

Performance of Special Economic Zones (SEZs)

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Chapter I: Introduction

1.1 Background

A Special Economic Zone is a geographical region within a Nation-State in which a distinct legal frame work provides for more liberal economic policies and governance arrangements than prevail in the country at large. Depending on their geographical location, Free trade zones around the world are called by different names. In the United States, they are called as *foreign-trade zones* while those in developing countries producing specifically for export are typically called *export processing zones*. They are also called *special economic zones* in China and India, *industrial free zones* or *export free zones* in Ireland, *Qualifying Industrial Zones (QIZs)* in Jordan and Egypt, *free zones* in the United Arab Emirates, and *duty free export processing zones* in the Republic of Korea.

India's tryst with trade zones started with its first Export processing Zone (EPZ) launched in 1965 at Kandla, Gujarat. The geographical areas thus notified were declared to be outside the normal customs territory of India. The 'Special Economic Zones' (SEZ) policy announced in April 2000 was intended to make the SEZs as growth engines that can boost manufacturing, augment exports and generate employment. SEZ is a specifically delineated duty free enclave and is a deemed foreign territory for the purpose of trade operations, duties and tariffs. Accordingly, goods and services from domestic tariff area (DTA) to SEZ are to be treated as exports and goods coming from SEZ into DTA are to be treated as imports. SEZs functioned from 1 November 2000 to 9 February 2006 under the provisions of the 'Foreign Trade Policy' (FTP) and fiscal incentives were made effective through the provisions of the relevant direct and Indirect tax statutes.

Though DoC has an outcome budget for SEZs, however, no outcome analysis of the scheme was done by the Department.

1.2 Objectives of the policy

The SEZ Act, 2005, supported by the SEZ Rules, came into effect from 10 February 2006, providing for simplification of procedures and for single window clearance on matters relating to Central as well as State Governments. The main objectives of the SEZ Act/policy are (i) Generation of additional economic activity, (ii) Promotion of exports of goods and services, (iii) Promotion of investment from domestic and foreign sources, (iv) Creation of employment opportunities and (v) Development of infrastructure facilities.

It was anticipated that the new law would trigger a large flow of foreign direct investment as well as domestic investment in infrastructure and productive capacity leading to creation of new employment opportunities.

1.3 Fiscal incentives and facilities offered to SEZs

Under the provisions of SEZ Act, several tax incentives and other facilities are offered to the SEZ Developers and units. They are discussed below.

Direct Tax Benefits:

- I. 100 per cent income tax exemption for Entrepreneurs on export income of SEZ units under section 10AA of the Income Tax Act 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,
- II. Income Tax exemption for Developers on income derived from the business of development of the SEZ in a block of 10 years in 15 years under Section 80-IAB of the Income Tax Act.
- III. Exemption from Minimum Alternate Tax (MAT) under section 115JB of the Income Tax Act (withdrawn from 1st April 2012),
- IV. Exemption from Dividend Distribution Tax (DDT) under section 115-O of the Income Tax Act (withdrawn from 1st June 2011),

Indirect Tax Benefits:

- I. Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units,
- II. Exemption from Service Tax (Section 7, 26 and Second Schedule of the SEZ Act),
- III. Exemption from Central Sales Tax,

Other Benefits:

- I. External commercial borrowing by SEZ units upto US \$ 500 million in a year without any maturity restriction through recognized banking channels,
- II. Single window clearance for central and state level approvals, and
- III. Exemption from state VAT tax, stamp duty and other levies as extended by the respective State Governments.

1.4 Approval process and administration of SEZs

The developer¹ is required to submit the proposal for establishment of an SEZ to the concerned State Government. The State Government has to forward that proposal, with its recommendation, within 45 days from the date of receipt thereof, to the Board of Approval (Department of Commerce, Ministry of Commerce and Industry). The applicant also has the option to submit the proposal directly to the Board of Approval. A Single Window approval mechanism has been provided through a 19 member inter-ministerial Board of Approval (BoA), headed by the Secretary, Department of Commerce. The applications, duly recommended by the respective State Governments/UT Administrations, are considered by the BoA, periodically. All the decisions of this Board are arrived at with consensus. The Approval Committee at the Zone level deals with approval of units in the SEZs and other related issues. At the grass root level, each Zone is headed by a Development Commissioner, who is ex-officio chairperson of the Approval Committee. Various stages involved in approval process and functioning of SEZs is illustrated in Figure 1.

To regulate the usage of SEZ area by the developers, the Central Government has notified the list of operations which can be authorized by the SEZ Board of Approval. Moreover, the Board will assess the size requirement of infrastructural facilities like housing, commercial space, recreational amenities, etc., based on the employment generation potential of the SEZ, and allow development in a phased manner, depending upon the progress in allotment/occupancy of units in the processing area.

All the imports/exports operations of the SEZ units are on self-certification basis. The units in the zones are required to be Net foreign exchange (NFE) compliant, which is calculated cumulatively for a period of five years from the commencement of production. These units have to execute a Bond-cum-legal undertaking with regard to imported/procured duty free goods and achievement of positive NFE.

An SEZ unit could opt out (de-bonding) of the SEZ scheme with the approval of the UAC and on payment of the applicable customs/excise duties on the imported and indigenous capital goods, raw materials etc. and finished goods in stock. In case of Developers, De-notification is to be approved by BoA at MOC&I.

¹ Developer means a person who, or, a State Government which, has been granted by the Central Government a letter of Approval (section 2(g) of SEZ Act, 2005)

1.5 Life cycle of Special Economic Zones (SEZs)

Figure 1

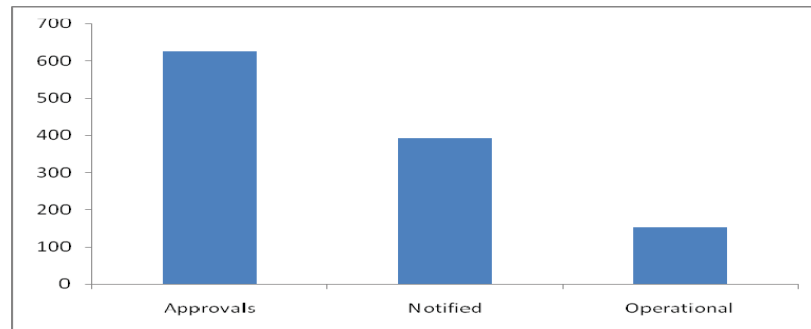
Stage	Key Activities
<p>Application</p> <p>↓</p> <p>Approval</p>	<ul style="list-style-type: none"> ➤ Developer submits proposal for setting up of SEZs either directly to BoA or through State Government ➤ BoA grants 'in-principle' or 'formal approval'
<p>Notification</p> <p>↓</p> <p>Operation of Unit</p>	<ul style="list-style-type: none"> ➤ Central Government issues Notification when developer proves the possession, contiguity and irrevocable rights on Land ➤ BoA allows the Developer for authorised operation and even with One Unit (approval given by UAC) the SEZ turns operational and LOP becomes valid for five years
<p>Monitoring and Control</p> <p>↓</p> <p>Closure of SEZ units/Developer</p>	<ul style="list-style-type: none"> ➤ Developer/Units are allowed various Tax Concessions/exemptions for effecting Exports ➤ Developers/units are required to submit HPRs/APRs in Form E and I respectively wherein details of the operations are reported to DC ➤ Monitoring of the performance of Developer/Unit is done by UAC and action is initiated under FTDR Act 1992 for the erring Developers/Units
	<ul style="list-style-type: none"> ➤ Exit and closure of SEZ Developer/ Units are approved by BoA on the basis of recommendation from Zonal DC that all the exemptions² availed by the Developer/Unit is deposited to Government Account

² In de-notification application (Form C6), the Development Commissioner has to certify that an amount equivalent to tax/duty exemption availed has been deposited to the Government Account.

1.6 SEZs in India-State wise Distribution

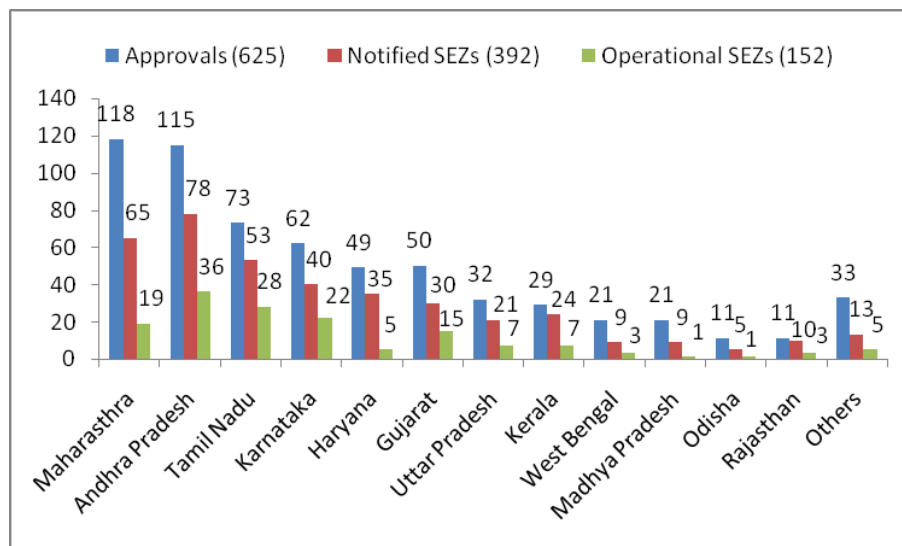
As per the data available on the website (www.sezindia.nic.in) of MOC&I, 625 SEZs were approved upto March 2014, out of these 392 units were notified and 152 were operational as depicted in Figure 2 below.

Figure 2: SEZs in India



State-wise distribution of the SEZs according to the stage of approval/operation is shown in Figure 3 below.

Figure 3: Distribution of SEZs in India



The number of operational SEZs in India is reported as 173 on the website of MOC&I. This includes 19 SEZs which existed prior to the enactment of the SEZ Act. Further, as per our verification, 2 SEZs in Andhra Pradesh (M/s APIIC Sarpavaram, Kakinada and M/s Maytas, Gopanpally) have been wrongly reported as operational units. Hence, pan India 152 SEZs have become operational subsequent to the enactment of the SEZ Act.

Andhra Pradesh has the highest number (36) of operational SEZs in the country followed by Tamil Nadu (28), Karnataka (22), Maharashtra (19) and

Gujarat (15). These states account for 78.95 per cent of the operational SEZs in the country. However, the percentage of Operational SEZs when compared with the total approvals in India works out to 24.32 per cent and it is only 38.77 per cent of the notified SEZs.

The state wise performance of operational SEZs and notified SEZs indicate that 5³ states account for over 79 per cent of all operational zones in the country.

DoC may like to examine that most of the SEZs are situated in the States which are industrialised and connected with sea ports. Other States (17 States) seemed to have lost out on SEZ based employment, income and investment.

1.7 Why we chose this topic

At a time when the Government faces hard choices in order to reduce the fiscal deficit and use available resources wisely, no expenditure or subsidy, indirect or direct cash transfer or tax revenues forgone, should escape careful examination of audit. It is imperative to ensure that the same set of controls that are applicable to expenditure are exercised in the case of tax expenditure too.

Several inadequacies on account of concessions given from Indirect Taxes angle were brought out in a Report of the Comptroller and Auditor General of India in 2008, myriad paragraphs on the concessions given to SEZs (Appendix 1). However, there has been no report to study all the aspects of the creation and functioning of SEZs. Thus, a review of the performance of SEZs, post enactment of the SEZ Act, was warranted in order to analyse the efficacy of the scheme under the new regime (SEZ Act) including private SEZs and to highlight the systemic and other issues, if any, so as to meet the intended objective of the scheme and harness maximum benefit by fostering exports, investments and employment.

1.8 Audit Objectives

While the primary aim of this audit was to assess the contributions of SEZs, and to evaluate the actual potential, economic and social costs and benefits of SEZs in the country, our work was guided by the following audit objectives set during our planning process.

³ Andhra Pradesh, Tamilnadu, Karnataka, Maharashtra and Gujarat.

To verify whether:

- a) There exists adequate statutory provisions/rules, regulations, instructions/ notifications with regard to approval, creation, functioning and monitoring of SEZs;
- b) SEZ/Units were approved and allowed to avail concessions under Central and State Taxation laws in accordance with the provisions;
- c) SEZ/Units were able to fulfil the intended socio-economic objectives spelt out in the SEZ Policy/SEZ Act/SEZ Rules/Letters seeking approvals; and
- d) Adequate and effective internal controls exist to safeguard the best interests of the Government.

1.9 Audit Scope and Methodology of Audit

Through a letter addressed to the Secretary/Commerce, Government of India, we had intimated the overall purpose of the stated audit with a request to extend necessary co-operation to our audit teams and produce the requisitioned records/information. Given the scope of the Performance Audit, an Entry Conference with Additional Secretary, MOC&I, Members, CBDT/CBEC was held on 22nd November 2013.

Considering that the subject selected cut across various functional wings of audit to review an array of issues, our field audit conducted between April 2013 and January 2014 involved review of the minutes of the BoA at MOC&I which is responsible for according in principle/formal approvals⁴ of the Developer's proposals. Followed by this, we had reviewed a representative sample of the notified, operational and exited SEZs in the States of Andhra Pradesh, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Odisha, Punjab, Rajasthan, Tamilnadu, Uttar Pradesh, West Bengal and union territory of Chandigarh for the period 2006-07 to 2012-13 at the offices of the jurisdictional Zonal Development Commissioners⁵ (to review the functioning and monitoring of the SEZs), concerned Commissionerates of Income Tax (for verifying the manner in which the assessee's returns were scrutinized) and the Commissionerates of Customs and Central Excise (to review the manner in which the indirect tax exemptions were allowed).

⁴ This classification is based upon the stage of approval of the SEZs. In the case of in-principle approval, the developer gets approval considering the plan of the SEZs projects. Formal approval, on the other hand, is the final approval for SEZs projects from the BoA.

⁵ Jurisdictional details of sampled states under Zonal DC's: DC KSEZ: Gujarat; DC VSEZ: Andhra Pradesh; DC FSEZ: West Bengal and Odisha ; DC CSEZ: Karnataka and Kerala; DC SEEPZ : Maharashtra; DC MEPSEZ: Tamilnadu; DC NSEZ: Punjab, Haryana, Rajasthan, Uttar Pradesh, Madhya Pradesh and Union territory of Chandigarh.

Further, information was also obtained from State Pollution Control Boards and Industrial Development Authorities to verify the process of Environment Impact Assessment (EIA) and award of other environmental clearances to the SEZ Developers/Units along with issues related to land allotments.

In order to analyze the quantum of IT exemptions availed by the SEZ assesseees, we had obtained data for both Companies and Individuals from DG IT (Systems), CBDT. Some assesseees being multi-locational were filing their returns in other states. With the help of our counterparts in other States, we could cross-verify the data and the deficiencies in assessment of those returns are also included in the Report.

Apart from this, all the Central and State Government SEZs and private SEZs (19 SEZs) which were operational before the enactment of SEZ Act 2005 were also selected. Further, information/records of various State Government departments/entities were also called for/examined for a 360 degree review of the process of approval and operations of SEZs.

In order to seek responses from various stakeholders of the system and in line with a request made by the MOC&I during the entry conference, we had administered a questionnaire on certain key areas of functioning of SEZs to the concerned DCs/Developers/Unit holders. The results are discussed in this report.

Information was also obtained through a questionnaire survey from Trade and Industry Association – PHD Chamber of Commerce and Industry - PHDCCI, Export Association - Federation of Indian Export Organisation-FIEO).

With a view to verify whether the Developers/Units had raised any loans through mortgaging government leased lands, we addressed various nationalized banks to furnish this information to which few responses were received.

The draft report was issued to DoR, DoC, CBEC and CBDT on 17 April 2014. Exit conference was held on 29 April 2014.

1.10 Audit Sample

Considering the volume of cases under different categories (in principle approval/formal approval/operational/non-operational) of SEZs, we had selected a representative sample of 187 Developers and 574 Units spread over 13 States (Andhra Pradesh, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Odisha, Punjab, Rajasthan, Tamilnadu, Uttar Pradesh and West Bengal) and union territory of Chandigarh which constitutes 31 per cent of total developers and 21 per cent of total units in the country for

assessing the entire spectrum of their functioning. Number of cases selected for the period of audit which ranges between nine percentage and 100 per cent for examining land related issues and the manner in which Indirect Tax exemptions were allowed. In case of Direct Taxes, not all the cases selected for Indirect Taxes evaluation could be selected since in many cases the IT returns did not come for scrutiny and as per the extant practice, Audit steps in only after a return was scrutinized by the Assessing Officer. Therefore, a different sample was chosen for DT cases, where scrutiny returns of 598 assessees were selected in audit.

List of files not produced to audit by MOC&I is enclosed (Appendix 2).

1.11 Audit Criteria

We bench marked our findings against the following sources of Audit criteria:

- I. Customs Act, 1962
- II. Export of Services rules, 2005
- III. Foreign Trade Policy (2004-09 and 2009-14) along with Handbook of Procedures with Appendices
- IV. Income Tax Act, 1961
- V. Instructions of the Ministry of Environment and Forests issued from time to time in safeguarding the environment and conditions attached in giving clearances
- VI. Indian Stamp Act, 1899
- VII. Land Acquisition Act, 1894 as amended from time to time
- VIII. RBI Master Circulars on EXIM policies
- IX. Recommendations of the Public Accounts Committee meeting dated 23rd August 2012
- X. Recommendation of Parliamentary Standing Committee on Commerce, 83rd Report on functioning of SEZs.
- XI. Recommendation of EGoM Meeting on SEZs
- XII. SEZ Act, 2005
- XIII. SEZ Rules, 2006
- XIV. Service Tax rules, 1994
- XV. Wealth Tax Act, 1957
- XVI. National database on growth, trade, infrastructure, employment and investment