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***Special Economic Zones in South Asia:  
Industrial Islands or Vehicles for Diversification?***

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*Abstract*

Bangladesh, India, and Sri Lanka have a long tradition of operating export processing zones. The favorable fiscal, infrastructure, and regulatory conditions under which firms in these zones operate have made it possible to attract substantial foreign direct investment and thereby bring new economic activities and employment opportunities to the countries. While it is challenging to evaluate the institutional characteristics and trade performance across zones and countries due to data limitations, the comparative assessment attempted in this study yields several lessons. In particular, diversity in operating conditions and export performance is more pronounced across different zones within a single country than across country-averages. This finding is mainly based on the importance of good access to transport infrastructure (air and seaports), and zones established to help develop backward regions are more likely to underperform than those in prime industrial locations. Moreover, the effect of EPZs on diversification varies by sector or type of activity. In some sectors, EPZ activity adds to already existing exports in the countries, in others it absorbs production and exports previously performed in the mainland economy, and in a third set it brings entirely new production processes to the country.

*JEL Classification:* F13 (Trade Policy), F14 (Country & Industry Studies of Trade)

*Keywords:* Exports, Incentives, Linkages

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# 1. Background

Many developing countries operate spatially confined economic areas in the form of export processing zones, special industrial zones, or free trade zones. They experiment in these areas with infrastructure, regulatory, and fiscal policies that are different from those implemented on the mainland. In particular, special economic zones (SEZs) offer a more investor-friendly business environment and are seen as vehicles to attract foreign investment, create employment opportunities, and introduce advanced technology.

Major changes to the external environment of SEZs in low income countries have taken place in recent years. On the one hand, fiercer competition for foreign direct investment has emerged from East Asia. On the other hand, new export opportunities through preferential programs like EBA and AGOA have opened up (Rolfe *et al.*, 2004, Cling *et al.*, 2005). These countervailing forces have further accentuated the differences between well performing SEZs and sluggish zones.

The potential role of SEZs as means to attract foreign investment, create employment opportunities and introduce more advanced technologies has been a controversially discussed topic. Individual country experiences with such spatially confined economic areas have been mixed. Yet, despite the existence of a large descriptive literature on SEZs (e.g. Madani, 1999; Watson, 2001), surprisingly little is known about the particular determinants (e.g. institutional setup, governance, labor costs, infrastructure support, regulatory environment, fiscal incentives) that have caused some zones to flourish while others have languished.

SEZs contribute to diversification through two pathways: First, by attracting manufacturing activities to predominantly resource-based developing countries, SEZs add to the diversity of economic activities just through their very existence. And second, SEZs can stimulate the mainland economy through productive linkages. The latter can be vertical by increasing demand for intermediate goods that are produced on the mainland, or horizontal by demonstrating the feasibility of manufacturing non-traditional products.

In this context, the central development questions concern (i) the institutional factors that have been instrumental for determining the relative performance of SEZs, and (ii) the extent to which the two types of linkages exist and can best be harnessed for the diversification of the mainland economy. This study addresses the two questions by assessing and comparing the experiences with special economic zones in Bangladesh, India, and Sri Lanka. These three South Asian countries were chosen as case studies, since they represent a similar socio-economic and cultural environment, have been operating SEZs for several decades, and make data on institutional characteristics and economic performance available.

The remainder of the analysis falls into four parts: Section 2 briefly summarizes the literature on SEZ development and diversification. Section 3 then compares the policies and characteristics of SEZs in the three South Asian countries, with a focus on factors that might explain differences in performance. The subsequent section 4 looks in more detail at trade patterns of SEZs in comparison with the mainland and across zones and activities in order to investigate to what extent SEZs have been the engines of economic growth and export diversification in different sectors. Finally, section 5 presents some summarizing remarks.

## **2. Overview of the Literature**

There is a sizeable empirical and theoretical literature on SEZ performance. Applied studies are most often based on case examples of individual countries, the findings of which are difficult to compare and generalize. Most studies find that SEZs have been successful in terms of the dynamics of economic activity and employment. Examples include Honduras, El Salvador, Mauritius, China, Indonesia, Malaysia, South Korea, and Sri Lanka. Yet, this overall optimistic impression might partly be due to sample bias in the sense that non-performing zones which stagnate and perish receive little attention from researchers, so that their fate remains untold. Also, it is not clear whether the incentives granted to SEZ-firms in apparently successful zones, such as tax breaks or subsidized infrastructure, can always be justified on a cost-benefit basis (Madani, 1999). For example, detailed analysis suggests that governmental infrastructure

investments in the export processing zones in the Philippines have not been justified by the outcomes in terms of employment, tax receipts and foreign exchange earnings (Jayanthakumaran, 2003). Moreover, there are often intangible factors that influence the success or failure of SEZs. In Trinidad and Tobago, the fear of unsteady labor relations has been seen as a reason for the relatively low attractiveness of the SEZ for investors compared with other zones in the Caribbean (Willmore, 1996). In Africa, many SEZs have suffered from lack of socio-political and economic management skills that have not made it possible to appropriately address the multiple challenges of EPZ-establishment, such as providing high quality infrastructure, government services, and human capital (Watson, 2001).

Concerning vertical linkages to the mainland, theoretical analysis shows that benefits from SEZ investments spread to the mainland through purchasing relations, if the SEZ-technology is expressing constant returns to scale and the purchased goods are not traded internationally (Din, 1994; Yabuuchi, 2000). In this case, the additional demand from SEZ-firms leads to a strengthening and expansion of the respective intermediate goods producing industries on the mainland. This structural shift entails economic diversification, if the industries in question are non-traditional.

With respect to horizontal linkages, empirical research on the Dominican Republic suggests possibilities for significant knowledge transfers from multinational to domestic firms within an SEZ (Rhee, Katterbach and White, 1990). In subsequent analysis on Malaysia, it was found that the spillovers were not confined to the SEZs, but that indirect benefits extended beyond the zone (Johansson and Nilsson, 1997). Successful SEZ-enterprises were reported as demonstrating to mainland firms how to produce, market, sell and distribute manufactured goods on the world market and thereby acted as catalysts for the diversification and growth of mainland production and exports.

These empirical findings on horizontal linkages between SEZs and the mainland are consistent with economic conjectures that postulate an ideas gap (Romer, 1993) or a lack of product discovery (Hausmann and Rodrik, 2003) as potential causes of the poorly diversified economies of low income countries. The absence of sufficient local product and marketing know-how prevents opportunities for productivity growth to be exploited

through the introduction and expansion of new activities. One important channel for the transmission of new ideas is foreign direct investment. The foreign affiliates may, for instance, provide an important example for potential indigenous exporters in terms of the required managerial, technical and marketing know-how to supply the world market. A study of nontraditional manufacturing industries in eleven developing countries and the circumstances behind their successful entry into the world market provides some support for this hypothesis (Rhee and Belot, 1990). In almost every case a particular person, firm or public agency played a critical role in the initial export phase by combining local endowments with managerial experience, marketing knowledge and mastery of relevant technology. In industries where the country in question had little or no previous experience, this role was often played by an affiliate of a foreign multinational enterprise. In this context, SEZs which attract inward FDI can act as catalysts for initiating the process of economic advancement and productive diversification.

### 3. Institutional Characteristics of SEZs in South Asia

Export processing zones in South Asia have a long tradition. The first such zones were established in India in 1966, in Sri Lanka in 1979, and in Bangladesh in 1983. All the three countries have subsequently added several other zones, and total employment has increased over time to more than 100,000 workers in each country (Table 1). The institutional and political environment for zone establishment and operation have changed markedly since the beginnings in response to global economic trends, general economic policy changes, and experiences in zonal management. Descriptions of the major phases in zonal development in the three countries are contained in the three country annexes to this study.

**Table 1: Summary statistics on EPZs in South Asia**  
(latest available data, referring to 2003-05)

	Number of zones	Total investment (million USD)	Total employment	Value of exports (USD)
Bangladesh	6	749	148,080	1,027,380,210
India	11	501	124,162	4,830,340,758
Sri Lanka	9	291	104,237	177,458,677

*Source:* Country case studies.

Many factors contribute to the institutional environment in which SEZ-firms operate. These include economy-wide characteristics, such as macroeconomic stability, labor skills, and wage levels, as well as zone-specific factors, such as incentive regimes, infrastructure quality, and zonal governance. The combination of these factors has a determining influence on production and investment decisions of firms, with different elements carrying differing weight for particular industries and investors.

Trying to capture the various factors for comparison purposes is challenging, as they are often complex, multidimensional, and not easy to quantify. In many cases, soft factors, such as the dynamism of the zonal management or the expectations of investing firms are more important determinants of success than hard facts. Also, the components of the institutional environment have evolved over time, so that ideally a full time series would be required to be able to represent the changes and make it possible to take time-lags between the alteration of particular factors and the production or investment response of SEZ-firms into account. Unfortunately, the available information in Bangladesh, India, and Sri Lanka does not make it possible to do justice to the full history of SEZ-development and a descriptive account of major trends has to suffice (see the country annexes). With these caveats in mind, the following comparative descriptions aim to highlight common and differing elements in the institutional set-up of SEZs in the three South Asian countries along the three major dimensions of incentive, infrastructure, and regulatory quality.

### **3.1 INCENTIVE REGIME**

#### **General and sector-specific incentives**

*Bangladesh:* Since 1998, imports into EPZ do not pay any VAT, import duties, or supplementary taxes (which can range from 20-350% for some products). No stamp duty is levied on the transfer of land within an EPZ. In 1998, additional incentives for backward regions have been granted. These include a subsidy of 50% on land and factory rents and a 30% cash incentive for agro-industries. Similar incentives also exist outside the EPZ, however.

*India:* There are multi product zones, service sector zones, electronic hard- and software zones, and biotechnology, non-conventional energy, gems and jewelry zones. Free trade and warehousing zones also exist. Until 2005, units were required to generate a certain value added in their activity but this obligation has been changed and units now have to create a cumulative positive foreign exchange within the first 5 years. There is no investment limit for firms in the SEZs while there are some sector specific thresholds for investment as Export Oriented Units. SEZ units are also exempt from a 12 percent service tax, customs and excise duties, and VAT. While central excise duties were only reimbursed until 2006, companies are now exempt from them. Some municipal bodies have also granted exemption from electricity duty and stamp duty on property transactions. The SEZ Act also directs the states to exempt zones from all local taxes. On the other hand, there exist zone-specific subsidies in West Bengal and Vishakhapatnam.

*Sri Lanka:* Incentives include duty exemption from importation of equipment, construction material and production inputs. In 1982, this scheme was extended to local suppliers in order to encourage backward linkages. Between the late 1990 and 2002, so-called “thrust” sectors (electronics, ceramics, glassware, mineral based, rubber based, and engineering based areas) were granted special tax holidays. In addition, all projects in industrial areas classified as difficult or most difficult, were offered tax holidays of 5 and 8 years (in other areas, non-thrust sector projects were only granted a concessionary tax of 15 percent for twenty years).

### **Treatment of profits and dividends**

*Bangladesh:* Since 1986, a tax holiday of 10 years is in effect after which tax liability is reduced to 50% of the tax attributable and interest on borrowed capital can be deducted from the income tax base. For the same time, non-resident shareholders are exempt from dividend tax and there is a depreciation allowance of 100% within the period of tax exemption.

*India:* Taxation of profits has changed repeatedly during the last 25+ years. While there was a general tax holiday for 5 years in 1981, this was extended to 10 years in 1999. In 2000, this scheme was revised and allowed full tax exemption for 5 years. During the



next two years, 50% of profits are exempted while 50% of the profits could be ploughed back during the following three years. In 2006, tax holidays for off-shore banks were made slightly more restrictive while tax benefits were extended for developers of SEZs under certain conditions. Since that year, SEZ units and developers are also exempt from the minimum alternative tax and SEZ developers are exempt from dividend distribution tax. The effective rate of corporation tax (basic duty plus surcharge) in 2006 was 33.7 percent for domestic and 41.8 percent for foreign firms. Inter-state differences in tax treatment of SEZ firms were eliminated in February 2006.

*Sri Lanka:* Incentives to attract FDI have changed frequently over the last 30 year. For example, tax holidays were granted up to 10 years in the beginning, were extended to 15 from the first year of profits in 1991 and for certain “thrust” sectors to 20 years in the late 1990s. At that point, tax holidays for other areas were withdrawn and replaced with a concessionary tax rate of 15 percent for 20 years. A subsequent reform in 2002 puts the re-establishment of a tax holiday of 5 years to all export oriented units followed by concessional rates of 10 percent for two years and rates of 15 percent thereafter. That reform, however, removed tax exemptions on paid dividends for companies that qualified for exemptions after 6 November 2002. Remittances of dividends are exempted from foreign exchange controls where they still persist. It has to be pointed out, however, that incentives granted in Sri Lanka to a company cannot be changed by subsequent changes in regulation.

### **3.2 INFRASTRUCTURE REGIME**

One of the critical elements for any export activity is adequate infrastructure, including physical infrastructure (transport system such as port, airport, water, electricity and communication facilities). Infrastructure within EPZs is generally of superior quality to that available in the wider economy. Comparing the three South Asian countries, some notable differences in facilities provided by the zonal administration emerge (Table 2).

**Table 2: Physical and social infrastructure provided by the zonal administration**

	Bangladesh	India	Sri Lanka
Standard Factories	Yes	Yes	No
Water	Yes	State board	State board
Electricity	Partial	State board	State board
Telecommunication	Line reservation	State board	State board
Ware housing	Yes	Yes	None
Transport facilities in zone	None	None	In 1 zone
Recreation facilities	Sport complexes	None	None
Hotels/guest house	Investor's clubs	Guest houses	None
Residence for admin staff	Yes	None	Yes
Hospital	None		None
Fire station	Yes	None	Yes

*Source:* Aggarwal, 2005.

### **Location and transport infrastructure**

*Bangladesh:* Three of the EPZs for which information is available are located in backward regions and three in a developed region or commercial area. Distances to the nearest (domestic) airport differ widely from less than 10 km to more than 100 km. Commercial centers can be even further away. Two of the three EPZs in backward regions have performed very poorly in attracting employment (even if taking into consideration that they are very new). There is no employment in Eshwardi, which is already in existence since 2001. In the Mongla-EPZ, also located in a backward region, only agro products are produced and exported. Exports per worker have increased slightly since 2001 from 9120 USD to 11,500 USD in 2003-04. At the same time, however, imports into the zone from the rest of the world have increased strongly, making the calculation of value added impossible.

*India:* In India, all SEZs are located either near an air- or seaport. About half of the SEZs are located in industrially backward areas.

*Sri Lanka:* In Sri Lanka, three EPZs have been around for a longer period of time while an additional six have been founded in or after 1999. Of the older zones, two are in the vicinity of Colombo while the third is located in the south of the island.

### **3.3 REGULATORY REGIME**

#### **Administrative organization and approval process**

*Bangladesh:* There are both public and private sector EPZs in Bangladesh but private sector EPZs have faced severe difficulties since the private sector was allowed to set up EPZs in 1996. It seems that no private-sector EPZ is fully functional until now. Structure of the administration consists of three tiers: the board of governors, the executive board (BEPZA), and a separate zone administration for each zone. The structure differs slightly for private EPZs. Approval for projects is generally granted within one week and takes place through a single window while it takes 35 days to start a business outside the zone.

*India:* The administrative structure consists of three levels, a central statutory body, the Board of Approval that deals with setting up zones and units, and the Unit Approval Committee headed by a Development Commissioner at the zone level. Proposals used to be approved by the Board of Approval, a central organ, until 1991 but are now approved by the Development Commissioners as long as a number of conditions are fulfilled (maximum foreign exchange requirement, certain value addition, non-polluting, ...). This is called automatic route. Proposals that do not fulfill these criteria continue to be forwarded to the Board of Approval where a decision is usually taken within 15 days. Since the SEZ Act of 2005, there is single window clearance for the automatic route.

*Sri Lanka:* The administrative structure in Sri Lanka consists of three layers: A ministerial committee at the top, the Board of Investment (BOI), which is also responsible for dealing with other foreign direct-and some other-investment, and the zone administration. The BOI and the zone management each consist of various departments. The authorities claim that attempts are made to provide all post-entry services through a single window, but it is unclear to which degree this aim is achieved.

#### **Local sales and backward linkages**

*Bangladesh:* 10 percent of last year's exports can be sold locally upon approval. Export Oriented Units outside the EPZs can sell 20% of their products locally after paying applicable taxes and duties.

*India:* Export Oriented Units can 50% of their production domestically at a concessional rate (a duty exemption of 25%). Firms from the EPZ can sell goods to the domestic market as long as they have "positive net foreign exchange earnings" over 5 years but have to pay the full import duty on these sales. Sub-contracting outside the EPZ has been allowed under certain circumstances for a while but data other than the number of contracts are difficult to obtain. Nowadays, subcontracting part of the production process is permitted (also abroad) given permission of the Development Commissioner.

*Sri Lanka:* 20 percent of production can be sold to the local market upon permission from the investor's service department. This value is 10 percent in the case of the clothing sector. Local supplies are treated like international supplies in the way that no duty has to be paid when these are used as production inputs, building materials, or equipment.

### **Labor regulations**

*Bangladesh:* Since 1989, zones were exempted from three major labor laws. Instead, there are two 'instructions' that regulate classification of employees, leave, payment, minimum wages, and other issues. The report does not specify how these regulations related to the labor laws that are valid in the rest of the country. Formation of labor unions is not allowed in EPZs and strikes are prohibited. Since 2004, there have been some transformations and since the end of 2006, workers have the right to form labor unions.

*India:* General labor laws apply and unannounced strikes are permitted. The new SEZ regime is expected to lead to some changes, especially increasing the powers of the development commissioner to control and enforce labor regulations in SEZs.

*Sri Lanka:* General labor laws are applicable to all enterprises, including those in EPZ and trade unions are allowed. The Board of Investment, however, encourages the establishment of employee’s councils instead.

#### 4. Trade Performance of SEZs in South Asia

The share of EPZs in a country’s exports is an indicator of the relative importance of the zones. In India, EPZ exports correspond to a modest 5 per cent of total exports, while the share reaches a fifth and a third, respectively, in Bangladesh and Sri Lanka (Table 3). The role EPZs have played in export performance varies also by zone and product concerned. Products from some of the sectors where substantial exports from EPZs can be observed, were already exported by Bangladesh, Sri Lanka, and India even before EPZs were set up. Analysis of the data shows that EPZs can play a supportive role in export performance in those cases where products of a given sector were already exported. Moreover, for some products the zones have played an initiating role, adding these “new” products to the overall export portfolio. In these cases, EPZs perform a fundamentally different role with regard to export performance and export diversification than in the former case. Finally, EPZs can also induce a relocation of activities from the mainland to the zones, due to the favorable business environment provided there.

**Table 3: Share of EPZ exports in total exports (in per cent)**

Year	Bangladesh	India	Sri Lanka
1973		0.14	
1979	8.0	0.59	
1985	1.5	4.86	27.8
1990	3.4	4.23	35.2
1995	9.9	4.07	31.1
2000	17.9	5.41	28.8
2001	19.5	5.62	29.5
2002	19.7	5.27	32.3
2003	21.3	-	33.2

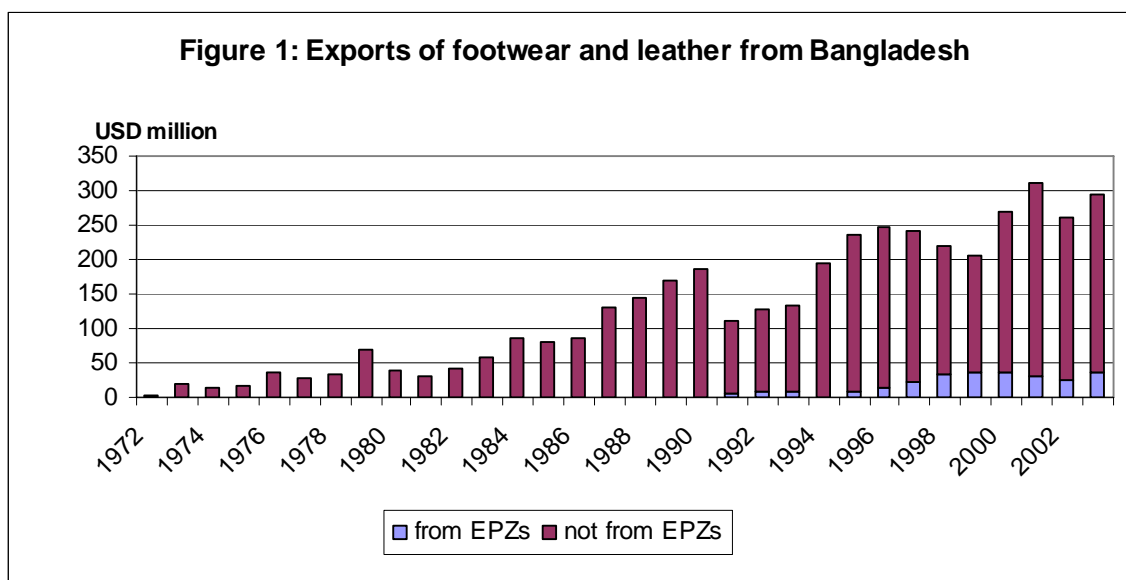
*Source:* Aggarwal, 2005.

We compare export data from a number of zones to export data that is accessible through COMTRADE. This is not a simple task for mainly two reasons:

First, data for the EPZs usually (at least in the case of Bangladesh and India) are reported in financial or operating years (i.e. 2002/03) while trade data that are accessible through COMTRADE are reported in calendar years. This makes an exact comparison difficult because we do not have specific information on how the exports in a operating year were distributed among calendar years. This problem is of varying importance depending on the role that EPZ-originating exports play in total exports of a given commodity and the overall consistency, trend, and magnitude of these trade flows. We will turn to this problem in more detail later.

Second, export data obtained from the EPZs uses generic descriptions of exports that are not necessarily in concordance with other classifications used for recording trade data. We are often left with general descriptions such as "electronic hardware" or "agro products". Comparing trends in exports performance of these sectors in the EPZs with performance of the same sectors outside the EPZ is consequently very difficult because trade flows cannot be matched in all cases.

We look at some examples to illustrate the role that EPZs have played in those cases where substantial exports of a given commodity already took place before EPZs were set up. In the case of Bangladesh, we have data of exports originating in EPZs as of 1991/92. Export values for each of the sectors that are broken down were already large in some cases when our data set starts. Clothing, the largest export sector in EPZs in 1991/92, accounted for USD 35 million of exports from Bangladeshi EPZs in that year. Nevertheless, this value represented only about 3.2 percent of Bangladesh's total exports of clothing in 1991 and this share increases to roughly 9.3 percent in 2003 (see figure 1). For relatively large export sectors that already existed before the foundation of EPZs, this seems to be a typical pattern of the (relative) performance of EPZ exports. A similar pattern can be observed for footwear and leather exports and knitting and other textile product exports from Bangladesh. In a more pronounced form, it can also be observed in the case of Sri Lankan exports of wearing apparel and leather, non-metallic mineral products, and food, beverage and tobacco. In these cases, some production capacity for goods that were already exported has either been added in or re-located to EPZs. Available data do not allow us to distinguish between these two theoretical possibilities.



Exports from EPZs can also interact differently with total exports when EPZ firms start to export goods that have so far not been exported from either the mainland or the EPZ. In these cases, exports from EPZs are diversifying the overall export portfolio. Establishing these cases in theory is simple but for a number of reasons it is much harder to identify these cases in the data.

As long as export data are very aggregated, it is difficult to identify cases where firms actually start to export new products. Often new, specialized product categories are grouped together with existing products. We would hence not observe the export of a new product but rather an increase in the size of exports of a given category. In the case of Bangladesh, a number of products have been broken out at a very detailed level and corresponding COMTRADE data indicate that total exports of these goods nearly equal EPZ exports. This indicates that the products in question are new products. Figure 2 shows the example of exports of tents from Bangladesh. Because a similar category is available in SITC-1, we can trace Bangladesh' overall exports of tents quite far back. There are two years where small but non-zero exports of tents took place (in 1978 and 1980, in both cases less than USD 300,000) but exports of tents only start to take off in 1992, the year exports of tents from the EPZs start. Until 2003, the last year for which data are available, nearly all exports of tents from Bangladesh came from the EPZ. The

picture is very similar for exports of fishing reels and golf equipment which started in 1991 and are also nearly completely from EPZs.<sup>1</sup> The low initial observed export values, however, support our hypothesis that it is indeed also a newly exported product. In the case of Sri Lanka, exports of paper, paper products, printing and publishing follow a similar pattern and appear to be solely driven by BOI-registered firms. Total exports did not exceed 350,000 USD until 1987, the year exports from BOI-registered firms started. Since then, exports have increased to 17.8 USD million, all of which are exported through foreign or jointly owned firms registered under the BOI.<sup>2</sup>

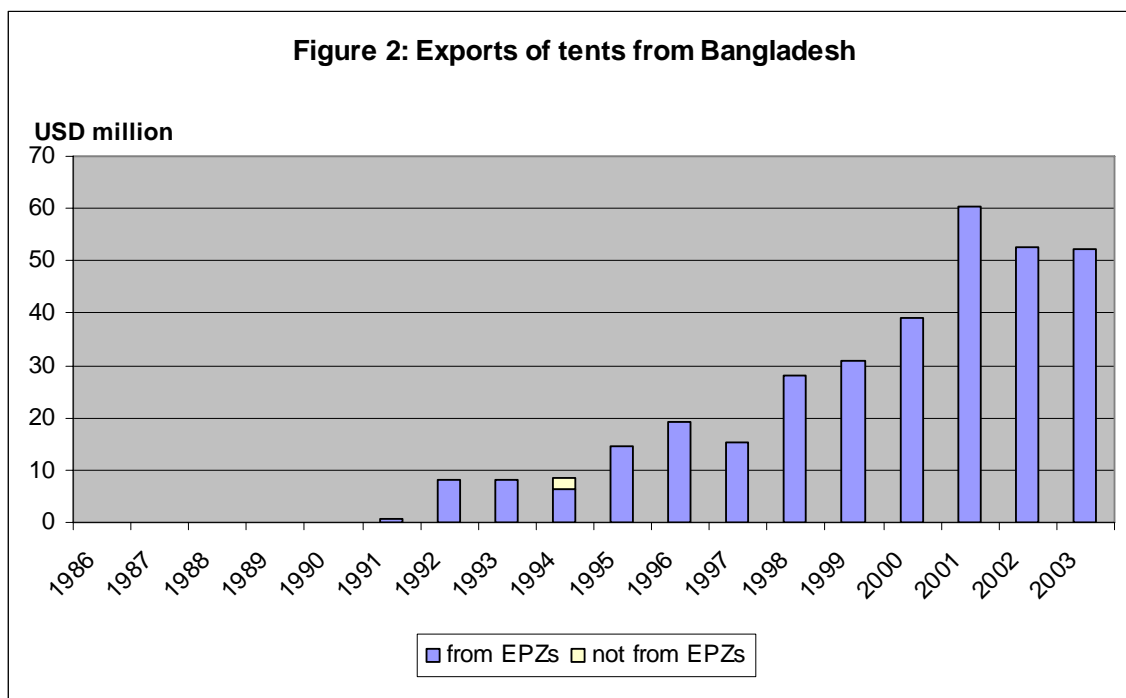
In the case of Sri Lanka, we also observe a third pattern of export performance, where exports of an existing product grow and all exported production is relocated to BOI-registered firms. During the 1970s, the average exports of chemicals, petroleum, coal, rubber, and plastics was about USD 50 million per annum while basically no exports originated in BOI registered firms. Exports then increased to about USD 150 million in 1990 of which about USD 20 million came from BOI-firms. During the 1990s, however, exports of these goods from BOI-firms started to increase strongly while overall exports remained constant before both started to increase at the end of the 1990. By now, only BOI-registered firms seem to export these goods. Unfortunately, we are unable to identify whether it is a firm that relocated or whether new firms within the EPZ have taken over production and driven the incumbent firms out of the market. It has to be kept in mind that EPZs also create distortions relative to firms established in the main land which could make it difficult for these incumbent firms to compete.

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<sup>1</sup> In this case, however, general export data is available only until 1991 when countries started to report in the harmonized system where fishing reels and golf equipment are broken out. Because we use mirror data and not all countries report in HS0 for that year, we might not pick up all Bangladeshi exports of these goods. We use mirror data because Bangladesh itself does not report any exports of golf equipment for these years, possibly because at that time EPZ exports were not considered special trade..

<sup>2</sup> These data for Sri Lanka, however, include exports of all units that have been set up through the Board of Investment. We cannot single out EPZ exports at a disaggregated level but EPZ exports accounted for approximately 50 percent of BOI registered exports.





Export data from EPZs is reported in operational years and not calendar years as is world trade data (the point that was alluded to earlier). In the above described cases of tents or fishing reels and golf equipment, we have adapted the data by considering overall reported exports as a maximum level and allocating EPZ exports over the two calendar years that are covered by any operating year in the following way. We allocate exports to the first calendar year until EPZ exports reach total exports and allocate the remainder to the subsequent calendar year. We then repeat this exercise for each year. In both cases, the amount of exports allocated to the subsequent calendar year never exceeds the total amount of EPZ exports in the operational year reported, indicating that our method is consistent with the originally reported numbers.

Assessing the performance of EPZs in India is cumbersome because first, trade flow data are only available for the time after 2000, leaving a short time period for comparison when EPZs were already functioning for a long time. Second, EPZ export data we have access to are very aggregated, making the comparison with world trade data difficult as no corresponding data classification is given. In India, the dominant element of EPZ exports are in “gems and jewelry” and have increased sharply (to more than 50% of EPZ exports since 2004). While firms that exports gems and jewelry are located in

zones that have already been in place since the 1980s, it is unclear whether these firms have actually been around that long. Comparing EPZ data on exports of ‘gems and jewelry’ with SITC data on “jewelry and gold/silver-smiths ware”, the share of Indian jewelry exports that originates in EPZs, has increased from about 60 percent in 2001/02 to slightly more than 70 percent in 2005/06.

Generally, it has to be pointed out that trade performance differs widely between zones, between sectors, and over time. In Sri Lanka, for example, exports of wood and wood products have increased by 190 percent from 5 to 14.5 million USD over the last 10 years from a very low base. However, the increase took place only recently between 2001 and 2003 while zone exports had actually decreased in dollar terms until then. Exports of non-metallic mineral products have increased up to 1993 but have fallen since 1995. Exports of textile, wearing apparel, and leather products have grown quite steadily over the last 10 years to a cumulative increase of 145 percent. In the case of Bangladesh, we observe a similar pattern of strong and consistent growth of textiles and garment exports while other sectors perform less uniformly. Ideally we would like to break down the export data into goods that would allow us to test for the importance of factor inputs that could explain these differences in performance. Yet, the available data are too aggregated while sometimes very specific products, which have been successful, are broken out. The kind of data that is available, and the large variety of successful sectors, does not allow us to draw clear conclusions on whether EPZs have been particularly successful in encouraging exports of labor-intensive, energy-intensive, or otherwise specialized products.

The data from Sri Lanka allow us to analyze another dimension of export performance: how homogeneously do different types of firms behave and perform in a given country? We can observe that the focus of economic activity differs between domestically, jointly, and foreign held companies in Sri Lanka. Similarly, we find that export performance for the same kind of goods differs strongly for these types of firms. Looking at exports only, we find that domestically owned companies are relatively more active in the food, beverage, and tobacco as well as in the services sector. Jointly held companies have a bias towards being active in the service sector, paper, paper products and printing, as well as in exports of non-metallic, mineral products. Foreign owned firms

account for nearly 90 percent of exports of fabricated metal, machinery and transport equipment, and for 70 percent of other manufactured products. Overall exports of textile, wearing apparel, and leather are distributed among the different forms of ownership in similar proportion to overall exports from each group. For this economic activity, which accounts for about 50 percent of these exports, performance over time differs strongly for the three types of enterprises. While foreign held companies saw their exports of these goods grow by a little more than 200 percent over the last 10 years, exports of jointly held firms grew by 460 percent over the same time period. The best performance, however, was registered by domestically held firms whose exports of the same goods increased more than 16-fold over this time period.

## **5. Summary Observations**

Bangladesh, India, and Sri Lanka have a long tradition of operating export processing zones. The favorable fiscal, infrastructure, and regulatory conditions under which firms in these zones operate have made it possible to attract substantial foreign direct investment and thereby bring new economic activities and employment opportunities to the countries. While it is challenging to evaluate the institutional characteristics and trade performance across zones and countries due to data limitations, the comparative assessment attempted in this study yields several lessons. In particular, diversity in operating conditions and export performance is more pronounced across different zones within a single country than across country-averages. This finding is mainly based on the importance of good access to transport infrastructure (air and seaports), and zones established to help develop backward regions are more likely to under perform than those in prime industrial locations. Moreover, the effect of EPZs on diversification varies by sector or type of activity. In some sectors, EPZ activity adds to already existing exports in the countries, in others it absorbs production and exports previously performed in the mainland economy, and in a third set it brings entirely new production processes to the country.

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# Annex 1: Characteristics of EPZs in Bangladesh

## I. EPZ POLICY REGIMES

### I.1. First Phase: 1984-1998

The policy framework that Bangladesh inherited and maintained at independence in 1971 was geared towards import substituting industrialization. The policy bias reflected in strict import controls, high tariff and non tariff barriers, overvalued exchange rate and export taxes on certain categories of exports. The public sector was assigned a lead role in industrialization and as part of this policy the government nationalized all large industrial enterprises.

After the change in government in 1975, the strategy of public sector led industrialization was abandoned and the process of trade and investment reforms was initiated. In 1976, a working paper prepared by an inter ministerial committee recommended setting up of EPZs in Chittagong, Dhaka and Khulna. Following this recommendation, delegations were sent to visit EPZs in other countries. Finally, in 1980, the idea was formally put to implementation with the creation of the Bangladesh Export Processing Zone Authority (BEPZA) under the BEPZA Act 1980. Its primary objective was to create and develop EPZs in the country. The first EPZ became operational at Chittagong in 1983-84. The size of the zone was mere 140 acres.

The reform process was intensified following major policy declarations in 1982. Under the new policy regime, export promotion became a major concern of the government. A wide array of export incentives were offered to boost exports. These included: export subsidy, duty free access to imports, tax holidays and rebates and credit guarantees. While the incentive package mostly centered around price factor, there were several non price constraints as well, crucial amongst which were paucity of investment capital, lack of access to improved technology, inadequate linkages with the global markets. It was felt that these non price constraints to export could be addressed by ensuring adequate inflows of FDI. In 1980, the Foreign Private Investment (Promotion and Protection) Act was enacted to provide equal treatment to domestic and foreign investors. More relaxations followed under the Industrial Policy of 1982. But attracting FDI requires development of infrastructure and other structural reforms also. Since the country-wide development of infrastructure would be expensive and implementation of economic and structural reforms would require time, establishment of EPZs was viewed as an important strategic tool for attracting FDI in the country. The objectives of BEPZA, which were inserted through an ordinance in 1984, clearly reflected this economic philosophy. They are to a) foster and generate economic development of Bangladesh by encouraging and promoting foreign investments in a zone, b) to diversify the sources of foreign exchange earnings by increasing export of Bangladesh through a zone, c) to encourage and foster the establishment and development of industries and commercial enterprises in a zone in order to widen and strengthen the economic base of Bangladesh; and d) to generate productive employment opportunity and to upgrade labor and management skills through acquisition of advanced technology.

In 1986, the government announced a revised Industrial Policy. This marked the second phase of trade and investment liberalization. A newer range of export incentives were introduced and efforts were made to liberalize imports by simplifying and rationalizing the tariff structure of the country. Though reforms in regulatory and trade policies improved the general economic environment in the economy, structural bottlenecks were far too widespread to be easily removed in the short run. The trade policy therefore underscored the continued need of EPZs and the

existing Chittagong EPZ was expanded by 60 acres. In addition, rules and procedures that regulated the EPZ were also simplified and incentives offered to EPZ units were further extended.

The most pro-active phase of trade and investment liberalization was taken up in 1992. Nominal applied most-favored-nation (MFN) tariffs fell by more than half, from an average of 58% in 1992/93 to 22% in 1999/2000 and the number of trade-related quantitative restrictions came down sharply. By 1994, the share of free import items rose to 94% of all HS-8 line items and only 0.4% were banned. While the process of import liberalization was accelerated, efforts were also made to invigorate the export sector through a newer range of incentives. In order to accelerate the export growth, it was considered desirable to expand the EPZ sector and relax the rules and procedures that governed the zones. The Chittagong EPZ was expanded by 253 acres of land increasing the size of the zone to 453 acres. Furthermore, the second EPZ was set up in Savar near the capital city Dhaka. Dhaka EPZ commenced its operations in 1993-94. Initially, its size was 141 acres but in 1997, it was expanded by 205 acres.

## **I.2 Expansionary Phase of EPZ Policy: 1998 Onwards**

Though the government made considerable progress in liberalizing trade and promoting exports, textile sector continued to dominate Bangladesh's exports, with their combined share growing from 70.4% in 1992 to 83.5% in 1998. These exports remained a principal source of Bangladesh's export growth. Such heavy dependence on a limited number of products made the Bangladesh economy vulnerable to increased competition from other Asian countries. In order to both accelerate and diversify Bangladesh exports, it was decided to give major thrust to the EPZ sector. Four more EPZs were set up in the late 1990s. These are in Mongla, Ishwardi, Comilla and Uttara. Recently, two more EPZs have become operational. These are Adamjee EPZ (near Dhaka) and Karnaphuli EPZ (near Chittagong).

In a major initiative, the government, in 1996, passed the "Private EPZ Bill" to encourage private sector EPZs. The government issued a permission letter to Youngone Corporation of Korea to set up an EPZ. Following this, a new company called Korea EPZ Corporation (Bangladesh) Ltd. (KEPZCL) was established in May, 1996. After completion of necessary administrative formalities, a total land area of 2,526.19 acres or 1,022 hectares was acquired. The formal gazette notification in this regard was issued in 1999. This was expected to be the largest EPZ of Bangladesh. However, till date its fate is uncertain. In contrast, a local private company was issued license to set up a sector specific EPZ at Rangunia without much delay. The name of the company was Chittagong Industrial Park Ltd. This company worked for over two years to develop the country's first private sector IT-related Export Processing Zone (REPZ). It had already established an equity-based tie-up with the US-based BACTEL Inc. with the US partner having the responsibility to maintain the fiber optic connectivity to facilitate operation of hi-tech IT companies in the zone. However, this company was refused also permission by the Telecommunications Ministry. Thus, the scheme of private EPZs could not really take off.

In sum, the government has moved expeditiously to liberalize the trade and investment regime. However, inadequate infrastructure and other essential services together with weak governance, bureaucratic bottlenecks, labor unrest and a deteriorating law and order situation continue to discourage domestic and foreign investors. In this scenario, EPZs, which seek to resolve such bottlenecks, are considered as engines of export growth and diversification in the country. As a result, liberalization of trade and investment regimes through successive phases has been matched by consolidation of the EPZ policy as well.

## II. THE LEGAL FRAME WORK

### II.1 Public Sector EPZs

The legal framework governing Public sector EPZs in Bangladesh and the operation of firms established in EPZs is provided by the following acts and rules:

**1. The Bangladesh Export Processing Zones Authority Act, 1980:** The Act lays down rules for the administration of the affairs of the Authority and specifies its functions, responsibilities and powers. Under the Act, the BEPZA takes possession of all land acquired by the government for the purpose of creation and development of a zone and creates infrastructure facilities which includes buildings, utilities and warehouses. In addition, BEPZA processes and sanctions applications for setting up EPZ units, provides custom bonded facilities in accordance with custom regulations, and provides single window services to EPZ units.

**2. Foreign Private Investment (Promotion and Protection) Act, 1980:** Under the Act, the Government accords fair and equitable treatment to foreign private investment. Foreign investors enjoy full protection and security in Bangladesh. The transfer of capital and the returns from it and, in the event of liquidation of industrial undertaking having such investment, of the proceeds from such liquidation is guaranteed. Currently, Bangladesh maintains one of the most liberal regimes in South Asia with few limitations on foreign equity participation.

**3. Principles and Procedures Governing setting up of Industries in EPZs (1981):** The broad features relating to the operation of the industrial enterprises in the zones are contained in these Principles and Procedures which lay down conditions for setting up units in the zones for different types of enterprises. As per these Principles and procedures, industries which may be set up in EPZs of Bangladesh may be classified as Type-A which are 100% foreign owned including investment by Bangladeshi nationals ordinarily resident abroad, Type-B, being joint venture projects between foreign and Bangladesh entrepreneurs resident in Bangladesh, and Type-C, which are 100% Bangladeshi entrepreneurs resident in Bangladesh.

**4. Customs Rules (EPZ) 1984:** These rules are framed by the National Board of Revenue, Bangladesh. These rules relate to imports, exports, removal of goods from the zones, subcontracting, procurement from the domestic mainland and disposal of solid waste.

**5. Circulars of different government bodies:** These circulars regulate various aspects of EPZ functioning and include foreign exchange control regulations for EPZ units and setting up of overseas banking units by the Bangladesh Bank, capital issue related matters by the Ministry of Finance, or income tax exemptions, issued by the Internal Resource division of the Ministry of Finance

### II.2 Private Sector EPZs

The Bangladesh Private Export Processing Zones Act (1996) allows setting up of EPZs in the private sector, with a view to attracting more investment especially foreign investment in the country and sets the direction for the governance of these zones. There are also other rules and custom procedures are as applicable to the public sector zones.

### II.3 Legal Framework for Investment outside the zones:

To promote and facilitate investment in the private sector both from domestic and overseas sources, the government has established the Board of Investment (BOI) by the Investment Board Act 1989. It is headed by the Prime Minister and is a part of the Prime Minister's Office. Its

membership includes representatives (at the highest level) of the relevant ministries –industry, finance, planning, textiles, - as well as others, such as the Governor of Bangladesh Bank and heads of some business associations.

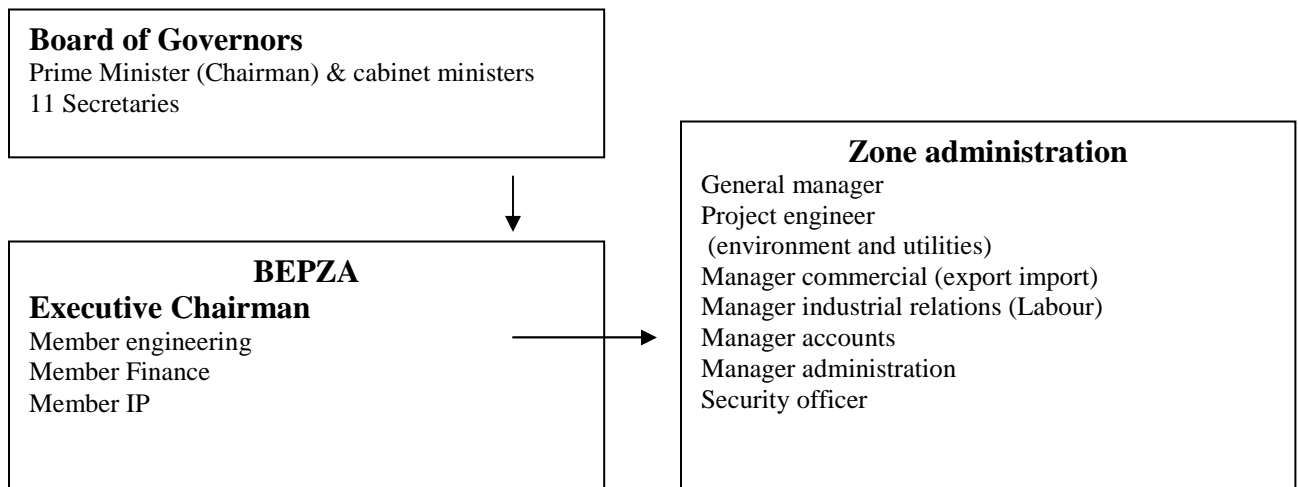
The BOI provides necessary facilities and assistance in the establishment of industries, implements investment related policies of the government, sanctions private sector industrial projects; and identifies competitive investment sectors and facilitating investment by providing information and services. The Operation Head and CEO of BOI is the Executive Chairman who is assisted by an executive council.

### III. ADMINISTRATIVE SET UP

#### III.1 Bangladesh Public sector EPZs have a three-tier administrative set up.

**1. The Board of Governors:** It formulates policies for the operation and management of the zones and BEPZA. The Board of governors is constituted under the chairmanship of the Prime Minister. It consists of 7 cabinet level ministers (dealing with industries, commerce, finance, planning, foreign affairs, energy and ports and shipping), 11 secretaries and the Governor, Bangladesh Bank.

**Fig. 1: The administrative set up: Bangladesh EPZs**



**2. Executive Board, BEPZA:** BEPZA is an autonomous body that ensures all the pre entry and post entry services to the investors. The general administration of the affairs of the Authority is vested in the Executive Board, which is headed by the executive chairman. The Executive Board, in discharging its functions, acts in accordance with the guidance, orders and instructions given by the Board of Governors of the Authority from time to time. The executive Board of the Authority consists of a Chairman and three other members. There are three broadly defined departments under the Executive Chairman: Engineering, Finance and Investment. These are in turn headed by three officials: Member (Engineering), Member (finance) and Member (Investment) respectively which are also members of the Executive Board. The Executive Board, in the discharge of its functions, is aided and advised by a Consultative Committee which consists of the representatives from the Ministry of Commerce, Ministry of Industries, Export Promotion Bureau, banks and industries.



**3. The zone administration:** Each zone is governed by a general manager who is responsible for the implementation of EPZ policies in the zone and its development. He is assisted by a team of managers who have clearly defined administrative responsibilities assigned to them ( see Fig 1).

### **III.2 Private Zones:**

**Board of Governor:** It is the top policy making organ chaired by the Prime Minister. There is a separate Board of Governors for private EPZ with the head of government as chairperson supported by as many as seven ministers and an equal number of secretaries. There is only one representation from the private sector in the person of the president, federation of Bangladesh chamber of commerce and industries (FBCCI). The executive chairman of BEPZA is represented in the board but none from the sponsor

**Executive Cell:** It is headed by a Director General, Prime Minister Office. Its functions are a) to acquire land for a zone, b) to sanction the establishment of the new zone, c) to sponsor companies to issue permission to investor to set up industry in a zone, and d) to sponsor companies to provide infrastructure.

### **IV. THE APPROVAL PROCESS**

BEPZA has the motto of 'one window same day service'. BEPZA sanctions projects generally within one week. The process takes maximum of 7 days and minimum 1 day. BEPZA is also authorized to provide at the time of entry: a) the registration under the factory act, b) the approval of building plans, c) the issue of Import/Export Permits, d) the issue of required Work Permits for foreign nationals working in EPZ enterprises, and e) the water connection.

Thus the authorities of inspector of factories, director of labor and municipal corporation have been delegated to BEPZA. BEPZA plays a role of facilitator in the provision of other services such as electricity connection and telephone connection. However the units have to deal with some other government authorities as well. These include National Board of Revenue, Department of Environment, Custom and Fire Safety. Though BEPZA facilitates their interaction with these government departments, the units may approach them directly to expedite the process. In day- to-day operations, the units have to deal mainly with BEPZA, custom authorities and Export Promotion Board. However, though all custom related services are provided within the zone, custom authorities are not directly under the jurisdiction of the EPZ administration.

**Approval Process outside the Zone sector:** Outside the zone BOI (Board of Investment) is responsible for processing investment proposals. Once registration process is complete with the BOI, units have to seek clearances from various other government departments. These include, department of company affairs, Inspectorate of factories, environment, VAT department, local bodies, customs, electricity, water and so on. Bangladesh demands eight procedures to start a business. According to a global business survey by the World Bank and International Finance Corporation (IFC) "Doing Business in 2006: Creating Jobs" the number of days needed to start a business in Bangladesh is 35 and the cost to start a business, as a percentage of the per capita income, is 81.4 percent which is the highest in the region. Furthermore, it takes 13 procedures to obtain a license and businesses need 185 days to obtain a license. In comparison, starting business in EPZs is relatively much easier, less time consuming and cheaper. Investment proposals for the EPZs are processed quickly, and the EPZ administrators take care of the investor's needs, from tax treatment to utility hook-ups.

## **V. RULES AND PROCEDURES**

### **Finance**

**Type A** (100% foreign owned companies): Total investment cost and working capital requirement to be self financed. No local borrowing is permitted. Recently, local borrowing for working capital requirement has been permitted by the government.

**Type B** (Joint ventures): Cost of machinery, spare parts and raw materials to be financed by foreign partners. Local partners finance working capital not covered by foreign partners. Local borrowing is allowed on conditional basis.

**Type C** (Local Companies): The first consignment of raw materials to be financed through Secondary Foreign exchange market. Later consignments are to be financed through own export earnings. The entire export proceeds must be surrendered to Bangladesh Bank.

### **Custom rules**

Any goods for which exemption has been granted by the Government under the Act shall be used exclusively within the limits of a zone. All goods cleared for exports/imports are forwarded to the custom stations/ zone under customs supervision. For exports, a pass is sent with the goods, specifying the name of the importer and the clearing agent, if any, number of conveyance, description and quantity of goods with the marks and number and contents thereof, and on receipt of the goods at the customs station, the officer of customs allowing the export of goods shall retain the pass. For imports, a pass is issued by the custom authorities specifying all the details and the custom officer at the zone retains it.

### **DTA Sales**

The quantity of goods to be imported annually shall not exceed 10% of the goods exported by the concerned enterprise during the previous financial year with prior approval/permission.

### **Subcontracting**

Sub-contracting within the EPZ is allowed;

### **Procurement**

Goods from the tariff area required for further processing in a zone shall be admitted after completion of export formalities, which are normally observed for export out of the country. Because of the various customs formalities, the local manufacturers were loosing interest to sale their products in the Export Processing Zones. In 1991, therefore, such procedures for constructions materials (like rod, cement, GI pipe, PVC pipe, sanitary ware, transformer, switch gear etc.) were simplified. For such supply to the Export Processing Zones, the local manufacturers will produce the challan of the Value Added Tax at nil rate and will be able to receive exemption of the tax automatically on the inputs used for the production of such products.

### **Temporary removal of goods**

No goods can be taken out of zone for transfer to another zone, or for being used in the production, manufacture, processing, repair, or refitting in the tariff area without the prior permission of the Collector of Customs.

The EPZ authority issues necessary "In-Pass" and "Out-Pass" for the machinery and equipment which are required to be brought out of the EPZ areas for the purpose of repair. On the basis of such passes, the Customs Authority, after making necessary entries in appropriate register, shall allow movement of machinery and equipment out of the EPZ areas for the purpose of repair and into the EPZ areas after repair.

### **Solid wastes**

Wastes of commercial value originating as by-products of the industries situated in the EPZ areas may, if necessary, be allowed to be imported into Bangladesh with the prior permission of the Ministry of Commerce, Chief Controller of Imports and Exports and on payment of customs duties and other dues.

## **VI. INCENTIVE PACKAGES**

### **VI.1 Overview of the tax structure in Bangladesh**

Direct taxes in Bangladesh consist of taxes on income (income tax, corporation tax, agricultural income tax) and taxes on property (wealth tax, gift tax, estate duty, capital gains tax, urban property tax, house rent, land revenue, registration and non-judicial stamp).

Indirect taxes include taxes on foreign trade which are a) Import Duty b) VAT (import), and c) supplementary Duty (Import) as well as taxes on domestic goods and services: a) VAT (domestic) b) Supplementary Duty (domestic) and c) Excise Duties

**Corporate tax:** The corporate tax rate for publicly traded companies it is 30%, for non publicly traded companies it is 40%. The personal income tax consists of four slabs with the highest rate of 25%

**Customs Duty:** The maximum import duty in 1992 was 350 per cent. Currently it is 25 percent with four tariff bands of customs duty : 0%, 6%, 13%, and 25%.

Due to the application of a number of other charges, such as supplementary duties and surcharges on imports, the average unweighted customs duty does not reflect the true extent of nominal protection. According to World Bank estimates, if these charges are taken into account, the average nominal protection rate stood at 27 per cent in 2002 while the average duty was [22] percent.

**Value Added Tax (VAT 1991):** Prior to 1991, domestic production and sales were subject to excise duty and sales tax respectively. In 1991, VAT replaced them. VAT is imposed on goods and services at import stage, manufacturing, wholesale and retails levels at the rate of 15 percent for both goods and services; 15 percent for all business or industrial units with an annual turnover of Taka 2 million and above; 4 percent where annual turnover is less than Taka 2 million. There is also a supplementary duty (SD) imposed at local and import stage under the VAT Act, 1991. Existing statutory SD rates on goods vary from 20% to up to 350%.

**Provincial taxes:** There are several provincial level taxes including octroi duty, water , electricity.

### **VI.2 Fiscal incentives offered**

BEPZA provides several tax, foreign exchange, customs and labor incentives to investors in the EPZs.

**Indirect Tax exemption:** Since 1981, exemption was granted from the whole of customs duties and sales tax leviable on the capital machinery and spares, instruments, apparatus and appliances including testing and quality control equipment and parts thereof, if these were imported for installation in an Export Processing Zone and raw materials, packaging materials, construction equipment and materials for use in EPZs. Bangladeshi goods or raw materials sold against foreign

exchange for use or processing in EPZs were treated as exports from Bangladesh and were subject to usual export formalities including payment of export duty. There were also eligible for export incentives from time to time. No excise duty was levied on goods produced in EPZs. In 1996, exemption from all import duties, value added tax (1991) and supplementary duty imposed on imported goods only for processing and value addition in the Export Processing Zones was granted. In 1998, these exemptions were widened to all import into EPZs.

**Direct tax exemptions:** In 1981, a tax holiday of 5 years was granted and salaries of a technician for a period of three years was exempted from tax payable. In 1986, the tax holiday was extended to 10 years and after the expiry of tax holiday, the tax liability was reduced to 50% of total tax attributable. Also, the dividend income of non-resident shareholder of a company out of its profits from any industry set up in any Export Processing Zone was exempted from the tax payable for the period for which the industry enjoyed tax exemption. Such exemption was also available even after the expiry of the tax exemption period if the dividend income was re-invested in the same project by the non-resident shareholder. Income tax on interest on borrowed capital was exempted and accelerated depreciation to any machinery or plant, other than office appliances and road transport vehicles within the tax exemption period was allowed. To these incentives, exemption from stamp duty on transfer of land in EPZs was added in 1987. Tax exemptions were again reformed in 1998, when additional incentives for the zones set up in backward regions were introduced. For instance, subsidy of 50% is now given on land and factory rent in these zones. Recently, the government has also announced a 30% cash incentive for agro based industries in three backward zones of Uttara, Mongla and Eshwardi which was already available to units outside the zone. Table 1 presents a comparison of the fiscal incentives under the EPZs and outside the EPZs.

**Table 1: A comparative analysis of Fiscal incentives**

1. Tax Holiday :	<p><b>EPZ :</b> 10 years with complete exemption from dividend tax for three years subject to certain condition</p> <p><b>Outside EPZs :</b> Generally 5 to 7 years in selected industries (Industrial undertakings not enjoying tax holiday will enjoy accelerated depreciation allowance. Such allowance is available at the rate of 100 per cent of the cost of the machinery or plant in the first year). This also includes export income from handicrafts and income from computer software business up to 30th June, 2008</p>
2. Tax exemptions	<p><b>EPZ:</b> Income tax rebate on export earning will be given at 50 percent after tax holiday Exemption of income tax on interest on borrowed capital. The expenditure incurred by an employer in respect of the remuneration of a foreign technician is fully exempted from income tax subject to the stipulated conditions.</p> <p><b>Others:</b> Income tax rebate on export earning given at 50% Tax exemption on the interest on foreign loans under certain conditions. Listed companies are entitled to 10% tax rebate if they declare dividend of 20% or more. The expenditure incurred by an employer in respect of the remuneration of a foreign technician is fully exempted from income tax subject to the stipulated conditions.</p>

2. Duty :	<p><b>EPZ :</b>  Duty free imports of capital goods, raw materials and all other materials used within zones  Exemption from VAT on all goods imported in the zones  Duty-free import of three motor vehicles under certain conditions.</p> <p><b>Other Units:</b>  No import duty for export oriented unit on machinery and spare parts, if it is in backward area. Spare should not exceed 10% of the value .  For all other units it is @ 5% ad valorem. spare parts up to 10 percent of the value allowed  For raw materials: duty drawback is fixed at a flat rate on exportable and potentially exportable goods. Exporter will receive duty drawback at a flat rate directly from the relevant commercial banks  Value Added Tax (VAT) is not payable for imported capital machinery and spares.</p>
3. Personal income tax Law :	<p><b>EPZs:</b>  Exemption from income tax up to 3 years for the expatriate employees in industries  Exemption from the tax payable on the dividend income of non-resident shareholder of a company out of its profits from any industry set up in any Export Processing Zone, for the period for which the industry enjoys tax exemption. Such exemption shall also be available even after the expiry of the tax exemption period if the dividend income is re-invested in the same project by the non-resident shareholder.</p> <p><b>Outside:</b> Exemption of income tax up to 3 years for the expatriate employees in industries</p>
4. Remittance :	<p><b>EPZs and non-EPZs:</b> Facilities for full repatriation of invested capital, profit and dividends.</p>
6 DTA sales	<p><b>EPZs:</b> 10% of exports  100% percent export-oriented industry outside EPZ: allowed to sell 20% percent of their products in the domestic market on payment of applicable duties and taxes.</p>
Other incentives to all exporting units	<p>The facility for importing raw materials, which are included in the banned/restricted list, but required in the manufacture of exportable commodities.  The import of specified quantities of duty-free samples for manufacturing exportable products are allowed  The local products supplied to local industries or projects against foreign exchange L/C will be treated as indirect exports and be entitled to all export facilities.</p>
Incentives to export oriented units outside the zone	<p>The Export-oriented industries which are identified by the government as "Thrust Sector" will be provided special facilities and venture capital support.  The export-oriented industries, further to the provisions of Bangladesh Bank foreign exchange regulations, will be entitled to receive additional foreign exchange, on case to case basis, for publicity campaign, opening overseas offices and participating in international trade fairs.  facilities for Bonded Warehouse and back-to-back Letter of Credit  The arrangement for providing loans up to 90 percent of the value against irrevocable and confirmed Letter of Credit/Sales Agreement.</p>
Cash Incentives	<p>EPZ: 30% cash incentive to agro units  Outside exporters: cash incentives on agro, leather, handloom, local fabrics, Frozen Shrimp and other fish and so on</p>

### **VI.3 Non fiscal incentives offered**

Non-fiscal incentives have also been extended over the years. In 1985 the government allowed operation of Offshore Banking units in the zones, exchange controls were simplified, foreign currency loan from abroad under direct automatic route was allowed and industries were allowed to retain the export proceeds, when realized, on convertible foreign currency accounts.

### **VI.4 FDI Policy**

Bangladesh maintains a highly liberal regime for FDI. The policy allows foreigners to have 100 percent ownership of businesses and promise foreign investors equal treatment with domestic capital. Recently the government allowed foreign firms to obtain working capital loans in taka from local banks. Most foreign firms are able to repatriate profits, dividends, royalty payments and technical fees without difficulty, provided the appropriate documentation is presented to the Bangladesh Bank. Some of the incentives offered to foreign investors in Bangladesh are as follows and are not EPZ specific. Apparently, foreign investors have no special incentives to operate from EPZs.

- All foreign investments secured by law.
- No ceiling on extent of foreign investment.
- Full repatriation of profit and capital permissible.
- Repatriation of investment including capital gains, if any, permissible.
- Remittances are allowed for a) all post tax profit and dividend on foreign capital, b) savings from earnings, retirement benefits, personal assets of individual on retirement/ termination of services and c) approved royalties and technical fees.
- 6 months multiple entry visa for the prospective new investors.
- Re-investment of repatriable dividend treated as new investment.
- Citizenship by investing a minimum of US\$ 5,00,000 or by transferring US\$ 10,00,000 to any recognized financial institution (non-repatriable).
- Permanent residents by investing a minimum of US\$ 75,000 (non-repatriable).
- Tax exemption on royalties, technical know-how fees received by any foreign collaborator, firm, company and expert
- Foreign investors or companies may obtain full working loans from local banks and development institutions. The terms of such loans will be determined on the basis of bank-client relations.

### **VI.5 Labor laws**

Bangladesh's labor unions, most of them associated with political parties, are often militant. Violence and the threat of violence by some trade unions have forced entrepreneurs to offer wage increases in excess of productivity increases, raising unit labor costs. Worker layoffs, or the mere threat of reductions-in-force, can be expected to cause some of the most serious and confrontational labor disputes. In 1989, therefore, the government exempted the zones from three major labor laws. These included the Factories act, The industrial dispute act and the Employment of Labor (standing orders) act. These were replaced by two instructions : Instruction 1 and Instruction 2. These instructions carried detailed guidelines on the classification of employees , minimum wages, additional benefits to be paid by the employers in general and for electronic industry, terry towel industry and textiles in particular. This was a major incentive to the EPZ units.

**Instruction 1:** Regulates classification of employees, service records, leave, maternity leave, termination of employment, and payment of wages of employees in export processing zones. Promulgated by the Bangladesh Export Processing Zones Authority

**Instruction 2:** Determines wages and benefits for workers in the garment, electronics, terry towel, and textiles industry operating in export processing zones.

Law forbids formation of any labor union in EPZS. Strike within the zones prohibited. BEPZA is vested with responsibility to administer labor matters for all enterprises in EPZs. In addition to the set minimum wages (see table 2), employees benefit from other schemes, such as Conveyance Allowance, House Rent, Medical Allowance and Festival Bonus.

**Table 2: MINIMUM WAGES (MONTHLY) in US \$**

I	Garment Industry	Electronics	Textile Industry
Apprentice/Trainee	25	28	25
Helper	40	-	40
Junior operator	48	48	48
Operator	70	70	70

Under US pressure, the Parliament of Bangladesh enacted a law giving legal coverage to Trade Unionism in EPZs on July 13, 2004. Under the Act EPZ workers are allowed to form welfare councils. Each industrial unit will have one welfare council by Oct. 31, 2006. After this date, workers will have the right to form trade unions. Workers of an industrial unit can move for Trade Union right if supported by 30% of the work force of that unit. The industrial unit will then hold referendum on whether or not trade unionism should be activated. At least 50% of workers of the unit will take part in the referendum and at least 60% of them will have to vote in favor of trade unionism.

## **Annex 2: Characteristics of EPZs in India**

### **I. EPZ POLICY REGIMES**

The success of any zone is strongly attributed to the policy framework. An attractive policy framework mainly covers areas such as zone administration, preferential policies & procedures, fiscal incentives, labor laws and flexibility in foreign investment and repatriation. More specifically, authorities in export processing zone offer single window administrative services with streamlined procedures, lengthy tax holidays, permission for 100% foreign ownership, very minimal restrictions in terms of profit repatriation and foreign exchange controls and relaxed labor laws. These concessions and incentives determine the advantages that industrial units enjoy in these sectors relative to the units outside the zones. Most countries have enacted overriding Special Economic Zones Laws / Policies and have on a regular basis made alterations/amendments to their policies to come up with an attractive framework to induce zone investment. In India, four phases in the evolution of the EPZ Policy may be identified.

In what follows, we provide an overview of the policy regime in each of the above phases. This is followed by a more specific analysis of legal policy framework (Section II), administrative set up (Section III), Approval mechanism (Section IV), rules and procedures pertaining to custom, subcontracting, domestic procurement, domestic sales, scrap disposal (Section V), and incentives including fiscal incentives, FDI policy, DTA sales and labor policy (Section VI)

#### **I.1 Initial Phase : 1964-1982**

After gaining independence in 1947, India embarked on a path of self-reliant economic development, the two main planks of which were planning and import substitution. To compensate exporters for the disadvantages created by the import control regime, the government initiated various schemes such as Cash compensatory support (1967), duty drawback (1972) and import entitlement license scheme (1962). However the bias created against exports could not be neutralized by these export incentives. For tapping the export potential of EPZs and encouraged by their growth in other countries, in 1965 the government set up the first EPZ at Kandla, a major port north of Bombay. It was one of the earliest zones set up in Asia. The site of Kandla was selected with the multiple objectives of assisting Kandla port as future alternative to the increasingly congested port of Bombay, developing an industrially backward region of the Kutch, and helping the refugee population from Sindh after the partition

A second zone followed in 1973. It was located north of Bombay city at Santa Cruz in 1974 with the objective of accelerating the progress of electronics manufacturing in India and to take advantage of the growing electronics market which was also relying on zones in other parts of the world.

An overall inward looking trade policy with umpteen controls and regulations followed by the government influenced the EPZ policy also. The system was characterized by extensive government controls over almost every aspect of zone administration. Zone authorities were delegated limited powers. There was no single window facility within the zone. The policies and procedures were rigid and the package of incentives and facilities was not attractive. This was because the domestic economy was heavily protected with high tariff rates, quantitative restrictions on imports and highly restrictive controls on foreign investment and it was feared that the concessions offered in the zone sector might be exploited by the entrepreneurs who set up units in the zone for their own benefits.



In addition, infrastructural facilities were also inadequate. Due to budgetary constraints and lack of proper planning, essential export infrastructure including rail and air links, banking, power, liner shipping, telephones, telex, housing and transport could not be developed. Government development expenditure which stood at Rs. 2.43 million in 1975-76 increased to Rs. 15 million in 1981-82. However, as a percentage of total exports, it declined from around 9% to only 1.5% over the same period.

The working of the two zones set up during this period was reviewed by various committees appointed by the government of India. Kandla was reviewed by the Kaul Committee in 1978 while SEEPZ by the Review Committee on Electronics in 1979. These committees pointed out that the growth of EPZs in this phase was hampered by the following fundamental handicaps:

- Absence of a policy
- Absence of implementation authority to centrally coordinate and control.
- Procedural constraints
- Infrastructural deficiencies
- Limited concessions
- Limited powers of the zone authorities to take actions on the spot resulting in inordinate delays.

## **I.2 The Expansionary phase : 1985-1991**

India's trade balance situation started deteriorating in the late 1970s. By 1981-82, the trade deficit became unmanageable. In 1981-82, it was placed at Rs. 5.9 billion. The share of India's exports in world exports had declined sharply from 2.42% in 1948 to .37% by 1981. In order to promote exports, government launched a new scheme of "100% export oriented units" (EOUs) in 1981 as complementary to the EPZ scheme. EOUs can be established anywhere in India but they function under the administrative control of the Development Commissioner of the Export Processing Zone, whose jurisdiction has been notified by the Ministry of Commerce. They undertake to export their entire production, except certain fixed percentage of sales in the Domestic Tariff Area (DTA) as may be permissible under the Policy. They have the freedom to locate their units in places of their choice and are given most of the benefits as provided to units set up in the Zones.

It was believed that free trade zones combined with 100% export oriented units ( under the EOU scheme) could make a useful instrument to the all-out export efforts. Government therefore decided to set up a task force on "free trade zones and EOUs" to recommend measures to improve their functioning, under the Chairmanship of Mr. P.L.Tondon. It recommended that in a country of India's dimension, it is important to locate 4 to 5 more zones to provide a fillip to the country's export promotion efforts.

Following the report, the government immediately initiated actions to establish four more zones. Four EPZs were set up at Noida (North India), Falta (East India) Cochin (South India) and Chennai (South East) in 1984. Thereafter, Visakhapatnam EPZ in Andhra Pradesh EPZ (South East) was established in 1989. Thus, the period witnessed establishment of 5 zones. Though some favorable policy changes were also introduced during this period, there were no significant changes in laws and procedures pertaining to EPZs.

## **I.3 Consolidating Phase (1991-2000)**

In 1991, a massive dose of liberalization was administered in the economy. The policy made a paradigm shift in its focus from import-liberalization to export-orientation. In this new regime,

EPZs were also seen as a major instrument to promote exports. Fresh initiatives were launched by the government to revamp the EPZ scheme. The focus had been on

- delegating powers to zone authorities,
- providing additional fiscal incentives
- simplifying policy provisions and
- providing greater facilities.

Controls were relaxed significantly. There was less suspicion of the private sector activity and permission needed were more freely given.

For encouraging exports of computer software and electronic hardware items including hard disk drives, computers, television, etc., the Ministry of Information Technology launched the scheme of Software Technology Parks of India (STPI) in 1991 and Electronic Hardware Technology Parks (EHTP) parks in 1993 . STPs/EHTPs can be set up by the Central Government, State Government, Public or Private Sector Undertakings or any combination thereof.

#### **I.4 Emergence phase: 2000 onwards**

In the year 2000, the second phase of liberalization was initiated in India. In a major initiative to boost export-led growth and motivated by the success of Chinese Special Economic Zones (SEZs) , the Government of India introduced a new “SEZ Policy” in India through the Export/Import Policy of 2000. SEZs are permitted to be set up in the public, private, joint sector or by the State Governments. SEZ is an almost self contained area with high class infrastructure for commercial as well as residential inhabitation. The units operating in these zones are to be deemed as outside the country’s customs territory and will have full flexibility of operations. The SEZ policy is Government's most significant thrust towards achieving export competitiveness.

On November 1, 2000 the Export Processing Zones at Kandla, Santa Cruz (Mumbai), Cochin and Surat were converted into SEZs. In 2003, the rest of the existing zones namely, Noida EPZ, Chennai EPZ, Falta EPZ and Vishakhapatnam EPZ were also converted into SEZs. According to the official website of the Ministry of Commerce , 61 SEZs are already approved/are under construction. Of these, 16 are in the private sector while the rest are being set up by the state governments and public sector undertaking.

**Table 1 : Summary of EPZ Policy Regime**

	EPZ	Industrial Policies
Initial Phase (1965-1983)	<ul style="list-style-type: none"> <li>➤ Cautious approach.</li> <li>➤ Rigid rules and regulations</li> <li>➤ A new Scheme “100% EOUs” initiated</li> </ul>	High import barriers : High custom duties High quantitative barriers High rates of taxation Highly regulated FDI and technology transfer regime
Expansionary phase (1983-1990)	<ul style="list-style-type: none"> <li>➤ 4 new zones came up. While the existing zones were located in western part of the country, new zones were created to cover north, east and south of India.</li> <li>➤ Cautious reforms in operating rules</li> </ul>	<ul style="list-style-type: none"> <li>➤ Period of cautious reforms</li> <li>➤ Thrust on domestic sector reforms</li> <li>➤ Reforms initiated in almost every aspect of economic life.</li> </ul>
Consolidating phase (1991-2000)	<ul style="list-style-type: none"> <li>➤ Signification policy reforms in governance, incentives, rules and scope</li> <li>➤ Software and Hardware parks were set up as export oriented clusters</li> </ul>	<ul style="list-style-type: none"> <li>➤ Period of liberalization, which slowed down by the mid 1990s.</li> <li>➤ Process was also affected by the East Asian crisis</li> <li>➤ Fiscal Reforms</li> </ul>
Emergence (2000-2005)	Shift from EPZ to SEZ scheme with major policy initiatives	<ul style="list-style-type: none"> <li>➤ Second phase of liberalization started</li> </ul>

Source : Based on the author's analysis

## II: THE LEGAL FRAMEWORK

Special over riding laws and legislation have been formulated at the outset in various countries to provide the necessary regulatory foundation for EPZs. In most countries, legislation has been enacted by national governments to create these zones, usually with an administrative body charged with the responsibility of managing the zone. The powers of the regulatory authority are usually specified in the enabling Act. However, In India, no such legislation came into effect. The policy relating to the EPZs are contained in the Foreign Trade Policy while incentives and other facilities offered to EPZ units are implemented through various notifications and circulars issued by the concerned Ministries/Departments. Table 2 provides summary information on multiplicity of authorities governing EPZs.

**Table 2 : Institutional set up for Policy formulation**

Policies	Authorities responsible
Policy Framework and rules and procedures	Ministry of Commerce and Industry, Directorate General of Foreign Trade
Income tax concessions	Department of Revenue, Income tax Department
Custom and excise related notification :	Department of Revenue, Central Board of excise and custom
Central Sales tax :	Ministry of Finance & Company Affairs, Department of Revenue
➤ Company affairs :	Ministry of Finance and Company Affairs, Department Of Company Affairs
➤ Export credit :	Chief Executives of all Commercial banks
➤ Ministry of environment and forests	(Department of environment) : Environment related issues
FDI	: Department of Industrial Policy & Promotion
➤ Foreign exchange, remittances, job work abroad:	➤ RBI
State level department	
➤ Labor related issues	State labor department and Factories department
Policy framework on environment and forests	Environment, Forests, Science & Technology (ENV) Department
State taxes : Revenue department	Revenue department
Infrastructure Development	Department of urban development
Power	Department/Ministry of Energy
Registration of industries	Directorate of Factories

Source: Created by the author based on the information provided on the official website of the ministry of Commerce

Government of India introduced the concept of Special Economic Zones (SEZs) in the year 2000 through a revision in the Export-Import Policy 1997-2002. However, a well designed policy framework remained non-existent. Though the new SEZ policy introduced some basic changes in the earlier policy, response to these changes was not encouraging. It was then realized that due to the multiplicity of authorities involved in policy making both at the center and the state level, the present system does not inspire enough confidence for investors to commit substantial funds for development of infrastructure and that to provide a long-term and stable policy and expeditious single-window clearance facilities, a Central Act for Special Economic Zones, in line with the international practice, was essential. There was need to provide a comprehensive SEZ policy and framework to satisfy the requirements of all principal stakeholders in an SEZ - developer & operator, occupant enterprise, out zone supplier and residents. The federal structure also makes it imperative to have special overriding legislation at Central as well as State levels to comprehensively cover all aspects. Consequent upon this realization, a SEZ Act was enacted in 2005. Special overriding laws and legislation were formulated to provide the necessary regulatory foundation for SEZs. However, the Act could become operative w.e.f. February 2006 when SEZ rules were finalized. This Act along with SEZ rules provides the umbrella legal framework for establishment of SEZs and also for units operating in such zones.

This Act for the first time in the history of the EPZ policy spells out the objective of the scheme. These are to generation of additional economic activity, promotion of exports of goods and

services, promotion of investment from domestic and foreign resources, and the development of infrastructure facilities.

The government of India maintains that the generation of economic activity , primarily in the manufacturing sector is the underlying objective of the scheme. Exploiting the full potential of the concept of SEZs would bring large dividends to the state in terms of economic and industrial development and the generation of new employment opportunities. In effect SEZs are expected to be engines for our economic growth.

The Government of India has advised the State Government to formulate a policy for the development of SEZs to provide a legal framework to cover state subjects like state commercial Taxes and duties, local taxes and duties, Power, Water, Pollution Control and Environment, Labor , law and order, local governance rules and regulations and companies’ registration. A “Model State Act” is developed to provide guidelines to the state governments. A few state governments have already enacted their SEZ Act.

Our discussion above suggests that, until the year 2000, the central government had taken the principal responsibility for developing these zones. It had largely developed the zones and had invested the necessary funds to create zone infrastructure. Contrary to this, the primary thrust of the Indian SEZ model is to facilitate state government run SEZs and ‘private sector led’ SEZs. New SEZs will now be established and operated by the state governments, public sector undertaking, private sector and the joint sector. The Central government would be responsible for the broad policy framework and monitoring of the scheme.

Unlike the earlier EPZ model, the SEZ model envisages a minimum size of 1000 hectare for all Greenfield SEZs. The minimum size stipulated for green-field SEZ for multi product zone is 1000 hectare. In each zone the minimum processing area stipulated in the SEZ act 2005, is 25% of the total area . Recently, this has been extended to 35% by introducing an amendment.

**Table 3: Minimum size stipulated for sectoral and other SEZs**

Nature of Economic Activity	Minimum Size
Multi product zone	1000 hectare
Service sector zone	100 hectare
For electronic hardware and software	10 hectare ( minimum built up area =0.1 mm sq. mt)
Bio technology, non conventional energy, gems and jewelry	10 hectares
Free trade and warehousing zones ( for multi product)	40 hectare ( built up area=.1 Mn. Sq. mt)
Free trade and warehousing zones ( for specific sector)	No minimum area

Source: The SEZ Act

There is a single policy framework for each of the three principal stake- holders identified by the Act :

**Developers**, including a co-developer, which is an enterprise engaged in the establishment and development of the zone, including individual components of infrastructure such as roads, water and drainage system.

**Operators**, which are enterprises engaged in the operation and/or maintenance of all/ any infrastructure facility in the zone

**Tenant/ units**, which are the occupant enterprises within the zone and include enterprises engaged in manufacturing, services and trading.

Prior to the SEZ Act	After the Act(2005)
<ul style="list-style-type: none"> <li>➤ EPZ : Legal Framework was provided by the Foreign Trade Policy and notifications of concerned departments for all the exporting units operating in India.</li> <li>➤ EOU : Legal Framework was provided by the Foreign Trade Policy and notifications of concerned departments for all the exporting units operating in India.</li> <li>➤ The policy provisions for STP and <b>EHTP Schemes</b> are substantially the same as those applicable to EOUs</li> </ul>	<ul style="list-style-type: none"> <li>➤ SEZ Act for the SEZ units</li> <li>➤ EOUs/STP/EHTP : No change in institutional set up for policy making.</li> </ul>

### III. ADMINISTRATIVE SET UP

Efficient and effective zone administration is a crucial factor contributing to the success of such zones. For this mechanism to work, it is necessary for the government to delegate the powers under various central and state government functions at the zone level so that it becomes an autonomous administrative unit for all commercial activities. In many countries it has been seen that the zone administration authority is usually a representative of the Municipal Government in which the zone is located. These authorities are primarily responsible for the development and maintenance of the zones. Procedural aspects are streamlined thus offering “single window” facility to the investors. This is achieved by clear devolvement of local body powers and functions at the zone level and by vesting the zone administration authority with these powers. The new SEZ policy in India is a step towards that direction. The present administrative set is evolved in the following two stages.

#### *Administrative set up under the EPZ regime*

EPZs ( prior to 2000) in India had a three-tier administrative set up.

- At the Apex level, there was a non statutory body headed by the Commerce Secretary. Development Commissioners were also members of this body. It periodically reviewed the working of the zones and considers various policy issues.
- At the middle level is the Board of Approval, which examines proposals for setting up enterprises and foreign collaborations.
- At the third tier is the Development Commissioner who is chief executive of the EPZ. He attends day-today administration, enforces various statutory provisions and monitors the performance of EPZs. He is assisted by a joint development commissioner (JDC), a Deputy Development Commissioner (DDC) , a joint/deputy Commissioner /assistant Commissioner of Custom and three to six assistant development commissioners. Assistant commissioners are assigned the responsibilities of estate management, public relation, EOUs’ administration, SEZ administration and labor. They have clerical staff to assist them. Joint/Deputy/ Assistant Commissioner of Customs is assisted by preventive officers, appraiser/s, and section officer and clerical staff. In addition, there are Accounts

Officer who heads the accounts section and a security officer who is responsible for the security of the zone. However, depending on the requirement and availability, there are variations in this set up across zones. For instance, the number of Assistant Commissioners and the division of responsibilities among them varies across zones. The strength of the Custom also varies across zones. All employees of the zones enjoy the status of central government employees and most senior officials are on deputation from the central Ministries.

#### *Administrative set up under the SEZ regime*

The typical administrative structure has not changed significantly after the introduction of the SEZ scheme even though functions, powers and constitution of authorities have undergone some changes. Under the SEZ scheme, the functioning of the zones is governed by a tree/four tier administrative set up –

- At the highest level, there is a non statutory body headed by the Commerce Secretary
- The Board of Approval now examines not only the proposals for setting up units but also SEZs.
- The Unit Approval Committee at the zone level is dealing with approval of units in the SEZs and other related issues. It consists of Development Commissioner, Customs Authorities and representatives of State Government. The performance of the SEZ units are monitored annually by the Unit Approval Committee and units are liable for penal action under the provision of Foreign Trade (Development and Regulation) Act, in case of violation of the conditions of the approval. A Development Commissioner, who is also heading the Unit Approval Committee, heads each Zone.

#### ***Administrative structure of the state and private SEZs***

All new zones basically function under the administrative control of the Development Commissioners of the Central Government owned SEZs. The government has notified the jurisdiction of each of the 7 central government zones<sup>3</sup> for the administration of these units. For instance, all new zones in North India fall under the jurisdiction of Noida SEZ Development Commissioner. He would be assisted by a set of officers drafted from various departments for issuing requisite clearances required by the units to be set up in the SEZ.

Currently, each state/privately owned zone is administered by an officer of the rank of Assistant Development Commissioner. He is deputed by the Development Commissioner of the zone in the jurisdiction of which it falls. He is assisted by custom officers and his own administrative staff appointed by the Development Commissioner. The Development Commissioner remains in constant touch with this set of officers who are to assist him in administration. An officer of the Assistant Development Commissioner's rank at the DC office assists him in dealing with these officers. Maintenance Agencies assisting the developer have chambers within the SEZ.

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<sup>3</sup> These are: Noida, Kandla, Santacruz, Madras, Cochin, Falta and Vishakhapatnam

**Table 4: Administrative Set up of exporters in India: A Comparative Analysis**

Type of exporter	Analysis of Administrative Set up
EPZ/SEZ	<p>Presence of administrative authorities within the bonded area, Dealings with the state government departments are facilitated by the zone authorities</p> <p>Each zone has offices of the infrastructure maintenance agencies, banks, post offices, ATMs, in some cases OBUs within the zone. Advantage of having personal relationships with the officials</p> <p><u>Under the SEZ scheme :</u> single window clearances</p>
EOU	<p>Prior to 1992, : governed by the central and state agencies</p> <p>After 1992 : Centrally administered by the central government zones in whose jurisdiction they are located ( but approval was not under the control of DCs).</p> <p>Deal with all state government departments independently in all other matters under the purview of the state governments.</p>
STP/EHTPs <sup>4</sup>	Administered by directors under the powers delegated by the Ministry of Communication and Information Technology
Domestic companies	Deal with central and state government departments independently.

#### IV. THE APPROVAL PROCESS

##### *Approval process before 1991: Highly centralized*

During this period, approvals were centralized with the Board of approval. It included representatives of relevant Ministries from both the Central and the state governments. The staff in the DC's office used to screen the application and discuss it with the entrepreneur before it was finally put up with the Board. There were no guidelines on cases which fall within the desirable and permissible limits. The Board of Approval did not have the powers to grant the various clearances and permissions required. It was a recommendatory body. Entrepreneurs had to acquire individual clearances from various state government and central government departments. Units needed clearances from drugs and cosmetics licenses, license under the factory act, production and excise act, boiler act, explosive act and so on. This involved a substantial time and financial cost for the entrepreneurs.

##### *After 1991: Decentralization of the approval process*

Powers of the Board of Approvals were decentralized by introducing an automatic approval route in 1991. Approvals under the automatic approval routes for EPZ units were granted by the DCs. Investment proposals under the automatic routes were cleared subject to following conditions :

- Foreign exchange requirement does not exceed Rs. 100 million
- Exports are to be directed to the general currency area

<sup>4</sup> In the rest of the paper, the term EOUs is inclusive of STPs and EHTPs also



- Payment of fees for foreign technology and royalty is less than Rs. 10 million/8%
- Sub contracting in the DTA is not envisaged<sup>5</sup>
- The proposed industry is non polluting
- The project does not fall in the restricted list.
- Value addition is as per the prescribed norms.

Proposals not covered by the automatic route were forwarded by the DC to the Board of Approval (BOA) for consideration. On consideration of the proposal by the Board, the decision would normally be conveyed within 15 days.

All proposals for FDI/NRI/OCB investment in EPZ/EOU/SEZ were eligible for approvals under the Automatic Route subject to prescribed parameters<sup>6</sup>. All proposals not covered under Automatic Route the applicant were directed to seek separate approval of the FIPB. It was stipulated that once the investment in equity had been approved, the import of capital goods, components and raw materials or the engagement of foreign technicians for short duration did not require any additional approvals. Approval of Ministry of Home Affairs was not needed for hiring of foreign nationals holding valid employment visa.

Another important development during the 1990s was the broad basing of the Board of approval. The earlier system of an inter-ministerial committee for approving EPZs was dispensed with and a combined board of approval was set up for both the EOU and EPZ units. The combined Board of Approval was a larger body and quite broad based to provide a single interface to those keen on setting up units. It had representatives of various Ministries like Small-Scale Industries, Environment and Forests, Science & Technology as members of the board. It has been broad based to include a representative of the Central Board of Direct Taxes and state government representatives also.

However, after the approval was acquired (through automatic/BOA route), as during the first period, entrepreneurs had to acquire individual clearances from various state government and central government departments. Green Card are issued by the DC concerned EPZ units automatically after the approval to facilitate its interactions with the departments outside the zone.

### ***After 2000: Single window clearance***

Any proposal for setting up units under EOU (excluding STP/EHTP)/SEZ scheme under automatic route are approved at the Zonal level by the Approval Committee consisting of Development Commissioner, Customs Authorities and representatives of State Government and

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<sup>5</sup> This condition was dropped in 1998.

<sup>6</sup> Approvals were placed under the automatic route for FDI/NRI and OCB investment, except:

- All proposals that require an Industrial Licence include (a) items requiring an Industrial Licence under the Industries (Development and Regulation) Act, 1951; (b) more than 24% foreign equity investment for units manufacturing items reserved for small scale industries; and (c) all items which require an Industrial Licence in terms of the locational policy notified by Government under the New Industrial Policy of 1991.
- All proposals in which the foreign collaborator has a previous venture/tie-up in India.
- All proposals relating to acquisition of shares in an existing Indian company in favour of a foreign/NRI/OCB investor.
- All proposals falling outside notified sectoral policy/caps or sectors for which FDI is not permitted and/or whenever any investor chooses to make an application to the FIPB and not to avail of the automatic route

departments. Conditions for automatic approvals are relaxed considerably. Automatic approval to projects is given where

- (a) Activity proposed does not attract compulsory licensing or falls in the services sector except IT enabled services;
- (b) Location is in conformity with the prescribed parameters;
- (c) Units undertake to achieve exports and value addition norms as prescribed in the Export and Import Policy in force;
- (d) Unit is amenable to bonding by customs authorities; and
- (e) Unit has projected the minimum export turnover

All other projects are cleared by the Board of Approval.

For setting up of SEZ in the Private/Joint/State Sector is routed through the concerned State government who in turn forwards the same to the Department of Commerce with its recommendations for consideration of the Board of Approval.

Under the SEZ Act, provisions have been made for single window clearance for setting up of an SEZ, setting up a unit in SEZs and clearance on matters relating to Central as well as State Governments.

A consolidated application seeking permission for setting up of a unit and all other clearances shall be made to the Development Commissioner. It covers

- annual permission for subcontracting,
- water connection,
- power connection,
- sales tax registration,
- small scale industries registration,
- allotment of land/SDF in the zone,
- registration with the Central Pollution Control Board,
- approval from inspectorate of factories,
- pollution control clearances
- Any other approval required by the state government

In other words, most clearances are to be given at a single point i.e. Development Commissioner who through a committee constituted under him could grant approvals as per the guidelines laid down for the purpose.

For all clearances required from state government agencies, State Govt shall notify a single form of application and Letter of Permission issued by the DC shall contain approvals of subjects covered by the application form

**Table 5: Approval Process of EOUs and other Domestic exporters:**

Domestic companies	Centralized: Secretariat of Industrial Approval, Ministry of Commerce, New Delhi
Foreign companies	Automatic route : RBI; Others: FIPB
STPI/EHTP	Jurisdictional STP authorities
EOUs (excluding STP/EHTP)	Pre 1998: Centralized : Secretariat of Industrial Approval Post 1998: Automatic route: Unit approval committee of the zone in whose jurisdiction the unit is located. Others: BOA ( domestic), FIPB (Foreign)
EPZs	<b>Prior to 1991:</b> Centralized with BOA <b>1991 onwards:</b> Automatic route : DC including FDI Others : BOA ( for domestic and FIPB ( for foreign) <b>Post 2000:</b> Unit approval committee under automatic scheme (Domestic and foreign); BOA for others; FIPB for foreign investment <b>Post 2005</b> Approval committee under automatic route with single window clearance BOA for other : FIPB for foreign

### Approval selection criteria

#### *Value added criterion :*

Initially, units were required to generate the required value added in their activity. This criterion was strictly adhered to. Proposals envisaging lower VA were rejected. These norms were considerably liberalized during the 1990s. The threshold VA norm was revised from time to time.

- Initially, it was uniform across sectors at 30% for Kandla zone and 50% for SEEPZ.
- During the late 1980s (Foreign trade policy 1985-88), it was fixed at 30% with some sectoral exceptions.
- In 1991, it was revised to 20%. However, there were sectoral exceptions. These included, engineering industries, textile sector industries (30%), garments (40%), computer software (60%), electronics hardware (15%), and gems and jewelry (10%-25%). In addition, latex gloves, cigarettes , granite etc were also subject to sector specific norms.
- In 1997: general VA condition of 20% was done away with and norms were made sector specific. Electronic units were allowed to be set up without stipulation of a positive net foreign exchange earning.
- In addition to achieving value addition norms, units were also required to undertake export obligations. Export projections for a period of 5 years of initial bonding were considered as export obligation. This was an ad hoc obligation. During the 1990s, it was rationalized by linking it with the imports of capital goods.

*Post 2000*

In the SEZ scheme, these obligations are done away with. Under the SEZ rule, a unit has to achieve positive net foreign exchange to be calculated cumulatively for a period of five years from the commencement of production.

In the 2002 Policy document such obligations were dropped for EOU units also.

**Table 6: Comparison of VA norms: EOUs vs EPZs**

Time Period	VA Norms
Pre 1990	EPZ : 30% EOU: 20%
1991-2000	EPZ/EOU : 20% in general with sectoral exceptions Separate norms for software and electronic hardware
Post 2000	SEZ: Positive net foreign exchange earning cumulatively over the period of five years
Post 2002	EOU: Positive net foreign exchange earning cumulatively over the period of five years

Note : Since 1996, the term EOUs is inclusive of STP/EHTP

*Sectoral coverage*

Prior to 1990, EPZ policy were allowed primarily in manufacturing activities. Trading, services, and agriculture related processing activities were out of the purview of the EPZs. The scope and coverage of the EPZ/EOU scheme was enlarged.

In 1992, sectoral scope was extended to include : Agriculture, horticulture and aqua culture, animal husbandry or similar activity and production of software. Services were considered on merit basis.

In 1994, coverage of agricultural sector expanded with the inclusion of floriculture, pisciculture, sericulture, viticulture, poultry etc.

In 1995, reconditioning, repair, testing, calibration, quality improvement, reengineering and upgrade of technology.

In 1997, special thrust was given to software units.

In 1999, EPZs permitted units in services

Lastly, in 2000, Trading was also permitted. The trading units may also undertake re-packing, labeling, minor processing etc. for which they shall be eligible for duty free procurement of packing, labeling materials etc. and the required capital goods. Further, the trading units may also procure goods without payment of duty from other EOU/EPZ/EHTP/STP units for exports. The trading units shall be required to achieve positive NFEP and export performance. Trading is not permitted in the EOU sector.

**Table 7: Sectoral coverage: EPZs and EOUs**

<i>Prior to 2000</i>	<i>Post 2000</i>
Sectoral coverage remains the same for EOUs and EPZs	Trading activities are permitted only in SEZs and not EOUs.

*Other criteria*

In addition to the selection criteria specified in the policy document, the approval authorities certain other factors were given weight in the consideration of granting approval.. These included the potential for employment generation, and the possibility of technology transfers etc.

Furthermore, certain types of economic activities were not approved within the zones. These were, for example before 1990 cases where the indigenous materials required for the manufacture of an export product in the zone was subject to an export restriction or was banned for exports, proposals based on the products using domestic raw materials, proposals for the use of raw materials obtained from various birds and animals which have been declared “threatened specie” were approved rarely, or projects that affected exports from the DTA were also rejected’

In the 1990, only non-polluting units were allowed to operate in the zones. Recycling of ferrous and non-ferrous metal proposal were considered only if the unit has Ignots making facility and proposes to achieve value addition. Certain items were considered sensitive items. These included: yarn texturising unit, textile processing, pharmaceuticals/ drugs formulations/ recycling of ferrous and non-ferrous metal scraps etc.

*The SEZ policy* in 2000 specifies a list of prohibited items which were:

- Recycling of plastic scrap or waste or other goods
- Reprocessing of used clothing or secondary textiles.
- Certain special chemicals, organisms, materials, equipments and technologies

Finally, in some zones, specific considerations also figure in the approval process: These include

- water intensive units are not allowed in Madras EPZ, Falta EPZ and Kandla EPZ
- Noida does not permit plastic scrap units
- Polluting units are not allowed in the zones

**Table 8 : Eligibility Criterion: A Comparative analysis**

<i>Pre 2000</i>	<i>Post 2000</i>
Eligibility criterion remains the same for EPZ and EOUs	Trading is allowed in SEZs while it is not permitted in the EOUs.
Non polluting activities not allowed in the zone. Such restrictions not for EOU,	Non polluting/recycling activities are not permitted in the zones. No restriction in the EOUs
zone specific considerations are given weight. No such considerations for EOUs	zone specific considerations are given weight. No such considerations for EOUs

## V. RULES AND PROCEDURES

### Delegation of powers to DCs

Prior to 1991, zone authorities had limited powers. There was no single window facility within the zone. The zone authorities did not have the powers to grant the clearance and permissions required. These powers were highly centralized with the Board of Approval and other concerned department. For instance, all custom related permissions including DTA sales were granted by the Chief Controller of Imports and Exports, New Delhi. Furthermore, any deviation from the obligations stipulated in the original approvals was to be cleared by the Board of Approval. The procedures were irksome and time consuming.

During the nineties, several policy changes were introduced to delegate powers to the Development Commissioners of the Export Processing Zones (EPZs)<sup>7</sup>. Development Commissioners of Export Processing Zones were now authorized to exercise the following powers in respect of units under EPZ/EOU scheme within their respective jurisdiction:

- To allow enhancement in the value of imported Capital Goods up to 75% of the value approved initially, subject to the maximum of Rs. 100 million<sup>8</sup>
- To allow increase in the value of Capital Goods imports in terms of Rupees, owing to foreign exchange rate fluctuations vis-à-vis foreign currencies.
- To attest list of imported capital goods, both new and second-hand, within the approved value, including additional value permitted in (1) above.
- To permit capacity enhancement of EOUs/EPZ units, without any limit in respect of de-licensed industries only, provided the requirement of additional imported Capital Goods does not exceed 50% of approved value subject to a maximum of Rs. 10.00.
- To permit broad-banding subject to the condition that it does not result in procurement of additional capital goods imports beyond 50% of approved value subject to a maximum of Rs.10.00<sup>9</sup>.

Besides, DCs were also allowed to

- authorize the change in name of the company or the implementing agency,
- to permit change of location from the place mentioned in the Letter of Approval/ Letter of Intent to another,
- to extend the validity period of Letter of Intent/Letter of Permission/Letter of Approval, in the case of EOUs and EPZ units, by three years,
- to revise the Value Addition upward or downward up to the minimum Value Addition percentage as prescribed for the item of manufacture under the Policy,
- to permit disposal of obsolete capital goods, in DTA, on payment of applicable duties, without any restrictions. to permit import of office equipment in accordance with EXIM Policy and Handbook of Procedures,
- to revise prospectively the export obligation stipulated in the approval letters ,
- to permit merger of two or more EOUs/EPZ units into one EOU/one EPZ unit,

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<sup>7</sup> vide Press Note No. 4 (1995 Series) dated 19<sup>th</sup> April, 1995. More powers were further delegated vide Press Notes No. 15 (1997 Series) dated 10.11.97, No.14 (1998 series) dated 16.10.98 and No. 20 (1998 Series) dated 15.12.98.

<sup>8</sup> The enhancement in value of imported Capital Goods can be on account of additional items of import or on account of increase in prices of permitted items.

<sup>9</sup> Broad-banding will be allowed in respect of only those industries, the design and production facilities of which are common and have similar manufacturing process and where physical exports are envisaged.

Under the SEZ scheme, the Development Commissioner is the nodal officer for SEZs and EOUs and help in resolution of problem, if any, faced by the units / developer. In addition, he is also delegated the

- powers of labor commissioner ;
- powers of issuing pollution certificates for “green industries”. The State Government would notify a list of non-polluting industries where no pollution clearance would be required in SEZ and NOC for such units, irrespective of their size, be given by the development commissioner; and
- powers of permitting any kind of physical inspections within the zone. A schedule would be worked out in consultation with the Development Commissioner and then only the inspections would be carried out. However, in case of any specific information of any violation, the inspecting agency would be visit after taking prior approval of the DC for their proposed inspection.

**Custom:**

The entire operations of an EOU/EPZ shall be in a Custom bonded premises, unless otherwise specifically exempted from physical bonding. In the case of EOU, the entire factory is the bonded area. Normally, three different custom bonds are to be executed by a unit with the assistant/deputy commissioner of custom to cover the activities, which include trans-shipment of duty free imports / exports between port of import/export and units' premises. These are

- Trans-shipment bond : It covers trans-shipment of goods from the port of importing/exporting country to the port of the country where the unit is located
- Transit bond : It covers transit from the port to units' premise
- Induce bond : It ensures that the imported goods are incorporated in the final product.

In addition, units have to execute bonds with the assistant/deputy commissioner of customs for the temporary removal of goods from the zones into the DTA area. This includes movement of duty-free goods for job work and return; temporary clearance for repair and display in exhibitions, testing/approvals etc and transfer from one warehouse to another. These bonds ensure that goods are not leaked out in transit and goods taken into Domestic Tariff Area for job work/ repair/ display etc are brought back. Bonds are discharged once the transit is complete and in case of temporary removal, goods are brought back. If there is any leakage, the unit is liable to pay applicable duty on such goods.

There have been various customs reforms over the years focusing on simplification of custom procedures and removal of various restrictions on export/import and the movement of goods.

Prior to 1991, custom policy and procedures were highly rigid, units had to execute multiple bonds for the movement of the goods, a gestation period of 2 years was specified after which the units had to start exporting and all exports and imports were subject to physical examination by the custom.

In 1990s, multiple bonds were replaced by an integrated B-17 bond. It covered all the activities. It was executed on the basis of projections for 3-6 months with the Assistant commissioner of Custom. Bond value was equivalent to 25% of the duty foregone. Bank guarantee equivalent to the bond amount was to be furnished. After every three years there was a review. The amount was adjusted for every transshipment and once it was exhausted, the units were asked to renew it. Procedures for sourcing indigenous capital goods and raw materials were simplified. And conditions for physical examination by custom authorities were relaxed. Private warehouses were

permitted for import, stock and sale of goods. Re-export of goods with and without processing was possible.

The SEZ scheme of 2005 removed the bond 17. Units now have to execute a Bond-Cum-Legal Undertaking in form H which will be jointly accepted by Development Commissioner and the custom officer. There will be no debit and credit of exports and imports. It will be monitored yearly and then in case of any shortfall a fresh undertaking is to be furnished. Bond is based on three months' projection and no bank guarantee is required.

The SEZ scheme also introduced that all activities of the SEZ units, unless otherwise specified, will be on the basis of self-certification. This means that for imports, the bill of entry is submitted by the unit with the custom. Goods are assessed on the basis of the information provided by the units. There is no physical examination of goods and the goods are allowed to move in after verifying marks and numbers on the packages only. For exports, it means that the assessment is based on the information furnished by the units. There is no routine examination of the export consignment. Containers come to the units' premise, are packed and sealed and then are taken to the custom office where they are verified. However, the custom authorities may examine the consignment when there is a specific information / intelligence. For this purpose, the order of the Assistant Commissioner of Custom is to be obtained.

This is an extremely relaxed regime. Procedures and highly simplified and almost all units are extremely satisfied with this system.

For Export Oriented Units, regulations have been similar. Domestic procurement is also possible and regulations have been relaxed during the 1990. Rules were highly simplified even before the SEZ regime came into force in 2006.

A major advantage to SEZ units relative to EOUs and other exporters lies in the custom procedures. Over the years, custom procedures have been becoming simpler to the advantage of the SEZ units. Under the current scheme, there is no interference from the custom officials. It is based on trust. EOUs are also placed on fast track. But, they have to deal with the jurisdictional custom offices. Sometime they have to travel long distances to reach these offices. They have to pick up the concerned officer and drop him there. In the process, a lot of time is wasted, resulting in delay in clearance of import consignments and procurement of indigenous good. If he is not around then there is further delay. Physical examination system also involves rent seeking. Other exporters have to face several problems, which are documented in several studies on India (See for instance, Aggarwal 2005).

#### **Domestic Tariff Sales (DTA):**

The 1982-83 budget permitted DTA up to 25% against valid import licenses of the domestic buyers. However, import licenses were very rarely issued for the products that were being produced in the zones. Most licenses were for intermediate products or raw materials and not for final products due to highly restrictive regime. The policy was therefore not effective.

In 1991, the condition of import license for DTA sale was waived and DTA sale up to 25% became subject to the domestic content of the product, fulfillment of minimum value addition and export obligation on payment of 50% custom duty. No DTA sale of jewelry and precious gems were allowed. Still, the domestic content requirement done away with in 1993 and agriculturally oriented units were allowed to sell 50% of production on the payment of 50% custom duty. In 1994, DTA sales for software were allowed for 25% of output and DTA sale started to be linked to net foreign exchange earnings as a percentage of exports in the electronics sector. Since 1997,



DTA over and above 25% are also permissible against full duty payment subject to the fulfillment of obligations.

Since 2000, SEZ units may sell the goods in the DTA on the basis of self-certification and with prior intimation to the Development Commissioner in writing giving the quantity and value of the goods being cleared into the DTA along with a certificate indicating the foreign exchange inflow and outflow cumulatively up to the end of the previous year. There is no limitation on DTA subject to the fulfillment of positive net foreign exchange earning over 5 years. However, DTA sales now are subject to full duty payment. All this means that SEZ units have a disadvantage vis-à-vis DTA units in selling their products in the domestic markets. This is because EOUs enjoy 50% DTA sale on 50% duty exemption basis and 10% DTA sale is permitted on gems and jewelry also. The new trade policy in 2004-05 has reduced the duty exemption to 25%.

*Table 12 : DTA sale: EOU vs SEZs*

EOUs	EPZs
25% since inception in 1980	Until 1982-83 : no DTA sale
Post 2000: EOUs continue to enjoy the DTA sale concession	Post 2000: DTA sales at concessional rates is not permissible. It is a major disadvantage to SEZ units relative to EOUs.

**Sub-contracting:**

In the 1980s, subcontracting was permitted for EPZ units with the approval of Commissioner of Custom on a case-to case basis after executing bond with the authorities in the DTA. The criteria for approval was the feasibility of bonding of the operations, fixation of input-output norms. In 1988, it was also permitted for EOUs with the approval of Commissioner of Custom on case-to case basis in the DTA. Since 1994, approval can be given by assistant commissioner of custom in the DTA. Sub-contracting was extended to firms outside the EPZs in 1997, in cases where firms used predominantly indigenous raw materials and since 1998, approval for subcontracting which can also involve change in the nature or form of the product is allowed. Similarly, approval for removing tools such as moulds, jigs, fixtures, hangers, patterns and drawings to the premise of the subcontractor subject to the condition that they would be brought back, became possible. These permissions have been made annual in 1999 and subcontracting in the DTA can since then make up to 50% of production. The permission of export direct from the job worker’s premises provided that the premises is registered with the Central Excise Department

Units in aquaculture, animal husbandry, electronics hardware, software, granite, textiles were ed to undertake job work for exports on behalf of DTA units provided that the goods are directly exported from the units. Goods, finished or semi-finished, including studded jewelry, containing quantity and purity equal to the gold/ silver/platinum so taken out, had to be brought back to the Zone within 30 days.

Since 2001, subcontracting of part of production process may also be permitted abroad with the approval of the Board of Approval. Since 2004, the Development Commissioner can approve such operations.

All units, including gem and jewelry, may sub-contract part of the production or production process through other units in the same SEZ (without limit) without permission of Customs authorities subject to records being maintained by both the supplying and receiving units. Since 2002, SEZ units other than gems and jewelry units may be allowed to undertake job-work for export, on behalf of DTA exporter, provided the finished goods are exported directly from SEZ units.

**Disposal of scrap :**

No specified norms existed before 1980 but during that decade, policies in regard to the disposal of scrap, and seconds were rigid. Any clearance of sub standard materials or imported packing materials attracted custom duty. In many cases getting them removed involved financial losses. As a result, units were accumulating stocks of scrap incurring loss and loosing space.

During the 1990s, permission for the sale of scrap/wastage had to be granted by the DC and was subject to full duty (50% of duty after 1995).

Since 2001, EOU may sell scrap/ waste/ remnants arising out of production process or in connection therewith may in the DTA as per the Standard Input-Output norms notified under the Duty Exemption Scheme on payment of concessional duties as applicable within the overall ceiling of DTA sale of 50% of FOB value of exports. Sales beyond this will be subject to full duty. For SEZ, sale of scrap can take place at full duty.

**Investment Limit**

No investment limit on EOU/SEZ/EPZ until recently but the Foreign Trade Policy 2002-07 imposed the following condition on these units:

Only projects having a minimum investment of Rs.1 crore in plant and machinery shall be considered for establishment as EOUs under the scheme. This shall, however, not apply to existing units and units in other clusters and Handicrafts/ Agriculture/ Floriculture/Aquaculture/ Animal Husbandry/Information Technology, Services, Brass hardware , handmade Jewelry and such other sectors as may be decided by the BOA. Sector-wise investment criteria shall be fixed by BOA. SEZ units are not subject to any such limits.

**Offshore Banking Units (OBUs)**

*Prior to 2002:* Offshore Banking Units (OBUs) were not permitted to be set up in the zones. These units would be virtually foreign branches of Indian banks but located in India. These OBUs, inter alia, are exempted from Cash reserve ratio and Statutory Reserve Ratio and give access to EPZ units to international finances at international rates.

*Post 2002:* The Foreign Trade Policy 2002-07 permitted setting up these units. In some of the zones these units have already been set up.

**VI. INCENTIVE PACKAGES**

An attractive incentive package confers a comparative advantage on EPZs over the wider economy. These incentives relate to “customs, direct and indirect taxes, exchange rates, labor, immigration, public order, investment and foreign direct investment. Incentives wipe out the distortions created by high tariff and non tariff barriers, high tax rates prevalent outside the zones and highly rigid policies.

**VI.1 Overview of the Indian tax structure**

India has a three-tier tax structure, wherein the constitution empowers

- the union government to levy income tax ( including corporate tax), tax on capital transactions (wealth tax, inheritance tax, gift tax etc.), sales tax on inter-state sales (Central Sales tax), service tax, customs and central excise duties;
- the state governments to levy sales tax on intra-state sale of goods ( State sales tax), tax on entertainment and professions, excise duties on manufacture of alcohol ( State excise duty), stamp duty on transfer of property and collect land revenue (levy on land owned);

- the local government are empowered by the state government to levy property tax, octroi (tax on entry of goods for use/consumption within areas of the Local Bodies) and charge users for public utilities like water supply, electricity and sewage etc.

Structure of the taxes on companies is as follows:

### Central Taxes

- *Corporate tax* : It can have three components :  
The basic duty,  
Surcharge and the  
Cess  
The rates change very frequently. Surcharge and Cess are temporary and depend on the requirement. Currently both surcharge and cess (education cess of 2%) are applicable.
- *Dividend distribution tax* : Domestic corporations have to pay dividend distribution tax on distributed profits.
- *MAT*: Corporations also have to pay for Minimum Alternative Tax, which was introduced in 1996. In a case where the total income of the company, as computed under the Income Tax Act after availing of all eligible deductions, is less than 30 per cent of the book profit, the total income of such a company shall be deemed to be 30 per cent of the book profit and shall be charged to tax accordingly.
- *Fringe benefit tax* : Fringe benefits include any benefit, facility or reimbursement to the employees, which has not been taxed in the hands of the employee. In other words it is levied on perquisites provided by employers to their employees on a collective basis. It was introduced in 2005.

### Excise duty :

Manufacture of goods in India attracts Excise Duty. It is levied on ad valorem basis or based on the maximum retail price in some cases and can have the following components.

- *Basic Excise Duty* :This is the duty charged on all excisable goods other than salt which are produced or manufactured in India .
- *Additional Duty of Excise* : This is levied in lieu of sales Tax and shared between Central and State Governments. These are levied under different enactment's like medicinal and toilet preparations, sugar etc. and other industries development etc.
- *Special Excise Duty* : The Finance Act,1978 levied Special excise Duty on all excisable goods on which there is a levy of Basic excise Duty. Since then each year the relevant provisions of the Finance Act specifies that the Special Excise Duty shall be or shall not be levied and collected during the relevant financial year.
- *Cess*: Currently education cess of 2% is applicable

### Custom duty :

Custom duty can have the following components:

- Basic customs duty,
- Special customs duty
- Special additional duty
- Countervailing duty
- Cess.

### Other taxes

- Service tax: (introduced in 1994)
- Central sales tax :

There are also taxes that are levied at the state level such as the sales tax , which is levied on the sale of movable goods. Most of the Indian States have replaced Sales tax with a new Value Added Tax (VAT) from April 01, 2005. VAT is implemented at the State level by State Governments. VAT is imposed on goods only and not services and it has replaced sales tax.

In addition there are some taxes at the municipal or local level with rates varying across jurisdictions. These are:

- Octroi / entry tax: - Some municipal jurisdictions levy octroi/entry tax on entry of goods
- Stamp duty on transfer of assets.
- Water charges
- Electricity duty
- Entertainment tax

## **VI.2 Fiscal incentives offered to SEZ units**

### **Indirect taxation:**

*Excise duties:* Prior to 1981, there was no standardized procedures for exemptions from excise duties. In SEEPZ, the suppliers had to pay excise duty and could claim refund only after the supply was made. In Kandla on the other hand, all inputs were entitled to excise exemptions. However, the law was then streamlined and the units supplying the goods to zone units have been exempted from excise duty since then.

*Central Sales Tax:* Since 1986 central sales tax was reimbursed (since 1987 also to EOU units). In 2006, this was changed and firms are now exempted from the central sales tax.

*Service tax:* Exemption from service tax

*Custom duty:* During the initial phase: Exemption from all duties on capital goods, raw materials, consumables, diesel, furnace oil for boilers used for manufactures, production and processing. In 1999, exemption from all duties on goods required by units for manufactures, production, services and in connection therewith was granted. Since 2001, all goods required by zone units for their activity are exempted from duty.

*State Sales tax/VAT:* Most states had given exemption from State Sales tax also . However, under the new scheme, zones are exempted from almost all the state level taxes. Andhra Pradesh government exempted them even from the entertainment tax.

*Municipal Bodies:* In several states municipal bodies had given exemption from the electricity duty. Zones have also enjoyed exemption from stamp duty on property transactions. Under the new SEZ scheme it is directed to the states to exempt the zones from all local taxes.

**Direct taxation:** Prior to 1981, no income tax advantage to zone units. Concessions were made available to the zone units under Section 80-HH and 80-I of the Income Tax Act. Section 80-HH relates to backward area incentives under the Income Tax Act whereby 20% of the taxable income of a unit located in any backward district was exempt from income tax for 10 years. Under Section 80-I, any new unit's profits up to 25% was exempt from the income tax for a period of 8 years. These schemes were available to all industrial units. In 1981, tax holidays for 5 years were extended to the units and since the tax holiday scheme was directed at the zone units, the existing income tax concessions under Section 80-I and 80-HH were withdrawn by the government.

In the late 1980s, profits and gains of the undertaking were no longer included in the total income of the assessed in respect of any five consecutive assessment years opted for by the assessed, falling within a period of eight years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things

Tax holidays in 1999 were granted for 10 years but this was changed again in 2000 to a 100% income tax exemption for a block of five years, 50% tax exemptions for two years and up to 50% of the Profits ploughed back for next 3 years under section 10-A of Income tax Act. Income tax exemption for 10 years up to 2010. In 2006, regulations were changed again and now grant 100% income tax exemption for a block of five years, 50% tax exemptions for two years and up to 50% of the Profits ploughed back for next 5 years with no time limit. For off-shore banking units, this is 100% Income-tax exemption for 3 years & 50% for 2 years under section 80-LA of the Income-tax Act. The extension of Income Tax benefit under Section 80 IA of Income Tax Act was granted to SEZ developers for a block of 10 years in 15 years as per the choice of the developers.

Additional Exemptions after the new SEZ rules include exemption from MAT for SEZ developers and SEZ units and exemption from Dividend distribution tax for SEZ developers. Export profits were not outside the purview of the MAT before the new SEZ rules.

**Table 9: Comparative analysis of tax incentives: EOUs vs SEZs**

Incentive	Tax benefit for SEZs	Tax benefit for EOUs
Income tax holiday	15 years (5+5+5) without time limit	10 years sunset year is 2009. After which no tax holiday.
Central Sales tax (CST)	Exemption	Reimbursement
Service tax	Exemption	No exemption
State tax	Obligatory	Not obligatory
Municipal bodies	Obligatory	Not obligatory

**Table 10: Comparative analysis of tax incentives: Other exporters vs SEZs**

Incentive	Tax holiday for SEZ	Tax holiday for domestic exporters
Income tax incentive	Income tax holiday Extended and made attractive	Exemption from corporate taxes introduced in 1982 Scope was widened gradually In 1986, 50% deduction on profits In 1989: 100% deduction on profits 2000-2004: phased out
MAT	No exemption	Exemption also phased out
Excise (Raw materials)	Exemption	Reimbursed through duty drawback for raw materials
Custom (Raw Materials)	Exemption	Reimbursed through duty drawback for raw materials
Custom (Capital goods)	Exemption	Zero duty (conditional) under Export Promotion Capital Goods (EPCG) scheme
Service tax	Exemption	No exemption

In last 10-15 years, Indian taxation system has undergone tremendous reforms. Tax rates have come down sharply and the tax structure has been rationalized. The process of rationalization of tax administration is ongoing in India. However, there still remain problems of multiple taxation of commodities and multiplicity of taxes, resulting in a cascading tax burden. Therefore, tax exemptions extended to SEZs are likely to have multiple effect. Despite the fact that tax rates have declined sharply and the tax structure is rationalized, they are expected to have a significant impact on the cost competitiveness of exports

**Table 11: Budget 2006 : Benefits to SEZ units**

	Effective rate (%)	SEZ Units
Corporation Tax: ➤ Domestic ➤ Foreign companies	Basic duty + surcharge + Cess 33.66 41.82	Exempted 100% for SEZ units for 5 years 50% for next five years 50% of the Profits ploughed back for next 5 years
MAT ➤ Domestic ➤ Foreign	11.22 % of book profit 10.455% of book profits	SEZ units and developers exempted
DDT	14.025%	Applicable
FBT (2005)	30% of perks	Applicable
Service Tax	12%	Not applicable
Peak custom rate (on non agricultural products)	12.5%	Not applicable
Excise duty	16%	Not applicable
VAT	12% (on most items)	Not applicable

### VI.3 Non-fiscal incentives offered

Apart from direct fiscal incentives, there are also more indirect and non-fiscal incentives offered to SEZ units. For example, a land subsidy of 75% concession on rent in the first year, 50% in the second year and 25% in the third year is granted for some plots, if the production had commenced in the first or the second year.

Some zones also give zone-specific subsidies. In West Bengal, a capital Investment subsidy of 7.5 percent on fixed capital investment made in fixed capital subject to a ceiling of Rs. 150 lakh (about 0.3 million US \$) exists. Also, a 50% subsidy on employee welfare payments for 5 years and a 25% interest subsidy on interest payments on term loan made to bank / financial institutions for project loan for a period of 5 years with a ceiling of Rs. 100 lakh per year (about 0.2 million US \$) are granted. There is also an electricity subsidy. In Vishakhapatnam, subsidies are given on the purchase of capital goods and on capital investment more generally.

### VI.4 FDI policy :

In the initial phases, FDI policy for the zones was rigid due to a restrictive attitude of the government towards FDI in the domestic economy. There was no blanket or clear cut blanket permission for 100% foreign equity holding in the zone. Each proposal was considered on case by case basis. The zones did not permit the foreign investors to hold hard currency accounts until 1980. There were severe restrictions on dividends and profit repatriation and transfer of shares. According to the business environment rating index which rated investment climate in 43 countries on the basis of 18 independent factors, Indian, zones were placed at the bottom for FDI (TCS 1976). In 1991, automatic route was introduced and was applicable to FDI also, as mentioned earlier. Also, permission through automatic route was given by the DC while for the

rest of the economy RBI was the approval authority. Another reform in 1992 allowed 100% foreign equity in the case of EOUs and EPZ when outside the zone. EOUs maximum equity permitted was 51%.

A distinguishing feature of the FDI policy in the zones is that no cap on foreign investment for small scale industries' reserved items exists. In the domestic economy foreign equity up to 24% is allowed in small scale industries.

Over the years FDI policy has been relaxed considerably. Zone foreign units have no relative advantages in this regard.

## **VI.5 Labor laws**

All labor laws of the land applicable to zones and zones are declared public utility service which means no unannounced strike permitted. Since 2003: DCs are delegated with the powers of Labor Commissioner and posting of an officer of Labor Department in SEZ to deal with labor matters or nomination of an officer by DC as labor officer. Under the new SEZ scheme it is expected that some reforms be introduced by the state governments. These should include the consolidation of various periodical returns (quarterly, half yearly etc.) prescribed under Factories Act, Wages Act, Maternity Benefit Act, Workmen Compensation Act, Contract Labor Act, Minimum Wages Act, Bonus Act. At the same time, it is expected that SEZ units be granted public utility status on permanent basis and the DCs be delegated with powers for granting permission for lay-off, retrenchment and closure and that they be appointed as the conciliation officers in respect of SEZs.

Also, a Labor Officer of SEZ should be appointed as Inspector under a number of Acts:

- Contract Labor (Regulation and Abolition) Act
- Payment of Wages Act,
- Contract Labor (Regulation and Abolition) Act
- Equal Remuneration Act
- Minimum Wages Act,
- Payment of Bonus Act
- Payment of Gratuity Act

No such benefits to EOUs outside the zone.

## **Annex 3: Characteristics of EPZs in Sri Lanka**

### **I. POLICY REGIMES**

#### **I.1 First Phase : 1978-1990**

Sri Lanka attained political independence in 1948. However, the process of industrialization was initiated in the late 1950s when the government formulated a new development strategy with emphasis on industrialization. The industrialization policies initiated in the late 1950s were influenced by the contemporary development thinking and hence were based on the ISI strategy. For around two decades till 1977 Sri Lanka remained a paradigm case of an inward oriented trade regime. By the mid 1960s, however, the balance of payment situation had almost reached a crisis point. This eroded popular support for the existing government, and in the general election of 1965, a new government was formed. The development strategy of the new government remained the same but there was a new policy emphasis on export promotion within the overall framework of ISI strategy. To eliminate anti-export bias, rupee was devalued and a dual exchange rate system was introduced. Various tax concessions for export oriented ventures were also introduced. In 1966, a White Paper on Foreign Investment was issued in which the government recognized the role of FDI in the export development drive and offered a package of production and tax incentives for export oriented FDI. The government also announced relaxation on the moratorium on the remittances of dividends interest incomes and profits, which had been in force since 1963. A Foreign Investment Advisory Committee was set up to function as the official body in charge of approving and monitoring FDI. However, these policy measures scheme could not remove the anti-export bias of the restrictive trade regime and failed to attract substantial export oriented FDI. By 1977, the country reached economic stagnation again.

In 1977, the process of trade and investment liberalization was initiated in the country. The then government introduced radical policy reforms, which aimed at establishing a substantially liberalized and export oriented trade regime in the country. The package of liberalization involved a drastic change in the system of exchange rate management, tariff rate structure and QRs. Promotion of export oriented FDI turned out to be a pivotal element in the new policy. In 1978, the government set up the Greater Colombo Economic Commission (GCEC) with wide ranging powers to facilitate FDI in the fully export oriented ventures. The Commission was authorized to set up EPZs within an area of authority covering 160 square miles north of Colombo and give approval to FDI. Thus, the first EPZ became operational in 1978 in Katunayake, which is in close proximity of Colombo. It is located in Gampaha district, which is one of the most developed districts in Sri Lanka. The zone was developed in four phases : 1978 to the early 1980s, early 1980s to the late 1980s, late 1980s to the early 1990 and thereafter. In the fourth phase 52 acres were added to the zone area, which is yet to develop. A highly attractive incentive package was offered to EPZ units. While the EPZ policy package was designed mainly to attract export oriented FDI, substantial reforms were introduced to improve the general investment climate in the rest of the economy also. These included : the removal of quantitative restrictions on imports, considerable relaxation of controls on capital and profit repatriation, and depreciation of rupee. A wide range of export incentives were introduced by a newly established Export Development Board. In addition to these economic policies, political developments also enhanced the investment climate. After the defeat in 1977 general election, the left-wing parties were in disarray and this in turn weakened labor unions. In 1980, the government crushed a major public sector strike using emergency powers which had a major impact on trade unionism in subsequent years.



Thus the investment climate was highly favorable for foreign investors after 1977 and Katunayake proved to be highly successful in attracting FDI. The success of Katunayake EPZ paved the way for setting up a second EPZ in Biyagama in 1983, again near Colombo in Gampaha district.

## **I.2 Consolidating Phase : 1990-1998**

A new policy package announced in 1990 was based on a more vigorous market oriented approach. These policies initiatives included an ambitious privatization program, rationalization of tariff structure, removal of non tariff barriers and the abolition of foreign exchange controls. In 1990, the Foreign Investment Advisory Committee was abolished and its activities were placed under GCEC to provide a unified framework for FDI. Besides, GCEC was empowered to develop EPZs in all parts of the country including those outside the area of jurisdiction of GCEC as demarcated by the original Act. As a result, the next EPZ was set up at Koggala in an industrially backward district of Galle of the Southern province. Since Koggala was located in a backward region, certain complimentary incentives were offered to the investors there. These included additional tax holiday, concessionary turnover tax and lower ground rent.

In 1992, all FDI promotion activities were placed under GCEC with a view to creating a one stop investment promotion centre and the reformed GCEC was renamed the Board of Investment (BOI). The BOI took over the functions of Foreign Investment Advisory Committee (FIAC), the Industrial Development Board (IDB) and the Local Investment Advisory Committee. Thus the scope of BOI operations was extended to include all FDI ( export oriented and domestic market seeking) and domestic large scale operations. BOI offers single window service to its clients so that the entrepreneurs are required to deal with only one agency. Several other policy initiatives were also taken to facilitate the inflow of export oriented FDI. The case-by-case approval mechanism was abandoned and a new system based on the concept of automatic approval procedure was introduced. Foreign investors were permitted to purchase up to 40% of shares of existing listed companies without approval and the Board was empowered to provide free trade zone status to foreign investors in all parts of the country.

During this phase major policy initiatives were taken to provide a unified policy framework and to strengthen investors' confidence in the long-term continuity of the outward looking policy stance of the government.

## **I.3 Expansionary Phase : 1998 onwards**

Since 1998, BOI has been involved in massive expansion of the EPZ scheme. Six new EPZs have come up during a short period of 1998 to 2000. These are : Malwatta (1998), Mirigama (1998), Wathupitiwela (1999), Mawathagama (2000), Polgatawela (2000) and Horana (2000). Four of the zones namely, Malwatta, Wathupitiwela, Mirigama and Horana are in the Gampaha district while Mawathagama and Polgatawela are in the Kurunegala district of the North Western province of the country, which is also industrially developed like Gampaha. In all, nine EPZs are currently operational in the country. Their total employment is over 110 thousands and exports over \$1000 million.

All the zones ( except Koggala) are located in industrially developed districts. One must however note that the location of Wathupitiwela and Mirigama is in difficult areas and therefore these are classified as difficult zones. Special efforts are made to promote them along with Koggala, which is categorized as the most difficult zone. Thus less than ideal locations were selected with the expansion in the EPZ scheme. Besides , some of the zones set up have a very small size. These

include, Wathupitiwela, Mawathagama and Malwatta. Their size varies between 10 hectares (29 acres) and 27 hectares (77 acres) and these are the smallest zones in South Asia.

## **II. THE LEGAL FRAMEWORK**

The legislation controlling EPZs' operations is the Greater Colombo Economic Commission Law No. 4 of 1978 which in 1992 was amended to be called the BOI Law. All benefits enjoyed by EPZs are derived from this law. The BOI functions as a central facilitation point for investors. It operates as an autonomous body that is directly responsible to the president of Sri Lanka.

The BOI Act provides for two types of investment approvals:

1) Approvals Under Section 17 of the Act, the BOI is empowered to grant special concessions to companies satisfying specific eligibility criteria which are designed to meet strategic economic objectives of the government . Companies established under Section 17 are governed by the rules and regulations contained in this section. These rules and procedures include laws related to Inland Revenue, Customs, Exchange Control and Import Control. These companies acquire the status of BOI companies and accorded special treatment.

2) Approval under Section 16 of the BOI Act permits investors' entry to operate only under the 'normal laws' of the country; that is, for such enterprises, the provisions of the Inland Revenue, Customs and Exchange Control Laws apply.

For the purpose of granting approvals and incentives, companies incorporated under the Companies Act are treated equally regardless of whether the shareholding is controlled by nationals or non-nationals.

EPZ units are approved under Section 17 and hence are governed by the BOI regulations and not by the normal laws of the land. Thus, EPZs in Sri Lanka are governed by a single unified policy framework.

## **III. ADMINISTRATIVE SET UP**

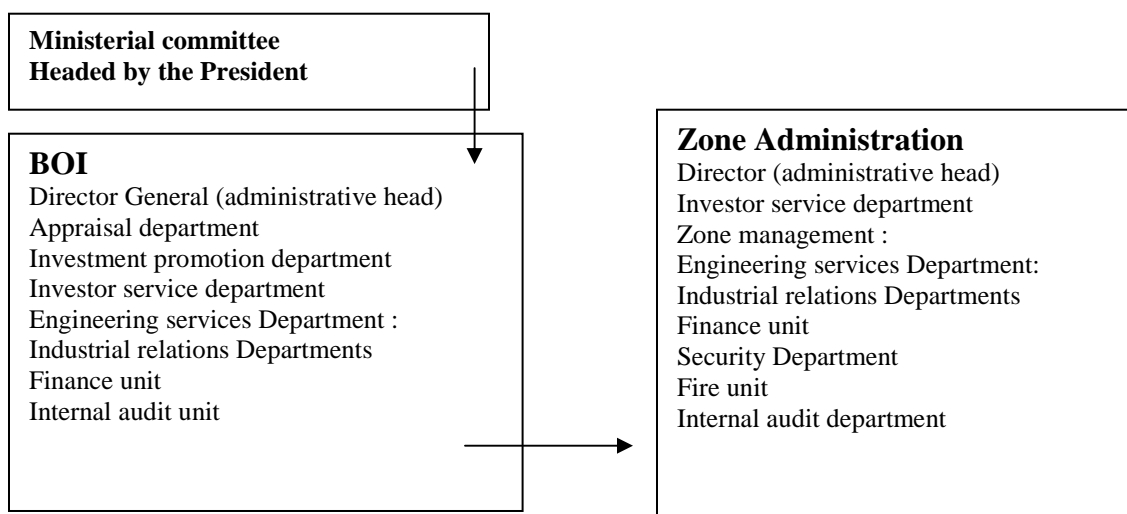
In Sri Lanka the Board of Investment is the apex EPZ authority. It has its origins in the Greater Colombo Economic Commission, which was established in 1978 and which was directly responsible to the President of Sri Lanka. In 1992 the Commission was reconstituted as the Board of Investment of Sri Lanka. It is the only organization that an investor needs to contact. It operates as an autonomous body that reports directly to the President. The Board consists of a Director General, the Chairmen of the Regional Economic Development Commissions and three members. The Director General is appointed by the President on the recommendation of the Minister concerned. The three members are also appointed by the President on the recommendations of the Cabinet of Ministers and comprise professionals in the field of finance, industry, trade and banking. It is assisted by a Ministerial Committee on Investment Promotion. It's operations are facilitated by a number of departments that look after different aspects of management (Figure 1). One must however note that the BOI is responsible not only for the promotion of EPZs but also for all other foreign direct investment and investment under Section 17 and 16.

The BOI provides advice and assistance at each stage of the investment process. There are various divisions within the Board to provide these services.

- The appraiser department evaluate applications and provides concessions

- The engineering Department provides assistance in site selection and clearance, advice on factory building and other technical matters and arranging infrastructure facilities such as water, power and solid waste. It also assists in environmental norms and facilitates environmental approvals.
- Investor's service department coordinates import/export clearances and custom procedures
- Industrial relations department maintains good industrial relations and helps in formation and operation of employees' councils.
- Investment promotion department is responsible for marketing aspect of zones. It also provides information and guidance before submission of project applications.
- Finance unit is responsible for all finance related matters.

**Figure 1 : The administrative set up of EPZs : Sri Lanka**



The zone is administered by a director under whose purview the following departments are placed:

**Zone management :** It manages the general administration of the zone. A senior management team spearheads the department. It is responsible for

- authorizing and facilitating entry to the zone (issuing entry permits, vehicle permits and identity cards for employees)
- authorizing the removal of locally purchased material and equipments,
- co-ordinating transport, health, sanitation facilities,
- disposal of solid waste and
- general maintenance of the zone.

**Investor services department :** It provides various services to EPZ units. Its services include

- processing import/export documents,
- issuing rules of origin certificates
- issuing export licenses for exporting garments to the EU and Canada,
- examining export import cargos,
- recommending the issuance of visas.

- allowing subcontracting
- permitting imports of motor vehicles for staff transportation on duty free basis
- removing machinery for repair and return

Engineering services Department : It coordinates with investors on all infrastructure matters. It also provides the following services

- The allocation of land to new investors.
- Approval of building plans
- Granting approval for duty waiver on construction materials
- Coordinating with the government agencies for providing water, electricity and sewage facilities.

Industrial relations Department : It

- handles complaints made by individual workers or workers' councils
- resolves industrial disputes.
- Advises investors on national labor laws and matters connected with industrial relations through circulars, discussions and clarifications.
- It also provides other services related to human resource such as providing enterprises with manpower resources, fixes terms and conditions of employment, wages and labor standard and provides updated information on employment statistics.

Finance unit : It accepts all payments on behalf of the BOI. These include ground rent, water bills, import-export and other service charges, stamp duty, defense levy and goods and services tax. The internal audit unit monitors financial areas of the BOI.

Security Department: It is responsible for surveillance duties , contingency management, preventing unauthorized entry and unauthorized removal of items.

Fire unit: This unit is responsible for the prevention of fire hazards. It maintains the fire hydrant system and trains employees in using fire fighting appliances installed within the unit and conducts regular inspection.

Thus, attempts are made to provide all post-entry services through single window. There are thus various departments at BOI and each has well defined responsibilities.

Medical Officer : A medical officer advises workers on health matters. A central dispensary issues drugs to workers free of cost.

#### **IV. THE APPROVAL PROCESS**

The BOI provides advice and assistance at each stage of the investment process. Here investors can obtain information on the investment opportunities in Sri Lanka and the incentive packages on offer. Prospective investors are required to submit a formal application to the BOI. Assistance can also be obtained in completing application forms and referring investors to the relevant department within the organization. Once the application is complete it is submitted to the Appraisal Department, a case officer is assigned to assist and guide the investor throughout the

approval process. He assists him in his dealings with other state authorities and relevant departments within the BOI. The Appraisal Department approves the application and decide on the applicable BOI investment incentives and conditions.

A properly completed application form takes 10 working days to complete and, in most instances, foreign investment approval is automatic. However, when a project is evaluated for special concessions, four weeks are needed to complete the assessment. Similarly, the relevant authorities will consider approval of foreign investment in regulated sectors usually within 30 days. BOI will obtain such approvals on behalf of potential investors.

If the project has met the necessary conditions, the BOI will then issue a Letter of Approval which informs the investor of the conditions, privileges and benefits granted. After receiving the Letter of Approval, the applicant must respond, in writing, agreeing to the terms and conditions. If any changes or special conditions and privileges are sought, they should be requested at this time. In order to finalize the agreement, the investor is required to incorporate the business as a company with the Registrar of Companies The Letter of Approval from the BOI is sufficient to confirm to the Registrar that the foreign investment has been officially approved.

The formal Agreement is usually signed within 30 days of issuing the Letter of Approval. The Agreement will confirm the incentives and concessions the company will be entitled to under Section 17 of the BOI Act.

Once the proposal is approved, the investor will be referred to the respective Director of the Zone or Zone Manager, if he/she wants to locate a project within one of the BOI administered Export Processing Zones (EPZ). The administration provides assistance in site selection, clearance, advice on factory building and other technical matters. The Engineering Approvals Department approves site locations. Once the site approval is granted, the investor can purchase the selected land or finalize the leasing agreement. The infrastructure requirements and environmental concerns of a project are addressed jointly by the Engineering and Environment Departments.

Investor services department makes recommendations to immigration Authorities for issuing resident visas. In our survey of the EPZs in Sri Lanka, the units revealed that they have to deal with only 3-4 authorities in addition to BOI at the time of entry. These are: the Department of Inland revenue, Registrar of Company Customs and Municipal boards. The BOI facilitates the provision of other facilities through its zone departments. While doing so, it plays a pro active role by participating in the process directly unlike in India where the role of the authorities is passive. A majority of respondents in the country opined that the single window clearances are satisfactory or highly satisfactory.

An important feature of the governance in Sri Lanka is that the incentives granted to the units at the time of signing the contract remain valid for their life time. These provisions cannot be changed by successive governments. This is a feature not shared by many countries.

## **V. RULES AND PROCEDURES**

Rules and procedures are highly simplified.

### **Custom rules**

Zones are not subject to regular export import procedures. All export-import formalities are completed within the zone. This department is responsible for physical examination of the cargo

for export and monitoring of the physical movement of the cargo to ensure and enforce the legal requirements. The Investor Services Department will liaise and assist the investor in the clearance of goods for both import and export

**DTA sales** up to 20% (10% for textiles) are allowed after the prior permission from the investor's service department.

**Subcontracting** outside the zone is also permitted after prior permission.

### **Procurement**

Companies approved under Section 17 of the BOI Act are entitled to purchase duty-exempt building materials for the purpose of plant/factory construction. Duty exempt materials must be first approved by the Appraisal Department and certified by the Engineering Department. In order to obtain duty free approval for the purchase of Capital Equipment and Raw Materials, each enterprise must submit a detailed list of project related capital equipment, spare parts and raw materials required for operational purposes to the Appraisal Department.

## **VI. INCENTIVE PACKAGES**

### **VI.1 An Overview of the Sri Lankan Tax Structure:**

**Corporate tax:** In 1991, the corporate tax rate was as high as 50%. An additional surcharge of 15% was also levied on the basic rate. Remittances were charged at the rate of 33.3% if they were less than 1/3 rd of taxable income and at 11.12% if they were higher than that. The rate declined sharply since then and the surcharge was also abolished. The current rate of income tax for a resident company, effective from the year 2003-04, is 32.5%. The standard rate has increased to 35% from the year 2006-07. While the basic tax rate remains the same for non-resident companies, they are liable to pay a tax of 10% on the remittances of profits abroad.

**Taxation of Dividends:** Dividends are generally subject to a withholding tax of 10% of the gross dividend.

**Withholding Tax:** Interest, rent, royalties and service fees paid by a resident company to another resident company or a non-resident company are subject to withholding tax. The rates are 10% for resident company and 15% for non resident company.

**Value Added Tax (VAT):** The VAT is chargeable at the time of supply on the value of goods imported by any persons and on the value of the local supply of goods or services made by a registered person. The VAT was introduced in 2002 replacing the "Goods and Service Tax (12.5%, in force in 1998) and the National Security levy (6.5%, in force since 1991). In 2002, the standard VAT rate was 20% while the basic rate (rate on essential commodities) was 10%. Currently, the structure consists of three rates, a rate for luxury items of 20 percent, a standard rate of 10 percent, a rate for basic commodities of 5 percent.

In 1998, the Goods and Services Tax had replaced the Turnover Tax that existed since 1964.

**Stamp Duty:** Stamp duty, other than stamp duty payable to Provincial Councils on the transfer of movable and immovable property, was abolished with effect from 1st April 2002. It is re-introduced in the 2006-07 budget.

**Economic Service Charge (ESC):** ESC is levied annually, effective from 1st April 2004, on every person or partnership in respect of the liable turnover of every trade, business profession or vocation carried on by such person or partnership. For BOI companies: during tax exemption period it is .25%, for others it is .5%. The maximum rate is 1%.

**Excise duties and Special Excise Levies** are charged on tobacco, cigarettes, liquor, motor vehicles and selected petroleum products.

**Port and Airport Levy:** Introduced in 2002, a new Port and Airport development levy of 0.5%-1% is imposed on the CIF value of imports. It was later raised to 1.5%. The 2006 budget has further raised it to 2.5%.

**Social responsibility Levy:** A Social Responsibility Levy (SRL) of rate of 0.25% was imposed with effect from 1<sup>st</sup> January, 2005. It is also raised from 0.25% to 1% .in the 2006-07 budget.

**Custom duties:** Radical trade reforms aimed at establishing a substantial liberalized and export oriented trade regime were introduced in Sri Lanka in 1977. The tariff regime was made less distortive during subsequent rounds of reform. The maximum tariff rate was reduced from 500 % in 1977 to 50% in 1989. By 1989, the country had reduced the number of tariff rates substantially. It relied on a three-pronged structure with rates of 10, 20 and 35 per cent. These reforms were further intensified in 1989 when the second wave of reforms was initiated. By 2002, there were only three bands : 5%, 10% and 25%. Rates on raw materials and intermediate goods were lowered in subsequent years to rationalize the tariff structure. Currently, customs levies a duty of 2.5 percent on basic raw materials, of 6 percent on semi-processed raw material, of 15 percent on intermediate product, and of 28 percent on finished goods.

While the average MFN rate has been reduced from 20% in 1995 to 9.8% by 2004. However there are other four additional charges on imports. These are an import duty surcharge (10%), a ports and airports development levy (PAL) on imports (which has recently been raised from 1.5% to 2.5%), the 'Cess' (levied on some items), excise fees on some products such as aerated water, liquor, beer, motor vehicles and cigarettes. VAT is also levied upon entry of the economic territory.

## **VI.2 Fiscal incentives offered**

Generally, enterprises are eligible for incentives offered under either of two regimes:

**BOI incentives under Section 17 of the BOI Act** - special incentives outside identified laws of the country, are available to enterprises approved by the BOI under Section 17 of the BOI Act. BOI has some 23 categories of firms and sectors that receive incentives in the form of lower corporate tax rates, duty exemptions, and tax holidays of various lengths. These include manufacturing of non traditional ( manufacturing sector ) goods for exports, export oriented services, small scale infrastructure projects, large scale infrastructure projects, R&D, IT and so on. In this report, we focus only on those incentives that are offered to export oriented units.

**General incentives under the normal laws of the country** - Firms that do not qualify for concessions under Section 17 of the BOI Act may seek incentives available under the normal laws of the country.

Sri Lanka offered several fiscal and non fiscal incentives to the units in **the initial phase of the zones' evolution** to attract FDI under the BOI law.

**Indirect tax exemptions:** Originally, these included duty exemptions from importation of equipment, construction material and production inputs. In 1982, the duty rebate scheme was extended to local suppliers who were supplying local materials to the zone units. The objective was to encourage backward linkages.

**Direct tax exemptions:** The fiscal incentives that BOI offered were tax holiday up to ten years with complete tax exemption on remuneration of foreign personnel employed, during the tax holiday and tax exemption on royalties and dividend of shareholders during the tax holiday. 1989 saw a second round of reforms, and an incentive package consisting of simplified and unified procedures for investment approval, granting tax holidays, concessionary duty rates, and

exemption from existing exchange control regulations were extended in the early 1990s. In 1991, while the corporate tax was as high as 45% for with additional 15% surcharge, the EPZ units enjoyed huge tax benefits. At this time, the tax holiday was enhanced to 15 years from the first year of profit and a concessional rate of 2-5% was applicable for the next 15 years from the expiry of tax holiday. Dividends paid to non resident share holders were fully tax exempted for the life time of the enterprise while dividends paid to resident shareholders were tax exempted during the tax holidays; the income from the capital gains arising from the transfer of shares to non citizens was also exempted from taxation. Expatriates were granted income tax exemption during the tax holiday. exemption from turn over tax and excise duty at the point of importation. On a company level, finished goods could enter duty free.

However in the late 1990s, the incentive structure was made more complex in order to promote exports in thrust industries and industrialization in backward areas. A distinction was made between companies in thrust areas (electronics, ceramics, glassware, mineral based, rubber based and engineering based) and other non -traditional areas (i.e. other manufacturing sector products). Highly attractive incentives were offered to units (whether new or old) in thrust areas (subject to investment and employment conditions). These units were given tax holiday up to 20 years depending on investment and employment. In addition, special incentives were introduced for projects located in industrial areas designated as difficult or most difficult. In difficult areas tax holiday of 5 years and in most difficult areas tax holiday of 8 years were offered. In addition to these changes, tax benefits were offered to new companies that provided transport facilities to their workers and passenger vehicles up to a value of US \$35,000 were exempted from import duties in the export sector.

At the same time, however, general tax incentives were made restrictive. For instance, the tax holiday on export oriented projects other than thrust areas was withdrawn . It was replaced by a concessionary tax of 15% for 20 years. Similarly, the tax exemption offered to foreign consultants and technicians were withdrawn. They were exempted from income tax in excess of tax in their own country.

In view of the worsening fiscal position, in 2002, a consolidated tax incentive structure for BOI and non BOI companies was introduced. To broaden the revenue base, exemptions, concessions, and tax holidays given to companies through the Board of Investment (BOI), which had distorted the tax system in the past, were reduced. Major changes in the incentive structure consisted of consolidating corporate tax exemptions by restoring the tax holiday of 5 years to all BOI export oriented units and granting a concessional rate of 10% for 2 years and 15% thereafter. At the same time, the exemption on dividends paid ceased to apply to any dividends paid on or after 1st April 2004 by any company which qualified for tax exemption on or after 6th November 2002.

During the consolidation of non BOI and BOI incentives, the exemption on the royalty paid by a BOI company during its tax holiday period to a non resident person was withdrawn with effect from April 1 2004. A withholding tax of 15% is applicable. Similarly, profits from foreign currency banking units which had been tax exempted became subject to a 20 percent tax in 2004.

In 2006, the 0.25% import levy applicable on imports for exports was withdrawn.

### **VI.3 Non-fiscal incentives offered**

Originally, non fiscal incentives included exemption from foreign exchange control procedures for all exports and imports from normal import-export, no restrictions on foreign ownership, exemption from foreign exchange controls on remittances of dividends, and free transfer of shares within or outside Sri Lanka with no control or foreign exchange controls. In 1979, the



government introduced the Foreign Currency Banking Units Scheme, which provided the EPZ units unlimited access to foreign Currency credit at interest rates prevailing in the world financial markets. Domestic tariff area (DTA) sales were allowed on a case by case basis, usually up to 5-10 percent of total output. The duration of land lease was 99 years but this was reduced to 50 years in the 1990 and to 30 years during the reform in 2002.

**Alternative incentives available under the Inland Revenue Law:**

Incentives are available, under the Inland Revenue Law, to exporters not qualifying for concessions under Section 17 of the BOI Act. These concessions are outlined below.

Export oriented units outside the GCEC were also offered liberal incentives such as 5 years' tax holiday ( 10 years for EPZs) in the initial years. Tax holiday was however withdrawn later and it was replaced by a tax rebate. For companies that commenced production prior to 1993, a lower tax rate of 15% was payable. In 1993, the incentive was further tightened and a time limit was specified. According to the new rule, companies that started their production after 1993 were subject to the concessionary rate of 15% until 2014. Under the new scheme introduced in 2002, tax incentives provided under the Inland Revenue Act are brought in line with those granted under the BOI Act. Along the lines of BOI incentives, tax holiday of 5 years, 10% tax rate for the first two years after the exemption and 15% in subsequent years is applicable to export profits outside the zones also. Dividends declared were subject to 15 percent tax. Companies that export gems and jewelry receive an open-ended exemption from income tax on their profits and income. A duty rebate scheme for imports of raw materials exists.

**Cash incentives:** The EDB invested in the equity of export ventures which are claimed as innovative and pioneering. Such investments did not exceed 30 per cent of equity. This was withdrawn in 1991. Direct cash subsidies were offered to units outside the BOI. These were withdrawn after 1991. The EDB however grants "pioneering status" to some types of projects in which it may invest. Such projects also benefit from the reimbursement of some expenses including feasibility studies, design and technical expertise, overseas market exploration and media promotion expenses.

**General Exemption on Fiscal Levies on Import of Capital and Intermediate Goods:** Full entitlement if production is for 50 per cent export and 50 per cent entitlement if 25 to 50 per cent is exported.

**Private bonded warehouse facilities:** Using customs approved bonded warehouses for duty-free clearance of goods against a block bank guarantee of 25 per cent of duties payable on such goods not converted for export purposes. Any manufacturer who is engaged in manufacturing for export may apply to the Customs Department for the approval of establishment of a manufacturing-in-Bond warehouse. Manufacturers can avoid paying of duty and taxes by the time of importation and goods imported and stored in this warehouse can be used for any kind of manufacturing such as mixing and assembling.

The EDB also offers assistance for participation in overseas trade fairs and exhibitions and to establish marketing outlets overseas. Support is also provided to establish a quality assurance system conforming to ISO 9000. It also grants incentives to a number of special product categories receive incentives and assistance from the EDB: These are diamond cutting, handloom textiles, gems and jewelry , electronics , rubber products, horticulture, spices and essential oils, and coir products.

Special tariff incentives for the protection of labor rights for Sri Lankan products exported to European Union member countries for 2 years from 01 February 2004 to the end of 2005. Under these special benefits, textiles and Clothing products (Chapters 50-63 of the Tariff) attached 40% reduction in duty (instead of the current reduction in duty (instead of the current reduction of 20%) in the full rate of duty payable. The flat rate of 3.5 percentage points granted under the normal GSP to sensitive agricultural and industrial products received an additional reduction of 5 percentage points in the full ad valorem rate of duty payable .

## **VI.5 Labor laws**

Labor laws of the country are applicable to all enterprises in the country, including BOI/EPZ enterprises, and the Ministry and Department of Labor are responsible for labor administration functions, including labor law enforcement and industrial relations. The employees of BOI enterprises have the right to form and join trade unions of their own choosing and to bargain collectively, subject to the provisions of the Trade Unions Ordinance and the Industrial Disputes Act.

However, the BOI encourages the formation of employees' councils and discourages labor unions. Detailed guidelines are issued for the formation and operation of employees councils. As a measure of promoting employees' participation in decision-making on matters affecting them and labor-management consultation and cooperation on matters of mutual concern at the enterprise level, the Board of Investment of Sri Lanka facilitates the establishment of Employees' Councils consisting of elected representatives of employees in the BOI enterprises. A council consists of not less than five members but not more than ten members, representing the different departments of the enterprise and the different categories of employees employed therein. This does not, however, preclude the possibility of the number being increased to more than 10 members in exceptional cases where the size of the workforce warrant such an increase. Every member of the Council is elected by secret ballot by the eligible employees of the enterprise. The objective of the councils is to "secure the mutual cooperation of the employees and the employer in achieving industrial peace and greater efficiency and productivity in the workplace. Efforts are made to resolve labor disputes through dialogue between the council and the management.

## **VI.6 Environment Protection License**

Environmental Protection Licenses (EPL) are issued by the Environment Department, according to the type of project. These licenses should be obtained prior to the start of operations. The relevant inspection and license fees are levied by the BOI. A guide on environmental norms together with other information is made available to the investor prior to the submission of applications.