Oreste Zevola

The **power** of productivity

Poor countries should put their consumers first.

William W. Lewis

After the Second World War, a vast array of international and national institutions—the United Nations, the World Bank, the International Monetary Fund, and a host of nongovernment and government aid organizations—was created to better the lot of the world's poor. Conventional wisdom came to hold that improvements in infrastructure, technology, capital markets, education, and health care would eliminate the stark distinctions between rich and poor nations.[1] Fifty years and billions of dollars later, this wisdom has proved wrong.

At the beginning of the 1990s, the Soviet Union's fall precipitated a new conventional wisdom. This "Washington consensus" focused heavily on macroeconomic policies, such as flexible exchange rates, low inflation, and government solvency, while also embracing microeconomic elements—for instance, price decontrol, privatization, and good corporate governance and market regulation. Market reform swept through the world, including countries as diverse as Argentina, Brazil, India, Mexico, New Zealand, Poland, and Russia. Most were thought to be doing virtually everything needed to spark rapid growth.

But once again the results were disappointing. By the end of the 1990s, most of these countries' growth rates had returned to levels so low that the profile of the global economic landscape wasn't changing at all. Today more than

[1] For more on the failure of development economics, see William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, Cambridge, Massachusetts: MIT Press, 2002.

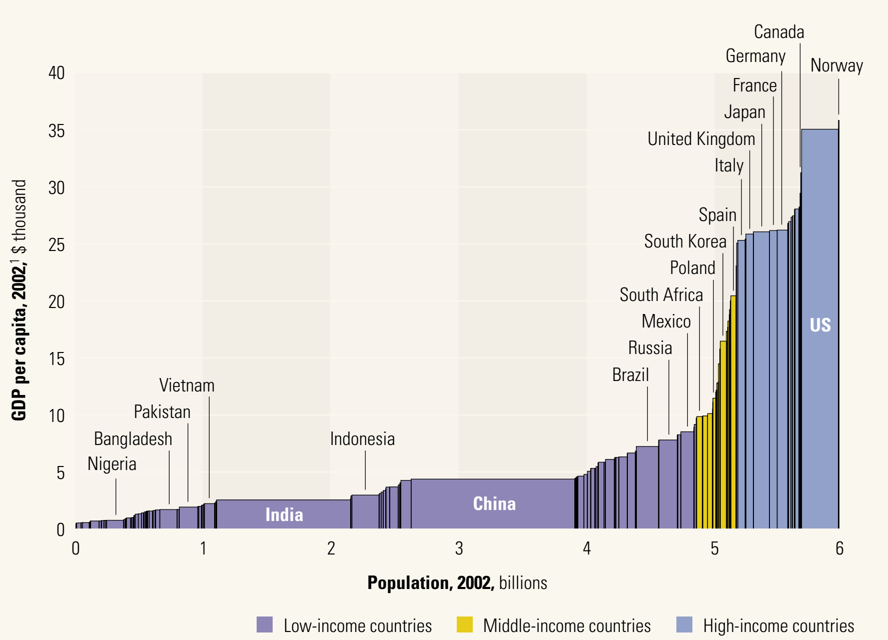
80 percent of the world's people still get by on less than a quarter of the average income in rich countries, much as they did 50 years ago.

Even worse, only a handful of countries, having moved out of dire poverty into the middle ground, enjoy a real prospect of joining the rich ones (Exhibit 1). This failure is worrisome because it means that today's poor countries will probably be poor 20 years from now. Economic development is a slow process. Even if poor countries grew at the extraordinary rate of 7 percent a year, it would take them 50 years to catch up. At *current* rates, it would take them a couple of centuries—if they ever did. As the tenacity of oppressive regimes and the rise in terrorism in these poor countries amply demonstrate, this gap between rich and poor is a major threat to global stability.

Conventional solutions have failed because they don't address the real causes of persistent poverty. The Washington consensus, like the 50 years of development economics before it, is grounded in an analysis of economies at the aggregate level. But that's like trying to learn about the physical universe by using only the telescopes of astronomy; most real understanding

EXHIBIT 1

A steep climb



[1]At purchasing power parity.
Source: World Bank; McKinsey analysis

in physics has actually come from studying the interaction of the tiniest particles in the universe. In economics, it is necessary to understand why individual companies operate as they do, since they are the ultimate sources of growth and job creation. Most economists can't afford the time and resources needed to look, in detail, at the way an entire country's economy works. They rely instead on broad national data sets and complex econometric tools that yield qualified answers at best.

At the McKinsey Global Institute (MGI) we have had, since 1990, the luxury of studying the dynamics and evolution of a representative group of industries in 13 countries: Australia, Brazil, France, Germany, India, Japan, the Netherlands, Poland, Russia, South Korea, Sweden, the United Kingdom, and the United States. In each, we analyzed the performance of 6 to 13 industries and compared it with the performance of the same industries in a handful of other countries. Our work is thus based on detailed studies of individual businesses, from state-of-the-art auto plants to black-market street vendors. It builds an understanding of the economy from the ground up, not the top down—a grassroots rather than a bird's-eye view.

Economists must understand how ***individual companies****—the sources of job growth—function*

This research has produced a new and unexpected understanding of the persistence of income disparities among nations. Economic progress depends on increasing productivity, which depends on undistorted competition. When government policies limit competition, even unintentionally, more efficient companies can't replace less efficient ones. Economic growth slows and nations remain poor.

It's productivity

GDP per capita is widely regarded as the best single measure of economic well-being.[2] That measure is simply labor productivity (how many goods and services a given number of workers can produce) multiplied by the proportion of the population that works. This proportion varies around the world—though, interestingly, not by much.

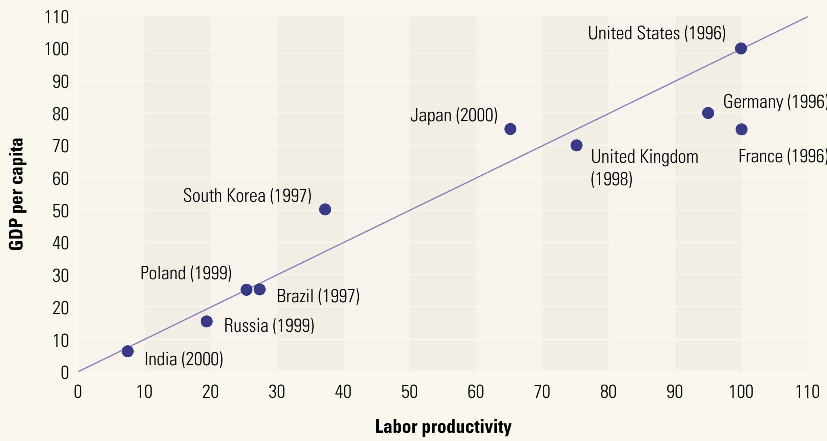
Productivity, however, varies enormously and explains virtually all of the differences in GDP per capita (Exhibit 2, on the next page). Thus, to

[2] Some people argue that indicators of health, life expectancy, and social well-being are just as important, if not more so. But men and women the world over want more than a subsistence living, and that is why millions of them emigrate from poor countries to rich ones, even doing so illegally and risking their lives in the attempt. The Soviet Union achieved military power but ultimately collapsed because it didn't provide enough consumer goods.

EXHIBIT 2

Productivity paves the way

Index: United States in 1996 = 100



Source: Economist Intelligence Unit; Organisation for Economic Co-operation and Development (OECD); McKinsey analysis

understand what makes countries rich or poor, you must understand what causes productivity to be higher or lower. This understanding is best achieved by evaluating the performance of individual industries, since a country's productivity is the average of productivity in each industry, weighted by its size. Such a micro approach reveals the important fact that the productivity of industries also varies widely from country to country.

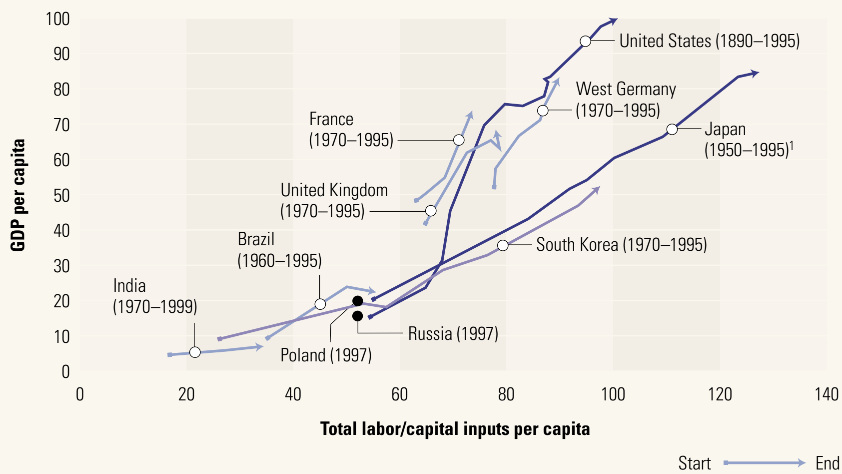
This approach yields two crucial insights. First, to understand why some countries are mired in poverty, it is necessary to look beyond broad macroeconomic policies, such as interest rates and budget deficits, and also consider the myriad zoning laws, investment regulations, tariffs, and tax codes that hold back the productivity of industries and thus a nation's prosperity. Of course, macroeconomic stability is necessary. MGI's studies of Brazil, India, and Russia show that without it companies concentrate on making money by exploiting the instability rather than by raising their productivity. Yet a stable economy alone isn't enough to make countries prosper and grow: Japan has had a stable economy for decades but has suffered from ten years of stagnation.

The second insight is the realization that the income level of a country is determined, above all, by the productivity of its largest industries. High productivity in the unglamorous "old-economy" sectors—retailing, wholesaling, construction—is most important, since more people work in them. The fabled high-tech enclaves and financial markets are less so. MGI's study of rapid US productivity growth in the 1990s found that it

EXHIBIT 3

The path to productivity

Index: United States in 1995 = 100



[1]Since 1995, gap between Japan's GDP per capita and that of the United States has increased to 30%.

Source: Bureau of Economic Analysis, US Department of Commerce; US Environmental Protection Agency (EPA); International Comparison Programme, United Nations; Korea National Statistical Office; Mary O'Mahony, *Britain's Relative Productivity Performance 1950–1996: An International Perspective*; Angus Maddison, *Monitoring the World Economy: 1820–1992*, Organisation for Economic Co-operation and Development (OECD), 1996; Penn World Table; Brazilian National Household Survey (PNAD); McKinsey analysis

was caused by just six industries, including retailing and wholesaling, not by the vaunted "new economy."[3] IT investments played a modest role. In India, the fast-growing IT industry has yet to raise the living standards of more than a minuscule part of the population.

Differences in productivity also explain the persistence of disparities in wealth among rich nations. Twenty-five years ago, the economies of the United States, Europe, and Japan were generally expected to converge because technology, capital, and business practices flowed freely among them and their workforces were healthy and well educated.

In fact, significant disparities of wealth remain even among rich countries. Despite Japan's world-class automotive and consumer electronics industries, for example, its average per capita income[4] is about 30 percent below the US average. Japan has followed a path different from that of the United States and Europe (Exhibit 3): economic growth during the past 30 years

[3] See William W. Lewis, Vincent Palmade, Baudouin Regout, and Allen P. Webb, "What's right with the US economy," *The McKinsey Quarterly*, 2002 Number 1, pp. 30–40 (www.mckinseyquarterly.com/links/3896).

[4] Measured at purchasing power parity, not current exchange rates. PPP compares standards of living in different countries more accurately because it measures the amount of goods and services different currencies can command in their home markets.

has been generated more by massive increases in the number of hours worked and the amount of capital equipment used than by an increase in the productivity of the workforce. South Korea has followed a similar path. But there is a limit to the number of hours that can be worked, and massive inputs of capital that don't earn an economic return eventually lead to diminished growth. Since 1990, Japan's real per capita income has barely grown. South Korea's tiger economy is running out of steam as well.

Barking up the wrong tree

Many economists still attribute differences in the productivity of countries to differences in their labor and capital markets. These economists therefore believe that big investments in education and health and generous development loans and grants are the keys to economic growth. MGI's research, however, found that these factors explain few, if any, differences in economic performance.

Consider education. In the early 1990s, Germany and Japan seemed to be passing the United States in economic performance. One of the principal reasons cited was the poor education of the US workforce. Since then, Japan's carmakers have built US factories that achieve 95 percent of the productivity these companies enjoy at home. Whatever the faults of the US education system, on-the-job training clearly compensates for them.

This truth holds for poor countries as well. Some of Brazil's private retail banks are as efficient as any in the world. South Korea's POSCO (formerly Pohang Iron & Steel) may have the highest productivity of any integrated steel producer. Carrefour operates with nearly the same efficiency in emerging markets and in Europe. Poor education systems haven't hindered these companies. If illiterate Mexican immigrants can reach world-class productivity levels building apartment houses in Houston, illiterate Brazilian workers can do so in São Paulo.

Similarly, MGI found that a lack of capital to finance investment isn't the main constraint on growth in poor economies. If local businesses organized and managed themselves as the world's best companies do, they would unleash rapid productivity growth. About 20 percent of India's people work in companies that are structured somewhat like those in the developed world, but their average labor productivity is only 15 percent of what their US counterparts achieve. MGI calculated that these companies could increase their productivity to about 40 percent of the US average without any additional capital investment,[5] just by reorganizing the way they

[5] Because of low labor rates, the lack of automation would prevent them from matching US productivity.

conduct work. In 1983, the high-performing Japanese auto company Suzuki Motor invested in a joint venture to make cars in India. Suzuki, which had operational control, built plants like the ones in Japan, organized the work as it is organized in Japan, and trained employees to work as they do in Japan. As a result, the productivity of these facilities is 55 percent of the US auto industry average.

Poor countries thus don't have to wait until they build bigger and better school systems and educate a whole generation of workers. Nor do they need to wait for more development aid from rich countries. If local businesses followed the proven approaches for organizing production and managing a workforce, poor countries could grow much faster than most people realize. Domestic savers and foreign investors hungry for good returns would also supply these countries with plenty of capital for new investments.

Poor nations ***don't have to wait*** *to build school systems and educate a whole generation of workers*

Competition is the key

If differences in labor and capital markets don't matter, what does? In each of 13 country studies, MGI found that the primary answer was the nature of competition in product markets.

Competition is the mechanism that helps more productive and efficient companies expand and take market share from less productive ones, which then go out of business or become more efficient. Either way, consumers benefit as companies offer better goods at lower prices, and this may in turn unleash a burst of new demand.

But government policies sometimes stand in the way of competition and prevent innovation from spreading. Such policies might exclude potential competitors, such as start-ups or foreign companies, or might favor particular classes of companies, such as mom-and-pop retailers. Often, policies (zoning laws, for example) have unintended consequences for business. When they do, competition is less intense and inefficient companies aren't pressured to change. Productivity growth is slower and countries remain poor.

The Washington consensus of the 1990s profoundly underestimated the importance of a level playing field for competition. Over and over again, MGI found industries in which more productive innovators were excluded and less productive companies favored. In much of Europe, for instance, zoning laws prevent large retailers from expanding as fast as they could and therefore from replacing less efficient small retailers. Because retailing is one of the largest sectors in most economies, it has important ramifications for a nation's standard of living. For instance, Tesco, the United Kingdom's largest food retailer, has failed to obtain planning permission to build a modern supermarket on the site of a derelict hospital—broken windows and all—near central London because the building is over 100 years old. The result of such failures is lower productivity for the UK economy and higher food prices for consumers.

In Japan, a combination of zoning laws, tax policies, and government subsidies has allowed the smallest, most inefficient retailers to thrive. Today they account for slightly over half of all retailing employment, compared with less than 20 percent in the United States. In one small shop in central Tokyo, I have seen the same hat sit unsold on a store shelf gathering dust for the past 15 years. Every time I'm in Tokyo, I check to see if the hat is still there. It is. The proprietors don't have to sell it to stay in business, since they get subsidized loans. Their shop sits on some of the world's most valuable land, so they know their estate will repay the loans.

Even the United States isn't immune to policies that limit competition. The 2002 steel tariffs, which have since been declared illegal by the World Trade Organization and withdrawn, protected US steel producers from lower-cost foreign competitors. The recent increase in US agricultural subsidies does the same.

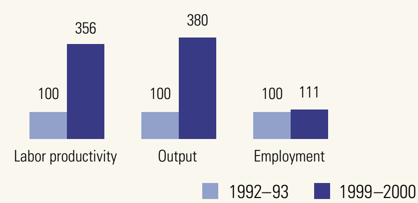
Poor countries, however, have adopted much more severe market-distorting measures. After the Soviet Union's fall, a flurry of new business activity took place in Russia. It was assumed that more productive companies would replace the unproductive Soviet ones and that Russia would rapidly become rich. But MGI found that the new Russian companies were no more productive than their Soviet predecessors. Why? More productive companies either tried to enter the market and failed or didn't bother to try. For instance, Carrefour, perhaps the best international retailer, concluded that it couldn't make money in Russia. Like virtually all multinationals, Carrefour pays taxes. The competitors it would face in Russia—the open-air markets—don't and thus have a decisive tax advantage. Before the ruble crashed in 1998, open-air markets also sold smuggled or counterfeited goods at prices Carrefour couldn't match.

A similar situation exists in Brazil. About 50 percent of its workers aren't registered with the government. Although many of these people are poor and wouldn't be taxed heavily, the total revenue forgone is substantial because of the number of workers involved. As a result, Brazil must collect twice as much in profit, employment, value-added, and sales taxes from corporations as the United States does to finance its government.[6] When taxes are included, it costs more productive companies as much to do business as it costs less productive, informal ones, which don't pay taxes. Modern, productive enterprises can't easily take market share from their unproductive counterparts, and the economy's natural evolution is stymied.

EXHIBIT 4

Invisible hand, visible results

Indian automotive-industry example; index: 1992–93 = 100



Source: Interviews; Society of Indian Automobile Manufacturers (SIAM); McKinsey analysis

Meanwhile, in India the government has directly limited competition by insisting that several hundred consumer goods can be manufactured only in small-scale plants. As a result, Indian consumers pay higher prices than they should, and India, unlike China, hasn't become a global center of low-cost manufacturing. (China actually exports to India.) Moreover, in housing construction, competition among developers and construction firms is based not on cost and productivity advantages but on gaining control of scarce parcels of land with clear ownership titles. Over 90 percent of land titles in India are subject to dispute, and nobody is going to invest in land someone else might claim.

If poor countries eliminated the policies that distort competition, they could grow rapidly. India's government, for instance, abandoned many of the limits on foreign investment in the country's automotive industry during the early 1990s. Subsequently, prices fell, demand for cars exploded, and output nearly quadrupled (Exhibit 4).

The barriers to growth

The main obstacles to economic growth in poor countries are the many policies that distort competition. Why are they so pervasive?

For one thing, most people favor the social objectives that inspire high minimum wages, small-business subsidies, and other business policies. They

[6]Brazil's bloated government contributes to the high tax burden and thus is an obstacle to growth. It currently spends 39 percent of the nation's GDP, compared with 37 percent in the United States. Back in 1913, when the United States had the same per capita income Brazil has now, the US government spent only 8 percent of the country's GDP.

may not be aware of the unintended adverse consequences that create major barriers to growth. Instead of attempting to achieve social objectives by limiting competition, countries should allow fair competition and thereby generate more national income, which can then be redistributed through taxes and government subsidies for the desperately poor.

Even more important, countries have bad policies because they benefit certain people. In rich countries, special interests generally aren't allowed to have their way so much that they can significantly undermine the common good. Most poor countries lack these limits. Moscow's government officials, for instance, allocate housing contracts to their cronies in the old Soviet construction companies. As a political favor to small companies that can't pay their bills, local governments in Russia prevent energy companies from cutting off their power. India's domestic retailers are wholly protected from foreign direct investment by global best-practice retailers.

*Countries follow **bad policies,** above all, because they benefit powerful or well-connected people*

In poor countries today, every domestic firm is a potential special interest that stands to lose from more competition. These unproductive firms' workers often think, mistakenly, that they too stand to lose. Certainly, the prospect of finding new work in an economy where most jobs pay near-subsistence wages is frightening. But to have healthy economies, countries must allow unsuccessful owners and managers to fail so that more productive ones can take their place. In that healthier economy, workers will find a better job market.

Think consumer

Undoubtedly, dismantling barriers to economic growth is difficult. Some firms must be allowed to go out of business, thus forcing workers to find new jobs. Industries must be opened to foreign competition, and the enforcement of tax codes and other regulations must be strengthened. And governments must stand up to special interests.

How can countries muster the political will to do all these things? The answer lies in focusing on consumers, not producers. Many people think that production itself creates economic value—an idea that sometimes makes governments protect businesses regardless of their performance. This approach is mistaken. Such people and governments fail to understand the link between production and consumption. Goods have value only if consumers want them. Otherwise sheer production does little to raise standards of living.

Most poor countries are far from having a consumption mind-set. Their governments and leaders, like those of the former Soviet Union, focus instead on output. A consumption mind-set requires some notion of individual rights, including the right to buy what you want from anybody who wishes to sell it to you. Consumers want to patronize companies that offer better products and services or lower prices. Those are the companies that survive if competition is equal. Thus, consumer interests are served when competition isn't distorted.

If policy makers in poor countries—and the many development experts who advise them—can accept this overlooked fact, those countries could unleash rapid growth. Only then will the shape of the global economic landscape begin to change for the better. Q

Bill Lewis, a McKinsey alumnus, was the founding director of the McKinsey Global Institute. This article was adapted from chapter 1 of his new book, *The Power of Productivity: Wealth, Poverty, and the Threat to Global Stability* (Chicago: University of Chicago Press, 2004).