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How governments in emerging economies can help boost and sustain growth

A focus on public-sector efficiency and competitive dynamics for companies are keys to outperformance.

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Governments in emerging economies have, over the decades, tried many different policy agendas to stimulate development, accelerate growth, alleviate poverty, and achieve any number of other goals to mixed success. After studying emerging economies' performance over 50 years, we find that countries tend to achieve the strongest and most consistent growth when they have adopted measures to improve their own effectiveness and encourage vibrant competition that enables the rise of strong companies that drive growth. This growth in turn has contributed to massive improvements in social indicators with more than one billion people lifted out of poverty since 1990.

In 2018, the McKinsey Global Institute (MGI) looked at the GDP per capita track record of 71 emerging economies over 50 and 20 years and identified 18 that outperformed the others. Seven long-term outperformers achieved or exceeded real annual per capita GDP growth of 3.5 percent from 1965 to 2016, while 11 recent outperformers achieved per capita growth of at least 5.0 percent over the 20 years ending in 2016.[1]

The 53 other developing economies studied fell into one of two other categories: 39 were middling economies that made less or inconsistent improvement in per capita GDP relative to the United States from 1965 to 2016, and the remaining 14 were underperformers that lost ground to the United States on per capita GDP over those same 50 years. The exhibit highlights the correlation among outperformance, and improvement in government effectiveness (as measured by the World Bank), regulatory quality, and the rule of law. (For the full report, see "Outperformers: High-growth emerging economies and the companies that propel them," McKinsey Global Institute, September 2018, on McKinsey.com.)

In this article, we focus on government actions that contributed to outperformers' economic growth and how governments can sustain that support.

Macroeconomic policies may be the first tools countries consider when they want to accelerate economic growth, and they are important. But other useful levers have received less attention. Outperformers became outperformers in part by focusing on improving government productivity and creating a very competitive business environment that spurs companies to improve their productivity as well. While the specific means to achieve these goals may change—after all, the global economy is continually reshaped by more sophisticated automation, shifting trade patterns, and changing demographics—innovative governments and competitive companies can find a way to move forward.

Governments in outperforming economies tend to be more open to experimenting with new approaches to markets and regulations by using pilot programs to test new ideas in a variety of contexts, modifying them as necessary, and then scaling up policies that work.

Many governments have established their own delivery labs and delivery units to test new approaches to delivering services. China famously used special economic zones to test policies before introducing them broadly. The Monetary Authority of Singapore uses a "regulatory sandbox" to relax regulations temporarily for select private-sector players to encourage innovation in fintech. Some nongovernmental groups, such as the Abdul Latif Jameel Poverty Action Lab in Cambridge, Massachusetts, work with governments on randomized control trials, in which the efficacies of interventions are tested and evaluated like science experiments.

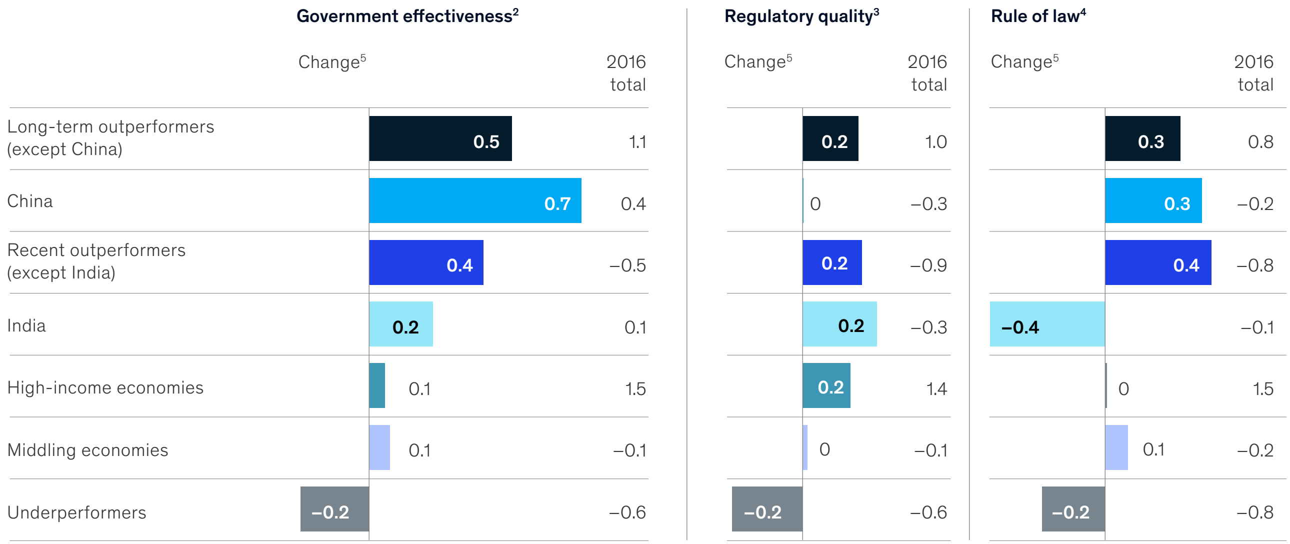
Governments have also worked to improve the capabilities of the public sector, including by hiring better government clerks, inspectors, and regulators and seeking innovative ways to train them. For example, South Korea invested in sending civil servants abroad to learn from those

[1] China, Hong Kong, Indonesia, Malaysia, Singapore, South Korea, and Thailand achieved the 50-year threshold; Azerbaijan, Belarus, Cambodia, Ethiopia, India, Kazakhstan, Laos, Myanmar, Turkmenistan, Uzbekistan, and Vietnam reached the 20-year goal.

Exhibit

Outperforming developing economies improved policy and institutional effectiveness.

Worldwide Governance Indicators score,[1] absolute change from 1996 to 2016



[1] Simple average across archetypes. Scores range from approximately –2.5 (weak) to 2.5 (strong).
[2] Reflects perceptions of quality of public services, quality of civil service and degree of its independence from political pressures, quality of policy formulation and implementation, and credibility of government's commitment to such policies.
[3] Reflects perceptions of government's ability to formulate and implement sound policies and regulations that permit and promote private-sector development.
[4] Reflects perceptions of extent to which agents have confidence in and abide by rules of society (in particular, quality of contract enforcement, property rights, police, and courts) and likelihood of crime and violence.
[5] Shows only the difference between 1996 and 2016. Does not reflect any decline early in that period or steady score more recently.

Source: US Federal Highway Administration; McKinsey analysis

in several highly regarded countries, while China systematically rotates promising bureaucrats by function and geography.

Outperformers' enthusiasm for experimentation grows out of the realization that public-sector implementation and accountability are important to building a stronger economy and promoting a pro-growth agenda of productivity, income, and demand. That agenda includes government efforts, such as mandatory contributions to pension plans, to encourage domestic capital accumulation and reduce dependence on more volatile foreign capital.

Just as important are government policies to foster competition within sectors. While some assert that problems like higher regulatory barriers to entry, corruption, cronyism, and fragmented markets make developing economies less competitive than their high-income counterparts, we find that emerging economies can be highly competitive environments and this competitiveness contributes to their success in developing corporate leaders. Outperforming emerging economies have about twice as many large companies (defined as public companies with annual revenues of at least $500 million) as other emerging economies relative to the size of their economies: just over 160 companies per $1 trillion of GDP in 2016 versus 80 companies in non-outperforming peers and 95 in high-income countries.

With so much competition in outperforming economies, companies that reach the top of their sectors find it difficult to stay there. In those economies, only 45 percent of the companies that reached the top quintile by measure of economic-profit generation between 2001 and 2005 managed to stay in place for a decade, according to our analysis. In high-income economies, 62 percent stayed on top in the same decade.

Amid an environment of such contested leadership, big companies in outperforming economies are motivated to grow rapidly and improve productivity by adopting new technology, innovating, experimenting, and sharpening their competitive edges against local rivals, then expanding internationally. As a result, their revenue relative to GDP almost tripled from 22 percent between 1995 and 1999 to 64 percent between 2011 and 2016, and their contribution of value added to national GDP also grew rapidly, from 11 percent in 1995 to 27 percent in 2016—or double the share among non-outperforming emerging economies.

Governments can stimulate economic growth in many other ways. Companies in many outperforming economies face fewer regulatory and tax barriers compared with companies in other countries. This, in turn, encourages business creation and improved efficiency. According to data from the World Bank Enterprise Survey, companies in outperforming economies are less likely than those in other developing economies to consider tax management a major obstacle (9 percent of respondents versus 23 percent). Similarly, fewer companies in outperforming economies reported customs delays and trade barriers (9 percent versus 16 percent) that could hinder exporting and importing activities. Senior managers in other developing economies report spending 11 percent of their time on government regulatory issues, while their peers in outperformer economies say they spend only 5 percent.

Outperformers have changed the global economy in recent decades, becoming main drivers of global growth and consumption. While congratulations are in order, complacency is not. Even top-performing regions have room for improvement, and all countries will face new challenges as the global landscape evolves. Yet the examples of the outperformers indicate there is still opportunity for those willing to innovate and reform. For the sake of their own society and the global economy, business leaders and policy makers must seize that opportunity.

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