



India's Foreign Investment Surge: Assessing the Role of the 1991 Economic Reforms – A Review Paper

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Abstract

This paper examines the impact of India's 1991 economic reforms on Foreign Direct Investment (FDI) inflows. It provides an overview of India's pre-reform economy, post reform economy and the reforms' objectives, evaluating their effectiveness in attracting FDI. Through literature review, data analysis, and consideration of internal and external factors, the study finds that post-1991, reforms significantly boosted FDI, despite challenges like bureaucratic hurdles and uneven sectoral distribution. The research highlights notable FDI growth in sectors such as electrical equipment and telecommunications and diversification in investment sources. It also emphasizes the need for targeted policies to address structural constraints and promote inclusive growth, underscoring the complex relationship between economic liberalization and FDI.

Key Words: Foreign Direct Investment, Economic Growth, 1991 Reforms, Liberalization.

1.1 Introduction

In 1991, under Finance Minister Dr. Manmohan Singh, India introduced comprehensive economic reforms to liberalize and modernize the economy (Ahluwalia, 2002). These reforms shifted from protectionist policies to address low growth, high inflation, and a balance of payments crisis (Vadlamannati, 2009). Key reforms included deregulation, privatization, and trade liberalization (Chakrabarty & Nunnenkamp, 2006), reducing government controls, encouraging private sector efficiency, and promoting export-oriented growth (Sahoo & Mathiyazhagan, 2003). The New Industrial Policy of 1991 dismantled complex licensing systems, opening sectors to private and foreign investment (Vadlamannati, 2009). Financial sector changes enhanced market functioning and regulatory frameworks (Dash & Sharma, 2011). This paper reviews the impact of these reforms on Foreign Direct Investment (FDI) and economic growth.

Post-1991, FDI became crucial for India's growth, facilitated by policies allowing 100% (In most of the sectors) foreign ownership and simpler FDI procedures (Ahluwalia, 2002). Previously, stringent regulations slowed FDI

inflows, but reforms significantly increased them, enhancing competitiveness and technology. Devajit (2012) underscores the importance of investor-friendly policies. The shift to a market-oriented economy attracted substantial foreign investment, boosting GDP and export growth (Dash & Sharma, 2011). FDI positively impacted manufacturing but had mixed effects on the primary sector (Chakrabarty & Nunnenkamp, 2008). The services sector saw increased FDI, enhancing growth (Chakrabarty & Nunnenkamp, 2006). Liberalization measures attracted world-market-oriented FDI, promoting technical collaboration (Chakrabarty & Nunnenkamp, 2006). While FDI presents challenges, such as reducing domestic savings (Sahoo & Mathiyazhagan, 2003), its increase post-1991 has bolstered economic growth. This paper explores the reforms' effects on FDI and economic growth.

Pre Reform Economy: The pre-reform period was marked by low growth rates, high inflation, and a severe balance of payments crisis, which underscored the need for significant policy changes (Vadlamannati, 2009). Structural weaknesses, such as inefficiencies, bureaucratic hurdles, and extensive state intervention, stifled economic growth and competitiveness (Ahluwalia, 2002). India followed an import substitution model, aiming to promote domestic industries by restricting imports, which led to inefficiencies and isolation from global markets (Vadlamannati, 2009). The economic conditions were further strained by high inflation rates and fiscal deficits, impacting government finances and economic stability. Limited export orientation and a lack of emphasis on global market integration further constrained economic growth (Ahluwalia, 2002). Overall, the pre-1991 economic conditions in India highlighted the urgent need for reform, as the country struggled with lower growth rates and lesser integration with the global economy, emphasizing the transformative impact of the 1991 reforms (Dash & Sharma, 2011).

1.2 Research methodology

In conducting this research, a comprehensive review of existing literature on the impact of India's 1991 economic reforms on Foreign Direct Investment (FDI) was undertaken, analyzing scholarly articles and reports from reputable sources like the World Bank and UNCTAD. The review examined FDI inflows, critical analysis, trend analysis, and cross-country comparisons, identifying key internal and external factors influencing FDI post-reforms. The findings were synthesized to provide insights into the interplay between economic reforms, internal conditions, and external factors shaping FDI dynamics in India.

1.3 The objectives of this study are to:

Explore India's pre-1991 economic challenges and the catalysts for reform.

Assess the effectiveness of the 1991 reforms, particularly in attracting FDI.

Review literature on economic liberalization's impact on FDI in India pre- and post-1991.

Critically analyze arguments regarding the 1991 reforms' role in India's FDI growth, considering internal and external factors.

2. Literature Review

2.1 Theories on the Relationship between Liberalization and FDI

The surge in Foreign Direct Investment (FDI) following India's 1991 economic reforms, driven by liberalization policies, necessitates examining theoretical frameworks to understand multinational corporations' motivations, policy impacts, and associated benefits and challenges.

2.1.1 The OLI Paradigm: A Framework for Understanding FDI: The Ownership-Location-The Ownership-Location-Internalization (OLI) paradigm, introduced by John Dunning (1980), outlines three crucial factors influencing foreign direct investment (FDI): ownership advantages, location advantages, and internalization advantages. According to John Dunning (1988) Ownership advantages refer to MNC-specific assets like technology or managerial expertise, while location advantages encompass benefits within the host country such as market size or infrastructure. Internalization advantages highlight the benefits of retaining ownership within the firm instead of opting for licensing. Liberalization policies directly impact this paradigm by enhancing host country location advantages and reducing internalization costs, thus making FDI more appealing to multinational corporations.

2.1.3 Horizontal and Vertical FDI: Different Drivers: FDI literature distinguishes between horizontal and vertical FDI (Markusen, 2002). Horizontal FDI involves replicating production in a foreign market to serve that local market, driven by factors like tariff reduction and market size. Vertical FDI entails fragmenting the production process across countries to leverage lower costs or access resources. Liberalization policies influence both types: reduced trade barriers and market size attract horizontal FDI, while policies lowering trade and labor costs or providing resource access incentivize vertical FDI.

2.1.4 Market Imperfections and FDI: Theories on market imperfections offer another perspective on the relationship between liberalization and FDI (Caves, 1971). In imperfect markets, characterized by transaction costs, barriers, or information asymmetries, MNCs gain an advantage by internalizing these imperfections through FDI. Liberalization policies that reduce these imperfections, such as simplifying regulations or removing foreign ownership restrictions, make FDI more viable and attractive for MNCs.

2.1.5 New Trade Theories and FDI Complementarity: New Trade Theories (NTT) (Krugman, 1980; Helpman, 1984) highlight a complex relationship between trade and FDI, challenging the simple trade-FDI substitution effect. NTT suggests that liberalization, particularly the reduction of trade barriers, promotes a complementary relationship between trade and FDI. Lower tariffs and trade restrictions allow MNCs easier access to foreign markets, incentivizing investment in local production facilities to serve those markets efficiently.

2.1.6 Political and Institutional theories and Factors: Economic theories are key to understanding FDI and liberalization, but political and institutional factors also play a significant role. Political stability, regulatory framework, and corruption levels greatly influence FDI decisions (Globerman & Shapiro, 2002). Stable politics

and efficient regulations attract investment, while regional integration agreements create larger markets and harmonize investment rules (Blomström & Kokko, 1997).

2.2 Critical Analysis

2.2.1 Arguments for the Economic Reforms (1991) and Their Role in FDI Growth: Economic Reforms (1991) aimed to liberalize and adopt a market-oriented approach to unleash India's economic potential, enhance competitiveness globally (Ahluwalia, 2002). Deregulation: Focused on removing restrictive controls to stimulate private investment and innovation (Ahluwalia, 2002). Foreign Investment: Liberalized policies attracted FDI and technology transfer by opening sectors to foreign ownership and simplifying approval processes (Ahluwalia, 2002). Industrial Growth: Reforms targeted industrial expansion by fostering competition, efficiency, and innovation (Sahoo & Mathiyazhagan, 2003). Export Competitiveness: Trade policy reforms lowered barriers, reduced protectionism, and improved market access to bolster India's global trade presence (Sahoo & Mathiyazhagan, 2003). Technological Advancement: Encouraged innovation and modernization across industries to drive productivity and competitiveness (Chakrabarty & Nunnenkamp, 2006). Growth Stimulus: Reforms aimed to fuel economic growth, attract investment, and position India competitively in the global economy (Dash & Sharma, 2011). China Comparison: Cited China's FDI success as a model, suggesting similar potential for India (Chakrabarty & Nunnenkamp, 2006).

2.2.2 Arguments Against the Economic Reforms (1991) and Their Role in FDI Growth: Infrastructure and Bureaucratic Challenges: Despite 1991 reforms, infrastructure bottlenecks and bureaucratic delays persist, hindering the full impact of liberalization on FDI (Saggi, 2002). Uneven FDI Distribution: FDI is concentrated in industrialized regions, indicating infrastructure and skill availability influence location decisions (Rodrik, 1998). Impact on Domestic Firms: Dominant MNEs may displace local firms, reducing their market share (Dash & Sharma, 2011). Capital Drain: Repatriation of profits by foreign firms may drain capital from India (Sahoo & Mathiyazhagan, 2003). Reduction in Savings: FDI might reduce domestic savings and investment by favoring foreign firms in local capital markets (Dash & Sharma, 2011). Domestic Market Focus: FDI in India is more geared towards the domestic market, limiting export potential (Dash & Sharma, 2011). Social and Environmental Concerns: Liberalization may exacerbate income inequality and environmental issues (Vadlamannati, 2009). Regional Disparities: Reforms may widen regional gaps, necessitating inclusive growth strategies (Vadlamannati, 2009).

2.3 Influences on FDI Inflow: Beyond Economic Reforms

2.3.1 Domestic Determinants of FDI Inflows: While the 1991 economic reforms significantly influenced Foreign Direct Investment (FDI) in India, several internal factors also play a crucial role. Key factors include infrastructure development, labor market flexibility, and fiscal challenges (Ahluwalia, 2002). The lack of unemployment insurance and effective policy implementation are crucial for creating a conducive environment for FDI. Fiscal constraints at central and state levels can crowd out private investment (Ahluwalia, 2002). Market size,

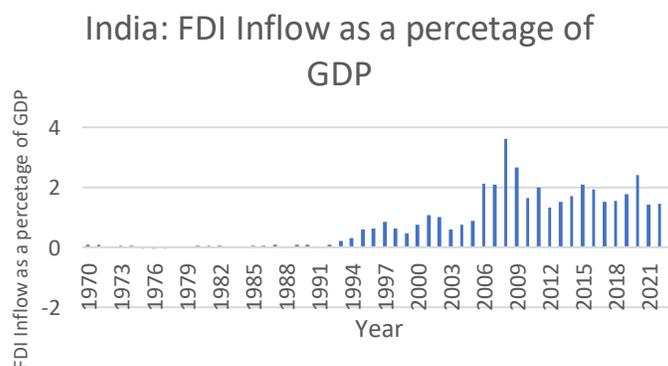
macroeconomic stability, political stability, a skilled workforce, and a transparent regulatory environment also impact FDI (Vadlamannati, 2009). Liberalized technology policies and relaxed foreign exchange requirements have further attracted FDI (Chakrabarty & Nunnenkamp, 2006). By addressing these internal factors alongside policy reforms, India can create a more favorable investment climate to attract and sustain FDI inflows, contributing to economic growth and development (Sahoo & Mathiyazhagan, 2003).

2.3.2 External Influences on FDI Inflows: External factors significantly influenced FDI in India post-1991 reforms. Globalization, with technological advancements and reduced trade barriers, created a conducive environment for FDI (Oman, 2000). The end of the Cold War expanded investment opportunities, enhancing competition for India (UNCTAD, 2000). Regional integration agreements like the WTO reduced trade barriers, shaping FDI patterns (Blomström & Kokko, 1997). Global MNEs influenced India's attractiveness for FDI, potentially draining capital (Dash & Sharma, 2011). India also faced competition from developing countries like China and Brazil (Sahoo & Mathiyazhagan, 2003). Considering these factors alongside reforms is crucial for India to sustainably attract FDI (Vadlamannati, 2009).

3. FDI Trend Analysis

3.1 Trends in FDI Inflows to India

Figure 1: Trends in FDI Inflows to India (1970-2022)

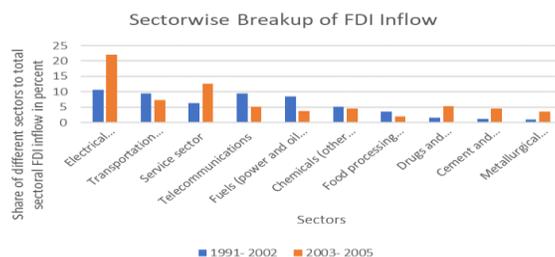


Source : World Bank Data Base

Before the 1991 economic reforms, India's FDI inflows as a percentage of GDP were low and volatile, fluctuating around low single-digit percentages due to restrictive policies and regulatory barriers. This limited foreign investor interest and hindered economic growth. Post-1991 reforms marked a significant shift, with the relaxation of foreign investment restrictions and reduction of trade barriers. FDI inflows began to rise steadily from the mid-1990s, exceeding 1% of GDP in the early 2000s and surpassing 2% by the mid-2000s. This growth reflects increased foreign investor confidence and India's emergence as an attractive destination for FDI.

3.2 Sectoral Distribution of FDI Inflows in India

Figure 2: Sector-wise inflow of Foreign Direct Investment (FDI) in India post-1991



Source: SIA News Letter April 2006 DIPP, Ministry of Industry and Commerce, GoI. (Reproduced from (Dutta & Sarma, 2008))

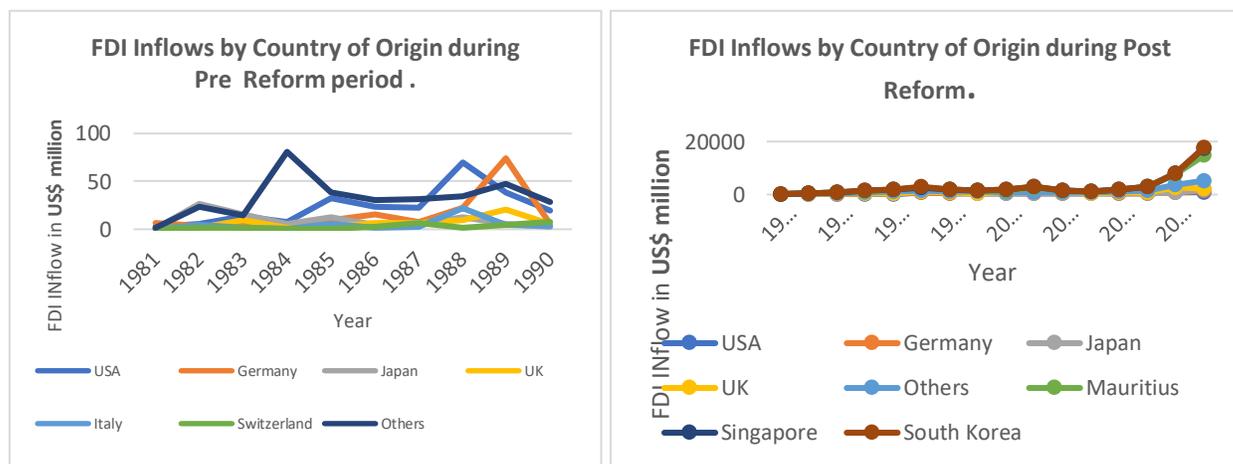
The sector-wise inflow of Foreign Direct Investment (FDI) in India post-1991 reforms reveals significant trends. The electrical equipment sector, including software and electronics, saw a major increase in FDI, rising from 10.56% in 1991-2002 to 22.14% in 2003-05, with an overall share of 14.02%. The transportation industry had a considerable share of FDI, accounting for 9.41% in 1991-2002, which decreased to 7.34% in 2003-05. The service sector experienced a significant rise in FDI inflows, jumping from 6.28% to 12.68% over the same periods, reflecting its growing economic importance. Telecommunications maintained a significant share but declined slightly from 9.43% to 5.14%. Other sectors like fuels and chemicals also attracted substantial FDI with varying percentages. The top ten sectors' combined share of FDI inflows increased from 56.78% to 71.10% between 1991-2002 and 2003-05. Overall, FDI inflows into India increased steadily, highlighting the post-reform attractiveness of the Indian market to foreign investors and the evolving sector-specific investment dynamics.

3.3 Foreign Direct Investment (FDI) Inflows in India by Country

Figure 3: FDI Inflows by Country of Origin

From 1981 to 1990, India's FDI inflows primarily came from the USA, Germany, Japan, and the UK, with notable increases from the USA in 1985 and 1988, and Germany in 1989. Japan, the UK, Italy, and Switzerland also contributed varying levels of investment.

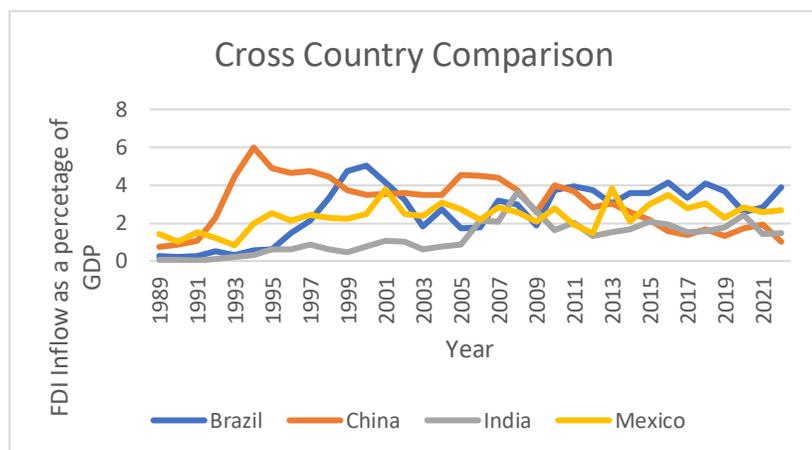
The late 1980s saw a surge in FDI, coinciding with India's economic reforms aimed at liberalization. From 1992 to 2008, the investor base diversified, with Mauritius becoming the leading FDI source, followed by the USA, UK, Germany, and the Netherlands. These trends highlight the positive impact of liberalization measures on creating a favorable investment climate and attracting foreign capital.



Source : Compiled from Annual Report, Reserve Bank of India (various issues), Reproduced from (Akhtar, 2013)

3.4 Cross Country Comparison - FDI Inflow Trends and Reform Impacts: Emerging economies: While India's economic reforms in 1991 were transformative, it's valuable to examine how its trajectory compares with other emerging economies that undertook similar liberalization measures. India's performance has been modest compared to other emerging economies. For example, China's FDI inflows surged from 0.018% in 1980 to 4.003% by 2010, driven by aggressive liberalization and rapid industrialization. Brazil's FDI peaked at 5.033% in 1991 and stabilized around 3-4% during the 2000s, due to its large market and natural resources. Mexico's FDI peaked at 3-4% during the 1990s and early 2000s, stabilizing at 2-3% in the late 2000s, influenced by NAFTA and better business regulations. China leads in FDI due to its manufacturing dominance, followed by Brazil and Mexico leveraging market size and location.

determinants of FDI policy liberalization in developing countries include country size, human resources, and trade openness, with larger, more open economies being more likely to attract FDI. The 1990s saw widespread FDI liberalization in developing countries, driven by rational decision-making and external pressures.

Figure 4: Emerging Countries (4) FDI Inflow Trends and Reform Impacts

Source : World Bank Data Base

4. Discussion

4.1 Findings

The review paper delves into India's 1991 economic reforms and their profound impact on Foreign Direct Investment (FDI). It finds that the reforms significantly boosted FDI inflows post-1991 compared to the pre-reform era, driven by liberalization policies aimed at attracting foreign capital and enhancing competitiveness. However, challenges such as bureaucratic red tape and uneven sectoral distribution of FDI persisted, necessitating targeted policy interventions. Insights from economic theory, critical analysis of reform objectives, and sector-wise trends underscore the complex relationship between liberalization and FDI. Despite disparities, sectoral analysis highlights significant FDI growth in sectors like electrical equipment and telecommunications. Country-wise examination reveals a diversification of investment sources, reflecting growing confidence in India's economy. Overall, while the reforms catalyzed FDI growth and positioned India as an attractive investment destination, addressing structural constraints and fostering inclusive growth remain imperative for sustainable development.

4.2 Limitations

The study's scope primarily focuses on analyzing the impact of India's 1991 economic reforms on Foreign Direct Investment (FDI), thereby limiting in-depth exploration of other aspects of economic policy changes during that period. Additionally, the reliance on secondary sources for data and analysis may present limitations in accessing real-time information and nuances not captured in existing literature. Moreover, the study's retrospective nature may overlook contemporary factors shaping FDI trends in India, necessitating caution in extrapolating findings to current contexts. Furthermore, while efforts were made to provide a comprehensive overview, constraints in accessing exhaustive data and varying methodologies across studies could introduce limitations in the depth and accuracy of the analysis.

4.3 Policy Measures and Suggestions

The paper "Foreign Direct Investment in India: Issues and Problems" by Nirupam Bajpai and Jeffrey D. Sachs underscores persistent challenges hindering India's attractiveness for Foreign Direct Investment (FDI) despite post-1991 economic reforms. These obstacles encompass a restrictive FDI regime, high import tariffs, labor laws, and inadequate infrastructure, compounded by centralized decision-making processes. Regional disparities in reform interest and economic performance further accentuate the need for targeted policy interventions, with southern states exhibiting greater dynamism in FDI attraction (Bajpai & Sachs, 2000). Bureaucratic hurdles and infrastructural deficiencies remain key obstacles to FDI retention and expansion (Chakrabarty & Nunnenkamp, 2006). Concerns persist regarding the sustainability of FDI inflows and their alignment with India's technological and export objectives (Dash & Sharma, 2011). To address these challenges, policy recommendations emphasize the importance of streamlining regulatory processes, enhancing infrastructure, and fostering an investor-friendly climate (Sahoo & Mathiyazhagan, 2003).

5. Conclusion

In conclusion, the review paper sheds light on the transformative impact of India's 1991 economic reforms on Foreign Direct Investment (FDI). The analysis underscores the pivotal role of liberalization policies in driving FDI inflows and positioning India as a competitive player in the global economy. While the reforms yielded substantial benefits, persistent challenges such as bureaucratic hurdles and uneven sectoral distribution of FDI underscore the need for targeted policy interventions. Moving forward, addressing these challenges and fostering inclusive growth are crucial for sustaining FDI momentum and realizing India's full economic potential in the evolving global landscape.

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