SEZs' ROLE IN INDIAN MANUFACTURING GROWTH
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EXECUTIVE SUMMARY

A Special Economic Zone (SEZ) is considered the sensitive outer skin of its host country; it is also regarded as a barometer to anticipate impending macroeconomic trends. SEZs have generated interest in developing countries; for instance, countries pursuing an export-led growth strategy expect SEZs to stimulate external trade and encourage economic activity in the domestic market. In India, specifically, SEZ success is expected to translate into exponential growth in the manufacturing sector.

The Indian government has granted several incentives, such as tax incentives and world-class physical infrastructure, to SEZ units to bolster the production of manufactured goods. With this initiative, the government expects SEZs to achieve the following basic objectives:

- Provide a fillip to the manufacturing sector, especially exports of manufactured goods
- Attract substantial foreign investment by allowing 100 per cent Foreign Direct Investment (FDI) in the manufacturing sector
- Boost infrastructure development; and
- Generate employment

Although about 30 per cent of operational SEZs\(^1\) are engaged in manufacturing, manufactured goods significantly dominates India’s exports from SEZs. Various sub-sectors in the manufacturing sector are attracted to export-oriented SEZs due to their benefits. Furthermore, industries impacted by lower tax breaks are now shifting focus to SEZs. The fiscal environment for SEZ developers and units in India has played an important role in attracting export-oriented foreign investment in areas such as hardware, apparel and shoes that would have normally headed to other Asian destinations in its absence.

The Indian government continues to focus on growth in the manufacturing sector through investment promotion zones such as SEZs. In addition, the government proposes to set up National Manufacturing and Investment Zones (NMIZs) to further boost manufacturing. Also, SEZs located in NMIZs would continue to enjoy the incentives provided under the SEZ Act.

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\(^1\) Excluding multi-product/services ones; data is from Ministry of Commerce and Industry
1. SEZs- AN OVERVIEW

A SEZ is a demarcated area of land that provides impetus to manufacturing and services, with the primary objective of boosting exports. SEZs typically feature liberal tax laws and economic policies. Units situated in SEZs are deemed to be outside the customs territory of India. Therefore, goods and services coming into SEZs from the domestic tariff area (DTA) are treated as exports from India, while goods and services rendered from the SEZ to the DTA are treated as imports into India.

SEZs have generated interest in developing countries with regards to boosting international trade and encouraging economic activity in the country’s domestic market. China experimented with SEZs in 1979-80 with the objective of opening its hitherto closed economy and thereby promote trade and investment. Following China’s lead, the countries of the Soviet bloc experimented with the SEZ model, mainly with an aim to boost FDI and solve their unemployment problem. However, China’s experiment with SEZ turned out to be the most successful. Successful SEZs create new jobs for citizens, provide laboratories for governments to run controlled trade policy experiments, attract FDI, strengthen industries, and help countries avoid potentially defective domestic laws and institutions that act as a barrier to growth.

Around the world, units set up in SEZs, enjoy key fiscal incentives / tax concessions. Some of the major ones are:

- Production inputs, raw materials and intermediate goods may be imported duty-free
- Corporate income tax benefits
- Foreign funded enterprises / joint ventures may be taxed at lower enterprise tax rates as compared to the national rate
- Tax holidays may be available depending upon the degree of export activity
- Exemption from import duty on imported items used for investment in the unit, and inputs for exported items
- Cheap land made available to SEZ projects

2. SEZs IN INDIA

Asia’s first Export Promotion Zone (EPZ) was set up in Kandla in 1965. Seven more zones were set up thereafter. However, according to the Department of Commerce, Government of India (GoI), these zones were unable to do much for export promotion on account of the multiplicity of controls and clearances, the absence of world-class infrastructure and an unstable fiscal regime.
While correcting the shortcomings of the EPZ model, some new features were incorporated in the SEZ Policy announced in April 2000. This was followed by the SEZ Act 2005, supported by SEZ Rules, which came into effect on 10 February 2006, providing for drastic simplification of procedures and for single window clearance on matters relating to Central as well as State Governments. The SEZ Rules provide for different minimum land requirements for different classes of SEZs.

2.1 Manufacturing sector’s growth spurt

Tax benefits offered by SEZ are:

- Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units.
- 100 per cent income tax exemption on export income for SEZ units for first five years, 50 per cent for next five years thereafter and 50 per cent of the ploughed back export profit for next five years.
- Exemption from Minimum Alternate Tax (MAT).
- External Commercial Borrowing (ECB) by SEZ units up to USD500 million per year without any maturity restriction through recognised banking channels.
- Exemption from Central Sales Tax.
- Exemption from Service Tax.
- Single window clearance for Central and State level approvals.
- Exemption from State sales tax and other levies as extended by the respective state governments.

2.2 Effective solution for infrastructure bottlenecks in India

Better infrastructure is one of the most important benefits offered by SEZs to manufacturing units. Infrastructure facilities in SEZs can be commonly used by members, thereby reducing the requirement of setting up individual facilities.

Infrastructure related to SEZs is of two types:

1. Facilitating internal functioning of SEZs [power generation plants and distribution network, internal water supply, sanitation and sewerage, and internal roads] with direct implications on productivity; and
2. Linking SEZs with non-SEZs through a supply chain [railway tracks, roads and bridges, airport facilities, telephone lines and telecom network].

SEZs, apart from offering better connectivity in the form of multi-lane roads that comply with global safety and quality standards, provide the following infrastructure facilities.
- Customised support infrastructure
- Adequate warehousing and cold storage facilities
- Inland container depots
- Captive airstrip/helipad
- Dedicated jetty for cargo movements
- Captive power plants of SEZs to support state electricity
- Safety and security measures

SEZs can be particularly helpful for small and mid-sized entities that cannot afford to set up captive infrastructure facilities; for example, large Indian companies, along with small and mid-sized firms, aim to set up units in SEZs with state-of-the-art infrastructure facilities and share the costs. Better infrastructure facilities in SEZs have enabled hassle-free manufacturing, as evident from an increase in exports.

2.3 Geographical distribution – South India leads the way

South India is ahead of other regions in taking advantage of the tax-free special economic zones scheme as 91 of 143 operational SEZs\(^2\) are located in the four southern states. According to the Department of Commerce, Andhra Pradesh leads with a maximum number of 36 operational SEZs followed by Tamil Nadu (28), Karnataka (20) and Kerala (7), according to latest government data.

The sector-wise data shows that out of 143 operational SEZs as of September 2011, a significant majority relate to IT/ITeS and electronic hardware. One of the reasons for the rush of these sectors in SEZs was stated to be the sunset clause on earlier schemes like Software Technology Parks of India (STPI).

Exhibit 1
Distribution of SEZs throughout India

Source: National & International Council for Scientific Research (NICSRI), Aranca Research

\(^2\) The data is as of October 2011 (from the Ministry of Commerce and Industry, and Ministry of External Affairs)
2.4 SEZ Status – Non-IT approvals picking up

<table>
<thead>
<tr>
<th>SEZ Status Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formally Approved: Status given when land is available to set up a SEZ</td>
</tr>
<tr>
<td>In-principle Approved: Status given when land has not yet been secured but all the other criteria are fulfilled</td>
</tr>
<tr>
<td>Notified: Status given when physical development work begins</td>
</tr>
</tbody>
</table>

According to the Ministry of External Affairs, in addition to seven Central Government SEZs and twelve State/private-sector SEZs set up prior to the enactment of the SEZ Act 2005, formal approval has been accorded to 587 proposals out of which 381 SEZs have been notified.

According to the Department of Commerce, in FY11, the six major sectors of IT/ITeS, Hardware etc., Textiles and Apparel (including Wool), Pharma and Chemicals, Biotech, Engineering and Multi-products accounted for bulk (82 per cent) of the SEZ formal approvals. Electronic Hardware/Semiconductor and Biotech and Engineering SEZs accounted for majority of the total formal approvals. More than half of the 587 formal approvals issued so far have reached the stage of notified SEZs. This ratio is the highest in Pharma/Chemicals sector (90 per cent) followed very closely by engineering sector (70 per cent).

While IT and ITeS have enjoyed prolonged tax incentives and have the maximum number of operational SEZs, in-principal approvals have now been accorded to more non-IT SEZs. IT accounted for only 7 per cent of total in-principal approvals as of December 2010.

3 Data as of October 2011
3. PERFORMANCE OF SEZs IN INDIA

In India, SEZs have played an important role in facilitating exports, thereby enabling the country to be a part of globalisation. During FY06-FY12, exports from SEZs increased at a CAGR of 59 per cent to USD78.6 billion; annual growth for FY12 was 15 per cent. Of this, 61.7 per cent share belonged to the manufacturing sector. This sector contributed 92.4 per cent of the total exports from central government SEZs in FY11. For state government or private SEZs established prior to the SEZ Act (2005) and SEZs notified under the SEZ Act (2005), manufacturing contributed 47.2 per cent and 58.3 per cent, respectively, to the total exports.

Although, as depicted in the graph below, manufacturing significantly dominates India’s SEZ exports, only 30 per cent of the operational SEZs are engaged in manufacturing. However in the recent past, export oriented units in various sub-sectors of manufacturing are moving into SEZs – specially light and heavy engineering industries, electronics industries and auto and auto-components industries. Besides these, industries which are being impacted by reducing tax breaks too are now moving towards SEZs. The gems and jewellery sector also has benefited as a lot of such units have relocated to SEZs to avail the tax incentives.

![Exhibit 3: Exports from SEZs in India (USD billion)](source: Ministry of External Affairs, Government of India, Aranca Research)

Conversion rate used is USD1 = INR46.11
**Exhibit 4**

Total Investment in SEZs as on 30 June 2011 (USD billion)

- Central Government SEZs: 2.0
- State/Pvt. SEZs set up before 2006: 1.5
- SEZs Notified under the Act: 37.4

Source: Ministry of External Affairs, Government of India, Aranca Research

**Exhibit 5**

Export Revenue Share of SEZs (FY 11) (in per cent)

- Manufacturing: 27.5%
- Trading: 10.8%
- IT/ITES: 61.7%

Source: Department of Commerce, Aranca Research

**Exhibit 6**

Sector-wise Export Revenue Share of SEZs (FY 11) (in per cent)

- IT/ITES: 46%
- Pharma: 7%
- Textile: 37%
- Multi-Product: 9%
- Others: 9%

Source: Department of Commerce, Aranca Research
3.1 Foreign investments in manufacturing SEZs

Over the years, the increasing attractiveness of the Indian market has lured investors from across the world. Consequently, the country is among the top five preferred destinations for FDI from Asian, European and North American investors.

At a more micro level, FDI inflows into key sub-sectors of manufacturing have also posted strong growth. The exhibits below highlight cumulative FDI inflows into key sectors of the Indian economy and their shares in overall inflows.

**Exhibit 7**
Cumulative FDI inflows into key sectors (from Apr 2000)

<table>
<thead>
<tr>
<th>Year</th>
<th>Computer Software &amp; Hardware</th>
<th>Telecommunications*</th>
<th>Housing &amp; Real Estate</th>
<th>Construction Activities#</th>
<th>Automobile Industry</th>
<th>Power</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY08</td>
<td>6</td>
<td>4</td>
<td>2</td>
<td>1</td>
<td>4</td>
<td>2</td>
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<tr>
<td>FY09</td>
<td>8</td>
<td>6</td>
<td>4</td>
<td>2</td>
<td>6</td>
<td>2</td>
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<tr>
<td>FY10</td>
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<td>8</td>
<td>6</td>
<td>4</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>FY11</td>
<td>12</td>
<td>10</td>
<td>8</td>
<td>6</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>FY12^</td>
<td>12</td>
<td>12</td>
<td>10</td>
<td>8</td>
<td>12</td>
<td>2</td>
</tr>
</tbody>
</table>

*Including roads & highways; ^ FY12 - (April - Feb)
*radio paging, cellular mobile, basic telephone services

**Exhibit 8**
Share in cumulative FDI inflows (Apr2000-Feb2012) (in per cent)

- Chemicals
- Petroleum & Natural gas
- Metallurgical Industries
- Automotive
- Power
- Housing & Real estate
- Computers
- Construction
- Telecommunications
- Services

Source: Department of Industrial Policy & Promotion; Aranca Research
Note: #including roads & highways; ^ FY12 - (April - Feb)
*radio paging, cellular mobile, basic telephone services
Substantial amount of FDI has already been made in SEZs. According to the Indian government, FDI amounting to USD2.4 billion\(^5\) were invested between FY07 and FY09. Some SEZs with major FDI component of investment are:

- Apache SEZ Development India Private Limited, Andhra Pradesh (Footwear SEZ)
- Nokia Special Economic Zone in Tamil Nadu (Telecom equipments SEZ).
- Mahindra City SEZ, Tamil Nadu (Apparels and fashion accessories; IT/hardware; auto ancillary).
- Mundra Port and Special Economic Zone, Gujarat (Multi product SEZ).
- Moser Baer SEZ, Noida, Uttar Pradesh (SEZ for Non-conventional energy including solar energy equipment).
- Divvy’s Laboratories Limited, Andhra Pradesh (Pharma SEZ).
- Flextronics SEZ in Tamil Nadu (Electronic Hardware SEZ).
- Biocon Limited, Karnataka (Biotech SEZ).
- Serum Bio-Pharma Park, Maharashtra (Pharma SEZ).
- Hyderabad Gems Limited, Hyderabad (Gems and Jewellery SEZ).
- Maharashtra Airport Development Corporation Limited, Maharashtra (Multi product SEZ).
- Reliance Jamnagar Infrastructure Ltd. (Multi Product).
- Suzlon Infrastructure Ltd. (Hi-tech Engineering Products & related services).

According to a study conducted by the Institute of South Asian Studies (SAS) in 2011, units and developers in SEZs enjoy a fiscal largesse. This has played an important role in attracting export oriented foreign investment in areas such as hardware, apparel and shoes, which would have normally headed for other Asian destinations in its absence.

4. POTENTIAL OF SEZs IN INCREASING INDIA’S MANUFACTURING OUTPUT

As stated above, 61.7 per cent of the SEZs’ total exports comprised of manufactured goods and given that exports from SEZ’s have increased exponentially in the last five years, it can be inferred that SEZs have played a vital role in boosting the country’s manufacturing output. Further, the Indian government expects SEZ exports to reach approximately USD75 billion, higher than USD68.4 billion in FY11.

**Setting up of NMIZs:** The government recently approved the National Manufacturing Policy – 2011 (unveiled on 25th October 2011), which aims to increase the share of manufacturing sector in total GDP to 25 per cent by 2022. Currently, the sector accounts for a share of about 16 per cent in GDP. It aims to create mega industrial zones across the country with world-class infrastructure facilities and creating 100 million jobs by 2022. The new policy proposes developing National Investment and Manufacturing Zones or mega industrial

\(^5\) Conversion rate used is USD1 = INR46.11
parks that will reduce compliance burden on the industry. Under the policy a special company will be established that will be a one-stop shop for all clearances for businesses interested in setting up operations in the industry parks. Special incentive will be given to small and medium companies in the form of tax breaks to operate in the park.

The proposed NMIZs, promise three major benefits for SEZs:

- Easier access to land.
- Flexible labour policies
- Getting regulatory clearances easily.

According to DIPP, the primary difference between a NMIZ and SEZ is the scale of operation. They will tend to significantly outsize SEZs since the rationale behind setting up of NMIZs is to drastically increase manufacturing. According to the policy, SEZs located in NMIZs will continue to enjoy the incentives provided under the SEZ Act.

5. SUCCESS STORIES OF INDIAN SEZs

5.1 Nokia Special Economic Zone (Telecom Equipment SEZ)

- Physical Exports of USD2.2 billion in four years i.e from FY07 to FY10.
- Investment of USD0.6 billion has already been made in this SEZ, out of which FDI is USD 0.2 billion.
- Projected investment of USD0.6 billion and projected direct employment of 20,000 persons.

5.2 Mahindra City SEZ (Apparel and fashion accessories; IT/Hardware; Auto-ancillary)

- Physical Exports worth USD0.5 billion in four years i.e from FY07 to FY10.
- Direct employment provided to 16,257 persons.
- Investment of USD0.4 billion has already been made in this SEZ, out of which FDI is USD41.5 million.
- Projected investment of USD0.5 billion and projected direct employment of 57,236 persons.

5.3 Apache SEZ Development India Private Limited (Footwear SEZ)

- Physical Exports worth USD31.3 million in four years i.e from FY07 to FY10.
- Investment of USD115.4 million has already been made in this SEZ, out of which FDI is USD89.2 million.
- Projected direct employment of 20,000 persons.

\(^6\) Conversion rate used is USD1 = INR46.11 throughout this page
5.4 Reliance Jamnagar Infrastructure Limited (Multi-product SEZ)

- Physical Exports worth USD15.7 billion in two years i.e from FY09 to FY10.
- Investment of USD8.1 billion has already been invested in this SEZ, out of which FDI is USD15.2 million.
- Projected investment of USD7.6 billion.

6. CONCLUSION

The first EPZ was set up in India in 1965. However, as the government’s EPZ strategy did not generate meaningful results, it was replaced by SEZs. This move led to a significant improvement in economic activity in the country—most importantly rendering exports competitive—as evident by the increase in India’s share of manufacturing exports across the globe vis-à-vis a decade ago. The sector has reported strong growth, outpacing overall growth in GDP, over the past few years. With regard to exports, India has a presence in key industries such as engineering goods and chemicals.

Considering the country’s SEZ exports are dominated by the export of manufactured goods, it is encouraging to know that most of the upcoming SEZs are related to the same. The share of manufacturing goods in total SEZ exports is estimated to increase, going forward.

Given the success of SEZs, the government plans to set up NMIZs, particularly focussing on manufacturing. Units in NMIZs will be offered special incentives and concessions for value addition; also, infrastructure facilities, which are not available elsewhere, are expected to be provided in NMIZs. Capital for funding NMIZs is also likely to be cheaper.
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