free environment would still be a dream for rest of the country, so infrastructure else where in the country would not improve. The performance of SEZ also depends on the inner infrastructure and how can we think of a great performance from SEZs when rest of the economy still suffers from the same unfriendly environment.

SEZ's were established by the China to encourage foreign investment, bringing jobs, technical knowledge, and future tax revenues in return for significant tax concessions at start-up of the operations and over a number of years. The biggest benefit to the investor is significant tax concessions early in the project. Tax concessions offered to a manufacturing startup in Chinese SEZ are:

- No tax during start-up years before making a profit
- The first year that any company makes a profit starts the "Tax Clock" and is year one
- The first and second year after the tax clock starts, there is no tax.
- For years three and four, there is 1/2 of the normal tax rate.
- In the fifth year, the company pays the full normal tax rate

In terms of tax benefits we are ahead of china. In SEZ policy tax benefits has been increased in comparison to EPZ but the failure of EPZs indicates that tax benefits can't alone boost the FDI and export performance. Table 3.2.2 below compares the performance of these two countries.

Table 3.2.2: Comparison of SEZ performance

	China	India
Share of SEZs in total export	23%	5%
Employmnet(Direct) generated through SEZs	2 million	0.1 million
FDI inflow through SEZs	US $ 60 billion	US $ 2 billion

Source: KPMG report, ministry of commerce and industry (GoI)

The contribution of Chinese SEZs to the country exports is in the range of 15-23%. According to available statistics, the share of SEZ exports to country exports in 1997 was 23% (i.e. approximately US $ 42 billion). Overall, all the zones put together have played an important role in the overall growth of the Chinese economy. These zones taken together employ more than two million people directly and approximately 16 million overall (both direct and indirect). Cumulatively, 20% of the total foreign direct investments into China have made its way into SEZs (i.e. approximately US $ 60 billion till date). Performance of SEZs in these two countries should not be compared just on the basis of export and other figures because size wise Chinese SEZs are much larger than Indian SEZs. But even in performance (export, employment) per Sq. KM China witnessed higher rate of growth and it was possible because of their liberal framework of SEZ policy.

As regards labour laws, it is difficult to imagine that a communist country like China has relaxed these laws by allowing a hire and fire policy for the SEZs. This single measure went a long way in attracting foreign investment to these zones. After investors gained confidence in the productivity of Chinese workforce, the hire and fire policy was substituted by the contract system. There is ample justification for adopting in India a flexible labour policy in India, not just for these exporting enclaves but also for rest of the country. Rigid and outdated labour laws hinder the economic development and it sets the rationale for having a labour reform. According to section 5B of the labour code any registered firm, that is employing more than 100 people, is required to seek permission from the state government to retrench its workforce. The country budget of March 2002 promised a change in the legislation to raise the level to 300 but due to coalition government it never happened. The result is that formal-sector firms (those that are registered and that pay their taxes) loath to take on new employment, and the vast majority of India's employment is informal, in small, tax-evading, inefficient enterprises. The policy in India on these critical issues is lukewarm. It just mentions that the laws of the land will apply and that the zones can be declared as public utilities under the Industrial Disputes Act. Merely declaring SEZs as public utilities will, however, not serve much purpose as seen in the EPZ experience.

The radical difference in the attitude of the Indian and Chinese governments on this matter is reflected in the recently published investors guide for Special Economic Zones in India. It states 'the labour laws of the land will apply to all units inside the Zone. However, the respective State Governments may declare units within the SEZ as public utilities and may delegate powers of the Labour Commissioner to the Development Commissioner of the SEZ' (Ministry of Commerce and Industry, 2002, p.15). In China, the right to hire and fire has been enshrined in SEZ regulations since 1982. Moreover, in India there are strict regulations stipulating that contract labour is only allowed work of a temporary nature. By contrast, the World Bank survey (2002b), estimates that in Guangzhou firms employ more than 20 per cent of the labour force as non-permanent workers. Of course many Indian employers find ways round the regulations through outsourcing and less formal means but the current system undoubtedly reduces flexibility.

China made the provincial and local authorities act as partners and stakeholders by delegating them powers for approving foreign investment. The SEZ authorities in China can approve investment proposals up to $30 million. This has been a significant feature of the Chinese policy and a key contributor to the success of SEZs. The Indian policy only enables the State governments to set up SEZs, but does not empower them to approve investment proposals. These powers have been vested with the development commissioners concerned who represent the Central Government. This will result in centralization of work in their offices. Government boasts of decentralizing the whole process and talks about single window clearance but anybody who goes through the SEZ act can figure out how complex and centralized this policy is. Last section of this research paper critically analyzes the 'so -called' decentralized nature of the SEZ policy.

Another ticklish issue is involvement of local government. Unless the State and local governments are directly made responsible for the management of SEZs and approving investment proposals, their political leadership and bureaucratic set up may not have any incentive to push the initiative forward. But in India all the important decisions are being taken by central government China has gone a step further by delegating powers to the local authorities. The local authority manages Shenzhen SEZ, which has the highest export turnover.

3.3 Current scenario in China

Over the last five years the GDP growth of china has been near about 10% and SEZs is being viewed as an engine for this rapid growth. Higher GDP rate can be considered as one of the major success of SEZ policy but regional disparities as an outcome of this policy has forced China to rethink and restructure this policy. Per capita income in the richest city is over 50 times per capita income in poorest city. Awarding a privileged status to some zones at the cost of others is responsible for this higher disparity. For instance, china had received the cumulative amount of US $ 128.1 billion of FDI between the year 1979 to 1995 and the coastal areas accounted for over 90% of all the FDI received in this period. It might be argued that there is no harm in developing country in pockets but how we can forget that these areas were developed by tax money paid by everyone. Government had to forego tax revenues as tax concessions were the main attracting features. All the tax revenue lost due to SEZ was/is being recovered through taxes from rest part of the country and resultantly all tax payers end up paying higher tax but the benefits are available for very few of them. I see this as the one of the main causes for high income disparity in China. To combat this problem even China has given emphasis on balanced development and tax benefits accorded to foreign investments in the SEZs has been partially lifted.

India's tax and tariff structures are still anti export. India's high overall tariff rates, especially tariffs on intermediate products that are used by exporters, impose a heavy indirect tax on export competitiveness. Deregulation of the private sector is perhaps one of the most critical areas in the context of India's reforms. Since almost 90-plus percent of the workforce is in the informal sector, it is of utmost importance to deregulate the private sector so as to get the unorganized sector workforce in the mainstream. Workers in large firms in the formal sector have a virtual guarantee of continued employment according to the Industrial Disputes Act. For firms of 100 employees or more, reductions in the workforce must be upon the permission of state government, which is almost never granted. Remarkably, loss-making firms are also not allowed to close their operations without government consent. The results of India's highly regulated labor markets have been devastating. Formal-sector employment in India is shockingly low, in large part because so much urban employment is carried on outside of formal registration. Out of a total labor force of around 406 million, formal sector employment accounts for only 28.1 million. Of this, 19.4 million works in the state sector (state enterprises and public administration), and just 8.7 million works in private firms with formal employment. Indeed with a more open and deregulated economy (economy is not just SEZs), India may well be in a position to perform as China has done over the last two decades.

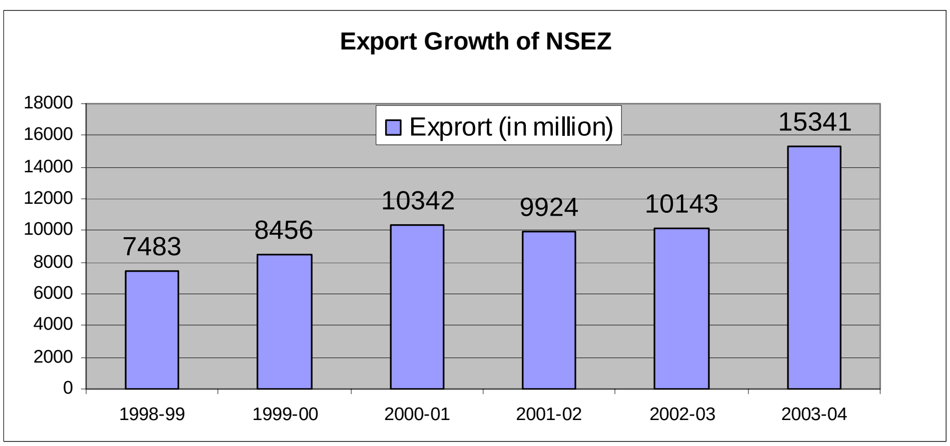
SECTION- IV

CASE STUDY: NOIDA SPECIAL ECONOMIC ZONE

4.1 Introduction

Noida EPZ was established in 1984 and attained the status of SEZ in the year 2000. Based on their share in exports, past performance and potential for growth, software and gem & jewellery have been identified as the thrust areas. Spread in 310 acre, NSEZ is just after SEEPZ in terms of export performance. NSEZ's proximity to Delhi sets it apart from other SEZs. Being close to national capital it has an easy access to skilled manpower, abundant managerial and technical expertise. With 151 units in operation, NSEZ contributed 30% of total exports from SEZ in the year 2004. It employs 19,857 people and per unit employment is 131. In terms of per unit employment SEEPZ and MSEZ are ahead of NSEZ with 239 and 150 employee per unit respectively. Units in NSEZ get the tax benefits according to SEZ act but at the same time they have been exempted from the payment of stamp duty, trade tax and entry tax. Noida has witnessed higher growth in export in comparison to other SEZs. The figure 4.1.1 shows the export growth of NSEZ:

Figure 4.1.1 Export growth trend of NSEZ



Source: NSEZ Authority

The total government investment in NSEZ is Rs 78 crore while the private investment is of 650 crores. NSEZ has the highest private investments and the reason for this is better business opportunities due to its proximity to Delhi. Another important factor is incentives given by the state government. Over the years exports in textile and hardware has been declining but gems & jewellery has witnessed a very high growth and in the year 2003-04 the total contribution was 49.87% in total exports from NSEZ. The table below summarizes the contribution of different sectors in total exports.

Table: 4.1.1 Contribution of different sectors in exports from NSEZ

Sector	Exports (Rs. Million)				
	1999-2000	2000-01	2001-02	2002-03	2003-04
Textile/Garments	1341	1388	1199	990	990
Hardware	1660	2697	885	739	930
Software	1393	1786	1906	1787	1980
ENGG. Goods	1201	1014	1184	1374	1640
GEM & Jewellery	1295	1928	3015	3437	7650
Chemical & Pharma	462	329	207	238	310
Leather Products	127	88	100	53	50
Plastic/Rubber/Synthetic	295	269	287	229	230
Miscellaneous	682	843	1141	1296	1560
Total	**8456**	**10342**	**9924**	**10143**	**15341**

Source: NSEZ Authority

4.2 The reasons for NSEZ's success:

A) **Proximity to Delhi:** One of the prime reasons of NSEZ's success is its proximity to Delhi. Noida has better transport and other infrastructural facilities in comparison to others SEZ. Noida was developed as an industrial area and therefore, the whole environment is business friendly. Noida is just 24 KM away from Delhi and it comes under national capital territory (NCT), so in terms of administration, infrastructure and business opportunities NSEZ has an edge over other SEZs.

B) **Special benefits given by the U.P. government:** It has been discussed in previous sections that the tax benefits are the key determinants in attracting investments. To woo the investors U.P. government has exempted SEZ developers and units from some state taxes as well and it has resulted in higher private investments in NSEZ Exemptions from the payment of entry tax, trade tax and stamp duty makes NSEZ the most sought after destination for setting up the units. Due to these exemption units in NSEZ export more to reap the benefits given by the state government at the fullest.

Section – V

Policy Analysis: A Critical Approach

Without doing the cost benefit analysis when a government establishes any economic policy which affects all the people in a direct or indirect way, it becomes important to raise some basic questions like whether the benefits of that policy would outweigh their costs, is it good for the country in the long run? SEZ policy has been enacted by parliament but ironically no cost benefit analysis was done before announcing it. As discussed earlier the prime objective of this scheme is to boost the export sector and a package of fiscal and non fiscal incentives are being offered to developers and units to achieve the objectives. One way to assess the rationale for having SEZ policy is to investigate what would have been the performance of the economy in the absence of this policy. Anticipating this would not be an easy task. Export performance of our country has been abysmal and there was a need to take some measures but according to me, preferential treatment should be the last measure and firstly any government should root out all those evils which are hindering the growth of export or for that matter whole economy. Rigid tariff regime highly regulated labour market, centralized governance are some major problems which obstruct the growth of the export sector and this also makes the investment climate unfriendly. Deregulating the labour market and decentralizing the whole process should have been the first priority of the government and making the whole country hassle free for investments and business opportunities would automatically boost the export sector. Establishing SEZs is a very complex task encompassing a wide range of policy, legal and regulatory issues. SEZ policy was praised initially as a well drafted policy but inter ministerial conflicts, heavy economic costs and recent cases of migration from DTA to SEZs actually highlights the blind spots of its designers.

5.1 Heavy Economic Costs

According to SEZ Act 2005, the firms are eligible for getting an extended Income Tax holiday for 15 years. Firms and developers have also been exempted from excise duty and custom duty. A loss of Rs. 39,704 crore of duty under export promotion schemes during 2003-04 (CAG Report, 2004) which accounts for 82% of customs duty collected that year gives an idea of how costly this whole affair is. According to an internal assessment by the

Finance Ministry, the Government may have to forego about Rs 90,000 crore in direct and indirect taxes over the next four years on account of SEZs.

5.2 Corporate Welfare

Very recently an article written by M.Bhardwaj appeared in 'Business Standard' which alleges that Haryana government acquired over 1700 acres of land from farmers at Rs. 300 crore and offered this land to Reliance for 360 crore in the name of SEZ while it was estimated that land was worth 5,000 crore. This is a perfect example of corporate welfare. It's true that the value of land goes up drastically when market anticipates the introduction of any such scheme into that particular area but taking away the land from farmers at a much lower rate can't be justified. According to the SEZ Act any state government can set up SEZ jointly with private sector. This can be called public private participation. Theoretically everything sounds good, so where is the problem. Now if any company has link with top politicians of a state, the possibility of favoured treatment can't be ruled out. Even in terms of incentives state can also offer a package of tax benefits. Imagine a situation where two firms which produces the same good, are operating from two different states and one of them gets an edge over another just because of preferential treatment by the state. Would you call it a fair competition? SEZ act enables the state government to offer land at a much lower rate and to provide extra incentives and what do we expect that the state governments would not misuse these powers?

5.3 Migration from DTA to SEZ

To avail all the facilities and incentives offered by SEZs, small firms and even big companies are shifting to these privileged enclaves. SEZs have encouraged inward migration. One of the prime objectives of this policy was to attract FDI but the share of FDI in investments in SEZs is very low and due to inward migration very few new manufacturing units have been set up in the SEZs.

5.4 Real Estate Play

State governments are offering land to SEZ developers at concessional rates. For real estate developers SEZ policy has come as an opportunity to grab the scarce land near cities. Ideally SEZs should be established in remote areas but due to lack of infrastructure the concentration of SEZs are near by cities. According to SEZ Act at least 25% of the total acquired area would be processing area and in the remaining area developers can build commercial complexes, malls, hospitals, hotels, educational institutions etc. Minimum area requirement for setting up SEZ is 1000 hectares and according to SEZ guidelines developers get a tax break even on all the buildings on the 750 hectares. On going real estate boom has shifted the focus from export to building residential complexes and commercial malls. Developers can always make huge profit from selling or leasing the buildings and this is where real estate play comes in. Land deals and compensation payments are known to be hot-beds of corruption so no wonder if farmers are being displaced from their place in the name of SEZ without giving adequate compensation.

Conclusion

Considering the need to boost export sector and attract FDI, government announced this policy but ironically the performance of SEZs in exports highlights the failure. When government should liberalize overall policy, government has decided to focus on one or two areas. The real attraction of SEZs is the tax holiday promised and to grow the business in hassle free environment firms are just shifting to these privileged enclaves. To compete with China a package of fiscal and non fiscal incentives are being given but this has been overlooked that tax benefits in china’s SEZ were available only to foreign investments, not exports. All exemptions and fiscal incentives should go in the process of overall tax and labour reform. Giving preferential treatment to any particular area in the name of exports can’t be justified in the democratic set up. Even if government wants to continue with this policy, only developers should be given the tax benefits if they are developing any SEZ in the remote area. The whole process is still centralized and government should minimize their role.

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<u>Annexure-1</u>

(List of all the fiscal and non-fiscal benefits given to SEZ developers and units)

i. 100% income tax exemption for a block of five years and an additional 50% tax exemption for two years thereafter

ii. 100% FDI in the manufacturing sector permitted through automatic route, barring a few sectors.

iii. External commercial borrowings by SEZ units upto US$500 million in a year without any maturity restrictions through recognized banking channels.

iv. Facility to retain 100% foreign exchange receipts in Exchange Earners' Foreign Currency Account.

v. 100% FDI permitted to SEZ franchisee in providing basic telephone services in SEZs.

vi. No cap on foreign investment for small scale sector reserved items.

vii. Exemption from industrial licensing requirements for items reserved for the SSI sector.

viii. No import licence requirements

ix. Exemption from customs duties on import of capital goods, raw materials, consumables, spares etc

x. Exemption from Central Excise duties on procurement of capital goods, raw materials, consumable spares etc., from the domestic market.

xi. No routine examinations by Customs for export and import cargo.

xii. Facility to realize and repatriate export proceeds within 12 months.

xiii. Profits allowed to be repatriated without any dividend-balancing requirement.

xiv. Job work on behalf of domestic exporters for direct export allowed.

xv. Subcontracting both domestic and international is permitted; this facility is available to jewellery units as well.

xvi. • Exemption from Central Sales Tax and Service Tax

• Facilities to set up off-shore banking units in SEZs.

• Exemption from duties on import /procurement of goods for the development, operation and maintenance of SEZ.

• Income tax exemption for a block of 10 years in 15 years.

• Exemption from Service Tax

• FDI to develop townships within SEZs with residential, educational, health care and recreational facilities permitted on a case-to-case basis.

Annexure – 2

Zone wise export performance of five years

ZONE	2000-01	2001-02	2002-03	2003-04	2004-05 (P)
KSEZ	527.89	475.98	729.29	1018.82	1060.14
SEEPZ	5193.74	5225.6	6083.02	7832.81	8298.59
NSEZ	1034.2	980.41	1001.17	1534.17	4266
MSEZ	690.84	762.59	822.35	1037.96	1376.91
CSEZ	304.3	258.5	270.42	298.91	462.99
FSEZ	519.97	923.63	512.39	825.34	569.15
VSEZ	219.08	250.98	357.27	435.97	579.27
Surat	62.28	311.86	280.71	869.9	1539.72
Manikan chan	Nil	Nil	Nil	Nil	95.94
Jaipur	Nil	Nil	Nil	Nil	5.27
Indore	Nil	Nil	Nil	Nil	55.02
Total	**8552.3**	**9189.55**	**10056.62**	**13853.58**	**18309**