STUDY OF THE BENEFITS OF ESTABLISHING A PAKISTAN-INDIA CROSS-BORDER SPECIAL ECONOMIC ZONE (SEZ)

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EXECUTIVE SUMMARY

Transnational Strategy Group LLC (TSG) has been retained by the United States Institute of Peace to conduct a pre-feasibility study on the possibility and benefits of establishing an India-Pakistan Cross-Border Special Economic Zone (SEZ). The study is intended to analyze issues affecting the feasibility of such an SEZ, obstacles, potential benefits, industries that may be likely to invest in the SEZ and to identify next steps.

This report contains this analysis and is intended to lead to further discussion and study by the Indian and Pakistani governments, their business communities and other stakeholders, and, potentially, to implementation. Realization of a cross-border SEZ would be an unprecedented step for the two nations and would promote commercial and economic expansion goals, job creation and regional cooperation in a new and mutually beneficial manner.

The study offers a high-level evaluation of the key components generally required for development of successful SEZs, with a focus on the Indian-Pakistani commercial and political relationship and suggests a going-forward action agenda.

The key areas reviewed included the following:

- Benefits derived from developing an SEZ;
- SEZs as conduits for country-wide economic development;
- Site selection criteria;
- Creation of an SEZ administering authority;
- Initiating "smart incentives";
- Comparative analysis of Indian and Pakistani SEZ legislation;
- Key benchmarking analysis;
- Major trade routes and transactional freight costs;
- Trade data;
- Potentially promising investment sectors;
- And, based on this analysis, where and how to begin with a pilot SEZ.
- We also provide observations (in an Appendix) of two cross-border zones - China/Khorgos (Kazakhstan) and Kaesong Industrial Region (North/South Korea) - and the U.S. Qualifying Industrial Zone (QIZ) initiative as illustrative of ways to organize and administer an India-Pakistan SEZ and ways in which third-countries can support creation of such zones.

The study suggests that while there are significant challenges to establishment of an SEZ, none are judged as insurmountable, given political will of both nations. An SEZ, beginning at the pilot stage, can provide a new commercial channel for additional steps to strengthen bilateral cooperation, led by mutual commercial interest.

The current phase of optimism towards trade normalisation between India and Pakistan began with Secretary-level talks between the two countries in 2004. Trade between two countries was really negligible prior to 2004 (at around US$ 500M). The rate of growth witnessed for about 3 to 4 years after the Secretary-level talks have more or less tapered off and there has been little growth since.[1] It would be fair to conclude that trade has become hostage to political developments and there appears to be no breakthrough in sight.

We think that the proposed SEZ will provide a breakthrough that other measures are unable to provide in the current state of bilateral ties.

One of the major infrastructure obstacles is availability of electric power, an issue on both sides of the border and confirmed by a surveys conducted by the World Bank after interviewing numerous investors. This offers an opportunity for both countries to develop "green power generation" using waste from the agricultural sector and/or jointly investing in, and sharing power inside the SEZ.

Both countries currently have SEZ legislation in place that shares many of the same objectives such as creating employment, increasing exports, attracting foreign investment and providing adequate infrastructure. The existing legislation provides a regulatory framework and dispute resolution clauses. However there are differences that would need to be brought into better alignment such as India's Minimum Alternative Tax and Pakistan's tax on profits and development surcharge.

We assess that a cross-border SEZ is most favorably placed at a point between the two Punjabs. While India's Punjab state has its own SEZ law, which offers additional incentives in addition to the Federal SEZ law, Pakistan's Punjab province follows the Federal SEZ law. This sub-federal level legislation in both nations would also need to be considered, and harmonized, in building a legal basis for the SEZ.

One of the principal benefits and goals for establishment of an industrial zone, whether wholly domestic or cross-border, is to create a more business-friendly environment so as to attract commerce, economic activity and job creation. We believe that establishment of the SEZ, starting with a suggested pilot phase, can make a contribution to lifting India's and Pakistan's low relative global rankings as assessed by the World Bank, by promoting transparency and reducing bureaucratic burdens. An SEZ can be a catalyst for broader reform in both nations.

The report summarizes relevant trade and transportation patterns to assess and provide further justification and a commercial rationale for the economic value of a cross-border SEZ. An important conclusion is that by reducing the sensitive and negative list of products (i.e. those goods specifically declared as unable to be

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[1] *From: Taneja et al: Normalising India Pakistan Trade, ICRIER New Delhi 2013*

imported) through reforms to establish an SEZ, land border crossing would be more viable and would encourage manufacturing companies to produce in the SEZ with direct access to both India and Pakistan from a single location.

In addition, another adverse result of the extensive negative lists is the current trade imbalance between India and Pakistan where India exports four times more products to Pakistan than it imports. These trade barriers, while protecting some industry sectors, actually have a negative impact on the overall economy by restricting competition and in many cases can reduce the quality of products.

Our analysis indicates an SEZ could provide potential benefits for the textile, automotive (especially components) and pharmaceutical industries. We believe that these three sectors offer strong opportunities for location in a prospective cross-border SEZ.

Other industries that might benefit from locating in the SEZ could include sporting goods, machinery and machine tools, surgical and scientific instruments, and electrical products that are currently being manufactured in both Punjabs and would likely benefit from a joint SEZ by consolidating operational costs, permitting trade in both directions and possibly offering the opportunity for joint ventures between Indian and Pakistani firms. Food processing is another possibility.

Benchmarking data and analysis in this report reveals poor rankings of both nations. The economic and regulatory reforms needed to establish an SEZ, even at the pilot stage, can help to lift rankings and act as a catalyst for broader reforms in both countries.

Due to a history of unresolved border issues and continuing border-related security issues, maintaining security of borders would be a major consideration of both counties in their final evaluation of the SEZ initiative.

We believe that internal security and military officials, especially those in charge of border security in the two countries, will need to be consulted by provincial and Central authorities and their input sought in design and secure operation of an SEZ. Since an SEZ would be secured, and entry and exit controlled, this should give a comfort level on both sides of the border, particularly to the military and intelligence services.

Finally, and very importantly, is the question of phasing. This report provides the analytical foundation for further, necessary work by both governments and business communities and potential international financial institution or other funders.

But we recognize that it is unrealistic to attempt to establish a fully developed SEZ immediately. We propose beginning with a pilot SEZ in which first investors and the governments would work cooperatively to negotiate minimum regulatory and legal reforms, incentives and other policy-related measures that enterprises looking into potential investment in the SEZ need and that governments can, initially, provide. We offer a suggested action agenda leading to establishment of such a pilot SEZ.

It is important to understand that no two SEZs are identical although they contain many of the same components such as special incentives, legal and regulatory transparency, and quality infrastructure. Other countries have faced similar challenges and discovered that a jointly developed, and customized, SEZ has proven to expand both economies, encourage improved cultural understanding, expanded peace and security, and proven to be a catalyst to economic reform. SEZs permit change in smaller scale policy "laboratories," experimentation that is often seen as safer than immediate and wide-ranging economy-wide reform. Some examples appear in the body and Appendix to this report.

This study indicates that there is potential for developing a cross-border SEZ between India and Pakistan, but only if a number of steps are agreed to, and implemented by both governments. There must be the political will by both India and Pakistan to sit together and compromise on issues such as having a transparent regulatory regime, assurances of mutual security, reducing the number of products on the sensitive and negative lists, aligning basic differences between their respective SEZ legislation, and reducing bureaucracy. A pilot SEZ is the way to start this process with small, do-able steps.

I. Special Economic Zones (SEZs) – General Considerations

SPECIAL ECONOMIC ZONES AS A POLICY TOOL

An SEZ is a geographically delineated, physically-secured, and often restricted access area that is regulated by liberalized legal provisions. A distinguishing feature of an SEZ is that the area usually falls outside the country's national customs territory for customs-duty and tax assessment purposes; offers a variety of investment incentives, quality infrastructure and reliable utilities; and freedom from restrictions relating to currency, repatriation of profits and capital.

For developing and emerging countries generally, SEZs have positive economic policy and infrastructure implications, regardless of whether the host nations are operating under in a politically stable or a post-conflict atmosphere. For post-conflict nations in particular, SEZs can act as a pioneering vehicle to foster peace building. Effective rule-of-law reform carried out in an SEZ setting that promotes human security, establishes basic law and order, creates a system to resolve property and commercial disputes, enforces contract rights, advances labor-rights protection and achieves equality before the law can contribute to peace-building throughout the post-conflict nations on an enclave-by-enclave basis, with positive spillover effects throughout each nation. Indeed, we often hear calls by potential investors to extend business-friendly regulatory, legal, fiscal and other measures applying in an SEZ to the entire economy.[2]

There are many examples where countries have formed joint industrial parks at borders not only to provide an opportunity for the people of both countries to interact, but also for substantial economic gains of both countries. This is therefore not a novel exercise as joint industrial zones exist between many countries including those that have not always been historically friendly neighbors. Examples include Sino-Singapore Suzho Industrial Park, the Kaesong Industrial Region between North and South Korea, the Egypt-Israeli Qualifying Industrial Zones, the China-Malaysia Qinzhou Industrial Park, and the China-Khorgos (Kazakhstan) SEZ. Several of these are examined in the Appendix.

Governments around the world adopt SEZ's in order to reinforce their ability to compete in the global market and to satisfy one or more of the following:

- To overcome access to land issues, especially land ownership by foreigners;
- To address an inadequate overall policy framework and a poor investment climate such as poor implementation of customs procedures, company licensing, etc.;
- To provide higher quality, efficiently-run infrastructure;
- To initiate the development of clusters of industries and supporting industries;
- To "jump-start" the economic growth of under-developed locations, generate more job opportunities and promote economic interaction in these locations.

SEZs offer certain economic and legal advantages - economic freedoms - to foreign investors who otherwise would be reluctant to conduct business in an unfamiliar foreign jurisdiction. Basic SEZ freedoms can include corporate income tax, import duty, import quota, and excise-tax exemptions, as well as foreign exchange and investment liberalizations. Additional SEZ features that foreign investors are now demanding across the globe are streamlined company formation, business registration, labor, immigration, environment, land acquisition, land use, customs, and tax standards and procedures. Transparent legal provisions designed to protect

[2] See for example a recent article on special zones in Japan that stated: "Testing such reforms in special zones is politically easier. And once the benefits become clear, champions of the zones argue, the rest of the nation would clamour to follow," *The Economist,* August 10, 2013.

private property rights and settle commercial controversies by means of modern alternative dispute resolution mechanisms also comprise part of the existing SEZ package of benefits as well.

BENEFITS OF SEZs:

- Facilitates customs and other controls;
- Conveys "free-trade status" for exporters;
- Facilitates regional growth and industry dispersal;
- Provides agglomeration benefits from concentrating industry in one location;
- Creates direct, indirect, and induced employment;
- Generates capital investment;
- Can provide net foreign exchange for components of local value-added such as salaries and wages, user fees such as utilities, and transport, locally sourced raw materials, machinery, intermediate goods, local repair, maintenance, profit and capital remittances.

SEZs can also be used as a catalyst for economic reform and broader economic integration within countries and regions as has happened in countries like Mauritius and the UAE, without the need to apply such reforms immediately throughout the country. This ability to institute reforms within a region or defined area permits introduction of structural reforms on a more politically palatable basis and as a means of relieving tensions and improving bilateral business and stability.

By offering smart economic performance incentives, reduced bureaucratic interference, and enhanced legal enforcement of property rights, SEZs have been able to create regulatory environments more conducive to business and more attractive to both domestic and foreign enterprises. The resulting foreign investor confidence typically attracts the initial direct investment outlay that is necessary to create new commercial ventures, generate indigenous employment opportunities, enhance export activities, and promote infrastructure development.

A good example of how establishment of an SEZ can jump-start reform and reverse political inertia can be found in Shenzhen, PRC. The Shenzhen SEZ was China's first, created nearly 35 years ago out of a desire to move from what China's then-leadership saw as a need to transition from a centrally planned economy to one more open to private sector business development. As described in a recent report[3]: "It was a bold strategy tempered by cautious tactical steps. Although an unprecedented move to introduce market practice and foreign investment to post-

[3] "The "Instant City" Coming of Age: China's Shenzhen Special Economic Zone in Thirty Years," Xiangming Chen and Tomas De'Medici, Center for Urban and Global Studies at Trinity College, Spring 2009, at: http://www.trincoll.edu/UrbanGlobal/CUGS/Faculty/Rethinking/Documents/The%20Instant%20City%20Coming%20of%20Age.pdf

reform China, it was implemented with the state's unfettered ability to control the experiment in a confined environment and restrict any negative effects. This coupling of audacity and caution made it possible to replicate success and reduce risks from the very outset of China's reform, when major success was far from certain and the risks of failure were perceived as high."

The challenge for an India-Pakistan SEZ is not introduction of market-based enterprises but to begin the first steps of a process of economic integration between two countries with historic rivalries. In the case of India and Pakistan, we believe that both governments will see establishment of a pilot SEZ as a limited-risk experiment where, as noted in the case of the Shenzhen SEZ, "major success was far from certain and the risks of failure were perceived as high."

A fully functioning, fully mature cross-border SEZ between India and Pakistan could very well become a catalyst for enhancing trade between the two counties by:

- Eliminating the current practices of trading between the countries via transshipping through a third country
- Attracting foreign investment by implementing an aligned import/export policy between the two countries
- Streamlining and aligning regulatory frameworks
- Enhanced freedom of currency transactions between the two countries;
- Controlled, secure freedom of movement by both countries

SEZS AS CONDUITS FOR COUNTRY-WIDE ECONOMIC DEVELOPMENT AND PEACE-BUILDING:

An important policy lesson learned from decades of zone development around the world is that SEZs cannot act as a substitute for country-wide legal/economic reforms. Rather, zones constitute one tool in a broad array of policy instruments that governments can use to create jobs, diversify exports, and promote FDI. The available evidence suggests that SEZs are more likely to achieve their stated objectives when the host countries, including nations like India and Pakistan, design such regimes to promote mutually beneficial legal/economic reforms in an integrated and cohesive fashion.

ESTABLISHING AN SEZ – KEY ELEMENTS

TYPES OF SEZS:

There are numerous categories of zones. Below are general types of zones and a brief description.

1. Free Trade Zone (FTZ): Also known as commercial free zones are fenced in, duty free areas, offering warehousing, storage, and distribution facilities for trade, transshipment, and re-export operations.
2. Export Processing Zones (EPZ): Are industrial estates aimed primarily at foreign markets. Hybrid EPZs are typically sub-divided into a general zone open to all industries and a separate EPZ area reserved for export-oriented, EPZ-registered enterprises.
3. Enterprise Zone: Intended to revitalize distressed urban or rural areas through the provision of tax incentives and financial grants.
4. Freeports: Typically encompass much larger areas. They accommodate all types of activities, including tourism and retail sales, permit on-site residence, and provide a broader set of incentives and benefits.
5. Single Factory EPZ: Provide incentives to individual enterprises regardless of location, factories do not have to locate within a designated zone to receive incentives and privileges. Single factory EPZ programs are similar to bonded manufacturing warehouse schemes, although they typically offer a broader set of benefits and more flexible controls.
6. Specialized Zones: Also known as Industry Specific Zones, include zones designated for specific industry sectors such as Airport-based Zones, IT Parks, Logistics Parks, and the like.

SITE SELECTION CRITERIA:

Site selection is an important step that affects both the success and the sustainability of any type of zone. The following represent criteria that must be taken into account in determining where a zone should be located. It provides a foundation for further study and decision making as to site selection.

- **Location:** Since an SEZ is intended to help kick start industry in the joint zone, the governments of India and Pakistan will need to identify locations near border crossings that have linkages to strategic local and international trade, local production, and are in close proximity to existing facilities or existing infrastructure networks. This helps the initial start-up phase of the site and also helps reduce costs that are associated with infrastructure, trade/transport accessibility and relocating or identifying labor, raw and intermediate materials and other supplies. The site(s) selection should be familiar to businesspersons in both nations. Familiarity is a very important aspect for industry when choosing a location since it creates an association that makes investors feel comfortable. This in turn helps reduce marketing costs associated with introducing a new site to investors. Associated political factors are also critical. It will be important to select site(s) that are supported by political leaders and other stakeholders and decision makers in both nations.

- **Accessibility:** Raw materials, industrial production, distribution channels, and the labor pool will need to be closely linked and accessible for the SEZ to be sustainable and successful. The SEZ needs to be in close proximity to the trade routes and should have physical links to the markets to which it is distributing its output as well as the markets from which it is obtaining its raw materials.
- **Topography and boundary for development:** The site should be picked with construction difficulties in mind. This includes all characteristics that can affect physical development. The topography of a site is very important in determining the land uses and construction costs associated with a development. Construction and ease of development makes an SEZ financially viable and decreases invisible costs such as earth works, leveling, filling foundation problems, etc.
- **Environmental conditions and sensitivities:** The concentration of industries in an SEZ can have major impacts on the environment and health and safety. These in turn can lead to serious financial consequences as a result of increased health care costs, damage to biodiversity, water treatment costs resulting from water pollution, rapid depletion of groundwater supplies, restrictions in land use capability due to contaminated soil, traffic congestion, and reduced worker productivity.
- **Adjacencies:** Social infrastructure is the range of activities, organizations and facilities supporting the formation, development and maintenance of special relationships with the community. It can include provisions of community facilities such as schools, community centers, police stations, day care, etc. or community organizations like non-profit clinics, community services and the like. It is important that these be in close proximity to the SEZ. Providing adequate social infrastructure either within the SEZ or very close by with easy access to those working in the SEZ is crucial for attracting quality manpower. Such social infrastructure will also be required to attract necessary management of the industrial facilities.
- **Proximity to utility services:** Due to the size and multitude of activities, the SEZ needs to be located close to a dominant water source or be linked to the existing water infrastructure.
- **Energy:** The SEZ will likely require large amounts of energy. It would be important to locate the SEZ at a site that has access to the electricity network or enable the SEZ to create a closed network that can supply its own power.

Self-generation would help to separate the SEZ from the general electrical grid and protect it from any grid failures.

- **Wastewater treatment:** Wastewater treatment facilities are very important to reduce liquid pollutants generated by industries as well as to mitigate the effects of any pollution dumping into waterways. If the site location has industrial grade water treatment facilities in the region, they should be expanded or renovated for the SEZ. If not, the SEZ should be located in a place that can handle such a facility or the SEZ should develop its own.
- **Telecommunications:** Telecommunications and data services are a must for companies, industries, new businesses, banking services and the general population alike. The SEZ should be located at a site where it can access telecommunications and data services or be located in an area where these services can be developed.
- **Proximity to raw materials and other production resources:** Raw materials for production are critical to industries involved in any type of manufacturing activity. If the industry profile for the SEZ shows a market assessment with heavy demand for certain industries or specific demands for raw materials such as limestone for cement, it would generally be a good idea to locate in a site that has access to these raw materials.
- **Availability of labor:** Local labor is an important contributor to the success of an SEZ and its industries. The SEZ should be at a site readily accessible by the local population or in close proximity to local labor.

The SEZ will create work opportunities as well as living communities as it develops in a well-planned and appropriate manner. If the selected site for development has current settlements within its boundaries, these communities should be very carefully considered during the planning process.

Once a site has been selected based on the foregoing criteria, there are other planning issues that need to be considered including master planning, phasing, long term planning, zoning, density, buffer zones, floor area ratios, etc. The two most important of these before construction begins are an international best practice master plan and adequate phasing.

Governance standards are equally as important as physical infrastructure considerations particularly in a cross-border conflict environment.

Although the adoption and observance of best practice governance standards can be a challenging task for conflict, or politically tense cross-border zones, a best practice legal regime can still be designed and adapted to a conflict environment.

To establish an enabling environment for effective development of a competitive and sustainable SEZ on the border of India and Pakistan, the governments should adopt at a minimum the following best practice governance principles:

- Standard provisions that establish definitions for key terms that prevent speculative land transactions, and that codify pre-exemption clauses;
- Market-driven legal features, including joint national treatment, private property, and international arbitration guarantees;
- Joint zone-designation criteria that promote social, environmental and community sustainability;
- Joint one-stop shop institutional framework with some representation from both sides especially with regards to customs and border agencies;
- Broad Public-Private Partnerships (PPP) and how their operating mechanisms will be implemented i.e. can one nation enter into a PPP without the other nation or do both nations agree to operate as a single regulatory unit;
- Where possible and practicable, offer consistent incentives, World Customs Organization customs procedures, and compatible labor standards.
- Collective security guarantees and arrangements.

CREATION OF AN SEZ ADMINISTRATING AUTHORITY:

Coordinated SEZ legislation (like the U.S.-Mexican Free Trade Zone legislation) will constitute the vehicle through which India and Pakistan can establish the SEZ's new administering authority. (There are different ways of achieving this that will be discussed later in the report). Ideally this body should be a joint establishment with equal numbers representing both countries and operate like a unified bilateral organization or commission. However each country could set up its own corporation that could act as individual shareholder of the SEZ by creating a Special Purpose Vehicle (SPV) and agree on a neutral third party Operator that acts on behalf of each partner under an agreed platform for administration, marketing, and operations. The SEZ authority will set out the zone's objectives, powers, duties, functions, and responsibilities of the administering authority.

The statutory objectives of the SEZ central authority would be determined by harmonizing the SEZ legislation of both countries and should include, among others, efforts to:

- stimulate the production of goods and services and the creation of employment in the various sectors as determined by demand analysis, in harmony with global best practices;
- encourage competition in the SEZ and to avoid where practicable monopolistic conditions by freeing up market access from the nationals of the other partner country;
- develop a high quality harmonized, and standardized business environment consistent with best practices;
- safeguard public health and safety;
- achieve efficient zoning;

- protect the environment in the SEZ, including water supply, natural resources, and biological diversity;
- protect workers rights and working conditions consistent with protocols enacted by each country;
- provide equal investment and employment opportunities;
- administer the SEZ through a one-stop shop approval and service center focused on bilateral trade that has a centralized office in the SEZ.
- create employment, trade, business opportunities, stability, and border community peace and prosperity.

To ensure the fulfillment of these objectives, the SEZ central authority should be presided over by a Board of Directors representing both nations and a Chairmanship that rotates between India and Pakistan at equal intervals of years.

The SEZ Board of Directors should confer the following powers to the administering authority:

- To administer, manage, and develop the SEZ;
- To issue licenses, permits, authorizations, and approvals to registered enterprises;
- To conclude MOUs with both national ministries and authorities having concurrent jurisdiction over their respective land sites, operations, or activities;
- To regulate all SEZ enterprises and activities;
- To provide itself or through third parties SEZ utility services if and when practical;
- To issue implementing regulations;
- To establish and impose administrative penalties, sanctions, and fines for any legal or regulatory violations or infractions occurring in the SEZ;
- To allocate and freely dispose of SEZ lands by whatever means;
- To revoke, cancel, suspend, withdraw, or modify licenses, permits, and authorizations in accordance with the implementing regulations as well as deny applications;
- To prohibit by regulation SEZ economic activities for reasons involving public morality, public safety or security, public hygiene or health, the protection of human health, life, or the protection of intellectual property rights;
- To have administrative responsibility and control over all government officials working in the SEZ except those responsible for public safety such as police, customs, fire, etc.

SMART INCENTIVES/ECONOMIC PERFORMANCE CRITERIA

The major attractiveness of SEZs as catalysts for inward investment, economic development and commercial growth lies not in fiscal incentives, but rather in dynamic synergies created by a cluster of enterprises in proximity to streamlined administration/regulation, improved infrastructure/services, an educated workforce, and trade-enabling dynamics.

Best practice SEZ statutes usually avoid relying on tax holidays and, instead codify into law smart, performance-based incentives such as customs duty exemptions and VAT zero-rating for processed merchandise that is exported, accelerated depreciation, training, R&D, loan guarantees, investment allowances, infrastructure incentives, and certain non-financial incentives.

II. A Cross-Border, India-Pakistan SEZ –Analytical Framework

COMPARATIVE ANALYSIS:
EXISTING INDIAN AND PAKISTANI SEZ LEGISLATION

Existing legislative authorities in both countries are as follows. Note that legislation summarized below governs activities within each nation alone; there is no legislation at this time governing activity in a cross-border SEZ.

INDIA:
The Federal or Central law is the Special Economic Zones Act, 2005[4]. The SEZ requires approval from both the Central and State Governments.

PAKISTAN:
Regulations of the SEZ Act 2012 are meant to cover all provinces of Pakistan[5]. The provincial authorities are integrated within the SEZ framework through the Provincial SEZ Authority that forms one tier of the SEZ structure.

Goals for SEZ legislation:

India:
The SEZ Act 2005 was enacted to meet the following goals:

1. Generation of additional economic activity.

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[4] http://www.sezindia.nic.in/writereaddata/pdf/SEZ%20Act,%202005.pdf

[5] *Special Economic Zones Act, 2012*
Gazette of Pakistan September 13, 2012
file:///C:/Users/mypc/Downloads/Gazette%20Notification%20SEZ%20Act.pdf

2. Promotion of exports of goods and services.
3. Promotion of investment from domestic and foreign sources.
4. Creation of employment opportunities.
5. Development of infrastructure facilities.

PAKISTAN:
The SEZ Act 2012 was enacted to meet the following goals:
1. Increase exports.
2. Increase Foreign Direct Investment (FDI).
3. Increase economic growth and employment opportunities.
4. Provide adequate infrastructure for developers and enterprises.
5. Standardize regulatory framework for foreign investment and full legal protection of foreign investment[6].

Special incentives available:

INDIA:
The SEZ Act 2005 lists special incentives and facilities:
1. Exemption from customs duties.
2. Exemptions from Excise tax.
3. Exemption from central sales and service tax.
4. Single window clearance for setting up an SEZ.
5. Simplified procedures and documentation.
6. No requirement for bank guarantees.
7. Dispute resolution clauses.
8. Punjab State has its own SEZ Act 2009 and can offer additional benefits at a State level in addition to Federal incentives.
9. Provision for Public, Private, or Public/Private development.

NOTE: Initially the Indian Government announced SEZs to be tax-free but later the Finance Ministry imposed what they called Minimum Alternative Tax (MAT). This has damaged their credibility with multinational companies. A cross-border SEZ would present an opportunity to enhance business certainty while not having a major, national impact.

PAKISTAN:
The SEZ Act 2012 lists special incentives and facilities:
1. Enterprises in the SEZ are entitled to Certificates of Origin from Pakistan the same as if they were in the customs territory.
2. Exemption from all taxes and duties on equipment, machinery, and materials
3. Loss carry-forward.

[6] *Investment Policy 2013*, Board of Investment Pakistan
http://www.sbi.gos.pk/pdf/SEZA/INVESTMENT%20POLICY-2013.pdf

4. Single window services including facilitation of import permits and export authorizations.
5. The Export Processing Zones Authority collects a tax between 0.5-1.25% of total profits when goods are exported, plus 0.5% development surcharge. Otherwise exemption from all federal, provincial, and municipal taxes for export production.
6. Full repatriation of capital and profits for foreign investors.
7. Board of Approval (BOA) may grant additional benefits in particular categories if justified.
8. Dispute resolution provision.
9. Income tax exemption for 10 years.
10. Provision for Public, Private, or Public/Private development.

Other key SEZ legislative provisions:

INDIA:
The SEZ Act 2005 lays down minimum sizes of land for various kinds of SEZs.

Multi Sector SEZ	1000 Ha
Sector Specific SEZ	100 Ha
FTWZ	40 Ha
IT/ITES/handicraft	10 Ha

Maximum land size allowed for SEZs: 5000 Ha. Recently the minimum size for multi sector SEZ has been reduced to 500 Ha.

PAKISTAN:
The SEZ Act 2012 allows for a minimum of 50 acres for SEZ development.

Additional provisions of the Act are:
1. Public owned land must be leased for a period of 50 years, extendable for a further period.
2. Developers must comply with all environmental, labor, and other applicable legislation in force in Pakistan.
3. Developers get a one-time exemption from all customs duties and taxes for all capital goods imported for the development, operation and maintenance of the SEZ.
4. Exemption from all taxes on income accruable in relation to the development and operation of the SEZ for a ten-year period.
5. Enterprises get an exemption from customs duties and taxes on imports of capital goods for installation in the SEZ.
6. Exemption from all taxes on income for a period of ten years.

Pakistan's legal system is based on British Common Law, with an overlay of Islamic legal precepts. In 2004, Pakistan's Cabinet approved Pakistan joining the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards.

Pakistan is also a member of the International Center for the Settlement of Investment Disputes, and the Pakistan Arbitration Act of 1940 also provides a mechanism for arbitrating commercial disputes[7].

Foreign direct investment in Pakistan is protected from expropriation by the 1976 Foreign Private Investment Promotion and Protection Act, and by the 1992 Furtherance and Protection of Economic Reforms Act.

Current government of Pakistan investment policy provides that all incentives, concessions, and facilities for industrial development be equally available to domestic and foreign investors.

Existing enterprises exporting at least 80% of their production are eligible for incentives under an Export Processing Zone program, but new enterprises are required to export 100% of their production in order to be eligible.

For new investments, a 50% first-year depreciation allowance for plant, machinery, and equipment can be used to offset taxable income, and unused allowances can be carried forward. An investment tax credit of up to 50% of plant, machinery, and equipment is available to encourage plant expansion and modernization.

In reviewing the current SEZ laws of India and Pakistan at this level of analysis, our overall view is that many regulations are similar and would not need a major overhaul. What seems to be the biggest hurdle is consistency and transparency in implementing the laws and reducing or eliminating perceived corruption of officials.

COMPARATIVE ANALYSIS: EASE OF DOING BUSINESS

BENCHMARKING HIGH LEVEL CRITERIA:

While the following Ease of Doing Business benchmarking analysis is by no means the only evaluation to be considered in deciding whether there should be a joint cross-border SEZ between India and Pakistan, it presents a high-level view and the benefits and challenges both countries need to examine in more detail, as well as the challenges faced by investors that the governments must recognize. As stated earlier, improving the business environment within the SEZ will help the economy-wide reform process in both nations.

[7] 2013 Investment Climate Statement Bureau of Economic and Business Affairs, Department of State, February 2013 Report, at: http://m.state.gov/md204710.htm

The World Bank's "Doing Business 2014"[8] ranks 189 countries in 10 key areas:

Starting a business	Dealing with construction permits
Getting electricity	Registering property
Getting credit	Protecting investors
Paying taxes	Trading across borders
Enforcing contracts	Resolving insolvency

For this exercise, a comparison not only between India and Pakistan was made, but also their neighboring countries. It is noted that Iran is one of the comparisons. It is not compared as a potential trading partner due to existing global sanctions, but rather as a potential competitor at some time in the future. (In this table, the lower the number, the better the performance.)

Topic:	India	Pakistan	Afghanistan	Bangladesh	Iran	Tajikistan
Starting A Business	179	105	24	74	107	87
Getting Electricity	111	175	104	189	169	186
Dealing With Construction Permits	182	109	167	93	169	184
Registering Property	92	125	175	177	168	78
Getting Credit	28	73	130	86	86	159
Protecting Investors	34	34	189	22	147	22
Paying Taxes	158	166	98	100	139	178
Trading Across Borders	132	91	184	130	153	188
Enforcing Contracts	186	158	168	185	51	39

[8] "Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises," The World Bank, Oct. 29, 2013, at: http://www.doingbusiness.org/reports/global-reports/doing-business-2014

Resolving Insolvency	121	71	115	119	129	81

The number of procedures and days to register a company is a significant indication of bureaucracy. While the domestic market may be accustomed to registration delays, this can be a deterrent to foreign investors. Conversely, reducing days to register can present an opportunity for reform, if there is the will to do so. Getting electricity is a major hindrance in both countries. Since both Punjabs are agricultural centers, a bio-fuel power station serving the SEZ could present an opportunity to solve this issue, as well as incorporating a "green" element that may well be a major selling point to multinational investors. An SEZ that has the regulatory oversight to guarantee legal transparency would improve investor's rights, contract enforcement and tax payment compliance.

Topic:	India	Pakistan	Afghanistan	Bangladesh	Iran	Tajikistan
Number Of Procedures	12	10	3	7	8	5
Time in Days	27	21	5	10.5	16	33
GLOBAL RANK	**134**	**110**	**164**	**130**	**152**	**143**

The World Bank also conducted an Enterprise Survey of existing and prospective companies to identify the top 10 business environment constraints faced or perceived by the firms surveyed. The India survey was last conducted in 2006[9] and Pakistan was last surveyed in 2007[10], however we believe the constraints are similar today.

The below numbers are in percentage of firms surveyed that indicated that factor was an impediment to business.

INDIA

Electricity	35.2
Tax Rates	16.5
Corruption	10.7
Tax Administration	8.5

[9] "India Enterprise Survey," The World Bank Group, 2006, at: http://www.enterprisesurveys.org/data/exploreeconomies/2006/india
[10] "Pakistan Enterprise Survey," The World Bank Group, 2007, at: http://www.enterprisesurveys.org/data/exploreeconomies/2007/pakistan

Access to Finance	6.5
Inadequately educated workforce	4.5
Labor Regulations	4.0
Access To Land	7.1
Transportation	2.5
Customs and Trade Regulation	2.5

PAKISTAN

Electricity	66.7
Corruption	11.7
Crime, Theft, and Disorder	5.5
Access to Finance	3.9
Tax Rates	3.7
Access to Land	3.6
Political Instability	1.2
Customs and Trade Regulations	.9
Inadequately Educated Workforce	.7
Tax Administration	.7

As can be seen from above, electricity is the major issue in both countries and corruption and tax rates are also a constraint in attracting investment. Globally, both India and Pakistan are ranked as difficult nations in which to do business, however they are competitive in comparison to their neighboring countries, which would indicate a joint SEZ – which provides both governments the ability to implement and showcase a dramatically more business-friendly environment on an experimental, small scale, pilot basis - has the potential to become a regional hub for trade and industry in the medium- to long-term.

COMPARATIVE ANALYSIS: INDIA-PAKISTAN TRADE ROUTES AND FREIGHT COSTS

Despite a long 2900 km land border that passes close to significant human settlements on both sides, cross-border trade between India and Pakistan is severely limited. Land trade mostly takes place through only one border crossing at Attari-Wagah and costs of other routes remain high. A joint SEZ straddling the India/Pakistan would substantially increase land-based trade access to both sides and likely reduce trading costs.

Due to the many sensitive products and products on negative lists (i.e. disallowed or discouraged for trade between the countries) maintained by both countries, many shippers prefer to use informal and quasi-formal routes via Dubai, Singapore, Iran and Afghanistan where such products are repacked, mislabeled and transshipped to the other nation. This has also led to limited land trading routes, principally at the Attari-Wagah border crossing and the Mumbai and Karachi sea route. This process adds considerable additional freight costs to both the shipper and consumer.

By reducing the sensitive and negative list of products, land border crossing would be more viable and would encourage manufacturing companies to produce in the SEZ with direct access to both India and Pakistan from a single location.

Another adverse result of the extensive negative lists is the current trade imbalance between India and Pakistan where India exports four times more products to Pakistan than it imports. These trade barriers, while protecting some industry sectors, actually have a deleterious impact on the overall economy by restricting competition and in many cases can reduce the quality of products.

The following provides an analysis of current formal and informal trade routes.

FORMAL TRADE ROUTES:[11]

Land Routes:

1. The major operational trading road route is through Attari/Wagah border in both Punjabs. Both India and Pakistan have also announced additional road routes, however they are not yet operational.
   Pakistan allows 137 items to be imported from India on the road route, whereas all items can be exported from Pakistan to India by the road route without additional restrictions.
2. Since October 2008, India and Pakistan have permitted trade across the "Line of Control" (LOC) on the disputed territory of Kashmir. India and Pakistan have permitted trade in a selected list of 21 primary products across the LOC. Only goods originating in Kashmir from both sides of the border are permitted to be traded on this route, which are allowed to be traded only under a barter system.

Railway Routes:

Currently there is only one operational railway route along the Punjab border via the Amritsar-Attari-Lahore rail line through Attari and Amritsar rail station for movement of cargo between the two countries. The cargo moves either by the goods train or by freight cars attached to bi-weekly Samjhauta Express. Both India and Pakistan have also announced other rail routes, however they are not yet operational.

[11] "Formalizing the In Formal Trade Between Pakistan and India," at http://www.lcci.com.pk/Articles/Pak-Indo%20Trade_Sidra.pdf

INFORMAL TRADE ROUTES:

Major Routes:

Informal trade between the two countries is conducted through as many as eleven routes. Contrary to the existing perception, smuggling, and not quasi-legal trade through third ports constitutes majority of the trade. The greatest volume of trade is carried out via Afghanistan. Other major routes are situated over land across the Sind Border and via sea from Mumbai to Karachi via Dubai.[12]

1. India-Dubai-Iran (Bandar Abbas)-Afghanistan (Kandhar-Chaman-Karachi)
2. India-Dubai-Iran (Bandar Abbas)-Afghanistan (Kabul)-Torkhum/Bara-Lahore and Rawalpindi
3. India-Iran- (Bandar Abbas)-Torkham/Bara-Lahore and Rawalpindi
4. India-Karachi-Afghanistan-Peshawar (Afghanistan Transit Trade)

QUASI -FORMAL TRADE ROUTES: Land & Air

1. Singapore
2. Dubai

(Note: Informal and quasi-formal routes are indirect routes with trans-shipment and sometimes repacking of items on the restricted or negative lists. These items are not necessarily restricted when the country of origin is not India or Pakistan.)

There are also opportunities for air cargo as both Punjabs have international airports with cargo facilities. The Lahore Airport, renamed Allama Iqbal Airport is only 23 Km from the main Wagah-Attari India-Pakistan border crossing, while the Amritsar international airport in India has air cargo facilities as well as a Container Freight Station (CFS) planned for the future.

TRANSACTIONAL FREIGHT COSTS

The latest available analysis of freight costs comparisons for transport between India and Pakistan was done in 2007 by Nisha Taneja, of ICRIER (Indian Council for Research and International Economic Relations) and published in the Economic and Political Weekly[13]. We use this to illustrate some of the historical issues affecting cross-border trade between the two countries. Some specific concerns may have been addressed and rates may have changed, but the main conclusion – higher costs due to current restrictions – is clear.

[12] "India-Pakistan Informal Trade, SDPI Report, p. 1," at http://www.sdpi.org/research_programme/researchproject-108-12-569.html

[13] Nisha Taneja: India's Exports to Pakistan: Transaction Cost Analysis. "Economic and Political Weekly, ICRIER," Vol. 42, No. 2 (Jan. 13-19, 2007) pgs. 98-99

The sea route between Mumbai and Karachi has operated unhindered and has been the only consistent operational transport link. Another major route used to transport goods from India to Pakistan is the indirect sea route via a third country such as Dubai. Since Pakistan allows only a limited number of items to be imported from India, those not on the permissible list are being traded through third countries.

The key sea routes are the Mumbai-Karachi sea route and the Mumbai-Dubai-Karachi route. The latter is used to transport items not on the permissible list. The Mumbai-Karachi sea route using a "switch bill of lading (SBL)" that can be obtained at a cost/bribe illustrates the magnitude of transactional costs on an illegal/unofficial route.

Table 1: Route-wise Transaction Cost (TC) Per Container (US $)

	Transport Cost			Bribes		Total cost
	Rail	Sea	Total	Clearances	Other	
Delhi-Mumbai-Karachi	460	550	1010	48		1058
Mumbai-Karachi		550	550	26		576
Mumbai-Dubai-Karachi		750-950	750-950	26		776-976
Mumbai-Karachi using Switch bill of lading		550	550	26	200	776

Estimates for transport have been obtained for a 20-foot container. Other bribes include procuring rail wagons and/or switch bill of lading.

The cost comparisons above would indicate that by establishing a cross-border SEZ, both countries could reduce total transportation costs on non-restricted items and be able to serve both sides of the border more efficiently.

PAKISTAN/INDIA TRADE PATTERNS: IMPLICATIONS FOR POTENTIAL SEZ INDUSTRY INVESTMENT

A study was conducted by the Pakistan Business Council to identify potential for bilateral trade between India and Pakistan[14]. It highlighted 419 items of interest for Pakistan's exports to India and 758 items of interest for India's exports to Pakistan. The study estimated initial potential bilateral trade of US $ 18 billion, of which US

[14] "Preliminary Analysis of Pakistan India Trade," Pakistan Business Council (PCB), at http://pbc.org.pk/wp-concommendation%20tent/uploads/2014/06/Preliminary_Analysis_of_Pakistan_India_Trade-_PBC_2.pdf

$3.6 billion is Pakistan's export potential to India and US $ 14.2 billion is the potential for Indian exports to Pakistan.

The study recommended that the Government of Pakistan, as a prelude to trade normalization with India, establish a strong regulatory and safeguard mechanism and strengthen regulatory bodies such as the National Tariff Commission (NTC) and the Pakistan Standards and Quality Control Authority (PSQCA).

INDIA/PAKISTAN TRADE DATA

In 2012/2013, India's trade with Pakistan was:

EXPORT	$2064.79 million	% Growth	33.94	% Share	0.69
IMPORT	$ 541.87 million	% Growth	36.26	% Share	0.11
Total Trade	$2606.66 million	% Growth	34.42	% Share	0.33

TOP 10 INDIAN EXPORTS TO/IMPORTS FROM PAKISTAN (2011)

Commodity Export	Exports (US $ millions)	% Share of total
Cotton	272.8	16.3
Oil-cake	168.3	10.0
p-Xylene	120.1	7.2
Tomatoes	65.2	3.9
Woven fabrics	50.8	3.0
Chickpeas	41,8	2.5
Polypropylene	41.8	2.5
m-Xylene	41.3	2.5
Pneumatic tires of rubber	40.3	2.4
Tea	35.1	2.1

Commodity Import	Imports (US $ millions)	% Share of total
Dates	69.6	19.8
Portland cement	36.8	10.4
Gold	32.5	9.2
Light Petroleum	29.6	8.4
Unwrought lead	13.7	3.9
Copper waste	10.0	2.8
Petroleum oils	9.0	2.6
Cotton yarn	7.1	2.0
Disodium carbonate	6.9	2.0
Gypsum	6.5	1.8

While these are the main non-restricted products traded between India and Pakistan, they by no means comprise all the opportunities potentially available for bilateral trade via a cross-border SEZ.

SEZs are a means for getting over the trade barriers between two countries that in all probability are politically impossible to remove in the short term. Both countries, in response to their domestic constituencies, are quite categorical in keeping out certain products based on their negative and sensitive lists. These may well be items that can be more easily produced in an SEZ and then exported in either direction.

A full market research assessment of which industries could gain the most from location in the SEZ is beyond the scope of this report. However, we see three of the most promising, and currently most trade-sensitive industries to be textiles, automotive (especially components) and pharmaceuticals.

Textile

More specifically, neither India nor Pakistan appears to have a comparative advantage in the textile sector with respect to each other. Both countries enjoy advantages in some products that the other country keeps out using sensitive and negative lists. A joint SEZ could offer entrepreneurs from either country opportunities to invest in SEZ-based manufacturing facilities, deriving from their company's comparative advantage and export in both directions and to third-nations.

Automotive

The same holds true in the automotive sector where Honda, Toyota, and Hyundai manufacture in both countries. Since India has a comparative advantage on costs, Pakistan restricts the import of components from India using the sensitive and negative lists. All three have assembly facilities in both countries though local content is much higher in India. Greater economies of scale could result through larger production facilities inside the SEZ that can then export not only to India and Pakistan, but also to other countries[15]. In fact we feel that international automobile companies will enjoy comparative advantage by locating in the SEZ (see detailed ICRIER study[16]).

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[15] Conversation with Dr. Miftah Ismail *Special Assistant to the Prime Minister/Chairman, Board of Investment (BOI)* , July 14, 2014

[16] "Assessing the Future of Trade in the Automobile Sector between Indi and Pakistan: Implications of Abolishing the Negative List" by Biswajit Nag (ICRIER New Delhi Working Paper 284 September 2014)

Pharmaceuticals

Generic pharmaceuticals are also less costly to produce in India than Pakistan. India enjoys a comparative advantage resulting in lower prices for consumers in India compared to those in Pakistan. A joint production facility inside a SEZ could minimize the cost differential and allow for supplying both markets.

Other promising sectors

Both Punjabs have industrial bases that produce for their respective domestic markets and limited exports. Several of these sectors are the same and could therefore also benefit from an SEZ by improving economies of scale and expanded market access. These sectors include sporting goods, machinery and machine tools, surgical and scientific instruments, and electrical products. These goods are currently being manufactured in both Punjabs and would likely benefit from a joint SEZ by consolidating operational costs, permitting trade in both directions and possibly offering the opportunity for joint ventures between Indian and Pakistani firms.

Agriculture/Food Processing

There is also the contentious issue of agricultural products. Pakistan insists that India's comparative advantage, if any, is because India subsidizes fertilizer, water and power. However if food processing facilities were established in the SEZ, then only processed food products could go across which neither country may oppose because they will retain basic agricultural production, and its resultant employment, in each country.

III. Standing Up a Pilot SEZ

POTENTIAL PILOT SEZ LOCATION

We believe there two possible SEZ locations where the border between the two countries is well defined and settled: namely between the two Punjabs and between Sind and Rajasthan/Gujarat.

There has been significant investment by both countries in providing infrastructure for overland trade facilitation at the Wagah Attari border in the Punjab. While the Munnabao (Barmer district Rajasthan) - Kokhrapar (Sind) crossing exists, there has been very little development of infrastructure in that location. Also, the links with points in both nations and with third-countries are far superior in Wagah Attari;

both the Lahore and Amritsar international airports are less than one hour away and connected by good roads. It is therefore our view that the SEZ should be located close to the Wagah Attari border crossing between the two Punjabs.

For these reasons, we focus on siting the SEZ in the two Punjabs area and present relevant sub-federal level SEZ legislation here.

Sub-Federal Legislation – The Punjabs

As mentioned earlier, the Pakistan Province of Punjab follows the Federal Special Economic Zones Act of 2012, while the Indian State of Punjab has enacted its own Act.

The Punjab (India) Special Economic Zones Act, 2009[17] in addition to the Federal Special Economic Zones Act of 2005, forms applicable legislation in this area. In 2005, the Governor of Punjab issued a Notification[18] to facilitate the development of Special Economic Zones in the State. Key aspects of the Notification are:

1. SEZs are deemed foreign territory for tariff and trade operations.
2. Single Window Clearance by liberalizing the regulatory framework.
3. No Objection Certificates and other clearances from the Pollution Control Board shall be granted in a timely manner, however an economic impact assessment required under the Central Government's Department of Environment and Forest will have to be adhered to and an environment clearance from that Ministry obtained.
4. The Developer of an SEZ has the freedom to establish an independent power plant.
5. The Developer of an SEZ is permitted to set up a system and facilities for water extraction, treatment, transmission and distribution within the Zone.
6. All SEZ units and SEZ Developers will be exempted from payment of Sales Tax/VAT, Purchase Tax, Electricity Duty on power purchased from PSEB and for consumption within the Zone, Stamp Duty and Registration Fee on purchase of land by the Developer (limited to 6% basic Stamp Duty while 3% surcharge for Social Welfare Fund will be chargeable), Property/House Tax.
7. The Powers of the Labor Commissioner will be delegated to the Development Commissioner. The Self Certification in respect of the Labor laws shall be followed by the units in the SEZ. All units setup in the SEZ shall be declared "Public Utility Services" under the Industrial Dispute Act, 1947.
8. No authority/representative of any department/agency of the Punjab Government shall carry out any physical inspection without approval of the Development Commissioner.

[17] http://www.sezindia.nic.in/writereaddata/statePolicies/punjab_sez%20act_2009.pdf
[18] http://www.sezindia.nic.in/writereaddata/statePolicies/punjab_sez_policy_2005.pdf

9. The Developer shall erect substantial boundary marks defining the limits of the Zone.

In addition to the above, another provision of the Punjab Special Economic Zones Act, 2009 includes:

> The State Government may transfer land owned, acquired or controlled by it to the Developer. The Developer may acquire land from any person by purchase, lease or allotment.
>
> While Pakistani provinces follow the federal legislation on SEZs, there are other features of Pakistani sub-federal legislation of relevance here.

Because of Pakistan's 18th Amendment that "devolved" power to the provinces, federal law no longer applies to labor law. Pakistan's Punjab province has set a minimum wage of Rs. 9000 per month. Pakistan's compliance with ILO conventions is challenging in the wake of devolution and some provinces have enacted laws that may violate international treaty norms.

Under the 18th Amendment, responsibility for labor regulation and enforcement, in addition to industrial relations, has been devolved to the provinces and all provinces have enacted Industrial Relations Acts.

In addition to the above, another provision of the Punjab Special Economic Zones Act, 2009 includes:

> The State Government may transfer land owned, acquired or controlled by it to the Developer. The Developer may acquire land from any person by purchase, lease or allotment.

HOW TO BEGIN?

Realities of today's Indian-Pakistani Relationship, and Implications for the SEZ

Given the commercial and political realities that currently define the Indian-Pakistani relationship, it will be important to identify politically feasible yet commercially valuable first steps to establish what we call a "pilot SEZ." The pilot SEZ would form the nucleus of a fully functioning, India-Pakistan SEZ whose feasibility and establishment is the focus of our report.

At this time, there will be limitations on what each government believes it can do in areas this report identifies as necessary to a fully functional, international standard

SEZ. Given that no concerted efforts to develop an SEZ have begun, those limits have not been probed and thus are not clear or defined, but they certainly exist. At the same time, there are also minimum requirements that private sector firms will need to see met to justify investment – especially early investment - in the zone.

Beyond that, the SEZ itself needs to be considered a commercial enterprise in its own right. While it should be developed and operated to achieve business and social objectives such as job creation, attracting FDI, and, of course, as a tangible anchor and stabilizer to the bilateral relationship, it must achieve financial self-sustainability as soon as possible.

Thus, the initial task to "kick start" a pilot SEZ will be to identify the minimal set of liberalizations, investment incentives, required legislative/regulatory changes and any other elements such first-mover investors require to make the pilot SEZ a commercially viable project. Both governments will need to understand these requirements, the potential gains and to offer what is needed. (A step-by-step action plan follows.)

Given commercial realities, an SEZ of any size will need to offer real business benefits to succeed. While many responsible businesses will be pleased to invest where such a venture helps to promote national or broadly shared social or ethical objectives, job creation and the like, a solid commercial case will need to be made first. A purely symbolic SEZ will neither, in our judgment, be viable in the long run nor will it be able to enjoy critically important business buy-in.

Developing a Pilot SEZ – A Suggested Action Agenda

Below are steps of an action plan that we believe should be taken to develop a pilot SEZ. Our objective at this first stage is to identify, as noted above, minimum requirements for early mover investors in the SEZ and positions and views of both governments as to the ability to deliver these needed liberalizations, legal/regulatory changes and the like.

1. Identify which industry sectors are to be targeted. As a starting point, we suggest the sectors that have been identified in this report as most promising, i.e. the automotive/parts; pharmaceuticals and textiles and other sectors also identified;
2. Hold an overall and introductory workshop, one in each capital, with potentially interested/prominent business executives and government officials laying out the results of this report and proposing these initial steps. While we will be guided by discussion at these roundtables, at this time, we believe the following procedure is appropriate.
3. Host a roundtable discussion with each targeted sector (to include businesses in that sector from both nations and from third countries, as

needed) to determine what would it take to encourage them to invest in such a zone. While all requirements such as infrastructure, financial incentives, regulatory framework, legal structure, etc. must be discussed, encourage representatives from firms in each industry sector to provide minimum requirements for investment in the SEZ. Ask industry representatives to provide preliminary estimates of the economic/job creation potential for their potential investments in SEZ to help to motivate government interest and action;

4. Afterwards, host a roundtable discussion with the relevant government authorities and stakeholders on both sides to present the results of the industry discussions and determine if the will for change exists;
5. If the results are positive, a joint task force should be formed comprising representatives of relevant ministries in both nations to focus on what these potential "first mover" industries have said are minimum requirements for investment. The joint task force should be tasked to review these requirements and ascertain if they can, in principle, be met. If so, we can move to next steps;
6. Should preliminary government-to-government discussions indicate a pilot SEZ is feasible, the joint task force should engage, via competitive tender, a joint Indian-Pakistani developer (likely a private sector joint venture between an experienced industrial zone development firm from each country) to begin to identify the most suitable specific site locations, size to be developed and infrastructure requirements. This joint developer (call it "SEZ Co.") would be awarded rights to develop, invest in and run the SEZ. At this pilot stage, we suggest that it may be more straightforward for the SEZ, though a unified entity, initially to be run as two subzones, one in each country and by SEZ Co.'s partner in that country. This may further facilitate launching the pilot SEZ.
7. SEZ Co. would be responsible for all activities required to build the pilot zone, contract with potential investors and liaise with both governments to ensure that investors' requirements are met and other vital government actions are taken.
8. At the same time as working to establish the pilot zone and bring in early mover investors, SEZ Co. would engage, 1) an experienced and qualified consulting firm to carry out a <u>detailed</u> market demand analysis identifying additional, promising industry sector investors and, 2) an experienced international legal advisor specializing in SEZs to conduct a detailed analysis of existing SEZ laws and investment promotion incentives in both countries, building on the analysis in this report. This market analysis and legal work would provide further information to both governments, motivating actions required to expand and liberalize the SEZ to be able to attract additional investment. The SEZ Co. will also need to conduct other, more routine activities to ensure the viability of the SEZ, for example by construction a 20-year financial model indicating potential revenue streams, required infrastructure costs, both onsite and offsite, operating costs, anticipated take-

up from investors, tax implications, cash flow analysis, internal rate of return, return on equity, net present value, and other work.

As the pilot SEZ begins to take shape and attracts initial, early mover investors, SEZ Co. will be in a position to: 1) demonstrate this early success, 2) have begun efforts needed to further liberalize each government's legal and regulatory systems, as noted in this report and, 3) have a study of potential market demand and promising industry sectors to use when seeking to attract additional, prospective Indian, Pakistani and third-country investors.

This will lead to a build-out of the SEZ from this first, pilot stage to a more significant commercial entity and, we would hope, a further stabilizer for the broader bilateral relationship.

CONCLUSIONS

The largest challenge to the India-Pakistan trade normalization process are existing trade barriers and, of course, existing political realities. It is widely believed on both sides that trade can only normalize between the two when both countries are able to resolve tariff and non-tariff barriers existing on both sides. Making exceptions in an SEZ as proposed is a logical and potentially politically acceptable way for both countries to resolve – on a small-scale basis - long-standing difficulties. In this way, the two countries can begin to escape the so-called 'reciprocity' trap into which their overall trade negotiations, to date, have fallen. Beginning with the suggested pilot SEZ will make the initial work more feasible.

We believe that there are economic, social and political benefits to creating a cross-border SEZ between India and Pakistan. Reports by Indian and Pakistani research institutes[19], as well as the by the World Bank, as noted previously, show that many of the challenges facing both counties are quite similar.

For instance the World Bank rankings on starting a business placed both nations in the bottom half globally; the same holds true on rankings relating to electric power, obtaining construction permits, paying taxes, and enforcing contracts. Other than getting electricity, all of the others could easily be improved in an SEZ since the institutional framework of an SEZ focuses on a relatively small area and can more feasibly reduce unnecessary bureaucracy than attempting to tackle such problems across the entire nation.

[19] Notable South Asian institutes include, in India: ICRIER (Indian Council for Research and International Economic Relations), and in Pakistan: SDPI (Sustainable Development Policy Institute), PBC (Pakistan Business Council).

Poor infrastructure in both countries will make exports from a cross-border SEZ to the region outside the two nations difficult. However if India and Pakistan have the political will to work toward a common objective using the framework of an SEZ operating under a "good practices" regime, trade from SEZ-based factories, moving in both directions, could grow substantially. We believe that an SEZ could also promote investment from one nation into the other by substantially liberalizing current impediments through efforts to establish the SEZ.

An SEZ as indicated earlier in the report would operate in a controlled and secure environment with both sides controlling what enters their country. Potentially quite promisingly, the SEZ framework could also bring about a solution to some contentious bilateral trade issues particularly in the automotive, textile and pharmaceutical sectors. An SEZ could improve the comparative advantages for manufacturers currently producing independently on both sides of the border and desiring to export to the other nation by permitting establishment of larger production facilities inside the Zone and supplying both countries.

In reviewing the current SEZ laws of India and Pakistan, generally speaking, many regulations are similar and would not need a major overhaul. What seems to be the biggest hurdle is consistency and transparency in implementing the laws and reducing or eliminating perceived corruption of officials.

The SEZ regime would eliminate the difficulty currently faced by investors in acquiring land for development by having a transparent allocation process whereby the investor would lease or purchase land that has been allocated under SEZ regulatory policy as defined by the zoning master plan and governed by the SEZ management organization.

Since an SEZ would be secured, and entry and exit controlled, this should give a comfort level on both sides of the border, particularly to the military and intelligence services.

One of the most challenging barriers to the realization of the SEZ and other trade and investment normalization and expansion efforts, is the deep history of mistrust that still characterizes bilateral relations, especially at the state and institutional levels. Political relations between India and Pakistan remain fragile and the dialogue process has only moved in fits and starts since the 2008 Mumbai terrorist incident.

Despite, however, the history of interrupted relations, the situation could change quickly. Among other things, the core driver would be political will on both sides, aided by business pressure. If there is political will, creation of a joint SEZ project - phasing in the project via a pilot stage SEZ - might be seen as an important, but feasible and commercially valuable agenda item in both nations. Focusing renewed political will on the establishment of an SEZ would, we believe, promote bilateral institutional coordination among ministries and could develop quickly since the focus of interaction is a limited joint project which brings a new concept and does not bring with it the baggage of old disputes and frozen conflicts.

Finally, we believe that cooperation between sub-federal political leaders and technocrats in the government administrations of both Punjabs holds great promise in advancing the SEZ initiative that can, in turn, help spur necessary action by federal government political leaders and officials in both nations.

We recommend that the two governments and business communities consider the action agenda leading to establishment of a pilot SEZ.

APPENDIX
OBSERVATIONS FROM OTHER ZONES AND KINDRED INITIATIVES

This Appendix reviews two cross-border SEZs that offer insight into how an India-Pakistan SEZ may be established. The agreements and institutional framework adopted provide some potentially valuable lessons. The two cross-border zones include:

- The Khorgos/Kazakhstan-China cross-border zone. Not a post-conflict SEZ, but it nevertheless faced challenges of blending two different economies and cultures into a common facility.
- The Kaesong North-South Korea SEZ confronted broadly similar hurdles as an India-Pakistan cross-border zone will face but in a much more contentious environment.

In addition, we present background information on the Qualifying Industrial Zones (QIZ) initiative, a U.S. unilateral trade preference program intended to provide support for the Middle East peace process.

KHORGOS-CHINA CROSS-BORDER SEZ

The Khorgos International Centre of Boundary Cooperation (ICBC) JSC is a public company established under agreements between the government of the Republic of Kazakhstan and the government of the People's Republic of China for the purpose of creation of the Khorgos International Center for cross border cooperation. The zone is currently under development on the Kazakhstan side and is expected to be operational in the near future.

The Khorgos ICBC consists of two parts: the Kazakhstan part - located in the territory of Panfilovskly region of Almaty area, and the China part - located in the territory of the Ili-Kazakhstan autonomous region of the Sinzjan-Uygur autonomic region. The Khorgos ICBC is 528 Ha of which 185 Ha belongs to Kazakhstan, and 343 Ha to China. Communication between the two parts is through the special pedestrian and transportation corridor.

Citizens of Kazakhstan and China can remain in the SEZ in both portions without the need for any visa for a period of up to 30 days.

The main objectives of the SEZ are:

- Creation of an efficient transport, logistics, and industrial center for trade and export activities;
- Promoting the development of economic and cultural exchanges with neighboring countries;
- Integration of Kazakh products into the global system of production and marketing;
- Creating innovative and competitive domestic products in accordance with international standards;
- Creation of a favorable investment climate to attract domestic and foreign investment;
- Accelerated regional development;
- Improved legal norms of market relations, introducing modern management systems, and job creation.

Defined priority sectors are:

- Warehousing and transport activity;
- Food and beverage processing;
- Manufacture of leather goods;
- Manufacture of textile and apparel products;
- Manufacture of chemical products;
- Manufacture of metal products excluding automobiles and their equipment.

Substantive provisions of the law establishing this zone include:

- Transition from government management of the SEZ to private management;
- The management company establishes a joint-stock company;
- The SEZ management company is independent of government and local executive powers;
- The structure of controls of the management company can include representatives of investors, government, and local executive powers.
- The Kazakhstani part of the SEZ is under the jurisdiction of Kazakhstan and the Chinese part is under the jurisdiction of the laws of China and the economic activities within the SEZ shall be subject to the requirements of the national legislation of the State in whose territory they are implemented;
- To ensure control over the movement of goods, persons, and vehicles across borders of the Parties' States within the territory of the SEZ, the Parties' concerned passport, customs, transport, inspection, quarantine and sanitation rules shall be in accordance with the national legislation of each Party;
- Any offences committed within the SEZ shall be investigated in accordance with the laws of the State in whose territory they were committed;

- The Parties shall take measures to prevent crimes and to assist each other to investigate and criminal and administrative offences.
- The Kazakhstani and Chinese part of the Zone are at least 10 meters from the state border and connected by a special passage through the state border of the two states.
- Each party shall create a corridor in its part of the Zone to control the movement of persons, goods and vehicles. There each party shall allocate control authorities in accordance with each party's national legislation.
- The taxation in the territory of the Zone is carried out in accordance with national legislation of the two states with a double taxation and income taxes avoidance agreement between the two Governments.
- The customs authorities of both parties exercise customs controls being transported to or from the Zone in accordance with the national legislation and regulations of the Parties' state.
- The Parties' customs authorities exchange customs statistics.
- Foreign exchange controls in the territories of the Parties are carried out in accordance with national legislation of both Parties.

KAESONG NORTH-SOUTH KOREA CROSS-BORDER SEZ[20]

The Kaesong Industrial Complex (KIC) is an over 10-year-old industrial park located in the Democratic People's Republic of Korea (North Korea) just across the demilitarized zone from South Korea. The complex resulted from an initiative led by Hyundai Group beginning in 1998 that coincided with the Republic of Korea's "sunshine policy" that attempted to improve relations between the two Koreas. The purpose of creating KIC was to develop an SEZ whereby South Korean firms could produce products using North Korean labor, thus opening up North Korea to liberalize and reform some of its economy and hopefully ease tensions across the DMZ.

South Korean firms operating in the Kaesong SEZ receive certain incentives and have certain rights negotiated by agreement between both parties. The KIC is a duty-free zone, has no restrictions on the use of foreign currency, and no visa requirements for entry or exit. Property rights are ensured and South Koreans charged with violations of law in the KIC do not go on trial in North Korea. South Korea also provides political risk insurance that will cover financial losses up to 90% of the investment in KIC up to $5.4 million, as well as reduced corporate tax (exempted for the first 5 years after generating a profit).

As of the end of 2010, over 120 medium-sized South Korean companies were employing over 47,000 North Korean workers to manufacture products in the

[20] Compiled from CRS Report to Congress April 18, 2011

Kaesong SEZ. The SEZ in 2010, produced $323 million in output, and has the land and infrastructure to house two to three times as many firms and workers.

Products vary widely, and include apparel and textiles, kitchen utensils, auto parts, semiconductor parts and toner cartridges, although the vast majority (60%) are in the apparel and textile sectors. At present, over 100 companies that have signed lease agreements to open factories have not done so. The project was planned, developed and financed largely by South Korea and has become a symbol of engagement between the North and South. In 2010, 76% in total trade between the two Koreas was attributable to the KIC.

Despite tensions, it appears that both Koreas are reluctant to allow the complex to be closed. Aside from the SEZ's symbolic importance, both sides would incur financial losses if it ceased operating. North Korea generates a constant revenue stream by taking a share from the salaries of the 47,000 North Korean workers. As for South Korea, a closure could make the government liable for many millions of dollars in insurance payments to South Korean companies and investors that have established in the SEZ.

Currently all products manufactured in KIC are transported to South Korea for sale or for export after clearing South Korean customs procedures. Primary export destinations in 2010 were Australia, the EU, Russia, and China.

PRODUCTION BY CATEGORY (US $1,000)

	Textiles/Apparel	Chemicals	Metals	Electronic Products	Other
2005	6,780	1,768	5,250	1.108	-
2010	179,235	32,092	48,637	59,147	4,212

The monthly minimum wage is about $61. On top of this, the North Korean authorities add a 15% social insurance fee. Female employees receive 60 days paid maternity leave and all employees receive 14 days per year vacation.

Geopolitical and Economic Issues

The KIC is at the hub of concentric sets of economic and geopolitical interests. Both participants are seeking profits, South Korea gives its small- and medium-sized companies a platform to access low-cost labor, while North Korea benefits from employment at generally higher wages than would otherwise be available to its people.

The Kaesong North-South Korean Zone has not reached the success initially envisaged for several reasons not the least of which includes U.S. and South Korean concerns regarding North Korean policy and the revenue KIC provides North Korea that helps enable those policies. It is however interesting to note that the Zone remained open during the 2013/2014 bilateral tensions.

There are similar political and security challenges to trade normalization between India and Pakistan. The possibility that another terrorist incident might again disrupt trade normalization remains. However a joint SEZ could mitigate some of these risks by incorporating legislation that would protect investments in the SEZ in case of such political and security shocks.

While neither the Khorgos/China nor Kaesong zone models are perfectly analogous for a proposed cross-border SEZ with India and Pakistan, there are elements in both which could be adopted into a workable framework and mutual discussion by both parties such as:

- Easing of visa access in the SEZ;
- A third-party, experienced management company to operate the zone;
- Each party offers political risk insurance to investors;
- Each party controls the movement of goods, persons, and vehicles entering or exiting into/from their domestic territory;
- Both Parties' customs authorities exchange customs statistics.

QUALIFYING INDUSTRIAL ZONE (QIZ) INITIATIVE

The U.S. Department of Commerce[21] describes the Qualifying Industrial Zone initiative as follows:

> In 1996, the U.S. Congress established the Qualifying Industrial Zone (QIZ) initiative to support the peace process in the Middle East. The QIZ initiative allows Egypt and Jordan to export products to the United States duty-free, as long as these products contain inputs from Israel. The QIZ legislation authorizes the President to proclaim elimination of duties on articles produced in the West Bank, Gaza Strip, and qualifying industrial zones in Jordan and Egypt.
>
> Generally speaking, U.S. tariffs on textile and apparel goods are relatively high, which makes production of these goods in QIZs especially attractive.

The QIZ has been remarkably successful in generating employment in both Egypt and Jordan. While the U.S.-Jordan Free Trade Area Agreement has largely supplanted the U.S.-Jordan QIZ program, QIZ-based industry and employment

[21] Qualifying Industrial Zone program, Office of Textiles and Apparel, U.S. Department of Commerce

generation remains vital to Egyptian economic health and employment generation. Even during the most difficult recent periods in Egyptian-Israeli political relations, the QIZ program remained in full force, with requisite Israeli inputs coming into QIZ factories and workers in place.

The U.S., or other third-country government(s) could encourage the creation of a cross-border India-Pakistan SEZ by providing similar benefits to selected products of the zone. While this would clearly enhance the attractiveness of investment in an SEZ, it is neither necessary to such success nor should an establishment of an SEZ be contingent on provision of such a unilateral trade benefit.

Transnational Strategy Group is not a law firm and is unable to provide legal advice and counsel regarding business decision-making or for other purposes in India, Pakistan or other nations. References to SEZ-related legislation or other legal issues in both nations contained in this report are deemed accurate however they cannot be, and do not represent opinions of a law firm. We recommend that those wishing further information regarding legal dimensions of a commercial or other transaction seek the assistance of competent legal counsel.

In addition, while this study identifies several industry sectors that we believe may see a cross-border SEZ as a promising location for investment, the scope of our work did not permit a comprehensive market analysis of the benefits, costs, uncertainties and other key factors that individual enterprises in these or other sectors must study before making commercial decisions. We recommend that those wishing specific market research seek the assistance of firms specialized in such work in the nation(s) of interest.

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