

# SGPTD

## Second Tier Cities and Territorial Development in Europe: Performance, Policies and Prospects

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**Executive Summary | Version 30/06/2012**



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## List of authors

### **European Institute for Urban Affairs, Liverpool John Moores University**

Professor Michael Parkinson

Professor Richard Meegan

Jay Karecha

Professor Richard Evans

Dr Gerwyn Jones

### **University of Tampere**

Professor Markku Sotarauta

Olli Ruokolainen

### **Metropolitan Research Institute, Budapest**

Dr Iván Tosics

Antal Gertheis

Andrea Tönkö

Dr József Hegedüs

Iván Illés

### **Institut Français d'Urbanisme, Université Paris-Est**

Professor Christian Lefèvre

### **University College, London**

Professor Sir Peter Hall



**The ESPON 2013 Programme**

## **EXECUTIVE SUMMARY**



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## 1. WHY DO SECOND TIER CITIES MATTER?

### *The Eurozone crisis, cities and economic competitiveness*

- 1.1 The global recession and Eurozone crisis have already had a huge impact upon the European economy and present even greater future threats. They have sharpened the existing debate about policies for competitiveness as policy makers struggle to make the European economy succeed in an increasingly turbulent, global world. They have also raised questions about the contributions that different territories make to national competitiveness. In particular they have encouraged a debate about the economic contribution of capital and non capital 'second tier' cities and whether countries perform better if they concentrate their investment in their capitals or spread investment across a wider set of cities. Recession in the property and financial services sectors have intensified debates in some countries about the need to rebalance their economies and raised questions about which economic activities should take place where in future. For national governments, they pose classic questions about the relationship between territory, economy and governance and the shape of regional and urban policy. For the European Commission, they pose key questions about strategic investment priorities – all of which are sharply reflected in debates about the future of the Structural Funds. The debate takes different forms in different countries, depending on the relationship between the capital and second tier cities. It is particularly, although not exclusively, significant in the new member states where capitals are especially dominant. It has already encouraged a more explicit and strategic territorial debate in many of those countries. But the issues are common to all countries. They have important implications for decisions about priorities and funds, at national and European level. They raise the question: why should policy makers invest beyond the capital cities in an age of austerity? This report argues they should.
- 1.2 It argues that continuing over-investment in capital cities and under-investment in second tier cities in the long run could be unsustainable and lead to economic under performance. It argues that although individual countries face different circumstances, European, national, regional and city regional leaders should exploit the policy levers, tools and resources they have to encourage more higher performing second tier cities if they want higher performing national and European economies. Given the complexity of the relationships, the range of places and the quality of available data, the report does not claim to provide absolute proof of the arguments. These are necessarily matters of judgement and interpretation. But, it presents a huge amount of compelling evidence from quantitative data analysis, policy reviews and individual city studies that point in the same direction. They cumulatively demonstrate that policy makers should take these issues more seriously in future and systematically examine how their decisions affect second tier cities.

### *What are second tier cities?*

- 1.3 We define them as those cities outside the capital city whose economic and social performance is sufficiently important to affect the potential performance of the national economy. It does not imply that they are less important than the capital cities. And second tier cities are not all the same – they vary enormously. Sometimes they are very large regional capitals. But many are much smaller. However, despite individual differences, second tier cities can play similar roles in their national economic systems. The 124 second tier cities in this study constitute almost 80% of Europe's metropolitan urban population. They lie between the capital cities which contribute a huge amount to their national economies and the many smaller places which contribute rather less. They are the crucial middle of the urban system. Selecting the second tier cities was not straightforward. It involved many technical and substantive issues. We decided to use the boundaries developed by the OECD and DG Regio for metro regions, especially since these are used in the *5th Cohesion Report*.

### *The economic and fiscal crisis makes the policy issues more pressing*

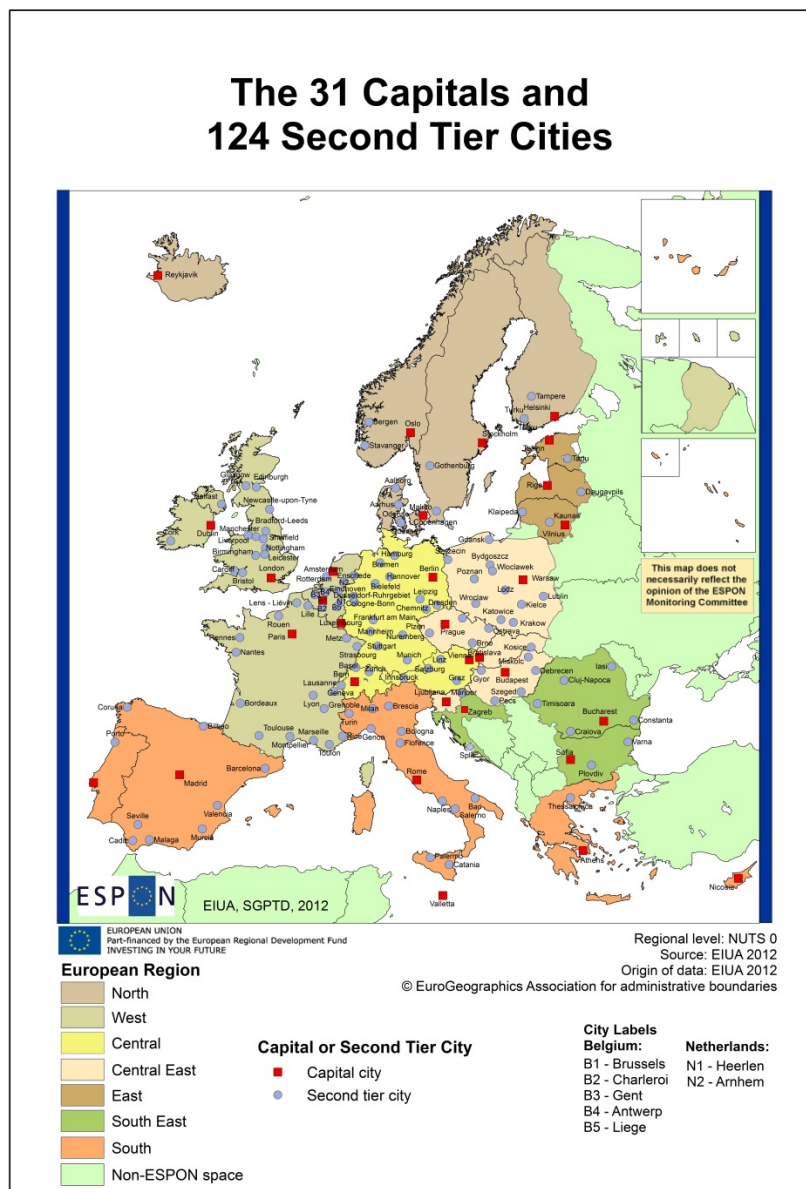
- 1.4 The policy debate about the role and contribution of capital and second tier cities will become more important during the next decade as economic recession and fiscal problems threaten to undermine the real achievements recently made by many second tier cities in Europe. In the past decade, second

tier cities in many countries improved their economic performance and made a growing contribution to national economic welfare. But it was a result of high performing national economies and substantial investment of public resources. Those conditions will not be found during the next decade. There is a risk that economic and fiscal problems and the competition for scarce public and private sector resources will limit the growth of second tier cities and widen economic and social gaps within them - and between them and the capitals. Declining public resources means it is crucial that governments are more transparent and explicit about their territorial investment plans and show how and why they invest public resources in different places, especially capital or second tier cities.

**How does this report contribute to the policy debate in Europe?**

1.5 This report assesses the performance of, policies for and prospects of second tier cities across Europe. It is based on a wide range of evidence: literature, interviews with policymakers and researchers, reviews of national policies, quantitative data about 124 secondary and 31 capital cities across 31 countries and detailed studies of 9 second tier cities: Munich, Barcelona, Turin, Tampere, Cork, Leeds, Lyon, Timisoara and Katowice. Map 1 identifies the 155 cities.

**Map 1: The 31 Capitals and 124 Second Tier Cities in this study**



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***At the start of this summary, what key policy messages?***

- 1.6 Some second tier cities make a substantial contribution both to national economic development and to the European economy itself. But others could do more. In most countries, second tier cities do not contribute as much to national economic performance as capital cities. But they could contribute more if they were given greater European and national policy support, tools and investment. It has been argued that there is no need for government intervention because the market itself will lead to increased investment in second tier cities as the costs of growth in the capital become more obvious and the opportunities in second tier cities become equally obvious. But our analysis does not support that view. The logic of over investment in the capitals and under investment in second tier cities has been shown to be too strong in too many countries in this study. There are three simple policy messages for governments. The first is for regional and city region leaders. City regions which strategically mobilised and exploited their assets flourished more in the boom years and are more likely to do better in the economic crisis. Increasing strategic governance capacity to deliver economic place-based policies at city region level must be a key target for all partners. The second message is for national governments. If they strategically invest in second tier cities they are more likely to maximise the economic potential of the national economy than if they concentrate all resources in the capital.
- 1.7 The third policy message is for the European Commission. City regions are crucial to the delivery of its strategic goals identified in *EU2020*. It must take city regions - and their leadership - more seriously in future. Commission policy for cities has varied in recent years and the economic place-making agenda has fluctuated in its significance. Many in this study believe the issues have slipped down the Commission's agenda in recent years and should be reasserted. The Commission needs to exercise leadership and provide clarity and resources in this field.
- 1.8 So for policy makers at all government levels - European, national, regional and city regional - the message is clear. Strong capitals matter to nation states' global positioning and competitiveness. However, strong second tier cities also matter. Both capital and second tier cities must be supported in future. It is a win-win, not a zero sum relationship. Governments at all levels should help second tier cities so they can emerge from the current recession with more 'investment ready' places to maximise future national economic performance. Now is the time to prepare for recovery from recession. The individual circumstances of countries, regions and city regions will vary and so will policy responses. But some general principles about investment apply. **Specifically governments should invest more in second tier cities when: (i) the gap with capitals is large and growing (ii) the business infrastructure of second tier cities is weak because of national underinvestment and (iii) there is clear evidence about the negative externalities of capital city growth. The stakes and the potential rewards are high.**

## **2. WHAT KEY ARGUMENTS AND FINDINGS?**

- 2.1 The logic of our study was to: (i) review the literature to generate a set of key arguments about second tier cities; (ii) collect a range of quantitative and qualitative data to test those arguments (iii) weigh the evidence to determine the strength of those arguments; and (iv) make a set of policy recommendations to European, national, regional and city regional policy makers in the light of our evidence and analysis. The report examines five key arguments about the performance and prospects of second tier cities and urban policy across Europe. We derived these arguments from a review of a wide range of literature - discussed at length in the Scientific Report - but also from discussions with senior policy makers. We test them in detail in our case studies, policy reviews and in our quantitative data analysis to see the extent to which they explain the performance of the cities in this study. The five arguments follow below.

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- 2.2 **National policies and governance matter.** The performance of second tier cities is significantly affected by national government policies - implicit or explicit, direct and indirect. Explicit urban policies – those which specifically focus on particular territorial targets - as well as mainstream policies for infrastructure, skills, investment, connectivity, research and development which have less explicit territorial dimensions - all affect the ways in which cities perform. Countries whose governments pay more attention to the territorial and urban impacts of those policies will have higher performing cities and national economies as opposed to those who do not.
- 2.3 **Deconcentration of investment and decentralisation to places matter. But mature national-local relationships are also crucial.** The second argument is that deconcentration of investment and decentralisation of decision-making and resources will lead to more high performing second tier cities. Institutional and financial decentralisation from national to regional and urban government will reduce the costs of overconcentration on the capital and maximise the contribution of second tier cities to national competitiveness and welfare. However, two conditions must be met for this to happen. First, national governments must provide second tier cities with the powers, resources and capacity needed to deliver these responsibilities. Otherwise they will be programmed to fail. In other words, there must be real not symbolic decentralisation. The second condition is that national governments cannot abdicate responsibility for the successful delivery of those policies. That requires significant institutional and political maturity.
- 2.4 **Local factors - especially leadership - matter.** Cities are constrained by external factors - historical, cultural, structural, political and institutional. But those factors can be shaped. Places that start in similar economic and social positions often have very different development trajectories. The economic performance of cities will depend upon their strategic capacity to manage their constraints and maximise their city assets to be successful. Leadership can come from a variety of sectors – the public, private and third. Usually a combination of all three is necessary. It will draw upon a range of assets – political, financial, territorial, institutional and intellectual. The scale and quality of leadership is not finite but can be increased. Although individual players can make a difference, leadership is essentially a systemic not a personal quality. It is a process and a relationship. Leadership is the institutional mobilisation of all resources and partners to deliver successfully agreed long term ambitions through systematic, coherent strategies and policies. Leadership needs vision, strategy, governance, partnership, policy capacity and delivery.
- 2.5 **The key drivers of territorial performance are: innovation, economic diversity, skills and human capital, connectivity, place quality and strategic governance capacity.** City regions' performance on those drivers shapes their trajectory. Again we derived these drivers from a review of a wide range of academic literature which is discussed in the Scientific Report as well as with conversations with senior policy makers. Judgments about the key drivers of urban success vary. Other studies have used some different or additional drivers. We considered but did not include them. But there is a broad consensus amongst both researchers and policy makers that these six are significant. The first four are the 'harder', most quantifiable and probably the most significant drivers. The final two – place quality and governance capacity - are softer, less quantifiable. Nevertheless they remain important. National and local policies on those key drivers are crucial. The drivers that can be most directly influenced at city-regional level are place quality and strategic capacity. The others – innovation, human capital, economic diversity and connectivity – are more directly influenced by European, national and regional policies. Influencing these drivers demands successful multi-level governance.
- 2.6 **Territory and places matter more not less in a global world.** Globalisation makes the governance capacity of place more important. It means that governance will be increasingly multi scalar. It also means that economic governance should be located at the widest achievable spatial level, preferably the city region. It also emphasises that second tier cities need explicit strategies to shape the different territorial roles they play at regional, national and European level.
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**WHAT KEY FINDINGS?**

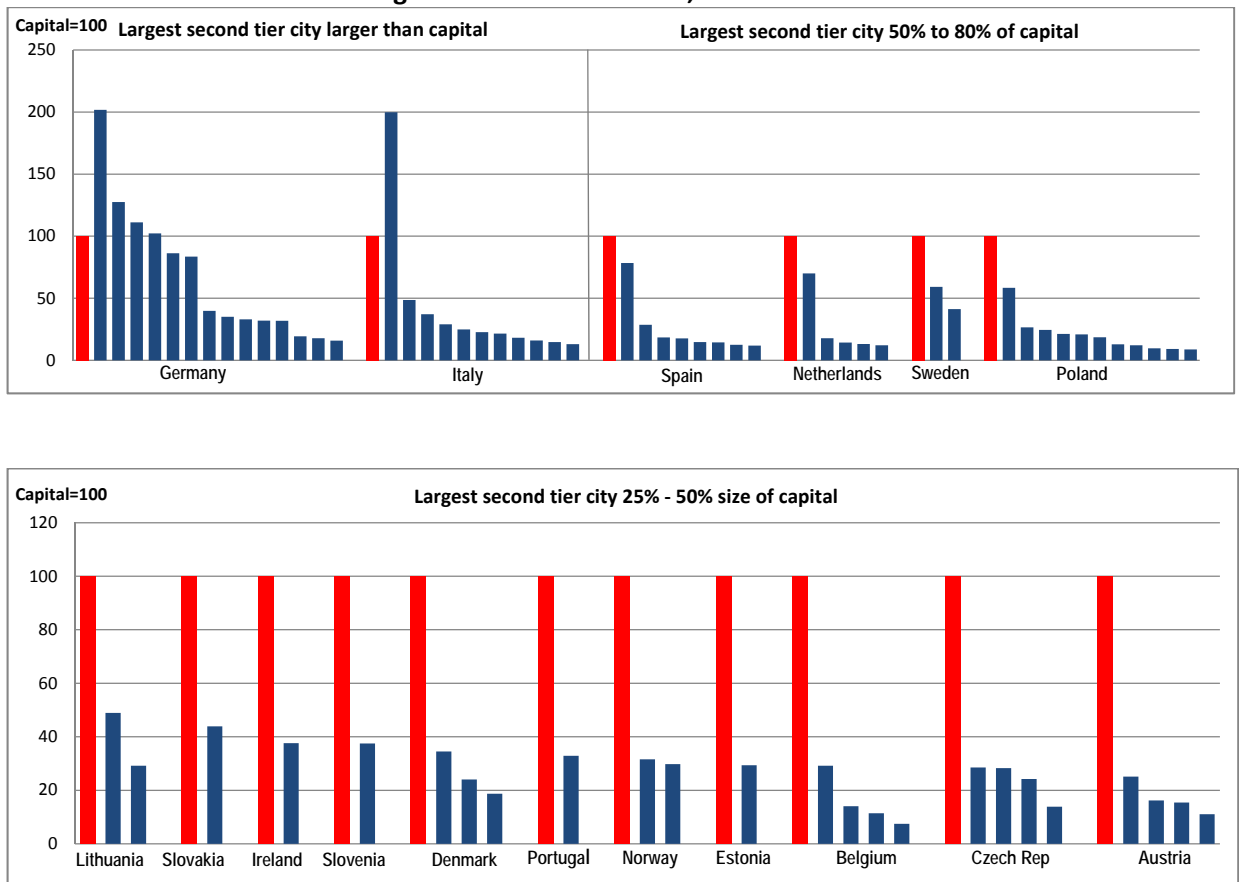
**2.7 What economic contribution do capitals and second tier cities make?**

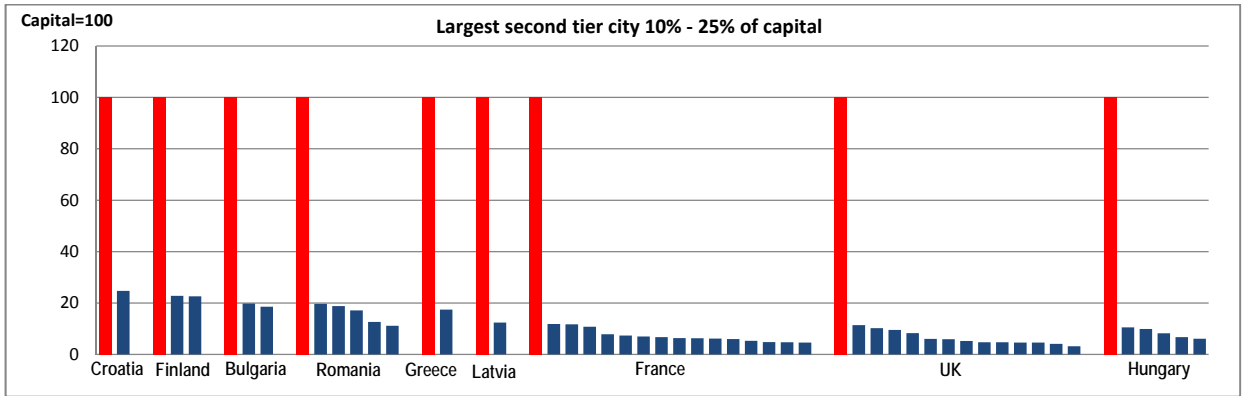
The report provides a lot of complex information. But two key features stand out. First in too many countries, the capital city plays a huge role in the national economy and second tier cities do not contribute enough. But in some they contribute much more. The second feature is that during the boom years many second tier cities improved their economic contribution dramatically and often grew faster than their capital cities. Given the right support they contribute a lot.

**The economic baseline. Capitals lead in many but not all countries. But second tier cities matter.**

**2.8** Capitals dominate their national economies. The total GDP of the capitals exceeds that of their leading second tier cities in all but 2 countries, Germany and Italy. Nevertheless, 12 of the top 28 European cities are second tier. Figure 1 shows the size of the gap between the GDP of the capital and the leading second tier city by country. Germany and Italy are the only member states where the largest second tier city has a GDP bigger than the capital. In Spain, Netherlands, Poland and Sweden the GDP of the most significant second tier city is between 50-80% that of the capital. In 11 countries the GDP of the largest second tier city is between 25 and 50% that of the capital- Ireland, Denmark, Portugal, Norway, Belgium and Austria and from the new member states - Lithuania, Slovakia, Slovenia, Estonia and Czech Republic. In Croatia, Finland, Bulgaria, Romania and Greece capitals dominate with the GDP of the largest second tier less than 25% of the capital. Capitals are most dominant where the largest secondary produced only 10-15% of the GDP of the capital. These include the UK and France where London and Paris dominate because of their global city status and the highly centralised states of Hungary and Latvia.

**Figure 1: Total GDP in PPS, 2007**



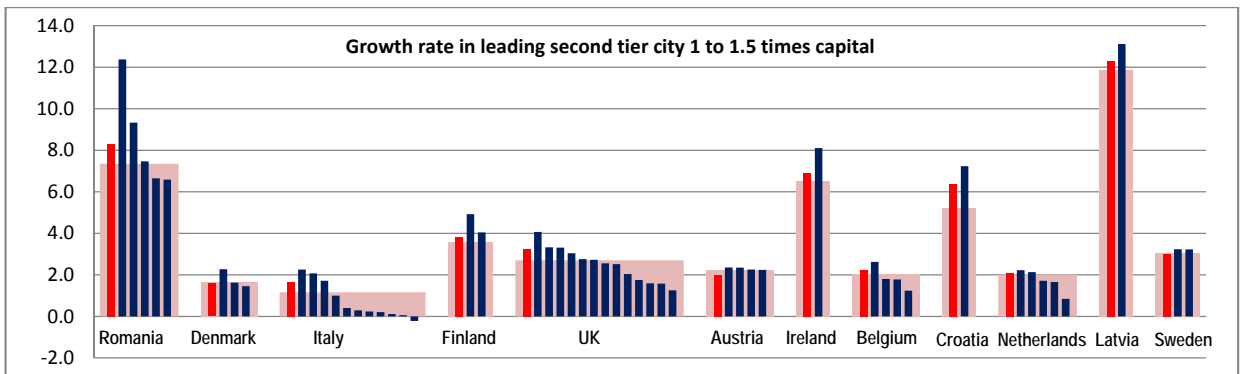
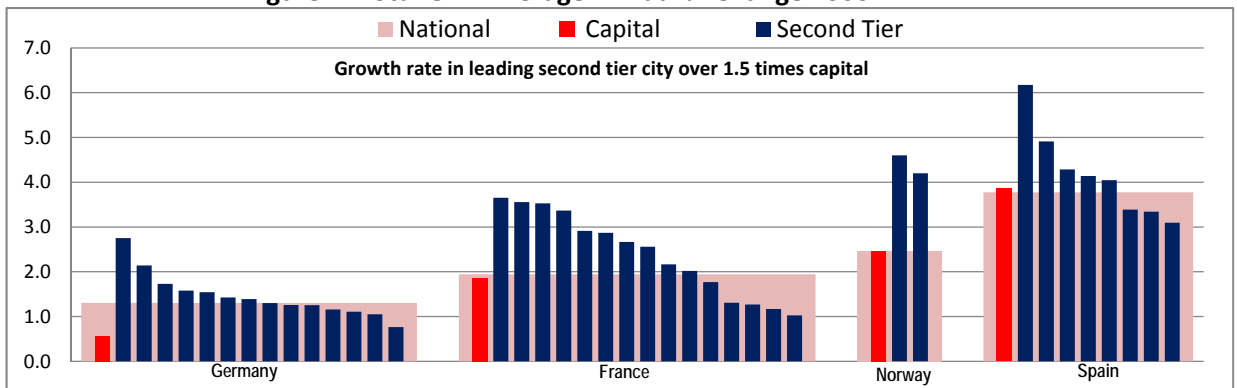


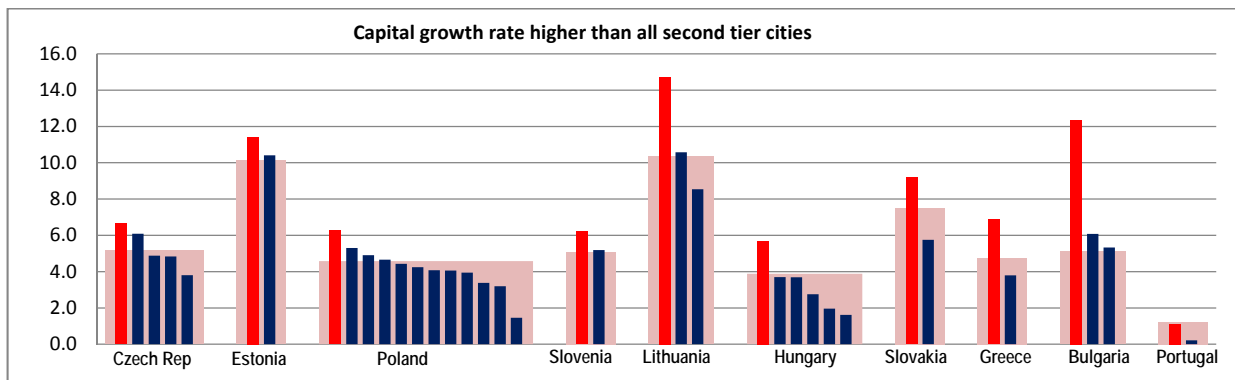
Source: Eurostat

**Change in the boom years. Second tier cities closed the gap in some but not all countries.**

2.9 Structurally, capitals dominate their national economies. But change is also important. And many second tier cities improved their position in the boom years 2000-7. In 16 of the 26 countries, 1 or more second tier cities had annual GDP growth higher than their capitals. In Austria and Germany, all second tier cities outperformed their capitals. The relatively strong growth rates in a number of capitals and second tier cities in eastern Europe, as their economies integrated into the European economy, also stand out. Indeed, the highest growth rates over this period were there.

**Figure 2: Total GDP Average Annual % Change 2000-7**



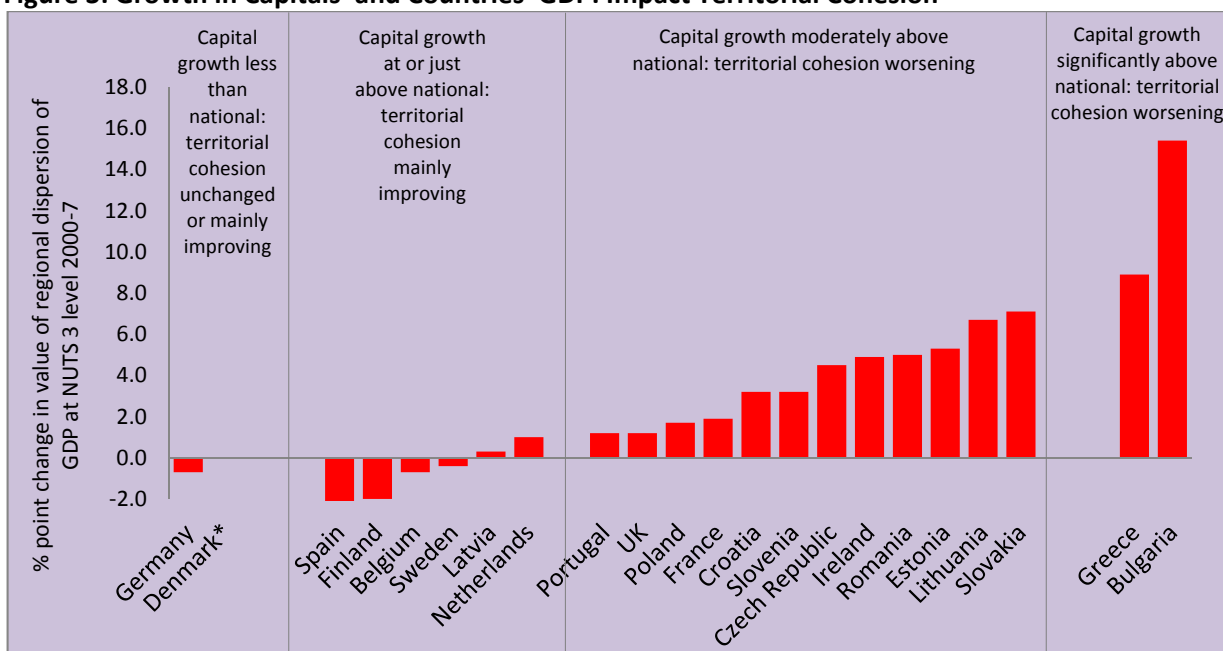


Source: Eurostat

### Impact of capital city growth on territorial cohesion

2.10 The growth in GDP of capital cities has an important impact upon territorial cohesion. Figure 3, which uses regional dispersion of GDP as one indicator of cohesion, shows the relationship. High GDP growth in capital cities is associated with worsening territorial cohesion. In countries where the growth of the capital city was either lower than or just above national growth, territorial cohesion improved or remained unchanged. This was the case for federal Germany and Belgium, Nordic Denmark, Finland and Sweden, and regionalised Spain. By contrast, in countries where the growth of the capital was moderately or significantly above the national rate, territorial cohesion worsened.

Figure 3: Growth in Capitals' and Countries' GDP: Impact Territorial Cohesion



Source: Eurostat; Notes: 'At or just above' refers to indexed growth rate of 1.00-1.10; 'moderately above' 1.11-1.50; 'significantly above' 1.51-2.50; \* Regional dispersion is unchanged in Denmark.

## 3. POLICIES, PERFORMANCE AND PROSPECTS

### The relationship between capitals and second tier cities

3.1 Although most capitals dominate second tier cities, the size of the gap varies and in some cases is declining. Also many second tier cities have successfully restructured their economies and are making a growing contribution to national prosperity. In terms of policy, some countries concentrate attention and resources on the capitals at the expense of their second tier cities. But many are beginning to develop policies which explicitly target them. More widely, in some countries mainstream national policies which implicitly affect urban competitiveness - innovation, diversity, skills and human capital, connectivity, place quality and strategic governance capacity - have been used to

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help second tier cities develop. Most interestingly, in countries which are less centralised and less economically concentrated, and where cities have greater powers, resources and responsibilities, cities have performed better and helped the national economy more.

***The boom is over – but some countries hit harder than others***

- 3.2 The crisis had a very varied territorial impact between and within countries in terms of output, employment and unemployment and in government fiscal balances and debt levels. If we examine national GDP growth rates over the crisis period, 2007-2010 for 33 European countries, there are some striking differences. In the EU27 GDP fell by just over 2%. Of the 33 countries, GDP fell in two thirds, in a number of cases quite dramatically. Standing out clearly are the large declines in the Baltic States - Lithuania 11%, Estonia 16%, Latvia 21% - and Ireland 10%. Poland is an exception since it has continued to perform impressively. It also clear that the crisis is a moving target with some stabilisation and recovery. For example during 2010-11, nearly 90% of countries increased GDP, if only by a small figure. The largest increases were in Turkey with 8.5%, Estonia 7.6%, Lithuania 5.9%, Latvia 5.5%, and Poland with 4.3%. But Greece's GDP declined by 6.9%.

***The crisis threatens to undermine achievements of second tier cities***

- 3.3 Many second tier cities performed well during the boom years when they had national government support and investment. But the recession has had a major impact on many of them - in particular those which flourished during the boom decade. Unemployment has increased dramatically. For example, only 4 capital cities had unemployment above 8% in 2007. In 2009 11 had. Of the second tier cities, 26 had unemployment over 10% in 2007. But by 2009 the number had increased to 47. Some such cities were holding up relatively well, however. In 2009 36% had lower rates of unemployment than their capitals and 48% had lower than their national rates. More than 75% of the cities experienced GDP falls in 2007-9. Capitals performed far better than second tier cities during the crisis. The better performing places were in Eastern Europe and in Poland in particular. The fastest growing 19 places – 12 Polish - were all in Eastern Europe. The Baltic cities were heavily hit. Major Western European countries have all been hit. In Germany only Berlin grew. All German second tier cities' GDP declined. In the UK all 14 second tier cities declined. In Italy all 12 and in Spain 8 of 9 second tier cities declined.

***Risk of increased gaps between second tier and capital cities***

- 3.4 Although the crisis is still unfolding, there is evidence that the GDP gap between capitals and second tier cities, which closed in many countries during the boom years, has begun to reopen. More generally there is a risk that the gap between the more and less successful cities across Europe will widen in the future. There will be intense competition between places for limited public and private investment in the coming years. There is a risk that private and public investment will focus on already successful cities which have better economic prospects. Because of this risk, national governments should be more explicit in their territorial investment strategies in the future than they have been in the past.

***Good governance - shared responsibilities and clarity of roles***

- 3.5 The key governance issue is not simply the division of powers and resources. It is also the extent to which responsibilities are shared and roles are transparent or confused. Cities' financial capacity, in particular the extent to which they rely upon national grant, transfers and financial equalisation or can raise their own revenue, also affects national policy impacts. In some cases, centralisation of power is exacerbated by the lack of strong, democratically elected regional government and fragmented metropolitan governance. In other cases, cities in decentralised states were in virtually the same position as those in centralised unitary states because decentralisation of responsibilities has not been matched by the decentralisation of financial resources.

***Governments' mainstream money matters most***

- 3.6 Mainstream policies matter more to second tier cities than explicit urban policies for three reasons. First, national governments' mainstream programmes dwarf financially explicit, area based initiatives

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which specifically target 'urban' problems. They affect cities much more significantly through education and skill, research and development, transport, housing, planning and business support. Second, many explicit urban programmes are more concerned with poverty and social cohesion than urban competitiveness and performance. Third, there is often a large gap between strategy and implementation in explicit programmes because of limited resources, siloed policymaking and fragmented governance at city region level.

***Keys to success of national policies – local discretion, shared values, flexibility and trust***

- 3.7 National policies work best where there is collective understanding at different government levels of how different interventions affect cities and the right levers to pull to maximise performance. National policies are most effective where there is scope to shape them to local circumstances. This requires multi-level governance as well as human and fiscal capacity and autonomy at city level. Also the consistency, transparency and reliability of national policy are critically important because urban economic development is a long term business. Finally, the most robust policy systems are underpinned by a set of shared principles and values. These include: focusing upon business and community needs; understanding and responding to future urban challenges; reconciling strategic and local perspectives; trust, reciprocity and mutual respect.

***Long term investment is critical***

- 3.8 National resources and investment matter. Some national governments have directly funded major urban development programmes which have helped reshape second tier cities. The extent of national support has varied depending upon the state of national finances, policy priorities and the availability of European funding. Structural Funds have also strengthened the regional tier of government, benefiting second tier cities even in the highly centralised Eastern European states. Some national governments have focussed research funding on the best or most competitive research sectors which has also favoured some second tier cities. Tax incentives have boosted Foreign Direct Investment. Feed-in tariffs have stimulated the growth of environmental industries. Some cities have benefited from national government procurement because they contain key strategic industries. Others have benefited from Government jobs either because they are important administrative centres or because of decentralisation of civil service activity from capitals.

***Decentralisation of powers - AND resources - matters***

- 3.9 Levels of centralisation matter. But decentralisation of responsibilities to cities only works if responsibilities are matched by corresponding powers and resources. Cities perform better in those countries which are less centralised and economically concentrated and where cities have greater powers, resources and responsibilities. Many policy makers and researchers believe that, given the impact of deconcentrating resources and decentralising powers on second tier cities, national policies should give them more powers, responsibilities and resources. A policy of economic place making has benefited many cities. It underlines the potential for wider implementation in national and European policies in the future.

***Challenges to second tier cities will grow***

- 3.10 Many of the dilemmas cities now face will continue in future. In fact they will become even more challenging because of economic and institutional restructuring, national deficits and credit restrictions. Second tier cities will face many of the following challenges: maintaining competitiveness in the face of increasing competition from rival cities, changing markets and a more austere economic climate; reconciling competitiveness, environmental sustainability and social cohesion; attracting international investment and workers without losing identity; devising new ways of funding development; getting clarity from national governments about cities' future roles and resources; strengthening governance at city regional level to deliver integrated place-based policies. Meanwhile the urban world is changing around them.

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### ***Second tier cities in a global economy - the bar has been raised***

- 3.11 European cities will have to operate in a fast changing global context. For example, it has been estimated that 600 cities account for 60 percent of global GDP and Europe has 153 of them. But by 2025 the makeup of these cities will have significantly changed as the centre of gravity of global development shifts south and east. Over 130 new cities are forecast to move into the leading group. All are from the developing world - mainly from China but also India and Latin America. 9 of the top 25 cities will be in Asia. While London, Paris and Amsterdam city regions might consolidate their position, other European cities are expected to drop out of it. The cities that will move up the hierarchy are in the countries that have been relatively immune from the global recession and are part of a step-change in urbanisation caused by this new phase of economic development. Those with leading technology-based companies will benefit from the global trends because of their innovative edge. This will favour cities in the centre and north of Europe where these leading companies are based. Another distinctive feature of the new phase of globalisation is the incorporation of Africa. This shift could favour some southern European cities because of their historic political links with the continent and their geographical proximity. However, cities in Eastern Europe are threatened by massive population losses and threats to their future economic development. Europe's economy and its leading cities are entering a new phase of globalisation that will bring new economic challenges in addition to those identified in this report.

### ***What implications for ESPON?***

- 3.12 This project has identified some key analytical, policy and technical issues. Many would benefit from further inquiry. In particular, this project indicates the following issues could be explored by ESPON: (i) are the metro region boundaries the most appropriate ones to determine second tier city regions? (ii) how can better data on social and environmental as well as economic performance be produced at the right spatial level? (iii) how can territorial governance be better shaped to deliver improved sustainable economic performance across functional urban economies? (iv) how can national government policies be better aligned to encourage more high performing second tier cities? (v) how can the territorial impact of EU policies upon second tier cities be more systematically monitored, evaluated and aligned? (vi) what is the impact of the economic crisis and recession upon second tier cities?

## **4. WHY INVEST BEYOND THE CAPITALS IN AN AGE OF AUSTERITY?**

- 4.1 This study examined the argument that spreading investment and encouraging high performance in a range of cities rather than concentrating on the capital city would pay benefits. It has provided significant evidence and support for this argument. Although the capital cities in many countries are responsible for a significant proportion of national GDP, second tier cities nevertheless make a significant contribution. Individually, the majority of second tier cities do not match the economic contribution of capital cities. But collectively their contribution to national economies is significant and in some cases greater than that of the capital itself. So the contribution of second tier cities that lie between the successful capitals and the lagging cities – the critical middle - is crucial to national economic success. It shows that policy makers at least must be more explicit in their territorial investment decisions in future. It suggests the more they can help second tier cities, the more they can help their nation – and Europe. And it suggests that in an age of austerity there is a serious case for investing beyond the capitals.

### ***Capital cities do matter***

- 4.2 In many respects capital cities receive preferential treatment from national governments. It has been argued that decision-makers find it easier to allocate resources to existing capitals rather than identify opportunities elsewhere. It has also been argued that private sector investors take the easiest strategy of investing in safe locations rather than taking risks with more marginal locations. The argument can be overstated. Nevertheless, capitals are privileged because they are typically the centres of national political, administrative and economic power. They have stronger private sectors. They are more

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integrated into global networks. They are more likely to contain international companies' headquarters. Their producer services are typically the most advanced. They contain major financial institutions and hence easier access to risk capital. They have significant agglomeration advantages. They contain leading academic and research institutions. They are at the hub of national transportation and ICT networks. They attract public and private 'prestige' investment because they are regarded as 'representing' their nations.

***But not at the expense of everywhere else***

- 4.3 Successful capitals are crucially important to their national economies and must be able to compete in a global market. But the risk is that they suck life out of the rest of the urban system so the national economy becomes spatially and structurally unbalanced. To avoid this, second tier cities need as much policy attention as capitals. Sometimes second tier cities do benefit from national policy. But often this happens in implicit rather than explicit ways. Most states do not have a policy for second tier cities so that their collective interests are often overlooked. A key policy issue is how to realise the potential of second tier cities so they can bring maximum added value to their national economies.

***Deconcentration and decentralisation can help economic performance***

- 4.4 The experience of Germany, for example, strongly suggests that decentralisation, deconcentration and a strong set of second tier cities helps drive strong national economic performance. By contrast, if the gap in economic importance and performance between second tier cities and capitals is very large, this will limit national performance. First, over-concentration in capitals will weaken more peripheral areas because they will not have buoyant second tier cities and support services. Second, second tier cities in systems dominated by capitals are less likely to feature in national policy because they are seen as less important. Third, the dominance of competitiveness-oriented urban policies will mean that already successful areas will be prioritised, increasing territorial imbalances. Finally, the lack of competitive second tier cities limits the scope to reduce the pressure on capital cities' land, property, environmental resources, transport and infrastructure by relocation.

***The costs of agglomeration – the limits of capital cities***

- 4.5 This study has also identified a series of concerns about the dominance of capital cities. One theme is the costs and negative externalities of agglomeration. The second theme is that all urban areas have potential which national policy should encourage rather than concentrating upon a limited number of already successful places. Agglomeration does obviously produce economic benefits. OECD research has shown that in some countries, the largest single metropolitan area produces between one-third and one-half of national GDP. However, the economic benefits of agglomeration are not unlimited. Cities can reach a point where external diseconomies make them less competitive because of negative externalities caused by unregulated urban growth and diminishing marginal returns. Beyond a certain point, congestion, land scarcity and sprawl, marginalised human capital and infrastructure deterioration contribute to an area's decline. And investors and developers may start to avoid them and move elsewhere. Given such potential risks, focusing on second tier cities would create greater economic growth and greater efficiency by reducing diseconomies of scale.

***Balancing investment in leading cities and those with potential***

- 4.6 The policy choice is not between favouring growing areas as opposed to the regeneration of declining areas. It is between putting the national eggs into a smaller or larger number of baskets. Our study suggests that national governments which concentrate attention and resources on their capital cities risk increasing uneven development, with whole regions and cities missing out on chances to enter the new economy. Second tier cities, although less able to act on the global stage, can still generate important dynamism for regions outside the capital and contribute to overall national growth. They cater for variations within nation states and contribute to territorial cohesion. They contain higher order services and offer companies better access to them than if they were all concentrated in the capital city. They can achieve many of the agglomeration effects of capitals,

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provided they have the right infrastructure, facilities, capacity and powers. They can lift the performance of their regions, reduce inter-regional inequalities and promote social cohesion.

***So what should the policy approach be?***

- 4.7 The relationship between capital and second tier cities should not be seen as zero-sum but as win-win. The capital city in virtually all European countries makes a huge economic contribution to the overall national economy. There is little demand for that to be artificially limited to encourage the development of second tier cities. Rather, the policy message is that it is better to encourage the development of both rather than to constrain the capital. The challenge is to grow the overall national urban economic pie without damaging the capital city. And a key issue is how to encourage second tier cities to absorb some of the capital city's growth as it reaches the limits of its capacity to accommodate it and the costs begin to outweigh the benefits.

***Transparency about territorial investment strategies***

- 4.8 There is often not enough transparency about the territorial investment decisions of national governments. They typically do not specify how they allocate resources to leading or lagging, growing or declining and capital or second tier cities. Those investment criteria should be made more explicit and transparent in future. In addition the potential sources of this investment need to be identified because of the recession. The recession, government debt and public sector expenditure cuts clearly reduce the funding potential of the public sector. The EU's Cohesion Policy and the European Investment Bank will remain important sources of public investment for cities. But it will not cover all cities in all countries. Initiatives like JESSICA will be important but will remain limited in scale and coverage. In this context, public-private partnerships and new investment funding mechanisms will be more important. Different forms of investment involving for example public sector pension funds and value capture including local asset backed investment vehicles and tax increment financing offer potential for public-private co-investment projects and financial as well as wider social and economic returns.

***What policy messages for the European Commission? Take second cities and their leaders more seriously***

- 4.9 European Commission policy has broadened and deepened to grapple with the complex mix of opportunities and problems facing different European cities. It has promoted and encouraged the principles of multi-level governance and of integrated, place-based economic development. But the EU should increase the territorial, place based spatial dimensions of its policies if it is to deliver its wider economic and social ambitions. The *EU2020* ambitious targets may or may not be realistic given many regions' current performance. However, cities are potential levers to deliver them. They account for 85% of Europe's GDP, 75% of its population and 80% of its carbon footprint. But many policy makers question whether Commission policy is yet sufficiently focussed upon the economic place-making agenda and in particular whether *EU2020* has a sufficiently explicit territorial focus and locates its targets or investment actions in particular places. *Territorial Agenda 2020* supported this view arguing that, despite many successes, EU policy needed: more effective coordination of different policies, actors and planning mechanisms; more sharing of territorial knowledge; more sophisticated multi-level governance arrangements and greater integration of the place-based approach into public policies at EU, national, regional and local levels.

***Meeting the economic, policy and governance challenge in eastern Europe***

- 4.10 Urban policy must recognise that Europe remains enormously diverse. National differences in cultural and ideological values, economic performance, governance arrangements and policies have an important impact upon second tier cities. In particular the capacity of different countries to incorporate the principles of place-based economic development varies enormously. They require flexibility, cross sectoral working, cross departmental working and partnership between public and private sectors. This has proved difficult in many countries. But it is particularly true of the new member states. Many of them are still constructing democratic governance, institutional and



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infrastructural capacity and modern economic systems. They typically have: highly centralised government systems segregated along department and sectoral policy lines; regional and local government with limited powers and resources; and limited incentives to encourage collaboration across policy and geographical boundaries. So policy must reflect that diversity of countries and cities across Europe but nevertheless find common principles and ways of unblocking barriers to implementing them.

***So when should national governments invest in second tier cities?***

- 4.11 The number of high performing second tier cities a country can sustain will vary according to both the country's size and level of economic development. For example, in smaller countries there will be less scope for a large number of cities to complement the capital. Equally in the developing economies of the east, at present the capital city is the most significant driver of the national economy. In both cases, capital cities might remain the initial focus for investment because they are most likely to have the capacity and critical mass to succeed. Nevertheless, countries must have strategies for developing second tier cities, to spread economic benefits and help them become the economic motors of their wider regions. In particular, given the impact of national policies and resources, national governments should focus their policies to encourage as many successful second tier cities as the population and pattern of economic growth and development permits.
- 4.12 Only individual countries have the detailed knowledge needed to make the right investment decisions in future. Each case should be determined on its individual merits. But some clear principles have emerged from this study. National governments in particular should be prepared to make investment in second tier cities where the following conditions are found:
- ❖ The productivity gap between capital and second tier cities is significant and growing.
  - ❖ The business environment in second tier cities is poor because of under investment in hard and soft infrastructure by national government.
  - ❖ There is clear evidence of negative externalities in the capital including, for example: high and increasing real estate prices, congestion, environmental pressure, skill shortages and wage inflation.
- Under such conditions investing more in second tier cities should benefit everyone, including the capital, by taking the pressure off it.

## **5. WHAT SHOULD POLICY MAKERS DO IN FUTURE?**

***More systematic policies for second tier cities***

- 5.1 Although capital cities have usually dominated national economies, leading second tier cities play a very important role in national wealth creation, maintaining social cohesion and increasing environmental sustainability. This has been true during recent boom times and recession. **In future national governments and the EU should fully recognise the significance of second tier cities and systematically pursue policies which maximise their potential.**

***Continue investment in the new member states***

- 5.2 The gap in economic performance between capitals and their leading second tier cities is particularly large in the new member states because of their traditionally centralised political systems, territorial underdevelopment and the effects of rapid marketisation. New member states still face much larger challenges of building institutional and infrastructural capacity than do the old member states. **EU funding to the new member states which has been critical to promoting regional decentralisation and modernising urban infrastructure must be sustained.**

***Monitor and maximise the territorial impact of national policies for competitiveness***

- 5.3 The classic drivers of competitiveness are strongly correlated with economic performance in second tier cities and capitals. A small number of governments have recognised this and focussed them on second tier cities. **More EU and member governments should recognise the importance of these**

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competitiveness drivers - innovation, economic diversity, connectivity, skills and human capital, place quality and strategic governance capacity. They should maximise their collective impact on the widest territorial scale and not concentrate policy attention solely on capital cities.

***Decentralise more responsibilities and resources - and deconcentrate more investment.***

- 5.4 Second tier cities perform better where national government policies support them, give them significant powers and resources and deconcentrate investment. **National governments should decentralise responsibilities and resources to cities and deconcentrate public investment more.**

***Create territorial economic governance at scale***

- 5.5 Few countries or cities have successfully addressed the key territorial challenge of developing economic governance at scale so that all the key actors and institutions across a functional economic area can maximise their assets to achieve integrated, place-based economic strategies. Too many cities are still attempting to use 19<sup>th</sup> century local boundaries and 20<sup>th</sup> century forms of government to shape and develop a 21<sup>st</sup> century global economy. Successful city regions need governance to be upscaled to the functional economic level. At the moment too often, there are too many, too small local government units which are not fit for purpose. **European, national and regional governments should incentivise and encourage voluntary collaboration but also strengthen formal territorial governance at city region level.**

***Encourage financial innovation***

- 5.6 The credit crunch and recession mean that public resources are under great pressure and new methods of financing urban development are needed. There is no single solution. **But governments should actively pursue a combination of public loans, pension funds, tax increment financing, local asset backed vehicles and pooled budgets.**

***Greater transparency about territorial investment strategies. Focus mainstream, implicit policies as well as explicit area based initiatives on second tier cities***

- 5.7 Urban policy across the EU is very uneven. There has been a shift in the orientation of explicit urban policies and greater emphasis on boosting urban competitiveness. But the funds allocated for them are dwarfed by mainstream spending programmes. Few states consider the effects of mainstream programmes and spending on the performance of second tier cities, since most governments are organised on functional non spatial lines. Also, very few member states have introduced conscious policies to promote their leading second tier cities. **Governments should be more transparent about their criteria for territorial investment and their impacts upon different city regions. Governments should monitor and publicise the territorial impacts of their expenditure programmes. In particular, Governments should ensure that all mainstream programmes, as well as special urban programmes are focussed on second tier cities and not concentrated upon the capitals. National government policies, for example, for innovation, research and development, education and skills, transport and connectivity, infrastructure investment have a major impact upon the relative performance of capital and second tier cities. It is crucial they are used strategically to avoid overconcentration upon and overheating of the capital and avoid limiting scarce resources to second tier cities. These principles will become more significant in a period of austerity.**

***Greater EU focus on second tier cities***

- 5.8 The European Commission needs to exercise leadership and provide clarity and resources in this field. It should do more to ensure that the economic potential of second tier cities is clearly recognised in its strategies. City regions are crucial to the delivery of its strategic goals identified in *EU2020*. It must take city regions - and their leaders - more seriously in future. Commission policy for cities has varied in recent years and the economic place making agenda has fluctuated in its significance. Many in this study believe the issues have slipped down the Commission's agenda in recent years and should be reasserted. The Commission should do more to ensure that the economic potential of second tier

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cities is clearly recognised in its strategies. The territorial impact of all Commission policies, not just those of DG Regio should be made more explicit. The sectoral policies of the Commission should be better integrated. The proposed revision of the Structural Funds could encourage this process. It is crucial that the proposed Integrated Territorial Investment approach and the proposal that at least 5% of funds should be focussed upon urban areas should be implemented. But the key challenge is to ensure that not only the explicit targeted resources but all mainstream Commission funding helps second tier cities in a more coherent way than it currently does. In a period of austerity, it is crucial that the Commission commits to the importance of those cities. First it should not retreat to a policy of concentrating only on small socially deprived areas but should focus more widely upon economic place making. Second it must not focus only on a limited number of already successful places but should make the wider longer term investments that will bring longer term economic prosperity to more places, more countries and hence to Europe.

***So when to invest in second tier cities?***

- 5.9 So for policy makers at all government levels - European, national, regional and city regional - the message is clear. Strong capitals matter to nation states' global positioning and competitiveness. However, strong second tier cities also matter. Both capital and second tier cities must be supported in future. It is a win-win, not a zero sum relationship. Governments at all levels should help second tier cities so they can emerge from the current recession with more 'investment ready' places to maximise future national economic performance. Now is the time to prepare for recovery from recession. The individual circumstances of countries, regions and city regions will vary and so will policy responses. But some general principles about investment apply. **Specifically governments should invest more in second tier cities when: (i) the gap with capitals is large and growing (ii) the business infrastructure of second tier cities is weak because of national underinvestment and (iii) there is clear evidence about the negative externalities of capital city growth. The stakes - and the potential rewards - are high.**

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