

# The Changing World

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olicymakers in the 21st century will find themselves pursuing development goals in a landscape that has been transformed economically, politically, and socially. Two main forces will be shaping the world in which development policy will be defined and implemented: globalization (the continuing integration of the countries of the world) and localization (the desire for self-determination and the devolution of power).

At the end of the 20th century, globalization has already demonstrated that economic decisions, wherever they are made in the world, must take international factors into account. While the movement of goods, services, ideas, and capital across national borders is not new, its acceleration in the last decade marks a qualitative break with the past.<sup>1</sup> The world is no longer a collection of relatively autonomous neighborhoods that are only marginally connected (by trade, for example) and are generally immune to events in other neighborhoods. Information and ideas can be accessed in all corners of the globe at the push of a button. The international economic order is

evolving into a highly integrated and electronically networked system. So close are its ties that a retailer in one country can describe the products consumers want to producers in several other countries, setting in motion immediate revisions in design and production. So closely interwoven are financial markets that exchange rates, interest rates, and stock prices are intimately linked, and the amount of private capital circulating in financial markets dwarfs the resources of many countries.

At the same time that globalization is gathering the world's countries together, the forces of localization are tilting the balance of power within them. The demand for self-determination can take a number of forms, including the replacement of authoritarian or single-party rule by multiparty politics, greater autonomy of subnational political units, and the involvement of community groups and nongovernmental organizations (NGOs) in governance. Even as private businesses consolidate to gain leverage on the global market, many countries are moving in the opposite direction, fragmenting, ques-

tioning established authority, and groping for mechanisms to coordinate their internal activities.

At first glance, globalization and localization may look like countervailing forces, but in fact they often stem from the same source and reinforce each other. For example, the same advances in information and communications technology that have been so important in the spread of global economic forces often allow local groups to bypass central authorities in the search for information, visibility, and even financing. Together, these global and local pressures are revolutionizing traditional forms of centralized governance and dramatically affecting development thinking.

Development economics, born after World War II, came into being in an era when strong and autonomous states were the chief decisionmakers. But that autonomy is gradually being eroded. Markets, for instance, have developed the potential to discipline states, punish their mistakes and call their bluff. Globalization has circumscribed the ability of many central governments to raise revenues by taxing corporations, which now have the option of moving part or all of their economic activity to low-tax venues. As central governments find themselves looking for other sources of revenue, regional and urban communities are coming together to assert their own interests, putting yet more pressure on the traditional forms of governance. The result has been new ways of thinking about how to manage the world's economies and a corresponding need to create new institutions to do so. These institutions will be needed at three levels: supranational, national, and local.

At the supranational level some institutions for shaping and channeling the forces of globalization are already in place. The World Trade Organization (WTO), the Basle Accords, and the Montreal Protocol, which affect, respectively, trade, banking systems, and the release of ozone-depleting chemical agents worldwide, are representative of the kinds of institutions the world will need in the 21st century. The events of the 1980s and 1990s have shown that existing institutions are far from sufficient to address the economic and environmental issues of the future: many more are needed. Economic catastrophes like the Latin American debt crises of the 1980s and the meltdown of the East Asian economies in the late 1990s may continue to occur, perhaps in even more dramatic forms. And while countries have begun initiating responses to important environmental issues

like climate change and preservation of biodiversity, these actions are but the first of many that must be taken to protect the global commons (see chapter 4). The lack of consensus on many vital issues and the difficulties inherent in protracted negotiations stand in the way of meaningful international institution-building.

At the national level many countries are learning which policies work well and which should be avoided for the purposes of macroeconomic stability. Many industrial economies learned of the potential boom-and-bust dangers of capitalism from events like the Great Depression and thus have put in place a bevy of national policies and institutions. These policies seek to moderate economic volatility through countercyclical macroeconomic actions designed to minimize the potential instability of capital flows; regulate the conduct of private agents; protect investors, depositors, and consumers; disclose the information necessary to assess risks and make prudent decisions; and provide social insurance to ride out temporary crises. Such institutions have become integral parts of the capitalist system in industrial countries, shaping expectations and fundamentally altering private sector decisionmaking. As developing economies are increasingly exposed to the new global economy, they build similar institutions in their own countries. They are likely to find that some policies in particular offer exceptional payoffs. A stable macroeconomic environment, a liberalized domestic business services sector, and a legal framework that induces transparency and protects investors' rights is advantageous. Conversely, deficiencies in financial policies and business practices are a recipe for disaster—a bitter lesson learned from the banking and currency crises of the late 20th century.

At the subnational level localization has led many central governments to grant political, fiscal, and administrative powers to local governments. But arrangements aimed at maintaining workable intergovernmental relations have not kept pace with the speed of decentralization. Ideally, decentralization rests upon effective institutions that determine voting procedures, provide for the disclosure of information, ensure accountability at the local level, and define a system of allocating resources and responsibilities to subnational authorities. But the devolution of central government authority and functions has often proceeded at its own pace—with elements not only of

learning by doing but of suffering by stumbling. There are virtually no good models of decentralization. Recent macroeconomic instability arising in part from tensions between the central government and subnational entities (although the cases are very different) in Brazil and Russia show how important harmonious relations between central and local authorities are in creating and sustaining market confidence. Governments at all levels have also begun to understand the importance of due process and inclusive, participatory, and consensual modes of public sector decisionmaking and resource allocation.

This chapter sets the stage for later chapters by defining the forces of globalization and localization. It explores issues such as trade, capital flows, and the implications of urban growth. And it looks at the institutional changes that will be needed to keep development sustainable, providing the groundwork for a more detailed examination in later chapters of the report.

### International trade

International trade flows are penetrating deeper into the workings of developing economies, affecting the overall economic structure in general and income distribution, employment practices, and productivity growth in particular.<sup>2</sup> Trade in goods and services has grown twice as fast as global GDP in the 1990s, and the share attributable to developing countries has climbed from 23 to 29 percent. These aggregate numbers do not reflect the important compositional changes of the last 10 years, which offer developing economies new opportunities for growth. Chapter 2 addresses these challenges and opportunities in depth.

The compositional shifts in trade have created a new pattern in the international exchange of goods, services, and ideas. Trade in components is one part of that new pattern. “Sourcing” such components from abroad is an increasingly common practice, and use of the Internet is sure to expand the process, encouraging entry by new producers throughout the developing world. While precise numbers are difficult to come by, in the early 1990s one-third of all manufactures trade (approximately \$800 billion) involved parts and components. This type of trade has generated an ever-spreading web of global production networks that connect subsidiaries within transnational firms to unrelated designers, producers, and distributors of components. These networks offer their con-

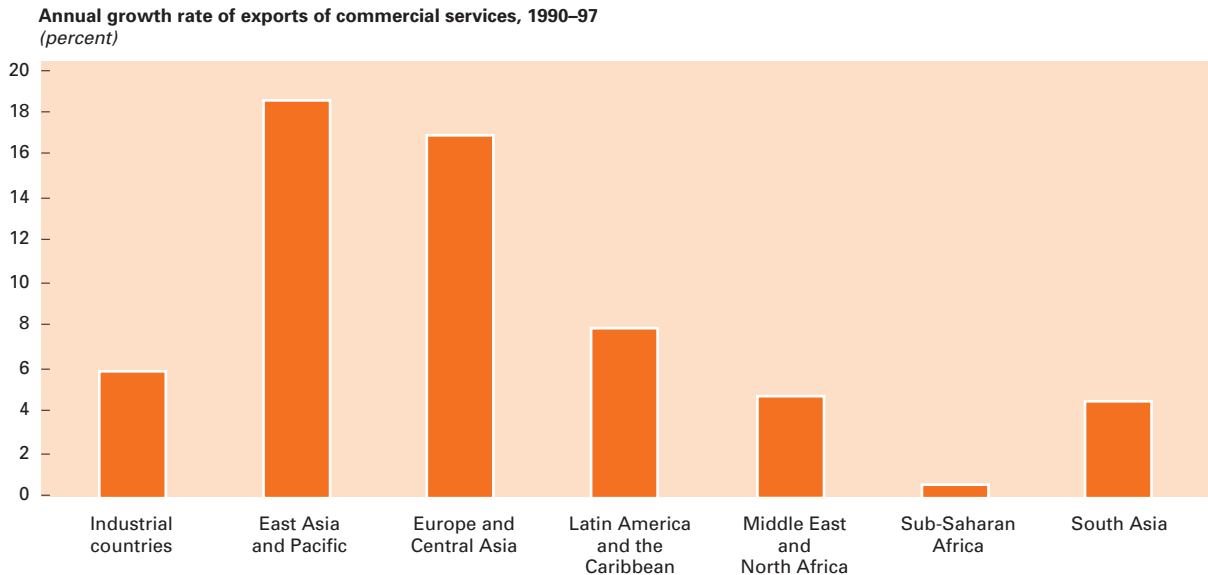
stituent firms access to new markets and commercial relationships and facilitate technology transfer. Advances in information technology help to link firms from developing countries into global production networks. General Electric, for instance, posts information on its components requirements on the Internet, and firms from all over the globe bid to supply them.

The tremendous growth of trade in services and, more recently, of electronic commerce is also a part of the new trade pattern. Exports of commercial services have been growing on every continent (particularly Asia) throughout the 1990s (figure 1.1). This change has its own special significance, as services are frequently used in the production of goods and even other services. Enhanced international competition in services means reductions in price and improvements in quality that will enhance the competitiveness of downstream industries. Both industrial and developing economies have much to gain by opening their markets. Developing countries would derive large gains from an easing of barriers to agricultural products and to labor-intensive construction and maritime services.<sup>3</sup> Over the longer term, electronic business will loom large as an area where expanding opportunities for trade require an expanding framework of rules.<sup>4</sup>

Underpinning this surge in trade flows is the growing commitment developing economies have shown to liberalizing their trade regimes. Their resolution has taken many forms: membership in the WTO (110 of 152 developing countries were members in 1999), participation in regional trade agreements, and unilateral reforms (figure 1.2).<sup>5</sup> But this push for trade reform is meeting with increased resistance, especially in industrial economies, where adjustment to the competitive pressure of the international marketplace can be a painful process. Successful trade reform requires reallocating resources among economic groups, and that adjustment can be costly for some. Increasingly, governments are recognizing that successful trade reform requires flexible labor market institutions, a point developed in chapter 2. Import-competing firms are also resisting further trade reform by using antidumping laws to reverse the gains in market access previous reforms have secured. At least 29 countries were applying such laws by 1997, and many more had them on their books.

Although the 1990s saw impressive progress in liberalizing trade regimes, sustaining that momen-

**Figure 1.1**  
Exports of commercial services have surged in most regions since 1990



Note: The annual growth rate for the European Union was zero in 1997. Figures for the European Union exclude intra-European Union trade.  
Source: WTO, *Annual Report*, various years.

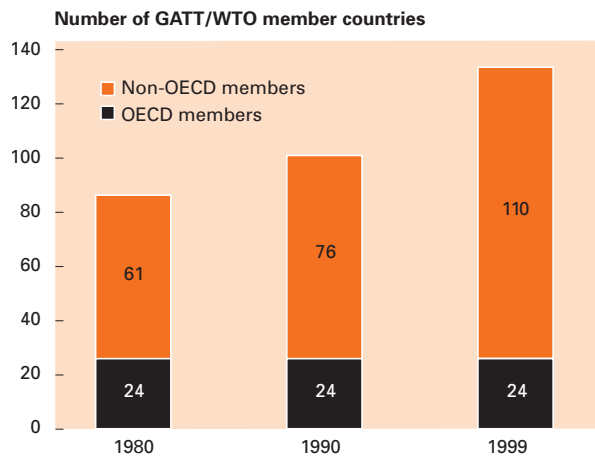
tum over the next 25 years will be more difficult. The Millennium Round commencing in November 1999 will provide the international community with an opportunity to meet the challenge. For the developing countries it will be important to be fully engaged and to use the technical expertise at their disposal to arrive at favorable outcomes in areas such as liberalization of agricultural trade and of trade in those services of greatest relevance to their future development. Recognizing that trade reform creates both winners and losers (and more of the former than the latter) is the starting point. The real test will be persuading the winners to forgo some of their gains in order to compensate influential losers who could otherwise stymie the process of reform.

**International financial flows**

The financial crises of 1997–99 have put the growing interdependencies among countries in the spotlight and led to their intense scrutiny. International capital flows to developing countries, though still concentrated in a dozen or so host economies, are rapidly becoming a major force, making the effective development, regulation, and liberalization of finan-

cial markets a top priority. Financial flows soared in the 1990s, spurred by the greater readiness of countries to liberalize capital account transactions. Even though they slipped in 1998, such flows are resum-

**Figure 1.2**  
An increasing number of developing countries is committed to trade reform



Note: Number of OECD members is for 1999.  
Source: WTO, *Annual Report*, various years.

ing their upward trend.<sup>6</sup> Much has rightly been made of the technological developments in computing and telecommunications that are reducing transactions costs. In addition, considerable attention has been given to the possibility that hedge funds and the use of new derivatives instruments could increase the volatility of capital flows.<sup>7</sup> At the same time, financial innovation has done much to contain the newly emergent risks and create a rich menu of investment possibilities—another trend that will not be arrested, simply because the potential rewards are so attractive.<sup>8</sup> More significant, the supply of financial resources will expand over the next two decades, fed by pension and mutual funds in industrial societies (box 1.1). The value of global pension assets rose from \$6 trillion in 1992 to \$9.7 trillion in 1997. Although

the rate of growth of pension assets in the United Kingdom and the United States could drop to 6–7 percent a year over the medium term, the projected value of global assets for 2002 is a hefty \$13.7 trillion. These resources will be aggressively seeking high returns throughout the world.

Increases in demand for funds will match, if not exceed, any increase in supply. Some 85 percent of the world's people reside in developing countries, half of them in cities. Large numbers of them (close to 1.5 billion in 2000) live on less than \$1 a day (a widely used poverty line). To modernize, industrialize, and urbanize, developing countries will need huge injections of capital. Most of it will come from domestic savings, but well-run developing countries offering solid returns can expect to supplement their

### Box 1.1 The global macroeconomics of aging

The aging of populations in industrial countries and some industrializing East Asian economies could seriously reduce the international supply of capital by 2025. Three factors will determine exactly how serious the reduction will be: the effect of aging and rising dependency ratios on household savings, the ages at which people retire, and the coverage provided by social security systems.

The bleakest scenario projects a substantial drop in household savings in industrial and East Asian economies as the number of people over 65 continues to climb. It points to an increasing tendency for people to retire in their fifties, as many already do in Europe. And it indicates that unreformed, pay-as-you-go social security schemes will go bankrupt or at least come under great pressure.

The median age of the population in northeast Asia will rise from 28 years to 36 years between 1995 and 2015.<sup>9</sup> Just 12.5 percent of the U.S. population and 11.8 percent of the Japanese population were over 65 in 1990, proportions that will rise to 18.7 and 26.7 percent by 2025. Between 1990 and 2025 rapid aging will raise the share of the 65-plus cohort from 6 to 13.3 percent in China and from 5 to 15 percent in the Republic of Korea.

As countries begin to gray, the number of men between the ages of 60 and 64 who are still in the labor force is dropping precipitously. In the 35 years leading up to 1995 the percentage of men in this age group who were still working fell from 80 to 55 percent in the United States, from 80 to 20 percent in Italy, and from 70 to 15 percent in France. This scenario suggests a severe global capital shortage that raises interest rates and depresses growth, trade, and commodity prices—a gloomy prospect.

A second and much brighter scenario suggests that a savings crunch can be avoided. Household surveys show that aging may not lead to the steep decline in savings some cross-

country studies predict. The growing numbers of women joining the labor force will partially offset the decreasing number of older male workers. And policies and institutions can narrow (if not close) the savings gap in some industrial countries and prevent shortages in developing economies.

Research on Japan and East Asia supports the view that savings could decline as populations age but that diminishing rates of investment will more than offset lower savings.<sup>10</sup> Furthermore, as fertility declines in South Asia and Central and South America, dependency ratios will fall during the next two decades, savings could climb—and countries in the region could gradually become capital exporters, like Japan.<sup>11</sup> In fact, some recent research on the United Kingdom and the United States points to the likelihood of higher savings rates as baby boomers approach retirement in the next two decades.<sup>12</sup>

Some sociologists believe that the retirement age will stop falling in the next two decades and may even begin to climb.<sup>13</sup> If it does—and there are plenty of opposing views that stress the attractiveness of retirement and the declining price of recreation—a savings shortfall in industrial countries would be a less pressing problem.<sup>14</sup> But even if this favorable scenario becomes more likely, industrial and developing countries with aging populations need to accelerate reform. Pay-as-you-earn social security schemes in industrial countries will run out of money in the next two or three decades unless governments increase funding, shave benefits, and maintain or raise the age of retirement. Raising contributions or cutting benefits will generate resistance, but this adjustment is unavoidable. The total bill over the next 30 years for pensions and medical care for the aged is estimated at \$64 trillion.<sup>15</sup> To meet their share of these expenses, industrial countries need to create an institutional framework that minimizes the threat of inadequate savings by ensuring that social security schemes are fully funded and by discouraging early retirement.<sup>16</sup>

savings with resources from all over the globe.<sup>17</sup> Developing countries are also the fastest-growing markets for the products of multinational corporations.<sup>18</sup> As these markets expand they will attract ever-greater amounts of foreign direct investment, which provides jobs and managerial and technical expertise, as well as capital. But the governments of developing countries must take measures to attract such investment, since it will not automatically find its way to them. In 1996 investors sent only one-quarter of their money to the developing world.<sup>19</sup>

The globalization of financial markets affects development because finance plays such an important role in economic growth and industrialization.<sup>20</sup> Financial globalization affects growth in two ways: by increasing the global supply of capital, and by promoting domestic financial development that improves allocative efficiency, creates new financial instruments,<sup>21</sup> and raises the quality of banking services.<sup>22</sup> Competition comes not only from other domestic banks but also from foreign banks and from thriving nonbank financial intermediaries. Both complement banks and, in the case of stock markets and other monitoring agencies, enhance discipline by continuously assessing information on portfolios and performance.<sup>23</sup> Moreover, experience suggests that foreign financial institutions do not undermine domestic banking systems; they are rarely dominant and tend to exhibit a long-term commitment.<sup>24</sup>

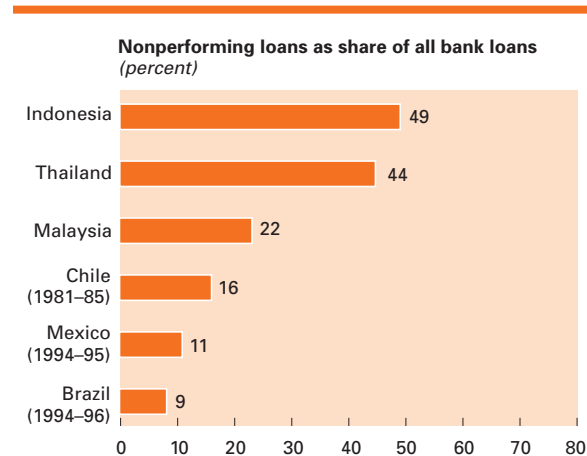
The financial performance of emerging markets in the 1990s made capital account liberalization an attractive option for developing countries. Markets seemed broadly stable and fairly disciplined, and many countries began to view the recommended sequence of liberalization (starting with the building of regulatory capabilities and the strengthening of banking and financial markets) as less important than research had indicated it was.<sup>25</sup> Several developing countries, urged by the weight of opinion in some industrial countries, began loosening controls on inflows and outflows of capital, and while most retained some constraints, a few abolished all of them.<sup>26</sup> Furthermore, openness remained the most popular option as containing outflows became increasingly difficult and the advantages of inflows grew ever more evident.

The crisis in East Asia in 1997 made policymakers apprehensive about further financial globalization. Several of the most successful emerging economies

have been badly bruised by financial turbulence associated with the East Asian meltdown. In fact, the costs of the crisis have been much higher than those associated with other recent financial debacles (figure 1.3). But the fiscal costs pale in comparison with the forgone growth and increased poverty and inequality these crises can create, especially in urban areas (figure 1.4).<sup>27</sup> The East Asian crisis has abruptly pushed the issue of sequencing liberalization measures to the top of the policy agenda. Several questions need to be answered. What role can capital controls play in minimizing exposure to sudden changes in the sentiment of portfolio investors? Are controls on capital outflows desirable, or even possible? And, given the increasing number of international transactions of goods and services, how easily can these controls be sidestepped?

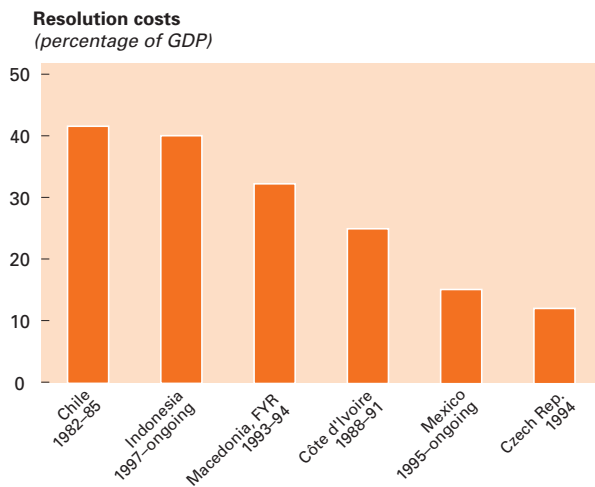
Like earlier crises, the East Asian meltdown has enhanced the attractiveness of long-term capital investment, with one difference. Until recently, governments preferred debt to equity financing or to foreign direct investment, both because they did not want foreign interests controlling major segments of the economy and because domestic owners of major corporations feared losing control.<sup>28</sup> The mood began shifting as countries recognized that foreign direct investment brings with it not only capital but also tech-

**Figure 1.3**  
Nonperforming loans can account for up to 50 percent of all bank loans at the peak of a banking crisis



Source: Figures for Indonesia, Malaysia, and Thailand are from official sources; figures for other countries are from *Wall Street Journal*, December 9, 1998.

**Figure 1.4**  
Resolving bank crises can cost up to 40 percent of GDP



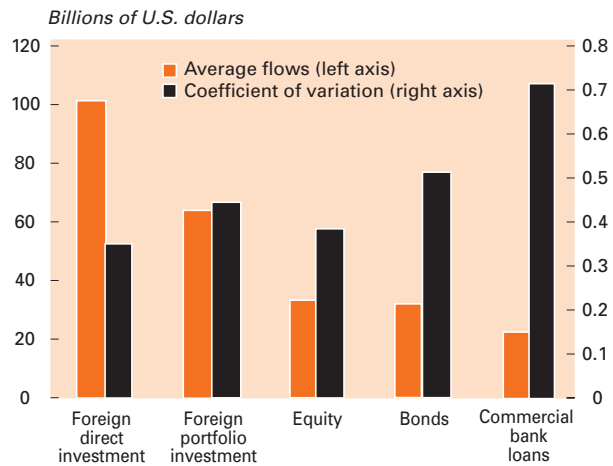
Note: Resolution costs include the government's direct costs as well as quasi-fiscal costs such as exchange rate subsidies, as defined by the IMF.

Source: Caprio and Klingebiel 1999.

nology, market access, and organizational skills.<sup>29</sup> Studies of recent episodes of financial turmoil have focused on the volatility of certain private financial flows and the ways in which it helps create an unstable environment and hurts economic development. An analysis of the period 1992-97 shows that foreign direct investment was less volatile (as measured by the coefficient of variation) than commercial bank loans and foreign portfolio flows (figure 1.5).

In 1997 developing countries accounted for 30 percent of the foreign direct investment stock, or \$1.04 trillion, 90 percent of which originated in industrial countries (table 1.1). Five countries—Argentina, Brazil, China, Mexico, and Poland—received half the total for developing countries.<sup>30</sup> Multinational corporations account for much of this investment. Their investment stimulates export-led growth in well-positioned economies through spillovers arising from the sourcing of their products, and distribution of their production facilities.<sup>31</sup> Philips Electronics, for instance, employs more workers in China than in the Netherlands. Alliances between multinationals continue to fuse markets as corporations take advantage of scale and scope economies and cope with the rising cost of technological innovation.<sup>32</sup> Chapter 3

**Figure 1.5**  
Foreign direct investment was less volatile than commercial bank loans and total portfolio flows, 1992-97



Source: UNCTAD, *World Investment Report*, 1998.

details how developing countries can reform their institutions and policies to attract more foreign direct investment.

The East Asian crisis also raised the issue of whether coordinated macroeconomic and regulatory actions could have averted or mitigated the crisis and lessened the contagion effects. A number of institutional possibilities are explored in chapter 3. Closer policy coordination among the principal economies in the Asia-Pacific region might have kept the exchange rate and associated interest rate fluctuations within reasonable bounds, leading to earlier concerted action to contain the crisis.<sup>33</sup> Coordination and some degree of uniformity could also have extended to financial regulation. Regional and possibly international bodies could have reviewed national banking practices to determine their compliance with the basic prudential rules for banks established by the Basle Accords. (In principle, countries can adopt unilateral or regional standards higher than those in the Basle Accords, including the changes in the accords proposed in 1999.)<sup>34</sup>

### International migration

Along with goods, services, and investment, people are crossing borders in record numbers. Each year between 2 million and 3 million people emigrate, with

**Table 1.1**  
**World foreign direct investment stock, 1997**

Region	Amount (billions of U.S. dollars)	Percentage of total
<b>World</b>	<b>3,455.5</b>	<b>100.0</b>
Industrial countries	2,349.4	68.0
Western Europe	1,276.5	36.9
North America	857.9	24.8
Other industrial countries	215.1	6.2
Developing countries	1,043.7	30.2
Argentina, Brazil, and Mexico	249.2	7.2
Other Latin America	126.2	3.7
China (includes Hong Kong)	244.2	7.1
Southeast Asia <sup>a</sup>	253.1	7.3
Other Asia	96.3	2.8
Africa	65.2	1.9
Other developing countries	9.4	0.3

a. Indonesia, the Republic of Korea, Malaysia, Philippines, Singapore, Taiwan (China), and Thailand.  
Source: UNCTAD, *World Investment Report*, 1998.

the majority of them going to just four host countries: the United States, Germany, Canada, and Australia, in that order.<sup>35</sup> At the beginning of the 21st century, more than 130 million people live outside the countries of their birth, and that number has been rising by about 2 percent a year. In relative terms the number of migrants is a modest 2.3 percent of world population. But they are concentrated in just a few regions—North America, Western Europe, Oceania, and the Middle East.<sup>36</sup> In North America and Western Europe the migrant stock grew at 2.5 percent a year between 1965 and 1990, far outstripping growth among indigenous populations. If Oceania is included in this group, 1 in every 13 people living in these regions is foreign born.<sup>37</sup> While the net benefits are positive for the receiving countries and for many of the originating countries as well, the resulting ethnic and labor market tensions in urban areas have led to tighter immigration restrictions in some countries.

Conflict and natural disasters have dramatically increased the number of refugees. By 1975 a total of 2.5 million refugees had crossed national borders, but by 1995 the total had risen to 23 million.<sup>38</sup> To that figure must be added the more than 20 million internally displaced persons who have migrated within their own countries.<sup>39</sup> The effects of such displacement are

not temporary, and they extend beyond those who moved. For example, the substantial displacement of people from southwestern Afghanistan caused considerable damage to the pattern of cultivation practiced there.<sup>40</sup> So many people left the area that the population fell below the levels needed to maintain the country's basic agricultural infrastructure.

Cross-border migration, combined with the "brain drain" from developing to industrial countries, will be one of the major forces shaping the landscape of the 21st century, for at least three reasons. First, migration is causing dramatic shifts in the demographic profiles of both industrial and developing countries. Second, the movement of highly skilled people from the developing world affects low-income countries and recipient countries alike. Third, the international diasporas have tremendous business potential.

In the next few decades many countries will see profound changes in their population growth rates and demographic profiles. Indigenous populations are declining in most industrial and East European countries, where fertility rates are low. But population growth rates remain high in Asia and Sub-Saharan Africa, although they have begun to slow. Shortages of agricultural land and urban unemployment are two important concerns, and through migration they could lead to problems for other economies. In Africa, parts of the Middle East, and South Asia, intense competition for jobs could create an additional incentive to emigrate. Shrinking and aging populations in Europe, Japan, and the United States might also boost the demand for migrant workers, as it did in Western Europe between the mid-1950s and the mid-1970s.<sup>41</sup>

In a positive scenario, policy reforms in developing countries, greater financial and trade integration, short-term migration generated by the liberalization of construction services, and increased possibilities for emigrating to industrial countries could enable low-income countries to cope with population pressures during the demographic transition. Foreign investment and trade also have a role to play in developing countries, where they accelerate growth, expand employment opportunities, and thus reduce incentives to emigrate.<sup>42</sup> This optimism must be tempered, however, by the fact that new, low-skilled migrants face serious hurdles as they enter labor markets in industrial countries.<sup>43</sup>

In other, less attractive scenarios, globalization slows, developing countries have less access to inter-



national capital and markets, and cross-border migration becomes more difficult because industrial countries are reluctant to liberalize trade in services that entail short-term cross-border labor movement and adopt policies to significantly reduce immigration. While a few low-income countries may respond decisively—reducing fertility and promoting growth by mobilizing domestic resources and fostering innovation—most are likely to experience ever-greater instability and slow income growth.

A second concern is the emigration of skilled workers from developing economies, especially from Africa and South Asia. A brain drain can impair a developing country's capacity to harness modern agricultural and industrial technology. Some countries in Sub-Saharan Africa, the Caribbean, Central America, and South Asia have, in fact, lost one-third of their skilled workers.<sup>44</sup> But recent research also points to the benefits of outward migration. The most important of these is the money migrants send to their countries of origin. These sums can be substantial: foreign workers remit about \$75 billion to their home countries each year, 50 percent more than total official development assistance.<sup>45</sup> Those remittances are used to support family members, or they may be invested (primarily in housing), thus stimulating other expenditures.<sup>46</sup>

Of all the potential overseas investors in a country, emigrants are likely to be the best informed about business and employment practices and legal norms. A country that adopts measures to enhance foreign direct investment and integrates with global production networks by maintaining low and predictable trade barriers will find that doing so generates additional benefits. If the quality and technological sophistication of a developing country's exports increases, highly skilled emigrants may decide to return. Several East Asian economies have benefited from this reflux.

However, experience suggests that returning emigrants do not always benefit a country. A study of reverse migration in Turkey notes that only half of the returned migrants were economically active in 1988.<sup>47</sup> Of those, 90 percent were self-employed, and many had used funds saved abroad to establish new businesses. The few returnees who did have educational qualifications found little demand for their skills in Turkey. National governments can take a number of measures to increase the benefits of re-

verse migration, however. Among the most important are encouraging emigrants to maintain their links with the home country and supplying information and advice both before and after their return.

The market for highly skilled workers will become even more globally integrated in the coming decades, and increasing returns to skilled people might continue to favor spatial concentration. Knowledge workers will cross borders freely, facilitating the circulation of technology, inducing the growth of technology-intensive industries (as in Israel), and helping to create a truly global marketplace of skills.<sup>48</sup> Because development requires a highly skilled workforce, primary and secondary education will continue to be important. Countries unable or unwilling to create such a workforce, compete for skilled workers, and build a technology-friendly environment will find themselves stuck on the lower rungs of the income ladder. In order to narrow the gap with rich countries, developing economies must also put in place policies to nurture, through tertiary-level training, and effectively employ skilled workers, as the Republic of Korea and Taiwan (China) have done. Without such policies, manufacturing and service activities with high value added will not take root in the countries where the need is most urgent.

A third facet of international migration in the 21st century will be the expansion of far-flung diasporas from developing countries—another source of global interconnection (box 1.2). Diasporas serve as informal channels for the flow of information, market intelligence, capital, and skills. They may supplement formal channels that rely on market institutions, providing a way for migrants to conduct transactions in an atmosphere of trust. In this way they act to offset information asymmetries and other market failures. Modern diasporas, like their Mediterranean predecessors, expedite business transactions by resolving monitoring problems, reducing opportunism, and building reputations and ethnic trust based on networking.<sup>49</sup> As migration continues, diasporas will expand, tying together regions and continents. Even if governments attempt to slow the process, communications, technology, and human relationships will maintain this trend.

Governments in South Asia, Central and South America, and Sub-Saharan Africa have made limited efforts to exploit the potential of overseas networks

**Box 1.2****The international Chinese network**

The Chinese diaspora embraces more than 50 million people, commands enormous resources, and is a force behind the development of the Asia-Pacific region.<sup>50</sup> This community, with its interlaced informal social and business ties and its formal overseas Chinese associations, is a source of dynamism for many East Asian economies. It has bridged market failures, created markets where there were none, and helped emerging economies become competitive in a remarkably short time. These successes are the result of collaboration with local communities and governments in the region. The cross-hatching of formal and informal business linkages will persist and perhaps eventually dwarf official linkages.

In addition to producing, assembling, and distributing goods through extensive manufacturing chains in the Asia-Pacific region, the Chinese diaspora has acquired widespread property holdings and citizenship rights. Citizenship rights are an elaborate mechanism for hedging against the risk of abrupt changes in economic conditions, political regimes, and regulations. That risk falls when developing economies in the region adopt rules-based regimes for trade, investment, and other policies, inducing members of the diaspora to shift their investment portfolios toward direct investment and away from risk-hedging devices.

Indeed, the diaspora's response to emergent rules-based regimes could be much faster and, at least initially, stronger

than the response from non-Chinese multinational corporations. Chinese investors have an edge over other investors, who do not have an intimate knowledge of the region's economic conditions and businesses. But an important caveat must be added here. Subnational governments must participate in building rules-based institutions in order to encourage continued investment. Only if every important level of government enhances the predictability of its laws and regulations will the countries of the Asia-Pacific region realize the many benefits the Chinese diaspora offers.

In the meantime, ethnic Chinese have been making substantial investments in Europe and the United States, particularly in the computer industry. In 1997 Taiwanese (Chinese) firms invested in 55 manufacturing projects throughout Europe, 44 of them in the computer industry.<sup>51</sup> The desire to be close to product and process development has also fueled an increase in the number of ethnic Chinese firms in California's Silicon Valley. At the same time, other migrant communities are increasing their business and commercial orientation. The South Asian diaspora, with a network reaching from Southeast Asia to the Middle East, the United Kingdom, and North America, has a net worth of between \$150 billion and 300 billion. Its potential remains to be tapped in the early 21st century. And throughout the Americas, Hispanics are developing networks that profoundly affect industrial development and trade.

to further development. The push to form partnerships may come from local governments, as in China, with the central authorities working to create an environment conducive to such interaction. The main hurdles in this process relate to openness and regulation. As long as economies remain inwardly oriented, predisposed to regulating business activities, and prone to arbitrary actions, diasporas may not be able to evolve into business networks that strengthen markets and prod development. In the next few decades, however, countries with large and growing emigrant communities scattered throughout the world will have the opportunity to tap into the development potential of their diasporas.

**Global environmental challenges**

Environmental concerns have long been the subject of international interest, in part because of the burgeoning world population. But at the end of the 20th century, global concerns have acquired a new urgency. Over the past 20 years the content and quality of the discourse on the environment have been completely transformed. By its sheer volume, the authoritative

scientific evidence available on environmental problems commands the attention of governments and the public alike. Moreover, along with globalization has come a new recognition of a shared responsibility for the environment. Numerous organizations—international, governmental, and nongovernmental—with a deep interest in this issue have appeared on the scene. These bodies have made full use of the United Nations system and the abilities of new communications technology to reach people all over the world.<sup>52</sup>

Climate change, the loss of biodiversity, and other issues related to the global commons are slowly being recognized as problems that the community of nations must take on collectively. Left unattended, they will worsen as the planet becomes more crowded and overpopulation puts increasing pressure on natural resources. Many of these issues are closely linked to the potential success of development efforts in poor countries, and the growing awareness of these linkages is part of the continuing shift in the development perspective. Only 10 years ago the development community often brushed environmental concerns aside, emphasizing instead the primacy of growth, stability,

and poverty reduction. Central to the discussion of environmental sustainability at the start of the 21st century is the problem of how to devise mechanisms that distribute the burdens of reform equally without discouraging the participation of every country that has the capacity to cause environmental damage. This challenge is particularly pressing because developing economies must sometimes balance environmental concerns with their people's desire to advance economically. Chapter 4 examines the preconditions for international agreements that support environmental sustainability. Two areas in particular require concerted international effort: climate change and biodiversity loss.

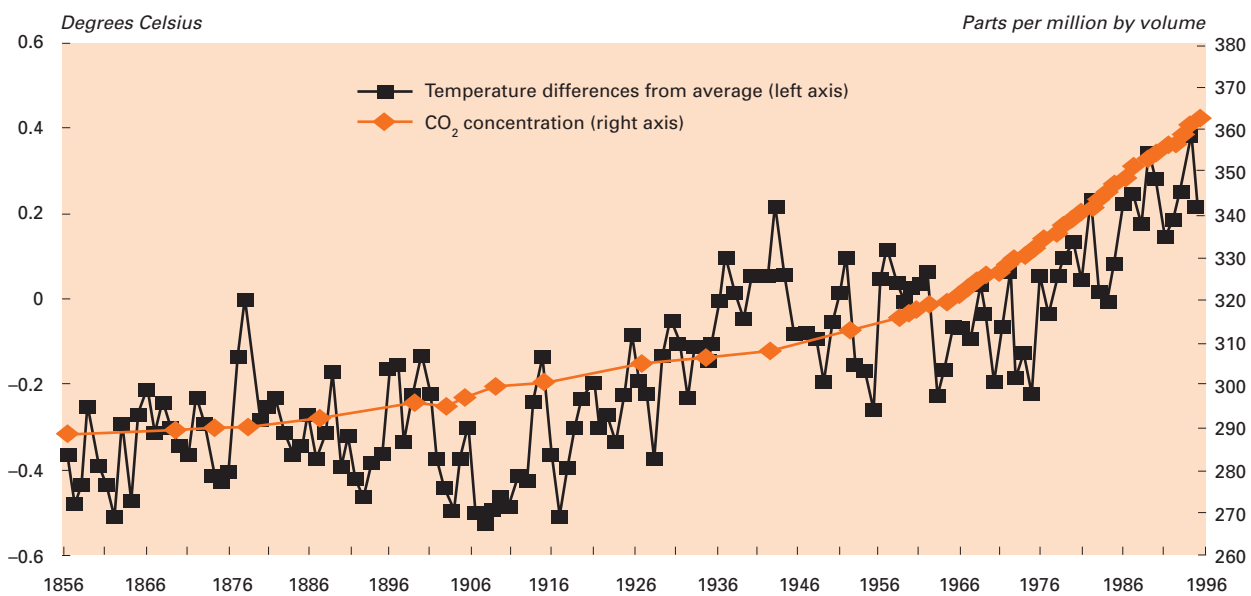
### Climate change

Climate change is occurring at unprecedented rates because huge quantities of carbon dioxide, methane, and other greenhouse gases are being released into the atmosphere daily (figure 1.6). Global temperatures have been rising slowly since 1800. The 20th century has been the warmest century in the past 600 years, and 14 of the warmest years since the 1860s occurred in the 1980s and 1990s. Temperatures in 1998 were higher than the mean temperatures for

the 118 years on record, even after the effects of El Niño are filtered out.<sup>53</sup> Satellite readings now confirm a similar elevation of temperatures in the upper atmosphere.<sup>54</sup> Moreover, wintertime temperatures of seawater north of 45° latitude have risen by 0.5° Celsius since the 1980s. As a result, the incidence of sea ice in the Grand Banks shipping lanes has declined, and in 1999, for the first time since the sinking of the *Titanic* in 1912, the International Ice Patrol did not report a single iceberg south of 48° latitude.<sup>55</sup> The concentration of carbon dioxide in the atmosphere has risen from 280 particles per million (ppm) in 1760 to 360 in 1990 and is expected to reach 600 ppm in 2100. Average temperatures could then rise by some 2° Celsius.<sup>56</sup> The source of the increase in carbon dioxide thus far, like the entire increase in atmospheric chlorofluorocarbons responsible for depleting the ozone layer, is anthropogenic.<sup>57</sup>

These facts are now widely accepted. Other information is less well understood: how severe fluctuations in weather will be in a warming world, how the effects of climate change on agriculture and living conditions will be distributed globally, the rapidity of the change, and how people displaced by rising sea levels in countries such as Bangladesh will be accommodated else-

**Figure 1.6**  
Temperatures are rising as concentrations of greenhouse gases increase



Source: Carbon Dioxide Information Analysis Center (CDIAC).

where.<sup>58</sup> These unknowns make precise measurement of the economic impact of climate change very difficult. Nonetheless the impact will be huge, and it will be felt primarily in developing countries.<sup>59</sup>

An international agreement to contain climate change faces many hurdles. There is uncertainty about the scale of possible benefits and the scope for adaptation. There is resistance to incurring the costs involved in bringing about a drastic flattening of long-run trends. And there is concern about the difficulty of monitoring compliance with emissions rules and enforcing adherence through credible sanctions. Distributional considerations also play a part. Industrial countries account for 60 percent of all energy-related carbon dioxide emissions, with the United States alone responsible for 25 percent in 1998. But in the absence of corrective policies, developing countries will be emitting a higher proportion of all greenhouse gases within 20 years, with China pulling ahead of the United States by 2015.<sup>60</sup> Until the early 1990s little progress was made in moving toward an agreement that embraced the concerns of both developing and industrial countries. In particular, developing countries argued that because greenhouse gases were the result of industrialization in wealthy countries, those countries must take responsibility for the ensuing problems. Developing countries also faced an uphill battle to build the regulatory capacity to control the release of gases and other pollutants.<sup>61</sup> This impasse has extended to other environmental issues, such as efforts to slow the loss of biodiversity. But some progress is being made on the international front to cope with climate change, with increased awareness of the long lags in arresting trends that are already apparent, such as the accumulation of greenhouse gases, and a greater sensitivity to the risks they pose.

There have been two international agreements to reduce emissions of greenhouse gases, in Rio in 1992 and in Kyoto in 1997. In the first, industrial countries undertook voluntary commitments to reduce their level of emissions in 2000 to the level in 1990. The 1997 agreement set more ambitious goals, and more binding commitments (though it too lacked effective enforcement measures). Developing countries have resisted entering into binding commitments, and without their agreement several industrial countries, such as the United States, are reluctant to impose binding commitments upon themselves. Moreover, without adequate global enforcement (including

monitoring) countries with stronger legal structures would wind up bearing inequitable burdens once treaties were ratified.

The Rio Convention defined emissions levels for countries relative to their past history; thus, countries that polluted more were allowed to continue to pollute more. For developing countries, this seemed unjust: why allow industrial countries to emit higher levels of emissions per capita (albeit lower levels of emissions per unit GDP) simply because they had done so historically?

While these equity issues were not effectively addressed at Kyoto, the Kyoto convention made an important step forward in trying to ensure efficiency in reducing emissions, through the Clean Development Mechanism. That scheme would allow industrial countries to help developing countries lower their emissions, while granting the industrial countries some "credit" for these lower emissions. Chapter 4 explores such issues and the possible course of institution-building.

### *Protecting biodiversity*

The evidence on biodiversity loss is growing. The United Nations Environment Programme (UNEP) estimates that about 22 million species exist at the end of the 20th century. About 1.5 million have been described. Some 7 million species, or more than four times the number described, risk extinction in the next 30 years. Among higher animals, three-fourths of the world's bird species are declining, and some observers claim that nearly one-fourth of the world's mammal species are threatened with extinction.<sup>62</sup> In agriculture, crop plant varieties disappear every year, but few of these crops are represented in world collections of genetic material. Wild varieties are even more poorly represented. Only 12 of the 38 base collections of rice listed in the International Board for Plant Genetic Resources (IBPGR) directory of genetic material include wild species, and only 5 collections have long-term storage facilities.<sup>63</sup>

The major causes of biodiversity loss are modern farming techniques, deforestation, and the destruction of wetland and ocean habitats, all of which are closely linked to development activities. Of all the world's countries, developing countries are richest in biodiversity, in part because many are in tropical climates. The pressure on these countries to protect biodiversity is severe. Just one-fifth of the earth's original

forests remains in large, relatively natural ecosystems, or frontier forests. Seventy-six countries have lost all of their frontier forest, and 70 percent of what is left is found in just three countries—Brazil, Canada, and Russia. Ninety percent of the remaining crop species are in Africa, Asia, and Latin America.<sup>64</sup> Despite these worrying trends, however, international agreement on preserving biodiversity is only beginning. Nonetheless, the Convention on Biological Diversity and the Global Environment Facility are important first steps in the process of preserving biodiversity.

### New political tendencies in developing countries

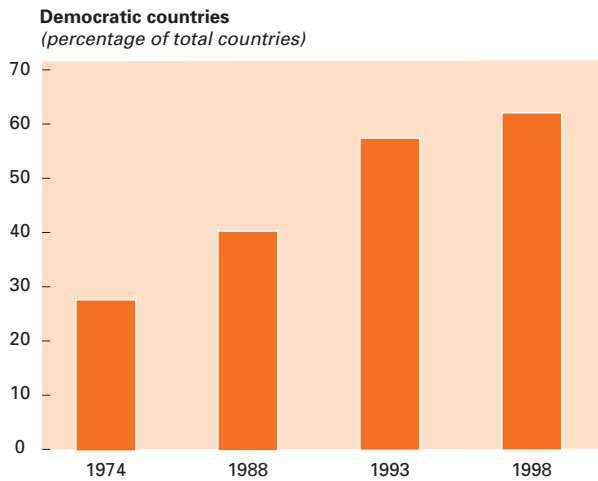
Along with the wave of globalization in trade, finance, and environmental issues, another worldwide force is reshaping development efforts everywhere—localization. Localization is the push to expand popular participation in politics and to increase local autonomy in decisionmaking. The impetus toward local autonomy stems in part from another global trend—urbanization.

What are the main elements of the new local landscape? One is the replacement of authoritarian or single-party rule by plural politics and the increase in citizen participation through community groups and NGOs. Another is a growing demand for substantial power and autonomy on the part of subnational units. Central governments have responded to this demand by devolving power and responsibility to local levels.

Plural politics and broad-based popular participation are rapidly becoming features of modern governance. The proportion of countries with some form of democratic government rose from 28 percent in 1974 to 61 percent in 1998. (figure 1.7). A majority of governments have made legally binding commitments to respect the civil and political rights of their citizens. Thus far, 140 countries have ratified the International Covenant on Civil and Political Rights, and 42 have signed the optional protocol of the covenant, recognizing the authority of the United Nations Human Rights Committee to consider claims from those alleging violations of their rights.

As people's participation in society grows, so does the number of organizations that give it voice. NGOs and civic movements are on the rise, assuming an ever-larger role in articulating people's aspirations and pressuring governments to respond. This swelling of participation promises to be of even greater

**Figure 1.7**  
More countries are becoming democratic



Source: Diamond 1996; Freedom House, *Freedom in the World*, 1998.

significance than elections. It will affect the process of institution-building and the types of policies that are likely to be effective. With power decentralized and the central government less able to impose its own solutions, the demand for socially oriented policies will grow.

What will the push for increased citizen participation and plural politics mean for development? Four changes are likely. First, vigorous political activity involving many organized groups rooted in assertive societies will substantially reduce the scope for autonomous government action. The central government will have to engage and negotiate with society, field claims and pressures from diverse quarters, and seek legitimacy by winning public approval for its performance. There will be less room for close business dealings, more calls for accountability, and a continuing move away from the authoritarianism practiced in various parts of the world between the 1960s and the 1980s.

However, this change has far-reaching implications. Taking swift policy action to adjust to shocks may become increasingly difficult. Efforts to promote strategic sectors that also benefit special interests will come under close scrutiny—and not only from the electorate. The business community, labor unions, and others may serve as checks on the central government's authority. The Korean government

learned of the power of these groups when it tried to push through a new labor code in 1997 and attempted to restructure large industrial conglomerates in 1998–99.

Recent events underscore the significance of the new political landscape and the difficulties international financial organizations face in negotiating agreements that can have adverse consequences for segments of a country's population, at least in the short term. The Russian and Brazilian parliaments refused to go along with international pledges made by their presidents during the East Asian crisis. Their reaction prompted U.S. Treasury Secretary Robert Rubin to remark that when it comes to saving countries from economic implosion, "the ultimate key is not economics or finance, but politics." Governments must learn to muster support for strong policies, especially when those policies require sacrifices by present generations for the generations yet to come.<sup>65</sup>

Second, political openness will highlight the disclosure of information and the emergence of the private monitoring, regulatory, and information-processing entities that are vital to a dynamic economy. These entities may include private mechanisms for enforcing public laws like those suggested for the countries of the former Soviet Union.<sup>66</sup> Authoritarian regimes tend to become predatory and, except in rare cases, have not succeeded in creating efficient, technocratic bureaucracies or in single-mindedly pursuing development. These failures are partly attributable to the temptations offered by patronage, political interference in the operations of public agencies, and the politicizing of bureaucrats at all levels. Plural politics and civic participation can reverse those forces, preventing the worst excesses of authoritarian systems. But good intentions are no guarantee of rapid progress, as India's situation illustrates.<sup>67</sup> Whether opportunities exist for institutional reforms that will encourage these reversals remains to be seen.

Third, participatory politics, by giving more voice to people, will hasten decentralization in some countries. This trend is most likely to be felt in large countries and those with marked ethnic divisions and deeply rooted local identities. Strong urban regions could accelerate the redistribution of central authority to subnational entities, requiring the central government to pursue major, long-term development

goals by consensus. And more responsibility for development may devolve to subnational governments.

Fourth, participatory politics and limited international labor mobility could increase calls for policies that address social dislocation.<sup>68</sup> Until regional and global governments begin coordinating policies to reduce the risks posed by shocks with potentially long-term consequences, national governments will be responsible for buffering their populations against extreme economic hardship. This situation will create a number of dilemmas. In order to finance safety nets, governments will have to adjust the composition of public spending, possibly dampening growth in the short term. Attempts to mobilize additional resources could meet with resistance from taxpayers who mistrust the government's ability to deliver services and are accustomed to a culture of tax avoidance.<sup>69</sup> Chapters 5 and 6 review the preliminary evidence on mobilizing financial and fiscal resources at the local level.

What about the differences among countries? Economic and social instability of the kind that exists in Russia and Ukraine could dampen the desire for change. In Sub-Saharan Africa the small size of the middle class, ethnic friction, and the region's recent history of clientelistic politics hinder the spread of pluralism and the pursuit of development objectives. Demographic pressure is testing African and Middle Eastern countries. In the next 20 years these countries will have to cope with large numbers of young people seeking jobs. Ethiopia's population, for example, is likely to double to 120 million by 2030, and already, more than half the people in Iran are under the age of 25. To sustain economic growth, political and social institutions will need to adapt rapidly to these changes. While the trend toward participatory politics is strong in the 1990s, the institutional reforms vital to future stability may not be keeping pace.

### Emerging subnational dynamics

As the 20th century draws to a close, people in subnational units such as provinces and states are demanding the right to self-determination and self-government. Such demands are part of the process known as localization. They may originate in dissatisfaction with a central government, reluctance to subsidize other parts of a country, or conflict between ethnic groups. Whatever its cause, localization generally results in the redistribution of power within a

country. It can, under certain circumstances (as in southeastern Europe and Central Asia), lead to the creation of new states.<sup>70</sup> The number of countries has more than doubled in the last three decades, rising from 96 in 1960 to 192 in 1998. And the number of countries with fewer than 1 million people has almost tripled, growing from 15 to 43. When accommodated in a democratic setting, localization involves a shift in the locus of decisionmaking, the structure and quality of governance, and modes of policy implementation. For this reason it is expected to have a significant effect on the future of development.

### *Localization and decentralization*

Governments have responded to demands for increased self-government by sharing power with and devolving authority to lower tiers of government. The action has been grudging at times, more forthcoming at others (especially when financially strapped central governments want to shed expenditure responsibilities). But the trend is clearly continuing, and the numbers speak for themselves. In 1980 national elections had taken place in 12 of the world's 48 largest countries, and local elections had been held in 10 of them. By 1998, 34 of these countries had held elections at both the national and local levels. Half the countries that decentralized politically also decentralized major functional responsibilities (table 1.2).<sup>71</sup> Poland has devolved responsibility for primary and secondary education, for example, while the Philippines has decentralized primary health care and local road maintenance. Decentralization often translates into substantial increases in the subnational share of public expenditure. In Mexico this share increased from 11 percent in 1987 to 30 percent in 1996, and in South Africa from 21 to 50 percent.<sup>72</sup>

Decentralization is not limited to large, wealthy countries. In the Middle East and North Africa, Jordan, Lebanon, Morocco, and Tunisia all have elected local governments. In Europe and Central Asia, the constitutions of Albania, Bosnia, Bulgaria, Croatia, Georgia, Hungary, Kazakhstan, Russia, Tajikistan, and Ukraine address the rights and responsibilities of subnational governments, although this does not automatically guarantee autonomy. The Baltics and the Kyrgyz Republic have also taken significant steps to strengthen local governments.<sup>73</sup> In Africa, 25 of the 38 countries that held national elections in the 1990s also had local elections—and that includes a

**Table 1.2**  
**Political and functional decentralization in large democracies, 1997**

Decentralizing politically only	Decentralizing politically and functionally
Bangladesh	Argentina
Iran, Islamic Rep.	Brazil
Kenya	Colombia
Korea, Rep. of	Ethiopia
Morocco	Mexico
Nepal	Philippines
Nigeria	Poland
Pakistan <sup>a</sup>	Russian Federation
Romania	South Africa
Thailand	Uganda
	Ukraine
	Venezuela

Note: Sample includes all countries that had populations of 20 million or more in 1997 and that introduced competitive multiparty elections at the subnational level between 1980 and 1995.

a. Local elections have not been held regularly in Pakistan, so local governments have mostly been run by administrators.

Source: Freedom House, *Freedom in the World*, 1996; U.S. Central Intelligence Agency, *The World Factbook*, 1998; country-specific sources.

number of very small countries such as Cape Verde, Mauritius, and Swaziland. In Latin America, every country has elected mayors. Excluding Argentina, Brazil, Colombia, and Mexico (all large federations), local governments account for 20 percent of government expenditures in the countries for which data are available.<sup>74</sup>

The end of the Cold War has been a key factor in the recent wave of decentralization. In the former Soviet Union, dissolution of the party monopoly on national political power has led subnational governments to step up demands for increased local authority. In Eastern Europe the collapse of communism removed the external military support that had been propping up unpopular governments. Local governments rebounded—both in reaction to former regimes' policy of forced centralization and as a bulwark against the return of authoritarianism. The declining threat of a major international conflict, combined with increased openness to trade, has made the advantages of being part of a large federation less attractive to smaller economies.<sup>75</sup>

The end of the Cold War has had effects that are less direct but no less important in other regions. In Latin America the declining threat of leftist violence (the initial grounds for military takeovers) has

contributed to the demise of authoritarian regimes throughout most of the region. (In Peru, where the threat of leftist violence did not decline, most spending decisions continue to be made by the presidency.) In Africa and parts of East Asia (Korea and the Philippines), both the United States and Russia have ended their support for authoritarian governments. In a number of African countries, reduced external support combined with domestic economic collapse have undermined authoritarian governments' ability to use public spending to maintain the support of key interest groups. Ruling elites have been forced to concede some power, though often they have relinquished just enough to permit them to retain their hold.<sup>76</sup>

The pace of decentralization and the kinds of reforms that have been implemented vary from country to country. India, a multiparty democracy at the federal and state levels, has relatively weak local governments (see box 5.4). China is still officially a centralized state with a dominant party, though provincial governors and mayors have had considerably more autonomy and managerial authority since the reforms initiated in 1978 (see box 5.5). In a number of countries decentralization has not resulted in the center relinquishing much control.<sup>77</sup> Ghana, Malawi, and Zambia have each created local councils, but the central government continues to direct almost all spending and management decisions. Similarly the ruling national party in Tanzania holds almost all subnational offices. Pakistan convenes local elections, but so infrequently that the country has only rarely had sitting, elected local governments.<sup>78</sup>

### *Institutional challenges*

Localization raises complex institutional and policy issues that governments will have to resolve in coming decades. The expanded power of subnational governments has implications not only for growth and macroeconomic stability but also for governance, coordination, and regulation. It will affect (and be affected by) the availability of international financing, the delivery of public services, the management of social safety nets, and the reduced ability to redistribute that could result in increasing inequality. Rules must be designed that apportion responsibility, manage relations among tiers of government, and strike an acceptable trade-off between central and local authority. The types of rules discussed in chapter 5 are intended to help keep governments ac-

countable and efficient—and to lessen the risk that excessive borrowing and fiscal deficits at the subnational level will cause economic instability.<sup>79</sup>

Development will succeed in localized economies only if subnational units provide sound, effective governance. Good local governance gives people a voice and incorporates rules that ensure the accountability of public employees. By providing citizens with the opportunity to express their views, encouraging them to monitor the workings of local government, and calling on them to participate, an effective system of governance creates a willingness to obey laws and pay taxes.<sup>80</sup> Over time, sound governance builds trust and social capital. Whether in Tanzania or northern Italy, well-governed communities are rich in social capital and adequately furnished with revenues.

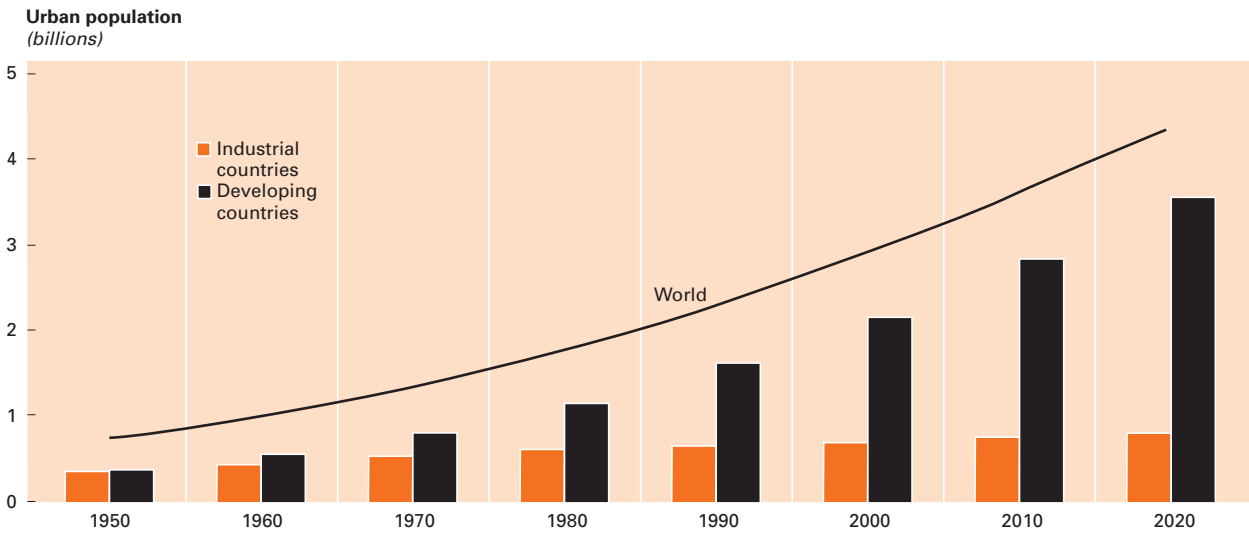
In many cases local governments need to develop the skills and resources to provide high-quality services that meet constituents' demands.<sup>81</sup> These services (along with adequate fiscal and financial resources) are what allow cities to perform well economically and to offer their residents a good standard of living. In most cases the private sector will need to be involved in providing services, especially in countries with weak access to international capital resources.<sup>82</sup> But encouraging the private sector to participate requires governments to have in place regulatory structures that minimize transactions costs and barriers to entry but also ensure that private providers deliver with respect to quality, cost, and volume. The good news is that increasing administrative and regulatory capacity and improving governance will allow subnational units to reap the benefits of market-led growth.

### **Urban imperatives**

At the beginning of the 21st century, half the world's population will be living in areas classified as urban. As recently as 1975 this share was just over a third, but by 2025 it will rise to almost two-thirds. The most rapid changes in urban demographics will occur in developing countries (figure 1.8). While the rate of urbanization has passed its peak in relatively high-income countries in Latin America, Eastern Europe, and the Middle East, the transition is just beginning in Asia and Africa (figure 1.9). Urban populations are expected to increase by almost 1.5 billion people in the next 20 years (figure 1.10). The speed of urbanization and the enormous numbers



**Figure 1.8**  
**Most urban dwellers reside in developing countries**



Source: UNDIESA, *World Urbanization Prospects*, 1998.

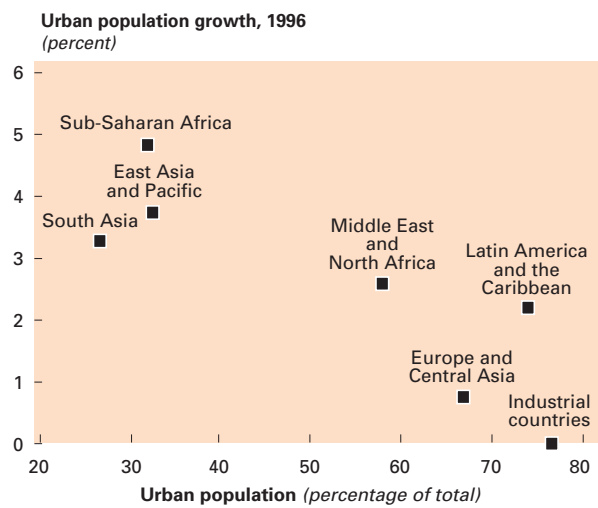
involved make it one of the major development challenges of the 21st century.

Despite the challenges it presents, urbanization should be a positive trend. In industrial countries economic growth and structural transformation accompanied urbanization. As agricultural sectors modernized, mechanized, and became more efficient, the number of agricultural jobs declined. Workers went looking for jobs in nonagricultural industries, which are generally located in areas with much higher population densities than farming communities—that is, in cities. Wealthy societies in the late 20th century are four-fifths urban and derive less than 3 percent of their GDP from agriculture, while in low-income countries agriculture still accounts for 30 percent or more of GDP.

Can this pattern repeat itself in developing countries, given that urbanization and economic growth in industrial countries took place over a fairly long period and involved much smaller numbers of people? These economies were pioneers, their growth unconstrained by external standards and codes pertaining to labor, human rights, or the environment. The conditions in which developing countries are attempting the transition to urban societies are now dramatically different and, with continuing advances in communications technology, will continue to alter.

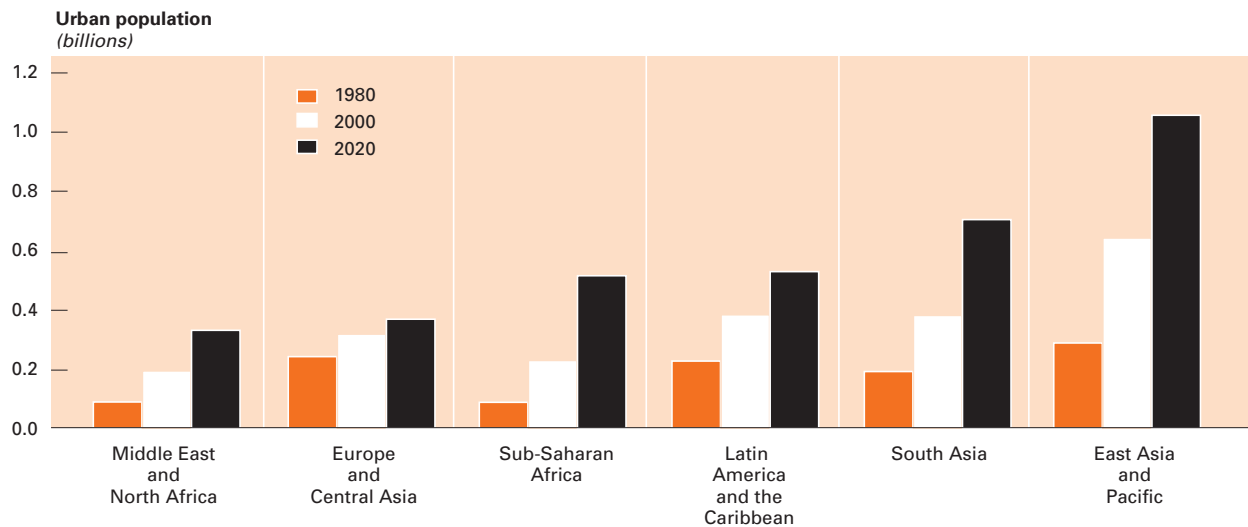
The East Asian experience with sustained economic growth and successful rural development suggests that the pattern can be repeated. Korea took just 40 years to transform itself from a society that was 80 percent rural to one that is 80 percent urban.

**Figure 1.9**  
**Asia and Africa are just beginning the urban transition**



Source: World Bank, *World Development Indicators*, 1998.

**Figure 1.10**  
**The largest increase in urban populations during 1980–2020 will occur in Africa and Asia**



Source: UNDIESA, *World Urbanization Prospects*, 1996.

As it did, the share of agriculture in GDP fell from a high of 37 percent in 1965 to 6 percent in 1996. But elsewhere, the link between urbanization and growth has been less obvious. Famines, civil wars, ethnic conflicts, stagnant agriculture, the absence of rural development, or merely the removal of constraints on mobility can push people to urban areas, which may lack the resources to absorb them productively. Regions such as Sub-Saharan Africa and South Asia, where per capita GDP growth has been slow or flat, have had the most difficulty in absorbing urban newcomers. The relationship between economic growth and urbanization is covered in detail in chapter 6.

Urban centers are expected to offer better access than rural areas to such essentials as water and sewerage and to health care and educational services. The quality of urban living conditions has traditionally been reflected in reduced morbidity and infant mortality rates and increased life expectancies. But since the mid-1980s the advantages urban areas (especially big cities) have enjoyed have been declining. In Sub-Saharan Africa mortality rates are nearly the same in rural areas and small cities—90 per 1,000—and rates in large Latin American cities have risen to those of smaller urban areas.<sup>83</sup>

Access to shelter in urban areas is, if anything, worsening. About 100 million people—including large numbers of children—have no permanent home and simply make use of whatever urban spaces they

can find. More than 700,000 people sleep on Mumbai's pavements.<sup>84</sup> The growth of *favelas* in Rio de Janeiro and São Paulo is typical of what is happening in other large cities in the developing world.<sup>85</sup> Increasing violence is linked to the growing inequality evident in urban areas, most notably in Latin America, but also in South Asia.<sup>86</sup> Immigration may exacerbate this trend.<sup>87</sup> The well off live in fortified enclaves, abandoning entire neighborhoods to the poor—an increasingly common characteristic of cities where the decline in public services and life chances has created an increasingly differentiated urban environment.<sup>88</sup>

In many respects these patterns are a replay of the decline in urban living conditions that occurred in Western Europe during the rapid industrialization of the first half of the 19th century.<sup>89</sup> The second half of the century witnessed a remarkable turnaround. Can historically similar reform strategies help reverse the trends in developing countries, or will urban decay become a permanent feature of municipal areas?

The development community has long been aware of the challenges rapid urbanization poses.<sup>90</sup> But decentralization, globalization, and industrialization will heap new challenges on the old.<sup>91</sup> Some of the most important issues for the 21st century are subnational borrowing for public infrastructure, the coordination of interregional infrastructure, and the location of lumpy investments. Competition for global

capital is another issue local authorities will have to contend with, learning, as they do, that probusiness policies must not take precedence over social welfare. National policies that inhibit the mobility of capital and labor are another significant issue. Governments will need to consider revising those policies in order to promote efficient industrialization that allows firms in mature industries to relocate from large to small cities.

During the three decades of development between 1960 and 1990, the concentration of economic activities in urban areas coincided with the rise of per capita GDP. But this trend was merely noted and did not leave a mark on policies or institutional design.<sup>92</sup> Now that globalization and decentralization are reshaping geographic as well as economic landscapes, the relationship between growth and urbanization can no longer be ignored.

Rapid urbanization also has social and political implications. The institutions, social capital, and politics that served a stable, dispersed rural population do not transfer well to cities. Much social capital is lost and needs to be replaced, reconstituted, and augmented. The moral economy of a hierarchical rural society, which provided a measure of insurance against risks, needs to be replaced by urban safety nets, both formal and informal.<sup>93</sup> Middle classes emerge and expand in cities and are subject to demonstration effects from industrial countries.<sup>94</sup> Second- and third-generation urban residents often begin to organize and voice their demands with more assertiveness. Governments need new political and social mechanisms in order to meet rising expectations.

### Implications for development policy

If governments do not establish the policies and institutions needed to manage urbanization and provide complementary infrastructure, urban areas could experience slow economic growth and social unrest, and valuable resources will be wasted. Mismanaged cities with inadequate resources and ineffective political processes are unattractive to new industries. They cannot raise the quality of life, and they do not build human capital or attract fresh talent. In addition, unless governments provide a level playing field, small and medium-size cities cannot compete effectively with their larger urban counterparts for manufacturing activity.

The absence of appropriate regulation in rapidly growing urban areas can create inefficient land-use

patterns that encourage reliance on private automobiles. Well-designed urban transportation systems not only affect land use but also improve growth prospects by better integrating the urban labor market.<sup>95</sup> Quality of life, which is often measured by the availability and efficiency of public services, is also a major issue.<sup>96</sup> Inadequate investment in sewers and sanitation systems can create serious health problems. Weak land market institutions that fail to clarify and strengthen tenure and ownership rights can hurt the quality of shelter. Karachi, Pakistan, and Lagos, Nigeria, which are experiencing a decline in the volume and quality of infrastructural and social services, are typical of cities where the public sector is on the verge of collapse. These problems require innovative solutions, including public-private partnerships, selective privatization of local functions, and community involvement in regulation.

Cities also face new industrial challenges. Expanded export opportunities and the emergence of “industry clusters” require careful planning to provide the necessary infrastructure and the skilled workforce modern high-technology industries require.<sup>97</sup> The poor quality of urban training facilities has hindered the growth of such industries in Latin America. But skills are only one part of the equation. Industrialization in Kerala, which has the most educated workforce in India, is inhibited by labor militancy, land tenure constraints, and power shortages.<sup>98</sup>

Institutional and regulatory reform in domestic financial markets must reflect not just national and global imperatives but urban infrastructure and housing investment requirements as well. Newly empowered state and local governments must find the means to finance these investments.<sup>99</sup> At the same time, they will need to develop new measures to cope with unemployment, poverty, and inequality. Avoiding urban poverty traps will require building industrial skills and creating a competitive urban economy. Skilled workers could move in search of employment, an important consideration because mobility is sometimes the only recourse for workers in towns where the industrial base is narrow and has been declining. Many urban areas in China, Eastern Europe, and the former Soviet Union, for example, are saddled with failing industries and rising unemployment.

Cities that want to compete for foreign direct investment need to meet world production standards. Being second best can also mean being saddled with high unemployment and increasing poverty.<sup>100</sup> The

ease of international sourcing in a competitive milieu with many specialized suppliers has changed labor markets. Because tasks can be combined flexibly, urban production centers worldwide are increasingly segmented between those that can meet the exacting standards of a global production system and those with too few skills to do so. This open production environment mercilessly weeds out those centers with below-par macroeconomic environments, services, and labor-market flexibility.

Urban dwellers also need formal safety nets. In rural villages kinship ties or patron-client relations often performed this function, but as people move to cities, their ties to their home villages weaken. Providing basic services and some income insurance will be a priority for governments in the 21st century. Local authorities and communities may be required to take the initiative in helping build safety nets. But success is predicated on organizational capacity, accountability, and trust. As with the Friendly Societies in Britain in the early 20th century, private and community provision can play a significant role, but only with adequate government support. Community efforts, abetted by responsive local governments, can supplement government resources in other areas as well.<sup>101</sup>

Developing countries enter the 21st century in a world that is being transformed by the forces of globalization and localization. It is a world subject to the

wide-ranging effects of demographic change and the movement of populations across countries and to urban areas. It is also a world that confronts an ongoing shift in the climate and loss of biodiversity. These forces are modifying the roles and obligations of national governments. However, developing countries need not and should not be passive respondents to these forces. The discussion in the chapters that follow, along with the specific case studies presented in chapter 8, suggest a number of strong institutional measures that can be taken to benefit from the opportunities offered by these trends, and to limit the risks. In this process, unilateral responses by national governments will not suffice. Instead, there must be a continuing interplay of commitments and responsibilities. Subnational governments will take on responsibilities but will be monitored by the central government. The central government will make commitments, which will be monitored by both the subnational governments and relevant international organizations. Market forces will play a central and vital role, both in providing the engine of economic growth and in responding to the incentives and constraints decided upon by different levels of government. Perhaps most important of all, the citizens of developing countries will partner with governments and nongovernmental organizations and work through open and participatory institutions to shape their own future.