

SM/06/382  
Correction 2

January 3, 2007

To: Members of the Executive Board  
From: The Secretary  
Subject: **India—Selected Issues**

The attached corrections to SM/06/382 (11/30/06) have been provided by the staff:

**Factual Errors Not Affecting the Presentation of Staff's Analysis or Views**

**Page 27, para. 1, line 4:** for “(e.g., may begin. . .” read “(e.g., have acquired land, may begin. . .”

**Page 30, para. 7, line 3:** for “the National Institute for Public Finance and Policy estimates” read “one researcher estimates”  
**line 7:** for “they estimate” read “she estimates”

**Page 34, para. 14, third bullet, line 1:** for “*Weak business climate*” read “*Business climate*”

**Page 37, line 9:** delete “National Institute of Public Finance and Policy,”

Questions may be referred to Mr. Kramer (ext. 38491) in APD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (4)

Other Distribution:  
Department Heads



### III. INDIA'S SPECIAL ECONOMIC ZONES: INTERNATIONAL PERSPECTIVES<sup>16</sup>

#### A. Introduction

1. **India has launched an initiative to develop Special Economic Zones (SEZs) with the passing of the SEZ Act in 2005.** The notification of the rules in February 2006 has intensified interest in the zones, and, as of end-October 2006, there are 237 zones with formal approval, 34 of which are “notified” (e.g., [have acquired land](#), may begin operation and start receiving incentives).<sup>17</sup> Some observers see the zones as holding promise for stoking investment and employment. At the same time, some have raised questions about the potential costs of SEZs, in particular about the potential revenue losses owing to tax incentives granted to companies operating in or developing the zones.

2. **This chapter examines international experience to see what lessons can be gleaned for India's SEZs.** It first provides some general background on SEZs in various countries. It then focuses on the international experience with tax incentives. The next section discusses broader experience with SEZs, namely their performance in stimulating employment and investment, looking in particular more closely at the case of China. The chapter concludes with a discussion of the implications of the international experiences for India together with some emerging trends for Indian SEZs.

#### B. Background on SEZs

3. **An SEZ is a geographical region that has more liberal tax or regulatory environment than the rest of the economy.** As of 2003, there were over 2000 zones (including SEZs and other types of economic zones) in over 120 countries, accounting for over \$600 billion in exports and 80 million direct jobs (Rao, 2004).

4. **The types of SEZs have evolved over time.** In the 1960s and 1970s, SEZs were mainly established in developing economies often by governments as duty free, fenced-in manufacturing zones (Export Processing Zones (EPZs)). Starting in the late 1970s, China launched large-scale zones to attract FDI, as well as to serve as enclaves for experimenting with economic reforms. Since the 1990s, private development of SEZs has gained prominence: these often feature “world-class” infrastructure (e.g., Dubai in United Arab Emirates and South Korea); a focus on the service sector; and heavy private sector

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<sup>16</sup> Prepared by Hiroko Oura.

<sup>17</sup> There are three types of approval: in principle approval, which can be given to proposals that might not have acquired the needed land (developers have to come back for formal approval after land acquisition); formal approval, which can be given to proposals that have acquired land; and notification, with which developers can start receiving incentives.

involvement in zone development and management. Economic zones have been established in developed economies as well in recent years; examples include U.S. Urban Enterprise Zones.

5. **SEZs have a variety of objectives**, including promoting exports and investment (FDI in particular); earning foreign exchange; transferring technology and skills; creating employment; diversifying economic activity; and experimenting with structural reforms.

- In the U.A.E., the initial primary objective was to diversify the economic structure away from the oil sector by, for example, developing Dubai as a distribution hub connecting Asia and Europe.
- In the Free Economic Zones established in Korea in 2003, major aims were revitalizing the economy and diversification away from manufacturing to the knowledge-based service sector.
- Unlike typical SEZs, industrial parks in Singapore are not granted preferential tax treatment, and stricter environmental requirements have been placed on the industrial parks than on the rest of the economy.
- In Japan, the Special Structural Reform Zones were established in 2003 as a vehicle to push forward structural reforms, by piloting them at a local level before they are considered for adoption nationwide.
- In the United States, Urban Enterprise Zones were designed to create jobs in economically distressed regions.

6. **India's SEZ Act targets:** (i) generating additional economic activity; (ii) promoting exports of goods and services; (iii) promoting domestic and foreign investment; (iv) creating employment; and (v) developing infrastructure. To achieve these objectives, the following features are envisaged:

- *Heavy private sector involvement in zone planning, development, and management.* A zone can be proposed by the private sector or state government. It is intended that the private sector will be heavily involved with zone construction and management.
- *Tax incentives.* There are incentives for both zone developers and operating units.<sup>18</sup> Developers receive incentives that include a ten-year corporate income tax holiday on all income from a zone; exemption from customs duty, central excise, service tax, central sales tax and local taxes for all inputs for zone construction; and

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<sup>18</sup> Incentives apply only to units that are net foreign exchange earners.

reimbursement of central sales tax paid on purchases from domestic tariff areas. Zone units receive incentives including corporate income tax holidays of 100 percent in the first five years and 50 percent in the next five years from profits on exports. In addition, taxes due up to 50 percent of export profits can be set aside as reinvestment allowances. Units are also exempted from customs duty on imports and exports; central excise on goods from domestic tariff area; and service and central sales tax.

- *Land use.* An SEZ can be established in any part of the country on unused land. Up to 65 percent of the area in a zone can be used for nonproduction purposes (including housing and recreation).
- *Minimum size.* A minimum area of 1,000 hectares is required for multi-product zones. Different minimum requirements apply for certain regions and sectors. For instance, a 10 hectare minimum requirement applies to IT, biotechnology, and jewelry specific zones.<sup>19</sup>
- *Other requirements.* A unit must be a net foreign exchange earner. Some additional requirements have been put in place by the Ministry of Commerce and Industry with the purpose of limiting fiscal costs. To discourage relocation of existing capital, tax incentives are not provided for used machinery and plant relocated to a zone. In addition, minimum investment requirements have been introduced for SEZ developers to qualify for incentives—Rs. 2.5 billion (\$55 million) for sector-specific SEZs and Rs. 10 billion (\$220 million) for multi-product SEZs.
- *Labor law.* The central government did not relax labor laws as a part of the Act. However, states have flexibility to liberalize these laws. Each state government may delegate the power of the Labor Commissioner to the Development Commissioner for SEZs, and declare the zones as public utilities, which would limit union activities to some extent. In addition, some states (Maharashtra, Andhra Pradesh, and Gujarat) have issued notifications that lift some provisions under the Contract Labour Act (1970), allowing some flexibility in temporary staffing.

### C. International Experience with Fiscal Incentives

7. **An active debate in India surrounds the question of the potential fiscal costs of SEZs.** The fiscal costs can be particularly burdensome for India, with general government expenditure of about 27½ percent of GDP and deficits of about 6½ percent of GDP (2006/07 budget) At the core of the debate is the question of how tax incentives will affect investment. If they stimulate new investment, they may result in revenue gains. If, alternatively, they

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<sup>19</sup> Ten hectares are about 13 times the size of an average soccer field.

cause already-planned investment to move to SEZs, this would cause losses of the tax revenue that would have been reaped if those investments had been made outside the SEZs. Various estimates have been produced of the potential fiscal costs. For example, one researcher the National Institute for Public Finance and Policy estimates the potential foregone revenue from corporate income tax alone as Rs. 241 billion per year (about 0.7 percent of 2004/05 GDP) using the statutory corporate income tax rate as a benchmark and assuming about 2.8 percent of 2004/05 GDP of investment in zones per year (Rao, 2006). In addition, they-she estimates Rs. 92 billion (about 0.3 percent of 2004/05 GDP) in one-time foregone revenue from excises and customs exemption for zone construction. On the other hand, the Ministry of Commerce and Industry estimates Rs. 1,400 billion in revenue gains over five years (about 4 percent of 2004/05 GDP) by estimating tax revenues from salaries and other expenditures created by the additional economic activities in the zones and assuming that a certain percentage of SEZ products will be sold to the domestic tariff areas (and hence some profits from these sales will be taxed).

8. **Many countries use tax incentives to induce investment.** In developing and emerging economies, they commonly include breaks on corporate income (often including tax holidays) and trade taxes. In China, for example, foreign funded enterprises operating in SEZs receive tax holidays and a reduced corporate income tax rate, as well as exemptions from customs duties and VAT for imported equipment and technology. In the U.A.E., corporate and personal income tax holidays extend for 50 years. In Korea, where the zone policy is geared to attracting FDI, the income tax exemption extends to the personal income tax of foreign executives working in the zones in addition to corporate income tax. In developed countries, tax incentives tend to be more targeted, and tax holidays are rare. For example, tax incentives for U.S. economic zones, most of which are granted by states, are more targeted toward narrow objectives.

9. **The international experience with the impact of tax incentives—both in SEZs and more generally—is mixed, but a few general points can be gleaned.**<sup>20</sup>

- *Tax incentives have some positive impact on economic activity in developed countries, but the impact seems smaller in developing countries.* There is a broad empirical literature in which many, but not all, studies find taxes to have a significant effect on investment for developed countries. Hassett and Hubbard (1998) find an elasticity of investment with respect to the post-tax user cost of capital to be about 0.6 for most major developed countries. Hall and Van Reenen (2000) find that the R&D tax credit in OECD countries has led to one-for-one increases in R&D spending.

<sup>20</sup> The studies cited cover the impact of tax incentives in general, including incentives given in economic zones as a special case. Incentives introduced in this section include ones specific to certain activities (e.g., FDI, R&D, investment, employment, and business sectors) irrespective of their location.

## D. International Experience with the Performance of SEZs

### 11. Two broad points stand out from a review of the international experience with the performances of SEZs:

- SEZs generally account for a small share of employment and exports, especially for larger and more developed countries (Table III.1).
- SEZs in China are particularly successful; for Shenzhen alone, its employment and exports are more than that for any other country on the table.

Country	Number of Zones 1/	Exports		Employment	
		US\$ billions	Percent of total 2/	Thousands	Percent of total
USA	366	20.0	2.0	330	0.2
China	120	...	88 (5/)	30,000	4.1
China (Shenzhen)	1	48.0	16.0	3,000	0.4
Indonesia 3/	...	0.2	0.3	98	0.1
Philippines	77	32.0	71.6	1,128	3.5
Thailand 4/	...	...	...	300	0.9
India	11	4.1	6.6	100	0.3
Sri Lanka	12	1.1	18.1	104	1.5
Bangladesh	6	1.1	15.3	144	...
Taiwan POC	9	7.8	3.5	68	0.7
Pakistan	22	0.1	1.1	411	1.1
S. Korea	5	0.1	0.0	39	0.2

Sources: International Labor Organization (2003); Aggarwal (2005); Rao (2004); Ministry of Commerce and Industry, India; Export Processing Zone Administration, Taiwan POC; Philippine Economic Zone Authority; and IMF, *World Economic Outlook*.

1/ Including SEZs, export processing zones, free trade zones, and industrial parks.  
2/ In percent of goods and services exports.  
3/ Bonded zones.  
4/ Industrial estates.  
5/ In percent of merchandise exports.

12. **Indeed, the success of China's SEZ policy has attracted much attention.** As Tseng and Zebregs (2002) note, various studies have shown that FDI has had a highly positive effect on China's economic performance, adding to capital formation, increasing productivity growth, creating employment, and developing a highly competitive export sector. The success of reforms and opening up of SEZs provided positive demonstration effects, spurring the extension of reforms and liberalization country wide.

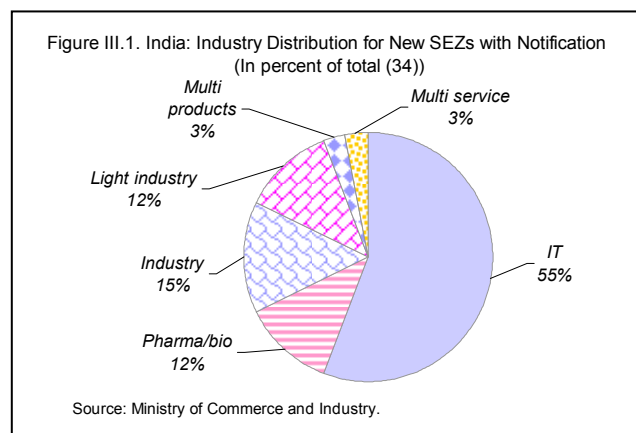
13. **At the same time, the policy had some costs** (Tseng and Zebregs (2002) and World Bank (2006)).

- The bias toward foreign funded enterprises was found to have stymied the development of domestic entrepreneurship and the emergence of globally competitive domestic companies.
- As noted earlier, China's system of income tax incentives has become increasingly complex—which China is now trying to rectify by leveling the playing field.
- The focus on coastal regions under China's initial FDI policy is thought to have contributed to growing income disparities between coastal regions and inland provinces. The Gini coefficient on income has increased from 30 in 1980 to 47 in 2003 (although this could reflect factors other than income disparity across provinces).

### E. Implications of International Experiences for Indian SEZs

14. **Are India's tax incentives likely to stimulate or divert investment?** This is a difficult question to answer definitively. However, there are some features of India's SEZs worth noting:

- *Concentration in the IT sector.* So far, most of the SEZs receiving notifications are in the IT sector, which has robust expansion prospects given strong demand. Accordingly, these companies may have ambitious investment plans so that tax incentives for them may not be important at the margin. The IT sector is already receiving fiscal incentives, which are due to sunset in 2009.



- *Heavy use of tax holidays.* The major part of the tax incentives for Indian SEZs is the corporate income tax holiday. While there are efforts to limit qualifying developers and entrepreneurs, the international experience suggests the instrument per se is not cost-effective compared to more targeted tax incentives.
- ~~Weak~~ *Business climate.* India ranks 134 out of 175 economies in the World Bank's Doing Business database. International experience suggests that tax incentives might play only a modest role in new investment decision.

15. **Will Indian SEZs repeat China's success?** The answer is not clear, and several points are worth highlighting.

- *Different stages of economic reforms.* In contrast with the situation in China when it launched SEZs in the late 1970s, India today has already been implementing economic reforms and liberalization country-wide for over a decade. Indeed, one result of the broader liberalization in India is the emergence of a number of world class companies.
- *Conformity with fiscal reforms.* A key feature of India's tax reform strategy is to create a simple tax structure with moderate rates and a broad base, which might be affected by the proliferation of exemptions under the SEZ policy.
- *Potential for regional disparities vs. inclusive growth.* The concentration of notified SEZs in the largest cities in India raises the question of increasing regional



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