



Breaking the Middle-Income Barrier

This editorial is based on "[Can India escape middle-income trap?](#)" which was published in The Hindu on 13/10/2024. The article brings into picture the challenges India faces in overcoming the middle-income trap, emphasizing slowing exports, rising protectionism, and premature deindustrialization. It highlights the need for investment, technology infusion, and domestic innovation to sustain growth and ensure inclusive economic progress.

For Prelims: [World Development Report 2024](#), [Middle-income trap](#), [Premature deindustrialization](#), [World Bank](#), [1991 liberalization](#), [K-shaped recovery](#), [Unified Payments Interface](#), [Production-Linked Incentive \(PLI\) scheme](#), [Total Factor Productivity](#), [IMF's World Economic Outlook](#), [National Logistics Policy](#), [International Solar Alliance](#).

For Mains: Middle Income Trap for India, Measures that can Help India to Overcome the Middle-income Trap.

The [World Development Report 2024](#) highlights the challenge of the "[middle-income trap](#)," where countries struggle to sustain growth as incomes rise. The report suggests a "**3i**" approach—**investment, global technology infusion, and domestic innovation**, to break this cycle. India faces unique difficulties due to **slowing exports, rising protectionism, and premature deindustrialization**.

Moreover, India's economic growth has not translated into **proportional wage increases**. This poses a significant challenge in **overcoming the middle-income trap**.

What is the Middle Income Trap?

- A **Middle Income Trap** occurs when a country that has successfully **moved from low-income to middle-income status gets "stuck"** and fails to transition to high-income status.
 - According to the [World Bank](#), this typically happens when a country reaches about **11% of US per capita income levels**.
 - At this point, countries find themselves in a challenging position: **they become too expensive to compete with low-wage economies in manufacturing exports**, yet lack the technological sophistication and innovation capabilities to compete with advanced economies.
- The trap manifests when **traditional growth drivers begin to lose their effectiveness**. Countries in this situation often face rising wages that **make labor-intensive exports less competitive**, while simultaneously struggling to develop the innovation and productivity levels needed for knowledge-based growth.
 - To escape this trap, the World Bank recommends a "**3i**" approach: **Investment in physical and human capital, Infusion of new global technologies, and fostering domestic Innovation capabilities**.
- The challenge is significant - over the last 34 years, **only 34 middle-income economies** (defined

as those with per capita incomes between **\$1,136 and \$13,845**) have successfully made the transition to high-income status, demonstrating **how difficult it is to break free from this economic plateau.**

How has India's Income Level Evolved Over Time?

- **1950s-1970s (Post-Independence Era):** India started with a per capita income of just ₹ 265 in 1950-51.
 - The **period saw slow growth at around 3.5%**. Agriculture dominated the economy. **Poverty rates** remained high at about **45%**.
 - The period was marked by **heavy state intervention, license raj, and emphasis on public sector enterprises.**
- **1980s-1990s (Pre & Early Liberalization):** Per capita income growth accelerated to **5.6% in the 1980s.**
 - The **1991 liberalization** marked a **pivotal shift**, opening up the economy. Services sector began its rise, surpassing agriculture's share in GDP.
 - The **middle class started expanding.** Foreign exchange reserves grew to **USD 5.8 billion in 1991.**
- **2000-2010 (High Growth Phase):** India achieved its **high growth phase with GDP growing at 8-9% annually.**
 - In terms of constant (1999-2000) prices, the **per capita income was Rs 16,173 in 2000-01 and rose to Rs 24,295 by 2007-08.**
 - The services sector became dominant. Software service exports increased from US \$0.50 million in 1990 to \$5.9 billion in 2000-01 to **23.6 billion dollars in 2005-06**
- **2010-2020 (Mixed Growth Phase):** Growth became more volatile but averaged 6-7%. Per capita income reached ₹1,08,645 (2019-20, constant prices).
 - Middle-class expanded significantly, with about 400 million people joining this segment.
 - However, inequality widened - the **top 1% owned 40.5% of national wealth by 2021.**
- **2020-Present (Post-Covid Recovery):** Despite Covid setback, India's GDP reached **\$3.75 trillion.**
 - **Per capita income recovered to ₹1,72,000 (2022-23).** However, **K-shaped recovery is evident.**
 - **Gig economy expanded with 7.7 million workers.** Digital payments hit a record with **Unified Payments Interface (UPI)** processed ₹80.8 lakh crore (\$964 billion) in April-July 2024, marking a 37% year-on-year increase.
 - Unemployment remains at **8.1% (CMIE, April 2024).**

Why Navigating the Middle Income Trap is Difficult for India?

- **Premature Deindustrialization:** India is experiencing **premature deindustrialization**, a phenomenon where the manufacturing sector's share in GDP and employment peaks at **lower levels of per capita income compared to early industrializers.**
 - The manufacturing's share in GDP has stagnated around **15-17%** for the past decade, **significantly below the targeted 25%.**
 - This trend is particularly concerning as it **limits the potential for productivity gains and technological spillovers** typically associated with a robust manufacturing sector.
 - The recent **Production-Linked Incentive (PLI) scheme**, while promising, has shown mixed results across sectors.
- **Services-Led Growth Model Limitations:** India's growth has been primarily driven by the services sector, which contributes over **50% to the country's GDP.**
 - While this has been a strength, it poses challenges for widespread job creation and inclusive growth.
 - The inability to create **mass employment in high-productivity sectors** limits the potential for rapid increases in per capita income, a crucial factor in escaping the middle income trap.
 - The recent report that the global technology spending growth rate has **dropped from 8.2% in 2022 to 4.4% in 2023** further highlights the vulnerabilities of this growth model.
- **Declining Total Factor Productivity Growth:** India's **Total Factor Productivity (TFP)** growth, a key indicator of economic efficiency and technological progress, has been declining.

- During the pandemic, the TFP for India declined by **2.9% in 2020** and marginally improved by **0.1% in 2021**.
- This decline indicates that India's recent growth has been **more input-driven rather than efficiency-driven**, a characteristic that typically hinders countries from escaping the middle income trap.
- The challenge is compounded by **India's low R&D expenditure**, which stands at **0.6-0.7% of GDP**, significantly below other emerging economies like **China (2.1%) and US (2.8%)**.
- **Informal Sector Dominance and Low Productivity:** India's economy is characterized by a large informal sector, **which accounts for about 90% of the workforce**.
 - This high level of informality leads to **low productivity and limited access to credit and technology**.
 - The Covid-19 pandemic exacerbated this issue, with the informal sector bearing the brunt of job losses.
 - The challenge of **formalizing the economy while ensuring job creation remains significant**, as evidenced by the **slow uptake of schemes like e-Shram portal**.
- **Demographic Dividend at Risk of Becoming a Burden:** While India's young population is often cited as an advantage, recent data suggests this **dividend might be at risk**.
 - Youth unemployment rate for those in the **15-29 years** age group rose to **10.2% in 2023-24**.
 - Furthermore, it is estimated that **only 2.3 % of the workforce** in India has undergone formal skill training.
 - The skill mismatch is evident in the IT sector, where studies have shown that **85% of the fresh engineering graduates are not immediately employable**.
 - This mismatch between education outcomes and industry requirements **could turn India's demographic dividend into a burden**, trapping a large portion of the population in low-productivity jobs.
- **Global Economic Headwinds:** India's path out of the middle income trap is complicated by a challenging global economic environment.
 - The **IMF's World Economic Outlook (October 2023)** projected global growth to slow from **3.5% in 2022 to 3% in 2023 and 2.9% in 2024**, citing factors like geopolitical tensions and monetary tightening.
 - India's export growth has been impacted, with merchandise exports contracted **9.3% to USD 34.7 billion in August 2024**.
 - These global headwinds make it **harder for India to rely on export-led growth strategies** that have historically helped countries escape the middle income trap.
- **Infrastructure and Logistics Bottlenecks:** Despite significant investments, India's infrastructure still lags behind many middle-income countries, hampering productivity and competitiveness.
 - The **World Bank's Logistics Performance Index 2023** ranked India **38th out of 139 countries**, indicating room for improvement.
 - While initiatives like the National Infrastructure Pipeline aim to invest ₹111 lakh crore in infrastructure by 2025, challenges persist in areas such as **power supply reliability, transportation efficiency, and digital connectivity**.
 - These infrastructure gaps **increase the cost of doing business, reduce efficiency, and make it harder for India to attract the high-value industries** necessary for transitioning to a high-income economy.

What Measures can Help India to Overcome the Middle-income Trap?

- **Boost Manufacturing Competitiveness through Targeted Industrial Policies:** India should refine and expand its **Production-Linked Incentive scheme**, which has shown promise in sectors like electronics and pharmaceuticals.
 - There is a need to extend the scheme to **new emerging sectors like green hydrogen and AI hardware**.
 - Simultaneously, focus on **reducing input costs for manufacturers by rationalizing import duties on key components and raw materials**.
 - Implement a time-bound plan to improve logistics efficiency, aiming to reduce **India's logistics costs from the current 14% of GDP to the global average of 8%**. The

recent [National Logistics Policy \(2022\)](#) provides a framework for this, but its execution needs to be accelerated with clear milestones and accountability measures.

- **Accelerate Digital Public Infrastructure and Skill Development:** Leverage India's digital public infrastructure, [India Stack](#), to create a **comprehensive digital skilling ecosystem**.
 - Expand the [Digital India initiative](#) to include a **national digital skills registry that matches skilled workers with job opportunities across sectors**.
 - Collaborate with industry leaders to develop and continuously update curriculum for emerging technologies.
 - This digital push should be complemented by modernizing traditional vocational training institutes **to align with Industry 4.0 requirements**.
- **Enhance R&D Spending and Foster Innovation Ecosystems:** Increase public R&D expenditure from the **current 0.7% of GDP to 2% by 2030**, with a focus on applied research in key sectors like **renewable energy, biotechnology, and advanced materials**.
 - Establish sector-specific innovation clusters across the country, modeled on successful examples like the **Bengaluru tech cluster**.
 - These clusters should **integrate academia, industry, and startups**, with the government providing shared infrastructure and regulatory sandboxes.
 - The recent success of India's space program, **particularly the [Chandrayaan-3 mission](#)**, demonstrates the country's innovative potential when resources are strategically allocated.
- **Innovation-Driven Manufacturing Policy:** Instead of competing with China on mass manufacturing, India could focus on **high-value specialized manufacturing**.
 - For instance, the PLI scheme's success in **mobile manufacturing** (attracting Apple) could be replicated in emerging sectors like **green hydrogen equipment or electric vehicles**.
 - Create specialized manufacturing zones with plug-and-play infrastructure and R&D facilities, similar to **Taiwan's Hsinchu Science Park**.
 - Focus on **developing complete manufacturing ecosystems rather than isolated units** - for example, not just solar panels but the entire solar value chain from **polysilicon to recycling**.
- **Skills-Education Integration Framework:** Transform education by integrating industry requirements directly into curriculum design.
 - Create a **national digital skills platform** that tracks real-time industry demands.
 - Implement mandatory industry internships from high school onwards, similar to **Germany's dual education system**.
 - Establish **sector-specific centers of excellence in tier-2/3 cities**, like the **upcoming [semiconductor fabrication facility in Gujarat](#)**.
 - Link **education funding to employment outcomes** to ensure practical skill development.
- **Green Technology Leadership:** Position India as a global leader in climate solutions. Scale the [International Solar Alliance](#) model to create similar alliances for **green hydrogen and battery technology**.
 - Create a national carbon market with international linkages, similar to the **EU's emissions trading system**.
 - Implement **green SEZs where only zero-emission industries** are allowed, with special incentives for green tech innovation. Use India's G20 presidency momentum to establish **global green technology standards that align with Indian capabilities, enhancing India's domestic economy**.
- **Reform Market Regulations:** India should focus on liberalizing product and factor markets to encourage competition and reduce inefficiencies.
 - Overcoming regulatory constraints, **especially those related to small and medium enterprises (SMEs)**, will enable the growth of high-potential firms, while removing subsidies that promote inefficiency and lack of competition.
 - **South Korea's model can be a lesson for India**, showing the importance of state neutrality and merit-based support for businesses, **letting underperformers fail**.
 - Strong business houses can drive growth by investing in innovation and new technologies, as seen with South Korea's chaebols, now global leaders in innovation.

Conclusion:

India's journey to escape the middle-income trap will require a **strategic focus on boosting manufacturing, fostering innovation, and addressing productivity challenges**. Leveraging digital infrastructure, enhancing skills, and embracing green technologies are critical steps to ensure sustainable growth. By executing **targeted policies effectively, India can transition to a high-income economy while maintaining**.

Drishti Mains Question:

India is at risk of falling into the middle-income trap amidst global economic headwinds. Discuss the key factors contributing to this risk and suggest a strategic roadmap for India to overcome it and transition to a high-income economy.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims

Q. With reference to 'IFC Masala Bonds', sometimes seen in the news, which of the statements given below is/ are correct? (2016)

1. The International Finance Corporation, which offers these bonds, is an arm of the World Bank.
2. They are the rupee-denominated bonds and are a source of debt financing for the public and private sector.

Select the correct answer using the code given below:

- (a) 1 only
- (b) 2 only
- (c) Both 1 and 2
- (d) Neither 1 nor 2

Ans: (c)

Q. India's ranking in the 'Ease of Doing Business Index' is sometimes seen in the news. Which of the following has declared that ranking? (2016)

- (a) Organization for Economic Cooperation and Development (OECD)
- (b) World Economic Forum
- (c) World Bank
- (d) World Trade Organization (WTO)

Ans: (c)

