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AN ASSESMENT OF THE INDO-CHINA SPECIAL ECONOMIC ZONES
THE CONCEPTUALIZATION

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SPECIAL Economic Zones (SEZs) basically are geographical regions concentrated with production or export-import activities being governed by specific economic laws. The goal is usually an increase in foreign direct investment (FDI) in the country. Conventionally, SEZs are created as open markets within an economy that is dominated by distortionary trade, macro and exchange regulation and other regulatory governmental controls (CII, 2005). SEZs create a favorable environment to promote investment and exports. The first Special Zone which bears any resemblance to the present-day ones was set up in Spain in 1929 with the intention of increasing exports by value addition to the raw materials available in that country. It was also the time when an unprecedented depression was stalking the economies of the West. Skillful technicians were employed and they were a privileged class. But the International Monetory Fund and the World Bank high jacked the idea in the 1960s. Many developing countries are developing the SEZs with the expectation that they will provide the engines of growth for their economies to achieve industrialization. In the late 1990s, when the then Commerce Minister of India, late Murasoli Maran, visited the special economic zones (SEZs) in China, he was inspired by the development that took place in china. This helped his vision of creating such world-class free zones in India. The Government to achieve its three-fold objectives of attracting FDI, increasing exports and accelerating the country's economic growth, announced the introduction of SEZs in its Export-Import Policy of March 2000.

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The concept of free zones is not new to India. The first export processing zone (EPZ) was set up at Kandla as early as 1965 followed by several others in various parts of the country. But the performance of these EPZs fell far short of expectations due to various reasons. In 2005, government passed SEZ Act and subsequently in 2006, SEZ rules was also passed which lays down the policy to govern establishment and functioning of SEZs in India, before these legislations SEZs were governed by laws scattered in various acts and rules There has been an unprecedented rise in the applications received by the commerce ministry and most of them have been accepted or are in the process of consideration. The Ministry of Commerce estimates an investment of Rs 1 trillion in these SEZs in the next few years and employment generation of 5,00,000. The purpose of having a separate Bill on Special Economic Zones (SEZs) is to clarify all policy initiatives relating to such special zones so that many more foreign and domestic investors can establish their units in these areas. But in spite of the tremendous potential of SEZs, the reality is that they have contributed only about 5% to India's total exports so far (Financial Express, 2006). News related to SEZs forms quite a substantial part of print media as well as electronic media and has ignited scholarly discussion involving politicians to common man. Through this paper, we have made an

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attempt to locate the balance of this Blitzkrieg approach taken by the government. Our effort is to look at both sides of the coin and suggest a well balanced approach which has drawn lessons from China.

While India was conceptualizing the SEZs, countries like China, the Philippines, UAE, Indonesia and Poland were already experiencing the power of the SEZ format. FDI data suggests that South Asia attracted FDI worth only about 1 percent of GDP annually as opposed to roughly 4 percent of GDP for China (Kapadia, 2006). One of the reasons why china is such a success story is its concentration and focus on world class infrastructure within the specifics zones. Thus, with a cumulative FDI of around $70 billion, the five SEZs namely Shenzen, Zhuhai, Shantou, Xiamen and Hainan together account for around 20 per cent of the exports from China, providing direct employment to over 8 million persons (Kapadia, 2006). Whereas in India there are 14 operational special economic zones and more than 140 have been approved or are under establishment as of April 2006. Despite the recent pick-up, India's share in world goods exports has been very small – at 0.9% for 2005 – due to the widely known gaps in the business environment. SEZs have long been seen as a means for India to create bigger inroads into small and medium scale manufacturing. Improving the business environment on a nationwide basis, providing a competitive platform to India's entrepreneurs will take time (Financial Express, 2006). Prima facie looking at this data we can arrive at only one conclusion that china is two decades ahead of India in terms of attracting FDI and ability to manage inflow of this hot money. Identifying foreign capital as the tool to boost its domestic manufacturing, China attracted investors by offering a slew of tax sops, flexible labour regime and quick clearances. PRC (SEZs are established by PRC in china) invests significant resources into developing and improving the infrastructure located within the SEZ and other infrastructure facilities, which are required to support SEZs. Although one should also remember that the development of SEZ will require some time. China's SEZ policy was essentially state-driven, having FDI and export markets as its main focus. With the governing philosophy being the scale of operations, China emphasised on establishing zones which were very big in size. Shenzen, which is the largest SEZ, has an area of 33,000 hectares. In case of Hainan, the entire province was declared as SEZ. Unlike China, India's focus is not so much on FDI as on generation of economic activity. The philosophy driving India's policy is to boost manufacturing, generate jobs while attracting FDI.

Business Summit at the WEF was concerned with the social, political and economic risks faced by China internally and China's impact (both positive and negative) on the world economy. The India Economic Summit, on the other hand, focused on how India can achieve Chinese growth rates while at the same time avoiding China's model of "growth first, equity later" — the very source of the risks many see facing China. As the Indian Prime Minister, Dr. Manmohan Singh, put it, "we have today a broad-based national consensus that the process of economic growth must enhance both equity and efficiency." (Asia Pacific Bulletin, 2006)

Hurdles to progress and prosperity of SEZs

Strategic Planning

The most prudent strategy for developing a SEZ is to have an essential and quality zone infrastructure. This will help attract industries. When we look at international market one observation can be clearly made, that the private sector has limited experience in development of these world class infrastructure zones. Therefore SEZ projects should evolve under the public-private partnership format. This step would ensure that the state governments concerned can overlook the progress and the planning of the SEZ and can jointly market the zone. This would increase the "comfort level" of the locating industries. The concept of SEZ embodies the business planning including strategic positioning of the zone in the world markets by leveraging on the strong backward linkages with hinterland/Domestic Tariff Area (DTA) and physical planning covering provision of world class enabling infrastructure. Therefore, the planning for SEZ requires multi disciplinary expertise in areas of business, economics, finance, legal and urban & infrastructure planning (Singh, 2005). Help could be sought from international funding agencies such as World Bank and Asian Development Bank, the short listing procedure should be stringent so that incapable consulting entities do not get short listed as technically qualified SEZ planners and put the claim of doing the assignment. Further, the planning for SEZs require a holistic approach addressing two aspects specifically.

First, all proposed SEZs should be strategically positioned as complementary to each other to the extent possible and serving their own market niches respectively. It requires monitoring by the central agency i.e. Ministry of Commerce that provides in-principle approvals to new SEZs on the basis of pre-feasibility reports being submitted by the respective state governments. Second, the SEZ scheme should be synchronized with other schemes (Singh, 2005). The other important factor that should be kept in mind while deciding the location of SEZ is it should provide 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 is yet to focus on this approach but Singapore is taking a lead in providing a similar natural gateway. If a SEZ is located near the urban areas then the labour needs of the units can also be easily satisfied, it would also ensure accessibility and uninterrupted supply of essential utilities, SEZs located near ports or airports or having proximity to a bigger city have shown more progress than the industrial sites.

Another defect in the Indian approach is the size factor. The Indian variants tend to be smaller than their Chinese equivalents, sectorally focused (in such sectors 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 (Asia Pacific Bulletin, 2006). In the globalized economy, SEZs have become a set pattern to attract investments and specially in the Indian subcontinent. These same multinationals are investing in china, India, Bangladesh, and Srilanka. China has by far the most attractive terms and conditions. There is an intense competition existing between these economies to attract the attention of these multinationals, these multinational have a tendency to keep changing their locations whenever they see a slight cost advantage or disadvantage. This can result in sudden rise and fall in the manufacturing as well as the employment factor. This can lead to some destabilization in the economy, therefore, such situations should be kept in mind and an action plan should be prepared to deal with such situations.

Impact of Governance

Efficient governance is an imperative factor in establishment and smooth functioning of SEZ and is crucial to its performance. It greatly influences the attractiveness of a zone to foreign investors and its eventual performance. The provision of efficient bureaucratic and economic services, a clear and transparent legal and regulatory structure and an unfettered and stable policy framework ensure the success of the zones (CII, 2005). India has a strong advantage in this regard as it has strong economic growth prospects, availability of large and skilled workforce, comparative advantage in several industries, a strong policy framework, availability of supporting ancillary industries, strong growth in the external sector and a huge domestic market. These factors give India a superior edge but the advantage can be nullified due to the sluggish attitude of government departments in granting various clearances. There should be a coherent policy both at the central and the state level so that these SEZs can be well marketed and maximized benefit is derived out of such opportunities. Lessons should be learned from some earlier ambitious programs of the government. The SEZ program requires for even more effective internal marketing. Training and motivational courses need to be designed for these officials so that these policies do not face any hindrances in their implementation on the ground level. If we review the current scenario, there is no autonomous authority responsible for the development of zones and for providing single window clearances in India. Preferably, the SEZs should be managed by autonomous authorities so that all necessary decisions can be taken instantly keeping the policy in mind, which should be constituted under specific Acts. In India, the biggest problem persisting is lack of coherence and synchronisation between centre and state executive, which is affecting the rate of progress of these SEZs.

Labour Laws

As per the new law of Special Economic Zones, all the labour laws as applicable within the country apply in a SEZ. This new law, as has been argued is unlikely to address the critical issue of labour flexibility. A restrictive labour law environment has been one of the major hurdles to the development of the Indian manufacturing sector. Currently, over 40 labour-related statutes have been enacted by the central government. In addition, the state governments have also enacted various statutes on this subject. However, a flexible labour policy has been elusive. One of the likely influences in this regard is the towering influence of the Left parties.

Analysts are divided about whether India's labour laws are actually implemented in its SEZs. For example, India's Contract Labour (Regulation & Abolition) Act 1970 prohibits employing contract workers in activities which are "permanent and perpetual" in nature. Almost all activities conducted in SEZs are arguably "permanent and perpetual" in nature and yet surveys by the International Labour Organization and testimonies by workers themselves suggest that the majority of the workforce in Indian SEZs are contract employees. These workers also do not come under the purview of the Minimum Wages Act, so India's relatively high minimum wages may not be a factor affecting investment decisions. Still, the uncertainty of the situation is discouraging to investors.

Nonetheless, recent legislative moves by India's Congress-led coalition government to formally relax labour legislation within SEZs appear to be an important policy shift by New Delhi. While the nature of the changes to labour laws is not yet clear, indications are that the Chinese model of flexible contracts may be followed. The Congress-led government has slowly but 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 in India. How the new legislation is received by Congress' Communist allies and by India's powerful trade unions will undoubtedly affect the success or failure of India's new SEZ policies. If the airport strikes that hit several critical terminals in protest against the privatization of the country's two major airports are a pointer, the path to labour reform in the SEZs will be rocky. But then it may be argued that any such drastic step would be violative of Art 14 of the Indian Constitution. There can be simpler labour law-related procedures in SEZs; there can even be more flexible schedules for the Contract Labour Act. Fundamental labour laws have to be identical in the domestic labour area and outside it.

The government should take the lead in developing large-size SEZs in a few key states. The government could go in for a tripartite structure with central and state government pooling in some public funding but attract a few private sector players as major partners, who in turn can take up the execution responsibility as well. The plan can be modelled on the government's plans for ultra mega power projects. While the new SEZ law may have resulted in significant rise in applications from the corporate sector, from a macro perspective this might not be the best solution. Many of these proposed investments could be mere substitution of investments that would have otherwise taken place outside the SEZ area. The new SEZ investments are unlikely to provide the much-needed fillip to Indian small and medium manufacturing sector competitiveness. We believe the government needs to rework the SEZ policy to push the "real" large SEZs China's SEZ policy was essentially state-driven, having FDI and export markets as its main focus. With the governing philosophy being the scale of operations, China emphasised on establishing zones which were very big in size. Shenzen, which is the largest SEZ, has an area of 33,000 hectares. In case of Hainan, the entire province was declared as SEZ. Unlike China, India's focus is not so much on FDI as on generation of economic activity. The philosophy driving India's policy is to boost manufacturing, generate jobs while attracting FDI.

The Special Economic Zones in India should specialise in terms of economic activities depending on the availability of human capital, resources and infrastructure in the region. They thus tend to transform into horizontally-integrated industrial clusters, which include industries that might share a common market for the end products, use a common technology or labour force skills, or require similar natural resources. It seems, therefore, that it would be desirable to develop zones as industrial clusters of specific products. This may encourage downstream industries also.

In a study related to the Shenzen SEZ, and of the labour laws in SEZs and EPZs in India. It was claimed by Kasture: "*We have a lot of timid traders, and few bold investors. Positra in Gujarat, which claimed to be a pioneer SEZ, has neither got a rail link nor an airport in the vicinity till now. All the major ports in India are located 500-1,000 km apart. Shenzhen SEZ has many major ports within a radius of 50 km*." (Ray, 2006)

Siddharth Shah, senior advocate, says: "Offshore baking units of Indian commercial banks could profitably operate at SEZs under the supervision of RBI. There's some uncertainty about the applicability of labour laws. But there are signs that the government would not impose those laws strictly. Also, for dispute resolution in the SEZs, the government would set up notified courts."

The finance ministry is also worried that SEZs aren't as export-oriented as they should be, but have devolved into land deals. Officials privately worry about this is becoming another land scam. But since SEZ developers have to submit a detailed project report with well-laid guidelines, there are built-in checks and balances, if only proper vigilance is exercised before approving fresh approvals. (Ray, 2006)

Land Acquisition

The Global Competitiveness Report[1] identifying institutional maturity as India's medium-term advantage over China is a good context in which to analyse the gathering controversy over special economic zones (SEZs) and the related but broader issue of land acquisition and even of farming as an occupation. As India is currently a robust democracy, major public policy attracts vigorous debate. China lacks such modes of expression so it may perhaps reap one day what it has sowed by making policy through command. The Congress in Bengal has joined Mamata Banerjee in agitating against efforts to secure land for industry. Farmers in Punjab have started protesting. The commerce ministry has issued a long list of do's and don'ts. The Left wants a ceiling on SEZ land to ensure "food security". Raghuvansh Prasad, the rural development minister, has called SEZs a "scam". (Express India, 2006)

To compound this problem, we now have distortions created in the land markets. State governments allow the conversion of agricultural land, offer them at subsidised rates to the developers and some of this land can also be used for real estate development. Courts get involved because the market value of such land eventually turns out to be much more than the original compensation. In the final version of the approach paper, the Planning Commission should have a section on disparities caused by SEZs (Debroy, 2006). It is now surprising that the units and developers are falling over backwards to relocate in SEZs. Or should we now have a new form of licensing through a cap on the number of SEZs?

1 An annual study taken out by the World Economic Forum. It is a vital tool for shaping economic policy and guiding investment decisions.

The Special Economic Zones need to be regulated as everything else, but the whole idea about fast-tracking the creation of world-class infrastructure will be defeated if an *Inspector Raj* is also created. The Commerce Ministry saying that only barren land should be acquired for SEZs assumes that every agricultural plot is of vital importance to this country. This is plainly wrong and it leads to the second misconception of the penultimate role of agriculture to the development of this country. Farming is a risky business today, if we keep in perspective the rise of suicides in this field. There are far too many agriculturists in this country and India cannot plan on developing by holding urbanisation and industrialisation at ransom. The SEZs are one of the many solutions we need to speed up urbanisation, create new and diverse jobs. So it shall benefit none if politicians keep on saying that SEZs won't affect farmers (Express India, 2006). This is not to suggest that we prioritise industry over agriculture now.

The issue of proper compensation is hotly debated in this regard, because there is still not a proper market for land in most areas SEZs are being proposed. An auction, as can be argued, is one solution. Another is to encourage land-owners to form commercial collectives. Fourth, to argue SEZs will threaten food security is absurd. Then what about encouraging manufacturing on a huge scale, which will require more land? (Express India, 2006)

Ideally speaking, there can be a national policy that no agricultural land should be handed over to non-agro industries. The agriculturists should be protected in the same way as the tribals. We have a policy where non-tribals cannot purchase tribal land. Similarly, there should be a policy that agricultural land can be purchased by and sold only to agriculturists. India has gained a significant deal of self-sufficiency in food requirements with the hard work of our planners, agricultural scientists and farmers. Of course there exists an obligation to defend this base from the greedy, corporate land mafia. If the government is really serious about export promotion and the SEZ, there are barren lands available in almost all parts of the country including Punjab, Haryana and Uttar Pradesh (Yadav, Sharad).

Special Economic zones have now been placed in the sphere of active political debate. The Communist Party of India (Marxist) sought "urgent changes" in the Special Economic Zone Act and Rules to include a cap on maximum area of a SEZ, review of tax exemptions, and proper compensation to farmers as well as agricultural workers. The party demanded that approval of state governments should be mandatory for SEZs. At the end of a three-day meeting of the Central Committee, party General Secretary Prakash Karat said they would take up the issue at the UPA-Left Coordination Committee meeting, expected next month (Debroy, 2006).

Even Mrs. Sonia Gandhi, the chairman of the United Progressive Alliance, hinted during her speech that farmers should be made "stake-holders " in the activity undertaken on land acquired from them. "Prime Agricultural land should not normally be diverted to non-agricultural uses. Industry requires land no doubt. But this must be done without jeopardising our agricultural prospects. Farmers must get proper compensation when their land is purchased. Could farmers also not become stake holders in the projects that come up on the land acquired from them? Our resettlement and rehabilitation policies must be strengthened and implemented in an effective and credible manner which will inspire confidence in the people who are displaced," Ms. Gandhi said (Ramachandran, 2006).

Taxation

An SEZ is a trade capacity development tool, with the goal to promote rapid economic growth by using tax and business incentives to attract foreign investment and technology. Today, there are approximately 3,000 SEZs operating in 120 countries, which account for over US$ 600 billion in exports and about 50 million jobs. By offering privileged terms, SEZs attract investment and foreign exchange, spur employment and boost the development of improved technologies and infrastructure (Crittle, 2006).

As per the Income-tax Act, 1961 ("ITA"), the following are the key tax benefits to be provided to SEZs and SEZ Units:

Advantages to the Developers

(a) 100 per cent of the profits of the Developer arising from the business of developing a SEZ, notified after April 1, 2005 under the SEZ Act, shall be deducted from taxable income[2]. This deduction can be claimed at the option of the assessee for any 10 consecutive years out of 15 years beginning from the year in which the SEZ has been notified by the Central Government. If a Developer who sets up a SEZ after April 1, 2005, transfers the operation and maintenance of the SEZ to another Developer, the transferee is entitled to the above deduction of profit for the remaining period.

(b) With regard to a Developer who is entitled to claim an exemption under Section 80-IA[3] of the ITA, the Developer can claim an exemption for the remainder unexpired exemption period under Section 80-IA, and thereafter it can claim the 10 year tax exemption available to such Developer under Section 80-IAB.

(c) The Developers of SEZ are not required to pay Minimum Alternate Tax[4].

(d) No dividend distribution tax shall be paid by a Developer engaged in developing, operating and maintaining a SEZ[5].

Advantages of the SEZ Units

(a) The Units set up in an SEZ which have begun to manufacture/provide services during the financial year beginning April 1, 2005 will get the following exemptions[6]:

- 100% exemption of profits and gains from business for the first 5 years
- 50% exemption on profits and gains from business for the next 5 years
- 50% exemption to the extent that such amounts are re-invested in the SEZ Special Reserve Account

If the SEZ Unit has already availed of benefits for 10 years under Section 10A of the ITA, the above exemptions are not available. Further, when a Free Trade Zone ("FTZ") or an Export Processing Zone ("EPZ") is converted into a SEZ, the Units, which have already availed of the 10-year tax exemption in an FTZ or EPZ, cannot avail of the Section 10AA exemptions.

(b) Losses falling under the heads "Profits and Gains from Business or Profession" and "Income from Capital Gains" can be carried forward / set off as long as such loss is related to the business of the SEZ Unit[7],

(c) Capital Gains on transfer of assets in case of shifting of an industrial undertaking from an urban area to a SEZ shall be exempt, provided that 1 year before, or 3 years after the transfer

(i) machinery / plant was purchased for the business of the industrial undertaking in the SEZ,

2 Section 80-IAB of the ITA.

3 Exemption of 10 years on profits from business available to an "industrial undertaking" or "enterprise engaged in infrastructure development" as provided for in the Section 80-IA of the ITA.

4 Section 115-JB(6) of the ITA.

5 Section 115-O(6) of the ITA.

6 Section 10AA of the ITA.

7 Section 10AA(6) of the ITA.

(ii) building or land was acquired or building was constructed in the SEZ,

(iii) the original asset was shifted and the establishment was transferred to the SEZ and

(iv) the assessee incurred such other expenses as are notified by the Central Government[8].

(d) Interest income received by a non-resident or a person who is not ordinarily resident in India, on a deposit made in an OBU situated in a SEZ, shall be exempt from income tax[9].

(e) No tax deduction shall be made by the OBU from interest paid[10]:

(i) on deposits made on or after April 1, 2005 by a non-resident or a person not ordinarily resident in India; or

(ii) on borrowings on or after April 1, 2005 from a non-resident or a person not ordinarily resident in India.

(f) The gross total income of an assessee having an OBU or an assessee being a Unit of an IFSC shall be deductible to the extent of 100% for 5 consecutive years from the year of grant of permission under the Banking Regulation Act / SEBI / other relevant law and 50% for the next 5 years 12. It further defines the exempted "income", which is:

- Income from an OBU in a SEZ
- Income from business referred to in the Banking Regulation Act, 1949, or any other Unit which develops, develops and operates, or develops, operates and maintains a SEZ
- Income from an approved unit of an IFSC

(g) Exemption from Securities Transaction Tax available to taxable securities transaction entered into by a non-resident through the IFSC.

Other Benefits

The other benefits accrued can be headed under customs and excise, foreign direct investment, borrowings, central and state tax benefits.

Customs and Excise

- *Exemption from Customs Duty*: SEZ Units may import or procure from the domestic sources, duty free, all their requirements of capital goods, raw materials, consumables, spares, packing materials, office equipment, DG sets etc. for implementation of their projects in the SEZ without requiring any licence or specific approval
- Goods imported/procured locally which are duty-free could or should be utilized within the approval period of 5 years
- Domestic sales by SEZ Units will be exempt from Special Additional Duty
- Domestic sale of finished products, by-products is permitted on payment of applicable customs duty
- Domestic sale of rejects, waste and scrap is permitted on payment of applicable customs duty on the transaction value
- Exemption from applicable excise duty on goods brought in from the DTA to a SEZ

8 Section 54GA of the ITA.

9 Section 10(15)(viii) of the ITA.

10 Section 10(15)(viii) of the ITA.

Foreign Direct Investment

- 100% FDI under the automatic route is allowed in the manufacturing sector in SEZ Units, except for arms and ammunitions, explosives, atomic substances, narcotics and hazardous chemicals, distillation and brewing of alcoholic drinks and cigarettes, cigars and manufactured tobacco substitutes
- Exemption from the applicability of Press Note 2 (2005)[11].

Borrowings

- Setting up OBUs has been allowed in SEZs. External Commercial Borrowings by SEZ Units up to US$ 500 million a year is allowed without any maturity restrictions
- Freedom to bring in export proceeds without any time limit
- Flexibility to keep 100% of export proceeds in an EEFC account and freedom to make overseas investments with it
- Commodity hedging permitted
- SEZ units allowed to 'write-off' unrealized export bills'

Central Sales Tax

- Exemption from Central sales tax on inter-state sale or purchase of goods

Other Central Enactments

- Exemption from other Central enactments, which are specified in Schedule 1 of the SEZ Act.

State Taxes

- The respective State Governments may for the purpose of giving effect to the provisions of the SEZ Act, notify policies for Developers and SEZ Units and take suitable steps for the enactment of any law for granting exemption from state taxes, levies and duties to a Developer or an entrepreneur.

Service Tax

- Exemption from Service Tax to the Developer and the SEZ Units to carry on authorized operations in the SEZ. Service tax exemption granted only to Units in the DTA providing services to a Developer or to a Unit.

The new law provides exemption for 15 years compared with 10 years under the old law. Another factor that has attracted corporates to SEZs is that existing tax exemptions for export-oriented units set up in non-SEZ areas (such as software technology parks) are due to expire in financial year 2009 (i.e. three years from now).

In China, the biggest benefit to the foreign investor is significant tax concessions during the early life of the project, which is similar as in India. These rates provided can vary from site to site, and are subject to change from time to time. Tax concessions offered by the People's Republic of China to a manufacturing start-up typically include:

- No tax during start-up years before making a profit.
- Zero tax for first two to three years of profits.
- The tax rate of one-half of the normal for next two years. Subsequently, the company bears full normal tax rate.

11 Press Note No 2 of 2005 prescribes certain conditions that a foreign investor proposing to make foreign direct investment in real estate sector in India has to satisfy.

- No tax on imported production equipment for "encouraged" enterprise.
- No tax on purchase of production merchandise for high tech enterprises.
- Availability of trained manpower that understands MNCs' procedures and policies.
- Economic development with a structured, long-term growth perspective (Kapadia, 2006).

The primary reason for the hyper-success of the SEZs in China is because the People's Republic invests significant resources into developing and improving the infrastructure which is located within the SEZ and other infrastructure facilities, which are required to support SEZs. Certain facilities like providing financial services like banking and insurance. SEZs are listed separately in national planning (including financial planning) and have province-level authority in economic administration. SEZs' local congress and government have legislation authority. Identifying foreign capital as the tool to boost its domestic manufacturing, China attracted investors by offering a slew of tax sops, flexible labour regime and quick clearances.

Criticism

One of the aims of the Reserve Bank of India (RBI) in raising interest rates twice recently is to cool the overheated property market. The RBI has also raised the risk-weighting of housing loans to 150% to discourage bank lending, and has sought to keep out foreign venture capital funds wanting to get into Indian real estate. As suggested by the RBI, the policy of Special Economic Zones will cause serious imbalances in our economy. As it is, we are already facing the problems of an imbalanced growth. There is mass migration of people from backward regions to advanced regions, the shift is from rural to urban or semi-urban areas. This has caused social tension in many states. The policy of SEZ is only furthering the regional imbalance. It will trigger off still larger migrations from one part to another resulting in serious regional tensions.

As elaborated by the Chief Economist of the International Monetary Fund Rajan Raghuraman, this policy of SEZs will dry up the government coffers. There will be huge revenue losses to the exchequer because units established in SEZ will get multiple tax exemptions. The production in non-SEZ areas will move to SEZ areas to enjoy tax incentives. According to an estimate by the Finance Ministry Rs. 90,000 crores revenue loss is expected from these tax exemptions. The investment expected is Rs. 1,00,000 crores. The loss of revenue on such a huge scale will make it difficult for the government to fulfil its social obligations to the people. Even its own functioning may be affected due to the cash crunch caused by the revenue loss resulting from tax exemptions to SEZ (Yadav, Sharad).

The government may end up losing indirect and direct tax revenue of Rs939 billion over the next four years (averaging Rs.234 bn p.a. or 0.4-0.6% of GDP) on account of existing/new export oriented units shifting to SEZs. Losing tax revenues at a time when the government's fiscal deficit is already high is not the best idea.

The SEZs might have to see close monitoring even from tax officials, who are reportedly asking for greater manpower and hi-tech equipment for unobtrusive observation of potential tax leakage in these zones. Finance Minister P. Chidambaram has recently said that each SEZ will require an additional 17 personnel. The ministry is expected to submit a proposal to the cabinet for an additional 1,400 personnel soon. This may well be required to plug the potential revenue loss of Rs 90,000 crore because of SEZs that the finance ministry had earlier pointed out. The commerce ministry had differed, arguing that SEZs would bring a net revenue gain of Rs 44,000 crore.

There has been a rush to set up SEZs after the government announced liberal tax breaks. "Most businessmen in India wrongly believe that SEZs are an expanded version of Export Promotion Zones

(EPZ). Some of them may also think that they can export the machinery of their existing plants to Dubai and import them back to set up units at SEZs,' says Sudhakar Kasture, visiting faculty at the Bankers Training College of RBI (Ray, 2006).

One of the key purposes of SEZs is to build scale-related advantages. However, most of the SEZs currently being planned are miniscule in size. The new law allows the minimum area for the SEZ area to be 1000 hectares (3.9 square miles) for multi-product zones, 100 hectares for product specific zones and just 10 hectares for IT, gems & jewellery and biotechnology zones (subject to minimum built-up area norms).

The Current Tension

The Government's rush to sign on private investors in infrastructure has landed in trouble, leading to an open confrontation between the Commerce Ministry (which succeeded in removing a cap on the total number of SEZ approvals) with the Finance Ministry, the Reserve Bank of India and even the International Monetary Fund, all protesting that the tax breaks would lead to government revenue losses estimated at a staggering 900 billion rupees, or $19.5 billion.

Those championing the zones, such as Kamal Nath, the Minister of Commerce and Industry, have refused to back off. "These zones will boost exports and increase employment," he said. The zones would be cleared by a single agency and, once sanctioned, would be "unshackled from the control of government inspectors," he added, referring to the country's notorious bureaucracy (Rai, 2006).

Supporting the finance ministry's "strong case" against SEZs, the Communist Party of India demanded that tax sops for the zones be pruned "drastically" as they would lead to heavy loss of revenue. The party also opposed denial of contracts to Chinese companies. "Why is there such an old mindset? Why is that Chinese companies are being prevented from participating in infrastructure development projects?" Karat said (Business Reporter, 2006),

And concern is spreading. The chief economist of the International Monetary Fund, Raghuram Rajan, wrote in a recent issue of the fund's quarterly magazine that although the idea behind the zones was laudable, the government should offer only limited tax breaks to developers.

After Concluding with Taxation: Counter-Criticism

So why are SEZs attractive? Earlier FTZs/EPZs were government-delivered. The present SEZs, after the law in 2005 and rules in February 2006, allow the private sector to come in. Hence, the euphoria. But the government may not pay anything directly to develop infrastructure in private SEZs. But a substantial amount of tax revenue is foregone. This could have been used to develop infrastructure, including infrastructure outside SEZs.

If the tax exemptions are removed completely, then undoubtedly the attractiveness of the SEZs will disappear. It can be argued that there is more to tax exemption than a tax waiver on exports. For that matter, SEZs, in their earlier incarnation of free trade zones (FTZs) or export processing zones (EPZs), have been around since the first one was set up in Kandla in 1965. In relative terms, why did they not succeed in raising the share of India's total exports? Bad infrastructure for one, cumbersome procedures for another. And, as import duties generally declined, through schemes like EPCG (Export Promotion Capital Goods) or 100 per cent EOUs (Export Oriented Units), the EPZs became unattractive. Given restrictions on sales in the domestic tariff area (DTA), the lower import duties were not worth it.

In that case, why is the present round of SEZs succeeding, the former EPZs/FTZs having been transformed into SEZs? When one can't liberalise across the board, one liberalises in selected enclaves.

But the enclave is a legacy of the past. We should be improving infrastructure and easing procedures. The Chinese export success is because the entire country has become a SEZ (Debroy, 2006). In that sense, SEZs should belong to a bygone era, unless we are convinced, we will be unable to liberalise across the board. When Murasoli Maran thought of SEZs in 2000/2001, there was another objective, drawing on the lessons of China/Bangladesh. That was about special and more flexible labour laws in SEZs. The idea was quickly buried, because it can't be done.

No figures are available on this foregone revenue. Note that tax exemptions extend to taxes other than income tax on export proceeds – central sales tax, FBT, service tax, etc. When the reform agenda drives towards standardisation and removal of discretions, the SEZ policy works against the reform agenda. Such incentives are available not only for developers of SEZs, but also for units which presumably should have benefited from the infrastructure private developers have created (Debroy, 2006).

The spectre now haunting Indian policy-making is of special economic zones. The Approach Paper to the 11th Five-Year Plan (2007-11) also talks about special economic regions (SERs) as well. *What is the difference?* SERs don't have income tax concessions on export income. SEZs do. There is a minor issue about export subsidies, defined by GATT/WTO as differential and preferential treatment of exports over domestic sales. That is different from an export incentive, where, for instance, one can refund or waive indirect taxes for exports (Debroy, 2006).

Recommendations

So how does one fuel growth in a Special Economic Zone?

The first prudent step would be to deal with the infrastructure, preferably inside and if possible even outside the SEZ. This was China's strategy and is the only area where we significantly fall short of. The move will inspire foreign investor confidence and also help in attracting local industries.

Secondly, national and international experience has shown that the private sector alone has limited knowledge and incentive to deal with the infrastructural aspect, and hence the crucial development of these zones. It is suggested that to develop these zones, the SEZ projects should be developed under the public-private partnership format, where they can be benefited from expertise and resources. Where the state governments concerned jointly market the zone along with the private developer. This would increase the comfort level of the locating industries.

The size of the SEZ does matter. In the context of the global economy today the scale of manufacturing is critical. The largest SEZ in the country is at Kandla in Gujarat which is spread over 1.2 square miles. Compare that with the top SEZ in China at Shenzen which covers 126 square miles. This, of course, is true for the SEZs that are multi-product and consist of mainly manufacturing industries. The size of the SEZ should really depend on the nature of industries locating there.

Also, while approving SEZ projects, care should be taken to screen out small SEZ projects that are largely aimed at availing tax benefits of the SEZ policy rather than creating quality infrastructure and boosting exports.

In the context of infrastructure, it is also important that while locating a SEZ, the connectivity factor to the hinterland be kept in mind.

Another very critical issue is that of labour. Flexibility in labour laws within SEZs, perhaps on a pilot basis, will help attract investors.

Lastly, it is important that there is stability in the SEZ policy in the country. Frequent modifications in the policy will only detract serious investors from investing in SEZs.

India's advantage lies in its strong economic growth prospects, availability of large and skilled workforce, comparative advantage in several industries, a strong policy framework, availability of supporting ancillary industries, strong growth in the external sector and a huge domestic market. These factors, combined with a proactive role from the government in marketing the SEZs, will go a long way in providing the much-needed momentum of the development of SEZs and in attaining the overarching objective of boosting India's exports and attracting export related foreign direct investment (FDI).

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