

## Preface

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The Commission on Growth and Development was established in April 2006 as a response to two insights: we do not talk about growth enough, and when we do, we speak with too much confidence. Too often, people overlook economic growth when thinking about how to tackle the world's most pressing problems, such as poverty, illiteracy, income inequality, unemployment, and pollution. At the same time, our understanding of economic growth is less definitive than commonly thought—even though advice is often given to developing countries with great confidence. Consequently, the Commission's mandate is to “take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers.”

To help assess the state of knowledge, the Commission invited leading academics and policy makers from around the world to a series of 12 workshops, held in 2007 and 2008 in Washington, D.C., New York, and New Haven, and commissioned a series of thematic papers. These papers reviewed areas such as monetary and fiscal policy, climate change, inequality, growth, and urbanization—the subject of this volume. In addition, 25 case studies were commissioned to explore the dynamics of growth in specific countries. Each presentation benefited from comments by members of the Commission and other workshop participants from the worlds of policy, theory, and practice.

The workshops turned out to be intense and lively affairs, lasting up to three days. It became clear that experts do not always agree, even on issues that are central to growth. The Commission had no wish to disguise or gloss over these uncertainties and differences. It did not want to present a

false confidence in its conclusions, beyond that justified by the evidence. Researchers do not always know the correct “model” that would explain the world they observe; and even if they know the factors that matter, they cannot always measure them convincingly.

While researchers will continue to improve our knowledge of the world, policy makers cannot wait for scholars to satisfy all of their doubts or resolve their differences. Decisions must be made with only partial knowledge of the world. One consequence is that most policy decisions, however well-informed, take on the character of experiments, which yield useful information about the way the world works, even if they do not always turn out the way policy makers hoped. It is as well to recognize this fact, if only so that policy makers can be quick to spot failures and learn from mistakes.

The workshops on cities and housing were held in March and May 2007. We were immensely fortunate to benefit from the wisdom and insights of outstanding researchers and experienced practitioners. We are grateful to all of the participants, who are listed below. The remainder of this preface is not an exhaustive summary of the workshops or the chapters in this volume. It instead replays some highlights of the discussion and presents some of the ideas that shaped the conclusions of the Commission’s final report, *The Growth Report: Strategies for Sustained Growth and Inclusive Development*.

## **Productivity and Cities**

Structural change is a key driver of rapid growth: countries diversify into new industries, firms learn new things, people move to new locations. Anything that slows this structural change is also likely to slow growth. Because urbanization is one of the most important enabling parallel processes in rapid growth, making it work well is critical.

Deciding whether urbanization causes growth or growth causes urbanization is very difficult, and largely beside the point. We know of no countries that either achieved high incomes or rapid growth without substantial urbanization, often quite rapid. There is a robust relationship between urbanization and per capita income: nearly all countries become at least 50 percent urbanized before reaching middle-income status, and all high-income countries are 70–80 percent urbanized. In all known cases of high and sustained growth, urban manufacturing and services led the process, while increases in agricultural productivity freed up the labor force that moved to the cities and manned the factories. In the high-growth cases that we examined in the Growth Commission, the average productivity of a worker in manufacturing or services is on the order of three to five times that of a worker in traditional sectors, and sometimes much more.

Urbanization deserves attention not to the detriment of improving agricultural productivity and rural livelihoods, but as a complement to such

measures. Improving agricultural incomes is very important for reducing poverty among the large numbers of people living in the rural areas of poor countries today. Still, no amount of growth in the rural sector is going to match the productivity increase that is caused by people moving across that boundary into high-productivity employment.

Urbanization's contribution to growth comes from two sources: the difference between rural and urban productivity levels and more rapid productivity change in cities. In the early decades of development, when the majority of the population is still rural, the jump from rural to urban employment makes a big contribution to growth. As cities grow larger, the second effect—faster gains in urban productivity—begins to dominate, as it operates on a larger base.

For these reasons, making urbanization work well is something that countries that want to grow quickly must learn to do. There are two important parts of making it work. The first challenge is to foster the growth of high-productivity activities that benefit from agglomeration and scale economies in developing country cities. The second involves managing the likely side effects of the economic success of cities—congestion, regional inequality, and high prices of land and housing. Meeting this second challenge is essential for mitigating the divisive impacts of successful economic growth and spreading the benefits of higher economic productivity widely.

Why is productivity higher in cities? Why, in other words, is proximity a source of efficiency? The cost of transport is one obvious reason why economic activity might cluster around a harbor or crossroads. Infrastructure and other public services are also cheaper to provide to densely packed populations. City dwellers may also benefit from knowledge spillovers: some theories predict that the aggregate gains from schooling are greater than the (sum of the) returns to individuals, implying that people learn a lot from each other without paying for it.

In addition to understanding what happens within cities, it is important to grasp what unfolds between them, and between cities and the rural hinterland. Urbanization can pose challenges that extend far beyond a mayor's jurisdiction. The migration from the countryside to the cities may, for example, be uncomfortably quick for people already living in cities, who face sharper competition for common, limited resources. Accommodating these pressures requires investments in infrastructure, often in public goods, which, in turn, tests government's capacity to mobilize new public resources and to shift the balance of spending towards cities. The economic success of cities may result in glaring income gaps between them and the rural hinterland, while making a new economic elite more visible to low-income groups flocking to urban areas. The agglomeration economies that make cities productive usually involve externalities or spillovers. Newcomers to cities impose costs that others must bear, and create benefits that others may capture. These externalities create a bias for an established city that makes it hard for secondary cities to grow, even if it would be more efficient

to do so. Such “growing pains” may be part and parcel of the modernization process. But to sustain rapid growth, policy makers need to contain the social and political tensions they create.

“Primacy”—the dominance of one city over all others—is one example. In developing countries, one city (such as Dhaka, Jakarta, Bangkok, or São Paulo) often outstrips the others. Governments often feel obliged to even things out. Should they do so? On the one hand, robust empirical evidence shows that productivity increases with the size of cities. On the other, some empirical evidence suggests that excessive “primacy” may reduce overall growth. Precisely how it does so is not clear, however. Nor is it clear that governments can or should act on this result. This issue sparked considerable discussion in the workshops and remains unsettled among scholars. It may, in any case, be easier to cope with the congestion (and other costs) of large cities than to divert the geography of growth away from one city and toward its rivals. Ideally, we would know much more about when cities become too large to accommodate further growth and how to counteract excessive city size effectively.

## Financing Urbanization

Economies rarely grow without their cities growing. But urbanization has its “dark side.” According to a UN survey, the vast majority of policy makers resist urbanization rather than welcome it. They would prefer to stem the urban tide and see people return to rural areas. This disaffection with urbanization reflects more than just nostalgia for simpler times. Rapid urbanization brings about real social and political headaches, such as overcrowding, concentrated squalor, crime, street violence, and the quick transmission of disease. Urbanization is probably inevitable and ultimately desirable. The question is not how to stop it, but how to reap its benefits without paying too high a cost.

Infrastructure and public services are part of the answer, and possibly the whole answer. According to some estimates, \$40 trillion of infrastructure spending is required to meet the needs of cities in developing countries. Where is that money going to come from? Devising means of financing such vast expenditures is probably the biggest challenge for urbanization policy in developing countries.

The economic benefits of cities are often reflected in property prices. It should therefore be possible for the government to capture a share of these benefits by taxing land or property. It could then spend the proceeds on the infrastructure required to offset some of the costs of cities, such as congestion. Economists find the idea appealing. But local government officials think property taxes are a big headache in practice, and they have not proven to be a rich source of investment finance.

Property taxes are cumbersome, costly to administer, and highly unpopular everywhere. In developing countries, the challenges multiply. The

administrative and political demands of property taxes are particularly ill-suited to local governments still building their technical capacity and credibility with the public. In many developing countries, the property market is underdeveloped and overregulated. Large tracts of land languish in public hands. Private transactions are underreported because they are heavily taxed. Rents may be controlled, depressing the value of the real estate. In the absence of reliable market prices, officials must arrive at their own estimation of property values, a job that demands some skill and leaves ample discretion. This discretion in turn opens the door to corruption. Besides, it takes time to raise a significant sum from property and land taxes. In countries with a history of exploitative landlords, heavy property taxes will be strongly resisted. Many properties in rapidly growing cities are informal and unserved, leaving them out of the tax net. Lastly, property taxes are typically designed to generate a steady stream of income reflecting the flow of benefits to property owners. Financing “lumpy” infrastructure investments with a property tax thus requires the additional hurdle of tapping financial markets, which are usually in an embryonic state when rapid urbanization takes hold. Over the long run, property taxes will likely become a mainstay of local taxation in developing countries as they are in the developed world. But in a transitional phase, these taxes must be supplemented by creative and perhaps unorthodox approaches to urban finance, including some methods used historically in developed countries.

Some countries have raised money by capturing land asset values in transactions with the private sector, be they leases, sales, developer’s exactions, or betterment levies. In a fast-growing economy, these transactions can be lucrative, raising large multiples of the sums available from other budgetary sources. In places like Hong Kong, China, the terms of a lease have been tweaked and adjusted to help shape a city, without the heavy-handedness of zoning. Economies and regions around the world—ranging from China; Hong Kong, China; and Singapore to Egypt; South Africa; India; Chile; and the rapidly growing jurisdictions in the western United States—have raised substantial sums to finance infrastructure using these techniques.

There are disadvantages. Asset transactions are inherently limited and should be used for investments rather than recurring costs. Leasing transactions may help shape the city, but long-term leases may also make it difficult to change land-use patterns. There is the potential for abuse and corruption in large one-time transactions involving valuable tracts of urban land. But whatever the relative merits of selling land, leasing it, or taxing property, the alternatives may be worse. In many developing country cities, for example, governments administer large tracts of underused land. This acreage is not put to the best use the market can find for it. Nor does it typically yield the government much revenue. It is a good way to squander a precious asset.

Capturing land asset values is lucrative and fraught with risks. It can reduce the need for central budgetary support that has usually been required for financing major urban infrastructure improvements. But land

asset-based finance also needs a supporting framework and supervision from higher levels of government. Whatever specific techniques are deployed, it is unrealistic to expect cities to “go it alone” for financing the infrastructure transformation that is needed to make urbanization work.

## Urbanization and Regional Inequalities

The economist Simon Kuznets hypothesized that as countries grow richer, inequality would first rise, then fall, tracing out the so-called “Kuznets curve.” The curve has a spatial equivalent: the income gap between urban and rural areas first widens, then narrows. In the United States, for example, regional inequality rose from 1820 to 1940, but declined thereafter. Whether developing economies will repeat this pattern remains to be seen. China took a conscious decision to tolerate inequality in its quest for growth. “We will let some regions and some people get rich first,” Deng Xiaoping famously said.

Some urban labor markets cope better than others with the influx of new labor. In the United States, mass immigration was accompanied by rising real wages from 1820. Immigrants from Europe and elsewhere found work in an expanding manufacturing sector that offered plentiful unskilled jobs. With the advent of mechanization in the 1920s, the demand for skills rose. But by that time, American high schools were turning out educated workers and policy makers had partially closed the door to immigration. The important conclusion is that if labor-intensive manufacturing is growing, economies can absorb migrants from the fields or foreign countries relatively easily.

In many developing country cities, most jobs, including those for new migrants, are in the informal sector of the economy. Although informal employment is on the rise in many countries, rich and poor, we know relatively little about the productivity of this sector or the mobility of workers from informal employment to formal jobs. However, research in Africa indicates that informal work in the cities is more productive than agricultural labor, even if it is considerably less productive than formal employment. In Ghana, for example, the differential between informal work in the cities and agricultural work was estimated at 2:1. Few of the workers in the informal sector seemed to escape into formal jobs. But perhaps their children will make the leap. We need further research to find out.

Urbanization also has implications for the position of women. In the United States, it was mostly men who migrated in waves to factory jobs in the cities. But this pattern is not universal. In China, for example, early migrants to the cities were often women. This remains true today in those industries that require refined motor skills. In the long run, cities promote growth, and growth enfranchises women. As incomes rise and female education improves, women have fewer children and enjoy higher rates of employment.

There was considerable discussion of whether government intervention could reduce spatial inequalities, and which policies actually succeed. Policy makers often feel obliged to reduce spatial disparities. But many of these efforts to promote some regions over others did not achieve much. Heavy investments in U.S. highways and targeted regional interventions in the EU may have facilitated convergence. But poorer countries face tighter budget constraints and fewer options. Central governments should probably devote their efforts to helping people move from lagging areas to prospering ones, rather than spending large sums on remote infrastructure that may be underused. Yet very difficult choices arise when regional income inequalities coincide with other social divisions such as ethnicity or religion. In such circumstances, fostering a sense of regional balance may become critical to national cohesion, and policy research thus far offers little firm guidance on how to do this.

## **Housing and Land Markets**

As people move to cities in large numbers, the demand for housing and serviced land in urban areas expands rapidly. Unfortunately, the market rarely meets this demand affordably. Ill-conceived planning laws and building standards coupled with insufficient public finance for infrastructure mean that supply responds sluggishly. As a result, the price of land and housing rises beyond the reach of poor people. Even in desperately poor countries such as Bangladesh, big-city land prices can be comparable to prices in industrialized nations.

The Republic of Korea provides one example of a dramatic effort to raise supply. By the late 1980s, the cost of housing had far outpaced GDP. The ratio of house prices to income reached 13:1, as compared with 3:1 in the United States. The government stepped in. Overnight, 25 percent of the country's land was declared "urban," clearing the way for real estate development, compared with 5 percent before. In addition, 2 million homes were added to the housing stock over seven to eight years. Today, Korea's house-price-to-income ratio is about 3.5:1.

The case of Singapore is also revealing. Singapore's government controlled the land and maintained a near monopoly over house-building. Quite exceptionally, the government could also control migration since the borders of the city and the nation coincided. In contrast to Eastern Europe, where unresponsive state monopolies produced low-quality, high-cost housing, Singapore's public housing was standardized and cheap. Its heavy housing subsidies served both social and economic ends. They brought an end to squalid slums and defused ethnic strife. They also ensured the wage competitiveness of workers in Singapore's small, open economy, which had pinned its hopes on foreign investment and exporting success.

The success of Singapore's housing subsidies is more the exception than the rule, however, and they carried significant risks. Its provident fund, a

mandatory saving scheme, was heavily invested in real estate. If Singapore had ever suffered a housing downturn, the consequences might have been disastrous. Fortunately, the economy thrived and home prices did not tumble. Subsidies for housing can become a political necessity, but they are also costly and hard to confine to the poor. Certainly, they should not be seen as a substitute for serious efforts to expand supply, including the supply of public services that often constrain efficient land use. Only a greater supply of serviced land and housing can lower costs, because it helps to solve the problem at its root as well as contain the fiscal burden of subsidies. In Mexico, for example, an upfront subsidy was combined with efforts to provide better infrastructure and security of tenure, allowing households to make investments in their home on their own.

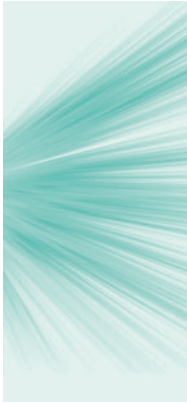
Mortgages can improve households' ability to buy decent housing. But finance relaxes demand constraints only. Unless it is accompanied by measures to increase supply, better finance may result in overshooting prices. This volatility can jeopardize macroeconomic stability. In a typical pattern, strong income growth leads to a rapid increase in housing demand. An injection of liquidity from some source, often overseas, may help overstimulate the market, leading to overoptimism and a dangerous concentration of wealth in real estate. This leaves buyers and bankers dangerously exposed when the bubble bursts, as illustrated by Thailand and Hong Kong, China, in 1997, Shanghai in 2003, and recently in the United States. In Sweden, the relaxation of mortgage-lending regulation left banks overexposed to a housing bubble and very vulnerable in the face of an economic contraction.

## Concluding Remarks

Rapid and sustained growth entails rapid and sustained urbanization. But, if mishandled, the growth of cities poses problems that can derail growth. Developing countries must accomplish in a few decades what today's industrialized countries achieved over a century or more. Policy makers are, as the *Growth Report* puts it, navigating uncharted waters with a set of incomplete, sometimes inaccurate, maps.

Their task is made no easier by the data at their disposal. Several speakers at the workshop noted that data on housing and real estate markets in developing countries are woeful, much worse than figures on agriculture, for example. This impedes intelligent consideration of policies. Better data could support stronger research on urban economics, finance, and the real estate market, which has been relatively neglected in developing countries. It is our hope that this volume will help people understand the role of urbanization in growth and tackle the formidable challenges it poses.

A. Michael Spence



## Workshop Participants

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**Abdel-Rahman**, Hesham, University of New Orleans  
**Alm**, James, Georgia State University  
**Angel**, Solly, New York University  
**Annez**, Patricia Clarke, World Bank  
**Arnott**, Richard, Boston College  
**Asabere**, Paul, Fox School of Business and Management, Temple University  
**Bertaud**, Alain, Independent Consultant  
**Bosworth**, Barry, The Brookings Institution  
**Brueckner**, Jan, University of California at Irvine  
**Buckley**, Robert, Rockefeller Foundation  
**Chiquier**, Loic, World Bank  
**Cho**, Man, The Korea Development Institute (KDI) School  
**Deichmann**, Uwe, World Bank  
**De Mello**, Luiz, Organisation for Economic Co-operation and Development (OECD)  
**Duranton**, Gilles, University of Toronto  
**Durlauf**, Steven, University of Wisconsin-Madison  
**Eldhagen**, Erik, Swedish International Development Cooperation Agency (SIDA)  
**Freire**, Maria Emilia, World Bank  
**Green**, Richard, George Washington University  
**Hannah**, Lawrence, World Bank  
**Hegedüs**, József, Metropolitan Research Institute, Budapest, Hungary  
**Henderson**, Vernon, Brown University  
**Hesse**, Heiko, World Bank  
**Hwang**, Min, George Washington University