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India Economics

The SEZs Rush

The Central Government's new SEZ law is attracting a good response from the corporate sector:

India has witnessed a huge rush from the private sector keen to set up Special Economic Zones (SEZs). As per press reports, the government has already accepted over 100 applications for SEZs in the four months since the new law became effective.

Right concept but not-so-right execution: Although SEZs appear to be the right fix for India's manufacturing exports, the government's current approach may not be the best way to boost Indian manufacturing, particularly in the SME sector. We believe the new law is attracting SEZ applications from investors primarily seeking to capture the tax benefit. Most applications for new SEZs are too small to effect the major push needed for small- and medium-scale manufacturing.

Government should push for large "real" SEZs: We believe that the central government should push for 5-6 large SEZs (of about 40 to 50 square miles) in coordination with the state governments. We believe the government should take the lead in conceptualizing these SEZs, arrange private sector participation and if needed provide capital subsidy.

The SEZs Rush

Overwhelming Response to New SEZ Law

India has witnessed a huge rush from private sector companies keen to set up Special Economic Zones (SEZs). The new SEZ law 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.

Right Concept....

Despite the recent pick-up, India's share in world goods exports has been very small – at 0.9% for 2005 – 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. Improving the business environment on a nationwide basis, providing a competitive platform to India's entrepreneurs will take time. 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 also provide scale-related advantages via the creation of clusters, reducing manufacturing costs. SEZs can be particularly helpful 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.

.....But Not-so-right Execution

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:

Most SEZ Applications Are Driven by Tax Benefits

We believe that a large number of new SEZs being planned are primarily aimed at winning tax benefits. Under the new

Exhibit 1

Major Emerging Markets: Share in World Goods Exports, 2005

Country	Rank	Share in World Exports	Country	Rank	Share in World Exports
China	3	7.3%	Malaysia	19	1.4%
Korea	12	2.7%	Brazil	23	1.1%
Russia	13	2.4%	Thailand	25	1.1%
Mexico	15	2.1%	India	29	0.9%
Taiwan	16	1.9%	Indonesia	31	0.8%

Source: WTO, Morgan Stanley Research

law, units in SEZs will be 100% exempt from corporate income tax for the first five years; 50% exempt for the next five years and, for the final five years, 50% 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 (i.e. three years from now).

According to the Ministry of Finance, the government may end up losing indirect and direct tax revenue of Rs939 billion over the next four years (averaging Rs234 bn p.a. or 0.4-0.6% of GDP) on account of existing/new export oriented units shifting to SEZs. We believe losing tax revenues at a time when the government's fiscal deficit is already high is not the best idea.

Size is Very Small to Get the Scale-related Advantages

We believe that one of the key purposes 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).

We believe that with the rapid globalization 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.

The largest (in terms of size) is being set-up in the state of Maharashtra near Mumbai. This is a twin SEZ project, a merger of Navi Mumbai SEZ and Maha Mumbai SEZ. The

total size of this project is 12,000 hectares or 46 square miles. Phase I of the project, to be implemented by 2007, envisages an investment of US\$1.1 billion. The big advantage of the twin SEZs are their locations. Given its proximity to the city of Mumbai, this SEZ should be able to leverage the city's infrastructure and will have easy access to quality manpower. The other large SEZ is being set up by Reliance in the northern state of Haryana. This SEZ will have a size of 10,000 hectares or 38 square miles. Both the Mumbai twin SEZs and Haryana SEZ projects are being set up on a PPP basis.

We believe that both these SEZs should be a big improvement over the current SEZs and better than most other new SEZs announced in the country. However, they will still be smaller than the major SEZs operating in China. The top three SEZs in China (i.e. Shenzhen, Xiamen and Zhuhai) cover 126, 51 and 47 square miles, respectively.

Labour Environment Will Still be an Issue

The new SEZ law is unlikely to address the critical issue of labour flexibility. A restrictive labour law environment has in our view 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, state governments have enacted various statutes on this subject. The most restrictive central government regulation is that which 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. As highlighted in the official report on employment released by the Planning Commission of India, although the law does not bar retrenchment or closure and only requires prior approval, in practice the Act has been interpreted in a way that has made retrenchment almost impossible. In practice, termination at the end of a probation period has also been treated as retrenchment, even if the termination was due to failure to pass a test that was a condition of employment.

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. The National Common Minimum Programme (NCMP) of the United Progressive Alliance also prevented the government from implementing a hire and fire policy. Labour being a concurrent issue, individual states still have the option to

amend their specific legislations to allow labour flexibility in SEZs set up under their jurisdiction.

Private Sector May Not Take Up Development of the Large SEZs Needed

Most of the infrastructure facilities for SEZs tend to be public. In addition, investment returns from SEZs tend to be spread over a long period. These investments are best suited for government balance sheets than the private sector. We do not expect the private sector to be very enthusiastic about undertaking such investments.

Some Policy Makers Opposing the SEZ Law

The Ministry of Finance (MOF) has been vocal in opposing the government's liberal approach towards the setting up of SEZs. The MOF has been concerned over potential revenue loss and has suggested an increase in the minimum area required. The government-appointed empowered group of ministers has decided against this. The government, however, has decided to cap SEZ approvals at 150 during the first six months after the notification of the SEZ Act (February 10, 2006). The government has also indicated that it will not allow the movement of existing businesses into SEZs. We believe that given the tax savings, companies may choose the new SEZ route for expansion plans that they otherwise would have pursued outside the SEZ area.

Undertaking Large SEZ Regions is the Real Solution

We believe the government should take the lead in developing large-size SEZs in a few key states. The government could go in for a tripartite structure with central and state government pooling in some public funding but attract a few private sector players as major partners, who in turn can take up the execution responsibility as well. We believe the plan can be modeled on the government's plans for ultra mega power projects. In the case of these power projects, the government is conceptualizing the basic structure of each mega power project in terms of the strategic location, sourcing of raw materials, logistics and potential markets. Similarly for SEZs, government can take the responsibility of land acquisition, lay out the plan on basic infrastructure, and implement it with state government and private sector partnership. For instance, a coastal region in Gujarat could be chosen for SEZ with textiles being the anchor sector. Similarly, a coastal region in Tamil Nadu could be chosen with automobiles and auto components being the anchor sector. On these lines the government could identify maybe five to six large development regions. Some policy makers have suggested similar views but we believe there is

no serious effort being taken to work on building such “real” SEZs.

Bottom-line

We believe that 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 sector competitiveness. We believe the government needs to rework the SEZ policy to push the “real” large SEZs.

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The Americas

1585 Broadway
New York, NY 10036-8293

United States

Tel: +1 (1) 212 761 4000

Europe

25 Cabot Square, Canary Wharf
London E14 4QA

United Kingdom

Tel: +44 (0) 20 7 425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008

Japan

Tel: +81 (0) 3 5424 5000

Asia/Pacific

Three Exchange Square
Central

Hong Kong

Tel: +852 2848 5200