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Fulfilling the promise of Latin America's cities

The region's prosperity depends on how its urban areas address economic and quality-of-life challenges.

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Latin America is a bright spot in the postrecession global economy, with growth rebounding strongly in much of the region. But to lengthen today's strides toward recovery into a sustained period of rising prosperity, it must take full advantage of its cities' economic potential.

The region is more urban than any other in developing markets, with 80 percent of its population living in cities, compared with about 50 percent in China. The shift from country to town has contributed much to Latin America's growth, as economies of scale have raised the productivity of expanding cities and reduced the cost of delivering their basic services.[1] Cities are critical to Latin America's overall economy.[2] The region's 198 large ones—defined as having populations of 200,000 or more—together contribute more than 60 percent of GDP. The 10 largest alone generate half of that output. Such a concentration of urban economic activity in the largest cities makes Latin America comparable to the United States and Western Europe in this respect but not to many other emerging regions. China's top ten cities, for instance, contribute around 20 percent of the nation's GDP.

Given the prominence of cities in Latin America's economy, fulfilling their economic potential is a key to sustaining growth in the region as a whole, according to new research by McKinsey's Latin America office and the McKinsey Global Institute (MGI).[3] Yet Latin America has already won a large share of the easy gains from expanding urban populations. Many of the largest cities are grappling with traffic gridlock, housing shortages, and pollution. To sustain growth, these cities must address challenges not only to their economic performance but also to their citizens' quality of life, to environmental sustainability, and to the strength of their finances and governance.

The relative youth of Latin America's population makes transforming the region's urban economies even more urgent. In marked contrast to Japan and Western Europe—as well as to some developing regions, including China and Eastern Europe—Latin America's working-age population is projected to expand steadily until it peaks, in the 2040s, at around 470 million potential workers. That will be 30 percent more than the region had in 2007 and a net increase of 85 million, equivalent to three-quarters of today's labor force in the United States or Western Europe.

This expansion offers Latin America a significant demographic dividend if its economies can grow sufficiently to generate enough high-productivity jobs for a large, young workforce—much of it in urban settings. Employed productively in a dynamic, job-creating

[1] In contrast, McKinsey Global Institute (MGI) research finds that urbanization will continue to be a major source of growth in China and India, which are both at earlier stages in their urbanization. See the MGI reports *Preparing for China's urban billion* (February 2009) and *India's urban awakening: Building inclusive cities, sustaining economic growth* (April 2010), available free of charge online at mckinsey.com/mgi.

[2] Our analysis covers entire metropolitan areas, which we name by their core cities.

[3] The full MGI report, *Building globally competitive cities: The key to Latin American growth*, is available free of charge online at mckinsey.com/mgi.

economy, young workers could create the wealth on which future investment and sustained growth depend. But a failure to create attractive opportunities in the formal sector would mean that informal or even illegal activity might become more likely for young people seeking to provide for themselves and their families.

By the second half of this century, Latin America's demographic profile will look more like Europe's, with the proportion of the population that's economically active not only shrinking but also having to provide for the growing proportion of older people. Unless Latin America's policy makers, businesses, and civil societies take steps to reform and develop their cities and create more productive jobs in the formal economy, the region runs the risk of growing old before it grows rich.

The key role of cities

Latin America's 198 large cities are expected to generate 65 percent of the region's growth over the next 15 years, MGI estimates—equivalent to about 6 percent of projected global GDP growth, as well as more than 1.5 times the contribution expected from Western Europe's large cities and similar to the level anticipated from India's.

However, in many of Latin America's top ten cities—those most critical for the economy—the rate of economic growth has declined since the era of rapid urbanization, roughly the half century from 1920 to 1970. Since then, growth rates in Brazil's São Paulo and Rio de Janeiro have dropped from above the national average to below it. Other leading cities in the region have also recently grown more slowly than the "middleweight" cities, which we define as those with populations of 200,000 to 10 million. Mexico City's metropolitan region, for instance, has posted a slower pace of growth than the average of Mexico's 45 middleweight cities.

Many of the region's top ten have started to run up against capacity constraints as urban management struggles to keep pace with the demands of expanding metropolitan regions that have swallowed up smaller towns that neighbor them but are outside their jurisdiction. The resulting fragmented political boundaries have often spread urban- management responsibilities—including economic development and housing—among mayors and officials in multiple municipalities, state governments, and federal institutions. Planning and policy have often been uncoordinated and funding hasn't been sufficient to meet growing needs. Many cities have outgrown the capacity of their infrastructure, the design of their transportation systems, and their ability to deliver adequate public services, making it difficult to get things done efficiently and effectively.

As a result, cities are not generating enough high-productivity jobs to employ an expanding labor force and have thus raised informal economic activity to damagingly high levels.[4]

[4] The region's regulatory environment, including inflexible labor regulations and costly red tape, also contributes to the region's high rate of informality. See the MGI reports *How Brazil can grow* (December 2006) and *New horizons: Multinational company investment in developing economies* (October 2003), available free of change online at mckinsey.com/mgi.

Unless the very largest cities significantly increase their productivity and the number of jobs they generate in the formal economy, as well as boost the efficiency of their operations and management, MGI expects their growth rates to remain below the average for the region's large cities. That could drag down Latin America's overall rate of growth.

Where to respond

Latin America's political and business leaders must act decisively on two fronts to improve the performance of the region's cities and turn its demographic profile to advantage: reforming and upgrading the largest cities and helping a broader group of high-performing middleweight ones to emerge.

First, to understand how Latin America's largest cities might improve, MGI has assessed the performance of eight of the top ten: in descending order of GDP, São Paulo, Mexico City, Buenos Aires, Rio de Janeiro, Lima, Bogotá, Santiago, and Monterrey. The assessment is based on 100 quantitative indicators along the four dimensions that interact to generate urban economic growth: economic performance, social conditions, sustainable resource use, and finance and governance. MGI has collated the results of this analysis in an Urban Performance Index (UPI), a proprietary benchmarking tool designed to compare the performance of cities.

Many Latin American cities lag behind others around the world and in their region on these four dimensions. Rio de Janeiro, for example, trails its regional peers, particularly in economic performance. Monterrey performs relatively strongly across all dimensions except sustainable resource use.

But our analysis also finds some examples of promising performance among the top cities. In Mexico, the technology cluster around the Tecnológico de Monterrey System has strengthened collaboration between academia and business. More broadly, Monterrey's per capita GDP has grown 40 percent faster than Mexico's in the past ten years, and the city also has Latin America's lowest share of population (4 percent) living below the poverty line. Bogotá and Buenos Aires stand out in health services: in each city, more than 90 percent of the population has health coverage, which is higher than the share of New Yorkers who have it (85 percent).

Alongside Latin America's largest cities, a broad base of high-growth middleweight ones has emerged. Today, 188 of them account for almost one-third of the region's GDP and could generate almost 40 percent of its GDP growth to 2025. These cities lag behind Latin America's largest urban centers in per capita GDP. However, the region's faster-growing middleweights will probably narrow most of that gap by 2025.[5]

[5] A number of factors are contributing to the faster expansion of midsize cities, including the end of centralized import substitution policies that favored capital cities and the recent resource boom favoring many emerging regions.

Middleweight cities that can provide an efficient environment attractive to businesses and skilled workers will not only boost their growth significantly but could also become the model for a better-designed and more sustainable urban future for Latin America. Promising examples of middleweight cities introducing innovative policies and management include Curitiba and Florianópolis (Brazil), Medellín (Colombia), Panama City (Panama), Toluca and Mérida (Mexico), and Viña del Mar (Chile).

How to respond

New approaches to managing Latin American cities would help them realize their economic potential and provide a good quality of life for citizens. Managers of cities can choose practical options to improve their performance on each of the four dimensions that together make them dynamic, safe, and prosperous.

Economic performance

While national policies—including regulation—significantly influence how cities are run, local policy choices are also very important to their economic performance. To underpin a stable environment conducive to strong local economic development, city policy makers should consider prioritizing these issues:

Transparent land ownership and zoning regulation. When businesses consider where to locate, critical factors include the regulatory framework governing land titles and ownership transfers. Uncertainty about these or zoning regulations can translate into high costs for "titled" land and discourage global businesses from investing.[6] In many Mexican cities, for instance, ambiguous land ownership continues to inhibit long-term investment because untitled land or buildings cannot be used as collateral for mortgages.

Reliable urban infrastructure. Chronically underfunded public utilities in many of the region's cities have led to unreliable and often costly public services. Every winter, for example, Argentina has severe electricity shortages, which many analysts blame on heavily regulated utility tariffs. Since the government froze them in 2001, private utility companies have limited maintenance and investment in unprofitable new capacity. Latin American cities need to step up investments significantly not only in energy supply but also in transport, housing, power, water, and waste management to avoid bottlenecks and capacity shortfalls.

Intercity transportation networks. In Asia, regional production locations are closely connected to one another within global value chains, but Latin American cities in different countries rarely have strong transport and trade links. In fact, many of these cities have better flight connections to the United States and even Europe than to one another. If they

[6] Harvard University economics professor Edward Glaeser has shown how high levels of land and housing regulation can help explain differences in city growth patterns in the United States via inelastic housing supply and therefore higher housing prices. See Edward L. Glaeser, Joseph Gyourko, and Raven E. Saks, "Urban growth and housing supply," Harvard Institute of Economic Research discussion paper, Number 2062, February 2005.

were better connected, they (like close-knit Asian production hubs) could benefit from collective economies of scale and opportunities for complementary specialization.[7] This could help change the region's economic dynamics.

Social conditions

An urban environment that attracts and retains skilled people and improves the well-being of its citizens will lure businesses looking to invest.

Public safety. In many Latin American cities, public safety is a serious issue. Cities looking for ways to improve theirs might examine New York's experience. In the 1990s, the New York Police Department implemented a seven-pronged strategy to reduce crime rates. The result has been a decrease in the number of homicides each year, from 2,420 in 1993 to 1,550 in 1995 and 778 in 2009.

Accessible housing. Good planning that reduces commute times improves the quality of life for urbanites and increases productivity by cutting fuel consumption and time spent in cars. Reorganizing the distribution of living and working districts is a challenge in most of the region's urban areas, however. Mexico City, for instance, will probably have to shift from horizontal to vertical construction to meet its housing needs.[8] The city must relocate population from the periphery to the center and thus increase its urban density to use existing infrastructure, such as mass transit, more efficiently. Harmonizing municipal land laws and regional transport projects with housing policy is crucial.

Efficient public transportation. Improving the capacity, efficiency, and cost effectiveness of urban transportation is a major challenge, but again the region has examples of best practice. In Curitiba, 54 percent of all journeys are on public transport—that's 1.3 million passengers a day. In addition, the city has a per capita GDP 1.4 times Brazil's average, a lower unemployment rate than the country as a whole, and 55 square meters of green space per resident (compared with the World Health Organization's recommended area of 16 square meters).[9]

High-quality education. For both economic and human-welfare reasons, cities should continue to make extending access to education a priority. Santiago, after significant efforts to improve its school system, boasts the highest OECD Programme for International Student Assessment (PISA) results among its regional peers in our Urban Performance Index (UPI). Santiago's initiatives include an extended school day and an

[7] For the consumer electronics analysis, see the MGI report *New horizons: Multinational company investment in developing economies* (October 2003), available free of charge online at mckinsey.com/mgi.

[8] Declining household size means that demand for dwellings and other household-driven goods and services is growing fast—MGI estimates that by 2025, São Paulo will need almost four million new dwellings, while Bogotá's housing demand will nearly double.

[9] For more detail, see Alicia Fazzano and Marc A. Weiss, *Curitiba, Brazil: Metropolitan Economic Strategy Report*, Global Urban Development, July 2004.

innovative certification program that encourages higher quality and constant improvement in the teaching profession. Chile's teacher certification system varies pay according to performance.

Public–private partnerships to improve access to public services. When the management and financing of the public sector fall short, public–private partnerships are an attractive way to improve urban services. Latin America has innovative examples, including Colombia's Vive Digital plan to quadruple broadband penetration, both fixed and mobile, in just four years.

Sustainable resource use

While densely populated urban centers are usually more environmentally efficient than dispersed ones or rural areas, most cities waste resources and generate unnecessary pollution because of poor management or misaligned incentives. Fortunately, cities have proven, cost-effective opportunities to incorporate environmental sustainability in their economic- and social-development plans.

Improve energy productivity. Cities should manage demand for resources rather than focus on building a (much more costly) new supply infrastructure to keep pace with unchecked demand. The key is to boost the level of output achieved from the energy consumed—that is, energy productivity.[10] To reap its full benefits, cities need to impose energy use standards and to offer incentives, backed by rigorous monitoring and enforcement, for reducing wasted energy.

Cities can set energy efficiency standards through building regulations, including codes requiring improved insulation, or by requiring energy-efficient lighting in new buildings. They can use incentives to encourage investment in energy-efficient industrial appliances, equipment, and lighting, as well as improved fuel efficiency in car fleets. By boosting energy productivity, Latin America's cities would generate positive returns from future energy savings and free up resources to invest elsewhere.

Set green standards for urban demand. Collaboration among the region's cities is another untapped opportunity. As bulk buyers of a broad range of goods and services, they could use their collective buying power to foster green standards. Cities that pool purchases from a supplier could both reduce their costs and increase demand for new technologies and solutions, incubating the growth of local suppliers and promoting green standards. Latin America has many examples of such initiatives. The Plan Verde in Mexico City has already

[10] For a full analysis of energy productivity and the investment needed to capture available opportunities, see the MGI reports *Curbing Global Energy Demand Growth: The Energy Productivity Opportunity* (May 2007) and *The Case for Investing in Energy Productivity* (February 2008), available free of charge online at mckinsey.com/mgi.

reduced the city's carbon emissions by almost six million metric tons (10 percent) since 2008 through measures such as upgrading the city's public transit and taxi fleet to newer, more fuel-efficient vehicles and reducing the sulfur content of gasoline.

Improve urban distribution. The inefficient distribution of goods around Latin America's cities contributes significantly to air pollution. Their travel and distribution infrastructures have failed to keep pace with growth, a pattern not uncommon in large cities around the world. Our analysis finds that traffic congestion and the carbon dioxide emissions of trucks could fall as much as 30 percent—at very low cost—by making the distribution of goods more operationally efficient.[11]

Make waste management profitable. Most waste-management systems in Latin America are ineffective because they neither encourage the public to reduce waste (by charging for the weight or number of bags) nor treat it sustainably. Most of it ends up in landfill sites, some of which are approaching full capacity. Solving this issue is not a simple task, but local government can act to promote the reduction, reuse, and recycling of waste.

Sound urban governance

Cities are highly complex to run. Their day-to-day management depends on strong leadership, effective and systematic urban planning to make the most sensible use of scarce resources, and sound finances.

Long-term planning and coordination. Many Latin American cities don't have a single governing body that is both responsible and accountable for results. Rather, they have a fragmented management structure that splits responsibilities among the various layers of governance (city, county, state, and federal) and among different authorities for specialized services, such as housing or transportation. Lack of coordination among all these components of urban governance exacerbates inefficiency and wastes resources. Integral planning that resembles its private-sector counterpart and includes rewards tied to achieving goals lies at the core of a new approach being adopted in Latin America. Rio de Janeiro, for example, has given the mayor's staff a set of financial and nonfinancial incentives to achieve success in 50 initiatives in four categories—economic, political, social, and environmental.

Sustainable, responsible fiscal management. A low rate of overall investment has chronically impeded the region's growth, particularly in cities, which should build infrastructure ahead of, rather than behind, the curve of demand. The main sources of revenue to finance it include higher property taxes, charges from users of publicly funded

[11] Cities as diverse as Kuala Lumpur (Malaysia) and Bristol (England) have pioneered cross-industry collaboration for distribution. They rely on cross-docking facilities on the city outskirts, from which logistical companies deliver goods in full trucks to specific urban locations. The benefits go far beyond the companies, since limiting the number of slow delivery trucks reduces the number of traffic jams—and thus time and gasoline costs—for citizens and companies alike.

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services, and public–private partnerships that mobilize capital from both sides and exploit the private sector's experience in using resources efficiently and minimizing risks. When public funding is insufficient, such partnerships can be an attractive alternative for financing and running infrastructure projects. Santiago—and indeed Chile, more broadly—has a number of sophisticated public–private partnerships for investments in highways, airports, stadiums, and even emergency services.

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MGI has drawn on tried and tested success stories from Latin America and around the world to identify tangible actions the region's urban leaders could take to address the most important issues they face. McKinsey's experience shows that effective policies can turn around a city's fortunes, sometimes in only ten years. If the number and productivity of urban jobs improves in cities of all sizes, Latin America's young population can help to fuel growth in the long term.

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