Is Mexico a new ‘China’???

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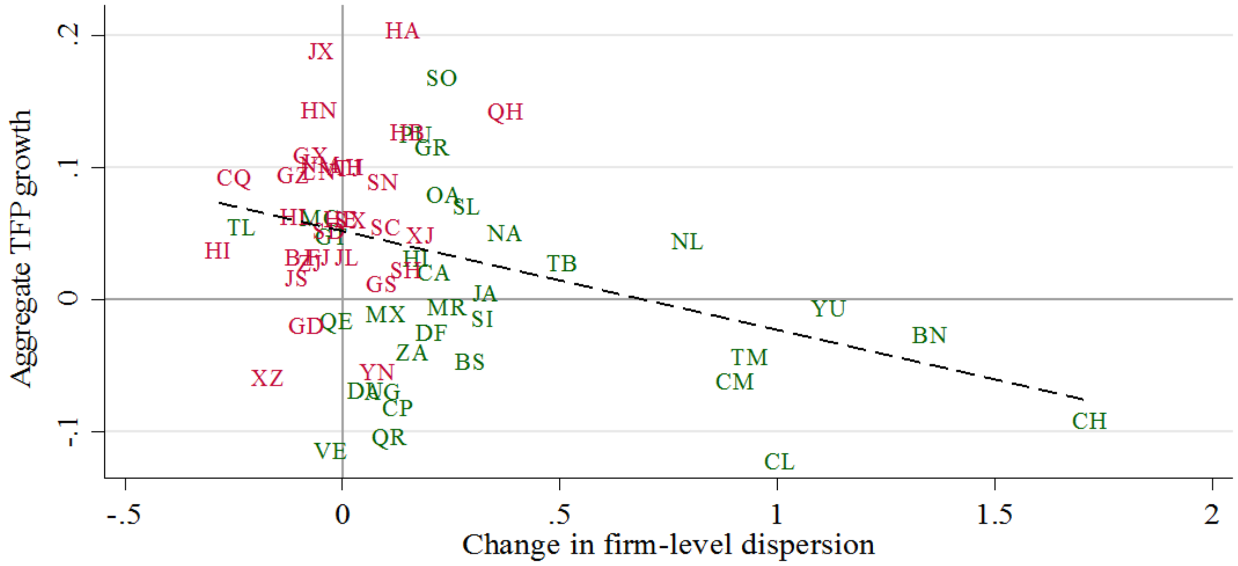
China’s spectacular growth during the 1990s and early 2000s made it the envy of many other emerging economies. Yet more recently, relative labour costs have risen substantially, and economies such as Mexico’s, which lost export market share for some time, have made a partial comeback. However, Mexico’s increasing competitiveness masks one of the country’s fundamental concerns, which is weak productivity improvements. In a new working paper being released today, while the Global Forum on Productivity opens in Lisbon, we examined the evolution of multifactor productivity in Mexico’s manufacturing sector, as compared to China’s (see Dougherty & Escobar, 2016). Firm-level micro-data were used to examine the distribution of productivity across Mexico’s states, and also to track the misallocation of resources.

It turns out that Mexico’s increasing competitiveness and attractiveness masks one of the countries’ fundamental concerns, which is the absence of productivity improvements. Mexico’s productivity lags behind that of other major emerging economies, and it has suffered from a negative growth trend – at least until the recent package of structural reforms (OECD, 2015a). It turns out that multi-factor productivity differs considerably across firms and regions, a situation not unlike that in many OECD countries. While Mexico’s most productive firms are performing relatively well, and can compete with China’s, the vast majority of firms are struggling to perform better with limited success, leading to a growing dispersion in productivity (see figure below). A similar situation is observed in other OECD countries where there is a rising gap in productivity between the most advanced firms and the laggards, and the gains in productivity of the most advanced firms are not enough to improve aggregate productivity (OECD, 2015b).

Aggregate TFP growth and firm-level dispersion

In China's provinces (in red) and Mexico's states (in green)



***Source*: Dougherty and Escobar (2016).**

Note: dispersion is measured as the standard deviation of firm-level productivity (see Figure 4).

We also took advantage of Mexico's federal structure to study the drivers of productivity using econometric techniques to address potential reverse causality. Our findings suggest that among other factors, a stronger rule of law increases productivity in Mexico. This is robust to previous OECD evidence, which suggests that firms in Mexico's states with more effective legal systems tend to be substantially larger and more productive (Dougherty, 2014).

Our results also show that among the institutional quality-related variables, *informality* has the strongest effect on productivity. Moreover, we consider informality as a source of distortions that contribute to the misallocation of resources. Our results are robust to various methods, and imply a strongly negative relationship between informality and productivity. Among different size firms, informality in microenterprises (up to 10 workers) has the strongest negative effects on productivity. The results also suggest – for the first time that we know of – that more productive states and industries suffer *more* from informality than less productive ones. This is likely due to resources being perversely tied up in informal activities, akin to the ‘Zombie firms’ that are now being investigated at OECD. Tackling informality is a complex challenge, and one that requires a multi-faceted approach (OECD, 2013, 2015a).

The results also suggest that the mere presence of foreign investment improves productivity – with the exception of *Maquiladora* industries, which are missing out on productivity gains. This is likely due to *Maquila’s* undue emphasis on low-end, low-skill assembly operations, which have often not fared very well in competition with China. Moreover, weak education quality simultaneously acts as a major restraint on productivity, and it aggravates informality.

In summary, we can conclude that Mexico is not a ‘China’, yet.

References:

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