

Working Paper 288

**Understanding the Fiscal
Implications of SEZs in
India: An Exploration in
Resource Cost Approach**

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The Institute for Social and Economic Change,
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UNDERSTANDING THE FISCAL IMPLICATIONS OF SEZs IN INDIA: AN EXPLORATION IN RESOURCE COST APPROACH

Malini L Tantri*

Abstract

This paper analyses the fiscal implications of SEZs on the government exchequer. Specifically, this paper proposes the following: (1) an argument that makes a case for the paramount importance of studying the fiscal dimensions of SEZs and (2) a framework for analysing the fiscal dimensions of SEZs. This framework is then employed to find the actual fiscal dimensions of SEZs in the country. The analysis is based on aggregating data collected from seven conventional SEZs and taking 1990-91 to 2007-08 as the reference period. The exercise reveals that the Government has spent huge sums of money to play the role of a trade facilitator and as a fiscal manager has lost considerable revenue. This, in turn, has affected both revenue and capital expenditure of the governments budget. Given the magnitude of these costs, one cannot but raise questions about the actual contributions of these enclaves to the national fiscal health and the feasibility of relentlessly adopting measures that seeks to promote these zones across the nation.

Introduction

Special Economic Zones (SEZs) have emerged as additional instruments of trade promotion, besides being used as engines to accelerate the pace of economic growth. In order to realise the objectives behind their promotion, the Government of India has allowed these zones to operate as separate economic entities with their own, unique fiscal codes. The unique privileges granted to these enclaves include exemption from central and state-specific taxes, apart from the extension of several subsidies. The role envisaged for these zones and the enthusiasm with which the Government has promoted them, notwithstanding, their creation and maintenance seem to affect the national exchequer in two ways. First, given the expenditure involved in creating separate institutional arrangements to reduce the long and taxing chain of bureaucratic procedures and creating world-class infrastructure, the Government is clearly and steadfastly playing the role of a trade facilitator. Second, in its role as a fiscal manager, the government has incurred considerable loss of revenue by providing fiscal incentives in terms of tax concessions and subsidies. In other words, the establishment and sustenance of SEZs have so far caused additional revenue and capital expenditure on the one hand and massive revenue loss on the other. Given these factors, while assessing the growth of SEZs and celebrating their contribution to trade expansion, employment generation and increased private investment, it is imperative that we consider the costs involved in the promotion of such ventures, especially because of the enormous stress they apparently place on the fiscal health of the economy.

In the recent past, there has been a debate among observers of SEZs concerning the issue of analyzing costs associated in the promotion of these enclaves^{d ii}. This debate, surprisingly, focused on the very legitimacy of the attempts to understand the costs associated with the expansion of SEZs, as if it is to be taken for granted. Though there are proponents of the view that inflow from the national exchequer and the recurring revenue loss need to be understood in detail, however, very little in the

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form of an appropriate methodology has come from these quarters. Further, no empirical data is available in the public domain regarding the cost components of SEZ expansion across zones and over the years. In an attempt to address the above-mentioned lacunae, this paper proposes the following: (1) an argument that makes a case for the paramount importance of studying the fiscal dimensions of SEZs; (2) a framework for analysing the fiscal dimensions of SEZs. This framework is then employed to find the actual fiscal dimensions of SEZs.

The paper is structured as follows: in the next section, we argue for the need to understand the fiscal dimensions of SEZs. In the third section, we present an analytical framework to understand these dimensions. In the penultimate section, we employ the analytical framework to tease out empirically the fiscal dimensions of SEZs. This paper concludes with a summing up of the results obtained.

Prelude to the Framework

The rationale behind the liberalisation process was guided by the assumption that its spillover effects would benefit the domestic economy, mainly by accelerating the pace of economic growth, and that the resultant benefits these would trickle down to the different segments of the economy. There has been a consensus regarding the potential of trade reform measures to boost economic growth vis-à-vis the initial restrictive trade regime. Yet, there are certain concerns that may pose questions about the rationale behind the reform process. The most common concern about various aspects of trade reform measures is related to the possible effect on the fiscal situation of the economy, particularly the revenue of the government, which in turn, may pose challenges to the government's efforts to meet the various development challenges. This is considered as the prime reason for resource constraints, which most of the developing economies have been facing in the post-liberalisation period, following a substantial drop in tax revenue. The empirical evidence in this respect seems to be both inconclusive and ambiguous in natureⁱⁱⁱ.

Given the additional burden these measures are likely to place on fiscal health, understanding the impact of trade policy reform measures on the fiscal position of the country is necessary in view of its known influence in terms of distributional aspects. Furthermore, in the literature, Government revenue is considered an important channel through which trade policy tends to have an impact on social welfare (Bussolo and Nicita, 2005). In this context, it is necessary to define the conceptual basis of trade reforms leading towards such a phenomenon. In simple terms, trade reforms can be defined as a cautious approach by the Government to gradually phase out the safety nets extended to domestic industries with a view to equalising the price rate prevailing in both national and international markets. This has been executed in different ways in different countries, depending on the initial economic conditions and priorities of nations concerned. Initially, it began with a gradual withdrawal of the quantitative restrictions on the trade tariff structure, followed by a reduction in tariff rates and subsequently, with the adoption of a uniform tax base (Bussolo and Nicita, 2005). The more complex and advanced system of trade reforms include the following:

- Bilateral and multilateral trading arrangements
- Provision for the operation of open area

- Integration with a set of economies
- Entry into WTO and so on (Bussolo and Nicita, 2005)

The different dimensions of the reforms measures, however, affect the domestic economy in various ways depending on two sets of factors (Greenway and Milner, 1991⁴): One is based on the initial economic conditions of the economy. If a country is highly insulated and underdeveloped, then exposure to the world market through trade measures can have severe adverse effects on the revenue sources, particularly through a substantial reduction in tax revenues. Two, the reforms undertaken depend on the measures adopted to smoothen out the reform process. If a policy initiative is directed by quantitative restrictions on import tariff and/or to replace duty exemption with lower tariff rate, then it is expected to increase the revenue source of income. On the contrary, if policy initiatives are targeted to gradually reducing import tariff, offering special incentives to any particular section of the society in the form of substantial tax concessions, providing tax exemptions etc., then it will definitely have some negative impact on the fiscal position of the economy. However, there is a counter-argument that a reduction in the tax base would increase demand for imports as well as reduce the extent of bureaucratic corruption and smuggling due to the reduced rate of import taxes (ibid). In the context of trade reforms, the fiscal situation of a country becomes more crucial considering the additional responsibilities to be taken up by governments in order to facilitate trade. To attract investment, governments of the respective states embark on building the social and economic infrastructure of the region besides acting as facilitating agents for infrastructure projects.

In the context of the Indian economy, the process of reforms in the trade sphere began with a gradual dismantling of quantitative restrictions along with lowering of imports tax rates. On an average, tariff rates in India were reduced from 128.0 per cent in 1990-91 to 39.6 per cent in 1999-2000 (Ahulwalia, 2009). As a result, the tax revenue showed signs of decline during post-1990s. Hence, this phenomenon has begun to draw the attention of policymakers and academicians with regard to its possible impact on the fiscal situation of the economy. This issue has gained further prominence in the recent past consequent on the introduction and gradual spread of the most ambitious trade measure of the government, namely, the SEZ policy. This policy has resulted not only in the reduction of tax rates but also in the withdrawal of major taxes by both the Central and in State governments⁵. Notably, these taxes constitute the main revenue source for both Central and State governments. This is quite extreme to the scenario as explained by Greenway and Milner (1991), because in the SEZ policy framework the government not only offered reduced tax rates but also withdrew major taxes for initial few years of the establishment of the SEZs. Therefore, it is necessary to devise an appropriate mechanism to estimate the costs incurred by the government in the promotion of SEZs because they have serious repercussions on the fiscal position of the economy. This is taken up for discussion in the next section.

Resource Cost Approach: Conceptual and Analytical Frameworks

There is hardly any study that seeks to analyze the fiscal implications of SEZs expansion in the country and weigh their benefits against costs involved in their promotion. Thus, at the outset, it is first necessary to define the conceptual framework for understanding the issue of fiscal implications as well

as to provide a platform for the discussion of the different elements of costs involved in the promotion of SEZ policy.

To begin with, we understand the fiscal implications of SEZs as a resource cost and is defined as those costs which in the process of generating NFE, will have a negative impact on the fiscal situation of the economy either directly or indirectly in the short or long run.

The fiscal implications of SEZs, as defined above could be categorised under a two-fold classification (Chart 1): First, those that have direct and immediate (short term) impact on the fiscal position of the economy. This further consists of two components, i.e., those that lead to loss of revenue to the government exchequer and those that contribute significantly towards additional expenditure of the government. The second encompasses those that have an indirect impact on the budgetary position of the economy not only in the short but also in the long term. Thus, the term 'resource' cost could be understood in a very broad sense and used for capturing the direct impact of the promotion of SEZs on the fiscal position of the economy (reduction in tax revenue and substantial increase in expenditure of the government). It can also be used to capture the indirect impact on budgetary position of the economy in the long and short term (See Table 1 for various components of resource costs and the projected benefits of SEZs). For instance, to promote SEZs in India, private lands have been acquired in rural areas for many of the upcoming projects. In such acquisitions, although monetary compensation is paid at the prevailing market price, alternative employment opportunities are not provided. Further, those displaced by land acquisition are generally left to fend for themselves. This, in turn, necessitates government intervention at different levels to rehabilitate and resettle the displaced which will eventually put additional burden on the fiscal position of the economy.

Chart 1: Resource Cost and SEZs

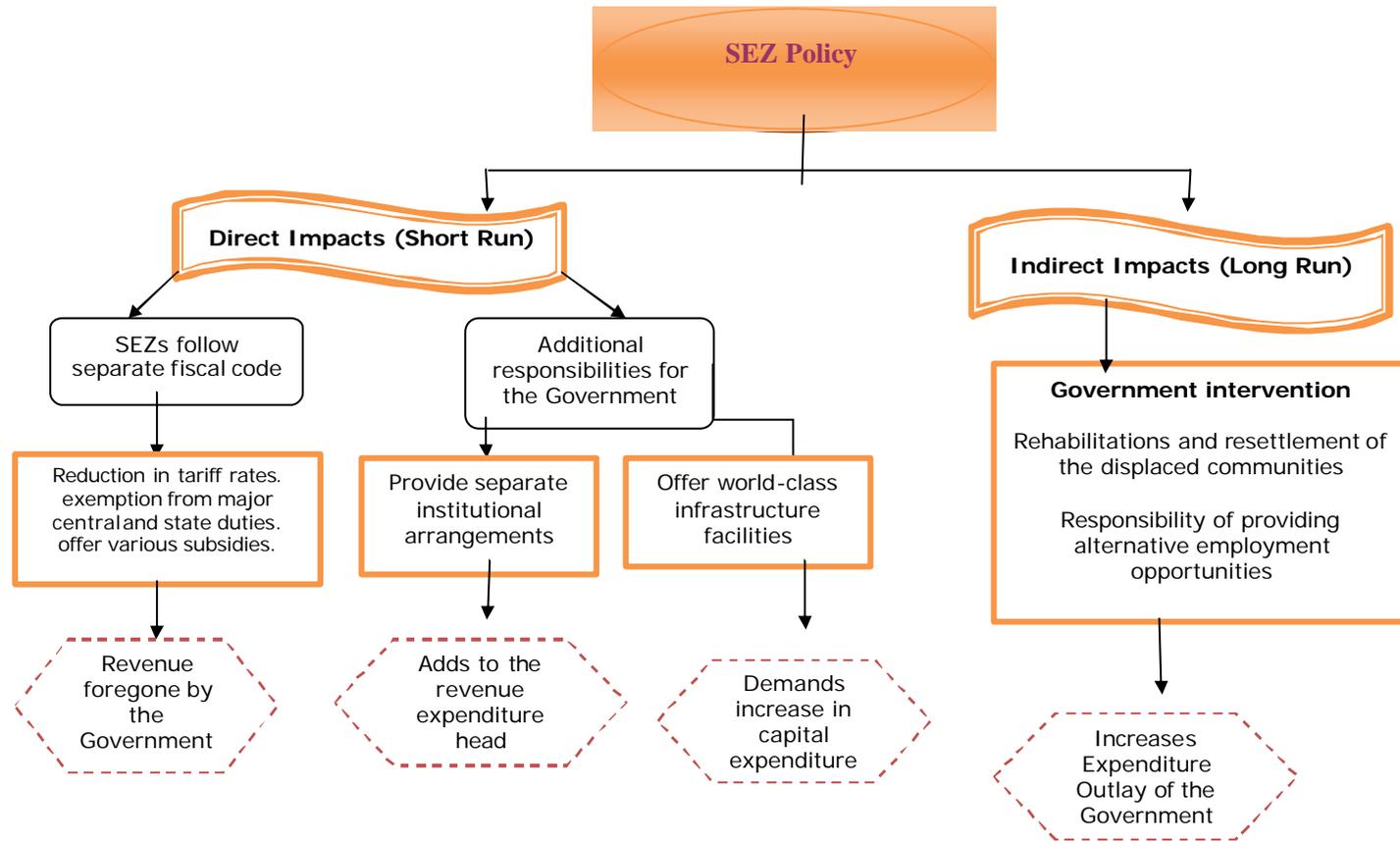


Table 1: Components of Resource Costs and Projected Benefits of SEZ Expansion

SI No	Components	Description
Resource Costs		
1	Administrative Costs	The Government incurs high expenditure on the maintenance of separate administrative offices in each zone, which eventually adds to the revenue expenditure of the Government budget.
2	Maintenance Costs	If zones are owned and funded by the Government, then all expenditure on the development of plots, infrastructure facilities and their maintenance has to be incurred by the Central Government and increases the expenditure of the Government budget known as 'capital expenditure' ^{vi} .
3	Revenue Foregone	To attract investors to these zones, especially foreign direct investment, both Central and State Governments have formulated a separate fiscal code for these enclaves. The code allows for substantial reduction in tax rates, a number of tax concessions as well as subsidies to different actors involved in the promotion of SEZs. These incentives, however, differ across zones. The tax concessions and subsidies have a direct impact on the fiscal position of the economy in terms of a substantial loss of revenue to the government exchequer.
4	Indirect costs	SEZs can adversely affect the economy indirectly. This, in turn, necessitates government intervention at different levels to address the imbalance. Such indirect costs are long term in nature and may not be realised/understood in the short run. The major one includes the cost of government intervention at different layers to protect the fundamental rights of people affected, cost of rehabilitation and resettlement of the displaced and addressing the negative externalities generated in the process and others.
Proposed Benefits		
1	Foreign Exchange Earnings	The foremost benefit expected from these zones is the generation of foreign exchange earnings. The apparent reason for focusing on SEZs to generate foreign exchange earnings is their purported innate capacity to generate spillover effects on the domestic economy in addition to the intended purpose of earning foreign exchange.
2	Employment Generation	Besides promoting exports, these zones are expected to generate employment opportunities on the domestic front to address the broader development objective of a nation state
3	Private and Foreign Investments	Besides exports earning and employment promotion, investments are considered as channels to reap the related spillover effects of SEZs (Engman <i>et al</i> , 2007).
4	Revenue Contribution	SEZs are expected ensure a fair flow of revenue to the government through different sources, including revenue from rent and advances on open plots and Standard Design Factory (SDF) ^{vi} , sale of water and electricity, and revenue through tax collections.
5	Spill Over Effects	These zones are expected to generate spillover effects on the domestic economy through purchase of domestic raw material, capital goods and, outsourcing part of production process in the DTA.

Source: Author's Compilation from Various Sources

Fiscal implications of SEZs, like fiscal implications of trade policy measures, depend on the following four factors^{viii}: the initial economic conditions of the economy, location choice, the type of fiscal code allowed in these zones and sectoral composition.

Initial Economic Conditions of the Economy and Location Choice

If an economy had been completely insulated from the external world till embarking on the experiment of such zones, then the creation and promotion of such zones could have very little adverse impact on the fiscal position of the economy. Initially, the government has to incur huge capital expenditure to provide better business environment and institutional arrangements but at the same time, if it succeeds in attracting fresh domestic and foreign investments, then it would contribute to various sources of government revenue in addition to ensuring alternative employment opportunities and livelihood to many. China is a good example to this. Before initiating the reform process, it was centrally planned and administered. Thus, the agricultural and industrial sectors hardly received any Government support or incentives for large-scale production or exports. Given this, the reform process initiated through SEZs was not only helpful to break the tradition of central planning but also to eliminate the rigidities and institutions that had affected large scale production and the movement of labour within the country, which were hindering growth. Moreover, the regions chosen for experiments of SEZs were highly underdeveloped. Therefore, at the time of introducing the SEZ policy, these regions were not making any significant revenue contribution to the government. Given this, the incentive structure offered in the SEZs region was helpful to boost investor confidence; besides, it also helped to bring about a structural transformation in the Chinese economy. Not surprisingly, when the SEZ policy was introduced in China, it created an additional source of government revenue. Moreover, both private and foreign investors participated in several infrastructure projects initiated by the Chinese Government and helped reduce the capital expenditure outlay of the government.

On the contrary, if SEZs were introduced after initiating reform process, then it would deplete the revenue source of the government. This is because, on account of wider reform process implemented in the economy, SEZs scheme would hardly provide any special privileges to investors, with the possible exception of incentives. Further, too much concentration of SEZs in a region may exhaust the existing resource base and infrastructure facilities. This, in the long term, may further increase the fiscal responsibilities of the government.

Fiscal Code and Sectoral Composition

In an attempt to popularise the SEZs scheme, the government allowed a number of fiscal incentives in terms of tax concession and/or subsidies that, in the present context, is referred to as the fiscal code. The type of fiscal code allowed in these zones also determines its possible repercussions on the fiscal position. In the SEZs scheme, if the Government offers subsidised tariff rate than the quantitative restrictions applicable elsewhere in the economy, it will positively add to government's revenue. On the contrary, if it provides a reduced tariff structure and/or gives exemption from domestic taxes, then it would have revenue depletion effect. Meanwhile, the sectoral choice and composition of SEZs also influence the phenomenon. For instance, the government may incur a very light fiscal burden if it

chooses sectors that require very low imports but have higher international demand and exports earnings. On the contrary, if SEZs are promoted in sectors that have high import intensity of high-value products, then it would definitely lead to substantial revenue loss to the government^x.

The Process

This study, while analysing the fiscal implications of trade policy, attempts to assess the resource costs involved in the process. According to available literature, this is measured by analysing the corresponding revenue loss to the government, specifically from trade taxes and fiscal deficit of the economy because they are directly related to trade promotion measures. Most of these studies have attempted to evaluate the liberalisation process of the economy as a single process^x. Further, these studies are country-specific and do not evaluate any specific policy of the government. Moreover, these studies specify only the fiscal implications of trade measures and overlook benefits arising from these costs, and thus reveal only a partial picture of the whole process. In this context, we attempt to quantify the resource cost involved in the promotion of SEZs, which is the most debated policy of the government. Further, we intend to weigh the proposed benefits against such resource costs.

This study is based on aggregated data collected from the seven conventional SEZs of the country^{xi} and the data on these components have been collected from the respective Development Commissioners' offices. The reference period is 1990-91 to 2007-08^{xii}. The data on costs include total government expenditure incurred in each zone over the years for maintaining the administrative machinery (revenue expenditure), development and maintenance costs (capital expenditure) and the revenue foregone under Central excise and custom duties^{xiii}. On the benefits side, we have considered data only on NFE (Net Foreign Exchange) and the revenue earned from land rent and advances.

It has to be mentioned here that with respect to the 'revenue-foregone', we have been able to collect data only on tax exemptions under customs and Central excise duties and not on other components of revenue loss to the government. This is specifically due to a number of data-specific problems involved in handling resource cost incurred by each SEZ. In fact, the problem associated with collecting information on the various costs involved in the promotion of such zones is not specific to Indian zones alone; it is well acknowledged in various studies with reference to other countries as well^{xiv}. Given these constraints, our analysis is restricted to only a few components of the resource cost and only the direct impact of SEZs on the fiscal position of the economy that occur in the short term and are not considered indirect fiscal repercussions of SEZs in the long term^{xv}.

Thus, the revenue loss to the government exchequer and such other items that contribute significantly to additional expenditure for the Government together measure the resource value that the Government has to forego in order to earn a rupee in terms of NFE earnings^{xvi} from these zones. The value is assumed to be between zero and one. This, in the present context, is used to compare the real resource cost involved in generating NFE earnings over the reference period^{xvii}.

Before looking into the value of resource cost that the Government has to forego to earn a rupee in terms of NFE earnings, we have computed a few basic estimates to assess a few benefits against specific components of resource costs involved in their promotion. They are as follows:

$$R1_t = r_t - re_t \quad \dots\dots\dots 1$$

Where:

- R1 = Partial net revenue earned
- t = Time period under consideration
- r = Revenue earned on rent and advance
- re = Administrative (revenue) expenditure incurred towards maintenance of a separate administration wing in each zone

It measures the partial net revenue earned in each zone. It is simply the difference between revenue earned (through rent and advance) and revenue expenditure incurred by each zone over the years. This helps us know whether each zone has managed to generate resources needed to cover at least its administrative costs and further move towards profits. A positive value indicates light burden on the Central Government for its administration:

$$R2_{it} = r_{it} - (re_t + ce_t) \quad \dots\dots\dots 2$$

Where:

- R2 = Total Revenue earned
- t = Time period under consideration;
- r = Revenue earned on rent and advance
- re = Administrative (revenue) expenditure incurred towards maintenance of separate administration wing in each zone
- ce = Capital expenditure incurred towards various forms of developmental and infrastructural maintenance in each zone

It measures the total net revenue earned in each zone. It is derived by taking the difference between the revenue earned (on rent and advances) and the total (revenue and capital) expenditure incurred by each zone over the years. This reveals whether each zone is capable of generating the resources needed for administrative maintenance and various zonal development projects. A positive value indicates less burden on the Central Government in maintaining administration and development of a zone.

$$RC1_t = \frac{Rf_t}{NFE_t} \quad \dots\dots\dots 3$$

Where:

- RC1 = Partial resource costs
- t = Time period under consideration
- Rf = Revenue foregone under customs and central excise duties exemptions
- NFE = Net foreign exchange earnings

The above equation estimates the value of resource costs involved in generating a unit of foreign exchange earnings; it is a partial estimation of resource cost as it considers only the revenue forgone as total cost in its numerator, whereas the Government also incurs a very huge amount in the form of revenue and capital expenditure^{viii}. Thus, Equation 3 could be extended to consider both revenue and expenditure of the fiscal implications of SEZs. It can be considered as the total resource cost (RC2) incurred by the government in earning a rupee of foreign exchange from these zones.

$$RC2_t = \frac{Rf_t + e_t}{NFE_t} \quad \dots\dots\dots 4$$

Where:

RC2 = Total resource costs

t = Time period under consideration;

Rf = Revenue foregone under custom and central excise duties exemptions

e_t = additional expenditure incurred in playing the role of a facilitator in SEZs . This includes revenue and capital expenditures of the Government

NFE = Net Foreign Exchange Earnings

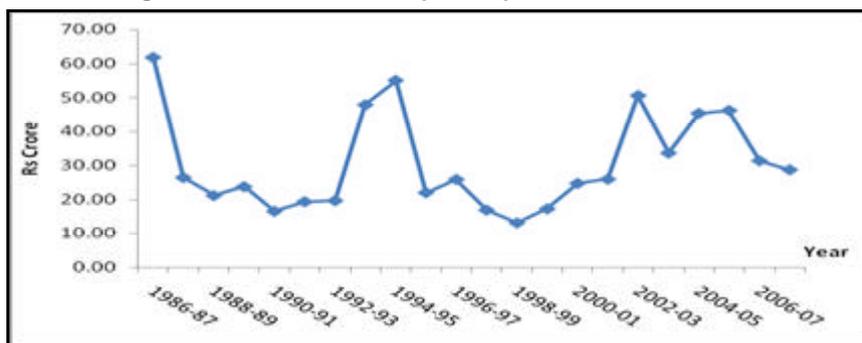
In the next section, we first present the scenario of various components of resource cost incurred by each SEZ over the years. This will be followed by an estimation based on ratios cited above as well as other types of estimation.

Fiscal Implications of SEZs: An Empirical Investigation

First, the different components of resource cost across zones and over the reference period are outlined. As stated above, the resource cost involved in the promotion of SEZs consists of two major components viz., the budgetary expenditure of the government and those that affect revenue side of the budget. To begin with, we focus on the budgetary expenditure of the government; they further consist of two types, viz., revenue and capital.

The seven zones taken up for discussion in the present case are owned by the Central Government, which also assumes the role of a developer. In order to develop plots and provide better infrastructure facilities within each zone the government envisaged an outlay of Rs 673.39 crore for the period 1986-87 to 2007-08. This could be a much higher figure if we consider the capital expenditure incurred by the government for each zone since inception. The capital outlay registered an upward trend particularly during the current SEZs period, reflecting the serious efforts of the government to improve the infrastructure in these zones (Figure 1).

Figure 1: Trends in Total Capital Expenditure of Seven SEZs

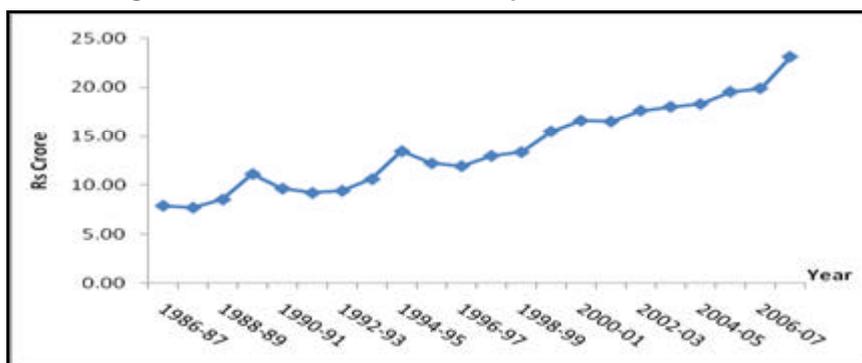


Source: Based on the data collected from seven Conventional SEZs Development Commissioner Offices

Note: Values are in Rs Crore and at constant price (1999-2000)

Besides capital expenditure, the government has incurred a total expenditure of Rupees 303.63 crore over the last 22 years on maintenance of separate administrative wings in these seven zones. Unlike capital expenditure, here we have not seen any specific trend because outlay on this is guided by the recommendations of the Pay Commission and not by any specific industrial or trade policy (Figure 2).

Figure 2: Trends in Total Revenue Expenditure of Seven SEZs

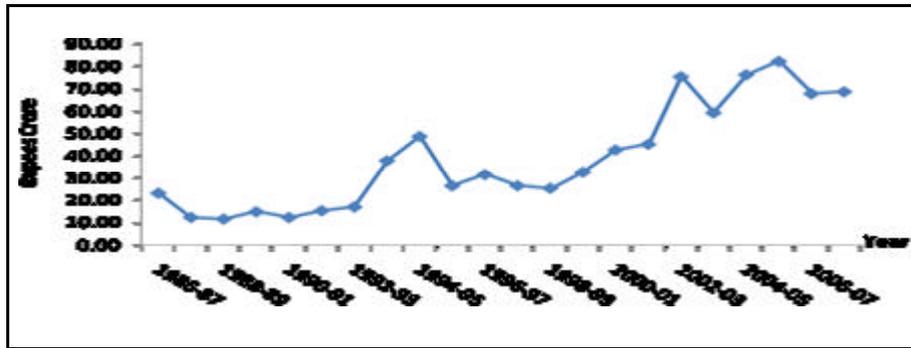


Source: Based on the data collected from Seven Conventional SEZs Development Commissioner Office

Note: Values are in Rs Crore and at constant prices (1999-2000)

Thus, over the years, there has been a substantial increase in the total government expenditure on the seven zones. Revenue and capital expenditure together amount to Rs 977.02 crore of investment undertaken so far in these seven zones (Figure 3). It should be noted here that with regard to data on expenditure on SEZs, in the present exercise, we have used data for the period 1986-87 to 2007-08 whereas zones like Kandla and Santa Cruz were set up before 1980s. The present analysis, therefore, have not considered the government investment till 1980 and the inclusion of such outlay would have inflated the corresponding capital outlay and the government's total budgetary outlay for these zones.

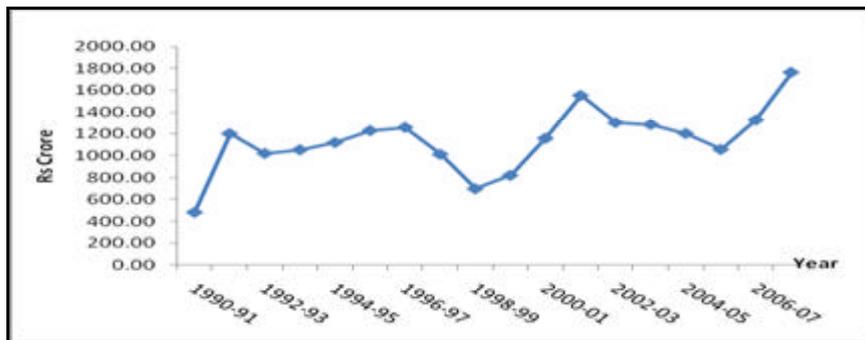
Figure 3: Trends in Total Budgetary Outlay of Seven SEZs
(Revenue and Capital Expenditure)



Source: Based on the data collected from Seven Conventional SEZs Development Commissioner Offices
Note: Values are in Rs Crore and at constant prices (1999-2000)

Apart from outlining the costs involved in the promotion of SEZs, it is equally important to analyse the revenue foregone by the government exchequer because it would have repercussions on the income side of the budgetary estimates. Given the constraints of availability and accuracy of data on this component, we have restricted our computation to the revenue foregone through customs and central excise exemptions. Since 1990-91, the government has foregone revenue to the tune of Rs 20634.19 crore from the seven zones. The extent of revenue foregone has shown fluctuations over the years. The steep decline in the late 1990s was in line with the slowdown of demand for imports from these zones in line with East Asian Crisis. Again, in the current SEZs phase, we notice a marginal fall in revenue foregone for the period between 2002-03 and 2005-06 and an upward trend thereafter.

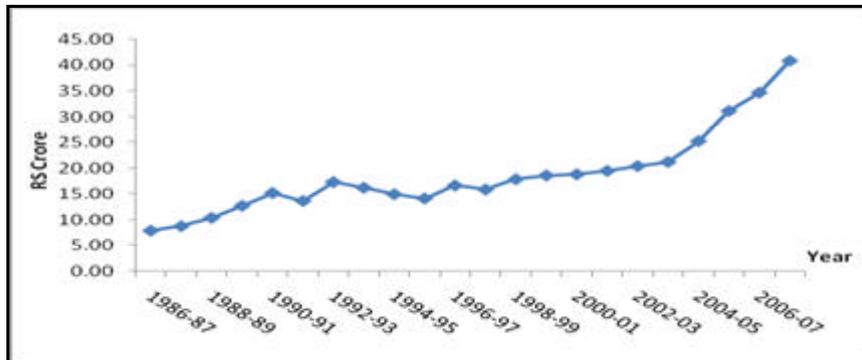
Figure 4: Trends in Total Revenue Foregone under Custom and Central Excise Duties of Seven SEZ



Source: Based on the data collected from Seven Conventional SEZs Development Commissioner Offices
Note: Values are in Rs Crore and at constant prices (1999-2000)

As against the total government revenue and capital expenditure to the tune of Rs 303.03 and Rs. 673.90 crore, respectively, these zones have cumulatively earned a revenue of Rs 414.40 crore (Figure 5)^{xix}. Figure 6 reports the steep increase in NFE from the seven conventional SEZs in the current phase.

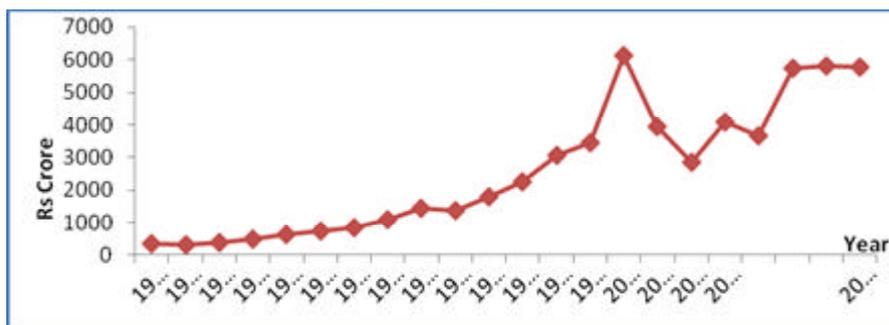
Figure 5: Trends in Total Rental Revenue Earned by Seven SEZs



Source: Based on the data collected from Seven Conventional SEZs Development Commissioner Office

Note: Values are in Rs Crore and at constant prices (1999-2000)

Figure 6: Trends in Net Foreign Exchange of the Seven Conventional SEZs

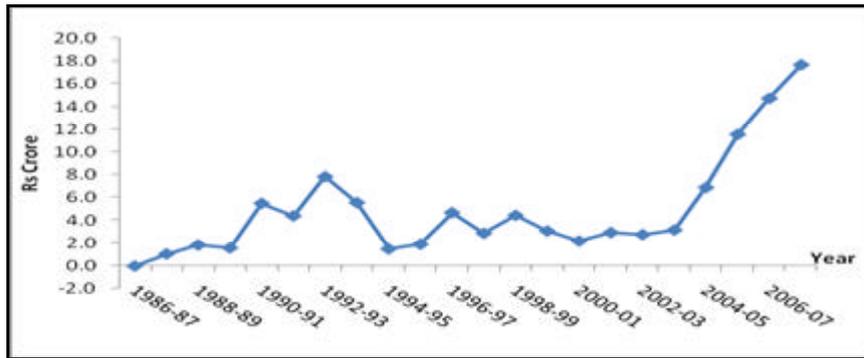


Source: Based on the data collected from the seven respective conventional SEZs Development Commissioner Offices

Note: Values are in Rs Crore and at constant prices (obtained after deflating from GDP 1999-2000)

In this context, a look at the net revenue earned by these zones provides interesting insights. Partial net revenue earning, as measured through R1 (as specified in Equation 1) has steadily increased over the years, particularly during the SEZs period (Figure 7). This could be attributed to steep increase in the exporting units in these seven conventional SEZs during the current period than under EPZs structure. This steady increase is a positive development; it shows that these zones have managed to earn enough revenue to pay, at least, for meeting the costs of administration.

Figure 7: Trends in Total Net Revenue Earned (R1) by Seven SEZs

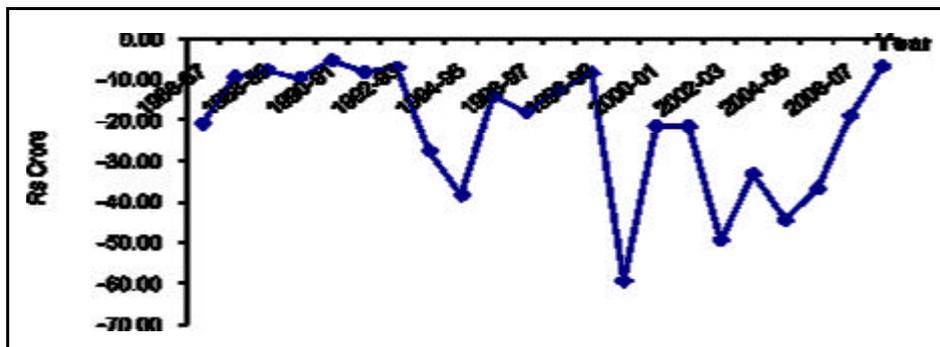


Source:Based on the data collected from Seven Conventional SEZs Development Commissioner Offices

Note: Values are in Rs Crore and at constant price of 1999-2000

However, looking at the phenomenon through R2 gives a negative picture, i.e., a continuous net revenue loss to the government (Figure 8). However, one may argue that revenue earning is not the main concern of the government with regard to its SEZ policy. Therefore, the inference that SEZs are a drain on government revenue and that hardly any benefits accrue from it stands challenged. For this purpose, we have taken into account benefits accrued in the form of NFE earnings and costs associated with such benefits in our study, since they are the prime objectives for the promotion of EPZs/SEZs in the country.

Figure 8: Trends in Total Net Revenue Earned (R2) by Seven SEZs



Source:Based on the data collected from Seven Conventional SEZs Development Commissioner Offices

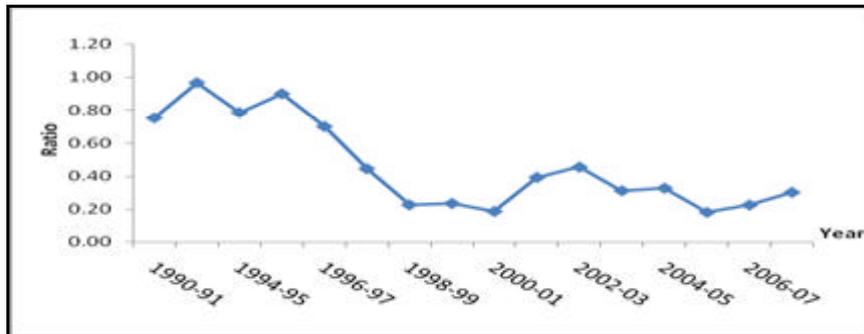
Note: Values are in Rs Crore and at constant prices (1999-2000)

To quantify the extent of revenue foregone to promote each rupee of net foreign exchange earned by these zones, we have computed partial and total resource cost as specified in Equations 3 and 4, respectively. The value of RC depends on two factors: one, the net foreign exchange earnings, and, two, the value of total costs including both revenue foregone and expenditure incurred by the government. If higher the total costs and lower the net foreign exchange earnings, then higher will be the corresponding RC. On the other hand, if the net foreign exchange earnings are much higher than

the total costs incurred by the government, then the RC value will be low. Lower the value, lower the RCs; on the other hand, higher values question the financial viability of SEZs.

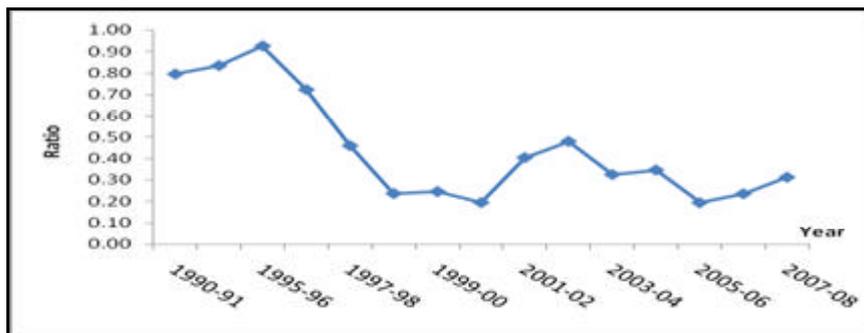
Partial resource cost as specified in Equation 3 considers only the revenue foregone as the associated resource cost in the promotion of SEZs. RC1, based on this, indicates that in order to promote each rupee of NFE, the government incurred a resource cost to the tune of Rs 0.30 in the year 2007-08 (Figure 9), which has shown over the years fluctuations. In fact, in the first two years of the 1990s (1991-92 and 1992-93), the associated resource cost was quite higher than per unit NFE earnings. Thereafter, it has shown a continuous declining trend. This high resource costs in the early of 1990s was due to slowdown in exports earnings due to the disintegration of the USSR, which was however not accompanied by an immediate and equal drop in imports payments. Thereby, it resulted in a low NFE but substantial revenue loss under the head of customs tax. Moreover, the substantial reduction in RC1 value over the period, among others, was due to the gradual reduction in import tariffs since early 1990s. However, a slight upward trend noticed in the initial few years of 2000s (current SEZs period) is due to the increase in the number of exporting units which necessitated an increase in demand for imports. More or less a similar trend is noticed with respect to RC2 (Figure10).

Figure 9: Trends in Partial Resource Cost (RC1) of Seven SEZs



Source:Based on the data collected from Seven Conventional SEZs Development Commissioner Offices

Figure 10: Trends in Partial Resource Cost (RC2) of Seven SEZs



Source:Based on the data collected from Seven Conventional SEZs Development Commissioner Offices

Most importantly, in the present exercise, we have considered only the revenue foregone by the government exchequer under the Customs and Central Excise duties. Within this, the results show that, in order to promote one rupee of NFE, the government incurred RCs to the tune of Rs 0.30 (in the case of RC1), and that only Rs 0.70 NFE was actually added to Government exchequer. On the other hand, in the case of RC2, in order to promote one rupee of NFE the government incurred resource costs to the tune of Rs 0.31, and only Rs 0.69 NFE was actually added to Government exchequer. However, the estimation as carried out in the study can be considered as an under-estimation. Perhaps, the corresponding ratio of revenue foregone to generate each rupee of NFE earnings, may fetch a higher value if one were to consider all other sources of revenue foregone to both the Central and State governments. For instance, as per the Union Budget 2010, the expected amount of revenue foregone for the year 2010-11 is Rs 3,204 crore as against Rs 2,324 crore for the year 2009-10. It therefore raises a question about the financial viability of SEZs in the country. Such questions, however, are beyond the scope of the present study due to limitations in data sets. However, we have attempted to provide a framework to answer the question of viability. Given the importance of ascertaining the costs involved in generating each rupee of exports and NFE through SEZs, from the point of view of the country's economic accounting, it is incumbent on the government to devise appropriate interventions to records such activities within the sphere of SEZs to quantify such costs.

Summary

Along with outlining their contribution to trade expansion, it is also important to explain the associated fiscal implications of the promotion of SEZs. This aspect is studied in this paper, within the framework of resource cost analysis, using the data collected from seven conventional SEZs and taking 1990-91 to 2007-08 as the reference period. The analysis provides the following preliminary pointers:

- The exercise reveals that the government has spent huge amounts in its role as facilitator. The figure reported under these two heads in the present analysis could be an underestimation of the real magnitude. Given the gaps in data, several other aspects of capital outlay of the initial years could not be captured. Apart from incurring substantial expenditure on the promotion of these zones, the government has foregone substantial revenue in the last 18 years through Customs and Central excise duty exemptions.
- In weighing the benefits against costs of its promotion, it is found that, in general, the seven conventional SEZs appeared to be capable of generating resources needed to meet their maintenance of administration expenditure. On the other hand, these zones were dependent on the Central Government outlay for incurring capital expenditure.
- With regard to resource cost in the promotion of per unit of NFE, we find that that it has been increasing substantially over the years. In order to promote one rupee of NFE, the government incurred resource costs to the tune of Rs 0.31 (in the case of RC-2, Total Resource Cost); thus, only Rs 0.69 NFE was actually added to Government exchequer.

As highlighted elsewhere in the paper, the estimation as carried out here can be considered as an under-estimation. Due to data constraints, the present study has considered the revenue foregone only under the heads of customs and central excise duty exemptions. Perhaps, the corresponding ratio of revenue foregone to generate each rupee of NFE earnings may fetch a higher value if one were to consider all other sources of revenue foregone to both central and state governments and, thereby, pose a broader question on the financial viability of these zones. Moreover, hardly anything is known about the fiscal implications of these zones at the disaggregate level and associated facts. This calls for further research in the area. It should be noted that the present study is the first attempt at understanding the issue of resource cost in the promotion of SEZs in the public domain. We encountered several problems because of non-availability of reliable data on SEZs activities in general and resource costs incurred for the promotion of SEZs in particular. This was due to the lack of commitment to put on record various statistical details pertaining to the establishment and operation of SEZs. Moreover, the respective Development Commissioner's Offices are further handicapped in collecting information on SEZ activities because they are not mandated to do so. To sum up, we wish to state that, along with restructuring the SEZ policy, there is also a need to pay attention to building databases on various activities carried out within the realm of SEZs. The scope of the study can be extended to understand the fiscal dimensions of SEZs at the disaggregate level.

END NOTES

- ⁱ This is mainly due to the resource crunch that government is facing at the implementation of most of the development projects at the one hand and also on the backdrop of the fear that SEZs are perhaps leading realignment of investment from DTA to SEZs than promoting fresh investment in the economy.
- ⁱⁱ See for detail Aggarwal (2007), Mukhopadhyay (2007), Rao (2007)
- ⁱⁱⁱ See for details: Ebrill *et al* (1999), Matlanyane and Chris (undated), Zafar (2005), Stiglitz and Charlton (2005), Soni *et.al.* (2007)
- ^{iv} This has been based on case study of five countries covered under Structural Adjustment Lending of the World Bank.
- ^v See Annexure table one and two
- ^{vi} In the case of all new upcoming SEZs, developers are either the Government, or private, foreign or joint ventures.
- ^{vii} If it is Government SEZs, such revenue through rents and advances on open plot and SDF will be part of Government exchequer or otherwise, will be part of private developer.
- ^{viii} Different factors as identified above shaping fiscal implications of SEZs are not tested in the present analysis. Because any such exercise require a cross country comparison and in-depth case study approach, which is not within the scope of the present study.
- ^{ix} See Tantri (2010) for relation between Import intensity of SEZs exports ad sectoral composition
- ^x See for details: Ebrill *et al* (1999), Matlanyane and Chris (undated), Zafar (2005), Stiglitz and Charlton (2005), Soni *et.al.* (2007)
- ^{xi} it includes, Kandla, Satacruz, Noida, Chennai, Cochin, Falta and Vizag SEZs
- ^{xii} This is to be noted that, the resource cost analysis is restricted only to 1990-91, whereas individual components of resource costs are explained for the period of 1986-87 to 2007-08
- ^{xiii} Up to 1999-2000, revenue-foregone figure includes both Central excise and custom duties; whereas since 2000-01 it includes only custom duty.
- ^{xiv} For instances, see Warr, 1988 and 1989
- ^{xv} Such estimation is beyond the scope of present analysis. However, we have provided a framework for analyzing the same. Moreover, it should be noted that, this is a very first attempt towards defining and estimation of resource cost in the context of SEZs. In the context of other countries, the issue of associated costs in the promotion of such zones is addressed within the framework of BCA. This, however, does not deal with the issue of fiscal implications of SEZs, rather considered opportunity cost of promoting such zones against proposed benefits. Moreover, as argued by Baissac (1996) and Johansson and Nilson (1997), dynamics of EPZs/SEZs, which are having multidimensional functions could not be measured within the framework of BCA. Because it takes into consideration only direct benefits and fails to capture the positive externalities associated with, and it draw conclusions on the viability and importance of EPZs/SEZs on the basis of net return value. In reality, however situation may be more complex (Johansson and Nilson 1997).

Alternatively, Domestic Resource Cost (DRC) technique is extensively applied in the literature to assess opportunity cost involved in the alternative trade measures. The concept of DRC technique indicates the opportunity cost involved in either generating or saving a unit of foreign exchange through export promotion or import substitution. This is widely adopted to evaluate alternative trade policy of the country namely, import substitution and export promotion. Thus, it is just another technique like Cost Benefit Analysis (CBA) for evaluating alternative policies of the Government. Our present interest is, however, not restricted to evaluating benefits of SEZs against their costs but also to explore associated fiscal implications of SEZs, which is not explored in the literature. Thus, we have not incorporated DRC technique; however, the present analysis is based on an understanding of this technique.

- xvi In order to identify resource costs involved in these zones, in the present exercise, we have not considered exports but considered only NFE. The objective of policy makers is not just exports promotion but ensuring high net foreign exchange earnings (NFE). In the case of higher imports value, corresponding increase in exports may not generate welfare impacts on the domestic economy. In such a case, exports earnings get equalized with imports payments. Further, based on the objectives of assessment, it can be modified accordingly and other proposed benefits can be employed in its analysis.
- xvii If, the scope of the study is extended to disaggregate level, i.e., across zones then corresponding analysis will be helpful in ranking of zones in terms of their relative efficiency.
- xviii This depends on the ownership pattern of SEZs. Since seven SEZs covered in the present analysis are centrally owned, thus government has to bare both revenue and capital expenditure.
- xix Due to data limitations, in the present study we have computed total revenue from rent and advance. It does not include revenue from sale of water, electricity etc.

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Annexure Table 1: Incentives Offered by the Central Government to the SEZs Developers and Unit holders

Incentives	Developers	SEZs Unit
Income Tax Holiday	100 per cent deduction from profit derived from developing SEZs for 10 consecutive assessment years out of the first 15 years in which the SEZs is notified by the Central Government	Income Tax holiday from the eligible profits and gains for 15 years as below a) 100 per cent for the first five years b) 50 per cent for the subsequent five years c) 50 per cent upon the creation of a specified reserve in the last five years
Other Direct tax benefits like DDT, Minimum Alternative Tax, Securities transaction tax	Exemption of DDT declared or paid after April 1, 2005 by the developer Exemption from the payment of Minimum Alternative Tax	Exemption from the payment of Minimum Alternative Tax
Central Sales tax	CST exemption on all sales and purchase of goods other than newspaper	The benefit is same as applicable to the Developer
Service Tax	Complete exemption from payment of service tax on all taxable services procured locally or from abroad.	The benefit is same as applicable to the Developer
R and D Cess	Exemption from payment of R and D Cess on import of technology	The benefit is same as applicable to the Developer
Custom Duty	Import and export of all the goods, inputs including capital goods are exempt from the payment of custom duty – general rate being 12.5% and from the applicable countervailing and/or additional custom duties.	The benefit is same as applicable to the Developer
Excise Duty	Exemption from the payment of Excise duty on procurement of manufactured capital goods and all other inputs	The benefit is same as applicable to the Developer
Other tax	In addition to this, the respective State Governments have provided exemption from the payment of majority of State level taxes	The benefit is same as applicable to the Developer
FDI	100 per cent FDI allowed for Township with residential, educational and recreational facilities on a case to case basis Franchise for basic telephone service in SEZs	100 per cent FDI allowed under automatic route in manufacturing sector with the exception of reserved industries No cap on foreign investment for SSI reserved items
Environment	-----	Exemption from public hearing under Environment Impact Assessment Notification
Drugs and Cosmetics	-----	Exemption from port restriction under Drugs and Cosmetics Rules
Sub-Contracting/Contract Farming	-----	SEZs units may sub-contract part of production or production process through units in the Domestic Tariff Area or through other EOU/SEZs Units SEZs Units may also sub-contract part of their production process abroad Agriculture/Horticulture processing SEZs units allowed to provide inputs and equipments to contract farmers in DTA to promote production of goods as per the requirement of importing countries

Source: Government of India 2005 and 2006

Annexure Table 2: SEZs Incentive Structure across Major Indian States

SL NO.	State	Incentives
1.	Uttar Pradesh	Exemptions is given for Mandi Shulka
2.	Maharashtra	Exemption from payment of stamp duty and Registration fees till the 31 st March, 2006 SEZs set up in C, D and D+ areas and No Industry Districts of the State have been exempted from payment of electricity duty for 15 years. However, units set up in other parts of the State have been exempted from payment of electricity duty for 10 years.
3.	Karnataka	Exemption from entry tax for SEZs units and developer: Reduction in tax on supply of petroleum products to SEZs Any sale of electricity to the zones should be exempted from payment of electricity tax
4.	Andhra Pradesh	Exemption from levy of tax on entertainment held within SEZs Exemption from the levy of the tax on luxuries provided within SEZs. 50 per cent exemption for payment of stamp duty and registration fee on transfer of land meant for industrial use in the SEZs. Complete exemption of stamp duty and registration fee for loan agreements, credit deeds, mortgages and hypothecation deeds executed by the SEZs units for assets in the SEZs in favor of banks or financial institutions will also be allowed The State exempts power in SEZs from Electricity Duty and Tax
5.	Tamil Nadu	All industrial units and their expansions to be located in the SEZs will be exempt from payment of Stamp Duty and Registration Charges toward land transactions
6.	Rajasthan	All industrial units and their expansions to be located in the SEZs will be exempt from payment of Stamp Duty and Registration Charges Exemption from work contract tax, entry tax, land building tax Exemption from payment of electricity duty to SEZs developers and units that generate, transmit, distribute power for a period of 10 years from the date of commencement of such services provided that the power so produce is consumed within the SEZs.
7.	Orissa	Exemption from work contract tax, entry tax, VAT, entertainment tax, luxury tax All transfer of SEZs land in favor of strategic Developer, Anchors Tenants Service Providers, SEZs Units would be exempt from payment of stamp duty and registration charges Power consumed (both purchased and self-generated) in development, operation and management of the SEZs by the SEZs developers would be exempted from payment of electricity duty/tax for a period of 20 years Power consumed (both purchased and self-generated) by the Units/ establishment within the SEZs would be exempted from payment of electricity duty/tax for a period of 20 years. However, there will be no exemption from payment of electricity duty/tax on sale of power outside the SEZs
8.	Kerala	Power generated within SEZs shall be exempted from payment of electricity duty for a period of 10 years from the date of commencement
9.	West Bengal	100 per cent electricity duty will be waived without any restriction in respect of all industries to be set up in Manikanchan SEZ and other SEZs
10.	Gujarat	Exemption from all State taxes including Sales Tax, VAT, Motor Spirit tax, luxury tax and entertainment tax , purchase tax and other State taxes. SEZs units shall be exempted from electricity duty for 10 years from the date of production or rendering of services Complete exemption on payment of Stamp Duty and Registration fees on transfer of land meant for industrial use in the SEZs area (this facility available to both developer and unit holder) Complete exemption on payment of Stamp Duty and Registration fees for loan agreement, credit deeds, mortgages etc., pertaining to SEZs units or which will be executed within the SEZs area

11.	Madhya Pradesh	<p>Exemption from all State tax including commercial tax, turnover tax, VAT, Octroi, Mandi tax, Purchase tax, electricity cess, stamp duty and any other such type tax of the State Government</p> <p>SEZs shall be exempted from electricity duty, cess and any other tax or levy on sale of electricity for self-generated and purchased power</p>
12.	Jharkhand	<p>Exemption from sales tax, VAT, luxury tax and entertainment tax and State duties on transaction within the SEZs. Sales tax and other taxes on inputs made to SEZ units from suppliers within the State</p> <p>50 per cent exemption will be allowed on Stamp Duty and Registration fee on transfer of lands meant for industrial use in the SEZs</p> <p>Complete exemption of stamp duty and registration fee for loan agreements, credit deeds, mortgages and hypothecation deeds executed by the SEZs units for assets in the SEZs in favor of banks or financial institutions</p>

Source: Author's Compilation based on various State-specific SEZs Act and Policy

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