

CHAPTER 4

EMERGENCE OF FREE TRADE ZONES: A BOON TO INTERNATIONAL TRADE

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CHAPTER 4

EMERGENCE OF FREE TRADE ZONES: A BOON TO INTERNATIONAL TRADE

4.1 Meaning and Development

We have seen earlier that The Theory of Comparative Advantage states that each member in a group of trading partners should specialize in and produce the goods in which they possess lowest opportunity costs relative to other trading partners. This specialization permits trading partners to then exchange their goods produced as a function of specialization. Free trade is a type of trade policy that allows traders to act and transact without interference from government. According to the law of comparative advantage the policy permits trading partners mutual gains from trade of goods and services.

Free-trade zones are among the most versatile, and under-used, devices available for saving on duties, taxes, and other costs involved with global trade. However, the rules and benefits vary widely from country to country. It came into wide usage around the globe after World War II as a way to encourage foreign investment, mostly in Third World countries. It supports free trade without all of the infrastructure and politics that multilateral agreements require. Therefore, free-trade zones and similar initiatives continue to advance the cause of globalization. Developing countries need foreign investment to create jobs and a

manufacturing base. At the same time, the world's manufacturing companies need incentives and cost-cutting advantages to compete globally. Free-trade zones will always play a role.

A free trade zone (FTZ) or Export processing zone (EPZ) or Special Economic Zone (SEZ) is one or more areas of a country where tariffs and quotas are eliminated and bureaucratic requirements are lowered in hopes of attracting new business and foreign investments. Free trade zones can be defined as labor intensive manufacturing centers that involve the import of raw materials or components and the export of factory products.

Under a free trade policy, prices are a reflection of true supply and demand, and are the sole determinant of resource allocation. Free trade differs from other forms of trade policy where the allocation of goods and services amongst trading countries are determined by artificial prices that do not reflect the true nature of supply and demand. These artificial prices are the result of protectionist trade policies, whereby governments intervene in the market through price adjustments and supply restrictions. Such government interventions generally increase the cost of goods and services to both consumers and producers.

Interventions include subsidies, taxes and tariffs, non-tariff barriers, such as regulatory legislation and quotas, and even inter-government managed trade agreements such as the North American Free Trade Agreement (NAFTA) and Central America Free Trade Agreement (CAFTA) (contrary to their

formal titles) and any governmental market intervention resulting in artificial prices that do not reflect the principles of supply and demand.

Most states conduct trade policies that are to a lesser or greater degree protectionist. One ubiquitous protectionist policy employed by states comes in the form agricultural subsidies whereby countries attempt to protect their agricultural industries from outside competition by creating artificial low prices for their agricultural goods.

Free trade agreements are a key element of customs unions and free trade areas. The details and differences of these agreements are covered in their respective articles.

Most FTZs are located in developing countries. They are special zones where some normal trade barriers such as import or export tariffs do not apply, bureaucracy is typically minimized by outsourcing it to the FTZ operator and corporations setting up in the zone may be given tax breaks as an additional incentive. Free trade has been the bedrock of United States foreign economic policy for decades, and is embodied in the world economy in the form of the World Trade Organization (WTO). While free trade has proven benefits, it also has proven costs, and therefore any true analysis of the merits of a free trade zone must take in the larger picture.

Usually, these zones are set up in underdeveloped parts of the host country, the rationale being that the zones will attract employers and thus reduce poverty and unemployment and stimulate the area's economy. These zones are often used by

multinational corporations to set up factories to produce goods (such as clothing or shoes).

4.1.1 Free Trade

Free trade is an economic regime that allows merchants to buy and sell without interference from government authority. In practical terms, this means that the government will not try to collect any tariffs, or special taxes on imports. Under normal free trade terms, whatever taxes would be applied to a domestic competitor, the same are still valid, as are all product or service standards. It is common for governments to use things like product inspections to throw up non-tariff barriers to imports, thus skirting the edge of their ratified free trade treaties. Therefore, while most of the world operates on what is supposedly a free trade footing, it could always be freer.

4.1.2 Free Trade Zones

A free trade zone (sometimes called a special economic zone) is an area, usually a city with a sea port, where the government has liberalized foreign trade terms beyond what are in force in the rest of the country. They are usually found in developing countries. The usual reason for doing this is to promote intense economic growth in a particular area by attracting international investment and increased mercantile activity. It is possible for a government that is already engaging in free trade to create a "free trade zone" by making trade there even freer. In fact, it is a not unusual practice for governments to designate free trade areas and offer incentives, such as tax exemptions, to investors and traders that would allow them to

undercut domestic competition elsewhere in the country. Some free trade zones even offer things which, strictly speaking are anti-free trade, such as government subsidies. The basic objectives of FTZs are to enhance foreign exchange earnings, develop export-oriented industries and to generate employment opportunities.

4.1.3 Comparative Advantage

Comparative advantage is central to the theory of free trade. What free trade is supposed to do is allow countries with particular advantages in producing a given commodity or service to export that and compete on a more or less equal footing with foreign competitors, both in the competitors home country and in the country's of third parties. This could take the form of superior quality, cheaper production costs (usually due to cheaper labor), or both. The consumers win because they have access to better goods at a cheaper price, and the economy as a whole wins because it is freed to re-task resources to focusing on its strengths, or comparative advantages.

4.1.4 Development

As previously noted, a free trade zone is mostly about attracting investment, but this does not mean that it does not take advantage of comparative advantage. What most countries setting up a free trade zone have to offer in terms of comparative advantage is cheap labor, allowing manufacturers to undercut their competition in production costs. A foreign company can set up a factory in the free trade zone, take

advantage of the more favorable local labor conditions, and export the product. Another comparative advantage could be an advantageous location. A good example of that is the entire city-state of Singapore, which is located on the heavily-trafficked Straits of Malacca, and essentially made its entire territory into a free trade zone early on in its independence. It should be noted that not all free trade zones permit domestic producers from locating their enterprises inside the free trade zone. Indeed, since the point is to attract foreign investment, some specifically exclude them. In such cases, the host government is shooting themselves in the foot, because by allowing foreigners access to privileges that domestic producers lack, they are effectively strangling domestic ownership of the economy.

4.1.5 Experimentation: A Major advantage of Free Trade Zones

One of the biggest advantages of a free trade zone is that by limiting the scope of trade liberalization, it allows a government to experiment with economic policies without the risks of applying them to the economy as a whole. A free trade zone can function as an economic laboratory, allowing a government to learn what will be of the most benefit to their economy over the long-term.

4.2 History of free trade

It is known that various prosperous world civilizations throughout history have engaged in trade. Based on this, theoretical rationalizations as to why a policy of free trade would be beneficial to nations developed over time. Before the appearance of Free Trade doctrine, and continuing in opposition to it to this day, the policy of mercantilism had developed in Europe in the 1500s. Early economists opposed to mercantilism were David Ricardo and Adam Smith.¹

Economists that advocated free trade believed trade was the reason why certain civilizations prospered economically. Adam Smith, for example, pointed to increased trading as being the reason for the flourishing of not just Mediterranean cultures such as Egypt, Greece, and Rome, but also of Bengal (East India) and China. The great prosperity of the Netherlands after throwing off Spanish Imperial rule, and declaring Free Trade and Freedom of thought, made the Free Trade/Mercantilist dispute the most important question in economics for centuries. Free trade policies have battled with mercantilist, protectionist, isolationist, communist, and other policies over the centuries.²

Wars have been fought over trade, such as the Peloponnesian War between Athens and Sparta, the Opium Wars between China and Great Britain, and other colonial wars. All developed countries have used protectionism due to an

¹ Adam Smith's: The Wealth of Nations.

² *ibid*

interest in raising revenues, protecting infant industries, special interest pressure, and, prior to the 19th century, a belief in mercantilism.

Many classical liberals, especially in 19th and early 20th century Britain (e.g. John Stuart Mill) and in the United States for much of the 20th century (e.g. Cordell Hull), believed that free trade promoted peace. The British economist John Maynard Keynes (1883-1946) was brought up on this belief, which underpinned his criticism of the Treaty of Versailles in 1919 for the damage it did to the interdependent European economy. After a brief flirtation with protectionism in the early 1930s, he came again to favour free trade so long as it was combined with internationally coordinated domestic economic policies to promote high levels of employment, and international economic institutions that meant that the interests of countries were not pitted against each other. Adam Smith reasoned out that³ some degree of protectionism is nevertheless the norm throughout the world.

The degree of protectionism that can be or should be allowed is and always has been a point of debate. A general feature is that the underdeveloped nations of today are not in the same position that the developed nations were in when they had a similar level of technology, because they are weak players in a competitive system; the developed nations have always been strong players, although formerly at an overall lower level. If the main defense of tariffs is to stimulate infant industries, a tariff must be high enough to allow domestic manufactured

³ *ibid*

goods to compete for the tariff to be possibly successful. This theory, known as import substitution industrialization, is largely considered to be ineffective for currently developing nations,⁴ and studies by the World Bank have determined that export-oriented industrialization policies correlate with higher economic growth as observed with the Four Asian Tigers.

Free trade zones in Latin America date back to the early decades of the twentieth century. The first free trade regulations in this region were enacted in Argentina and Uruguay in the 1920s. However, the rapid development of free trade zones across the region dates from the late 1960s and the early 1970s.

⁴ www.wikipedia.org

4.3 The US and free trade

Trade in colonial America was regulated by the British mercantile system through the Acts of Trade and Navigation. Until the 1760s, few colonists openly advocated for free trade, in part because regulations were not strictly enforced—New England was famous for smuggling—but also because colonial merchants did not want to compete with foreign goods and shipping. According to historian Oliver Dickerson, a desire for free trade was not one of the causes of the American Revolution. Free trade came to what would become the United States as a result of American Revolutionary War, when the British Parliament issued the Prohibitory Act, blockading colonial ports. The Continental Congress responded by effectively declaring economic independence, opening American ports to foreign trade on April 6, 1776.

The 1st U.S. Secretary of the Treasury, Alexander Hamilton, advocated tariffs to help protect infant industries in his "Report on Manufactures." This was a minority position, however, which the "Jeffersonians" strongly opposed for the most part. Later, in the 19th century, statesmen such as Senator Henry Clay continued Hamilton's themes within the Whig Party under the name "American System." The opposition Democratic Party contested several elections throughout the 1830s, 1840s, and 1850s in part over the issue of the tariff and protection of industry. The Democratic Party favored moderate tariffs used for government revenue only, while the Whig's favored higher protective tariffs to protect favored industries. The economist Henry Charles Carey

became a leading proponent of the "American System" of economics. This mercantilist "American System" was opposed by the Democratic Part.

The growing Free Trade Movement sought an end to the tariffs and corruption in state and federal governments by every means available to them, leading to several outcomes. The first and most important was the rise of the Democratic Party with Grover Cleveland at its helm. The next most important were the rise of the "Mugwumps" within the Republican party. For many Jeffersonian radicals, neither went far enough or sufficiently effective in their efforts and looked for alternatives. The first major movement of the radical Jeffersonians evolved from the insights of a young journalist and firebrand, Henry George.⁵

The tariff and support of protection to support the growth of infrastructure and industrialization of the nation became a leading tenet of the Republican Party thereafter until the Eisenhower administration and the onset of the Cold War, when the Democratic and Republican parties switched positions.

In the 1930s, the US adopted the protectionist Hawley-Smoot Tariff Act which raised rates to all time highs beyond the Lincoln levels, which many economists believe exacerbated the Great Depression. Europe, which had less protectionism at the time, had largely come out of the depression while the US remained mired in the depression. Franklin D. Roosevelt

⁵ Kenneth R. Gregg, George Mason University History News Network.

resorted to Hamilton's earlier formula of tariff Reciprocity coupled with subsidy to industry which went unbroken until the 1970s when protectionism was reduced after the Kennedy Round of trade talks in the late sixties.

Since the end of World War II, in part due to industrial supremacy and the onset of the Cold War, the U.S. government has become one of the most consistent proponents of reduced tariff barriers and free trade, having helped establish the General Agreement on Tariffs and Trade (GATT) and later the World Trade Organization (WTO); although it had rejected an earlier version in the 1950s (International Trade Organization or ITO). Since the 1970s U.S. government has negotiated numerous managed trade agreements, such as the North American Free Trade Agreement (NAFTA) in the 1990s, the Dominican Republic-Central America Free Trade Agreement (CAFTA) in 2006, and a number of bilateral agreements (such as with Jordan).

4.4 Criticism

The creation of special free trade zones is criticized for encouraging businesses to set up operations under the influence of often corrupt governments, and giving foreign corporations more economic liberty than is given indigenous employers who face large and sometimes insurmountable "regulatory" hurdles in developing nations. However, many countries are increasingly allowing local entrepreneurs to locate inside FTZs in order to access export-based incentives. Because the multinational corporation is able to choose between a wide range of underdeveloped or depressed nations in setting up overseas factories, and most of these countries do not have limited governments, bidding wars erupt between competing governments.

Often the government pays part of the initial cost of factory setup, loosens environmental protections and rules regarding negligence and the treatment of workers, and promises not to ask payment of taxes for the next few years. When the taxation-free years are over the corporation which set up the factory without fully assuming its costs is often able to set up operations elsewhere for less expense than the taxes to be paid, giving it leverage to take the host government to the bargaining table with more demands in order for it to continue operations in the country. The widespread use of free trade zones by companies such as Nike has received criticism from numerous writers.

4.5 Shenzhen: The Proven Success Story of Free Trade Zones

The great success story of free trade zones is the Chinese city of Shenzhen. It was a fishing village when Chinese leader Deng Xiaoping declared it as a Special Economic Zone in 1979. It was chosen because of its proximity to Hong Kong, and for the express purpose of attracting investment from there. The result was that, using its location, cheap labor and favorable business terms, Shenzhen grew into one of China's largest and most economically vital cities. Thus China showed to the world the importance of having a good Free Trade Zone and the kind of investment and prosperity it can bring upon a country.

4.6 Free Trade: An Indian Perspective

Most developing countries in the world have recognized the importance of facilitating international trade for the sustained growth of the economy and increased contribution to the GDP of the nation. As part of its continuing commitment to liberalization, the Government of India has also, since the last decade, adopted a multi-pronged approach to promote foreign investment in India. The Government of India has pushed ahead with second-generation reforms and has made several policy changes to achieve this objective. India converted eight of its existing export processing zones into SEZs six years ago. An analysis of the zones' contribution to industrialisation efforts in India reveals that EPZs have had a catalytic effect in promoting new production sectors, exporting new products and in building up the country's image in certain products in international markets.

4.6.1 Special Economic Zones: Meaning and Importance

The emergence of SEZs in a conservative society like India is aimed at changing the Indian outdated thinking and environment. India has witnessed a huge rush from private sector companies keen to set up Special Economic Zones. The new SEZ Act was approved in February 2006, and the government has already received over 100 applications. Before the new legislation, SEZ-related laws were scattered among different acts and rules. The new legislation provides a uniform SEZ policy and comprehensively covers all aspects of establishment, operation and fiscal oversight. The government has also given greater operational freedom to the Development

Commissioner as the key authority managing the SEZ. However, the most important change is related to tax incentives.

A SEZ is a geographical region that has economic laws that are more liberal than a country's typical economic laws. A 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. The promotion of SEZs is an attempt to deal with infrastructural deficiencies, procedural complexities, bureaucratic hassles and barriers raised by monetary, trade, fiscal, taxation, tariff and labour policies. These structural bottlenecks affect the investment climate adversely by increasing production and transaction costs. Since countrywide development of infrastructure is expensive and implementation of structural reforms would require time, due to given socio-economic and political institutions, the development of SEZ is seen as an important strategic tool for expediting the process of industrialisation.

Despite the recent pick-up, India's share in world goods exports has been very small largely 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.

It is a straightforward understanding that it would take time to improve the business environment on a nationwide basis and provide a competitive platform to India's entrepreneurs if business or expansion is done in the conservative manner. SEZs, however, can quickly help create high-quality

infrastructure in pockets, providing a liberal and supportive business environment, and thus kick-start the much-needed push for manufacturing exports. They allow the government to experiment with the liberalization of labour laws.

SEZs can provide help for small and medium-scale entities that cannot afford to set up captive infrastructure facilities, but can share the costs in a large group. Finally, they can attract foreign capital and technology.

The SEZ policy was first introduced in India in April 2000, as a part of the Export-Import ("EXIM") policy of India. Considering the need to enhance foreign investment and promote exports from the country and realizing the need that level playing field must be made available to the domestic enterprises and manufacturers to be competitive globally, the Government of India in April 2000 announced the introduction of Special Economic Zones policy in the country deemed to be foreign territory for the purposes of trade operations, duties and tariffs. To provide an internationally competitive and hassle free environment for exports, units were allowed be set up in SEZ for manufacture of goods and rendering of services. All the import/export operations of the SEZ units is on self-certification basis. The units in the Zone are required to be a net foreign exchange earner but they would not be subjected to any pre-determined value addition or minimum export performance requirements.

4.6.2 Features of SEZ in India

India is one of the first countries in Asia to recognize the effectiveness of the Export Processing Zone (EPZ) model in promoting exports. Asia's first EPZ was set up in Kandla in 1965. With a view to create an environment for achieving rapid growth in exports, a Special Economic Zone policy was announced in the Export and Import (EXIM) Policy 2000. Under this policy, one of the main features is that the designated duty free enclave to be treated as foreign territory only for trade operations and duties and tariffs. No license required for import. The manufacturing, trading or service activities are allowed.

To provide a stable economic environment for the promotion of Export-import of goods in a quick, efficient and hassle-free manner, Government of India enacted the SEZ Act, which received the assent of the President of India on June 23, 2005. The SEZ Act and the SEZ Rules, 2006 ("SEZ Rules") were notified on February 10, 2006. The SEZ Act is expected to give a big thrust to exports and consequently to the foreign direct investment ("FDI") inflows into India, and is considered to be one of the finest pieces of legislation that may well represent the future of the industrial development strategy in India. The new law is aimed at encouraging public-private partnership to develop world-class infrastructure and attract private investment (domestic and foreign), boosting economic growth, exports and employment.

The Ministry of Commerce and Industry lays down the regulations that govern the setting up and administering of the SEZs. The Central Government is functioning, while the State Governments play a significant lead role in the development of SEZs in their respective States by stipulating the conditions to be adhered to by an SEZ and granting the necessary approvals. The policy framework for SEZs has been enacted in the SEZ Act and the supporting procedures are laid down in SEZ Rules.

4.6.3 Legal Requirements

The Special Economic Zone Act 2005 came into force with effect from 10th February 2006, with SEZs Rules legally vetted and approved for notification. The SEZs Rules, inter-alia, provide for drastic simplification of procedures and for single window clearance on matters relating to central as well as state governments. Heavy investments are expected in sectors like IT, Pharma, Bio-technology, Textiles, Petro-chemicals, Auto-components, etc. The SEZ Rules provides the simplification of procedures for development, operation, and maintenance of the Special Economic Zones and for setting up and conducting business in SEZs. This includes simplified compliance procedures and documentation with an emphasis on self-certification; single window clearance for setting up of an SEZ, setting up a unit in SEZs and clearance on matters relating to Central as well as State Governments; no requirement for providing bank guarantees; contract manufacturing for foreign principals with option to obtain sub-contracting permission at the initial approval stage; and Import-Export of all items through personal baggage.

With a view to augmenting infrastructure facilities for export production it has been decided to permit the setting up of Special Economic Zones (SEZs) in the public, private, joint sector or by the State Governments. The minimum size of the Special Economic Zone shall not be less than 1000 hectares. Minimum area requirement shall, however, not be applicable to product specific and port/airport based SEZ. This measure is expected to promote self-contained areas supported by world-class infrastructure oriented towards export production. Any private/public/joint sector or State Government or its agencies can set up Special Economic Zone (SEZ).

In addition, there are certain requirements of the SEZs under the said scheme:

- These units have to achieve positive Net Foreign Exchange earning i.e. NFE;
- They also have to provide periodic reports to the Development Commissioner and Zone Customs;
- These units are also supposed to execute a bond with the Zone Customs for their operation in the SEZ.
- Moreover, any company set up with FDI for undertaking Indian operations, has to be incorporated under the Indian Companies Act with the Registrar of Companies.

4.6.4 Administrative Set up for SEZs:

SEZs is governed by a three tier administrative set up

- a) The Board of Approval is the apex body in the Department,
- b) The Unit Approval Committee at the Zonal level dealing with approval of units in the SEZs and other related issues, and
- c) Each Zone is headed by a Development Commissioner, who also heads the Unit Approval Committee.

4.6.5 Approval Mechanism of SEZs

Any proposal for setting up of SEZ in the Private/Joint/State Sector is routed through the concerned State government who in turn forwards the same to the Department of Commerce with its recommendations for consideration of the Board of Approval. On the other hand, any proposals for setting up of units in the SEZ are approved at the Zonal level by the Approval Committee consisting of Development Commissioner, Customs Authorities and representatives of State Government.

The SEZ Act 2005 offers a highly attractive fiscal incentive package, which ensures:

- Duty-free import/domestic procurement of goods for development, operation, and maintenance of SEZs and SEZ units.
- Extension of income tax benefits to SEZ developers for a block of 10 years in 15 years, as per the choice of the developers.

- 100% income tax exemption for SEZ units for the first 5 years, 50% for 2 years thereafter, and 50% of the ploughed back export profit for the next 3 years.
- 100% income tax exemption for 3 consecutive years and 50% for the next 2 years to off-shore banking units set up in Special Economic Zones.
- External commercial borrowing by SEZ units without any maturity restrictions through recognized banking channels.
- Treating supplies from the Domestic Tariff Area (DTA) to SEZ at par with physical exports.
- Exemption from Central Sales Tax on sales made from the DTA to SEZs.
- Exemption from Service Tax for SEZ units and developers.
- Exemption from State taxes and levies, as notified by various State Governments.

Moreover, provisions have also been made for (i) establishing free trade and warehousing zones for creating trade-related infrastructure, thereby facilitating import and export of goods; (ii) setting up of offshore banking units and units in an international financial service centre in SEZs; (iii) public private participation in the infrastructure development; and (iv) setting up of SEZ authority in each central Government SEZ for developing new infrastructure and also for strengthening the existing one.

4.6.6 Hindrances:

Although SEZs as a concept appear to be the right solution to encourage India's manufacturing exports, the government's current approach may not be the best way to achieve the much-needed push to boost India's manufacturing, particularly in the SME sector. The following are some of the issues arising from the government's current approach:

SEZ applications were driven by tax benefits: A large number of new SEZs being planned are primarily aimed at winning tax benefits. Under the new law, units in SEZs will be 100 per cent exempt from corporate income tax for the first five years; 50 per cent exempt for the next five years and, for the final five years, 50 per cent of the profits ploughed back will be exempt from tax.

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. As per the current policy the tax exemption to STPs is available only if 30 per cent to 50 per cent of the production is exported and it is a net foreign exchange earner.

According to the Ministry of Finance, the government may end up losing indirect and direct tax revenue to a large extent on account of existing/new export oriented units shifting to SEZs.

It is foreseen that companies will simply relocate to SEZ to take advantage of tax concessions being offered and little net

activity will be generated. The act will lead to a large-scale land acquisition by the developers, displacement of poor farmers and meager compensation being handed over to them with no alternative livelihood. SEZ will be built on prime agricultural land with serious implication of food security.

Scale-related advantages unlikely: The key purpose of SEZs is to build scale-related advantages. However, most of the SEZs currently being planned are minuscule 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).

With the rapid globalisation of manufacturing scale, small SEZs appear to have outlived their relevance in today's environment. Among the ones announced, there are probably only two medium-scale SEZs being taken up for development. Both these zones are being set up by Reliance Industries, India's largest private sector company.

Labour issues: The new SEZ law 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. The most restrictive central government regulation is one that requires all employers with more than 100 employees to gain compulsory government approval (normally a long drawn-out process) before retrenching workers or closing part of an enterprise.

This provision has not changed since 1982. The original draft of the new SEZ law intended to give state governments the freedom to allow implementation of flexible labour laws within the SEZ area. However, before the final approval from the lower house of Parliament, the government was forced to drop this clause in the face of leftist opposition.

Although the Ministry of Commerce is in favour of the policy with arguments that SEZs are expected to attract huge investments and will create additional direct jobs, there are arguments that the SEZ Act was framed without giving adequate thought to most of the ancillary issues. No exercise were undertaken to ensure that legal institutions are in place for massive land acquisition.

No long-term strategy was drawn to counter the socio economic consequences of the scheme. No serious research was conducted on how SEZ will affect the regional economy, how much fertile land will be lost, how many farmers will be affected and what the tax implications of SEZs will be.

Also, the sectoral breakup of SEZ approvals it is found that the approval granting rate is very slow. This pattern is worrisome. In view of declining competitiveness of the manufacturing sector, the focus of the SEZ policy needs to be making India a preferred destination for manufacturing.

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 sectors' competitiveness. The best solution would be for the government to rework the SEZ policy to facilitate the development of large employment generating SEZs, without hurting the country's exchequer and dissuading all vested interests. Another possible solution would be to set them up in the barren land or in land with low agricultural productivity.

But even today some still argue that agriculture must be the priority, while others contend that industry should take precedence. There is no use in debating, as this approach will get India nowhere. Be it increasing urbanization or SEZs, we must accept the fact that change has arrived on India's doorstep and agriculture will have to adapt to these modifications. What India needs is to welcome these transformations, and manage them successfully. However, there still are many critics of this scheme who point at the following issues:

- real estate exploitation;
- the loss of land to agriculture and inadequacy of compensation and other deprivation suffered by farmers and rural workers;
- the impact of tax exemptions and other fiscal incentives, on the central state and state revenue;
- the impact on the regional balance in developments and

- administrative weaknesses.

4.6.6.1 Exploitation of the Real Estate

There is a huge interest among private developers, especially property developers, to rush into the area of SEZ development. The reason for that can be found in Section 5(2) of the SEZ Act, which addresses the issue of land acquisition. It provides for non-industrial use of 75% of the land in the possession of an SEZ developer. This is justified by the argument that social infrastructure, which would constitute things like housing facilities and entertainment, is extremely critical. This means that many real estate companies who have no track record in manufacturing or exports have become SEZ promoters.

The developers are aided by duty exemptions on their inputs and other fiscal exemptions plus cheap acquisition of land from farmers. They are therefore bound to make a huge profit through real estate. The development of housing and other social infrastructure requirements in the non-processing parts are being given the same fiscal incentives as the business units in the processing area, allowing prosperity in real estate development.

The whole scheme is one that paves the way for private capital to make huge profits at the expense of the small property owner and the state with limited benefits in the form of foreign exchange revenues.

Solution

It has been suggested that the Government should evolve a new Township Development Policy with suitable rules and incentives (fiscal and non - fiscal). The incentives should be stronger at the proposed township that is farthest from the Metros and big cities, therefore providing less urban areas with the opportunity of prosperity.

SEZs should be primarily devoted to exporting. If any social infrastructure has to be built, it should be only for the provision of housing for workers and other stakeholders (healthcare, education etc). If any further infrastructure has to be built in the surrounding areas, it should be treated as a township whereby the government develops a separate and more suitable policy.

4.6.6.2 Loss of Land to Agriculture and Inadequacy of Compensation

The biggest bone of contention in the SEZ skeleton is the building of SEZ units on prime agricultural land and the displacement and inadequate compensation provided to farmers, and other deprivation suffered by them and other rural workers. For acquisition of land from farmers, two methods are followed. The first is of compulsory acquisition, whereby the so called 'fair' market price is determined. The other way is to let the SEZ developers' purchase the land directly from the farmers. In either method, the farmer stands at a disadvantage. In the compulsory acquisition mode, he is at a serious disadvantage because the recorded sales rarely disclose the real opportunity price.

In the other mode also the farmer is a weaker bargaining party and the SEZ developer is immensely more powerful, given his financial prowess and the easy availability of real estate intermediaries. Critics argue that the process of acquiring land, laid out by the Land Acquisition Act 1894, is illogical. Once notification is issued, public objections are invited, and after they are heard the Government decides on the compensation package. The question that arises is this; how can people accept or reject land acquisition until they know what deal they are going to get?

When agricultural land gets transformed into industrial or urban land, it secures a huge value addition, and this is something that needs to be taken into consideration. As an example, one can look to Mumbai, where land acquisition law states that the price of the land should not only be judged by the current market rate, but also of the value of the land after development takes place.

Solution

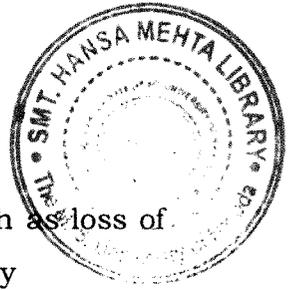
Adequate safeguards need to be provided in the SEZ policy to ensure that irrigated and agriculturally fertile land is not swallowed up by the SEZs. The SEZ proposals should be supported by certification of the agricultural quality of land by the local revenue authority and the format of assessment for building on prime agricultural land should be made clear. The CPI (M) also wants a new Act to replace the existing Land acquisition Act of 1894. The Government has said that the Land Acquisition Act will have to be reviewed in light of the SEZ rules, 2006 and the SEZ Act, 2005. Sonia Gandhi also expressed opposition. She said, "Prime agricultural land

should not normally be diverted to non-agricultural uses” and called for satisfactory compensation to be paid when land was taken over.

State governments must prescribe minimum prices for land in various areas, which will be valid both for registration of sales deeds as well as payment of compensation. The prices should be high enough to reflect the opportunity prices of land. In addition to suitable financial compensation, the displaced farm labour and rural workers should be given preference in employment either by the SEZ developer or in the business units in the SEZ. Every SEZ developer should be required to set up a training institution where appropriate training is provided for these workers who have been displaced from their traditional employment. The government has drafted a National Policy on Relief and Rehabilitation stating that all projects leading to ‘involuntary displacement’ can be challenged in court, if violated.

The policy, which also underlines that farmers be adequately compensated for their land and rehabilitated fairly, comes in the face of mounting pressure from farmers and political parties who believe that the development of business interests, took precedent over the interests of India’s farmers. The new policy introduces several firsts. Amongst the exhaustive list includes:

- Introducing the concept of Social Impact Assessment (SIA) along with the current norm of Environmental Impact Assessment. The SIA would also involve public



hearings on displacement related issues such as loss of livelihood; compensation; and effects on family

- For agricultural workers, at least one person in the family shall be given employment or a one time “rehab grant”. If it is a corporate project, a fifth of the compensation will be in the form of the company’s shares
- State governments will appoint an officer to be in charge of control formulation, execution and monitoring of the rehab plan, alongside a National Rehabilitation Commission and high level national monitoring committee who will monitor progress of implementation of scheme
- If a land development project, a site or apartment within the development project will be given to a member of the affected family.
- Those whose entire land has been acquired may be allotted the same cultivable land to the extent of actual land loss subject to one hectare of irrigated land and two hectares of unirrigated land.

The issue of land acquisition arises with the concern that SEZs will be built on prime agricultural land with serious implications for food security. The state governments believe that mainly waste and barren land and, if necessary, single crop agricultural land alone, shall be acquired for SEZs. If double crop land should be acquired, then the minimum area requirements should not exceed 10%. While this may be good

in theory, in practice many Indian states do not have sufficient free land. In India there are huge wastelands in comparison with the total cultivable land, which can be utilized for such purposes.

We have seen the very recent case of **Tata Motors in Singur**, West Bengal and the problems faced by the Government, the company and the problems of the poor farmers. In a way this was a blot on the industrial history of West Bengal but maybe it was in the interests of people at large. The saving grace so far India as a nation had was the shifting of the plant from Singur to Gujarat, otherwise this case was a bad reflection and bad advertisement for the industrialization of the nation. The Government has separate policies for industry, SEZs, labour and land acquisition, but no policy for agriculture, on which more than 50 per cent of the population depends.

4.6.6.3 Impact of tax exemptions and incentives on revenue

Tax concessions and other privileges extended to SEZ projects are steadily leading to an unequal trade-industry regime, which is bound to be hazardous to the country's economic health in the medium and long term. "We also oppose tax holidays for SEZs and demand that labour laws be made applicable there," said CPI (M) politburo member Sitarm Yechury.

The Ministry of Finance has estimated huge losses of revenue until 2010 of which about 50% will be due to loss of direct taxes and the rest as loss of customs and excise duties and other central taxes. To the extent that tax concessions to units

in SEZs erode the legally defined tax base and that the revenue loss is permanent. The International Monetary Fund, Finance Ministry and the Reserve Bank of India have also criticised the policy in recent times. All have pointed to hundreds of proposed or approved SEZs that are far too small to improve India's performance in the long term. These SEZs have proved to be little more than tax loopholes for real estate speculators and developers. The IMF research director Raghuram Rajan described India's SEZ policy as a tax "give-away" that was likely to shift Indian production to SEZs rather than create new economic activity. He said the zones would be viable only if they focused on providing superior infrastructure, business-friendly regulations and exemptions from labour laws "rather than offering often misdirected subsidies, guarantees, and tax sops that a stretched budget can ill-afford".

Tax exemptions were incorporated in the Income Tax Act 1961 through sections 80I and 80J and were consequently replaced by section 80IA, 80IB AND 80IC which allow for tax exemptions for new industries in the SEZs. The operation of these provisions gave rise to endless problems and litigation. They caused problems in administration and gave rise to inefficiencies in the economy by creating distortions. The SEZ Act 2005, consolidates, and extends the benefit meant primarily for promoting exports and new technology and have been extended from time to time under the umbrella of free trade areas (FTAs), and EPZs.

Since the development of SEZs is an activity that the private sector can both initiate and participate in, the incentives have

been extended to apply to the development of the SEZs as well as the establishing units. Section 10A and 10B of the Income Tax Act are to be phased out in 2010. However, the SEZ Act, 2005 seems to have given a fresh lease of life for tax incentives. This means that the incentives in income tax along with the exemption from customs and excise will be available for SEZ units even after sections 10A and 10B cease to apply. The continuation of tax incentives for exports under the SEZ act has been questioned for the following reasons:

- These incentives are not all compatible with India's WTO obligations.
- There is no evidence to substantiate that tax benefits to SEZs have served to foster their growth in recent years or played any significant role in promoting exports. Special dispensation for exports was not considered necessary when India's economy was heavily controlled and protected, the tax system was not export friendly and Indian industry was not globally competitive.

Solution

One of the most emphatic panels has been the Kelkar Task Force on Direct Taxes, appointed in 2002. They have also strongly recommended ending the "exemption raj". The task force recommended the elimination of concessional terms for SEZs, since they are deemed to benefit from superior infrastructure. Further, since other exporters cannot avail these concessional terms in their sales, such provisions discriminate against exports from the rest of the economy, (an

issue which we will revert to later in the article). There is no good evidence to support the case for tax incentives for SEZ units apart from remission of customs and domestic trade tariffs, which should apply to all exports irrespective of whether they are located in an SEZ or outside.

India believes that by providing breaks in the tax it will encourage investment. The breaks need to be designed carefully in order to ensure their efficacy and minimize costs. It is argued that these tax breaks do not adequately benefit society. Further, the tax subsidies being offered by the government may well be challenged in the World Trade Organization, and could attract trade retaliatory measures from importing countries.

4.6.6.4 The Impact on the Regional Balance in Development

The issue of the impact on the regional balance in development has briefly been touched upon already in this article. It is contended that the SEZ policy has induced further imbalances in the regional distribution of industrial activity. The number of SEZ proposals and the number of those approved vary greatly across states. The numbers are far greater in the states that are already industrially more advanced and the discrimination so created with regards to the businesses and the entities located outside the SEZ will be unjust and will be difficult to sustain even in a court of law. New manufacturing units tend to be located in the SEZs, because of the tax benefits and the better infrastructure that they allegedly provide, and the areas outside SEZ, will get to host fewer units. The fear is that even the existing units outside SEZs

may consider relocating into SEZs, provided that the costs of relocation are not out-weighed by the benefits available in the SEZs. On the one hand, checks are being provided against such relocations. On the other hand, some tax incentives are being provided for relocation, such as exemption of capital gain tax on the disposal of industrial assets outside the SEZs, when such disposal is a precursor to relocation into an SEZ.

Solution

Measures must be taken to help the industrially backward states to generate and implement SEZ projects. The state governments, while recommending SEZ proposals and the Board of Approvals while approving them should ensure that the SEZs are located not in the vicinity of larger urban areas and thereby further expanding their sprawl.

The SEZs should be close to the smaller towns which have the potential for expansion and trained manpower which can be gradually expanded by educational and training effort. [This proposal will be contended by SEZ units and developers who believe that it is essential to develop their units nearer to larger urban areas, due to the superior transport facilities available to them].

“All the SEZs so far created are in the urban town areas, which already otherwise are well developed. At many places over development of these areas has created an urban chaos so creating SEZs here makes in no sense of the logic that SEZs are meant for sustainable development of the economy. SEZs in these areas would create further urban chaos”.

The SEZ model has come under heavy criticism, even in China, as it creates enormous economic disparities, rather than broad based development and this evaluation is apt for the problems that India may face in the future.

4.6.6.5 Administrative Weaknesses

The last issue that must be addressed is the administrative weakness of the SEZ laws and proposals. The Development Commissioner and the Approval Committee have been given authority under numerous SEZ laws with the objectives of minimizing the hassles of the SEZ developers as well as potential investors. However, ownership of the entire SEZ land vests in the developer and if a land dispute arises between the state and developer, then the latter will have more prowess to reign supreme. There should be an independent regulatory authority to deal with issues related to SEZs.

Communist Party India member Sitarm Yechury argues that the SEZs are being used as real estate developments for those acquiring land at very inexpensive prices. In many cases, the SEZs are little more than real estate ventures rather than production zones. The rules require only that 35% of a SEZ be devoted to productive activity. A developer can use the rest of the land to build apartments, hotels and commercial offices. States have urged the Central Government to come up with a clear-cut policy to prevent "improper usage of land" by the developer.

Tax concessions and other privileges extended to SEZ projects are steadily leading to an unequal trade-industry regime, which is bound to be hazardous to the country's economic

health in the medium and long term. Despite the Government's determination to proceed, the flaws and criticisms of the SEZs are a significant blow to the investors and developers. A recent Financial Times article described the situation. "While manufacturers are attracted to India's low-cost environment and burgeoning domestic market, they are worried about moving their goods—be it cars, mobile phones or textiles—through the country's poor network of roads, overburdened airports and clogged ports. Power cuts can force business to a grinding halt." As it stands, tax concessions and other privileges extended to SEZ projects are steadily leading to an unequal trade-industry régime, which is bound to be hazardous to the country's economic health in the medium and long term.

Solution

The policy relating to the SEZs is contained in the Foreign Trade Policy, incentives and other facilities offered to the SEZ developer and units are implemented through various notifications and circulars issued by the concerned Ministries/Departments. The present system, it is argued, does not inspire enough confidence for investors to commit substantial funds for development of infrastructure. To provide a long-term and stable policy framework, a Central Act for SEZs is necessary to be compatible with international practice. The introduction and passage of the Bill should provide the confidence and stability to domestic and foreign investors and signal the Government's commitment to the SEZ policy framework.

4.7 Conclusion

The concept of FTZs has been a good success internationally wherever operated and it is seen as the future of international trade. A number of countries have benefited immensely from this concept, China has till date used this concept in the best manner and has reaped the benefits. The advantages of this concept being many it has helped the countries in aspects other than international trade as well and thus provided an overall development of the nation.

In the case of India it was believed that the Bill of 2005 would have provided a stable framework for SEZs to create employment opportunities, and initiate deals on both the foreign and domestic front, however, a lot more still needs to be done. Business leaders are also pushing for more pro-corporate labour laws, regulations, land zoning and taxation across the country, not just in the SEZs. An analysis of the zones' contribution to industrialisation efforts in India reveals that EPZs have had a catalytic effect in promoting new production sectors, exporting new products and in building up the country's image in certain products in international markets. However, there is no assurance that SEZs will follow the same way. The constant backlash that the scheme faces ensures that road to SEZs will be a rocky one.