How Can India Escape the Middle-Income Trap?

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Is India transgressing in a regressive decline towards a middle-income trap?

Recently economists like Indermit Gill and Homi Kharas's work on the middle-income trap explore the stagnating growth trajectories of the East Asian economies followed by a period of rapid growth. Their core idea of 'policy misdiagnosis,' resulting from unsupportive political and economic structures in a country is one that deeply resonates with India's growth story.

Economists, including Barry Eichengreen, Indermit Gill and Ricardo Hausmann, explore the concept of a "middle-income trap," where countries struggle to transition from middle to high-income status.

Eichengreen highlights that to break free, countries need structural reforms, more innovation, and a focus on developing human capital. Hausmann emphasises economic diversification and strengthening institutions, while Gill focuses on the need to improve economic productivity.

Each of these ideas resonate with India's current macroeconomic challenges. Issues like stagnant economic (especially labour) productivity, rigid labour markets, and a need for greater innovation have held back the country in its growth trajectory. By tackling these, India has the potential to avoid getting stuck and instead move toward sustained and inclusive high-productive growth.

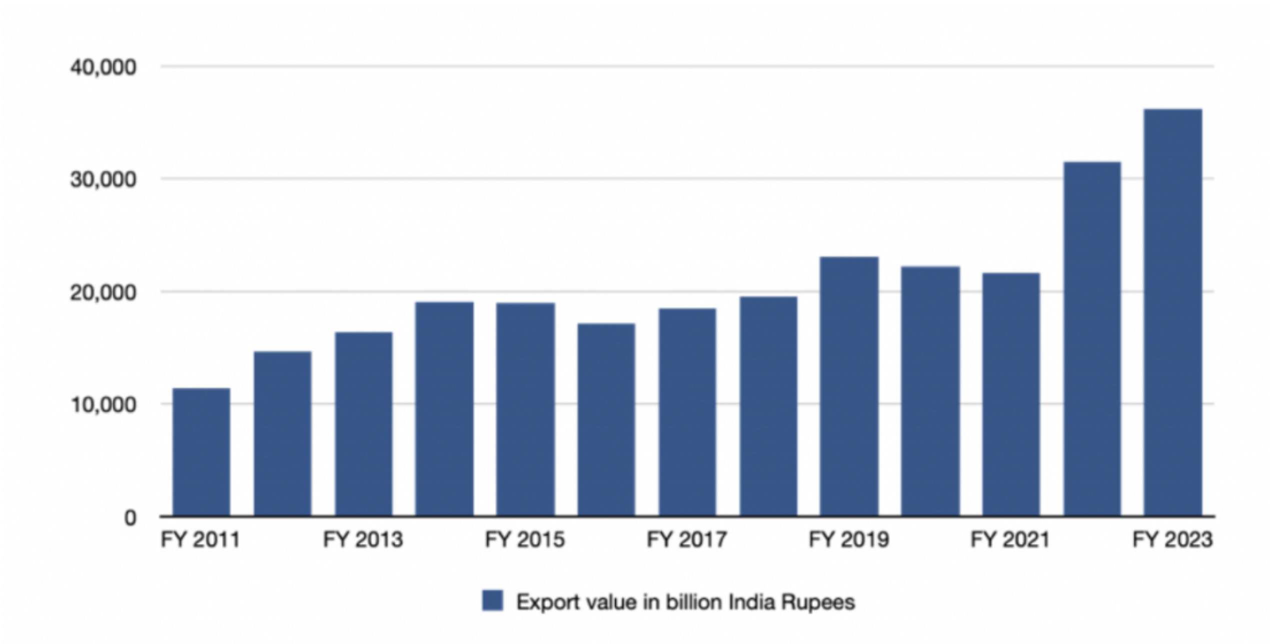
Structural reforms mean making it easier for businesses to operate by cutting red tape and improving infrastructure like roads, ports, and digital networks. This also means giving workers better opportunities by modernising labour laws and investing in education and skills.

Developing a more holistic environment for boosting innovation is also vital. Indian economy can't rely solely on cheap labour (largely unskilled and less educated) forever; it needs to boost investment in human capital development: from research, developing new labour-intensive technologies, and support start-ups to move into high-value industries employing new technological tools and clean energy.

Diversifying the economy further plays a pivotal role. Instead of relying heavily on a few industries, India should expand its footprint in areas like advanced manufacturing, services, and emerging tech sectors. Finally, strong institutions – transparent, stable, and efficient – are crucial. Reducing corruption, improving governance, and creating a business-friendly environment will attract investment and help India reach its true potential. By focusing on these areas, India can chart a path to long-term prosperity.

As a part of India's *Viksit Bharat* mission, India aspires to emerge as a global manufacturing hub, however, Raghuram Rajan, Rohit Lamba and others in their recent work have commented on India's export-led growth strategy, stating that export-led growth requires conducive institutional reform and a gradual pivot towards service-based export strategy (where India already has a comparative advantage both in terms of trade and employment generation).

Figure 1: India's exports data



Source: Ministry of Commerce and Industry

To sustain its export growth trajectory, India must enhance opportunities to optimise their manufacturing capabilities. In 2022-23, manufactured goods accounted for US $ 453 billion out of a total of US $ 762 billion. Furthermore, growth in formal employment can be credited to India's manufacturing-based approach. 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, conducive institutional schemes like PLI and Make in India are required for India to optimise the positive effects of its high exports.

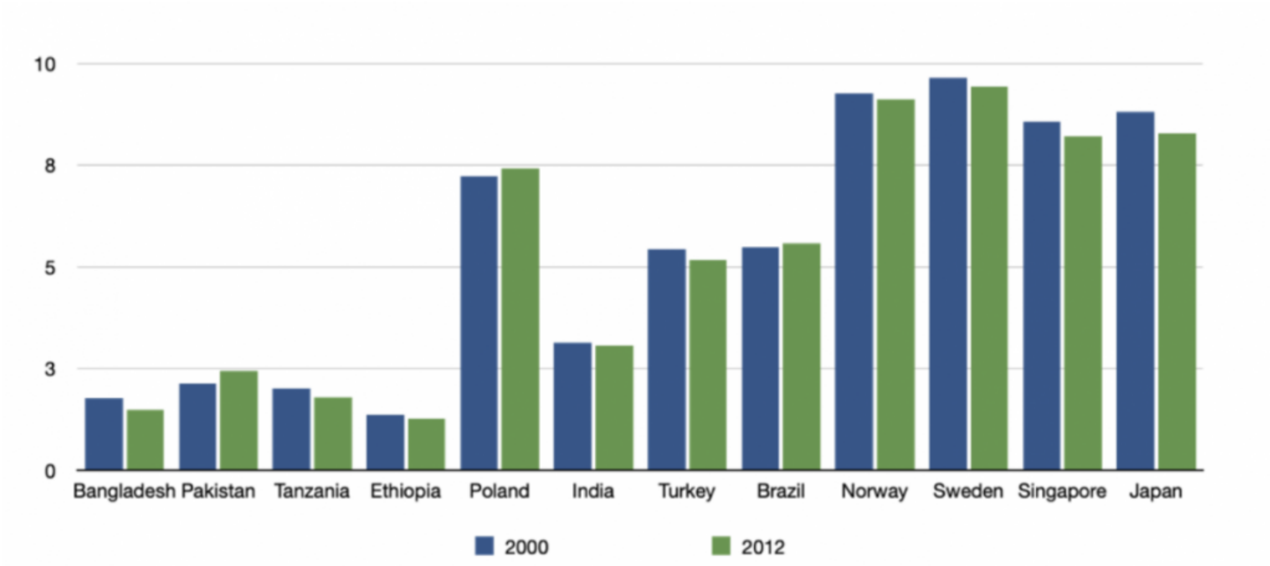
A stronger industrial policy that focuses on distributive growth benefits, by prioritising sectors like textiles and battery manufacturing, and by providing performance-based support for these industries can help them be at par with leading sectors in exports like pharmaceuticals, medical device manufacturing 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 business-to-government contact to ensure growth.

India's knowledge economy

Gill and Kharas's emphasis on 'knowledge economies' and how countries jump into this stage without ensuring that initial checks of structural and developmental changes are met, is noteworthy.

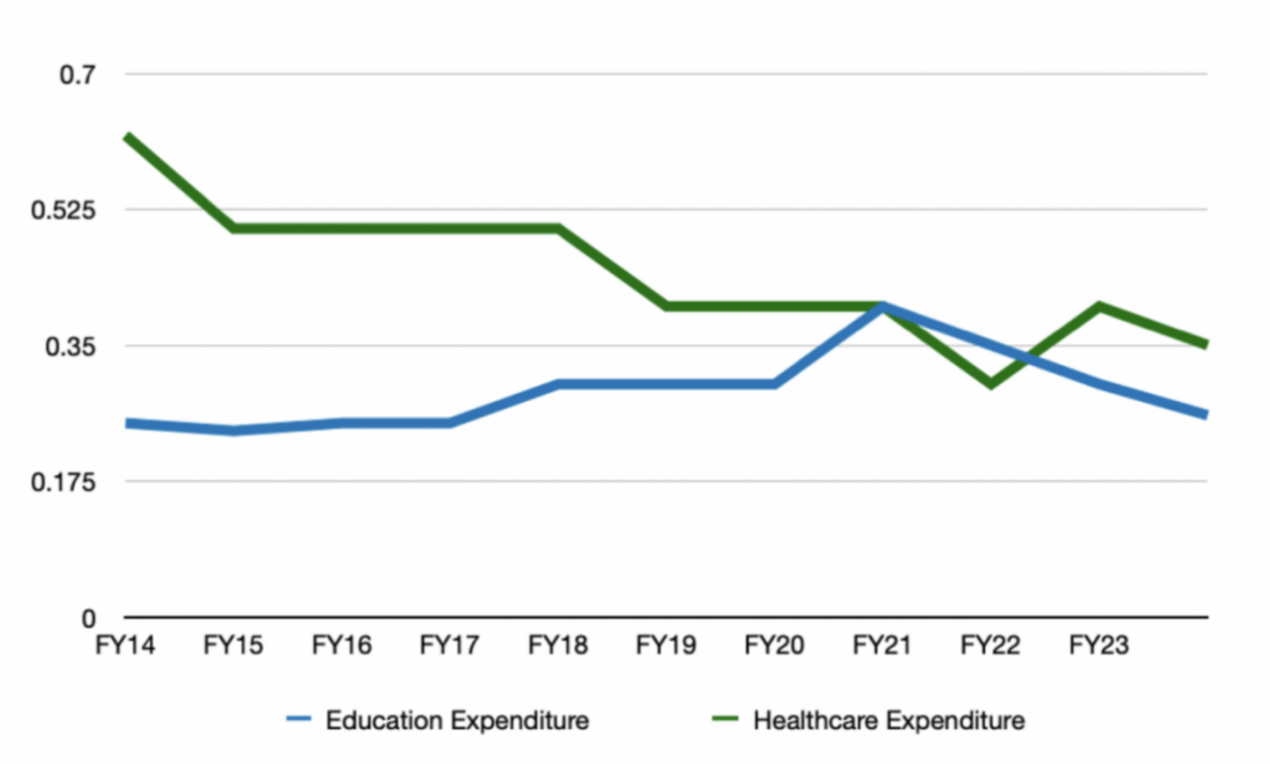
The Knowledge Economy Index Report measures a country's utilisation of its demographic dividend and knowledge economy. Here, India is at the 109th rank with a grade point of 3.06 on 10. To achieve this, India is expected to prioritise employment and skilling, development in the social sector and socioeconomic safeguards. One of the primary measures for this is India's Human Development Index which stands at 0.64, because of the declining importance given to educational and health sectors.

Figure 2



Source: KEI Report

Figure 3



Source: CMIE and Union Budget

Figure 3, paints a dismal image of India's declining health and educational budgetary expenditure. Health stands at 0.21% of the GDP in FY21 and education at 0.27% of the GDP in FY24.

Figure 4

This 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.

Interestingly, Figure 4 and Figure 2 show that high-earning and highly democratic countries like Norway, Singapore, and Sweden also figure higher on the KEI report. Sweden maintains a first rank in both the KEI reports. This emphasises the importance of prioritising development indicators in order to transition to a high-income economy.

Persisting challenges

India’s dream of becoming a global economic leader faces a significant hurdle and that is coming from a workforce with low levels of education and skills. This gap hampers the country’s ability to attract and retain high-value industries, essential for long-term growth and innovation. Without skilled talent, India risks getting stuck in the middle-income trap, struggling to move from a low-income to a high-income economy. To break free, India needs to invest heavily in education and skill development, ensuring its workforce is ready to compete on the global stage.

India’s path to becoming a high-income economy faces another major challenge: inadequate healthcare and infrastructure. Poor health outcomes drain workforce productivity, while outdated infrastructure in transportation, energy, and other sectors makes it hard to attract the kind of investment needed for sustained growth. These issues contribute to the risk of India getting stuck in the middle-income trap, where progress slows, and the leap to high-income status feels out of reach. Without immediate, bold reforms, India is on a path to economic stagnation, watching its competitors surge ahead while it remains bogged down by its failures.

India's rising inequality is alarming. According to the Oxfam report, 'Survival of the Richest: The India Story' the bottom 50% of the population owns less than 3% of the country's wealth, while the top 10% controls over 80%. With 228.9 million people living in poverty—the highest globally—India's number of billionaires surged from 102 in 2020 to 166 in 2022, their combined wealth reaching INR 54.12 lakh crore.

The pandemic and inflation have hit the poor hardest, deepening debt and worsening health outcomes. This growing disparity fuels social unrest, and political instability, and stifles demand for higher-quality goods and services. To tackle this, taxing the wealthiest 1% could generate the funds needed to improve essential public services like healthcare and education, which would help reduce poverty and inequality. But the real question is: do we have the political will and moral courage to take such a bold step? Without decisive leadership, these necessary reforms may remain elusive, leaving the gap between the rich and poor to widen even further.

On the economic front, India's limited integration into Global Value Chains (GVCs) is one of the major reasons it continues to struggle with the Middle-Income Trap (MIT). The country still focuses on low to mid-value exports like textiles and petroleum which limits its ability to climb up the value chain and achieve higher productivity. This situation reflects a broader issue: the insufficient development of manufacturing and high-tech sectors.

While other nations excel in high-value industries, India's manufacturing and tech sectors haven't reached the level needed to drive significant economic advancement. There is a need to create more trade-related jobs so that the country integrates itself into the global value chains that could help in creating opportunities for innovation and productivity growth. All this could help in escaping the middle-income trap that the country is facing now.

On top of that, India's lack of competitiveness in global markets is glaring. Countries like Germany, South Korea, and Japan are racing ahead by exporting high-value goods, while India is left behind with products that just don't offer the same growth potential. The absence of substantial investment in research and development and the persistent skill gaps in the workforce show that India isn't doing enough to foster innovation. To escape the middle-income trap, India needs to focus on investing in education and skill development to create more high-productivity jobs and economic growth.

In addition to these challenges, structural weaknesses in India further entrench the middle income trap. Outdated infrastructure, such as inefficient transportation networks and unreliable utilities, severely hampers business operations and limits economic productivity. Inefficiencies within public institutions also delay crucial reforms and affect resource management. These problems make it even harder for India to advance up the value chain.

Addressing these structural deficiencies, while also boosting innovation and enhancing integration into GVCs, is essential. Investing in research and development, closing skill gaps, and supporting the growth of high-tech industries are critical steps toward economic advancement. By tackling these issues head-on and making strategic changes, India can move closer to escaping the middle-income trap and achieving its fuller economic potential.

With research inputs from Ankur Singh, Bhanavi Bahl, Niharika Amte and Theresa Jose.

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Read the analysis by data researchers of the Centre for New Economics Studies' InfoSphere team at O.P. Jindal Global University here and here.