



## **Low productivity in Mexico, why? : Need for Its Improvement in SMEs**

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### **Dual Economy in Mexico—Expanding disparities in productivity between large companies and SMEs**

Mexico's GDP ranks the world's 14th largest with its population of 115 million. Mexico has the second largest economy after Brazil in Latin America with per capita GDP exceeding 10 thousand dollars. The best part of the economy is its openness. As a member of the North American Free Trade Agreement (NAFTA), Mexico plays a role as an important manufacturing hub in the North America. In addition, Mexico has concluded FTAs with 45 countries<sup>1</sup> and especially has attracted many automobile companies from Japan which have contributed to the rapid accumulation of technology in automobile industry in Mexico.

Although the economy has been experiencing rapid industrialization, little known about is its slow improvement in productivity. Chart 1 shows the comparison of growth rate of per capita GDP and contribution of the total factor productivity<sup>2</sup> (TFP) among major emerging economies in the 2000s. It is a surprise that Mexico had the lowest growth in the TFP showing negative value of -1.5%. In this period, Mexico recorded 1.1% growth in per capita GDP but its growth had been totally supported by the heavy input (2.6%) of production factors like labor and capital

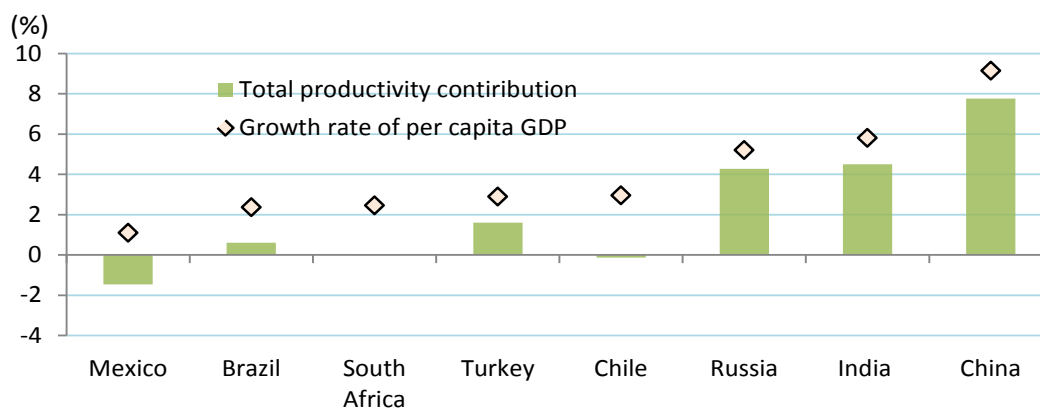
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<sup>1</sup> Includes Bolivia with which Mexico has a preferential trading agreement virtually similar to FTA.

<sup>2</sup> TFP(total factor productivity)is a variable which accounts for effects in total output not caused by traditionally measured inputs of labor and capital and is measured as a residual not caused by inputs and taken as a measure of an economy's long-term technological change or technological dynamism.

while the TFP deteriorated. This trend does not change even when it was traced back to the 1990s.

**Chart 1 Per capita GDP and Total Factor Productivity in Major Emerging Countries (2000-2011)**

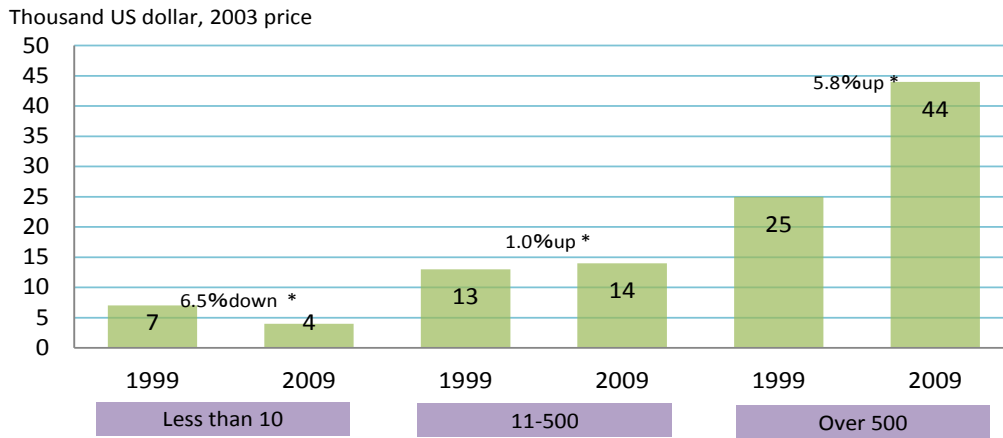


(資料)OECD <http://dx.doi.org/10.1787/888932802990>

What are the reasons for the deteriorated TFP of Mexico? McKinsey Global Institute, an American Think-tank, has highlighted in its newly published report<sup>3</sup> the low productivity in the SME sector in Mexico's economy. According to the report, per capita output of the large companies recorded an annual increase of 5.8% from 1999 to 2009, while that of mid-sized companies remained roughly flat (increase of 1.0%) and that of small companies fell by 6.5%. The share of employment by small companies increased from 39% in 1999 to 42% in 2009. The share of large companies remained the same (20% of the total) while that of mid-sized companies declined from 41% to 38%. As a result, the improvement of productivity by large companies was virtually offset by the deteriorating productivity of small companies, resulting in the total improvement of only 0.8% in the overall economy.

<sup>3</sup> McKinsey[2014]

**Chart 2 Per capita Output by the Size of Companies**



(Source) McKinsey Global Institute (\*) annual rate

### Most Small Companies belong to the Informal (Traditional) Sector

How to improve the productivity in the SMEs is a big challenge for Mexico. Let's check the longer term trend of economic growth and productivity. Mexico achieved an annual growth of 2.7% since 1990, of which 0.8% was accounted for by the increase in labor productivity. The rest (1.9%) came from the increased input of labor. However, even in Mexico the pace of natural increase of population has been on a downward trend and its increase is forecast to slow down to around 1.2% by 2025 from the current 2% level. If the improvement of the labor productivity stays at current 0.8%, the potential growth rate of Mexico will also slow down toward 2%. The government of Mexico has set 6% target for the medium-term growth rate, but in order to achieve this target, it has to accelerate the rise of labor productivity to 4.8%, six times as fast as the present speed. This is a very ambitious task.

Even if the government tries to pursue the growth rate of 3.5%, which has been thought to be the Mexico's potential growth rate, rather than 6%, it has to raise the labor productivity by threefold from the current level. This inevitably requires the improvement of productivity in the SMEs but it first has to deal with the problem of informal sector.

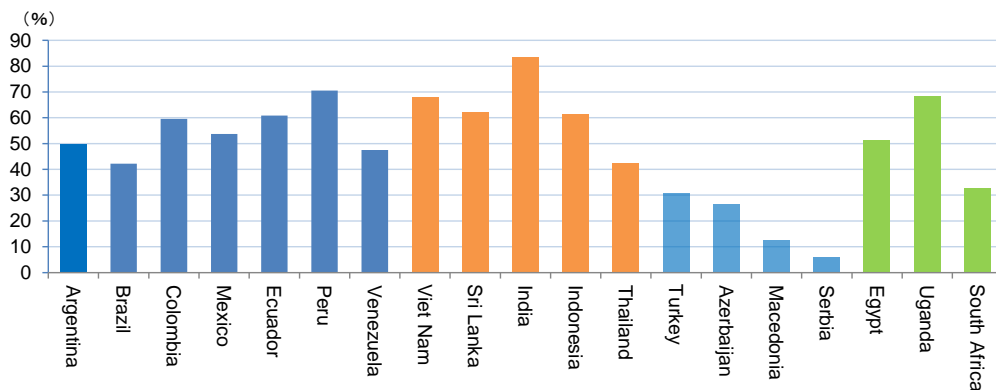
Informal sector refers to traditional enterprises and includes all the entities with characteristics of family enterprises that have no juridical personality<sup>4</sup> In most cases, they are business entities that operate to avoid the social security and tax burdens. They include sidewalk

<sup>4</sup> Based on the definition by the National Institute of Statistics and Geography (INEGI by its name in Spanish, Instituto Nacional de Estadística y Geografía)

vendors, temporary construction workers, car window cleaners, junk dealers, and unlicensed cab drivers. Employment by these enterprises is regarded as an informal employment.

Even the companies that belong to the formal (modern) sector sometimes employ workers informally to avoid the cost for medical insurance, pension, workers compensation, etc. The high ratio of informal employment is one of the characteristics in Latin America, and the ratio reaches 54% in Mexico. This number includes the informal workers employed by large companies, but even excluding those employments, the informal sector informally employs 34% of the total employment. Since the small companies account for 42% of the total employment, this means that substantial part of the small companies belong to the informal sector. Therefore, it is a big challenge for Mexico to improve the productivity in the informal sector which is mostly composed of small sized companies.

**Chart 3 Ratio of Informal Employment in Non-Agricultural Sector**



(\* ) 2009 data, except for Colombia, Thailand, Macedonia, Serbia, South Africa (2010). 2005 data for India  
 (Source) Key Indicators of the Labour Market, 7th Edition

### Adverse Effects of Proliferating Informal Sector

Several factors can be pointed out for the reasons why the informal sector is saddled with low productivity.

- ① The informal sector embraces a lot of micro companies which have difficulties to utilize the economy of scale and therefore tend to miss the chance to make technological innovation.
- ② Workers' skills are generally at low levels and there is hardly any chance for them to improve their skills.
- ③ Small companies face high hurdles in obtaining bank lending from formal banks to

expand their business capacity.

The expansion of an informal sector with low productivity has by itself a negative effect in the economy by directly pulling down the growth rate, but it also produces a vicious cycle of bringing adverse effects to the whole economy as discussed below.

Firstly, informal companies tend to exploit the low cost labors rather than introducing new equipment and new technologies, thus inviting a deterioration, to say nothing of an improvement, in productivity which in turn leads to the decrease of wages. In fact, the real wages in the small enterprises fell by an annual rate of 2.4% in the period of 1999-2009. The decrease of wages has produced a widening disparity of income among the workers, hampering the growth of middle income class.

Secondly, the existence of a large informal sector weakens the taxation capability of the government. The fact that the more than half of the employed populations are informal workers implies that the burden of income tax has to be borne by the rest of the tax payers of less than half of the population, creating a feeling of unfairness about the tax burden among the taxpayers. This feeling is all the more intensified because Mexico depends less on indirect taxation. Even taking into account its high dependence on income from the oil, there is no doubt that the informal sector has shrunken the tax base. Smaller revenues of the government most likely put a constraint on the expenditures for infrastructure investment which is indispensable for the future development of the economy.

Although in the advanced economies an expansion of government sector may give a negative image for the country, expectations are high and wide for the government roles in a country that experiences a transition from middle income to high income economy. In addition to the improvement of infrastructure, there are strong demands ranging from for better functioning public services to improved and well-developed welfare policies for pension and health, to strengthened income distribution functions through foregoing measures. Now Mexico is just entering that phase, and shifting the informal sector to the formal sector is all the more urgently needed.

**Chart 4 Tax Structures of the OECD, Latin America and Mexico (% of GDP)**

	OECD (2011)	Latin America (2011)	Mexico (2012)
Income tax	11.4%	5.0%	5.2%
Indirect tax	11.0%	9.6%	4.2%
Tax on capital	1.8%	0.7%	0.4%
Other taxes	0.7%	0.3%	
<b>Tax total</b>	<b>25.0%</b>	<b>15.7%</b>	<b>9.8%</b>

(Source) JETRO

### **Reasons for Remaining in the Informal Sector and Necessary Measures for Inclusion of SMEs in the Formal Economy**

Many small companies continue to remain in the informal sector despite the demerits thereof and they have a reasonable rationality for it. In the case of Mexico, following reasons are cited.

① High costs in the formal economy

In addition to an increase in the social security and tax burdens the small companies have to bear if they become modern and formal company, they will lose the preferential treatment on electricity fees for home use. On the other hand, street vendors can avoid sales tax if only they pay license fees. In the formal sector, there also exist regulations that put a brake on a business expansion. For example, fees for getting permission of expansion of offices and factories are higher than in the neighboring countries.

② Imperfect implementation of laws

Crackdowns are loose and lenient on the murky business and illegal use of informal employment, and penalties for them are halfway. People well know that they can escape from the charges with a bribe.

③ Rigid labor regulations

In Mexico, temporary or fixed-term employment is not permitted basically. There is no retirement age and companies have the obligation to keep even the elderly employees. There was no probationary period until 2012 when labor law was amended to incorporate it. In addition, many more “socialistic” facilities are stipulated in the Mexican labor laws, which the formal enterprises have to bear the cost of. For this reason, there is no decrease in the informal employment not only by informal companies but also by formal companies.

In order to encourage the informal sector to shift to the formal economy, it is necessary to remove these disincentives one by one. It will be required to review the preferential taxation

system (tax deduction system) given to them, and reduce the cost of various registration fees and requirements. In addition, it is important to improve the law enforcement capacity of the government to eradicate corruptions.

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