Mexico Misallocated

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Economic growth in Mexico presents a puzzle. Mexico has followed many of the standard recommendations that are said to support economic growth. For example, it has prevented a recurrence of the inflationary fevers that used to grip Mexico every few years. Rates of national investment are up. Investment in education and human capital is up. Mexican workers have a high labor force participation rate. Mexico has signed international agreements to reduce trade barriers. It has done a reasonable amount of privatization and deregulation And the result of all these changes has been slow growth.

Santiago Levy describes this puzzle and offers his own answer in Under-Rewarded Efforts: The Elusive Quest for Prosperity in Mexico, published by the Inter-American Development Bank (July 2018). Here's Levy on Mexico's sluggish growth, which actually implies a negative rate of productivity growth in recent decades.

> From 1996 to 2015, the country's per capita GDP growth averaged only 1.2 percent per year. Moreover, this unimpressive figure arguably overestimates Mexico's performance, as it reflects the fact that because of the country's demographic transition, its labor force grew more rapidly than its population during these years (2.2 versus. 1.4 percent). In fact, GDP per worker grew on average by only 0.4 percent on an annual basis, far from what is required to create a prosperous country. ...

> Over the same two decades, accumulated per capita GDP growth in Mexico was 25.7 percent, less than every country in Latin America except Venezuela. ...Over the medium term, growth occurs because the labor force increases (in quantity and quality), because there is more investment in physical capital, and because the productivity of labor and capital (total factor productivity – TFP) increases. Decomposing Mexico's growth over this period into these three components, one finds that TFP growth averaged only 0.14 percent annually, without any corrections for the quality of the labor force. Considering increases in schooling (that is, taking into account that workers with more years of schooling can potentially contribute more to output than those with fewer years), yields a negative TFP growth rate of 0.53 percent. ... [T]he result is that Mexico's GDP growth has resulted only from the accumulation of physical capital and growth of the labor force. There have been no improvements in efficiency. Thus, by and large the question of why Mexico grows so slowly is equivalent to the question of why productivity has stagnated.

Why has Mexico's productivity growth been so poor? Levy looks for clues in data on the productivity of Mexico's firms. In a healthy and growing economy, one expects that average productivity of firms will rise. As part of that process, one expects that firms with higher productivity levels will tend to succeed and expand, while firms with lower productivity will either move to higher productivity, or they will contract and even sometimes go out of business.

Levy provides data that this expected process isn't happening. In looking at data on firms in

Mexico, For example, he points out that in Mexico in 2013 census data, informal firms were 90 percent of the total, "absorbed more than 40 percent of the capital stock and 55 percent of employment," and "constituted the majority in 51 percent of all six-digit sectors in manufacturing, 81 percent in commerce, and 88 percent in services." Levy writes:

> The comparison of the four censuses [from 1998 to 2013] shows that, contrary to what one would expect, the composition of economic activity shifted over time towards the informal sector, measured by the number of firms, the number of six-digit sectors where these firms are a majority, and the share of capital and labor absorbed by them. In parallel, the average size of formal firms increased, and they became more capital-intensive, but the average size of informal firms fell. The net result of all these trends was a fall in average firm size, and larger differences in capital intensity between formal and informal firms, within informal firms, and across firm sizes. In other words, heterogeneity increased across firm sizes and types. ...

> "[L]arge differences in firm productivity inside each six-digit sector ... widened over this 15-year period. There were more high-productivity firms in 2013 than in 1998. This is welcome news: a subset of Mexican firms over the last two decades have performed very well, which supports the image of a productive Mexico successfully competing in the international arena. But this is not the whole story. There were also more low-productivity firms in 2013 than in 1998. And the unwelcome news is that those firms attracted even more resources than the high-productivity ones. This result
> serves to make a key point: simply noting that over time there are more high-productivity firms, and that these firms are growing, is not enough to claim that things are moving in the right direction. One must also consider the left-tail of the productivity distribution, and when this is done, one finds the image of an unproductive Mexico, lagging other regions of the world. ...

> But the main finding, very worrisome to Mexico, is that this large firm churning failed to increase productivity. There are three inter-related problems:
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> - The exit process does not distinguish sufficiently between high- and low-productivity firms, so many low-productivity firms survive, and many high-productivity ones die.
> - There is little sorting of entering firms by productivity levels, so many low-productivity firms enter.
> - There is a bias in favor of the entry of new firms and against the growth of existing firms, even if the latter have higher productivity. ...

> What about firms that survived? Many changed size and type between 2008 and 2013. Surprisingly, changes from informal to formal status were almost equally offset by changes in the opposite direction. In parallel, more firms became smaller than larger. This suggests that, in the case of Mexico, the view that informal firms that survive in the market grow and formalize is mostly flawed. ... [S]urviving firms did not create any additional jobs—in fact, their employment fell. Instead, these firms grew by capital deepening. ...

> It is as if in Mexico the Schumpeterian process of creative destruction was countered by a parallel process of destructive creation. A vicious circle is present: misallocation induces dysfunctional firm dynamics, and dysfunctional firm dynamics serve to reproduce misallocation from one year to the next. As a result, on balance, the allocation of capital resulting from new investments, and the allocation of labor resulting from growth in the labor force, fail to increase aggregate productivity. ...

In a broad sense, these patterns suggest that Mexico is misallocating its economic resources. The interaction of competing firms in Mexico is not directing resources to areas of highest productivity and skill. Research into how long-lasting misallocations of resources can occur and persist are a lively current topis in economics. For an overview, see the article by Diego Restuccia and Richard Rogerson, "The Causes and Costs of Misallocation." in the Summer 2017 issue of the *Journal of Economic Perspectives*.

This process of what Levy calls "destructive" creation," with high-productivity firms exiting and low-prioductivtiy firms entering, isn't good for workers:

> The other side of the coin of large firm churning is large firm-induced job changes—as firms exit and enter, workers transit from job to job. ... [T]he exit of high-productivity firms caused the loss of high-productivity jobs, and the entry of low-productivity firms implied the creation of low-productivity jobs. As noted, no net jobs were created in surviving firms because these firms grew mostly by capital deepening. All in all, the census data reveal that between 2008 and 2013 job changes associated with firm churning were almost equally balanced between productivity-reducing and productivity- enhancing ones. Useless firm churning translated into useless job changes.

> [T]o the extent that the incentives to invest in education depend on the returns that are obtained from doing so, and given that misallocation lowers these returns, Mexican workers invest less in education prior to entering the labor force. This has long-term implications for the stock of human capital available to the country. ... [I]n the last two decades the returns to education in Mexico fell. ... {T]he returns to experience in Mexico are not only lower than in other countries of the OECD, but also wer than in Chile and Brazil, the other two Latin American countries with comparable data. In addition, ... the returns to experience fell between 2005 and 2015. The implication of this trend is powerful: given whatever education workers acquired while young, their earnings paths once they entered the labor market were basically flat over that decade. Put differently, the returns to their experience were nil. The combination of falling returns to education and falling returns to experience is very disconcerting.

Moreover, Levy argues that the extent of misallocation appears to be rising in Mexico. What factors might cause this misallocation of resources to arise and to persist? He argues that "the main policies and institutions impeding growth are those related to taxation, labor and social insurance regulations, and enforcement of contracts." The book goes into considerable detail on many related issues: laws about salaried and unsalaried workers differ, both in provision of social insurance and in the ability of firms to fire workers; how workers are taxed differently based on their labor contract and firms are taxed differently based on their size; and how law and institutions "determine the trust that agents (banks, firms, workers) place in the institutions enforcing contracts, and the degree of competition in product markets." Here's a sample:

> In other countries, the distinction between salaried and non-salaried contracts is probably innocuous. But in Mexico it is central because, following constitutional mandates, since the middle of the past century many of Mexico's policies and institutions have been designed specifically for salaried workers, with obligations imposed on firms only when they hire salaried workers. Among these are the obligations to pay for workers' social insurance, to comply with dismissal regulations, and to withhold workers' income taxes. In parallel, other policies have been designed for non-salaried workers, with different obligations on firms. Among these are the provision of free social insurance benefits, and the exemption of firms from dismissal regulations and withholding obligations. As a result, laws with respect to labor taxes, pensions, health, day care, housing, and separation from employment differ depending on the nature of the contract between firms and workers. In parallel, the institutions in charge of enforcing obligations or providing benefits to salaried and nonsalaried workers also differ. ...

Here's one summation of his argument from Levy:

> After the lost decade of the 1980s, Mexico embarked on a program to restore growth focused on macroeconomic stability, an open trade regime, investments in human capital, promotion of domestic competition, and sector-specific reforms to increase efficiency. This program was accompanied by a substantive expansion of social spending ... [T]he main achievements under this program ... [were] most of them very welcome, and some very impressive.

> On the other hand ... this program was unable to deliver growth with social inclusion. The combination of tax, social insurance, and labor regulations deployed to increase social welfare taxed the high-productivity segment of the economy and subsidized the low-productivity segment, impeding productivity growth and thwarting rapid GDP growth. It also failed to provide workers with satisfactory levels of protection and efficient coverage against risks, while limiting their opportunities to get better paid jobs congruent with their increased schooling. Thus, over a quarter of a century later, it is not possible to assert that this program delivered the prosperity expected from it.

> This does not mean that this program should be abandoned. In fact, most of its components were right on the mark, and need to be consistently pursued. But it does mean that, with the benefit of hindsight, this program had an Achilles' heel: it did not address the main reasons for large and persistent misallocation, and in fact exacerbated some of them. And, looking forward, it implies that continuing to pursue only this program will not address this shortcoming, and that prosperity will continue to elude Mexico. ... It is difficult for inclusive growth to occur under exclusive and malfunctioning institutions.

Levy's argument about misallocation of resources in Mexico has a number of intriguing implications.

1) The causes of economic growth matter. When thinking about the "fundamentals" of economic growth, it's not enough to focus on investment in physical and human capital, a stable macroeconomic environment, and participation in the global economy. The ways in

which laws and institutions affect the allocation of resources in an economy can also matter.

2) Mexico's economy matters. For example, If you are worried about immigration from Mexico, immigration that arrives through Mexico, the strength and the opportunities in Mexico's economy are one of the main factors affecting how many people will want to emigrate from Mexico.

3) Mexico is a (vivid) example of a country that has drawn legal and regulatory distinctions between salaried and unsalaried workers, and between smaller and larger firms. But in the US and around the world, technology is enabling the possibility of a shift to "gig economy" of alternative work arrangements and how firms organize themselves. In thinking about possible laws will affect treatment of these alternative workers, and the firms that hire them, and the provision of social insurance to these workers, it will be important also to consider the incentives that are being set up for how markets will reward productivity and skills--or not.