URBAN ECONOMIES AND NATIONAL DEVELOPMENT

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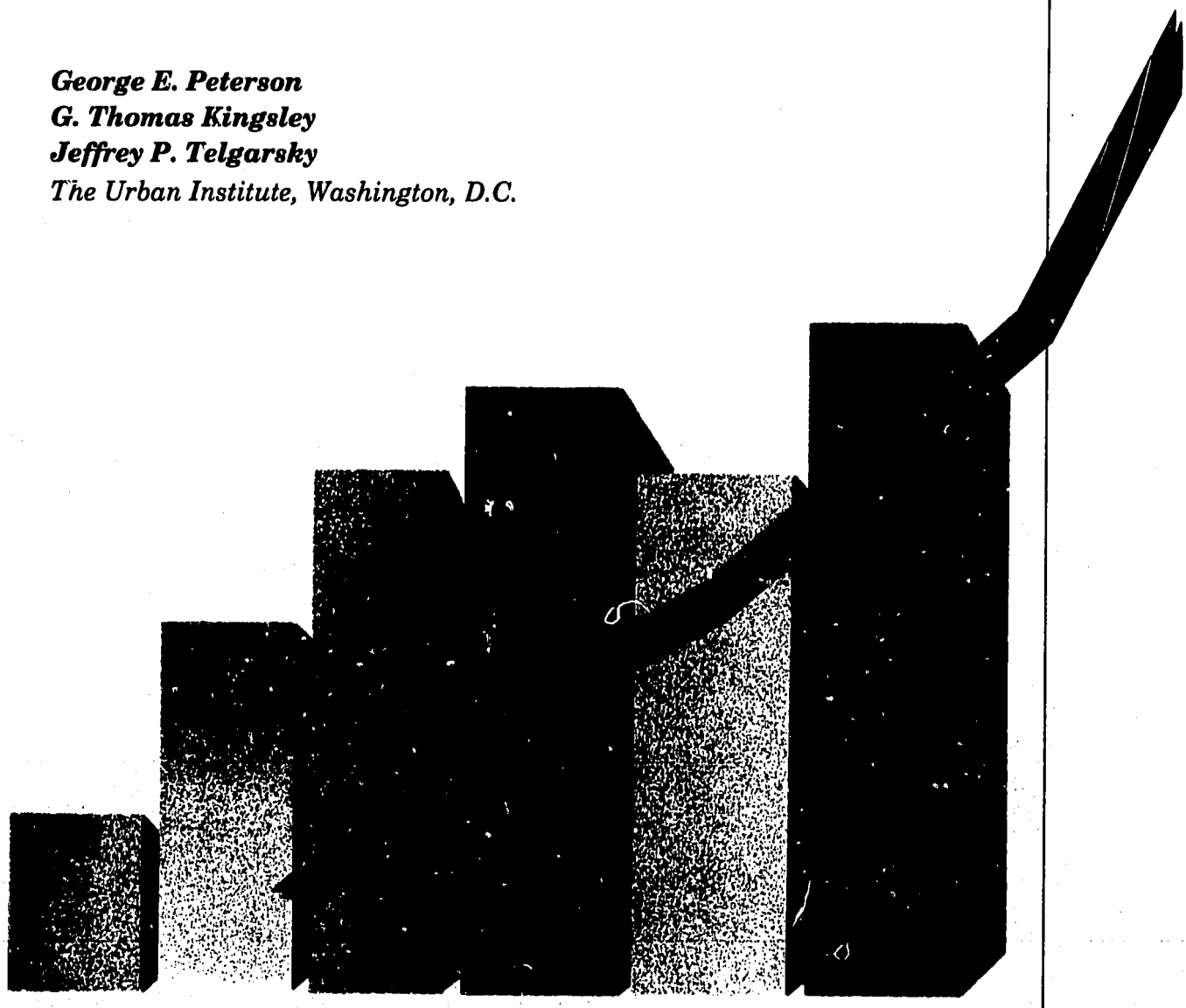

Office of Housing and Urban Programs
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CONTENTS

■ *LIST OF TABLES*

■ *LIST OF FIGURES*

■ *LIST OF BOXES*

ABSTRACT

This report is the product of research conducted by The Urban Institute under the sponsorship of USAID's Office of Housing and Urban Programs. It focuses on the relationships between the urbanization process and national economic development. The study is based on original field work, a review of recent analytical literature, and on the results of three seminars organized by The Urban Institute for USAID. The seminars focused on the relationship between urban development and macroeconomic policies; the impact of the functioning of urban land markets and systems of urban infrastructure provision on the national economy; and the interrelationships among urban development, urban labor markets, urban-rural linkages, and environmental conditions.

The first chapter of the report explains why many developing nations (along with international donors) have changed their view on the role of urbanization in the development process. Most are now coming to see urban growth more as a positive opportunity than a problem. The chapter also offers an economic framework for analyzing urban size and efficiency.

The next chapter considers the relationships between urban development and macroeconomic policy by focusing on the effects of the structural adjustment programs of the past decade. A special section looks in depth at the linkages between urban housing finance and macroeconomic policies.

The third chapter explores urban economic development from the local perspective. It examines how economic growth is (and can be) affected by local policies influencing land and infrastructure markets, local subsidies designed to attract industry, and public-private cooperation in the formulation of local development strategies that take advantage of a locality's competitive strengths.

The implications of the study's findings for policy and research are discussed in the final chapter.

IS ABOUT

■ This is a report about "urban economic development." The term invites many interpretations. It is perhaps most commonly used in the local sense. When city leaders speak of formulating an urban economic development strategy, their goal is to achieve faster economic growth and generation of jobs for their own community. At the national level, urban economic development policies are often understood to mean those that will produce more growth for the urban sector, or those that will favor urban activities at the expense of rural activities.

From the perspective of a Chamber of Commerce, mayor, or League of Cities, this focus is understandable. To them, in the short run, it may not matter greatly how urban growth is generated, or whether it is inefficiently diverted from other locations through public policy.

That is not the perspective of this report. Our concern lies with the contribution urban areas can make to national economic growth. If this goal is best achieved by having major urban areas grow more slowly or assume more of the burden of their own financing against the wishes of local taxpayers and businesses, we argue that the resulting strategy is still desirable national policy and desirable urban development policy. There should be no presumption that urban policy must be pro-urban in the narrow sense of trying to make cities better off relative to the rest of the nation.

One of the most important lessons from the experience reviewed here is the futility of talking about rural and urban development as if they were opposing alternatives. Rapid urbanization does go hand in hand with economic growth, at least in the intermediate stages of economic development. Attempts to prevent urbanization, by prohibiting internal migration or freezing the number of business establishments in cities, will almost always inflict high economic costs. But this in no way implies abandoning fruitful rural development themes in favor of a pro-urban stance. Rather, governments and international donors should strive for policies that enhance market efficiency across all locations, without trying to construct a specifically "rural" or "urban" policy program.

INTENDED AUDIENCE

This report attempts to bridge the gap between "urban policy" and "national economic policy," and between urban development specialists and those making or advising on macroeconomic decisions.

We hope it will be useful, first of all, to those who design urban housing programs, infrastructure projects, and local small business policies and programs. Too often, these programs are designed as if they stood alone, without reference to a national economy, and as if their success could be judged on project terms and not by their ability to contribute to national economic development. Local government officials, of course, should be myopic to some degree; their effectiveness rests on their ability to think first and most vigorously about the local community. However, external advisors, whether in state or national government or international aid agencies, have the obligation to assess the impacts of local action on the entire country. And even local officials must take into account the national market realities

that constrain their choices. We see this report as an introductory guide to the best strategies to use in moving from a local perspective on urban programs to a national market perspective.

We hope, too, that the report will be useful to those who design or recommend national economic policies. Because cities contain such a high concentration of economic activity and politically influential households, the policies adopted toward them have great potential for generating gains or losses in national economic efficiency. Not every national growth strategy needs to have a parallel "urban development strategy." But many of the policy prescriptions contained in structural adjustment programs, for example, are played out in the cities. Those who design and try to implement these programs need an appreciation of the specifically urban institutions and urban markets in which abstract plans get translated into reality. It is one thing for a central government official (or international advisor) to conclude that, because central government budgets are unbalanced, more responsibility for revenue raising ought to be delegated to local government; or that housing and local infrastructure investments should pay for themselves through higher fees, charges, and interest rates. It is quite another thing for a local official to implement this policy change. Besides the political opposition to be encountered, the new policies are likely to disrupt local markets in ways that central government officials, with their macroeconomic perspective, have not anticipated. Many national economic reform programs have failed, not because they did not make sense at the national scale, but because they were incompatible with the way institutions and markets operate at the local level. We hope this report will help convince national policymakers of the relevance to national development objectives of such "nuts and bolts" matters as urban land use regulations, housing mortgage finance systems, and local tax incentives to attract industry.

AREAS IN NATIONAL ECONOMIC DEVELOPMENT

Chapter 1

■ *Recent world events have caused developing country leaders to rethink their economic growth policies, and have led to increasing acceptance of market-oriented development strategies that imply rapid urbanization. In the 1970s, the case for focusing on rural development was based in part on a view that cities were inefficient and drained scarce national resources with little productive return. However, recent experience and analysis demonstrate the limits of exclusively rural development strategies and indicate that cities are more efficient sources of economic growth than was previously thought.*

For developing countries, the 1980s are likely to be regarded as a fundamental turning point. At the start of the decade, the societal mind-set in most of these countries was fixed on government as the prime mover in development. Events subsequently shattered that paradigm. Mounting evidence on the failures of public sector enterprises, the highly publicized successes of export-oriented market economies (like Taiwan and the other "Asian Tigers," noted as much for bringing a large share of their populations out of poverty as for growth per se), the ideological shock wave that emanated from China's acceptance of the profit motive, and, finally, the collapse of the old order in Eastern Europe and the Soviet Union have caused almost all developing countries to rethink their economic growth policies. Third world leaders have not abandoned their traditional social goals, but by 1990 there were few who did not see a healthy private sector as the central mechanism for achieving national economic development.

The 1980s also witnessed the start of another important change in policy thinking in the developing world, one closely linked to the acceptance of market-oriented economies: the growing acceptance of rapid urbanization. Through most of the post-colonial era, the majority of national leaders and international donors, at least in rhetoric, were anti-urban. Cities, particularly large cities, were regarded as parasitical and their growth—implying massive concentrations of poverty—was viewed as a threat to social betterment. To be sure, there were good reasons for these concerns. Moreover, the language discouraging big-city growth was rarely matched by public policy, which often continued to favor those who lived and worked in the cities. Nonetheless, today rapid urban growth is more often seen as not only inevitable but as a natural

Today rapid urban growth is more often seen not only as inevitable but as a natural accompaniment to economic and social progress.

From the 1940s through the mid-1970s, a mandate seemed present to focus on rural development. In 1960 rural areas accounted for 77 percent of the population of all developing countries, and an even larger percentage of households in poverty. On the opportunity side, the ideas were then being formulated that would create the Green Revolution.

accompaniment to economic and social progress.[1]

This chapter examines why cities were often given low priority in development theory in the past. It then assesses the most recent analytical findings, which suggest that the cities' negative role in development has been overdrawn and that urban development can contribute importantly to national economic development. The chapter concludes by presenting an economic framework for considering the efficiency of urban growth.

THE CASE FOR RURAL DEVELOPMENT

Much of the opposition to urban development as a national economic strategy has stemmed from the belief that rural development should have a higher claim on public policy, and that the two development strategies must compete with each other for resources and pre-eminence.

Well-designed support strategies will always focus on topics and locations where two conditions are present: the existence of a serious problem and realistic opportunities for solving it. From the 1940s through the mid-1970s, a mandate seemed present for focusing on rural development in developing countries. The problem was certainly there. In 1960 rural areas accounted for 77 percent of the population of all developing countries, and an even larger percentage of households in poverty (United Nations, 1986). On the opportunity side, the ideas were then being formulated that would create the Green Revolution. High-yielding plant varieties coupled with effective fertilization, irrigation, and other techniques offered the potential for vast increases in output per acre. At the same time, there appeared to be a number of reasons for avoiding investment in urban areas. These are discussed below.

"Cities Already Benefited from an Urban Bias"

From the 1940s into the 1980s many countries either heavily subsidized foods and other basic commodities consumed by urban populations or placed ceilings on their prices.[2] They steered large shares of infrastructure investment into the cities. The price ceilings directly limited the incomes that could be generated in agriculture, while it was the rural economy that had to cover much of the costs of the subsidies. Behind this skewing of incentives lay the fact that the elites who control national policy normally live in the largest cities, as do the bulk of civil servants. The rural development strategy advanced by many international agencies called for direct support to small farmers. It was feared that the benefits of investment in the cities would be captured by suppliers there, without reaching the rural community at large or the urban poor. Moreover, poor households in the cities were thought to already benefit from more public subsidy than the poor in small towns or rural areas. All of these considerations implied that, at the margin, both national and external funds could be employed more productively and more equitably outside the big cities.

"Cities Are Too Expensive"

Urban growth necessitates expensive infrastructure investments in piped water supply, sanitation, better local roads and other capital networks, as well as housing. Urban migration often appears wasteful because it has the paradoxical effect of

leaving behind serviceable housing and other capital in the areas of out-migration while requiring large capital investment to accommodate migrants in their new locations. Capital costs for productive activities are also usually higher per worker in cities than elsewhere. Estimates made in the 1970s of the total cost of investment needed to accommodate urban growth were startling. According to one (Prakash, 1977), the investment required just to provide housing and infrastructure for the expected migrants to Asian cities in the last two decades of this century would exceed the region's *total* domestic savings.

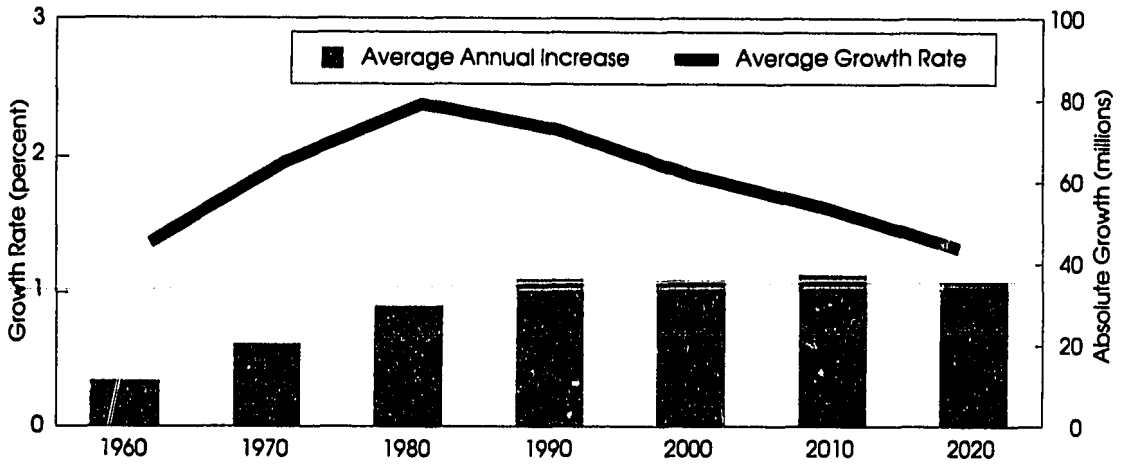
"Cities Increase Unemployment"

The average population growth rate of the world's developing regions from 1960 to 2000 is estimated at slightly over 2.1 percent per year. At this rate, total population will rise from 2.1 billion in 1960 to 5.7 billion in 2010. The employment challenge is stiffer still. An especially large population cohort was born in the 1950s and 1960s at a time when death rates had plummeted but birth rates had not yet begun to decline rapidly. This cohort has now reached working age. In order to avoid increases in the global unemployment rate, job creation must accelerate faster than population growth or youth must be kept in school longer, which will occur only if there are economic rewards to more years of schooling. Starting in 1990, an average net increase of more than 35 million jobs per year will be required to provide employment to all new labor force participants, even assuming much larger rates of school attendance (see Figure 1.1). However, the *acceleration* in labor force growth has begun to stabilize and decline.[3]

A dominant theory of the 1970s held that the employment problem would manifest itself most acutely—and with ever-increasing severity—in cities. Urban labor

A dominant theory of the 1970s held that the unemployment problem would manifest itself most acutely and with ever-increasing severity in cities. The rapid growth of squatter settlements and street vending in virtually all major cities of developing countries seemed to verify this theory.

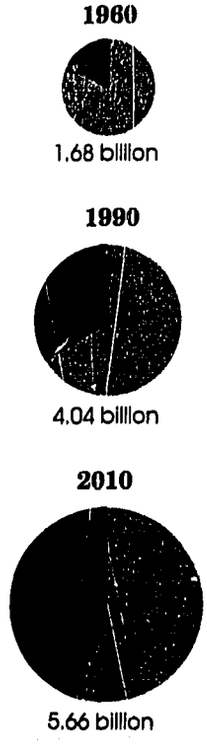
Figure 1.1
PROJECTED GROWTH OF LABOR FORCE IN DEVELOPING COUNTRIES, 1960-2020



Source: ILO, 1986.

Why is the case for emphasizing rural development breaking down? On the one hand it has become clear that rural areas in most countries are incapable of absorbing a major share of labor force growth. On the other hand, there are signs that urban economies have more dynamism than was assumed in the 1970s and can help support growth in the rest of the country.

Figure 1.2
THIRD WORLD URBAN AND RURAL POPULATION, 1960-2010



Source: United Nations, 1986.

supply in developing countries was believed to increase much faster than urban labor demand. Institutional rigidities in cities were said to artificially raise wage rates in the formal or modern sector of the urban economy. This stimulates continuing migration by job seekers from the countryside even when there is insufficient demand for them. The result is: first, escalating unemployment, as even a relatively low probability of finding a high-paying job spurs families to add themselves to the urban labor supply; and second, a dualism in urban labor markets, as a burgeoning but fundamentally unproductive informal sector springs up to cushion the severe unemployment caused by the lack of jobs in the formal sector.[4] The rapid growth of squatter settlements and street vending in virtually all major cities of developing countries during the 1970s seemed to verify this theory. The continued growth of underemployed, marginal populations in the cities was seen as a basic threat to societal aspirations and even stability. Rural development policies were advocated in part because they could diminish this flow of would-be workers into the cities.

RECENT REASSESSMENTS: A MORE POSITIVE VIEW OF URBANIZATION

The case for concentrating on rural development was persuasive. Not only did rural growth prospects seem promising, but there was added urgency because the alternative—massive migration to the cities—appeared disastrous. Why is the case for emphasizing rural development breaking down? There are several reasons, but two are probably most important. On the one hand, it has become clear that rural areas in most countries are incapable of absorbing a major share of labor force growth. Even where the Green Revolution has been most successful, urbanization has accelerated. On the other hand, there are signs that urban economies have much more dynamism than was assumed in the 1970s and, with the right policies, can help support growth in the rest of the country. These and other factors are beginning to shift policy–makers' attitudes about urban development.

Limits of Rural Labor Absorption

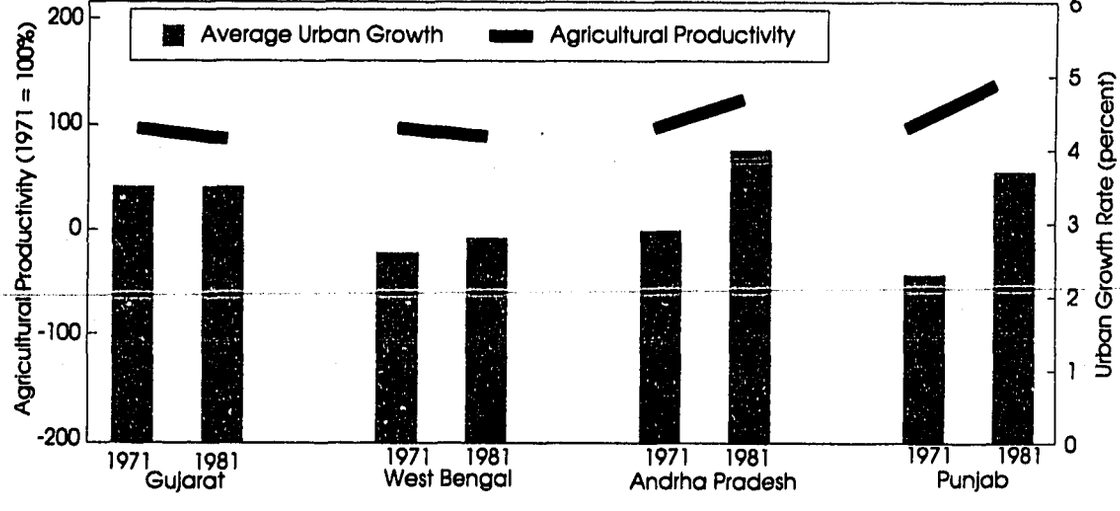
Even though hopes in the early 1960s

for major expansions in agricultural output have since been fulfilled in many countries, it is now clear that this success did not inhibit movement to the cities. In fact, urban migration has been most pronounced where the agricultural sector has performed well. The very success of the Green Revolution means that more agricultural output can be produced with fewer workers, producing an "excess" rural population that has to be absorbed elsewhere in the economy. The United Nations estimates that between 1960 and 1990 the rural populations of developing countries grew at an annual rate of 1.7 percent, while their urban populations grew at 3.7 percent. Urban populations of developing countries almost tripled over the period (see Figure 1.2). Figure 1.3 illustrates the trend of rapid urban growth even in areas where agricultural development has been successful. Those states in India that have had the best performance in agricultural productivity growth nonetheless have seen their urban populations burgeon.

As evidence like this has been compiled, there is now much broader acceptance of the view that rural areas will not be able to employ a large share of the growing labor force, even under the most favorable conditions. Moreover, the largest gains from the Green Revolution have already been accomplished in most countries. USAID's Bureau for Asia and the Near East (1989) recognizes this and the importance of urban-rural linkages in the development process:

> *As agriculture continues to grow, the demand for labor declines as yield increases begin to slow. New entrants into the rural labor force, who are often better educated, tend to look to the industrial and services sectors for employment. Expansion in these sectors,*

Figure 1.3
URBAN GROWTH AND AGRICULTURAL PRODUCTIVITY IN INDIA, 1971-81



Sources: Mohan, 1984; Mohan & Thottan, 1988.

Box 1.1
URBAN LABOR MARKETS AND RURAL-URBAN MIGRATION

The traditional view of labor markets holds that rural workers are lured to the city by the hope of earning high wages. Once there, they discover that these wages are available only for a fortunate few who can gain entry into the modern private sector. The other migrants end up unemployed or marginally employed in the informal sector. Detailed country studies, however, reveal that migrants are much better informed about job opportunities than previously supposed, make broadly rational migration choices, and use extended family and village networks to insure themselves against some of the risks of moving. Research in India illustrates these points.

First, most rural migrants to urban centers do not strike out on their own, but follow migration paths already established by others from their extended families and villages. Migrants generally do not leave for the city until they have secured a good job prospect. A study of Punjabi migrants to Delhi found that 70 percent of migrants had a job one month after arriving in the city and 94 percent had found work after two months.

Second, migrants who take up informal sector jobs do not necessarily earn lower incomes than urban residents with formal sector employment. Surveys in Calcutta, Delhi, and Bombay showed that manual workers in many fields (such as construction) and those employed in informal activities that draw on traditional skills (such as tailors, smiths, and carpenters) have earnings that surpass those

caused by growing domestic demand for non-agricultural goods and services, leads to increased employment there. Such expansion also leads to declines, first in the growth rate of the agricultural labor force and in its relative size, and then in the proportion of net national income generated by agricultural sector activities. Increases in urban sector incomes, which continue to be supported by low food prices, lead to shifts in consumer demand away from cereals toward higher quality protein in the form of meat, poultry, and dairy products, and greater dietary reliance on processed rather than bulk agricultural products. During this process, the source of growth in agricultural employment shifts from field production to processing, marketing, and transportation—initially to meet domestic demand, and later to service exports.

Efficiency and Dynamism of Urban Labor Markets

Research by Kahnert (1987), Kannappan (1985), and others (e.g., Bowles, 1988) demonstrates that many of the assumptions underlying the dual labor market model of the 1970s—which assumed that urban wage levels were segmented between modern and traditional activities in ways unrelated to productivity differentials—have not been sustained by closer empirical studies (see Box 1.1). In particular, wage differentials, both among urban occupations and between city and rural alternatives, have been found to be closely related to worker productivity, as

of mid-level formal sector employees (such as high school teachers or clerical workers). The informal sector is not a waste bin for those who cannot find work, but a competitive center of economic activity.

Third, extended households share income between those who remain in rural areas and those who move to the city. This allows the household to maximize its income while keeping total risk to a minimum. Migrants to Delhi were found to make remittances to rural areas that were significant in improving the welfare and productivity of household members who remained in the village; migrants who moved to the city retained the option of returning to the village if they were unable to find jobs.

Migration to the city, in short, boosts earning opportunities for migrant workers and their extended families. However, migration for economic advancement is not equally open to all rural or village families. Greater rural property holding and higher education levels increase the probability of migration. In other words, initial resource endowments are important in successfully entering the urban economy. The unequal personal endowments of migrants are reinforced within urban areas by the paucity of institutions that grant uniform access to schooling, information, credit, employment, and shelter. Migration could be still more successful in boosting labor productivity and earnings if urban institutions were more democratic. However, even with these constraints, the best picture of migration and the urban labor market is not one of market failure, but of market participants with scarce and unequal endowments struggling to make rational lifetime earnings choices.

Sources: Kannappan, 1985; 1988.

Migration into cities, rather than exacerbating resource misallocation, has increased the net productivity of the economy by directing labor to locations where it can earn a higher wage and make a greater contribution to economic production.

evidenced by education, skills, and other embodied human capital, rather than the product of arbitrary market segmentation between traditional and modern sectors. This evidence indicates that urban labor markets are more efficient at allocating resources than previously supposed. It then follows that migration into cities, rather than exacerbating resource misallocation, has increased the net productivity of the economy by directing labor to locations where it can earn a higher wage and make a greater contribution to economic production. It should also be noted that natural increase in the urban population has become more important, and rural-urban migration less important, as a factor in urban population growth.

Other claims of the dual labor market model have been similarly rebutted:

- Although the dual labor market model predicts a spiraling accumulation of unemployed labor in the cities (Todaro, 1977), subsequent studies have failed to find empirical evidence of aggregate growth in the urban unemployment rate. If anything, open unemployment rates appear to have declined in the 1970s and early 1980s, and underemployment rates are now estimated to be much lower than previously believed. The revised view of underemployment stems in part from recognition of the competitive earning power of work in the informal sector.
- New migrants to the cities, in particular, appear to possess much more realistic information about job opportunities than previously thought. In several countries where local empirical studies have been conducted (Peterson et al., 1988), the

The rapid growth of "informal sector" populations in cities appears to have been misinterpreted as a sign of the accumulation of would-be workers unable to find productive employment. Instead, informal sector activities most often have been deliberately chosen. Net incomes of informal sector workers on average have been found to exceed those of similarly experienced formal sector workers.

Box 1.2
LOCAL ENTREPRENEURIAL DRIVE AND JOB GROWTH: THE CASE OF BANGLADESH

Through the 1970s, Bangladesh had a small, traditional manufacturing sector. Jute products were its primary export. Its policies were strongly inward-looking, and rapid economic restructuring appeared unlikely. It was the second poorest country in the world. The success of its new export garment industry in the early 1980s, therefore, came as a shock to most observers.

It began with an agreement between a major South Korean manufacturer (Daewoo) and a new Bangladesh firm (Desh). Desh would purchase sewing machines from the South Korean firm and give it royalties equivalent to 8 percent of sales. In return, the South Koreans would train Desh's staff, advise on textile production, and handle external marketing. Most important, they also showed Desh how to establish a bonded warehouse system. This exempted the firm from many of the restrictions of the highly protected Bangladesh economy.

By the end of 1979, 130 Desh staff had completed training in South Korea. By April 1980, with 500 employees and 400 machines, Desh was ready to start operations. It grew rapidly and built so much confidence that after its first year and a half, it cancelled its collaboration with Daewoo and

unemployment rate among recent migrants has been found to be significantly lower than among longer term residents of cities. This reflects the fact that new migrants typically investigate job possibilities before making a commitment to move, and have an active network of extended family or village members already resident in the city, from whom they can acquire information and assistance in job placement.

■ The rapid growth of "informal sector" populations appears to have been misinterpreted as a sign of the accumulation of would-be workers unable to find productive employment. Instead, informal sector activities most often have been deliberately chosen, in response to a rational weighing of economic opportunities, given the bureaucratic red tape and other factors limiting entry into the formal sector. Several country studies have found that the net incomes of informal sector workers have been found to exceed on average those of similarly experienced formal sector workers, thus offsetting the greater instability of the informal sector. Informal sector housing investment, as well as use of the home to produce income through rental or retail and production activities, appear to be the result of highly rational economic decision making (Strassman, 1987; Fass, 1988). Moreover, the distinction between the formal and informal sectors can easily be exaggerated. Most extended households in the informal sector have at least one member employed in the formal sector. Informal firms often are important suppliers to formal sector firms. Households that can be classified as belonging to one sector for work purposes may belong to another for residential purposes. Thus, the informal sector is best viewed not as marginal or unproductive, but as a competitively remunerated population that has chosen to conduct its affairs outside many of the regulations of

began doing its own marketing. Growth accelerated. In 1987, Desh sold 2.3 million shirts valued at US$5.3 million- almost 100 times the value of its first year's sales.

Desh was the catalyst, but it was only a small part of the story. Over the first 7 years, 115 of the 130 original trainees left the firm and many started their own clothing businesses. Others learned from their success. By 1985, 700 garment-exporting businesses were operating in Bangladesh. At that point, with external sales of over US$400 million, clothing had replaced jute as the nation's leading export.

Then the fledgling industry faced a setback. Because of concern for its trade deficit, the United States—then the dominant customer for Bangladesh garment firms—imposed an import quota on Bangladesh products. Canada, Britain, and France also established quotas. The majority of the Bangladesh firms were forced to close.

Negotiations in 1986 and 1987 led to a loosening of the quotas, however, and the industry has since bounced back. As a result of the experience, Bangladesh firms are attempting to diversify their customer base (giving more emphasis in marketing to Australia, Japan, the Soviet Union, and other countries) as well as their range of products.

Sources: The World Bank, 1989b; The Economist, 1989.

the formal sector because of the latter's high costs.

Urban labor markets—at least in the private sector—appear to be relatively efficient devices for allocating resources. Their dynamism largely reflects genuine earnings opportunities, rather than artificial wage levels or uninformed drifting toward the city.

Potential of Urban Entrepreneurism

Whether cities in the future will be able to generate enough jobs to keep the urban unemployment rate from rising is unknown. What is clearer is that the principal burden of job creation will fall on the private sector. At a time when public sector deficits represent one of the gravest dangers to financial and fiscal stability, it is unrealistic to look to the public sector for strong labor demand. In a large number of countries, national governments are attempting to cut the public work force.

In the past, many observers claimed that a lack of entrepreneurs willing to assume economic risks, coupled with a lack of access to capital markets sharply limited the private sector's growth potential, especially in the poorer developing countries. Private-sector success stories of late have demonstrated that there is a considerable reservoir of entrepreneurial flexibility. The transition from protected domestic markets to international competitiveness undoubtedly will be traumatic in many countries (as it has been in the United States), and will require a degree of risk-taking that investors prefer to avoid. However, the fear that high-profit investment opportunities will go unexploited, for lack of entrepreneurial spirit, seems to have been exaggerated. The growth of export-oriented clothing production in Bangladesh provides an illustration of local entrepreneurial drive and its employment-generating potential (Box 1.2).

In the past, many observers claimed that a lack of entrepreneurs willing to assume economic risks sharply limited the private sector's growth potential, especially in poorer developing countries. Private sector success stories of late have demonstrated that there is a considerable reservoir of entrepreneurial flexibility.

Box 1.3
RURAL-URBAN LINKAGES: EFFECT OF CITY GROWTH ON AGRICULTURE

Research in Sub-Saharan Africa by Jean-Marie Cour of the World Bank shows farmers to be active economic agents who respond relatively efficiently to price signals and benefit from increases in urban domestic market demand. Farmers have met increased demand from food consumers with a lag of 15 to 18 months, as long as demand was allowed to express itself through free price mechanisms.

Food productivity was found to be significantly higher (and to grow faster) in countries that have experienced rapid urbanization. The food surplus per farmer produced in West Africa, for example, is twice as high as that in East Africa, which is much less urbanized.

As a result of these relationships, cash income per farmer has increased much faster in countries where the urban market has been allowed to develop. Cour finds that artificially repressed urban growth is quickly becoming a constraint on agricultural production. Farmers will not grow crops more intensively on their land if there is not a cash market for their increased output. This potential cash

Studies of the migration patterns from rural villages to cities have shown that migration is a highly self-selective process. Those who move to the cities tend to be risk takers willing to try to build businesses on their own. In fact, one of the greatest long-run contributions to economic growth that cities can make is to provide a productive outlet for the entrepreneurial drive of migrants, who otherwise would be frozen into village economic and social patterns, where their entrepreneurial potential would remain unrealized.

Reduction of Urban Bias

The structural adjustment programs implemented in developing countries in the 1980s have almost universally involved reducing public subsidies and price distortions. By increasing agricultural prices and earnings, these policies have gone far to reduce the urban bias found in the capitals of many less developed countries (see Chapter 2). Public sector workers, traditionally the most overpaid group and the one whose wages bear the least relation to productivity differentials, have been particularly hard hit by structural adjustment programs, experiencing sizable employment reductions and real wage losses. Food subsidies for the biggest cities have been trimmed. Charges for public services, though still usually subsidized, are moving toward cost recovery. Once these price signals are made right, there is considerably more justification for letting markets operate, even if they produce rapid growth of urban areas.

Importance of Rural-Urban Linkages

Neither rural nor urban development can proceed in isolation. Urban populations must be fed, and the domestic urban market normally provides the largest cash market for small- and medium-sized farmers. Successful urban growth translates

market can be suppressed either by public policy that discourages urbanization or by policies that prevent farmers from realizing market prices for their output.

Case studies of Ghana and Côte d'Ivoire illustrate these differences. The Côte d'Ivoire has had very rapid growth of secondary cities, fueled by rural migration. Concurrent with these population shifts have been strong increases in agricultural productivity (1.7 percent annually over the period 1965-1985). Food crops for domestic consumption accounted for more than half of the real doubling of farmers' monetary incomes in this period. The growth in demand from a rapidly increasing urban population is strong enough that per capita incomes of rural producers should keep on growing even if the urban-rural terms of trade turn against them and the value of export crops stagnates.

In contrast, Ghana's rate of per capita income growth during the same period was much lower—despite having a similar resource endowment as Côte d'Ivoire. Ghana pursued a policy of discouraging urban population growth and refusing immigration to the cities from other African countries. The resulting stagnation of domestic demand for food crops triggered a 14 percent decline in agricultural production between 1965 and 1982.

Sources: Cour, 1987; 1988.

directly into higher demand for domestic agricultural production. In fact, a study of eight less developed countries during the 1960s (Bose, 1978) found no case of real wages in private-sector manufacturing rising without agricultural wages also rising. At the same time, rural towns and regional centers support agricultural development by providing marketing and transportation facilities, inputs such as fertilizer, seeds, and farm machinery, and retail goods for farm consumption. These rural-urban linkages have long been recognized by analysts.[5] However, recent studies suggest that urban growth and the possibility of rural-urban migration may be even more critical to agricultural productivity gains in developing countries than previously thought. Jean-Marie Cour's research for the World Bank on Sub- Saharan Africa has concluded that unimpeded urban growth is crucial to rural income and productivity gains (see Box 1.3). If this is so, much of the conflict between rural and urban growth strategies disappears.

Recent studies suggest that urban growth and the possibility of rural-urban migration may be even more critical to agricultural productivity gains in developing countries than previously thought. If this is so, much of the conflict between rural and urban growth strategies disappears.

Payoff to Urban Investment

Nothing has changed the view that more capital is required to support population growth in cities than in rural areas. However, recent evidence suggests that the additional investment may be both more manageable and more worthwhile than previously assumed. First, earlier capital needs estimates were based largely on shelter and infrastructure standards inherited from developed countries. More recent studies suggest that with lower standards and less capital-intensive technologies, basic urban infrastructure needs can be met within domestic resource capacities, at least in many developing countries.[6] Second, there has been greater recognition of the fact that urban infrastructure has been more heavily sub-

sidized than is desirable or necessary. No one thinks that expanding local cost recovery to finance local infrastructure will be easy politically, but at least the economic possibility of doing so is now apparent.[7] Several countries have formally taken policy decisions that their major metropolitan areas should be "self-sufficient" in financing public capital investment, meaning that savings or taxes generated elsewhere in the country should not be used to pay for infrastructure facilities in the big cities.[8] Significant practical movement toward greater cost recovery is visible in many large urban regions.

Finally, there is more acceptance of the view that while initial capital requirements may be greater in the cities, the payoff to such investment also can be high. Residential infrastructure costs are higher in part because households are better equipped with piped water, waste removal, and electricity when living in urban areas—all factors that generally show up in better health indicators. Households moving to cities typically upgrade their sanitary conditions, educational levels, and transportation access. It is more efficient to upgrade facilities under the high-density living conditions of the cities than to attempt to install comparable infrastructure networks in rural areas. Thus, the higher capital investment caused by urbanization brings health and social benefits that could be achieved in rural areas only at far greater costs.

Capital investment costs for new job creation also tend to be higher in the cities. Some observers have inferred from this fact that it is more efficient to create jobs elsewhere. However, the returns to industrial or commercial investment also tend to be higher in cities than in small towns or rural regions. There is a better chance of creating productive and well-compensated jobs in the cities, in part because workers have more complementary capital inputs to increase their productivity. It is fruitless to search for universal rules as to where new manufacturing and service investments can most efficiently be located. However, in making such judgments for individual countries, it is the rate of return to capital in alternative locations, corrected for externalities, that is critical. A policy of trying simply to minimize the capital costs of job creation makes no sense, despite its popularity in national development planning and foreign aid projects.

While initial capital requirements may be greater in cities, the payoff to such investment also can be high. Urbanization brings health and social benefits that could be achieved in rural areas only at far greater costs. There is a better chance of creating productive and well-compensated jobs in cities, in part because workers have more complementary capital inputs to increase their productivity.

Remaining Problems Associated with Urbanization

None of this is to deny that urban growth poses special development problems, some of which have been badly underestimated in the past. The environmental degradation produced by urban growth through pollutant discharges, whether into air, water, or landfills, has yet to be adequately reflected in either market pricing or, in most countries, government regulations. As a result, urban investments can appear to be more valuable to society than they in fact are, once adverse externalities are taken into account.

Perhaps the most difficult problem to address is the fact that neither rural nor urban development, and not even large-scale job creation, offers a fully adequate way out of poverty.

The most recent data (World Bank, 1990a) indicate that poverty is still dispro-

portionately concentrated in rural areas—whether poverty is measured in terms of income levels, ability to meet minimum food consumption standards, or health indicators. There has been a steady shift of poverty concentrations to the cities, however, paralleling the general population distribution. Over the next few decades, aggregate poverty will become much more of an urban problem than it has been in the past for most developing nations.

Although migration to cities contributes to aggregate poverty reduction, there are very real limits to what it can achieve. For the poorest developing nations, cities are unlikely to create jobs at the rate countries need to keep unemployment from getting worse.[9] Moreover, for workers of comparable characteristics, the real wage differentials between city and rural locations are now relatively small. Migration to the city, therefore, cannot by itself be a primary solution to poverty. The city may create better long-run economic opportunities—for education, entrepreneurial development, and skills training—but urban poverty has a special harshness, both for the individual who may be cut off from a family support system, and for society, because urban poverty can be more easily transformed into social discontent.

Urban economic development is in no sense a total remedy for underemployment or poverty. It is, however, a necessary ingredient of any program to attack poverty.

AN ECONOMIC FRAMEWORK FOR ANALYZING THE EFFICIENCY OF URBAN GROWTH

Some of the controversy over the role of urbanization in economic development arises from confusion about how the basic empirical evidence regarding city performance should be interpreted. Critics of cities often affirm that they are inefficient locations for economic investment because wage levels and land prices are higher there. Defenders of cities point to the higher productivity of the urban labor force. An economic framework for considering city size and efficiency can help disentangle these claims and counter-claims.

In the basic economic models of urban growth (Bergsman et al., 1972, 1975; Henderson, 1988) cities enjoy productivity advantages that derive from three sources: 1) economies of urban scale, 2) economies of agglomeration (that is, efficiency advantages produced by the clustering of firms in a given industry or related industries, regardless of overall urban size), and 3) location-specific factors, such as access to natural resources or water routes that are used in trade.

Table 1.1 illustrates just how large the productivity differentials can be by comparing the concentration of national output in cities with the concentration of national employment or population. Ljung and Farvacque (1988) estimate that, overall, some 60 percent of the gross national product of developing countries is now produced in urban areas, although these areas contain only about one-third of the total population. They further estimate that "even if efforts to promote agricultural growth and to remove whatever urban bias may still exist prove successful, some eight-tenths of (future) GDP growth will come from urban areas."

The productivity advantages of urban areas permit enterprises to pay higher wages to urban workers, and if labor and

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If markets are functioning smoothly, the very fact of urban growth is a sign that the economy is adjusting to the relative productivity advantages that cities (or some cities) possess. Assertions that urbanization is unproductive implicitly rest on claims of different kinds of market failure.

Table 1.1
IMPORTANCE OF URBAN AREAS

	Year	% of National Population	Shares of National Output
All Urban Areas			
Haiti	1976	24	58% national income
India	1970	20	39% NDP*
Kenya	1976	12	30% national income
Mexico	1970	60	80% personal income
Turkey	1981	47	70% GNP
Individual Cities			
Abidjan, Ivory Coast	1985	15	70% economic & commercial transactions
Sao Paulo, Brazil	1970	9	36% NDP
Guayaquil, Ecuador	n/a	13	30% GDP**
Karachi, Pakistan	1974	6	16% GDP
Lima, Peru	1980	28	43% GDP
Manila, Philippines	1970	12	25% GDP
Bangkok, Thailand	1972	11	37% GDP
Bangkok, Thailand	1985	13	86% GDP in financial sector 74% GDP in manufacturing
Lagos, Nigeria	1980	5	40% skilled labor force

*NDP: Net Domestic Product **GDP: Gross Domestic Product

Sources: Kahnert, 1987; Research Triangle Institute, 1988.

production markets are competitive, will force them to do so. They also drive up urban land and housing prices, since land ownership is the key to gaining access to the urban productivity advantage. By themselves, high wage levels, high land and housing prices, and high per worker productivity do not demonstrate either the desirability or undesirability of accommodating incremental growth in a given location. In fact, in a simple equilibrium model, the size of different cities will expand to the point where the economic efficiency of all cities is just the same. Cities with large productivity advantages (stemming from locational features or from the agglomeration of industries with the highest returns to industry concentration) will expand to the largest population size and command the highest nominal wages and land and housing prices. Cities with lesser productivity advantages will grow to a smaller size, where land prices, nominal wages, and average worker productivity are all lower.

In equilibrium, the resultant hierarchy of city sizes will be stable. From the worker's perspective, the higher wages paid in the biggest cities will be offset by the higher overall cost of living. That is, "real" wages across locations will be constant. From the firm's perspective, the productivity advantages of expanding in a certain city will be offset by the higher wages that must be paid to workers.

Of course, in the real world, as production techniques change and the mix of consumer demand changes, some cities are always gaining or losing productivity advantages relative to others, and relative to the rural sector. Competitive advantages will show themselves first as higher profit rates for the firms located in more favorable locations. In a competitive market, however, these higher-than-usual profits will soon be absorbed by higher wages, as new firms spring up to take advantage of the favorable cost structure. Higher wages in turn will attract higher rates of in-migration of labor, which will lead to higher housing and other costs. That is to say, the entire urban and rural system will adjust. One consequence of this adjustment, if it is triggered by new efficiency advantages in the cities, will be a flow of migrants into the cities and higher nominal wage rates there.

Many of the arguments laid out in this report can be interpreted within this simple framework of city size and city efficiency. If markets are functioning smoothly, the very fact of urban growth is a sign that the economy is adjusting to the relative productivity advantages that cities (or *some* cities) possess. Urbanization is a fundamental part of normal economic development. Assertions that urbanization is unproductive implicitly rest on claims to different kinds of market failure in the simple model.

The dual labor market models, for example, hypothesized a system where wage levels were segmented between modern and traditional activities, in ways unrelated to productivity differentials. This inefficiency was exacerbated by distorted and exaggerated information about the availability of higher paying jobs. The allure of high wages was said to set in motion a stream of migrants who could not find jobs at any wage level once they arrived in the city.

Models of urban bias allege that the economic attractiveness of the city stems not from any real productivity advantages, but from artificial advantages created by public policy—namely, food subsidies, infrastructure investment steered to cities for political reasons, protected civil service jobs, and so on. Movement to the cities, on these assumptions, would merely aggravate resource misallocation by building up the pressure for more subsidies and more politically inspired investment.

Perhaps the most serious current critique holds that the basic economic model fails to incorporate the harmful environmental effects of urban growth. In principle, one could argue that deteriorating air quality and water and health hazards are recognized by households as negative amenities. Potential residents would then demand higher wages or lower living costs, to offset such negative externalities. If so, the basic market model of urbanization could continue to function efficiently, as migration to environmentally hazardous locations would slow, and compensating wage differentials would

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force firms to recognize the costs associated with environmental externalities. Indeed, there are a number of studies in the United States that demonstrate that environmental differences between metropolitan areas are capitalized into housing and land prices and metropolitan wage levels. However, in developing countries many of the consequences of environmental deterioration go unrecognized by households, with the result that there are no market forces to correct for them. Moreover, many of the harmful effects take place on a scale much larger than the metropolitan region or over longer periods of time than the individual's working life. Even in principle, then, market forces generally will be inadequate to take environmental effects fully into account. Government regulation is required. Until this is in place, urban areas are likely to "underprice" the costs of environmental degradation.

CONCLUSION: OPPORTUNITIES FOR EFFICIENCY GAINS

The basic economic framework helps identify opportunities for efficiency gains in managing the system of cities.

At the national level, the greatest sources of inefficiency come from price distortions and subsidies affecting the way urban markets interrelate with the rest of the economy. Chapter 2 addresses several of these structural issues, which have become the focus of recent national structural adjustment programs. Another important source of distortion is government planning and regulation conducted outside the market system. National housing programs illustrate both types of inefficiency. In some countries, mortgage subsidies to urban homebuyers have become so large that they have distorted the entire financial and fiscal system, inflicting large dead-weight losses on the economy as a whole. At the same time, public house-building or house-financing agencies have often tried to dictate to the market by building houses where planners think they "ought" to be located. Unfortunately, the result often is that housing ends up being built in locations where there are no jobs. Either there is unnecessary unemployment while jobs go unfilled, or employers have to pay additional wages to attract workers to locations where no adequate housing exists. The entire productive system suffers from the failure to acknowledge market realities in the urban housing sector.

At the local level, both the national government and local governments have numerous options for making local markets function more efficiently. Local public services can be provided at better quality and lower costs. Land markets can be regulated (or deregulated) in ways that avoid unnecessarily large land rents that end up boosting the costs of local production. Local economic planning can help build a base for economic development that takes advantage of a location's natural cost advantages or fills a specialized niche in national markets. In all these cases, there are economy-wide productivity payoffs to local policy.

The rest of this volume examines some of the specific opportunities for urban policy to improve the productivity of the national economy.

THE STRUCTURAL REFORM AGENDA AND ITS URBAN IMPACTS

Chapter 2

■ *The economic choices of many developing countries are now being driven by structural adjustment programs. These rarely contain a special policy program for the urban sector. However, they establish the framework for urban policy. Changeovers from protectionist to market-driven export polices; restructuring of rural-urban terms of trade; credit policy reform; and public sector deficit reduction all combine to establish a* de facto *urban policy, and to establish how urban areas can contribute most effectively to national growth during restructuring. Two sectors of the national economy are especially closely tied to urban areas: housing and infrastructure. Housing policies have strong effects on the financial system and on labor mobility. Infrastructure is a critical input to production that needs to respond to, rather than shape, the emerging pattern of economic development.*

For many developing countries, especially those in Africa and Latin America, the 1980s were a lost decade. Per capita real incomes at the end of the decade were no higher than they were at the outset, and in some places were lower. Development plans frequently collapsed under the weight of external and internal debt and inefficient cost structures that could not survive international competition.

To revive growth prospects, much of the developing world has embarked on structural adjustment programs. These are designed to restore cost competitiveness in international markets, and to wring out the inefficiencies imposed on the domestic market by ill-advised public policy.

National structural adjustment strategies do not normally contain a special policy program for the urban sector. Nonetheless, many of the market distortions they address, as well as the policies they recommend, have a critical urban dimension. The search for national-level policies that can more efficiently link national development to urban development, therefore, can best begin by considering the current macroeconomic reform agenda.

MACRO REFORM STRATEGIES THAT AFFECT CITIES

Governments sought to compensate consumers for the high cost of protectionist policies by imposing price controls and subsidies. Once in place, these policies proved hard to dismantle. They became a staple element in appealing for political support from the urban households that dominate political activity in most countries.

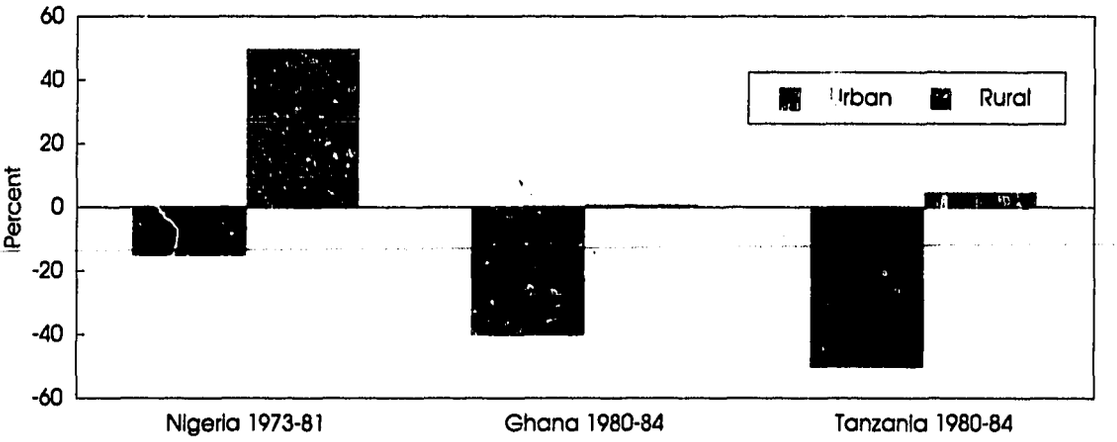
Structural adjustment programs have taken a great variety of forms in different countries, but all are designed to increase market efficiency, rationalize credit policies, and reduce government's detailed management of the economy. Many nations have moved in these directions. Reusse (1987) notes that only two of the twenty countries in Africa eligible for subsidized lending from the World Bank have failed to formulate liberalization programs.

Adjustment of Urban-Rural Terms of Trade

The dominant development model for most of the post-World War II period involved industrial development that was protected from international competition by tariffs and import controls. Governments sought to compensate consumers—especially urban consumers—for the high costs of these protectionist policies by imposing price controls or granting subsidies for many of the basic commodities produced locally, especially foodstuffs, and by establishing minimum wage levels for urban formal-sector workers. The result was skewed terms of trade between rural and urban locations. Farmers were required to buy high-cost domestic manufactured products, almost always produced in urban centers, while their own produce was subject to price controls imposed for the benefit of the urban population. Agricultural export taxes, which further reduced net payments to farmers, were often imposed on export crops to pay for government budgets.

It is now widely agreed that these policies set back national development. Inadequate price incentives depressed agricultural output, cutting into both domestic food production and foreign exchange earnings. The subsidy and wage policies designed to favor urban residents

Figure 2.1
STRUCTURAL ADJUSTMENT AND THE CITIES: CHANGES IN RURAL AND URBAN HOUSEHOLD INCOMES IN SELECTED AFRICAN COUNTRIES



Sources: Hamer, 1986; Ljung and Farvacque, 1988.

became a critical element in government spending and public sector deficits. Once in place, these policies proved hard to dismantle. They became a staple element in appealing for political support from the urban households that dominate political activity in most countries.

Almost all structural reform programs have tried to stimulate agricultural production by shifting the urban-rural terms of trade in favor of the agricultural sector. This shift has led to a de facto urban policy. The reforms aim to eliminate or reduce urban food subsidies and price controls, abolish requirements that part of export food production be diverted to the domestic market, reduce the urban wage structure in cases where government pays or mandates above-market wage levels, and reallocate government capital investment away from subsidies for urban industrial production and public service provision toward support for the production and transportation of products in the rest of the country. In a review of the outcomes in Africa, Hamer (1986) concludes that "the very foundations of urban bias are being destroyed," noting "mounting evidence that both in absolute terms, and relative to agriculture, urban (real) wages have suffered precipitous declines" (see Figure 2.1).

Despite this progress, reduction of urban bias continues to be an important element of efficient urban policy. Scrutinizing urban-rural terms of trade for distortions introduced by public policy should be part of any urban economic development assessment. For example, analyses of development trends in Ecuador make clear that the windfall gains from higher petroleum prices in the 1970s were used to prop up currency values, thereby subsidizing consumer imports for urban households, and to raise government spending and government wages, again targeted on urban areas. Much of the next decade was spent trying to dismantle these trade and budget regimes in the face of entrenched political opposition. The current (1990) surge in oil prices poses a new threat of long-term destabilization if foreign exchange earnings are again squandered on subsidies and government spending programs for the cities (Romero-Follette et al., 1990).

Across-the-board policy bias in favor of cities or the urban population is much less common in 1990 than it was in 1980 or 1970. However, sectoral policies that reflect urban bias can still be found. The leading candidates for such bias today are above-market wages paid to government employees in the cities and skewing of infrastructure investment patterns in favor of city locations. Excessive protection of local industry also still exists. These policies retard national economic growth. They may seem to "help" cities relative to other parts of a country, but by making city economies more dependent on public subsidy, they breed an insulation from market competition that will sooner or later prove injurious.

Moving Toward Export-Led Growth

Structural reform packages typically have sought to restructure domestic participation in international markets by removing the various barriers and subsidies that prevent international price signals from reaching local producers. This has generally meant higher levels of international trade, as export profitability has been restored and imports are allowed to enter local markets. Most structural

Sectoral policies that reflect urban bias can still be found. They may seem to "help" cities relative to other parts of a country, but by making city economies more dependent on public subsidy, they breed an insulation from market competition that will sooner or later prove injurious.

Box 2.1
URBAN DEVELOPMENT IMPLICATIONS OF SHIFTING FROM IMPORT SUBSTITUTION TO EXPORT-LED GROWTH

In the 1970s Chile carried out drastic economic liberalization. Import protection policies were abolished. The country was opened up to international trade and foreign capital investment. Currency controls were dismantled. The result was a violent restructuring of the economy, initially against the backdrop of serious recession, later in the context of strong economic growth led by the export sector.

Accompanying these sectoral changes in economic activity were strong regional and local shifts. Growth was concentrated at first in the northern region, where copper experienced an export boom that spread to copper manufacturing, and in the central agricultural region, where the export of fruit and wines boomed, promoting the growth of Rancagua, the major secondary city in the region. The principal losers were traditional manufacturing centers outside the Santiago metropolitan region—especially Valparaiso. Under intense market pressures, domestic production tended to concentrate among the largest and most efficient producers serving the largest domestic market, Santiago. Other production centers lost large numbers of industrial jobs. Later, when aggregate economic growth resumed, manufacturing production continued to be highly concentrated in Santiago. The other regional producers never recovered their relative roles.

reforms also include one or a series of currency devaluations.

The spatial impact of opening the domestic economy to international trade is unlikely to be the same in all countries. One body of planning theory has held that import-substitution development strategies helped promote artificially large cities. Firms that sold only to the national domestic market naturally tended to locate in the largest market areas. Further, the economic health of these businesses was so dependent upon government protection that there was a strong incentive to locate near government offices in the capital city. These motivations undoubtedly led to inefficient concentration. However, the validity of the reverse theory, that switching to export-led growth will produce less concentration in mega-cities, is far from clear. For example, a careful study of the growth of Seoul, Korea, has found that this metropolis grew fastest, relative to national population, precisely during the period when the economy opened up to an export orientation and began its spectacular manufacturing growth (Kwon, 1986). In Chile (see Box 2.1), a retrenchment in local production for the domestic market, caused by reducing barriers to import competition, led to a greater concentration of production in the main metropolitan region, as producers found it necessary to seize least-cost access to the biggest local market.

In any event, the aggregate effect of export-led growth on city size is far less relevant than its impact on particular

In Mexico national spatial development policy has long sought to slow the growth of Mexico City and stimulate growth of the poorer north central and southwest regions. There have been infrastructure investment programs to build up secondary cities in these regions. However, the planning programs have been overwhelmed by market forces and by the incentives that the central government has established for industrial production, especially for export. As a consequence, new urban growth has been focused on the border area, where American capital investment in "in-bond" industries has been concentrated. Industrial investment of this type is estimated to have created 100,000 new jobs in border cities over the last decade.

Mexico's 1989 National Development Plan acknowledges for the first time that the greatest future growth will occur in export-oriented zones and in the capital region. This regional development pattern follows directly from the national economic strategy that assigns top priority to exports and integration into world markets. The Development Plan no longer calls for placing infrastructure in places where it can compensate for, or correct, market forces, but supports the placement of investment in "natural growth corridors" in order to get the highest return from capital, both public and private. The Development Plan continues to support compensatory fiscal assistance for the nation's poorer regions. However, the plan recognizes that the most powerful instrument for spreading the benefits of growth will be household migration, not the subsidized steering of development into new growth poles where market realities are uninviting.

Sources: Boisier and Silva, 1985; World Bank, 1990b.

types of cities. A high volume of exports places a premium on port cities, especially those with specialized facilities for efficiently handling major export products. There is a similar premium on international financial centers. Industrial production will shift geographically from areas that have specialized in producing for the domestic market to areas that specialize in producing for export. The switch to export-led development, in other words, implies a shift in the relative economic importance of different cities and regions, as well as a shift in the types of public investment that can maximize the contribution of cities to economic development. Public investment needs to be flexible enough to anticipate, or at least respond to, these shifts in growth patterns.

Export-led growth often conflicts with national physical planning goals. Export development strategies almost always imply focusing investment on existing urban centers, but national physical development plans often call for steering public investment away from the successful urban centers to laggard regions of the country. For example, Tunisia's adoption of an export development strategy, coupled with greater openness to international trade, will accelerate the concentration of investment and economic activity in the East Coast littoral, where its major ports and cities are located. That country's national physical development plan, however, calls for redirecting investment to the interior of the country (PADCO, 1990). In conflicts such as these, physical

Export development strategies almost always imply focusing investment on existing urban centers. But national physical development plans often call for steering public investment away from the successful urban centers to laggard regions of the country. Physical planning should complement the national development strategy, rather than impose a de facto strategy of its own.

planning proposals almost always lose out to the national economic growth strategy. It would be more useful for planners to acknowledge the basic growth strategy by facilitating migration—for example, by making it possible for those moving to the city to find affordable housing—than to persist in plans to place infrastructure projects in other regions of the country. Physical planning should complement the national development strategy, rather than try to impose a *de facto* strategy of its own.

Rethinking Credit Policies

Credit policies have been another important object of reform in structural adjustment programs. In many countries, the traditional development strategy was premised on the availability of below-market capital, either supplied directly by government or mandated by government through its intervention in private credit markets. A study of the period 1974 to 1985 found that 26 of 33 developing countries maintained negative real interest rates for most of the economy (Gelb, 1988).

The damage done by such policies is threefold (Peterson et al., 1990). First, negative real interest rates discourage domestic financial saving. If deposits in the financial system cannot keep pace with inflation, investors will try to steer their savings elsewhere—to land or buildings, to jewelry and other tangibles, to foreign countries where savings are denominated in hard currency, or out of savings altogether into current consumption. Empirical studies conducted in a variety of countries have reported that real interest rates have a relatively modest impact on the aggregate saving level, but in developing countries have a much stronger effect on financial savings—i.e., the share of savings held in the formal financial sector. This impact is important because financial savings tend to generate the highest social rates of return. Intermediate financial institutions such as banks, insurance companies, and stock markets specialize in the search for the highest-yielding investment opportunities. The capital invested through them tends to produce better returns than capital invested outside the marketplace by government or invested directly by savers in their own activities.

Second, negative real interest rates directly lower the average productivity of capital investment. When borrowed funds are available at interest rates below the rate of inflation, there is an across-the-board incentive to borrow, with little incentive to target scarce investment capital to the investment projects with the highest rates of return. Any project that can keep pace with inflation becomes profitable if financed with loans having negative real interest rates. Real estate and consumer durables are two of the favorite havens for such investment.

Third, countries with negative real interest rates typically rely heavily on government allocation of capital. Government intervention is necessary because of the excess demand for capital that is generated at below-market rates of interest. Credit then has to be rationed. In principle, government bureaucrats might be able to allocate capital as efficiently as the market, but in practice they are not able to do so. Government intervention typically has the overriding objective of steering savings into financing—often at below-market terms—the government's

own debt, issued to cover government budget deficits. This policy generally diverts investment funds from the private sector. In addition, as part of their development strategies, governments typically have targeted certain sectors of the economy for preferential financing. The record shows that these investments perform less well than those made by the private sector paying market rates for capital.

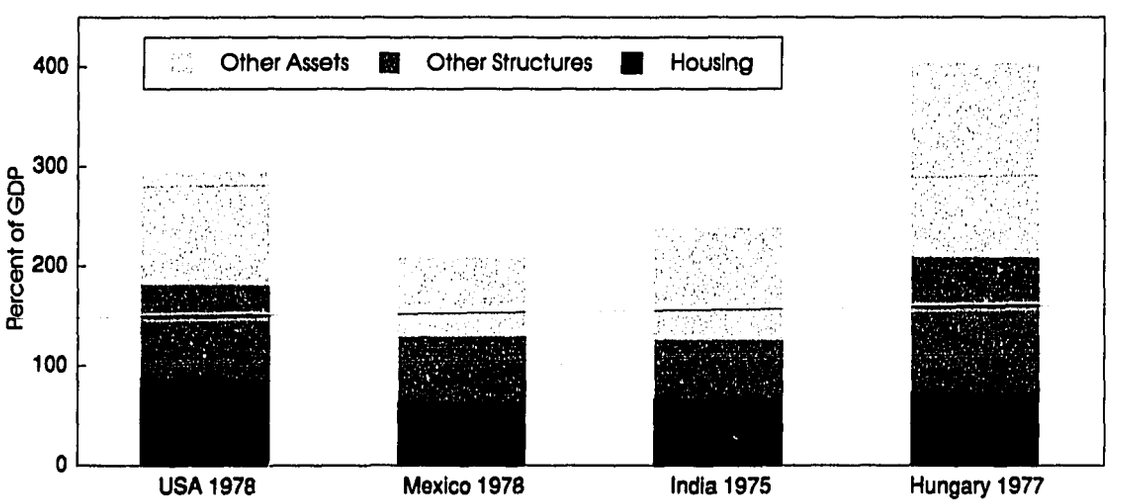
The urban sector has a critical role to play in both the savings and investment side of credit markets. Urban housing and urban infrastructure investment account for an even larger share of capital formation in developing countries. Various estimates place investment in housing and urban civil works at about 20 to 25 percent of total gross investment. Because of their long lives, these assets account for a significant share of developing countries' total capital stock (see Figure 2.2). With such a large part of domestic investment occurring in the urban sector (even excluding business investment), urban interest rate policies are critical to the overall functioning of credit markets.

Capital historically has been provided for urban housing and infrastructure investment on highly concessionary terms. This makes housing and infrastructure finance an important source of distortion in many countries' credit markets. Elimination of the distortions can contribute significantly to overall economic efficiency and growth as will be discussed below.

At the same time, household surveys reveal that the principal motive for family saving among lower and middle income groups in the cities is the desire to buy or improve a home. Drawing these households into the formal financial system by finding ways to attract their housing-related deposits to banks or other financial intermediaries can make an important contribution to economic development.

Housing and infrastructure finance is an important source of distortion in many countries' credit markets. Elimination of the distortions can contribute significantly to overall economic efficiency and growth.

Figure 2.2
HOUSING'S SHARE OF NET CAPITAL STOCK IN SELECTED COUNTRIES



Source: World Bank, 1989c.

Urban economic development has been directly affected by efforts to bring public sector budgets under control. Infrastructure outlays for both capital and maintenance have suffered a steep decline. The pressure to cut central government and national parastatal deficits is likely to end up transferring more expenditure responsibility to local and provincial governments, especially in urban regions.

Reducing Public Sector Deficits

No goal has received more attention in structural adjustment programs than the attempt to reduce public sector deficits. As Balassa (1981) notes, the financing of deficits jeopardizes growth prospects, whatever strategy is used.

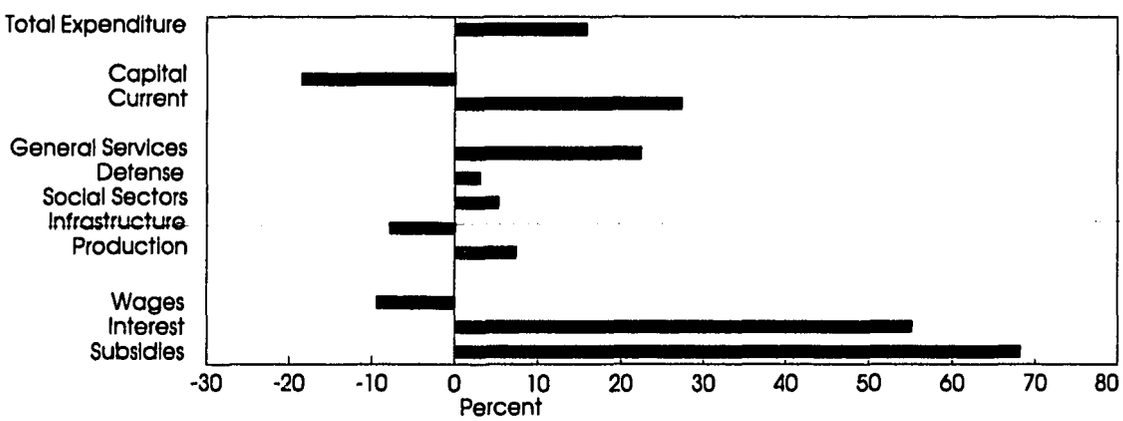
> *Government budget deficits increase the money supply and the balance of payments deficit if financed by borrowing from the central bank, they reduce the availability of funds for private investment if financed through domestic borrowing, and they add to the debt service burden if financed from the proceeds of foreign loans.*

The piling up of government operating deficits in the late 1970s and early 1980s was an important factor in the explosion of international indebtedness.

In the aggregate, less developed country budget deficits peaked in 1981 and 1982, and have been gradually declining ever since. Urban spending patterns have been directly affected by the efforts to bring public sector budgets under control. Although cutback planning typically targets current expenditures as the highest priority for spending reduction, in practice the greatest cuts have come from the public investment budget. Current expenditures generally, and especially government subsidies, have fared far better in countries that have had to cut spending growth in the face of high indebtedness (see Figure 2.3). Infrastructure outlays for both capital and maintenance have suffered a steep decline. Public sector wages have also been reduced.

The pressure to cut central government and national parastatal deficits has important consequences for urban policy. On the expenditure side of budgets, it has fueled a movement to grant greater spending autonomy to local governments, especially in urban areas. Many countries are moving to reassign responsibility for infrastructure investment, public service provision, and public employee wage negotiations to local governments. The motives behind this decentralization are

Figure 2.3
CHANGES IN GOVERNMENT SPENDING IN HIGH-DEBT COUNTRIES, 1978-1984*



* Argentina, Bolivia, Brazil, Chile, Costa Rica, Israel, Mexico, Morocco, Turkey, Uruguay & Venezuela.
Source: Hicks, 1989.

mixed; they range from a principled desire to make public spending more responsive to local citizen preferences to a simple desire to shift the burden of budget adjustment elsewhere. Whatever the motivation, the battle to bring central government budgets under control is likely to end up transferring more expenditure responsibility to local and provincial governments, especially in urban regions.

On the revenue side of government budgets, there is pressure to increase tax and fee collections in the cities. If budget deficits are to be cut and urban-rural terms of trade redressed, there is little choice but to make city residents and businesses pay for a greater share of their public service costs. Under centralized models of service delivery, the increased revenue will end up in central government budgets. Under decentralized models, the revenue will be used by local government to pay for services. In either case, economic structural adjustment in management at the national level is likely to lead to structural adjustment at the urban level, where services are delivered and revenues collected.

SPECIAL LINKS AMONG HOUSING, INFRASTRUCTURE AND THE NATIONAL ECONOMY

Two economic sectors that are closely linked to urban growth are housing and infrastructure. The continuing migration from rural areas and small towns into the cities, coupled with natural population growth, generates a constantly growing demand for urban housing and the infrastructure support systems that sustain both housing and economic activity. The close ties among shelter, infrastructure, and urban programs are reflected in the fact that both developing countries and international donor organizations often bundle the three functions together in a single ministry or administrative division.

Economic policymakers in the past tended to regard housing and housing-related infrastructure as consumer goods, which absorb capital but otherwise bear little relation to economic development. Housing and infrastructure policy was classified as a social issue. This perspective ignores a number of very important linkages to the national economy.

Connection between National Credit Markets and Housing

As a sector that is especially sensitive to interest rates and credit policies, housing responds rapidly to shifts in national macroeconomic management. Conversely, lending policy in the housing sector can have large repercussions on national credit markets.

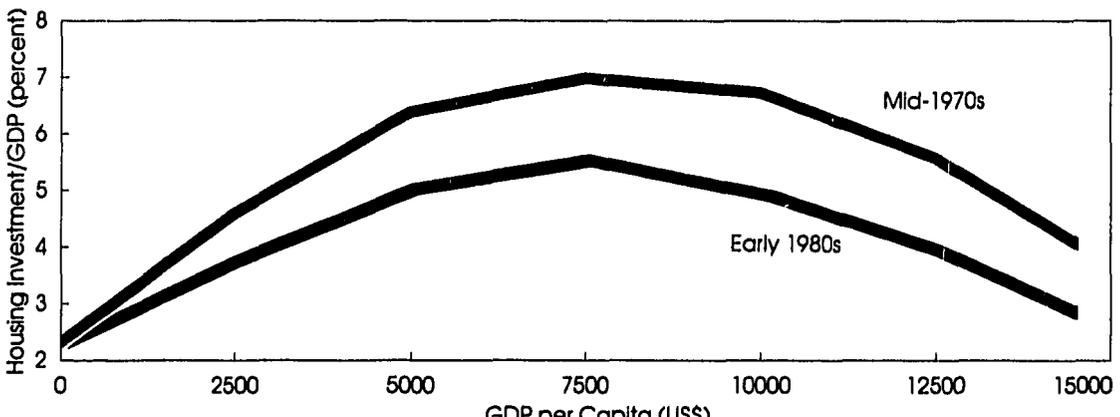
In the 1980s, when developing countries tightened their credit policies as part of structural adjustment, housing investment declined. Buckley and Mayo (1988) analyzed data for about 50 developed as well as developing countries for two periods: the mid-1970s and the early 1980s. Their regressions indicate a generally consistent and stable relationship between housing investment (as a share of GDP and as a share of gross fixed capital formation) and national per capita income. As per capita income increases, housing's share of GDP goes up fairly rapidly, then—at about US$8,000 per capita in 1981—begins to decline (see Figure 2.4).

Buckley and Mayo found that while the general shapes of the housing investment curves were similar in the two periods studied, spending levels in the

Economic policymakers in the past tended to regard housing and housing-related infrastructure as consumer goods, which absorb capital but otherwise bear little relation to economic development. Housing and infrastructure policy was classified as a social issue. This perspective ignores a number of very important linkages to the national economy.

Although developing countries cut back on credit allocations to housing, for much of the 1980s they continued generous housing subsidies. Thus, while fewer households were able to borrow for housing, those that did gained very large financial benefits.

Figure 2.4
EFFECT OF 1980s CREDIT RESTRICTIONS ON HOUSING INVESTMENT



Source: Buckley and Mayo, 1988.

early 1980s were significantly lower than they had been in the earlier period. Housing investment's share of GDP fell by between 11 and 24 percent and its share of fixed capital formation declined on average by 17 percent. The explanation lies in the selective credit policies that countries adopted. Faced with the necessity of earning foreign exchange to repay debt, countries tried to steer credit to "productive" investment, especially for export, and away from housing. This was accomplished by such devices as decreasing central bank credit supply to housing finance institutions.

Paradoxically, although developing countries cut back on credit allocations to housing, for much of the 1980s they continued generous housing subsidies. Government-financed mortgages often remained far below market rates. Thus, while fewer households were able to borrow for housing, those that did gained very large financial benefits. Governments sought to control the fiscal losses created by their subsidy policy by restricting the volume of credit rather than by lowering the subsidy per beneficiary.

Policies such as these can inflict large welfare losses on the economy as a whole (see Box 2.2 for the case of Argentina). In effect, large numbers of households are prevented from meeting their housing demands by administratively restrictive credit policies, while a relatively few households are deeply subsidized in their housing consumption and housing investment. In countries where empirical studies of the distribution of housing credit subsidies have been conducted (e.g., Klak and Peterson, 1990), the subsidy pattern has been found to display very little, if any, progressivity. Random members of the middle class appear to gain the most from below-market mortgages. The harmful effects of below-market mortgage lending are exacerbated by the negative real rates of interest paid to depositors in savings institutions. In order to maintain a spread between their costs of capital and mortgage lending rates, housing finance institutions must

Box 2.2
WELFARE LOSS FROM HOUSING POLICIES IN ARGENTINA

Housing policies in Argentina illustrate the linkage between housing finance policy and national economic development—in this case, a negative linkage.

Over the period 1980-1986, Argentina struggled to cope with extraordinary inflation and falling real income. One strategy was to impose tighter controls over the credit provided by financial institutions, including those in the housing sector. The size of the formal financial system contracted sharply and, in this risky environment, private long-term credit such as that for mortgages virtually disappeared. Between 1980 and 1986:

- Net housing production was very low and, taking account of depreciation, probably turned negative;
- The supply of rental housing units from the existing housing stock in Greater Buenos Aires, a market that accounts for over 40 percent of the national rental market, contracted by more than 25 percent;
- Real rents in Greater Buenos Aires more than doubled; and
- Housing construction's share of national product fell to less than half of historical levels, at 2 percent of GDP.

Despite these credit policies, the country continued its very deep public subsidies for those fortunate enough to receive mortgages. For example, FONAVI (a fund for publicly financed housing collected through a mandatory 5 percent tax on wages) is estimated to have provided subsidies that averaged US$16,000 per housing unit, or roughly 90 percent of the total cost of the housing it financed. Part of this subsidy was delivered in the form of below-market interest rates; even more was delivered de facto by the failure to collect mortgage payments due. FONAVI provided extremely high subsidies to about 30,000 housing buyers annually, while more than one million households in need of housing, with incomes low enough to qualify for FONAVI financing, were made to wait for such financing.

In a word, Argentina's housing finance system channeled enormous subsidies into the housing sector. This produced large financial losses for government, yet very little new housing was being produced. Households that could have financed their home purchases at much lower subsidy rates instead had to join the queue of those waiting to become eligible for FONAVI's deep subsidy loans. Because of the low housing production, housing prices were driven up for all urban markets. Robert Buckley estimates that the "welfare loss" to the economy as a whole from these policies may have been as large as 6.5 percent of GDP.

Source: Buckley, 1988.

pay below-market rates of interest to depositors. This discourages saving and further distorts capital market decisions.

Since the mid-1980s, more countries have moved to adopt market-rate, or at least positive-real-interest-rate lending policies for housing mortgages. This has reduced housing's distortion of credit markets. However, in most less developed countries housing subsidies continue to be delivered in the form of interest-rate reductions rather than up-front capital

A national development strategy that concentrates new investment in urban areas, where the rate of return to investment is highest, relies heavily on migration to spread the benefits of growth. Sectoral credit policy, local land-use regulations, and the pattern of infrastructure provision go far to determine whether housing can be built at prices that make mobility feasible.

Box 2.3
NEGATIVE EFFECTS OF MISMATCHED LABOR AND HOUSING POLICIES IN PRE-REFORM POLAND

On the surface, Poland would seem to be an odd place to have housing problems. Under the old regime, the country made a very strong public sector commitment to housing. Fully 13 percent of government expenditures was allocated to housing subsidies—the equivalent of 3 percent of GDP and 34 percent of all household subsidies, second only to food. Yet housing remained in very short supply, with strongly negative effects on the economy as a whole. This was because:

- Poland's government directed credit away from housing toward more "productive" sectors;
- Consistent with this philosophy, and recognizing that housing does not generate export earnings, the government also directed imports away from housing, leading to extreme shortages of building equipment and supplies;
- Government set interest rates with little regard to market forces. The real return on savings held in Polish banks is estimated to have ranged from minus 8.3 percent to minus 47.6 percent. This discouraged household financial saving;
- Rent controls were imposed on all state housing, limiting rentals to no more than 2 to 3 percent of household income;

subsidies, which can be better targeted to the truly poor.

Effect of Housing Markets on Labor Mobility

As emphasized throughout this report, a national development strategy that concentrates new investment in urban areas, where the rate of return to investment is highest, relies heavily on migration to spread the benefits of growth. Households move from rural areas and small towns to capture the earnings opportunities created in the cities.

A critical element in the mobility of labor is the urban housing market. If the urban housing supply can grow in tandem with demand, without creating housing shortages that drive up prices, the whole adjustment process will be much more efficient. Otherwise, housing price inflation will discourage labor movement, and the benefits of urban investment will go primarily to landowners, housing owners, and existing workers, instead of to large numbers of new workers.

The most spectacular mismatch between labor demand and housing tends to arise in non-market economies, when government bureaucrats decide to place economic investments in one location and housing investment in another. An extreme case of such a mismatch is Poland, before the freeing of its economy (see Box 2.3).[10] Even in market economies, the public sector still builds the largest share of worker housing in most developing countries. There have been instances of large-scale shelter projects (some of them internationally financed)

- The government forbade speculative building for resale, ownership of more than one dwelling per household, or borrowing against the value of housing; and
- Publicly constructed housing was built where government thought demand "ought" to exist or where building and land prices were cheapest. Excess demand in existing markets was not used as a market signal to increase production in locations of shortage.

These policies seriously retarded urban housing production. The average waiting time for cooperative housing in Warsaw in the late 1980s was as high as 14 to 15 years. The severity of the shortage is indicated by the difference between the cost of building housing and the price at which it could be sold: Sale prices of newly built homes were from 50 to 150 percent higher than construction costs.

Because housing was so difficult to obtain, workers were discouraged from moving to obtain new employment opportunities. In cities where housing shortages are severe, employers have had to offer higher wages and benefits to compensate for the difficulties workers will face, such as excessively long commutes and sharing overcrowded units. Mayo and Stein estimate that such policies have increased the wages of urban workers by between 5 and 20 percent depending on the sector. This adds significantly to production costs and diminishes the international competitiveness of Poland's products.

Sources: Mayo and Stein, 1987; Buckley and Mayo, 1988.

which remain vacant or undeveloped because the sites are too far removed from job opportunities. To an even greater degree than in developed countries, mass housing in developing nations is an intermediate good: it is valued for the access it provides to jobs and other income-generating opportunities. To plan housing projects as if all that matters is less expensive housing consumption is to miss this linkage to the productive economy.

Housing costs and the volume of local housing provision are other potential obstacles to migration. Local land-use regulations and development approval procedures can greatly limit housing supply in areas where demand is strong. At times, these costs are imposed inadvertently by a bureaucracy that has established excessive standards for development approval or public development agencies that are sluggish in implementation. Often, however, there are fundamental conflicts of interest that get incorporated into local housing policy. In Santa Cruz, Bolivia, for example, the strong influx of semi-skilled construction workers has depressed construction wages, leading local worker organizations to demand tighter controls on informal-sector developments, as a means of sustaining a tighter labor market. Whenever housing is in short supply relative to demand, there will be economic rents generated. Those who receive such rents—typically the more powerful members of society—have an interest in sustaining them, rather than seeing them dissipate through boosts in shelter supply that make migration easier.

During the 1980s planning strategies and investment priorities were overhauled to deemphasize planners' a priori conceptions of where development "ought" to take place, and to respond more promptly to market forces. Vast capital outlays in new towns were downplayed in favor of incremental development strategies that built slightly ahead of or slightly behind market demand.

Infrastructure

Like housing, infrastructure interacts with the national economy through many different channels. Roads, water systems, and other networks are essential to shelter provision. Their placement determines which parts of a metropolitan region or even which regions of the country will be opened up to development. Other types of infrastructure, such as electricity, ports, and highways are more direct inputs into the production process.

During the 1980s there evolved in many countries a physical planning analog to macroeconomic structural adjustment. Planning strategies and investment priorities were overhauled to deemphasize planners' *a priori* conceptions of where development "ought" to take place, and to respond more promptly to market forces. Vast capital outlays in new towns were downplayed in favor of incremental development strategies that built slightly ahead of or slightly behind market demand. This strategy is the developmental equivalent of "just-in-time" inventory control, and has the same motivation, namely, to cut down on the costs of stockpiling idle capital in anticipation of future use.

Infrastructure Investment that Shapes Spatial Patterns of Development

Economic development never takes place evenly across national terrain. Some areas grow faster and achieve higher densities than others. The issue of what the spatial pattern "ought" to be has been hotly debated in the developing world. Concern has been expressed about the continuing growth of the largest cities and the economic imbalances that have arisen between regions as well as between cities and rural areas within regions. The implied prescription in the past was often a national spatial policy that would promote deconcentration and "spatial balance." The placement of public infrastructure was the primary tool for implementing this policy.

In a frequently advocated paradigm, the central government was to be the leading actor in determining the spatial development pattern. Government would decide how many cities of what size there should be, and where these key cities should be located. It would then build infrastructure to support the desired pattern. Population and economic activity would fill in the mold in the right proportions. No country fully implemented such a paradigm, but the model has been influential, sometimes motivating the advanced placement of infrastructure for isolated new communities or the provision of substantial excess infrastructure capacity in favored market towns. There are some examples of success with the strategy, especially in creating new tourist resort centers. However, in many other instances, the anticipated economic and population growth never materialized. The infrastructure sits idle, incurring serious costs to the economy.

Recent international research suggests four conclusions about infrastructure and national development patterns:

1. Infrastructure alone is not influential enough to steer development. Perhaps the best testimony to this is the unhappy experience with developing country industrial park programs in the 1970s. Many of these sites still remain vacant. Water, streets, and other services were not enough to "go against the market" that was drawing development to other locations. Kyu Sik Lee's studies in Colombia (1989), Korea

(1985) and Thailand (1988) indicate that larger manufacturers do have natural incentives to move out to the fringes of metropolitan areas and are doing so. Indeed, investment projects that take advantage of market realities may be able to steer firms to particular locations. However, many examples indicate that government developments too far removed from national markets are not likely to succeed. One example is Banweol, Korea, located less than 30 kilometers from Seoul. This development was planned to accommodate 1,000 firms, but only a few moved there in its first four years, and many that did suffered from excess capacity and financial losses. Another example of failed development is Lampang, Thailand, 23 kilometers from Chiang Mai but still regarded by local entrepreneurs as too distant from the city. A third example is Tema, a 63-square-mile planned development, 20 kilometers from Accra in Ghana. Half the land was zoned for industry, but through 1989 only a third of the area had been occupied.[11]

2. Building free-standing new cities or designating small towns as "growth poles" is particularly risky. Growth poles have often become enclaves that are ineffective in stimulating development. They require very heavy outlays for infrastructure up-front.[12] Research on urban infrastructure costs in the developing world suggests that incremental additions of capacity to the existing pattern of cities is the least expensive way to accommodate new urban growth.[13] A number of countries that have been strong advocates of investment in remote locations are now questioning these investments. For example, the recent report of India's National Commission on Urbanization (1988) criticizes past policies as efforts:

> *. . . to try and put some marginal resources into the development of small towns selected on an ad hoc basis to induce investment in so-called backward areas which have little potential for growth, by artificial stimulants and the launching of employment programmes in rural areas which do not create assets which can sustain employment in the future. Works which are akin to relief operations cannot possibly provide long-term employment to the surplus population of rural areas. This population must not only be permitted to move to some form of urban or semi-urban settlement but, in fact, should be encouraged to do so.*

The Commission recommended instead that priority for strategic infrastructure be given to a number of "generators of economic momentum," i.e., fast-growing middle-sized cities that have shown the economic potential to compete with larger metropolises

3. There is substantial doubt that governments can design an "optimum" spatial pattern ahead of time. Economists have generally concluded that the notion of an "optimum city size" or even an "optimum hierarchy of city sizes" is not very useful for policymaking (Richardson, 1976 and 1977). In Indonesia, for example, urban structures vary among regions, but there are usually good economic reasons for the differences. Central Java has a large number of small- and intermediate-sized cities consistent with its role as an intensely developed agricultural region. In contrast, the urban structure in East Kalimantan, a sparsely

A number of countries that have been strong advocates of investment in remote locations are now questioning these investments. Indonesia's National Urban Strategy project concluded that a "crash program" to build intermediate cities to conform to an idealized concept of city size distribution would be extremely wasteful.

settled and heavily forested resource region, is dominated by two large cities. Indonesia's National Urban Strategy project (Government of Indonesia and UNCHS, 1985) concluded that a "crash program" to build intermediate cities only to conform to an idealized concept of city size distribution would be extremely wasteful. Heightened investment in such cities can only be justified later after further economic development of the countryside creates real demand for them.

This is not to deny that there are important congestion problems associated with the growth of large metropolises. However, congestion effects can often be dealt with more effectively by internal measures such as changes in price incentives[14] than by attempts to enforce direct limits on city size or attempts to create new growth poles.

Infrastructure systems not only serve city residents. They are direct contributors to manufacturing production and distribution. The failure of the public infrastructure support system directly affects the cost competitiveness of manufacturing firms.

4. Infrastructure investment should be tied to market demand. This does not mean that investment should always follow, rather than lead, development. But when it leads, investment decisions must be made carefully and not try to do too much.

Market forces can normally help pinpoint critical bottlenecks. For example, the surge of export-oriented growth in Thailand has created obvious excess demand for port facilities in Bangkok that can only be relieved by new investment. Queues of applicants waiting for stalls in the central market or high volumes of commercial traffic brought to a standstill by impassable local roads are other signals of critical bottlenecks in the system. As obvious as such market signals may be, many countries' planning and investment systems lack methods for systematically monitoring market demand or incorporating the results of such monitoring in investment priority setting.

Infrastructure Costs for Businesses

Infrastructure systems not only serve city residents. They are direct contributors to manufacturing production and distribution. In fact, in recent years it has become clear that the costs to business of inadequate infrastructure are substantially greater than previously imagined.

A study of infrastructure quality in Nigeria (Lee and Anas, 1989), for example, indicates that as much as 50 percent of the country's installed electric capacity may be inoperable at any given time, mostly due to inadequate maintenance of transmission and distribution networks. Faced with this reality, local firms have no choice but to provide themselves with alternative sources of electricity by installing generators to serve their own plants. They also have to drill boreholes for their own water supply and provide for their own garbage removal because there is no public trash collection.

The impact of poor infrastructure on economic development is highly negative. First, the capital requirements for installing electricity generating systems are large. Small- and medium-sized firms in Nigeria (those with fewer than 50 employees) were found to spend 25 percent of their total investment in plant and equipment on electrical generators (see Table 2.1). The scale of capital investment acts as a barrier to entry for small start-up businesses in manufacturing, and lowers the amount they can invest in other types of productive equipment.

Second, even for firms that can afford the capital costs, self-provision of infra-

Table 2.1
COST OF PRIVATE INFRASTRUCTURE PROVIDED BY NIGERIAN MANUFACTURERS

Privately Provided Machinery and Equipment	Average Cost (US$ 000s)	Infrastructure per Firm As Percent of Total: Small Firms[a]	Large Firms[b]	All Firms
Generators for Electricity	127.2	24.8%	10.1%	10.4%
Boreholes for Water Supply	34.9	2.8	1.9	1.9
Vehicles for Garbage Disposal	8.6	0.2	0.5	0.5
Radio Equipment to Substitute for Telephones	11.2	1.5	0.6	0.6

a. Fewer than 50 employees b. 50 or more employees

Source: Lee and Anas, 1989.

structure services is very inefficient. Medium-sized Nigerian firms purchasing electricity for their own use have to pay ten times as much or more than they would pay to a reasonably efficient common utility. The failure of the public infrastructure support system directly affects the cost competitiveness of manufacturing firms.

Note, however, that the potential cost advantages of publicly provided electricity or water do not necessarily imply that the best policy alternative is for government to undertake these investments. The empirical record in Nigeria demonstrates that public authorities have not had the financial or technical capacity to maintain the generating plants and distribution networks that already exist. Lee and Anas recommend that, at least as an intermediate term strategy, the public sector can best advance efficiency by eliminating regulations that prevent private suppliers of electricity from serving more than one user. Most of the present cost inefficiencies derive from the fact that the average factory or business establishment is too small to reap the economies of scale that are achievable in power generation. However, public regulations prevent firms from setting up electrical supply systems to serve more than their own needs. More enlightened public regulation, which would allow private firms to set up localized electrical systems to serve many plants, could be a direct and more efficient substitute for costly public investment.

CONCLUSION: POLICY LINKAGES BETWEEN CITIES AND THE NATIONAL ECONOMY

There are countless economic ties between cities and the national economy. It could not be otherwise, since in most developing countries a handful of cities account for at least half of total domestic product.

The policy linkages are equally strong. Structural adjustment programs adopted at the national level are played out, to large extent, in the cities. Conversely, seemingly local policies such as mort-

gage financing for urban housing can have large repercussions on national financial markets.

As obvious as these connections may seem, in policy formulation the linkages are often overlooked. Sometimes they are even resisted. Physical planners may turn a blind eye to the implications of export-led growth policies and continue to plan for new towns or new infrastructure projects in the interior regions of a country, even though currency devaluations, tax policy, and international capital investment are all steering development to urban export regions. The resulting mismatch between urban investment policy and national economic policy is always wasteful—of planners' talents and time if physical planning is ignored by economic planners, and of national resources if the country builds its infrastructure network based on one plan and adopts economic policies based on another.

Countries cannot afford the luxury of trying to sustain a housing finance system that is insulated from other financial markets, nor a housing investment strategy that looks only at physical development plans.

In this chapter we have looked at how national economic policies can affect urban markets and planning. One goal is to anticipate more accurately the impacts on cities of structural adjustment programs and other national policy changes. The more essential point is that urban policy has the opportunity to support national economic strategy.

Those designing an urban shelter program, for example, should start by understanding national credit market policy and national growth strategy. Urban mortgage finance should be structured so that it reinforces rather than undermines the national credit structure. The selection of cities to participate in shelter programs should follow from growth projections that are consistent with national economic policies. Sites and services projects should be built in locations where workers can get access to jobs. Private markets are the channels through which economic signals are most efficiently transmitted. Housing programs should allow markets to help decide where urban growth will occur. They should not limit the private sector's role to house construction after public authorities (or international funders) have decided where and when the housing will be built. Countries cannot afford the luxury of trying to sustain a housing finance system that is insulated from other financial markets, nor a housing investment strategy that looks only at physical development plans.

The decision to decentralize spending and revenue-raising responsibilities because of a central government budget crunch is another example of a national decision with strong local repercussions. Too often local authorities are caught off guard by such initiatives, and do no more than complain about the unfairness of cutting central government aid. Local officials can seize the opportunity presented by forced decentralization to establish their own priorities. They can demand more permanent grant-in-aid formulas or revenue sharing, more flexibility in local tax-rate setting and investment planning, and other measures that enhance their role in local public service delivery. There is nothing like a budget crisis to break old ways of thinking and open the road to change. For local authorities that have in mind economic development strategies, the coming decade will offer numerous opportunities to seize the initiative.

THE LOCAL ROLE IN URBAN ECONOMIC DEVELOPMENT

Chapter 3

■ *Local leaders in developing countries have begun to assign high priority to stimulating local economic growth. However, reliance on subsidies rather than improvement of competitiveness to attract local development can produce negative results at the national level and high costs for taxpayers. Local development can contribute to local* and *national economic development if it exploits local market advantages and promotes the growth and evolution of "informal" business activities. Local governments should consider how present land use regulations, development controls and standards, land titling procedures, and infrastructure investment policies limit business development by increasing land costs and limiting opportunities for entry into the business sector.*

This report has so far considered national policies toward urban economic development. Local governments and local community groups have a different perspective on economic growth. Their principal objective is to create jobs and economic opportunities for local residents rather than to worry about the competitiveness of the entire national economy.

The formulation of local economic development strategies has long been a priority of municipal governments in the United States and Europe. There is less of a tradition of municipal-led development in most developing countries. However, this is rapidly changing. In many parts of the world a new generation of elected mayors has given much higher priority to stimulating local economic development, often supported by decentralization programs that have given local officials more tools to work with.

COMPETITION FOR ECONOMIC GROWTH

In market economies, local economic development involves competition. In order to grow, a particular locality must offer competitive advantages such as lower costs of doing business, better access to markets, or a more skilled labor supply. Much of the competition localities engage in is with other cities in their own country, but increasingly the competition

In market economies, local economic development involves competition. In order to grow, a particular locality must offer competitive advantages.

The way in which localities compete with one another makes a great deal of difference. If the competitive battle is waged on the cost and efficiency side the outcome of competition will be a lower cost structure throughout the nation. If the competitive battle is waged with special subsidies, the competitive outcome is likely to be damaging to the national economy.

has become international. When Montego Bay, Jamaica builds a teleport to transmit and receive data by satellite, it is trying to bolster its competitiveness for data entry and data processing business, such as credit card and airline accounts. It must compete not only with Kingston, Jamaica as an alternative location within the country, but with Bridgetown, Barbados and other cities in the Caribbean; with Staten Island and Brooklyn, New York, which are struggling to retain in the New York region the back-office functions of banks and other financial firms; with cities in South Dakota, where many credit card billing operations have moved; and with cities in Southeast Asia, which are attempting to take advantage of the fact that with new technologies, reliable and low-cost labor forces have become more important to data entry and data processing than physical proximity to the customer.

This chapter distinguishes two broad strategies for strengthening local competitiveness. Governments (whether local governments or national public authorities) may try to reduce the costs of doing business in the local environment by providing better public services, lowering general tax burdens, or regulating land markets in a way that keeps land prices down while maintaining an abundant supply of development parcels. These policies, if successful, make the urban area a more efficient location for doing business of any kind.

A second class of strategies is much more targeted. It aims to provide specific incentives to particular industries, or even to individual business firms, so that they will move into an area, or remain there. These incentives may take the form of tax holidays, below-market loans to finance capital investment, or exemptions from regulatory burdens. Alternatively, a local government may judge the production of certain goods to be so critical to local economic development, that it enters the market itself as a public producer.

From a national standpoint, the way in which localities compete with one another makes a great deal of difference. If the competitive battle is waged on the cost and efficiency side—that is, if communities compete for growth by trying to offer lower cost public services or better-functioning land markets—the result of competition will be a lower cost structure throughout the nation. The country as a whole will become more competitive and citizens at large will be able to share in the benefits of greater productivity.

In contrast, if the competitive battle is waged through special subsidies, the outcome is likely to be damaging to the national economy. If tax breaks or other subsidies are restricted to certain localities, economic growth will be diverted from its most efficient locations merely to take advantage of the tax inducements. If special subsidies proliferate to the point that all competing localities offer them, in the end they will have no locational impact. However, the competitive offering of subsidies will be costly to taxpayers. The final result will be a transfer of resources from citizens at large, who must pay for the subsidies, to the business sector, which receives them.

In this chapter, we first examine local land markets as a critical example of how public policy can affect the general costs of doing business in an area. We then consider targeted "economic development" policies, which are designed to stimulate local growth in specific economic activities.

IMPORTANCE TO LOCAL ECONOMIC DEVELOPMENT OF APPROPRIATE LAND MARKET POLICIES

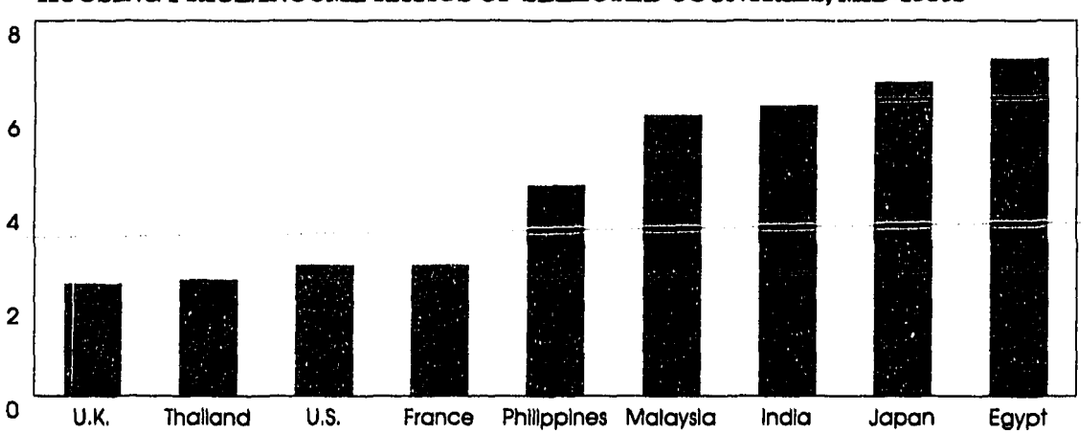
In the long run, the most important contribution that public policy can make to local economic development is to control the overall urban cost structure. The government's key tools in doing this are land regulation, infrastructure investment, building regulations, and public service supply. The more efficiently local authorities can manage each of these functions, the lower the cost of living and doing business in the region. Land prices are a prime illustration of the cost consequences of government policy and regulation. As shown in Figure 3.1, urban land and housing costs in most developing countries are considerably higher relative to household incomes than they are in the United States or Europe. Land and building costs also account for a higher share of total business costs. Moreover, urban land prices are rising very rapidly (Figure 3.2)—much more rapidly than land prices in most developed nations. The potential impact of land policy on the overall cost structure of urban areas is correspondingly large.

Land markets, like other markets, operate on the basis of supply and demand. The demand for urban land is derived from the locational advantages that an area possesses for business production or residence. Residential demand, in turn, is closely related to the local labor market; there is strong demand for housing where job opportunities are most abundant, and growing most rapidly.[15] There is also a speculative aspect to demand, which rests largely on projections about the future attractiveness of the area to business and labor markets.

Given demand levels, land prices will be determined primarily by supply conditions. In tight land markets, public regulations that constrain land availability can have large impacts on the price

Land prices in the cities of most developing countries are very high and are rising rapidly. The critical constraints on land supply are the result of public policy rather than physical land characteristics.

Figure 3.1
HOUSING PRICE/INCOME RATIOS OF SELECTED COUNTRIES, MID-1980s



Source: Renaud, 1989.

The implications of land prices for the urban cost structure can be glimpsed from the fact that in 1988 the annual increase in urban land values (in Korea) exceeded the total wage income of the Korean labor force.

structure. Such constraints include planning or zoning regulations that prohibit growth in certain areas; legal rules that remove land from the development market; building regulations that make it uneconomic to develop some parcels; or a scarcity of infrastructure provision that leaves land areas without road access, water, or electricity. Constraints such as these almost always have a public objective behind them, but their cost impacts typically are underestimated by local officials or ignored altogether. The result is over-regulated urban land markets which limit urban land supply and drive up land and building costs.

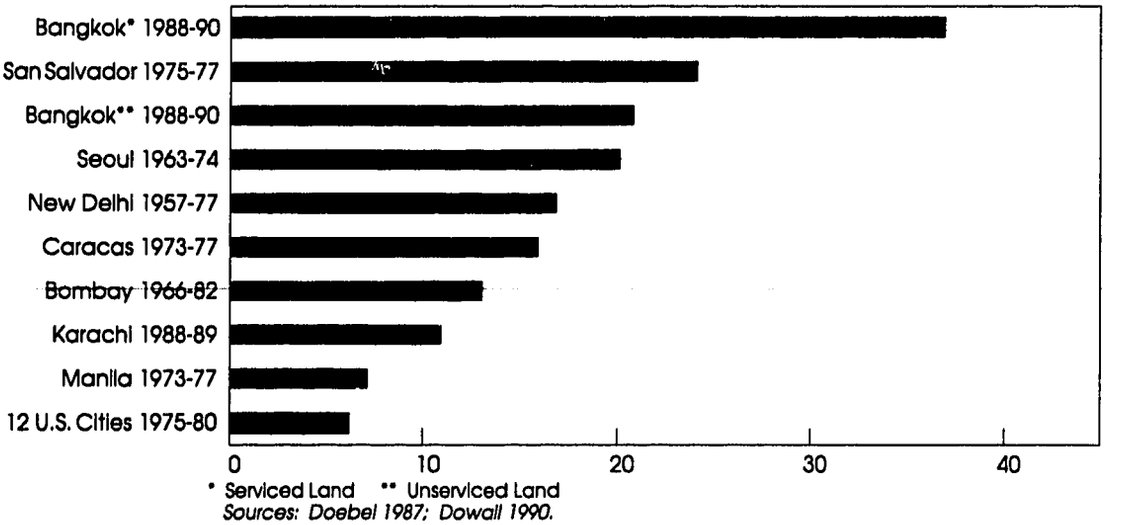
Planning and Zoning Regulations

Public restrictions that remove developable land from the market will always tend to raise prices, but the impact will be greatest where there already are tight land markets.

Renaud (1989) has demonstrated the impact of government land use controls on land and housing prices in Seoul. South Korea's capital city faces strong rules limiting the conversion of agricultural land to urban use; these were adopted to sustain agricultural production in the face of market competition from urbanization. A strict greenbelt policy blocks the outward expansion of the metropolitan area. As part of a policy of guided development, public authorities have acquired and held off the market large tracts of land intended for future development.

Given the strong demand for business and residential location in Seoul, the result of these restrictive policies has been a spectacular increase in land values. Land prices are now estimated to be rising in real terms at an annual rate of 25 percent. The implications for the urban cost structure can be glimpsed from the fact that in 1988 the annual increase in

Figure 3.2
URBAN LAND PRICE INCREASES (ANNUAL REAL PERCENT INCREASE)



Sources: Doebel 1987; Dowall 1990.

urban land values exceeded the total wage income of the entire Korean labor force (Far Eastern Economic Review, 1989). Because land is such an expensive factor of production, relative to labor, it acts as a barrier to entry for new business firms. At the same time, land-value appreciation adds vastly to the wealth of existing urban property owners.

In India, government intervention in the urban land market has led to even more severe supply restrictions. The Urban Land Ceiling Act of 1976 had the purpose of curtailing private speculation in urban land markets. It declared all private holdings of undeveloped urban land above designated limits to be "excessive." Such land was subject to compulsory government purchase for housing development at far below market rates. The ceiling levels for vacant land holdings were very restrictive. In Class A urban areas, maximum holdings of undeveloped land per owner were set at 500 square meters (Raj, 1990).

The Urban Land Ceiling Act was intended to restrain urban land prices by forcing speculative holdings onto the development market, but in practice it has had just the opposite effect. Once a public development authority notifies a landowner of its intention to acquire land under the Act, no further private development can take place. But public authorities have moved so slowly to develop parcels that the land in effect is entirely removed from the market. As of 1986, only 0.37 percent of the land holdings declared by government to be "excess" and subject to the law had actually been developed by government. Government had acquired a little less than 9 percent of total "excess" land holdings, and most of this amount was tied up in legal disputes and thus frozen out of development of any kind. Meanwhile, the remaining "excess" vacant land, though not acquired by government, was placed under a legal cloud since it could be confiscated at any moment. As a result, owners were unwilling to invest in its development. The sales market for vacant urban land virtually disappeared because no buyers were willing to assume the risk of acquiring "excess" parcels.

Under such supply constraints, urban land prices in India exploded. Government-sponsored studies found annual price increases during the early 1980s of 60 percent in Delhi, 30 percent in Madras, and even higher rates in Ahmedabad and parts of Bombay—several times greater than the inflation rate (Government of India, 1985). Government intervention, far from forcing the release of developable land and restraining land prices, removed land from the market and greatly accelerated land price inflation.

In Karachi, Pakistan, despite a vast supply of vacant land surrounding the metropolis, land prices have risen in real terms at 11 percent per year—far faster than household incomes (Dowall, 1989a, 1990). In this case, the apparently abundant supply of land is constrained by the government's infrastructure policy, which severely limits the number of serviced plots, and by the fact that some 90 percent of all vacant land is owned by the government and only released to the market in the form of finished development projects. Formal sector land supply thus is effectively determined by the speed of government development operations, which is very slow (Nientied and van der Linden, 1990).

India's Urban Land Ceiling Act was intended to restrain urban land prices by forcing speculative holdings onto the development market, but in practice it has had just the opposite effect.

Box 3.1
LAND AND BUILDING COSTS IN MALAYSIA

Since the 1960s, income growth in Malaysia has spurred significant increases in the demand for housing. Government has tried to support this demand by facilitating financing. In 1968 government required all commercial banks to invest a minimum of 50 percent of their savings deposits in housing loans or long-term government securities, but the requirement was probably unnecessary since the commercial banks saw a healthy market in housing and were already rapidly expanding their mortgage lending activities. Considering all sources of funds, mortgage lending has grown on average by 22 percent per annum since 1960. Clearly, finance has not been the constraint on housing development in Malaysia that it has been in many other countries.

As might be expected in this environment, housing investment in Malaysia has been quite high in relation to GDP. Yet further analysis shows that much of the aggregate increase in housing investment was captured by increases in land and housing prices. The values of newly built houses increased at a rate of 18.9 percent per year from 1972 to 1982, much higher than the rate of increase in rents or consumer prices. The nominal rate of income growth over the same period averaged only 10.5 percent. Housing affordability declined sharply.

What caused the steep price increases? The costs of inputs remained relatively stable. But analyses showed that there was an inelastic land supply. The growth in housing demand was being

In any growth situation, the benefits of stricter land-use controls need to be balanced against the costs they impose. There is no a priori way to determine whether the benefits of more compact or more highly regulated growth are worth the costs in terms of higher land and building prices. Ultimately, society at large must make these tradeoffs.

It needs to be emphasized, however, that the costs inflicted on the land market do not result from public ownership of land per se. In fact, municipal land banking can hold down land costs when the system is effectively administered. The city of Santa Cruz, Bolivia was one of the fastest growing big cities in Latin America during the 1970s and 1980s. Its growth was fueled by very high migration rates, as the population balance of Bolivia shifted from the highlands to the Amazon basin. Land prices in Santa Cruz could have skyrocketed. However, the city had the good fortune of having been laid out by planners in the 1950s with three ring roads that opened up relatively easy access to land supply, and of having had large municipal land holdings (Peterson et al., 1988). The municipality steadily released the land it owned to the market, sometimes through direct development and sometimes in collaboration with worker cooperatives. This farsighted policy enabled the city to grow at rates near 10 percent per annum for 20 years, while keeping land and housing costs under control. Now, however, the municipal-owned land supply has been nearly exhausted.

In any growth situation, the benefits of stricter land-use controls need to be balanced against the costs they impose. Unfortunately, this often involves professional conflicts. Economists tend to look at the costs of controls. Physical planners look at the benefits. The same restrictions that drive up urban land prices may succeed in preserving green areas within the metropolitan environment, or promote better road service to developed areas. There is no *a priori* way to determine

captured by land price increases because land supply could not increase very much. Excessive development standards were one factor in limiting land supply. In the words of a World Bank report, "...it appears that about 25 percent of the land developed for residential purposes is wasted due to excessive road areas, arbitrary setback regulations and, to a lesser extent, redundant community facilities. Due to such wastage, only 25 to 50 percent of the land area developed may be saleable (in contrast to the 65 percent typically achieved in other countries)."

Slow applications processing was another significant factor in holding back land development. In Malaysia, it normally takes from three to five years to obtain land development and building approvals for a new project. From 15 to 20 separate government departments are typically involved in the approval of plans and specifications. Such a long waiting period raises costs and adds to uncertainty about ultimate approval.

Malaysia's zoning and land-use controls have been much stiffer than those of another fast-growing Southeast Asia country, Thailand. As a result of the system of controls, Malaysia's urban cost structure is clearly higher. Whether this cost differential is justified by better land-use organization is difficult to determine.

Source: The World Bank, 1989a

whether the benefits of more compact or more highly regulated growth are worth the costs in terms of higher land and building prices. Ultimately, society at large must make these tradeoffs. The dimensions of the choice should be recognized as clearly as possible, however. Just as is true of national planning, there is a danger at the local level that physical planning will march off in one direction, while economic planning proceeds in another, contradictory direction.

Unrealistic Development Standards

Government-imposed development standards can also raise land and building costs (see Box 3.1). Bertaud et al. (1988) found standards to be an important factor in development costs in Uttar Pradesh, India. Regulations required excessive road widths, large tracts of public open space, and large plot sizes. The researchers estimated that only the top 5 percent of all urban households could afford to locate in developments built to those standards. Similarly, cost analysis by Jamaica's Construction Resource and Development Centre (1987) showed that only the top 15 percent of the area's income distribution could afford minimal housing that met the standards of the Kingston Development Order.

Development standards typically require, as well, a strict separation of commercial and industrial land uses from residential uses. These requirements, when enforced by authorities, impose substantial costs on small-scale enterprises, which normally have a preference for locating business operations in the owner's residence in order to cut down on total land and building costs, transporta-

The same measures that reduce costs to business will also reduce costs to residents, lending double impetus to local economic growth.

tion costs, and warehousing costs. Even when business zoning standards are not enforced, they create an atmosphere of uncertainty that can discourage business investment.

While the problem of excess standards has often been termed a "colonial inheritance," zoning and building rules have frequently become more severe since independence. Design professionals have been very cautious, adding in sizeable "safety factors" to make absolutely sure that hazards would be avoided, often without consideration of the effect on costs or affordability. [16] Zoning plans often have been prepared without any analysis of the cost implications for either the residential or business sectors.

Problems in Registering and Transferring Land Titles

When investors want to purchase land to start a new business or expand an existing one, they require speed and certainty in the acquisition process. Long delays increase both costs and risks. To avoid future legal difficulties and to be able to borrow against their new property, owners must have secure title.

Unfortunately, the laws and processes regulating land title transfers in many developing countries seriously frustrate these objectives. In some countries laws permit all members of extended families to retain interest in ownership. The process of land assembly is considerably delayed by the myriad of transactions required to clear title. Another typical problem is inadequate public records on land ownership. This is the result of faulty systems design or inadequate administration, and is exacerbated where the perceived barriers of the formal system are so great that buyers fail to record their purchases. The World Bank (1986) notes, for example, that up until recently India had reasonably well-maintained records of land ownership. These systems are now deteriorating. High stamp duties (25 percent of value including interest) and capital gains taxes, along with additional legal impediments, have provided strong disincentives to registering private land sales in the formal sector. Of course, the vast settlement of land by the informal sector also goes unrecorded.

Finally, even where records are decently maintained, the land registration process itself may be extremely complex and time consuming. The process in Peru, as documented by de Soto (1989) involves a sequence of 44 separate steps.

But not all developing countries have these problems. Tanphiphat and Simapichaicheth (1990) explain the responsiveness of Thailand's Torrens system:

> *. . . Relevant information is recorded on the land title certificate and it can be used to record any subsequent changes of ownership, rights, or obligations. . . . All information relating to a particular land parcel (on the certificate) is held at the offices of the Lands Department. . . . There is, therefore, no need for title searches or title insurance which could be very costly and time consuming. Better still, because the Lands Department requires the use of standardized land sales contracts and other documents, most transactions do not require lawyers . . . . Ownership transfers and recording of changes of rights and obligations can be completed quickly*

and, in fact, must be completed by the end of the day when the application is made . . . . Over the years, there have been relative few cases of mal-administration by lands officials.

The effect of Thailand's flexible land titling system, along with other measures that cut down on regulation of the urban land market, can be seen in Figure 3.1, which shows housing (and land) costs to be unusually low relative to household incomes.

Cost Impacts of Local Public Policy

The land market is a sensitive barometer of local public policy. Actions taken to restrict the supply of developable land will quickly show up as higher land prices, and therefore higher costs for housing and business facilities for any purchasers of property.

Given the magnitude of wealth that can be created by higher land prices, there will always be a constituency of existing landowners who favor continued restrictions on land development, and who favor cracking down on informal land development or mixed business and residential use. Such restrictions act as a barrier to entry by new businesses and slow down the pace of migration to the city from rural areas. They therefore are at odds with the economic development interests of the country at large and with the interests of the poorer segments of society.

Other public policies also affect the general cost competitiveness of local economic activity. The previous chapter emphasized the link between infrastructure investment and business productivity. In countries where local tax rates must cover the costs of public service provision, the overall efficiency of local government as a supplier of public services will significantly affect business costs. The same measures that reduce costs to business will also reduce costs to residents, lending double impetus to local economic growth.

TARGETED ECONOMIC DEVELOPMENT STRATEGIES

Most of the activities undertaken by local governments directly or indirectly affect the local economic climate. However, there is a special subset of policies often labeled "economic development" programs. These are undertaken with the explicit intent of stimulating local economic growth, often by attracting or retaining particular businesses.

Business establishments—especially industrial firms—are largely free to locate where they choose. Local governments can influence this choice in some degree by making themselves more attractive as business sites. They can lower local tax burdens for particular industries, subsidize the cost of a firm's capital investment, provide factory space, or adopt other targeted measures to lower the costs of local production. None of these measures is likely to be sufficient to overcome strong market disadvantages, but in a city near the competitive range as a location for business, publicly provided incentives may be enough to tilt the location decision.

Strategies to Lure Industry

The simplest local economic development strategy is to try to attract business firms by offering them special tax or financial advantages. The process may be

The simplest local economic development strategy is to try to attract business firms by offering them special tax or financial advantages.

illustrated by the first use of industrial incentives—or "smokestack chasing"—in the United States. This occurred during the 1930s at a time when the rural South resembled a less developed country. Mississippi's "Balance Agriculture with Industry" program offered tax-free financing from local governments for industries that newly located in the state. The incentives were used particularly to accelerate the transplanting of textile firms from New England to the South, where they could take advantage of lower wage rates. Other Southern states later adopted the same practice. Tax-exempt industrial financing eventually spread to all of the states (Netzer, 1991).

Subsequent evaluations demonstrated that as long as the program was limited to the South, it did indeed have some effect on industrial location decisions. Once the program spread to all states, however, it became extremely costly and lost its differential incentive effects. The states finally wound up petitioning Congress to impose national limitations on the amount of industrial bond financing that any state could provide. Because of interstate competition, no state by itself was able to retreat from offering fiscal incentives; a halt to the self-defeating escalation of incentives was possible only by having Congress impose rules that applied equally to all states.

In the United Kingdom, competition based on tax breaks has been restricted by limiting industrial investment write-offs to certain parts of the country, which have been designated as high priority development regions. These include Scotland, Wales, and the inner cores of old industrial cities. Despite this attempt at targeting, studies have found that the tax advantages are too widespread to be effective in steering development, and not powerful enough to offset the appeal of London and South England as investment sites.

The experience with local industrial subsidies in developing countries parallels that in the United States and the United Kingdom. Local governments in Brazil, for example, have competed for business firms' location by offering free land, tax holidays, and below-market financing for investment. Research indicates that in the area surrounding Sao Paulo, local government subsidies have helped to accelerate the decentralization of firms from the central city (Ferguson, 1990a). Such decentralization was occurring in any event because of high land, transportation, and labor costs, but the additional subsidies offered by outlying communities speeded up the process. The most aggressive localities appear to have succeeded in capturing extra growth through their incentives. However, attempts by cities farther removed from Sao Paulo to use the same incentive programs were unsuccessful. Relocating firms limited their search for alternative locations to a relatively small radius and could not be induced by fiscal incentives to locate in the interior of the state.

In Chile, local government desires to attract industry by offering special tax breaks were largely responsible for the central government's decision not to allow local governments discretion in setting local tax rates. National economic strategists feared that the efficiency of firms' locational decisions would be distorted by local tax differentials. Therefore, they have required a uniform local tax and fee structure throughout the country.[17]

How to Make Local Ecomonic Development Planning More Effective

As an alternative to simply offering tax advantages to firms willing to relocate within its boundaries, a city may attempt to put together a more comprehensive local economic development plan.

The experience to date with local economic planning in less developed countries is not very encouraging. Cities have rarely made the effort to analyze their own strengths and weaknesses in competing for economic growth, or to formulate a plan that would take advantage of their strengths in certain sectors of the economy. Instead, most cities reflexively undertake the same investments as their neighbors.

For example, analysis of the local development projects undertaken by Latin American municipalities in the 1960s and 1970s under USAID and Interamerican Development Bank funding found that almost all borrowing municipalities wanted to build public slaughterhouses (Gall, 1976). This investment was undertaken without regard to the current availability of private slaughterhouse facilities, excess capacity in neighboring towns, or the cost effectiveness of new construction. As a result, a vast oversupply of local slaughterhouses was built, leading to low utilization rates for all, as well as the impossibility of establishing fee schedules that would allow recovery of investment costs. Slaughterhouse construction was viewed more as a matter of municipal prestige—confirmation that a town was as important as its neighbor—than as an economic investment in local development. Secondary towns in African countries likewise have often reduced municipal economic development to a single measure—expansion of the local public market—without regard to the adequacy of current stall space or probable demand for new facilities.

One reason for the narrowness of local economic planning is the lack of understanding that most local officials, except those in the largest cities, have of their community's position in the national economic system. Typically, local officials possess no information regarding the way local economic activity fits into the national picture—i.e., what is produced in the local region, where it is shipped and to what users, what the current cost competitiveness of local products is and how it has changed in recent years, in what subsectors of the economy national demand is likely to grow fastest in coming years, who the locality's chief competitors (nationally and internationally) are, and what cost structures these competitors have.

Realistic local economic development planning must start with this type of information and assessment. Before any local funds are spent on development strategies, a brief but focused report should be produced, which summarizes the current economic position of the community, its competitive prospects, and the principal bottlenecks and opportunities that confront the city. It should then be possible to develop a "marketing plan" for the community. The plan should target certain key markets where it is feasible for the community to preserve or enhance its market share. Specific strategies for encouraging local development can be evaluated in this context.

The content of local development plans, as well as the strategy for putting them together will vary greatly by locality.

Cities have rarely made the effort to analyze their own strengths and weaknesses in competing for economic growth, or to formulate a plan that would take advantage of their strength in certain sectors of the economy. Instead, most cities reflexively undertake the same investments as their neighbors.

Box 3.2
SUCCESSFUL URBAN REDEVELOPMENT IN INNER KINGSTON, JAMAICA

An inner-city redevelopment program sponsored by USAID in Kingston, Jamaica, illustrates the process of local economic development planning and implementation.

The central area of Kingston has gone through a period of more than 40 years of severe decay. The business and middle-class population, as in the United States, moved to the suburbs. Political conflict erupted into violence in the central city. By the mid-1980s, the remaining population in downtown Kingston had some of the highest unemployment rates in the country—as high as 70 percent in the core residential areas. The old part of the city was littered with burned-out shells of buildings as well as abandoned buildings still in good structural condition.

An assessment of the labor market in Kingston concluded that it was unrealistic to expect inner-city residents to find jobs in outlying areas. There were no affordable transportation links. The downtown labor force was viewed by suburban employers as untrained, unreliable, and excessively politicized; would-be workers were placed at the bottom of any hiring queue. The residents themselves felt intimidated by the formal business sector and did not apply for jobs.

The inner city did have several advantages for redevelopment, however. It remained the headquarters of the country's court system and associated legal community. Land and rental prices were far lower than in the newly developed business area of New Kingston. At the same time, there were a number of abandoned buildings that could be rehabilitated at considerably less cost than new construction. Explosive growth in New Kingston had produced tight rental markets there as well as severe traffic congestion and concerns about limits on water supply and wastewater removal, indirectly enhancing the competitive position of downtown. There was an immense pool of downtown labor willing to work at low wages.

An analysis of competitive position concluded that downtown Kingston could be restored to market competitiveness at a moderate subsidy cost. The competitive analysis also indicated that the

Boxes 3.2 and 3.3 offer two concrete examples of successful local development efforts, preceded by action planning. These cases illustrate three characteristics that are shared by most successful local development programs.

1. Collaboration between the public and private sectors. The private sector needs to be involved in local economic development planning not only because it is the group which has the most at stake and will be making investment decisions, but because public-private collaboration around a planning framework can create continuity that bridges different political administrations. Otherwise, the high turnover of local elected officials and their staffs can cause economic planning to grind to a halt, or reverse course, after each local election.

2. Constant attention to feedback from the marketplace as to where demand exists, and which programs are working successfully. Local development plans never work out exactly as formulated. It therefore is critical to

principal short-term bottleneck on industrial growth in the Kingston metropolitan area was a lack of suitable factory space. Therefore, it was decided that the redevelopment plan should emphasize the restoration of factory space for labor-intensive industry. Factories would be restored and space leased at market terms, with the goal over a five-year period of demonstrating the profitability of such activity, then turning over financing and reconstruction to the private sector. Simultaneously, reinvestment in commercial property would be undertaken on the principal streets to consolidate downtown's role as a headquarters location for commercial and legal firms.

During the first three and a half years of the project, some 200,000 square feet of industrial space were rehabilitated. Large volumes of commercial space have also been restored. One hundred percent of the space was rented at market rates that allowed a competitive return to capital. USAID funds were used to pay for the initial rounds of capital investment. Later, private sector equity financing was used to finance the redevelopment projects. In all, some 1,300 direct permanent jobs were created. The major downtown firms committed to reinvestment in headquarters locations.

The experience with the inner-city labor force has also been encouraging. Follow-up interviews with employers found that two-thirds of the firms reported that the downtown labor force had performed better than expected, and that the overwhelming majority of employers regarded downtown labor as comparable to that available in other locations. About 30 percent of all new jobs were filled by downtown workers.

As a demonstration project, Inner Kingston Redevelopment has been largely successful. Most important, it has created a non-profit private sector organization that performs economic and investment planning, raises private market funds for downtown investment, and establishes links with the central government on behalf of the city.

Source: The Urban Institute, 1991.

monitor actual results and adjust policies and projects to better fit market demand and institutional limitations, as these are revealed in practice.

3. Learning by doing. Although some "planning" needs to take place before launching a costly local development strategy, too much planning is as severe a threat as none at all. Comprehensive development plans are anathema to effective economic development strategies. The preparation of comprehensive plans typically delays start-up by several years. It locks public agencies into particular physical designs and mixes of economic activity. When (as often happens) private sector demand fails to materialize for the publicly planned activities, the whole plan is often dropped or transferred to a public agency to implement in spite of the market.

Support for the Local Informal Sector

For more advanced developing countries, the key to local economic growth may be formal-sector business firms, or even international firms that can bring capital

Box 3.3
SUCCESSFUL DEVELOPMENT EFFORTS IN TOLEDO, BRAZIL

Toledo is a medium-sized city (120,000 inhabitants) in the state of Parana, Brazil. It has grown rapidly as a result of rural migration, precipitated by the change from small-scale, labor-intensive agriculture to industrial-scale, capital- and land-intensive soybean and wheat crops.

Like many other towns, Toledo first sought to compete for economic growth by attracting footloose industrial firms. For example, in the mid-1970s, salesmen came to town promising to build a soft-drink factory with backing from Pepsi Cola. The town eventually provided free land and tax holidays to the venture, called King Cola. Residents bought large amounts of stock in the company. But after a year the plant closed and the entrepreneurs disappeared with the remaining cash. The alleged connection to Pepsi Cola proved to be a scam.

In the 1980s, Toledo, led by its mayor and a partner in the local seed company, tried an alternative path: community industries. A group of business people met regularly over a year to assess the community's potential competitive advantages. It settled on trying to use the by-products from its large meat packing plant to set up new economic activities, starting with a tannery that would use animal hides. A group of 21 residents put up the initial capital. Shares were later sold to residents at large. The town donated land and infrastructure.

In its first year of operation, the tannery employed 28 persons and generated a profit. Intoxicated by success, the town began to set up numerous other community industries, also designed to take

A local development strategy that provides fertile ground for informal business development is likely to have a high payoff—one that is less risky and less costly than competition for footloose, major industrial firms.

and modern technology into an urban region. For most countries, however, the most dynamic part of the urban economy is the informal sector. It generates the most employment and is the source of indigenous firms, which start out small and can graduate into national and international markets.

A local development strategy that provides fertile ground for informal business development is likely to have a high payoff—one that is less risky and less costly than competition for footloose, major industrial firms. It also can target benefits more directly to citizens of modest wealth. Despite the appeal of "informal" business growth, local governments have often resisted it. They have imposed regulations that unnecessarily impede informal business development out of a desire to "plan," "control," or "regularize" the economic growth pattern.

Effective support for informal sector development combines reform of general land-use and regulatory policy with targeted programs aimed directly at informal businesses. One important lesson of the last decade, however, is that government usually can do more to help the informal business sector through supportive land-market and regulatory policies than through highly subsidized small loan programs. A land policy that supports small-scale economic activity would: [18]

1. Permit commercial and industrial activities to occur in low-income residential areas. Studies for many

advantage of local raw materials—e.g., shoe, handbag, and soccer ball companies using leather; door manufacturers; rabbit meat and other enterprises. However, this proliferation of enterprises ran into a severe management constraint: there was not enough managerial skill available locally to run the companies successfully. Moreover, community ownership eventually led to conflict over the companies' direction and operating style.

In the end, the experiment in community economic planning did not produce a large number of permanent community industries. Rather, the legacy of participative economic planning was to be found in the private sector. Given the entrepreneurial surge that was produced, existing business firms and cooperatives began to encourage their employees to set up associated small businesses. For example, employees of the agricultural cooperative set up separate fertilizer companies and a livestock feed factory. Between 1982 (the year the first community industry was launched) and 1988 the number of registered businesses in Toledo jumped from 1,532 to 3,974. Farm profits were reinvested in the city's industrial sector. Industrial activity not only grew but diversified. The city became much less dependent on its biggest employers and on single markets.

The experience with community economic planning was also transferred to political decision making. A municipal-owned company was set up to carry out all local infrastructure investment, and neighborhood groups were organized to give expression to local preferences for infrastructure investment projects.

Source: Ferguson, 1990a; 1990b.

parts of the world have demonstrated that informal sector business works most effectively when business and residential uses are mixed together (Haiti—Fass, 1988; Latin America—Strassman, 1987; India—Benjamin, 1991; and Côte d'Ivoire—Serageldin, 1990). A shop owner will live above his business, so that he can provide security for it and save on total expenses. At a lower level of income, an owner will devote one room of his house to retail sales or services such as haircutting. Capital generated from price appreciation in residential real estate is often reinvested in the business that occupies part of the premises. Some minimal rules regulating urban land uses are certainly appropriate—such as the exclusion of auto junk yards and animal slaughtering from high-income residential areas—but in lower-income areas, regulations separating business and residential activity damage economic development without serving other ends.

2. Design subdivision regulations with an eye to commercial and industrial use, not just residential use. Development is a dynamic process that cannot be foreseen in detail or dictated by planners. Therefore, it is critical to allow flexibility for different land use choices as market demand develops. Specifically, it is important that plot sizes, roads, and sites for future infrastructure be laid out so that they can accommodate more intensive commercial and industrial activity in the future. Plot dimensions

Government efforts to "go against the market" almost always fail. It is far more effective for government to go with the winners, and build on districts that already show signs of rapidly rising productivity. Public improvements can then be targeted so as to keep pace with private investment.

that allow modular subdivision or modular recombination are extremely useful in encouraging business growth.

3. Treat infrastructure provision as critical to informal business growth. Certain types of infrastructure networks are especially important.

Roads and Road Paving. Interviews with business owners in Côte d'Ivoire, Haiti, Thailand, and Indonesia single out road building and road paving as the most important factor in promoting informal economic activity. Commercial and industrial activities tend to cluster along paved roads, often redeveloping existing parcels at higher densities when paving takes place. Vehicular access during the rainy season can be crucial to business success.

Electricity. The importance of electricity to small- and medium-scale industry is often overlooked. Yet casual observation in any city in a developing country will reveal that almost all small-scale production uses some form of electric motors. Electrically powered tools and machinery are by far the most versatile, reasonably priced, and efficient technology available. Benjamin's study of Delhi (1991) highlights not only the importance of electricity in general, but the special importance of access to heavy duty, 240-volt, 3-pole electricity once production has reached a certain stage of development. Few urban strategies have focused on electricity supply as a key element in business growth.

Telephones. Telephones tend to be viewed as a consumer luxury item. However, they are a major factor in encouraging economic activity. Small enterprises typically operate on a "just-in-time" basis, and efficient communication is essential.

In general, infrastructure needs to be planned and provided with an eye to supporting small-scale business development, as well as residential growth and major industrial firms.

4. Target upgrading plans to areas where microbusinesses already are growing rapidly. Government efforts to "go against the market," whether in steering investment to poor regions of the country or channeling local informal development into designated areas, almost always fail. It is far more effective for government to go with the winners, and build on districts that already show signs of rapidly rising productivity. In the absence of other information, visual inspection of building activity and monitoring of land values can identify areas where market demand is the strongest. Public improvements can then be targeted so as to keep pace with private investment.

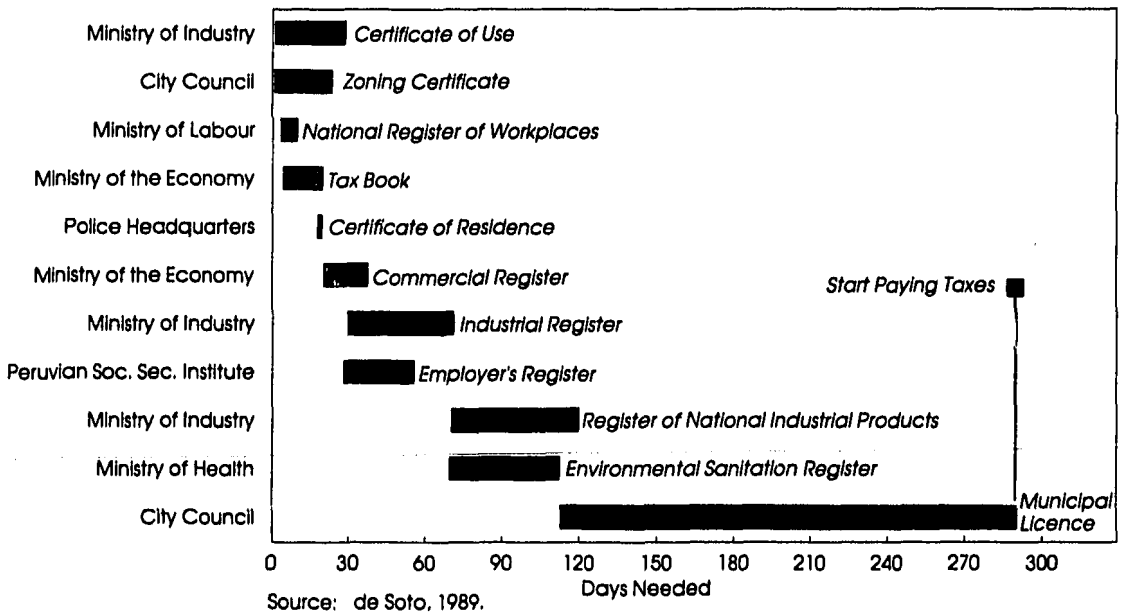
5. Try to decentralize and democratize land use policy and infrastructure decisions. Bureaucratic decisions about investments, however well intentioned, are unlikely to meet citizen preferences or business needs as effectively as locally expressed demands. Community groups need to have their horizons enlarged so that they can visualize making choices that assist business activity, not just household consumption. Once this is done, evidence indicates that citizens take decision making seriously. For example, in Yopougan, Côte d'Ivoire, when citizens were brought into investment priority setting, they urged that restoration of the

Municipal Hall be postponed and that the funds be redirected to strengthen access to the local market by building three bridges that would link isolated neighborhoods to the market and by street paving in the market area. Neighborhood groups of small business owners should be viewed as a critical resource in setting infrastructure priorities, since they have the best market information on the bottlenecks to further growth.

6. Reduce the government red tape required to set up and register small businesses. Developing countries are notorious for the bureaucratic delays and paperwork they require to set up and register small businesses. Hernando de Soto (1989) found that the same business activity that took 72 hours to set up in Florida required a minimum of 290 days and multiple bribes to set up in Peru (see Figure 3.3). The time and out-of-pocket costs of regulation drive most small establishments out of the formal sector.

In some respects, this escape from the formal sector represents a satisfactory solution to over-regulation. However, it also gives rise to an uncertainty about legal status that discourages business investment and often precludes business operations from gaining access to normal sources of credit. Interviews with informal sector business owners in many countries have confirmed that the majority of owners would prefer to legitimize their business status, even at the cost of paying higher taxes.

Figure 3.3
RED TAPE INVOLVED IN SMALL BUSINESS REGISTRATION IN PERU (PARTIAL LISTING OF REQUIREMENTS)



Source: de Soto, 1989.

Box 3.4
EAST DELHI, INDIA—AN INFORMAL SECTOR SUCCESS STORY

After Independence, the neighborhood of Viswas Nager, East Delhi, was transformed from an agricultural village to one of the largest centers for the production of copper wire and PVC-coated wire in Asia. Three factors triggered this growth:

- Construction of a bridge across the Juma River connecting Viswas Nager to markets in the rest of Delhi;
- An influx of Punjabis with strong entrepreneurial skills, displaced from their homes by the Partition with Pakistan;
- Establishment nearby of a government industry in copper ingots.

However, at each development stage, local land use practices greatly facilitated the development of an efficient production center:

- In its earliest stage, the area developed as an unauthorized colony. But public authorities chose not to crack down on land use violations or lack of formal titles.
- Plots were laid out by the occupants in 20-foot modules that could be easily subdivided or recombined to meet different sized demands for space, as markets evolved. Government did not try to impose standard zoning.
- At an early stage, political pressure brought paved roads and street lighting. Paving was critical to access; street lighting was critical to security. Both types of public investment also conferred a *de facto* recognition of development, reducing the threat of public demolition.
- Factories were built into residences. One of the first factories, for the drawing of copper wire, was begun in the front room of a house, then extended to occupy most of the lower floor. The

Boxes 3.4 and 3.5 illustrate these themes by contrasting two local approaches to informal business regulation.

CONCLUSION; WHAT CAN LOCAL GOVERNMENTS DO TO HELP THEIR OWN ECOMONIC DEVELOPMENT?

This chapter has advocated a local economic development agenda that is very different from current economic development planning in the cities of most developing countries. The most typical local development strategy at present starts by trying to get the central government to locate a factory or industrial park in the city. Local planners also lobby for subsidized business loan programs financed by the central government and international agencies. If these efforts to get central government to bear the costs of local development do not succeed, the city may look for a fast payoff to spending its own resources, by offering tax breaks to attract industrial firms, sponsoring local public works programs to generate employment, or, as a last resort, hiring people to work for government.

upper floor was used as a residence. A corner room on the ground floor was leased to a photography shop.

- Installation of full 240-volt electricity made possible the expansion of factories and establishment of heavier industrial processes.
- Property dealers and "chit funds" sprang up in the area, as property values rose. Profits from property transactions generated much of the cash that was reinvested in business expansion and equipment. Capital gains were realized by subdividing properties and selling off one part, or by owners who invested in local real estate on the site.
- Viswas Nager became a key destination for domestic migration, as ambitious workers and entrepreneurs moved into the area. Typically, workers would stay three to five years on the job, then become foremen in new plants. Village school teachers and others migrated to become owners of new home-based factories.
- Secondary activities flourished—such as the production and repair of cycle rickshaws used to transport products.
- In response to market demand, buildings constantly were added onto or increased in height. Lots were combined to make room for bigger factories or split up for sale to generate cash for investment. The modular nature of lots and buildings was critical to this process. By contrast, government-sponsored programs built fixed factories with rigid block construction that could not be modified to fit evolving demand.

Sources: Benjamin, 1991; Doebele, 1989.

If a city is able to obtain special industrial subsidies from the central government, whether due to its political clout or because it is the birthplace of the president, it would be foolish not to press this advantage. However, for the country at large, competitive maneuvering for central government favors, like tax inducements to get industrial firms to move, will be unproductive unless the real cost structure is lowered. What one community gains, another loses. Even worse, the nation in the aggregate will be worse off if the location decisions produced by subsidies are less efficient than those that would otherwise occur.

Local governments will do better to think of themselves as long-term investors in development. They can identify the region's potential competitive advantages, then build on these strengths through public and private investment, flexible business regulation, and efforts to control the local cost structure. Of course, urban areas are part of a national and international economy. Even the best designed local development strategy cannot overcome severe market disadvantages.

For the country at large, competitive maneuvering for central government favors or industry location is unproductive. What one community gains, another loses. Local governments will do better to think of themselves as long-term investors in development; to identify the region's potential competitive advantages; then build on these through public and private investment, flexible business regulations, and efforts to control the local cost structure.

Box 3.5
KUTUS, KENYA—AN INSTRUCTIVE FAILURE IN INFORMAL BUSINESS REGULATION

Kutus is a small but rapidly growing town in central Kenya. Virtually all business activity takes place in the informal sector.

Despite the informal sector's importance to the local economy, the last decade has witnessed continual conflict between local government and small business, even when the ostensible purpose of government projects was to assist economic growth.

In 1981 the town council ordered the arrest and eviction of all handcart operators in the town. Their presence violated business regulations. In 1983 the council forcefully relocated all wood workshops, including cartmakers and carpenters, to a site two kilometers away. Again the action was taken to remove incompatible business uses. In 1986 the council evicted all barbershops and beauty salons from town homes because they mixed commercial and residential use. Later, local artisans were removed from their central location to a new center built for them outside of town. A bulldozer was sent to clear the old site, and police were dispatched to seize the business equipment of those who refused to move.

The economic impact of these measures was disastrous. Although the town council provided workshop plots at the new artisan center, it allocated plots only to individual owners without provision for joint occupancy. In the old site, there were more than two operators for each workshop. The new plots were separated by barbed wire fencing, so that no reconfiguration could take place to meet users' needs. The old site had access to electricity, was located next to a bus park, and was close to the main road. The new site had no water or electricity, and was far removed from the market and main road.

As a result of the forced move, business incomes declined. Average employment per business fell from five to one, and wages fell drastically.

Source: DeGroot, 1990.

POLICY PRIORITIES

Chapter 4

■ *Governments can best support urban economic development by facilitating private sector investment and efficiency, not by acting as direct producers. Fundamental to the public sector role is development of a coherent economic development strategy that recognizes local market realities. However, the formulation of such strategies will require more information, better market orientation, and closer collaboration with the private sector than most governments now enjoy.*

Given the evidence reviewed in this report, what policy approach should governments and international donors take to ensure that urban economies contribute as fully as possible to national development?

GOVERNMENT AS ENABLER AND FACILITATOR

The most effective role for government in economic development is an indirect one. A central theme of urban economic development policy should be the same as that endorsed by developing countries for the shelter sector in the United Nations' Global Strategy for Shelter to the Year 2000 (1988): government should change its primary role from that of producer to that of enabler and facilitator of private sector activity.

The public sector does not have to provide the capital to finance productive investment in cities, and usually should not do so. Government does not have to own or build industrial parks; own or operate basic industries; or take responsibility for organizing the informal sector. These are tasks best left to the private sector and the market. Even if, because of historical traditions in a country or because of monopolistic behavior in the private sector, governments find it necessary to more directly intervene in urban markets, they should do so in the spirit of facilitating a constructive private sector role. The public sector "urban development corporations" that many countries have established too often have betrayed their names. Instead of investing in fundamental infrastructure projects, or carrying out land clearance and land assembly projects that would spur higher levels of private investment, they have become designers, investors, owners, builders, and operators of urban real estate projects. There have been occasional successes, but by and large these public projects have displaced private

Government should change its primary role in economic development from that of producer to that of enabler and facilitator of private sector activity.

investment. Worse, they have often crippled private development by making the private sector hostage to the delays, uncertainty, and unresponsiveness to market demand that frequently mark large-scale public development efforts.

Both national and local governments have their hands full financing and performing their basic service responsibilities. Urban development can make more progress if governments concentrate their resources on these core tasks, rather than trying to supplant the private sector as direct investor and operator of income-producing projects.

An uncritical focus on job generation has at least two dangers. First, it is not just more jobs that are needed, but more high productivity jobs. Second, government officials are not the right agents to create jobs.

Government and Job Generation

Considering the enormity of labor force growth, it is not surprising that many third world political leaders now see job generation as the most important task confronting cities. The possibility that urban unemployment and underemployment will grow jeopardizes many of the social objectives for cities—better housing, health care, and schooling—and threatens social stability.

Nonetheless, an uncritical focus on job generation has at least two dangers. First, the goal as stated omits an important modifier. It is not just more jobs that are needed, but more *high productivity* jobs. Poverty in the cities is as much a problem of low-paying, low-productivity jobs as it is of unemployment. The modifier may get less emphasis than it deserves because the term "higher productivity" conjures up strategies that focus more on machines than workers. It is true that economic development strategies in developing countries have often been too capital intensive. However, the only way to tackle poverty is by creating opportunities for higher productivity work. This will require an approach to urban institutions and public and private investment that looks to market demand and seeks efficient ways for the urban labor force to meet it.

The second danger in focusing uncritically on job generation is that government officials who aim to reduce unemployment are likely to want to do something about it directly. But most such officials are not the right agents to create jobs. The widespread failure of overstaffed parastatals operating in the productive sectors is well documented. Governments (and taxpayers) are now paying the price of excessive hiring in other public agencies. The costs are felt not only in budgets, but in the credibility and effectiveness of the public sector when jobs are created where there is no productive work to be performed.

During the 1980s, a number of developing nations, using funds provided by international donors, launched "employment generation" programs. These typically took the form of public works projects targeted on cities. The intention was twofold: to absorb some of the urban unemployment and thereby relieve the social and political pressure on cities, and to add socially useful infrastructure, like paved streets and water connections, to the urban network. However well these programs may have met their short-term political objectives, they were conspicuous failures as urban development tools. Because the criteria used for priority setting were speed and size of job creation, contractors were encouraged to adopt inefficiently labor-intensive means of

production, which then accustomed them to higher cost structures. Projects were selected for their ability to generate jobs rather than their payoffs to consumers. Project financing was placed on a fast track which avoided cost recovery from beneficiaries. This has increased the difficulty of imposing fees on service users for similar projects in other locations, or for projects in the same city initiated after the temporary employment generation program was terminated.

In short, government programs that forced labor absorption in an inefficient manner bought a few years' respite from acute unemployment, but made the ultimate adjustments to market realities more difficult. They fostered the illusion that when there are not enough jobs to go around, the right approach is to exert political pressure on government to create them. Ironically, the very international organizations that in other contexts insist on market-oriented project appraisals and payments by beneficiaries to recover service costs abandoned these principles in the name of employment generation.

Formulation of Economic Development Strategies

This report has emphasized the importance of putting together coherent economic development strategies, both at the national and local levels. The support role that government should play as a facilitator of development begins with the formulation of a strategy for growth, which then can be translated into specific policies.

The framing of urban development strategies is a formidable task. In agricultural development, there was the potential of great progress from having a very small number of technical innovations applied by millions of farmers who, despite some important variations, were essentially doing the same thing. Given the variety and complexity of urban economies, there is no similar master strategy for urban development. Instead, economic development planners must construct an individualized strategy that fits their own circumstances.

Successful strategy formulation will require much more information about urban markets than most countries now possess. As argued in Chapter 3, local urban development policies require knowledge about demand for local production, comparisons of the local cost structure with that of competitors, and realistic assessments of the strengths and weaknesses of different sectors of the local economy. Only from such an assessment can there emerge a strategy as to how the local community should target its development efforts.

At present, the knowledge base for strategy development is totally inadequate. Data about even the most basic aspects of urban economies are sketchy and hard to uncover. But local officials tend to assign very low priority to assembling better information. They are impatient to produce visible results, and so launch projects in the hope that they will bear fruit. When governments act directly in the urban sector, they can rely to a certain extent on the magnitude of their intervention to produce change. If a local government spends a large sum of money to build new stall space in the public market or to install electricity in new parts of town, the results will at least be

Government programs that forced labor absorption in an inefficient manner bought a few years' respite from acute unemployment, but made the ultimate adjustments to market realities more difficult.

Successful economic development strategy formulation will require much more information about urban markets than most countries now possess and also will require close collaboration between the public and private sectors.

noticeable and of benefit to some. The switch to being a facilitator of private development implies that governments have to understand much better the markets in which they are intervening so that their policies can achieve the desired results without unexpected side effects. This, in turn, requires systematic information about how markets operate, and the capacity to analyze this information.

International agencies can effectively support local economic development by giving greater importance to the formulation of coherent development strategies, buttressed by market information and analysis. One important advance in this direction can be achieved by encouraging shifts in the orientation of local planning offices. Planning offices are now dominated by land-use planners, who draw up master plans and then try to force the market to comply with them through public regulation and direct public construction. As economic development becomes a more important part of local government's mission, the planning mix should shift to give greater importance to understanding and responding to market demand. Planning agencies should have an overall strategy for strengthening the local economy's ability to respond to market demand at lower costs. Everything from housing finance to informal sector regulation, and from local tax policy to local land-use regulation should be examined in this light. As emphasized in Chapter 3, for example, land-use regulations that are designed to promote market efficiency will assume very different forms from land-use regulations designed to impose public planners' conception of orderliness.

Successful strategy formulation also will require close collaboration between the public and private sectors. For the local public sector, collaboration means looking at private business as a permanent partner in development planning. A first step can be the establishment of an economic development task force composed of key leaders from the business community, the mayor, and key agency heads from local government. The establishment of such a task force often has proved to be a breakthrough in local economic planning—especially if the initial priorities identified by the task force can be addressed swiftly with concrete actions. Over time, a public-private economic development task force should become the principal agent responsible for identifying information and "research" needs. As the task force finds its strategy development hampered by information gaps, it should assign local government agencies (or Chamber of Commerce groups) the responsibility for collecting data, commissioning expert studies, or doing whatever else is necessary to fill the gaps. Such requests gradually should re-orient economic planning to make it more useful to policy design.

At the national level, successful urban economic development depends on the incentives created by sensible macroeconomic and regional planning policies formulated by central government. Central governments have the responsibility of making physical development planning consistent with economic planning. They need to get prices right by dismantling arbitrary subsidies that favor certain locations or certain subsectors of the economy at the expense of others.

Central governments, too, have responsibility for establishing the rules of local competition so that it promotes national efficiency, rather than encouraging localities to launch competitive wars through local subsidies that ultimately distort locational choices.

GUIDELINES FOR URBAN ECONOMIC DEVELOPMENT

This report does not advocate a single set of "urban" policies. However, several themes sounded in the report should help orient policy formulation in the 1990s. These themes are elaborated below.

National structural adjustment policies create an opportunity to redefine urban markets and local government functions on a more efficient basis. Although urban institutions do not figure prominently in structural adjustment policies, local authorities can seize the openings now being created by structural adjustment to press for local reforms that support such adjustment, while also achieving other objectives. The need to cut central government spending, for example, provides an opportunity to overhaul local government hiring practices (which typically involve hiring far too many unskilled workers and not enough professionals), and to delegate some service functions and revenue-raising responsibilities to the local level. A wise local government will not resist this adjustment, but will attempt to shape it so that local authorities can begin to provide the services that are most appropriately delivered locally. Structural adjustment also creates the opportunity to decentralize more of the tools needed for local economic development planning.

International lenders have now accepted the principle that poverty populations need to be protected during structural adjustment. Identification of the sub-groups especially at risk in cities and of their vulnerability to particular policy changes can help target support measures for health, schooling, and basic food consumption that will allow city economies to change without throwing parts of the population into crisis.

An emphasis on national economic growth and export-led development will usually mean that new investment resources must be directed to already successful regions and cities. This, in turn, implies a critical role for internal migration in spreading the benefits of growth. Physical planners may lament the importance being given to aggregate economic growth, and prefer stronger policies of regional equalization in investment. However, they must accept reality. At this stage, planning can contribute most effectively to equity objectives by making sure that the migration process works as smoothly as possible. This means providing for the possibility of low-cost shelter in cities, carrying out infrastructure upgrading programs for new settlements, and making public service institutions, like schools and health clinics, more easily accessible to new migrants.

There is an analog to this process at the local level. Maximizing local economic growth usually will require providing infrastructure and policy support to the particular development zones that are growing fastest. The challenge then is to spread the benefits of growth to the rest of the urban population. For this purpose, it is critical to design transportation systems

National structural adjustment policies create an opportunity for strengthening the local role in service delivery and economic development.

so that the residential population can reach the locations where jobs are (intra-metropolitan mobility); to design tax systems so that the public sector benefits from the growth of productive activity and property values; and to overhaul regulatory systems so that entry into successful business sectors is as open as possible to the population at large.

Governments have considerable control over the entire cost structure of urban areas. Public policy should be directed to lowering these costs. As noted in Chapter 3, one significant element of the cost of doing business or living in urban areas is land and building costs. Public decisions about how much land to authorize for development or endow with infrastructure and about what development standards to require, all greatly affect land and building costs. These costs, in turn, get built into the larger cost structure for urban production. Public service and infrastructure costs have similar repercussions. Thus, governments have a great deal of control over items which contribute to a city's cost competitiveness, and need to think of their activities as directly entering into the local production function.

NOTES

1. Recent policy documents reflecting more positive views of urbanization include Government of India, 1988 and Government of Indonesia and UNCHS, 1985.

2. For a discussion of the theory and consequences of urban bias, as well as the most recent empirical evidence pro and con, see Lipton, 1984 and the accompanying articles in the special issue of *Journal of Development Studies* devoted to this topic.

3. Estimates by the United Nations, 1986, and the International Labour Office, 1987.

4. See, for example, Todaro, 1969 and 1977.

5. In his study of rural areas in the United States Berry, 1968, found a hierarchy of city size and functions, linking towns to their rural service areas. The smallest towns in the hierarchy provide banking, food retailing, farm machinery sales and repair, physician and religious services. The next largest towns also provide furniture and drug retailing, and agricultural product marketing, and legal services. Regional centers offer hospitals and apparel retailing. Recent studies of rural and urban linkages in developing countries include Haggblade et al., 1987, and Rondinelli, 1988.

6. These studies are documented in Government of Indonesia and UNCHS, 1985; Acharya and Mohan, 1990 (for India); and Richardson, 1987, who presents a cross-country comparison of estimates for Bangladesh, Egypt, Indonesia, and Pakistan.

7. See discussion of this potential in Peterson, 1988.

8. For example, Thailand has established a policy that all public capital investment and public service provisions in Bangkok should be self-financing. See Peterson et al., 1986.

9. For example, officials of the World Bank project an increase of some 20 million residents in Sub-Saharan African cities over the next years. Roughly half this number will be potential members of the labor force. Yet even under optimistic assumptions, urban employment projections are for only 25-40 million additional jobs.

10. The linkage between labor mobility and big-city housing markets has also generated a great deal of attention in the United States and England. See for example, Ermisch (ed.), 1990.

11. See, also, Choe and Song, 1984 and The World Bank, 1989c.

12. A comprehensive review of experience with growth pole policies is provided in Lo and Salih, 1976.

13. See National Urban Development Strategy Project, 1985.

14. Such measures are discussed in Linn, 1983.

■ *Notes*

15. The demand for *urban* land also depends upon the availability of agricultural land for development. Thailand's growth illustrates this connection. Despite extremely rapid economic growth, Thailand's urban population between 1965 and 1985 grew at a much *lower* rate than the national population, 33 percent vs. 64 percent. The explanation for this unusual phenomenon is the availability of cultivable agricultural land. "Excess" rural population migrated primarily to new rural areas rather than the cities. This helped restrain urban land prices. By the mid-1980s, however, the rural land supply had been exhausted, foretelling greater pressure on urban land markets, especially in Bangkok. See Tanphiphant and Simapichaicheth, 1990.

16. See Gakenheimer and Brando, 1987, for a broader discussion of the incentives that have supported high development standards.

17. Margaret Thatcher's introduction of the poll tax in Great Britain was motivated in large part by this same concern. It allowed the Government to eliminate local differentials in property tax rates on industry, which were thought to distort firms' locational choices.

18. The paragraphs that follow draw heavily on Doebele, 1989.

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