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Latin America's missing middle

Rebooting inclusive growth

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Preface

Latin America made notable progress in reducing poverty and creating jobs during the commodity boom at the beginning of this century, but those efforts have since stalled. Growth has continued to be tepid and the gains of that growth have not been shared among the broad base of the population. That outcome is stoking social and political tensions in the region. It also stands in sharp contrast to the trajectory of some other emerging regions that have grown more prosperous and are now catching up with Latin America as measured by GDP per capita.

How can Latin America restore its erstwhile dynamism and ensure a more prosperous middle-class life for a larger proportion of its population? This report, the latest in the McKinsey Global Institute's ongoing coverage of Latin American economies, presents a new diagnosis of the region's key challenges with a focus on two "missing middles": a missing tier of midsize companies that could create better-paying jobs and ignite a stronger competitive business environment, and a missing burgeoning middle class of consumers whose spending and saving could fuel domestic demand and investment.¹ The report also highlights the new opportunity for the region to reboot inclusive growth by harnessing the forces of digital technologies, as some entrepreneurs in Latin America are already notably starting to do.

Jaana Remes, an MGI partner in San Francisco directed the project, together with McKinsey & Company senior partners based in Latin America—Andrés Cadena in Bogota, Alberto Chaia in Mexico City, and Vijay Gosula in Salvador—as well as MGI's three directors, Jacques Bughin, James Manyika, and Jonathan Woetzel. Tilman Tacke, an MGI partner based in Munich, and Nicolás Grosman, McKinsey's head of economic research for Latin America, provided valuable thought leadership to the effort at all stages of the project. We are grateful for the helpful input from Pablo Ordorica, Nicola Caliccio, and Sree Ramaswamy. Kevin Russell headed the research team, which was composed of Julio Fu, Jose Pablo Garcia, Rachel Garber, Michel Rassy, and Henrique Sosa.

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¹ MGI has studied Latin American economies for 25 years. Recent reports include *A tale of two Mexicos: Growth and prosperity in a two-speed economy* (March 2014) and *Connecting Brazil to the world: A path to inclusive growth*, (May 2014).

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This report contributes to MGI's mission to help business and policy leaders understand the forces transforming the global economy, identify strategic locations, and prepare for the next wave of growth. As with all MGI research, this research is independent and has not been commissioned or sponsored in any way by any business, government, or other institution. We welcome your comments at MGI@mckinsey.com.

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Latin America's missing middle: Rebooting inclusive growth

Latin America used to be the world's most prosperous emerging region, but it is on the verge of being overtaken by other regions that were long considerably poorer. It has lost ground since the 1980s despite reform initiatives because of sluggish growth and the unequal distribution of the gains of that growth. In this report, which focuses mainly on Brazil, Colombia, and Mexico, we examine two “missing middles” holding the region back: a robust cohort of midsize companies and a solid middle class with growing spending power. Both middles will need to be filled if Latin America is to have a new chance of generating sustainable growth that benefits the broad base of the population.

- Latin America's average annual GDP growth of 2.8 percent between 2000 and 2016 has been slower than the 4.8 percent average of 56 other emerging economies, not including China. Almost three-quarters of Latin America's growth came from expanding the number of workers rather than through productivity gains, which averaged just 0.8 percent annually, or one-fourth the productivity gains in emerging-market peers. The expansion of the working population as a share of total population will soon reverse, meaning that growth will increasingly depend on finding sustained productivity gains.
- Dynamic and competitive companies propel growth and well-paid jobs, but Latin American firms have yet to overcome a persistent polarization between a few very large companies and a long tail of small, unproductive firms. The missing middle tier of companies reflects the lack of dynamism: Latin America has fewer firms that have scaled up revenues above \$50 million than higher-growth emerging economies do, which also translates into fewer large growth companies. The region needs more and larger companies willing to make bold investment in new technologies, including digital adoption, to boost productivity growth.
- The second missing middle is a cohort of upwardly mobile consumers whose rising incomes from productive jobs drive economic demand and investment. The poverty rate was halved to below 15 percent since 2000 but one-quarter of the region remains vulnerable because of high prices and a dearth of higher-productivity, higher-wage jobs. Rapid expansion of the workforce has held back wage growth, squeezing the middle class. In Mexico, average wage growth has been flat even in export-oriented sectors with rising productivity. In Brazil, the resource boom lifted wages, but taxes and the high cost of consumer goods have depressed purchasing power; cars retail for more than double their price in the United States. Latin America's bottom 90 percent of earners accounts for less than two-thirds of domestic consumption, the lowest of all regions.
- Filling in the missing middles will require a comprehensive commitment to growth and inclusion that none of our focus countries has so far achieved. Brazil has seen a higher share of income go to labor and has expanded credit but is constrained by limited access to global supply chains and a protected “Brazil cost” on firms and consumers. Mexico's market-opening reforms such as NAFTA boosted investment and productivity but did not translate into expanded domestic markets or sustained productivity growth. The region does have some success stories, including Chile, Colombia, and Peru, which have grown faster—albeit from a lower base for the latter two and a labor share of income growth that was no higher than the rest of the region.
- We estimate that Latin America could raise its GDP growth by 50 percent versus a baseline scenario to 3.5 percent annually in 2030, a gain of more than \$1,000 per capita and \$1 trillion in total, if the region converged toward the patterns of inclusive growth found among peers. Alongside more conventional policy approaches, digital adoption at scale could be a powerful new tool to achieve that goal, although it will not be a cure-all. Three priorities can help capture the productivity-enhancing opportunities. First is to establish a competitive business environment that reduces the cost of entry, improves access to finance, and cuts red tape, enabling small and middle-tier firms to thrive. Second is to spread productivity gains to the vulnerable and middle classes through better-paying jobs, longer-term investments, and more participatory labor and consumer markets. Third, governments could undergo digital transformation themselves, improving delivery of public services and being more experimental. Government and business leaders have no time to lose if they are to meet the aspirations of millions of Latin Americans impatient for a more prosperous middle-class life.

Latin America's two missing middles

Igniting inclusive growth requires addressing the “missing middle” of midsize firms and a solid middle class with growing spending power.

Latin America

Benchmark economies

China, India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey

Supply

Average number of firms per \$1T GDP, grouped by revenue, 2016

Over \$5B



\$500M – \$5B



\$100M – \$499M



\$10M – \$99M



Less than \$10M



← Millions

Millions →

Latin America needs to expand the pool of modern, globally competitive firms to raise productivity and increase the number of high-wage jobs. Digital technologies provide a new opportunity.

Demand

Percent of population contributing per quintile of consumption

Upper quintile

4%

6%

Upper middle quintile

8%

12%

Middle quintile

14%

17%

Lower middle quintile

22%

24%

Lower quintile

51%

43%

Three-quarters of the population in Latin America accounts for just 40 percent of total consumption, compared to two-thirds in benchmark countries

More productive jobs with higher wages and rising middle-class prosperity increase demand and spur new investment. This can accelerate a virtuous cycle of inclusive growth.



Executive summary

Latin America used to rank as the most prosperous emerging region in the world, thanks to an abundance of natural resources and the legacy of earlier industrialization. Yet over the past four decades, its erstwhile dynamism has seeped away. GDP growth has been weak and often volatile—and the fruits of that growth have not been broadly distributed to the benefit of citizens. Other emerging economies in Asia and beyond, meanwhile, have achieved more robust economic growth and raised living standards for much larger swaths of their population. As a result, when measured by the prosperity of consumers and households, Latin America is on the verge of being overtaken by other regions that were long considerably poorer (Exhibit E1).

The first decade of the 21st century showed progress toward faster and more inclusive growth, due to increasing macroeconomic stability, pockets of global competitiveness, the boost from commodity prices, and programs to transfer more wealth to lower income groups. However, this proved fragile, with reversals on poverty reduction and limited productivity growth in recent years.

In this report, we examine why this has happened and explore ways for the region to find its path back to broad-based prosperity. We focus mainly on three economies: Brazil, Colombia, and Mexico, which together account for 60 percent of Latin America's GDP. All three countries, we find, are missing a middle—or, more precisely, two middles. One is a vibrant tier of midsize companies that grow, compete, and create better-paying jobs. They are needed to fill a persistent gap in the corporate landscape between a small number of large, established firms and a long tail of low-productivity and often informal small firms. While those at the top are relatively scarce, many of them have become globally competitive and raised the bar for productivity at home. But the middle—and the good jobs that go with it—is being squeezed by a lack of competitive dynamism to encourage innovation and investment, barriers to finance for small firms, and a challenging regulatory environment.

This business landscape has held back the creation of more productive and better-paid jobs, which in turn contributes to the other missing middle: the lack of a burgeoning middle class of consumers whose spending and saving could help fuel domestic demand and investment on a sustainable basis.¹ That is needed in a region with, at one end, a wealthy elite that accounts for an exceptionally large share of consumption and, at the other end, a large cohort of vulnerable households that are no longer poor but that have yet to reach comfortable middle-class consumption levels. Firms base investment decisions on expected market growth, and the stalled middle class creates demand constraints that reinforce the squeeze on small and medium-size enterprises.

Filling in these missing middles will not solve all of Latin America's economic challenges, but it will go a long way toward ushering in a more sustained era of broad-based prosperity to which its people aspire. No one factor explains their absence; some factors that contribute, such as low access to finance and poorly functioning labor markets, also exist in countries with relatively more midsize and large firms and middle-class growth. Nonetheless, the connection between the missing middles makes the challenges behind them harder to solve one at a time. New technologies may help to some extent. Above all, Latin America needs to spark a virtuous cycle of inclusive growth (see Box E1, "Inclusive growth in the context of a virtuous economic cycle"). Creating this cycle and preparing the groundwork for the adoption of digital at scale will in turn require focused efforts by both government and business leaders to create a more

¹ Definitions of what constitutes the middle class vary. Some institutions, including the World Bank, use a daily dollar amount of either income or consumption on a purchasing power parity basis. Other definitions are based on a range of income deciles, making the definition relative to each nation's income distribution. In this report, we define middle-class households as those with per capita income between \$11 and \$50 per day, based on 2011 purchasing power parity. That corresponds approximately with the fourth to ninth deciles in Latin America.

competitive environment for companies, share productivity gains more equitably, and improve public-sector efficiency.

In his speech accepting the 1982 Nobel Prize for literature, the Colombian novelist Gabriel García Márquez described Latin America as “a boundless realm of haunted men and historic women, whose unending obstinacy blurs into legend.” From an economic perspective, the obstinacy is not unwillingness to change, but the frustratingly disappointing results of the changes that have been made. All three of our focus countries have introduced reforms, which differ in nature but have similarly failed to deliver because they have not managed to accelerate growth nor altered the concentrated pattern of economic activity among both firms and households. That, in turn, has stoked political and social tensions in the region.

Latin America faces a dual challenge of slow GDP growth and unequal distribution of the gains of that growth

Growth in Latin America has been slower and more volatile than in other emerging economies, and the unequally distributed gains from that growth have failed to ignite the domestic economy and sustain growth.

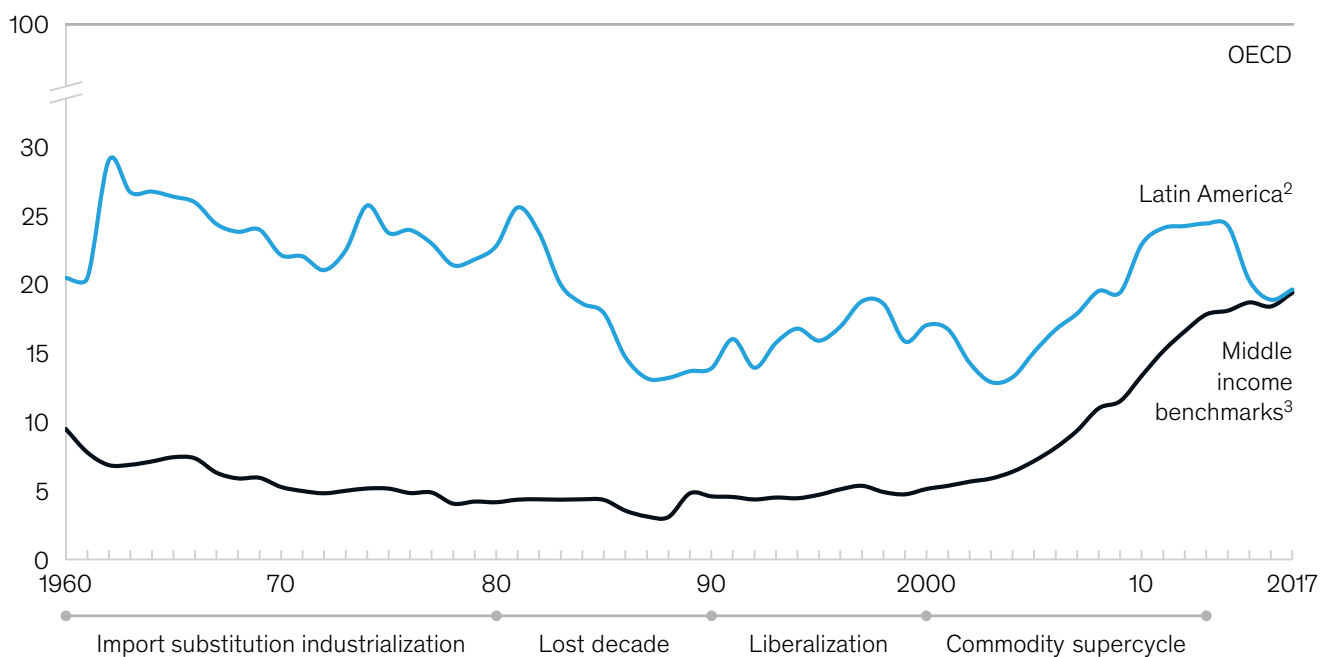
Labor expansion more than productivity gains has fueled growth in the region

GDP growth in the region averaged 2.8 percent annually between 2000 and 2016, far lower than the 4.8 percent rate in 56 other emerging economies in the same period (not including China, which grew at twice that pace). Among Latin American economies, Peru grew most strongly, averaging 5.2 percent per year. Of the three countries that are the focus of this report, Colombia performed best, with average growth of 4.2 percent. Brazil’s growth rate, at 2.4 percent, was closer to the regional average, while Mexico’s was weaker, at 2.1 percent. In addition to being weak, regional growth has been volatile, buoyed by the commodity boom,

Exhibit E1

Latin America’s GDP per capita gap to developed economies has not narrowed, while other emerging economies have caught up.

GDP per capita (PPP)
Index: 100 = OECD average¹



¹ Weighted average of 24 OECD member states excluding Latin American members (Chile and Mexico).

² Weighted average of region.

³ Weighted average of benchmark economies (China, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey).

Source: World Bank; McKinsey Global Institute analysis

Box E1

Inclusive growth in the context of a virtuous economic cycle

For this research, we define inclusive growth as sustained increases in income for low- and middle-class workers from productive, higher-wage jobs. This definition directs attention to the need not only for productivity growth on the supply side, but for expanding income from higher wages and rising consumer purchasing power for the bottom 90 percent on the demand side.¹

We place inclusive growth in the context of our prior work on the virtuous cycle of economic growth. The cycle starts with growing productivity, made possible by accumulating capital and technology and by improving the efficiency of operations. The fruits of improved productivity are then distributed throughout the economy in the form of increased profits and higher wages for workers, lifting more people into the middle class, and in turn supporting higher levels of consumption and savings. This, along with better access to global markets, increases overall demand for goods and promotes further investment and productivity gains.²

Adopting a pro-growth agenda that attends to efficiency at each step in this cycle is a distinguishing characteristic of fast-growing emerging economies. An analysis we conducted of the 50-year track record of 71 emerging economies shows that those countries whose policies were able to generate this virtuous cycle enjoyed robust and sustained growth that far exceeded the GDP per capita growth of peers.³ While government policy is a prerequisite of this pro-growth agenda, the often-underappreciated role of companies and strong competitive dynamics also help create the virtuous cycle.

¹ Definitions of inclusive growth can differ and sometimes include qualitative aspects such as well-being. For example, the Organisation for Economic Co-operation and Development (OECD) compiles a Better Life Index that includes social connections, civic engagement, and environmental quality, among other metrics of well-being, alongside income and wealth and housing data. *Better Life Index*, OECD. Other definitions include the UN's Human Development Index, the World Economic Forum's Inclusive Development Index, and the World Bank's Atlas of Sustainable Development Indicators. The subject is extensively studied in academia and has been the subject of past McKinsey Global Institute reports, including *Poorer than their parents? Flat and falling incomes in advanced economies*, June 2016.

² *Solving the productivity puzzle: The role of demand and the promise of digitization*, McKinsey Global Institute, February 2018.

³ *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

which saw prices for resources such as oil, mineral, and some agricultural products surge, only to fall back sharply.²

The largest driver of GDP growth in Latin America has been expansion of the labor force, the result of a demographic boom and increased participation of women.³ The workforce grew by 66 million workers between 2000 and 2016, and this expansion accounted for 72 percent of the region's overall GDP growth. The demographics are now changing: fertility rates in Latin America declined from 4.2 in 1980 to replacement rate in 2015. This means the region will need to count on productivity growth rather than labor expansion as the main driver of GDP growth.⁴ This would bring Latin America into line with other emerging economies, where labor expansion has been a much smaller factor in driving GDP growth—37 percent on average in 56 countries excluding China—and considerably less important than productivity growth.

² Prior MGI research found that 18 of 71 emerging economies consistently outperformed their peers over 50 and 20 years. No Latin American country is among them. See *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018. For a discussion of the supercycle and its aftermath, see *Beyond the supercycle: How technology is reshaping resources*, McKinsey Global Institute, February 2017.

³ The female-to-male labor force participation ratio increased from 58 percent to 67 percent between 2000 and 2017 for the region, according to the World Bank. Mexico's ratio remained below the regional average, increasing from 47 to only 56 percent. World Bank Gender Data Portal 2018.

⁴ World Development Indicators, World Bank.

A sharp reduction in poverty is a notable success, but more than 150 million people in Latin America remain vulnerable

Since 2000, 56 million people—or more than 40 percent of Latin America’s poor in 2000—have crossed the \$5 per day absolute poverty threshold, reducing the overall proportion of people in poverty to 13 percent of the total from 27 percent.⁵ Both the income boom from rising commodity prices and governments’ pro-poor policies propelled this movement. These include conditional cash transfer programs in Mexico and Brazil, which tie transfers to keeping children in school or making preventive healthcare visits.⁶ Bolsa Família, the Brazilian program launched in 2003, now reaches 14 million households, about one-quarter of the population, and helped bring down the proportion of those living in extreme poverty from 10 percent to 4.3 percent over a decade.⁷ The poverty-reduction momentum has slowed in the wake of the 2008 global financial crisis and the end of the commodity boom, however. By 2018, poverty and extreme poverty rates had risen above the levels of a decade earlier.⁸

56M

Number of Latin Americans who crossed the absolute poverty threshold since 2000

While poverty has been reduced since 2000, the slow expansion of higher-productivity and higher-wage jobs has left many vulnerable. No longer officially poor, they have not yet reached comfortable middle-class spending patterns—meaning they are still unable to afford goods and services that go beyond basic needs and may not have access to credit—and remain at high risk of falling back into poverty during a recession or in the event of a health or employment crisis.⁹ More than one-third of the region’s population lives on less than \$11 per day, based on purchasing power parity, including 152 million people in the “vulnerable” category of \$5 to \$11 per day (over 60 percent from Brazil, Colombia, and Mexico). More than 60 percent of the population lives on less than \$20 per day (Exhibit E2).

The bottom 90 percent in Latin American households consumes just 64 percent of the total, the lowest share in the world

Consumers crossing over to the middle class have more money and more access to credit to spend beyond basic necessities and they tend to spend a higher share of their income than more affluent people. However, social inequality marks consumption patterns in Latin America. The bottom 90 percent of the income distribution in Latin America—the region’s poor and vulnerable, and most of the middle class—accounts for just 64 percent of domestic consumption. This is the lowest share in the world, akin to that in Sub-Saharan Africa but substantially lagging behind other regions, where the bottom 90 percent consumes about 70 percent or more of the total (Exhibit E3).

A missing middle of dynamic midsize companies reduces competition and innovation

The business landscape in Latin America is polarized. The region has some powerful companies, including some with very high productivity that have successfully expanded from their strong local base to become global companies or “multilatinas”—regional powerhouses operating across Latin America. They include AB InBev, America Movil, Arcor, Bimbo, CEMEX, Embraer, FEMSA, Techint Group, among others. By comparison with large firms in other regions, such companies are fewer in number and less diversified beyond energy, materials, and utilities. At the same time, Latin America has a long tail of small, often informal companies that collectively provide large-scale employment, but whose low productivity and stagnant growth hold back the economy.

⁵ World Data Lab. We use the World Bank’s categories for upper middle income countries of household income per day: poverty line of \$5.50, \$5.51–\$13 for the vulnerable class, \$13.01–\$50 for middle class. Due to data availability, we adjust this slightly (\$0–\$5 for poverty, \$5.01–\$11 for vulnerable or near-poor, \$11.01–\$50 for middle class).

⁶ The Oportunidades program ran from 2002 to 2014 and has since been replaced by the Progresá program. See *A model from Mexico for the world*, World Bank, November 19, 2014, and Santiago Levy, *Progress against Poverty: Sustaining Mexico’s Progresá-Oportunidades Program*, Washington, DC: Brookings Institution Press, 2006.

⁷ Deborah Wetzel, *Bolsa Família: Brazil’s quiet revolution*, World Bank, November 4, 2013, worldbank.org/en/news/opinion/2013/11/04/bolsa-familia-Brazil-quiet-revolution.

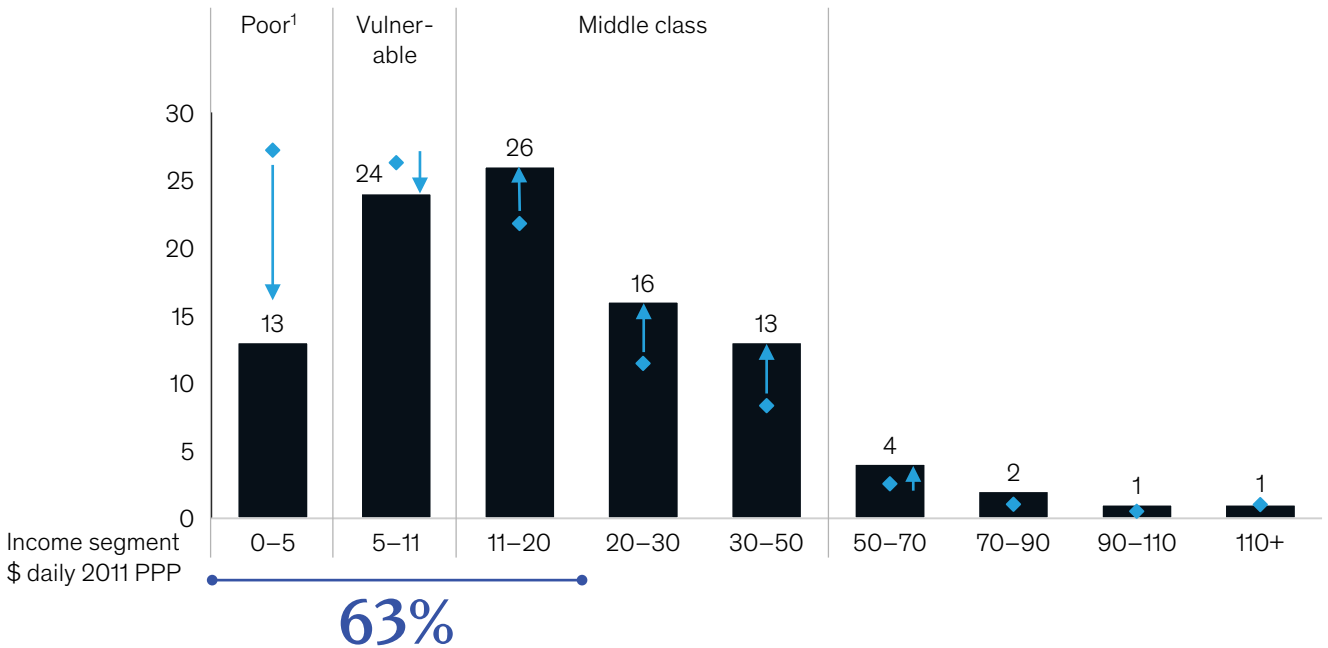
⁸ *Social panorama of Latin America 2018*, UN Economic Commission for Latin America and the Caribbean, January 2019.

⁹ For a discussion of the consuming class, see *Urban world: Cities and the rise of the consuming class*, McKinsey Global Institute, June 2012, McKinsey.com.

Latin America has substantially reduced poverty since the turn of the century, but over 60 percent remain below \$20 per day of income.

Latin America population by income segment, 2000–17
%

■ 2017 ◆ 2000



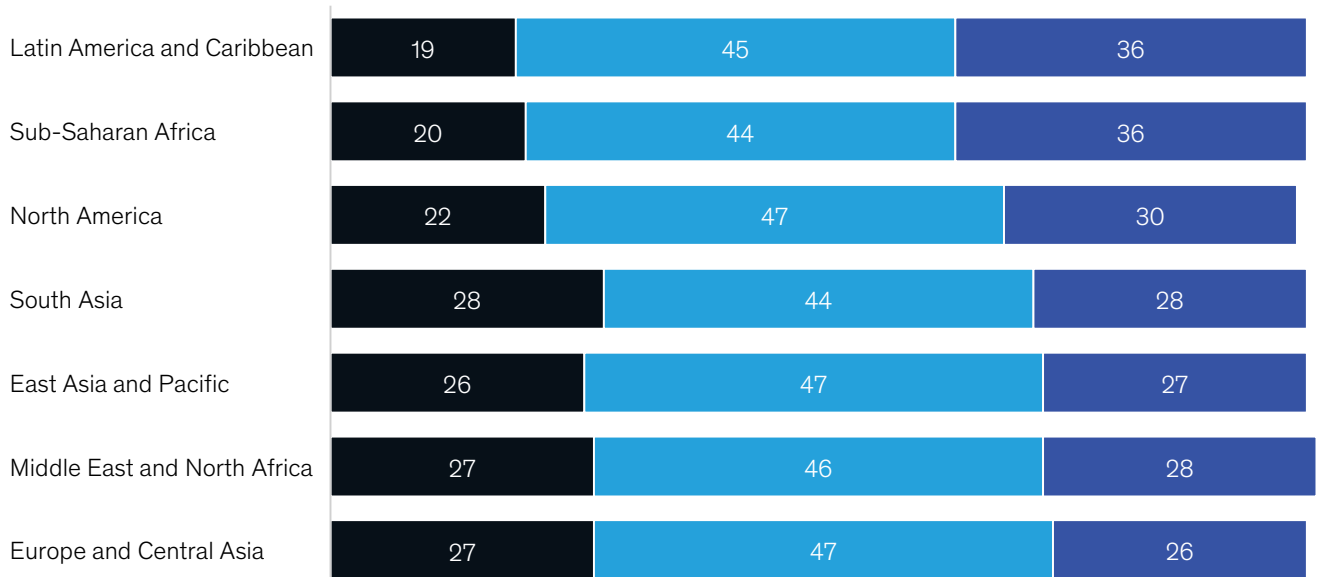
¹ Income data from World Data Lab are post-tax and transfer, this holds throughout the report.

Source: World Data Lab; World Bank; McKinsey Global Institute analysis

Despite progress, Latin America’s consumption share from the bottom 50 percent and bottom 90 percent of the population remains the lowest in the world.

% of total consumption by region and income percentiles,¹ 2017

Percentile ■ 1st–50th ■ 51st–90th ■ 91st–100th



Note: Consumption power based on in-country income percentiles, not across regions (eg, sum of total consumption in bottom 50% of all LatAm countries). Data set includes 168 countries: East Asia and Pacific (25), Europe and Central Asia (49), Latin America and Caribbean (27), Middle East and North Africa (13), North America (2), South Asia (7), and Sub-Saharan Africa (45). Figures may not sum to 100% because of rounding.

¹ Numbers may not add up due to rounding

Source: World Data Lab; McKinsey Global Institute analysis

Missing is a cohort of vibrant midsize companies that could bring dynamism and competitive pressure to expand the number of productive and well-paying jobs in Latin America, much as these firms do in many high-performing emerging regions. Exhibit E4 shows how much less prevalent large and midsize companies (over \$50 million in revenue) are for the size of the Latin American economy compared with peers elsewhere. Given their relatively small number, these large firms account for less than three-quarters of the total revenue relative to GDP.

Latin America's large companies can face less dynamic domestic competition than peers in other regions

The missing middle of companies reduces competitive pressure on large incumbents. In comparing Latin American companies with large firms in a benchmark set of ten countries—China, India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey—we find several indications that the competitive dynamics are less powerful, but with important variation across countries.¹⁰

First, the number of public companies with revenue of more than \$100 million is smaller proportionately in Latin America than in high-performing Asian countries. Whereas over 80 percent of publicly listed companies of this size in our benchmark countries crossed the \$100 million threshold since 2000, the proportion is less than 60 percent in Brazil and Mexico. Colombia's much smaller corporate sector has been more vibrant, with these firms accounting for 81 percent since 2000.

Second is the degree of turnover at the top of the rankings. Top-quintile companies with more than \$500 million in revenue in the best-performing emerging economies have a hard time getting to the top and staying there: less than half of top-ranked firms in economic profit—that is, returns above the cost of capital—in one cycle were still at the top in the next cycle.¹¹ In Latin America, we see a distinction between Mexico, where two-thirds of the top-quintile firms in terms of economic profit remained in place over the past 15 years, whereas in Brazil, only one-third did, indicating a more vibrant market. Other economies in the region tend toward the average of our benchmarks.

Third, these dynamics have correlated with concentrated gains in some cases. Some recent research shows that Latin American firms have been able to command larger and more stable markups on their products, dating to the 1980s. That was even before the rise of the “superstar” phenomenon among large global firms that are capturing an ever-larger share of profits and pulling away from their peers.¹² We also find that midsize and large firms' profit margins in our three countries are higher across most sectors since 2000 than in our benchmarks. The variation in economic profit is also higher: the top quintile economic profit is higher and the lowest quintile economic profit is lower (more negative) than in the benchmark economies. Trade protection, a legacy of earlier import substitution policies, also continues to contribute to high consumer prices in a number of industries.

The causes of this firm distribution and dynamics are rooted in common legacies of import substitution that favored a few private licenses or large state-run firms in many sectors. Other reasons are differing ways in which state companies were privatized and, especially in Brazil's case, tax and compliance-heavy regulation that favors either large scale or informality. Unequal access to finance, weak infrastructure, and high input costs also squeeze the middle. The result is a weak level of innovation and specialization needed for future growth. Brazil, Colombia, and Mexico rank below their development level on innovation indices; they have

2/3

Proportion of top firms in Mexico that remain in place over 15 years. In Brazil, that figure is one-third

¹⁰ We chose these benchmarks based on geographic variation and similar levels of development. We also included some outperforming emerging economies to highlight best-in-class examples and allow for a range of comparisons that are of interest across our analyses. Some of the benchmark countries are less dependent on commodity cycles than our Latin American focus countries. We do not claim they are globally representative, and they are too few to provide meaningful statistical evidence.

¹¹ *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

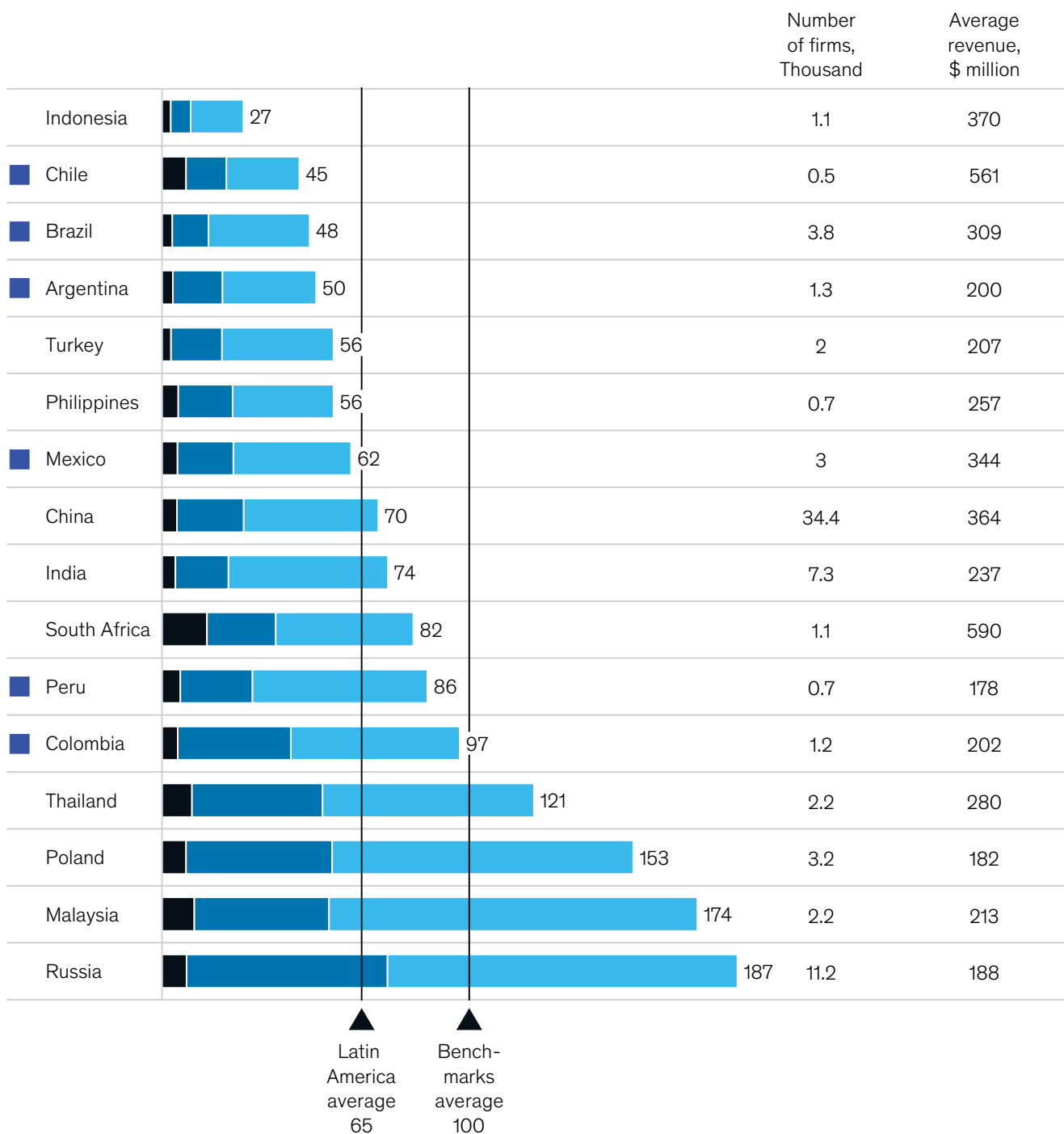
¹² US and European companies have more recently caught up in the size of the markups, according to this research. Moreover, a “superstar” effect has created a skew in corporate profitability among the largest global companies: the top 10 percent of firms with revenue exceeding \$1 billion capture 80 percent of the economic profit, and their gains today are 1.6 times larger than they were 20 years ago. Jan de Loecker and Jan Eeckhout, *Global market power*, NBER working paper number 24768, June 2018; *Superstars: The dynamics of firms, sectors, and cities leading the global economy*, McKinsey Global Institute, October 2018.

Latin American economies have fewer large and midsize firms over \$50 million in revenue.

Firms per \$1 trillion GDP in Latin America and other emerging markets, indexed to benchmarks¹

Index: Share of firms compared to benchmark average, 2015–17

■ Latin America ■ Over \$500 million ■ \$100 million–\$500 million ■ \$50 million–\$100 million



¹ Public and private firms with revenues over \$50 million per year.

Source: McKinsey Corporate Performance Analytics database; WB WDI; McKinsey Global Institute analysis

one-quarter to one-third of the digital diffusion of the United States, for example. Research and development investment in the region is relatively low, at just 0.3 percent and 0.5 percent of GDP for Colombia and Mexico, respectively, although it reaches 1.2 percent for Brazil. This compares with about 1 percent for benchmarks.¹³

Much of Latin America's labor force is trapped in a long tail of small, unproductive, and often informal firms

The other side of this dual economy is a multitude of small companies, many of which operate outside the formal economy (as do some midsize and even large firms). These small companies tend to have low productivity and absorb a significant proportion of low-skill workers. They are most concentrated in sectors like retail, construction, and agriculture. Brazil has had the most success in reducing the level of informality in the overall labor force: the rate fell below 50 percent in 2015–16. Mexico and Colombia have much higher rates, of 57 percent and 62 percent, respectively, according to household surveys in each country.

Retail highlights how the long tail of small companies drags down overall productivity. In Mexico, for example, small retailers employ two-thirds of the sector's workforce, or 6.6 million workers, but value added per worker is only about one-seventh that of large and more efficient retailers (Exhibit E5).

28%

Proportion of workers in our survey saying they expect to leave their jobs within a year

To increase our understanding of the long tail of small businesses and its resistance to change, we conducted a survey of 3,000 workers—in informal, formal, and self-employed—in Brazil, Colombia, and Mexico. It suggests that a majority of workers see self-employment as the main fallback option when wage employment is not available: 70 percent of respondents said temporary or informal self-employment was a viable option in a time of financial uncertainty. Such uncertainty is high, with 28 percent of all workers saying they expected to leave their job in the next 12 months.

The survey also highlights the constraints of small business. Some 28 percent of the sample were self-employed, of which about half were formal businesses. Only one in four respondents indicated that they had access to the credit needed to expand their businesses—but two in three said they would like to expand if they could.

A missing middle of consumers holds back domestic demand and incentives for investment

The other missing middle is a cohort of upwardly mobile consumers whose rising disposable income helps drive economic demand and investment on a sustainable basis. Furthermore, compared to benchmarks, a higher proportion of the consumption growth that has occurred in Latin America has come from expanding population rather than rising per capita consumption. As noted, many of those lifted out of poverty remain vulnerable and have not reached a comfortable middle-class existence. For this cohort, the main path to sustained and rising prosperity comes from access to productive, well-paid jobs—which have been too scarce to meet the needs of the rapidly expanding labor force in the region. As the supply-side challenge of a missing middle of companies has constrained the expansion of attractive jobs with higher wages and opportunities to build skills, it has contributed to the demand-side challenge of a missing cohort of middle-class consumers with sufficient income to sustain robust domestic demand. The sluggish demand acts as a serious drag on the economy. It limits the growth of markets for domestic businesses that constitute the majority of jobs in a modern economy. It also holds back the development and provision of more complex goods and services, which in turn could strengthen the economy by encouraging investment.

The growth patterns providing the context for this missing middle differ among our focus countries. In Brazil, the commodity boom led to rising wages and helped draw workers from small-scale agriculture to low-skill jobs in small establishments with below-average productivity. In Mexico, by contrast, wage growth has been strikingly weak and at times negative, even in expanding, high-productivity sectors such as automotive.

¹³ Global Innovation Index; McKinsey Digital Maturity Index; World Bank, World Development Indicators.

Retail shows how the long tail of mostly informal firms continues to add workers even as productivity is flat or decreasing and more modern firms grow quickly, especially in Mexico and Colombia.

Productivity and employment share growth of retail by firm size in Brazil, Mexico, and Colombia, 2010¹

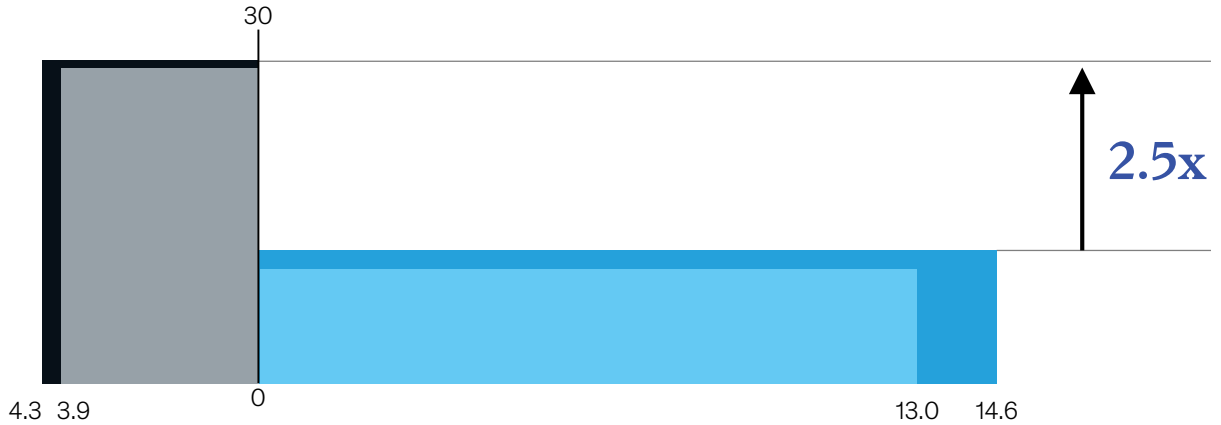
■ Larger firms
■ Small firms

Labor productivity
Value added per worker (\$ thousand)

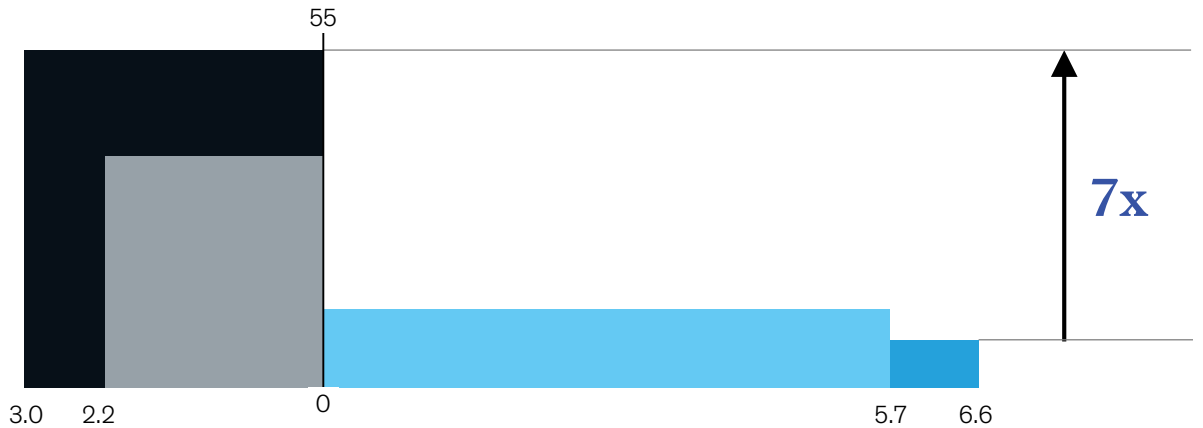


Not To Scale

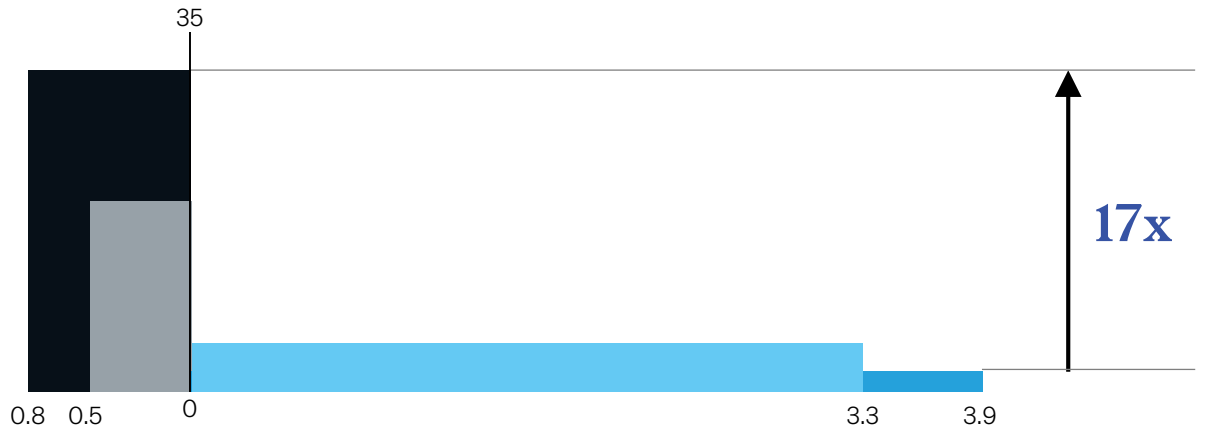
Brazil
2007–15



Mexico
2003–13



Colombia
2008–15



¹ Small firms = <20 employees for Brazil and Colombia; <10 for Mexico.

Source: Mexico INEGI Household Survey, Economic Census; Brazil IBGE Economic Census, Household Survey; Colombia DANE Household Survey, Commerce Census; National Accounts; McKinsey Global Institute analysis

Consumption has grown with expanding population, exports are not filling the demand gap, and both investment and savings are relatively low

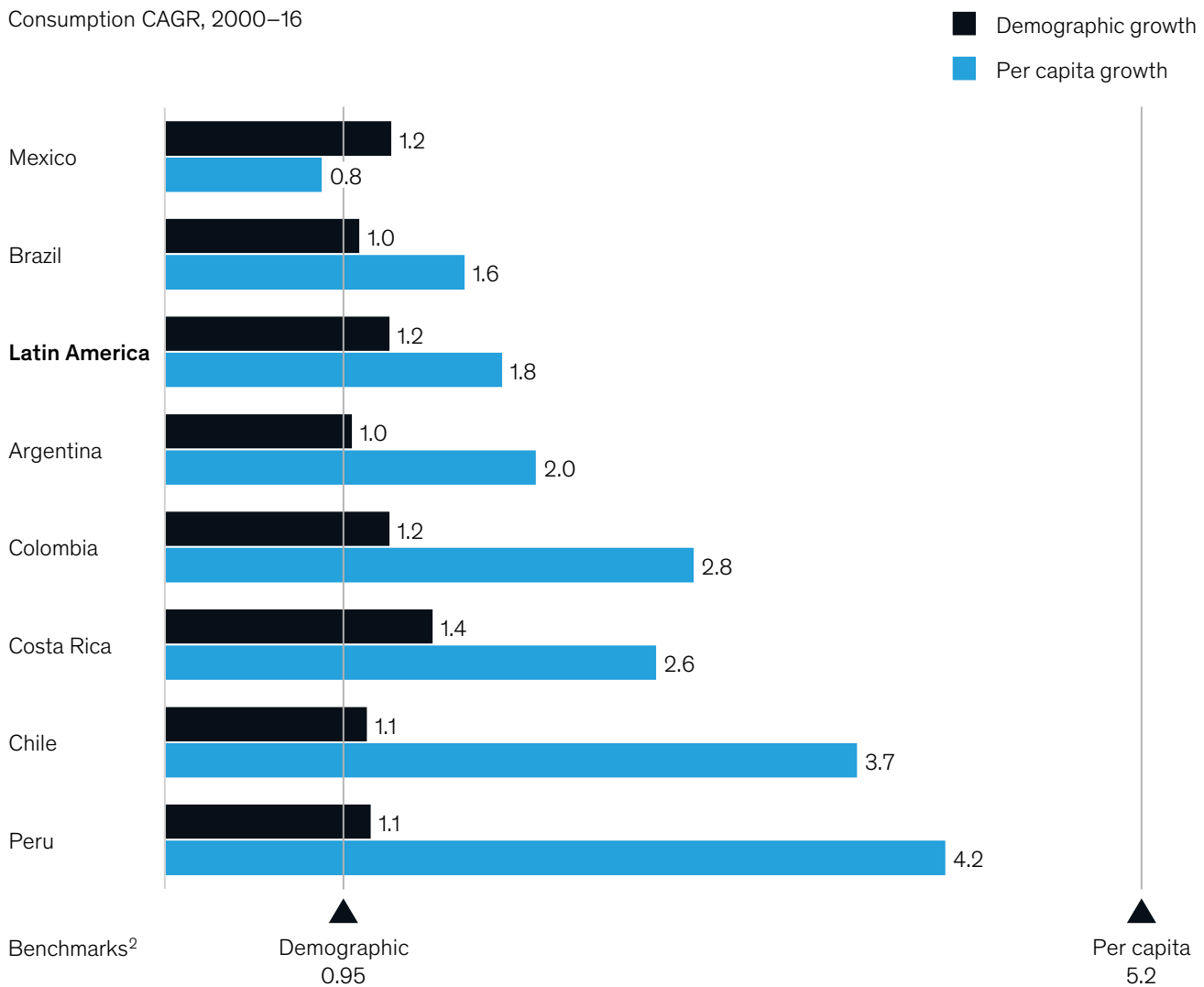
Household consumption represents the biggest share of GDP expenditure in any economy and 64 percent in Latin America, yet it has expanded only slowly, contributing 1.9 percent to GDP growth compared to 2.7 percent in our emerging-market benchmarks. Furthermore, compared to benchmarks, a higher proportion of the consumption growth that has occurred in Latin America has come from expanding population rather than rising per capita consumption. Since the turn of the millennium, per capita consumption growth in Latin America has been just 1.8 percent, less than half the 4.3 percent in benchmark countries. Colombia is high for the region, with per capita consumption growth since 2000 of 2.8 percent, while Chile and Peru are outliers at 3.7 and 4.2 percent respectively (Exhibit E6). In Mexico, the reverse is true: per capita consumption growth accounted for less than the population growth's contribution, consistent with low wage growth. This matters because consumption patterns change as incomes rise, with markets for more complex goods and services growing to provide new growth opportunities for business.

The purchasing power of Latin American consumers is further taxed by the high cost of many consumer goods. Trade barriers continue to raise local prices above global ones, including

Exhibit E6

Consumption gains per capita in the region are well below benchmarks with the exception of Peru and Chile.

Consumption CAGR, 2000–16



¹ Decomposition is based on total consumption growth CAGR and population CAGR with residual attributed to per capita growth.

² Weighted average of benchmarks (India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, Turkey); China excluded from consumption growth due to weight.

Source: World Bank; UN World Population Prospects 2017; McKinsey Global Institute analysis

for basic goods such as food. Similarly, taxes can limit the purchasing power of those most ready to spend. In Brazil, value-added tax represents 40 percent of the total tax burden, compared with 32 percent of the tax burden in Organisation for Economic Co-operation and Development (OECD) countries on average.¹⁴ Taxes on cars approach 50 percent of the cost to consumers. Counting all taxes, the lowest decile ends up paying 32 percent of income in taxes, compared with 23 percent for the middle decile and 21 percent for the top decile.¹⁵

The difficulty in obtaining consumer credit and underdeveloped digital services in finance and retail compound the plight of the vulnerable. Financial inclusion is limited, with less than 50 percent of people in Mexico and Colombia having access to bank accounts. This restricts the ability of households to make the most of their incomes by borrowing and saving. Only 6 percent of sales in Brazil in 2017 took place online, for example, about the same proportion as in India and Indonesia, but substantially lower than in China (16 percent) and South Korea (13 percent). However, digital disruption is starting to appear. In Colombia, notably, a startup called Rappi is providing on-demand delivery of items such as groceries and medication and has become one of Latin America's first "unicorns"—a startup with a valuation of at least \$1 billion. The Argentine digital marketplace MercadoLibre is also gaining ground and spreading across the region.

22%

Latin American exports as a percentage of GDP on average; in Mexico, the proportion was 38%

Exports could help fill this demand gap, providing the incentives and markets that companies in Latin America need to invest and broaden their production. However, with the notable exception of Mexico, exports play a smaller role than in the other emerging economies we use as benchmarks; exports in the region account for just 22 percent of GDP compared with 36 percent in the benchmark countries. Mexico has achieved a much stronger export performance since the establishment of NAFTA. Its exports of goods and services rose from 25 percent of GDP in 2000 to 38 percent in 2017. However, the benefits of its export growth have not spilled over into the domestic economy more broadly.¹⁶

Expectations of future demand are a main reason for companies to invest in larger and better production capabilities. With limited access to export markets and slowly growing domestic demand, Latin American economies have maintained rates of investment below those of their peer economies. Latin American and Caribbean investment in 2016 amounted to 19 percent of GDP, below the global average of 24 percent and the investment rate among East Asian emerging countries of 41 percent. Of our three focus countries, only Colombia reached the global average, recording a rapid rise from 13 to 24 percent between 1999 and 2015, before dipping.

Income is not flowing through to expanded domestic consumption for different reasons: A comparison of Brazil and Mexico

The flow of income to expanding domestic consumption can slow for different reasons. Brazil and Mexico provide two examples. In Brazil, social policies, minimum wage increases, and a credit expansion during the commodity-cycle upswing all gave a boost to the domestic market—but it was not sustained. Employed labor income accounted for 57 percent of gross income growth, due mostly to expansion of low-skill retail and other services. The demand boom was not matched by supply-side reforms to raise productivity, however. Moreover, high consumer prices and expensive credit continued to tax the purchasing power even of those with rising incomes. The benefits faded away through inflation and macroeconomic instability once the commodity boom ended. The demand boom was thus unsustainable because it was not supported by supply-side initiatives or a macro environment conducive to private investment.

Mexico, by contrast, focused on supply reforms and access to external markets, boosting productivity among the large modern segments of many industries by as much as 5.6 percent in the 2000s.¹⁷ Yet domestic demand has lagged. Productivity in the long tail of small

¹⁴ Adolfo Sachsida and Erich Endrillo Santos Simas, *Reforma tributária (Fiscal reform)*, Instituto de Pesquisa Econômica Aplicada, 2018.

¹⁵ Fernando Geiger Silveira et al., "Equidade fiscal no Brasil: Impactos distributivos da tributacao e do gasto social," *Comunicados do Ipea*, Instituto de Pesquisa Econômica Aplicada, 2011, Number 92.

¹⁶ See *A tale of two Mexicos: Growth and prosperity in a two-speed economy*, McKinsey Global Institute, March 2014.

¹⁷ *Ibid.*

industries did not improve and, unlike in Brazil, the gains did not feed through into broad-based wage growth; rather, they accrued mainly to the profit share of income. For example, while manufacturing productivity increased by an average of 1.7 percent annually between 2005 and 2015, average wages were stagnant. Given that a higher share of wage income is spent (rather than saved), this limited the multiplier potential of the productivity gains to translate into a more sustained source of domestic demand expansion. Domestic market growth was thus limited, crimping incentives for investment. The middle lost out amid these changes.

The Mexican auto sector provides one striking example of the divergence between productivity growth and wages. Production has grown at an annual average rate of 7 percent since 2006, and after doubling in a decade, labor productivity now ranks with that of the top producers in the world. Labor income gains have come from added workers at a wage level that is 1.6 times the national average, yet the average wage of Mexican autoworkers declined in the same period. By comparison, South Korea at the same point in its auto industry development saw a 58 percent increase in sector wages over the corresponding ten years of productivity growth.¹⁸

In Colombia, the patterns of growth since the turn of the century have been more inclusive. Wage growth averaged more than 2 percent annually, exceeding productivity growth and reflecting productivity gains across sectors. Some six million workers joined the workforce between 2000 and 2015, with disproportionate gains for women. However, this rapid expansion slowed wage growth compared with some peers. For example, Thailand grew at about the same rate in this period but nonetheless achieved wage growth of 3.7 percent, almost double that of Colombia, thanks to substantial productivity gains and a tighter labor market.¹⁹

Filling in the missing middles to capture the next wave of growth

If Latin American economies were able to fill in and strengthen the missing middles, thereby establishing a virtuous cycle of inclusive growth, the potential reward would be substantial. Using a macroeconomic simulation that assumes conservative growth in productivity is matched by increased labor shares and consumption in line with more inclusive countries, we find that achieving such a growth cycle could lift GDP in the region in 2030 by 50 percent above a baseline scenario that factors in current trends, including reduced labor force expansion. That would amount to an increase per person of more than \$1,000 per year, or a \$1 trillion incremental boost to GDP in 2030. Obtaining that prize will be challenging. Governments and business leaders will need to embrace a growth-focused policy agenda that addresses the missing links of past reforms.

Even in a time of social and political tensions, Latin America has a new opportunity to revitalize inclusive growth—and new tools to achieve it: digital technologies that can raise productivity growth and develop the missing middles, if embraced and adopted at scale. Digital entrepreneurship is already on the rise, with new platforms and applications from e-commerce to digital finance springing up across the region; several digital startups have achieved valuations of \$1 billion valuation or more.

Digital technologies can help directly address some of Latin America's challenges around the missing middles. While not a “silver bullet” or cure-all, the technologies can make it easier for companies to open businesses, register property, and file taxes over the internet, reducing the cost of red tape. Digital can facilitate more efficient markets from land and jobs to local services. Digital platforms make it possible for small and midsize companies to become “micromultinationals” able to compete with much larger competitors by offering their goods and services through online marketplaces regionally or globally. Critically, digital can and is already creating new, more productive jobs in Latin America—and the potential productivity



Potential boost to GDP in Latin America in 2030 if the region were able to fill in the missing middles, according to our modeling

¹⁸ South Korea national accounts data.

¹⁹ Colombia also has high non-wage costs of labor at about 50 percent of labor costs. These act as an incentive for firms to employ informally, particularly since informal wages are already often below the relatively high minimum wage. See *Colombia Policy Notes: Toward sustainable peace, poverty eradication and shared prosperity*; World Bank, September 2014.

boost it could give to the region's economies as a whole could offset the drag from its changing demographics. At the same time, these technologies present potential risks for inclusive growth in terms of job displacement and further concentration of profits.

Three priorities will be needed to lay the foundations for a pro-growth, inclusive agenda for the region and make it better able to embrace digital disruption

First is the need to create efficient markets and a competitive business environment in which digital can thrive, innovation is rewarded, and opportunities are created for all, especially squeezed firms in the middle. That will mean using digital tools where available to cut red tape, improve access to finance, and reduce barriers to entry and growth that reduce dynamism and performance pressure.²⁰ Second, policy shifts will need to create more participatory labor and consumer markets that spread productivity gains to the vulnerable and middle classes. If Latin America is to boost prosperity for all, productivity gains must flow to rising incomes for workers as they increase in skill level and to firms well placed to reinvest in their people, technology, and communities. Third, government itself can leverage digital platforms to raise public-sector efficiency and improve the delivery and cost of public services. Institutions will need to adapt and shift focus from protecting and regulating the status quo to encouraging new investment and experimenting with new delivery solutions.

Such changes will make Latin America better able to harness digital technologies, which could serve as a powerful source of productivity and growth. For this, digital-focused policies will also be needed, including building out broadband infrastructure, adapting regulation to a digital age, promoting digitization of government and society more broadly, and investing in the skills needed to bring about large-scale digital transformation. While the changes may be led by digital companies and technologies, they will extend to non-digital parts of the economy, too. Many countries in Latin America have already started on this path; if that energy can be maintained and built out, the region may be ripe for a Digital Spring.

Latin America has a new chance to rewrite the course of inclusive growth in the region, but the context requires immediate action. Navigating the digital wave and reigniting productivity growth will require an urgent collaborative effort across sectors at a time when declining fertility poses risks to the region's economic prospects. Beyond disruptive global forces, now more than ever the region's future is in its own hands. Solutions are available. A comprehensive approach combining supply-side and demand-side reforms is needed to build competitive capabilities for growing firms and ensuring that the broad base of the population benefits from the gains. This is not just a task for governments; a constructive role for business leaders is also called for. At a time of rising public disgruntlement, the people of Latin America need the prospect of a brighter economic future in which they can believe.

Latin America's future is more than ever in its own hands. A comprehensive approach is needed to improve competitive capabilities for firms and ensure that the broad base of the population benefits from the gains.

²⁰ Digital tends to benefit the largest firms more than smaller ones, as large firms have a clearer business case for digital efficiency and can deploy digital to create increasing returns to scale. Thus, digital should not be seen as a cure-all for the polarized business landscape in the region, even if it can contribute to a renewed dynamism.



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Latin America's dual challenge of growth and inclusion

Most Latin American countries are classified as “upper middle income” by the World Bank, and they have long ranked among the most prosperous developing economies. Over the past four decades, however, the region's GDP growth has been tepid and the rise of middle-class prosperity has stalled. Growth returned for a few years after the turn of this century, helping lift millions out of poverty—and raising expectations for a better future—but it proved short-lived and has since petered out, giving rise to political frustration.

Measured in per capita terms by the prosperity of consumers and households, Latin America has not closed the gap with more advanced economies and is on the verge of being overtaken by other regions that were long considerably poorer (Exhibit 1). China's GDP per capita in 2000 was roughly equivalent to that of Bolivia, one of Latin America's poorest and fastest-growing economies; today, China's GDP per capita is more than 2.6 times larger than Bolivia's and has caught up with the Latin American average.

A dual challenge for Latin America underlies this erosion: GDP growth has been sluggish, and the gains from that growth have not been distributed to the broad population. Weak productivity growth is the region's Achilles' heel. In faster-growing emerging economies, productivity growth has served as the main driver of GDP growth. In Latin America, by contrast, productivity has barely improved and GDP has been driven primarily by labor expansion. This has created more jobs but not better-paid ones—and it will be unsustainable as the region's demographics change. The search for solutions is urgent. Countries have introduced a range of reforms with varying results, but none has so far solved this dual challenge of growth and inclusion.²¹

This report seeks to offer a fresh perspective on what has gone awry by taking a full-cycle view of economic growth and offering some options to put the region back on track to sustainable growth, particularly in this digital age. In this opening chapter, we examine the dual challenge and its historical context and look at how reform efforts have so far failed to spark a self-reinforcing cycle of productivity growth that benefits the broad base of the population and further catalyzes domestic market expansion. We focus mainly on three countries—Brazil, Colombia, and Mexico. These countries are large and geographically varied, and they have followed different reform paths since the liberalization era of the 1990s. Yet their patterns of growth and inclusion remain stubbornly similar, reflecting causes rooted in common historical development policies dating to the 1950s that continue to shape the business landscape and the distribution of wealth.

²¹ The two dimensions of this challenge are not necessarily independent of each other. The vast literature on the relationship between growth and inequality points to many possible causal channels between the two, although empirical evidence is inconclusive (see, for example, Roland Bénabou, “Inequality and growth,” in *NBER Macroeconomics Annual 1996*, Volume 11, Ben S. Bernanke and Julio J. Rotemberg, eds., Cambridge, MA: MIT Press, 1996; Jess Benhabib, “The tradeoff between inequality and growth,” *Annals of Economics and Finance*, 2003, Volume 4, Issue 2; and Nancy Birdsall, *Income distribution: Effects on growth and development*, Center for Global Development, Working Papers 118, April 2007). Some academic research provides evidence that wealth inequality may be detrimental to growth for more developed economies (consistent with the Kuznets hypothesis of inequality rising then falling with development), but also that trends since the 1980s suggest growth may be biased toward rising wage inequality in these countries (see Philippe Aghion, Eve Caroli, and Cecilia García-Peñalosa, “Inequality and economic growth: The perspective of the new growth theories,” *Journal of Economic Literature*, December 1999, Volume 37, Number 4). Other studies point to the role of innovation as the link between growth and top income inequality (Philippe Aghion et al., “Innovation and top income inequality,” *The Review of Economic Studies*, January 2019, Volume 86, Number 1) and the forms of government and social contracts that underwrite stability under different distributive models (Daron Acemoglu and James A. Robinson, *Economic Origins of Dictatorship and Democracy*, New York, NY: Cambridge University Press, 2006; and Roland Bénabou, “Unequal societies: Income distribution and the social contract,” *The American Economic Review*, March 2000, Volume 90, Number 1). In this report, we focus on the conditions and policies that can enable the virtuous cycle that positively links growth and inclusion, the particular regional features that have inhibited this link in Latin America, and how innovation and technology adoption, especially digital, can help overcome these obstacles rather than exacerbate them.

Latin America's growth is slower than that of other emerging regions and driven more by labor expansion than productivity gains

Latin America's GDP growth averaged 2.8 percent annually between 2000 and 2016.

Growth has been more volatile and slower than in other emerging economies, especially in Asia. China's growth in this period, 9.5 percent on average, was more than triple that of Latin America. But even excluding China, the average GDP growth rate in 56 other emerging economies in the same period amounted to 4.8 percent—more than 70 percent higher than Latin America's growth record (Exhibit 2). Only five of the 56 countries, all in Central and Eastern Europe, grew at a rate below the Latin American average.²²

Among Latin American economies, Peru grew fastest, with GDP growth over the 2000–16 period averaging 5.2 percent. Of the three countries that are the focus of this report, Colombia performed the best, with average growth of 4.2 percent. Brazil's growth rate, at 2.4 percent, was close to the regional average, while Mexico's was weaker, at 2.1 percent.

Latin America started this period with a considerably higher income level than many other emerging economies. The region experienced rapid growth in the mid-20th century, becoming the first emerging region to industrialize and urbanize. However, Latin American incomes have not continued to rise, while some Asian and other high-performing economies accelerated and achieved rapid and more sustained growth in GDP per capita.²³ Latin America's performance has also been more volatile in recent years, in part because prices

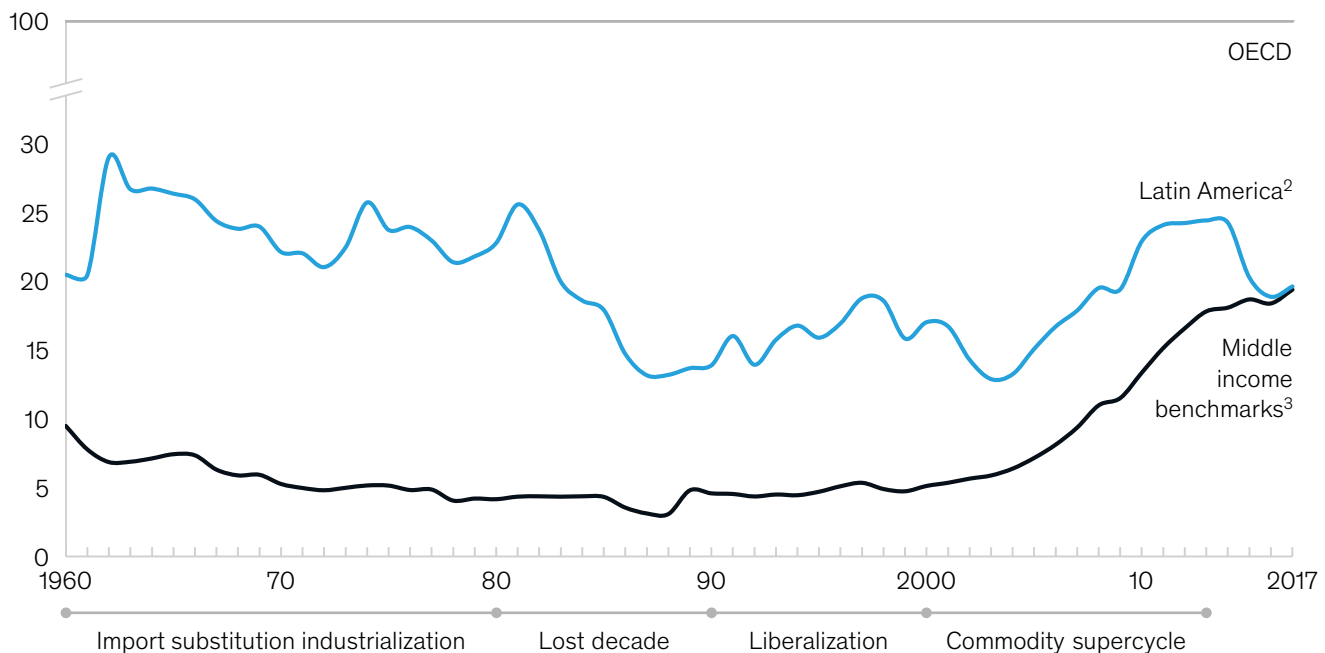
²² The five were Croatia, the Czech Republic, Hungary, Slovenia, and Ukraine. We do not include Jamaica. For the firm-level comparisons in this report, we mainly use ten emerging economies as benchmarks: China, India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey.

²³ Prior MGI research found that 18 of 71 emerging economies consistently outperformed their peers over 50 and 20 years. No Latin American country is among them. See *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

Exhibit 1

Latin America's GDP per capita gap to developed economies has not narrowed, while other emerging economies have caught up.

GDP per capita (PPP)
Index: 100 = OECD average¹



¹ Weighted average of 24 OECD member states excluding Latin American members (Chile and Mexico).

² Weighted average of region.

³ Weighted average of benchmark economies (China, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey).

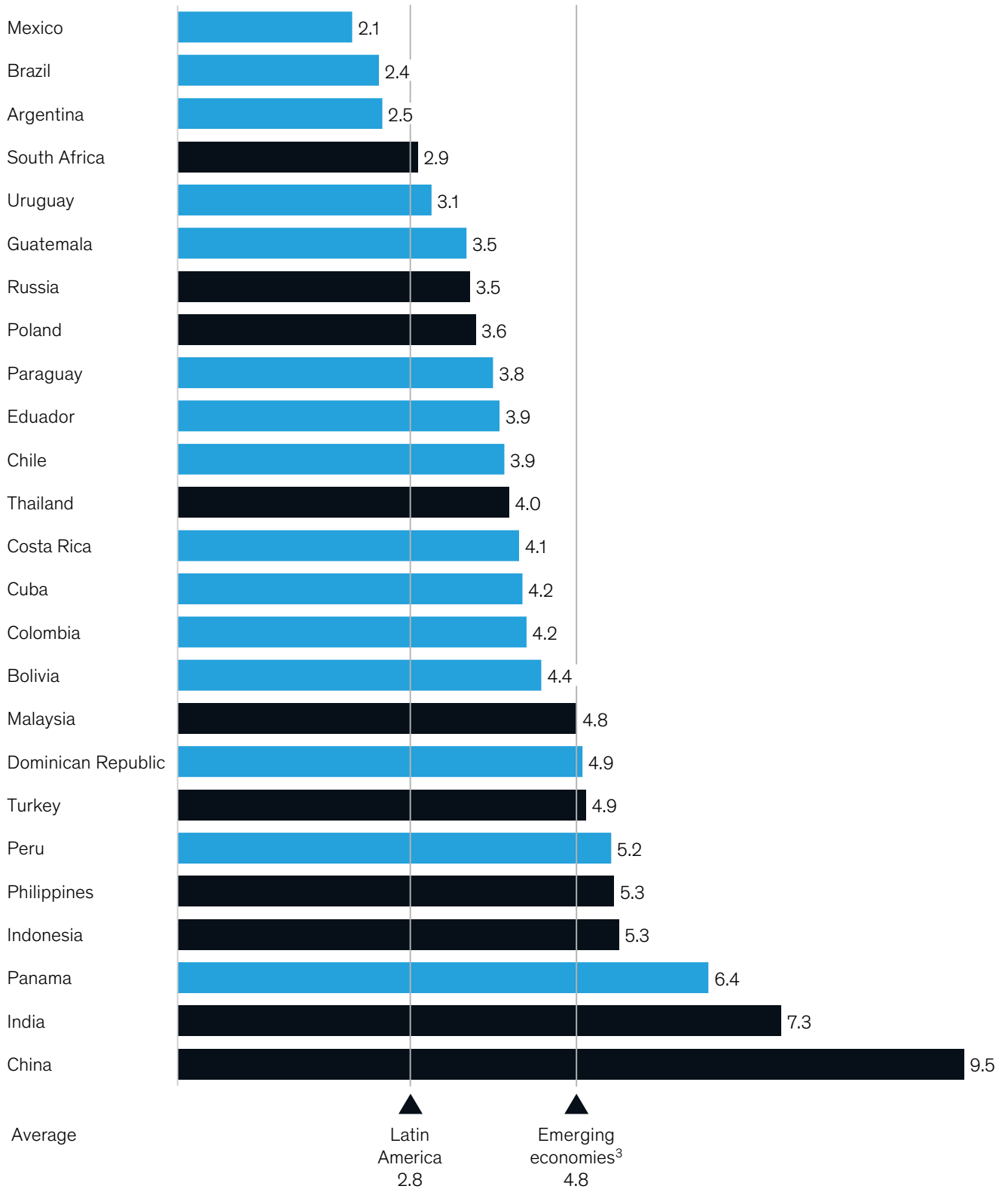
Source: World Bank; McKinsey Global Institute analysis

Since 2000, Latin American growth has lagged behind emerging economies, especially in Asia.

GDP growth by country

Compound annual growth rate, 2000–16, %

■ Benchmarks¹ ■ Latin America²



¹ The emerging economies average includes all emerging economies for which comparable data were available across relevant report analyses. It is a weighted average by GDP of 56 countries and excludes China due to outside impact.

² The Latin America average is also weighted by GDP. Venezuela is not included; it grew at 2.7 percent in 2000–14, but reliable data are unavailable after that.

³ The ten benchmarks are those we use throughout the report with similar size, GDP/capita and some geographic diversity but with a focus on Asian cases. The countries are: China, India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey.

Source: GGM; World Bank; McKinsey Global Institute analysis

for some resources such as oil and mineral products surged, raising natural resources sector growth by 7 percent from 2000 to 2013, only to fall back sharply when the bust came.²⁴

Growth has also varied across sectors. Finance and insurance grew at 5.4 percent from 2000 to 2016, about double the average for the region's economies. The services sector grew at 2.9 percent while manufacturing was weaker, achieving 0.4 percent growth.

GDP growth has come mainly from labor expansion, which is now fading

In addition to being weaker, Latin America's growth has also been different in nature from that of many better-performing peers in other regions. The largest driver of GDP growth has been expansion of the labor force, as a result of a demographic boom and increased participation of women. The workforce grew by 66 million workers between 2000 and 2016, and this expansion accounted for 72 percent of the region's overall GDP growth (Exhibit 3). The ratio of female to male labor force participation for Latin America increased from 58 percent in 2000 to 67 percent in 2017; Mexico's ratio, which increased from 47 percent to 56 percent, remains below the regional average. The female labor force participation rate in the region increased from 47 percent to 52 percent.²⁵

In Asian countries, the reverse is true: in the best-performing economies, including China, Malaysia, and Thailand, labor expansion has contributed a much smaller share of overall GDP growth. While the absolute level of workforce growth has been comparable, their more dynamic economies have been able to improve productivity much faster. Indeed, productivity growth for the Asian countries that have outperformed their peers over a period of 50 years has accounted for 89 percent of total GDP growth.²⁶

While the economy in Latin America expanded, the lack of high-productivity jobs to absorb the growing labor force has resulted in a large pool of low-productivity and low-wage workers, many self-employed and often working outside the legal framework. The expanding labor force has limited the pressure to raise wages even in companies and sectors where productivity has been rising. As we will see in chapter 3, this is especially visible in Mexico, where wages have been essentially flat despite sharp increases in productivity in the automotive and other sectors.

The demographic bonus in Latin America is now fading as declining birthrates since the 1970s lead to slower growth in the working-age population. The fertility rate in the region declined from 4.2 in 1980 to 2.6 in 2000 and reached replacement rate in 2015.²⁷ For most countries in the region, the "demographic dividend," under which the proportion of people of working age (15 to 64) is increasing, will end between 2020 and 2030.²⁸ The region's growth will increasingly depend on boosting productivity growth.

Absolute poverty has declined, but the middle class is squeezed and those in between remain vulnerable

One of the big success stories in Latin America over the past two decades has been a sharp reduction in the level of absolute poverty, as the benefits of the commodity boom and government policies aimed at the poor took effect. The poverty-reduction momentum has now slowed, however, and the lack of higher-productivity and higher-wage jobs has left many of the former poor in socioeconomic limbo—no longer living below the poverty line but not yet fully integrated into the consuming class. Inequality remains a scourge for the region and social mobility is limited.

²⁴ For a discussion of the commodity supercycle and its aftermath, see *Beyond the supercycle: How technology is reshaping resources*, McKinsey Global Institute, February 2017. For discussion of the general growth and volatility patterns, see Andres Solimano and Raimundo Soto, *Economic growth in Latin America in the late 20th Century: Evidence and interpretation*, United Nations Economic Development Division, CEPAL, February 2005.

²⁵ World Bank Gender Data Portal.

²⁶ That proportion is skewed by China, where 95 percent of GDP growth has come from productivity gains. However, across the fastest-growing emerging economies, productivity growth has consistently outstripped labor expansion as the driver of GDP growth. See *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

²⁷ World Development Indicators, World Bank.

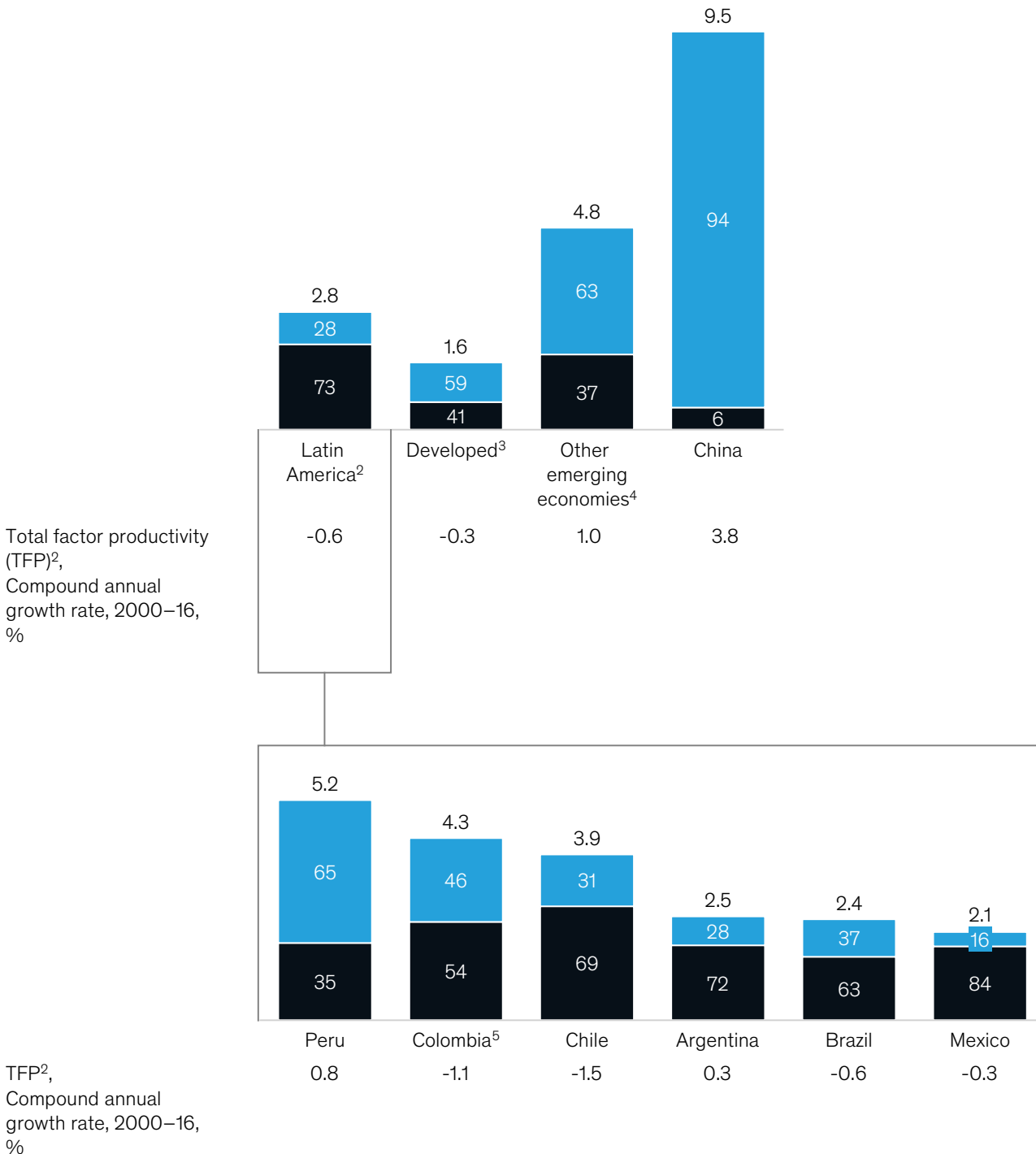
²⁸ United Nations Population Division medium-variant projections; Mexico's demographic dividend is predicted to peak five to ten years later.

Latin America's growth has come mainly from labor expansion with low productivity gains.

Components of growth, production view¹

Compound annual growth rate, 2000–16, % of total contribution

■ Labor
■ Productivity



¹ Productivity per employee; it can reflect TFP growth or human or physical capital intensity (per worker) growth. The country sample of 96 countries for Latin America, Advanced, Other Emerging economies, and China covers 96% of World GDP in 2017 based in World Bank. For region aggregates we use The Conference Board Total Economy Database for shares and World Bank for growth rates; Conference Board region aggregates growth rates differ by less than 0.2%.

² Total Factor Productivity estimated with Growth Accounting and Total Factor Productivity database from The Conference Board. This methodology decomposes GDP growth by: labor quality, labor quantity, total capital and total factor productivity. Aggregates shows average for the region.

³ Sample of 13 Latin American countries.

⁴ Includes 26 advanced economies.

⁵ Sample of 56 countries. Excludes China.

⁶ Colombia proportions based on 2001–16 data from DANE (2019 GEIH) to avoid change of employment methodology in 2000–01.

Source: INEGI; DANE; IBGE; The Conference Board Total Economy Database™ (Original version), November 2018; World Bank WD; McKinsey Global Institute analysis

40%

of Latin America's poor crossed the \$5 per day threshold out of absolute poverty between 2000 and 2015

Absolute poverty in Latin America declined sharply, although the trend has recently reversed

While different measures of income thresholds exist globally, we use an absolute poverty threshold of \$5 per day.²⁹ Between 2000 and 2015, 56 million people—or more than 40 percent of Latin America's poor in 2000—crossed this threshold, reducing the overall proportion of people in poverty to 13 percent of the total, from 27 percent. Uruguay (2.0 percent), Chile (6.4 percent), and Argentina (7.1 percent) report the lowest poverty rates in the region.

The income boom from rising commodity prices combined with pro-poor policies including conditional cash transfer programs established by several governments proved effective: together, they lifted millions of people out of absolute poverty and helped reduce some of the more glaring inequalities.³⁰ Mexico pioneered the cash transfer programs with its Oportunidades program (since replaced by the Progresa program), which ties transfers to health and education and has benefited nearly six million families.³¹ In Brazil, the Bolsa Família program likewise provides poor families with small cash transfers in return for keeping their children in school and making preventive healthcare visits. A decade after the program was launched in 2003, on the back of faster economic growth, Brazil's extreme poverty had been halved. It fell from just below 10 percent of the population to 4.3 percent, and income inequality as measured by the Gini coefficient also declined sharply. The program reaches about 14 million households, or as much as one-fourth of the population.³²

Recently, however, the trend toward poverty reduction has gone into reverse, including in Brazil, where the commodity boom ended and growth stalled as inflation and the public sector deficit rose. After 12 years of significant decreases in extreme poverty, a study by the UN Economic Commission for Latin America and the Caribbean shows that overall poverty and extreme poverty rates in 18 Latin American countries began rising again in 2015 and continued to do so through 2017. The extreme poverty rate in these 18 countries rose from a low of 7.8 percent in 2014 to an estimated 10.2 percent in 2018, higher than the level a decade earlier.³³ Much of the recent trend is driven by Brazil and Venezuela (see Box 1, “Venezuela's cautionary tale of an unsustainable consumption boost”).

The 2008 global financial crisis and the end of the commodity supercycle both provide context for this reversal in the reduction of extreme poverty. The financial crisis took a toll, particularly in Mexico, which was heavily exposed to the United States and fell into a recession reflected in slowing poverty reduction. While the commodity bust began in 2011–12—and while prices of some resources have recovered from lows—the region's commodity exporters, including Argentina and Brazil, continue to feel the effects. Shifting commodity prices are only one factor, however: the following chapters of this report focus on the structural factors that have stranded those moving out of extreme poverty with limited prospects for economic gains through better-paying jobs. Without more fundamental changes, rising social spending by governments is unlikely to translate into sustained progress toward broad-based prosperity.

Many crossing the poverty threshold remain vulnerable

The slow expansion of higher-productivity, higher-wage jobs and economic volatility has led to the creation of a sizable cohort of “vulnerable” households with per capita incomes between \$5 and \$11 per day. These are households no longer classified as poor but which do not yet generate sufficient income to join a more prosperous middle class (Exhibit 4). More than one-third of the region's population lives on less than \$11 per day based on purchasing

²⁹ We use the World Bank's categories of per capita income as a basis. For upper middle income countries these are: \$5.50 a day for poverty, \$5.51–\$13 for the vulnerable class, \$13.01–\$50 for middle class. Due to data availability, we adjust this slightly (\$0–\$5 for poverty, \$5.01–\$11 for vulnerable, \$11.01–\$50 for middle class).

³⁰ Francisco H. G. Ferreira et al., *Economic mobility and the rise of the Latin American middle class*, World Bank, 2012; *Retaking the path to inclusion, growth, and sustainability*, World Bank Group, May 2016.

³¹ The Oportunidades program ran from 2002 to 2014 and has since been replaced by the Progresa program. See, *A model from Mexico for the world*, World Bank, November 19, 2014, and Santiago Levy, *Progress against Poverty: Sustaining Mexico's Progresa-Oportunidades Program*, Washington, DC: Brookings Institution Press, 2006.

³² Deborah Wetzel, *Bolsa Família: Brazil's quiet revolution*, World Bank, November 4, 2013, worldbank.org/en/news/opinion/2013/11/04/bolsa-familia-Brazil-quiet-revolution.

³³ *Social panorama of Latin America 2018*, UN Economic Commission for Latin America and the Caribbean, January 2019.

Box 1

Venezuela’s cautionary tale of an unsustainable consumption boost

A core implication of our findings is that to generate inclusive growth, countries need the supply- and demand-side dimensions of the virtuous cycle to work properly and to stay in sync. Venezuela offers a cautionary tale: it boosted consumption through transfers and subsidies funded by unsustainable forms of public expenditure rather than through sustainable income growth from an expansion of productive jobs.

Between 2000 and 2014, aggregate consumption grew at 5.1 percent annually, considerably higher than the regional rate of 3.5 percent and 1.9 percent in Venezuela in the 1990s.¹ The consumption boom was largely fueled through public-sector transfers, financed early on by revenue from the commodity windfall. Between 1998 and 2014, Venezuela’s terms of trade increased more than any other Latin American country. The consumer transfers included

Misiones for subsidized food stores, subsidized basic medical care, and indirect consumer subsidies such as the low cost of gasoline.²

Yet on the supply side, meeting rising demand became increasingly challenging for private companies as government established price controls on final goods and complex exchange-rate regimes raised the cost of imports of intermediate goods. A number of large and small private enterprises were expropriated, and private-sector activity and employment dramatically declined in sectors including agriculture, oil and gas, telecommunications, and utilities. For example, steel production dropped from over 480,000 metric tons in 2008 to less than 5,000 in 2018.³

The gap between declining production and sustained demand was filled by imports, which rose from \$19 billion in 2000 to \$86 billion in 2012—an annual growth of 11.4 percent.⁴ As oil prices declined, balancing demand and production grew increasingly difficult.

¹ World Development Indicators, World Bank.

² Francisco Rodriguez, “An empty revolution: The unfulfilled promises of Hugo Chavez,” *Foreign Affairs*, 2008.

³ Moises Naim and Francisco Toro, “Venezuela’s suicide: Lessons from a failed state,” *Foreign Affairs*, 2018.

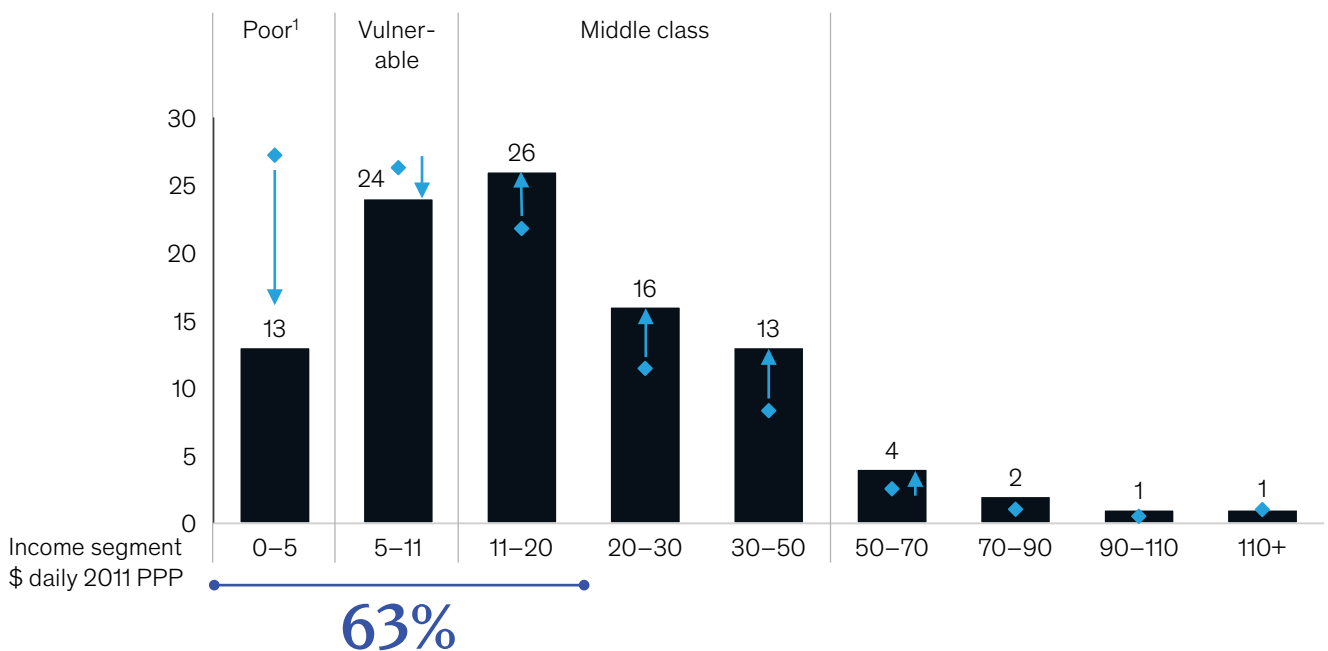
⁴ Atlas of Economic Complexity, Center for International Development at Harvard University.

Exhibit 4

Latin America has substantially reduced poverty since the turn of the century, but over 60 percent remain below \$20 per day of income.

Latin America population by income segment, 2000–17
%

■ 2017 ◆ 2000



¹ Income data from World Data Lab are post-tax and transfer, this holds throughout the report.

Source: World Data Lab; World Bank; McKinsey Global Institute analysis

power parity.³⁴ In all, we estimate that there are about 152 million vulnerable persons in Latin America; more than 60 percent of them are in Brazil, Colombia, and Mexico.

These individuals have crossed the poverty threshold but lack the job opportunities necessary to propel them into the middle class and economic security. They have low-productivity, usually informal jobs associated with low social protection and low, unstable income. As a result, they remain at high risk of falling back into poverty in a recession or in the event of a health or employment crisis.³⁵ Moreover, many in this cohort lack the labor skills they would need for jobs that could sustainably increase their income. In 2013, more than 30 percent of Latin American men and 20 percent of Latin American women above the poverty line were unskilled, according to the World Bank.³⁶ Millions who strive to attain a more comfortable middle-class life remain frustrated by weak income growth and the high price of consumer goods.³⁷

Social vulnerability can fuel political resentment, as unmet expectations of a better life translate into frustration and alienation that can contribute to political volatility and electoral upsets. Social volatility can also threaten the sustainability of growth.³⁸ Recent International Monetary Fund (IMF) research found that inequality causes shorter growth spells, meaning that the distribution of the benefits of growth is not able to sustain a “virtuous cycle” over an extended period; we will return to this idea in more detail later.³⁹

Missing expansion from the middle of consumers

A growing middle class is an important driver of economic growth.⁴⁰ These are consumers with money to spend beyond the basic necessities of food and shelter, and they spend a higher share of their income on consumption than the wealthy.⁴¹ A middle-class household is also able to consume a wider array of goods and services and be a fertile market for companies serving their needs. These consumers can invest in their children’s education, propelling upward mobility for future generations.⁴² As poverty has declined and households have become more prosperous, the number of people in Latin America joining the global middle class has increased by more than 110 million individuals in absolute terms, representing 57 percent of total domestic spending, up from 53 percent in 2000. In line with this, employment as a share of the working-age population in the region increased two percentage points (from 65 percent in 2000 to 67 percent in 2016).

Yet middle-class consumption remains low in relative terms. The bottom 90 percent of the income distribution in Latin America, comprising the region’s poor and vulnerable, and most of the middle class, accounts for 64 percent of domestic consumption.⁴³ This is the lowest share in the world, akin to that in Sub-Saharan Africa but substantially lagging behind other regions, where the bottom 90 percent consumes about 70 percent or more of the total (Exhibit 5). Of

Bottom 90%

of the population in Latin America accounts for just 64% of domestic consumption, the lowest proportion of any region in the world

³⁴ World Data Lab, Global Spending Model. www.marketpro.io and www.worlddata.io

³⁵ *Latin American economic outlook 2019: Development in transition*, OECD Development Centre, United Nations Economic Commission for Latin America and the Caribbean, Development Bank of Latin America, and European Union, 2019.

³⁶ *Working to end poverty in Latin America and the Caribbean; Workers, jobs, and wages*, World Bank, June 2015.

³⁷ Prior MGI research on Brazil estimated that it would take approximately R\$19–R\$27 in income per person per day (or R\$1,900–R\$2,700 per family per month) to meet the fundamental needs that constitute a more empowered life with a measure of economic security. See *Connecting Brazil to the world: A path to inclusive growth*, McKinsey Global Institute, May 2014.

³⁸ Andrew Berg and Jonathan D. Ostry, *Inequality and unsustainable growth: Two sides of the same coin?*, IMF staff discussion notes number 11/08, April 8, 2011.

³⁹ Jonathan D. Ostry, Prakash Loungani, and Andrew Berg, *Confronting Inequality: How Societies Can Choose Inclusive Growth*, New York, NY: Columbia University Press, January 2019.

⁴⁰ Definitions of what constitutes the middle class vary. Some institutions, including the World Bank, use a daily dollar amount of either income or consumption on a purchasing power parity basis. Other arbiters, including William Easterley of New York University, define it based on a range of income deciles. This makes the classification of middle class relative to each nation’s income distribution. In this report, we define middle-class households in Latin America as those with per capita income levels of \$11 to \$50 based on 2011 purchasing power parity. This is similar to the definition in Francisco H. G. Ferreira et al., *Economic mobility and the rise of the Latin American middle class*, World Bank 2013. In 2016, this corresponded roughly with the fourth to ninth deciles in Latin America.

⁴¹ See *Urban world: Cities and the rise of the consuming class*, McKinsey Global Institute, July 2012; *The global consumers to watch*, McKinsey Global Institute, July 2016; Homi Kharas, *The emerging middle class in developing countries*, OECD Development Centre working paper number 285, OECD, 2010.

⁴² Homi Kharas, *The unprecedented expansion of the global middle class: An update*, Global Economy & Development working paper number 100, Brookings Institution, 2017. For a broad discussion on the role of the middle class in developing economies, see Nancy Birdsall, *The (indispensable) middle class in developing countries; or, the rich and the rest, not the poor and the rest*, Center for Global Development, Working Paper 207, March 2010.

⁴³ To capture country-level dynamics, the bottom 90 percent throughout this report refers to country shares, which are then averaged by consumption weight, not the bottom 90 percent of the region taken as a whole.

the three countries on which we focus in this report, Mexico is just above the Latin American average, at 65 percent, while both Brazil and Colombia are below; the bottom 90 percent in both countries accounts for only 61 percent of total consumption.

The missing consumption is most striking among the bottom 50 percent, which includes Latin Americans who have been lifted out of poverty and across the vulnerable and lower-middle-class thresholds. This cohort accounts for just 19 percent of total domestic consumption, compared to more than 28 percent in South Asia. The lack of relative consumption power for the broad base leads to more limited influence of the middle class on the market.

Affluent Latin Americans, who disproportionately inherited their wealth, represent the highest consumption share in the world

While people formerly classified as poor moved into the “vulnerable” category and the vulnerable moved into the ranks of the middle class, the upper class sustained its share of overall consumption. The increase in people with income above \$70 per day has been in line with population growth, maintaining a 4 percent share of the population. This elite accounts for 22 percent of consumption. That share is unchanged since 2000, illustrating how the rise in middle-class income has not been sufficient to expand the middle-class consumption share needed to bolster a thriving consumer economy.

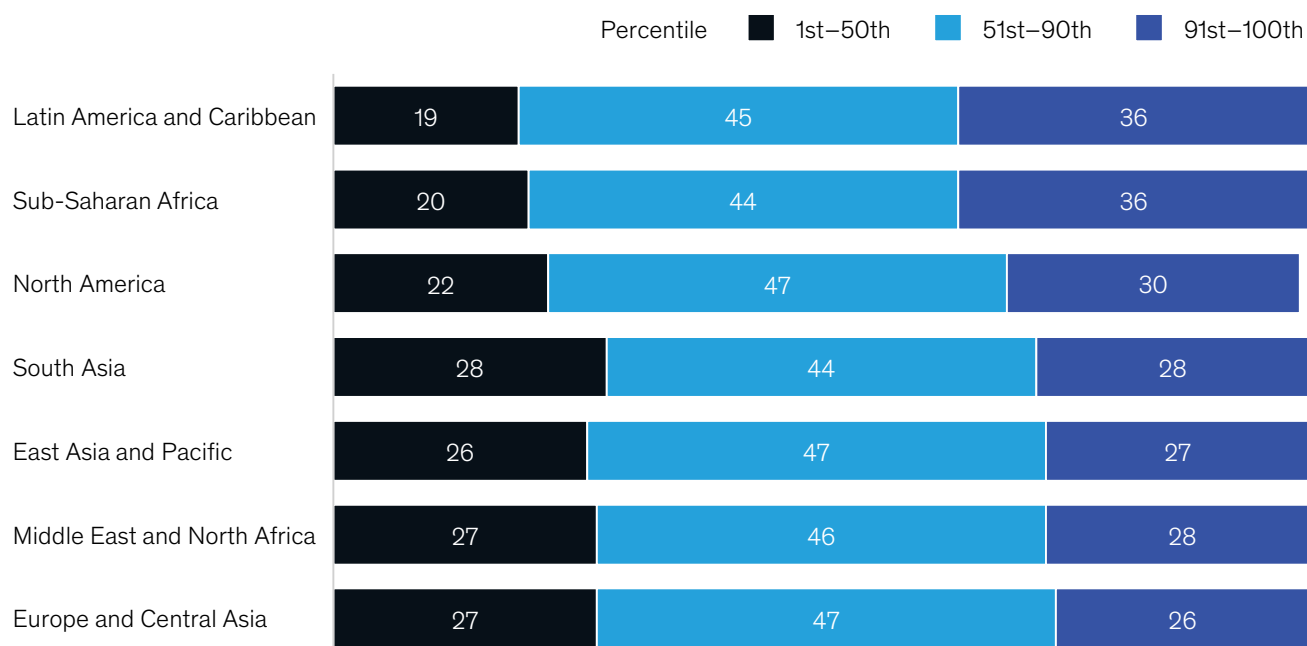
Looking at the very top of the income distribution, Latin America accounts for about 7 percent of global GDP, and the region is home to about 7 percent of the world’s billionaires.⁴⁴ Although the number of very affluent people is proportionate, the manner in which they acquired their wealth is not: about 50 percent of Latin American billionaires inherited their wealth. That is considerably more than in other regions; it compares with about 29 percent in the United States and just 20 percent in Asia. One of the reasons is that intergenerational wealth

⁴⁴ Richard Kersley and Antonios Koutsoukis, *The global wealth report 2016*, Credit Suisse Research Institute, November 2016, credit-suisse.com/corporate/en/articles/news-and-expertise/the-global-wealth-report-2016-201611.html.

Exhibit 5

Despite progress, Latin America’s consumption share from the bottom 50 percent and bottom 90 percent of the population remains the lowest in the world.

% of total consumption by region and income percentiles,¹ 2017



Note: Consumption power based on in-country income percentiles, not across regions (eg, sum of total consumption in bottom 50% of all LatAm countries). Data set includes 168 countries: East Asia and Pacific (25), Europe and Central Asia (49), Latin America and Caribbean (27), Middle East and North Africa (13), North America (2), South Asia (7), and Sub-Saharan Africa (45). Figures may not sum to 100% because of rounding.

¹ Numbers may not add up due to rounding

Source: World Data Lab; McKinsey Global Institute analysis

is heavily protected in Latin America; the top inheritance tax rate in Brazil is 4 percent, compared to 40 percent in the United Kingdom. In Mexico the rate is zero.⁴⁵

While economic participation is increasing, intergenerational mobility and equality of opportunity remain low

Economic participation is increasing across the region. For example, access to education, especially secondary education, has continued to rise. Young Latin Americans today receive significantly more schooling than their parents. Economic mobility has been similarly positive in aggregate. Of the 54 percent of the population in the vulnerable and middle class in 1995, only 2 percent shifted down to a lower class by 2010, while 41 percent of the 79 percent that started in the poor and vulnerable classes moved up by 2010. However, intergenerational mobility and equality of opportunity remain low, as children's economic prospects closely correlate with their parents' income.⁴⁶ Similarly, those whose parents received lower-than-average levels of education are themselves likely to receive lower-than-average levels of education.

The pro-poor initiatives mentioned earlier have had some impact on overall inequality. This has continued to improve: between 2005 and 2015, Gini coefficients for 11 countries in Latin America declined by more than four points, indicating greater equality. They included Bolivia, Brazil, Colombia, and Peru. Mexico saw no change. The momentum has since slowed, however. The recent report by the UN Economic Commission for Latin America and the Caribbean shows that, while the Gini coefficient has declined since 2002, the average annual pace of that decline has decelerated. The largest decline to the coefficient in the region, 1.3 percent, took place between 2002 and 2008. Thereafter, the pace slipped to 0.8 percent between 2008 and 2014, and to just 0.3 percent between 2014 and 2017.⁴⁷ Despite the progress, Latin America remains the most unequal region in the world in terms of the Gini coefficient. Brazil, Honduras, and Panama are among the countries with highest inequality, while El Salvador, Uruguay, and Argentina show the lowest figures.

Disparities remain in other social factors, including gender, ethnicity, and geography

The gulf between income groups is a key social division in Latin America, but not the only one (see Box 2, "Latin America has seen mixed progress on social indicators"). Other disparities can arise from factors including gender, ethnicity, and where a person lives in a region or neighborhood.

Gender: Female workforce participation in Latin America increased faster than in other regions between 2000 and 2015. This was especially the case in Colombia, where the ratio of female-to-male participation rose from 52 to 71.⁴⁸ Gender imbalances remain significant, however; according to the World Economic Forum, on current trends the region as a whole could take another 72 years to fully close the gender gap.⁴⁹ Female participation in the workforce in Latin America, at less than 70 percent, is lower than the rates of 80 percent or more in China, Sub-Saharan Africa, North America, and Western Europe. Women in Latin America are also more likely to participate in the informal, or less productive, economy rather than taking formal, high-productivity, and high-wage jobs.⁵⁰ Beyond fewer economic opportunities and less income than men, women in Latin America are also subject to high levels of gender-based violence. The "Ni una menos" protest movement that began in Argentina in 2015 in repudiation of violence against women is now spreading across the region and has become a public expression of widespread discontent among the region's women; harassment and gender-based violence on public transport is also a barrier to economic participation.⁵¹ Addressing gender equity matters for the region's growth prospects.

Less than 70%

Female participation in the workforce in Latin America, lower than in many other regions

⁴⁵ Facundo Alvaredo et al., eds., *World inequality report 2018*, World Inequality Lab, 2017; Alan Cole, "Estate and inheritance taxes around the world," Fiscal Fact, Number 458, Tax Foundation, March 2015.

⁴⁶ Francisco H. G. Ferreira et al., *Economic mobility and the rise of the Latin American middle class*, World Bank, 2012.

⁴⁷ *Social panorama of Latin America 2018*, UN Economic Commission for Latin America and the Caribbean, January 2019.

⁴⁸ World Bank, Gender Data Portal 2018.

⁴⁹ *The Global Gender Gap Report 2018*, World Economic Forum, weforum.org/docs/WEF_GGGR_2018.pdf.

⁵⁰ *Women and men in the informal economy: A statistical picture*, third edition, International Labour Organization, April 2018.

⁵¹ The movement has recently regained momentum in the region with the continuing debate around legalizing abortion and the rise of the green handkerchiefs (*pañuelos verdes*); see also *Ella se mueve segura – she moves safely: A study on women's personal security and public transport in three Latin American cities*, Latin American Development Bank and Fia Foundation, December 2017.

Increased participation of women in the labor force could boost GDP by 14 percent, or about \$1.1 trillion, by 2025 if all Latin American countries were to improve gender equality to the level in Chile, the best-performing country in the region.⁵²

Ethnic differences: Indigenous and Afro-descendant populations are overrepresented in poor income segments across Latin American countries. Members of these populations are only half as likely as others to be in the top 20 percent of income earners and twice as likely to be in the bottom quintile.⁵³ Despite poverty reduction measures, the poverty gap between indigenous and non-indigenous people has increased in several Latin American countries, including Brazil, Bolivia, and Ecuador.⁵⁴

⁵² *The power of parity: How advancing women's equality can add \$12 trillion to global growth*, McKinsey Global Institute, September 2015.

⁵³ *The social inequality matrix of Latin America*, UN Economic Commission for Latin America and the Caribbean, 2016.

⁵⁴ *Indigenous Latin America in the twenty-first century*, World Bank, March 12, 2018.

Box 2

Latin America has seen mixed progress on social indicators

Social indicators are a statistical measure of a country's economic development progress that show the well-being of its population beyond levels of income and consumption. Latin America has a higher level of social development than many other emerging economies. Yet despite making significant progress on key health, education, and access indicators, the region has not been able to narrow the gap with advanced economies.

Health: Life expectancy in Latin America has increased by four years on average since 2000, from 71 years to 75 years. This places the region ahead of most benchmarks in non-European regions, where 2016 life expectancy ranged from 64 years (in South Africa) to 76 years in China. However, it is still behind the OECD average of 81 years.¹

The under-five mortality rate for Latin America has declined since 2000 from 32 deaths per 1,000 live births to 17, with high variance throughout the region. The region's lowest-income countries, including Bolivia and Guatemala, have rates of 36 and 28 respectively. In Chile, Costa Rica, and Uruguay, the rates are below 10. Benchmark economies, and especially South Africa and India, closed a significant gap between 2000 and 2016, with the number of deaths per 1,000 births falling from 40 to 18. Mortality rates in both Latin America and the benchmarks are on average four times higher than in OECD countries.²

Education: Latin America has markedly increased its educational coverage, with 92 percent of primary school-age children enrolled in school. But enrollment rates decline after primary school, with net enrollment of 69 percent for lower-secondary and 52 percent for higher-secondary students.

The quality of education remains a challenge. More than 75 percent of Latin American students are enrolled in schools considered poor quality, compared to 43 percent across Asia. In 2015, Latin American students earned improved PISA scores, but the region still lagged behind other OECD and peer economies across all subjects. All ten Latin American countries with PISA scores in 2015 performed worse than expected given their level of GDP per capita.³

Access to basic services: Almost everyone in Latin America—about 98 percent of the population—now has access to electricity, up from 92 percent in 2000.⁴ The region's major economies have achieved nearly full coverage, which is the OECD standard. Smaller Central American economies still lag behind, however. Nicaragua has 82 percent coverage, and Honduras 87 percent. In Haiti, the Caribbean region's outlier, only 39 percent have electricity. Ninety percent of urban dwellers but only 68 percent of the rural population in Latin America and the Caribbean had access to at least basic sanitation services in 2015 (and only 22 percent of the region uses safely managed sanitation systems).⁵ Similarly, access to at least basic drinking water services is 98 percent in urban populations and 86 percent among rural (the same rate as in South Asia and just under the rate for East Asia and the Pacific).⁶

¹ World Health Organization, Global Health Observatory data.

² Ibid.

³ *Drivers of student performance: Latin American insights*, 2017, McKinsey.com.

⁴ World Development Indicators, World Bank.

⁵ Ibid.

⁶ Ibid.

Geography: Latin America was the first developing region to industrialize and urbanize. More than 80 percent of Latin Americans live in urban areas, compared to 58 percent in China and 34 percent in India.⁵⁵ During the rapid industrialization, the region's growth was concentrated in ten cities that today generate one-third of the region's total GDP, a higher share than in any other region in the world.⁵⁶ Yet infrastructure, housing, and services in these cities have not kept pace with rapid population growth. As a result, the gulf between poor and rich neighborhoods is especially wide, with 20 percent of Latin Americans living in slums.⁵⁷ This is reflected in crime and poor quality of life. More than 80 percent of the most violent cities in the world are in Latin America.⁵⁸ Basic infrastructure and quality-of-life indicators, such as life expectancy, crime, and commute times, reflect the hardship of these circumstances, which represent a drag on both the supply and demand efficiencies in the economy.

In Brazil, Colombia, and Mexico, common development legacies continue to slow progress against the dual challenge

The three countries we focus on in this report, Brazil, Colombia, and Mexico, capture 60 percent of the region's GDP. Each of the three, in its own way, has tried to resolve the dual growth and inclusion challenge that is common to all. Given the countries' different sizes, geographies, and choice of policies, analysis of the three paths provides a comparison of what has worked and what has not in the efforts to raise economic growth and make that growth more inclusive in the region. For all the country differences, a common regional history is the source of more fundamental factors that explain the difficulty of bringing about sustained change, most importantly the distribution of firms and household consumption—the two “missing middles” of this report.

Import substitution industrialization brought a growth boom but left an inward-focused business landscape

Latin America's golden growth era of the mid-20th century was based on an economic model that ran out of steam by the 1980s. The region has seen a wave of reforms since then, yet it has failed to return to past levels of growth.⁵⁹

The import substitution industrialization policies of the 1950s and 1960s set off a growth boom, as production expanded to serve domestic demand in protected national markets. Import tariffs and business licenses granted to multinational corporations made expanding capacity to serve local markets attractive even in many of the smaller Latin American countries.⁶⁰ However, these policies created limited competitive pressure for companies to adopt the latest technology and aspire to globally competitive productivity levels. Multinationals operating in small local markets saw limited need to build an expansive local supply chain or ecosystem of companies. Nor did the policies lead to a broadening of the export base beyond exports of resources. Given the profitable and growing local markets, leading companies in the region had few incentives to look for opportunities abroad.

This legacy helps explain the industry structure we see today, in which a few large firms constitute a disproportionately large share of total revenue. These firms include successful “multilatina” companies that operate across the region, as well as others that have grown sufficiently large to join the Global Fortune 500.

⁵⁵ United Nations Population Division, *2018 revision of World Urbanization Prospects*, May 2018.

⁵⁶ *Building globally competitive cities: Key to Latin American growth*, McKinsey Global Institute, August 2011.

⁵⁷ World Development Indicators, World Bank, 2018.

⁵⁸ Igarape Institute Homicide Monitor.

⁵⁹ Mauricio Cárdenas and Steven M. Helfand, “Latin American economic development,” in *The New Palgrave Dictionary of Economics*, online edition, Steven N. Durlauf and Lawrence E. Blume, eds., 2011; *Economic Development in Latin America: Essay in Honor of Werner Baer*, Hadi Salehi Esfahani, Giovanni Facchini, and Geoffrey J. D. Hewings, eds., London, UK: Palgrave Macmillan, 2010; Marcus J. Kurtz and Sarah M. Brooks, “Embedding neoliberal reform in Latin America” *World Politics*, January 2008, Volume 60, Number 2.

⁶⁰ Carlos A. Primo Braga, “Import substitution industrialization in Latin America: Experience and lessons for the future,” in *Economic Development in Latin America: Essay in Honor of Werner Baer*, Hadi Salehi Esfahani, Giovanni Facchini, and Geoffrey J. D. Hewings, eds., London, UK: Palgrave Macmillan, 2010; Henry Bruton, “A reconsideration of import substitution,” *Journal of Economic Literature*, June 1998, Volume 36, Number 2; Jan Peter Wogart, *From import substitution to export diversification in Colombia*, Kiel Institute for the World Economy, working paper number 31, July 1975.

Macro stability has improved while development reforms have failed to resolve the inclusive growth challenge

Starting in the 1990s, many Latin American economies have made substantial progress on reducing macroeconomic instability, although they and other countries in the region face continuing challenges, including sustainable public finance. Colombia has long had low inflation and stable interest rates and was one of the countries least affected by the debt crises of the 1980s. Mexico's macroeconomic situation has also been stable since 1994, with the major dip coming with the global financial crisis in 2008–09. Brazil used the commodity cycle to develop substantial international reserves, but high government debt and interest rates persist as does volatile inflation. In Argentina, persistent macro vulnerabilities led to a crisis in 2018: annual inflation reached 48 percent, GDP fell by 2.5 percent, and unemployment and poverty increased.⁶¹ Chile and Peru have been able to maintain robust and steady growth since 2000 even with relatively high dependence on natural resources and agricultural exports.

Colombia's growth has been stronger than that of most of its regional peers based on a stable macroeconomy and investment recovery since its financial crisis in the late 1990s and the peace process leading to the end of armed conflict in the country in 2016.⁶² Historically, it has managed the macro economy of resource exports relatively well—from coffee in the 20th century to oil and gas and minerals more recently—and inflation has been stable since the 1970s with the exception of the 1990s crisis.⁶³ Productivity rose in both export commodity industries and domestic services in the 2000s. However, Colombia is just catching up to larger economies in per capita income and has not yet delivered on the promise of “la apertura comercial,” the period of opening to trade and capital in the early 1990s. This aimed to reduce protection and develop comparative advantages in higher-value-added sectors sufficient to boost its smaller economy and insulate it from commodity cycles.

Mexico has been a leader in export-oriented reforms, largely bolstered by NAFTA following its debt crisis in 1994–95. Its inflation and fiscal situation also improved, resolving the macro instabilities of the 1980s.⁶⁴ However, the productive modern economy has been outpaced by a more traditional economy in job creation, and most workers do not benefit from productivity gains. They have thus contributed little to expanding consumption or domestic savings.⁶⁵

In Brazil, the policy focus of the past 15 years has continued to rely on the country's large, protected domestic market to expand jobs and raise wages. This approach helped boost employment, incomes, and demand during the post-2000 commodity boom and was aided by expanded credit and a large domestic market that translated the resource windfall into jobs in services for low-skill workers (Exhibit 6). However, growth remains stunted by resurfaced macro concerns, limited higher-value-added exports, and a persistent “Brazil cost” on the supply side, which has held back innovation and the growth of new companies and inflated the cost of consumer goods.⁶⁶ During the downturn the fiscal situation again deteriorated and interest rates rose in an effort to stave off recurring inflation, pushing public finance concerns and the long-term investment environment back to the top of the policy agenda.⁶⁷

In Argentina, persistent inflation, fiscal vulnerability, and current account imbalances (which reached nearly \$32 billion by the end of 2017, nearly 5 percent of GDP) triggered a run against the Argentine peso, which fell by 52 percent against the dollar in 2018.⁶⁸ External shocks played an important role, too. Monetary tightening in the United States put further pressure

⁶¹ Instituto Nacional de Estadística y Censos.

⁶² *Towards sustainable peace, poverty eradication, and shared prosperity*, World Bank, Colombia Policy Notes, September 2014.

⁶³ Jose Antonio Ocampo, “Performance and challenges of the Colombian economy,” *Initiative for Policy Dialogue* network paper, 2013.

⁶⁴ Gordon Hanson, “Why isn't Mexico rich?” *Journal of Economic Literature*, Volume 48, Number 4, 2010.

⁶⁵ *The tale of two Mexicos: Growth and prosperity in a two-speed economy*, McKinsey Global Institute, March 2014.

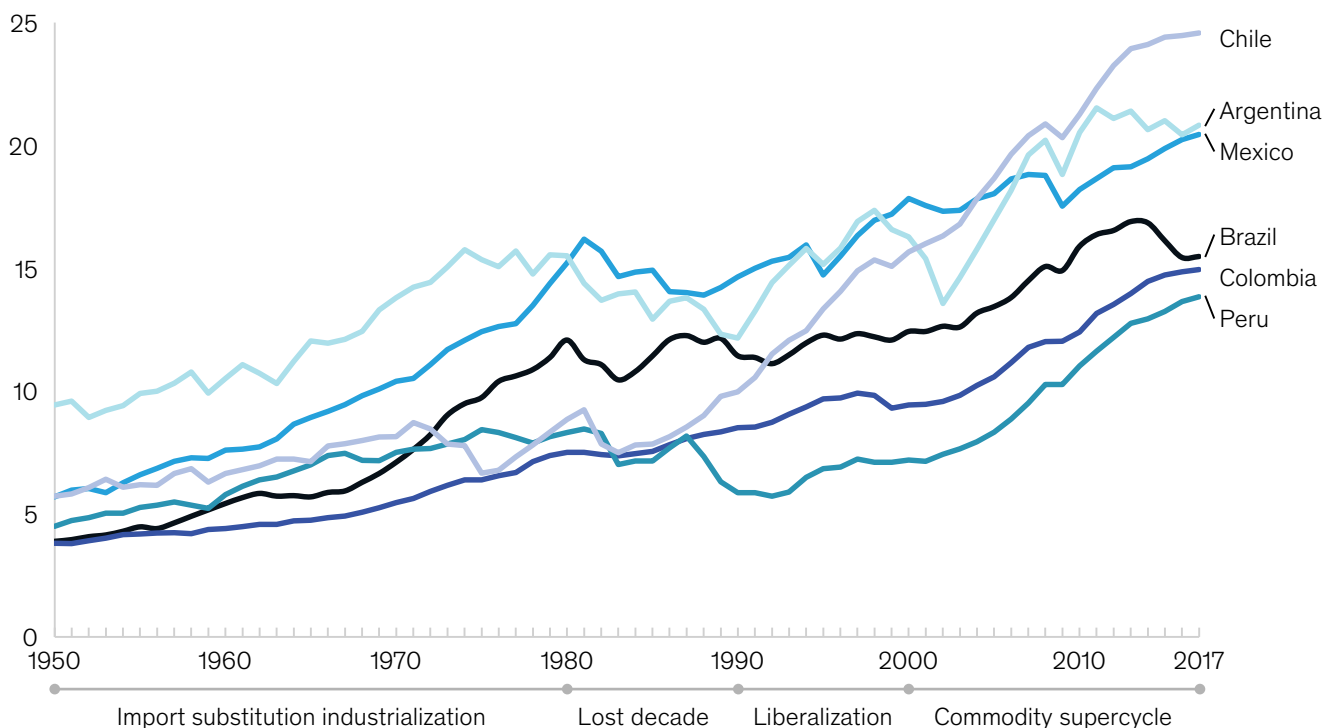
⁶⁶ *Connecting Brazil to the world: A path to inclusive growth*, McKinsey Global Institute, May 2014.

⁶⁷ *Public policy notes – towards a fair adjustment and inclusive growth*, World Bank Brazil Policy Notes, August 23, 2018, <http://www.worldbank.org/en/country/brazil/brief/brazil-policy-notes>; *Retaking the path to inclusion growth and sustainability*, World Bank Report No. 101431-BR, Brazil systematic country diagnostic, May 2016.

⁶⁸ Instituto Nacional de Estadística y Censos and Central Bank of Argentina.

Recent growth trajectories have differed across the region.

GDP per capita
2017 \$ (converted to 2017 price level with 2011 PPPs)



Source: Conference Board Total Economy Database 2018; McKinsey Global Institute analysis

on an already delicate external situation, while agricultural GDP fell by 15 percent, caused by a severe drought.

In response, the government switched monetary policy and, in 2018, secured a \$57 billion stand-by loan from the IMF, the largest in the IMF's history.⁶⁹ The IMF deal imposed tight targets for public finance stabilization, with an explicit goal of eliminating the fiscal deficit by the end of 2019. Ongoing efforts to reduce government expenditure have been intensified, yielding meaningful results. The primary deficit has fallen from 4.3 percent of GDP in 2016 to 3.8 percent in 2017 and 2.4 percent in 2018 (below the IMF target of 2.7 percent).⁷⁰

In parallel, external account imbalances have significantly decreased, while regulated utility rates have gradually been returning to market prices.⁷¹ While external headwinds seem to be abating and agriculture is on its way to a record harvest, questions remain.⁷² The acceleration in inflation has fueled expectations and intensified pressures for redistribution, with workers demanding wage increases that compensate for lost purchasing power. Short-term debt obligations and upcoming elections at the end of the year intensify the uncertainty and put pressure on the ongoing efforts to stabilize macro fundamentals.

⁶⁹ After abandoning inflation targeting, Argentina switched from monetary targeting to exchange-rate targeting through a crawling peg regime.

⁷⁰ Ministerio de Hacienda.

⁷¹ Such distortions arose from the introduction and expansion subsidies to contain utility prices that took place between 2005 and 2015. While such subsidies helped lower income households access public services, the lack of adjustment in prices in a context of high inflation led to large distortions in relative prices and spiraling fiscal costs. The nature of such subsidies, targeting the supply of services in urban areas, also created significant inclusion errors, creating disproportionate benefits for high-income households. By 2015, subsidies represented 4.1 percent of GDP according to estimates from ASAP, a nonprofit focused on strengthening transparency in government spending. The largest share of the burden was driven by energy subsidies, which represented 2.9 percent of GDP by 2014. Between 2000 and 2015 price levels were estimated to increase by nearly 1,400 percent (equivalent to being multiplied 15-fold), while electricity prices saw an increase of barely 34 percent during the same period.

⁷² *El Gobierno proyecta 140 millones de toneladas para la campaña agrícola 18/19*, Ministerio de Producción y Trabajo, November 7, 2018.

Some other economies in Latin America have had more positive economic outcomes (see Box 3, “Regional examples of success: Chile, Peru, and Uruguay”). A table summarizing economic indicators for Latin America and some benchmarks follows this chapter (Table 1).

While this opening chapter focused on the economic track record in Latin America and the legacies that helped condition it, this report mainly looks forward rather than back. In the following chapters, we focus on two implied tasks that will be needed for Latin America to achieve a virtuous cycle of inclusive growth through a rebuilding of the “missing middle.” First is the imperative of increasing labor productivity to promote sustainable growth, especially through expanding the pool of modern firms and incentives they have for bold investment. Second is the need for an upward trajectory toward a stable middle class in which a much larger proportion of the population moves into higher-productivity jobs and reaps the income rewards. The period since 2000 has been distinguished by a new focus on inclusive growth in the region, but until the more fundamental economic forces associated with the missing middles are addressed, the prospects for sustainable inclusive growth will remain fragile.

Regional examples of success: Chile, Peru, and Uruguay

From 2000 to 2016, Chile—one of the wealthiest economies in the region—grew at 3.9 percent annually, while Peru grew at 5.2 percent annually, faster than Malaysia and Thailand. In inclusiveness, Uruguay has one of the lowest Gini coefficients in the region and the highest GDP per capita in purchasing power parity terms. Chile's bottom 90 percent consumed just 63 percent of the domestic market, below the regional average, while Peru ranks among the more inclusive economies. Each of these countries offers important lessons for how policy and its effective execution can lead to faster and more inclusive growth.

Chile

Chile has long been regarded as one of Latin America's economic success stories, with strong institutions, political stability, and an open trade regime resulting in consistent economic growth.¹ This has translated into welfare gains for the broad base of its population. In 2016, 82 percent of Chile's population was above the middle-class threshold, among the highest proportions in the region, up from 54 percent in 2000. However, income inequality and the resulting consumption patterns pervasive throughout Latin America remain a challenge.

Growing exports bolstered by a pro-trade policy framework reducing barriers and tariffs, free-trade agreements with major economies, and a pro-business environment are keys to Chile's success. It is the global leader in copper production and exports, and commodity exports remain a keystone of the economy, accounting for more than 50 percent of exports. This makes the country susceptible to commodity cycles.²

An open trade environment not only can expand production and create more productive jobs, but can also increase average wages, especially for skilled workers.³ A study evaluating the impact of trade policy on wages in Chile found that opening to trade can increase wages for high-skill workers, especially in medium-size institutions best positioned to benefit from pro-trade policies.⁴

Peru

Peru's growth rates were well below the regional average between 1960 and 1990, but since the 2000s, the country has become a regional outperformer. Its per capita income doubled from 2000 to 2014, poverty rates dropped by more than half, and more than 20 percent of the population joined the middle class.⁵ A foundation of macro stability and strong fiscal policy allowed Peru to benefit from the commodity boom and navigate the

bust better than its peers. The country committed to an industrial policy focusing on entering global value chains in agriculture and commodities, an accessible transformation given the country's natural advantages and level of development. Its reforms also strategically addressed competition in both local and international markets. The government recently strengthened the national competition authority, removing subnational barriers to entry and driving productivity gains.⁶

The agriculture sector remains a significant part of Peru's production, employment, and export portfolio, despite an ongoing structural transformation.⁷ Agricultural exports have driven broad-based growth, particularly of the lower income segments, and have been stimulated by strategic policy incentives creating an attractive but competitive business environment.

Peru's ongoing challenges continue to be informality and regional inclusiveness. Nonagricultural labor informality rates are above 70 percent, hampering productivity gains in industrial and service sectors.⁸ The benefits of growth, especially in agriculture, have not been shared equally across regions, in part because of infrastructure barriers and resource endowments.

Uruguay

Uruguay is one of the best examples of inclusive growth in the region. GDP grew at 3.1 percent from 2000 to 2016, and in 2016 the country had the highest GDP per capita in the region at \$22,600 (in purchasing power parity terms), just below Chile's level of \$24,600.⁹ Uruguay's Gini coefficient of 39.5 is one of the lowest in the region. Uruguay has thrived on the back of its openness, strong institutions, and ability to attract investment.

Policy reforms after the 2002 banking crisis have included special tax regimes to attract investment, development of new industries (software), higher public spending on science and technology, and a focus on keeping taxes low. These policies resulted in productivity gains, particularly in agriculture. Competitiveness also increased, resulting in exports of goods and services that rose above one-fifth of GDP, higher than regional peers; however, this proportion is still relatively low compared to some high-performing emerging economies.

From an inclusion perspective, Uruguay's policies expanded social programs, such as a pension system covering 87 percent of the population over 65 years old. Extreme poverty has been essentially eradicated, with 0.1 percent of the population living under \$1.90 PPP a day. Health programs have also been effective: life expectancy at birth is almost 78 years.

¹ *Country Partnership for the Republic of Chile*, World Bank, 2011.

² *Chile - systematic country diagnostic: Transitioning to a prosperous society*, World Bank, 2017.

³ Irene Brambilla, Daniel Lederman, and Guido Porto, *Exporting firms and the demand for skilled tasks*, policy research working paper WPS 8603, World Bank, 2018.

⁴ Ivan T. Kandilov, "Do exporters pay higher wages? Plant-level evidence from an export refund policy in Chile," *World Bank Economic Review*, June 2009, Volume 23, Number 2.

⁵ *Peru country overview*, World Bank, September 2018, worldbank.org/en/country/peru/overview.

⁶ Marc Tobias Schiffbauer and James Sampi, *Enforcing competition and productivity: Evidence from 1,800 Peruvian municipalities*, policy research working paper WPS 8714, World Bank, January 2019.

⁷ Michael Morris et al., *Gaining momentum in Peruvian agriculture: Opportunities to increase productivity and enhance competitiveness*, working paper 116859, World Bank, June 2017.

⁸ Juan Jose Diaz et al., *Pathways to formalization: Going beyond the formality dichotomy—the case of Peru*, policy research working paper WPS 8551, World Bank, August 2014.

⁹ World Development Indicators, World Bank.

Table 1

Summary of economic indicators and company and consumer data

■ Lower than benchmark ■ Higher than benchmark

| Indicators | | Argentina | Brazil | Chile | Colombia | Mexico | Peru | Bench- marks/ other emerging markets | China |
|---|---------------------------------------|-----------|--------|-------|----------|--------|------|--|---------|
| Macro indicators | Population, 2016, million | 43.8 | 207.7 | 17.9 | 48.7 | 127.5 | 31.8 | n/a | 1,378.7 |
| | GDP per capita, 2016, \$ thousand PPP | 20.1 | 15.2 | 23.2 | 14.1 | 18.2 | 13.0 | 21.1 | 15.5 |
| | GDP growth rate, 2000–16, % | 2.5 | 2.4 | 3.9 | 4.2 | 2.1 | 5.2 | 4.8 | 9.5 |
| GDP production view, 2000–16, % ¹ | Productivity | 28 | 37 | 31 | 46 | 16 | 65 | 63 | 94 |
| | Labor | 72 | 63 | 69 | 54 | 84 | 35 | 37 | 6 |
| GDP income view, 2000–16, % ² | Profits and mixed income | 65 | 43 | 57 | 67 | 78 | 68 | 61 | 49 |
| | Employees | 18 | 27 | 26 | 18 | 23 | 12 | 15 | 3 |
| | Wages | 16 | 30 | 17 | 16 | -1 | 20 | 24 | 48 |
| GDP expenditure view, 2000–16, % ³ | Consumption | 74 | 63 | 70 | 56 | 58 | 65 | 56 | 33 |
| | Investment | 24 | 7 | 30 | 37 | 27 | 25 | 31 | 54 |
| | Government | 17 | 24 | 13 | 20 | 18 | 14 | 12 | 12 |
| | Net exports | -15 | 6 | -12 | -13 | -3 | -4 | 1 | 1 |
| Pool of large and midsize firms ⁴ | Index to benchmarks | 50 | 48 | 45 | 97 | 62 | 86 | 100 | 70 |
| Middle-class consumers, ⁵ percentile | 1st–50th | 21 | 17 | 19 | 17 | 22 | 21 | 25 | 26 |
| | 51st–90th | 48 | 44 | 44 | 44 | 44 | 47 | 46 | 47 |
| | 91st–100th | 31 | 39 | 37 | 39 | 34 | 32 | 28 | 27 |

¹ Decomposes GDP growth into percentage shares attributable to growth in real GDP per worker and expansion of the labor force (see Exhibit 3).

² Decomposes GDP (income) growth into percentage shares based on who receives it. "Profits and mixed income" is a residual category here for all non-employed labor income. "Employees" refers to the increase in labor income attributable to more workers at constant wages. "Wages" refers to the increase in labor income attributable to higher wages for constant labor force size (see Exhibit 17).

³ Decomposes GDP growth into percentage shares according to changes in the four standard GDP expenditure categories.

⁴ Number of firms above \$50 million per size of GDP, relative to benchmarks.

⁵ % of total consumption.

Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Global Institute analysis



2

A missing middle of dynamic midsize companies

Companies large and small across Latin America have an essential role to play in raising productivity and helping make growth inclusive. As we have seen, the region's GDP growth has come about largely from adding workers rather than by increasing productivity. As labor force expansion slows, the urgency of increasing skilled employment and raising productivity climbs.

The step change in labor productivity growth that the region needs can be achieved only if companies overcome the business polarization in Latin America—the persistent division between a small number of large and well-established incumbents and a long tail of small, unproductive, and often informal firms that continue to employ between 40 and 80 percent of the workforce. Conspicuously absent in this tale is a cohort of vibrant midsize companies that could bring dynamism and help expand the number of productive and well-paying jobs in Latin America. In this chapter, we look at ways to encourage the emergence, proliferation, and growth of firms that can build up the ranks for midsize and larger firms.

A missing middle of firms reduces industry dynamism

The legacy of the import substitution policies era combined with a wave of mergers and acquisitions since the 1990s have shaped the corporate landscape in Latin America. Exhibit 7 highlights the very different contours of that landscape compared with a range of other emerging economies. Latin America has a number of powerful local and global companies, but these tend to be fewer and with lower total revenue relative to the size of the economy. In this report, we define large companies as those with revenue of more than \$500 million and midsize as between \$50 million and \$500 million.⁷³

The exhibit visualizes how large and midsize Latin American companies with more than \$50 million in revenue are less prevalent for the size of the economy. Specifically, Argentina, Brazil, Chile, and Mexico have about half the number of such companies per dollar of GDP than the simple average of our benchmarks.⁷⁴ Malaysia, by comparison, has almost twice the average number of these firms and four times as many as Brazil, adjusted by GDP. The Latin American economies bear more resemblance along this metric to the less developed Southeast Asian economies such as Indonesia and the Philippines, where a few large conglomerates own large shares of the economy.⁷⁵

While the absolute difference in number of firms is higher in the middle, Latin America also has fewer large firms relative to benchmarks. As a result, the ratio of revenue from midsize and large firms to GDP is less than three-fourths on average among the six Latin American economies in Exhibit 7, compared to the benchmarks. Within the region, Chile, Brazil, and Mexico have high shares from companies above \$5 billion in revenue, but are below China and South Africa – an outlier among the smaller benchmarks.

⁷³ Data for large and midsize companies with revenue of more than \$10 million is from the McKinsey Corporate Performance Analytics database. Below this threshold, we use local sources and categories, which are usually defined by number of employees. The large companies correspond to the same pool we studied globally in the MGI report on outperforming emerging economies, but we also add a broader set of midsize companies in the analysis in this report. While there is inherently more uncertainty in the data the lower the threshold, we apply a number of robustness checks described in the technical appendix and use the higher thresholds of \$50 million, \$100 million, and \$500 million for our analyses. See *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

⁷⁴ These results are robust to sector mix. Normalizing by PPP reduces but does not close the gap. See technical appendix for details of robustness checks.

⁷⁵ For discussion of the relatively fewer very large firms in Latin America see Lourdes Casanova, *Why are so few of the world's biggest companies from Latin America?*, World Economic Forum, June 13, 2016.

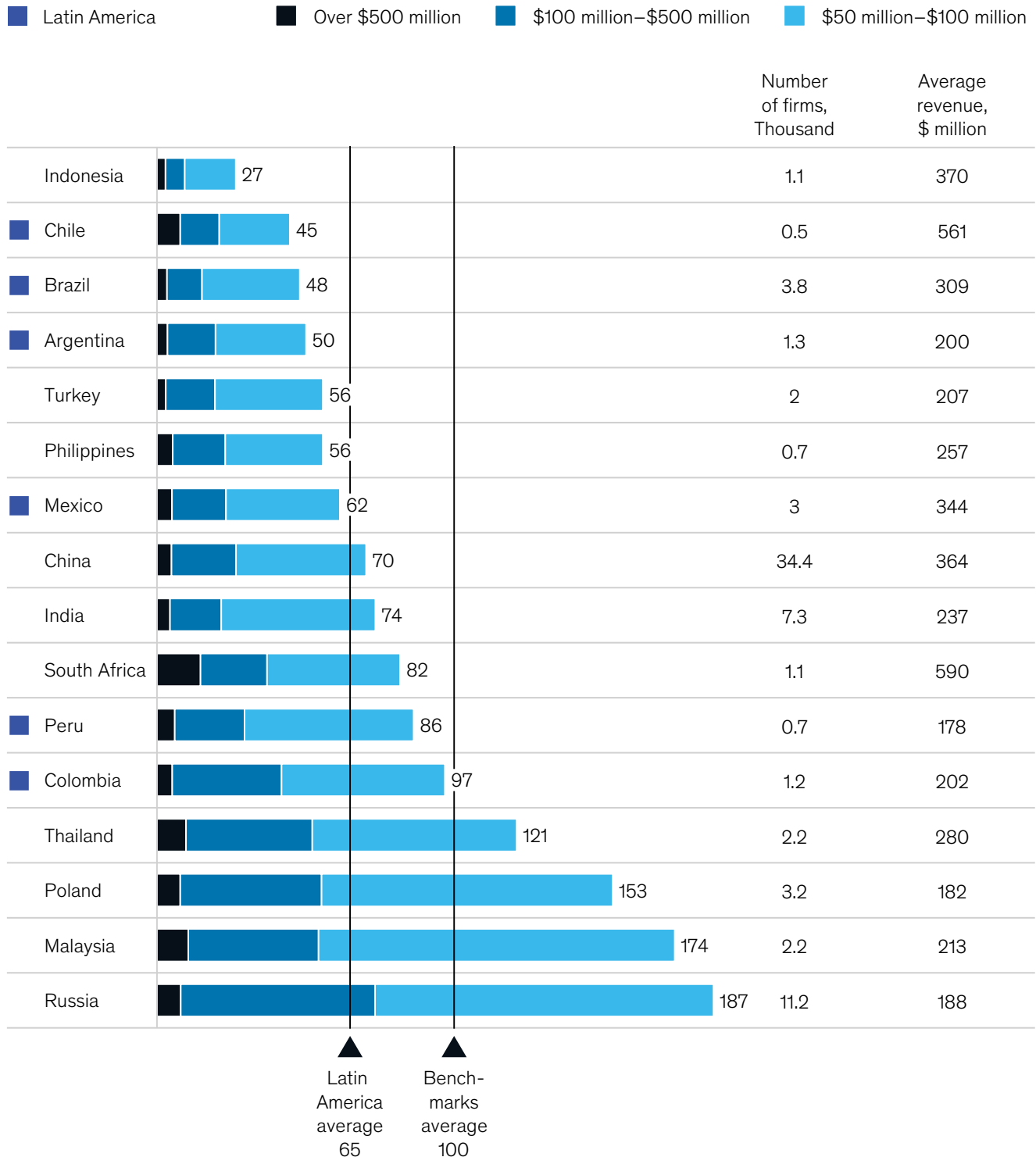
Many of the large Latin American firms at the very top operate in natural resources industries, telecommunications, and banking in their home country markets. National oil companies are among the largest across the region. Brazil's Petrobras, Mexico's Pemex, Argentina's YPF, and Colombia's Ecopetrol were among the first Latin American companies to enter the Fortune Global 500, along with telecommunications companies in Mexico and Argentina.

Exhibit 7

Latin American economies have fewer large and midsize firms over \$50 million in revenue.

Firms per \$1 trillion GDP in Latin America and other emerging markets, indexed to benchmarks¹

Index: Share of firms compared to benchmark average, 2015–17



¹ Public and private firms with revenues over \$50 million per year.

Source: McKinsey Corporate Performance Analytics database; WB WDI; McKinsey Global Institute analysis

From 2000 to 2017, the number of Latin American firms on the list more than doubled to 19 from nine, with the more recent entrants including a number of banks in Brazil and Colombia. In Asia, by contrast, international investment led to the flourishing of domestic firms beyond resources and finance. Of the 171 Fortune Global 500 firms in East Asia and the Pacific in 2017, 44 were in industrials and 38 in retail, including Singapore's Wilmar International, an agribusiness holding company, Hong Kong wholesaler the Noble Group, and South Korea's Lotte Shopping.⁷⁶

Overall, the lack of midsize and large companies in Latin America translates into less dynamism and growth than in our benchmark economies. Our analysis shows that publicly listed newcomers that attain scale above \$100 million are fewer and contribute less to growth, turnover among leading firms is lower in the case of Mexico, and profits tend to be more concentrated. These measures of competitive pressure vary from country to country, as do the mix of factors explaining the lack of midsize and large firms. Notably, Brazil's larger domestic market enables more competition, despite a challenging regulatory environment, while Mexico's market reforms and Colombia's better performance among sizable firms show important progress.

Latin America's large companies can face less intense competitive pressure than peers in other emerging economies

We compared Latin America's midsize and large companies with those in our benchmark countries of China, India, Indonesia, Malaysia, the Philippines, Poland, Russia, South Africa, Thailand, and Turkey. In prior research into high-growth emerging economies, we found that large firms in these outperforming economies have often become battle hardened through competitive dynamics in their home markets, which in turn has contributed to their emergence on the world stage as formidable competitors.

Latin America, too, has productivity champions that have gone global, building on success in their home base to become highly competitive multinational companies or regionally focused "multilatinas." These companies, which include AB InBev, Alicorp, AntarChile, Arcor, Bimbo, Cemex, FEMSA, Embraer, Nutresa, and Techint, often highlight the best of Latin American operational efficiency and entrepreneurial prowess. In many of these companies, international expansion has helped spur productivity growth.

Largely missing from this picture, however, are the new entrants, the fast-growing midsize companies that could expand the pool of Latin American competitive companies at home and abroad. They can insert new capabilities and business models that add pressure to improve productivity and competitiveness in their home markets.

Our analysis of public firms with revenue of more than \$100 million shows that a much smaller proportion has broken through this threshold recently in Latin America than in our benchmark countries.⁷⁷ Whereas more than four in five publicly listed companies in our benchmarks of this size crossed this threshold since 2000, the proportion is less than 60 percent in Brazil and Mexico. Colombia's much smaller corporate sector has been more vibrant in the recent past, with new firms accounting for 81 percent of companies reporting revenue of more than \$100 million since 2000 (Exhibit 8). In addition to bringing performance pressure and innovation, these firms are an important source of growth; they reached revenue equal to 13 percent of GDP by 2017 in Brazil, Colombia, and Mexico, while the incumbent firms

13%

2017 revenue of public firms exceeding \$100 million since 2000 in Brazil, Colombia, and Mexico, as a percentage of GDP

⁷⁶ This difference in sector diversity at the top can be measured in other ways as well. We have already noted that a disproportionate number of very affluent people in Latin America inherited their wealth. The share of billionaires' wealth coming from sectors associated with regulated services is also larger than in other regions. Conversely, the share of billionaires' wealth coming from innovation-related sectors remains low in Latin America. See *Convergence and Inequality, Transition Report 2016-17, Transition for all: equal opportunities in an unequal world*, European Bank for Reconstruction and Development.

⁷⁷ We concentrate on public firms with revenue of more than \$100 million based on the availability of more complete data to 2000 and as an indicator of market dynamism. Private firms are much more prevalent than public ones in our overall dataset above \$10 million but public firms become increasingly important above \$100 million. For a broader discussion of the role of under-developed capital markets see Augusto de la Torre, Juan Carlos Gozzi, and Sergio L. Schmukler, "Capital market development: Whither Latin America?" in *Financial markets volatility and performance in emerging markets*, Sebastian Edwards and Marcio G. P. Garcia, eds., University of Chicago Press, 2005.

of this size increased revenue to GDP ratio by only 2 percent.⁷⁸ The many new entrants of this size in our benchmark economies accounted for almost twice as much revenue as those in these Latin American countries, the equivalent of 24 percent of GDP.⁷⁹

Another manifestation of limited dynamism is the relatively low rate of churn among top companies in Latin America. In the best-performing emerging economies, it is hard for companies to get to and stay at the top: less than half of large public firms over \$500 million that were top ranked in economic profit over the period from 2001 to 2005 were still at the top between 2012 and 2017.⁸⁰ In Latin America, turnover at the top for large companies is considerably less pronounced in Mexico, more pronounced in Brazil, with Colombia in between, albeit with a smaller sample size. In Mexico, two-thirds of large companies in the top 20 percent in economic profit in 2001–05 still ranked in the top quintile in 2012–17.⁸¹ Only the

⁷⁸ To smooth year-by-year variation, we compared average revenue from 2000–04 to 2012–17; Colombian incumbents were a positive outlier, growing at an annual average rate of 11 percent in this period. From an EBITDA perspective, the contribution of these firms was about the same between benchmarks and Latin American countries at 2.3 percent of GDP, while incumbents' share remained constant in both cases at 2.6 percent in Latin America and just over 4 percent in benchmarks.

⁷⁹ The argument that more midsize firms could contribute to growth is thus both indirect (through competitive dynamism that is present in fast-growing emerging economies) and direct (through more prevalent modern, productive firms); we do not claim that midsize firms themselves grow faster (i.e. counter to Gibrat's law).

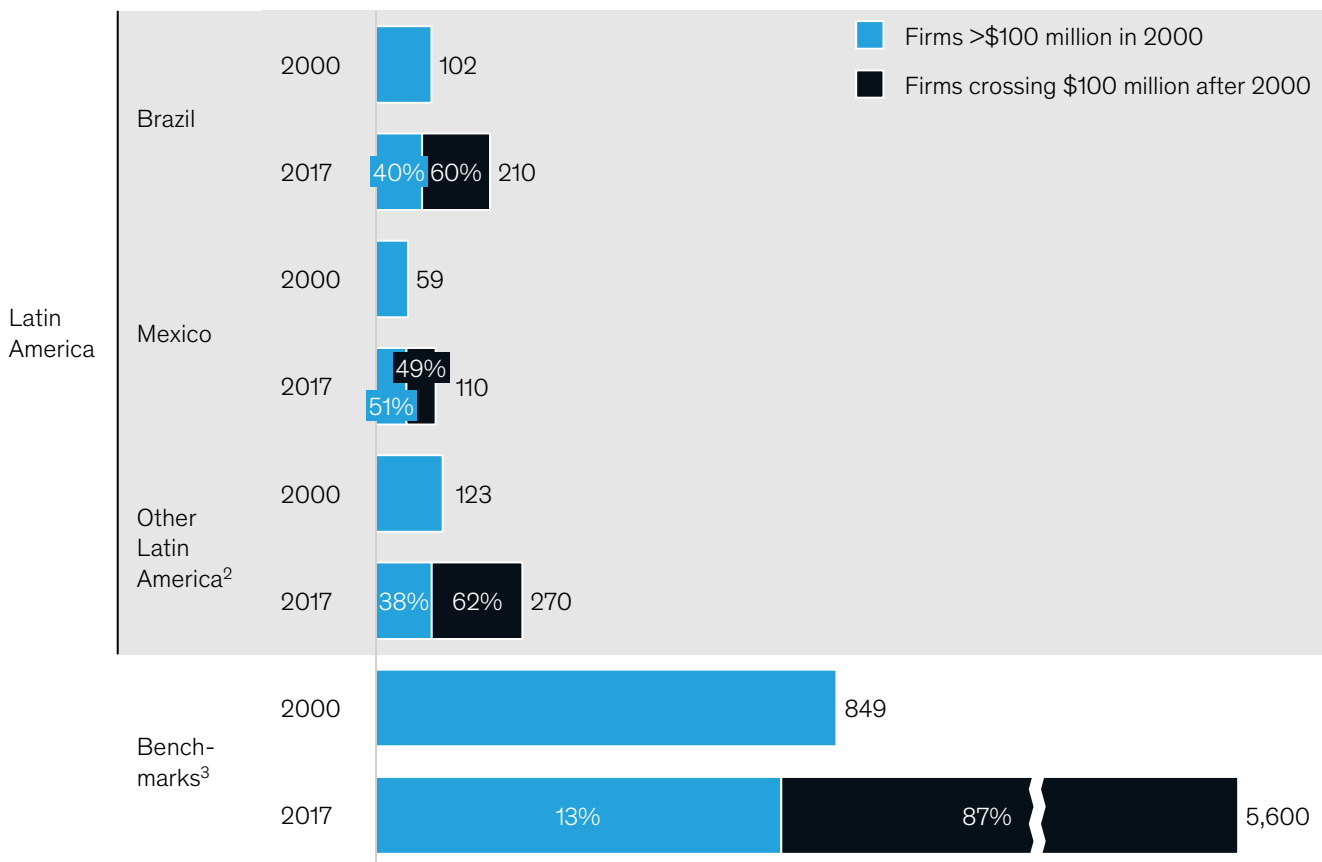
⁸⁰ *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

⁸¹ The relatively small number of large companies in Colombia limits the power of this analysis.

Exhibit 8

The region has seen a lower proportion of publicly listed firms rise above \$100 million in revenue than benchmarks, indicating less market dynamism.

Number of public firms in Latin America and other emerging economies¹



¹ Public firms with revenues over \$100 million.

² Includes Argentina, Chile, Colombia, and Peru.

³ Sum of benchmarks: China, India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey.

Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Corporate Performance Analytics database; McKinsey Global Institute analysis

Philippines among our benchmarks had a larger proportion. In Brazil, one-third of the firms stayed in the top quintile in 2012–17, similar to China. In Colombia, two of the five top-quintile firms remained there during this period. A combined sample of firms from our benchmarks shows that more than half of them were displaced from the top, with Mexico and Brazil on either side (Exhibit 9). This highlights how the dynamics of the missing middle can vary across countries; Brazil's big market has a more intense competitive landscape, for example, as we explore below.

Looking more closely at individual countries from a revenue perspective, we find that six of the top ten companies in Mexico in 2000 were still in the top ten in 2017; only FEMSA rose to this level from outside the top 25. In Brazil, six of the top ten companies in 2000 were still in place in 2017. The largest firms continued growing, in part through mergers and acquisitions. They included Itau, Bradesco, and Santander in banking during a period of consolidation in the 1990s and early 2000s, Petrobras across the energy supply chain, Grupo Pão de Acucar in retail, and Vale in mining; Vale alone has made 40 major acquisitions since 2000.⁸² In Colombia, half of the top ten in 2017 were in place in 2000.

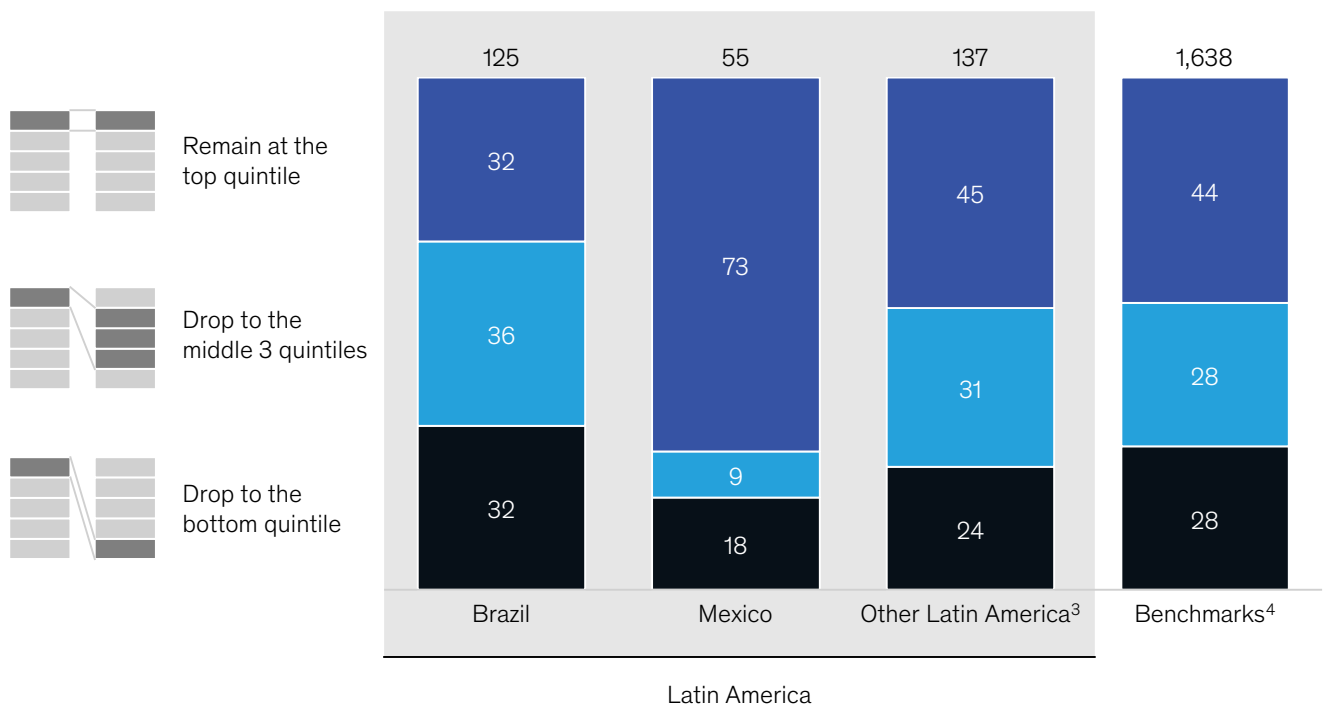
These dynamics can raise costs to consumers and business customers—and allow for higher profit margins. Recent research shows that Latin American firms had larger and stable markups on their products, dating to the 1980s, when import substitution industrialization

⁸² Vale, vale.com/EN/investors/information-market/acquisitions-divestments/Pages/default.aspx

Exhibit 9

Top firms by economic profit in Latin America generally have similar turnover as benchmarks, but Mexico has less and Brazil more.

Distribution of trajectory for top quintile economic profit generators over 11 years¹
%; number of firms (n = 16 countries and 1,955 total companies²)



¹ Quintiles based on rankings within archetype by economic profit generation between 2001–05 and 2012–17. Economic profit defined as Net Operating Profit Less Adjusted Taxes (NOPLAT) – [Invested capital x Weighted Average Cost of Capital].

² Publicly listed companies with more than \$500 million in revenue in 2017, with data available throughout 2001 to 2017.

³ Other Latin America includes: Argentina, Chile, Colombia, and Peru.

⁴ Benchmarks includes China, India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey.

Note: Figures may not sum to 100% because of rounding.

Source: McKinsey Strategy Practice (Beating the Odds model v20.0); McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

policies left a few big players at the top of many industries.⁸³ In our midsize and large firm database we also find that, in comparison with benchmarks, companies have a higher operating profit margin after taxes in our three countries across most sectors since 2000; the average profit margin after taxes is 16 percent, versus 12 percent in benchmarks (Exhibit 10).⁸⁴ With fewer midsize and large firms, the variation in economic profit in our sample is also higher: top-quintile firms in Brazil, Mexico, and Colombia created two to four times as much value on average, and bottom-quintile firms destroyed two to seven times more value on average than companies in Malaysia and Thailand, for example.⁸⁵ One World Bank study also finds high sector concentration in the region, though relatively less so in Brazil and Colombia.⁸⁶

⁸³ Jan De Loecker and Jan Eeckhout, *Global market power*, NBER working paper number 24768, June 2018. US and European companies have more recently caught up in the size of the markups, with other emerging economies still lagging slightly behind, according to this research. While these authors link these increases to a concentration effect, others point to factors such as intangible assets and regulation (for a review of these contributions, see p. 8 of *Superstars: The dynamics of firms, sectors, and cities leading the global economy*, McKinsey Global Institute, October 2018). Margins in the past 20 years, especially in developed economies, are also influenced by a “superstar” effect that has created a skew in corporate profitability among the largest global companies, with revenue exceeding \$1 billion: the top 10 percent of firms globally capture 80 percent of the economic profit, and their gains have grown. These top-decile firms capture 1.6 times more economic profit today compared to 20 years ago, with larger revenues and higher profit margins than in the past. By contrast, the bottom decile destroys more value than the top 10 percent creates. The economic losses of this bottom 10 percent of firms are 1.5 times larger on average than those of their counterparts 20 years ago. *Superstars: The dynamics of firms, sectors, and cities leading the global economy*, McKinsey Global Institute, October 2018. For a recent global assessment of trends in markups, see Federico J. Díez, Jiayue Fan, and Carolina Villegas-Sánchez, *Global declining competition*, IMF Working Paper 19/82, April 2019.

⁸⁴ The differences are slightly larger when interest and taxes are added back in, reflecting the high cost of capital, particularly in Brazil, and corporate taxes.

⁸⁵ Across all sectors, top-quintile firms averaged \$154 million in Brazil, \$298 million in Mexico, and \$245 million in Colombia in economic profit from 2013 to 2017, compared with \$68 million in Malaysia and \$75 million in Thailand. Bottom-quintile firms had negative economic profit of \$219 million, \$158 million, \$79 million, \$37 million and \$32 million in Brazil, Mexico, Colombia, Malaysia, and Thailand, respectively.

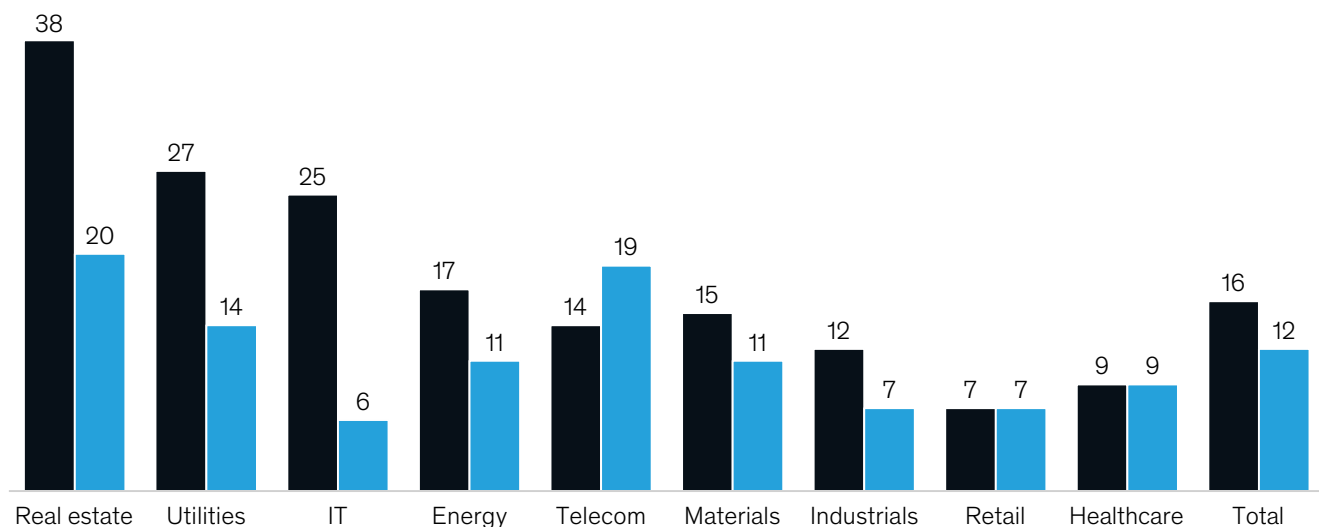
⁸⁶ World Bank research that compares a Herfindahl index measure of concentration to expectations controlling for other factors like market size shows Latin America to be particularly high in nontradable and nonfinancial sectors, though Colombia and Brazil are relatively less concentrated. Daniel Lederman et al., *Latin American entrepreneurs: Many firms but little innovation*, World Bank, 2014.

Exhibit 10

Latin American economies have had higher profit margins among their midsize and large firms compared to benchmarks.

Operating profitability of firms over \$100M in revenue, 2000–17
NOPLAT¹ as % of revenue²

■ Latin America average³ ■ Benchmarks⁴



¹ NOPLAT ratio to revenues.

² Firms with revenues over \$100 million per year. Sample of firms subject to availability of financial data, coverage for Latin America is 34% of the total firms revenue, while 58% for Benchmarks. Data are not available for IT in Mexico, IT and real estate in Colombia, and real estate in Turkey.

³ Simple average of: Brazil, Mexico and Colombia

⁴ Simple average of 10 benchmarks: China, India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand and Turkey. PEMEX excluded due to limited financial information.

Source: McKinsey Corporate Performance Analytics database; McKinsey Global Institute analysis

Competitive dynamics of midsize and large companies vary across our focus countries, with differing incentives and barriers to entry

Prior MGI work has shown the critical importance of competition among companies in their domestic markets as a way of driving productivity improvements and growth in emerging economies.⁸⁷ Multiple factors affect competitive dynamics. While the legacy of import substitution industrialization weighs on the market landscapes of the region, the reform era since the 1990s has not been able to remove all of the barriers to entry and incentives that explain the persisting missing middle across countries.

Brazil is notable for showing more dynamic competition in the measures above. More companies compete in Brazil's large domestic market. Turnover at the top is also higher. Brazilian companies generally have a lower overall profit share level and growth than firms in Mexico and Colombia, in part because of high regulatory and borrowing costs and competition from informal firms.⁸⁸ Yet both the regulatory environment and trade policy constrain the expansion of the pool of midsize and large firms.

Navigating the costly and complex business environment can be a major barrier for all companies, but especially for midsize ones.⁸⁹ The convoluted tax system offers one example.⁹⁰ Firms in São Paulo spend an estimated 2,000 hours per year to comply with tax obligations, ranking Brazil 184th out of 190 countries worldwide.⁹¹ For small firms with up to roughly \$1.5 million in annual revenue, Brazil created a regime called *Simples Nacional* that unifies six taxes in one and charges only based on revenue. Large firms, for their part, are typically well equipped with sophisticated compliance teams to navigate the regulatory thicket—leaving midsize firms to feel the tightest squeeze.⁹² Furthermore, a peculiarity of Brazilian value-added tax is the limitation of tax credits at each step of the value chain. This creates incentives to vertically integrate and avoid taxes on outsourced inputs, even if independent suppliers could otherwise deliver them at lower cost.⁹³

Brazil's high trade protection further reduces the incentives to specialize. The country is ranked 110th out of 136 on the World Economic Forum's Enabling Trade Index for 2016.⁹⁴ It improved its performance in 2018, cutting the time to import in half to 24 days, for example, but the combination of concentration and complexity remains a non-trade barrier, since few firms can understand and run the risks of competing in the Brazilian market, especially against incumbents that have developed scale and knowledge to navigate.⁹⁵

In Mexico, reforms implemented since the early 1990s created more competition and incentives for innovative companies. Many of today's incumbents responded to these reforms with high growth and returns. Three of the regulated sectors that have been more

24 days

Time needed for imports in Brazil in 2018, half as much as previously

⁸⁷ William W. Lewis, *The Power of Productivity: Wealth, Poverty, and the Threat to Global Stability*, Chicago, IL: University of Chicago Press, 2005; *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

⁸⁸ See previous McKinsey Global Institute reports on Brazil: *How Brazil can grow*, December 2006; *Stimulating competitive cities: The key to Brazilian growth*, March 2012; *Connecting Brazil to the world: A path to inclusive growth*, May 2014; and *Productivity: The key to an accelerated development path for Brazil*, March 1998. After taking out mixed income, profit share in Brazil was 32 percent of GDP, compared to 46 percent in Mexico and 33 percent in Colombia in 2016, according to national accounts.

⁸⁹ For a recent review of regulatory reform, see *Doing Business 2019: Training for reform, economy profile Brazil*, World Bank, 2019, doingbusiness.org/content/dam/doingBusiness/country/b/brazil/BRA.pdf.

⁹⁰ Since a new constitution was implemented in 1988, Brazil has created an average of 46 new tax rules per working day, which in turn has led to an overlap of exceptions granted depending on state, sector, product characteristics, and other aspects. *Brasil cria, em média, 46 novas regras de tributos a cada dia útil*, Instituto Brasileiro de Planejamento e Tributação, October 15, 2014.

⁹¹ *Doing Business 2019: Training for reform, economy profile Brazil*, World Bank, 2019. As one example, value-added tax, on which Brazil's tax system mostly relies, is charged through five different taxes at the city, state, and federal levels: ICMS (tax on transit of goods and services collected by states), ISS (tax on services collected by cities), IPI (tax on manufactured goods collected by federal government), PIS (contribution on payroll to social integration collected by federal government), and Cofins (contribution on revenues to social security).

⁹² Alketa Peci, "Reforma regulatória brasileira dos anos 90 à luz do modelo de Kleber Nascimento," *Revista de Administração Contemporânea*, January–March 2007, Volume 11, Number 1.

⁹³ Marcos J. Mendes, *Os sistemas tributários de Brasil, Rússia, China, Índia e México: Comparação das características gerais*, Consultoria Legislativa do Senado Federal, 2008.

⁹⁴ World Economic Forum, *Enabling Trade Index 2016*, reports.weforum.org/global-enabling-trade-report-2016/enabling-trade-rankings/.

⁹⁵ *Doing Business Report: Brazil steps up reform agenda, carrying out record business reforms in past year*, World Bank press release, October 31, 2018.

72%

Top marginal tax rate on corporate profits in Colombia

concentrated—power, oil and gas, and telecommunications—have undergone important reforms since 2013 and have seen an inflow of new local and international players.⁹⁶

Colombia has outpaced Brazil and Mexico in productivity and investment growth since 2000 and it has the highest number of midsize and large firms in the region relative to GDP. Its incumbent midsize and large companies have grown at over 10 percent. A legacy of protection and entry barriers for new companies nonetheless remains at the industry level, holding back the proliferation of competitive firms. Electricity is 35 percent more costly on average compared to our benchmarks, correlating with pretax earnings that are over three times higher in this regulated sector. Colombia ranks 146th out of 190 in the world in taxes as a burden on ease of doing business, mainly because of the top rate, which reached 72 percent of profits.⁹⁷ Freight and logistics are also subject to regulatory restrictions that bear on downstream industries, along with a low logistics infrastructure rating and overall rank of 58th out of 160 on the World Bank's Logistics Performance Index.⁹⁸

The degree of product market regulation has increased since “la apertura comercial” reduced tariffs on imports in 1991: the coverage of nontariff barriers expanded from 27 to 78 percent of imported goods by 2014.⁹⁹ Competitive pressure is limited in agriculture due to trade protection, measured as the ratio of domestic to international prices of roughly 1.2 since 2003. In sugar, high subsidies correlate with low production growth and downstream manufacturing of refined products, which have not increased since 1995.

A long tail of less productive and mostly informal small firms accounts for the majority of jobs

In Latin America's dual economy, the few large companies at one end of the spectrum coexist with a long tail of small companies at the other end, often operating outside the formal economy (see Box 4, “Informal businesses in Latin America”). These firms tend to be small and less productive. They absorb a significant proportion of low-skill workers, accounting for between 40 and 80 percent of the workforce across the region, with an average of 55 percent.

4%

Annual average improvement in productivity between 2003 and 2013 among modern retailers in Mexico with more than 10 employees

Retail provides one example of the persistent polarization. Modern formats and scale in operations have allowed larger firms to boost productivity, but the majority of workers remain in small, less productive firms (Exhibit 11). In Mexico, for example, retail establishments with more than 10 employees grew from 2.2 million to 3.0 million workers and productivity increased by almost 4 percent per year in the decade from 2003 to 2013. During this period, modern players introduced more efficient operations and formats and consolidated the sector: the top ten firms increased share from 22 to 33 percent; the top three alone have 20 percent of the market. Hypermarkets and convenience stores expanded in grocery retail while traditional stores shrank to 31 percent of grocery retail, compared to 48 percent in Brazil and 68 percent in Colombia. However, employment in these larger firms represented just one-third of all retail workers. The remaining 6.6 million workers were employed by small, mainly informal retailers whose productivity decreased by as much as 5 percent between 2003 and 2013. The result was a sevenfold gap between the two types of firms in terms of value added per worker. In Colombia, the share of retail workers in firms with more than 20 employees amounts to just 17 percent of the total, and these firms have 17 times the value added per worker as small ones (Exhibit 11).

The pattern extends to other sectors. For example, in Mexico's automotive industry, 40 percent of employment is concentrated in small subcontractors, which have just one-tenth

⁹⁶ *OECD telecommunication and broadcasting review of Mexico*, OECD, 2017; *World energy outlook special report: Mexico energy outlook*, International Energy Agency, 2016. Market structure and distribution channels in food also reflect concentration, under which high prices are disproportionately passed on to the lower income segments that spend more of their consumption on food. Juan Delgado, *Market structure, growth, and competition in the supermarket sector in Latin America*, Competition Policy International, 2015, competitionpolicyinternational.com/market-structure-growth-and-competition-in-the-supermarket-in-latin-america/.

⁹⁷ *Doing Business 2019: Training for reform, economy profile Colombia*, 2019, doingbusiness.org/content/dam/doingBusiness/country/c/colombia/COL.pdf.

⁹⁸ World Bank International LPI, lpi.worldbank.org/international/global.

⁹⁹ Jorge García et al., *Una visión general de la política comercial Colombiana entre 1950 y 2012*, Banco de la República de Colombia, borradores de economía 817, April 30, 2014.

Box 4

Informal businesses in Latin America

Many small companies in Latin America operate outside the formal economy, and their prevalence has been widely documented.¹ However, informality is not limited to small firms; it can be found across the business spectrum. Informal workers are most concentrated in sectors like retail, construction, and agriculture, but are also present in more productive sectors such as auto manufacturing.

We define informal businesses as those that fail to comply with all regulatory requirements. They may not be registered with the authorities; they may underreport income to avoid paying all or part of their tax obligations; and they may pay bribes to avoid land use, sanitary, or other regulations. Informality varies widely, ranging from large modern companies that cut corners in parts of their operations by hiring informally, to midsize companies that are properly registered yet employ most of their workers informally and may not comply with all health or other regulations, to completely informal businesses that operate entirely under the legal radar.

In Brazil, attempts to bring more firms into the formal economy helped reduce informality to below 50 percent in 2015–16. Chile, Costa Rica, and Uruguay have the lowest informality rates in the region, according to the International Labour Organization.² Mexico and Colombia have rates of 57 percent and 62 percent, respectively, according to household surveys in each country, but are still far from countries like Bolivia, Guatemala, and Nicaragua, where informality rates approach 80 percent. Brazilian measures to counter informality have included creating tax credits for fiscal receipts, simplifying the tax system for small and medium-size enterprises, and enforcing labor laws more vigorously.

Various studies have examined the economic impact of informality. One study of Mexican firms found that informal firms constituted 90 percent of companies in the 2013 census, 40 percent of the capital stock, and 55 percent of employees, with little geographic or sector variation. Thanks to their lower costs, these firms are able to survive despite lower productivity: 47 percent of low-productivity firms in the study survived from 2008 to 2013, just 10 percent below the survival rate of high-productivity companies.³

¹ Rafael La Porta and Andrei Shleifer, "Informality and development," *Journal of Economic Perspectives*, Summer 2014, Volume 28, Number 3; Veronica Alaimo et al., *Jobs for growth*, Inter-American Development Bank, 2016.

² ILOSTAT.

³ Santiago Levy, *Under-rewarded efforts: The elusive quest for prosperity in Mexico*, Inter-American Development Bank, 2018.

the productivity of modern parts suppliers. Mexico's traditional small bakeries are far less productive than more modern ones.¹⁰⁰

Small firms face three important constraints on productivity and growth.¹⁰¹ First, regulatory and tax avoidance creates a cost advantage that is a strong economic incentive to stay small and informal even if a company could grow. This factor also makes it harder for formal companies wanting to invest and grow, as they face competition from informal players with a cost advantage from evasion. Second, small firms face more difficulty accessing credit, because income is both volatile and undocumented or hard to prove, while larger firms can receive loans more easily, tap international markets, or self-fund. This affects consumption and investment. Third, the precarity of work in the informal economy reduces incentives to invest in skills that could in turn raise productivity and instead perpetuates social vulnerability. Workers do not gain access to social security through their employment, and their prospects for developing career paths are poor. These constraints are not limited to informal firms. Indeed, only a handful of small firms will have the entrepreneurial talent and management to become larger and more productive even under propitious conditions, while many who work in

¹⁰⁰ *A tale of two Mexicos: Growth and prosperity in a two-speed economy*, McKinsey Global Institute, March 2014.

¹⁰¹ *A tale of two Mexicos: Growth and prosperity in a two-speed economy*, McKinsey Global Institute, March 2014; Veronica Alaimo et al., *Jobs for growth*, Inter-American Development Bank, 2016; Norman V. Loayza, *Informality in the process of development and growth*, policy research working paper WPS 7858, World Bank, 2016.

Retail shows how the long tail of mostly informal firms continues to add workers even as productivity is flat or decreasing and more modern firms grow quickly, especially in Mexico and Colombia.

Productivity and employment share growth of retail by firm size in Brazil, Mexico, and Colombia, 2010¹

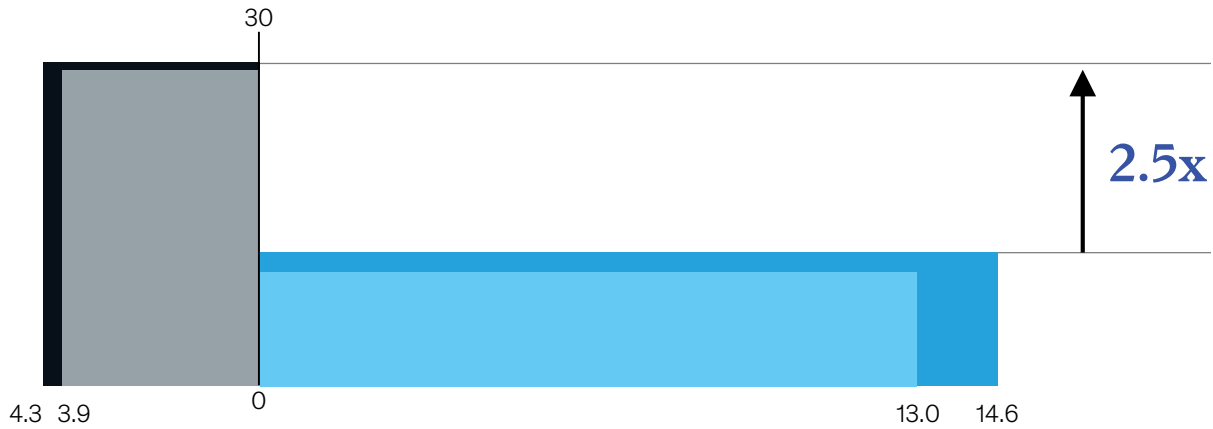
■ Larger firms
■ Small firms

Labor productivity
Value added per worker (\$ thousand)



Not To Scale

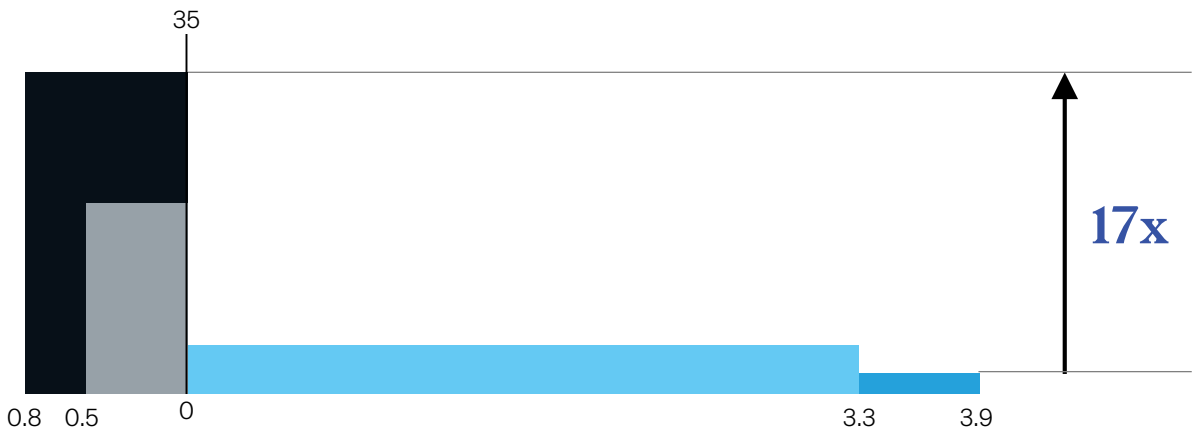
Brazil
2007–15



Mexico
2003–13



Colombia
2008–15



¹ Small firms = <20 employees for Brazil and Colombia; <10 for Mexico.

Source: Mexico INEGI Household Survey, Economic Census; Brazil IBGE Economic Census, Household Survey; Colombia DANE Household Survey, Commerce Census; National Accounts; McKinsey Global Institute analysis

the long tail will be better off becoming workers as the modern sector grows.¹⁰² But the firms that can break through are particularly important for the growth of jobs and output.¹⁰³

Regulation and tax systems constrain productivity growth among small companies and slow the expansion of a competitive middle

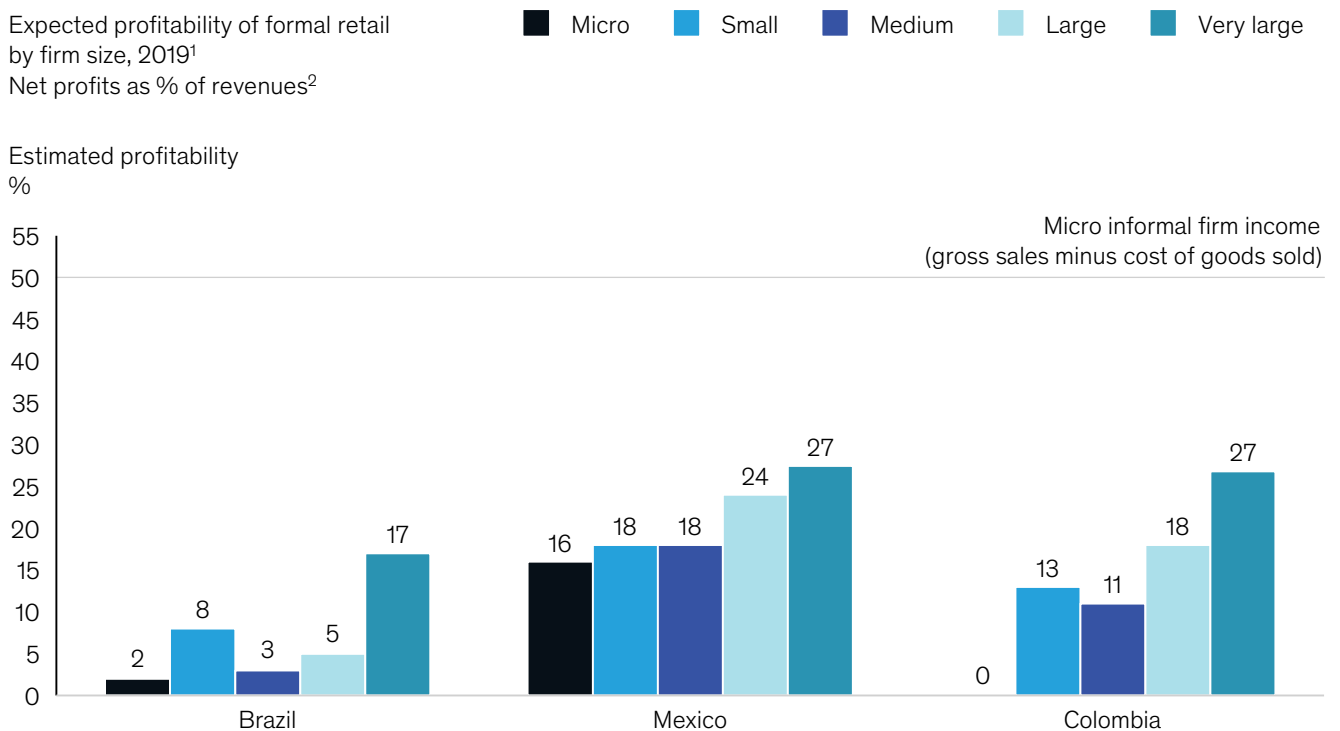
One of the factors constraining the expansion of midsize companies is the large economic benefits from informality. Smaller companies are less likely to attract attention from regulators and more likely to avoid the cost of full compliance, which discourages business growth. The tax burdens and business factors that vary with scale create the biggest squeeze on companies with gross margins around \$100,000 to \$1 million. Exhibit 12 highlights the extent to which estimated margins in retail reflect this pattern. Large firms have stronger margins because they can negotiate better prices, raise revenue, and adopt modern formats and best practices including digitized inventory. Small retailers can also be relatively profitable under simplified regimes, but the middle is squeezed. In all cases, informal micro firms that avoid tax and regulatory costs generally have higher margins but cannot grow.

Legal companies in a country with a sizable informal economy bear an additional burden: they pay a disproportionate amount of total tax revenue. Corporate income tax rates in our three countries are among the highest in the world, reaching 72 percent in Colombia, 65 percent in Brazil, and 53 percent in Mexico, according to the World Bank. This increases

¹⁰² Rafael La Porta and Andrei Shleifer, "Informality and development," *Journal of Economic Perspectives*, Summer 2014, Volume 28, Number 3; Eduardo Lora and Francesca Castellani, eds., *Entrepreneurship in Latin America: A step up the social ladder?*, Inter-American Development Bank and World Bank, 2014.
¹⁰³ For examples of the US context, see John Haltiwanger, Ron S. Jarmin, and Javier Miranda, "Who creates jobs? Small versus large versus young," *The Review of Economics and Statistics*, May 2013, Volume 95, Number 2; and John Haltiwanger et al., *High growth young firms: Contribution to job, output and productivity growth*, Center for Administrative Records Research and Applications, working paper number 2017-03, US Census Bureau, February 2017. For a regional view, see Daniel Lederman et al., *Latin American entrepreneurs: Many firms but little innovation*, World Bank, 2014.

Exhibit 12

In retail, estimated profitability by size illustrates how formal firms can become viable at scale but small firms have a strong incentive to remain small and informal.



¹ Theoretical small shop based on interviews with experts, varying gross margin and store efficiency by size of firms. By annual revenue: micro = Up to \$10,000; small = \$10,000 to \$100,000; medium = \$100,000 to \$1 million; large = \$1 million to \$10 million. Considers lowest tax regime available.

² Considers changes in taxes, competition, and gains of scale; disregards interest and depreciation expenses.

Source: Local tax agencies; expert interviews; McKinsey Global Institute analysis

the incentive to remain small or informal to avoid them. By comparison, rates in Malaysia and Thailand are 39 percent and 30 percent, respectively.¹⁰⁴ A heavy tax burden creates incentives to pursue loopholes and tax evasion and harms the competitiveness of formal companies that do comply.

The stagnant productivity of small traditional businesses comes with a high human cost: declining productivity depresses low-skill workers' incomes. Stagnant and falling wages make life more difficult for millions of workers and limit the expansion of a healthy consuming class—and the purchasing power needed to ignite domestic demand. We explore this factor in more detail in the next chapter.

Limited access to finance creates challenges for the expansion of small and medium-size companies

Differences in the way companies finance their growth may partly explain why few small and medium-sized enterprises (SMEs) are able to grow and expand the cohort of firms in the middle in Latin America. The region's capital markets and financial depth more broadly have grown steadily since the 1990s, but they remain small as a share of GDP relative to peers.¹⁰⁵ Latin America is overweight in low-risk investments such as government bonds, which channel the economy's savings back into government consumption, while higher-risk equity and loans to the private sector are considerably smaller as a proportion of GDP, limiting growth and innovation.¹⁰⁶

The gap in financing to business is particularly stark in bank lending, the main source of external funds for small and medium-size companies. While loans in both China and the benchmark emerging economies for this report easily exceed 100 percent of GDP, loans in Brazil, Colombia, and Mexico total considerably less. The comparable figures are 66 percent in Mexico and 82 percent in Colombia. In Brazil they amount to 70 percent of GDP—just one-third of all financial assets, including government debt securities (Exhibit 13).

1/3

Bank loans as proportion of all financial assets in Brazil

In Brazil, where interest rates have been chronically high, credit for small businesses and large firms is often subsidized, while midsize firms have no alternative but to bear high market prices. Inspired by policies relating to chaebols in South Korea, Brazilian conglomerates able to tap into global markets have been the main focus of Brazilian development bank credit, which offers competitive rates financed by the government. At the other extreme, the two leading state-owned banks for retail target the poorest borrowers with subsidized credit lines, such as finance for family businesses in agriculture and popular housing. As a result, almost 50 percent of the credit is delivered by state-owned enterprises that combine social goals with profitability goals. In addition, low-risk government bonds with high basic interest rates attract 78 percent of GDP of capital compared to 24 percent in benchmarks, squeezing the already-low levels of savings, which have remained below 20 percent of GDP since 2013.¹⁰⁷ Finally, the lower level of loans in Brazil reflects high reserve requirements that constrain the ability of banks to increase loan penetration.

In Mexico, larger firms are more easily able than smaller competitors to overcome lending constraints and raise capital, tapping into relatively low baseline interest rates, international markets, and self-funding. While banking reforms after 1994 stabilized the sector through reserve-to-risk requirements, deposit insurance, foreign competition, and limited insider lending, creditor protections remain a constraint on lending.¹⁰⁸ One study showed that marginal increases in SME credit return three to five times market interest rates, indicating

¹⁰⁴ Doing Business 2019, World Bank, doingbusiness.org/en/doingbusiness. These numbers differ from the nominal rates, but they are the main driver, and the pattern is similar.

¹⁰⁵ Myriam Quispe Agnoli and Diego Vilán, *Financing trends in Latin America*, Federal Reserve Bank of Atlanta, 2008.

¹⁰⁶ While it is challenging to disentangle the direction of causality between financial market depth and growth (see, for example, Ross Levine, *Finance and growth: Theory and evidence*, NBER working paper number 10766, 2004), the case in Mexico seems particularly severe. See Gordon H. Hanson, *Why isn't Mexico rich?*, NBER working paper number 16470, October 2010; Yongseok Shin, *Financial markets: An engine for economic growth*, Federal Reserve Bank of St. Louis, July 2013.

¹⁰⁷ World Development Indicators, World Bank.

¹⁰⁸ Gordon H. Hanson, *Why isn't Mexico rich?*, NBER working paper 16470, October 2010; Santiago Levy, *Under-rewarded efforts: The elusive quest for prosperity in Mexico*, Inter-American Development Bank, 2018.

that access is a binding constraint on productive investment.¹⁰⁹ Past MGI work shows that more than half of Mexico's midsize firms are underfinanced, while a survey by Mexico's statistical agency INEGI showed that 90 percent of micro firms (1–10 employees) and 70 percent of small firms (11–50 employees) have no financing.¹¹⁰ At the same time, returns on equity for banks are roughly six points higher than the global average. Foreign banks have about two-thirds of the banking assets in Mexico and have a share of their global net income from Mexico that is 2.5 times the share of their global assets in the country.

Colombia falls between Mexico and Brazil on both lending rate and domestic credit to the private sector. Less than 40 percent of Colombian SMEs say they sought credit from the financial system in 2018.¹¹¹ Part of the reason for the low pursuit of banking credit may be that more than half of the SMEs sought financing outside the banking system. Nonetheless, over 60 percent that did not seek credit said it was because they did not need it and pointed to other constraints: lack of demand was the most cited challenge and talent development the most important for improving performance.

The three countries are currently implementing a series of regulatory improvements to broaden the reach of the financial sector. In particular, they are encouraging further credit information-sharing and the entry of fintech firms. One example in Brazil is the rise of

¹⁰⁹ David McKenzie and Christopher Woodruff, "Experimental evidence on returns to capital and access to finance in Mexico," *World Bank Economic Review*, December 2008, Volume 22, Issue 3.

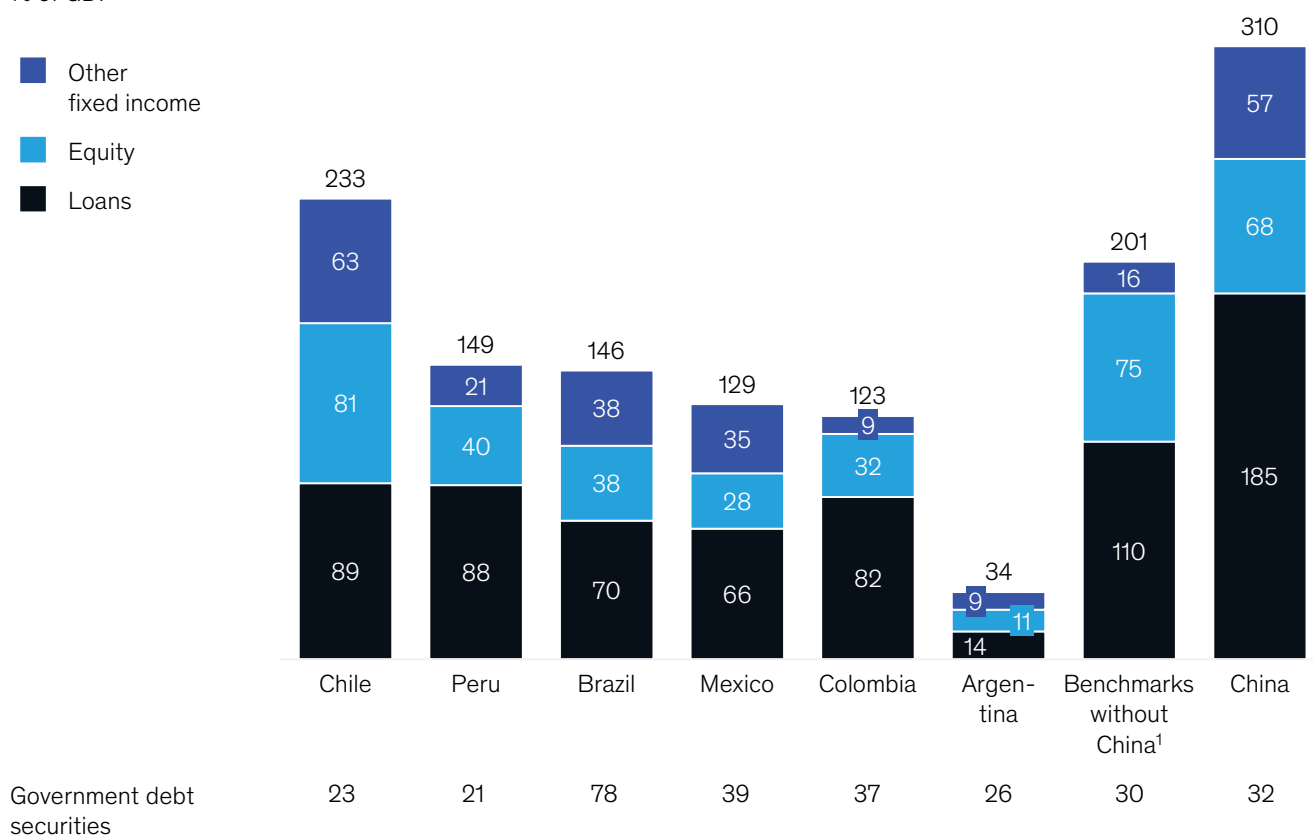
¹¹⁰ *Encuesta nacional sobre productividad y competitividad de las micro, pequeñas, y medianas empresas (ENAPROCE)* 2015, INEGI, July 2016. The micro firms constituted 98 percent of the firms in the sample and were only one-sixth as likely to give training to workers than medium firms with 50–250 employees. Only one-quarter used a computer or the internet compared to 95 percent of the small and medium firms.

¹¹¹ *La gran encuesta pyme: 2do semestre 2018*, Asociación Nacional de Instituciones Financieras Centro de Estudios Económicos, 2018, anif.co/sites/default/files/publicaciones/gepnacional_ii-18.pdf

Exhibit 13

Brazil, Mexico, and Colombia are underfinanced vs peers, with savings flowing to government bonds rather than private-sector investment needed especially by SMEs.

Financial depth, 2017
% of GDP



¹ Weighted average of India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, and Turkey.

Source: McKinsey Global Institute Financial Assets database; McKinsey Global Institute analysis

investment brokers in a market where more than 95 percent of deposits are under banks' management; in the United States, by comparison, independent agents concentrate 90 percent of deposits.

A survey of 3,000 workers we conducted in Brazil, Colombia, and Mexico highlights the precarity of work and challenge for developing skills and small businesses

To round out our picture of employment and social concerns in the workforce, we conducted a survey of more than 3,000 workers—in informal, formal, and self-employed—in equal shares from Brazil, Colombia, and Mexico.¹¹² The results paint a complex picture about the precarity of work and the challenges of acquiring skills and building small businesses (Exhibit 14).

Informality is broadly viewed as an income cushion by default in times of uncertainty—but it is not a comfortable cushion. Given the choice, respondents would prefer to sacrifice the flexibility of informal labor for the stability of wages that comes with formal work. This result is consistent with the notion that many entrepreneurs in Latin America are “necessity entrepreneurs,” who are not prepared to lead firms that will push the frontier of productivity but see no other choice to find basic income.¹¹³ The survey underscored the point that, for workers to move beyond financial vulnerability, grow their businesses, and gain relevant workforce skills, the economy needs more jobs from the modern, formal sector. These

¹¹² The survey was conducted in December 2018 and January 2019 by Dynata. www.dynata.com
¹¹³ Eduardo Lora and Francesca Castellani, eds., *Entrepreneurship in Latin America: A step up the social ladder?*, Inter-American Development Bank and World Bank, 2014.

Exhibit 14

Informal self-employed workers are less likely to have the resources, knowledge, or intent to expand their businesses.

Agreement of self-employed, formal vs informal, %



Source: Inclusive growth in Latin America worker survey, conducted by Dynata, McKinsey Global Institute, 2019; McKinsey Global Institute analysis

jobs would be the link that connects an expanding pool of modern, competitive firms with expanding prosperity to address the missing middle of consumers.

The survey showed that 70 percent of all workers see temporary or informal self-employment as a viable option in a time of financial uncertainty. (In Brazil, where the informality rate is lower than in Mexico and other Latin American countries, workers were about ten percentage points less likely to see informality as a cushion.) Such uncertainty is common: 28 percent of all workers expected to leave their job in the next 12 months, and among the self-employed in Colombia, the figure was 40 percent. This is consistent with empirical findings that show worker turnover of 25 percent for Brazil, 30 percent in Mexico, and up to 45 percent in Peru compared to 10 percent in the United Kingdom and 6 percent in Germany.¹¹⁴

Respondents perceive their income cushion as thin: 47 percent of informal respondents do not have full or partial access to secure income, but 88 percent of informal respondents rated this element as a highly important criterion in job selection. Financial stability was the most frequently cited concern, with 45 percent of respondents agreeing that they do not have enough savings to ensure that stability. Among Brazilian respondents, the views were once again more favorable, with the difference being as much as ten percentage points. One of the most important consequences of this picture of precarity is the challenge for building skills: 77 percent of all respondents indicated they will not gain skills or training in the next 12 months, with formal workers 59 percent more likely to say they would.

The survey also highlighted how people perceive the advantages and disadvantages of informality from a micro business perspective. Among the 28 percent of the sample who are self-employed—about half of them in informal businesses (which do not make social security contributions)—only one-quarter indicated that they have access to the credit necessary to expand their business. At the same time, 67 percent of self-employed respondents indicated their intention to expand.

45%

Say they do not have sufficient savings to ensure financial stability

Latin America's missing middle reflects limited capacity to innovate, although a new digital generation is on the rise

Latin America can be highly innovative. Brazilian companies are at the forefront of aerospace development and are pioneering agribusiness, including transforming soybeans into a tropical crop—and now a leading export—by developing a technology to make Brazil's savanna arable. In Mexico, a one-stop government online portal consolidates 34,000 databases from 250 government institutions and 5,400 public services.¹¹⁵ The site, launched in 2014, is the centerpiece of Mexico's drive to digitize the operations of its federal government, part of a wave of global efforts to improve government productivity. Similar success stories in the region include Argentina's INVAP, Colombia's Colciencias, and Fundación Chile, a nonprofit focused on fostering innovation.

3 to 5 years

Estimated gap in digital adoption between Latin American and North American companies

A new wave of “digital attackers” is reinvigorating business dynamism. The rise and expansion of tech startups in the region bodes well for the emergence of innovation-led growth. Players such as MercadoLibre, an Argentine digital marketplace; Despegar, an online travel agent; Rappi, a Colombian app focused on food delivery; and Nubank, a Brazilian digital wallet startup, have grown quickly domestically and some are expanding into new markets. While most of the new entrants have concentrated around digital marketplaces and fintech firms, the combination of talent and competitive costs positions Latin America as an attractive playing field for digital disruption.

Yet the region has not been at the frontier of past innovation waves, and without a change, it risks missing the next one. Limited competitive pressure in many markets continues to limit incentives to innovate. MGI estimates that Mexico has realized just 4 percent of its digital potential, Brazil 5 percent, and Colombia 6 percent. Digital diffusion remains low in

¹¹⁴ Luis Beccaria and Roxana Maurizio, “Labor turnover in Latin America: How intensive is it and how differently does it behave across countries?” *International Labour Review*, 2018.

¹¹⁵ Max Cesar, Alberto Chaia, Andre de Oliveira Vaz, Gonzalo Garcia-Munoz, and Philipp Haugwitz, *How Mexico can become Latin America's digital government powerhouse*, November 2018, McKinsey.com.

all countries—the United States is at 18 percent of the frontier, and the European average is around 12 percent.

Some incumbents are nonetheless surfing the digital wave. A recent survey of large firms suggests that Latin American leading companies' performance is very close to their North American peers in digitization. Estimates suggest that large Latin American firms are roughly three to five years behind North American companies in relation to the digital frontier.¹¹⁶ Despite the relatively small gap at the top, the region needs to pursue a digitization agenda in two levels: developing entirely new digital offerings and business models to push the digital frontier, and ensuring that the long tail of small unproductive firms can access the benefits of digitization. Priorities for narrowing the gap include leveraging digital channels to boost sales (17 percent of sales come from digital channels, versus 23 percent in North America), expanding the digital labor force (16 percent of the labor force is allocated to digital initiatives, versus 26 percent in North America), and enabling the expansion of digital natives and cross-industry digital ecosystems (7 percent of market share goes to digital natives, versus 10 percent in North America).

For now, the region has only mediocre rankings on international innovation indices, in part because of relatively low spending on research and development and weak government procurement of advanced technology.¹¹⁷ Relative to peers, however, Latin America has lower aggregate investment in R&D. This is especially the case for Colombia and Mexico, where R&D was 0.3 and 0.5 percent of GDP, versus 1.0 percent for benchmarks and 1.2 percent for Brazil.¹¹⁸ The region is also not a wellspring of new commercial ideas and products; just 2 percent of global patent applications were registered in Latin America in 2015, according to the UN World Intellectual Property Organization, compared with 65 percent in Asia. Laborious processes may account for some of the challenge. In Brazil, firms can wait up to 15 years to receive patent approval. To accelerate the process, some firms register patents abroad first.

The degree of innovation and digitization varies significantly across sectors and businesses, reinforcing the dual economy. Sectors like information and communications technology, finance, and media are among the most digitized, while large traditional sectors like retail, education, and agriculture are lagging behind. There are also important differences within sectors, largely reflecting and intensifying the contrast between large productive firms and the long tail of unproductive firms. Smaller firms lack access to multiple enablers for

¹¹⁶ Based on expected growth of digital revenue data on maturity from US companies in 2015. The McKinsey & Company survey was conducted in mid-2018 as part of a yearly survey on digitization at companies. The sample featured more than 12,000 management executives throughout the world.

¹¹⁷ Latin American countries are relatively far down the World Economic Forum's rankings of competitiveness, for example, with no country scoring above 50 out of 100. *The global competitiveness report 2018*, World Economic Forum, 2018.

¹¹⁸ World Development Indicators, World Bank.

3-5 years

**Estimated digital gap
between large Latin
American firms and their
peers in North America,
based on McKinsey survey
of global executives.**

technology adoption, such as finance, talent, digital infrastructure, and often even information on relevant use cases.

Rapid advances and growing adoption of disruptive technologies will create a new wave of opportunity for reinvigorating the middle. Digital can help small businesses leapfrog and scale by increasing productivity and expanding to new markets through digital platforms, advanced analytics, and the Internet of Things.¹¹⁹ As we outline in Chapter 4, capturing the digital prize will require significant effort and collaboration from governments, businesses, and individuals. Latin American societies will need to work together to transform digital potential into value creation and to ensure that the digital value benefits different members of society, especially small businesses and vulnerable workers.

The missing middle in corporate Latin America, squeezed out by a few large companies on one side and by a mass of largely informal and uncompetitive small companies on the other, is not a new phenomenon, but it is one that so far has stubbornly resisted change. If the region is to raise its GDP growth and make that growth more inclusive, it will need to go much further in bolstering and building out the corporate middle. That in turn will help create the much needed higher-wage and higher-productivity jobs that are the causal link to the other missing middle: the lack of middle-class demand and purchasing power, which we examine in the following chapter.

¹¹⁹ Innovation can play a large role when aimed at creating new markets and enabling access to essential goods and services for typically excluded households. See Clayton M. Christensen, Efoso Ojomo, and Karen Dillon, *The prosperity paradox: How innovation can lift nations out of poverty*, Harper Business, 2019.



3

The other missing middle: Middle-class consumers to fuel demand and investment

The other “missing middle” in Latin America is a cohort of upwardly mobile consumers whose rising disposable income helps propel economic demand and investment on a sustainable basis. As noted, one of the big success stories of the past two decades in Latin America has been the 56 million people lifted out of poverty since 2000. Yet many of these people have not found productive, well-paid jobs that would enable them to join the burgeoning middle class and live increasingly comfortable lives. A sizable proportion has remained vulnerable, with some already falling back into poverty and many others at risk of doing so.

The lack of spending power is reflected in sluggish demand in the economy. While the dearth of midsize companies is one factor behind the shortage of jobs, the lack of well-paid jobs in turn limits the growth of markets for domestic companies. Demand for more complex goods and services suffers, and this in turn limits opportunities to expand business and encourage investment in more advanced technologies. The patterns underlying this stagnant demand vary between countries. In Brazil, workers benefited from higher wages during boom times, but the gains proved unsustainable without needed supply-side reforms and more competitive consumer prices. In Mexico, the export demand boost from NAFTA and modernization of some sectors spurred productivity increases but did not feed through into broad-based wage growth that could spark an expansion of domestic purchasing power.

In this chapter, we explore the economic and policy factors constraining the expansion of robust middle-class demand in the region. These include the limited growth of high-productivity jobs, the distribution of productivity gains between workers and business owners, high consumer prices limiting household purchasing power, and the role of government as regulator and economic actor. While the weight of different factors varies by country, the result across the region has been a sluggish expansion of domestic demand that has depressed investment and growth. Moreover, while exports could potentially help stimulate the missing demand, they have not been a major engine for growth; Latin American firms are not particularly well integrated into global value chains, partly for historical reasons.

High-productivity jobs are not emerging fast enough, limiting income growth for most workers

Latin America has not managed to create and expand the number of high-productivity jobs to the degree needed to raise overall productivity levels and lift incomes. The missing middle of firms results in a missing middle of good jobs.

The job creation challenge facing the region is particularly acute because, as we discussed in chapter 1, Latin America’s high fertility rates have contributed to a faster expansion of working-age population than in all other regions other than Africa. While more workers helped boost GDP growth, it also meant that the region’s labor markets needed to absorb a large cohort of new workers every year. The small and slowly expanding modern businesses have

not expanded fast enough to create sufficient numbers of productive, higher-paying jobs. Instead, most new entrants to the workforce end up in jobs at less productive industries, often as self-employed or informal workers.

The pattern of jobs that fill the void varies among our focus countries. In Brazil, the post-2000 commodity boom transformed agriculture, and high commodity prices and expanding access to credit led to a domestic demand surge. Subsistence farmers and agricultural workers moved to service jobs in the booming retail, construction, and personal services sectors. Brazil's retail industry alone added two million workers between 2007 and 2012.¹²⁰ These positions were overwhelmingly low-skill jobs in small establishments, however, with below-average labor productivity. Growth of more productive jobs in manufacturing, mining, and professional services was much smaller. When the commodity boom ended, the more productive jobs in larger establishments retracted as commodity income and expanded debt dried up. The strong currency during the boom years had eroded the competitiveness of many manufacturing and skilled services businesses.¹²¹ Since 2014, job growth has come exclusively from small establishments with fewer than 20 employees—again highlighting the absence of a middle tier of vibrant firms able to provide higher-productivity and higher-wage work (Exhibit 15).

In Mexico, productive job growth came from large establishments, especially in manufacturing. For example, auto manufacturing doubled its value added between 2006 and 2015, adding almost half a million high-productivity jobs. Nonetheless, with the rapidly expanding labor force, manufacturing and utility jobs as a whole actually decreased in share by 0.7 percent of total employment in that period, though they have since regained ground. Agriculture decreased by 0.8 percent of total employment between 2006 and 2017, leaving the bulk of job creation in services, including construction and business services, but especially retail. As described in chapter 2, the sector was modernizing and consolidating, raising productivity among the large hypermarkets and convenience-store chains, but

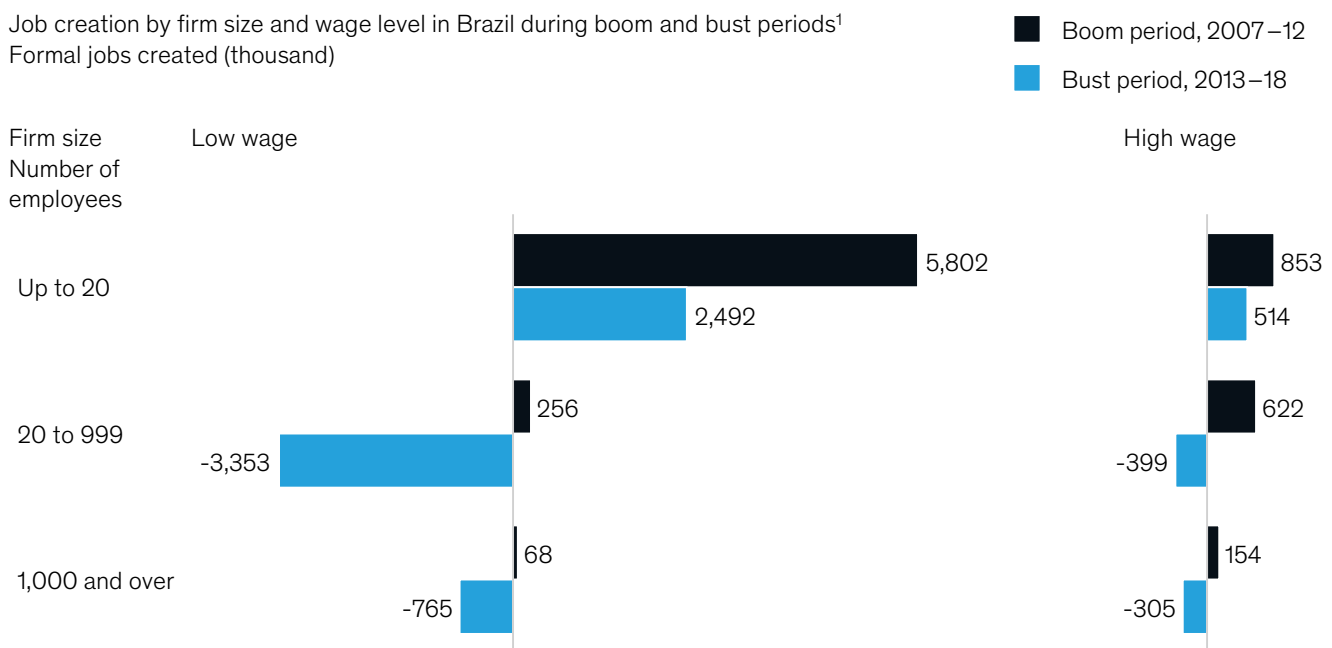
¹²⁰ Retail here is defined broadly to include hotel and restaurant services, for example, per national accounts, Instituto Brasileiro de Geografia e Estatística.

¹²¹ Laura Carvalho, *Valsa Brasileira: Do boom ao caos econômico*, Todavia, 2018.

Exhibit 15

In Brazil, even formal job creation came from micro firms in sectors that pay low wages, while in the bust period midsize firms suffered job loss, widening the missing middle.

Job creation by firm size and wage level in Brazil during boom and bust periods¹
 Formal jobs created (thousand)



¹ Based on a granular view of 1,347 sectors, considering average hourly wages between 2007 and 2018, adjusted to 2010 terms = R\$28/hour, or roughly \$16/hour. Source: CAGED; McKinsey Global Institute analysis

deepening the gap with the largely informal players that continued to add the most workers. Business services and real estate, both with above-average labor productivity, gained employment share and contributed to the expansion of more productive jobs. However, productivity within those sectors declined relative to the rest of the economy. With too few good manufacturing jobs and limited productivity growth in service sectors, the labor market overall remained loose—with important wage implications we explore below.

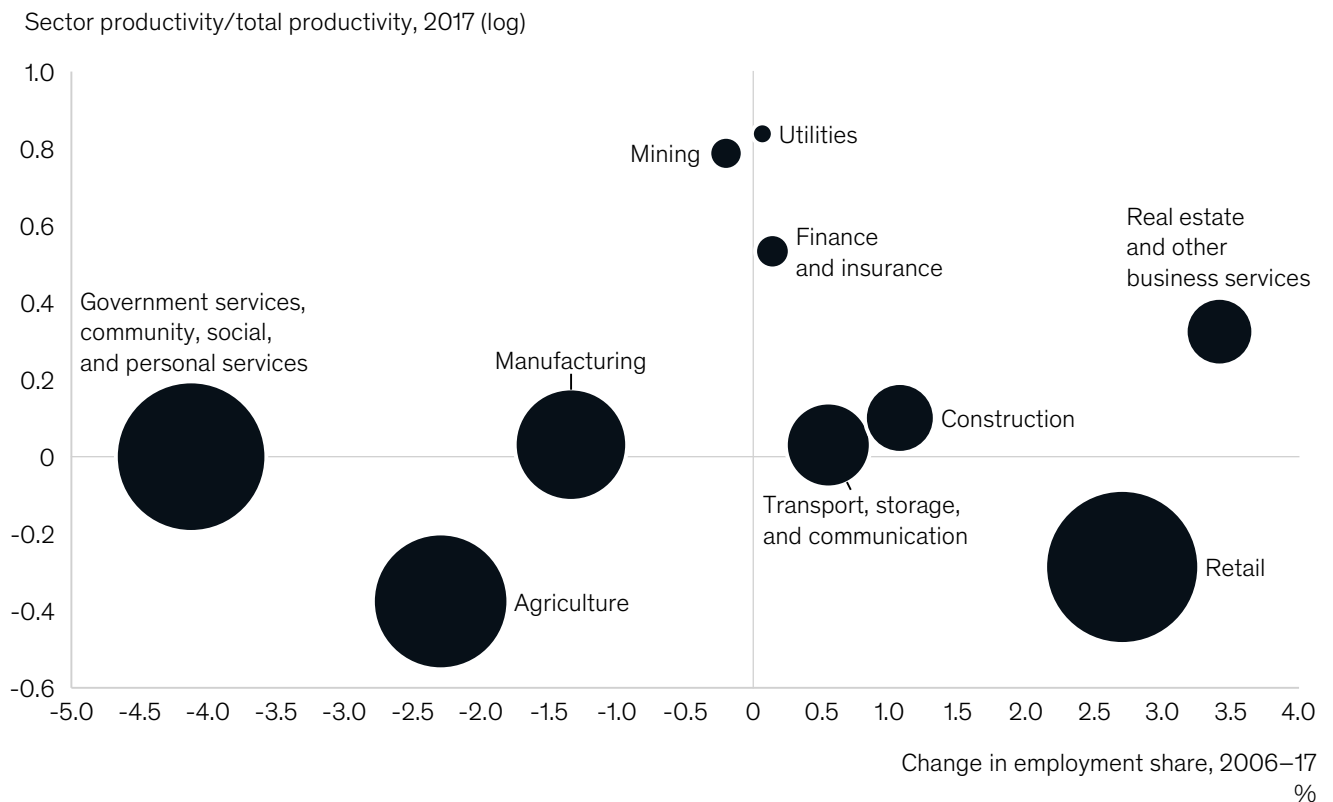
In Colombia, as in Brazil, construction and low-skill service jobs expanded between 2006 and 2017, including almost a million additional workers in retail and half a million in construction (Exhibit 16). Unlike in Brazil, productivity in construction rose with employment. Demand for housing and civil construction was fueled by higher infrastructure investment facilitated by national infrastructure programs, and as a result, the civil construction sector reduced its informality rate by over 10 percent in the same period. Oil and mining also increased productive jobs as sector output rose by 50 percent between 2000 and 2015. The success reflected not just the commodity boom but also the fact that Colombia's oil industry benefited from the influx of many experienced Venezuelan oil industry workers at all skill levels. By contrast, agriculture shrank considerably as a share, from 19 percent to 16 percent of the workforce, while productivity growth lagged behind the economy's, reflecting price regulation and limited modernization.

Exhibit 16

Colombia reduced employment share in agriculture and expanded in some high productivity sectors, but many workers were added to low productivity retail.

Colombia sectoral productivity and employment, 2006–17

Size of bubble represents 2006 share of employment



Source: DANE format follows Dani Rodrik, "Productivity Growth Lessons for Brazil from Other Countries," September 2013; McKinsey Global Institute analysis

Wages have grown in Brazil and Colombia, but in Mexico they stagnated even in sectors with productivity growth

The fact that most job growth has come from below-average productivity segments is reflected in the way gains from expanding output are distributed.¹²² In Latin America, overall income of workers accounted for 1.1 percent of the 2.8 percent GDP growth per year since 2000, of which 0.8 percent reflected the expanding pool of workers. Across the region, average wage growth accounted for only 0.4 percent of GDP income growth per year. In comparison, the wage growth in emerging-market peers accounted for more than three times the share of the economy's growth. The remaining 60 percent of GDP growth gains in Latin American economies, 1.7 percent of GDP per year, accrued to capital owners, self-employed workers, and government income through taxes.

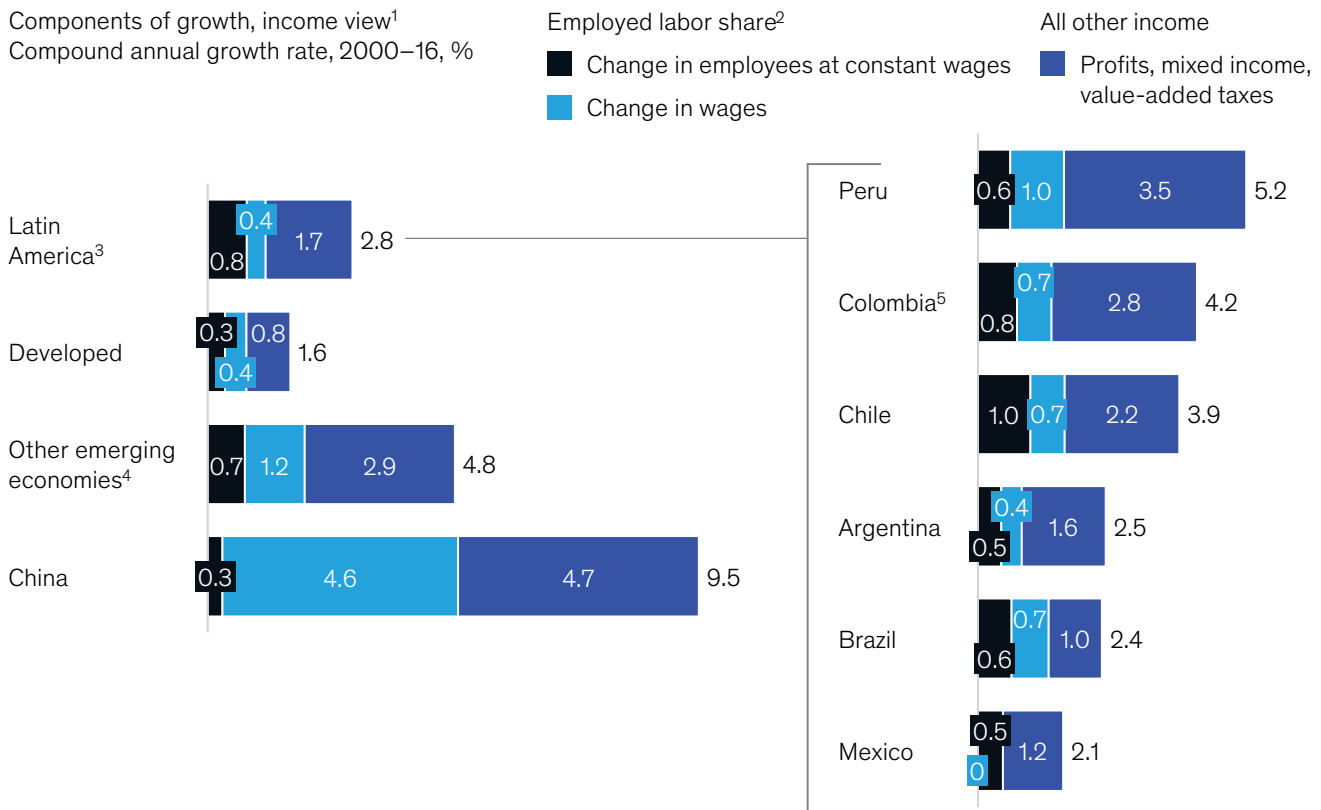
The differences between Brazil, Mexico, and Colombia are notable: while average wages in Brazil and Colombia each accounted for 0.7 percent of GDP per year, in Mexico average wages were flat (Exhibit 17). This again reflects the different ways in which the virtuous cycle of inclusive growth can break down.

Beyond low productivity growth, wages can be constrained for other reasons. A decreasing labor share globally has been attributed in part to technology advances—which decrease the relative price of investment goods and encourage automation of routine tasks. In emerging

¹²² The analysis is based on the national accounts income view that measures the way the income from producing GDP is distributed among workers, owners of capital (both corporations and self-employed), and government in taxes.

Exhibit 17

Low productivity gains have not fed through to higher wages in Mexico, whereas in Brazil wages grew strongly but not sustainably.



¹ Country weights done using World Bank 2015 GDP.

² Assumes that half of residual labor share is attributed to average wages and employees. See technical appendix.

³ Excludes Argentina and Venezuela.

⁴ Excludes China.

Source: GGM; World Bank WDI; INEGI; IBGE; DANE; The Conference Board Total Economy Database™ (Original version), November 2017; McKinsey Global Institute analysis

economies, global market integration has been another important contributor to wage stagnation, according to the IMF. Market concentration may also be a factor that brings down labor share in both developed and developing economies.¹²³ General trends notwithstanding, country-level differences in labor shares can be large: one study found that Brazil saw an increase of about seven percentage points between 1975 and 2012, the second-largest increase in the 59 countries studied. (In two-thirds of these countries, the labor share declined.) Mexico saw an eight-percentage-point decline in income share going to labor, the sixth-largest drop.¹²⁴ This was in part due to policy differences during our period of study.

In Brazil, after a period of declining real wages in the 1990s, government policies shifted to proactively broadening the reach of the benefits from the commodity-cycle upswing. Social policies, including targeted transfers already described, minimum wage increases, and a credit expansion, all promoted inclusive growth. As a result, wage growth ran considerably ahead of productivity growth, including in high-employment sectors like construction and retail. In extractive industries and manufacturing, both industries where unionization was strong, wages grew even though productivity declined. Agriculture and finance were exceptions where robust productivity growth outstripped wage growth. The income translated into a demand and consumption boom that ended once commodity prices fell back.¹²⁵

In contrast, Mexico's access to the North American market and many supply-side reforms had surprisingly little impact on broad-based wage growth, which lagged behind productivity gains in many sectors (Exhibit 18).¹²⁶ While manufacturing productivity in Mexico increased by an average of 1.7 percent annually between 2005 and 2015, average wages declined by 0.9 percent in the same period. In the auto sector, one of the NAFTA success cases, value added has grown at an annual average rate of 7 percent since 2006, and labor productivity ranks with that of the top producers in the world. Yet average wages of Mexican autoworkers have declined in the same period. By comparison, South Korea at the same point in its auto industry development saw a 58 percent increase in sector wages over the corresponding ten years of productivity growth.¹²⁷

Given Mexico's expansive supply of labor and the minority role of large export firms, companies have been able to recruit workers without wage increases. As noted, our survey showed that workers are willing to forgo higher income in self-employment for the stability and skill building that wage employment with modern large companies offers. As Mexico positioned itself as an attractive and competitive investment location, labor market policies were not focused on raising wages in the short term. In domestic services, the pattern was the same: leading retailers faced little pressure to share the benefits of productivity growth with workers drawn from the same large labor pool as the rest of the fragmented market. The real minimum wage in Mexico grew by 0.6 percent per year starting in 2000, and then increased by 16 percent for 2019, to reach just under \$5.50 per day (and \$9 per day in Border Minimum Wage municipalities), a third of the level in Chile and less than half of Brazil's. Among OECD countries, the minimum wage is the second-lowest relative to median income. The consequence is that most middle-income workers have seen their incomes stagnate. While decades of reform have changed Mexico, the country has not yet succeeded in reigniting the expansion of domestic middle-class demand as an engine of sustained growth.

¹²³ "Understanding the downward trend in labor income shares," in *World Economic Outlook, April 2017: Gaining momentum?*, IMF, 2017. See also David Autor et al., *Concentrating on the fall of the labor share*, NBER working paper number 23108, January 2017, which focuses on a "superstar" firm effect that concentrates bargaining power, and Wyatt J. Brooks et al., *Exploitation of labor? Classical monopsony power and labor's share*, NBER working paper number 25660, March 2019.

¹²⁴ Loukas Karabarbounis and Brent Neiman, "Trends in factor shares: Facts and implications," *NBER Reporter*, December 2017, Number 4. In addition to the capital-labor substitution dynamics, these authors highlight economic profit beyond the price of capital, consistent with Simcha Barkai, *Declining labor and capital shares*, Stigler Center new working paper series number 2, University of Chicago Booth School of Business, November 2016.

¹²⁵ See for example Ricardo Hausmann, *In search of the chains that hold Brazil back*, Harvard Kennedy School working paper RWPO8-061, October 2008. This shows how, at the height of the demand boom, high interest rates related to low savings and high government borrowing became the binding constraint on growth.

¹²⁶ The narrow aggregate gap between wage and productivity growth reflects the weight of the oil and gas industry, in which productivity growth declined without a decline in wages.

¹²⁷ South Korea national accounts. Note that the expanding employment in the auto industry has created almost 500,000 new jobs with wages 60 percent above the national average, contributing to the expansion of better-paid jobs.

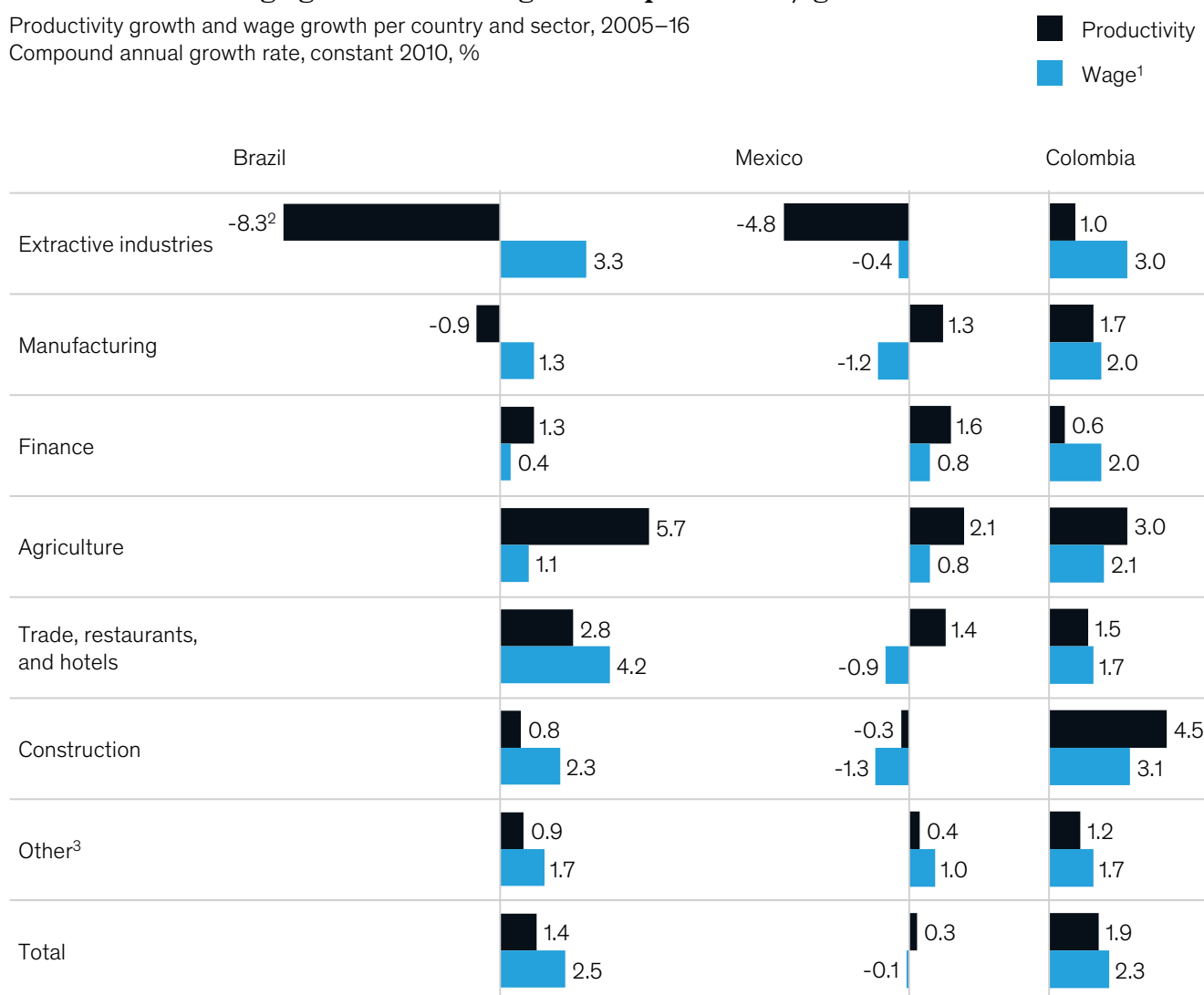
Colombia's relatively strong growth was more inclusive and balanced: average wage growth of more than 2 percent per year on average exceeded productivity growth and more closely correlated with productivity gains across sectors. Workers in extractive industries and construction saw the fastest wage growth, especially during the resource boom years. While Colombia outperformed most regional peers, it nonetheless lagged behind global benchmarks. Take Thailand, which has similar population and per capita income and has seen GDP growth at a comparable rate since 2000. Thailand's workforce grew at a slower rate, and growth came to a greater degree from improved productivity. As a result, individual workers have accrued greater benefits from growth: average wages in Thailand increased at 3.7 percent per year over this period. That spurred rapid growth of the middle class: middle-income earners accounted for 70 percent of Thailand's population in 2015, up from 42 percent in 2000.¹²⁸ In Colombia, the same middle-income segment accounted for just 57 percent of the population in 2015; this represented a significant increase from 36 percent in 2000, but growth was well below the level in Thailand.

¹²⁸ We use income of between \$11 and \$110 per day, based on 2011 purchasing power parity, to define Thai middle-income earners.

Exhibit 18

In some sectors, wage growth has diverged from productivity growth in Mexico and Brazil.

Productivity growth and wage growth per country and sector, 2005–16
Compound annual growth rate, constant 2010, %



¹ Wages measured as "compensation to employees" per employee from National Accounts.

² Extractive Industries (mining, including oil and gas) value added in Brazil grew until 2013; it had a 40% drop in 2015 and then halved in 2016 due to increases on intermediate consumption. Employment decreased at a smoother pace during that period, falling 5 percent in 2015 and 15 percent in 2016.

³ Includes: utilities; transport, storage and communication; real estate and business services; and government, social and personal services.

Source: IBGE; INEGI; DANE; McKinsey Global Institute analysis

The dearth of well-paid job opportunities perpetuates the missing middle of consumers and acts as a brake on domestic demand

The lack of wage growth feeds through into consumption—or, rather, fails to feed through into consumption. Stagnant middle-class income is a severe constraint on the power of domestic demand to be a sustained engine of the region's growth. To generate a virtuous cycle of rising prosperity, income needs to flow to those who will spend it and create demand in the local markets. Rising incomes also help expand markets for new, higher-quality goods and services, which would encourage investment from entrepreneurs who would find larger markets and greater variety of niches to sell differentiated products and services. It is these opportunities for growing businesses that could fill in the missing middle on the supply side. Exhibit 19 shows consumption by income ventile—that is, per 5 percent segments of the income distribution. One-quarter of the economy's consumption is from the top 5 percent of income earners. That is a significantly higher share than in the other emerging economies we use as benchmarks; on average, the top 5 percent in these countries accounts for 19 percent of total consumption, or six percentage points less than in Latin America. All other income groups along the bottom 80 percent of the distribution, by contrast, consume less than their peers in other emerging economies.

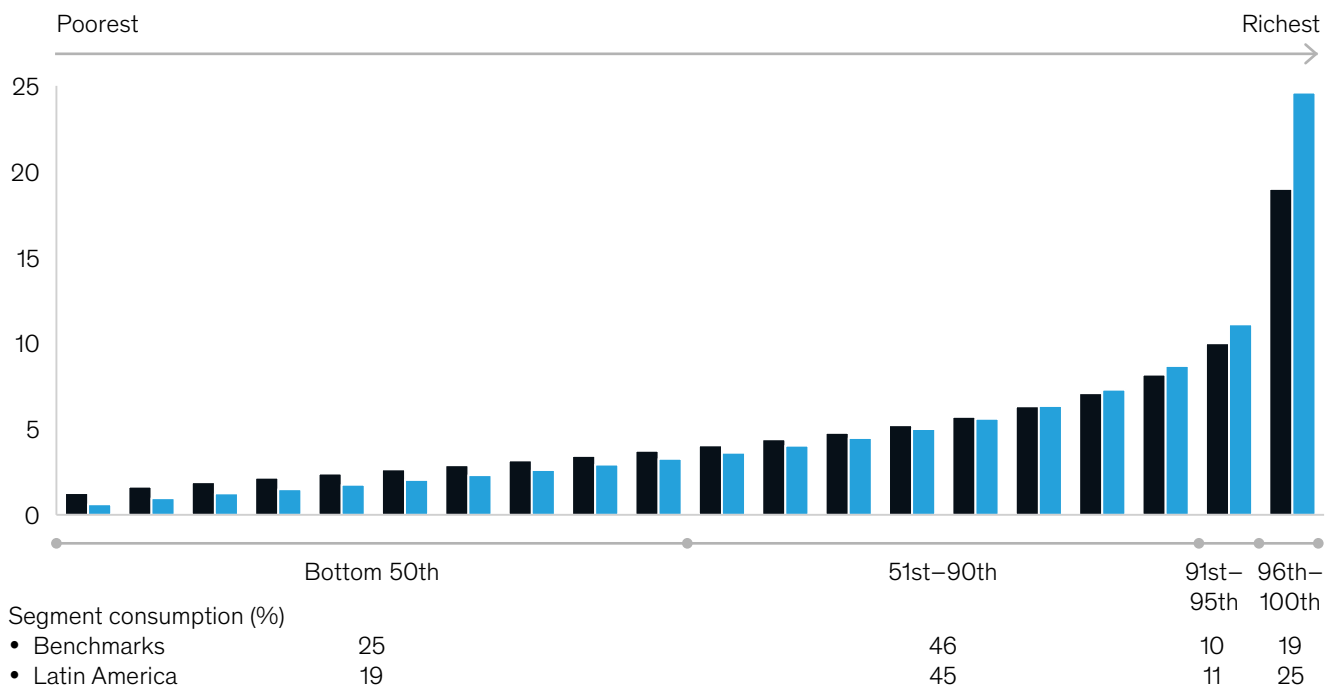
This matters for growth because the highest income segments tend to have the lowest propensity to spend: they can afford to save more of their income. Low- and middle-income households spend a higher share of their income. This means that the more of national income goes to the latter, the larger the multiplier effect of the income spent that feeds back to domestic demand. Their spending, in turn, increases the willingness of domestic companies—including startups—to invest, thereby perpetuating the virtuous cycle of production,

Exhibit 19

Latin America's top 5% of earners concentrate a quarter of consumption.

% of Latin America consumption by income ventile, 2000–16
2011 PPP

■ Benchmarks ■ Latin America



Source: World Data Lab; World Bank; McKinsey Global Institute analysis

income, and demand.¹²⁹ This demand matters for manufacturing as well; one study found that consumption channels accounted for much of the difference in industrial employment between Latin America and benchmark economies.¹³⁰ Domestic markets have also been an important factor for attracting foreign direct investment to Brazil and Mexico.¹³¹

Consumption has grown because of an increase in the number of consumers rather than higher per capita spending, holding back the evolution of domestic markets

Low-income households have a higher propensity to spend than higher-income households. In Brazil, people in the bottom 50 percent of income distribution consume more than \$1.20 worth of goods and services for every \$1 in income, often relying on credit or subsistence production, while the top 10 percent spends as little as \$0.80. At the same time, as income

¹²⁹ For example, a survey of 291 CEOs in seven developed economies found increased or expected increase in demand to be the most frequent reason (1.5x more than the next highest answer) for making investments in the previous three years (McKinsey Quarterly Survey, 2017); SMEs in Colombia also cite lack of demand as the number one problem facing their businesses (*La gran encuesta pyme: 2do semestre 2018*, Asociación Nacional de Instituciones Financieras Centro de Estudios Económicos, anif.co/sites/default/files/publicaciones/gepnacional_ii-18.pdf)

¹³⁰ Rishabh Sinha, *What explains Latin America's low share of industrial employment?*, policy research working paper WPS 8791, World Bank, March 2019.

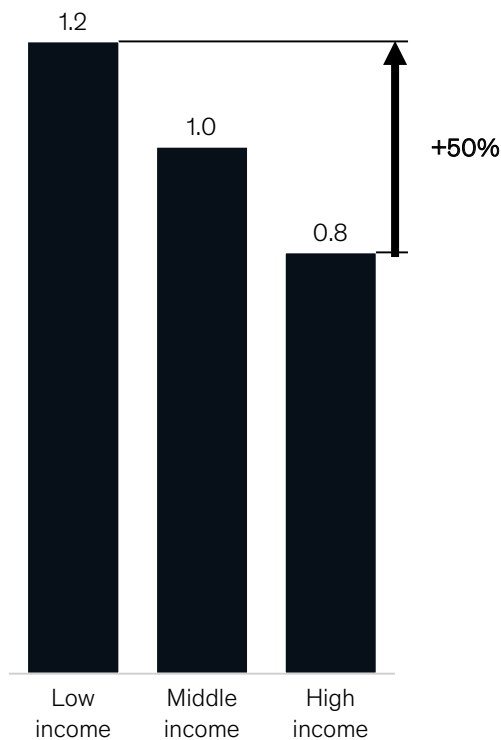
¹³¹ Steven Samford and Priscila Ortega Gómez, "Subnational politics and foreign direct investment in Mexico," *Review of International Political Economy*, 2014, Volume 21, Number 2; Correa da Silveira, Eduarda Martins, Jorge Augusto Dias Samsonescu, and Divanildo Triches, "The determinants of foreign direct investment in Brazil: Empirical analysis for 2001–2013," *CEPAL Review*, April 2017; *New horizons: Multinational company investment in developing economies*, McKinsey Global Institute, October 2003.

Exhibit 20

Income growth of lower income segments tends to boost the domestic market due to their propensity to consume.

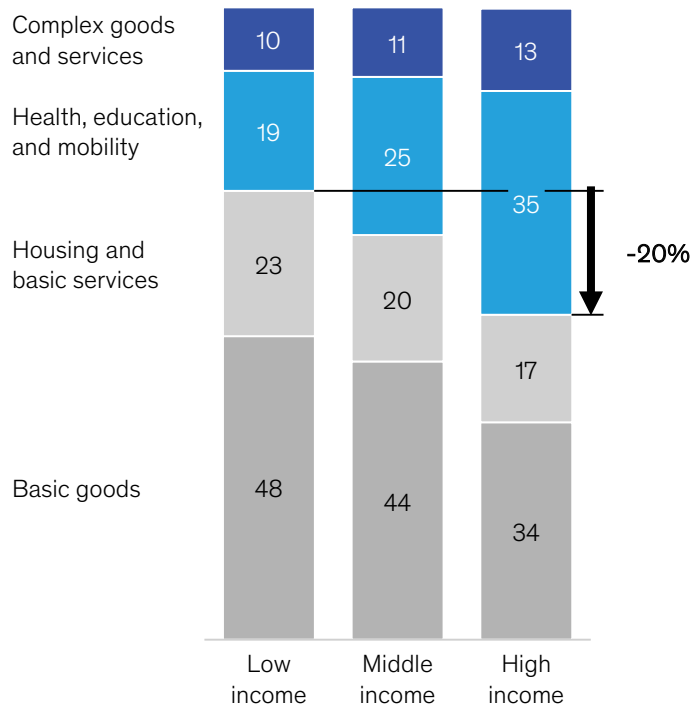
Brazil propensity to consume¹ by income level²

Spend per extra \$1 in income, 2009



More complex goods and services are added as income grows

Brazil consumption basket per income level² % , 2010 \$ PPP



¹ Propensity to consume uses self-reported income and expenditure data by income decile; includes transfers, scholarships, and other income; based on POF 2009 microdata and 2016 household surveys.

² Per day income (\$ PPP): low = 50th percentile; middle = 51st–75th percentile for consumption basket and until 90th percentile for propensity to consume; high = remainder of population.

Source: IBGE PNAD and POF 2009; FVG "Tributação e desigualdade" 2016; McKinsey Global Institute analysis

grows, consumption patterns change, with more complex services being added to the basic subsistence items in the basket of goods (Exhibit 20).

Our prior research has shown how the adoption of many products as a function of income follows an “S curve” that climbs rapidly when incomes rise before flattening out once penetration is high.¹³² In the takeoff phase, small changes in income tend to yield strong demand growth. For example, penetration of refrigerators starts to rise at around annual per capita income of \$5,000 at purchasing power parity and flattens after \$15,000, while demand for washing machines jumps around the per capita income level of \$15,000 and grows sharply until it exceeds \$25,000. In Brazil, 100 percent of households have fridges and 90 percent have washing machines, reflecting high consumer demand (and credit) during the boom period. In Mexico and Colombia, penetration rates are lower, at 85 percent and 70 percent, respectively. While in Brazil the rate has increased at an annual average rate of 5 to 6 percent, in Mexico it is stagnant. In Colombia, growth was between 3 and 4 percent from 2010 to 2017.

Consumption growth in Latin America has come largely from population growth rather than from the rise in per capita consumption that would accompany a middle-class demand boom. A comparison with the benchmark countries we use in this report illustrates this gap. Overall consumption growth was slower: household consumption grew by 2.9 percent annually in Latin America from 2000 to 2016, which is lower than the 5.2 percent growth in benchmark countries. Taking into account the region’s faster population growth, the comparison is even starker: consumption growth measured on a per capita basis in Latin America has been just 1.8 percent, less than half the 4.3 percent in benchmark countries (Exhibit 21).

1.8%

Per capita consumption growth in Latin America is less than half the 4.3% growth in benchmark countries

Colombia’s per capita consumption growth is high for the region, at 2.8 percent, while Chile and Peru are outliers, at 3.7 percent and 4.2 percent, respectively. In Mexico, however, the ratio is reversed: consumption growth come more from population growth than for per capita increases in consumption. This is exceptional among the 10 benchmark economies and the six Latin American economies we analyzed. As we discussed above, Mexico’s weak consumer spending record is affected by the divergence of wages from productivity growth, which means that workers have not benefited proportionately from gains in the economy—or, in some sectors, have not benefited at all.

Across the region, high prices, consumption taxes, and limited consumer financing options further constrain consumption

Limited income growth is not the only constraint on middle-class consumption. Relatively high prices in protected domestic markets, regressive taxes, and underpenetration of consumer finance that could improve access to goods and services also reduce the purchasing power of the broad consumer base. In Brazil, consumer prices rank high and purchasing power low in global comparisons, reflecting trade protection and a high tax burden from cumulative state and federal value-added taxes.¹³³ In Colombia, trade protection and direct price regulation lead to elevated consumer prices in specific industries, while in Mexico, prices of many traded products have declined with NAFTA. However, credit is limited, which constrains demand.

The sticker price of automobiles is one example of the relatively high cost of goods. In Brazil, cars cost 2.4 times as much as they do in the United States. In Colombia, the difference is 2.8 times. Two main factors explain the higher cost. First, the expensive “Brazil cost” in the supply chain resulting from protectionist policies and nontrade barriers such as poor infrastructure jacks up the end price to consumers. Production costs in Brazil are 10 percent higher than in the United States, even though its labor cost inputs are 50 percent lower. This happens because steel and nonsteel parts that represent 80 to 90 percent of total costs are 20 percent more expensive in Brazil. Second, high value-added taxes raise the price

¹³² *Urban world: Cities and the rise of the consuming class*, McKinsey Global Institute, June 2012.

¹³³ One index of purchasing power in 119 countries ranks Brazil in 87th, where scores are calculated by comparing the ratio prices to average wages and indexing to a benchmark (New York City). Colombia is even lower at 92nd Cost of Living Index 2019, Numbeo.

even further; in Brazil, these consumption taxes amount to almost half of the total cost to the auto consumer.

The legacy of import substitution policies is reflected in protected markets where local producers benefit from prices that are higher than the global market price. In Colombia, domestic agriculture prices remain 20 percent above international prices due to protection. For example, over 60 percent of farm receipts in sugar were from trade-related price distortions in 2010.¹³⁴

Indirect taxation required to finance governments in informal Latin American economies further squeezes lower- and middle-class consumption. The vulnerable and middle classes in Latin America shoulder a larger share of the tax burden proportionately than wealthier people, further constraining their ability to consume, save, and prosper.

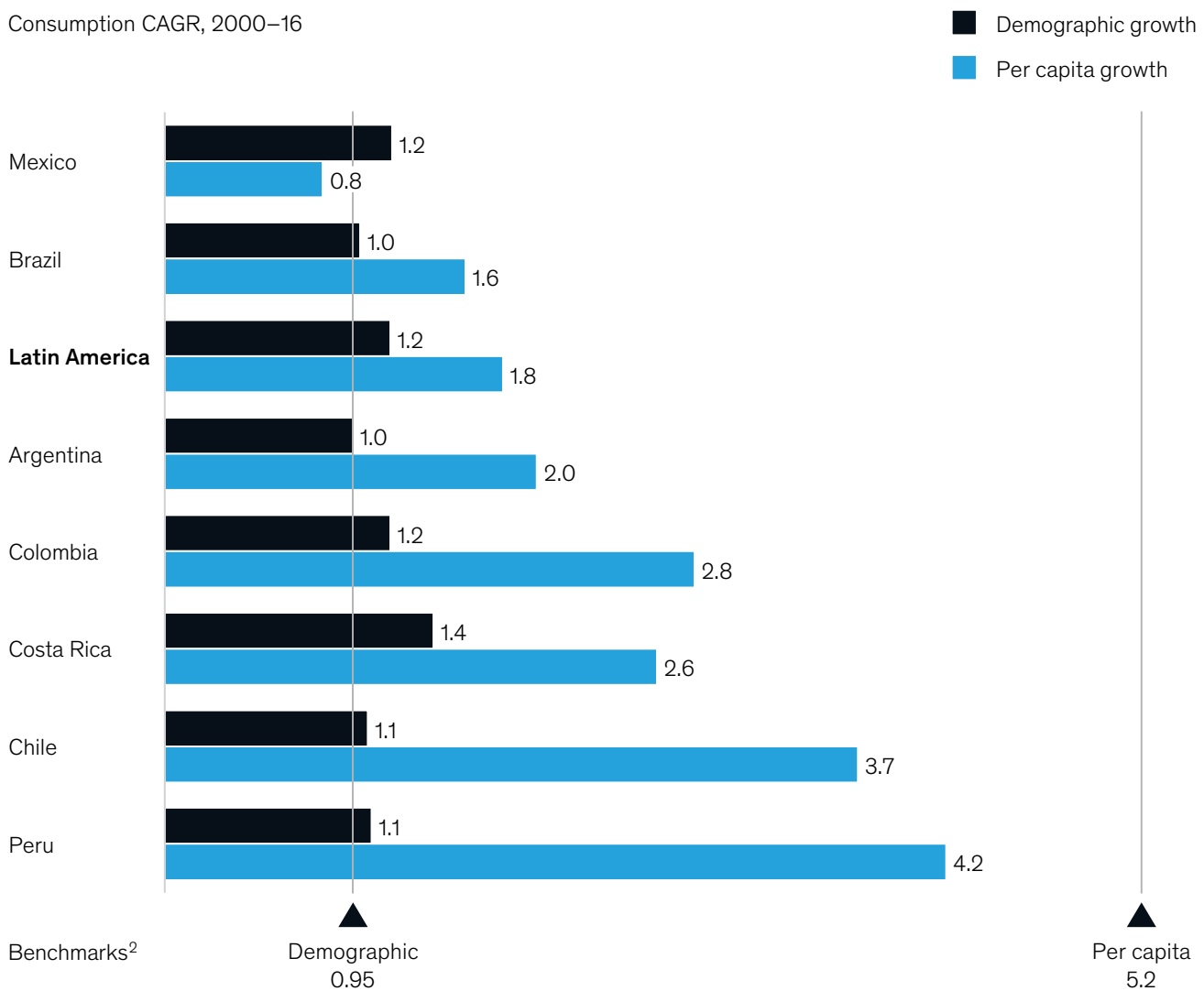
Brazil is a striking example: value-added tax represents 40 percent of the tax burden compared with 32 percent in OECD countries on average. The reliance on consumption taxes makes the tax burden regressive: in Brazil, the lowest decile pays 32 percent of their

¹³⁴ Farm receipts generally include sales, income from government programs, and private insurance.

Exhibit 21

Consumption gains per capita in the region are well below benchmarks with the exception of Peru and Chile.

Consumption CAGR, 2000–16



¹ Decomposition is based on total consumption growth CAGR and population CAGR with residual attributed to per capita growth.

² Weighted average of benchmarks (India, Indonesia, Malaysia, Philippines, Poland, Russia, South Africa, Thailand, Turkey); China excluded from consumption growth due to weight.

Source: World Bank; UN World Population Prospects 2017; McKinsey Global Institute analysis

income in taxes, compared with 23 percent for the middle decile and 21 percent for the top decile (Exhibit 22).¹³⁵ In other words, in relative terms as a percentage of income, the tax burden on the poorest 10 percent in Brazil is 50 percent higher than the burden on the richest 10 percent.

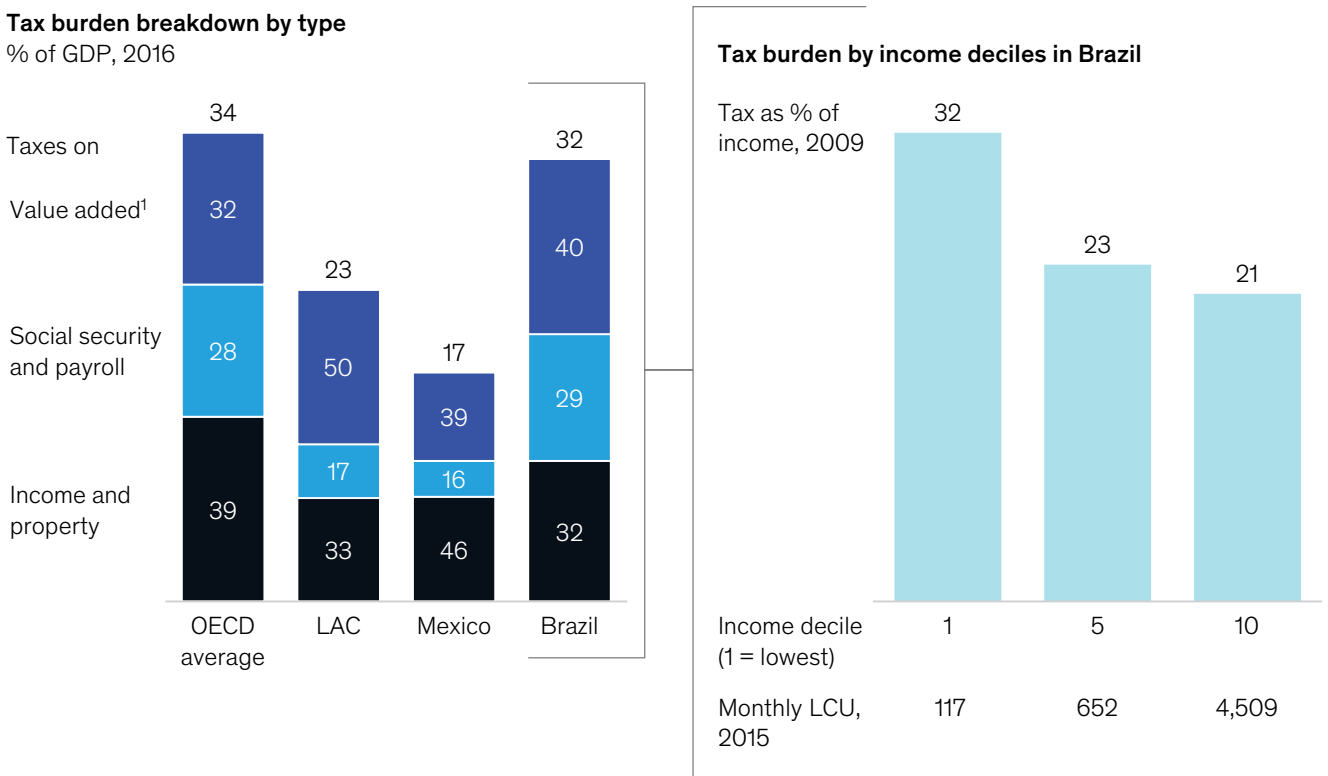
For personal income taxes, the poorest people receive exemptions—as do the wealthiest, through tax deductions. The richest 0.1 percent of the population in Brazil receives 7 percent of total income, but about half of their earnings are exempt from taxes, since they take the form of dividends and stock options, which are not taxed or are deductible from taxes; this creates incentives for profit redistribution rather than reinvestment.¹³⁶ At the other end of the income distribution, for the bottom 20 percent, about three-fourths of their earnings are exempt from taxes and a further 5 percent can be deducted. However, the middle deciles of earners are neither exempt nor able to take big deductions. As a result, they pay taxes on 64 percent of total declared income (Exhibit 23).

Beyond high prices and taxes, limited access to and high cost of consumer credit further limit domestic consumer market purchasing power. Domestic credit in all three of our focus countries is substantially underdeveloped by comparison with most of the other emerging economies we benchmark. Of the three, Brazil has the highest level of domestic credit to the private sector, amounting to 67 percent of GDP. That proportion is more than double the credit available in Mexico, which totals just 32 percent of GDP, and considerably higher than in Colombia, at 47 percent. Similarly, financial inclusion as measured by whether

¹³⁵ Fernando Geiger Silveira et al., “Equidade fiscal no Brasil: Impactos distributivos da tributação e do gasto social,” *Comunicados do Ipea*, Instituto de Pesquisa Econômica Aplicada, 2011, Number 92.
¹³⁶ Sergio Wulff Gobetti and Rodrigo Octavio Orair, *Progressividade tributária: A agenda negligenciada*, Instituto de Pesquisa Econômica Aplicada, April 2016.

Exhibit 22

Tax burden is highest for the lowest income segment, especially in Brazil where over 30% of income goes to direct and indirect taxes.



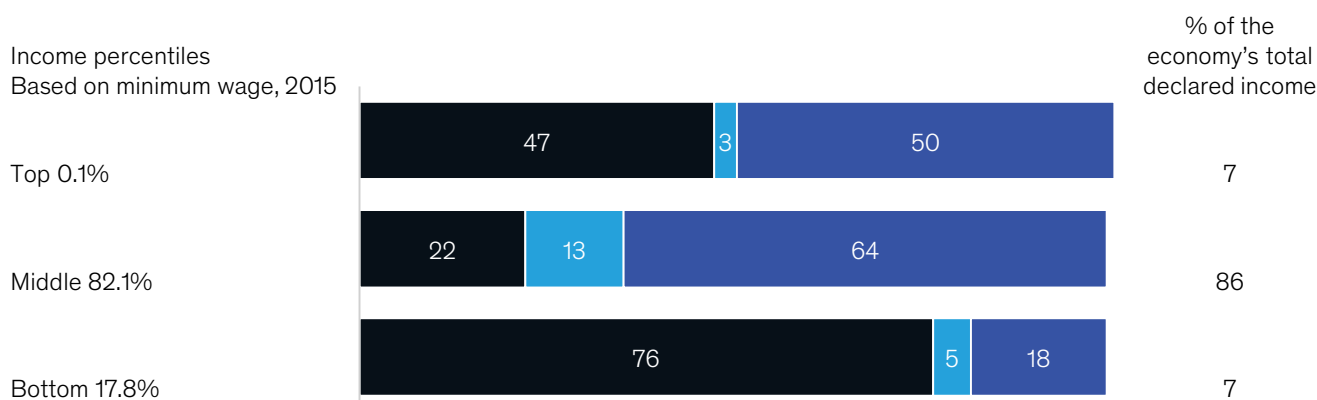
¹ We use the term "value added" to refer to any national tax that embodies the basic feature of value added tax. It corresponds to "Taxes on goods and services" from OECD.

Source: OECD; IPEA, "Equidade fiscal no Brasil: Impactos distributivos da tributação e do gasto social," based on IBGE POF 2009; McKinsey Global Institute analysis

Middle-income workers have the highest percentage of taxable income.

Income tax exemptions by income level in Brazil, 2015
% of declared income

■ Exempt earnings ■ Deductions¹ ■ Taxable income²



¹ Expenses within certain limits on healthcare, education, spousal pension, and social security contributions.

² Dividends, stock options, scholarships, unemployment insurance, and, in some cases, pensions and real estate backed investments.

Source: DIRPF 2016; Brazilian Tax Agency; based on income tax data from 2015; McKinsey Global Institute analysis

someone has a bank account was 70 percent in Brazil but just 37 percent in Mexico and 46 percent in Colombia in 2017.¹³⁷

Weak demand expectations have dampened investment

The most powerful incentive for firms to invest is their expectation that markets will grow and deliver returns. Yet Latin America has a chronically low investment rate by comparison with higher-growth emerging economies.

In the most dynamic high-growth emerging economies, investment as a share of GDP ranged between 20 and 30 percent in the period between 1995 and 2015, between three and 13 percentage points higher on average than investment in other developing economies.¹³⁸ In contrast, Latin American and Caribbean investment in 2016 amounted to 19 percent of GDP, below the global average of 24 percent and a simple average of 27 percent among our benchmarks (Exhibit 24). Of our three focus countries, only Colombia was ahead of the global average, a result of strong policy incentives for investment, a national infrastructure program, and a peak in mining-related capital formation. It has since reversed. Across the region, higher incomes and purchasing power could draw capital into productive use.

Export demand can reward firm competitiveness and specialization, but beyond primary goods in the region outside Mexico, it has not

Beyond household demand, exports have a role to play in accelerating the virtuous cycle. They have not been a major engine for Latin America's growth, however, and firms from the region are not particularly well integrated into global value chains.

Exports not only tap into global demand but can be powerful catalysts for investment and improved productivity. Being part of global value chains offers access to networks of customers and collaborators. Export performance reflects company competitiveness. Indeed, the success of the Asian tigers and then China and Southeast Asian economies in capturing large segments of global supply chains often draws attention to the critical role of exports in emerging-market growth.¹³⁹ With the exception of Mexico, however, export intensity in Latin America is low and undiversified (Exhibit 25).

¹³⁷ World Bank Financial Inclusion database, 2017.

¹³⁸ *Outperformers: High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

¹³⁹ Jonathan Anderson, *How to think about emerging markets, part 2: Who makes it, who doesn't?*, Emerging Advisors Group, April 24, 2018.

Exports account for just 22 percent of GDP in Latin America, compared with 36 percent in the benchmark countries. In Brazil, the export share is 13 percent of GDP, while Colombia's is 15 percent; its export share has declined slightly since 2000. Mexico has achieved a much stronger export performance in the post-NAFTA era. Its exports of goods and services rose from 25 percent of GDP in 2000 to 38 percent in 2017. However, the benefits of its export growth have largely failed to spill over into the domestic economy more broadly.

Exhibit 24

Latin American economies increased their investment as share of GDP slowly since 2000 but the region still lags behind other emerging markets.

Total investment share of GDP
% of GDP

| | Average, 2014–16 ¹ | Gross capital formation compound annual growth rate, average 2000–02 to average 2014–16 % ² | |
|------------------------|-------------------------------|--|-----------------|
| Latin America | Colombia | 24 | 8 |
| | Peru | 24 | 9 |
| | Mexico | 23 | 2 |
| | Chile | 23 | 6 |
| | Brazil | 18 | 2 |
| | Argentina | 17 | 5 |
| Other emerging markets | China | 46 | 13 |
| | India | 34 | 9 |
| | Indonesia | 32 | NA ³ |
| | Turkey | 29 | 7 |
| | Malaysia | 25 | 5 |
| | Russia | 23 | 4 |
| | Philippines | 22 | 6 |
| | Thailand | 22 | 4 |
| | Poland | 20 | 4 |
| | South Africa | 20 | 5 |

¹ Average for infrastructure investment was done from 2014–15 due to data availability.

² We use World Bank to calculate investment growth.

³ Indonesia was negative in the baseline period due to disposal of fixed assets.

Source: World Development Indicators, World Bank; National Accounts for: Brazil, China, India, Russia, South Africa, Argentina, Indonesia; McKinsey Global Institute analysis

The nature of exports, not just the volume, is also indicative of economic health. Export complexity is a predictor of higher growth and lower inequality.¹⁴⁰ In both Brazil and Colombia, primary goods account for half or more of total exports. Mexico's relative openness, particularly within NAFTA, means it has a higher export intensity than benchmarks on nonprimary goods, as measured by percentage in relation to GDP, and is less dependent on primary goods. Nonetheless, by other measures, Mexico's economic complexity is lower than that of countries such as Thailand and Malaysia. This indicates the earlier starting point of export-oriented industrial policy in Thailand and Malaysia, as well as their deeper integration into global supply chains compared to a higher share of Mexico's "maquiladora" factories, which capture less of the value chain.

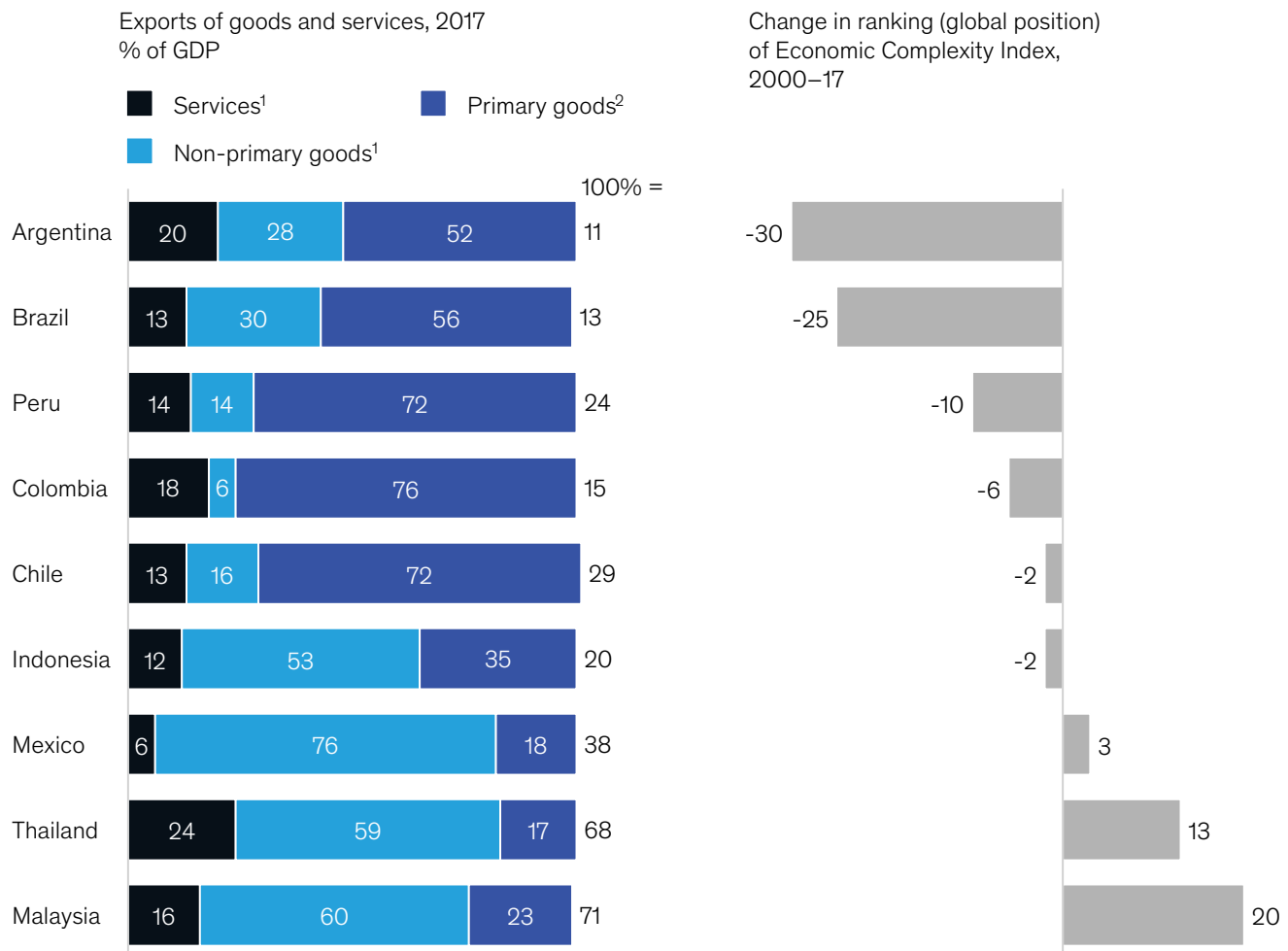
The legacy of inward-focused import substitution is reflected in the notably low share of regional trade within Latin America, compared with intraregional trade elsewhere. While intraregional trade accounts for more than 50 percent of total trade in Asia and Europe, in Latin America, it amounts to just 22 percent of both exports and imports.¹⁴¹ About 45 percent of exports go to the United States, which is also the provenance of one-third of imports.

¹⁴⁰ Dominik Hartmann et al., "Linking economic complexity, institutions, and income inequality," *World Development*, May 2017, Volume 93.

¹⁴¹ *Globalization in transition: the future of trade and value chains*, McKinsey Global Institute, January 2019.

Exhibit 25

Exports in Latin America have been low and concentrated in primary goods, with the exception of Mexico.



Note: Figures may not sum to 100% because of rounding.

¹ Services as share of exports from World Bank.

² Primary vs non-primary based on Atlas of Economic Complexity; former includes: Mineral products, metals, food and vegetable products.

SOURCE: World Bank WDI; Atlas of Economic Complexity for the Center for International Development of Harvard University; McKinsey Global Institute analysis

Mexico's intraregional trade is especially low, at just 5 percent of exports and 3 percent of imports, whereas in Brazil, 20 percent of exports are to countries in the region and 17 percent of imports are sourced from other Latin American countries.

Latin American governments could spur demand through public investment, efficient services, and education

Beyond regulation, government can play a more direct role in accelerating the virtuous cycle, or potentially derailing it.

The challenge for all governments is how to spend government funds in a way that promotes inclusive growth. Four tools are available. First, redistribution can help address extreme inequality and help fill in the missing middle of consumers. Second, public investment can directly translate national income to productive investment through infrastructure spending, public procurement and adoption of technologies that can have spillover effects, and forward-looking research and development for emerging industries. Third, government delivery of essential services (as well as infrastructure) can enable the broad base of the population to participate more fully in the country's economy on both the supply and the demand sides. Finally, governments can boost the earning potential of workers and expand high-skill and high-productivity jobs through a focus on education and skill building.

Across all of these categories, executing the budget with minimal waste from institutional inertia and corruption will directly reduce the friction that government spending otherwise introduces to the virtuous cycle.

Government budget levels and allocation vary, but most countries in the region have not played an effective redistributive role

In Brazil, government spending of 47 percent of GDP in 2017 is high compared with benchmark countries, but future-oriented investments are squeezed by current expenditure in a range of social categories (Exhibit 26). As a result, some basic public services are still missing; for example, 35 million Brazilians do not have access to water sanitation. Government spending in Mexico, by contrast, is at the low end of the scale, at just 13 percent. Brazil spends as much on pensions as advanced economies including Denmark, Germany, and Japan, while Mexico's pension expenditure as a proportion of GDP is the lowest among OECD countries. In Brazil, interest expenses are nine times higher than in Mexico due to factors affecting supply and demand for financing, which makes government debt service a high proportion of spending at 9 percent of GDP. Public administration in Brazil is also costly, despite the number of public employees being among the lowest compared to OECD countries. This is explained by salaries in the public sector, which grew two times faster and reached 67 percent higher than the level of comparable private-sector jobs.¹⁴² All of these expenses in Brazil were affected by constitutional requirements and indexation to minimum wages, which grew rapidly in the period.

35 million

Brazilians do not have access to water sanitation

¹⁴² *A fair adjustment: Efficiency and equity of public spending in Brazil: Volume I – overview*, World Bank, 2017.

Brazil's spending on social benefits nonetheless reduced the nation's level of inequality as measured by Gini scores before and after taxes and transfers. On the other hand, in Mexico and Colombia, the government role has created limited redistributive impact, which is a regional characteristic (Exhibit 27).

Public investment has lagged behind, particularly in infrastructure

Infrastructure is a long-standing challenge in the region, with the lowest regional spend as a share of GDP in the world since 1992 and most countries in the region below expected infrastructure quality for their level of development (Exhibit 28). Colombia has set out to address the challenge with major investment under the 4G infrastructure program and the National Infrastructure Agency. The initial 2011 plan aimed at investment of \$55 billion over ten years, with an emphasis on transportation networks and ports, later updated with a transportation master plan for 2015–30.¹⁴³ Given the challenging geography, a lack of infrastructure has affected not only competitiveness but inclusion of rural populations in the nation's economy.

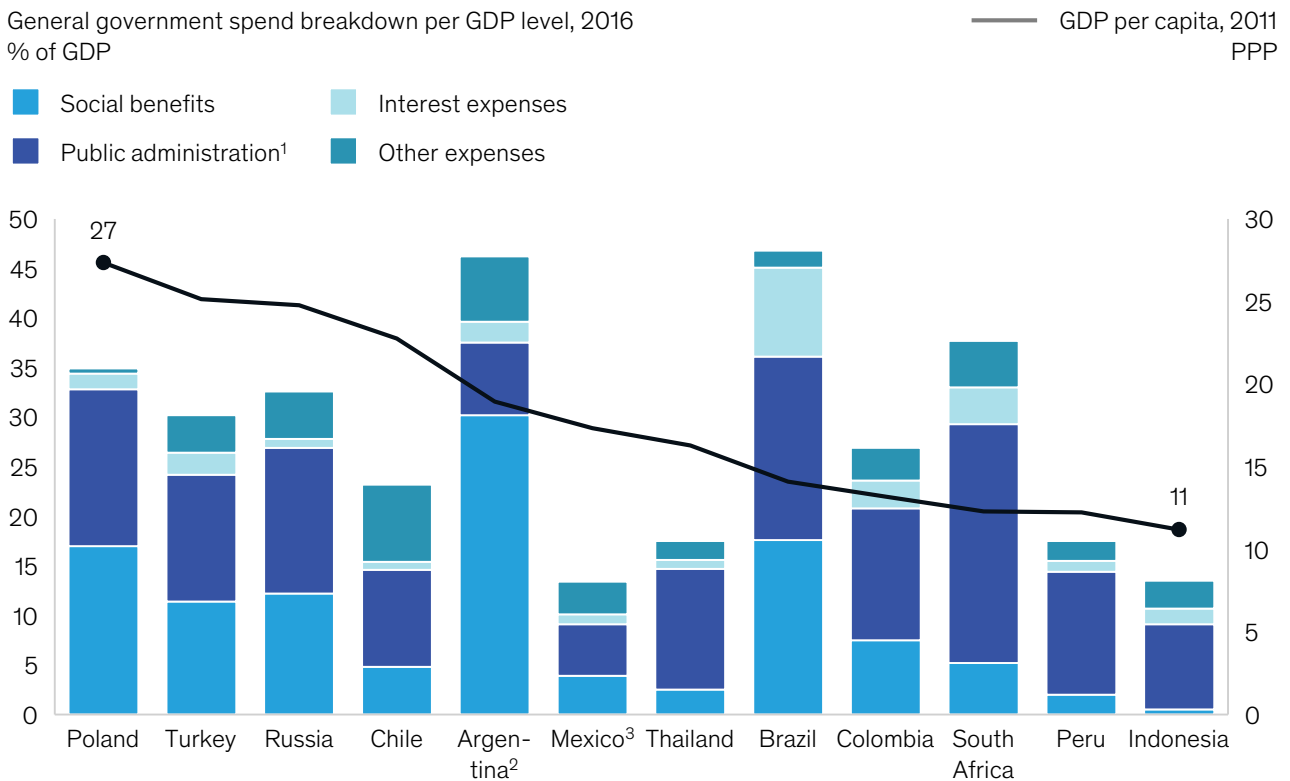
A lack of affordable housing is one factor that reduces purchasing power of consumers, as governments have failed to invest in public housing or control land markets.¹⁴⁴ At the city level, better delivery of security, transportation, childcare, and other enablers is needed to reduce costs and increase economic participation of the lower and middle classes. The example of São Paulo shows how the vulnerable class can be pushed to the urban periphery, in neighborhoods with low life expectancy and a long commute from good jobs (Exhibit 29).

¹⁴³ "Colombia thinks big with \$70 billion infrastructure program," Worldfolio, theworldfolio.com/news/colombia-thinks-big-with-70-billion-infrastructure-program/3959/.

¹⁴⁴ See *A blueprint for addressing the world's affordable housing challenge*, McKinsey Global Institute, October 2014.

Exhibit 26

Brazilian public expenses are high for its level of income in all categories but investments, while in Mexico government presence is low, especially in administration of public services.



¹ Includes compensation of employees and consumption of goods and services.

² Argentina values correspond to 2015.

³ For Mexico, classification adapted from local source; social benefits and public administration includes all transfers and is split based on average of all countries.

Source: IMF; INEGI; McKinsey Global Institute analysis

Security is a concern: murders per 1,000 population can vary tenfold from one neighborhood to another. Poor public health and water sanitation outcomes already mentioned also bear disproportionately on these communities. Childcare is an important means of keeping women in the workforce, addressing one of the critical constraints on the growth of productive formal firms.¹⁴⁵ One study showed that among salaried women, 79 percent of educated women but only 62 percent of less educated women remained in a salaried position a year later.¹⁴⁶

Better education services, from childcare to vocational employment, are needed in Latin America, at a time of changing perspectives about the future of work

From childcare to the acquisition of midcareer skills, Latin America can do considerably more to boost educational services. Mexican spending per child, for example, is just one-quarter of the OECD average. For now, enrollment rates in early childhood education and care services, for newborns to two-year-olds, are 2.5 percent in Mexico versus 33.2 percent on average for OECD countries.

Skill mismatches in the workforce are already evident in some Latin American countries, including for young people. A 2012 survey of young people and employers conducted in nine countries showed that 40 to 50 percent of local employers cited a lack of skills as the

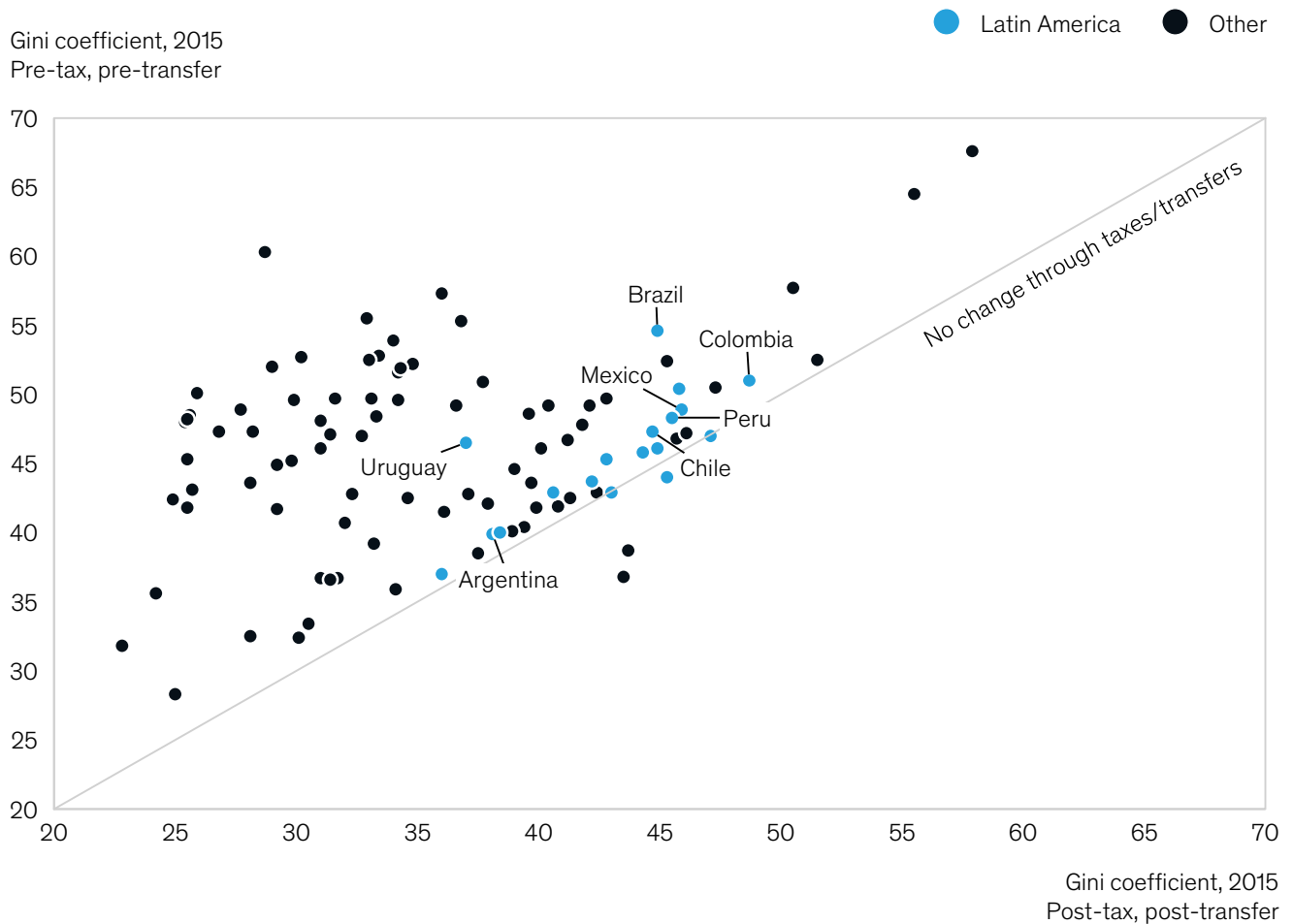
¹⁴⁵ Mercedes Mateo Díaz and Lourdes Rodríguez-Chamussy, *Cashing in on education: Women, childcare, and prosperity in Latin America and the Caribbean*, Inter-American Development Bank, 2016.

¹⁴⁶ Luis Eduardo Arango, Francesca Castellani, and Eduardo Lora, eds., *Desempleo femenino en Colombia*, Inter-American Development Bank and Banco de la República Colombia, 2016. The number for men falls from 82 percent to 68 percent.

Exhibit 27

Latin America has not effectively solved inequality through taxes and transfers.

Gini coefficient, pre- vs post-taxes and transfers, 2015¹



¹ 2015 Gini coefficient, ±1 year based on data availability.

Source: SWII; McKinsey Global Institute analysis

main reason for entry-level vacancies. In Brazil, 68 percent of managers said that they had difficulties filling positions, followed by Argentina at 41 percent, Costa Rica at 40 percent, and Mexico and Panama at 38 percent. The gap between supply and demand is particularly acute for technical degrees. A separate study showed that in Colombia, 10.4 percent of online job listings asked for bachelor's degrees, which 7.5 percent of Colombians have, but 57.3 percent of openings asked for technical degrees, which only 11.1 percent have.¹⁴⁷

This mismatch between educational attainment and available jobs is worsened not only by the quality of educational services, but also how demand is geographically distributed: workers with desired skills may be in short supply where companies are hiring, while places with the highest unemployment may have little job creation. This geographic imbalance is occurring both across national borders and within them. McKinsey's 2012 study on education to employment found that in the Latin American countries surveyed, between 50 and 60 percent of young people were working in jobs unrelated to their field of study. Another study finds that 50 percent of 15-year-olds in Latin America who took the Programme for International Student Assessment (PISA) exam did not meet basic competence on math, science, and reading, compared with the OECD average of 21 percent.

¹⁴⁷ Eduardo Lora, *The worrisome deficit of technicians and technologists*, Colombia Atlas of Economic Complexity, Harvard University, July 28, 2015.

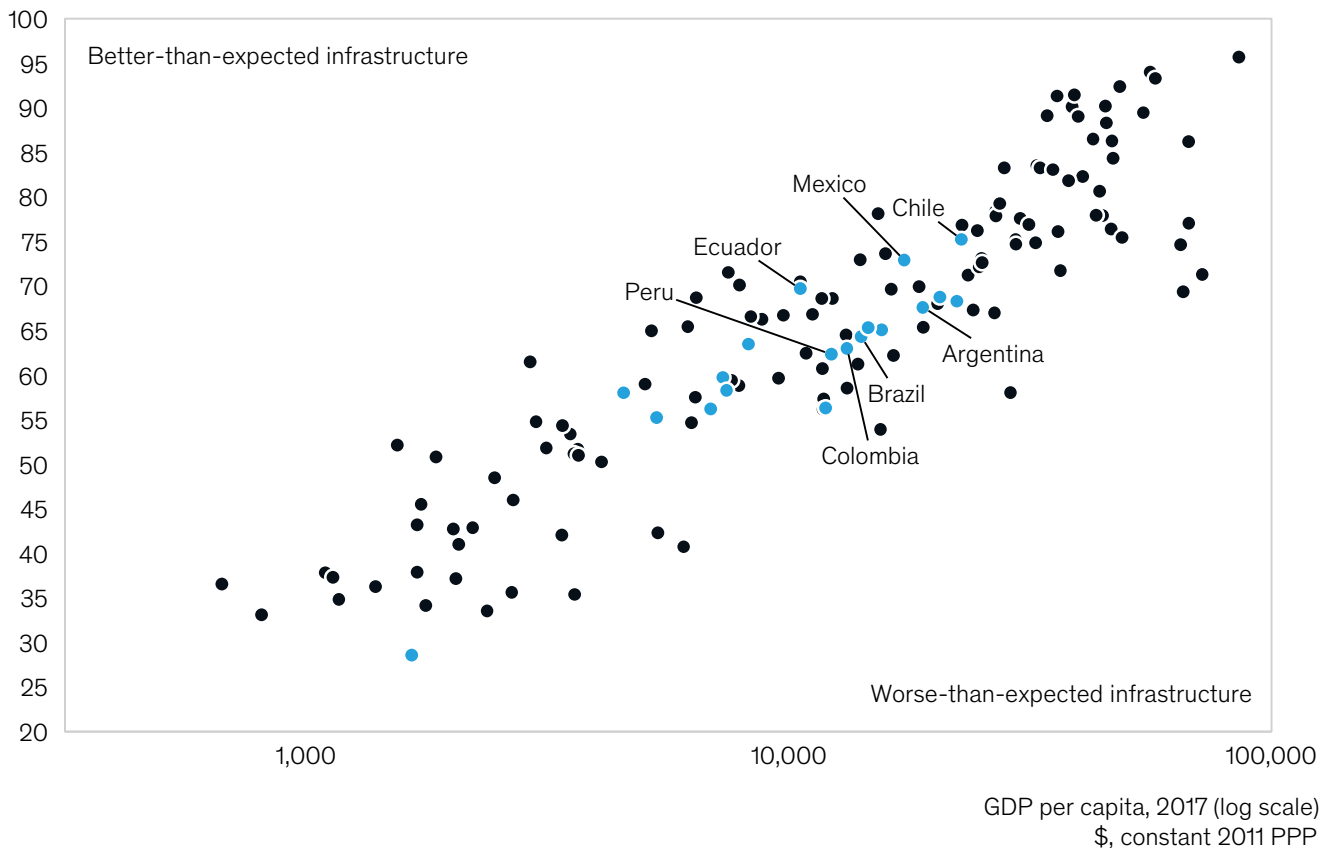
Exhibit 28

Latin American quality of infrastructure is generally below expected levels relative to countries' development, including Colombia and Brazil.

Infrastructure quality vs GDP per capita for selected countries

● Latin America ● Other

World Economic Forum infrastructure quality Score (higher is better)



Source: World Economic Forum 2018; World Bank WDI; McKinsey Global Institute analysis

Meanwhile, the opportunities in global competition grow stronger in knowledge-based sectors, especially through digitization, which requires new skills. According to LinkedIn, most of the top skills demanded by employers in Brazil relate to digital technologies, with statistical analysis and data mining, web architecture, development framework, and mobile development topping the list of requirements. The supply of suitable talent is far from meeting demand, but conversely, it may be that workers are not always realizing their potential. LinkedIn also found that 37 percent of respondents said their current job did not fully utilize their skills or provide enough challenge.

Latin America does have examples of how education can promote inclusive growth. In Mexico, Monterrey became an education cluster, forming talent for highly productive activities. Sobral, a city in one of the poorest states in the country, managed to achieve the highest ranking in Brazilian education; it prepares highly qualified engineers for the competitive aerospace industry.

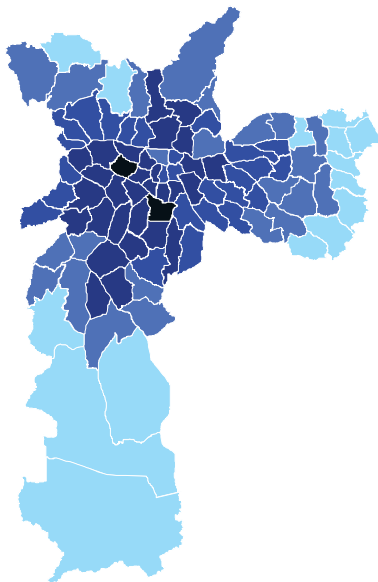
Exhibit 29

Urban marginalization limits purchasing power and work alternatives.

Example: São Paulo

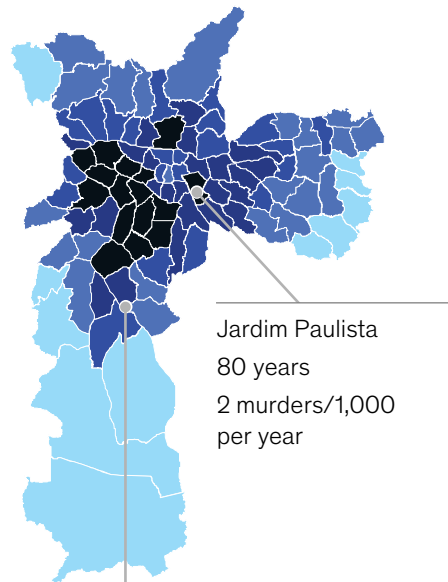
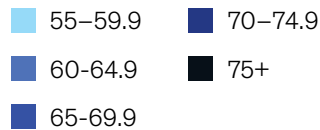
The poorest live in city peripheries ...

% of households earning up to 2 minimum wages



... with very low life expectancy ...

Life expectancy by neighborhood
Years



Jardim Paulista

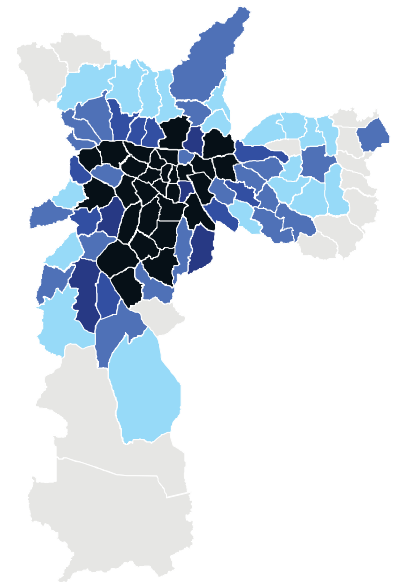
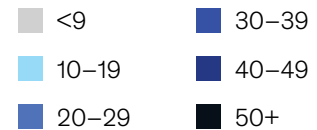
80 years
2 murders/1,000
per year

Jardim Angela

56 years
19 murders/1,000
per year

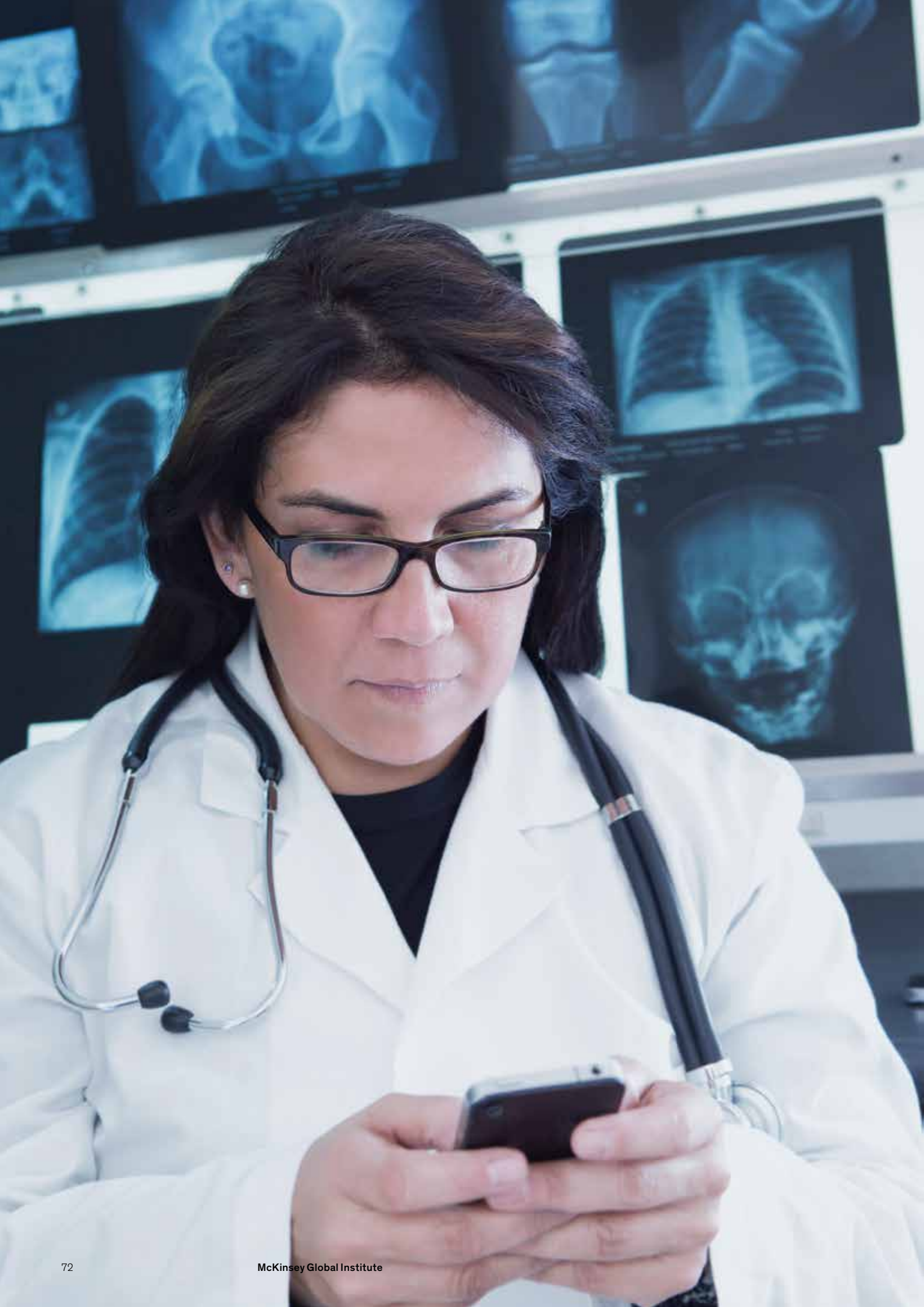
... and far from the concentration of jobs

Total jobs by neighborhood
Thousand



Source: IBGE Census 2010; Mapa da Desigualdade 2015, Rede Nossa São Paulo; Urban Mobility Research, Rede Nossa São Paulo, 2017; McKinsey Global Institute analysis

The missing middle of consumers and the missing midsize firms are two critical holes in the fabric of Latin American society. To go from poverty reduction and commodity-driven growth to sustainable, inclusive growth requires addressing gaps on both the supply and demand sides: the experiences of Brazil and Mexico illustrate how the virtuous cycle fails when the two fall out of sync, even when there is good progress on one or the other. While the commodity boom has subsided, a new productivity boom is already at hand, with the digital revolution. With carefully targeted measures by both policy makers and business leaders, this is an opportunity to fill the missing middle of firms, create better-paying jobs, and expand middle-class demand. In our final chapter, we examine some of the most important options.



4

A digital reboot for inclusive growth

Throughout its history, Latin America has periodically had to find new policy tools to help it restore economic growth and ensure rising prosperity. The period since 2000 was remarkable for its progress on inclusion of the very poorest, yet the region missed the productivity transformation that could make that progress sustainable. Greater macroeconomic stability and improved social protection during the commodity boom did not change the fundamental economic patterns that have stood in the way of stronger and more inclusive growth. The challenge ahead is to fill in the missing middles that speed up the virtuous growth cycle of rising incomes for the broad base of the population and bolster demand for investment and productivity gains.

While there is no shortage of policy prescriptions for lifting growth, including in our own past work, we focus this last chapter on the new tools that can help reboot inclusive growth in the region: the transformative power of digital technologies.

These technologies can help directly address some of Latin America's challenges around the missing middles. They can make it easier to open businesses, register property, and file taxes over the internet, reducing the cost of red tape. Digital can facilitate more efficient markets from land to local services. Digital platforms make it possible for small and midsize companies to become "micromultinationals" able to compete with much larger competitors by offering their goods and services through online marketplaces regionally or globally. Larger companies with more resources can use digital to scale up, innovate, and improve decision making via advanced analytics and, increasingly, artificial intelligence. Critically, digital can and is already creating new, more productive jobs in Latin America even as it is transforming jobs in the traditional economy including displacing some. The potential productivity boost it could give to the region's economies as a whole could offset the drag from changing demographics.

To be clear, digital is not a cure-all. Yet, if well harnessed, the technologies could be powerful allies in the increasingly urgent struggle to restore the region's dynamism and create prosperity for all. Countries will need to address important challenges and risks, especially those relating to how automation will change occupations and the skills required to do them. New technologies may also bring the risk of increased concentration for the most successful firms.

We focus on three priorities that together could lay the foundations for a pro-growth inclusive agenda for the region and enable the productivity gains from digital adoption at scale. They are the need to create competitive and open markets by cutting red tape, improving access to finance, and expanding market reach; spreading productivity gains to the vulnerable and middle classes through the creation of integrated labor and consumer markets; and improving government delivery and encouraging more public-sector experimentation and collaboration.

A virtuous cycle for the digital age

The core finding of the report's diagnostic is that the virtuous cycle of growth, from innovation and productivity gains to well-paid jobs to demand for new investment, has stalled and squeezed the power of the middle segments to be reinforcing engines of domestic market growth. On the supply side, many individual firms have made great strides but markets as a whole do not yet reflect enough contribution from growing firms with new ideas and ambition. This, in turn, reflects lack of clear and transparent markets with easy access to finance, land, infrastructure, and talent.

The changes needed to fix the supply side have been extensively studied and documented.¹⁴⁸ On the demand side, our diagnostic points to an urgent need to also focus attention to the feedback loop from raising productivity to higher incomes for workers and their real purchasing power to generate demand for goods and services in the local markets. Mexico's impressive productivity gains in industries tied to global supply chains and modernizing services were not enough to raise wages at scale. The case of Brazil shows how labor policy to spread existing gains can help, yet the gains are short-lived unless they are tied to sustained improvements in supply-side productivity. For the virtuous cycle to operate efficiently at the critical income step, supply and demand policies must remain in sync.

For Latin America, the current digital transformation provides a welcome window to catalyze a step change in inclusive growth by using digital tools to accelerate change across both supply and demand side challenges. Digital tools offer new, cost effective ways to address old problems. Perhaps more importantly, the digital revolution—just like past major technology transformations—is shaking up global value chains and opening opportunities for Latin American companies and regions to reposition themselves for global competition.

Latin America's digital spring

Digital is already galvanizing entrepreneurs in Latin America. New waves of digital startups are creating new markets and services, lifting the sophistication of the regional ecosystem (see Box 5, "A new generation of Latin American tech startups").

Finance is one of the sectors where digital disruptors are already emerging. Brazil is ahead in the fintech race for now, with some 380 startups, closely followed by Mexico (nearly 240).¹⁴⁹ They have been two of the most proactive countries in creating regulation to enable fintechs, with explicit goals to expand access to financial services.¹⁵⁰ Colombia represents the third-largest fintech ecosystem in the region, with more than 120 startups. Most countries in Latin America are seeing annual growth rates of nearly 50 percent in the number of financial startups. They offer a wide variety of services, ranging from digital services to finance management (B2B and B2C), loans, and crowdfunding, among others.

\$1.35B

Funding for Latin American tech companies in 2017

Booming funding for Latin American tech companies, which hit a high of \$1.35 billion in 2017, has fueled the rise of digital disruptors in the region, and early estimates suggest it set another record in 2018.¹⁵¹ This is up by nearly \$900 million in five years. Brazil leads the region, attracting nearly \$4.7 billion of the approximately \$6.3 billion invested in tech deals since 2012. In the same period, firms in Argentina have raised \$600 million, and in Mexico \$570 million. Last year, Brazilian food delivery firm iFood raised \$500 million in capital, the largest funding round for a tech startup in Latin America.

The growing interest of venture capitalists in the region has not gone unnoticed by global accelerators. The inflection point for accelerators occurred in 2010, when Start-Up Chile was launched, soon followed by local operations from 500 Startups Mexico City and NXTTP Labs. The rise of regional accelerators fostered many of today's successful tech programs, such as IncuBAte (Buenos Aires) and Ruta N (Medellín). Today, dozens of Latin American startups are joining US accelerators, with Colombia claiming a privileged spot. At least six Latin American startups were presented during demonstration day last year at Y Combinator, a US seed accelerator.

The pace, magnitude, and value of the digital wave are still far behind those of leading markets like the United States and China—and the digital ecosystem in Latin America is just getting started. The situation encompasses both opportunity and the risk of falling behind. National and local governments are playing important roles as enablers of the digital waves, working with the private sector to create adequate ecosystems where tech startups can proliferate.

¹⁴⁸ See for example, *A tale of two Mexicos: Growth and prosperity in a two-speed economy*, McKinsey Global Institute, March 2014; *Connecting Brazil to the world: A path to inclusive growth*, McKinsey Global Institute, May 2014.

¹⁴⁹ Finnovista, 2018.

¹⁵⁰ S. Pelin Berkmen et al., *Fintech in Latin America and the Caribbean: Stocktaking*, IMF working paper number 19/71, March 2019.

¹⁵¹ *Latin America tech booms as Brazil dominates and regional investors grow*, CBInsights, July 18, 2018, [cbinsights.com/research/latin-america-tech-funding/](https://www.cbinsights.com/research/latin-america-tech-funding/)

Box 5.

A new generation of Latin American tech startups

The list of digital success stories in Latin America is already long and growing rapidly. So far, 18 tech companies in the region have entered the billion-dollar club (Exhibit 30). The largest number of such digital disruptors (nine) are to be found in Brazil, followed by Argentina (four). The list includes companies such as MercadoLibre (digital marketplace), Rappi (delivery), Nubank (fintech), Globant (software), Despegar (travel), and Crystal Lagoons (artificial lagoons). Three of the rising stars are:

MercadoLibre, the largest tech company in Latin America. It was launched as a digital marketplace in Argentina in 1999 and quickly expanded to other countries. Currently it reaches more than 200 million users, almost one-third of the region's population, in 19 countries and has expanded to incorporate digital payments, advertising, logistics, and solutions for online shops. It has a market cap of more than \$25 billion and employs almost 6,000 people. The "Amazon of Latin America" is currently investing heavily

in logistics and payments infrastructure to improve product delivery and provide digital finance solutions for consumers currently excluded from the traditional system.¹

Rappi, a Colombian startup founded in 2015 as a bicycle delivery service. Its valuation reached \$1 billion last year. In April 2019, Japan's SoftBank said it would invest \$1 billion in the company.² Revenues come mostly from food delivery, but Rappi also provides grocery shopping, package delivery, and other services including cash delivery. It recently launched a digital payments platform. It has 1,500 employees and has expanded to countries including Argentina, Brazil, Chile, Mexico, Peru, and Uruguay.

Nubank, founded in 2013 in São Paulo, a financial technology company focused mostly on digital banking services in Brazil. It offers credit cards, financial accounts, and a rewards program. The company is valued at about \$4 billion and says it has four million registered accounts and twice as many credit card holders. One of its largest backers is China's Tencent, which invested \$180 million last October.³

¹ Ezequiel Minaya, "Argentinian company wants to build the Amazon of Latin America," *Wall Street Journal*, March 19, 2019.

² Carolina Mandl, "Japan's SoftBank invests \$1 billion in delivery app Rappi," *Reuters*, April 30, 2019.

³ Carolina Mandl, "China's Tencent invests \$180 million in Brazil fintech Nubank," *Reuters*, October 8, 2018.

Exhibit 30

The billion dollar tech club in Latin America.

Includes startups (unicorns) and firms that went public or were acquired by global firms



¹ Acquired by IBM in 2013.

² Public.

³ Acquired and merged with other platforms to create the OLX group (owned by Naspers), which has operations in Argentina as well as 45 other countries.

Source: "The Global Unicorn Club," CBInsights; LAVCA; McKinsey Global Institute analysis

The value beyond the hype

Digital has the potential to deliver a substantial economic boost to the region's economy and society. Previous research from MGI finds that automation technologies themselves can help accelerate growth by between 0.8 and 1.4 percent annually through increased productivity.¹⁵² All sectors and firm types can benefit from this by incorporating use cases from digital that range from improving procurement processes to digitizing interactions with customers.¹⁵³

Digital platforms like Facebook, Amazon, and MercadoLibre can help SMEs expand their consumer base and go global. The Internet of Things can improve efficiency in multiple sectors, from optimizing warehouse operations to creating smart irrigation grids in agriculture. Digital can also ease the integration of smaller suppliers into the supply chains of larger customers. Machine learning solutions can help reduce costs, increase revenues, and lower risk by improving demand forecasting and better matching offerings to consumer needs.

Increases in productivity are key for enabling sustained increases in wages that can deliver inclusive growth. The region is already seeing a payoff from the digital ecosystem in the form of new, well-paid jobs. In Argentina, for instance, the knowledge-based services sector has become the third-largest employer in the economy, with average wages significantly above the median.

A study shows that between 1948 and 2001, 96 percent of the return of technological advances from corporations went to consumers.¹⁵⁴ Citizens can reap large benefits. Previous MGI research finds smart city applications can improve key metrics by 10 to 30 percent. Some of the applications with the greatest potential address core challenges for the region, such as safety (30 to 40 percent potential improvement in crime incidents prevented), commuting (15 to 20 percent shorter commute times), and health (8 to 15 percent reduction in disease burden).¹⁵⁵

Governments should go beyond enabling the creation of digital value for individuals and business and embrace their own digital transformation. For instance, digital technologies can help improve public finance through multiple levers. Advanced analytics can help boost tax revenues by 5 to 10 percent by reducing informality and increasing fraud detection, cutting debt write-offs, and streamlining the taxpayer journey. Establishing joint costing platforms can help reduce transfers by 5 to 10 percent by defining a common understanding of costs and financial needs across units and capturing the efficiency behind it. Finally, digital technologies can also help optimize procurement processes, which can deliver value of 10 percent or more.

A cautionary note for inclusive growth

Technological advances and their adoption by companies will take adjustment and can pose new challenges. Ensuring broad and equal connectivity will be key to ensure that the digital wave reaches all segments of society and opens up opportunities for all.¹⁵⁶ Digitization will also change competitive dynamics in many industries and alter the nature of work itself.

The economies of scale in digital risk higher concentration of profits. For workers, automation is already creating additional pressure on dysfunctional labor markets. Previous MGI research finds that 7 to 14 percent of work activities in Latin American countries could be displaced due to automation by 2030 in a midpoint scenario, depending on the economic structure, demographics, and cost of labor.¹⁵⁷ Brazil faces the highest potential displacement rate (13.9 percent), followed by Mexico (12.9 percent). Colombia falls in the middle of the range at 10.5 percent, very close to Argentina and Chile. While digital technologies and other trends will also ignite growth for multiple occupations and create many that do not yet exist,

7 to
14%

Proportion of work activities in Latin America that could be automated by 2030 in a midpoint adoption scenario

¹⁵² *A future that works: Automation, employment, and productivity*, McKinsey Global Institute, January 2017.

¹⁵³ See *Notes from the AI frontier: Insights from hundreds of use cases*, McKinsey Global Institute, April 2018.

¹⁵⁴ William D. Nordhaus, *Schumpeterian profits and the alchemist fallacy*, Yale Working Papers on Economic Applications and Policy, discussion paper number 6, April 2, 2005.

¹⁵⁵ *Smart cities: Digital solutions for a more livable future*, McKinsey Global Institute, June 2018.

¹⁵⁶ A growing body of literature focuses on the effect of technology adoption on income and wealth inequality, in particular the wage implications for middle-income workers in advanced economies. See, for example, *Under pressure: The squeezed middle class*, OECD, April 2019.

¹⁵⁷ *Jobs lost, jobs gained: Workforce transitions in a time of automation*, McKinsey Global Institute, December 2017.

45%

Proportion of households with internet access in 2016 in Latin America, up from 22 percent in 2010

the transition could be painful, particularly for low-skill workers in jobs that involve routine activities that are easily replicable by machines.

Other challenges and risks include misuse or abuse of technologies, including threats to cybersecurity, difficulties safeguarding personal information, and the importance of building out broadband infrastructure to ensure that Latin Americans have access to the internet. For now, internet penetration in the region remains significantly below OECD averages, although it is growing rapidly. In 2010, just 22 percent of Latin American households had internet access. In 2016, penetration more than doubled to reach 45 percent of households, compared to OECD penetration of 83 percent.¹⁵⁸

Three priorities to fill in the missing middles in the digital era

Digital on its own cannot fill in the missing middles we have identified in this report, but it is by far the most powerful new addition to the toolkit that can help achieve this goal. We identify three priorities that could help Latin America expand the undersized cohort of midsize and large firms and ensure that middle-class consumers benefit more broadly from the growth that is created. Beyond traditional approaches, we try to emphasize here how digital tools offer additional possibilities for reform in otherwise familiar areas such as ease of doing business, accessing finance, and building skills. The faster, more extensive, and more reliable processing of information on which the digital revolution rests can create more transparent and participatory product, labor, and land markets and change the relationship between governments and their constituencies. We have seen in other emerging economies that the most successful models will likely emerge from an approach incorporating experimentation, attention to local conditions, and engagement with a broad array of stakeholders and reform constituencies—features of successful development models that are unlikely to change, even as the tools do.¹⁵⁹

Creating competitive and open markets by cutting red tape, improving access to finance, and expanding market reach

The first priority aims to address the missing middle in the business landscape. Reduced barriers to entry are critical for enabling new players and competition, as Mexico's reforms in telecommunications, oil and gas, and power demonstrate.¹⁶⁰ Beyond a level playing field, small firms need regulation that enables investment rather than holding it back, more accessible finance, and stronger capabilities and market reach. In each case digital is not the only or whole answer, but it makes solutions more feasible than they have ever been.

- **Replace red tape with enabling regulation and rights.** Beyond adopting technology to ease processing, which can be simply based on smartphones, improving the business climate will require more stable and simpler tax and regulatory policies. The persistence of onerous business regulations and excessive tax burden in the region calls for “zero-based” approaches that can help separate unnecessary red tape from adequate requirements for opening and operating businesses. Particular emphasis should be placed on benefiting midsize firms. For example, creating single-account digital portals for corporations to track all online transactions with the government, as Denmark has done, can ease the cost and time of compliance while increasing the transparency of regulation

¹⁵⁸ *State of broadband in Latin America*, UN Economic Commission for Latin America and the Caribbean, 2017.

¹⁵⁹ *Outperformers: Fast-growing emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

¹⁶⁰ The 2013 structural reforms led to increased competition, reducing the leading wireless carrier's market share from 84 percent to 72 percent, adding 50 million mobile broadband subscriptions, and reducing prices for consumers by as much as 75 percent. *OECD telecommunication and broadcasting review of Mexico 2017*, OECD, 2017. The power market reforms resulted in new players in power generation and sales, boosting efficiency, bringing much-needed investment, and opening the way for one of the most cost-competitive renewable sectors in the world. Similarly, oil and gas reforms provided transparent and credible contracting that cleared the way for new investment that would not otherwise have happened, although output will take years to be realized. In both cases, the net productivity gain will be significant: an increase in oil and natural gas liquids from 2.0 million barrels per day from a low point in 2020 to about 3 million in 2040 and a decrease in industrial electricity prices of 14 percent in the same period despite natural gas price increases. Half of the 120 GW of new generation capacity will come from renewable energy sources under the new policies, according to the International Energy Agency. See *World energy outlook special report: Mexico energy outlook*, International Energy Agency, 2016, iea.org/publications/freepublications/publication/MexicoEnergyOutlook.pdf.

30%

Estimated proportion of owner-occupied houses in Mexico that do not have a full deed

and fiscal incentives.¹⁶¹ This can help address the risk of digitization blurring the frontiers across sectors, creating potential loopholes to avoid sector-specific regulations. Another critical digital breakthrough is in possibilities for clear property rights and fast, secure transactions that are the foundations of market value creation. Land in particular has been plagued by poor or nontradable titling that locks up value in the hands of current property holders. By one estimate, 30 percent of owner-occupied houses in Mexico do not have a full deed, depressing value by 5 percent (with wide variation).¹⁶² Blockchain, while still at very early stage of implementation, is one digital tool that could virtually eliminate ambiguity of proof of ownership and the costs of transactions for land and housing.¹⁶³ Creating the legal framework and digitized records can clear the way.

- **Embrace digital finance to broaden access to credit that small and medium-size enterprises in Latin America need to fund their growth.** The explosion of fintech firms in Brazil and other Latin American countries heralds significant changes in finance across the region, bringing more choice to consumers and more competition to incumbents. Kenya-based M-Pesa has plugged tens of millions of people into the financial system building off an initial customer need to securely transfer money.¹⁶⁴ Digital payments have transformed the commercial landscape in China, reaching \$870 billion in 2016, 11 times the US value. And moving to digital payments can be an entry point into broader finance solutions for SMEs that need to develop reliable data to establish their creditworthiness. They can complement nondigital information-sharing mechanisms that improve credit as well as regulatory and judicial reforms to bring down the incidence and cost of nonperforming loans. Separate licensing could be created for new entrants to serve SMEs exclusively, specializing in the above areas with risk insurance.
- **Equip small firms to reach broader markets.** Digital platforms can complement existing efforts to strengthen global integration through increasing the number of free trade agreements, boosting investment in infrastructure, and improving trade-related processes and regulations. Digital technologies can be a powerful enabler of change: platforms from Alibaba and Amazon to regional players such as MercadoLibre have already allowed new and open markets to thrive globally. Digital platforms can also help independent workers connect with new markets. For instance, IguanaFix helps consumers connect online with home improvement contractors. In its first three years, the company directly employed 140 people and attracted more than 25,000 contractors in Argentina, Brazil, Mexico, and Uruguay into the formal economy.¹⁶⁵ While digital platforms have significant transformative power, a broader agenda is needed to ensure that everyone can harness their benefits. Priorities here include continuing expansion of broadband access (particularly ensuring last-mile delivery to all households and businesses), enabling the expansion of delivery services, and helping laggard firms and households understand the benefits of digital platforms and how to access them.

Spreading productivity gains to the vulnerable and middle classes through the creation of more participatory labor and consumer markets

The second priority aims to address the missing middle on the demand side, by enabling productivity gains to flow to higher incomes for workers and lower prices for consumers. This will mean preparing workers for the skill demand of the digital era through education and training. It will also mean increasing the efficiency of the labor market itself in order to maintain flexibility for business while promoting investment in talent, a fair share for workers,

¹⁶¹ Matthias Daub, Axel Domesy, Julia Klier, and Martin Lundqvist, "Digitizing the state: Five tasks for national governments," November 2017, McKinsey.com.

¹⁶² Paavo Monkkonen, "Where do property rights matter more? Explaining the variation in demand for property titles across cities in Mexico," *World Development*, December 2016, Volume 88. For more on the inequity in residential real estate, see Perry Ferrell, "Titles for me but not for thee: Transitional gains trap of property rights extension in Colombia," *Public Choice*, January 2019, Volume 178, Issues 1–2.

¹⁶³ J. Michael Graglia and Christopher Mellon, "Blockchain and property in 2018: At the end of the beginning," *Innovations: Technology, Governance, Globalization*, Volume 12, Issue 1–2, Summer-Fall 2018. For a nuanced view of blockchain's capabilities, see Matt Higginson, Marie-Claude Nadeau, and Kausik Rajgopal, *Blockchain's Occam problem*, January 2019, McKinsey.com.

¹⁶⁴ *Digital finance for all: Powering inclusive growth in emerging economies*, McKinsey Global Institute, September 2016.

¹⁶⁵ Clayton M. Christensen, Efoso Ojomo, and Karen Dillon, *The prosperity paradox: How innovation can lift nations out of poverty*, Harper Business, 2019.

and better information and transparency for all stakeholders. Here again, digital technologies have the potential to accelerate the needed evolution.

- **Provide better job matching and align the growth incentives of business and labor.** MGI research has highlighted the power of digital platforms to match job seekers with employers, thereby significantly improving the fluidity of labor markets.¹⁶⁶ At the same time, we have seen a rise in independent work in many countries, which digital platforms can service effectively and bring into the formal economy.¹⁶⁷ Both of these are highly relevant to Latin America, where a sustainable source of income growth for the middle class needs to come from better jobs with rising wages. Involving women in the labor force could be at the heart of the effort. While fertility rates continue declining and limiting the expansion of the labor force, women are potentially a large source of untapped value to deliver a new demographic bonus.
- **Teach new skills to workers in an age of automation.** The adoption of automation and AI will likely bring about significant workforce transitions in Latin America and globally. Certain abilities, including basic cognitive skills and physical and manual skills, will no longer suffice as machines take on increasingly routine tasks. Instead, demand will increase for technological skills as well as social and emotional skills and higher cognitive skills, such as creativity and complex problem-solving.¹⁶⁸ Government and business leaders both have a key role to play in introducing large-scale training initiatives and revamping school curricula to emphasize the skills that will be essential for the next generation of workers in Latin America. The high level of informality in the region could make this task more challenging. Governments could identify workers in vulnerable occupations and help them retrain and transition to new jobs that are less susceptible to automation. For business leaders, investing in the workforce will be essential. Skilled labor will be an increasing success factor in tomorrow's economy and, at the same time, will help improve workers' long-term purchasing power. That will require a focus on investing in human capital as a strategic priority.
- **Protect vulnerable workers and households.** The region can build on its success in lifting citizens from poverty by finding ways to strengthen wage income growth and boost the vulnerable class. While much has been done in terms of constructing pro-poor programs in Latin America, the region can benefit from protecting vulnerable households and workers by minimizing the risk of falling into poverty and helping them progress toward a consolidated middle class. This means complementing existing safety nets against poverty with safety ropes for aspiring middle-class workers and households. Regional minimum wage policies can be effective in cases where representation is low and employers concentrate bargaining power. More flexible models include the creation of wage boards that can define minimum pay standards by sector and occupation, in collaboration with multiple stakeholders. Digital transformation will bring change and new opportunities but also challenges for labor markets. Digital tools can help increase transparency on workplace conditions and workers' representation. Integrated platforms for social policy delivery can include one-stop shops for benefits, providing feedback on social programs and service delivery, and data collection on long-term effectiveness. Digital technologies can also help with the design and delivery of social policy, for instance by harnessing big data in real time and using advanced analytics to tailor responses to the needs of different groups. Businesses can help, too, by investing in local communities. Most successful cities and regions in the world are those where the business community takes an interest in the success of the local economy. Protecting workers and households is also key for reducing income volatility and improving the prosperity of the vulnerable class.
- **Ensure broad access to markets and competitive prices.** This includes access to affordable housing as a renter or owner.¹⁶⁹ Digital services from finance to e-commerce

¹⁶⁶ *Connecting talent with opportunity in the digital age*, McKinsey Global Institute, June 2015.

¹⁶⁷ *Independent work: Choice, necessity, and the gig economy*, McKinsey Global Institute, October 2016.

¹⁶⁸ *Skill shift: Automation and the future of the workforce*, McKinsey Global Institute, May 2018.

¹⁶⁹ *A blueprint for addressing the global affordable housing challenge*, McKinsey Global Institute, October 2014.

will increase transparency and create competition, lowering the cost of products, which in turn will improve purchasing power. Governments could prioritize access to digital services by building out broadband infrastructure. A good example of this has been the Vive Digital effort in Colombia, which helped increase the municipality connectivity rate from 24 percent in 2010 to 98 percent in 2018. Such efforts should be complemented with “last-mile” programs that help strengthen connectivity at the household level. Efforts that aim at helping consumers connect to global markets should be closely accompanied by the measures already discussed that ensure protection of vulnerable workers and facilitate their transition toward new occupations in cases where reducing barriers to trade can lead to job displacement.

Improving government delivery and encouraging more public-sector experimentation and collaboration

While the first two priorities entail many policy shifts, governments can also adapt their own capabilities to deliver with digital and build learning into that process. These reforms go beyond technical advances to create transparency, public accountability, and trust in government. These building blocks are essential for shifting to more citizen-centric government that will make a priority of efforts to deliver on the promise of inclusive growth.

- **Build new government capabilities for delivery.** Filling in and expanding the missing middles will go a long way toward establishing more inclusive growth in Latin America, but one critical enabling factor will also make a significant difference: government efficiency. Governments could start by digitizing themselves. E-government is already proving effective at both reducing public spending on services and improving their delivery, including through more efficient communication with the public. McKinsey & Company has estimated that government digitization using current technology alone could generate more than \$1 trillion annually worldwide.¹⁷⁰ Mexico is a regional leader in establishing a one-stop shop for citizen services, reducing the time to replace a birth certificate, for example, from months to minutes.¹⁷¹ State-owned enterprises across the region could help deepen the digital economy as a customer of digital tools and by training workers for careers working with these technologies. Government digitization should be accompanied by broad efforts to strengthen capabilities in order to increase government spending efficiency, in line with the findings from recent Inter-American Development Bank research.¹⁷²
- **Test and learn what digital channels can do to create citizen-centric government.** Rethinking policy design to allow for greater experimentation, combined with continuous learning from monitoring and evaluation, has proved effective in other countries including Singapore, as has the establishment of focused policy delivery units.¹⁷³ The imperative rises as the potential use cases grow, artificial intelligence advances, and data are simultaneously more diffused within the public and more concentrated into the data pools of tech giants. One of the most important areas for governments to test and learn is in reducing the corruption and impunity that remain a major drag on the region's economies. How can electronic salary payments and SME e-platforms further reduce the role of extortionate middle men? India, for example, introduced a digital ID scheme that is now the world's largest, with 1.2 billion people enrolled, and is used to make welfare payments directly to recipients' digital bank accounts, thereby cutting out potential fraud and other leakages.¹⁷⁴ Digital processes and transparency could potentially also bring down the time required to resolve contractual disputes that tie up working capital in escrow and deter productive investment; in Latin America, these last more than two years on average at a

¹⁷⁰ Bjarne Corydon, Vidhya Ganesan, and Martin Lundqvist, *Transforming government through digitization*, November 2016, McKinsey.com.

¹⁷¹ Max Cesar, Alberto Chaia, Andre de Oliveira Vaz, Gonzalo Garcia-Munoz, and Philipp Haugwitz, *How Mexico can become Latin America's digital government powerhouse*, November 2018, McKinsey.com.

¹⁷² Alejandro Izquierdo, Carola Pessino, and Guillermo Vuletin, eds., *Better spending for better lives: How Latin America and the Caribbean can do more with less*, Inter-American Development Bank, September 2018; Alejandro Portes and Lori D. Smith, "Institutions and national development in Latin America: A comparative study," *Socio-Economic Review*, October 2010, Volume 8, Issue 4.

¹⁷³ *Outperformers: High-growth emerging economies and the large companies that propel them*, McKinsey Global Institute, September 2018.

¹⁷⁴ *Digital India: Technology to transform a connected nation*, McKinsey Global Institute, March 2019.

cost of one-third of the claims.¹⁷⁵ The potential impact of improving delivery and reducing the cost and time of conflict resolution will manifest far beyond the immediate benefit if it results in more trust in government and the market rules on which investment depends.

The three priorities and the digital applications within each are not a replacement for other policies needed to build competitive capabilities.¹⁷⁶ Nor will they guarantee more fundamental institutional reforms that will also be needed. A growing body of literature continues to point to the importance of institutions that reduce rent-seeking opportunities for established businesses and the benefits that are circulated back to politicians at the expense of the economy.¹⁷⁷ Institutions are particularly important in the context of new available technologies, when the right incentives for investment can have the most impact on growth and mitigate some of the biggest risks to inclusion.¹⁷⁸ Nonetheless, by definition, digital disruption changes incentives as sectors become blurred and supply chains disintermediated, creating opportunities and imperatives for new models. In this sense, filling in the missing middle is not necessarily a headlong reversal of the current landscape, but a crowding out of the old model through an agenda that enables more old and new firms and workers to access new sources of productivity.

Progress in this direction calls for new spaces for collaboration and shared value creation—among firms and workers, small and large firms, and government with all stakeholders. For instance, initiatives like the regional productivity factories in Colombia can help disseminate best practices and knowledge sharing across businesses, while helping SMEs connect to potential suppliers and buyers. Private-sector associations like ANDI in Colombia can help bring together different voices from the private sector and articulate priorities together with the public sector. Alternative forms of collaboration may also include the creation of formal private-public organizations, similar to Mexico's Consejo Nuevo León, which brings together private-sector leaders, top government officials, and representatives from academia and the social sector.

Collaborative spaces can only do so much; their efforts will need to be complemented with continuing work on improving “institutional fundamentals,” such as strengthening the rule of

>\$1,000 per person

**Potential incremental gain
in GDP in 2030 if Latin
America fills and expands
its “missing middles”**

¹⁷⁵ *Doing Business 2019: Training for reform - Mexico*, World Bank, 2019.

¹⁷⁶ See for example, Dani Rodrik, “Industrial policy: Don’t ask why, ask how,” *Middle East Development Journal*, 2009, Volume 1, Issue 1.

¹⁷⁷ See for example, Santiago Levy and Michael Walton, eds., *No Growth without Equity?: Inequality, Interests, and Competition in Mexico*, Washington, DC: Palgrave Macmillan and the World Bank, 2009; The long legacy of concentrated economic power in Latin America, in this argument, is closely tied to political access. In a “rent-sharing equilibrium” governments create rents, for example through subsidies, licensing, trade protection and non-tariff barriers, weak competition regulation and enforcement, or contracting rules that result in concentrated benefits and often underinvestment from the economy-wide perspective. In turn, the economic beneficiaries help sustain the parties that deliver those rents. Neither group has a strong incentive to change even as the form of laws and regulation might shift to ensure the pact has enough “insiders” to hold. See also, James A. Robinson, “Colombia: Another 100 years of solitude?,” *Current History*, February 2013, pp. 43–48. More generally, on the institutional emphasis in development economics in the last two decades, see Daron Acemoglu, D. S. Johnson, and J. A. Robinson. 2002. “Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution,” *Quarterly Journal of Economics*, Volume 117, Number 4, pp. 1231–94; Dani Rodrik, Arvind Subramanian, and Francesco Trebbi, *Institutions rule: The primacy of institutions over integration and geography in economic development*, IMF Working Paper, 02/189; William Easterly and Ross Levine, “Tropics, germs, and crops: How endowments influence economic development,” *Journal of Monetary Economics*, Volume 50, 2003. For a sociology-based critique, see Alejandro Portes and Lori D. Smith, “Institutions and national development in Latin America: A comparative study,” *Socio-Economic Review*, Volume 8, 2010.

¹⁷⁸ Acemoglu, Johnson, and Robinson, for example highlight how the “reversal of fortune” for better institutionalized countries manifested with the industrial revolution.

law and rebuilding citizens' trust. A renewed effort to strengthen international cooperation should also accompany cross-sector collaboration.¹⁷⁹ Working on these priorities can help make a difference on the path toward social inclusion. While much work and collaboration are needed, the reward can be substantial.

Strengthening the middle could boost Latin America's GDP growth by 50 percent, adding \$1 trillion in GDP in 2030

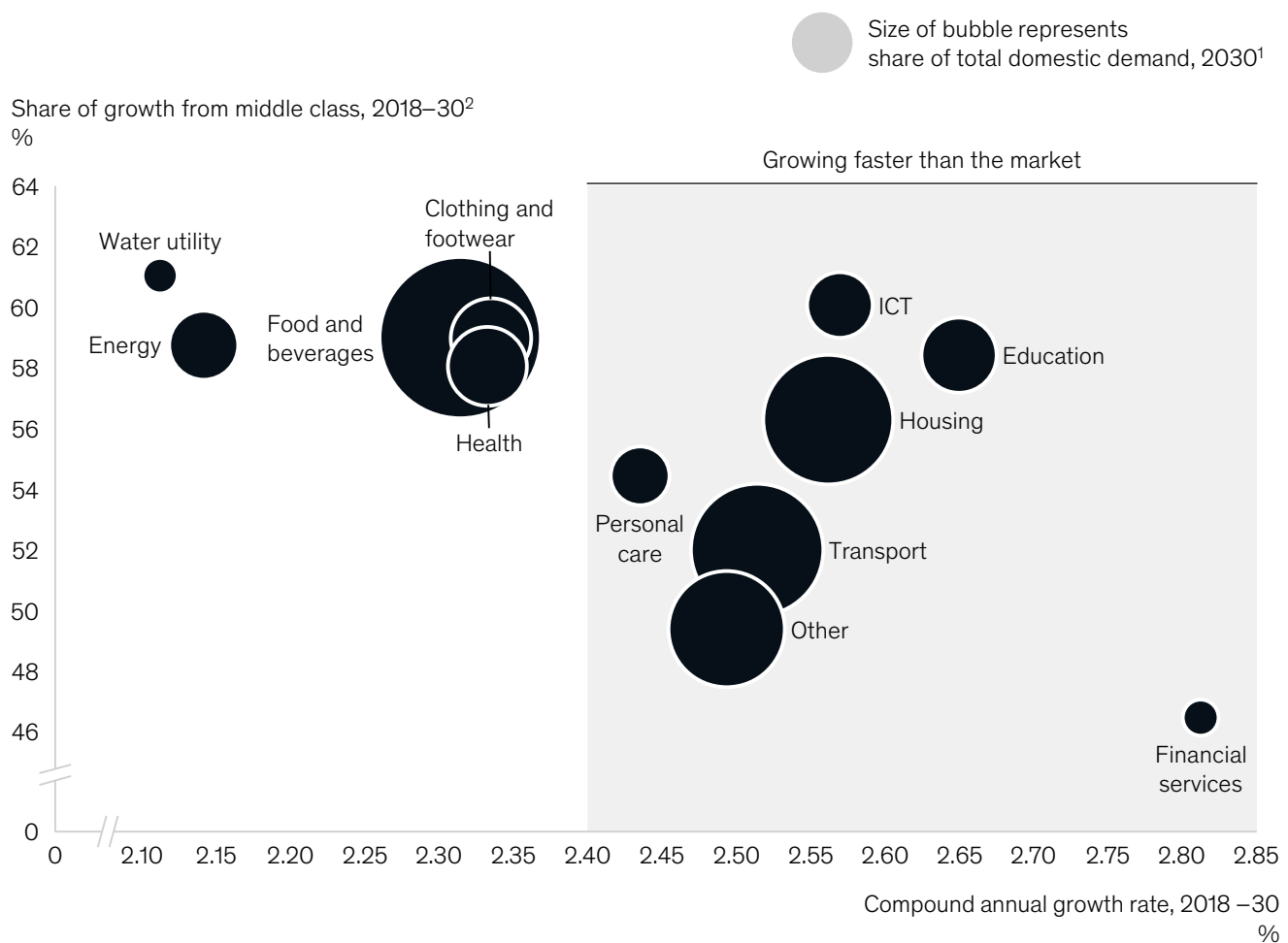
If Latin American economies were able to fill in and strengthen the missing middles, thereby establishing a virtuous cycle of inclusive growth, the potential reward could be very significant. Using a general equilibrium macroeconomic simulation, we modeled the region with the productivity potential of digital along with income patterns characteristic of inclusive economies in terms of labor income share and consumption.¹⁸⁰ The result was a difference of more than \$1,000 per person by 2030 over a baseline scenario based on trends in demographics and the global economy.

¹⁷⁹ *Latin American Economic Outlook 2019: Development in transition* is the OECD's Development Centre's annual perspective on economic development in Latin America, in partnership with the Economic Commission for Latin America and the Caribbean, the Development Bank of Latin America, and the European Commission.

¹⁸⁰ Our macroeconomic simulation is based on McKinsey & Company's proprietary Global Growth Model, a general equilibrium macroeconomic model that covers more than 100 countries with data from 1960 through 2015. For details see *Shifting tides: Global economic scenarios for 2015–25*, McKinsey & Company, September 2015. See technical appendix for details.

Exhibit 31

An inclusive growth scenario for the region shows which industries have the most to gain.



¹ Weighted average of Brazil, Colombia, and Mexico.

² Based on World Bank consumption segmentation.

Source: World Bank; World Data Lab; GGM; McKinsey Global Institute analysis

This exercise is theoretical but revealing. It shows that Latin America's overall GDP growth rate could rise 50 percent, to 3.4 percent annual growth.¹⁸¹ Over half of that growth is attributed to productivity gains, compared with just 31 percent in the baseline scenario and 28 percent since 2000. Growth is not only higher but also shared with the broad base of the population. Wages would increase by 1.6 percent, or more than three times faster than in the baseline scenario.

Under this simulation, total domestic consumption would increase by up to 2.7 percent annually, with most of that coming from wage earners in the bottom 90 percent of the population. Not only would domestic consumption expand local markets across sectors, but the increase in middle-class consumers would also change the total consumption profile of the region. Sectors that are positioned to serve the needs of the consuming class, including financial services, information and communications technology, and transportation, would grow faster than the market as whole (Exhibit 31). Some social elements would also be affected. For example, demand for better-quality education would increase, indicating a likely shift in political demands or an expansion of private offerings of publicly available goods. Most important, the combination of opening to trade and the expansion and diversification of domestic markets would increase investment to 27 percent of GDP compared with about 20 percent today.

Solutions for Latin America's sluggish growth and inequality are at hand, reflecting best practices in the region and in other emerging economies. The ongoing digital transformation of economies and society can be an important spur to higher productivity, one that presents Latin America with a new chance for inclusive growth. To lay the groundwork, governments and business leaders will need to fill in the missing middles by building competitive capabilities for growing firms and ensuring that the broad base of the population benefits from the gains. No magical realism is needed. Rather, the context calls for more evidence-based policies and closer collaboration across sectors. Harnessing the opportunities and navigating the challenges of the digital era require immediate action, because the region cannot afford to miss another chance for spurring inclusive growth. At a time of changing geopolitics and rising public disgruntlement, the people of Latin America need an economic future that they can believe in, one that will restore the luster to the region's economies and make everyone more prosperous.

¹⁸¹ Relative to our baseline scenario without these shocks, where growth slows due in part to the end of the demographic dividend.



Technical appendix

We include here a summary of our methodology. The topics are:

- 1. GDP growth decompositions**
- 2. Large and midsize firm analyses based on our CPAT database**
- 3. Small firm analyses based on local sources**
- 4. The survey that we conducted**
- 5. Our growth model simulation**

GDP growth decompositions

In order to identify where are the constraints to Latin American sustained inclusive growth, we rely on the decompositions from the standard production and income views of National Accounts (Exhibits 3 and 17).¹⁸² The production view decomposes GDP into its labor productivity and labor quantity components. The income view is reported in national accounts as the labor share, gross operating surplus (including mixed income), and value-added tax.¹⁸³

For the production view, we estimate labor productivity growth by calculating the annual compound growth of value added per employee and attribute the remainder as growth from labor expansion. We use local national accounts sources for GDP and employment numbers to do this calculation for our three focus countries (from IBGE in Brazil, INEGI in Mexico, and DANE in Colombia) as we do for all analyses in the report, unless otherwise noted. GDP growth numbers from these sources are within 0.1–0.2 percentage point of other sources (for example, World Bank, Conference Board). For benchmark countries we calculate productivity growth using GDP and employment numbers from the Conference Board Total Economy Database™ (2017).

For the income view, we further decompose the labor share of income (a reported category) into a portion attributable to growth of employment and a portion attributable to growth in the average wage. For the former we take the change in employment over the 2000–16 period and multiply by the initial wage. For the latter we multiply the change in wage by the initial employment number. For the remainder, which corresponds to the change in labor times the change in wages, we attribute it equally to both.

The labor share in these calculations does not include mixed income, a portion of which could be considered labor share and is often incorporated through a variety of estimates.¹⁸⁴ For our purpose of comparing changes over time across countries, we use the well-defined measure of labor share of employees (which includes informal employed workers).

Large and midsize firm analyses

We analyze firm distribution and dynamics using McKinsey's Corporate Performance Analytics company-level financial database. Chapter 2 introduces new analyses for the region with the distribution of firms by size, the expansion of public firms, turnover over our period of study, and operating profit margin and economic profit comparisons. We compare

¹⁸² The demand step decomposition using the GDP expenditure method of consumption, investment, government consumption, and net exports was not used directly in this report.

¹⁸³ Note that in our countries of focus, national accounts use basic prices to calculate GDP with value-added tax (VAT) as an additional category rather than a common method of using market prices and no separate category for VAT.

¹⁸⁴ See, for example, Brian Reinbold and Paulina Restrepo-Echavarría, *Measuring labor share in developing countries*, Federal Reserve Bank of St. Louis, First Quarter, 2018.

Latin American firms to other emerging economies, taking advantage of the data set's global coverage.

The global data set covers 1.7 million companies with revenue data, ranging from granular filings to estimated revenues from local vendors and company surveys, and includes financial institutions, and both publicly listed and private firms. For the countries analyzed in Exhibit 7, there are 270,000 firms in the data set. We then limited the sample to those over \$10 million in revenue where the coverage across countries is more consistent and to higher thresholds for some specific analyses, to limit a decline in data quality. We kept only parent companies and foreign subsidiaries to minimize double counting of revenues bringing the total down to about 60,000.

For public firms, for which better financial performance data are available, we confirmed that the coverage of our data set matches those published on the World Federation of Exchanges. We acknowledge that there are caveats, particularly for Peru and India where our coverage was between 50 and 60 percent and otherwise averaged 98 percent. We attribute fluctuations of about 10 percent above and below 100 percent mainly to the fact that some firms in our data set (which is based on headquarters location) are companies operating in the host countries but listed on foreign exchanges.

We expect to refine the data set as financial reporting coverage improves. A number of limiting factors inherent to the scale, dynamic nature, and cross-national coverage of the data set exist. A large body of literature also explores the complex distributional characteristics of firm sizes.¹⁸⁵ Our current conclusions rest on a series of robustness checks and calibrations.

- For the static firm size distribution per trillion-dollar GDP analysis (Exhibit 7), we did the following tests across which our main result of fewer midsize and large firms in the region consistently held with a ratio of 50–75 percent, while individual country rankings changed from case to case as noted. To check whether we were missing coverage we calibrated with local data, both by comparing available data on total registered firms with the total number for which we have revenue and by using published lists of top firms by revenue or firm size data from national statistical agencies (usually by number of employees per firm which has wide variance relative to revenue across sectors). This resulted in significant scaling up of the number of firms under \$100 million, especially for Indonesia, India, Chile, and South Africa, and affected the ranking of our country level assessment; the regional result held with and without the scaling. To check whether our results were being driven by exchange rate fluctuations (since our revenue threshold and normalization are in US dollars) we evaluated real exchange rate changes and found them to be about the same in Latin America and benchmarks on aggregate; we also used a 2015–17 average and both nominal and PPP for the GDP normalization. Finally, for firms over \$1 billion we swapped in a more conservative estimate based on a scrub of all cross-holdings and using firms only for which financials were available. The main result of fewer firms and revenue among midsize and large firms was robust to all of these tests as well as when we limited analysis to capital intensive sectors or removed them.
- For the analysis on new entrants of public firms since 2000 (Exhibit 8), we tested our robustness by using different start years to minimize the risk that results are driven by changes in coverage. For the same reason we raised the threshold to firms above \$500 million and found no significant change in the cross-country comparisons though of course fewer firms crossed that threshold.

¹⁸⁵ See for example, Robert Axtell, "Facts, Formulae, Fables and Fantasies," Brookings Institutions and Johns Hopkins University Center on Social and Economic Dynamics, Working Paper No. 44, February 2006 and Xavier Gabaix, "Power laws in economics and finance" *Annual Review of Economics*, 2009, 1:255-93 and on the relationship of firm and establishment size distributions to productivity and growth see for example, "Firm size distortions and the productivity distribution: evidence from France" Luis Garicano, Clarie Lelarge, John van Reenan, *American Economic Review*, 2016, 106(11), Bento, Pedro, and Diego Restuccia. 2017. "Misallocation, Establishment Size, and Productivity." *American Economic Journal: Macroeconomics*, 9 (3): 267-303, and "Plant Size Distribution and Cross-Country Income Differences," Laura Alfaro, Andrew Charlton, Fabio Kanczuk, in *NBER International Seminar on Macroeconomics 2008*, University of Chicago Press. Few studies with sales revenue are global and include private firms, with a recent exception focused on performance in Federico J. Diez, Jiayue Fan, and Carolina Villegas-Sánchez, *Global declining competition*, IMF Working paper, WP/19/82, April 2019.

- For the analysis of firms which stay in the top quintile of economic profit in their economies over time (Exhibit 9) and the comparison of the magnitude of top and bottom quintile economic profits across countries, we averaged over a five-year period to guard against year to year volatility of economic profits (comparing 2001–05 to 2013–17 for the turnover analysis and using 2013–17 for economic profits). To add the countries into one benchmark measure for the chart in Exhibit 9, we added up the total number of firms that were in the top quintile in their own economies and allocated them to the quintiles where they ended up also in their own economies (that is, we did not redefine quintiles within one aggregate benchmark economy as we are interested in dynamism as an economy characteristic).
- We tested the profits by sector analysis (Exhibit 10) by changing the years (using data since 2010 instead of 2000), testing with different measures (EBITDA versus NOPLAT) and doing weighted and simple averages of benchmarks, without major changes to the main finding (that is, that the region’s total margins are about 4–5 percent higher, with gaps remaining in the same sectors). It is interesting to note that while the capital share for Brazil in national accounts is the lowest of our three countries at 32 percent with Mexico the highest at 46 percent, the profit margins are higher for Brazil in this analysis of firms over \$100 million at 18 percent compared to 13 percent in Mexico. In other words, this is consistent with the Chapter 2 analysis that emphasized how the difficult business environment in Brazil leaves firms in the middle below our \$100 million threshold squeezed with neither the scale to manage compliance nor the informality or simplified small business regulation to avoid it.

Small firm analyses

To compare employment and productivity growth of small firms of under 20 employees with larger ones in retail (Exhibit 11), we used establishment survey data from the national statistical agencies that reports value added and employment by establishment size. However, in each case these surveys are samples, not comprehensive censuses. Using national accounts data, we could calculate the “missing” value added and employment for the sector overall. The remaining question is then only how to attribute them to the two firm-size categories.¹⁸⁶ Because the surveys generally cover larger firms, we attribute the missing value added and employment entirely to the small category except for Mexico, which had much higher and more representative coverage and for which we simply used the productivity ratio of the two firm sizes in the census survey. While these methods are not perfect, we are mainly interested in highlighting the change over time, which would tend to net out systematic error.

To estimate the profitability of firms by size in the three countries (Exhibit 12), we simulated an income statement for five different firm sizes operating formally and an informal micro firm, all indexed to 100 in sales. We then estimated: cost of goods sold, formal taxes (VAT, payroll, social security, and corporate income tax), adjustments for simplified regimes that apply to small firms by country, store size, and thus rent costs for urban centers in each country, and labor costs. Economies of scale due to bargaining power in COGS, average store size, and labor costs (including replacement with technology in the largest firms) tend to increase profits above the small and medium level, whereas the simplified tax regime is the main benefit of the micro to small and depends on the programs in each country. For the micro informal firms, COGS were the only costs (set at 50, which is equal to the COGS for formal micro firms) with the profits interpreted as income for the self-employed (or family that runs the business). While the outcomes were stress-tested with industry experts, they should be interpreted as illustrative trends to compare across firm sizes and countries.

Survey

We used the polling company Dynata to conduct a survey of Latin American workers in January 2019 across our three focus economies: Brazil, Mexico, and Colombia. The survey

¹⁸⁶ In the case of Colombia, the survey data actually showed more employment in the larger category than the national accounts source. In that case we used the productivity level from the survey and applied it to the employment data from national accounts.

focused on perspectives on various types of work, future opportunities, and incentives of various job types including formal and informal employment, and self-employment.

A total of 3,013 workers were surveyed, with minimum 1,000 respondents in each country. The respondents accessed the survey primarily through mobile phones and were compensated for their participation. Because of this selection method, respondents are more likely to live in urban markets and have higher levels of education than the national average. We attempted to maintain a critical mass of respondents across the following dimensions: gender, employment status (employed, self-employed, unemployed), and formality (as measured by contributions to national social security equivalent in the past 12 months). Due to the focus of the survey, those who are unemployed and not actively seeking work (for example, retirees) were excluded from the results.

Growth model

In Chapter 4, we created a scenario for 2030 GDP for Latin America that reflects improved but realistic inclusive growth, in terms of GDP, wages, and middle-class market expansion. We used a general equilibrium model for Brazil, Colombia, and Mexico, scaling the results to the rest of the region given past GDP performance.¹⁸⁷ We created three shocks relative to a baseline scenario that includes population and commodity price projections.

The first inclusive growth shock was to productivity. We assume each economy increases total factor productivity (TFP) on average 0.5 percent a year from 2018 to 2030 above the baseline. Given Latin America's poor productivity growth since 2000 and the opportunity to improve on this front, as well as what is typically achieved annually in peer emerging markets, we believe that this is a modest and attainable assumption for the region that can reasonably be achieved with successful digital adoption as the main driver.

Second, for Colombia and Mexico we assume labor share converges with or toward peer emerging markets. For these countries, labor share is far lower than what is seen in peer economies. Looking at 2016 data for our ten benchmark economies, we exclude outliers on each end of the distribution and reach an average labor share of 38 percent. Given Mexico's labor share in 2017 is 27 percent, we think it is unrealistic for the country to reach the average labor share by 2030; instead, we set their convergence threshold at 34 percent, or 0.5 percent movement a year from 2018 to 2030. The inclusive growth scenario thus doubles the share of wages in the income growth view relative to the baseline scenario in Mexico and Brazil and triples it in Colombia.

Finally, we assume an investment level at or above 27 percent of GDP, which is a typical level found by the MGI Outperformer report to be a necessary condition to sustain high economic growth in outperforming economies, and which is reasonably achievable with the corresponding incentives from the productivity and income shocks (and which Colombia showed was possible by briefly reaching that level in 2015).¹⁸⁸

Taken together the results of the model raise GDP growth by 1.1 percent per year in Brazil and 0.8 percent in Mexico and Colombia. To get to a regional growth number (that is, account for the one-third of GDP that is not from our three countries) we assume a similar increase, adjusted up or down based on how they did relative to our three countries since 2000.

Finally, to understand the market implications of the growth, we use the World Bank Global Consumption Database (GCD) to extrapolate how consumption growth—which is attributed such that the bottom 90 percent gets the bulk, while the top ten percent maintains consumption growth in line with population growth—shifts the demand for goods and services

¹⁸⁷ We relied on the McKinsey Global Growth Model, a proprietary supply-side econometric macroeconomic model that takes into account the dynamic interactions of multiple variables, including population, employment, capital formation, and productivity. The McKinsey Global Growth Model uses different sources to build the historical and forecast scenarios. Its main sources are the World Bank World Development Indicators, Oxford Economics, IMF World Economic Outlook, IMF International Financial Statistics, Economist Intelligence Unit, UN Population Division, World Bank Global Financial Development Database, and the McKinsey Global Institute Financial Asset database, as well as some other UN and OECD databases.

¹⁸⁸ Outperformers: *High-growth emerging economies and the companies that propel them*, McKinsey Global Institute, September 2018.

in the economy. This database provides country-specific consumption basket views for five segments of each economy: lowest, low, middle, higher, and all (national average). Given the Global Consumption Database publishes 2010 data for each country, we first evaluated how Brazil, Mexico, and Colombia's consumers have evolved from 2010 to 2017 in terms of the four segments using the WDL consumption data. Using these established thresholds, we then classify each ventile of the population in both 2017 and 2030 into one of the four consumption basket segmentations. Using this approach, we estimate the total consumption in both years attributed to each segment and allocate total spending to the appropriate industry based on the country-segment-specific consumption basket. This means that industry growth is affected by both the change in number of consumers in each segment between 2017 and 2030 and the average spending change within each segment. We can then see which sectors grow the fastest, and which are driven mostly by the middle consumption segment.

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