ISID Institute for Studies in Industrial Development
An institution of Indian Council of Social Science Research (Ministry of Education)
Policy Research to Foster India's Industrial Transformation

ISID Policy Briefs #22-01 January 2022

Special Economic Zones and India's Industrialisation: Opportunities, Challenges, and the Way Forward

The policy brief summarises the perspectives on the challenges that Indian special economic zones (SEZs) have faced and the key policy recommendations of the various stakeholders (including policymakers, business associations, and academia) based on the session organised by ISID in the India Land Development Conference, 2021 on November 24, 2021. The session was moderated by Prof **Nagesh Kumar**, Director, ISID, who set the narrative of the session by stating the importance of SEZs to Indian economy and the challenges that await realisation of its full potential. A detailed and insightful presentation on this issue was given by Prof **Aradhna Aggarwal**, Copenhagen Business School. Distinguished panellists included Mr **Srikanth Badiga**, Vice President, Export Promotion Council of EOUs and SEZs; Mr **Bipin Menon**, Development Commissioner, NOIDA SEZ; Dr **Malini Tantri**, Assistant Professor, Institute for Social and Economic Change, Bengaluru; and, Dr **Ramaa Arun Kumar**, Assistant Professor, ISID, who also coordinated the session. The YouTube link of the https://youtu.be/lduKMRF8YII

Introduction

The importance of special economic zones (SEZs) as a tool of industrial policy has been realised across economies, given their growing presence on the global stage. For example, in 2019, there were 5,383 SEZs spread across 147 countries. Alongside this evolution, there has been a proliferation of a variety of SEZs across economies. A number of structural changes have taken place in the evolution of SEZs at a conceptual level. Initially, these zones were located near ports as they were mainly of the nature of export processing zones. However, they have now evolved to take the form of various kinds of zones such as those engaged in transhipment activities, commercial or manufacturing hubs, hybrid zones (inter-mix of SEZs), and general economic zones.

Special economic zones help developing countries to overcome production bottlenecks or failures by offering an attractive business and investment environment. By augmenting resource allocation and productivity – both being the drivers of economic growth – SEZs offer a tremendous opportunity for economies to extract maximum benefit in terms of rise in employment opportunities and export growth, among others.

These benefits, however, may be limited if appropriate policies are not in order. The SEZs are delineated zones within an economy; however, if they remain delinked from the economy, the zones may fail to move up the value chain. Factors like global competition for attracting FDI, economic risks arising from business cycles, and financial risks may undermine the advantages that the SEZs possess. External shocks and recent global developments such as increasing tariff barriers, and the global slowdown post-2008 have especially affected the global value chains that have either been reshoring or back-shoring, thereby affecting the SEZs.

Indian SEZs: A Mixed Bag of Successes and Failures

Unlike the successes of SEZs in countries like South Korea, Taipei China, and People's Republic of China, the experience of India in gaining from the SEZ model was limited to a few zones. The unparalleled success of the SEZ model of China has been looked up to by many economies that have emulated the SEZ model, successfully attracting FDI and generating employment with economic restructuring at varying degrees. For example, countries in South East Asia like Malaysia, Vietnam, and the Philippines; Bangladesh in South Asia; Dominican Republic and Costa Rica in North America; Ethiopia and Mauritius in Africa; and, Poland in Europe.

Till 2000 India did not have any SEZ as it followed the approach of facilitating export processing through various export processing zones (EPZs). The SEZ policy in India gained momentum in 2005 when the SEZ Act, 2005 was implemented "for the establishment, development and management of the Special Economic Zones for the promotion of exports and for matters connected" (SEZ Act, 2005). Following the announcement of the SEZ policy in 2000, the previous seven EPZs set up by the central government were converted into SEZs; these were Kandla (Gujarat), Santa Cruz (Maharashtra), Cochin (Kerala), Noida (Uttar Pradesh), Chennai (Tamil Nadu), Falta (West Bengal), and Visakhapatnam (Andhra Pradesh). In addition, an EPZ in the private sector in Surat, Gujarat was also converted into an SEZ. In the interim period between 2000 and 2005 (when the SEZ Act was formulated), several state level SEZs were formed either by the government or private players.

However, in terms of implementation, the potential of SEZs could not be leveraged as it unfolded over the years. The round table brought forward the following challenges sharply:

Lack of Institutional Preparedness: A mix of wrong policies pertaining to archaic land acquisition laws and lack of institutional preparedness led to widespread resistance among the people, especially rural land owners, in the very beginning. These gave the state and the private players authority to acquire massive land masses with a very narrow window for response from land owners. As a result, as much as 50 percent of the land marked for the development of SEZs remained underutilised in respect of 369 notified SEZs in 2017.

Policy Reversals: The initial rise in the number of SEZs after 2005 was also neutralised due to the lack of sustained incentives to the units. The removal of key incentives in terms of exemptions from minimum alternate tax and dividend distribution tax in 2011–12 was a turning point for the growing popularity of SEZs in India. Moreover, the introduction of the sunset clause for developers and SEZ units that phased out the direct tax holidays also exacerbated the weakening of the SEZ concept in India. Consequently, the overall area under SEZs fell to 419.7 sq kms in 2020–21 from 496.21 sq kms in 2012–13.

Underutilisation of Land under SEZs: In terms of performance of existing SEZs, the operating SEZs have contributed positively to the current account balance and sectoral growth for sectors such as electronics, modern jewellery, and information technology. Employment in SEZs has risen to 2.5 million in 2021 from 0.13 million in 2006–07. However, in terms of employment intensity measured as employment per hectare, the figure stood at 61 persons per hectare of land under SEZs. One explanation is the underutilisation of infrastructure set up for SEZs in the allotted lands, which has failed to boost employment growth. Another explanation for low employment intensity is the sectoral distribution of SEZ units, which is oriented towards less employment intensive sectors such as the services sector which hosts around 61 percent of the total operational SEZs. Within the services sector, it is the Information technology and information technology enabled services that account for 94 percent of the total SEZs. The share of manufacturing sector, which holds the potential for generating employment, remains subdued.

Absence of Single Window Clearances: Although fast-track approvals have been put in place, in terms of implementation many exporters across SEZs have reported that documentation and procedural issues are still prevalent. For example, the certificate of origin and goods and services tax issued by the development commissioners are not recognised by the exporters to Dubai and Japan. Additionally, the approved MSME exporters also encounter transaction delays within SEZs due to lack of one-stop shop services wherein environmental approvals and labour department approvals have to be taken separately.

In the midst of these challenges, there have been a few success stories in the SEZ ecosystem, one of which is that of Sri City, Andhra Pradesh which is discussed below.

Success Story of Sri City SEZ

There are a few SEZs which have succeeded in portraying the potential that can be achieved through the right mix of policies and institutional approach such as Sri City in Chittoor district, Andhra Pradesh. Spread over 3,800 acres of land, it is a hybrid zone comprising a domestic tariff zone (DTZ) and an export area that are adjacent to each other. The export capabilities of most companies operating even in the domestic processing zone was high, with some of them exporting up to 70 percent of their total output.

The zone has displayed a transformation from a backward region dependent on subsistence farming with majority of the landholdings remaining less than one acre to a successful SEZ comprising about 100 companies and providing employment to 50,000 people in the first phase.

The region's backwardness was characterised not only by limited and, predominantly, barren landholdings leading to economic restraint, but also by social issues like early marriage of girls, low literacy rates, and lack of basic amenities like toilets within dwellings.

What made Sri City a success was the humanitarian approach to land acquisition, assuring that no dislocation of habitats took place and ensuring employment opportunities to the inhabitants through training programmes. Proper evaluation of land and other assets like mango trees, wells, and tube wells were made to ensure a fair compensation. The resulting compensation, therefore, was as much as ten times of the actual value of land acquired, depending upon the type of land.

In addition, the policies that were the key enabling factors for the Zone's success were high-class infrastructure facilities by huge investments in design and development and one-stop shop policy of developers ensuring smoothness in the implementation of development plans.

Key Policy Takeaways

The Indian economy promises a strong and resilient economic structure that not only overcame the adverse effects of global economic crisis of 2008, but also displayed its strength during the most challenging pandemic crisis in the present times. In terms of SEZs, the exports from these zones rose by 53 percent in the manufacturing sector while services exports grew by 10 percent during the period January to June 2021.

Presently, SEZs provide state-of-the-art infrastructure with greater connectivity in the form of roads, railways, and ports. Some of the SEZs offer around 22–25 percent reduction in the costs due to duty free imports of raw materials and construction material for developers. Fast track clearances are in place whereby procedural delays have reduced, for example, in Noida SEZ.

However, there is a lot to be done to ensure that the SEZ development is integrated into the development strategy of the policymakers. The key policy takeaways from the above discussion are as follows:

- Policies to exploit the underutilised existing infrastructure should be the starting point for overcoming the constraints that have lurked around for many years in restricting the SEZ growth in India. For these, incentives such as removal of export obligation for units to operate in SEZs, allowing sales to domestic tariff areas (DTAs), and enabling transactions between SEZs and DTAs to be undertaken in domestic currency are some measures that can be taken by the government to evolve from the existing policies.
- The manufacturing sector should be given a boost through SEZs. For this, apart from land, other important inputs such as skilled manpower which needs to be sourced locally, and availability of raw materials, ports, roads, etc., are essential for units to locate themselves in SEZs.
- Integration of production-linked incentive schemes with the SEZ policy in sectors such as apparel, pharmaceuticals, automobiles, and avionics can accelerate the industrialisation process of the Indian economy.

In the end, it can be said that the Indian SEZ policy holds immense potential to boost economic growth by enabling better allocation and utilisation of inputs and raising productivity of the firms located therein. The case study of Sri City shows that a well-implemented SEZ can be an important driver of inclusive and sustainable industrialisation and development. The lessons learnt from such successes need to be scaled up and replicated to exploit the full potential of SEZs for India's development!

Acknowledgment: *This Policy Brief has been prepared by Dr Ramaa Arun Kumar, Assistant Professor, ISID, based on the discussions at the session organised by ISID in the India Land Development Conference 2021 on "Special Economic Zones and India's Industrialisation: Opportunities, Challenges, and the Way Forward," held on November 24, 2021.*

ISID Institute for Studies in Industrial Development
An institution of Indian Council of Social Science Research (Ministry of Education)
4 Vasant Kunj Institutional Area, New Delhi - 110070, India