



INDIA'S SEZ POLICY

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Over the last few decades India has emerged as an economic giant. In 2000 the Special Economic Zone (SEZs) policy became part of a strategy to maintain high growth and promote India's manufacturing sector. However, India's current SEZ policy does little to strengthen India's economy. India should consider modifying its SEZ policy or abandoning it in favor of broader economic reform.

India has experienced dramatic economic growth in recent decades. To consolidate this process and expand the country's manufacturing capabilities, Special Economic Zones (SEZs) have been established across India. The question is whether these SEZs actually have contributed to the Indian growth story.

SEZs are geographic areas where investors enjoy beneficial tax and tariff policies. They can serve as tools for developing countries that wish to attract foreign business without having to undertake wider economic reform.

In 2000 the Government of India announced its SEZ policy and in 2005 the Indian Parliament passed the SEZ Act. The purpose was to increase exports, attract foreign direct investment (FDI), and create employment opportunities.

India is not new to the concept of export zones. It was the first in Asia to establish Export Processing Zones (EPZs). However, insufficient infrastructure, centralized administration and restrictive trade policies prevented EPZs from significantly contributing to Indian exports. With the SEZ policy operational, EPZs were incorporated into the SEZ framework.

The SEZ Act was designed to tackle some of the problems facing the EPZs. The Act encouraged larger zones and cut red tape with single window clearances by a Board of Approvals. It also decentralized the decision-making process by making it possible for states to set up SEZs. All units established within SEZs are exempt from tariffs, pay no income tax the first five years and only 50 percent in the following five, among other favorable conditions.

It was not India's own EPZ experience that prompted the central government to pursue SEZs on a much larger scale, but rather the perceived success of Chinese SEZs.

The People's Republic of China launched its SEZ policy in 1980. The following year Chinese SEZs accounted for

almost 60 percent of the country's total FDI. SEZ's share of FDI and exports steadily dropped as China reformed its economy, but the zones served as initial testing grounds for foreign investments and economic reform. Currently, several different types of zones operate alongside the original five SEZs, including a wide range of high-tech and service promotion zones. Together they contribute 12 percent of GDP, 26 percent of exports and 8 percent of FDI. Shenzhen is widely seen as a success story, while the verdict on other SEZs in China is mixed.

Comparing Chinese and Indian SEZs is popular but inappropriate, since the contexts in which the two SEZ policies were implemented differ widely. SEZs acted as vanguards of China's opening process; while the Indian SEZs were introduced a decade after economic liberalization began in 1991. India's SEZs should be examined through the specified goals of its own SEZ Act.

Evaluating the SEZs

India's SEZ Act states that SEZs should promote exports, create employment and encourage FDI. Under the Act, the SEZ Board has formally approved 584 new zones, in addition to the 143 currently operational.

Exports from SEZs have expanded dramatically in recent years. The SEZ share of total exports rose to 28 percent in 2011, exceeding that seen in China. SEZs were projected to create over two million jobs. It's ambitious but appears feasible since the zones employed over 676,000 by March 2011. Data of foreign investment in SEZs are limited, but for converted EPZs the foreign share of investments is approximately one third. These figures seem encouraging, but hide several problems.

First, the distribution of SEZs is highly skewed both in terms of sector and location. About 61 percent of ap-



proved SEZ units and an estimated 54 percent of employees are found within the IT/ITES sector. IT firms currently enjoy tax breaks in special “IT Parks” and SEZs offer a way to extend these provisions. Further, while exports from the SEZs surged last year, shipments abroad were virtually stagnant. This is either because the rise in SEZ export share is due to relocation rather than expansion or because the increase largely occurred within the service sector. This highlights the need for manufacturing within SEZs.

Moreover, most units within the newly approved SEZs are established by domestic investors. Some of them may have foreign backing, but the attraction of SEZ incentives for foreign investors seems to be limited.

During the political debate preceding the SEZ Act it was argued by some that the SEZ scheme should cover all states and that development should be inclusive. However, this ambition has failed to materialize.

Geographically the zones are concentrated in coastal states, including Gujarat and Maharashtra and Tamil Nadu, which are financially stronger. Andhra Pradesh is also leading in SEZ approvals, but a vast majority of these SEZs contain IT/ITES and are situated around Hyderabad, an already established IT hub. The situation is similar for Haryana and Uttar Pradesh, where SEZs are concentrated around the IT hubs of Gurgaon and NOIDA, both close to New Delhi.

SEZs do lead to a loss of fiscal revenue. Estimates of forgone revenue through taxes and tariffs vary greatly, but amounted to 51 billion rupees according to the government’s own figures. This is roughly one percent of the annual central government tax revenue.

Meanwhile, land acquisition by the states has become the most sensitive public issue surrounding SEZs. Protests have flared up across India, sometimes turning violent as seen at the protests in Nandigram, West Bengal. The new land acquisition problem is largely due to poor legislation. The Land Acquisition Act of 1894 gives states the right to acquire land if it is in the public interest, but all stakeholders

do not qualify for compensation and market value is vaguely defined. Last year a bill was introduced to replace this act, but SEZs were exempt from these provisions.

Moving Forward

The benefits of the SEZs are highly skewed in terms of geographic location and sector. Given the dominance of the IT sector, in which India already enjoys a competitive advantage, it is worth asking if generated economic activity is too costly, especially given the large amounts of fiscal revenue forgone by the government.

India could attempt to improve its current SEZ policy. It could adapt its approval process to attract more foreign investors and manufacturing companies by changing either the SEZ fiscal incentive structure or the directives of the SEZ Board. The creation of National Manufacturing and Investment Zones (NMIZ) could be seen as productive SEZ policy adaptation.

The other policy option is to divert focus from SEZs altogether and shift towards broader economic reform. To attract foreign investors and stimulate growth, overall business environment, physical infrastructure and access to a skilled workforce are more important than tax incentives.

To continue growing, India needs to encourage investments, create employment opportunities and improve welfare provisions. In its current form India’s SEZ policy does not contribute to these ends. The government should consider adapting its SEZ policy or abandon it altogether in favor of wider economic reform.

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