

EXECUTIVE SUMMARY

The urban sector strategy (USS) was one of several Asian Development Bank (ADB) sector strategies formulated around the end of the 1990s, and was intended to bring more coherence to ADB's work in the urban sector. At the time, ADB had two urban development, water supply, and housing divisions: one for East Asia and one for West Asia. The USS took a wide view of the scope of the urban sector and included urban water supply and sanitation, housing, urban drainage and flood control, urban transport, urban environment, slum improvement, sites and services, (urban) institutional strengthening and capacity building, urban land management, urban governance, and urban finance. Poverty reduction components and microcredit were also endorsed as part of the urban sector, when included in urban development projects.

The USS summarized urban challenges and presented objectives, guidelines, and good practices. In response to rapid urbanization in Asia, the USS called for a systematic and incremental expansion of ADB's involvement in the urban sector—in terms of the volume of lending, the range of subsectors to be addressed, and the interrelationships of project components. The USS also called for greater attention to poverty reduction; more community participation in projects; more institutional strengthening and capacity development; more private sector involvement; more policy lending; and more lending for urban transport, housing, and land management projects. Consistent with ADB's approach to sector strategy development at the time, the USS did not assess the resources needed to implement the strategy. The USS highlighted the following operational objectives: (i) maximizing the economic efficiency of urban areas, (ii) reducing urban poverty, (iii) improving quality of life, and (iv) achieving more sustainable forms of urban development. However, these objectives were neither quantified nor set out in a manner that could be monitored to assess progress. The USS was approved by Management in July 1999 and sent for information to ADB's Board of Directors. The Board did not discuss or approve it nor was there significant formal consultation with developing member countries (DMCs) or other stakeholders in preparing it.

ADB's Regional and Sustainable Development Department (RSDD) planned to review and revise the USS by the end of 2005. This was viewed necessary as some important developments were not reflected, such as the adoption of poverty reduction as ADB's overarching objective, the emergence of the Millennium Development Goals, and ADB's joining of the Cities Alliance in 2002. The original USS was prepared before new guidelines on ADB policies and strategies had been formulated, so it was viewed as lacking the appropriate disciplined approach and procedural rigor. To provide the necessary analysis to revise the USS, it was agreed that the Operations Evaluation Department (OED) would look at the appropriateness and implementation of the existing strategy, while RSDD would identify and analyze emerging urban sector trends, directions, good practices, and related issues. Revision of the USS by RSDD is now expected to be completed in the fourth quarter of 2007.

Given that the USS has been in effect for only 6 years and most projects approved after it was adopted are still in various phases of implementation, this evaluation pays limited attention to the on the ground impact of urban projects. Rather, the study analyzes ratings of completed projects and technical assistance (TA) grants, analyzes whether the USS's targets are being addressed, and assesses ongoing urban operations. Additional questions addressed in the evaluation are (i) why is ADB's urban sector program not much larger than it is today, given the rapid urbanization in the Asia Pacific region; (ii) what is the value added of ADB involvement in urban sector projects against the transaction costs, as perceived by ADB clients; and (iii) is a USS needed and under what conditions would it be most effective? The

assessment of the changes in urban sector operations was based on a comparison of projects approved in the 6 years before (mid-1993 to mid-1999) and after (mid-1999 to mid-2005) the USS was adopted. The special evaluation study (SES) analyzed ADB databases, documents of all 88 projects and 191 TA grants approved since mid-1993, and all available country urban sector strategies. The SES also conducted a questionnaire survey of all 52 ongoing urban sector projects (with an 85% response rate) and undertook case studies for People's Republic of China (PRC), India and Philippines.

Urbanization is a mega-trend in Asia. ADB's Long-Term Strategic Framework (2001–2015) marked it as one of its main challenges. The region is in the midst of a transformation from a rural, agriculture dominated region to an urban, industrial/service sector dominated region. Asia has the fastest growing urban population in the world. Asia's share of global urban population has risen from 9% in 1920 to over 48% in 2005. It is expected to exceed 50% by 2020. Asia's urban population may grow from 1.35 billion (37% of the total population) in 2000 to 1.94 billion (48%) in 2015. By 2010, 12 of the world's 23 megacities are expected to be in Asian developing countries.

Asia's urbanization has generally had positive effects on the countries' economies but is also associated with serious negative externalities. There is strong evidence to suggest that cities increase productivity, generate economic growth, and jobs. However, productivity rates could be even higher if the efficiency of cities is enhanced. Unmanaged urbanization can lead to poor quality of life for urban dwellers even if income poverty declines, and to significant urban environment problems. With limited fiscal resources and poor planning, urbanization can lead to large urban subpopulations living in squalid living conditions and abject poverty. Analysis of current trends suggests that urban poverty and urban slum incidence in the poorer DMCs is increasing. Financing requirements for just water supply, sanitation, and waste management (WSSWM) and slum upgrading in urban areas may be \$25 billion per annum for ADB's DMCs. This would double to \$50 billion per year if urban roads are included. Using a conservative assumption that 100 kilometers of rail mass transit system are constructed in Asia's large cities only, a further \$10 billion per annum would have to be added to urban funding requirements. The requirements in housing exceed all of these amounts by far. Current investment programs of governments, external agencies, and the private sector fund no more than half of the demand for water supply, sanitation, and urban transport. There is a pressing need for further investment and greater capacity development of urban bodies to enable them to effectively extend, operate, and manage these services.

Problems related to urbanization are complex and cannot always be addressed effectively from the perspective of a single sector. The platform offered by urban ministries and urban governments for holistically addressing interrelated problems in different sectors offers opportunities for effective interventions. Given the existence of such large numbers of potential clients, there is ample scope for pursuing an urban strategy, provided that ADB can seize the opportunity. If ADB were to maintain its position as Asia's premier development institution, going forward would require a greater focus on urban development, which would also address many of the poverty reduction and environment related issues.

A major finding of this SES is that, although urbanization is increasingly driving economic development in Asia, ADB's institutional focus on the urban sector has been lost. One and a half years after the USS was adopted, ADB underwent reorganization and introduced new business processes. ADB's professional expertise in the urban sector was dissipated. The two urban sector divisions were dissolved and staff were scattered over five new departments and four newly created regional social sector divisions, which included sector

specialists in education, health, and other social themes. From an operational perspective, the link between urban development, health, and education is tenuous. Housing finance and all management and governance operations were shifted to four new governance and finance divisions in the regional departments. The urban transport operations were to be identified by the transport divisions, which historically focused on intercity and rural roads. The earlier division and sector strategies were overshadowed by an increasing focus within ADB on country strategies. ADB's water supply and sanitation operations, including those in urban areas, fell increasingly under the framework of ADB's Water Policy, approved January 2001 by the Board and managed by RSDD. As noted by a recent independent assessment of ADB's reorganization, ADB's sector expertise has declined. ADB's sector classification of projects and TA grants was streamlined in 2004. The new system did not include the urban development and housing sector as a distinct group, leading to fewer options for monitoring the urban sector portfolio. Urban development projects are now classified as multisector projects, a disparate group that includes rural development projects, environment projects, and a variety of other types of projects.

Notwithstanding the loss of institutional focus, the urban sector portfolio grew modestly after the issuance of the USS. Before the USS was adopted, urban sector lending constituted 9.0% of the total loans approved between 1993 and 1999 (11.0% if some large emergency loans during the Asian Financial Crisis are excluded). After the USS was adopted, it accounted for 11.5% of total lending from 1999 to 2005. An analysis of the pipeline suggests that this share should increase in the future. However, in dollar terms, lending grew by only 5.9% (from an average of \$551 million per year in the 6 years before the USS to \$583 million per year after)—much less than the 15% growth in urban population in ADB's DMCs over the same period. ADB's professional staff with an urban sector designation increased from 10 at the time the USS was approved to 16 at present. Urban sector projects often involve many components and many cities. These types of projects require intense supervision, which is facilitated by the increasing number and strength of resident missions (RMs). It could be argued that the urban portfolio has persisted in spite of the institutional dilution, and that it is due to continuing demand from DMCs in the face of urbanization. With more institutional focus on the urban sector, ADB may be better placed to respond to demands and opportunities and the urban portfolio could be larger than its current size. A stronger institutional focus on the urban sector might have expanded or strengthened ADB's knowledge products, TA, policy dialogue, project formulation, and portfolio management. By comparison, the World Bank, with a similar sized lending program in the Asia and Pacific region, has (i) 48 urban sector experts for this region, (ii) various urban theme groups in the infrastructure department, (iii) urban sections in many RMs, and (iv) retained urban development (like rural development) as one of its 11 main themes.

Project completion reports (PCRs) show that urban multisector projects have generally performed well, with 81% rated successful or highly successful between 1995 and 2005. WSSWM projects have not performed quite as well (67% were rated successful). However, this level of success is still on a par with the average for other sectors. OED's project performance audit reports, issued on average 2–3 years after the PCRs, are somewhat less positive, and raise issues related to the sustainability of many urban sector projects. Urban sector projects were generally rated as relevant, effective, and efficient. Because of their complexity and the often lower capacity at local government level, urban sector projects require more TA support than some other sectors. However, increased TA was not forthcoming after the USS. In fact, it declined by about 40% after the USS, whereas TA funds in other sectors increased by 29%. OED reports in the period 2000–2005 confirm that the success rate of urban multisector projects is comparable to that of the other sectors on average, whereas the performance of WSSWM projects is somewhat weaker.

To broaden the context, the study also scanned ongoing operations in some countries. It found that the success of the ongoing project portfolio varies with the country. The three country case studies point to excellent progress with projects in the PRC, more uneven progress with the relatively younger portfolio in India (but still encouraging prospects) and disappointing progress with the current portfolio of complex projects in the Philippines. However, in all three countries, the project managers were satisfied with some key features of ADB operations. A questionnaire survey found that project managers in executing agencies were dissatisfied with national decision-making systems, except in the PRC. SES missions reviewed some evaluations of central government funded urban programs, and noted unsatisfactory performance, indicating generic difficulties in the urban sector and in DMCs.

Project managers in DMCs also voiced some consistent criticisms of some elements of ADB's policies and practices. There is a widely shared view that many problems with urban sector projects are caused by ADB's project processing and implementation model. These concerns add to the occasionally lukewarm responses to the question regarding the clients' willingness to engage in further urban borrowing from ADB, and a lack of lobbying for follow-on projects.

Some of the concerns identified by this study are being addressed by ADB-wide reform processes, such as the Innovations and Efficiency Initiative. These should, in principle, increase the potential for engaging in more and better urban sector interventions. ADB needs to restore some of the institutional focus and urban sector leadership it has lost since 2002. As a result of the urban sector review process initiated, it is already taking steps in that direction. ADB's Medium-Term Strategy II (2006–2008), issued recently, identified urban infrastructure as one of the core operational sectors where ADB plans to build up a critical mass of expertise to act as a leading provider of assistance. The litmus test will be whether the pipeline of urban sector projects, relying on growth in India and the PRC in particular, and perhaps a resurgence of borrowing by Indonesia and Pakistan, will lead to the expansion in lending that the USS saw as appropriate given the growing demand for capital investment in Asia's rapidly growing cities.

As to the issue of capacity building, partnerships and anticorruption measures, the SES findings imply that there is more desired. The use of consultants to support project implementation is still widespread, long term partnerships with city clients have been limited, and support to urban governance reform has been rare.

Corruption is widely acknowledged to be a major threat to the efficiency of both projects and service provision in the urban sector in Asia. About half of the reports and recommendations of the President reviewed were found to have reported on and/or highlighted specific anticorruption measures or capacity building.

OED assesses the USS of 1999 as partly successful given lower efficiency in influencing operations, in spite of good relevance to Asia and the Pacific. Its ambition to go beyond what ADB was already providing up to that time was not realized, except in a few countries, like India. OED assesses ADB's urban sector operations as broadly successful, mainly on account of the above average effectiveness of projects and TA, and in spite of their higher than average sustainability risks. Overall, ADB failed to seize the opportunity to significantly increase the size and quality of its urban lending portfolio and TA activity. The rationale for the rating of the USS and subsequent operations is summarized below, followed by a set of recommendations.

Rating of the Urban Sector Strategy

Relevance. The USS was relevant in terms of highlighting urbanization as one of Asia's mega-trends, and in identifying the need for ADB to focus on a response. All trends and issues identified by the USS are still relevant in 2005. The strategy appropriately anticipated ADB's increasing focus on poverty reduction. The 1999 USS was consistent with ADB's subsequent 2001 Long-Term Strategic Framework (2001–2015), which reflected urbanization as a major challenge for ADB, and one that ADB was particularly suited to address. However, the USS had little effect on the subsequent Medium-Term Strategy (2001–2005). The USS' objective of increasing lending to urban areas was highly relevant given ADB's comparative strengths as an organization promoting infrastructure and capacity development. The strategy could have been more relevant as a guide to current operations if it had (i) made more distinction between regions and countries within the Asia and Pacific region in terms of urbanization, needs, and approaches; and (ii) given more guidance as to the role of the private sector in ADB's operations.

Efficiency. The number of goals and targets make the USS hard to pursue in practical terms and hard to evaluate. After ADB's reorganization, the USS was even harder to pursue; urban sector staff were scattered and the new RSDD was not staffed with sufficient specialists to pursue special urban issues and coordinate effectively. The USS was not successful in providing a statement that focused ADB, as an institution, on the urban sector. Economic and sector work was not expanded. Country urban sector profiles and strategies have generally not resulted in a clear urban focus in country strategies and programs. ADB's TA for the urban sector diminished. ADB's 2002 reorganization and the new business processes led to much greater attention on country planning rather than sector planning. ADB's leadership and institutional focus on the urban sector, widely acknowledged in the 1990s, was due to the pre-2002 division-centered organization. The efficiency of the USS within ADB is low, given its incompatibility with the present organizational structure. Growth in lending, TA, and knowledge products would normally need to be accompanied by appropriate levels of staffing. Given that ADB currently has a cap on increased levels of staffing, this would mean a redeployment of existing positions. The urban sector does not perform more efficiently in terms of preparing and implementing projects than before; there are as many delays and loan cancellations as (i) before the USS, and (ii) in many other sectors. Borrowers perceive ADB's transaction costs as high, although many executing agencies recognize significant ADB added value. Since ADB lost its specialized urban divisions and has few urban sections in RMs, there is a lack of focal point for urban clients.¹ This has led to the lack of an effective internal lobby to promote ADB involvement in the urban sector.

Rating of Urban Sector Operations

Effectiveness. Urban lending operations increased but not significantly. Intended expansions of operations into public-private sector partnerships, urban (mass) transit, and land management were not achieved, although there was some growth in the housing sector. The number of program loans and sector loans did not increase as planned. No more large urban forums were organized. However, other knowledge products increased. PCRs have generally rated the performance of urban sector projects as higher than the average of all ADB projects, especially integrated urban development (multisector) projects. OED ratings of completed urban sector projects have also been in the middle range, some sectors perform better and some

¹ However, after the drafting of this study, one urban development division was created in a restructured South Asia Regional Department (May 2006).

perform worse. Given a reduced TA program in recent years and no growth in loan consulting services and loan components for institutional development or training, it is unlikely that the policy or capacity impact of current operations is higher than before the USS. Increased cofinancing sources may have partly offset this trend, but more TA resources could have made the impact larger. The USS did not specify outcomes across Asia and these are hard to quantify. To give an indication of the coverage of ADB's lending operations, ADB urban sector loans in the last 12 years covered 12% of the urban population in DMCs.

Sustainability. The sustainability of urban operations varies according to subsector and country, in line with country contexts. OED evaluations have given lower ratings than PCRs with reference to the sustainability of urban sector projects and impact on institutions. There has been some progress with appropriate tariff setting and cost recovery in water supply and sewage systems, but practically all systems still need government subsidies, and are therefore less than sustainable. The housing finance subsector program, relying on financial intermediaries which add a margin when setting the cost of housing loans to final borrowers, has not been sustainable in some countries because of increasing availability of competing private sector sources and lower commercial interest rates. From ADB clients' point of view, the need for urban sector projects continues to grow, but an exponential rise in demand is not foreseen, partly because of external debt considerations for many DMCs. ADB has yet to decide on a strategy for significantly increasing sub-sovereign lending. Doing so would increase the lending modalities that could be used to assist the financially stronger municipalities.

Main Recommendations

The SES recommends:

- (i) ADB should formulate an Urban Sector Strategy II.
- (ii) The Urban Sector Strategy II should include a road map or business plan for implementation to translate the broad goals and objectives of the strategy into reality, given various constraints.
- (iii) The Urban Sector Strategy II should also include a results-based framework with clear, monitorable indicators.
- (iv) The new strategy needs to be grounded in a custodian division in RSDD, to coordinate across departments, monitor targets, and elaborate common themes.
- (v) ADB needs to provide some guidance to staff on how to engage in anticorruption initiatives in the urban sector.

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