

Special Economic Zones: Socio-economic Implications

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This report of a conference held at the Indian Institute of Advanced Study on special economic zones raises doubts about their desirability on different counts. It is centred around three themes: (1) SEZs and economic development; (2) SEZs and distributive implications; and (3) SEZs and the legal issues.

A large number of special economic zones (SEZs) have come into existence in the last two-three years. Many of them occupy hundreds of acres of land each and often the land is acquired by the government from unwilling farmers. The SEZs are extremely attractive to exporters, industrialists and entrepreneurs because of differential application of laws and favourable tax concessions. There is a possibility of an avalanche of SEZs to appear in the country in the future. Consequently, it is important to analyse the economic and social implications of such a large number of SEZs appearing on the scene. Among these, particularly important are the implications for food security, political stability of the country and the functioning of the democratic institutions. In this context, a conference which was held in the Indian Institute of Advanced Study, Shimla, with the collaboration of Indian Academy of Social Sciences, Allahabad on “Special Economic Zones: Economic and Social Perspective”, during 18-20 September 2008, conceptualised around three main themes: (1) SEZs and economic development; (2) SEZs and distributive implications; and (3) SEZs and the legal issues. The conference covered issues such as: land acquisition for SEZs under eminent domain power; principles for determining compensation for acquisition of land; rehabilitation policy; compatibility of the policy of land acquisition for SEZs with the core values of the Indian Constitution; impact of displacement on the way of life of the displaced people; the relative sizes of decrease of employment because of displacement of the people (and activities) on the one hand, and increase in employment because of establishment of SEZs on the other; the questions of governance posed by SEZs; and incompatibility of SEZs with democracy – both at the local and at a broader level. These were based on economic theory; results of empirical research including

case studies; and studies analysing the people’s responses, in particular, agitations on the land question with respect to SEZs. The wider issues relating to the desirability or otherwise of the modern or western kind of development for India were also discussed.

In the remaining part of this article, we take a look at the main issues that emerged regarding SEZs. Due to constraints of space, this article is not able to discuss all the articles presented at the conference.

Objectives of SEZs

The kinds of special provisions and concessions now given legal sanction through enactment of the Special Economic Zones Act, 2005 (Act 28 of 2005) were earlier justified for export promotion. The preamble to the SEZ Act, 2005 says that this is

[a]n Act to provide for the establishment, development and management of the Special Economic Zones for the promotion of exports and for matters connected therewith or incidental thereto

The objectives of the Act and hence its *promise and rationale* are captured in the Guidelines provided in Section 5 of the Act:

5. (i) The Central Government, while notifying any area as a Special Economic Zone or an additional area to be included in the Special Economic Zone and discharging its functions under this Act, shall be guided by the following, namely:

(a) generation of additional economic activity; (b) promotion of exports of goods and services; (c) promotion of investment from domestic and foreign sources; (d) creation of employment opportunities; (e) development of infrastructure facilities; and (e) maintenance of sovereignty and integrity of India, the security of the State and friendly relations with foreign States.

It is obvious that the SEZs are *being justified* not in terms of exports expansion alone, but as an engine of growth and employment generation. Emphasis is laid on infrastructure. Thus, Alok Sheel in his study on some debatable issues of SEZ asserts that a policy encouraging investment in infrastructure and modern manufacturing (crucial for economic development) needs to be supported, yet, he warns that, “use of tax incentives as a proxy for tweaking the policy environment is fraught with long-term hazards”.

I thank Satish Jain for helpful comments.

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Though the first export processing zone (EPZ) was established in India 40 years ago – these were slow to multiply – the hectic, almost feverish, expansion of SEZs has started taking place only after passing of the SEZ Act, 2005 and framing of the SEZ Rules, 2006. Sheel points out that 95% of investment, over 60% of employment and dramatic spurt in exports in SEZs have taken place only after February 2006.

Partha Mukhopadhyay shows that most of SEZs, post-2005, are tiny and are connected with information technology and information technology-enabled services (IT/ITES). They dominate in numbers, but occupy a small share in the area under SEZs, and yet, provide bulk of employment in SEZs. These SEZs are generally close to already existing urban centres – the greatest concentration of SEZs is along three to four select corridors near Delhi, Mumbai, Hyderabad, etc. Special economic zones have not helped spread industrial or service sector activities to the remote areas or rural hinterlands.

Sivaramakrishnan, reflecting on enclave approach inherent in SEZ policy says, “factories and office buildings can be gated with control access and exit but communities cannot be”. India created numerous new (industrial) towns which were beset with this problem, unresolved to date, yet SEZs go back to the same concept of a privately built and managed company township!

Manufacturing, Technology and Exports

Aradhana Aggarwal finds that the SEZs helped India in exporting certain new products. However, these could *not* induce technology-based dynamism. Though appreciative of possibilities opened up by SEZs, she finds that the “overall impact... can at best be termed ‘moderate’”. Since, the concurrent changes in terms of exports or technology or employment in the rest of economy were not part of the study, it is a moot point whether the *net* effect of SEZs on the economy as a whole would be even moderately positive.

In the light of early fascination with China’s “success” in this regard, it was shown that this kind of policy has led to a whole host of adverse and unintended consequences (Shrivastava) in terms of

increased inequalities across the income classes, worsening geographical imbalances and social security system, and adverse impact on agriculture. Given a very different political system, China was, however, able to isolate its SEZs from the rest of economy, and could even exercise control over the kind of economic activities it wished to encourage in the SEZs. As China is no more regarded as a role model, penetrating studies of SEZs in China and other economies will yield valuable insights.

Land and Natural Resources

The most widely discussed issue in the conference was that of land acquisition for SEZs – mostly from farmers. Studies from the field, where agitations have taken place/are going on and studies of so-called “model SEZ policy” in terms of amicable transfer of land were presented in the conference (papers by Patankar, Sunil, Panda and Asher). The setting up of SEZs has often been opposed by the farmers whose land is being acquired as also by the local people. It was claimed that the farmers are neither adequately compensated nor properly rehabilitated. It was argued that the nature of the SEZ model of industrialisation destroys more jobs than it creates. Similar past projects have been the sagas of *unfulfilled promises* of compensation, rehabilitation and jobs (Kumar). A number of the displaced persons have been reduced to street begging in cities, and at best, only a few have got low skill, low grade jobs, such as that of a chowkidar.

Patankar presented his study of struggle of people in Alibag (Raigad district, Maharashtra) over the last two years. He argues that the scale of planned power projects substantially exceeds the energy needs of the entire state of Maharashtra in the near future, and further that these projects will spell an ecological disaster. The paper proposes an alternative energy strategy, which does not involve the mega projects as hitherto planned for the Konkan region.

Asher, in her field study from Gujarat, narrated four case stories, and examined the so-called successful Gujarat model of SEZ. Problems related to acquisition of land for SEZs are found to be not very different

(some of the largest SEZs are in Gujarat, the state accounting for the largest land area under SEZs). The image of “peaceful” establishment of SEZs has been possible due to the *silence* of the political class across the board, including the opposition. Some of the adversely affected communities are nomadic tribes without formal ownership of land, though dependent on land resources for their livelihoods. They are not even aware of the uncertain future in store for them. In a startling case story, she reveals that a private company, as if exercising the power of *eminent domain*, actually issued a “land acquisition notice” to a panchayat.

The SEZ policy is seen as a part of a larger objective of grabbing control of natural resources. The issue of water resources was seen to be of particular importance. From which sources would huge water needs of many SEZs be met? It is feared that water will become more and more a marketed commodity, with diminishing control of ordinary people over it. Water being vital for human survival, water wars are likely to result. Land grab and water grab could seriously jeopardise food security. Some representatives of the people resisting the proposed land acquisition for SEZ in Una district in Himachal Pradesh came to the conference and presented the relevant facts and their case against the proposed SEZ.

Incentives and Macroeconomic Implications

A strange phenomenon is being witnessed in India in recent times. Instead of the firms competing with each other, as suggested in economic theory, the states are competing with each other in a sort of rush to the bottom by promising cheap land, tax incentives and other facilities to attract companies to set up SEZs. The prospects of revenue loss are alarming. It is going to severely constrain the state governments in their expenditure, especially on public programmes, and adversely affect the poor in particular (Kumar) – in the light of the Fiscal Responsibility and Budget Management (FRBM) Act. The incentives given to SEZs could adversely impact the rest of the economy, and the *net investment* is likely to remain low. Low employment intensity in the capital-intensive activities

in SEZs implies an adverse impact on the aggregate employment.

How have the states with or without SEZs fared? Rohit Prasad provides some preliminary answers. A statistical comparison of these two types of states on several economic parameters shows that “the main difference between SEZ states and non-SEZ states is the scale of operation of SEZ states”. The SEZ states show significantly higher total production, state domestic product (SDP), as well as higher levels of agricultural and industrial production. But these differences disappeared when it was analysed in per capita terms. The only variable which distinguishes them apart is the share of export income as a percentage of respective SDP. He also finds that there is no significant impact of SEZs either in boosting infrastructure, manufacturing and agriculture, or, in fostering balanced regional development or in giving a boost to low skill employment.

Theoretical Analysis

Theoretically, the problem of SEZs could be argued at two levels – one at purely logical level, and two, at the level of dominant

economic theory. It is shown that SEZ policy fails to pass the muster in either criterion (Naresh Kumar Sharma). Logically, we end up in a contradiction: the SEZs either boost economic activity or they do not. If they do not, there is no case for SEZs. And even if they do boost economic activity, still there is no case for SEZs – why a policy beneficial for an enclave would not do greater good when applied to the entire economy.

Economic theory does suggest that profitability at every level of production is improved, if costs are uniformly reduced. Assuming there are no drastic changes in demand, it can be shown that production would increase. However, this theoretical result applies to an SEZ taken by itself, i.e., under the assumption that nothing else changed in the world. However, at least two qualifications must be considered on theoretical grounds. One, there are distributional consequences. Even if there is an increase in the overall production, it does not imply that there is an increase in the production across the board. Everyone may not gain to the same extent, some may even lose. Two, the overall performance

can be judged by considering only the net effect on production, exports, income creation, etc, for the economy as a whole. With differential economic environments inside and outside the SEZs, productions inside the SEZs and in the rest of the economy both are affected. Net change in production for the whole of economy is difficult to predict a priori. Theory suggests that distortionary tax/incentive structures generally reduce overall output. There is yet another issue to be considered on theoretical grounds alone. With differential economic environment created in the same larger economy, there are obvious gains to be made from moving into the preferred zone, the SEZ. These gains, theory suggests, will be wiped out for producers through rent-seeking behaviour of the developers.

Law and Economics

The issue of acquisition of land by state for the purpose of establishing SEZs was the focus of study from a theoretical perspective of law and economics (Hazra, Jain, Mahanta and Pal). Pal discussed the principles of compensation in some detail

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and explained how the problem of holdout may arise. The problem of acquisition of land by state for SEZ was put to rigorous theoretical analysis by Jain. He derives the conditions for avoiding the misuse of power of eminent domain (ED) and also the conditions conducive for wealth creation. It is shown that the condition in both cases turns out to be identical: compensation must not be less than the subjective valuation of the land by the landholder. Note that if this condition is satisfied, the land can as well be acquired through market mechanism. Case for use of power of eminent domain arises when there is a holdout problem, which is unlikely to be the case with SEZs. Further, frequent use of this power is likely to be *social wealth reducing*. Thus, the use of power of eminent domain by the state must be subjected to “public purpose” as its justification. Public purpose becomes an ineffective criterion, if it is too broadly defined. *It is shown that private entity, regardless of its character, can never justifiably claim to be serving a public purpose.* Hence, there is no case for acquisition of land by the state for the purpose of SEZs at a compensation which is below subjective valuation of land by their owners.

ED power can be useful in the presence of “transaction costs” and for redistributive purpose. Evidently, since farmers have shown their unwillingness to give up their land at the compensation offered, the whole exercise entails a redistribution from a multitude of marginal farmers to the entrepreneurs developing SEZs (also Mahanta). The proponents of the SEZs are also great adherents of the market mechanism (for its alleged economic efficiency). They oppose any kind of subsidies *even to the poor*, instead, favouring direct payments. By the same token, it will be appropriate that the government, rather than subsidising them through cheaply acquired land, executes direct payments to SEZ developers. Besides serving the ends of achieving economic efficiency, *it will also be a transparent mechanism to show the SEZs for what they really are – a mechanism of redistribution from the less well-off (landowners) to the far more well-off (entrepreneurs – SEZ developers), at*

least in terms of the acquisition of land for SEZs.

That the SEZ developers can acquire land through market process and that it entails economically superior outcomes (since based on voluntary trade) was demonstrated in their respective papers by Hazra and Mahanta. The bargaining process will lead to an optimum (and market) outcome, in which the last seller might demand the whole of rent available in the SEZ (Mahanta). But how the rent between the last seller and the developer is divided is immaterial for creation of social wealth and is purely a redistributive problem between two private parties. Hazra, on the other hand, cites the bargaining process involved in acquisition of a company by another company by acquiring shares from highly dispersed and numerous investors. The same process can be used to resolve the holdout problem in land acquisition. He also draws attention to the distinction between criterion of “public good” and “public purpose” and how the latter can be open to abuse through a wide meaning being given to it.

Democracy and Constitution

Attention was drawn by several scholars to the undermining of democratic institutions in creation of SEZs under the SEZ Act 2005 (particularly, Jain, Kumar and Sivaramakrishnan). It was demonstrated how setting up of SEZs is contrary to the basic character of Indian Constitution. There is a provision for *not* having any democratically elected bodies of local governance in the SEZs. The question was raised: are the SEZs beyond the pale of Constitution? Sivaramakrishnan quotes from the Sixth Report of the Second Administrative Reforms Commission:

...no islands can exist within the country outside the jurisdiction of constitutionally elected governments. Therefore, a SEZ must be in conformity with the laws and rules relating to local governments. ... The Commission is of the view that local bodies should have full jurisdiction with regard to enforcement of local civic laws in the SEZs

And yet, there are illustrations of the local municipal bodies being kept out where the SEZs are concerned. For example, in spite of there being over 10 SEZs

in the vicinity of Greater Mumbai Metropolitan Planning area, ... no reference has been

made to the Mumbai Metropolitan Region Development Authority.

Jain pointed to contradictions between basic tenets of a democratic society and SEZs and further suggested that provisions of SEZ Act run counter to the *basic character* of Indian Constitution. First, it has been alluded earlier that the SEZs are basically instruments of redistribution of wealth from numerous poor – mostly marginal and small farmers to the private entrepreneurs. SEZs are, thus, putting thousands and in due course millions of livelihoods at peril. This act of depriving them of their means of livelihood violates the fundamental right to life and liberty granted to every citizen by the Constitution. Second, by enacting different sets of laws for SEZs and the rest of the country, it could be violative of the fundamental right of equality. Jain also puts related and disturbing question: what would such a dual system do to the political stability of India as a democratic society?

Concluding Remarks

The presentations at the conference and subsequent discussions raised serious doubts over desirability of SEZs from various aspects. Prima facie, SEZs can lead to some serious consequences. Struggles on the land issue are already surfacing in different parts of the country. These are also struggles for right to livelihood of one's choice based on one's values and *vidya* (knowledge). The local responses to these may vary from place to place – the process of acquisition of land and setting up of SEZs could, for example, be peaceful in some cases. But more often than not conflicts have emerged. There are theoretical grounds and empirical evidence to suggest that at the worst the SEZ policy can lead to serious and adverse consequences including social conflict, civil strife and breakdown of democratic institutions. It is also likely to lead to increased inequalities, and possibly shrinking of economic space for the ordinary people by making their production more unremunerative. Thus, the least we need is a thorough study of this phenomena and a vigorous debate. These tasks are becoming urgent as a large number of SEZs are being approved, notified and set up.