
KEN ORVIDAS

Micro lessons for **Argentina**

Heinz-Peter Elstrodt, Pablo Ordorica Lenero,
and Eduardo Urdapilleta

In Latin America, macroeconomic reform isn't enough: sustained growth can be achieved only by removing microeconomic barriers to productivity as well.

Latin America appeared to make substantial progress in handling its macro economy in the 1990s. Following the emerging-market textbook for economic development, the region's major countries brought down inflation and public deficits, at least initially. Yet these efforts turned out to be superficial; sustained economic growth remained elusive. Mexico, Brazil, and now Argentina have lurched from one financial crisis to another.

There is little doubt that Argentina's collapse into economic chaos at the end of 2001 was caused in part by mismanagement of public finances. Less debated is the role of microeconomic factors, yet microlevel barriers were responsible for a failure to improve productivity and thus contributed to the country's eventual inability to sustain the peso peg against the dollar.

Good macroeconomic management is critical if an economy is to achieve a sustained increase in productivity—the key determinant of growth and wealth. Fiscal and monetary stability eases interest rates, makes investors more confident, and thereby helps companies raise their productivity. But stability isn't enough. Our microlevel analysis of several Latin American countries shows that sectors and companies within them perform very differently even under the same macroeconomic conditions.

Productivity problems are rife in Latin America. In Brazil, for example, the dairy industry's productivity stands at a mere 10 percent of the US level but the poultry industry at 80 percent, while individual institutions in the commercial-banking industry are 20 to 120 percent as productive as the industry's US counterpart. In Argentina, the residential-construction sector achieves only 26 percent of the US sector's productivity, though some individual companies boast as much as 52 percent. In meat processing, the average is 39 percent, with some producers at 69 percent.

Such differences in productivity among industries in the same country, and even the same industry, strongly suggest that nonmacroeconomic factors prevent inefficient companies from raising their productivity and productive companies from gobbling up inefficient ones.

Argentina is a good example of the inadequacy of pure macroeconomics. Besides pegging the peso to the US dollar at parity in 1991, the country lifted price controls and regulations on the movement of capital and embarked on a sweeping program of privatization, including mining, oil, telecommunications, transport, and utilities. In the beginning, these bold moves virtually eradicated inflation and pushed down interest rates; the fiscal deficit was brought under control, and interest payments on foreign debt became manageable. From 1990 to 1995, the country's GDP grew by 5.9 percent a year and labor productivity by 4.5 percent. The International Monetary Fund (IMF) hailed Argentina as the role model for reform in emerging markets.

Then things started to go wrong. In the second half of the decade, the growth of labor productivity slowed to 0.4 percent, contributing to the slide into recession in 1998. Tax revenues slumped while public spending continued to boom, debt obligations became increasingly hard to meet, and the currency peg came under pressure. By January 2002, Argentina had abandoned it and defaulted on government debt.

Barriers to productivity growth

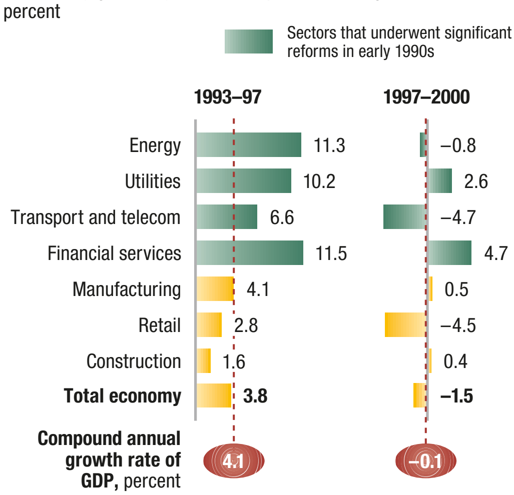
What happened to Argentina's nascent productivity miracle—if there ever was one? A detailed look shows that the productivity gains of the early 1990s were confined to newly privatized sectors. These gains, moreover, were largely one-off occurrences: multinational companies bought former state monopolies, drastically cut their inflated workforces, and brought in updated business practices and technology.

Other sectors, accounting for more than 80 percent of the country's GDP, achieved only slight productivity growth throughout the past decade despite vastly improved macroeconomic conditions (Exhibit 1). In 2001, before the most recent crisis, the overall productivity of Argentina's economy stood at just 32 percent of the US level compared with 29 percent in 1990—a modest achievement. Why?

EXHIBIT 1

The tango slows down

Productivity growth by sector, compound annual growth rate, percent



Source: Dirección Nacional de Cuentas Nacionales; McKinsey analysis

The components of improved productivity are well understood: greater scale, new technology, and better business practices and organizational structures. Only by analyzing each sector in detail is it possible to determine why some sectors or companies within them fail to become more productive. Such studies are rare, partly because analysis has traditionally focused on macroeconomics and partly because microlevel information is relatively difficult to find.

In the autumn of 2001, we looked at three of the biggest sectors of the Argentine economy: construction, food processing, and retailing. We analyzed in detail two stagnant subsectors: residential construction, which accounts for 4 percent of GDP and 5 percent of employment, and meat processing, one of the biggest areas of food processing and the key to Argentina's substantial beef exports.

In both subsectors, we found outdated business practices and a lack of scale, mainly as a result of two problems that are common throughout Latin America. The first is tax evasion, which penalizes bigger, law-abiding, and more productive companies and so prevents industry from consolidating. The second, a maze of sector-specific (and often overlapping) regulatory barriers on the national, provincial, and municipal levels, conserves anachronistic business practices and distorts competition (*see* sidebar, "Small is expensive," on the next page).

Residential construction

Argentina's residential-construction sector is a prime example of the way tax evasion and regulatory barriers distort competition and hinder productivity.

Small is expensive

We estimate that the ratio of taxes evaded to taxes collected in Argentina's hotel and restaurant sector comes to some 160 percent, meaning that for every $100 paid, $160 is evaded. The ratio is between 115 and 125 percent in textile and shoe manufacture, between 70 and 80 percent in retailing, between 70 and 80 percent in food processing, and between 50 and 60 percent in transport. Even in more formal sectors, such as teaching, health, and social services, tax evasion is in the 40 to 50 percent range—a significant barrier to productivity.

A 1998 McKinsey Global Institute (MGI) study of Brazil showed that tax evasion there gave traditional food retailers an edge while discouraging efficient volume traders.[1] In Brazil's construction sector, MGI found an inefficient two-tier system in which small subcontractors, hired by general contractors, employed most of the labor force, solely because subcontractors were good at evading taxes and therefore helped cut costs along the value chain.

In Argentina as in Brazil, we found a multitude of regulatory barriers that distort competition in favor of small, relatively unproductive companies. In the retailing of pharmaceuticals, for example, low productivity is ensured by such factors as zoning regulations, limits on over-the-counter sales, and a legal requirement that in certain jurisdictions owners of pharmacies must themselves have degrees in pharmacology and be present in their stores. This rule ensures that pharmacies remain small and prevents the emergence of more productive drugstore formats.

[1] *See* Martin N. Baily, Heinz-Peter Elstrodt, William Bebb Jones Jr., William W. Lewis, Vincent Palmade, Norbert Sack, and Eric Zitzewitz, "Will Brazil seize its future?" *The McKinsey Quarterly*, 1998 Number 3, pp. 74–91.

As a rule, it is far more cost-effective to build large-scale housing developments consisting of standard homes than to build the same number of customized homes, because the large-scale developer achieves economies of scale. Thus in a normal housing market, only affluent families can afford to buy plots of land and build customized houses. It is therefore a startling anomaly that some 85 percent of single-family homes in Argentina—not a particularly prosperous country—are custom-built. By stark contrast, in the far wealthier United States, 75 percent of all single-family homes are built in large-scale developments of 20 or more units.

A market distortion is clearly at work: in Argentina, a unique house costs no more to build than a standard one, though the labor productivity of a house in a large-scale development is double that of a single-plot house. Why are the normal laws of the market reversed? The answer is that by evading the value-added tax, or VAT (21 percent on materials and 10.5 percent on construction work), and labor taxes (around 20 percent on top of wages), small firms developing single-plot houses can compete equally with—or even outgun—large-scale developers who pay taxes.

The theoretical cost of building an average single-plot home in Argentina breaks down as follows: land, 14 percent; general-contractor profit and administrative expenses, 17 percent; project management, 3 percent; materials, 29 percent; labor and labor taxes, 22 percent; and other taxes such as VAT, gross-income taxes, and stamp taxes, 15 percent. In reality, however, smaller companies, which are harder for the tax authorities to track, can usually cut the overall cost to the tune of some 18 percent by evading their VAT, gross-income taxes, and stamp taxes completely and by paying, on average, no more than 50 percent of the labor taxes they owe. Small building firms typically declare only the proportion of their wage bill that they would pay under the required minimum wage. The rest they pay, in cash, under the table.

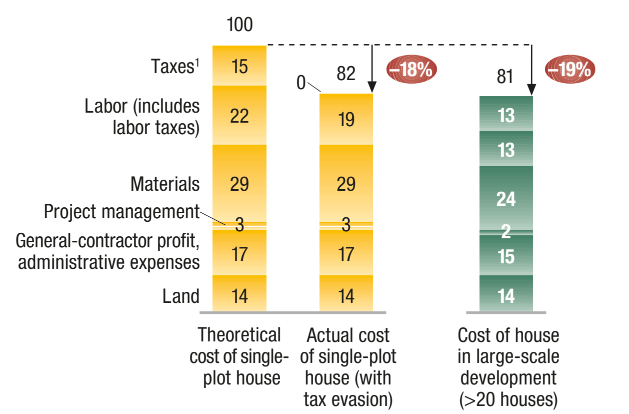
By spreading the architect's fee over a large number of houses, purchasing materials in bulk, and using equipment capacity more efficiently, the big developers can cut their overall costs by 19 percent. But their costs are only about equal to those of single-plot builders when tax evasion is taken into account (Exhibit 2).

Productivity in Argentina's highly fragmented residential-construction sector is only 26 percent of the US level: 29 square meters produced for every 1,000 person-hours, compared with 110 in the United States. We estimate that for every $100 in taxes paid in Argentina $175 is evaded and that the effects of tax evasion account for about 45 to 55 percent of the country's huge productivity gap with the United States. This high degree of tax evasion has intertwined macro- and microeconomic effects: it has a negative impact on Argentina's public finances—in itself a

EXHIBIT 2

Cheaper by the dozen?

Index: sale price of house = 100



[1]Includes value-added tax, income tax, and stamp taxes.
Source: Cámara Argentina de la Construcción; *Fiel*; McKinsey analysis

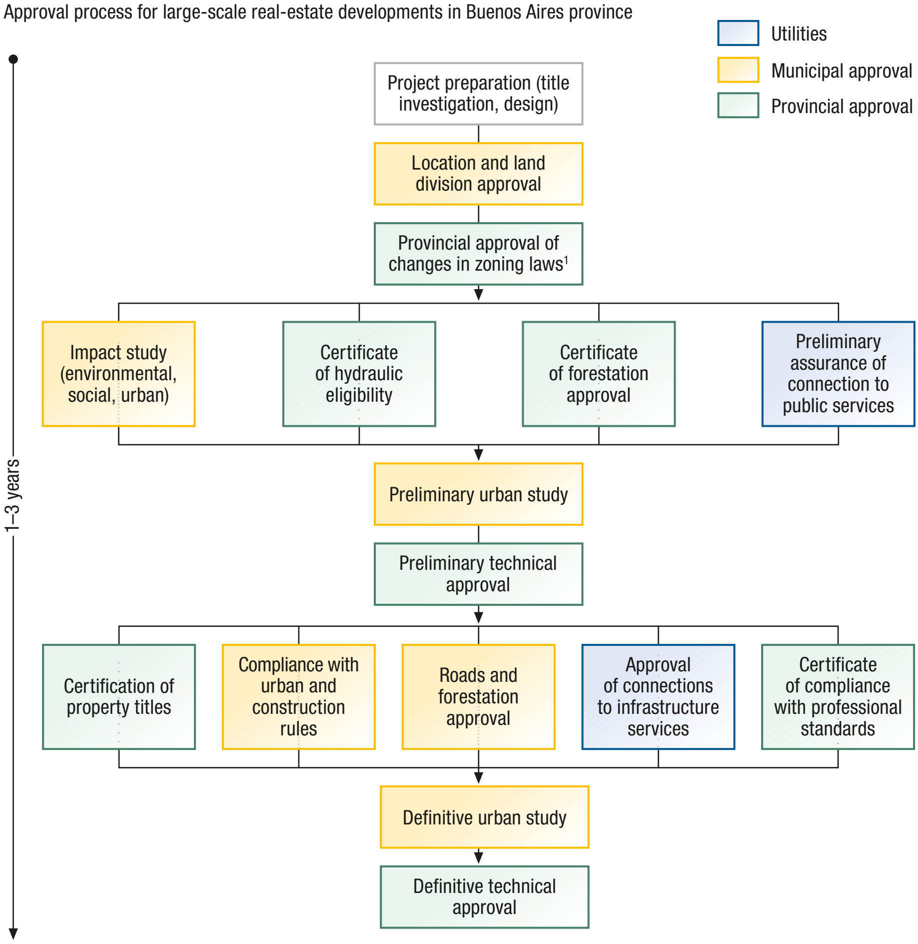
serious problem—so the government, desperate for revenues, compensates by imposing ever higher taxes on big law-abiding companies, thus distorting competition and raising a barrier to productivity.

An additional 10 to 20 percent of the productivity gap between Argentina and the United States, we estimate, results from red tape, which most developed economies have worked hard to make less burdensome. In Argentina, a slow and tortuous approval process hampers large building developments. In the province of Buenos Aires, for example, it can take up to three years for a developer to negotiate a path through a maze of overlapping municipal and provincial authorities (Exhibit 3). We interviewed one large-scale developer who sent in an application for a certificate of "hydraulic eligibility" (an

EXHIBIT 3

Borgesian bureaucracy

Approval process for large-scale real-estate developments in Buenos Aires province

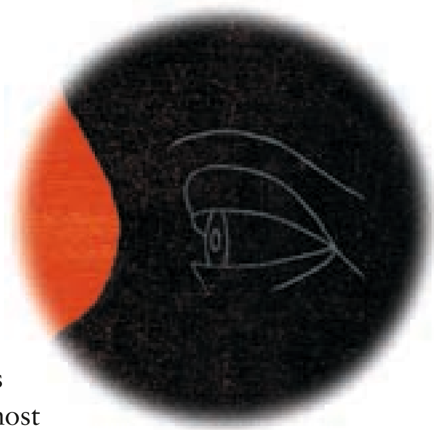


[1]Required only when projects change land use as determined by local zoning laws.
Source: Interviews; McKinsey analysis

assessment of flooding risks and other factors affecting the land's suitability for development) only to have the application returned unprocessed eight months later with a request for an additional signature. The signature was duly added, and the application took another eight months to be processed. Small-scale competitors don't have to go through the process at all.

Meat processing

The Argentine meat-processing industry is another prime example of rampant evasion of taxes and regulations throughout the value chain, and these evasions affect not only the productivity of this industry but also the efficiency of the retail sector. Meat processing is an important business, helping to deliver the traditional Argentine dinner—red meat and a freshly tossed salad—to domestic tables and accounting for around 4 percent of exports.



Workers in Argentina's fragmented meat industry process an average of 31 kilograms of meat per hour worked—39 percent of the US level. But large-scale Argentine slaughterhouses process some 150,000 head of cattle a year, almost five times the national average, achieving some 69 percent of US productivity. In this sector, scale is clearly important. The grisly process of preparing meat for the retail trade is twice as efficient on the slaughterhouse conveyor belt than in the butcher's shop, yet in Argentina an estimated 65 percent of all meat is sold in the form of half- or quarter-carcasses to butchers who do the rest of the work themselves.

In this sector, as in residential construction, large-scale, productive players find it hard to make headway in the market mainly because their smaller and less productive rivals evade taxes and regulations. The productive companies might potentially include the multinational food-processing groups that could make use of Argentina's cheap, plentiful land for rearing high-quality free-range cattle. Many multinationals have taken an interest in Australia, which like Argentina has an abundance of suitable land. But in Argentina, the industry has no foreign competitors at all.

We estimate that evasion of taxes and sanitary regulations explains about 50 to 60 percent of the Argentine industry's productivity gap with US industry. The evasion starts with the cattle farmers. Some 50 million head of cattle have their ownership registered with the Servicio Nacional de Sanidad y Calidad Agroalimentaria (SENASA), the national animal-health and food-control authority. Yet only 25 million are registered with the Administración Federal de Ingresos Públicos (AFIP), the country's tax collection agency! Clearly, most farmers want to monitor the health of herds but don't want to pay taxes on them.

The evasion continues in the next stage. After being rounded up by Argentine cowboys, or *gauchos*, around 75 percent of the animals are processed by midsize or large slaughterhouses certified by SENASA to sell carcasses and meat cuts to domestic and foreign wholesalers and supermarkets. The rest of them go to small slaughterhouses authorized by municipalities to operate locally. Municipally licensed slaughterhouses often contract with informal third-party buyers to slaughter cattle and sell half- or quarter-carcasses to neighborhood butchers.

Slaughterhouses licensed by the municipalities **generally evade** taxes and health regulations by dealing only with informal players

SENASA-certified slaughterhouses focusing on exports tend to play the game by the rules, paying taxes and meeting food quality rules. Other SENASA plants mostly adhere to food regulations but are not averse to tax evasion, accomplished, for example, by declaring the right number of cattle but hugely underestimating their weight. Municipal slaughterhouses tend to evade both taxes and health regulations by dealing only with other informal players—buying direct from the farmer and selling direct to the butcher.

Tax evasion affects the profitability of slaughterhouses dramatically. Large-scale meat processors use their scale to achieve *twice* the labor productivity of the smaller ones. Yet the price to consumers of meat produced by smaller firms is 10 to 15 percent *below* that of the large companies' meat. The reason for this startling statistic is the evasion of the 10.5 percent VAT by smaller firms, which tend to split the money they save with all of their partners along the chain, from farmers to purchasers of leather goods and butchers, who in turn split the savings with consumers.

Such evasion also favors fragmentation and inefficiency at the retail end of the chain. Small slaughterhouses sell to neighborhood butchers rather than supermarkets because the tax authorities don't closely monitor small butchers, who retail 60 to 70 percent of Argentine beef, though only 17 percent of other foods and beverages are sold through neighborhood grocers.

Small-scale processors also take advantage of the unequal imposition of sanitary regulations. Plants that are certified by SENASA are subject to dozens of mandatory controls and checks, which are strictly enforced and generally observed. Regulations for small municipally authorized plants are far more lax, and they are obeyed in a more cavalier way. Apart from the deleterious effect on food quality—including the spread of foot-and-mouth disease, which has been so damaging to the industry—this inequality of regulation hurts the competitiveness of the larger processors, adding to their administrative costs and therefore making it harder for them to make productive investments. This problem, we estimate, explains a further 10 to 30 percent of the productivity gap with the United States.

The industry's productivity is also hindered by overlapping layers of regulation. Many municipalities, eager to collect revenues and protect employment in local plants, levy additional sanitary fees—essentially a disguised tariff—on products already controlled and approved by SENASA. In the province of Buenos Aires, for example, a producer in San Isidro selling beef to a supermarket in Tigre may have to pay 6.8 cents a kilo when the shipment passes through San Fernando and then an additional 4 cents a kilo in Tigre. Fees are collected either on main roads accessing municipalities or at offices within them, and this delays distribution significantly (Exhibit 4). No sanitary inspection actually takes place.

Tearing down the barriers

Identifying obstacles to productivity in any one sector is obviously only a first step. The next is for national, provincial, and municipal authorities to launch short-term initiatives to remove the most damaging barriers. We have learned from experience that a program must be designed for the sector in which it will be applied; the "identikit" solutions that have been the norm in Latin American reform programs have proved ineffectual. Too often, the reforms of the past focused on big companies, which are not the

EXHIBIT 4

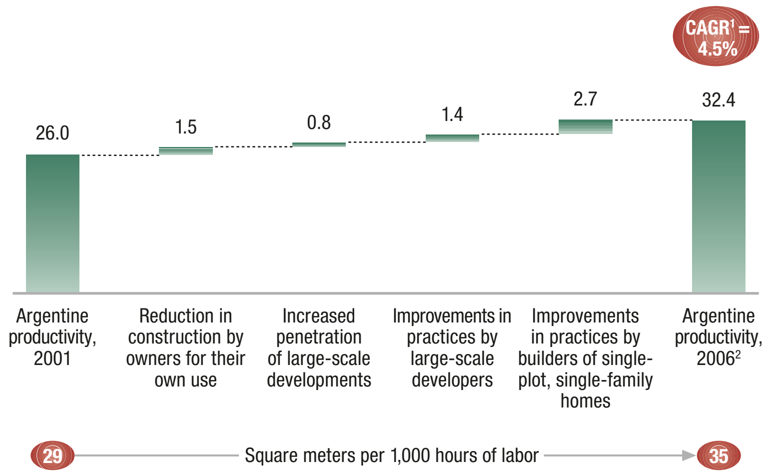
One inspection for the price of five

Fees collected by municipality, cents per kilogram	Tigre	San Fernando	San Isidro	Vicente Lopez	General San Martín
Dairy products	4.0	8.9	5.0	3.0	3.0
Beef	4.0	6.8	5.0	10.0	5.0
Chicken	3.0	8.9	5.0	10.0	5.0

EXHIBIT 5

A cause for optimism

5-year impact of removing barriers on residential-construction labor productivity, index: US = 100 in 2001



[1]Compound annual growth rate.
[2]Forecast.
Source: Interviews, McKinsey analysis

main problem, and largely ignored the different barriers and solutions in different sectors. It is hard, in the middle of a crisis, to envisage the right reforms being implemented. Nevertheless, they are much needed.

Simple things can be done. One way of tackling tax evasion in Argentina's construction sector, for example, would be to connect new homes to public utilities only if those homes were registered and if VAT payments and Social Security documentation were presented at the same time. To find solutions, the national, provincial, and municipal authorities would have to collaborate—for example, by jointly establishing a simplified process, with a six-month time limit, for approving large-scale building developments.

In the meat-processing industry, the government should establish national minimum sanitary standards for all slaughterhouses, regardless of size, and enforce these standards through efficient, integrated inspection teams, which could also simultaneously make sure that taxes were collected.

In the longer term, far more sweeping changes will be needed to tackle an entrenched pattern of tax evasion and excessive regulation in many sectors. But the sector-specific initiatives described here could in themselves have a significant impact on productivity if implemented quickly.

Our case studies suggest that improved tax enforcement and a streamlined approval process for large-scale developments could raise labor productivity in building to 32.4 percent of the US level, from 26 percent, within five years (Exhibit 5). This improvement would imply an annual 4.5 percent increase in the sector's productivity, compared with average growth of 1.1 percent in the 1990s, and over five years would be worth from $1.8 billion to $2.6 billion—1 percent of Argentina's annual GDP. In meat processing, the enforcement of taxes and the equalization of regulatory regimes could raise productivity to 60 percent of the US level, from 39 percent.

These significant numbers justify the effort of implementing the reforms. Of course, politicians in Argentina have their hands more than full with the current crisis. But even while pursuing the Holy Grail of macroeconomic stability, the governments of Argentina and other Latin American countries must pursue detailed, fact-based, and pragmatic microeconomic reforms. Otherwise, Argentina will continue to perform below its potential, and damaging crises will continue to be an inevitable feature of life there.

Heinz-Peter Elstrodt is a director in McKinsey's São Paulo office; **Pablo Ordorica Lenero** is a principal in the Mexico City office; **Eduardo Urdapilleta** is a principal in the Buenos Aires office.