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SEZ AND INVESTMENT OPPORTUNITIES

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INTRODUCTION

Special Economic Zones (SEZs) were established in many countries as testing grounds for implementation of liberal market economy principles. SEZs are viewed as instruments enhancing the acceptability and credibility of transformation policies, attracting domestic and foreign investment and also for the opening up of the economy. SEZs in India seek to promote the value addition component in exports, generate employment as well as mobilise foreign exchange.

India over the past two decades has progressively opened up its economy to face new challenges and opportunities of the 21st century effectively. Unlike the first phase of industrialization, visualized by Pundit Jawaharlal Nehru whose aim was mainly state-led investment in the industry and now with the influence of liberalization and globalization all over the world, our strategy is being shifted towards private sector-led development which has both cheap capital and technology at its disposal. Establishment of Special Economic Zones (SEZs) is one among the major changes in the economic policies made by the Government of India.

The Government of India has taken a right step in promoting new investment and given the positive state-business relationship it has started resulting in positive returns in terms of new employment opportunities, local area development, etc. The policy agenda in the setting up of Special Economic Zones (SEZs) in India is to be looked at from this angle.

Special Economic Zone (SEZ) is an economic model to process and promote the manufacturing of specific products for domestic consumption as well as exports from the country. The concept is associated with formation of a handful of enclaved zones, set apart from the rest of the country by providing specific facilities such as quality infrastructure, attractive fiscal package with minimum possible regulations. In April, 2000, the Government of India introduced a policy for setting up of SEZs for industrial activities with the underlying objective of providing an internationally competitive, hassle-free environment for production. This policy provides for setting up of SEZs by

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the governments (both Central and States), private players and as joint venture between the public (the state) and the private sector. It was stated in that policy that the existing Export Processing Zones (EPZs) operating in the country would be converted into SEZs. Accordingly, eight EPZs, which were in operational till 2000 were converted into SEZs (and it was also mentioned in the Export-Import Policy of the Government of India, 2002-07) and fiscal incentives to these converted EPZs, were made effective through provisions of relevant statutes.

The Government converted Export Processing Zones located at Kandla and Surat (Gujarat), Cochin (Kerala), Santa Cruz (Mumbai-Maharashtra), Falta (West Bengal), Madras (Tamil Nadu), Visakhapatnam (Andhra Pradesh) and Noida (Uttar Pradesh) into a Special Economic Zones. In addition, 3 new Special Economic Zones were approved for establishment at Indore (Madhya Pradesh), Manikanchan – Salt Lake (Kolkata) and Jaipur and have already commenced operations.

The Government of India announced the introduction of Special Economic Zones in April 2000 to achieve the following objectives:

Generation of additional economic activity

Promotion of exports of goods and services

Promotion of investment from domestic and foreign sources

Creation of employment opportunities

Development of infrastructure facilities

In order to give a long term and stable policy framework with minimum regulatory regime and to provide expeditious and single window clearance mechanism, the Special Economic Zones Act, 2005 has been brought into effect along with the Special Economic Zones Rules, 2006 from 10 February 2006.

The Act and the Rules together aim to provide a single self contained legislation governing the operations of SEZs and replaces the hitherto applicable legislations and rules governing the operations of SEZ in India.

Other than the specific objectives, as mentioned in this Act, the overarching objective was to install a stable policy regime, which can boost investors' confidence. Laying down this objective was a real boost for investors to invest in the SEZs. Under the Act, SEZ could be set up either jointly or severally by the Central Government, State Government, or any person (including a private or public limited company, partnership or proprietorship):

for manufacture of goods;

or for rendering services; or

for both manufacturing of goods and for rendering services; or

as a Free Trade and Warehousing Zone.

Apart from the primary attraction of tax benefits that are offered to SEZs, the government also proposes to introduce fresh incentives such as single window clearance for customs and excise duty, relaxation from various labour law regulations, allowing companies in the SEZ to conduct board meetings via video conferencing by amending the Companies Act 1956, thus making SEZs the next big investment and growth opportunity for Foreign Direct Investment (FDI) in India.

After acting in accordance with all the provisions of Special Economic Zones Act, 2005 and also ensuring the investors' interests, the government in India has been proactive in the development of SEZs. They have formulated policies, reviewed them occasionally and also ensured that ample facilities are provided to the SEZ developers as well as the companies setting up units in SEZs. These favourable conditions resulted in the biggest ever corporate rush for the development of SEZs in India. Over 234 companies received formal approval, 162 companies received in-principle approval and 100 companies received notification to set up SEZs. The Indian government is expecting an investment to the tune of Rs. 53,561 crore (USD 13274 million) and an additional job creation for 15,75,452 individuals in SEZs by the end of this year. These figures clearly show that SEZs are creating investment opportunities for investors.

APPROVAL MECHANISM OF SEZS:

117 new Special Economic Zones (including 3 Free Trade Warehousing Zones) spread over 15 States and 2 Union Territories in the Private/Joint Sector or by the State Governments and its agencies. Of the 117 SEZs approved for establishment, 7 SEZs have already become operational, 6 SEZs are now getting ready for operation and the other are at various stages of implementation. 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. The Board of Approval has 19 members (sec. 8 SEZ Act). It comprises various joint secretaries and other officials from several ministries, such as the Ministries of Commerce, Economy, Science and Technology, Home Affairs, Defence, Environment, Law, Overseas Affairs, Urban Development and Finance as well as that of a nominee of the state government concerned, a professor at the Indian Institute of Management or the Indian Institute of Foreign Trade. Thus, this Central Government institution is the major authority for applications and approvals regarding the establishment of SEZs. 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.

ADMINISTRATIVE SET UP:

SEZs is governed by a three tier administrative set up –

(i) The Board of Approval is the apex body in the Department,

(ii) The Unit Approval Committee at the Zonal level dealing with approval of units in the SEZs and other related issues, and

(iii) Each Zone is headed by a Development Commissioner, who also heads the Unit Approval Committee.

Once an SEZ has been approved by the Board of Approval 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 the 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, in case of violation of the conditions of the approval.

INCENTIVES FOR INVESTORS

INCOME TAX BENEFITS:

As per the Income-tax Act, 1961 ("ITA"), the following are the key tax benefits to be provided to SEZs and SEZ Units:

Benefits to SEZ Units:

(a) The Units set up in an SEZ which have begun to manufacture / provide services during the financial year beginning April 1, 2005 will get the following exemptions:

* 100% exemption of profits and gains from business for the first 5 years
* 50% exemption on profits and gains from business for the next 5 years
* 50% exemption to the extent that such amounts are re-invested in the SEZ Special Reserve Account

If the SEZ Unit has already availed of benefits for 10 years under Section 10A of the ITA, the above exemptions are not available. Further, when a Free Trade Zone ("FTZ") or an Export Processing Zone ("EPZ") is converted into an SEZ, the Units, which have already availed of the 10-year tax exemption in an FTZ or EPZ, cannot avail of the Section 10AA exemptions.

(b) Losses falling under the heads "Profits and Gains from Business or Profession" and "Income from Capital Gains" can be carried forward / set off as long as such loss is related to the business of the SEZ Unit.

(c) Capital Gains on transfer of assets in case of shifting of an industrial undertaking from an urban area to an SEZ shall be exempt, provided that 1 year before, or 3 years after the transfer (i) machinery / plant was purchased for the business of the industrial undertaking in the SEZ, (ii) building or land was acquired or building was constructed in the SEZ, (iii) the original asset was shifted and the establishment was transferred to the

SEZ and (iv) the assessee incurred such other expenses as are notified by the Central Government[2]

(d) Interest income received by a non-resident or a person who is not ordinarily resident in India, on a deposit made in an OBU situated in an SEZ, shall be exempt from total income[3]

(e) No tax deduction shall be made by the OBU from interest paid[4] :

(i) on deposits made on or after April 1, 2005 by a non-resident or a person not ordinarily resident in India; or

(ii) on borrowings on or after April 1, 2005 from a non-resident or a person not ordinarily resident in India

(f) The gross total income of an assessee having an OBU or an assessee being a Unit of an IFSC shall be deductible to the extent of 100% for 5 consecutive years from the year of grant of permission under the Banking Regulation Act / SEBI / other relevant law and 50% for the next 5 years[5]. It further defines the exempted "income", which is[6]:

Income from an Offshore Banking Unit (OBU) in an SEZ.

Income from business referred to in the Banking Regulation Act, 1949, or any other Unit which develops, develops and operates, or develops, operates and maintains an SEZ.

Income from an approved unit of an International Financial Service Centres (IFSC).

(g) Exemption from Securities Transaction Tax available to taxable securities transaction entered into by a non-resident through the IFSC

2 Section 54GA of the ITA
3 Section 10(15)(viii) of the ITA
4 Section 10(15)(viii) of the ITA
5 AIR 1978 SC 1025.
6 Section 80LA of the ITA

CUSTOMS AND EXCISE TAX:

Exemption from Customs Duty: SEZ Units may import or procure from the domestic sources, duty free, all their requirements of capital goods, raw materials, consumables, spares, packing materials, office equipment, DG sets etc. for implementation of their projects in the SEZ without requiring any licence or specific approval.

Goods imported/procured locally which are duty-free could or should be utilized within the approval period of 5 years

Domestic sales by SEZ Units will be exempt from Special Additional Duty

Domestic sale of finished products, by-products is permitted on payment of applicable Customs duty

Domestic sale of rejects, waste and scrap is permitted on payment of applicable customs duty on the transaction value

Exemption from applicable excise duty on goods brought in from the Domestic Tariff Area (DTA) to an SEZ

SERVICE TAX:

Exemption from Service Tax to the Developer and the SEZ Units to carry on authorized operations in the SEZ. Service tax exemption granted only to Units in the DTA providing services to a Developer or to a Unit STAMP DUTY:

No stamp duty is chargeable in respect of any instrument executed, by, or, on behalf of, or, in favour of, the Developer, or Unit or in connection with the carrying out of the purposes of the SEZ

SUB-CONTRACTING:

SEZ Units may sub-contract part of their production or production process through Units in the DTA or through other EOU / SEZ Units. SEZ Units may also sub-contract work from the DTA exporters, and export from the SEZ. Units can be set up to provide manufacturing services to overseas entities subject to certain conditions

INFRASTRUCTURE:

Provisions have been made for

(i) the establishment of free trade and warehousing zones to create world class trade-related infrastructure to facilitate import and export of goods aimed at making India a global trading hub;

(ii) the setting up of offshore banking units and units in an international financial service centre in SEZs; and

(iii) the public private participation in infrastructure development; and

(iv) the setting up of a "SEZ authority" in each central government SEZ for developing new infrastructure and strengthening the existing one.

TRANSACTION INCENTIVES WITH DOMESTIC TARIFF AREA (DTA)

Any supplies from a DTA to an SEZ are to be treated as physical export. A DTA supplier would be entitled to:

Exemption from Central Sales Tax

Exemption from State Levies

Income-tax benefit as applicable to physical export under Section 80 HHC of the Income Tax Act.

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 (i.e. three years from now).

OTHER BENEFITS FOR INVESTORS:

1. The SEZ Act 2007 sought to reduce regulatory hazards by creating the Office of the Development Commissioner – which was supposed to sort out regulatory issues such as environment, power, water and labour clearances via an administrative single window. This window was supposed to reduce the transactions costs of an investor. In the absence of this single window, investors needed to knock the doors of numerous

state- and central-level ministries and officials for investment approvals. However, the industry departments in most of the states provide strategic guidance to the investor. This aids a preferred investor in clearing numerous regulatory bottlenecks before making a successful investment.

2. Industrial bureaus of states governments bring out good investment packages in conjunction with SEZ benefits. This helps them attract big investors to their states. They work hard to woo good investments, with the hope that if one major player gets convinced, it will be easy to convince others. States like Tamil Nadu and Andhra Pradesh succeeded in attracting investors who would have otherwise found a place in countries like China, Vietnam and Malaysia.

3. An important feature of the Act is that it provides good governance at the area where the work has been carried out. It provides a comprehensive SEZ policy framework to satisfy the requirements of all principal stakeholders in an SEZ – the developer and operator, occupant enterprise, out zone supplier and residents. Earlier, the policy relating to the EPZs/SEZs was contained in the Foreign Trade Policy while incentives and other facilities offered to the SEZ developer and units were implemented through various notifications and circulars issued by the concerned ministries/departments.

SEZ AND FOREIGN DIRECT INVESTMENT:

Foreign direct investment continues to play an important role. India has the opportunity to become a manufacturing hub for textiles, automobiles, steel, metals, petroleum products etc. for the world market. The Government of India (GoI) first launched the concept of SEZ in the Exim Policy 2000 to boost the country's exports and attract FDI.

SEZ is a specifically delineated duty free enclave and is deemed to be foreign territory for purposes to trade operations and duties and tariffs. Goods and services going into the SEZ area from DTA are treated as exports and goods coming from the SEZ area to DTA are to be treated as if these are being imported.

RBI has granted general permission to foreign companies to establish branch offices/units in SEZs to undertake manufacturing and service activities. Foreign companies can establish branch offices/units in SEZs provided 100 per cent Foreign Direct Investment (FDI) is permitted in the relevant sectors. The said branch offices/units should function on a stand-alone basis restricted to the SEZ alone and no business activity / transaction allowed outside SEZs in India.

Some of the policy measures taken to attract foreign direct investment (FDI) in Special Economic Zones (SEZs) include:

i. FDI upto 100% under automatic route for all manufacturing activities except arms and ammunition, explosives and allied items of defence equipments, defence aircraft and warships, atomic substances, narcotics and psychotropic substances and hazardous chemicals, distillation and brewing of alcoholic drinks and cigarettes/cigars and manufactured tobacco substitutes.

ii. 100% FDI allowed for development of townships including housing, commercial and recreational facilities on a case-to-case basis.

iii. Facility to foreign companies to set up manufacturing units in SEZs as branch operation on standalone basis without approval from RBI.

Thus all these measures taken by Government are in consonance with the underlying objective of the SEZ, Act. The Government of India through SEZ provides to increase economic growth and activity through increased Foreign Investment and also to boost exports further. Because of all these incentives, the country's special economic zones (SEZ) have attracted foreign direct investment (FDI) of over Rs 10,900 crore in the last three years.

SUGGESTIONS FOR INVESTORS:

Due to the reduction in the regulatory bottlenecks in SEZs, there are reasons for optimism that Indian SEZs are poised for consolidation and growth. India has been able to attract foreign investment in areas such as hardware, shoes and apparel manufacturing, which would have earlier gone to other Asian countries. This constitutes the real success of India’s SEZ policy. Investors need to figure out the niceties of the Indian investment climate and if perceived as being attractive, the concerned state governments in India will go a long way to remove the regulatory obstacles to investment.

Given the aforementioned parameters affecting the success of SEZ investments in India, a typical investor needed to be concerned about the following issues:

The investor needed to understand its attractiveness given the needs of a particular state government in India. A state with high profile investments will yield fewer benefits than one, which is still trying to win big investors to the state.

Land acquisition must be preceded by a generous rehabilitation package. The people of the area must be convinced that what they are getting in return for giving up their agricultural land and traditional livelihoods will improve their economic and social conditions.

Investors should avoid becoming part of partisan politics in the state.

Large SEZs could gain by getting the government and some anchor investor involved in the equity of the special purpose vehicle running the SEZ, as in the case of the Kakinada SEZ described above. This helps build stakes between the government, the developer, and commercial units within the SEZ.

Local governments will be able to serve investors better in areas such as roads, ports, airports and railways – if the state and the central governments are working together rather than in opposition to each other's interest in a particular state.

SUGGESTIONS FOR GOVERNMENT TO MAKE MORE INVESTOR FRIENDLY POLICIES:

1. STRATEGIC PLANNING

The most prudent strategy for developing a SEZ is to have an essential and quality zone infrastructure. This will help attract industries. Therefore SEZ projects should evolve under the public-private partnership format. This step would ensure that the state governments concerned can overlook the progress and the planning of the SEZ and can jointly market the zone. This would increase the .comfort level of the locating industries. The concept of SEZ embodies the business planning including strategic positioning of the zone in the world markets by leveraging on the strong backward linkages with hinterland/Domestic Tariff Area (DTA) and physical planning covering provision of world class enabling infrastructure. Therefore, the planning for SEZ requires multi disciplinary expertise in areas of business, economics, finance, legal and urban & infrastructure planning.

In the globalized economy, SEZs have become a set pattern to attract investments and specially in the Indian subcontinent. These same multinationals are investing in

China, India, Bangladesh, and Srilanka. There is an intense competition existing between these economies to attract the attention of these multinationals, these multinational have a tendency to keep changing their locations whenever they see a slight cost advantage or disadvantage. This can result in sudden rise and fall in the manufacturing as well as the employment factor. This can lead to some destabilization in the economy, therefore, such situations should be kept in mind and an action plan should be prepared to deal with such situations.

2. IMPACT OF GOVERNANCE

Efficient governance is an imperative factor in establishment and smooth functioning of SEZ and is crucial to its performance. It greatly influences the attractiveness of a zone to foreign investors and its eventual performance. The provision of efficient bureaucratic and economic services, a clear and transparent legal and regulatory structure and an unfettered and stable policy framework ensure the success of the zones. India has a strong advantage in this regard as it has strong economic growth prospects, availability of large and skilled workforce, comparative advantage in several industries, a strong policy framework, availability of supporting ancillary industries, strong growth in the external sector and a huge domestic market. These factors give India a superior edge but the advantage can be nullified due to the sluggish attitude of government departments in granting various clearances. There should be a coherent policy both at the central and the state level so that these SEZs can be well marketed and maximized benefit is derived out of such opportunities. Lessons should be learned from some earlier ambitious programs of the government.

3. LABOUR LAWS:

As per the new law of Special Economic Zones, all the labour laws as applicable within the country apply in a SEZ. A restrictive labour law environment has been one of the major hurdles to the development of the Indian manufacturing sector. Currently, over 40 labour-related statutes have been enacted by the central government. In addition, the state governments have also enacted various statutes on this subject.

Analysts are divided about whether India's labour laws are actually implemented in its SEZs. For example, Indi's Contract Labour (Regulation & Abolition) Act 1970 prohibits employing contract workers in activities which are permanent and perpetual in nature. Almost all activities conducted in SEZs are arguably .permanent and perpetual in nature and yet surveys by the International Labour Organization and testimonies by workers themselves suggest that the majority of the workforce in Indian

SEZs are contract employees. These workers also do not come under the purview of the Minimum Wages Act, so India's relatively high minimum wages may not be a factor affecting investment decisions. Still, the uncertainty of the situation is discouraging to investors.

Thus there can be simpler labour law-related procedures in SEZs. Hence Government should make more flexible schedules for the Contract Labour Act. Fundamental labour laws have to be identical in the domestic labour area and outside it.

CONCLUSION-THE ROAD AHEAD:

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 country-wide development of infrastructure is expensive and implementation of structural reforms would require time, due to given socio-economic and political institutions, the establishment of such industrial enclaves like SEZs is seen as an important strategic tool for expediting the process of industrialisation in the country.

The investors need to figure out the details of the Indian investment climate and if perceived as being attractive, the concerned state governments in India will go a long way to remove the regulatory obstacles to investment through establishing SEZs.

At the same time the government to attract more investment and to create healthy and smooth environment for investment opportunities, should remove all the detrimental issues like land acquisition, revenue loss, loss of agricultural land, misuse of land for real estate etc.

Increased foreign exchange earnings also result in increasing government's ability to provide services and infrastructure to the wider population. From the government's point of view, long-term benefits include indirect employment creation, skills upgrading, female employment, technology transfer, the 'demonstration effect' arising from application of 'best practices' and regional development. To achieve these results, the SEZ must operate under a good practice framework linked to targeted government objectives and economic growth. Hence government should remove all the hurdles for investors and provide a competitive and unrestricted market for investors.

Thus, it can be fairly concluded that government by adopting the new scheme of "Special Economic Zones" (SEZs) in 2000 and after that enacting SEZ Act in 2005, has improved the investment opportunities to both domestic and foreign players because of removing most of the regulatory and administrative bottlenecks. The policy has given a big push to exports, employment and investment in SEZs.

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