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City Size and Economic Performance: Is Bigger Better, Small More Beautiful or Middling Marvellous?

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ABSTRACT *This article discusses the contribution that second-tier cities can and do make to the economic performance of national economies across Europe. It reviews the competing theories about size, investment and economic performance. It presents a range of evidence about the performance of over 150 European capital and second-tier cities in 31 countries. It identifies some key policy messages for local national and European policy-makers. It presents evidence that decentralizing responsibilities, powers and resources, spreading investment and encouraging high performance in a range of cities rather than concentrating on the capital city produces national benefits. It argues that in a period of austerity national governments should resist pressures to concentrate investment in capital cities and invest more in second-tier cities when there is evidence that: (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. It argues that the issues have slipped down the European Commission's agenda and it should do more to ensure its strategies help realize the economic potential of second-tier cities in future.*

1. The Recession Makes the Discussion of City Size More Important

This special edition focuses upon the economic contribution and performance of different-sized cities across Europe. The issues have always been academically significant, but the current recession makes them even more significant politically. They have sharpened the debate about policies for national competitiveness. They have also sharpened the debate about the economic contribution of capital and second-tier cities and whether countries perform better if they concentrate their investment in their national capitals or spread investment across a wider set of cities. Does size matter—and how much—for

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cities and national economic performance? They pose a single crucial question: "Why should policy-makers invest beyond the capital cities in an age of austerity?" In the recent past a major focus of academic research has been on the larger global cites (Sassen, 2001, 2012; Brenner & Keil, 2006). However, the new economic conditions mean policy-makers will have to pay more attention in future to the potential and actual contribution of cities further down the urban hierarchy—the second-tier cities.

The global recession and Eurozone crisis have had a huge impact upon the European economy and present great future threats. This debate will become more important during the next decade as the crisis threatens to undermine the real achievements made by many European cities. In the past decade, cities in many countries improved their economic performance and made a growing contribution to national competitiveness. 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. Many underlying economic and social problems in cities—which had been masked by the boom—have already been intensified by the crisis. There is a risk that economic and fiscal problems and the competition for scarce public and private sector resources will limit the growth of cities and widen economic and social gaps within them and between them and the capitals. The investment that was made during the growth years before the crash paid off, improving the economic performance and national contribution of many second-tier cities. It is crucial that the investment that was made—and which is now at risk in the recession—is not lost. The argument is essentially one about investment and economic performance as much as territorial justice.

This article explores some of the policy and research questions raised by this debate, based upon a major study we recently conducted of European cities in the age of austerity.

2. What Are the Analytical Arguments About City Size, Investment and Economic Performance—Place-Neutral vs. "Place-Based" Policies?

2.1. *Competing Theories*

There has been a rediscovery of the importance of agglomeration and urbanization economies and externalities in urban and regional economic growth. A number of different theoretical frameworks compete for attention including, notably, neo-classically based endogenous growth theory, geographical economics and institutional and evolutionary theories. Geographical economics and the so-called "New Economic Geography" focus, for example, on the external economies and increasing returns to scale associated with regional industrial specialization and concentration and the urbanization economies from agglomeration of firms from different industries that underpin the growth of urban locations (Krugman, 1990, 1991, 1993; Fujita et al., 1999; Duranton & Puga, 2004; Kitson et al., 2004; World Bank, 2009). Agglomeration economies also feature in macro-structural economic transition theories which link local and regional growth potential to the transition from the macro-economic era of mass production to the current era of "flexible specialisation" (Piore & Sabel, 1984; Storper & Scott, 1988; Scott, 1988). Institutional and evolutionary theories of regional economic development have focused on the institutional arrangements and "softer" factors like networking, trust and social capital that together provide externalities that encourage the emergence and subsequent growth of local and regional economies (Grabher, 1993; Amin & Thrift, 1995; Maskell, 2002).

2.2. *Competing Policy Paradigms*

These theoretical differences translate into different policy recommendations. Free market neo-classical economists stress the importance of agglomeration economies as the justification for allowing capital cities to grow in an unrestricted fashion to reflect market demand and forces. In this view, capital cities have significant agglomeration advantages. They are typically the centres of national political, administrative and economic power. They have stronger private sectors. They are more integrated into global networks. They are more likely to contain companies' headquarters. Their producer services are typically the most advanced. They contain major financial institutions which provide easier access to risk capital. 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 "represent" their nations. Henderson, for example, argues that capital cities receive preferential treatment from national governments because public decision-makers find it easier to allocate resources to existing capitals rather than identify opportunities elsewhere (Henderson, 2010). Similarly, it has been argued that private sector investors adopt the safer strategy of investing in buoyant, capital locations rather than taking risks with more distant, perhaps more economically marginal locations.

The neo-classical position also encourages a "place-neutral" approach to economic development best illustrated in the World Bank's arguments that that policies should emphasize people over place and that, because growth and development are inevitably unbalanced, it is counterproductive to attempt to shift that market balance (World Bank, 2009). Urban and regional development policy should emphasize "space-blind" provision of universal public services like education and social services and general infrastructure investment with only very limited use of explicitly spatially targeted interventions (Hildreth & Bailey, 2013).

The "place-neutral" approach is challenged from an institutional and evolutionary economic geography perspective, which emphasizes the costs and negative externalities of agglomeration. Agglomeration clearly produces economic benefits. However, the economic benefits of agglomeration are not unlimited. Capital cities can reach a point where diseconomies make them less competitive because of the negative externalities caused by unregulated growth and diminishing marginal returns. The OECD has made a significant contribution to this debate with a series of studies exploring the contribution of different regions to national competitiveness. Some of its recent work has focussed specifically upon the middle regions, showing that growth does not come only from a small number of leading regions at the top but from the many more regions further down a long territorial tail of the regional hierarchy, whose collective contribution is crucial. OECD's policy position is that the economic contribution of the middle regions is typically underestimated and governments should do more to maximize their contribution if they want to maximize national competitiveness (OECD, 2006, 2012a, 2012b; Garcilazo et al., 2010).

From this perspective, urban and regional policies need to be more sensitive to local context and local specificity, "place-based" as opposed to "place neutral" (Barca, 2009; Barca & McCann, 2010; McCann & Ortega-Argilés, 2011; McCann & Rodríguez-Pose, 2011; Barca et al., 2012). "Bottom-up" policies that take into consideration, for example, the localized forces that influence innovation and development are needed, albeit reconciled with "top-down" policies in an approach to urban and regional development issues from a meso-level perspective (Crescenzi & Rodríguez-Pose, 2011). The emphasis on "place-based" policy also explains the growing demand for decentralization of powers from national to sub-national governments (Ascani et al., 2012). Our work supports this latter view.

3. What Was the Economic Contribution of Capital and Second-Tier Cities in the European Boom and Recession?

This article draws on a recent study for ESPON of 124 second-tier and 31 capital cities across Europe (Parkinson et al., 2012; Parkinson & Meegan, 2013). There are many typologies of cities. All have their limitations. We use the concept of second-tier cities—those cities outside the capital 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. It certainly does not mean that they are second class. And it does not mean they are the "second" city—because there is only one of these in each country. And second-tier cities are not all the same—they vary enormously. Sometimes they are very large regional capitals. Sometimes they are the second largest city of the country with huge national significance—for example Barcelona, Munich and Lyon. But many are much smaller. However, while they differ in many respects, second-tier cities can play comparable national economic roles. The second-tier cities we studied in the research for ESPON constitute almost 80% of Europe's metropolitan urban population. They lie between the capital cities which contribute a huge amount to their national economy and the many smaller places which contribute rather less. They are the middle of the urban system.

We recognize that the distinction between capital and second-tier cities is an administrative rather than a functional one. However, we use it at least partly because a key policy concern of our work is the extent to which national governments focus attention and resources on their capitals rather than on other cities in their urban system—and the consequences for national economic performance. There is some argument that they do so (Henderson, 2010). Also this is a hugely significant policy issue for the European Commission who commissioned the research. They were aware that many member states, especially in the east of Europe, favoured investing EU resources in their capital cities on the grounds it would lead to greater national economic gains. We wanted to test that argument. However, although partly an administrative distinction, in the vast bulk of countries the capital is by far the largest city economically and demographically. So we are effectively examining relationships between economically dominant cities and their urban systems in European countries. We recognize this is not the first time this concept has been used. Markusen et al. (1999) looked at the phenomenon of second-tier cities. However, their work primarily focussed on non-European cities and they were typically more recently developed and often smaller cities than ours. This work adds new information and develops the concept.

3.1. *Decentralization and Deconcentration Matter*

What are our key messages? Our evidence shows that decentralizing responsibilities, powers and resources, spreading investment and encouraging high performance in a range of cities rather than concentrating on the capital city produces national benefits. 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 second tiers. More widely, in some countries mainstream national policies which implicitly affect urban competitiveness—innovation, diversity, skills, connectivity, place quality and strategic governance capacity—have been used to help second-tier cities develop. Most interestingly, in countries which are less centralized and less economically concentrated, and where cities have greater powers, resources and responsibilities, cities have performed better and helped the national economy more. There is evidence that levels of government decentralization do matter. Between 2000 and 2007 for example, in the Federal states, all German and Austrian and half of Belgium's second-tier cities outperformed their capitals. In the regionalized states, all Spanish and a third of Italian second-tier cities grew faster than their capitals. In the Nordic states, all grew faster than their capital. In the unitary centralized states of Hungary, Hungary, Slovakia, Slovenia, Estonia, Lithuania and Bulgaria all second-tier cities and all but one in the Czech Republic had lower growth rates than their capital cities. Only in Romania, Latvia and Croatia did some second-tier cities outperform their capital.

Our study and this article argue that continuing over-investment in capital cities and under-investment in second-tier cities in the long run will be unsustainable and lead to economic under-performance. It finds much evidence that decentralizing responsibilities, powers and resources, spreading investment and encouraging high performance in a range of cities rather than concentrating on the capital city produces national benefits. Although the capital cities in many countries are responsible for a significant proportion of national GDP, second-tier cities still make a large contribution. In many cases the collective economic contribution that second-tier cities make is greater than that of the capital itself. Individually, second-tier cities may lag behind capitals. But collectively their contribution to national economic performance is hugely significant.

However, we do not claim, and our evidence does not show, that every second-tier city in every country performed well in the boom or recession or that they outperform the capital city. But enough cities in enough countries have performed well enough to challenge the assumption that capital cities should be the first choice for investment to achieve national economic success. Our work does present a huge amount of compelling evidence from quantitative data analysis, policy reviews and individual city studies that point in the same direction. We can only present a limited amount of that quantitative evidence in this article. They cumulatively demonstrate that policy-makers should take these issues more seriously in future and systematically examine how their decisions affect second-tier cities.

3.2. *Germany Proves the Point*

Germany provides important lessons on the economic role of second-tier cities. Of course Germany is unique. It is a Federal system which has changed its capital. The country has been divided and reunited. Its-second-tier cities are typically state capitals with extensive powers and resources. It has a unique system of regional banking and powerful middle-sized firms. It is not possible for other European countries to simply imitate the structural characteristics of the German system. Nevertheless, the key principles of the German experience can be transferred between different countries. Its experience particularly underlines the argument that decentralization of powers and resources and the spatial deconcentration of investment leads to a higher performing national economy. Economic activity—private and public—is more evenly distributed across a range of cities that form a powerful multi-cylinder, economic engine. Between 2000 and 2007 populations increased faster in six German second-tier cities than in Berlin. All its 14 second-tier cities had productivity growth rates above those in Berlin. At a European level, 5 of the top 10 second tiers in GDP growth between 2000 and 2007 were German. Five of the top ten most innovative cities were German.

3.3. *Capital Cities Dominate but Second-Tier Cities Make an Important Contribution to Competitiveness*

The essential picture is that—with the crucial exception of Germany—capital cities dominate the European urban system in terms of population, employment and output. The gap between capital and second-tier cities is large and in virtually all the former socialist states of Eastern Europe, it is growing. The total GDP of capital cities in 2007 was greater than their leading second-tier cities in all but two countries, Germany and Italy (Figure 1). In 19 countries the total GDP of the capital was more than twice that of the largest non-capital city and was as much as 8 times greater in 4 states—UK, France, Hungary and Latvia. Nevertheless our evidence shows that all second-tier cities made a contribution—and some a significant one—to economic growth in Europe between 2000 and 2007, even if many were overshadowed by capital cities to different degrees in different parts of Europe. The size of the gap between capitals and secondaries varies and in some cases is declining.

Structurally, capitals dominate their national economies. But change is also important. And many second-tier cities improved their position in the boom years 2000–2007. 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 found there (Figure 2).

3.4. *Second-Tier City Growth During the Boom—Regionally Differentiated*

Although many second-tier cities performed well during the boom years when they had national government support and investment, there were large regional disparities (Map 1). The prosperous city-regions in the North, Central and West of Europe contrast with the less prosperous city-regions of the Central East, East and South East. Together, the North, Central and West groupings housed over four fifths of the leading city-regions. By contrast only 3 of the 27 city-regions in the former socialist Unitary states of Czech Republic, Hungary, Poland, Slovakia and Slovenia were leading, 3 were intermediate and the great majority were lagging. There were some shifts during the period. The lagging city-regions of East and South East Europe, and to a lesser extent, of Central East Europe had a rapid burst of growth in the eight-year period. Those in

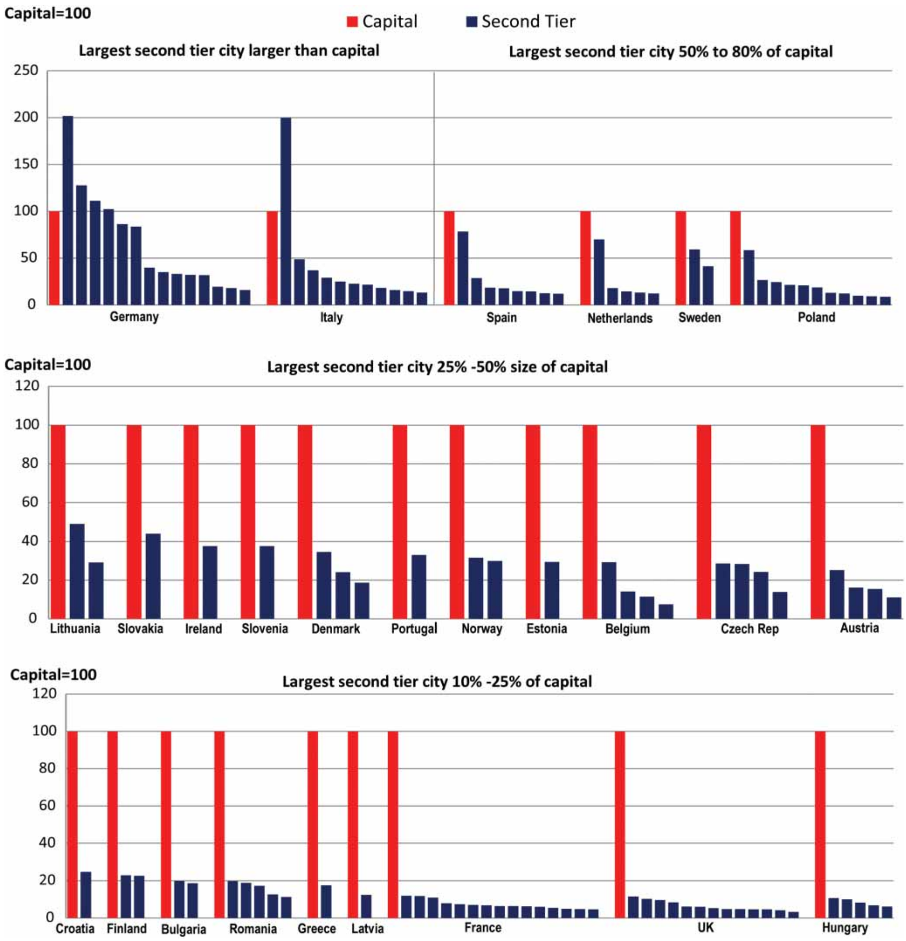


Figure 1. Total GDP in PPS, 2007.
Source: Parkinson et al. (2012).

transition to capitalist economies and integrating into the European economy had average growth rates 6 and 7 times those of the established West and North.

3.5. *The Crisis Threatens to Undermine Achievements of Second-Tier Cities*

But the recession has had a major impact on many of them—in particular those which flourished during the boom decade (Map 2). More than 75% of the cities experienced GDP falls 2008–2010. 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 Baltics have been heavily hit. Major Western European countries have all been hit. In Germany only Berlin grew. In all other German cities GDP declined. In the UK all 14 cities declined. In Italy all 12 cities declined. In Spain 8 of 9 declined.

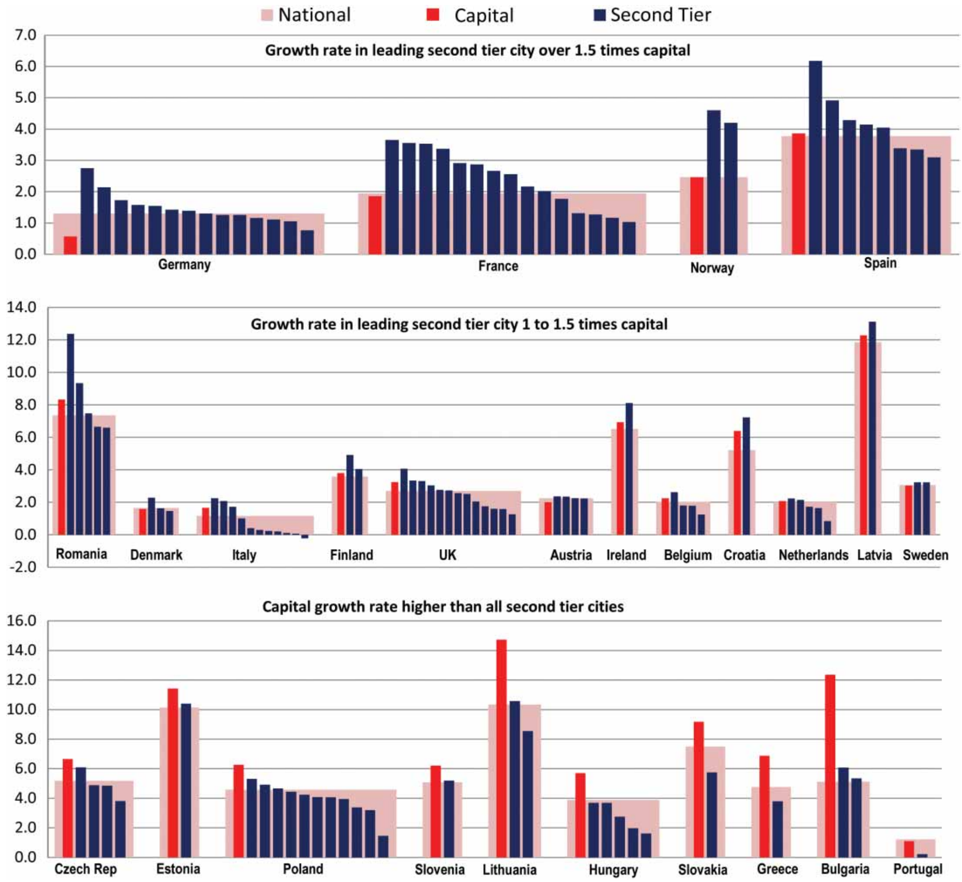
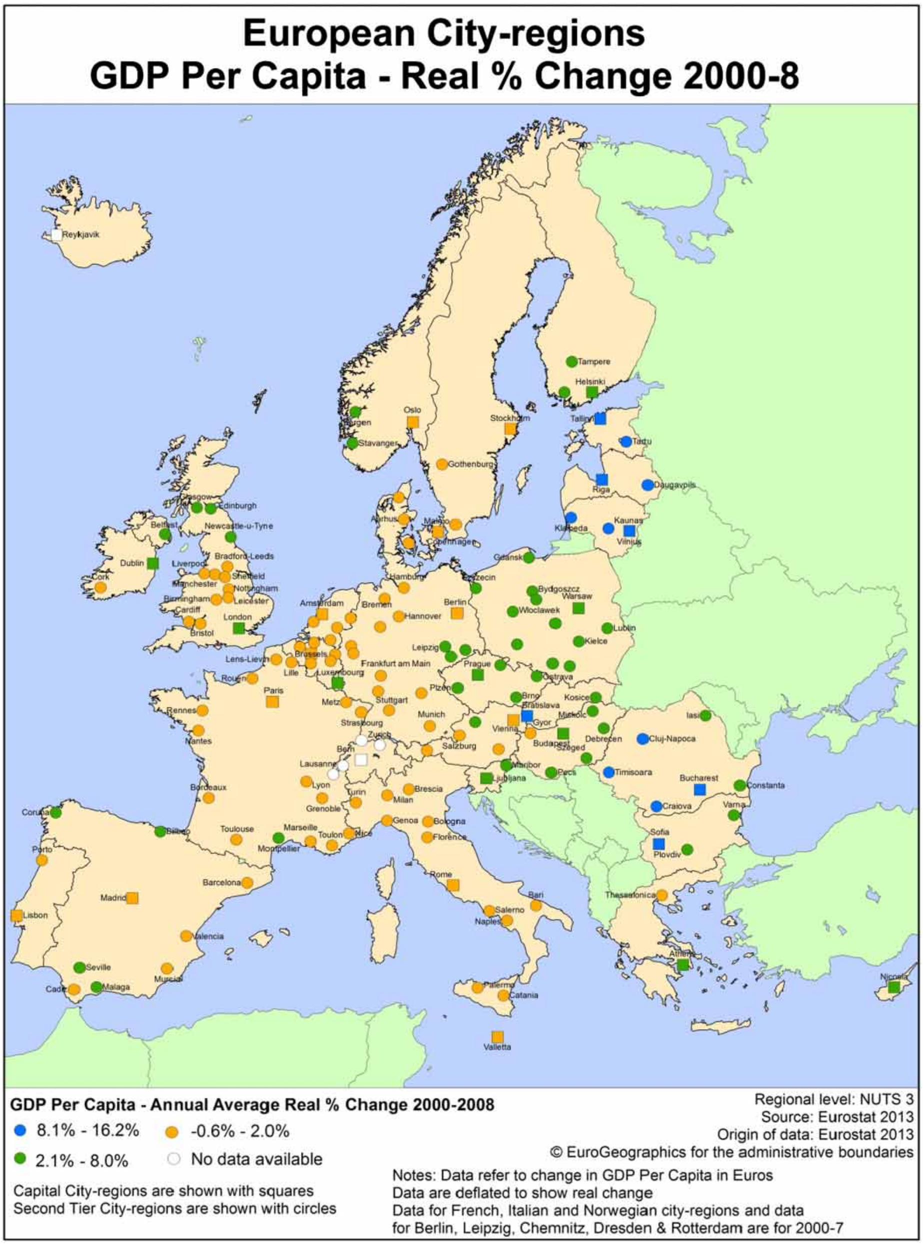


Figure 2. Second-tier cities' contribution increasing: total GDP average annual real % change 2000–2007.
Source: Eurostat.

4. So What Are the Policy Messages for Governments About Second-Tier Cities?

4.1. *Decentralization of Powers and Resources—to Match Devolved Responsibilities—Is Crucial*

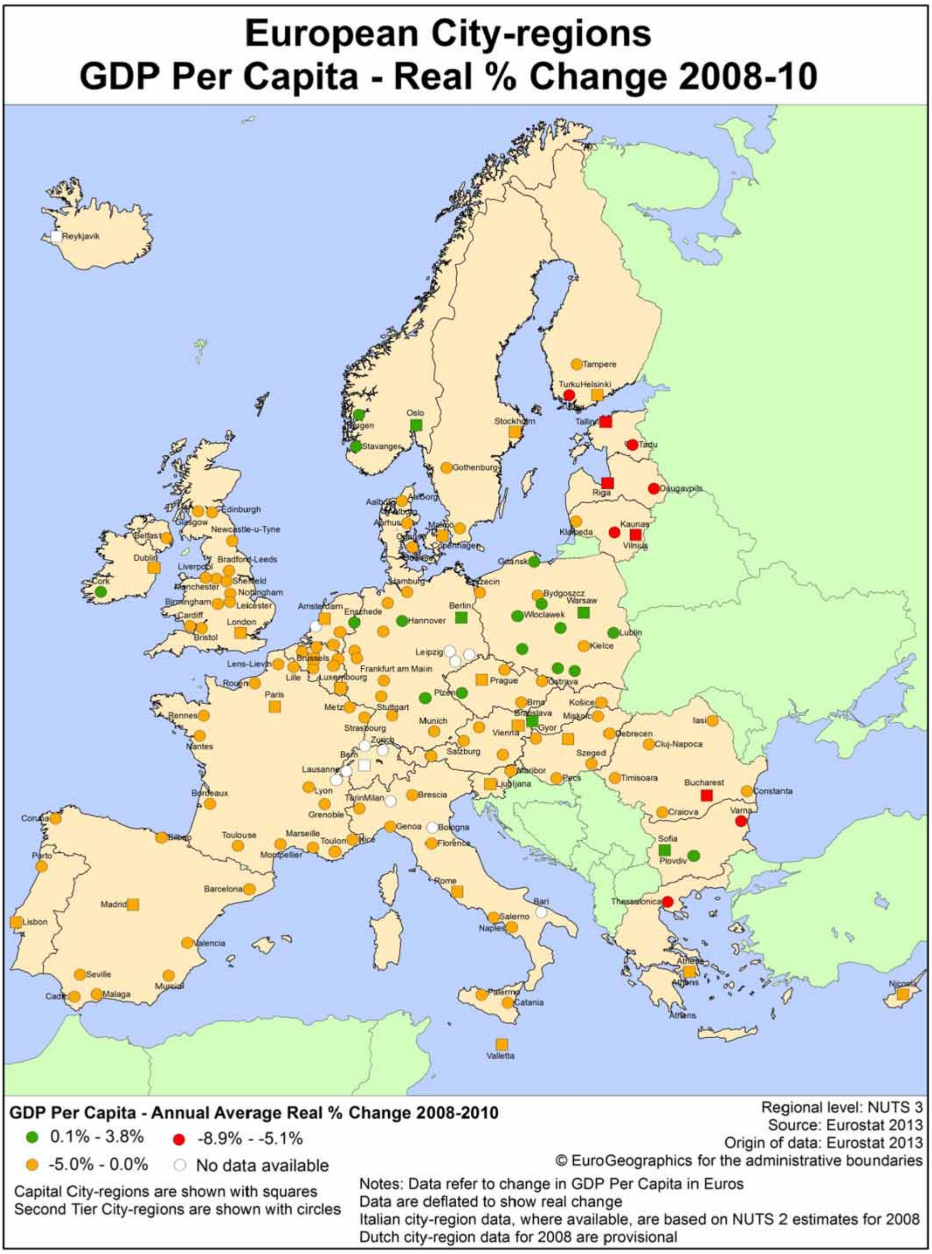
Levels of centralization matter. But decentralization of responsibilities to cities only works if responsibilities are matched by corresponding powers and resources. Cities perform better in those countries which are less centralized and economically concentrated and where cities have greater powers,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



Map 1. European city-regions' economic growth, 2000–2008.
Source: Parkinson et al. (2014).

4.2. *The Limits of Capital Cities*

Our study 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



Map 2. European city-regions in recession, 2008–2010.
Source: Parkinson et al. (2014).

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 limitless.

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, sprawl, marginalized 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.

4.3. *Capital Cities Matter—but Not at the Expense of Everywhere Else*

Capital cities matter, are crucially important to their national economies and must be able to compete in a global market. But the risk is that they dominate the rest of the urban system so the national economy becomes spatially and structurally unbalanced. 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, which means their collective interests are overlooked. 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. In many cases they punch beyond their weight. 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, 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.

4.4. *Win–Win Not Zero Sum*

So 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. A key policy issue is how to encourage second-tier cities to absorb some of their capital city's growth as capitals reach the limits of their capacity to accommodate that growth and the costs begin to outweigh the benefits. Government should help second-tier cities so they can emerge from the current recession with more "investment ready" places to maximize future national economic performance.

4.5. *Will the Market Deliver?*

We argue that second-tier cities could contribute more if they were given greater support and investment. Some argue there is no need for government intervention to address regional and urban imbalances. They believe the market itself will self-regulate and lead to increased investment in second-tier cities as the costs and price of growth in the capital become more obvious and the opportunities in second-tier cities become equally obvious. But our analysis, in keeping with much regional economic analyses, does not support that view. The logic of over-investment in the capitals and under-investment in second-tier cities is simply too strong in too many countries. As the German experience demonstrates, it requires public intervention and good governance.

4.6. *Good Governance—Shared Responsibilities and Clarity of Roles*

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. For example, urban policies tend to be vertically integrated in German cities because key functions are shared, or because the Federal Government funds urban and regional partnership experiments or because they are the subject of extensive negotiations between federal, state and city governments. Cities' financial capacity, in particular the extent to which they rely upon national grant, transfers and financial equalization or can raise their own revenue, also affects national policy impacts. In some cases, centralization of power is exacerbated by the lack of strong, democratically elected regional government and fragmented metropolitan governance. In other cases, cities in decentralized states were in virtually the same position as those in centralized unitary states because decentralization of responsibilities has not been matched by the decentralization of financial resources.

4.7. *Good Governance—Local Discretion, Shared Values, Flexibility and Trust*

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 maximize 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 the 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: focussing upon business and community needs; understanding and responding to future urban challenges; reconciling strategic and local perspectives; trust, reciprocity and mutual respect.

4.8. *Territorial Economic Governance at Scale*

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 maximize their assets to achieve integrated, place-based economic strategies. Too many cities are still attempting to use nineteenth century local boundaries and twentieth century forms of government to shape and develop a twenty-first century global economy. Successful city-regions need governance to be upscaled to the functional economic level. At the moment too often, they are too many, too small and not fit for purpose. European, national and regional governments should incentivize and encourage voluntary collaboration but also strengthen formal territorial governance at the city region level.

4.9. *Greater Transparency about Territorial Investment Strategies. Greater Focus on Second-Tier Cities*

Urban policy across Europe is very uneven. There has been a shift in the orientation of explicit urban policies and greater emphasis on boosting urban competitiveness. But the national and regional 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 organized on functional rather than territorial lines. Also, very few 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 publicize 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, and 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 over concentration upon, and overheating of, the capital as well as to avoid the limiting of scarce resources to second-tier cities. These principles will become more significant in a period of austerity.

4.10. *So When Should National Governments Invest in Second-Tier Cities?*

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. Governments should encourage as many successful second-tier cities as the population and pattern of economic growth and development permit.

So for policy-makers at all government levels 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. A key policy issue is how to encourage second-tier cities to absorb some of their capital cities' growth as capitals reach the limits of their capacity to accommodate that growth, and the costs begin to outweigh the benefits. Governments at all levels should help second-tier cities so they can emerge from the current recession with more "investment ready" places to maximize future national economic performance. The individual circumstances of countries, regions and city-regions will vary and so will policy responses. However, some general principles to guide future territorial investment have become clear. 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.

4.11. *Policy Messages for Europe*

A final policy message is for the European Commission. City-regions are crucial to the delivery of its strategic goals identified in EU2020 (European Commission, 2010). It must take city-regions—and their leadership—more seriously in future. Commission policy for cities has varied in recent years and the significance of the economic place-making agenda has fluctuated. 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. It should do more to ensure that the economic potential of second-tier cities is clearly recognized 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. But the key challenge is to ensure that not only the explicit targeted resources but all mainstream Commission funding impacts on 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 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.

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