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EVOLUTION OF SPECIAL ECONOMIC ZONES AND SOME ISSUES: THE INDIAN EXPERIENCE

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EVOLUTION OF SPECIAL ECONOMIC ZONES AND SOME ISSUES: THE INDIAN EXPERIENCE

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The enactment of the Special Economic Zone (SEZ) Act 2005 and the subsequent implementation of SEZ rules in 2006 have evoked immense interest amongst the investors' community for establishment of SEZs as a business proposition in order to reap the benefits of globalisation. At the same time, large scale acquisition of land for SEZ development coupled with burst in construction activities in the zones, particularly in the IT/ITES sectors has also invited criticism from various quarters that the SEZs are one of the land grabbing activities, and are providing undue advantages to the real estate business at the expense of revenue earnings of the Government due to provision of excessive tax concessions and other incentives. This paper attempts to put forward an analytical abstract of the evolution, development and the issues concerning the SEZs, not only in India but also the related happenings in the rest of the world. It also evaluates certain critical perspectives and offers suggestions for the success of the SEZs in India. The paper offers some conclusions such as the SEZs are the new developmental enclaves with forward and backward linkages. They enhance manufacturing facilities, production capability and competitiveness to boost the exports, and augment employment opportunities. A balancing strategy, however, needs to be adopted to safeguard the interest of all the stake-holders without hindering the basic objectives of SEZ proposition. The desired objectives could be achieved through restricting the proliferation of zones by limiting sector-specific zones, encouraging multi-product zones, creating conducive environment for private investments and greenfield FDI, excluding agricultural land for zone development, instituting standard compensation packages and mitigating revenue pilferages.

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INTRODUCTION

Special Economic Zones (SEZs) have been recognised as an important mechanism for trade and investment promotion, creation of infrastructure, employment generation, promotion of regional development, increase in foreign exchange earnings, improving export competitiveness and transfer of skills and technology. These are considered as growth drivers in the developing countries. The SEZs have been in existence for decades, but have attracted renewed attention world-wide in recent years due to globalisation of trade and financial markets. Historically, SEZs were the result of the spurt in economic growth. It is well recognised that the SEZs are instrumental in developing local and regional infrastructure facilities, which in turn are necessary for overall economic development of a country.

In India, the concept of free zone - Export Processing Zone (EPZ) - emerged during the 1960s when the first EPZ was set up in Gujarat. Subsequently, Santacruz EPZ was established. The basic objectives of these zones were to promote exports and employment opportunities. Investors' interest in setting up of SEZs in India has increased many folds during the recent period since the enactment of SEZ Act 2005 and subsequent announcement of SEZ rules, which came into existence in February 2006. Various concessions offered by the Government with the intention of promoting manufacturing industries, exports and employment in order to pave way for overall economic growth catalysed the investors' interest to view the process of SEZ development as a business proposition. At the same time, the critics voiced concerns that creation of large number of SEZs may not be desirable as this would result in agricultural land grabbing on account of huge land requirement for such ventures; revenue loss to the Government due to excessive fiscal concessions and tax holidays; massive gains to few private business enterprises, *etc.* The IMF also opined that the planned private sector-led SEZs could be helpful in attracting Foreign Direct Investment (FDI) and promoting exports in India, particularly if close links were developed with the rest of the

economy, but stressed that care was needed to avoid a complex and biased tax incentive system that could lead to substantial revenue losses.

In the above mentioned backdrop, this paper attempts to outline the evolution and the current status of SEZs, not only in India but also tries to capture other country practices. Accordingly, the rest of the paper is organised in seven sections. Section I endeavours to track the genesis and evolution of the concept of SEZs. Section II attempts a comparative analysis of best practices in various countries and the lessons drawn for India. The Indian experience on evolution of policy framework for setting up of such SEZs is reviewed in Section III. Current status of expansionary phase of SEZs in India is set out in Section IV. Section V critically evaluates the issues in the development and operationalisation of such SEZs on the desirability of encouraging proliferation of SEZ promotion in India. Section VI suggests some policy options. Finally, concluding observations are drawn in Section VII.

Section I

GENESIS AND EVOLUTION OF THE CONCEPT OF SEZs

The concept of free zone/special zone has existed for many years. Typically, special zones are regions designated for economic development oriented towards attracting the FDI and export promotion, both fostered by special policy incentives. These also include Export Processing Zone (EPZ)¹. An EPZ provides institutional umbrella in an underdeveloped region. It is a specifically delineated duty free enclave and shall be deemed to be a foreign territory for the purposes of trade operations, levy of duties and tariffs.

The term SEZ is a comprehensive one, which represents Strategic Economic Zone, EPZ, Foreign Trade Zone, Free Trade Zone, Free Trade Area, Open Coastal Zone, *etc.* These zones are marked by minimum bureaucracy, best infrastructure, generous tax holidays, unlimited duty free imports of raw material, other inputs as well as capital goods. Economic activities which take place in the zone are subject to similar conditions that manufacturing firms would face in a developed country, whereas activities located outside the zone operate in an underdeveloped institutional environment. Evidently, a SEZ is almost a self contained area with high class infrastructure for commercial operations as well as residential inhabitation. In other words, SEZs have evolved and transformed from the original concept of industrial estates, which were focused on manufacturing for export purposes.

It is believed that SEZs could stimulate infrastructure development through forward and backward linkages not only within the zones but also facilitate economic development in the peripheral areas. Further, they can also contribute to technology transfer, generate employment and income and thereby enhance government revenues besides exerting positive influence on policy

¹ An EPZ is defined “as a clearly delineated industrial estate, which constitutes a free trade enclave in the customs and trade regime of a country and where foreign manufacturing firms producing mainly for export benefit from a certain number of fiscal and financial incentives” (World Bank, 1981).

makers in the host country. In other words they can act as free market oases for foreign exchange earnings and job creation.

Conventionally, the concept of EPZs evolved to provide special incentive package to offset the anti-export bias and promote exports. The standard definition applied by international organisations (World Bank 1992 and UNIDO 1995) states that an EPZ is an industrial area that constitutes an enclave with regard to customs' tariffs and the commercial code in force in the host country. Traditionally, therefore, the concept of EPZs evolved to compensate for anti-export-bias created by the import substitution industrial policy regime (Aggarwal 2005). In the neoclassical trade theory, the EPZs are considered as the second best policy choice to promote exports. In lucid terms, the EPZs are industrial clusters of units that are concentrated in a geographic region and share the common economic infrastructure, pool of skilled human capital, access to education (both in government and other institutions), specialised training facilities, information and technical support. The recent experience shows that the adoption of export-led growth strategies by developing countries has led to a considerable increase in the number EPZs across the world.

Shannon export processing zone in Ireland is the first example of a SEZ, which was set up in 1958. Since the 1960s, such zones have been set up by many developing countries particularly in Asia to break away from import substitution development strategy in favour of export-driven economic growth. Governments in this region have also promoted such zones as pilot projects to test policy reforms before introducing them across the country. In the context of difficulties involved in strengthening the infrastructure base in a country and hindrances in reforming national policies, the EPZs as islands of excellence with relatively superior infrastructure and policy environment served as useful policy implements. Further, in the backdrop of the benefits that they offered, there was a conscious attempt on the part of policy makers to replicate such models in many regions, especially in countries such as China.

Section II

INTERNATIONAL EXPERIENCE IN SEZs

The expansion and development of the SEZs has been significant during recent years. Thirty years ago, 80 EPZs in 30 countries generated barely \$6 billion in exports and employed about 1 million people (Table 1). In 2006, 3,500 SEZs operated in 130 countries and accounted for over \$600 billion in exports and 66 million direct jobs. By offering privileged trading terms for manufacturing-based exports, SEZs attract investment and foreign exchange, spur employment generation, facilitate adoption of improved technologies and assist in creation of infrastructure.

Country-wise, the US has more number of Free Trade Zones due to its attractiveness to the foreign commerce and local businesses. China stands next to the US as China has implemented an ambitious export-oriented growth strategy during the 1980s and 1990s, the central feature of which was the establishment of SEZs and Open Coastal Cities (Table 2). Vietnam, Hungary, Costa Rica and Mexico have considerable number of SEZs due to export oriented growth strategy that was adopted by these countries in recent years. Countries in the Asian region have also implemented SEZ development strategy in a big way with the objectives of promoting employment and exports.

A look at the size of the free port zones confirms that Kaliningrad in Russian Federation is the largest zone with 15,000 square kms area followed

Table 1: Global Distribution of EPZs/SEZs

Item	1975	1986	1997	2002	2006
1	2	3	4	5	6
No. of Countries	25	47	93	116	130
No. of EPZs	79	176	845	3000	3500
Employment (million)	22.5	43	66

Source: ILO database on Export Processing Zones.

Table 2: Major SEZs in the World with Employment and Exports in 2007

Country	No. of Zones	Country	Employment (Thousands)	Country	Exports (US \$ Million)
1	2	3	4	5	6
China	187	China	50,000	China	\$145,000
Vietnam	185	Indonesia	6,000	Malaysia	117,013
Hungary	160	Mexico	1,300	Hong Kong (China)	101,500
Costa Rica	139	Vietnam	950	Iran, Islamic Republic of	87,289
Mexico	109	Pakistan	888	Ireland	82,500
Czech Republic	92	UAE	552	Czech Republic	68,626
Philippines	83	Philippines	545	Algeria	39,423
Dominican Republic	58	South Africa	535	Argentina	36,478
Kenya	55	Thailand	452	Philippines	32,030
Egypt,	53	Ukraine	387	Korea,	30,610
Poland	48	Malaysia	369	Tunisia	20,544
Nicaragua	34	Lithuania	369	Bangladesh	11,716
Thailand	31	Honduras	354	Lithuania	11,404
Jordan	27	Hong Kong (China)	336	Mexico	10,678
UAE	26	Tunisia	260		

Notes: Excludes zones in OECD countries.

Sources: Bearing Point; ILO database; WEPZA (2007); FIAS research.

by the Panamas and Hong Kong zones (Table 3). An analysis of country experiences reveals vivid perspectives in the establishment and operations of the SEZs as detailed below.

Table 3: Size of Free Ports/Specialised Zones

City/Country	Size Km ²	Year Established
1	2	3
Kaliningrad, Russian Federation	15000.0	1995
Howard, Panama	1500.0	2004
Hong Kong (China)	1042.0	1841
Singapore	693.0	1819
Batam, Indonesia*	416.0	1978
Aqaba, Jordan	375.0	2000
Shenzhen, China	327.0	1980
Subic Bay, Philippines	300.0	1992
Labuan, Malaysia	92.0	1990
Macau	25.0	1887
Gibraltar	6.5	1830
Iquique, Chile	2.4	1975

* The Indonesian government has announced plans to remove Batam's bonded zone status in favour of traditional EPZs on the island.

Source: FIAS, World Bank Group.

The United States: The US continues to be a great source for manufacturing investment for economic zones. Foreign Trade Zones (FTZs) have played a pivotal role in establishing the US as a hub for manufacturing, though the globalisation, current dynamics and changed comparative advantage have resulted in large scale outsourcing of low value manufacturing processes to China and other South East Asian economies. The FTZs in the US are designated sites where special customs procedures apply and the FTZ Board, established in 1934, provides license and regulates FTZs. These zones have helped in creating level playing field in terms of the business costs associated with imports and customs clearance. The FTZs have also assisted state and local officials to develop their economies by attracting foreign commerce. Further, by helping the US companies improve their international competitiveness, FTZs have helped these companies to retain local business and encourage the development of additional jobs.

China: The first four SEZs set up in China in 1980 were Shenzhen (32,750 hectare (Ha)), Zhuhai (12,100 Ha), and Shantou (23,400 Ha) in Guangdong Province and Xiamen (13,100 Ha) in Fujian Province, which are multi-product SEZs. They were chosen specifically because of their proximity to major regional world trading centres of Hong Kong, Macao and Taiwan. The understanding was that this proximity would make it easier to attract FDI and in turn would facilitate the firms to shift parts of their production processes to China. In 1984, fourteen coastal towns were opened up to form Open Coastal Zones and in 1988 the island of Hainan (3,40,000 Ha) received full provincial status and was officially declared as the fifth SEZ. The five SEZs cover an area of 421,350 hectare. SEZs apart, China has conceptualised various other forms of free zones depending upon their geographical locations, type of investments and regional political structure such as Open Coastal Areas, Open Economic Zones, state level Economic and Technology Development Zones (ETDZs) and FTZs. The ETDZs cover an area of 30,000 hectare. The contribution of Chinese SEZs to the country's exports is in the range of 15-23

per cent. These zones, taken together, employ more than two million people directly and approximately 16 million overall. Cumulatively, 20 per cent of the total FDI into China has made its way into SEZs. Prominent industries established in these zones are textile and garments, metal works and machinery, trading, warehousing, logistics and high technology enterprises, chemicals and pharmaceuticals and healthcare product manufacturing.

Ireland: Ireland has enacted free zone customs procedures within the overall ambit of EU laws. Ireland has one operational Free Zone – Shannon Free Zone. Shannon was a hub airport during the early transatlantic air travel. With the advent of modern long flying aircrafts, Shannon lost its geographical importance. In 1959, Government of Ireland decided to develop an industrial hub at Shannon and declared it as a Free Zone. The zone has a total area of 240 hectare. Some of the sectors operating in the zone are engineering, electronics, telecommunication, aviation, software, shared services, logistics and transport and financial services.

Poland: Poland enacted a SEZ law in 1995 for creating SEZs. The main objectives of developing the zones were creating employment, protecting the environment, applying new technology, managing natural resources, and taking advantage of unused assets and infrastructure. In order to attract investors, preferential tax treatment applies to the SEZs. An important aspect of the policy is to provide incentives based on type of investment, quantum of investment, the number of local people employed and trained. Some of the prominent industries established in the zones are automotive and automobile parts, aircraft manufacturing, metal working, food processing and beverages. At present, there are 17 special zones in Poland covering an area of around 6338.92 hectare. The zones currently employ more than 14,000 people. Euro Park Mielec, spread over 575 hectare, is one of the successfully operating SEZ in Poland.

Mauritius: Mauritian EPZs, established in 1971, were geared towards separating the EPZ activities from the rest of the economy by reducing the

cost of doing business through tax and duty exemptions, access to concessional finance, fast-track approvals for all administrative procedures, and preferential market agreements and marketing support. Mauritian EPZs have been excessively dependent on the textiles and garment sectors, which represented 77 per cent of total EPZ exports and 83 per cent of total EPZ employment. A Textile Emergency Support Team (TEST) was set up to address the issues related to the increasing number of closures of EPZs due to changed dynamics in the international textiles and garment markets. The Government is also moving toward integrating the EPZ and non-EPZ economies to increase the economic impact of EPZ models.

Africa: In the case of African countries, *Madagascar* started to develop an EPZ in 1989 to attract FDI. Although Malagasy EPZs are regarded as a successful story in their own right, they, however, have been criticised for operating largely outside of the national economy, thus contributing insignificantly to overall economic performance. *Senegal* EPZ programme offers a number of features that have enabled Senegal to take advantage of existing market opportunities such as provision of EPZ status to both goods and services exporters, access to fiscal and non-fiscal incentives; enabling a framework to allow for private sector participation in management of zones; equal treatment accorded to domestic and foreign investors; and streamlined customs procedures largely in line with Kyoto Convention standards and guidelines. A free zone was established in 1992 in *Zanzibar*, focusing on the development of a manufacturing base in this largely spice and seaweed exports dependent island region. The mainland government introduced an EPZ program in 2002, to promote export-oriented industrial investment.

South East Asia: In the case of South East Asian Region, *Cambodia* follows the international best practice of avoiding different tax incentives for firms located in SEZ/EPZ. *Vietnam and Thailand*, however, do not follow this practice and provide additional incentives in their promotion zones. The duration of the tax holiday in Vietnam's promotion zone is 2–4 years, except

for high-tech zones for which it is 8 years. Thailand offers complete withholding tax exemption in its zones, while Vietnam provides for a reduced rate, essentially making the provision of direct incentives more favourable.

Lessons drawn

International experience shows that the size of SEZs varies from 2 to 15000 square kilometres. Size is influenced by the degree of self-sufficiency and integration in the zone. However, a minimum land area is necessary to support the desired level of economic activity. Additionally, strategic location and multi-modal connectivity with major trading destinations are critical factors for success of SEZs. In most cases, it has been observed that the zones are purposefully located giving the units in the zones an easy gateway to international trade.

Further, countries have focused on attracting investments in specific industries considered strategically important for the economy. Excessive reliance on exports of a particular set of products can be unsustainable when market conditions change to competitors' advantage. The diversity in industries operating in the zone helps in effectively balancing the swings and cyclicity in individual industry performance. Diversity in multiple economic activities including a range of manufacturing and services activities is critical for a SEZ to evolve as an economic entity in itself.

Government participation in developing zone infrastructure, especially in the initial stages, has played an important role in their success. Availability of integrated facilities and services such as housing, recreation, educational and health care are added attractions to investors. A larger domain of infrastructure facilities and supporting services make SEZs more attractive for investors. Availability of skilled and cost-effective labour and resource benefits such as access to raw materials and other inputs have been projected as key advantages enjoyed by the Chinese SEZs. However, productivity of enterprises

in terms of costs and benefits of production is usually the most critical positive factor which can enhance the favourable effects of such zones.

International experience indicates that the costs associated with SEZs are often too high. The main costs of SEZs to the government arise from tax breaks. There is ample evidence that such privileges are not among the main determinants of the decision of foreign firms to invest; for these firms it is more important to be subject to a stable and fair tax regime. A study by McKinsey Global Institute (2003) finds that official targeted incentives rarely have a positive effect, and have often resulted in inefficiency and waste of resources. Enforcement costs, to prevent producers/consumers outside the zone from taking advantage of the zone's privileges, are the second source of direct costs and tend to increase over time.

Another key success factor in the flourishing zones has been involvement of private sector in developing, operating and maintaining core infrastructure components. Efficient and effective zone administration has also contributed to the success of SEZs. Simplification of administrative procedures and mechanisms for speedy approvals are the other important features of many of these zones. In a generic term, the advantages of SEZs are based on the whole idea of quality in all the aspects of investment climate aiming to offset market inefficiencies in a country. This is done through streamlined opportunities that confirm to international best practices. Based on global experience, it has been observed that the SEZs have played an instrumental role in promoting private investment-led economic growth in many countries.

Section III

INDIAN EXPERIENCE IN SEZs – RULES AND REGULATIONS

India is the first country in Asia to recognise the effectiveness of the EPZ model in promoting exports. The first EPZ was set up in Kandla in Gujarat as early as in 1965. It was followed by the Santacruz export processing zone in Mumbai which came into operation in 1973. The EXIM Policy has introduced a new scheme since April 1, 2000 for establishment of SEZs in different parts of the country. The SEZs are permitted to be set up in public, private, joint sector or by the State Governments with a minimum size of land areas prescribed for different categories of SEZs. The role and responsibilities of the Central as well as State Governments have been well defined and the incentives, both fiscal and non-fiscal, extended to the units operating in SEZs are detailed below. It may be mentioned that the Export Oriented Units (EOUs) scheme introduced in early 1981 is complementary to the SEZ scheme.

An Act of parliament, the SEZ Act 2005 was enacted for the establishment, development and management of the SEZs in India with a view to promote exports and other matters connected therewith. The Act came into effect on June 23, 2005 and has clearly laid down legal backup for establishment of SEZs and the constituents of approval and administrative machineries like Board of Approval (BoA), Development Commissioner and SEZ Authority, *etc.* This Act has provision to convert the existing EPZs into SEZs and allows extension of all concessions and other benefits applicable under this Act to the enterprises in the zones.

The SEZ rules came into force with effect from February 10, 2006. These rules deal with the procedures to be followed for establishment of SEZs, nature of units in the SEZ, terms and conditions for the developers and the entrepreneurs in the SEZ, the movement of goods from/to Domestic Tariff Area (DTA), monitoring by the authorities, *etc.* The SEZ rules, *inter-*

alia, provide for drastic simplification of procedures and for single window clearance on matters relating to Central as well as State Governments. Any proposal for setting up of SEZ in the Private/Joint/ State Sector is routed through the concerned State Government who in turn forward the same to the Ministry of Commerce with its recommendations for consideration of the BoA. 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. The functioning of the SEZs is governed by a three tier administrative set up, *viz.*, (i) Board of Approval is the apex body, (ii) Unit Approval Committee at the zonal level dealing with approval of units in the SEZs and related issues, and (iii) each Zone is headed by a Development Commissioner, who is also heading the Unit Approval Committee. The performances of the SEZ units are monitored annually by the Unit Approval Committee and units are liable for penal action under the provisions of Foreign Trade (Development and Regulation) Act, in case of violation of the conditions of the approval.

To attract the private investors, Government of India has been offering concession packages for setting up of SEZs such as duty-free import/domestic procurement of goods for development, operation, and maintenance of SEZs; extension of income tax benefits / income tax exemptions; external commercial borrowing by SEZ units without any maturity restrictions through recognised banking channels; treating supplies from the DTA to SEZ at par with physical exports; exemption from Central Sales Tax on sales made from the DTA to SEZs; exemption from Service Tax for SEZ units and developers and exemption from State taxes and levies, as notified by various State Governments.

In addition, State Governments have also been providing some concessions such as exemption from the State and local taxes, levies and duties, including stamp duty, exemption from electricity duty or taxes on

sale of self generated or purchased electric power for use in the processing area; allowing generation, transmission and distribution of power within SEZ subject to the provisions of the Electricity Act, 2003; providing water and such other services; delegation of power to the Development Commissioner under the Industrial Disputes Act, 1947; declaration of the SEZ as a public utility service under the Industrial Disputes Act, 1947; and providing single point clearance system to the developer and the units under the State acts and rules.

Section IV

DEVELOPMENT OF SEZs IN INDIA : CURRENT STATUS

After the announcement of SEZ policy, the erstwhile eight EPZs² were converted into SEZs in the year 2000. In addition, three new SEZs were approved for establishment at Indore, Manikanchan–Salt Lake and Jaipur, which have commenced operations in 2004-05. Mahindra City SEZ in Chennai for IT and Apparel Park and Salt Lake Electronic City in Kolkata for software and IT have also started functioning. Currently, there are 19 functional SEZs, which were established before the announcement of SEZ rules. With the announcement of SEZ rules and other concessions provided by the Government, about 700 firms/companies applied for setting up of SEZs, of which 552 have been given formal approval, of which 274 SEZs have been notified (Table 4). The functional SEZ units provided employment to about 3.63 lakh persons, of which SEZs operated by the Government provide about 54 per cent of the total employment.

State-wise Approvals for SEZs

Investors have shown much interest in establishment of SEZs in the developed states like Maharashtra, Andhra Pradesh, Tamil Nadu, Karnataka and Gujarat. Though maximum approvals to set up SEZs were granted in Maharashtra (104), only 43 have been notified as of December 2008. The maximum number of notified SEZs are in the state of Andhra Pradesh (57) followed by Tamil Nadu (44) (Chart 1).

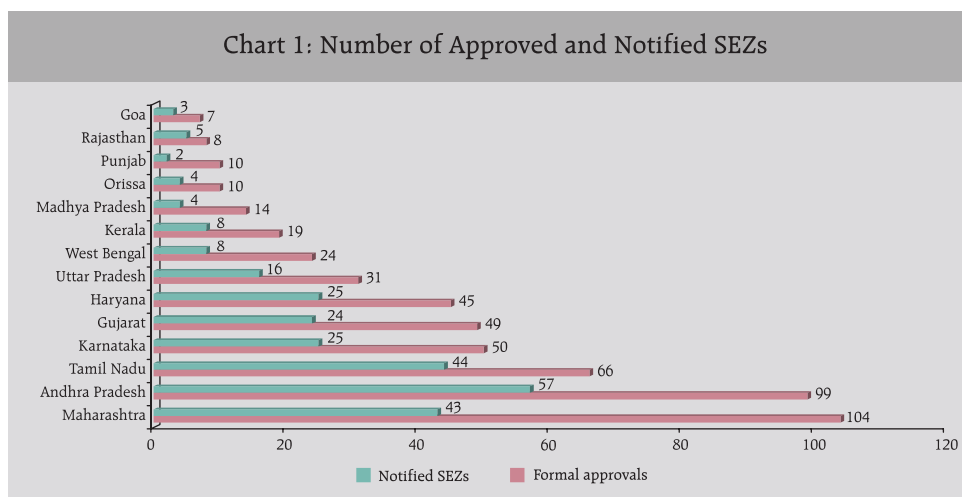
Table 4: Status of SEZs in India

(As on December 2008)

Item	Number
1	2
Functional SEZs (Prior to SEZ Act)	19
Formal Approval Granted	552
Of which Notified SEZs	274
In Principle Approval Granted	141
Source: Ministry of Commerce.	

² Kandla, Surat, Cochin, Santa Cruz, Falta, Chennai, Visakhapatnam and Noida.

Chart 1: Number of Approved and Notified SEZs



Though the aim of the SEZ policy is to encourage infrastructure development through multi-product SEZs, specific product SEZs have been approved in large numbers in many states. Sector-wise shares reflect that IT/ITES zones got a lion's share in the formal approvals and notified SEZs with 61.8 per cent and 66.1 per cent, respectively. Other sectors such as Bio-tech, Multi-Products, Engineering, Pharmaceuticals/chemicals, Textiles/Apparel/Wool and Multi-Services have been granted significant number of approvals. The number of formal approvals and notifications thereon for multi-product SEZs are very low due to large scale land requirements of over 1000 hectare for this category. Many of the multi-products SEZs have been awarded in-principle approvals, constituting 37.6 per cent of the total, but were not notified due to land acquisition problems. Some large size multi-product SEZs have been approved to be set up in the states of Maharashtra and Gujarat (Table 5).

Investment in the SEZs

The financing specifications in the SEZ Act and Rules prescribed that a minimum investment of Rs. 1,000 crore and net worth criteria of Rs. 250 crore for the multi-product SEZs. Sector-specific SEZ developers must make a

**Table 5: Industry-wise Share of Approvals and Notified SEZs
(As on December 2008)**

				(Per cent)
Sector	Formal Approvals	Notified SEZs	In-Principle Approvals	
1	2	3	4	
IT/ITES	61.8	66.1	7.8	
Bio-tech	4.7	3.3	0.7	
Multi-Product	4.2	4.4	37.6	
Engineering	4.2	5.1	7.1	
Pharma/chemicals	4.0	5.1	1.4	
Textiles/Apparel/Wool	3.6	3.6	9.2	
Multi-Services/Services	2.9	1.8	7.8	
Gems and Jewellery	1.8	1.1	2.8	
Steel/Aluminium/Foundry	1.4	1.1	2.8	
Footwear/Leather	1.3	1.5	1.4	
FTWZ	1.3	0.4	5.7	
Port-based multi-product	1.3	0.7	0.0	
Agro	0.9	0.7	2.1	
Petrochemicals	0.7	0.4	0.0	
Power/alternate energy	0.7	0.7	0.7	
Food Processing	0.7	1.1	1.4	
Non-Conventional Energy	0.7	0.4	0.0	
Handicrafts	0.7	0.4	0.7	
Mineral/metals	0.5	0.4	0.0	
Electronic products	0.5	1.1	2.8	
Auto and related	0.5	0.4	3.5	

Source : Compiled from the data available on the SEZ web site of Government of India

minimum investment of Rs.250 crore or have net worth of Rs. 50 crore. The SEZ Act allows for 100 per cent FDI in the manufacturing sector through the automatic route, barring a few sectors, for establishment of units in the SEZs and also 100 per cent FDI to develop townships within the SEZs. External commercial borrowings of up to \$500 million can be raised by the SEZ units in a year without any maturity restrictions and with flexibility to keep 100 per cent of export proceeds in an EEFC account. SEZ units are eligible to make overseas investments up to any amount under the automatic route to be funded out of EEFC balances of the unit. Such investments will be subject to an overall ceiling of US\$ 500 million. As of December 2008, the total investments in the SEZ units stood at Rs.93,507 crore.

Taking into consideration the rules relating to the investments and the business prospective of the SEZs, Gujarat attracted 60.2 per cent of the total investment in the SEZs covering 30 per cent of all SEZ land. One multi-product SEZ in Gujarat accounts for 40 per cent of all SEZ investments. Maharashtra attracted 8.4 per cent investment at the end of March 2008, followed by Tamil Nadu with 8.3 per cent, Karnataka with 7.4 per cent and Andhra Pradesh with 7.2 per cent (Table 6). Other States managed to attract only a meagre share in total investments in the SEZs. With the increasing number of approvals, the investment flow is expected to be much higher over the coming years along with huge employment that these projects offer. Heavy investments are expected in sun rise industrial sectors such as the IT, Pharmaceuticals, Bio-technology, Petrochemicals, Auto components, *etc.*

Land Usage in SEZs

The concept of SEZ envisaged to promote multi-product SEZs and thereby increases the exports. As the minimum land requirement for such category is fixed at 1000 Ha, these SEZs have accounted for 48.7 per cent and 53.76 per cent of the total land area for formally approved and notified SEZs, respectively (Table 7).

**Table 6: State-wise Investment in SEZs
(As on March 31, 2008)**

State	Investment (Rs. Cr.)	Share in Total Investment (%)
1	2	3
Gujarat	41,733	60.2
Maharashtra	5,853	8.4
Tamil Nadu	5,781	8.3
Karnataka	5,163	7.4
Andhra Pradesh	4,990	7.2
Haryana	2,287	3.3
Kerala	1,101	1.6
Uttar Pradesh	1,058	1.5
Total	69,350	100.0

Source: Compiled from the data available on the SEZ web site of Government of India.

Table 7: Industry-wise Share of Land Area for Approved and Notified SEZs (As on December 2008)

(Per cent)		
Sector	Formal Approvals	Notified SEZs
1	2	3
Multi-Products	48.70	53.76
IT/ITES/Software	13.63	16.47
Textiles	4.39	5.25
Pharmaceuticals	4.18	4.54
Multi-Services	3.95	3.95
Port based	3.95	1.23
Engineering	3.86	3.14
Food Products	0.59	1.76
Other Sectors	16.75	9.90

Source: Compiled from the data available on the SEZ web site of Government of India.

Sector specific and multi-services SEZs occupied the remaining land area. IT and the ITES SEZs account for much higher number of approvals and notifications but their share in terms of land area remains very low at 13.63 per cent and 16.47 per cent, respectively of the total approved and notified SEZs. The average land holding of formally approved and notified SEZs accounted for 127 Ha and 118 Ha, respectively. However, the average land size of the in-principle approved SEZs accounted for a higher area of 869 Ha. It, however, poses difficulties in acquiring huge tracks of land for operationalisation of these SEZs. It may be interesting to note that total notified SEZ land in India is less than the land area of China's first SEZ.

State-wise land areas earmarked for SEZs reflect that Gujarat accounted for largest share followed by Andhra Pradesh in case of notified SEZs. It may be noted that 90 per cent of all SEZ land notified pertaining to top five States, *viz.*, Gujarat (30.8 per cent), Andhra Pradesh (23.0 per cent), Maharashtra (19.3 per cent), Tamil Nadu (10.3 per cent), and Karnataka (5.9 per cent) (Table 8).

**Table 8: State-wise Share of Land Area Approved for SEZs
(As on December 2008)**

(Per cent)		
State	Formal approvals	Notified SEZs
1	2	3
Gujarat	29.6	30.8
Maharashtra	20.1	19.3
Andhra Pradesh	18.5	23.0
Tamil Nadu	10.5	10.3
Karnataka	4.5	5.9
Orissa	3.6	1.3
West Bengal	3.5	0.5
Haryana	2.7	3.9
Other States	7.0	5.0
Total Land Area (in HA)	70,037	32,435

Source: Compiled from the data available on the SEZ web site of Government of India.

Section V

DEVELOPMENT OF SEZs IN INDIA: SOME ISSUES

In India, the SEZs have been introduced as a growth driver through increase in export potential of the country, development of infrastructure facilities and generation of employment opportunities. The infrastructure development in some of the regions has taken place due to the development of SEZs. However, Jagdish Bhagwati has remarked that “given the current progress in reforms undertaken in earnest since 1991 in India, there is no need to establish SEZs”. He says that India needs only clear policies that will integrate the country into the world market. Some are advocating that the SEZs are beneficial to certain business people rather than to the common man. Some others attribute that there is huge revenue loss to the Government due to various concessions extended to the SEZs. Some major issues in this regard are discussed below.

Increasing Numbers of SEZs: Critics argue that developing a sizeable number of SEZs in the country may not be a viable solution to achieve the desired goals. In India, more than 400 SEZs are in the pipeline to get notified, in addition to 274, which have already been notified. Overall, therefore, 552 SEZs have been formally approved, with an average land size of about 127 Ha. Another 141 SEZs have been given in-principle approval with an average land size of 869 Ha. The notified SEZs have the average land size of 118 Ha.

In China, the five SEZs, which are huge in terms of the land size of about 421,350 hectare encompassing all the amenities and with proximity to airports and sea ports have provided the necessary thrust for exports. The USA and China, which have a large number of SEZs at 266 and 190, are still behind India with 274 SEZs already notified, in addition to 19 existing zones. Majority of the investors have exhibited interest in specific product SEZs. Many of the African SEZs of this category have failed when the world

production and consumption pattern underwent changes. Bigger size multi-product SEZs only could provide the required infrastructure and are sustainable options.

Are SEZs inherently anti farmers? This is the oft cited criticism against SEZs in India. The minimum area of land prescribed for multi-products SEZ is 1000 Ha. Small states like Jammu & Kashmir, Goa and the Union Territories do not have sufficient barren land stretches to develop multi-product SEZs. Therefore, the minimum land requirement has been prescribed at 100 Ha for these regions. The reduced land requirement is applicable for sector specific SEZs also. Specific products where India has a comparative advantage, the minimum land requirement has been reduced further to 10 hectare (Table 9). According to an assessment by the Government of the ground realities with regard to the land usage of SEZs, the total area for the proposed SEZs constitutes a miniscule share of the total land-size of the country. The approved land size for the SEZs (both formally approved and in-principle approval) would not exceed 0.063 per cent of the total land area in the country and not be more than 0.116 per cent of the total agricultural land in India.

Table 9: Minimum Land Area Requirement for SEZs

Classes of SEZ	Area in Hectare
1	2
Multi Product SEZ	1000
Multi Product SEZ for Services	100
SEZ in North Eastern Region	100
SEZ in Jammu & Kashmir, Goa and UTs	100
SEZ for Specific Sector or Port or Airport	100
SEZ for Electronic Hardware/Software, IT	10
SEZ for Bio-Technology, non-conventional energy, Gems & Jewellery	10
SEZ for Specific Sector in NER	50
SEZ for Specific Sector in HP, Uttarakhand, J&K, Goa and UTs	50
Free Trade and Warehousing Zone	40
Source: Compiled from SEZ Rules, 2006.	

As per the Government regulations, more than one crop agricultural land area, which falls within the area for acquisition for the SEZ should not exceed 10 per cent of the total land area of the SEZ. In India, contrary to that in China, the availability of waste or barren land at a stretch to develop huge size SEZs is limited. The barren land available in India is either reserved for forests or for coastal zone. If these lands acquired for the purpose of development of SEZs, it may create environmental imbalances. Some stretches of such barren land are surrounded by agricultural land. If acquired and developed into SEZs, such land areas may adversely affect the agricultural production and even in some cases, severely affect the livelihood of the common man.

Taking these factors into account, a look at the agricultural pattern of the country reflects that about 39 per cent of total cultivable areas are irrigated. Remaining agricultural lands are either single crop land or double crop land depending upon the monsoon condition of the region, which are also critical for the livelihood of the masses. Further, considering the demographic transition which is taking place in India, India would be one among the most populated countries in the world by 2030 (according to UN). India, therefore, should be in a position to feed the vast population and be self sufficient in the availability of foodgrains. If agricultural lands are diverted for SEZ development, it would pose a difficult situation in terms of food problem in the long run.

Another fall-out of such a policy is that the farmers are paid low value for the land acquired for SEZs as compared to the market value of their land. Furthermore, in India, the rehabilitation and compensation policy is inadequate and varies depending upon the area, nature and political scene in the region. There are no standardised packages available for compensation of the affected farmers. The average selling price of the land for the past one year is fixed as compensation for the land acquired for SEZ purpose. This can, however, have two-way implications. One, if there were no SEZs, there would be no market value for farmer's lands which are acquired for the purpose. More importantly, given that the states governments are the ultimate authority for land use, the

farmer is not in a position to get the market value for his land on his own. Two, state control of sale of land is maintained on account of the fear that farmers would otherwise sell-off all their lands for industrial and urban use and there would be no farmland left. Given the nature of land use laws in India, there seems to be no easy way out of this dilemma.

Are sector-specific SEZ like IT/ITES a Viable Business Option? The sector-wise composition of approved SEZs reflects that more than 60 per cent of the SEZs are IT or ITES category due to recent boom in the IT related businesses. The land requirements for IT or the ITES is fixed at 10 hectare as compared with large stretches of land required for multi-product SEZs. However, sector-specific SEZs may be affected easily by cyclical and other economic factors, as could be seen from the fact that the IT related industries, particularly BPO sector faced severe attack due to the on going global economic recession that erupted during the latter half of 2008. As a result, considerable number of approved SEZs of IT/ITES category may not start their business due to uncertainty in the sector and the gloomy future outlook. Therefore, large scale development of the sector specific small and fragmented SEZs may not be a viable business option in the long-run and alternatively multi-product SEZs would withstand any such sudden shocks.

Another criticism in respect of sector-specific SEZs for IT/ITES highlights that since the minimum land requirement is very low with a minimum build up processing area of one lakh square meter, more than 50 per cent of the SEZs belong to the IT/ITES segments in almost all major states. This makes real estate development for processing, office accommodation as well as for dwellings imperative. Regulations permit the developers of sector-specific SEZs to build a maximum of 7,500 houses, a 100-room hotel, a 25-bed hospital, and have office space, retail stores and multiplexes up to 50,000 square meter, while a multi-product SEZ developer can build a maximum of 25,000 houses, a 250-room hotel, a 100-bed hospital and office space, retail stores and multiplexes of 200,000 square meter.

According to the Ministry of Commerce, about 35 per cent of the land within the SEZ is to be used for processing purposes and about 40 per cent of the land is to be reserved for open space, drainage, sewerage, *etc.* Housing for dwelling, hospital, school, recreation, *etc.*, are to be developed in the remaining 25 per cent of the land. Therefore, huge property development is involved in the multi-product or specific product SEZs due to the nature of the proposition and the real estate activities will boom in the initial phase of the development of SEZs.

SEZs are offered undeserving tax holidays and other incentives: There is much more validity in this argument as SEZs promises both administrative simplicity, and economic incentives. Among them, the former represents the waiver of routine custom shipment inspections, and no licensing for production reserved for micro and small enterprises (MSEs). Economic incentives range from time-bound income-tax exemptions under Section 10A to zero duties on domestic and imported inputs. The theoretical basis of a trade-neutral policy, which assigns no special preference to either exports or imports, is violated by the SEZ schemes. The revenue losses due to excessive fiscal concessions to the SEZs could be sizeable but at the same time the SEZs would generate more production and exports and thereby more revenue accruals, which would compensate the revenue losses incurred during the course of SEZ development. In addition, pick up in organised sector employment arising from the new SEZs should lead to improved tax administration which could partly offset losses due to tax concessions. However, free trade zones like Santacruz in Mumbai grant very limited privileges but are working as successful SEZs. In fact, it is difficult to precisely estimate the cost-benefit of incentives and these incentives might often cost more than the benefits from the activity.

SEZs are essential to boost exports: This argument is true which is reflected in the export growth from SEZs in recent years (which recorded an overall growth of 381 per cent over past four year) (Table 10). The share of exports from the SEZs in the total manufacturing exports has been increasing steadily during the recent period and constituted about 16 per cent of the country's manufacturing

Table 10: Export Performance of SEZs

Year	Exports from SEZs (Rs. Cr)	Growth (%)	Share in Total Manufacturing Exports (%)
1	2	3	4
2001-02	9190	..	5.8
2002-03	10057	9.4	5.2
2003-04	13,854	37.8	6.2
2004-05	18,314	32.2	6.7
2005-06	22,840	24.7	7.1
2006-07	34,615	51.6	9.0
2007-08	66,638	92.5	16.1

Source: Ministry of Commerce and Handbook of Statistics on the Indian Economy, RBI.

exports (in 2007-08). In general, the critics have been reluctant to recognise merits to this institutional mechanism on grounds that it is an inferior alternative to free trade and non-discriminatory commercial policy. The role of production clusters, *per se*, is well supported by economic theory. These clusters lead to external economies for all units in the form of good roads, power, *etc.*, which no manufacturing unit by itself would be inclined to provide.

Another aspect of the argument is that a sizeable chunk of exports of gems and jewellery, textiles and clothing, automobiles and parts and IT services are being produced in the naturally developed clusters like Chennai, Bangalore, Tiruppur, Delhi and Surat. In IT, for example, there is no evidence that the Government has had a major role in developing Bangalore or Delhi clusters. The coming up and success of SEZs rests mainly availability of adequate infrastructure with an aim to boost exports. The major constraints to development of such zones are port congestion and transport bottlenecks. It may be noted that the IMF called upon the industrial countries to improve market access for India's exports, particularly by reducing trade-distorting subsidies and tariff and non-tariff restrictions on textiles, agriculture, and skill-intensive services, thereby generating considerable welfare gains not only for India, but also for consumers in advanced economies.

Possibility of shifting of existing manufacturing units to SEZs: It is generally argued that entrepreneurs like to do business in SEZs than in the DTA due to lucrative concessions and profit motive. Therefore, the units that would otherwise have come up in DTA would simply be diverted to tariff free zone, thereby reducing Government revenues without adding to employment or output. The obvious problem is that there would be an incentive for existing export units to switch to SEZ locations simply for the purpose of benefitting from the incentive provisions.

Private vs Government SEZs: The crucial issue of whether a private-operated and financed SEZ can compete with a Government operated and financed SEZ sparked a considerable amount of debate. The fact is that strong developers are required to finance the creation of SEZs, but financing of economic zones, like all project finance, requires careful structuring to allocate risks appropriately. Risk mitigation is important, including phased build-up of infrastructure, and involving public agencies in financing to ensure and to signal Government commitment. One way of achieving this may be through public-private partnership (PPP).

Exclusion of backward Areas from SEZs: Many SEZ developers exhibit interest in setting up of SEZs in developed states like Maharashtra, Gujarat, Tamil Nadu, Andhra Pradesh and Karnataka, where the basic infrastructure has developed to an extent. On the other hand, the developers have not shown much interest in setting up of SEZs in backward states like Bihar, Jharkhand, Uttarakhand, *etc.*, where sufficient barren lands may be available. In an open economy and a free market regime, Government cannot make it obligatory upon anyone to set up SEZs in such States. However, developers could be encouraged to set up SEZs in such regions if necessary concessions are provided and basic infrastructure is put in place in these states to make it attractive for the investors. Overall, a well balanced and conducive policy environment is required to make the SEZ programme a successful proposition.

Section VI

SOME SUGGESTIVE POLICY OPTIONS

Indian SEZs have to adhere to the following characteristics. SEZs have been useful as pilot zones for trying out reform measures prior to introducing other policy reforms on a country-wide basis and these zones are here to stay. Second, since it is expensive to make high quality infrastructure investments, SEZs have also been used to converge infrastructure investment in a particular geographical area to enable the manufacturing sector to achieve international competitiveness. Third, SEZs have usually been introduced as export processing zones devoted primarily to production for exports. It is in this context, they are provided duty free status so that they are able to get inputs at international prices which then enable competitive production, and would in turn increase the exports. Fourth, they have been used to counter anti-export bias in an environment of high tariff. Fifth, SEZs are usually formed to attract private investment and FDI in particular and specially designed for export production.

In the above backdrop, some suggestive policy options are outlined below. Some of the following view points may be necessary preconditions to achieve the desired objectives and to balance the outcome of creation of more SEZs in the country.

- The location of SEZs must be such as to promote manufacturing exports. Linkage to ports and airports should be taken into consideration while setting up the SEZs. Well developed transport infrastructure may improve the performance of the SEZs even if they are located little far off from these points and then it may not necessary to locate the SEZs very near to the ports/airports.
- Encouragement for modern version of SEZs like free ports, free coastal zones, setting up of growth poles and clusters should be encouraged. The experience of countries like Korea, Japan, Malaysia, Hong Kong, Taiwan and Singapore confirms this.

- Free ports may be far bigger than the SEZs and should offer a world class environment in terms of legal framework, regulatory procedures, infrastructure, production facilities and easy access.
- Offering of greater flexibility to firms in terms of plant location in the zone would encourage the investors' participation.
- The size of each SEZ should be such as to promote the efficient provision of infrastructure services, particularly the provision of power, water and other services.
- Due recognition can be given to the ongoing tariff reform where the non-agricultural peak tariff is already 10 per cent. As the peak tariff rate approached 5 per cent, there will be little need for duty free zones. The administrative procedures required for monitoring and administering duty free imports will no longer be cost-effective.
- Efficient investor friendly administration is crucial to the success of SEZs. This may be difficult to achieve if there is a proliferation of zones. Therefore, limiting the number of zones, particularly for specific product zones, would be easy to administrate.
- Gradual promotion of SEZs but not at one go approval would smoothen the developmental process and will avoid wider criticism.
- While providing approval, prioritisation of the zones is needed according to the strategic importance of the product and development needs of the region.
- On investment front, encouragement for more greenfield FDI in the zone to supplement domestic investment would attract more private investors. China is the glaring example where about 20 per cent of the FDI has flown into SEZs. Allowing the private sector to be responsible for investment in the zones would sustain the development. Domestic investment in the zone should have long-term orientation and not fly by night characteristic.

- While selecting the location, it would be necessary to exclude the agricultural lands altogether from the promotion of SEZs.
- Establishment of well balanced compensation and rehabilitation policy to be designed for displaced people.
- Maintaining a stable and fair tax regime with no special privileges would enhance the fiscal strength of the country. At the same time, it would be necessary to physically enclose the zones to curb revenue pilferage. If required, tax privileges should be given at the very initial stage.
- Enforcement of good governance in the SEZs with flexible labour laws would be an important component for SEZ success.
- A natural fall-out of successful operations of SEZs is creation of effective forward and backward linkages. It should be noted that just establishing SEZ does not guarantee investment interest, higher industrial activities and exports as experienced in African countries.

The purpose of setting up of SEZs in many countries is the export promotion, technology transfer and thereby generation of more employment and growth. Under the WTO regime, the global economies are better integrated and liberalised to face the emerging competition under the free trade regime. However, many of the EMEs have to promote exports but at the same time they are constrained to safeguard their domestic industry from cheap imports. Therefore, sustaining the SEZ development and thereby increase exports in the competitive environment has to be a core part of development agenda, especially in developing countries.

Section VII CONCLUDING OBSERVATIONS

India has 274 notified SEZs as on December 2008 in addition to 19 existing zones established before the enactment of the SEZ Act 2005 as compared with the US, China, Indonesia, Philippines and Thailand, where the number of SEZs are much lower and the land areas of their multi-product SEZs are huge in size. In addition, more than 400 SEZs are in the pipeline due to aggressive policies adopted to promote them as growth drivers but are delayed for notification due to land acquisition problems, lower growth prospects for some specific zones, *etc.* No doubt, the SEZs are promoting infrastructure and also instrumental in increasing manufacturing growth and thereby exports. But the growing number of SEZs with sector-specific small sized fragmented zones may not yield the desired results.

India has well established track record of its own successful experience with EPZs and export-oriented units. Therefore, there is a need for more rational and balanced approach towards establishment of large scale multi-product SEZs. Although, the multi-product SEZs are catalyst for export growth, employment generation, infrastructure development and economic progression but less than 5 per cent of the notified SEZs belong to this category. Facilitating conditions should be created to ensure that the SEZs achieve the desired goals and thereby provide benefits to the lower strata of the society. In order to smoothen the process of setting up of large zones, the land acquisition policy should be reoriented towards locating the zone at strategic places without encroaching upon the agricultural land and the compensation package should be standardised without adversely affecting the displaced poor and the farm sector. As the investors are mainly looking for a standardised policy, the SEZ policy should focus on long run implications for the economy. Cross-country experiences suggest a structure that entails less interference from the Government and much greater headroom for the private sector. When the private sector exhibits more

enthusiasm for the development of SEZs, the policy should be reoriented to attract not only domestic investors but also the greenfield FDI.

On the whole, the SEZs may be encouraged but within manageable parameters; approve after thorough scrutiny of the sustainability of such propositions with a preference for developing them in the barren regions, thereby not affecting the cultivable areas; compensate and rehabilitate the land holders and the affected poor with well balanced standard compensation package including employment opportunities; provide well developed infrastructure facilities within the vicinity of SEZs with forward and backward linkages; limit the fiscal concessions and standardise them with a focus on long term perspective; and above all, develop basic transport infrastructure including export infrastructure while operationalising the SEZ units to ensure smooth movement of goods produced and thereby enhance the competitiveness of the products in the world market. In India, the SEZs are a necessary channel to promote industry, infrastructure, employment generation and growth. Therefore, at this juncture, the SEZs will continue to stay in India, but a balancing strategy needs to be adopted to safeguard the interest of all constituents.

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