Can India escape middle-income trap?

How does the World Bank define the threshold for middle-income economies? Why is state intervention considered crucial for breaking the middle-income trap? What lessons can be drawn from South Korea and Chile? What challenges does India face in balancing state intervention with democratic values?

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RAHUL MENON

The World Development Report 2024 — authored by the World Bank — calls attention to the phenomenon of the "middle-income" trap, or the slowing down of growth rates as incomes increase. The World Bank estimates a stagnation of income per capita when economies reach a level of per capita incomes 11% of that of the U.S., hindering their journey to high-income status. Over the last 34 years, only 34 middle-income economies — defined as economies with per capita incomes between $1,136 and $13,845 — have transitioned to higher income levels.

The WDR details the policies and strategies necessary to break out of the trap based on the development experiences of those countries that did manage the transition. It highlights the importance of the "3i" approach: investment, infusion, and innovation. Economies must invest, ensure the infusion of new global technologies, and develop an environment conducive to domestic innovation. This is no easy task and requires nimble and responsive state policy. In the modern economy, there are plenty of headwinds that India must overcome to successfully navigate the middle-income trap.

Role of the state

Most countries that broke the trap were part of the European Union which facilitated growth and mobility of capital and labour for its members. Such institutions that aid free factor mobility are not available for most countries, for whom capital inflows are liberalised — largely flowing into their economies — with restrictions on the movement of labour. An important non-European country that managed to escape the trap is South Korea.

The South Korean state was heavily interventionist, often directing the private sector's activities and ensuring their participation in an export-driven growth model. Successful companies were rewarded with access to new technologies and other supportive measures, while firms that did not perform were allowed to fail. This was no pure free market, but one where a powerful state intervened to bring about developmental goals, disciplining local elites and ensuring they followed the dictates of the state's economic plan.

Another economy that broke the middle-income trap was Chile. But it too, saw state intervention in ensuring the success of natural resource exporting sectors. The salmon industry, for instance, succeeded in Chile due to the targeted intervention of the state on multiple fronts to ensure that the industry flourished.

The South Korean government's approach carries significant lessons for India today. The state must be seen as being neutral amongst private players and ensuring those who do not make the mark are allowed to fail. The benefits firms receive from the state must be based on their performance instead of closeness to power. The presence of powerful business houses can promote growth provided they invest, ensure the adoption and infusion of new technologies, and innovate. South Korean business houses, or chaebols, are among the leaders in innovation today.

The pitfalls

South Korea's success was built on manufacturing exports; such a strategy is not possible in today's economic scenario. World export growth has slowed, with demand from large economies slowing down following the multiple shocks of the last few years. Several countries have seen a slow turn to protectionism. The employment losses in developed economies caused by free trade have made it more difficult for countries such as India to access foreign markets.

Moreover, several countries have been hit by what economist Dani Rodrik terms 'premature deindustrialisation'. Modern economies face a reduction in the income share of manufacturing at much lower levels of GDP compared to previous economies. Manufacturing is no longer an engine of growth for developing economies, and it remains to be seen whether the service sector is strong enough to break the trap.

Challenges facing India

The power of billionaires in the Indian economy has increased, and they are seen as being close to the state, with the state unable — or unwilling — to ensure high rates of investment from domestic capital. The manufacturing sector has stagnated, and there has been a reversal of the process of structural transformation, with employment increasing in agriculture and in low-productive forms following the pandemic.

The growth of the aggregate economy is not being reflected on the ground. While the government estimates a real GDP growth of around 7% in recent years, wages have not kept up. According to the PLFS, nominal wages for regular wage workers at the all-India level between April and June 2023-24 has only grown at around 5%, and that of casual workers at roughly 7%. With an inflation rate of roughly 5% during this time, this implies that wage earners have seen little to no real wage growth. An economy cannot break a middle-income trap if workers are unable to partake in the growth process, as reduced consumption demand will become a drag on the economy.

Most importantly, the question of democracy looms large. South Korea's export strategy was overseen by a military government that ruled till the 1980s. The government frequently quelled labour unions to aid the accumulation process of capital. Chile deposed the democratically elected government of Salvador Allende by a military coup, installing General Augusto Pinochet as the head of state. It is vital not to take the wrong lessons from these countries, and think that democracy is an acceptable price to pay for higher growth. The challenge for policy is to promote state intervention to ensure growth while maintaining the sanctity of the democratic ethos.

Rahul Menon is Associate Professor in the Jindal School of Government and Public Policy at O.P. Jindal Global University

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