



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)

