Working Paper 296

How Much Do We Know about the Chinese SEZ Policy?

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ISBN 978-81-7791-152-7

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Malini L Tantri*

Abstract

Though India's SEZ policy owes its conceptual base to the successful model of China's SEZs experience, hardly any attempt has been made to explain what made them so successful. In this paper, we trace this phenomenal success to the well articulated and executed SEZ policy in China. Apart from this, the success of SEZs in China is also attributed to the various supporting mechanisms, both internal and external. Hence our contention that SEZs cannot be expected to deliver optimum performance under ceteris paribus condition.

Introduction

The Special Economic Zone (SEZ) policy holds special significance among the various policy measures implemented by the Deng Xiaoping Government to liberalise the external sector of the Chinese economy. It was an early attempt by the Chinese Government to test-fire capitalism (Zeng, 2011) within a socialistic framework. These enclaves acted as the prime engines of the economic transformation of China in the post-reform period and, subsequently, gained worldwide attention and emulation. Apparently, a few economies, including India,[i] were keen observers of the development path of China's economic reform and, even tried to imitate these strategies. Unfortunately, the replication of the Chinese model in India led to certain setbacks and raised question over its appropriateness[ii]. Undoubtedly, the current Indian SEZ policy owes its conceptual base to the successful experience of the Chinese SEZ policy[iii]. However, excepting the study by Gopalakrishnan (2007) and Tantri (2011), hardly any investigation has been carried out, in the Indian context, to highlight the foundation of the Chinese SEZ policy and performance. This particular attempt is necessary for redefining the SEZ policy in India by understanding the determinants of its success. With this prelude, we set out the two-fold objectives of this paper: First, to explain the underpinnings of Chinese SEZ policy and second, to explore the factors responsible for its success. Based on the analysis in this paper, we argue that a larger part of the current controversy over SEZs in India is traceable to the failure of Indian policy makers to understand the various components of China's SEZ policy. Further, the success of SEZs in China cannot be attributed to the Chinese 'SEZ policy' alone. Various supporting mechanism, both internal and external factors are found have played important role in scripting this success story.

The finding of this paper is based on analysis of various policy documents on Chinese SEZs and validated by the author's extended fieldwork in China. The paper comprises four sections including the Introduction. In the second section, the early initiatives of economic reforms in China are briefly discussed. The various components of China's SEZ policy are elaborated in the third section. Section four sums up the major findings of this paper and highlights the findings relevant for policy prescriptions.

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I express my gratitude to the Indian Council of Social Science Research (ICSSR) for providing financial assistance to undertake fieldwork in Beijing and Shenzhen, China, under the 'Data Collection Abroad' programme. I am also grateful to my PhD Supervisor, Prof R S Deshpande, Director, ISEC, Bangalore, for his comments and suggestions.

Early Initiatives in the Process of Economic Reforms in China

The reform process in China gathered momentum through a gradual trial and error approach. The Chinese government followed the 'Gradualism Approach' rather than 'Shock Therapy' or the 'Big Bang Approach'[iv] followed by other socialistic countries, to initiate the process of economic reforms and transition. Agriculture and allied sectors were the first to experiment alternative reforms measures in China to compensate the disadvantages and disincentives imposed on these sectors in the pre-reform period. The focus during the pre-reform period in China was on the '*Heavy Industry Oriented Development Strategy*' and for the purpose a rigid institutional framework was designed for the agricultural sector. It was based on the three basic features: an inward looking strategy, a unified purchasing and marketing system for agricultural products and collectivisation of agricultural products (Huang, 1998). The crux of such a policy was to keep prices low for agricultural products and reduce the cost of production in the industrial sector and based on the assumption that it would multiply and spread the benefits generated by the industrial sector. These expectations, in later days, severely affected the growth and composition of the agricultural sector. Thus, the agricultural sector was the first to be brought under reform process in the late 1970s.

Broadly, the reforms in agricultural sector comprised three major modules (Mao-Kau and Susen, 1993) – an attempt to rejuvenate the traditional household oriented farming systems, to revise the prices received by farmers for the sale of their products and to expand the participation of the private sector in marketing agricultural products. In later days, the gradual increase in agricultural prices significantly contributed to the improvement of agriculture in terms of trade (Balassa, 1988). Though scores of measures were undertaken to reorganise the agricultural sector beginning in 1978, the Household Registration System (HRS) contributed significantly towards the growth of agricultural output and productivity in the early 1980s (Huang, 1998). Thus, for the first time, the decision making power of farmers was recognised. This, in turn, gave farmers bargaining power vis-à-vis government and consumers. Following this, reforms in the agricultural sector were complemented by reforms in the other sectors of the economy including reforms in the fiscal responsibility of the central and local governments, the banking sector and the labour market. These internal adjustments were made to improve the performance of the external sector. Reforms in this area began with allowing foreign capital in mainland China (1979), followed by several other measures[v]. The creation of SEZs is one such step that holds special significance in the reform process because it facilitated the Chinese government to experiment with the market economy within a socialistic framework.

The Underpinnings of Chinese Policy on SEZs

In the late 1970s, SEZs were proposed as an integral measure to reform the external sector of the Chinese economy. Apart from the number of ordinance and circulars issued by both the central and respective local governments in the promotion of these enclaves, '*Regulation of the Peoples Republic of China on Special Economic Zone'* passed in 1980 provided legal framework for the creation and operation of SEZs in China. In this section, we present the various components of the SEZ policy in

China, in order to explain how Chinese policymakers meticulously redefined the various components of the reform measures required for the promotion and success of SEZs.

The Concept

Before evaluating the success of China's SEZ policy, it is necessary first to understand how the Chinese perceived the SEZ policy in the overall process of economic reforms in China. Undoubtedly, the origin of the SEZ concept dates back to the early 19th century under different nomenclatures, but the present Chinese policy has rightly taken the credit for popularizing the term *Special Economic Zone'*. It was introduced as an experimental tool to test the possible implications of injecting market economy into a centrally planned and controlled economy. At the outset, it seems to be a replication of the Asian Export Processing Zone. However, closer scrutiny reveals that the Chinese SEZ policy is a revised and enlarged version of the EPZs not only in terms of geographical size but of policies, incentives, institutional structure, management and coverage of economic activities[vi]. This implicitly justifies the term 'special' and helps define how different these enclaves are not only within China but also in comparison with their counterpart in other countries.

The SEZs were designed and perceived as 'windows and radiators' (Ge, 1999) of economic reforms in China. As a 'window' to the outside world, SEZ were expected to disseminate the dimensions of the world market and promote technology transfer. As a 'radiator', the SEZ was promoted to establish links to other sectors of the economy. The SEZ was also perceived as a bridge between foreigners and the Chinese (Wall, 1993). Article 1 of the *'Regulation of the Peoples Republic of China on Special Economic Zone'* provides a clear illustration of the objectives in the promotion of SEZ in China, while; Article 4 outlines the economic activities permitted in such a zone.

> *'Certain areas are delineated from the three cities of Guangdong Province to form SEZ to promote economic cooperation and technical exchanges with foreign countries and to encourage the socialist modernization programme'*
>
> *(Article 1 of Regulation of the Peoples Republic of China on Special Economic Zone)*
>
> *'............ Investors may establish, with their own investment or in joint ventures with our side, all projects that have positive significance for international economic cooperation and technical exchanges ,including industry, agriculture, animal husbandry, aquaculture, tourism, housing and construction, and research and manufacture involving high technology, as well as other businesses of common interest to investors and to our side'.*
>
> *(Article 4 of Regulation of the Peoples Republic of China on Special Economic Zone)*

Variants of Development Zones in China and its Location

It is interesting to note that Chinese policy makers experimented with other types of development zones besides SEZs. Initially, four SEZs were set up, one each at Shenzhen, Zuhai, Shantou (in Guangdong Province) and Xiamen (in Fujian Province). In this context, it is to be noted that, through the SEZs the government targeted the development of a particular sector (Ramachandran and Cletuts, 1999). Subsequently, based on the successful experience of the initial four SEZs, different types of developmental zones were initiated in the other coastal regions of the country. Accordingly, 14 coastal regions were opened up for foreign trade and investment in 1984. This includes Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai (Bahl, 1996). Following this, the Chinese government decided in 1985 to open economic zones in the Yangtze River Delta, Pearl River Delta, Xiamen-Zhangzhou-Quanzhou Triangle in south Fujian, Shandong Peninsula, Liaodong Peninsula, Hebei and Guangxi and create an open coastal belt. In addition, 15 free trade zones, 32 state-level economic and technological development zones, and 53 new and hi-tech industrial development zones were established in large and medium-sized cities to attract technology-intensive and export-oriented industries. Hainan Island was given the status of a province in 1988, and subsequently it emerged as the fifth SEZ of China. Shanghai was given the status of 'open area' in 1990 and later ten major inland cities were opened up. The Chinese government experimented with different types of reform measures to liberate the external sector of the economy by taking into account the geographic advantages and development prospectus of the region. This broadly corresponds to the different generations of reform in the administration and maintenance of these zones. However, there are differences between these zones in terms of geographical size, incentive structure and administrative control. The SEZs were given more liberal incentive oriented investment environment than the ETDZs and open areas.

The Chinese policy makers took a very prudent approach in not only deciding the number of zones but also in identifying and locating the development zones across China. Among the eight coastal provinces of China at that time, Guangdong and Fujian lagged far behind in terms of economic strength, industrial development and commercialisation (Ng and David, 1985). It is evident therefore that apart from economic factors, social and ethnic considerations played significant roles in the location of the zones (ibid). It was done specifically to target the overseas Chinese residing in Hong Kong, Macau and Taiwan. Hence, the SEZ policy in China was also used as a strategy to use the nationalistic spirit of non-resident Chinese for the achievement of a broader objective. This objective of the government was clearly spelled out in Article 1 of the Rules (1980) governing SEZs in Guangdong and other provinces. Among the five SEZs, Shenzhen is closer (36 kms) to Hong Kong, Zuhai is near Macau, Shnatou is home to most overseas Chinese and the Xiamen SEZ (Fujian Province) is closely linked to Taiwan (Table 2.1). A similar approach was followed while locating the fifth SEZ at Hainan and other ETDZs and open areas in Shanghai. It enabled these regions to understand and grasp the industrial culture of neighbouring regions by attracting nearby overseas investors.

Geographically all these types of development zones were located close to the coastal regions of south and southeast China to provide port facilities and expand trade activities (Map 1). Notably, these regions were given special facilities and liberal incentives. In contrast, at that time, other parts of China were still under the rigid control of the Chinese central planning system. This policy of the Chinese authorities represented the principle of *'one country two policies'.* A deeper insight into this duality is very crucial to understand and evaluate the Chinese policy of economic reforms.

Table 1: Basic Profile of Chinese SEZs

Sl. No	SEZs	Province	Geographical Size	Before SEZ	Inherent Advantages	Administration
1.	Shenzhen (1979)	Guangdong	316 sq km Four district of Shenzhen municipality covered under SEZs (out of six)	Small fishery village	Near Hong Kong city Access to port	It was independent of the province to which it belong
2.	Zuhai (1979)	Guangdong	Initially it covered only 6.7 sq km. Later it spread to 121 sq km.	Underdeveloped	Near Macau It had long tradition in international relations	Controlled by provincial Government
3.	Shantou (1979)	Guangdong	234 sq km.	It already had an established industrial centre	It was home of many Chinese emigrants	It was independent of the province to which it belong
4.	Xiamen (1979)	Fujian	130 sq km.	It was a trading point	It had family ties with Taiwan	It was independent of the province to which it belong
5.	Hainan (1984)	Hainan		It was underdeveloped in term of industrial base and infrastructural facilities	It had a good natural resource base that was almost exclusively shipped to the mainland	Controlled by provincial Government

Source: Authors compilation

Map 1: Location of SEZs and ETDZs in China

Source: Zeng (2011)

Strengthening Supply Side Factors through Institutions, Infrastructure and Incentives

The Three Is – institutional structure (administration procedures), the incentives scheme and the infrastructure arrangements – have evidently influenced the transition process of the Chinese economy through SEZs. They are discussed in detail below.

Changes in the Institutional (Administration) Structure

Prior to the onset of reforms, all economic decisions in China were determined through centralized planning, which adversely affected the speed and efficiency of bureaucratic procedure in China. In order to rectify this and to try out an alternative system of administration, the SEZ policy came in handy. It also marked the beginning of decentralisation in China and broke the long tradition of the centrally planned model of economic administration. The system of decentralisation introduced as a part of economic reforms in general had far-reaching impact in three ways (Li, 2004): First, due to autonomy, local level governments become more actively interested in a firm's performance than the central government. Second, the arrangement of sharing revenue between local and higher level governments acted as an incentive to the former to take extra care to improve the performance of the economic actors under their control. Third, the division of resources and economic activities among different layers of government enabled local governments to distribute time and resources effectively and enhance their performance.

The system of decentralisation was implemented through Article 24 of '*The Regulation of the People's Republic of China on Special Economic Zone*', and SEZs were brought directly under the control of the local provincial committee, which enjoyed vast powers in the administration, management, promotion and maintenance of SEZs. The Shenzhen SEZ was brought under the administration of the Guangdong Provincial Committee. Similar offices were set up in Shantou, Zuhai and Xiamen. All the five SEZs were independent of local government rules and regulation but were integrated with the broader national policy (P M Hameed, 1996). In addition, Shenzhen and Hainan had the special power to formulate separate laws consistent with national policies to promote and achieve the objectives of SEZs in their respective regions. For instance, the Guangdong Provincial Committee enjoyed the following jurisdictional powers in the Administration of SEZs.

1. To formulate and implement the development plans for the special zones;
2. To examine and approve the various investment projects of investors in the zones;
3. Handling registration of industrial and commercial enterprises in the special zones;
4. Dealing with land allotment in the special zones;
5. Facilitate coordinate working relations among the banking, insurance, taxation, customs, frontier inspection, postal and telecommunications and other organisations in the special zones;
6. Administer labour-specific issues like providing adequate labour to the enterprises in the special zones and protect the legitimate rights and interest of workers;
7. Maintaining law and order in the special zones

(Article 23 of Regulation of the Peoples Republic of China on Special Economic Zone)

In addition to this, local governments were also empowered to take decisions either to reduce or exempt surtax payable by foreign funded enterprises (Kundra, 2000). In a nutshell, this system of decentralisation of power has had greater impact on the overall working of SEZs in China, specifically in breaking the dominance of central planning and administration at the sub-national level, which hampered the efficiency of the administrative structure.

Incentives as a mechanism to publicize Its New Economic Policy

At the time of initiating reforms, due to rigid practices of the Communist government, the Chinese economy hardly attracted any attention from either foreign or domestic investors. Given this, it was necessary for the government to ensure publicity for its new economic policy as well as the liberalised business environment in China. The incentive structure became the instrument of choice for the promotion of SEZs in China. Various fiscal and non-fiscal incentives were offered[vii] within the SEZS while a very restrictive investment environment was in existence in other parts of China. The incentives offered to enterprises within SEZs, varied across the zones. Further, by 1984, the government had introduced different slabs of incentives to various projects and particularly for joint ventures that assured new technology transfers and/or higher investments (Oborne, 1986). Needless to add, the incentive package was flexible in nature.

One of the striking features of the incentive structure related to the difference in the incentive slabs applicable to domestic and foreign investments (Yuan, 2011). For example, the corporate income tax rate at 15 per cent was much lower than the 30 per cent imposed on domestic enterprises. In addition, the foreign enterprises were exempt from the 3 percent local income tax. Foreign-funded manufacturing enterprises got a two-year exemption from corporate income tax and paid half-tax rate for the ensuing two years. This was intended to promote the fundamental objectives of SEZs i.e., to attract foreign investment rather than allow reallocation of domestic resources from one region to another. However, after some time, the SEZs witnessed illegal transfer of domestic capital to foreign countries and it returned to the country as repatriated capital and invested in the SEZs in the form of foreign investment to avail the incentives available to foreign investors (field perception). This however was nothing but shifting resources from one area to another rather than contributing towards the generation of additional investment. This calls for caution in employing numerous incentives in the promotion of SEZs. Moreover, it also emphasizes the need for proper checks to be in place before allowing foreign investment in the different sectors of economy. For example, in the case of Shenzhen, in the initial years, foreign investment was concentrated on real estate development, which led to speculative activities in the initial few years. As a result, prices of residential buildings rose very sharply.

The incentive structure, which was initially restricted to the SEZs, was gradually extended to the rest of China to promote development in other priority sectors. For instance, in later days, the government on the one hand, shown reservations against extracting natural resourcesextended full support to investment in the service sector. This is particularly noticeable in the low share of the service sector in the GDP in comparison to the manufacturing sector. This reveals the dynamic policy strategies adopted by the Chinese policymakers over the years to suit emerging challenges and development priorities. It is worth noting here that despite such a huge incentive structure being available, the SEZs in China did not result in revenue loss to the government exchequer mainly because of the judicious geographical location and promotion of these enclaves in China (author's field perception). The regions that were opened up for such experiments were underdeveloped with agriculture as the prime occupation of the residents. The implementation of the SEZ policy, as expected, contributed to government revenue rather than create adverse fiscal situations.

Infrastructure as a tool to address supply side constraints

Besides the incentives packages, the favourable business environment created for these enclaves ensured success for the SEZs. The significance of planning and infrastructure development was duly recognized in the promotion of SEZs (Yeh, 1985). For instance, in Shenzhen a two-tier planning process was put in place (ibid). First, a Shenzhen Social and Economic Development Plan was formulated to deal with the different issues related to population, migration and related issues. Second, a Master Plan was formulated in each zone to address issues related to land use and physical developments. This was essential because the Chinese SEZs, unlike EPZs in other countries, comprised real population. In the process of developing infrastructure and attracting foreign investors in SEZs, the Chinese followed the proverb '*Build a nest first; birds will follow later*'. What requires to be noted here is that Chinese policy makers did not stop at spelling out the need to promote infrastructure facilities in each zone. Meticulous attention was paid to the allocation of responsibility for all the tasks involved in building infrastructure. Under Article 5 of the Rules, the respective municipal governments were assigned with the legislative power to take appropriate steps to ensure infrastructure facilities at the zonal level. For instance, the Guangdong-Provincial Committee was held responsible for the development of infrastructure facilities in the Guangdong region. Wherever necessary, foreign companies were allowed to participate in developing infrastructure facilities. A distinct feature of the Chinese SEZ policy is its well thought-out plan for mobilising resources needed for the development and maintenance of infrastructure facilities within each zone. The local government could undertake infrastructure projects by mobilising resources from various sources (P M Hameed, 1996) like revenue generated from taxes, profit from State Owned Enterprises (SOEs), loans from banks, domestic and foreign investment and a minimal contribution from central government grants. These sources of revenue varied across the zones. In Shenzhen, a major source of revenue was generated from land use rights and in Xiamen, it was the Xiamen Municipal Budget. Domestic and foreign investments were the major sources for infrastructure development in Hainan ((P M Hameed, 1996).

Approach towards Managing Factors of Production

In Communist China, historically, the government retained control over the masses by exerting control over land and labour (Wall, 1993). Ownership of land is vested in the government, and therefore, it is able to decide the land use pattern in the country. Furthermore, the presence of a strong Hukou system, which determines migration and supply of labor in urban areas, strengthens the government's hold over land and labour. Thus, as a part of economic reform through SEZs, initiatives were taken to address the rigidities that existed in land and labour markets. Besides providing excellent infrastructural facilities, the Chinese government also ensured adequate supply of labour for the operation of the SEZs. For this purpose, a Labour Service Company was set up in each zone, as stipulated under *Article 19 of the Rule on SEZs,* in order to meet the demand for professional employees by the foreign companies. The Labour Service Company was used mainly as an instrument to break the rigidities in the labour market because of the Hukou system. Labour was supplied through this company in different ways (Chen 1988). Initially it was done via '*Transfer through Consultation and Selection*', under which a team of officials from the respective Municipal Organisation travelled to different parts of the country and recruited suitable candidates for the SEZs. In 1982, *Recruitment through Examination and Invitation*' came into operation, under which the Municipal Government used to advertise the post to be filled up and selections were carried out accordingly. In this system, an assurance was given of housing facility in the respective zones and, often, employment for the spouse. Other incentives employed to attract skilled labourers from mainland China included medical insurance, permanent residence to workers and their family irrespective of past affiliations to Hukou, i.e., whether they were permanent or temporary residents and whether they were from rural or urban areas (Chu, 1985). In the traditional Chinese economic system, migration between provinces was not allowed due to the rigid 'Hukou System'. The third system was known as '*Borrowing and Offering Joint Appointment*'. These different recruitment mechanisms could be categorised under two broad heads. Recruitment under the initial two channels offered permanent residence in the respective regions whereas in the third channel, employees of the Chinese Government attempted to arrest the persistent problem of unemployment in the country. According to one estimate, in 1982 alone, between 20,000 and 30,000 temporary workers were brought into the Shenzhen SEZ (Oborne, 1986). In addition to this, the government also trained labour within the region. Accordingly, a university was founded in Shenzhen by the Municipal Government (Oborne, 1986).

Despite putting in place such mechanisms, the companies in all zones enjoyed the freedom to hire the required labour either through the state agencies or with the help of SEZs developers after taking the consent of the respective Provincial Committees. Nevertheless, in either case it was mandatory to have a contract between employers and employees about the wage levels, types of wages, bonus and incentives. Further, it was mandatory (under Article 22), to act appropriately to protect the interests of labourers as well as working conditions. During my discussions with a Chinese academician (in November-December 2007), it was reported that the enterprises were first allowed to appoint workers for a six-month probation period. During this period, workers could be fired without any formalities and compensation. After this probation period, a formal contract was signed between the employer and the employee and workers could not be dismissed without adequate explanation and proof. Besides protecting various labour specific issues, the interests of employers were also given due attention in the SEZ policy. One such condition was the mandatory stipulation that the employee return the training cost to the employer when the employee quits the job before the expiry of contact period. This provision was made in the initial period to ensure that SEZs are not used as mere training centres.

In addition to this, SEZs also helped to relax state control on various issues related to the labour market (Wall, 1993): First, the practice of '*iron rice bowl*' was relaxed for the first time in China. Accordingly, enterprises ceased to shoulder life-long responsibility for its workers and in its place, the contract labour system introduced for the first time. Second, '*freedom to market one's own labour*' was also encouraged for the first time. In Shenzhen SEZs, university graduates were allowed to find jobs of their choice as against the practice of being assigned to workplaces Third, the system of *market intervention in food supply*' was introduced in place of the conventional method of '*rationing*'. This was helpful in the long-run to relax the restrictions on the movement of labour between regions. Four, the '*system of moonlighting'* was encouraged, under which workers were allowed to take up a second job while still holding on to their 'iron rice bowl'. The other relaxations include 'Home Purchase Scheme' for workers and gradual reduction of the heavy subsidy offered by the government on workers' housing (Wong, 1987). However, it is worth noting here that, the government did not introduce any changes in the wage structure. Thus, wages were determined by the employers and not through negotiation/bargaining (Wall, 1993). Indisputably, these interventions were helpful in breaking the traditional barriers as well as improving labour productivity and competitiveness.

With regard land, through SEZ policy, the Chinese government introduced reforms in land market in urban areas. The earlier practice of government ownership of land and its discretionary power over land use pattern afforded very little security to foreign investors in terms of land ownership and tenancy management. In order to boost investors' confidence in the SEZs, 'The Provisional Regulations on Land Control in Shenzhen Sez' was enacted in 1981 (Yeh, 1985). This spelled out in detail the role of the Shenzhen government about planning, land management, development and the rent for land use for foreign investors. Guidelines consist of Six major conditions (ibid): First, all proposals for the use of land had to be submitted to the Shenzhen government. Personal negotiation with a landowner (on land use) was not allowed without prior consent of the government. Second, a lease system was allowed for the first time in China under different conditions across investment volumes and types of land use[viii]. Further, a different slab of land use fee was levied depending on its use and location with a lower rate for industrial activities. This was in line with the government's commitment to promote industrialisation in the region. However, a concessional rate was allowed for investments on education, medicine, technology and related issues. These land rates were subject to revision once in three years. Three, foreign investors had to take land use certificate from Shenzhen Municipal Government. Fourth, in order to avoid illegal land transactions a strict system was put in place to oversee such transactions. Fifth, in order to ensure that the plot is developed for the allotted purpose, a strict time limit was imposed. Land use certificates were cancelled if foreign investors failed to follow the procedures. In addition, the government also made land developers responsible for the cost of checking environmental pollution, if any. In furtherance of the decision to promote industrial activities by attracting foreign investment and to experiment with the capitalistic mode of development, large tracts of agricultural land was diverted to non-agricultural purposes. Needless to add, adequate monetary compensation was given to the community that owned land use rights[ix], along with assurance to provide employment in the upcoming SEZ projects. Moreover, the government also made efforts to train farmers to make them employable in the emerging industries. This also resulted in the displaced farmers getting handsome economic advantages in the process.

In a nutshell, the Chinese policymakers were not only enthusiastic about experimenting with the system of capitalism within the socialistic framework through SEZs but also gave due attention to the nitty-gritty of its promotion.

Summary

The above analysis helps us conclude that a larger part of the success of SEZs in China could be attributed to the systematic approach in defining and executing the SEZ policy. It can be stated confidently that the insights gained by our analysis of the Chinese tryst with SEZ can provide valuable suggestions for future reforms in not only China but also other countries that are trying to emulate the Chinese model. The major findings of the paper are as follows:

- The incentive scheme cannot be the sole factor responsible for the promotion and success of the SEZ policy. There is a need to give proper attention to the development of infrastructure facilities and the creation of efficient administrative machinery. A cautious approach is needed in attracting foreign investment with incentives in the domestic market as well as in different sectors of economy because it may provide scope for the re-allocation of resources from domestic area to SEZs area rather than generate additional investment.
- Furthermore, it is not just SEZ policy, which enabled to transform a traditional Chinese economy into a modernised one. Evidently, both internal and external factors supported the government to achieve the objective of reforms through the SEZ policy. Specifically, the break from the rigid economic system followed during the pre-reform period seems to have unlocked the pent up potential of the nation, which coupled with the subsequent reform measures provided the main thrust for the success of reforms in China. This also indicates that, the Chinese policymakers recognised the loopholes in their economy and used the SEZs as a mechanism to remove them before introducing reform measures across the nation. Further, higher initiatives at different levels of government and decentralisation boosted the efficiency of the administration.
- Apart from the internal factors, a few favourable external factors like the strong active presence of overseas Chinese investors ensured the success of reform measures. Further, when China initiated the reform process, it hardly had any competitors in the world market, particularly in East Asia. Therefore, the timing of reforms enabled them to reap maximum benefits.

Thus, the above descriptive analysis clearly indicates that the decision to promote SEZs only constitutes the first step. The success of SEZs, however, depends on identification of the factors hindering economic growth in the country. Besides, it also seeks effective integration and co-ordination of different conducive policies on the domestic and external fronts. To be precise, SEZs as a trade policy cannot be expected to work under *ceteris paribus* conditions; rather it requires careful identification and execution of supportive factors, which may vary between countries, SEZs and/or between sectors within a given economy.

Notes

[i] In 2008, Pakistan also followed a similar line of reforms by introducing SEZs in its country.

[ii] See for debate on Current SEZs Policy of India Bhaduri, 2007; Sharma 2007; Gill 2007; Kasturi 2008; Mukhopodyay 2009; Patnaik, 2007

[iii] However, it seems ironical that the Indian version of SEZs are customized versions, *mutatis mutandis*, of the Chinese experiment in Shenzhen and other provinces which, in turn, were inspired by the Export Processing Zones (EPZs) that were set up in India in the early 1960s. SEZs, hence, are institutions that have undergone transformation or, one could say, are reincarnations of the earlier EPZs.

[iv] Theory of 'Shock Therapy' or 'Big Bang Approach' is a theory of economic reform followed by socialistic countries. This theory argues that reform should be carried out simultaneously in all sectors of the economy rather than pursuing piece-meal approach for transition process of a socialistic country into the market economy. This theory influenced the transition process of Soviet Union and East European Countries.

[v] The major reforms undertaken since 1980s have been presented in Annexure 1

[vi] Detailed explanation on each of these are explained in the subsequent sub-section

[vii] See Annexure Table two for detailed description of incentives offered in SEZ and non-SEZ areas.

[viii] The land rent further differs across zones (Nishitateno, 1983)

[ix] In the Chinese case, terminologies involved in land acquisition are different from elsewhere. For instance, in case of India, the government/purchaser has to pay compensation to purchase land ownership whereas in China compensation has to be paid to acquire 'right to use'. The system of private property and related concepts do not exist in China.

[x] As per this system retired workers were replaced by his/her son or daughter

[xi] Local taxes include net income surtax, real estate tax, vehicle license tax, vessels and license tax

[xii] It includes, piecework, hourly basis, daily basis, proposition of fixed and floating wages

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Annexure 1: Major Policy Changes in the Post-Reform China

Year	Major policy Initiative
1. Reform in agriculture sector and rural areas of China	
1978	The introduction of Household Registration Systems (HRS) (initially was permitted in poor regions only) Hike in the prices of agricultural products and reduction in the prices of agricultural inputs
1981	HRS was allowed to spread throughout the country
1983	Permission was given to peasants to employ seven workers
1984	Permission to sell agricultural product beyond borders Market mechanism was introduced. Like establishment of 'double track system' Township and Village Enterprises were established Contract period for the lease of private plot was extended from 5 to 15 years for annual crops and 50 years for tree crops
1986	Land administration law was introduced. In this 'Government Guidance Price' was hiked which was on average higher than the contract purchasing prices but still lower than 'free market prices'
1987	A tax on agricultural land was imposed Law on Organizing Village Peoples Committee was passed and implemented
1989	Agricultural Development Fund was established under the supervision of provincial Government. This fund was utilized for developing agricultural infrastructure facility
1990	The national Grain Reserve Bureau was set up in Zhengzhou (Henan Province)as a part of the grain reserve system
1992	Government involvement in agriculture market was widened
1993	Several measures were taken to reform the grain distribution system in 1993 The Agricultural Law was enacted
1994	Two alternative steps were introduced to balance demand and supply of agricultural products
1998	Grain Purchasing Regulation was enacted Steps were taken to liquidate the 'Beijing Commodity Exchange' accordingly, 11 commodity exchanges across the country were integrated into three exchanges in Shanghai, Zhenghou and Dalian Law on Organizing Village Peoples Committee was revised to reform agricultural administration
2. Labour reform	
1978	Retirement age system was introduced – 60 years for male and 55 years for female
1981	System of contract and temporary workers were approved
1986	The system of 'Dingt Zhi[xi]' was abolished by replacing it with the contract labour system
1992	Labour Union Law was enacted Right to fire workers was introduced
1993	The procedure of firing was issued The amount of retirement compensation was revised Regulation was passed for reallocation of surplus staff and workers of SOE The regulation on Unemployment Insurance was issued The regulation on dealing with labour disputes in firms was issued

1994	The Aribitrarna Law was enacted Labour law was enacted
3. Reform in Financial Sector	
1979	The China International Trust and Investment Corporation (CITIC), established
1981	The first treasury bonds were issued and sold on a compulsory basis to enterprises and individuals
1982-83	The Peoples Bank of China became the Central Bank of China Three other specialised banks were also permitted to operate: in agriculture, the Agricultural Bank of China; in state construction, the People's Construction Bank; and in foreign exchange management, the Bank of China The issuance of enterprise shares started on an experimental basis for private firms in 1982, and for state enterprises in 1985 Auction law was enacted
1984	The People's Bank of China narrows its operations to that of a central bank, and the newly created Industrial and Commercial Bank takes over the commercial banking function of the People's Bank
1985	Foreign banks were permitted to set up branches and local subsidiaries and to establish joint ventures with Chinese partners in the special economic zones
1986	Five cities were identified as financial experiment cities (GuangZhou, Hongquing, Wuhan, Shanghai and Changzhou) Special banks were permitted to conduct foreign transactions and gradually allowed to engage in general banking activities Urban and rural credit co-operatives were established as alternative banks
1987	The Bank of Communication was re-established.
1990	The first Stock Exchange was set up in Shanghai
1991	Second Stock Exchange was set up at Shenzhen
1992	Regulation on Corporate Accounting and Corporate finance was issued
1993	Introduction of tax assignment system Regulation on management of corporate bonds was issued Decision taken to reform the financial system and to set up three policy oriented banks, namely, the State Development Bank of China, the Import and Export Bank of China and the Agricultural Development Bank of China.
1994	Decision to allow foreign companies to expand their network
1995	Audit law was introduced China Minshering Bank was founded
1996	A few decisions were taken to reform the rural financial systems. Rural credit co-operative units of each city were merged with urban co-operative banks and later renamed as Urban Commercial Bank (1998)
1998	Reforms in state-owned enterprises were carried out

4. Fiscal Reform	
1980	Replacement of unified revenue and expenditure systems to classified revenue and expenditure systems
1985	Reform in taxation was implemented with focus on tax for profit A revenue sharing arrangement was established. Under this system, there were three types of taxes: • Taxes accruing to the centre; • Taxes accruing to the localities; • Revenue that is allocated among the centre and localities A new arrangement was designed to create incentives for revenue collection by each province: the province's permitted expenditures depend in part on its budget balance in the previous year
1988	A new fiscal contract system introduced six types of revenue sharing, further increasing the portion of revenue retained by localities
1992	Regulation on saving was issued
1993	A new scheme of revenue sharing system was enacted. In this central government is given a large share
1995	Budget law was enacted. It prohibited central government borrowing from central bank and from deficit financing its current account
5. Trade and Investment Policy	
1979	Law on Chinese Foreign Joint Ventures was enacted. This allowed flow of foreign capital to China
1980	\`Regulation on Special Economic Zones in Guang Dong Province' was approved. This provided for the creation of four SEZ (Shenzhen, Zuhai, Shantou and Xiamen)
1981	A single exchange rate was set for the internal settlement of trade transactions, the rate being 2.8 Yuan per dollar, while the official exchange rate was 1.53 yuan per dollar
1982	Government assured through law to protect the interest of foreign investors and investment
1983	First wholly foreign oriented enterprises was set up in the SEZ
1984	Fourteen coastal cities were designated as technological and Economic Development Zones Hainandao became a quassi SEZ
1985	Three more costal zones were opened as development zones Overseas Economic Contract Law was enacted
1986	China formally applied to join the GATT. The law on foreign capital enterprises was introduced
1987	Technology contract law was enacted
1991	All direct export subsidies to FTCs were removed
1992	The regulation on country of origin of export was enacted
1993	Import quota system was introduced
1994	Tax rebate system was introduced for exports

Source: Ash (1988), Yamamoto (2003), Huang (1998)

Appendix 2: Incentive Structure for SEZs and Non-SEZ Area

1. Income tax			
1.1.	Direct sale	SEZ	There is no local surtax. Passive China-source incomes like interest, royalties and license fees are subject to a 20 per cent withholding tax. However, this rate can be lowered from 10 per cent to 0 per cent for contracts involving advanced technology, technical data & technical training.
1.2.	Equity joint venture	Non-SEZs	The rate of taxation on net income is set at 30 per cent along with 3 per cent local surtax. However, companies may apply for an exemption for the two first profit making years and a 50 per cent reduction for the following three years
		SEZs	Income tax rate is at 15 per cent without any local surtax. Ventures commencing operations before 1985, or investing more than HK$ 5 million using advanced technology, those having a long lead time, or considered as highly desirable, may apply for an exemption for the first three profit-making years or a reduction of 20-50 per cent (in Shenzhen); this exemption can be extended up to five years (Xiamen). Investors whose profits are reinvested for no less than five years can apply for tax reduction/exemption on reinvested profits.
1.3.	Wholly foreign owned enterprises	Non-SEZs	They require special authorization to start business outside SEZs
		SEZs	They are allowed to settle in SEZs and ETDZs. They enjoy similar treatment as do joint ventures
1.4.	Accelerated deprecation	Non-SEZs	Straight-line method is usually used. Depreciation period is between five years for electronic equipment and 30 years for buildings
		SEZs	Faster depreciation rates can be granted to joint ventures inside the SEZs
1.5.	Remittance tax	Non-SEZs	After all taxes and legal transaction funds are paid. The same treatment applies for capital remitted abroad after a 10 per cent withholding tax is paid. The same treatment applies for capital remitted abroad after the termination/liquidation of a company, once all liabilities and taxes have been paid.
		SEZs	No withholding tax

1.6.	Import tax	Non-SEZs	Not clear.
		SEZs	Investment goods and raw material are exempt. Consumers goods can enjoy a re-education/exemption of import tax
1.7.	Export tax	Non-SEZs	
		SEZs	No export tax levied on goods exported or delivered within the SEZs. However goods delivered to domestic markets are subject to export tax, and the repayment of import taxes that were not levied on the inputs incorporated
1.8.	Commercial and Industrail Consolidated Tax (CICT)	Non-SEZs	Capital contributed in the form of imported machinery equipment and spare parts or additional capital of the same sort can be exempt from CICT, provided imported items cannot be produced in China. Enterprises experiencing difficulties in paying CICT for sales on the domestic market can apply for reduction/exemption. Enterprises may apply for exemption on CICT for export goods, except for a few commodities.
		SEZs	Exemption from CICT based on approval were available for the following" • construction or production imports; • a reasonable amount of office supplies; • means of transportation imported by foreign representatives for own use; • food and beverages imported for tourists and restaurants can be exempt from CICT upon approval. 50 per cent reduction of CICT on imported high tax commodities If goods are manufactured mainly for export, no CICT is levied at the factory level, except for a few types of commodities In Shenzhen, municipal authorities consider lowering the rate of CICT when applicable.
1.9.	Local taxes[xi]	Non-SEZs	They are assessed at the discretion of local authorities
		SEZs	No local surtax levied on net income.

1.10	Personal taxes	Non-SEZs	Foreign personnel staying less than five years on their word, and with no intentions of becoming residents, irrespective of whether or not they remit their overseas income to China, are not required to report or pay tax on their oversees profit. They may remit free overseas 50 per cent of their Chinese income after tax after paying a 10 per cent withholding tax and apply to the Bank of China if they wish to remit a higher proportion of their Chinese after tax income
		SEZs	Income earned inside China will enjoy 50 per cent tax cut. After tax, income can be freely remitted without any withholding tax. In addition to this, foreign employees enjoy reduction/exemption of import tax on daily life necessities.
1.11	Special conditions for ethnic Chinese investors	Non-SEZs	No special consideration
		SEZs	In Xiamen, Taiwan investors who wish to invest in the SEZ will enjoy special preferential treatment in income tax No income tax levied on foreign workers in any overseas Chinese investment.
		2. Costs	
2.1.	Industrial land rents	SEZ	Industrial land rent in Shenzhen is in the range HK$ 19-32 per sq.m/year and in Shantou HK$ 16-64 per sq.m/year. In the three Guangdong Zones, this rent can be revalued every three years by not more than 30 per cent. In Xiamen rent is in the range HK$ 3-63 per sq.m/year and can be revalued every five years by less than 20 per cent.
2.2.	Industrial standardised buildings	SEZ	The SEZs development companies provide standardised office space for investors. In Shenzhen, the monthly range is HK$ 1,200 sq.m.
2.3.	Purchase of workshop	SEZ	A company which so wishes can purchase workshops. In Shenzhen the rate is HK$ 1,100 – 1, 900 per.sq.m and in Shantou it is HK$ 1,200 sq.m
2.4.	Water and energy	SEZ	These costs are said to be lower than in Hong Kong: water 0.18 Rmb/cubic meter, electricity: 0.085 Rmb/Kwh for industrial use, 0.2 Rmb/Kwh for domestic use
2.5.	Participation in infrastructure cost	SEZ	If the company is located where there is no infrastructure, then the company has to pay a specified amount as construction fees.

2.6.	Labour costs	SEZ	Labour cost has three components (1984): 70 per cent is given directly to labour; 25 per cent is used for social labour insurance and to companies for various state subsidies for workers and 5 per cent is reserved by the enterprises to subsidise its welfare fund. Labour cost varies from about HK$ 500 in Shantou, Zuhai and Xiamen to around HK$ 700 in Shenzhen and HK$ 800 in Shakou. Wages are to be increased each year by 5 to 15 per cent. An amount equivalent to 2 per cent of total wage bill must be given to labour trade unions. Enterprises were allowed to choose the system of remunerations[xii], work schedule.
2.7.	Currency and settlements	SEZ	Usually foreign currencies are used to pay costs described above. But if Rmb are earned through access to the domestic market, companies may apply to use them to settle these costs.
2.8.	Rate of change	SEZ	Net hard currency earnings from exports are entitled to be changed into Rmb at international settlement rate (2.8Rmb/$) rather than official rate (2.5Rmb/$ in September 1984) by the Bank of China.
2.9.	Special consideration for ethnic Chinese investors	SEZ	In Xiamen, Taiwan, investors enjoy special conditions for land rent.
3. Relation with the domestic market			
3.1.	Access to domestic inputs	Non SEZ	Material needed by a joint venture should be priced according to the current prices in China and paid in Rmb except for precious metals, petroleum, coal and timber that are valued at their international prices and paid for in Rmb. However, material falling in the category of goods imported (or exported) by China will be priced according to the c.i.f. international prices plus import duty and business tax I import commissions fees (respectively according to the international f.o.b. prices).
		SEZ	Companies within SEZ do not usually pay tax on imported goods from abroad; goods exported by China will be priced preferentially on the basis of their international f.o.b. prices.

3.2.	Access to domestic market	Non SEZ	On a case-by-case basis, wider access to the domestic market can be granted to goods that are otherwise imported by China. Products should be sold to the relevant foreign trade cooperation at a value related to their international prices and usually paid for in foreign currency.
		SEZ	Unlike projects in the 14 coastal cities or others in rest of China that are often renovation projects, investments in the SEZ should be export oriented. The ratio of domestic sales (average 20 percent) depends upon demand.
3.3.	Special condition for Chinese overseas	SEZ	In Xiamen, Taiwan, investors will be permitted to sell at least 30 per cent of their production on the domestic market. In addition, they will enjoy preferential rates on the loans in Rmb or in foreign currency.

Source: Oborne (1986)

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