SEZs: Lessons from Chinese Experience

Vijay Kumar Kaushal[1] and Vikrant Saklani[2]

Introduction:

SEZ is a region operating under special set of rules and regulations. SEZ enjoys special facilities which may not be available in the other areas of the country. It is a designated free trade enclave with special tax laws and duty exemptions, permission to have captive power plants and distribute power therefrom, have their own water and gas supply units. SEZ is a mini city which is deemed as a "foreign territory" for the purpose of trade operations, duties, and tariffs. It owns infrastructure including ports, airports, roads and bridges. SEZ is variously known as the free trade zone, bonded warehouse, free port and custom zone. SEZ is defined by the International Labour Organization (ILO) as "industrial zone with special incentives set up to attract foreign investors, in which imported material undergoes some degree of processing before being re-exported."

SEZ is an old concept. The developing countries wanted to compete with western developed nations. These countries used SEZs, export processing zone (EPZs) and free trade zone (FTZs) as economic development instruments to take on their western counterparts. In 1947 Puerto Rico, a small Latin American country passed a special tax exemption law with the purpose to attract companies from mainland USA. Thus it paved the way for SEZ. India is also having long history of export promotion schemes. The first EPZ in Asian region was set up in 1965 at Kandla (Gujarat). The Santa Cruz

[1] Dr Vijay Kumar Kaushal, Associate Professor, Department of Commerce & Management, ICDEOL, H.P. University, Shimla-171005.E-mail kaushalvijju@gmail.com.

[2] Research Scholar in the Faculty of Commerce & Management, H.P. University, Shimla-171005. E-mail saklanivikrant@gmail.com.

EPZ (Mumbai) quickly followed it and made its presence in 1973. Chinese government established four SEZs at Shenzhen, Zhuhai, Shantou and Xiamen in 1980.

Shenzhen and Jebel Ali are among the world's most successful zones from an investment promotion perspective. Jebel Ali free zone was handed over to the Jabel Ali Free Zone authority (JAFZA) for management. JAFZA is a commercial organization financially supported by Dubai government. JAFZA's mandate is to attract investments, create jobs and promote trade and industry.

Chinese Experience:

China developed SEZs in late 1970s to encourage foreign investment, bringing much needed jobs, technical knowledge and future tax revenues. Chinese government's objective was to bring back compatriots in Hong Kong, Macao and Taiwan. The first four SEZs (Shenzhen, Zhuhai, Xiamen and Shantou) were set up along southeastern coastline and were close to trading and financial centres of these regions. Current SEZs are located in Guangdong province, Fujian province, Hainan province, Hunchun and Pudong development zone (Shanghai). Shenzhen, Zhuhai and Shantou come under Guangdong province, Xiamen comes under fujian province while entire province of Hainan is designated as SEZ.

The most successful of these SEZs is Shenzhen which was a little town on the border of Hong Kong in the Guangdong province in southern China. Today it is the world's number one SEZ with an annual growth rate of 28 percent since 1980. It covers almost 40,000 acres area with more than 10.5 million residents and home to some elite global brands and fortune companies. In 2004 its exports were US \$ 150 billion which accounted for $1/7^{th}$ of the Chinese total exports and attracted more than US \$ 140 billion foreign direct investment (FDI). Shenzhen owns ports, terminals (export and import), power generation and water supply. The management is having free hand while dealing with economic and civic affairs. The city's greatest strength is its entrepreneurs who have flocked to the southern boom town from all over China. Out of 1,70,000 registered companies in the SEZ, more than 1,35,000 are private. Key names include 'Huawei Technologies', already a global brand in the telecommunications equipment industry. 'Everyone Happy Store' and 'Best Buy Store' are the leading Chinese franchise retailers that are competing head on with foreign retail giants. More than 800 software companies are now aspiring to expand beyond China's borders. The Chinese internet instant messaging software company 'Q.com', which has more than 400 million global users, was born in the city, set up by three young engineers. (George Zhebin GU, 2005).

Xiamen along the coast of Fujian province is directly across from Taiwan. Its geographical advantages and improved investment environment attracted top overseas investors like Dell, ABB, Kodak and Boeing. The biggest investor is Dell and ABB has built the largest medium voltage switch production and research base of Asia in Xiamen.

In 1992 Suzhau was a farmland, while today over 18,000 domestic and global companies are present. Its annual turnover is now over US $ 100 billion. The region is home to 10 industrial and high tech parks four of which are of national level, looked after by the central government and six are of state level administered by the provincial government, (money control.com, Assessed in 2006).

Hainan used to fall under jurisdiction of south China's Guangdong province until 1988, when it became a province of its own and the country's largest special economic zone. It is blessed with an economic development structure with high efficiency tropical agriculture and pleasure-seeking holiday tourism as the economic powerhouses, supported by new industries. Shantou is about five hour by car from Hong Kong while Zhuhai is across the border from Macao.

Chinese government offers various incentives to foreign investors in relation to SEZs and development zones. Most benefits are in the form of tax benefits, including value added tax, custom and income tax benefits for making investment in a SEZ or in special sectors and areas.

There are five SEZs in China in the south of the country, the main tax benefits are:

- Corporate tax of 15 percent.
- A benefit at "2+3 years" which mean an exemption from tax for the first two years and tax at the rate of 7.5 percent for the next three years.

Economic & Technological Development Zone (ETDZ)

- When companies are operating in the manufacturing sphere and they have been operating for over 10 years, the benefits are similar to those as in SEZ.

Pudong Zone (Shanghai)

- In the Pudong zone there are five development zones specializing in hi-tech, financial services, agriculture. The benefits are similar to those granted to investors as in SEZ.

Hi-Tech Development Zones

- ❖ There are fifty two zones in china that deal with investments in the manufacture of high tech products. The tax benefits are similar to those granted as in ETDZ.

Investments in specific cities

- ❖ In China there are fourteen coastal cities and twenty cities in the Chinese interior that offer tax benefits such a reduced corporate tax of 24 percent or corporate tax of 15 percent in the case of top priority projects.

SEZs played significant role in the economic development of China. Chinese economy grew at a rate of 10.9 percent since 1980 due to sustainable performance of the SEZs. The various incentives offered by Chinese government along with flexible labour laws, productivity-linked wages, technological innovations and favorable regulatory policies are some of the contributing factors for the stunning success of Chinese SEZs.

All of the SEZs were strategically located close to the boundary of Hong Kong, a commercial and financial hub. This resulted in large amount of foreign investment inflows from the nearby region into China. Almost 60 percent of the FDI inflows come from Hong Kong. In fact, some of the SEZs like Guangdong have been able to attract almost 25 percent of China's FDI. (Majumder, 2003).

China is also paying huge cost of export-driven growth through SEZs. China has to feed 22 percent of the World's population on only 7 percent of land. Every year, an additional ten million people have to be fed. The development of SEZs caused diversion of more than 21 percent of arable land to non-agricultural uses. The per capita land holding is 0.094 hectares which is very low. In just thirteen years (1992 to 2005), twenty million farmers were laid off agriculture due to land acquisitions. This has become the major cause of dispute between the public and the government. Protests against land acquisition and deprivation have become a common feature of provinces of Guangdong (South), Sichuan, Hebei (North) and Hainan province.

Shenzhen, the most successful Chinese SEZ is now paying a huge cost in terms of environment destruction, soaring crime rate and exploitation of its working class, mainly migrants. Shenzhen is designated as a 'global environmental hotspot' in 2006 by United Nations Environment Programme which means a region that had suffered rapid environmental destruction. According to the World Bank, the environmental problems are the cause of some 300,000 people dying each year. The pollution costs Chinese government around US $ 200 billion in a year which is about 10 percent of its GDP. The living and working conditions of migrant workers are very poor. For example Shenzhen has long denied the children of migrant workers the right to attend public schools.

Indian Experience:

India was one of the first Asian countries to have set up export processing zones (EPZs). These EPZs were established in strategic locations for the purpose of better organization of exports. But the performance of these EPZs was gloomy. They were unsuccessful in attracting the foreign investment and technological inflows. These were not well integrated with the domestic areas in terms of financial linkages.

In the year 2000, the Government of India announced a scheme on SEZ in the EXIM policy with a view to enhancing the export base, attracting foreign direct investment and accelerating economic growth. The EXIM policy of 1997-2002 came into effect on April 1, 2000. It laid down the path for the creation of SEZs namely Kandla and Surat (Gujarat), Cochin (Kerala), Santa Cruz (Mumbai – Maharashtra), Falta (West Bengal), Chennai (Tamil Nadu), Visakhapatnam (Andhra Pradesh) and Noida (Uttar Pradesh).

The Special Economic Zone Act, 2005 was passed by Parliament in May 2005 which received Presidential assent on the 23 June, 2005. After extensive consultations, the SEZ Act, 2005, supported by SEZ rules, came into effect on 10 February 2006. It provides 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:

(a) Generation of additional economic activity

(b) Promotion of exports of goods and services

(c) Promotion of investment from domestic and foreign sources

(d) Creation of employment opportunities

(e) Development of infrastructure facilities.

The various incentives and facilities offered by Indian government to the units in SEZs including foreign investment are as follows:

- Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units.
- 100 percent income tax exemption on export income for SEZ units under section 10AA of the Income Tax Act for the first five years, 50 percent for next 5 years thereafter and 50 percent of the ploughed back export profit for next 5 years.
- Exemption from minimum alternate tax under section 115IB of the Income Tax Act.
- External commercial borrowing by SEZ units up to US $ 500 million in a year without any maturity restriction through recognized banking channels.
- Exemption from Central Sales Tax
- Exemption from Service Tax
- Single window clearance for central and state level approvals
- Exemption from state sales tax and other levies as extended by the respective state governments. (sezindia.nic.in, Assessed in 2007)

The major incentives and facilities available to SEZ developers include:

- Exemption from customs/excise duties for development of SEZs for authorized operations approved by the BOA.
- Income Tax exemption on export income for a block of 10 years in 15 years under section 80-IAB of the Income Tax Act.
- Exemption from minimum alternate tax under section 115 IB of the Income Tax Act.
- Exemption from Central Sales Tax (CST).
- Exemption from service tax (section 7, 26 and second schedule of the SEZ Act) (sezindia.nic.in, Assessed in 2007)

The total land in India is 2973190 sq. km. of which 51.6 percent i.e. 1534166 sq. km. is agricultural area while rest 1439024 sq. km. is non-agricultural area. The land in possession of the 63 SEZs notified accounts for approximately 67 sq. km. only. The 234 formal approvals granted also work out to only around 350 sq. km. SEZs in-principal approvals require 1400 sq. km. area. The total area of proposed SEZs both formally approved and in principal approvals is not even more than 0.1 percent of agricultural land and 0.06 percent of total land area. (Table 1)

Table 1: SEZ Ground Realities

No. of valid formal approvals	234
No. of Notified SEZs	63
No. of formal approvals pending notification	171
Total land area	2973190 sq. km.
Agricultural area (51.6%)	1534166 sq. km.
Non-agricultural area	1439024 sq. km.
SEZ Notified	67 sq. km.
SEZs formally approved	350 sq. km.
In-principal approvals	1400 sq. km.
Total area proposed for SEZ	1750 sq. km.
As % of total land area	0.06%
As % of agricultural land	0.1%

Source: Compiled from www.sezindia.nic.in

The minimum area of SEZ should be of 1000 hectares of which 25 percent earmarked for developing industrial units. This minimum area condition is not applicable to product specific and port/airport based SEZs. Table 2 presents the minimum requirements and business model for different types of SEZ.

According to Indian Constitution, land acquisition is under the purview of the state government while central government can only issue directions. Following directions are issued by the central government:

- SEZs should be set up only on barren land

- In critical conditions the land acquisition should be limited only to single crop agricultural land
- In case of any double crop agriculture, if land has to be acquired to meet the minimum area for SEZ, it should not be more than 10 percent of the total area.

The export through SEZs is increasing for the last three years. The export increased from Rs. 13,854 crore in 2003-04 to Rs.18,309 crore in 2004-05 and further to Rs.22,511 crore in 2005-06. But the growth rate is not satisfactory. It is decreasing from its peak 39 percent in 2003-04, to 32 percent in 2004-05 and further to 23 percent in 2005-06 (Table 3).

Table 2: The SEZ Business Model Matrix

Type of SEZ	Minimum Requirements (as mandated by GOI)	Business Model
Multi-Product	1000 hectares of land, net worth of Rs.250 crore and investment of Rs. 1000 crores	• Long gestation • High capital • High risk-high return
Sector-Specific	10 hectares of land, net worth of Rs.50 crore and investment of Rs.250 crore	• Niche players with sector skills • Moderate capex and gestation • Moderate returns
IT/IT services	10 hectares of land, net worth of Rs.100 crore and investment of Rs.250 crore	• Short gestation • Easy to sell • Low capital • Project could be funded through client advances • Moderate to high returns
Captive SEZs	10 hectares of land, net worth of Rs.50 crore and investment of Rs.250 crore	• Companies masquerade new export – oriented factories as SEZs • Fiscal incentives justify new investments

Source: Business World Nov 13, 2006, p. 36.

Table 3: Export through SEZs

Year	Exports (Rs. in crore)	Growth (%)
2003-04	13,854	39
2004-05	18,309	32
2005-06	22,511	23

Source: Ministry of Commerce

EOUs and SEZ Units play a stellar role in the growth of exports from the country. In 2006-07 total exports from EOUs & SEZs were recorded at Rs. 90287 crore (US $ 19797 Million). Of these, exports from EOUs stood at Rs. 55500 crore (US $ 12169 Million) and those from SEZ Units at Rs. 34787 crore (US $ 7629 Million) [Table 4]. EOUs/SEZ Units cover major industrial sectors, like textiles, gem & jewellery, leather goods, food & agro products, electrons and software, pharmaceuticals and chemicals, engineering, minerals, granites and other stones, plastic and rubber goods etc.

EPCES (Export Promotion Council for EOUs & SEZ Units), represents EOUs/SEZ sector, which has over 3275 operational EOUs/SEZ units and more than 405 SEZ developers spread all over the country. EOU/SEZ sector contributes over Rs. 90287 crore (US $ 19.79 billion) in our export basket with a contribution of 16% in national exports .

Table 4: Exports Performance of EOUs & SEZ Units

Year	SEZ Units		EOUs		Total	
	Rs. in core	US $ Million	Rs. in crore	US $ Million	Rs. in crore	US $ Million

2000-01	8552.3	1859.00	15912.00	3536.00	24464.03	5395.00
2001-02	9189.55	1915.00	18735.45	3930.11	27925.00	5845.11
2002-03	10056.62	2095.00	23590.60	4874.56	33647.22	6969.56
2003-04	13813.58	2996.00	28827.58	6273.51	42641.16	9269.51
2004-05	18655.00	4140.00	39228.40	8726.78	57883.40	12866.78
2005-06	22839.53	5159.02	49462.35	11172.00	72301.88	16331.02
2006-07	34787.47	7628.72	55500.00	12168.75	90287.47	19797.47

Source: Ministry of Commerce & Industry

Table 5 gives the exports from State Govt./Private SEZs established prior to SEZ Act for the period 2005-06. The total exports of such SEZs were Rs.3182.86 crores in 2005-06. Surat SEZ export is maximum (Rs. 2337.67 crore) followed by Manikanchan SEZ (Rs. 510 crore), Indore SEZ (Rs. 145.89 crore), Wipro SEZ (Rs. 95.54 crore), Mahindra IT SEZ (Rs. 75.35 crore), Jaipur SEZ (Rs. 16.27 crore) and Jodhpur SEZ (Rs. 2.14 crore). Nokia SEZ commenced exports in 2006-07. Its current exports are Rs.1221 crore up to January, 2007.

The projection of exports from special economic zones for 2007-08 is quite impressive. The Ministry of Commerce is expecting Rs. 67299.62 crores exports which are three times that of exports made in 2005-06.

Table 5: Exports from State Govt. /Private SEZs established prior to SEZ Act (2005-06)

Rank	Name of SEZ	Exports (in Rs. crore)

1.	Surat SEZ	2337.67
2.	Manikanchan SEZ	510
3.	Indore SEZ	145.89
4.	Wipro SEZ	95.54
5.	Mahindra Industrial Park (IT) SEZ	75.35
6.	Jaipur SEZ	16.27
7.	Jodhpur SEZ	2.14
8.	Nokia SEZ	*
	Total Exports	3182.86
*Commenced exports in 2006-07. Current exports: Rs. 1221 crores up to Jan. 2007		

Source: Compiled from www.sezindia.nic.in

At present there are 1016 units operating in the SEZs which provide direct employment to 178763 persons about 40 percent of whom are women. Total private investment by entrepreneurs in SEZs established prior to the SEZ Act is Rs.4431 crore in which private investment in Government SEZ is Rs.2823.08 crore while in private SEZs it is Rs.1608.04 crore (Table 6). In the 63 notified SEZs which have come up after 10 February 2006, investment of Rs.13435 crore has already been made in less than one year. Those SEZs have so far provided direct employment to 18457 persons.

Table 6: Breakup of Employment and Investment in Central/State/Private SEZs prior to SEZ Act

	Government	Private	Total
No. of units	862	154	1016
Employment (persons)	158197	20566	178763
Investment (Rs. crore)	3350.85*	1608.04	4958.89
*Rs. 527.77 crore is Govt. investment while Rs.2823.08 crore is private investment inclusive of FDI.			

Source: Compiled from www.sezindia.nic.in

There are divergent views about the establishment of SEZs in India. There are some differences between commerce and finance ministries on the issues of tax concessions offered to SEZs, number of SEZs and administrative control of these zones. According to Finance Ministry SEZs will result in significant revenue loss to the government. The Finance Ministry argued that there will be huge revenue losses of Rs.175487 crore in taxes within 2005-10. The loss on account of direct taxes is estimated Rs.56191 crore, on account of customs Rs. 97807 crore and on account of excise Rs.21489 crore in coming four years (Table 7). RBI said that these tax sops to SEZs are justified if sufficient forward and backward linkages are created with the rest of the economy.

Table 7: Revenue loss due to SEZs Projected by the Finance Ministry

(In Rs. Crore)

Year	Direct Taxes	Customs	Excise	Total
2005-06	2451	2970	3045	8466
2006-07	4156	14112	3785	22053
2007-08	10003	22024	5037	37064
2008-09	16668	25979	4491	47138
2009-10	22913	32722	5131	60766
Total	56191	97807	21489	175487

Source: Fortune India, Sep. 5, 2006, p. 73

The commerce Ministry termed these losses as notional one as there would not have been any additional economic activity had there been no SEZs. They argued that SEZs will actually generate Rs. 44,000 crore revenue over a period of ten years. Apart from world class infrastructure, SEZs are predicted to create 57552 additional jobs by December, 2009. The additional investment growth and increased employment opportunities will offset this revenue loss. Successful zones will not only generate jobs but also offers higher salaries.

Finance Ministry wants to restrict the number of SEZs but commerce ministry is strongly opposing this view. Moreover Finance Ministry is against administrative control of such zones in the hands of Board of Approvals in Commerce Ministry. They favour that administrative control of SEZs should lie with the Finance Ministry.

Reserve Bank of India (RBI) and Insurance Regulatory Development Authority (IRDA) are also not in favour of SEZs scheme. RBI asked commercial banks to treat loans granted to SEZ developers as lending to real estate developers which means rise in cost of funding. RBI viewed that there will be uneven economic development of country due to SEZs as resources will be pulled out of vast areas to feed some other regions. IRDA refused to treat SEZs in special way. The authority made it clear that insurance companies cannot be allowed 100% FDI in these zones. But Indian businesses are quite familiar with such practices.

One major criticism of SEZs is land acquisition. In most of the cases farmers are being cheated and forced off their lands. Land mafia may take unfair use of this scheme like using duty free raw material for unearmarked purposes. There are serious conflicts in rural India between farmers and governments. Farmers do not want to be displaced due to their generation's long attachment with the land. There are allegations that a large portion of cultivated land is being converted into SEZs. These zones are fast displacing more than ten lakh people dependent on agriculture. The farmers are not skillful to adopt alternative professions.

In case it becomes inevitable to use agricultural land for the establishment of SEZs then equal piece of non-agricultural land should be developed as agricultural land. There should be clear distinction while notifying land for SEZs. Provision should also be made to rehabilitate displaced farmers. Land mafias who are planning to enter SEZs should be placed under strict vigil. Farmers should be compensated as per their expectations. The Land Acquisition Act should be amended in a way that farmers get a fair share in future appreciated value of land.

The availability of power is another major concern for the successful operations of SEZs. The power sector added only 21000 MW of additional power generation in the 10^{th} plan as against the target of 40000 MW. The completion of a large number of ongoing power plants had been delayed and a significant capacity addition would be witnessed in the next two years with the plants going on stream. In case all sanctioned SEZs become operational, it will require at least 40,000 MW of power as per estimates. The SEZs which require uninterrupted power supply will have adverse effect on their functioning. According to the Committee on infrastructure, headed by the Prime Minister, India requires 90,000 MW of new generation capacity in the next seven years. This would be in addition to the present generation capacity of 122 giga watts. Despite being the fifth largest electricity-generation country in the world India has a low per capita consumption of 606 units, which is less than half of China.

Concluding remarks:

SEZ scheme is going to play a dynamic role in coming decade in Indian economy through creating high class infrastructure, generation of huge employment opportunities, increasing exports and attracting FDI and new technologies. India should learn about size and location of SEZs from Chinese experience of establishing such zones. China gradually set up only five huge SEZs close to Hong Kong and Taiwan within large area ranging from 120 to 400 sq. km. Chinese SEZs are strategically located along its coastline. In comparison to these, Indian SEZs are small places approved across different parts of the country. Tiny places of land are not ideal for SEZs. The size of SEZs should be reexamined and there location should be carefully chosen with attention to infrastructure in place.

The Chinese government invites private enterprises to set up units only after acquiring the land and developing the required infrastructure. In the Indian case the government acquires the land and hands it over to private players to develop the SEZs infrastructure. Indian government should not transfer land ownership to private developers. They should be allowed to take land on lease.

SEZs development on the agricultural land should be discouraged. In case of acquisition of agricultural land, the displaced farmers should be adequately compensated along with providing livelihood security. The government should concentrate more on protecting the interests of displaced farmers. There is vast potential for domestic demand in India as household consumption ratio to GDP is 68 percent in comparison to 38 percent in China. India should not target to only become an economy that is export driven for growth. SEZs should also target the huge domestic market. The various existing units whose tax benefits are coming to an end may relocate themselves in SEZs to save taxes. For example financial services centers under SEZ are exempted from securities transactions tax. This will encourage such companies to shift from other locations to SEZ areas. Such companies should be restrained from misusing the SEZ scheme. The financial entities within the SEZs should not be provided with tax benefits. SEZ policy should be fine tuned to make it a boom for India. The central and state governments should work in coordination to exploit the opportunities and face the challenges provided by SEZs.

References:

1. Banerjee, Arindam and Seethapathi, K. (2005). *Special Economic Zones,* Treasury Management. ICFAI Press. December.
2. Chaudhary, C.M. (2007). *Economics of SEZ: An Analysis,* ICFAI Reader. May.
3. City and Industrial Development Corporation (CIDCO). (2003b). *Navi Mumbai Special Economic Zone,* Information Memorandum of the Proposed NMSEZ for Inviting Expressions of Interest. Navi Mumbai India.
4. GU, George Zhibin. (2005). *Shenzhen at 25,* www.trafford.com. September.
5. Majumder, S. (2007). *India Needs a Unique SEZ Model,* The Business Line. April 24.p. 9.
6. Mohapatra, Surjit. (2006). *Indian SEZs: Replacing Chinese Model,* Treasury Management. ICFAI Press. December.
7. Mudgal, Vipul. (2007). *Development Vs Displacement,* Hindustan Times, March 26. p. 13.
8. Nallathiga, Ramakrishna. (2007*). Potential of SEZs in Promoting Industrial and Regional Economic Development: An Analysis,* The ICFAI Journal of Industrial Economics. Vol. IV, No.1.
9. Putatunda, Pradip and MacPherson, Stewart. (2001). *China Perspectives,* Sterling Publishers. New Delhi.
10. Ramanathan, Ramesh. (2006). *SEZs: Issues,* Yojana, Vol. 50, December.
11. Rao, Katuri Nageswara. (2007). *SEZs: Too Small and Too Many,* Professional Banker. ICFAI Press. March.