

The Political Economy of Inclusion: How Institutional Barriers Deflect the Benefits of Economic Expansion in India

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Abstract:

India's post-1991 economic expansion has generated sustained GDP growth and substantial poverty reduction, but its benefits remain unevenly distributed. This paper examines how institutional barriers in labour, credit, land, human capital, and regulatory systems limit inclusive participation in growth. Using institutional economics, resource-misallocation theory, and dual-economy frameworks, the study employs a non-econometric analysis of official statistics, World Bank data, World Inequality Lab estimates, and peer-reviewed evidence. The findings indicate a persistent gap between output and employment transformation, with services contributing 54.7 per cent of GVA while over 45 per cent of workers remain in agriculture. High income and wealth concentration further indicate unequal access to economic opportunities. These institutional constraints misallocate labour, capital, and entrepreneurial talent, reducing productivity and employment intensity. The paper argues that inclusive institutional reforms can simultaneously improve efficiency, productivity, and income distribution. Strengthening financial access, labour formalization, human capital, land markets, and state capacity is therefore essential for achieving broad-based and sustainable economic growth in India.

Keywords: Inclusive growth; institutional barriers; resource misallocation; inequality; employment; productivity; India

Introduction

Economic expansion does not automatically translate into widespread improvements in living standards, productive opportunities, or economic mobility. Institutional economics emphasizes that the rules governing property rights, contracts, market entry, credit, labour relations, and access to productive assets influence both the level and distribution of economic activity (North, 1990; Acemoglu & Robinson, 2012). Institutions that permit broad participation allow individuals and firms to allocate labour, capital, entrepreneurship, and land toward their most productive uses. Conversely, institutional barriers can generate rents for incumbent groups while preventing potentially productive workers and entrepreneurs from entering higher-return activities.

India provides a particularly important setting in which to examine this relationship. Since the economic reforms initiated in 1991, India has moved from a relatively closed, heavily regulated economy toward a substantially more market-oriented and globally integrated growth model. The World Bank's national

accounts series records real GDP growth of 5.5 per cent in 1990 and an extended sequence of relatively high growth rates after liberalization, including 8.3 per cent in 2016, 7.6 per cent in 2022, and 6.5 per cent in 2024. India's GDP reached approximately US\$3.91 trillion in current prices in 2024, while GDP per capita reached approximately US\$2,695.

The aggregate expansion has generated substantial improvements in absolute living standards. The World Bank estimates that the share of India's population living below the \$3.00-per-day poverty line in 2021 purchasing-power-parity terms was 5.3 per cent in 2022. These gains demonstrate that economic growth has been consequential and cannot be characterized simply as an expansion benefiting only a narrow elite. The central issue, therefore, is not whether growth has occurred, but how effectively the institutional structure of the economy transmits the gains from growth across workers, entrepreneurs, regions, and social groups.

Recent distributional evidence provides a particularly important qualification to the aggregate growth story. The World Inequality Report 2026 estimates that in India the top 10 per cent received 57.7 per cent of national income, while the bottom 50 per cent received 15.0 per cent. The concentration of wealth is substantially greater: the top 10 per cent held approximately 65.0 per cent of total wealth, compared with only 6.4 per cent held by the bottom half of the population. The top 1 per cent alone accounted for 22.6 per cent of national income and approximately 40.1 per cent of wealth.

These estimates should not be interpreted as evidence that all gains from growth have been captured by high-income groups. Rather, they indicate that the transmission of aggregate growth into broadly distributed economic resources has been highly unequal. The distinction is important because poverty reduction and inequality can move simultaneously: absolute incomes may rise for lower-income households while their share of national income and wealth declines.

Labour-market evidence reinforces this distinction. According to the Economic Survey 2023–24, India's workforce was estimated at approximately 56.5 crore, with more than 45 per cent employed in agriculture, 11.4 per cent in manufacturing, 28.9 per cent in services, and 13.0 per cent in construction. This structure is striking when compared with the composition of output: services alone accounted for 54.7 per cent of GVA at current prices in FY2023–24. The contrast illustrates the persistence of India's structural dualism: a relatively high-productivity modern economy coexists with a very large workforce concentrated in lower-productivity activities.

Labour-market participation has improved in recent years, but the composition of employment remains important. PLFS 2023–24 data show that self-employment accounted for 64.7 per cent of rural employment among persons in usual status, with regular wage or salaried employment accounting for only 12.7 per cent and casual labour 22.5 per cent. These figures suggest that rising employment cannot automatically be equated with the creation of secure, high-productivity wage employment.

This paper therefore examines the institutional mechanisms through which economic expansion can become disconnected from broad-based productivity and income gains. The focus is strictly economic. Social and political dimensions are considered only insofar as they affect economic institutions, incentives, factor allocation, productivity, and market outcomes.

The central argument is that India's distributional problem is partly a problem of institutional allocation. Where access to productive assets, credit, education, formal employment, land, and markets depends heavily on inherited economic or social position, the economy fails to allocate resources according to

productivity alone. Growth consequently occurs, but at a lower level of potential aggregate productivity and with weaker employment transmission.

Theoretical Framework: Institutions, Misallocation, and Inclusive Growth

Standard neoclassical growth theory often treats institutions as background conditions. Institutional economics instead places institutions at the centre of economic performance. Property rights, contract enforcement, market-entry rules, financial institutions, labour regulations, and public-service capacity influence the incentives and constraints facing households and firms (North, 1990).

Acemoglu and Robinson (2012) distinguish broadly between inclusive and extractive institutions. Inclusive institutions provide relatively broad access to economic opportunities, while extractive institutions allow economic rents and productive opportunities to be concentrated among relatively narrow groups. The distinction is useful in the Indian context not because India can be classified categorically as either inclusive or extractive, but because individual markets can contain varying degrees of institutional inclusion.

Methodology

Methodology is deliberately designed as a non-econometric, secondary-data institutional analysis because the objective is to identify economic mechanisms rather than estimate a new causal coefficient.

First, the paper employs a comparative descriptive approach using official Indian macroeconomic and labour-market statistics to establish the divergence between aggregate growth, sectoral output, and employment structures.

Second, it uses distributional estimates from the World Inequality Lab to examine the concentration of income and wealth and to assess whether the gains from expansion have been broadly distributed across population groups.

Resource misallocation:

The most direct economic mechanism is resource misallocation. If capital, labour, land, or entrepreneurial talent cannot move toward their highest-productivity uses, aggregate output falls even when the total stock of resources remains unchanged.

Hsieh and Klenow (2009) demonstrate the importance of this mechanism in manufacturing, showing that distortions affecting firm-level capital and labour allocation can generate substantial aggregate total factor productivity losses in developing economies. Their framework provides a useful foundation for analysing Indian institutional barriers because restrictions on credit, labour mobility, land transactions, or market entry can be interpreted as wedges between private returns and social productivity.

Caste-linked credit constraints provide a particularly direct Indian example. An empirical study by Raj and Sasidharan (2018), using the Fourth All India Census of Micro, Small and Medium Enterprises, finds that firms owned by socially disadvantaged groups had lower probabilities of obtaining formal credit even after controlling for creditworthiness and other observable factors. More recent work finds a more nuanced pattern: marginalized-caste entrepreneurs may be more likely to obtain formal credit on the extensive margin but receive significantly smaller loan amounts conditional on access.

The distinction between access and loan intensity is economically important. A firm that receives a small loan but cannot finance machinery, inventory, technology, or expansion remains financially constrained.

Thus, financial inclusion measured only by the probability of receiving any credit may substantially overstate effective financial inclusion.

A recent study in the Journal of Monetary Economics provides especially strong evidence for the productivity channel. It finds that historically disadvantaged-caste entrepreneurs have higher average revenue products of capital than high-caste enterprises, with much of the difference explained by unequal access to credit. Its quantitative model estimates that these asymmetries reduce output per capita by approximately 5.6 per cent. This is precisely the type of institutional misallocation emphasized in the theoretical framework.

Dual-economy dynamics:

The second mechanism arises from structural dualism. Lewis (1954) conceptualized development as a process through which surplus labour moves from traditional low-productivity activities into modern higher-productivity employment. In a successful structural transformation, labour moves toward sectors with higher marginal productivity and wages. India's experience has been different in important respects. The modern services sector has expanded rapidly, while agriculture continues to employ a disproportionately large share of workers. The Economic Survey 2023–24 reports that services represented 54.7 per cent of GVA, while agriculture employed more than 45 per cent of the workforce.

This divergence indicates that output transformation has proceeded more rapidly than employment transformation.

When workers cannot easily move from agriculture or informal activities into formal manufacturing and modern services, the productivity gap between sectors persists. Labour-market regulations, skill mismatches, inadequate urban infrastructure, housing constraints, gender barriers, transport costs, and weak social protection can all raise the effective cost of labour mobility.

The resulting equilibrium can produce strong aggregate GDP growth without proportionate growth in secure wage employment.

In equality and aggregate demand: A third mechanism concerns demand. Lower-income households typically have higher marginal propensities to consume than very high-income households. Consequently, when a large fraction of incremental income accrues to high-income groups, the domestic consumption multiplier associated with that income expansion may be weaker. This does not imply that inequality mechanically reduces growth in every circumstance. High-income households may save and invest more, and capital accumulation can support productivity. The economic issue is instead one of composition: when productive investment opportunities are insufficient, concentrated savings may not translate proportionately into broad domestic demand or employment. The Indian distributional data are relevant here. The World Inequality Report 2026 estimates that the top 10 per cent receive 57.7 per cent of national income, while the bottom 50 per cent receive only 15.0 per cent. Such concentration can weaken the expansion of mass consumption markets relative to an alternative distribution in which a greater share of incremental income accrues to households with higher propensities to consume.

Thus, inequality can create a feedback mechanism: concentrated income supports capital- and skill-intensive sectors, while weak mass demand limits the expansion of labour-intensive activities.

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India's Growth Experience and the Distribution of Gains

India's post-liberalization growth trajectory represents a major structural transformation. The World Bank's World Development Indicators show repeated periods of growth above 6 per cent after the reforms, although the trajectory has included significant cyclical fluctuations, including the COVID-19 contraction. Real GDP growth was 8.3 per cent in 2016, 7.6 per cent in 2022, and 6.5 per cent in 2024 in the World Bank series. The expansion has been increasingly service-oriented. According to the Economic Survey 2023–24, agriculture, industry, and services accounted for 17.7 per cent, 27.6 per cent, and 54.7 per cent of GVA respectively at current prices in FY2023–24.

This sectoral structure has important implications for inclusion. Services can generate substantial productivity and export earnings, but many high-productivity service activities require advanced education, digital skills, English-language proficiency, professional credentials, or urban access. Consequently, service-led growth can increase aggregate productivity without absorbing workers in proportion to their numbers. The employment structure demonstrates this challenge. The Economic Survey estimated that more than 45 per cent of the workforce remained in agriculture, compared with 11.4 per cent in manufacturing and 28.9 per cent in services. The persistence of such a large agricultural workforce alongside a service-dominated output structure indicates that structural transformation remains incomplete.

Recent PLFS evidence further illustrates the nature of employment. In rural India during 2023–24, 64.7 per cent of workers were self-employed, while regular wage or salaried employment accounted for 12.7 per cent and casual labour for 22.5 per cent. Self-employment should not automatically be interpreted as entrepreneurial success. It encompasses both high-return entrepreneurship and low-productivity own-account work undertaken because formal wage opportunities are limited. The distribution of national income and wealth presents a parallel picture. World Inequality Report 2026 estimates that the top 10 per cent received 57.7 per cent of national income and held 65.0 per cent of wealth, while the bottom 50 per cent received 15.0 per cent of income and held only 6.4 per cent of wealth.

The evidence therefore points to a central paradox: India has achieved substantial aggregate economic expansion while retaining a highly segmented structure of productive opportunity.

Institutional Barriers in the Indian Context

Labour-market dualism and regulatory rigidities

India's labour market has historically been segmented between a relatively small formal sector and a much larger informal sector. Formal workers benefit from greater employment protection and social security, while informal workers generally face greater income volatility and weaker institutional protection. Historically, complex labour regulations contributed to concerns about the cost of formal hiring and firm expansion. The consolidation of labour legislation into four labour codes represents an attempt to simplify the regulatory framework, but the economic effects depend heavily on implementation and state-level

enforcement. The central problem is therefore not regulation per se, but the structure of incentives. If formalization raises expected labour costs without providing sufficiently valuable productivity benefits, firms may remain small, informal, or capital-intensive. The result is a segmented equilibrium: large formal firms can adopt capital-intensive production techniques, while smaller informal firms absorb surplus labour under low-productivity conditions.

The employment data provide evidence of the scale of the problem. With more than 45 per cent of workers still in agriculture and substantial shares in self-employment and casual work, the economy has not completed the transition toward high-productivity formal employment.

Credit-market frictions and caste-linked distortions

Credit-market imperfections constitute one of the clearest channels through which institutions affect productivity. Entrepreneurs with profitable projects may lack collateral, credit histories, formal records, or established banking relationships. Social identity can compound these constraints. Raj and Sasidharan (2018), using the Fourth All India Census of MSMEs, find that disadvantaged-caste firms had lower probabilities of obtaining formal credit even after accounting for observable differences in creditworthiness. However, the newer evidence demonstrates that the mechanism is more nuanced. Kadam, Singh, and Chatterjee find that marginalized-caste entrepreneurs may be more likely to obtain formal credit but receive significantly smaller loan amounts conditional on access. This distinction suggests that financial inclusion should be measured not merely by whether an entrepreneur enters the formal credit system, but by whether the amount and terms of finance are sufficient to support productive investment. The productivity consequences can be substantial. Evidence from the Journal of Monetary Economics indicates that historically disadvantaged-caste firms have higher average revenue products of capital, with differences largely explained by credit access; the associated quantitative model estimates a 5.6 per cent reduction in output per capita from these credit-access asymmetries.

The implication is straightforward: if capital is rationed away from high-return entrepreneurs because of institutional constraints, the economy loses output even without losing any physical capital.

Land-market imperfections

Land is both a productive input and an important store of household wealth. Secure titles, efficient registration, transferable rights, transparent land acquisition, and functioning rental markets are therefore important components of structural transformation. Unclear titles and costly transactions increase the fixed cost of investment. For firms, this can delay industrial expansion and infrastructure development. For households, weak land markets can prevent the efficient transfer of land from low-productivity uses to higher-productivity users.

The economic consequence is a reduction in the mobility of both capital and labour. Workers may remain tied to rural activities because relocation requires housing, infrastructure, and employment opportunities, while firms may avoid investment because land assembly is uncertain or expensive.

Land-market reform should therefore be viewed as an efficiency reform rather than simply a property-rights issue.

Human-capital inequalities and intergenerational barriers

Human capital determines whether workers can enter the sectors generating the highest productivity gains.

India's service-led growth has increased demand for technical, professional, managerial, digital, and communication skills. However, access to high-quality education remains uneven across income groups and locations.

The economic consequence is cumulative. Children from low-income households are less likely to acquire high-quality skills; lower skill levels reduce access to high-productivity employment; lower earnings then restrict investment in the next generation's education.

This produces an intergenerational productivity trap.

Human-capital inequality therefore affects both distribution and growth. An economy that fails to develop the skills of a large part of its population operates with an artificially restricted effective labour supply.

Gender-related labour-market barriers

The underutilization of female labour is another major source of potential output loss.

The World Inequality Report 2026 estimates that women's share of total labour income in India was only 15.7 per cent. This is not simply a distributional statistic; it indicates substantial underutilization of productive capacity.

Constraints involving childcare, transport, workplace safety, occupational segregation, social norms, and the availability of suitable jobs can reduce women's labour-market participation.

From an efficiency perspective, the relevant issue is the gap between potential and realized labour supply. Increasing women's participation in productive employment can expand the effective workforce without requiring a proportional increase in the working-age population.

Regulatory and administrative capacity

Institutional quality also determines the transaction costs of economic activity.

Delays in obtaining approvals, enforcing contracts, resolving disputes, registering property, or accessing public services increase uncertainty and fixed costs. These costs are particularly important for small firms because compliance costs represent a larger share of their revenues.

Weak state capacity can therefore generate a size-dependent distortion: large firms can absorb administrative costs through scale, while smaller firms remain informal or fail to enter formal markets. India's federal structure further creates variation across states. Differences in infrastructure, judicial capacity, education, health, land administration, and regulatory implementation can produce large differences in the returns to private investment.

Consequently, aggregate national growth can coexist with substantial regional divergence in productivity and economic opportunity.

Legacy and persistence of institutional structures

Historical institutions influence current economic outcomes through path dependence. Colonial land, administrative, and legal institutions were designed partly around revenue extraction and administrative control rather than universal access to productive opportunity.

Post-independence India substantially transformed these structures through democratic governance, public investment, land reforms, affirmative action, financial expansion, and welfare institutions. Nevertheless,

institutional legacies can persist through property ownership patterns, administrative practices, social networks, and unequal state capacity.

The relevant economic concept is therefore not historical determinism but institutional persistence: earlier distributions of assets and capabilities influence current access to markets.

Efficiency Losses and Demand-Side Constraints

The institutional barriers identified above generate two major categories of economic costs.

Static and dynamic efficiency losses

Static efficiency losses arise when existing resources are allocated to less productive uses. A credit-constrained entrepreneur may operate below optimal scale; a skilled worker may remain in low-productivity employment; and land may remain in a low-return use because transactions are costly. Dynamic losses arise because today's allocation influences tomorrow's productive capacity. Children receiving poor-quality education become lower-skilled workers; informal firms unable to obtain investment finance remain small; and workers without social protection may be reluctant to migrate toward higher-productivity opportunities.

The result is a cumulative reduction in total factor productivity.

The caste-credit evidence illustrates the magnitude that such mechanisms can reach. The estimated 5.6 per cent reduction in output per capita associated with cross-caste credit-access asymmetries suggests that institutional distortions can have macroeconomic consequences rather than merely affecting individual households.

Demand-side constraints

The second mechanism operates through aggregate demand.

When incremental income is concentrated among households with relatively low marginal propensities to consume, the consumption response to economic expansion may be weaker than it would be under broader income gains. India's estimated distribution is relevant: the top 10 per cent receive 57.7 per cent of income while the bottom 50 per cent receive 15.0 per cent. This distribution can influence the composition of production. High-income consumers generate strong demand for premium goods, financial services, real estate, and skill-intensive services. Lower-income households generate relatively stronger demand for mass-market consumer goods and basic services. If mass purchasing power remains constrained, the domestic market may not generate sufficient demand to support large-scale labour-intensive industrialization.

Thus, distribution can affect not only who receives the benefits of growth but also what types of firms and technologies become profitable.

Empirical Synthesis

The empirical evidence considered in this paper is consistent with four interrelated patterns.

First, India has achieved sustained high aggregate growth. World Bank data show repeated periods of growth above 6 per cent in the post-reform period, with GDP growth of 6.5 per cent in 2024.

Second, output transformation has outpaced employment transformation. Services accounted for 54.7 per cent of GVA in FY2023–24, while more than 45 per cent of workers remained in agriculture.

Third, employment remains substantially self-employed and informal, particularly in rural areas. PLFS 2023–24 indicates that 64.7 per cent of rural workers were self-employed.

Fourth, income and wealth are highly concentrated. The World Inequality Report 2026 estimates that the top 10 per cent receive 57.7 per cent of income and own 65.0 per cent of wealth, while the bottom half receives 15.0 per cent of income and owns 6.4 per cent of wealth.

These patterns do not establish that institutional barriers are the sole causes of inequality. They do, however, fit the theoretical prediction that barriers to factor mobility, credit, human capital, and formalization can prevent aggregate productivity gains from being translated into broad-based economic opportunity.

Policy Implications from an Efficiency Perspective

The policy implications follow directly from the institutional mechanisms identified above.

Labour-market formalization: Labour-market reform should reduce the cost of formalization while simultaneously expanding social protection. The objective should not be simply to weaken employment regulation. Rather, policy should make formal employment attractive to both firms and workers. Portable social-security accounts, simplified compliance, predictable labour regulation, improved dispute resolution, and incentives for small firms to enter the formal sector can reduce the informal-formal divide.

Productive financial inclusion

Financial inclusion should move beyond account ownership toward productive credit.

Policy should improve credit information, collateral systems, digital financial records, and lending technologies capable of evaluating small firms without conventional collateral. The caste-credit evidence indicates that the size and terms of loans matter in addition to access itself.

Financial policy should therefore monitor lending outcomes by firm size, sector, location, and social group while preserving commercial incentives and minimizing politically directed lending.

Land-market reform: Land records should be digitized and regularly updated, property registration simplified, and land-leasing institutions strengthened.

Transparent acquisition procedures with fair compensation can reduce uncertainty for infrastructure and industrial investment.

A functioning land market can also facilitate labour mobility by allowing households to monetize rural assets and relocate toward higher-productivity employment.

Human-capital investment: Public education and health expenditure should be treated as productive investment. The objective should be to raise learning quality rather than merely increase enrolment. Early childhood development, foundational literacy and numeracy, teacher quality, vocational training, digital skills, and industry-linked technical education can improve the supply of workers capable of entering higher-productivity sectors.

Increasing women's productive participation: Policies that reduce the fixed costs of female employment can increase aggregate output. Affordable childcare, safe public transportation, flexible employment arrangements, skills programmes, and reduced occupational segregation can increase the effective supply of labour. The low female share of labour income indicates the scale of the unused productive potential.

Strengthening state capacity: Institutional inclusion ultimately depends on administrative capability. Better contract enforcement, faster courts, transparent land administration, predictable regulation, and reliable public services reduce transaction costs across the economy. Improving state capacity may therefore have a larger long-run growth effect than narrowly targeted subsidies because it changes the environment in which millions of private economic decisions are made.

Fiscal policy and distribution: Redistributive fiscal policy can complement institutional reform. Progressive taxation can finance investments in education, health, infrastructure, and social protection while reducing excessive concentration. However, redistribution alone cannot solve the underlying productivity problem. The primary objective should be to change the process through which income is generated: more workers should enter productive employment, more entrepreneurs should obtain productive capital, and more households should acquire the human capital required to participate in high-productivity sectors.

Conclusion

India's post-1991 experience demonstrates that rapid economic expansion and broad-based economic inclusion are related but distinct processes.

The country has achieved substantial growth, poverty reduction, global economic integration, and structural transformation. Yet the transmission of these gains remains constrained by institutional segmentation.

The evidence reveals a persistent mismatch between output and employment structures. Services accounted for more than half of GVA in FY2023–24, while agriculture continued to employ more than 45 per cent of the workforce. The distribution of income and wealth is also highly concentrated: the top 10 per cent receive 57.7 per cent of income and own 65.0 per cent of wealth, compared with 15.0 per cent of income and 6.4 per cent of wealth for the bottom half.

These outcomes should not be interpreted simply as failures of redistribution. They are also manifestations of resource-allocation problems.

Labour-market dualism prevents workers from moving rapidly toward higher-productivity employment. Credit constraints prevent some entrepreneurs from operating at efficient scale. Land-market imperfections increase transaction costs and delay structural transformation. Human-capital inequality restricts the supply of workers capable of accessing high-productivity activities. Gender barriers leave a substantial portion of potential labour underutilized. Weak administrative capacity increases the fixed costs of formalization and investment.

The evidence on caste and credit demonstrates particularly clearly why inclusion can be an efficiency issue. Where productive entrepreneurs face financing constraints because of institutional or social barriers, capital does not necessarily flow to its highest-return use. Recent empirical research suggests that such distortions can reduce aggregate output per capita by several percentage points. The policy implication is therefore broader than conventional redistribution. India's challenge is to construct institutions that permit a larger share of its population to participate directly in productivity growth. Inclusive institutions can increase the effective supply of skilled labour, improve capital allocation, facilitate structural transformation, expand domestic demand, and raise total factor productivity. The political economy of

inclusion is consequently also an economics of efficiency. For India, the next stage of development will depend not merely on maintaining high GDP growth, but on reducing the institutional barriers that determine who can acquire productive assets, who can enter high-productivity employment, who can obtain finance, and who can convert economic opportunity into sustained income growth. The fundamental development challenge is therefore to move from growth with unequal access to opportunity toward growth generated through broad-based access to productive opportunity.

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