India’s Middle-Income Trap

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Theoretical Underpinnings of the Middle-Income Trap and India

- Indermit Gill and Homi Kharas's seminal works on the Middle-Income Trap have long established that East Asian economies are headed for a period of stagnating growth, after their successful growth stories. They categorised this as a 'middle-income trap'.
- One of the core postulations of their works establish a correlation between institutional structure/reform and the income grouping of economies. In this context, they described the trap as a 'policy misdiagnosis' as economies failed to match growth strategies with the existing institutional structures of their economies.
- Gill and Kharas outline two common types of traps that middle-income countries fall into- **1)** a sustained manufacturing export-led growth model without economic foundations that support its sustenance. **2)** efforts to create a 'knowledge economy' without a conducive state infrastructure.

Remarks on India’s Export-led Growth Strategy

- As a part of India’s *Viksit Bharat* mission, India’s path to becoming into a manufacturing hub, is one marred with challenges. Raghuram Rajan, a leading economist and former governor of the RBI states that India’s export-led growth model will require infrastructural changes in the state to ensure India emerges as a manufacturing hub. India’s exports have witnessed remarkable growth over the years. In FY23, India’s exports stood at INR 36,206, accounting for 21.89% of the GDP.
- To o sustain its exports growth trajectory, India must enhance opportunities to optimise their manufacturing capabilities. In 2022-23, manufactured goods accounted for USD 453 Billion out of a total of USD 762 Billion. In 2024, India’s Purchasing Manufacturer’s Index (PMI) rose to 59.1- the highest it has been in 16 years. This displays a renewal in employment opportunities and job creation.
- Throughout 2023 and 2024, India’s export performance has been strong, however, stronger government and institutional frameworks like PLI and Make in India are required for India to optimise the positive effects of its high exports.

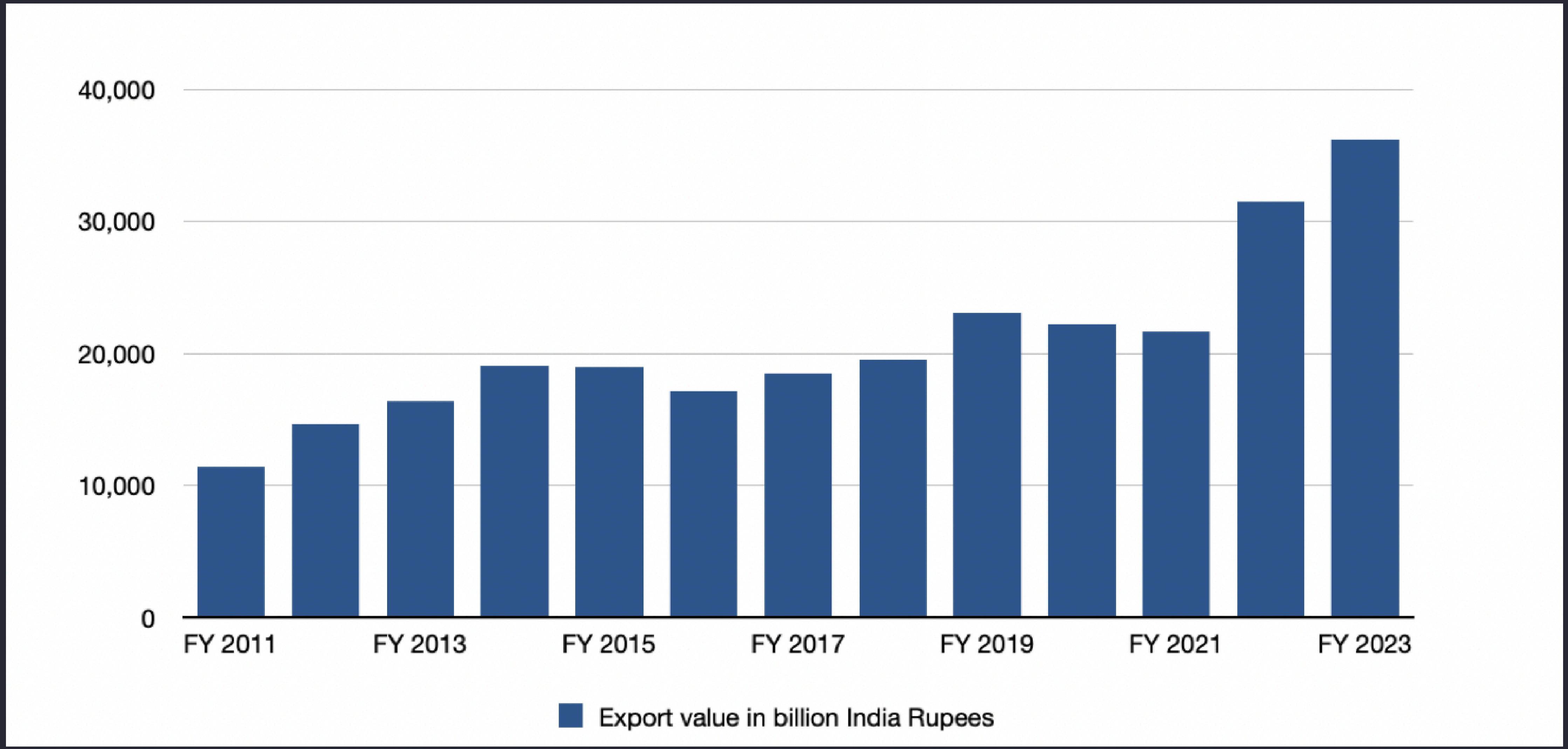

Figure 1: India’s Exports data

- A stronger industrial policy that focuses on distributive growth benefits is crucial. By prioritising sectors like textiles, battery manufacturing through performance-based support for these industries can help them be at par with leading sectors in exports like pharmaceuticals, medical device manufacturing and electronics. To ensure this, the state must focus on its ‘embedded autonomy’ – a term coined by Peter B. Evans, in ‘Embedded Autonomy: States and Industrial Transformation’ which enables smoother firm to government contact and to contribute to growth.

India’s Knowledge Economy

- Gill and Kharas have further discussed the manner in which countries jump into adopting the traits and characteristics of a ‘knowledge economy’ without any focus on fostering socioeconomic growth, human capital development, low levels of education and skills.

- India’s Knowledge Economy Index (KEI) is at the 109th rank with a 3.06 grade on a 10 point scale. In order to efficiently utilise its demographic dividend and in turn, optimise its knowledge economy, India must promote institutional framework that calls for greater support to private enterprise and corporate governance through collaborative efforts between the legal, political and economic system. In that regard, Gill and Kharas have also called for India to utilise its demographic dividend, by promoting female labour force participation, which is currently at 37%, a marked increase by 4.2% since 2021-22 data, as per the Periodic Labour Force Survey.

- Furthermore, there is a need to focus on educational and health budgetary allocations, that contribute to India's HDI values, which currently stands at 0.64. Budgetary allocations for both areas have witnessed a downturn. Education specifically stands at 0.27% of the GDP in FY24. For healthcare expenditure, FY21 witnessed growth to 0.21 %. Thus, the focus must be on not just ensuring basic education, but also designing polices that promote higher education.

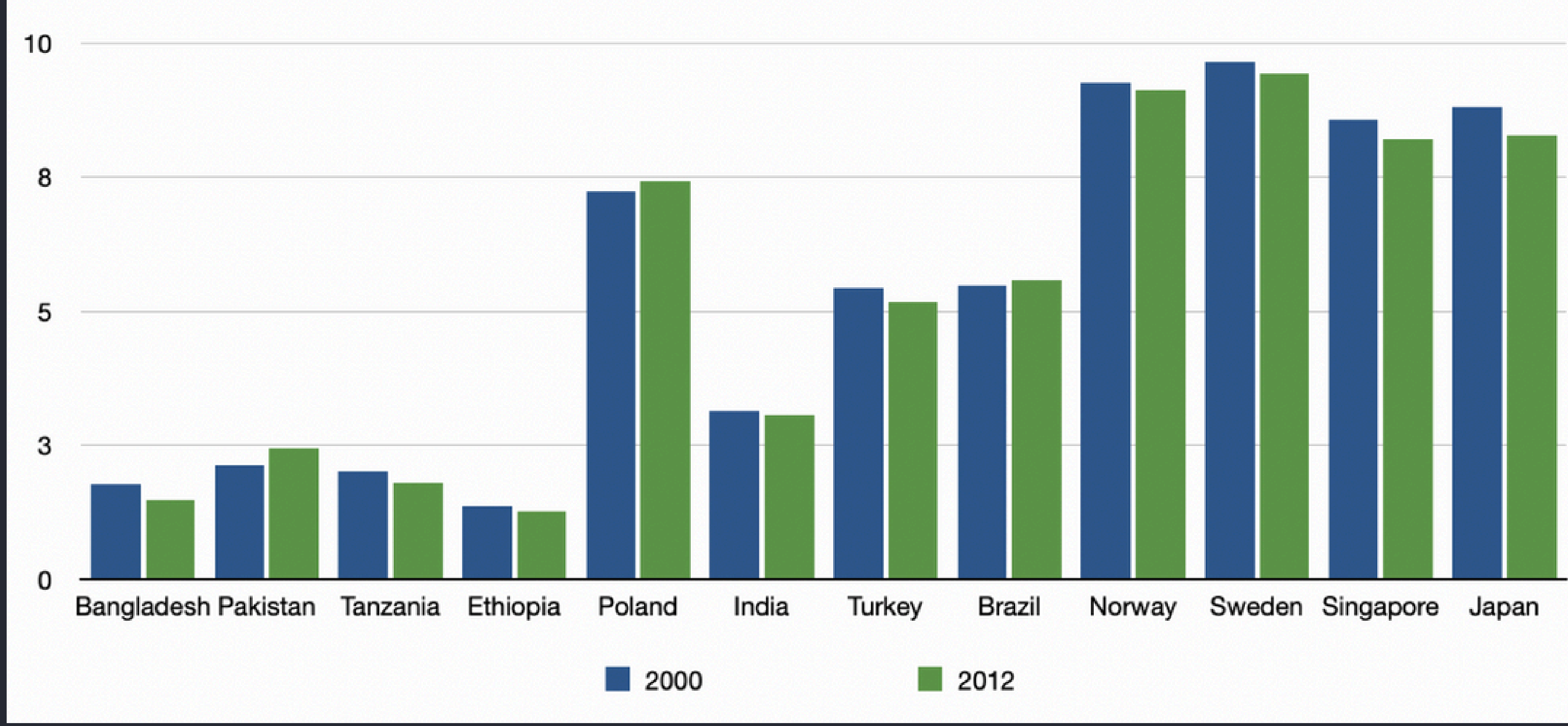

Figure 2: KEI Index Report

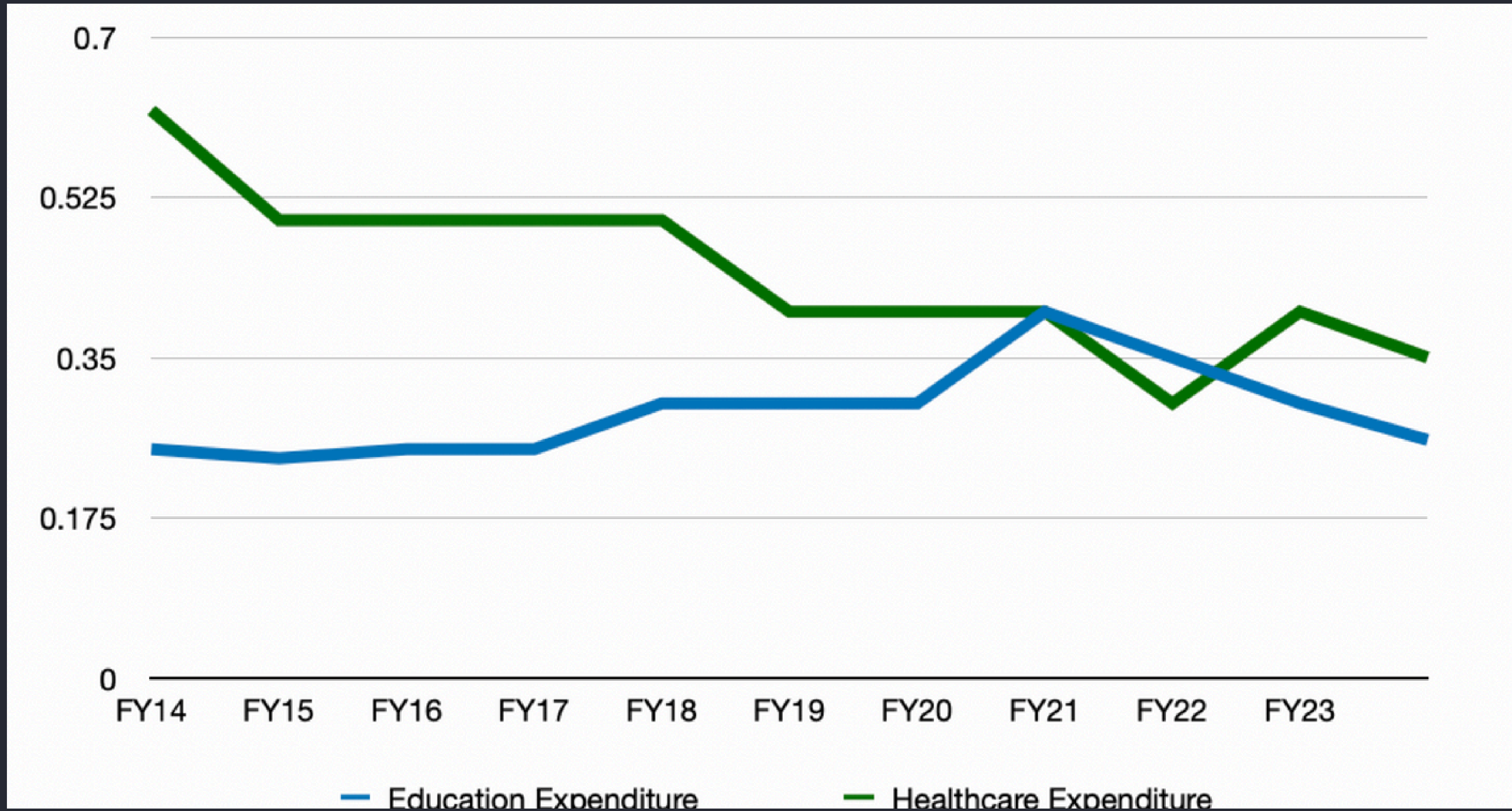

Figure 3: India's Budget Outlays for Education and Health

- Thus, in order for India to transition out of a Middle-income trap, an institutional framework that supports its transition is imperative.
- The scatter plot shows a positive correlation between a country's GNI per capita (PPP) and its Democracy Index score. Higher-income countries (blue dots) tend to have higher democracy scores and GNI per capita, while lower-income countries (red dots) generally score lower on both metrics. Middle-income countries (green dots) are spread across the spectrum but lean closer to lower scores, suggesting that both higher income and stronger democratic institutions are often linked.

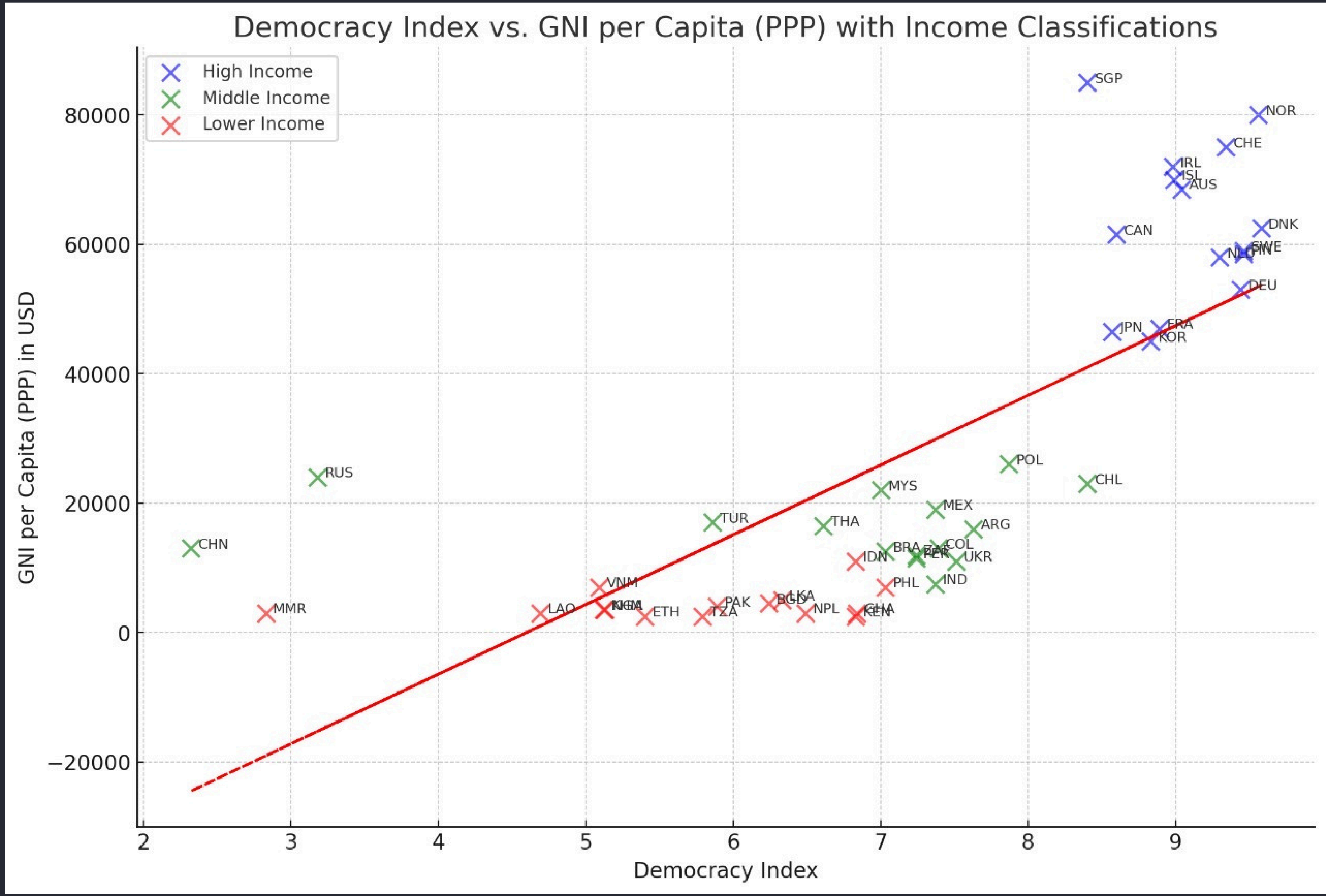

Figure 4

Persisting Challenges

Human Capital Deficiencies and Inequality

Low Levels of Education and Skills:

- India's workforce suffers from low levels of education and skills, hindering the country's ability to attract high-value industries crucial for sustained economic growth. Without significant investment in education and skill development, the country risks falling into the middle-income trap and unable to transition to a high-income economy.

Inadequate Healthcare and Infrastructure:

- Poor healthcare outcomes and outdated infrastructure in sectors like transportation and energy reduce workforce productivity and deter investment. These challenges increase the risk of India being trapped in the middle-income bracket, stalling progress toward becoming a high-income nation.

Rising Inequality:

- India's wealth distribution is highly skewed, with the bottom 50% owning less than 3% of the wealth, while the top 10% control over 80%. This growing inequality, exacerbated by the pandemic, deepens poverty and fuels social unrest. Taxing the wealthiest could help fund essential public services, addressing poverty and inequality.

External Vulnerability and Global Factors

1. High Dependence on Exports and Economic Volatility:
    - India’s export is projected to grow by 13.84% in FY 2022-23, have been crucial for economic growth and financial stability. However, the growth in key sectors like Pharmaceuticals and Petroleum may be driven by volatile factors such as supply chain disruptions, raising concerns about the sustainability of this growth amid global uncertainties.
2. Lack of Competitiveness in the Global Market:
    - India's exports are dominated by low-to-mid value commodities like textiles and agricultural products, which limits its competitiveness compared to countries like Germany and Japan that focus on high-value industries. This lack of competitiveness is due to insufficient investment in R&D, low-skilled labour, and limited innovation.
3. Exposure to Global Financial Shocks:
    - India's economy is vulnerable to global financial shocks, as seen during the 2013 Taper Tantrum and the 2020 pandemic. These events led to significant capital outflows and currency depreciation, highlighting the interconnectedness of global economies and the risks associated with such exposure.

Low Global Value Chains and its issues

- India - low participation in global networks - Reason: Stagnant growth of its manufacturing sector, low ability to attract FDI in manufacturing, low research and development
- Existing Global Value Chains (GVC) linkages of India are in low-value-added manufacturing tasks
    - India is a major exporter of ICT services but it carries out labour-intensive tasks like coding and body-shopping
- India can expand its share in GVC if it simplifies its customs and trade procedures and engages its MSMEs with global lead firms
- Increased participation in GVCs can lead to growth in the economy, higher productivity, job creation and an increase in the living standard of the people
    - According to the World Bank, a one per cent increase in GVC participation is estimated to boost the per capita income levels by more than one per cent
- The country can take advantage of its huge consumer market, and labour force and implement investor-friendly government policies
- This can lead to a reduction in the trade deficit, and boost employment opportunities which will result in higher incomes.

- India’s GVC participation grew until 2008 to 47.6% but declined to 41.33% by 2018. GVC exports witnessed slower growth.
- In the 2000s, high and low-tech manufacturing and business services had similar shares in GVC exports
    - By 2019, high-tech manufacturing had increased - more than half of the GVC exports accounted for this
- India is not able to capitalize fully on the opportunities offered by the shift in GVCs. It can take advantage of the large number of MSMEs to increase linkages with lead firms to enhance exports
- MSMEs in India contribute around 30% to GDP and nearly 50% to the country’s exports. However, this has not helped in increasing the engagement with GVCs mainly due to weak innovation, lack of access to finance and limited linkages with lead firms.
- With the increase in investments in research and development, it will help in increasing its share in GVCs.

Insufficient Development of Manufacturing and High-Tech Sectors

- The FDI equity inflow in India decreased by 3.49% in FY24 to $44.42 billion from $46.03 billion in FY23 which showed a 22% decline in the year compared to FY22.

- The reduction in investments in sectors such as services, computer hardware and software, telecom, auto and pharma can be seen as the primary reason for the slump in FDI inflow.
- As per the RBI annual Report, India's manufacturing sector is also witnessing the lowest foreign direct investment (FDI) inflows in five years in the financial year 2024
  - The manufacturing sector received $9.3 billion FDI in FY24, 17.7% less than the $11.3 billion inflows in FY23. In FY22 the sector received $16.3 billion in FDI.
- The lacklustre FDI inflows shown in Figure 1 could be due to the red tape and scrapping of Bilateral Investment Treaties (BITs), which resulted in the lack of protection of foreign companies from the judicial proceedings of India.

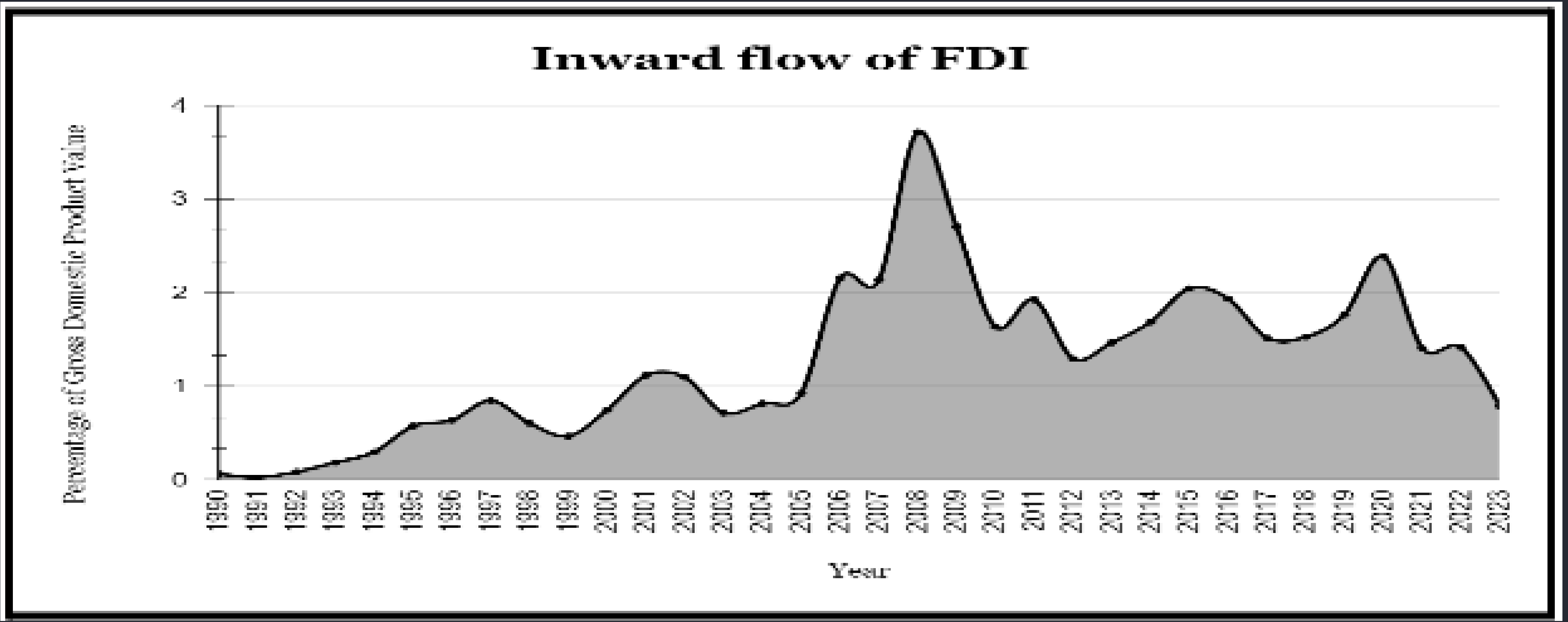

Figure 5: UNCTAD

Labour supply-demand mismatch

- India’s labour supply for high-skilled manufacturing and services like IT is minimal due to the issues of the education system and the lack of skill development which leads to a shortage of high-skilled workers who could have contributed to better economic conditions for the country
- The main reason that was given for the lack of employment opportunities in India is the nation’s stagnant manufacturing sector which has been more capital-intensive than labour-intensive which led to the reduction of mass employment opportunities
- According to the Centre for Monitoring the Indian Economy, the manufacturing workforce drastically declined from 51 million workers in 2017 to 27.3 million in 2021
- The lost manufacturing workforce shifted to the agriculture sector which added 11 million jobs in the past three years
- This happened when there was a need for a shift from agriculture to industry which could have increased the productivity and wages for the people.
- There is a need for increased investment in labour-intensive manufacturing which could be a solution to the rising unemployment that the country is facing at the moment.

For inputs, comments or clarifications please contact The Centre for New Economics Studies at cnes@jgu.edu.in