



Do special economic zones induce developmental spillovers? Evidence from India's states [☆]



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ABSTRACT

Do special economic zones induce local development? Research drawing on the case of China's special economic zones suggests that subnational polities can target the location of export zones in order to catalyze local and regional socioeconomic development. Since 2006, a number of Indian states have pushed forward similar zones in the face of accusations of land grabbing, arguing that the zones will be engines for improvement in exports, employment, and infrastructure. I argue that local development spillovers are an important, albeit previously understudied, dimension by which to evaluate the effects of special economic zones. I then present the first systematic analysis of the developmental effects of India's SEZs, leveraging an original dataset on their locations, together with 2001 and 2011 census data containing a host of social and economic developmental variables. The findings show these SEZs have failed to bring about local socioeconomic development. To explain this absence of developmental spillovers, I provide a theoretical framework based on the crucial role of political economy incentive structures facing local politicians. I outline the mechanism through which Indian state politicians use state-owned development corporations for rent capture, undermining the potential effectiveness of SEZs and leading to their developmental failures. The combination of available means for extracting rents and the limited political constraints on such rent extraction leads to a lack of developmental spillovers. This framework can also help to explain the difference in the effects of SEZs in India and in China. These findings have theoretical importance for understanding the conditions under which subnational polities can use export zones and other export policies to catalyze development, and practical implications for understanding the mixed pattern of SEZ success across the world.

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1. Introduction

Following the success of China's economic reforms, the effects of special economic zones (SEZs) have been widely debated by academics and policymakers, even as the number of SEZs has rapidly increased globally (Aggarwal, 2012; Farole et al., 2011; Moberg, 2017). While research has actively investigated the effect of these zones on national and sometimes regional growth and employment, there has been limited theoretical and empirical focus on the highly localized effects of these zones. In many cases, including that of India, spatially-disaggregated empirical analysis has often been constrained by the absence of systematic data.

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Export-oriented zones are often an important component of a country's foreign economic policy, and are also important examples of place-based policies¹ that create local economic hubs, potentially helping to generate growth, employment, and industrial development in the surrounding areas. For example, SEZs in Guangdong and other coastal Chinese provinces have become global manufacturing and export centers, and have also served as engines of rapid local development. However, SEZs in India have had uncertain and untested results, especially in the case of the large number of new zones that have been established since the 2005 SEZ Act. Anecdotal evidence criticizes government policy on these zones from any number of angles, and SEZs have also sparked substantial

¹ Kline and Moretti (2014b, p. 630) define place-based policies as those that "...explicitly target geographic areas for some form of special treatment, be it tax subsidies, public investments, or special rules and regulations." In developed countries, place-based policies often, though not always, target underperforming areas or regions; while SEZ policy in India was not specifically designed with this purpose, the term place-based policies has also been used to describe SEZ policies in other countries, such as China.

protests and contention. This motivates the paper's research question: have place-based export policies, specifically SEZs, promoted local development in India? If not, what are the political economy factors that explain why these zones have failed to induce development, even while such place-based export policies have been at least partially successful in China?

In India, the SEZ Act has been justified via the zones' potential impact on growth and development; according to the central government, "...The main objectives of the SEZ Act are: (a) generation of additional economic activity; (b) promotion of exports of goods and services; (c) promotion of investment from domestic and foreign sources; (d) creation of employment opportunities; and (e) development of infrastructure facilities."² Given these purported aims, what are the actual impacts on local development around SEZs?

This paper provides the first systematic analysis of the developmental effects of India's special economic zones. I use an original dataset on the location of India's rural SEZs, matched with 2001 and 2011 census data containing a rich set of geographically disaggregated social and economic indicators. Analysis focused on a key set of variables suggests that Indian SEZs did not have significant effects on local socioeconomic development after the first five years. Since SEZ locations are neither randomly nor quasi-randomly assigned, this analysis does not provide a causally identified analysis of the effects of SEZs. However, to help account for the non-random geographical assignment of SEZs, I employ a matching algorithm suited for continuous treatments, the Covariate Balancing Propensity Score. This helps to take into account the very different pre-treatment levels of development between regions where SEZs are sited and where they are not, and increases confidence in the estimation of SEZ's spillover effects. The results are robust to specifications weighted by both the number and area of SEZs, and to estimates that weight effects by the amount of time SEZs have been in place.

To explain why SEZs have not produced developmental spillovers, I present a theoretical framework based on the political and economic incentives faced by local politicians. The framework predicts that place-based export policies such as SEZs can be beneficial to local development only when local politicians are incentivized, through elections or promotion, to support such development (as in the case of China) and when rent extraction is sufficiently constrained. The general absence of these incentives and constraints in India has contributed to the developmental inefficacy of SEZs in India. The mechanism explaining the failure of India's SEZs to induce developmental spillovers focuses on the role of political capture of and collusion with state-owned development corporations. I argue that politicians in India have used SEZs as opportunities to extract rents. This ability and willingness to influence the bureaucracy and the absence of political incentives to use SEZs to spur broader development explain why these zones have not been successful in India. Evidence for this mechanism draws on field interviews as well as secondary source coverage of India's SEZs. I also rule out a prominent alternative explanation, that co-partisan political alignment would explain the developmental under-performance of SEZs.

This paper contributes to practitioners' and academics' debates on SEZs and other place-based export policies in several ways. First, it sets out an alternative set of criteria by which to evaluate the effects of SEZs, providing an important complement to existing frameworks, and one that is increasingly appropriate given regional and local variation in the pace of economic liberalization in India and elsewhere (Sud, 2014a). Second, the development of a novel dataset of India's rural SEZs facilitates the quantitative analysis of these zones' effects in the Indian context, where such analysis has previously not been possible. This has important

contributions for the debate within India, given the central government's continued support for SEZ development and the inclination for subnational governments to use place-based economic policies to attract international and domestic capital.

Third, and more broadly, the political economy theory for the conditions predicting SEZ success also points to the general conditions under which place-based export policies are more or less likely to succeed, and can thus contribute to debates on SEZ policy implementation and expansion in many other countries. The application of this framework is not intended to explain all variables which might determine the developmental effects of place-based zones. The framework explains important aspects of India's experience with SEZs, and also actively contrasts the political economy conditions in India and China. The comparison with China is critical given its role as a model for many other countries. This analysis is particularly timely given the proliferation of SEZs during the past couple of decades, and their mixed patterns of success across different countries. Finally, the findings also contribute to debates on when decentralization spurs local economic development.

I first discuss the political context surrounding special economic zones in India, and puts forward an argument for why an assessment of local developmental spillovers should be added to existing dimensions for evaluating the effects of SEZs.³ Using an original dataset, I then evaluate the developmental performance of India's special economic zones, showing that there has been a lack of promised developmental spillovers. Following this finding, and drawing on evidence from field interviews and secondary research, I present a theoretical framework on how political and economic incentives have led to an absence of induced developmental spillovers, and conclude with a comparative analysis of SEZs in India and China.

2. Subnational politics, economic development, and place-based policies

Indian states' policies to attract and encourage investment are key drivers of state-level economic development (Sinha, 2005). Divergent foundations of political economy have led to different attitudes towards business among Indian states, with very different levels of engagement with the global economy as well as high levels of regional diversity in patterns of development and inequality (Kohli, 2012). These divergences have their roots in a long history of subnational variation in policymaking and complex central-local relations (Jenkins, 2004). The increased, emerging role of states in India's political economy has led to a new, spatially-mediated pattern of economic restructuring (Kennedy, 2014a).

The model of economic development driven by local leaders is not unique to India. In the Chinese case, arguments made by Xu (2011) point to the importance of decentralization for growth, driven by the idea of a "market-preserving federalism" (Montinola, Qian, & Weingast, 1995). This decentralization and localization of economic policy, of which SEZs are a key component, play important roles in accounts of China's political reform and its ability to attract capital (Shirk, 1993; Naughton, 1996). However, the positive accounts of subnationally-led economic development policy have been challenged, both cross-nationally (Cai & Treisman, 2005, 2009) and in the specific case of China (Cai & Treisman, 2006a). In the case of foreign direct investment, FDI may empower local politicians to pursue their own interests vis-a-vis the center (Malesky, 2008). In developing countries, FDI may also increase corruption by increasing market concentration and the rents that public officials can extract (Pinto & Zhu, 2016). Strong centralized leadership can constrain rent extraction as well as demands for autonomy by local politicians, an argument advanced in the case

² <http://www.sezindia.nic.in/about-introduction.asp>.

³ For a thorough review of existing approaches, see Aggarwal (2012, Chapter 5).

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