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POLICY  
PAPER

URBAN  
POLICY AND  
ECONOMIC  
DEVELOPMENT  
AN  
AGENDA  
FOR THE  
1990s



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*Urban Policy and  
Economic Development  
An Agenda for the 1990s*

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*A  
World  
Bank  
Policy  
Paper*

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## *Executive Summary*

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Rapid demographic growth will add 600 million people to cities and towns in developing countries during the 1990s, about two-thirds of the expected total population increase. Of the world's 21 megacities, which will expand to have more than 10 million people, 17 will be in developing countries. With urban economic activities making up an increasing share of GDP in all countries, the productivity of the urban economy will heavily influence economic growth.

This paper analyzes the fiscal, financial, and real sector linkages between urban economic activities and macroeconomic performance. It builds on this analysis to propose a policy framework and strategy that will redefine the urban challenge in developing countries:

- First, the developing countries, the international community, and the World Bank should move toward a broader view of urban issues, a view that moves beyond housing and residential infrastructure, and that emphasizes the productivity of the urban economy and the need to alleviate the constraints on productivity.
- Second, with urban poverty increasing, the productivity of the urban poor should be enhanced by increasing the demand for labor and improving access to basic infrastructure and social services.
- Third, more attention should be devoted to reversing the deterioration of the urban environment, an issue receiving short shrift in the face of global environmental problems.
- Fourth, the serious gap in understanding urban issues must be closed. With the decline in urban research during the 1980s, few countries have a sound analytical basis for urban policy.

How are the World Bank and the international community responding to these challenges? Past urban operations focused on neighborhood

interventions—such as sites and services and slum upgrading during the 1970s and municipal development and housing finance during the 1980s. Assessments of this assistance conclude that citywide impacts have been rare and that the pace of urban growth far exceeded the scale of the urban program. Today, there is a need to focus urban operations on citywide policy reform, institutional development, and high-priority investments—and to put the development assistance in the urban sector in the context of broader objectives of economic development and macroeconomic performance.

### **The Challenge of Urban Growth**

Since 1950 the world's urban population has grown from under 300 million to 1.3 billion persons, with unrelenting annual growth of 4 percent, adding 45-50 million persons a year. Growth rates of smaller towns have been even higher as non-farm employment has supported agricultural growth. While urban settlement patterns have varied across countries, in no country have efforts to restrain migration or urban growth been successful. Secondary cities such as Kano, Surabaya, or Guadalajara have become metropolitan areas. Today, natural increase has replaced migration as the major source of urban growth in most continents except Africa.

The forces contributing to urban growth are strong. Higher urban wages reflect the higher productivity of labor in cities where economies of scale and agglomeration have made households and enterprises more productive. This productivity growth, although beneficial, has not solved the massive urban problems of the developing world, and serious issues of urban poverty and a deteriorating urban environment remain. Many households have not found employment and income-generating activities, and many live in squatter areas unserved by essential infrastructure. In 1988 some 330 million urban residents—about a quarter of the total urban population—lived in poverty. Even if poverty is still largely rural in many countries, as the 1990 *World Development Report* concludes, urban poverty will become the most significant and politically explosive problem in the next century.

### **Past Government Efforts and Donor Assistance**

Since 1972 government efforts, particularly those supported by donors, have addressed urban growth and urban poverty through low-cost investment projects in shelter, water supply, sanitation, and urban transport. Sites-and-services and slum-upgrading projects were intended to demonstrate replicable approaches that could provide benefits to the poor while recovering costs and reducing the financial burden on

the public sector. Many of these projects were reasonably successful in meeting their physical project objectives; this required devoting attention to physical implementation rather than sustaining policy change and strengthening institutions. As a result, they have not had major impact on the policies of national and local governments and the broader issues of managing the urban economy. In only a few cases, such as the *Kampung Improvement Program in Jakarta*, have citywide impacts been achieved. Most important, because many urban programs did not achieve sustainable policy reform and institutional development, they were not replicable. Government and donor programs tended to divide a city into projects, improving specific neighborhoods without improving the urban policy and institutional framework such as the functioning of citywide markets for land and housing. Government efforts have not mobilized the private sector and community initiative, but in many cases have increased the cost of private solutions through overregulation and the rationing of scarce capital for investment.

From a broader perspective, several additional conclusions come from assessing past efforts. First, it is apparent that neither governments nor donors have sought to understand the impacts of macroeconomic policy on urban economic activities. Second, those institutions and experts working within the urban sector have not appreciated the impact of their activities on macroeconomic performance. A third dimension of this narrow perspective on the relationships between the macroeconomic and urban levels is the absence of discussion of short- versus long-term impacts of policies at one level on the other. Finally, one of the most glaring deficiencies of previous efforts has been the insufficient attention given to the issue of productivity within the urban economy. The policy framework presented in this paper seeks to address these weaknesses of previous urban policy. It also seeks to incorporate the issues of increasing urban poverty and a growing urban environmental crisis within this broader perspective.

### **A New Policy Framework: The Urban Economy and Macroeconomic Performance**

The policy framework developed in this paper distinguishes between macroeconomic policies that are managed at the national level and urban policies that are largely, though not exclusively, managed at the city level. Macroeconomic policies establish the broad economic environment for urban economic activities. They affect interest rates, direct and indirect taxes, incentives for manufacturing and trade, and the pricing of key inputs such as energy and water. The financing of national fiscal deficits absorbs credit needed for productive investment, while also

increasing interest rates and contributing to inflation. Trade incentives have direct impacts on urban production, concentrating industrial investment and adding to the growth of port cities. Similarly, national strategies for education and health have direct consequences for the quality of the urban labor force. Achieving the long-term objective of improving the productivity of the urban economy thus depends heavily on the successful balancing of the many parts of macroeconomic policy.

The performance of the urban economy also affects macroeconomic performance. Three linkages—financial, fiscal, and real sector—produce significant urban impacts at the macroeconomic level. The weak condition of the financial sector in most developing countries, and particularly its difficulty in mobilizing private savings, has left most of the financing of urban investments to the public sector. Since the spending of local and provincial governments, coupled with residential capital investment by households, accounts for 10-15 percent of GDP and 30-40 percent of fixed capital formation in the urbanized countries of Latin America, the financing of these investments can contribute to the widespread financial distress in these countries. The fiscal linkage between the urban economy and the macroeconomy is equally important: poor local government revenue performance contributes to the consolidated budget deficit at the national level. Similarly, the absence of means to mobilize private savings for housing has resulted in large public subsidies for housing. Local government expenditures can also destabilize fragile fiscal balances. In the real sector, constraints on productivity at the city level such as infrastructure deficiencies reduce the productivity of firms and households and thus reduce the aggregate productivity of the economy.

Within this perspective, better macroeconomic management over the long term is needed to establish the parameters for urban economic growth. At the same time, the short-term disruptions in orderly macroeconomic growth have important consequences for cities. Structural adjustment policies at the macro level are intended over the longer term to create an enabling policy environment for more productive urban economies. Such an environment would increase the efficiency of firms and households and would thus support the economywide adjustment and the resumption of growth. For many countries, however, these policy changes require a corresponding urban adjustment to support national economic adjustment goals. Such a process should result in more flexible institutional and regulatory regimes at the city level to adjust to new macroeconomic realities. It would affect the production of goods and services and the broad context for investment, savings, resource mobilization, and capital formation in urban areas.

## Improving Urban Productivity

The increased importance of the urban economic activities in national production requires greater effort to improve their productivity. But improved macroeconomic management is only a necessary but not sufficient condition to improve productivity at the city level. Macroeconomic policy must also take into account the spatial dimensions of the urban economy. Economies of scale and agglomeration economies are the benefits of the concentration of urban population and economic activities; however, these economies also have costs. Key constraints such as infrastructure deficiencies, the regulatory framework governing urban markets for land and housing, weak municipal institutions, and inadequate financial services for urban development all affect these spatial dimensions and limit the productivity of firms and households in producing goods and services. The cumulative effect of these constraints is to reduce the productivity of the urban economy and its contribution to macroeconomic performance.

Infrastructure deficiencies seriously constrain the productivity of private investment in most cities in developing countries. Firms must invest significant shares of their capital in private electric power generation. Traffic congestion impedes the movement of goods and services and thus reduces the economies of agglomeration of urban markets. Some cities have more cars than telephones, while the unreliable water supplies in other urban areas constrain manufacturing. Inadequate public collection and disposal of vast quantities of solid waste add to the deterioration of air, water, and land. These public infrastructure services constitute needed *intermediate* inputs to economic activities. If such services are unavailable, private enterprises are forced to provide them on their own. That increases their total investment requirements and constrains the productivity of that investment—reducing the growth of profits, incomes, and employment, and raising prices.

A second major constraint is the heavy cost of inappropriate urban regulatory policies. Regulations affecting the establishment of productive activities significantly hinder the speed and efficiency of investment. Lengthy procedures to obtain construction permits impose heavy additional costs. Other regulations, such as those governing the markets for land and housing, have less direct, but nevertheless significant impacts on productivity by decreasing the costs of industrial and commercial investment and inputs needed for production.

A third constraint on urban productivity is the weakness of municipal institutions, both financial and technical. The dominant role of central government in planning and financing urban infrastructure has starved local governments for financial resources. The recent financial

crisis has made this situation worse, especially in Latin America where previously well-established municipal institutions have withered in the absence of central government financial transfers. In a 1984 survey of 86 developing countries, property taxes averaged less than 1 percent of total revenue. And in 19 countries between 1978 and 1986, the deficits of subnational governments (provincial and municipal) accounted on average for half the consolidated government deficit, and thus a significant percentage of GDP.

Financial dependency on central governments also affects the operation of local governments. Central control over the public investment process has undermined local commitment and capacities to operate and maintain public infrastructure and services, directly affecting the efficiency of resource use. The failure to maintain infrastructure has reached crisis proportions, and maintenance has become a developmental priority.

A fourth constraint on urban productivity is the inadequacy of financial services for urban development. Poorly developed financial sectors constrain investment in infrastructure, housing, and other urban economic activities. Weak financial systems are unable to mobilize private savings and lead governments to use public resources to finance housing. The links between the financial sector and the urban economy go in both directions, as pressure for financial subsidies in housing can have macro-financial effects.

These constraints on urban productivity matter more as urban economic activities have made up a growing share of GDP in developing countries. In the short term, the resumption of economic growth will depend in part on alleviating these constraints. In the long term, the economic future of urbanized countries will be closely linked to the level and growth of the productivity of their urban economies. While the stakes are of national significance, reducing these constraints will depend heavily on local policies and institutions, such as those for managing local fiscal deficits.

To increase the productivity of the urban economy and ensure its contribution to macroeconomic performance requires actions at the national and city levels to reduce these constraints on urban productivity. Achieving this objective will require sustained policy reform and increased efforts to strengthen urban institutions. It will involve a shift in the role of central governments from direct providers of urban services and infrastructure to "enablers," creating a regulatory and financial environment in which private enterprises, households, and community groups can play an increasing role in meeting their own needs. It will also require some measure of decentralization of responsibility to municipalities for urban finance and the management of infrastructure, with adequate safeguards to ensure accountability. This will be a complex and

politically difficult process, requiring establishing a productive and sustainable balance between local autonomy and central control.

The strategy for loosening the constraints on urban productivity has four elements which apply to regional cities of different sizes as well as the capital city:

- Strengthening the management of urban infrastructure at the city level—by improving the level and composition of investment, reinforcing the institutional capacity for operation and maintenance, and seeking opportunities for greater private sector involvement.
- Improving the citywide regulatory framework to increase market efficiency and to enhance the private sector's provision of shelter and infrastructure.
- Improving the financial and technical capacity of municipal institutions through more effective division of resources and responsibilities between central and local governments.
- Strengthening financial services for urban development.

### **Alleviating Urban Poverty**

Despite the efforts of governments and donors, the numbers of urban poor continue to increase as a result of demographic growth and constraints on productivity, and therefore on the growth of employment and incomes, and constrained access to services. The physical manifestations of urban poverty are evident in all cities in developing countries: vast neighborhoods of squatters—*barriadas*, *bidonvilles*, and *bustees*—living outside the legal framework of the city, lacking water, sanitation, urban transport, and adequate shelter, and unserved by social services such as health and education. Poor quality of life is worsened further amidst a deteriorating local environment.

Although serious in all countries, urban poverty has become particularly problematic in countries undergoing macroeconomic adjustment. Reduced subsidies to food, water, transport, and energy in urban areas, coupled with the shifting demand for labor and transitional unemployment, have reduced urban real incomes. Lower-middle class groups have been affected most, pushed into the lower-income category until the resumption of growth leads to improved opportunities for employment, higher productivity, and increased wages. These social costs of adjustment have been particularly visible in the political arena.

Three broad channels link adjustment to the incidence of poverty:

- *Wages.* Since the urban poor are especially dependent on their labor, rather than asset ownership, they bear the greatest risk

when unemployment rises. Restrictive monetary and fiscal policies affect the urban poor by shrinking labor demand.

- *Prices.* Wages adjust much more slowly than the prices of goods and services as adjustment reduces absorption, and as currency devaluations impose upward pressure on import prices. Whereas the rural poor might derive some benefit from exchange devaluation, the urban poor are net losers. In addition, fiscal reform usually involves real increases in tariffs, which again tend to affect the urban poor disproportionately.
- *Public services.* Cuts in public expenditure are usually a necessary component of adjustment programs, including reductions in public health or education which tend to have disproportionate impacts on the poor.

Managing these links between macroeconomic developments and impacts on the urban poor are important on both equity and efficiency grounds. Supporting the productive contribution of the urban poor to the urban economy will require an appropriate strategy to stimulate the demand for labor while ensuring, through provision of adequate social services and infrastructure, that the poor can take advantage of the opportunities provided. It also requires a safety net for the most vulnerable.

The challenge of urban management in the economic environment of the 1990s is to improve productivity while directly alleviating the growing incidence of urban poverty, and thereby also improving equity. As *World Development Report 1990* spells out, this does not require a trade-off between strategies to promote economic growth and to reduce poverty; poverty reduction is possible in part through improving productivity at the individual, household, firm, and urban levels. This approach involves directly increasing the labor intensity of productive investment and improving the human capital of the poor through better education, health, and nutrition.

To alleviate urban poverty—due to the short-term impacts of macroeconomic adjustment and the longer-term structural problems of demographic growth, low productivity, and constrained access to urban services—requires:

Managing the economic aspects of poverty, through—

- Increasing the demand for the labor of the poor through government policies to encourage labor-intensive productive activities.
- Alleviating the structural constraints inhibiting the productivity and growth of the informal sector by reforming regulations and codes that limit the access of the poor to urban services, infrastructure, credit, and markets.
- Increasing the labor productivity of the poor by reducing constraints preventing labor-force participation, such as constraints