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Mumbai and Malgudi: Cooperate on SEZs to Bring Prosperity to All

Shyam Sunder¹

It is sometimes possible to make collective decisions that can make ALL members of society better off. Yet, such decisions often fail to be made because effective and trusted social mechanisms for the purpose are not devised and deployed. The recent controversies surrounding the Nandigram, Singur and other proposals to create special economic zones (SEZs) in some parts of India are unfortunate examples of such failures and foregone opportunities to improve the welfare and prosperity of all. This article analyzes the problem and proposes a framework for decision making to achieve both efficiency as well as equity.

Consider a proposal to use agricultural land for creating an industrial zone. Since the land needed for the zone is likely to be owned by many, and since such a proposal is likely to affect the land-owners as well as others, an element of collective decision making enters the picture. Under the existing regime, the state government, if convinced of the desirability of such a project, uses the legal instrument of eminent domain to acquire land from its existing owners by paying them the prevailing market price, and hands it over to the industrial developers or users.

This process often leads to dissatisfaction, protest, political turmoil, conflict, and even bloodshed. Could the process be improved for benefit of all?

The main source of conflict is not the desirability of such projects themselves (although arguments against the projects may often be made to gain negotiating leverage, and may be valid in some cases), but the equitable distribution of the gains from the project.

The SEZ projects require contributors of four classes of inputs (land, labor, physical and financial capital) in addition to the entrepreneur and the government as the main participants. Let us examine SEZ projects from the points of view of each class of participants.

The Entrepreneur

The entrepreneur (E) develops and brings the idea of the project, sometimes combined with some risk capital, to the government. E expects to earn a return on the financial and skill capital he commits to the project. Typically, E looks at many possible locations and chooses one that promises the highest rate of risk-adjusted return that includes the gain in the value of the land and the profits earned on investment of human, financial and physical capital.

¹ Yale University and Center for Study of Science, Technology and Policy. Without implicating them, the author is grateful to V. S. Arunachalam, T. N. Srinivasan and Manjula Shyam for the comments on an earlier draft.

If the packet of land needed, and the number of individual landowners is large, E faces a holdout problem. Even if 99 out of 100 necessary transactions are successfully concluded, the owner of a parcel of land located in the midst presents a difficult problem for E because the land acquired in the first 99 transactions may remain unsuitable for the project without the consummation of the 100th transaction. This gives a small number of owners of land incentives to hold out for a better deal. For this reason, E may turn to the government for help in acquiring land through its powers of eminent domain, instead of negotiated market transactions.

The relevant state or local government body (G) may be open to such proposals if it sees the developmental benefits of the project (in form of employment, educated work force, tax revenues, ancillary housing and commercial development and property values, etc.) worth the costs (for development of infrastructure, environmental burden, resettlement, and administration, etc.) If the benefits exceed the costs by sufficiently large amounts, G may find it worthwhile to incur the political costs of using the powers of eminent domain to override the commercial transactions by which land transfers usually take place.

Land

Public use is the traditional basis for employing government's powers of eminent domain for acquisition of land. Construction of public works such as roads, railways, canals, embankments, pipelines, etc. would not be possible without the government's ability to acquire rights to small but contiguous parcels of land owned by hundreds or thousands of parties. Even airports, hospitals, government office buildings, though smaller in size may call for use of such powers to acquire sufficiently large compact parcels of land for operations of government entities.

Expansion from "public use" to "public purpose" as the basis for exercising the powers of eminent domain is a recent phenomenon. It involves transfer of land from one private party to another using powers of government when the G considers such transfer serves a public purpose such as development, removal of blighted areas, etc. Public purpose as the basis for eminent domain has been problematic for several reasons.²

First, in private-to-public transfers, any hardship inflicted on the individual land-owners may be ameliorated by the benefits of the public use (although not necessarily to the individuals harmed by the transfer and almost certainly not in proportion to their respective sacrifices). The same can be said of any losses that arise from having to transfer land at prices that do not cover the current market value and various adjustment costs. At least there will be a hospital for the sick, a school for the children or a road to get the produce to the market—all these benefits distributed widely among the local populace.

In contrast, in private-to-private land transfers effected through the powers of eminent domain, a significant part of the benefits of bearing the hardship may accrue largely to

² See the controversies surrounding the U.S. Supreme Court ruling in *Kelo v. City of New London* 545 U.S. 469 (2005) (http://en.wikipedia.org/wiki/Kelo_v._New_London).

entrepreneurs, investors, or skilled employees attracted from far away. None of the benefits of any land undervaluation errors accrue to the local community.

Second, there is the problem of handling the wealth consequences of land price appreciation induced by the project itself. Development projects tend to bring sharp increases in price of land covered by the project as well as the neighboring tracts. E would prefer to pay the prices prevailing in the area before the existence of the project becomes known to the public, and thus pocket the entire increase in price of the project land associated with the public announcement and subsequent development. E would defend such a process on the grounds that (1) the price appreciation is a direct consequence of his actions because absent his decision to undertake the project, there would be no appreciation in land prices; and (2) the announcement will bring about an increase in the price of the tracts surrounding the project area, and it will constitute the local public's share of land price appreciation.

The landowners, on the other hand, would want to transfer the land at prices no lower than the post-announcement levels, leaving only the subsequent gains in land prices in the hands of E. This raises the question of how should the gains in land prices due to project announcement be shared, and what could be the mechanism to implement the chosen sharing rule.

Third, the patterns of wealth distribution induced by private-to-private transfers for SEZs can be radically different from the effects of typical private-to-public transfers. Most private-to-public land transfers involve relatively small parcels of land, or long, narrow contiguous strips consisting of many parcels. Such transfers take all the land of only some of the owners, leaving a part of the land of most owners to appreciate as their share of the price appreciation. Such small parcels or strips have plenty of bordering lands and the gains from land price appreciation are widely shared, generating less support for community opposition to such projects.

In contrast, when land is acquired in large compact blocks in private-to-private transfers for SEZs, most owners of small parcels part with all their land because it falls entirely within the SEZ boundaries; they have no land left to own which may appreciate with the project. Further, the larger the size of the SEZ of a given shape, the smaller is the ratio of its periphery to its area.³ Thus the larger the size, and more compact the shape of an SEZ parcel of land, smaller (per acre of project land) is the opportunity for the owners of the surrounding parcels of land to benefit from land price appreciation. One should not be surprised, then, that such projects with smaller spillover effects to the surrounding communities generate greater resistance from the community.

³ The length of the periphery of the acquired land can be thought of as a measure of the benefits that would accrue to the owners of the un-acquired lands adjacent to the project area. The periphery/area ratio is $4/D$ for a circle of diameter D as well as for a square of side D . For a rectangle of length D and width xD , the periphery-to-area ratio increases indefinitely as the rectangle narrows into a thinner strip of land as x gets smaller (the ratio is $2(1+1/x)/D$).

Labor

Generation of opportunities for employment is often the over-riding public purpose of SEZs. Effects of these projects on employment opportunities, and the distribution of such opportunities, are important policy considerations.

First, consider the landowner who has cash from the sale of his land but no longer has a means of earning a living by tilling the land. There is a good chance that the land has been in the family for generations and the owner has no other usable skills. Using the proceeds from land to buy land elsewhere requires (1) self-discipline to avoid spending the money on long suppressed wants of a subsistence farmer; (2) thinking of land as a commercial asset, which is typical in urban and developed societies but less so in rural settings; (3) knowledge of alternative places where land is available and tillable with the farmer's skills; (4) skills to conduct an unfamiliar land transaction; (5) willingness to live and work in a new place amongst strangers, and adjust to a social milieu and village life which may not be receptive to outsiders.

This suggests that even if the issues about land prices mentioned in the preceding section are resolved to the satisfaction of the landowners, there is still a good chance that some of them will quickly spend the money, and end up as destitute families on streets of a nearby city unless the land transfer is associated with an alternative means of living and occupation in a familiar and receptive environment. Paying landowners in the form of an annuity may slow but not eliminate such outcomes. People can borrow and spend immediately by signing off their rights to the annuity, often at usurious interest rates. Locking up the money in annuity may prevent even those who are willing to buy land elsewhere from doing so. Living on an annuity, assuming it is enough, may rob the individual of the self-respect and satisfaction from earning a living through work.

Second, consider the land-less labor who earns his living from the piece of land transferred to the SEZ. Typically being at the bottom of the socio-economic pyramid, he has little education and sellable skills or property other than possibly a place to live that he may not own. This person has little mobility, does not get the compensation the landowner gets, and is left without the only means of living he may have known all his life. This person has little to lose from opposing the SEZ land deal, and is a good target recruit for any passing politician looking to incite trouble or armed bands interested in stoking violence.

SEZs tend to attract enterprises which need skilled technical workforce supplemented by some administrative, clerical, maintenance, custodial and protective duties personnel for their operation. Even during the temporary construction phase when there is greater demand for unskilled workforce, the farmers and farm labor may or may not be willing to subject themselves to the grueling construction duties under day or piece wages. As the displaced farmers and farm labor watch from outside the fence, strange faces appear in cars from nowhere, occupy newly built houses they could only dream of, and earn a good living while they, the "sons-of-the-soil", descend into destitution. Displacement of job opportunities for the land-less labor in the area is a frequent source of resistance to SEZs and largely ignored in analyses of such projects.

Physical and Financial Capital

It seems reasonable to assume that most of the financial and physical capital for the SEZ project will come from markets and we do not need to discuss here in any detail. A part of the capital, say 10 percent, of the publicly held enterprises in the SEZ could be raised locally by giving the owners of acquired land an option of receiving a part of their compensation the form of shares of the SEZ firms. This will give local community a stake in the economic success of the SEZ, and help expand the equity ownership of Indian corporations beyond Mumbai to Malgudi.

A Trusted Mechanism

Economic development through SEZ projects could be assisted by creating an efficient, equitable, transparent, and trusted mechanism. Let us try to outline a possible structure of such a mechanism in the hope of stimulating thoughtful debate on the subject that may lead to further improvements.

For each SEZ project that calls for acquisition of land through powers of eminent domain, the government should appoint a (corruption free) task force of civil servants, economists and technologists to perform the following duties. The central planning commission could create a bureau of experts who could be seconded to the task force in advisory capacity on request of the state government.

1. Identify various classes of people and organizations who will participate in, and be affected by, the project (entrepreneurs, investors, bankers, builders, employees from distant locations, employees from local area, land owners, housing owners, local residents, local government, schools, water and other utility suppliers, transport services, etc.
2. Estimate the effects and demands on these groups placed by the proposed project.
3. Estimate the gross and net wealth generated by the project (sum of gross and net wealth generated for each group of participants or organizations).
4. Focus attention on those participants who have limited capacity to remediate these effects through transactions in developed markets. These may include agricultural land owners, land-less labor, and other residents of the area.
5. Develop a plan that will allow the people affected by the project to (1) pursue their living elsewhere assisted by migratory advice, (2) change their living assisted by appropriate educational and vocational programs.
6. Assess a land pricing scheme for equitable distribution of price gains among the entrepreneur, the local government and the existing owners of the project land as well as the neighboring lands. For the sake of equity, this may require the owners of the adjacent

tracts (which are likely to appreciate in value) to pay a share of increment in the value of their land in form of additional taxes.

7. Develop a menu of alternatives for land-owners to take their compensation in various combinations of cash, annuities, and equity in any publicly-owned corporations to be established in the SEZ.

8. Develop an employment scheme to attract labor with necessary skills to the project, and sharing the newly created jobs with the newly trained local population, especially those displaced by the project itself.

9. Include investments needed to be made by the local government (roads, utilities, schools, counseling, health, environment, etc.) as part of the consideration of the project so the local government has the adequate resources to meet these demands.

10. Develop a zoning plan for appropriate approvals for the area surrounding the project land to define land use plan that includes transportation, public facilities, parks, education, etc.

11. Ask the entrepreneur to conduct negotiations simultaneously for more than one potential site in order to limit on the hold-up incentives of the local participants.

12. Devise a process which is sufficiently open and trusted by various participants so the final outcome will be beneficial to all concerned.

While the above is only an initial outline of a proposal, development of a process along such lines to establish SEZ may make it easier to establish such projects for the benefit of all.