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Special economic zone: evaluation of incentives and performance

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Abstract

The Government of India had announced a SEZ scheme in April, 2000 with a view to provide an internationally competitive environment for exports. The objectives of SEZs include making available goods and services free of taxes and duties supported by integrated infrastructure for export production, expeditious and single window approval mechanism and a package of incentives to attract foreign and domestic investments for promoting export-led growth.

In order to give a long term and stable policy framework with minimum regulatory regime and to provide expeditious and single window clearance mechanism, the Special Economic Zones Act, 2005 has been brought into effect along with the Special Economic Zones Rules, 2006 from 10 February 2006. Benefit derived from SEZs is evident from the investment, employment, exports and infrastructural developments additionally generated. The benefits derived from multiplier effect of the investments and additional economic activity in the SEZs and the employment generated thus will far outweigh the tax exemptions and the losses on account of land acquisition. Stability in fiscal concession is absolutely essential to ensure credibility of Government intensions. In this research paper we are analyzing the schemes and performance of SEZs in India with special reference to investment, employment, export and foreign capital.

Keywords: Informal Sector, Unorganised Manufacturing Sector, Policies & Prospects.

1. Introduction

India was one of the first in Asia to recognize the effectiveness of the Export Processing Zone (EPZ) model in promoting exports, with Asia's first EPZ set up in Kandla in 1965. With a view to overcome the shortcomings experienced on account of the multiplicity of controls and clearances; absence of world-class infrastructure, and an unstable fiscal regime and with a view to attract larger foreign investments in India, the Special Economic Zones (SEZs) Policy was announced in April 2000.

This policy intended to make SEZs an engine for economic growth supported by quality infrastructure complemented by an attractive fiscal package, both at the Centre and the State level, with the minimum possible regulations. SEZs in India functioned from 1.11.2000 to 09.02.2006 under the provisions of the Foreign Trade Policy and fiscal incentives were made effective through the provisions of relevant statutes.

To instill confidence in investors and signal the Government's commitment to a stable SEZ policy regime and with a view to impart stability to the SEZ regime thereby generating greater economic activity and employment through the establishment of SEZs, a comprehensive draft SEZ Bill prepared after extensive discussions with the stakeholders. A number of meetings were held in various parts of the country both by the Minister for Commerce and Industry as well as senior officials for this purpose. The Special Economic Zones Act, 2005, was passed by Parliament in May, 2005 which received Presidential assent on the 23rd of June, 2005. The draft SEZ Rules were widely discussed and put on the website of the Department of Commerce offering suggestions/comments. Around 800 suggestions were received on the draft rules. After extensive consultations, the SEZ Act, 2005, supported by SEZ Rules, came into effect on 10th February, 2006, providing for drastic simplification of procedures and for single window clearance on matters relating to central as well as state governments.

A Special Economic Zone (SEZ) is a geographical region that has economic laws that are

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more liberal than a country's typical economic laws. Usually the goal is an increase in foreign investment. Ones of the earliest and the most famous Special Economic Zones were founded by the government of the People's Republic of China under Deng Xiaoping in the early 1980s. The most successful Special Economic Zone in China, Shenzhen, has developed from a small village into a city with a population over 10 million within 20 years. Following the Chinese examples, Special Economic Zones have been established in several countries, including India, Iran, Jordan, Poland, Kazakhstan, the Philippines and Russia. North Korea has also attempted this to a degree, but failed. Currently, Puno, Peru has been slated to become a "Zona Economica" by its president Alan Garcia. In the United States, SEZ are referred to as "Urban Enterprise Zones".

According to World Bank estimates, as of 2007 there are more than 3,000 projects taking place in SEZs in 120 countries worldwide.

2. Objectives

The main objectives of the SEZ Act are:

- i) Generation of additional economic activity
- ii) Promotion of exports of goods and services;
- iii) Promotion of investment from domestic and foreign sources;
- iv) Creation of employment opportunities;
- v) Development of infrastructure facilities;

It is expected that this will trigger a large flow of foreign and domestic investment in SEZs, in infrastructure and productive capacity, leading to generation of additional economic activity and creation of employment opportunities. Under the Act, SEZ could be set up either jointly or severally by the Central Government, State Government, or any person (including a private or public limited company, partnership or proprietorship):

- i) for manufacture of goods; or
- ii) for rendering services; or
- iii) for both manufacturing of goods and for rendering services; or
- iv) As a Free Trade and Warehousing Zone.

The Act provides for certain fiscal incentives to developers of SEZ and units established in SEZs. Key fiscal incentives have been outlined below:

3. Fiscal Incentives for Developers/ Sez Units

3.1. Indirect Tax Incentives

Developer and the SEZ unit shall be entitled to the following exemptions, drawbacks and concessions:

- i) exemption from customs duty on goods imported into the SEZ by the Developer or SEZ Unit to carry on the authorized operations;
- ii) exemption from customs duty on goods exported from the SEZ by the Developer or SEZ Unit to any place outside India;
- iii) exemption from excise duty on goods brought from Domestic Tariff Area ("DTA") to the SEZ by the Developer or SEZ unit to carry on the authorized operations;
- iv) drawback or such other benefits (as may be admissible from time to time) on goods brought from the DTA into a SEZ by the Developer or Unit to carry on the authorized operations;
- v) Exemption from service tax on taxable services provided to a Developer or Unit to carry on the authorized

operations in a SEZ. However, please note that there is no specific service tax exemption on services provided by a Developer of an SEZ or a SEZ Unit. Exemption, if any, would be as per the service tax legislation;

- vi) exemption from the securities transaction tax in case the taxable securities transactions are entered into by a non-resident through the International Financial Services Centre ("IFSC");
- vii) exemption from levy of Central Sales Tax on the sale or purchase of goods by the Developer or SEZ unit if such goods are meant to carry on the authorized operations;
- viii) Local sales tax/ VAT exemption or concession on supply of goods to an SEZ Developer or Unit or sale of goods by an SEZ Developer or Unit is subject to the respective sales tax/ VAT legislation of the state in which the SEZ is set up.

The Central government has prescribed the manner, terms and conditions subject to which above exemptions/ concessions would be available.

Removal of goods into DTA is subject to prescribed conditions and on payment of applicable customs duties as levied on importation of such goods into India.

3.2. Income Tax incentives for SEZ units

- i) Tax Holiday for SEZ units engaged in manufacture or providing services A new section 10AA has been inserted in the IT Act by SEZ Act, 2005 which provides that the units in SEZ which start manufacturing or producing articles/ things or which start providing services on or after April 1, 2005 will be eligible for a deduction of 100 percent of export profits for the first five years from the year in which such manufacture/ provision of services commences and 50 percent of the export profits for the next five years. Further, for the next five years a deduction shall be allowed of upto 50 % of the profit as is debited to the profit and loss account and credited to the Special Economic Zone Reinvestment Reserve Account (subject to conditions).
- ii) Tax Holiday for Offshore Banking units in SEZ. A deduction in respect of certain incomes would be allowed under the new section 80LA, to scheduled banks or foreign banks having an Offshore Banking unit in SEZ or to a unit of IFSC. The deduction shall be for 100 percent of income for five consecutive years beginning from the year in which permission/ registration has been obtained under the Banking Regulation Act or the SEBI Act or any other relevant law and 50 percent of income for next five years.
- iii) Interest received by non-residents and not ordinary residents on deposits made with an Offshore Banking Unit on or after April 1, 2005 shall be exempt from tax.
- iv) Exemption from Minimum Alternate Tax ("MAT"). Income arising or accruing on or after April 1, 2005 from any business carried on, or services rendered by SEZ unit would be exempt from MAT under section 115JB.
- v) Exemption from Capital Gains. Capital gains arising on transfer of assets (machinery, plant, building, land or any rights in buildings or land) on shifting of the industrial undertaking from an urban area to any SEZ would be exempt from capital gains tax.
- vi) The amount of exemption for capital gains would be restricted to the costs and expenses incurred in relation to all or any of the purposes mentioned above.

4. Fiscal Incentives - Income Tax Incentives for Sez Developers

- i) Tax holiday for SEZ developers: A new section 80-IAB has been introduced in the IT Act vide SEZ Act, 2005 whereby a deduction of 100 percent of profits derived from the business of developing SEZ (notified on or after April 1, 2005) would be available to developer of SEZ for any 10 consecutive years out of 15 years beginning from the year in which SEZ has been notified.
- ii) Exemption under section 10(23G) that was available to infrastructure capital fund or a cooperative bank on interest and long term capital gains investment had been extended to investment made by SEZ developers qualifying for tax holiday under section 80-IAB of the IT Act. However, this exemption has been withdrawn with effect from assessment year 2007-08.
- iii) Exemption from Dividend Distribution Tax ("DDT"): No DDT would be payable by a developer of SEZ on dividend declared, distributed or paid on or after April 1, 2005 out of current income.
- iv) Exemption from MAT: Any income earned on or after April 1, 2005 by a SEZ developer would be exempt from MAT under section 115JB of the Act.
Sale from Domestic Tariff Area (DTA) to SEZ

5. Sez Present Status

Consequent upon the SEZ Rules coming into effect w.e.f. 10th February, 2006, Twenty-eight meetings of the Board of Approvals have since been held. During these meetings, formal approval has been granted to 531 SEZ proposals. There are 143 valid in-principle approvals. Out of the 531 formal approvals, 260 SEZs have been notified. The total land requirement for the formal approvals granted till date is approximately 67680 hectares out of which about 109 approvals are for State Industrial Development Corporations/State Government Ventures which account for over 20853 hectares. In these cases, the land already available with the State Governments or SIDCs or with private companies has been utilized for setting up SEZ. The land for the 270 notified SEZs where operations have since commenced involved is approximately over 31405 hectares only.

Out of the total land area of 2973190 sq km in India, total agricultural land is of the order of 1620388 sq km (54.5%). It is interesting to note that out of this total land area, the land in possession of the 270 SEZs notified amounts to approximately over 314 sq km only. The formal approvals granted also works out to only around 676 sq km.

Out of the 531 formal approvals given till date, 174 approvals are for sector specific and multi product SEZs for manufacture of Textiles & Apparels, Leather Footwear, Automobile components, Engineering etc., which would involve labour intensive manufacturing. SEZs are going to lead to creation of employment for large number of unemployed rural youth. Nokia and Flextronics electronics hardware SEZs in Sriperumbudur are already providing employment to 14577 and 1058 persons. Hyderabad Gems SEZ for Jewellery manufacturing in Hyderabad has already employed 2145 persons. majority of whom are from landless families, after providing training to them. They have a projected direct employment for about 2267 persons. Apache SEZ being set up in Andhra Pradesh will employ 20, 000 persons to manufacture 10,00,000 pairs of shoes every month. Current employment in Apache SEZ is 5536 persons.

Brandix Apparels, a Sri Lankan FDI project would provide employment to 60,000 workers over a period of 3 years. Even in the services sector, 12.5 million sq meters space is expected in the IT/ITES SEZs which as per the NASSCOM standards translates into 12.5 lakh jobs. It is, therefore, expected that establishment of SEZs would lead to fast growth of labour intensive manufacturing and services in the country.

6. Benefits Derived From Sez

Benefit derived from SEZs is evident from the investment, employment, exports and infrastructural developments additionally generated. The benefits derived from multiplier effect of the investments and additional economic activity in the SEZs and the employment generated thus will far outweigh the tax exemptions and the losses on account of land acquisition. Stability in fiscal concession is absolutely essential to ensure credibility of Government intensions.

6.1. Exports from the functioning SEZs during the last three years are as under

Year	Value (Rs. Crore)	Growth Rate (over previous year)
2003-2004	13,854	39%
2004-2005	18,314	32%
2005-2006	22 840	25%
2006-20007	34,615	52%
2007-2008	66,638	92%

Source: Economic Survey 2007-08

6.2 Investment and employment in the SEZs set up prior to the SEZ Act, 2005

At present, 1943 units are in operation in the SEZs. In the SEZs established prior to the Act coming into force, there are 1143 units providing direct employment to over 1.97 lakh persons; about 37% of whom are women. Private investment by entrepreneurs in these SEZs established prior to the SEZ Act is of the order of over Rs. 5626.24 crore.

Current investment and employment:	
▪ Investment:	Rs. 83450crore
▪ Employment:	1,13,426 persons

6.3: Total employment in SEZs: 3, 49,203 Lakh persons
Total incremental employment generated in SEZs since Feb., 2006: 2,14,499 persons Break Up are as follows

DIRECT Employment created in notified SEZs (as of 30.6.08)	100885 persons (all Incremental Employment generated after February 2006)
DIRECT Employment in Private/State Govt. SEZs which came into force prior to SEZ Act, 2005 (as of 30.6.08)	48988 persons (Incremental employment generated since Feb. 2006: 36,250 persons)
DIRECT Employment in 7 SEZs established by the Central Government (as of 30.6.08)	1,99,330 persons (Incremental employment generated since Feb. 2006: 77,094 persons)

6.4: Total investment in Special Economic Zones as of 30.6. 2008: Rs. 81093 crore Incremental investment since February, 2006: Rs. 77058 crore

Investment in notified SEZs (as of 30.6.08)	Rs. 73348 crore (all Incremental Employment generated after February 2006)
Investment in Private/State Govt. SEZs which came into force prior to SEZ Act, 2005 (as of 30.6.08)	Rs. 3701.91 crore (incremental investment generated since Feb. 2006 is Rs. 1946 crore)
Investment in 7 SEZs established by the Central Government (as of 30.6.08.)	Rs. 4043.28 crore (incremental investment generated since Feb. 2006 is Rs. 1764.08 crore)

area is used to provide housing facilities, malls, multiplexes etc.

Also Tax exemption is for specific period say for 10 yrs or so.

7. Impact of the Scheme

The overwhelming response to the SEZ scheme is evident from the flow of investment and creation of additional employment in the country. The SEZ scheme has generated tremendous response amongst the investors, both in India and abroad, which is evident from the list of Developers who have set up SEZs:

- i) Nokia SEZ in Tamil Nadu
- ii) Quark City SEZ in Chandigarh
- iii) Flextronics SEZ in Tamil Nadu
- iv) Mahindra World City in Tamil Nadu
- v) Motorola, DELL and Foxconn
- vi) Apache SEZ (Adidas Group) in Andhra Pradesh
- vii) Divvy's Laboratories, Andhra Pradesh
- viii) Rajiv Gandhi Technology Park, Chandigarh
- ix) ETL Infrastructure IT SEZ, Chennai
- x) Hyderabad Gems Limited, Hyderabad

8. Future Prospects

The Union government is pressing the Reserve Bank of India (RBI) to reclassify special economic zones (SEZs) and give them infrastructure status so that the duty-free enclaves get easier access to credit and loans at cheaper rates than other sectors.

The commerce department has written to RBI urging quick action to operationalise the changed status, which was decided on by a ministerial panel nearly a month ago.

“We have underlined the need to take urgent action to implement the decision as SEZ activities are being adversely affected due to credit shortage,” a commerce department official told ET.

The panel decided in October 2008 to classify SEZ activities as being part of the infrastructure sector instead of the real estate sector in which it had been grouped. A notification by RBI formalizing the change will allow SEZs access to a special fund for the infrastructure sector. They will also get loans from the fund at a 2% cheaper rate from the prime lending rate (PLR). PLR is the rate of interest at which banks lend to their favoured customers.

The official said the implementation of approved SEZ projects had slowed because of unavailability of credit. Developers have been complaining that they do not have access to bank credit anymore and even SEZs which have been notified are not starting operations, the official added.

As many as 531 SEZ projects have been formally approved, of which less than half have been notified and 143 projects given in-principle approval. “Our focus is now on ensuring that the projects that have approval get implemented,” the official of RBI said.

It should be noted that if 100 acres are allotted for SEZ, then only 30-35% of area is used for setting up plants. Rest of the