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## **Special Economic Zones in India: New Challenges for Governance and Public Policy<sup>1</sup>**

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### **Executive Summary**

India's Special Economic Zones (SEZs) have been shrouded by controversies. The most contentious debates have been regarding the acquisition of land for these zones. SEZs have highlighted existing ambiguities in the laws on land acquisition as well as the process for determining compensations. In more recent months, financial viabilities of SEZs have been under the scanner with certain zone developers contemplating exits due to poor economic prospects. The SEZ policy is also inviting criticism for having a myopic vision on urban management and constitutional identities of the zones. The paper examines some of the challenges to public policy and governance produced by SEZs.

The latest SEZs were not the first occasions for which land was acquired by governments for industrialisation. Private land is being acquired for long in 'public purpose' as defined by the Land Acquisition Act (LAA) of 1894. But large-scale acquisitions for SEZs have raised questions on whether the government should intermediate in acquiring land for private developers and whether such acquisition is justified as 'public purpose'. The questions have extended to a critical query: Is the 'eminent domain' of the Indian state discriminating against small and medium landowners? The passion aroused by the debate has been intensified by demands for restoring the right to property as a 'fundamental' right – an issue currently being examined by the Supreme Court.

Extant laws suggest fixing compensation for acquired land on the basis of its market price. But India's opaque land markets prevent the discovery of 'correct' prices. Land prices recorded in sale (or purchase) deeds are usually under-quoted to avoid high stamp duties. Proposals for deciding market price on the basis of transactions for land of similar quality fail to address the problem squarely. Compensation also depends upon changes in land value arising from future use. Such changes are difficult to quantify and accommodate in compensation computations, given the restrictive provisions on conversion of land use.

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The economic downturn and poor export prospects have forced several SEZ developers to put their projects on hold or seek exits. SEZs involve substantive fixed costs in the forms of land acquisition and development of internal infrastructure. Given the high costs, many zones are becoming financially unviable. The situation is also becoming more complicated with developers facing difficulties in raising finance. Bank loans for developing SEZs attract interest at rates similar to those charged on commercial real estate, causing the cost of finance to be exceedingly high.

With developers seeking exit, two complex issues have come to the fore. The first is whether stalling partially-complete zones can create friction between the centre and states. The concern arises from the disagreement between the Union government and the government of Goa on scrapping SEZs in Goa. The second is the financial implication of scrapping SEZs. This involves the complicated task of computing all fiscal incentives availed by developers for their refund or compensating developers when closing zones is forced upon the latter, as in Goa.

A further complication arises from the urban management of SEZs that draws attention to their constitutional identities. Zone authorities are responsible for administering zones including the imposition of user charges for the maintenance of civic facilities. However, does this contradict the writs of municipalities (or *panchayats*) that are constitutionally-approved local authorities for the lands on which the zones figure?

## **Introduction**

The paper argues that governance challenges created by SEZs are the result of hasty implementation of an industrialisation strategy that overlooked land and other factor market imperfections. As a result, the state's role in land acquisition has become intensely controversial. Given the information asymmetries in India's land market, direct transactions between developers and farmers are unlikely to be efficient. But state mediation will inevitably be in 'public purpose'. The paper suggests that a valuation process involving licensed valuers can help in determining compensation. It also proposes the consideration of a transfer of developmental rights to original land holders as a possible measure for avoiding problems in computing changes in land value from future use. Finally, financial viabilities of SEZs cannot improve without better access to finance. The paper argues for a cogent exit policy for SEZs by underscoring that an easy entry but difficult exit will hardly attract investments in zones.

India was one of the earliest developing countries to have export-processing zones. The first Asian export zone and the third such in the world was established at Kandla in India's western state of Gujarat in 1965. Forty years later, India introduced the SEZ Act of 2005 in August 2005 followed by the promulgation of new SEZ rules in February 2006. Before the SEZ Act came into force, there were 15 such zones in the country. Since the passage of the Act and until December 2008, 274 additional SEZs have been notified.

The rapid growth of SEZs has been accompanied by debates on various aspects of these new zones. The most intensive debates have been on the process of land acquisition and the role of federal and state governments in this development. The debate has highlighted the existing ambiguities in the laws on land acquisition along with difficulties involved in awarding 'correct' compensations for acquired land.

While land has dominated the debate on SEZs, recent months have seen the focus extending to the financial viabilities of these zones. The onset of the economic downturn and poor export outlook has forced several developers to withhold plans and contemplate exit. This has unfolded new complications in the SEZ policy, including questions regarding their urban management and constitutional identity.

This paper examines some of the contentious aspects of the growth of SEZs that pose major challenges to India's public policy and governance. It is divided into three sections: Section 1 addresses concerns over land acquisition and examines attendant issues and implications along with the effectiveness of proposed legal amendments. Section 2 delves into the financial viability of SEZs accompanied by a review of the role of real estate developers, issues pertaining to exits and urban governance problems. Section 3 summarises the main concerns and attempts to provide some tentative policy directions.

### **I. Land for SEZs**

#### Land Acquisition

The issue of land acquisition has been central to the debate on SEZs. However, SEZs were not the first occasions on which land was acquired by India's central and state governments for building industries. India's public sector has been acquiring land for expanding capacity since independence. The expansion of both central and state public enterprises, as well as the

establishment of new townships (for example, Chandigarh, Durgapur and Bhubaneswar) involved large-scale acquisitions and relocation of existing habitations (Palit and Bhattacharjee, 2008).<sup>3</sup> The past acquisitions, as well as the present ones, have been done under the umbrage of ‘public purpose’ as provided in the LAA of 1894.

### What is ‘Public Purpose’?

The LAA of 1894 has been variously criticised for being an archaic legislation. This is, however, a relatively recent criticism surfacing in response to SEZs. It is not clear why the Act was not in the eye of the storm when India’s public sector was on an acquiring spree. One explanation could be that ‘public purpose’ – the ostensible ground on which acquisition by government agencies is sanctified by the LAA – was never disputed as long as the land remained with the public sector. The same ‘public purpose’ became contestable for privately-developed SEZs. As state governments began acquiring large chunks of contiguous land under ‘public purpose’ and made the same available to private developers, the debate generated a critical query: Can states acquire land in ‘public purpose’ for use of private developers?

India’s SEZ policy has two apparently irreconcilable aspects. It relies heavily on the active involvement of private developers for building zones. At the same time, it expects state governments to be ‘facilitators’ by acquiring land on behalf of developers. Implicit in such expectation is the realisation that land markets in India constrain efficient market-based transactions due to information asymmetry. State governments, therefore, are expected to mediate between landowners and developers.

Under Section 4(1) of the LAA, state (and central) governments can identify land for acquisition and issue notifications accordingly. Objections filed under Section 5(1) are heard by the district administration (that is, collector) and the final declaration is issued under section 6(1) of the LAA.<sup>4</sup> It is important to note that the only aspect of this acquisition process that can be challenged in a court of law is the amount of compensation provided to land owners. The seizure of the land by state in ‘public purpose’ cannot be legally questioned (Palit and Bhattacharjee 2008). Part II, Section 4(1) of the LAA clearly indicates:

#### 4. Publication of preliminary notification and power of officers thereupon.

*(1) Whenever it appears to the [appropriate government] the land in any locality [is needed or] is likely to be needed for any public purpose [or for a company], a notification to that effect shall be published in the Official Gazette and in two daily newspapers circulating in that locality of which at least one shall be in the regional language, and the Collector shall cause public notice of the substance of such notification to be given at convenient places in the said locality [(the last of the dates of such publication and the giving of such public notice, being hereinafter referred to as the date of the publication of the notification)]. [Emphasis added]*<sup>5</sup>

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<sup>3</sup> Palit, A., and Bhattacharjee, S. (2008), *Special Economic Zones in India: Myths and Realities*, Anthem South Asian Studies, Anthem Press (London, New York and Delhi).

<sup>4</sup> In case of urgency, section 5(A) can be dispensed under section 17(4) and the need for hearing does not arise.

<sup>5</sup> The Land Acquisition Act, 1894 at <http://business.gov.in/outerwin.htm?id=http://dolr.nic.in/hyperlink/acq.htm> [accessed on 2 May 2009].

The LAA defines ‘public purpose’ in an exhaustive manner.<sup>6</sup> An amendment introduced in 1984 (amendment 68 of 1984) expanded the original definition to accommodate the needs of private industrial projects. While central and state governments have been traditionally employing ‘public purpose’, the mediatory role of states in the context of SEZs has provoked the criticism that ‘public purpose’ is being misused for aiding private developers at the expense of landowners.

The Lower House of the Indian Parliament recently passed the Land Acquisition Amendment Bill of 2007.<sup>7</sup> The Bill further extends the scope of ‘public purpose’<sup>8</sup> to include the following acquisitions:

- a) Strategic purposes pertaining to requirements of air force, navy and military;
- b) Infrastructure projects<sup>9</sup> of appropriate government with benefits accruing to general public; and
- c) Any other purpose useful to the general public for which 70 percent of the land has already been purchased but the remaining 30 percent remains to be acquired.<sup>10</sup>

The inclusion of infrastructure projects is presumably for justifying SEZs. On the other hand, the limitation of government mediation to instances where 70 percent of the land has already been acquired is probably for blunting criticism regarding the government’s ‘overtly’ proactive role in the acquisition process. Such limitation, however, does not reduce the qualitative significance of state mediation. Indeed, contentious cases of land acquisition are mostly expected to be those where some small patches offer most resistance and prevent developers from acquiring large contiguous tracts. The Maha Mumbai SEZ of the Reliance

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<sup>6</sup> Part I, Section 3(f) of the Land Acquisition Act of 1894 defines ‘public purpose’ to include: i) the provision of village-sites, or the extension, planned development or improvement of existing village-sites; ii) the provision of land for town or rural planning; iii) the provision of land for planned development of land from public funds in pursuance of any scheme or policy of government and subsequent disposal thereof in whole or in part by lease, assignment or outright sale with the object of securing further development as planned; iv) the provision of land for a corporation owned or controlled by the state; v) the provision of land for residential purposes to the poor or landless or to persons residing in areas affected by natural calamities, or to persons displaced or affected by reason of the implementation of any scheme undertaken by government, any local authority or a corporation owned or controlled by the state; vi) the provision of land for carrying out any educational, housing, health or slum clearance scheme sponsored by Government or by any authority established by government for carrying out any such scheme, or with the prior approval of the appropriate Government, by a local authority, or a society registered under the Societies Registration Act, 1860 (21 of 1860), or under any corresponding law for the time being in force in a state, or a co-operative society within the meaning of any law relating to co-operative societies for the time being in force in any state; vii) the provision of land for any other scheme of development sponsored by government or with the prior approval of the appropriate government, by a local authority; viii) the provision of any premises or building for locating a public office, but does not include acquisition of land for companies. See The Land Acquisition Act, 1894 at <http://business.gov.in/outerwin.htm?id=http://dolr.nic.in/hyperlink/acq.htm> [accessed on 2 May 2009].

<sup>7</sup> The Bill is introduced in the Winter Session of the Parliament in 2007. It was passed by the 15<sup>th</sup> Lok Sabha in its last session in February 2009. The Bill needs to be passed by the Rajya Sabha and receive the ascent of the President before becoming a law. See <http://www.india-server.com/news/lok-sabha-passes-resettlement-and-6331.html> [accessed on 3 May 2009].

<sup>8</sup> Ibid.

<sup>9</sup> Projects relating to generation, transmission and supply of electricity, construction of roads, highways, bridges, airports, ports, rail systems or mining activities, water supply project, irrigation project, sanitation and sewerage system and any other public facility notified by the central government. See Amendment of Section 3 of original LAA of 1894 as mentioned in Section 5(vi) of the Land Acquisition Amendment Bill of 2007. At <http://164.100.24.209/news/whatsnew/Landacqbill.pdf> [accessed on 3 May 2009].

<sup>10</sup> See as in 4 above.

Industries and the Kalinganagar zone of the POSCO are typical examples. The state is still therefore expected to intervene, which leaves the scope of criticism regarding its role wide open.

Section 6 of the Bill proposes deletion of the words 'or for a company' from throughout the LAA. Thus Section 4(1) of the LAA cited earlier in this section will stand amended. The amendment again appears to have been driven by the objective of countering the view that governments (central or state) should not be perceived as discriminatory towards developers at the expense of landowners. However, all the amendments including this one appear to have overlooked the critical fact that intervention requests are likely to come from developers, not landowners, who will in all likelihood oppose such intervention. Thus criticisms regarding discrimination are unlikely to end.

### Fair Compensation

According to Section 23(1) of the LAA, compensation is to be determined on the basis of the market value of land as on the date of notification for acquisition and damages sustained (if any) by the owner on various accounts (such as damage to crops and trees or property or from shift in residential property induced by acquisition). On the other hand, Section 24 of the LAA outlines factors that will not influence compensation. These include degree of urgency leading to acquisition, disinclination on part of the owner<sup>11</sup> and increase in value arising from future (that is, post-acquisition) use of land as well as from improvements made on it.

The above provisions have interesting implications in deciding the amount of compensation. Market value is obviously the key to determining compensation. But how does one arrive at the true market value in India's opaque land markets?

The LAA bestows upon the executive (that is, the Collector or the District Commissioner) the responsibility of fixing compensation. The only official indicators of land prices are those recorded in sale (or purchase) deeds. But these are rarely accurate indicators of prevailing market prices. Stamp duty<sup>12</sup> rates in most Indian states are more than ten percent, making such rates in India far higher than those prevailing between one and two percent in developed country markets such as Europe and Singapore.<sup>13</sup> High stamp duties encourage under-quoting of prices in sale deeds. But barring these under-quoted prices, there is no other database of land or property prices available with district administrations. Determining correct market price therefore remains an almost impossible task.

The Land Acquisition Amendment Bill of 2007 has tried addressing these concerns. For determining the 'correct' market value of land, it has proposed the consideration of:<sup>14</sup>

- a) Minimum land value specified in Indian Stamp Act of 1899 for registration of sale deeds in the area of the concerned land;

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<sup>11</sup> This again shows that not only do landowners have little choice in parting with land; their reluctance does not influence compensation.

<sup>12</sup> Stamp duty needs to be paid on all documents entailing registration of property purchased. The duty rates vary between Indian states.

<sup>13</sup> See <http://www.indianground.com/legal.aspx> [accessed on 2 May 2009]

<sup>14</sup> See No 13, page 5 of The Land Acquisition Amendment Bill 2007 at <http://164.100.24.209/newls/whatsnew/Landacqbill.pdf> [accessed on 3 May 2009].

- b) Average sale price of similar land in the locality; this is to be assessed from at least 50 percent of the sale deeds registered in the last three years where higher prices have been paid; or
- c) Average sale prices ascertained from prices paid for at least 50 percent of land already purchased for the project where a higher price has been paid.

The higher value between (b) and (c) is to be chosen for awarding compensation.

Will these proposals help? Problems in choosing prices from sale deeds, as proposed in (a) above, has already been mentioned. Items (b) and (c) implicitly assume that other sale deeds executed in the locality for similar land have been more 'honest' in quoting prices; also that the district authorities have full record of all the land transactions in the area across a variable range of prices as well as for the current project. It is unrealistic to expect land records to be maintained in an orderly and updated manner in India's districts as much as to assume that such records containing accurate data are exhaustive.

### Land Use and Regulatory Constraints

A critical provision of Section 24 of the LAA is that compensation will not be influenced by '*...any increase to the value of the land acquired likely to accrue from the use to which it will be put when acquired*'. This draws attention to a vital aspect of the debate on acquisition and compensation.

Land derives value from its use. An ordinary tract of agricultural land derives value from its present use. However, following acquisition and in the light of the knowledge that the land will henceforth be a part of a modern industrial zone, the value of the land will multiply overnight. Section 24 prevents the enhanced value (from a different use) from figuring in the determination of compensation for erstwhile owners. This is identified as a distinct 'anti-farmer' bias in the extant process of acquisition and awarding of compensation (Swaminathan 2007).<sup>15</sup>

The inability of the LAA in considering the enhanced value from 'new' use has been attempted to be addressed by the Land Acquisition Amendment Bill. The latter specifies that while estimating market value of land and deciding compensation, the Collector shall consider the intended land use category of the acquired land and the value of the land in the intended category in the locality.<sup>16</sup>

Unfortunately, these provisions fail to address the central issue. Even if the Collector is aware of the intended purpose, it is practically impossible to determine *ex-ante* the value of the tract following improvements and new use. Checking the value of similar-use land in the vicinity will also not be of much help. The value of land belonging to a representative non-agricultural establishment in the locality will not be comparable to that in a modern SEZ possessing state-of-art facilities and bearing the stamp of a reputed developer.

The relationship between the use of land and the value derived from such use has also drawn attention to the extant restrictions on the conversion of agricultural land to non-agricultural

<sup>15</sup> Swaminathan, M. S. (2007), 'India's Tryst with Destiny in Agriculture', 8<sup>th</sup> Agricultural Science Congress, Tamil Nadu Agricultural University, 15 February.

<sup>16</sup> See No 13(3), page 6 of The Land Acquisition Amendment Bill 2007 at <http://164.100.24.209/news/whatsnew/Landacqbill.pdf> [accessed on 3 May 2009].

land. The value of farm land has increased sharply in states such as Haryana that have dispensed with the restriction. In states that have yet to do so, obtaining a non-agricultural use clearance is mandatory for conversion. Such clearances are difficult to obtain and involve high transaction costs. Thus when state governments acquire agricultural land on 'public purpose', developers, or the final users, acquire significant rents as state mediation eliminates the requirement of a conversion clearance. It is argued that these regulatory restrictions inflict an arbitrage loss of almost 140 percent for landowning farmers and depress the price of agricultural land from its true values (Morris and Pandey 2007).<sup>17</sup>

### Is the Eminent Domain becoming Overarching for the Indian State?

Successive constitutional amendments and changes in the LAA have expanded the 'eminent domain'<sup>18</sup> of the state in India. Articles 19 and 31 of the Indian Constitution mandated that the 'right to property' was a fundamental right. The right was subsequently downgraded into a 'constitutional' right by the 44<sup>th</sup> amendment to the Constitution introduced in 1978. Much before the introduction of this amendment, however, Indian law-makers had empowered state governments and the central government to enact laws for the acquisition of property under Schedule VII of the Constitution.

The controversy over land acquisition following SEZs has raised questions over whether the 'eminent domain' of the Indian state has enlarged in a manner that is discriminatory against landowners, particularly small and medium agriculturalists. This is reflected in demands arguing for the right to property to be converted into a fundamental right again. The Supreme Court is currently examining a Public Interest Litigation (PIL) challenging the 44<sup>th</sup> amendment.<sup>19</sup> The matter will take time to be heard and settled. However, notwithstanding the progress on the litigation, there is no denying that the Indian state is being increasingly perceived as an instrument for expropriation, rather than a fair arbiter (Mukhopadhyay 2009).<sup>20</sup>

The National Rehabilitation and Resettlement Policy (2007) admits negative externalities arising from the exercise of eminent domain. The Preamble to the Policy mentions:

*1.1 Provision of public facilities or infrastructure often requires the exercise of legal powers by the state under the principle of eminent domain for acquisition of private property, leading to involuntary displacement of people, depriving them of their land, livelihood and shelter; restricting their access to traditional resource base, and uprooting them from their socio-cultural environment. These have traumatic, psychological and socio-cultural consequences on the affected population which call for protecting their rights, in particular of the weaker sections of the society including members of the Scheduled Castes, Scheduled Tribes,*

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<sup>17</sup> Morris, S., and Pandey, A. (2007), 'Towards Reform of Land Acquisition Framework in India', *Economic and Political Weekly*, Vol. XLII (22), 2-8 June.

<sup>18</sup> Eminent domain refers to the power of the federal or state governments to acquire private property in public purpose notwithstanding the owner's objections. See <http://www.nolo.com/definition.cfm/Term/F0EE4223-3796-4B58-BB4BDED46C36F6B1/alpha/E/> [accessed on 2 May 2009].

<sup>19</sup> A Supreme Court Bench comprising Chief Justice Balakrishnan and Justice Sathasivam has sought response of the Union Law Ministry on a PIL challenging the constitutional validity of the 44<sup>th</sup> amendment of the Indian Constitution. See <http://timesofindia.indiatimes.com/India/Should-right-to-property-return/article-show/4202212.cms> [accessed on 2 May 2009].

<sup>20</sup> Mukhopadhyay, P. (2009), 'The Promised Land of SEZs' in *Special Economic Zones: Promise, Performance and Pending Issues*, Centre for Policy Research (CPR), Delhi, March.



*marginal farmers and women. Involuntary displacement of people may be caused by other factors also.*<sup>21</sup>

The above submission is a rare admission of the detrimental consequences of exercising the eminent domain in India. The SEZs have aptly highlighted the excesses. Future developments on SEZ policy and land acquisition in India cannot afford to overlook this critical aspect.

## **II. Financial Viability, Exit and the Urban Imbroglia**

### Real Estate Firms in SEZs

One of the controversial aspects of SEZs has been the heavy involvement of commercial real estate developers. This has resulted in the zones being perceived as speculative instruments in India's opaque urban property market.

There is no denying the substantive engagement of leading real estate firms in building SEZs. Prominent property developers such as Raheja, DLF, Ansal, Parsvnath and Unitech are creating SEZs in different parts of the country. On the other hand, some real estate firms (for example, Maytas Properties, Emaar MGF, Suzlon Infrastructure and Videocon Realty Infrastructure) are particularly active in specific states.<sup>22</sup> SEZs have attracted real estate developers as the latter perceive the zones as ideal opportunities for developing modern urban facilities with considerable concessions.<sup>23</sup> Zone areas are divided into 'processing' and 'non-processing' categories. Non-processing areas can house residential and commercial facilities including recreational options.<sup>24</sup> The diverse range of permitted facilities make SEZs ideal development options with strong commercial prospects in a country where the growth of urban facilities has lagged far behind that of its urban population.

The commercial prospects of SEZs probably clouded the assessments of the real estate industry on some critical downsides. The mounting public criticism regarding SEZs turning into speculative real estate entities forced government to reduce some key flexibility available to developers. These included a reduction of the non-processing area to a maximum of 50 percent of the total zone area from the earlier ceiling of 65 percent.<sup>25</sup> The cut has cramped

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<sup>21</sup> The National Rehabilitation and Resettlement Policy, 2007; Ministry of Rural Development, Department of Land Resources, Land Reforms Division; 31 October 2007, New Delhi.

<sup>22</sup> Maytas Properties are developing 3 zones in Andhra Pradesh, while Emaar MGF, Suzlon Infrastructure, Indiabulls Industrial Infrastructure Ltd and Videocon Realty and Infrastructure Ltd are developing several zones in Haryana, Karnataka, Maharashtra, and West Bengal respectively. See Palit and Bhattacharjee (2008).

<sup>23</sup> Developers are eligible for a slew of fiscal incentives including exemption from income tax, customs and excise duties.

<sup>24</sup> In the relatively smaller IT and IT-enabled services zones, authorized operations approved by the central government and the Development Commissioners of zones include recreational facilities such as clubhouse, indoor and outdoor games and gymnasium. Other permissible facilities include swimming pool, crèche, medical centres, shopping arcades, convention centres, housing apartments, cafeterias, food courts and playgrounds. The bigger sector-specific zones are also allowed to have schools and technical institutions, while the largest multi-product zones can have ports, airports, inland container depots and banks. These are operations notified by the Ministry of Commerce and Industry, Government of India on 27 October 2006 and published in the *Gazette of India, Extraordinary*, Part-ii, section-3, sub-section (ii) dated 27 October 2006. See <http://www.sezindia.nic.in/HTMLS/Not-27-10-06onauthorisedoperationsinSEZs.pdf> [accessed on 1 May 2009] for further details.

<sup>25</sup> Notification published in *Gazette of India, Extraordinary*, Part II, Section 3, Sub-section (i) by the Ministry of Commerce and Industry, Government of India on 12 October 2007. See [http://www.sezindia.nic.in/HTMLS/Third\\_Amendment-3rd\\_October\\_2007.pdf](http://www.sezindia.nic.in/HTMLS/Third_Amendment-3rd_October_2007.pdf) [accessed on 1 May 2009].

room for the creation of ‘non-core’ facilities, which are significant in increasing the attractiveness of zones to future residents. Further, it was also stipulated that vacant non-processing land could not be leased to any entity other than co-developers.<sup>26</sup>

The global downturn and the concomitant depressing outlook for the zones raise the question whether developers had overestimated their commercial prospects. Leading firms such as Parsvanath and DLF have either put projects on hold or are seeking exits.<sup>27</sup> There are several complications involved in exits which would be discussed later. These complications along with difficulties faced by developers in obtaining finance are creating serious doubts regarding financial viabilities of SEZs.

The significant involvement of real estate firms in India’s SEZs must also be viewed from a supply-side perspective. SEZs require contiguous land free of encumbrances. Such land is not easily available for industrial use. Several real estate firms, however, have land banks comprising idle contiguous land. They also possess capacities for developing the diverse array of facilities envisaged in zones. Thus, both in terms of endowment as well as capabilities, real estate enterprises enjoy clear competitive advantages over other firms in developing SEZs. Eliminating such a monopoly would be inconceivable until the land markets are unlocked, making the supply of land a determination of the market and the government invests in preliminary zone infrastructures.

#### Financial Viability and Resource Mobilisation

India’s new SEZ policy can be distinguished from the earlier version focusing on export-processing zones in selective locations by its emphasis on the private sector. The new policy envisages significant private investment for erecting zones. International evidence on successful zones underlines the importance of strategic location, size, managerial autonomy, efficient regulatory frameworks and the involvement of private developers as the key drivers of success (Palit and Bhattacharjee, 2008). In India, the almost explosive growth of SEZs following the introduction of the SEZ Act in August 2005 and announcement of SEZ rules in February 2006 resulted in an eruption of controversies on land acquisition. In the process, the debate on SEZs lost sight of the key issue of financial viability of these zones.

SEZs comprise two sets of fixed costs: acquisition of land and development of internal infrastructure. Several developers, no doubt, overestimated the ability of state governments to obtain land at low costs. Developers with reasonably big land banks were better placed to manage land costs. But even then they have to bear substantive costs of developing zone infrastructure, particularly in the bigger multi-product zones of more than 1,000 hectares. One cannot help noting the significant difference of the Indian SEZ policy vis-à-vis that in China, where the start-up infrastructure was developed by the government, and which acted as a ‘pull’ factor for private investment.

Building infrastructure and managing the costs of such developments in an economy prone to cost-push price pressures created by supply-demand mismatches, has made SEZs financially challenging ventures for several investors. The difficulties have been compounded by limited access to institutional finance. High domestic interest rates ranging between 12 to 14 percent

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<sup>26</sup> ‘List of Authorized Activities in Non-Processing Areas of SEZs to be Notified’; Annex II; Press Information Bureau (PIB), Government of India, 21 September 2006.

<sup>27</sup> <http://www.southasiablog.com/2009/04/should-or-should-not-indian-real-estate-companies-build-special-economic-zones-sez/> [accessed on 1 May 2009].

have constrained access to bank credit for many investors. In addition, the Reserve Bank of India's (RBI) directives making bank loans to SEZs equivalent to loans to commercial real estate has caused domestic bank credit to be practically inaccessible to most developers.<sup>28</sup> Risk weight on loans extended by commercial banks to SEZ developers is as high as that for commercial real estate (Palit and Bhattacharjee, 2008).

On the other hand, the SEZ policy discriminates between zone developers and units in SEZs in mobilising resources from overseas markets through external commercial borrowings (ECBs). While units can raise ECBs up to US\$500 million per year without any maturity restrictions, developers cannot raise ECBs, since such borrowings have end-use restrictions for commercial real estate development.

Restrictions on accessing finance have led many developers to explore joint ventures with foreign partners including ones with reasonably big land banks.<sup>29</sup> The SEZ policy allows 100 percent FDI under the automatic route for developing township facilities in zones as well as for franchise in basic telephone services. However, the global downturn is likely to adversely affect financial capacities of these collaborations as well. Problems have been compounded by sub-rule (9) of Rule 11 of SEZ Rules of 2006 that prohibits the selling of SEZ land. Many developers are now stuck with land without enough resources for developing facilities.

Will the granting of 'infrastructure' status to SEZs improve their financial viability?<sup>30</sup> It is likely to make bank loans available at cheaper rates. But given the sensitiveness of Indian banks to the accumulation of non-performing assets (NPAs), funds are unlikely to flow to SEZs until the banks are satisfied about their financial viability. Given the poor outlook for exports, including smaller information technology (IT) zones, banks are unlikely to perceive them favourably at least in the near term. Even if developers with considerably 'deep' pockets are barred, most SEZs will be forced to struggle even if they are granted 'infrastructure' status.

### How to Exit?

The SEZ Act of 2005 does not include an exit clause for zone developers presumably because the possibility of developers quitting these tax-free enclaves was never visualised. But with the export outlook worsening and access to finance remaining constrained, many zones are becoming unviable. Following the earlier de-notification of one of its IT SEZs in Delhi, DLF – one of the largest real estate developers involved in SEZs – has requested for permission to withdraw from four more of its IT zones in Bhubaneswar, Gandhinagar, Kolkata and Sonapat respectively.<sup>31</sup>

DLF's request for de-notification has drawn attention to two critical aspects. First, the poor outlook for IT has led to a sharp reduction in demand for commercial space in SEZs. Developers are finding it increasingly difficult to sell the spaces to prospective units. This is

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<sup>28</sup> 'Lending Curbs on SEZs to be removed'; See <http://www.indianrealtynews.com/sezs-india/lending-curbs-on-sezs-to-be-removed.html> [accessed on April 29, 2009]

<sup>29</sup> Some prominent joint ventures include: Unitech and Salim Group of Indonesia, Rockman Projects Ltd with Tishman Speyer of US and Emaar Properties of UAE with MGF India.

<sup>30</sup> 'Grant Infrastructure Status to SEZs; Govt. asks RBI'; See <http://www.rediff.com/money/2008/dec/02sez-grant-infrastructure-status-to-sezs--govt-asks-rbi.htm> [accessed on 29 April 2009].

<sup>31</sup> The first DLF IT SEZ to be de-notified was in Delhi. See <http://www.financialexpress.com/news/dlf-to-surrender-4-it-ites-sezs/448111/> [accessed on 26 April 2009].

adversely affecting returns on investments. Most developers are finding their zones unsustainable. Despite higher interest rates and risk weights, several developers might have taken bank loans, assuming the SEZs to yield high returns. Such assumptions are proving to be incorrect. It may not be surprising if some bank loans extended to SEZs degenerate into NPAs.

The de-notification requests also highlight complexities involved in the 'exit' of SEZs. In December 2007, the state government of Goa yielded to public protests and recommended the de-notification of three SEZs.<sup>32</sup> The centre, however, refused de-notification on the ground that there was no such provision in the SEZ Act of 2005. It also indicated that SEZs under the SEZ Act are legal entities and cannot be recommended for de-notification by state governments.

As mentioned earlier, the SEZ Act of 2005 is indeed silent on its exit. However, the Goa SEZs were arguably denied de-notification on two other grounds. First, it must be noted that the developers did not request for the scrapping of these zones. The latter are in an advanced state with land having been acquired and several units becoming operational.<sup>33</sup> The centre would have realised that *suo moto* de-notification of zones at such junctures will imply an award of substantive compensation for the developers. Second, protests against SEZs in Goa were qualitatively different from those witnessed in Haryana, Maharashtra, Orissa and West Bengal over land acquisition. The Goa protests arose from popular concerns over adverse impact of the upcoming zones on tourism and environment. Withdrawing SEZs on these grounds would have reflected the latter and the policy-making authorities in poor light, given that the former have been espoused as triggers for India's long-awaited export-oriented industrialisation.

Eventually, however, the centre and the Goa government have begun discussions on scrapping the zones. Compensating developers is a key issue with the former having opted for legal recourse.<sup>34</sup> Nonetheless, the centre's refusal to accede to the state government's demand in the first place reveals its sympathies for the developer as opposed to public concerns. Such apparent disregard of public sentiment is somewhat surprising (Kannan 2009).<sup>35</sup> Indeed, this implies that if more states convey decisions for de-notification arising from public discontent against zones, then they are unlikely to be accepted due to the lack of an exit clause. Given that the impasse arose in Goa – a Congress-ruled state with a Congress-led United Progressive Alliance (UPA) government at the centre – the possibility of de-notification of SEZs emerging as a source of potential friction between state governments and the centre in future cannot be ruled out.

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<sup>32</sup> The zones are being developed by Meditab Specialities Private Limited, Peninsula Pharma Research Centre Private Ltd and K Raheja Corporation Private Limited respectively. See 'Go-Ahead Signal for New SEZs' at <http://www.realestatetv.in/ResearchDesk/Print.aspx?articleid=590> [accessed on 26 April 2009].

<sup>33</sup> See 'DLF SEZs won't be cancelled till realtor refunds duty sops' at <http://economictimes.indiatimes.com/Real-Estate/DLF-SEZs-wont-be-cancelled-till-realtor-refunds-duty-sops/articleshow/4422369.cms> [accessed on 26 April 2009].

<sup>34</sup> Meditab Specialities Private Ltd has filed a petition on the decision of the Goa government. The matter is currently pending with the Panaji Bench of the Bombay High Court. See 'HC orders Goa, Centre to take decision within six weeks' at <http://www.indopia.in/India-usa-uk-news/latest-news/101021/National/1/20/1> [accessed on 26 April 2009].

<sup>35</sup> Kannan, K. (2009), 'SEZs : Engine Derailed'; See <http://www.indiatogether.org/2009/jan/eco-sezbust.htm> [accessed on 26 April 2009].

This is, however, not to exclude the possibility of state governments themselves being reluctant to recommend de-notifications without the consent of developers. The Goa episode has drawn attention to the contentious issue of compensating developers in the event of de-notifying functional zones. On the other hand, developers will also need to carefully assess the financial implications of de-notification if they moot the same. A notified SEZ is empowered to enjoy all fiscal incentives mentioned in the SEZ Act of 2005. A notified SEZ will be de-notified only after the developer refunds all fiscal benefits availed.<sup>36</sup> This will be another additional burden for cash-strapped developers such as DLF. Matters will be more complex in instances where zones have operating units. De-notification and closure in such cases might entail the developer compensating the units as well.

The growing number of requests for de-notifications necessitates the framing of an enabling 'exit policy' for developers. The SEZ Act of 2005 does provide for central government intervention in circumstances where the developer is detected to be in financial difficulties constraining the fulfilment of his commitments.<sup>37</sup> A future exit policy can be shaped on these provisions. The apparent short-sightedness of not precluding the possibility of notified SEZs actually withdrawing due to unavoidable circumstances can grow into a serious policy challenge as more SEZs experience the liquidity crunch and contemplate exit.

#### Are SEZs Extra-constitutional Entities?

While financial viabilities of SEZs are expected to worsen, their rapid growth, accompanied by increasing urbanisation, has given birth to new urban governance issues. The zones envisage the housing of considerable resident populations, particularly in the larger multi-product enclaves. Given the variety and scale of operations permitted, the zones are expected to shape up as independent cities/towns. But the SEZ policy appears to have overlooked the critical aspect of urban planning for these zones. This can have serious implications in the efficient management of urban outgrowth of the zones (Mukhopadhyay 2009).

Discussions on the urban management of zones have raised fundamental questions on the constitutional identity of SEZs. The context to this issue needs to be set carefully. The development of adequate internal civic facilities is essential for meeting the demands of resident populations. Developers are expected to erect zone infrastructures. The administrative management of zones, however, is left to SEZ authorities. Chapter VII, Section 31 of the SEZ Act allows for establishment of these Authorities. Section 34(1) specifies:

*Subject to the provisions of this Act, it shall be the duty of each Authority to undertake such measures as it thinks fit for the development, operation and management of Special Economic Zones for which it is constituted.* Section 34(2) further indicates these *measures* as the

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<sup>36</sup> The benefits include exemptions from customs duty as well as local duties on purchases made from the domestic tariff area, state duties like stamp duty and value-added tax.

<sup>37</sup> Section 10 (1)(d) of the SEZ Act of 2005 mentions : 'If at any time the Board is of the opinion that a developer...whose financial position is such that he is unable to fully and efficiently discharge the duties and obligations imposed on him by the letter of approval...' then the Board of Approval (BoA) might suspend the letter of approval issued to the developer. The letter of approval gives developers three years for obtaining legal rights over land. Following furnishing of such evidence, SEZs are notified by the central government and Development Commissioners are appointed. See Palit and Bhattacharjee (2008).

development of infrastructure, promoting exports, review function of zones and levy user charges. [Emphasis added]<sup>38</sup>

Read together, the provisions appear to suggest that the developer's efforts in building infrastructure will be regulated by the Authority. The latter will also collect user charges and receive grants or loans (if any) from the central government. Indeed, this implies that the Authority can impose user charges different from those prevailing. Does this amount to a violation of the writs of local municipalities who are constitutionally approved local authorities for the land on which the zone stands?<sup>39</sup>

From the perspectives of rural *panchayats* and urban municipalities as well, SEZs are administrative dilemmas. Consider two examples: Municipalities in Maharashtra, Karnataka and Andhra Pradesh can levy water and sewerage charges. Will these be applicable in zones coming up in their administrative domains? Probably not, since zone authorities can frame independent charges. Does that mean that zones are distinct administrative entities where local self-government rules do not apply? It appears that knowingly or unknowingly, the SEZ policy has created a third set of local self-government entities in the country, with constitutional status not well-defined.

The municipalities also perform the important function of licensing certain activities/trades. Will their licenses for professionals such as architects and plumbers, as well as for activities such as the selling of fish and poultry be accepted in zones? If yes, then there is no reason why the rest of the municipal authority cannot extend to zones.

The SEZ policy has not looked into the critical aspect of defining the administrative relationships between the zones and local self-governments. The implicit sense regarding the administrative stature of the SEZs appears to have been guided by a particular provision of the Indian Constitution. A proviso to Article 243Q of the Constitution imparts special dispensation to industrial townships such as Bhilai and Jamshedpur. Several state governments have utilised the provision to pass notifications for excluding SEZs from the purview of local self-governments (Sivaramakrishnan 2009).<sup>40</sup> Such actions, however, have raised a host of issues having significant implications for India's federal structure and urban governance. These include the criteria that determine carving out a part of municipalities as zones, extension (or denial) of rights available to residents of municipalities to those in zones and whether the 'industrial township' proviso is inconsistent with the main spirit of the Constitution.<sup>41</sup>

### III. Conclusion

Four years after the passage of the SEZ Act of 2005, SEZs are posing major governance challenges. The challenges have arisen primarily due to the hasty implementation of an

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<sup>38</sup> The Special Economic Zones Act 2005; See <http://www.sezindia.nic.in/HTMLS/SEZ%20Act,%202005.pdf> [accessed on 4 May 2009].

<sup>39</sup> Following the 73<sup>rd</sup> and 74<sup>th</sup> Amendment of the Indian Constitution, *panchayats* or municipalities are local self-governments for villages and sub-urban and urban areas respectively.

<sup>40</sup> Sivaramakrishnan, K.C. (2009), 'Special Economic Zones: Issues of Urban Growth and Management' in *Special Economic Zones: Promise, Performance and Pending Issues*, Centre for Policy Research (CPR), Delhi, March. In Andhra Pradesh, Haryana, Karnataka, Kerala, Maharashtra, Madhya Pradesh, Orissa, Punjab, Rajasthan and West Bengal, state governments can declare SEZs as industrial townships and free them from decrees of local self-governments. For further details see Sivaramakrishnan (2009).

<sup>41</sup> As in 38 above.

industrialisation strategy that paid scant attention to the imperfections in factor markets, particularly land markets. The problems being faced with the new SEZs underline the uneven pace of reforms between India's product and factor markets. Reforms in the former have outpaced the latter. But a lack of depth in factor market reforms is now acting as critical constraints to India's latest efforts at export-oriented industrialisation.

The Land Acquisition Amendment Bill of 2007 has tried addressing some of the concerns pertaining to land acquisition, albeit in a piecemeal manner. The future of the Bill itself, however, is uncertain. Although the UPA government in its second tenure has displayed a willingness to urgently implement the Bill, pressures from coalition partners might prevent progress on the same. The Trinamool Congress – a key ally of the current coalition – is unhappy with the proposal to limit government intermediation to a maximum of 30 percent of total land to be acquired. It feels that direct acquisition of land by developers from farmers will result in a greater use of coercive forces by the former in a form injurious to the interests of the latter.<sup>42</sup>

The debate on the state's mediating role in land acquisition is unlikely to die in a hurry. Doing away with state mediation implies direct interface between developers and landowners. Such interface is welcome on efficiency grounds. However, given the information asymmetry in India's land markets, a facilitating role by the state becomes almost unavoidable. It is important to assess state mediation in light of these asymmetries. And if state mediation is allowed for, the use of 'public purpose' cannot be avoided, even if intervention is limited to instances where 70 percent of land has already been acquired.

The award of 'just' compensation for acquired land remains a vexing issue. Determining 'correct' market value of land in a system lacking maintenance of land titles is a serious problem. At the same time, perverse incentive structures encourage the suppression of actual value. An independent valuation process involving licensed valuers can help avoid litigations arising from disputes pertaining to the awarding of compensation. But the controversy over determining compensation will continue until a method for imputing the enhanced value of land following its post-acquisition use is arrived at. The LAA Amendment Bill has hardly addressed this aspect.

Other options for 'compensation' are essential to examine until an acceptable price-discovery mechanism for land is found. The transfer of developmental rights (TDR) to original land holders for a part of the acquired land could be an option. Indeed, it is even possible to visualise a market for coupons embodying TDRs (Morris and Pandey 2007). Furthermore, as some developers have already proposed, and in line with the thought outlined in the National Resettlement and Rehabilitation Policy, making landowners stakeholders in zone growth by issuing them equity shares can also be examined.

The financial viabilities of SEZs cannot improve unless their access to finance increases. Such access is constrained on account of fundamental differences in the perceptions of SEZs between different agencies. While the Ministry of Commerce views SEZs as vehicles of growth and change, the RBI considers them as entities abetting speculation in real estate. The latter view has prevented banks from granting concessional finance to SEZs. It is therefore important for agencies to arrive at an agreed perception of zones.

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<sup>42</sup> 'Mamta Banerjee opposes Land Acquisition Bill' Business Standard, 24 July 2009; <http://www.business-standard.com/india/news/mamata-banerjee-opposes-land-acquisition-bill/68753/on> [Accessed on August 2, 2009].

The issue of 'exit' also assumes importance in this regard. India's organised enterprise sector is famous (or infamous) for denying easy exit to enterprises. If SEZs are denied exit on grounds of their being 'legal' entities, they will hardly inspire confidence among potential developers. Up and running zones must be allowed to exit following the fulfilment of refund obligations. The same should also apply to upcoming zones. The attractiveness of industrial policies is determined by the ease of both entry and exit. Easy entry and difficult exit will hardly help the SEZ policy.

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