Section 2.

Cities as Economic Growth Engines

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In 2008, for the first time, a majority of the world's people lived in cities. This ongoing broad demographic transformation is nowhere more dramatic than in the developing world. And the urbanization drumbeat is projected to continue until at least mid-century. UN HABITAT estimates that the urban population in developing countries will increase from 1.9 billion in 2000 to more than 3.9 billion in 2030, equivalent to 70 million people per year.

Higher income countries are already very urbanized, with 74 percent of the population living in cities. Hence, heightened urbanization will result substantially from increased urbanization in the developing world, with the share of the population living in cities anticipated to rise from 44 to 67 percent by 2050. Africa has the lowest current level of urbanization (38 percent), but it has the highest urban growth rate (3.3 percent per year between 2000 and 2005), which is expected to remain high. Kabul, Afghanistan is the most rapidly growing city in the world. Secondary cities rather than the largest cities will grow the most.

Economies of Scale

Urbanization is increasing at this rapid pace for a simple reason. Cities account for most of a country's economic growth—to the benefit of the households who live there and the firms that operate in them. The record is clear that cities are more efficient at generating economic product than rural areas.

But what accounts for this greater efficiency? The answer, put simply, is the gains that arise from the concentration of economic activity. These economies of scale or agglomeration effects can be classified into three types: (1) those generated internally by firms (i.e., firms can set up large enough plants to reap large internal production efficiency gains); (2) those shared by firms in the same industry (i.e., they access a common skilled labor force and suppliers); and (3) those more generally available to producers in a large urban area (transportation links, efficient finance, specialized legal services, etc.).

Cities foster economies of scale of all three types, realize efficiencies, and drive economic development. Higher densities promote greater economies while longer distances between activities work against such economies. It is no accident that extremely high commercial and residential densities characterize the great cities of all regions.

The largest cities in developing and transition countries account for a disproportionate share of national GDP, and more highly urbanized countries produce more GDP per capita. Globally, the largest 100 cities produce nearly 25 percent of the world's GDP.

Examples of ways that urban agglomerations of various sizes produce growth include market towns that facilitate economies of scale in marketing and distributing agricultural products and inputs, medium-sized cities that provide shared-resources for manufacturing industries, and very large cities that provide a wide range of facilities and services to business, government, and service providers such as schools and universities, and hospitals.

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Just how important are the economies of scale from urbanization? The World Bank has rendered its verdict: "No country has grown to middle income without industrializing and urbanizing. None has grown to high income without vibrant cities."

Implications for Country-wide Growth

Urban economic growth can, in turn, facilitate country-wide development. As urban centers prosper, they provide new markets and increased demand for goods produced elsewhere in the country. Also, a portion of urban earnings are often cycled back to the countryside by way of remittances. Further, the gains in human capital and new technologies, while initiated in urban areas, often spread country-wide. Thus, urbanization can be a driver for national growth reaching all areas.

It is important to note that increased urbanization does not, however, guarantee growth, particularly after the initial stages. While so-called "pathological urbanization"— significant urbanization gains without economic growth--is uncommon, such a pattern has emerged in some poor countries. Downward trends in rainfall have pushed people to some African cities even without any urban job magnet.[2] Over the longer run, the clear evidence on development is that rural-urban and within-urban disparities in welfare both narrow with development over time.

Vitality in the Informal Sector

The productivity made possible by urban economies of scale is helped considerably by the economic energy apparent even in the most squalid slums. While the terms "urban informal settlements" and "urban slums" conjure up images of extremely poor families living in jam-packed, overcrowded neighborhoods, lacking in basic infrastructure and urban services (described more fully below), it is equally essential to recognize the positive contributions of such informal settlements to the economic life of cities in many developing countries. Urban slums, contrary to popular perception, often bustle with micro- and small enterprises within the retail, manufacturing, service, repair, and distribution sectors. However, value added is often low since many small entrepreneurs are not well integrated into value chains of larger formal sector firms as suppliers of goods and services and, although the growth of micro-credit has helped, many still often lack access to finance that would allow them to expand.

It is also critical to appreciate the facilitative role such settlements play in helping to transition rural migrants into the realities of urban life and in providing essential employment opportunities for those whose education levels and skills do not allow them access to the formal sector. The informal economy is particularly important for women, who, because of domestic responsibilities and/or local customs, are often able to work only in or close to their homes. As C.H. Prahalad has said in his seminal work, *The Fortune at the Bottom of the Pyramid:* "If we stop thinking about the poor as victims or as a burden and start recognizing them as resilient and creative entrepreneurs and value-conscious consumers, a whole new world of opportunity will open up."

The urban poor also represent a potentially huge latent market for goods and services. The "bottom of the pyramid" market in Asia (including the Middle East), for example, is estimated to represent 83 percent of the region's population and 42 percent of its aggregate purchasing power; in sub-Saharan Africa it represents 71 percent of aggregate purchasing power.

Until recently, many developing countries ignored the informal sector, considering it illegal and something to be eradicated. However, some have now begun to recognize it as an important sector of the economy where innovation can flourish. In Kenya, for example, informal manufacturing enterprises *(jua kali)* have been promoted as an export industry and political leaders recognize the importance of these enterprises to national economic growth.

It is true that the impacts of the recent worldwide economic downturn and the concomitant shrinking of international trade will be felt hardest by the most economically vulnerable in developing countries, typically those working in the informal sector. The global financial crisis affects both urban and rural populations, but the urban poor are particularly vulnerable given their heavy reliance on the informal economy, inability to rely on their own food production, and vulnerability to a sudden drop in income without a social safety net for protection. But it is also true that this increased relative hardship will be temporary and that urban growth will once again dominate in increasing a country's productivity and living standards.