EU Cohesion Policy

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Innovative Directions for EU Cohesion Policy after 2020[1]

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Much is expected of EU cohesion policy, but it may struggle to deliver because some of the demands on it pull in competing directions and the resources assigned to it are relatively limited. Even so, it is the policy that currently absorbs the highest share of the EU budget and, with the process of negotiating the next Multi-annual Financial Framework (MFF) about to start, the objectives, scale and scope of the policy will come under renewed scrutiny.

Several dilemmas and paradoxes characterise cohesion policy. For the European Commission, it is the investment policy of the EU, contributing to the build-up of public capital, yet a sizeable proportion of academic economists consider its function to be primarily redistributive. Its roots are in regional policy, implying selectivity in the territories it supports, but in the last two MFFs, there have been cohesion policy interventions in even the richest member states. Moreover, certain social aims of the policy are not spatially targeted. There are profound disagreements over the results of the policy, with empirical studies of different sorts arriving at conflicting verdicts (see the overview by Bachtler *et al.* 2016).

Some of the most difficult challenges facing the policy will probably be how to fit into the system of EU economic governance. The wider policy architecture has evolved in a number of ways, ranging from the many reforms of macroeconomic governance to the advent of the European Fund for Strategic Investment (EFSI), which can also claim to act as the EU's investment policy. The implications for cohesion policy include managing expectations of which policy does what, including how to reconcile conflicting views on conditionality in these various domains.

[1] The author is grateful for funding under the *FIRSTRUN* Horizon 2020 project (grant number 649261).

This article starts by looking at the demands on cohesion policy and how they can be expected to evolve, then explores what kind of growth is conducive to achieve economic development goals, emphasising innovation. It subsequently turns to governance, identified as a crucial component of a successful policy, elaborating on the challenges of integration with other policies. This leads into a discussion of future directions for cohesion policy followed by a few conclusions.

SHIFTING DEMANDS ON COHESION POLICY

By any standards, the last decade has been an economically and politically turbulent one for the EU. In particular, the protracted recession is likely to have aggravated cohesion problems by destroying existing productive capacity and, perhaps more significantly from the perspective of divergence, the endogenous capacity of regions to raise growth rates. The seventh Cohesion Report (European Commission 2017a) finds that during the crisis years many of the less developed regions lost employment and saw unemployment rise more rapidly than richer regions. Although there are signs that this divergence trend came to an end for employment in 2014 and GDP per head in 2015, the legacy of the crisis years is bound to represent a challenge for future cohesion policy.

The report also points to regions stuck in a middle-income trap, squeezed between a relatively high cost base and a lack of innovation capacity. It goes on to emphasise the contribution made by cohesion policy to investment, noting that it provides "funding equivalent to 8.5 percent of government capital investment in the EU, a figure which rises to 41 percent for the EU13 and to over 50 percent for a number of countries" (European Commission 2017a, xxii). At a time of low pubic investment in many member states, this investment role is often crucial, but so too is the contribution of cohesion policy to alleviating the adverse social consequences of the crisis. The difficulties of dealing with migration add to these demands.

Funding for cohesion policy is unlikely to remain at its current level. The combination of the expected loss, following Brexit, of at least some of the British net contribution to the EU budget, along with demands

to fund 'new priorities', will trigger a search for cuts in established lines of expenditure.[2] A strong *status quo* bias (Begg 2018) is likely to deter huge changes, but both Cohesion Policy and direct payments under the Common Agricultural Policy (CAP) are likely to be vulnerable to some reduction in funding.

Several recent contributions to the analysis of regional disparities and the drivers of regional development can be expected to influence future cohesion policy. A major worry for the EU in an era of intense global competition has been the decline in productivity growth. While the continuing relative decline of industry is part of the explanation, a distinctive cause for concern is the growing gap between lead regions and lagging regions in productivity growth. This suggests a problem of diffusion of new technologies and leading-edge activities. It also implies a different approach to economic development policy in which the focus is more on identifying and overcoming obstacles to innovation-led growth. As Bachtler *et al.* (2017) note, commenting on the growing productivity gaps: while EU market and economic integration has been a successful convergence machine for countries, these gains have not been distributed equally inside each country.

WHAT KIND OF GROWTH?

Many of these demands on cohesion policy invite a reappraisal of the model of economic growth and development. Since 2006, the conflation of cohesion policy with the EU's Lisbon, Europe 2020 and Sustainable Development strategies signalled the objective of facilitating wide-ranging structural reform. This objective sits uncomfortably alongside the treaty goal of reducing regional disparities. However, it also implicitly acknowledges shifts in thinking on the determinants of growth, giving greater weight to endogenous growth, mobilising local potential and going beyond mere 'catch-up'.

There are striking trends in what makes regions attractive to the growing areas of economic activity, leading Iammarino *et al.* (2017, 4) to argue that "the current long wave of development fundamentally favours geographical concentration of the best jobs and most innovative activities". Cities, in particular, have become recognised as the sources of much of the innovation occurring in advanced economies (Florida *et al.* 2017). The importance of metropolitan areas in leading regional development is likely to be greater after 2020 because successful cities attract both more advanced business services and increasingly prominent creative industries. In this regard, and in contrast to their experience in earlier decades, there has been a resurgence in many (though by no means all) regions characterised by large cities, reflecting their attractiveness to these high-value services and creative industries.

Although there are systematic influences on the concentration and dispersion of economic activity (for an overview, see Iammarino *et al.* 2017), their incidence on the prospects of individual regions can be very diverse. Growth potential is influenced not only by public investment, but also by the sectoral mix in a locality (Boschma *et al.* 2017) and how it relates to innovation. High value-services and other 'knowledge' sectors are strengthened by spending on 'digital' rather than on the sort of R&D supportive of innovation in manufacturing.

The OECD (2016) has called for a far greater emphasis on productivity as the key to regional development. To redress the widening productivity gap between leading and lagging regions, a comprehensive approach to boosting productivity in laggard regions is required, including not just subsidies, but transformative strategic investments. For cohesion policy, these sorts of investments can be difficult to achieve, partly because of conflicting incentives at national and local levels, but partly also because of capacity constraints in the delivery of programmes.

The most tricky challenge is likely to be how to manage the evolution from an approach in which the emphasis was on physical capital to one focused on innovation. Differences in the innovation performance and, arguably more importantly, in the potential of regions are striking, with only a relatively small group standing out as leaders. This ties into productivity divergence between the relatively small number of regions that are productivity leaders and the larger mass of followers.

The Role of Innovation

Support for innovation has been given increased prominence in cohesion policy over the last three programming periods. However, evidence suggests that its impact on productive potential has been limited (Bachtler *et al.* 2016), while practitioners have found it harder to reframe programmes around an innovation narrative compared to one focused on physical capital.

The OECD has used the term 'democratisation' to advocate an alternative approach to innovation aimed at greater inclusivity, because innovation tends to occur in relatively few firms and localities, leaving others as followers and inhibiting inclusive growth. Given the prominent link from innovation to growth, the inclusiveness of innovation strategies – meaning encompassing localities and social groups hitherto neglected in national policy approaches – could become a significant theme of post-2020 cohesion policy. In arguing for a democratisation of innovation, the OECD (2015, 83) asserts that although there are advantages in clustering, "concentrating innovation

[2] Speaking at the CEPS Ideas Laboratory held in Brussels on 22 February 2018, Jean Claude Juncker hinted at cuts of 15–20 percent in the Cohesion Policy budget.

activities and democratising innovation are not opposites". This reframing of the long-running equity *versus* efficiency debates in regional policy implies new thinking on how to integrate sectoral and spatial policy aims in economic development. One option could be to regionalise sectoral policies, such as the promotion of 'digital', much more explicitly.

Smart specialisation has become the favoured approach to innovation support, despite lingering ambiguity over how it should be applied. The underlying problem is how to match aspirations for an innovation strategy with regional potential and capabilities. In particular, the level of competence and experience of those implementing programmes are often pivotal, if under-recognised features. It follows that a strategic approach to enhancing innovation has to emphasise more than innovation policies. Instead, it has to enhance the relevant economic development skills and expertise, create the financial and other frameworks conducive to an innovation culture, and promote engagement with other domains of policy.

The Pattern of Innovation

Basic indicators of innovation, such as patenting rates and spending on research and development as a proportion of GDP, offer some insights into medium and longer term economic development prospects. These data can be somewhat misleading in cases where what is recorded is affected by certain industry clusters or a dominant large company, but the sheer scale of regional level disparities suggests a fundamental challenge for those at the lower end of the scale. Two revealing statistics are the number of patents taken out by high-tech and ICT inventors, expressed per million inhabitants, and recorded in the European Commission's competitiveness database (averaged for 2011–2012). In leading regions, the number is in the hundreds, but there are many places where the rate is in single figures.

The patenting rate on either or both indicators in several of the regions of Bulgaria, Croatia, the Czech Republic, Greece, Poland, Portugal, Romania and Slovakia was zero or one and attained a maximum of eight. The position was slightly better in the Baltic countries, but only one region in Hungary and one in Slovenia achieved rates in double figures, respectively, 16 and 12. In Spain only Catalonia, Madrid and the Basque County had rates above 10 (just), while in Italy the most inventive region (Liguria) had rates of 18 (high-tech patents) and 24 (ICT), but no region in the South was in double figures.

The weakness of all these southern European regions contrasts with those in the North. In Finland, Denmark and Austria, all regions were in double figure for both indicators and, in Sweden, even the more remote and rural regions, although in single figures, exceeded the best of the first group listed above. The intensity of patenting on these two indicators in the most inventive regions of Finland, Sweden, Germany and the Netherlands was as much as twenty-five times as high as the best of the first group and ten times as high as the best in Spain.

Data on the intensity of research and development, for which a key Europe 2020 target is to attain 3 percent of GDP, tell a similar story. Several northern regions exceed this target, albeit with the highest rates concentrated in relatively few regions, such as Braunschweig (7.3 percent), Stuttgart (6.0 percent), Styria (4.9 percent), Midi-Pyrenées (4.8 percent) and East Anglia (4.7 percent). By contrast no region in Croatia or Romania has an R&D share of GDP above 1 percent, and there is only one each in Bulgaria (Yugozapaden, with 1.1 percent), Greece (Crete, with 1.4 percent) and Slovakia (Bratislava, with 1.6 percent). Indeed, in the South and among those member states that acceded to the EU from 2004 onwards, there is just one region (the Basque country, at 2.2 percent) in which R&D spending is above 2 percent of GDP.

How much does this matter? Plainly, regions with economies dominated by primary activities or tourism are far less likely to need, let alone have advanced innovation systems and thus to score well on innovation indicators. But to the extent that a capacity to innovate is vital for making the transition to newer and higher productivity economic activities, capable of sustaining higher incomes, the weak innovation record in so many regions already at the wrong end of the income league tables is worrying. An attendant risk is of locking a region into a low growth and/or low income equilibrium is often reinforced by incentives for more qualified workers to leave. If potential investors associate a region with only a limited range of skills and a relative dearth of higher skills, they will only create jobs attuned to this skills mix. The upshot is likely to be a bad equilibrium, as De Stefanis (2012) shows for labour markets in southern Italy. Much the same reasoning is likely to apply to the propensity to innovate. For regional policy generally, and cohesion policy specifically, the challenge is how to break such a pattern.

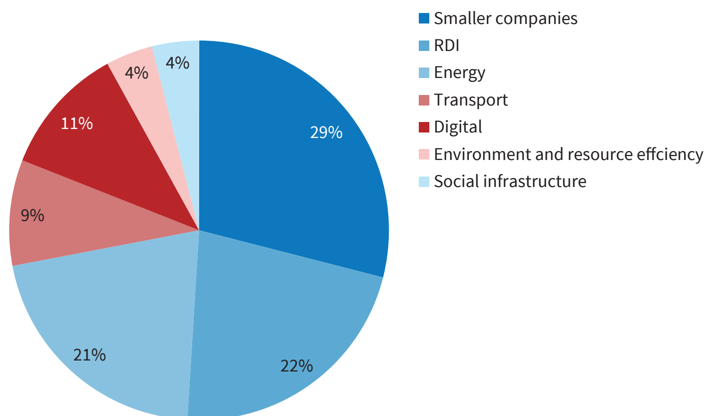
GOVERNANCE AND ADMINISTRATIVE CHALLENGES

How effectively space-based policies are implemented has become recognised as vital, bringing various aspects of governance to the fore (Rodriguez-Pose 2013). They include the notion of the 'logic of intervention', with the message for regional actors that they will need a more effectively designed conceptual basis for future programmes. In practice, regions have to identify what it is in the region that inhibits development; and thus what needs to be overcome to make progress. They then have to establish realisable objectives that address these needs and to focus on results in the implementation of the programme. While

Figure 1

Shares of EFSI Approvals by Project Type

As of 06 February 2018



Source: European Investment Bank. © ifo Institute

The original aim of EFSI was to support investment projects which either would not have been carried out, or only undertaken on a smaller scale, without the support of the fund. As with the EU's Horizon 2020 research programme, EFSI was not intended to have geographical quotas and there was to be some preference for riskier projects. Information on the dedicated EFSI web-site shows that transport and energy projects account for 30 ercent of projects approved, but also that just under 30 percent of the funding went to SMEs and 22 percent to research development and innovation, but only 11 percent to 'digital' projects (Figure 1).

this might seem both obvious and desirable, it implies a shift away from a mentality of simply spending the money, spreading it to satisfy competing local interests, or of being concerned principally about direct project outputs, such as kilometres of road built or business supported.

Instead, an intervention logic should articulate a development strategy capable of achieving the desired transformation of the economy supported: out*comes* rather than out*puts* (Bachtler *et al.* 2016). These strategic objectives should, moreover, evolve as successive milestones are achieved. This approach is intrinsically more complex and may require different skills from economic development practitioners as interventions shift from more familiar investments in basic infrastructure to some of the less tangible forms of support for human and social capital enhancement or for inclusive growth.

Deficiencies in governance can have a debilitating effect on the results of cohesion policy for two distinct reasons. Firstly, they can mean, simply, that available resources are not used in a timely manner and may, in the extreme, be lost to the region. This effect is compounded if complementary investment is deterred. Secondly, they may mean that the coherence and quality of the programmes and projects undertaken may be sub-optimal, and thus that they contribute too little to regional development. Poor quality administration does not necessarily signal corruption, or that there is illegality, though they may coincide.

Policy Integration

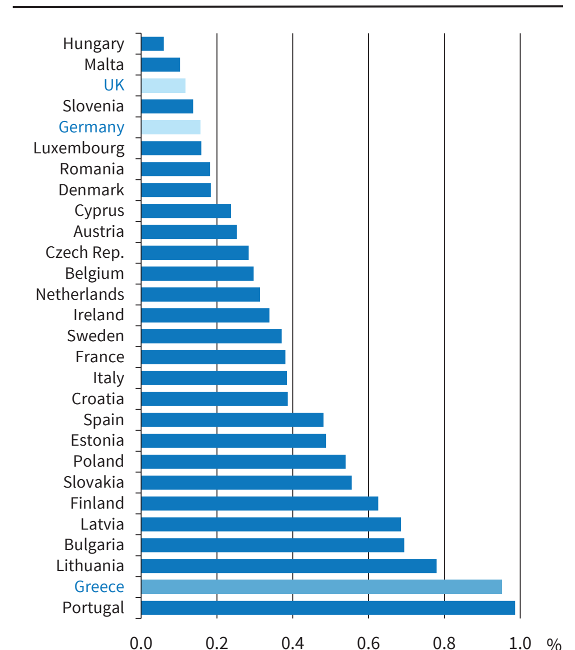
At an EU level, policy integration has to reconcile what falls under the umbrella of cohesion policy with the substantial intervention of the European Fund for Strategic Investment (EFSI), but also with the recast governance of economic and monetary union. In parallel, local inputs are vital to avoid the obvious traps of too prescriptive a policy model.

Some projects, for example for hospitals or social housing (under the heading of social infrastructure) or for airports and railway rolling stock (under the transport heading), seem to be similar to those that would be funded under cohesion policy. There is a surprisingly large variation in the value of EFSI projects approved to date, with some countries having few projects and low rates of investment, including Germany and Britain (highlighted), whereas Bulgaria, Greece (highlighted) and Portugal have had approvals close to one percentage point of 2017 GDP.

There is a sharp contrast between the allocation of EU spending among member states for cohesion

Figure 2

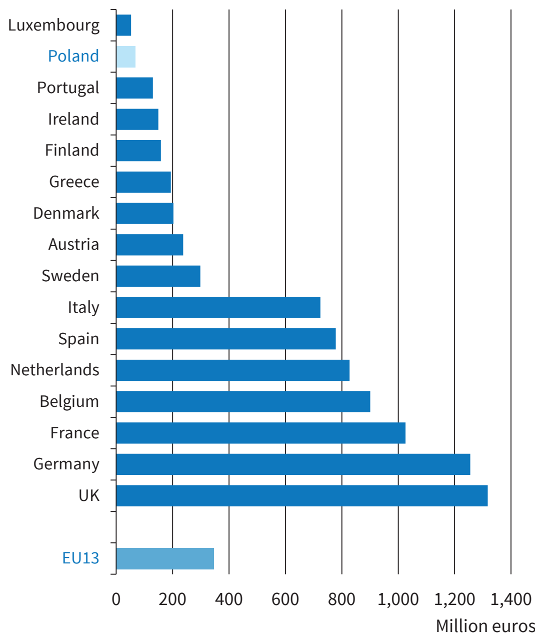
Value of EFSI Projects Approved as a Proportion of 2017 Nominal GDP



Source: European Investment Bank. © ifo Institute

Figure 3

Distribution of EU Research Funding among Member States in 2016



Source: EU Financial Report (2016). © ifo Institute

policy compared with spending on research. Figure 3 shows strikingly how research spending flows overwhelmingly to richer member states in North-West Europe. In fact, as can be seen from the last column in the research chart, the aggregate amount for all thirteen countries acceding to the EU from 2004 onwards is barely higher than Sweden and well below the Netherlands: 4 percent of the total research budget. By contrast, as Figure 4 shows, the newer member states are major beneficiaries from cohesion policy, securing 55 percent of the total disbursed in 2016.[3] Even here, the substantial amounts accruing to 'older' Europe (Greece, Italy, Portugal and Spain) are noteworthy.

Conditionality

A likely area of contestation in the design of policy will be conditionality, a term that elicits strong reactions, but also encompasses very distinct procedures. *Ex-ante* conditionalities were among the reforms introduced in 2013, requiring recipients of support from the European Structural and Investment plans to have strategic plans, including provisions for enhancing institutional capacity to deliver. The emerging evidence suggests that these obligations have improved the quality of operational programmes and should be further refined for policy beyond 2020.

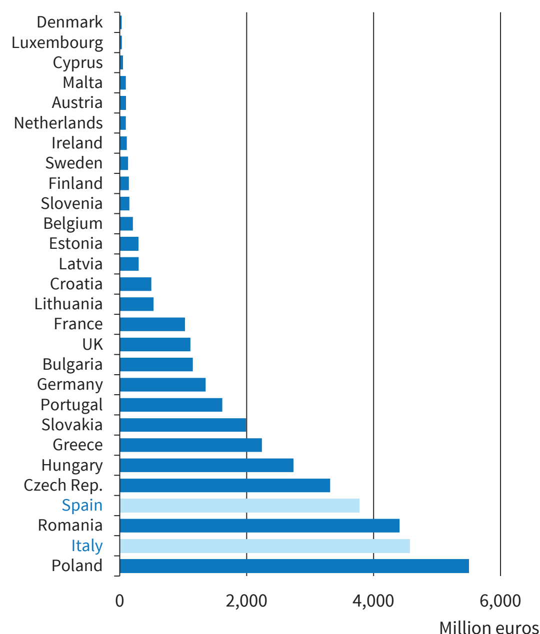
[3] Data for a single year may potentially give a somewhat distorted picture, but 2016 is not only the most recent year, but is also well into the respective programmes; and thus less likely to reflect the delays in starting programmes that were a feature of cohesion policy spending in a number of member states.

So-called macroeconomic conditionality is much more contentious because it links Cohesion Policy programmes to (especially) compliance with the various disciplining processes associated with assuring the effective governance of EMU. Part of the rationale is that public investment will achieve less if it is not accompanied by discipline in public finances, because its absence will deter private investors and public co-financing will be hard to obtain. Moreover, if appropriate structural reforms are not undertaken, investments supported by regional policy will generate a lower effective return. Although sound governance in this context relates to actions of national governments, what regional governments do cannot be seen in isolation, and an implication is that the latter nevertheless have a responsibility to ensure that the national level conforms to rules and recommendations. As explained in the 6th Cohesion Report: "macroeconomic conditionality, therefore, increases the incentive for all tiers of government to manage public finances prudently and there is a collective responsibility to ensure this" (European Commission 2014, 248).

There have also been suggestions to extend the principle to compliance with other political aims such as sharing the burden of coping with asylum seekers. Macroeconomic conditionality was hotly contested in the run up to the current programme period, but a closer link to overall economic governance and the semester process is foreshadowed in the Reflection Paper on the EU's finances (European Commission 2017b). The two questions at the heart of this are,

Figure 4

Distribution of EU Cohesion Policy Funding by Member States in 2016



Source: EU Financial Report (2016). © ifo Institute

firstly, whether incentives can be suitably aligned; and secondly, whether the proposed conditions are enforceable.

The incentives dilemma is that a regional programme could be subject to curbs because of the actions of a national government over which the region holds no sway. For example, failing to implement country-specific recommendations under the European semester, to correct a fiscal deficit under the Stability and Growth Pact (SGP), or to unwind a macroeconomic imbalance (the MIP) could be triggers for penalties. Experience of enforcement of fiscal and other macroeconomic rules is not encouraging, with recent evidence suggesting a continuing reluctance to impose the financial penalties provided for under these processes, let alone to go further by suspending ESIF allocations (Begg 2017). At an EU level, political economy considerations have inhibited the use of the financial sanctions notionally available to bolster enforcement.

A more constructive alternative would be to reward 'good' behaviour by reserving a proportion of funding as additional support for recipients meeting relevant criteria. A crucial difference would be avoiding disruption of existing programmes and projects because of suspension of payments, even if the aggregate flow of resources to a programme is initially lower. Moreover, the prospect of receiving additional funding can motivate the identification of new opportunities.

IMPLICATIONS FOR FUTURE COHESION POLICY

A key question is how cohesion policy should adapt to, on the one hand, a changing conceptual basis for regional policy interventions and, on the other, various new demands, ranging from the aftermath of the years of crisis to the long-run dimensions of sustainable economic development. The strong emphasis in the past on physical infrastructure was justified by the manifest gaps in many of the less developed regions of the European Union. While there are still regions insufficiently well-connected, and scope remains for upgrading the stock of physical capital and the services associated with infrastructure, 'softer' policy objectives are becoming more important. The latter include boosting human capital, social inclusion, various facets of governance and, increasingly, the seizing of opportunities afforded by the digital economy.

An implication for cohesion policy is that the barriers to growth have to be identified as part of a 'needs' assessment. The ensuing logic of policy intervention should be to customise support to counter these barriers. Place-based polices, however, have to work in concert with sectoral and other policies, rather than being seen as separate. In this respect, cohesion policy has to move on from optimising purely spatial multi-level governance to integration across policy domains. The catch here is that what is so easily stated is beset by implementation difficulties, including the formal legal frameworks for different policy domains.

What happens to the EU budget overall is plainly of central importance. Cohesion policy is likely to face a double squeeze from a reduced British net contribution and pressures to allocate more funding to new priorities. In the past cohesion policy has, to some extent, been able to accommodate such pressures by setting its own priorities. Thus, under both the 2007–2013 and 2014–2020 regulations, operational programmes had to devote at least a set proportion to policies to counter climate change. A reshaping of the thematic priorities for 2014–2020 could easily be used to enable cohesion policy to replicate this approach. If, for example, integration of migrants or security were identified as needing additional funding, they could become new themes.

However, it is less likely that cohesion policy will be able to repeat this trick after 2020 for three main reasons. The first concerns the underlying narrative of the EU budget. Europe 2020, while still in the background, has declined in visibility and influence, whereas the annual semester process has been in the ascendancy. Governance of EMU seems set to be more influential, potentially shifting the emphasis from regional and territorial concerns towards the macroeconomics of both fiscal adjustment and sectoral polices. If so, old battles between sectoral and spatial priorities in economic development are likely to be re-fought.

Secondly, after over three decades of cohesion policy in its present form, there will be renewed calls for more fundamental restructuring of the policy. While many incremental reforms have been introduced over the years, especially those applied during the current period, certain key questions have not yet been addressed. For example, should cohesion policy be limited to poorer member states? Thirdly, the politics of budget making are likely to demand visible EU actions to key challenges, making it harder to subsume them within Cohesion Policy. There might, for example, be moves to establish new budget lines for dealing with the integration of migrants or border security, perhaps echoing the Connecting Europe and Youth Guarantee initiatives.

CONCLUSIONS AND IMPLICATIONS FOR THE POLICY REFORM DEBATE

Despite the powerful *status quo* bias in EU expenditure policies, the conjunction of Brexit, the aftermath of years of crisis and the political salience of new policy priorities makes a more comprehensive reform of cohesion policy more likely than in previous rounds. New thinking on the sources of regional economic success makes a fresh approach all the more timely. Yet change will be hard to effect and one imperative will be to avoid overloading cohesion policy. It is perhaps

unavoidable that it will have to find its niche within the overall economic governance framework, but it also has to avoid too many goals and expectations.

Moving towards a more innovation-centred policy should be a priority, but one that requires a more subtle approach than in previous rounds. Building on local knowledge and experience will be vital in devising innovation policies that reflect local capacities, while also avoiding the trap of importing inappropriate policy objectives and instruments. While the smart specialisation philosophy goes some way in this direction, it has struggled where institutional capacity has not been commensurate. More fundamentally, the lesson from the indicators of innovation presented above is that policy has to target the potential for regions to innovate.

The implication for the future can perhaps be summarised as constructing a *policy for innovation*, able to overcome obstacles to boosting innovation and to exploit local advantages, *not just an innovation policy* aimed primarily at stimulating such activity in (particularly) smaller businesses. This implies looking at how different policy mechanisms can add value to innovation efforts. Better integration of EFSI and of EU research funds with cohesion instruments will be part of this approach, but the design of an innovation strategy also has to take account of the role played by finance and research providers. Assuming the aggregate cohesion policy budget is reduced, leverage of complementary funds will become more important. With national funding squeezed, private investment will assume greater importance. However, as noted in the report of the HLGOR (2016), richer member states and regions typically find it easier to make use of financial instruments. The ramifications of a more extensive use of them will have to be monitored taking care to avoid exacerbating disparities.

Conditionality will have to navigate a minefield. On the one hand, a sound appraisal of programmes and projects is needed, especially if the overall budget is destined to shrink. Improved strategic planning and coherent priorities are crucial, and there will be a premium on identifying what has to change for the region to prosper sustainably. However, extreme caution is required in imposing punitive conditionality, both for reasons of fairness and to avoid creating adverse incentives. In this regard, blunt threats to withdraw funding for reasons outside the control of the regional authority are more likely to be counter-productive than helpful. At the same time, having some positive incentives in the form or performance reserves could be beneficial.

Cohesion will also increasingly have to connect to the wider economic governance procedures of the semester, with its country-specific recommendations, and the disciplining mechanisms bearing on fiscal policy and the macroeconomic imbalances. This could prove uncomfortable for economic development practitioners if it means regional priorities have to be reframed to relate to macroeconomic goals. This leads us to the conclusion that cohesion policy has to adapt, which is never an easy challenge to meet.

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