

## Seizing the Benefits of Urbanization: Opportunities and Challenges for MCC

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Today, more than half the world's population lives in urban areas, and at expected rates of growth, this number could reach two-thirds by 2050 (United Nations 2018). Driving this change is not just overall population growth but also rural-to-urban migration, itself a function of rural poverty, conflict, and climate change. Urbanization can nonetheless yield profound benefits, in terms of both economic growth and poverty reduction, but not without careful management, investment, and design. Capitalizing on its experience funding compacts and threshold programs in urban areas, the Millennium Challenge Corporation (MCC) aims to refine its investments and better exploit the dynamism of urban economies to foster private investment, accelerate economic growth, and reduce poverty.

### Urbanization and Economic Growth

Cities are fundamental to economic growth. In lower-income countries (LICs) where MCC works, urbanization plays a key role in structural transformation, a necessary process for sustaining growth and poverty reduction over the long term (Page *et al*, 2020). Separately, well-functioning cities reap the rewards of agglomeration—clusters of industry-specific firms and deep labor pools that sustain each other—and provide a foundation for economic diversification. In cities, workers can access more jobs, firms can choose from more workers, and producers connect with each other to buy and sell inputs, goods, and services. Interconnectedness among firms also induces positive externalities in the form of technology transfer, knowledge spillovers, and innovation hubs, leading to more productive, higher-value economic activity (Lall *et al*, 2021; Cervero, 2001; Henderson, 1974). Urbanization can also facilitate the more efficient delivery of public services such as transportation, health care, and business services to spatially concentrated populations, with strong implications for poor and middle-class residents. In short, the features of scale, density, and interaction can generate substantial productivity gains, consequently raising overall incomes (Glaeser and Xiong, 2017).

### Constraints to Urban-Led Growth

Constraints to the operation of agglomeration economies, however, can depress the productivity and incomes of workers and firms in cities. High costs of transport weaken the connectivity between firms and workers. Inadequate water or power infrastructure can deprive firms of key inputs and threaten public health. Inefficient land markets and poorly functioning property rights systems can limit the productive use of land and reduce accessibility to both individuals and businesses.

These constraints disproportionately impact the urban poor. While extreme poverty in urban areas only represents one-fifth of the global total, urban settings account for more of the “new poor,” particularly in the wake of the COVID pandemic. While this segment is better educated and less likely to work in agriculture than the chronic poor, it also lacks the security of on-farm food production and is far more vulnerable to national and global food price shocks. The pandemic and conflict in Ukraine, for example, highlight how faraway shocks lead to higher food and energy prices in many remote, developing economies (World Bank, 2022).

MCC's approach to identifying investment opportunities views cities as areas of unique constraints and opportunities. With its country partners, MCC identifies the constraints to economic growth that stand in the way of greater private sector investment and economic growth. This analysis sometimes reveals constraints related to urban infrastructure—water, power, or roads—for example to be most binding. In other cases, inefficient land markets or ineffective urban planning underlie constraints such as insecure property rights or traffic congestion. As a result, MCC typically marries its hard infrastructure investments with policy and institutional reforms to address both the constraint to growth and its

underlying root cause. MCC looks to expand its analysis of constraints unique to urban settings to better understand their impact on overall growth. A recent partnership with the Brookings Institute has developed an [initial framework](#) that may be tested and refined (Page *et al* 2020).

### **Box 1. The challenge and opportunity in sub-Saharan Africa**

Africa's population is growing faster than that of any other region and will be majority urban by the end of this decade. The United Nations projects that Africa's urban population will nearly triple by 2050, adding 800 million people, the current urban population of Europe and North America combined.

Africa's cities face three challenges. First, they are crowded but not economically dense. Investments in infrastructure have not kept pace with population growth, and the costs of congestion can quickly overwhelm the benefits of agglomeration. Second, Africa's cities are disconnected. Fragmented neighborhoods coupled with unreliable transportation limit job opportunities and stifle agglomeration. Finally, Africa's cities pose high costs to households and firms. High nominal wages and transaction costs deter investors and trading partners, especially in tradable sectors. Workers face high food, housing, and transport costs, passing labor costs to firms and reducing expected returns on investment. As a result, African cities have failed to generate enough high-productivity jobs to absorb the growing labor force, pushing Africa's urban workers into the low-productivity informal sector, entrenching poverty along the way (Lall *et al* 2017).

Despite these challenges, evidence suggests African urban populations outperform rural counterparts in almost all dimensions, and about one-third of Africa's per capita GDP growth in the past two decades is due to urbanization (OECD 2022). The key question becomes: how can Africa realize the full economic potential of its cities?

### **MCC's Programmatic Examples**

MCC's extensive history of urban investments spans a range of constraints. Below are several illustrative examples.

- **Kenya Proposed Threshold Program, in development (\$60 million)** Approved by MCC's Board in March 2022, the proposed Kenya Threshold Program will wholly focus on the city of Nairobi. The program addresses transport and land-related constraints around urban connectivity by targeting integrated transport planning, first and last mile connections, and land use planning.
- **Malawi Transport and Land Compact – City Council Land-Based Revenue Modernization Activity, signed 2022 (\$24 million)** This compact expands coverage and collection of land-based revenues in Malawi's four largest cities to fund key services and increase investment in urban land.
- **Timor-Leste Compact – Water, Sanitation, and Drainage Project, signed 2022 (\$308 million)** This project aims to reduce contamination in drinking water and groundwater in the capital, Dili. Investments include standing up a factory to produce chemical disinfectant for the city's water supply, building the country's first central wastewater system, improving the drainage network for the capital and four nearby municipalities, policy and institutional reforms, and social and behavior change to improve sanitation and water management at the household level.
- **Mongolia Water Compact, 2021-26 (\$350 million)** To stem the impact of an impending water scarcity crisis, Mongolia Water Compact aims to provide a sustainable supply of water to the capital city of Ulaanbaatar. The compact seeks to increase the available water supply through new groundwater wells, wastewater treatment plants, and capacity building.

- **Cote d'Ivoire Compact – Abidjan Transport Project, 2019-25 (\$295 million)** This project raises efficiency in the transport of people and goods in the capital city, better integrates transport systems, and improves road safety and pavement surface conditions along major transport arteries.
- **Benin Power Compact – Electricity Distribution Project, 2017-23 (\$261 million)** MCC is modernizing Benin's electricity distribution infrastructure to expand grid capacity, accommodate future demand growth, improve service reliability, reduce losses, and minimize outages. The project focuses on improving the power grid serving the city of Cotonou, Benin's center of commerce and government, as well as areas in northern Benin with high levels of poverty.
- **Zambia Compact, 2013-18 (\$332 million):** The Zambia Compact invested in large-scale water infrastructure and utility institutional strengthening in the capital city of Lusaka. In partnership with the municipal government, activities consisted of infrastructure improvements to prioritized water supply, sanitation, and drainage assets.

### Questions for the EAC

MCC's analytic approach begins with a Constraints Analysis that identifies the major binding constraints to poverty-reducing economic growth, followed by a Root Cause Analysis that studies the underlying drivers that give rise to the constraints. MCC utilizes cost-benefit analyses to inform the design of projects, rank different alternatives, and ensure that economic returns meet critical thresholds. Complementing these inputs are political economy analyses (PEA) that uncover the institutional and political forces that shape the investment's operating environment. Within this analytic framework and operating inside its larger institutional constraints, MCC faces a variety of questions regarding urbanization as new opportunities emerge and activities in this sphere accelerate.

- **Growth diagnostics**
  1. How can MCC apply its growth diagnostics to better capture constraints to investment and growth in cities? How can MCC determine whether an urban-oriented constraint is more or less binding than a rural one?
  2. What are the critical challenges around city-level provision of goods and services and productivity improvement?
- **Interventions**
  3. What interventions can most impact growth and poverty in urban settings? What investments best unlock the agglomeration potential of urban areas as opposed to investments that simply operate in an urban setting?
  4. Are certain types of infrastructure more valuable for capital (e.g., electricity) versus labor (e.g., healthcare) and how should MCC think about this trade-off in terms of benefits?
  5. What investments help countries mitigate climate change pressures on urbanization, in the process safeguarding and/or stimulating growth?
- **Targeting**
  6. How can MCC identify high-potential cities in low-income countries and/or "pockets of poverty," particularly in middle-income countries?

7. Given higher urban population densities, does the ability to reach more beneficiaries justify more urban-centric investments, particularly given that urban areas typically experience both a lower prevalence and severity of poverty?

## References

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