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The path to sustainable and inclusive growth

Can collaboration between business, government, and society spur economic growth that benefits everyone without destroying the planet?

April 2022

In this episode of the *Inside the Strategy Room* podcast, three coauthors of a recent *McKinsey Quarterly* article articulate the scope and potential solutions for one of the biggest challenges of our times: fostering economic growth for the good of all.[1] Tracy Francis, a member of McKinsey's global leadership team, leads the firm's consumer-packaged-goods and retail work across Latin America. Anu Madgavkar is a member of the McKinsey Global Institute (MGI) and leads work on labor markets and human capital, technology's economic impact, and inclusive growth. Sven Smit is cochair of MGI and coauthor of the bestselling book *Strategy Beyond the Hockey Stick*.[2] This is an edited transcript of the discussion. For more conversations on the strategy issues that matter, follow the series on your preferred podcast platform.

Sean Brown: What was the impetus for this article?

Sven Smit: We wanted to introduce what is likely to be a challenge ten times greater than the pandemic, which is creating a path to sustainable and inclusive growth. Three dimensions together will drive our future prosperity, but we lead with growth because sustainability and inclusion will not be possible without growth. The aspiration around economic growth needs to be not only about increasing wealth but broader well-being. That growth can spur inclusion by creating equal opportunity and broad-based progress, lowering inequality, and raising the dignity of work. While growth, inclusion, and sustainability are often framed as trade-offs, we think about them as "and," not "or." We need all three for this equation to work.

Sean Brown: Why is growth so important to promoting the other two elements?

Sven Smit: First, growth leads to work. Growth increases our incomes and our standards of living. It increases security and resilience, poverty alleviation, and education, so there are many positive associations. But growth touches on inequality because skills bias leads to a dispersion of income, so growth also promotes the wealth of the people at the bottom of society. Growth has a footprint effect on sustainability, but it also makes it possible to finance decarbonization investments—in fact, the impact of economic growth on environmental footprint is smaller than the leverage it provides to finance a reduction in that footprint.

'Growth increases incomes, security, and resilience, poverty alleviation, education, so there are many positive associations. But growth touches on inequality because skills bias leads to a dispersion of income.'

–Sven Smit

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[1] Bob Sternfels, Tracy Francis, Anu Madgavkar, and Sven Smit, "Our future lives and livelihoods: Sustainable and inclusive and growing," *McKinsey Quarterly*, October 26, 2021.

[2] Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick: People, Probabilities and Big Moves to Beat the Odds*, Hoboken, NJ: John Wiley & Sons, 2018.

Sustainability investments lead to new jobs and business models, but at the same time an energy transition typically hits the poorest first, negatively affecting inclusion. So the picture is complex.

Sean Brown: How has economic growth affected inclusion and sustainability in the past and what impact do you see it having in the future?

Anu Madgavkar: We sometimes get lost in the ups and downs of cycles, but the world's per capita GDP is 40 percent higher now than it was 20 years ago. Over the next two to three decades, GDP could more than double, so we are far from reaching the limits of growth.

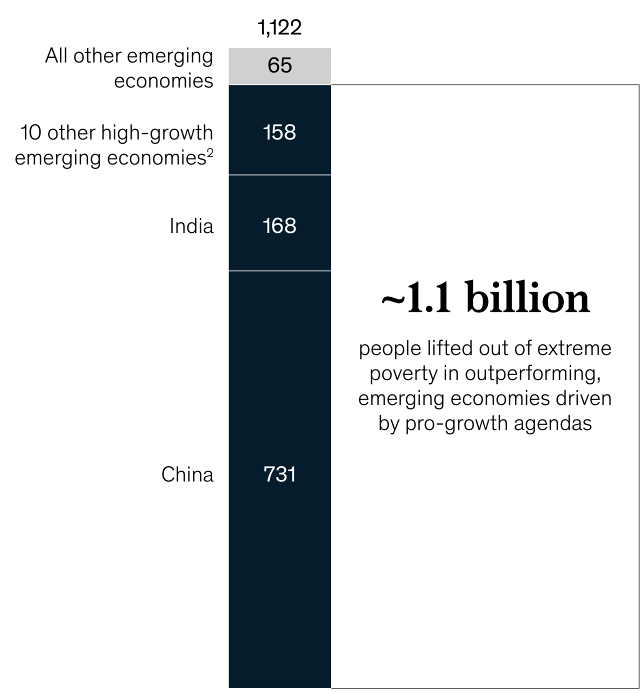
This progress has delivered powerful benefits, particularly to poor populations, lifting more than a billion people out of poverty [Exhibit 1]. Economic sufficiency is a primary measure of inclusion, so growth has been a positive force for inclusion. While the poverty challenge remains immense, the number of people who need to be lifted out of extreme poverty today is lower than the number that had been lifted out in the past couple of decades, largely as a result of growth.

Growth is also important to sustainability. To make the step-up investments needed to achieve net-zero emissions by 2050, we estimate that a $3.5 trillion of incremental annual investment will be required—60 percent higher than what we spend currently. That's a very large number that policy makers and business leaders struggle to wrap their heads around. For example, it's more than the average annual increase in public debt. But growth can help us finance and sustain that level of investment. Compare the incremental investment required relative to the corporate profit pool: today, that investment is about 50 percent of global corporate profits, but in a high-growth scenario that boosts corporate profits, the figure drops to about 20 percent, making those step-up investments more feasible.

Exhibit 1

Growth has boosted inclusion by lifting over a billion people out of poverty.

Population lifted out of extreme poverty,[1] 1990–2013, million



[1]Defined by the World Bank as living on less than $1.90 per person per day.
[2]Bangladesh, Bolivia, Kenya, Mozambique, Paraguay, Philippines, Rwanda, Senegal, Sri Lanka, and Tanzania.
Source: McKinsey Global Institute analysis

‘The number of people who need to be lifted out of extreme poverty today is lower than the number that had been lifted out in the past couple of decades, largely as a result of growth.’

–Anu Madgavkar

Having said that, growth is not automatic. The economy did not always come out from past recessions with strong and sustained growth. But we are seeing businesses doubling down on the growth agenda, so the conditions could arise to enable us to enter an age of renewed economic progress.

Sean Brown: How does this global picture translate to national economies?

Anu Madgavkar: The global picture ultimately comprises individual economies, and this is where the connection between growth, inclusion, and sustainability comes through. Case in point: in emerging economies where 50 to 60 percent of the population still lacks electricity at home, the arrival of electrification and rising incomes will produce a surge in energy consumption. For such countries, it is almost impossible to sacrifice the aspiration of raising incomes in order to forestall that steep increase in resource consumption. Every country will have to set its own threshold for what its population can accept and afford in making climate-related transitions.

Tracy Francis: To help bring this to life, my colleagues and I recently talked about the sustainability challenge in India. It was news to some that Indians burn lignite [the lowest quality of coal usually used in electricity generation] in their kitchens, and therefore moving to anthracite, or black coal, would be a benefit to those populations. What sustainability means in Australia or North America is quite different from what it means in developing economies. I live in Brazil, a country that has had periods of very high growth, but that growth increased inequality in an already extremely unequal society. We have also had periods of lower growth when inequality significantly improved.

Anu Madgavkar: Companies also face these questions because their specific footprint on the world will guide their priorities in sustainability, inclusion, and growth [SIG]. For a large retailer, the biggest priority may be the reskilling agenda because if they equip a large workforce for the challenges of the future, they will contribute a lot to the “I” dimension. Companies with large resource and material footprints, on the other hand, may need to double down on the “S” dimension.

Sean Brown: What role does the productivity rate play in whether we get the growth necessary to boost both inclusion and sustainability?

Anu Madgavkar: Productivity growth is the biggest driver of economic growth. It is the only sustainable, long-term way to grow an economy, tap into demand, and do so in a competitive way. But the long-term trend on productivity growth in many economies has been flat to declining. What’s more, aging demographics suggest that workforce expansion will not be a big lever for economic growth in the next 20 to 30 years. MGI research shows that bottom up, sector by sector, there is potential to increase productivity growth by between 1.5 and 2 percent annually, but a fundamental by-product of productivity growth are shifts in the nature of work.

Technology is a big driver of productivity, but technological changes imply changes in skills workers need.

Sean Brown: Income and wealth inequality has been rising globally. How can we prevent future growth from further exacerbating this disparity?

Anu Madgavkar: Growth lifts entire economies, so the primary effect of growth is positive for inclusion. However, the benefits of that growth are not distributed equally. We have, for example, skills-oriented inequality. The supply of needed skills is not keeping pace with the demand. In the different skill and pay strata, we find much faster growth in demand for high-skill workers, which plays out in faster wage growth, while demand for the middle-skill and middle-pay segment has declined, so wages have flatlined. On one level, this is a huge opportunity: if we can move workers up the skills pyramid, there are better-paying jobs waiting for them. But if that supply does not grow fast enough, we will see rising inequality.

Sean Brown: Are there structural limits to how many people can be retrained before you see diminishing marginal returns in productivity growth, because there won't be enough jobs for this expanded skilled workforce?

Anu Madgavkar: Two hundred years ago, we would have asked the same question and given the same fallacious answer that there are limits to how much we can upskill people. When people thought of the transition out of agriculture, they never imagined that today 40 percent of the population in rich countries would have a college degree and be doing very different jobs. There are not many limits, in my view, because it's hard to predict what jobs the future will bring. We need to focus on building adaptability, empathy, and interpersonal relationships—these are the skill sets that will equip the world for the future.

Sven Smit: We should also bring automation into the equation. Automation could bring higher productivity without necessarily requiring much upskilling. What if every stonemason had a brick-laying machine that handled the difficult pieces? Their jobs would be different but not more difficult. Take driving assisted by digital maps—that makes the job easier and can increase the productivity. It's the mix of automation and human skills that will bring us to the next level of productivity.

Sean Brown: Do you think education systems need to change beyond offering specific skills training?

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–Tracy Francis

Anu Madgavkar: We need to radically rethink education. It's not just about accelerating skills training, it's about building the cognitive and interpersonal skills that people will need. We have to think generationally, and it's not clear that education systems around the world are building that adaptability and creativity that people will need to remain relevant in the workforce. It is not just a challenge for the educational system—every company also needs to create experiences that help workers learn, not only through explicit training but methods and practices through which people unconsciously learn. From a CEO's perspective, probably the biggest near-time opportunity is to strengthen that organizational capital—the processes, the practices—because the learning you enable in your workforce will sustain productivity and income growth.

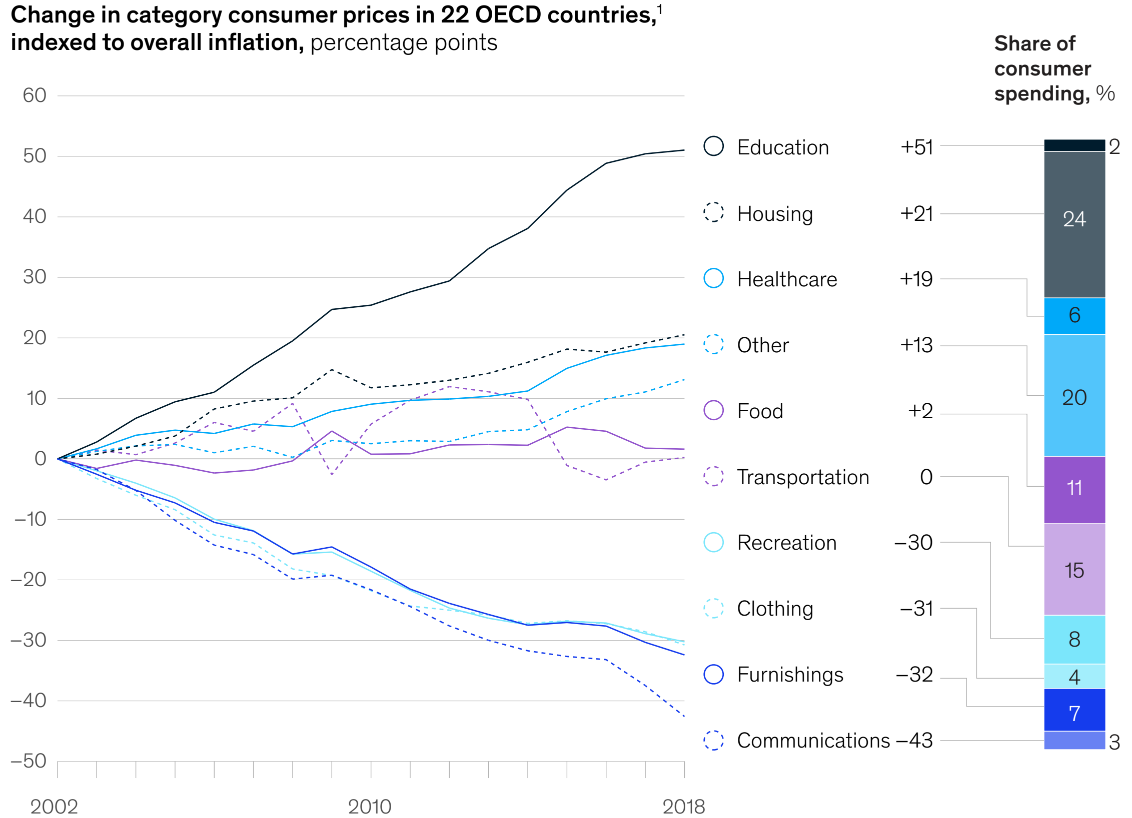
Sean Brown: Has growth generally translated into higher standards of living?

Anu Madgavkar: Growth leads to rising consumption, but the supply side needs to align with the demand. In segments such as clothing, furnishing, or communications, consumers have benefited from price declines thanks to globalization and new technologies, which has been enormously beneficial from an inclusion perspective. Education, housing, and healthcare, on the other hand, have not benefited as much from technology and globalization, and many markets see inflation eating up to 70 percent of the average household's income gains [Exhibit 2]. In those areas, growth has not promoted inclusion, but fixing this problem is a huge opportunity for businesses. Innovations in construction techniques, for example, could help

Exhibit 2

Growth can lead to higher costs of living, exacerbating inclusion challenges.

Change in category consumer prices in 22 OECD countries,[1] **indexed to overall inflation,** percentage points



[1]Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, South Korea, Spain, Sweden, Switzerland, United Kingdom, United States.
Source: McKinsey Global Institute analysis

ease housing supply and address some of the price inflation.

Sean Brown: What impact do you see population growth having on sustainability?

Anu Madgavkar: As an economy grows in GDP per capita, its impact on the planet also grows steeply because consumption increases on many fronts: energy, water, food—or the complexity of the nutrition basket—housing. Some of the fastest-growing countries also have rapidly growing populations, so their overall demand for resources will grow. This reality has repercussions for the planet as a whole. Many inclusion strategies are country specific, but we need a global approach because the rising population and per capita income in lower-income countries will significantly affect the planet.

Additionally, the energy transition will be more disruptive for some groups. For example, the transition could erode three-quarters of what oil-producing countries earn from fossil fuel production. Low-income households, in both rich and poor countries, may be unable or unwilling to pay for the higher energy costs resulting from the shift away from fossil fuels. And, as we discussed, a big concentration of the need for those investments is in developing countries that are impaired financially. Navigating through this in a way that is least disruptive to the growth and inclusion agenda will be a critical part of the puzzle. And sustainability can bolster growth, too. If we get the financing right and minimize the pain for all population segments, we could see strong growth as we create more green jobs and productivity rises. We could also see significant mitigation of risks related to acute climate events that harm productive assets and GDP.

Sean Brown: You paint a complex picture with many interconnected parts and high costs. How do we pay for it all?

Tracy Francis: We don't pretend to have all the answers, but it is a worthy and necessary challenge for us as an institution and for leaders in business and society. Developing countries need $500 billion of financing for climate change adaptation by midcentury. I live in a developing country, and after a couple of years of a pandemic the government doesn't have much money to invest. Should we think about transfers between countries and financing across generations? Are those currently in the workforce prepared to pay for what needs to happen over the next 20, 30, 40 years?

The second question is around inequality. In the global knowledge economy, what happens when workers in developed economies can easily access skills training and other economies cannot? Oil-producing countries are looking at a 75 percent decrease in per capita income, and those countries have some of the largest youth populations in the world. We can all imagine that this transition has to be smooth, with help from other countries, or it will have a difficult situation.

Finally, we face growth headwinds. How do we jump-start productivity in the context of an energy transition? How do we navigate labor supply constraints? We currently have an upside-down labor market, where people are available but not returning to the workforce. We have to think through what needs to change around each of these elements for sustainable, inclusive growth to become a reality.

Sean Brown: In your article, you make six recommendations that point to the paths ahead. What are some of the main steps?

Tracy Francis: We set up six challenges and six metrics as a way of getting a pulse on whether we are moving toward the goal. One is reducing the $3.5 trillion transition costs of decarbonization through technology and innovation. If we target shaving 20 percent off that number through innovations, that would make a substantial difference. On reskilling, we estimate that by 2030 we need 100 million workers retrained, so let's start tracking that. Basic things such as housing, healthcare, education, digital access, and energy need to be affordable and available for all and we need to track that as well.

Sean Brown: What is the role of individual business leaders in addressing these challenges?

Tracy Francis: Business leaders should think about three areas. Is your aspiration right and are you moving fast enough on addressing sustainability, inclusion, and growth? Secondly, have you worked out what your organization should prioritize versus what will require a broader consensus? Finally, how can the conflict between this long-term narrative and short-term business realities be addressed?

Sean Brown: What role should governments play in ensuring that corporate management teams make these goals organizational priorities?

Anu Madgavkar: The channels through which inclusion and sustainability surface on the agenda alongside productivity growth come down to national economic frameworks. In many emerging economies, a central requirement is the concept of contested leadership, whereby incumbents are not occupying large amounts of the economy and resources in a highly protected manner but are subject to the forces of competition enabled by broad access to capital. Such conditions promote upward mobility in the size and productivity of firms and a healthy churn where incumbents that are no longer productive are eased out and new, more efficient businesses take their place. We looked at about 100 emerging economies and found that the one common thread connecting the high-growth economies that delivered well on inclusion and sustainability was a higher level of contested leadership. Vibrant capital markets are the life blood of such economies, but they also need laws, respect for contracts, and deregulation of markets.

Sean Brown: What incentives should corporate leaders have to pursue sustainable, inclusive growth?

Tracy Francis: This is squarely on the CEO agenda. Earlier this year, we sent a letter to CEOs that talked about this concept, and I was very happy with the response. Everyone we have spoken to said, "Yes, this is the challenge of our times." It sounds daunting. We talk about how important it is to be optimistic, and we are optimistic as an institution because we see that data on how the world faced substantial challenges in the past. We think it is important to be positive, with an educated, open-eyed optimism. We are not looking for perfection, we are not looking for bolts of lightning to come from the sky, but we are looking for optimistic persistence and resilience at taking on this challenge.

People talk about stakeholder capitalism, but I don't think the incentive structure has caught up with that ideal. Having said that, CEOs are acutely aware that if they do not meet expectations on these topics, the court of public opinion is growing stronger.

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