WESTERN BALKANS & CROATIA

URBANIZATION AND TERRITORIAL REVIEW

OVERVIEW

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Urbanization & Territorial Review

OVERVIEW

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Acronyms

ADF	Albanian Development Fund
CMT	Cut-make-trim
ECA	Europe and Central Asia
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GIS	Geographic Information Systems
GVA	Gross Value Added
HBS	Household Budget Survey
LiTS	Life in Transition Survey
LQ	Location Quotient
MSME	Micro, Small and Medium Sized Enterprises
NSO	National Statistical Office
NTL	Nighttime Lights
NUTS	Nomenclature of Territorial Units for Statistics
OPT	Outward Processing Trade
PISA	Programme for International Student Assessment
pp	Percentage points
PPP	Purchasing power parity
R&D	Research and Development
SILC	Survey of Income and Living Conditions
UPP	Urban Partnership Program
VAT	Value Added Tax
WDI	World Development Indicators

A note on data

This Urbanization Review covers countries in the Western Balkan region—those that make up the former Socialist Federal Republic of Yugoslavia (except for Slovenia) and Albania. Among these countries, Croatia has been a member of the European Union since 2013. The main objective of the report is to shed light on economic, demographic, and urbanization trends in the seven countries of Albania, Bosnia and Herzegovina, Croatia, Kosovo, Montenegro, North Macedonia, and Serbia, and by doing so, to inform recommendations for policies that would produce economic and welfare gains.

However, due to severe limitations on both national and subnational data—in terms of availability, quality, and comparability—analyses across the four chapters vary with regard to the inclusion of specific countries, the time frames covered, and the subregional focus in the level of disaggregation. Having said that, to fulfill the objective of the report as well as to deliver robust findings, data gaps wherever possible were bridged with supplementary data sources, and multiple sources were considered to corroborate key messages.

CHAPTER 1: The chapter covers all seven countries for which data are available and comparable. Nationally, analysis of urbanization, demographic, and economic trends is based mainly on World Development Indicators (2018) and The United Nations World Urbanization Prospects (2017 Revision), which use the official definition of urban areas to establish urbanization levels. The study of the links between the share of the urban population and economic development is based on a global dataset produced by Roberts et al. 2017, which uses definitions of urban areas that are consistent across countries. For the city-level analysis, the chapter relies mainly on two datasets: a global urban dataset produced by Roberts et al. 2017 and an Eastern Europe and Central Asia city dataset produced by Restrepo et al. 2017.

CHAPTER 2: The chapter covers capital cities Sarajevo, Tirana, Belgrade, Skopje, Podgorica, and Zagreb when data are available and comparable. Analysis of economic and demographic indicators relied on the Oxford Economics 2016 Global dataset and on data from national statistical offices, when available. In most cases the period used was post-2009, and the definition of capital city region was maintained at the NUTS 3 level to ensure consistency across countries. The Enterprise Survey (2013) and the Doing Business Report (2019) were used to characterize the business regulatory environment. The water utility database compiled by the DANUBIS water platform, the Life in Transition Survey III (LiTS 2016), and the dataset compiled by Kaza et al. (2018) were used to determine the quality of public services and infrastructure. Case studies and consultations carried out mainly in Tirana and to some extent in Belgrade provided additional evidence for findings.

CHAPTER 3: This chapter covers all the countries except Croatia. The chapter uses mainly household survey data—Household Budget Survey (HBS) and Survey of Income and Living Conditions (SILC) in the Western Balkans—and the Life in Transition Survey (LiTS), complemented by administrative data. In-depth analyses focus on Albania and Serbia small-area estimates of household welfare and poverty were available for those two countries, which could be correlated with service delivery outcomes. One caveat: household survey data in Albania do not allow for separate representative estimations for urban and rural areas. The subnational regions are defined as available and representative in the household survey.

CHAPTER 4: The chapter contains some analysis of North Macedonia, Serbia, Albania, and Croatia. It focuses on disaggregated data at NUTS3 level to ensure comparability and consistency. For some countries, GDP data at NUTS3 level were not available, and unfortunately GVA (Serbia) and GDP/GVA data were available only for short periods (for example, 2010–15 for Albania and 2013–16 for Serbia). More detailed quantitative and qualitative analysis focused mainly on Albania and Serbia, because field work and case studies were undertaken in those countries.

Executive Summary

To accelerate growth and create jobs, the Western Balkans and Croatia will need faster economic growth generated by advanced industries and services that usually concentrate in cities. Raising the competitiveness of leading cities will thus be the priority for growth and job creation in the region. At the same time addressing the challenges of places left behind will be increasingly important for shared prosperity and sustainable growth. EU accession, technological changes, and globalization are most likely to create growth opportunities that will favor cities and their agglomeration economies. These trends, if left unchecked, are also more likely to increase spatial welfare disparities.

This report advocates for a stronger focus on cities, especially capital cities and their metro regions, as engines of growth and job creation. It also argues for policymakers to focus on lagging regions to address spatial welfare disparities likely to increase with the concentration of people and economic activity in fewer places.

Small, sparse, and shrinking cities limit agglomeration

Cities in the Western Balkans and Croatia are small, sparsely populated, and in many cases shrinking. Urban populations and economic activity are also more dispersed than elsewhere. These characteristics limit the scale of agglomeration economies and the potential of cities to contribute to national economic growth. Recent trends suggest, however, that most countries in the region are moving toward greater concentration of population and economic activity in fewer cities. While this is good news for the region, it will reinforce the decline in populations of smaller cities.

Capital cities can do a better job in driving growth and creating jobs

Capitals in the Western Balkans and Croatia have not shouldered the responsibility of driving growth and creating jobs. Their economic growth is subpar, compared with similar capitals in Europe and Central Asia. Their low productivity, tepid productivity growth, and only modest employment gains have kept cities from capitalizing on the potential of agglomeration. Greater economic integration with the EU and global markets and increasing economic and population concentration in capital city regions means more emphasis will need to be placed on the role of capital cities as engines of growth.

Spatial welfare disparities should be kept in check with fair access to opportunity

Since economic growth is often unbalanced, promoting fair opportunities for people across a country is important to keeping spatial welfare disparities in check, strengthening the social contract, and ensuring inclusion and shared prosperity. Addressing spatial disparities in people's welfare does not necessarily imply balancing economic activity and growth across the country but rather ensuring opportunities for people regardless of where they live. Providing equitable basic services across space and easier movement of people to thriving areas would help all individuals benefit from the changing economic geography in the Western Balkans. These key policy principles are relevant in addressing the specific challenges of lagging regions, for example.

Lagging regions can be places of opportunity

While raising the competitiveness of leading cities will be the priority for accelerating growth in the Western Balkans and Croatia, addressing the challenges of regions being left behind will be increasingly important for shared prosperity and sustainable growth. While, spatial disparities in economic output are moderate, all countries in the region have entrenched lagging areas. Maximizing the potential of lagging regions and the people in them can be achieved by building on local endowments while improving service delivery to ensure social equity and to support labor mobility.

Spatially differentiated policies can deliver more equitable growth and opportunity

Spatially differentiated policies can be applied across the portfolio of places: the leading areas that include capital city regions and some secondary cites; and lagging areas that including small declining cities, low-income mostly sparse and peripheral regions, and low-growth regions with agglomeration potential. These policies can simultaneously position cities to act as drivers of economic growth, increase productivity, and create jobs, while also ensuring that lagging regions are not left behind as trends in demographics, technology, and integration with EU further push to concentrate population and economic activity in fewer places. To this end, the report encourages policymakers to focus on 3Cs:

- **CONCENTRATE** resources on leading city-regions to drive national growth and support secondary cities to become growth centers that expand opportunities to their hinterland.

- **CONNECT** people and places to opportunities, by developing competitive tradable sectors to leverage the comparative advantages of cities and regions, integrating enterprises into local, regional, and global markets, and delivering high-quality public services to citizens regardless of where they live.

- **CAPACITATE** local governments by strengthening financial and technical expertise and improving local planning, coordination, and governance, while investing to raise human capital to ensure that citizens can take full advantage of their potential regardless of where they are born.

Across cities, the priority is to concentrate resources on capitals-to unlock the benefits of agglomeration and reduce congestion. Governments can give impetus to population and economic concentrations by reducing domestic barriers, such as gaps in human capital and connectivity, easing restrictions in labor and housing markets, and reforming policies that prevent people and businesses from moving to areas of greater opportunity. Higher concentrations of urban populations and economic activities, if well managed, can support the emergence of agglomeration economies in larger cities. As populations concentrate in larger cities, however, some smaller cities will likely experience an abrupt decline, and that will also need to be managed.

For lagging regions, policymakers should focus on strengthening endowments and removing distortions that prevent the formation of productive agglomerations. Cross-cutting interventions can be supported by well-targeted sectoral interventions to accelerate the development of tradable sectors. For more centrally located regions, policies should emphasize strengthening secondary cities to attract investors in tradable sectors and to induce high-skilled jobs and innovation. For more peripheral and sparsely populated regions, policies should emphasize service delivery of critical economic and social infrastructure and implementing sectoral niche initiatives that leverage regional endowments. Above all, and for all types of lagging regions, investment in human capital will be critical to boost their growth potential and to strengthen the assets of individuals and enable them to exploit opportunities wherever they may be found.

Overview

Since the end of socialism in 1990, the Western Balkans and Croatia made notable strides in economic growth. Not only was the economic growth faster than world and EU averages during the transition period, but it was also pro-poor[1]. However, the process of convergence drastically slowed down following the global financial crisis, which dealt a dramatic blow to the growth trajectory and revealed the shortfalls of reforms implemented during transition. Growth was reliant on the public sector and was mainly fueled by consumption and real estate development driven by remittances rather than by private investment linked to export sectors.[2]

Today, the region's economies are struggling with low productivity and high unemployment. Almost a decade after the global financial crisis, GDP growth rates across the region remain low and volatile. During 2010–15, the average annual growth rate for the Western Balkans and Croatia was 1.2 percent, less than the 2.6 percent for comparator countries [3]. Growth has been characterized by low productivity and weak job creation. Aggregate labor productivity is almost half that of other small transition countries in Europe, while labor force participation is low and unemployment high, at 17 to 35 percent across countries.[4]

Implementing spatially informed policies will be critical for achieving faster and more inclusive growth. To transition to high income (Croatia already has), the Western Balkans will need faster economic growth that would typically originate from advanced industries and services that concentrate in large and diverse cities. However, in the Western Balkans and Croatia, not only are cities small and sparse but almost three quarters of them have been registering a decline in population. This leaves only a few city-regions likely to foster the growth of such industries. Indeed, spatial Gini coefficients show increasing concentration of both population and economic activity in only a small number of cities. Primary among them are the capital cities that on average host at least a quarter of the national population and will continue to grow, albeit at a slow rate given demographic trends.

However, these capital city-regions are underperforming, with weak productivity growth and limited job creation. Moreover, while increasing economic and population concentration in leading cities would be beneficial for accelerating growth, it may put further pressure on spatial disparities, aggravating the challenges of lagging regions.

This report outlines the territorial dimensions of development in the Western Balkans and Croatia. It advocates for a stronger focus on cities as engines of growth and job creation, especially capital cities and their metro regions. The report also argues for policymakers to pay attention to spatial welfare disparities, with specific emphasis on lagging regions.

To prepare for the challenges and opportunities emerging in the Western Balkans and Croatia, this report calls for a differentiated set of priorities targeting a portfolio of places. These are organized around three Cs:

- **CONCENTRATE** rresources on leading city-regions to drive national growth and support secondary cities to become growth centers that expand opportunities to their hinterland.

- **CONNECT** people and places to opportunities, by developing competitive tradable sectors to leverage the comparative advantages of cities and regions, integrating enterprises into local, regional, and global markets, and delivering high-quality public services to citizens regardless of where they live.

- **CAPACITATE** local governments by strengthening financial and technical expertise and improving local planning, coordination, and governance, while investing to raise human capital to ensure that citizens can take full advantage of their potential regardless of where they are born.

Urbanization
and
the role of Cities

The importance of cities

Urbanization is both an outcome and a driver of development. A country's degree of urbanization is a good indication of its stage of development. More developed countries tend to have a higher share of their population living in cities than do developing countries. Economic advantages, known as agglomeration economies, emerge when people and firms locate together in cities: Workers benefit from access to more jobs, firms can more easily find the right workers and suppliers, and spatial proximity enables both workers and firms to benefit from knowledge spillovers. By fostering agglomeration economies and minimizing the costs that arise from spatial concentration, known as congestion forces, well managed urbanization can drive productivity gains, contributing to faster economic growth. But exploiting the potential for agglomeration in cities will not be easy for countries in the Western Balkans and Croatia, which face structural challenges of small city size and sparsity, exacerbated by demographic challenges, including large-scale outmigration and a rapidly aging population.

Urbanization trends

The easy growth dividends from urbanization are likely over

The Western Balkans and Croatia experienced a period of rapid urbanization between 1960 and 1990 when the share of the urban population grew almost 2 percent annually. Since then, however, the urbanization rate has stalled at just 0.6 percent annually with the urban share having reached just 51 percent by 2017, nearly 20 percentage points (pp) lower than the Europe and Central Asia (ECA) regional average (figure 1). In all countries except North Macedonia, recent increases in the urban population share reflect rural population declines more than urban gains. These structural challenges will continue to act as a drag on cities' ability to generate the benefits of agglomeration economies. Therefore, while rapid population growth in urban areas could help drive growth in the past, sustaining growth in the medium to long term will require raising productivity levels in cities.

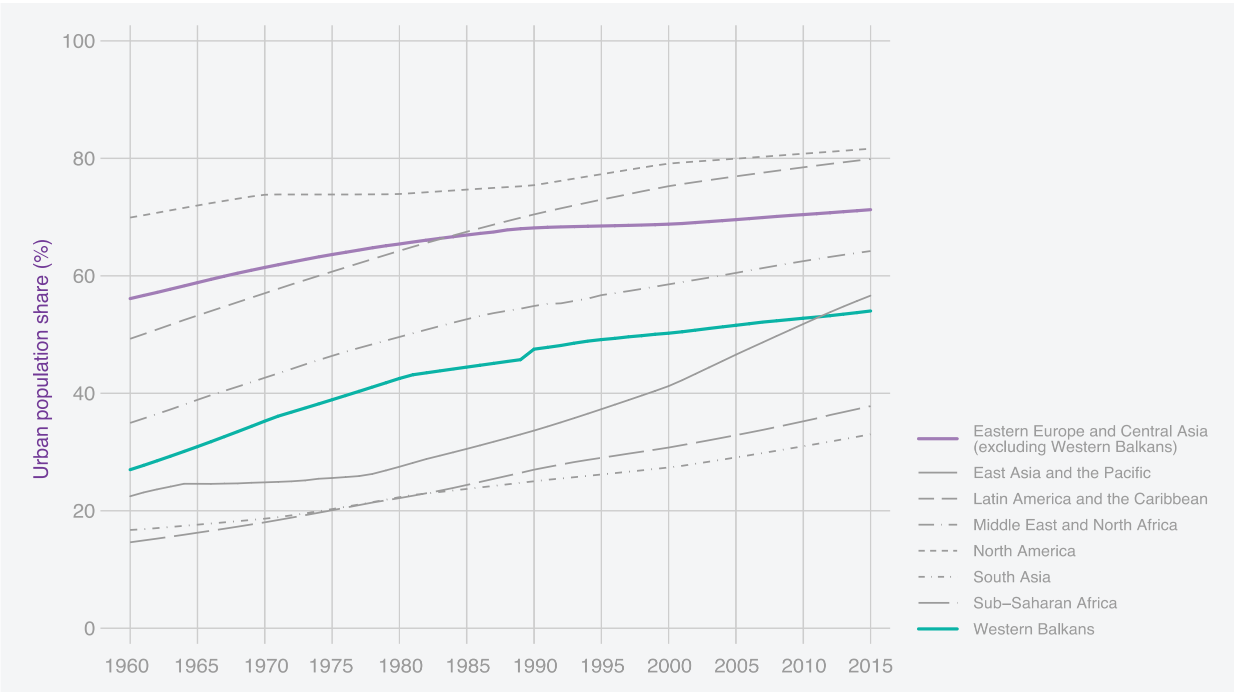


Figure 0.1 Since the 1990s, urban share of the population has stalled at a relatively low rate of urbanization

Source: World Development Indicators 2018.

Note: Excludes Kosovo, as data are not available for the entire period of analysis.

Cities are small and sparse

The sparsity and small size of cities in the Western Balkans and Croatia inhibits realization of agglomeration economies. The average city has only 30,000 inhabitants, lower than in other global regions, including other countries in ECA. The low population density in these cities (942 inhabitants per square kilometer) is second only to that in North America, whose cities are known for their sprawl. Location fundamentals, which explain about 59 percent of the location decisions of populations and economic activities worldwide, explain only 39 percent in the Western Balkans and Croatia. This is likely to have negative implications for productivity and economic performance in the region.

Shrinking cities pose a unique challenge

Cities are not only small and sparse, they are also declining. Demographics and net outmigration are contributing to declining and aging urban populations. Fertility rates have been below replacement levels for years. The share of the youth population (0–14 years) has been declining since the 1990s, while the share of the population over the age of 65 has substantially increased (figure 2). Of particular concern for leveraging productivity gains from cities is the decline in the working age population (ages 15–64), which peaked in 2005–15 and is now falling across the region.

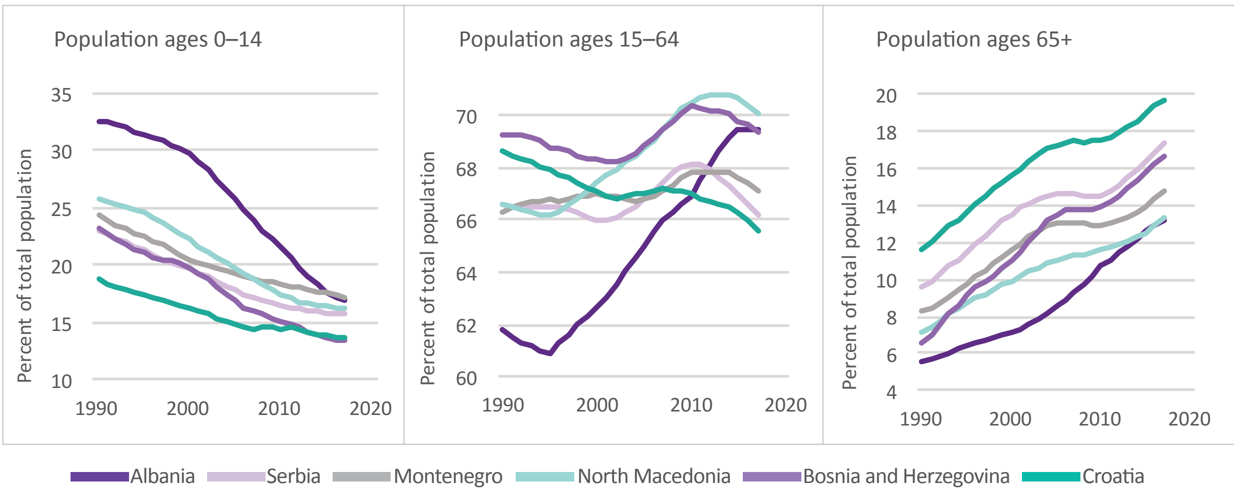


Figure 0.2 Rapid demographic changes in the Western Balkans are leading to a shrinking working age population and an expanding old age population, 1990–2015
Source: World Development Indicators 2018.

These trends are common across the ECA region, but they are particularly acute in the Western Balkans and Croatia, where nearly three-quarters (73 percent) of cities lost population between 2000 and 2010, the latest figures available (figure 3 and box 1). But the story of urban decline is nuanced. In several countries including Albania, Montenegro, and Serbia, rapidly declining cities coexist with rapidly growing ones. Cities that are shrinking tend to be those that started small, while growing cities tend to be larger and often part of a multicity agglomerations. On average, shrinking cities lost 10.0 percent of their population between 2000 and 2010, while growing cities added 10.4 percent to their population.

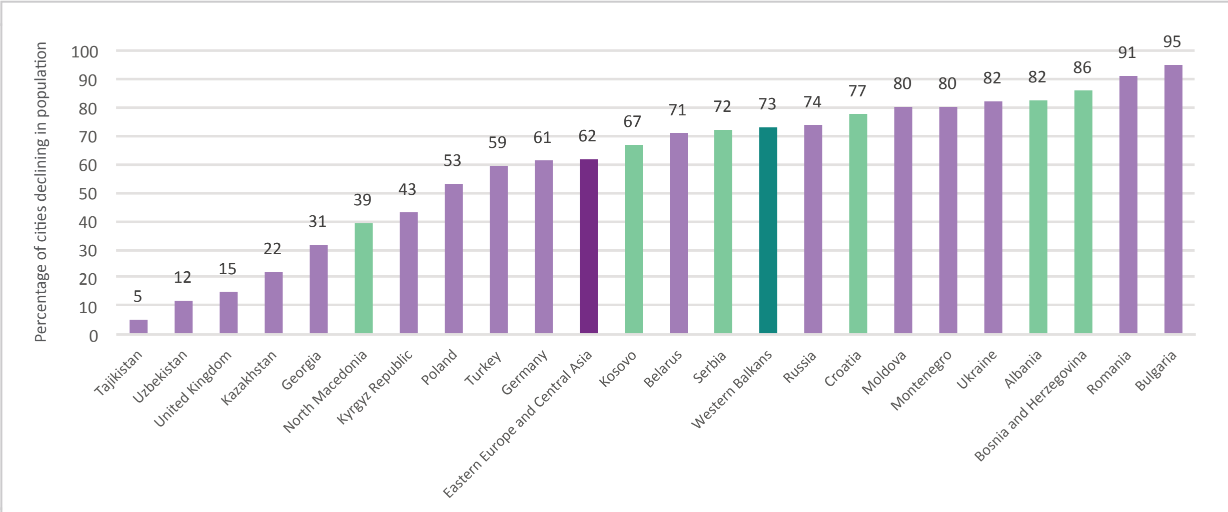


Figure 0.3 Many Western Balkan countries are losing population in their cities, 2000–10

Source: Updated and expanded from Restrepo Cadavid, Paula, Grace Cineas, Luis E. Quintero, and Sofia Zhukova. 2017. Cities in Europe and Central Asia: A Shifting Story of Urban Growth and Decline. Washington, DC: World Bank.

BOX 0.1

Shrinking cities need to manage decline

Cities in the Western Balkans and Croatia are losing population primarily from changing demographics and outmigration, mirroring the dynamics at the country level. Shrinking cities in the region are primarily small cities but are not necessarily in economic decline, yet. Policymakers, however, need to be aware that shrinking cities are also more likely to have rising levels of aging populations, decreasing demand for education services, increased demand for health services, and changing infrastructure needs such as for transport. Declining city populations will also impact the local tax base, may change the priorities for national transfers and will have impacts on density and scale economies that will need to be managed. There is evidence from countries like Bulgaria that shrinking cities can lead to declines in housing values, often stranding residents who might otherwise leave to take advantage of opportunities for higher productivity and earnings elsewhere. Japan, Germany, and the United States all have innovative examples that might point the way for cities in the region to manage declining population, including creating urban land banks, implementing transit and compact city center-oriented development plans, and adopting innovative sectoral development strategies.

Source: Adapted from Restrepo et al., box 3.

Low levels of concentration work against cities as drivers of growth, but the trend is (mostly) positive

Low levels of population and economic concentration limit the scale of agglomeration economies and the potential of cities to contribute to national economic growth. All countries in the region except Croatia have spatial Gini values for urban population—a measure of the degree of concentration of population and economic activity across the urban system—below the ECA average. The Western Balkans (but not Croatia) also have low levels of urban primacy, which measures the concentration of the urban population in the largest city. On average, just 30.6 percent of the urban population in the Western Balkans live in the largest city, compared with 37 percent for ECA comparator countries and 51 percent for global comparators. For Croatia, it is 40 percent. However, analysis suggests that in the Western Balkans and Croatia, urban population and economic activities are increasingly concentrating, just as they are in other ECA countries.[5] In fact, all countries except Bosnia and Herzegovina experienced an increase in the concentration of economic activities over 2000–10.

The economic performance of cities is mixed, but capital cities appear to be underperforming

Despite the challenges of sparsity and declining and aging populations, cities in the Western Balkans and Croatia, taken as a whole, are performing in line with their global and ECA comparators, though below the performance frontier of Western European countries. But this masks significant variation across countries and city types. Cities in Albania and Bosnia and Herzegovina are less productive than comparators in ECA, whereas cities in Croatia, Kosovo, North Macedonia, Montenegro, and Serbia outperform their ECA peers. Moreover, capital cities are struggling to pull their weight. In all countries in the region, the productivity performance of capital cities is below that of ECA comparators, while capital cities in Albania, Bosnia and Herzegovina, and Serbia also perform below their global comparators. Given the typically leading role of capital cities as engines of national growth, the underperformance of capital cities in the Western Balkans and Croatia is concerning and calls for further investigation.

Capital cities

Capital cities should be driving economic growth

From a static perspective, the economies of capital city regions in the Western Balkans and Croatia are unquestionably more advanced than other regions in their respective countries. On average, GDP per capita in capital cities is about 2.5 times that of the poorest regions.[6] And unlike other cities in the Western Balkans and Croatia, capital cities have both high population density and growing (if slowly) populations. The rising population trend is projected to continue, and capital cities are likely to remain the major urban agglomerations in their countries.[7] Capital cities account for a large share of national output and are home to a large number of firms and jobs (figure 4).

With growing populations, a high concentration of the population, and a large share of national economic activity, capital cities are stark outliers among cities in the region.[8] Benefits of agglomeration are predicated on these characteristics, making capital cities the prime candidates to accrue the dividends of agglomeration. Their status as economic centers and their position in denser networks connecting with international markets reinforce their edge.

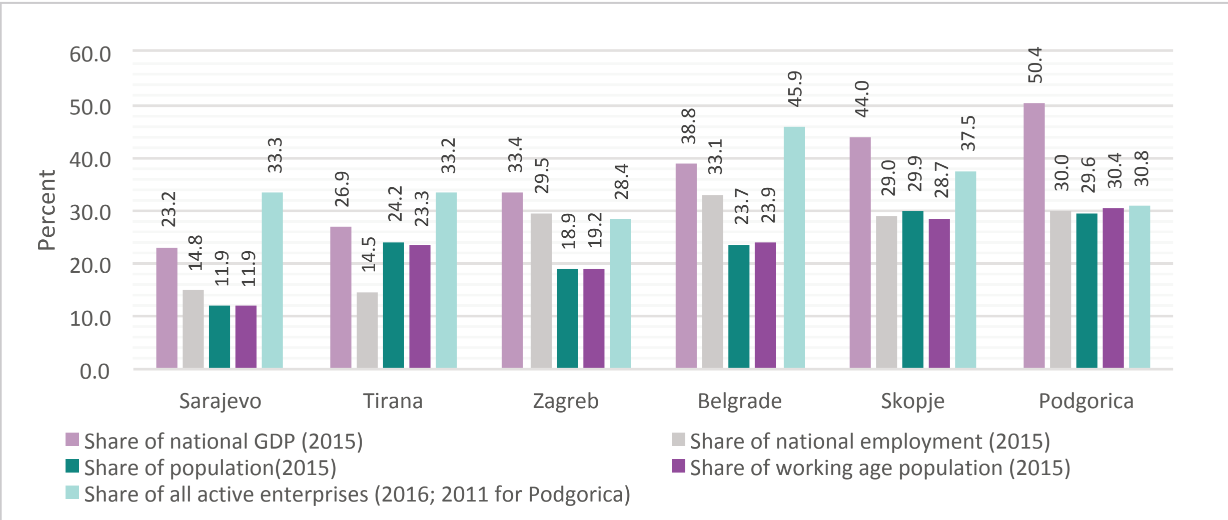


Figure 0.4 Capital cities account for a large share of national GDP, population, labor force, jobs, and active enterprises

Source: Oxford Economics 2016; Statistical Office of the Republic of Serbia, SORS 2018; Republic of North Macedonia, State Statistical Office, MAKSTAT 2018; Eurostat 2018; Institute of Statistics of the Federation of Bosnia and Herzegovina 2018; Albanian Institute of Statistics, INSTAT 2018; Statistical Office of Montenegro, MONTSTAT 2018.

But capital cities are underperforming

Although capital cities have been growing, their growth has been subpar when compared with growth in other regions in their country and with comparable capital cities in ECA. Since 2009, GDP growth in capital cities has been low and stagnant, unable to recover to levels achieved before the global financial crisis. Between 2010 and 2015, the average annual GDP growth rate for the average regional comparator in ECA was about 2 pp higher than that of the average Western Balkan capital city (this includes Croatia). In addition, GDP per capita is growing more slowly in most Western Balkan capital cities than at the national level both during and after the global financial crisis of 2008–09. In fact, according to data from the National Statistical Offices, Belgrade, Zagreb, and Tirana were among the lowest performing regions in their country.[9]

Why have capital cities been struggling to pull their weight?

Capital cities' productivity performance has been weak

Efficient economic growth calls for both sustained productivity growth and consistent job growth.[10] In the Western Balkans and Croatia capitals, the story of growth does not fit such a pattern. Growth has been lopsided in most of them. A simple accounting exercise decomposing aggregate level growth per capita into employment generation, output per worker, and population structure shows that growth has been driven by employment generation without corresponding increases in labor productivity.

Labor productivity and labor productivity growth have been uniformly low across the six capital cities of Zagreb, Belgrade, Tirana, Sarajevo, Podgorica, and Skopje.[11] As a group, labor productivity in these cities has grown at a significantly weak 0.2 percent annually, compared with 1.7 percent for regional comparator capital cities. In four of the six capital cities, labor productivity growth was lower than the national average over 2006–15.

Employment generation has been modest at best

Despite rising employment accounting for much of their economic growth, employment growth has not been particularly noteworthy (figure 5). While it's true that demographic trends in Western Balkan capitals and Zagreb are not favorable to job growth, with the share of the working age population falling or stagnant, comparator cities outside the region are facing similar trends but still doing better. In most comparator countries, capital cities show a significant premium on job creation relative to the rest of the country.[12] In only three of the six countries in the Western Balkan and Croatia region did capital cities outperform the rest of the country in average annual employment growth.

The share of highly productive tradable service sectors is relatively low

The economic structure of competitive capital cities across the globe generally is typified by the concentration of knowledge-based business services, which typically are highly productive sectors. But in Western Balkan capitals and Zagreb, the concentration in these sectors, though higher than in their whole country, is still low in absolute terms. The share of total city employment in these knowledge-intensive business sectors for Prague is 28 percent and for Bratislava 32 percent. In contrast, the share in Skopje is a meager 15 percent. Belgrade's share, the highest among the four capital cities examined in this section (Skopje, Zagreb, Belgrade, Sarajevo), is a fairly low 23 percent.

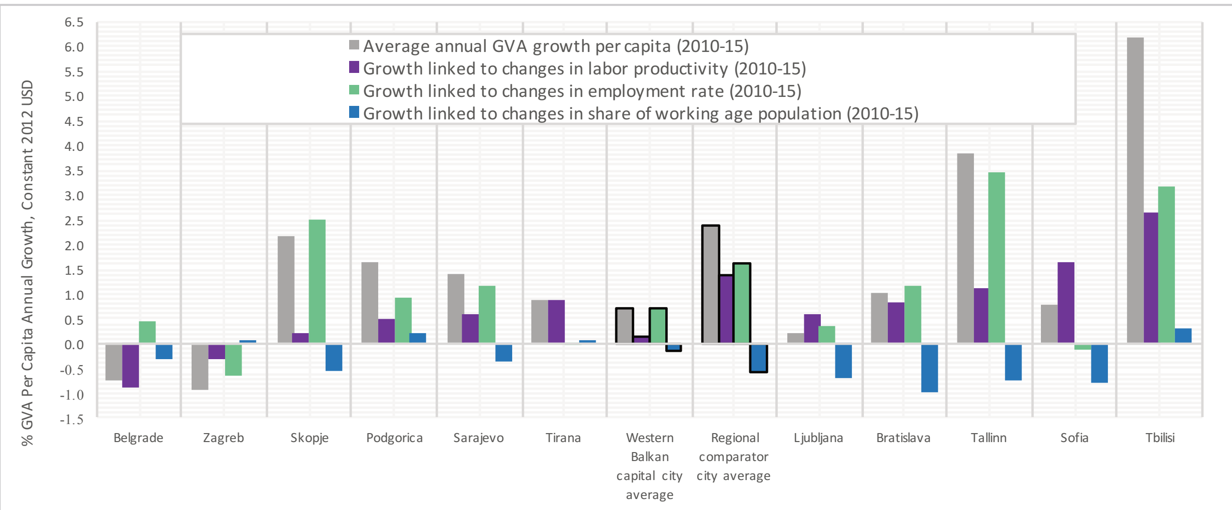


Figure 0.5 Decomposition of average annual per capita gross value added indicates inefficient economic growth in Western Balkan capitals, 2010–15

Source: Oxford Economics 2016.

Note: Some data points may differ from those derived from national statistical offices because a different methodology was used to make data comparable across cities.

Patterns of sectoral change do not appear to be conducive to economic growth

While cities are creating jobs, it is not necessarily occurring across the right mix of sectors, which explains the weak productivity performance. In Skopje for example, local consumer services, which make up 32 percent of employment and are the least productive sector in the economy, have been growing rapidly at 8 percent a year. At the same time, high value-add tradable sectors such as finance have been declining. This pattern of growth, driven by local demand and services, is unsustainable in the absence of faster productivity growth. Employment data for Tirana suggests that much like Skopje, job growth has been mostly contained in sectors that typically have low output and low earnings while jobs in high productive sectors may be on the decline.

While both Sarajevo and Zagreb register a slow growth in tradable service sectors, these sectors have, however, been unable to increase local service jobs as has happened in Belgrade, Bratislava, and Prague (see figure 2.8 in chapter 2). In Sarajevo, although public services grew nominally, jobs in the remaining local service sectors dwindled. This signals frictions between the tradable and local service sectors and the consequent need to strengthen both backward and forward linkages of the local economy to tradable enterprises. In Zagreb, the observed dissociation between the growing tradable sectors and the local service sector can be explained by the simultaneous decline in gross value added across the tradable service sectors—restraining the realization of any positive spillovers. The declining productivity of these otherwise high value-added sectors suggests that firms are for some reason unable to effectively benefit from agglomeration economies.

How can capital cities increase productivity and job growth?

By fostering agglomeration economies and minimizing congestion forces, well managed urbanization can drive productivity gains and thus economic growth. Capital cities need to be at the center. Organized around the three Cs introduced at the outset of this report, national and local governments across the region can take key actions and support the potential of capital cities as engines of growth and job creation.

CONCENTRATE

Capital cities, as the leading regions in each country, will need to have adequate infrastructure and services to foster agglomeration and keep congestion at bay. Policymakers can concentrate resources on leading city-regions to support these objectives. For these capital cities, this would mean ensuring that infrastructure and services are adequate to meet demand, that cities have sufficient resources for investment, and that land is not a binding constraint on growth.

Expand coverage and efficiency of public services

The effective provision and maintenance of public services to an acceptable standard is important for ensuring livability and sustaining economic growth. The quality of public services across these cities is at best satisfactory. Non-revenue water, for example, in capital cities of the Western Balkans and Croatia is strikingly high, particularly in Tirana (73.6%) and Sarajevo (75.2%). Only Belgrade and Sarajevo have 100 percent water coverage. Wastewater coverage is well below 100 percent in most of the capital cities. Utilities and public infrastructure face current and impending congestion. Capital cities appear to have higher incidences of sewer system blockages than other regions and local roads need upgrades. In Skopje, 41 percent of households surveyed expressed dissatisfaction with the quality of local roads, in Tirana, 24 percent, and in Belgrade, 22 percent. Solid waste collection levels, too, are low in several capital cities (figure 6).

Capital cities need to ensure adequate investment in upgrading of existing infrastructure to avoid service deterioration. In addition, capital cities will need to adequately plan for the growing population—and in the future for meeting EU standards for many different infrastructure services. There is some evidence that capital investment planning in some cities in the region is hampered by poor planning and uncertainties surrounding the availability of external capital funding. Increasing the attractiveness and livability of capital cities in the Western Balkans and Croatia with improved urban amenities, including affordable housing and cultural facilities, will be essential for attracting and retaining urban populations with increased EU integration (see the Spotlight).

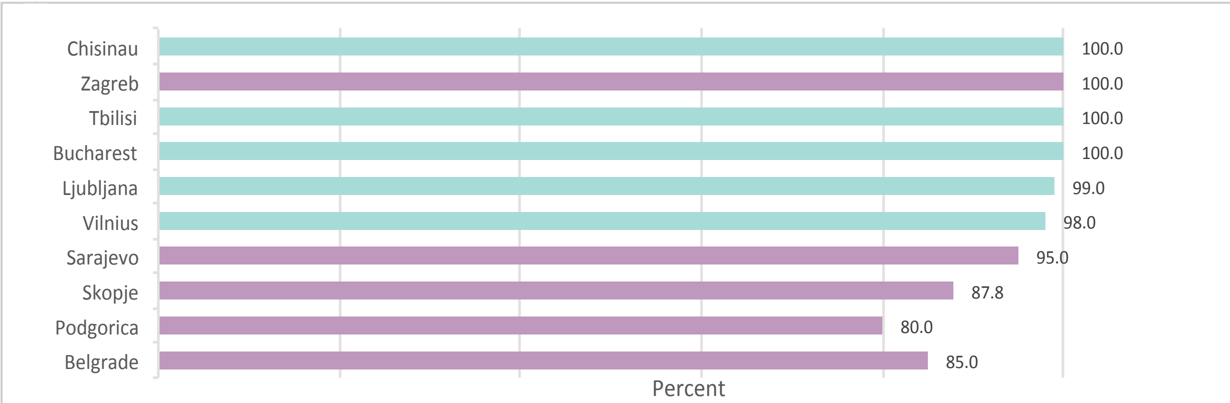


Figure 0.6 Waste collection rates for Western Balkan capital cities are lower than for similar capital cities in the Europe and Central Asia region (percent)

Source: Kaza et al. 2018.

Note: The chart reports the highest rate (percentage) for waste collection among four indicators: (1) total households, (2) total waste generated, (3) total population, and (4) total geographic area. The year of the reported data varies by country, ranging from 2012 to 2016.

Expedite the implementation of land reforms and property legalization

Despite several reforms, challenges related to property rights and land administration continue to restrict investment and hamper urban planning. Because cities are spatially concentrated, their growth and competitiveness depend crucially on land-use planning, regulation, and development. Clear assignment, protection, and information on land ownership; comprehensive and quality maintenance of land records; and well-functioning land markets are prerequisites for boosting investment, enhancing public service delivery, and advancing productive entrepreneurial activity. But severe constraints exist in all areas of land management within capital cities in the region (figure 7).

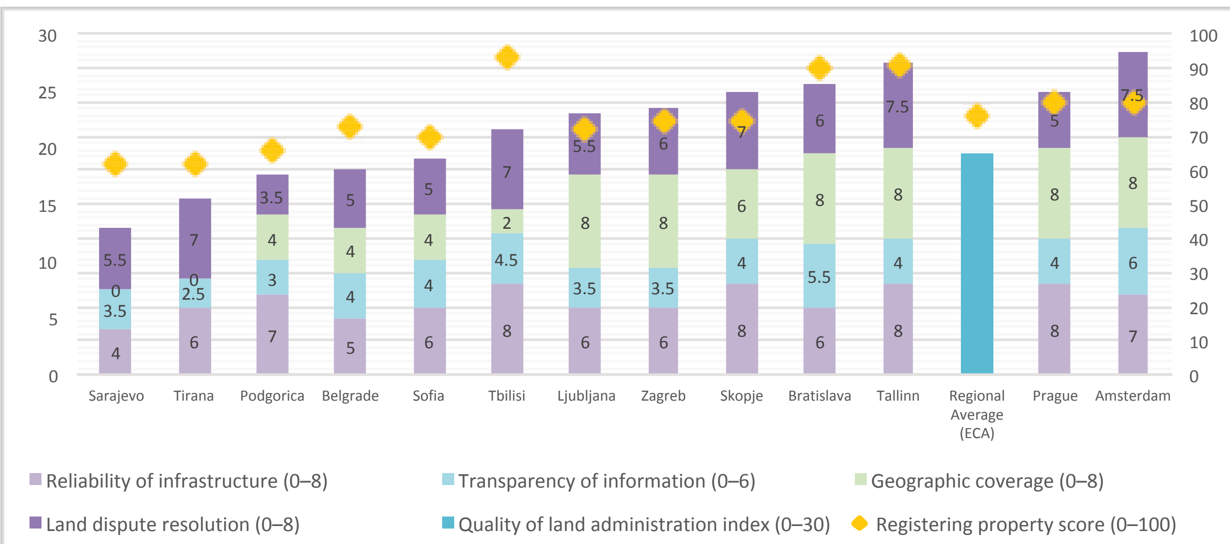


Figure 0.7 The quality of land administration requires improvement

Source: World Bank 2019.

Recent reforms have made big strides in improving land administration and access to land. Belgrade and Tirana implemented laws to formalize illegal settlements and adopted geographic information systems for land registration. Sarajevo, Skopje, Tirana, and Zagreb have digitized land registries. And Belgrade, Podgorica, Skopje, and Tirana have simplified transfer and registration procedures. However, a monumental task remains: To reconcile property rights, formalize settlements, and update and maintain cadasters. For example, in Tirana, a very significant share of the cadastral zones have not been updated since 1995, while an estimated 75 percent have manually archived records. A majority of property owners in Tirana do not possess ownership certificates. In Belgrade, it has been estimated that there are around 800,000 requests for legalization statewide, and only small fraction has been resolved in the first year after enactment of the current law.

Updating land administration tools and ramping up administrative systems remain priorities. Adjudicating and assigning land and property rights and creating, maintaining, and disseminating spatial records and land deeds are among the continuing reforms needed.

CONNECT

Capital cities can connect to local, regional, and global markets by developing tradable sectors engaged in high productivity activities that leverage the agglomeration benefits cities have to offer. This requires creating the right enabling environment. Among the priority areas are to improve the tax environment to advance business dynamism, address informality, and ensure enterprise support and finance—dealing with the unmet needs of firms that impede productive job growth.

Enhance the presence and performance of high value-added tradable service sectors and industries

To increase city competitiveness, it is essential that city administrations focus on supporting tradable industries and knowledge-intensive businesses services at the higher end of the productivity scale. This involves fostering agglomeration economies by implementing economywide reforms that requires establishing appropriate policies for institutions and regulations, skills and innovation, and enterprise support and finance as well as facilitating targeted industry-specific interventions that are more contextual and depend on a nuanced understanding of constraints and requirements facing entrepreneurs in the particular sector. For major sustained productivity gains, growth in the number of tradable service enterprises and the expansion of existing ones are vital.

Create an enabling environment for business

Identifying priority areas for reforming the business environment is perhaps the most difficult task, given the breadth of the relevant policies. However, consistent results emerge from Doing Business, Enterprise Surveys, and grievances expressed repeatedly by different stakeholders in the case studies and consultations conducted for this report. They show that the overall business regulatory environment requires vast improvements and that tax administration, judicial administration, and informality are plaguing growth prospects the most. The common thread is the general lack of government engagement with the private sector. To cultivate a more dynamic business environment, capital cities would benefit from shifting from top-down regulation of the private sector to enabling its growth. City governments can focus on a number of priorities. These include:

- *Improve the tax environment to advance business dynamism.* Effective tax rates in capital cities across the

Western Balkans and Croatia are generally in line with those in comparator cities, but the number of taxes is staggeringly higher. Belgrade, Sarajevo, Tirana, and Zagreb have more than 30 business taxes, while the regional comparator average is 9 and the ECA average is 16. Capital cities can (and some are) reorient toward fewer taxes and focus on tax administration, especially audit and inspection, and on enabling rather than enforcing compliance. The accountability and transparency of tax authorities are of paramount importance, especially during inspections, which should also provide businesses opportunities to receive filing support and air and redress grievances.

- *Streamline and automate judicial processes and introduce regular training of judicial and court staff.* The cost of enforcing contracts is 10 pp higher in Western Balkan capital cities and Zagreb than in comparator cities, on average.[13] The cost of enforcing contracts in local courts can be as high as 40 percent of the value of the claim in Belgrade and 35 percent in Sarajevo and Tirana. In comparator cities such as Ljubljana, on average, the cost is as low as 12 percent of the value of the claim. In addition, on average, around 70 percent of business respondents to Enterprise Surveys in 2013 in the six capital cities disagreed with the statement that the court system is quick. A large share of businesses in the city also believe that courts are biased, corrupt, and incapable of enforcing their decisions. Capital cities in the Western Balkans and Croatia would benefit from increasing automation and digitization in the judicial system—which would simplify resolving commercial disputes and contracts. These cities would also benefit from regular and specialized training of judicial and court staff. This would not only allow staff to be informed of the evolving regulatory environment but also prove vital to uniform, efficient, and objective enforcement.

- *Assess the forms and drivers of informal business practices.* Businesses, especially small and medium enterprises, in Western Balkan capital cities and in Zagreb consider informal activities to be a major obstacle. Capital city administrations in the region would benefit from devising policies that encourage formalization instead of policies that discourage informality. Cities must also streamline regulations, reform the tax environment, reduce institutional inefficiencies to protect both workers and firms, and encourage a culture of compliance by building public awareness and support for appropriate practices. However, given the opacity of informal practices, attempts to gauge what kind of informal practices dominate, what drives them, how firms engaging in them link to the formal economy, and which sectors are most affected by their presence or absence, are precursors to reducing the prevalence of informal practices.

- *Distinguish micro, small, and medium enterprises (MSME's) as a separate category of borrowers.* About 15 percent of surveyed firms stated that access to finance was the primary problem in their daily operations. About 91.5 percent of these firms belonged to the MSME category. MSMEs face a large gap between their financing needs and the options for meeting those needs. They face higher transaction costs, and their lack of credit information diminishes their perceived creditworthiness. Credit bureaus and registries can relieve this constraint by addressing MSMEs as a special category of borrowers, offering them specific services, using more sources that report on MSME borrowing, and lowering the minimum credit threshold for reporting transactions.

BOX 0.2

The barriers to tech entrepreneurship in Tirana

An enterprise startup community emerged in Tirana around 2012, with its visibility confined largely to events and conferences in the city. There has been no discernible growth in scale or in the number of startups (the same startups repeatedly attend these events). Sporadic attempts at community building have lasted no more than a year or two, at best. The sector has just about kept its head above water.

The tech entrepreneurship ecosystem is a classic example of how a highly productive sector has been struggling to scale up largely because agglomeration economies are not being properly used. Despite its locus of activity in the capital city with a large concentration of businesses and labor, the gains from sharing, matching, and learning are minimal.[14]

In Tirana, the tech entrepreneurship sector shows how the lack of essential industry-specific components such as venture capitalists and credible accelerators has prevented the sector from scaling up, while a hostile regulatory environment along with the distorted market for skilled labor discourages startups. The size of the market also limits the potential of the industry.

Economywide and industry-specific interventions would enhance the productivity and presence of these firms and make them more than the sum of their parts.

CAPACITATE

Address skill shortages in the economy

In the Western Balkans and Croatia, although knowledge-intensive business sectors are growing slowly, the level of technical and transferable skills to cater to these sectors is growing even slower, reinforcing the low proportion of high value-added industries in the economy.[15] A survey in Albania, for example, finds that skills constraints particularly curtail expansion and increased investment in firms likely to provide productive employment opportunities (firms that are not local trade and repair services but are large or foreign-owned firms engaging in external trade).[16] Focus groups in Tirana revealed that employers are dissatisfied with the employability of graduates and consistently struggle with finding individuals with requisite know-how.

The need for interventions to create a pool of qualified labor to fuel the growth of knowledge-intensive businesses is great. To allay the concerns of businesses, higher education institutions in capital cities could revamp their curricula and provide platforms for practical and experiential learning. Close coordination between businesses and universities would be required. In addition universities and city administrations can collaborate and undertake more efficient matching of individuals with firms by creating platforms for networking and recruiting.

Enhance the entrepreneurial skills of business managers and owners

Small and medium enterprises have considerable room for productivity gains. The productivity of firms depends on the business acumen and managerial capabilities of business owners and managers, who determine targets, goals, and operations. It appears that in Western Balkan capital cities and Zagreb, owners of small and medium enterprises do not possess the skills or the desire to perform such tasks as outsourcing, forming partnerships, financing investments, or seeking efficiency gains. Internal firm productivity appears to be reduced by the lack of managerial skills and business acumen of firm owners.

The low productivity due to poor management practices is compounded by the scarce use of technology and business digitization. The capacity of firms to absorb new technology is weak, and the consequent inability to be up to date with changing production techniques erode their competitiveness.

Entrepreneurs and business owners of firms need to be armed with basic 21st century management techniques and exposed to the benefits of business digitization. This can be achieved by creating platforms for knowledge exchange and mentorship. In addition, incentives can be put in place that encourage the adoption and successful use of new management systems and technology. Focusing on increasing entrepreneurial abilities would increase firm productivity and better equip these firms to take advantage of agglomeration.

Increase the ability of capital cities to finance critical infrastructure

Throughout the region, municipalities are responsible for providing basic urban infrastructure services—water supply, sewerage, solid waste management, and urban streets—that enable cities to function. Across most of the region, revenue allocation formulas designed to promote equalization mean that while capital regions tend to receive the largest share of resources, there remains a relative bias toward sparse and peripheral regions, which relative to capital cities with large and growing populations, have much lower infrastructure needs.

In this context, capital cities may require greater revenues to ensure they have sufficient resources to invest in and maintain key infrastructure and services. Systems of local finance that concentrate resources in major cities are, in this sense, desirable. This can be made possible by increasing the scope for capitals to generate their own revenue both through a wider range of instruments and greater leeway in adjusting rates. A number of fiscal instruments are available to capital cities across the region (although they vary from country to country) including personal income tax, property tax, and tariffs on services provided by municipal authorities, including water supply and sewerage. However, any proposed increases in taxes or tariffs will be met with potential opposition and fiscal impacts would need to be carefully considered. Moreover, significant gains may be realized through improving tax administration rather than imposing higher rates. Better investment planning and budget execution can also improve the efficiency and impact of capital investment expenditures.

Expand local administrative capacity

A number of issues identified cannot be resolved by the capital city administration alone. The involvement of other tiers of the government is necessary. To implement reforms, it is essential that city and national authorities adopt a more inclusive governance approach that encourages private sector engagement and that strengthens inter- and intra-governmental coordination, keeping in mind that at all stages the proactive engagement of the local government is a must.

But city administrations by themselves, too, can significantly impact the level of competitiveness Experience of cities and subnational governments around the world shows that city administrations have a very important role in promoting economic development. For instance, there is a growing evidence that even while majority of business environment conditions are regulated at the national level, local reforms can produce results through initiatives like setting up one-stop shops, easing processes of licensing and adjudicating land use restrictions.[17]

BOX 0.3

City administrations have an important role

Examples of successful city initiatives promoting competitiveness can be found across Eastern Europe. A recent review of business regulation practices in Bulgaria, Hungary, and Romania has shown that even though the regulations and procedures are defined nationally there is a great variation among cities in the ease of doing business, and there is a lot that cities can learn from each other to improve their business environment. Improvement is most commonly achieved through improving coordination between various regulatory agencies - like Craiova in Romania did to speed up issuing construction permits. Constanta in Romania, introduced and promoted information technology solutions encouraging a quarter of firms to register online.[18] Sofia attracted R&D investment, including Coca-Cola's second largest research facility globally, built an efficient FDI promotion division, improved IT infrastructure and cultivated tech entrepreneurship. It is now ranked third in Europe in the number of IT start-ups.

Spatial welfare disparities and the challenge of lagging regions

The 2009 World Development Report argues that as economies transform and develop, economic growth is often unbalanced, with some regions growing faster than others. Uneven spatial development is associated with faster growth, due to the productivity benefits of agglomeration. But when output and wealth are highly concentrated territorially, poor people left behind in lagging regions are more likely to face multiple factors of deprivation and thus a more difficult path to escaping poverty. Moreover, these disparities may contribute to low-growth traps for regions and ultimately act as a drag on national growth potential.[19] Particularly for the Western Balkans, increasing disparities across regions raise risks for social and political cohesion.

Addressing spatial disparities in people's welfare does not necessarily imply balancing economic activity across the country but ensuring that people have opportunities regardless of where they live. Providing equitable basic services across space and easier movements of people to thriving areas, along with support to create and take advantage of opportunities in lagging regions, would help all people benefit from the changing economic geography in the Western Balkans and Croatia.

Spatial disparities are large

Differences in household income and consumption are large across subnational regions and between rural and urban areas in all Western Balkan countries.[20] Estimates based on household survey data indicate that the gap in mean income or consumption per capita between the poorest and richest regions in a country could reach 50 percent in Albania, 38 percent in North Macedonia, and 33 percent in Serbia (figure 8). The coefficient of variation in income or consumption between regions[21] in recent years is around 20 percent in Albania, Montenegro, and Serbia putting them among the top third of countries in ECA for disparities across subnational regions and higher than the OECD average of 14 percent.[22] Disparities are similar between rural and urban areas. The rural-to-urban ratio in mean income or consumption per capita is around 70–80 percent in most countries in the region, and the ratios in North Macedonia and Serbia are among the lowest in ECA (figure 9). Poverty rates, at the poverty line of US$5.50 a day (in 2011 purchasing power parity), are also typically higher in rural than urban areas, further illustrating the correlation between residence and welfare.

RATIO OF POOREST TO RICHEST REGION

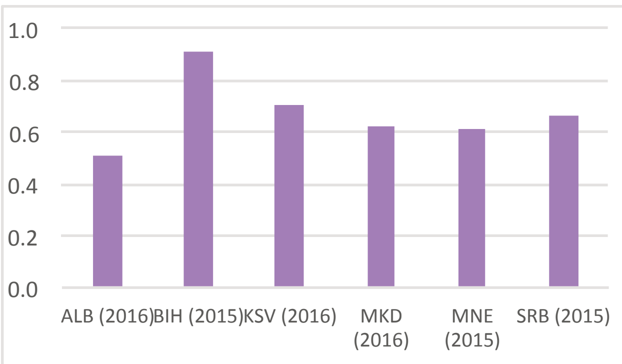


Figure 0.8 The gap in mean per capita income or consumption between the richest and poorest regions is large in the Western Balkans

Source: Based on World Bank harmonized data of household income or consumption for countries in Europe and Central Asia, using European Union Surveys on Income and Living Conditions data for North Macedonia and Serbia and Household Budget Survey data for other countries.

Note: Gap is measured as one minus ratio of mean consumption or income.

a. Data for Bosnia and Herzegovina allow for separating income or consumption only for the Federation of Bosnia and Herzegovina, Republic of Srpska, and Brčko District.

RATIO OF RURAL TO URBAN

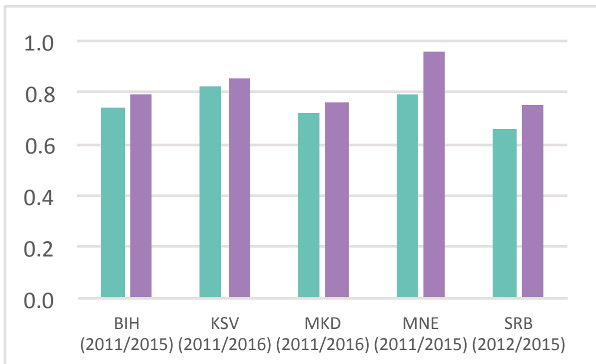


Figure 0.9 The gap in mean per capita income or consumption between rural and urban areas, while narrowing, is also large in the Western Balkans

Source: Based on World Bank harmonized data of household income or consumption for countries in Europe and Central Asia, using European Union Surveys on Income and Living Conditions data for North Macedonia and Serbia and Household Budget Survey data for other countries.

Note: Albania is excluded because household survey data do not include information on the rural or urban locale of households.

a. Data for Bosnia and Herzegovina allow for separating income or consumption only for the Federation of Bosnia and Herzegovina, Republic of Srpska, and Brčko District.

Trends in spatial inequality in household income or consumption across subnational regions are mixed. Disparities in living standards across subnational regions, as measured by the coefficient of variation of average household income or consumption, declined from around 2011 to around 2016 in Albania, North Macedonia, and Serbia and increased slightly in Kosovo and Montenegro. But gaps are still substantial in absolute terms. The coefficient of variation of regional disparities remains higher than ECA averages, particularly in Montenegro and Serbia. And greater polarization is likely in the coming years, as EU accession, demographic factors (low fertility and high outmigration), and skill-biased technology changes are all expected to strengthen the competitiveness of core metropolitan regions at the expense of more peripheral regions.

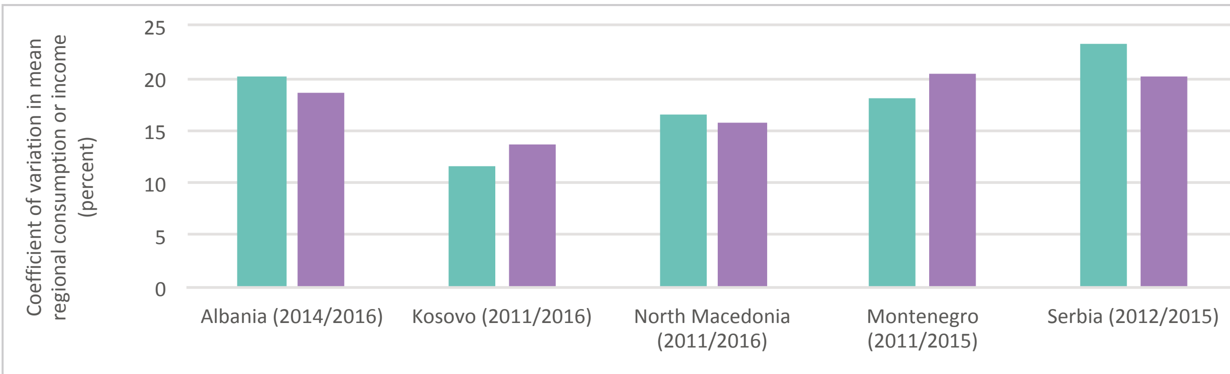


Figure 0.10 Disparities in living standards across subnational regions have declined in some Western Balkan countries but risen in others

Source: Based on World Bank harmonized data of household income or consumption for countries in Europe and Central Asia, using European Union Surveys on Income and Living Conditions data for North Macedonia and Serbia and Household Budget Survey data for other countries.

Note: Regions are at the Eurostat Nomenclature of Territorial Units for Statistics 2 (NUTS 2) level. Bosnia and Herzegovina is excluded because household survey data enable measuring average consumption for too few regions.

All countries have entrenched lagging regions

Which are the regions that are lagging? Looking at the NUTS 3 level and proxying spatial welfare through measures of economic output (GDP per capita) and growth, 10 of Serbia's 25 regions, 7 of Croatia's 21 regions, 6 of Albania's 12 regions, and 2 of North Macedonia's 8 regions are lagging far below the national average on the basis of per capita income ("low income") and another 8 higher income regions are lagging far below average on the basis of growth ("low growth"). And each Western Balkan country and Croatia has at least one region that is both poor and growing slowly (figure 11). These regions include Podunvjle, Raska, and Rasina in Serbia; Polog in North Macedonia; and Kukes and Elbasan in Albania.

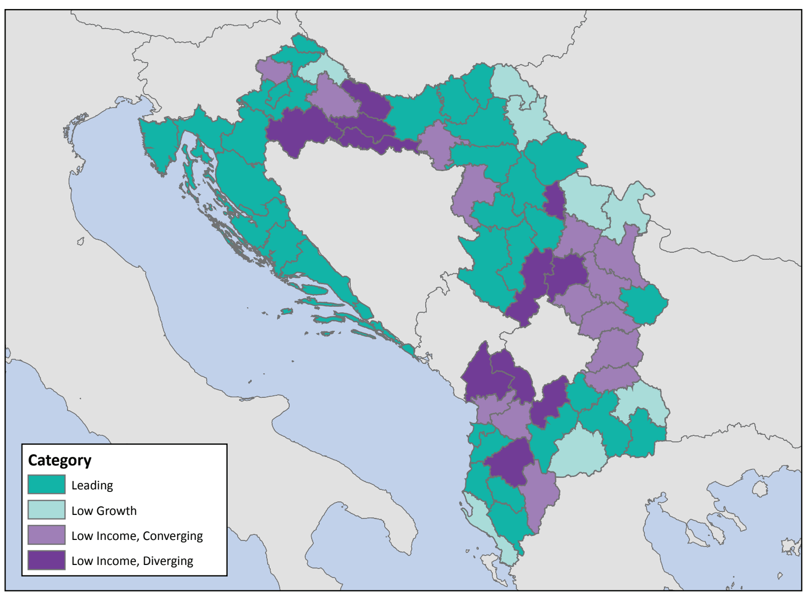


Figure 0.11 Many of the poorest regions in Albania, Croatia, North Macedonia, and Serbia are clustered around the Bosnia and Herzegovina, Kosovo, and Montenegro borders

Source: National Statistics Offices.

Most of the poorest regions are rural and peripheral, though some are adjacent to the leading metropolitan region in all four countries. Many lagging regions of Albania, Croatia, North Macedonia, and Serbia are around regional land borders, with a notable cluster around the borders to Bosnia and Herzegovina, Kosovo, and Montenegro (figure 11).

Raising individual endowments through improved human capital

Differences in individual endowments are an important driver in differences in living standards between regions within the Western Balkans. Education and household characteristics generally accounted for more than half of income or consumption disparities between urban and rural areas (figure 12a), while they account for a smaller but still important share of disparities between richer and poorer regions (figure 12b). In Serbia in particular, differences in endowments account for the majority of welfare differentials across most of the geographic comparisons.

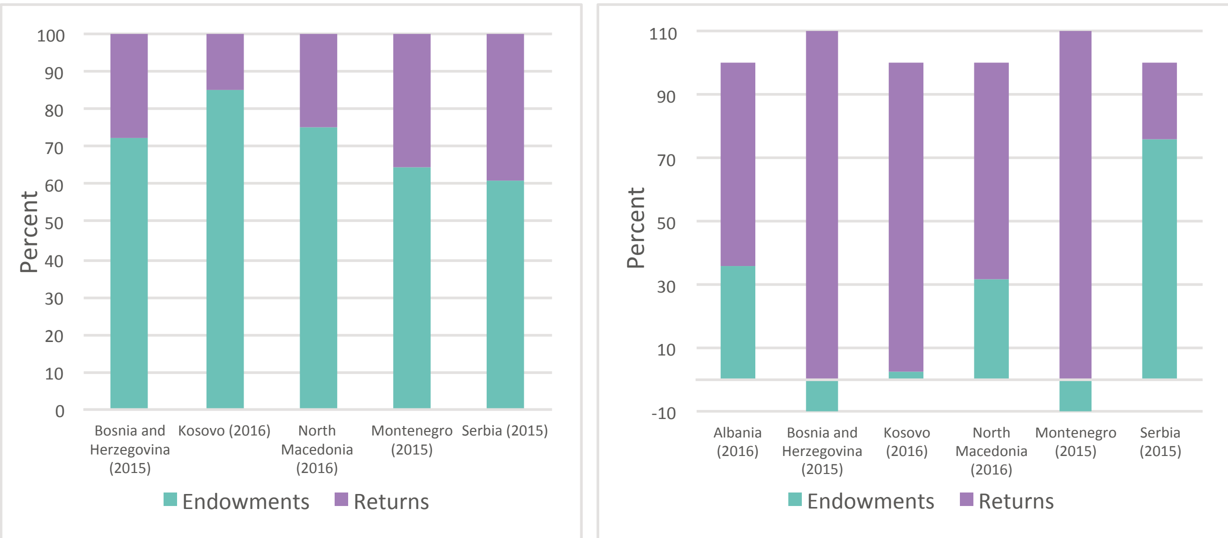


Figure 0.12 Endowments contribute significantly to income differentials between regions

Source: Based on World Bank harmonized data of household income or consumption for countries in Europe and Central Asia, using European Union Surveys on Income and Living Conditions data for North Macedonia and Serbia and Household Budget Survey data for other countries.

Note: Returns refer to returns due to location-specific factors. Richer and poorer subnational regions are those with mean per capita consumption or income above or below the national average. Blinder–Oaxaca decomposition is based on a regression model that includes the following endowments: shares of children, adults, elderly in the household, and variables related to portable endowments of the household head (age, age squared, education level, and occupation). Information on the occupation of the household head and on rural or urban residence of households was not available for Albania.

Gaps in endowments across regions are driven mostly by large differences in educational outcomes. In Albania, for example, nearly 60 percent of the adult population in low-income lagging regions has a lower secondary education or below, compared with just over 50 percent in leading regions; the tertiary education rate is almost 25 percent higher in leading regions and more than double in Tirana These human capital deficits in lagging regions result from poorer education outcomes, amplified by spatial sorting as the most skilled workers migrate from lagging to leading regions. Lower education outcomes in lagging regions result not just from individual choices to invest less in education, but also from poorer education quality. Results from standardized student tests show substantially lower performance for students in remote rural areas even when controlling for the socioeconomic profiles of students.

Removing barriers to labor mobility

As the Western Balkans work to enhance the competitiveness of their cities and boost productivity in the coming years, wage differentials between urban and rural areas are expected to rise as a result, making internal labor migration attractive. Reducing barriers to internal labor mobility can lessen labor market frictions and help people from different areas of a country maximize their returns to human capital by moving to locations with greater economic opportunity.

Except for Albania and Kosovo, the internal movement of people is lower in the Western Balkans than in other transition economies. The share of people who have ever moved from one part of a country to another is highest in Kosovo (53 percent) and Albania (45 percent).[23] The share is below 30 percent in Montenegro, North Macedonia, and Serbia. Skills, social benefits, urban policies, housing and credit markets, subnational policies, information and networks, and labor market institutions can all act as barriers to internal labor mobility in ECA. A recent case study for Serbia, for example, found that housing market, liquidity constraints, and weak coordination of employment services across localities appear to be important barriers to labor mobility.

Strengthening and leveraging place-specific endowments

Location factors are significant, and call for tailored regional development strategies

As shown, location-specific factors explain a significant share of welfare disparities, particularly between richer and poorer regions. In other words, for individuals with a similar endowment in human capital, the characteristics of where they live can greatly affect their ability to earn income. Differences in returns can be linked to gaps in market size and market access, basic service provision, economic infrastructure, the local business environment, and institutions.

Targeted development strategies can maximize regional potential by building on regional endowments while improving service delivery to ensure social equity. An effective strategy recognizes that not all regions have the same development prospects and thus starts with the explicit objective of maximizing the potential of each region based on its unique capabilities.[24]

Structural factors shape regional economic potential and help define priorities

Structural factors—particularly population and economic density (determining the potential for agglomeration) and distance (scale of accessible markets)—shape regional potential. Population sparsity is the most common structural feature of lagging regions in the Western Balkans and Croatia, where virtually all lagging regions, and four of every five regions[25] overall, are below EU average density (figure 13).

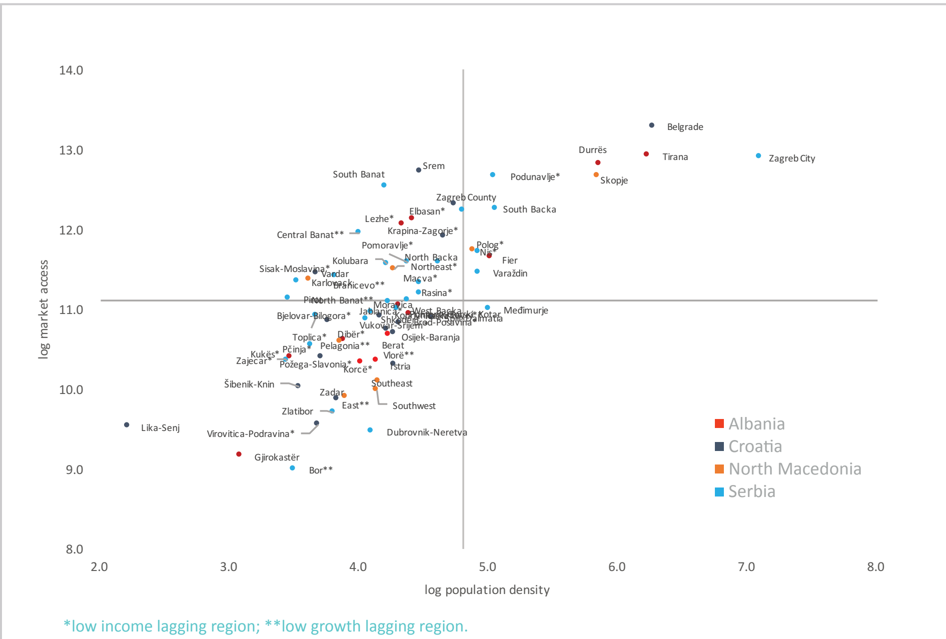


Figure 0.13 Population sparsity is the most common structural feature of lagging regions, latest year available

Source: World Bank Geospatial Operations and Support Team and UN DESA (2017).

Note: The X axis crosses at Western Balkans and Croatia NUTS 3 region average market access; the Y axis crosses at EU average NUTS 3 region population density.

These structural conditions determine the scope of opportunity for regions, and help define set of policy priorities appropriate for different types of lagging regions:

- *Densely populated, centrally located regions.* These regions are unlikely to be lagging unless they are in the very early stages of integration (poor regions that will converge rapidly). Indeed, just 2 of the 11 densely populated central regions—Polog in North Macedonia and Podunavjle in Serbia—are categorized as lagging regions. These regions are likely lagging as a result of serious government failures or major institutional weaknesses or conflicts. Place-based interventions for these regions would be limited to addressing government and institutional failures.

- *Densely populated, peripherally located regions.* These are the regions where typical place-based policies may be most relevant. Market and government failures may be creating distortions that result in under-investment, while coordination failures may be preventing agglomerations from emerging. This the most common category for lagging regions in the EU. But only one region, Mediumurje in Croatia, is classified as both dense and peripheral.

- *Sparsely populated, peripherally located regions.* These regions, which make up the majority of lagging regions in the Western Balkans and Croatia (along with many non-lagging regions), face substantial structural constraints that likely limit their development potential. Place-based development policies should be deprioritized in favor of policies to enhance equality of opportunity, specifically by developing institutions to support social services, with a focus on human capital accumulation. Niche sectoral development based on fixed territorial endowments (natural resources, tourism) may also offer opportunities, along with policies to support agricultural transformation.

- *Sparsely populated, centrally located regions.* These regions, around half of which are lagging and the other half non-lagging, are typically close to larger agglomerations, so the priority is to improve the connectivity of the region to the agglomeration. Place-based policies may also be relevant. The challenge is that limited agglomeration potential means that specialization is likely to be particularly important, which raises the typical risk inherent in industrial policies that aim to pick winners.

In line with these priorities, policymakers can promote density and accessibility alongside endowment-building through human capital and institutional development by following the principles of the three Cs outlined at the beginning of this report.

CONCENTRATE

Cities can be growth engines in lagging regions with agglomeration potential

Leveraging urbanization is not only about capital cities; it is also relevant for the lagging regions agenda. Research in Romania found that many secondary cities, including some in lagging regions, have large productivity premia and function as magnet cities, attracting migrants from the regional hinterlands.[26] Despite low overall density, some lagging regions in the Western Balkans have sizable urban concentrations—for example Elbasan and Shkoder in Albania and Niš, Novi Pazar, and Zrenjanin in Serbia. And as shown, secondary cities on the whole have performed relatively well in the Western Balkans in recent years. For secondary cities with the potential to be regional growth poles, a short-term priority is to ensure adequate infrastructure quality to support private investment. But it is equally important to strengthen cities' dynamism to retain the skilled youth population. This requires investing in city amenities, including good quality, affordable housing and cultural infrastructure, and leveraging the potential of universities to attract and retain youth and support research and innovation.

CONNECT

Closing infrastructure service delivery gaps and connecting to market opportunities address both growth and equity priorities

Ensuring equitable access to high-quality public services, through both infrastructure provision and service delivery, is the most important priority for connecting individuals to opportunities regardless of where they live. Yet, differences remain large in access to public services across subnational regions. In Albania, for example, access to water supply varies from 47 percent of households in Durres County to 88 percent in Shkoder County. Across the Western Balkans, some poorer localities manage to achieve higher than average outcomes (for example, Kamez municipality in Albania and Novi Pazar in Serbia), while some wealthier localities have weaker service provision. This variation suggests that factors other than local income, such as local institutional capacity or redistributive government financing, can strongly influence basic service provision.

Connective infrastructure is also central to increasing returns in lagging regions. For sparsely populated central regions, improving connectivity with large agglomerations can open opportunities for product and labor market integration. This includes linking to capital cities, but also to wider regional markets (box 4). For sparse and peripheral regions, connecting to agglomerations is also important. But efforts to close the large connectivity gaps need to avoid emphasizing costly transport infrastructure without a clear understanding of the expected costs and benefits, and a plan for sustainably financing maintenance. Moreover, in many sparse and peripheral lagging regions, addressing the large gaps in intraregional connectivity, including the maintenance of secondary road networks, may be a higher priority.

BOX 0.4

Connecting to opportunities in the region by overcoming border frictions

While integrating into European value chains is a key channel for the economic transformation of the Western Balkans, taking advantage of trade opportunities among countries within the region is a starting point. And it may be particularly important for lagging regions, which tend to specialize in sectors (agriculture, tourism, other services) which are most often traded regionally.

Intraregional trade in the Western Balkans is low and relatively stagnant. One reason is that traders face large border frictions that raise the time and cost of cross border trade. Delays at border crossings are five times longer than in many EU countries. These border frictions have a particularly pernicious effect on regions that are already lagging (box figure 1).

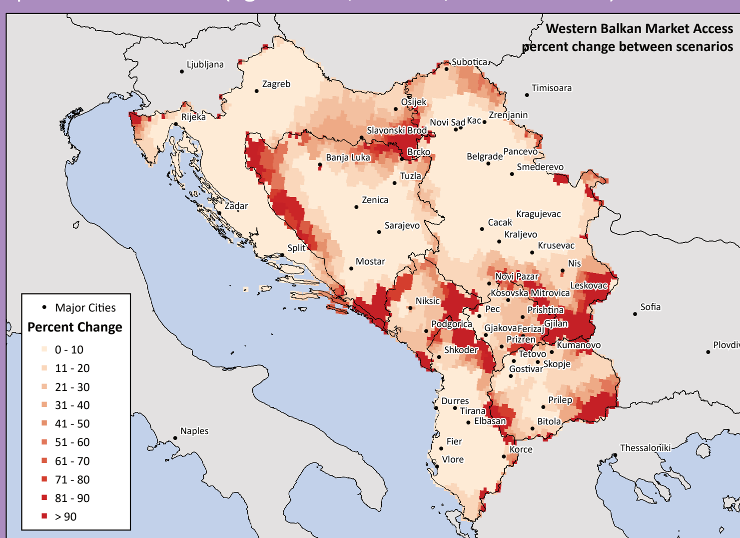


Figure BO.4.1 Many border regions face greatly reduced market access as a result of border frictions, 2018

Source: World Bank Geospatial Operations and Support Team.

Note: Figure depicts difference (percentage change) in market access between a 'no border' scenario and a scenario that takes into account average delays at each border.

Expand tradable sectors in lagging regions to support productivity growth and job creation

Long-term underperformance in the EU's lagging regions, particularly in Southern Europe, has been attributed to their failure to develop competitive tradable sectors.[27] Similarly, in the Western Balkans, lagging regions are characterized by specialization in low productivity non-tradable sectors, and weak firm competitiveness. In most lagging regions of the Western Balkans, three-quarters or more of output is concentrated in sectors with typically low productivity growth.

Developing competitive, tradable sectors in lagging regions may involve both facilitating foreign direct investment (FDI)—as Central Banat has done through developing competitive industrial parks—and strengthening the local enterprise base. Ideally, these are complementary initiatives, with FDI bringing supply chain opportunities and new technologies that can help upgrade enterprises. Finally, failure to coordinate effectively across territorial units or sectoral initiatives can undermine the benefits of tradable sector development. For example, initiatives targeting agriculture and nature tourism in lagging regions in Albania are often at odds with other development initiatives built around natural resource extraction.

CAPACITATE

Alongside broad investments to raise human capital outcomes in lagging regions discussed earlier in this section, ensuring effective institutions to develop lagging regions requires strengthening national institutional structures to support regional policymaking and local government capacity and service delivery.

Make better use of regional development institutions

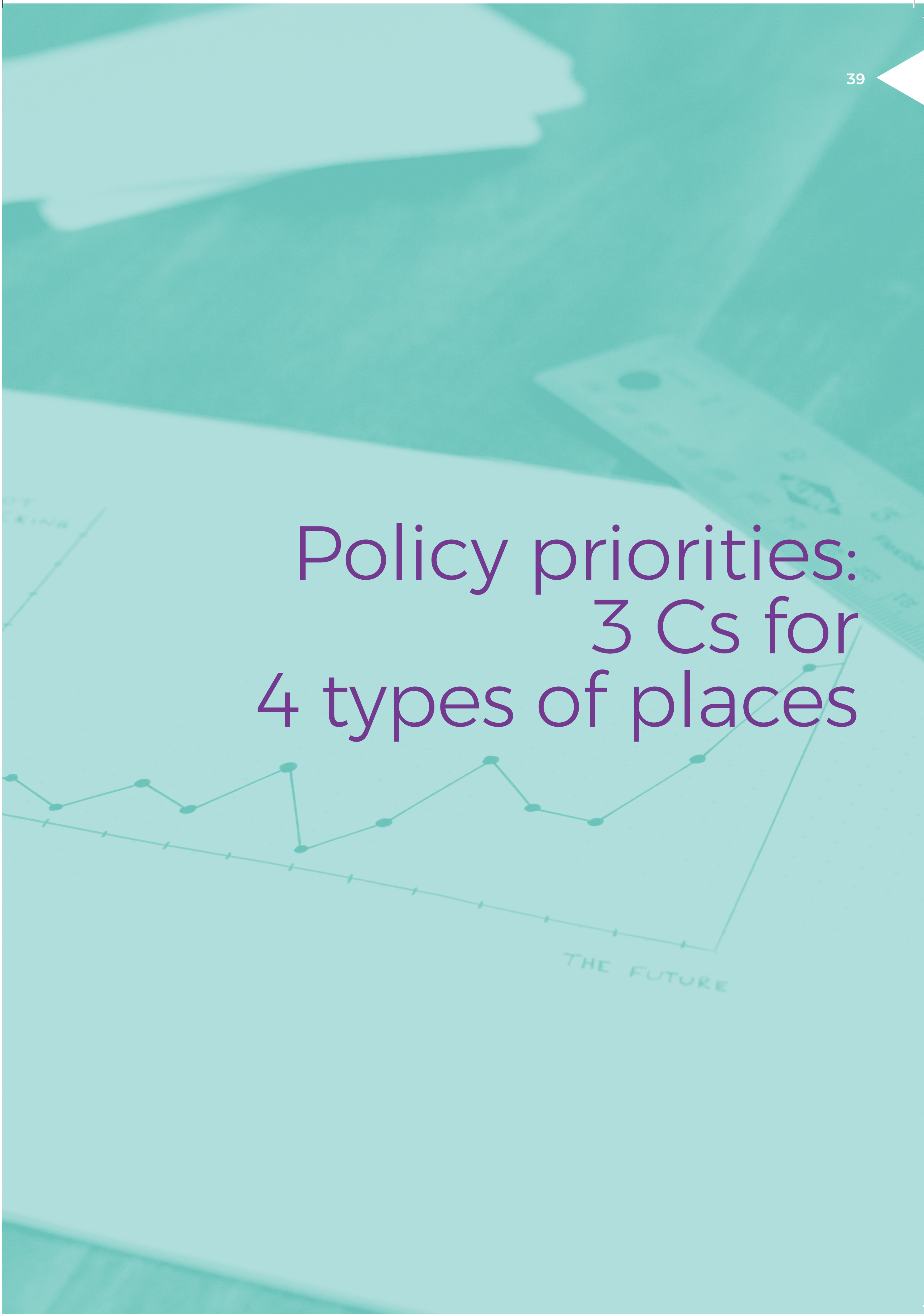
Regional development institutions are common in the EU, which allocates substantial resources along regional lines. Regional institutions can improve the identification of development needs and the coordination of service delivery and can support local governments by coordinating across multiple local authorities. They also allow for investment in specific technical capacities that may be unavailable to local authorities.

While the Western Balkans have tried to develop some regional capacities, the approach to regional development remains centralized and top-down. Albania and Serbia have developed useful institutional capacity to support the regional development agenda, but important shortcomings in the approach to regional development may limit its effectiveness.

Improve the technical and financial capacity of local governments

Local governments are critical in delivering on the core objectives of growth and equality of opportunity, through their role in supporting the environment for private investment, connectivity, and social services delivery. In the Western Balkans, local governance institutions are weak, especially in lagging regions. Moreover, their capacity to address the challenges of development is often further constrained by a lack of access to technical and financial resources to support local development.

A high priority across the Western Balkans is to strengthen the technical capacity of local governments to develop and manage economic and investment plans and public financial management. This can be supported through adopting performance-based budgeting, which links financing to outcome-based delivery targets rather than simply to spending, and by introducing and strengthening independent monitoring of projects. Beyond financing, the centralized development models common in the Western Balkans limit the ability of regions to direct their own development path. Having some control of regional endowments in the hands of local and regional authorities may enable them to identify niche opportunities and implement strategies to exploit them.



Policy priorities: 3 Cs for 4 types of places

The challenges faced by the leaders (capital city regions, some secondary cites) and the laggards (sparse and peripheral or stagnating areas) require different policy responses for achieving inclusive growth. The largest cities are facing a tough challenge of entering competition with cities of Western Europe and identifying their position at the top end of the global value chains. To increase productivity and lead countries into the high-income status, capital cities need to identify and nurture their competitive advantages for high value-added economic activities, while also creating an environment that attracts both investors and talent and supports innovation. At the same time, national capitals are facing typical issues of urban growth: pressure on underfunded infrastructure, unaffordable housing (Belgrade) and emerging pockets of urban poverty (Skopje). Lagging subnational regions, by contrast, should not be expected to be growth leaders and should first be empowered and well-resourced to provide services to the population. But even peripheral areas often have assets with a certain economic potential that are underused due to various constraints related to governance, market, or coordination failures.[28]

To ensure inclusive growth across the portfolio of leading and lagging regions, policymakers can follow the basic principles of 3 Cs, tailored to the needs of individual regions (box 5).

BOX 0.5

The 3 Cs—Principles for supporting a portfolio of places in the Western Balkans and Croatia

- ***Concentrate*** resources on leading city-regions to drive national growth, and support secondary cities to become growth centers that expand opportunities to their hinterland.

- ***Connect*** people and places to opportunities, by developing competitive tradable sectors to leverage the comparative advantages and cities and regions, integrating enterprises into local, regional, and global markets, and delivering high quality public services to citizens regardless of where they live.

- ***Capacitate*** local governments by strengthening financial and technical expertise and improving local planning, coordination, and governance, while investing to raise human capital to ensure that citizens can take full advantage of their potential regardless of where they are born.

Policymakers can develop and prioritize policies across the portfolio of places that can simultaneously position cities to act as drivers of economic growth, increase productivity, and create jobs, while also ensuring that lagging regions are not left behind as trends in demographics, technology and integration with the EU further push to concentrate population and economic activity in fewer places (table 1). The priorities presented here are meant to provide broad guidance rather than specific policy advice, for which design and sequencing would vary from country to country and from region to region.

Across cities, the priority is to concentrate resources on capitals- to unlock the benefits of agglomeration and reduce congestion. Governments can give impetus to population and economic concentrations by reducing domestic barriers, such as gaps in human capital and connectivity, easing restrictions in labor and housing markets, and reforming policies that prevent people and businesses from moving to areas of greater opportunity. Higher concentrations of urban populations and economic activities, if well managed, can support the emergence of agglomeration economies in larger cities. As populations concentrate in larger cities, however, some smaller cities will likely experience an abrupt decline, and that will also need to be managed.

For lagging regions, policymakers should focus on strengthening endowments and removing distortions that prevent the formation of productive agglomerations. Cross-cutting interventions can be supported by well-targeted sectoral interventions to accelerate the development of tradable sectors. For more centrally located regions, policies should emphasize strengthening secondary cities to attract investors in tradable sectors and to induce high-skilled jobs and innovation. For more peripheral and sparsely populated regions, policies should emphasize service delivery of critical economic and social infrastructure and implementing sectoral niche initiatives that leverage regional endowments. Above all, and for all types of lagging regions, investment in human capital will be critical to boost growth potential, to strengthen the assets of individuals in lagging regions to enable them to exploit opportunities wherever they may be found. Three typical types of cities are considered below when outlining general policy directions—capital city regions; secondary cities and small shrinking cities. For lagging regions, the focus is on low-income, mainly sparse, peripheral regions and low-growth regions with agglomeration potential, the two most common types of regions in the Western Balkans and Croatia.

Table O.1
Broad guidance for policy possibilities

	CAPITAL CITIES AND SECONDARY CITIES	SMALL/DECLINING CI
CONCENTRATE	Invest in urban amenities that will attract and retain residents Upgrade aging public infrastructure that will ensure the reliability and quality of services required to keep congestion at bay Expedite land reforms and legalization of property rights (Mainly capital cities) Improve land administration and upgrade tools for better functioning housing and land markets both for firms and people (Mainly capital cities)	Be cautious not to 'over invest' (e.g. in fixed infrastructure) in trying to 'reverse' decline and avoid undue fiscal burdens Manage the population decline in accordance with the changing demographic and their needs (such as aging cities) and use, as applicable, active densification/compact city strategies
CONNECT	Enhance the presence and performance of high value-added tradable service sectors through both vertical and horizontal interventions Advance business dynamism by creating a favorable regulatory environment Improve access to finance by distinguishing MSME's as a separate category of borrowers Connect secondary cities with large agglomerations/capital city regions and with their hinterlands (Mainly secondary cities)	
CAPACITATE	Enhance the entrepreneurial skills of business managers and owners and incentivize greater business innovation and digitization Address the skills gap through better coordination between universities, private and public sector Make better use of local planning and development instruments that will facilitate denser cities and better manage that density for effective outcomes Consider options for increasing own-source and discretionary finance and provide larger cities with more authority to increase revenues, and access other forms of finance (PPS, capital markets) Improve coordination mechanisms across jurisdictions for inter-municipal and intergovernmental cooperation and coordination (most capital cities include peripheral urban municipalities) Expand and build dialogue between the public and private sectors by creating processes and platforms to ensure regular, proactive, and constructive private sector engagement	

CITIES

Ensure a basic level of infrastructure and urban services

Close gaps in basic services between individuals

Ensure quality foundational education and health to provide necessary endowments for access to opportunity

Enhance the capacity of local governments to develop and implement smart decline strategies as exemplified by global best practices

LOW-INCOME (MAINLY) SPARSE AND PERIPHERAL REGIONS

Emphasize efficiency of investment in public infrastructure and social services

Encourage regional development strategies/agencies/funds monitoring and cooperation between municipalities for coordination of investment

Target niche sectoral development in existing sources of comparative advantage

Beyond roads, close gaps in access to key infrastructure and social services between individuals

Be cautious not to 'over invest' in large-scale, expensive connectivity that may not yield the expected returns

Reduce border frictions to support regional trade

Ensure coordination of development initiatives across sectors (such as agriculture/natural resources/tourism)

Elevate human capital—ensure quality foundational education and health to provide necessary endowments for access to opportunity

Strengthen the technical capacity of local governments to develop and manage economic and investment plans, financial management, and budget transparency

Encourage labor mobility by removing constraints (such as housing and employment coordination)

Target niche sector development in areas of comparative advantage and enhance productive capacity with access to finance

Ensure coordination of development initiatives across sectors such as agriculture/natural resources/tourism

LOW-GROWTH REGIONS WITH AGGLOMERATION POTENTIAL

Invest in urban infrastructure and amenities, primarily in secondary cities/towns to attract and maintain population in the region

Leverage regional endowments such as universities

Connect these regions and their secondary cities/towns with large agglomerations/capital city regions

Attract foreign direct investment in regional and EU value chains and develop local supply linkages

Promote innovation and entrepreneurship in high potential secondary cities by leveraging universities, developing regional knowledge networks, and supporting growth-oriented SMEs

Strengthen capacity for vocational training and sector-specific skills development

Leverage regional endowments such as universities

Build local government capacity to plan, finance and manage investment

Consider options for increasing own-source and discretionary finance in medium-sized cities

Improve vertical coordination between national and local governments, including, where applicable, regional development agencies

Encourage economic diversification through sector linkages and between regional urban centers and surrounding municipalities

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Endnotes

[1] World Bank 2017b.

[2] Ibid.

[3] Comparator countries include Bulgaria, Slovak Republic, Estonia, Georgia, and Slovenia. Data from Oxford Economics, 2016.

[4] World Bank 2017b.

[5] Restrepo et al. 2017.

[6] Estimations from data provided by National Statistics Offices of Croatia, North Macedonia, Serbia and Albania (at the NUTS 3 level).

[7] World Urbanization Prospects 2018.

[8] Although there are also some secondary cities also growing in population.

[9] The same picture—capital cities not performing as expected of leading regions—appears repeatedly across various data datasets and different periods of analysis. Findings of night-time lights data, which takes into account a longer time period along with the analysis of data from the national statistical offices of the Western Balkans and Croatia and the Oxford Economics global dataset, all indicate the same conclusion.

[10] World Bank 2010.

[11] World Bank 2017b.

[12] The average difference in annual employment growth was only 0.15 percentage points between capital city employment growth and rest-of-the-country employment growth in the Western Balkans and Croatia, while it was 1.2 percentage points in the average comparator country

[13] Enterprise Survey 2013.

[14] Duranton and Puga 2004.

[15] Bartlett 2013.

[16] Honorati et al. 2018.

[17] White 2016.

[18] The World Bank 2017a.

[19] Farole, Rodríguez-Pose, and Storper 2011

[20] For this analysis of spatial welfare, Croatia is not included.

[21] Regions correspond largely to the Eurostat Nomenclature of Territorial Units for Statistics 2 (NUTS 2) level or to the way the regions are defined in the Household Budget Survey. There are 12 regions in Albania, 3 in Bosnia and Herzegovina, 7 in Kosovo, 8 in North Macedonia, 3 in Montenegro, and 4 in Serbia in the household survey dataset.

[22] Bussolo et al. 2019. At the NUTS 2 level.

[23] EBRD 2016.

[24] Barca 2009; Farole, Goga, and Ionescu-Heroiu 2018.

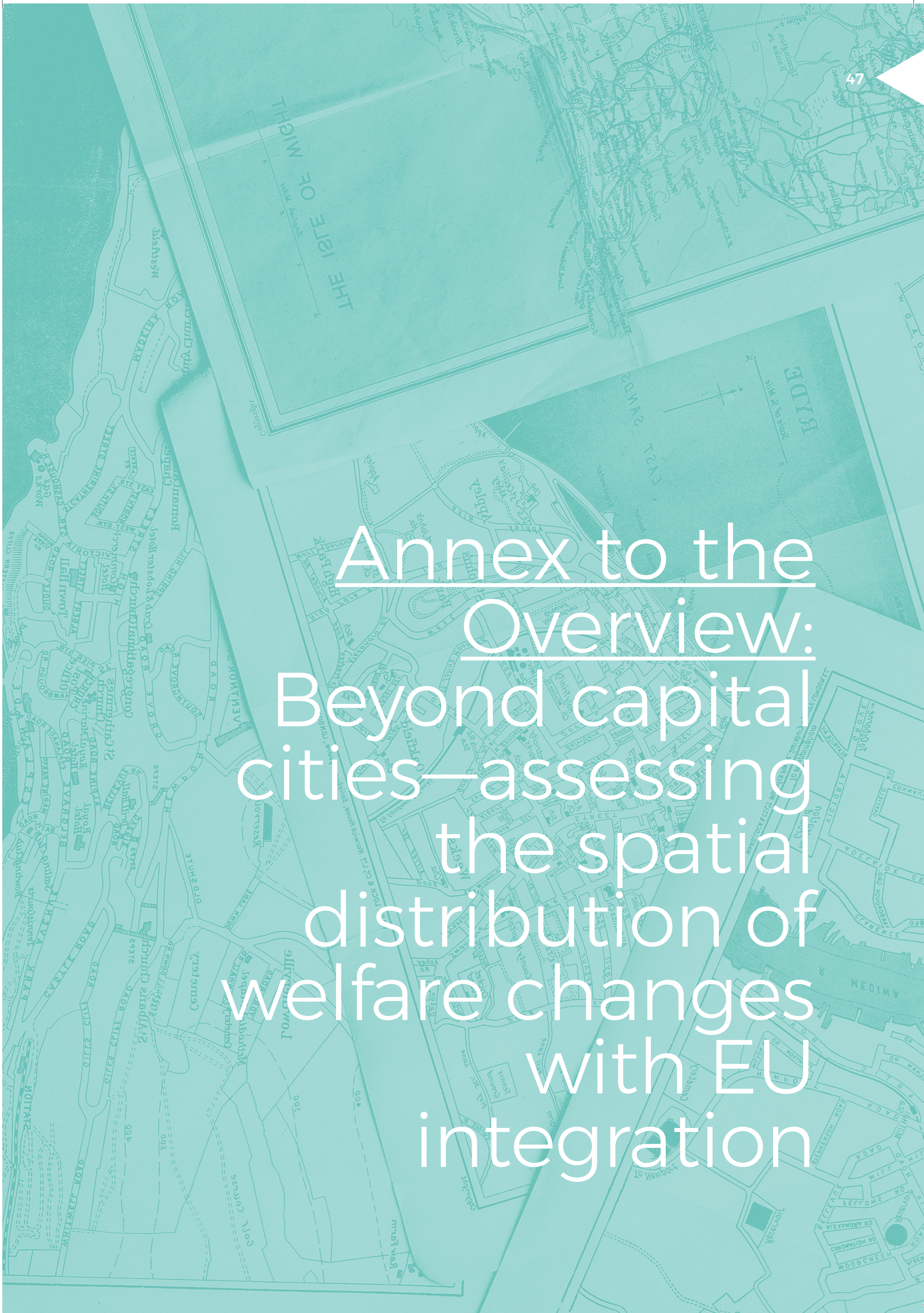
[25] The countries considered for this part of the analysis include Albania, Croatia, North Macedonia, and Serbia.

[26] Cristea et al. 2017.

[27] OECD 2018; Farole, Goga, and Ionescu-Heroiu 2018.

[28] Farole, Goga, and Ionescu-Heroiu 2018.

[29] Waiting times at direct EU borders are assumed to be reduced to zero with EU integration, and border times between the Western Balkans and Croatia are assumed to be cut in half.



Annex to the Overview: Beyond capital cities—assessing the spatial distribution of welfare changes with EU integration

EU integration represents a huge opportunity for the Western Balkans and Croatia, and one that should result in large net gains in welfare over time. However, the distribution of these welfare gains is unlikely to be even across geographical areas. To understand the spatial impacts of EU integration, a general equilibrium model was calibrated for Bosnia and Herzegovina, Montenegro, and Serbia. Because economic integration often brings both gains and losses, and because different regions may be affected differently, analyzing the implications of greater EU integration requires a general equilibrium approach. Moreover, a spatial general equilibrium model can measure total welfare gains and losses, helping to understand the aggregated effects that a change has on welfare—in this case, greater integration with the European Union.

Two interventions to improve EU integration are considered in the model: improving regional transport corridors, and reducing border impediments between countries and with EU countries.[29] The model also incorporates a complementary policy of improving amenities in selected cities to make them more attractive to people and firms. And it assesses how moving costs affect the welfare impacts of interventions by comparing situations where the cost of moving within the country is expensive to one where the cost of moving is much lower.

For overall welfare gains and spatial disparities, the model underscores the important role that investing in cities and reducing mobility costs can have on improving welfare. The key takeaways:

- *Reducing border impediments and improving roads appear to have a larger effect on a country's welfare than just improving roads.* For Serbia, with high moving costs, reducing border frictions in addition to improving roads leads to an estimated welfare gain of 3 percent, while improving roads alone leads to a gain of 1 percent.

- *National welfare is maximized when domestic mobility costs are low.* In Serbia, EU integration increases welfare by an estimated 3 percent when mobility costs are high but by 14 percent when costs are low. Results are similar for Montenegro, with welfare increasing from 6 percent to 12 percent, and Bosnia and Herzegovina, with increases from 2 percent to 12 percent.

- *Complementary policies such as increasing the attractiveness of cities seem to be key to achieving the highest welfare outcomes.* While EU integration policies usually focus on improving transport connectivity and reducing border frictions, increasing amenities—such as schools, other social services, and cultural and recreational facilities—in a subset of cities, along with improving roads and reducing border impediments, also appears to lead to a large reduction in spatial inequalities in real wages by contributing to higher mobility. Under the high-moving-costs scenario, this combination of policies resulted in an estimated reduction in the coefficient of variation of real wages of −5.27 percent in Montenegro, −3.54 percent in Bosnia and Herzegovina, and −3.03 percent in Serbia.

- *Road and border improvements have a low impact on workers' market access.* As expected, the only policy that appears to have a large effect on reducing disparities in access to opportunities is reducing the costs of moving. It is also important to highlight that under the high-moving-costs scenario, an improvement in urban amenities appears to increase disparities in access to opportunities in the case of Montenegro. This does not happen in the low-moving-costs scenario.

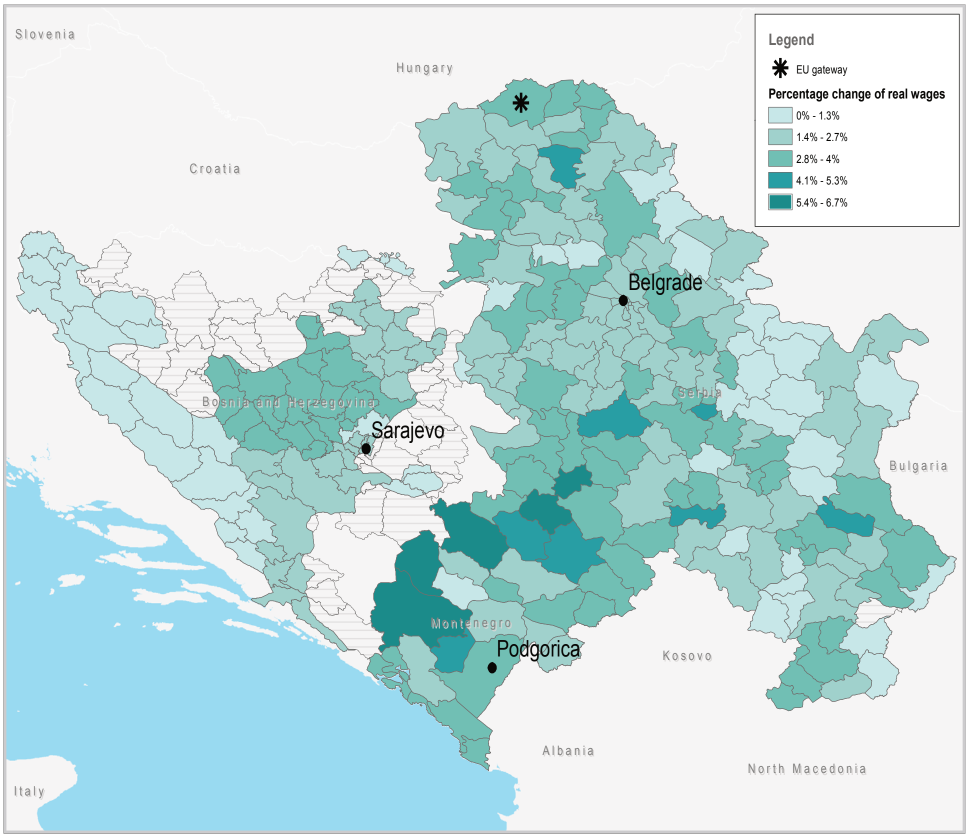


Figure OA.1 Percentage change in real wages: Road improvements only

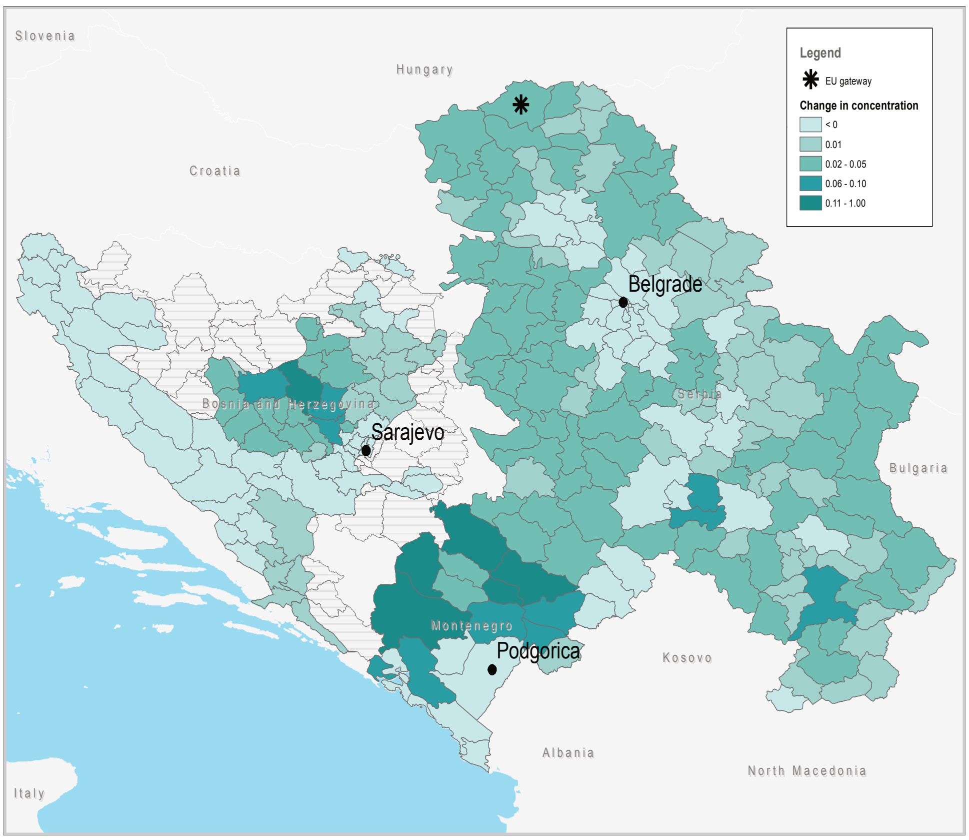


Figure OA.2 Percentage change in real wages: Road and border improvements

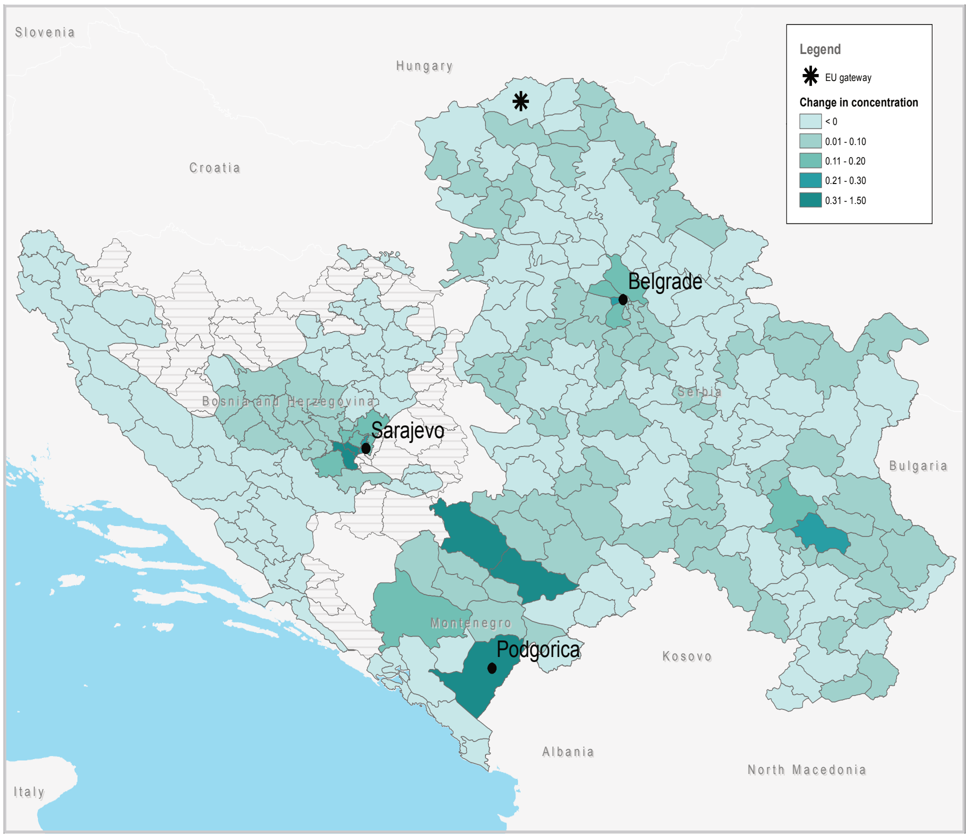


Figure OA.3 Change in population concentration: Road and border improvements only

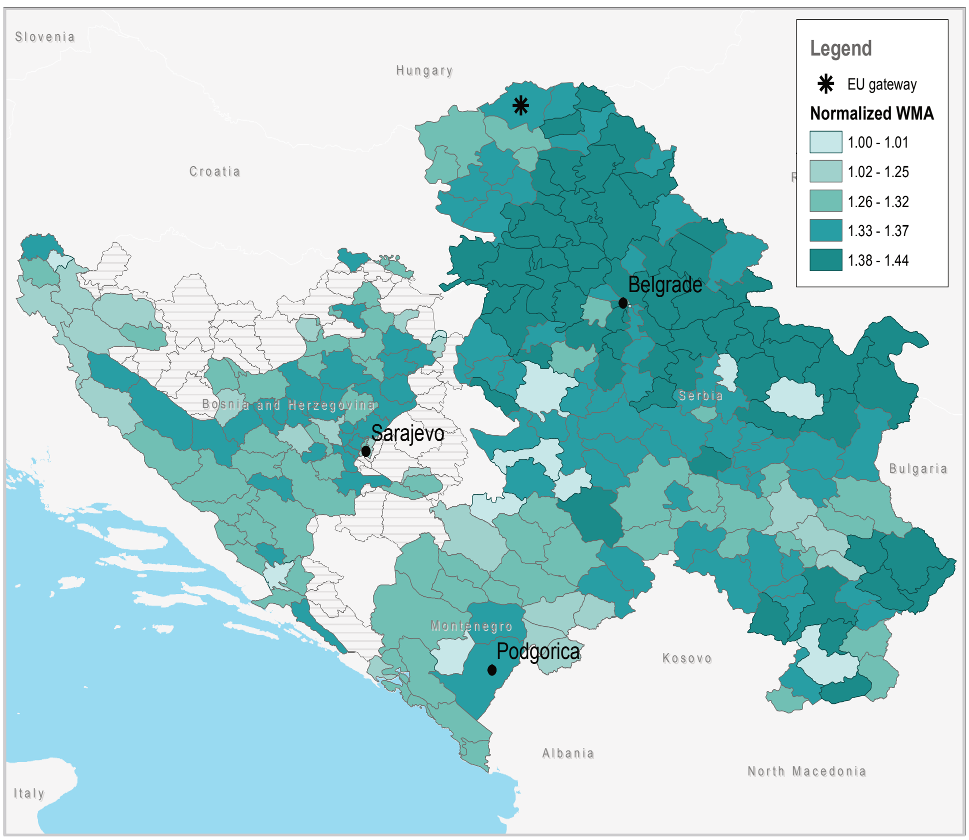


Figure OA.4 Change in population concentration: Road, border, and amenity improvements

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