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Trade Liberalization and Economic Growth in India: An Evaluation of Previous Research Studies

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Abstract

Trade liberalization has been widely promoted as a strategy to stimulate economic growth, yet its actual impact remains contested, particularly in developing economies like India. Classical and neoclassical economic theories emphasize the benefits of trade openness in enhancing productivity, fostering foreign direct investment and facilitating knowledge diffusion. However, empirical findings suggest that the outcomes of trade liberalization vary significantly across countries and sectors. Theoretically, trade liberalization enhances economic efficiency by promoting competition, allowing resource allocation based on comparative advantage, and facilitating technology transfer. In the Indian context, trade liberalization gained prominence with the economic reforms of 1991, which marked a shift from a protectionist, inward-looking economy to a more market-driven, globally integrated economy. In the light of the above, the paper is an attempt to analyze the earlier research studies on trade liberalization and economic growth as well as on specific sectors of the Indian economy covering pre and post economic reforms.

Keywords: *Liberalization, Economic growth, GDP, Literature Review, Sectoral Growth.*

1. Introduction

Since the early 1980s, a significant number of developing countries were both voluntarily and involuntarily, adopting policies of trade liberalization irrespective of their level of growth and development. Encouraged by the success of the export-oriented Asian economies, the main objective behind the trade liberalization policies was to increase both production and exports (Cihan & Dutta, 2005). Trade liberalization is known to be a driving force in countries' growth. Many countries around the world have started opening their borders to trade in the hope of promoting growth in their economies (Aga & Hussien, 2023). Trade liberalization, broadly defined as the removal or reduction of trade barriers such as tariffs, quotas, and import restrictions, has been a cornerstone of economic policy reform in many developing economies, including India. Theoretically, trade liberalization enhances economic efficiency by promoting competition, allowing resource allocation based on comparative advantage, and facilitating technology transfer (Krugman, 1980; Sachs & Warner, 1997). In the Indian context, trade liberalization gained prominence with the economic reforms of 1991, which marked a shift from a protectionist, inward-looking economy to a more market-driven, globally integrated economy (Bhagwati & Srinivasan, 1993). Prior to 1991, India followed a "license raj" system, characterized by high tariffs, import restrictions, and excessive state intervention in trade and industry. This led to low productivity, sluggish GDP growth, and limited foreign direct investment (FDI) (Ahluwalia, 2002). By the late 1980s, India faced a severe macroeconomic crisis, with rapid increase in fiscal deficits, declining foreign exchange reserves, and a balance of payments shortfall that brought the country to the brink of default. In response to this crisis, the Indian government launched a comprehensive programme of economic reforms in 1991, with trade liberalization forming a central component. The reforms dismantled the License Raj, reduced tariffs, removed import restrictions, and opened the economy to foreign direct investment (FDI) and global competition (Panagariya, 2004). In the decades following liberalization, India experienced accelerated economic growth, increased trade volumes, and a significant rise in foreign investment. The country transitioned from a protectionist

regime to a more globally integrated economy, with the services sector—particularly information technology—emerging as a key growth driver (Rodrik & Subramanian, 2005). However, the post-liberalization period also witnessed new challenges, including rising income inequality and uneven regional development (Dev & Ravi, 2007).

This proposed study hence seeks to examine the earlier research studies on trade liberalization and economic growth as well as on specific sectors of the Indian economy covering pre and post economic reforms. Thus, the study will contribute to the existing studies by addressing the literature gaps thereby enabling government and policy makers in formulating effective economic decisions and policies in the country.

2. Problem Identification:

Trade liberalization has played a pivotal role in reshaping India's economic landscape since the 1991 economic reforms. By reducing tariffs, easy foreign investment restrictions, and promoting export-led growth, India has integrated more deeply into the global economy. This shift has led to significant increases in GDP growth, foreign direct investment (FDI) inflows, and trade volumes, making India one of the fastest-growing economies in the world (Wikipedia, n.d.). Trade liberalization has been widely promoted as a strategy to stimulate economic growth, yet its actual impact remains contested, particularly in developing economies like India (Rasoanomenjanahary et al., 2022). Classical and neoclassical economic theories emphasize the benefits of trade openness in enhancing productivity, fostering foreign direct investment (FDI), and facilitating knowledge diffusion. However, empirical findings suggest that the outcomes of trade liberalization vary significantly across countries and sectors (Kumar & Dhar,2020). Most of the conclusive studies on trade liberalization and economic growth have been conducted in developed economies, while research on India remains limited. Furthermore, existing studies on India's trade liberalization experience have primarily relied on historical and cross-sectional data, which may not adequately capture the evolving economic landscape. Given these gaps, there is a pressing need for a

comprehensive investigation into the relationship between trade liberalization and economic growth in India.

3. Objective of the study

To explore previous theoretical and empirical research on trade liberalization and economic growth along with the sectoral performance in Indian context.

4. Methodology Adopted

Keeping in view the objective of the paper, researchers employed qualitative approach to review of earlier research relating the policy framework and institutional changes associated with trade liberalization; trade agreements such as General Agreement on Tariffs and Trade (GATT), World Trade Organisation (WTO) Agreements, Regional Trade Agreements (RTAs) etc; Foreign Direct Investment (FDI) liberalization, Tariff and Trade policy Reforms etc. The data required for the study have been collected from various government reports, policy papers, and scholarly articles on trade reforms such as- RBI, Ministry of Commerce & Industry, WTO reports, Economic Survey of India etc.

5. Review of Research and Discussions:

Trade liberalization, which refers to the removal or reduction of trade barriers such as tariffs, quotas, and subsidies, has been a key economic policy for many countries aiming to enhance economic growth. This literature review synthesises existing studies thematically, focusing on the theoretical aspects and empirical evidence.

5.1. Theoretical Review

The theoretical foundation of trade liberalization is rooted in classical economic thought. Adam Smith (1776) introduced the concept of absolute advantage, arguing that countries benefit from specialising in goods they can produce more efficiently. In essence, a country has an absolute advantage over another in the production of a good if it can produce more of it with the same quantity of resources or if it can produce the same amount with fewer resources. This theory suggests that trade liberalization enhances productivity and economic growth by allowing

countries to focus on their strengths. The theory assumes that all countries have an absolute advantage, which is not always the case, particularly for resource-poor nations (Krugman & Obstfeld, 2003). Moreover, it ignores the role of economies of scale and technological progress in shaping trade patterns (Grossman & Helpman, 1991). Building upon this, David Ricardo (1817) extended Smith's ideas by developing the theory of comparative advantage, which argues that even if a country lacks an absolute advantage, it should still specialise in the production of goods where it has the least opportunity cost, or in other words, the goods that cost them the least to make. In essence, a country should focus on producing the goods it can make most efficiently (with the least cost) compared to other countries, even if it is not the best at making everything. This theory provides a fundamental justification for trade liberalization, predicting that free trade leads to mutual benefits and overall economic growth. The theory assumes labour and capital immobility between countries, which is unrealistic in today's global economy (Krugman, 1991). The assumption of full employment is often invalid, especially in developing countries with high unemployment (Rodrik, 2018). In the 20th century, neoclassical economists incorporated trade into growth models. Heckscher-Ohlin extended trade theory by explaining how factor endowments determine trade patterns. The Heckscher-Ohlin (H-O) model (Heckscher, 1919; Ohlin, 1933) argues that countries should export goods that use their abundant factors of production intensively and import goods that use their scarce factors. This model predicts that trade liberalization leads to greater efficiency and economic growth. The model assumes identical technology across countries, which contradicts real-world differences in technological capabilities (Leontief, 1953). Moreover, it cannot explain intra-industry trade, which is significant among developed economies (Helpman& Krugman, 1985). Neoclassical growth models, particularly the Solow-Swan growth model (Solow, 1956; Swan, 1956) argues that economic growth is driven by capital accumulation, labour force expansion, and technological progress. Trade liberalization fosters growth by allowing capital inflows, enhancing investment, and promoting knowledge diffusion. The model assumes diminishing returns to capital and predicts that growth will eventually slow down unless technological progress occurs. However, it does not explain how

trade liberalization directly influences technological progress (Barro & Sala-i-Martin, 2004). It treats technological progress as an exogenous factor, ignoring how policies like trade liberalization may shape innovation and R&D activities within an economy (Romer, 1990). Harrison (1994) argues that trade openness facilitates the inflow of capital goods and technology, which enhances industrial activity and promotes economic growth.

Modern trade theories have emerged, addressing the complexities of trade by incorporating a broader range of factors. These models focus on endogenous growth, proposing that developing countries can achieve long-term economic growth through factors that are inherently determined rather than externally. The Endogenous growth theories developed by Romer (1990) and Lucas (1988) emphasize the role of human capital, innovation, and knowledge spillovers in economic growth. Romer (1990) argues that knowledge and R&D investment drive long-term economic growth. Trade liberalization facilitates access to advanced technology, global expertise, and larger markets, promoting innovation. Lucas (1988) argues that human capital accumulation plays a crucial role in economic growth. Trade liberalization enhances skills and knowledge diffusion, enabling developing countries to benefit from global expertise. Grossman and Helpman (1990) expand on endogenous growth theory by linking trade openness and foreign direct investment (FDI) inflows to economic growth, noting that technology diffusion drives technological advancement and stimulates growth. The endogenous growth framework suggests that open economies experience higher productivity growth because they have access to global knowledge networks and are exposed to competitive pressures that drive innovation. Moreover, multinational corporations play a key role in transferring technology and managerial expertise to developing countries, reinforcing the benefits of trade openness (Barro & Sala-i-Martin, 2004). However, some scholars challenge these optimistic views, arguing that trade liberalization may not automatically lead to technological advancement in all contexts. For example, countries with weak absorptive capacity- due to low levels of human capital or inadequate institutions- may struggle to reap the benefits of trade-induced technological spillovers (Rodrik, 2007).

5.2. Empirical Review

5.2.1. Trade Liberalization and Economic Growth

Trade liberalization has a vital role in promoting economic growth, as observed by many studies investigating the effects of trade liberalization on economic growth (Shakeeb Mohsen & Chua, 2020). Most researchers argue that a country which is highly liberalized in respect of trade can benefit from industrialized economies' technological prowess, and so enhance their own productive capacity so as to grow faster than countries with lower levels of trade liberalization (Alnour et al., 2021).

Mano-Bakalinov (2016) conducted an analysis of the effects of trade liberalization on economic growth in Macedonia, utilizing an Autoregressive Distributed Lag (ARDL) model applied to annual data from 1993 to 2014. The study revealed that increased trade openness and population growth have significant positive effects on Macedonia's GDP. The study suggests that market liberalization and international trade play a crucial role in Macedonia's economic development, both in the short and long run. Moreover, Khobai and Chitauro (2018) examined the relationship between trade liberalization and economic growth in Switzerland using annual data from 1990 to 2014, incorporating foreign direct investment (FDI) and employment rate (EMP) as additional variables in a multivariate framework to assess the long run and short run dynamics. The study revealed that trade openness and FDI have a positive and significant effect on economic growth in both the short and long run, while employment contributes positively only in the long run. In addition, Mbingui and Etoka-Beka (2021) conducted an analysis of the impact of trade openness on economic growth in the Republic of Congo, using Vector Error Correction Model (VECM) estimation method for the period 1986 to 2016. The study revealed that trade openness had a negative effect on economic growth in Congo, both in the short and long run. Therefore, it appears that Congo does not benefit from the trade openness policy.

Hye and Lau (2014) also examined the relationship between trade openness and economic growth in India from 1971 to 2009. The study revealed that trade openness has a positive effect on

economic growth in the short run, however, it has a negative effect in the long run. Likewise,

Wani (2022) investigated the relationship between trade openness, capital formation, and economic growth in India from 1992 to 2019 using Autoregressive Distributed Lag (ARDL) bounds testing approach. The study revealed that the short run impact of trade openness is statistically significant, but the long run effect is marginally negative, indicating that India has not fully reaped the benefits of trade liberalization. Furthermore, Adeel-Farooq et al. (2017) investigated the effects of trade openness and financial liberalization on economic growth in Pakistan and India from 1985 to 2014 using Autoregressive Distributed Lag (ARDL) model. The study revealed that trade openness positively affects economic growth in Pakistan, both in the short and long run, while financial liberalization has a positive impact only in the long run. However, in India, both trade openness and financial liberalization significantly boost economic growth in both the short and long run. Therefore, it appears that India benefits more from liberalization policies compared to Pakistan. Likewise, Murthy et al. (2014) investigated the interrelationship between trade openness, financial development and economic growth in India from 1971 to 2012. The study revealed that although trade liberalization is beneficial but it does not have an independent effect on economic growth unless supported by financial sector improvements. Similarly, Marelli and Signorelli (2011) analysed the economic growth trajectories of China and India with a focus on trade openness, foreign direct investment (FDI) and economic integration. The study revealed that trade openness and FDI have a positive and statistically significant impact on economic growth in both China and India.

Another empirical study into the issues was that of Khobai et al. (2018), which investigated the relationship between trade openness and economic growth in Ghana and Nigeria from 1980 to 2016. The study revealed that while trade openness had a positive and significant impact on economic growth in Ghana at the 1% level of significance, in Nigeria, it had a negative effect, but the impact was not statistically significant. Meanwhile, employing the Autoregressive Distributed Lag Bounds technique for co integration using data from 1981 to 2018, Duru et al.

(2020) investigated the association between trade liberalization and economic growth in Nigeria. Their findings showed that trade liberalization did not promote Nigerian economic growth. Likewise, Ali and Abdullah (2015) investigated the relationship between trade liberalization and economic growth in Pakistan from 1980 to 2010. Their findings indicated a positive relationship between trade liberalization and GDP growth in the short run, while in the long run, there was a negative impact of trade liberalization on economic growth in Pakistan. In addition, Gries and Redlin (2012) analyses the relationship between trade openness and economic growth in 158 countries between 1970 and 2009. Their study revealed a long-term association between trade openness and economic growth.

5.2.2. Trade Liberalization and Sectoral Growth

5.2.2.1. Impact on the Industrial sector

Several studies show that trade liberalization positively influenced industrial growth by increasing competition, efficiency, and foreign investment**. Goldar and Kumari (2003)** found that post-1991 reforms led to a significant reduction in tariffs and improved productivity in manufacturing industries. Similarly, **Topalova (2010)** demonstrated that tariff reductions enhanced firm-level productivity, especially in industries that relied on imported inputs. However, **Rodrik (2005)** pointed out that while liberalization increased efficiency, it also led to job losses in less competitive industries. **Kakarla Pudi (2010)** analysed the impact of trade liberalization on employment in India's manufacturing sector and found that while there was an increase in employment growth post-liberalization, the export growth rate reduced, and import growth increased during the same period. Hasan et al. (2007) examined trade reforms, labour regulations, and labour-demand elasticities in India, finding that trade liberalization led to increased demand elasticities, suggesting that firms adjusted their labour more flexibly in response to trade policy changes. **Chaudhuri and Ravallion (2006)** investigated the impact of trade reforms on poverty in India, concluding that while trade openness contributed to economic growth, the benefits were unevenly distributed, with rural areas experiencing less poverty reduction compared to urban areas**. Pandey (2004)** analysed the impact of

trade liberalization on India's manufacturing sector during the 1980s and 1990s, finding that industries experienced significant productivity gains due to increased competition and access to better technologies.

5.2.2.2. Impact on the Agricultural sector

Chand (1998) examined the impact of trade liberalization on India's agricultural sector, focusing on institutional and structural aspects, finding that the 1991 economic reforms led to significant policy shifts, including the removal of trade restrictions, reduction in tariffs, and increased export opportunities. These changes resulted in a substantial rise in agricultural exports, particularly in high-value crops like fruits, floriculture, basmati rice, and cotton. Padhi and Dey (2017) also examined the impact of trade liberalization on India's agricultural sector by comparing pre-reform (1980-1990) and post-reform (1991-2014) periods and found that trade liberalization led to an increase in agricultural exports and a higher share of agricultural trade in national trade. Ramesha (2019) investigated the impact of liberalization, privatization, and globalization (LPG) on India's agricultural sector and found that while globalization provided new market opportunities and improved access to modern agricultural technologies, it also led to significant challenges. The agricultural growth rate declined post-reform, with increasing input costs, reduced subsidies, and market volatility negatively impacting farmers. Kumar (2020) studied the impact of liberalization on Indian agriculture, focusing on trade policies and market dynamics post-1991 reforms and found that liberalization facilitated agricultural trade growth, with increased exports and reduced import dependence. Garhwal and Sharma (2017) studied the impact of trade liberalization on the Indian agriculture sector, focusing on terms of trade before and after economic reforms and found that liberalization led to increased global integration, reduced trade restrictions, and higher agricultural exports. However, Bhalla and Singh (2009) have examined the impact of economic reforms on agricultural output and found that the agricultural sector in India neither experienced any significant growth subsequent to the initiation of economic reforms in 1991 nor did it derive the expected benefits from trade liberalization. Similarly, Storm (2003) analysed the transition problems in India's agricultural trade liberalization

using a dynamic general equilibrium model. The study found that while liberalization could improve efficiency and agricultural productivity, it also led to significant distributional concerns, particularly for small farmers and rural labourers.

5.2.2.3. Impact on the Services sector

Mehta and Hassan (2011) studied the effects of trade and services liberalization on wage inequality in India and found that labour reallocations and wage shifts due to liberalization accounted for about 29% of the rise in inequality between 1993 and 2004, with the impact of services reforms being significantly larger than that of trade liberalization. Their study concluded that while liberalization contributed to inequality, much of its impact was absorbed by broader economic adjustments. Also, Gordon et al. (2003) studied the factors behind the rapid growth of India's services sector, particularly its acceleration in the 1990s and found that economic reforms play a crucial role through technological advances in boosting services growth. Mitra (2009) studied the impact of trade liberalization on employment in India's services sector and found that trade liberalization alone was insufficient to generate large-scale employment in the services sector, highlighting the need for complementary policies to boost job creation. **Ahmed et al. (2024)** developed a general equilibrium framework to investigate the impact of trade liberalization on wage rates in India. Their empirical validation indicated that tariff reduction in capital-intensive importing sectors raised wages for both skilled and unskilled workers, influencing the services sector's wage dynamics. **Mukherjee (2013)** studied the impact of trade liberalization on India's banking sector, finding that increased competition led to improved efficiency and customer services, contributing to the overall growth of the services sector.

6. Research Breach:

Despite extensive research on the relationship between trade liberalization and economic growth, there remains no clear consensus on its effectiveness, particularly in the context of developing economies. While classical and neoclassical economic theories emphasize the benefits of trade openness, empirical findings indicate that the impact varies significantly across countries. Many studies suggest that trade liberalization fosters

economic growth through capital inflows, knowledge diffusion, and innovation, but others highlight potential drawbacks such as trade deficits, economic volatility, and structural imbalances. Many conclusive studies on trade liberalization and economic growth were carried out in developed countries, however, very few studies have been conducted in India. Moreover, the previous studies carried out in Indian context over-relied on historical and cross-sectional data, which may not address the country's specific issues.

7. Direction for Upcoming Research

Review of studies relating to the policy framework and analysing the impact of trade openness on economic growth and sectoral performance, this study will offer evidence-based insights that can inform policy decisions aimed at enhancing India's trade and investment environment. For policymakers, the study will help in designing trade policies that maximize economic benefits while mitigating potential risks such as trade deficits and industrial imbalances. For businesses and investors, understanding sectoral performance in response to trade liberalization will assist in making informed investment decisions. Additionally, this research will contribute to the academic discourse by addressing methodological limitations in previous studies and offering new perspectives on how trade liberalization influences economic growth in India.

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