Attracting FDI by reviewing policy on Special Economic Zones

The advent of COVID pandemic and the expected shift in global supply chain has reinvigorated debate on sound industrial policy to attract investment from companies that are looking to diversify their supply chain. Since the outbreak of the pandemic, India has taken several reform measures to attract foreign investment; some of these measures are relaxing farm laws, legislating the much awaited three labour codes, relaxing foreign direct investment norms in defence and announcing production linked incentive schemes to key manufacturing sectors, among others.

In its race to attract fair share of investment from foreign companies, India is facing stiff competition from South-East Asian countries such as Vietnam, the Philippines, Taiwan, Thailand, Malaysia and Indonesia.

Last year, the government reduced corporate tax for new manufacturing companies to 15% (excluding surcharge and cess), which is still competitive compared to Vietnam (20%), Indonesia (22%), Thailand (20%), Malaysia (24%), Philippines (30%) etc.

In order to promote domestic manufacturing, Government of India has been hiking import duty on several industrial and consumer goods in the last few years, which is perceived as the reversal of its 25 years of tariff reduction policy. According to noted economist Dr. Ajit Ranade, "average import tariff on industrial products in India has increased from 13% to 18% and this tariff level is applied to nearly one-third to one-half of all 10,000 odd product lines."

Despite the above measures, experts and sources from the industry point out to the challenges facing India in becoming a globally competitive manufacturing hub. Apart from the often-cited challenges of complex labour regulations and land acquisition norms, the industry points to high cost of raw materials faced by local manufacturers. Countries such as Vietnam are said to be sourcing raw materials at competitive rate under its free trade agreements with other countries. In this regard, Vietnam may reap benefit from major trade agreements such as ASEAN-China FTA, ASEAN-Australia-New Zealand FTA and Vietnam-Chile FTAs.

Another challenge pointed out by the local industry is the high borrowing cost in India. For instance, it is reported that lending rate in China is as low as 1.5% compared to 10-12% in India. Therefore, local industry wants access to capital at interest rates that is comparable to other competing nations.

Industry also calls for certainty in government policy, with regard to taxation. World's leading electronic manufacturer Nokia had to shut down its Chennai plant, its largest facility outside Europe in 2014. Although its declining market share in the mobile phone segment was the major reason for the shutdown of the plant, its tax dispute with the state government was also said to be another reason for the plant closure. Multinational companies need a predictable tax regime before committing investment in a jurisdiction.

In this context, experts are debating the effectiveness of special economic zones (SEZs) in attracting foreign direct investment and promoting inclusive economic growth. Media reports suggest that researchers from India's Jadavpur University will conduct a joint study on this subject with their counterparts in Kiel Institute of World Economy Germany, Copenhagen Business School, Denmark and University of Ghana. Experts from the National Institute of Socio Economic Information and Broadcast, Vietnam will also participate in this study.

India is said to have pioneered the special economic zone model by setting up Asia's first Export Processing Zone in Kandla in 1965. Today, there are more than 240 operational special economic zones (SEZs) besides seven Central Government SEZs and 12 State or Private Sector SEZs that were established prior to the enactment of the SEZ Act, 2005. SEZs account for around 21% of exports from India.

However, these SEZs have not transformed India into a globally competitive manufacturing destination. One of the reasons for this is that many of these SEZs are in the services sector, especially in IT & ITES sector. Services exports account for 57% of overall exports from SEZs in the country.

The size of the Indian SEZs is far less compared to similar zones in China. For instance, the total area of all the notified SEZs in India is 457 square km, which is not even a quarter of Shenzhen agglomeration (2,000 sq. km), a leading SEZ in China. Large size of SEZs offer economies of scale for manufacturing units.

Since 2008, the government has denotified 101 SEZs as many developers decided to quit these projects because of various commercial reasons. These developers opted to exit their projects because of poor market response, lack of demand for SEZ space and change in the fiscal incentive regime for SEZs, besides other reasons. Some experts blame that many applicants rushed to develop SEZs in India only based on tax benefits, without having support infrastructure. These SEZs failed to take off because of lack of physical infrastructure connectivity such as roads, railways and ports.

In this context, Government of India's recent policy to develop coastal SEZs under the 'Sagarmala' project with robust connectivity facilities with the hinterland is a welcome move.

Also, it is reassuring that Government of India is implementing the recommendations of the Baba Kalyani Committee to revamp policy on SEZs. The major recommendation of the Committee was to shift policy focus on SEZs from merely 'exports' to a broad set of indicators such as investment commitment, job creation, promoting women in job, value addition, technology differentiation, trade potential and priority industry.

As India braces to capture a significant share of shifting supply chain in the post-Covid world, it is time the central and state governments act on all the recommendations of this committee.

Notifications

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