



Export Promotion through Tax Incentives in Special Economic Zones (SEZs): Benefits and Concerns

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ABSTRACT

India's Export Processing Zone Scheme, launched in 1965, was the precursor to the present day SEZ (Special Economic Zones) Scheme. The SEZ Act was enacted in 2005 and made operational through SEZ Rules in February 2006. The SEZ scheme provides an ecosystem conducive to exports, wherein all clearances, starting from setting up of the unit, allocation of space, approval of raw material, capital goods, issuance of letters of permission, monitoring of exports, permission for sale in DTA (Domestic Tariff Area) etc. are provided at one place. The services sector is an extremely important component of our foreign trade and there are large inflows of investment into SEZs (specifically for software exports) and this trend is likely to continue over the next decade. In the light of this, we examine whether intended benefits are being achieved through the SEZ scheme and the related tax incentives. We also look at the concerns in the area of SEZs.

Keywords: *Special Economic Zones (SEZs), Tax incentives, Services sector, Export Processing Zones.*

1.0 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 (Gujarat) in 1965. However, the EPZs were not able to emerge as effective instruments for export promotion on account of multiplicity of controls and clearances, absence of world-class infrastructure and an unstable fiscal regime.

Considering the need to enhance foreign investment and promote exports from the country and realising the need that level playing field must be made available to the domestic enterprises and manufacturers to be competitive globally, the Special Economic Zones (SEZs) Policy was announced in April 2000.

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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 November 1, 2000 to February 9, 2006 under the provisions of the Foreign Trade Policy and fiscal incentives were made effective through the provisions of relevant statutes.

To instil 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 was prepared after extensive discussions with the stakeholders. The Special Economic Zones Act, 2005, was passed by Parliament in May 2005 which received Presidential assent on June 23, 2005. After extensive consultations, the SEZ Act, 2005, supported by SEZ Rules, came into effect on February 10, 2006, providing for drastic simplification of procedures and for single window clearance on matters relating to Central as well as State Governments. The main objectives of the SEZ Act are the following:

1. Generation of additional economic activity.
2. Promotion of exports of goods and services.
3. Promotion of investment from domestic and foreign sources.
4. Creation of employment opportunities.
5. Development of infrastructure facilities.

The SEZ Act, 2005 envisages key role for the State Governments in export promotion and creation of related infrastructure. A single window SEZ approval mechanism has been provided through a 19 member inter-ministerial SEZ Board of Approval (BoA). The applications duly recommended by the respective State Governments/UT Administrations are considered by BoA periodically. All decisions of the BoA are with consensus.

The SEZ Rules provide for differentiated minimum land requirements for different classes of SEZs. Every SEZ is divided into a processing area where alone the SEZ units would come up and the non-processing area where supporting infrastructure is to be created. The SEZ Rules also provide for simplified procedures for development, operation and maintenance of the SEZ, setting up units in SEZs, single window clearance both relating to Central as well as State Governments for setting up of an SEZ and units in a SEZ, and simplified compliance procedures/documentation with emphasis on self-certification. A Board of Approval has been constituted by Government in exercise of the powers conferred under the SEZ Act.

SEZs in India seek to promote value addition component in exports, generate

employment and mobilize foreign exchange. SEZs when operational are expected to offer high quality infrastructure facilities and support services, besides allowing for the duty free import of capital goods and raw materials. Additionally, attractive fiscal incentives and simpler customs, banking and other procedures are offered in such zones. Setting up of SEZs is also treated as an infrastructure development activity and offered same incentives. SEZs in India closely follow the Chinese model.

SEZs are intended as engine for economic growth supported by quality infrastructure, with minimum possible regulations, and an attractive fiscal package, both at the level of Central and State Governments.

Various incentives and facilities are offered to both SEZ developers and units in SEZs for attracting investments, including foreign investment, into SEZs. These incentives and facilities are expected to 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.

2.0 Approval Mechanism and Administrative Set up of SEZs

2.1 Approval mechanism

The developer submits the proposal for establishment of SEZ to the concerned State Government. The State Government has to forward the proposal with its recommendation within 45 days from the date of receipt of such proposal to the BoA. The applicant also has the option to submit the proposal directly to the BoA.

BoA has been constituted by the Central Government in exercise of the powers conferred under the SEZ Act. All the decisions are taken in the BoA by consensus. BoA has 19 Members. It is headed by the Secretary, Department of Commerce in the Ministry of Commerce and Industry, Government of India.

2.2 Administrative set up

The functioning of the SEZs is governed by a three- tier administrative set up. BoA is the apex body and is headed by the Secretary, Department of Commerce. The Approval Committee at the Zone level deals with approval of units in the SEZs and other related issues. Each Zone is headed by a Development Commissioner, who is ex-officio chairperson of the Approval Committee.

Once an SEZ has been approved by the BoA and Central Government has notified the area of the SEZ, units are allowed to be set up in the SEZ. All the proposals for setting up of units in the SEZ are approved at the Zone level by the Approval Committee consisting of Development Commissioner, Customs Authorities and representatives of

State Government. All post-approval clearances including grant of importer-exporter code number, change in the name of the company or implementing agency, broad banding diversification etc. are given at the Zone level by the Development Commissioner. The performance of SEZ units is periodically monitored by the Approval Committee and units are liable for penal action under the provision of Foreign Trade (Development and Regulation) Act, 1992 in case of violation of the conditions of the approval.

2.3 Criteria for approval

Proposals for setting up SEZ in the public/private/joint/State sector are required to meet the following conditions.

- a) Minimum size of the SEZ shall not be less than 1000 hectares. This would however, not apply to existing EPZs converting into SEZs as such or for notifying additional area as a part of such SEZ or to product-specific port/airport based SEZs.
- b) SEZ and units therein shall abide by local laws, rules, regulations or bye-laws in regard to area planning, sewerage disposal, pollution control and the like. They shall also comply with industrial and labour laws and such other laws/rules and regulations as may be locally applicable.
- c) SEZs shall make adequate arrangements to fulfil all the requirements of the laws, rules and procedures applicable to such SEZs.
- d) Only units approved under the SEZ scheme would be permitted to be located in SEZ.

Proposals received for setting up of SEZs are considered by an Inter-Ministerial Committee known as the Board of Approval (BOA), in its meeting held every month. The promoters of the SEZs are also invited to such meetings to explain the salient features of their proposals and to furnish clarifications, wherever required. Proposals that are received up to 15 days prior to the scheduled meeting of the Board of Approval are placed for its consideration and any proposals received thereafter are considered in the next meeting.

3.0 Conversion of EPZs into SEZs

3.1 How are SEZs different from EPZs?

In one sense, SEZs are only a variant of EPZs. Both have delineated area and enjoy duty free import of capital goods and raw materials. Both aim to attract foreign investment for setting up export-oriented units by providing developed infrastructure, conducive operating environment and a package of fiscal incentives.

However, the objectives of SEZs are much larger than mere promotion of export processing activities. While EPZs are industrial estates, SEZs are virtually industrial townships that provide supportive infrastructure such as housing, roads, ports and telecommunications. The scope of activities that can be undertaken in the SEZs is much wider and their linkages with the domestic economy are stronger. Consequently, they have a diversified industrial base. Their role is not transient like that of EPZs, as they are intended to be instruments of regional development as well as export promotion. As such, SEZs can have tremendous impact on exports, inflow of foreign investment and employment generation.

Indian EPZs have not fared well as these are so few and their areas are small. For some, the location is inappropriate and they are subject to cumbersome procedures for long. However, in many East Asian economies, EPZs have been highly successful in their initial phase of opening up. Therefore, the mere fact that India is switching over to the SEZ model may not per se guarantee success as demonstrated by China unless policy parameters and implementation strategy are planned carefully.

Some of the existing EPZs have been converted into SEZs. For example, the Government has converted EPZs located at Kandla and Surat (Gujarat), Cochin (Kerala), Santa Cruz (Mumbai-Maharashtra), Falta (West Bengal), Chennai (Tamil Nadu), Visakhapatnam (Andhra Pradesh) and NOIDA (Uttar Pradesh) into SEZs.

3.2 Will EPZ conversion help?

The proposal to convert existing EPZs into SEZs does not make much sense, because their size and infrastructure will remain the same. It is only the customs regime envisaged for SEZs which is sought to be superimposed on them, though not favoured by the entrepreneurs in some of the EPZs. Unless there is a demand from entrepreneurs for switch over to the SEZ regime, it should not be forced upon them. China has only five SEZs but a variety of other EPZ type zones which have a slightly different policy framework. In the hinterland and in backward areas, India may have to rely on smaller EPZ type zones, as it is not possible to set up SEZs everywhere, having regard to the availability of skills and social and economic infrastructure.

4.0 Tax Incentives and Facilities offered to Units in SEZs

The incentives and facilities offered to the units in SEZs for attracting investments into the SEZs, including foreign investment, include the following:

- a) Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units.

- b) 100 percent income tax exemption on export income for SEZ units under Section 10AA of the Income Tax Act for first 5 years, 50 percent for next 5 years thereafter and 50 percent of the ploughed back export profit for next 5 years.
- c) Exemption from minimum alternate tax under Section 115JB of the Income Tax Act.
- d) External commercial borrowing by SEZ units up to US\$ 500 million in a year without any maturity restriction through recognized banking channels.
- e) Exemption from Central Sales Tax.
- f) Exemption from service tax.
- g) Single window clearance for Central and State level approvals.
- h) Exemption from State sales tax and other levies as extended by the respective State Governments.

4.1 Tax Incentives and Facilities available to SEZ Developers

These include the following:

- a) Exemption from customs/excise duties for development of SEZs for authorized operations approved by the BoA.
- b) Income tax exemption on income derived from the business of development of the SEZ in a block of 10 years in 15 years under Section 80-IAB of the Income Tax Act.
- c) Exemption from minimum alternate tax under Section 115 JB of the Income Tax Act.
- d) Exemption from dividend distribution tax under Section 115O of the Income Tax Act.
- e) Exemption from Central Sales Tax (CST).
- f) Exemption from Service Tax.

5.0 Apprehensions and Concerns

Concerns have been expressed regarding acquisition of agricultural land for setting up SEZs. The State Governments have been advised that in land acquisition for SEZs, first priority should be for acquisition of waste and barren land and if necessary single crop agricultural land could be acquired for the SEZs. If perforce a portion of double cropped agricultural land has to be acquired to meet the minimum area requirements, especially for multi-product SEZ, the same should not exceed 10 percent of the total land required for the SEZ. Various issues relating to setting up of SEZs in the country including issues raised by various political parties are being addressed by the Empowered Group of Ministers.

Some of the apprehensions against the SEZs are the following:

1. Generation of little new activity as there may be relocation of industries to take advantage of tax concessions.
2. Revenue loss.
3. Large-scale land acquisition by the developers which may lead to displacement of farmers with meagre compensation.
4. Acquisition of prime agricultural land having serious implications for food security.
5. Misuse of land by the developers for real estate.
6. Uneven growth aggravating regional inequalities.

Many of these apprehensions, however, can be addressed through appropriate policies and safeguards.

5.1 SEZs and national security

SEZs coming up in different parts of India have raised security concerns in government circles, particularly the Home Ministry. Government is reluctant to allow any SEZ near the border, fearing threat to national security. All zones with a port or near an existing dock are being closely watched. However, the government-owned Kandla Port Trust, which is setting up a Rs. 7,300 crore port-based zone, has been allowed to proceed further with the project. Similarly, doubts are being raised about gems and jewellery SEZs on the ground that operating units could smuggle precious metals and stones in and out of the country. Furthermore, pharmaceutical industry is also on the watch list. The Home Ministry wants a stricter dispensation for companies undertaking DNA-related work in the SEZs.

In short, Government's thinking is clear on the subject, i.e. country's security is paramount and any unit in a SEZ could be shut down the moment it is found to be indulging in anything that is detrimental to national interest.

6.0 Lessons from China

6.1 Size of SEZ

Chinese SEZs are like townships. India has not gone that far, but it is heartening that realising that size does matter, the government has decided to have large-sized SEZs. According to the guidelines, the area of an SEZ should be 1,000 hectares. This reflects a sea change in the Government's perception. The best performing EPZ in Mumbai has an area of 93 acres only. It hardly needs reiteration that only a large-sized zone can generate economic activity on some reasonable scale. In a small zone, the requisite infrastructure and services cannot be provided nor can multiple economic activities be promoted.

The SEZs proposed to be set up at Positra in Gujarat, Navi Mumbai in Maharashtra, Nanguneri in Tamil Nadu, Kakinada in Andhra Pradesh, Paradeep in Orissa, Kapri in West Bengal, Bhadoi in Uttar Pradesh and Indore in Madhya Pradesh are much bigger than the existing EPZs, though compared to the Chinese SEZs, their size is small.

6.2 Customs regulations

The customs regime in Chinese SEZs provides tremendous operational ease. The customs regulations designed for Indian SEZs also seem to be far less cumbersome than those for EPZs. The entrepreneurs will be free from routine inspections of import-export cargo. Procedures for operations such as record keeping, inter-unit transfer, sub-contracting and disposal of obsolete material and waste and scrap will be simpler. Enterprises will be allowed to utilise duty free raw materials over five years. These changes will definitely make the customs regime investor friendly.

6.3 Incentives package

The incentive package in India is quite liberal and may even be a shade better than that for Chinese SEZs. In fact, it is more or less on par with the package for the existing EPZs. Duty free import of capital goods and raw materials, reimbursement of Central sales tax, tax holiday for specified period, 100 percent repatriation of profits for subcontracting facilities are allowed. The Government has done well by extending incentives for the infrastructure sector to zone developers and the units as well. This can attract foreign direct investment for providing internationally competitive infrastructure.

Thus, so far as the size of SEZs, their customs regime and incentive package are concerned, the Indian policy compares quite favourably with the Chinese policy framework. However, in relation to the regime of labour laws, decentralisation of powers in favour of State Governments and the duty structure for DTA access, it falls short of expectations.

6.4 Labour laws

As regards labour laws, it is difficult to imagine that a communist country like China has relaxed these laws by allowing a hire and fire policy for the SEZs. This single measure went a long way in attracting foreign investment to these zones. After investors gained confidence in the productivity of Chinese workforce, the hire and fire policy was substituted by the contract system. There is ample justification for adopting in India a flexible labour policy, at least for these exporting enclaves, on the ground that they are exposed to uncertain international market conditions, recession or rejection of consignments. On the positive side, they create gainful additional employment and

facilitate inflow of foreign investment. The policy in India on this critical issue is lukewarm in as much as it states that the laws of the land will apply and that the zones can be declared as public utilities under the Industrial Disputes Act. Merely declaring SEZs as public utilities will, however, not serve much purpose as is borne out by the EPZ experience.

6.5 Involvement of State and Local authorities

China made the provincial and local authorities partners and stakeholders by delegating them powers for approving foreign investment. The SEZ authorities in China can approve investment proposals up to US\$ 30 million. This has been a significant feature of the Chinese policy and a key contributor to the success of SEZs. The Indian policy only enables the State Governments to set up SEZs, but does not empower them to approve investment proposals. These powers have been vested with the development commissioners concerned who represent the Central Government. This will result in centralisation of work in their offices.

Unless the State Governments are directly made responsible for the management of SEZs and approving investment proposals, their political leadership and bureaucratic set up may not have any incentive to push the initiative forward. Their cooperation and active participation in the drive for setting up SEZs is essential. China has gone a step further by delegating powers to the local authorities. The local authority manages Shenzhen SEZ, which has the highest export turnover. India needs to do likewise.

Some additional measures will be necessary to deepen and widen the interface with the State Governments and attract foreign investment. As States were not associated in the past with export promotion activities, they have little idea of what is required to be done. For their meaningful participation, they need to have role clarity and a sense of identification with the scheme. They should fully comprehend the details of the SEZ model for proper micro planning at their end.

6.6 DTA sales

Another ticklish issue relates to domestic market access for units in the SEZs. The proposed policy of levying full import duty on DTA sales does not seem to be right in view of the current differentials in the effective rates of import and excise duties. This will bar the entry of units based on indigenous inputs into SEZs since such sales will not be viable for them. The SEZs will only attract import intensive investment with low net foreign exchange earnings. Though China has set up a variety of zones, the infrastructure and incentive package for SEZs were the most attractive. For Indian SEZs, this may not be the case in so far as domestic market access is concerned. For a country of India's

size, domestic market access is an important issue for investors in SEZs. In the Chinese SEZs, about 50 percent production is sold in the DTA.

6.7 Foreign investment and technology

The thrust of SEZs in China was on attracting foreign investment and technology and that should also be the prime concern in India. This is not possible without aggressive marketing and promotion. Zone managements in China wooed investors aggressively and provincial and local authorities competed with each other to attract investors.

7.0 Issues relating to SEZs

7.1 Impact of Direct Tax Code (DTC)

The issue is related to deadlines for profit-linked deductions: As per the DTC, SEZ developers will be allowed profit-linked deductions for all SEZs notified on or before March 31, 2012. Units in SEZs that will commence commercial operations by March 31, 2014 too will be allowed profit-linked exemptions. Developers and units notified after these dates will only have investment-linked exemptions and not profit-linked exemptions. There is concern about these dates among developers and units particularly in the big SEZs with long gestation time.

7.2 Goods and Services Tax (GST)

As per the GST model being considered, GST will be levied on imports with necessary constitutional amendments. Though full and complete set off would be available on the GST paid on import of goods and services, after the introduction of the GST, tax exemptions, remissions, etc. related to industrial incentives should be converted, if at all needed, into cash refund schemes after collection of tax, so that the GST scheme on the basis of a continuous chain of set-offs is not disturbed. Regarding special Industrial Area Schemes, such exemptions, remissions would continue up to legitimate expiry time both for the Centre and the States. However, any new exemption, remission, or continuation of an earlier one would not be allowed. In such cases, the Central and State Government could provide reimbursement after collecting the GST.

7.3 Power generation and distribution

Another area of concerns is the generation and distribution of power by the SEZ developers/units. While one opinion is that it should be left to the entrepreneur to decide whether he would like to provide power as an infrastructure, as defined in the SEZ Act,

or set up a unit to sell power as a good, another view is that power cannot be an infrastructure and can be only a good to be generated and distributed by the unit. It may be worth considering appropriate policy to encourage power generation and distribution.

7.4 Dual control and co-ordination

The Directors, STPI, have been declared Development Commissioners (DCs) for the IT SEZs under their respective jurisdiction. An STPI is under administrative control of the Department of Information Technology. Other multi-product and sector-specific SEZs are under the charge of DCs appointed by the Department of Commerce. However a number of issues, for example processing of notification of IT SEZs, coordination with state governments etc, relating to IT SEZs are also looked after by the DCs appointed by the Department of Commerce. This leads to a situation of dual control adversely impacting effective coordination and needs to be resolved.

7.5 Disinvestment

The new SEZs have come up mainly in the private sector with no funding from the Government. Now the time has possibly come to see whether some of the established SEZs which are state owned could also be privatized. Disinvestment in these SEZs could not only add to the kitty of the Government and release more money for social-sector development but could also make these SEZs more efficient.

To sum up, the recent initiative of the Government of India to set up SEZs on the pattern of China is a welcome change in the strategy for economic development and export promotion. The move is a bold departure and a paradigm shift in the basic approach to development efforts. It is an acknowledgement of the potential of export-led development strategy.

SEZs have been set up in various parts of the country in the private sector, as joint ventures and also by the State Governments. However, this new approach to development is facing resistance in some of the States, particularly from the farming community which is accusing the government of forcibly taking over fertile land from them at heavily discounted prices as against the prevailing market prices.

As the things stand, SEZs are coming up in a select few States which are offering various concessions and facilities to private entities. The already lagging-behind States are not receiving much attention from private developers. This might sharpen regional inequalities as was experienced after the green revolution of late 1960s and early 1970s.

The challenge ahead lies in appropriately sequencing to sustain the popular support for reforms and reconciling the conflicting interests of the various reforms constituencies. The recent debate about SEZ indicates the kind of considerations that

have to be taken into account in the formulation of policies. While the initiative on SEZs is laudable, its success will depend on how well the model is evolved and the implementation strategy worked out.

The task ahead is to examine how far the key policy parameters that contributed to the success of SEZs in China have been incorporated in the Indian policy framework. The distinguishing features of Chinese SEZs are their large size, investment friendly customs regime, flexible labour laws, liberal policy for DTA access, attractive package of incentives and delegation of powers in favour of provinces and local authorities for managing the zones.

The process of decentralisation needs to be taken to its logical conclusion by empowering local authorities and State Governments to approve investment proposals. The Central and State Governments should market SEZs aggressively to attract foreign investment. Relaxation of labour laws and rationalisation of duty on DTA access can give a big boost to the scheme.

8.0 Conclusion

To sum up, India's Export Processing Zone Scheme, launched in 1965, was the precursor to the present day SEZ (Special Economic Zones) Scheme. The SEZ Act was enacted in 2005 and made operational through SEZ Rules in February 2006. The objectives of the SEZ Scheme, as laid out in Section 5 of the SEZ Act, are as follows: (a) promotion of exports of goods and services, (b) promotion of investment from domestic and foreign sources, (c) creation of employment opportunities and (d) development of infrastructure facilities.

Underlying the enactment of the SEZ Act was the need to provide long-term stability and continuity to the scheme. In order to achieve this objective, income-tax provisions were incorporated in the Act. However, in 2011, minimum Alternate tax (MAT) and dividend distribution tax (DDT) were imposed on the SEZs, which has severely hampered the progress of the SEZ scheme.

The SEZ scheme, in terms of export promotion through tax incentives, is not unique to India. Such schemes continue to be in operation in some form or other in several countries. The need for strengthening of this scheme is felt for the following reasons:

1. The SEZ scheme provides an ecosystem conducive to exports, wherein all clearances, starting from setting up of the unit, allocation of space, approval of raw material, capital goods, issuance of letters of permission, monitoring of exports, permission for sale in DTA (Domestic Tariff Area) etc. are provided at one place.

2. It provides a mechanism enabling manufacturing units to repeatedly import raw materials and capital goods for export production and export, without having to separately seek Advance Authorization, EPCG Authorization etc each time.
3. The scheme is especially helpful for SME investors as they lack the resources available to bigger players for obtaining various kinds of approvals, finding space etc.

The Services sector is an extremely important component of our foreign trade. There are large inflows of investment into SEZs (specifically for software exports) and this trend is likely to continue over the next decade.