The Mexican Paradox

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After a series of macroeconomic crises in the mid-1990s, Mexico undertook bold reforms, from liberalizing its economic policies to investing in education. But, while these efforts brought some benefits, they failed to spur significant productivity and economic growth.

CAMBRIDGE – Few economies pose as big a paradox as Mexico’s. Emerging from a series of macroeconomic crises in the mid-1990s, Mexico undertook bold reforms that should have put it on track for rapid economic growth. It embraced macroeconomic prudence, liberalized its economic policies, signed the North American Free Trade Agreement (NAFTA), invested in education, and implemented innovative policies to combat poverty.

In many respects, these reforms paid off. Macroeconomic stability was achieved, domestic investment rose by two percentage points of GDP, and average educational attainment increased by nearly three years. Perhaps the most visible gains were on the external front. Exports jumped from 5% to 30% of GDP, and the GDP share of inward foreign direct investment tripled.

But where it counts – in overall productivity and economic growth – the story is one of substantial disappointment. Since 1996, per capita economic growth has averaged well below 1.5%, and total factor productivity has stagnated or declined.

If ever there was a country that was destined to be the poster child of the new orthodoxy in economic development, it was Mexico. Instead, the country fell behind even its Latin American peers. Why?

A large part of the answer has to do with the Mexican economy’s extreme dualism – a problem that has been called the “two Mexicos.” The bulk of Mexican workers remain employed in “informal” firms – especially firms in which employees are not on salaried contracts – where productivity is a fraction of the level in large, modern firms that are integrated into the world economy.

What is striking is that this dualism has worsened during the period of Mexico’s liberalizing reforms. Research by one of us (Levy) shows that informal firms have absorbed a growing share of the economy’s resources. The cumulative growth of employment between 1998 and 2013 in the informal sector was a whopping 115%, compared to 6% in the formal economy. For capital, cumulative growth was 134% for the informal sector and 9% for the formal sector.

Mexico does not seem to lack economic dynamism. A considerable number of new firms are the main source of employment growth. But this churn does not seem to be of the kind that increases overall productivity.

Evidence shows that many low-productivity firms survive, while high-productivity firms die. Productive heterogeneity, and the misallocation that goes with it, has been increasing in
commerce, services, and manufacturing alike. As a result, the economy’s overall productivity has been stagnant or declining.

It is not entirely clear why structural change has, perversely, reduced growth. One possible explanation is Mexico’s parallel system of social insurance. Firms and workers in the formal sector must pay for health insurance, pensions, and other employee benefits. But, because workers undervalue these benefits, the result is pure tax on formal employment.

By contrast, when firms and workers are informal, workers receive a similar bundle of health and pension benefits for free. The result is that formal employment is unwittingly penalized, whereas informal employment is subsidized.

Another possibility, which can accompany the first one, is that Mexico’s rapid opening to imports has bifurcated its economy between a relatively small number of technologically advanced, globally competitive winners, and a growing segment of firms, particularly in services and retail trade, that serve as the residual source of employment. In the absence of productive development policies of the type used in East Asia, modern firms may have not been able to expand rapidly enough. The beneficiaries of globalization are typically those countries that complemented it with a strategy to promote new activities, policies that favored the real economy over finance, and sequential reforms that emphasized high-productivity employment.

Whichever of these stories is correct, it seems clear that Mexico’s growth problem is not the result of macroeconomic instability, the absence of foreign competition, or lack of human capital. In fact, returns to education have been falling partly because the supply of skilled workers has outpaced demand, as most informal firms do not require them.

In the end, the effects of efficiency-minded reforms have been offset by factors – social insurance policies and market imperfections – that systematically channel too many resources to informal firms and create obstacles to formal firms. Given the inflammatory rhetoric of US President Donald Trump, discussion in Mexico is understandably revolving around the renegotiation of NAFTA. But if policymakers are to avoid missing the mark, after that process is completed, they must turn their attention to the structural factors that are depressing Mexico’s growth.

There are two broad lessons here for other developing countries. First, for too long, these economies have been obsessed with opening to international trade, attracting foreign direct investment, liberalizing prices, and achieving macroeconomic stabilization. These reforms work, typically in conjunction with others, when they promote productivity-enhancing structural transformation. When they do not, or when other policies perversely counter them, the results will be disappointing.

The second lesson is that countries need to pay close attention to how social insurance policies affect the behavior of firms and workers. Good intentions aside, the result may be that the low productivity segment of the economy is subsidized, while the high productivity segment is taxed.

Mexico has shown that successful growth strategies cannot be built on ready-made blueprints. Rather, they require targeted, country-specific reforms that remove actual obstacles to the expansion of modern sectors, and social policies that are compatible with structural transformation.
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