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Trade Liberalization and Its Impact on FDI Inflows in India: Evidence from 1991–2023

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ABSTRACT

Globalization has reshaped economic activity significantly by increasing international trade, investment flows, and economic integration. Trade openness and tariff reforms play a crucial role in attracting Foreign Direct Investment (FDI), which also supports economic growth and development in emerging economies such as India. This study attempts to examine India's experience from 1991 to 2023, analyzing how trade liberalization, average tariff rates, GDP growth, and inflation influence FDI inflows. Using time-series data, the study first reviews long-term trends in these variables and then regression analysis to evaluate their relationships with FDI. The findings depict a positive association between trade openness and FDI, while higher tariff rates tend to discourage foreign investment. Although greater trade openness reduces market barriers, its impact on FDI is shaped by factors such as institutional quality and policy stability. The results also reveal a negative but statistically weak relationship between GDP growth and FDI, suggesting more complex interactions between domestic economic conditions and foreign investment decisions. Inflation is found to exert minimal influence on FDI inflows during the study period. Overall, the study highlights that trade openness and lower tariffs contribute to a more favorable investment environment, while emphasizing the continued importance of stable and effective governance to maximize the benefits of FDI.

Keywords: FDI, GDP, India, Tariff, Trade Openness

1. Introduction

Globalization has profoundly transformed economic activity over the last few decades, fostering heightened international interdependence in trade, finance, and labor, largely driven by technological advances and policy liberalization. These changes have led to intricate global supply chains, greater competition, evolving employment patterns, and growing disparities across sectors. Trade liberalization and Foreign Direct Investment (FDI) have emerged as crucial

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catalysts for growth in developing economies, enabling expanded market access, enhanced competition, and inflows of capital, technology and expertise. By reducing barriers, trade liberalization promotes cross-border integration, while tariff reforms directly influence the strategic choices of multinational corporations by altering production costs and shaping market accessibility. Collectively, these forces affect whether a country attracts efficiency-driven, export-oriented investment or market-seeking, tariff-jumping investment [1]. While trade liberalization opens domestic economies to the global market, FDI brings in valuable resources, generates employment, and supports both technological and human capital development. A wide body of global research confirms a robust positive association between trade openness and rising FDI inflows. Studies have consistently shown that increased trade liberalization attracts higher levels of FDI by expanding market size, reducing business barriers, and deepening economic integration. Skandalis and other researchers note the persistence of this relationship across regions [2]. Other studies conducted to understand the scenario in Arab and Asian economies, including work by Aziz, Mishra, and Dongui, further establish significant positive links between trade openness and FDI inflows [3].

India's experience since 1991 vividly illustrates how sweeping policy reforms can stimulate trade and FDI. Faced with a Balance of Payment crisis, India undertook pivotal reforms centered on Liberalization, Privatization, and Globalization, moving away from the License-Permit-Quota system to encourage competition and improve efficiency. These steps made the Indian economy more globally integrated and welcoming to foreign investment, mainly through tariff reductions, streamlined FDI approval processes, and deregulation in strategic sectors. The next few years witnessed rapid growth in both FDI inflows and trade volumes [4]. India's momentum accelerated further in the late 1990s and early 2010s, aided by Free Trade Agreements (FTAs) with countries such as Japan, Korea, and Singapore, facilitating additional tariff cuts and increased market openness [5]. This evolution is well depicted by the figures on FDI inflows. India received USD 81.04 billion in FDI in FY 2024-25, marking a 14% increase from USD 71.28 billion in the preceding year. This increase is highly significant compared to the USD 36.05 billion attained in FY 2013-14, representing the continuous effort to position India as a leading global investment hub. Quarterly net flows climbed from just USD 7 million in June 1991 to USD 27.1 billion in September 2020, tracing the lasting impact of economic reforms[6]. The service sector continues to hold the largest share, accounting for 19% of total FDI in FY 2024-25, while manufacturing FDI rose by 18% to USD 19.04 billion. Key destinations include Maharashtra, Karnataka, and Delhi, with Singapore, Mauritius, and the United States as prominent source countries [7].

Trade openness and lower tariffs have simplified the movement of goods and contributed to the dynamism of both India's export and import sectors. As trade barriers diminished, foreign

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investors found it easier to enter new markets with reduced transaction costs. However, higher tariffs have sometimes prompted companies to undertake local production to bypass duties. This phenomenon is often termed as tariff jumping. Broader tariff cuts tend to promote higher-quality and efficiency-driven investments. Recent hikes in U.S. tariff on Indian exports reached 50%, impacting around 55% of exports, yet ongoing negotiations could see these rates fall back to 15%-16% [8]. At present, India's average applied tariff stands at 17%, among the highest in major global economies, underlining the critical need for ongoing reforms [9]. The upward trajectories in FDI inflows and trade volumes point to the positive effects of market-opening and barrier-lowering reforms on economic growth, job creation, and investor confidence. Sustained monitoring and a balanced approach to openness and economic safeguards remain essential for ensuring India's attractiveness to foreign investors and securing sustainable long-term growth.

The relationship between trade openness, tariffs, and FDI is very important to be investigated to understand how these variables interact as India pursues deeper global integration. This study builds upon this context and attempts to examine the impact of trade openness and tariffs on FDI inflows in India. The next section elaborates on the existing literature in this field of research.

2. Literature Review

An extensive review of existing studies has been done to understand the relationship between trade liberalization, tariff reforms, and foreign direct investment (FDI) inflows. This relationship is important because trade openness and tariff policies influence production costs, market access, and the overall investment climate, which in turn affect the volume and stability of FDI in emerging economies, including India.

Empirical evidence suggests that trade openness generally encourages FDI inflows, although the magnitude and direction of the effect vary across countries and contexts. A study has been conducted to examine six emerging economies i.e. Brazil, China, India, Mexico, Russia, and Turkey using a panel random effects model over 1996–2014. It found that trade liberalization, measured through preferential and regional trade agreements, significantly increased FDI inflows. Market size, economic development, and human capital were also positively associated with FDI, highlighting that broader economic factors alongside trade liberalization influence foreign investment [10]. Another study focused on Vietnam using quarterly data from 2005 to 2019 with a vector autoregression model and found that trade openness had a positive effect on FDI inflows, although the impact was influenced by past FDI shocks [11]. Similarly, another study examined for 12 Asian emerging economies using panel data from 1996 to 2019 and reported a statistically significant positive long-term relationship between trade openness and FDI. Granger causality tests indicated that trade openness drives FDI inflows in these economies [12].

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However, the relationship between trade liberalization and FDI is not always positive. A study which investigated Romania from 1997 to 2019 using an ARDL bounds testing approach, reported that trade openness negatively affected FDI in both the short and long run. Granger causality tests suggested a unidirectional relationship from FDI to trade openness, indicating that the effectiveness of liberalization policies in attracting investment depends on complementary factors such as institutional quality, market structure, and industrial competitiveness [13].

Tariff policies also play a significant role in shaping foreign investment. Lower tariffs reduce production costs and encourage efficiency-seeking FDI, while higher tariffs may induce tariff-jumping investment, where foreign firms establish local operations to bypass import duties. A study analyzed Indian industry-level data from 1991–1998 and found that trade liberalization, especially tariff reductions and higher export intensity, increased import intensity and facilitated vertical integration, thereby promoting productive FDI. However, horizontal intra-industry trade had a limited effect on FDI inflows, highlighting that tariff reforms and trade liberalization jointly influence investment patterns [14].

India's post-1991 liberalization experience demonstrates the combined effects of trade openness and tariff reforms on FDI. The LPG reforms dismantled restrictive licensing regimes, lowered import tariffs, and liberalized foreign investment norms, creating a more favorable investment climate. Subsequent free trade agreements with countries such as Japan, South Korea, and Singapore further enhanced market access and integrated Indian industries into regional and global production networks. Empirical evidence shows a consistent rise in FDI inflows, with deregulation, streamlined approval processes, and tax reforms contributing to growth. Sectoral analyses suggest that industries more integrated with global trade, such as IT and services, benefited more than traditional manufacturing, indicating that policy changes interact with sectoral competitiveness [15].

There are several studies that have been conducted in this field but despite that, there are certain gaps in literature. Most studies focus on either aggregate trade openness, short-term policy effects, or sectoral analyses, providing limited understanding of long-term trends in India's FDI inflows in relation to trade liberalization and tariff reforms. Moreover, the combined influence of macroeconomic factors such as GDP growth and inflation alongside trade policies has received insufficient empirical attention. These gaps highlight the need for a systematic examination of trends over multiple decades to understand how trade openness, tariffs, and macroeconomic conditions collectively shape FDI inflows.

To address these gaps, the present study empirically investigates the relationship between trade liberalization, average tariff reforms, and FDI inflows in India from 1991 to 2023. Using time-series data and regression analysis, the study focuses on identifying trends and quantifying the

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association between trade openness, tariff rates, GDP growth, inflation, and FDI inflows. This approach provides a data-driven foundation for understanding how India's policy and macroeconomic environment has shaped foreign investment over the past three decades and sets the stage for the methodology and results sections that follow.

3. Methodology

This section elaborates on the objectives of this research, data sources, variables and analytical framework of the study.

3.1 Objectives of the Study

The objectives of the study are stated as below:

1. To analyze long-term trends in key economic and policy variables in India, including FDI inflows, trade openness, average tariff rates, GDP growth, and inflation from 1991 to 2023.

2. To examine the impact of trade openness, tariff reforms, and macroeconomic indicators on FDI-inflows.

3.2 Data and Variables

The study employs annual time-series data for India for the period 1991–2023. The dependent variable is taken as FDI inflow (% of GDP), capturing the relative scale of foreign investment in India. The independent variables are taken as Trade Openness Index measured by. Ratio of total trade (exports + imports) to GDP, representing India's integration with global markets and Average Tariff Rate which is measured as Weighted average of import duties, reflecting trade liberalization policies. Control Variables are taken as GDP Growth Rate i.e. annual percentage growth of GDP, capturing the overall economic performance and Inflation Rate measured by annual percentage change in the consumer price index, representing macroeconomic stability. The data for all these variables has been taken from the World Bank's World Development Indicators [16-22].

3.3 Analytical Framework

The study firstly adopts the approach of trend analysis to observe long-term patterns in FDI inflows, trade openness, tariff rates, GDP growth, and inflation. To examine the impact of trade openness, tariff reforms, and macroeconomic factors on FDI inflows, the study employs a multiple linear regression framework. FDI inflow (% of GDP) is regressed on trade openness, average tariff rate, GDP growth, and inflation. The regression analysis is conducted using the

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ordinary least squares (OLS) method. Diagnostic checks are carried out to ensure robustness. This combined approach provides a comprehensive understanding of the evolution of India's macroeconomic and policy environment and its impact on foreign investment over the last three decades.

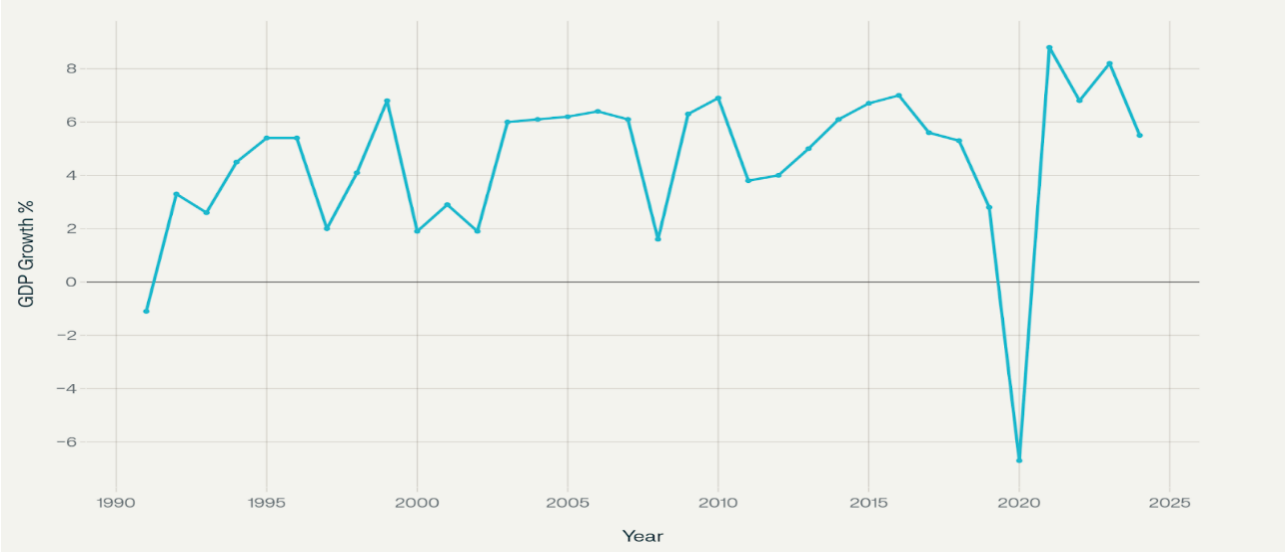
4. Results and Findings

This section presents the long-term trends in FDI inflows, trade openness, average tariff rates, GDP growth, and inflation in India from 1991 to 2023, followed by the results of the regression analysis examining the impact of these variables on FDI.

4.1 Trends in Key Macroeconomic Variables

The trends in key macroeconomic variables have been discussed along with graphs for year 1991 to 2023. Figure 1 to 5 below depicts the trends in the variables along with their interpretations.

Fig 1: GDP Growth Rate (1991-2023)



The figure above shows that India's GDP growth rate rose strongly after the 1991 reforms, averaging between 6-7% during good years. There were clear dips, such as a sharp fall to -7% in 2019-20 when COVID-19 hit, but then the economy bounced back quickly, reaching around 8% by 2021. For many years, growth stayed above 5%. These ups and downs match times of global recession, policy changes, and recovery. The biggest jumps in growth often came after the government introduced industry-friendly reforms or supported new sectors.

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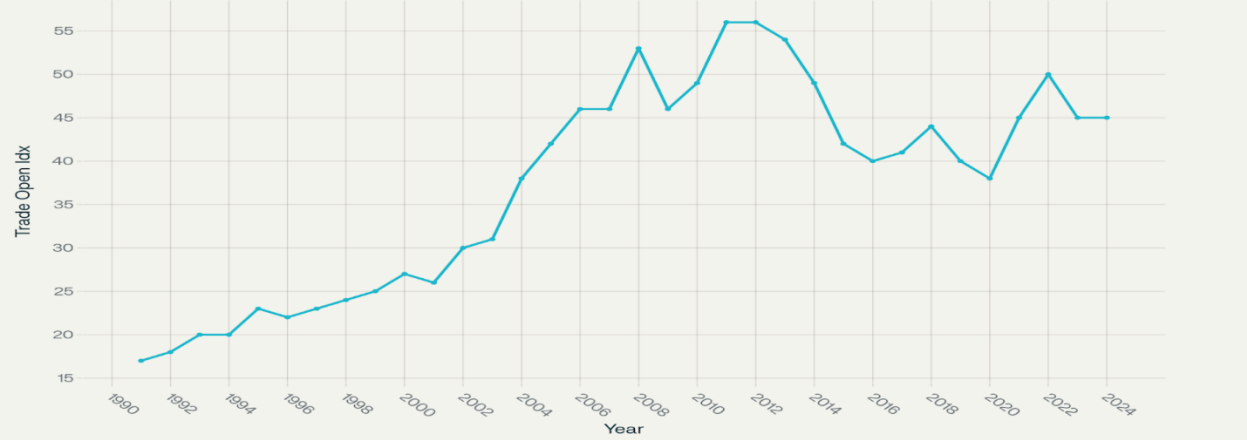
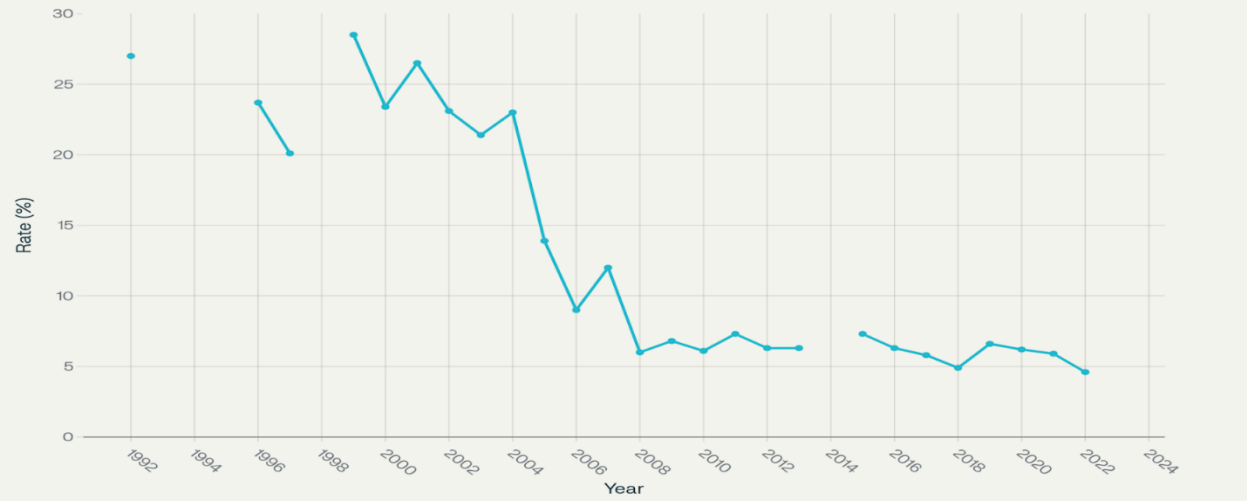
Fig 2: Trade Openness Index (1991-2023)



Trade openness increased rapidly after 1991, as India opened its economy to the world. The index moved steadily up from around 17 in 1991 to over 50 by the mid-2010s. Major dips in trade happened around 2009 and 2016, often caused by global market slowdowns or shifts in policy, but trade usually picked up again as new deals and export pushes came into effect. The steady rise in this index means India has become much more involved in international trade and relies more on global partnerships.

Fig 3: Average Tariff Rates (1991-2023)



The tariff rate dropped sharply from above 30% in the early 1990s to under 10% after 2010, as India cut taxes on imports to make trade easier. There were a few years when tariff rates stayed flat or went up a little, but the overall direction was down. By 2024, tariffs were close to 7%,

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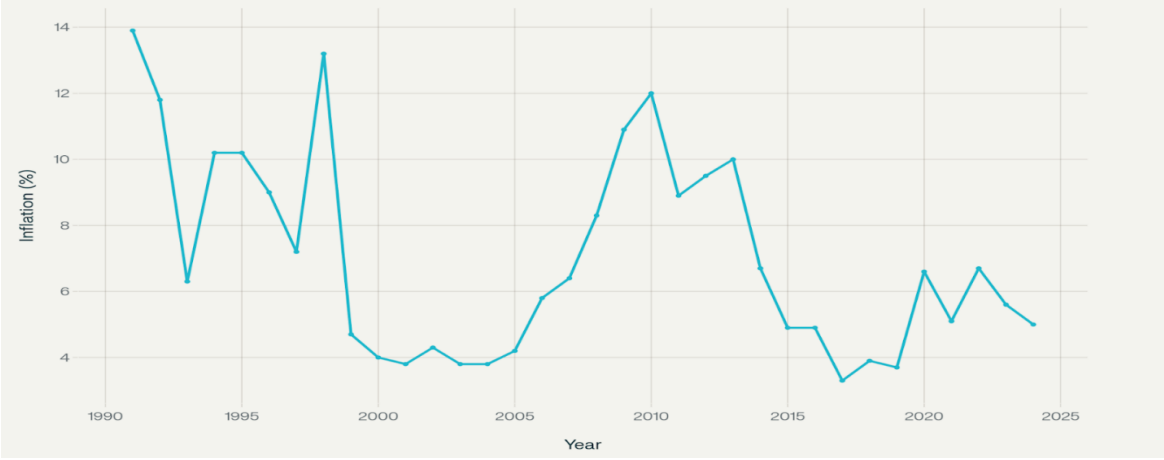
helping boost exports and lower prices for many goods. This long-term decline matches the government's focus on open markets and greater competition.

Fig 4: FDI Inflow in India (1991-2023)

FDI inflow climbed steadily with liberalization, going from just $97 million in 1991 to $81 billion by 2024. The graph shows FDI spiked in the mid-2000s when India started attracting more global capital and welcoming foreign businesses. Lower points on the graph fit with times of global financial trouble or uncertainty in domestic policy, but FDI still increased overall, showing India's enduring appeal for investors. In recent years, FDI growth has supported jobs, technology, and new industries across the country.

Fig 5: Inflation Rate (1991-2023)



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India's inflation was extremely high in the early 1990s, crossing 14% during years of financial trouble and unstable currency. When the government improved money management and reduced subsidies, inflation fell to as low as 4% between 1999 and 2004. Prices went up again during global oil shocks, moving above 10% a few times, especially in the mid-2000s. More recently, inflation has stayed mostly between 4-7%, only jumping during sudden supply problems or market changes. The last decade's figures show improved control thanks to stronger policy.

4.2 Regression analysis

The regression analysis has been conducted to identify the key macroeconomic determinants of Foreign Direct Investment (FDI) inflows as a percentage of GDP in India during the period 1992–2022. The explanatory variables included the Trade Openness Index, Average Tariff Rate, GDP Growth Rate, and Inflation Rate. The model yielded an R-squared value of 0.63 indicates that approximately 63% of the variation in FDI inflows is explained by the independent variables included in the analysis.

The overall F-statistic (8.93, $p < 0.01$) confirms that the regression model is statistically significant, implying that the variables collectively have explanatory power in determining FDI inflows. The regression equation is stated below.

$$FDI\_inflow = \beta_0 + \beta_1(Trade\_Openness\_Index) + \beta_2(Average\_Tariff\_Rate) + \beta_3(GDP\_Growth\_Rate) + \beta_4(Inflation\_Rate) + \varepsilon$$

Table 1: Regression Results for impact of trade liberalization on FDI inflows in India

Variable	Coefficient	Std. Error	t-Statistic	p-Value
Trade Openness Index	0.0214	0.0189	1.14	0.269
Average Tariff Rate	-0.0454	0.0236	-1.92	0.068
GDP Growth Rate	-0.0780	0.0355	-1.99	0.059
Inflation Rate	-0.0024	0.0387	-0.05	0.958
Constant	1.5569	0.9926	1.57	0.132

R-squared: 0.6298; F-statistic: 8.93 ($p < 0.01$); N: 26

The coefficient of the Trade Openness Index is positive (0.0214), implying that a more open economy is associated with higher FDI inflows. However, the coefficient is statistically insignificant ($p = 0.269$), suggesting that while openness facilitates cross-border investments by reducing trade restrictions and enhancing accessibility, other factors such as infrastructure

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quality, institutional efficiency, and policy consistency may have stronger influences on FDI inflows. The Average Tariff Rate shows a negative coefficient (–0.0454) that aligns with theoretical expectations, indicating that higher import tariffs deter foreign investors by raising trade costs and limiting market accessibility. Although the relationship is marginally insignificant ($p = 0.068$), the negative association supports the hypothesis that trade liberalization and tariff reduction have encouraged foreign investment inflows into India since the 1990s.

Interestingly, the coefficient for GDP Growth Rate (–0.0780) is negative and marginally insignificant ($p = 0.059$), which contrasts with conventional expectations. This may suggest that during periods of high domestic growth, FDI inflows could slow due to increased reliance on domestic capital formation or changing sectoral investment patterns. The Inflation Rate (–0.0024) also shows a negative but statistically insignificant relationship ($p = 0.958$), indicating that moderate inflation has not posed a significant deterrent to foreign investors. This reflects the relative resilience of FDI inflows to short-term macroeconomic fluctuations and the growing stability of India's monetary framework in recent decades.

Overall, the findings reveal that trade liberalization and tariff reduction have played a significant role in facilitating FDI inflows, even though individual coefficients lack strong statistical significance. The positive sign on trade openness and the negative sign on tariff rates align with theoretical predictions, underscoring the importance of open and predictable trade policy in attracting foreign investors. However, the results also highlight that macroeconomic indicators alone cannot fully explain the dynamics of FDI inflows. Institutional quality, policy stability, and the overall investment climate exert a stronger influence on investment decisions. Thus, while India's openness and reform-oriented policies have created favorable conditions for foreign investors, sustained growth in FDI will depend on continued improvements in governance, infrastructure, and ease of doing business.

5. Discussion

The results collectively indicate that trade liberalization and tariff reduction policies have played a crucial role in shaping FDI inflows into India, even though the coefficients are not statistically significant at conventional levels. The positive association between trade openness and FDI aligns with the findings of a study conducted by Albahouth and Muhammad Tahir [23]. It underscores the importance of outward-oriented economic policies. The negative relationship between tariffs and FDI reinforces the view that protectionist policies can discourage foreign investment as showed by the Lee Kuan Yew School of Public Policy, National University of Singapore [24].

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The unexpected negative sign of GDP growth contrasts with the findings of a few studies such as one published in the Asian Journal of Economics that found that there is a positive linkage between domestic economic growth and FDI inflows [25]. This may signal that investors respond not only to macroeconomic performance but also to policy predictability, institutional stability, and long-term profitability prospects. Inflation, as a measure of macroeconomic stability, appears to have limited influence on FDI decisions in India, indicating that investors may be more sensitive to structural rather than cyclical factors.

Overall, the regression analysis highlights that while macroeconomic openness and liberalization are necessary conditions for attracting FDI, they are not sufficient by themselves. The statistical insignificance of individual variables suggests that non-economic determinants including governance quality, political stability, and infrastructure likely play a stronger role in shaping investment outcomes. Future research could extend this analysis by incorporating institutional and financial development variables to better capture the multifaceted drivers of FDI inflows in the Indian context.

6. Conclusion

This study examined the trends and determinants of foreign direct investment (FDI) inflows in India from 1991 to 2023, with a focus on trade openness, average tariff rates, GDP growth, and inflation. The analysis reveals that FDI inflows have generally increased over the period, reflecting the effects of rising trade openness and declining tariffs, while GDP growth and inflation exhibited fluctuations influenced by both domestic and global economic conditions. These trends highlight the significant role of trade liberalization and tariff reduction in creating an environment conducive to foreign investment. The findings underscore that maintaining transparent, predictable, and liberal trade and tariff policies is critical for attracting and sustaining FDI. Policymakers can use these insights to continue designing macroeconomic and trade strategies that support foreign investment, while monitoring broader economic conditions that may influence investor confidence. By fostering an open and stable economic environment, India can strengthen its position as an attractive destination for foreign capital. This study focused only on the aggregate macroeconomic indicators, without considering non-economic determinants such as sector-specific characteristics, institutional quality, regulatory frameworks, or the composition and quality of FDI. Future research could incorporate these factors, along with comparative studies across emerging economies, to provide a more nuanced and comprehensive understanding of the determinants of FDI inflows in India.

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