Special Economic Zones in India – A Study

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Abstract: While the initiative on SEZs is laudable, its success will depend on how well the model is evolved and the implementation strategy worked out. It lays emphasis on export-led development strategy in accelerating economic growth. Strong political push and administrative support are the key determinants of success. Unless the State governments are directly made responsible for the management of SEZs and approving investment proposals, their political leadership and bureaucratic set up may not have sufficient effectiveness to push the initiative forward. As States were not associated in the past with export promotion activities, they have little idea of what is required to be done. For their meaningful participation, they need to have role clarity and a sense of identification with the scheme. Also, there is ample justification for adopting a near flexible labour policy, at least for these exporting zones, on the ground that they are exposed to uncertain international market conditions.

Introduction:

A policy was introduced in India in April 2000 for setting up of Special Economic Zones (SEZs) with a view to provide an internationally competitive and hassle free environment for exports. Units may be set up in SEZ for manufacture of goods and rendering of services. The units in the Zone have to be a net foreign exchange earner but they shall not be subjected to any pre-determined value addition or minimum export performance requirements. The policy provides for setting up of SEZ's in the public, private, joint sector or by State Governments.

SEZ's in India have been functioning under the provisions of the Foreign Trade Policy and were eligible for fiscal incentives as provided under the relevant statutes. In order to instil confidence in investors and signal the government's commitment to a stable SEZ policy regime, a comprehensive Special Economic Zone Act, 2005, has been passed. The Act came into force on February 10th, 2006.

It is reported that almost 45 to 50 per cent of the exports in the major economies of the world are channelised through SEZs. World-over, there are about 750 SEZs, China being the leader, with over \$300 billion exports out of their SEZs. Total SEZ world trade was worth \$950 billion in 2004. In order to promote Indian exports and earn foreign exchange, the Government of India too launched the second-generation reforms few years ago with SEZs being a vital initiative in that direction. While 8 of the existing Export Processing Zones were converted into Special Economic Zones, the new initiative also called for setting up of new SEZ's in the public, private, joint sector or by state governments. As a result, approval has been given for setting up of over 117 SEZs in various parts of the country

Status of SEZs

There are 341 SEZs so far approved spread over several States and union territories with a committed investment of over Rs 1000 bn. This is expected to generate employment for over 0.5 mn people by 2009. Out of these, 61 are under establishment and 15 are fully functional. Seven new SEZs will shortly become functional. In the 15 functional SEZs, there are 811 operating units with investments of about Rs.18 billion and around Rs. 183 billion of exports from the SEZ's. The maximum exports were from SEEPZ SEZ, Mumbai. One of the important reasons for the delay in start-up as admitted by the Ministry of Commerce & Industry is the land acquisition problem.

Incentives for setting up units in the SEZs

- 100% foreign direct investment ("FDI") is permitted under automatic route to units located in SEZ (which otherwise require certain prior approvals)
- Tax benefits / holidays for any block of 10 years in 15 years
- No capital gains tax on shifting units to SEZ
- Exemption from customs duty and excise duty, service tax, central sales tax as well as local levies such as octroi, road tax etc.
- (There is a proposal for a probable exemption of VAT also.)

SWOT Analysis of Indian SEZs

Strengths

- Large NRI base
- Familiarity with Western concepts of business practices
- Western style legal redress system
- Low labour cost
- Large English speaking workforce
- Huge untapped potential in terms of resources, industrialisation and modernisation.
- Large and growing domestic market

Weaknesses

Indian SEZ will have to comply with all Indian labour laws & so labour indiscipline. The only ray of hope is that the Development Commissioner of the zone, who is appointed by the Ministry, will double up as the Labour Commissioner. This is expected to minimise the time taken to settle labour disputes.

The advantage for Export Processing Zones is that they can sell upto 50 per cent of their exports in the Domestic Tariff Area (DTA) at half the rates of customs duties, whereas SEZ manufactures can sell in DTA only on payment of full duties. DTA sale is a very important option for EOU/EPZ/SEZ units, as the international markets are not always booming or lucrative.

- Poor infrastructure
- Inadequate institutional support

Opportunities

- Undertake overall infrastructure development
- Realistically establish competitive advantages in SEZs
- Encourage investments by NRI in SEZs
- Lower the high transaction costs to exporters
- Capitalise on English speaking population
- Tap the advantages of WTO
- Increase investments in core strength areas especially in IT and software products and services

Threats

- The pressure to quickly reform the domestic economy, build a better infrastructure and simplify procedures is very strong. Land Acquisition may involve some difficulties.
- A Committee headed by Development Commissioner and consisting of Director General of Foreign Trade (DGFT) officials and customs authorities will do the monitoring of performance of SEZ. This is specified, because, customs authorities and DGFT authorities are 'natural adversaries'.
- Local public support from farmers who would resist their land acquisition for SEZs is very critical and may require very judicious and selective approach.
- High cost of capital
- Affirmative action needs to be followed by private corporate sector as a part of growing demand for greater corporate social responsibilities.

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SEZs in China – a background

Unlike India, China was not forced to undertake reforms by any economic, political or social crisis. Rather, Chinese leaders, in spite of the significant achievements in the pre-reform era, realized that the economy was becoming increasingly costly in terms of suppression of personal consumption and that sustaining the past strategy will not be possible. There are four consistent themes in the Chinese approach to reform: gradualism, partial reform, decentralization and self-reinforcement of reforms. In almost all areas of reform, implementation has been spread over time, often several years and usually after experimentation. Such experiments were carried out in designated reform areas and after the results of trials were observed, these were then spread to other parts of the country. Thus by using the gradual approach and by not subjecting the state sector to major shocks, China has succeeded in avoiding severe social costs during its transition.

In China the SEZs have been used to test reforms that have subsequently been adopted nation-wide, with the result that today there is very little difference in policies, between, the SEZs and the general economy. In India, on the other hand, reform generally has moved ahead much slower and the SEZs have not been seen as the leading edge of reform.

Other factors such as labour legislation also play a role in India. Recent legislative moves by India to formally relax labour legislation within SEZs appear to be an important policy shift. While the nature of the changes to labour laws is in a transitional stage, indications are that the Chinese model of flexible contracts may be followed. The government has steadily moved India’s third-generation economic reforms forward. Certainly, labour laws are an important part of this process and affect everything from foreign investment decisions to social contracts between employers and workers. How the new legislation is received by all stakeholders including trade unions will undoubtedly affect the success or failure of India’s new SEZ policies.

SEZs were encouraged in China for a number of reasons: -

- China had to improve its infrastructure as also its industries, which had been stifled under state-run organisation.
- Low cost labour brought in manual, high labour intensive manufacturing and assembly operations.
- To upscale it's industrial capabilities which is delivering mixed results as corporations were looking to China as a source of low cost, low skill (or unskilled) labour.
- In the long term, SEZs were seen as a source of major tax revenue. However, in the short-term major tax concessions had to be offered to entice new investment

Advantages that SEZs in China had:

- Chinese SEZs were close to regions with a high concentration of overseas Chinese. Nearly 80 per cent of the investment (in SEZs) was from the overseas Chinese;
- Land is under the State control and hence could be given free or at a minimal cost to the units;
- Chinese SEZs had a geographic advantage with most of the SEZs located near the ports unlike the Indian SEZ’s that are more in the mainland;
- Chinese SEZs have strong ties with Hong Kong;
- Cheap labour and finally
- The Global reach of Hong Kong entrepreneurs.

China however now intends to phase out the SEZ in conforming with the dictates of the WTO as they give preferential tax treatment to foreign investors (foreign companies pay 15% as tax compared to a 33% tax on Chinese companies). WTO expects a level playing field for domestic and foreign companies.

Special Economic Zones – India Vs China

Indian policymakers' ongoing fascination with special economic zones was inspired by China's roaring success with this enclaves of galvanised

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production. New Delhi has sanctioned close to 200 SEZs. Guess, how many SEZs China has since kicking off the policy in 1979? Exactly six: Shenzhen, Zhuhai, Shantou, Xiamen, Hainan and Pudong.

Is India getting something wrong in its SEZ policy, or should we merely conclude that India will soon be 33 times as successful as China?

China's success in attracting oodles of foreign direct investment and becoming one of the top exporting countries of the world hinged on the careful implementation of its SEZ policy. More than two decades later, India, too, is trying to tread on the same ground.

Following are the areas where Chinese SEZs look different to Indian SEZs.

The Chinese started their liberalization and industrialization with the formation of SEZs in late 70s and early 80s. But in India, SEZ is being incorporated 15 years after the start of liberalization process. China had a Master Plan and an economic framework on how to build and proceed with SEZs, most probably inspired by the success of Asian Trading Hub, Hong Kong. The Chinese started building massive cities for manufacturing and industrialization under their SEZ framework. They also rolled out red carpet for foreign companies to build and operate from these SEZs.

Chinese SEZ initiative is government driven; Indian SEZs are driven by private sector. Dr. J J Irani, former CMD of Tata Steel and currently one of the powerful Directors on Tata Son's is of the opinion, "India should also go slowly like China has done". Mohandas Pai, Executive Director, Infosys Technologies said, “We should look at entire districts, with a port and a hinterland for SEZ. We should make large-scale investments in that so there is synergy, and we should ensure that manufacturing has priority, followed by services, but the vision has to be much larger. The way it is today, the vision is too myopic, and too small, and I am afraid we will not get the benefit that China did".

Lessons for India from China

Sops: Foreign-funded enterprises in the Chinese SEZs had to pay a uniform income tax of 15 per cent against the standard 33 per cent. Profits were tax-exempt for the first two years. And a maximum of 50 per cent of the profits between years three and five were taxable.

Different exchange rate system: China used a different exchange rate system in the initial years to kick-start investments (a unified exchange rate was introduced later in 1994).

Powers of Governor: The governor of the SEZs in China (equivalent to the Development Commissioner in India) has enormous powers, including the right to approve projects involving investments up to $ 30 million and also to grant concessions and incentives to foreign investors.

Flexible Labour Laws: Foreign companies in the Chinese SEZs enjoy tremendous flexibility in terms of labour laws. Employment is contractual, the wages – subject to a minimum between 120 per cent and 150 per cent higher than state-enterprise wages – are fixed by the companies themselves, and retrenchment is permitted.

Size: The Chinese SEZs are spread over a vast area of 330 sq kms. Even the small Pudong SEZ is spread over 1,30,000 acres.

Infrastructure: The SEZs of China are well connected with the latest telecommunication network and latest means of transport.

Conclusion

The Indian SEZ model, has been growing is strength and is becoming as much successful as the Chinese model. The Indian zones have had difficulty attracting foreign and domestic investors for a variety of reasons.

One of the important differences has been the lack of a natural gateway that could serve as a source of capital and a conduit for the movement of goods in the manner that Hong Kong and Taiwan function for China. India does not have a similar natural gateway, although Dubai and Singapore are fast taking on that role.

Another factor is the way in which Indian SEZs are designed and structured. The Indian variants tend to be smaller than their Chinese equivalents, sectorally focused (in sectors such as handicrafts, leather products, auto parts, apparel, electronics and IT services, gems and jewellery, food processing) and separated from their surrounding communities.

Chinese SEZs are large, multi-sectoral, and no longer have formal boundaries separating them from surrounding communities. These points up another difference between the Chinese and Indian approaches.

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