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CAN NON-FISCAL INCENTIVES LIKE REVERSE JOB WORK REVIVE THE SEZ?

THE CASE STUDY OF GEMS AND JEWELLERY SECTOR IN INDIA

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EXECUTIVE **SUMMARY**

Introduction

Globally, special economic zones (SEZs) are created to boost exports and promote investment by providing units located inside the zones with certain fiscal and non-fiscal incentives that are not available and/or are different from those given to firms in the domestic tariff area (DTA). In India too, SEZs were created with certain export growth, investment and employment objectives. However, unlike in many other countries, no well-defined targets were set in terms of the objectives.

The gems and jewellery sector is among the key sectors located in Indian SEZs. The share of gems and jewellery exports in total exports from SEZs was around 24 per cent in 2019-20. Prior to 2019, there were around 500 gems and jewellery units in the SEZs, primarily driven by three benefits offered: (i) infrastructure (ii) ease of doing business and (iii) availability of fiscal and non-fiscal benefits (see Figure A). However, in recent years, many gems and jewellery units exited out of the SEZs and during 2021-22, there were close to 360 gems and jewellery units in the Indian SEZs.

Key Highlights

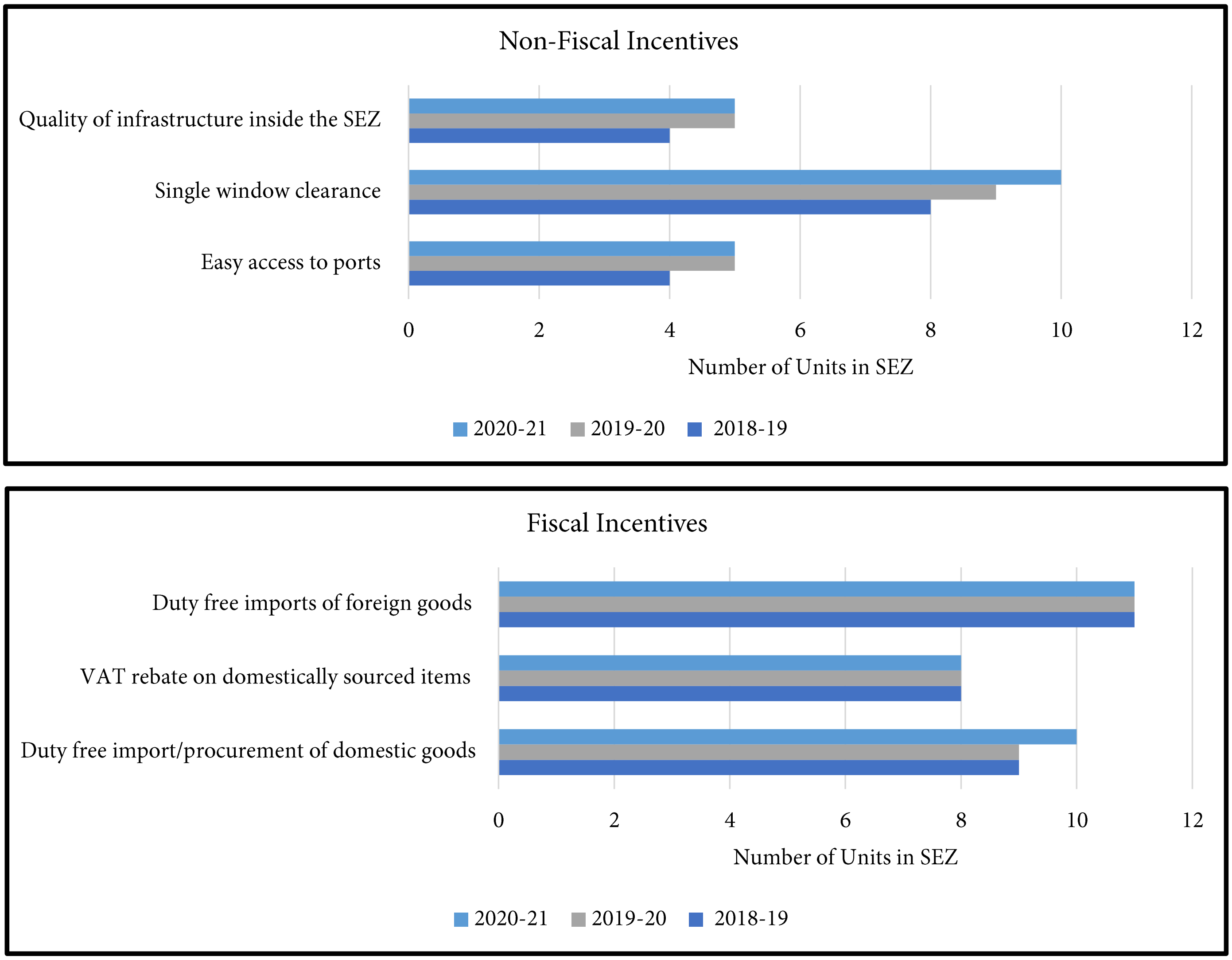
- India's exports of gems and jewellery increased from USD32.46 billion in 2010 to USD38.15 billion in 2021 whereas imports increased from USD68.3 billion in 2010 to USD88.3 billion in 2021.
- The share of SEZs in total gems and jewellery exports from India declined from around 30 per cent during 2019-20 to around 20 per cent during 2020-21.
- There is a need for clear achievable targets, policy certainty and WTO compliant fiscal and non-fiscal incentives under the DESH Bill.
- 71 per cent of surveyed units want a transparent reverse job work policy.
- India has the potential to develop as a global gems and jewellery processing hub, with SEZs playing a key role in promoting exports.

During 2020-21, the share of gems and jewellery in total exports from SEZs also declined to 15.7 per cent. This is because of multiple reasons including better non-fiscal incentives received by firms in other competing countries, withdrawal of fiscal benefits in India, pandemic related demand and supply disruptions and SEZ related policy uncertainties.

In the Indian SEZs, fiscal benefits were tied to the net foreign exchange earnings (NFE) criteria. However, the United States of America (USA) challenged a number of Indian export promotion schemes, including the SEZ, in the WTO and won the case in 2019, leading to the withdrawal of export-linked subsidies to SEZs. This prompted India to design WTO compatible zones and the country is in the process of initiating the Development (Enterprise and Services) Hubs (DESH) Bill, 2022. This Bill has removed the NFE requirement for incentives and proposed certain non-fiscal incentives such as reverse job work.

Given this background, the objective of this paper is to study how the gems and jewellery units operating in the Indian SEZs can be revived through incentives such as reverse job work. The paper examines the impact of reverse job work on gems and jewellery units operating in Indian SEZs, its impact, if any, on DTA units and whether it will enhance sourcing from within the Indian SEZs vis-à-vis imports. It discusses the issues faced by gems and jewellery units in SEZs and makes policy recommendations on how to make Indian SEZs a hub for gems and jewellery manufacturing and exports.

Figure A: Top Three Benefits of Being Located in SEZ over the Last Three Years



Source: Pilot Survey of SEZ Units

The study is based on secondary research and data analysis, key informant interviews (KIIs) and four stakeholder consultations.

Key Findings

1. Global Demand and Indian Exports are Changing.

In the past, the bulk of exports were in the heavy handcrafted gold jewellery and cut and polished diamonds categories. During 2010-2021, exports in these segments grew marginally, at a compound annual growth rate (CAGR) of 1 per cent and 0.7 per cent respectively. However, exports in new product categories such as lab-grown diamonds grew at a CAGR of 48 per cent during 2010-2021. As competing countries such as Turkey have swayed the global market in light weight gold jewellery for which demand is rising, there is a need for Indian SEZ units to move into newer products and, within each product category like gold jewellery, towards segments like light weight gold jewellery.

2. Balance of Trade Issues in Gems and Jewellery SEZs

Given that the exports of traditional gems and jewellery products such as heavy handcrafted gold jewellery is growing marginally whereas imports of raw materials are rising, there are concerns related to negative trade balance of trade in the SEZs. After removal of NFE criteria for giving incentives, trade balance may need a thorough review.

3. SEZs Sourcing from DTA and DTA Sale

Two-years available data show that gems and jewellery units in SEZs mainly source diamonds from the DTA, and this sourcing is primarily through job work (diamond and other stone processing/polishing in the DTA) and has grown by 5 per cent between 2019-20 and 2020-21. SEZs sales to the DTA in handcrafted gold jewellery has drastically increased from INR17,735 crore during 2019-20 to INR96,246 crore during 2020-21. Overall, sourcing from DTA seems to be lower than sales to DTA and there seems to be a rise in domestic demand for the type of products produced in SEZs. However, longitudinal data is needed to analyse the trends.

4. Investment in Research and Development (R&D), Advanced Technology and Skilling of Workforce is Low in the Gems and Jewellery SEZ Units.

Of the total 14 gems and jewellery SEZ units surveyed, only 4 reported having made such investment. There are limited training programmes and modules to upgrade skills in the use of modern technology, a lack of funds, and gaps in technical training and quality of training.

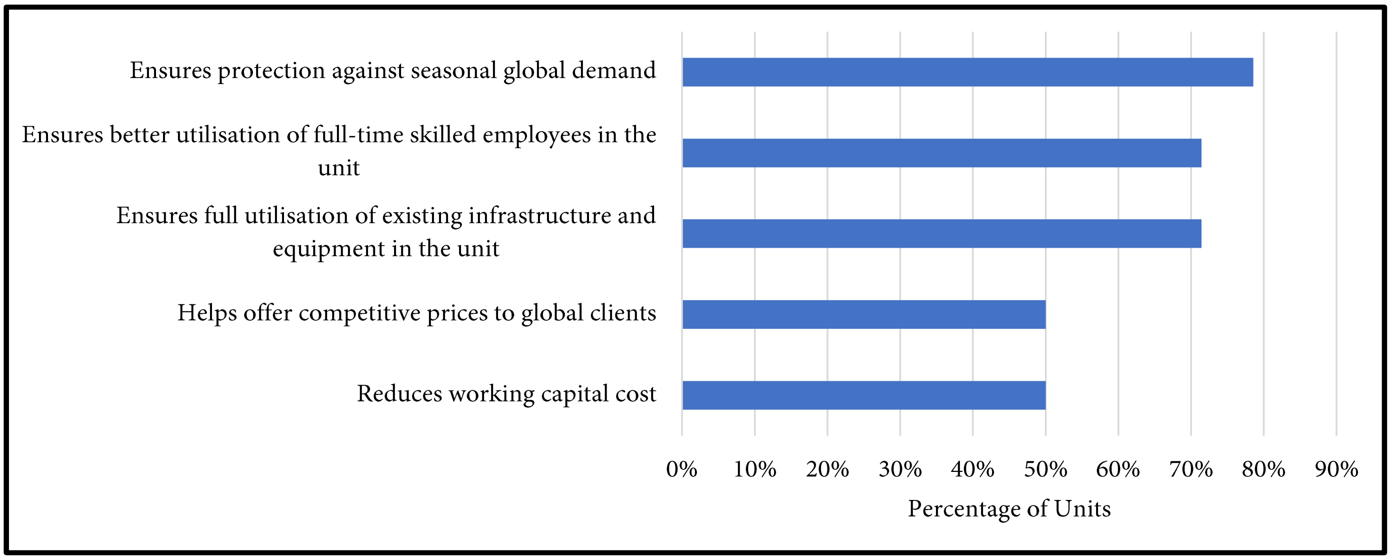
5. Foreign Direct Investment (FDI) in SEZ Units is Negligible.

This is an area of concern as FDI helps to get technology. It also helps in brand building, networking and marketing. Some of the reasons behind low FDI in Indian SEZs are the lack of investment protection agreements, unlike countries like Vietnam; negative perception about the SEZs and limited marketing and brand building to address those perceptions.

6. Need for Both WTO Compliant Fiscal and Non-Fiscal Incentives.

The withdrawal of fiscal incentives has reduced the price competitiveness of Indian units as fiscal incentives help to mitigate the high logistics and other input costs. All units felt that fiscal incentives should be smartly designed to make it WTO compliant. Along with this, non-fiscal incentives such as reverse job work will help improve productivity and efficiency, and enhance the ease of doing business (see Figure B). Seventy-one per cent of surveyed SEZ units said that they would benefit from a transparent reverse job work policy.

Figure B: Benefits of Allowing Reverse Job Work



Source: Pilot Survey of SEZ Units

7. There is a Growing Demand in the Domestic Market for Jewellery Produced in Indian SEZs.

Most domestic retailers felt that sourcing from the SEZs would be beneficial in providing good quality products at low price, which can replace imported products, create employment in the sector, and align with the Indian government's Aatmanirbhar Bharat Abhiyan and Make in India initiatives. According to 58 per cent of the DTA retailers, products of SEZs have better finishing and a variety of western designs. Eighty-nine per cent of DTA retailers agreed that Indian SEZs should be allowed to sell their products to domestic retailers, subject to payment of duty.

Barriers Faced by the Gems and Jewellery Units in SEZ

1. Policy Uncertainty and Gaps in the DESH Bill

Both the SEZ and DTA units said that the evolving new SEZ policy, i.e., the DESH Bill (2022), lacks clarity on the objective, on the type of fiscal and non-fiscal incentives it will provide to the units, the conditions that are required to be met to get the incentives, and the terms and conditions applicable to sell in the DTA. It does not have any performance targets.

2. Strong Competition from Other Countries

SEZ units in India are facing increasing competition from gems and jewellery units in other countries like China and Turkey. The competition is due to a several reasons including better technology and innovation, better utilisation of existing resources, lower production costs that enable more competitive pricing, and policies such as allowing reverse job work that allow efficient utilisation of labour and equipment. In competing countries, there is policy certainty. Further, non-fiscal incentives like reverse job work are available, subject to certain terms and conditions, like payment of appropriate taxes and duties, which helps firms mitigate the risk related to seasonality of export demand.

3. Seasonality of Exports

Due to the seasonality in demand in the export market, labour and equipment capacity in SEZs are not optimally utilised. Moreover, there are demand uncertainties due to supply chain disruptions related to the COVID-19 pandemic, the Russia-Ukraine war, etc.

4. Limited Non-Fiscal Incentives

Indian SEZs units have much fewer non-fiscal incentives compared to their counterparts in many developing countries.

5. Limited Skill Development and Training Programmes

The survey participants pointed towards skill shortages in this sector, the need for skill upgradation, and limited government participation and collaboration with the private sector and other stakeholders in imparting training for skill development.

6. Low Ease of Doing Business

The SEZs suffer from certain problems such as a complicated and time-consuming exit process, involving approval from multiple authorities at the centre and state levels, unlike countries such as Philippines and Indonesia. These problems undermine the ease of doing business.

Policy Recommendations

1. Need for Robust Research and Data-driven Policy Making

There is a need for data collection on domestic sales, domestic sourcing, exports, imports, etc., to understand the contribution of SEZs to the economy. Since, firms in SEZs want fiscal incentives, the targets for exports, employment, investment, etc., must be specified and the likely cost and benefits must be examined. At present, data on many indicators, such as imports into SEZ or sourcing from DTA, are not available in the public domain, making it difficult to understand the contribution and performance of SEZs. Such data should be made available for analysis and inputs into policymaking. The DESH Bill should provide a robust WTO compliant SEZ policy, which brings clarity on (a) the performance criteria and their measurement against which fiscal incentives may be given to the units, (b) rules of origin, and how it can be applied on sales from SEZs to the DTA (c) incentives that will be provided to SEZ units vis-à-vis units located in the DTA. There is need for a detailed study on the costs and benefits of extending schemes such as RoDTEP to SEZs. With increasing servicification of manufacturing, subsidies can be given to the services used in manufacturing (like worker training, or in logistics services, software implementation, etc.,) as these can be WTO complaint. This, again, will require detailed study to identify the needs of SEZ units and the impact these incentives will have on the performance of SEZ units. The need may be different for different sectors. There is need for detailed study on the design of the fiscal incentive and its impact, and on non-fiscal incentives given by competing countries that could help the Indian government design a comprehensive non-fiscal incentive package to facilitate exports.

2. Need for Definitional Clarity in DESH Bill, 2022

The SEZ policy does not provide clear definitions of terms such as 'job work', 'reverse job work' and 'manufacturing services'. At present, the DESH Bill, 2022, is not clear on what kind of manufacturing services may be included if reverse job work is permitted. It is important to have definitional clarity and the DESH Bill may lay down a glossary of terms, which will cover the definitions.

3. Remove Restrictions on Imports of Raw Materials/Intermediate Products

The restrictions on advance payments for import of gold and silver and its articles may be removed. For sales to the DTA using imported raw materials, domestic value addition has to be calculated for each product category and this information has to be provided by the industry to the government for designing policy on rules-of-origin for sales to the DTA.

4. Need for Government Support in Training and Research & Development

To match the skills of the Indian workforce with that available to emerging competitors in various segments, the government must raise upskilling efforts by sponsoring and supporting various capacity building and training programmes, customised to the needs of this sector. In this area, there is significant scope for public-private partnerships.

To conclude, the above recommendations will help design a robust SEZ policy and help improve the export competitiveness of the gems and jewellery sector. The industry needs to modernise, invest in R&D and innovation, and upgrade skills. There is scope for collaboration between business and government in areas such as capability building and training and brand building. Indian SEZs can learn from experiences of countries such as Vietnam and United Arab Emirates (UAE) in creating a transparent and predictable FDI policy, and on marketing and brand building, which helps to attract foreign investors to the zones. Non-fiscal incentives like reverse job work can help address some of the issues faced by units in SEZs including seasonality of demand, but such incentives need to take into account three factors: (a) they should not lead to relocation of units from the DTA simply to claim the incentives (b) there should be no adverse impact on revenue and employment in the DTA and

(c) it should be aligned with the overall objective of creating export zones, which is to promote exports. As many developed countries are entering into a possible recessionary phase that can adversely affect our exports, the Indian government must keep open the possibilities of SEZs catering to the domestic market. However, it is important to ensure that such policies do not put the DTA manufacturers at a disadvantage; it should also not be a drain on the government finances and the country should benefit from the policy.