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Unlocking Mexico's Economic Potential through Innovation and Entrepreneurship

Transition Policy Note

This policy note posits that Mexico's economic growth can be driven by private sector productivity and leveraging of impactful entrepreneurship and innovation. Mexico's economic growth has been stagnant in recent years, with GDP per capita increasing at an average annual rate of only 2.2 percent between 1991 and 2021 (World Bank, 2022). Sluggish productivity growth is the main culprit, as total factor productivity declined by an average of 0.45 percent per year over the same period (INEGI, 2022). The COVID-19 pandemic has exacerbated these challenges, with firms facing lower revenues, employment, and wages. However, the pandemic has also opened up new opportunities for Mexico to attract investment and boost exports, as global companies seek to diversify their supply chains and nearshore production to reduce risks and improve resilience.

Mexico's policymakers can influence the quality of national and regional ecosystems and increase the probability of generating impactful entrepreneurship. This can be achieved by fostering the entry of more formal firms, facilitating high growth, innovative, and globally integrated firms that can create more, and better-quality jobs. Such firms need resources that include infrastructure, physical capital (facilities and equipment), human capital, and knowledge, as well as access to strong talent and markets. Regulations, and access to financial capital, as well as social capital also affect firms' access to resources.

This note builds on the World Bank's Mexico Entrepreneurship Ecosystem Diagnostic report and highlights critical challenges and important opportunities. Specifically, it outlines short/medium term policy actions that the Mexican authorities could undertake within the next two years to have on boosting firm innovation and impactful entrepreneurship in Mexico. These high impact activities include:

1. **Develop a comprehensive and coherent strategy to foster growth-oriented entrepreneurship.** At present, the spatial and sectoral distribution of entrepreneurship is highly uneven. In Mexico, manufacturing firms tend to be more productive and growth-oriented than those in services, and the northern and north-Pacific regions exhibit higher levels of dynamism than the southern states (World Bank, 2022). A comprehensive strategy should be developed via close collaboration of federal and subnational governments and key ecosystem stakeholders such as the private sector, research and ecosystem builders. It should also establish clear targets and mechanisms to monitor and evaluate progress over the short, medium, and long term.

2. **Expanding access to finance, especially for innovative firms and impactful entrepreneurs.** In Mexico, access to finance is limited, with only 10 percent of microenterprises, 25 percent of SMEs, and less than 33 percent of large firms having access to credit (INEGI, 2019) This can be alleviated by expanding access to finance

for innovative firms by:

- Enhancing access to credit information, and tailoring a broader set of financial instruments such as credit guarantee programs to encourage lending to younger, riskier firms with limited collateral, and developing new types of alternative collateral such as receivables or purchase orders.
- Evaluating and scaling up royalty-bearing grant, seed and venture capital funds to support high-potential startups and technology-based firms, particularly in sectors with strong nearshoring potential.
- Strengthening the insolvency regime to facilitate the efficient reallocation of resources from less productive to more productive firms.

3. **Investing in managerial capabilities and workforce skills**. The average Mexican firm scores significantly lower on management practices than the median US firm (Bloom et al., 2022). About 30 percent of formal firms cite an inadequately educated workforce as a major constraint (World Bank Enterprise Surveys). Key recommendations to strengthen firm capabilities, include:

- Providing incentives and training programs for firms to hire professional managers and access consulting services to improve managerial practices and technology adoption, especially to promote digitalization and greening of firms.
- Collaborating with industry associations, universities, and vocational institutes to assess and address skills gaps in high-potential sectors such as ICT, automotive, and aerospace.
- Strengthening the quality and market relevance of secondary and tertiary education, with a focus on digital skills, language proficiency, and entrepreneurship training.

4. **Incentivizing private sector investments in technology adoption and innovation.** Mexico spent just 0.28 percent of GDP on R&D in 2019, well below OECD peers (OECD, 2021a). Only 12 percent of microenterprises and 10 percent of SMEs introduced any type of innovation in 2016-2017 (INEGI, 2018). This can be remedied by positioning firms at the center of public policy for innovation, including by:

- Evaluating and reforming fiscal incentives such as R&D tax credits to encourage greater private investment in innovation, and exploring alternative instruments such as matching grants for collaborative R&D projects.
- Accelerating technology adoption, especially of digital and energy efficiency and other environmental technologies, across all firms aspiring to grow their exports directly or via GVCs.

- Strengthening technology transfer offices and industry-academia linkages to facilitate the commercialization of public research and the creation of spinoff firms.
- Leveraging public procurement to spur innovation in strategic sectors such as health, energy, and the environment, drawing on international best practices and engaging SMEs in the process.

5. **Eliminating regulatory barriers and strengthening the rule of law.** The regulatory environment poses barriers, with weak contract enforcement and high compliance costs equivalent to 3.4 percent of GDP at the federal level (INEGI, 2020a). Recommendations to enhance the environment in which firms operate, include:

- Simplifying business registration and licensing procedures at the federal and state levels, with a focus on reducing the time and cost of starting and operating a formal business.
- Expanding the implementation of the Better Regulation agenda, particularly at the subnational level, to streamline regulations and improve regulatory quality across all levels of government.
- Strengthening contract enforcement and alternative dispute resolution mechanisms to reduce the costs and uncertainties of doing business, particularly for SMEs.

6. **Supporting greater sophistication of Mexican exporter firms and accelerating their integration into global value chains (GVCs).** Only 4.6 percent of SMEs participate in GVCs, and they only join around age 10 on average (INEGI, 2018). However, nearshoring trends offer significant opportunities for Mexico to attract new investment and boost exports in key sectors such as automotive, aerospace, and medical devices (IADB, 2022). The promotion of interanationalization and GVC integration can be promoted via:

- Developing targeted supplier development programs in partnership with multinational firms to facilitate SME linkages and upgrading in key GVC sectors such as automotive, aerospace, and medical devices.
- Enhancing export promotion and market intelligence services to help SMEs identify and pursue new market opportunities, particularly in the context of nearshoring trends.
- Improving logistics infrastructure and reducing bottlenecks in cross-border trade, with a focus on enhancing connectivity and efficiency in the southern states.

Designing and implementing effective entrepreneurship programs will require careful diagnostics, robust monitoring and evaluation frameworks, and close coordination across different levels of government and ecosystem stakeholders. The policy mix must pivot from a predominant focus on supporting subsistence microenterprises to catalyzing high-potential growth firms, particularly in sectors and regions with strong comparative advantages.

The costs of inaction are high. Without a strong ecosystem to enable entrepreneurs to start and scale innovative, productive firms, Mexico risks falling further behind in the global economy. But with the right policies and investments in place, the country has the potential to unleash a new era of dynamic, innovation-driven growth - delivering higher incomes and living standards for all Mexicans.

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