

2. Fostering Growth through Business Dynamism¹

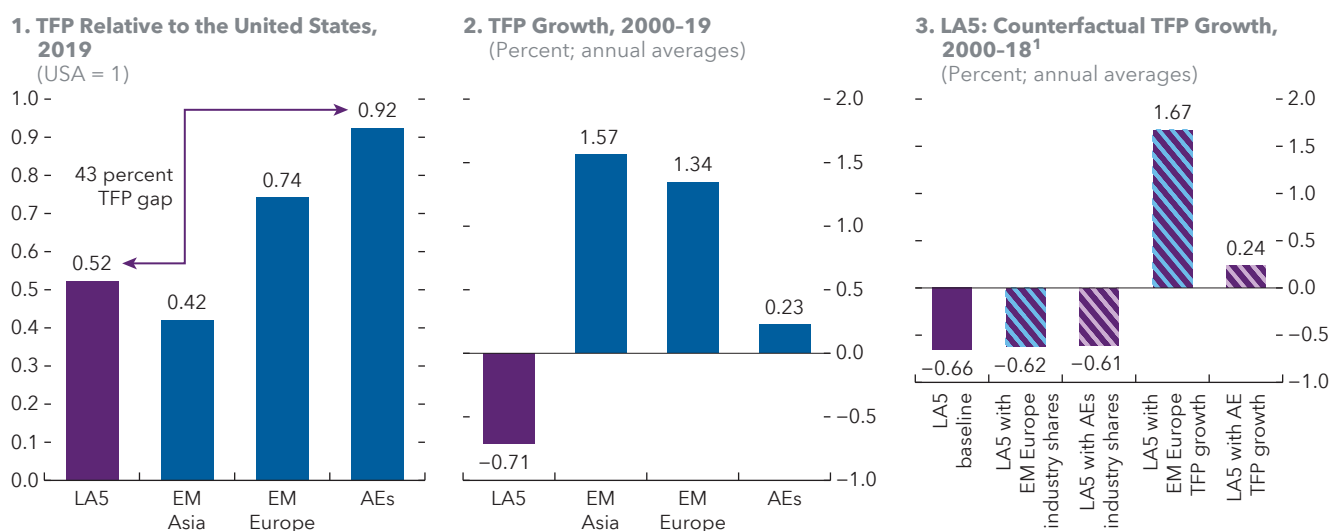
Low productivity has weighed on Latin America’s growth over the past decades, in part attributable to persistent resource misallocation and sluggish productivity growth among firms, constraining the region’s ability to foster growth. Addressing these challenges requires reforms targeting core frictions, including size-based regulations, financial constraints, and limited market competition. Successful reform efforts in other regions offer valuable guidance to reinvigorate productivity and enhance business dynamism.

2.1 Introduction

Latin America’s (LA) weak productivity performance remains a major constraint on the region’s income convergence with advanced economies (AEs). Despite periods of strong capital accumulation and labor force expansion, the region has struggled to achieve sustained convergence with AEs, unlike other emerging market economies (EMs) that are gradually closing the productivity gap with AEs (Figure 2.1, panels 1 and 2).

At the heart of this underperformance is a dual productivity challenge: low *levels* of total factor productivity (TFP) and persistently weak TFP *growth*. These challenges reflect, inter alia, resource misallocation and associated sluggish firm-level productivity gains. Persistent misallocation, where resources are not allocated toward more productive firms, can constrain not only aggregate productivity but also firms’ incentives and ability to make

Figure 2.1. Latin America’s Dual Productivity Challenge: TFP Levels, Growth, and Sectoral Gaps



Sources: IMF, World Economic Outlook database; EU KLEMS database (Bontadini and others 2023); LA KLEMS database (Gu and Hofman 2021); national authorities; Penn World Table 10.01 database; and IMF staff calculations.

Note: Aggregates are purchasing-power-parity GDP-weighted averages. Regional groupings use 2005 *World Economic Outlook* classification. Countries are abbreviated using International Organization for Standardization (ISO) country codes. AEs = advanced economies (AUT, BEL, DEU, DNK, FIN, FRA, GRC, ITA, JPN, LUX, NLD, NOR, ESP, SWE, GBR, USA); EM = emerging markets; EM Asia = IDN, IND, MYS, PHL, THA; EM Europe = CZE, EST, LTU, LVA, SVK, SVN, POL, ROU; LA5 = Latin America 5 (BRA, CHL, COL, MEX, PER); TFP = total factor productivity.

¹Excludes EM Asia and some countries (NOR, POL, ROU) because of data availability. No data are available for 2019.

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productivity-enhancing investments. Moreover, high-productivity firms consistently face barriers to expansion, barring them from scaling up to a more efficient size. Low-productivity firms, on the contrary, remain active for too long. Misallocation also inhibits the shift of resources across firms. Jointly, these margins hold back productivity growth in LA.

The region's productivity underperformance extends across all sectors of the economy. It does not appear to be driven by the sectoral composition of the economies (for example, predominance of sectors characterized by sluggish productivity growth). For instance, if the sectors could have achieved productivity growth rates comparable to those in peer EMs, LA's performance could significantly improve (Figure 2.1, panel 3; see Online Annex 2 for methodology).

Understanding these challenges is essential for formulating effective policy responses. This chapter explores why productivity remains low in LA, which margins are holding back productivity growth, what kind of structural frictions are behind these margins, and what policies could unlock higher productivity growth.² It contributes to the literature by examining how business dynamism—productive firms' growth, efficient resource reallocation, and entry and exit—can enhance productivity and foster a more competitive economy (Banerjee and Moll 2010; Busso and others 2012; Hsieh and Klenow 2014; Hsieh and Olken 2014; Camacho and others 2024; Eslava and others 2024; Fentanes and Levy 2024; Amundsen and others 2025).

2.2. A Deeper Understanding of the Dual Productivity Challenge

Assessing the drivers of LA's productivity challenges requires connecting aggregate trends to the underlying dynamics using firm-level data. This section decomposes the TFP level and its growth rate into underlying drivers, with resource misallocation and low firm-level productivity growth emerging as important contributors.

Resource Misallocation Contributes Significantly to Low Total Factor Productivity Levels

TFP can be constrained by low firm-level productivity and by misallocation of resources across firms. Although TFP naturally increases when countries host many high-productivity firms, these firms can only scale to efficient size when they have access to adequate production resources. In a frictionless economy, inputs such as labor and capital flow freely toward their most productive use at firms with the highest marginal returns, thereby maximizing aggregate output. However, frictions—such as credit constraints or regulatory barriers—can disrupt this process, leading to resource misallocation that reduces aggregate productivity. These frictions create “wedges” between firms' marginal benefit and costs from additional inputs, preventing high-productivity firms from expanding and allowing low-productivity firms to retain resources.

Hsieh and Klenow (2009) provide the canonical measure of misallocation by analyzing differences in revenue-to-input ratios across firms. In the case of optimal resource allocation, these ratios should be similar. When these ratios differ, their dispersion across firms indicates that some firms are using inputs more efficiently than others but are not receiving enough resources. Therefore, reallocating inputs from firms with low revenue-to-input ratios (less productive use) to those with high ratios (more productive use) would increase aggregate output without additional inputs. Formalized in a general equilibrium framework, this insight enables the calculation of aggregate allocative efficiency—the ratio of actual TFP to a benchmark without variation in revenue-to-input ratios—and thereby the estimation of the TFP loss from misallocation (for further details, see Online Annex 2).

² This topic has been extensively analyzed within the IMF and across other policy institutions. See, for example, Goncalves (2018), IDB (2018, 2024), David and others (2021), Acosta-Ormaechea and others (2022), Arena and Chau (2024), and Bakker and others (2024).

Empirical estimates show that misallocation imposes significantly higher TFP costs in LA than in AEs.³

- Misallocation in manufacturing reduces TFP in LA3 (Brazil, Colombia, Mexico) by 18 percent below potential. This reduction is substantially higher than the 12 percent gap in emerging Asia and Europe and the benchmark of AEs, which exhibit significantly lower misallocation levels (Figure 2.2, panel 1).
- Misallocation is consistently higher than in AEs across all sectors (Figure 2.2, panels 2 and 3).
- From 2005 to 2021, misallocation increased in EMs but declined slightly in AEs (Figure 2.2, panel 4).⁴
- Misallocation of variable inputs—such as labor and intermediate goods—accounts for over 95 percent of the overall TFP loss in LA and other EMs (Figure 2.2, panel 5).⁵

Addressing misallocation challenges could reduce the overall TFP gap relative to AEs by more than one-third. Achieving convergence to levels of misallocation observed in AEs (that is, increasing the region's TFP by 16 percent in Figure 2.2, panel 3) would close 37 percent of the region's current productivity gap with AEs (estimated at 43 percent in Figure 2.1, panel 1), presenting a substantial gain for the region.

Frictions are particularly severe for high-productivity firms (Figure 2.2, panel 6; Restuccia and Rogerson 2008). These firms face greater exposure to frictions—for example, because of increasingly binding constraints in terms of access to finance, regulatory burdens, or market access—often limiting their growth (Ayerst and others 2024).⁶ Although this pattern is observed globally, it is more pronounced in LA, arguably because of deeper institutional and market frictions. As a result, high-productivity firms remain smaller than optimal, which can also help to explain why large firms in LA account for a relatively smaller share of total employment compared to AEs.

Firms Improve Their Productivity Less in Latin America

TFP gaps have been persistent amid low productivity growth, which can be decomposed into contributions from surviving firms and from firm entry and exit (Griliches and Regev 1995; Melitz and Polanec 2015).⁷ Surviving firms—that is, operating throughout the relevant time-window—contribute through two channels: improvement of firms' productivity and reallocation of resources toward more productive ones. Entry contributes positively when new firms are more productive than surviving firms, whereas exit does so when exiting firms are less productive.

Slow productivity growth among surviving firms is the main drag on TFP growth in LA3 (Figure 2.3, panel 1). For the 2005–19 period, average TFP growth in LA3 was –0.7 percent, with a 0.9 percent contribution from firm entry and exit, and a –1.5 percent contribution from surviving firms. The firm entry and exit margins contributed equally, reflecting strong selection dynamics—new entrants are generally more productive than surviving firms, whereas exiting firms are significantly less so—attenuated by low entry and exit rates. This may reflect higher entry and exit barriers, leading to stronger selection at low rates.⁸ Although LA's entry and exit margin outperforms

³ Estimates are based on firm data from the Orbis dataset adjusted for sampling differences across countries with observation weights constructed from the World Bank Enterprise Surveys. The sample covers 2005–21. Estimates for LA are based on data for Brazil, Colombia, and Mexico. See figure footnotes for other regions and Online Annex 2 for details on the data construction and implementation of Hsieh and Klenow (2009).

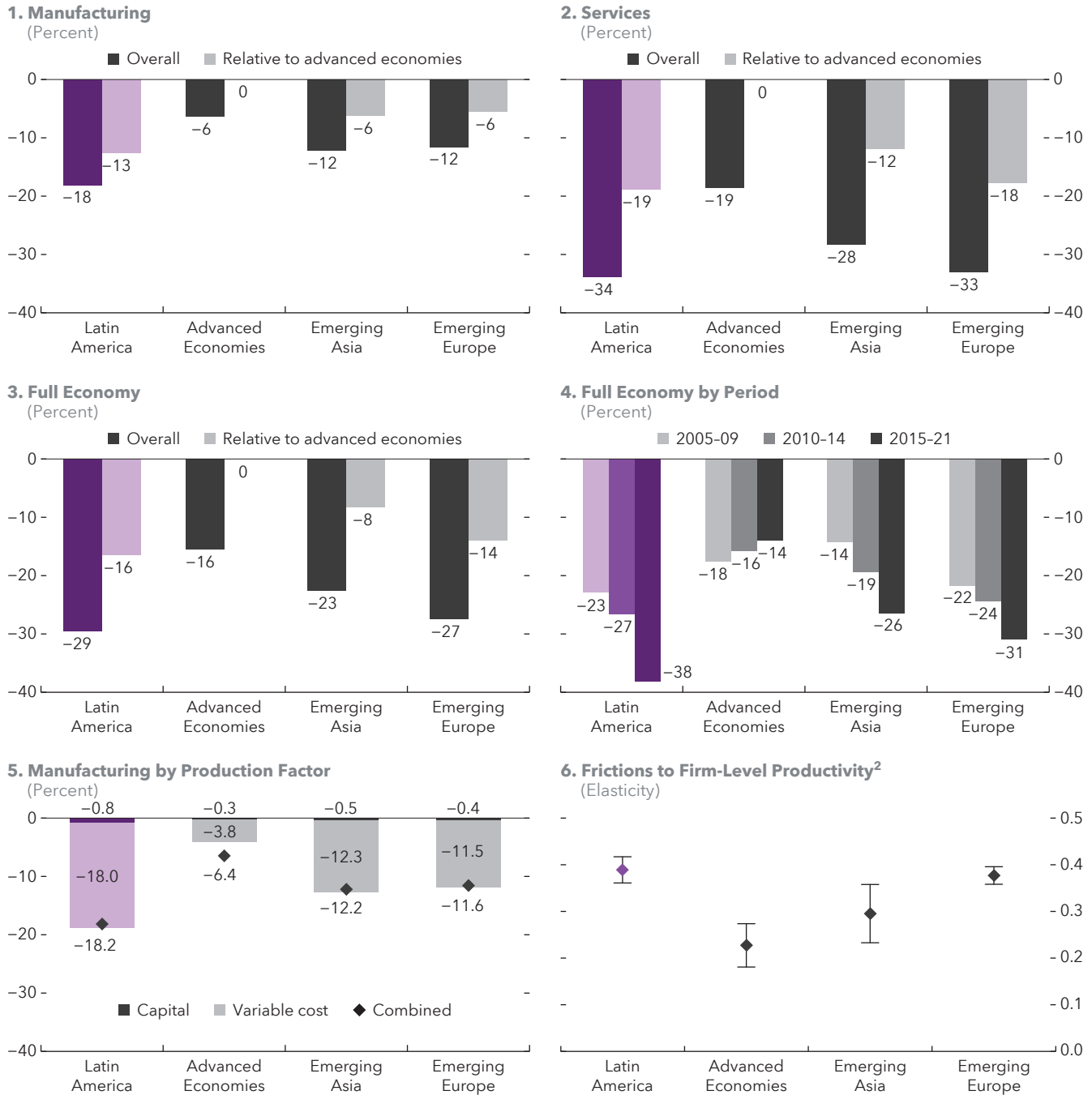
⁴ In line with this finding, Chapter 3 of the April 2024 World Economic Outlook documents that rising misallocation contributed significantly to low TFP growth in emerging markets for 2000–19.

⁵ This finding is driven by the low estimated output elasticity to capital rather than low misallocation of capital. Indeed, capital is consistently more misallocated across all countries. However, such misallocation is muted by an output elasticity that is commonly below 0.1, whereas variable costs enter with an elasticity of 0.9 or higher under the assumption of constant returns to scale. If the capital output elasticity was larger, its contribution to misallocation would increase as well.

⁶ High-productivity firms tend to expand output, employ more labor, and invest more to exploit their efficiency advantage, which means that they need more financing and broader market access than less productive firms. Because their marginal returns to capital or labor are higher for a given level of capital and labor inputs, frictions such as lack of financing, trade barriers, and logistic bottlenecks prompt larger foregone productivity gains.

⁷ See Online Annex 2 for additional details on the decomposition. Reported results combine the decomposition approach proposed in Griliches and Regev (1995) and Melitz and Polanec (2015). Firm-level productivity is estimated as residual from a two-factor Cobb-Douglas production function in capital and variable costs. Factor elasticities are estimated using the production function estimation approach followed by Díez and others (2021).

⁸ To further caveat, the Orbis sample for Brazil and Mexico is tilted toward large, often-listed firms for which entry and exit may be inherently low. Although this study adjusts for this via sampling weights, those adjustments might be imperfect when studying entry and exit.

Figure 2.2. TFP Losses from Misallocation¹

Sources: IMF, World Economic Outlook database; Penn World Table 10.01 database; Orbis; World Bank Enterprise Surveys; and IMF staff calculations.

Note: Estimates from applying the Hsieh and Klenow (2009) framework from 2005 to 2021. Aggregates are purchasing-power-parity GDP-weighted averages. Regional groupings use 2005 *World Economic Outlook* classification. Countries are abbreviated using International Organization for Standardization (ISO) country codes. Estimates relative to advanced economies report gains from achieving advanced economies' level of misallocation. Observations are weighted to match the size distribution in the World Bank Enterprise Surveys. Advanced economies = DEU, FRA, ESP; Emerging Asia = MYS, THA, VNM; Emerging Europe = SVN, SVK, LVA, LTU, ROU; Latin America = BRA, COL, MEX; TFP = total factor productivity.

¹In TFP level decomposition, results are driven by Brazil and Colombia.

²Regression coefficients for regressing the Hsieh and Klenow (2009) measure of frictions on firm-level productivity. A positive coefficient suggests that more productive firms are greater constrained by frictions with the effect increasing in the magnitude of the coefficient. Regressions control for year-country-four-digit industry fixed effects. Standard errors clustered at the industry and country level.

other regions, its surviving firms' margin is notably negative, whereas it is either positive or only slightly negative in other regions. If LA's survivor margin had matched the levels observed in AEs, TFP growth would have matched the highest regional rate at 0.9 percent annually observed in emerging Asia. The negative productivity contribution from surviving firms in LA3 reflects their deteriorating performance over time. This pattern aligns with broader findings of negative productivity growth in LA. Many surviving firms appear constrained in their ability to invest and upgrade, including in R&D, limiting their long-term performance. This finding suggests that there may be more scope for productivity-enhancing exits as some surviving firms increasingly drag down productivity.

The negative survivor margin in LA stems from weak within firm productivity growth (Figure 2.3, panel 2). Although AEs also experience negative productivity growth among survivors, they benefit from a strong reallocation effect that mitigates the impact. In contrast, other EMs exhibit strong productivity growth among surviving firms, even if reallocation effects are weaker. LA, however, shows both stagnant productivity within firms and limited reallocation, preventing the region from harnessing productivity gains over time. Qualitatively, the results are in line with a world in which production resources are stuck and unresponsive to productivity signals while firms fail to make productivity-enhancing investments.

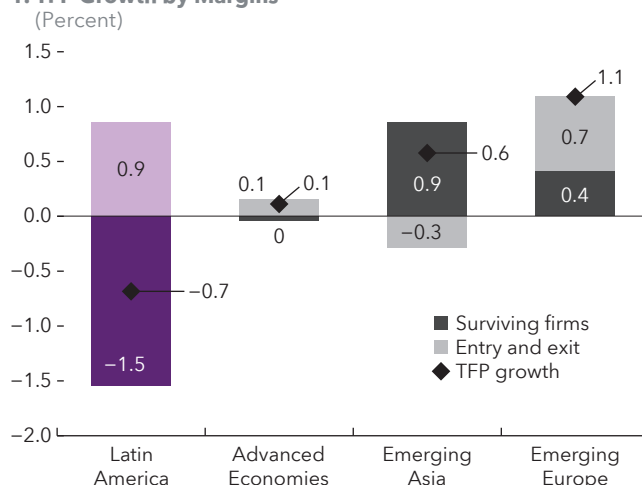
2.3 From Diagnosis to Reforms: Linking Productivity to Underlying Frictions

The preceding analyses highlight two interrelated drivers behind LA's persistent productivity underperformance: misallocation of resources across firms and stagnant productivity within surviving firms. Capital and labor are not flowing to their most productive use—resources are stuck in the wrong places—and therefore, firms that continue operating fail to become more efficient, unlike trends observed in more dynamic regions.

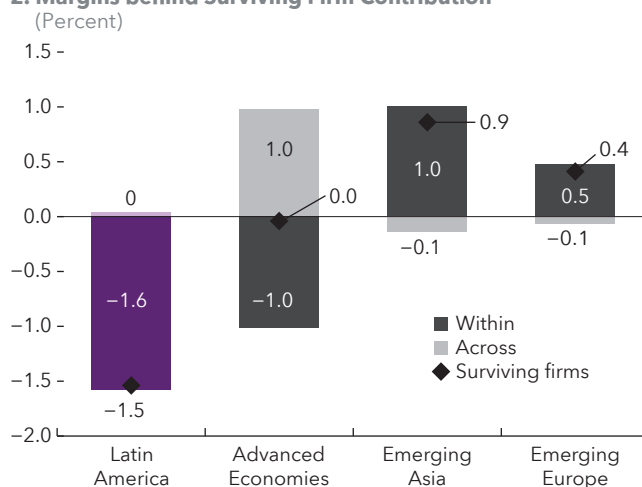
The literature suggests that these drivers stem from institutional, regulatory, and financial frictions (IMF 2024b, 2024e, 2024f). Misallocation and firm-level stagnation reflect structural distortions—such as limited access to finance, regulatory burdens, or restricted market access, impairing firm behavior (Hsieh and Klenow 2009). High-productivity firms often face disproportionately high barriers that hinder their growth and innovation (Restuccia

Figure 2.3. TFP Growth Rates Decomposition¹

1. TFP Growth by Margins



2. Margins behind Surviving Firm Contribution



Sources: IMF, World Economic Outlook database; Penn World Table 10.01 database; Orbis; World Bank Enterprise Surveys; and IMF staff calculations.

Note: Melitz and Polanec's (2015) decomposition of growth rates and contributions. Aggregates are purchasing-power-parity GDP-weighted averages. Regional groupings use 2005 *World Economic Outlook* classification. Countries are abbreviated using International Organization for Standardization (ISO) country codes. Observations are weighed to match the size distribution in the World Bank Enterprise Surveys. Advanced economies = DEU, FRA, ESP; Emerging Asia = MYS, THA, VNM; Emerging Europe = SVN, SVK, LVA, LTU, ROU; Latin America = BRA, COL, MEX; TFP = total factor productivity.

¹In the TFP growth analysis, results are driven by Brazil and Mexico.

and Rogerson 2008; Ayerst and others 2024). Meanwhile, low-productivity firms persist, often shielded by subsidies, preferential (including subsidized) credit, or weak enforcement of market discipline (including toward state-owned enterprises).⁹ This results in an environment that undermines incentives for upgrading and slows productivity gains (Konig and others 2022).

In what follows, the chapter focuses on a selection of frictions that are likely binding in the LA context. Although a wide array of frictions may curb productivity, the ones assessed in this section are both closely linked to misallocation and stagnation margins revealed in the data and empirically documented across the region.

a. Size-Based Frictions. Many countries in LA operate dual-track regulatory regimes. Firms below a size threshold face lighter compliance burdens—in taxation, labor regulation, or social security contributions. Though originally designed to support small enterprise survival and tackle informality, these regimes create disincentives for firms to grow, ultimately discouraging productivity gains and scaling up (Guner and others 2008; Benedek and others 2017). Empirical evidence suggests that firms tend to cluster just below regulatory thresholds to avoid higher taxation and compliance costs. These structural distortions compress firms' size, limiting allocative efficiency¹⁰ (Figure 2.4, panels 1 and 2; Online Annex 2).

b. Financial Frictions. Financial market inefficiencies restrict firm expansion. Credit-to-GDP ratios in LA remain well below EM averages, and even productive firms may lack adequate access to financing (Figure 2.4, panel 3).¹¹ In LA, these constraints are compounded by concentrated banking sectors, weak creditor protection, and underdeveloped risk assessment tools. Relaxing financial frictions could allow surviving firms to expand and startups to enter markets.

c. Limited Competition. This friction prevents the reallocation of market share toward more efficient producers and reduces incentives for surviving firms to innovate. In LA, competition is often undermined by weak enforcement of antitrust rules, high market entry costs, and regulatory capture. The region is characterized by high market concentration and the presence of dominant conglomerates (Figure 2.4, panel 4). When competition is weak or absent, the incentive for productivity-enhancing investments diminishes. Thus, without competitive pressure, firms stagnate, reallocation forces weaken, and aggregate productivity slows (Brooks and others 2021; Armangué-Jubert and others 2025; Schiffbauer and others 2025).

Policy Levers to Lift Constraints

LA's productivity challenge is deep-rooted but could be addressed through well-designed and targeted reforms. Reform experiences elsewhere (Box 2.1) show that targeted, well-sequenced actions in high-impact areas can deliver gains and boost business dynamism, investment, and growth.¹² For instance, gradual phasing out of size-based thresholds and the introduction of smoother compliance regimes can eliminate *size-based distortions* (Online Annex 2). Expanded credit information systems, improved legal frameworks for creditor rights,

⁹ Weak enforcement of market discipline implies that underperforming and inefficient firms are not forced to restructure or exit because of insufficient application of competitive pressures, financial discipline, or regulatory forbearance.

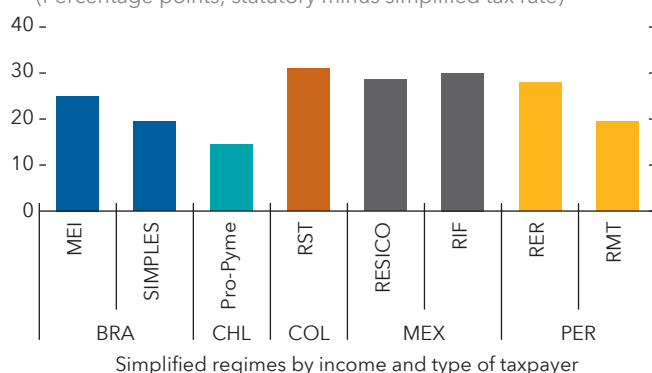
¹⁰ Empirical research supports these findings. Garicano and others (2016) and Aghion and others (2023) document how such thresholds in France distort firm behavior, leading to productivity losses. Akcigit and others (2025) estimate that removing such regulations in Türkiye could raise the share of large firms and boost GDP. Dabla-Norris and others (2018) find that size-based tax regimes in Peru lead to inefficient hiring and underuse of managerial talent. However, Moreau (2019) finds that firms misreport their employment to take advantage of preferential treatment without actually suppressing hiring, suggesting that size-based policies may further foster tax evasion.

¹¹ Theoretical models suggest that financial frictions exacerbate misallocation by misdirecting capital away from more productive firms. Banerjee and Moll (2010) and Moll (2014) emphasize that persistent credit constraints can reduce long-term aggregate TFP. Empirically, Midrigan and Xu (2014) show that such frictions explain substantial productivity gaps in emerging markets. Cavalcanti and others (2024) highlight that these frictions are important in the developing market context.

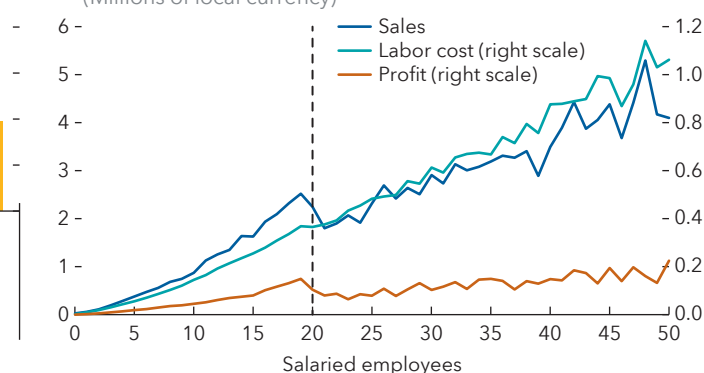
¹² Budina and others (2023) find that structural reforms improve economic performance in developing countries, while Eslava and others (2004) study the structural reforms in Colombia during the 1990s, finding an improvement in business dynamism. Relatedly, Bustos (2011) finds that market expansion due to the Mercosur agreement led to investment in technology adoption by Argentinian firms and improved aggregate productivity.

Figure 2.4. Frictions**1. LA5: Incentive Gap in Corporate Income Tax¹**

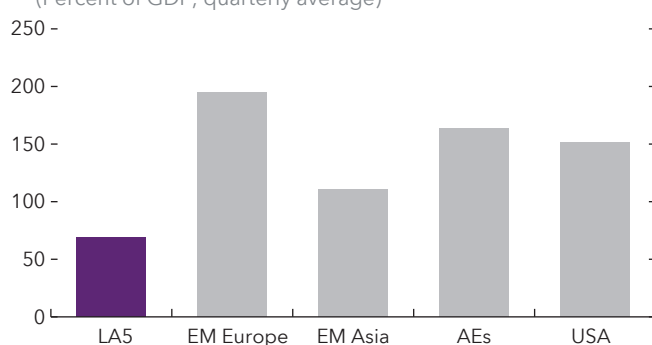
(Percentage points; statutory minus simplified tax rate)

**2. Peru: Firm Performance and Frictions at Thresholds²**

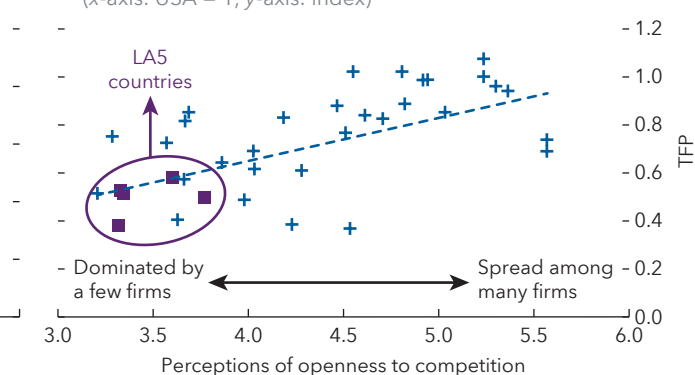
(Millions of local currency)

**3. Total Credit to Non-Financial Sector, 2022-24³**

(Percent of GDP; quarterly average)

**4. TFP and Competition, 2019⁴**

(x-axis: USA = 1; y-axis: index)



Sources: Bank for International Settlements; Dabla-Norris and others (2018); IMF, World Economic Outlook database; EU KLEMS database (Bontadini and others 2023); LA KLEMS database (Gu and Hofman 2021); national authorities; Penn World Table 10.01 database; World Economic Forum; and IMF staff calculations.

Note: Country labels refer to the International Organization for Standardization (ISO) country codes. AEs = advanced economies (AUT, BEL, DEU, DNK, ESP, FIN, FRA, GBR, GRC, ITA, JPN, LUX, SWE); EM = emerging markets; EM Asia = CHN, IDN, IND, MYS, THA; EM Europe = CZE, EST, HUN, LVA, LTU, NLD, SVK, SVN; LA5 = Latin America 5 (BRA, CHL, COL, MEX, PER); TFP = total factor productivity.

¹Simplified regimes included here are as follows: BRA = Microempreendedor Individual (MEI), Simples Nacional (SIMPLES); CHL = Régimen Tributario enfocado a pequeños y medianos contribuyentes (Pro-Pyme); COL = Régimen Simple de Tributación (RST); MEX = Régimen simplificado de confianza (RESICO), Régimen de Incorporación Fiscal (RIF); PER = Régimen Especial de Renta (RER), Régimen MYPE Tributario (RMT). For BRA–SIMPLES, COL–RST, and MEX–RESICO, the median statutory CIT within each STR schedule by revenue bracket and/or sector is used. This illustrates the presence of incentive gaps under these regimes. BRA–SIMPLES rates bundle multiple taxes, including CIT and social security contributions. For comparability with the general regime's CIT of 25 percent, after surtax, the SIMPLES CIT is proxied by subtracting the 9 percent social contribution from the median SIMPLES nominal rate across revenue brackets and sector. For MEX–RIF, the year-1 schedule (100 percent CIT discount from the general regime rate) is used to reflect entry incentives; the discount decreases by ten percent each year over ten years. For PER–RER, there is no annual CIT, but a statutory monthly revenue-based quota of 1.5 percent. CIT = corporate income tax; STR = simplified tax regime.

²Stricter labor regulations apply only to firms with more than 20 salaried workers. Each taxpayer identification number is treated as a separate firm; some firms may split into subunits with different identification numbers to remain below the threshold.

³Aggregates are purchasing-power-parity GDP-weighted averages.

⁴The 2019 market dominance index reflects the responses to the following survey question: "In your country, how do you characterize corporate activity?" in the Global Competitiveness Index 4.0 dataset (WEF 2019). This indicator is based on a perception survey of business executives and should be interpreted with caution. Perception-based indicators may reflect respondents' views at the time of the survey and can be affected by sampling biases, framing, and changes in sentiment.

and stronger bank competition can mitigate *financial frictions*. Fintech solutions and digital credit platforms can broaden access while reducing risk premiums. Strengthening antitrust bodies, streamlining business registration, and enhancing transparency in public procurement can help strengthen *competition*.

Tackling core frictions can help unlock firm dynamism and support stronger productivity growth. Reforms in the region would be instrumental in fostering stronger growth, unlocking the full potential of human and capital resources, and supporting income convergence with AEs.

Box 2.1. Successful Reforms in Reviving Business Dynamism: New Zealand and Peers

This box describes cases of well-aligned, cross-cutting reforms to unlock productivity (see Online Annex 2 for technical details).

Comprehensive and well-sequenced reforms revitalized New Zealand's economy in the mid-1980s. They transformed it from one of the most regulated in the Organisation for Economic Co-operation and Development into a dynamic environment conducive to firm entry, growth, and innovation. Reforms comprised trade policy, financial markets, taxation, and labor policies, which enhanced competition, expanded access to credit, eliminated frictions, and bolstered productivity.

Productivity gains were driven by both within-sector improvements and resource reallocation toward higher-productivity industries. Notably, labor productivity surged in the reformed sectors such as information and telecommunications, transportation, and agriculture (Box Figure 2.1.1, panel 1). Although aggregate productivity gains were moderate, the sectoral breadth of improvement underscores improved business dynamism.

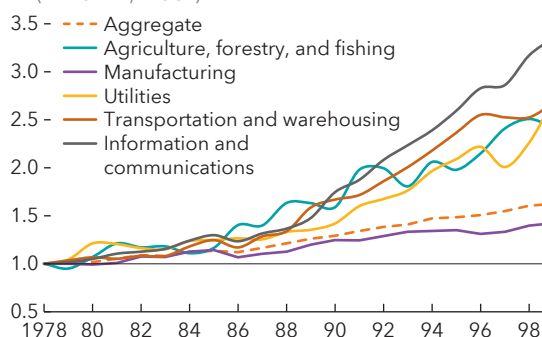
Financial sector reforms played a pivotal role. Private sector credit increased from about 50 to about 115 percent of GDP after reform, whereas foreign direct investment inflows rose from 1.3 to 4.5 percent of GDP (Box Figure 2.1.1, panel 2). These shifts reflect stronger capital allocation, increased investment, and greater firm turnover.

Peer reformers offer parallel lessons. Estonia's early 2000s reforms in deregulation and digital governance enhanced transparency, reduced red tape, and fostered firm creation. Peru's 1990s reforms similarly addressed labor rigidities, boosted capital flows, and expanded financial intermediation—echoing New Zealand's path to strengthening business dynamism.

Box Figure 2.1.1. New Zealand Indicators

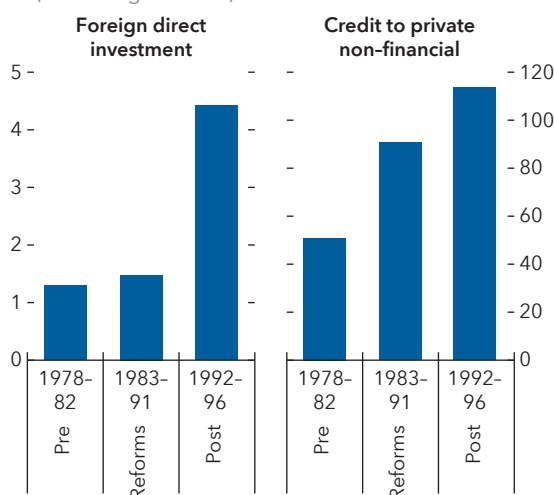
1. Labor Productivity Growth by Industry¹

(1978 = 1; index)



2. Foreign Direct Investment and Credit to Private Non-Financial Sector²

(Percentage of GDP)



Sources: Federal Reserve Bank of St. Louis, Federal Reserve Economic Data; Stats New Zealand; World Bank, World Development Indicators; and IMF staff calculations.

¹Growth in real GDP per unit of labor input.

²Foreign direct investment shows net inflows. Credit is provided by domestic banks, all other sectors of the economy and non-residents. The "private non-financial sector" includes non-financial corporations (both private-owned and public-owned), households and non-profit institutions serving households.