# Indian Institute of Advanced Studies, Shimla

# National Conference on Special Economic Zones

**Sept 18-20, 2008,**

**Shimla**

# Special Economic Zones in India: Some Debatable Issues

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*In association with*

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## Abstract

***The Paper highlights and discusses some issues that have been extensively debated in the discourse on Indian SEZs. It gives a snapshot of Indian SEZs, analyses their rationale, and outlines the policy framework in the areas of export promotion, size and land acquisition, provision of infrastructure, tax concessions and flexibilities in the policy environment. It arrives at three broad conclusions. Firstly, while there are strong economic arguments in support of special economic zones, their linkage to exports constitutes something of a red herring. Secondly, using tax incentives as a proxy for tweaking the policy environment is fraught with long-term hazards. Thirdly, ifs and buts notwithstanding, any policy that leads to accelerated investment in infrastructure and manufacturing on ground needs to be supported in view of the special role played by manufacturing, and by extension modern services, in ramping up economic growth and labour productivity.***

# Special Economic Zones in India: Some Debatable Issues

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## I. SEZs in India: A Snapshot

1. Special Economic Zones can be described as enclaves typically located in developing countries that are insulated from the domestic policy environment and, in addition, given fiscal concessions for promoting exports. India was amongst the first countries in Asia to set up special export enclaves with the establishment of the Export Processing Zone (EPZ) in Kandla in 1965. Unlike several other Asian countries, most notably China, these enclaves did not contribute substantially to India's exports, until very recently. Total (physical) exports from SEZs stood at Rs. 13854 crore in 2003-04, and 22840 crore in 2005-06, equivalent to just 2.5% of the country's projected merchandize and net invisible exports.

2. The Special Economic Zones (SEZs) Policy was announced in April 2000, and from 1.11.2000 to 09.02.2006 SEZs functioned under the provisions of the Foreign Trade Policy, with fiscal incentives given through provisions in relevant statutes. There was a comprehensive policy overhaul with the passage of the Special Economic Zones Act, 2005, following which there has been a major spurt in economic activity and exports in SEZs.

3. It was not so much the novelty of the concessions, but the fact that these concessions were legislated, and not simply acts of executive largesse that could be withdrawn anytime, that elicited a powerful investment response. Exports from SEZs increased by over 50% in 2006-07, and by another 93% in 2007-08 to touch Rs. 66638 crore. They are projected to increase by another 89% in 2008-09 to Rs. 125950 crore, equivalent to about 10% of the country's projected merchandize and net invisible exports. Of the total employment of 3.5 lakhs generated in SEZs, over 60% was created after February 2006, following the implementation of the new Act. Similarly, of the total investment of Rs. 81093 crore in SEZs as on June 30, 2008, 95% was made after February 2006. The Commerce Ministry expects investment in SEZs to cross Rs. 200,000 crore and employment 800,000 by March 2010. 513 SEZs, covering an area of 625 square kms, have been formally approved, while 250 have actually been notified as of August 11, 2008. Another 138 have been approved in-principle.[1]

## II. The Case for SEZs

### Kaldor's Law

4. What is the economic logic for such export enclaves? According to Kaldor's law GDP growth bears a positive relation to manufacturing growth on account of the returns to scale and

[1] Ministry of Commerce figures at ***http://sezindia.nic.in/.*** The projections for March 2010 were made by the Commerce Secretary at a seminar, and cited in ***The Financial Express***, New Delhi, August 22, 2008.

associated productivity gains.[2] During the colonial period enforced free trade constrained the rise of modern manufacturing in developing countries, at least till the inter-war period that saw some rise in tariffs and a weakening of communication links with industrializing Europe.[3] Growth in the colonies (white settler colonies excepted) was either stagnant or extremely low.[4]

5. In the post-colonial period newly independent developing countries promoted manufacturing within a largely inward 'import substitution industrialization' (ISI) framework. While the growth of manufacturing did impart some static gains to scale that raised growth rates above those attained during the colonial period, per capita incomes between developed and developing countries continued to widen since the largely autarchic model limited the dynamic gains to scale that accrue through competition and associated technological progress.

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[2] Kaldor, N. ***Causes of the Slow Rate of Growth of the United Kingdom***. Cambridge University Press (1966). The Indian data also shows that rise in growth rates was associated with a sharp decrease in the relative contribution of agriculture (and allied services) to growth.

**GDP at factor Cost Constant Prices Base 1999-00**

| | Average annual GDP (compounded) growth rate | Contribution of agriculture |
|---|---|---|
| 1950/51 to 1979/80 | 3.40% | 24.50% |
| 1980/81 to 1989/90 | 5.40% | 21.50% |
| 1992/93 to 2001/02 | 6.10% | 14.50% |
| 2002/03 to 2007/08 | 8.80% | 10.70% |

[3] Thus during the inter-war period Indian manufacturing grew at a rate well above world average, and grew faster than that of the UK, US and Germany. The growth was, of course, on a small starting base. Morris D Morris, ***The Growth of Large-Scale Industry to 1947*** in Dharma Kumar ed., **The Cambridge Economic History of India, Vol. II, 1757-2003** Orient Longman Private Limited (2005), Part II, Chapter VII, p. 609.

[4] According to Angus Maddison India's per capita income increase by just 16% in real terms in the period between 1870 and 1947. Alan Heston's estimate is twice at high, but even this gives a compounded annual growth rate of just 0.4%. Alan Heston, ***National Income*** in in Dharma Kumar ed., **The Cambridge Economic History of India, Vol. II, 1757-2003** Orient Longman Private Limited (2005), Part I, Chapter IV, pp. 402-03. Angus Maddison, **Historical Statistics of the World Economy: 1-2003 AD** http://www.ggdc.net/maddison/Historical_Statistics/horizontal-file_03-2007.xls

6. The charge to narrow the per capita income gap between developed and developing countries through rapid growth was led by some East Asian economies in the seventies as they followed an aggressive outward looking model with manufacturing exports as their engine of growth.

7. With spectacular advances in information technology, services are also becoming increasingly exportable and software technology export parks, such as the highly successful STPIs of India[5], are supplementing manufacturing as objectives of export promotion in special zones.[6] It could be argued that services in a globalized world have scale and productivity advantages similar to manufacturing. The Indian SEZ Act consequently covers both manufacture of goods and rendering of services.[7]

## Kaldor's Law and Exports

8. Kaldor's law explains the special role played by manufacturing in enhancing growth and living standards. It is for this reason that Nicholas Kaldor also advocated a tax policy that favoured the manufacturing sector. From this it does not necessarily follow that manufacturing *exports* or even manufacturing enclaves should be incentivized. In the case of the early East Asian industrializers

[5] About 95% of India's software and associated services exports from India are from STPIs.
***http://www.stpi.in/Perform.htm***
***http://www.nasscom.in/upload/5216/IT_Industry_Factsheet_May_2008.doc***

[6] In view of India's putative competitive advantage in services, it is not at all surprising that about a third of total SEZ exports in 2007-08 was in the area of trade and services.
***http://sezindia.nic.in/HTMLS/Sectorwise-breakup-of-Physical-Exports-2007-08-from-SEZ-in-india.pdf***

[7] The Special Economic Zones Act No. 28 of 2005, ***Gazette of India, Extraordinary Part II-Section I dated June 23, 2005***. (Hereafter SEZ Act 2005). Para 3 (1).

exports had a special role to play since returns to scale were limited by the small size of their domestic market. This is not the case with either China or India that between them account for over a third of the human race.

9. There is, of course, a difference between potential market size, and actual market size that may be limited on account of low median incomes, which is indeed the case in both China and India[8] where a disproportionate share of the workforce continues to be engaged in low income agriculture and the informal sector. However, while low median incomes might explain why growth may be export led in some circumstances, it is not a compelling reason for a *policy bias* in favour of exports. By way of illustration, while there are certainly advantages in producing luxury BMWs over the Spartan Nano because of the greater value addition in the former, there is no good reason why government should tax poor Indians to incentivize selling BMWs to rich foreigners as opposed selling Nanos to poor Indians in the domestic market.

## Exports and BOP

10. A bias towards exports may nevertheless be warranted on account of balance of payment weaknesses, especially since an ISI

[8] According to a recent World Bank study, 36.3% of China's population and 75.6% of India's population live off less than $ 2 per day at 2005 PPP. Shaohua Chen and Martin Ravallion, ***"The Developing World is Poorer Than We Thought, But No less Successful in the Fight against Poverty",*** Policy Research Working Paper # 4703, World Bank, August 2008. Low incomes are directly related to low labour productivity. Despite lower income, domestic demand contributes much more to growth in India than China, with India running a merchandize trade deficit close to 10% of GDP. In 2006, domestic consumption accounted for 68.5% and 51% of GDP respectively in India and China. **(*United Nations Statistics Division*).**

model has an inherent anti-export bias through high trade barriers and overvalued exchange rates. It is not surprising, therefore, that export oriented manufacturing enclaves in developing countries originated during the autarchic phase as a means of earning scarce foreign exchange to balance trade – such as India's Kandla EPZ set up in 1965. However, they acquired critical importance as levers of growth only as part of the export led model of growth. The spectacular success of China's Special Economic Zones needs to be seen in this light.

11. China however has no compelling reason for incentivising exports over domestic sales on BOP considerations as it has a ballooning current account surplus. India, of the other hand, continues to run a huge merchandise trade deficit. However, much of this deficit is covered by 'invisible' income that limits the current account balance within a manageable range of 3 % (with high oil prices) to 1% of GDP that can be financed through capital inflows even after considering that some of these inflows are volatile. Both China and India are accumulating hard currency reserves on a scale that renders monetary management difficult. In these circumstances incentivizing exports on BOP grounds is not easily justifiable.

## Clustering and Competitive Advantage

12. In the case of both India and China, therefore, it could be argued that Government policy should be neutral between production for the domestic market and for exports. The case for incentivizing

manufacturing and services however remains on account of their special role in ramping up growth, employment, improving productivity and raising living standards. If general conditions in the economy are not conducive to accelerated growth of manufacturing there is a strong case for creating enclaves focused on economic activity that are insulated from the general policy environment. This is indeed the case in India, with its putative supply side constraints in infrastructure, both physical and social, rigid labour and exit policies and governance. Unlike what happened in China, it has not been possible to substantially insulate SEZs from the domestic policy environment to create an internationally competitive level playing field on account of differences in political systems. While it could plausibly be argued that in such circumstances tax incentives could be a proxy for such policy changes, this is at best a second best option and at worst could work to indefinitely postpone difficult decisions and make subsidized units dependent on State sops.

13. The competitive advantages of agglomeration and clustering are also well known.[9] Michael Porter has pointed to the competitive advantages of clustering through increases in productivity, innovation and stimulation of new businesses. The externalities generated by clusters are also imparted to the wider economy. Indeed, Michael Porter has argued that in the globalized world competitive advantage

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[9] Some well known success stories are the the US automobile production plants concentration in Detroit, the Silicon valley in California in the field of computer technology, Bangalore, in India, for software outsourcing,, and the Research Triangle Park, in North Carolina, for high-tech and biomedical businesses and a center research and development.

matters much more than comparative advantage based on received factor endowments. [10]

## III: Policy Structure of Indian SEZs

### Exports

14. According to the preamble of the SEZ Act 2005, it is "an Act to provide for the establishment, development and management of the Special Economic Zones for the promotion of exports and for matters therewith or incidental thereto". It would appear from this that the SEZ is basically a zone for export promotion. However, since exports include deemed exports to the domestic tariff area, physical exports need occur only to the extent that the net foreign exchange (NFE) balance is negative.[11] It has been argued that a physical export floor of say 51% should have been made mandatory, but that would have disadvantaged SEZs against EOUs that do not have any physical export targets. Since direct tax benefits can be availed only when physical exports take place, there are inbuilt disincentives against SEZs selling in the domestic tariff area. While indirect tax benefits are available on inputs, SEZ units are required to pay full customs duty on sales in the DTA, whereas EOUs pay concessional duties. Since the SEZ fiscal incentive structure is biased towards physical exports it is not surprising that over the last few years over 80% of the exports

[10] Porter, M. ***"The Competitive Advantage of Nations",*** (1990, Free Press).

[11] Rule 53 of The Special Economic Zones Rules, 2006, ***Gazette of India Extraordinary, dated February 10, 2006*** (hereafter SEZ Rules of 2006).

from SEZs have been in the form of physicals exports.[12] Indeed, in view of the comfortable FE reserve position, and problems arising out of their monetisation, it is arguable whether even a positive NFE clause is necessary.

15. Even as the fiscal incentive structure in SEZs is biased towards physical exports, the guidelines for notifying SEZs mention exports of goods and services as just one of six criteria to be considered while approving SEZs. Other criteria include additional economic activity, investment promotion, creation of employment opportunities, development of infrastructure and maintenance of the integrity of India.[13] While it could be argued that Para 5(1) of the Act must be read along with the Preamble, there is ample scope for hairsplitting in this regard.

## Size and Land Acquistion

**16.** Land acquisition for SEZs has generated heated political controversy, notably in Nandigram in West Bengal, where the state government attempted to acquire land, using the 'public interest' provisions of the Land Acquisition Act. This attempt was abandoned following extensive social unrest and violence.

**17.** Vast powers are vested with government in India, as in several other countries, for acquiring privately owned under eminent domain

[12] Physical exports from SEZs increased over 90% from Rs. 34615 crore in 2006-07 to Rs. 66638 crore in 2007-08, and this growth rate is expected to be sustained in 2008-09 as well. ***http://sezindia.nic.in/HTMLS/exp-frmsez-200607-200708.pdf***

[13] ***SEZ Act of 2005***, Para 5 (1) (a to f).

under the Land Acquisition Act. The compensation given is much more generous than what is given in China for similar purposes, but the 'fairness' is not only contestable in a democratic environment, but often falls short of market/replacement value. Moreover, the definition of 'public interest/purpose' is debatable where the objective is not to construct public infrastructure but privately owned projects. The Supreme Court has however recently ruled that land acquisition by the State for private parties setting up large projects that bring in foreign exchange, generate employment opportunities, and secure economic benefits to the State and the public at large could be construed as 'public purpose'. [14]

**18.** While a comprehensive resettlement and rehabilitation policy, including the issue of ensuring livelihood from the project to at least one person from each displaced family, is still to be worked out, with related legislation pending in Parliament, most State governments now seem to be veering around to the view that that it would be unwise to use the provisions of the Land Acquisition Act for the purpose of setting up SEZs, and that it should be the responsibility of the developer to acquire the land through private negotiations with the parties. However, in view of the extremely fragmented landholding pattern, the residual problem of how to handle a small minority that might not agree would remain. This problem was recently underscored by the controversy surrounding setting up of the Nano automobile plant by Tata Motors in Singur in West Bengal.

[14] The judgment in question was that of a Supreme Court bench comprising Justices CK Thakker and DK Jain concerning land acquisition for the Emaar integrated township and golf course project in Nanakramguda in Andhra Pradesh. http://in.news.yahoo.com/48/20080906/814/tnl-sc-nothing-wrong-if-acquired-land-us.html

While it might be prudent for the laws of the land to handle such cases through the judicial system rather than through government intervention, this could result in inordinate project delays.

**19.** In view of the controversies generated on account of acquisition of land for SEZs, including the issue of conversion of prime agricultural land for non-agricultural purposes, Government has set a ceiling on the optimum geographical size for multi-product SEZs at 5000 hectares. The minimum limit for multi-product Greenfield SEZs (not applicable to existing EPZs, EOUs converted to SEZs, and sector specific SEZs) has been set at 1000 hectares.[15] The State Governments have also been advised by the Centre that in case of land acquisition for Special Economic Zones, first priority should be for acquisition of waste and barren land and, if necessary single crop agricultural land could be acquired for the SEZs. Should a portion of double-cropped agricultural land be acquired to meet the minimum area requirements, especially for multi-product Special Economic Zones, the same should not exceed 10 per cent of the total land required for the SEZ.

**20.** Size restrictions are eminently debatable as they could constrain Indian SEZs in expanding to global scale and in competing with Chinese SEZs that are much fewer and bigger[16] with vast pools

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[15] ***SEZ Rules, 2006 - Amendment No.3: G.S.R.1744(E) dated 12th October 2007.*** However, in Assam, Meghalaya, Nagaland, Arunachal Pradesh, Mizoram, Manipur, Tripura, Himachal Pradesh, Uttaranchal, Sikkim, Jammu and Kashmir, Goa or in a Union Territory, the area can be two hundred hectares or more.

[16] The 250 SEZs notified to date cover cover a total of 293 sq. km, and 513 formally approved 625 sq. km. 138 SEZs given in-principle approvals would cover another 1156 sq. kms. In contrast, The Xiamen SEZ in China is 131 sq. kms, the Shenzen SEZ is 327 sq. kms, while the Hainan SEZ extends over 34000 sq. kms! ***http://sezindia.nic.in/HTMLS/groundrealities.pdf***

of labour residing within the SEZ area. Indeed, Chinese SEZs may be effectively considered to be becoming even larger because the entire country is tending to become one big exporting zone as SEZ policies are increasingly applicable to the wider economy. On the other hand, while the floor for certain categories of SEZs has been capped at just 10 hectares, even this could disadvantage small IT start-ups in particular in availing benefits under the Act.

## Infrastructure

21. The huge infrastructure deficit is one of the major constraints on manufacturing growth in India. Under the rules at least 50% of the SEZ area is to be utilized for productive activities[17], while the balance can be used for other purposes, including provision of infrastructural facilities such as residential accommodation, hotels, educational institutions, recreation facilities, shopping facilities, etcetera. Tax exemptions however are available only for those supporting activities and infrastructure necessary for productive activities specifically 'authorized' by the Board of Approvals. SEZs can now set up infrastructure in excess of the quantum approved by the Board of Approval, but no tax benefits would be available for unauthorized infrastructure.[18]

22. It is sometimes argued that this has the potential to attract real estate ventures to SEZs with little interest in productive activities. However, in view of the widely acknowledged infrastructural deficit in

[17] ***SEZ Rules, 2006 – Amendment No. 3.***
[18] ***SEZ Rules, 2006 - Amendment No.2: S.O.393(E) dated 16th March 2007***

the country, particularly in urban areas, a more liberal, rather than restrictive, policy on creation of fresh infrastructure is eminently justifiable even though permitting 'unauthorized' non tax-exempt infrastructure might add to the complexity of accounting. No duty concessions are available for the maintenance and operations of activities in the non-processing area. It may also be kept in mind that unlike China, where the infrastructure investment in SEZs is done by the State through taxpayer money, the entire infrastructure, including cost of land acquisition, is borne by the developers at market rates.

23. It should also be borne in mind almost similar benefits are in any case available to developers for infrastructure investment outside the SEZ. For instance, Section 80-I of the Income Tax Act extends direct tax benefits to infrastructure projects such as power generation/transmission/distribution, including cross-country natural gas distribution networks.

## Tax Concessions

24. SEZs have been given indirect and direct tax concessions under the SEZ Act of 2005.[19] While it is standard international practice and consistent with WTO norms not to export indirect taxes, exemption from corporate tax on profits from exports from SEZs has generated some amount of controversy even though such concessions are given to SEZs in countries such as China and Thailand. It is argued that such rebates may be construed as subsidy under extant WTO

[19] Chapter VI of the ***SEZ Act of 2005***. The Income Tax Act of 1961 has also been modified accordingly.

guidelines that can be countervailed by the importing country. There is also justifiable apprehension that with the termination of direct tax benefits under sections 10(A) and 10(B) of the Income Tax Act, fresh investment in SEZs may lead to diversion of economic activity from the DTA area, since direct tax concessions would still be available in SEZs. This apprehension relates particularly to the IT sector, especially since the bulk of recent SEZ approvals are in this sector.

25. The revenue loss from tax concessions is likely to be substantial. There are however widely differing assumptions and calculations in estimating revenue losses in studies done by ICRIER and NIPFP[20] as a result of which they have come up with vastly different results. There is lack of consensus regarding the quantum of direct and induced investment likely, how much of this is likely to be fresh/diverted investment, the allocation between manufacturing, township and infrastructure, the methodology for arriving at the value added output and profits, whether indirect benefits should also be considered in addition to direct benefits, the proportion of output that would be exported, and etcetera. There is even lack of consensus on applicable tax rates! Consequently, while the revenue loss from direct tax concessions given under the SEZ Act is likely to be substantial, it is virtually impossible to put a figure on the revenue losses, or even to determine whether these would fall short of or exceed the benefits.

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[20] Aradhna Aggarwal, ***"Economy-wide Impact of Export promotion Schemes: A Quantitative Assessment of SEZs, EOUs and STPI."*** Indian Council for Research on International Economic Relations, New Delhi. Working Paper No. 199. September 2007***. "Special Economic Zones Act. The Limitations and the Implications"***, National Institute of Public Finance and Policy, May 2006. M. Govinda Rao and R. Kavita Rao, ***"Special Economic Zones: The Objective Seems To Be Tax Shelters for Influential Groups",*** **Financial Express**, New Delhi, May 9, 2006. R. Kavita Rao, "***Special Economic Zones - Gain or Drain?"*** **Business Standard,** New Delhi, September 8, 2007. Sunil Jain, **"*Numbers Don't Ad Up.*"** **Business Standard,** New Delhi. September 3, 2007. Aradhna Aggarwal and Rajiv Kumar, "***De-Mystifying SEZs***." **Business Standard**, New Delhi, October 21, 2007.

26. Be it as it may, since tax concessions are part of the SEZ Act, it would be prudent to persist with the newly legislated regime for some time to inspire confidence amongst investors regarding stability of the policy regime.

## Flexible Policy Enclaves

**27.** Recent gains notwithstanding, Chinese SEZs have been far more successful in attracting investment and boosting labour intensive manufacturing exports than those in India[21] because the former are more flexible in their approach to insulating these enclaves from the domestic policy environment to ensure targeted outcomes. Perhaps nothing explains the reasons for these divergent outcomes more than Deng Xioping's overriding approach to SEZs: "for us to establish SEZs and adopt open door policies we must have a clear guiding ideology, that is 'Not to constrain but to release'".

28. In contrast, while it is well known that apart from infrastructure, Indian manufacturing is mostly constrained by limited access to cheap finance, inflexible labour laws and exit policies that make investment in India less attractive than places like China, similar policy flexibility has not been possible in India perhaps on account of differences in the political system and environment. For instance, Chinese SEZs provide for flexible labour laws with provisions for

[21] About 65% of exports from Indian SEZs are in two areas of India's traditional strengths, viz. services and import intensive gems and jewellery. Another 15% is accounted for by electronics hardware. ***http://sezindia.nic.in/HTMLS/exp-frmsez-200607-200708.pdf***

contract appointments for specified periods. While Indian SEZs have been declared as public utilities under the Industrial Disputes Act, it has not been possible to change labour laws exclusively for SEZs. Indian labour may be cheaper than China in nominal terms, but not when controlled for skill levels (because of much lower investment in human capital) and inflexibility in labour laws. Winding up processes for companies are also complicated and protracted and can deter investors. While there are provisions in the Act to set up International Financial Centers where domestic financial regulation would not apply, these have still to see the light of day.

## IV: Concluding Remarks

29. Three broad conclusions could arguably be derived from the earlier sections of this Paper. Firstly, while there are strong economic arguments in support of special economic zones, their linkage to exports constitutes something of a red herring. The linkage should be to internationally competitive environments instead. Secondly, using tax incentives as a proxy for tweaking the policy environment is fraught with long-term hazards. Thirdly, it appears impossible to arrive at consensual estimates of diversion of investment or costs and benefits on account of vastly differing assumptions. However, ifs and buts notwithstanding, any policy that leads to accelerated investment in infrastructure and modern manufacturing, especially labour intensive, on ground needs to be supported even at the cost of some revenue loss in view of the special role played by manufacturing, and

by extension modern services, in ramping up economic growth and labour productivity.

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* ***The author is Secretary, Prime Minister's Economic Advisory Council. These are the personal views of the author and not the views of the Council or government.***