Indian SEZs- A Disruptive force in Strategy Formulation

All firms, across sectors, need to assess impact of SEZs on its strategic options says Arindam Chakrabarti of TSMG

In 2005, China attracted FDI of around USD 27 billion in manufacturing alone. In contrast, most of India's FDI of USD 5.3 billion was in services. During that year, Indian exports of manufactured products totaled 10% of that of China. This is in spite of India having lower labor cost in manufacturing. So, what holds back Indian manufacturing?

Collective wisdom identifies infrastructural deficiencies for India's relative lackluster performance. The Global Competitiveness Report 2005 reflects the same by ranking India below China in select metrics (**Figure-1**).

Figure-1: Gaps in Infrastructure Quality

Parameters Analyzed	China's Rank	India's Rank
Port Infrastructure Quality	62	76
Quality of Electricity Supply	80	94

Source: World Economic Forum – Global Competitiveness Report 2005

Besides poor infrastructure quality, relatively higher cost of doing business (**Figure-2**) added to India's problems in achieving global competitiveness.

Figure-2: Cost of doing Business

Business Environment Factors	Duration	China	India
Start a business	Days	48	71
Register property	Days	32	67
Enforce contracts	Days	241	425
Close a business	Years	2.4	10
Degree of difficulty in retrenching workers[1]		40	90

Source: World Bank Report – Doing Business 2005
Note: 1. higher score indicates greater difficulty

The SEZ Act aims to make Indian firms competitive by reducing operating costs and by bridging the infrastructure gap with China.

SEZ Act 2005: Some policy level concerns

The enactment has witnessed a flurry of proposals from firms wishing to set up SEZs. The Board of Approval (BOA) has already accorded provisional approval to over 150 new proposals. Closer analysis of the initial 150 proposals highlights some concern areas.

- Around 58% of the proposals are for setting up of IT/ITES SEZs, which can be viewed as pure fiscal plays. IT/ITES exporters will exploit direct tax exemptions by locating in SEZs (**Figure-3**).

Figure 3: Profile of first 150 formally approved SEZs after passing of the SEZ Act

Sector	Number of SEZs	Total Land Requirement (ha)	Average Land Requirement (ha)
IT & ITES	87	2,816	32
Pharma & Biotech	13	1,229	95
Multiproduct & Services	**13**	**18,068**	**1,390**
Textiles & Apparel	10	1,850	185
Electronics	8	915	114
Engineering	4	605	151
Auto & Auto Components	3	346	115
Leather & Footwear	3	205	68
Gems & Jewelry	2	181	91
Agro & Food Processing	2	212	106
Non-conventional energy	1	12	12
Chemical	1	160	160
Petrochemical	1	440	440
Paper	1	121	121
Glass	1	171	171
Summary	**150**	**27331**	**182**

Note: 1 ha= 1 hectare = 10,000 sq m = 0.01 sq. km

- Small sized SEZs are unlikely to result in any major investment in supporting infrastructure. Except for multiproduct SEZs, the average acreage planned is small (**Figure-4**)

Figure 4: Profile of multiproduct SEZs among the first 150 formally approved SEZs

State	Developer	Land Requirement (ha)
Andhra Pradesh	Kakinada SEZ Pvt. Ltd.	4,134
Andhra Pradesh	APIIC, Vishakhapatnam	2,309
Gujarat	GIDC, Dahej	1,768
Gujarat	Mundra SEZ	1,082
Gujarat	Adani Ports, Mundra	2,659
Gujarat	Essar SEZ, Hazira	1,100
Gujarat	Essar, Jamnagar	2,470
Haryana	Uppal Housing, Gurgaon[1]	110
Kerala	Cochin Port Trust	400

Maharashtra	Claridges Hotels, Raigad[1]	242
Maharashtra	MIDC, Amravati	1010
Pondicherry	Pondicherry SEZ Co.	346
Uttaranchal	SIDC, Udhamsingh Nagar	440

Note: 1. These are Multiservices SEZ

- With little government subsidy in land acquisition and rehabilitation, private developers setting up SEZs will have bear high start-up costs.
- Most developers lack the appetite for projects with long gestation periods. High start-up costs may result investments getting diverted to realty developments for returns.
- Uncertainty on quality power supply at reasonable costs persists especially for small SEZs located far from coal belts or the coast
- Among SEZs analyzed, only six new SEZs are proposed in labor intensive sectors like textiles, leather and footwear and gems & jewelry (**Figure-3**).

How SEZs can impact strategy formulation in the long run?

Notwithstanding current policy level debate and controversies SEZs are here to stay. In a recent address to the business community, the Prime Minister has assured that while distortions will be removed, the Act will be enforced.

The Act is a watershed in policy that promises to reduce red tape and lower costs of doing business. It will eliminate cascading local taxes and ease exim trade for firms in SEZs. It will drastically reduce the operating costs and time cycles for SEZ units as compared to their DTA (Domestic Tariff Area) counterparts.

Several large sized multiproduct and sectoral SEZs can potentially create business discontinuities which in turn impact firm level strategies across sectors.

Potential business scenarios from effective SEZ functioning have been outlined below.

- **Cost advantages for multi-tiered industry sectors**: SEZ based units are exempted from payment of indirect taxes for all sales within the common processing area. Sectoral hubs in large SEZs that host entire multi-tier clusters will save on cascading local taxes which otherwise is applicable in the domestic area. Self certification of exim cargo will also drastically reduce transportation delays and demurrages. This is expected to boost investments in automobiles, engineering, pharmaceuticals, electronic hardware etc.
- **Skill and low cost advantage will eventually score**: Labor intensive manufacturing will draw larger investments in SEZ based units with comparatively liberal labor laws. With requisite factor advantages but low share in global trade, India provides a natural alternative to China in apparel, footwear etc. The current reluctance among domestic investors is only temporary. A major investment trigger, especially from

East Asian firms, is all that is required to set the pace. This trigger can also come from large multinational buying houses as they de-risk their supply chains.

- **DTA firms to face increased SEZ competition**: As India continues to lower its import duties, pure domestic firms which currently enjoy protection on account of import duties will face increasing pressure from "domestic market-seeking" SEZ units. The cost savings from global sized operations in an SEZ environment is expected to be far greater than a target import duty barrier of 7.5%~10%. This threat is especially true for categories currently having low entry barriers. As competition for the domestic market intensifies, pure DTA firms may consider increasing operating scale / efficiencies or relocating in SEZs.

- **Exports driven mega-projects framed as SEZs**: Mega projects like Posco Steel and Reliance Petroleum will classify themselves as anchor clients in SEZs. This will significantly reduce their expenditure on capital goods import. Apart from exporting to other countries in the region, such projects will also have the option to serve the domestic market with lower cost products. A substantial investment in natural resource based industries is expected along these lines e.g. chemicals, refining, mining, metals etc.

- **Free Trade & Warehousing Zones (FTWZ) to reduce dwell time in exim trade**: FTWZs promise world class common user facilities such as customized warehouses and sophisticated material handling equipment. As tenants in FTWZs, traders can import goods at bulk and retail it to small enterprises with relative ease. They can also use FTWZ facilities as consolidation centers for small exporters. A network of interlinked FTWZs can substantially cut down on the dwell time for exim cargo and also provide for efficient market making.

- **Boost to real estate development**: Large number of planned IT and ITES units will drive real estate development in the non-processing areas. Residential apartments, malls, cinema halls, recreation centres etc will have to be developed to cater to the workforce deployed in these units. This is especially true for SEZ which will be located far from current urban centres. It will drive urbanization with the creation of new satellite townships. Further, it will drive demand for a variety of goods and services from DTA during the start up and later.

- **Increased usage of 3PL services**: Increased exim trade of manufactured products will trigger greater demand for 3PL services. This will attract greater participation from global service providers and invite investments in related infrastructure. Indian domestic trade is expected to see greater use of containerization and multimodal transport.

- **An entirely new market segment called SEZ**: Most marketers in the DTA need to take note of SEZ as one of the fastest growing segment for their products and services. Doing business with such units having deemed export status will require a unique set of business norms and terms of trade.

It appears that a score of large sized multiproduct SEZs, each of at least 10 square km area, will eventually flourish in the country. In addition, there will be over a hundred sector-specific SEZs. Jointly they will catalyze investments of around USD 30 billion and provide employment to over 2 million people. Upcoming SEZs present growth opportunities hitherto unknown to Indian firms.

Every firm, no matter what sector it belongs to, needs to assess possible impact of SEZs on its strategic options and competitive position. Planned carefully, SEZs can be an opportunity for investment and market growth. Plain DTA units can expect intense competition from cost efficient SEZ units. One thing is certain, no sector will remain unaffected!

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