DISCUSSION PAPER

CUTS Centre for International Trade, Economics & Environment
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SEZs in India

Do SEZs Constitute an Optimal Economic Growth Strategy?

Introduction

Special Economic Zones[1] (SEZs) have been in the news over the last few years. Sometimes the debate is over the government view that concentrated economic activities and consequent economies of scale boost exports and at other times it ranges over the way in which sector specific SEZs have been developed. The argument in favour of setting up SEZs is that the incremental and concentrated investment and ensuing business activity in an identified area generate benefits to the economy in excess of those possibly generated from any alternative use of invested resources. The reason given is the mentioned economies of scale associated with the operations of SEZs. The cluster approach embodied in SEZs is characterised by concentrated development of infrastructure such as transport, telecom, power, etc. around geographically proximate production units implying such investment in such infrastructure yields an adequate rate of return. SEZs are thus thought to be a big driver of investment – both from India and overseas. It is also felt that these can give a boost to exports and employment generation.

India's policy of SEZs proliferation, however, recently come under severe criticism from various quarters, including some departments of the government (Ministry of Finance being critical of tax exemptions and incentives[2] granted to SEZ units), civil society organisations, the agrarian community (mainly as a protest against agricultural land acquisition) etc. Conflicts between the state and agricultural communities have also been witnessed at a few places.

The ensuing controversy is surprising in view of the tangible economic benefits from SEZs which have now come to occupy a prominent place in the government's export development policy. These contribute about 2 percent of India's gross domestic product (GDP), account for over one-tenth of the total exports and provides employment to over 0.5 million people. According to one estimate, by the end of 2017, SEZs in India will account for some US$213bn in physical capital, employ 14 million workers and generate US$350bn in annual export earnings. SEZs would contribute to housing space of three billion square feet (three million units) for 12 million people impart training and skills to both workers and entrepreneurs. The mentioned economies of scale and the implied enhanced attractiveness of investment would lead to an increase in the competitiveness of Indian firms at the global level. Given the tangible and intangible benefits, the sacrifice of resources in the bargain has been miniscule. The notified SEZs have led to acquisition of only 0.019 percent of the total agricultural land in the country.

What is then the source of the present controversy and the wide protests surrounding SEZs? These have emerged due to flaws in the design of the SEZ Act 2005, which came into force in early 2006. The act does not pay adequate attention to non-economic and social issues – it allows acquisition of arable and sometimes extremely fertile land with consequent adverse implications for food insecurity; it does not guarantee adequate compensation for farmers displaced by land acquisition; and finally it does not factor in environmental concerns arising from deforestation and waste disposal by established SEZ units.

To understand the basic issues and concerns raised by different sections of people, it would be useful to re-examine in detail the basic objectives[3] which led to the emergence of SEZs in India and also the benefits which have resulted from SEZs/Export Processing Zones (EPZs). This paper covers the evolution and the basic rationale behind establishment of SEZs/EPZs in India; analyses the tangible economic benefits associated with SEZs/EPZs especially in terms of investment mobilisation, exports growth, and employment generation; focuses on analysis of the basic economic and legal aspects that have made SEZs/EPZs proliferation in India a controversial issue; and concludes and makes some recommendations.

Evolution of SEZs in India

The basic rationale behind setting up of EPZs in India was that, exporting companies without access to inputs at globally competitive prices may be at a significant disadvantage in a competitive global market. The problems got further aggravated because of recurring bottlenecks affecting the general business climate in the economy which discouraged foreign direct investment (FDI) inflows. It was thought that EPZs would neutralise such disadvantages because of associated financial incentives, streamlined business administration and other encouragement for exporting activity.

India was one of the first Asian countries to recognise the effectiveness of the EPZ in promoting exports, with Asia's first EPZ set up in Kandla in 1965. It, however, deserves mention that EPZs were also motivated by the potential these offered for import substitution which often acted against outward economic orientation.

The evolution of EPZs in India can be divided into four phases. The initial phase from 1964 to 1985, witnessed the setting up of the first zone in Kandla in 1965, which was followed by a second one in Santacruz starting its operations in 1973. The EPZ policy, however, initially never appeared to be part of a coherent national strategy and its impact on the Indian economy was minimal. The policy was not effective in addressing issues related to administrative inefficiencies, rigid customs procedures for bonding and bank guarantees, foreign ownership and infrastructural shortcomings.

Incidentally, it can be recalled that this phase also witnessed the green revolution in India[4], which made the country less dependent on food grain imports.

The unimpressive performance of EPZs in the initial phase led the government to set up three committees. The committees, however, were not able to identify the real issues and problems faced by the EPZ units and despite their poor performance, made a strange recommendation for setting up of more EPZs in India.

The second phase, known as the expansionary phase, covered the period between 1985 and 1991 and witnessed the setting up of five more EPZs in India.

The third or consolidating phase lasted for about a decade till 2000. This phase witnessed the formulation of new measures and policies by the Indian government for revamping of EPZs, and led to relaxation of strict controls, liberalisation of provisions, and also simplification of procedures. During this phase, various types of units covering agriculture, trading, horticulture, re-engineering, and other agro-based processing units were granted permission to set up business units in EPZs.

The fourth phase relates to the period after 2000. This phase witnessed the formulation and implementation of the Export-Import (EXIM) Policy that led to introduction of a new scheme for setting up SEZs in various parts of the country. The EXIM Policy also introduced a scheme to convert all EPZs into SEZs. This finally led to enactment of the SEZ Act 2005, which came into force in early 2006.

Current Strength of SEZs in India

The latest revision in the SEZ policy took place in 2006, with permission granted subsequently to 558 such projects. Out of these, 315 have been notified in the official gazette. As of now, a total of 91 zones, with 2,263 units working inside them, are functional and account for a significant share in India's total exports. Of these, 43 are in information technology and related industries, 13 cater to multiple products, and 35 relate to specific sectors.

Box 1: Some Recent SEZ Developments that have hit the headlines

- The plans for a large multi product SEZ in Kalinga Nagar have been dropped by the Orissa government
- Maharashtra government has decided to reduce the size of the planned Maha Mumbai SEZ. Lately, farmers of Raigadh, near Mumbai, won a legal battle over land for the proposed SEZ against Mukesh Ambani
- The Finance Ministry and the Reserve Bank of India have expressed unhappiness with the SEZ policy on grounds of excessive exemptions leading to revenue loss and real estate speculation
- The Rural Development Ministry has objected to the large scale acquisition of agricultural land
- The International Monetary Fund (IMF) and the Asian Development Bank (ADB) have criticised the provided tax exemptions which have made SEZs 'business-friendly' rather than 'market-friendly'
- The Parliamentary Committee on Commerce has demanded a freeze on new SEZs pending a fresh look at the policy, ban on use of irrigated crop land, and a ceiling on use of land for SEZs and that too on lease rather than purchase
- The Commerce Ministry meanwhile has issued a new notification making SEZ developers responsible for the rehabilitation of displaced persons
- India's federal government has announced a suspension of all land acquisition for establishing new SEZs until a new policy on the rehabilitation of displaced people is announced

Box 2: The Evolution of SEZs in India

Phase	Nick-named	Period	Characteristics
First Phase	Initial Phase	1964-85	Inadequacy of facilities andincentives
Second Phase	Expansionary Phase	1985-91	Setting up of five EPZa in India
Third Phase	Consolidation Phase	1991-2000	Relaxation of strict controls, liberalisation of provisions and simplification of procedures
Fourth Phase	Extension of Consolidating Phase	Post 2000	Formulation of EXIM Policy, introduction of a scheme for setting up of SEZs, conversion of EPZs into SEZs

Contribution of SEZs to the Indian Economy

Investment Mobilisation

Investment in SEZs, especially after the SEZ Act 2005, has risen at an impressive pace. In 2008-09 it reached Rs1000 billion (US$22bn), an increment of over Rs 300 billion (US$6.7bn) over the preceding year. If one looks at the total cumulative investment made prior to the SEZ Act 2005, which amounted to only Rs 78.6 billion (US$1.8bn), the incremental growth in investment post the SEZ Act 2005 appears to be very impressive. It highlights the significance of the SEZ Act 2005, which is one of the most important developments after the 1991 reforms.

The magnitude of total investment attracted by SEZs in India is reflective of their potential. In terms of generation of incremental investment, the SEZs have indeed helped the Indian economy to meet official targets for investment mobilisation. However, in terms of foreign investments, SEZs are far off the target. The available data indicates that FDI constitutes an insignificant part of the total investment made in SEZs. It is a clear reflection that FDI mobilisation, one of the basic purposes of SEZ expansion, has not been achieved through the establishment of SEZs. Out of the total investment made in 2008-09, FDI accounts for Rs 48.9 billion (US$1.08bn), or even less than 8 percent of total investment. Considering that India has now become one of the most attractive destinations for FDI globally, as reflected by inflows of US$24bn and US$35bn in 2007-08 and 2008-09 respectively, the small share of FDI in total SEZ investment is unimpressive and therefore needs improvement.

Employment Generation

Some studies[5] reveal that employment generation has been the most important channel through which SEZs contribute to the development of India. Employment generated by zones is more remunerative than that offered outside SEZs. Moreover, it enhances the competition among firms in the labour market and therefore leads to an increase in average wage rates in the economy. Besides, working conditions, non monetary benefits, incentive packages and social security systems are considerably better than what is prevailing outside the zones, especially in the small/informal sector. Studies also reveal that the quality of life of people has improved after their employment with SEZs units.

According to a United Nations projection, the working age population (between 15-64 years) in India will increase to 977 million by 2020 and 1.1 billion by 2050. As a share of total population, the labour force is set to increase to 67 percent in 2020 with demographic transition making the population more youthful in the near future. To keep pace with transition, SEZ development appears to be an important strategy for future employment generation, given that such generation after the economic liberalisation of the 1990s has fallen short of expectations.

Operational SEZs in India can be classified into two sections: (a) those SEZs which came into existence prior to SEZ Act 2005 (converted into SEZs from EPZs including seven government run EPZs); and (b) those which came into existence after the SEZ Act, 2005. While the former category covers 19 SEZs, there are 206 SEZs which were notified after the implementation of the SEZ Act 2005.

The total employment in operational SEZs (both direct and indirect) has been estimated at 554,800. Out of these, SEZs that came into existence prior to the SEZ Act, 2005 have a share of 43 percent in total employment generation. These SEZ units appear to have performed reasonably well in terms of employment generation, considering that investment made in these units is less than 10 percent of the total investment made in all SEZs combined. This corresponds to a per employee investment of Rs 33000 only which is quite low even in comparison to that for the overall industrial sector.

The picture for SEZs coming into existence after the SEZ Act, 2005 is quite different. These are associated with per employee investment of nearly Rs 0.22 million (US$0.08mn), over six times that corresponding to the SEZs established before the SEZ act. Besides this, it can be also observed that only a little over 31 percent of the total employment attributed to such SEZs is direct, the rest 69 percent being indirect. This is a clear indication that SEZs established prior to 2005 have done much better in terms of employment generation.

Comparison of SEZs and non-SEZ data on capital intensity, however, demonstrate that the overall scenario is much better in SEZs. In the non-SEZ sector, investment per employee[6] increased from Rs 0.13 million in 1979-80 to Rs 0.19 million in 1989-90. It substantially increased to over Rs 0.79 million in 2001-02 and over Rs 0.9 million in 2004-05. Per-employee capital intensity has further gone up in the later periods.

Table 1 demonstrate the total employment generated by the SEZs by both types of units.

Table 1: Employment Generated by SEZz Units in India *(as on end March 2008)*			
Type of SEZs	Employment		
	Direct	Indirect	Total
A. SEZs Prior to SEZ Act 2005	238,242	—	238,242
B. SEZs Post SEZ Act 2005	98,000	220,600	316,000
C. Total (A+B)	336,242	220,600	554,242

Export Performance of SEZs

Exports from SEZs registered an extraordinary growth of 47 percent over that in the preceding year 2007-08 to Rs 980 billion in 2008-09. The growth rates for the two years preceding 2007-08 were 92 and 52 percent respectively. The attainment of a level of almost a trillion rupees in 2008-09 appears extremely impressive if one considers that the level as recently as 2003-04 was only Rs138 billion in 2003-04

The export performance of SEZ units recorded significant improvement after the SEZ Act 2005 and sustained such improvement even during the period of global recession (see Graph 2). In sharp contrast, the country's overall merchandise exports that logged 29 percent growth in 2007-08 showed marked deceleration in growth to only 3.4 percent in 2008-09. As a result during the year 2008-09, exports from SEZs showed an increase of Rs 313.60 billion over the previous year as compared to a increment of Rs 337 billion for all exports, implying that non-SEZ exports increased by only Rs 23.4 billion (see Graph 4). The contrasting trends in the growth of SEZ and overall merchandise exports have led to an increasing share of the former in the latter. During a short span of six years, the share of SEZs in the total exports has more than doubled from 4.7 percent in 2003-04 to over 12 percent in 2009-09.

Table 2: Exports from the Functional SEZs

Year	Value (Rs billion)	Average Annual Inflation* (%)	Real Export growth (%)
2003-2004	138.54	5.4	33.6
2004-2005	183.14	6.4	25.6
2005-2006	228.40	4.4	20.6
2006-2007	346.15	5.4	46.6
2007-2008	666.38	4.7	87.3
2008-2009	980.00	8.4	37.6

**Based on RBI Annual Average Wholesale Price Index for different years*

The figures for SEZ exports also imply that the value of SEZ exports every year almost equals the value of SEZ capital – in other words, export-capital ratios are extremely high suggesting a very high level of efficiency. Similarly, the value of exports per employee is Rs 1.76 million, again a very high figure.

Thus, in terms of exports performance, the SEZ initiative has proved to be a boon for the exports sector, especially during the ongoing financial crisis and meltdown in the global economy which has also affected developing countries such as India.

Influence of SEZs on Infrastructure Development

SEZs in India, as elsewhere, thrive on infrastructure[7] directly or indirectly created. Infrastructure is essential for establishment and successful operation of businesses. For SEZs, the importance of infrastructure is even greater. The SEZ Act 2005 has increased awareness among the state governments as well as local bodies about the need to invest[8] in adequate and strong infrastructure to support globally competitive economic activities.

Infrastructure related to SEZs are of two types: that facilitating the internal functioning of SEZs (power generation plants and distribution network, internal water supply, sanitation and sewerage, internal roads etc.) with direct implications for productivity; and the other, linking SEZs with the non-SEZ world through a supply chain (railway tracks, roads and bridges, airport facilities, telephone lines and telecom network).

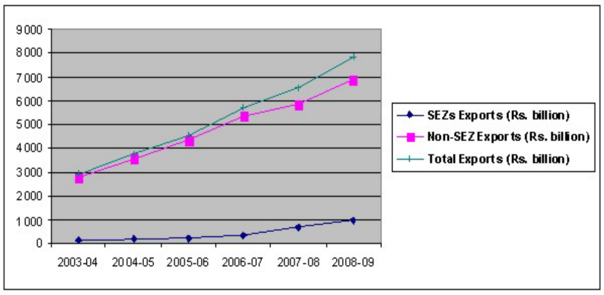
The success achieved by a number of SEZ units in India is a clear indication that these have been quite successful in influencing creation of adequate infrastructure in their respective areas. The infrastructure created for facilitating the successful operation of the SEZs has in all cases led the establishment of links between two or more business centres and in the process created infrastructure for the remote or previously inaccessible areas falling in between the two centres. These units have also contributed to infrastructure development in the surrounding areas.

Controversies Surrounding the Indian SEZs

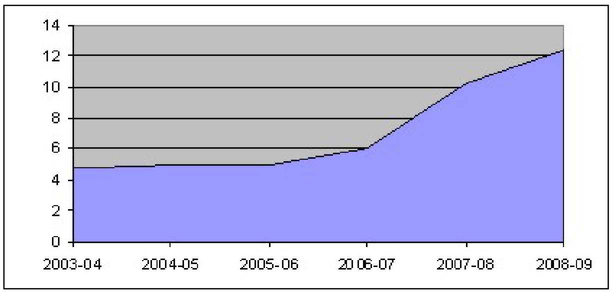
SEZs in India are presently shrouded in controversies – some legal and some related to socio-economic issues. These now involve almost all stages starting from SEZs' inception to their becoming operational. These also involve various levels of governance – different ministries in Central and state governments, coalition partners in governments, land owners, social activists, and stakeholders associated with environmental protection.

Legal Issues

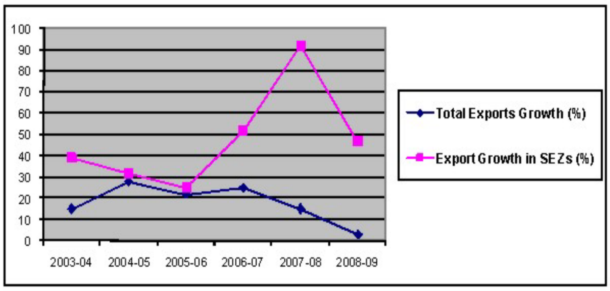
Land acquisition for SEZs in India is done under the Land Acquisition Act (LAA) of 1894, which has been widely criticised for being an archaic legislation. This is, however, Graph 1: Trends in SEZs and Non-SEZs Exports



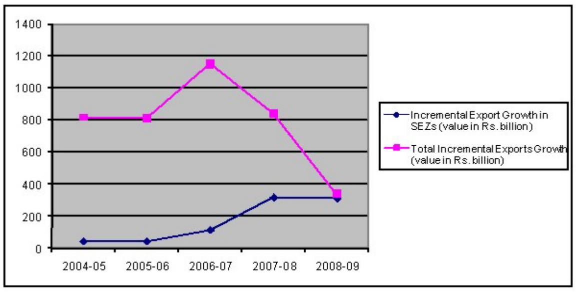
Graph 3: SEZs Share (%) in Total Exports



Graph 2: Growth in Exports: SEZs and Non-SEZs



Graph 4: Incremental Exports: SEZs and Non-SEZs



a relatively recent criticism as far as SEZs are concerned. The Act was never questioned when huge amounts of land were acquired for India's public sector. One explanation given is that such acquisition was for 'public purpose'. The same 'public purpose' has, however, now become contestable as it has served the end of privately developing SEZs. It is also thought that the current land acquisition by the government and its transfer to private developers does not directly serve any national interest and that state governments have become 'facilitators' by acquiring land on behalf of developers. The rationale for such acquisition is said to be the result of information asymmetry on the efficiency characterising market-based transactions in Indian land markets.

The SEZ Act 2005 took it for granted that once a particular chunk of land is notified because of acquisition of land for the public sector during the early years of industrialisation, it would not require any de-notification. However, with the entry of the private sector, which was to play a significant role post 2006, people's perceptions about government land acquisition for 'public purpose' have changed.

Moreover, investments by private developers in SEZ areas are based on business opportunities which are, in turn, influenced by a number of other factors – government tax exemptions and incentives; effective response from manufacturing units; gestation periods etc. It is not surprising that developers who have not succeeded in attracting investments from manufacturing units have requested for de-notification. Such developments have put a question mark on the SEZ Act.

The existing LAA of 1894 bestows upon the executive (the Collector or the District Commissioner) the responsibility of fixing compensation. The only official indicators of land prices are those recorded in sale (or purchase) deeds. These are, however, hardly any real indicator of prevailing market prices. Stamp duty rates in most Indian states are more than ten percent, encouraging under-quoting of prices in sale deeds. But barring these under-quoted prices, there is no other database of land or property prices available with

Box 3: Land Acquisition Amendment Bill of 2007

The Bill extended the scope of 'public purpose' to

- Strategic purposes pertaining to requirements of air force, navy and military
- Infrastructure projects
- Any other purpose useful to the general public for which 70 percent of the land has already been purchased but the remaining 30 percent remains to be acquired

Box 4: Land Acquisition Amendment Bill of 2007 for determining correct market value of land proposed

- Minimum land value specified in Indian Stamp Act of 1899 for registration of sale deeds in the area of the concerned land;
- Average sale price of similar land in the locality; this is to be assessed from at least 50 percent of the sale deeds registered in the last three years where higher prices have been paid; or
- Average sale prices ascertained from prices paid for at least 50 percent of land already purchased for the project where a higher price has been paid.

district administrations. Determining correct market price therefore remains an almost impossible task, making the whole process of land acquisition more controversial. Moreover, not only do landowners have little choice in parting with land, their reluctance does not influence compensation.

The SEZ Act 2005 does not spell out the minimum infrastructure that is mandatory but the maximum that can be developed, leaving the issue of infrastructure creation a vague term which is open to convenient interpretation. It creates scope for small SEZs to exploit the infrastructure of the neighbourhood instead of augmenting the same. This is contrary to the basic rationale – infrastructure creation – of the SEZ regime.

The existing provisions do not ensure that existing industry does not relocate in new SEZs. Safeguard clauses stipulating that undertakings eligible for tax exemption cannot be formed by the splitting up of or reconstruction of an existing business or by the transfer to a new business, of machinery or plant previously put to use do not feature in the existing SEZ provisions.

Socio-economic issues

Many critics opine that SEZs might aggravate regional disparities. A majority of all approved SEZs are located only in a few States – Andhra Pradesh, Gujarat, Haryana, Karnataka, Maharashtra and Tamil Nadu. Maharashtra and Andhra Pradesh alone account for more than a third of all approvals. These states are all relatively well developed with high industrial capacity. These are also highly urbanised with the exception of Maharashtra in certain pockets.

Rehabilitation of displaced people is another potent issue. It is estimated that various development projects have displaced some 38 million people in India since independence. Studies also show that not even half the number of those displaced got properly rehabilitated. Some have been displaced more than once.

The revenue loss to the government on account of SEZs is also considerable – in 2004-2005 alone, the government incurred an estimated loss of Rs 41,000 crores – a staggering 72 percent of customs revenues and 23 percent of total indirect tax revenue of any kind. It is estimated that Rs 1.75 lakh crores will be lost by the end of 2010.

However, in spite of these issues raised by critics SEZs have fulfilled the objectives behind their creation – employment and export generation, improvements in infrastructure etc. Moreover, the criticisms all relate to how the SEZ policy has been implemented in India and not any fundamental flaws in a development driven SEZ strategy.

Conclusion

Any new policy or law is intended to address issues, including inefficiencies in the system, which cannot be addressed by existing law(s) due to various reasons – changing socio-economic and demographic dynamics, changes in preferences, newly emerging issues etc. Policies for ushering in the green revolution starting late 1960s and an industrial revolution through EPZ/SEZ schemes (finally leading to The SEZ Act 2005) are no different. While the new agricultural policy was successful in increasing food grain production, the other still has a long way to go. The criticisms of the policy, however, relate mostly to non-economic issues, especially social concerns.

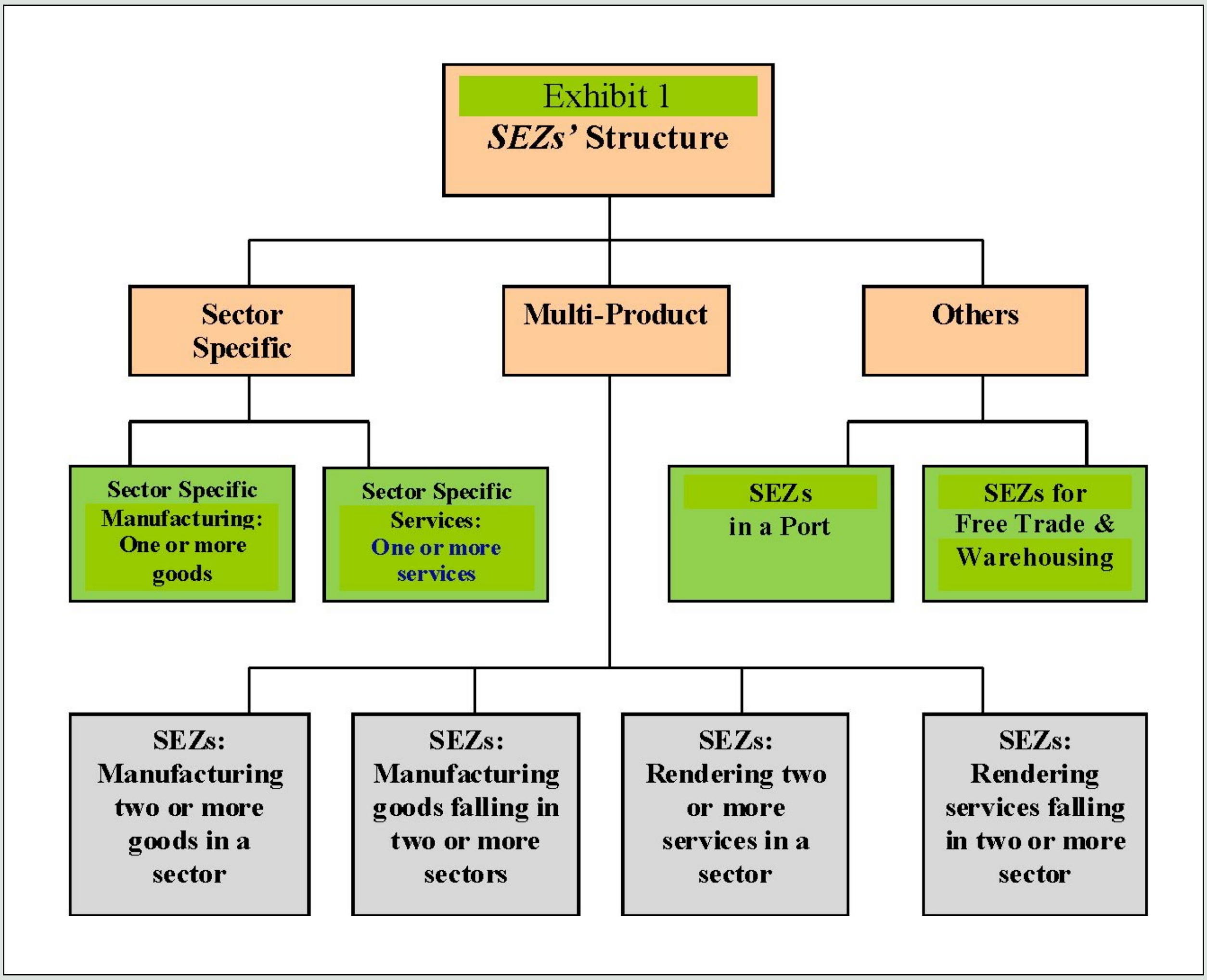
In conclusion, it deserves reiteration that the success of the SEZ scheme in India should be measured on the basis of the realisation of the basic objectives behind its initiation: (i) promotion of clustered economic activity leading to better utilisation of infrastructure facilities and economies of scale, (ii) creation of world class infrastructure due to greater investment, (iii) increase in foreign investment, (iv) increased exports of non-traditional items, and (v) employment generation.

While the SEZ approach has done exceedingly well in terms of some objectives, in terms of others it has not been so successful. In terms of the promotion of clustered economic activities, most operational SEZs have performed reasonably well, leading to increased economic activity in construction, trading, manufacturing, infrastructure creation etc. It is estimated that the generation of one job in SEZ units has a multiplier effect of 2.3 jobs elsewhere due to backward and forward linkages; in many cases such linkages encourage ancillary activities in and around the SEZ.

The debate on whether India could have done better or worse in realising the broad objectives of economic development by investing the huge fund exceeding Rs1000 billion allocated for SEZ development in other activities will continue. There will be many critics who contend that these funds could have been better spent elsewhere such as development schemes, programmes for human capital generation, adaptation of agriculture to climate change etc. These critics also point to the association of proliferation of SEZs with the rural unrest produced by related land acquisition.

However, even though SEZs in India are at a very nascent stage (these are less than a decade old), the performance of this scheme is not unimpressive and indicate that SEZ units have become an important and credible engine of economic growth. According to one estimate, as indicated above, by the end of 2017 SEZs in India will propel more than US$210bn in investment, create some 14 million jobs, and will account for more than US$350bn of annual exports. SEZs are also expected to bring about construction of some three billion square feet of housing (three million units) for 12 million people. Most importantly, there is no single scheme in India, except the National Rural Employment Guarantee Scheme (NREGS), of comparable revealed potential in bringing about economic development in India.

To conclude, SEZs appear to be an important policy tool with demonstrated utility for dealing with problems such as pressure of population on agricultural land, unemployment, deficits in housing, scarcity of capital resources, lack of adequate infrastructure etc. There have been problems in regard to implementation but the baby should not be allowed to drown in the bath water.



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Endnotes

1 Special Economic Zone (SEZ) is a specifically delineated duty free enclave and deemed to be foreign territory for the purposes of trade operations and duties and tariffs. Units in SEZs are allowed to sell in domestic market also after paying the requisite taxes

2 In 2004-2005 alone, the government incurred a loss of Rs 410 billion – a staggering 72 percent of customs revenues and 23 percent of total indirect tax revenue. It is estimated that Rs 1750 billion will be lost by the end of 2010

3 The objectives of a SEZ in India are to: (i) promote concentrated economic activities, (ii) creation of world class infrastructure, (iii) attracting foreign investment, (iv) increased exports of non-traditional items, and (v) employment generation. The whole approach is based on the premise that paucity of appropriate and adequate infrastructure, weakness of the regulatory regime and the high cost of financing are some of the major constraints to rapid growth of the Indian economy

4 The Green Revolution in India transformed the country from a net importer to net exporter of food grains. Its success can be attributed to its simplicity — it involved only two types of primary stakeholders: (a) local farming community; and (b) the government. The SEZ policy has been much more difficult to implement because of the multiplicity of stakeholders – government, private sector, farmers, labour, real estate agents etc. An important feature of this movement in India was the absence of structural gaps in terms of usage of farm land unlike those encountered by implementation of the EPZ/SEZ policy

5 Aradhna Aggarwal, Impact of Special Economic Zones on Employment, Poverty and Human Development, ICRIER Working Paper No. 194, May 2007

6 http://www.drnarendrajadhav.info/drnjadhav_web_files/Published20papers/Size20and percent20Capital percent20 Intensity percent20in percent20Indian percent20Industries.pdf (accessed on August 31, 2009)

7 The existing and notified SEZs in India are currently spread over an area of 1750 sq.km, equivalent of 0.06 percent of the total mass of land of 29,73,190 sq km. It, however, covers an area about three times that of Singapore. It has also a farm land component of 0.1 percent of the total farm land. The issue of infrastructural development, as far as SEZs are concerned, is confined to this mass of land and its surrounding areas. The major components of infrastructure include construction, electricity generation; water works and supply; railway tracks; roads and bridges, airport facilities; telephone lines; port facilities; and sanitation and sewerage

8 According to the Planning Commission, for the economy to grow at 9 percent per year, investment in infrastructure must increase from below five-eight percent over the next five years. This will require an investment of US$500bn during the 11th Five Year Plan

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