Why manufacturing has lagged in India

India's manufacturing sector underperforms compared to China and South Korea, partly due to public sector wages that raise costs and reduce competitiveness; despite growth in private industries like software and services, India sees limited technological upgrading, uneven wage growth, and increasing inequality

Published - December 24, 2025 10:54 pm IST

RAHUL MENON

For representative purposes. | Photo Credit: Getty Images

A reason why India has lagged behind certain non-Western economies — such as China and South Korea — despite starting from roughly equivalent positions early in the 20th century is the relative underperformance of its manufacturing sector. While China and South Korea have seen significant increases in manufacturing, the share of manufacturing in India's GDP has remained relatively constant over time and has recently lost ground to services.

In a recent discussion of his book *A Sixth of Humanity*, economist Arvind Subramanian explained why India has been unable to industrialise to the extent of China or South Korea. In his view, high government salaries drew workers away from manufacturing, raising prices and making it difficult for the sector to remain competitive, thus hindering its expansion. Mr. Subramanian used a theoretical framework known as the 'Dutch disease' to examine this outcome.

What is the Dutch disease?

The Dutch disease refers to a phenomenon where an economic windfall can often translate into negative outcomes in other sectors, such as manufacturing. It was initially coined to explain how the discovery of the Groningen gas fields in 1959 affected Dutch manufacturing.

The theory goes as follows: imagine an economy where a substantial holding of some natural resource — such as oil or another important mineral — is discovered. This would lead to a rise in wages as the sector bids away labour from other sectors, raising the economy-wide wage rate. Moreover, exports of the resource would lead to an appreciation of the currency, increasing imports and decreasing other price-sensitive exports. These effects would hurt domestic manufacturing, which would be outcompeted by cheap imports from abroad and, at the same time, become relatively expensive in foreign markets.

But how would the Dutch disease apply to non-tradeable goods, such as government services? Suppose an economy expands its government sector and sets high wages for its workers. Manufacturing would then find it hard to meet these wages at its given level of productivity. Increased demand from government employees — due to higher incomes — would raise prices of domestic goods. Under a regime of free trade, this would boost demand for cheaper imports, reducing demand for domestically manufactured goods even if the nominal exchange rate does not change. The real exchange rate would appreciate due to higher domestic prices.

The Dutch disease model can be used to outline such a process in which the expansion of one sector leads to reduced outcomes for other sectors through price movements. In this model, the Indian State's policy choices to raise salaries in the public sector negatively affected manufacturing and can be seen as one of the reasons why the process of structural transformation in India has stagnated.

Question of technology

One problem is that the framework was initially used to analyse the effects of a windfall discovery, not the effects of policy. The relatively higher salaries cannot easily be compared to the discovery of an oil field, because one is a conscious political decision undertaken by a democratically elected government, while the other is a natural endowment.

One could argue that while the nature of the economies — one with a strong public sector and one with a natural resource endowment — is drastically different, the effects are the same and operate through the same channel of a real exchange rate appreciation. But turning the question around offers another way to view the problem. If high government salaries were initially a problem, why did technological growth not occur over the long run to make manufacturing more productive to sustain higher wages?

The theory of 'induced innovation' holds that labour scarcity and high wages can induce technological and capital-biased growth. The economist Sir John Habakkuk hypothesised that 19th-century Britain grew faster than the U.S. because of its relative scarcity of land and labour. Economic historian Robert C. Allen states that Britain's high wages ensured the need for technological innovation, which led to the Industrial Revolution occurring there rather than on the continent. In more contemporary times, Nobel laureate Daron Acemoglu used this to explain why automation led to faster productivity and wage growth in economies like Germany, Japan and South Korea — with an ageing labour force — while automation restricts wages in countries like the U.S., with a larger labour force.

Limits of wages

An analysis of India's development story must focus on the nature of technological change and on why the private sector growth has not translated into rising wages. The question is stark in India's fast-growing services and software industries. Entry-level salaries at major Indian software giants have shown little growth since the 2000s, despite the retreat of the State, the proliferation of markets and the rise of private sector billionaires.

A case can be made that India's modern software unicorns — such as Swiggy, Zomato, Blinkit and Ola — rely on India's abundant labour reserves rather than representing genuine technological upgradation.

The Indian private sector has undoubtedly shown significant levels of dynamism and growth. But this growth has been lop-sided, as the rapid increase in inequality has shown us. If public sector salaries kept wages higher earlier, it is legitimate to ask why manufacturing has not responded with an adequate level of technological change to ensure productivity growth. Did government intervention prevent the ability to adopt new technology? Or did manufacturing become addicted to the reserves of cheap labour and not invest in technological upgradation, leading to a relative stagnation over time?

Rahul Menon is associate professor at O.P. Jindal Global University

Published – December 24, 2025 10:54 pm IST

In Case You Missed It

Post Hiroshima: Disquieting accounts of nuclear modernity

With 7 lakh units monthly production capacity, India becomes Samsonite's biggest...

How Indian States are following a pro-incumbency trend

Success of LVM-3 mission reinforces India's growing role in global commercial...

Implications of the Vande Mataram discourse

CBI to move Supreme Court challenging suspension of Kuldeep Sengar's life sentence...

India expresses concern over demolition of Hindu deity's statue in...

Trump-backed candidate Nasry Asfura declared winner of Honduras' presidenti...