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WESTERN BALKANS & CROATIA

URBANIZATION AND TERRITORIAL REVIEW

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Western Balkans and Croatia

Urbanization & Territorial Review

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1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

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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 cities; 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-poor¹. 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 countries³. 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** 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.

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

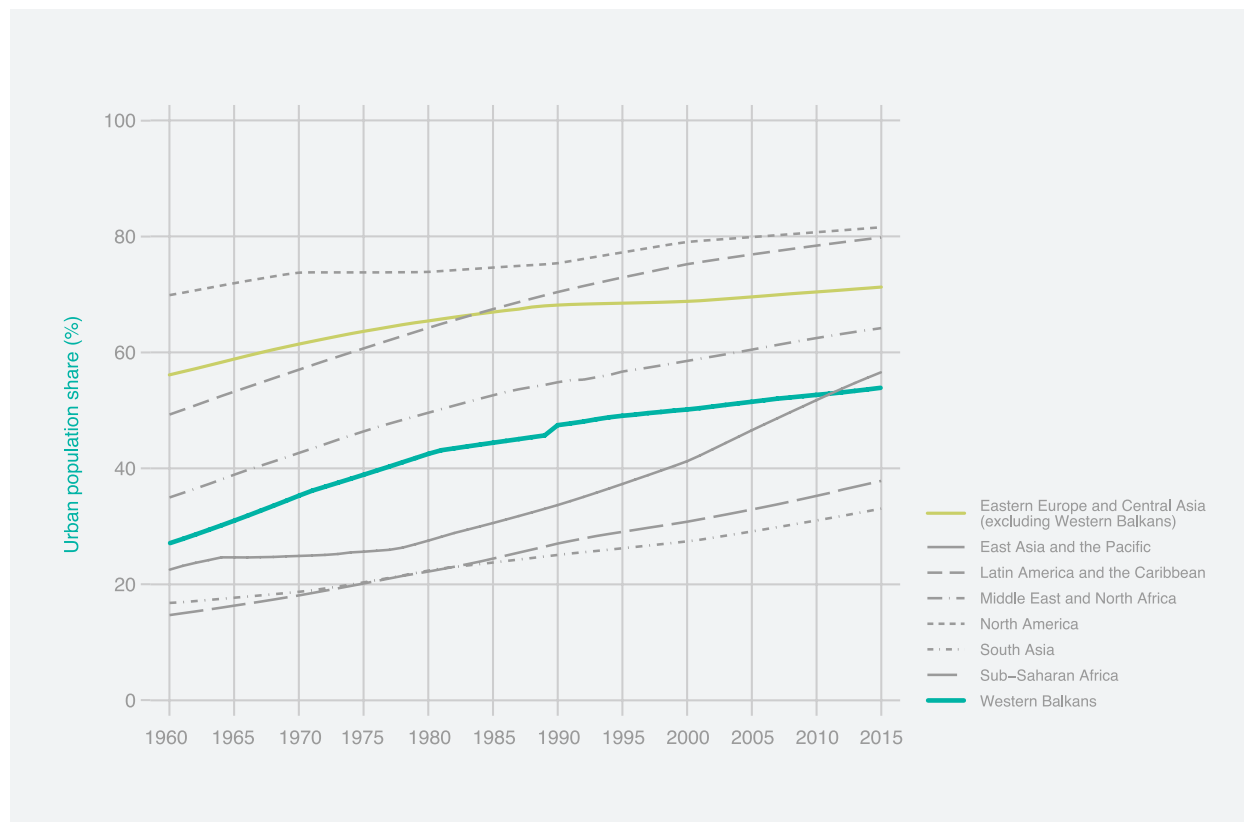


Figure O.1 Since the 1990s, urban share of the population has stalled at a relatively low rate of urbanization

Source: World Development Indicators 2018.

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

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.

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.

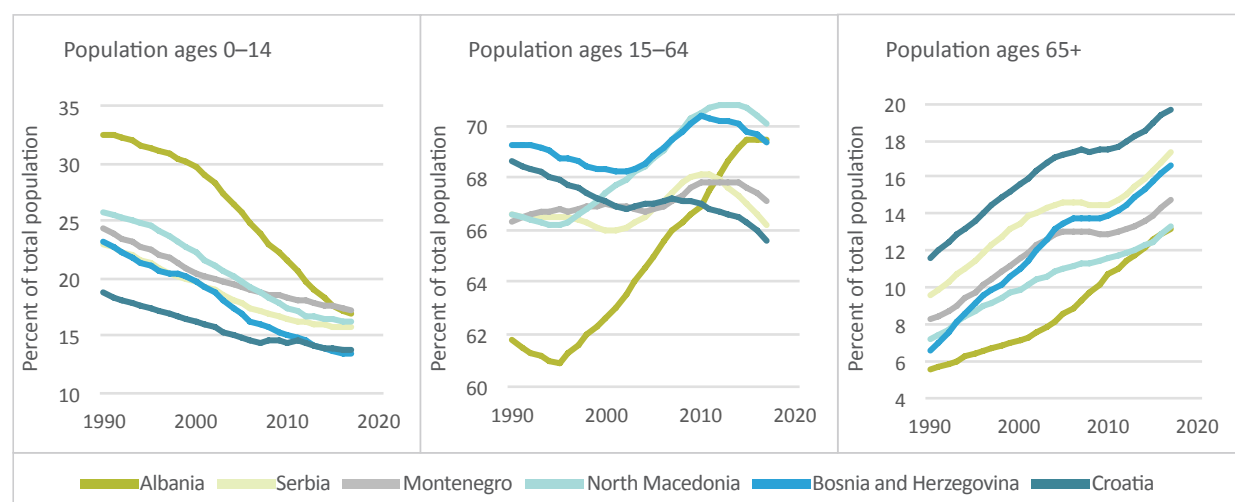


Figure O.2 Rapid demographic changes in the Western Balkans are leading to a shrinking working age population and an expanding old age population, 1990–2015

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.

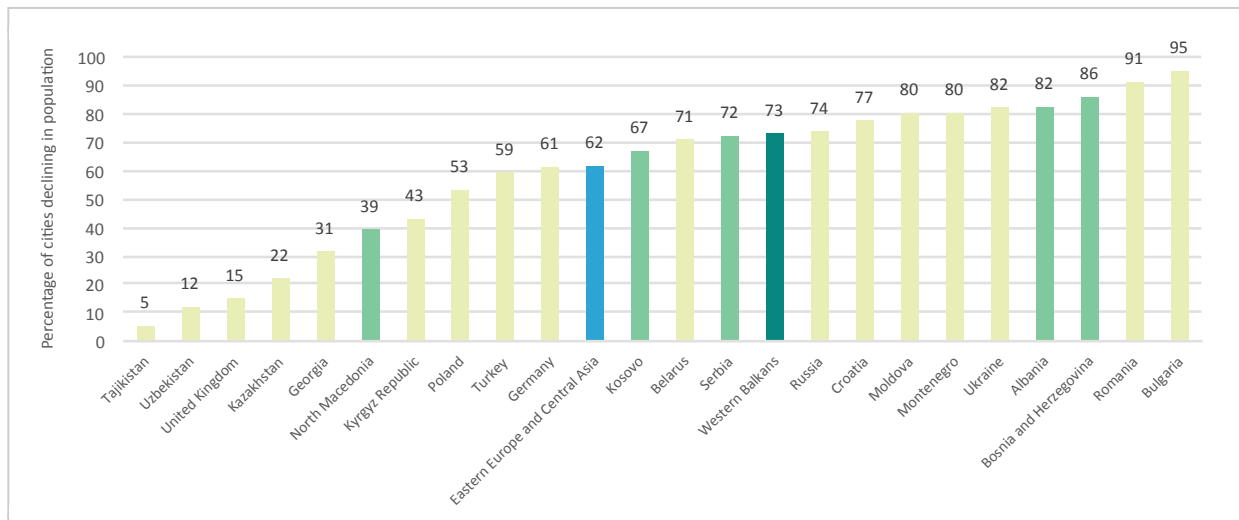


Figure O.3 Many Western Balkan countries are losing population in their cities, 2000–10

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 O.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

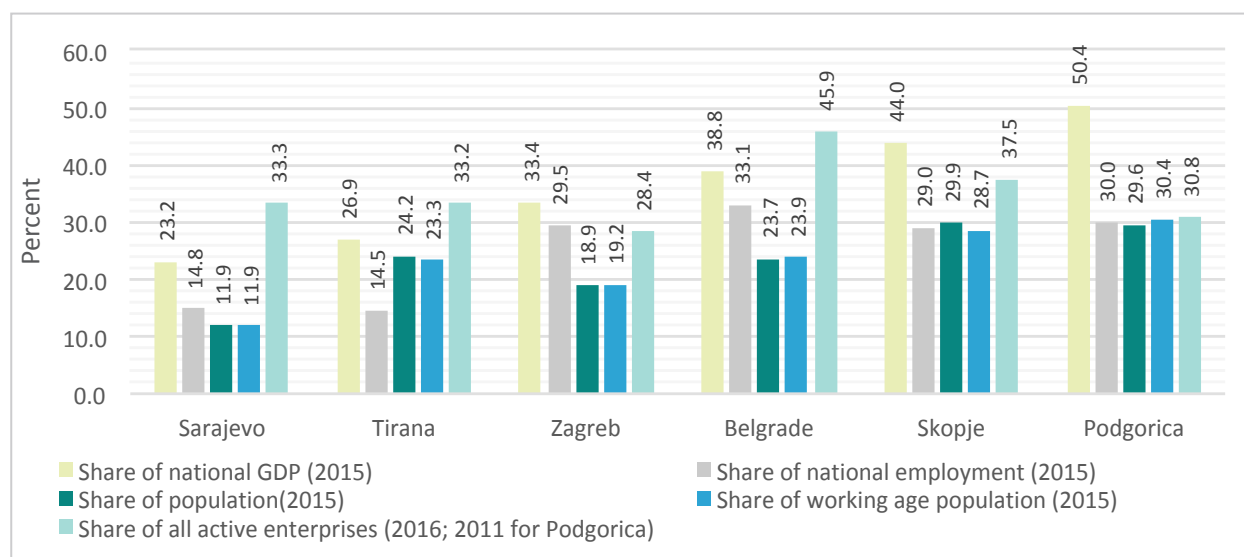


Figure O.4 Capital cities account for a large share of national GDP, population, labor force, jobs, and active enterprises

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.

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.

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

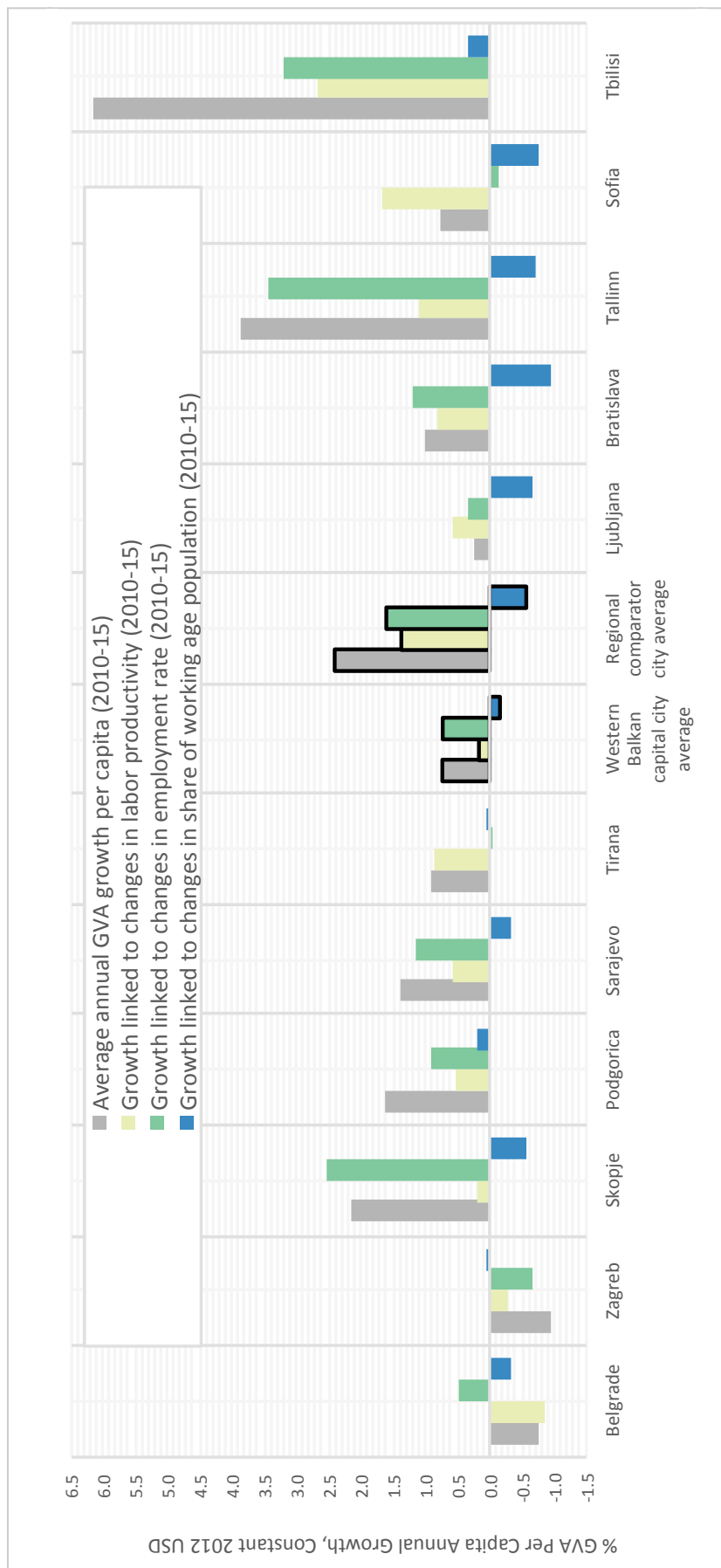


Figure 0.5 Decomposition of average annual per capita gross value added indicates inefficient economic growth in Western Balkan capitals, 2010–15

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.

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.

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 O.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).

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

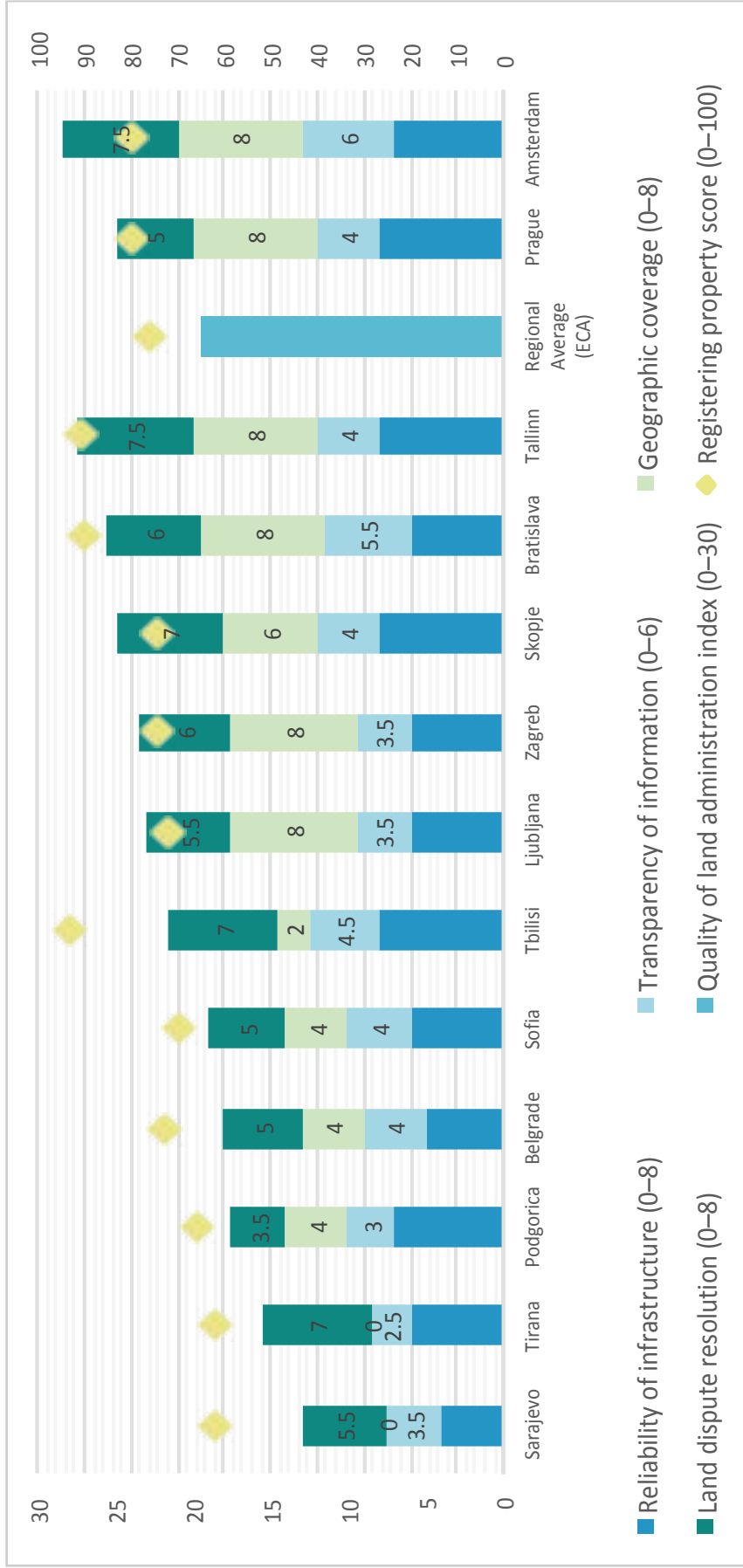


Figure O.7 The quality of land administration requires improvement
 Source: World Bank 2019.

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 regions²¹ 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

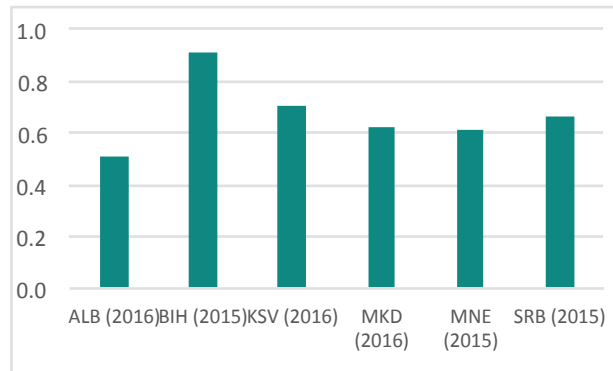


Figure O.8 The gap in mean per capita income or consumption between the richest and poorest regions is large in the Western Balkans

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

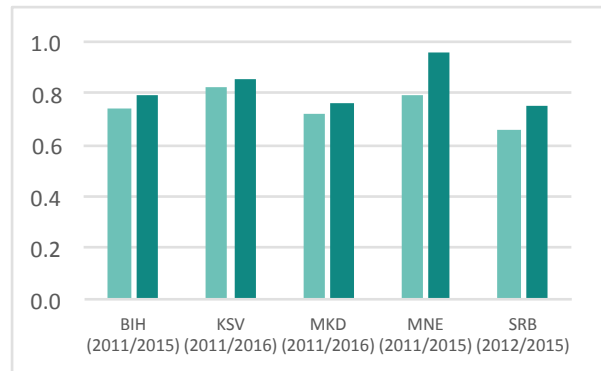


Figure O.9 The gap in mean per capita income or consumption between rural and urban areas, while narrowing, is also large in the Western Balkans

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.

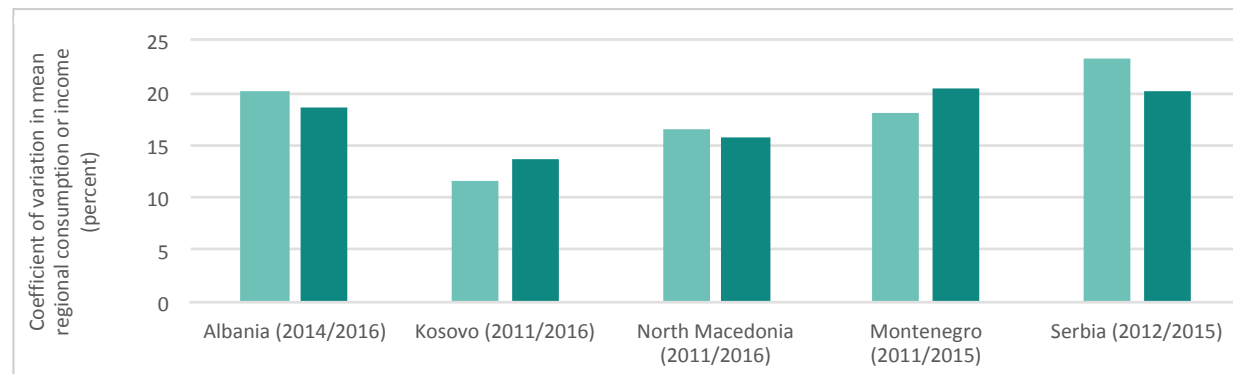


Figure O.10 Disparities in living standards across subnational regions have declined in some Western Balkan countries but risen in others

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 Podunavlje, Raska, and Rasina in Serbia; Polog in North Macedonia; and Kukes and Elbasan in Albania.

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).

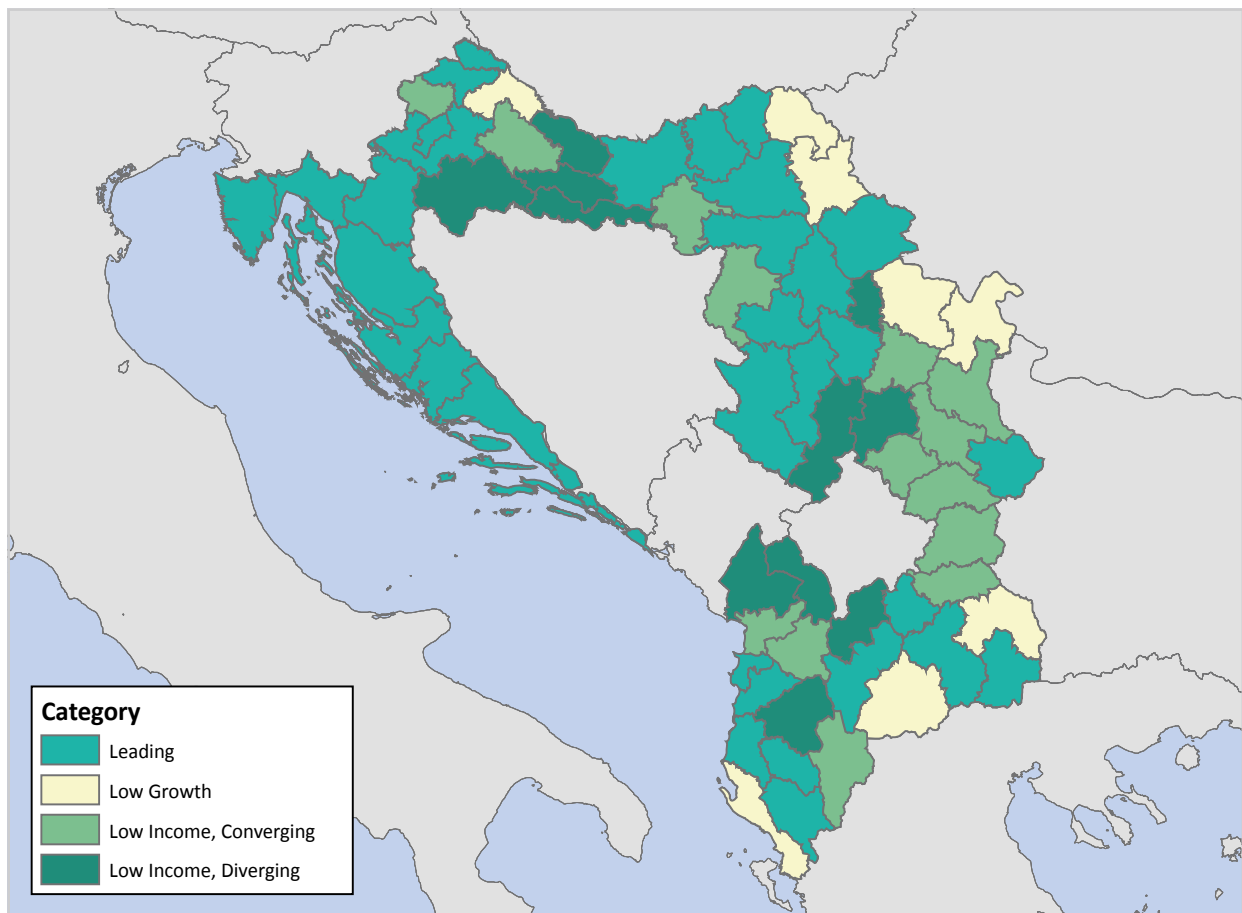


Figure O.11 Many of the poorest regions in Albania, Croatia, North Macedonia, and Serbia are clustered around the Bosnia and Herzegovina, Kosovo, and Montenegro borders

Source: National Statistics Offices.

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.

A. BETWEEN RURAL AND URBAN AREAS



B. BETWEEN RICHER AND POORER REGIONS

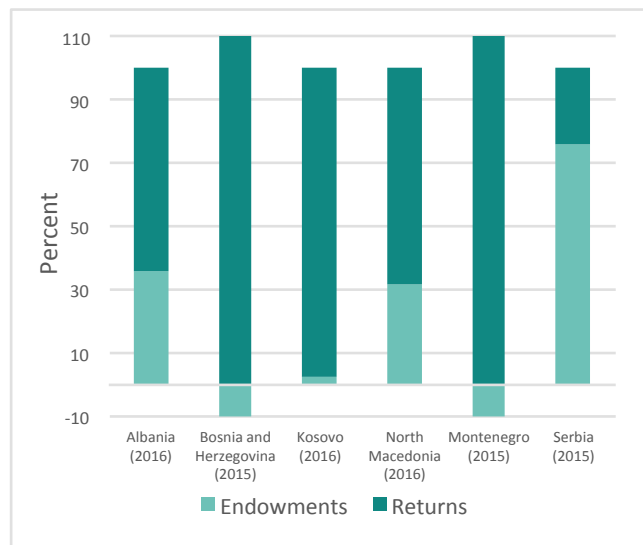


Figure O.12 Endowments contribute significantly to income differentials between regions

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

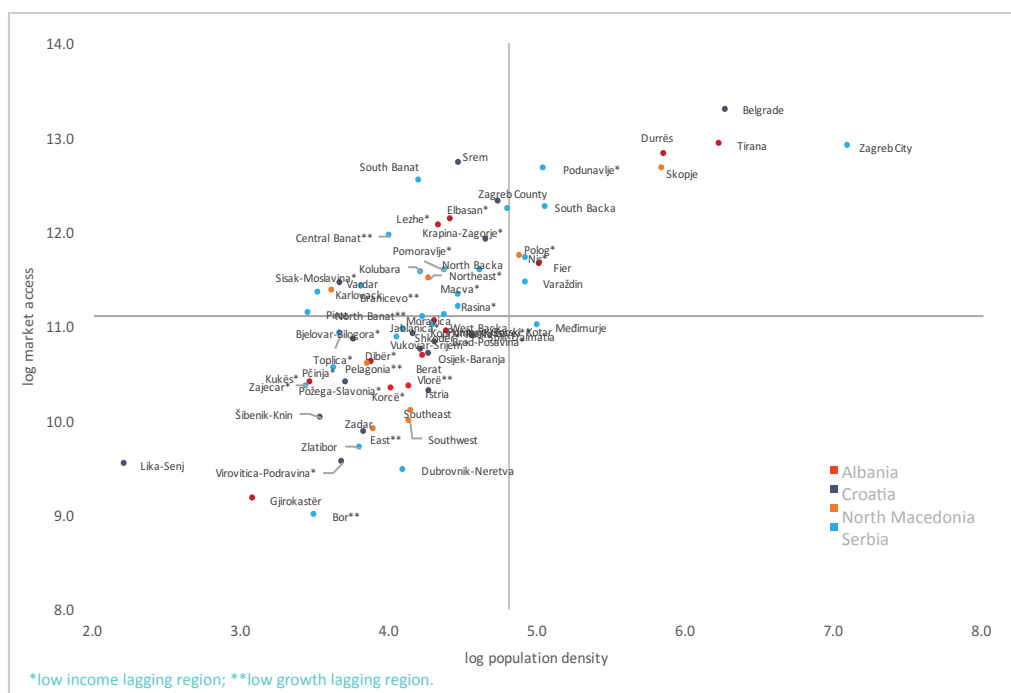


Figure O.13 Population sparsity is the most common structural feature of lagging regions, latest year available

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.

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 regions²⁵ overall, are below EU average density (figure 13).

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 Podunavlje 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

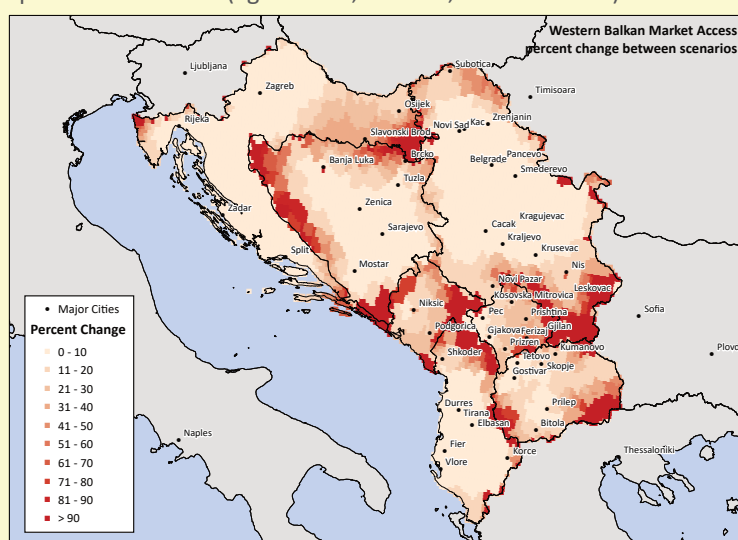
Closing infrastructure service delivery gaps and connecting to market opportunities address both growth and equity priorities

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.

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.

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.

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 cities) 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

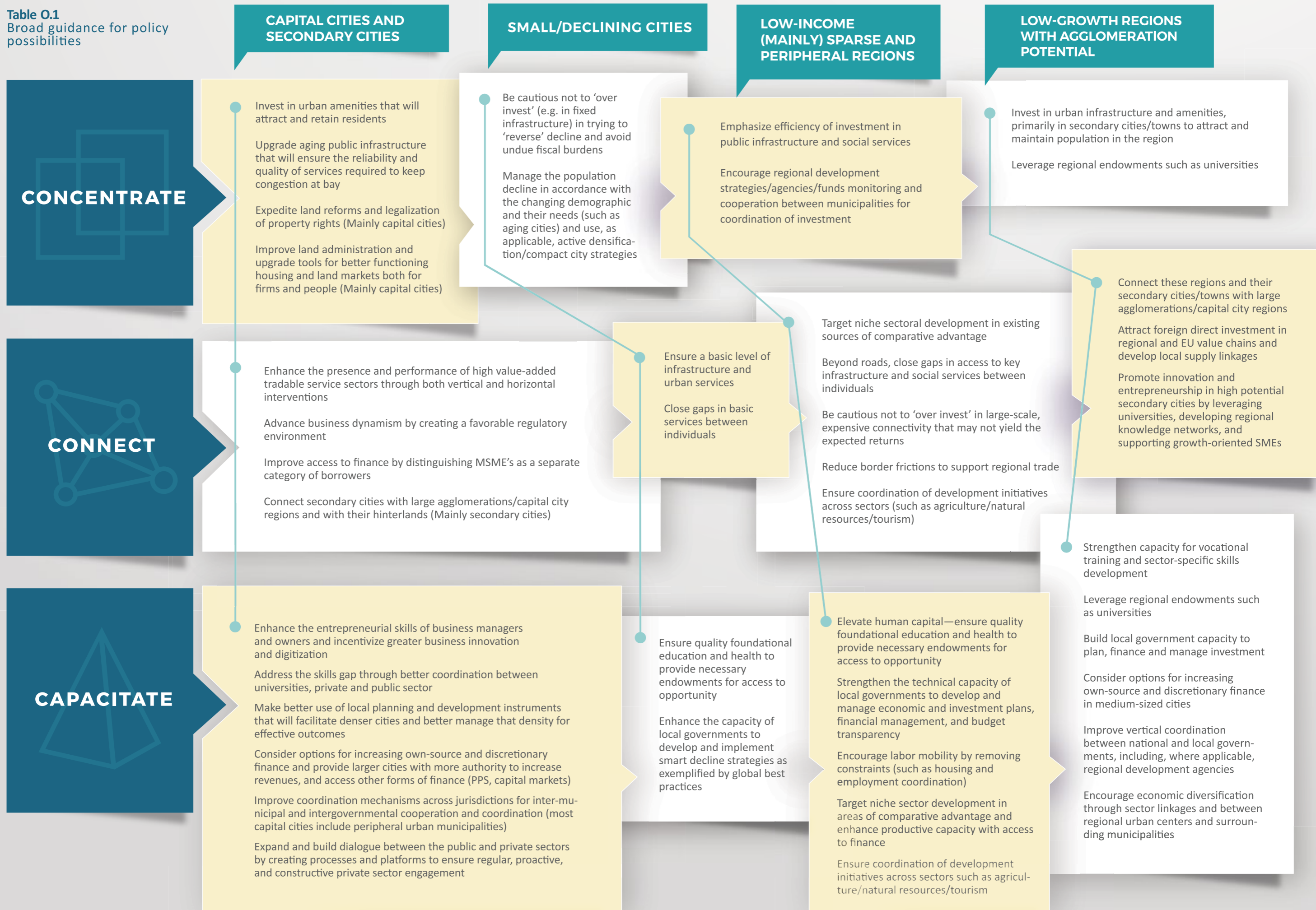
- **Concentrate** resources on leading city-regions to drive national growth, and support secondary cities to become growth centers that expand opportunities to their hinterland.
- **Connect** people and places to opportunities, by developing competitive tradable sectors to leverage the comparative advantages 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



CONCENTRATE

CAPITAL CITIES AND SECONDARY CITIES

SMALL/DECLINING CITIES

LOW-INCOME (MAINLY) SPARSE AND PERIPHERAL REGIONS

LOW-GROWTH REGIONS WITH AGGLOMERATION POTENTIAL

- 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

- 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

- 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

- 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)

- Ensure a basic level of infrastructure and urban services
- Close gaps in basic services between individuals

- 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)

- 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

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

- 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

- 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

- 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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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. 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.

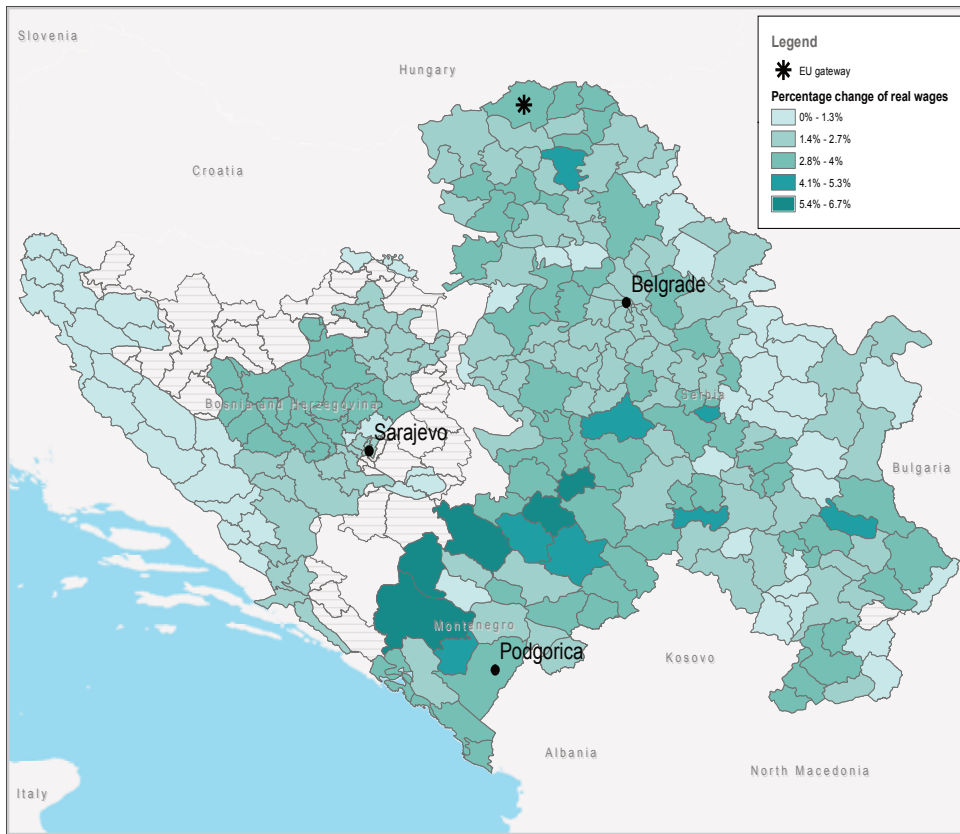


Figure OA.1 Percentage change in real wages: Road improvements only

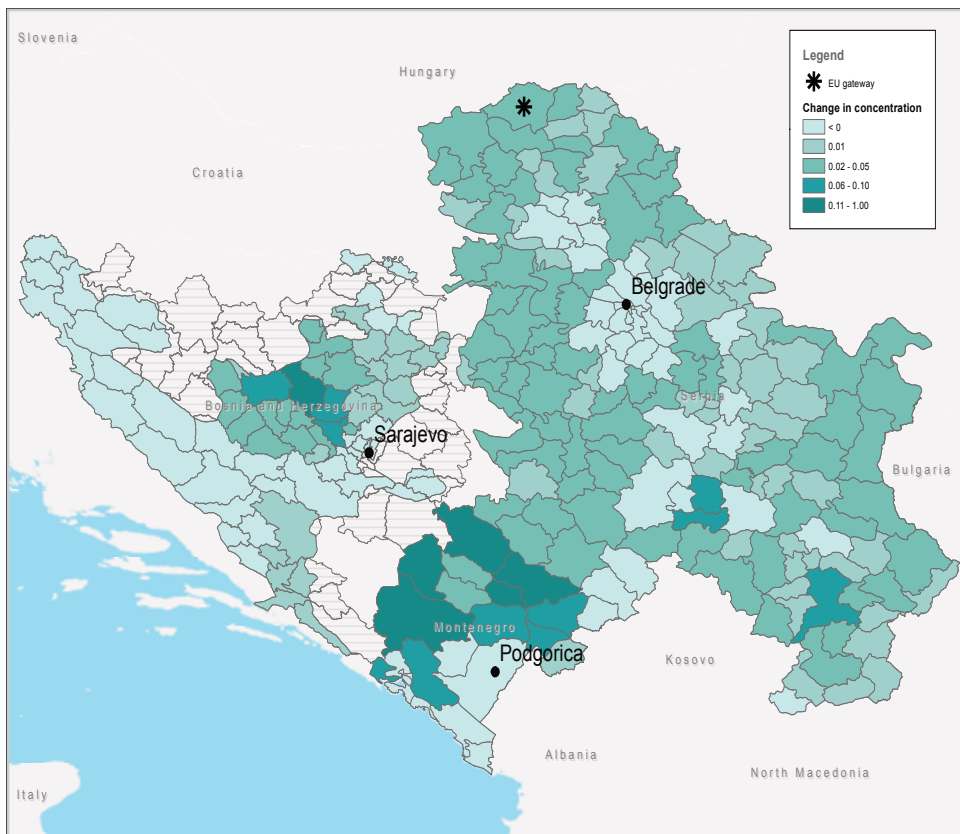


Figure OA.2 Percentage change in real wages: Road and border improvements

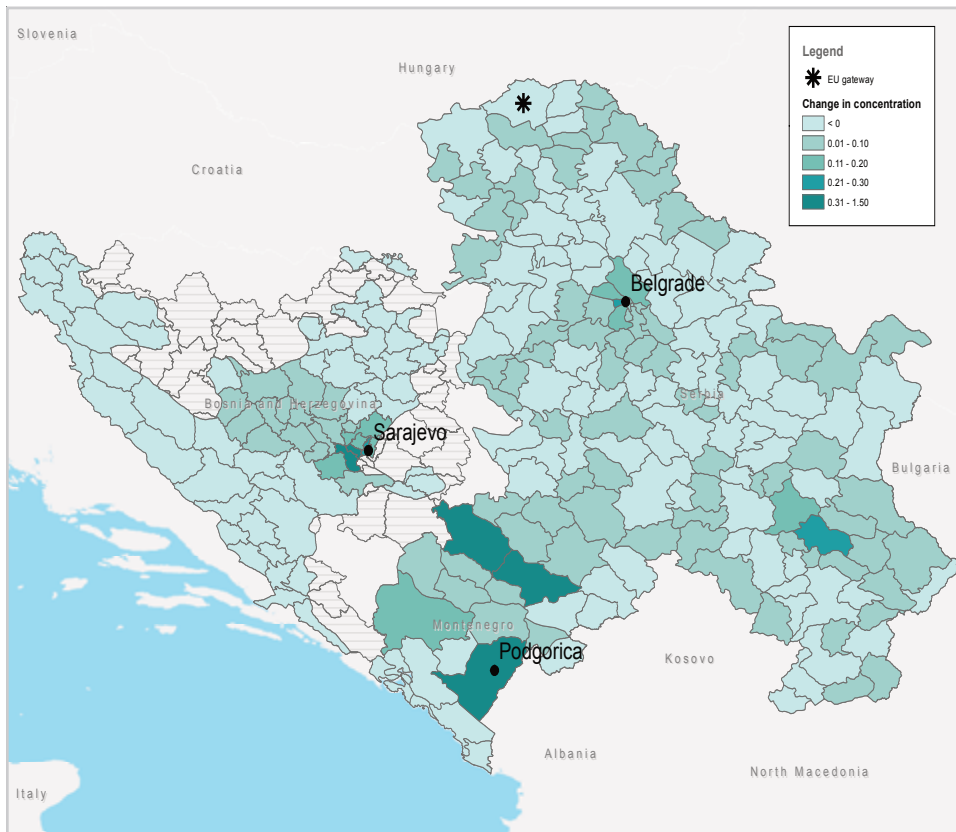


Figure OA.3 Change in population concentration: Road and border improvements only

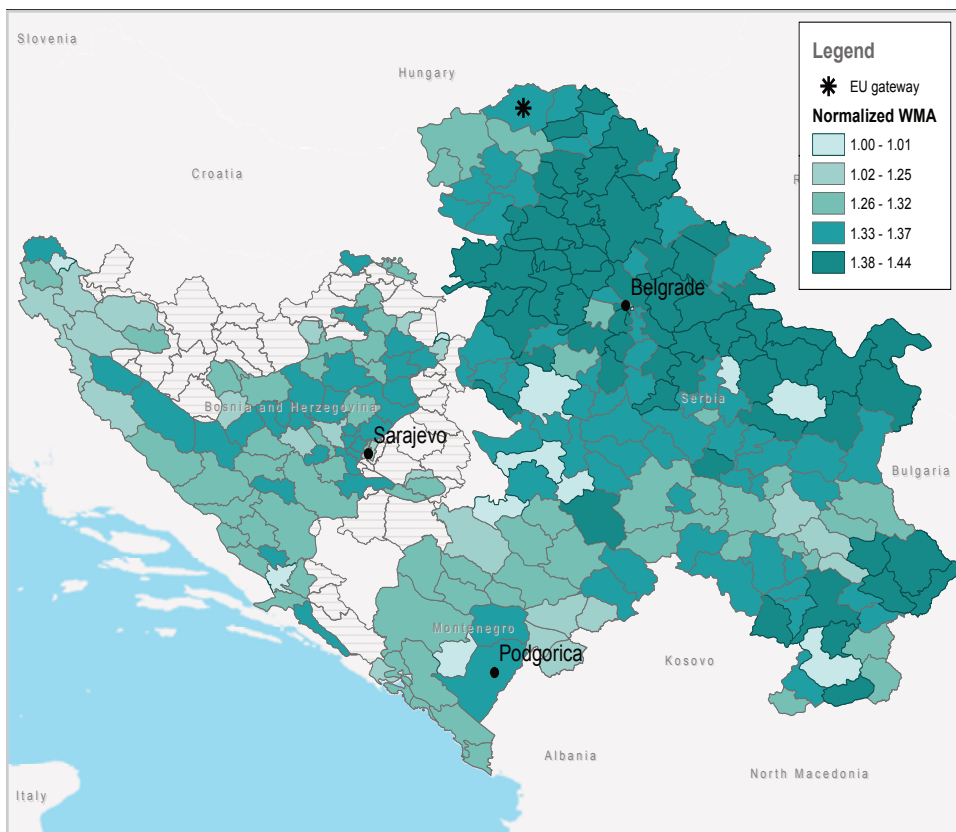


Figure OA.4 Change in population concentration: Road, border, and amenity improvements
Source: Authors' calculations based on the general equilibrium model.

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.

Chapter 1.

Urbanization in the Western Balkans and Croatia: Rising to the many challenges

Key findings and policy implications

This chapter reviews the progress of urbanization in the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia) and Croatia and describes its links with economic development. It compares cities in the Western Balkans and Croatia with others around the world to identify any unique features of urbanization in the study area. It also seeks to identify challenges still to be tackled and opportunities to be exploited.

Compared with urbanization elsewhere, the rate of growth of urban populations in the Western Balkans and Croatia dipped and stalled much sooner. Emigration and low fertility are reducing populations and shrinking the workforce. The population is also aging. While the urban population will remain stable for decades, 73 percent of cities in the region lost population between 2000–10⁴. Population growth is concentrated in a few urban centers that tend to be larger cities that expand beyond a single administrative entity (“multicity agglomerations”).

Relative to the rest of the world, cities in the Western Balkans and Croatia are small, sparsely populated, and poorly located for trade. Urban population 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 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 population declines in smaller cities.

While the average city in the Western Balkans and Croatia has some room for improvement with regards to economic performance, the large and capital cities, seem to be underperforming comparators elsewhere, especially in terms of their contribution to economic growth. During prosperous times, in Europe and Central Asia (ECA) larger cities have had consistent advantages for economic growth, but in the Western Balkans and Croatia the relationship between city size and economic growth is less strong and not consistent.

The urbanization and demographic patterns observed in the region are creating long-lasting challenges for national and local policymakers. Some patterns, such as the increasing concentration of the population in large, multicity agglomerations, are common in developing countries, but others, such as aging populations generally and declines in city populations and workforces, require new policy responses. National and local governments need to move from policies aimed at turning around the declining population trends and redirect their efforts to better managing shrinking cities and helping all cities respond to the needs of aging populations.

While small city size is not something policymakers can easily change, they can influence how cities are structured and function by fostering agglomeration economies and working to minimize congestion costs. Policymakers can improve inner-city connectivity and support the development of more compact cities, with density-oriented development along transport corridors and nodes. They can also improve land and property registration so that those systems do not become a barrier to doing business in cities (see chapter 2). Reducing barriers that prevent people from moving where the opportunities are (see the Spotlight on integration with the European Union [EU] and chapter 4) will also boost the performance of cities and countries.

Urbanization, though challenging, is worth looking into

Cities are important to a country's economic development. Urbanization is evidence of a deep structural transformation that is linked to economic growth. It reflects the movement of people from low-productivity sectors like agriculture, in rural areas, to more-productive sectors like services and manufacturing, which cluster in and around cities². The degree of urbanization is a good indication of a country's stage of development. On the whole, more developed countries have a higher share of their population living in cities than developing countries do.

Economic advantages known as agglomeration economies emerge when people and firms locate together in cities. For firms, clustering allows sharing of indivisible costs, thus increasing their profits. Workers can more easily find jobs that match their skills, and firms can more easily find the right workers. Spatial proximity can also enhance learning and knowledge spillovers, which boost productivity by fostering innovation within and between industries³. However, concentration of people and firms also generates congestion forces, such as traffic, pollution, and crime, that can stifle productivity. Well-managed urbanization that fosters agglomeration economies and minimizes congestion forces can drive productivity gains and thus economic growth.

It is important that governments recognize how urbanization affects service provision and planning. Information on urbanization provides indirect evidence of where people are and where they are moving and thus where services are needed. Understanding urbanization at the national level and population trends at the local level can enable governments to identify, for example, where needs for infrastructure are emerging and accordingly plan and set up systems to finance and manage them.

After a period of rapid growth, urbanization has stalled

In the 1960s, urbanization in the Western Balkans and Croatia seemed to be proceeding along lines common in other developing economies (figure 1.1), hitting about 4 percent a year, about the same rate as in Latin America and the Caribbean and in East Asia and the Pacific. Since then, however, urban population growth in the region has slowed much more than in other developing regions, until by 1995 it had hit zero. While the rate has since picked up a bit, it is still far outpaced by urban population growth elsewhere.

Until 1990, the Western Balkans and Croatia experienced a steady increase in the share of the population living in urban areas, but since the mid-1990s, growth has slowed considerably (figure 1.2). In 1960, the Western Balkans were predominantly rural, with only 24.8 percent of the population living in urban areas. By 1990 that share had reached 43.3 percent. Since then, the urban share of the population has just been inching up; by 2017 it had only reached 51.1 percent. Though the trend was similar in other ECA countries, urbanization stalled at much higher levels in these other countries in ECA than it did in the Western Balkans and Croatia (figure 1.2).

The changes in urbanization trends in the Western Balkans and Croatia took place as Yugoslavia was breaking up in the early 1990s and as the communist regime in Albania fell in 1990. In the turbulence, many industrial jobs disappeared, and workers moved back to ethnically safer hometowns. Migration both internally and abroad was considerable; many cities were abandoned⁴.

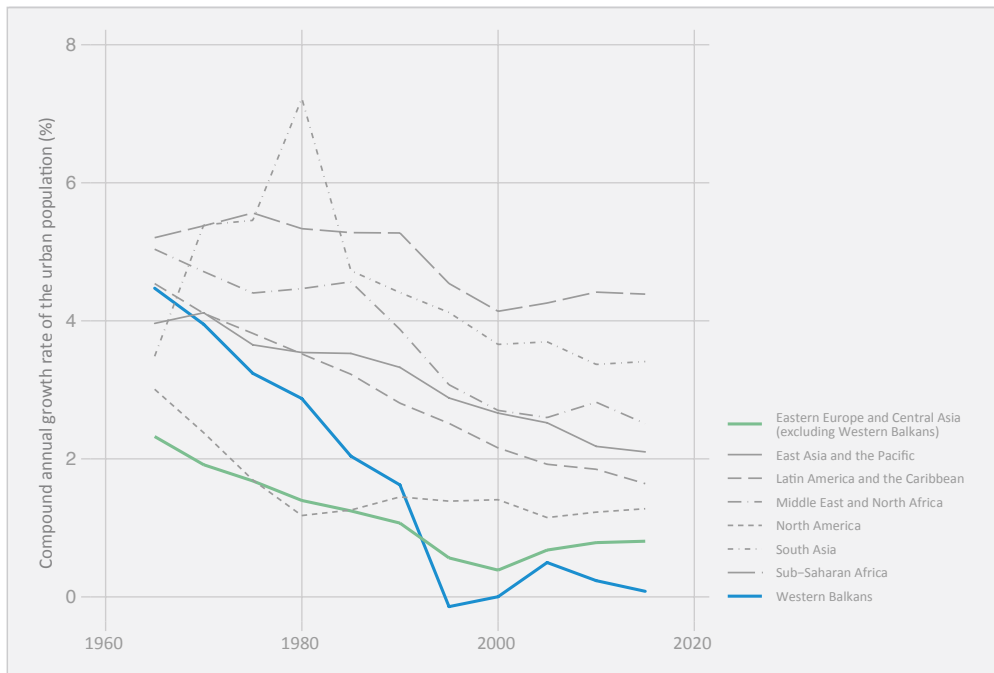


Figure 1.1 Urban population growth rate dropped much faster in the Western Balkans and Croatia than elsewhere (1960–2015)

Source: World Development Indicators (WDI) 2018.

Note: Data for the Western Balkans excludes Kosovo, data for which are not available for the entire period of analysis.

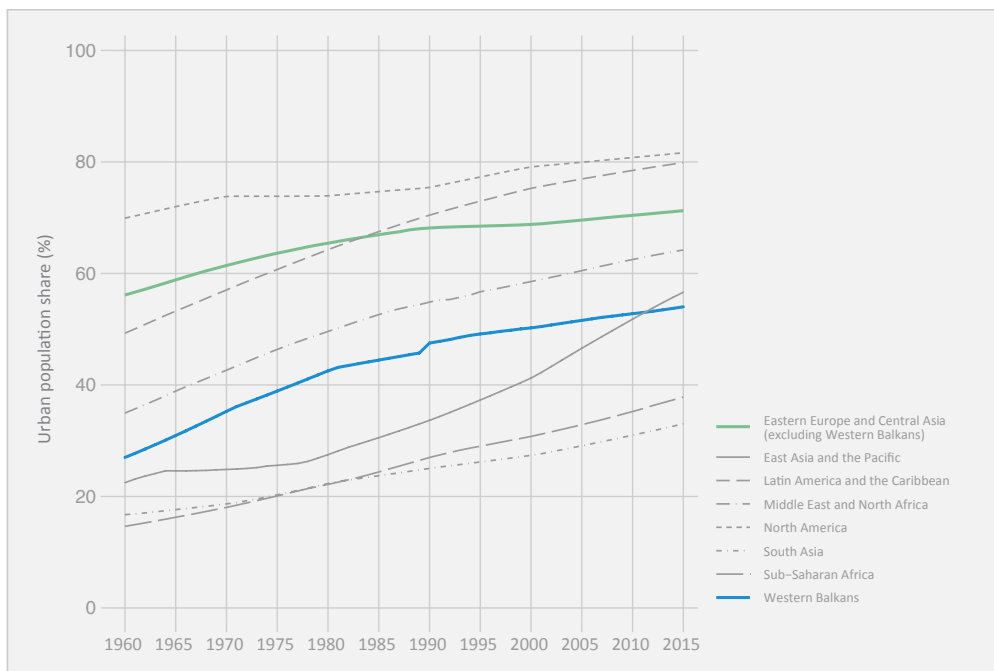


Figure 1.2 The urban share of the population rose in the Western Balkans and Croatia until the 1990s, then stalled (1960–2015).

Source: WDI 2018.

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

There are, however, differences by country (figures 1.3 and 1.4). Trends in Bosnia and Herzegovina, Croatia, North Macedonia, and Serbia are similar with the urban population and its share of national population either declining or growing very slowly. In Albania and Montenegro, however, the urban population has been growing rapidly, drawing from the rural population. In all countries except North Macedonia, the increase in the urban share of the population is influenced more by a shrinking rural population than by growth in cities.

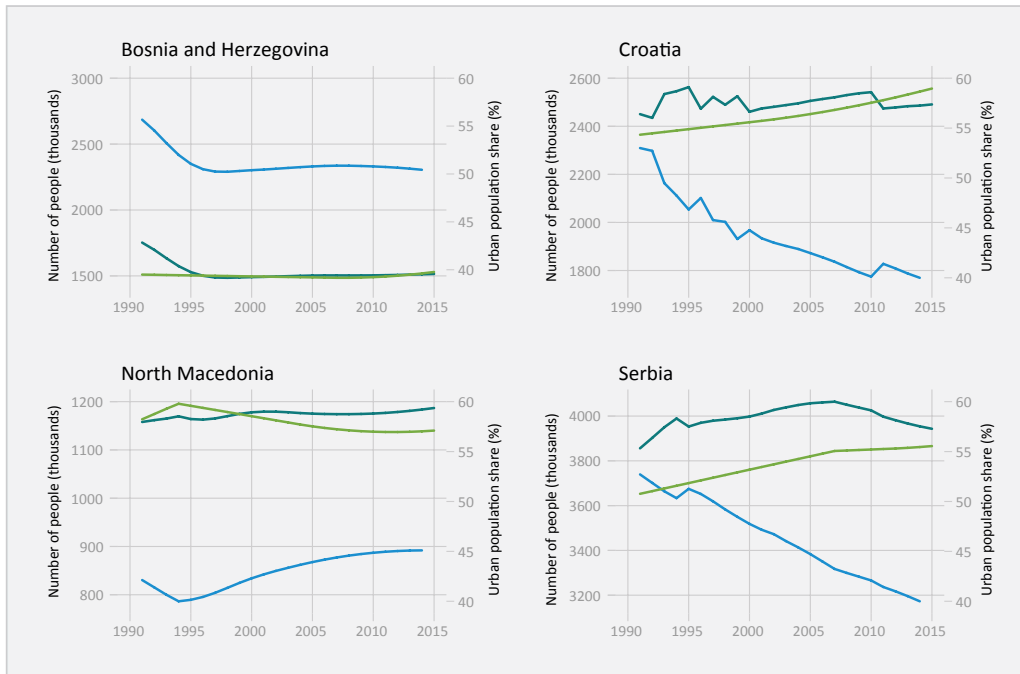


Figure 1.3 Urbanization in Bosnia and Herzegovina, Croatia, North Macedonia, and Serbia mirrors regional trends (1990–2015)

Source: WDI 2018.

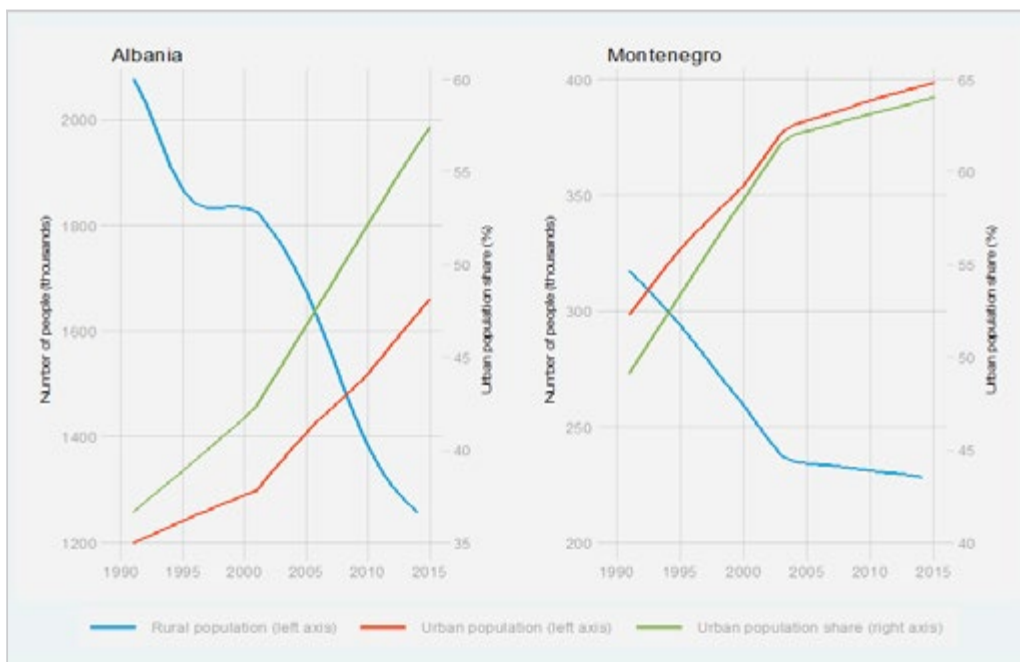


Figure 1.4 Urbanization in Albania and Montenegro diverges from regional trends (1990–2015)

Source: WDI 2018.

In coming decades, urban populations are projected to remain stagnant

Demographic transition and migration trends are stalling urbanization

Behind the atypical urbanization in the Western Balkans and Croatia lie unfavorable demographic and migration trends. Much as in the rest of ECA, fertility rates have been below replacement levels for years⁵. Since the 1990s, the share of the population aged 0–14 has been declining and the share aged 65 and up has increased substantially (figure 1.5). The share of the working age population (aged 15–64), which peaked in 2015, is now declining.

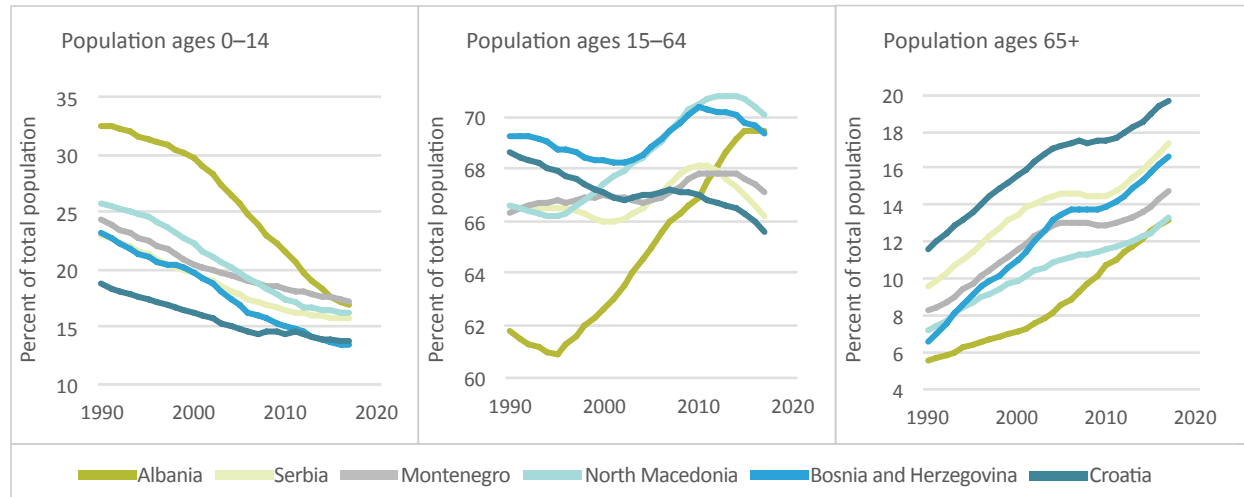


Figure 1.5 Because of rapid demographic changes in the Western Balkans and Croatia, the working-age population has been shrinking and the old-age population expanding (1990–2015)

Source: WDI 2018.

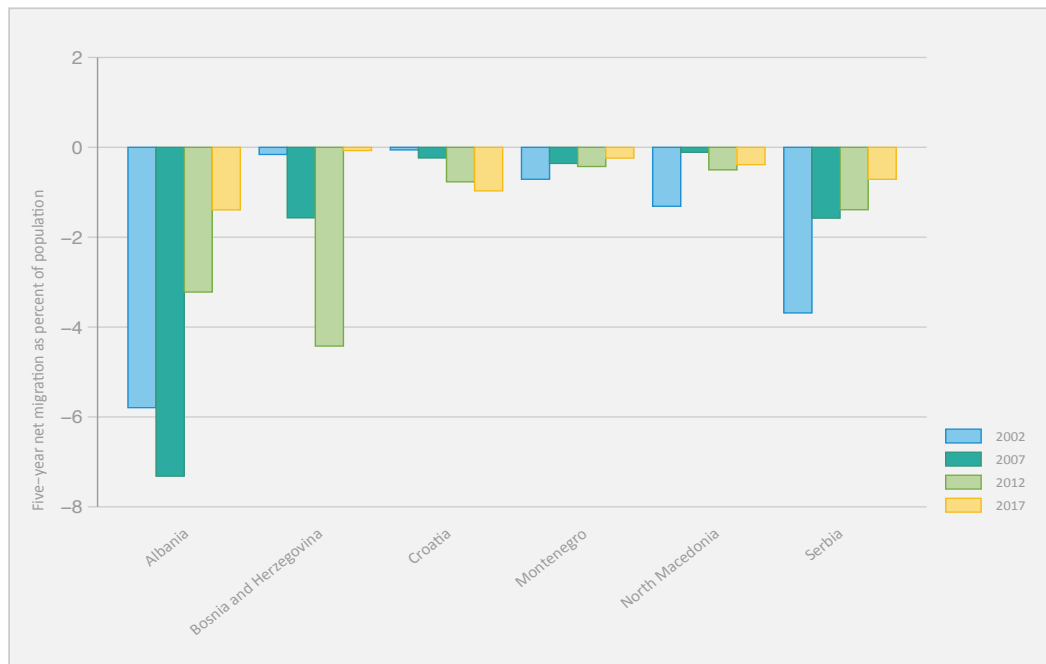


Figure 1.6 All the Western Balkans and Croatia suffer from negative net migration, (2002–17, percent of population)

Source: WDI 2018.

Note: Net migration is the number of immigrants minus the number of emigrants over a five-year period divided by the population of the country in that period.

Emigration is reinforcing these natural demographic changes. More people are leaving than entering the Western Balkans and Croatia, especially Albania, Bosnia and Herzegovina, and Serbia (figure 1.6). Although in recent years all Western Balkan countries except Croatia have seen migration outflows decline, it is still contributing to the regional decline in the working-age population⁶.

Moreover, greater integration of the region with the EU may reduce barriers to emigration and thus in the short term promote higher emigration, exacerbating the national and urban demographic trends of aging and population decline. The long-term migration effects of closer integration with the EU will depend, however, on whether Western Balkan economic development and employment converge with that of the EU, and how quickly that occurs. the regional decline in the working-age population.

Very low fertility rates and emigration mean that the Western Balkans and Croatia will slowly lose population for the next 20 years. While the urban share of the population may increase in coming decades, it will mainly be due to a decline in the rural population rather than an increase in the urban population. Except for Albania and Montenegro, urban populations in the Western Balkans seem to have reached stasis (figure 1.7). Montenegro will do so in 2035, when it is expected to have about 450,000 urban residents, and Albania in 2040, when it will have about 2.1 million.

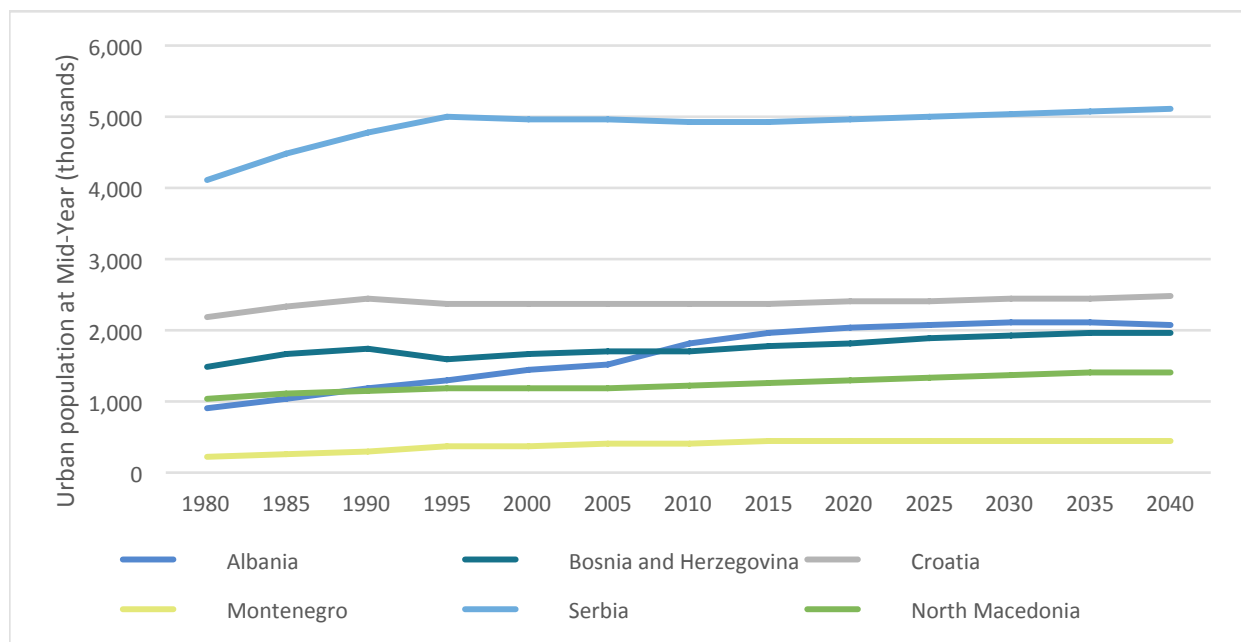


Figure 1.7 Urban populations in the Western Balkans and Croatia are expected to plateau through 2050

Source: United Nations—World Urbanization Prospects: The 2017 revision.

While most cities are shrinking, a few are growing

National demographic trends are trickling down to cities, and many cities are shrinking

The sweeping national demographic changes are also affecting urban populations. As in ECA generally, the population in the average Croatian and Western Balkan city appears to be fairly stable (Restrepo et al. 2017)⁷. But between 2000 and 2010, some 72.8 percent of cities in the Western Balkan and Croatia lost population compared to 61.5 percent of cities in ECA—only North Macedonia at 39 percent was below the ECA average (figure 1.8). At the high end of urban population loss are Albania (in 82.3 percent of its cities), Montenegro (80 percent), and Croatia (77.4 percent). Although data are not available for the same period for Bosnia and Herzegovina, 85.7 percent of its cities

lost population in 1991–2013. However, because the Bosnian war in 1991–95 led to many casualties and internal and external migration, its urban population estimates should be viewed with caution.

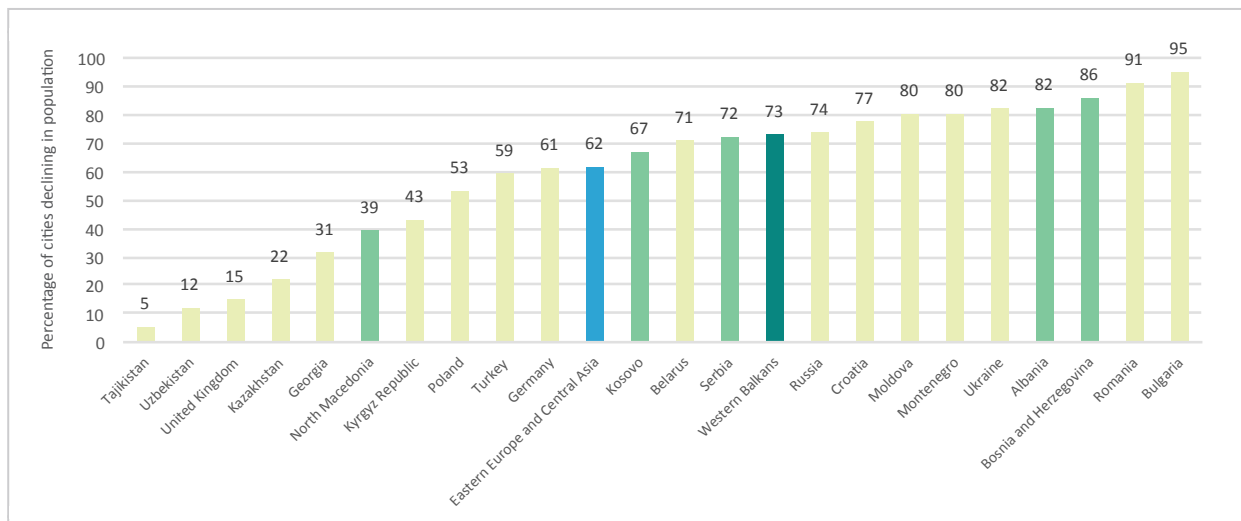


Figure 1.8 A Large share of Western Balkan and Croatian cities are losing population (2000–10)

Source: Data from Restrepo et al. 2017, updated and expanded.

Note: ECA and Western Balkan averages are weighted and do not include Bosnia and Herzegovina or Kosovo because their data are for different periods (1991–2013 for Bosnia and Herzegovina and 1991–2001 for Kosovo). Results for Kosovo should also be interpreted with caution because the sample is small.

BOX 1.1

The negative implications of city population declines

Cities can lose population because of external shocks, such as changes in the global economy (as in Cleveland and Detroit) or natural or anthropogenic disasters (as in New Orleans and Chernobyl). Cities can also lose population because of changing demographics, such as the national population declines in the Western Balkans and Croatia.

Having fewer inhabitants reduces municipal revenues because income from local and shared taxes declines. Unconditional transfers from the central government may also decline if they are distributed on the basis of population, although declines may be partially offset by equalization formulas to favor poorer jurisdictions. Conditional transfers, such as for education, may not drop much because of buffers to ensure that funding for teachers remains intact even when the number of students is falling. Declining densities can result in a loss of economies of scale and raise the per capita costs of providing some municipal services when fixed costs cannot be reduced.

With fewer inhabitants, housing vacancies rise, which can depress housing prices and promote rises in crime and urban blight. Although declining prices can have severe consequences for municipal revenues, cities in the Western Balkans and Croatia derive little revenue from property taxes. High housing vacancy rates can threaten a country's cultural heritage and discourage tourism. That is happening in Gjirokastra, a UNESCO World Heritage city in Albania, where many vacant historic houses are in disrepair.

Shrinking cities often experience a decline in population density, because the urban footprint declines more slowly than the population. Having fewer, more dispersed inhabitants can complicate delivery of services, particularly those that benefit from economies of scale or density. For example, lower densities can reduce bus ridership and make certain bus routes too expensive to operate. Consumption of less water can lead to longer retention times in reservoirs and cause greater risk of bacterial growth.

The implications of city population decline also vary depending on who stays and who leaves. There is anecdotal evidence for the Western Balkans and Croatia that leavers who go abroad or to larger, growing cities are disproportionately young with more skills, with the residents left behind aging and less skilled, so that cities may have to cope with higher demand for health services and a decline in demand for primary and secondary education. Population aging also has implications for urban transport patterns (elders tend to commute less and at different times of day), and other urban infrastructure and services will need to be adapted to be more accessible to an aging society. The emigration of working-age residents, especially those with more skills, also means that cities will have less human capital with which to build their economy.

Source: Adapted from Restrepo et al. 2017, box 3.

In some countries, rapidly shrinking cities coexist with rapidly growing ones

In Croatia and the Western Balkans between 2000 and 2010, on average shrinking cities lost 10 percent of their population and growing cities gained 10.4 percent. However, there are variations: In Albania and Montenegro, rapidly shrinking and rapidly growing cities co-exist (figure 1.9). In Croatia and North Macedonia, cities are growing or declining much more slowly. And in Serbia, some cities are shrinking rapidly, but others are growing much more slowly.

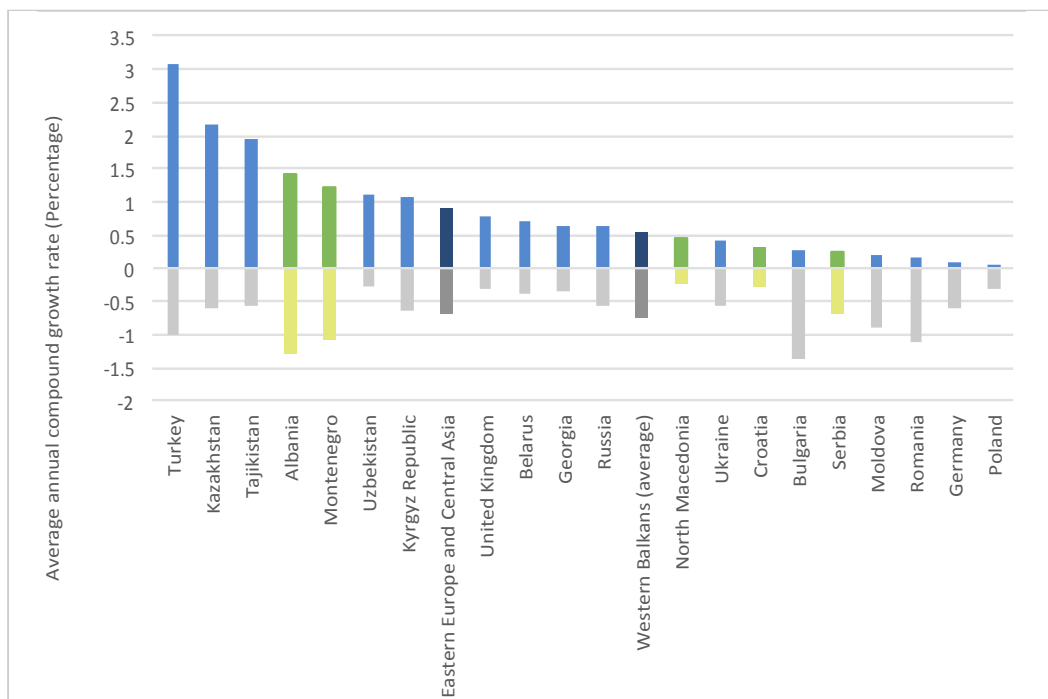


Figure 1.9 Some cities in the Western Balkans have been shrinking rapidly, others growing steadily (2000–10)

Source: Restrepo et al. 2017, updated and expanded.

Note: ECA and Western Balkan averages are weighted and do not include Bosnia and Herzegovina or Kosovo because their data are for different periods (1991–2013 for Bosnia and Herzegovina and 1991–2001 for Kosovo).

Shrinking and growing cities differ in several respects

While most cities in the Western Balkans and Croatia are losing population, the few still growing (figure 1.10) share certain characteristics: They are larger, and many belong to multicity agglomerations. Cities on the periphery of these agglomerations are growing more than cities at the center. Capital and secondary cities are also growing much more than smaller cities and towns. This is similar to what is happening in ECA generally⁸.

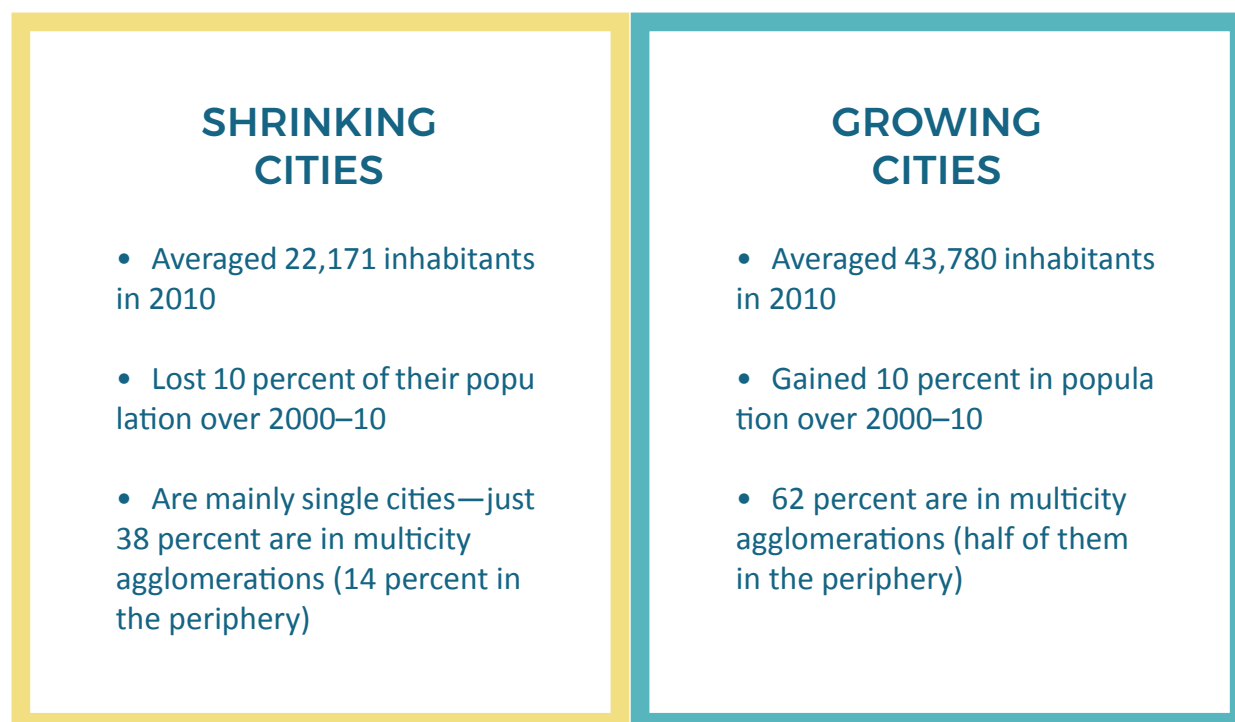


Figure 1.10 Shrinking and growing cities differ

Policy Implications

The urbanization process in the Western Balkans and Croatia is unusual. In most countries in the region urban population growth is approaching zero—no growth, no decline—and is expected to remain there for the foreseeable future. However, major demographic changes now underway present long-lasting challenges for national and local policymakers.

- First, the share of the working-age population is dropping in most countries and the population is aging. Boosting productivity and adapting to an aging society will thus be vital for sustainable economic growth in the Western Balkans and Croatia—policymakers will need to work hard to ensure that cities deliver the productivity benefits of urbanization.
- Second, many cities in the region are losing population, though a few continue to grow. Given the broader demographic changes, it is unlikely that shrinking cities will be able to reverse the decline. National and local governments thus need to start taking steps to better manage urban population decline, recognizing its serious implications for local government finances and service delivery (box 1.1). Fortunately, to manage population decline policymakers can now draw upon a growing number of policy tools that can be adapted to local needs (box 1.2). Meanwhile, local and national governments need to take measures to enable growing cities to develop harmoniously and efficiently and realize their potential to become engines of economic growth.

BOX 1.2

Examples of smart national and local policy responses to city decline

Although having fewer inhabitants poses challenges for local and national government in the Western Balkans and Croatia, many negative outcomes are the result of a failure to manage population decline wisely. Urban population decline can also have advantages: Housing can become more affordable, city centers can revive, congestion costs can fall, and required capital investment can reduce.

So how can cities better manage their population decline? First, policymakers, businesses, and residents need a better understanding of what is happening so that they can shift from policies aimed at attracting more people to policies aimed at making their cities better places to live and to do business for those who are there. Second, though there is not enough empirical evidence to identify the best policies to manage population decline, a growing set of policy tools is emerging from developed countries coping with similar trends.

A sustainable answer: Creating new green spaces and land conversion

Since the early 2000s Flint, Michigan, and Youngstown, Ohio, two of the cities in the United States that were declining fastest, have acted to use their land more efficiently and reduce the impact of vacant properties. In 2002 Flint created a regional land bank to take greater control of vacant land by placing it in public hands. In 2005, Youngstown prepared the first urban plan to deal with smart decline, which aimed at making the city more livable. It proposed focusing services on neighborhoods with the highest population densities and converting vacant land in neighborhoods with declining densities into green spaces.

A top-down approach to incentivize smart decline

Japan and Germany have been pioneers in national policies to incentivize smart decline and make cities more inclusive for an aging population. The Japanese government has merged local governments, cutting the number in half, and implemented a vacant land and housing policy to better manage abandoned land. In 2002, 2006, and 2016 it also passed several reforms of urban renewal regulation. Germany introduced the Urban Redevelopment East (Stadtumbau Ost) in 2001 to address the decline of eastern German cities after reunification. The program provided subsidies to cities for demolishing buildings, with the condition that the cities draft comprehensive urban development plans. Almost all cities in eastern Germany applied to the program, which supported the demolition of 350,000 apartments.

Revitalizing city centers and transit-oriented development

Detroit, Michigan, in the United States, and Toyoma in Japan demonstrate the use of active densification strategies to manage the urban infrastructure and transport challenges that accompany a decline in population density. After decades of population shrinkage, Detroit's mass public transit system, fixed monorail, was operating at just 10 percent of capacity and

had become financially unsustainable. The city conducted a transit-oriented assessment and identified investments to incentivize the densification of the central business district and the development of transport corridors between points in the larger metropolitan area and the central business district. Toyoma is implementing multiple policies to address the decline and aging of its population. City officials drew up a long-term strategy to revitalize public transit by encouraging residents and businesses to relocate along new light rail lines, and to renew the city center to make it more vibrant and pedestrian-friendly.

Rethinking the potential of cities

When city population decline is associated with a decline in certain sectors of the economy, such as manufacturing and mining, managing it requires evaluating the city's endowments (location, human capital, infrastructure, institutions) to determine whether it is possible to shift the economic base. Bilbao, Spain, and Manchester, UK, have taken this approach. Bilbao, which suffered from decades of decline in the steel and heavy metal industries, created a dedicated agency, Bilbao Metropoli 30, to carry out a strategic development plan to reorient the city toward a service-based economy. Construction of the Guggenheim Museum and the conversion of abandoned factories into art centers are examples of the types of activities the development plan supports. Bilbao also supported the development of complementary tourism infrastructure and cluster associations to boost the consolidation of creative industries (information and communication technology, design, furniture). Today, the city is one of the main economic centers of northern Spain. Manchester took a similar approach after its manufacturing base was eroded, transforming the city into a cultural and knowledge hub. Cities that follow this approach often focus their economy on such emerging economic sectors such as creative industries and tourism. But not all cities can become cultural and tourism hubs. Any strategic redirection of the economy needs to take the city's relative endowments into account.

A spatially targeted response to city decline

After its industrial base declined, Pittsburgh, Pennsylvania, USA, faced both a loss of population in the city center and growth in suburban populations. In the early 1980s, the city started to diversify its economic foundation with an emphasis on higher education, using Carnegie Mellon University as a magnet, and health care. The city also made spatially targeted investments to regenerate and revitalize decaying areas in the city center through private–public partnerships (for example, Three Rivers baseball stadium) and bringing jobs and people back to the city (such as Home Depot in East Liberty). All spatially targeted investments were developed in partnership with the local community to increase local ownership and better meet local needs.

Adapting planning instruments for smart decline

Dresden, Germany, experienced severe economic decline after German reunification and the fall of the Soviet Union. People abandoned the city, and birthrates fell. Between 1989 and 1999, Dresden lost 60,000 of its 500,000 inhabitants, resulting in an oversupply of infrastructure and high housing and office vacancy rates. In 2000, the city revised its urban plans, previously focused on growth, to better respond to population decline through a compact-city approach that supported revitalization of the city center.

Source: Adapted from Restrepo et al. 2017, box 7.

What is different about Western Balkan and Croatian cities?

City size, population density, and location influence a city's economic performance. Larger cities tend to have larger local markets, which can benefit their firms and workers. Denser cities can foster higher labor productivity through enhanced interactions that facilitate knowledge spillovers, which are easier when people are close together. If not well-managed, however, high population densities can generate congestion forces that undermine economic performance.

Location characteristics, often called fundamentals, can both influence the emergence of a city in a particular place and affect its long-run economic performance. The role of location appears to have shifted over time. Before about 1950, when transport costs were high, cities benefited from being close to fertile hinterland, which could feed the nonagricultural population⁹. As transport costs fell and global markets became more integrated, proximity to agricultural activity has been less relevant, since food supplies can be easily shipped in from abroad at competitive prices. In a highly connected world, cities benefit instead from being close to waterways and other trade facilities.

Small, sparsely populated, and unfavorably located

Cities in the Western Balkans and Croatia have few such advantages. They are small, sparsely populated, and unfavorably located. Drawing on two global datasets, this section compares cities in the region and beyond in terms of size, population density, and location. The dataset used to analyze city size and population density covers 63,629 urban areas in 192 countries, and 435 cities in the Western Balkans¹⁰. A new gridded global dataset is used to assess the extent to which such characteristics as being close to a coast or natural harbor explain the location of cities in the study region¹¹ in order to establish whether they emerged in places advantageous for agriculture and trade.

Small and sparsely populated

Most Western Balkan cities and those in Croatia are small and sparsely populated. The average city (figure 1.11) has only 30,000 inhabitants, less than the average for other cities in ECA and the lowest average of any region in the world. Though they have relatively few people, these cities occupy more space¹² than cities of comparable population in other regions.

Even the largest Western Balkan and Croatian cities are on average small and sparsely populated (figure 1.12). The 10 largest cities in each country average 120,937 inhabitants, compared with 1,057,665 in the rest of the world. They average 1,683 inhabitants per square kilometer, less than the averages for ECA and all other regions except North America's 942 average.

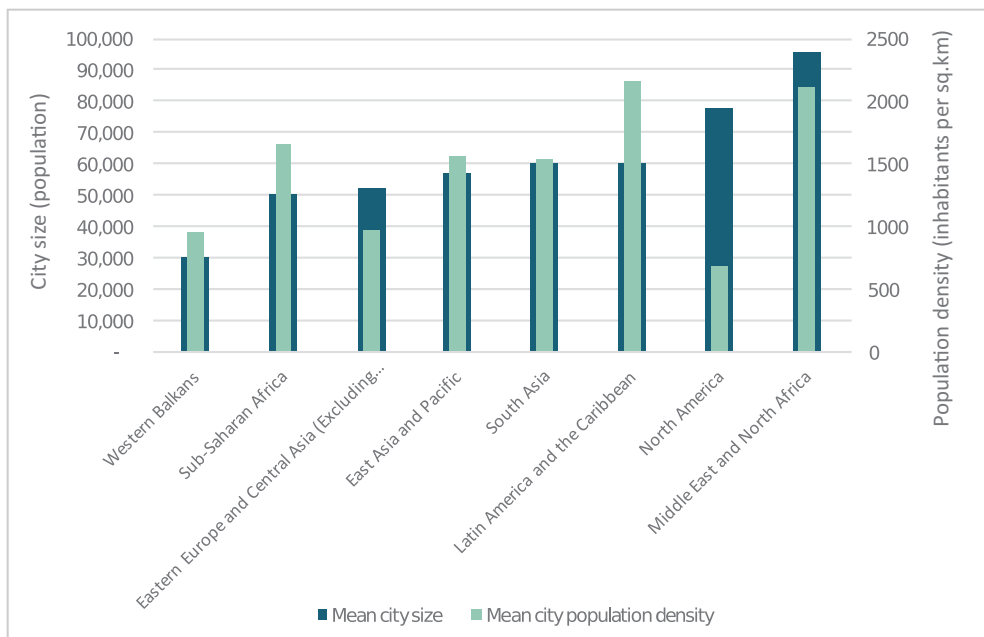


Figure 1.11 Western Balkan and Croatian cities are smaller and more sparsely populated than those in other regions
Source: Roberts et al. 2017.

The structure of today's city network in the Western Balkans and Croatia has likely been affected by history. After being part of a single country, countries in the new Former Republic of Yugoslavia States had to adjust their economic and administrative structures while firmly establishing their new territories. After the collapse, most of the new capitals were based on structures followed in the capitals of the former Yugoslav republics. They attracted mostly people from the predominant national ethnicity and the formal ethnic composition changed, allowing ethnic conflicts and segregation to develop¹³. Also, as outlined by Henderson and Wang (2007), countries that urbanized in planned economies, tended to have urban populations that were more evenly spread across cities, limiting the growth of the largest cities,, perhaps to assure political stability. These political changes contributed to cities being small and sparsely populated.

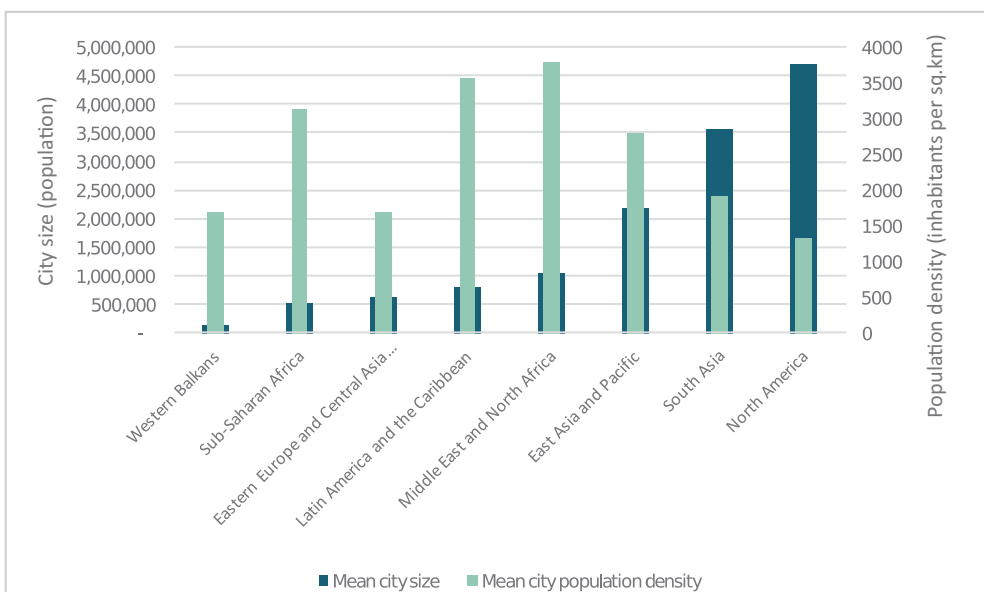


Figure 1.12 The largest Western Balkan and Croatian cities are tiny by world standards

Source: Roberts et al. 2017.

Note: The data are for the 10 largest cities in each country.

Rather than being compared with much larger and more populous countries, what happens when cities in the region are compared with cities in countries with similar characteristics? Following Ferreyra and Roberts (2018), a global set and an ECA set of comparator countries were identified¹⁴. The global set consists of the three countries elsewhere in the world that are most similar to each Western Balkan country and Croatia, and the ECA set consists of the three most similar countries in the ECA region. For example, for Croatia the global comparators are Costa Rica, Georgia, and Panama, and the ECA comparators are Georgia, Latvia, and Lithuania.

The average city in the Western Balkans and Croatia is small relative to both ECA and global comparators (figure 1.13a), and the largest city in each is small relative to ECA comparators (figure 1.13b). The average and the largest Western Balkan and Croatian cities are less densely populated than global comparators but have slightly higher densities than ECA comparators.



Figure 1.13 Western Balkan and Croatian cities are small even when benchmarked against global and ECA comparators
Source: Roberts et al. 2017.

Poorly located for trade

Western Balkan cities seem to have emerged in places not very favorable to trade (see Annex 1A for details), and less likely than those in other regions to be in places with strong natural advantages (close to natural harbors, in areas with close to fertile hinterland). This suggests that perhaps noneconomic factors (institutional settings) played a role in their emergence and growth. For instance, in planned economies, city location and growth were often determined by central government decisions, and the decisions about where to locate a city or whether to allow more people to settle there were often guided by noneconomic purposes, such as territorial control or defense.

This is not to suggest that Western Balkan cities should be relocated, or that better-located cities should be created. In fact, manmade features like highways, airports, or seaports can compensate for poor location fundamentals. However, the location of Western Balkan cities might be a disadvantage compared to other cities in the region and the world, so maximizing city productivity—given their location—will be central to heightening their economic performance.

Historically dispersed urban populations are now becoming more concentrated

Urban population and economic activity have been dispersed

Both populations and economic activities are more dispersed in Western Balkan and Croatian cities than elsewhere. Again, historical features such as urbanizing in planned economies and the breakup after the fall of communism probably had much to do with the degree of dispersion. Two indicators are used to measure dispersion. One is the spatial Gini coefficient, a measure of the degree of concentration of population and economic activity in an urban system, which ranges from 0 (equal distribution across all cities) to 1 (concentration in a single city). The approach and dataset follow Restrepo et al. (2017), which in the absence of robust economic indicators for cities of all sizes uses the intensity of nighttime lights emitted by cities as a proxy for economic activity¹⁵. The second indicator is urban primacy, which measures concentration of the population in the largest city.

Studying urban primacy and the concentration of population and economic activity in cities is important because, as countries develop, such concentration is generally beneficial for economic growth¹⁶. However, when population is too concentrated, especially in large cities, congestion costs rise, which can reduce a country's economic growth and productivity¹⁷.

Urban population and economic activity as proxied by nighttime lights are more dispersed in cities in the Western Balkans and Croatia than elsewhere. The average spatial Gini for urban population concentration in the study area is .622, compared with .677 in ECA comparators and .632 in global comparators. Similarly, economic activity has an average spatial Gini of .647 in the Western Balkans and Croatia, .702 in ECA comparators, and .691 in global comparators.

The dispersion of urban population and economic activity across cities in the Western Balkans and Croatia is particularly evident in comparisons with the rest of ECA (figure 1.14). The spatial Gini values for urban populations in the study area except Croatia are below the ECA average, as are the spatial Ginis for concentration of economic activity. Montenegro, Bosnia and Herzegovina, and Kosovo have the lowest Gini values for both, which suggests that in those countries urban populations and economic activity are much more dispersed. The values for Albania, Serbia, and Croatia are closer to the ECA averages but still below them.

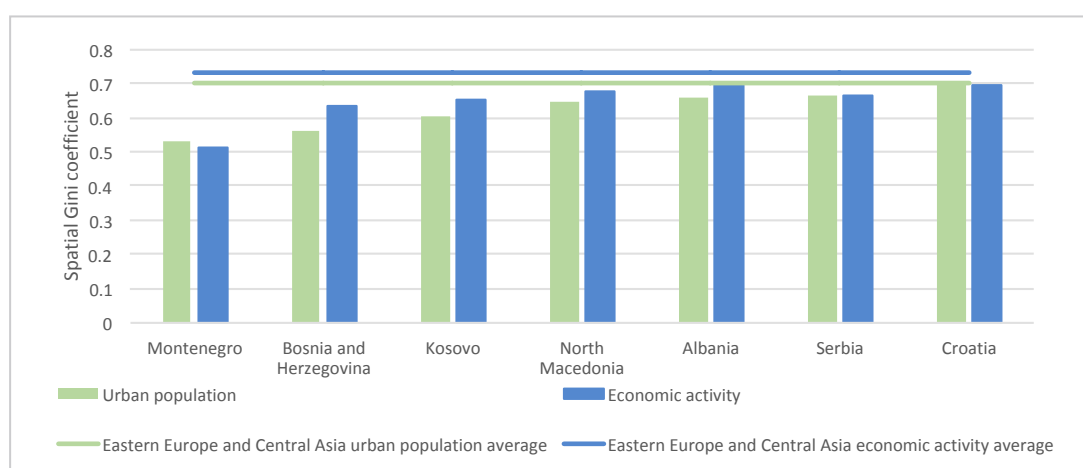


Figure 1.14 Urban population and economic activity are more dispersed in the Western Balkans and Croatia than in other countries in ECA

Source: Roberts et al. 2017.

Note: The spatial Gini coefficient is a measure of the degree of concentration of population and economic activity in an urban system, ranging from 0 (equal distribution across all cities) to 1 (concentration in a single city).

Most of these countries also have low urban primacy. On average, 30.6 percent of their urban populations live in the largest city, compared with 37 percent for ECA comparators and 51 percent for global comparators (figure 1.15).

However, in Bosnia and Herzegovina and Serbia urban primacy is very low, with less than 30 percent of the urban population living in the largest city, while in Croatia and Montenegro urban primacy is close to 40 percent, above the ECA comparator average ECA comparators (figure 1.16). The low level of primacy for Bosnia and Herzegovina is expected, given a fragmented administrative structure that supports development of large cities in both the Federation and the Republic of Srpska. Kosovo's very small size and very young system of cities may partly explain why primacy is not higher there. Furthermore, "medium-sized cities demographics [in the Western Balkans] resisted external shocks due to conflicts, redrawing of national frontiers and institutional upheaval better than large agglomerations" (Dimou and Schaffar 2009), which may have contributed to the low levels of primacy observed today.

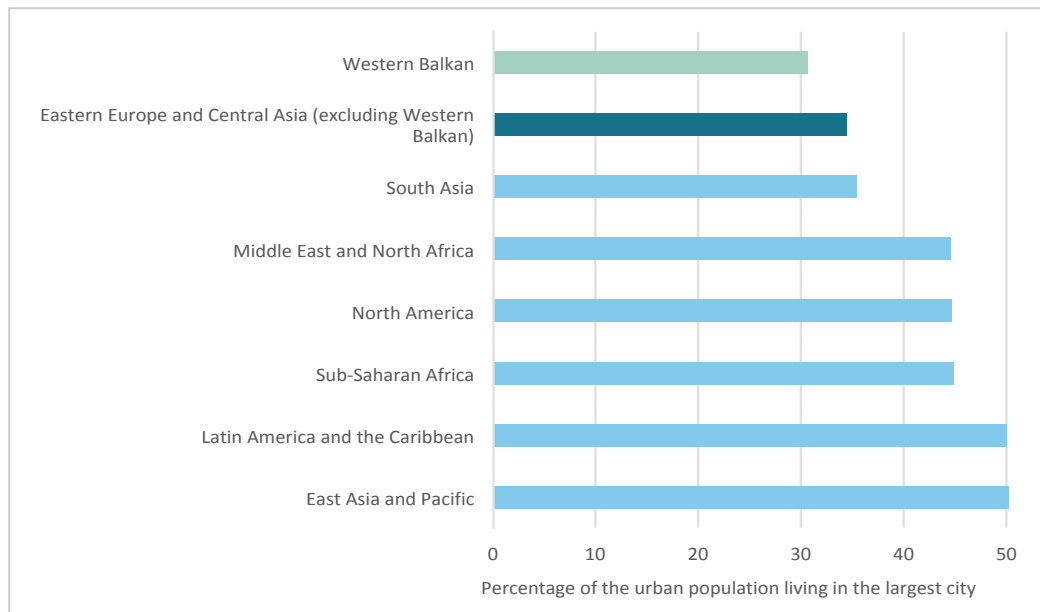


Figure 1.15 Urban primacy is lower in the Western Balkans and Croatia than in other regions

Source: Roberts et al. 2017.

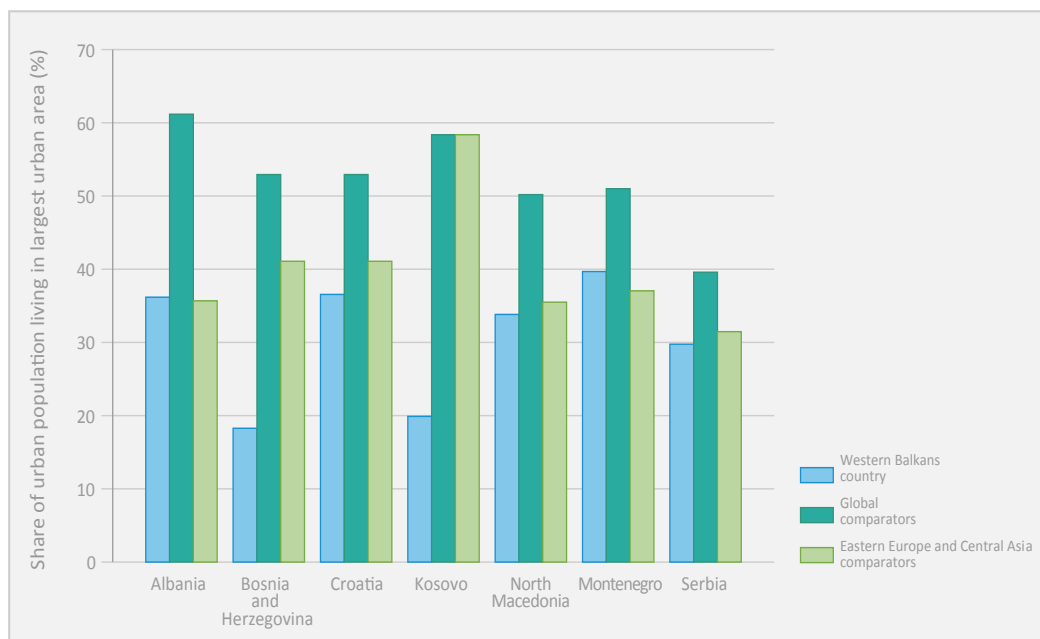


Figure 1.16 Urban primacy is also lower in most Western Balkan countries than in ECA and global comparators

Source: Roberts et al. 2017.

Urban population and economic activity are increasingly concentrated in fewer cities

While urban populations and economic activity appear to be more dispersed in the Western Balkans and Croatia than elsewhere, it is still important to assess trends in the spatial Gini coefficient. The analysis, using the Cities in ECA database, suggests that, as in ECA generally, in a number of countries urban populations and economic activities are increasingly concentrated in a few cities (table 1.1)¹⁸. However, the results for Croatia and Kosovo for 2000–10 suggest that their urban populations are spreading even more thinly. While caution is needed in interpreting the results for Kosovo because the sample is small, the results for Croatia might require further study. In 2000–10 all countries except Bosnia and Herzegovina saw economic activities become more concentrated.

Country	Urban population Gini trends		Economic activity Gini trends	
	1990–2000*	2000–10*	1990–2000	2000–10
Albania	+	+	+	+
Bosnia and Herzegovina		+	+	–
Croatia	+	–	–	+
Kosovo	–	–	–	+
Montenegro	+	+	+	+
North Macedonia	+	+	+	+
Serbia	–	+	–	+
Western Balkans, average	+	+	+	+
Eastern Europe and Central Asia, average (excluding the Western Balkans)	+	+	+	+

Table 1.1 In nearly all Western Balkan countries, urban populations and economic activity became increasingly concentrated (1990–2010)

Source: Restrepo et al. 2017.

Note: Regional (ECA and Western Balkans) averages are weighted and do not include Bosnia and Herzegovina or Kosovo because their data are for different periods (1991–2013 for Bosnia and Herzegovina and 1991–2001 for Kosovo). The spatial Gini coefficient is a measure of the degree of concentration of population and economic activity across the urban system, ranging from 0 (equal distribution across all cities) to 1 (concentration in a single city).

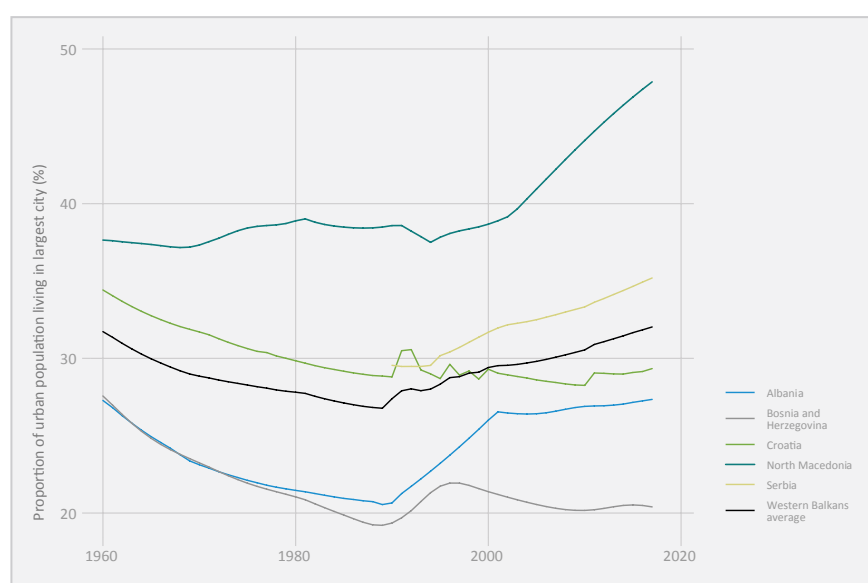


Figure 1.17 Urban primacy is rising in the Western Balkans and Croatia, though at different rates, 1960–2015

Source: WDI 2018.

In many countries in the region, notably Albania, North Macedonia, and Serbia, urban primacy has been rising steadily since the early 1990s, (figure 1.17). In Bosnia and Herzegovina and Croatia, urban primacy levels have not changed much since 2000.

Policy Implications

Western Balkan and Croatian cities are small, sparsely populated, and unfavorably located for trade. Urban population and economic activities also appear to be more dispersed across cities in the region than elsewhere. These characteristics limit potential agglomeration economies. Being poorly located for international trade also limits integration into international markets. Being small and poorly located are factors not very amenable to changes in policy, and demographic trends are likely to exacerbate these conditions, resulting in smaller and possibly more sparsely populated cities. Thus, greater efforts will be required if these cities are to better their economic performance

- First, there appears to be room for urban population and economic activity to become more concentrated. Fortunately, this is already happening in most of the study countries, with dispersion diminishing and urban primacy increasing. Governments can give impetus to concentration by reducing domestic barriers that prevent people and businesses from moving to areas of greater opportunity. Higher concentrations of urban populations and economic activities, if well-managed, can facilitate emergence of agglomeration economies in larger cities. However, as populations become concentrated in larger cities, some smaller cities are likely to suffer an abrupt decline, which will also need to be managed.
- Second, national and local governments can influence how cities are structured and managed in order to foster the emergence of agglomeration economies and keep congestion costs low. While small cities are inevitable, given the small average populations in the Western Balkans and Croatia (3.7 million inhabitants), population sparsity is likely a result of local policies. For example, local government can, for example, encourage denser urban environments around transport corridors. Improving inner-city connectivity can enhance productivity gains linked to agglomeration. Finally, reducing coordination failures within multicity agglomerations can boost productivity, in particular in large agglomerations (box 1.3).

BOX 1.3

Beyond density and fragmentation: The importance of urban forms and institutions

A study of Latin American cities and the links between city productivity and three dimensions of urban form (the shape of the city's border, the street network, and land use patterns) shows how these factors influence a city's economic performance¹⁹. Beyond density, the study found, the shape of the city's border and its internal structure (for example, street or intersection density) also matter.

Because various dimensions of urban form can affect a city's productivity, local governments have an important role in unlocking this potential by improving the city's internal structure. Focusing on these three dimensions of urban form, cities should draft a strategy that allows them to enhance their current situation and become more productive. For instance, sparsely populated cities with good intra-city connectivity can be more productive than dense cities with poor connectivity.

In improving city performance, multicity agglomerations often suffer from the failure of local governments to coordinate. This is true of many of the largest Western Balkan cities. In their study of five OECD countries, Ahrend et al. (2014) found that administrative fragmentation is associated with lower city productivity, although a metropolitan governance body can cut the negative effects in half. Duque et al. (2019b) have extended this to developing countries, finding that in Latin America, the more administrative units in a given city, the greater the negative effect on productivity, and metropolitan governance institutions are failing to mitigate the effects of administrative fragmentation.

These findings suggest two major factors that can promote multicity productivity: effective local institutions and efficient coordination between local governments. Although functioning institutions are crucial to achieve high city productivity, multicity agglomerations need to take a further step. Since multicity agglomerations require an administrative structure in which many different local governments interact, they should pay special attention to those interactions to avoid coordination failures and devise methods and processes that assure efficient collaboration between local governments.

How are cities performing economically?

Two types of assessment were conducted to explore the economic performance of Western Balkan and Croatian cities. One looked at whether the relationship between urbanization and economic development in countries in the study area differs from that in countries in other regions. The second examined the economic performance of cities by benchmarking their performance against that of cities elsewhere in the world, using such indicators and proxies of economic performance as GDP per capita, employment growth, and nighttime light intensity. The question was whether urbanization in the study area has followed the path of more advanced economies and to determine how the cities are performing economically relative to a subset of similar countries.

Countries are performing at the global average but below the productivity frontier

The results of urbanization in the Western Balkans and Croatia are similar to those elsewhere in the world

A regression analysis was conducted to study the relationship between urbanization (urban population shares at the country level) and economic development (GDP per capita in purchasing power parity [PPP] terms). The analysis, which followed the approach of Restrepo et al. (2018) confirmed a close relationship between the urban population in a given country and its GDP per capita. Globally, for the average country, a 1 percent increase in the share of a country's urban population is linked to a 3.7 increase in its GDP per capita.

The Western Balkans and Croatia do not diverge from the global norm: urbanization seems to be producing the same economic development results there as in the rest of the world. However, the global average has been lowered by regions like Sub-Saharan Africa, where urbanization is producing mediocre economic development results²⁰, so it might be more revealing to compare the Western Balkans and Croatia to better-performing countries.

The Western Balkans and Croatia are performing below EU 2004 and EU 2007 accession countries and the global frontier

If the Western Balkans and Croatia aspire toward convergence with more developed economies or wish to follow the path of other countries in ECA that recently joined the EU, their performance should be compared with the global economic frontier—in this case Western Europe. To be a country on the economic frontier means, today, using resources in the most efficient ways, specifically using cities and the system of cities to produce the best economic outcomes seen globally.

Consider two hypothetical countries with the same share of population living in urban areas and a similar system of cities. In one, city population density is organized along transport corridors, institutions are in place to manage multicity agglomerations and solve administrative coordination failures, and people can move freely from one city to another to find jobs that match their skills and incomes that maximize their welfare. In the other, none of this is happening. These differences in the management of urban areas are likely to have very different economic outcomes.

Urbanization in the Western Balkans and Croatia is producing results that statistically are significantly below those of Western Europe, the global frontier (see annex 1B)—although the Western Balkans and Croatia are performing at the global average, there is considerable room for improvement. The fact that urbanization in EU 2004 and EU 2007 accession countries is not significantly different from what is happening elsewhere in Western Europe suggests that those countries, unlike the study area, have been more efficient at reaping the economic development benefits of urbanization.

Cities are performing above the global average but below the productivity frontier

Because of the lack of data on the economic performance of cities, this analysis uses nighttime light intensity data as a proxy for city productivity, and changes in intensity as a proxy for productivity growth. Two types of nighttime light data are used. One is the World Bank's Global Nighttime Lights (NTL) dataset²¹, which records urban footprints and the light they emitted at intervals in 1996–2010. The other is satellite data derived from the Visible Infrared Imaging Radiometer Suite, which since 2011 has been producing higher-resolution data that is much more accurate in predicting economic performance at a fine spatial scale²². In both cases, Western Balkan cities are benchmarked against cities around the world, in the ECA region, and ECA and global comparators.

To compare the economic performance of Western Balkan cities with that of other cities around the world, productivity, measured by changes in nighttime light intensity, was regressed against city population in 2012 (agglomeration economies are expected to enable a bigger city to be more productive than a smaller one, holding everything else constant). For a given city size, Western Balkan cities (the fitted red line in figure 1.18) seem to be performing above the global average (the fitted blue line). However, for a given city size, there is also large room for improvement, as many cities elsewhere are much more productive than those in the study area.

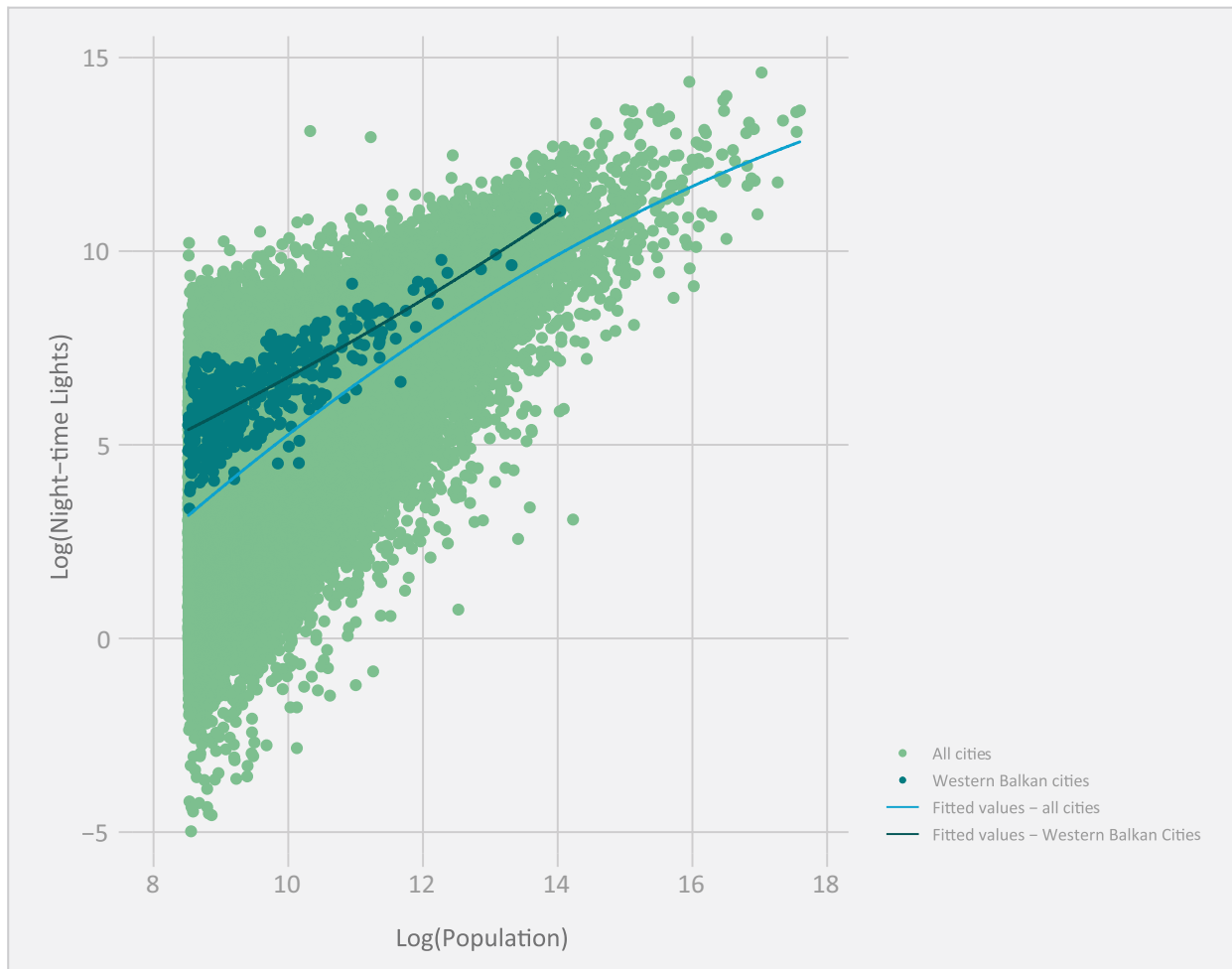


Figure 1.18 Western Balkan cities are performing economically above the rest of the world but below the global frontier
Source: Data from Roberts et al. 2017.

In global and regional comparisons, city economic performance is mixed

The economic performance of cities in the Western Balkans and Croatia was assessed against global and ECA comparators (countries of similar population and area matched to each country in the study area). To control for population—since comparator countries can have cities of different sizes—the residuals from the city performance regression illustrated in figure 1.18 are used. The residual, “urban area productivity,” is a measure of how much a given city’s productivity is above its predicted population-based level. (This can best be interpreted as labor productivity.) A positive value implies higher-than-predicted productivity for a city’s size.

This analysis reveals several patterns worth highlighting. First, as expected, the mean urban area productivity across the Western Balkans and Croatia is positive—cities in these countries are performing, on average, above their population-based predicted level (figure 1.19). Second, they are also performing, on average, above their global comparators. However, when their performance is benchmarked against ECA comparators, the results are mixed. Cities in Albania and Bosnia and Herzegovina appear less productive than their ECA comparators, which suggests room for improvement. In the other countries, the average city appears to be performing better than its ECA comparator.

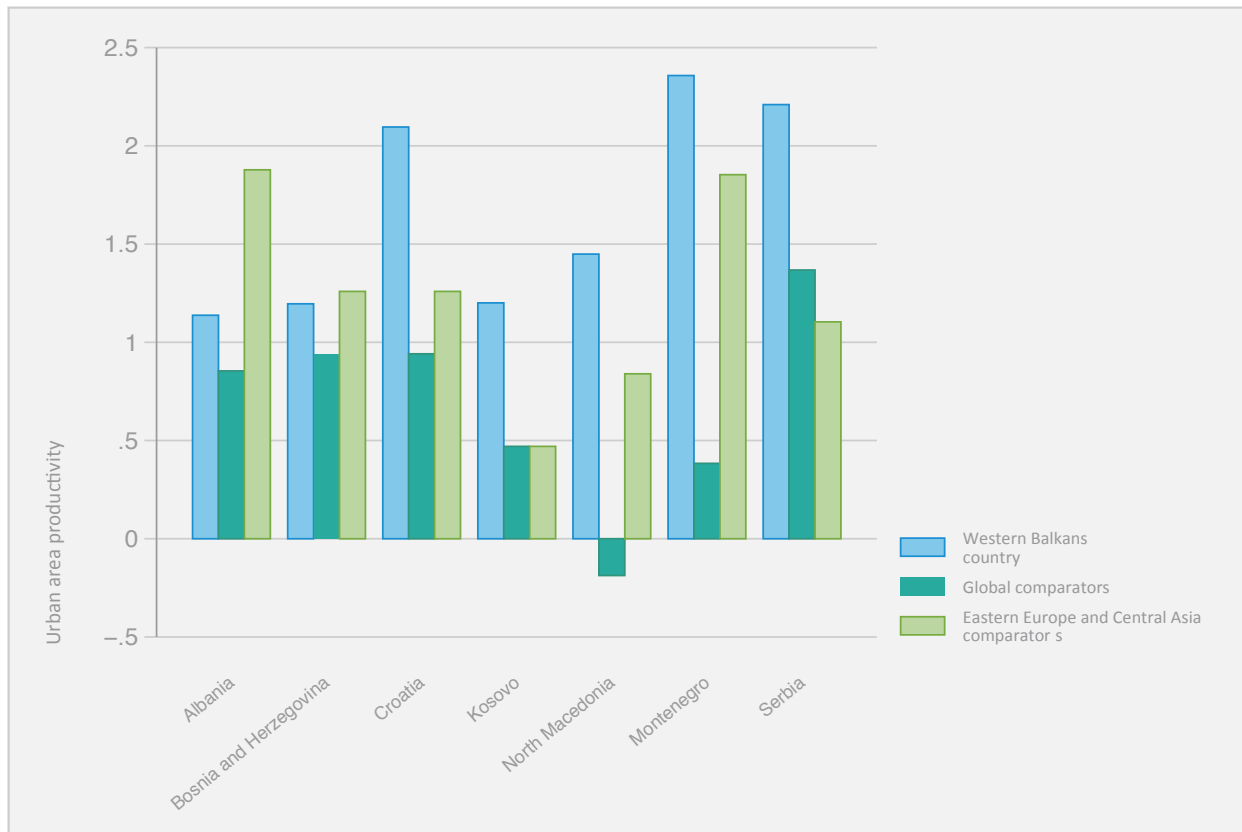


Figure 1.19 The economic performance of Western Balkan cities relative to ECA comparators is mixed

Source: Urban area productivity is measured using the residuals from the regression of $\ln(\text{sum nighttime lights 2015})$ and $\ln(\text{population 2012})$ shown in figure 1.19. A country's mean urban area productivity is given by the mean of these residuals across its urban areas.

City economic performance in greater detail

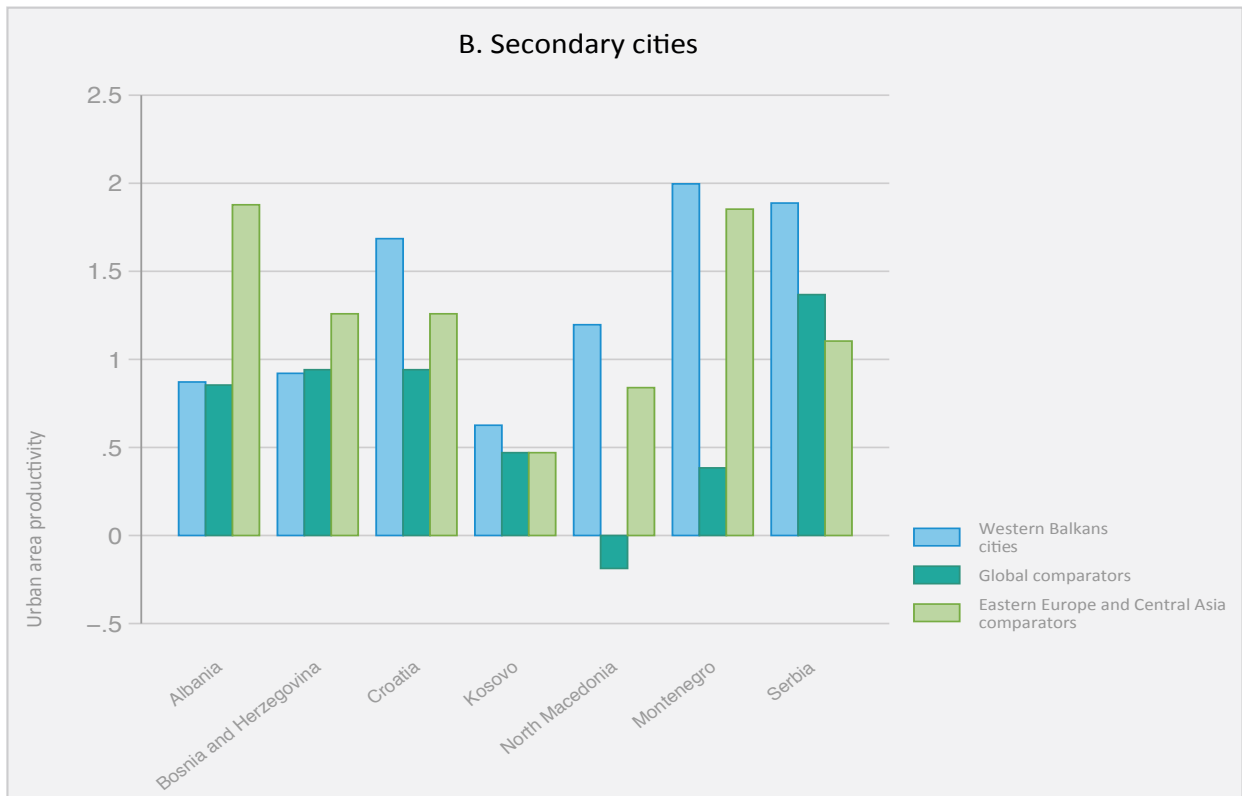
Prominent characteristics of Western Balkan and Croatian cities—small size, sparse and dispersed population, and poor location for trade—limit their potential to foster agglomeration economies and become engines of national growth. In what follows, the benchmarking exercise is expanded to compare the labor productivity (derived from nighttime lights data) of cities of different sizes in the study area to get a more granular understanding of urban economic performance.

Small and secondary cities seem to be performing better than capital cities

The results of this analysis of Western Balkan and Croatian cities, by size (figure 1.20):

- Capitals in all countries studied are performing below capitals in ECA comparators, and the capitals of Albania, Bosnia and Herzegovina, and Serbia are also performing below global comparators.
- Except in Albania and Bosnia and Herzegovina, secondary cities (those in the top quintile of the urban population distribution in each country minus the capital city) are performing better than both global and ECA comparators

- The performance of small cities is mixed. Small cities in Albania seem to have the lowest performance comparatively, followed by Bosnia and Herzegovina. In the rest of the region, small cities are outperforming global and ECA comparators in labor productivity.



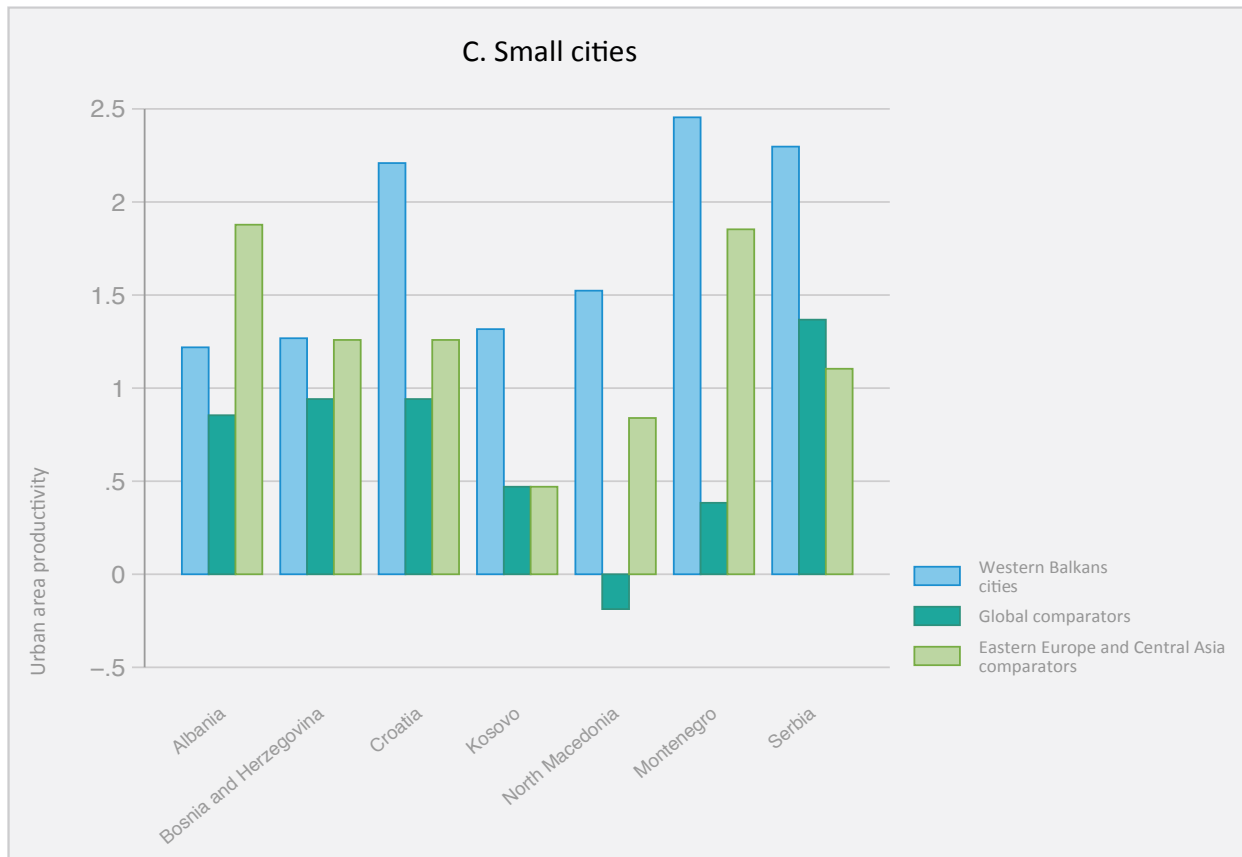


Figure 1.20 Capitals in the Western Balkans and Croatia apparently underperform secondary and small cities in labor productivity

Note: Urban area productivity is measured using the residuals from the regression of $\ln(\text{sum nighttime lights 2015})$ and $\ln(\text{population 2012})$ shown in figure 1.19. A country's mean level of urban area productivity is given by the mean of these residuals.

Source: Roberts et al. 2017.

Are bigger cities better for growth?

Bigger cities are usually more productive than smaller ones because of agglomeration economies, so they are often engines of growth for the country. Long-term economic growth, proxied by growth in nighttime light intensity, was analyzed to assess the contribution of city size and of the capital and secondary cities in the Western Balkans and Croatia and in ECA as a whole. The compound annual growth rate of nighttime light intensity was estimated for three periods (1996–2000, 2000–05, and 2005–10) and then regressed on the log of city population, using fixed effects by country to account for national differences in growth rates.

Before the global financial crisis (1996–2000 and 2000–05), being a bigger city in the Western Balkans and Croatia had no significant effect on long-term economic growth in the first period (column 1 in table 1.2) but was associated with significantly higher growth in the second (column 2). However, during the crisis, being bigger was associated with significantly slower growth (column 3). In the rest of ECA, bigger cities were associated with significantly higher growth in both pre-crisis periods (columns 4 and 5) and with significantly slower growth during the crisis. In short, being bigger was an advantage for cities in ECA as a whole when times were prosperous, but the relationship is less strong for cities in the study area. During economic downturns, being bigger seems to have been worse for growth in both the Western Balkans and Croatia and ECA comparators. This is probably because bigger cities generally have closer ties than smaller ones to global markets.

Variable	Western Balkans and Croatia			Europe and Central Asia (excluding the Western Balkans and Croatia)		
	(1)	(2)	(3)	(4)	(5)	(6)
	1996–2000	2000–05	2005–10	1996–2000	2000–05	2005–10
City size (log city population)	0.315 (0.27)	1.033*** (0.28)	−0.983*** (0.10)	0.541*** (0.10)	1.114*** (0.11)	−0.843*** (0.03)
Constant	−1.753 (2.67)	−7.904*** (2.73)	15.425*** (0.95)	−12.837*** (1.15)	3.030** (1.22)	11.082*** (0.34)
Number of observations	201	201	201	2,750	2,750	2,751
R-squared	0.36	0.35	0.673	0.317	0.381	0.497

Table 1.2 Being bigger was apparently not an advantage for cities in the Western Balkans and Croatia in 1996–2010

Source: Data from Restrepo et al. 2017, updated.

Note: The compound annual growth rate of nighttime light intensity was estimated for three time periods (1996–2000, 2000–05, and 2005–10) and then regressed on the log of city population. All regressions include country fixed effects.

Shrinking cities do not seem to be performing systematically worse than growing ones.

Most cities in the Western Balkans and Croatia are losing population, and demography and emigration data suggests the trend is likely to continue for some time. In the best-known global examples of city population decline—the “Rust Belt” in the United States Midwest and the “Monotowns” of the former Soviet Union—population fell along with a city’s decline, often because a predominant industry was shrinking.

Is the economic performance of shrinking cities in the Western Balkans and Croatia worse than that of growing cities? Two proxy indicators of productivity in 2010 (nighttime light intensity per square kilometer and per capita) were used to compare the performance of shrinking cities, growing cities, cities growing above the national city growth average (“winners”) and cities growing less than the average (“losers”). Comparing winners with losers

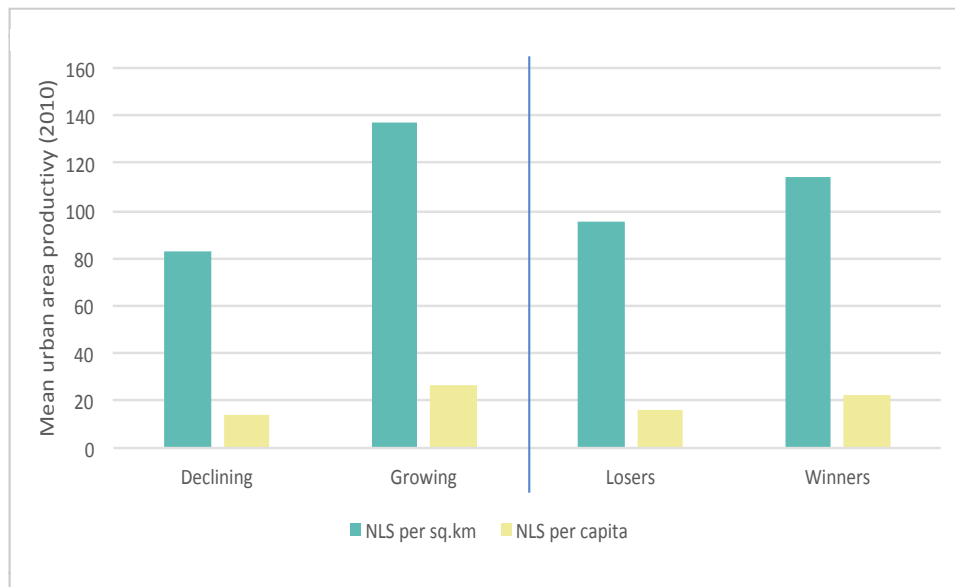


Figure 1.21 Cities losing population are less productive than cities gaining population

Source: Data from Restrepo et al. 2017, updated.

may be more informative for the study area, where so many cities are shrinking. The analysis found that the average shrinking city is underperforming²³ the average growing city in these countries, and the average loser city is underperforming the average winner (figure 1.21).

However, when looking at growth rates proxied by growth in nighttime lights, the results are mixed. Declining cities performed worse than growing cities before the financial crisis (2000–05) but better after (2005–10). The same is true in comparing loser and winner cities (figure 1.22). This suggests that city population decline in the Western Balkans and Croatia is not closely linked to economic decline; nor is population growth linked to economic growth.

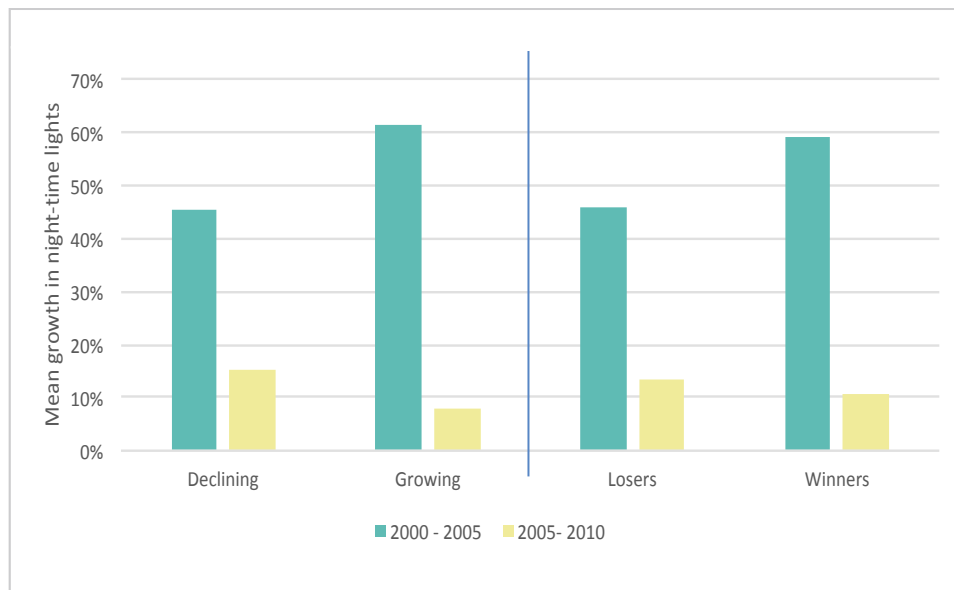


Figure 1.22 Economic and population growth are not closely linked in Western Balkan and Croatian cities

Source: Data from Restrepo et al. 2017, updated.

Key Findings and the Way Forward

Urbanization in the Western Balkans and Croatia seems to have delivered economic gains similar to those in countries globally, but performance in the region still trails that of Western Europe (the productivity frontier). Cities in the study area except Albania and Bosnia and Herzegovina also seem to be performing well relative to similar countries in ECA and in the world.

However, a more granular analysis reveals that even as the average city in the Western Balkans and Croatia is doing well, large and capital cities are not contributing much to economic growth. In fact, they are underperforming such cities in similar ECA countries. And while being a large city was advantageous for economic growth in ECA countries in prosperous times, that was less true for large cities in the study area. Since 2009 large and capital cities in these countries seem to be trailing rather than leading national economic growth. Understanding the reasons for the underperformance of capital and large cities and how their potential can be unleashed will be critical if these countries are to reap the full benefits of urbanization (see chapter 2).

Finally, while globally a declining urban population is often linked to economic decline, that is apparently not the case in Western Balkan and Croatian cities. In fact, many shrinking cities are performing as well as or better than growing ones, particularly since the global financial crisis.

If plans go as expected, most Western Balkans countries will become EU members (Croatia is already an EU member state). Capital and secondary cities will be able to access EU markets more easily but will also face more severe competition for workers. Small coastal countries might become part of regional tourism circuits but to benefit sustainably they might require better-quality amenities and management. Greater integration of the Western Balkans with the EU also has implications for population concentration, spatial disparities, and overall welfare, as discussed in the Spotlight.

Endnotes

¹ Population data for cities in the Western Balkans and Croatia are generally available for years around 1989, 2000, and 2010. To make the discussion easier to follow, those three years are used throughout the chapter but designated with an asterisk to indicate “around” that year (1989*, 2000*, and 2010*).

² Chenery and Taylor 1968; Henderson 2003.

³ See, for example, Marshall (1890) and Duranton and Puga (2004).

⁴ Hajdu and Racz 2011

⁵ In 2016, all Western Balkan countries had fertility rates below replacement levels except Kosovo, whose fertility rate was 2.1.

⁶ Bussolo, Koettl, and Sinnot 2015.

⁷ Population in the average Western Balkan city is shrinking by 0.098 percent a year, while population in the average city in ECA (excluding cities in the Western Balkans and Croatia) is growing by 0.079 percent a year.

⁸ Restrepo et al. 2017.

⁹ Henderson et al. 2016.

¹⁰ Roberts et al. 2017.

¹¹ Henderson et al. 2016.

¹² This is true for all cities with fewer than 250,000 inhabitants, which includes most cities in the Western Balkans and Croatia. For cities with more than 250,000 inhabitants, results are mixed.

¹³ Hajdu and Racz 2011.

¹⁴ The procedure for selecting comparator countries has two steps. First, every country is classified as an island or landlocked or neither. Each Western Balkan country is compared only with countries in the same classification. Second, three comparator countries that are closest in area, population, and population density are selected for each Western Balkan country. This comparator selection process is conducted for ECA and globally.

¹⁵ The use of night-time light data to proxy economic activity was first proposed by Henderson, Storeygard, and Weil (2011, 2012) and is now a well-established practice in the absence of better economic data. As outlined by Henderson et al. (2016), Shi et al. (2014), and Restrepo et al. (2017), among others, there are a strong positive correlation between growth in night-time light and GDP growth at the country level and one between night-time light and GDP at the subnational level.

¹⁶ World Bank 2008.

¹⁷ Henderson 2000.

¹⁸ Restrepo et al. 2017.

¹⁹ Duque et al. 2019a.

²⁰ Ferreyra and Roberts 2018.

²¹ The Global Night-time Lights dataset was produced by the Defense Meteorological Satellite Program (DMSP) Optical Line Scanner. The dataset addresses saturation issues found in the raw night-time lights and also incorporates interannual calibration to ensure comparability across years.

²² Shi et al. 2014.

²³ Statistically significant at .01.

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Annex 1A: The location of cities in the Western Balkans and Croatia

The analysis here replicates the work of Henderson et al. (2016). It assesses how cities emerge as a consequence of certain natural characteristics, rather than manmade features. Here, it helps to understand the fundamentals of study area city sites, and how they compare to those of cities elsewhere. Economic activity, proxied by nighttime light radiance in 2010, was regressed on three groups of location fundamentals—base, agriculture, and trade fundamentals, following Henderson et al. (2016) and borrowing an approach from Restrepo et al. (2017). Base fundamentals are variables related to disease vectors and terrain ruggedness, agriculture fundamentals are variables related to agricultural viability, and trade fundamentals are variables related to access to water transport.

The results suggest that population and economic activity in the Western Balkans and Croatia is concentrated in locations not very favorable for trade: Location fundamentals explain just 39 percent of the location of population and economic activity in the study area, compared with 58 percent worldwide (figure A1.1.1). The explanatory power of location fundamentals is also much lower than for ECA comparators (44 percent), global comparators (59 percent), market economies (58 percent), and planned economies (59 percent).

Among location fundamentals, trade fundamentals (25 percent) explain much less than agriculture fundamentals (38 percent) about where economic activity occurs in the Balkans. That is also true for most of the comparators, which is not surprising since many of them urbanized at a time when transport costs were high and thus location of their cities was influenced more by agriculture than by trade. However, when the role of trade in explaining the location of economic activity today is compared, the Western Balkans and Croatia value (25 percent) is even lower than for planned economies (27 percent).

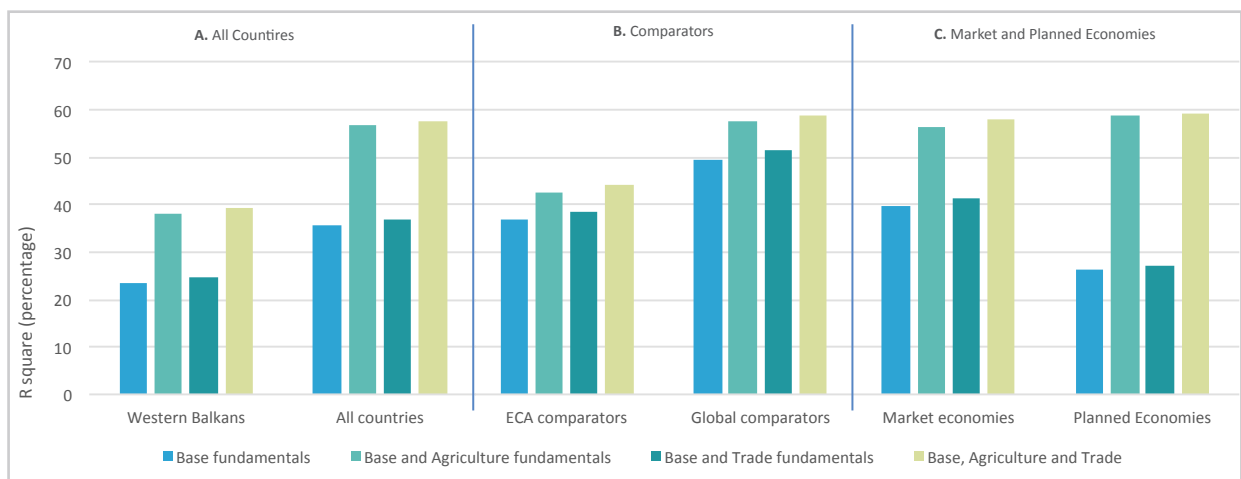


Figure 1A.1 Location fundamentals explain only about 39 percent of where population and economic activity occur in the Western Balkans and Croatia

Source: For Panel A: Henderson et al. 2016); for B and C: World Bank calculations based on data from Henderson et al. 2016.

Note: This figure shows estimated R-squares of regressions of the dependent variable natural log of radiance-calibrated nighttime lights on combinations of base, agriculture, and trade fundamentals. The unit of observation is the individual grid cell. Base fundamentals include disease (malaria) and terrain ruggedness, agriculture fundamentals include 14 biome indicators (2 for the Western Balkans), and trade fundamentals include variables related to access to water transport. All regressions include country fixed effects.

Finally, among all location fundamentals, elevation seems to have the most influence over the location of economic activity in the Western Balkans and Croatia (figure A1.1.2). The Balkan and Alp mountain ranges seem to have been a clear structuring element for the economic geography of the region. In contrast, being near the coast, a river, or a harbor seems to have had the least influence, which explains the poor location of these cities for trade.

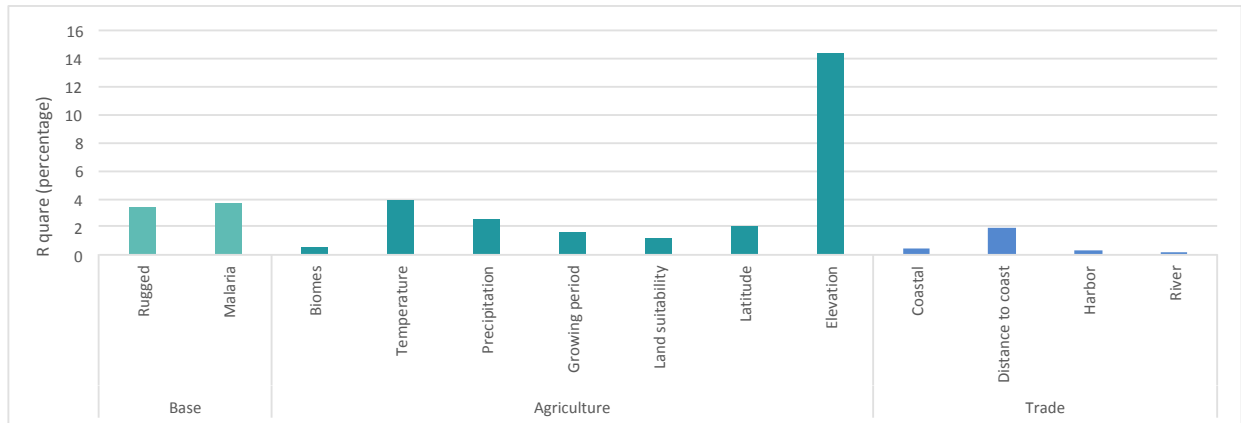


Figure 1A.2 Among location fundamentals, trade and agriculture do not explain much about the location of Western Balkan cities

Source: Data from Henderson et al. 2016; World Bank calculations.

Note: This figure summarizes regression results. The dependent variable is economic activity, and the independent variables correspond to base, agriculture, and trade location fundamentals. The figure reports R-squared for each of the regressions. All regressions include country fixed effects.

Annex 1B Urbanization and economic development: The Western Balkans and Croatia

Variable	(1)	(2)	(3)
	All countries	With Western Balkans and Croatia dummy variable	Western Balkans and Croatia relative to the global economic frontier
Urban population share	3.743***	3.757***	3.539***
	-0.459	-0.460	-0.379
Western Balkans and Croatia		0.386	-0.859**
		-0.41	-0.377
EU 2004 accession (<i>Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia</i>)			-0.072
			-0.342
EU 2007 accession (<i>Bulgaria and Romania</i>)			-0.440
			-0.595
South Caucasus			-1.287**
			-0.496
Belarus, Russia, Ukraine, and Moldova			-1.101**
			-0.44
Central Asia			-1.828***
			-0.402
Turkey			-0.665
			-0.818
Rest of world			-1.555***
			-0.206
Constant	6.861***	6.837***	8.210***
	-0.294	-0.295	-0.32
Number of observations	146	146	146
R-squared	0.316	0.320	0.575

Table 1B1 Testing the relationship between economic development and urbanization for the Western Balkans and Croatia, 2012

Source: World Bank 2018 and urban population shares based on the urban areas defined using a cluster algorithm (as described in Ferreyra and Roberts 2018).

Note: The table shows the results of regressions at the country level where the dependent variable is GDP per capita in PPP terms in natural log, and the independent variables are the urban share and regional dummy variables.

A regression analysis was used to study the relationship between urbanization (urban population shares by country in 2012) and economic development (GDP per capita in purchasing power parity [PPP] terms). Results from the regression analysis can be found in table . In testing for all countries, there is a highly significant positive relationship between the share of the urban population in a country and its GDP per capita (table A1.2.1, column 1). A 1 percent increase in the urban population is linked to a 3.7 percent increase in GDP per capita. When a dummy variable for the Western Balkans and Croatia was added to the regression to test whether these countries diverge from the global relationship, there was no significant divergence (table A1.2.1, column 2). Thus, urbanization seems to be producing the same economic development results in the study area as in the rest of the world. When additional dummies are added to incorporate Western Europe as the global productivity frontier (table A1.2.1, column 3), however, there is a significant divergence, suggesting that the Western Balkans and Croatia are underperforming the global productivity frontier (negative coefficient). Table A1.2.1, column 3, also reveals that the urbanization process in EU 2004 and EU 2007 accession countries is delivering economic benefits close to the global productivity frontier.

Spotlight

The spatial effects
of greater
integration with
the European
Union

Since the 1990s, the Western Balkans and Croatia have experienced a series of dramatic shocks that have affected patterns of urbanization and territorial development. The history of the Western Balkan region has been a long sequence of waves of integration and disintegration¹ —Hajdu and Racz (2011) called it the “region of changing empires.” The past 30 years represent the latest wave of disintegration, and possibly one of the most dramatic. They have seen the emergence of new states and national borders, changes in political regimes, major revisions of economic systems from central planning to market economies, wars, mass migrations, and a geopolitical reorientation toward Western Europe. Integration with the European Union (EU) is the next chapter in the story of geopolitical change that will markedly affect the region’s economic geography.

This Spotlight presents the results of analyses using a spatial general equilibrium model developed and calibrated for the Western Balkans and Croatia to assess the subnational and national impacts of greater integration with the EU. For data quality reasons and to ensure consistency of the analysis across countries, the model focuses on Bosnia and Herzegovina, Montenegro, and Serbia. General equilibrium models are used to examine the interaction of all economic agents and thus generate broad results that are difficult to spot in a partial equilibrium analysis (see box S.1 for details on the methodology). 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, clarifying the aggregate effects on welfare of a change—in this case, greater integration with the EU.

BOX S.1

Methodology: A spatial general equilibrium model to evaluate transport interventions

Research in quantitative spatial economics explores how firms and workers decide what, how much, and where to produce. These decisions are reconciled through general equilibrium models that can be calibrated based on such observed variables as population density and economic activity. Because of their meaningful connection with regional data, the models can be used to assess the effects of different transport interventions—such as improved roads, removal of trade barriers, and increased permeability of borders—on the spatial distribution of economic activity.

The spatial general equilibrium model for the Western Balkans and Croatia assesses the effects of improvements in the internal transport network on the integration of regions with global markets. The model looks at how reductions in domestic transport costs affect the competitiveness of regions in the production of imports and exports. Detailed in Lall and Lebrand (2019), the model relies on previous work on Argentina², the Belt and Road Initiative in Central Asia³, and Bangladesh⁴. Its three main building blocks—geography, economic activity, and workers—are connected by the land rents, goods prices, and wages that prevail in each region. Consistent with the idea of a general equilibrium, in each region prices and wages adjust to balance supply and demand. This model is used to look at counterfactuals for transport and border scenarios and for the impact of improving urban amenities in a subset of cities.

EU integration and the Western Balkans and Croatia

Economic integration with foreign markets is an important driver of economic development, especially for small countries⁵. It raises income through specialization and provides access to cheaper and higher-quality imported goods. Border reforms and improvements in transport infrastructure influence the degree of economic integration. Many trade and transport projects supported by the EU are intended to strengthen regional connectivity by integrating the Western Balkans and Croatia into the EU's Trans-European Transport Network (TEN-T)⁶.

Cities and regions within the Western Balkans and Croatia are likely to adjust to trade openness and improved connectivity driven by better integration with the EU. The potential gains from integration arise from greater opportunities for local producers and workers to access larger markets and suppliers. How regions adjust is influenced by how much market access improves; local comparative advantages (endowments of primary factors, technology, and preferences); labor mobility; and changes in technology that allow for clustering and economies of scale.

As outlined in chapter 1, population and economic activity in the Western Balkans and Croatia are more dispersed than in other regions. Western Balkan cities are notable for being small, sparsely populated, and unfavorably located for trade. From an economic perspective these are disadvantages. Reductions in trade and transport costs affect wages, goods prices, and land rents, which drive workers' decisions about whether to migrate and firms' decisions about whether and where to produce. All these forces must balance, but the economic and spatial outcomes from better EU integration—for instance, whether it leads to population growth and concentration in certain cities—remain unclear without further analysis⁷.

Better roads, more permeable borders, and more attractive cities

Poor road quality in the main transport corridors and impediments at border crossings block better integration of the Western Balkans and Croatia with the EU. In the region, as in the rest of Europe, roads are the major transport mode for moving goods and people⁸. Several corridors act as the main arteries linking the region with Europe⁹. More investments are necessary to improve the comprehensive and core road networks, segments of which are of poor quality. Border compliance time for exports ranges from 4 hours for Serbia to 9 hours for Albania¹⁰. Those times, while not long in global comparison, are long for small countries, making it difficult for Western Balkan producers to compete with EU producers, which can access consumers and firms in a border-free zone. Nor do Western Balkan cities offer a good pool of amenities that can attract the workers and firms needed to create and benefit from agglomeration economies.

Interventions to improve EU integration

The model looks at two interventions to improve EU integration: improvement of regional transport corridors (figure S.1) and a reduction in border impediments between the Western Balkans and Croatia and EU countries¹¹. The model also incorporates a complementary policy of improving amenities in selected cities to make them more attractive to people and firms. Finally, 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 situations where it is much lower.

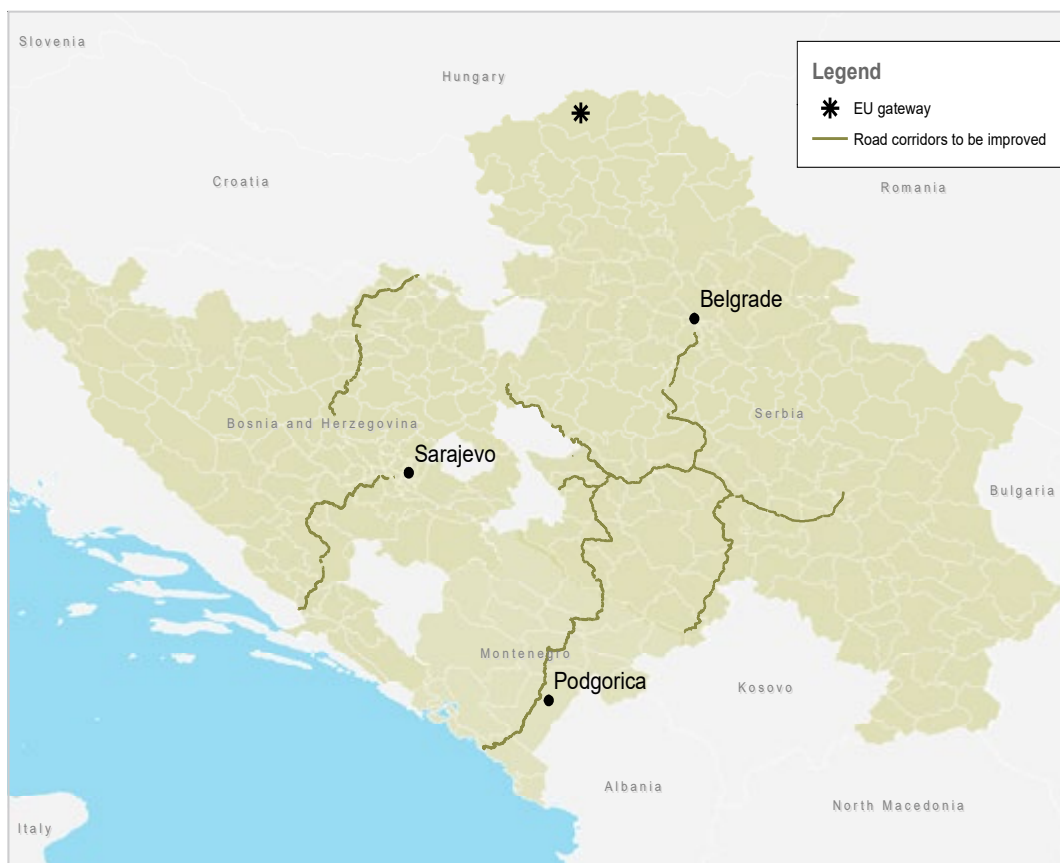


Figure S.1 Proposed investments to improve regional road networks

Source: Roads proposed to be upgraded in the Western Balkans Investment Framework, “Connectivity Agenda Co-financing of Investment Projects in the Western Balkans in 2018.” See: <https://www.wbif.eu/sectors/transport/road>

Improving roads and reducing border impediments have heterogeneous regional impacts

As expected, regions are affected differently by different EU integration interventions. For the road corridor improvement, the percentage reduction in transport costs is, not surprisingly, greater for regions along the transport corridors, but nonexistent for some regions (figure S.2). In contrast, when interventions include both improving roads and reducing border impediments, transport costs are reduced for almost all regions in the three countries studied (figure S.3). These results are based on a baseline scenario with high moving costs (described below).

The welfare gains are also larger when the two types of intervention are combined. Thus, for example, while in some regions real wages decline after road improvements alone (figure S.4), they rise in all regions when time at the border is also reduced (figure S.5). These different welfare outcomes illustrate the importance of using general equilibrium models to assess benefits.

Real wages increase most in regions that benefit from large declines in transport costs due to improved roads and reduced border impediments; have a higher share of manufacturing in total production; and generally have higher livability scores. In the three Western Balkan countries, better connectivity and higher comparative advantage in manufacturing are the main determinants of welfare gains. Urban centers attract a moderate number of additional workers¹².

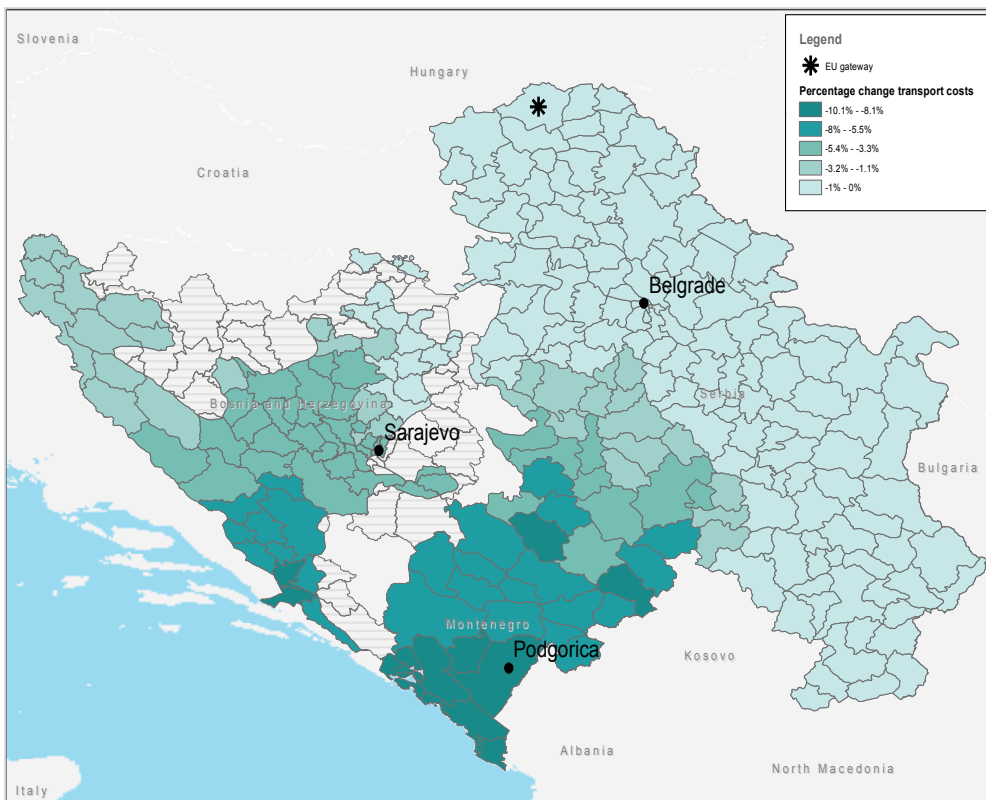


Figure S.2 Change in transport costs: Road improvements only

Source: World Bank staff calculations based on the general equilibrium model.

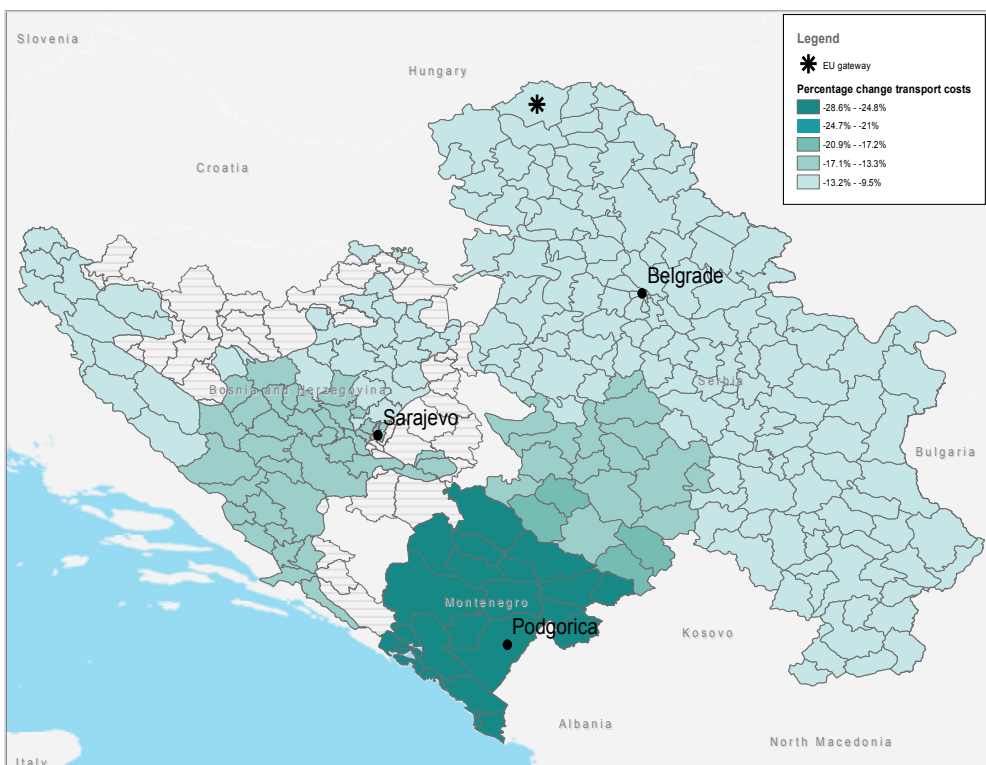


Figure S.3 Change in transport costs: Road and border improvements

Source: World Bank staff calculations based on the general equilibrium model.

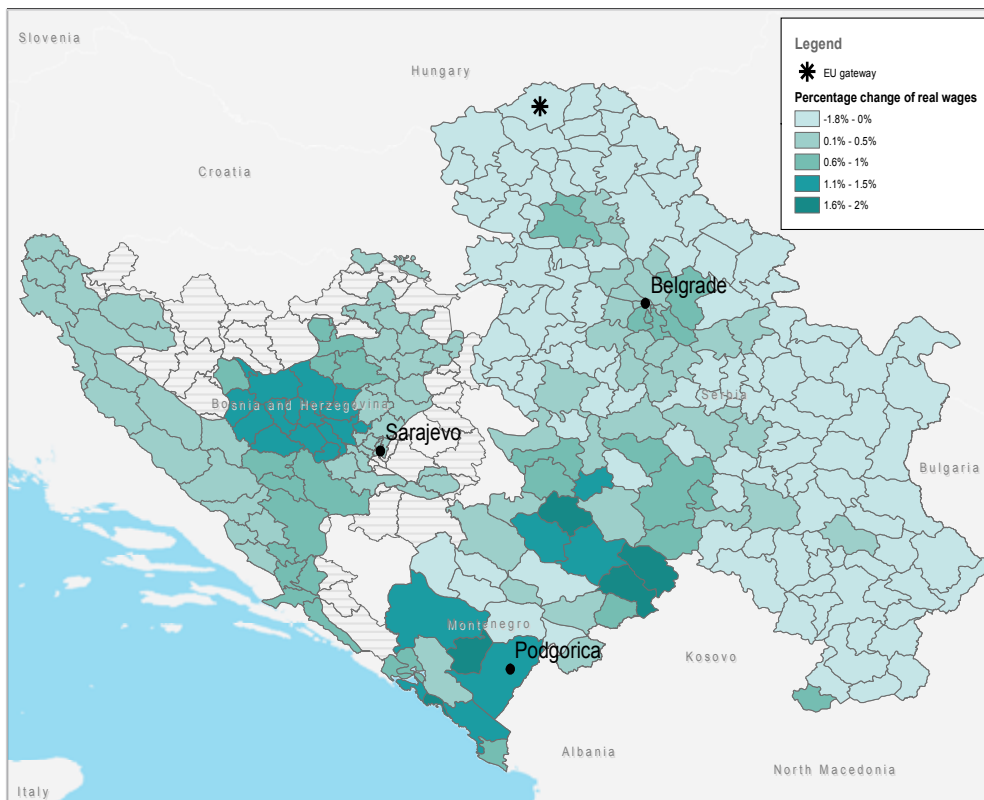


Figure S.4 Percentage change in real wages: Road improvements only

Source: World Bank staff calculations based on the general equilibrium model.

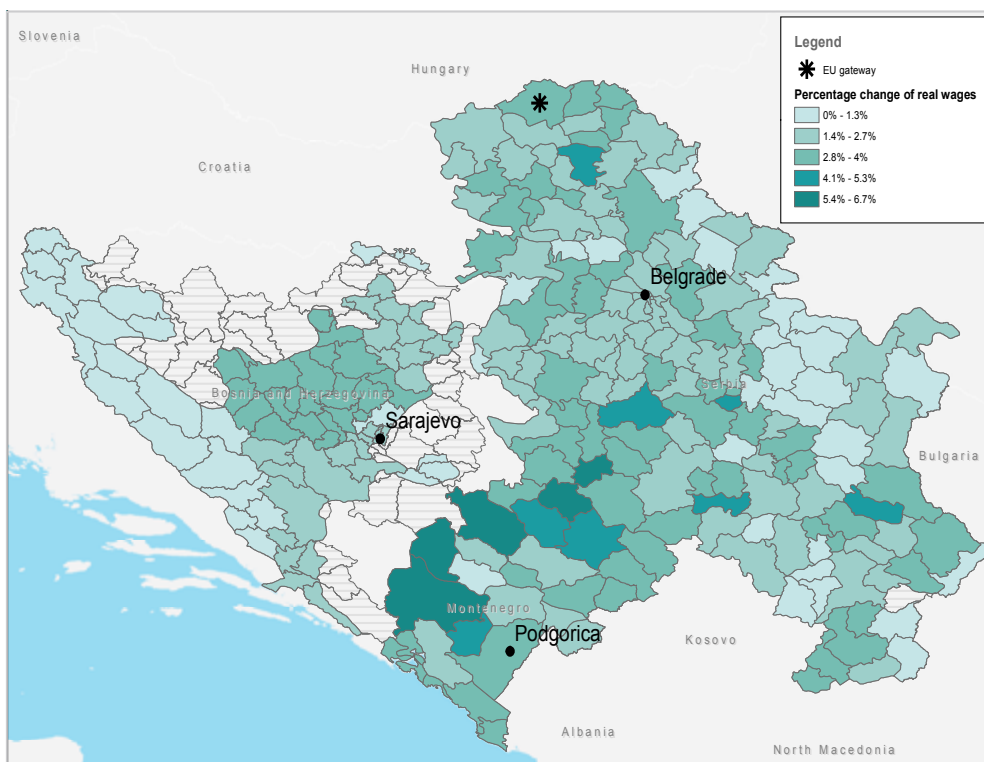


Figure S.5 Percentage change in real wages: Road and border improvements

Source: World Bank staff calculations based on the general equilibrium model.

Introducing complementary policies: Making cities more attractive and moving less expensive

Cities with better amenities offer a higher quality of life and attract more people and firms. Many Western Balkan cities lack such amenities, as evidenced by the initial low level of population concentration. That absence explains why investing only in road and border improvements will not lead to higher population concentrations. As chapter 1 showed, in the small, sparsely populated, and dispersed urban systems in the Western Balkans and Croatia, more concentration in fewer urban centers is likely to lead to better economic performance and greater welfare gains. However, with the current limited attractiveness of Western Balkan cities, the model results indicate that the two interventions examined (improved roads and border crossing) might lower population concentration in urban areas (figure S.6).

To study the effects of improving amenities, the analysis considers the impact of a complementary policy to improve the amenity scores by 20 percent in a subset of cities in Bosnia and Herzegovina, Montenegro, and Serbia, in addition to road and border improvements¹³. For the three Western Balkan countries studied, the model shows that the share of total population in the most densely populated regions will decline if cities do not also improve their attractiveness as they increase their integration with the EU; failure to do so would reduce the gains from agglomeration for workers and firms (figure S.6). In contrast, population density increases when amenity investments are added to road and border improvements (figure S.7).

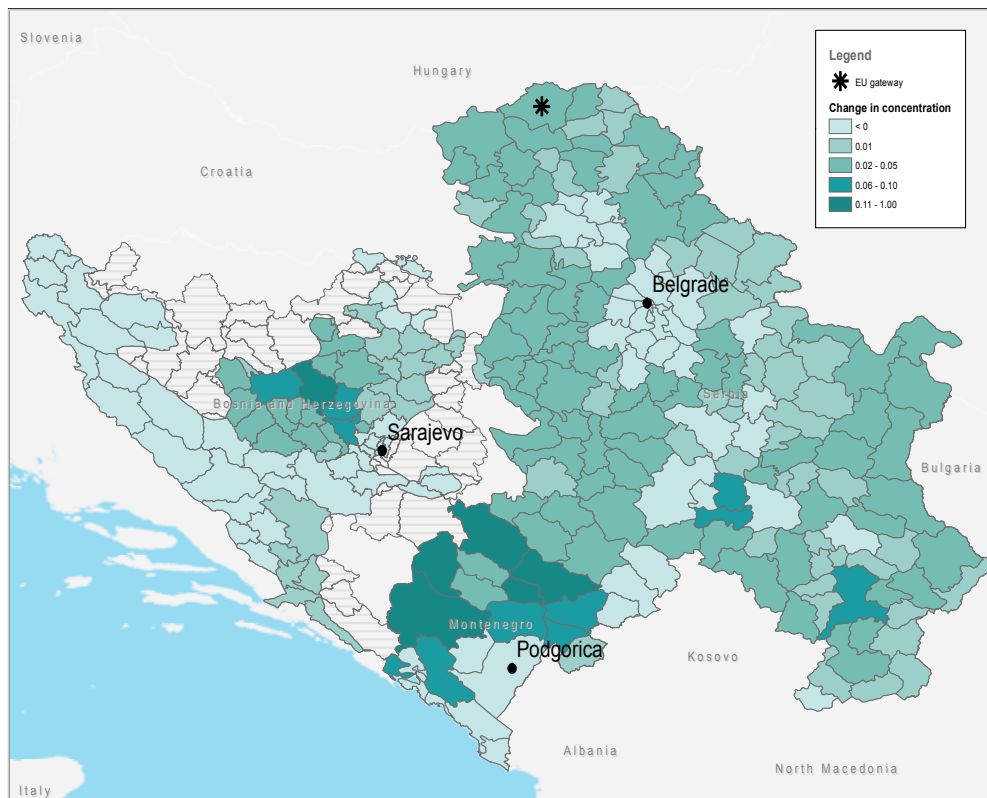


Figure S.6 Change in population concentration: Road and border improvements only

Source: World Bank staff calculations based on the general equilibrium model.

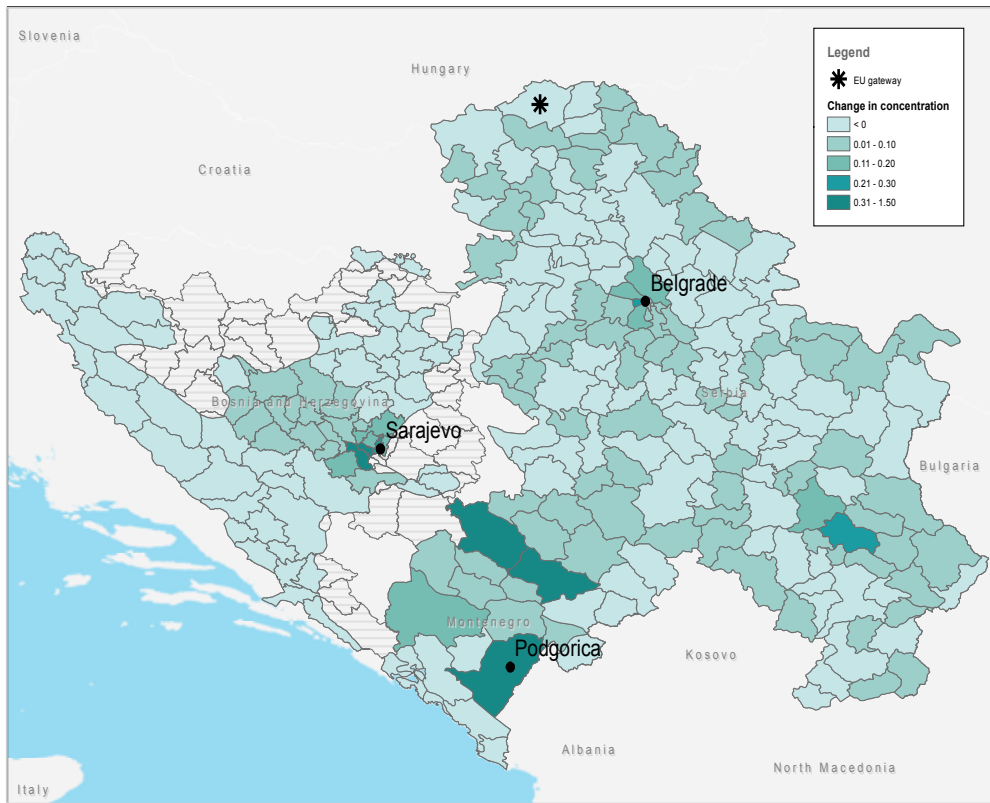


Figure S.7 Change in population concentration: Road, border, and amenity improvements

Source: World Bank staff calculations based on the general equilibrium model.

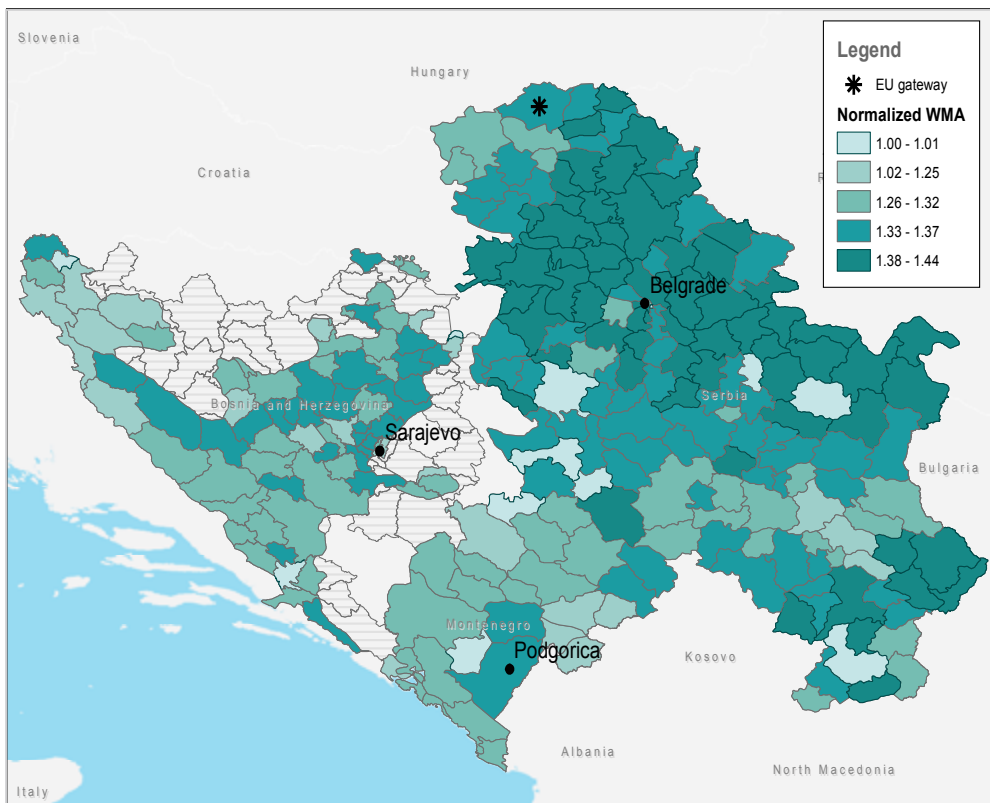


Figure S.8 Worker Market Access index scores by region for a high-cost-of-moving scenario

Source: World Bank staff calculations based on the general equilibrium model.

Note: Access to opportunities is captured by the Worker Market Access index, a weighted sum of the welfare for each region within countries given the matrix of mobility costs between regions.

To better understand how a change in city amenities can affect population concentration, it is also necessary to consider the cost of moving to another location to take advantage of better amenities. This exercise considers two possible scenarios: one with high labor mobility costs and one with low. Following EU integration, the key to encouraging population concentration is making urban areas more attractive while removing constraints on domestic mobility.

High monetary costs for domestic mobility reduce the monetary gains from work and push domestic workers to areas with the most amenities, generally the capital. Moreover, high mobility costs created by formal or informal barriers—due, for example, to inefficiencies in labor and housing markets—will increase the disparities for workers from different regions in accessing the opportunities created by EU integration (captured by the Worker Market Access index¹⁴). When mobility costs are high, the difference in access to opportunities between workers with the best access and those with the worst is 43 percent in Serbia, 35 percent in Bosnia and Herzegovina, and 18 percent in Montenegro (figure S.8). These disparities disappear when mobility costs are low.

National impacts of road, border, and complementary policy interventions

An advantage of general spatial equilibrium modeling is the ability to look beyond specific gains and losses at a lower scale or for the units studied (firms, households) to measure the global effects of a specific national policy. To assess the benefits of greater EU integration, as modeled by an increase in transport connectivity and reduced border impediments, national welfare gains are measured and compared with the baseline scenario. Then the impacts on welfare and spatial inequality are assessed for implementing complementary policies—in this case, lowering mobility costs and improving amenities in selected urban regions. Tables S.1 and S.2 report results for conditions of high and low mobility costs for Bosnia and Herzegovina, Montenegro, and Serbia.

In terms of welfare gains and spatial disparities, the following are the main lessons of this exercise:

- *Reducing border impediments and improving roads has a larger effect on a country's welfare than just improving roads.* For instance, when moving costs are high for Serbia, reducing border frictions in addition to improving roads leads to an estimated welfare gain of 3 percent, while improving roads alone brings a gain of 1 percent (table S.1). For Montenegro, the estimated welfare gains increase from 3 to 5 percent when reducing border frictions is added to highway construction¹⁵.
- *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 and by 14 percent when costs are low. Similarly, in Montenegro, welfare increases from 6 to 12 percent, and in Bosnia and Herzegovina from 2 to 12 percent (see table S.1, change in baseline for improved roads + reduced border frictions).
- While EU integration policies usually focus on improving transport connectivity and reducing border frictions, *complementary policies like making cities more attractive seem to be necessary to achieve the highest welfare outcomes.* Increasing amenities in a subset of cities, along with improving roads and reducing border impediments, also seems to produce a large reduction in spatial real wage inequalities. In the high-moving-costs scenario, this policy combination 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 (table S.2).
- *Road and border improvements have little impact on workers' market access.* As expected, the policy that is most effective in reducing disparities in access to opportunities is reducing the costs of moving. It is

also important to highlight that in the high-moving-costs scenario, an improvement in urban amenities appears to increase disparities in access to opportunities in Montenegro. This does not happen in the low-moving-costs scenario.

Intervention	Bosnia and Herzegovina		Montenegro		Serbia	
	High cost of moving	Low cost of moving	High cost of moving	Low cost of moving	High cost of moving	Low cost of moving
<i>Welfare levels (1 = baseline with no change and high costs)</i>						
Baseline	1.00	1.10	1.00	1.08	1.00	1.11
Improved roads	1.01	1.11	1.03	1.09	1.01	1.11
Reduced border frictions	1.02	1.13	1.05	1.11	1.03	1.13
Improved roads + reduced border frictions	1.02	1.12	1.06	1.12	1.03	1.14
Improved roads + reduced border frictions + improved amenities	1.04	1.14	1.09	1.15	1.06	1.17
<i>Welfare gains (percentage change at the national level)</i>						
Improved roads	0.5	0.50	3.00	0.95	0.50	0.10
Reduced border frictions	1.11	1.60	4.88	2.80	2.70	2.28
Improved roads + reduced border frictions	1.62	2.10	5.77	3.65	2.90	2.50
Improved roads + reduced border frictions + improved amenities	3.99	3.90	9.00	6.60	5.90	5.40

Table S.1 Welfare effects of national interventions, with high and low mobility costs

Source: World Bank staff calculations based on the general equilibrium model.

Indicator	Bosnia and Herzegovina		Montenegro		Serbia	
	High cost of moving	Low cost of moving	High cost of moving	Low cost of moving	High cost of moving	Low cost of moving
<i>Change in spatial inequality (coefficient of variation of real wages; percent)</i>						
Improved roads	-0.38	-0.40	1.75	3.10	0.47	0.87
Reduced border frictions	-1.53	-1.57	0.36	1.60	-1.55	-1.17
Improved roads + reduced border frictions	-1.95	-1.98	0.16	1.40	-1.77	-1.41
Improved roads + reduced border frictions + improved amenities	-3.54	-3.51	-5.27	-3.83	-3.03	-2.70
<i>Differences in access to opportunities (normalized Worker Market Access index score)</i>						
Improved roads	1.35	1.0006	1.1779	1.0004	1.439	1.0009
Reduced border frictions	1.35	1.0006	1.1779	1.0004	1.439	1.0009
Improved roads + reduced border frictions	1.354	1.0006	1.1779	1.0004	1.439	1.0009
Improved roads + reduced border frictions + improved amenities	1.351	1.0006	1.36	1.0004	1.439	1.0009

Table S.2 Change in spatial disparities as a result of interventions, with high and low mobility costs

Source: World Bank staff calculations based on results from the general equilibrium model.

Endnotes

¹ Trbovich 2008.

² Fajgelbaum and Redding 2018.

³ Lall and Lebrand 2019.

⁴ Herrera Dappe, and Lebrand 2019.

⁵ World Bank 2017.

⁶ Priorities are identified in the Regional Balkans Infrastructure Study (World Bank 2015). It was recently announced that the European Union will provide grants for an additional 11 high-priority transport projects (road, rail, and ports) worth €190 million (http://europa.eu/rapid/press-release_IP-18-3821_en.htm). This investment can leverage up to €1 billion in loans from international financing institutions.

⁷ See Lall and Lebrand (2019) for a detailed description of the forces at work.

⁸ World Bank 2015.

⁹ SEETO 2018.

¹⁰ World Bank 2019.

¹¹ 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.

¹² This framework assumes that only goods, not services, can benefit from better EU integration. In reality, urban centers could also benefit from EU integration through trade in services (tourism, financial, and information technology services).

¹³ Attractiveness, captured by the amenity score, is increased by 20 percent for the following regions: all regions in the Sarajevo region, all regions in the Belgrade and Niš regions, and the Podgorica region.

¹⁴ Access to opportunities is captured by the Worker Market Access (WMA) index, a weighted sum of the welfare for each region within countries given the matrix of mobility costs between regions. Workers who have a high cost to move toward districts with high opportunities will have a low WMA score. The lower the monetary costs of mobility, the closer are the WMA index values across regions. Region WMA scores are normalized by dividing by the lowest WMA within each country.

¹⁵ In comparison, IMF estimates for the Bar-Boljare highway only are that total GDP in 2023 will be about 3 percentage points of 2014 GDP higher with the highway than without it (Article IV of 2018). The estimates of table S.1 do not include neither fiscal multipliers as in the IMF model nor the construction and maintenance costs associated with the project. It is clear that while the construction of the major highway project can boost economic growth, it also raises government debt, with a cost for the first phase of the project of nearly ¼ of GDP (Article IV of 2018).

Chapter 2.

Boosting the
competitiveness
of capital cities for
jobs, productivity,
and higher incomes

Given their primacy, concentration, market access, and skilled labor, capital cities should take the lead in jump-starting fast economic development. Capitals in the Western Balkans and Croatia have not shouldered that responsibility. Their economic growth is subpar compared with similar capitals elsewhere in ECA and is not noticeably different from that of other domestic cities and towns. Their low productivity, tepid productivity growth, and only modest employment increases provide reason to state that they have been unable to capitalize on the potential of agglomeration.

Competitive cities help their firms generate jobs, raise productivity, and raise the incomes of their citizens. As economic centers, capital cities, are confronting various macroeconomic changes as they prepare for imminent EU integration. This means, capitals in the Western Balkans must become more competitive, and in Croatia, already an EU member, Zagreb must take better advantage of member benefits. Pursuing productivity gains and job growth, all must work on four simultaneous priorities: (1) attract and expand knowledge-intensive, tradable sectors high on the productivity scale that benefit from agglomeration effects; (2) create conditions and platforms to help firms enhance productivity; (3) strengthen links between diverse sectors of the economy to ensure economywide growth; and (4) keep congestion forces at bay.

Capitals in the Western Balkans and Croatia need to create an environment that enables them to consistently meet all four objectives. Such an environment can be fostered by formulating well-conceived and prudent policies in four areas: institutions and regulations, infrastructure and land, skills and innovation, and enterprise support and finance. While the capitals vary considerably in the magnitude of persisting gaps and specific opportunities in their local economies, certain conditions pertain to all of them demand immediate attention.

Authorities need to emphasize their role as enablers of private-sector-led growth rather than regulators, and reform their regulations and institutions accordingly. Distortions in skilled labor markets impede productive job growth; policymakers must therefore ensure that the job skills of the workforce are relevant to the 21st century. Support to micro, small, and medium enterprises needs to be broader and deeper to enhance their productivity. Rapid improvements in land administration and public investments in infrastructure would speed achievement of the benefits of agglomeration.

Interventions required for capitals are not necessarily confined to a single city and require the involvement of national as well as local authorities. Considering their central role in the economy, such policies and programs would not only be beneficial for capitals, but also consequential for the national economy. Locally, to promote competitiveness, city administrations must use the full extent of their capacity and adopt more inclusive forms of governance, such as engaging more with the private sector and enhancing coordination between different tiers of government.

Capital cities: Evaluating economic importance against economic performance

Capitals act as the anchor of the economy

Capital cities and their suburbs are central to the economic agenda of their country—and rightfully so. Their dominance throughout the Western Balkans and Croatia region is easy to recognize, given the otherwise dispersed nature of economic activity and population there (chapter 1). They house, on average, about 24 percent of the

national population and are the only major urban agglomeration in their country (figure 2.1). They host 15 to 33 percent of all jobs nationally, and an average of about 35 percent of all active enterprises. In addition, a large chunk of the labor force—on average, 23 percent of the nation’s working-age population—resides in the capital city region.

Capitals have such a large concentration of population and economic activity that their contribution to national GDP is also pronounced. In 2015, capital cities in the Western Balkans and Croatia accounted for 36 percent of national GDP on average. Podgorica was responsible for 50 percent of Montenegro’s GDP, Skopje for 44 percent of North Macedonia’s, and Belgrade for 40 percent of Serbia’s. The lower GDP shares of Sarajevo, Bosnia and Herzegovina, and Tirana, Albania, still represented 25 percent of the national economy. The major share of labor, jobs, and businesses harbored in the capitals of the Western Balkans and Croatia and their notable contribution to GDP highlight their potential to propel their national economies to high-income status.

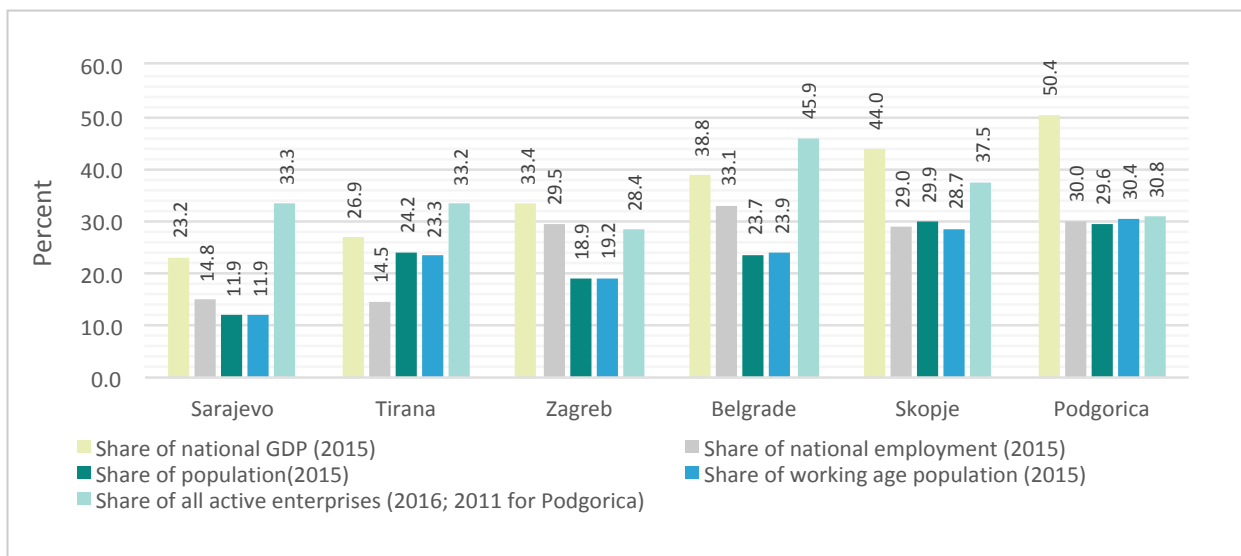


Figure 2.1 Capitals account for a large share of national GDP, jobs, population, labor force, and active firms

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; Institute of Statistics Albania (INSTAT) 2018; Statistical Office of Montenegro (MONTSTAT) 2018.

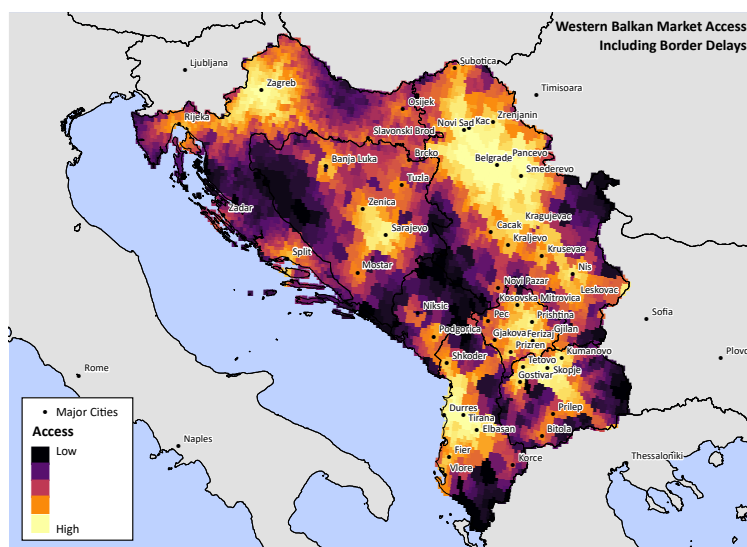


Figure 2.2 Capitals had the highest market access in the Western Balkans and Croatia (2018)

Source: World Bank 2018a.

Capitals are also focal points for engaging with international markets. A nation's path to prosperity is correlated with the magnitude of its involvement in global markets¹. The Western Balkan region as a whole has been somewhat isolated, for reasons ranging from topography to political structure to recent instability. The process of integration with the global economy, which in recent years has gained momentum, has been championed by capitals in two ways: (1) capital regions have the highest market access²—breaking a path for larger volumes of trade (figure 2.2). Within each country, even among regions with high market access, capitals are at the top³. Though this is largely the consequence of how transport infrastructure is configured to serve capitals, it puts capital city economies in a position to benefit from potential EU integration. (2) Most foreign-owned and joint enterprises in the Western Balkans and Croatia operate from or are headquartered in capitals—Tirana accounts for as much as 80 percent of foreign and joint enterprises in Albania⁴. These enterprises strengthen links to global value chains and help countries tap overseas investments, absorb expertise, and benefit from knowledge exchange.

Capital cities are struggling to pull their weight

Despite their economic primacy, they have been slow to lead growth

The economies of capitals in the Western Balkans and Croatia are unquestionably more advanced than in any other regions of each country. On average, GDP per capita in the capital is about 2.5 times that of the poorest regions⁵. The same pattern prevails in other ECA capitals and reflects conditions in European transition economies⁶.

Growth trends, however, tell a different story. Capitals in the study area have grown slower than both other regions in their countries as well as other capitals of ECA comparators⁷.

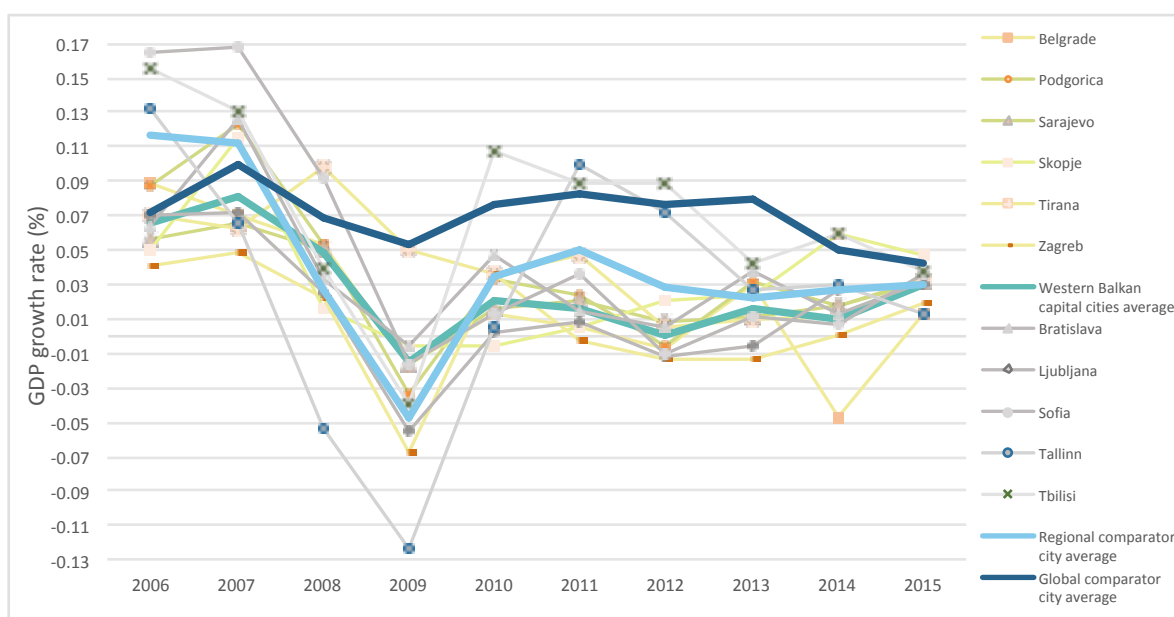


Figure 2.3 GDP growth in Western Balkan capitals has been low and stagnant since 2009, trailing regional and global comparators (2006–15)

Source: Oxford Economics 2016.

Note: Includes Zagreb.

GDP for most cities has been growing, but very slowly; growth rates have not yet reached pre-crisis levels. Before the 2008 global financial crisis, GDP growth on average in Western Balkan and Croatian capitals was generally high and rising; since 2009, however, it has been low and stagnant (figure 2.3). Capitals in ECA comparators, whose GDP growth had plummeted even further during the crisis, recovered more quickly and in most, GDP has gone up

steadily since 2010. Between 2010 and 2015, average annual GDP growth rate for the average ECA comparator capital was about 2 percentage points (pp) higher than that of the average Western Balkan capital. The relatively slow recovery of Western Balkan capitals is mainly attributable to the lingering effects of the crisis and to a series of recessions that many of these cities have since weathered. Although such unfavorable macroeconomic conditions provide a compelling explanation for slow growth, they highlight the need to expedite structural reforms to make the economies more impervious and resilient to external shocks and instability.

GDP growth in capitals across the Western Balkans and Croatia lags even when compared to their own countries both during and after the crisis. The growth performance of capital cities when analyzed for three periods—2006–10, 2011–15, and 2006–15—reveals that most capital cities grew at lower GDP per capita rates than their own countries (table 2.1). Belgrade, Tirana, Skopje, and Sarajevo all grew at lower rates during the global crisis, 2006–10. After the crisis, in 2011–15, only Podgorica and Skopje grew at higher rates than their country, while GDP per capita growth in Belgrade, Tirana, Sarajevo, and Zagreb was below that of their country. Only Podgorica performed better than its country both during and after the crisis.

Capital city, country	Capital city's GDP per capita growth compared with the country's		
	2006–10	2011–15	2006–15
Belgrade, Serbia	–	–	–
Podgorica, Montenegro	+	+	+
Sarajevo, Bosnia and Herzegovina	–	–	–
Skopje, Macedonia	–	+	–
Tirana, Albania	–	–	–
Zagreb, Croatia	+	–	+

Table 2.1 Growth in capitals relative to their country makes it clear they did not perform as the expected engines of economic growth

Source: Oxford Economics 2016.

Note: For each period, the difference between city and national GDP per capita growth is calculated using the following formula: for example, for 2006–2010: $\frac{(\text{city GDP per capita}_{2010} - 1)}{\text{city GDP per capita}_{2006}} - \frac{(\text{nat GDP per capita}_{2010} - 1)}{(\text{nat GDP per capita}_{2006} - 1)}$. A plus sign (+) indicates a city with GDP per capita growth above the national, and a minus sign (–) indicates a city

Annual GDP per capita growth in capitals was below the median growth of other statistical regions (NUTS 3 level) in the country (figure 2.4). According to data from their national statistical offices, Belgrade, Zagreb, and Tirana were among the lowest-performing regions domestically⁸. While growth rates typically plateau at high levels of income because economies have optimized the utility of all the resources they can marshal, this does not seem to have happened in capitals in the study area. Capitals are still a long way from their economic frontier, and production factors are being underused (chapter 1).

The poor performance of Croatian and Western Balkan capitals within their countries may perhaps be because they are more exposed to macroeconomic conditions. Urbanization patterns caused by the coexistence of shrinking and growing cities within the country may also have some effect on per capita growth dynamics. However, comparator ECA capitals like Bratislava (Slovakia), Sofia (Bulgaria), and Tbilisi (Georgia) were similarly affected by the crisis and exposed to the global economy, and like Belgrade, Tirana, Zagreb, and Skopje had slow population growth have nevertheless achieved post-crisis medium to high growth GDP per capita growth compared with other regions in their countries (figure 2.4).

The same picture—capitals not performing as expected—emerges repeatedly in a variety of datasets and periods of analysis. Nighttime lights data (see chapter 1) that take into account a longer period and analysis of national statistical office (NSO) data for the Western Balkans and Croatia as well as the Oxford Economics global dataset all support the same conclusion.

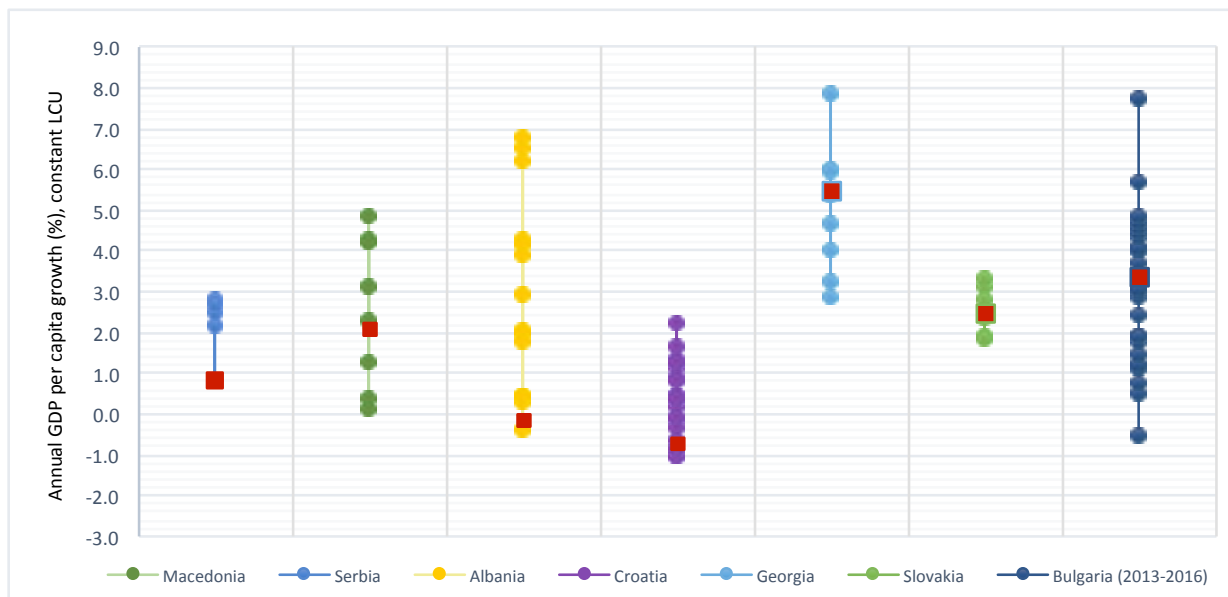


Figure 2.4 Annual GDP growth of capital city regions in the Western Balkans and Croatia trails that of other regions cities in the same country (2010–15)

Source: National Statistics Office of Georgia (GEOSTAT) 2018; National Statistical Institute, Bulgaria 2018; Statistical Office of the Slovak Republic 2018; Republic of North Macedonia, State Statistical Office (MAKSTAT) 2018; Croatian Bureau of Statistics 2018; Institute of Statistics, Albania (INSTAT) 2018; Statistical Office of the Republic of Serbia (SORS) 2018a.

Note: Derived from data from the national statistical offices (NSOs). The figure charts the average annual per capita GDP growth for all statistical regions in Albania, Croatia, North Macedonia, Serbia (at the NUTS 2 level) Georgia, Slovakia for 2010–15 and Bulgaria for 2013-16. Current GDP values derived from NSOs were changed to constant values using country-specific deflators. The base year of the deflator varies by country. The red markers represent capital cities.

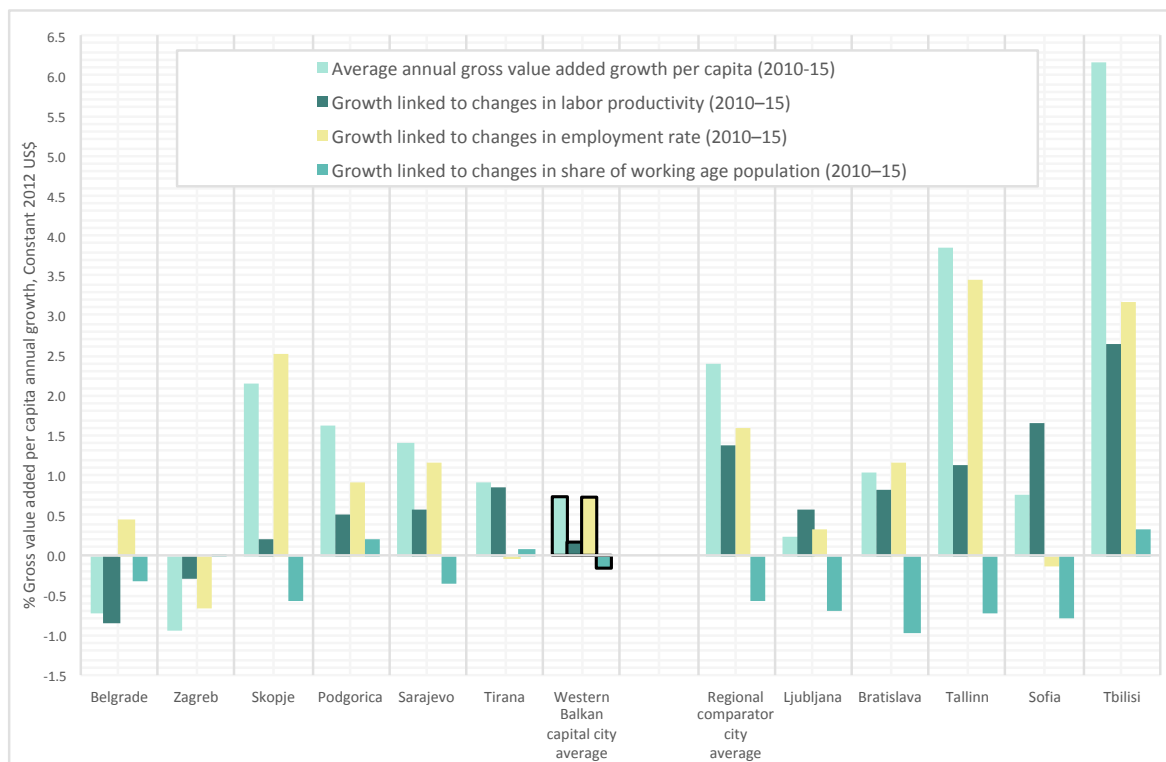


Figure 2.5 Decomposition of average annual per capita gross value-added indicates inefficient economic growth in Western Balkan and Croatian capitals (2010–15)

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 city data comparable. Zagreb is included.

Economic growth has been driven by job creation but growth in labor productivity has been conspicuously slow

Efficient economic growth calls for both sustained productivity growth and consistent job growth⁹. That has not been the pattern in capitals in the Western Balkans and Croatia. Based on a simple accounting exercise linking aggregate growth per capita to job creation, output per worker, and population structure, it appears that growth in most has been lopsided. It has been driven by job creation alone, without corresponding increases in labor productivity (figure 2.5). Skopje, the fastest-growing Western Balkan capital, with average growth of 2.15 percent in annual gross value-added (GVA) per capita exemplifies this trend: the annual contribution of labor productivity to growth has been a meager 0.2 percent, while new jobs contributed 2.5 percent. Podgorica and Sarajevo demonstrate similar discrepancies, though not as large as Skopje's. In Belgrade, declining labor productivity overrode gains in employment. Tirana is the exception; there growth was entirely determined by productivity gains, with a negative contribution from job creation. The average Western Balkan capital contrasts markedly with comparator capitals, the growth profiles of which on average are more balanced between labor productivity and job growth. In addition to economywide conditions that determine firm-level productivity, the growing concentration of tradable and more productive sectors in capitals like Bratislava and Prague can be recognized as the foundation for such assured growth in comparator capitals.

Capitals in the Western Balkans and Croatia suffer from both low labor productivity and minimal growth in that factor. In 2015 labor productivity in the average regional comparator capital was almost 1.4 times higher than the average for the Western Balkans and Croatian capital¹⁰. The six capitals cities in the study area vary considerably in productivity. For example, in 2015, labor productivity in Zagreb, the highest in the group, was almost triple that in Belgrade, the lowest. Labor productivity growth, on the other hand, has been uniformly low across the six cities and on average lower than both the average regional and global comparator capitals. Between 2010 and 2015 annual growth in labor productivity in the Western Balkan capitals and Zagreb averaged an alarmingly low 0.2 percent; in ECA comparator capitals it averaged 1.7 percent.

Relative to their countries, depending on the period, trends in labor productivity growth in Western Balkan capitals differed. During the financial crisis, 2006–10, Skopje was the only capital that performed better than its country, but in 2011–15, three capitals outperformed their country. However, for the combined 2006–15 period, labor productivity growth of the capitals did not take the lead. Four of the six displayed even lower productivity growth than their countries, which themselves are characterized by low productivity and productivity growth¹¹.

Low productivity and persistent low productivity growth are detrimental to economic advancement of the capitals; efforts to boost productivity gains deserve top priority.

Capital city, country	Capital city employment growth relative to the country		
	2006–10	2011–15	2006–15
Belgrade, Serbia	+	+	+
Podgorica, Montenegro	+	–	+
Sarajevo, Bosnia and Herzegovina	+	–	+
Skopje, Macedonia	+	–	+
Tirana, Albania	+	+	+
Zagreb, Croatia	+	+	+

Table 2.2 Job generation in capital cities and their countries

Source: Oxford Economics 2016.

Note: For each period, the analysis calculates the difference between city employment growth and the corresponding national employment growth, using the following formula (for example, for 2006–10): $\left(\frac{\text{city GDP per capita}_{2010}}{\text{city GDP per capita}_{2006}} - 1\right) - \left(\frac{\text{nat GDP per capita}_{2010}}{\text{nat GDP per capita}_{2006}} - 1\right)$. A plus sign (+) indicates cities with employment growth that is above their national employment growth, and a minus sign (–) indicates those with employment growth below their national employment growth.

Growth in the number of jobs in capitals has not been impressive, though capitals in the Western Balkans and Croatia have mostly done better than their countries in generating jobs. During the global financial crisis all the capitals did better than their countries but thereafter their performance was mixed (table 2.2).

Typically, national employment growth is driven by the country's economic centers—in the Western Balkans and Croatia, these are the capitals—which act as a major pull factor. Although rising employment in the capitals accounts for much of their economic growth, unlike in ECA comparators it has not been significantly higher than in the rest of the country (figure 2.6)¹². The average difference was only 0.15 pp between job growth in the capital and in the rest of the country, compared to 1.2 pp in the average comparator country.

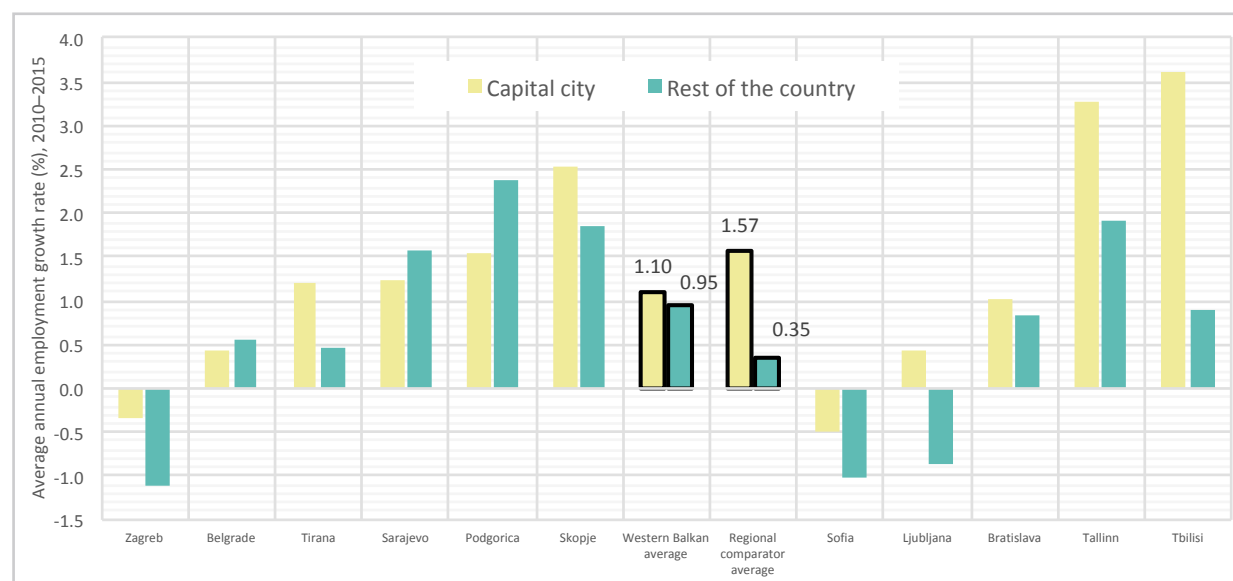


Figure 2.6 Unlike in comparator countries, annual job growth has not been notably higher in Western Balkan and Croatian capitals than in the rest of their country (2010–15)

Source: Oxford Economics 2016.

Note: Includes Zagreb.

Demographic trends are not the main barrier to growth

Demographic trends are unfavorable but do not seem to be especially detrimental to economic growth. As the Western Balkans and Croatia have been depopulating, the populations in all their capitals have been growing. However, the demographic pattern does not typically promote economic growth. In all six Western Balkan capitals, in 2010–15 the share of working-age population declined or stalled: average annual growth in that group ranged from 1.25 percent in Tirana to –0.03 percent in Belgrade and averaged a mere 0.37 percent in the average study region capital¹³. During that period the dependency ratio rose for Belgrade, Sarajevo, and Skopje, and the population aged in all six capitals (figure 2.7). These trends, though not ideal, need not deter growth, as evidenced by comparators dealing with similar demographic trends (figure 2.5). Bratislava, for example, saw a steep drop in the working-age population, but maintained positive labor productivity and growth in GVA per capita¹⁴.

Although a low net increase in the working-age population may not severely threaten economic growth, a low net increase of the skilled share of the working-age population may hinder the growth of high-value-added firms and industries. Anecdotal evidence suggests that in Tirana brain drain is severely depressing economic growth.

In summary: Capital cities are the best bets for economic development, and their economic performance is crucial

Capital city regions have the highest growth potential. In most countries, spatial concentration of people and economic activity correlates with economic development¹⁵. The Western Balkans and Croatia are more dispersed than ECA comparators (see chapter 1) in both population, as reflected in the degree of urban primacy, and economic activity, as measured by the spatial Gini coefficient. This automatically puts the group at a disadvantage in attaining faster growth. Moreover, not only are cities in these countries small and sparsely populated, but most seem to be shrinking.

In this situation, the increases in urban primacy in the region are reassuring. Although the total urban population has not grown uniformly in all Western Balkan countries, the population of capital metro regions has been rising slowly. This trend is projected to continue, and capitals are likely to remain their country's sole major urban agglomeration¹⁶. With growing populations, high population density, and a large share of national economic activity, capitals are stark outliers among cities in the region¹⁷. Because the benefits of agglomeration are predicated on these characteristics, capitals are prime candidates, and possibly the only cities in their country, to capture the dividends of agglomeration. Their status as economic centers and their position in denser networks connecting with international markets reinforce their edge.

The capital, already endowed with a large population and concentrated economic activity, may be the only region in its country that can rapidly leverage agglomeration and urbanization to transform the national economy. The current disappointing economic growth and productivity in these capitals indicate lost opportunities. Clearly, these cities have not yet been able to capitalize on their strengths in terms of economic concentration and agglomeration.

Any failure to increase competitiveness will have direct effects on welfare. Capitals are clearly confronted by increasing demand for jobs because their population growth is driven by migration rather than natural increase¹⁸. Satisfying this demand is imperative to curb unemployment and maintain standards of social welfare. The need to increase competitiveness and productivity is exacerbated by both the demographic transition capitals face and the emigration of skilled labor. Populations seem to be aging, intensifying demand for health and public services, and the younger share of the population is slowly declining (figure 2.7), which foreshadows a reduced labor force. Labor productivity gains and generation of more productive new jobs could mitigate the effects of the decline in skilled labor and help provide for the aging population.

Realizing the potential benefits of EU accession will depend on the performance of capital cities. Imminent EU accession for Western Balkan nations has been largely regarded as favorable to their economies, as it has been for Croatia. But a positive outcome of accession is not guaranteed (see the Spotlight); to a great extent it depends on how competitive the capitals are. More concentration in fewer urban centers would be necessary to reap the benefits of accession. Increased integration with the EU is also likely to decrease the population of Western Balkan capital metro areas due to enhanced mobility. If the cities fail to make themselves more attractive as mobility increases, the consequent dispersion of population would likely result in economic losses across the region.

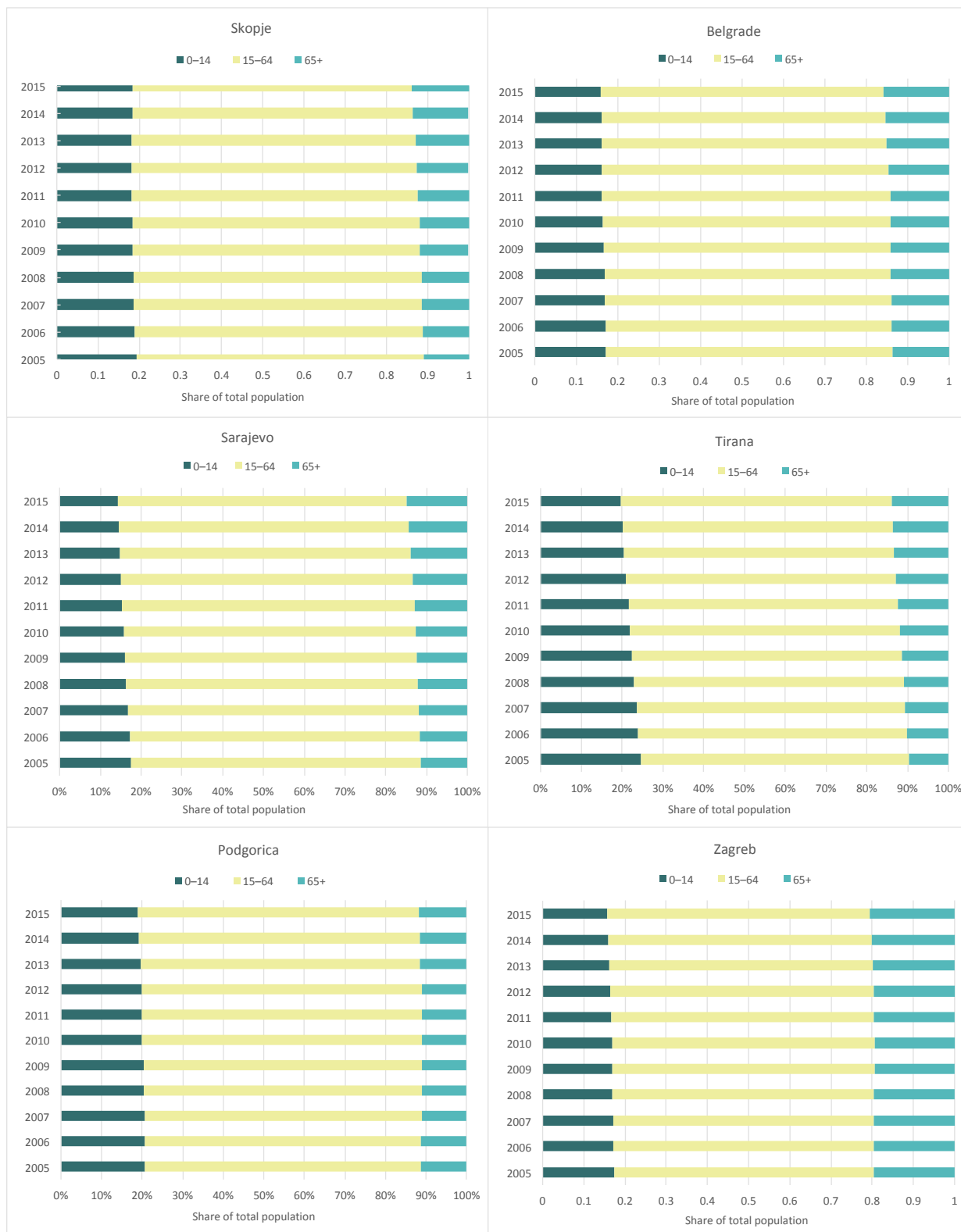


Figure 2.7 In Western Balkan and Croatian capitals, populations are aging, and the shares of younger workers are declining (2004–15)

Source: Oxford Economics 2016.

Capitalizing on agglomeration by promoting growth of tradable sectors

The correlation between city competitiveness and the share of tradable sectors in overall economic activity has been well-documented. In general, tradable sectors are those in which both demand for and consumption of the good or service produced extend beyond the local market. Strong tradable sectors are a hallmark of competitive cities, and their robust growth portends growth throughout the economy¹⁹. The productivity differentials between tradable and nontradable sectors found in numerous empirical studies²⁰ which can be linked to tougher competition in larger markets for tradable goods—provide a logical basis for these conclusions. In addition, tradable and nontradable sectors are inextricably linked, and burgeoning economic activity in tradable sectors has positive spillover effects that can uplift the entire local economy²¹. The growth of jobs in traded sectors sparks generation of employment in nontradable sectors²². This spillover results from a multiplier effect—higher earnings in the more productive tradable sectors push up demand for local services.

Capitals in the region are relatively concentrated in tradable service sectors

Capitals in the Western Balkans and Croatia are diverse, and relative to national economies as a whole they typically specialize in high-value-added tradable services²³. A common measure of regional specialization is the location quotient (LQ), the regional share of employment of a sector relative to the national share. An LQ of more than 1 indicates some degree of specialization. By this definition, Western Balkan capitals mirror diverse city economies more closely than specialized ones (figures 2.8 and 2.9). Their specialization in all sectors except agriculture and industry is not unexpected. Since capitals are the largest urban agglomerations and centers of economic activity in their country, most service activities gravitate to them. Among services, Western Balkan capitals appear to be more specialized in the tradable ones—professional services, finance and insurance, and information and communications. These sectors, also classified as knowledge-intensive businesses, typically have very high productivity, are more willing to innovate and invest in skill-building, and benefit most from agglomeration effects.

The economic structure of Western Balkan and Croatian capitals conforms to expectations about large, economically diverse cities capable of generating agglomeration economies. Large cities have the advantage of generating positive externalities created by their relative size and density. Externalities, or agglomeration economies, are realized through three channels: better matching of workers and employers, entrepreneurs and financiers, and producers, suppliers, and consumers; sharing capital costs; and facilitating knowledge spillovers²⁴.

When firms choose cities, they face a tradeoff between marginal gains from agglomeration externalities and the cost of labor²⁵. In strategizing based on this tradeoff, confirmed in a rich body of literature, more labor-intensive firms would choose smaller cities with lower costs, while more efficient firms that are more concerned with innovation and knowledge exchange would choose larger, more diversified cities²⁶. Indeed, Combes et al. (2012) found empirical evidence suggesting that firms in sectors that exhibit higher labor productivity are disproportionately more efficient in larger cities.

The room for growth in these tradable service sectors is substantial

The economic structure of competitive capitals across the globe is typified by the concentration of knowledge-based business services. But in Western Balkan capitals and Zagreb, concentration in these sectors, though higher than in their nations, is in absolute terms low²⁷. The share of total city employment in knowledge-intensive business sectors is 28 percent in Prague, 32 percent in Bratislava, but just 15 percent in Skopje. In Belgrade, the highest among the four capital cities examined here (Skopje, Zagreb, Belgrade, Sarajevo) it is a fairly low 23 percent.

The difference in the degree of specialization between capitals in the Western Balkans and Croatia and in ECA comparators is evidence of opportunities for growth in the finance and insurance, information and communications, and professional, technical, and scientific services that tend to locate in more diverse, larger, and more concentrated areas to benefit from agglomeration economies. So, given the small and dispersed nature of Western Balkan cities, the relative size and density of the capitals probably make them the best option for hosting such high-value-added, knowledge-intensive, tradable business services and subsequently experiencing sustained productivity gains and job growth. Agglomeration economies drive sectors that exhibit high productivity to begin with, creating a virtuous cycle of productivity and economic growth.

Prevailing patterns of sectoral change do not seem conducive to economic growth

Changes in sectoral structures in recent years largely explain the curtailed economic growth and low labor productivity growth in the Western Balkan and Croatian capitals. The dual objective of enhancing productivity and increasing the number of jobs is a compelling reason for these countries to take steps to enhance the growth of tradable sectors—especially those that are highly productive. But even though the sectoral composition of the economy more or less mirrors what one would expect, the pattern of sectoral evolution neither reflects the norm nor adheres to the prescribed trajectory for economic growth. Since each city has its own story, generalizations are almost impossible, but by and large, sectoral changes in the capitals are cause for concern.

Belgrade is the only Western Balkan capital whose economic structure demonstrates an efficient growth pattern. As in Bratislava and Prague, economic growth is apparently driven by the tradable sectors (figures 2.8 and 2.9). Employment in high-end services, whose workers are the most productive in the city, averaged growth of 10 percent annually in 2014–16. Employment in agriculture and industry also grew at a brisk 6 percent a year. However, although the rapid growth in tradable services should have fueled higher growth of per capita GDP, economic growth in the Belgrade region was among the slowest in the country. This could be attributable to the austerity measures that reduced the share of the public sector in the economy: The gains due to growth in tradables were overridden by contraction in the public sector because of its relatively large footprint in the city's economy.

As Skopje demonstrates, capitals may not be growing the right kinds of jobs. The discord between the pattern of sectoral change in Belgrade, Bratislava, and Prague (see figure 2.8) and Skopje's pattern (figure 2.9) is obvious. Skopje has been the fastest-growing capital in the region, but nearly all its growth stems from employment generation, without gains in output. Jobs in Skopje grew, but productivity was stagnant, when growth in both jobs and productivity would be ideal. Shifts in Skopje's sectoral structure explain how this happened. Local consumer services, which make up 32 percent of employment and are the least productive sector in the economy, have been growing at a rapid 8 percent a year, and high-value-added tradables like finance have been declining. The information and communications sector has grown, but more slowly than nontraded sectors, and its small share in the economy means its growth has little positive impact. Skopje's pattern of growth, driven by local demand and services, is not sustainable because it limits productivity gains. While generating employment is positive, it is essential to ensure that job growth occurs across the right mix of sectors, as in Bratislava.

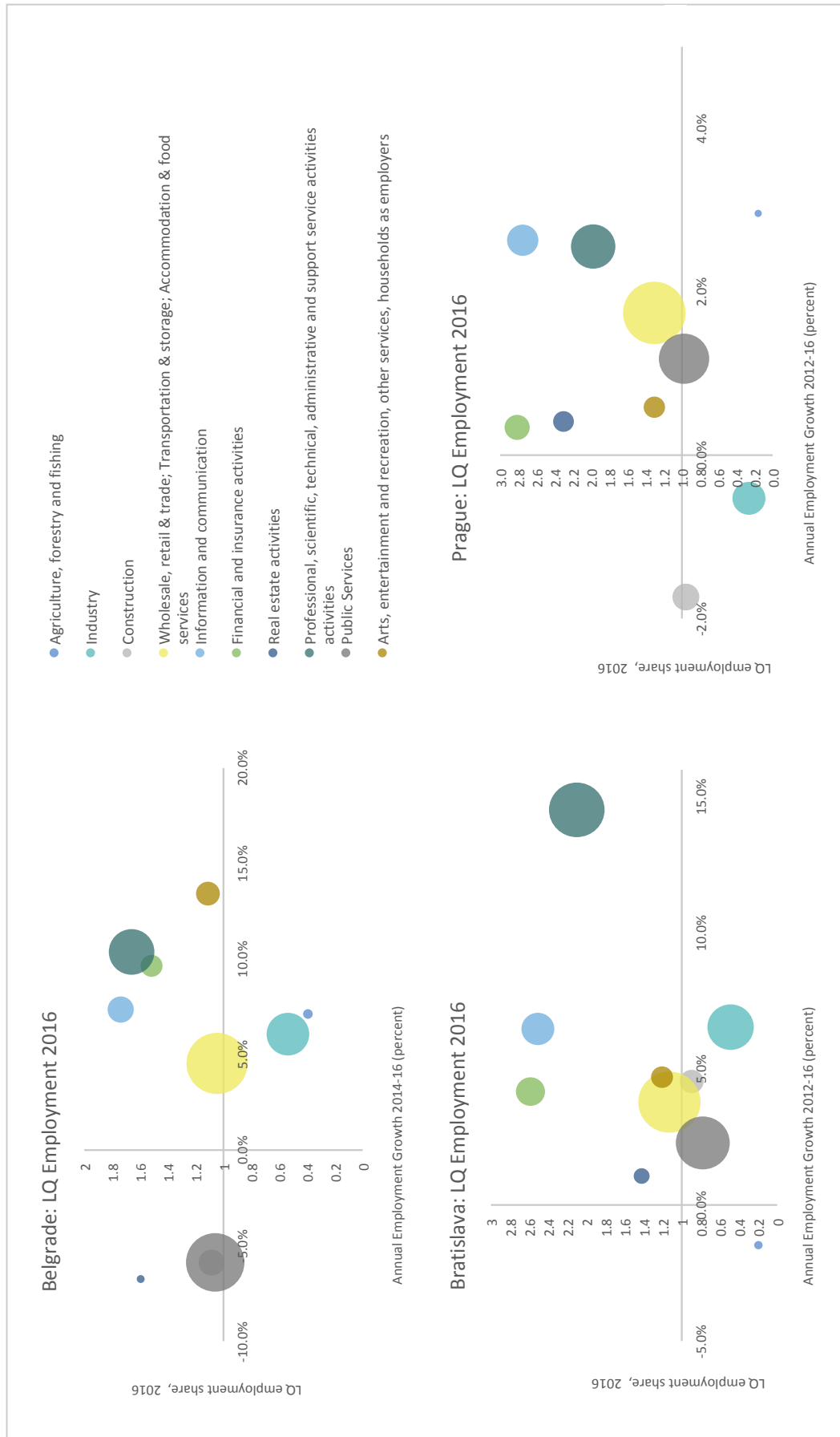


Figure 2.8 Specialization in high-value-added service sectors is higher in comparator capitals Prague and Bratislava than in any Western Balkan capital; as in Bratislava and Prague, economic growth in Belgrade has been driven by tradable sectors

Source: Data from the Statistical Offices of the Slovak Republic (2018), Statistical Office of the Republic of Serbia (2018) and the Czech Statistical Office (2018).

Note: LQ, location quotient, is the regional share of employment of a sector relative to the national share. An LQ of more than 1 indicates some degree of specialization. Size of bubble indicates the share of total city employment the sector accounts. Estimations for share of employment and LC are for the same year.

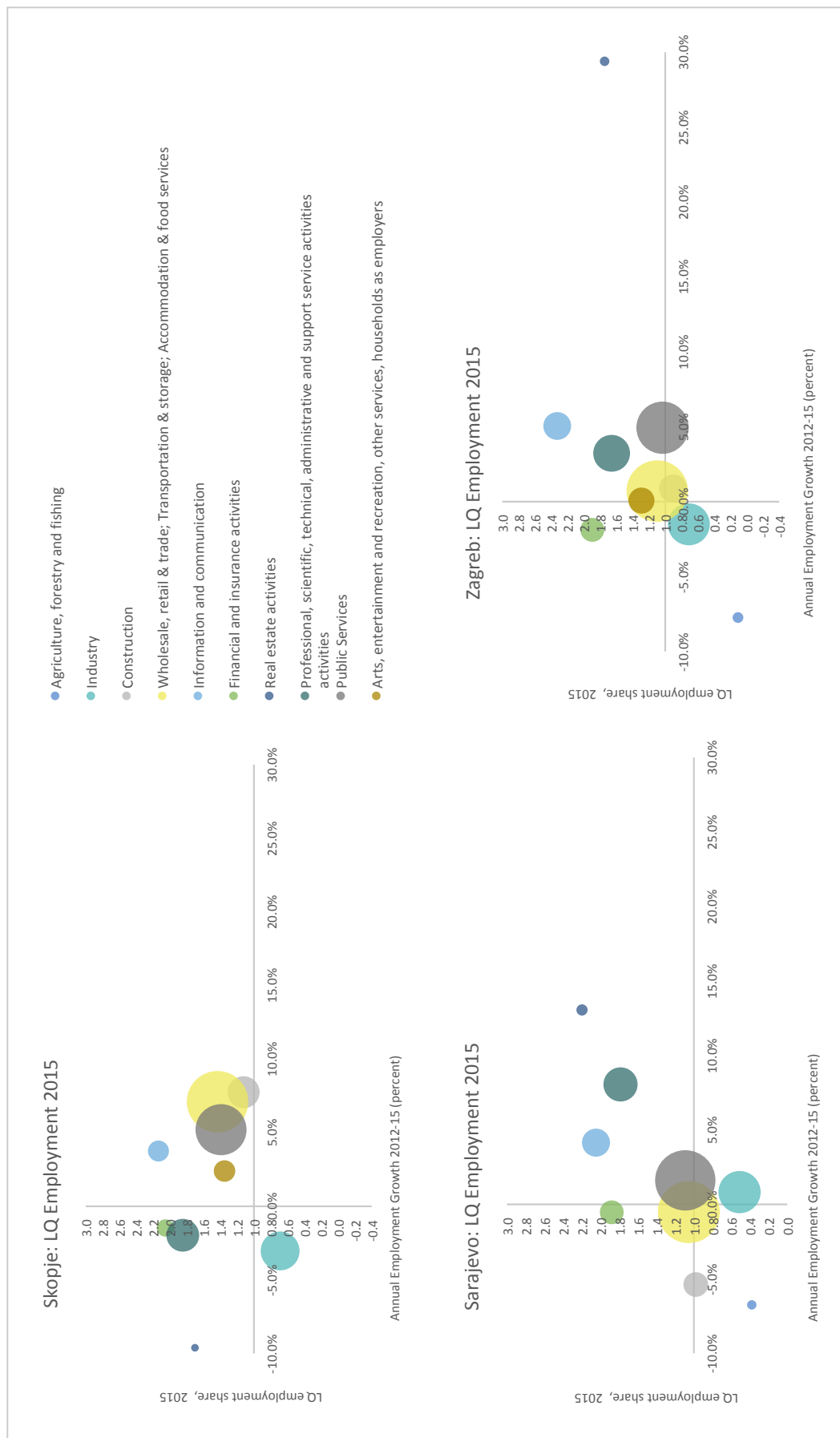


Figure 2.9 Sectoral structures in Skopje, Sarajevo, and Zagreb are unlike those in Belgrade, Bratislava, and Prague and are not conducive to sustained growth

Source: Data from Republic of North Macedonia, State Statistical Office (2018); Croatian Bureau of Statistics (2018); and Institute of Statistics of the Federation of Bosnia and Herzegovina (2018).

Note: LQ, location quotient, is the regional share of employment of a sector relative to the national share. An LQ of more than 1 indicates some degree of specialization. Size of bubbles indicates the share of total city employment accounted for by the sector. Estimations for share of employment and LQ are for the same year.

Atypical patterns of sectoral change may indicate other problems. Tirana's sectoral structure has veered into areas that do not support vibrant economic growth. The highest labor productivity, surprisingly, is in local services and construction²⁸. Employment data for Tirana suggest that, much like Skopje, job growth has been mostly in sectors with typically low output and low earnings; jobs in high-productivity sectors may be on the decline. Clearly, factors other than earnings in high-value tradable sectors are driving up demand for local services in both Tirana and Skopje.

The injection of remittances into the economy may explain deviances by creating isolated demand for local services without backward links to growth in tradable sectors. In 2014 remittances to the Western Balkans and Croatia averaged up to 9 percent of GDP²⁹. For capitals where the trend is most visible, such a scenario results in an economy fueled by consumption rather than production, which is preferable. Though the influx of non-labor income into the economies of capitals helps alleviate poverty and improve the quality of life, it may create an illusion of sustainable economic growth. In practice, it often promotes growth of low-productivity consumer service industries, which pushes up prices for inputs and labor, which in turn could delay the growth of tradable parts of the economy.

However, the dynamism of tradable and nontradable sectors is far from uniform: In both Sarajevo and Zagreb, growing tradable service sectors apparently are not stimulating growth in local services. Both capitals are seeing annual growth of about 5 percent in information and communications technology and professional and business services sectors, but a decline in financial and insurance services (figure 2.9). Unlike what happened in Belgrade, Bratislava, and Prague, however, the growing tradable sectors in Sarajevo and Zagreb have not created more service jobs (figure 2.8). In Sarajevo, although public services grew nominally, jobs in other local services dwindled. This signals frictions between the tradable and local service sectors and a consequent need to strengthen both backward and forward links of the local economy to tradable enterprises.

In Zagreb, the dissociation between the growing tradable sectors and the local service sector can be explained by the decline in GVA in tradable service sectors, which limits the realization of any positive spillovers. Despite having the fastest annual growth in employment of any sector in 2012–15, productivity in information and communications declined by about 2 percent a year. The trend in Zagreb's professional services was very similar. The declining productivity of these otherwise high-value-added sectors suggests that for some reason these firms are unable to benefit from agglomeration economies.

It is vital to enhance the presence and performance of high-value-added services and tradable industries

Due to their size and status as national economic centers, capital cities across the Western Balkans and Croatia have a comparative advantage in the high-value-added services that benefit disproportionately from density. For major sustained productivity gains, entry of numerous tradable service firms and expansion of those already operating are vital. But in the capitals, the sectors are either declining or growing very slowly, delineating lost opportunities and threatening future productivity gains. Several firms in knowledge-intensive business service sectors and tradable industries have not been able to harness their full potential.

In the capitals, which typically benefit from agglomeration, manufacturing apparently is not contributing substantially to the economy either. It is at the lower end of the productivity spectrum. In fact, analysis of data on Croatian firms found a statistically significant negative relationship between population density and labor productivity for manufacturing (see annex 2A). The Croatian situation might be explained by the poor location of cities in the region (see chapter 1), very high congestion costs, or the methodology of collecting firm level data. In any case, even though this result contradicts economic theory, it again points toward the inability of capitals to maximize benefits derived from agglomeration.

While cities generate agglomeration economies due to the close proximity of firms and workers that results in better matching, learning, and sharing³⁰, they also generate negative externalities in the form of congestion costs that directly impact the cost of living and doing business³¹. Among components of these costs are poorly defined property rights; provision of public goods like roads, transport, and sewerage; the quality of air; public spaces like parks; and the amount of traffic and crime in a city. As cities grow larger, congestion costs rise but can be counteracted by effective investment and city management. Capitalizing on agglomeration thus entails ensuring that urbanization is managed well and congestion costs are minimized.

Manufacturing in capitals should strive for high-value production. Although the share of manufacturing in employment in Zagreb and Western Balkan capital cities is substantial, averaging about 13 percent, they do not appear to be specializing in manufacturing. In Skopje and Zagreb, its share is declining, but in Sarajevo and Belgrade, manufacturing is growing. While none of the capitals specializes in manufacturing, it can be a substantial part of urban economies with growth potential, as illustrated by the study of textile firms in Tirana. Following Black and Henderson (1999) and Barufi, Haddad, and Nijkamp (2016), manufacturing firms in capitals cities should aim to move up the production value chain to benefit from density and market access³². After EU accession, they may also be able to position themselves to attract manufacturing investment, as the Bratislava region did very successfully. While manufacturing is unlikely to become the main driver of economic growth, cities should see it as an important potential contributor, promoting a shift to higher-value-added and more technology-enabled production (box 2.1).

Both economy-wide and industry-specific interventions are necessary

What is stalling the growth of higher-productivity activities in capitals? The obvious answer is an inability to use agglomeration to their advantage. But going deeper, it appears that such firms and sectors grapple with two other problems: Economy-wide gaps limit gains from agglomeration and industry-specific challenges stifle their growth and expansion.

To heighten the competitiveness of a city, it is essential that its administration directs its efforts to supporting tradable industries and knowledge-intensive businesses services that engage in more productive activities. This requires fostering agglomeration economies through economy-wide reforms and targeting industry-specific interventions. Some of the most common economy-wide factors that affect the business environment are regulations and access to finance. Industry-specific interventions, on the other hand, are more contextual and depend on a nuanced understanding of constraints and requirements facing firms in a single sector.

Tirana's tech startup ecosystem and its textile and garment industry provide insights into these challenges. In the tech sector, lack of venture capitalists and credible accelerators has prevented scaling up, a hostile regulatory environment discourages startups, and the small size of the domestic market is limiting. Nevertheless, the sector has kept its head above water for the past decade.

The footwear and garment industry is one of the largest manufacturing and export industries in the Tirana metro area. Though relevant for the past two decades, it has also been on the lower end of the productivity spectrum (box 2.1). This stagnation can be partly explained by the fragmentation of the industry and the lack of opportunities and skills to help business owners enter new product and consumer markets and adopt innovative processes.

Interventions at both levels—economy-wide and industry-specific— would not only promote the productivity and presence of these firms but also make them more than the sum of their parts. Policy movement in this direction would induce a faster and healthier growth trajectory.

BOX 2.1

The reality and potential of garment and footwear manufacturing in Tirana

For more than 15 years, the footwear and clothing industry, which is concentrated in the Tirana–Durrës region, has held a dominant position in Albania’s exports, and it continues to grow. It accounts for about 43 percent of all Albanian exports and 60 percent of the country’s exports to the European Union. Between 2013 and 2017, its exports grew by 69 percent³³. According to the General Directorate of Customs, the import value of goods related to the garment and footwear industry was 96.4 billion Albanian leke; the import value of all other goods was just 19.9 billion leke. In fact, in 2016 and 2017 it was the only industry that registered a positive trade balance.

Despite its importance to the Albanian economy, however, garment and footwear manufacturing is not a major contributor to GDP. It is a low-wage, low-value-added industry. Even though it is one of Albania’s largest exporters, absorbs a large proportion of unskilled labor, and accounts for a major share of the foreign-owned and joint enterprises registered in the capital region, it does not drive growth, has evolved little in the past two decades, and is still stuck at the bottom of the value chain. The industry works on the Outward Processing Trade (OPT) system. This means that most firms in the industry are confined to cut-make-trim (CMT) processes subcontracted to them from businesses in countries like Italy and Germany. Because few businesses have been able to break away from this type of production to manufacture ready-made products, the industry itself seems stuck.

The garment and textile industry in Tirana needs to reform its business model to break away from low-value-added production and high dependency on macroeconomic conditions. Increased access to skilled labor and finance and greater government engagement are necessary to unleash its potential and help the industry engage in more technology and skills-enabled production processes that will enable it to access new markets.

Surveys of 30 owners and managers of garment and footwear production units (fasons) in the Tirana metro area and interviews with industry experts in Tirana, led to three useful findings:

1. *The current business model makes the industry vulnerable to external shocks, discourages innovation, and drives firms to compete with each other solely on the basis of labor costs.* Firms rarely design or sell their own products on a large scale. Clients, mostly Italian and German firms, supply primary and secondary raw materials and machinery—in fact, for 60 percent of the firms surveyed, the clients even provide logistics and transportation of products. Although this business model seems efficient and helps expand the volume of exports, it severely limits firm competitiveness. Firms have almost no scope for differentiation. Moreover, the business model makes the industry highly susceptible to such macroeconomic conditions as exchange rates. Incentives to innovate under this model are close to nonexistent. Firm owners do not participate or co-create with clients but instead are perpetually in the waiting mode—for production inputs, orders and contracts. Despite a high level of engagement with global markets, interaction with clients and buyers rarely produces knowledge exchange and adoption. Of the 30 firms surveyed,

70 percent were large, with more than 50 employees, and some had as many as 2,200 full-time employees; the rest were micro, small, and medium enterprises. Only six firms were making products under their own brand name, five of which were micro or small firms that produce low volumes and sell only in local markets.

2. *Firm owners and managers want to create their own brands and new products and expand the scale of production, but their ambitions are constrained by very little access to finance and labor and the general shortage of skills. Almost 50 percent of those surveyed expressed a desire to create their own brand, expand to new markets, or scale up production within Albania. The rest were more pessimistic: while some did not foresee any change, others noted that the lack of adequately skilled labor might decrease their production in the future. Access to labor, access to finance, and skills shortages are three of the biggest constraints facing fasons in Tirana (figure B2.1.1).*

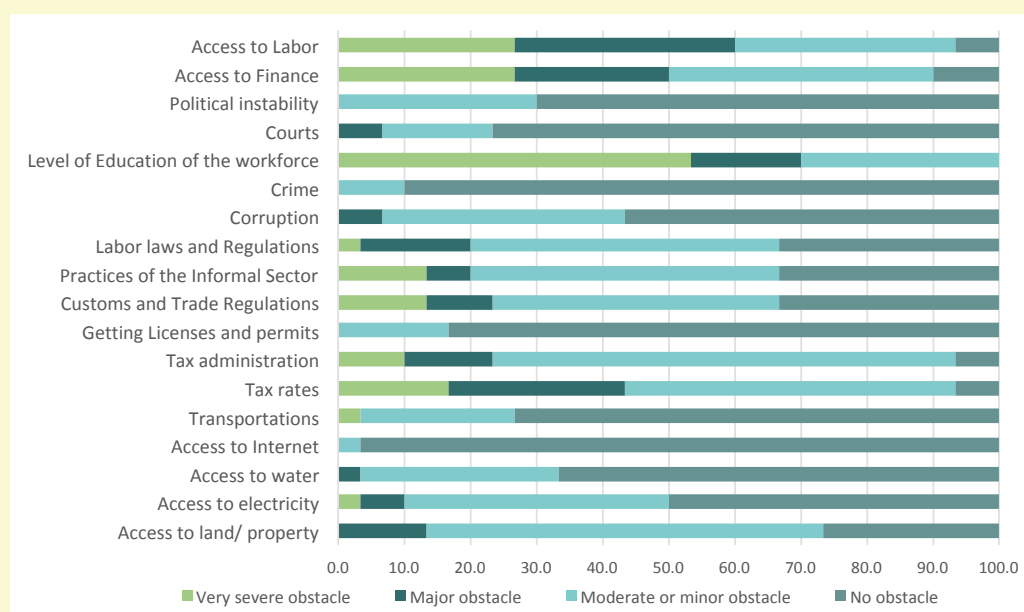


Figure B2.1.1 Shortage of skilled labor and access to finance are the most severe obstacles to growth of the textile and garment industry

3. *The industry is fragmented, and there is minimal engagement with local government. So far, the garment and footwear industry in Tirana has been unable to advance its reform interests for two reasons: (1a) The industry is fragmented. Because firms regard each other as competitors, efforts to coordinate and lobby for industry needs by forming a unified association have not succeeded. Currently, the industry has at least 10 “chambers of commerce,” each with its own agenda—but only 46 percent of the firms surveyed belong to one. Although some respondents consider these associations to be beneficial for networking and information-gathering, most firm owners saw no benefits to membership. Many stated that the associations were “useless” and did not raise pertinent issues. (b) Although the textile, garment, and footwear industry is major and one of the largest employers, it has no formal representation in either local or national government units, and the level of engagement with public authorities is minimal at best.*

Source: World Bank study survey (WBUTR 2019).

Economy-wide conditions —and areas for reform

Capitals in the Western Balkans and Croatia have not taken full advantage of the underlying benefits of agglomeration; but benefiting from agglomeration is not the only determinant of competitiveness. The quality and efficiency of the factors of production that are shaped by economy-wide characteristics, constraints, and conditions also shape the performance of individual firms.

The pursuit of productivity gains and job growth in capitals across the study area requires a simultaneous focus on four activities: attracting and expanding knowledge-intensive, tradable sectors on the higher end of the productivity scale; creating conditions and platforms that help firms enhance productivity and reap the benefits of agglomeration; strengthening links between diverse sectors in the economy to ensure economy-wide growth; and keeping congestion forces at bay by managing density and providing adequate and efficient urban infrastructure and public services.

To maximize agglomeration effects and realize fast and sustained economic growth, cities need to give priority to four areas that cover the entire scope of policies that govern urban competitiveness. They are institutions and regulation, infrastructure and land, skills and innovation, and enterprise support and finance³⁴.

This section examines economy-wide constraints, pitfalls, and challenges confronting firms in each of the four areas. To cast a wide net, corroborate emerging findings, and pinpoint priority areas for reform, several sources were consulted, among them the latest Doing Business reports³⁵ and World Bank Enterprise Surveys³⁶ and the literature on best practices. Figure 2.10 shows how the study capitals perform on the 10 indicators for ease of doing business³⁷, and table 2.4 lists the top five “primary problems” identified by businesses in each city in the Enterprise Surveys.



Figure 2.10 Performance of capitals on the 10 Doing Business indicators varies (2019)

Source: World Bank 2019.

Note: An economy’s ease of doing business rating is scored on a scale of 0 to 100, with 0 representing the lowest and 100 the best performance.

To garner a more accurate and granular understanding of current gaps, two case studies were conducted in Tirana³⁸. These were complemented by consultations with local firms, business associations, and government institutions in both Tirana and Belgrade.

Even given the unique characteristics of each city and the considerable heterogeneity of their performance on the indicators, it was possible to identify gaps and opportunities that can apply to all. However, for a given determinant of competitiveness, it is possible that one of the cities may have exemplary policies and good outcomes while others are performing poorly.

Finally, while some of the policy interventions proposed here are beyond the administrative remit of the local jurisdiction, ultimately their consequence would be most significant for capitals given their economic predominance. Granted, some economy-wide problems cannot be resolved without national involvement, but city administrations can contribute by using their authority to the fullest extent and lobbying for policies beyond local capacity.

Biggest obstacle affecting the operations of the establishment (percent of total responses)	Sarajevo	Skopje	Podgorica	Zagreb	Belgrade	Tirana
Access to finance	8.70	25.23	-	22.06	18.63	13.53
Practices of the informal sector	6.52	22.52	-	8.82	10.78	24.64
Political instability	54.35	19.82	13.04	-	21.57	-
Tax rates	-	-	39.13	39.71	12.75	13.04
Courts	6.52	6.31	-	5.88	-	-
Corruption	13.04	-	-	5.88	8.82	-
Tax administration	-	-	8.70	-	-	14.98
Customs and trade regulations	-	5.41	13.04	-	-	-
Electricity	-	-	8.70	-	-	12.56
Total share of respondents (percent)	89.13	79.28	82.61	82.35	72.55	78.74

Table 2.3 The top five problems of businesses in each city, percent

Source: Estimates from World Bank Enterprise Survey 2013.

Institutions and regulations

Identifying priority areas for reforming institutions and regulations is perhaps the most difficult task, given the breadth of the applicable policies. However, similar results from Doing Business and Enterprise Surveys, grievances expressed repeatedly by different stakeholders, and consultations made it clear that the business regulatory environment requires vast improvement and that tax administration, judicial administration, and informality are major deterrents of growth. A common thread was the general lack of government engagement with the private sector. To cultivate a dynamic business environment, capitals would benefit from shifting the focus from regulating the private sector to enabling its growth.

Improve the tax environment to advance business dynamism

A remarkably large number of taxes, coupled with inefficient efforts at compliance and post-filing procedures, makes it difficult for Western Balkan capitals and Zagreb to attract businesses (figure 2.11). Besides being the primary source of revenue for local and national governments, taxes often are also used to incentivize investment and attract businesses. Using taxes for both these vital objectives poses an implicit trade-off that requires careful planning. Although effective tax rates in capitals across the study region are generally in line with those in comparators, unlike them the number of taxes is staggeringly high. Belgrade, Sarajevo, Tirana, and Zagreb have more than 30 business taxes. The comparator average is 9 and the ECA average 16. The number of taxes encumbers businesses

with a diversity of compliance procedures, attenuates investor confidence in the economy, and pushes up the cost and effort involved in administering them. It takes much longer to obtain tax refunds and complete tax corrections in Zagreb and Western Balkan capitals except Belgrade than in comparators. While this is in part a function of the sheer number of taxes, businesses also consider it a sign of administrative inefficiency.

Recent reforms to make paying taxes more convenient require fine-tuning. Electronic tax filing has been introduced in all the Western Balkan capitals. Business owners in Tirana, however, have found that digitization has not necessarily eased compliance. Online automated systems often suffer from glitches, may not reflect changes in regulations, or may not be comprehensive enough to cover niche scenarios. Worse, they may seem unintuitive and intimidating to the average tax payer, who is not well-versed in technology.

Tax authorities are perceived as hostile to businesses. The 2013 Enterprise Survey corroborates claims that businesses owners are subjected to frequent tax inspections: 66 percent of the firms surveyed in the six capitals reported having been visited by a tax inspector in the previous year. Of these, about 35 percent were visited more than five times in the same year in Tirana, and about 10 percent in Belgrade, Skopje, and Zagreb. Such frequent and sporadic inspections heighten the discretionary powers of individual inspectors; provide multiple opportunities for graft and other corruption;³⁹ discourage potential entrepreneurs from starting new enterprises; and disincentivize the formalization of small firms.

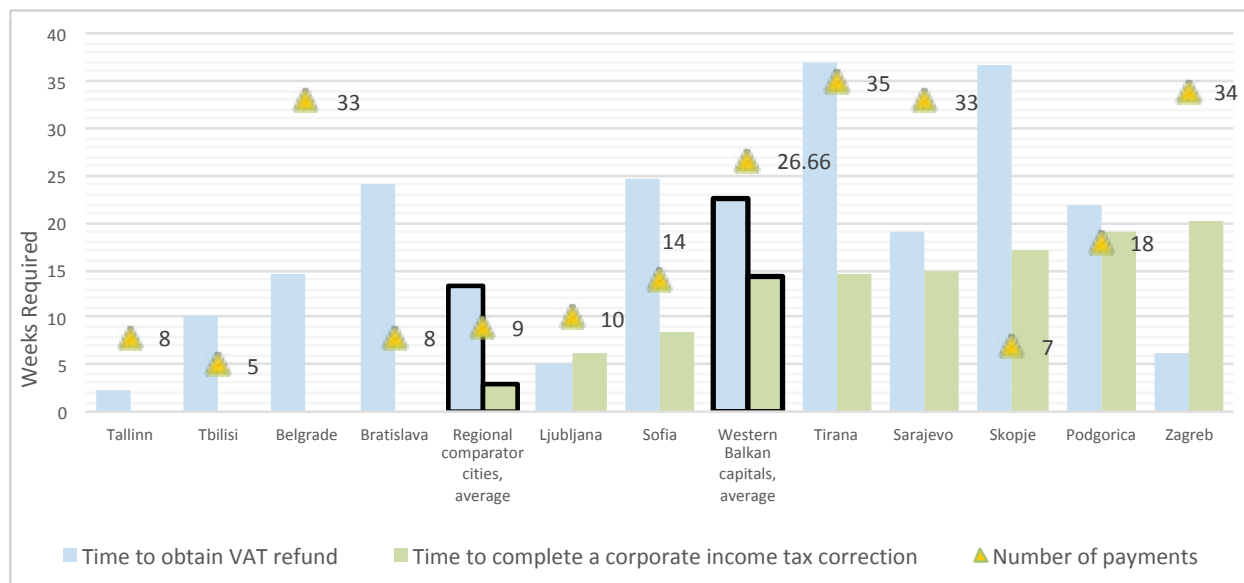


Figure 2.11 The number of taxes and the time required post-filing for refunds and corrections are high for Western Balkan and Croatian capitals

Source: World Bank 2019.

In Tirana, business owners are apprehensive about inspections and audits, which can result in non-tax-related fines for, e.g., the number of employees declared or the obstruction of facades⁴⁰. Small and new businesses, with little or no allowance for error in compliance details, may be penalized unreasonably. Complex compliance procedures, tax filing problems, and unsympathetic and unsupportive tax administrators support the perception of adversarial relationships.

The costs of complying with taxes can determine whether firms choose to set up business in a city. For larger firms, such costs may govern location choices, discouraging investments and operations in capitals. Smaller and younger firms, disproportionately disadvantaged by compliance costs, may choose to operate informally, diverting much of their attention to evading formal structures, or simply shut down⁴¹.

The tax environment in Western Balkan capitals and Zagreb does not increase jobs, productivity, or competitiveness. Capitals need to reorient toward fewer taxes and redirect tax administration, especially audit and inspection, to enabling rather than enforcing compliance. Good practice calls for fewer taxes and easy and convenient filling. Automation increases efficiency and convenience only when accompanied by training for taxpayers, a reliable operating system, and timely updates to reflect current business regulation. Accountable and transparent tax authorities are of paramount importance, especially during inspections, which should give businesses opportunities to receive filing support and air and redress grievances.

Streamline and automate judicial processes and regularly train judicial and court staff

The environment for enforcing contracts and resolving commercial disputes affects economic outcomes⁴². Businesses prefer to invest and operate in environments with high certainty and reliability. Objective, clearly defined, and consistently enforced laws assure businesses that conflicts can be resolved expeditiously at low cost. But businesses view the court systems in Western Balkan capitals and Zagreb as biased, corrupt, and inefficient.

About 70 percent of business respondents to the 2013 Enterprise Surveys in the six capitals disagreed with the statement that the court system is quick (figure 2.12). This view seems to be especially widespread in Belgrade and Zagreb. Doing Business 2019 reveals that the time required to enforce contracts is highest in those two cities: 650 days in Zagreb and 635 in Belgrade⁴³. A large proportion of businesses also believe that courts are biased, corrupt, and incapable of enforcing their decisions. In four of the six countries, a higher share of businesses in capitals than in other cities viewed the courts as a major or very severe obstacle to daily business operations.

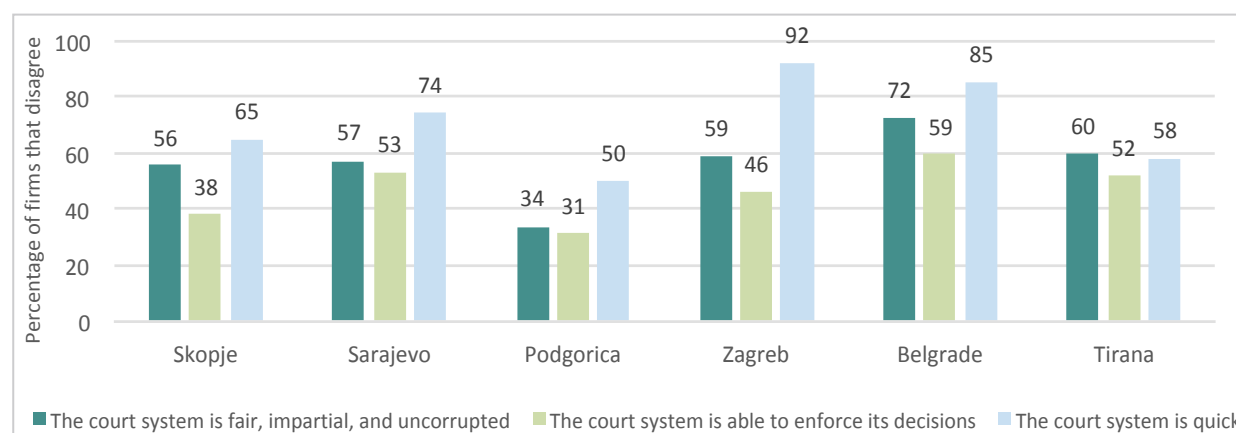


Figure 2.12 Businesses in Western Balkan and Croatian capitals see the courts as inefficient (2013)

Source: World Bank Enterprise Survey 2013.

The cost of enforcing contracts averages 10 pp higher in Western Balkan capitals and Zagreb than in comparators⁴⁴. In local courts the cost of enforcing contracts can be as high as 40 percent of the value of the claim in Belgrade and 35 percent in Sarajevo and Tirana. In comparators like Ljubljana, the cost can be as low as 12 percent.

Capitals would benefit from further automating and digitizing the court system, which would simplify resolving commercial disputes and contracts. For example, Tbilisi, Georgia (ranked 8th on the Doing Business enforcing contracts indicator) introduced electronic filing and payment in courts and boosted the use of information management systems for cases, reducing the time and cost of resolving commercial disputes. Such systems also lessen bias, error, and corruption in courts.

Capitals would also benefit from regular specialized training for judges and court staff. It would be advantageous for them to introduce commercial courts and train judges and court staff in insolvency, intellectual property, and other areas of commercial law. This would allow those trained to stay aware of the evolving regulatory environment and would also be vital for uniform, efficient, and objective enforcement.

Assess the forms and drivers of informal practices to better target policy

In Zagreb and Western Balkan capitals, businesses, especially small and medium ones, consider informal activities to be a serious problem. In five of the six capitals, informal competition is identified as one of the top five obstacles to doing business (table 2.4)⁴⁵. On average, 25 percent of respondents in the six cities ranked the informal sector as a major or very severe obstacle in their day-to-day operations, and at least 43 percent had at some point faced competition from informal or unregistered firms⁴⁶. The problem was worst in Sarajevo at 55 percent and Skopje at 52 percent.

Since 2013 when the Enterprise Survey was conducted, Western Balkan cities have acted to improve regulations related to informality. The improvements so far, which primarily concerned business registration, made it easier for firms to start a business and, as in Tirana, made stringent demands on firms to formalize. Yet, informal practices are still rampant—an outcome that can only be explained by the heterogeneity of informal activities. Thinking of informality as binary—licensed and unlicensed firms—is a mistake. In Western Balkan capitals, informal practices can be linked to firm registration, irregular adherence to business regulations, tax evasion, hiring employees without contracts, and even under-reporting sales. The opacity of the informal sector conceals its causes and its degree of integration with the formal economy. Reasons for informality range from the complexity of registration, inefficient institutions, unfavorable business regulation, tax evasion, and unpredictable tax administration to avoiding employer obligations and a general culture of noncompliance in the economy.

Despite the variety, studies have been able to make useful generalizations about the sector. Whatever their size, firms engaging in informal practices are generally less efficient than their formal counterparts⁴⁷. However, they tend to dominate local service sectors like retail and construction⁴⁸, and they are linked to the formal economy⁴⁹. La Porta and Schleifer (2014), who characterize informal firms as small, unproductive, and stagnant, attribute their inefficiencies to a lack of entrepreneurial skills in the individuals running them. While informality is a permanent feature of any economy, it becomes less pervasive as countries develop and institutions and regulations grow more efficient⁵⁰.

Informality undermines competitiveness because it dampens productivity growth and threatens businesses wanting to operate in the formal sector. These businesses are afraid of being undercut in prices and labor costs. The prevalence of informality contributes to a perception that regulations and institutions are unfair and inefficient. Moreover, in several Western Balkan capitals, as in many economies, formal firms feel targeted by the tax and regulatory authorities.

How can capital administrations curb informal practices? First and foremost, they must gain a more nuanced understanding of how informality operates in the local economy. Policies for curbing informal practices and firms should be designed carefully. For example, if low productivity is forcing firms to avoid taxes and regulations, enforcement that pushes them to reduce spending or even close may unintentionally cause unemployment. Capitals should attempt 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. The capital administration can then design more targeted and effective reforms and sidestep negative consequences.

Capitals in the region would benefit from policies that encourage formalization rather than discouraging informality. At the same time, they must streamline regulation, reform the tax environment, reduce institutional inefficiencies to protect both workers and firms, encourage a culture of compliance by building public awareness and support for appropriate practices, and, most important, help businesses to become more productive⁵¹.

Land and infrastructure

Policies related to land and infrastructure mainly target the forces of congestion that cities must deal with. The good news is that local city jurisdictions have the authority to implement policies and reforms that keep congestion costs at bay. For capitals in the Western Balkans and Croatia, land governance and administration are proving costly. Investments in public infrastructure and the provision of quality services could help mute the effects of congestion and help businesses garner more benefits from agglomeration.

Expedite land reforms and property legalization

Despite several reforms, problems related to property rights and land administration continue to curtail economic growth and city planning. Because cities are spatially concentrated, their growth and competitiveness are highly dependent on land-use planning, regulation, and development. Clear assignment, protection, and information on land ownership; comprehensive and accurate maintenance of land records; and well-functioning land markets are prerequisites for boosting investment, enhancing public service delivery, and supporting productive entrepreneurial activity. But constraints in all areas of good land management have affected capitals in the study region (figure 2.13).

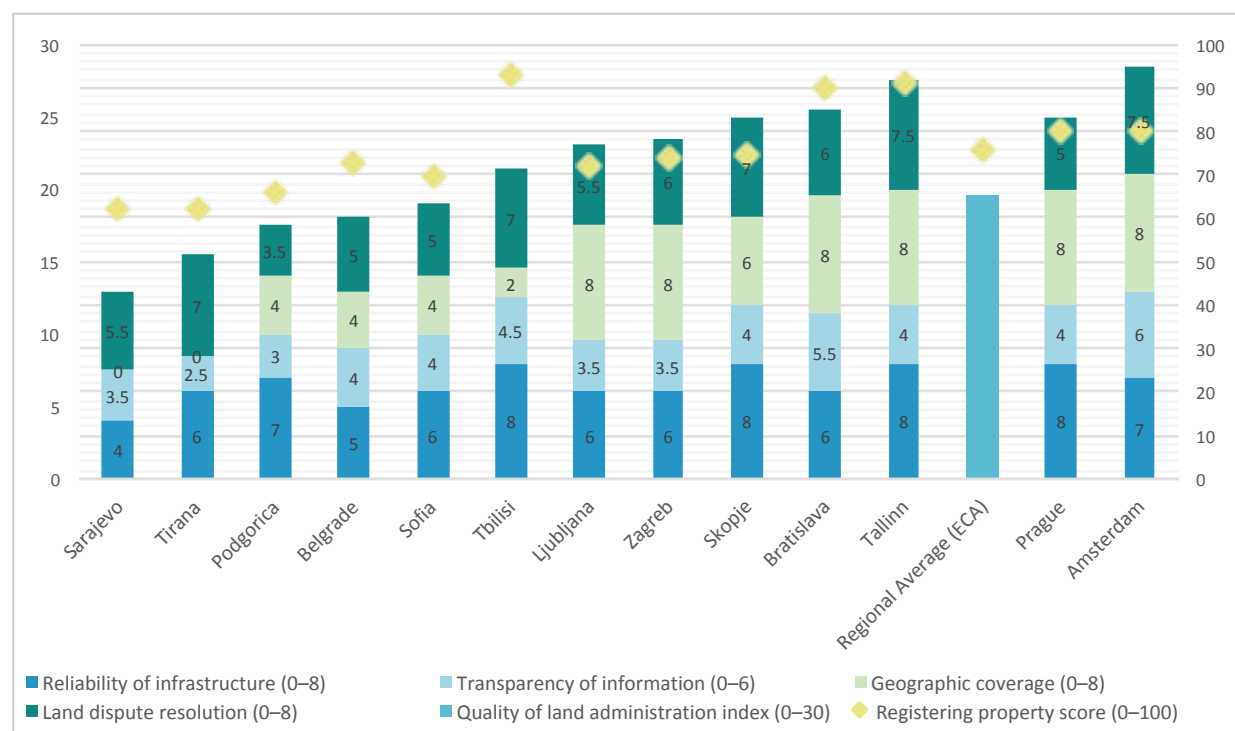


Figure 2.13 The quality of land administration requires improvement

Source: World Bank 2019.

Improper land administration in capitals has stifled economic growth and undermined the realization of urban planning. It has impelled inefficient land consumption and incorrect land valuations, and it has heightened inefficiency in land transactions. Fuzzy property rights prevent entrepreneurs from using property as collateral to

access finance. Planned urban expansion and capital region development are stymied when local administrations cannot collect optimal amounts of land and property tax and processes for land consolidation, maintenance of public land, and carrying out territorial plans are subject to interminable delays.

Informal settlement, construction, and commercial activity were defining features of the rapid urbanization of the capitals of the Western Balkans and Croatia in the 1990s and early 2000s. Combined with slow land reform, these resulted in unregistered property, inaccurate or overlapping ownership titles, inconsistent cadastral maps, informal land transfers and transactions, and land disputes. These problems also reduced property tax collections.

Recent reforms have made major strides in improving land administration and access to land. Belgrade and Tirana have passed laws to formalize illegal settlements and adopted geographic information systems (GIS) 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, and that is to reconcile property rights, formalize settlements, and update and maintain cadasters. For example, in Tirana, a significant share of the cadastral zones has not been updated since 1995, and an estimated 75 percent of records are still manually archived. The majority of property owners in Tirana have no ownership certificates. Similarly, in Belgrade, in the first year after the new law was enacted, there were about 800,000 requests for legalization statewide⁵². Only a small fraction have as yet been resolved.

The 2019 Doing Business report paints a bleak picture of land administration in Western Balkan capitals, with some doing worse than others⁵³. Their scores on the quality of land administration are on average lower than those for comparator cities or the ECA average (figure 2.13). Sarajevo and Tirana have the lowest scores; scores for Skopje and Zagreb are somewhat higher. The scores of Sarajevo and Tirana on geographic coverage are red flags—in both, privately held plots are neither registered nor mapped. In most capitals in the region, coordination is poor between land mapping agencies and immovable property rights agencies. All capitals have started to record boundaries in electronic databases, but digitization needs to be extended to archived deeds and maps. Currently, not all immovable property rights agencies have committed to delivering updated maps and binding documents indicating property ownership, and systems for tracking land transactions are inadequate.

The need of the hour is speedy updating of land administration tools and ramping up the administrative system. Adjudicating and assigning land and property rights and creating, maintaining, and disseminating spatial records and land deeds are daunting tasks that require a complex institutional infrastructure. Reforms in land governance do not lead immediately to better outcomes, and setbacks are frequent. However, other countries faced with similar problems have demonstrated that with effective change management, capitals in the Western Balkans and Croatia can reap the benefits of efficient land administration. Land reforms in Rwanda demonstrate that policies need to be carefully crafted and yet flexible, with regular evaluations. Regular consultations with key agencies and stakeholders, community participation, and multiple rounds of testing improve the chance of success. Vilnius, Lithuania, one of the best performers in land governance, relies heavily on digital platforms and the integration of land data with databases on, e.g., population, business registrations, and mortgages. Ensuring smooth access to all information on land administration expedites transactions and investment. The experience of the Republic of Korea demonstrates how a solid commitment of resources and time can reduce corruption and increase transparency. Its land administration system now provides a sound basis for urban planning⁵⁴.

Expand the coverage of public services and make their delivery more efficient

In every country in the study region the capital is the most densely populated city, and its population growth is likely to continue (see chapter 1) and intensify as its economic performance improves. As capitals take advantage of agglomeration effects to engage businesses and generate jobs, they must also be prepared to mitigate the effects

of congestion. Sustained economic growth is both determined by and determines provision of public services that is effective in maintaining an acceptable standard of living for residents.

The quality and coverage of public services in study area capitals is at best satisfactory. But considering the efficiency and coverage of services in other domestic urbanized areas and municipalities, and in comparator cities, it is evident that service provision in the capitals can be substantially improved. For example (table 2.5), the proportion of nonrevenue water⁵⁵ in capitals is strikingly high—particularly in Tirana and Sarajevo (table 2.5). In almost all countries, nonrevenue water rates demonstrate better management of water supply by other utilities than by the capital city utility. Only Belgrade and Sarajevo have 100 percent water coverage; Tirana has 95 percent, and Skopje, 81 percent. In all four cities, sewerage coverage is still short of 100 percent. Waste collection in Western Balkan capitals must be raised to match the 100 percent coverage in comparator cities (figure 2.14).

Service	Tirana (2014)		Skopje (2014)		Sarajevo (2014)		Belgrade (2015)	
	Share of country's utilities performing better		Share of country's utilities performing better		Share of country's utilities performing better		Share of country's utilities performing better	
	Value	Value	Value	Value	Value	Value	Value	Value
Water coverage (% of total population served by the utility)	95.46%	28.1%	81.59%	49.1%	100%	0.0%	100.00%	0.0%
Sewerage coverage (% of total population served by the utility)	72.79%	19.3%	84.07%	42.6%	80.50%	16.7%	80%	15.0%
Staff efficiency (staff per 1,000 people served)	0.86	11.8%	1.25	9.3%	0.84	7.1%	0.82	30.4%
Nonrevenue water (% of water supplied in m ³ /km/day)	73.67%	80.7%	63.72%	71.2%	75.18%	92.9%	37.63%	57.1%
Sewer system blockages (Blockages/km/yr)	–	–	6.02	73.3%	4.42	79.5%	1.22	33.1%
Network renewal (km/1,000 population)	–	–	–	–	0.18	61.4%	0.22	48.7%
Unit operational cost (US\$/ m ³ of water and wastewater sold)	0.78	68.4%	0.7	69.2%	1.65	9.9%	0.67	32.5%

Table 2.4 Water utilities in capitals are underperforming those in the rest of the country

Source: DANUBIS Water Platform n.d.

Note: The year for each city is the latest with data available for all water and wastewater utilities in the country.

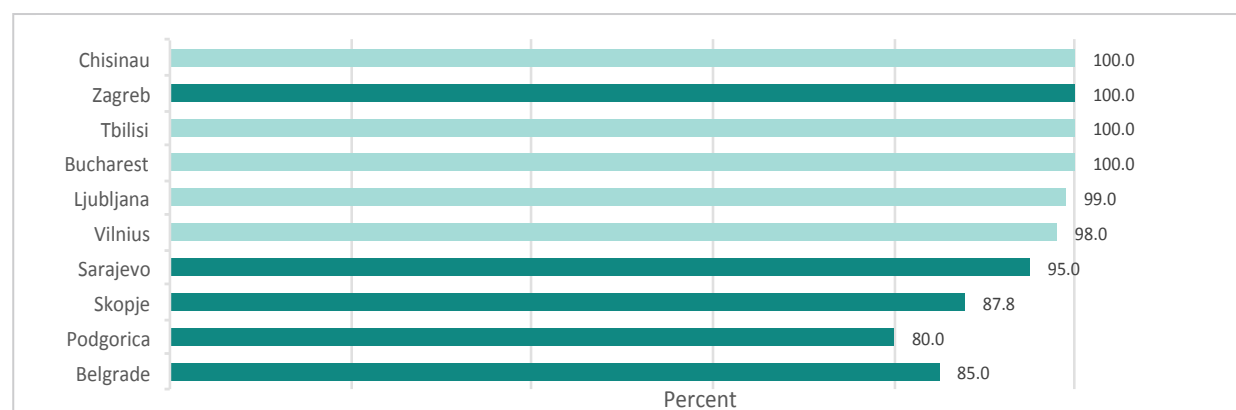


Figure 2.14 Waste collection rates for Western Balkan capitals are lower than for similar capitals in ECA (percent)

Source: Kaza et al. 2018.

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

Upgrade aging infrastructure

Utilities and public infrastructure face current and impending congestion. Capitals have a higher incidence of sewer system blockages than other regions (table 2.5). Local roads need upgrades (figure 2.15): in Skopje, 41 percent of households surveyed expressed dissatisfaction with the quality of local roads, in Tirana, 24 percent, and in Belgrade, 22 percent.

The deteriorating state of basic infrastructure impairs efforts to increase efficiency and coverage in providing services. Roads, urban transport networks, and sewerage and water pipelines in Western Balkan capitals are old and await reinvestment. The band-aid approach to upgrading is untenable. Cities dealing with imminent and continuing sprawl and heightened density must increase the quality and quantity of services through large-scale infrastructure investments.

Inaction on upgrading infrastructure is dangerous for Western Balkan capitals and countries. Closer integration with the EU (see Spotlight) risks higher emigration from the capitals—dissipating much-needed gains from agglomeration. Boosting amenities and attractiveness in capital cities is a precondition for favorable outcomes from EU integration.

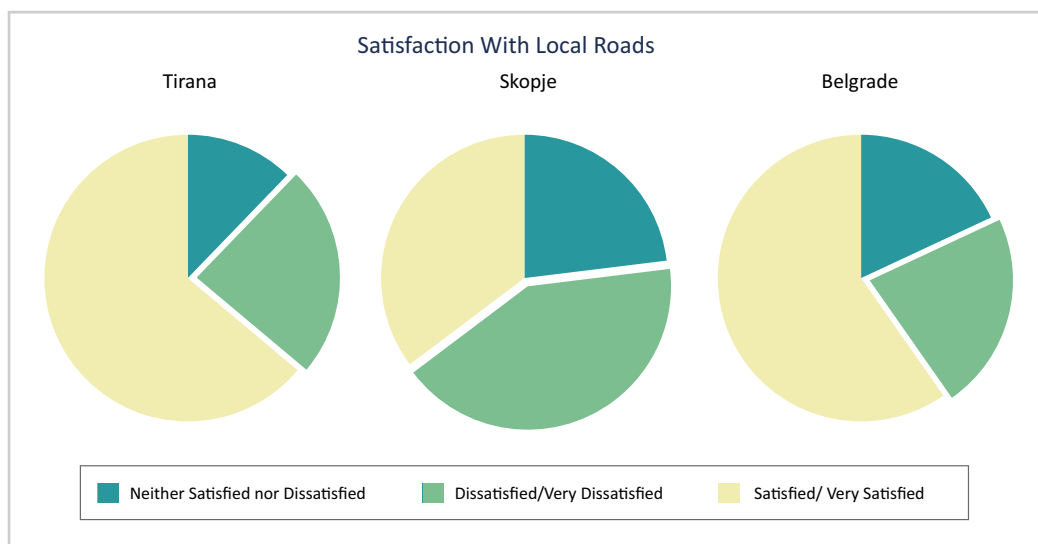


Figure 2.15 Many are dissatisfied or very dissatisfied with the quality of local roads

Source: EBRD 2016.

Note: Results were derived from the responses of 319 households in Tirana, 406 in Skopje, and 358 in Belgrade.

Enterprise support and finance

Modernize collateral registries and increase the breadth and depth of credit reporting

It is important both to modernize secured financing systems and to increase the breadth and depth of credit reporting. Reforms to improve access to finance have been implemented across the region, among them establishing credit bureaus and expanding their coverage, modernizing credit and collateral registries, and adopting new insolvency laws. However, as gleaned from the Doing Business 2019 results, firms seeking credit still encounter major obstacles in many capitals, especially Belgrade, Sarajevo, and Zagreb. The burden of validating debtors' credentials and ascertaining their ability to make payments falls on the creditor, who must also bear all risks related to the value of and legal rights to the collateral offered. Secured-financing and credit reporting systems in all six capitals require upgrading. Collateral registries can be made more accessible and geographically unified. Currently, four of the six

capitals require upgrading. Collateral registries can be made more accessible and geographically unified. Currently, four of the six capitals do not have a notice-based collateral registry and three of the six do not have a unified legal framework for secured transactions. Credit-reporting systems can also be made more viable by offering value-added services such as credit scores, casting a wider net by incorporating data from utilities and other sources, and expanding their coverage.

Make MSMEs a distinct category of borrowers

Access to finance can be improved through additional support for micro, small, and medium enterprises (MSMEs). Access to finance is fundamental for businesses—particularly MSMEs—to take advantage of growth opportunities and advance innovative ventures. Although MSMEs⁵⁶ are most likely to suffer credit constraints, the benefit on job growth of expanding their access to credit is much more pronounced than for larger firms⁵⁷. According to responses to the 2013 Enterprise Survey, limited access to finance in Western Balkan capitals and Zagreb is impeding the growth of jobs and productivity: about 15 percent of the firms surveyed stated that access to finance was the primary problem in their daily operations. About 91.5 percent of these firms were in the MSME category. In five of the six cities, firms perceived access to finance as one of the top three problems.

There is a large gap between MSME financing needs and their options for meeting those needs. They face higher transaction costs, and lack of information diminishes their perceived creditworthiness. Credit bureaus and registries in the capitals 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 transactions⁵⁸. Currently, except in Belgrade, no bureau or registry in the six capitals distinguishes MSMEs from large enterprises. Tbilisi, in contrast, recognizes MSMEs as a separate category and gives them specific credit scores⁵⁹.

Skills and innovation

Address the skills shortage through better coordination between universities and the private and public sectors

To varying degrees, skills shortages are widespread and prominent in the capitals studied. As in most transition economies, this issue is a familiar one, as the education system had been unable to keep pace with changing market needs. In the Western Balkans, although knowledge-intensive business sectors are growing slowly, the technical and transferable skills to cater to these sectors is growing even more slowly—which explains the low proportion of such high-value-added industries in the economies studied⁶⁰.

Skills shortages are apparently self-sustaining. Neither higher education and vocational training institutes nor universities have been successful in adequately incorporating skills and application-based learning into their curricula. Employers are dissatisfied with the employability of graduates and consistently struggle to find individuals with the requisite know-how (box 2.2). Almost all businesses consulted in Tirana expressed concerns about current learning methods in universities. Yet despite the inadequacy of curricula⁶¹, college graduates have the highest probability of getting a job, because they are considered highly skilled—an indication of the excess demand for skilled labor. This situation, left to itself, does not stimulate improvements in how skills are imparted and distorts the skilled-labor market. The few large, mature firms generally absorb most of the technically skilled workforce due to much higher pay packages. This skews expectations and leaves smaller and growing firms in a tough spot. Anecdotes from tech firm owners substantiate the difficulties of finding adequately skilled employees and being able to match their expectations.

To make matters worse, the high propensity of skilled individuals emigrating abroad widens the skills gap⁶², further constraining the growth of knowledge-intensive, high-productivity businesses. In all consultations and interviews with individuals from the ICT sector, this issue was a constant. Young graduates actively seek better pay and opportunities abroad, spurred by the lack of jobs matching their skills. Among those registered as unemployed in 2013, 3.3 percent had completed tertiary education and by 2015 the share had grown to 5 percent⁶³. This is the pool most susceptible to leaving the country.

BOX 2.2

Barriers to tech entrepreneurship in Tirana

The tech entrepreneurship ecosystem in Tirana has been struggling to scale up, largely because agglomeration economies are not being used properly. Gains from sharing, matching, and learning are minimal. City administrations can kick-start this subsector by offering tailored programs and ensuring that economy-wide conditions are not burdensome.

In about 2012 an enterprise startup community emerged in Tirana. Its visibility has been confined largely to events and conferences within the city. There has been no discernible growth in scale or in the number of startups (the same firms repeatedly attend these events) since. Sporadic attempts have been made at community building, but they have lasted no more than a year or two at best.

Lack of coordination has produced a fragmented ecosystem. Prominent players operate in silos. Networking assets are small, and accelerator and incubator programs, experts, and event organizers seem to be disconnected. The result is an oversupply of similar programs and gaps in the systems needed to support firms that are growing or want to enter international markets.

The private sector and universities do not engage with startups or themselves coordinate to foster the entrepreneurial ecosystem. Somewhat larger private tech companies view startups as competitors and do not operate as a pipeline. University curricula do not align with the skills digital enterprises demand.

Most startups are self-financed, supplementing this with grants and competitions organized by foundations, international organizations, and government ministries. These grants are however small and are disbursed inefficiently; startups can get grants for seed funding but not for capital investments. Access to finance appears to be a barrier to scaling up. Tirana has no venture capital.

A hostile regulatory environment creates hurdles, often stifling the entrepreneurial spirit. Startups are not distinguished by law from other businesses, and registration, tax, and other legal processes are confusing and complex—entrepreneurs are regularly penalized for noncompliance. International investors are reluctant to do business with tech startups in Albania because the regulations are opaque.

Albania has been less successful than other Western Balkan countries in attracting venture capitalists and other investors in startups. As a market it is smaller and isolated by geography,

language, and culture, and there is still a stigma, originating from Albania's political past, attached to cooperation with Albanian firms. Startups report downplaying their Albanian identity and sometimes incorporate in other countries.

A conspicuous shortage of skills is the most debilitating constraint. A severe undersupply of people with the requisite technical and managerial skills for responding to strong demand from the growing information technology sector makes it very difficult for startups to recruit people—or even to get started. Startups cannot match the salary expectations larger tech firms create. As a result, they must either outsource most of their back-end work or hire interns and others with less skill, which puts them at a competitive disadvantage. There is no formal platform to facilitate skills matching. University career portals, the primary recruitment centers for startups, are dysfunctional or host only larger firms. Investors report a willingness to invest but an inability to find ventures worth investing in.

There is a desperate need for intervention to create a pool of qualified labor that will fuel the growth of knowledge-intensive businesses. Indeed, the Skills Towards Employment and Productivity Employer Survey conducted in Albania found that skills constraints particularly curtail expansion and investment in firms likely to provide productive employment opportunities (firms that are not local trade and repair services, large firms, or foreign-owned firms engaging in external trade)⁶⁴.

To allay the concerns of businesses, higher education institutions in capitals should not only revamp their curricula but also provide platforms for practical and experiential learning. That will require close coordination between businesses and universities. Moreover, universities and local governments should collaborate to more efficiently match individuals with firms by creating platforms for networking and recruitment.

Enhance the entrepreneurial skills of business owners and managers

Small and medium firms have considerable room for productivity gains. Their productivity depends on the business acumen and managerial capabilities of their owners and managers, who set targets and goals and design the operations of their firms. Currently, firm productivity seems to be mired as much in the lack of managerial skills and business acumen of firm owners as in low levels of digitization and innovation.

Figure 2.16 examines two indicators of managerial skills. Figure 2.16a shows how firms deal with inefficiencies: Asked how long it takes before they reassign or dismiss underperforming employees, an average of 50 percent of managers in Belgrade, Skopje, Tirana, and Zagreb said that underperforming employees are rarely or never dismissed or reassigned. This suggests that their firms either do not have maximizing profits as an objective or are not recognizing the connection between employee and firm performance. Figure 2.16b shows that a considerable number of firms in Skopje, Tirana, and Zagreb did not regularly monitor production, suggesting a lack of desire for or understanding of how to enhance achievement or mitigate inefficiencies.

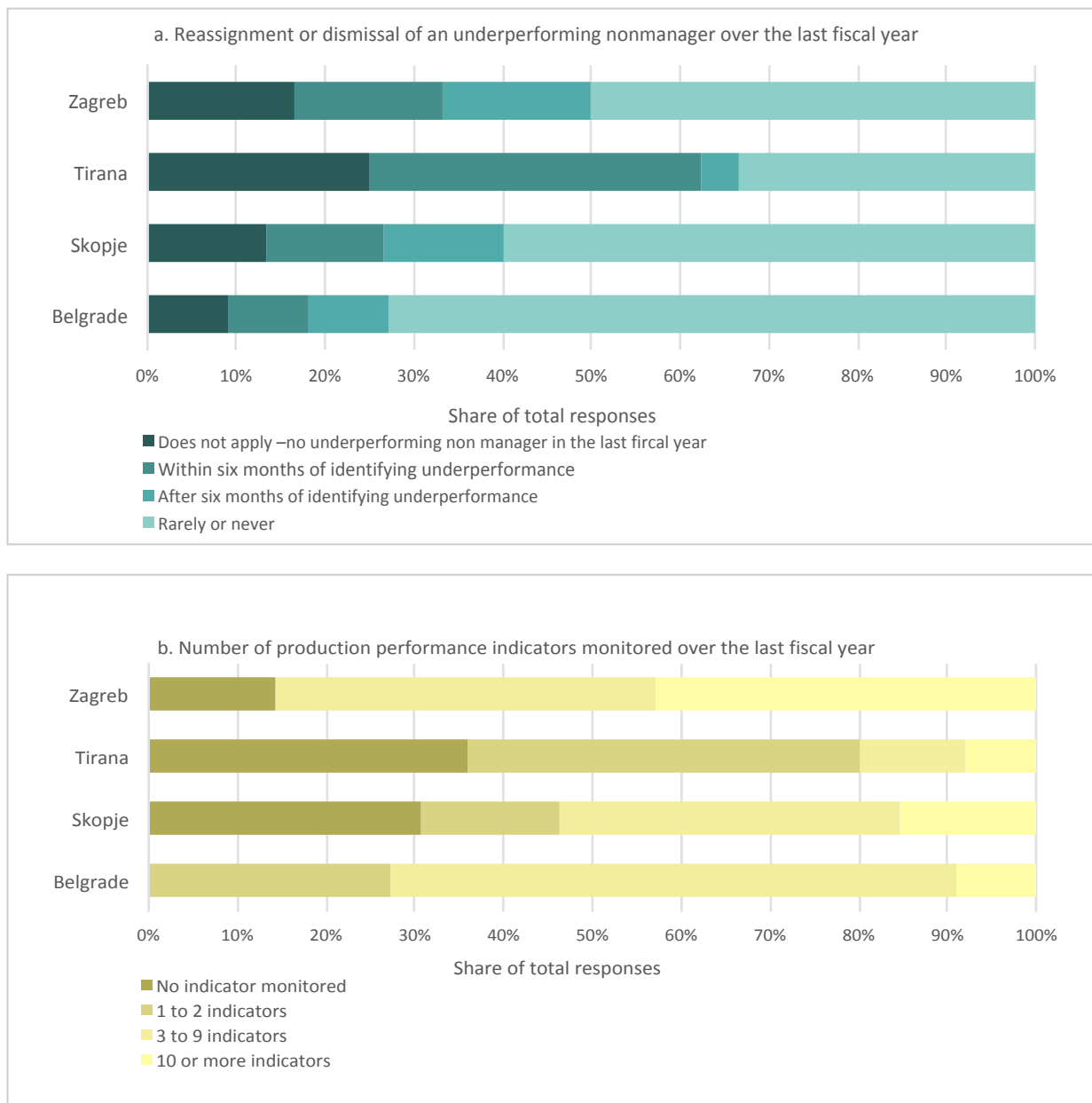


Figure 2.16 Mediocre managerial skills keep firms from optimizing productivity

Source: World Bank Enterprise Survey 2013.

Apparently, in Western Balkan capitals and Zagreb, owners of small and medium enterprises do not possess the skills nor the desire to perform such tasks as outsourcing, forming partnerships, financing investments, or seeking efficiency gains. Low productivity due to lack of good management practices is compounded by the scarce use of technology. The capacity of firms to absorb new technology is weak, and the consequent inability to be up to date with changing production techniques depletes their competitiveness.

Entrepreneurs and owners of firms need to be armed with basic 21st century management techniques and exposed to the benefits of digitization. This can be achieved by creating platforms for knowledge exchange and mentorship. Incentives can be put in place that encourage the adoption and successful use of new management systems and technology. Focusing on expanding entrepreneurial abilities would not only boost productivity but also better equip these firms to take advantage of agglomeration.

City administrations have much to contribute

A number of issues identified in this chapter will not be resolved without national governments. For one thing, many of the recommendations are beyond the capacity and legal authority of city administrations. Constraints of capacity and scope play out more glaringly in more centralized economies like countries in the Western Balkan

The challenges confronting capitals illustrate the structural problems and the barriers existing in the Western Balkans and Croatia. For example, the fact that capitals struggle to grow advanced industries is closely related to the fact that exports from the Western Balkans depend on relatively low skills and technology content (box 2.1). This is just one example of the national challenges that are most obvious in capital cities. Factors that shape these outcomes may not be unique to the capitals, but they are most visible there. Among widely recognized growth constraints typical of the Western Balkans and Croatia are business and labor market regulation, taxation practices that act as disincentives for business, failure of the education system to meet the skills demands of businesses, and infrastructure deficits ⁶⁵.

However, the experience of cities and subnational governments elsewhere in the world shows that they can do much to promote economic development. For instance, the evidence is growing that even when the majority of conditions for doing business are regulated nationally, local reforms can stimulate positive results through initiatives like setting up one-stop shops, easing licensing processes, and adjudicating land use restrictions ⁶⁶.

Examples of successful city-level initiatives promoting competitiveness can be found across Eastern Europe. A recent review of business regulation in Bulgaria, Hungary, and Romania found that even when regulations and procedures are defined nationally, cities vary considerably in difficulty of doing business, and cities can learn a great deal from each other on how to enhance the business environment. The most improvement usually comes from improving coordination between regulatory agencies, as the city of Craiova, Romania, did to speed up issuance of construction permits. Also in Romania, by promoting information technology solutions, Constanta was able to incentivize 25 percent of firms to register online ⁶⁷—substantially more than the national percentage. Sofia, capital of Bulgaria, is another example of opening new avenues for economic growth. It has been successful in attracting R&D investment, including Coca-Cola's second largest research facility, and has been cultivating tech entrepreneurship until it is now ranked third in Europe in the number of IT start-ups. It has done this by not only building an efficient FDI promotion division, but also by improving IT infrastructure⁶⁸. Subnational initiatives in Poland and Slovakia showcase a role for local governments in linking local education institutions to businesses to achieve better outcomes for students and increase the innovation potential of the local economy. In the Podkarpackie region in southern Poland, with support from the World Bank and the European Commission, regional authorities are setting up a Center for Innovation. It will act as a bridge between local universities and businesses to create opportunities for commercializing research, engaging academics in solving business issues, and prototyping new products⁶⁹. In the Presov region of Slovakia, regional authorities are drafting a proposal to channel additional investment into education and vocational training schools based on their commitment and readiness to meet the needs of local businesses and economic development priorities⁷⁰.

Of course, the powers and capabilities of each city will differ, but these examples show that in almost any situation cities have a role to play.

A helpful way to think of the role of the city in promoting economic growth is in terms of what is known as the "City Wedge."⁷¹ The underlying principle is that broad policy measures do not necessarily have to be the sole

responsibility of local governments but can be addressed at different levels of governments, or by collaborations between local governments on cross-boundary issues, or even by nongovernment actors. The city administration can actively advance competitiveness by ensuring that at some level reforms and policies are being carried out. The success of reforms and policies cannot be realized without the proactive engagement of the local administration.

The concept of the wedge is useful both for defining the space for action by city authorities and local actors and expanding it over time. The city wedge dictates three components that should be considered in identifying and expanding the limits of city powers: ensure full use of internal scope and capacity; engage constructively and proactively with neighboring jurisdictions and other tiers of government; and create growth coalitions with the private sector. Each component may unlock opportunities for Western Balkan cities and Zagreb, though they will differ based on the context of each city.



Figure 2.17 The “City Wedge” can expand the capacity and authority of city administrations

Source: World Bank 2015.

Use city authority and capacity to the fullest extent

The authority held by cities in the Western Balkans and Croatia makes it clear that there is much they can do to promote economic growth, though perhaps in different ways. The responsibilities that local governments in Western Balkans hold or share with other levels of government give them a meaningful amount of control over areas that have been identified as problems⁷². For example, inspection services are under the control of local governments in Bosnia and Herzegovina and North Macedonia, and city planning and issuing construction permits is the responsibility of local government in most countries. Moreover, local governments have authority to manage local economic and tourism development, some authority for adult education, and almost full control of developing local amenities and efforts to curb congestion forces through, e.g., transport, traffic management, parks and recreation, and cultural activities. Of course, because the details will differ significantly from place to place, no policy responses apply universally. However, each capital city can identify policy areas within its authority that are pivotal for addressing its main challenges.

Efforts to promote competitiveness would most likely be inefficient unless the objective of doing so and the successful implementation of the associated reforms are part of a mission shared explicitly by all relevant administrative departments. Coordination failures to deliver policies—even those within the administrative remit of local governments—are frequent and blatant: e.g., in Belgrade, the goal of increasing tourism does not appear to have been supported by coordinated efforts across city departments.

To expand their capacity, governments of capitals should be given adequate resources to address their needs. Utilities and public services in capitals are wanting, and deteriorating infrastructure increases congestion costs. Local administrations are responsible for land use and planning as well as urban infrastructure. But managing urbanization as city populations grow requires additional resources. Box 2.3 sets out a strong case for allowing capitals to collect and retain more tax revenue.

Adopt more collaborative forms of governance

Capitals in the Western Balkans and Croatia should move to increase their engagement with the private sector and other local actors to build growth coalitions. When the World Bank team behind the seminal study of competitive cities tried to identify commonalities between best-performing cities in different parts of the world, the answer was not specific policies or management practices, it was mechanisms for building consensus, identifying priorities, and promoting engagement between public and private actors. Globally, these collaborations took very different forms: in Bucaramanga, Colombia, it was a formal consultative forum; in Gaziantep in Turkey it was mostly informal contacts between key actors; and in Cape Town, South Africa, collaboration was organized around several promotion organizations⁷³.

In Belgrade and Tirana public-private collaboration proved to be minimal. Businesses rarely feel they are being heard, and often do not even consider local government to be a partner that can help address their grievances. The drafting of current policies and their implementation have no formal platforms for feedback. Both Belgrade and Tirana suffer from persistent distrust between the business community and the government. The absence of systematic collaboration between public and private actors is pronounced—more in Belgrade than Tirana. Government engagement with the private sector is paramount for a number of reasons. The reforms and policies needed for each city are based on the requirements of both old and new firms. Businesses can lead economic development by investing in and carrying out large-scale projects, and their support can advance national lobbying efforts. City administrations that fail to leverage that capacity lose an opportunity. There is clearly a need to rebuild trust between public and private actors.

Cities should also collaborate with their neighbors to make sure that their policies cover the entire extent, the functional urban area, of the local economy. Tirana, Belgrade, and other capitals in the Western Balkans can be defined by sprawling agglomerations where functional urban economies greatly exceed administrative boundaries. Thus, there is a clear case for close horizontal collaboration between neighboring local authorities to address issues like transport and housing and to coordinate, e.g., planning and investment promotion activities. However, as yet examples of success are few. In Tirana, for example, though the city administration appears to be using its operational capacity to the fullest extent, greater intergovernmental engagement could advance efficiency and expand capacity. Tirana is recognized as a part of the Tirana–Durëss corridor, which links the capital to Albania’s main port and is largely a single extended urban area. Tirana–Durëss has a integrated cross-sectoral development plan⁷⁴ and a Regional Development Authority that has been tasked with economic development of the region. However, engagement with the Tirana administration has shown clear opportunities for more intense collaboration between local administrations within the corridor.

BOX 2.3

Municipal finance: Are capital cities getting their due?

While the functions assigned to local governments vary in the Western Balkans and Croatia, urban infrastructure has been entirely within the remit of local jurisdictions. The most important distinction is between countries where local governments primarily provide urban infrastructure and countries where local governments also provide social services, such as education and social assistance. In the former, local governments typically construct and maintain roads, water supply, sewerage, and solid waste collection and treatment facilities and conduct related regulatory functions like land use planning and building control. Except for road construction and maintenance, these services are typically performed by municipal enterprises that generate their own revenue from tariffs. In the second group of countries, local governments provide similar infrastructure services plus social services, such as primary and secondary education (Kosovo, North Macedonia, Croatia) and social assistance (Albania). Local control over these functions is limited. Spending on social services is typically financed by earmarked transfers from the central government.

The structure of local revenues varies for the two groups: In countries where local functions are largely confined to infrastructure services, local governments derive a majority of financing from discretionary revenues: shared taxes, unconditional transfers, locally administered taxes, fees, and tariffs, though generally tariff revenues do not appear in municipal accounts because they are imposed and retained by municipal service firms. In countries where local governments also provide social services, conditional (earmarked) grants are a major source of revenues.

Equalization elements in unconditional transfers to some extent offset cross-jurisdictional variations in per capita resources between capital and other municipalities. All unconditional transfer systems in the Western Balkans have an equalization element—a component that favors poorer jurisdictions.

In Serbia, the transfer formula is explicitly designed to bring the per capita personal income tax revenues of poorer jurisdictions up to 90 percent of the national average with the amounts reduced for municipalities classified as “more developed.” In Croatia, the per capita revenues of Zagreb were about 75 percent higher than the average of all other jurisdictions (figure B2.3.1) in 2017. This is almost entirely due to Zagreb’s personal income tax revenues, which are 3.4 times the average of other municipalities. These variations are offset by Croatia’s system of unconditional transfers: Zagreb’s revenues per capita from unconditional transfers are one-sixth the average for all other jurisdictions. Without these transfers, Zagreb’s revenues would be 2.3 times the average of all other jurisdictions.

Tirana receives only about 65 percent of the amount per capita that other jurisdictions average. This reduces Tirana’s advantage in discretionary revenue per capita to 1.8 times the average for other jurisdictions even though its revenues from land development fees are eight times as high as the average for other jurisdictions, revenues from property taxes are 3.7 times as high and revenues from other taxes and fees are 3.3 times as high.

Similarly, metropolitan Skopje receives only about one-third as much in unconditional transfers per capita as other municipalities. This has only a modest impact on Skopje’s per capita revenues because the small scale of the equalization transfers cannot make up for Skopje’s advantage in per capita discretionary resources. However, without the unconditional transfers, Skopje’s discretionary resources, which are twice those of other jurisdictions, would be 2.5 times higher.

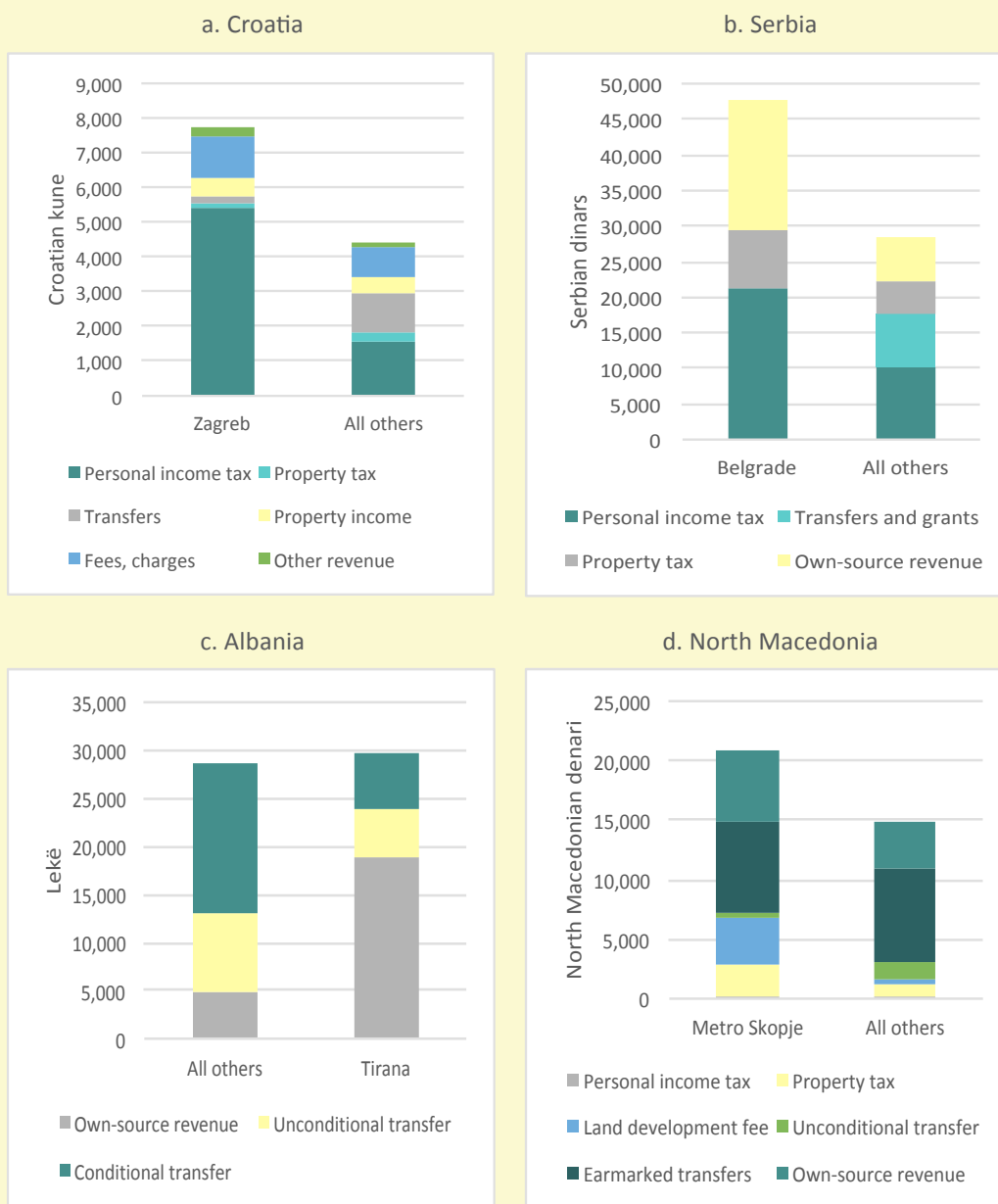


Figure B2.3.1 Per capita revenue from unconditional transfers used to invest in and maintain urban infrastructure is much lower for capitals than for other municipalities

Source: Panel a: Municipal Finance Review Database, World Bank; b. City of Belgrade Official Gazette (2018); all others, North Macedonian Ministry of Finance (<https://www.finance.gov.mk/en/node/6915>). Panel c Financat Vendore database (<http://www.financatvendore.al/data/revenues>); Panel d MFR2 database.

Based on the functions that discretionary revenues finance, a strong case can be made for retargeting finances to capitals. Discretionary revenues finance mainly urban infrastructure and related land use management functions. They include not only the recurrent costs of infrastructure services but also a significant proportion of capital investment in infrastructure. While data on local spending across functions are scarce, the experience of Belgrade suggests that most discretionary revenues are being used for operations, subsidies, and servicing debt rather than capital investment in public infrastructure.

At present, even the largest cities in the region are too small to compete in the global economy, and any population growth in their countries is concentrated in those cities. Analysis of the quality and coverage of public services and infrastructure in and around capitals identifies areas for improvement and investment—such as upgrading roads and renewing sewage pipelines. Rural areas are losing population, which suggests that the need for infrastructure spending will be concentrated in large cities. Systems of local finance that concentrate resource in major cities are thus desirable.

Endnotes

¹ World Bank 2017d.

² Market access or market potential is a measure of how accessible any given location in the country—or region in this case—is to all other destinations/ market centers. It is based purely on time. To calculate market access across the Western Balkan and Croatia region, road networks were used as the basis for analysis, while destinations used included cities in the Western Balkans and Croatia, cities in bordering countries as well as cities in the rest of Europe (only those with a population of more than a million). Equally spaced gridpoints (or origin points) were created across the Western Balkan and Croatia region, and then the travel time from each of those grid points to every destination/ market town was calculated and weighted according to the population of each town. The weighted travel times for each origin point was summed, after which a standard market accessibility/potential formula was applied.

³ Estimates based on analysis by the Geospatial Operations Support Team, World Bank.

⁴ INSTAT 2016.

⁵ Estimates based on data provided by the national statistics offices of Albania, Croatia, North Macedonia, and Serbia.

⁶ Farole, Goga, and Ionescu-Heroiu 2018.

⁷ Comparator cities were selected using the Oxford Economics 2016 dataset, which details demographic and economic indicators for 750 cities across the world. Only capitals that displayed similar levels of primacy to the Western Balkan capitals and Zagreb were considered. Within this pool, capital cities that did not mirror Western Balkan capitals and Zagreb in terms of population size and national share of population were filtered out. The selection of regional comparators (cities from ECA) for the benchmarking analysis factored in comparators chosen in chapter 1 as well as those chosen in recent regional World Bank studies. Comparisons with the selected cities serve primarily to gauge the relative performance of the Western Balkan capitals and Zagreb and to draw high-level trends. Although, by and large, efforts were made to use the same set of regional comparators consistently across the chapter, on occasion some comparators were replaced by others due to the availability of data for a particular indicator.

⁸ During 2010–15, even Skopje displayed an average GDP per capita growth rate marginally lower than the country's in these data, as opposed to the results from the Oxford Economics data for 2011–15.

⁹ World Bank 2010.

¹⁰ Oxford Economics 2016.

¹¹ World Bank 2017a.

¹² This analysis is different from the analysis comparing growth performance of the capital city and its country. In this case the rest of the country excludes the capital city region.

¹³ The share of the younger population also declined or stalled over 2010–15 (see figure 2.7), implying limited growth in the labor force/working age population in coming years.

¹⁴ Oxford Economics 2016.

¹⁵ World Bank 2009.

¹⁶ UNDESA 2018. In Croatia, between 2010 and 2016, Zagreb was the only region (NUTS 3) that registered a positive average annual population growth rate. Similarly, Tirana and Belgrade were the fastest growing regions in terms of population and among the only 3 regions that registered a positive population growth across the same time frame.

¹⁷ Although some secondary cities are also growing in population.

¹⁸ Estimations based on data from Oxford Economics (2016). Natural increase is the difference between the birth rate and the death rate. The average rate of natural increase in Belgrade and Sarajevo has been negative over 2010–15, while that in Podgorica has been 0 percent. Skopje demonstrated the highest rate of increase at about 2 percent.

¹⁹ World Bank 2015; Fikri and Zhu 2015.

²⁰ Mano and Castillo 2015; Frocrain and Giraud 2019.

²¹ Traded and nontraded sectors, although intrinsically different, are essentially interdependent. Products and services generated by the localized sectors provide crucial inputs for the creation of tradable goods. The costs of these inputs significantly affect the competitiveness of the tradable sectors (Lee and Vanino 2018), and the relative prices of nontradable goods hinder the growth of high value-added tradable enterprises in the local economy (Frocrain and Giraud 2019). Frocrain and Giraud (2019), analyzing employment growth trends across tradable and nontradable sectors in France during 1999–2013, find that for every 100 new tradable jobs, 64 additional jobs were generated in nontradable businesses in the same region. Employment growth in tradable services was also recognized as disproportionately benefiting major cities. In contrast, the study also concluded that dwindling employment in traded industries was associated with widening wage and productivity gaps between the two types of sectors.

²² Frocrain and Giraud, 2019; Moretti 2010; Moretti and Thulin 2013.

²³ Viewing the city economy's sectoral composition and its evolution not just to determine areas of comparative advantage but also to describe tradable and nontradable sectors lends a clearer picture of the efficiency of growth patterns. This section examines the sectoral distribution of economic activity across standardized classifications by alphabetical code of the Nomenclature of Economic Activities (NACE), which are aggregated into 10 distinct categories. To differentiate between traded and nontraded sectors, it draws from previous research in broadly classifying 4 of the 10 NACE categories as tradable sectors: industry, professional services, financial and insurance services, and information and communications (Mano and Castillo 2015; Frocrain and Giraud 2019; Fikri and Zhu 2015; Schnabl and Zenker 2013).

²⁴ Duranton and Puga 2004.

²⁵ Gaubert 2018.

²⁶ Audretsch and Feldman 1996; Nocke 2006.

²⁷ LQ values for the service-oriented tradable sectors that Western Balkan capitals and Zagreb specialize in range between 1.52 and 1.74 in Belgrade (figure 2.8a), 1.8 and 2.1 in Skopje, 1.8 and 2.0 in Sarajevo, and 1.6 and 2.3 in Zagreb (figure 2.9). LQ values for the same set of sectors in Bratislava, a comparator city, fall between 2.1 and 2.5 (figure 2.8b). Prague, a capital city with a slightly more advanced economy (WDI 2018), demonstrates even higher LQs with a larger share of population employed in these sectors (see figure 2.8a).

²⁸ Estimations from INSTAT 2018.

²⁹ World Bank 2017a.

³⁰ Duranton and Puga 2004.

³¹ Duranton 2009.

³² A paper on Brazil by Barufi, Haddad, and Nijkamp (2016) finds that high- and low-tech manufacturing benefit the most from agglomeration economies, while low-skilled services and medium-tech manufacturing benefit least. In the United States, Black and Henderson (1999) suggest that high-tech manufacturing industries tend to be more concentrated and more mobile than machinery-related ones.

³³ INSTAT 2018.

³⁴ World Bank 2015.

³⁵ Since Doing Business assigns scores to national economies based on two in-depth case studies carried out in the capitals, its ranks and scores across the 10 indicators provide a good indication of the costs and regulatory hurdles confronting medium-size firms across capital cities (World Bank 2019). The analyses in this section include all six Western Balkan capital cities and Zagreb and two comparator cities—Tallinn, Estonia, and Tbilisi, Georgia. These comparator economies were chosen because of their exceptional performance on the ease of doing business indicators in 2019. Tbilisi rose to rank 6th worldwide, while Tallinn ranked 16th.

³⁶ World Bank Enterprise Surveys, though susceptible to sampling bias, provide insight into the problems and relative severity of challenges faced by both unregistered and registered firms. These surveys, which typically cater to small and medium-size firms, highlight factors that are not included in the Doing Business indices—specifically those related to institutions and regulations (<http://www.enterprisesurveys.org/>).

³⁷ World Bank 2019.

³⁸ The first involved an in-depth survey administered to 30 firms in the footwear and garment industry (see box 2.1). The objective of the survey was to delve deeper into both industry-specific and economywide challenges that firms in the capital city face. The second case study focused on Tirana's digital startup environment. Two focus groups were conducted, seeking clarity on specific challenges faced by individual entrepreneurs and the general conditions that stalled their growth. In addition, seven industry experts in the information and communications technology sector in Tirana were interviewed.

were conducted, seeking clarity on specific challenges faced by individual entrepreneurs and the general conditions that stalled their growth. In addition, seven industry experts in the information and communications technology sector in Tirana were interviewed.

³⁹ Alon and Hegeman 2013. 16 percent of firms inspected in Belgrade report that an informal gift or payment was requested during the inspection. The number is lower for Tirana, Skopje, and Sarajevo at 10 percent, 4 percent, and 6 percent respectively (Enterprise Survey 2013).

⁴⁰ Shosha 2013.

⁴¹ Dabla-Norris et al. 2017.

⁴² Trebilcock and Leng 2006.

⁴³ World Bank 2019.

⁴⁴ World Bank 2019.

⁴⁵ The Enterprise Survey, though suggestive, gave no precise definitions of practices of informality, allowing respondents to interpret the question differently.

⁴⁶ Enterprise Survey 2013.

⁴⁷ La Porta and Schleifer 2014; Loayza 2018.

⁴⁸ Benjamin et al. 2014. Unsurprisingly, the results of the Enterprise Survey (table 2.1) suggest that informal sector practices are more prevalent in Skopje and Tirana—economies that are more reliant on local services than on other sectors.

⁴⁹ Chen 2005.

⁵⁰ La Porta and Schleifer 2014; Loayza 2018; Medina and Schneider 2018.

⁵¹ World Bank 2017c.

⁵² See for example press statement of Ms. Aleksandra Damjanovic, Assistant Minister, available in Serbian at <http://www.rts.rs/page/stories/sr/story/13/ekonomija/1523647/zahtev-za-legalizaciju-izbegavanje-bagera.html>. This is also the figure has been mentioned by interviewees in dealing with legalization matters both in the city of Belgrade and statewide.

⁵³ World Bank 2019.

⁵⁴ Hilhorst et al 2015.

⁵⁵ Nonrevenue water is the difference between water supplied and water sold, expressed as a percentage of net water supplied. It essentially indicates the volume of water that is “lost” (DANUBIS Water Platform n.d.).

⁵⁶ Access to finance in this section refers mostly to getting credit. In the Western Balkans cities, most firms, particularly MSMEs, perceive loans as the most reliable financial instrument. In Tirana, for example, instruments such equity financing are rarely used by enterprises (European Investment Bank 2016).

⁵⁷ Ayyagiri et al. 2016. An examination of comprehensive firm-level data across a large set of developing countries found that at firms with access to a loan, employment growth was higher—by between 1 and 3 percentage points—than at firms without such access. The same study found that this effect was more pronounced among MSMEs: an exogenous increase in the supply of credit (proxied by the introduction of a credit bureau) resulted in job growth in MSMEs that was 6 times greater than growth in larger firms.

⁵⁸ Ramhalo et al. 2018.

⁵⁹ World Bank 2018b.

⁶⁰ Bartlett 2013.

⁶¹ Bartlett 2013.

⁶² Responses from households in the Life in Transition Survey III suggest the same, though the sample size is low. The share of individuals willing to move out of the country among those who have been unemployed in the past year is higher in Western Balkan capital cities than in comparator capital cities. Within the pool of individuals willing to move abroad, the share having secondary education is highest, followed by those with tertiary education (EBRD 2016).

⁶³ INSTAT, 2018.

⁶⁴ Honorati et al. 2018.

⁶⁵ World Bank 2017a.

⁶⁶ White 2016.

⁶⁷ World Bank 2017e.

⁶⁸ Shehadi 2019.

⁶⁹ World Bank 2018c.

⁷⁰ World Bank 2019b.

⁷¹ World Bank 2015.

⁷² NALAS 2019.

⁷³ World Bank 2015.

⁷⁴ http://planifikimi.gov.al/index.php?id=pins_durana&L=2.

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Annex 2A: Evidence of agglomeration economies in Croatia

Examination of how population density is associated with the labor productivity of firms in cities¹ in Croatia reveals the benefits of agglomeration. However, agglomeration economies² appear to be prevalent in only certain sectors of the economy.

In Croatia, the relationship between population density and labor productivity, proxied by income per employee, seems to be negative. Interestingly, the effect is more pronounced when the capital is excluded from the analysis (figure A2.1.1). This suggests that density in the capital, Zagreb, is positively associated with labor productivity, which somewhat compensates for the general negative relationship³.

A deeper look into the sectoral composition shows different effects for different economic activities. Figure A2.1.2 illustrates a pronounced positive association between density and service sectors such as information and communications or professional, scientific, and technical activities. On the other hand, there is a statistically significant negative relationship between population density and income per capita for activities like agriculture and manufacturing, showing that there may be no agglomeration economies for them—apparently for these sectors, operating in a denser environment is detrimental to labor productivity. This result seems intuitive for agriculture but not for manufacturing. Possible explanations may be related to congestion effects, land availability, or even data where the location of firm headquarters is used rather than the location of production. The negative association with density might also be explained by variations in the type of manufacturing firms dominating the economy. Barufi, Haddad, and Nijkamp (2016) found that high- and low-tech manufacturing benefit most from agglomeration economies in Brazil but low-skilled services and medium-tech manufacturing have the lowest coefficients of agglomeration economies.

What is important to note here is that it is knowledge-intensive business services that are deriving the greatest benefits from agglomeration. The variations in the relationship between density and productivity by sector could be determining the economy-wide negative relationship and offer a plausible explanation for the differences in negative slope observed when the capital was part of the analysis and when it was not.

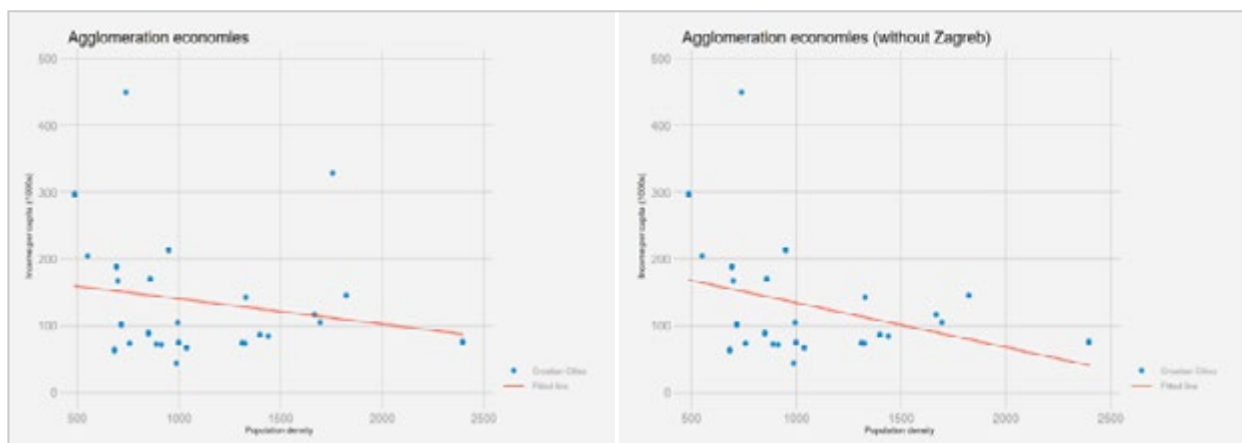


Figure 2A.1 The negative relationship between population density and labor productivity becomes more pronounced when Zagreb is not part of the analysis

Note: Currency in Croatian Kune.

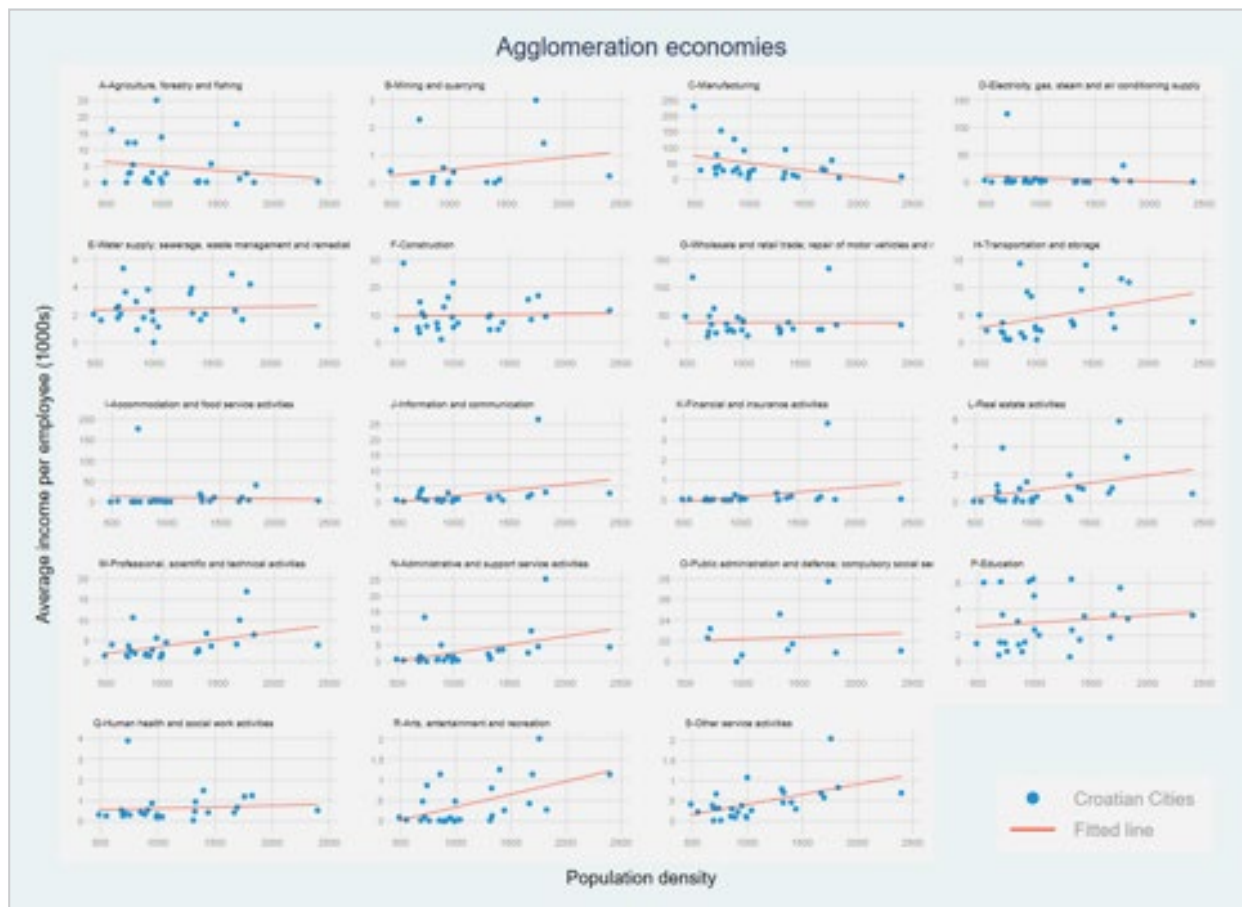


Figure 2A.2 The relationship between population density and labor productivity in Croatia varies by sector
Note: Currency in Croatian Kune.

Chapter 3.

Spatial welfare
disparities:
Promoting fair
opportunity
regardless of
location

In addressing the challenging patterns of urbanization to pursue faster growth in the Western Balkans and Croatia⁴, national policymakers need to consider the welfare of citizens wherever they live. Focusing on spatial differences in welfare, this chapter seeks to understand what drives the differences and to motivate policymakers to promote fair opportunities for people wherever they live. In an ideal equal-opportunity situation, circumstances like place of birth, gender, and parents' background—characteristics beyond an individual's control—should not determine that person's access to productive activities and social services. Yet multiple dimensions of spatial development—gaps in basic education, health, other services, infrastructure, and access to jobs—contribute to disparities in living standards.

This chapter uses monetary indicators of welfare, mainly per capita household income or consumption, but also links to nonmonetary indicators to the extent the data allow, especially for education, health, and other basic services. The results reveal the multidimensionality of within-country disparities in household welfare: localities lagging in economic performance tend also to lag on a wide range of living standards indicators. The chapter focuses on the six Western Balkan countries and for certain analyses going beyond household surveys, more on Albania and Serbia than on the others.

People have vastly different living standards that vary by locality within the Western Balkans and Croatia. Despite some signs of weak convergence, spatial disparities in household income or consumption are noticeably higher in some Western Balkan countries than in other ECA countries. These disparities matter for inclusive development and social cohesion.

Disparities in household income or consumption between richer and poorer localities and between urban and rural areas reflect both differences in people's endowments and different economic returns in the form of higher income in some locations. Endowment differences mainly refer to gaps in both access to and the quality of human capital. Differences in returns result from spatial gaps in public service provision, infrastructure, and the business environment. Even if gaps in education and other basic services are addressed, however, people still need to be able to move to places where they might earn a higher income. In parts of the region there is little movement within countries to better jobs. Housing and credit market constraints and limited information on job opportunities limit internal labor mobility and economic potential.

Given the history of conflicts within the region and the relatively recent emergence of democratic institutions, spatial welfare disparities, which can give rise to distributional tensions and threaten social cohesion, should not be ignored. Support for more competitive cities and agglomerations to accelerate economic growth and EU accession are expected to change economic landscapes in the Western Balkans and Croatia. Economic activity and wealth could thus become more concentrated if growth acceleration policies are not complemented by policies to enable people from different areas of the country to benefit from agglomeration and the concentration of economic activity in urban areas. Evidence from the EU between 2005 and 2015 shows wide divergence in GDP per capita between subnational regions⁵. The 2019 World Development Report argues that as economies transform and develop, economic growth is often unbalanced. Yet with the right policies, development can still be inclusive and support convergence in living standards⁶.

Since economic growth is often unbalanced, promoting fair opportunities for people throughout a country is important to minimize spatial welfare disparities, reinforce the social contract, and ensure inclusion and shared prosperity. Addressing spatial welfare disparities does not necessarily imply balancing economic activity and growth across the country; rather it calls for ensuring opportunities for people regardless of where they live. Providing equitable basic services and easing the movement of people to thriving areas would help everyone benefit from the changing economic geography. These key policy principles are particularly relevant in addressing the specific challenges of lagging regions. Chapter 4 focuses on these regions, how they can be characterized, and what policies can help deliver on their potential.

The challenge of spatial welfare differences

Why do we care?

The economic and social dynamics in the Western Balkans and Croatia have implications for both economic activity and the well-being of individuals. As discussed in chapter 1, population and economic activity are more dispersed in this region than elsewhere in the world, which limits the benefits of agglomeration economies and of the spatial concentration of production and population. However, as countries in the region prepare for EU accession and strive to develop more competitive cities to accelerate economic growth, economic activity and better-paid jobs may become even more concentrated. If that happens without better access to opportunities in other locations, wealth may also be further concentrated.

Inequality between geographic locations in a country contributes to inequality between individuals. When place of birth or residence determines people's opportunities to build critical assets, access quality services, and generate income, notions of equity and fairness can be called into question. For example, differences in government presence and institutional capacity can affect service delivery and create inequalities of opportunity. A recent study of transition economies found that whether people are born in a rural or an urban area affects their chances of getting a higher education, being employed, and having a good job. Birthplace explains on average 18 percent of inequality of opportunity in access to jobs (as measured by the Dissimilarity Index), and in the study region that percentage is relatively high for Albania, followed by Montenegro and Serbia⁷ —which means people born in certain localities have less opportunity to find a job. This also reduces productive use of a country's workforce.

Spatial disparities also matter for voice and social cohesion, which are critical to the development trajectory of the Western Balkans and Croatia and the social inclusion requirements for EU accession. Spatial disparities may affect institutional dynamics, such as the bargaining power and ability of local stakeholders in lagging areas to influence central policy, which undermines both their voice and government accountability to them. Persistent spatial disparities can generate tensions and discontent if individuals from certain areas within a country feel systematically excluded. Spatial divisions that align with political or ethnic divisions can also erode the social compact. A recent World Bank report found that though vertical inequality as measured by the standard Gini coefficient may be declining in ECA, horizontal inequality between localities and groups persists and may contribute to perceptions that inequality is increasing⁸. It found that distributional tensions are rising, which conflicts with the general preference for equity in ECA and generates calls for rethinking the social contract. The risks may particularly affect the Western Balkan region due to its history of conflicts and the newness of its emerging democratic institutions.

Household income and consumption vary substantially within countries

In all Western Balkan countries, there are large differences in household incomes and consumption between subnational regions and between rural and urban areas. Household survey data suggest that the gap in mean income or consumption per capita between the poorest and richest internal regions⁹ could reach 50 percent in Albania, 38 percent in North Macedonia, and 33 percent in Serbia (figure 3.1). The coefficient of variation in income or consumption between sub national regions in recent years is about 20 percent in Albania, Montenegro, and Serbia (figure 3.9); by this measure, they are in the top third of countries in ECA for internal disparities and well above

the OECD average of 14 percent¹⁰. Full comparability of this measure across countries may be limited by differences in definition of subnational regions and levels of aggregation, but similar disparities are common between rural and urban areas. The rural-to-urban ratio in mean income or consumption per capita is about 70–80 percent in most Western Balkan countries (figure 3.2). The ratios in North Macedonia and Serbia are among the lowest in ECA. Poverty, at the poverty line of US\$5.50 a day (in 2011 PPP), are also typically higher in rural than urban areas, another illustration of the correlation between residence and welfare status.

RATIO OF POOREST TO RICHEST REGION

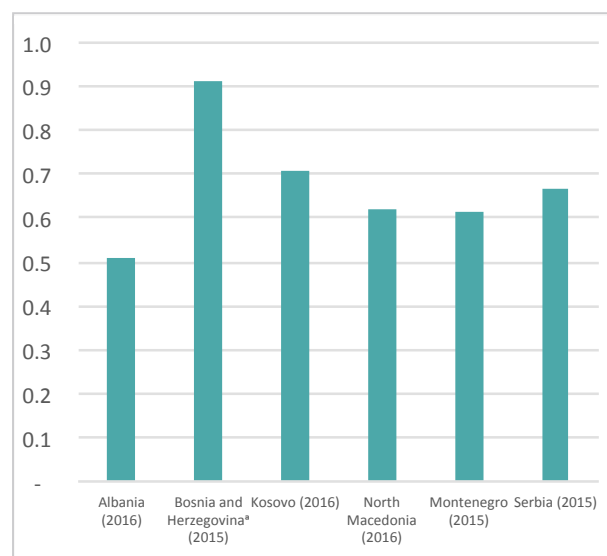


Figure 3.1 The gap in mean per capita income or consumption between the richest and poorest regions is large in the Western Balkans and Croatia

Source: World Bank harmonized data of household income or consumption for countries in ECA, using EU 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 the 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

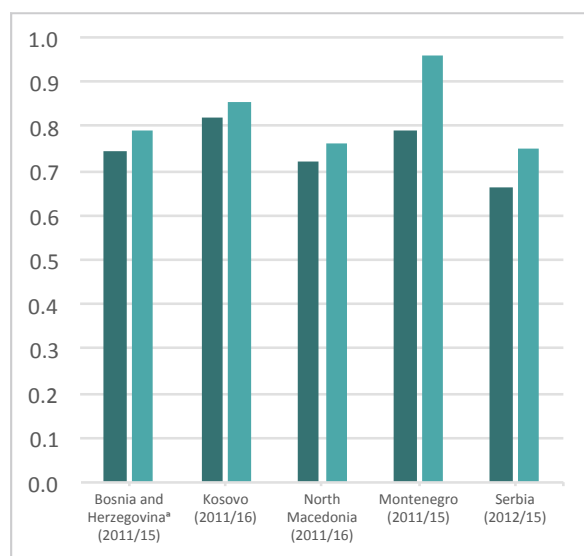


Figure 3.2 Although it is narrowing, the gap in mean per capita income or consumption between rural and urban areas is also large

Source: World Bank harmonized data of household income or consumption for countries in ECA, using EU 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 ask whether households are rural or urban.

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.

Differences are even larger for lower-level geographic units. Previous analyses for Albania and Serbia found poverty to be especially high in some areas¹¹. In Albania, where in 2012 14.3 percent of the population lived in poverty, it was higher in the northeast and lower in the south and southeast; poverty varied from 2.6 percent in the commune of Zagori in Gjirokastër prefecture to 38.5 percent in the commune of Kalis in Kukës prefecture (figure 3.3).

In Serbia, poverty rates in 2012 were high in many municipalities in the south. The estimated share of households living on less than 60 percent of the national median income (the at-risk-of-poverty rate) ranged from 4.8 percent in Novi Beograd near Belgrade to 66.1 percent in Tutin in the region of Šumadija and in Western Serbia (figure 3.4). Even within the same region, the at-risk rate varied considerably. In Southern and Eastern Serbia, for example, it ranged from 13.4 percent in Medijana to 63.4 percent in Bojnik municipality. Average household income and consumption also varied widely, from 544,555 Serbian dinars (RSD) per capita in Novi Beograd to RSD 156,060 in Tutin municipality. Thus, national or regional indicators can mask important variations at more disaggregated geographic levels. Similar patterns of spatial differences in living standards at the micro level are expected to hold in other Western Balkan countries, though these have not yet been studied.¹²

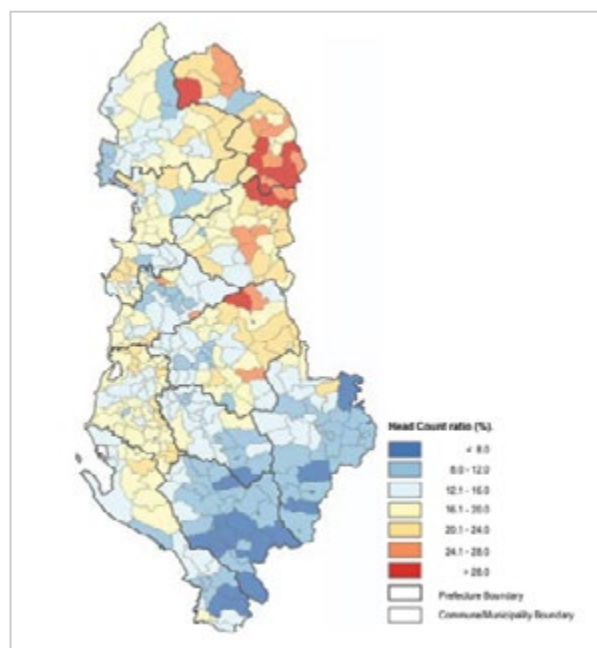


Figure 3.3 Poverty varies considerably by commune in Albania (2012)

Source: Dávalos and Thomo 2016.

Note: The map was rescaled to fit and does not reflect the country's true size and geography.

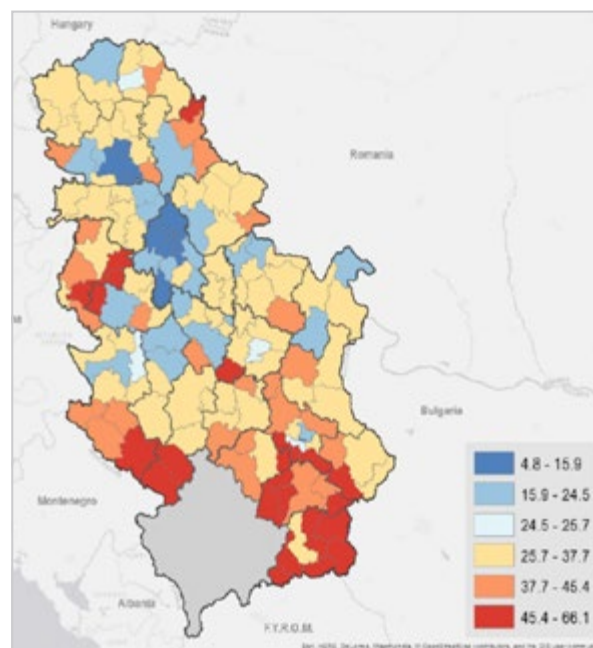


Figure 3.4 Rates of people at risk of poverty vary considerably by municipality in Serbia (2012)

Source: Statistical Office of the Republic of Serbia and World Bank 2016.

Note: The at-risk-of-poverty rate is the estimated share of households living on less than 60 percent of the national median income. The map was rescaled to fit and does not reflect the country's true size and geography.

Household welfare differences by location partly mirror the dispersion in economic activity discussed in chapter 1. In characterizing lagging regions, Chapter 4 looks at a complementary dimension, differences between regions in GDP per capita. Local economic opportunities, which tend to concentrate in agglomerated (urban) areas, are expected to lead to higher labor income and higher household consumption there. Although it is difficult to attribute causality, localities with better labor market indicators tend to have higher household incomes and less poverty. Unemployment in Albania and Serbia is negatively correlated with average income and consumption by municipality (figures 3.5 and 3.6). Localities with higher labor force participation and employment rates tend to have higher household income or consumption.

However, the correlation between household income and population density is not robust. In Serbia, densely populated municipalities tend to have higher incomes and less poverty. Those with higher population growth or slower population decline also tend to have slightly less poverty. In Albania, however, the correlation in municipalities between population density and household consumption is not statistically significant, and there is substantial variation in population density even in municipalities with similar poverty rates.

Country-wide studies in Serbia echo the pattern of regional disparities. For example, Jakopin (2014) estimates that the GDP per capita gap between the richest and poorest regions in Serbia is one of the highest in a group of transition economies at a medium level of development (the others are Croatia, the Czech Republic, Hungary, and Poland). He argues that during the 2000s economic growth was not accompanied by reductions in regional inequalities: 23 towns and municipalities accounted for about 80 percent of the newly created assets, revenues, income, and employment, resulting in high economic concentration; meanwhile, about 25 municipalities were experiencing chronic underdevelopment, high poverty, and depopulation. Miljanovic et al. (2010) state that regional polarization is evident from the concentration in Belgrade of 20 percent of Serbia's population, 33 percent of its employment, and 40 percent of its investment.

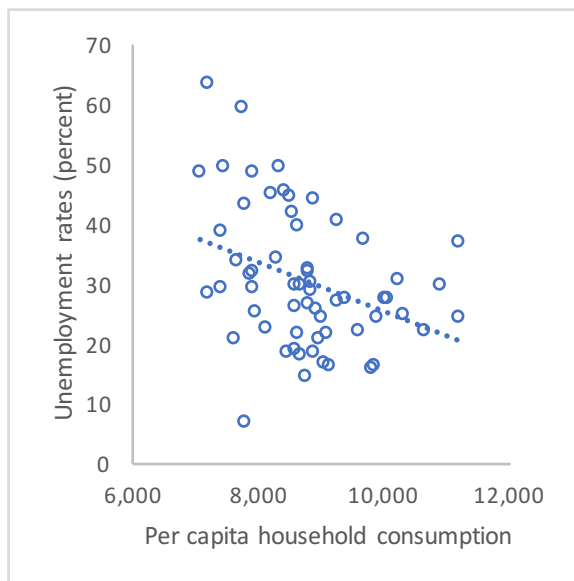


Figure 3.5 Per capita consumption is higher in Albanian municipalities with less unemployment

Source: Dávalos and Thomo 2016.

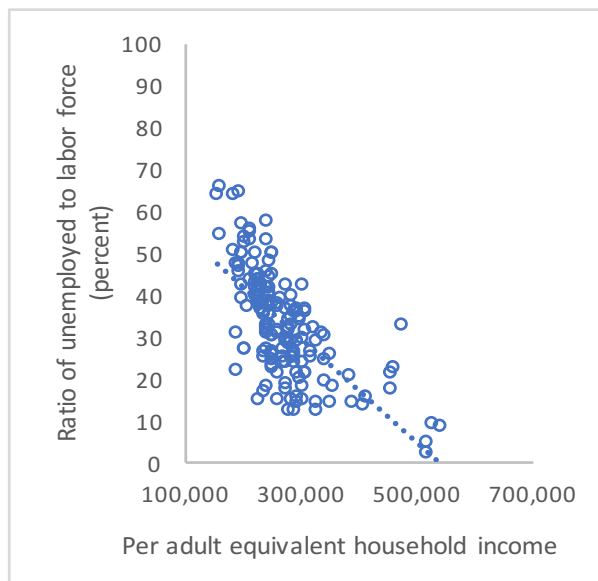


Figure 3.6 Municipalities in Serbia with higher registered unemployment tend to have lower per-adult-equivalent household income

Source: Statistical Office of the Republic of Serbia and World Bank 2016.

In recent years inequality in the Western Balkans and Croatia has been declining. The Gini coefficient for inequality in per capita incomes or consumption, calculated from household survey data, fell somewhat in 2003–13¹³. Recently, the Gini has declined slightly for Albania, Bosnia and Herzegovina, Kosovo, and North Macedonia (figure 3.7). The Gini coefficient for consumption in the Western Balkans and Croatia is generally in line with that elsewhere in ECA. However, in Serbia, the Gini coefficient of income, at close to 40 percent, is higher than in all but one EU country.

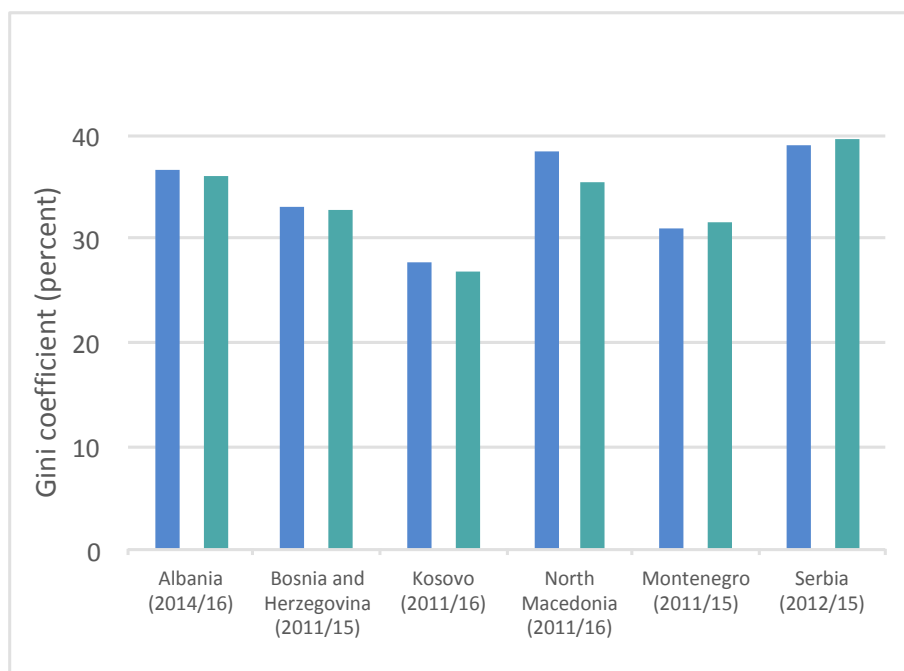


Figure 3.7 Inequality has declined in several countries in the Western Balkans and Croatia

Source: World Bank harmonized data of household income or consumption for countries in ECA, using EU Surveys on Income and Living Conditions data for North Macedonia and Serbia and Household Budget Survey data for other countries.

Inequality in individual incomes can be higher in more economically developed regions. More than 90 percent of inequality in the Western Balkans and Croatia is due to inequality within subnational regions, as evidenced by the large variation in household welfare in lower-level geographic units (figures 3.3 and 3.4). Further decomposition of inequality by subregion shows that the capital regions in Albania (Tirana) and North Macedonia (Skopje) account for larger shares of national income and also contribute most to total national inequality indicators (figure 3.8). In Serbia, however, the Sumajia and western regions, rather than Belgrade, contribute most to national inequality. But this measure of individual inequality does not fully capture horizontal inequality by group, such as spatial inequality between populations living in different subnational regions.

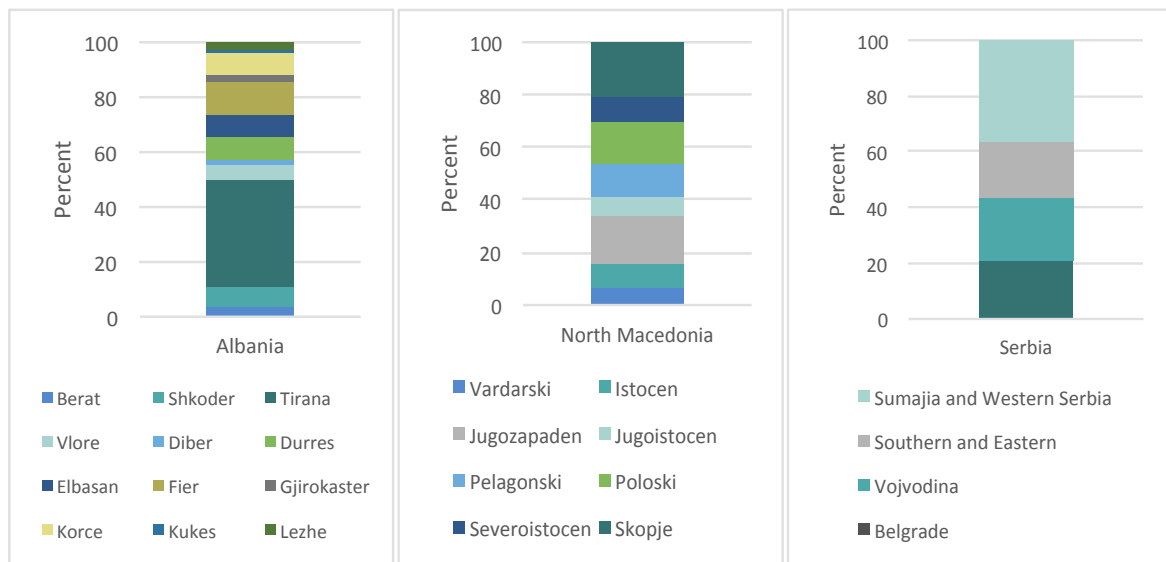


Figure 3.8 Inequality within capital regions contributes significantly to total inequality

Source: World Bank harmonized data of household income or consumption for countries in ECA, using EU Surveys on Income and Living Conditions data for North Macedonia (2016) and Serbia (2015 income year) and Household Budget Survey data for Albania (2016).

Note: The figure shows the contribution of inequality within each region to total within-region inequality in the country, using Theil index decomposition.

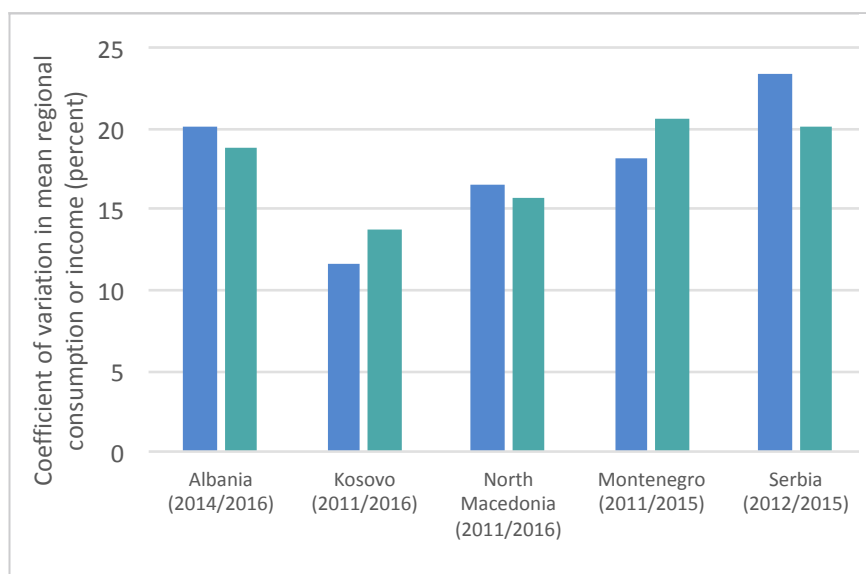


Figure 3.9 Subnational disparities in living standards have declined in some Western Balkan countries but risen in others

Source: World Bank harmonized data of household income or consumption for countries in ECA, using EU 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 do not make it possible to measure average consumption enough regions.

Across subnational regions, trends in spatial inequality in household income or consumption are mixed, though with a slight convergence in some Western Balkan countries. Subnational disparities in living standards, as measured by the coefficient of variation of average household income or consumption, declined from about 2011 to about 2016 in Albania, North Macedonia, and Serbia and increased slightly in Kosovo and Montenegro (figure 3.9). Declining coefficients point to a narrowing subnational gap in mean income or consumption. Rural and urban areas also saw convergence in average income or consumption per capita (figure 3.2). But in absolute terms the gaps are still substantial. Compared with ECA averages the coefficient of variation of regional disparities is still high in several Western Balkan countries, particularly Montenegro and Serbia.

Reasons for spatial disparities: Gaps in endowments and returns

What factors could account for the spatial welfare differences in the Western Balkans and Croatia? Multiple dimensions of spatial development can contribute to differences in people's living standards, such as gaps in the delivery of basic education, health, and other services; infrastructure provision; and access to jobs. Incomes may be lower because workers have less education, worse health, or personal characteristics that are intrinsic to individuals wherever they live. Spatial differences also arise when returns to those characteristics are lower in some locations because of differences in, e.g., other basic services, infrastructure, local governance, or the business environment.

Standard decomposition analysis can attribute subnational differences in average household income to variances in endowments and returns. Endowment gaps refer to differences in characteristics that remain with the individuals even if they move (portable characteristics). Gaps in returns refer to what cannot be explained by portable characteristics, such as factors specific to where people live. While not implying causality, the Blinder–Oaxaca technique (box 3.1) was used to better understand what contributes to spatial disparities in the Western Balkans and Croatia by decomposing the welfare differences between two subnational regions (rural versus urban, richer versus poorer¹⁴, richest versus poorest¹⁵, and the capital versus the rest of the country) into endowments or returns. The analysis used the latest available household survey data for each country.

BOX 3.1

The Blinder–Oaxaca decomposition technique

The Blinder–Oaxaca decomposition technique separates the relative contributions of portable characteristics (endowments that remain with individuals even if they move) and returns to endowments (what cannot be explained by portable characteristics) to differences in income or consumption. The technique decomposes welfare differentials between groups, in this study between households in contrasting regions (rural and urban, leading and lagging, richer and poorer), into what is attributable to (explained by) differences in observable endowments in

productive and portable characteristics and what is not (unexplained). The unexplained part essentially reflects marginal returns to endowments or, in broad terms, the effect on income or consumption of factors that cannot be observed.

Specifically: for two regions (R) A and B, the log of the main welfare indicator W (per capita income or consumption) is predicted as a linear function of individual characteristics X:

$$\ln W_R = X_R \beta_R + \varepsilon_R,$$

where ε is a random term, normally distributed with known variance.

After simple manipulation, the mean differences in welfare can be decomposed as difference in means and difference in coefficients:

$$\overline{\ln W_A} - \overline{\ln W_B} = (\overline{X_A} - \overline{X_B})(D\beta_A + (1 - D)\beta_B) + (\beta_A - \beta_B)((1 - D)\overline{X_A} + D\overline{X_B}),$$

where $\mathbf{1}$ is an identity matrix and D is a matrix of weights. The diagonal elements of matrix D are equal to 0.5, so that average coefficients and characteristics are used.

In this analysis, the set of covariates comprises the household head's age, sex, education, and occupation and variables related to the household's demographic characteristics, such as the relative shares of children, adults, and elderly.

For any two regions, the technique estimates the linear function of determinants of welfare based on a set of variables and decomposes the differences in welfare into differences in means of characteristics and differences in estimated parameters (coefficients).

Source: Adapted from Ruggeri Laderchi et al. 2017.

Differences in endowments

Differences in individual endowments were found to be important drivers of differences in living standards between regions, especially rural and urban, and between the capital and the rest of the country. Education and household characteristics generally accounted for more than half of income or consumption disparities between urban and rural areas (figure 3.10a) and between the capital region and the rest in North Macedonia and Serbia, where the data allow for this analysis. Endowments also accounted for a large share of disparities between richer and poorer regions (figure 3.10b), especially between the richest and poorest regions in Albania, North Macedonia, and Serbia, though less so in the other countries (figure 3.10c). In Serbia, in particular, differences in endowments accounted for welfare differentials in most of the comparisons analyzed.

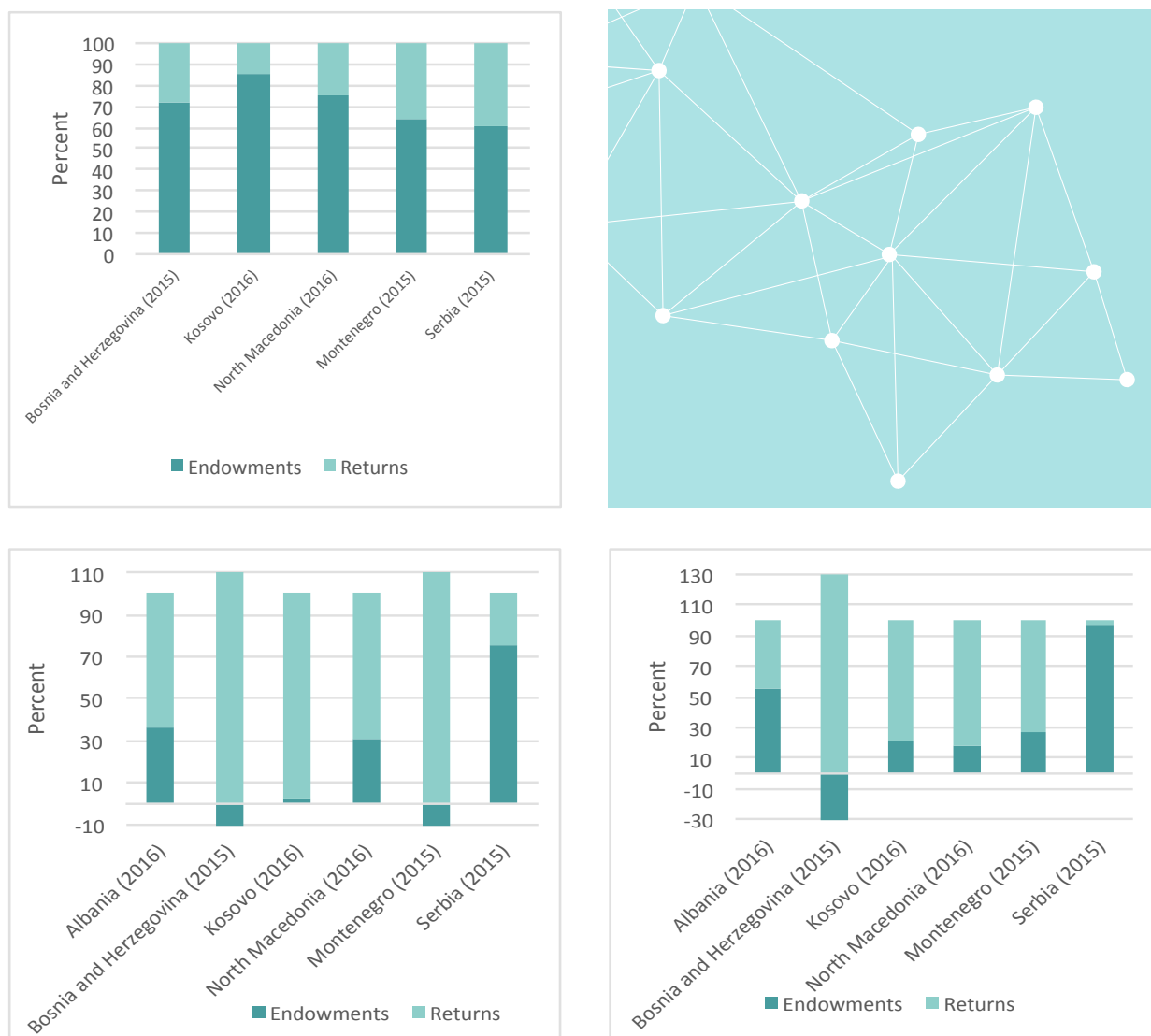


Figure 3.10 Both endowments and returns contribute significantly to regional income differentials

Source: World Bank harmonized data of household income or consumption for countries in ECA, using EU Surveys on Income and Living Conditions data for North Macedonia and Serbia and Household Budget Survey data for other countries.

Note: Information on occupation of household heads and on rural or urban residence was not available for Albania. Returns are those 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. Richest and poorest subnational regions are those with the highest and lowest mean regional per capita consumption or income. Blinder–Oaxaca decomposition is based on a regression model incorporating the following endowments: shares of children, adults, and elderly in the household; and variables related to portable endowments of the household head (age, age squared, education, and occupation).

Human development indicators vary substantially within countries and correlate positively with welfare. In Albania and Serbia, households differ greatly by municipality in the educational attainment of adult members, and educational attainment is strongly and positively correlated with the municipality's average income or consumption, and negatively with poverty rates (figure 3.11). In North Macedonia in 2016, about 32 percent of 0–5-year-old children in the East and Pelagonia regions were in preschool education, but only 8 percent in the Northeast. Albanian municipalities tend to have fewer teachers with bachelor's degrees or higher¹⁶. Education quality and learning outcomes also vary. For example, the urban–rural gap in reading scores on the Programme for International Student Assessment (PISA) is about 45 points in Albania and Serbia, equivalent to 1.5 years of schooling.

Health status is also closely correlated with average household income or consumption in a location. For example, in Albania, stunting is higher among children in poorer localities: in Kukës, the prefecture with the highest poverty rate, 19.9 percent of children under 5 are stunted, while in Gjirokaster, the prefecture with the least poverty, 13.1 percent are¹⁷. Similarly, poorer prefectures tend to have fewer hospital beds per 10,000 inhabitants. In Serbia, municipal infant mortality and poverty rates are positively correlated. Since better endowments are critical to generating higher income and living standards, such spatial gaps in opportunities to enhance human capital heighten the spatial welfare differences observed.

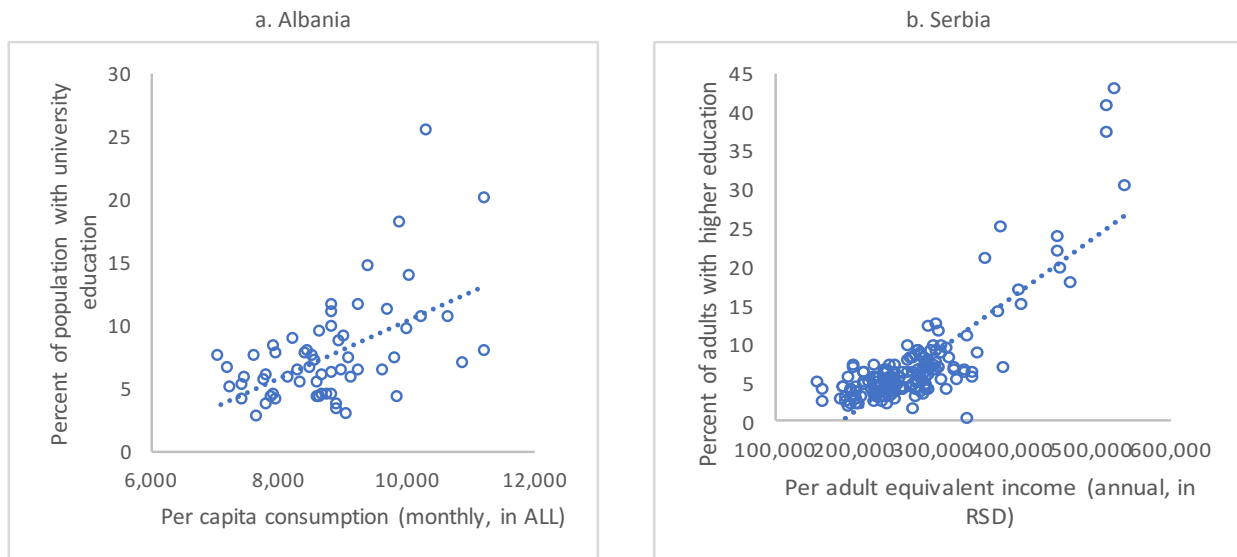


Figure 3.11 In Albania and Serbia, educational attainment varies substantially by municipality and correlates with household welfare

Source: Data from the Albania Institute of Statistics (2018) and the Republic of Serbia Statistical Office (2016).

Differences in returns due to location-specific factors

In addition to endowments, differences in returns due to location-specific factors explain a significant share of income disparities, particularly between richer and poorer regions. In other words, for individuals with a similar endowment of human capital, where they live can greatly affect their ability to earn income. Decomposing the gaps between the richest and poorest regions shows that gaps in returns contribute largely to these regional differences in welfare.

Differences in returns are linked to gaps in economic infrastructure, basic service delivery, network and market access, local institutions, and the business environment that can make economic activity in certain locations more efficient. Among these broad location-specific factors are both tangible assets (e.g., infrastructure and access to markets, electricity, heat, water, and sanitation) and intangible factors (e.g., institutions, the business environment, and regulation). Location-specific factors may be linked to better production technologies that allow people to be more productive, resulting in higher returns for a given human capital endowment. Firm growth rates between leading and lagging regions indeed vary substantially, though exact data on subnational business environments are not available.

Geographically disaggregated data for Albania and Serbia show significant differences between municipalities in services such as water and sanitation. In Albania, for example, access to water supply varies from 47 percent of households in Durres County, one of the poorest areas, to 88 percent in Shkoder County, one of the richest (figure 3.12a). Municipalities with high shares of dwellings with an indoor toilet, such as Gjirokaster, tend to have the least poverty; those with low access to sanitation, such as Diber, have the most (figure 3.12b). In Serbia, service provision is positively associated with local household welfare, though with considerable variation (figure 3.13). And some poorer localities manage to achieve higher than average outcomes (for example, Kamez municipality in Albania and

Novi Pazar in Serbia), while some localities that are not as poor have worse service provision. This suggests that factors other than local incomes, such as local institutional capacity or redistributive government financing, can strongly influence provision of basic services.

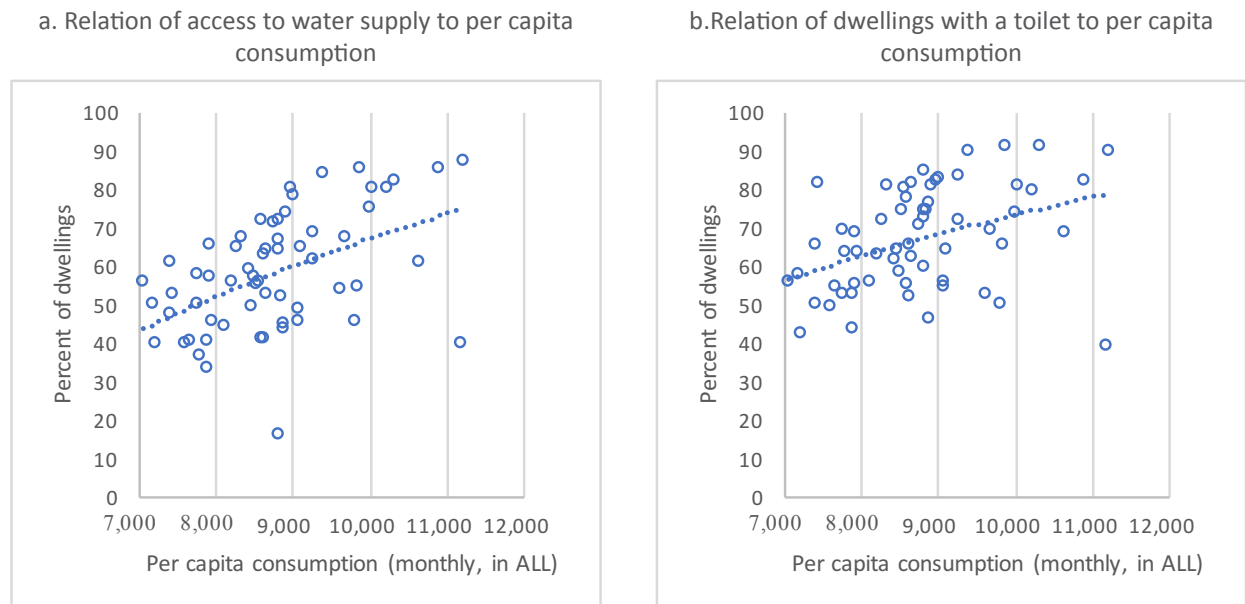


Figure 3.12 In Albania, access to water supply and in-home toilets are closely linked to municipality per capita consumption

Source: Based on 2011 census data from the Albania Institute of Statistics.

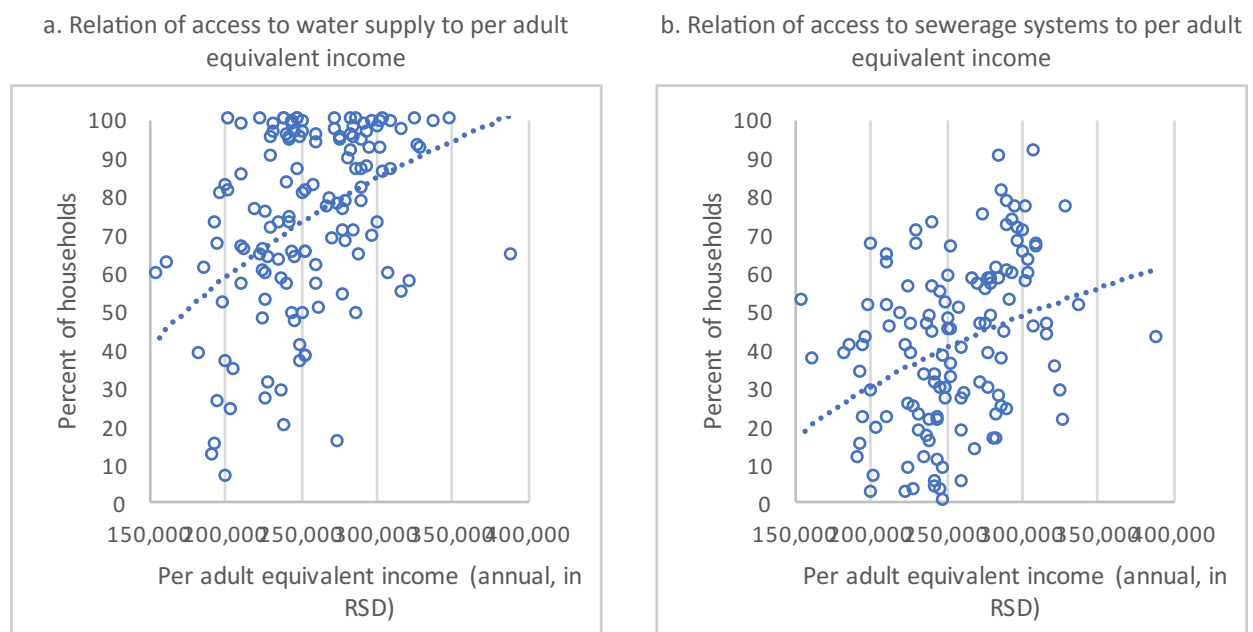


Figure 3.13 In Serbia, access to water and sewerage systems is linked to municipality household incomes

Source: Data from the Statistical Office of the Republic of Serbia (2016).

Addressing gaps in endowments and basic service provision

Promoting more equitable opportunities for residents regardless of where they live requires addressing spatial gaps in endowments and in access to good-quality basic public services. Gaps in service provision may be due to fewer resources, less efficient spending, less effective local institutions, or a combination of these. Chapter 4 looks at specific policies to maximize the potential of lagging regions and the people who live there in terms of the role of local institutions, financing, and the need to ensure basic service provision.

Moving to jobs in higher-productivity areas

Ensuring that service provision is equitable is not enough to bridge spatial welfare gaps if barriers to labor mobility prevent people from moving for better economic opportunities. Low labor mobility helps to create pockets of poverty and spatial gaps in welfare.

While international migration, particularly to the EU, is appealing, internal labor migration can also be an important force for raising incomes. As the Western Balkans and Croatia work in coming years to enhance the competitiveness of their cities and boost productivity, wage differentials between urban and rural areas are expected to rise, making internal labor migration more attractive. Reducing barriers to internal labor mobility can lessen labor market frictions and help people from other areas of the country benefit from concentrated economic activity in urban areas. Labor mobility also facilitates more efficient factor allocation in the economy, thus increasing productivity generally. Indeed, as argued in the Spotlight, complementary policies to reduce the cost of moving within a country and enhanced urban amenities would lead to the higher real wage gains from border cost reduction associated with EU accession.

Greater movement of workers with the right skills to localities with tighter labor markets could also reduce unemployment in the Western Balkans and Croatia, where unemployment varies significantly within countries. Municipalities with high unemployment tend to have lower mean incomes (figures 3.5 and 3.6). Census 2011 data for Albania show wide variations in unemployment by municipality, ranging from about 5 percent to about 65 percent. Second quarter 2018 Labor Force Survey data for 12 prefectures reveal unemployment rates ranging from 5.1 to 23.5 percent. In Serbian municipalities, the registered unemployed as a share of the formal labor force vary by a similar magnitude. Unemployment is higher in the southern and eastern regions than in Belgrade, which has shortages of transport and construction workers. In Montenegro, unemployment is close to 31 percent in the north, lowest at 3.2 percent in the coastal region, and about 10 percent in the central region, which is within commuting distance of the coast. This suggests there is potential for further labor mobility to bring workers with relevant skills to jobs in other parts of the country¹⁸.

Low internal labor mobility

Except for Albania and Kosovo, internal movement of people is lower in the Western Balkans and Croatia than in other transition economies (figure 3.14). 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)¹⁹, but below 30 percent in Montenegro, North Macedonia. However, data also point to the importance of movement between urban areas or between rural areas in Bosnia and Herzegovina, Kosovo, and Montenegro (figure 3.15). The intention to move internally in the next 12 months is below 5 percent of the adult population in all transition economies in the Life in Transition survey.

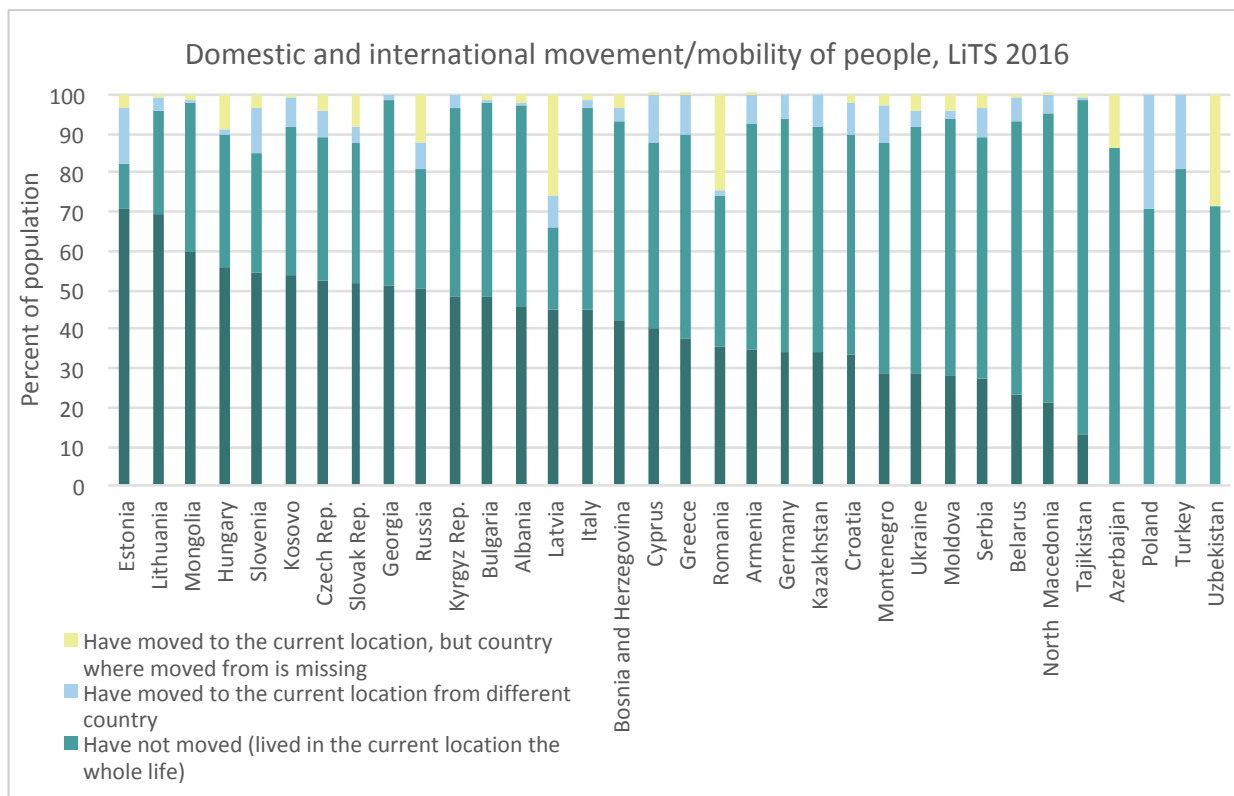


Figure 3.14 Internal movement of people is low in several Western Balkan countries

Source: 2016 Life in Transition Survey data (EBRD 2016); World Bank staff calculations.

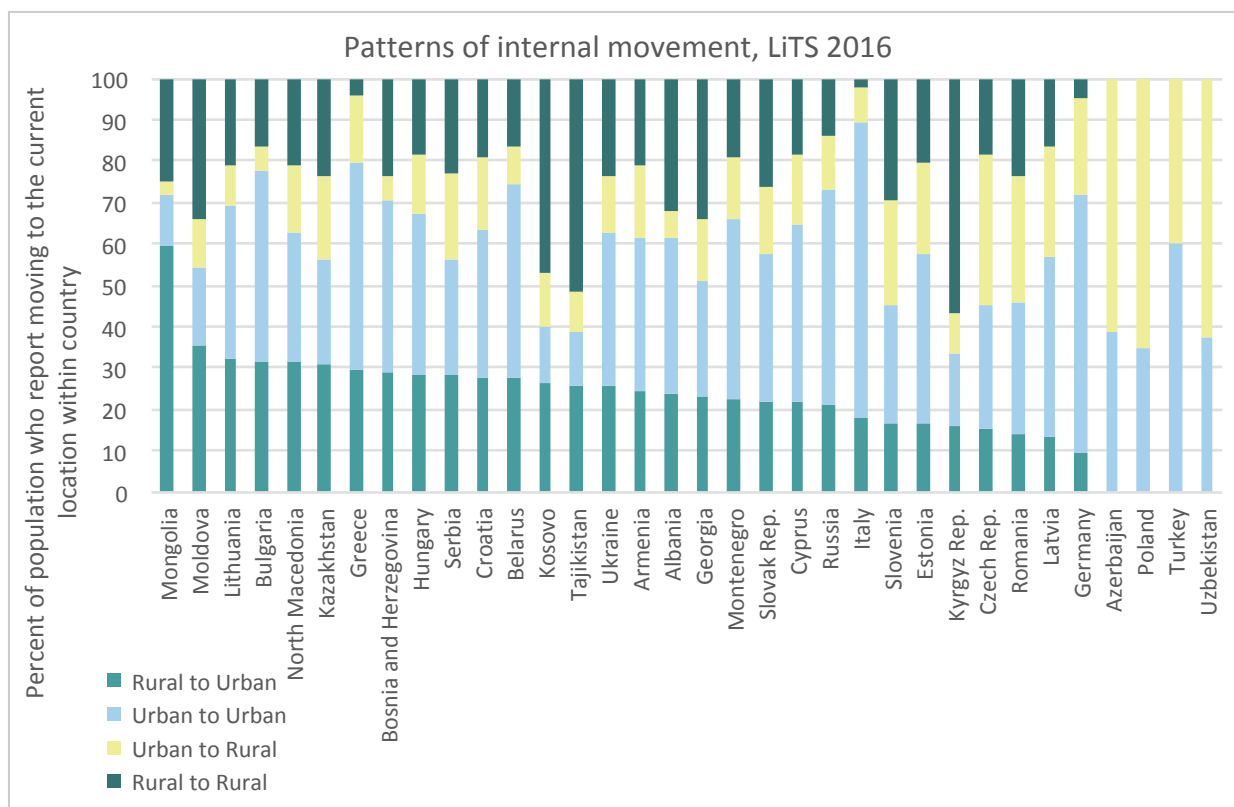


Figure 3.15 Most internal mobility in the Western Balkans and Croatia is between urban areas and between rural areas

Note: The data describe people who reported moving within the country to their current location.

In the Western Balkans and Croatia, movement for jobs, or labor mobility, varies within the range for transition economies but internal labor mobility is low in Eastern Europe compared with other regions²⁰. Willingness to move within a country for a job, like actual internal migration, is high in Albania and Kosovo (figure 3.16). The other Western Balkan countries are in the middle of the distribution for transition economies, though willingness to move for a job is particularly low in North Macedonia.

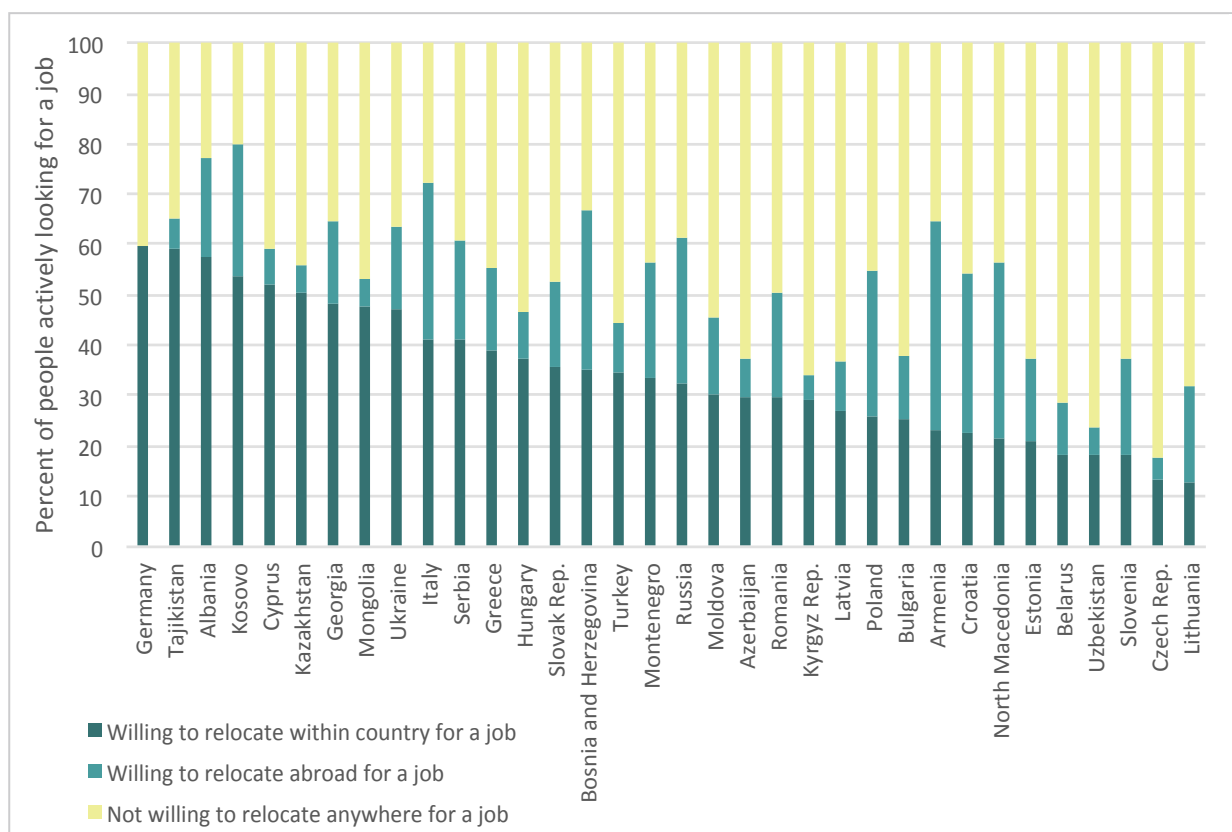


Figure 3.16 Willingness to relocate for employment is high in Albania and Kosovo but moderate in other Western Balkan countries

Source: 2016 Life in Transition Survey data (EBRD 2016); World Bank staff calculations.

Note: The figure shows the share of adults (aged 18–64) actively looking for a job who reported that they were willing to relocate for employment.

Profiles of those most likely to move for a job—young single men—suggest that the transaction costs of relocation may be lower for them (table 3.1). For example, in Albania, the mean age is 36.2 for respondents ready to relocate to another part of the country for a job and 41 for those who are not willing to move. In Serbia, the average ages are 34.5 for those willing to move and 41.3 for those not willing. In all study countries except North Macedonia, the likelihood of being willing to move is lower for women and individuals with families. Individuals are also more willing to move if they have a higher education or are living in a rural area, probably because of better chances of finding employment in urban areas and the rural–urban wage differentials. Finally, the results are mixed according to respondents’ welfare status as roughly approximated by the Life in Transition Survey asset index. For example, in Albania, individuals with a lower asset index tend to be more willing to move, but in Serbia the opposite is true.

Characteristic	Albania		Bosnia and Herzegovina		Croatia		Kosovo		Montenegro		Serbia		North Macedonia	
	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes
Age of respondent	41.0	36.2	41.9	36.9	37.7	34.7	35.8	33.0	42.2	32.4	41.3	34.5	40.1	34.3
Female	0.71	0.36	0.65	0.48	0.44	0.52	0.46	0.35	0.52	0.39	0.54	0.39	0.39	0.54
Single	0.10	0.36	0.05	0.42	0.31	0.39	0.18	0.36	0.23	0.62	0.27	0.48	0.21	0.37
Married	0.90	0.62	0.89	0.50	0.63	0.56	0.81	0.58	0.68	0.34	0.65	0.45	0.75	0.57
Previously married	0.00	0.01	0.06	0.08	0.06	0.05	0.01	0.06	0.09	0.05	0.08	0.07	0.04	0.06
Share of children	0.12	0.08	0.16	0.07	0.14	0.11	0.21	0.15	0.11	0.06	0.08	0.08	0.15	0.10
Share of adults	0.83	0.85	0.83	0.88	0.77	0.84	0.72	0.79	0.84	0.88	0.83	0.82	0.80	0.82
Primary education	0.47	0.32	0.39	0.44	0.42	0.42	0.60	0.27	0.32	0.19	0.40	0.28	0.44	0.39
Secondary education	0.22	0.40	0.54	0.40	0.52	0.46	0.34	0.51	0.57	0.45	0.48	0.58	0.39	0.38
Tertiary education	0.31	0.28	0.07	0.17	0.05	0.12	0.06	0.22	0.12	0.36	0.12	0.14	0.17	0.23
Asset index	0.08	-0.11	0.24	0.15	0.26	0.34	-0.35	-0.06	0.21	0.10	0.08	0.22	0.05	0.21
Resides in urban areas	0.64	0.43	0.47	0.60	0.58	0.44	0.23	0.40	0.45	0.50	0.47	0.49	0.51	0.51

Table 3.1 Willingness to relocate for employment by personal characteristics (percent)

Source: 2016 Life in Transition Survey data (EBRD 2016); World Bank staff calculations.

Potential barriers to labor mobility

The literature suggests that in ECA countries such market and institutional factors as skills, social benefits, urban policies, housing and credit markets, subnational policies, information and networks, and labor market institutions can be barriers to internal labor mobility. For example, undeveloped housing and financial markets can lead to prohibitively high costs of moving to and living in some potential destinations. Administrative barriers that anchor residence through registry requirements, often tied to the social benefits system, can push up relocation risks and transaction costs. Another barrier is undeveloped labor market information systems that do not provide useful information on vacancies and labor market conditions in regions with jobs²¹.

Several of those factors seem to discourage internal migration in Serbia, as found in a case study specifically concerned with regulatory and institutional factors (box 3.2)²². While legislation directly related to internal migration is not a significant constraint on mobility, a comprehensive set of market and institutional factors that would make internal migration less costly, such as affordable housing and access to information on good jobs, is not yet available. Underdeveloped housing markets and liquidity constraints seem to be the most important barriers. In Serbia the share of home ownership is high; only 1 percent of the Serbian respondents to the 2016 European Quality of Life Survey stated that they rented accommodation. Among European countries Serbia ranks second after Greece in the percentage of its population whose total housing cost exceeds 40 percent of disposable income; 28.2 percent of

Serbians are in this category. Aside from the housing market and the financial costs of moving, other factors may function as additional barriers. To have priority access to preschool, both parents have to be in formal employment, but it may be difficult for both parents to quickly find a job in a new location. The National Employment Service supports interregional mediation but career guidance is still geared to the place of residence.

BOX 3.2

Internal labor mobility in Serbia: A case study

Internal migration for jobs seems to be less responsive to spatial disparities in Serbia than might be expected. Migration flows seem focused on a few localities, and population is declining in many migrant-originating regions. The empirical literature on individual countries confirms the perceived pattern of sustained welfare polarization by region and suggests possible reasons for low labor mobility, such as imperfect credit markets, liquidity constraints, lack of affordable housing, and a reliance on networks and kinship in hiring. Limited information on labor opportunities by region and imperfect cross-regional cooperation in employment services are also cited as constraining mobility.

Housing cost is the major hurdle for workers relocating. Real estate prices in destination regions have been rising, though the rate of increase has been uneven, reflecting general economic conditions in Serbia. There has been some improvement in legal procedures for selling and buying real estate, notably adoption of a mortgage law, which seems to have expanded the housing market and helped potential internal migrants.

Yet issues remain in enforcing regulation of apartment leases. The Law on Residence and Temporary Residence requires all citizens who move to register at their new place of residence. However, for tax avoidance reasons, parts of the rental housing market operate without formal contracts and registration. As a result, they are beyond formal regulation and efficient dispute resolution. Property owners are sometimes reluctant to allow tenants to register at their address for fear of seizure of assets if the tenant has unpaid debt. Undeveloped housing rental markets could lead to high transaction and information costs for incoming internal migrants.

Informality and the associated uncertainty and risks are also aspects of the labor market. One barrier to internal migration may be the prevalence of temporary contracts in the informal labor market, with low pay and unfavorable work conditions. An estimated 20 percent of workers in Serbia have informal jobs. Social benefits, including child allowances and unemployment benefits, are accessible regardless of place of residence but other costs of migration include the difficulty of placing children in preschool facilities in richer localities. In many municipalities with higher mean income, preschool enrollment is high and reflects welfare disparities.

The National Employment Strategy 2011–20 recognizes the importance of labor mobility. A new mechanism for informing and matching labor across regions and municipalities, begun under the National Action Plan for Employment in 2017, offers promise for increasing labor mobility, though migration still has high transaction costs. The National Employment Service offers a

small one-time payment to help with the cost of travel and relocation, but there has been very little take-up.

Overall, the study found that even though the laws do not explicitly constrain internal migration, certain market and institutional factors, such as affordability of housing and access to information on good jobs could be further improved to make internal migration less costly.

Source: [Jandric 2019](#).

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Chapter 4.

Supporting lagging
regions:
Delivering on
economic potential
and equality of
opportunity

Making leading cities more competitive will be the priority for accelerating growth in the Western Balkans and Croatia but addressing the challenges of regions that would be left behind will be important for shared prosperity and sustainable growth. Targeted development strategies can maximize the economic potential of lagging regions by building on local endowments and also improving service delivery to ensure social equity and support labor mobility.

Although spatial disparities in economic output are moderate, all countries in the region have entrenched lagging areas. Greater polarization is likely because EU accession (market integration), demographic factors (low fertility and high outmigration), and skills-biased technology changes are all expected to strengthen the competitiveness of leading metropolitan regions relative to regions more sparsely populated and peripheral.

Any consideration of economic opportunities for lagging areas must take structural features into account. The most common is population sparsity—just 3 of the 25 regions identified as lagging in this chapter have a population density above the EU average²³. Population sparsity has serious implications for the potential of lagging regions to generate sustainable productivity growth. Another common structural feature is distance, which has implications for connectivity. However, many lagging regions are reasonably central, which opens up opportunities for better connectivity to link them to agglomerations.

In response to the structural factors (density and distance) that shape the potential of lagging regions, policymakers should focus on strengthening endowments and removing distortions that prevent the formation of productive agglomerations. Such cross-cutting interventions can be supported by sectoral interventions that are well-targeted to accelerate development of tradable sectors. For more central regions, policies should emphasize strengthening secondary cities by establishing an environment attractive to investors in tradable sectors as well as to high-skilled youth and promoting innovation. For more peripheral and sparsely populated regions, policies should emphasize delivery of critical economic and social infrastructure and sectoral niche initiatives that leverage regional endowments. For all types of lagging regions, investment in human capital will be critical both to boost their growth potential and to strengthen the assets of resident individuals to enable them to exploit opportunities wherever they may be found.

Finally, regional development is still centralized and top-down; local authorities lack the financial resources, technical capacity—and the authority—to effectively design and apply local and regional development strategies. Thus, institutional capacity for the design and delivery of locally owned and effectively coordinated development strategies needs to be built up at all levels, especially regional and local.

The challenge of lagging regions

Chapter 3 highlighted significant spatial variations in welfare throughout the study area, with poverty and other measures of deprivation significantly higher in certain areas of each country. It also showed that these living standard inequalities are, apart from Serbia, explained less by differences in individual endowments (although these also exist) but mainly by the opportunities for individuals to leverage those endowments for welfare gains. This suggests significant differences in the capacity of regions to support high-quality earnings opportunities for their residents. And indeed, the spatial inequalities in welfare outcomes documented in Chapter 3 are closely associated with inequalities in economic output.

Economic activity is never evenly distributed. While in the past disparities in economic output by country have been large, for the last 20 to 30 years national incomes have been converging, driven in part by global trade and investment integration²⁴. Within many countries, however, there has been increasing concentration of output and wealth in core metropolitan regions, with rural and peripheral regions falling farther behind. Such patterns are evident around the world, particularly in regions that have integrated rapidly into global markets, such as East Asia, Mexico, and post-Communist transition countries. It is also evident in high-income regions in the United States and the EU (figure 4.1).

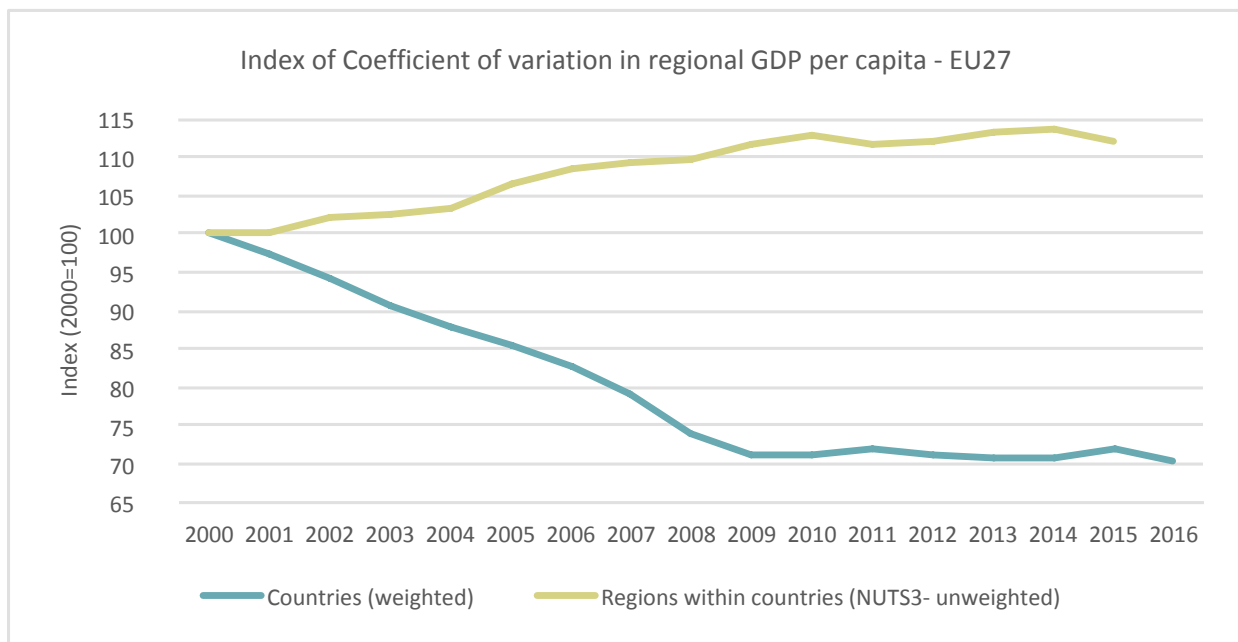


Figure 4.1 Country convergence across the EU in income, but within-country divergence (2008–16)

Source: Data from Eurostat.

Note: Regions are at the Eurostat Nomenclature of Territorial Units for Statistics level 3 (NUTS 3) regional classification, the most detailed level.

Why care about lagging regions?

Regional disparities in economic output are not necessarily a problem. The geographic concentration of economic activity is positively associated with economic growth²⁵ because of agglomeration-induced gains in productivity²⁶ and the mutual reinforcement of agglomeration and innovation²⁷. Moreover, regional disparities in output do not necessarily result in major disparities in living standards. Across the EU, the average variation in disposable income per capita is 55 percent lower than the variation in GDP per capita. In such countries as Austria, Denmark, and the Netherlands, taxes and transfers reduce the gap between output and disposable income by more than 80 percent²⁸.

But even allowing for labor mobility and redistribution as adjustment mechanisms, there are reasons to be concerned about growing regional disparities in output. The first and most obvious is from a welfare and equality of opportunity perspective (see chapter 3). When output and wealth are highly concentrated territorially, poor people are more likely to face multiple factors of deprivation and thus a more difficult path to escaping poverty. Second, these disparities may have direct impact on aggregate economic efficiency. Many lagging regions are not simply failing to keep pace, they are also failing to make productive use of the resources available. This leads to low-growth traps for those regions and also undermines national growth potential²⁹. Finally, increasing disparities between regions threaten social and political cohesion. More prosaically, regional inequalities tend to increase

demand for redistributive rather than productive policies, which may dampen growth generally³⁰. Given the history of the Western Balkans especially (see chapter 3), there are reasons to be concerned that regional inequalities risk fracturing still-fragile social and political cohesion.

Although spatial disparities in economic output are moderate, lagging areas remain a concern

Although chapter 3 highlighted relatively high levels of spatial inequality of household consumption in the Western Balkans and Croatia, as measured by economic output, inequality is not substantially higher than the EU average. The coefficient of variation in GDP per capita across the Eurostat Nomenclature of Territorial Units for Statistics level 3 (NUTS 3) regions³¹ ranges from a low of 0.27 in Albania to a high of 0.36 in EU-member Croatia (figure 4.2). These levels of inequality are somewhat higher than in Slovenia but substantially lower than in such recent EU accession countries as Romania, Poland, Bulgaria, and Hungary.

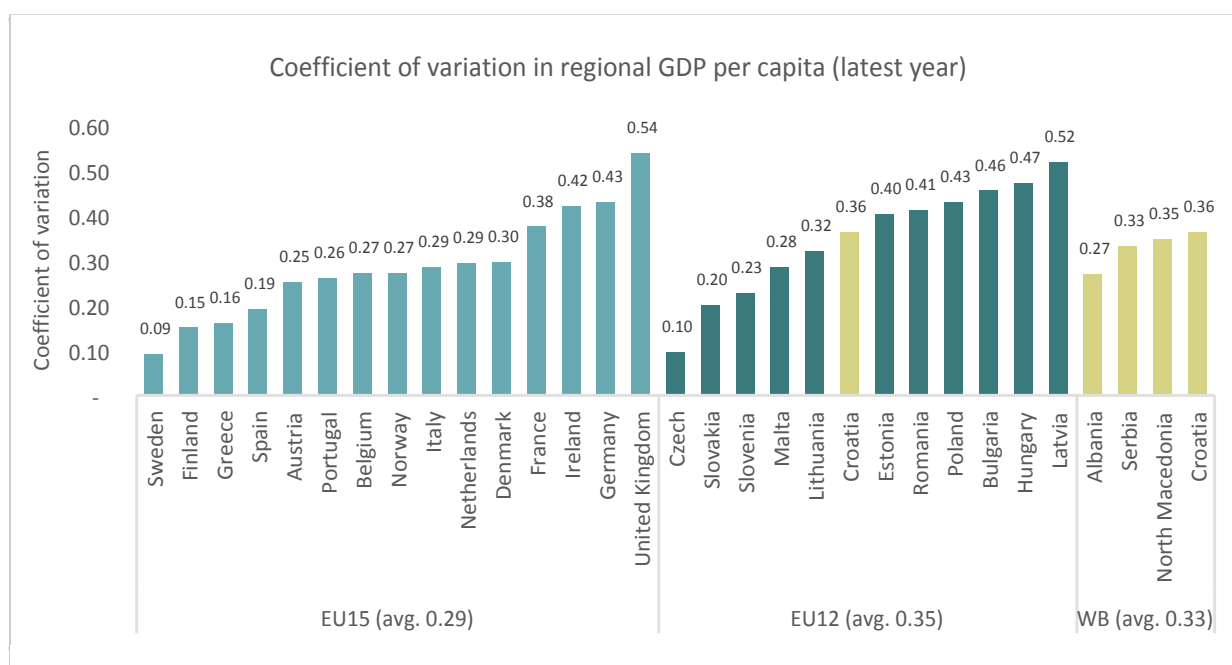


Figure 4.2 Regional inequality in the Western Balkans and Croatia is lower than in many recent EU accession countries

Source: Data from Cambridge Econometrics European Regional Database and national statistics for the Western Balkans and Croatia, latest year available.

Note: Regions are at the Eurostat Nomenclature of Territorial Units for Statistics level 3 (NUTS 3) regional classification, the most detailed level.

In Albania and North Macedonia, regional inequalities declined after the 2008 crisis before rising again (figure 4.3). In Croatia, regional inequality increased somewhat immediately after the crisis but stabilized after 2010. In Serbia, where regional output data³² are available only from 2013 on, spatial inequalities were about 10 percent lower in 2016 than in 2013. Without longer time series data for the Western Balkans and Croatia, it is difficult to assess how spatial inequalities have evolved over time. There are elements in the region's history that would have aggravated regional disparities and others that would have attenuated them (box 4.1).

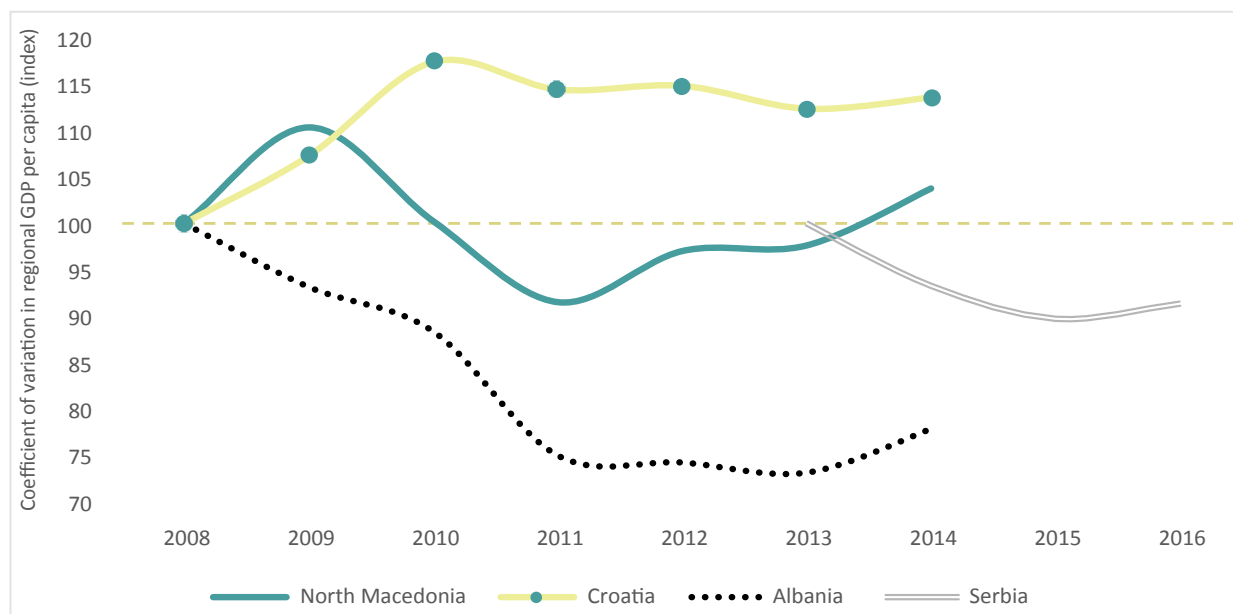


Figure 4.3 Since the financial crisis of 2008, regional inequality has moderated in most of the Western Balkans and Croatia

Source: National statistics, latest year available.

Note: Regions are at the Eurostat Nomenclature of Territorial Units for Statistics level 3 (NUTS 3) regional classification, the most detailed level.

BOX 4.1

Historical patterns and drivers of spatial inequality in the Western Balkans

As part of the Yugoslav Republic up to 1990, Slovenia, Croatia, and Vojvodina (Serbia) were leading areas, and Bosnia and Herzegovina, Kosovo, and North Macedonia lagged. The Yugoslav economy was more decentralized than other socialist states in the region, with substantial devolution of political and economic power to the republics. The decentralization was complemented by strong local control of production, investment, and employment decisions through the system of labor-managed firms³³.

While the Yugoslav government promoted regional economic convergence with large capital transfers and industrial policy, there were restrictions on capital and labor mobility, barriers to firm creation, and (in later stages) differences in curricula and the quality of education systems³⁴. These factors all contributed to divergences in employment and productivity across the country. Moreover, while central planning for locating industry reduced regional disparities, it also established path-dependence that contributed to later challenges of deindustrialization. With the breakup of Yugoslavia in the 1990s, regional economies became more and more delinked, and economic collapse and political crises, as well as the EU accession of Slovenia and Croatia, contributed to further divergence.

Despite moderate regional inequality, lagging areas are still a concern. One reason, as discussed in chapters 1 and 2, is that the moderate spatial inequality in the Western Balkans and Croatia is driven more by the weak performance of leading cities than by the improved performance of rural and peripheral areas. In addition, most countries have some regions that have trailed the rest of the country for a long time.

Likely future developments

For several reasons, regional inequalities in the Western Balkans and Croatia are likely to increase. One is EU accession, which may have a strong concentrating effect (see the Spotlight)³⁵. Most recent EU accession countries, among them Croatia, experienced a significant increase in regional divergence, with the main driver being the rapid growth of leading metropolitan regions. This has been particularly evident in Poland, Hungary, and Bulgaria. If leading cities in the Western Balkans and Croatia match previous patterns of increasing competitiveness and investment in metropolitan regions, divergence is likely even as aggregate national outcomes improve.

In the years ahead, demographic decline and emigration are also likely to contribute to regional disparities. While large-scale emigration from lagging (mostly rural) areas has reduced regional disparities in the short term, the resulting convergence in regional GDP per capita is clearly unsustainable. Demographic decline in regions that were already lagging can be expected to weigh heavily on regional growth prospects, particularly as internal migration tends to shift the most productive workers (young and skilled) from lagging to leading regions.

Changing technologies and skill demands will also aggravate regional divergence. Across Europe, trade and technology have combined to drive a rapid shift in investment away from jobs requiring manual skills to those requiring cognitive skills. This is polarizing labor markets, raising returns for workers with the skills to complement new technologies but reducing opportunities for the least skilled. These dynamics have spatial implications, with the most productive firms and workers likely to concentrate in leading metropolitan areas at the expense of lagging areas.

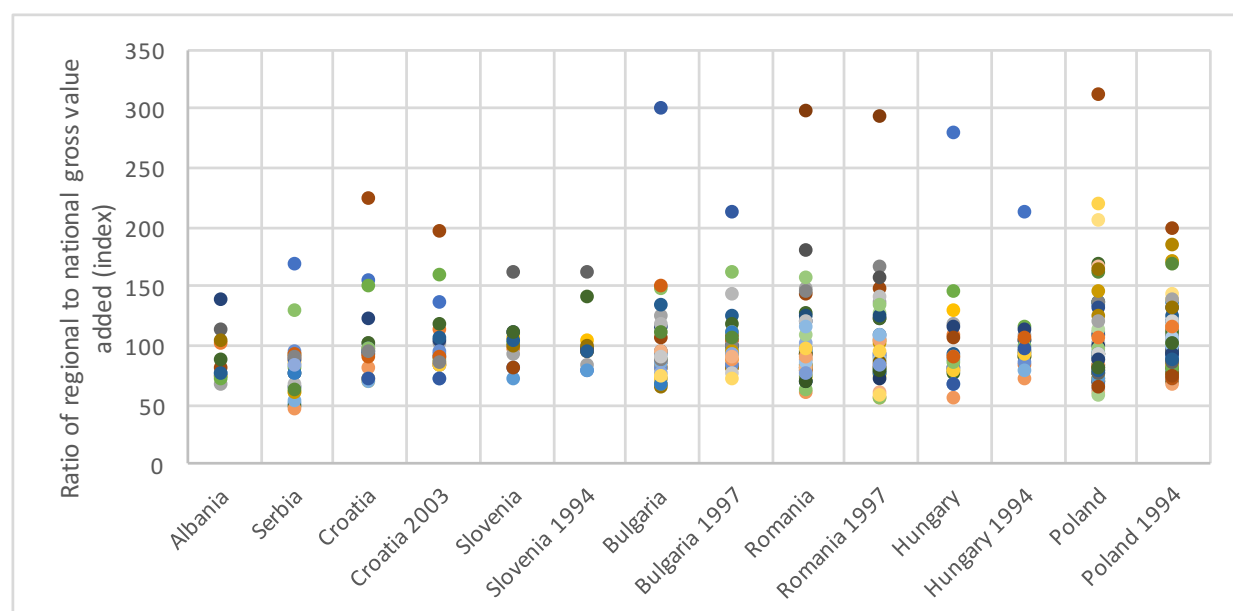


Figure 4.4 Rapid growth in metropolitan regions has driven increasing regional disparities in recent EU accession countries (2014 unless otherwise indicated)

Source: Data from Cambridge Econometrics European Regional Database and national statistics for the Western Balkans and Croatia.

Note: Regions are at the Eurostat Nomenclature of Territorial Units for Statistics level 3 (NUTS 3) regional classification, the most detailed level.

While the disruptions caused by demography, technology, and EU accession may deepen the challenge of regional disparities, they also create opportunities to forge new development paths. Indeed, the EU provides evidence of substantially changing regional fortunes over time. For example, GDP per capita in Bulgaria's Vratsa Province (Northwest Region) rose from 10 percent below the national average in 1997 to 25 percent above it by 2014. During the same period, Dobrich Province (Northeast Region) went from 16 percent above the national average to 17 percent below. In Poland, in just 20 years GDP per capita in Ciechanowskopłocki (Mazowieckie region) rose from 13 percent below the national average to 35 percent above it. Regions like Abruzzo in Italy and Galicia in Spain have shown that lagging regions can make substantial progress in less than a generation (box 4.2).

BOX 4.2

Examples of non-metropolitan regions winning from the EU transition

Abruzzo, Italy

Since the 1980s, Abruzzo has been the best-performing region in the Italian Mezzogiorno, with steady growth and high economic well-being. Abruzzo's relatively strong growth and low unemployment can be attributed to rapid expansion of industry and the emergence of high-value-added services and new agricultural sectors. Production is led mainly by a few large businesses in industrialized areas. Automobile, energy, and petrochemical sectors developed in combination with hydropower plants. The region is innovative, investing heavily in research and development and human capital and having built pure and applied research hubs and a regional university. Other success factors were construction of superhighways to Rome, effective bargaining with local trade unions, cooperative banks, and policies that enhanced socio-institutional conditions.

Galicia, Spain

While Galicia is still a relatively poor region with an underdeveloped private sector, in the last 20 years it has transitioned from a predominantly agricultural to a more diversified and industrialized economy. It has become more dynamic by attracting tradable sectors, among them textiles (Inditex/Zara's textile exports from the region are 4 percent of Spain's total), automotive, timber, and seafood products; developing domestic, academic, and international tourism; and becoming one of Spain's hubs for technology firms. Galicia achieved this transformation by building up human capital, concentrating infrastructure investment in growth poles, and promoting key institutions for trade and economic development.

Dolnoslaskie, Poland

Starting in 2000 with a relatively high income among regions in Poland, Dolnoslaskie grew rapidly to reach 76 percent of EU average income per capita by 2018. Supported by large investments in infrastructure, the region has pursued innovation policies and smart specialization in knowledge-based services and high- and mid-tech industry (chemicals, food

processing, transport, machinery, and one-third of Poland's information technology software production). The region's strategy combined indigenous capital with links to growth poles based on heightened competitiveness, a highly qualified workforce, efficient use of resources, and establishment of special economic zones. It has also built on its attractions as a tourist destination. Proximity to EU15 countries, social capital, and trade unions have also contributed to development. Despite these successes, however, here are still concerns about poverty, emigration, and high structural unemployment.

South Muntenia, Romania

While South Muntenia remains among the poorer regions in Romania, within a decade it has experienced a sevenfold increase in GDP per capita, due largely to its proximity to Bucharest and to a few dynamic regions surrounded by rural areas. New high-density industrial parks and an extensive network of public roads has attracted foreign investment.

Where are the lagging regions?

Identifying lagging regions based on income and growth

Countries use metrics of varying complexity to identify lagging regions, including indicators that measure multiple elements of economic and social outcomes, such as the poverty and welfare indicators discussed in chapter 3³⁶. In the analysis in this chapter, we focus on basic economic outcomes—income level and growth³⁷. We adopt the language and basic approach of the EU Cohesion Policy's Lagging Regions Initiative, which identifies two types of lagging region: those that are “low income”—poor—and those that are “low growth³⁸.” The analysis covers Albania, Croatia, North Macedonia, and Serbia using the NUTS 3 regional classification (NUTS 3 regions are not defined for Kosovo and Montenegro). Data availability restricts the time frame for the analysis to 2010–15 for Albania, Croatia, and North Macedonia and 2013–16 for Serbia.

Because most Western Balkan countries have lower incomes than the EU average, the analysis categorizes regions relative to their regional (Western Balkans and Croatia) and national contexts. Benchmarking against EU averages would result in every NUTS 3 region except Zagreb being considered low-income, which though important for their future access to the EU Cohesion Fund is not useful for differentiating regions for prioritizing domestic policies. Thus, the EU Cohesion Fund categorization was adjusted to define low-income regions as those with incomes below 75 percent of the Western Balkans and Croatia average and low-growth regions as those with below-average incomes that are growing at less than 75 percent of the Western Balkan and Croatia average.

A regional perspective on leading and lagging regions in the Western Balkans reveals no obvious country-level clustering of regional income level and growth aside from EU-member Croatia, where incomes are considerably higher (figure 4.5). Almost half (20 of 45) of the regions outside Croatia qualify as low-income at the 75 percent regional average GDP per capita threshold, while just three—Podunavlje and Pčinja in Serbia and Polog in North Macedonia—fall below 50 percent of the regional average. Among low-income regions, several stand out for

both poverty and slow growth: Podunavlje, Raska, and Rasina in Serbia; Polog in North Macedonia; and Kukës and Elbasan in Albania. The other 14 low-income regions are growing faster than the regional average and thus may be considered on a convergence path. Several higher-income regions, particularly in Croatia and Serbia, are growing far below the Western Balkans and Croatia average. Notable among them are the capital cities of Belgrade, Tirana, and Zagreb.

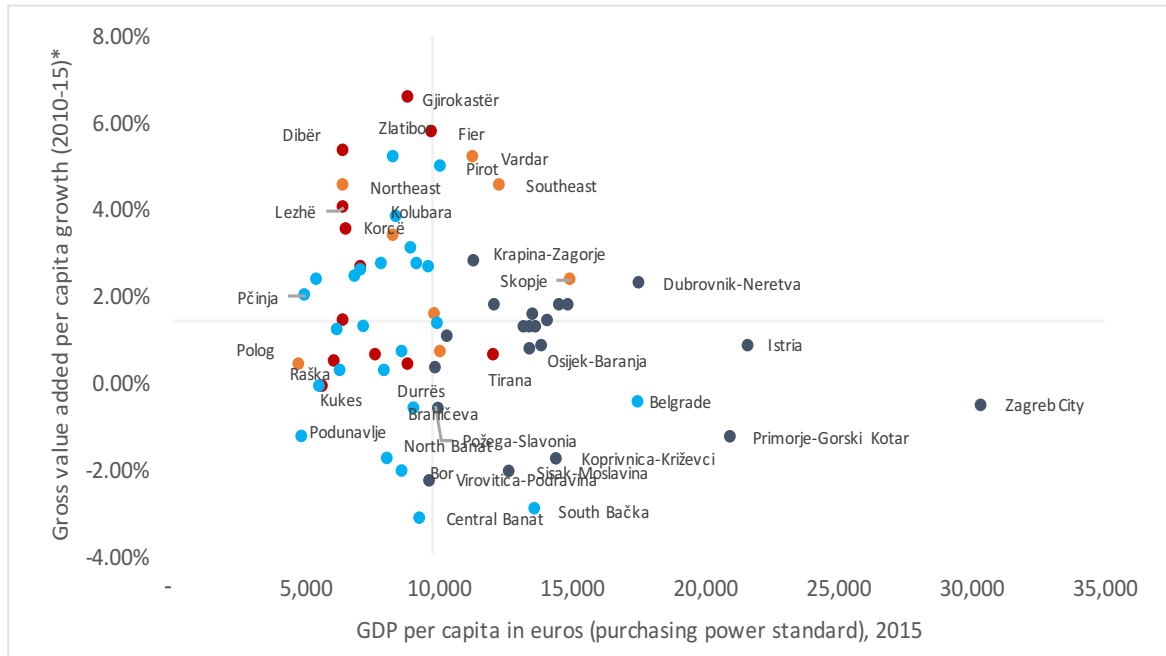


Figure 4.5 A regional perspective shows no distinct national clusters of leading and lagging regions (2010–15)

Source: Data from national statistics offices.

Note: Data for Serbia are gross value added per capita for 2013–16. Axes cross at regional averages.

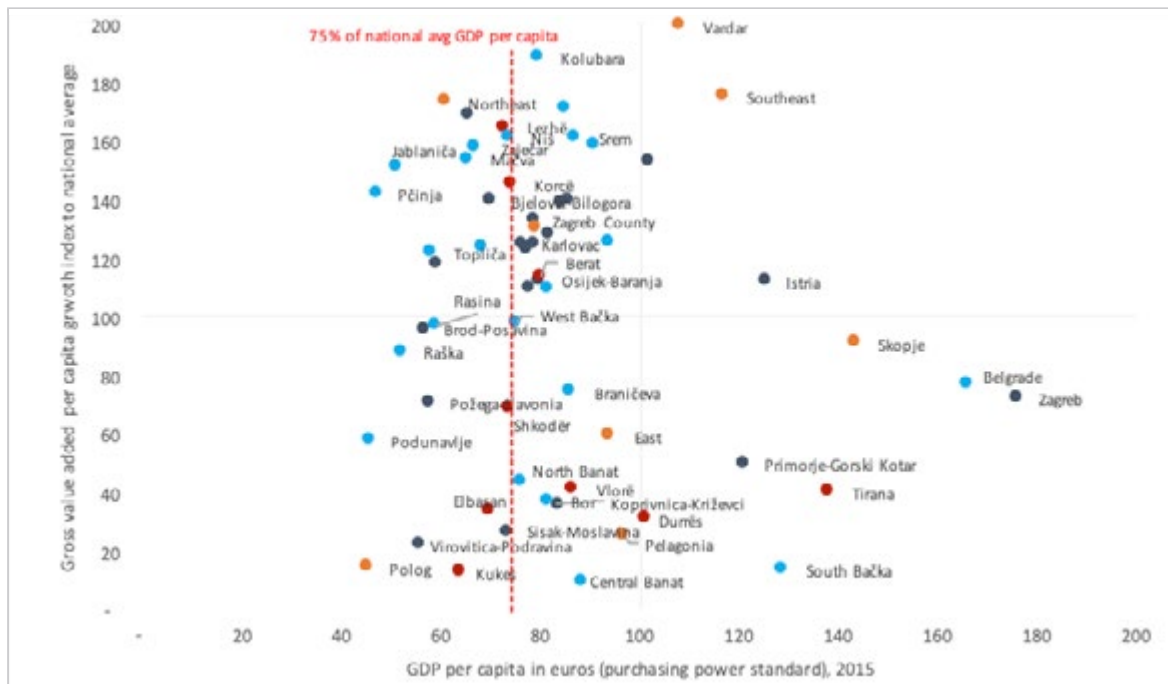


Figure 4.6 A regional perspective shows no distinct national clusters of leading and lagging regions (2010–15)

Source: Data from national statistics offices.

Note: Data for Serbia are gross value added per capita for 2013–16. Axes cross at regional averages.

But from a national perspective that compares regional incomes and growth to national averages, all countries have some low-income lagging regions, among them 10 of Serbia's 25 regions, 7 of Croatia's 21, 6 of Albania's 12, and 2 of North Macedonia's 8 (figure 4.6; see annex 4.1 for details). The trajectory of lagging regions varies by country. For example, 4 of Croatia's 7 lagging regions and 3 of Albania's 6 are on a divergence path, growing at below the national average, but 7 of Serbia's 10 lagging regions are converging. Most slow-growing regions are richer than average. Regions that classify as low-growth but not low-income are North Banat, Central Banat, Bor, and Braniceva in Serbia; East and Pelagonia in North Macedonia; Vlore in Albania; and Koprivnica-Križevci in Croatia.

Low-income regions tend to be clustered geographically and are often rural and on the periphery, although in all four countries there are some lagging regions adjacent to the leading metropolitan region (figure 4.7). Many lagging regions of Albania, Croatia, North Macedonia, and Serbia are at regional land borders, with a notable cluster around the borders with Bosnia and Herzegovina, Kosovo, and Montenegro. Low-growth regions are more varied geographically. They include a mix of regions that are undergoing structural transition (typically former leading industrial areas that have deindustrialized) and entrenched poor regions (such as Kukës in Albania) that have long lagged the national economy and are facing heightened demographic decline.

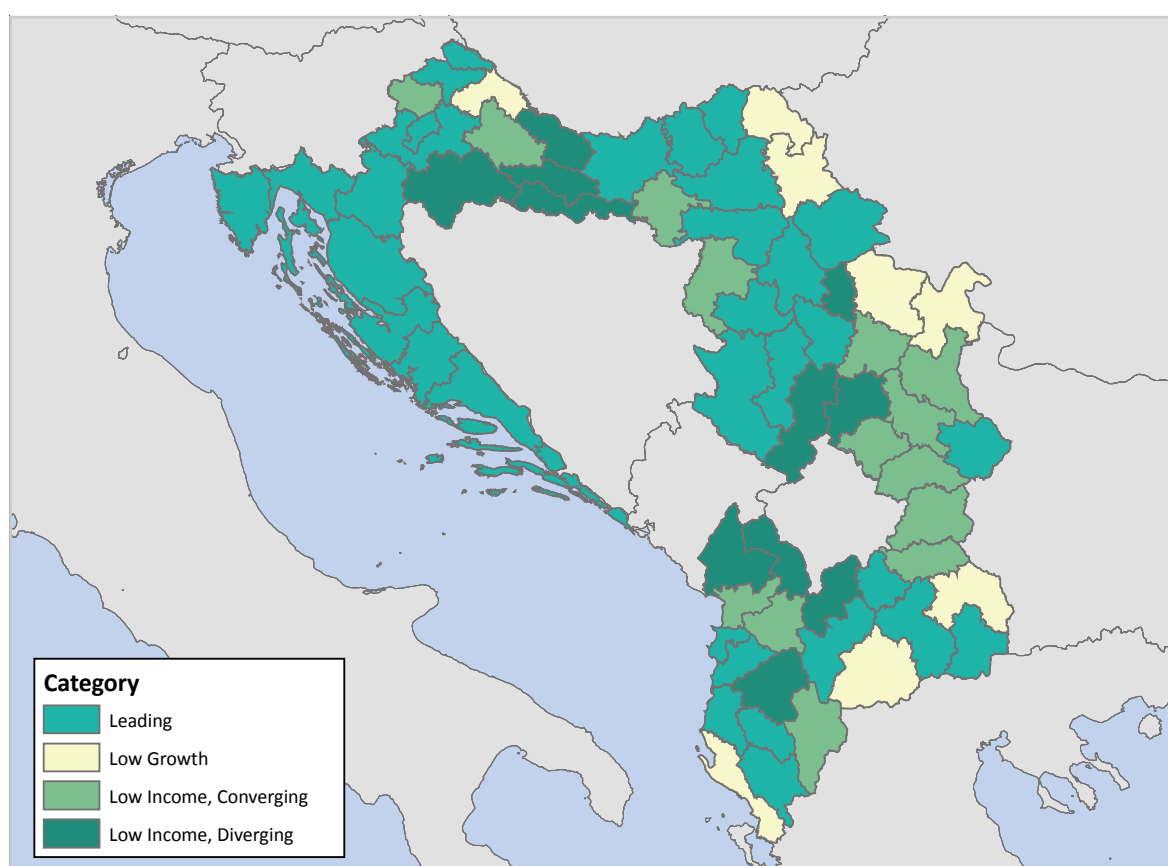


Figure 4.7 Many of the lagging regions in Albania, Croatia, North Macedonia, and Serbia are clustered at the Bosnia and Herzegovina, Kosovo, and Montenegro borders

Source: Based on data from national statistics offices.

Links between economic and social outcomes in lagging regions

These lagging regions are not only trailing in terms of output but are also confronted by cyclical and structural employment challenges, especially high levels of youth and long-term unemployment. In Serbia, employment

growth for 2010–17 in low-growth regions trailed the rate in low-income regions by one-third and in leading regions by two-thirds. In Albania, while the number of long-term unemployed fell by 5 percent nationally between 2010 and 2016, it rose in the low-growth regions of Kukës by 16.5 percent, Vlore by 2 percent, and Shkoder by 1 percent. The large gaps between regions in labor market outcomes appear to be a major catalyst for emigration from lagging regions⁴¹.

Maximizing economic potential and supporting equality of opportunity in lagging regions⁴²

Framework for policy priorities: Starting from structural conditions

Strategies to address the challenges of lagging regions around the world have often assumed, if implicitly, that all regions would follow similar development paths and reach similar income levels. Such an approach may result in one-size-fits-all programs, with limited development resources spread evenly across locations. A more effective approach, recognizing that not all regions have the same development prospects, starts with the explicit objective of maximizing the potential of each region based on its unique capabilities⁴³. In addition to this objective, regional development strategies must also raise the assets of individuals and ensure their mobility so that no matter where they live, they have access to opportunities to maximize their productive potential.

Structural factors play a significant role in shaping regional potential. World Development Report 2009: Reshaping Economic Geography reflects this clearly with its focus on density and the formation of urban agglomerations that drive productivity growth; distance and access to market opportunities; and division—whether policy or other barriers jeopardize prospects for forming and connecting to agglomerations⁴⁴. These structural characteristics, especially density and distance are applied here in a basic framework for supporting lagging regions (figure 4.8). The framework emphasizes building up regional endowments, both territorial and individual, through policies that are broadly universal even if designed for and delivered in specific locations.

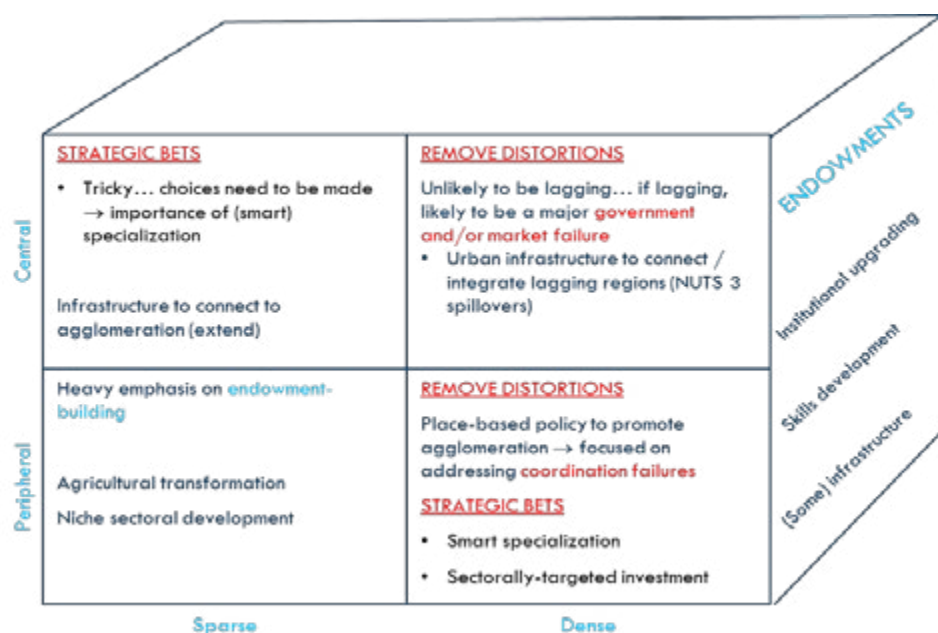


Figure 4.8 Structural conditions shape pathways to regional potential, but the approach to building endowments is universal
 Source: Farole, Goga, and Ionescu-Heroiu 2018.

These measures are supported by policies to remove distortions—targeting government, market, and coordination failures in lagging regions with the highest potential—to maximize the effectiveness of place-based sectoral interventions (strategic bets).

Regions in Albania, Croatia, North Macedonia, and Serbia are then mapped onto these dimensions (figure 4.9; for details on the categorization of each region, see annex 4.1). Most notable is that virtually all lagging regions, and 80 percent of all regions, are below EU average density. The framework differentiates policy priorities for four regional types:

- *Densely populated, centrally located:* These regions are unlikely to be lagging unless they are in the very early stages of integration (poor regions that will converge rapidly). Indeed, 9 of the 11 densely populated central regions are categorized as leading regions. When such a region is lagging, that is likely to be the 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.

Regions in this category: Polog in North Macedonia and Podunavlje in Serbia.

- *Densely populated, peripherally located:* For these regions, typical place-based policies may be most relevant. Market and government failures may be creating distortions that discourage investment, or coordination failures may be preventing agglomerations from emerging.

This the most common category for lagging regions in the EU. But no lagging region in the Western Balkans, and only Mediumurje in Croatia, is classified as dense and peripheral.

- *Sparsely populated, peripherally located:* Substantial structural constraints likely limit the development potential of these regions. Place-based development policies should be replaced as priorities by policies to enhance equality of opportunity, specifically by building 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.

Most lagging regions in the study area are in this category. In Albania: Diber, Korçe, Kukës, Shkoder, and Vlore (low growth). In Serbia: Bor, Jablanica, Pcinja, Raska, Toplica, and Zajecar (low growth). In Croatia: Bjelovar-Bilogora, Brod-Posavina, Koprivnica-Krizevci, Požega-Slavonia, Virovitica-Podravina, and Vukovar-Srijem (low growth). Many leading regions also fit into this category, among them Berat and Gjirokastër in Albania; Moravica, West Backa, and Zlatibor in Serbia; Southeast and Southwest in North Macedonia; and 8 of Croatia's 13 leading regions.

- *Sparsely populated, centrally located:* These regions tend to be close to larger agglomerations, so the priority is typically to better connect 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 risk inherent in industrial policies that aim to pick winners.

Across the Western Balkans and Croatia, 10 of 19 sparsely populated, centrally located regions are lagging, among them Elbasan and Lezhe in Albania; Krapina-Zagorje and Sisak-Moslavina in Croatia; Northeast in North Macedonia; and Braniceva, Central Banat, Macva, North Banat, and Pomoravlje in Serbia.

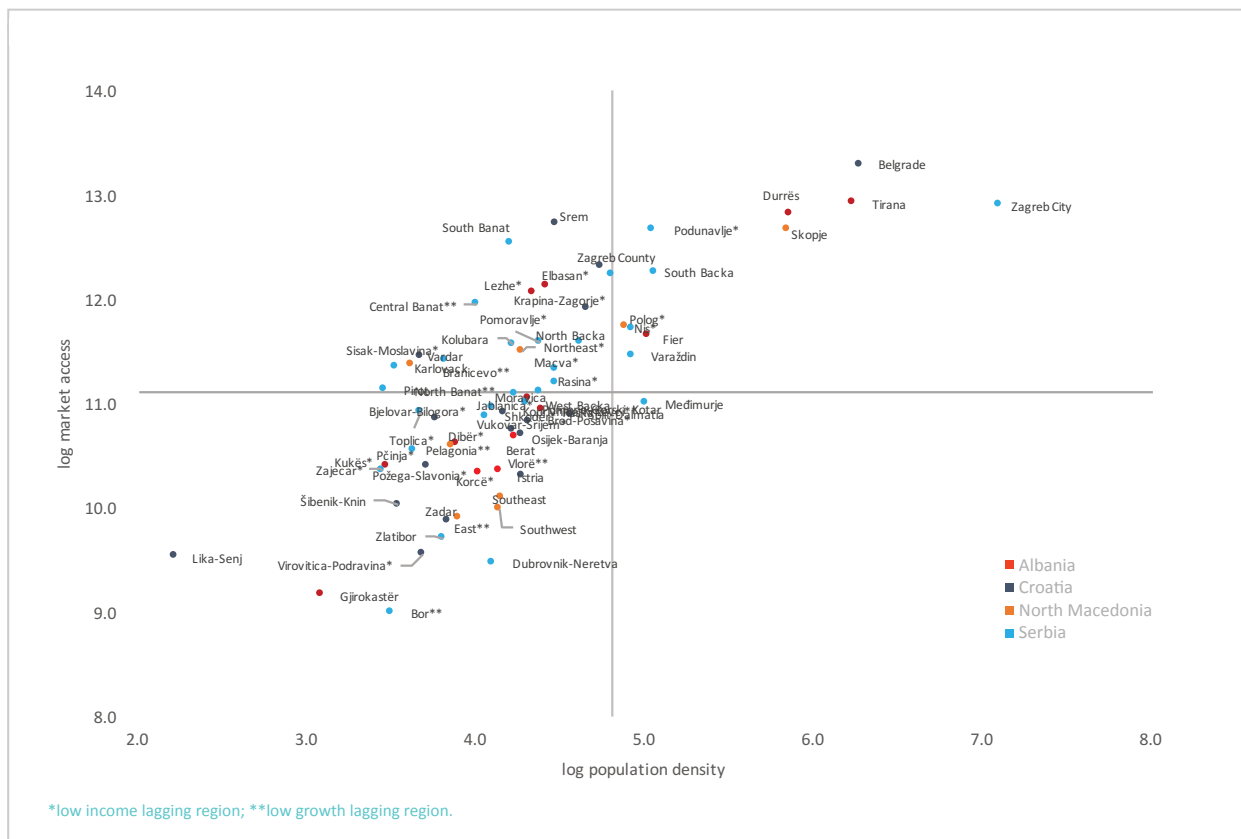


Figure 4.9 Population sparsity is the most common structural feature of lagging regions in the Western Balkans and Croatia (latest year available)

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.

The following discussion draws on the framework shown in figure 4.8 to discuss policy priorities for lagging regions, with emphasis on Albania and Serbia. Regions where case studies were carried out—Diber and Kukës in Albania and Central Banat in Serbia—receive special attention. In line with the priorities set out in figure 4.8, the discussion begins with policies to promote density and accessibility and to reduce division by addressing market, government, and coordination failures through, e.g., policies on urbanization and connectivity, reforms to develop and strengthen tradable sectors, and building endowments by enhancing human capital—the top priority in most lagging regions. The last section of the chapter looks at building the capacity of local and regional institutions.

Urbanization: Strengthening cities as engines of regional potential

Although chapter 2 focused on leading metropolitan areas as drivers of national growth, secondary cities matter more for promoting the development potential of lagging regions. Urban policy is most relevant for regions that are densely populated and either central or peripheral (the right-side quadrants in figure 4.9).

An assessment of secondary city performance in Romania shows that the main growth poles outside of the capital⁴⁵, with productivity about double the regional average, function as “magnet cities⁴⁶,” attracting migrants from the regional hinterlands. But Romania also shows a clear premium for city size in both productivity growth and potential for generating spillovers to the hinterland. Many lagging regions may not have a secondary city with high potential as an engine of growth.

Indeed, across the Western Balkans and Croatia, the opportunity for lagging regions to leverage secondary cities varies considerably. In Albania, most lagging regions are sparsely populated. And in the poorest regions, such as Diber and Kukës, low population density is aggravated by emigration and by low levels of urbanization—Kukës and Diber are the least urbanized regions in the country and the least densely populated of lagging regions. Yet some lagging regions, such as Elbasan and Lezhe, have higher population densities, and Shkoder, though low in density, has sizable population concentrations in urban areas, with the city of Shkoder a potential regional growth pole. In Serbia, the Niš region has high agglomeration potential through the city of Niš, and the cities of Zrenjanin, in the low-growth Central Banat region, and Novi Pazar, in low-income Raska, may have the scale to support agglomeration.

For secondary cities with the potential to be regional growth poles, a short-term priority is to ensure the infrastructure is of adequate quality to support private investment. Across the Western Balkan region, capital stock is low and declining⁴⁸. Combined with land rights issues, which are a particularly problem in Serbia (see chapter 2), infrastructure is a major impediment to private investment. For low-growth regions, which tend to have established agglomerations, it is equally important to strengthen the dynamism of cities so that they can retain skilled youth. Evidence from other EU regions, such as Abruzzo in Italy and Dolnoslaskie in Poland, shows that the share of youth employment in traditional industries has declined significantly. Establishing an urban environment that is attractive to younger skilled workers also requires making available good quality, affordable housing and services and investing in cultural infrastructure.

The city of Zrenjanin in Central Banat, Serbia, for example, has attracted manufacturing investment by developing industrial parks and supportive infrastructure. This has had a large spillover effect on rural parts of Central Banat—for example, outside Zrenjanin, Dräxlmaier, a German manufacturer of wire harnesses for automobiles, is the largest employer for most of the surrounding municipalities. Yet the region struggles to retain skilled youth, whose exodus has contributed to skills gaps and anemic entrepreneurialism. Evidence from dynamic lagging regions in recent EU accession countries points to the importance of good-quality universities, particularly those with strong technology faculties, to the dynamism of secondary cities (box 4.3). This is a clear problem for Zrenjanin, whose university has a traditional engineering focus, and in the Albanian regions of Diber and Kukës, which lack the scale to support a university.

BOX 4.3

Dynamic universities can advance development of a lagging region: Iași, Romania

The Northeast is the poorest region in Romania at the NUTS 2 level, and one of the poorest in Europe, with a peripheral location, low urbanization, and the dominance of small-scale agriculture. The region has a bright spot, though, in the city of Iași, the third largest university center in Romania, with a student population in its four main universities of about 55,000 (15 percent of Iași's population). This brings to the city a constant flow of young and well-educated people, which is critically important, especially where there is demographic decline.

While Iași is only 12th in the country in economic output, it is 4th in the number of migrants it attracts. Its universities draw students not only from nearby cities like Bacău, Piatra Neamț, and Suceava, but also from other large university towns like Brașov, Bucharest, Cluj-Napoca, and Timișoara and from neighboring countries, notably Bulgaria, Hungary, Moldova, Serbia, and Ukraine. As a consequence, Iași has a large and diverse pool of human capital, which has supported the growth and transformation of the local economy. With more than a thousand information and communication graduates each year, the city has shifted from a reliance on manufacturing to building a strong information technology sector. Iași is now the third largest information technology outsourcing location in the country and hosts large international firms like Continental, Oracle, Pentalog, and Xerox.

Connectivity: Linking lagging areas to market opportunity

Not all regions can support dynamic cities. The priority for lagging regions with sparse population should be on connecting to agglomerations—but efforts to close the current large connectivity gaps, particularly in the most peripheral lagging regions, must avoid emphasizing costly transport infrastructure at the expense of other development priorities.

As outlined in chapter 1, the impact of improved connectivity depends on mobility conditions. For sparsely populated central regions, better connectivity with large agglomerations can open opportunities for product and labor market integration. In Central Banat, Serbia, planned motorway investments have the potential to bring Zrenjanin and its surrounding municipalities within commuting distance of Belgrade. This could be transformative if the development of multimodal transport infrastructure creates an economic corridor linking Zrenjanin to Belgrade. For example, in Romania, a comprehensive long-term strategy that includes investment in both roads and commuter rail, logistics infrastructure, and business parks has contributed to successful corridor development between Timisoara and Arad, making both cities more competitive. Similar strategies were pursued in Dolnoslaskie, Poland, which has become a major transport hub⁴⁹.

Regions that are sparsely populated and peripheral risk overinvesting in response to overly buoyant assessments of the potential of connective infrastructure. In the EU, for example, huge investments in transport infrastructure—roads, high-speed trains, and airports—in some of the most sparsely populated regions in Italy, Portugal, and Spain soon revealed rapidly decreasing returns to their large-scale transport investments⁵⁰. Moreover, failure to properly plan and secure resources for regular maintenance has in many cases contributed to the degradation of productive assets.

Risks may be similar in some parts of the Western Balkans and Croatia, where structural conditions have many similarities with lagging areas in southern Europe, and where effective investment management capacity in local governments is severely limited. For example, Diber is among the least connected regions in Albania, with travel times to Tirana approaching four hours and connectivity to secondary cities no better. A planned motorway promises to cut travel time to the capital to less than 2 hours and to connect Diber to North Macedonia. While opening access to markets for the region's agricultural and tourism businesses might be game-changing, it is sobering to realize that a motorway completed in 2010 that similarly reduced travel time from Kukës to Tirana and Durrës had no discernable positive impacts on the Kukës economy, which has since actually diverged further from the national average. The Diber motorway investment, on its own, should not be expected to transform the region. Rather, development strategies, and resources, must also focus on helping Diber to take advantage of the opportunities the motorway makes available, for example, by investing in upgrading agriculture and tourism infrastructure.

Most lagging regions in the Western Balkans and Croatia also suffer large gaps in intraregional connectivity, with secondary road networks underdeveloped and minimal resources for maintaining them. For centrally located regions, secondary road networks can be an effective investment for integrating the regional economy. For more peripheral regions, the economic rationale for secondary road networks may be less persuasive, although there may be an equity argument for investing in rural roads to better deliver services. In the Western Balkans and Croatia, rapid demographic decline intensifies the complexity of balancing service delivery with the high costs of service provision and maintenance in remote areas. Given the scale of emigration in many lagging regions, a priority for regional development is to find innovative strategies for ensuring connectivity with and service delivery to rural areas. It will also be critical for local governments to build their capacity to manage public investment, e.g., by adopting approaches like performance-based budgeting.

Finally, overcoming border frictions could be transformative in a number of lagging regions (see the Spotlight). For example, Serbian municipalities in Central Banat that are on the Romanian border have already benefited from cross-border investments, and further development of cross-border tourism offers promise. Here, while borders are still a barrier, delays are minimal. By contrast, in the lagging regions of Pčinja and Pirot in Serbia, Southeast in North Macedonia, and Vukovar-Srijem in Croatia, border frictions cut realizable market access by more than half (figure 4.10). While many lagging regions are already taking advantage of EU funding for cross-border initiatives, complementary funding would be needed to support broader programs in regions with high cross-border opportunities. Moreover, easing border frictions is most profitable for regions with economic activities in tradable sectors, which is generally not the case in lagging regions.

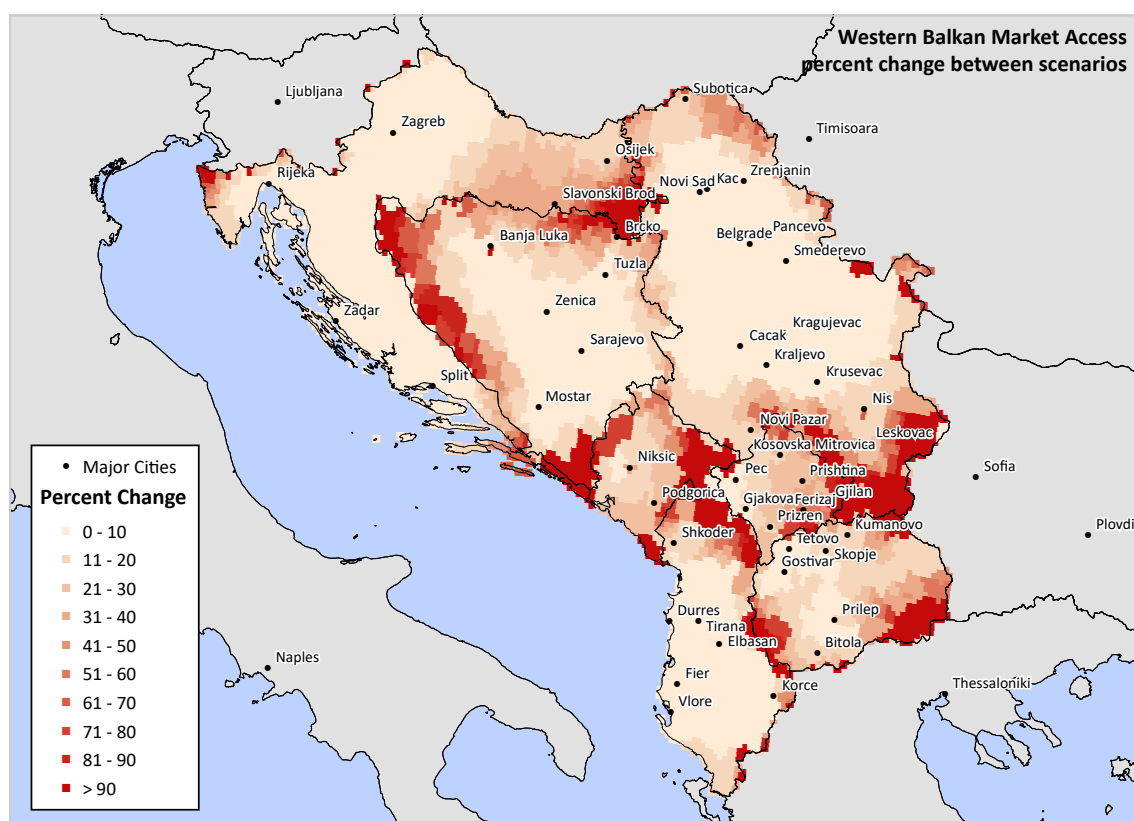


Figure 4.10 Border frictions greatly reduce market access for many border regions, 2018

Source: World Bank Geospatial Operations and Support Team.

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

Tradable sector development: Facilitating investment and entrepreneurship

Building on the opportunities for cross-border trade will be important for economic growth in lagging regions in the Western Balkans and Croatia. EU experience shows that successful growth in sparsely populated regions is closely associated with exports. In recent decades the poor performance of most low-growth regions in Southern Europe has been attributed to their failure to develop competitive tradable sectors⁵¹.

In low-income lagging regions, lack of export participation reflects both specialization in low-productivity and nontradable sectors and weak firm competitiveness. In Albania, on average 75 percent of GDP in low-income

lagging regions comes from sectors with typically low productivity growth, 10 pp higher than in non lagging regions. For example, in Kukës, agriculture accounts for more than 40 percent of the economy, with trade, construction, and the public sector accounting for 20 percent each. Economies in the low-income lagging regions of Croatia, North Macedonia, and Serbia are similarly reliant on primary sectors and local nontradables.

In sparsely populated peripheral regions like Diber and Kukës in Albania, boosting agricultural productivity and connecting to markets are top priorities for regional development. Beyond this, mining, hydropower, and tourism may provide tradable natural resource-based opportunities. Here, it is critical to coordinate investments in rural roads and other infrastructure that enable tourism and the provision of social services. Coordination is also necessary to ensure consistency and complementarity between sectoral development initiatives, particularly when new investments in energy or extractive sectors is being considered.

Albania's experience illustrates, for good and bad, the importance of sectoral and spatial coordination. Its development strategy for low-income peripheral regions appropriately emphasizes agro-tourism. Many initiatives financed by both development partners and the government's nascent "100 Villages" program hold promise for opening up a realistic development path for rural villages. These initiatives take into account the complex, cross-ministerial coordination required for success (box 4.4). However, in some areas development of mining and hydropower may undermine the potential for tourism, especially agro-tourism. For example, hydropower projects often end up restricting access to water for local farmers. Moreover, while mining and hydropower projects may deliver significant national benefits, they tend to create few local jobs and few opportunities to build local supply chains. Moreover, local governments typically capture very little of the taxes and royalties generated by extractive industries, even though they bear many of the associated costs, such as for the costs of pollution control and road maintenance.

BOX 4.4

100 Villages: Albania's scalable model for developing niche opportunities in sparsely populated, peripheral lagging regions?

The goal of Albania's "100 Villages" program, being piloted in 2018–20, is to promote rural development through pilot projects replicable across regions. The plan is to develop eco- and agro-tourism by supporting local entrepreneurs, emphasizing cultural heritage factors, and improving infrastructure and human capital. Following from the previous government's urban regeneration program and involving inter-ministerial cooperation coordinated by the prime minister's office, 100 Villages is being promoted as a leading development program. The program will be implemented by municipalities and public agencies like the Albanian Development Fund, funded by contributions from several ministries. As of 2018, about €7.5 million had been committed. With funds and local capacity limited, the program will work in coordination with donors to maximize its long-term impact.

Developing competitive, tradable sectors in lagging regions may require both facilitating foreign direct investment (FDI) and building up the local enterprise base. Ideally, these are complementary initiatives, with FDI bringing supply chain opportunities and new technologies that can help upgrade enterprises.

While globally investment subsidies to attract FDI to lagging regions are common, FDI in manufacturing and in high-value-added services tends to concentrate in regions with agglomerations (dense regions)⁵². In the Western

Balkans and Croatia, therefore, strategies to attract FDI are most relevant in leading regions and in centrally located low-growth lagging regions. In the Czech Republic, Hungary, Poland, and Romania before their EU accession, FDI linked to automotive, machinery, and information technology value chains centered in the EU was critical in supporting regional development.

The Western Balkans and Croatia have attracted less investment in these sectors. Yet some regions have had relative success in attracting FDI—among them Central Banat in Serbia—through targeted efforts to overcome investment constraints (box 4.5). However, success in leveraging dynamic gains from FDI through supply chain links and spillovers of knowledge and technology has been elusive for Central Banat. Moreover, the region risks getting locked into a role as a low-wage, low-value-added location, with the risk that footloose investors may move away if the supply of cheap labor dries up, whether because of rising wages or, as is already happening, because labor supply limits are reached. Recognizing these challenges, Central Banat is working on improving skills in sectors that worked for EU-member neighbors. However, it must also focus on innovation capacity, especially in broader technology areas that allow productivity to rise without being locked into narrow sectors and firms.

BOX 4.5

Central Banat in Serbia: Using industrial parks to attract investment

While industrial parks and special economic zones have had very mixed results globally, the city of Zrenjanin in Central Banat, Serbia, has benefited from using industrial parks to overcome constraints on foreign direct investment (FDI) in manufacturing. Zrenjanin is one of the largest agro-industrial centers in Serbia and was the third largest center in the former Yugoslavia.

In 2007–08 the Zrenjanin city chamber of commerce started the first industrial park in Serbia with a €4 million investment. The project is city-owned and operated, with many benefits for investors, such as access to land with clear title (otherwise a major issue for businesses) and guaranteed high-quality public infrastructure (electricity, water, sewerage). Today, the city has two industrial zones and one free-trade zone (tax-exempt and reserved for FDI) on 2,000 hectares of land. More than half of the investment is FDI. Dräxlmaier first invested in 2007 to produce wire harnesses for automobiles and expanded in 2017 with an additional 3,000 jobs. Essex Europe, a South Korean copper wire producer, established a plant in 2018. Investment of up to €1 billion is now anticipated from a Chinese rubber factory.

Low-income lagging regions have fewer established firms and more informality. Low-income regions in Albania have 25 percent lower density of firms (figure 4.11) and in Serbia, 66 percent lower density (figure 4.12). In 2016 in Albania, Kukës had just 221 formal enterprises per 10,000 inhabitants and Diber just 231, compared with 687 in Gjirokaster and 675 in Fier. Since more than 90 percent of firms in low-growth regions are microenterprises (1–4 employees), clearly few formal job opportunities are available in lagging regions⁵³, where large productivity gaps are also barriers to firm competitiveness. Firm-level data for Serbia indicate that average labor productivity is almost 50 percent lower in low-income than in leading regions.

The situation differs somewhat in low-growth and low-income lagging regions, although some of the symptoms are the same. Low-growth regions frequently have an established, often export-oriented, industrial base that is

struggling to stay competitive. Reliance on established manufacturing sectors, often with very large enterprises, limits the establishment and growth of new firms, so firm density is low.

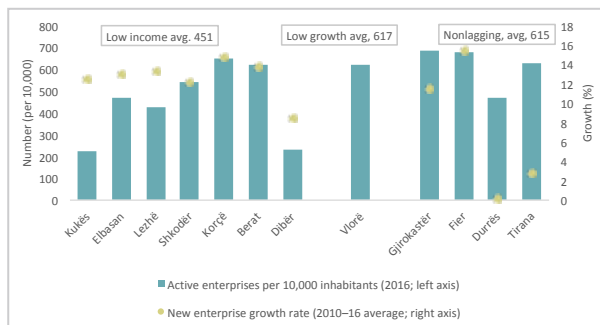


Figure 4.11 Albania's poorest regions have few private enterprises (2010–16)

Source: Data from the national statistics office.scenario that takes into account average delays at each border.

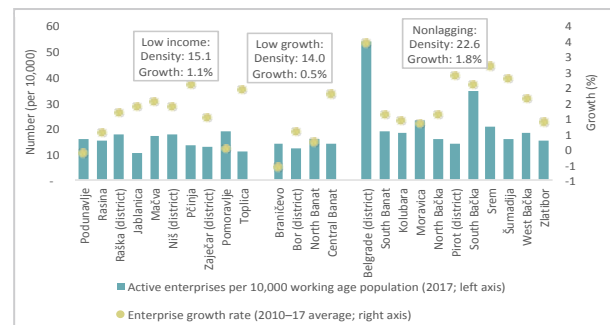


Figure 4.12 Serbia's lagging regions trail significantly on firm numbers and growth rates (2010–17)

Source: Data from the national statistics office.

While building dynamic small and medium-size enterprises is typically the goal of businesses in lagging regions, gaps in financing, technology, and market connections are formidable barriers. These obstacles are compounded by lack of scale and of access to skilled labor. But beyond these structural issues, the failure of national and local governments to establish and maintain a facilitative business environment has been well-documented as a significant constraint to private investment in many lagging regions⁵⁴. With the notable exception of North Macedonia, countries in the region perform poorly on measures of the business environment. In most, starting a business and accessing finance are difficult, labor and tax regulations are rigid, and corruption is commonplace.

Investors in lagging regions must often deal with additional hurdles. Initiatives introduced by the city of Zrenjanin in Central Banat, Serbia, to improve the business environment have not been adequate. For example, the StartIT Center was set up to provide knowledge support to the emerging information technology sector. However, it has had difficulties attracting people under age 30 to its co-working space, revealing the importance of recognizing and dealing with multiple obstacles. And while “I love Zrenjanin,” a marketing website for the city initiated by a young entrepreneur, has established a platform for young, skilled workers, issues of low wages and high taxes in the formal sector are still impediments to attracting young entrepreneurs. Small businesses in Kukës, Albania, are facing similar problems of an unattractive business environment (high taxation, delays in VAT refunding, etc.) and lack of finance, exacerbated by emigration of the most skilled workers. In Albanian lagging regions, with their high unemployment rates and a disproportionate share of young women, promising measures could include promotion of gender equality in education and specific programs oriented to developing small business and consultancies (for example, in tourism and marketing).

Human capital development: Improving education and the skills mix

Along with the structural factors of density and distance, human capital is by far the most important element in the development potential of lagging regions⁵⁵. It is also central to supporting labor mobility. Thus, it is vital to ensure the equal quality of education, in both foundational knowledge and technical skills, across all regions of a country.

Lagging regions in the EU show deficits in educational outcomes in the labor force and in the flow of new workers. For example, the share of the adult population with a tertiary education is on average about 20 percent

lower in lagging than in nonlagging regions. In Bulgaria and Romania, the share of 15–24-year-olds in secondary or tertiary education is about 25 percent lower in lagging than in nonlagging regions.

Similar gaps exist in the Western Balkans and Croatia (see chapter 4). In Albania, nearly 60 percent of the adult population in low-income lagging regions has no more than a lower secondary education, 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 (figure 4.13). Gjirokastrë, which outperforms its structural potential (it is sparsely populated and relatively remote), has by far the most educated population outside of Tirana. In Serbia, the share of the adult population with an incomplete primary education is markedly higher in both low-income and low-growth lagging regions. For example, in Braničevo and Zaječar, about 13 percent of women and 7–8 percent of men have not completed primary education compared with 3 percent and 1 percent in Belgrade. Educational attainment is lowest in low-growth lagging regions. The average secondary school completion rate, for example, is 10 pp lower in low-growth lagging than in leading or low-income regions in Serbia (figure 4.14). These education gaps are likely to greatly reduce the ability of these regions to shift to a more knowledge-intensive economy.

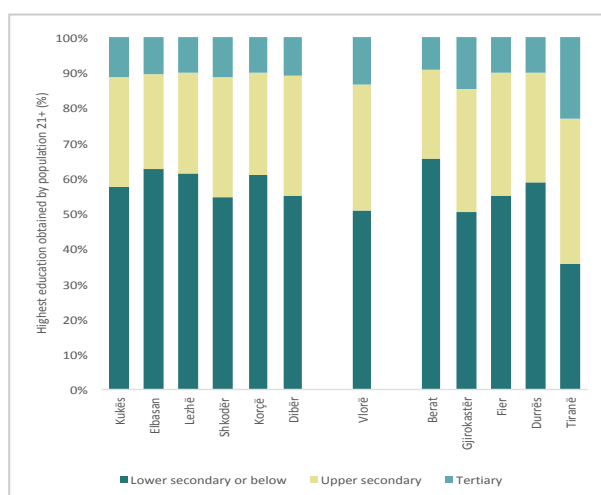


Figure 4.13 Lagging regions in Albania have a substantially higher share of low-educated residents (2012)

Source: Data from the national statistics office.

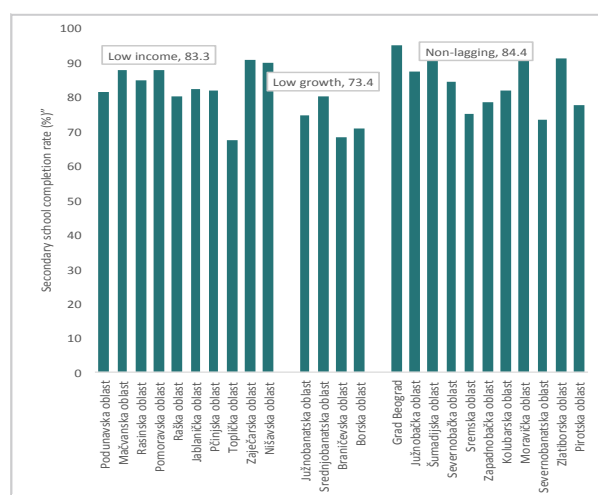


Figure 4.14 Secondary school completion rates lag in Serbia's low-growth regions (2017)

Source: Data from the national statistics office.

These human capital deficits result from poorer education outcomes in lagging regions, amplified by spatial sorting as the most skilled workers migrate from lagging to leading regions. Moreover, lower education outcomes in lagging regions result not just from individual choices to invest less in education but also from poorer education quality. Cross-country comparisons of learning outcomes⁵⁶ show that, except for Serbia, the Western Balkans and Croatia perform below ECA regional norms. Moreover, spatial effects are strong, especially in Albania, with substantially poorer outcomes for students in remote rural areas even when controlling for the socioeconomic profiles of students (figures 4.15 and 4.16)⁵⁷.

Lower performance in lagging regions is not simply a matter of fewer resources. Data on education inputs—such as number of schools and class size—suggest that lagging regions are often well-resourced. For example, regions like Diber and Kukës in Albania have more schools and teachers relative to their population and smaller classes than many leading regions. This reflects an explicit effort to ensure access to education regardless of where people live. It also reflects the demographic decline in rural areas—schools remain but with many fewer students.

Finland and France represent two possible models for addressing education challenges in remote, sparsely populated areas through decentralized education⁵⁸. The two countries closed schools with too few students but had different strategies to support rural schools.

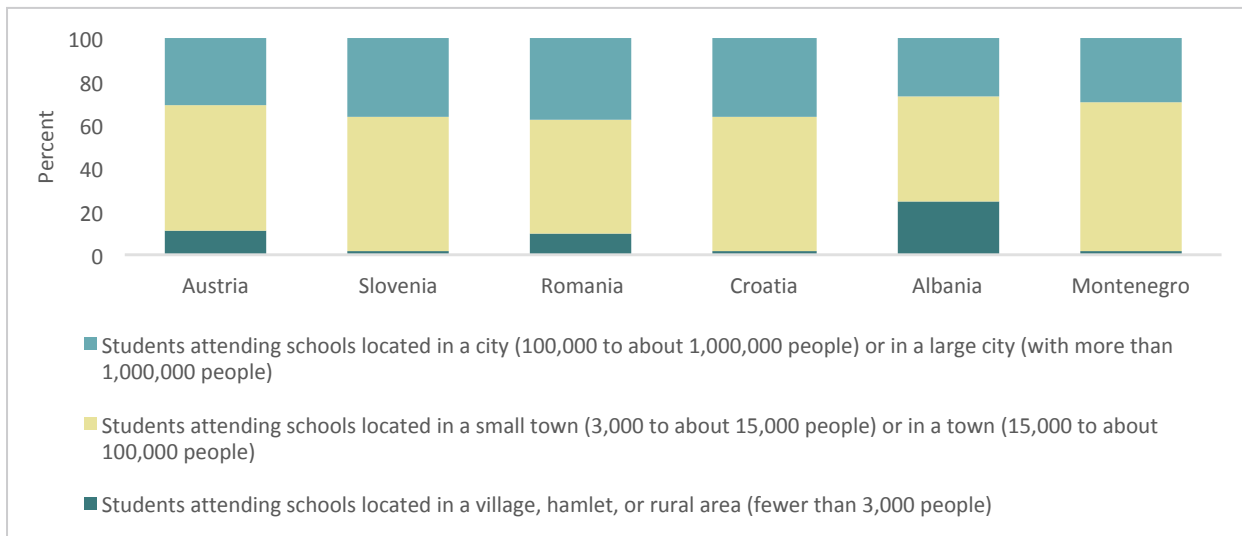


Figure 4.15 Many Albanian students attend schools in sparsely populated rural areas (2009)

Source: OECD 2010.

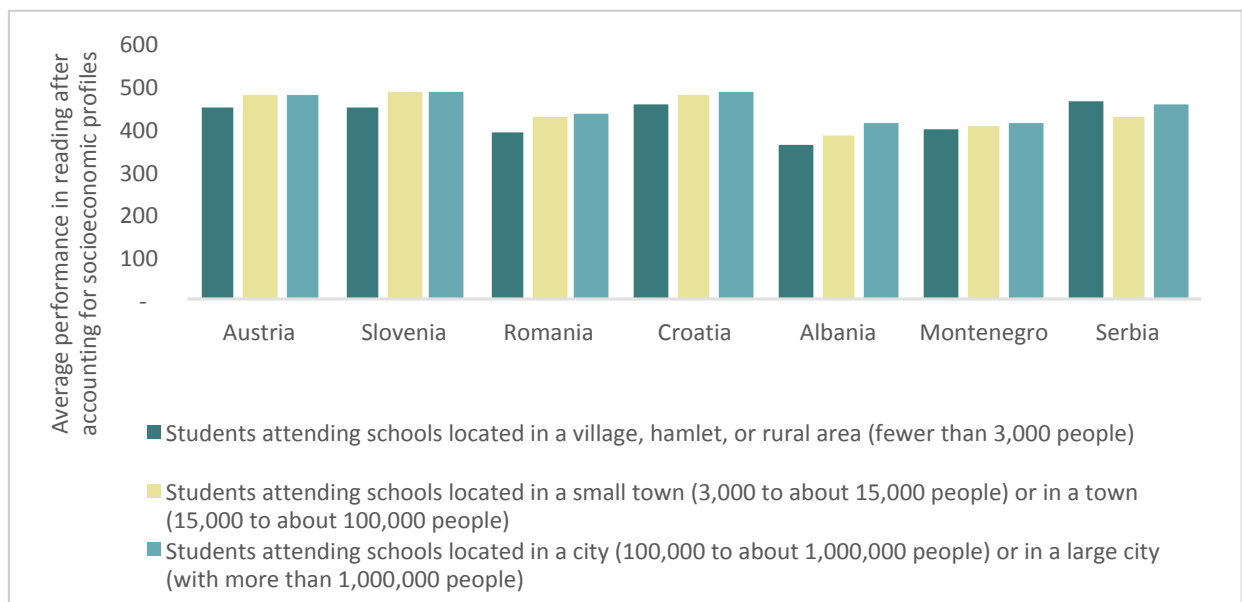


Figure 4.16 ...and these students have substantially lower education outcomes (2009)

Source: OECD 2010.

Finland, a country consistently in the top rankings on the Programme for International Student Assessment (PISA), followed principles of equity and trust in all reforms linked to deregulation and devolution of nearly all responsibilities to local governments. It focused on strict teacher selection criteria and mixed local and national evaluation, but it also stressed cooperation between families and schools and allowed flexibility in teaching methods and curriculum adaptation. Like the process of school rationalization begun in 2010 in Moldova, Finland regularly updates its school networks. Moreover, resource allocation is guaranteed, and transportation is free in Finland.

France established Intermunicipal Pedagogical Groupings (RPIs), which have received considerable support, as an alternative to the much criticized urban Priority Education Zones for disadvantaged communities, which have been plagued by social problems. The RPIs were set up in the 1970s in response to demographic decline

as essentially a restructuring process based on a contractual arrangement between communes to concentrate education activities in (a) one school for all pupils from surrounding areas or (b) several schools, with pupils distributed by grade level in schools across districts. Grouping small schools and bundling resources have been particularly beneficial in remote mountainous regions, where they ease teacher training and education projects.

Beyond having a population with a good foundational education, a critical element in the competitiveness of regions is the availability of sector-specific skills. Vocational programs and technical schools are often under-resourced, with outdated curricula that impart skills that do not match current labor market needs. The World Bank's Skills Measurement Employer Survey suggests that the skill mismatch is greater in North Macedonia than in Albania or Serbia, although this may be linked to a better business environment in North Macedonia and therefore a greater need for specific skills. In Zrenjanin, local and regional institutions are working with the Serbian Ministry of Education and the private sector to develop suitable dual education and general education upgrades.

For low-growth urban regions like Zrenjanin, a priority is to establish strong education support systems that link higher education institutions, the private and public sectors, and civil society⁵⁹. Such cooperation can improve the relevance and quality of tertiary and vocational education, and creation of entrepreneurial universities, research and development labs, and technology transfer centers can enhance regional innovation⁶⁰. Private sector involvement in managing institutions and designing curricula has been a major success factor in Brazil's National Service for Rural Apprenticeship, a pioneer in vocational education and training in rural areas, and Namibia's network of Community Skills Development Centers, which provide competency-based skills training to communities across the country⁶¹.

Strengthening institutions to support lagging regions

Delivering on the priorities for lagging regions requires effective national, regional, and local institutions. Quantitative evidence for the EU shows a strong correlation between regional institutional quality and regional per capita income⁶².

Institutional deficits

Evidence from the World Bank's World Governance Indicators suggests that the Western Balkans and Croatia have serious institutional weaknesses in both government effectiveness and transparency. Local capacity, particularly in management and financing, is low throughout the region⁶³. In Italy, the effectiveness of local and regional public spending has been found to depend to a large extent on the incidence of corruption⁶⁴. More broadly, recommendations have called for improvements in local capacity⁶⁵; less fragmentation, particularly in the use of structural funds⁶⁶; and concentration of investments, as in Poland⁶⁷. Other recommended models for upgrading local capacity for financing and data collection are being developed in Albania and Serbia, drawing on Galicia's intermunicipal investments⁶⁸ and Abruzzo's performance-based transfers⁶⁹.

Effective institutional support of lagging regions requires strengthening national institutional structures to support regional development policymaking and service delivery and local government capacity. These are discussed below.

Regional development institutions

Use of regional development institutions is common in the EU, which allocates substantial resources along regional lines. Regional institutions can better identify development needs and coordinate service delivery and can support local government by coordinating the activities of multiple local authorities. Regional institutions also allow for investment in specific technical capacities that may be unavailable locally.

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

First, regional development institutions in Albania and Serbia do not always align with political and administrative structures. Even though approaches to regional development in the EU vary, having some alignment of administrative structures, political authority, and regional development planning can be effective (box 4.6). In Albania, the national framework for regional development has defined four development regions, each containing both leading and lagging regions (for example, Region 2 includes the leading regions of Tirana and Durrës and the lagging regions of Diber). This approach could support an emphasis on strengthening leading regions and supporting spillovers to lagging regions. But such a holistic regional development program may prove difficult to implement in the absence of any associated regional administrative structures and detailed data and analysis on local potential, opportunities, and performance. The Serbian model is more bottom-up, with regional development authorities formed by local stakeholders. While in theory these may be better aligned with administrative structures (many are closely linked to city administrations), in practice most of the 17 accredited regional development authorities operate at the NUTS 3 level, for which there are no equivalent administrative structures⁷⁰.

BOX 4.6

Lessons from the EU on organizing regional development: Greece and Poland

Cohesive policy programs vary considerably across the EU. In Greece, for 1993–2010 regional programs reflected the priorities of the central government, with no strong regional institutions and procedures for local participation in decision-making. In 2010, Greece introduced elected local authorities and decentralized EU funds. However, there was still a strong administrative disconnect between regional management of the EU funds and the existing structure of government, resulting in parallel systems (the same thing happened in Romania). Regional funds are managed through a Special Management Authority (SMA), chaired by the elected president of the regional government. The relationship between the regional government and the SMA has meant that regions have been able to use the SMA in their planning and in prioritizing their programs in line with the national regional operational program (ROP). In contrast, municipalities, which have a nonhierarchical relationship to the region, are unable to capitalize similarly on SMA resources and therefore enter into discussions on the ROP at a disadvantage. Furthermore, because of the nonhierarchical relationship between local and regional entities in Greece, priorities may not be aligned: local governments tend to follow the priorities of their national thematic parent ministry rather than those of the region.

Poland has a more hierarchical system with greater administrative alignment; the regional level of government (województwa) corresponds to NUTS 2 regions. Below that is the county or district, and below that towns and rural communes. Each level is governed by a self-governing elected council. There is an overlap between the central administration and the elected councils in that the provincial governor is nominated by the president. This appears to enable a more coordinated approach to regional development, while also providing a clear channel for prioritization and program development to emerge from the local level. Most notably, in contrast to Greece and Romania, which have a single national ROP, Poland has 16 autonomous ROPs, reflecting strategies designed by and for individual regions.

Second, regional development institutions do not operate within a clear national legal and institutional framework, with a clear national strategy for regional development. In Albania, decentralization is still weak despite its early start in 1998 with a charter of self-government integrated into the Constitution. In 2013 an administrative territorial reform reduced the number of counties, and in 2014 four development regions were established, but they were not aligned with administrative divisions. It is not clear how the regional development authorities are defined, although most appear to be linked to regions based on functional urban areas and spatial interactions. Serbia's 2009 Law on Regional Development (amended in 2010 and 2015) established a territorial classification that divided Serbia into five statistical regions, according to NUTS2 classification. A Strategy for Regional Development for 2007–12 established the basis for Serbia's regional program, but no new strategy has since been adopted. Institutional changes diluted the focus on regional development and shifted authority from the Ministry of Economy to a minister without portfolio who was responsible for "balanced regional development"⁷¹.

In both Albania and Serbia, regional development agencies have recently been integrated into organizations with a wider remit, an organizational change that brings both opportunities and risks. Albania ended the system of regional development authorities in 2018, and their staffs have been integrated into the Albanian Development Fund (ADF). Since the ADF represents the most important source of regional development funding in Albania, this may allow for better alignment of regional development planning. But it raises the risk that such planning will be recentralized. In Serbia, as of 2016, the National Authority for Regional Development was merged with the Serbia Investment and Export Promotion Agency to establish the new Development Agency of Serbia. Unlike in Albania, the effect has been to further decentralize the activities of regional development authorities, but at the cost of a loss of influence given the generally stronger role of local governments in Serbia. Moreover, the reorganization has pushed the orientation of regional development toward a narrow focus on attracting investment.

The result in both countries is that regional development authorities have a limited, largely technical, role in regional development. They help local authorities prepare projects and contribute local knowledge about access to financing. In Serbia, it seems that at least some regional development authorities have also helped local authorities prepare development plans. However, the regional development authorities tend to lack the authority, and the resources, to deliver comprehensive regional development plans. In Albania, regional development authorities have also supported local municipalities in preparing development plans, which almost all municipalities have completed. However, the centralized approach has meant that the plans are not always locally relevant or owned in full. Moreover, as in Serbia, funding to support implementation is limited. The ADF has a valuable funding role, but it has focused on large-scale public infrastructure. Moreover, competition to secure ADF funding has disadvantaged some of the lagging regions that need it most.

Local government capacity and financing

Local governments are critical for delivering on the core objectives of growth and equality of opportunity, especially through their role in supporting the environment for private investment, connectivity, and social services delivery. The literature on regional economic development increasingly emphasizes local institutional capabilities and the capacities of multiple actors to build and sustain coalitions to articulate and deliver on growth strategies⁷². In the Western Balkans and Croatia, institutions of local governance 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.

Across the region, to deliver on their mandated functions local governments depend largely on transfers from the national government. For infrastructure, this comes largely through shared taxes and unconditional transfers, along with fees charged by municipal service enterprises. Social services delivery is largely funded through earmarked transfers. These transfers represent half of total municipal revenues in Albania and nearly half (46 percent) in North Macedonia. In Croatia, earmarked transfers for teacher salaries account for about half of local revenues in the statistics reported by the Ministry of Finance.

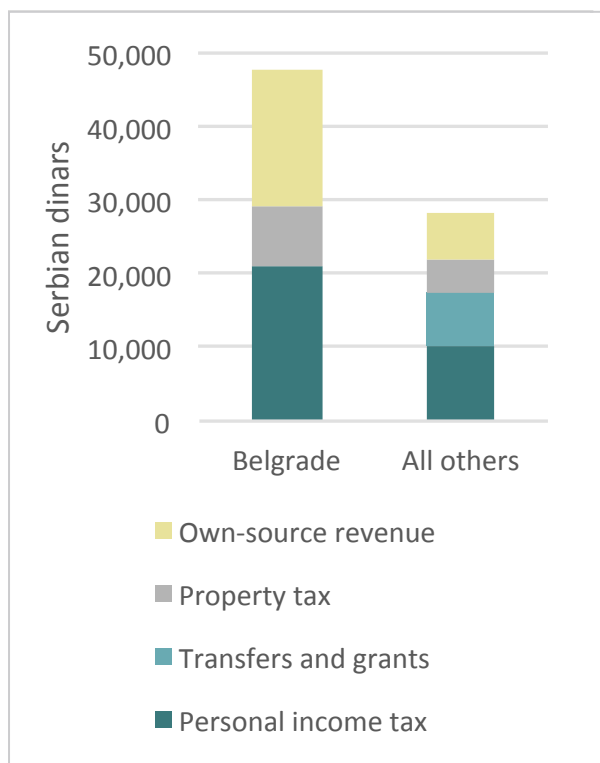


Figure 4.17 Per capita revenue for Belgrade and average for all other municipalities, by source

Source: For Belgrade, City of Belgrade Official Gazette (2018); for all others, North Macedonian Ministry of Finance. (<https://www.finance.gov.mk/en/node/6915>).

Note: The average of all other jurisdictions in panel A is calculated as the sum of their revenues divided by the sum of their populations; calculating the average per capita revenues of each municipality would yield a larger discrepancy.



Figure 4.18 Per capita revenue for Tirana and average for all other jurisdictions, by source

Source: Financat Vendore database (<http://www.financatvendore.al/data/revenues>)

Outside of leading metropolitan regions, local governments have limited capacity to generate their own revenues (figures 4.17 and 4.18). This is particularly a problem in low-income lagging regions, which have a limited local tax base, exacerbated by property rights issues that limit its potential. For example, in 2017, Diber and Kukës generated less than 7 percent of revenues locally⁷³. Moreover, 70 percent of the 94 percent of their revenues that came as transfers from the Albanian government were earmarked for specific, centrally determined purposes⁷⁴. Some equalization is also ensured by shared taxes (taxes on small businesses, used vehicles, and transfers of property rights). By contrast, Tirana generates more than 60 percent of its revenues locally.

Many lagging regions have substantial natural resources, but mineral rents (taxes and royalties are paid directly to the national government, and local governments receive no revenues from hydropower projects within their jurisdictions. Diber and Kukës, for example, are rich in both minerals (chrome) and water resources (hydropower). This has the potential to generate local revenue streams, but revenue reforms are needed to make that possible. Options to raise local revenues linked to these resources could include allowing local governments to tax companies directly for local impact and operational costs linked to natural resource exploitation, increasing the shared part of the mineral rent and place-based criteria for distribution, extending the mineral rent to water resources, and creating a dedicated fund for investment in municipalities to compensate for environmental damage from industrial activities.

A high priority throughout the Western Balkans is to strengthen the technical capacity of local governments to develop and manage economic and investment plans and manage public finances. These measures are essential to ensure that any additional revenues can be used effectively, especially in contexts like Albania that are working on fiscal consolidation. This includes building up planning and public investment management capacity to ensure that investments are made with a clear understanding of both expected economic impacts and the costs to maintain infrastructure to ensure continuing effective service delivery. This can be supported by adopting performance-based budgeting, which links financing to outcomes-based delivery targets rather than just to spending, and by introducing and strengthening independent monitoring of projects. Moreover, efficiency gains should be sought through improvements in revenue administration and the quality of service delivery before introducing new taxes and fees, which risk negatively impacting the environment for private investment in lagging regions.

Decentralization is in process in one form or another in most countries in the region, and reforms or changes to the laws continue. Although these aim in principle at strengthening the mechanisms for multi-level governance and delivering sustainable fiscal systems, the local impact may not always be as expected.

In Albania, for example, recent decentralization under the Law on Local Self-governance has aggravated both the technical and fiscal challenges of dealing with lagging regions by (a) expanding their spatial responsibilities, including coverage of many sparsely populated municipalities; and (b) assigning local governments responsibility for a new set of “exclusive” competencies, including pre-university dormitories, social centers, preschool education buildings, maintenance of school buildings, salaries and training of preschool staff, salaries for support staff in pre-university education, irrigation and drainage, fire protection, forest administration, and rural roads, among others. The new law on local finances stipulates that unconditional transfers must be not less than 1 percent of GDP and not less than the level in the previous year. Before the reform in 2015, unconditional transfers averaged 0.8 percent of GDP; in 2018 they accounted for about 1.3 percent. Some local governments have indicated that they do not have sufficient current resources to cover more responsibilities and invest in infrastructure. Although this has to be seen in the context of national and local fiscal consolidation, the lack of resources may jeopardize the provision of quality municipal services, which is already an issue in lagging regions.

Beyond financing, the centralized development models common in the Western Balkans limit the ability of regions to direct their own development path. Letting local and regional authorities have some control of regional

endowments may enable them to identify niche opportunities and implement strategies to exploit them. Access to infrastructure and natural resources can be game-changing for lagging areas, but the lack of authority to decide about access and use may undermine these opportunities (box 4.7). However, the lack of capacity in local governments has been a major impediment, as is transparency in the prioritization of projects.

BOX 4.7

Lagging regions and the use of national endowments for local development

Kukës, the poorest region in Albania, has a large share of households on social assistance and a very limited economic base. Developing Kukës will require taking full advantage of all the resources and opportunities that become available to the region. Lack of control over some of the region's main endowments has had negative impacts on regional development. For example:

- **Natural resources.** Kukës hosts several large mining projects and an estimated 12–14 hydropower plants. Hosting these projects has both direct costs (impacts on local roads, which the local government is responsible for maintaining) and indirect ones (negative impacts on tourism and agriculture, the mainstays of the regional economy). Yet there has been a lack of clarity on how the mineral rent, a 5 percent tax paid to the national government, is shared with municipalities, and transfers have been unpredictable. Moreover, the tax on environmental pollution is low, and often companies do not compensate local authorities. Kukës, like all districts and municipalities in Albania, receives no rent or compensation from the hydropower projects.
- **Kukës Airport.** A new airport was completed in 2013 as a gift from the United Arab Emirates “to the people of Kukës.” It was hoped that the airport would create employment opportunities and help to realize the region's tourist potential. Yet due to exclusive national agreements on airport concessions, the airport has never become fully operational.
- **Motorway tolls.** The Kukës–Durrës road was completed in 2010, greatly improving connectivity to Tirana and Durrës. However, in 2018, a toll was introduced just outside Kukës by a national public–private partnership. While this decision may have been critical to ensure financial sustainability of the investment, it greatly raised the cost of using the road for local residents and businesses.

Coordination and collaboration

Effective institutional coordination between local governments and national ministries is critical for delivering on development opportunities in lagging regions. So, too, is coordination across local governments, particularly for drafting and carrying out strategic and public investment plans that cut across local government boundaries.

Territorial coordination in lagging regions can be particularly important so that they can reap scale economies and to ensure management of spillovers (positive or negative) from the actions taken in any single jurisdiction. Effective coordination can be achieved through a combination of bottom-up instruments based on local government needs and top-down instruments imposed by national government, depending on the regional context and the issues to be addressed. Western Balkans countries may need to establish a means for greater bottom-up coordination, both to support development and investment planning activities and to coordinate specific regional development programs and projects, including sectoral initiatives. Croatia has recently introduced Development Agreements to support regional development. These use a contractual agreement to help coordinate plans and align and prioritize resources; they have been effective elsewhere in the world to address challenges in central-local coordination, local planning, and delivery of priority investments. They may also be useful for the Western Balkans to consider.

Finally, the capacity of local governments and other stakeholders to form cohesive, sustainable coalitions for local economic development varies. In lagging regions, these coalitions tend to be weak and unrepresentative. In Albania, business networks consist mainly of nongovernmental organizations or associations that, although dynamic and linked to international stakeholders, have had limited impact on local public investment. This is less because local governments are unwilling to interact with local businesses and listen to their concerns and more because complicated regional political patterns demonstrate that small business have little economic influence compared with the influence of major investors, particularly in natural resources. In Serbia, Zrenjanin evidences close cooperation on urban development, promotion of skills, and support for socially disadvantaged groups among the chamber of commerce, the local government, foreign investors, the StartIT Center, and the association of large businesses (Zrepok, whose members represent 25 percent of GDP in Central Banat). Reaching out to the university and dynamic start-up associations to target young entrepreneurs could strengthen the ability of these coalitions to attract young people to Zrenjanin and advance sustainable economic development. In similar contexts, such as Abruzzo in Italy, Dolnoslaskie in Poland, and Galicia in Spain, efforts to further academic tourism, invest in research and development on employment, strengthen trade unions, bridge social capital, and establish links with other growth poles have supported development (box 4.2).

Endnotes

¹ It is important to note that firm-level analysis has certain limitations. In cases where the headquarters and production facilities/branches are located in different cities, it is tricky to disentangle the two with the available data, so the location of the headquarters is used.

² With the available data, it is not possible to see how much the benefits of agglomeration are linked to compositional differences in the workforce (the sorting effect where skilled labor chooses to live in denser areas with better amenities), and how much is linked to locational effects and impacts of the enabling environment. Empirically understanding the extent to which density itself drives productivity would require deeper analysis.

³ The results remained the same even after removing the second densest city- Split.

⁴ This chapter does not include Croatia in in the analysis.

⁵ World Bank 2018c.

⁶ World Bank 2018b.

⁷ EBRD 2016.

⁸ Bussolo et al. 2019.

⁹ 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.

¹⁰ Bussolo et al. 2019. At the NUTS 2 level.

¹¹ Dávalos and Thomo 2016; World Bank 2016.

¹² Small area estimation of poverty in Croatia shows a similar range of variation in the poverty headcount across municipalities. <http://www.worldbank.org/en/news/infographic/2016/10/19/croatia-mapping-poverty>.

¹³ Bussolo et al. 2018.

¹⁴ Richer and poorer subnational regions are those with mean per capita consumption or income above or below the national average.

¹⁵ Richest and poorest subnational regions are those with the lowest and highest mean per capita consumption or income at the regional level.

¹⁶ World Bank (forthcoming).

¹⁷ Albania Institute of Statistics 2018.

¹⁸ World Bank 2018a.

¹⁹ EBRD 2016a.

²⁰ Bussolo et al. 2018.

²¹ Arias et al. 2014; Bussolo et al. 2018.

²² Jandric 2019.

²³ The analysis uses latest available population data from national statistical offices. Given known caveats with data, the analysis avoids where possible to report changes in population over time.

²⁴ Lakner and Milanovic 2013.

²⁵ Bourguignon and Morrisson 2002.

²⁶ Duranton and Puga 2004.

²⁷ Feldman 1994; Verspagen 1997.

²⁸ Farole, Goga, and Ionescu-Heroiu 2018.

²⁹ Farole, Rodríguez-Pose, and Storper 2011a.

³⁰ Aghion, Alesina, and Trebbi 2004.

³¹ At the Eurostat Nomenclature of Territorial Units for Statistics level 3 (NUTS 3) regional classification, the most disaggregated.

³² Regional output data for Serbia are available at the NUTS 3 level only for gross value added and at the NUTS 2 level for GDP.

³³ Kukić 2017.

³⁴ Protner and Vujisic-Zivkovic 2015.

³⁵ While Croatia is the only Western Balkan country that is already an EU member, association agreements are in place with the others. Moreover, the European Union is by far the largest trading partner and source of investment for all countries in the region.

³⁶ Farole, Goga, and Ionescu-Heroiu 2018.

³⁷ To allow for comparison across countries, income is based on 2015 GDP per capita in euros at purchasing power standard. Growth is measured as the change in gross value added per capita over 2010–15 in constant terms using national currencies. Growth in Serbia is measured over 2013–16, the only period with comparable data.

³⁸ In the European Union, low income lagging regions are defined as NUTS 2 regions with GDP per capita below 50 percent of the EU average; low growth regions are those with GDP per capita below 90 percent of the EU average that have failed to converge toward the EU average over the past decade. Given a short time period of data, “low growth” needs to be considered as a rather recent development than a longer trend.

³⁹ The variation in regional growth performance in Albania, North Macedonia, and Serbia appears to be much greater than in most EU countries.

⁴⁰ Some other regions are just on the edge of this categorization, including Shkoder and Vlore (Albania) and Toplica and Pomoravlje (Serbia).

⁴¹ The correlation between employment and net migration is above 60 percent for Albanian regions and 85 percent for Serbian regions, despite lower overall migration. In North Macedonia, however, the relationship between employment outcomes and migration is weak.

⁴² This policy recommendations in this section derive in large part from the case studies carried out in Albania and Serbia, although they are intended to be relevant across the region.

⁴³ Barca 2009; Farole, Goga, and Ionescu-Heroiu 2018.

⁴⁴ World Bank 2009.

⁴⁵ Braşov, Cluj-Napoca, Constanţa, Craiova, Iaşi, Ploieşti, and Timişoara.

⁴⁶ Cristea et al. 2017.

⁴⁷ While Diber and Kukës have the lowest population density among lagging regions in Albania, Gjirokaster (not a lagging region) is even less densely populated.

⁴⁸ World Bank 2017.

⁴⁹ OECD 2008.

⁵⁰ Cantos, Gumbau-Albert, and Maudos 2005; Herranz-Loncán 2007.

⁵¹ OECD 2018; Farole, Goga, and Ionescu-Heroiu 2018.

⁵² Barrell and Pain 1999; Chidlow, Salciuviene, and Young 2009.

⁵³ There has been rapid growth in enterprise formation in Albania, particularly in many lagging regions, since 2015, when the government initiated a policy to reduce informality.

⁵⁴ Farole et al. 2017.

⁵⁵ World Bank 2018.

⁵⁶ Harmonized learning outcomes, which draw from standardized testing scores, particularly from the Programme for International Student Assessment (PISA).

⁵⁷ The PISA index of economic, social, and cultural status collects household socioeconomic data to allow for better comparisons between students and schools with different socioeconomic profiles.

⁵⁸ Ferreira 2011.

⁵⁹ Materu 2007; Caniëls and van den Bosch 2011.

⁶⁰ Etkowitz and Klofsten 2005; Puukka and Marmolejo 2008.

⁶¹ World Bank 2007.

⁶² Charron, Dijkstra, and Lapuente 2014.

⁶³ Milutinovic and Jolovic 2010.

⁶⁴ Del Monte and Papagni 2001.

⁶⁵ Farvacque-Vitkovic and Kopanyi 2014.

⁶⁶ Lupu and Asandului 2015.

⁶⁷ Tridico 2007; Churski 2014.

⁶⁸ Hulbert and OECD Secretariat 2012.

⁶⁹ d'Agostino and Scarlato 2015.

⁷⁰ Regional development authorities (RDAs) cover one, two, or in a few cases three NUTS 3 regions. A few cover functional spaces across NUTS 3 regions, such as the Sandzak Economic Development Agency, which works from Novi Pazar; RDA Panonreg, from Subotica; and RDA for Podrinje, Podgorina, and Rađevina, from Loznica.

⁷¹ In practice, the program supporting “balanced regional development” focuses on developing agricultural cooperatives and supporting village or rural community development.

⁷² Crescenzi 2005; Ramirez de la Cruz 2009; Farole, Rodríguez-Pose, and Storper 2011b.

⁷³ Based on Financatvendore data.

⁷⁴ Shutina, Boka, and Toto 2016.

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Annex 4A: Leading and lagging regions by country

CROATIA		NORTH MACEDONIA		ALBANIA		SERBIA	
Low income, diverging (4)		Low income, diverging (1)		Low income, diverging (3)		Low income, diverging (3)	
Brod-Posavina	sparse peripheral	Polog	dense central	Elbasan	sparse central	Podunavlje	dense central
Požega-Slavonia	sparse peripheral			Kukës	sparse peripheral	Rasina	sparse central
Sisak-Moslavina	sparse central			Shkodër	sparse peripheral	Raška	sparse peripheral
Virovitica-Podravina	sparse peripheral						
Low income, converging (3)		Low income, converging (1)		Low income, converging (3)		Low income, converging (7)	
Bjelovar-Bilogora	sparse peripheral	Northeast	sparse central	Dibër	sparse peripheral	Jablaniča	sparse peripheral
Krapina-Zagorje	sparse central			Korcë	sparse peripheral	Mačva	sparse central
Vukovar-Srijem	sparse peripheral			Lezhë	sparse central	Niš	dense central
						Pčinja	sparse peripheral
						Pomoravlje	sparse central
						Topliča	sparse peripheral
						Zaječar	sparse peripheral
Low growth (1)		Low growth (2)		Low growth (1)		Low growth (4)	
Koprivnica-Križevci	sparse peripheral	East	sparse peripheral	Vlorë	sparse peripheral	Bor	sparse peripheral
		Pelagonia	sparse peripheral			Braničeva	sparse central
						North Banat	sparse central
						Central Banat	sparse central
Leading (13)		Leading (4)		Leading (5)		Leading (11)	
Dubrovnik-Neretva	sparse peripheral	Southeast	sparse peripheral	Berat	sparse peripheral	Belgrade	dense central
Zagreb City	dense central	Southwest	sparse peripheral	Durrës	dense central	South Bačka	dense central
Istria	sparse peripheral	Skopje	dense central	Fier	dense central	South Banat	sparse central
Karlovac	sparse central	Vardar	sparse central	Gjirokastër	sparse peripheral	Kolubara	sparse central
Lika-Senj	sparse peripheral			Tiranë	dense central	Moraviča	sparse peripheral
Međimurje	dense peripheral					Pirot	sparse central
Osijek-Baranja	sparse peripheral					North Bačka	sparse central
Primorje-Gorski Kotar	sparse peripheral					Srem	sparse central
Šibenik-Knin	sparse peripheral					Šumadija	dense central
Split-Dalmatia	sparse peripheral					West Bačka	sparse peripheral
Varaždin	dense central					Zlatibor	sparse peripheral
Zadar	sparse peripheral						
Zagreb County	sparse central						

Source: Data from national statistics offices.







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