

Stagnant Manufacturing in India: The Role of TFP and Trade

Executive Summary

Manufacturing has historically been central to economic development, yet many developing countries today face stagnation or even decline, particularly in terms of the labor share of this sector. India exemplifies this challenge: while its services sector has expanded rapidly, manufacturing has remained stagnant at about 10-12% of the labor share for the last 4-5 decades. This study develops and calibrates a three-country, three-sector open economy general equilibrium model—including income effects, asymmetric productivity (TFP) growth, and trade—to investigate India’s structural transformation. Through counterfactual experiments, the analysis shows that India’s sluggish manufacturing performance is primarily the result of weak productivity growth in the sector. Trade has provided some compensation, but faster TFP growth in services has skewed the transformation toward services, bypassing the traditional manufacturing-led pathway. Strikingly, even if India’s TFP growth had matched China’s, the model suggests only limited structural divergence between the two economies, underscoring the depth of the challenge. The findings highlight three core insights. First, TFP growth is the most critical driver of structural transformation and manufacturing competitiveness. Second, while trade can support growth, its benefits are constrained in the absence of robust productivity improvements. Third, India’s shift away from agriculture directly into services risks missing the developmental benefits of manufacturing, including large-scale employment absorption and productivity convergence. Drawing lessons from China and South Korea, the paper argues that India must complement productivity-enhancing reforms with export-led industrial policies, including deeper trade partnerships and a stronger focus on producing export-oriented goods. At the same time, limitations of the study—such as its static framework and omission of capital accumulation—point to the need for future research using dynamic models that capture investment, technology adoption, and firm-level heterogeneity.