Global Headwinds, Demand Slowdown: Are India's SEZs Losing Their Sheen?

At present, the government needs to revamp the SEZ system so that it gets proper attention from businesses and brings the best international practices to boost the potential output of SEZs, say experts

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by Abhishek Sharma

In 1965, the first Export Promotions Zone (EPZ) was set at Kandala, Gujarat, followed by seven special economic zones (SEZs) at other locations. Started with an aim to attract foreign investment to boost the domestic economy, however, they couldn't deliver the expected results. Hence in April 2000, the SEZ policy was initiated with several incentives followed by SEZ Act 2005 and SEZ Rules 2006.

Thereafter, several new policies and amendments were also enacted till 2023 and various states have also come out with policies and acquired huge land and more than 50 per cent is still unutilised. However, experts noted that so far the outcome is not so promising.

Recently, a media report revealed that the Modi government is eyeing to amend the SEZ Act in the upcoming budget session of the Parliament ahead of major general elections. The report while citing sources stated that the proposed amendment will permit domestic firms established within the SEZs to avoid tax for the sale of goods and services and get economies of scale without being subjected to a double whammy of taxation.

Notably, the government has informed Parliament that reforms in the country's SEZs are an ongoing procedure based on suggestions and inputs from stakeholders and the operational framework of these zones. It has recently amended SEZ rules to allow floor-wise denotification that will allow commercial space owners to use the vacant space in these special zones.

SEZs are treated as foreign territory for trade operations and hence, custom duty is exempted somewhat similar to the duty-free regime for all exporters. However, domestic sales outside SEZ attract custom-duty to purchasers hence, it becomes less competitive. Income-tax incentives are mostly identical to exports from non-SEZ zones except few such as non-applicability of MAT under the Income Tax Act.

Vijay Kalantri, Chairman, MVIRDC WTC Mumbai said, “We feel the special economic zones (SEZ) is an under-utilised concept as these zones, which were set up under the 2005 Act, need a fresh policy push by reconsidering tax incentives and giving units in these zones the flexibility to sell their goods in the domestic tariff area (DTA), whenever they are unable to meet their export target due to global slowdown. By giving a fresh policy push, we can optimally use the spare capacity in our SEZ and support the manufacturing sector.”

At SEZ, other business regulations are somewhat liberal and many laws are not applicable. Land and other approvals for starting new units are also quicker. All domestic and foreign purchases are exempted from GST. There are additional incentives from States as per their SEZ policies.

“Considering aforesaid feasibility aspects, in the past five to six decades, there has been no significant success, especially for the manufacturers despite many fiscal incentives, easy land allocations and good infrastructures. About 60 per cent of land in all SEZs is still lying idle. Also, a huge built-up area is vacant,” said RP Gupta, Industrialist, Economist and Author.

Global Market Conditions

Currently, India has 272 operational SEZs. In FY2022-23, they exported goods and services of about USD 133 billion, a 17.2 per cent share of total exports from India. Out of USD 133 billion, the share of service exports, mostly IT services, is about 55 to 60 per cent.

According to the information available on Statista, Kandala had the highest export value of around USD 38 billion accounting for 63 per cent of the export value among key SEZ zones. Despite these numbers, SEZs did not witness as much success as those in China amid several policy benefits.

Experts have said that over time, the global competitive advantage that Indian SEZs initially had, slowed down due to many ASEAN nation changing their regulatory and economic policies to attract foreign investment by providing more lucrative incentives and operational flexibility to international players. As a result of this paradigm shift, several business units migrated to other ASEAN nations that provided better fiscal benefits and trade environment.

According a KPMG, this loss of business has resulted in relatively reduced forex earnings attributable to the SEZ sector. The same is also supported by the decline in the value of exports, from Rs 7,96,669 crore in FY 2019-20 to Rs 6,10,301 crore in FY 2021-22. It cited the reasons for winding down operations as variations in international market conditions, slowdown of orders, merger of units, etc.

Initially, companies in special economic zones received a 100 per cent income tax exemption on export profits for the first five years and a 50 per cent exemption for the following five years. However, the World Trade Organisation (WTO) expressed concern about the measure, which is aimed at ensuring a level playing field for all countries involved in international trade.

In this case, goods and services are delivered all over the world, which means governments cannot grant excessive tax breaks or subsidize production too cheaply. As a WTO member, this prompted India to reconsider her SEZ policy.

Withdrawal of tax incentives under sunset clauses, lack of consistent policy and the introduction of minimum alternative tax have put the future of India's SEZs in question, experts noted. Large areas under special economic zones remain unused or vacant due to sector-specific restrictions.

“Also, with the WTO ruling against India in the case of export incentives in SEZs, the time has come to re-look at our SEZ policy and reorient it as an employment and manufacturing zone, rather than an export-oriented zone. The government may relax the existing restrictions on the sale of SEZ-manufactured goods in Domestic Tariff Areas (DTAs). This will help SEZ units to use the spare capacity to cater to the domestic consumer market and ensure optimal utilisation of capacity in our SEZs,” WTC’s Kalantri mentioned.

Meanwhile, SEZ units are also complaining that they are facing unfair competition from manufacturers in countries with which India has signed free trade agreements (FTAs) as these manufacturers can sell goods duty-free to the Indian market, while our SEZ units have to bear customs duty to sell in the domestic market (DTAs)

Way Forward

Experts said that at present government needs to revamp the SEZ system so that it gets proper attention from businesses and brings best international practices to boost capacity utilisation and potential output of SEZs. The country needs to accelerate the implementation of port connectivity projects under Sagarmala and boost multi-modal connectivity to SEZs.

This is expected to help in promoting manufacturing activities in the sector. Currently, many SEZs are dominated by service sector activities such as IT services and IT-enabled services, including Global Capability Centers (R&D, consulting), audit, legal and other professional services).

In the manufacturing sector, there are some success stories of pharmaceuticals, gems jewellery and electronics manufacturing SEZs. Apart from this, there is no breakthrough in promoting manufacturing activities in India’s SEZs (even though India pioneered the SEZ concept way back in the 1960s by setting up Asia’s first SEZ in Kandla).

“We need to promote manufacturing infrastructure in SEZs by boosting multi-modal transport, logistics and port connectivity infrastructure. This will reduce the cost of logistics in manufacturing and make our SEZs globally competitive,” added Kalantri.

Gupta stated that in the SEZ location, any manufacturing company shall evaluate its feasibility based on the input cost (landed) and sales realisation. If the major production cost is towards imported inputs, then SEZ-location might be feasible; provided they export a major portion of finished product.

"Hence, it may not be a viable option for all exporters when choosing SEZ-location. Other incentives are mostly intangible and those can’t be the sole deciding factor. For the assemblers of imported parts to finished products and having an export market, SEZ is a good option. However, this system encourages cheaper imports without paying customs duty," Gupta stated.

He stated that for service exporters, like IT services, the basic input is man-power cost which is cheaper in India and they get cheaper land and good infrastructures and enjoy liberal business laws. Their market is majorly export based and hence, it’s a good option for them. So far, other service exports are not so significant.

No doubt, exports must grow at a faster rate and India must become a trade surplus even at the cost of fiscal expansion; that will generate consistent and high GDP growth. For this, the right choice is improving the economic efficiency of India by reducing basic input costs such as capital, energy, logistics and minerals besides providing regulatory easements.