

ISAS Working Paper

No. 211 – 21 September 2015

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Institutional Changes Favours FDI Inflows to India: Gradual Transformation Since 1969¹

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Abstract

How did India respond to globalization in the realm of inward foreign direct investment (FDI)? This paper presents the economic institutional change favouring FDI inflows at the union level of India by tracing political and economic history from the Indira Gandhi government in the late-1960s to the current Narendra Modi government. From a historical institutionalist perspective, it highlights the significant correlation of institutional evolution with socio-political factors such as ideas of key policy makers and various interests in society. The paper argues that the institutional changes favouring FDI inflows to India can be defined as 'gradual transformation'. This argument is based on the ideational tipping point model that underlines the role of endogenously-driven

¹ The earlier draft of this paper was presented at the 56th Annual Meeting of the International Studies Association (ISA) at New Orleans on 18 February 2015.

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ideas that favoured foreign capital and finally won over various interest groups that were opposed to FDI inflows. It stresses that the dynamics of ideas and interests contributed to an incremental institutional change over a period of time. By demarcating three different periods based on the policy regime change toward foreign capital and foreign investments—anti-FDI (1969-1975), selective FDI (1975-1991), and pro-FDI (after 1991), the paper presents empirical evidence which backs the gradual transformation mode of institutional change, discussed in scholarly literature on historical institutionalism.

Introduction

How do socio-political factors explain the economic institutional change of foreign direct investment (FDI) inflows to India? Given that the concept of institutions includes rules, norms, and beliefs having a role of facilitating individuals to choose behaviour (Greif and Laitin, 2004: 635), an economic institutional change means the change of such rules, norms, and beliefs in the economic sphere.³ For example, an institutional change in the realm of FDI inflows would deal with the change of rules and beliefs toward foreign investments. Therefore, this paper is concerned with the change of ideas that key policymakers in India have toward foreign capital and foreign investments over time. In fact, this idea-oriented approach has been used to look at economic institutional changes in India. Some students of India's political economy have argued that the economic orientation of key policymakers has a decisive role for producing institutional changes (see Frankel, 2005; Kothari, 2009).

However, the idea-oriented approach overlooks the impact of interests on the changes. Those who advocate it have stressed the pluralist structure of Indian society and various interest groups as the source of such changes (see Nayar, 1971; Bardhan, 1984). Despite the significance of both approaches, research on the correlation between the two strong socio-political factors—idea and

³ Greif and Laitin (2004) plainly summarized two differing approaches—game theory and historical institutionalism—in dealing with the rules, norms, and beliefs in the context of institutional changes. In game theory, these notions are understood as motivation for individuals' behaviour and as a set of probability distributions which may not be necessarily self-enforcing over an equilibrium strategy combination. On the contrary, historical institutionalism takes the notions of rules, norms, and beliefs to understand institutional stability. Historical institutionalists believe that 'only shared beliefs corresponding to self-enforcing behaviour can rationally prevail' (Greif and Laitin, 2004: 634). For historical institutionalist perspective, see also Pierson (2000; 2004) and Thelen (1999).

interest—and India’s economic institutional change remains unexplored due to the lack of attention. In addition, many of the studies dealing with the India’s economic institutional change have focused on the economic factors as the source of change. This paper is an attempt to fill some of the gaps in the challenging area, taking both idea and interest as strong factors that would bring institutional changes. For this paper, an intensive fieldwork was conducted from December 2011 to March 2012. I interviewed several key political leaders, bureaucrats, and industrialists in India during this period.

Following a historical institutionalist perspective that emphasizes the political context in institutional changes, this paper explains an economic institutional change favouring FDI inflows at the union level in India by supporting a ‘tipping point’ model of India’s economic reforms. With a historical institutionalist perspective, Mukherji (2013) suggested the tipping point model to explain India’s gradual movement toward globalization. In the model, Mukherji highlighted the ideas of key policymakers and domestic politics as the critical source of the change. By comparing the balance of payments (BOP) crises in 1966 and 1991, Mukherji argued that the ideas of key policymakers favouring liberalization pushed deregulation in 1991 under the necessity of IMF conditions while the ideas of technocrats favouring state-led import substitution did not respond to globalization in 1966. Mukherji stressed that India’s economic reform in 1991 was gradually driven by ideas and domestic politics, even though there was some influence from exogenous shocks like the BOP crisis. Mukherji’s argument pointed that the dynamic of Indian state’s autonomy enabled more state-led development interventions rather than the coercive apparatus of the international financial institutions with the Washington Consensus (Ban and Blyth, 2013).

Likewise, an argument in this paper points that economic institutions in the realm of FDI inflows have also changed incrementally with endogenously driven ideas favouring foreign investments at the union level in India rather than with external shocks. In other words, the primary aim of this paper is to specify the gradual process of deregulation in foreign investments in the Indian market within the larger picture of globalization process that Mukherji explained. Furthermore, the paper aims to define the nature of institutional change in the area of FDI inflows in India as ‘gradual transformation’ that several leading comparative historical institutionalists explained (see Streeck and Thelen, 2005: 9). In fact, the tipping point model and the gradual transformation mode of

institutional change address the same ‘time span’ issue—both deal with institutional changes that occur over a long period of time—and the ‘institutional stability’ issue—both see institutions as more likely to remain stable unless a shock which would result from accumulative negative feedback that cannot sustain institutions creates a change of institutional evolution (see Mukherji, 2013; Pierson, 2000; Streeck and Thelen, 2005). This theoretical framework will be discussed in detail in the next part of the paper.

As the historical institutionalists have highlighted, this paper will address the significance of endogenous socio-political factors for the institutional change. The factors are (1) competing ideas between foreign capital supporters and their opponents; and (2) conflicting interests of different individuals or groups. Taken together, the paper will examine the institutional change favouring FDI inflows in India that has gradually evolved from the period of anti-FDI inflows (1969-1975) to selective FDI inflows (1975-1991) and finally to pro-FDI inflows (after 1991).⁴

The subsequent part of this paper will clarify the concept of gradual transformation which the institutional change favouring FDI inflows in India could be categorized. Discussions in the next parts will present three different phases of FDI inflows in India according to the changes of policy regime toward foreign investments. In conclusion, suggestions will be provided for further study.

‘Gradual Transformation’ and ‘Tipping Point’ in Historical Institutionalism

Several historical institutionalists have categorized four differing types of institutional change—(1) Reproduction by adaptation; (2) Gradual transformation; (3) Survival and return; and (4) Breakdown and replacement (Streeck and Thelen, 2005). In fact, this categorization would be a useful tool to understand the institutional change favouring FDI inflows in India.⁵ Table 1 presents how the four modes of institutional change are defined according to the nature of process and result

⁴ I have discussed the three phases of institutional evolution in the realm of FDI inflows in India elsewhere, see Shin (2014). A discussion in Shin (2014) was an empirical analysis. However, this paper attempts to connect the empirical analysis with theoretical framework suggested in historical institutionalism.

⁵ This categorization was originally aimed to explain the governing behaviour in the political economies of advanced capitalism in a volume of several studies (See Streeck and Thelen, 2005: 10).

of institutional change. Some significant characteristics of the four institutional changes are as follows.

Table 1: Four Modes of Institutional Change

		Result of Institutional Changes	
		Continuity	Discontinuity
Process of Institutional Change	Incremental	Reproduction by Adaptation	Gradual Transformation
	Abrupt	Survival and Return	Breakdown and Replacement

Source: Streeck and Thelen (2005: 9).

First, the process of institutional change addresses the existence of disruption like a war or a revolution while institutions evolve. Historical institutionalists see that both the reproduction by adaptation mode and the gradual transformation mode have no disruption while institutions evolve toward a certain direction. Therefore, institutions in the two modes are more likely to be ‘stickier’ and ‘stable’ against a change, thereby the process of institutional change would be incremental rather than abrupt. On the contrary, the survival and return mode and the breakdown and replacement mode are disturbed by any disruption while institutions evolve. Therefore, institutions in the two modes are less sticky and less stable toward a change; thereby the process of institutional change would be abrupt rather than incremental. In addition, these two modes seem to be affected by exogenous shocks rather than endogenous factors for changes.

Second, the result of institutional change sees whether or not the institutional change has a nature of continuity. Historical institutionalists explained the difference between continuity and discontinuity by using the notions of ‘minor’ and ‘major’ change. For example, the reproduction and adaptation mode and the survival and return mode tend to present minor changes while the gradual transformation and the breakdown and replacement mode are useful to explain major changes. In fact, distinguishing minor and major changes is a difficult task since researchers may have a disagreement to judge a certain mode of institutional change. In order to avoid such disagreement, this paper deals with different phases of economic regime toward foreign capital and foreign investments at the union level of India from the anti-FDI period to the selective FDI, further to the pro-FDI period. In other words, the change of rules and beliefs from the anti-FDI to

the pro-FDI inflows that has occurred over time supports an argument of a ‘major’ change. At the same time, the change favouring FDI inflows is endogenously driven by key policymakers having an idea of foreign investments as helpful financial resources for Indian industry. In other words, the endogenously driven idea rather than external forces had a role in bringing an incremental change.

The gradual transformation mode of institutional change, with which the institutional change favouring FDI inflows in India can be explained, is understood when the result of institutional change has a nature of discontinuity caused by incremental and creeping changes. Then a question is: What is the relationship between the institutional discontinuity and creeping changes? The ‘tipping point’ model mentioned above could answer this question. It is because the tipping point has a role of connecting creeping changes and institutional discontinuity in the gradual transformation mode of institutional change. In historical institutionalism, a tipping point indicates a moment at which “far-reaching change can be accomplished through the accumulation of small, often seemingly insignificant adjustments” (Streeck and Thelen, 2005: 8). As briefly discussed above, for example, Mukherji (2013) used the concept to indicate the economic reform of 1991 during which the idea of Indian technocrats drove liberalization. Mukherji argued that India reached an ideational tipping point after experimenting with gradual policy change that began in the 1980s. For Mukherji, small policy changes in the 1980s are creeping changes for the institutional change of 1991 which he called as paradigm shift. For Mukherji, the paradigm shift means institutional discontinuity occurred in 1991 because economic policies after 1991 were very different from those before 1991 that were more state-led and autarkic.

Likewise, this paper argues that the institutional discontinuity occurred in 1991 when institutions evolved toward pro-FDI inflows. This paper sees the economic reforms of 1991 as a tipping point at which far-reaching institutional change favouring FDI inflows was accomplished. In other words, the tipping point in 1991 occurred through the accumulation of small adjustments and brought institutional discontinuity in the realm of FDI inflows. The subsequent parts of the paper discuss how historical details back the argument.

Anti-FDI Inflows (1969-1975)

Congress Government's Socialist Orientation

The discussion in this part begins with the year 1969 when the Congress government under Indira Gandhi's leadership initiated institutional arrangements with a socialistic orientation.⁶ The state's approach to foreign private capital was more rigorous than any other regime under Indira Gandhi's leadership especially from 1969.⁷ Several institutions were arranged in this period for stringently regulating financial resources, especially foreign capital. Domestic banks were nationalized in 1969 and Foreign Exchange Regulation Act (FERA) was enacted in 1973. In addition, the quantitative restriction imposed a restriction on imports up to a limit on items which are sensitive to Indian industry (Kaviraj, 1986: 1699; Hewitt, 2008: 9; Tendulkar and Bhavani, 2007).

A question is then, what made Indira Gandhi pursue socialist goals and further institutional arrangements toward anti-foreign capital clearly from 1969? A series of political and economic crises seem to have encouraged her to do so. Desai and Bhagwati (1975) pointed that a foreign exchange rate crisis in 1956 enhanced socialist orientation in economic planning during the Second Five-year Plan that was pursued from 1956 to 1961. The socialist orientation aimed at expanding the heavy industry and the public sector investment, which turned out to be unsuccessful due to the lack of participation from the private sector in the heavy industry. After the unsuccessful implementation of the Second Five-year Plan, India suffered from economic instability in foreign aid because the US suspended its financial aid to India and Pakistan in 1965 during the Indo-Pakistan war (Frank, 2001: 296). The financial aid from the US and international organizations was crucial at the nascent stage of India's industrialization when domestic private capital was not

⁶ The period of anti-FDI inflows contrasts with the period of Jawaharlal Nehru's government. Jawaharlal Nehru who served as the first Prime Minister of India from August 1947 to May 1964 had an idea favouring foreign capital and foreign investments for the growth of Indian industry. He thought foreign capital could contribute to the national interests of India, although it needed to be carefully monitored and regulated by the state (Panagariya 2008, 30). During the Nehru government, the group of foreign companies was larger than the group of domestic companies in Indian industry (Kidron, 1965; Tomlinson, 1978).

⁷ An important reason why the discussion here begins with the year of 1969 was because several economic policies implemented in 1969 were based on the socialist orientation, which was in the opposite direction of deregulation attempt in 1966 in the Indira Gandhi government. For the failure of economic reform attempt in 1966, see Mukherji (2013).

yet competitive in the global market to contribute to India's economy. The US and international organizations forced the Congress government to enforce devaluation. In late March 1966, Indira Gandhi visited the US to get food and foreign exchange (Malhotra, 1989: 95). During a meeting with the US President, Indira Gandhi was forced to pursue liberalization with the promise of continuous financial assistance from the US. Meanwhile, the BOP status was reaching a crisis point. However, the Congress government's attempt at liberalization was short-lived (Mukherji, 2000; 2014a; 2014b).

Interestingly, Desai and Bhagwati discussed the close nexus between the left-wing parties and a left-wing group within the Congress Party for election purposes. This political nexus was another factor to push the Indira Gandhi government to implement socialist orientation. Indira Gandhi, who was at the centre of left-wing group within the Congress Party, castigated the old right-wing group of the Congress Party. This political nexus was not only based on *swadeshi* [self-sufficiency] but also their conflicting interests with liberalization policies and foreign capital inflows to Indian industry when the Indira Gandhi government attempted liberalization in 1966. Trade unions also opposed the policies by organizing *bandhs* [strikes] in many provincial states such as West Bengal, Bihar, Odisha, Kerala, Uttar Pradesh, and others (see Verghese, 2010). As a consequence of these *bandhs* and continuous political instability, the Congress Party lost 95 seats in many states in the fourth general election in February 1967 (Frank, 2001: 304). Even though the party could remain in power, factional conflicts intensified through the party's split in 1969.

Bank Nationalization, 1969

In such unstable political and economic conditions, the Congress government nationalized domestic banks in 1969. The bank nationalization aimed at solidifying Indira Gandhi's political support from the poor and left wing parties. An episode behind Indira Gandhi's political decision is well described by I G Patel, who served as the Governor of the Reserve Bank of India (RBI) having a close relation with Indira Gandhi (see Patel 2002, 135-38). For the efficient management of financial resources, the Congress government established the Banking Department under the Ministry of Finance (MOF) and gave it autonomy to manage nationalized banks. Indira Gandhi used the new presence of this government body as a means of securing her political support from the poor. Bank nationalization was a way to easily manipulate banking resources in hard times and

food scarcity. According to Patel, Indira Gandhi “was heralded as the angel of the poor and she made *garibi hatao* [poverty alleviation]” after the bank nationalization (Patel, 2002: 136). Patel also agreed that the influence of political struggles between Indira Gandhi and her opposition on economic policy decisions by commenting: “It is remarkable how momentous decisions are made in the heat of political struggle” (Patel, 2002: 136).

Foreign Exchange Regulation Act (FERA), 1973

Like the bank nationalization, the enactment of the FERA was also a by-product of Indira Gandhi’s socialist idea that was encouraged by her political struggle. FERA was introduced in line with the Industrial Development and Regulation Act that was enacted in 1951 for regulating industrial investments and production. This act included various restrictions on (1) the import and export of foreign currency; (2) acquisition and holding of immovable property; and (3) the establishment of business in India for “the interests of the economic development of the country” (RBI, 2012). The key point of this act gave the central government a monopolistic role in the overall activities related to foreign currency. It was because none of state agencies could participate in any activities regarding foreign currency, except the RBI, the national bank of India, which was designated as the only authorized dealer by the central government. The act also restricted foreign equity shares in domestic Indian companies to 40% under strict monitoring by the RBI. In addition, the FERA was in favour of domestic companies when they bargained with foreign companies in Indian industry. The enactment of FERA enhanced the bargaining position of Indian companies because competition among the multinational corporations for accessing the Indian market escalated through FERA (Encarnation, 1989: 118).

For strict monitoring, several key bureaucrats closely dealt with the foreign exchange issue within the RBI. Some of them are L K Jha who served as the Governor of the RBI from 1967 to 1970, I G Patel who was the Governor of the RBI from 1977 to 1982, and Ashok Mitra who served as the Chief Economic Advisor in the Banking Department. Patel was especially trusted and was asked by Indira Gandhi to prepare the bill for nationalizing domestic banks in 1969. As a well-known economist, he also worked in the Planning Commission, MOF, and the United Nations Development Program (UNDP). In his autobiography, Patel lively narrated his role in dealing with

the major economic issues of the time (Patel, 2002: 135-38). According to him, the Secretary of the RBI is significant because the position has an exclusive responsibility for the larger questions of monetary policy, management of government debt, and foreign exchange.

The enactment of FERA struck a blow to domestic private capital as well as foreign capital. Many companies retaining more than 40% of foreign equity shares were discriminated under the FERA scheme. These companies had to either reduce foreign shares to 40% or sell its ownership to other Indian industrialists. This discrimination continued until the economic reforms of 1991. Due to such institutional arrangements controlling Indian industry, India under Indira Gandhi's leadership was considered as the "most comprehensively regulated market economy in the world" (Tendulkar and Bhavani, 2007: 23). In an interview with *Outlook* (2004), Rakesh Mohan who was the Deputy Governor of RBI under both the BJP and the Congress governments, also described the Indira Gandhi government in the 1970s as "the dark age for the industrial economy".

Likewise, "care [had] to be taken to ensure that foreign collaboration is resorted to only for meeting a critical gap and does not inhibit the maximum utilization of domestic know-how and services" in the area of foreign collaboration and its application of related rules (GOI, 1969: Chap14).

According to the 4th Five-Year Plan:

It [was] necessary to subject every proposal for foreign collaboration to fairly rigid tests; even [import of foreign knowhow particularly in sophisticated industrial fields], it would be essential to make simultaneous efforts for the adaptation of such know-how through indigenous effort and to improve on it to avoid the need for future purchase (GOI, 1969: Chap 14).⁸

In order to identify fields where foreign collaboration is needed and to streamline the procedure for acceptance, the Foreign Investment Board (FIB) was set up. Unlike today's Foreign Investment Promotion Board (FIPB) in the MOF that promotes foreign investments, the role of the FIB under the Indira Gandhi government addressed the controls and regulations of foreign investments.

⁸ The report is available at <http://planningcommission.nic.in/plans/planrel/fiveyr/4th/4planch14.html> (accessed on 28 April, 2014).

Selective FDI Inflows (1975-1991)

Economic Transition in 1975

Indira Gandhi attempted to neutralize political and economic threats from the opposition against her through the internal emergency of 1975. Her leadership “sought to open up channels to key sections of society—notably the middle classes and peasants—to enhance cooperation and collaboration with the state, as well as to ensure a more efficient form of resource extraction” (Hewitt, 2008: 128). The emergency functioned as a means of centralizing and personalizing her power by transforming economic management. Through the streamlining of industrial licensing and emphasis of bureaucratic efficiency, the public sector could utilize its capacities to increase its output. In 1976, industrial output increased 10% compared to the output of 1975 (Hewitt, 2008: 129). Nayar (2006) also argued that the year 1975 was the initiation of an incipient liberalization for India’s economy and the end of the Hindu growth rate. The economic transformation was affected by intolerable inflation and difficulties of getting commercial loans from the IMF.

Deregulation in the private sector significantly contributed to further growth in India’s economy.

The *Economic and Political Weekly* (EPW) issued in 1976 states:

Industrial licensing has been diluted through a series of relaxations and exemptions, the restrictions on large houses have been relaxed and the anti-concentration provisions of the MRTP Act have been rendered virtually inoperative, import policy has been relaxed, a variety of generous subsidies and concessions have been extended to exports, foreign companies are being encouraged to expand under the liberal provisions of FERA... In other words, major advances have been made in the direction of an open, free market, private enterprise economy...Private businessmen, whether American or British, have sought to conceal their preferences even less (EPW, 1976: 1809-10).

The economic transition of 1975 also influenced the area of foreign investments in Indian industry. Hewitt (2008: 130) mentioned that the Emergency was in fact used to encourage foreign capital to participate in Indian industry, although its original aims addressed socialist goals. Frank (1977)

also saw a change of the economic orientation around 1976. He put it, “the state is being reorganized to serve the interests of big—and foreign—capital more efficiently and, relative to other economic sectors and political interests, more exclusively” (Frank, 1977: 473).

The Indira Gandhi government’s deregulation and the encouragement of foreign capital’s participation in Indian industry contributed to an increase in the total reserves of India. The reserves gradually grew after 1975 to over US\$11 billion in 1979 and 1980 (see Table 2). As can be seen in Table 2, foreign reserves were steadily garnered when the Janata Party government was in power from March 1977. At that time, Morarji Desai took over as Prime Minister from Indira Gandhi and H M Patel became the Finance Minister of India. Morarji Desai’s leadership, which was getting political support from the communist parties of India, took a very cautious view of the growth of remittances. The Janata government did not use the readily available foreign exchange reserves although the overall economy had recovered in the areas of growth, inflation, and foreign exchange (see Joshi and Little, 1994). In fact, the chronic shortage of foreign exchange that continued in the preceding governments strongly affected the policymakers in the central government to consider foreign reserves as a means of saving (Tendulkar and Bhavani, 2007). This tendency was contrary to the cases of East Asian countries like South Korea that deemed foreign reserves could be earned by export.

Table 2: Foreign Reserves of Total External Debt in India from 1975 to 1991

Year	Current US\$ Million*	Percent of Total External Debt
1975	2,064	15
1976	3,729	26
1977	6,085	39
1978	8,316	50
1979	11,815	64
1980	12,010	57
1981	8,109	35
1982	8,242	30
1983	8,216	26
1984	8,536	25
1985	9,493	23
1986	10,480	22

1987	11,512	20
1988	9,186	15
1989	8,048	11
1990	5,637	7
1991	7,616	9

Note: *including gold

Source: Based on the World Bank Indicator (<http://databank.worldbank.org>)

The Janata government under Charan Singh's leadership attempted an overall transformation in the industrial sectors except in the area of foreign investments. The industrial changes were designed to increase the participation of non-resident Indians (NRIs) and domestic private capital in Indian industry but not foreign capital. The changes included import and export controls, tariffs, technology collaboration with foreign companies, and investment of NRIs (GOI, 1978: 4). Although key policymakers in the Ministry of Commerce at that time considered foreign technology acquisitions important, they did not implement any policies to promote foreign investments through which domestic companies could easily gain access to advanced technology. The ideological base of the Janata Party that valued a self-reliant economy seems to have influenced it. Besides, a nationalist wave for a self-reliant economy affected some of the US-based MNCs such as the Coca-Cola Company, IBM, and PepsiCo to be pulled out of India in 1977.

When Indira Gandhi returned as the Prime Minister of India in 1980, industrial deregulation accelerated. The attitudinal change occurred in the Indira Gandhi government favouring the private sector in the wake of economic slowdown and the BOP crisis in 1979-80.⁹ For business groups, the Monopolies and Restrictive Trade Practices (MRTP) Act was diluted and entry barriers to the Indian market were reduced. With an attempt at deregulation, the Indira Gandhi government sought to simplify licensing procedures. Nonetheless, there were two limitations in this reform attempt. First, Indira Gandhi's perspective on foreign capital did not change much while she supported the participation of domestic private capital in industry.¹⁰ Second, despite the

⁹ The detailed discussion on economic slowdown in India from the late 1970s to the mid-1980s, see Joshi and Little (1994: Chap 6).

¹⁰ Rodrik and Subramanian (2005) offered the limitations of India's economic transition in the 1980s. They argued that India pursued "pro-business" strategy in the 1980s, which was in favour of existing businesses and producers through trade protection by using increased tariffs and quantitative restriction rather than "pro-market" strategy favouring new entrants and consumers. This attitudinal change was not followed by "actual policy framework", therefore the authors point the transition as "attitudinal" change rather than policy reform (Rodrik and Subramanian, 2005: 216).

considerable streamlining of licensing procedures in industry, further improvements were needed “in reducing the period of time taken for disposal of applications for the creation of new capacities, proposals for substantial expansion, and the production of new items” (GOI, 1980). After all, the attempt of economic reforms under Indira Gandhi’s leadership was unsuccessful (see Kohli, 1989).

Attitudinal Change towards FDI

The foreign reserves of the total external debt steadily decreased in the 1980s during the Congress governments led by Indira Gandhi and Rajiv Gandhi. The failure of reforms in promoting the private sector for capital formation under Indira Gandhi’s leadership, external pressures from rising oil prices, and the world recession in the early 1980s again resulted in resorting to commercial borrowing rather than foreign investments (Joshi and Little, 1994: 58-62; see also Ganguly and Mukherji, 2011). Under pressure from the crises to get financing from external resources, an idea favouring foreign investments developed in the Congress government under Rajiv Gandhi’s leadership in the late 1980s. At a national conference organized by the Confederation of Engineering Industry (CEI) [predecessor of current Confederation of Indian Industry (CII)], Rajiv Gandhi (1988) pointed out the meagre performance of foreign investments in India and benefits of foreign investments as follows:

Our policy towards foreign investment is clear. It is *not an open door* [emphasis added] policy. We permit foreign investment on our terms, in a wide range of sectors within certain percentages of foreign equity. These percentages can be relaxed in areas of high technology, or where there is a special contribution to exports. This basic policy is sound and *does not need any change*. Yet the actual inflow of direct investment into our economy is minuscule compared to inflows into other developing countries. Foreign investment in the ASEAN countries is around Rs.1,500 crore per year. Foreign investment in socialist China is about Rs.2,000 crore per year. Foreign investment in India is only about Rs.100 crore. The external borrowing has expanded over the past several years, reflecting our growing needs and absorptive capability. But the flow of direct investment has remained very small. Yet *direct investment has some advantages over loans*

[emphasis added]. Loans have to be repaid whether investments are productive or not. Investment leads to outflows only after there is production and then too only when there is profit... One reason for the low levels of direct foreign investment is that our efforts at streamlining procedures, which have yielded good results in the area of domestic industrial licenses, have not been effectively extended to foreign investment proposals. I was given many examples of such problems on my recent visit to Japan. There is need to expand procedural simplification and efficiency on this area also. *We can absorb a larger flow of foreign investment, with advantage to our economy, by speeding up procedures and removing unnecessary irritants* [emphasis added].

Two factors seem to have affected Rajiv Gandhi's idea to support FDI inflows. First, Rajiv Gandhi's visit to Japan offered a chance to learn its experience for development.¹¹ Through the experience, he confirmed his belief in the significance of technology and close ties between the state and industry for development. He knew that domestic industry can access advanced technologies through foreign investments. Second, his idea favouring foreign capital was encouraged by the difficulties of handling external resources (Sawhney, 1985). Nonetheless, Rajiv Gandhi's leadership failed to entirely open the Indian market to foreign investors due to the strong lobby from domestic capital.

India's BOP crises were deteriorating and the country had to resort to further commercial borrowing. The foreign trade policies were formulated and the 8th Five-Year Plan was designed for the structural transformation of the market and society under financially difficult conditions (Singh, 1990a; 1990b; GOI, 1991a). The Janata Dal government led by V P Singh, who succeeded Rajiv Gandhi as the Prime Minister of India, pursued economic reforms. Titled as *Towards Social*

¹¹ Interestingly, some other political leaders both at the Centre and state levels also visited Japan to learn about the East Asian development strategies in the 1980s. Their inspirations were in reality embodied to devise industrial strategies in India in a way to make the state and industry more cooperative. For example, MGR who was the Chief Minister of Tamil Nadu at that time visited Japan with some of his party members including C Ponnaiyan serving as the Finance Minister of Tamil Nadu in order to learn about the East Asian industrial development. Interview with Ponnaiyan in Chennai on January 31, 2012. The strategies were witnessed in various government reports issued. See also Abegglen and Etori (1981), Mukherji (2014: Chap 4), and Sawhney (1985). In particular, Mukherji (2014: 152) also presented that Chandrababu Naidu, who served as the Chief Minister of Andhra Pradesh from 1995 to 2004, was impressed by economic development models in East and Southeast Asia and convinced to promote investment projects in the state.

Transformation, the 8th Plan highlighted various sectors in the market and society such as modernizing industry and the credit system, domestic savings, rural development, employment generation, land reforms, health care, increase of literacy rate, and the enhancement of women's social and economic status. For the efficient regulation of domestic capital markets, new statutory organizations like the Securities and Exchange Board of India (SEBI) were established. Since the inception of the SEBI, it has played an important role in managing FDI proposals. According to the *Economic Survey 1990-91*, the economic conditions became worse in the consecutive government led by Chandra Shekar, who was in power as the Prime Minister of India beginning in November 1990. Yashwant Sinha, who served as the Finance Minister of India at that time, narrates in his autobiography that the government began to behave more responsibly than most of the people had expected by successfully negotiating with the IMF for financial assistance (Sinha, 2007: 6-7). He assessed that the financial deficit was the outcome of shortcomings in the macro-management of the past economy. Key policymakers including Yashwant Sinha at the centre thought India had to share its economic concerns with the Parliament and the people so that the restoration of the economy could be achieved as a collective responsibility (Singh, 1990a: 12).

Pro-FDI Inflows (After 1991): Ideational 'Tipping Point'

Budget 1991-92

The financial difficulties in the early 1990s were finally reflected in new economic policies in the area of foreign investments. First, Montek Singh Ahluwalia confidentially submitted a new industrial policy paper titled "Towards Restructuring Industrial, Trade and Fiscal Policies" to the PMO in 1990 (Mohan, 2012; see also Acharya and Mohan, 2010: Chap5). The paper in fact became the original design for economic reforms that were implemented in 1991. It suggested the complete deregulation of the industrial sectors including foreign investments. For example, it contained a scheme to increase the equity of foreign investors from 40% to 51% in domestic companies in many sectors. Through this scheme, foreign capital could actively participate in the process of industrialization in India. Second, the *Budget 1991-92* also showed the need of foreign investments. In a budget speech, Manmohan Singh, who succeeded Yashwant Sinha as the Finance Minister of India, strongly supported FDI inflows in the domestic market (GOI, 1991b: 5). He

believed that FDI inflows would provide access to capital and technology in the global market that could contribute to economic growth in India.

The imminent threat of the BOP crisis of 1991 and the consensus of key policymakers for liberalization led India's economy to open up to foreign capital. Since the extensive economic reforms of 1991, the total FDI inflows have steadily increased. Table 3 shows FDI inflows to India and China from 1991 to 2013. Interestingly, India has outpaced China recently in terms of FDI inflows as a percent of gross fixed capital formation (see Table 3). This means that FDI inflows in India have played a more important role in capital formation than in China in recent years. Through the reforms of 1991, foreign capital could participate in the process of India's industrialization comparatively more easily than before by sharing up to 51% of their equity in domestic companies of India in many sectors (Panagariya, 2008: 199-200).

Table 3: FDI Inflows to India and China (1991-2013)

Year	FDI, Net Inflows (BOP, Current US\$ Million)		FDI, Net Inflows (% of GDP)		As a Percentage of Gross Fixed Capital Formation	
	India	China	India	China	India	China
1991	74	4,366	0.0	1.2	-	-
1992	277	11,156	0.1	2.6	-	-
1993	550	27,515	0.2	6.2	-	-
1994	973	33,787	0.3	6.0	-	-
1995	2,144	35,849	0.6	4.9	-	-
1996	2,426	40,180	0.6	4.7	-	-
1997	3,577	44,237	0.8	4.6	-	-
1998	2,635	43,751	0.6	4.3	-	-
1999	2,169	38,753	0.5	3.6	-	-
2000	3,584	38,399	0.8	3.2	1.9*	11.9*
2001	5,472	44,241	1.1	3.3	3.2	10.3
2002	5,626	49,308	1.1	3.4	3.0	10.5
2003	4,323	49,457	0.7	3.0	4.0	11.5
2004	5,771	62,108	0.8	3.2	3.2	12.4
2005	7,269	111,210	0.9	4.9	3.0	7.7
2006	20,029	133,273	2.1	4.9	6.6	6.4
2007	25,228	169,390	2.0	4.8	5.8	5.9
2008	43,406	186,798	3.5	4.1	3.7	5.8
2009	35,581	167,071	2.6	3.3	8.2	4.3
2010	27,397	272,987	1.6	4.6	4.5	4.1

2011	36,499	331,592	1.9	4.5	5.6	3.7
2012	23,996	295,626	1.3	3.6	4.0	3.1
2013	28,153	347,849	1.5	3.8	4.7	2.9

Source: *World Development Indicators (various issues)*, *World Investment Report (various issues)*.

Note: *annual average from 1990-2000.

When the plan for economic reforms was announced in 1991, opinions were diverse in the state and society. Many policymakers strongly supported the so-called ‘Montek paper’ that showed a comprehensive economic vision for both Indian industry and international relations (Institute of Economic Growth Delhi, 1990; Shastri, 1997: 50). However, several key bureaucrats critically pointed out the feeble position of the Indian state in pursuing the reforms against the power of vested interests such as rich farmers, business groups, and trade unions. P N Dhar (1990), former principal secretary to the Prime Minister under the Indira Gandhi government and assistant secretary general of the United Nations, was one of them. He was concerned about the pervasive political fragmentation within political parties, which acted as a barrier to positive relationships with economic policies. His comment on the political fragmentation is noteworthy: “In circumstances of political fragmentation economic policies are political weapons in power struggles rather than solutions to problems” (Dhar, 1990: 26).

The power of vested interests in society and political fragmentation strongly upset the progress of economic reforms of 1991. The domestic big business group responded firstly to the reforms. Before the sanction of industrial policies, several dominant business associations showed different opinions. The Associated Chambers of Commerce and Industry (ASSOCHAM) argued the need for a free flow of foreign investments while the Federation of Indian Chambers of Commerce and Industry (FICCI) held a reluctant view in increasing the equity of foreign investors. The FICCI, whose membership is dominated by indigenous business groups, felt that “the final judgment on whether or not such investment is desirable should be left to the Indian entrepreneurs” (*The Hindu*, 1991). The main concern of the FICCI was the structural changes of Indian business where foreign investors could more easily control companies once their equity increases.

The Bombay Club’s ‘*swadeshi*’ debates would be another example that showed how the interests of Indian big business influenced the reform process. The Bombay Club is a symbolic term indicating the Indian big business such as Bajaj, Birla, Thapar, Modi, Godrej, Singhanian groups,

and some others. The Club was led by Rahul Bajaj who is the chairman and managing director of the Bajaj Auto and it was unhappy with the increased competition from foreign capital as a result of the reforms (see Chibber, 2003). Focusing on the Confederation of Indian Industry (CII) and the FICCI, the Club began to demand a level playing field for access to foreign capital in the Indian market. Its resistance to economic reforms was strengthened in late 1993 when the imperative economic crisis was eased (Kochanek, 2007). In an interview with a newspaper, Hari Shankar Singhanian, one of the Bombay Club members, argued that Indian big business wants “a breathing space to catch up with other countries where industries were not hamstrung by a license-permit raj” (*The Times of India*, 1998b).

Indian big business lobbied to protect their business interests against foreign capital during the BJP-led National Democratic Alliance (NDA) government that was led by A B Vajpayee. Since *swadeshi* was the ideological base of the BJP, the voice of domestic big business in insisting on a level playing field was strong. However, key policymakers in the NDA government seemed unhappy with such opposition from domestic business group. For example, P Chidambaram (2007) who served as the Finance Minister of India at that time was concerned about the hostile attitude of Indian big business toward foreign capital in his autobiography. He put it, “Rahul Bajaj (and what survives of the Bombay Club) maintains that ‘money has colour’. According to him, there is foreign money and there is Indian money, and the latter has to be preferred to the former” (Chidambaram, 2007: 52).

The second response from the Indian society to the reforms came from social activists who spoke for producers of small industries, farmers, artisans, and consumers. Social activists opposed domestic big business when they claimed their interests and a level playing field against the economic reforms. For the social activists and the poor in society, big business sought its own profit in the name of *swadeshi*. Such a negative response from society was toward not only domestic big business but also foreign capital. The response was often expressed through agitations and attempts to evict the MNCs. Because of the strong agitations and political lobbies from interest groups in society, many foreign investors had to withdraw their investments in India.

Interestingly, such agitations usually involve either the left-wing political parties that seek political support by making alliances with the labour class or the extreme right-wing political groups that aim to protect the interests of domestic companies. By explaining the two different approaches toward FDI inflows, Prasenjit Bose who was the convener of the research unit in the CPI(M) stressed the fear that citizens had when the citizens were displaced in the process of FDI inflows.¹² He put it, “There are two types of anti-FDI pictures from our perspective. First is a grass-roots level resistance, which is protesting for people who are displaced from their resources, livelihood, and land. Second is a sector-by-sector approach at the macro-economic policy level. We do not oppose the FDI inflows of every sector. We accept that we cannot avoid globalization. So we consider the sensitivity of each sector [for opposing FDI inflows].”

The Rashtriya Swayamsevak Sangh (RSS), a right-wing Hindu nationalist organization, has also opposed globalization and FDI inflows. The Swadeshi Jagran Manch (SJM) [self-reliance awareness front] that was organized in 1994 by the RSS has strongly resisted FDI inflows (Frankel, 2005: 728-29). Its opposition activities were clearly observed when Vajpayee was the Prime Minister of India. The SJM often alleged that it would conduct a social boycott of political leaders and bureaucrats who negotiated with the World Trade Organization and MNCs, by describing its opposition to MNCs as the “second war of India’s independence” using the slogan of “MNCs quit India; we won’t accept globalization” (*Business Standard*, 1997). Likewise, the Vishwa Hindu Parishad, another right-wing Hindu nationalist organization, strongly opposed foreign capital. For example, it campaigned against a McDonald’s outlet on the grounds of ‘cultural pollution’ in Mumbai in 1998 (*The Times of India*, 1998a). After then, the RSS continued to oppose FDI projects in multi-brand retail and in insurance sectors by asserting that the central government’s decision on deregulation in the sectors would affect India’s internal business and thereby threat its economy (*The Economic Times*, 2014a; 2014b; *The Indian Express*, 2015).

FERA to FEMA in the NDA Government, 1999

Despite such strong opposition from both the left-wing and right-wing political groups against foreign capital and foreign investments, the NDA government pursued institutional arrangements

¹² Interview at the head office of CPI(M) in Delhi on 12 and 21 December, 2011.

favouring FDI inflows under Vajpayee's strong view favouring liberalization. One of the most significant institutional arrangements was the enactment of the Foreign Exchange Management Act (FEMA) in 1999, which was reconstituted from the FERA of 1973 (RBI, 2000). Unlike FERA, FEMA acknowledged some of the state agencies such as the SEBI as participants in dealing with foreign currency in addition to RBI. The foreign currency-related works were subdivided to different organizations through the act. SEBI and RBI are mainly concerned with Foreign Institutional Investment (FII) and FDI inflows that do not need approval since they are reviewed under an automatic route.¹³ Under the automatic route, foreign investors in various industrial sectors are allowed to embark on their business more easily than those in the other route.¹⁴ The Secretariat for Industrial Assistance (SIA) and the Foreign Investment Promotion Board (FIPB) examine proposals that are excluded from the automatic route described above. Thus, the role of the FIPB has become more significant in the approval and rejection of proposals since the initiation of FEMA.

Continuous Reforms by UPA Government and NDA Government, 2004-2014

The United Progressive Alliance (UPA) government under Manmohan Singh's leadership also implemented policies favouring FDI inflows. Manmohan Singh who served as the Prime Minister from May 2004 to May 2014 strongly supported deregulation in the area of FDI inflows. During his tenure, many industrial sectors such as petrol and natural gas, insurance, defence production, telecom, and multi-brand retail raised the cap of FDI inflows up to 100%. Manmohan Singh's ideas favouring FDI inflows were based on the expectation of employment and economic growth. He said, "I believe that these steps [for deregulating many industrial sectors for foreign investors] will help strengthen our growth process and generate employment in these difficult times; I urge all segments of public opinion to support the steps we have taken in national interest" (*The Indian Express*, 2012). Key ministers in the central government in the UPA government also strongly supported the ideas favouring FDI inflows. Anand Sharma, the Commerce and Industry Minister of India, mentioned, "I am strongly in favour of raising the cap in telecom sector [up to 100%]"

¹³ For the three categories—Wholly-Owned Subsidiary (WOS), Mergers and Acquisitions (M&A), and Joint Venture (JV)—of FDI routes in India. See RBI (2003).

¹⁴ Interviews with Anupam Srivastava and Udit Srivastava in the Invest India [Joint Venture between the GOI and FICCI for FDI promotion] of FICCI at New Delhi on 5 March, 2012.

(*Live Mint*, 2013). The idea behind increasing the FDI limit in the sector was to help the industry lower financial burden.

The current NDA government under Narendra Modi's leadership also supports the idea favouring FDI inflows. It has stressed the significance of manufacturing sector and infrastructure in boosting India's economy by propagating the 'Make in India' campaign. This campaign pays attention to foreign investors in the manufacturing sector, in particular with the catchphrase 'Come and Make in India'. The current PM of India, Modi remarked that FDI should be understood as 'First Develop India' and urged foreign investors to create jobs in India.¹⁵

However, several groups in the state and society opposed such further deregulation that the UPA and BJP governments pursued for over the past 10 years. When the UPA government decided to allow 100% of the cap in railways and to raise the cap from 26 to 49% in defence, some political parties and NGOs were against the idea.¹⁶ Derek O'Brien, a Member of Parliament from the All India Trinamool Congress Party, mentioned, "FDI is not the solution for all the problems. FDI is not 'Foreign Direct Investment'; it is 'Foreign Direct Instruction'; it is 'Foreign Direct Intrusion'. ... There should be a 'no' to FDI in insurance, defence and rail. Don't sell our country" (GOI, 2014: 244). The Swadeshi Jagran Manch (SJM), a Hindu nationalist organization, also revealed its anti-FDI orientation with its *swadeshi* ideological base. Against the Narendra Modi government's aggressive drive to attract FDI inflows, a member from the SJM mentioned, "Multinational companies are coming through the backdoor in the name of platform, so we are quite apprehensive of all these developments, especially the way these companies are operating on a larger scale" (*The Economic Times*, 2014).

Despite the opposition, the ideas of key policymakers favouring FDI inflows seem to push economic reforms and make foreign investments transferable. The 'Make in India' campaign, for

¹⁵ His ideas favouring FDI inflows and strong support of FDI projects in India are easily accessible in his official webpage at <http://narendramodi.in>.

¹⁶ As of June 2015, for example, the percentage of FDI cap for the defence sector is 49%; the FDI cap for the multi brand product retail trading is 51% while that for the single brand retail trading is 100%. Except such several sectors, most of industrial sectors allow the FDI cap of up to 100%. See Government of India (2015), "Consolidated FDI Policy", Ministry of Commerce and Industry. Data is available at http://dipp.nic.in/English/policies/FDI_Circular_2015.pdf (accessed on 12 June, 2015).

example, is likely to appeal not only to foreign investors but also to Indian domestic industrialists since the BJP's *swadeshi* ideology is linked to the primary aim of the campaign to boost India's manufacturing sector upon which domestic industry can develop.¹⁷ It means that the strategies of the current NDA government to attract FDI were carefully manipulated to support both Indian domestic industrialists and foreign investors. This is clearly ideational evolution that has been developing incrementally since the economic reforms of the central government toward liberalization in 1991. Such ideational evolution has been the source of gradual institutional change favouring FDI inflows which can be demarcated by three differing periods—anti-FDI (1969-75), selective FDI (1975-91), and pro-FDI (after 1991)—as discussed above.

Conclusion

This paper has discussed how India responded to globalization in the realm of FDI inflows. It presented the economic institutional change favouring FDI inflows at the union level of India by tracing political and economic history from the Indira Gandhi government in the late 1960s to the current Narendra Modi government. From a historical institutionalist perspective, it argued that the institutional change favouring FDI inflows can be understood as 'gradual transformation'. And it supported an ideational tipping point model that underlines the role of endogenously driven ideas favouring foreign capital that finally won over various interest groups opposing FDI inflows. It meant that the gradual institutional change occurred because of ideational evolution that key policymakers developed rather than through external forces.

However, the institutional change favouring FDI inflows may have differing patterns at the sub-national state level since the ideas of key state leaders have evolved in a dissimilar fashion. Such ideational development and institutional evolution will substantially depend on the societal structure and the state-society relations that vary at the state level.

¹⁷ This perspective was discussed in a seminar offered by Sudheendra Kulkarni, chairman of Observer Research Foundation Mumbai, at the ISAS in Singapore on 16 April, 2015.

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